

*'Trade and Flag: The Changing Balance of Power in the
Multilateral Trading System'*

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SECOND SESSION: Ideas and Power in Contemporary Trade Developments¹

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Introduction

This paper will attempt to provide a perspective on the future of trade and trade policy, by focusing on two important and on-going developments that will crucially shape the future global landscape. These developments could also be characterised as puzzles or paradoxes that require further reflection. They are: the challenge of globalisation in the West, especially the United States; and the imminence of mega-regionalism, involving the preferential integration of the largest trading economies in the world—the US, Europe, and Japan, and possibly China.

More broadly, though, these developments reflect an interplay between ideas and power. The challenge of the West illustrates a struggle between the objectives of globalisation and broader forces—economic stagnation, inequality, and aspects of globalisation itself—that may undermine the ability to sustain globalisation. The initiation of mega-regionalism by the US is really an opening shot in the bigger stakes between a stagnant or declining power (US) and a rising power (China), which is facing its own challenges. As such, mega-regionalism is both the theatre for this larger drama, as well as a determinant of the transition from the recent G-1 world of American primacy to an inchoate future.

Before turning to these developments in Sections II and III, I briefly present three major features of the trading system of relevance to the future.

I: Three Features of Recent Globalisation

In Subramanian and Kessler (2014), we noted seven major features of the current era of trade integration and of today's trading system:

- The hyper-globalisation of trade
- the dematerialisation of globalisation (the importance of services)
- democratic globalisation (the widespread embrace of openness)
- criss-crossing globalisation (the similarity of North-to-South trade and investment flows with flows in the other direction)
- the rise of a mega-trader (China), the first since Imperial Britain
- the proliferation of regional trade agreements and the imminence of mega-regional ones
- the decline of barriers to trade in goods but the continued existence of high barriers to trade in services

Here we focus on three of relevance for this paper.

A. Hyper-globalisation

Since the 1990s, aided by broad-based rapid growth (“convergence with a vengeance”), the world entered a fourth phase of trade integration which we dubbed “hyper-globalization” (Subramanian and Kessler). World trade has soared much more rapidly than world GDP. Merchandise exports-to-GDP ratios soared from 15 % to 26 %, and goods and services exports

to about 33 %², over the course of the last two decades. This rapid increase is somewhat surprising, because transport costs do not appear to have declined as rapidly as in earlier eras (Hummels, Ishii, and Yi 2001; Baldwin 2011a). The cost of information and communications did decline significantly, however.

Part of the increase in trade reflects the fragmentation of manufacturing across borders—the famous slicing up of the value-added chain—as individual production stages are located where the costs of production are lowest. This phenomenon, whereby technology no longer requires that successive stages of manufacturing production be physically contiguous or proximate, has been dubbed the “second unbundling” (Baldwin 2011a).^{3 4}

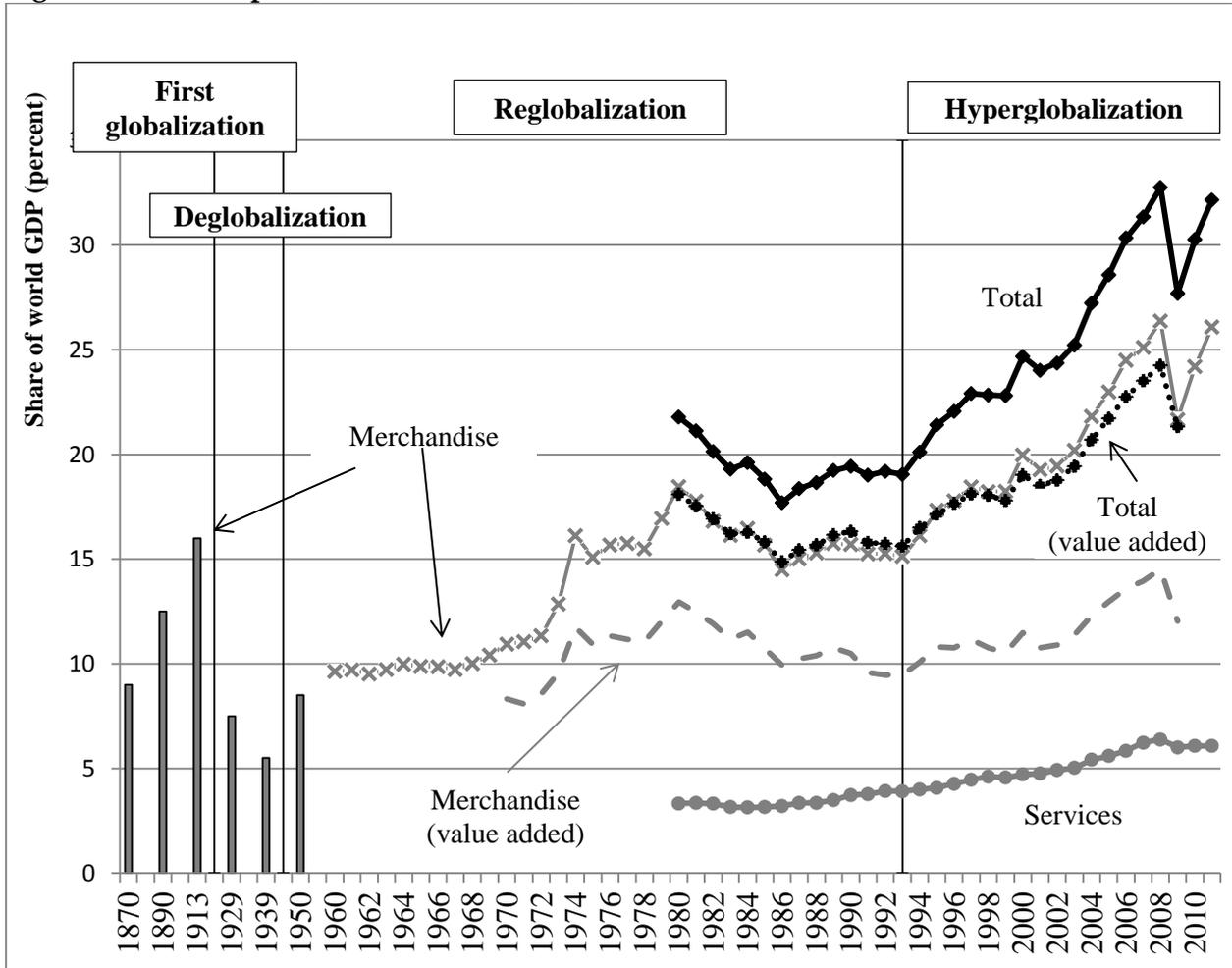
This phase as well as the previous three are depicted in Figure 1 below. The years between 1870 and 1914 have been described as the first golden age of globalisation. World trade as a share of gross domestic product (GDP) surged from 9 % in 1870 to 16 % on the eve of World War I. This was the era that Keynes waxed eloquently about, noting that an inhabitant of London “could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep” (Keynes 1920, p.11).

² Unless otherwise specified, trade data are measured on a gross basis.

³ The first unbundling reflected in the quotation from Keynes is the separation of the producer from the consumer that increased trade permits.

⁴ This real technological impetus to trade tends to artificially inflate recorded trade. Because value is added at each stage of the production chain, it is recorded as exports at successive links in the chain. Gross exports flows therefore overstate real flows of valued added (exports net of imported intermediate goods). Figure 2.1 shows that, even though value added-based exports of goods and services are about 5 percentage points lower than exports measured on a gross basis, their trajectory (i.e. for total trade in goods and services) has been similar to that of conventionally measured exports. More recently, value added as a share of exports has not declined substantially or across all trading regions (Hanson 2012; WTO 2013).Koopman, Wang, and Wei (2013) further refined the measurement of value-added trade by distinguishing where countries are (upstream versus downstream) in the value-added chain. The aggregate value-added measures reported here are computed as in their paper.

Figure 1. World Exports, in Current Dollars, 1870–2011



Source: Subramanian and Kessler (forthcoming).

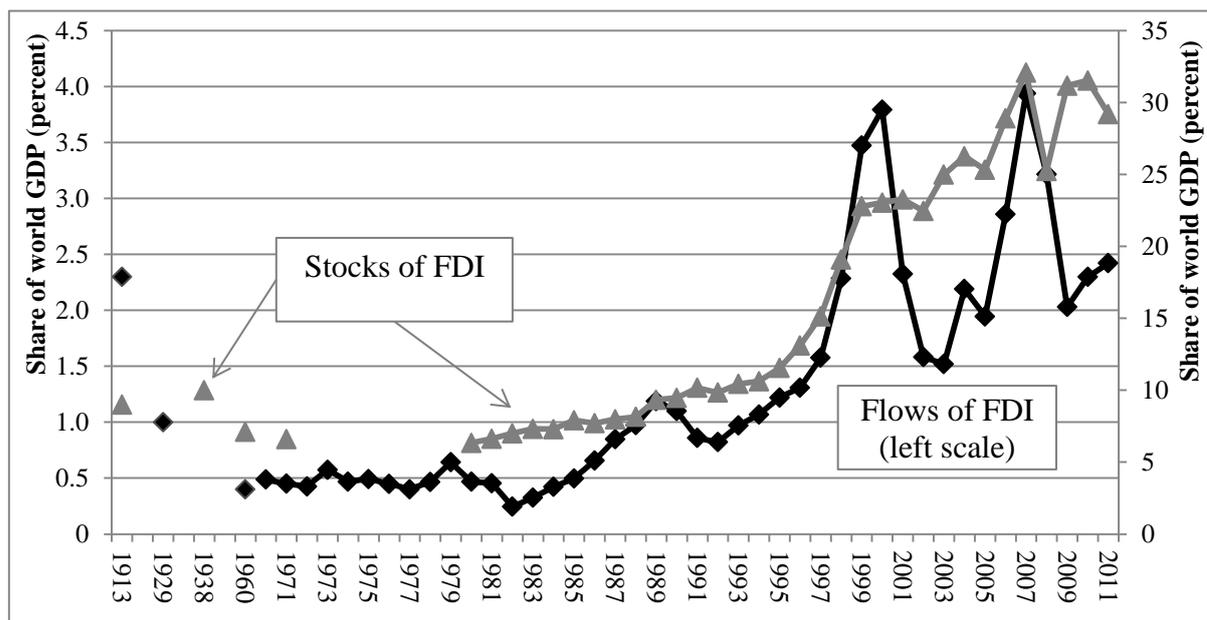
The period between 1914 and the end of World War II witnessed the Great Reversal of globalisation, as the combustible mix of isolationism, nationalism, and militarism ignited protectionist policies. World trade plunged to a low of 5.5 % of world GDP just before World War II began (O'Rourke and Williamson 1999; Frieden 2006; Irwin 2011).

A third era, starting after World War II, saw the restoration of world trade, aided by declines in transport costs and trade barriers. Only by about the mid- to late 1970s did world trade revert to the peaks seen before World War I.

A related feature of this era of hyperglobalization is the rise of multinational corporations and the sharp surge in flows of foreign direct investment (FDI), which have both caused and been caused by cross-border and other flows of goods and services. Since the early 1990s (broadly coinciding with the era of hyperglobalization), FDI flows have surged, growing substantially

faster than GDP (figure 2). Global FDI as a share of world GDP, which hovered around 0.5 %, increased sevenfold, peaking at close to 4 % just before the onset of the recent global financial crisis. Even discounting the two surges of 1997–2000 and 2005–08, the general trend is steadily increasing. Global FDI stocks (which are less volatile than flows) jumped from less than 10 % of GDP in the early 1990s to 30 % in 2011. FDI flows, and stocks, now surpass levels achieved in the first golden era of globalisation, before World War I. By 2009, there were more than 80,000 multinationals, accounting for about two-thirds of world trade (UNCTAD 2010).

Figure 2. Stocks and Flows of Foreign Direct Investment, 1913–2011



Source: Subramanian and Kessler (forthcoming).

B. The Rise of a Genuine Mega-Trader: China

When Krugman (1995) surveyed the evolution of world trade, he noted as one of the distinctive features the rise of a number of Asian super-traders, including Singapore, Hong Kong (China), and Malaysia, all of whose exports exceeded 50 % of GDP, a feature never seen in the first era of globalisation (in 1913, the United Kingdom’s ratio of export to GDP was 18.5 %). But mega-traders can be defined in two senses: globally (relative to world trade) and nationally (relative to a country’s own output). Krugman clearly applied the latter criterion. Had he applied the former, one mega-trader he would have identified would have been Japan in the 1980s, which accounted for about 7.5 % of global trade at its peak. Based on this criterion, none of the other East Asian Tigers would have been noteworthy, despite their astonishing performance: the small economies of Singapore, Hong Kong (China), Taiwan (China), and Malaysia accounted for a very small share of world trade at their peaks.

Since 1990, a true mega-trader has emerged, China. It qualifies as such under both definitions of

the term. Its integration to world trade has accelerated with its accession to the WTO in 2001, and transformed the country into the world's largest exporter and importer of manufactured goods, having surpassed the United States in 2012 (table 2.2).

Table 1. Merchandise Exports as Share of World Exports by Mega-Traders, 1870–2030 (%)

Year	<i>United Kingdom</i>	<i>Germany</i>	<i>United States</i>	<i>Japan</i>	<i>China</i>
1870	24.3	13.4	5.0	0.1	2.8
1913	18.5	18.0	9.0	0.8	2.0
1929	15.1	16.6	14.4	2.1	3.0
1950	10.2	3.9	16.2	1.3	0.9
1973	5.1	12.9	12.2	6.4	1.0
1990	5.3	12.0	11.3	8.2	1.8
2000	4.4	8.5	12.1	7.4	3.9
2012	2.6	7.7	8.4	4.4	11.2
2020 (projected)	1.9	5.3	8.8	3.9	12.1
2030 (projected)	1.4	3.6	7.3	3.2	15.0

Sources: Maddison 1995; UNCTAD various years; Subramanian 2011; and authors' projections.

China's exports as a share of GDP are now almost 50 %. When its size and income level are taken into account, it is a substantial over-trader, comparable to the United Kingdom in the heyday of its empire and a vastly bigger trader than the United States, Japan, or Germany at their peaks.

For example, in 1975, the United States' trade-to-GDP ratio was 13.3 %. Given the size and income level of the United States, that number represented under-trading of about 50 %. Japan in 1990, with a trade-to-GDP ratio of 20 %, under-traded by about 50 % (see Table 2). In contrast, China's trade-to-GDP ratio in 2008 was 56.5 %, which represented over-trading of nearly 75 %. Only Imperial Britain was a mega-trader in both senses of the term. In 1913, its exports represented 18.5 % of world exports. Its export-to-GDP ratio was 12 %, which represented over-trading of about 84 %.⁵ China is thus the first mega-trader since Imperial Britain. If trade continues to grow in line with income, China's dominance in world trade will become even greater.

C. Growing Regionalisation, Preferential Trade, and Impending Hyperregionalisation

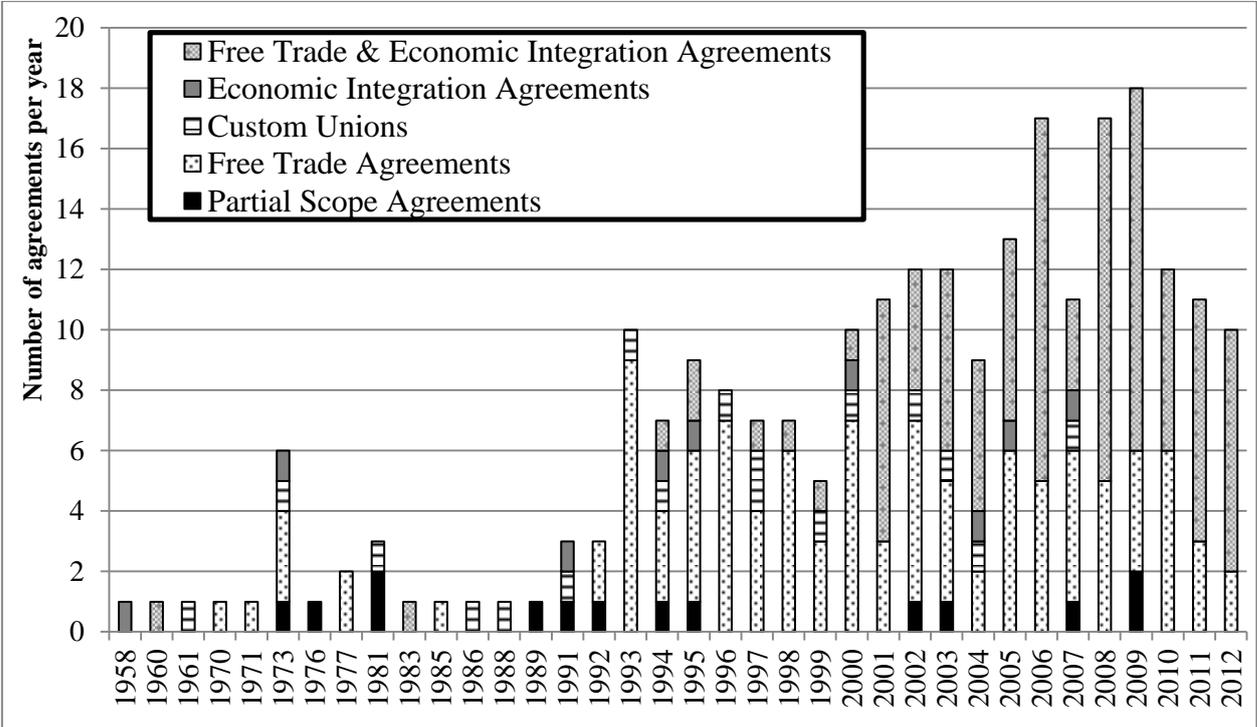
The era of hyperglobalization has been accompanied by a proliferation of preferential trade agreements (PTAs). Today, about half of the exports of the top 30 exporters go to preferential

⁵ All these estimates are in Table 2.3 in Subramanian and Kessler (2014).

trade partners. Between 1990 and 2010, the number of PTAs increased from 70 to 300 (figure 2.6). In the mid-1990s, about 75 % of PTAs were regional; by 2003, this share had dropped to about 50 %. All World Trade Organization (WTO) members except Mongolia have concluded at least one PTA; some, such as the European Union, Chile, and Mexico, have concluded more than 20.

An interesting new dimension of these PTAs is the extent to which they feature “deep integration” (Lawrence 1996)—that is, liberalise not only tariffs and quotas but other “behind-the-border” barriers, such as regulations and standards, as well. In the last 10 years, for example, nearly 40 agreements have included provisions on WTO-Plus issues (competition policy, intellectual property rights, investment, and the movement of capital). This figure is four to five times greater than comparable agreements in the pre-WTO era (WTO 2011) (see Baldwin 2011b).

Figure 3. Number of New Signed Preferential Trade Agreements, 1958–2012



Source: WTO 2011.

Note: The year of the count is the year of notification of the agreement to the WTO. To simplify the classification of agreements, included in the “economic integration agreement” category are all agreements that are both economic integration agreements and customs unions or partial scope agreements.

On regional agreements, seismic changes are under way, with the possible negotiation of mega-regional agreements between the United States and Asia (the Trans-Pacific Partnership) and the United States and Europe (the Transatlantic Trade and Investment Partnership). Trade between these groups of countries accounts for about \$2–\$3 trillion a year in world trade, signifying a potentially major jump in the volume of trade covered by preferential agreements. These PTAs would represent the first between the top four major regions of the world (China, the United States, Europe, and Japan), with consequences that will be discussed below. If the Transatlantic Trade and Investment Partnership and Trans-Pacific Partnership (to the extent that it includes Japan) are concluded, more than half of global trade will be covered by those deeper regional agreements. It is not unforeseeable to think of an era in which nearly all trade becomes regional which is illustrated in Table 2 below.

Table 2. Free Trade Agreements: Last Men Standing

	<i>USA</i>	<i>European Union</i>	<i>Japan</i>	<i>South Korea</i>	<i>ASEAN</i>	<i>Brazil</i>	<i>China</i>	<i>India</i>
<i>USA</i>								
<i>European Union</i>	Initiated (TTIP)							
<i>Japan</i>	Initiated (via TPP)	Negotiations near-completion						
<i>South Korea</i>	Done	Done	Initiated					
<i>ASEAN</i>	Initiated (via TPP)		Initiated (via TPP)	Done				
<i>Brazil</i>	No	Negotiations under way	No	No	No			
<i>China</i>	No	No	Early stages (via RCEP)	Early stages (via RCEP)	Initiated (via RCEP)	No		
<i>India</i>	No	Negotiations advanced	Done	Done	Done	No	Early stages (via RCEP)	

II. Ideas. The West's challenge of hyperglobalisation meeting economic decline

A. *The bad news*

Public support for free trade agreements in the United States is at its lowest point since 2006, according to the Pew Center (2010)—and the decline occurred quickly. In 2009, the share of people who supported free trade agreements exceeded the share who opposed it by a margin of 11 percentage points. In 2010, opponents of free trade outnumbered supporters by 8 percentage points. Surprisingly, among Republican-leaning voters, the turnaround was even more dramatic: the margin in 2009 was 7 percentage points in favour of free trade agreements; the margin in 2010 was 26 percentage points against free trade agreements. This weakening collective perception of the benefits of openness is matched, mirrored, or validated by intellectual opinion.

Samuelson (2004) argues that the rise of developing countries such as China and India could compromise living standards in the United States, because as they move up the technology ladder, they provide competition for U.S. exports, reducing their price.⁶ Krugman (2008) focuses on the impact of imports from developing countries, particularly China, on the distribution of income in the United States and the wages of less-skilled workers. His conclusion is that “it is likely that the rapid growth of trade since the early 1990s has had significant distributional effects” and that “it is probably true that this increase (in manufactured imports from developing countries)... has been a force for greater inequality in the United States and other developed countries” (Krugman 2008, 134–35).

Blinder (2009) draws attention to the employment and wage consequences of the outsourcing that has been facilitated by technological change and trade in services. He estimates that 22–29 % of all U.S. jobs will be offshored or offshorable within the next decade or two.

Summers (2008a, 2008b) has highlighted the problems stemming from increasing capital mobility. Hypermobile U.S. capital creates a double whammy for American workers. First, as companies flee in search of cheaper labour abroad, American workers become less productive (because they have less capital to work with) and hence receive lower wages; the “exit” option for capital also reduces the incentive to invest in domestic labour. Second, capital mobility impairs the ability of domestic policy to respond to labour’s problem through redistribution because of an erosion in the tax base as countries compete to attract capital by reducing their tax rates. Spence and Hlatshwayo (2012) argue that almost all the increase in employment of 27.3 million jobs in the United States between 1990 and 2008 was in the nontradable sectors, where productivity growth was much slower than in the manufacturing and tradable sectors, explaining the long-term stagnation of wages in last segment of the workforce.

Most recently, Paul Krugman and Joe Stiglitz have made strident calls against the new trade policy initiatives of the US, the TPP and TTIP.

⁶ See Bhagwati, Panagariya and Srinivasan (2004) for a response to Samuelson.

That a constellation of intellectuals—instinctively cosmopolitan and ideologically liberal—talks like this is an important signal, not least because the objective circumstances have changed. One might call this challenge that of the irresistible force of globalisation and hyperglobalisation meeting the immovable object of weakening economic and fiscal fortunes in the West.

In the United States, except for a brief spell in the late 1990s, median wages have stagnated for three decades; inequality has been sharply rising, particularly because of rising incomes at the very top of the income spectrum (Piketty and Saez 2003); and mobility has declined (Haskins, Isaac, and Sawhill 2008) Worse, as in all industrial countries, indebtedness has risen (average debt in the G-7 is now about 80 % of GDP), prospects for medium-term growth in the future are not bright (according to the latest *World Economic Outlook* forecast), and aging and entitlements add to the serious fiscal pressures looming ahead. These objective conditions are not the most propitious for sustaining globalisation.

This structural malaise is captured in the following metaphor that Larry Katz, of Harvard, uses: “Think of the American economy as a large apartment block. A century ago—even 30 years ago—it was the object of envy. But in the last generation its character changed. The penthouses at the top keep getting larger and larger. The apartments in the middle are feeling more and more squeezed, and the basement has flooded. To round it off, the elevator is no longer working. That broken elevator is what gets people down the most” (quoted by Luce 2010).

The policy challenge in the advanced countries is that sustaining current levels of openness will require addressing these domestic challenges at the very time when growth could be slowing and the ability to effect redistribution is being impeded by broader medium-term fiscal concerns. In this light, the changing attitudes to globalisation and free trade cited above are not surprising.

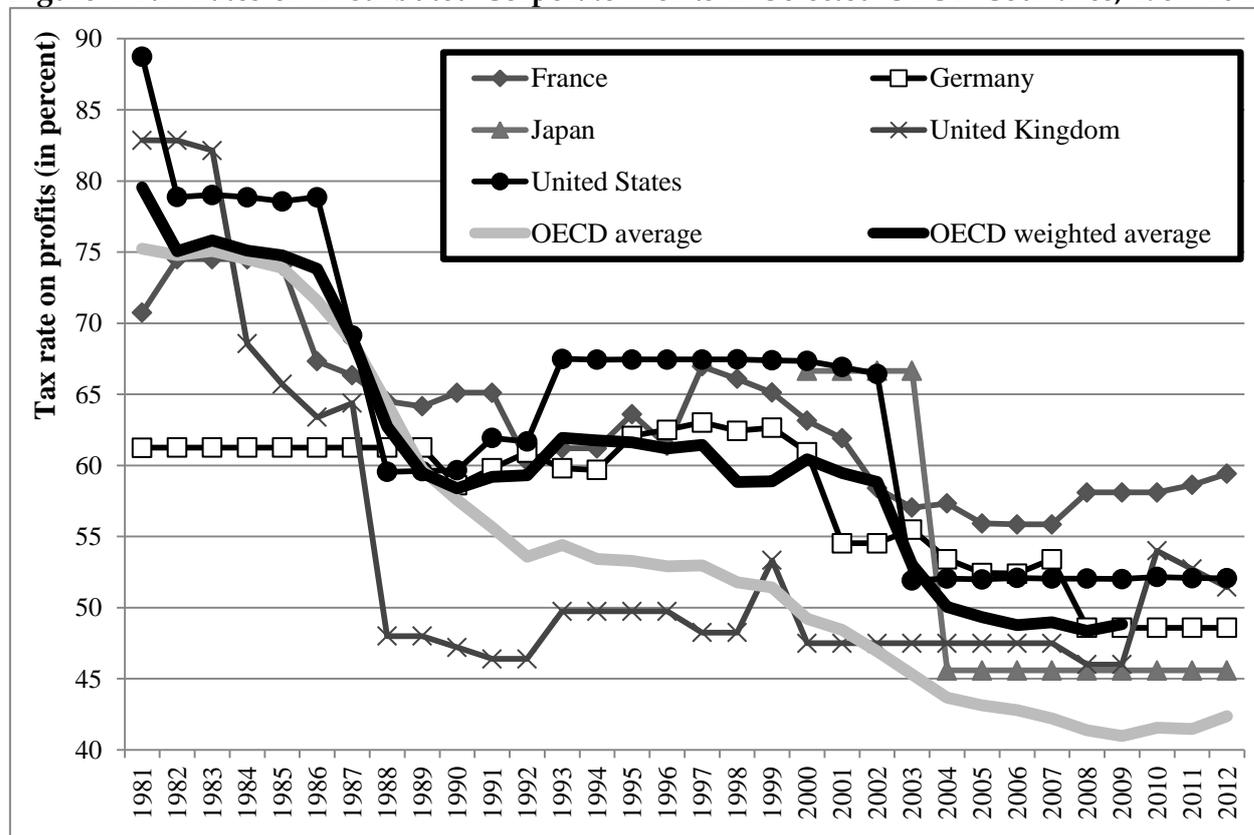
We focus here on what is now different in the West’s ability to sustain globalisation. A starting point is the view, described in Rodrik (1998), that sustaining openness requires a domestic social consensus in its favour, which in turn requires mechanisms of social insurance to cushion domestic actors against globalisation-induced shocks. Rodrik (1998) provides evidence showing that this domestic consensus can be captured in the relationship between the size of government (a proxy for social insurance mechanisms) and openness.

More direct evidence of the importance of social insurance comes from a paper by Autor, Dorn, and Hanson (2013), who show that rising exposure to Chinese imports increases unemployment, lowers labour force participation, and reduces wages in local labour markets. They estimate that the exogenous component of this shock explains one-quarter of the contemporaneous aggregate decline in U.S. manufacturing employment. They estimate that rising exposure to Chinese import competition explains about 16 % of the decline in U.S. manufacturing employment between 1991 and 2000 and 27 % of the decline between 2000 and

2007. Transfer payments for unemployment, disability, retirement, and health care also rise sharply in exposed labor markets. They estimate the increase in annual per capita transfers attributable to rising Chinese import competition at \$32 in the first 10 years and \$51 in the last 7 years of the sample, which translates into total expenditure of about \$5 billion in the 1990s and almost \$15 billion in the 2000s. The deadweight loss of financing these transfers is one-third to two-thirds as large as U.S. gains from trade with China.

Can the West sustain these social insurance mechanisms? According to Summers (2008a), globalisation both increases the need for social insurance and undermines the government's ability to provide it, because it renders more factors, especially capital and high-skilled labour, more mobile and less easy to tax. Has capital become less easy to tax? Figure 4 plots the marginal effective tax rates on capital in some important OECD countries and for the OECD as a whole. These rates have been sharply declining, and there is little pressure to reverse these trends.

Figure 4 Tax Rates on Distributed Corporate Profits in Selected OECD Countries, 1981–2012



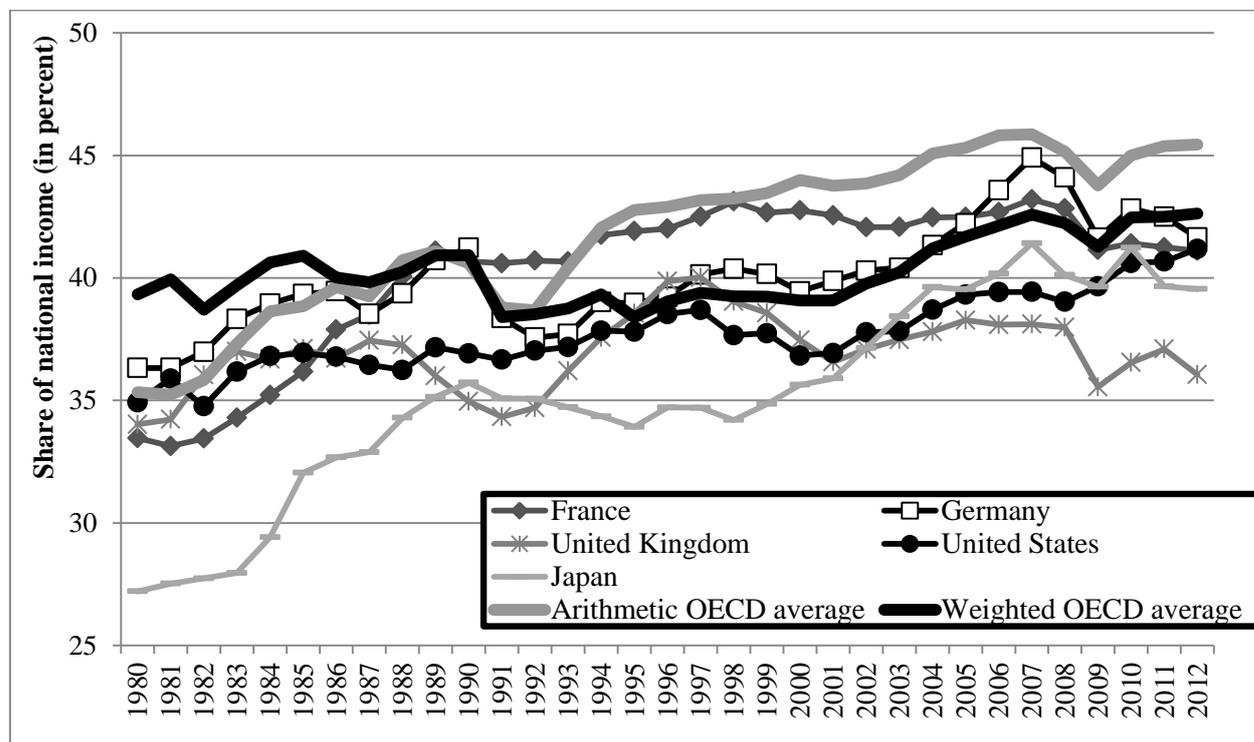
Source: OECD various years.

Note: Overall (corporate plus personal) tax rate on distributed profits are computed as effective statutory tax rates on distributions of domestic source income to a resident individual shareholder, taking account corporate income tax, personal income tax, and any type of integration or relief to reduce the effects of double taxation.

For the OECD as a whole, the average marginal tax rate declined from about 55 % to almost 40 %, a 15 %age point decline. These declines were witnessed across most if not all countries. In the United States, rates declined from 65 % to just over 50 %; in Germany they fell from about 60 % to less than 50 %. Of course, these declines reflect pressures other than globalisation and the attendant difficulty of heavily taxing mobile capital, but these pressures have been important.

A new development adds to the problems. Across the OECD, the share of the economic pie accruing to capital has been increasing, increasing from about 35 % to 40 % in the last few years (figure 4.2). More recently, in a highly acclaimed new book, Piketty (2014) has warned that the tendency of capital to garner even larger shares of the pie is likely to continue in the 21st century. This increasing share has prompted several commentators, including Krugman, to argue that the debate about inequality and trade and inequality in the 1990s, which related to inequality within types of labour (skilled versus unskilled), should now be viewed through a different lens, because inequality is increasingly between capital (and those who own it) and labour.

Figure 5 Share of Capital in National Income in Selected OECD Countries, 1980–2012



Sources: Annual Macroeconomic Database of the European Commission (AMECO) various years.

Note: The share of capital is computed from the AMECO database using the adjusted wage share at current market prices.

For the purposes of our argument, what is important is this: Not only is the ability to finance mechanisms of social insurance being undermined by weak growth and the burden of debt (Ruggie 1998); slippery, mobile capital is now accounting for a larger share of the economic pie. The funding of social insurance through taxation is thus going to become more difficult.

B. The good news: The protectionist dog that barked but did not bite

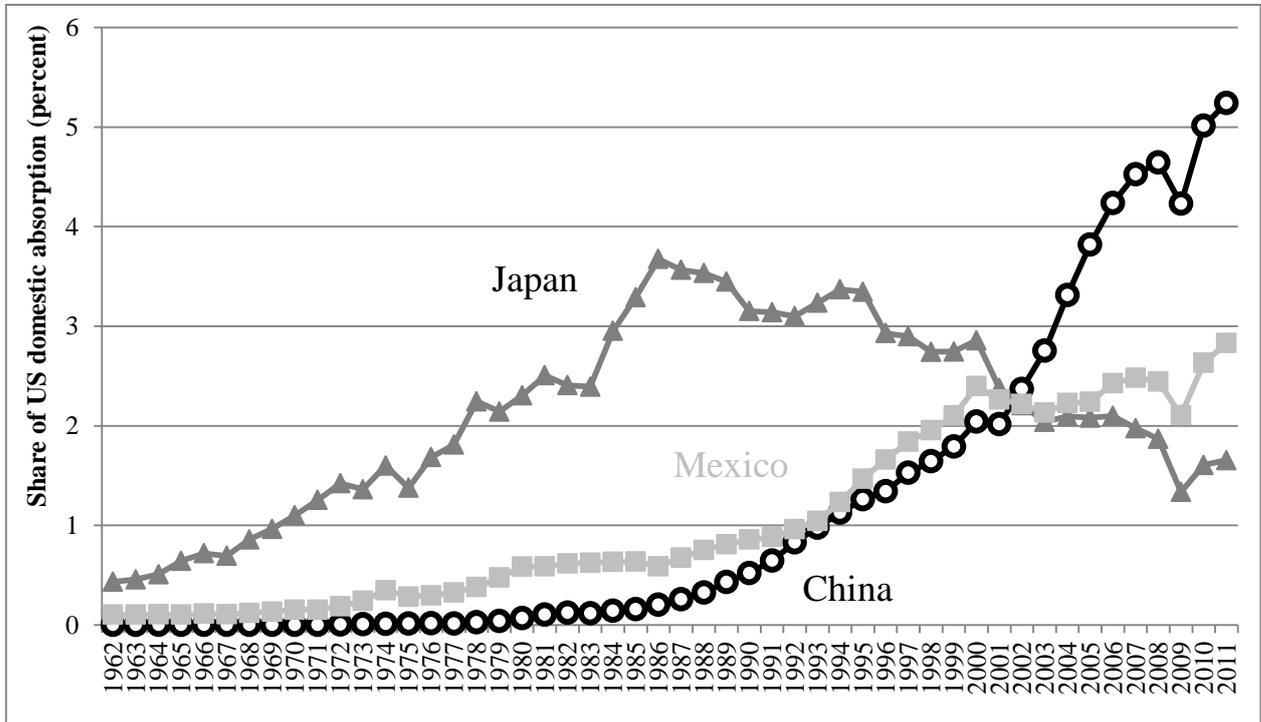
Several commentators have remarked on the fact that despite suffering perhaps the biggest global trade shock in the recent global financial crisis, the world did not succumb to protectionism. This response stood in stark contrast to the experience of the 1930s. Explanations for the difference have included the facts that (a) countries could use macroeconomic policy instruments (monetary and exchange rate), which adherence to the gold standard initially prevented in the 1930s (Eichengreen and Irwin 2009); (b) automatic stabilisers were in place, by way of transfers and unemployment benefits (Autor, Dorn, and Hanson 2013); and (c) the deeper integration created by modern production chains rendered protectionism self-defeating (Baldwin and Evenett 2009).

The bigger puzzle is this: How did the West, and the United States in particular, adjust to arguably the biggest structural trade shock in its history—namely, rising imports from China—without any serious recourse to protectionism? Why was there less protectionist outrage in the United States against China than there was against Mexico in the 1990s or Japan in the 1980s? The domestic uproar against China did not match the backlash created in the context of the North American Free Trade Agreement (NAFTA), and actual protectionist actions did not come remotely close to the actions taken against Japan (the Reagan era witnessed the greatest upsurge in trade barriers in the post-war period; see Destler 1992).

The differences cannot be explained by the relative magnitude of the three shocks, as the Chinese shock was orders of magnitude larger than the early shocks. Figure 6 plots imports from Mexico, Japan, and China as a share of U.S. domestic consumption between 1962 and 2011. At their peaks, Japan accounted for 3.6 % of U.S. consumption, whereas China accounts for about 5.2 %.⁷

⁷ In Subramanian and Kessler (2014), we plot the same data but for a shorter period for which value-added trade data can be computed. Gross exports overstate value-added exports for China, but they overstate them even more for Mexico.

Figure 6. Import Shocks in the United States from Mexico, Japan, and China, 1962–2011



Sources: IMF various years.

Note: Domestic absorption is GDP minus trade balance.

Table 3 quantifies the trade shocks to the United States from the three countries. The shock is computed in three ways (each scaled by the working-age population in the United States or the domestic consumption of manufacturing): (a) average imports over the relevant period (for convenience, all shocks are considered to extend over a 20-year period: Japan 1970–90, Mexico 1980–2000, and China 1990–2010); (b) the change in imports over the period⁸; and (c) both average changes and changes calibrated by per capita GDP in each country.

⁸ Trefler (1993) shows that cross-industry differences in protection are associated with the change in import penetration, not its absolute value. Autor, Dorn, and Hanson (2013) use import penetration as a share of working-age population as the measure of trade shock.

Table 3. Magnitude of Import Shocks to the United States from Japan, Mexico, and China

Country	Period	Real imports (dollars per working-age adult)		Import absorption (% of domestic consumption)		China shock as multiple of earlier shocks (based on import absorption)			
		Average	Change	Average	Change	Average value		Change	
						Without adjusting for per capita GDP	Adjusted for per capita GDP	Without adjusting for per capita GDP	Adjusted for per capita GDP
Japan	1970–90	373.6	355.2	6.79	6.15	1.2	10.0	2.4	19.5
Mexico	1980–2000	197.3	542.2	2.93	5.46	2.9	17.2	2.9	17.2
China	1990–2010	671.8	1258.6	8.49	14.92	n.a.	n.a.	n.a.	n.a.

Sources: Authors, based on data from IMF various years; U.S. Census Bureau various years; and Penn World Tables 7.1.

Note: Real imports are total nominal imports deflated by the unit price of imports. Import absorption is defined as (nominal) imports from each country divided by (nominal) domestic consumption (GDP less trade balance). n.a. = Not applicable.

As table 3 shows, depending on the measure used, the Chinese shock was either 4–5 or 10 times as great as the Japanese and Mexican shocks. Calibrated by per capita GDP, it was even greater. (One reason to calibrate by per capita GDP is that trade with low-income countries is of the Hecksher-Ohlin variety. It therefore imposes greater domestic political costs [than, say, trade in similar goods between countries at similar levels of development], in particular because these costs are disproportionately borne by unskilled labour, which competes more directly with foreign imports.⁹)

Several explanations are possible for the differential response to the China shock. One could be that the measure of recorded imports exaggerates the trade shock because of the difference between gross flows and value-added flows. Chinese exports embody less value added than the exports of many other countries because of the large volume of intermediate inputs it imports and transforms into exports. Even making allowances for this distinction, however—and the problem was arguably as acute in relation to Mexican *maquiladora* exports to the United States—would hardly make a dent in the numbers presented above.¹⁰

⁹ Krugman (1995) elaborated on the reasons for intra-industry trade posing fewer political problems compared with Hecksher-Ohlin trade.

¹⁰ In appendix table A.1, the figures for China are recomputed based on value-added trade data (we cannot do the same for the Mexican and Japanese shocks, which would bias the comparison in favor of understating the China

A second explanation could be that in the case of Mexico, the uproar was exaggerated because there was a focal point: a trade agreement that had to be passed by the U.S. Congress. But in the case of China, there has also been an identifiable target and identifiable policies: currency manipulation. Moreover, Mexico was an ally, whereas China is a potential adversary and competitor to big power status, which should have increased the outcry and concerns in domestic U.S. politics.

A third explanation is that by the time the China trade shock arrived, the United States had specialised so much away from unskilled labour that there was less to disturb domestically. For example, the number of workers employed in the U.S. clothing sector declined from 900,000 in 1990 to 150,000 in 2013. In technical terms, the United States is no longer in the cone of diversification (Edwards and Lawrence 2013). The estimates of employment disruption by Autor, Dorn, and Hanson (2013) for the Chinese case suggest that this argument cannot be a full, or even an important, explanation, however.

A fourth argument for the relatively muted domestic response is that the size of the Chinese market and the strategy of openness to U.S. FDI essentially co-opted U.S. companies and capital, which had an incentive to support rather than criticise China. The Japanese experience was different from the Chinese experience in two important respects: trade conflict with Japan reflected head-to-head competition in some specific industries (steel, cars, semiconductors) rather than conflict based on unequal endowments. It was U.S. capital rather than labour that was the victim in the Japan episode; as it had unusual influence in the political process, there was correspondingly more of a response. In addition, Japan had not created the same stake for U.S. companies in Japan as China had.

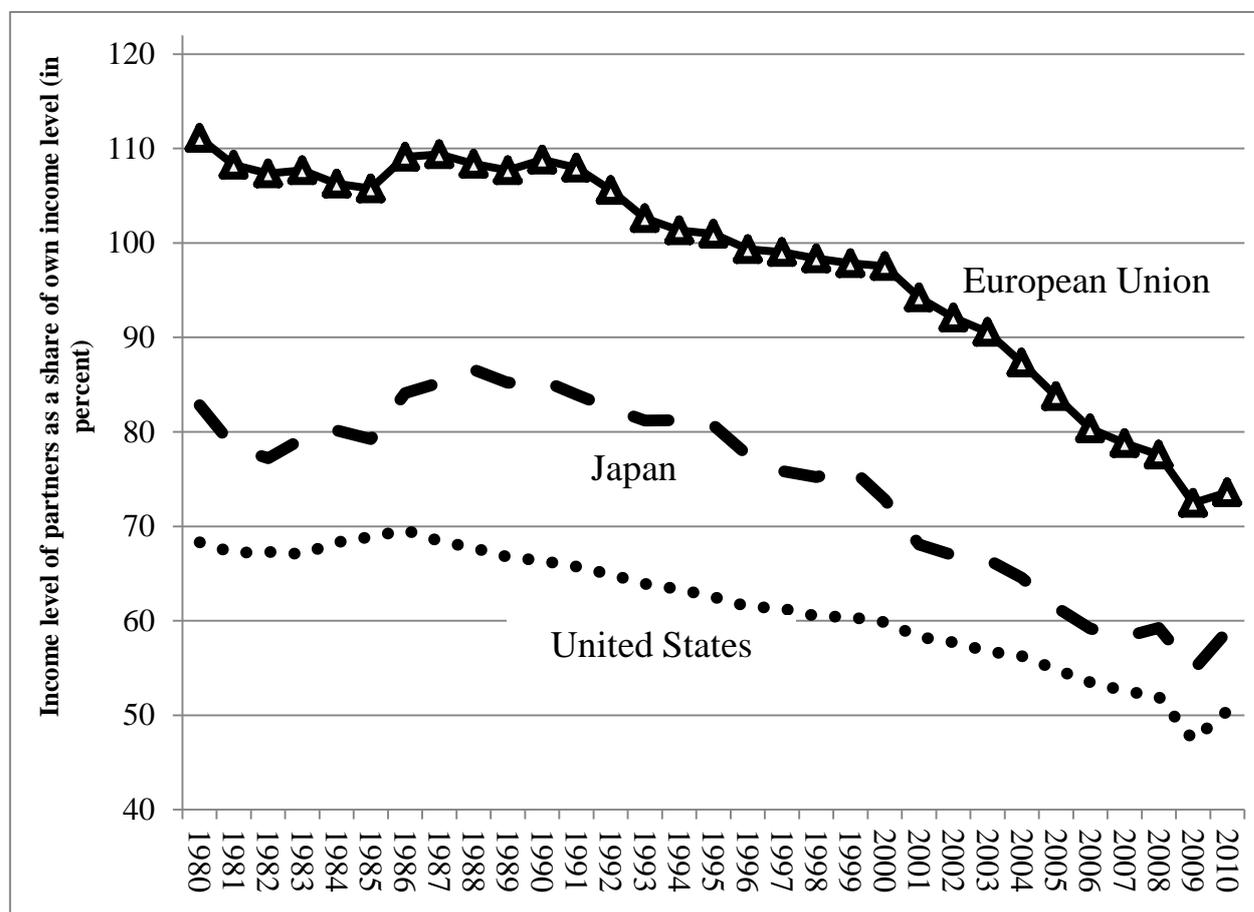
This explanation, however, begs the question of why American labour, which has been seriously affected by the China shock (see Autor, Dorn, Hanson and Song, 2013) has not been more vociferous in complaining against China. The complaints, such as they have been, have paled in comparison with those articulated in the run-up to NAFTA. Even today, NAFTA is the lightning rod for all the angst about globalisation even though China is actually having the greatest impact. Finally, it is possible that the underlying macroeconomic situation was better when the Chinese export juggernaut arrived.

One conclusion from all this is that if U.S. domestic politics could survive a shock as great as that from China, there may be an underlying resilience (helped considerably by government insurance mechanisms) that should not be underestimated. Moreover, it could be argued that structural shocks similar to China's are unlikely to repeat themselves. This fact should temper unremitting pessimism about the future of globalisation.

shock). The size of the Chinese shock declines, but it remains orders of magnitude larger than the earlier shocks from Japan and Mexico.

One can generalise the Chinese experience in the United States more broadly to other advanced countries. Figure 7 illustrates the change in OECD country imports in favour of developing countries. They plot the average income level of manufactured imports into the United States, Japan, and the European Union. The per capita GDP level of each source country, measured relative to that of the importing country, is weighted by its share in total manufactured imports of the reporting country (the per capita GDP is fixed at the 1980 level). In all cases, imports from the early 1990s are being sourced progressively from poorer countries, suggesting an increase in competition from lower-wage countries. In the European Union, for example, the average income level of imports drops from 100 % to 75 %. The point is that all advanced economies have experienced large trade shocks, without recourse to serious protectionism.¹¹

Figure 7. Relative Income Level of Exporters to the European Union, Japan, and the United States with Fixed Weights, 1980–2010



Sources: IMF various years; Penn World Tables 7.1

Note: See note to figure 4.4. GDP weights are fixed to their initial 1980 value. The fixed-weight index

¹¹ The value-added counterpart of figures 4.4 and 4.5 are appendix figures A.2 and A.3. The broad trends remain the same.

$RI_{EU,t}^{FW}$ becomes:

$$RI_{EU,t}^{FW} = \sum_i \left(\frac{GDP_{i,1980}}{GDP_{EU,1980}} \right) * \left(\frac{M_{i,EU,t}}{M_{EU,t}} \right).$$

So, the question going forward is this: can the idea of globalisation survive the headwinds of economic forces that are going to keep growth in the US and Europe relatively muted, to strain public balance sheets, to erode the tax base necessary to sustain the political consensus for globalisation, and to cause inequality to worsen especially in the US? Should one be sanguine based on the experience of the China shock or should one be more cautious because of ominous, globalisation-threatening forces?

III. Power. Mega-regionalism Meets China

The United States has embarked on two major trade initiatives. The Trans-Pacific Partnership (TPP) aims to create a high quality free trade area (“deep integration”) in the Asia-Pacific. The Trans-Atlantic Trade and Investment Partnership (TTIP) aims to do the same between the US and Europe.

A. Why has the US embarked on TPP and TTIP?

Consider first the TPP. The fact (or possibility) of a grand geo-strategic rationale underlying it should not obscure its conjunctural origins. Circa 2011, vulnerable to accusations of business unfriendliness, anxious for bipartisan bonding with Republicans, and convinced that export dynamism was a key element of reviving growth and shedding the US’ global role as importer and financier of last resort, the Obama administration seized upon trade.

Pursuing free trade with a set of Asian countries then held a number of attractions. First, it afforded an opportunity for American firms to gain further access to the most dynamic region in the world: hence the choice of Asia over Latin America or Europe.

Second, the TPP was more likely to succeed. The TPP model is one of the US, as a large country, negotiating with a set of smaller countries, allowing the US to retain an overwhelming balance of bargaining power (the inclusion of Japan and Canada in TPP changes that model to some extent but not fundamentally.) Why is this important?

Structurally, the US is increasingly handicapped in trade negotiations which require give-and-take. By virtue of being a relatively open economy, it does not have much to give. Thus, only with smaller countries is it able to secure opening by others without having to open much itself. From this follows a key feature of TPP: broadly *asymmetric* market opening. The assumption underlying TPP is that the US would expect partner countries to liberalise their trade and upgrade their regulatory regimes to American standards. The US would undertake some opening—in dairy and textiles, and possibly diluting export controls—but not a substantial amount. Asymmetric liberalisation would have the political virtue of muting opposition from

domestic economic constituencies.

The third geo-strategic attraction of TPP is China, or rather the opportunity to contain it both economically and politically. Especially with Canada, Mexico, and Japan brought into the TPP architecture, liberalisation within this bloc will raise barriers to Chinese products (in the jargon, there will be trade diversion away from China). Economic containment is embodied in worsening the access for Chinese companies in American and Asian markets.

TPP also co-incided with, and was a response to, Asian countries seeking a greater American presence in the region in the wake of Chinese military assertiveness. Symbolically, if not substantively, TPP has become emblematic of political containment, in part because Asia wanted it to be so.

The trans-Atlantic demarche (TTIP) will differ from its Pacific counterpart in one crucial respect in requiring broadly symmetric market opening by both the US and Europe. The US and Europe are near-equals (or at least not very unequal) in size and power, implying that the US cannot demand of Europe what it will of its TPP partners, namely one-way opening.

The deeper rationales of the TTIP are twofold. TTIP is an attempt to shore up some semblance of Atlantic commonality and community as NATO declines in importance and as economic dynamism shifts to Asia. Economically, TTIP like TPP aims to contain China but in a different way. Leveraging the size of two very large markets, TTIP aims to preempt China from imposing its technical standards (telecommunications, hardware, data, agriculture, etc.) on the rest of the world. If the US and EU can agree to common global (and non-Chinese standards), it is Chinese firms that will have to pay the cost of entering American and European markets rather than the other way around.

To some extent, the pursuit of TPP and TTIP reflected frustration at the lack of progress in the Doha Round of multilateral negotiations, which was attributed to obstructionism by China and especially India. Even if that were true, it is only partial. The Doha Round held few attractions for the US and its private sector interests. In other words, even a successful conclusion of a Doha Round would not have detracted from the appeal of, nor obviated the perceived need for, pursuing initiatives such as the TPP and TTIP.

In sum, TPP will involve opening mostly by the US' trading partners, while TTIP will entail reciprocity of market opening. TPP will have the effect (symbolic if not substantive) of politically containing China which TTIP does not. TPP and TTIP both aim to contain China economically but in different ways: TPP will serve to raise barriers to Chinese firms in a dynamic Asia-Pacific market, while TTIP will serve to leverage the size (not the dynamism) of two large economies to pre-empt Chinese standards being imposed on the world.

B. What are the economic benefits of TPP and TTIP?

Both will confer benefits and impose costs in particular sectors. But it can safely be assumed that neither TPP nor TTIP will confer large (as in macro-economically significant) economic benefits. Why so?

In the case of the TPP, the modest gains for the US stem from the asymmetric market opening. It is well-known that most of the economic/welfare gains from trade liberalisation stem from a country's own liberalisation. In the TPP, the US is unlikely to undertake significant opening itself, hence US consumers don't stand to reap large gains. The economic gains to the US will accrue in the form of rents to American producers in partner country markets that are opening up preferentially. The magnitude of these rents will depend on how protected these markets are in the first place. The big partner country markets—Canada, Japan, and Korea—are relatively open, reducing the potential rents that US firms will reap. One (probably optimistic) estimate by Petri and Plummer (2012) finds that the gains to the US in 2025 from a TPP that includes Japan, Mexico, Canada, and Korea will be about 0.4 % of GDP.

In the case of the TTIP, the economic gains are unlikely to be large but for different (and subtler) reasons. Conventional trade barriers in both the United States and Europe—with notable exceptions such as government procurement and air transport and these are likely to remain exceptions—are relatively small; and where they are significant, their scope is narrow (as in agriculture). For these reasons, TTIP cannot generate large economic gains measured as a share of the US economy.

What about the gains from regulatory harmonisation or convergence? TTIP will focus to a great extent on addressing differences in regulation across the two jurisdictions. In agriculture, the EU favours strict safety and sanitary regulations—sometimes beyond what is called for by the science. In relation to data, the EU favours stricter standards to safeguard privacy and private rights while the US favours market-driven solutions. France seeks to protect its artistic heritage by way of an “*exception culturelle*” to free trade. In relation to protecting wines and spirits, the EU favours high levels of protection for certain geographical appellations (think “Champagne”).

Now, the economic/welfare calculus of regulatory convergence—if indeed that is going to happen under TTIP—is complicated. If to start with, each country's trade-off between regulation and liberalisation represents some kind of revealed collective preference, any departures that changed that trade-off will not have unambiguous consequences.

If the EU relaxes its safety regulations to allow more US beef, EU beef-eaters will benefit but they will also lose because they have in some sense been exposed to more risk (which is a cost); after all, that is why they had the stricter regulation in the first place (unless of course the regulation was pure protectionism even to begin with). Similarly, if the US strengthens protection for geographical appellations such as “Champagne,” more French bubbly will

benefit some American consumers but there will also be costs because access to new world bubbly will be curtailed (they will no longer be able to use the “Champagne” appellation). The bottom line is that by definition, the nature of integration between the US and EU will result in very small overall gains if regulations are properly accounted for. So, given the nature of the two economies and the integration that is envisaged, any claims about large benefits are simply not plausible and should be discounted.

In sum: TPP will confer modest overall benefits because the US will itself liberalise very little. Thus, US consumers will benefit little. There will be some benefits to US producers but these are unlikely likely to be significant because barriers in the large Asia-Pacific countries are not great. TTIP will also only confer modest benefits because conventional trade barriers in the US and Europe are low. And the trade benefits from regulatory convergence will be offset by the losses implicit in having to change regulations from previously preferred levels.

C. The impact of TPP and TTIP on China

In trade terms, the biggest prize is China for two reasons. It is not only one of the world’s largest and dynamic markets, it is also one of the most protected ones. While China’s formal trade barriers have come down sharply in manufacturing, barriers are substantial in services and government procurement, and informal barriers are also extensive in scope due to the actions of state-trading enterprises. In contrast, US and EU markets are more open.

Consider how China’s markets can be further liberalised. The strongest pressure on China to liberalise will be domestic. There are signs that the new leadership wants to re-balance and reform its economy especially its state-owned and services sectors in order to secure durably high and high quality growth. This is unilateral opening.

How can the US influence China’s market opening in a bargaining environment? It can do so in three ways. First, the US could say, “you (China) open you markets and we will open ours.” This is the standard mercantilist reciprocity bargain. The problem is that this bargain runs up against the problem of asymmetry: the US is very open and has not a lot to offer, while China is closed. In this exchange, China has the overwhelming balance of mercantilist bargaining power. So, shifting power militates against this strategy.

Second, the US could say “you (china) open your markets otherwise we will close ours.” But this is dangerously belligerent. It is protectionist in tone and intent and would go against the spirit of the current liberal trading system which China will surely exploit. So, ideas and power will both militate against this approach.

The third alternative is to impose costs on China indirectly: not by raising American barriers but by discriminatorily lowering barriers in American, Asian and European markets to the disadvantage of Chinese firms. This is what TPP and TTIP will achieve. They will indirectly

inflict costs on China by worsening its competitive position in international markets.

Now, China can respond in a number of ways. It can offset its own disadvantage relative to American competition in Asia-Pacific markets by negotiating free trade agreements of its own with these countries. Indeed, that is what it is doing. China has negotiated agreements with four countries already and the Regional Comprehensive Economic Partnership (RCEP) between ASEAN and six other countries (Australia, Japan, New Zealand, Korea, India and China) is aimed at widening this circle of free trade agreements to parry similar American efforts.

But such agreements negotiated by China also impose a cost on American and European firms because in Chinese markets they are now disadvantaged relative to Asian firms. De facto, TPP and TTIP combined with Chinese responses to them amount really to an elaborate trade war by proxy.

How will this war end? A lot will depend on China. If it chafes under this strategy of containment, it could prolong the war by targeting the US, for example, by negotiating trade agreements with Korea and Japan that would create even more discrimination against American business.

On the other hand, Chinese pragmatism might prevail. Seeking to avoid the impact of TPP and TTIP on its own exports and economic trajectory, China could come to the negotiating table. The early evidence relates to the fact that Japanese entry to the TPP negotiations may have altered China's approach to the TPP. China quickly recognised the economic losses it would suffer as a result and hence became much more forthcoming about its own market opening. This changed approach is manifest in China's willingness to negotiate a BIT agreement with the US, seeking to join the Trade in Services Agreement (TISA) negotiations in Geneva, adopting a more nuanced approach (and less obstructionist) to the ITA-2 agreement in Geneva, willing to join negotiations on environmental trade, and even desire/willingness to join the TPP itself. Especially if China wants to liberalise for domestic reasons (and there are increasing signs pointing in that direction), China might want to do what Premier Zhu Rongji did in getting China to join the WTO more than a decade ago. By negotiating with its larger trading partners, China could seek to extract concessions for its own liberalisation actions that it might want to undertake in any case.

The state of the TPP and TTIP negotiations are in considerable flux in the US. The Democrats have ruled out the grant of trade promotion authority until after the Congressional elections in November 2014. But even after it is not clear that the US as a whole can muster the political support to pursue negotiations. There are multiple ironies and paradoxes here.

First, the fact that the US even initiated TPP and TTIP as a China-containment play was surprising given the shifting power balance between the two. Second, the fact that it did so

when the climate for pursuing trade liberalisation (in this twentieth anniversary of NAFTA, which is the lightning rod attracting all the grievances against globalisation) is also surprising. So, on power and ideology grounds, TPP and TTIP were bold gambits, to some extent defying underlying trends.

But the third irony is this. The US is retreating, or being forced to retreat from these initiatives, at the very time when they seem to be “working” vis-à-vis China. So, the US, even though declining in status does seem to have vestigial power that it can effectively wield against the rising power.

What is clear is that the politics of TPP and TTIP in the US will depend a lot on the China dimension. The economics of these two initiatives will be perceived in the political arena as either marginally negative or neutral. The TPP will fare slightly better than TTIP because TPP involves more asymmetric liberalisation. Fewer domestic interests—producers or labour—will be threatened by TPP. And some producer interests—American exporters—will gain. The politics of TTIP, on the other hand, will be ambiguous because it will entail some liberalisation which will threaten domestic US producer interests. Moreover, because of regulatory changes, resistance will also come from domestic agencies, attempting to ward off encroachment on, and dilution of their, authority.

On foreign policy grounds too, TPP will fare better than TTIP. TPP entails double containment of China—economic and political. This will overwhelmingly resound with an instinctively insular and China-wary Congress. TTIP may not have the same resonance because China will not be explicitly targeted.

4. Concluding observations

Two major developments are under way in trade: challenges to globalisation in the West and mega-regionalism initiated by the United States. On the former, a major question going forward is this: can the idea of globalisation survive the headwinds of economic forces that are going to keep growth in the US and Europe relatively muted, to strain public balance sheets, to erode the tax base necessary to sustain the political consensus for globalisation, and to cause inequality to worsen especially in the US? Should one be sanguine based on the experience of the China shock or should one be more cautious because of ominous, globalisation-threatening forces?

On mega-regionalism, the question relates to power: will the US achieve its objective of containing China politically and inducing China to open up its markets economically or whether its actions will provoke frictions in and lead to fragmentation of the trading system. Will the status quo power achieve its ends or will the rising power mount a challenge?

Where all this leaves the WTO and multilateralism is, of course, of pressing concern. It is not that the WTO and multilateralism have become totally irrelevant. More and more countries,

including Russia, want to join the WTO. Its dispute settlement system functions effectively, its basic rules are broadly respected. The question is whether it retains its relevance as a key forum for facilitating further liberalisation or transforms itself into an institution that serves mainly as a court of trade law and an overseer of expanding regional trade.

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