

AT THE END OF A LONG TRADE POLICY ROAD

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I. INTRODUCTION

Because the United States' bilateral trade deficit with China is so large and has grown so quickly, and because we depend so heavily on China to finance our deficit spending, the U.S.-China trade relationship attracts attention and commentary as if it were qualitatively, as well as quantitatively, different from the relationship between the United States and other major trading nations which, like China, have for years run large structural trade surpluses—e.g., Japan, Germany, Korea, and Taiwan. During Treasury Secretary Geithner's confirmation, Senator Schumer of New York pressed Mr. Geithner on the issue of China's trade surplus and currency manipulation. Mr. Geithner's response, that "President Obama . . . believes that China is manipulating its currency" and that his "new economic team will forge an integrated strategy on how best to achieve currency realignments in the current

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economic environment,”¹ suggests a belief that if China were more flexible on the question of currency appreciation, it would go a long way towards resolving our current account deficit problem.

In the time since Secretary Geithner’s answer to Senator Schumer’s questions, others have blamed China’s currency manipulation for the global economic crisis we are in:

Geithner is correct that China manipulates its currency. What’s more, this manipulation is arguably the most important cause of the financial crisis. Starting around the middle of this decade, China’s cheap currency led it to run a massive trade surplus. The earnings from that surplus poured into the United States. The result was the mortgage bubble.²

The contention is that trade deficit leads to massive inflows of surplus country savings, which inflate investment bubbles.

There is much to the claim that China’s policy has been to keep the value of its currency low enough to promote export-led growth which, in turn, is meant to create millions of jobs to support the migration of tens of millions of China’s peasants to its industrial cities.³ It is also fair to link China’s economic policies to the present monumental imbalances in trade flows and to link these global trade imbalances to the present global economic crisis. But it is neither fair nor productive to single out China for blame, much less to blame China’s “currency manipulation” as “the most important cause of the financial crisis.” The problem is the imbalance in U.S. trade with the world as a whole. The United State’s bilateral deficit with China is a significant part of that problem, but is troublesome only because of the size of its global deficit.

Once the immediate challenge of regenerating the growth of global demand has been met, policy makers here and overseas would be well advised to address the need for changes to the structure of the economic incentives and disincentives in both deficit and surplus countries that lie behind the trade imbalances. In particular, China, Japan, Germany, Korea, and other surplus countries will have to temper their reliance on export-led growth generally and exports to the United States in particular. The United States will have to move to improve the competitiveness of its industry, to promote production in the United States, and to reduce its dependence on debt-financed imports for consumption.

Structural change will be very difficult, but without it, the risk is that restoration of global economic growth will simply set the stage for the next global economic crisis. A return to the pre-crisis status quo, albeit with tighter financial sector regulation, will not change the incentives that producers in China, Japan, Germany, and elsewhere have to produce for export, nor will it change the mix of incentives and disincentives in the United States that leads the United States to import so much more than it is able to export. Structural change should be the product of international cooperation and accommodation, but if it cannot be accomplished

1. *Finance Committee Questions for the Record: Hearing on Confirmation of Mr. Timothy F. Geithner to be Secretary of U.S. Department of Treasury Before the S. Comm. on Finance*, 111th Cong. 81 (2009) (answering question from Sen. Schumer).

2. Sebastian Mallaby, *What OPEC Teaches China*, WASH. POST, Jan. 25, 2009, at B7.

3. See, e.g., FLORIS-JAN VAN LUYN, *A FLOATING CITY OF PEASANTS: THE GREAT MIGRATION IN CONTEMPORARY CHINA* (The New Press 2007).

cooperatively, the United States may have no alternative but to rethink its approach to trade policy as a buffer between different national systems of economic regulation instead of a march to freer trade.

The premises of this paper are that the long-term stability of the global economy requires more balanced trade flows; that the problem of gigantic trade deficits and off-setting trade surpluses is a trade problem that requires a trade policy response and that the free trade fundamentalists who insist otherwise are badly mistaken; that an effective trade policy response requires a break from the trade policy orthodoxies of the past thirty-five years; and that, left unaddressed, the problem will sooner or later precipitate another global economic crisis. Though China is at the heart of the problem, it is counterproductive to think of the need for trade policy change solely (or even primarily) as a response to the trade imbalance in U.S.-China trade.

II. A SET OF BASIC TRADE POLICY QUESTIONS REQUIRING SERIOUS DEBATE

If large structural trade imbalances are not a serious problem (and there are schools of economic thought that say that they are not), or if these sorts of imbalances are not a legitimate trade policy concern (and the weight of current conventional economic wisdom seems to say that they are not), then the analysis and prescriptions for policy change that follow are, at best, beside the point. But if structural trade imbalances are a serious economic problem, and if they are in whole or significant part the result of government policies that: (a) in the structural surplus countries, promote export-led growth and discourage imports; and (b) in the United States and other structural deficit countries, encourage imports for consumption and the outsourcing of production as long as there is a near-term profit to be had by it—then there is a pressing need to consider the way in which U.S. trade policy and the rules of the trading system ought to be changed to address the problem.

A. *Are Gigantic Trade Imbalances a Problem?*

For some time now, serious economists have questioned the ability of the global economy to sustain the U.S. trade deficit and offsetting surpluses in China and elsewhere: “For how long can the global economy endure America’s enormous trade deficits—the United States borrows close to \$3 billion a day—or China’s growing trade surplus of almost \$500 million a day? These imbalances simply can’t go on forever.”⁴

The view that structural trade imbalances are a problem is, however, far from universal. The Cato Institute, for example, has long proclaimed that the U.S. deficit is a sign of U.S. economic strength. Cato’s free-market/free-trade fundamentalists argue that foreign countries run their trade surpluses in order to earn dollars that

4. Joseph E. Stiglitz, Op-Ed, *How to Fix the Global Economy*, N. Y. TIMES, Oct. 3, 2006, available at <http://www.nytimes.com/2006/10/03/opinion/03stiglitz.html>.

they can then invest in U.S. assets.⁵ The idea that producers of textiles in China or autos in Japan and Korea sell us as much as they do only because they want to earn dollars they can then invest in the United States in, say, sub-prime mortgages borders on silliness. Others, more sober in their analysis, have viewed the U.S. deficit generally, and China's surplus in particular, as benign and self-correcting. In a July 18, 1997, piece for *Slate*, Paul Krugman dismissed China's then embryonic \$24 billion trade surplus as an "illusion" that would soon disappear:

In fact, one might well expect that emerging economies would typically run trade (or at least current account) *deficits*. After all, such countries will presumably attract inflows of foreign investment, allowing them to invest more than they save—which is to say, spend *more* than they earn. To put it another way, a country that attracts enough foreign investment "both to service debt and to finance growth" must, by definition, buy more goods and services than it sells—that is, run a trade deficit. The point, again, is that the money has to show up *somewhere*. . . . How can a country run a trade deficit when it has a huge cost advantage that comes from combining First World productivity with Third World wages? The answer is that the premise must be wrong: when productivity in emerging economies rises, so must wages—that is, the supposed situation in which these countries are able to "produce sophisticated goods and services at rock-bottom prices" never materializes.⁶

By 2007, China's global trade surplus had jumped to \$262.2 billion—in other words, a more than ten-fold increase; this is hardly an "illusion."⁷

At the recent meeting of the G-20 in Pittsburgh, the leaders of the world's largest economies recognized the need for more balanced global growth, but did nothing of consequence to achieve it. Their "Statement" on the issue was entirely aspirational:

"Our framework for Strong, Sustainable and Balanced Growth is a compact that commits us to work together to assess how our policies fit together, to evaluate whether they are collectively consistent with more sustainable and balanced growth, and to act as necessary to meet our common objectives."⁸

There is something to be said for recognizing the problems that gross structural trade imbalances create, but the distance between problem recognition and problem resolution is considerable.

5. See generally Daniel T. Griswold, *America's Record Deficit: A Symbol of Strength*, CATO INST. (2001) (arguing that deficits are usually accompanied by improving economic conditions), available at <http://www.fretrade.org/pubs/pas/tpa-012.pdf>.

6. Paul Krugman, *The East is in the Red: A Balanced View of China's Trade*, SLATE, (Jul. 18, 1997), <http://www.slate.com/id/1922> (last visited Sept. 18, 2009).

7. *China's Global Trades Surplus Jumps to Record Level*, N.Y. TIMES, (Jan. 11, 2008), available at <http://www.nytimes.com/2008/01/11/business/worldbusiness/11iht-11surplus.9146603.html>.

8. Leaders' Statement: The Pittsburgh Summit, para. 15 (Sept. 24–25, 2009), available at <http://www.pittsburghsummit.gov/mediacenter/129639.htm>.

B. Are Gigantic Trade Imbalances a Legitimate Trade Policy Problem?

Although the consensus among economists now may be that large structural trade imbalances are indeed a problem, the clear consensus is also that trade imbalances are a macroeconomic problem associated with an abysmal U.S. savings rate or a surplus country “saving glut,” and are not, in any sense, a legitimate trade policy concern. In a nutshell, the analysis is that macroeconomics dictate trade imbalances—that is, because our national investment needs far exceed our national savings, and the structural surplus countries save far more than they invest at home, their savings glut makes up for our savings shortfall. To quote Federal Reserve Chairman Bernanke:

The extensive attention paid to the trade imbalance in the media and elsewhere has tempted some observers to ascribe the growing current account deficit to factors such as changes in the quality or composition of U.S. and foreign-made products, changes in trade policy, or unfair foreign competition. However, I believe—and I suspect that most economists would agree—that specific trade-related factors cannot explain either the magnitude of the U.S. current account imbalance or its recent sharp rise. Rather, the U.S. trade balance is the tail of the dog; for the most part, it has been passively determined by foreign and domestic incomes, asset prices, interest rates, and exchange rates, which are themselves the products of more fundamental driving forces.⁹

If, however, the persistence of the U.S. deficit and the offsetting surpluses were “passively determined” by macroeconomic phenomena, surely the economics profession would have done a better job of pinpointing the precise reasons why the U.S. trade deficit has been trending upward over the past thirty-five years through periods of strong and weak U.S. growth, through periods of budget deficits and surpluses, and through periods of a strengthening and weakening dollar.¹⁰ Similarly, if macroeconomic phenomena were the root of the problem, economists would also be able to show why over the same thirty-five year period Japan and Germany have, through thick and thin, maintained their structural trade surpluses.¹¹ More fundamentally, the fact that the current account deficit can be expressed as the difference between national savings (both private and public) and national investment does not mean that a low savings rate or an Asian savings glut *caused* the deficit.

There are occasional hints in even the most mainstream of economic analyses that suggest imbalances may, in fact, be the product of something more than the low U.S. savings rate or a foreign savings glut. In his 2004 Per Jacobssen Lecture,

9. Ben S. Bernanke, Member of the Board of Governors, Fed. Res. Sys., Remarks at the Sandridge Lecture, Virginia Association of Economics: The Global Savings Glut and the U.S. Current Account Deficit (Mar. 10, 2005), *available at* <http://www.federalreserve.gov/boarddocs/speeches/2005/200503102/default.htm>.

10. For an analysis of the growth of the U.S. trade deficit over the past 35 years and the surpluses run by Japan, Germany, China and South Korea, see BRUCE C. GREENWALD & JUDD KAHN, GLOBALIZATION THE IRRATIONAL FEAR THAT SOMEONE IN CHINA WILL TAKE YOUR JOB, 151–56 (2009) [hereinafter GREENWALD & KAHN].

11. *Id.*

Lawrence Summers attributed the U.S. trade deficit to the decline in U.S. savings, but in doing so, pointed out:

For reasons that economists poorly understand, it was first noted in 1969 that the elasticity of U.S. exports with respect to foreign economic growth is less than the elasticity of U.S. imports with respect to domestic economic growth. . . . This is known as the Houthakker-Magee effect. Lacking a convincing explanation, economists have predicted that this was some kind of anomaly that would go away in the next 30 years, and it has not, as yet. Consistently, the output elasticity of foreign imports is far less than in the case of American imports.¹²

But couldn't deep differences in the openness of different national markets to imports explain the Houthakker-Magee effect?

In fact, the data behind the U.S. deficit and offsetting surpluses suggest that "trade related factors," specifically how governments provide different sets of incentives to produce, to produce for export, to consume, and to import for consumption, are much more than the tail of the current account deficit dog. The U.S. merchandise trade deficit grew from \$84.5 billion in 1992 to \$794 billion in 2007.¹³ Energy accounts for a large part of this growth; oil and gas imports, which were \$42.8 billion in 1992, rose to \$319 billion in 2007.¹⁴ But there were also very significant increases in the deficits in auto sector trade (from \$36.4 billion in 1992 to \$138 billion in 2007), electronics, including computers (a \$14.2 billion deficit in 1992 became a \$100.5 billion deficit in 2007), and industrial machinery (where an \$8.3 billion trade *surplus* became a \$51.7 billion trade deficit).¹⁵ These data raise a host of questions:

- (1) Why do Europe, Korea, and Japan all run very large auto sector trade surpluses while the United States runs such a large deficit? Some easy answers—their companies make better cars than the U.S. industry—do not hold up that well under close examination. After all, Ford and GM are major European auto manufacturers and also control Japanese production. At the same time, major European producers (e.g., Renault, Peugeot, Fiat) have tried and failed to make it in the U.S. market, and Daimler-Benz's acquisition of Chrysler was something less than successful. On the other hand, specific trade-related factors like Europe's ten percent auto tariff; Japan's, Europe's, and Korea's distribution systems; the Korean government's effort to channel tens of billions of dollars into the expansion of the Korean auto industry's capacity; the control of Japanese industry by other group companies and, therefore, less of an emphasis on near-term profitability; and government interest in German and French producers would all seem to have much to do with auto sector production and trade flows.

12. Lawrence H. Summers, The U.S. Current Account Deficit and the Global Economy, Lecture for the Per Jacobsson Lecture Series 4–5 (Oct. 3, 2004), available at www.perjacobsson.org/2004/100304.pdf.

13. U.S. *International Trade in Goods and Services: Annual Revision for 2007*, U.S. BUREAU OF ECON. ANALYSIS, U.S. CENSUS BUREAU, at 4 (2008).

14. *Id.* at 56.

15. *Id.* at 5–6.

- (2) One of the more noteworthy developments in U.S. auto sector trade has been the rise in imports from Mexico. In 1992, the U.S. auto sector trade deficit with Mexico was \$643 million.¹⁶ By 2007, it had increased by a factor of 32 to \$20.5 billion.¹⁷ Would the consensus among economists be that the North American Free Trade Agreement (NAFTA) was *not* a factor behind the change?
- (3) Turning to the electronics sector, a relevant question is why U.S. computer manufacturers are so much quicker to outsource production than Japanese computer manufacturers? Isn't part of the explanation that funding is available without much regard to profit maximization under Japan's heavily regulated financial system, and that the nature of Japanese corporate control results in less pressure on near term profits?

Economic behavior in the United States and in the surplus countries is shaped by the incentives that have been baked into their respective systems of economic regulation (or non-regulation). That is, the United States has structured its economy to encourage import competition and maximize current consumption, while China, Japan, Korea, Taiwan, Brazil, India, and even Germany have, through formal (e.g., high tariffs) or informal barriers to trade (e.g., anticompetitive business groupings) and other mechanisms (e.g., intervention in currency markets, state regulated banking systems that support domestic production without much regard to profit, and the absence of effective protection for intellectual property), structured their economies to encourage production for export and to limit "disruption" of their domestic markets from import competition. Two examples—how financial market regulation affects manufacturing activity, and how company executives are rewarded—illustrate the point.

The economic case for free trade is grounded in the idea of comparative advantage, that is, that when each country produces the goods it can produce at the lowest cost relative to the cost of producing other goods, global production efficiencies are maximized to the benefit of all.¹⁸ But the assumption that relative production efficiencies dictate trade flows encounters a host of real world problems, one of which is the difference in the ability of producers to sell at a lower price even when their production costs are higher due to differences in how national capital markets operate. When, for example, U.S. financial markets demand a high market rate of return on investment while regulated Japanese, Korean, or German capital markets require a lower rate of return, a more cost-efficient U.S. producer will still

16. Office of Trade and Industry Information, TradeStats Express, <http://tse.export.gov/> [hereinafter OTII] (click "National Trade Data"; then "Product Profiles"; then select "Individual Countries" under Trade Partner section and choose Mexico from the drop down menu; then select "Imports" under Product section; then choose 1992 from "Chart Year" drop down menu and click "go" button. To compare data, repeat this but select "Exports" under Product section) (last visited July 26, 2009) (presenting import statistics for "vehicles, except railway or tramway, and parts etc.").

17. *Id.* (click "National Trade Data"; then "Product Profiles"; then select "Individual Countries" under Trade Partner section and choose Mexico from the drop down menu; then select "Imports" under Product section; then choose 2003 from "Chart Year" drop down menu and click "go" button. To compare data, repeat this and select "Exports" under Product section) (last visited July 26, 2009) (presenting import statistics for "vehicles, except railway or tramway, and parts etc.").

18. See United States Department of Labor, BLS Information: Glossary, <http://www.bls.gov/bls/glossary.htm#C> (last visited Oct. 11, 2009).

be unable to compete successfully with its Japanese, Korean, or German competitors.

In the 1980s and 1990s, the Korean government's policy was to develop an automobile industry with substantial export capacity. Korea's three major automotive producers, Hyundai, Kia, and Daewoo, expanded their production capacity far beyond any conceivable level of Korean demand.¹⁹ Even Samsung, which was not an automobile manufacturer, incurred over \$5 billion in debt to become one.²⁰ The growth of Korea's auto industry was funded by tens of billions of dollars in investment funds from Korean banks that were either controlled or guided by the Korean government, and the Korean market was, for all practical purposes, reserved for the Korean industry through a series of formal and (more importantly) informal measures designed to keep auto imports at a miniscule level.²¹ Because increased Korean industry capacity added to global overcapacity, there was never any realistic prospect for a return on the investment, but that was of little concern to the government-controlled banking system. Ultimately, tens of billions of dollars in bad debt had to be written off.²² Daewoo and Kia went into bankruptcy, Hyundai took over Kia, and GM purchased most of Daewoo's assets.²³ But the capacity added in the 1980s and 1990s largely remains in place; thus, Korea remains a significant (i.e., \$9.7 billion in 2007) net exporter of motor vehicles to the United States.²⁴

Differences among countries in patterns of stock ownership and forms of executive compensation also shape company behavior and, therefore, trade flows. An American executive who can boost short term (e.g., quarterly) profits by outsourcing production has every reason to do so. He will be seen as serving his stockholders' interests and therefore will likely qualify for a substantial bonus and/or significant stock option benefits. By contrast, a Japanese executive working for a company that is controlled by other companies of the same corporate group is responsive to stockholders that are primarily interested in the stability of the financial and commercial relationships among group companies. The Japanese executive is more often rewarded more for growth of the business, which creates opportunities for promotion and leads to greater corporate perks (e.g., entertainment allowance) than for the profitability of the business. Japanese executives, unlike their U.S. counterparts, are not typically given large bonuses linked to company profitability and do not receive significant stock options.

19. See ERIK ECKERMANN, *WORLD HISTORY OF THE AUTOMOBILE 206–08* (Peter L. Albrecht trans., 2001) (describing Korean car manufacturers' aggressive production goals).

20. See Kwang-Tae Kim, *Samsung to Appeal Ruling on Auto Debt*, ASSOCIATED PRESS, Feb. 25, 2008 (stating that the district court ordered Samsung to pay creditors of its failed car business about half of the \$5.2 billion demanded).

21. See ECKERMANN, *supra* note 19, at 206 (noting that South Korean auto manufacturers took advantage of "cunning import restrictions in terms of both tariffs and psychological considerations").

22. See *id.* at 208.

23. See Suh Hae-sung, *Kia Motors completes stunning turnaround*, ASIA TIMES ONLINE, Feb. 18, 2000, available at <http://www.atimes.com/asia-crisis/BB18Db02.html> (discussing Hyundai's takeover of Kia); *GM Acquires Daewoo Units for \$1.2 Billion*, FOX NEWS.COM, Apr. 30, 2002, <http://www.foxnews.com/story/0,2933,51560,00.html> (discussing GM acquisition of Daewoo).

24. See OTII, *supra* note 16 (click "National Trade Data"; then "Product Profiles"; then select "Individual Countries" under Trade Partner section and choose South Korea from the drop down menu; then select "Balance" under Product section; then choose 2008 from "Chart Year" drop down menu and click "go" button) (last visited July 26, 2009) (presenting balanced import/export statistics for vehicles, with a net export of \$9.7 billion for South Korea in 2007).

Responding to a different mix of incentives, the Japanese executive will be less interested in action to boost near-term profits and will accordingly be much slower to shift his business to off-shore suppliers.

The ways in which differences in systems of micro-economic regulation impact trade flows are many and constantly changing, but their impact should be beyond question.

- (1) Japan's *kieretsu* system, with group banks backed by Japan's Central Bank and the Ministry of Finance, sustains a system that restricts foreign-producer access to distribution networks, subordinates profits to production, and generally keeps uncompetitive domestic firms in business. The U.S. Department of Commerce has found that Japanese producers have been systematically "dumping" in the U.S. market.²⁵ When asked why prices for a particular product in Japan were 60 percent higher than Japanese export prices to the United States, one company executive replied: "The U.S. market is very competitive." What about the Japanese market? "Not so much."²⁶
- (2) Despite the sharp depreciation of the U.S. dollar against the euro and the yen, a Chinese furniture manufacturer continues to concentrate on production for the U.S. market instead of for the German or Japanese markets. The explanation? Exporting to the United States is so much easier. A Chinese apparel exporter has faced similar difficulties in the Japanese market. In the case of textiles, the problem appears to be the role of trading companies in the Japanese distribution system.²⁷
- (3) Korea's *chaebols* are a variation of Japan's *kieretsus*: they limit foreign access to the Korean market.²⁸ Korea's LG and Samsung Corporations have, for example, become two of the world's largest producers of household appliances and other consumer products. Both control large Korean "big box" distribution chains.
- (4) India and Brazil, which protect their domestic markets with high tariffs, use elaborate systems of subsidies to promote exports (e.g., exporters do not have to pay the high duties for their imported production equipment or material inputs).²⁹

25. See Press Release, Int'l Trade Admin., Dept. of Commerce, Commerce Finds Unfair Dumping of Glycine from Japan and the Republic of Korea (Nov. 21, 2007), available at http://www.trade.gov/press/press_releases.asp (announcing final determinations in the antidumping duty investigations on imports of glycine).

26. This comment was made in the context of a proceeding about which I have first-hand knowledge. Based on my experience in practice, I believe it is representative of the difference in the nature of U.S. and Japanese markets for a range of traded goods.

27. These observations were also made in the context of antidumping proceedings in which I was involved, and based on my experience in practice, I believe that they too are fairly representative of differences in the ease of exporting to different national markets.

28. See Amir N. Licht, *Legal Plug-Ins: Cultural Distance, Cross-Listing, and Corporate Governance Reform*, 22 BERKELEY J. INT'L L. 195, 210-13 (2004) (providing information on chaebols).

29. See WTO Secretariat, *Trade Policy Review: India*, WT/TPR/S/182 (Apr. 18, 2007) (providing an overview of India's trade policies); WTO Secretariat, *Trade Policy Review: Brazil*, WT/TPR/S/212 (Feb. 2, 2009) (providing an overview of Brazil's trade policy).

(5) China has a legitimate claim to a comparative advantage in the production of labor-intensive products such as wooden furniture or apparel, but what is the comparative advantage behind China's determination to have its state-controlled enterprises move into "high-tech" industries? For example, China has recently announced its decision to produce large commercial aircraft by 2014.³⁰ One state-supported aircraft manufacturer, Airbus, has already been a factor in driving two U.S. companies, Lockheed and McDonnell Douglas, out of the commercial aircraft market.³¹ A Chinese entry into the market is bound to put added pressure on Boeing, the United States' largest exporter.

It is hardly remarkable that differences in each country's mix of economic incentives drive the U.S. structural trade deficit and the structural trade surpluses run by these exporting countries. It simply means that different systems of economic regulation are working as they are intended to work.

C. *Exchange Rate Shifts May Not Be the Answer*

After major currencies began to float, exchange rate shifts were supposed to avoid the sorts of gross trade imbalances that have developed—and perhaps the problem could still be addressed without a collapse of the dollar. To date, however, that correction has not happened for two reasons. First, some countries that promote export-led growth (China, Japan, and Korea) have resisted (and will likely continue to resist) the sorts of exchange-rate adjustments that would have a significant impact on their exports. Second, the magnitude of the exchange-rate shifts needed to have a major impact on patterns of trade appears to be very large indeed because, with export capacity in place, producers in countries that depend on export-led growth have been willing to sacrifice profits for market share without fear of either shareholder revolt or limitations on their access to government-regulated financial markets.

The most sobering data regarding the relationship between exchange rate shifts and trade flows relate to the appreciation of the Japanese yen between 1985 and 1995. In 1985, the average yen/dollar exchange rate was ¥238.54/\$1; by 1995, the value of the yen had strengthened to ¥94.06/\$1—that is, in 1995, the value of the yen was *more than 2.5 times* its 1985 level.³² Over the same period, Japan's global trade surplus expressed in yen dropped only marginally from ¥12.95 trillion to ¥12.34 trillion, and, expressed in dollars, it more than doubled (from \$54.3 billion in 1985 to \$131.2 billion in 1995).³³ These data suggest that when economies that are structured to encourage exports and discourage imports, they do just that even in the face of very significant exchange rate shifts. (The data may also reflect that as long as other

30. Don Durfee and Joanne Chiu, *High Hurdles for China's Commercial Aviation Ambitions*, REUTERS, Sept. 10, 2009, available at <http://www.reuters.com/article/rbssIndustryMaterialsUtilitiesNews/idUSHKG10428120090910>.

31. CLAYTON M. CHRISTENSEN, SCOTT D. ANTHONY & ERIK A. ROTH, *SEEING WHAT'S NEXT: USING THEORIES OF INNOVATION TO PREDICT INDUSTRY CHANGE* 131 (2004).

32. Pacific Exchange Rate Service, *Foreign Currency Units per 1 U.S. Dollar, 1948–2007*, <http://fx.sauder.ubc.ca/etc/USDpages.pdf> (click on "per 1 US Dollar" under "archive") (last visited July 6, 2009).

33. Japan Ministry of Finance, *Summary of Balance of Payments, Annual Figures (Calendar Year), 1985–2004*, <http://www.mof.go.jp/bpdata/es1bop.htm> (last visited July 6, 2009).

factors support the desired level of surplus, the Japanese government is willing to let the yen appreciate, but when the trade impact becomes significant, it lets the yen fall.)

A more recent example makes the same point. On January 2, 2002, the euro was worth \$0.90; on February 28, 2008, it was worth \$1.52.³⁴ At a 1/\$1.50 exchange rate, Airbus, Europe's heavily subsidized large aircraft manufacturer, is not cost competitive with Boeing. Yet despite its significant cost disadvantage, once the subsidized A330 had been launched, EADS, Airbus' parent, had an incentive to price it low enough to win a \$35 billion-plus contract awarded on February 28, 2008 to supply the U.S. Air Force with a new fleet of tankers.³⁵

If China, in particular, were to allow its currency to appreciate significantly and other structural surplus countries were to follow suit, it could be a significant step in restoring more balanced trade flows. Experience, however, teaches that even sharp exchange rate shifts can be insufficient to neutralize the effect of government policies that are designed to encourage export-led growth; once export capacity is in place, exports follow.

III. AS PRESENTLY STRUCTURED, THE INTERNATIONAL TRADING SYSTEM IS ILL-EQUIPPED TO DEAL WITH CHANGING CONDITIONS OF INTERNATIONAL TRADE

The refusal to attribute the growth and persistence of today's trade imbalance to factors that raise legitimate trade policy concerns (such as exchange rate manipulation and other mechanisms to promote exports and discourage imports) stems from the belief, expressed by Mr. Bernanke, that "specific trade-related factors cannot explain either the magnitude of the U.S. current account imbalance or its recent sharp rise."³⁶ But this dismisses the impact of systemic differences in the sets of economic incentives and disincentives that shape national economic activity. Surely, it is at least plausible that we import as much as we do because we have chosen a "consumption first" approach to economic policy that promotes debt-driven consumption, and also because U.S. executives have powerful incentive to source off-shore if it means a near term boost to earnings (and their pay). And surely it is also at least plausible that Japan, China, Korea, Germany, and most of the other structural surplus countries run their trade surpluses because, as a matter of deliberate economic policy, they encourage production for export, discourage in various ways "disruptive" imports, and place a far greater value on the stability of their domestic industries than does the United States.

34. The Federal Reserve, Foreign Exchange Rates (Weekly), Historic Rates for Euro Area, http://www.federalreserve.gov/releases/h10/Hist/dat00_eu.htm (last visited Aug. 29, 2009).

35. See Caroline Brothers, *Boeing and Airbus Prepare (Again) for Tanker Battle*, N.Y. TIMES, June 16 (stating contract value), 2009, available at <http://www.nytimes.com/2009/06/17/business/global/17boeing.html>. Boeing has since successfully protested the award of the Air Force tanker contract to Airbus. See *id.* (noting contract award withdrawal following investigation of procurement irregularities); Press Release, Boeing, Boeing Protests U.S. Air Force Tanker Contract Award (Mar. 11, 2008) (announcing Boeing's filing a formal protest on the basis of irregularities in contract procurement), available at http://www.boeing.com/ids/news/2008/q1/080311b_nr.html.

36. Bernanke, *supra* note 9.

A common objection to the contention that trade flow imbalances are the result of deliberate government policies is to focus on allegations of “unfair” trade practices which are not significant enough to explain “either the magnitude of the U.S. current account imbalance or its recent sharp rise.”³⁷ In thinking about the trade policy implications of today’s trade imbalances, it is, however, a mistake to focus on the narrow question of “unfair” foreign competition. The ways in which structural differences in systems of national economic regulation (or non-regulation) affect trade flows go far beyond a question of “fairness” under the rules of the World Trade Organization (WTO). There is nothing inherently unfair about the role of government, or of banks that are under the control or influence of government, in the economies of Korea, China, Japan, or Germany. However, in each country the government has, directly or indirectly, a strong influence on decision-making by business. Similarly, there is nothing that is per se unfair about the organization of Japanese industry by *kieretsu* or the organization of Korean industry by *chaebol*, but the impact of intra-*kieretsu* and *chaebol* business relationships on economic activity in both countries is undeniable.

Although differences in the structures of economic regulation among different countries are well understood, they have had no discernible impact on the evolution of the rules of the international trading system, nor do they inform the political debate over trade policy issues. Instead, the press has tended to dumb down trade policy discourse into “free trade vs. protectionism” platitudes; the inclination of the editorial boards of *The Washington Post*, *The New York Times*, and *The Wall Street Journal* to label any departure from free trade orthodoxy as “protectionist” has choked off serious debate. When John Maynard Keynes said that he had been “brought up . . . to respect free trade not only as an economic doctrine which a rational and instructed person could not doubt, but almost as a part of the moral law,”³⁸ he could be speaking today for most of academia, Wall Street, and the establishment press.

By the late 1930s, however, Keynes had become “a pragmatic, rather than ideological, free trader.”³⁹ He recognized the limitations of free trade policies in a world in which major trading nations were pursuing policies of “economic nationalism,”⁴⁰ and was critical of the American free trade “theologians” with whom he negotiated the structure of the post-war economic order.⁴¹ The parallel today is the challenge to the trading system presented by the export-led growth and import restricting policies that were pioneered by Japan, and have since been emulated by Korea, China, Taiwan and, more recently, Brazil, India, and others. There has been very little discussion of the implications for the international trading system of the changes that have occurred, and continue to occur, in the composition of the major trading nations—but the fact is that China, Japan, India, Brazil, and Korea of the

37. *Id.*

38. John Maynard Keynes, *National Self-Sufficiency*, 22 *YALE REV.* 755, 755–69 (1933).

39. ROBERT SKIDELSKY, JOHN MAYNARD KEYNES, 1883–1946: ECONOMIST, PHILOSOPHER, STATESMAN (Penguin Books 2003), at 635.

40. *See generally id.* (arguing that the world was abandoning the nineteenth century free trader’s economic internationalism in favor of a new economic plan).

41. SKIDELSKY, *supra* note 39, at 811. (“Clayton was at his most doctrinaire, haranguing them on the theme that Britain’s greatness had been built on free trade and convertibility. Coming out of the explosive confrontation Keynes remarked: ‘At one time I had come to believe that the *Mayflower* was filled with lawyers. Now I am inclined to go back to my original belief that it was filled with theologians.’”).

twenty-first century have little in common with Great Britain, France, Canada, and Australia of the late 1940s.

In the aftermath of World War II, Keynes was a principal architect of the Bretton Woods post-war international economic order, including the International Monetary Fund, the General Agreement on Tariffs and Trade (GATT), and the World Bank. The idea behind it was a return to an economic internationalism in which all countries would share in the benefits of open international markets. For the next twenty-five years, as long as the global economy was dominated by countries that shared a commitment to open markets with, more or less, limited intervention by the state, the Bretton Woods system worked well.

To be sure, even in the early post-war years there were countries, particularly Japan, that were nationalist in their export-promotion and import-restricting policies.⁴² But as long as they were the exception to the rule, and as long as inefficiencies in transnational communication and shipping gave domestic production a significant advantage over foreign supply, the threat they presented to the international trading system was manageable.

Today's trade problems are, by contrast, not so easily managed. There are two reasons for this. First, today's global economy is vastly different from the one that existed in the early post-war years. Since the creation of the Bretton Woods international economic order, the international economy has been transformed by: (1) a revolution in information technology and international shipping that makes outsourcing much easier than ever before, and (2) the rise in economic significance of a group of countries that have been wedded to policies of export-led growth coupled with protection of their own markets. These changes lie behind today's unprecedented imbalances in trade flows.

A commitment on the part of China, Korea, Japan, India, Brazil, and Germany to let their currencies float freely, focus less on exports and more on the growth of domestic demand, and make their markets more hospitable to imports would go a long way towards defusing the trade imbalance problem, but this would entail a fundamental restructuring of their economies. For example, it might require a substantial reduction of high tariff barriers, less government "guidance" of industry and the banking system to promote production for export, more vigorous enforcement of rules that protect intellectual property and proscribe anticompetitive collusion by business, better access for imports to distribution systems, or an end to their interventions in currency markets. However, left to their own devices, the probability is that these structural countries will be unwilling either to let their currencies appreciate to the point where their competitiveness in export markets is seriously compromised or put more emphasis on the growth and liberalization of their domestic markets.

China's recent decisions to put an end to its short lived policy of allowing the yuan to appreciate against the dollar and increase its tax rebates on exports exposes a real resistance to meaningful change. So too does the reaction of Japan's economic minister, Kaoru Yasano, to his country's first monthly trade deficit in twenty-six years (excluding atypical trade data for January, when Japanese exports drop for the holidays): "I expect it will only be a temporary phenomenon and believe that the

42. See GREENWALD & KAHN, *supra* note 10, at 142–46 (discussing trade surpluses in Japan, China, South Korea, and Germany).

Japanese economy has not been seriously ill”⁴³ Mr. Yasano, like most Japanese government and business leaders, apparently believes that large Japanese trade surpluses are in the nature of things.

Restoration of a sustainable balance in trade flows will, to be sure, also require very significant changes to the incentives that drive economic behavior in the United States. The United States must act to reign in consumption financed by debt and improve the competitiveness of our industries both by near term measures (e.g., reform that lightens the health care burden on industry), mid-term measures (e.g., an energy policy that reduces the U.S. reliance on imported energy), and long-term measures (e.g., educational reform and worker retraining). Further, a shift away from incentives that make U.S. management so quick to outsource production in order to boost near term profitability (e.g., a lower corporate tax rate for companies that, in any given year, expand their domestic production and employment, and a higher tax on the ordinary income of high-income individuals that tempers the incentive to focus on short-term gains) or make U.S. financial institutions so focused on quick, high returns without sufficient regard to risk (e.g., tighter financial sector regulation) should also lead to salutary changes in U.S. corporate and consumer behavior. Yet, without major changes in the incentives that shape economic behavior in the surplus countries, any measures taken by the United States on its own will almost certainly be insufficient to restore balance to the trading system.

The second reason for the difficulty in addressing today’s trade imbalances relates to the transition from the post-war GATT system which worked primarily through trade diplomacy to the WTO, which focuses far more on the adjudication of trade disputes. As a result, it has become more difficult to deal with trade policy problems that cannot be resolved through trade law litigation. The GATT was flexible enough to allow a country like the United States to use the threat of unilateral measures to press structural surplus countries to moderate their export promotion policies and open their markets to imports. However, with the WTO’s emphasis on adjudicated dispute settlement, the ability to press for policy changes needed to restore more balanced trade flows is much more limited. By its very nature, the WTO’s emphasis on dispute settlement means a narrow focus on evidence showing violations of specific WTO rules. Because the WTO rules do not impose meaningful discipline on most of the policies that structural surplus countries use to maintain their surpluses (e.g., limits on access to distribution systems, inadequate intellectual property protection, and intervention in currency markets), there is no obvious WTO solution to the problem posed by today’s structural trade imbalances.

IV. A PRESCRIPTION FOR TRADE POLICY CHANGE

For sixty years, U.S. trade policy has been centered on the idea that U.S. interests are best served by negotiated agreements to reduce tariffs and non-tariff barriers on a most-favored-nation (MFN) basis. For the last thirty years, the focus on negotiated trade barrier reductions has been complemented by an effort to judicialize the world trading system through binding WTO dispute settlement. The

43. Blaine Harden, *Japan, World’s 2nd-Largest Economy, Reports Rare Trade Deficit*, WASH. POST, Sept. 27, 2008, at A20.

path of least resistance for the new administration will be to continue the policies of the past with modest variations.

In the past, a persuasive case could be made for this sort of continuity of U.S. trade policy. Although millions of manufacturing jobs were lost in import-sensitive industries, often replaced by lower pay and lower benefit service-sector jobs, the real and perceived benefits of free trade were not only substantial but also thought to outweigh any costs by a wide margin with respect to: (1) the American consumer; (2) the efficiency of resource allocation; (3) its role as a check on inflation; and (4) its encouragement of innovation.⁴⁴ Conventional wisdom also favored the shift away from international trade diplomacy to a rule of international trade law, even though the assumed benefits of that shift were impossible to quantify.

More recently, the case that the overall benefits of continuity in trade policy clearly outweigh the costs has become much more difficult to make. As the U.S. trade deficit has ballooned,⁴⁵ U.S. economic growth has been supported by surplus country lending that has, in turn, fueled the recent dot-com and housing bubbles, millions of Americans have lost their manufacturing jobs, and the real income of average Americans has stagnated and, most recently, declined.⁴⁶ Furthermore, it is increasingly apparent that one of the key unspoken assumptions behind U.S. trade policy—that the export opportunities associated with the growth of global demand are shared more or less equally among major trading nations—is demonstrably false. Simply put, U.S. producers of goods and services do not have nearly the same level of access to the markets of China, Japan, Korea, India, or Brazil as their producers have to the U.S. market. Moreover, there is little evidence that the growth of domestic demand in these countries will be sufficient to offset the impact of a drop in U.S. demand on the global economy.

Notwithstanding all of this, present U.S. policy may well end up as little more than an extension of previous approaches, focusing on a series of bilateral free trade agreements and the Doha Round of multilateral trade negotiations. The U.S.-Korea bilateral trade agreement is particularly disappointing because it holds little promise for the sort of structural changes needed to make the Korean market more hospitable to imports.⁴⁷ As to the Doha Round, if it were to conclude with the set of

44. Lori G. Kletzer, *Globalization and Job Loss, From Manufacturing to Services*, 29 *ECON. PERSPS.* 2nd Q., at 38, 42–43 (2005) (discussing manufacturing job loss); James Langenfeld & James Nieberding, *The Benefits of Free Trade to U.S. Consumers: Quantitative Confirmation Of Theoretical Expectation*, 40 *BUS. ECONS.* 41, 43–45, 49 (2005) (discussing perceived trade benefits). This is not to deny that the loss of manufacturing jobs in the United States over the past few decades has been more the consequence of productivity gains than imports. Ambassador Terry Miller, *Productivity Growth, Not Trade, Is Cutting Manufacturing Jobs*, HERITAGE FOUND., Nov. 27, 2007, <http://www.heritage.org/Research/Economy/wm1709.cfm> (last visited Oct. 4, 2009).

45. The U.S. trade deficit peaked in 2006 at \$765 billion, or 5.8% of gross domestic product. It fell to \$708.5 billion, or 5.1% of GDP, in 2007. See Christian E. Weller and Holly Wheeler, *Nothing to Brag About: U.S. Trade Deficit Remains High Priority Despite Recent Improvements*, Center for American Progress, Mar. 26, 2008, http://www.americanprogress.org/issues/2008/03/high_priority.html (last visited Oct. 14, 2009).

46. Hope Yen, *U.S. Income Gap Widens as Poor Take Hit in Recession*, ASSOCIATED PRESS, Sept. 29, 2009, available at http://www.msnbc.msn.com/id/33066877/ns/business-stocks_and_economy.

47. It is important to distinguish between the Korean bilateral, which should be subject to a careful review of the changes needed to open the Korean market for autos and other manufactured imports in a meaningful way, and the bilaterals with Colombia and Panama. Colombia and Panama have been far more hospitable to American products than Korea.

agreements presently contemplated, it would do nothing of consequence to significantly open the markets of structural surplus countries. *In fact, if the Doha Round were to conclude with the sorts of concessions now on offer, it would be counterproductive because it would lock in, for another decade, limits on access to the markets of structural surplus countries as well as a set of rules that do not adequately address the core trade challenges we face.* The sorts of changes to the WTO rules needed to address structural imbalances in trade flows are not even on the negotiating agenda, such as the ability to impose safeguard measures on a selective rather than a most-favored-nation basis and the transformation of an archaic set of GATT/WTO “balance of payment” rules into a workable set of “balance of trade” rules.

Accomplishing the very difficult changes needed to restore balance to the international trading system is a daunting task that will require time, resolve, and patience. The best course of action would be to put the Doha Round and the Korean free trade agreement on hold for a year or two to give the new administration the time to: (1) put the immediate emphasis on regenerating the growth of the global economy and (2) mobilize support for real, long-term change. The United States cannot expect to do what needs to be done on its own. Therefore, a break from the status quo should include a much better working relationship on trade matters with Europe and other countries that generally share the United States’ commitment to open markets and vigorous international competition. This is not to minimize the trade policy differences we have with Europe, Canada, and others on agriculture and other products (such as commercial aircraft and softwood lumber), but, in the great scheme of things, these differences do not threaten the viability of the international trading system. The problems posed by structural trade imbalances do.

There are three final points to be made. First, much has been made (rightly) of the link between trade and economic development. The Doha Round was launched as an effort to improve conditions of trade for developing countries. However, the reality is that in any number of sectors, the MFN trade barrier reductions that the United States and others would make in the Doha Round negotiations would benefit China and other structural surplus countries *at the expense* of many of the poorest countries. Textile trade data illustrate the point. In the last round of multilateral trade negotiations, the Uruguay Round, the United States agreed to eliminate its textile quotas. Between 2002 and 2007, U.S. imports of knit and woven apparel increased by \$15.7 billion, from \$58.9 billion to \$74.6 billion.⁴⁸ The increase in imports from China, which rose from \$7.1 billion in 2002 to \$24 billion in 2007, was greater than the increase in total imports.⁴⁹ Thus, despite the overall rise in imports, the net result of the Uruguay Round liberalization of textile and apparel trade was the displacement by Chinese imports of apparel that had been previously been imported to the United States by several developing countries, including Mexico.⁵⁰ In addition, MFN tariff barrier reductions under negotiation in the Doha Round

48. See OTII, *supra* note 16 (click “National Trade Data”; then select “Global Patterns”; then select “Imports” under flow and select item “HS-61”; then select display years “2002 to 2007” and click “Go” button. Then repeat for “HS-62”) (last visited July 6, 2009) (presenting import statistics for “apparel articles and accessories, knit or crochet” and “apparel articles and accessories, not knit etc”).

49. See *id.*

50. See *id.* (showing decrease in dollar amount for imports from Mexico for apparel articles and accessories, including “knit or crochet” and “not knit etc”).

would *reduce* the value of the preferential duty-free access to the U.S. market that developing countries now receive under free trade agreements and the U.S. system of generalized preferences.⁵¹

In an April 6, 2008 editorial, *The New York Times* perpetuated the fiction that the Doha Round will deliver significant benefits to the world's poorest countries ("Would [Senator Clinton and Obama] want to block a global trade accord designed to help the poorest countries?").⁵² But if real development is the objective, the evidence suggests that an end to China's (or India's or Brazil's) form of modern day mercantilism through, for example, significant appreciation of China's currency coupled with preferential access to the U.S. market for imports from the poorest countries would do far more for development than a set of Doha Round agreements ever would.

Second, there is a legitimate question about whether the measures needed to force changes that would open the markets of the structural surplus countries to imports would be consistent with the rules of the international trading system as they now exist. The answer is "no" and "yes": "no" because the WTO places strict limits on unilateral measures, but "yes" because certain unilateral measures are permitted,⁵³ and, in any event, each WTO member is free to act inconsistently with the rules on the understanding that other countries may demand compensation or take retaliatory measures of their own. Despite efforts to judicialize the trading system, it still depends on *voluntary* adherence to the rules, which, in turn, should depend on a satisfactory balance of benefits among WTO members.

The fact is that the existing rules simply do not satisfactorily address the impact of a systematically undervalued currency, a multitude of non-tariff barriers to trade, and informal business combinations on which most export-led growth and import-restricting policies depend, and there is presently little incentive for surplus countries to accept the need for change. The reasons Brazil and India have resisted offering meaningful concessions in the Doha Round on their tariff levels, for example, are no mystery. First, having seen the impact of imports from China on U.S. manufacturing, neither country is about to let the same thing happen to their industries. Second, they view the status quo, with its easy access to the markets of the U.S. and other industrialized countries, as perfectly acceptable.

Because the United States has already reduced most of its tariffs on manufactured goods to nuisance levels (or less), because the United States does not permit business combinations that operate as effective non-tariff barriers to trade, and because the trade measures that the United States does use, such as the anti-dumping law, are already subject to strict WTO discipline, it has little leverage within the WTO system that can be used to persuade a country such as China, South Korea, India, or Brazil to agree to significant changes in their export incentives or import disincentives. The leverage needed to promote exchange rate adjustments and to open overseas markets that now limit the access of U.S. goods and services must be created. If we lived in a world where all major trading nations shared the

51. Raj Bhala, *Resurrecting the Doha Round: Devilish Details, Grand Themes, and China Too*, 45 *TEX. INT'L L.J.* 1, 96 (2009).

52. Editorial, *Some Truth About Trade*, *N.Y. TIMES*, Apr. 6, 2008, available at <http://www.nytimes.com/2008/04/06/opinion/06sun1.html>.

53. Anti-subsidy measures could, for example, be used to offset a country's intervention in currency markets.

U.S. commitment to free market economics, there would be no need to argue for change to a U.S. trade policy that has been remarkably consistent for the past sixty years. Unfortunately, that is not the world we live in.

Third, if the United States cannot convince its structural surplus trading partners of the need to change their export-promoting and import-restricting policies, the only recourse may be for the United States to think of trade policy not as a march to freer trade but as a buffer that limits the trade imbalances and resulting dislocations attributable to deep differences in national systems of economic regulation (or non-regulation). If U.S. thinking were to come to this, it would mean a complete and regrettable, but unavoidable, break with U.S. trade policy of the past sixty years.

One of the lessons of the global financial crisis has been the fragility of a global economy that depends too heavily on U.S. consumption and the debt that supported it. Healthy growth of the international economy requires that: exchange rates adjust to eliminate sustained trade imbalances, export capacity that has been targeted at the U.S. market look to demand elsewhere, countries that have depended on export-led growth shift their focus to their domestic markets, and the United States import less and export more. The danger is that once the present crisis passes, and global growth resumes, the path of least resistance will be to revert to the economic and trade policies of the past. That will simply create the conditions for the next global economic crisis. In order to encourage the difficult adjustments needed to restore a sustainable balance in the global economy, the United States is in dire need of a more pragmatic, less ideological, approach to trade policy.