Globalization Doesn't Make as Much Sense as It Used To

Since its founding, America has swung from protectionism to free trade. What's next?

The restored nose and cockpit section of a World War II-era B-24 bomber Rebecca Cook / Reuters

Like *The Atlantic*? Subscribe to the Daily, our free weekday email newsletter.

A large number of American voters are tired of globalization—that much is clear. With Donald Trump calling for the abandonment of the North American Free Trade Agreement (or, more commonly, NAFTA) and Hillary Clinton turning her back on the Trans Pacific Partnership (TPP) free-trade agreement she herself had originally helped launch, both major-candidates abandoned what had come to be the standard pro-globalization position of those vying for the nation's highest office. Most economists and many think-tank researchers have bemoaned this development, insisting that globalization generally leaves most nations—and most people—better off. But a review of American economic history suggests that something fundamental has changed: Increased globalization may make less sense now than it did in the recent past.

An exploration of the fundamental concepts of modern life
Read more

Trump supporters would argue that this is the problem - other countries do not play by the rules that America has set - business should not be supported or subsidized by government policy or action. And why should they you might ask? You would be right, and thats why Donald Trump won, to stop America from playing the losing hand in the game

In the earliest days of the United States, globalization and competitiveness were some of the biggest issues on its founders' minds. Adam Smith's *The Wealth of Nations* was published in 1776, and the framers later debated Smith's arguments for deregulation, free markets, and open trade. Thomas Jefferson saw the United States as primarily an agricultural producer and spoke for the Southern planters, who depended on foreign markets and who embraced Smith's notion of minimal government. Alexander Hamilton felt differently: Aware of the mercantilism-fueled Industrial Revolution in the U.K. and the unprecedented wealth it created, he took the side of the nascent manufacturers of the Northern colonies by calling for subsidies to support the development of technology and manufacturing industries, as well as high tariffs to protect them.

Hamilton understood Smith's free-market, free-trade arguments and agreed that if all nations played by Smith's rules, free trade would be the best policy for the fledgling United States to adopt. But he noted that neither the U.K. nor any other nation yet adhered to the conditions Smith laid out, and warned that it would be folly for the U.S. to be the exception. George Washington sided with Hamilton on the issue. In contrast to most of his upper-class peers, Washington wore only garments made of domestically produced fabric, and emphasized that he bought no cheese or beer "but such as is made in America."

When the War of 1812 was nearly lost for want of the young nation's capability to produce the necessities of war, Jefferson changed his mind. Declaring that "manufactures are now as necessary to our independence as to our comfort," he came around in support of high tariffs to protect American industry. Thus, from shortly after the war to about 1950, the United States enacted mercantilist trade and industrial policies; by 1900, it had become the richest country the world had ever seen. America became rich, not from free trade but from making things... and umm...slavery)

By the end of World War II, with the economic infrastructure of Europe and Japan in ruins, virtually every American industry could out-compete those in the rest of the world. American industry was so strong, in fact, that it no longer needed the help and protection of the government. Rather, it needed the rest of the world to recover economically from the war, so that there would be markets open to its exports and investment. And once there were, the U.S. would gain from pursuing policies that promoted globalization.

The theory behind globalization was first enunciated in 1817, when the British banker David Ricardo outlined the concept of comparative advantage. Using the example of the production of cloth and wine in Britain and Portugal, Ricardo posited that Britain needed 100 hours of labor to produce a unit of cloth and 120 to produce a unit of wine, while in Portugal the time required was only 90 hours for cloth and 80 for wine. Portugal was the lower-cost producer of both products, but Ricardo's key insight was that the Portuguese had a bigger advantage in wine than in cloth. If both countries specialized in the product in which they held a comparative advantage and traded for the rest, the global amount produced of both products would be greater and each country would have more of both.

Economists after Ricardo added more specifics to his ideas. They theorized that global trade flows were determined by a given country's endowments of labor, capital, and natural resources. Nations with lots of cheap labor would produce labor-intensive products (shoes, textiles) while those with a lot of capital would produce capital-intensive products (machinery, cars), and those with abundant natural resources (oil, ore) would mine and export them.

The period between 1945 and 1975 saw the appearance first of a miraculous German recovery in the 1950s and then a miraculous Japanese recovery in the 1960s.

So, in theory, free trade was a win-win proposition, but only as long as a few key assumptions held true: There needed to be fixed exchange rates, full employment, an absence of international flows of labor or capital, an absence of economies of scale, and perfectly competitive markets. Too many rules. America could only succeed at this complicated game when other countries were undeveloped.

Such conditions could almost never be found in reality, but as it happened, the features of global economy in the late 1940s and 1950s came pretty close to matching them: The International Monetary Fund maintained a system of fixed exchange rates, such that the dollar was valued at a fixed amount of gold and all other currencies were fixed to the dollar; most international trade was in commodities like sugar and iron ore, which were traded in more or less perfectly competitive markets with no economies of scale; and the rise of multinational corporations was mostly still in the future, so international financial, labor, and technological flows were limited. These circumstances made free trade newly viable, and the country swiftly abandoned mercantilism.

For about 30 years it worked splendidly, with the U.S. profiting greatly from the global postwar recovery and participating in the foreign markets it revived. With Washington taking the lead, a series of international negotiations dramatically reduced tariffs and trade barriers. In addition, advances in shipping dramatically reduced transport costs, while corporations started making more foreign investments, carrying new technologies with them. The period between 1945 and 1975 saw the appearance first of a miraculous German recovery in the 1950s and then a miraculous Japanese recovery in the 1960s. Meanwhile, in the U.S., median household income and per-capita income roughly doubled during that postwar period, while unemployment and inflation remained generally low.

This is an extremely important point below - American cities like Detroit and Cleveland were sacrificed in order to help the free world win the Cold War.

Then circumstances changed. As the productivity of other countries rose faster than America's in the rush of recovery from the war, exchange rates initially set in the late 1940s should have been adjusted to reflect the changes in relative productivity. But for various reasons—in part because of the U.S.'s desire during the Cold War to strengthen the economies of its allies—exchange rates were held steady, and was reflected in the U.S.'s balance of international payments, which went into a steep deficit as America increasingly imported more than it exported. In 1971, the United States ran its first trade deficit—$1.3 billion—since 1888. The dollar was at that time convertible into gold, and the metal flowed out of the country as foreign exporters cashed in their dollars for something they deemed safer for the long run.

Despite government efforts to stem the deficit, it only continued growing. In 1972, President Nixon threw out the postwar fixed-rate system by refusing to make further gold payments and letting the value of the dollar be determined by the forces of the currency markets. That provided some relief for America as currencies adjusted to more realistic exchange rates, but many countries continued to maintain substantial barriers to imports and began buying and selling dollars in efforts to keep their currencies somewhat undervalued versus the dollar. By 1980, America's trade deficit was nearly $20 billion and growing, as globalization broadened.

These shifts represented departures from those crucial base-state theoretical conditions upon which free trade depended. First, the advent of shipping containers and the construction of huge vessels dramatically reduced the costs of international transport. Also, trade that in the past had been largely in commodities came to be dominated by the manufactured goods of industries characterized by economies of scale, such as steel, cars, and chemicals—which violated another theoretical assumption in the argument for free trade.

Further deviating from those assumptions were the policies of major trading countries such as Japan, which accounted for half of the U.S.'s trade deficit. In theory, nations were expected to concentrate on producing and exporting what they did best while importing most everything else. But, like Alexander Hamilton and a number of early American leaders, Japan and others chose not to go along with that thinking. Some of the key elements of Japan's approach were a focus on exports, the protection of domestic markets, government-guided investment in industries that featured economies of scale (steel, ship-building, and semiconductors, to name a few), and the management of the yen to be undervalued versus the dollar. As an architect of Japan's strategy, Naohiro Amaya, explained to me for my 1988 book *Trading Places*, "We did the opposite of what the American economists told us."

This was not the comparative-advantage theory of Ricardo—it was catch-up industrial policy, and it worked so well that it was quickly imitated by countries in Asia and beyond. It was through a strategy like this, in which the government favored certain industries, that South Korea—a country with little in the way of natural resources, capital, or skilled labor—could come to gain an edge in producing cars, semiconductors, and other goods.

The notion that the government could pick winners and losers did not fit with the American suspicion of government.

These policies, along with expanded international flows of finance and technology and trade dominated by industries with economies of scale, essentially negated the assumptions upon which the postwar conventional wisdom of free trade was based. Indeed, in the early 1980s, the economists Paul Krugman, James Brander, Joseph Stiglitz, and others began to note that the standard assumptions of free trade had become unrealistic. Krugman in particular emphasized that economies of scale are a driver of trade flows as important as land, labor, and capital, at least in industries such as aircraft- and car-manufacturing. For this work, he was eventually awarded the Nobel Prize in economics in 2008.

Some thought that these economists' work would influence trade policy. But there was a problem. Incorporating economies of scale into the equation meant that comparative advantage depended not only on the factors of production—labor, land, capital—but also on quantities produced. Advantage, as Hamilton had long ago perceived, could thus be created by policies that would, through the selective imposition of tariffs, subsidies, and other policies, encourage certain industries to thrive. This is what Naohiro Amaya meant when he spoke of rejecting American advice on free trade: He was in the business of picking winners.

So why are Americans still listening to American economists now? They have been wrong every time. See below...

But the notion that the government could pick winners and losers did not fit with the American suspicion of government, not to mention with the established views of academics and pundits heavily invested in orthodoxy. Conservatives automatically rejected the idea of such government intervention, and national-security groups that had become accustomed to using free-trade deals as bargaining chips for foreign geopolitical support were also strongly opposed. Some academics added that mercantilism might work in theory but would be captured by special interests in practice. (Still, none seemed to recognize that having little policy in the face of other countries' policies was still a policy—one that deserted the industries targeted by other governments.) Meanwhile, American industry dies while government does nothing while the rust belt rusts

So, there came to be a consensus that the fix was for America to negotiate more and better free-trade deals, and that is what Washington tried to do until about a year ago. The result has been the establishment of the World Trade Organization (WTO), NAFTA, the U.S.-Korea (KORUS) free-trade agreement, and China's entrance into the WTO. These developments have been accompanied by a steady increase of the U.S.'s annual trade deficit (from the roughly $20 billion in 1980 to the current $500 billion), the offshoring of much formerly U.S.-based production (even in capital- and technology-intensive industries), and the widening of inequality in U.S. incomes and wealth.

The results of the election seem to indicate that—the views of economists and foreign-policy experts notwithstanding—America is about to change course on trade policy. That doesn't necessarily mean a return to pre-World War II protectionism. It could instead simply mean a revival of the spirit that inspired the foundations of the postwar economic order. That spirit, articulated by the economist John Maynard Keynes, focused on assuring balanced trade—the avoidance of chronic surpluses on the part of some trading partners and chronic deficits on the part of others. Thus a new order might operate to prevent the misalignment of currency valuations, to abolish or offset the impact of tax subsidies, and to mitigate the implicit subsidization of state-owned enterprises. It has been largely forgotten that one of the key objectives of postwar free-trade policy was to maintain a roughly balanced trade account—a goal that the country is likely about to pursue anew and that will likely affect its policies touching on not just trade, but investments, currency, technology, and labor as well. Donald Trump full speed ahead...except on Taiwan, please take it easy on Taiwan, there is only 1 China okay?