UNIVERSITY OF CAMBRIDGE
Faculty of Economics

Cambridge Working Paper Economics

Cambridge Working Paper Economics: 1825

UNDERSTANDING THE CHALLENGES TO THE WORLD TRADING SYSTEM

Meredith A. Crowley

6 April 2018

This paper discusses the challenges to the world trading system presented by the Brexit vote in the UK and the election of Trump in the U.S. It reviews two recent books and several papers that inform our understanding of these issues

Understanding the challenges to the world trading system

Meredith A. Crowley[1]

I. Introduction

The last two years have brought unprecedented challenges to the post-war world trading system that was established in 1947. Beginning with a General Agreement on Tariffs and Trade (GATT), an agreement that sought to reduce import tariffs and establish ground rules for fair trade among 23 countries, the system expanded to ultimately embrace a World Trade Organization of 164 countries, ``deeper'' agreements that sought to integrate nations economically, like the European Union, and hundreds of smaller regional trade agreements like the North American Free Trade Agreement (NAFTA) that liberalized almost all trade in goods between close neighbors. Seventy years after establishing the GATT as the architecture to govern and deepen trading relations among nations, support for free trade and the institutions that support it has plummeted. In 2016, the world witnessed the British public voting to exit from ever deeper integration with the European Union and the election of a US president who is a vociferous opponent of free trade and open borders.

The question confronting us today is whether recent changes in US and UK trade policy signal the end of the post-war liberal economic order and the broad commitment to free trade or just a rejection of particular institutions and/or specific policies.

The challenges to the rules-based system of trade governance (the WTO) are taking place in the context of some important and relatively recent changes in the international economy. Firstly, the rise of global supply chains, facilitated by improved communications and transportation infrastructure, has reorganized the political economy of trade policy. The long-standing alliance between import-competing firms and their workers to jointly lobby for import tariffs and other trade restrictions has given way to shifting and, at times, divided interests with multinational firms having to consider the impact of any trade restrictions on their foreign subsidiaries, before they worry too much about their workers. Secondly, a number of economic studies have documented the unprecedented magnitude of the difficult reallocation of US workers out of import-competing manufacturing sectors in response to the rise of China as an export power (Autor, Dorn, Hansen, 2013 and Pierce and Schott, 2016). Finally, a failure to address concerns with WTO rules through cooperative negotiations has forced many contentious issues to be resolved through the WTO's Dispute Settlement System. This, in turn, has led to rulings that created a perception that global trade rules are unfairly tilted against high-income countries, especially the US.

The two books under review, Douglas Irwin's Free Trade Under Fire, 4th edition, and The Handbook of Commercial Policy (HCP), edited by Kyle Bagwll and Robert Staiger, together offer insightful and rigorous analyses of the current controversies surrounding trade policy.

A steady stream of attacks on the institutions of the global trading system have been present since well before the first edition of Irwin's Free Trade under Fire was published in 2002. Episodes of popular anti-globalization backlash such as the Battle in Seattle at the time of the WTO's 1999 Ministerial Conference provided the motive for putting together a book that carefully explained the economic problems frequently attributed to international trade and then developed a thoughtful rebuttal by combining economic theory with contemporary empirical evidence. Now in its fourth edition, the book seems has become even more relevant and vital for understanding the dramatic

---

[1] University of Cambridge Faculty of Economics and the Centre for Economic Policy Research

changes in the world that we have witnessed over the last two years. The revised edition provides a wonderful elucidation of the intellectual case in favour of free trade alongside a sensitive analysis of important controversies like the steep decline in high-wage manufacturing jobs over the last twenty years. Irwin's book covers the main arguments raised as defences against free trade and deftly dispels the misconceptions and misunderstandings in a manner accessible to a broad audience.

A more technical and academic treatment of some of the topics covered in Irwin's book can be found in the recently published Handbook of Commercial Policy (HCP), edited by Robert Staiger and Kyle Bagwell. The HCP reviews the academic literature on trade and commercial policy from a number of vantage points. Its opening chapters review the facts and literature on both the formation and effects of trade policy for individual countries. It then proceeds to deeper theoretical questions with chapters on the institutional design and purpose of trade agreements. Finally, it reviews a large number of detailed policy areas in international trade such as special tariff protection under contingency measures, preferential trade agreements, WTO dispute settlement, the treatment of intellectual property rights under the WTO, non-tariff barriers to trade, and the special position of developing countries in the world trading system.

Together, these two books – one easily accessible to non-economists and the other written for PhD students in economics and academic specialists – provide useful insights for understanding the current, heated controversies over the future direction of the US's trade policy.

II. The case for free trade today

Irwin's book opens with facts familiar to many economists, but which are important for correcting misunderstandings that interested non-specialists might have gleaned from newspapers and the popular media. He introduces and explains the principle of comparative advantage and provides examples from history, such as Japan's opening to trade in the 1850s, to illustrate important points. Further benefits of trade, such as the decline in prices and markups when monopolistically competitive firms are exposed to more competition, are also described with vivid examples.

In presenting the case for free trade, Irwin appeals to a wealth of data and studies – a long history of trade liberalization has created real benefits in the form of higher productivity and lower prices. While some of the evidence on productivity and the welfare gains from trade are familiar, Irwin makes interesting points about the environmental case for freer trade and other non-economic benefits such as the promotion of peace and the expansion and strengthening of democratic institutions. Environmentalists sometimes advocate purchasing locally-produced goods so that the pollution associated with shipping can be prevented. Irwin points out that not only shipping, but production costs must be taken into account. He offers the example of shipping cut flowers from Kenya to the Netherlands. Even though flowers travel from East Africa to Europe in energy-intensive, polluting jets, they still create a lower negative environmental burden than energy-intensive hot house flowers grown in the Netherlands. Other examples include the use of import tariffs on sugar ethanol and solar panels, which aid farmers and producers at the environment's expense.

To wrap up the case for free trade, Irwin devotes a chapter to the costs of trade protection. He examines the cost-benefit trade-off of tariffs that raise prices for consumers and downstream input users in order to save small numbers of jobs. An important point raised is that the political economy in support of import restrictions is counter-productive not only because of its high cost to save so few jobs, but also because it creates a lost opportunity for new employment in other, more productive industries. Overtime, the balance of power in the political economy of trade policy has shifted. Irwin notes that whereas import-competing interests were traditionally better-organized and more united than downstream firms in their lobbying for trade restrictions, this began to change in the 1990s with successful organized opposition by downstream firms to costly trade barriers on steel and memory chips. This trend continues today in the opposition on the part of American manufacturers to proposals to withdraw the US from the North American Free Trade Agreement. These producers understand the interconnectedness and dependence of their activity on that of production taking place in Canada and Mexico, even if the US president does not.

II. How has freer trade impacted workers?

The central focus of the trade policy debate in the high income world today is the relationship between open markets, competition from lower wage countries, and manufacturing job loss. Trade-induced employment loss is also a top concern in middle income countries in which rising wages create fear of production de-location to lower wage destinations. The lowest income countries express their employment fears in terms of premature de-industrialization due to cheap robots that could replace humans in the manufacture of even the most labour-intensive goods. What are we to make of this and what is the evidence on the relationship between trade, employment, wages, and the distribution of income?

Irwin tackles all of these questions in a review of the history of US manufacturing employment and wage growth from the 1960s through today. His review of the evidence first focuses on long term trends and emphasizes the difficulty in identifying job losses associated with trade competition versus technological change – but ultimately concludes that technology is the most important driver behind some occupations becoming irrelevant and reductions in the number of workers required for production in many manufacturing sectors.

The real problem in the US economy today is that of reallocating workers to new jobs when their old ones have disappeared either because of intense import competition from a lower wage country or because of better technology. A number of recent papers discussed by Irwin (Autor, Dorn, Hansen, 2013 and Pierce and Schott, 2016) have found that the cliff-edge declines in US manufacturing employment in the wake of the 2001 recession and the 2008 global financial crisis were *caused* by increased imports from China. The scale of job loss in the manufacturing sector is unprecedented and has clearly created real hardship for those workers who have struggled to find new jobs that offered the same wages and working conditions as the jobs they have lost.

The chapter concludes with a description of the US's Trade Adjustment Assistance (TAA) program that is designed to aid workers who have suffered trade-induced job loss. In a nutshell, the program does not have a great track record – an evaluation by Mathematica Policy Research in 2012 found that program participants ended up worse off than a control group of workers who did not receive any TAA benefits! However, the failure of the specific program could simply point to flaws in its design relative to peoples' needs; an alternative program of government wage insurance for displaced workers sounds promising and is worth studying.

Irwin's study is entirely focused on the consequences of trade liberalization for US workers, but what about the rest of the world? A review of the literature of the impact of trade policy changes on numerous outcomes: (1) trade volumes, prices, the extensive margin, and the gains from trade, (2) firm productivity, costs, and markups, (3) labour markets, and (4) poverty is covered in the HCP's chapter on "The Effects of Trade Policy" by Goldberg and Pavcnik. A key point raised in their chapter is that labour market studies in high income countries tend to look at the response of labour markets to changing trade volumes or import competition (which are clearly endogenous to policy changes) whereas studies in middle and lower income countries tend to use variation in trade policy, such as that observed during trade liberalizations, to study the impact on employment and wages. A central conclusion is that the impact of trade policy changes on workers depends on the local labour market frictions in the country under study, the geographical concentration of affected industries and workers' geographic mobility within the country. Broadly, trade liberalizations tend to have small impacts on employment and relatively large impacts on wages in developing countries whereas in high-income countries the margin of adjustment is primarily employment, with only small adjustments to wages.

III. Special import protection and the World Trade Organization

The 70 years of gradual tariff and quota liberalization under the GATT and WTO was conducted cooperatively, through rounds of trade negotiations in which countries made offers of liberalization of some sectors in exchange for substantially equivalent market opening by their trading partners. Along the way some sectors, notably textiles and apparel and agriculture, raised a fierce resistance to liberalization and the job loss it entailed as production of simple, labour-intensive goods moved to lower wage countries. The result was to develop specific carve-out agreements that allowed protection against imports through, for example, a system of globally established quantitative restrictions for textiles and apparel or detailed commitments over the level and form of state aid to the farm sector.

Other sectors of the economy also received extensive "special" protection against competition from imports through a number of GATT and WTO sanctioned agreements. Irwin discusses this set of policies – safeguard, antidumping and anti-subsidy tariffs and trade restrictions – in his chapter on "Relief from Foreign Competition." Irwin's analysis focuses on the stated objectives of these policies, whether their application is in line with the stated objectives, and, finally, and most importantly, whether the design of the policies is premised on sound economic analysis.

These various policies are often split into two distinct groups – fair and unfair trade remedies. Antidumping and anti-subsidy (or countervailing) duties address "unfair" trade while safeguards are used to respond to "fair," but intense foreign competition. The premise behind the unfair trade remedies is that foreign firms might engage in anti-competitive price-undercutting that creates permanent harm to domestic import-competing firms that are then forced to leave the domestic market and ultimately, leave consumers exposed to the whims of a foreign monopolist. The anti-subsidy part of the unfair trade law takes a similar view with regard to foreign government subsidization of foreign industry – even if the short term result of foreign actions is low prices that benefit an importing country's consumers, the long-term costs could be high if the subsidies undermine an import-competing industry that, but for the foreign government action, would have a comparative advantage.

As Irwin explains, the problems really begin with the implementation of these policies --- a great deal of research has documented the application of these policies is almost entirely unrelated to anti-competitive practices by firms. Historically, the methodologies in the United States have shown a clear bias in favour of finding "unfair" pricing, even when it might be more properly described as aggressive or time-varying, and of finding harm *caused* by import competition even when other factors, such as a general slump in domestic demand are behind the industry's woes. Irwin points out that while "fair" trade policies, which are meant to a provide a period of reduced pressure from intense competition to help a stressed or lagging industry get back on its feet, appear to be less abused by protectionist interests, they are still a relatively inefficient policy for addressing the troubles befalling a laggard industry; direct subsidization or technology transfer would be less costly and arguably more effective at raising productivity.

This entire discussion raises questions of how important are these policies for countries like the US and why are they used if they are such an inefficient way of addressing a problem. This is taken up by several chapters in the HCP, first by Chad Bown and myself in our overview of trade policy around the world and then, in greater depth with regard to the institutional details of each policy, by Bloningen and Prusa in a chapter on anti-dumping, Beshkar and Bond on safeguards, and Lee on subsidies and countervailing (anti-subsidy) policies. These different chapters reflect different approaches to understanding the entire system of import protection; the chapters by Bown and myself and by Beshkar and Bond, "The Empirical Landscape of Trade Policy" and "The Escape Clause in Trade Agreements," respectively, both offer a holistic view that analyses special import protection in the context of the larger WTO agreement to liberalize trade. In contrast, Blonigen and Prusa's and Lee's chapters take an approach more similar to that in Irwin by offering a review of the literature on antidumping and subsidies that explores each policy on its own merits, largely from an industrial organization and strategic policy perspective.

To understand special import protection as part of the larger WTO agreement, it is useful to step back and start with a broader question: do some countries have more liberal trading regimes than others? Bown and I take this up in the opening chapter of the HCP. The short answer is yes *if we limit our analysis to applied most-favored-nation (MFN) import tariffs.* Cross-country differences in the average level of the import tariffs are large and are correlated with a country's level of economic development. High-income countries generally charge low import tariffs and maintain liberal trade regimes. Middle-income countries vary tremendously in the extent of their openness, but many offer substantial access to their markets while low-income countries, on average, have the highest import tariffs in place.

However, the answer becomes more complicated when we extend the set of policy barriers to trade beyond applied MFN tariffs. For example, high income countries appear even more open when we expand the analysis to include preferential import tariffs that they offer to select trading partners. The members of the European Union, the world's largest and most important customs union, charge no import tariffs on merchandise from one another implying that the average import tariff that the European Union countries charge over union members and non-members is even lower than its headline tariffs reported under the WTO. However, both high income and emerging economies appear less open when we expand the set of policies beyond tariffs to include special import protection (antidumping, safeguards, countervailing duties, often referred to collectively as temporary trade barriers). While sometimes dismissed as quantitatively not that important, Bown and I document that, for the US, approximately 5 percent of Harmonized System (HS) 6 digit product codes had a temporary trade barrier – a tariff or quota – in place in every year over the last twenty years. Similarly, the EU had some kind of temporary tariff barrier in place against non-Union imports on about 3 percent of HS products. In sum, trade policy in many high-income economies is characterised by free or almost free trade in the vast majority of goods alongside restrictive, time-varying tariffs and quotas in smaller set of goods.

Both theoretical and empirical research confirm that the sustainability of a liberal trade agreement depends on whether and how much flexibility governments have over tariffs in response to import volume shocks. Thus, the holistic view of special import protection as a necessary feature of a liberal trade agreement claims that we observe low tariffs on most importable goods alongside high, time-varying import tariffs on a small share (about 5 percent) of imported goods because self-enforcing trade agreements require contingency provisions to relax commitments to low tariffs or free trade in the face of sector-specific shocks to import demand or export supply.

In “The Design of Trade Agreements,” Bagwell and Staiger’s chapter in the HCP, they present a review of the literature in which the fundamental problem sovereign nations face in implementing tariff reductions is that, if the countries are large, unilateral tariff reductions will cause a deterioration of the country’s terms of trade, lowering its welfare. The efficient solution to this problem is then to negotiate tariff reductions with a large trading partner (or partners) reciprocally, so that tariff reductions in country A which worsen its terms of trade are offset by tariff reductions in country B which (symmetrically) worsen its terms of trade – the end result is no change in either country’s terms of trade (due to the reciprocal symmetry), but an expansion of trade and more efficient production associated with lower trade barriers. Beshkar and Bond’s chapter on “The Escape Clause in Trade Agreements” continues with this story by discussing how flexibility to adjust the terms of the symmetric liberalization for a sector hit with a large change in import volume, either through import tariffs or export taxes, is essential to maintaining the broad level of liberalization over all other sectors of the economy.

Empirically, Bown and I offer an assessment of special import protection that expands on the ideas reviewed in Beshkar and Bond’s chapter. Namely, *all special import measures* – not only safeguards, but also antidumping, and, to some degree, anti-subsidy duties – function as contingent tariffs used to offset import volume shocks. In this view, it is unsurprising that antidumping rules and practice are so wildly divorced from any sensible assessment of anti-competitive practices. Because they have become a de facto policy to address any kind of intense import pressure, the criteria used to evaluate their formation should be, in practice, related to their role as a safety valve for pressure in trade agreements. This is the precisely the finding in a series of papers (Bown and Crowley, 2013a and Bown and Crowley, 2013b; and Bown and Crowley 2014) discussed in the Beshkar and Bond chapter.

While there is certainly some truth to Irwin’s argument that the frequent use of antidumping in situations with no clear evidence of anti-competitive behaviour occurs because of abuse by protectionist forces within the US, it is also the case that a substantially open economy with almost no policy barriers to trade might only attainable in the first place *because* severe short-term disruptions associated with intense import pressure can be mitigated through the use of temporary import restrictions.

Irwin wraps up his book with a clear and articulate description of the World Trade Organization and its system of dispute settlement. He discusses its negotiating history and fundamental principles like non-discrimination in trade policy. This chapter offers a thorough, but far less technical treatment of many important aspects of the WTO that are discussed extensively in the HCP. Irwin’s coverage of the WTO dispute settlement process hits on all the important points – what kinds of complaints are brought, on what basis are judgements made, which countries bring disputes and which countries “win” and, finally, what happens when a country is unhappy with a ruling.

Irwin’s thoughtful exposition of the WTO dispute settlement is particularly valuable today because it is this highly-regarded system of settling international disputes that is being undermined by current US policy. As described above, for high-income economies like the US and EU, special tariffs are an important part of the countries’ overall trade policy regimes. Over the last twenty years, aggressive use of these policies, especially antidumping, resulted in a number of challenges to US policy at the WTO that focused on the technical methodologies employed by the US. Ultimately, a long series of cases have chipped away at the US's discretion to use special import restrictions by finding that various US methodologies for assessing dumping were not compatible with the WTO rules.

Thus, at some level, the WTO rulings that restricted the use of special tariff policies forced upon the US a level of trade liberalization that the domestic population, or at least a part of the domestic population, really did not want. How to moderate this tension – between commitments to international rules that allow firms to invest and engage in long-term planning and the democratic responsibility to respond to the needs of voters and workers – is the crucial challenge today for the rules-based system of trade governance.

References

Autor, David H., David Dorn, and Gordon H. Hanson. 2013. "The China Syndrome: Local Labor Market Effects of Import Competition in the United States." *American Economic Review*, 103(6): 2121-68.

Bagwell, Kyle and Robert Staiger, eds. 2016 *The Handbook of Commercial Policy,* Volume 1 Parts A and B. Elsevier.

Bown, Chad P. and Meredith A. Crowley. 2014. "Emerging Economies, Trade Policy, and Macroeconomic Shocks." *Journal of Development Economics,* 111: 261-273.

Bown, Chad P. and Meredith A. Crowley. 2013a. "Import Protection, Business Cycles, and Exchange Rates: Evidence from the Great Recession." *Journal of International Economics,* 90(1): 50-64.

Bown, Chad P. and Meredith A. Crowley. 2013b. "Self-enforcing Trade Agreements: Evidence from Time-Varying Trade Policy." *American Economic Review,* 103(2): 1071-90.

Irwin, Douglas A. 2015. *Free Trade Under Fire: Fourth Edition*. Princeton; Oxford, Princeton University Press.

Pierce, Justin R., and Peter K. Schott. 2016. "The Surprisingly Swift Decline of US Manufacturing Employment."*American Economic Review*, 106(7): 1632-62.