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# WEEKLY ECONOMIC COMMENTARY

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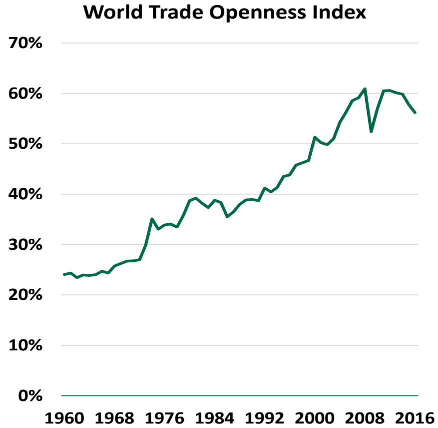
***Editor's Note: This is the fourth in a series of pieces that will examine key economic issues surrounding the 2020 U.S. election.***

In his 1999 book "The Lexus and the Olive Tree: Understanding Globalization," Thomas L. Friedman wrote about how the world was stuck between two struggles: the longing for prosperity and development (symbolized by the Lexus) and the desire to retain national identity (symbolized by the olive tree).

Today, the olive tree stands taller. After decades of increasing globalization in trade, capital flows and people, the tide has tilted towards de-globalization. Measures of trade openness have been on a steady decline over the past decade. Since 2017, the United States has been a leading exponent of protectionism, a posture likely to remain in place regardless of the election outcome.

In aggregate, globalization has generally been beneficial for countries and consumers, particularly for low-income economies. Exports are an avenue through which poor nations can develop their economies and reduce poverty. Free trade has also been a key driver of the prevailing low inflation and low interest rates seen in major markets.

**World Trade Openness Index**




**Estimated Cost of U.S. Tariffs**

| Tariff | Value of Affected U.S. Imports (2019) | Tariff Rate | Additional Cost Burden |
|---|---|---|---|
| Section 232, Steel | $11.4 B | 25% | $2.9 B |
| Section 232, Aluminum | $8.4 B | 10% | $841.4 M |
| Section 232, Derivative Steel Articles[3] | $510.2 M | 25% | $127.5 M |
| Section 232, Derivative Aluminum Articles[3] | $249.1 M | 10% | $24.9 M |
| Section 301, List 1 | $22.9 B | 25% | $5.7 B |
| Section 301, List 2 | $8.5 B | 25% | $2.1 B |
| Section 301, List 3 | $128.0 B | 25% | $32.0 B |
| Section 301, List 4A | $174.7 B | 7.5% | $13.1 B |
| Section 301, List 4B | $159.3 B | Suspended | $0 |
| **Total[4]** | **$354.8 B** | **7.5 – 25%** | **$56.8 B** |

*Sources: Our World in Data, American Action Forum*

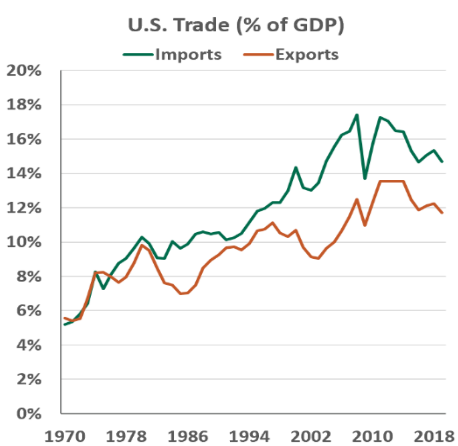
But the benefits of globalization can be uneven, leaving some markets and communities behind. This has drawn the attention of politicians, including the U.S president. The current administration has enacted a range of tariffs covering a variety of goods (see table). Over the last four years, the U.S. has withdrawn from two critical trade negotiations: the Trans-Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP). The White House also threatened to walk away from the North American Free Trade Agreement as leverage to strike a new deal. Merely a month after the enactment of the new United States-Mexico-Canada Agreement (USMCA), the administration revived tensions with Canada, a traditional ally, by reinstating 10% tariffs on Canadian aluminum imports.

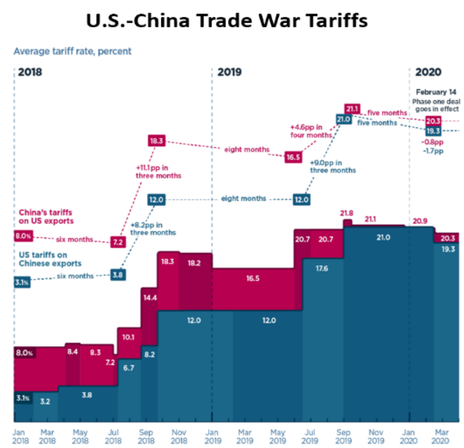
Trade accounts for over one-fourth of America's economy. Trade frictions have therefore caused more harm than good to the U.S. economy in the short-term. According to recent studies, the trade war has already cost the U.S. economy nearly 300,000 jobs, up to 0.7% of gross domestic product and over $45 billion in tariffs paid by American corporations. Over 3,500 companies have filed lawsuits against the U.S. government to challenge its China tariffs. To compensate them for lost international sales, U.S. taxpayers have shared $46 billion in aid to farmers.

Since 2017, realigning trade with China has been at the center of U.S. trade policy. The strategy has aimed to pressure the Chinese into better practices, which would be broadly beneficial to the U.S. in the long run. While the confrontational posture originated in the White House, it has received support from several world capitals. It will take time and patience to achieve the desired result.

**The U.S. election outcome won't reverse de-globalization, but it might slow it down.**

Even if the White House changes hands, those hoping for a reversion of trade policy after the U.S. elections will likely be left disappointed. Democrats have traditionally been skeptical of free trade because of its impact on labor and the environment. Even though Joe Biden, the Democratic presidential nominee, has supported free trade and is expected to adopt a more constructive stance on the topic, he is advocating "buy American" policies to support American industries.




Sources: World Bank, PIIE

While their approaches on China might differ in style, the objectives of both candidates will likely be similar, especially in the technology sector where China aims to challenge America's position. Though President Trump has taken a tough stand, a Biden presidency could pose bigger challenges for China, as he may seek to build a formidable international alliance against the Asian economic powerhouse.

Multilateralism, already under threat, would face greater challenges in a second Trump term. The recent World Trade Organization (WTO) decision against U.S. subsidies to Boeing and tariffs on Chinese goods has angered the White House and raises the chances of a U.S. withdrawal from the organization. The administration has already blocked nominees to the WTO resolution panel, which has made it very difficult for that body to function.

Candidate Biden is likely to work towards restoring confidence in institutions like the WTO, which has supported U.S. grievances in the past. Without some rules and central coordination, global trade could contract even more rapidly in coming years, to the detriment of economies large and small. A breakdown in international trade and supply chains would be especially costly for China, which has arguably been the world's biggest beneficiary from free trade and has the most to lose from its retreat.

**A breakdown of the global trading system would harm all participants, including the U.S.**

De-globalization is happening not just in trade, but in foreign investment and financial flows as well. Research shows that as tariffs and trade frictions rise, financial globalization declines at least proportionally. Reorganizing supply chains is an expensive affair, and corporate profits, particularly of multinational corporations, will decline, weighing on stock markets. According to a National Bureau of Economic Research paper covering 64 nations, the GDP downturn would have been slightly worse with renationalized supply chains than under current levels of trade.

Recent trends in international commerce are cause for concern. That said, we are not witnessing the end of globalization; only a partial reversal. Economic considerations such as manufacturing efficiency still hold some significance. And some countries, including the United States, will find it very difficult (and expensive) to re-shore certain kinds of production. America's fortunes will continue to be linked with those of other countries, necessitating careful collaboration.

The United States has historically been a champion of free markets and stands as the world's most integrated economy. We may therefore have more to lose from de-globalization than our politicians comprehend. Olive trees are bucolic and soothing, but we do like having a Lexus in the driveway.

## Adjusting To Change

"Do what you do best, and outsource the rest" was the mantra that fueled globalization. Merchandise trade as a percentage of global gross domestic product (GDP) tripled between 1960 and 2008. This helped hundreds of millions around the world out of poverty, raised competition, lowered prices and contributed importantly to unprecedented gains in asset markets.

Not everyone prospered as borders opened. Exposed to keen international competition, many domestic industries struggled. Their market shares, and even their very existence, came under threat. As a prominent example, American mills produced over 20% of the world's steel in 1970; today, imported steel has driven that fraction down to only about 5%.

Workers in sectors disrupted by trade face a difficult transition. Some struggle to find new opportunities, and when they do, they often have to accept lower wages and relocate. Economic disruption resulting from industrial change is among the contributors to advancing income inequality and declining economic well-being for many households.

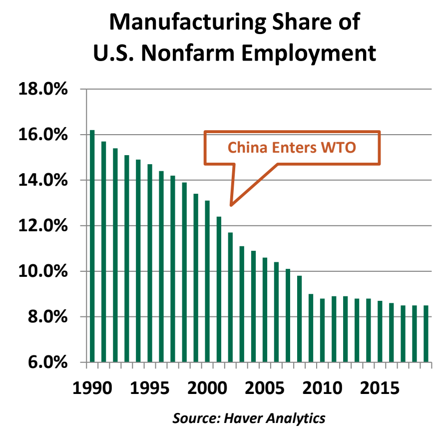
To cushion the blow, the U.S. government began offering Trade Adjustment Assistance (TAA) in the 1960s. TAA has been an important part of trade negotiations ever since; it featured prominently when the first North American Free Trade Agreement was constructed in the 1990s, and again when China was granted entry to the World Trade Organization in late 2001. U.S. manufacturing employment, already in long-term decline, began falling much more rapidly thereafter.

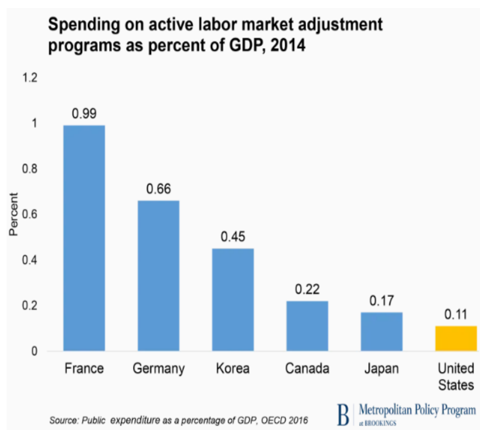
TAA encompasses programs that retrain workers and find them new opportunities, as well as programs that offer direct financial support to ease in the transition. The annual budget for the effort is about $800 million.

The broad design sounds sensible, but the results of TAA have been disappointing. Administratively, the program is cumbersome. Technology and other industrial changes can also contribute to job disappearance, making it difficult for workers to prove they have been displaced by trade. Studies have shown that the red tape discourages prospective TAA candidates, many of whom opt to simply collect unemployment or disability payments instead.

**Facilitating change requires good transition plans.**

Even when applied, TAA's effectiveness has often been limited. Retraining is supposed to be central to the effort, but this requirement is often waived. While younger workers generally take advantage of the opportunity to update their skills, older workers often do not. In general, TAA has done a poor job of getting workers back on track. Congress has reauthorized the program several times, but only because dropping it seemed harsh and redesigning it would be expensive and time-consuming. Some fresh thinking is sorely needed.




Trade is only one example of the kind of transformational development that presents risks to the fabric of an economy. Technology was reducing American manufacturing employment long before China became a formidable competitor, and technology is currently disrupting a number of service-based occupations. As we discussed earlier this year, the speed of technological change may accelerate in the wake of the pandemic, putting a broadening range of professionals at risk.

The inexorable evolution of economies requires adaptation. Trying to control these evolutions is difficult and expensive, and may limit growth. Allowing them to proceed unfettered can leave some families and communities behind, producing income inequality and complicated politics. To address the challenge of industrial evolution, many countries make substantial investments in labor force transition programs. As shown in the chart, however, the United States is not among the world leaders on this front.

Societies must continue to balance the broad benefits of embracing change with the consequences change can bring to citizens and communities. Failure to achieve this balance will almost certainly result in calls to turn back the clock.

## Close Call

We entered 2020 in a simpler time, wondering whether the newly-announced Phase One trade deal between the U.S. and China would help settle the quarrel between the world's largest manufacturer and its biggest customer. In short order, COVID-19 brought China, and then the rest of the world, to a standstill. But Phase One remains in place. Will the deal stand the test of time?

Phase One's key achievement was China's commitment to increase its imports from the U.S. by

$200 billion (relative to 2017 levels) by the end of 2021. These targets were ambitious under any circumstance, leaving no room for idiosyncratic risks like a pandemic that stalled trade.

As it stands today, China is behind on its targets. Through August, China's purchases of all covered products were only at 50 percent of its prorated target. However, trade flows are not steady throughout the year; for instance, the peak month for soybean exports from the U.S. is October, for which data will not be available until December.

Encouragingly for its trading partners, China is returning to its prior levels of activity. In September, it set a new one-month record for total imports. The Chinese economy is leading the world in the speed at which it recovered from COVID-19. If its trade activity continues to grow, China could recover just in time to meet its annual commitment.

**China's first COVID-19 lockdown began the week after Phase One was signed.**



*Sources: Peterson Institute for International Economics, General Administration of Customs, Haver Analytics*

The Phase One agreement did not include penalties for underperformance. When one party breaches the agreement, the two sides must meet to attempt to resolve the dispute. If they cannot find a way forward, either party may leave the agreement without penalty. The dissolution would increase the likelihood of higher tariffs and trade restrictions.

Phase One, as the name implies, was supposed to be the first in a series of accords between the U.S. and China. Negotiating a Phase Two agreement, which was to be more expansive, was a key goal for 2020. Unfortunately, the pandemic put those talks on hold and damaged relations between Washington and Beijing. The next phase of Sino-American economic relations will not be an easy one in the next presidential term.

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