

U.S. FOREIGN ECONOMIC POLICY:
TRADE, INVESTMENT, AND AID ISSUES AND POLICIES

I. TRADE THEORY AND BACKGROUND

- A. Classical Liberalism argues: more freedom of all kinds is better. People and states have large common interests. These are best realized by fostering political, economic, and religious freedom. We should replace absolute monarchy with democracy; religious absolutism with freedom of religion; and economic controls with free markets and free trade.
- B. Free Trade versus Mercantilism:
1. **Free trade ("liberal") doctrine** holds that a state's **prosperity is maximized by the unfettered exchange of goods and services with other states**. This is achieved by minimizing restrictions on trade.
 2. **Mercantile doctrine** holds that **a state's prosperity is maximized by achieving a trade surplus**--by exporting more than it imports. This is achieved by state subsidies to exporting industries, and by state restrictions on imports, such as tariffs, import quotas, and import-impeding regulation of imported products. Motives: to accumulate specie (1700s); and/or to end recessions/limit unemployment (recent times).
- C. The logic of free trade rests on **David Ricardo's theory of comparative advantage (1817)**: "Utopia is far more efficient than Flatland at making cheese, and moderately more efficient at making wine. Utopia and Flatland both prosper by trading Utopia's cheese for Flatland's wine, even though Utopia now imports wine from a country that makes it less efficiently than Utopia, because trade lets Utopians specialize in what they do best." A social science theory of great importance!
- D. A short history of trade: Restrictions on trade have fallen since the late 1700s, and especially since 1945, as "liberal" ideas won the day. The US led the movement to free trade during 1945-today.
But the U.S. still restricts imports of some products, especially those produced by fading U.S. "sunset" industries--agriculture and textiles/apparel. Agriculture and textiles are the "sunrise" industries for the world's poorest countries so these U.S. restrictions are a harsh blow to the world's poor.
- E. 2-way vs. 1-way trade. Ricardo noted the benefits of 2-way trade. Many in the U.S. today implicitly prefer 1-way (export-only) trade, which is a form of mercantilism.
- F. Is a US trade deficit good or bad? Neo-mercantilists believe it bad. Others argue that it represents a net transfer of wealth to America, hence is good. Americans

wind up with neat stuff--cars and electronics from Japan and China--while Japan and China get only paper promises (your money). We get the benefits of trade without doing any work! What's wrong with that?

II. NINE PROTECTIONIST ARGUMENTS

A. "Save US jobs": "We must exclude imports to save jobs and industries threatened by foreign competition!" This argument is advanced by industries too inefficient to compete on equal terms against foreign imports. But others argue:

-- We can save jobs and industries by using monetary policy (having the Federal Reserve Bank lower interest rates) or fiscal policy (moving to deficit spending) to regulate the business cycle and pep up the economy when it slows. This is how the US has prevented another depression since 1941 and moderated the Great Recession of 2007-present.

-- We can subsidize the retraining of workers in industries that can't beat the foreign competition, instead of indirectly subsidizing the industries themselves through trade restrictions.

-- Other countries may retaliate by restricting their US imports, causing a spiral of protectionism that closes down world trade and leaves all worse off. The collapse of world trade after Congress passed the Smoot-Hawley tariff (1930) illustrates.

When the U.S. has low unemployment we rarely hear the jobs argument. When unemployment is high we hear it more loudly.

B. Infant industry arguments (Adam Smith, Alexander Hamilton, Friedrich List): "Infant industries merit protection while they develop the economies of scale and expertise they need to face international competition." Many economists accept this argument. But will the infant ever grow up and get off the dole? Some fear not.

C. Strategic trade argument--an expansion of the "infant industry" argument. It holds: in industries in which firms (1) achieve large economies of scale, and (2) "learn by doing"--get more efficient as they gain experience--the top dog in the industry can dominate the world, destroy competitors, and earn monopoly profits.

-- Implication: states should protect and subsidize such industries.

-- Problem: there are few such industries. Aircraft manufacture may be an example, but there aren't many others, if any. This reflects the power of global-scale market forces. Global markets are especially powerful since they are so vast. They are usually too strong to override by state policies. Let others (Japan) try--they'll be sorry. Their strategic trade restrictions damage us in small ways but damage them in

larger ways. So let's not follow them on their path of folly.

- Another problem: governments are inept at identifying such industries even if they do exist.
- D. Externalities arguments: "We should subsidize and protect industries (e.g., high-technology industries) that produce spinoffs (e.g., high technologies) that benefit the rest of the economy." But can governments correctly identify these industries?
- E. Coercing other governments to change policies.
 1. Some advocate protection to coerce others to open their markets. "We should restrict others' imports until they ease their restrictions on US imports."
 - > But will retaliation start a trade war, leaving all worse off? In other words, can we tell whether retaliation will cause "deterrence" or a "spiral"?
 2. Some advocate protection to coerce others into other trade-related policy changes, e.g., to adopt U.S. labor standards, or environmental protection standards. But critics say: "These demands are just excuses to protect relatively inefficient U.S. industries from international competition."
 3. Many advocate trade sanctions--limits on imports and exports--to coerce others to align non-trade-related policies (e.g., security policies or human rights policies) with U.S. wishes.
 - a. Unilateral economic sanctions never work, but sanctions can be an effective tool of persuasion when pursued multilaterally. Threat of multilateral sanctions succeed as often as threat of force. See e.g., US-led sanctions against Iran, 2013-15.
 - b. "Smart" sanctions--actions aimed at the assets and lifestyle of governing elites, such as freezing their foreign accounts--are often wiser than trade sanctions, because trade sanctions injure whole populations while smart sanctions target only the decision makers. But the banking community dislikes smart sanctions, so often trade sanctions are unwisely pursued instead.
- F. National security: "Free trade injures national security."
 1. "If our adversary gains more from trade than we do we shouldn't trade with them, because they may convert their gains into weapons and subjugate us." This is the main reason why military adversaries seldom trade with each other, and a key argument against US trade with China.
 2. "We must maintain critical war industries that feed our military machine, hence we must protect them from foreign competition if they could not survive the competition of world markets in peacetime." 60 years ago some argued for protecting the U.S. steel industry on these grounds.

- G. Economic stratification--"Free trade helps the rich but punishes the poor."
1. Impoverishment of unskilled workers in the advanced countries (i.e., the U.S.): "Free trade puts U.S. unskilled workers in direct competition with vast pools of unskilled workers in the Third World; this drives down wages for US unskilled workers; this widens the income gaps between U.S. classes." The Stolper-Samuelson theorem frames this argument. In theory we might deal with this problem by subsidizing the wages of low-wage workers, or by otherwise compensating low-wage workers. But in practice this doesn't happen in the U.S. See assigned reading by Dani Rodrik.
 2. Worldwide "races to the bottom" in social policy: "When goods and services move freely, companies can more easily move to the country that gives it the best terms--i.e., low taxes, narrow labor rights, the right to pollute--and then export their products to their main markets. Companies can use this threat to move as a lever to compel governments everywhere to restrict labor rights and transfer tax burdens from businesses to others." A global "race to the bottom" results that widens the gulf between rich and poor in all societies.
- H. Protecting other cultures--"Under free trade the U.S. exports its noxious culture products to the world, enraging or corrupting other societies":
1. Other countries (Canada, France, Islamic states) object to U.S. insistence that they cannot restrict imports of U.S.-made TV, film and other entertainment. Their argument: "We want our culture, not yours. Your media products preach violence, hedonism, and greed. Many are pornographic. Such rotten values caused Rome to fall. Please keep MTV and such to yourselves. We don't want to swim in that sewer." Others answer: "If you don't want these products, don't buy them." And the answer comes back: "Market forces often cause bad results for society. You Americans won't allow free import of cocaine, despite the market for them. Why should we allow free import of poisons from Hollywood?"
 2. Some argue that jamming MTV down the throat of traditional cultures fuels angry religious fundamentalism around the world. "The U.S. should stop exporting its noxious entertainment products for its own good."
- I. Rapid economic churning--the rise and fall of industries--is harmful. It creates personal insecurity and disrupts valuable social institutions--communities (see Edmund Burke on their value), neighborhoods, and extended families. Outsourcing jobs destroys social fabric. Free trade should be limited when it fosters harmfully rapid "creative destruction" in the US.

III. NON-ECONOMIC ARGUMENTS FOR FREE TRADE

- A. "Free trade causes economic interdependence, which causes peace, so let's promote free trade."
- B. "Free trade causes prosperity, which causes democracy, which causes many good things including peace, so let's promote free trade."

IV. BOLSTERING FREE TRADE: METHODS

- A. Reciprocity. Restrict imports from countries that restrict U.S. imports.
- B. Make regional free trade agreements, e.g., the 1993 North American Free Trade Agreement, or "NAFTA", which established free trade between Canada, the US, and Mexico.
- C. Make global free trade agreements, e.g., the General Agreement on Tariff and Trade, or "GATT", established in 1947, institutionalized and renamed the World Trade Organization, or "WTO", in 1995.
- D. Spread some enlightenment! Educate publics on how much they are losing by protecting their economy!

V. INVESTMENT ISSUES

- A. Raising US national rates of savings and investment will spur U.S. economic growth. And if so...
- B. Should the US government protect multinational corporations in their conflicts with Third World nationalist governments? Won't this encourage capital outflow in the form of foreign investment? For example, have efforts to punish Cuban abuses of U.S. corporations in Cuba (e.g., the 1990s-era Helms-Burton law) serve U.S. interests?
- C. Should the US fear foreign investment here? Is it scary or good that foreigners own much of America?

VI. FOREIGN AID ISSUES

- A. US foreign aid is small--only \$23 billion (one twenty-third the size of the US defense budget, ~1 percent of total US federal budget). This is chump change.
- B. What can aid achieve?
 - 1. Can rich states pull poor states from poverty by giving aid? The evidence is mixed. The counter-argument: "aid distorts market forces."
 - 2. Is aid an effective foreign policy tool? Yes. Bribery-by-"foreign aid" often works! Aid as baksheesh.

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