9 Defending an Open World Economy

Jagdish Bhagwati

The London Summit's official communiqué on April 2 began by applauding an open economy and briefly, therefore, generalizing the celebration of free trade to openness in a broader sense, as strongly urged in my writings of early 2009. According to the official communiqué, "We believe that the only sure foundation for sustainable globalization and rising prosperity for all is an open world economy."

But, except for some attention to actions on the trade front in the "London Summit Outcomes" released in London, the communiqué did not follow through with any details on the many dimensions of the threat to openness, which include immigration and labor markets and direct foreign investment. We face those threats today, even as the twin crises on Wall Street and Main Street continue to afflict us. Neither can we find an impassioned and substantial case being made for openness, nor the necessity of defending it, by the prominent leaders of the G20.

In particular, where was President Obama, whose rhetorical powers are remarkable enough for him to have given yet another

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Although I am broadly supportive of the stimulus package, the threats to openness are built directly into it, as with the Buy America provision that has already initiated a trade war with Canada, which has lost American markets and has retaliated against the provision. President Obama does not have the luxury of waiting to confront threats to openness until he fixes the economy; the two policies are intertwined.

of his famous speeches, this time on the virtues of free trade and openness and the perils of protectionism and mutually harmful xenophobia in our and others' policy making?

On the dangers to openness, let me begin with trade, go on to foreign investment, and then to immigration, touching the principal danger points that should have prompted and informed such a presidential speech. But first consider briefly the issue of why openness is worth defending.

Openness and the Postwar Experience

The post-World War II decades began with a divide between rich and poor countries. Rich countries sought to restore openness to the world economy through liberal reforms promoting trade, direct foreign investment, and immigration (recall the *gastarbeiter* programs that made European recovery possible). Poor countries, on the other hand, generally shied away from such policies, afraid that openness would have a malign impact.

But by the 1980s it was clear that the anti-openness model had brought grief to the poor countries. As the proponents of that discredited economic philosophy (often married to "antimarket fundamentalism") tried to sabotage the pro-openness reforms, proposing that we resurrect the prehistoric dinosaurs like Steven Spielberg, the answer to them was best provided in John Kenneth Galbraith's witticism about an opponent: "his tragedy is that his prescriptions have been tried."

So with rich and poor countries finally in sync about the advantages of openness on the three critical dimensions of trade, direct investment, and immigration, both shared in the unparalleled prosperity that those policies produced.

But the opponents of this openness had a new card up their sleeve. Prosperity gained, yes, they said, but the poor had lost. But now, after hearing passion on one side and patient facts on the other, there is virtual unanimity that the prosperity produced by pro-openness policies, in tandem with other reforms, helped lift nearly half a billion poor above the poverty line in less than two decades.

Even in the rich countries, the stagnation of workers' wages has had little to do with trade and the outward flow of direct investment or the inward flow of unskilled workers. My own empirical work, updated in 2004 in my book, *In Defense of Globalization* (Oxford, 2004), and the recent work of Robert Lawrence of The Kennedy School at Harvard argue that trade with the poor countries is likely to have moderated the pressure on wages from other causes, such as acute labor-saving technical changes. The work of Giovanni Peri of the University of California argues that for unskilled immigration as well.

The pro-openness economists therefore have nothing to apologize for: openness serves the cause of the poor in the poor countries and is likely to be working for unskilled workers in the rich countries. Thus the assault on openness that has arisen worldwide threatens those gains and must be stoutly opposed.

Dangers to Openness Today

Let us consider the protectionism afflicting post-crisis trade, direct investment, and hiring and firing of immigrants, in turn.

A. Trade. Let me address three important ways in which the threat of protection in trade has arisen recently: Buy America provisions in the stimulus bill, the auto bailout, and the Obama embrace of labor standards in trade treaties (which is a form of insidious protectionism, as I explain below).

1. Buy America. The Buy America provision, inconsistent as it was with our World Trade Organization (WTO) obligations in the original House and Senate versions, has now been qualified by a new clause requiring that its application be consistent with the international obligations undertaken by the United States. Nonetheless, some protectionist defenses and aspects of it need to be addressed.

First, my brilliant Massachusetts Institute of Technology student Paul Krugman has argued that increased U.S. spending, as required today, would leak into demand for foreign goods, raising its cost to the United States in shape of increased debt. So there is a case for using protection to keep its impact on the United States itself: the Buy America provision would prompt others to imitate us; they would spend more and use protection to keep *their* increased spending to themselves. The result would be more spending (i.e., stimulus) worldwide and admittedly more such protection. But the cost of protection is small in any event, Krugman argues, especially compared to the benefits of increased spending that it would allegedly facilitate.

Unfortunately, we must reject the Krugman argument because its premises are implausible and violate what we have already observed. Plenty of evidence exists that others will retaliate and that, too, not in a fine-tuned fashion. As the post-Smoot-Hawley experience showed, trade wars are fought, not by the gentlemanly rules of English cricket but by the no-holds-barred rules of American freestyle wrestling. The cost of protection, which even at the best of times is estimated by the best economists on the subject (such as Robert Feenstra, who leads the National Bureau of Economic Research's Program on International Economics, and Paul Romer, whose work on growth is most highly regarded) to be on the high side, is likely to be even higher if we foolishly leave ourselves open to such trade wars.

Second, some spokespeople for the American Federation of Labor and Congress of Industrial Organizations (AFL-CIO) claim that the European Union denies us access to its government procurement in several sectors and thus we are entitled to retaliate, suspending its access to our procurement. But this is a misunderstanding of the nature of the 1995 Government Procurement Agreement (GPA) at the WTO. The signatories to it (forty nations in all) have listed their sectoral and other exclusions and inclusions; these do not match, of course, because the overall balance of "concessions" when the Uruguay Round was concluded and the WTO was launched extended across many sectors such as manufactures and rules such as antidumping. We cannot unilaterally suspend the obligations we undertook under the GPA as part of that overall balance. If we were to unilaterally violate our treaty obligations under President Obama, who has promised we will return to the rule of law and work with other nations rather than wielding a machete over their heads and aiming an AK-47 at their hearts to get our way, we would be no better than Libya or the first George W. Bush administration.

Finally, does the qualifier, inserted at Obama's insistence in the conference version that will now be law—that we will practice Buy America in a WTO-consistent way—protect us from the prospect of a trade war? Not likely. There are two problems.

This first would mean that we would now begin to exclude China, India, Brazil, and other nonsignatories to the GPA (the developing countries were *not* expected to sign the GPA, one may recall), with the result being that they, in turn, could retaliate against our exports in several WTO-consistent ways (e.g., through raising lower-applied tariffs toward the higher-bound tariffs, switching purchases of nuclear plants from General Electric to France and aircraft from Boeing to Airbus). Thus we would have a WTO-consistent trade war breaking out. President Obama has listened to critics, such as myself, in a January op-ed. in the *Financial Times,* and insisted on WTO-consistency; he now needs to step up to the plate and denounce raising trade barriers and discriminatory policies even when they are technically WTO-consistent.

The second is, as anyone who understands trade litigation already knows, inserting a qualifier on WTO consistency and leaving in the Buy America provisions means that any well-heeled lobby can persuade the relevant agencies to give it a Buy America exclusion (even of signatories to the GPA) by claiming that the exclusion was WTO-consistent. The lobby would expect to get away with such behavior unless the matter is brought before the WTO Dispute Settlement Mechanism by the adversely affected signatories. (Essentially, this is what happened with the Safeguards action against foreign steel soon after President George W. Bush first took office: the administration claimed that its action was WTO-consistent, although many claimed it was not; it was then declared to be inconsistent at the WTO.)

Whether or not they take us to the dispute settlement court at the WTO, the excluded signatories will likely retaliate. It seems more sensible therefore to eliminate the Buy America provision altogether, as Senator McCain properly suggested.

2. Bailouts. Because bailouts embody actual (versus implicit) subsidies, they are regulated by the 1995 Subsidies and Countervailing Mechanism (SCM). Any sectoral subsidies under the SCM agreement are considered "actionable" (with only two subsidies, for local content or exports, declared illegal). There is little doubt therefore that an auto bailout, which is limited to one sector, would be actionable under the SCM agreement; when confined only to Detroit and not extended to foreign transplants, the bailout raises further red flags.

In fact, as French president Sarkozy plans to help Peugeot and other French car firms through similar bailouts, the Obama and Sarkozy administrations need to sit down and see whether they can confine their assistance to the car industry to either restructuring under Chapter 11-style bankruptcy procedures or WTO-consistent nondiscriminatory consumer subsidy schemes that subsidize car purchases regardless of who has produced the cars. The bankruptcy procedures would be allowed as long as explicit subsidies are not included in the bankruptcy-defined restructuring (in any event, even with no SCM agreement on airline services, many airlines in the United States have resorted to Chapter 11 and survived; one, Continental, has resorted to Chapter 11 twice and is now known as the Chapter 22 airline).

All this holds, of course, regardless of the *economic* wisdom of granting sectoral support to one industry when several are in recession, an issue on which there is much division in the country.

3. Labor and Environmental Standards. The preoccupation with labor and (domestic) environmental pollution standards in trade treaties and institutions is a form of "export protectionism," prompted largely by the unions' fear that trade with the poor countries is driving down U.S. workers' wages. If you believe that, and do not wish to be recognized as a protectionist worrying about import competition, what could be better than getting your competitors to raise *their* costs of production closer to your levels by getting them to accept your standards? In short, turn Tom Friedman on his head: make the world flat when it is not. Level the playing field. Call it "fair trade." Pretend you are doing it for *their* workers, not yours, that you are being truly altruistic, and that your own self-interest is not the driving force behind those demands.

Obama has bought into the above because the Democratic Party has bought into it, and the party has bought into it because the labor unions bought the Democratic Party off at election time. Not surprisingly, the big, democratic countries such as Brazil and India see through this self-serving nonsense; when Howard Dean raised that demand at Davos this year, he was chewed out by Foreign Minister Celso Emorim of Brazil, as he deserved to be.

The sad part of the story is that there is no compelling evidence that trade with the poor countries is a significant factor in the workers' predicament and plenty of argumentation and evidence on the other side. So the Democrats' position on this issue is not merely protectionist in the sense of export protectionism but also based on a faulty empirical analysis. The sooner President Obama abandons that sanctimonious approach to the issue, which does him no credit, the better.

Instead he needs to use his intellectual ability and his political skills to steer the Democrats away from this *external* scapegoating of the issue of workers' wages and resulting obsession with labor and domestic environmental standards in trade treaties and institutions and focus instead on appropriate *domestic* institutional measures to expand union membership, and other related measures, to address the problem.

B. Foreign Investment. Three popular measures on direct foreign investment need to be distinguished, of which one is not protectionist:

1. Eliminate the incentive to go out. Presidential candidate Obama did claim during the campaign that he would remove any bias in U.S. tax law that encouraged U.S. firms to produce abroad rather than at home. (In his State of the Union address on February 25, he restated his disapproval of this bias, in, disappointingly, the only policy statement on the growing protectionism in his splendid speech.) Eliminating such a bias in our tax code is surely all right because no economist would be in favor of discriminatory taxation that distorts the choice of investment location.

2. Create incentives to invest at home rather than abroad. One should not discriminate by favoring the location of firms at home rather than abroad, for that would also be a distortion. Unfortunately, excoriating U.S. firms that invested abroad, especially when they closed down a plant in Nantucket and opened up one instead in Nairobi, was what Senator John Kerry did during his presidential campaign, calling such firms Benedict Arnolds. (Not having grown up in the United States, I thought that Benedict Arnold must be an obscure English poet, a distant cousin of Matthew Arnold, whom Senator Kerry had come across when he was at Yale because, unlike President George W. Bush, he must have been attending classes and getting good grades. But I was wrong on both counts. It turns out that Senator Kerry's grades were worse than those of President Bush. Besides, as every American schoolchild knows, Benedict Arnold was America's worst traitor. So Senator Kerry was calling such firms traitors.) The epithet was, in fact, applied increasingly to firms that simply bought online services and imported components from abroad, rather than just to those who folded operations at home and started them up abroad.

3. Sarkozy: Asking French firms to come home. President Sarkozy took the matter to its absurd extreme when he claimed that French firms already producing abroad (except when producing for the foreign host countries) should come home.

C. Hiring and Firing Immigrants. The proposed, and sometimes implemented, measures here include restrictions on hiring and encouraging the firing of foreigners: what might be described as admonitions, and occasional legislation, to hire citizens first and fire them last. With illegals, this has implied intensified enforcement and deportations in the United States. With legals, such as those brought in temporarily under H1 (b) visas, legislation requires tighter restrictions than before to ensure that no visa is issued if native workers have been laid off. Prime Minister Gordon Brown has faced pressures from British workers for such near-xenophobic measures.

Concluding Remarks

This sketch of the pressures building up to depart from openness in crisis indicates why President Obama's missing eloquence on openness to date is a matter of the utmost regret. Will he surprise us?