CHAPTER 1

A Better Balance

The global trade regime has never been very popular in the United States. Neither the World Trade Organization (WTO) nor the multitudes of regional trade deals such as the North American Free Trade Agreement (NAFTA) and the Trans-Pacific Partnership (TPP) have had strong support among the general public. But opposition, while broad, tended to be diffuse.

This has enabled policy makers to conclude a succession of trade agreements since the end of World War II. The world's major economies were in a perpetual state of trade negotiations, signing two major global multilateral deals: the General Agreement on Tariffs and Trade (GATT) and the treaty establishing the World Trade Organization. In addition, more than five hundred bilateral and regional trade agreements were signed—the vast majority of them since the WTO replaced the GATT in 1995.

The difference today is that international trade has moved to the center of the political debate. During the most recent US election, presidential candidates Bernie Sanders and Donald Trump both made opposition to trade agreements a key plank of their campaigns. And, judging from the tone of the other candidates, standing up for globalization amounted to electoral suicide in the political climate of the time. Trump's eventual win can be chalked up at least in part to his hard line on trade and his promise to renegotiate deals that he argued had benefited other nations at the expense of the United States.

Trump's and other populists' rhetoric on trade may be excessive, but few deny any longer that the underlying grievances are real. Globalization has not lifted all boats. Many working families have been devastated by the impact of low-cost imports from China, Mexico, and elsewhere.[1] And the big winners have been the financiers and skilled professionals who can take advantage of expanded markets. Although globalization has not been the sole, or even the most important, force driving inequality in the advanced economies, it has been a key contributor. Meanwhile, economists have struggled to find large gains from recent trade agreements for the economy as a whole.[2]

What gives trade particular political salience is that it often raises fairness concerns in ways that the other major contributor to inequality—technology—does not. When I lose my job because my competitor innovates and introduces a better product, I have little cause to complain. When he outcompetes me by outsourcing to firms abroad that do things that would be illegal here—for example, prevent their workers from organizing and bargaining collectively—I may have a legitimate gripe. It is not inequality per se that people tend to mind. What's problematic is *unfair* inequality, when we are forced to compete under different ground rules.[3]

During the 2016 US presidential campaign, Bernie Sanders forcefully advocated the renegotiation of trade agreements to reflect better the interests of working people. But such arguments immediately run up against the objection that any standstill or reversal on trade agreements would harm the world's poorest, by diminishing their prospect of escaping poverty through export-led growth. "If you're poor in another country, this is the scariest thing Bernie Sanders has said," ran a headline in the popular and normally sober Vox.com news site.[4]

But trade rules that are more sensitive to social and equity concerns in the advanced countries are not inherently in conflict with economic growth in poor countries. Globalization's cheerleaders do considerable damage to their cause by framing the issue as a stark choice between existing trade arrangements and the persistence of global poverty. And progressives needlessly force themselves into an undesirable trade-off.

The standard narrative about how trade has benefited developing economies omits a crucial feature of their experience. Countries that managed to leverage globalization, such as China and Vietnam, employed a mixed strategy of export promotion and a variety of policies that violate current trade rules. Subsidies, domestic-content requirements, investment regulations, and, yes, often import barriers were critical to the creation of new, higher-value industries.[5] Countries that rely on free trade alone (Mexico comes immediately to mind) have languished.[6]

That is why trade agreements that tighten the rules, such as TPP would have done, are in fact mixed blessings for developing countries. China would not have been able to pursue its phenomenally successful industrialization strategy if the country had been constrained by WTO-type rules during the 1980s and 1990s. With the TPP, Vietnam would have had some assurance of continued access to the US market (existing barriers on the US side are already quite low), but in return would have had to submit to restrictions on subsidies, patent rules, and investment regulations.

And there is nothing in the historical record to suggest that poor countries require very low or zero barriers in the advanced economies in order to benefit greatly from globalization. In fact, the most phenomenal export-oriented growth experiences to date—Japan, South

Korea, Taiwan, and China—all occurred when import tariffs in the United States and Europe were at moderate levels, and higher than where they are today.

So, for progressives who worry both about inequality in the rich countries and poverty in the rest of the world, the good news is that it is indeed possible to advance on both fronts. But to do so, we must transform our approach to trade deals in some drastic ways.

The stakes are extremely high. Poorly managed globalization is having profound effects not only in the United States but also in the rest of the developed world—especially Europe—and the low-income and middle-income countries in which a majority of the world's workers live. Getting the balance between economic openness and policy space management right is of huge importance.

Europe on the Brink

The difficulties that deep economic integration raises for governance and democracy are nowhere in clearer sight than in Europe. Europe's single market and single currency represent a unique experiment in what I have called in my previous work "hyperglobalization."[7] This experiment has opened a chasm between extensive economic integration and limited political integration that is historically unparalleled for democracies.

Once the financial crisis struck and the fragility of the European experiment came into full view, the weaker economies with large external imbalances needed a quick way out. European institutions and the International Monetary Fund (IMF) had an answer: structural reform. Sure, austerity would hurt. But a hefty dose of structural reform—liberalization of labor, product, and service markets—would make the pain bearable and help get the patient back on his feet.

As I explain later in the book, this was a false hope from the very beginning.

It is undeniable that the euro crisis has done much damage to Europe's political democracies. Confidence in the European project has eroded, centrist political parties have weakened, and extremist parties, particularly of the far right, are the primary beneficiaries. Less appreciated, but at least as important, is the damage that the crisis has done to democracy's prospects outside the narrow circle of eurozone countries. The sad fact is that Europe is no longer the shining beacon of democracy it was for other countries. A community of nations that is unable to stop the unmistakable authoritarian slide in one of its members—Hungary—can hardly be expected to foster and cement democracy in countries on its periphery. We can readily see the consequences in a country like Turkey, where the loss of the "European anchor" has played a facilitating role in enabling Erdogan's repeated power plays, and less directly in the faltering of the Arab Spring.

The costs of misguided economic policies have been the most severe for Greece. Politics in Greece has exhibited all the symptoms of a country being strangled by the trilemma of deep integration. It is impossible to have hyperglobalization, democracy, and national sovereignty all at once; we can have at most two out of three.[8] Because Greece, along with others in the euro, did not want to give up any of these, it ended up enjoying the benefits of none. The country has bought time with a succession of new programs, but has yet to emerge out of the woods. It remains to be seen whether austerity and structural reforms will eventually return the country to economic health.

History suggests some grounds for skepticism. In a democracy, when the demands of financial markets and foreign creditors clash with those of domestic workers, pensioners, and the middle class, it is usually the locals who have the last say.

As if the economic ramifications of a full-blown eventual Greek default were not terrifying enough, the political consequences could be far worse. A chaotic eurozone breakup would cause irreparable damage to the European integration project, the central pillar of Europe's political stability since World War II. It would destabilize not only the highly indebted European periphery but also core countries like France and Germany, which have been the architects of that project.

The nightmare scenario would be a 1930s-style victory for political extremism. Fascism, Nazism, and communism were children of a backlash against globalization that had been building since the end of the nineteenth century, feeding on the anxieties of groups that felt disenfranchised and threatened by expanding market forces and cosmopolitan elites.

Free trade and the gold standard had required downplaying domestic priorities such as social reform, nation-building, and cultural reassertion. Economic crisis and the failure of international cooperation undermined not only globalization but also the elites that upheld the existing order. As my Harvard colleague Jeff Frieden has written, this paved the path for two distinct forms of extremism. Faced with the choice between equity and economic integration, communists chose radical social reform and economic self-sufficiency. Faced with the choice between national assertion and globalism, fascists, Nazis, and nationalists chose nation-building.[9]

Fortunately, fascism, communism, and other forms of dictatorships are passé today. But similar tensions between economic integration and local politics have long been simmering. Europe's single market has taken shape much faster than Europe's political community has; economic integration has leaped ahead of political integration.

The result is that mounting concerns about the erosion of economic security, social stability, and cultural identity could not be handled through mainstream political channels. National political structures became too constrained to offer effective remedies, while European institutions still remain too weak to command allegiance.

It is the extreme right that has benefited most from the centrists' failure. In France, the National Front has been revitalized under Marine Le Pen and has turned into a major political force mounting a serious challenge for the presidency in 2017. In Germany, Denmark, Austria, Italy, Finland, and the Netherlands, right-wing populist parties have capitalized on the resentment around the euro to increase their vote shares and in some cases play kingmaker in their national political systems.

The backlash is not confined to eurozone members. In Scandinavia, the Sweden Democrats, a party with neo-Nazi roots, were running ahead of Social Democrats and had risen to the top of national polls in early 2017. And in Britain, of course, the antipathy toward Brussels and the yearning for national autonomy has resulted in Brexit, despite warnings of dire consequences from economists.

Political movements of the extreme right have traditionally fed on anti-immigration sentiment. But the Greek, Irish, Portuguese, and other bailouts, together with the euro's troubles, have given them fresh ammunition. Their euro skepticism certainly appears to be vindicated by events. When Marine Le Pen was asked if she would unilaterally withdraw from the euro, she replied confidently, "When I am president, in a few months' time, the eurozone probably won't exist."

As in the 1930s, the failure of international cooperation has compounded centrist politicians' inability to respond adequately to their domestic constituents' economic, social, and cultural demands. The European project and the eurozone have set the terms of debate to such an extent that, with the eurozone in tatters, these elites' legitimacy has received an even more serious blow.

Europe's centrist politicians have committed themselves to a strategy of "more Europe" that is too rapid to ease local anxieties, yet not rapid enough to create a real Europe-wide political community. They have stuck for far too long to an intermediate path that is unstable and beset by tensions. By holding on to a vision of Europe that has proven unviable, Europe's centrist elites have endangered the idea of a unified Europe itself.

The short-run and long-run remedies for the European crisis are not hard to discern in their broad outlines, and they are discussed below. Ultimately, Europe faces the same choice it always faced: it will either embark on political union or loosen the economic union. But the mismanagement of the crisis has made it very difficult to see how this eventual outcome can be produced amicably and with minimal economic and political damage to member countries.

Fads and Fashions in the Developing World

The last two decades have been good to developing countries. As the United States and Europe were reeling under financial crisis, austerity, and the populist backlash, developing economies led by China and India engineered historically unprecedented rates of economic growth and poverty alleviation. And for once, Latin America, Sub-Saharan Africa, and South Asia could join the party alongside East Asia. But even at the height of the emerging-markets hype, one could discern two dark clouds.

First, would today's crop of low-income economies be able to replicate the industrialization path that delivered rapid economic progress in Europe, America, and East Asia? And second, would they be able to develop the modern, liberal-democratic institutions that today's advanced economies acquired in the previous century? I suggest that the answers to both of these questions may be negative.

On the political side, the concern is that building and sustaining liberal democratic regimes has very special pre-requisites. The crux of the difficulty is that the beneficiaries of liberal democracy, unlike in the case of electoral democracies or dictatorships, typically have neither numbers nor resources on their side. Perhaps we should not be surprised that even advanced countries are having difficulty these days living up to liberal democratic norms. The natural tendency for countries without long and deep liberal traditions is to slide into authoritarianism. This has negative consequences not just for political development but economic development as well.

The growth challenge compounds the democracy challenge. One of the most important economic phenomena of our time is a process I have called "premature deindustrialization."[10] Partly because of automation in manufacturing and partly because of globalization, low-income countries are running out of industrialization opportunities much sooner than their earlier counterparts in East Asia did. This would not be a tragedy if manufacturing was not traditionally a powerful growth engine, for reasons I discuss below.

With hindsight, it has become clear that there was in fact no coherent growth story for most emerging markets. Unlike China, Vietnam, South Korea, Taiwan, and a few other manufacturing miracles, the recent crop of growth champions did not build many modern, export-oriented industries. Scratch the surface, and you find high growth rates driven not by productive transformation but by domestic demand, in turn fueled by temporary commodity booms and unsustainable levels of public or, more often, private borrowing. Yes, there are plenty of world-class firms in emerging markets, and the expansion of the middle class is unmistakable. But only a tiny share of these economies' labor is employed in productive enterprises, while informal, unproductive firms absorb the rest.

Is liberal democracy doomed in developing economies, or might it be saved by giving it different forms than it took in today's advanced economies? What kind of growth models are available to developing countries if industrialization has run out of steam? What are the implications of premature deindustrialization for labor markets and social inclusion? To overcome these novel future challenges, developing countries will need fresh, creative strategies that deploy the combined energies of both the private and public sectors.

No Time for Trade Fundamentalism

"One of the crucial challenges" of our era "is to maintain an open and expanding international trade system." Unfortunately, "the liberal principles" of the world trade system "are under increasing attack." "Protectionism has become increasingly prevalent." "There is great danger that the system will break down . . . or that it will collapse in a grim replay of the 1930s."

You would be excused for thinking that these lines are culled from one of the recent outpourings of concern in the business and financial media about the current backlash against globalization. In fact, they were written thirty-six years ago, in 1981.[11]

The problem then was stagflation in the advanced countries. And it was Japan, rather than China, that was the trade bogeyman, stalking—and taking over—global markets. The United States and Europe had responded by erecting trade barriers and imposing "voluntary export restrictions" on Japanese cars and steel. Talk about the creeping "new protectionism" was rife.

What took place subsequently would belie such pessimism about the trade regime. Instead of heading south, global trade exploded in the 1990s and 2000s, driven by the creation of the World Trade Organization, the proliferation of bilateral and regional trade and investment agreements, and the rise of China. A new age of globalization—in fact something more like hyperglobalization—was launched.

In hindsight, the "new protectionism" of the 1980s was not a radical break with the past. It was more a case of regime maintenance than regime disruption, as the political scientist John Ruggie has written. The import "safeguards" and "voluntary" export restrictions (VERs) of the time were ad hoc, but they were necessary responses to the distributional and adjustment challenges posed by the emergence of new trade relationships.[12]

The economists and trade specialists who cried wolf at the time were wrong. Had governments listened to their advice and not responded to their constituents, they would have possibly made things worse. What looked to contemporaries like damaging protectionism was in fact a way of letting off steam to prevent an excessive buildup of political pressure.

Are observers being similarly alarmist about today's globalization backlash? The International Monetary Fund, among others, has recently warned that slow growth and populism might lead to an outbreak of protectionism. "It is vitally important to defend the prospects for increasing trade integration," according to the IMF's chief economist, Maurice Obstfeld.[13]

So far, however, there are few signs that governments are moving decidedly away from an open economy. President Trump may yet cause trade havoc, but his bark has proved worse than his bite. The website globaltradealert.org maintains a database of protectionist measures and is a frequent source for claims of creeping protectionism. Click on its interactive map of protectionist measures, and you will see an explosion of fireworks—red circles all over the globe. It looks alarming until you click on liberalizing measures and discover a comparable number of green circles.

The difference this time is that populist political forces seem much more powerful and closer to winning elections—partly a response to the advanced stage of globalization achieved since the 1980s. Not so long ago, it would have been unimaginable to contemplate a British exit from the European Union, or a Republican president in the United States promising to renege on trade agreements, build a wall against Mexican immigrants, and punish companies that move offshore. The nation-state seems intent on reasserting itself.

But the lesson from the 1980s is that some reversal from hyperglobalization need not be a bad thing, as long as it serves to maintain a reasonably open world economy. In particular, we need to place the requirements of liberal democracy ahead of those of international trade and investment. Such a rebalancing would leave plenty of room for an open global economy; in fact, it would enable and sustain it.

What makes a populist like Donald Trump dangerous is not his specific proposals on trade. It is the nativist, illiberal platform on which he seems intent to govern. And it is as well the reality that his economic policies don't add up to a coherent vision of how the United States and an open world economy can prosper side by side.

The critical challenge facing mainstream political parties in the advanced economies today is to devise such a vision, along with a narrative that steals the populists' thunder. These center-right and center-left parties should not be asked to save hyperglobalization at all costs. Trade advocates should be understanding if they adopt unorthodox policies to buy political support.

We should look instead at whether their policies are driven by a desire for equity and social inclusion or by nativist and racist impulses, whether they want to enhance or weaken the rule of law and democratic deliberation, and whether they are trying to save the open world economy—albeit with different ground rules—rather than undermine it.

The populist revolts of 2016 will almost certainly put an end to the last few decades' hectic deal making in trade. Though developing countries may pursue smaller trade agreements, the two major regional deals on the table, the Trans-Pacific Partnership and the Transatlantic Trade and Investment Partnership, were as good as dead immediately after the election of Donald Trump as US president.

We should not mourn their passing. We should instead have an honest, principled discussion on putting globalization and development on a new footing, cognizant of our new political and technological realities and placing the requirements of liberal democracy front and center.

Getting the Balance Right

The problem with hyperglobalization is not just that it is an unachievable pipe dream susceptible to backlash—after all, the nation-state remains the only game in town when it comes to providing the regulatory and legitimizing arrangements on which markets rely. The deeper objection is that our elites' and technocrats' obsession with hyperglobalization makes it more difficult to achieve legitimate economic and social objectives at home—economic prosperity, financial stability, and social inclusion.

The questions of our day are: How much globalization should we seek in trade and finance? Is there still a case for nation-states in an age where the transportation and communications revolutions have apparently spelled the death of geographic distance? How much sovereignty do states need to cede to international institutions? What do trade agreements really do, and how can we improve them? When does globalization undermine democracy? What do we owe, as citizens and states, to others across the border? How do we best carry out those responsibilities?

All of these questions require that we restore a sane, sensible balance between national and global governance. We need a pluralist world economy where nation-states retain sufficient autonomy to fashion their own social contracts and develop their own economic strategies. I will argue that the conventional picture of the world economy as a "global commons"—one in which we would be driven to economic ruin unless we all cooperate—is highly misleading. If our economic policies fail, they do so largely for domestic rather than international reasons. The best way in which nations can serve the global good in the economic sphere is by putting their own economic houses in order.

Global governance does remain crucial in those areas such as climate change where the provision of global public goods is essential. And global rules sometimes can help improve domestic economic policy, by enhancing democratic deliberation and decision-making. But, I will argue, democracy-enhancing global agreements would look very different than the globalization-enhancing deals that have marked our age.

We begin with an entity at the very core of our political and economic existence, but which has for decades been under attack: the nation-state.