

How can the free trade system be saved from crisis?

U.S. President Donald Trump's tariff strategy has thrown the world trade system into significant disarray. As a result, the free trade system is said to be facing a serious crisis.

What exactly is a free trade system in the first place, and what specifically does it mean when people say there is a crisis?

The world trade system was first supported by the General Agreement on Tariffs and Trade (GATT), which came into being under the post-World War II Bretton Woods system. Since 1995, it has been backed by the World Trade Organization, which replaced GATT.

The GATT regime was led by Western countries, but emerging economies and developing countries joined the WTO as active members, enabling the organization's influence to spread across many countries and regions. A particularly important turning point for the WTO was China's accession in 2001.

In the context of this article, the free trade system refers to the trading system that has developed since China joined the WTO. To be specific, it is a trading system that not only facilitates traditional trade between major countries — the selling and buying of final products and resources — it also drives global economic growth through the cross-border division of labor thanks to the supply chains stretching across the world.

This environment features a complex global division of labor, as well as cross-border trade within enterprises and diverse networks of direct investment.

U.S. journalist Thomas Friedman focused on this environment in his 2005 book "The World is Flat." Since China's accession to the WTO, the global economy has undergone a significant transformation, continuing to grow at an unprecedented speed.

Based on the anticipation that emerging economies were likely to underpin global economic growth, the term "BRICs" was coined to denote the economies of Brazil, Russia, India and China.

The world economy's fast growth stumbled temporarily in 2008 due to the Lehman shock, but the "flattening" of the world continued thereafter.

In that time, the United States' view of China has changed. A senior U.S. government official told an international conference that American officials expected China to come closer to their way of doing things by joining the WTO, but it seems that China has made a U-turn midway.

Protectionist policies have become evident in



INSIGHTS INTO THE WORLD

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the United States after the inauguration of the Trump administration. But tensions between the United States and China — the world's No. 1 and No. 2 trading powers — had been apparent before that. In other words, the process of reviewing the flattening of the world economy had already begun. Increased trade liberalization seems to be a good thing for every economy in the world. However, nearly 30 years of dynamic growth in the global economy — the brisk rise of China in particular — has fostered an entirely different view within the United States.

Over that period, the U.S. manufacturing industry was hit hard by the sharp increase in imports from China.

This situation was analyzed by David Autor, a professor at the Massachusetts Institute of Tech-

nology, and others in their "China shock" theory. Their analysis sent out shock waves among scholars who had advocated free trade.

Areas exposed to fierce competition from inexpensive imports from China witnessed a significant increase in unemployment and a notable decrease in wages. Moreover, labor-force participation rates — the number of people employed and actively seeking employment as a percentage of the working-age population — fell conspicuously, with low-education, low-skilled workers hit particularly hard.

Of course, advocates of the China shock theory do not dismiss the benefits of trade. But while the gains from trade tend to be thinly spread throughout society, the pain of trade is concentrated in certain areas and industries.

Many people live their daily lives without feeling the gains from trade, but those who are compelled to feel the pain of trade strongly resent imports.

This is why protectionism, which advocates trade restrictions from the perspective of political economy, tends to come to the fore even though free trade is desirable in economic theory.

Post-Trump U.S. policy

Many people may think that U.S. protectionism results from Trump's unique way of thinking. However, as pointed out by the China shock theory, the global trade system, which has developed over the past 30 years or so, has brought a greater shock to the U.S. economy than previously thought. There are concerns that the trend of protectionism will remain strong even in a post-Trump U.S. trade policy.

Trump's tariff measures violate the WTO regime's two important principles — one that prohibits countries from raising tariffs and the other, known as the most-favored-nation (MFN) treatment principle, that bans countries from imposing discriminatory tariffs on certain trading partners.

It is no exaggeration to say that these two principles have fundamentally supported the free trade regime. The United States has now broken

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these principles, which it should have supported. Indeed, the United States is endangering the free trade system.

Proactive corporate activity is vital for a flattening global economy. How much should a company produce in which country? Which overseas companies should it collaborate with? In which market should it expand sales? Each company makes investments based on outlooks regarding these factors.

Such decision-making inevitably requires an environment devoid of uncertainty. After a tariff has been decided, it should not be raised arbitrarily. Compliance with the WTO principles, in other words no increase in tariffs and upholding the MFN treatment, is a prerequisite for global corporate activity.

The increase in import duties resulting from

the Trump administration's tariff measures is having a major impact on immediate trade. This itself is a major issue, but aside from this temporary impact, there is one more concern that should be addressed.

The concern is: to what extent will trade be affected in the medium to long term once we have an environment in which tariffs change frequently, embedding uncertainty into the trade system?

As mentioned earlier, the flattening of the world has continued over the past 30 years or so, during which time the global economy has registered high growth.

If the rise of protectionism sets back the process of such flattening, there will be a significantly negative impact on economic growth. The question then is how protectionist movements will spread in the post-Trump United States and other major countries.

As explained earlier in connection with the China shock theory, the political and economic factors driving protectionism are deep-rooted. So, now that the United States has begun moving toward protectionism, it is not easy to stop it. Also, it is unlikely that we can expect any other country to replace the United States in leading the free trade system.

That is all the more reason for major countries to first of all deepen their understanding about how enormous the economic costs of protectionism are.

The debate over the China shock theory has shown that naive theories advocating free trade are not persuasive enough. So, what is required now is to make it clear how dangerous naive protectionism is.

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