From Old World to Real World

By Steven Pearlstein
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Ever since David Ricardo constructed his simple, two-country, two-product analysis back in 1817, all right-thinking people have understood that trade is good. The British make the wool, the Portuguese make the wine, and because of the magic of specialization, scale economies and comparative advantage, everyone is better off from the cross-border exchange.

Economics has developed considerably since then, but the logic of free trade has remained essentially unchanged. Therein lies a problem. Because in the real world of many countries and many goods, of multinational corporations and the free flow of technology and capital, "free trade" may not be the win-win proposition that economic theory suggests.

Consider Intel's recent announcement that it would build an advanced, $2.5 billion chip fabrication plant in Dalian, on China's northeast coast.

We can all agree this plant will be a boon to the Chinese economy. And we can be pretty sure it will be in the interests of Intel shareholders. But is it really in the best interests of the U.S. economy?

It would be one thing if the Chinese had developed the capacity to make advanced microchips on the basis of their own investment and ingenuity. But it is quite another when the technology for the chips and chip production has been created by American researchers and American companies, and transferred wholesale to a developing country that makes no secret of its intention to use that knowledge and experience to improve its own industry.

By what reasoning is this a net plus for an American economy that is supposed to prosper in this globalized world on the basis of its high-tech know-how? Can you really say that, in such a high-value-added industry, the lower cost of imported computer chips will offset the foregone economic output -- jobs and profits -- that Intel's move entails?

As it turns out, the reason it will be cheaper for Intel to make those chips in China has little to do with lower-cost labor. That's because chip factories aren't particularly labor intensive. In fact, a study by the Semiconductor Industry Association found that 90 percent of Asia's cost advantage over U.S. production is attributable to government subsidies and tax breaks. In the case of Intel's new plant, I'm reliably told that those subsidies amount to about $500 million. That's a sum well beyond anything available to Intel in the United States. And it hardly fits into any common-sense notion of free trade or fair and open competition.

In fact, there is a name for this kind of economic pump priming -- strategic trade -- and

economists have known for decades that when pursued by a developing economy, it can largely negate the benefits of trade to a developed country like the United States. That was Paul Krugman's contribution to trade theory, and it is as relevant now in thinking about China as it was in thinking about Japan when Krugman devised it.

In the hands of Japan and China, strategic trade has also involved currency manipulation -- keeping the value of their currencies artificially low to stimulate exports and disadvantage foreign competitors. Once again, this is not something to be found in any of the idealized models of free trade, where the rise in the productivity of Chinese workers is supposed to be reflected in the rising value of the yuan. As long as China keeps the yuan artificially pegged to the dollar, that natural adjustment cannot occur and trade flows never balance out. The result is a large and growing U.S. trade deficit which, with each passing year, represents a drain on the national income (to pay the interest on the accumulated debt) and transfer of ownership of the country's productive capacity into foreign hands. These are very real costs, but as far as I can tell, they are rarely included when economists calculate the benefits of trade.

Finally, it's fair to note that some trade benefits begin to disappear when the country you're trading with steals your intellectual property, whether it's hit movies, drug formulas or high-tech patents. It's hard to believe a government that has proven so effective in controlling so many other aspects of life in China is somehow impotent in the face of commercial theft.

Does this mean we should shut down trade or investment with a country like China? No. But it does suggest that we've gotten well beyond wool and wine and Ricardo's neat little model, that trade has morphed into something more complex called globalization and that we need mechanisms to ensure the benefits are well distributed, not only between countries but within them.

Contrary to what you hear from editorial writers and other free-trade ideologues, it is not "protectionist" for the United States to impose countervailing duties on imports from a country that subsidizes exports and keeps its currency pegged to the dollar.

It's not "anti-business" to toss out a tax code that encourages multinational corporations to invest overseas and replace it with one that gives tax preferences to companies that create high-value-added jobs in the United States.

And it is not "class warfare" to raise taxes on those who have benefited from globalization to pay for health care, wage insurance and retraining of workers who have lost their jobs as a result of globalization.

There is a reason that, when it comes to trade and globalization, more Americans believe Lou Dobbs than Hank Paulson and Ben Bernanke -- and it's not because they've been bamboozled. The reason is that Americans perceive, correctly, that in recent years liberalized trade has not delivered as promised, that education alone is not the answer,

and that neither party has come up with economic policies as tough and effective as China's.