The Betrayal of American Prosperity: Free Market Delusions, America's Decline, and How We Must Compete in the Post-Dollar Era

(Clyde Prestowitz)

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For decades, "free trade" has been the American orthodoxy across the mainstream of both Left and Right. Some recent erosion has occurred, though, with the Bernie Sanders Left dividing from the neoliberal Left on this issue, and with the reactionary and Trumpian segments of the Right dividing from the corporatist Right. However, cogent, clear-eyed intellectual support has been thin for the position that wholly unfettered and unguided free trade is not necessarily a wonderful tonic for every economy. This 2010 book provides such support, and was an early entrant in a field that will, perhaps, become more crowded over time.

Clyde Prestowitz, the author, isn't some hack, or a crank, like George Gilder or Peter Schiff. He served as the principal trade negotiator for Asia in the Reagan administration (though he will be the first to tell you that his impact was minimal), and has had an advisory role with respect to the Commerce Department. In addition, he is a moderately prominent public intellectual on economic matters—for example, this week he wrote a review in the *Washington Monthly* on Dani Rodrik's new book *Straight Talk on Trade*. I think *The Betrayal of American Prosperity* may be too pessimistic, as the world shifts around us in this Trumpian age, and its title does make the author sound like a conspiracy theorist, which he is not, but the book makes worthwhile reading.

The book is certainly more timely today than it was nearly a decade ago. In fact, it is so timely as to be ironic, at least on a small scale, in that a key trope of the book is that Prestowitz repeatedly objects, as exemplifying bad free trade, that most of what China sells us is consumer goods of increasing sophistication, and a significant portion of the goods we sell China are literally garbage—i.e., waste. To Prestowitz, even if the dollar values of what we trade with China balanced (they don't), this says very bad things about America. To an unfettered free trader, though, goods for garbage is merely Ricardian comparative advantage. It seems that Prestowitz has had the last laugh, at least on the issue of goods for garbage. This month, in January of 2018, China has announced that it will simply no longer accept "foreign waste," including much of the waste we ship China. Apparently selling garbage rather than value added products is not, after all, a viable economic strategy for the long term. Even if we are not going to fight China, they are calling the tune, and we are dancing.

Prestowitz would say this failure is just one example of the necessary result of decades where America, and only America, failed to guide its actions with a coherent strategy to ensure future competiveness. Now, we have a mountain of garbage and owe trillions, and China has hard assets, fresh infrastructure, and owns our debt. Prestowitz's argument boils down to two related points. First, the idea that unfettered free trade, through the supposed magic of Ricardian comparative advantage, necessarily maximizes each country's return is false. Second, even were free trade to maximize return, we don't have unfettered free trade. We have a global system where we, America, have no national strategy, while the rest of the developed and developing world competes with a strategy that involves active public-private cooperation, and active government support, in myriad ways targeted to achieve economic objectives. And as a result, America, and Americans, are getting screwed. Our economy is not growing as it should, and baleful effects like increased inequality and lack of social mobility have resulted.

The author's key distinction is between "unilateral" and "reciprocal" free trade. At its simplest, the former means that a country reduces tariffs to zero, even if its trading partners maintain their tariffs. In essence, this is what America has done since the 1960s. At a more complicated level, unilateral free trade means no support for domestic industry. No other modern country, besides the United States, has ever endorsed, much less practiced, unilateral free trade. Rather, they carefully negotiate "tit for tat" free trade, while supporting their own objectives within that framework. In other words, the world is not flat. But Prestowitz has much more to say than that. What Prestowitz wants, at its core, is for the United States to adopt strategies that lead to a trade surplus, a robust manufacturing base, and keeping key knowledge, and chains of knowledge, centered in the United States.

Prestowitz begins with a pessimistic view of the "Real State of America." Here, he focuses on the importance of the dollar as global pricing and reserve currency, and the consequent ability of America to finance current account imbalances without apparent cost. Of course, this only works if the dollar stays the reserve currency (the end of which status is the jumping off point for Lionel Shriver's recent dystopian novel, *The Mandibles*). He notes that American economic superiority after World War II allowed us to get into the bad habit of trading economic carrots for geopolitical cooperation, so we voluntarily engaged in unilateral free trade early and often, because we could afford to. And even though American economic superiority long ago disappeared, we keep doing it, and we similarly keep quiet about the one-sided and "unfair" behavior of our trading partners (at least we did before Trump showed up). As a result, we are a debtor nation, our infrastructure is decaying and, of most importance, our manufacturing base is shot. "In 2008, 80 major [industrial] plants costing in excess of $1 billion were being constructed somewhere in the world. None of them was being constructed in the United States." We make less and less that the world values, yet we keep consuming through the magic of dollar-denominated debt.

Prestowitz attributes the falling behind of the United States, that is, behind the rest of the developed world, especially in manufacturing, mainly to six actions other countries take but we do not. First, they devalue their currencies relative to the dollar, making exports more attractive. Second, they offer "tax holidays, capital grants, free infrastructure, labor wage agreements, and regulatory exemptions that many countries use to entice investment by targeted global companies and that the United States does not match." Third, they enforce a variety of coercive quid pro quo requirements, such as Boeing being required to build airplanes in China, and such as technology transfer obligations common when American companies open foreign factories. Fourth, they offer low corporate tax rates. Fifth, they avoid "onerous and complex U.S. regulatory procedures." Sixth, they also avoid the uncooperative relations that characterize labor and management in the United States. And Prestowitz rejects the idea that it is high labor expense in the United States that makes it an undesirable place to manufacture. Much industry is not labor-intensive, and these six actions are, collectively, in his view determinative.

Of course, Prestowitz is aware that the standard globalist response to this, from Democrats and Republicans, at least traditionally, is that free trade is a universal salve and manufacturing is inessential. At its most naked, this is encapsulated in a quote Prestowitz offers from Herbert Stein, a former chairman of the Council of Economic Advisers: "They will sell us Toyotas and we'll sell them poetry." But even when we're not pushing poetry, and instead pushing high technology and high-end services like medical diagnostics, we're losing ground there too, for many of the same reasons. For example, in 1999, 36 percent of semiconductor wafers were produced in the United States; in 2009, about 15 percent. I looked up more recent statistics; in 2015, it was 13 percent, and in 2016, the last major United States wafer manufacturer was purchased by a Taiwanese company who, it is safe to assume, will eventually move production to Taiwan. And, as Prestowitz points out repeatedly, when manufacturing leaves, so does the R&D-manufacturing ecosystem that goes along with it, including people with knowledge. This is at least as important, for it eats our seed corn. Not to mention that we are generally producing less knowledge—American universities increasingly educate foreigners, especially in STEM, and university administrators view themselves as serving the globe, not America.

Prestowitz offers a lot of history to illuminate the present. He praises the "American system" that America used up until World War II, originated by Alexander Hamilton, an export-led growth model involving substantial government protection and support of American industry, of its infrastructure, manufacturing capability and generation of intellectual property. He lauds the economist Daniel Raymond, an early proponent of the idea that Adam Smith's focus was excessively and unrealistically on the individual, and he notes the various tariff policies of the nineteenth century, along with government support for industry and technology. He spends equal time, though, on English history, which began with a similar, if more mercantilist, model, but in the nineteenth century, under the influence of Smith and, even more, David Ricardo, moved increasingly to unilateral free trade. The rest of Europe (i.e., the rest of the world that mattered at the time) did not; they followed economists like the German Friedrich List, whose focus was the "national economy," not the individual's consumption, who criticized Smith's and Ricardo's analysis as both static and relying on false simplifications and assumptions (I know, shocking for an economist to do that).

Thus, England stood alone in adopting unilateral free trade—and paid the price in a decline that began not, as often perceived now, in the early twentieth century, but in the mid-nineteenth, with its lunch being eaten by America and Germany. The English exported much less manufactured products and much more raw materials, especially coal—not dissimilar, Prestowitz claims, to us shipping garbage to China in return for manufactured goods. And they relied increasingly on exported services. This economic decline was masked by the dominion of Empire and control of world shipping; Prestowitz quotes John Maynard Keynes's famous 1920 soliloquy beginning "The inhabitant of London could order by telephone, sipping his morning tea in bed, the various products of the whole earth, in such quantity as he might see fit, and reasonably expect their early delivery upon his doorstep. . . ." He may still be able to do that, but England's relative position has declined to near irrelevancy, and Prestowitz ascribes that to more than a hundred years of slavish and irrational devotion to unilateral free trade.

The United States, in 1922, hiked tariffs massively, with the Fordney-McCumber tariff of 1922. You have never heard of this, although you have heard of Smoot-Hawley, a 1930 tariff bill often blamed for causing the Great Depression. What followed Fordney-McCumber, though, was the Roaring Twenties, and Prestowitz follows many modern economists in blaming the Depression primarily on bad monetary policy, as well as global depression affecting United States exports, rather than on Smoot-Hawley. (He points out that in the Depression, duty free imports fell more than dutiable imports.) After World War II, the United States economy exploded, as we all know—but America, shortsightedly perceiving itself as permanent hegemon, began engaging in unilateral free trade (in part to buy geopolitical concessions from allies). Meanwhile, as with Britain and the continent in the nineteenth century, the rest of the free world did nothing of the sort—rather, they all, from Japan to Europe, engaged in various forms of aggressive government support for industry and exports. So the United States followed the bad path of Britain, and its relative position eroded.

Prestowitz goes through the gritty details of Bretton Woods, GATT/WTO, the end of the gold standard, and so forth. In particular, he complains that America, which was running massive trade surpluses at the time of Bretton Woods, blocked Keynes's proposal that the IMF penalize trade surpluses as well as trade deficits, as well as his proposal for a new international currency, the bancor, to prevent the foreseeable ill effects of the dollar's dominance, such as the ability for America, and only America, to thereby "accumulate chronic deficits, export inflation, live beyond its means." The gold standard was thought to reduce the risk to any given country, since trade deficits would result in gold reserves flowing outwards, but we know what happened to that.

The author then spends two entire chapters attacking the dogma of efficient markets (he was doubtless pleased Richard Thaler won the Nobel Prize last year), adducing Long-Term Capital Management, the dot-com bubble, and, of course, the 2008 financial crisis, housing, and CMOs. And as America turned more and more to unilateral free trade, in part based on the new economics of efficient markets, the industrializing Asian economies were engaging in private-public action of various kinds, such as Korea's earlier Heavy and Chemical Industries programs, creating not only export-focused industry but, perhaps more importantly, knowledge networks (and requiring that United States companies desiring to sell into their markets transfer knowledge to those networks).

Prestowitz then turns back to examine Ricardo some more. He notes the commonplace that Ricardo not only made many simplifying assumptions, but that many of the core facts of his world, such as the inability to transfer factories to other countries, no longer are true. Prestowitz cites Paul Krugman's work (before he became a politicized hack) on creating a revised Ricardian world, including adding the effects of currency fluctuations, monopolies, cross-border movement of capital, knowledge, and labor and, most importantly, accounting for economies of scale, as well as the work of Ralph Gomory, William Baumol, Gary Pisano, and Willy Shih. I am not qualified to evaluate any of this, but Prestowitz makes a compelling case for the deficiency of unilateral free trade based on claimed Ricardian premises, which is all you usually hear from politicians and from businesspeople who will personally benefit from it. Prestowitz goes so far as to say that "Indeed, the cross-border flow of capital, technology and labor—modern globalization, in other words—make the concept of comparative advantage irrelevant." Flowing from this is the related problem that there are many "Companies Without a Country"—most big corporations in America don't care about America, they care about lining their pockets and being seen as global citizens, not to mention that many foreign companies, and foreign interests, maintain very effective lobbies in Washington.

Much of this analysis is related to Richard Baldwin's in *The Great Convergence*, which ascribed part of the economic rise of six countries (China, Korea, India, Indonesia, Thailand, and Poland) largely to cheaper communications allowing comparative advantage to take place on a subnational scale. Thus, a country can compete without fully industrializing, and therefore only sectors of a country may benefit from the upside of comparative advantage, while other sectors get only the downsides. America transfers knowledge, developed here with taxpayer resources, to foreign countries in order to run factories there; the American elite benefit, as does the target country, but most Americans are harmed by the increase in foreign competition.

Prestowitz then turns to what an American "export-led" strategy would look like. It would not look like the caricature of those who bring up Smoot-Hawley whenever this topic comes up. He notes that "Tariffs are not the only means of limiting imports. An export-led economy is organized and managed so as to avoid any imports that might prevent the achievement of that country's trade surplus objective. Thus, the myriad regulations, inspections, standards, and distribution arrangements that in a laissez-faire economy are left to individual actors, in an export-led economy, are carefully managed and orchestrated to achieve policy goals." Prestowitz offers the example that in the 1970s Japan agreed to reduce tariffs on imported semiconductors—then immediately directly subsidized domestic manufacturers, put pressure on Japanese companies to only buy Japanese semiconductors, limited investment by foreigners in Japanese semiconductor companies, and devalued the yen to make exports competitive and encourage saving. The result was a minimal increase in semiconductor imports into Japan.

All this, of course, is in service of Prestowitz's conclusion that what we need is to adopt our own export-led strategy. All other developed countries have such a strategy; we don't, because we're blinded. (Prestowitz points out that, contrary to a common belief, WTO agreements do not preclude a variety of such tactics that the United States nonetheless, unlike its trading partners, refuses to use.) Unsurprisingly, perhaps, those demanding free trade never engage with the ideas of people like

Prestowitz. There is muttering about "protectionism" and "mercantilism," but they never seem to respond in any material fashion. This is because we're blinded by a false ideology held across the political spectrum and by the fact that United States executives often act as "foreign emissaries." One might have thought Trump could have led such a move, but, unfortunately, Trump is both not consistent enough, and is surrounded by enough people who do not have America's interests at heart, to press for turning America into an export-led economy.

Of course, not all government support is good support. The problem is not (necessarily) that the government is bad at picking winners and losers. On a scale larger than individual companies, we already do (ignoring the corruption under Obama that funneled money to individual companies like Solyndra). We already favor agriculture, home buying and construction, and most importantly the financial sector, which in 2005 had forty percent of all business profits in the country, due to the billions spent on lobbying. So we do have a strategy. "It is to overconsume, and to promote weapons production, financial services, construction, medical research and services, agriculture, and oil and gas consumption and production. Further, it is both to offshore production and provision of all tradable manufacturing and services as well as, increasingly, high-technology R&D, and to expand domestic retail, food service, and personal medical services industries." It's just not a good strategy.

Rarely, but sometimes, Prestowitz strikes a false note, or a falsified note, such as when he complains about American dependence on oil as a key element of the trade deficit, and pushes (though not hard) so-called green technology. He insists that part of restoring United States competitiveness and growth is reducing our dependence on oil, and that we will never come close to the 1970 record for domestic oil production. But he could not foresee the fracking revolution (which affects natural gas even more than oil), or predict, as is true, that in 2018 the United States will produce more oil than in 1970—more than any other year in history, that is. He concludes we need to conserve and move to alternative energy, in order to keep petroleum from being a major contributor to our trade deficit.

Even if that were still true, "green" policies only make sense if they make sense objectively; whether it is green, whatever that means (national policies should not turn around protean and ideologically freighted terms) should have nothing to do with it. Prestowitz emphasizes that getting ahead in alternative energy relies in part on being the first mover, and thus being the first to achieve economies of scale. Maybe, although there are plenty of counter-examples, including first movers who went down blind alleys, or invested and were leapfrogged by others. But leaving those problems aside, it is only important to be the first mover in something that is actually desired by a real market. Being first mover to sell goods into an end market that only exists due to massive government subsidies to suppliers and buyers, which is all alternative energy, is worth no more than being the first mover into the market for home tooth extraction.

On the other hand, maybe things are looking up, even if Trump is not particularly coherent. The corporate tax rate has been slashed, thereby taking one of the six actions Prestowitz identifies as key elements of an export-led strategy (and other related tax actions have been taken to encourage firms to return to America). I see in today's *Washington Post* that "Apple said Wednesday that it will spend $350 billion in development and create 20,000 jobs in the United States in the next five years, following the recent corporate tax changes and a greater push to increase manufacturing in the U.S." I am sure that Prestowitz was not surprised to learn that China's response to these recent Republican moves (for, after all, not a single Democrat voted for these changes) was to temporarily exempt foreign companies located in China from paying tax on their earnings—as long as they invest those earnings in sectors favored by the Chinese government, including railways, mining, and technology. And the Chinese measure was retroactive a full twelve months, unlike the American tax changes. More broadly, it is all over the news that China has implemented aggressive plans, as a direct response to the American move, to support (read: prop up) the yuan, implement more capital controls and manipulate interest rates. Finally, I see in the *Wall Street Journal* from a few weeks ago that, according to an article with the headline "The EU, A Disciple of Free Trade, Is Erecting Barriers," the supposedly single-market EU is increasingly facing member countries erecting barriers to protect their own industries, going beyond the traditional barriers put up to support EU economies as a whole. All this pretty much proves Prestowitz's thesis, that America is late to the game of giving its citizens a leg up. That it took Trump to do this suggests the United States could not implement a broader reversal of strategy if it wanted, at least under the current structure of government and society. I fear that "industrial policy" in America as it exists today would merely be a form of crony capitalism—again, that's what we saw under Obama, with subsidies to favored companies like General Electric and fake "green" companies. But maybe, just maybe, we may revise our strategy to one that favors America as a whole.