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## ECONOMIC NEWS UPDATE

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### **Grim Days for Free Traders**

Don't be deceived by the headlines coming out of Washington. There is more going on than a tussle over the wisdom of the President's decision to send more troops to Iraq. The battles over economic policy are just as intense, if not as eye-catching.

There is Barney vs. Ben -- Barney Frank, chairman of the House Financial Services Committee, vs. Ben Bernanke, chairman of the Federal Reserve Board. Bernanke wants his colleagues to begin to think about setting an explicit, though flexible, inflation target to use as a guide in setting interest rates. Exceed the target, and raise rates. Frank fears that will divert the Fed from its other mission, maintaining full employment. In short, in one corner we have soft money Democrats, for whom a whiff of inflation holds no terror, but to whom a few tenths of a percentage point rise in the unemployment rate is anathema. In the other corner we have the Fed, ever fearful that once inflation takes hold it is

difficult to wring out of the system without causing a major recession.

That battle is a tame dispute compared to the one shaping up over trade. Democrats howled in anger when the full-year trade figures were released. The trade deficit hit \$764 billion last year, a rise of 6.5% over 2005, and the fifth consecutive record. That prompted House Speaker Nancy Pelosi to demand that the President deliver a plan within 90 days to reduce the deficit with the European Union, China and Japan. Pelosi is fond of setting deadlines -- for the passage of favored legislation, or the withdrawal of troops from Iraq, or, now, the adoption of protectionist measures.

She and her Democratic allies were not placated when a closer look at the data showed that exports are rising rapidly, partly in response to the weaker dollar. The 13% jump in exports, which Commerce Secretary Carlos Gutierrez labeled "very significant growth", is thought by many experts to be a harbinger of future steady reductions in

the deficit and “will provide support for US growth”, according to economists at Goldman Sachs.

For the Democrats, attacking the trade deficit is part of their broader plan to identify themselves with what they perceive to be the anxieties of the average working American. The coherent program goes something like this. The Bush tax cuts favored the rich, and should be modified in some ways to tilt the benefits more towards the middle class. Rising income inequality is the result not only of those tax cuts, but of the failure of the Republicans to rein in excessive corporate compensation and bankers bonuses, and to allow oil, pharmaceutical and other industries to mulct the government of billions of dollars in special benefits. Through all of this, corporate profits have risen, partly because the administration’s free trade policies have forced American workers to compete with \$1-a-day Asian labor, while allowing big corporations to outsource work that once provided good jobs for Americans.

Pelosi knit all the pieces of this description of the economy neatly together in a letter to President Bush. “The consequences of these persistent and massive trade deficits include not only failed businesses, displaced workers, lower real wages and rising inequality, but also permanent devastation of our communities.” She wants Bush to take a tougher line in talks with China, including levying tariffs on imports that are “subsidized”, either directly or by the Chinese policy of keeping the renminbi at an artificially low level.

Japan is also in the Democrats’ sights. They complain that the Japanese are manipulating the yen to keep its value low, and don’t accept Treasury

Secretary Hank Paulson’s view that the weak yen reflects underlying economic conditions in Japan.

About all that can be said for this description of the enormous growth of the American economy is that it is internally coherent. Of course, it fails to explain how the suffering middle classes have managed to buy more and bigger homes, increase their net worth, convert flat-screen television sets from a luxury to a must-have appliance that now graces the homes of middle America, and send more and more of their offspring to institutions of higher learning -- well, colleges and universities, at any rate. Combined with voter disquiet over developments in Iraq, the Democrats’ tale of middle class angst hits the Republicans where it hurts, in the polls. Remember: if the Democrats merely add economically struggling Ohio to the states won by the appalling John Kerry, they will control the White House in addition to both houses of congress.

Although enthusiasm for freer trade is waning, and the odds against a revival of the broad Doha Round are mounting unless secret meetings held a few days ago in London bear fruit, there is some talk that a deal can be cut that will result in the approval of a series of smaller pacts. Democrats in congress, responding in part to pressures from their increasingly important Hispanic constituents, and unwilling to give Venezuela’s Hugo Chávez ammunition for his anti-American campaign, are prepared to approve deals with Peru, Panama and Columbia if the administration will include provisions regulating labor standards in those countries. Word from the office of the US Trade Representative is that the administration is prepared to make that concession.

Through all of this German Chancellor Angela Merkel continues to press forward with her plan for a “transatlantic partnership” that would “harmonize” intellectual property rules and other regulations, and bring down non-tariff barriers to trade. Bush is signed on, but my guess is that when if “harmonization” means importing EU-style regulations into the US, enthusiasm for the project will wane on this side of the ocean. That will leave it up to Britain’s Chancellor of the Exchequer and likely Blair successor, Gordon Brown, long an advocate of a TransAtlantic Free Trade Agreement (TAFTA), to press for an EU-US trade deal. He might persuade congress that such an arrangement is necessary to counter Chinese and Japanese competition. But so long as the present atmosphere prevails, such a deal will likely remain out of reach.



## **THE SUNDAY TIMES**

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