

## Robert Skidelsky: The case for compensated free trade

According to Harvard's Dani Rodrik, the nation-state, democracy, and globalisation are mutually irreconcilable: we can have any two, but not all three simultaneously. In fact, there may be a solution to Rodrik's "trilemma", **writes Robert Skidelsky**



Robert Skidelsky,  
Professor Emeritus of  
Political Economy at  
Warwick University

### Globalisation 'dangerously incompatible with democracy

Almost all liberals support globalisation and oppose economic nationalism. They ignore the mounting evidence that, in its current form, globalisation is dangerously incompatible with democracy. In his 2011 book [The Globalization Paradox](#), Harvard's Dani Rodrik says that the nation-state, democracy, and globalisation are mutually irreconcilable: we can have any two, but not all three simultaneously (he calls this a "trilemma").

All over the world, the "nation" has been revolting against globalisation in the name of democracy. That became clear this year when US President Donald Trump imposed the first of a widening set of tariffs against Chinese goods, with China retaliating in kind. Trump has also torn up two major

international trade treaties and threatened to withdraw from the World Trade Organization.

The trigger for America's turn to economic nationalism is its widening trade deficit – \$566 billion in 2017, and growing – as the US economy recovers. But the deeper reason is the correct perception that the resulting current-account deficits are not “benign” when they are being financed by inflows of short-term capital, or “hot” money.

## Protectionism and geopolitics

A current-account deficit means that a country is importing more than it is exporting. And those excess imports can lead to a net loss of “good” jobs. Six million manufacturing jobs disappeared in the first decades of the 2000s. The Rust Belt made Trump president. “It's time to rebuild Michigan, and we are not letting them take your jobs out of Michigan any more,” he told cheering crowds in Detroit in 2016.

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### *Trump's protectionism also has a geopolitical root*

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Trump's protectionism also has a geopolitical root. Metal imports have led to the closing of many enterprises that might be needed for defence. China's strategic “Made in China 2025” plan is a high-tech industrial policy aimed at transforming China into a dominant global leader in the industries of the future. It significantly relies on stealing advanced technologies from the United States. If MIC25 is successful, the US will have a depleted economic and political future.

In strictly economic terms, the political character of one's trading partners should not matter. However, in a world of strategic competition, international commerce can be, and usually is, an instrument of policy, and its use in that context should not be denied simply because it breaches the sacred principle of free trade.

As Friedrich List, the nineteenth-century pioneer of economic nationalism pointed out, free trade assumes a peaceful world. Selective tariffs can be useful for protecting defence-related industries or to prevent other countries from stealing cutting-edge technologies. But as an overall trade policy, tariffs are crude and inexact. The US will incur high costs and might end up without a substantially lower trade deficit or other meaningful benefits.

## Compensated Free Trade

Is there a way to limit free trade that does not lead to trade wars? The economist Vladimir Masch has advocated an ingenious “compensated free trade” (CFT) plan as a way to achieve legitimate protectionist aims without disrupting the world economic system. Under this plan, policymakers would establish a ceiling for the trade deficit each year and impose limits on trading partners' surpluses. (Any products needed from a surplus partner would be exempted from the partner's export limit.)

In the US case, this ceiling would largely affect China, Mexico, Japan, and Germany, which contributed \$375 billion, \$71 billion, \$69 billion, and \$64 billion, respectively, to the overall trade deficit in 2017.

Under CFT, a trade surplus country can reduce its exports to the set limit. But it could also exceed its export quota if its government paid the partner government a fine equal to the value of the excess exports, either collecting the necessary sum from its export producers or using its currency reserves. (The receiving government could use the fines to enlarge its own investment programs.) But if the surplus country tried to exceed its export limit without paying the fine, its surplus exports would be blocked.

## 'Smart protectionism'

This “smart” protectionism has several advantages over crude tariffs. First and foremost, it would automatically prevent trade wars. Because CFT imposes limits just on the trader’s surplus, any attempt by the surplus country to decrease the value of its imports from the US would automatically decrease the value of its allowed exports.

Second, CFT would confront, in one stroke for each partner, government subsidies, price and currency manipulations, and the other dirty tricks of international trade. In contrast to prolonged and often fruitless haggling over trade treaties, results would be obtained immediately.

Third, by re-balancing the financial and trading arrangements of the global economy’s participants, CFT would represent a step toward addressing its current dysfunction. CFT is not a complete solution, because it leaves open the question of who should adjust to whom. A reformed global payments system, which mandates symmetrical adjustment of global imbalances, would need to tackle this issue.

Fourth, because of America’s leverage, its adoption of CFT would “nudge” reluctant trade surplus countries to accept such a payments system. Global finance would have to operate within the limits that a balanced payments system establishes.

Fifth, in terms of economic benefits to the US, implementing CFT would stimulate the return of off-shored enterprises and jobs, thus restoring the country’s industrial potential and social balance.

## Learning from history

From a historical perspective, CFT essentially amounts to a unilateral activation of the scarce-currency clause (Article 7) of the Bretton Woods Agreement, which allowed the International Monetary Fund to declare “scarce” the currency of a country running a persistent trade surplus, permitting other members to discriminate against its goods. It is consistent with Article XII of the General Agreement on Tariffs and Trade (the WTO’s predecessor), which states that any country “in order to safeguard its external financial position and its balance of payments, may restrict the quantity or value of merchandise permitted to be imported.”

In short, CFT addresses trade deficits, overcomes the limitations of tariffs, fights trade manipulation, corrects current mainstream economic theory, and is a necessary step toward re-establishing a feasible global payments system. In a nutshell, it overcomes the Rodrik trilemma: one can have the nation-state, democracy, and globalisation at the same time.

But only one nation-state, the US, has the clout to deliver this. By doing so, it would stop the global stampede to a virulent form of economic nationalism. For that reason alone, the Masch plan deserves serious consideration.

This article first appeared in [Project Syndicate](#)

## Author

### **Alissa Lefebvre**

Economist

[alissa.lefebvre@ing.com](mailto:alissa.lefebvre@ing.com)

### **Deepali Bhargava**

Regional Head of Research, Asia-Pacific

[Deepali.Bhargava@ing.com](mailto:Deepali.Bhargava@ing.com)

### **Ruben Dewitte**

Economist

+32495364780

[ruben.dewitte@ing.com](mailto:ruben.dewitte@ing.com)

### **Kinga Havasi**

Economic research trainee

[kinga.havasi@ing.com](mailto:kinga.havasi@ing.com)

### **Marten van Garderen**

Consumer Economist, Netherlands

[marten.van.garderen@ing.com](mailto:marten.van.garderen@ing.com)

### **David Havrlant**

Chief Economist, Czech Republic

420 770 321 486

[david.havrlant@ing.com](mailto:david.havrlant@ing.com)

### **Sander Burgers**

Senior Economist, Dutch Housing

[sander.burgers@ing.com](mailto:sander.burgers@ing.com)

### **Lynn Song**

Chief Economist, Greater China

[lynn.song@asia.ing.com](mailto:lynn.song@asia.ing.com)

### **Michiel Tukker**

Senior European Rates Strategist

[michiel.tukker@ing.com](mailto:michiel.tukker@ing.com)

### **Michal Rubaszek**

Senior Economist, Poland

[michal.rubaszek@ing.pl](mailto:michal.rubaszek@ing.pl)

**This is a test author**

**Stefan Posea**

Economist, Romania  
[tiberiu-stefan.posea@ing.com](mailto:tiberiu-stefan.posea@ing.com)

**Marine Leleux**  
Sector Strategist, Financials  
[marine.leleux2@ing.com](mailto:marine.leleux2@ing.com)

**Jesse Norcross**  
Senior Sector Strategist, Real Estate  
[jesse.norcross@ing.com](mailto:jesse.norcross@ing.com)

**Teise Stellema**  
Research Assistant, Energy Transition  
[teise.stellema@ing.com](mailto:teise.stellema@ing.com)

**Diederik Stadig**  
Sector Economist, TMT & Healthcare  
[diederik.stadig@ing.com](mailto:diederik.stadig@ing.com)

**Diogo Gouveia**  
Sector Economist  
[diogo.duarte.vieira.de.gouveia@ing.com](mailto:diogo.duarte.vieira.de.gouveia@ing.com)

**Marine Leleux**  
Sector Strategist, Financials  
[marine.leleux2@ing.com](mailto:marine.leleux2@ing.com)

**Ewa Manthey**  
Commodities Strategist  
[ewa.manthey@ing.com](mailto:ewa.manthey@ing.com)

#### ING Analysts

**James Wilson**  
EM Sovereign Strategist  
[James.wilson@ing.com](mailto:James.wilson@ing.com)

**Sophie Smith**  
Digital Editor  
[sophie.smith@ing.com](mailto:sophie.smith@ing.com)

**Frantisek Taborsky**  
EMEA FX & FI Strategist  
[frantisek.taborsky@ing.com](mailto:frantisek.taborsky@ing.com)

**Adam Antoniak**  
Senior Economist, Poland

[adam.antoniak@ing.pl](mailto:adam.antoniak@ing.pl)

**Min Joo Kang**

Senior Economist, South Korea and Japan

[min.joo.kang@asia.ing.com](mailto:min.joo.kang@asia.ing.com)

**Coco Zhang**

ESG Research

[coco.zhang@ing.com](mailto:coco.zhang@ing.com)

**Jan Frederik Slijkerman**

Senior Sector Strategist, TMT

[jan.frederik.slijkerman@ing.com](mailto:jan.frederik.slijkerman@ing.com)

**Katinka Jongkind**

Senior Economist, Services and Leisure

[Katinka.Jongkind@ing.com](mailto:Katinka.Jongkind@ing.com)

**Marina Le Blanc**

Sector Strategist, Financials

[Marina.Le.Blanc@ing.com](mailto:Marina.Le.Blanc@ing.com)

**Samuel Abettan**

Junior Economist

[samuel.abettan@ing.com](mailto:samuel.abettan@ing.com)

**Franziska Biehl**

Senior Economist, Germany

[Franziska.Marie.Biehl@ing.de](mailto:Franziska.Marie.Biehl@ing.de)

**Rebecca Byrne**

Senior Editor and Supervisory Analyst

[rebecca.byrne@ing.com](mailto:rebecca.byrne@ing.com)

**Mirjam Bani**

Sector Economist, Commercial Real Estate & Public Sector (Netherlands)

[mirjam.bani@ing.com](mailto:mirjam.bani@ing.com)

**Timothy Rahill**

Credit Strategist

[timothy.rahill@ing.com](mailto:timothy.rahill@ing.com)

**Leszek Kasek**

Senior Economist, Poland

[leszek.kasek@ing.pl](mailto:leszek.kasek@ing.pl)

**Oleksiy Soroka, CFA**

Senior High Yield Credit Strategist

[oleksiy.soroka@ing.com](mailto:oleksiy.soroka@ing.com)

**Antoine Bouvet**

Head of European Rates Strategy

[antoine.bouvet@ing.com](mailto:antoine.bouvet@ing.com)

**Jeroen van den Broek**

Global Head of Sector Research

[jeroen.van.den.broek@ing.com](mailto:jeroen.van.den.broek@ing.com)

**Edse Dantuma**

Senior Sector Economist, Industry and Healthcare

[edse.dantuma@ing.com](mailto:edse.dantuma@ing.com)

**Francesco Pesole**

FX Strategist

[francesco.pesole@ing.com](mailto:francesco.pesole@ing.com)

**Rico Luman**

Senior Sector Economist, Transport and Logistics

[Rico.Luman@ing.com](mailto:Rico.Luman@ing.com)

**Jurjen Witteveen**

Sector Economist

[jurjen.witteveen@ing.com](mailto:jurjen.witteveen@ing.com)

**Dmitry Dolgin**

Chief Economist, CIS

[dmitry.dolgin@ing.de](mailto:dmitry.dolgin@ing.de)

**Nicholas Mapa**

Senior Economist, Philippines

[nicholas.antonio.mapa@asia.ing.com](mailto:nicholas.antonio.mapa@asia.ing.com)

**Egor Fedorov**

Senior Credit Analyst

[egor.fedorov@ing.com](mailto:egor.fedorov@ing.com)

**Sebastian Franke**

Consumer Economist

[sebastian.franke@ing.de](mailto:sebastian.franke@ing.de)

**Gerben Hieminga**

Senior Sector Economist, Energy

[gerben.hieminga@ing.com](mailto:gerben.hieminga@ing.com)

**Nadège Tillier**

Head of Corporates Sector Strategy

[nadege.tillier@ing.com](mailto:nadege.tillier@ing.com)

**Charlotte de Montpellier**

Senior Economist, France and Switzerland

[charlotte.de.montpellier@ing.com](mailto:charlotte.de.montpellier@ing.com)

**Laura Straeter**

Behavioural Scientist

+31(0)611172684

[laura.Straeter@ing.com](mailto:laura.Straeter@ing.com)

**Valentin Tataru**

Chief Economist, Romania

[valentin.tataru@ing.com](mailto:valentin.tataru@ing.com)

**James Smith**

Developed Markets Economist, UK

[james.smith@ing.com](mailto:james.smith@ing.com)

**Suvi Platerink Kosonen**

Senior Sector Strategist, Financials

[suvi.platerink-kosonen@ing.com](mailto:suvi.platerink-kosonen@ing.com)

**Thijs Geijer**

Senior Sector Economist, Food & Agri

[thijs.geijer@ing.com](mailto:thijs.geijer@ing.com)

**Maurice van Sante**

Senior Economist Construction & Team Lead Sectors

[maurice.van.sante@ing.com](mailto:maurice.van.sante@ing.com)

**Marcel Klok**

Senior Economist, Netherlands

[marcel.klok@ing.com](mailto:marcel.klok@ing.com)

**Piotr Poplawski**

Senior Economist, Poland

[piotr.poplawski@ing.pl](mailto:piotr.poplawski@ing.pl)

**Paolo Pizzoli**

Senior Economist, Italy, Greece

[paolo.pizzoli@ing.com](mailto:paolo.pizzoli@ing.com)

**Marieke Blom**

Chief Economist and Global Head of Research

[marieke.blom@ing.com](mailto:marieke.blom@ing.com)

**Raoul Leering**



Senior Macro Economist

[raoul.leering@ing.com](mailto:raoul.leering@ing.com)

**Maarten Leen**

Head of Global IFRS9 ME Scenarios

[maarten.leen@ing.com](mailto:maarten.leen@ing.com)

**Maureen Schuller**

Head of Financials Sector Strategy

[Maureen.Schuller@ing.com](mailto:Maureen.Schuller@ing.com)

**Warren Patterson**

Head of Commodities Strategy

[Warren.Patterson@asia.ing.com](mailto:Warren.Patterson@asia.ing.com)

**Rafal Benecki**

Chief Economist, Poland

[rafal.benecki@ing.pl](mailto:rafal.benecki@ing.pl)

**Philippe Ledent**

Senior Economist, Belgium, Luxembourg

[philippe.ledent@ing.com](mailto:philippe.ledent@ing.com)

**Peter Virovacz**

Senior Economist, Hungary

[peter.virovacz@ing.com](mailto:peter.virovacz@ing.com)

**Inga Fechner**

Senior Economist, Germany, Global Trade

[inga.fechner@ing.de](mailto:inga.fechner@ing.de)

**Dimitry Fleming**

Senior Data Analyst, Netherlands

[Dimitry.Fleming@ing.com](mailto:Dimitry.Fleming@ing.com)

**Ciprian Dascalu**

Chief Economist, Romania

+40 31 406 8990

[ciprian.dascalu@ing.com](mailto:ciprian.dascalu@ing.com)

**Muhammet Mercan**

Chief Economist, Turkey

[muhammet.mercan@ingbank.com.tr](mailto:muhammet.mercan@ingbank.com.tr)

**Iris Pang**

Chief Economist, Greater China

[iris.pang@asia.ing.com](mailto:iris.pang@asia.ing.com)

**Sophie Freeman**

Writer, Group Research

+44 20 7767 6209

[Sophie.Freeman@uk.ing.com](mailto:Sophie.Freeman@uk.ing.com)

**Padhraic Garvey, CFA**

Regional Head of Research, Americas

[padhraic.garvey@ing.com](mailto:padhraic.garvey@ing.com)

**James Knightley**

Chief International Economist, US

[james.knightley@ing.com](mailto:james.knightley@ing.com)

**Tim Condon**

Asia Chief Economist

+65 6232-6020

**Martin van Vliet**

Senior Interest Rate Strategist

+31 20 563 8801

[martin.van.vliet@ing.com](mailto:martin.van.vliet@ing.com)

**Karol Pogorzelski**

Senior Economist, Poland

[Karol.Pogorzelski@ing.pl](mailto:Karol.Pogorzelski@ing.pl)

**Carsten Brzeski**

Global Head of Macro

[carsten.brzeski@ing.de](mailto:carsten.brzeski@ing.de)

**Viraj Patel**

Foreign Exchange Strategist

+44 20 7767 6405

[viraj.patel@ing.com](mailto:viraj.patel@ing.com)

**Owen Thomas**

Global Head of Editorial Content

+44 (0) 207 767 5331

[owen.thomas@ing.com](mailto:owen.thomas@ing.com)

**Bert Colijn**

Chief Economist, Netherlands

[bert.colijn@ing.com](mailto:bert.colijn@ing.com)

**Peter Vanden Houte**

Chief Economist, Belgium, Luxembourg, Eurozone

[peter.vandenhoute@ing.com](mailto:peter.vandenhoute@ing.com)

**Benjamin Schroeder**

Senior Rates Strategist

[benjamin.schroeder@ing.com](mailto:benjamin.schroeder@ing.com)

**Chris Turner**

Global Head of Markets and Regional Head of Research for UK & CEE

[chris.turner@ing.com](mailto:chris.turner@ing.com)

**Gustavo Rangel**

Chief Economist, LATAM

+1 646 424 6464

[gustavo.rangel@ing.com](mailto:gustavo.rangel@ing.com)

**Carlo Cocuzzo**

Economist, Digital Finance

+44 20 7767 5306

[carlo.cocuzzo@ing.com](mailto:carlo.cocuzzo@ing.com)