CHAPTER EIGHT

The Trading System

ECONOMISTS OF every persuasion are convinced that free trade is superior to trade protection.[1] In fact, they consider free trade to be the best policy for a country even if all other countries should practice trade protection, arguing that if other countries resort to trade protection, the economy that remained open would still gain more from cheaper imports than it would lose in denied export markets. Despite this powerful inclination within the economics profession to favor free trade and open markets, trade protection has never totally disappeared; and indeed, during the past two centuries, restricted trade has been a pervasive feature of the world economy. As economic historian Paul Bairoch has pointed out, free trade has historically been the exception and protectionism the rule.[2] Although nations want to take advantage of foreign markets, they are frequently unwilling to open their own economies. Nations and domestic interests alike fear a world in which market forces rule and relative prices determine the patterns and distribution of the gains from trade. Throughout modern history, trade has been regarded either as an international public good from which everyone benefits or a battleground in which there are winners and losers.[3] Even though the argument for free trade is powerful, trade protectionism continuously resurfaces in new guises.[4]

The classic era of free trade and international laissez-faire lasted less than three decades, from the repeal of the Corn Laws (1846) to approximately the 1870s, when protectionist tariffs increased. From the latter decades of the nineteenth century to the years immediately

[1] This chapter draws from Chapter 3 of my book, *The Challenge of Global Capitalism: The World Economy in the 21st Century* (Princeton: Princeton University Press, 2000).

[2] Paul Bairoch, *Economics and World History: Myths and Paradoxes* (New York: Harvester Wheatsheaf, 1993), 16.

[3] John Dunn quoted in Vincent Cable, "The Diminished Nation-State: A Study in the Loss of Economic Power," in *What Future for the State? Daedalus* 124, no. 2 (spring 1995): 25.

[4] A valuable history of the debate over free trade is Douglas A. Irwin, *Against the Tide: An Intellectual History of Free Trade* (Princeton: Princeton University Press, 1996).

following World War II, trade protection grew steadily and became increasingly prevalent up to and during the Great Depression of the 1930s. Following World War II, the world again experienced an era of trade liberalization and expansion, largely as a consequence of successive rounds of trade negotiations carried out under the auspices of the General Agreement on Tariffs and Trade (GATT) and strongly supported by American leadership. International trade grew even more rapidly than did national economies. Consequently international trade integrated national economies more closely with one another. In the mid-1970s, global stagflation, the New Protectionism, and other developments slowed and, in some cases, reversed this liberalization trend.[5] The United States was particularly guilty of New Protectionism in its use of such nontariff barriers as "voluntary export restraints" to keep out Japanese and other imports.

Major steps were taken toward further trade liberalization with new rounds of trade negotiations, and particularly with the successful completion of the Uruguay Round of trade negotiations (1993). The Uruguay Round created the World Trade Organization (WTO) to replace the increasingly obsolescent GATT. However, new threats also surfaced in the form of managed trade, economic regionalism, and a new trade agenda dealing with such problems as "fair" labor standards and environmental protection. Tension between free trade and trade protection has continued, and the future of a free-trade regime remains precarious.

At the opening of the twenty-first century, the free-trade regime is threatened by intellectual, economic, and political developments. The shift from "comparative" to "competitive" advantage as the basis of trade, the implications of the new strategic trade theory, and other developments have undermined the theoretical or intellectual arguments for trade liberalization. Increasing trade penetration into domestic economies and national affairs has forced recognition of such complex problems as formulation of definitions of "fair and legitimate" economic behavior; that which is considered "fair" in one society may be considered "unfair" in another. Trade issues have become focused on culture, national sovereignty, and other complex issues that are not easily amenable to bargaining and compromise solutions. In addition, political opposition to trade liberalization has grown among many groups concerned about worker welfare, the environment, and human rights. Many less developed nations now believe

[5] H. Richard Friman, *Patchwork Protectionism: Textile Trade Policy in the United States, Japan, and West Germany* (Ithaca: Cornell University Press, 1990).

that the trading system functions to their disadvantage. It is particularly noteworthy that the three major trading powers—the United States, Western Europe, and Japan—became convinced that the political costs of lowering certain trade barriers in response to demands from one or another major power had become unacceptable. These several obstacles to further trade liberalization reached a crisis point at the November 1999 meeting of the WTO in Seattle.

The Debate over Free Trade

The liberal doctrine of free trade is based on the principles of the market system formulated by classical economists. Adam Smith and David Ricardo argued that removing the impediments to the free movement of goods would permit national specialization and facilitate optimal utilization of the world's scarce resources. Trade liberalization would lead to efficient trade patterns determined by the principle of comparative advantage; that is, by relative factor prices (of land, capital, and labor). Adoption of the principle of comparative advantage or comparative cost would ensure that a country would achieve greater economic welfare through participation in foreign trade than through trade protection. Underlying this liberal commitment to free trade is the belief that the purpose of economic activity is to benefit the consumer and maximize global wealth. Free trade also maximizes consumer choice, reduces prices, and facilitates efficient use of the world's scarce resources. From this perspective, the primary purpose of exports is to pay for imports rather than to enhance the power of the state.

According to its advocates, trade liberalization produces a number of specific benefits. In the first place, trade liberalization increases competition in domestic markets, and thereby undermines anticompetitive practices, lowers prices, increases consumer choice, and increases national efficiency. In addition, free trade increases both national and global wealth by enabling countries to specialize and to export those goods and services in which they have a comparative advantage while importing those goods and services in which they lack comparative advantage. Free trade also encourages the international spread of technology and know-how around the globe and thus provides developing economies with the opportunity to catch up in income and productivity with more advanced economies. Last, but not least, free trade and the international cooperation that it entails increase the prospects of world peace.

Ever since Adam Smith's attack on mercantilism in *The Wealth of Nations* (1776), economists have rejected trade protection because of its high costs to an economy, and there are many empirical studies strongly criticizing trade barriers.[6] For example, a study by Gary Clyde Hufbauer and Kimberly Ann Elliot, published in 1994, in the context of the bitter controversy over the ratification of the North American Free Trade Agreement (NAFTA), found that past protection of twenty-one American industries had actually saved few jobs and that the cost to consumers had been approximately $170,000 per job saved! The equivalent figure for Japan is $600,000. While one may quarrel with the precision of these figures, it is indisputable that trade protection constitutes a heavy burden on an economy.[7]

Trade protection also has a negative impact on income distribution. A tariff or other restrictive measure creates economic or monopoly rents and shifts income from consumers and nonprotected sectors to the protected sectors of the economy. American restrictions in the late 1980s on the importation of flat panels and memory chips for computers provide an excellent example of the cost to American consumers and the harm done to other industries by protection of one particular industry. In this example, import restrictions raised costs for American computer makers and thus made them less competitive; restrictions on importation of flat panels led Apple Computer to shift production of its then popular Powerbook computer overseas. Paradoxically, some types of import protection can even shift income from domestic consumers and producers to foreign producers. A notable example was the imposition of voluntary export restraints on Japanese automobile imports into the United States in the early 1980s. This action proved very advantageous for the Japanese automobile industry at the same time that it decreased the competitive stimulus to the American automobile industry. Finally, one of the most serious dangers of trade restrictions is that they tend to protect declining noncompetitive industries.

The one important exception to economists' universal belief in the superiority of free trade over trade protection is the protection of infant industries.[8] Many economists, I believe, accept the argument first set forth by Alexander Hamilton that nourishing infant industries

[6] Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations* (New York: Modern Library, 1937 [1776]).

[7] Gary Clyde Hufbauer and Kimberly Ann Elliot, *Costs of Protection in the United States* (Washington, D.C.: Institute for International Economics, 1994).

[8] Another alternative to free trade is the imposition of an optimum tariff. Under certain circumstances, a large country can impose a trade barrier that improves its terms of trade to the disadvantage of its trading partners. However, the gains will probably be too small to warrant the risk to the trading system and political consequences.

can provide an acceptable rationale for trade protection. An infant industry is one that, if protected from international competition, will become sufficiently strong and competitive to enable it to survive when protection is eventually removed. A major problem with infant-industry protection, however, is that protection too frequently becomes permanent. Another important problem is that no theoretical or other means exists to determine whether or not a particular infant industry, if protected, could eventually achieve a competitive position in world markets. Only a trial-and-error process can determine the long-term competitiveness of a protected industry. Nevertheless, as I pointed out in chapter seven, most successes attributed to industrial policy and strategic trade policy are really examples of successful infant-industry protection.

From eighteenth-century mercantilists to present-day protectionists, advocates of trade protection have desired to achieve certain political, economic, and other objectives more than the economic benefits for the entire society of free trade. However, the specific objectives sought by protectionists have varied over time and space. Economic nationalists regard trade protection as a tool of state creation and statecraft; for example, a trade surplus is considered beneficial for national security. Many representatives of less developed countries believe that trade with industrialized countries is a form of imperialism; they fear that free trade benefits only the developed economy and leads to dependence of the less developed countries on the developed ones. Opponents of free trade in developing economies also include advocates of the "developmental state" who believe that the state rather than free markets should have the principal role in the process of economic development. In developed economies, proponents of trade protection reject free trade and other forms of globalization as threats to jobs, wages, and domestic social welfare; organized labor in industrialized countries increasingly advocates protection against imports from low-wage economies with inadequate labor standards. In recent decades, more and more environmentalists have denounced trade as a threat to the environment. Many liberals (in the American sense of the word) have come to believe that trade violates human rights and encourages child labor. Unfortunately, the forces in developed countries that are opposed to free trade, especially in the United States, gained considerable momentum in the 1990s.

The most systematic economic rationale for economic nationalism and trade protection was provided by Friedrich List, a German who fled to the United States in the middle of the nineteenth century to avoid political persecution. Strongly influenced by Alexander Hamilton's protectionist ideas, List argued in his *National System of Political Economy* (1841) that every industrial nation has pursued and should pursue protectionist policies in order to safeguard its infant industries.[9] List maintained that once their industries were strong enough to withstand international competition, these countries lowered their trade barriers, proclaimed the virtues of free trade, and then sought to get other countries to lower their barriers. Free trade, List believed, was the policy of the strong. If one were to translate List's ideas into modern parlance, one would say that every successful industrial power at some point in its history has carried out an activist industrial policy.[10]

At the beginning of the twenty-first century, many trade protectionists advocate promotion through national industrial policies of high-tech and certain other favored sectors in order to build the nation's industrial strength and increase its competitiveness. They believe that the state should guide and shape the overall industrial and technological structure of the society through trade protection, industrial policy, and other forms of government intervention. In addition to such high-tech industries as computers and electronics, economic nationalists also favor support for more traditional manufacturing industries such as the automobile and other mass-production industries characterized by high value-added and high wages. Although in its efforts to catch up with the West, Japan has conspicuously and aggressively pursued an industrial policy, industrial policies have also been employed by the United States, Western Europe, and many developing economies to promote industries believed important for national security and economic development.

Economists have strongly disputed the alleged benefits of trade protection.[11] Trade protection, they point out, reduces both national and international economic efficiency by preventing countries from exporting those goods and services in which they have a comparative advantage and from importing those goods and services in which they lack comparative advantage. Protection also decreases the incentive of firms to innovate and thus climb the technological ladder; it also discourages shifting national resources to their most profitable use.

[9] Friedrich List, *The National System of Political Economy* (New York: Longmans, Green, 1928; first published in 1841).

[10] Support for List's position comes from Paul Bairoch, *Economics and World History: Myths and Paradoxes*, Chapter 4.

[11] An outstanding critique of protectionist arguments for protection is W. Max Corden, *Trade Policy and Economic Welfare* (Oxford: Clarendon Press, 1974).

As David Hume (1711–1776) demonstrated, protectionism decreases exports over the long term. Although erecting trade barriers can improve exports temporarily, this improvement causes the value of the currency to rise, thus undercutting competitiveness; protectionism can also increase the cost of inputs, and that decreases competitiveness over the long term. The protectionist argument that competition from low-wage economies lowers wages and causes unemployment in industrialized economies is rejected by most economists; they point out that the principal cause of the economic plight of unskilled workers in the developed economies is the rapid technological change caused by the computer and the information economy, both of which favor highly skilled workers. The major consequence of protectionism, economists argue, is redistribution of national income from consumers to protected producer interests. Finally, trade protection invites retaliation from other countries, and this means that everyone will lose.

Despite economists' arguments supporting trade liberalization, trade protectionism persists, and its advocates too frequently succeed. Endogenous trade theory explains the success of protectionism by calling attention to the fact that the political process generally favors special interests desiring protection rather than general consumer interests. Whereas the benefits of free trade diffuse across a society, the benefits of protection are concentrated in a few groups of producers. This situation provides motivation for producers to organize in order to influence public policy and thus gain protection.[12] As the *Wall Street Journal* has quipped, "The first rule of trade agreements is that the benefits are widely dispersed, the costs are very concentrated, and the losers are very vocal."[13]

Trade and the Economy

Not only is the debate over free trade inconclusive, but also there are several misunderstandings regarding what trade does and does not do, and these misunderstandings have fueled protectionist rhetoric. They have also contributed to negative attitudes in the United States and elsewhere about economic globalization and its alleged consequences for the economy.

[12] On the political economy of trade, consult John S. Odell and Thomas D. Willett, eds., *International Trade Policy: Gains from Exchange between Economics and Political Science* (Ann Arbor: University of Michigan Press, 1990).

[13] *Wall Street Journal*, 6 December 1999, A1.

One pernicious misunderstanding in the United States at the opening of the twenty-first century is the idea that a nation's trade deficit is due to the "unfair trade practices" of a country's trading partners. Obviously, some countries do cheat and gain temporary advantage in trade. However, a chronic trade deficit like the one the United States experienced during much of the last quarter of the twentieth century was due to macroeconomic factors and not to cheating by trading partners. The trade/payments balance of a country is a result of a nation's spending patterns and is due, in particular, to the difference between national savings and domestic investment. A country with a high savings rate relative to its investment rate will have a trade/payments surplus. On the other hand, a nation with a savings rate that is low relative to its investment rate will have a trade/payments deficit. The behavior of a nation's trading partner does not affect the former's trade/payments balance. In the 1980s and 1990s, the huge and persistent trade/payments deficit of the United States was due primarily to the low rate of American savings. Nevertheless, incorrectly blaming Japan for the deficit, in the early 1990s the Clinton Administration launched an aggressive attack on Japan as an unfair trader.[14]

Another and equally unfortunate misunderstanding is the belief that imports from low-wage developing countries are responsible for increasing wage inequality in the United States and for unemployment in Western Europe. Most economists agree on the facts regarding income inequality in the United States. Late in the twentieth century, income inequality increased significantly. Between the end of World War II and 1973, rapid economic and high productivity growth did raise income uniformly for Americans of all income brackets, and incomes approximately doubled. Between 1973 and the mid-1990s, however, the pace of income growth slowed and income inequality increased. Whereas median family income increased 10 percent between 1973 and 1999, income in the highest bracket (95th percentile) grew more than a third while income in the lowest income grouping (20th percentile) remained virtually unchanged, especially for women. The real earnings of many low-wage and middle-class workers stagnated or experienced only modest gains, while the wealthier 20 percent of American families gained greatly. In brief, after the 1970s, the standard of living of many American workers grew very slowly, while income inequality increased considerably.

[14] This subject is discussed in Gilpin, *The Challenge of Global Capitalism*, Chapter 8.

A large number of Americans, particularly organized labor, blame manufactured and other imports from low-wage economies for income inequality and job insecurity and demand restrictions on imports. Protectionists like Ross Perot and Patrick Buchanan have asked how an American worker earning $20 or more an hour could possibly compete against billions of Chinese, Indians, Indonesians, and Bangladeshi earning less than $.20 an hour! This unfair competition from low-wage countries, many proclaim, has been rapidly advancing up the technological ladder so that it is harming a growing number of white-collar workers; India, for example, has become a world-class center of data processing and software development. Globalization has also increased immigration of workers from poorer countries into the advanced industrial countries, workers who then "take jobs away" from local workers. Therefore, many critics of globalization charge that increased trade flows, "run-away" plants of American multinational firms, and immigration are responsible for the deteriorating economic plight of more and more workers in the United States.

Most American economists have disputed these charges and attributed almost all of the relative decline in the wages of low-skilled American workers to technological changes within the American economy itself. Technological advances such as the computer and information economy, they have argued, significantly decreased the demand for low-skilled workers and greatly increased the demand for skilled, especially college-educated, workers. Furthermore, these economists have noted that the relatively small trade flows between the United States and low-wage economies cannot possibly explain the roughly 30 percent difference in wages between skilled/college-educated and unskilled workers in America. Instead, this decline in the wages of low-skilled workers has been due to such technological developments as automation, lean production techniques, and computerization.

At the beginning of the twenty-first century, advanced economies are rapidly shifting from unskilled, blue-collar, labor-intensive industries to service industries and to greater reliance on skilled labor in manufacturing as well as in other aspects of economic life. This structural change parallels the shift from agriculture to manufacturing in the late nineteenth century when, as agriculture became more mechanized, superfluous farm workers migrated from the land to the factory. In the late 1990s, many of the tasks formerly performed by unskilled and less skilled workers were being carried out by computers and automated processes. The new service- and knowledge-based industries require more highly skilled workers than in the past, and this means that the demand for unskilled workers has declined dramatically throughout the American economy. The semiskilled assembly-line worker in Detroit or Cleveland who once commanded a high wage in the automobile and other mass-production industries is indeed becoming superfluous in the information economy.

British economist Adrian Wood disagrees with this consensus among economists and points out that competition from low-wage countries has stimulated labor-saving technological change in the United States and thereby reduced the demand for low-wage labor.[15] Although, viewed from this perspective, some of the effects on wages attributed to technological changes can be attributed to trade competition from low-wage economies, it is highly doubtful that imports from low-wage economies are as significant as opponents of globalization have claimed. It is certain that trade protection is not a wise solution to the problems of stagnant wages, income inequality, and job insecurity. The solution lies in job-training programs and other programs to aid adjustment to rapidly changing economic and technological developments.

In the 1990s the issue of trade and unemployment became important in both Western Europe and the United States. In Europe, a high rate of long-term or structural unemployment had emerged in the 1970s, particularly in southern Europe, France, and even Germany. The overall rate of unemployment in Western Europe in the 1990s had reached approximately 10 to 12 percent, more than twice that of the United States. In some countries the rate climbed over 20 percent! Not surprisingly, it became almost an article of faith among business, political, and intellectual leaders that imports from low-wage economies were responsible for this situation. In the United States, the issue became inflamed during the debate over the ratification of the North American Free Trade Agreement (NAFTA). Some political leaders, especially Perot and Buchanan, along with organized labor, proclaimed that the agreement would result in the loss of millions of American jobs. The Clinton Administration, after considerable vacillation, maintained that the agreement would create "jobs, jobs, jobs." Both positions were wrong.

A country's unemployment rate is determined principally by its macroeconomic policies. Through fiscal and monetary policies, the developed countries in Western Europe and the United States can,

[15] Adrian Wood, *North-South Trade, Employment, and Inequality: Changing Fortunes in a Skill-Driven World* (Oxford: Clarendon Press, 1994).

within certain limits, manage a nation's rate of unemployment. In a well-functioning economy, trade does not decrease or increase unemployment. While NAFTA has not affected the number of jobs in the American economy, it has redistributed jobs from one economic sector or region of the country to others. In Western Europe, the high rate of unemployment has been a consequence of several factors: inflexible labor markets, overly generous welfare programs that discourage expanded employment, and highly restrictive macroeconomic policies associated with meeting the requirements for nations to join the European Monetary Union. Domestic factors and not international trade have been the major causes of Western Europe's high level of chronic unemployment.

Trade, however, does create losers as well as winners in the areas of both wages and employment. Economic sectors in which a nation possesses or wins a comparative advantage gain from trade, while sectors in which a nation loses comparative advantage suffer. As losers frequently feel the pain more acutely than winners feel the gain, both ethical and political reasons make it necessary that national policy assist or compensate workers and others harmed by trade liberalization. In any case, the worst response a nation can make to inevitable shifts in comparative advantage is to close itself off from the stimulus of trade competition.

Revisions of Conventional Trade Theory

Since its development in the early 1930s by Eli Heckscher and Bertil Ohlin, the factor endowments or factor proportions model has been accepted as the standard explanation of international trade. The Heckscher-Ohlin (or H-O) model of comparative costs or advantage postulates that a country will specialize in the production and export of those products in which it has a cost advantage over other countries. This theory is based on assumptions of constant returns to scale, universal availability of production technologies, and determination of a country's comparative advantage and trade pattern by its factor endowments.[16] This theory implies that:

(1) A country will export those products that are intensive in its abundant factor; that is, a capital-rich country will export capital-intensive goods.

[16] This section draws on Ronald Rogowski's highly innovative paper entitled, "How Economies-of-Scale Trade Affects Domestic Politics,." Center for International Relations, Working Papers No. 13, May 1997, University of California, Los Angeles.

(2) Trade will benefit the owners of locally abundant factors and harm owners of the scarce factors. Thus, although all countries will benefit in absolute terms, there will be important distributive consequences that will favor either capital or labor in trading countries (Stopler-Samuelson Theorem).
(3) Trade in factors (capital or labor) and trade in goods will have the same effect and can fully substitute for one another (Mundell equivalency).
(4) Under certain circumstances, trade in goods will over time equalize the return (wages to labor and profits to capital) for each factor of production (Factor-Price Equalization Theorem).

The basic problem with the H-O model or theory is that actual trading patterns frequently differ from what the theory predicts. A notable example is found in intraindustry trade among countries with similar factor endowments. Indeed, most trade among industrialized countries takes place largely in the same product sectors; for example, the United States both exports to and imports from other industrialized countries. As a consequence of the efforts by economists to explain this and other departures from the H-O theory, the concept of comparative advantage has been made increasingly elastic. Some economists regard actual trade patterns as resulting from many factors other than natural endowments, factors including historical accidents, government policies, and cumulative causation. Moreover, the standard H-O theory itself has been modified and expanded to include such important factors as human capital (skilled labor), "learning by doing," technological innovation, and especially economies of scale. Revisions have so transformed the original H-O model that some economists now argue that the theory of international trade is not much more than an eclectic enumeration of the many factors that determine comparative advantage and trade flows.

However, it is very difficult to incorporate these newly recognized factors into a formal model, and because there is no satisfactory alternative model, economists continue to support the standard H-O theory of trade based on factor endowments. As Richard Caves and Ronald Jones have argued, the Heckscher-Ohlin theory, with its emphasis on factor endowments, is still largely valid.[17] Moreover, as economists argue, national specialization and the benefits of a territorial division of labor remain valid concepts that are of overwhelming

[17] Richard Caves and Ronald Jones, quoted in David B. Yoffie and Benjamin Gomes-Casseres, *International Trade and Competition: Cases and Notes in Strategy and Management*, 2d ed. (New York: McGraw-Hill, 1994), 8.

importance for the efficient use of the world's scarce resources. True! But this generalization does not explain or determine which country will produce what, and nation-states will always be very reluctant to leave that decision entirely up to the market.

Concept of Human Capital

An especially important modification of trade theory followed Wassily Leontief's discovery of the Leontief Paradox.[18] In his research, Leontief discovered that the United States had a comparative advantage in exporting labor-intensive goods, especially agricultural products and other commodities. This empirical finding ran counter to the prediction that the United States as a capital-rich country would have a comparative advantage in capital-intensive goods. According to the Stopler-Samuelson theorem, derived from conventional trade theory, a country will export goods produced by its most abundant factor of production and import goods made by its least abundant factor. The paradox or anomaly that Leontief found in American exports was eventually resolved by introduction of the concepts of "human capital" and of economies of scale into both trade theory and the neoclassical theory of economic growth.[19] Recognition of the importance and effect of investment in training, education, and know-how in the United States, and of the resulting increase in the skills and productivity of American workers, explained the Leontief Paradox. While the idea of human capital considerably enriched and extended our understanding of international trade, it did make the original H-O theory less rigorous or, as economists would say, less robust.

Rise of Intraindustry Trade

Since the reconstruction of Western Europe and the freeing of trade through successive GATT negotiations, most trade has taken place, contrary to the H-O theory, between countries with similar factor endowments; most exports of industrialized economies go to other industrialized countries. Such *intra*industry trade entails an economy's exporting and importing goods in the same economic sectors (as in exportation of one type of automobile and importation of another type). *Inter*industry trade, on the other hand, entails exporting and importing goods in very different economic sectors, such as exporting manufactured goods and importing raw materials. Intraindustry trade

[18] Wassily W. Leontief, "Domestic Production and Foreign Trade: The American Capital Position Reexamined," *Economia Internazionale* 7, no. 1 (1954): 3–32.

[19] William A. Kerr and Nicholas Perdikis, *The Economics of International Business* (London: Chapman and Hall, 1995), 24–26.

has been a prominent feature of north-north trade, whereas interindustry trade has tended to characterize north-south trade. How can this type of trade among advanced industrialized economies be explained?

The Heckscher-Ohlin model predicts that most trade should take place among countries with *dissimilar* endowments and that intraindustry trade should not even exist. If comparative advantage and trade patterns are determined by fixed endowments and relative prices, why should the industrial countries in effect be "taking in one another's laundry"? This anomaly can be explained by differing national tastes, product differentiation, and economies of scale. Americans, for example, traditionally like big cars, and Europeans, small ones; Americans have tended to possess a comparative advantage in the former and Europeans in the latter. Yet, there is a market in the United States for small European cars and vice versa. Since the importance of intraindustry trade was recognized, the Heckscher-Ohlin model has been applied primarily to trade between developed and less developed countries and not to the intraindustry trade based on product differentiation and scale economies that is characteristic among industrial countries.

However, here another anomaly is encountered. Japan, during most of the latter half of the twentieth century, imported a remarkably small share of the manufactured goods that it consumes. Unlike Western European and U.S. trade, only a small portion of Japanese trade has been intraindustry trade—that is, a two-way flow of trade within particular industries. For example, whereas Japan was the world's largest exporter of automobiles for many years, its imports of automobiles and auto parts were negligible. Instead, even in the 1990s, the pattern of Japanese trade continued to be largely *interindustry* trade; Japan was importing mainly food, fuel, and raw materials and exporting mainly motor vehicles and other manufactures. While this unique Japanese trading pattern began to change in the final years of the twentieth century, it had long been a major source of economic conflict between Japan and its trading partners.

Integration of International Trade and Foreign Investment

Another important development in the postwar era has been the increasing integration of international trade and foreign direct investment (FDI) by multinational corporations (MNCs). When capital in the form of portfolio investment became increasingly mobile across borders in the late nineteenth century, economists assumed that international capital movements were due to differences among countries in rates of return and in investment risk. When foreign direct investment—for example, the establishment of a production facility by a firm of one nationality within another economy—became an increasingly important feature of the international economy, economists assumed that FDI, like portfolio investment, was due to differences in interest rates and that exports and foreign production were, in essence, perfect substitutes for one another. This acceptance of the Mundell equivalency continues to pervade economists' attitudes toward FDI. Recently, a number of economists have begun to rethink the nature and significance of foreign direct investment and have applied industrial organization theory to the behavior of multinational firms and the determination of international trade patterns.

The increasingly important role of the MNC in the world economy has resulted in a significant movement toward internationalization of both services and industrial production. Organization of service industries and of manufacturing on a regional or global basis has greatly affected the trading system. A substantial proportion of world trade now takes place as *intrafirm* transfers at prices set by the firms and as part of global corporate strategies. By the 1990s, this type of managed trade had become a prominent feature in the international economy. In the late 1990s, over 50 percent of American and Japanese trade was intrafirm trade. The resulting trade patterns frequently do not conform to conventional trade theory based on traditional concepts of comparative advantage.

There is intense disagreement on the implications of FDI's increasing importance for international trade and for the international distribution of wealth and economic activities. Assuming that investment and its trade effects are just another application of the law of comparative advantage, many if not most economists believe that FDI has only marginal implications for patterns of trade and that its distributive effects are primarily domestic. Many noneconomists, however, believe that FDI and the activities of multinational corporations have an immense impact on patterns of international trade and on the distribution of wealth—and, I shall add—power. In addition, whereas most business economists believe that the MNC is above politics and facilitates the rational organization and utilization of the world's scarce resources to everyone's benefit, critics believe that MNCs pursue their own private interests (and/or those of their home countries) to the detriment of everyone else.

From Comparative to Competitive Advantage

Another important intellectual development that has undermined the H-O theory of international trade is a shift among economists from emphasizing "comparative" to emphasizing "competitive" advantage, especially in high-tech sectors. International competitiveness and trade patterns frequently result from arbitrary specialization based on increasing returns rather than from efforts to take advantage of fundamental national differences in resources or factor endowment.[20] This new thinking about the arbitrary or accidental nature of international specialization and competitiveness emphasizes the increasing importance of technology in determining trade patterns.[21] The increasing importance of technology and of economies of scale has become an important factor in corporate and national economic strategies.

In 1966, Raymond Vernon's product cycle theory of foreign direct investment incorporated technology into trade theory; his work foreshadowed later writings on the importance of technological innovation for trade and investment patterns.[22] According to Vernon, American FDI in the 1960s could be explained primarily as a result of America's competitive advantage in product innovation and of the desire of American firms to deter or forestall the rise of foreign competitors.

Additional influential work on the broad subject of the shift from comparative to competitive advantage has been produced by Michael Porter, a professor at Harvard University's Business School. Through his extensive research, Porter has attempted to explain why the firms of some countries have been more competitive in specific industrial sectors than the firms of other countries.[23] The United States, for example, has been very strong in aircraft, while Japan has had an advantage in consumer electronics and automobiles. Through his detailed and extensive empirical studies of the trading patterns of several countries, Porter found determinants of such patterns, at least among industrialized countries.

The central finding of Porter's research was that the internal characteristics of a national economy (including what I have identified as the national system of political economy) affect the environment of

[20] Krugman, *Geography and Trade* (Cambridge: MIT Press, 1991), 7.

[21] Robert M. Solow, "Growth Theory," in David Greenaway, Michael Bleaney, and Ian Stewart, eds., *Companion to Contemporary Economic Thought* (London: Routledge, 1991), 407.

[22] Raymond Vernon, *Sovereignty at Bay* (New York: Basic Books, 1971); and Vernon, "International Investment and International Trade in the Product Cycle," *Quarterly Journal of Economics* 80, no. 2 (May 1966): 190–207.

[23] Michael E. Porter, *The Competitive Advantage of Nations* (New York: Free Press, 1990).

domestic firms in ways that either facilitate or obstruct development of competitive advantage in certain industries. According to Porter, several aspects of a national economy are particularly important: the national culture and its influence on the purpose of economic activities, the status of capital and labor, the nature of effective demand, the condition of supporting industries, and the industrial structure of the economy. These several factors, Porter argues, determine domestic competitive conditions, and those conditions in turn influence the international competitiveness of particular sectors of the economy.

Using specific industrial sectors as the units of analysis rather than the individual firm or the national economy as a whole, Porter demonstrates that an economy with a competitive advantage in a particular sector invariably has several strong firms in that sector. Intense domestic competition among these oligopolistic firms confers on them their strong competitive position in international markets. Thus, for Porter, the competitive advantage of Japanese firms in automobiles and consumer electronics is explained by the supercompetitiveness of the domestic market. This supercompetition in Japan has been concentrated on winning market share rather than profit maximization, and is carried out primarily through product innovation, application of technology to productive processes, and great attention to quality control rather than through the price competition characteristic of American firms. Intense oligopolistic competition at the domestic level, Porter concluded, provided a better explanation of the international competitiveness of Japanese firms in certain sectors than did any other factor, certainly more than possible corporate collusion or government interventionist policies.

As a good economist, Porter eschews the importance of the nation itself as a factor in international competitiveness. However, in fact Porter is talking about the importance of differences in national policies as an explanation of international competitiveness. Although it was not his intention, Porter actually demonstrates that national governments *do* play an important role in helping or thwarting the efforts of firms to create competitive advantage. Government policies can and do support or hinder the supply-and-demand factors affecting the success of particular sectors. Furthermore, governments can protect infant industries from international competition until they are strong enough to compete on their own, and they can also foster technological innovation through support for R & D, assist domestic firms to gain access to foreign technology, and protect proprietary knowledge from foreign competitors. In short, a government can take a long-term perspective and establish policies that foster a favorable domestic environment for those sectors most likely to be competitive in international markets.

As he substitutes the term "competitive advantage" for the traditional emphasis of neoclassical economics on "comparative advantage," Porter's research strongly supports the idea that advantage in international trade, at least in high-tech industries, can be and is created by deliberate corporate and national policies. Comparative or competitive advantage results from deliberate corporate decisions and government policy choices rather than appearing as a gift from Mother Nature. If international competitiveness is indeed increasingly based on technological developments, learning by doing, and economies of scale, then individual firms are ultimately responsible for creating or failing to create competitive advantage, but governments can and do have an important and even decisive role in promoting their own national firms in international markets.

Mainstream economists have been hesitant to acknowledge the increased importance of such factors as technology and learning by doing in the determination of trade patterns.[24] Nevertheless, the fundamental idea that comparative or competitive advantage is largely arbitrary and a product of human intervention rather than a fixed gift of nature is accepted by growing numbers of mainstream economists.[25] Introducing the concept of "knowledge capital" as a determinant of economic growth and international competitiveness, Grossman and Helpman argue that comparative advantage results from natural endowments supported by experience.[26] Moreover, they emphasize that nations with a headstart in a particular technology tend to strengthen their position over time, and that technologically deficit nations, especially small nations, may find it impossible to ever catch up.[27] As the idea of path dependence teaches us, productivity increases

[24] Despite the importance of Michael Porter's pioneering empirical studies, his ideas appear to have had almost no impact on the American economics profession, perhaps because the work is largely empirical and the findings cannot be expressed in a formal model.

[25] Gene M. Grossman and Elhanan Helpman, "Trade, Innovation, and Growth," *American Economic Review* 80, no. 2 (May 1990): 86.

[26] Gene M. Grossman and Elhanan Helpman, "Comparative Advantage and Long-Run Growth," *American Economic Review* 80, no. 4 (September 1994): 796–815.

[27] Gene M. Grossman and Elhanan Helpman, "Hysteresis in the Trade Pattern," in Wilfred J. Ethier, Elhanan Helpman, and J. Peter Neary, eds., *Theory, Policy and Dynamics in International Trade: Essays in Honor of Ronald W. Jones* (New York: Cambridge University Press, 1993), 288. The term "hysteresis" is used by economists to mean that an economic outcome has been determined by historical factors. This is a rare concession to the role of history in economic outcomes.

with cumulative experience and is determined to a considerable degree by the initial pattern of specialization.

These important considerations that "international comparative advantage in the production of and sale of high-technology goods . . . . must be struggled for and earned through superior technological innovativeness" has significantly intensified what F. M. Scherer has labeled "international high-technological competition."[28] The drive for technological superiority has notably increased the receptivity of governments to the "new trade theory."

New Trade Theory

The most important and certainly the most controversial development challenging the conventional theory of international trade is the "new trade theory," more commonly known as "strategic trade theory" (STT). Therefore, I repeat here much of my earlier discussion of strategic trade theory. Strategic trade theory is the culmination of earlier challenges to conventional trade theory because it incorporates a growing appreciation of imperfect competition, economies of scale, economies of scope, learning by doing, the importance of R & D, and the role of technological spillovers. STT is significant because it challenges the theoretical foundations of the economics profession's unequivocal commitment to free trade. In fact, STT originated with the development of new analytical tools and growing dissatisfaction with conventional trade theory and its inability to explain the increasing trade problems of the United States, especially with respect to Japan in the 1980s.[29] The application to trade theory of novel methods associated with important theoretical advances in the field of industrial organization provided the means to develop an alternative to the H-O model. Mathematical models of imperfect competition and game theoretic models were first incorporated into trade theory in the early 1980s by James Brander and Barbara Spencer (1983), two theorists of industrial organization.[30] Before I consider the theory, however, I will discuss oligopolistic competition briefly.

[28] F. M. Scherer, *International High-Technology Competition* (Cambridge: Harvard University Press, 1992), 5.

[29] David B. Yoffie and Benjamin Gomes-Casseres, *International Trade and Competition: Cases and Notes in Strategy and Management*, 2nd ed. (New York: McGraw-Hill, 1994), 5–17.

[30] James A. Brander and Barbara J. Spencer, "International R & D Rivalry and Industrial Strategy," *Review of Economic Studies* 50 (1983): 707–22.

Under conditions of perfect competition, strategic behavior is not possible because the behavior of one or just a few firms cannot significantly change market conditions for other firms. However, if unit costs in certain industries do continue to fall as output increases (economies of scale), the total output of firms will expand but the number of firms will decrease. Economies of scale in an industry mean that the market will support only one or just a few large firms; that is, the industry will become oligopolistic, and the market will eventually be dominated by a few firms. This would permit the behavior of one firm to make a difference and to alter the decisions of other firms. If imperfect or oligopolistic competition exists, then monopoly rents or abnormally high profits can exist in that economic sector; the resultant rents or superprofits could then be captured by a small number of firms or even by one firm. Individual firms, then, may well pursue corporate strategies to increase their profits or economic rents.

Oligopolistic firms can and do consciously choose a course of action that anticipates the behavior of their competitors. If successful, such action enables them to capture a much larger share of the market than would be the case under conditions of perfect competition. For example, oligopolistic firms can and do follow strategies in which they adjust their own prices and output in order to alter the prices and output of competitor firms. Two of the most important strategies used to increase a firm's long-term domination of an oligopolistic market are *dumping* (selling below cost to drive out competitors in the product area) and *preemption* (through huge investment in productive capacity to deter other entrants into the market).

Imperfect or oligopolisitc competition is most likely found in certain high-tech industries characterized by economies of scale and learning by doing. The sectors most likely to become oligopolistic include computers, semiconductors, and biotechnology; these technologies, of course, are identified by most governments as the "commanding heights" of the information economy. Many are dual technologies, because they are very important to both military weaponry and to economic competitiveness. Many countries consider it essential for both commercial and security reasons to take actions that will ensure a strong presence in some or all of these sectors. The importance of a head start in these industries encourages firms to pursue a "first-mover" strategy so that cumulative processes and path dependence will strengthen their market position.

The theory of strategic trade takes the existence of imperfect or oligopolistic competition one step further and suggests that a government can take specific actions to help its own oligopolistic firms. Government policies can assist national firms to generate *positive externalities* (e.g., technological spillovers) and to *shift profits* from foreign firms to national firms. Economists have long appreciated that a nation with sufficient market power could enact an optimum tariff and thereby shift the terms of trade in its favor. By restricting imports and decreasing the demand for a product, a large economy may be able to cause the price of the imported good to fall. Strategic trade theory, however, goes much farther than optimum trade theory in recognizing the capacity of a nation to intervene effectively in trade matters and thus to gain disproportionately. A government's decision to support a domestic firm's plans to increase its productive capabilities (preemption) or even to signal intention to build excess productive capacity exemplifies a strategic trade policy. Through use of a direct subsidy to a firm or outright protection of a domestic industry, the government might deter foreign firms from entering a particular industrial sector. Since a minimum scale of production is necessary to achieve efficiency, especially in many high-tech industries, the advantage of being first ("first-mover advantage") encourages a strategy of preemptive investment.

Strategic trade theory departs from conventional trade theory in its assumption that certain economic sectors are more important than others for the overall economy and therefore warrant government support. Manufacturing industries, for example, are considered more valuable than service industries because manufacturing has traditionally been characterized by higher rates of productivity growth and has produced higher profits, higher value-added, and higher wages. Some economic sectors, especially such high-tech industries as computers, semiconductors, and information processing, are particularly important because they generate spillovers and positive externalities that benefit the entire economy. Because a new technology in one sector may have indirect benefits for firms in another sector, firms that do extensive research and development are valuable to many others. However, because firms may not be able to capture or appropriate the results of their research and development activities, many will underinvest in these activities. Proponents of strategic trade theory argue that such a market failure indicates that firms should be assisted through direct subsidy or import protection, particularly in high-tech industries, which frequently raise the skill level of the labor force and thus increase human capital. If, as the proponents of strategic trade believe, such special industries do exist, then free trade is not optimal, and government intervention in trade matters can increase national welfare.

Strategic trade theory has become a highly controversial subject within the economics profession. Some critics argue that strategic trade theory is a clever, flawed, and pernicious idea that gives aid and comfort to proponents of trade protectionism. Other opponents of the theory agree with this negative assessment and maintain that the theory itself adds nothing really new to dubious arguments favoring trade protection. Perhaps in response to the severe denunciations of strategic trade theory by leading mainstream economists, some of its earliest and strongest proponents have moderated their initial enthusiasm. Many economists consider STT to be an intellectual game with no relevance to the real world of trade policy. Despite these criticisms and recantations, however, strategic trade theory has had an important impact on government policy and has undoubtedly been a factor in the slowdown in the growth of world trade.

What can be concluded about strategic trade theory and the industrial policy to which it provides intellectual support? The case for *profit shifting* from one economy to another has neither been proved nor disproved; it is difficult to assess whether or not government intervention in oligopolistic markets actually works, because economists lack adequate models of the ways in which oligopolistic firms really behave, and because the effects of trade policy in oligopolistic industries can depend to a critical degree on that behavior. The *positive externalities* argument for strategic trade policy and its first cousin, industrial policy, have strong support in the literature. Even though empirical evidence for the success of industrial policy is admittedly mixed, government support for particular industrial sectors has frequently been very successful in creating technologies that spill over into the rest of economy. Most importantly, there is strong evidence that government support for broad-scale R & D produces a very high payoff for the entire economy. Certainly, governments around the world believe that providing support for high-tech industries is a highly productive investment over the long term.

Postwar Trade Regime

The post-World War II trading system was born in conflict between American and British negotiators at the Bretton Woods Conference (1944). Reflecting their industrial supremacy, US negotiators wanted free trade and open foreign markets as soon as possible. Although the British were also committed to the principle of free trade, they were extremely concerned over the "dollar shortage," possible loss of domestic economic autonomy to pursue a full employment policy, and a number of related issues. The eventual compromise agreement to create the International Trade Organization (ITO) left many issues unresolved.

In 1948, the United States and its principal economic partners created the General Agreement on Tarriffs and Trade (GATT) to promote "freer and fairer" trade, primarily through negotiated reductions of formal tariffs. When the ITO was turned down by the U.S. Senate in 1950, the GATT became the world's principal trade organization. The GATT is a fixed-rule trading system, and such a rule-based system is quite different from managed or "results-oriented" trade that sets quantitative targets or outcomes. The GATT was also based on the principle of multilateralism; trade rules were extended without discrimination to all members of the GATT; unilateralism, bilateralism, and trading blocs were prohibited except in unusual cases. Another feature of the system was the principle of overall or general reciprocity; that is, trade liberalization and rules were to be determined by mutual balanced concessions. A system of specific reciprocity, on the other hand, requires that quite specific rather than general concessions must be made. The GATT also incorporated provisions for the impartial adjudication of disputes.[31] Although the principles of the GATT trade regime were significantly qualified by escape clauses and exceptions, its creation was a major accomplishment, and it has facilitated extremely important reductions in trade barriers.

The GATT proved remarkably successful in fostering trade liberalization and providing a framework for trade discussions. However, in contrast to the abandoned ITO, its authority and the scope of its responsibilities were severely limited; it was essentially a negotiating forum rather than a true international organization, and it had no rule-making authority. Moreover, it lacked an adequate dispute-settlement mechanism, and its jurisdiction applied primarily to manufactured goods. The GATT did not have authority to deal with agriculture, services, intellectual property rights, or foreign direct investment; nor did the GATT have sufficient authority to deal with customs unions and other preferential trading arrangements. Its power to resolve trade disputes was also highly circumscribed. Successive American Administrations and other governments became increasingly cognizant of the GATT's inherent limitations, and following the Uruguay Round, they incorporated it in 1995 within the World Trade Organization (WTO), whose responsibilities and au-

[31] Jagdish Bhagwati, *The World Trading System at Risk* (Princeton: Princeton University Press, 1991).

thority are much broader and which is a full-fledged international organization rather than merely an international secretariat (like the GATT).

The GATT, and later, the WTO, served the important political purpose of facilitating the reduction of trade barriers. The principle of comparative advantage indicates that a nation would increase its gains by opening its market to foreign goods; also, an open economy would enjoy lower prices, consumer choice, and greater national efficiency. Nevertheless, because potential losers would strongly oppose lifting trade barriers, proponents of free trade have to confront a mercantilist attitude that believes exports are good and imports are bad. This attitude is revealed when trade agreements are characterized as "concessions" to a foreign government. Because of this prevalent attitude, and for other political reasons, negotiated reductions of trade barriers based on the principle of reciprocity are necessary. The political logic of the GATT/WTO is that because liberalization harms certain interests that will inevitably oppose trade liberalization, it is necessary to liberalize in a coordinated way with concession for concession, thus making it easier to defeat protectionists. Once trade barriers have been lowered, a framework of agreements makes it quite difficult to raise them again.

The GATT, despite the limitations of its mandate and its cumbersome organizational structure, was important for many years in reducing barriers to international trade and in helping to establish rules to reduce trade conflict. The GATT provided a rule-based regime of trade liberalization founded on the principles of nondiscrimination, unconditional reciprocity, and transparency (for example, use of formal tariffs and publication of trade regulations); as trade relations constitute a Prisoner's Dilemma situation, unambiguous rules are required to forestall conflict.[32] Trade rules were determined and trade barriers were reduced through multilateral negotiations among GATT members. In effect, GATT members agreed to establish regulations lowering trade barriers and then let markets determine trade patterns; member states pledged not to resort to managed or results-oriented trade that set import quotas for particular products. Under GATT, markets were opened and new rules established by international negotiations; agreements were based on compromise or unconditional reciprocity rather than on unilateral actions by the strong or by specific reciprocity. GATT's goal was an open multilateralism; that

[32] Avinash K. Dixit, *The Making of Economic Policy: A Transaction-Cost Politics Perspective* (Cambridge: MIT Press, 1996), 124.

is, the agreement provided for extension of negotiated trade rules to all members of the GATT without discrimination. However, candidates for membership did have to meet certain criteria and agree to obey its rules. The founders of the GATT wanted a steady progression toward an open world economy, with no return to the cycle of retaliation and counterretaliation that had characterized the 1930s.

The postwar period witnessed a number of agreements to lower tariff barriers. A significant shift in negotiations took place during the Kennedy Round (1964–1967). That Round, initiated by the United States as a response to growing concern over the possible trade diversion or discrimination consequences of the European Economic Community, substituted general reciprocity for the prior product-by-product approach to tariff cuts (specific reciprocity). GATT members agreed to reduce tariffs on particular products by certain percentages and made trade-offs across economic sectors. The Round resulted in a reduction of trade barriers on manufactures of approximately 33 percent and in a number of basic reforms, including regulation of "dumping" practices. In addition, preferential treatment was given to exports from less developed countries (LDCs).

The next major initiative to liberalize trade was the Tokyo Round (1973–1979), which, after years of bitter fighting, proved far more comprehensive than earlier efforts. It included significant tariff cuts on most industrial products, liberalization of agricultural trade, and reduction of nontariff barriers. In addition, the industrial countries pledged to pay greater attention to LDC demands for special treatment of their exports. However, the most important task of the Tokyo Round was to fashion codes of conduct to deal with unfair trade practices. To this end, the negotiations prohibited export subsidies and eliminated some discrimination in public procurement. However, that Round did not resolve the serious American-European dispute over agriculture, satisfy the LDCs, or stop the noxious proliferation of nontariff barriers that occurred as a consequence of the New Protectionism that had commenced in the 1970s.[33]

Nevertheless, trade-liberalizing agreements did enable international trade to grow rapidly. Substantial expansion of trade meant that imports penetrated more deeply and trade became a much more important component in domestic economies. In fact, in some European Economic Community countries, exports soared. And even the domestic markets of the United States and Japan were internationalized

[33] European Union agricultural subsidies are approximately $324 per acre in contrast to $34 per acre in the United States. *Burlington Free Press*, 12 December 1999, 3A.

to a significant extent. It is particularly noteworthy that Japanese imports soon included a growing percentage of manufactured goods. Meanwhile, GATT membership greatly expanded over the years, and growing trade flows created a highly interdependent international economy, despite the 1970s slowdown.

The Uruguay Round and World Trade Organization

By the mid-1980s, the Bretton Woods trade regime was no longer adequate to deal with a highly integrated world economy characterized by oligopolistic competition, scale economies, and dynamic comparative advantage. In addition, the New Protectionism of the 1970s had led to the erection of numerous nontariff barriers, such as quotas and government subsidies.[34] Moreover, the character of trade itself was changing and outgrowing the rules and trading regime of the early postwar era. Trade became closely intertwined with the global activities of multinational firms, and trade in both services and manufactures expanded rapidly; trade among industrialized countries became the most prominent feature of the trading system. In the 1980s, the "new regionalism," especially acceleration of the movement toward European integration, was recognized as a threat to the multilateral trading system. And at least from the early 1980s, the United States pressured its West European and other trading partners for a new round of trade negotiations to strengthen the multilateral trading system. Eventually, this American pressure overcame European and other resistance, and the Uruguay Round of trade negotiations was launched at Punta del Este, Uruguay, in 1986, resulting in intense negotiations until its conclusion in 1993.

The treaty produced by the Uruguay Round, which came into force on January 1, 1995, reduced tariffs on manufactured goods and lowered trade barriers in a number of important areas.[35] At the same time

[34] The New Protectionism, as distinct from the "old" protectionism, was characterized by hidden trade barriers, a shift from rules to discretion, and a return to bilateralism. See W. M. Corden, *The Revival of Protectionism* (New York: Group of Thirty, 1984).

[35] A detailed and optimistic assessment of the Uruguay Round is found in Ernest H. Preeg, *Traders in a Brave New World: The Uruguay Round and the Future of the International Trading System* (Chicago: University of Chicago Press, 1995). John Whalley and Colleen Hamilton, on the other hand, believe that the success of the Round was greatly overstated, especially with respect to new rules governing antidumping practices, subsidies, and other areas of agreement that were quite modest. Nor, they point out, did it do much for services or FDI. See Whalley and Hamilton, *The Trading System After the Uruguay Round* (Washington, D.C.: Institute for International Economics, 1996).

that formal tariffs on merchandise goods were reduced to a very low level, the Uruguay Round decreased or eliminated many import quotas and subsidies. The agreement's twenty-nine separate accords also reduced trade barriers and for the first time extended trade rules to a number of areas that included agriculture, textiles, services, intellectual property rights, and foreign investment. By one estimate, by the year 2002 the agreement should increase world welfare by approximately $270 billion. While many economists and public officials praised the agreement, others emphasized the modesty of its gains. However, the long-term effects of these achievements remain in doubt. Speaking of the agreement, John Jackson, a leading expert on trade law, stated that the "devil is in the details."[36]

The Uruguay Round's most significant accomplishment was the creation of the World Trade Organization (WTO). In doing this, the Round took an important step toward completion of the framework of international institutions that had originally been proposed at Bretton Woods (1944). Although the WTO incorporated the GATT along with many of its rules and practices, the legal mandate and institutional structure of the WTO were designed to enable it to play a much more important role than the GATT had played in governance of international commerce. The WTO has more extensive and more binding rules. Moreover, the WTO has, in effect, the primary responsibility to facilitate international economic cooperation in trade liberalization and to fill in the many details omitted in the 22,000-page Uruguay Treaty. That Agreement establishing the WTO expanded and entrenched the GATT principle that trade should be governed by multilateral rules rather than by unilateral actions or bilateral negotiations.

The World Trade Organization (WTO) is, in essence, an American creation. The WTO's predecessor, the General Agreement on Tariffs and Trade (GATT) had served well America's fading mass-production economy, but it did not serve the emerging economy equally well. As a consequence of economic and technological developments prior to

[36] The sheer magnitude of the agreement is extraordinary. As John Jackson has commented, the Uruguay Round negotiations were undoubtedly the most extensive ever carried out by any international organization. The agreement contained 22,000 pages and weighed 385 pounds! Although the agreement did not achieve many of the objectives sought by the United States, which had proposed the negotiations, it was an impressive achievement nevertheless. See John H. Jackson, in Peter B. Kenen, ed., *Managing the World Economy: Fifty Years After Bretton Woods* (Washington, D.C.: Institute for International Economics, 1994), 132f.

the Reagan Administration, the United States had become an increasingly service-oriented and high-tech economy. Therefore, in a major effort to reduce trade barriers, the Uruguay Round was initiated by the Reagan Administration and later was supported by the Bush Administration and, after much vacillation, by the Clinton Administration as well.

Although the WTO was not given as extensive rule-making authority as some desired, it does have much more authority than the GATT. The GATT dispute-settlement mechanism was incorporated in the WTO, reformed, and greatly strengthened by elimination of such basic flaws as long delays in the proceedings of dispute panels, the ability of disputants to block proceedings, and the frequent failure of members to implement decisions. The agreement also established a new appellate body to oversee the work of the dispute panels. Most importantly—and controversially—the WTO was empowered to levy fines on countries that refused to accept a decision of the dispute panel.

The institutional structure of the trade regime also changed significantly. Whereas the GATT had been a trade accord supported by a secretariat, the WTO is a membership organization that increases the legal coherence among its wide-ranging rights and obligations and establishes a permanent forum for negotiations. Biennial ministerial meetings should increase political guidance to the institution. The Uruguay Round also created a trade-policy-review mechanism to monitor member countries. With over 130 members, however, the WTO's ability to carry out its assigned responsibilities is subject to doubt.

Despite the impressive achievements of the Uruguay Round in reducing trade barriers, many vexing issues were left unresolved. Trade in certain areas such as agriculture, textiles, and shipping continues to be highly protected. The failure to reduce tariffs on agriculture and textiles was and continues to be especially vexing because lower tariffs would greatly benefit LDCs. Trade barriers are still high in most developing countries, especially with respect to services, and developed countries continue to restrict imports of automobiles, steel, textiles, consumer electronics, and agricultural products. Completion of the Uruguay Round's so-called "built-in" agenda is crucial, and the many issues unresolved at the close of the negotiations remain problematic at this writing. In addition, since the end of the Uruguay Round, a number of new and extremely difficult issues have surfaced, including labor standards, the environment, and human rights. Even more ominous, American public opinion has become more skeptical of the costs and benefits of trade, and by the late 1990s the WTO and trade liberalization were clearly on the defensive.

New Threats to an Open Trading System

In order to deal with the many issues left unresolved in the Uruguay Round and eliminate the many barriers that continue to restrict free trade, in 1999 the WTO prepared to launch a Millennium Round of trade negotiations. The proposed round was very ambitious, and the following issues were among the important matters to be considered:

(1) Further reduction of trade barriers on industrial products.
(2) Reductions of barriers, particularly high tariffs in less developed countries, to trade in services, including information technology, financial services, and telecommunications.
(3) Reduction of fishing subsidies that promote over-fishing.
(4) Simplification of customs procedures.
(5) Increasing transparency in government procurement of goods and services.
(6) Granting duty-free access to ADC markets for the poorest countries.
(7) Extension of the interim agreement not to impose customs duties on Internet transactions or e-commerce.
(8) Paving the way for agreement on foreign investment and competition policy.[37]
(9) Reviewing WTO antidumping and antisubsidy rules to curb abuse of these otherwise legitimate trade rules.
(10) Reviewing problems in implementing existing ("built-in") agreements on textiles, intellectual property protection, and investment rules.
(11) Establishing a forum involving the World Trade Organization, International Labor Organization, and United Nations Conference on Trade and Development (UNCTAD), as well as other organizations to discuss links among trade, economic development, and labor questions.

The Millennium Round, where these important and highly controversial trade issues were to be negotiated, was to be launched in November 1999 at a WTO trade ministers meeting in Seattle, Washing-

[37] The purpose of international competition policy or what Americans call "antitrust" policy is to set the terms on which global business is conducted.

ton. Unfortunately, strong differences among member governments, especially among the three major economic powers, along with turmoil in the streets, resulted in near chaos and the collapse of that conference. Launching of the Millenium Round therefore had to be delayed.

The New Trade Agenda

As the volume of world trade expanded and trade penetrated more and more deeply into national societies, it became increasingly entwined with politically sensitive matters and came into conflict with powerful domestic interests, especially in the United States. This development has produced the "new trade agenda," which includes such highly controversial issues as labor standards, human rights, the environment, and national sovereignty. Although some proponents of the new trade agenda are unalterably opposed to free trade and are even outright protectionists—and large parts of American organized labor provide a prime example of those who want free trade only on their own parochial terms—most advocates of one or another of the issues on the new trade agenda want radical changes in the WTO that would, most experts believe, greatly weaken the trade regime. Examination of the new trade agenda and the intense political controversy surrounding various items reveals serious threats to the trade regime that will be difficult to overcome.[38]

The issues of "fair" labor standards, human rights, and environmental protection center mainly on the question of whether these important and politically sensitive issues should be treated together with conventional trade issues or in a different venue. On the one hand, powerful groups, especially in the United States and Western Europe, believe strongly that these matters should be incorporated into the international trade regime, and that trade liberalization should be made subordinate to achievement of the particular specific objectives of their varying political agendas. On the other hand, most economists, governments, and business groups are strongly opposed to integrating these issues into international trade negotiations, fearing that, however well intended some groups are, the important issues of labor standards, human rights, and environmental protection will be and are being exploited by outright protectionists. Indeed, the stalemate generated by these possibly irreconcilable positions led to

[38] These matters are discussed in I. M. Destler and Peter J. Balint, *The New Politics of American Trade: Trade, Labor, and the Environment* (Washington, D.C.: Institute for International Economics, 1999).

the defeat in 1997 of President Clinton's request for "fast track" authority that could have greatly facilitated negotiation of trade agreements.

In the United States, the opposition of environmentalists to the trade regime had become intense by the late 1990s.[39] This opposition was inflamed by two controversial decisions of the trade dispute settlement mechanism. The first was a 1991 GATT ruling against the American ban on importing tuna caught by methods that killed dolphins; the second was another trade ruling in 1998 against an American law intended to protect sea turtles. The dolphin issue illustrates the difficulties created when environmental issues and trade matters intersect. The case arose from a Mexican accusation that the American law protecting dolphins discriminated against Mexican fishermen. The GATT based its ruling on the established principle that governments should not discriminate on the basis of the ways in which a good is produced. This principle had been accepted because such an extension of GATT authority to cover productive processes would have required it to probe deeply into sensitive domestic matters, and few countries would tolerate such an extension of authority. In addition, the American law had been poorly drafted and did indeed discriminate against Mexican fishermen. Moreover, the law had been passed without adequate discussions of the issue with Mexico. A different approach might have met the desires of both environmentalists and those who feared that environmental laws would be used as protectionist devices.

American environmentalist critics of the trade regime fall into two major camps, one of which accepts the principle of free trade but believes that environmental protection should be incorporated into trade negotiations and be given equal if not a higher priority than trade liberalization. This group also believes that the WTO and its dispute-settlement mechanism should become more open to the public. The other and more radical position opposes free trade as a threat to the environment and rejects the WTO as an instrument of powerful corporate interests; this latter group agrees with American neoisolationist conservatives that the WTO constitutes an infringement of American sovereignty. Together, the environmentalists have become a formidable force in the political struggle over trade.

Although few economists or other advocates of trade liberalization challenge the importance of protecting the environment, most have

[39] Daniel C. Esty, *Greening the GATT: Trade, Environment, and the Future* (Washington, D.C.: Institute for International Economics, 1994).

strongly opposed integration of trade liberalization with environmental protection. There is great concern that environmental regulations could and would be used to promote trade protection. Many are also seriously concerned that trade measures designed to protect the environment would shift the domain of trade negotiations from products to industrial processes. Yet, environmentalists are rightly concerned because trade negotiations and the trade regime do give priority to commercial interests over the environment, and there is indeed reason to worry that trade negotiations could lead to a *downward* harmonization of environmental standards. As both trade liberalization and environmental protection are desirable objectives, work toward both goals must continue through international negotiations.

The issues initially raised by environmentalists in Seattle are serious and must be addressed by national governments. Yet, with a few particularly important exceptions such as global warming and pollution of the oceans, almost every environmental issue can be most effectively dealt with on a domestic or regional basis. The serious problems of nuclear and other hazardous wastes, water contamination, air pollution, toxic dumps, and carbon dioxide (CO_2) emissions have little or nothing to do with international trade. One of the most vehement groups of protesters in Seattle consisted of opponents of logging and especially of "clear cutting." That problem is primarily the result of high government subsidies to timber companies (as in Alaska) and to forest destruction caused by land-hungry farmers and the national development strategies in many less developed countries (LDCs). Even though the primary responsibility for overcutting belongs to national governments, environmentalists have made the WTO the whipping boy in this matter and many others. Moreover, even when environmental issues do relate to international trade (as does happen in ocean oil spills and in trade in endangered species), the WTO does not have either the authority or the power to deal with such matters. These pressing matters can be dealt with effectively in such other ways as international conventions; this did happen in the international agreement on safety rules for genetically modified foods.[40]

The issue of labor standards has become a major impediment to trade liberalization, especially in the United States where it has been raised forcefully by organized labor and, to a lesser extent, by human rights advocates genuinely concerned over child labor in less developed countries, and in China in particular. Actually, a disproportion-

[40] Although this agreement was hardly perfect, it permits countries to bar imports of genetically modified foods. *New York Times*, 30 January 2000, A1.

ate number of the street protesters in Seattle were union members mobilized by the American AFL-CIO, whose president, John Sweeney, rejoiced at the collapse of the meeting. The International Labor Organization (ILO) has established labor standards, but most advocates of labor standards and opponents of child labor believe that that organization is much too ineffective to deal with these issues; moreover, the United States and a number of other countries have not even ratified all of the ILO's standards. Although some advocates of labor standards and of prohibitions against child labor are genuinely concerned over the oppressive conditions of labor in many countries, others use the issue as a protectionist device. Suspicion that American unions are more interested in keeping LDC exports out of the United States than they are in helping LDC workers is reinforced by the following episode: in early 2000, the United States agreed to increase Cambodia's quota of textiles imported into the United States in exchange for the latter's agreement to improve labor standards, including raising wages substantially. Under the agreement, Cambodian textile workers would have earned \$40 per month (compared to \$20 per month for Cambodian university professors). However, implementation of this agreement was blocked by American unions.[41]

Most economists, businesses, and national governments also reject the idea that labor standards and human rights should be incorporated into trade negotiations. Economists are concerned that consideration of labor standards in trade negotiations would unduly complicate the already horrendous task of achieving agreement on trade liberalization and would provide a convenient and effective rationale for protectionist measures against low-wage economies. Developing countries have strongly denounced efforts to impose "Western" standards on them. They have reason to believe that such proposals are motivated by protectionist interests and would be used to reduce their comparative advantage based on low-wage labor and provision of only minimum welfare benefits.

The closely related issues of labor standards, human rights, and child labor are legitimate and need to be addressed. Furthermore, some countries are undoubtedly guilty of "social dumping"; that is, of competing through denying workers fundamental rights and decent working conditions. However, remedying the problem will be extraordinarily difficult. As almost every LDC is strongly opposed to incorporating labor standards and human rights into the WTO, the effort to do so would be likely to destroy the effectiveness of the

[41] *Wall Street Journal*, 28 February 2000, A1.

organization. It is particularly ironic that many of the protestors at Seattle who denounced the rulings of the WTO as an infringement of American sovereignty also advocated that the WTO impose labor and human rights standards on delinquent LDCs! Needless to say, it will be difficult indeed to reconcile the positions of those who desire and those who oppose incorporation of workers' rights into the trade regime.

Ultimately, the solution to the associated problems of labor standards, human rights, and child labor must be provided through a combination of education and economic development. In general, those countries with the highest labor and environmental standards and those that have respect for human rights are the most developed countries, countries in which there is great wealth and a strong and concerned middle class. In societies with low income per capita, where parents frequently need the wages of their children, outside intervention like trade sanctions is unlikely to succeed.[42] In the short term, the best solution is to exert organized consumer pressure against those firms and countries that violate decent labor standards, human rights, and child labor. For example, according to the *New York Times*'s Thomas Friedman, following the GATT ruling against the American law banning tuna caught with nets that also catch dolphins, consumer pressures in the United States forced firms and the fishermen they deal with to change their practices; soon many brands carried the label "dolphin safe."[43] While such a method of dealing with a problem would fail to satisfy the AFL-CIO and others, there is some evidence that suggests that this technique has been used successfully with certain issues.

One of the most disturbing aspects of the new trade agenda is that the WTO and other international economic institutions have come under heated attack by an unholy alliance of environmentalists and human rights advocates, protectionist trade unions, and ultraconservative neoisolationists. As in the vehement protests surrounding the WTO's November 1999 meeting in Seattle and the April 2000 protests in Washington, the WTO and other international agencies have become lightning rods for concerned and frustrated groups around the globe who want the world to be different from its present unfortunate state. The impossible and contradictory demands of the Seattle protesters ranged from abolishing the WTO altogether, because it is

[42] Economists such as Jeffrey Sachs and Paul R. Krugman have pointed out that the important issue in many LDCs is whether there will be enough jobs.

[43] Thomas Friedman, *New York Times*, 8 December 1999, A31.

undemocratic and infringes on American sovereignty, to demands that it actively intervene in the sovereign affairs of nations to eliminate such destructive practices as forest clear-cutting and pollution of streams, lakes, and rivers. The World Trade Organization, the World Bank, and the International Monetary Fund have become the symbols of globalization for all those groups and individuals who blame globalization for their own and the world's problems.

International economic institutions have certainly made a number of serious mistakes. The controversial role of the IMF in the East Asian financial crisis is a prime example. The World Bank also has funded many questionable projects in poor countries. The WTO may have erred in certain of its decisions. Reforms that will make these institutions more accountable and sensitive to noneconomic matters are required. Yet, the wholesale attack on these institutions by the political left and right is unwarranted. It is wrong, for example, to blame these institutions for failures to achieve debt relief for poor countries, to open ADC markets to LDC exports, and to prevent the environmental damage caused by development projects supported by the World Bank. The responsibility for these failures lies with national governments. Debt relief was thwarted by the refusal of the rich industrial nations to appropriate the funds required to make debt relief possible. Opening the American market to more LDC goods has been resisted by labor unions and other powerful interests. Prevention of the environmental damage caused by large development projects in less developed countries has seldom been a priority for the LDCs themselves. If these and other problems of the global economy are to be resolved, protesters should direct their attention to the national governments that are ultimately responsible.

The argument that the WTO violates American sovereignty and somehow has been imposed on the United States is particularly disturbing. The WTO was created by a treaty sponsored by President Reagan, has been endorsed by Presidents Bush and Clinton, and was ratified by a two-thirds vote of the United States Senate. Under the American Constitution, a ratified international treaty becomes part of the law of the land and is incorporated into the definition of American sovereignty. The United States and other members have delegated to the WTO the responsibility to enforce existing trade agreements. It is not, as critics charge, a supergovernment that can legislate new laws. A dispute panel's interpretation of a trade law obviously can have a significant effect on trade regulations, but the WTO cannot force a country to do anything against its will. Moreover, international law permits a nation to abrogate a treaty if it believes that the treaty no longer serves its national interest.

Disarray Among Major Economic Powers

Although the Seattle street protestors attracted the most attention at the November 1999 WTO meeting, responsibility for the abysmal failure of that meeting belongs to the major economic powers, and to the Clinton Administration in particular. For domestic political reasons, President Clinton tried to force the conference to include the issue of "labor standards" on the agenda of future trade negotiations. His irresponsible reference in a newspaper interview to the imposition of economic sanctions on countries that did not meet certain labor standards was especially noxious to developing countries, who quite correctly viewed the President's motives as protectionist. Another factor in the breakdown of the negotiations was the inexperience of the newly appointed WTO Director-General Mike Moore. Still other factors were the lack of adequate preparation for the meeting, lack of an agreed-upon agenda, the unwieldiness of a meeting composed of 135 member-nations, and the "brusque chairmanship" of Charlene Barshefsky, head of the U.S. delegation.[44]

The unwillingness of the major economic powers, especially the United States and the European Union (EU), to contemplate serious trade liberalization was also critical in the Seattle fiasco. Each major economic power had a different agenda that conflicted with others and precluded a successful outcome. High on the Clinton Administration's formal agenda were such issues as elimination of European agricultural subsidies and protection of intellectual property rights. However, at the conference, President Clinton subordinated this formal agenda to the issue of labor standards. Furthermore, the Clinton Administration refused to discuss the outrage in Japan and other countries over the Administration's extensive and improper use of the WTO's antidumping provision as a protectionist device.[45] The Administration also opposed the European Union's (EU's) strong desire to put competition policy on the agenda and instead supported a nar-

[44] Ms. Barshefsky insisted on chairing the meeting with what many delegates charged was an abrasive and domineering style. Poorer members, for example, complained that they were excluded from "behind closed doors" meetings where important decisions were made.

[45] Under both GATT and WTO rules, a country can impose duties on goods being dumped on the world market. Both the United States and Western Europe have grossly misused this safeguard provision for purely protectionist purposes.

row agenda favoring American export interests—financial services, information technology, aircraft, and agriculture—while demonstrating little concern for the welfare of American consumers.

At Seattle, both the Japanese and the West Europeans, also for domestic political reasons, adamantly opposed opening their economies to agricultural imports. In the EU, protection of agriculture through large subsidies to farmers is considered essential to the achievement of European economic and political integration. In Japan, the ruling Liberal Democratic Party, needing the votes of rural Japanese, opposed opening its market to imports of rice and other agricultural imports. The inability of the major economic powers to find compromises to these fundamental differences doomed the conference to failure. For all three major participants, domestic political objectives took precedence over trade liberalization.

The prospects for a major breakthrough in trade negotiations are not especially promising. Trade barriers in a number of important sectors such as textiles and agriculture may have declined, but only to a level that is politically acceptable to powerful constituencies. Moreover, both in the United States and in Western Europe, public opinion has grown increasingly worried about the impact of imports, especially from low-wage economies. In addition to obstacles to further liberalization raised by the industrialized countries, the industrializing countries have also become increasingly disillusioned with opening their markets. Experience of the East Asian economic crisis has increased the concerns of many about the dangers of opening their economies.[46] Reenergizing the process of trade liberalization will require strong political leadership.

Conclusion

The trade regime was one of the most important achievements of the latter half of the twentieth century. The eight GATT rounds of trade negotiations, beginning with the Kennedy Round in the early 1960s, reduced tariffs in industrialized countries to less than 4 percent on average, one-tenth of what they had been in the 1940s; quotas were reduced, and many subsidies were reduced or eliminated. There are estimates that lowered trade barriers have put an additional $1000 annually into the pockets of American consumers. The economies of less developed countries have also gained greatly as these countries

[46] David Woods, "The Seattle Fiasco," *Braudel Papers*, No. 24, (São Paulo, Brazil: Braudel Institute, 2000), 1.

have reduced their own trade barriers. Despite intense controversy over some of its decisions, the WTO dispute mechanism thus far has worked well. The number of GATT/WTO members has increased from twenty-three to one hundred thirty-five, and about thirty additional states wish to join in 2000. The shift around the world since the 1980s to more market-oriented economic policies is indicated by all these developments. However, as trade has expanded and penetrated more deeply into domestic economies and the trade agenda has broadened significantly, trade has come into conflict with powerful local interests and has thus become increasingly controversial. The clash between the forces of economic globalization and domestic concerns has triggered a backlash against globalization that threatens to undermine the political foundations of the trade regime.