# ONE

# Trade and Trade Issues

This book has two missions. The first is to explain the fundamental dilemmas that surround international trade and trade policy issues. How we respond to these trade dilemmas will not only shape our economy but also determine the kind of society in which we will live. Too often, trade is treated purely as an economic phenomenon that is—or ought to be—divorced from politics. In fact, because the political and the economic components of international trade are intertwined, neither can be understood without the other. I examine the dilemmas of trade in the context of several contemporary controversies, especially the Japanese-American trade relationship, the Asian financial crisis, the **European Union** (EU), the **North American Free Trade Agreement** (NAFTA), and the **World Trade Organization** (WTO).

The second mission is to introduce the basic principles of international political economy by examining how politics and economics interact to shape trade policies. To provide historical and theoretical perspective, I discuss nineteenth-century British trade policy and the evolution of the international economic system from the **Bretton Woods** institutions of the post-World War II era to the "Battle of Seattle" over the contemporary WTO. To demonstrate the enduring relevance of these basic principles and fundamental dilemmas, I also discuss their role in shaping recent proposals to revise the architecture of global economic institutions and to rethink the trade policy advice given to developing nations.

## The Themes of the Book

Whenever people purchase products made abroad, they unknowingly act in accord with one set of interests, values, and theories concerning international trade but in discord with another set. The decision by a firm to market its goods abroad also carries implications beyond its immediate intentions. This book demonstrates that the consequences of these individual choices pose fundamental policy dilemmas for governments as well as for the people directly involved. States seek many outcomes from trade—full employment and improved living standards for its citizens, long-term growth and stability for its economy, and power, security, and friendly external relations for the state itself—yet discover that these desirable outcomes are frequently incompatible. The resulting dilemmas can be seen with clarity only when the standard economic theories of international trade are understood to be partial and incomplete. They must be augmented with treatments rooted in the perspective of international **political economy**.

Since the nineteenth century, **economic liberalism** has been the dominant theoretical perspective on international trade. Liberal economic theorists maintain that free markets establish prices that result in the most **efficient allocation of factors of production,** such as land, labor, and **capital**. Thus, from the time of Adam Smith (1723–1790), they have concluded that **free trade** is the surest path to economic prosperity and growth. Both the global economy as a whole and each nation within it are said to be better off when unencumbered trade permits each consumer to buy the most desirable products and each **entrepreneur** to invest resources in the most productive way. Consequently, they have urged that governments refrain from interfering with private entrepreneurs and free markets in international trade. Yet in the intervening two centuries, virtually no national government has followed this advice.

> **The Meaning of Economic Liberalism**
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> The term "economic liberalism" is not to be confused with the ambiguous way th term "liberal" is applied in American politics. Economic liberalism is wary of gov interference with the market, whereas those called liberals often advocate it.

This book probes the reason for this curious disparity between accepted economic theory and established political practice, rejecting the interpretation proffered by some economists that the discrepancy results from irrational or corrupt policy. Instead, the book's political economy perspective acknowledges that governments seek to influence trade because markets generate multiple consequences, many of which exceed the boundaries of economic theory yet touch the fundamental responsibilities of government. For example, just as trade affects the prices of individual products, global markets influence which individuals and nations accumulate wealth and political power. They determine who will be employed and at what wage. They determine what natural resources will be used and at what environmental cost. They shape opportunities and constraints in foreign policy. They even affect the viability of domestic policies, the sustainability of economic growth and the integrity of a nation's culture and institutions. Because trade affects such a broad range of social outcomes, conflict among alternative goals and values is inevitable. Because these social outcomes affect various individuals and groups differently, these conflicts are inevitably politicized. As a result, governments, which seek to balance all the interests and values of society, confront dilemmas that require painful choices.

In this book I describe the dilemmas resulting from the distributional consequences of trade, the competing values affected by trade, and the impact of trade on the concerns of the state. I also explain how various governments (and individuals) respond to these dilemmas and why.

## The Importance of Trade

Most economists and policymakers believe that trade provides substantial benefits for individual nations and the global economy as a whole. Exports enable corporations to earn higher profits, employ more workers, and generate greater tax receipts for governments than if they were restricted to selling in a single national market. Exports also bring in revenue in the form of foreign currencies that can be used to purchase imports. The very fact that individuals choose imported products implies either that similar goods cannot be produced domestically or that imports are of higher quality or lower price than domestic alternatives. In either case, import expansion implies an increase in welfare for consumers.

Considerable evidence supports the view that trade improves productivity, consumption, and therefore welfare. The growth of the global economy has been most rapid during periods of trade expansion, especially during the quarter-century after World War II, and has slowed when trade levels have fallen, especially during the **Great Depression** of the 1920s and 1930s. Periods of national growth have also coincided with trade expansion, most notably in Germany, Japan, and Korea. There is some uncertainty about whether trade leads to growth or growth leads to trade, but there is little doubt that most governments believe that trade expansion improves living standards.

Table 1.1, which shows the importance of exports in selected nations in 1960, 1980 and 1997, demonstrates that trade has grown substantially, becoming an important element in the economies of all nations. Because global trade has grown nearly twice as rapidly as total global production since 1950, about a quarter of all goods and services produced globally are now traded among nations. Technological advances in transportation and communication can account for much of this growth, with freight costs having declined by 2/3 since the mid-1980s. However, driven by the liberal theory described in chapter two and the political dynamics portrayed in chapter three, governments have adopted policies and created international institutions that have played an even greater role in facilitating trade expansion. Chapter four shows that the Bretton Woods system initiated after World War II has been especially significant in expanding trade and that the recent addition of the WTO promises even greater integration among national economies. The vast economic restructuring entailed by this globalization has had a far-reaching impact on many aspects of economic, social and political life, making it evident why trade issues have become so politically explosive in recent years.

Table 1.1 also reveals considerable variation in the importance of trade across nations and suggests some patterns within that variation. Larger nations, which have sizable domestic markets of their own, tend to rely less on trade than smaller nations. For example, Japan, with exports constituting less than 10 percent of its **gross national product** (GNP), is much less dependent on trade than any European nation, despite its reputation as a great trading nation. The sheer size of Japan's economy, second only to that of the United States, enables it to meet most of its own needs and to consume most of its own production. Smaller nations, such as Belgium and Jamaica, must engage in greater levels of trade because they can neither supply goods to meet all their own needs nor provide a market sizable enough for many industries to produce in the large volumes required to be efficient. For the same reasons, trade constitutes a larger share of GNP in most poor countries than in more developed ones. In recent years the export volumes of nearly 50 nations have approached or exceeded half their total economic output, and they have relied upon imports for a comparable share of their total consumption. Because any major reduction in trade would require a vast economic restructuring that would entail huge welfare losses, such heavy dependence guarantees that trade-related issues will dominate the political agenda.

TABLE 1.1 Exports as a percentage of Gross National Product

| *Nation* | *1960* | *1980* | *1997* |
|---|---|---|---|
| United States | 5.2 | 10.2 | 11.6 |
| Canada | 17.0 | 28.2 | 39.6 |
| Mexico | 8.6 | 10.7 | 30.2 |
| United Kingdom | 20.9 | 27.3 | 29.5 |
| France | 14.5 | 21.5 | 24.0 |
| Sweden | 22.7 | 29.5 | 40.0 |
| Belgium | 38.2 | 57.0 | 68.5 |
| Ireland | 30.6 | 47.6 | 76.4 |
| Japan | 10.7 | 13.7 | 9.9 |
| China | 4.6 | 6.3 | 23.0 |
| Hong Kong | 84.4 | 89.9 | 131.6 |
| Korea | 3.3 | 33.9 | 38.1 |
| Thailand | 15.7 | 24.1 | 47.0 |
| Malaysia | 51.4 | 57.5 | 94.3 |
| Indonesia | 15.6 | 34.2 | 28.0 |
| Philippines | 10.6 | 23.6 | 49.0 |
| Argentina | 7.6 | 5.1 | 9.0 |
| Brazil | 6.8 | 9.1 | 7.6 |
| Jamaica | 33.2 | 51.1 | 51.0 |
| Republic of Congo | 20.5 | 60.0 | 76.9 |
| Nigeria | 9.2 | 29.4 | 40.9 |

SOURCE: World Bank, *World Development Indicators 1999 CD-ROM*.

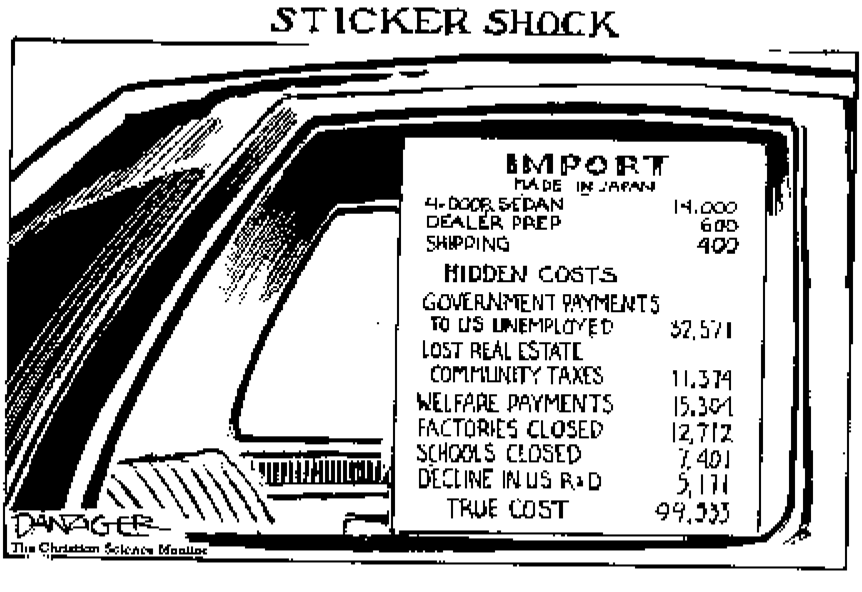
Even if we allow for differences in size and wealth, however, trade has been much more significant for some countries than others. East Asian nations, for example, maintain trade levels more than double those of comparable Latin American economies. The variations in government policy largely responsible are sketched below, and the explanation for these disparate choices is the focal point of much of the book. Chapter five illustrates these variations by contrasting the policies of Japan and the United States. Chapter six emphasizes regional organizations, beginning with the European Union that facilitates trade within Europe and concluding with the North America Free Trade Agreement designed to allow a similar growth of trade among the United States, Canada, and Mexico. Together with the advent of an East Asian group centered around Japan, these developments may foreshadow a world of **trade blocs** in which free trade prevails within each bloc but trade between blocs is restricted.

The growing importance of global trade and its accompanying dilemmas are exemplified by the experience of the newly industrializing countries (NICs) of East Asia detailed in chapter seven, especially Korea, Thailand, Malaysia, Indonesia, and Philippines. The United States and Japan, each in their own way, have been influential in driving the policy approach of these NICs, which have made international trade the centerpiece of their economic development strategy. As Table 1.1 reveals, there is considerable irony in this since the U.S. and Japan are less reliant on exports than all but a handful of other countries (at about 10% of GNP), while these NICs are massively dependent (between 28% and 94%). Though American trade reliance has increased dramatically, it has still not reached the level that was common in Europe decades ago, which helps to explain why the trade issues that have occupied Europe for many years have entered the policy agenda in the United States only quite recently. While the U.S. has long been the world's strongest advocate of the liberal theory that encourages trade, it has less experience than most with the dilemmas posed by relying upon it.

## Concerns about the Trade Balance

Whereas nearly all nations have sought trade expansion for its economic benefits, they have generally tried to avoid an excess of imports over exports, which is known as a deficit in the **balance of trade**. Trade deficits are controversial and difficult to analyze because they generate complex and unpredictable consequences, many of which become visible only in the long term. The immediate concern is that the consumption of imports permits foreigners to enjoy employment and profits from production that might otherwise benefit citizens of the home country. For example, the high levels of unemployment and attendant social problems suffered in Detroit since the mid-1970s were ascribed partially to annual sales of nearly 2 million Japanese cars in the United States. This would be of little concern if these imports were balanced by exports that produce comparable levels of employment and profits from American products sold abroad, but during a **trade deficit** they are not.

Table 1.2 demonstrates that the United States has run a persistent balance-of-trade deficit since the 1970s, with the annual deficits assuming huge proportions since the middle of the 1980s. To put in perspective these vast sums—a record $300 billion is



projected for 1999—imports will exceed exports by more than $1000 per American, over 3 percent of the American GNP. At the estimated rate of 20,000 jobs lost for every $1 billion in trade deficit, this corresponds to about 6 million jobs lost to the deficit. With the U.S. unemployment rate at an historic low in the late 1990s, it is easy to be complacent about this effect, but the longer-term repercussions, though uncertain, are unlikely to be so benign.

The long-term danger of trade deficits stem from the capital flows associated with them. Consider that since the last American trade surplus in 1975, much more money has flowed *out* of the American economy in the form of dollars to pay for imports than flowed back *into* the economy through payments for American goods purchased by foreigners. In fact, these annual deficits cumulate to more than $2 trillion, more than a quarter of annual U.S. GNP. The obvious question is, What are foreigners *doing* with those dollars? The answers point to the dangers inherent in trade deficits.

Some are investing these dollars in the United States to generate future income. For example, the U.S. federal government **budget deficit**—in the magnitude of $200 billion annually from the early 1980s to the mid-1990s—was financed partially by the selling of **Treasury bonds** to foreigners, especially Japanese investors. When the government sells Treasury bonds, it borrows money and agrees to pay interest on the debt. Thus, some of the money sent abroad by American consumers to pay for imports has been borrowed back by the U.S. government at interest rates that will keep the United States paying for this balance-of-trade deficit for years to come.

Table 1.2 U.S. Balance of Trade, 1975-1998

| | *Exports* | *Imports* | *Trade Balance* | |
|---|---|---|---|---|
| | | *($ billion)* | *(% of GNP)* | |
| 1975 | 107.09 | 98.18 | 8.91 | 0.56% |
| 1976 | 114.74 | 124.23 | -9.49 | -0.54% |
| 1977 | 120.81 | 151.91 | -31.10 | -1.58% |
| 1978 | 142.05 | 176.00 | -33.95 | -1.52% |
| 1979 | 184.47 | 212.01 | -27.54 | -1.11% |
| 1980 | 224.25 | 249.76 | -25.51 | -0.94% |
| 1981 | 237.05 | 265.07 | -28.02 | -0.92% |
| 1982 | 211.17 | 247.65 | -36.48 | -1.15% |
| 1983 | 201.80 | 268.89 | -67.09 | -1.97% |
| 1984 | 219.93 | 332.41 | -112.48 | -2.97% |
| 1985 | 215.91 | 338.09 | -122.18 | -3.02% |
| 1986 | 224.11 | 368.75 | -144.64 | -3.39% |
| 1987 | 250.94 | 410.18 | -159.24 | -3.52% |
| 1988 | 321.09 | 447.70 | -126.61 | -2.60% |
| 1989 | 363.47 | 478.00 | -114.53 | -2.18% |
| 1990 | 390.71 | 498.95 | -108.25 | -1.95% |
| 1991 | 418.58 | 491.40 | -72.82 | -1.28% |
| 1992 | 442.13 | 536.45 | -94.32 | -1.56% |
| 1993 | 458.72 | 589.44 | -130.72 | -2.06% |
| 1994 | 504.45 | 668.59 | -164.14 | -2.44% |
| 1995 | 577.69 | 749.57 | -171.88 | -2.44% |
| 1996 | 613.89 | 803.32 | -189.43 | -2.56% |
| 1997 | 681.27 | 877.28 | -196.01 | -2.50% |
| 1998 | 672.90 | 921.00 | -248.10 | -3.04% |

SOURCE: Based on data for merchandise trade in billions of Current U.S. dollars from World Bank,

Some of the dollars piling up abroad have also returned to the United States in the form of investments in new plant and equipment—funded by the profits of Japanese auto firms—such as the Honda plant in Marysville, Ohio. New auto plants produce American jobs, of course, but the profits are earned by Japanese corporations, which will presumably return them to Japan one day. Such **repatriation** of profits again implies that paying for trade deficits can be postponed, but the burdens of such a deficit must eventually be faced.

Finally, some foreigners have been content to accumulate dollars, using them much as they do their own currency—as a convenient storehouse of value and as a medium of exchange with others willing to accept them. Meanwhile, the U.S. benefits from their willingness to hold dollars, just as an individual would if he or she could write checks that others would neglect to cash. In the short-term, this balance-of-trade deficit means that American citizens are *consuming* more than they are currently *producing*. Thus, they enjoy a higher standard of living than would otherwise be possible.

Economists disagree about whether these developments ought to raise alarm over the longer term.[1] Some emphasize that the above processes are all temporary and that eventually foreigners will demand American goods and assets in exchange for their excess dollars. That would require the U.S. to generate a trade surplus (more exports than imports) to compensate for past trade deficits. Of course, to export more than they import would imply that U.S. residents as a whole would consume less than they produce— and experience the lower standard of living implied by that gap. However, other economists emphasize that the continuing willingness of foreigners to invest in the United States and to accumulate dollars is an indication of their confidence that the American economy will grow fast enough to tolerate these effects without serious damage.

Nevertheless, there are signs from international **currency markets** that the persistent balance-of-trade deficit is eroding that confidence. The demand for dollars by foreigners—to purchase products or investments from the United States—is smaller than the supply of dollars created by Americans purchasing foreign products and investments. Like any other item, when supply exceeds demand, the price falls. As a result, the value of the dollar, equivalent to about 300 Japanese yen when the string of U.S. balance-of-trade deficits began in 1976, declined in 1995 to under 100 yen. The declining purchasing power of the dollar means, for example, that the 1 million-yen cost of a Japanese automobile would translate into a dollar price of about $3,000 at the old exchange rate (300 yen per dollar) but more than $8,000 at the rate prevailing in mid-1999 (about 120 yen per dollar). The higher price that Americans face for foreign products signifies that the process of paying for the trade deficit of the past two decades has already begun.

Of course, the effects of trade deficits are hazardous to forecast because their connection to currency declines are neither automatic nor immediate. Witness that between 1995 and 1999, the U.S. ran a cumulative trade deficit of more than $800 billion while Japan accumulated a trade *surplus* of $400 billion—yet during this same period the dollar *increased* in value from about 80 yen to 120 yen. Nonetheless, balance-of-trade deficits tend to lead to such currency declines eventually—sometimes very suddenly and with catastrophic consequences. As chapter seven describes in detail, several nations in southeast Asia ran trade deficits greater than 3% of their GNP for several years in the mid-1990s with no apparent ill effects. Indeed, they were among the fastest growing nations in the world despite trade deficits that often exceeded 5% of GNP and sometimes much more. But when investors eventually lost confidence in the summer of 1997, the fall was dramatic and painful. For example, Indonesia, the fourth most populous country in the world, suffered more than a 70% decline in the purchasing power of its currency and a 50% decline in its stock market within a few months. The resulting economic chaos included massive bankruptcies, soaring unemployment, plummeting living standards, and social unrest that culminated in a change of government.

Thus we see that trade deficits may permit greater levels of consumption in the short-term, but—whether through repayment of loans, repatriation of profits, or the price increases that come from currency declines—they also imply that future consumption will be reduced and standards of living will fall. In short, a trade deficit engineers a shift in welfare from the future to the present.

## Policy Alternatives

Thus, national governments have traditionally sought to avoid balance-of-trade deficits while expanding the volume of trade. Some nations have given emphasis to one or the other of these twin targets though most have sought both. Different nations have attempted to achieve these goals in many different ways, but their policy actions fall within four basic approaches. Each is discussed briefly in the following sections, followed by a preliminary exploration of the dilemmas posed by these options and the reasons different governments have chosen among them differently.

The first approach consists of efforts to increase exports by improving the overall international **competitiveness** of a nation's economy. The second uses various subsidies for **export promotion** within a nation's **industrial policy**. The third approach is to reduce imports through **protectionist** trade barriers such as tariffs and quotas. The fourth seeks to enlarge exports by securing international cooperation to remove the trade barriers of other nations and to build regional or global institutions that facilitate trade. The first and fourth are essentially **liberal** approaches that place greater reliance upon the free reign of markets; the other two, which are usually referred to as **mercantilist**, involve government actions to influence or displace the market.

## Free Trade and The Search for Competitiveness

One trade policy approach seeks to increase the international competitiveness of all the nation's firms by solving social problems and eliminating government policies that drive up their costs. (If the factors that burden import-competing or export firms are unique to those sectors, the government may target them directly with a so-called industrial policy, which is discussed in the next section.) Implicit in this strategy is the acceptance of free trade, because protectionism adds to firms' costs at home and encourages protectionism abroad. Furthermore, if competitiveness is achieved, neither protection nor export subsidies are required. The strategy of enhancing international competitiveness is usually motivated by the desire to increase exports, but if successful it will also tend to minimize trade deficits. Domestic firms able to cut costs become more competitive in global markets— thus expanding exports—while they also compete more successfully against foreign producers in their own market, thereby reducing imports.

However, the following brief discussion of factors that affect competitiveness demonstrates the dilemmas that this trade policy approach presents, particularly with respect to the distributional effects of trade and the tension between alternative values. Trade issues cannot be separated from the remainder of the public agenda because competitiveness problems cannot be solved without sacrificing other values.

First, most American corporations carry the burden of health care coverage for their workers. For example, the U.S. auto industry now spends more for health care than it does for steel. Because American health care costs are the highest in the world—overall, Americans spend about 14 percent of GNP on health care—this burden undermines the competitiveness of all American firms. Those who address this issue cannot avoid contact with some of the toughest issues in American politics: trust in government bureaucracies versus private insurance bureaucracies, breadth of coverage for all citizens versus quality care for some, and the possibility of explicitly rationing health care.

Second, since World War II American expenditures for defense have been many times higher than those of nations with which the U.S. competes. Ironically, much of that money has been spent directly protecting the very nations against which U.S. competitiveness has slipped, especially Germany, Japan, and Korea. These expenditures erode the competitiveness of American business by requiring higher tax levels, they constrain the funds available to spend on other items that could enhance competitiveness, and they divert a substantial share of American scientific and technological expertise into military innovation and away from commercial areas. The trade-off between competitiveness and defense may be judged differently by different individuals, but it can be ignored by none. Giving up global leadership or national security may be a wise choice, but it is not without costs of its own.

Third, the quality of American education, once the best in the world, has eroded. Although the global division of labor now places a premium on skilled labor, many other countries now have a better-educated citizenry and a better-trained workforce—which may explain why the growth in American economic productivity since the 1960s is among the lowest in the industrial world. Because both the American school day and school year are now among the shortest in the world, fixing education may require a substantial increase in cost, compromises with cherished traditions, and flexibility on the part of parents, teachers, and children. Like defense and health care, this problem acquires more urgency in the context of a competitiveness issue, but there are very good reasons for wanting to improve education that do not involve the balance of trade.

Fourth, the decline of America's infrastructure—decaying roads and bridges and overburdened water, sewer, and mass-transit systems—costs American business daily. Because the provision of infrastructure is largely a function of government, this competitiveness issue is intertwined with questions of taxation, government effectiveness, and citizen trust. Infrastructure problems are unexciting—and thus unpopular as a locus of innovation or spending among politicians—but it is evident that trade competitiveness cannot be sustained without government no matter how vibrant the private sector may be.

Fifth, very high debt levels, including personal credit card debt, corporate debt, and years of federal budget deficits, require that savings be used to fund past consumption rather than to invest in the future. Furthermore, because the American personal savings rate is the lowest in the industrial world, U.S. interest rates must be kept higher in order to induce foreigners to supply the investment funds from their savings that Americans do not provide. But these higher interest rates—what economists would call the higher cost of capital—become an additional expense for American businesses that must borrow money for expansion. This illustrates exactly how close to home competitiveness issues can come: The family budget is a matter of national security!

Sixth, other social problems, including crime and drugs, contribute in indirect ways to increased costs for American business. Richard Lamm estimates that "American business spent $51 billion in 1986 for private anti-crime measures such as alarms, iron bars, video cameras, and security guards."[2] American tax dollars support nearly two million inmates, with the U.S. incarceration rate six to ten times higher than in most of Europe and seventeen times greater than in Japan. Even ecological problems affect business because the deteriorating environment diminishes the health and productivity of workers, forces higher costs for health care, and complicates the choice of business location.

Finally, some have blamed corporations themselves for fixating on the short term and ignoring long-term competitiveness. Expenditures on research and development occupy a much smaller portion of corporate spending in the United States than in Japan or Germany, for example, and the pay of top corporate executives is much higher in America than in its chief competitors.

Some proposed solutions to the competitiveness problem violate the definition of competitiveness laid out in a report from the President's Commission, "the degree to which a nation, under free and fair market conditions, produces goods and services that meet the test of international markets *while simultaneously maintaining and expanding the real incomes of its citizens*."[3] The last clause of this definition disqualifies from consideration such proposals as the abolition of the minimum wage, Social Security, workplace safety regulation, pensions, sick leave, workman's compensation, unions, vacations, holidays, and so on.[4] This list exemplifies the dangers of affording competitiveness concerns too high a priority on the national agenda: Cutting wages and benefits for workers would surely make American corporations more profitable and better able to compete, but the attempt would be self-defeating from the standpoint of national welfare. National policy should seek to make corporations more competitive in order to improve the lives of its citizens, not compromise citizen welfare in order to improve competitiveness. The United States has been able to avoid the most damaging of these compromises, but the many developing countries whose firms compete principally on the basis of cheap labor have not been so fortunate. For them, this trade-off between alternative values poses an especially painful policy dilemma.

### Export Promotion and Industrial Policy

The second method employed to maintain a desirable volume and balance of trade utilizes export promotion, usually in conjunction with what is called an industrial policy. By industrial policy is meant a set of government actions designed to encourage the growth of particular industries, usually those believed to be especially important for the future of the economy. Most nations that engage in aggressive industrial policy—Japan is the most frequently cited example—target the export sector because of the growth prospects offered by the global economy, though industrial policy often has other targets as well.

Export promotion is accomplished through a variety of techniques. The simplest is a direct export **subsidy** or bounty, a government payment for each good exported from the target industry. The result is that a domestic firm has the incentive to export goods even though it may not have a cost advantage in comparison with competing firms in other nations.

Such a policy has at least three aims. First, increased production in the chosen industry will likely lead to employment growth, perhaps enough for the government to enjoy the political benefits of having reduced the unemployment rate. Second, these firms will gain a greater share of foreign markets, which might give them greater leverage to increase prices (and profits) in the future. Third, increasing exports will improve the balance of trade, thus avoiding the problems inherent in trade deficits discussed earlier.

This policy also yields distributional effects—and the political controversies they engender—because its impact on prices benefits some people and harms others. For example, the domestic consumer will see the price of subsidized goods rise by the amount of the subsidy, since otherwise firms would prefer to export the product in order to earn the bonus. Furthermore, the revenue to pay for that bounty must be raised through taxes. The domestic consumer would thus appear to be a double loser while the exporting firm gains, but there may also be distributional effects that become apparent only over time. For example, the sacrifices of the current generation may benefit future consumers if this subsidy eventually transforms an **infant industry** into a powerful enterprise that can repay the subsidies through cheaper prices, greater employment, or higher tax payments.

Another form of industrial policy is simply to provide subsidies to particular firms or industries that appear to have long-term export potential whether or not they are presently exporting. Such subsidies might be direct cash payments, special tax advantages, help in attracting investment, or relief from regulations that might otherwise constrain the industry. Many newly industrializing nations have found that their existing firms have very limited trade prospects despite government subsidies, so their industrial policy has focused on pursuading multinational corporations to establish new ones. They offer an array of benefits in the hope of luring foreign investment that would expand the economy's export potential as well as employ otherwise idle workers. Industrial policies that invite foreign investment through these special benefits are often combined with a more general competitiveness approach designed to allow firms to cut costs by minimizing taxes, limiting regulation, and holding down wage rates.

Many forms of export subsidies are now prohibited by the **General Agreement on Tariffs and Trade** (GATT), an international treaty that forms the basis for much of the international law that governs trade matters. Not all are prohibited, however, and the exact limits are both highly technical and much disputed. Furthermore, subsidies are not always easy to see. The United States, which explicitly rejects industrial policy, nonetheless engages in behavior that yields the same outcome. For example, American military expenditures often have spillover effects into civilian production, especially for export. The Boeing B–52 bomber introduced many elements that led to the highly successful Boeing 707 passenger jet. American agriculture has benefitted from the activities of the Agricultural Extension Service and other subsidies of agricultural research. Grants to universities for research yield benefits for industry. Some nations promote their exports by lending the sale price to importing nations; in the United States, these export credit subsidies are handled by the Export-Import Bank.

Such industrial policies are controversial both in the nations that enact them and in those with whom they trade. Liberal theorists contend that they don't really work or that their costs usually outweigh their benefits, a position generally accepted in the United States, especially by the Republican Party. Moreover, export-promotion policies attract the opposition of other nations because they place their firms at a severe competitive disadvantage. The U.S. steel industry has been particularly outspoken in its denunciation of steel imported from foreign companies that are heavily subsidized by their governments. They contend that American jobs and American profits are being undercut by this unfair competition. They call for the U.S. government to guarantee "fair trade" either by prohibiting the importation of such subsidized goods or by levying heavy taxes on them (so-called **countervailing duties**). Export promotion and industrial policy has interesting distributional implications, however. For example, it benefits the consumers of countries into which subsidized products are imported, at least in the short-term.

## Forms of Import Restrictions

The third approach to trade policy is protectionism, which seeks to achieve a favorable trade balance by limiting imports. Protectionism has been very common historically; indeed, all nations engage in at least some protectionist measures. This was the dominant approach throughout Latin America in the 1950s and 1960s, where states sought to develop their economies through a strategy known as **import-substitution industrialization** (ISI). They insulated domestic firms in certain sectors from foreign competition, hoping to replace imports with domestically-produced products, thereby both improving the trade balance and building domestic industrial capacity. Nations which give priority to avoiding trade deficits frequently combine import restrictions with industrial policy designed to expand exports. The origins of both in the mercantilism of early England is the subject of an extensive case study in Chapter 2.

There are many forms of import restrictions, all of which are designed to limit the purchases of goods from abroad. Domestic import-competing industries, protected from foreign competition, can then capture a larger share of the market. The simplest of these mechanisms is the **quota**, a government restriction that places a fixed limit on the quantity or value of goods that can be imported. This is usually accomplished by requiring that importers obtain import licenses that are strictly rationed by governments. The usual effect of a quota is to raise the domestic price of the commodity by limiting the number of lower-priced products that can be imported. A quota allows domestic producers to gain a larger market share but this artificial restriction of supply also enables both domestic and foreign producers to charge higher prices to consumers. Prohibitions are a special case—namely, they set a quota at zero. This form of trade barrier is relatively infrequent today, but it was common in an earlier age. In fact prohibitions were the major source of protection in early England.

The most widely used trade barriers are tariffs (or import duties), which are taxes applied to imports. Most are *ad valorem*, calculated as a percentage of the value of the good imported. All nations use tariffs to one degree or another, though not entirely for protectionist purposes. Historically, tariffs have been a significant source of government revenue, especially in poor countries that find it difficult to maintain effective income tax systems. In 1980, for example, tariffs provided more government revenue than either income taxes or sales taxes in about 40 nations. Most countries maintain elaborate tariff schedules which specify different tax rates for different products, allowing each rate to be set at a level that provides the desired degree of protection for each particular industry. This wide variation in rates across hundreds or even thousands of product categories makes it difficult to generalize about the exact level of tariff protection in any given country.

Still, it is clear that tariff rates, like the level of trade they are designed to control, vary widely across nations. The highest rates are found among less developed nations whose firms are especially threatened by foreign competition. The average tariff rate is around 30% in India, Nigeria, and Tunisia—depending upon how the average is computed—and between 10 and 20% in most other developing nations. American tariffs average about 4 percent, roughly the same as most developed nations. All of these figures understate the actual protective effect of tariffs, however, because rates can be many times higher than the average for products where a nation's firms actually face foreign competition, whereas they are usually low or zero in categories where no domestic industry exists to protect.

Tariffs have also varied enormously across time, with average tariff levels throughout the world having declined steeply from their peak in the 1930s. In the United States the average tariff rate reached a modern high of 59 percent in 1932 under the Smoot-Hawley Act, a remarkably irresponsible tariff law that has been widely credited with triggering a spiral of restrictions by other nations that helped plunge the global economy into the Great Depression of the 1930s. The average tariff level had previously reached 70 percent in 1813 and about 60 percent in the "tariff of abominations" of 1828 but remained between 40 percent and 50 percent from the Civil War until the turn of the century. It was reduced to 25 percent after World War II and declined to about 5 percent after the Tokyo Round of GATT negotiations concluded in 1979. Average *ad valorem* import duties reached their high in Britain in the 1820s at more than 50 percent, retreating to about 5 percent at the height of the British free trade era in 1880 before spiking again in the 1930s at about 50 percent.

Probably the most controversial remaining tariffs are the duties imposed by the EU in the context of the **Common Agricultural Policy** (CAP). These tariffs sustain higher food prices in Europe than would prevail if cheaper American grains were admitted without barrier. Because the higher prices of European producers leave them unable to compete on global markets, the revenue derived from the tariffs is used to subsidize exports. Both elements of the CAP have infuriated the United States in recent years: its restrictions on American exports to Europe and the advantage its subsidies provide to European agricultural producers wherever they compete with American exporters.

While tariffs have declined, a variety of **nontariff barriers** (NTBs) has arisen since the early 1980s. An early version was the 1969 **voluntary restraint agreement** (VRA) with Japan and the **European Community,** which was designed to reduce steel imports into the United States. Over the next twenty-five years, **voluntary export restraints** (VERs) became common. The most famous case of VERs is that in which Japanese automakers in 1981 "voluntarily" agreed to limit exports to the United States.[5] (Had Japan refused, a quota that would have been more damaging to Japanese automakers would have been imposed in place of the VER.) The Federal Trade Commission (FTC) has estimated the cost to U.S. consumers at about $1 billion per year in the form of higher prices for autos. Not only did the restricted supply of Japanese autos cause their prices to rise because of the artificial shortage but it also enabled American manufacturers to maintain higher prices in the absence of this competition. A VER is essentially a quota system that is managed by the exporter rather than by the importing nation.

Other protectionist measures include local content regulations that restrict imports by imposing a burden on purchasers of intermediate goods to make sure that imports do not exceed a prescribed fraction of their total purchases. Another form is government procurement policies, which often favor domestic firms. For example, the EU requires that government contracts be open to all bidders, but they permit governments to give a 3 percent "preference margin" to European firms or to exclude entirely any product produced largely outside of Europe.[6]

Other regulations, such as product-safety standards, can have a protectionist effect even though their motivation may be open to interpretation. The Europe Union, for example, bans the importation of beef treated with hormones, citing cancer risks. The U.S., where most cattle receive hormone treatments to stimulate growth, successfully challenged the EU ban in the WTO as a disguised form of protection against American products.

The GATT has sought to sharply limit all non-tariff barriers by converting them to tariffs, which are more visible and easier to reduce through international negotiations. For example, quotas are now permissable only in quite specific circumstances and so-called "grey-area measures" such as VERs are to be eliminated entirely. But imports can be restricted by so many different means—even increases in income taxes or interest rates tend to reduce imports—that a nation seeking protectionism can always find numerous policy tools to accomplish it.

## International Cooperation to Stimulate Trade

A fourth approach to trade policy emphasizes creating conditions abroad that are favorable to trade expansion. This strategy, which lies as much in the realm of foreign policy as trade policy, involves securing the cooperation of other nations. The most common form, an explicit reaction against protectionism, involves direct negotiations to lower the trade barriers imposed by others. All nations—including those which practice protectionism themselves—utilize this technique to improve their export prospects, though of course they do so with varying degrees of success. Usually nations try to induce others to lower trade barriers by agreeing to lower their own in return.

A more expansive version of this approach consists of diplomatic efforts to create and maintain regional or global institutions that facilitate trade. The simplest of these institutions provide a forum for nations to negotiate limitations on trade barriers, but others go far beyond that. The most extensive and most successful effort to achieve free trade at the regional level is the European Union. Conventional trade barriers among its nations have virtually disappeared, but to fully exploit the benefits of free trade and to manage the dislocations it produces the EU has found it necessary to build a much more comprehensive set of regional institutions. Most importantly, it has found that stable trade patterns cannot emerge without a stable monetary system that facilitates the financial transactions necessary for trade to occur. For example, in order to eliminate the trade disruption inherent in fluctuating currency values, the currencies of individual nations are being phased out in favor of the **Euro**. High levels of trade bring an increasing interdependence among nations, so that individual states are no longer able to solve economic, environmental or social problems without considering the effects induced by the policy actions of others. In fact, many traditional activities of the nation-state have been absorbed by the legislative, executive, and judicial branches of the EU. Monetary and fiscal policies are now coordinated at the regional level, with more standardized tax rates and regulations. The EU illustrates that trade expansion requires more than merely eliminating barriers; it must also have facilitating arrangements in monetary affairs and some provision to cope with the resulting interdependence. Various other regions have experimented with a much more limited version of encouraging regional trade, most notably NAFTA, which is designed to expand trade among the United States, Canada, and Mexico.

The outstanding example of a similar strategy at the global level is the Bretton Woods trade and monetary regime, created under the leadership of the United States at the end of World War II. The Bretton Woods regime, centered around the institutions of the **General Agreement on Tariffs and Trade** (GATT) and the **International Monetary Fund** (IMF), has governed international trade and finance for more than fifty years, though it has evolved and changed markedly in that time. Before being superceded by the World Trade Organization in 1995, the GATT provided a setting for nations to negotiate reductions in tariffs and other barriers to trade, while also helping to resolve trade disputes. The WTO has continued to broaden the range of national policies deemed to constitute unfair impediments to trade and thus subject to international negotiations designed to increase trade opportunities. Increasingly, the resultant restrictions on the policies of nations have aroused opposition because they pose the dilemma of exchanging the gains of trade for some loss of **national autonomy**.

Recent experience in Latin America and Asia has also demonstrated that trade expansion requires steps beyond the mere dismantling of overt trade barriers. Trade of goods cannot occur unless foreign currencies can be exchanged as well. Furthermore, trade expansion is not necessarily accompanied by a balance between the imports and exports of individual nations. Such imbalances can destabilize currencies, wreck national economies and eventually disrupt trade unless some institutional mechanism exists to contain the deleterious effects of extreme interdependence. After all, when all nations come to rely heavily upon trade, a financial disaster anywhere in the system threatens stability everywhere. Historically, the major responsibility for building institutions to cope with these problems has fallen to those nations with the political power to exert global leadership. The U.S. originally sponsored the IMF to expand trade by guaranteeing stability in monetary affairs and providing mechanisms to finance imports and adjust trade imbalances. In the light of the recent Asian experience, where the trade imbalances inherent in open trading systems shook the growth prospects of nations half a planet away, the entire architecture of global economic affairs has been brought into question.

## The Dilemmas of International Trade

All nations seek to expand trade and avoid trade deficits, but they have chosen among these four trade strategies in very different ways. That is because, as the foregoing discussion suggests, no single trade policy is objectively and unequivocally "best". Instead, each option offers its own set of advantages and liabilities, which each nation weighs from its own perspective. The complexity of these considerations can be reduced somewhat by organizing the choices in terms of three sets of dilemmas that must be confronted. Each is elaborated in the following sections; together they constitute the focus of our discussion of trade policy and its consequences throughout the remainder of the book.

The first, the **distributional dilemma** stems from the unfortunate fact that no trade policy benefits everyone. Instead, each rewards some individuals and groups but harms others, affecting the domestic distribution of income, wealth, and political power in the process. Thus, in addition to seeking an optimal level and balance of trade, governments must also weigh which groups it wishes to help, which it can afford to harm, and how it can make these distributional effects politically palatable to those involved. The second, the **values dilemma** arises because the same economic changes that enable a nation to secure the benefits of trade may imply a compromise of other societal values. Ultimately trade affects the society, polity, and culture as much as it does the economy. Allowing trade levels to be determined solely by the logic of the market—even if we could be confident that maximum economic growth would result— is tantamount to denying the legitimacy of any human motivation other than economic gain. The third, the **state goals dilemma** revolves around the tension between trade and the unique mission of the state to provide security, independence, and peace for the nation. Purely economic theories are not adequate to understand these issues because state actions are motivated by power and autonomy as much as by growth and efficiency. For example, the high levels of interdependence associated with intensive trade links necessarily limit self-sufficiency. This may improve economic efficiency and even enhance prospects for international peace, but it also constrains the capacity of the state to act independently of others when required to do so by the national interest.

## The Distributional Dilemma

The distributional dilemma emerges from the propensity of trade to alter the distribution of income and wealth within a nation. Simply put, some individuals and groups gain from trade while others lose. Because any government policy designed to regulate trade yields its own distinctive pattern of winners and losers, trade is inevitably politicized. Standard economic theory tends to deemphasize these distributional effects in its focus upon the impact of trade on the economy as a whole. Because these distributional consequences have such obvious political implications, however, the state is much more attentive to them than economic theorists are.

The most visible distributional effects are usually sectoral because trade policy often protects or promotes one industry or sector of the economy at the expense of others. For example, **tariffs** on imported steel protect the domestic steel industry by making foreign-produced steel more expensive, but they also harm domestic automakers who must pay higher prices for the steel they use. As in this case—where car buyers face higher prices—most protectionist barriers to trade benefit some sector of the economy at the expense of consumers. Conversely, the free trade policies advocated by liberal theory usually benefit consumers through lower prices, but as the case of foreign autos and Detroit demonstrates, they also devastate the workers of the corporations that must compete against foreign imports. Further, they also damage the economies of the regions in which those import-competing industries are located.

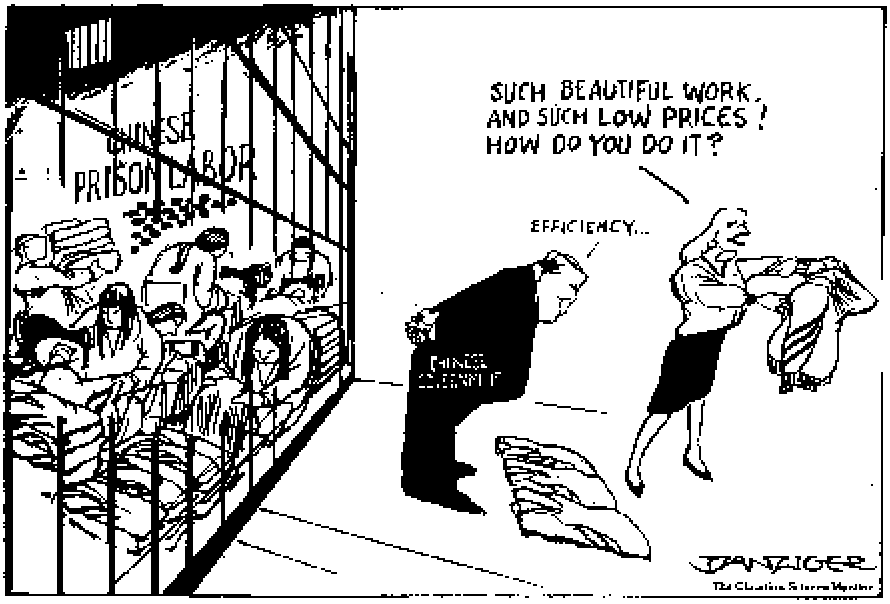
Just as trade policy redistributes costs and benefits from one sector to another, it also benefits some classes at the expense of others. An especially persistent theme in American trade policy debates has been the fear that trade will benefit the owners of large corporations but erode the employment prospects and wage rates of unskilled workers. For example, the elimination of trade barriers under NAFTA forces some American manufacturing workers into direct competition with Mexican workers who earn a markedly lower wage. Unless U.S. wage rates decline, production may shift to Mexico and American jobs will be lost. However, if that competition drives down wage rates in the U.S., the profits earned by the owners of American business might be maintained at the expense of the standard of living of workers in those industries. The losses from such wage competition will be greatest for workers in high-wage countries employed in industries that can move either their products or their production facilities most easily across national boundaries. Others, particularly more affluent professionals such as doctors, lawyers, and university professors, who face less direct competition from abroad, stand to gain from trade because it lowers prices on the goods they consume.

A final distributional effect of trade policy was illustrated by the observation that trade deficits--an excess of imports over exports--can shift economic welfare across time. Because the imports are enjoyed immediately while the costs of trade deficits are felt later, trade deficits sacrifice the future for the present. In short, trade produces different effects on different sectors, regions, classes, and generations. *Trade opportunities thus pose the distribu-tional dilemma: Whichever trade policy the government chooses will harm some group*.

### The Values Dilemma

The values dilemma arises because trade generates many outcomes that citizens evaluate on the basis of ethical principles and social values. Because these fundamental values are frequently incompatible with one another, policies designed to affect trade patterns become an expression of the relative priorities attached to them. The most venerable trade policy debates concern the trade-off between economic benefits and a variety of less tangible interests. Liberal theorists advocate free trade because they believe that it maximizes economic efficiency and therefore material standards of living. Opponents point out that allowing markets to operate freely also allows economic considerations to dominate more important ethical ones.

For example, trading with nations that permit shabby treatment of workers—or even outright human rights abuses—poses a difficult moral dilemma. Should we purchase cheap foreign goods even though they may have been made with child labor—or even slave labor? We may not *intend* to condone those practices, but we cannot escape the fact that our purchases of such goods helps to sustain the system that produced them. Market mechanisms of supply and demand are notoriously poor at coping with such issues, not only because individual consumers can seldom vouch for the production processes of the goods they buy, but also because individual actions can do little to change them. Consequently, trade policy becomes the arena for addressing these value trade-offs, especially in democratic nations where citizens can determine the trade regulations that accord with their own ethical priorities. Trade policy debates invariably become highly charged because these values, while deeply held, are inherently subjective. Thus, citizens would disagree on the outcomes to be pursued, even if we were certain how trade policy could be used to bring them about.




Cultural considerations are among the many other values have been cited as justifications for restricting imports. For example, many nations decry the cultural imperialism embodied in American trade. Rock music and Hollywood films not only celebrate ideas that are deeply offensive elsewhere - such as sex, drugs, violence, free expression, and resistance to authority- but also threaten to undermine the cultural industries that sustain national identity. France restricts the hours of TV programming offered in English, while Canada restricts the percentage of magazine ads that can advertise American products.

Ecological values have also assumed an increasingly prominent role in trade debates. Some nations have restricted the export of goods whose exploitation threatens their own natural environment, like timber or products derived from endangered species. Because not all nations have done so and because the environment is a planetary resource shared both materially and spiritually without regard to borders, others have attempted to curtail these activities by banning their importation.

Many trade policy issues involve value considerations intertwined with economic interests. The U.S. embargo of trade with Cuba not only protested the absence of democracy in Cuba but also Castro's seizure of property owned by U.S. businesses. Japan banned imported rice not only to protect the financial interests of Japanese farmers but also to sustain venerated Japanese traditions embodied in the image of life in the rural village. Agricultural trade policies elsewhere, most notably in the United States and France, have similarly aimed to protect the family farm for a combination of economic and more abstract reasons.

Some of the most enduring value controversies overlap with issues of distribution and concern the propensity of the distributional effects of trade to generate inequality by undermining the position of workers. For example, the NAFTA debate cited above as an example of the distributional dilemma achieved special salience because of the ethical implications of adopting a policy that would disadvantage unskilled workers, a group already marked by high levels of poverty. Whether one prefers to live in a country with higher growth and greater inequality rather than a more equal but less prosperous one depends not only on whether you anticipate that you would fall within the richer or poorer group but also on highly subjective ethical and aesthetic judgements about the value of equality.

Trade raises these issues because it places greater competitive pressure on firms to lower their costs. They, in turn, pressure the state to alter policies that keep them from doing so, including environmental regulation, health and safety requirements, and other restrictions designed to meet various legitimate social values. Labor costs are an especially frequent target. Lower wages could be paid if the minimum wage was eliminated and collective bargaining and labor unions were outlawed. The abolition of seniority systems and age-discrimination laws would enable companies to terminate workers when their efficiency declined (or at the whim of a boss). Eliminating pensions, health care, vacations, and holidays would also lower company labor costs. But such actions entail a compromise with very fundamental values about the kind of society in which we want to live. We prefer that workers have security and a decent standard of living, that income gaps among citizens be moderate, and that the attendant class conflict remain muted enough to sustain social harmony.

If trade competitors do not share these values, however, it may prove difficult for the United States to maintain them—without restricting trade, accepting deficits, or designing state policies to alleviate the most dire consequences, especially the concentration of winners and losers among certain economic sectors, geographic regions, and social classes. Concentrated geographic unemployment, for example, brings a litany of social problems including inequality, crime, drugs, urban violence, and, potentially, social collapse. Ripple effects cause trade issues to influence many other domains of social concern and public policy because geographic concentrations often imply disproportionate effects on particular ethnic groups and sectoral concentrations often imply disproportionate effects on women or teenagers.

Economists can show that the most efficient approach to many of these problems, in theory, is to earn the benefits of free trade and use the proceeds to compensate the losers. Actually achieving that mix is a good deal more difficult than it sounds, however, so government officials usually prefer to restrict trade instead, even though that also requires that the benefits of trade be sacrificed.

A nation committed to trade also faces pressures from other nations seeking favorable treatment for its firms, which can be expected to object to any policy that raises their costs or restricts their access to markets. Yet nations have many interests that seem to justify trade restrictions; surely the pressures of international trade need not require that we abandon all other values. In the U.S., trade restrictions on Chinese imports have been proposed to protest human rights abuses, on tuna imports to protect dolphins, and on exotic hardwoods to protect tropical rain forests, for example. To elevate economic gain to the sole value pursued by trade policy is one option, but it is far from the only one. *Trade policy thus poses the values dilemma: Whichever choice is made, some values must be compromised to achieve others.*

### The State Goals Dilemma

A third dilemma concerns the effect of trade on the ability of states to meet their goals. Some state goals simply reflect the social values discussed above, but here we concentrate on those that fall within the special purview of the state and its unique mission to embody the nation's autonomy and provide peace and security. These goals apply most directly and obviously to foreign policy, but autonomy and security are elusive and multifaceted concepts, prone to expansive definitions by states.

All states attach the highest priority to preserving the power and autonomy of the state itself, because without the capacity to act effectively and independently no other goals can be achieved. Trade can substantially affect the power and autonomy of the state, both in relation to domestic actors it must control in order to govern meaningfully and with respect to foreign nations with which it must interact to guarantee security. In the most elementary sense, states rely on trade to obtain the revenues they require to function, either directly through import taxes or indirectly through income and sales taxes on the economic activity that trade stimulates. More broadly, however, the state must command the allegiance of its citizens, in part by demonstrating its capacity to manage the economy in a way that provides prosperity while also managing foreign policy in a way that provides peace, security and autonomy.

While trade is essential to meeting all of these aims, states have an ambivalent attitude toward it. After all, if a nation's trade can enhance the power of its state, it can also strengthen the state in nations with which it trades. Since states must be acutely aware of relative power when engaged in foreign policy, they cannot be indifferent to the effects of trade on the power and prosperity of others. For this reason, they prefer to trade with allies and to avoid trade with rivals and potential enemies. The profit considerations of private actors often conflict with the power and security considerations of the state, particularly when trade restrictions are used as an instrument of foreign policy. During the Cold War, the U.S. and its Western European allies sharply limited the products that could be exported to the Soviet Union and Eastern Europe, especially those with either direct or potential military application. Over the strong objections of American farmers, the list sometimes included wheat as well. The U.S. has banned all trade with Cuba for decades in an attempt to weaken the Castro regime, and still restricts some technology exports to any nation.

States are also wary of trade because the interdependence implicit in relying upon foreign actors constrains independent action and threatens autonomy. States fear that the loss of self-reliance will leave them vulnerable to economic disruptions arising out of both impersonal market forces and deliberate threats by other states. The higher the level of trade (and the smaller the nation), the more the state loses control over the economy and relinquishes the capacity to shape the nation's destiny. Because citizen perception of the performance of the government and even the legitimacy of the state itself frequently rests on this very capacity, the risk to political stability can be high. For many developing nations extreme dependence upon trade and the capital flows associated with it subjects the state to irresistible pressures from foreign investors and lenders. As a result, states have been forced into budgetary and regulatory decisions that are more attentive to foreign interests than to domestic constituents, with predictable consequences for either the longevity of the government or the character of the political system.

The international institutions that are necessary to facilitate trade even compromise **national sovereignty** because membership in them requires a nation to forego some policies that would otherwise be pursued. Protectionism is the most obvious target of these prohibitions. However, a wide array of monetary, fiscal, regulatory and social policies have also been ruled inconsistent with the obligations of membership in regional institutions (e.g., the EU and NAFTA) and global ones (e.g. the WTO and IMF). As a result, many nations have avoided such institutions, even though they offer considerable trade benefits. Britain, for example, remains ambivalent about the EU out of concern that the "level playing field" necessary to achieve fair competition under free trade threatens also to level cultural and political differences among nations. Similarly, Canadian fear of the economic dominance of the United States long delayed a free trade agreement that was proposed as early as 1851. China has resisted full acceptance of the conditions required for its accession into the WTO.

To minimize dependence, many states restrict trade, especially in sensitive sectors important to the economy (e.g., food, banking, insurance or steel) or to national defense (e.g., microelectronics, telecommunications, or satellite technology). But states must tread carefully because these restrictions also limit the benefits of trade, not only to their own economy but to other nations. Strong objections to these restrictions from trade partners can endanger friendly relations and even international peace. It is difficult to generalize about how states will respond to these dilemmas because while some nations become subordinate and their freedom of action diminishes in the face of trade, others become dominant and expand the scope of their power and influence. All find that they must anticipate the reactions of others much more frequently and tailor their actions accordingly. Whenever trade occurs, tensions inevitably follow. Sometimes—thankfully not often— these escalate into resentment and conflict. The violence of the 1930s and 1940s is an awful historical precedent that some fear may lie ahead for American relations with Japan or China.

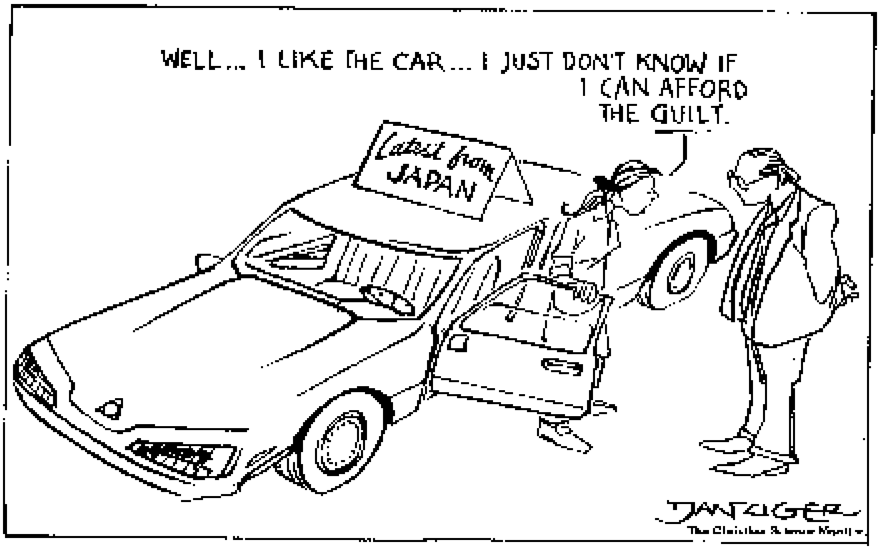
But theorists of **interdependence** also remind us that trade can force nations to recognize both the need to coexist and the opportunity to "coflourish" through cooperation. The Bretton Woods international economic system created at the end of World War II is an example at the global level. Both the European Union and the North American Free Trade Agreement are examples of these same principles of cooperation pursued at the regional level. This dilemma raises a theoretical question: Under what conditions does trade lead to conflict and when does it generate peaceful cooperation? It also presents a policy challenge: How do we find one path and avoid the other?

Theories that insist upon seeing trade only through the lenses of economic analysis miss these political and social considerations. Thus, the policy advice that emanates from them is, at best, incomplete and, at worst, counterproductive for states that must balance the benefits of trade against its dangers. *Trade thus poses the state goals dilemma: Any trade policy that strengthens the capacity of the state to achieve its goals in one respect is likely to weaken it in another.*

## Choices for the Individual

These dilemmas must be confronted in the formulation of trade policy, but they also challenge individual citizens when contemplating any purchase. Economic theory explains consumer behavior as the maximization of material interests. But a citizen also assumes the role of a moral agent responsible for the chain of outcomes set in motion by the consumer choice. The motivation behind the **Buy America** bumper sticker, for example, is not the logic of best product and lowest cost but an appeal to other ethical considerations.

In fact, every day each individual must—explicitly or implicitly — assume a stance on the dilemmas previously identified. Is it patriotic to purchase domestic products? Should a Japanese consumer buy a foreign car, knowing it means unemployment for a Japanese worker? Do we owe greater obligations to domestic workers and corporations than foreign ones? Should one save money by purchasing an inexpensive foreign product, even though it is cheap because it was made with slave labor or by workers deprived of human rights?




Should one choose transportation that requires the importation of foreign oil, knowing it encourages a costly American military presence in the Middle East? Should one lobby the government to restrict the sales of American forestry products abroad because they compromise environmental concerns? Should a French citizen support the end of farm subsidies that would threaten traditional life in the French countryside? Answering these questions requires normative judgments as well as a keen understanding of the empirical consequences of trade—the motivations for this book.

In particular, trade affects the individual in six different roles, each of which requires him or her to weigh somewhat different values, interests, and perspectives:

1. As a consumer, it is rational to prefer free trade because it makes imports cheaper. (But if the absence of protection drives domestic firms out of business and gives a **monopoly** to foreign firms, future prices could rise.)
2. As a worker, it is usually wise to prefer free trade if one is employed in a sector that exports goods or imports raw materials but to prefer **protectionism** if employed in a firm that competes with imports.
3. As a member of an economic class, it is usually reasonable for a worker to prefer policies that favor labor and for a business owner to prefer policies that favor capital. Since the early 1970s, American labor has generally supported protectionism and American business has supported free trade.
4. As a resident of a community, it is sensible to prefer policies that benefit local industries even if one is not directly involved in that sector. For example, most residents of Detroit prefer protection against auto imports because it contributes to the general prosperity of the region, and residents of agricultural states prefer **export promotion** policies, which increase farm prices.
5. As a citizen of a nation, it is natural to prefer policies that strengthen the nation as a whole. Because it is not always obvious what policies will accomplish that goal, one must analyze the impact of trade on the foreign policy relations between nations as well

as the economic gains from trade.

6. Finally, an individual must weigh all of these considerations in the context of one's own personal sense of values and obligations. It is not the purpose here to judge whether one's obligation to the interests of the nation should outweigh one's individual interest or to stipulate whether economic interests should dominate more ethereal ethical concerns. It is possible, however, to clarify those consequences of trade and trade policy that individuals should consider when making their own ethical choices.

## Conclusion: Choosing a Trade Policy

A principal mission of this book is to explain why nations select the policies they do. At the broadest level, that means explaining why they would choose to emphasize either mercantilist or liberal strategies and focus either on the volume or on the balance of trade as the principal policy target. Thus, as a starting point, Chapter 2 describes the historical evolution of both mercantilism and liberalism. It will quickly become obvious that understanding the motivations and the assumptions that underlie these two broad families of approaches requires an appreciation of how they respond to the trade dilemmas discussed earlier.

The cases examined in the remainder of the book suggest that the trade policy choices of governments are partially predictable because they result from the interaction among prevailing theories of economics and social justice; the state of supply and demand conditions in markets; and the balance of political power among those who represent producers, consumers, and the state. I discuss each briefly in turn.

Trade policy is affected by both economic theory and ethical doctrines. We cannot divorce current attitudes toward international trade from the goals that we expect public policy to achieve or from the social and political values these goals express. The importance accorded to maximizing national economic growth by contemporary trade policy debates is in part a reflection of the set of values that dominate modern Western society. But these ethical theories are not unchallenged, and thus the debates over trade policy contain within them a clash of values. We ask not only What trade policy will best achieve our goals? but also What should our goals be? Remembering the values dilemma—that all debates over trade policy are ultimately debates over alternative values—will help us understand why a nation selects the trade policy that it does. Societies which accentuate the values of stability and community—Japan, for example—or those with a greater commitment to equality—like most of Western Europe—are much less likely to adopt free trade policies than societies where individualistic and material values dominate, such as the United States. As demonstrated by the 1999 Seattle protests against the WTO, groups more interested in ecological values than economic ones resist free trade as well.

Market conditions also affect the desirability of regulating international trade. When falling transportation costs and efficient markets magnify the gains available from trade—among developed countries in the modern era, for example—policies to expand trade usually follow. Nations whose firms cannot successfully compete internationally—most of Africa today—usually opt for protectionism rather than risk the trade deficits likely to follow from liberalizing trade. It is no coincidence that the industrialists of nineteenth-century England agitated for free trade only after the Industrial Revolution had left them with a major advantage against their foreign competitors. Similarly, it is no coincidence that many American trade unions (notably the AFL-CIO) abandoned their free trade position in favor of protectionist sentiments just as

American heavy industry began to be seriously challenged by foreign competitors. Of course, in assessing market performance, one must carefully weigh the distributional dilemma of trade—that all debates over trade policy are also ultimately debates over who will win and who will lose.

Whereas prevailing theory and values interact with market conditions to shape attitudes toward trade, it is the balance of political power among various groups that determines how these attitudes are translated into public policy. The dilemmas posed by trade are typically resolved by appeals to theory, to values, and to market conditions, but the theory, values, and conditions cited by proponents of one position are usually very different than those cited by advocates of another. The winning side need not have the best arguments if it has the political power to prevail. Where multinational corporations have greater political power than domestic industries, for example, policies that maximize trade usually emerge. Where labor unions are strong, either trade is heavily regulated or a substantial social safety net is constructed to protect workers from its effects.

Trade policy is also affected by the balance of power between the state itself and other domestic actors, because governments, which regard trade policy as a component of foreign policy, are more attentive to issues of autonomy, self-sufficiency, and national security than those who see only trade's impact on the domestic economy. Because nations more reliant on trade must often sacrifice assertiveness in foreign policy to avoid disrupting trade relations, states which aspire to autonomy generally seek to minimize trade dependence, especially in critical areas like food or weaponry. Naturally, the power of the state relative to other states also influences trade policy. Powerful states can tolerate levels of interdependence that would be considered dangerous by weaker ones. Finally, weak states may not be able exercise much choice in trade policy if foreign actors assert their power.

In sum, trade poses fundamental dilemmas between competing values, alternative income distributions, and disparate affects on state goals and capacities.  For this reason, no single trade policy is unequivocally “best”. Further, economic theory alone cannot be a reliable guide to either the most appropriate choice or the most likely one. Instead, each nation resolves the dilemmas of trade in its own way, as it responds to prevailing theories, the state of markets, and the balance of political power.

## Chapter One endnotes

1. If economists are uncertain about some of the negative effects of these developments, the public is not. For example, in 1988 (during the Cold War), Americans were asked, "Which poses the greatest threat to our national security, a military adversary like the Soviet Union or economic competitors like Japan?" Almost twice as many Americans answered the latter. John Marttila, "American Public Opinion: Evolving Definitions of National Security in, "Edward K. Hamilton, ed., *America's Global Interests: A New Agenda* (New York: W. W. Norton, 1989), pp. 261–315.

2. Richard Lamm, "The Uncompetitive Society," in Martin K. Starr, ed., *Global Competitiveness*: *Getting the U.S. Back on Track* (New York: W. W. Norton, 1988), pp. 12–42.

3. Laura D'Andrea Tyson, "Competitiveness: An Analysis of the Problem and a Perspective on Future Policy," in Starr, *Global Competitiveness.* Emphasis added.

4. These are among the American institutions that Richard Lamm suggests that we must reform and revitalize. See his essay "The Uncompetitive Society," in Starr, *Global Competitiveness*.

5. The original agreement restricted imports to 1.68 million cars, then to 1.85 million in 1984. Since then Japan has voluntarily remained under that target. However, Japanese auto companies evaded these restrictions by producing cars in the United States. Further, they increased revenues with the same number of imports by shifting from cheap cars to luxury models.

6. See Rene Schwok, *US-EC Relations in the Post-Cold War Era: Conflict or Partnership?* (Boulder: Westview Press, 1991), chapter 6.