CHAPTER 3

The United States in the World Economy

THE CRISIS ATMOSPHERE that marked the world economy in recent years was dispelled considerably by economic developments in 1984. Progress in several areas—notably on the international debt problem and economic stagnation in the industrialized nations—provided the global economy with more breathing room than it has enjoyed in recent years.

The events of 1984 also demonstrated, once again, the extent to which national economies are linked to one another through international trade and financial relations. Many recent positive international developments can be traced to vigorous economic recovery in the United States. A growing, open U.S. market provided strong stimulus to its trading partners in both the industrialized world and in debt-burdened developing countries. For the latter, increased export demand was a critical factor in their improved economic health.

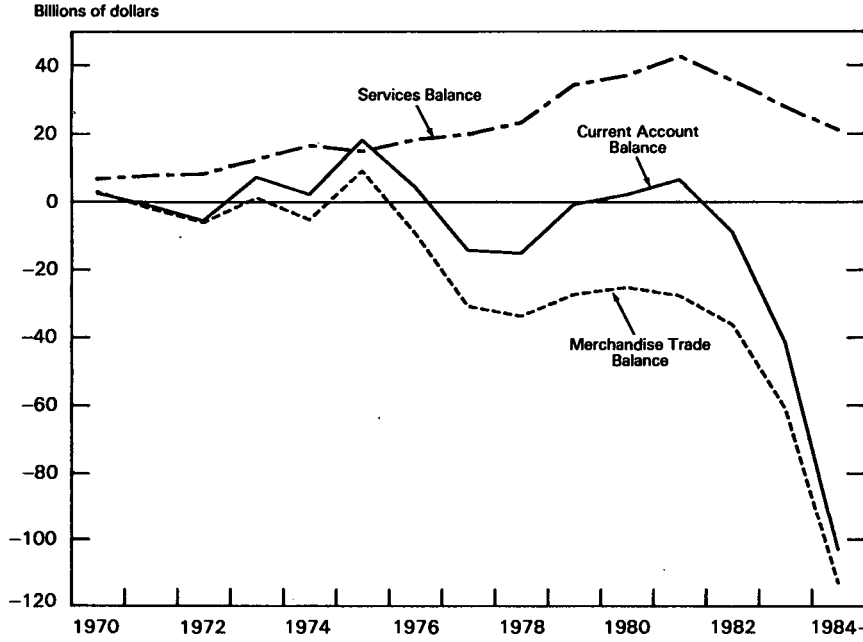
While there was some tendency for the benefits of faster U.S. growth to spread throughout the global economic system, the strength of the U.S. recovery also resulted in increased divergence between the United States and its partners in several related aspects of economic performance. Two developments—the growing U.S. current account deficit and the high level of the dollar—merit closer examination of their causes and effects.

Compared to progress on international debt and growth, improvements in other problem areas have been less dramatic. Economic stagnation in many countries in the early 1980s provided an environment well suited to the advance of protectionism. Reversing this trend has turned out to be difficult. The recent marked improvement in economic conditions and the commencement of a new Presidential term provide a good opportunity for evaluating new policy initiatives, including a new round of multilateral trade negotiations. First, however, it is helpful to look at the position of the United States in the world economy and to examine recent developments in U.S. trade policy.

The United States has led the industrialized world in economic recovery during the past 2 years. It also has experienced a sharp decline in its current account position—the difference between exports and imports of merchandise and services, minus net transfer payments made to foreign residents. In 1984 the U.S. current account position declined from a deficit of about $42 billion in 1983 to a deficit of more than $100 billion (Chart 3-1). Most of the decrease was attributable to the U.S. merchandise trade deficit, which widened by about $50 billion in 1984 to reach an all-time high of almost $110 billion.

Chart 3-1

Balances on Merchandise, Services, and Current Account



[1] First three quarters at annual rate; seasonally adjusted.

Source: Department of Commerce.

As a result, there have been increased calls for trade protection and other types of market intervention. Although such measures might provide a limited short-run advantage to affected sectors, they would do so only at great cost to the U.S. economy and to the integ-

rity of the global system of free-trade relationships. Moreover, such steps are difficult to reverse. Accordingly, it is important to understand the origins of the present large external deficits in order to evaluate correctly their associated costs and benefits and to establish policy priorities. As discussed below, recent large external deficits and associated capital inflows are in large part the consequences of successful recovery in the United States, rather than problems requiring separate, new policy actions.

A current account deficit is not necessarily a negative factor for the economy as a whole. A current account deficit merely implies that (ignoring transfer payments) U.S. residents are purchasing more goods and services than they are now producing. Its counterpart is a capital account surplus, which measures the net claims on U.S. residents that foreign residents have accepted in payment. Thus, net capital inflow provides the financing for an excess of current expenditure over output. This inflow has been important in financing the recent U.S. investment boom.

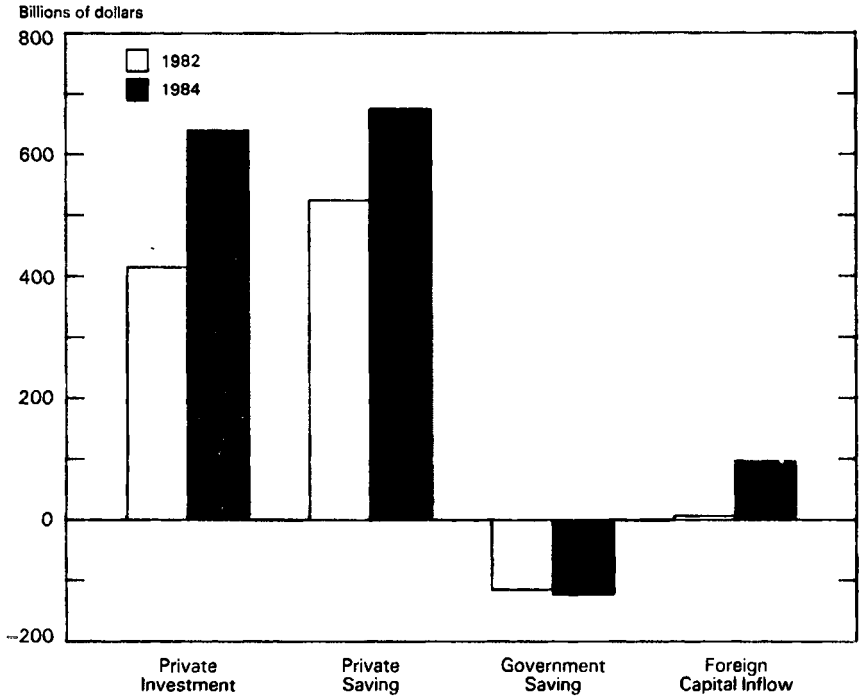
Chart 3-2 shows how U.S. financial flows shifted during the past 2 years. Private investment is financed by saving from three sources: private saving (including undistributed profits), government saving (the negative of government borrowing), and capital inflow from abroad (the capital account surplus). Between 1982 and 1984, private saving rose by about $150 billion to help finance a roughly $220 billion increase—a more than 50 percent rise—in U.S. private investment; a small upswing in total government borrowing partly offset this additional private saving. However, greater capital inflow from abroad financed almost $90 billion—about 40 percent—of the increase in private investment.

Large current account deficits and corresponding capital account surpluses are not likely to go on indefinitely. In the past when deficits or surpluses have emerged, either their underlying causes were temporary, or natural market forces (or policy responses) eventually brought about adjustment. In such episodes, whether or not the entire process of deficit and adjustment is judged to have been beneficial depends on whether the increased current expenditure is used productively. If greater current expenditure is mostly consumed, gains may be slight and subsequent adjustment painful. In the case of the present U.S. current account deficit, however, both private saving and investment have been strong. Elements seem to be in place for a sustained expansion with less likelihood of a difficult future adjustment.

Although the U.S. trade balance has fallen sharply, this decline did not arise from deterioration in U.S. productive efficiency. Since the beginning of the recovery, U.S. output per hour has advanced at

Chart 3-2

Investment and Saving in 1982 and 1984



Note.—Data for 1984 are preliminary.
Source: Department of Commerce.

an annual rate of over 3 percent, easing earlier concerns about declining productivity growth. Wage increases have also decelerated, with the result that there has been a marked improvement in U.S. unit labor costs. During the present recovery, real exports have increased at an annual rate of about 4½ percent (about 6¼ percent in 1984 alone), only slightly less than in comparable stages of recent recoveries. The strong performance of investment in the present upswing is a positive sign for the continuation of these trends.

CAUSES OF THE TRADE DEFICIT

In last year's *Annual Report,* three factors were singled out as leading causes of the large trade deficit: the strong dollar, reduced U.S. exports to heavily indebted developing countries, and faster growth in the United States compared with its industrialized trading partners. These factors still are present, but the emphasis that each de-

serves has shifted. Improved conditions in many developing countries have allowed them to resume import growth, though certainly not at pre-1981 rates. Although the growth-rate gap between the United States and its industrialized partners widened earlier this year, some convergence has been evident lately as U.S. growth slowed and expansion in Europe accelerated somewhat. The dollar, however, continued to strengthen in 1984.

Estimates of how much each of these factors contributed to the recent decline in the U.S. trade balance are inherently inexact, in part because these factors are not independent of one another. Nonetheless, rough estimates give a general impression of their relative importance. Since 1981, U.S. real growth has exceeded that of its main industrialized trading partners by about two-thirds of a percentage point per year on average; in 1984 the gap in growth rates was more than four times as large. Even at unchanged relative prices, with faster growth of U.S. spending, U.S. purchases of imported materials and products normally will increase. On this score alone, one can account for roughly one-quarter of the $85 billion decline in the annual U.S. trade account position since 1980. Slower growth in U.S. exports to debt-burdened developing countries, which were obliged by financing constraints to reduce their imports, accounts for a slightly smaller share of the decline. This factor was especially significant in trade with Latin America, where the United States has a large stake in export markets.

Not all external developments have increased the U.S. deficit. The dollar price of oil has moved downward by more than 20 percent since 1981. Lower prices, recent shifts to other energy sources, and conservation have meant that annual payments for imported oil by the United States have been cut by about $20 billion in the past 4 years. When these gains in the cost of imported oil are included, a net decline in the U.S. trade balance of about $60 billion to $70 billion remains—much of it attributable to the strong dollar.

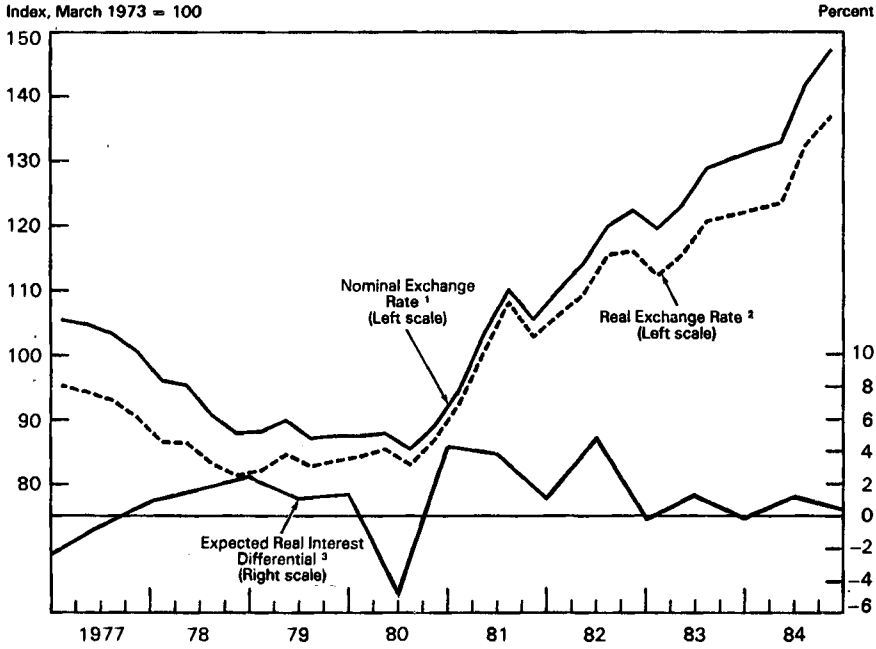
THE STRONG DOLLAR

One of the most striking features of the present recovery in the United States is that it has been associated with a pronounced and persistent rise in the value of the dollar. Since 1980, the latest year in which the U.S. international current account was roughly in balance, the dollar has advanced steadily against a weighted average of other major currencies until by the end of 1984 it was about 65 percent above its 1980 average and at its highest level since flexible exchange rates were adopted in 1973 (Chart 3-3). The largest increases in the dollar's value occurred in 1981 and 1982 from an unusually low level in 1980. However, during the eight quarters since the trough of the

recession at the end of 1982, the dollar strengthened by about 20 percent.

Chart 3-3

Nominal and Real Exchange Rates and Expected Real Interest Differential



[1] Multilateral trade-weighted dollar.
[2] Nominal exchange rate adjusted by relative consumer prices.
[3] U.S. interest rate (3-month) minus trade-weighted average interest rate (also 3-month) for six industrial countries adjusted by corresponding OECD inflation forecasts.

Sources: Board of Governors of the Federal Reserve System and Organization for Economic Cooperation and Development (OECD).

Given enough time, exchange rates adjust so that a representative bundle of goods costs roughly the same in countries linked by open trading. There is ample evidence, however, that this relationship need not hold over the short or medium term. Changes in the dollar's real exchange rate (i.e., the nominal exchange rate adjusted for consumer price levels here and abroad) have generally been less pronounced than changes in the nominal exchange rate, but the latter have not merely compensated for relative price performance. Since 1980 the dollar's real rate of exchange has risen by about 60 percent, only slightly less than the nominal exchange rate (Chart 3-3). From the fourth quarter of 1982 to the fourth quarter of 1984, the dollar's real exchange rate appreciated by about 18 percent.

Over shorter horizons that are relevant for many economic decisions, exchange rates are determined in international asset markets. Asset prices, including the exchange rate, can change quickly in response to changing expectations about fundamental characteristics that influence asset demand and supply. International investors make their portfolio decisions mainly on the basis of expected rates of return, including expected exchange rate changes, adjusted for risk and other special factors. It is useful, therefore, to compare expected real interest rates on dollar and nondollar assets (i.e., nominal interest rates adjusted for expected inflation) to understand what has been happening in foreign exchange markets.

Starting in 1979, expected U.S. real interest rates moved strongly upward, despite a brief interruption in mid-1980, and peaked in 1982. Although they have fallen since then, they are still at relatively high levels. A rise in real interest rates abroad at about the same time was much less pronounced and left a substantial positive gap between U.S. and foreign real interest rates, as indicated in Chart 3-3.

Reasons for the marked increases in U.S. expected real interest rates and the dollar's value at this time are found largely in the character of the successful U.S. recovery. Increases in U.S. real interest rates were associated with the 1979 change to a tighter U.S. monetary stance. Subsequent declines in inflation contributed to a strengthened dollar between 1980 and 1982, as the expected real return to holding dollar assets rose and improved U.S. inflation performance itself justified a higher nominal dollar exchange rate.

More importantly, as emphasized in Chapter 1, the Economic Recovery and Tax Act of 1981, together with reduced inflation, significantly raised the after-tax rate of return on new business investment. This increase in the real rate of return on U.S. business investment spilled over to the return on dollar-denominated assets generally and to the level of the dollar itself. After 1981, expanding Federal budget deficits may also have raised the level of U.S. real interest rates and helped to strengthen the dollar. However, the extent of upward pressure on real interest rates and on the dollar through this channel is uncertain, and numerous studies have failed to uncover significant effects.

Higher real returns and lower inflation account for some but not all of the upward movement of the dollar. The fact that the real exchange rate has risen steadily, while the real interest rate gap in favor of the dollar has narrowed since 1982 (and occasionally has been negative), suggests that other factors have continued to push up the demand for dollar assets. Evidently the combination of increased after-tax profitability of U.S. corporations, demonstrated strength of

the U.S. recovery, reversal of international lending outflow from U.S. banks, and generally more favorable longer run prospects for the U.S. economy have prompted an additional increase in demand for dollar assets. Just as in 1980, when a relatively low level of the dollar probably reflected a more pessimistic view of future U.S. performance than could be measured by the real rate of interest and other available indexes, in 1984 a relatively high value of the dollar probably reflected more optimistic assessments than these indexes captured.

The recent strength of the dollar has had both positive and negative effects. As the dollar has risen, some U.S. industries that compete in international markets have experienced difficulties. Many of these problems are concentrated in the manufacturing sector, where declines in trade balances across industries have been widespread. However, some manufacturing industries with large trade losses are troubled by problems beyond those arising from dollar strength, including relatively high labor costs, raw material costs, and other factors that have contributed to a loss of comparative advantage. The traditional U.S. surplus in agricultural products has contracted by about $8½ billion from its level of 3 years ago, as dollar appreciation and slower demand growth have kept dollar prices and export volumes down. Declines have also occurred in U.S. exports of raw materials.

In many respects, however, the dollar's rise in value has been beneficial. The strong dollar has stimulated production and investment in sectors less involved in international trade. In other industries, competition from imports has prompted more expenditure on plant and equipment as well as greater attention to controlling wages and other costs. Prices of traded goods and close substitutes have been kept lower than they would have been otherwise, thereby benefiting both U.S. consumers and U.S. producers who use imported inputs. Undoubtedly, the dollar's rise since 1980 has made the task of bringing inflation under control considerably easier. In addition, because of the shift in demand toward dollar assets, U.S. interest rates have been lower and real investment higher than would have been the case otherwise. Stronger U.S. investment will ultimately mean higher productivity and faster potential growth.

THE DEBTOR COUNTRIES: RECENT PROGRESS

External deficits have narrowed markedly in recent years for many borrowing countries. Since 1981 the total annual current account deficit of the largest 17 debtors among the developing countries has declined by about $44 billion to a level estimated to have been about $20 billion in 1984, despite increased interest burdens. Some coun-

tries have made especially dramatic gains; Brazil and Mexico stand out in particular. The Brazilian current account deficit declined by more than $8½ billion in 1983 and is estimated to have fallen by about another $6 billion in 1984 to only about $½ billion. For Mexico, the gains have been even more dramatic—a total improvement of $19 billion between 1981 and 1983. The Mexican current account was in surplus by $5 billion in 1983, and the surplus is estimated to have been only slightly less in 1984.

Initial improvements in the current accounts of borrowing countries were achieved primarily through cuts in imports. Subsequently, import declines continued in response to restrictive fiscal and monetary policies and exchange-rate devaluations that were part of adjustment programs supported by the International Monetary Fund. More recently, as the potential for further import reduction has been exhausted, continued improvement in borrowers' external positions has resulted from expanding exports. Almost all of the major borrowing countries experienced export growth in 1984. Most have shown stronger real output growth as well. This has been important in maintaining the political consensus needed to sustain their economic adjustment.

Increased exports have been largely a reflection of expanding demand in the industrialized countries, especially the United States. As the leader in the global recovery, the United States with its comparatively open markets has played a disproportionate role in absorbing the output of the debtor countries. Among the industrialized countries, the United States now buys about 45 percent of the exports by the 17 largest debtors, up from about 40 percent only 2 years ago.

Although in 1983 and 1984 banks slowed their lending to the debtor countries from earlier peaks, bank loans and official lending still have been available at levels adequate to support adjustment programs. In consequence, the ratio of debt to exports—a measure that is often used as an indicator of a borrowing country's financial position and ability to pay—has stopped rising in most countries and has started to decline in many others. However, the average ratio is only slightly below 2, which is still considerably above the average level of about 1½ in the mid-1970s.

Positive steps have also been taken in restructuring outstanding debt—the most notable development being a rescheduling agreement between Mexico and its private bank creditors in September 1984 on Mexico's outstanding public-sector debt of about $50 billion. Previous rescheduling of smaller amounts of sovereign debt had generally been on a 1-year basis; the Mexican agreement broke new ground by covering debt maturing over the following 6 years. Partly in view of

Mexico's excellent performance under its adjustment program and continued good prospects, the lending terms in the new agreement were attractive—a quite low interest-spread and a generous grace period. In addition, up to 50 percent of a bank's outstanding credits to Mexico may be converted at the bank's option to its home currency, thus enabling more secure funding.

The recent gains made by Mexico, Brazil, and several other key debtors confirm that their strategies for economic adjustment and repayment are basically sound. International debt problems have not been solved, however. Progress among debtor nations has been quite uneven. Although some countries have made substantial improvements in their current account positions, the majority of the large debtors are still in deficit, indicating that they are still increasing their net indebtedness to the rest of the world.

In some cases, relatively poor performance arises from special factors. Countries that depend heavily on exports of certain raw materials (such as copper, rubber, tin, and oil) have been set back by recent price declines. In general, price trends for exports of developing countries have not been favorable lately; the average dollar price of industrial raw materials (excluding oil) has fallen by almost 15 percent since the end of 1983. In other cases, essential domestic adjustments have not yet been made. The differing performance of these countries underlines the fact that the extent of a debtor country's recovery depends closely on export growth, maintenance of competitive exchange rates, well-conceived investment plans, and noninflationary macroeconomic policies.

Recent events also reveal clearly how sensitive the performance of the debtor countries is to the state of the world economy—including the level of interest rates, the value of the dollar and, especially, the rate of growth of the industrialized economies. Sustained growth in the industrialized countries, however, is not sufficient to ensure that demand for the exports of developing countries will continue to expand. The markets in industrialized countries must remain open, not only to traditional exports from the developing debtor countries, but also to more skill-intensive exports that emerge as their comparative advantage evolves. In recent years, increased protection has been directed at this latter class of products—particularly those from the so-called "newly industrialized countries." The costs of such protection include not only misallocation of resources but also damage to the prospects for successful debt repayment.

Both production and the prospects for debt repayment would be further enhanced by expansion of foreign direct and portfolio investment flows. These flows could increase if host countries were to provide a better investment climate. Increased foreign direct invest-

ments, in particular, would not only partly relieve borrowing needs but would also provide additional benefits, such as technological transfers, training, and improved export marketing know-how.

INDUSTRIALIZED TRADING PARTNERS

There have been significant differences among the major industrialized countries in their recovery from the 1980–82 world recession. These differences were still apparent in 1984. Although the United States, and to a lesser degree Japan and Canada, experienced further healthy expansion (albeit from a fairly deep trough in Canada), recovery in Europe still lagged well behind. Average real growth in the four major European economies (Germany, France, the United Kingdom, and Italy) accelerated slightly in 1984 to about a 2¼ percent annual rate, but this was less than half the average of the three non-European countries mentioned above. Although some progress has been made lately in revitalizing the European economies, fundamental problems remain. The most visible symptom of these problems is the presence of persistent and rising unemployment, currently equivalent to almost 11 percent of the Western European work force.

Two factors are often cited to explain the slow economic recovery in Europe: structural problems in European labor markets and disincentives to adjustment and growth. Structural factors include highly indexed wages, high nonwage labor costs and social charges, and arrangements for excessive job security that contribute to a low rate of labor mobility and new hirings. Disincentives include various government regulatory burdens, high marginal tax rates on labor and capital incomes, and large subsidies paid to agriculture and declining industrial sectors.

One consequence has been relatively low rates of investment in Europe. Expressed as a share of output, private investment has declined steadily since the first oil shock in 1973 and is now well below the level of investment shares seen in Europe in the 1960s. There has also been essentially no net job creation in Europe in the past 15 years. In addition to disincentive effects and labor market rigidities, labor market conditions have been worsened by demographic factors—especially a heavy influx into the work force of younger workers. Labor force growth is expected to decelerate in coming years, but in the absence of a marked pickup in investment, achieving a significant reduction in European unemployment will be difficult.

Many European countries have given priority to reducing large government deficits and limiting the expanding share of government expenditure in total demand. Progress has been made, but the hope that deficit reduction and curbs on public spending would contribute

significantly to higher growth by releasing resources to the private sector has not been fully met.

On balance, the external sector has provided little net stimulus to growth in Europe. This is not to say that European exports to the United States have been weak. On the contrary, U.S. imports from the European Community (EC) have grown at about a 17 percent annual rate since 1982. However, the U.S. market makes up a relatively small share of total EC export sales (about 16 percent, not including intra-EC trade). Trade within the Community has fallen since 1980, and other important EC export markets—Organization of Petroleum Exporting Countries (OPEC), the Eastern Bloc, and major debtor countries—have been stagnating or declining. In these latter markets, however, even the market shares of European exporters have not increased, despite significant gains in competitiveness vis-a-vis the United States in the past 2 years.

Although progress has been slow in Europe, there are grounds for optimism. Nominal wage increases have decelerated in several countries. In some cases, performance in 1984 has been affected by special factors, such as persistent inflation in France and sectoral strikes in the United Kingdom and Germany. The rapid rebound of activity in Germany following the settlement of the metalworkers' strike suggests that underlying German growth potential is strong. Economic performance in the other countries may improve for similar reasons once their particular difficulties are dealt with successfully. Continued control of inflation and reduction of government expenditures may provide many European countries with a foundation for more stable economic growth.

In contrast to the European economies, Canada and Japan have performed well. The U.S. market is relatively much larger for both countries (70 percent of total exports for Canada and 30 percent for Japan), and recent export growth to the U.S. market has been robust (since 1982, annual growth of about 19 percent for Canada and 25 percent for Japan). The fact that Japan also exports heavily to the rapidly expanding newly industrialized countries of Asia (South Korea, Taiwan, Hong Kong, and Singapore) also has contributed to its largely export-led recovery.

Trade relations with Japan have sometimes been singled out as a special problem. In a period in which the United States is running the largest trade deficit of any nation, Japan is in quite the opposite position with a trade surplus of just over $44 billion in 1984. Furthermore, the U.S. deficit in bilateral trade with Japan expanded significantly in 1984 to an estimated annual deficit of over $33 billion.

Emphasis on the bilateral balance in a multilateral trading system is misplaced, however, and can be misleading—just as would be inferences about a person's financial standing based on his or her relationship with only one creditor. In fact, the decline in the U.S. bilateral trade position with Japan since 1981 has been less than that with either the European Community or Latin America. Although some problems have arisen in the past in relation to foreign access to particular markets in Japan, an agreement reached in early January 1985 between the President and the Japanese Prime Minister to establish high-level talks on this issue is a sign of potential progress in this area.

RECENT U.S. ACTIONS IN INTERNATIONAL TRADE

U.S. policies in international trade are tied inextricably to domestic political and economic considerations. They are also developed within the larger context of a dynamic international marketplace and the sometimes abusive trading policies of other countries. Against that backdrop, U.S. actions in 1984 represent progress toward freer trade, as well as some increases in protection. Significant actions include the passage of a major trade bill by the Congress in cooperation with the Administration, decisions on several important import relief cases, and the extension or modification of existing import restrictions in several sectors.

THE TRADE AND TARIFF ACT OF 1984

Despite unusually strong protectionist pressures, the Congress and the Administration put in place an omnibus trade law that generally supports freer trade. The major provision of the Trade and Tariff Act of 1984 renews until 1993 the Generalized System of Preferences, which eliminates tariffs on eligible imports from qualifying developing countries. Some imports (notably textiles) are not included. In addition, the renewed program establishes eligibility criteria for participation that include the extent to which participating countries offer access for U.S. exports, protect intellectual property, eliminate trade-distorting investment policies, and enforce certain rights of workers, including rights of association. Countries with a per capita gross national product exceeding $8,500 (a figure indexed to one-half the rate of U.S. economic growth) are ineligible for the program.

The Act also provides authority for negotiations (with Israel, specifically, and with other countries) to establish a free-trade zone. Congressional ratification is required, however, and the President retains the power to impose quotas or to negotiate export restraints if

the U.S. International Trade Commission determines that increased imports cause or threaten to cause injury to domestic industries.

Certain measures in the new Act extend the Trade Act of 1974 to provide specific authority for the President both to retaliate against and to negotiate reductions in barriers to U.S. exports, including exports of services and foreign investment. The Act provides explicit authority for the U.S. Trade Representative to initiate investigations of unfair trade practices and expands the countervailing duty statutes to include specifically products that benefit from subsidized inputs.

In a series of provisions, the Act extends the legal definition of affected industry to allow grape producers 2 years to file petitions against foreign trading practices affecting the wine industry (this provision deviates from the established principle of allowing petitions only from firms with like or directly competing products); revises the criteria for determination of injury due to imports under section 201 of the Trade Act of 1974 (by requiring the International Trade Commission to consider plant closings and producers' inventories of imports in determining injury); and provides explicit authority for the President to implement his recently announced steel trade program, which is discussed below. The Act also reduces tariffs on about 100 products.

OTHER TRADE ACTIONS

The International Trade Commission investigated several section 201 "escape-clause" cases during 1984. After a finding of injury due to imports by the Commission, the President is charged with making the final decision on whether to restrict imports based upon the national economic interest. The Commission determined that imports were not a substantial cause of serious injury, or threat of serious injury, to three small domestic industries. In two major cases involving unwrought copper and carbon steel, however, the Commission did find injury and recommended import relief in the form of various trade restrictions. The President rejected import relief in the case of copper, primarily because of potentially large damage to the U.S. copper fabricating industry.

The President also rejected the import relief for steel proposed by the Commission, but opted instead to negotiate voluntary restraint agreements (VRAs) to be in effect for 5 years. The President acted in response to sharp surges of steel imports during the year, which were the result in part of foreign government subsidies. The restrictions are expected to limit imports to roughly 20 percent of domestic steel consumption. Agreements for new export restrictions have been reached with Japan, South Korea, Spain, Australia, South Africa, Mexico, and Brazil. A general restriction agreement with the EC will

continue through 1985, but new restrictions on pipe and tubes will extend through 1986.

In April 1984, the 3-year Japanese VRA on automobiles announced in 1981 was extended an additional year at a slightly higher limit of 1.85 million cars per year. Following losses by U.S. automobile manufacturers in 1980, Japanese automobile exports to the United States were restricted in April 1981 to 1.68 million cars per year on the grounds that the U.S. automobile industry needed time to adapt to world competition through introduction of new technology and cost-cutting measures.

In agriculture, the United States maintains a number of significant import restrictions, including limitations on cotton, peanuts, dairy products, and sugar. With the exception of the quota on sugar, these restrictions remained unchanged in 1984. The sugar quota was reduced by 17 percent to be consistent with the domestic price support for sugar and changing market conditions, including reduced sugar demand, increased use of sugar substitutes, increased domestic sugar production, and surging imports of products containing sugar from Canada and Mexico. In January 1985 the quota was further reduced by extending the quota year by 2 months.

In August 1984, new interim regulations governing U.S. textile imports were announced that codified the "substantial transformation" principle used by the U.S. Customs Service to determine the country of origin of imported goods. These regulations were issued in response to claims by domestic producers that foreign suppliers were circumventing relevant export restraint agreements by shipping parts of garments to other countries for superficial processing before final shipment to the United States. Foreign producers, importers, and domestic retailers objected strongly to the new rules. Their comments and those of other interested parties on the interim regulations were being reviewed by the U.S. Customs Service at the end of 1984.

ACTIONS IN INTERNATIONAL FINANCE

The United States now maintains a full array of essentially open financial markets for international investment and fundraising, as do several other industrialized countries, including Germany, Switzerland, and the United Kingdom. In May 1984 an agreement was reached between the Japanese and U.S. Governments on measures designed to liberalize markets for yen-denominated financial assets. The agreement marks an important stage in Japan's continuing movement toward fully liberalized financial markets.

The U.S. objective of unrestricted capital flow is also evident in the removal in 1984 of the U.S. withholding tax on interest earned by nonresidents on U.S. bonds and other financial instruments. The new

tax rules now make it feasible for U.S. corporations to issue securities directly to foreigners without having to go through the previous cumbersome and costly procedure of issuing indirectly through an offshore shell subsidiary. Soon after the U.S. rule change, both Germany and France dropped their own corresponding taxes on interest payments to nonresidents, and Japanese authorities have announced their intention to do the same.

The United States has also been at the forefront of efforts in the Organization for Economic Cooperation and Development (OECD) to restrict the use of subsidized financing for exports. In the case of so-called "mixed credits"—the use of concessionary loans for development aid to boost exports through tied sales—the consequences are costly not only to competing exporters, but also to aid recipients because choice of supplier and, often, choice of product are restricted.

In characterizing U.S. actions in international trade and finance in 1984, one cannot say that U.S. policy greatly advanced the cause of free trade; neither can one say, however, that U.S. policymakers capitulated to the unusually strong domestic protectionist pressures. On balance, the Administration and the Congress managed to resist those pressures and helped to set the stage for potential advances toward freer trade in 1985 and in years to come.

THE CHALLENGE OF COMPREHENSIVE FREE TRADE

The world is moving away from, rather than toward, comprehensive free trade. In major industrialized countries, for example, the proportion of total manufacturing subject to nontariff restrictions rose to about 30 percent in 1983, up from 20 percent just 3 years earlier. Although tariffs among industrialized countries have been reduced substantially since World War II, tariffs also remain high in some sectors (textiles, footwear, steel, wood products, and shipbuilding, for example) and among developing countries. In nonmanufacturing, international trade is subject to even more severe restrictions and market distortions, especially in agriculture and services.

New international initiatives are required to sustain the post-World War II momentum toward comprehensive free trade and the world economic growth that it has fostered. Speaking to the International Monetary Fund and World Bank Joint Annual Meetings on September 25, 1984, the President called for just such initiatives:

"For the millions around the globe who look to us for help and hope, I urge all of you today: Join us. Support with us a new, expanded round of trade liberalization, and, together, we can strength-

en the global trading system and assure its benefits spread to people everywhere."

Accordingly, what follows is first, a restatement of the case for free trade, including a rebuttal of the myths of protectionism; second, a discussion of the obstacles to progress toward free trade; and, finally, a discussion of strategies for surmounting these obstacles.

THE CASE FOR FREE TRADE

The persuasive power of arguments for free trade arises not from abstract economic reasoning, but from concrete historical comparisons of the achievements of free trade against those of protectionism. The conclusions to be drawn from such comparisons over the past two centuries are unambiguous: Countries that have followed the least restrictive economic policies both at home and abroad have experienced the most rapid economic growth and have enabled the greatest proportion of their populations to rise above subsistence living standards. Nevertheless, the demonstrated achievements of free trade cannot be taken for granted—the myths of protectionism persist, eroding the discipline of national economic policies around the world and frustrating new free-trade initiatives.

The Achievements of Free Trade

The power of free trade is amply demonstrated in history, including the early history of the United States. Under the Articles of Confederation, protectionist interests in individual States moved quickly to restrict the flow of competing products from other States. The debilitating effects of this protectionism on the States' economies convinced the framers of the U.S. Constitution to forbid individual States from levying tariffs (and the Federal Government from levying export duties). Federal courts have guarded the integrity of this prohibition, ruling as recently as 1981, for example, that a Louisiana tax on natural gas passing through the State was unconstitutional. The constitutional ban on State tariffs was crucial to the development of the U.S. economy not only because it established a free-trade area among the 13 original States, but also because it ensured that the free-trade area would expand automatically as new States joined the Union.

A second experience that illustrates the power of open markets is Britain's movement toward freer trade in the middle of the 19th century. There are two salient features of this experience. First, Britain's move was unilateral. The repeal of the Corn Laws by Robert Peel's government in 1846 was not conditional upon "concessions" from Britain's trading partners. Rather, the repeal was motivated by the growing recognition that the tariffs on imported grain set by the Corn Laws were a barrier to the advancement of Britain's own econ-

omy. Second, the results of free trade were exactly opposite to predictions that a decline in the prices of imported grains from repeal of the Corn Laws would lead to a corresponding decline in wages. Rather than falling, however, wages rose rapidly due to growth. Thus, Britain was very much an "engine of growth" in the 19th century world economy, and freer trade fueled the engine.

More recent experiences sustain the point. The slide of the world economy into the Great Depression of the 1930s was accelerated by unprecedented tariffs imposed by the Smoot-Hawley Act of 1930 and by similar measures abroad. In response to such disastrous protectionism, the U.S. Secretary of State, Cordell Hull, organized passage of the Trade Agreements Act of 1934, which became the basis for multilateral trade liberalization. Further trade liberalization, however, was delayed until after World War II. Significantly, 1984 marked the 50th anniversary of the Trade Agreements Act.

Since World War II, successive rounds of multilateral trade liberalization have demonstrated the power of open markets through almost four decades of world economic growth. After full implementation of the current Tokyo Round tariff cuts in 1987, import tariffs among major industrialized countries will average below 5 percent on industrial products, down from averages of more than 50 percent at their peak in the 1930s. These cuts have played a central role in the post-World War II expansion of the world economy.

During the same period, the emergence and expansion of the European Community liberalized trade even further among Western European countries. As the United States had done almost two centuries earlier, the members of the EC accelerated their economic growth by establishing a large, relatively unrestricted common market. The opening of the European market has been central to Western Europe's economic growth.

A final illustration of the achievements of freer trade is particularly important. As former colonies gained independence after World War II, they typically sought to achieve economic independence as well. Many embarked upon extensive import substitution policies to reduce their dependence on imports from former colonial trading partners. The overwhelming conclusion of studies of these policies, however, is that they severely stunted economic growth. In contrast, those developing countries that pursued more open economic policies have experienced truly remarkable records of economic growth. Recent examples include Hong Kong, Singapore, Taiwan, and South Korea, among others.

Acknowledging the record of free trade as a development strategy, the President made the following commitment on his departure to

the International Meeting on Cooperation and Development in Cancun, Mexico in 1981:

"Free people build free markets that ignite dynamic development for everyone. We will renew our commitment to strengthen and improve international trading, investment, and financial relations, and we will work for more effective cooperation to help developing countries achieve greater self-sustaining growth."

The Myths of Protectionism

Despite the achievements of open markets, myths regarding the benefits of protectionism persist. The most misleading of these, perhaps, is the claim that import restrictions save jobs at home. While employment in one sector may be higher with protection than without, job losses in other sectors of the economy are often even larger in the intermediate term and about the same magnitude in the longer term. Thus, import restrictions have little or no effect on total employment, although they do distort the distribution of employment among sectors. Moreover, estimates of the annual cost to consumers of each job saved in protected sectors are as high as $250,000 for some sectors. Finally, the influence of protection on employment in an industry is usually small relative to other determinants, such as the general prosperity of the economy or long-term trends in the demand for the product.

A second myth is that protection can provide a breathing period for an industry to modernize and to become more competitive. A related argument is that the protection permits a smooth "rundown" of existing production in the industry. Most of the evidence on either argument runs to the contrary. Although protection may increase resources for improving competitiveness, it also reduces pressure for adjustment. Once protection is granted it is common for productivity and unit costs to deteriorate even further relative to other industries.

Paradoxically, more recent forms of protection (in particular, VRAs) help *foreign* producers by enabling them to charge higher prices for the restricted exports. United States protection of steel in the 1970s, for example, is estimated to have increased the annual profits of Japanese steel producers by about $200 million—or about half of the Japanese expenditure on research and development in steel (the world's highest).

By the same token, protection does not simply facilitate a smooth rundown of existing activity—it often frustrates adjustment by attracting new resources to the sector. In many countries a disproportionate amount of entrepreneurial activity is devoted to protected sectors. Fully one-third of all the clothing and textile establishments in the United States at the end of 1982, for example, were not in the industry just 6 years earlier, and more than one-fifth of all new man-

ufacturing firms in France in recent years have been in the clothing and textile industry. Thus, it is not surprising that the "temporary" protection many industrial countries sought for textiles beginning in the early 1960s has resulted in a formal, long-term policy of protection.

Another myth of protectionism is that protection is a "fairer" policy than free trade for lower and middle income families. The burden of protection, however, typically falls most heavily on lower income consumers. The tariffs (explicit or implicit) embodied in U.S. trade barriers are more regressive than any other major tax, including sales taxes. Trade restrictions in industrial countries are skewed toward restriction of those basic, labor-intensive goods that comprise a relatively large share of lower income budgets. In most industrialized countries, for example, the proportionate burden of restrictions of textile imports on lower income consumers is several times greater than on higher income consumers.

There is also the argument that the United States should restrict the flow of imports to protect the economy from "unfairly" subsidized products from other countries. In many respects this argument, too, is incorrect. Permanently subsidized exports to the United States obviously make U.S. imports cheaper than they otherwise would be. Thus, rather than being a "beggar-thy-neighbor" trading policy, such subsidies are an "enrich-thy-neighbor" policy. Moreover, a State within the United States is not permitted to restrict imports of goods produced in other States that provide "unfair" tax subsidies.

There are two cases, however, in which this argument for restraint can be correct. One is when the foreign subsidy is not permanent. Countries might, for example, use subsidies to expand domestic production in some industries during the down period of a business cycle. In this case the importing country suffers recurring adjustment costs as its own domestic industry responds over the business cycle to variations in the level of subsidized imports.

A second theoretical possibility is in those rare instances where oligopolistic profits might be large. A country could attempt to increase its share of the potential oligopoly profits by subsidizing its own industry, either directly or indirectly. In both of these special cases, however, the best solution is an international compact on acceptable subsidization policies, rather than protectionism.

Another argument offered for protection is that the United States must restrict imports in order to protect "basic" industries. Because the U.S. economy has been characterized by certain industries since the Great Depression, the argument runs, these same industries must be protected from foreign competition to ensure continued economic growth. This argument mistakes the prospects for continued vitality

of the economy as a whole with the prospects of particular industries. So-called "basic" industries can always be identified at a point in time, but the hallmark of a dynamic economy is that basic industries can change. Most importantly, there are numerous examples of countries that have failed with the strategy of propping up weak industries, with no apparent successes.

Finally, there are, of course, legitimate national security considerations in some industries, but import restraint is a particularly inefficient method of attempting to maintain some minimum level of domestic capacity in an industry.

OBSTACLES TO COMPREHENSIVE FREE TRADE

Before concrete free-trade initiatives are proposed, the obstacles to new international commitments to free trade should be clearly identified and understood, since initiatives that do not address the real obstacles to liberalization are doomed to failure. The following discussion of these obstacles focuses on several issues: the inertia of existing trade barriers and distortions, the appeal of new trade barriers, the participation of developing countries in multilateral trade negotiations, and the presence of domestic policy constraints.

The Inertia of Existing Trade Barriers

Existing trade barriers carry a life of their own, as political inertia works against their elimination. In heavily protected sectors, adjustment to liberalized trade is especially painful unless the overall economy is expanding. As a consequence, it is imperative that free-trade initiatives be comprehensive enough to assure each country that at least some sectors of its economy will expand rapidly enough to cushion the adjustment of other sectors. Expanding sectors not only often reduce the extent of the contraction in formerly protected sectors, but also provide new opportunities for any displaced workers and resources. This strategy has worked reasonably well for the multilateral tariff reductions among industrial countries since World War II, and should be a key element in any new initiatives.

The comprehensiveness of trade liberalization, however, is itself threatened by extraordinary pressures to retain existing trade barriers. Remaining barriers have been revealed as those most difficult to eliminate, since these are the restrictions that negotiators have been forced to ignore. Nontariff barriers, in particular, pose difficult problems. Quantitative restrictions, import licensing, exchange controls, technical standards misused to restrict trade, and the like, are much more difficult to compare, to evaluate, and to negotiate than tariffs. Without strong incentives on all sides to make mutual progress toward free trade, negotiation of nontariff barriers can be excruciatingly slow and tedious. A new, formal round of multilateral

trade talks to deal with such barriers, for example, is expected by some to take several years to complete successfully, if at all.

The difficulty of negotiating reductions in nontariff barriers is exacerbated by another standard feature of international trade negotiations. Existing trade restrictions are the bargaining chips a country uses in international trade negotiations. Thus, countries are reluctant to liberalize their own trading practices for fear that their ability to obtain reciprocal liberalization from their trading partners will be reduced in the future. As a consequence, countries are in the paradoxical position of "needing" certain trade restrictions in order to eliminate others. To succeed fully, any new initiative must break through this paradox.

The Appeal of New Trade Barriers

Most countries are under strong domestic political pressure to aid one or more ailing industries. Unfortunately, quantitative and other nontariff trade barriers are becoming the policy of choice. The reasons are not complicated. Such measures are typically "off-budget," so that no explicit governmental appropriation is required to subsidize the industry. They are also often extra-legal, falling outside normal rules and restrictions of the General Agreement on Tariffs and Trade (GATT), and requiring no formal legislative action. The general political appeal of trade restrictions arises from the fact that the benefits accrue to small, identifiable groups, whereas the costs, although greater, are borne less visibly by society at large.

In addition, nontariff restrictions are sometimes welcomed by the country's established trading partners. For example, VRAs transfer implicit tax revenues from consumers in the importing country (which would be collected domestically if tariffs were used instead) to producers in the exporting countries (through the effect of restricted sales on prices). Although some progress has been made in a few areas in recent years, new international commitments that limit the discretion of individual governments to maintain or impose nontariff trade barriers are clearly needed.

Incentives for Developing Country Participation

Another serious obstacle to comprehensive trade liberalization is the problem of encouraging the full participation of developing countries. In previous multilateral rounds of liberalization, developing countries have not been required to reciprocate fully in multilateral tariff reductions by lowering their own trade barriers, and most still maintain substantial levels of both tariff and nontariff trade barriers. These countries are unlikely to participate in further liberalization as long as key sectors in which they have a comparative advantage (especially textiles) are exempted from the liberalization process.

Sustained progress in opening the capital and service markets of developing countries is not likely, for example, without accompanying progress for these countries in opening world markets for their manufactured products. Furthermore, the current trade preference schemes extended to developing countries by most industrialized countries give these countries a vested interest in existing tariff barriers in industrialized countries, since the benefit their exporters derive from the preference schemes depends upon the level of tariffs levied on goods from competing exporters.

Domestic Policy and Institutional Barriers

In some instances, trade restrictions simply reflect domestic policies. Nowhere is this more obvious than in agriculture. The absence of strong international commitments to open markets in agriculture has fostered the development of restrictive domestic policies by the EC under the Common Agricultural Policy, by the United States and other industrialized countries, and by developing countries. These costly domestic policies require an increasingly elaborate array of international restrictions on trade in agricultural products. Hence, little progress on liberalized trade in agriculture can be expected without reforms in related domestic policies. A country cannot, for example, maintain a direct price support program for a domestic agricultural product that sets the price above the price of available imports without also imposing trade restrictions on imports either through quotas or variable import levies. Otherwise, the domestic price support would be an impossibly expensive world price support.

Domestic industrial policies can pose similar barriers. Tariffs, preferential procurement, direct subsidies, preferential credit arrangements, exclusive market rights, and the like, are examples of explicit barriers to imports. Barriers can also be implicit, however. The complex and extensive relationship between the Japanese Ministry of International Trade and Industry and major Japanese domestic industries is often cited as an example of this phenomenon. Moreover, private Japanese trading companies distribute a substantial share of imports at the same time that they have very strong ties with domestic manufacturers. In some instances these ties are reinforced by shared equity or other financial interests. Not surprisingly, therefore, trading companies do not typically market imported products that compete with those produced by domestic manufacturers with whom they already trade.

The emphasis on such institutional barriers to trade can sometimes be misleading. When institutional and commercial practices are not sustained by government policy, practices that violate the fundamentals of a competitive marketplace are subject to challenge by new entrants. This suggests that when no government trade restraints are

present and no new entrants appear, existing practices may be efficient. Thus, the fundamental issue is whether and how governmental policies are used to raise artificial barriers to entry. In some instances the artificial barriers are direct and obvious (as in the official Japanese domestic monopoly in telecommunications—ostensibly to be eliminated in 1985—or the high tariffs on wood products); in others the barriers are less direct or obvious (as in the case of arbitrary technical standards or rules regarding exclusive dealerships).

A STRATEGY FOR FREE TRADE

Despite the obstacles to free trade, there are several reasons to push now for comprehensive trade liberalization. First, the trend toward increasing protectionism at the national level may actually help mobilize a consensus for a new international initiative toward comprehensive free trade. Furthermore, recovery of the global economy presents the opportunity to resist protectionist pressures and to reach just such a free-trade consensus.

There is also some evidence that many countries around the world may be willing to consider domestic policies that emphasize open markets, market incentives, and private control to a greater degree than before: members of the EC are under increasing pressure to find a less costly alternative to their current common agricultural policy; the Administration will seek agricultural reforms in 1985 farm legislation that will increase U.S. flexibility in negotiating freer trade in agriculture; and many developing countries appear to be at least more receptive to private, competitive markets. This possible change in the world temperament toward open, market-oriented policies poses the opportunity for successful new initiatives.

Finally, the President and the heads of government of major U.S. trading partners have already agreed at the Williamsburg Economic Summit to consultations on a new multilateral round of trade negotiations under the auspices of GATT. At the subsequent London Summit they agreed to seek early agreement on a new round. A multilateral round of trade talks is the most effective vehicle for successful trade liberalization.

A New Round of Multilateral Trade Negotiations

To exploit present opportunities the United States must pursue decisive, extraordinarily disciplined policies. At the most general level, a successful international strategy requires that the United States push aggressively forward on comprehensive multilateral trade negotiations under the auspices of GATT. At a more concrete level, the United States itself must be committed to comprehensive trade liberalization. In this context, comprehensiveness has several dimensions—products, factors of production, countries, and types of trade

distortions, including VRAs and various preferential treatments of domestic industry. Each of these dimensions is important to successful liberalization.

With regard to products, the United States should push especially hard for liberalized trade in agriculture, services, telecommunications equipment, advanced electronics, automobiles, textiles, wood products, and steel, to mention just some of the major problem areas. The United States has much to gain from liberalizing these areas, and developing countries in particular will have reduced incentives to participate without the promise of liberalized textile trade. In the industries above where the United States has significant restrictions—automobiles, steel, textiles, and agriculture—the costs of protection are large. In agriculture, for example, the annual cost of restrictions on sugar imports is estimated to be in excess of $3 billion, and the consumer cost of import restrictions on dairy products is even higher.

With regard to the various types of distortions, some progress has been made in GATT in the areas of subsidies, government procurement practices, and other nontariff barriers, but a new U.S. initiative at this time could accelerate and expand agreements in these and other areas.

The Role of GATT

GATT was established in 1948 to foster liberalized trade and has sponsored several successful rounds of multilateral trade negotiations. An effective GATT is essential to further liberalization and expansion of international trade. In particular, GATT obligations can help to restrain protectionist trends around the world by providing a source of external discipline to national policies. Just as the U.S. Constitution puts interstate trading policy beyond the control of individual States, international commitments can constrain the use of tariffs and other major forms of nontariff barriers by individual countries. Moreover, because no policy is likely to be completely successful in this regard, an ambitious program of trade liberalization under GATT auspices is needed to counter the inevitable individual lapses into protectionism at the national level.

The objectives of U.S. policy toward GATT are to strengthen the existing framework in the short term and to expand the scope of the agreement in the longer term. To achieve these goals, the United States supports the work program agreed to by the GATT Contracting Parties at the Ministerial meeting in 1982. Efforts to strengthen and expand the existing framework include working parties on safeguards and structural adjustment, quantitative restrictions and other nontariff measures, and dispute settlement procedures. The United States supports the negotiation of an effective "safeguards" code that

would discipline the use of temporary import restrictions as a method of dealing with domestic industry adjustment to import competition. The continuing proliferation of quantitative and nontariff restrictions on trade is also of major concern. The working party on this issue has catalogued existing quantitative restrictions and other nontariff measures and judged their consistency with GATT principles. This information should facilitate negotiations to eliminate the restrictions, perhaps as part of the preparation for a new multilateral round of trade negotiations. Finally, a major weakness of GATT is its inability to resolve disputes effectively. A greater reliance on professional panelists to resolve disputes might lead to a more predictable settlement process less subject to control by member countries. The recommendations of the GATT Secretariat would improve the process of forming panels, as well as the implementation of panel recommendations.

The GATT Contracting Parties have discussed extension of the GATT framework into agriculture, services, counterfeit goods (and other issues of intellectual property rights), high-technology goods, and textiles. In order to bring agriculture more fully under the rules of GATT, the United States supports a reduction in quotas and licensing programs limiting agricultural imports and a general prohibition on export subsidies. The EC, however, opposes a general prohibition and believes that export subsidies should be permitted.

Although trade in services constitutes an increasing portion of international trade, it too continues to remain outside the GATT framework. Liberalization of trade in services has been slow due not only to the complexity of the subject but also to intense opposition in principle, especially among developing countries. The service industries in these countries are usually small, and the governments argue that further growth of the industries would be impossible without restrictions on foreign competition. Despite such opposition, the United States has recently persuaded other Contracting Parties to consider the issue of services under GATT auspices.

Trade in counterfeit goods has increased noticeably in recent years. In addition to the economic losses to trademark owners, trade in counterfeit goods presents potential safety and health hazards to consumers. The United States believes that GATT provides the best forum for negotiating and implementing an agreement to handle this problem and urges the formation of a working party on trade in counterfeit goods. Developing countries have opposed such a working party on the grounds that GATT is an inappropriate forum. Their underlying fear, however, is that developed countries will use rules to restrict the trade of counterfeit goods as protectionist measures to limit imports of legitimate goods. GATT Contracting Parties

agreed at the 1984 Ministerial meeting to establish an experts group on intellectual property rights in general. The group will collect information on abuses and propose alternatives for action. As required by the Trade and Tariff Act of 1984, the United States is also preparing a survey of problems around the world with intellectual property rights.

In 1982 the United States proposed that GATT examine trade in high-technology goods. As a result of opposition, the study was transferred to the OECD. Two major findings have now emerged from this study. First, open international markets are necessary to capture fully the benefits of high-technology industries. Second, restrictive trade practices are increasing trade frictions in these industries. Major issues include the role of preferential public procurement (especially in telecommunications), the role of product standards, limiting the access of domestic firms to government sponsored research, the influence of various types of government sponsored research and technology on commercial and industrial technology, and the effect of government policies on investment.

Finally, textiles remain exempt from standard GATT rules. The Multi-Fiber Arrangement, which establishes rules governing quotas for textiles, is due to expire in July 1986. A working party is examining the possibility of bringing textile trade into the GATT framework, perhaps through the negotiations on renewal of the Multi-Fiber Arrangement which begin in 1985. Textile restrictions began in the early 1960s as a temporary expedient to give the textile industries in the United States and other industrial countries time to adjust to increased foreign competition but, perhaps predictably, have evolved into a more permanent obstacle to freer trade.

Secondary Strategies

A potential problem with multilateral negotiations is that they may be stalled by a relatively small group of countries. If this occurs, the United States and others may eventually be forced to resort to secondary strategies for liberalization. The new free-trade area (FTA) negotiating authority given the President offers one possible option. FTA negotiations (and less than fully multilateral negotiations in general) tend to reverse the usual incentives in international trade negotiations by making countries more eager to be among the first to agree to liberalize trade rather than among the last. The incentives for countries to be among the first to enter an FTA or a plurilateral agreement with the United States could be strong. Because no duties would be levied on intra-FTA exports of FTA members, the first entrants would enjoy substantial competitive advantages over outsiders in the large U.S. domestic market, especially if highly restricted sectors were to be included in the FTA agreement. In addition, as the

number of countries joining an FTA grows, the incentives for outsiders to join increase, because unfavorable trade diversion increases and the size of the non-FTA market decreases as the FTA expands.

One possible criticism of an FTA initiative is that it may appear to some as a regression to narrow, bilateral trade negotiations. This need not be the case. First, the possibility of an FTA strategy would be considered only if multilateral negotiations stalled. Second, an FTA initiative would not be the same as the narrow, complex trade "haggling" characteristic of the 1930s because there are GATT criteria for permissible FTAs and plurilateral agreements. Third, an FTA or plurilateral initiative would be as multilateral as the number of countries that chose to join the agreement. There is nothing intrinsically bilateral about an FTA. Again any FTA initiative would at all times be subordinated to resumed progress in multilateral trade negotiations.

Perhaps most importantly, however, the possibility of FTA or, more broadly, plurilateral negotiations offers the United States and others the option of using a free-trade instrument, rather than protectionism, as a lever against protectionist countries that are recalcitrant in fully multilateral negotiations. This distinction is important because there are several fundamental difficulties with using trade sanctions to persuade other countries to liberalize their trading practices. First, trade sanctions hurt the country that imposes them, in some instances as much as, or more than, the foreign country. Second, the foreign trading partner knows that this is the case. As a consequence, threats of trade sanctions are often not credible. Then, of course, there is always the additional threat of foreign retaliation.

In rare instances, however, the United States may be forced to use trade sanctions to persuade a particular trading partner or a group of trading partners to abandon especially restrictive trading practices. Although such sanctions raise the danger of retaliation, there may be isolated instances where this danger is minimal relative to potential gains. However, sanctions should be used only in accordance with clearly established rules, not as a pretext for protectionist actions. Thus, threat of a sanction should always be accompanied both by an unambiguous explanation of which trading practice the sanction is aimed at eliminating and by credible assurances that sanctions will be removed when the restrictive practice halts.

A sanction is more likely to succeed in an industry where the trading partner's exports to the U.S. market are more important to them than they are to the United States. Thus, trade sanctions must be carefully tailored to particular circumstances. A sanction appropriate for one issue of concern to the United States, such as the use of concessionary loans to boost exports, may be inappropriate for other

issues of similar concern, such as preferential government procurement, infringements of intellectual property rights, or cyclically varying subsidies. One would also expect strategic sanctions to be used only at the discretion of the highest policy levels of the government.

A Final Caveat

It is often assumed that opening markets abroad for U.S. exports by reducing trade barriers will necessarily improve the fundamental position of the U.S. current account deficit. This is not necessarily the case. A country's current account balance is determined fundamentally by domestic investment and saving behavior (including government) relative to investment and saving behavior abroad. As pointed out earlier, this is true because of two fundamental economic relations. First, a current account deficit, for example, is necessarily offset by a corresponding capital account surplus. Second, the capital account surplus is identically equal to the excess of domestic investment over domestic saving (including government). Thus, changes in trade barriers will affect the current account in a fundamental way only to the extent that they change saving or investment. Accordingly, the use of the U.S. current account (either with the rest of the world or with particular countries) as a measure of success in liberalizing trade is likely to lead to frustration. Comprehensive free trade is a policy objective because of the proven benefits of open markets, not because it will lead to a particular external balance.