CHAPTER 4

Opening International Markets

ONE OF THE MORE REMARKABLE FEATURES of the past 40 years has been the rapid increase in real income per capita in many parts of the world. This economic expansion has been fueled in large part by a tremendous growth in world trade. In turn, growth in world trade has resulted from a major effort led by the United States and other countries to reduce global barriers to international commerce.

These events stand in direct contrast with the decade preceding the start of World War II. Then, stagnation in the domestic economies of major nations was compounded by the spread of import barriers, export subsidies, trade wars, and a general emphasis on closing domestic markets to foreign competition.

Determined not to see this scenario unfold again after the war, the United States sparked a move to establish a world trade system complete with firm rules to govern trade practices and to ensure that trade policies would not degenerate into beggar-thy-neighbor protectionism. International organizations were created to guide the world economy along this new path. Among them was the General Agreement on Tariffs and Trade (GATT), set up to initiate a reduction of trade barriers and to mediate commercial disputes between member nations.

GATT has presided over seven multilateral rounds of negotiations that have produced historic global tariff reductions. As tariffs have come down, the volume of international trade has increased much faster than world production. Unfortunately, while GATT has been expanding trading opportunities among countries, largely through tariff reductions, these efforts have been undermined by new and much less transparent protectionist measures.

The world thus stands at a crossroads similar to the one it faced 40 years ago. The commercial playing field is littered with government policies aimed at protecting various industries from the rigors of international competition. Trade in major product sectors—including steel, automobiles, electronics, textiles, apparel, and footwear—is becoming increasingly regulated by measures such as voluntary export restraints and orderly marketing agreements. The cost of these policies is enormous while the benefits reach only a few. Unless some-

thing reverses the trend toward government-sponsored trading arrangements, the growth enjoyed by world economies over the past four decades could be severely curtailed.

The United States, as the largest participant in world trade and as a long-time champion of free trade, stands in a unique position to fight this move toward greater protectionism. From its start, the Administration has supported free trade. Most recently, it reaffirmed this position in a policy statement issued on September 23, 1985, which contained a multipronged program to enhance and strengthen the international trading environment. Elements of the program included macroeconomic policies aimed at dollar realignment, fiscal deficit reduction, and an effort to ease the debt burden of developing countries.

With respect to trade policy, the statement proposed that the United States undertake a number of bilateral measures aimed at reducing foreign trade barriers. A second thrust of U.S. trade policy would be to rekindle the GATT process by urging fellow members to enter into a new round of multilateral trade talks.

More than a year has passed since these policies were announced. Using a series of self-initiated cases under Section 301 of the Trade Act of 1974, the Administration has sought to eliminate certain unfair trading practices of foreign governments. A fund of money has been established to support Export-Import Bank loans as part of an effort to persuade foreign countries to restrict and eliminate commercial subsidy elements of their foreign aid grants. Bilateral talks aimed at establishing free-trade areas have been concluded with Israel and begun with Canada.

And because of a leading role taken by the Administration, a new round of multilateral trade liberalization talks—held under the auspices of GATT—has commenced in Geneva. This new round presents an important opportunity for rolling back interventionist measures and for strengthening rules of conduct in international trade. Indeed, it offers prospects to rein in the various new forms of protection that have arisen because of current weaknesses in the GATT process. The new round also provides the opportunity to extend rules of commercial relations to areas previously exempted from or not covered by GATT, including agriculture, services, direct foreign investment, and intellectual property rights.

This chapter reviews the Administration's trade policy initiatives of the past year, especially as they relate to efforts to open foreign markets. The fundamental premise behind these efforts is that free trade offers Americans the greatest hope for a prosperous future. Consequently, this chapter begins by reviewing the benefits of free trade.

THE CASE FOR FREE TRADE

Governments have long interfered with the exchange of goods across their boundaries. One purpose of their barriers was to collect revenues through tariffs or tolls. Local industry usually supported and benefited from the protective effect of these policies. Indeed, in many instances, pressure from domestic producers induced governments to shelter them from foreign competition with trade restrictions. Another purpose was to achieve trade surpluses through export subsidies and import restrictions. These policies, whose ostensible goal was to increase and preserve domestic wealth at the expense of other countries, became known as mercantilism.

For more than 200 years, many economists have argued against mercantilist policies and made the case for free trade. They generally believe that restrictions on commercial activity reduce wealth rather than increase it. Conversely, the argument for free trade is relatively simple yet compelling.

The case for free international trade is much the same as the case for free internal trade. Commerce between the United States and Japan benefits Americans as does commerce between New York and California. The exchange of goods, internally or internationally, arises as a natural outcome of specialization. Because of factors such as climate, natural resource endowments, or technology, different economic regions possess different abilities to produce certain goods. Individuals, firms, and industries within these regions tend to concentrate their efforts in the goods and services that they are best able to produce. Then their output is exchanged in the marketplace for that of other economic agents.

Specialization allows for a more efficient use of scarce resources and permits improved productivity of the economy. The larger the size of the market, the greater are the possibilities for specialization and for increasing the wealth of the community. The extent of specialization in international trade is related to the forces of international competition. As barriers between markets are lowered, some domestic producers will face increased competition from abroad. Other producers will exploit export opportunities as accessible markets expand. Hence, production will tend to contract in industries where foreign goods are superior relative to domestic goods on a price and/or quality basis. In those industries where domestic goods are relatively superior to foreign, local output will expand. These latter industries are said to have a comparative advantage.

In essence, comparative advantage means that an industry will export if it is more efficient relative to other domestic industries. An industry's productivity relative to other industries within the same

country determines its ability to command scarce resources within that economy and, thereby, to export to the rest of the world. Thus, a local industry's efficiency compared with that industry in foreign countries is not the main determinant of whether it exports or faces import competition.

Because comparative advantage refers to an internal ranking of productivity, a country may import goods even if the local producing industry is more efficient than its foreign rival. A country will tend to concentrate production in those industries in which it has the greatest comparative advantage. Standards of living rise as resources are put to their most productive uses. One sign of rising standards of living, of course, is a rise in real wages.

A common misconception about international trade is that it is unfair. For instance, some argue that because U.S. wages are high relative to wages in other countries, U.S. producers cannot compete. This argument is true for some industries, but not true in general. U.S. wages are high because American workers are in general more productive than their foreign counterparts. The relatively high U.S. productivity comes about from this Nation's enormous stock of physical and human capital. As U.S. productivity levels increase, so do wages paid to workers. This puts upward pressure on wages even in relatively inefficient sectors of the economy. But if wages rise and productivity does not keep pace, then American firms will have trouble competing.

An instructive example comes from the U.S. steel industry. From 1965 to 1981, wages rose much faster than labor productivity in steel and faster than wages and labor productivity in overall manufacturing. As a consequence, unit labor costs increased dramatically, and the comparative advantage of U.S. steel products deteriorated badly. In other sectors where wages are relatively high but productivity remains strong, such as aircraft and computers, U.S. products compete successfully in world markets.

In addition to raising the general standard of living, the forces of free trade also produce dynamic gains for the economy. These benefits accrue because, in the absence of government intervention, investment in new plant and equipment and in research and development tends to concentrate in the most efficient sectors of the economy. This increases the rate of growth of the economy. Conversely, in an economy riddled with protectionist policies, investment is often diverted from more efficient industries because of government-induced distortions in relative rates of return.

Finally, political gains arise from free-trade policies. As countries rely more on each other for goods and services, they are more likely to settle international disputes through negotiation rather than hos-

tile action. An example is the remarkable reduction in national tensions between the countries of Western Europe since the adoption of internal free-trade policies following World War II.

It is sometimes argued that the benefits of free trade depend upon special assumptions about economic behavior. But the case for free trade is quite general. Early arguments for free trade assumed that industries were perfectly competitive and that trade arose from climatic or technological differences between countries. Later, economists focused on trade resulting from relative differences in national endowments of factors of production, such as labor and capital. In both instances, the free-trade outcome was one where production expanded along the lines of comparative advantage and countries enjoyed the consequent gains of trade.

More recent theories of international trade flows stress the importance of imperfectly competitive market structures arising from such phenomena as increasing returns to scale and domestic barriers to entry. Even here, however, free international trade is beneficial. Expansion of markets because of freer trade may allow a firm to realize economies of scale from an output level higher than would be expected in the absence of trade. These economies can then be passed on to the consumer as lower prices. Expansion of markets through free trade also leads to an erosion of monopoly power enjoyed by those industries where both significant barriers to domestic entry and foreign competitors exist. Another source of gain is the benefit to consumers from an increase in product diversity, in both quality and variety.

The benefits of free trade are relatively independent of actions taken by foreign countries. In particular, it is often argued that because protectionist policies exist in foreign countries the United States must follow suit. This argument is generally false. The benefits to the United States flow from buying goods and services for which foreign producers have a comparative advantage and selling U.S. goods and services where U.S. companies have a comparative advantage. To the extent that foreign policies reduce these trade possibilities, those countries and the United States gain less.

Furthermore, the benefits of free trade do not require that trade be balanced at any point in time. Indeed, overall trade balances and the associated international capital flows allow countries the mutual benefit of trading goods and services over time. Countries with overall trade deficits borrow from the rest of the world. Such borrowing can provide the requisite funds for financing investment expenditures crucial to economic growth. Countries with overall surpluses lend to the rest of the world. This lending raises the wealth of the country if it is allocated to projects that earn higher rates of return than would

otherwise be possible. However, neither borrowing nor lending can go on indefinitely, and economic forces will work over time to ensure that imbalances are closed. Thus, trade in goods and services between any country and the rest of the world tends to be in balance over the long run.

On the other hand, trade between any two countries may never be in balance. For a variety of reasons, countries tend to amass surpluses with some countries and deficits with others. Unfortunately, interest in bilateral trade balances—essentially a mercantilist trait—remains great. In May 1986, the House of Representatives passed an omnibus trade bill, H.R. 4800, that called for the President to identify countries that have "excessive" trade surpluses with the United States and then to negotiate with or take actions against these countries, regardless of the underlying causes of the surpluses. The President labeled the bill "kamikaze legislation" and promised to veto the measure, but it died when the 99th Congress adjourned.

Despite the obvious benefits of a liberal trading order, various forms of protection abound and are proliferating at an alarming rate. Why do governments continue to pursue these policies? Various justifications have been put forward by governments to defend protectionist policies. Examples include government revenue, national defense, unfair foreign trade practices, preservation of certain ways of life, and short-term aid to revitalize industry.

Whatever the motive, protection in any form redistributes income and wealth. And because the redistributive effects are usually not readily apparent, special interest groups sometimes favor and governments often choose these methods over other more visible and much less costly forms of subsidy. Protection raises the price of imports and domestically produced import-competing products. But, consumers are seldom aware of the tax imposed upon them by protection because they rarely have the opportunity to observe the difference between domestic and world prices. The cost of protection to consumers can be quite dramatic. For instance, the Council of Economic Advisers estimated that if Congress had been successful in its attempt to override the President's veto of the Textile and Apparel Trade Enforcement Act of 1985, Americans would have had to pay up to an additional $44 billion for textiles and apparel over the next 5 years.

Given these considerations, the Administration supports policies designed to improve the efficiency and productivity of the U.S. economy. Such steps should make Americans more prosperous. These policies include retraining for displaced workers, reforming antitrust laws, and strengthening property rights, both domestically and abroad. Other initiatives include the repeal or reform of regulations that unnecessarily impinge upon U.S. competitiveness.

SECTORAL MARKET OPENING INITIATIVES

SECTION 301 ACTIONS

Trade imbalances are largely macroeconomic phenomena, not related directly to market access barriers or unfair trade practices by foreigners. But trade barriers and unfair practices distort economic activity and generally harm economic efficiency. For this reason, the Administration is committed to eliminating foreign trade policies that pose a significant burden on U.S. exports.

Section 301 of the Trade Act of 1974, as amended, provides the authority and procedures for the President to act against certain unfair trading practices of U.S. trading partners. The President must first find that action is appropriate to enforce U.S. rights under any trade agreement, or to respond to any act, policy, or practice of a foreign country that (a) is inconsistent with the provisions of, or otherwise denies the United States benefits under, any trade agreement, or (b) is unjustifiable, unreasonable, or discriminatory and burdens or restricts U.S. commerce. If he so finds, then he is authorized to act to enforce these rights or to eliminate the act, policy, or practice.

Unjustifiable practices are those that violate or are inconsistent with U.S. international rights. The term "unreasonable" refers to acts, policies, or practices that are not necessarily illegal or inconsistent with U.S. international legal rights, but are viewed as being unfair. The act applies not only to practices that harm U.S. trade in goods and services, but also to actions against U.S. direct foreign investment that affect trade in goods or services.

Section 301 is administered by the Office of the U.S. Trade Representative (USTR). Petitions may be filed by any interested party or they may be "self-initiated" by USTR on its own or at the request of the President. Once an investigation has been opened, USTR, in cooperation with other U.S. Government agencies, determines the extent of harm to domestic interests and recommends action for the President. At the same time, USTR consults with the foreign government involved in the complaint and attempts to negotiate a settlement.

Depending upon the specific nature of the alleged practice, USTR has up to 12 months to conclude the investigation and recommend action to the President. If no solution is reached, USTR may recommend that the President impose duties or other restrictions on imports from the foreign country or take any other action authorized by law. Retaliatory actions taken under Section 301 may be nondiscriminatory or solely against the goods and services of the foreign country involved in the dispute. The products subject to retaliation need not correspond to the products related to the dispute.

Between January 1975 and November 1986, 57 cases had been initiated under Section 301. Table 4–1 details the disposition of these cases. In addition, numerous firms and industry groups have consulted with USTR regarding the Section 301 process or have filed and then withdrawn their petitions before a case could be initiated. More than 60 percent of initiated cases were begun under the current Administration. Until 1985, all of these came as the result of privately filed complaints. Recently, however, the role of Section 301 as an active component of U.S. trade policy has grown, with the President directing USTR to self-initiate four investigations and three trade actions aimed at the practices of several U.S. trading partners. Five of the seven proceedings have been favorably resolved, while two are pending. Brief descriptions of the circumstances of these self-initiated cases follow.

TABLE 4–1.—*Summary of cases under Section 301*

[January 1975 to November 1986]

Category	Number
Petitions considered	57
Petitions withdrawn	6
Cases terminated:	
Due to resolution of dispute	20
Due to other reasons	4
Cases resulting in retaliation	12
Cases suspended	3
Cases pending	15

Note.—Case resolutions do not equal number of petitions considered because cases may fall into more than one category.
Source: Compiled by Council of Economic Advisers from data provided by Office of the U.S. Trade Representative.

Self-initiated Section 301 Cases

On September 16, 1985, at the request of the President, an investigation was begun into practices that act as a barrier to U.S. cigarette sales in Japan. These practices included tariffs combined with internal ad valorem excise taxes, an absolute prohibition on the manufacture of foreign cigarettes in Japan, discriminatory treatment in the collection of excise taxes, and restrictions on the distribution of foreign cigarettes. Bilateral consultations were held between representatives of USTR and the government of Japan. Japan promised to suspend altogether tariffs on cigarette imports. It also agreed to eliminate the discriminatory deferral in collecting excise taxes, terminate discriminatory distribution practices, and make its price approval system virtually automatic. On October 6, 1986, the President suspended the investigation with the intent that it be terminated upon full implementation of the agreement.

In the autumn of 1985, the President directed USTR to self-initiate two Section 301 investigations against the practices of Korea. The first involved restrictions on the ability of U.S companies to sell fire and life insurance in Korea. The second was aimed at the lack of effective protection of U.S. intellectual property rights, such as copyright protection for literary and artistic works, including computer software, and patent protection for chemical and pharmaceutical products. Bilateral consultations resulted in agreements covering both complaints. The first increased U.S. market access to Korea's insurance market by allowing U.S. insurers to underwrite both life and other insurance. The second promised to expand dramatically the protection of intellectual property rights. The President approved the agreements in August 1986, and the investigations were terminated.

On August 1, 1986, the President determined that Taiwan's practice of calculating customs duties based on prices listed in duty-paying tables violated a trade agreement or was unjustifiable and a burden on U.S. trade. In effect, this practice had led to increased duties paid to Taiwan, because the prices in the tables often exceeded transactions values. Before USTR could recommend an appropriate method of retaliation, Taiwan agreed to stop the practice.

In October 1985, Taiwan agreed to provide greater market access for U.S. exports of beer, wine, and cigarettes within 6 to 12 months. In particular, Taiwan agreed to lift an import ban on beer and to allow U.S. products to be sold at all retail outlets where Taiwanese products were sold. It also agreed to limit retail markups on U.S. products to the level applied to local products and to allow market forces to determine the levels of importation of U.S. products.

On October 27, 1986, the President determined that Taiwan had not honored the agreement and accordingly found the Taiwanese practices to be unreasonable and a burden on U.S. commerce. He directed USTR to retaliate. On December 5, 1986, before the retaliation could be implemented, Taiwan agreed to settle the dispute and the President ordered the case terminated.

On March 31, 1986, the President announced his intention to impose quotas on several European Community (EC) products in response to EC restrictions affecting U.S. exports of oilseeds and grains to Portugal. He also vowed to increase tariffs on certain products if the EC did not provide compensation for reduced U.S. exports of corn and sorghum to Spain as a result of the replacement of Spain's 20-percent tariff on these products by the EC's variable levy. The EC had taken its actions in connection with the accession of Spain and Portugal to the EC.

On May 15, 1986, the President imposed quotas on EC imports in response to the Portuguese import restrictions. However, to date,

these actions have not restricted trade. On July 2, 1986, the EC and the United States reached an interim agreement, and the quotas were lifted to permit continued sales of corn and sorghum to Spain for an additional 6 months. Both sides had agreed to December 31, 1986, as a deadline for the final agreement. Unfortunately, subsequent negotiations have failed to produce a settlement. Consequently, on December 30, 1986, the President announced that ad valorem tariffs of 200 percent would be placed on certain products, primarily imported from the EC, with a trade value approximately equal to the estimated loss of corn and sorghum exports. The tariffs will be implemented no earlier than January 31, 1987, thus allowing additional time for negotiations.

On September 16, 1985, at the President's direction, USTR began a Section 301 investigation into all aspects of Brazil's computer and computer-related (informatics) products policies. Included in the investigation were practices concerning import restrictions, limitations on U.S. investment, and failure adequately to protect intellectual property rights. On October 6, 1986, the President announced that Brazil's informatics policy was unreasonable and a burden or restriction on U.S. commerce, but ordered that the case be continued until December 31, 1986, to give both sides more time to reach an agreement. In the meantime, he requested that USTR notify GATT of U.S. intentions to suspend the application of tariff concessions to Brazil and to effect such suspensions when appropriate.

In the weeks that followed the Presidential announcement, some progress was achieved on certain procedural aspects of Brazil's informatics policy. Consequently, on December 30, 1986, the President suspended those aspects of the investigation. In addition, he ordered a further extension, until July 1, 1987, to give negotiators additional time to settle remaining issues in the case.

Analysis of Section 301 Actions

The Administration's decision to self-initiate several Section 301 cases has sent important signals. First, U.S. industries know that if they encounter unreasonable trade barriers in foreign markets, a mechanism exists to help them overcome these barriers. Moreover, both the self-initiations and actions in cases initiated in response to industry filings demonstrate U.S. concern to its trading partners about their commercial policies. The message of the Section 301 process is that in the products and countries involved in the various cases, the United States thinks its comparative advantage is being unfairly denied.

Section 301 puts the weight of the President behind disputes over specific, narrowly defined trade practices abroad. This attention sharpens the focus of the dispute and allows pressure to build on a

clear and remediable problem. The threat of retaliation can provide leverage to negotiate an end to unfair foreign practices. Section 301 also encompasses a greater range of issues (in goods, services, investment, and intellectual property rights) than does GATT.

Section 301 should be used with caution. Actions taken under it may be perceived as an intrusion into the policies of a foreign government. And, while these policies may clearly be egregious and often lower the economic welfare of the foreign country, in some cases the threat of retaliation may not provide the best incentive for successful resolution of the issue.

Political leaders may not want to appear to be vulnerable to foreign threats and may resist a mutually beneficial agreement to preserve national pride. Thus, Section 301 cases are most likely to succeed in areas that have little economic and political significance to foreign governments, and retaliation is more likely in those cases with significant foreign national interest.

The level of contentiousness is even higher when the process is initiated at the President's direction without a petition filed by a U.S. firm or industry. In these cases, it is most unlikely that the investigation will lead to any finding other than unreasonableness. The possibility of abandoning the case because the costs of retaliation are too high is limited.

U.S. retaliation may inflict as much or more harm on the American economy as it does on its target. In addition, unless carefully handled, it is likely to violate GATT rules, undermining an already weak international dispute settlement process. Moreover, retaliation does not always stop with the issue at hand, but may escalate into further rounds of retaliation and counter-retaliation. The potential for mutually destructive trade wars rises with the magnitude of the case and with the size of the trading partner.

While the focus of a Section 301 case is usually on a specific product, the effects of a settlement may extend to other related areas. For instance, the recently concluded agreement with Japan over trade in semiconductor products has led, at least temporarily, to increases in the prices of these products. As semiconductor prices rise, the competitiveness of industries using these products as inputs may diminish.

Several proposed trade bills recently considered by the 99th Congress would have amended the Section 301 decisionmaking process. Most of these proposals are ill-advised. For instance, Senate bill S.1860 would have mandated the President to self-initiate several Section 301 investigations each year. It would also have required the President to retaliate if settlement were not reached after a fixed period of time. Such requirements add inflexibility to areas where

flexibility is vital, and do nothing to address the fundamental problem of opening foreign markets. The decision to self-initiate raises the stakes in the negotiating process. Section 301 currently allows the President to lend the force of his office in those situations where it most benefits the outcome of the process.

Finally, the credibility of U.S. complaints about foreign trade barriers depends in part on the extent of its own barriers. U.S. tariffs are low on average, but tariffs on certain products remain high and nontariff barriers affect a significant percentage of total imports. For example, the United States participates in the international Multifiber Arrangement, which authorizes complex bilateral trade-restricting agreements between exporters and importers of textiles and clothing. The United States has asked its trading partners to limit their exports of steel and machine tools and uses nontariff barriers or high tariffs to restrict trade in sugar, dairy products, lumber products, motorcycles, and a number of other goods.

MARKET-ORIENTED, SECTOR-SELECTIVE TALKS

A much less confrontational approach to bilateral market opening is represented by a series of sectoral negotiations between the United States and Japan. Following the successful conclusion of talks to liberalize Japanese financial markets, both governments sought to address the often contentious issue of commercial trade with Japan. In 1985, high-level discussions, called Market-Oriented, Sector-Selective (MOSS) talks, began with the purpose of identifying and removing impediments to market access in Japan. Sectors initially chosen for discussion were telecommunications, electronics, medical equipment and pharmaceuticals, and forest products. Transportation machinery was added later.

The MOSS talks have shown substantial progress. Japan has implemented reforms in telecommunications, forest products, and medical equipment and pharmaceuticals. MOSS discussions on electronics were largely preempted by the semiconductor agreement. Negotiations in transport machinery, especially involving trade in automobile parts, still continue.

RECIPROCAL MARKET OPENING INITIATIVES

Opening markets on a piecemeal basis is difficult and inefficient. A more fruitful approach is to enter into discussions with foreign governments to open all markets reciprocally. These discussions can occur on a bilateral or multilateral basis. Important progress was made on both fronts in 1986.

A free-trade area (FTA) is an arrangement between two or more countries to remove barriers to trade among themselves but to maintain separate barriers with respect to nonmember countries. The benefits from FTAs resemble those attributed to free trade in general: expansion of market size can lead to efficiency gains through specialization. Consumers gain because they pay lower prices for certain goods because of increased competition.

Conclusion of FTA agreements can help to maintain the momentum for liberalizing trade. When the international climate does not permit widespread reductions of trade barriers, liberalization among like-minded nations promotes free trade. When nations that refuse to reduce their trade barriers see that others will achieve gains from trade by reducing barriers bilaterally, they might reconsider their commercial policies and join the effort to open markets.

FTAs have their problems. The potential cost of FTAs relative to freer trade in general arises from the fact that FTAs discriminate in favor of trade between member nations and against trade with nonmember countries. Hence, the source of trade may be diverted away from the lowest cost world producer in favor of a higher cost FTA member.

Both the Administration and Congress, however, think that free-trade area arrangements are worthwhile. The Administration's 1985 trade policy statement noted that bilateral negotiations are no substitute for multilateral negotiations, but that "such agreements could complement our multilateral efforts and facilitate a higher degree of liberalization, mutually beneficial to both parties, than would be possible within the multilateral context." Congress, for its part, has granted the Administration authority to enter into bilateral trade-liberalizing negotiations.

FTA Agreement with Israel

The Trade and Tariff Act of 1984 specifically authorized the President to conclude an FTA agreement with Israel. Formal talks began in January 1984. An agreement was signed in April 1985 and the first stage of liberalization went into effect in September 1985.

The agreement covers both tariff and certain nontariff barriers that exist between the two countries. Although most substantive elements of the agreement address liberalized trade in goods, some relate to trade in services and protection of intellectual property rights.

The U.S.-Israel FTA is the first such agreement reached by the U.S. Government. One motivating factor for negotiating this agreement was Israel's previous entry into a similar agreement with the EC covering trade in manufactured products. By negotiating an FTA

with Israel, the United States regained the competitive advantage that U.S. exporters had lost to their European competitors.

FTA Talks with Canada

More trade passes between the United States and Canada than between any two other countries. In 1985, this trade totaled about $120 billion. Canada is this country's largest foreign market, accounting for 22 percent of total merchandise exports. The United States is Canada's largest market, purchasing more than 75 percent of total Canadian exports. The two countries engage in substantial trade in services. In addition, about 20 percent of U.S. direct foreign investment is in Canada.

Over the course of U.S.-Canada relations, special trade pacts have periodically been considered. From 1855 to 1866, trade between the two countries was governed by special treaty. Since 1965, the United States and Canada have had a sectoral agreement covering trade in automobiles. However, more comprehensive and longstanding agreements have eluded American and Canadian negotiators for decades.

Recently, a new effort to reinforce U.S.-Canada economic ties began. On September 26, 1985, the Prime Minister of Canada called for negotiations between the United States and Canada to achieve "the broadest possible package of mutually beneficial reductions in barriers to trade in goods and services." The Administration welcomed this proposal and formally notified Congress in December 1985 of its intent to enter into negotiations under the negotiating authority established in the Trade and Tariff Act of 1984. These negotiations were begun in May 1986.

After consultations with advisory committees representing industry, labor, and agriculture, the Administration developed objectives for the talks. The first objective is the elimination of Canadian tariffs. A second broad goal is the elimination of nontariff barriers to certain U.S. exports. The United States is also interested in eliminating barriers to foreign investment in Canada, liberalizing trade in services, and protecting intellectual property rights.

Canadian objectives include reducing U.S. tariffs and improving access to the government procurement process, both Federal and State, from which Canadian vendors have often been excluded because of various Buy American provisions. Both sides seek a dispute settlement mechanism that could be used to enforce any agreement emerging from these negotiations and to deal with individual disputes in the future.

The mutual economic gains of liberalized trade with Canada are likely to be substantial. The United States would benefit because Canadian tariffs are quite high and hence reduction of these barriers could lead to increased market access for U.S. exporters. Canada

would gain from taking advantage of the economies of scale that it could achieve through producing for a market ten times larger than its own. Both countries also stand to gain in many nonquantifiable ways, not the least of which is the reduction of commercial tensions.

Since 1981, the Administration has concluded or examined comprehensive bilateral trading arrangements with several countries. Although such arrangements are better, in general, than sectoral negotiations between countries—and far better than negotiations conducted under threat of retaliation (such as Section 301)—multilateral trade talks are the most efficient and all-encompassing means by which to reduce global trade barriers. Hence, the Administration has placed strong emphasis on a new round of GATT talks.

THE NEW GATT ROUND

An important Administration success in trade policy has been the launching of a new round of talks in GATT to reduce barriers to international trade and to strengthen and improve the global trading system. The announcement of an agreement to begin this new round was made at an international gathering of trade ministers at Punta del Este, Uruguay, on September 20, 1986. Organized discussions began on October 27, 1986; the negotiations are scheduled to continue for 4 years.

The Uruguay Round holds considerable promise for U.S. commercial interests. In addition to traditional areas, new topics that will be considered in the negotiations include trade in services, treatment of foreign investment, and protection of intellectual property rights. The Administration played a key role in ensuring that these issues would be included in the talks.

History of GATT

GATT was created at the end of World War II as one of several international agreements designed to promote world peace and development. It serves both as a forum for trade liberalization talks and international commercial dispute settlement and as a multilateral body that sets rules of conduct in international commerce. Countries that agree to follow GATT rules are said to be contracting parties. As of December 1986, GATT comprised 92 contracting parties, including all developed Western economies. In addition, numerous developing countries, as well as several Eastern-bloc countries, are GATT contracting parties. Together, GATT members account for about 85 percent of international trade.

As a code of commercial conduct, GATT prohibits quantitative restrictions on trade in goods, and the GATT subsidies code outlaws government export subsidies for nonagricultural products. It does permit certain protective measures for balance of payments reasons,

to provide temporary relief for local industries in distress (i.e., safeguards protection), or to promote infant industries in developing countries. GATT has procedures for settling disputes arising between members. The dispute settlement process may sometimes be long and problems over compliance with decisions may develop. In the Uruguay Round, the United States hopes to streamline and strengthen the dispute settlement process.

Since 1947, GATT has served as a forum for seven rounds of talks aimed at reducing international barriers to trade. Perhaps the two most successful and well-known are the Kennedy Round of the 1960s and the Tokyo Round of the 1970s. The major achievement of the Kennedy Round was across-the-board tariff cuts, averaging 35 percent, on manufactured products. In the Tokyo Round, manufactured goods tariffs were cut again, this time an average of 31 percent. In addition, codes concerning nontariff barriers, such as government procurement practices and customs valuation procedures, were established.

The operating principle underlying the agreements to cut tariffs is the unconditional most favored nation (MFN) treatment among countries. This notion holds that if a contracting party grants trade concessions to another contracting party or to a nonmember country, it must grant the same concessions to all contracting parties. The economic basis for this principle is sound. Because all countries belonging to GATT are treated alike, and because GATT members account for most of world trade, trade flows will tend to occur along the lines of comparative advantage. Thus, potentially trade-distorting discriminatory treatment is minimized. The MFN rule also protects small countries by preventing big countries from negotiating exclusive mutual concessions. Thus, less developed countries benefit from the full weight of U.S. influence in negotiating trade concessions. The MFN rule is extremely efficient in that it enables countries to avoid the huge administrative costs of conducting the thousands of bilateral trade agreements that are the effective equivalent of a multilateral GATT round.

ADMINISTRATION AIMS IN THE NEW GATT ROUND

Talks in the new round will be conducted on the basis of a comprehensive agenda in two parallel areas, one involving trade in goods and the other trade in services. The negotiations involving trade in goods represent an extension of previous negotiations. Topics to be addressed include tariff and nontariff barriers, trade in tropical and natural resource based products, textiles and clothing, agriculture, and trade-related investment and intellectual property rights issues. In addition, negotiations will seek to strengthen GATT rules related

to subsidies, dispute settlement, and safeguards protection. The talks involving trade in services represent the first multilateral negotiations ever undertaken on this issue.

Dispute Settlement

GATT acts as a forum for the settlement of disputes concerning the rules and obligations set out in the GATT agreement. In the first years of GATT, the dispute settlement process was effective in interpreting the rules of GATT and pressing countries to adhere to GATT rules. Beginning about 1960, however, confidence in GATT procedures and compliance with its rules began to wane. The Tokyo Round attempted to tighten the dispute settlement process, but significant problems remain.

Basic weaknesses pervade the settlement process. The fundamental problem is delay. It is not atypical for cases to drag on for several years. Under current arrangements, parties to a dispute can block adoption of settlement recommendations, thereby compounding the problem of unsuccessful resolutions. Furthermore, the process is least effective where GATT rules themselves are weak or ambiguous, as with agriculture.

The United States is strongly committed to repairing and improving the dispute settlement system. The Administration supports new rules and procedures designed to restore international confidence in the system. Included in these rules would be the development of new arrangements to ensure compliance with GATT rules and rulings. New and strengthened trade rules make no sense for the world trading system without effective enforcement.

Trade in Services

From 1950 to 1985, the production of services increased as a share of total U.S. output from 47 to 57 percent. As employment in manufacturing was falling as a share of total employment, employment in the services sector was rising faster than total employment. Today, about 60 percent of American jobs are in the nongovernmental services sector. Between 1950 and 1980, real service exports rose faster than real GNP. Other developed economies have shared similar experiences. In the economies of developed countries, on average, services now account for about 50 percent of value added and constitute approximately 20 percent of international trade.

Despite the growing importance of the production and trade of services in the U.S. economy and the economies of other developed countries, little has been done to limit government policies that restrict or distort trade in services. A key element of the Ministerial Declaration at Punta del Este was the establishment of a negotiating

group on services: the object is to fashion a legal framework to reduce barriers to and govern trade in services.

The agreement to consider trade in services required considerable effort by U.S. negotiators. Opposition to negotiations over services was largely related to issues of national sovereignty. Several countries remain concerned about their ability, in the face of foreign competition, to develop domestic services industries in such sectors as telecommunications and insurance. Moreover, these countries fear that without domestically supplied services they will be at risk. These familiar mercantilist arguments have no more validity in this instance than they do with trade in goods.

The Administration has stated objectives regarding talks in services. It would like to see a legal framework that consists of at least the following elements: transparency of restrictions, so that all parties to the agreement are aware of laws and regulations in place to protect local industry; open regulatory procedures; limitations on the activities of local monopolies; a dispute settlement process; and a commitment to pursue liberalization in future talks.

Negotiators will still face the appropriate definition of the service sectors. The Administration seeks a framework covering activities readily traded internationally, including but not limited to, insurance, telecommunications, data processing, shipping, aviation, construction, and engineering. A second and potentially more difficult problem lies with the measurement of production and trade in services. For most countries, adequate data on trade in services do not exist. Developing better measures of activity in the services area could be an important by-product of the Uruguay Round.

Investment

The international diversification of capital through direct foreign investment raises economic welfare around the world. In countries that receive the investment, standards of living rise because real wages rise, resources are used more efficiently, and technology levels increase. Countries that export financial capital under free market conditions also benefit because they allocate their capital to projects that earn higher rates of return than could have been earned otherwise. Thus, the international flow of capital between countries is mutually beneficial, in a fashion similar to the free exchange of goods.

Governments that unnecessarily restrict the location and operation of foreign capital lower the welfare of their citizens by lowering their incomes. All investment policies that distort or impede trade alter the pattern of trade away from that dictated by comparative advantage and lower the economic well-being of both the countries that impose the laws and the rest of the world.

The United States has traditionally welcomed foreign investment and only limits it in a few sensitive areas, generally on essential national security grounds. Many countries have established free-trade zones and offer incentives to potential foreign investors. In effect, they subsidize direct foreign investment in their countries and thereby distort capital and trade flows. Typical trade-distorting incentives include performance requirements, which establish minimum export levels expected of the foreign corporation. Laws that require the use of domestic parts or labor, exchange controls, controls on technology transfer, local equity requirements, and regulations on licensing, research, and development are other common restrictions. In the Uruguay Round, the United States will seek to develop effective multilateral disciplines over the whole range of trade-distorting investment measures.

Intellectual Property Rights

Economic growth is spurred through the inventive, innovative, and creative activities of individuals and companies. When the resulting ideas are disseminated widely, the ideas of one person often contribute to the creative activities of others. In order to encourage this process, countries establish systems of laws to promote and protect inventions, literary and artistic works, trademarks, and other forms of intellectual property. These patent, copyright, and trademark laws provide incentives to create intellectual property by granting exclusive rights to their creators. For instance, patents afford inventors time to recover their investment and the costs of creating and marketing inventions. Copyrights give authors control for a period of time over the reproduction, dissemination, and public performance of their works. Trademarks assure consumers about product characteristics such as quality.

Different countries provide different levels of intellectual property protection. The United States seeks comprehensive protection for all forms of intellectual property. Certain other nations afford little protection to foreign holders of intellectual property or limit protection in several important areas. Some countries provide only minimal protection and use compulsory licensing to acquire foreign technology or reproduce copyrighted works. This problem is becoming increasingly important as U.S. producers expand the marketing of items such as computer software and pharmaceutical products abroad.

The Administration hopes the conclusion of an enforceable multilateral trade agreement will eliminate trade-distorting practices arising from inadequate protection of intellectual property. Part of this agreement would seek the adoption by GATT members of minimum standards of protection contained in existing international conventions where the United States perceives standards to be adequate. In

areas where no convention exists or the standards under existing conventions are considered inadequate, the Administration will seek greater protection.

Agriculture

Trade policies affecting agricultural products are perhaps the most difficult and contentious issues awaiting the new round. Virtually all countries distort their trade in agriculture through tariffs, quotas, and export subsidies.

Industrialized countries adopt domestic agricultural policies aimed at raising farm income. Instead of providing farmers with income transfers decoupled from production, governments employ price-distorting policies that encourage agricultural production. In order to limit the cost of these programs, governments typically will also impose import tariffs or nontariff barriers, such as quotas or variable levies, and may subsidize the export of unwanted surpluses of domestic production. Thus, a direct relationship exists between domestic agricultural policies and the distortion of agricultural trade.

The cost of these policies, to both consumers and taxpayers, is exceedingly high. Consumers are often forced by their governments to pay several times more than world price for the same product. For instance, the price of sugar in the United States has recently been 300 percent above the world price. Japanese consumers currently pay eight times the world price for rice. Beef prices in the EC are currently more than twice world prices.

The budget costs are also enormous and are worsening. Trade in agricultural products should be determined by comparative advantage; instead it is determined by which government is willing to tax its own citizens the most in order to subsidize domestic producers. This situation has prompted competitive, countersubsidy trade wars among the industrial countries in an effort to capture world markets. It is not surprising that the predominate source of all GATT dispute settlement cases has been agricultural trade. The same is true for Section 301 cases. Current rules on agricultural trade are weak, vague, and easily circumvented. Practices are tolerated that GATT has elsewhere forbidden.

The keen interest of the United States in negotiating tougher rules to govern agricultural trade stems in part from its role as a major exporter of agricultural products. In 1985, U.S. farm exports totaled $29.6 billion, accounting for 13.9 percent of U.S. merchandise exports. U.S. agricultural exports have been declining rapidly, however. In 1981, the peak year for U.S. trade in this area, exports totaled $43.8 billion, 18.7 percent of all U.S. merchandise exports. Some of the loss of export markets can be attributed to the strength of the dollar. In addition, recent technological advances in agricultural pro-

duction have allowed countries that were only recently net importers of agricultural products to increase their production levels and become net exporters. High support prices in other countries have had similar effects. For example, in the mid-1970s, the EC was a net importer of 25 million tons of grains—20 percent of world trade in these products. By 1985, largely because of its internal farm policies, the EC had become a net exporter of 16 million tons, a swing of 41 million tons in the world market in a decade.

Some of the lost market for U.S. products has been caused by the production and export subsidy practices of certain competing nations. In order to stave off this reduction in markets, the United States has resorted to subsidizing exports. The Uruguay Round offers the opportunity to end this costly and counterproductive subsidy war. Stable, undistorted world agricultural markets offer the best opportunity for America's farmers to export their products.

The United States seeks to improve the climate of international agricultural markets by bringing them under effective and enforceable multilateral rules. The United States hopes the Uruguay Round will make progress in reducing import restrictions on agricultural products, in outlawing export subsidies, and in reducing other forms of market barriers in developed and developing countries alike. Clearly, the key to achieving fundamental reform in this area will be for countries to agree to eliminate distorting domestic agricultural policies.

CONCLUSION

The Administration seeks to open foreign markets to U.S. exporters. Administration actions include the increased use of Section 301, which attacks specific foreign trade practices; the initiation of negotiations leading to bilateral free-trade areas between the United States and several important trading partners; and the achievement of a new round of multilateral trade liberalization talks in GATT.

The Administration's approach stands in sharp contrast to efforts proposed by some to attack the trade imbalance with protectionist policies. Instead of bilateral market opening, these forces recommend bilateral restrictions. Instead of multilateral trade liberalization, they call for general import surcharges. Calls for protection ignore its cost to consumers, its deadening effect on the efficiency of U.S. industry and the global economy, its invitation to counter-retaliation that stings U.S. exporters, and the inspiration it gives to other industries to seek government assistance in the guise of import relief. Raising trade barriers would only reduce the opportunities to open world markets for American products. Through its efforts to contain and reverse the growth of protectionism both at home and abroad, the Administration hopes to ensure that the postwar expansion continues in the years to come.