

CHAPTER 7

Trade Liberalization and Economic Growth

THE GLOBAL TRADING SYSTEM has been a driving force of economic growth and prosperity, with world trade increasing more than one and a half times as fast as world income since the early 1960s. The fraction of U.S. production sold abroad has more than doubled since then, and exports now account for about one-eighth of gross national product (GNP). As the world's largest economy, the United States has greatly benefited from the rapid growth of trade. By promoting innovation, flexibility, and competition, the expansion of trade and the globalization of markets and firms have stimulated economic growth and improved living standards.

Many natural economic forces—such as the declines in transportation and communication costs—have contributed to the growth of trade, but trade liberalization through substantial reductions of tariff barriers has also been a significant factor. Seven rounds of multilateral trade negotiations, conducted under the auspices of the General Agreement on Tariffs and Trade (GATT), have helped reduce average tariffs in industrial countries on manufactured goods from over 40 percent in 1947 to about 5 percent today. GATT has also promoted trade by establishing internationally accepted rules of fair play that have prevented and resolved numerous commercial conflicts between nations.

A number of recent bilateral and regional economic policy initiatives have also helped to lower barriers to trade. In the Western Hemisphere, for instance, implementation of the U.S.-Canada Free-Trade Agreement has reduced many trade and investment barriers. Further market opening would come from a U.S.-Mexico free-trade agreement as well as from the hemisphere-wide system of free trade envisioned in the Enterprise for the Americas Initiative.

The current round of GATT negotiations, known as the Uruguay Round, is aimed at further lowering trade barriers and at preventing increased protectionism and government management of trade. An important goal of the United States and other countries in the Uruguay Round is to modernize and improve the rules embodied in the articles of the General Agreement on Tariffs and Trade. This includes extending rules to areas either previously uncovered or for which coverage is neither systematic nor explicit, such as services,

intellectual property rights, and foreign investment; deepening and broadening coverage of agriculture and textiles; applying rules more thoroughly to developing countries; strengthening the dispute settlement procedures; and updating unfair trade rules to reflect modern business practices. Another goal is to cut tariffs worldwide and eliminate them altogether in several large manufacturing sectors.

Unfortunately, the negotiations were suspended in December 1990 due to an impasse in the part of the talks dealing with agriculture. Successful completion of the Uruguay Round is important. In recent years, the world has experienced a rise in nontariff barriers, managed trade arrangements, and other protectionist measures that have hindered the expansion of trade and offset market-opening initiatives. *The opening of markets around the world that would come from the success of the current GATT negotiations could greatly increase U.S. and world GNP. By contrast, a breakdown of the multilateral trading system could increase protectionist pressures to erect trade and investment barriers.* Just as market opening stimulated economic growth, increased protection can reduce long-run growth and prosperity. In addition, an escalating cycle of import protection that led to a severe and sudden rise in trade barriers could contribute to a short-run economic downturn; the ensuing declines in income and employment might, in turn, increase pressures for protection. The last great cycle of antitrade policies contributed significantly to the Great Depression of the 1930s.

Today's trading environment is vastly more complicated than it was in previous eras. New, complex products and services now permeate the world marketplace; trade barriers are more intricate; and companies are increasingly globalized. Through foreign direct investment and other international linkages, such as joint ventures and production-sharing arrangements, multinational companies have dispersed their production, research, and marketing facilities throughout the world. The result has been greater integration of the world's markets and firms. Today, companies compete worldwide not only through exports, but also through the location of facilities. Globalized companies are also playing an increasing role in world trade; for example, two-thirds of U.S. exports are traded by multinational corporations, with about two-fifths of these exports traded "internally" between the parents of multinationals and their affiliates located abroad. International trade and foreign direct investment are now inextricably entwined.

THE GAINS FROM FREE TRADE AND LOSSES FROM PROTECTIONISM

Trade—whether between individuals within a town, between towns within a country, or between countries—is a natural economic process. The tendency for individuals to engage in trade stems from the fundamental fact that voluntary trade benefits all participants. Even within a town, the exchange of goods and services permits greater efficiency and prosperity for all residents because it allows individuals to specialize in what they do relatively well. Clearly, it would be an inefficient use of a town's resources if all its citizens grew all of their own food, made all of their own clothes, and built their own shelters. With a division of labor and trade among individuals, the town will produce more goods using its available resources.

Countries, like individuals, are not all equally proficient at producing all goods. Just as specialization and trade among individuals in a town make everyone better off, international trade increases the prosperity of all nations by allowing countries to concentrate on what they do well and to trade for goods that they are relatively less efficient at producing. Technology, for example, enables U.S. companies to develop and manufacture many advanced goods more cheaply than companies from developing countries—even though American wages are many times higher than developing country wages. For less technologically advanced goods, the United States may also enjoy higher labor productivity. This productivity advantage, however, may not be enough to overcome the wage difference. As a result, firms from developing countries may be able to produce such goods at a lower cost.

If market forces are allowed to act freely, countries will make the products they are relatively cost efficient at producing and will trade for other products. Since this international division of labor is cost effective, all goods will be cheaper; consequently, all nations will benefit. Trade barriers restrict the market forces that lead to this efficient international division of labor. *Removing trade barriers increases the well-being of all nations by allowing a more efficient international allocation of resources.*

EFFICIENCY, PRODUCTIVITY, AND GROWTH

In 1817 when David Ricardo first argued that trade benefits all nations, an efficient international allocation of resources was relatively simple. Countries made certain products and traded for others. Today, trade is much more complex. Firms increasingly engage in international joint ventures, technology-sharing arrangements, and long-term supply contracts, as well as direct investments in foreign companies and facilities. Through these interna-

tional linkages, firms achieve greater productivity and risk-sharing in research and development, marketing, and manufacturing. Thus, by improving the efficiency and flexibility of the allocation of resources, the globalization of firms and increased competition among them boost the prosperity of all nations.

Open markets and multinational firms increase efficiency by allowing companies to take advantage of national differences in productivity and resource costs. But they also promote efficiency even more directly. The development, production, and marketing of some products and services require large up-front investments. Unrestricted international trade and investment permit firms to attain the most efficient scale of operation, thereby increasing productivity and lowering average costs. The realization of these economies of scale is generally good for business and benefits consumers by increasing their choice of products and raising the purchasing power of their incomes.

These beneficial effects, usually called the efficiency gains from trade, are permanent, although this fact is not universally understood. For instance, it has been claimed that the economic cost of a major rise in trade barriers worldwide would be no greater than that of a mild recession. This claim, however, misses the point that recessions typically last for less than a year, while protectionist trade barriers impose costs that would lower incomes around the world for decades. Thus, even if the costs of a mild recession and an increase in protection were comparable on an annual basis, a major rise in trade barriers would have a much greater total cost.

Globalization and the Flexibility of the Economy

In today's rapidly changing world marketplace, flexibility is important: An efficient allocation of resources this year may not be efficient next year. *The globalization of markets and companies increases the ability of the U.S. economy to respond to changes in technology and the state of the world economy.* Access to foreign markets, technologies, and capital allows resources to move more quickly from one sector to another when patterns of international competitiveness shift. It also permits U.S. companies to respond more rapidly and effectively to changes in technology, products, and markets. The globalization of production networks also implies that reducing trade barriers in a particular foreign market may well lead to outcomes other than increased exports from the United States. These alternative outcomes include increased exports by companies that are affiliated with U.S. multinationals but located abroad; increased exports by foreign multinationals located overseas; and the establishment by U.S. companies of new facilities in the foreign market through direct investment.

Pro-competitive Effects of Trade

Competition helps push companies to produce efficiently goods that consumers want and to charge competitive prices. If a domestic manufacturer tried to charge too much for its products, for example, consumers would buy from the competition. Trade barriers, which tend to restrict import competition, reduce these beneficial effects. *Import competition promotes cost efficiency, quality awareness, and competitive pricing by domestic firms.* As discussed below, added competition can also encourage the rate of innovation.

Investment Effects of Removing Trade Barriers

Freeing up international trade and investment promotes a more efficient use of resources. These efficiency gains, however, reflect only part of the benefits from an open trading system. To the extent that capital becomes more efficient and profitable, investing in new capital becomes more attractive. *Market-opening initiatives can improve the investment climate, thereby promoting investment and spurring growth.* An example can be seen quite clearly in the investment-led growth that Spain experienced after it joined the European Community (EC) in 1986. Membership in the EC committed Spain to removing all barriers to the movement of goods, people, and capital between Spain and the other EC nations. During the following 2 years, Spanish investment grew at an annual rate of 14 percent—almost three times the rate of growth of Spanish income. In contrast, investment in Spain grew more slowly than income during the first half of the 1980s. While the lowering of trade barriers was not the only factor stimulating Spanish investment, the induced capital formation magnified the efficiency gains from liberalization by providing additional productive resources.

Long-Term Growth Effects of Trade

Long-term growth has many sources. Growth of the labor force, for instance, provides more workers every year and thus the possibility of more output every year. Another source of long-term growth is improved technology and the rise in output per worker—that is, in labor productivity—that accompanies it. The effectiveness with which capital and labor are combined to create output is constrained by technical and managerial know-how. Advances in such know-how are primarily produced by profit-motivated firms. To develop new products or improve manufacturing efficiency for existing products, a firm must invest in knowledge creation. The return on such investments is the profit that flows from the temporary advantage that the innovation gives the firm over its competitors. From an economy-wide perspective, these profit-motivated innovations allow more output to be produced from the economy's re-

sources. The resulting productivity growth boosts the growth of living standards.

International trade can promote long-term growth by encouraging technological innovation. By permitting innovators to sell to a larger market, trade may increase the profitability of innovation. That, in turn, spurs innovation and growth of productivity and incomes. For instance, access to foreign markets may allow firms to spread research and development costs over more sales, thereby increasing the profitability of innovation. However, this pro-innovation effect of a larger market may be partly offset by the fact that there may be more competing innovators and innovations in a larger market. Depending on the circumstances, trade may stimulate innovation and productivity growth by confronting firms with a stark choice between innovating and going out of business.

The globalization of firms and markets also spurs technological progress through the international exchange of technical knowledge. Domestic companies, for example, often use imported components in making final goods. Foreign innovations that improve the quality or lower the price of such components improve the quality and lower the price of the final goods. A closely related pro-growth effect is the way in which international trade and investment may help alleviate duplication of research effort, thereby permitting more efficient use of the world's research resources.

The notion that international trade increases economic growth is centuries old and widely accepted today. Quantitative estimates of the impact of market opening on growth are more difficult to obtain than its efficiency effects, however, because economists have begun only recently to develop analytic frameworks that can capture the links between trade, innovation, and growth. Typically, estimates of the gains from market opening incorporate only the efficiency effects. However, in assessing the quantitative impact of market-opening initiatives such as the Uruguay Round, it is important to include the innovation and growth effects as well, since they are potentially quite large (Box 7-1 and Chart 7-1).

IMPORT PROTECTION AND MANAGED TRADE

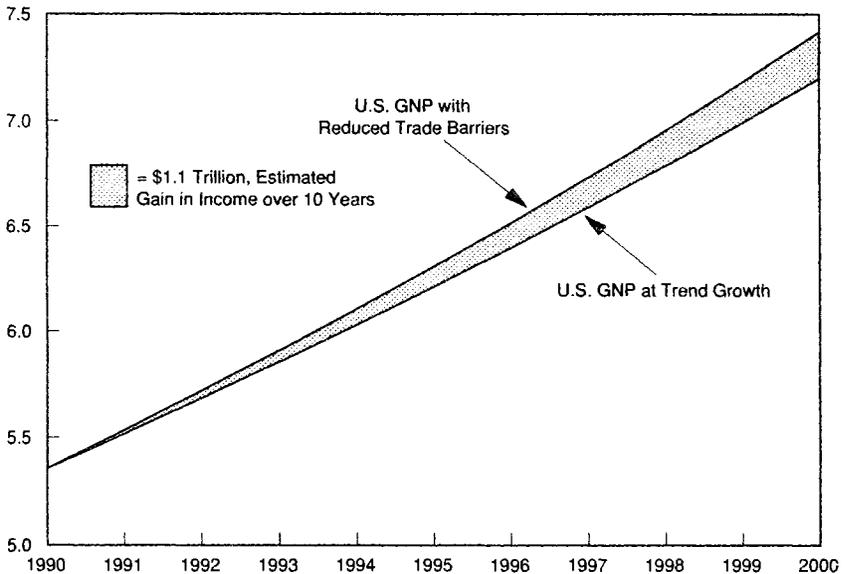
Just as opening markets is beneficial, policies that protect markets from international competition reduce efficiency and impede growth. Import protection policies take many forms: Tariffs reduce import competition by taxing imports, import quotas restrict the quantity of imports directly, and voluntary restraint agreements (VRAs) reduce imports by inducing foreign producers to decrease their exports. Policies that manage international market forces or alter market outcomes, such as government management of market shares, prices, or the composition of imports or exports, are examples of managed trade.

Box 7-1.—The Income Effects of a Successful Uruguay Round

Successful completion of the Uruguay Round would raise U.S. income significantly. The substantial reduction of tariff and nontariff trade barriers resulting from a successful conclusion of the round would boost U.S. income by enhancing the efficiency of the U.S. economy. Additionally, a more open world trading and investment system would promote growth by encouraging innovation and investment. Chart 7-1 shows projected growth paths with and without successful completion of the Uruguay Round. Taking growth and efficiency effects together, it is estimated that the level of U.S. GNP would be 3 percent higher in the year 2000 than it would be without the reduction of trade barriers that is likely to result from successful completion of the Uruguay Round. Of course, U.S. income would be higher even during the years preceding 2000. Adding up the annual gains over the next 10 years yields an impressive \$1.1 trillion.

Chart 7-1 Estimated increase in U.S. GNP from a Successful Uruguay Round
Reduced trade barriers resulting from a successful Uruguay Round would boost U.S. income substantially.

Trillions of 1989 dollars



Sources: Office of the U.S. Trade Representative and Council of Economic Advisers.

Protectionist policies in general, and managed trade in particular, dampen U.S. productivity and growth for many reasons. When governments interfere with market forces, the allocation of resources reflects political interests and power, which do not usually produce an allocation of resources that maximizes economic efficiency or average living standards. Moreover, such allocations typically involve a delicate political balancing, which makes it difficult to react flexibly to changes in the international economy or shifts in competitiveness. Also, governments rarely have the necessary information, background, or general understanding of commercial realities to make good business decisions. Finally, detailed government intervention may diminish competition, which is essential to the proper functioning of the free-market system. When governments determine market shares, sales, or prices, they lessen the pressure on firms to produce efficiently and price competitively. Indeed, managed trade often results in market cartels.

The Costs of Protection

The cost of import restrictions drives home the importance of open markets. Import restrictions of all kinds tend to reduce import competition, thereby raising the prices of both imports and those domestic products that compete with them. Higher prices benefit domestic producers of the goods but harm consumers who buy them. *In this sense, import restrictions are like a sales tax on imports that is used to finance a production subsidy to the protected domestic industry.*

In the clothing and textile sector, for example, trade is managed in great detail by a worldwide web of thousands of bilateral quotas involving more than 50 countries. The quotas and their associated growth rates are renegotiated under an international agreement known as the Multi-Fiber Arrangement. Every few years since 1974, the Multi-Fiber Arrangement itself has been renegotiated. Additional quotas are intermittently placed on new fabrics and new suppliers when their exports rise enough to disrupt domestic production. In the United States, imports of textiles and clothing are restricted by hundreds of these bilateral quotas, as well as by relatively high tariffs. U.S. producers benefit from the higher prices on each item they sell, while U.S. buyers lose because they must pay higher prices on each item they buy, whether imported or domestic. It has been estimated that protection in this sector cost American consumers about \$11 billion in 1987, while U.S. producers gained slightly more than \$4 billion.

This pattern of gains and losses is similar for import restrictions on other products. Between 1981 and 1985, for example, the number of imported Japanese automobiles was restricted by a voluntary restraint agreement. One study estimates that this VRA cost U.S. consumers \$5.8 billion in 1984, while U.S. automakers

gained only \$2.6 billion. The imports of machine tools are currently restricted by VRAs. The consumer cost of VRAs on machine tools was \$48 million in 1988, while the gain to U.S. machine tool manufacturers was only \$11 million. Since consumers of machine tools are typically U.S. manufacturers themselves, the VRAs have an additional effect. By raising the cost of important inputs, the VRAs may reduce the competitiveness of other U.S. manufacturing firms.

Sugar provides another complex example of import protection. The U.S. Department of Agriculture (USDA) must by law enforce a price floor of 18 cents per pound of sugar. Moreover, the USDA must maintain that price with no cost to the government. The problem is that the world price of sugar is far below 18 cents, and it fluctuates. If sugar imports were not managed, almost all U.S. consumers would buy less costly imported sugar, driving the U.S. market price below 18 cents. Since the USDA stands ready to buy unlimited quantities from U.S. producers at 18 cents, it would be forced to purchase the entire U.S. sugar output every year. That, of course, would violate current law. The solution implemented by USDA is to manage a set of trade restrictions that reduces sugar imports enough to ensure that U.S. demand meets supply above 18 cents a pound. Moreover, since market conditions change in the United States and the rest of the world, government officials must adjust these import restrictions to keep the market price near 18 cents a pound. It has been estimated that import restrictions on sugar cost American consumers \$1.9 billion in 1987, while producers benefited by only \$1 billion.

The Myth that Protection Saves Jobs

Although it is commonly asserted that protection saves jobs, this assertion is misleading. *Protection does not save jobs in the long run for the economy as a whole, it merely keeps jobs in the protected sectors.* Removing protection can, however, lead to short-run unemployment as displaced workers look for new jobs. The studies of voluntary restraint agreements mentioned above also calculated the consumer cost of the relevant protectionist policies relative to the number of jobs "saved." What these calculations actually show is the consumer cost of keeping one person employed in the protected sector instead of some other sector. To take one example, the consumer cost per job "saved" by the machine tool VRAs was estimated to be \$120,000 a year.

Political Economy of Protectionist Policies

The discussion of protection leads to the issue of why some sectors are protected, while others, indeed most, are allowed to adjust to import competition. More generally, it raises the question: *If consumers always lose more than producers gain, why do the United States and other countries have import restrictions?*

The answer is that the cost to consumers is spread over many millions of people, while the gain to producers is divided among many fewer people. As a result, producers often find it worthwhile to pay the cost of organizing and influencing their governments. Since the per consumer cost of import restrictions is typically low, consumers generally do not find it worthwhile to pay the cost of participating in such efforts.

Fairness in Trade

To many, the economic effects of trade barriers are only part of the story. To them it is simply unfair that some governments discriminate against foreign products through the use of tariffs or other barriers to trade. Overly bureaucratic procedures that impede imports, unilateral decisions that imports do not mesh with certain tastes or standards, and seemingly arbitrary health standards provide examples of governmental discrimination against foreign products that go against many peoples' notion of fair play.

The concept of fairness in trade is embodied in the principles of GATT. A basic GATT precept, for example, is the most-favored-nation (MFN) rule. Under MFN, countries that are members of GATT must treat all other members equally in their application of trade measures. Most countries, including the United States, prefer to reduce trade barriers in concert with other nations, in part because resistance to lowering protection is likely to be mitigated if it can be done on a more equal, or fairer, basis. The exchange-of-concessions approach to trade negotiations endorsed by GATT (discussed below) embodies this notion of fairness.

Another concept related to fairness is that of "national treatment," that is, the idea that the products of domestic and foreign firms should receive equal treatment with respect to domestic taxes and regulations. In the process of assessing and mediating many international disputes over alleged unfair trade barriers, GATT typically applies the national treatment rule by determining if the products of foreign firms are being treated differently from those of local firms.

SUMMARY

- Markets and companies are increasingly global in scope. The resulting increase in trade and investment benefits the United States and the world as a whole by allowing resources to be more productively and flexibly utilized.
- Opening markets to international trade pushes companies to produce efficiently goods that consumers want and to charge competitive prices. Open markets also improve efficiency by allowing companies to operate at the most efficient scale of operation.

- Reducing barriers to international trade and investment can improve the investment climate and increase the rate of innovation, thereby increasing the rate of growth of living standards.
- Managed trade and protectionist policies are harmful because they reduce the efficiency and flexibility of the economy and hinder economic growth.

GLOBAL TRADE AND THE URUGUAY ROUND

GATT has contributed significantly to the rapid growth of world trade. By facilitating the reduction of trade barriers through multilateral trade negotiations, GATT has stimulated trade growth directly. Trade has also been fostered more indirectly by the strengthening and continued acceptance of GATT's rules governing international commerce. Just as domestic business laws are essential to the smooth functioning of commercial relationships within a country, GATT is important in facilitating trade among countries.

Today, the GATT system is facing many challenges. The original agreement was written primarily to deal with trade in manufactured goods among developed countries, yet today only about three-fifths of world export earnings come from manufactures. Services account for about one-fifth of world export earnings, agriculture accounts for about one-tenth, and oil and minerals account for the rest. Moreover, in recent years many developing countries have become important participants in the trading system, yet they are not fully subject to GATT rules. Foreign direct investment by corporations is also an increasingly important aspect of the world trading system, yet GATT rules do not explicitly address such investment.

The nature of today's trade barriers poses new challenges to the GATT system. Since tariff barriers are quite low on average—at least in developed nations—continued market opening requires that nontariff barriers be reduced. While tariffs are easy to quantify and relatively easy to negotiate, many of the nontariff barriers to trade discussed in the Uruguay Round, such as government subsidies and import quotas, have proved more difficult to negotiate and reduce. Additionally, in the past decade the number of managed trade arrangements has increased. Agriculture, automobiles, consumer electronics, semiconductors, steel, textiles, and other sectors have been subjected to governmental management of exports, market shares, and prices in various parts of the world. Finally, in today's highly interdependent world, what appear to be domestic policies may have international trade implications. In fact, a number of recent trade disputes have their roots in national poli-

cies that are not related to international trade in an obvious way (Box 7-2).

Box 7-2.—“Nontrade” Policies Can Cause Trade Disputes

Some recent cases linking trade and nontrade concerns involve meat, cigarettes, wine, and trapped fur.

- In 1989 the European Community banned all imports of meat treated with growth promotants following a Community-wide ban on nontherapeutic hormones used in livestock production. The United States believed the directive was not based on scientific evidence and that it constituted an unjustifiable restriction on trade. Bilateral consultations were eventually able to resolve a number of points of contention, but not the underlying issue of how to deal with food standards that are not based on scientific evidence.
- The government of Thailand instituted a ban on cigarette advertising in addition to a ban on imported cigarettes and other restrictive practices. In response to a complaint from the United States, GATT found the import ban illegal but ruled that Thailand can prohibit tobacco advertising for health reasons.
- In accordance with a U.S. law prohibiting residues in foods of chemicals not registered with the Environmental Protection Agency, the United States recently imposed a temporary ban on EC wine imports containing a fungicide called procymidone until the health risk can be adequately determined. The EC and the United States are engaged in consultations on the temporary import ban.
- A possible EC ban on certain furs caught in countries that permit the use of steel leghold traps would restrict U.S. fur trade. There is widespread support in the United States as well as in Europe for the development of more humane traps. However, the U.S. Government opposes the imposition of an arbitrary deadline to meet standards that have not yet been developed and argues that trapping serves the desirable environmental goal of managing the population of fur-bearing animals.

PROCESS AND TIMING OF THE NEGOTIATIONS

The Uruguay Round negotiations are an ambitious attempt to open markets as well as to meet the challenges posed by the greatly increased complexity of trade, trade barriers, and the firms in-

volved in trade. Successful completion of the Uruguay Round would encourage growth and raise living standards in the United States and around the world. Success would also help defuse trade tensions and conflicts that might otherwise escalate. The use of costly agricultural export subsidies, for example, might increase if the Uruguay Round fails. Moreover, complaints from U.S. industries about unfair trade practices might rise, possibly increasing the use of retaliatory actions under U.S. trade law. For these reasons, the Administration has encouraged all nations to make the commitments necessary to bring the Uruguay Round to a successful conclusion.

The Uruguay Round talks were scheduled for completion in early December 1990 at a meeting in Brussels. Due to an impasse in the part of the talks dealing with agriculture, the Brussels meeting broke down, and the Uruguay Round talks were suspended with no formal agreements in any of the many areas of negotiation. The impasse occurred when countries could not agree on a basis for detailed negotiations concerning agricultural export subsidies, domestic farm policies that affect trade, and agricultural import barriers.

Trade negotiations are based on what is referred to as an "exchange of concessions." That is, negotiators talk about mutual policy reforms as if they were exchanging concessions, even though the reforms would benefit countries on all sides of the bargaining table. For instance, as discussed above, U.S. import restrictions on clothing cost American consumers billions of dollars a year. Yet, developing countries ask the United States to make concessions on clothing—that is, to open further the U.S. market to clothing imports—before they will make market-opening concessions that are likely to save their consumers billions. The word "concession" is used because domestic producers who compete with imports tend to resist such market opening. This exchange-of-concessions approach has been quite successful in previous GATT rounds, primarily because it allows governments to counter national groups opposed to opening the domestic market with the political influence of domestic exporters who seek market openings in other countries.

AREAS OF NEGOTIATION

The Uruguay Round talks have addressed three goals: reducing barriers to trade, extending GATT rules to new sectors, and improving GATT rules by strengthening and updating them to match modern commercial realities. In pursuit of these goals, the negotiations have proceeded on a wide range of areas, several of which are discussed below.

Tariff Reduction and Elimination

A very important part of the negotiations is the reduction of tariffs. Participants in the Uruguay Round have already agreed to

reduce the average of their tariff rates by about one-third. They have not, however, agreed upon the specific products on which tariffs will be cut. A vast number of products may be affected. The United States, for instance, has requested foreign tariff cuts on thousands of specific products and has offered to cut U.S. tariffs on thousands of products.

The United States has also put forth a novel tariff-cutting proposal called the Zero for Zero Initiative. Under this initiative the United States offers to cut U.S. tariffs to zero in particular sectors—such as steel, electronics, construction equipment, and pharmaceuticals—if other countries agree to cut their tariffs to zero in the same sectors. *When fully implemented, the initiative would result in free-trade sectors (FTSs) involving thousands of products made in scores of countries, thereby improving export opportunities for a large number of companies.* The volume of U.S. exports that would be covered by the proposed FTSs is larger than the volume of U.S. exports to Canada, the Nation's largest trading partner.

Agriculture

The strongest advocates of reducing protection of agriculture in the Uruguay Round have been the United States and a coalition of 14 food exporting nations known as the Cairns Group, which includes Australia, Canada, and New Zealand, as well as Argentina and several other developing nations. *Indeed, the importance of an agriculture agreement to some nations has had broad implications for the entire Uruguay Round.* Key trading countries from the developing world, including Brazil, Indonesia, Malaysia, Thailand, and several others, have expressed a reluctance to forge agreements unless agricultural reform is also negotiated and other issues of great interest to them are addressed. The Cairns Group has threatened to reject agreements on all other issues unless comprehensive agricultural policy reform is achieved.

Agricultural trade makes up about one-tenth of world trade, yet it has never been seriously subject to GATT discipline. Indeed, virtually every government intervenes in its agricultural sector. Particularly in industrial economies, agricultural policies often promote producers' interests through trade barriers or subsidization. The EC maintains high domestic food prices with a maze of import barriers and export subsidies that largely insulates its 8 million farmers from world market forces. Japan and South Korea maintain even higher barriers against most food imports. Canada, the United States, and many other nations also protect their agricultural sectors to some degree in a variety of ways.

The EC provides a prime example of government protection of agriculture. The EC was once a major food importer. Now government-controlled prices are set so high that European farmers produce much more than European consumers wish to buy. To dis-

pose of these surpluses, the EC must subsidize exporters to buy EC products at the high internal prices and sell them on the world market at much lower prices. Other countries may have to match the EC's subsidized export prices if they are to compete in the world market. The net result of these and other similar practices is that world prices of many agricultural products are significantly depressed and resources are inefficiently allocated. In 1987, the first full year of the Uruguay Round negotiations, the EC spent about \$10 billion on export subsidies and the United States spent about \$1 billion (Box 7-3).

An agreement to reduce agricultural trade barriers and subsidies would bring significant efficiency gains to the global economy. By allowing market forces to determine agricultural production and prices, such reductions would increase the amount of trade in most agricultural commodities and, according to one study, would add \$35 billion annually, in real terms, to the combined income of developed market economies. The largest efficiency gains would accrue to the economies of the EC, the United States, and Japan. In Europe manufacturing output and total employment would increase, while in Japan land and food prices would fall. Despite these beneficial effects, Europe and Japan have strongly resisted reform, partly because of the high levels of protection that existing barriers give to their politically powerful farm groups.

The United States, which exported about \$40 billion worth of agricultural products in 1990, has a large stake in achieving comprehensive agricultural policy reform. It has been estimated that the net effect of global agricultural protection lowers the U.S. agricultural trade balance by \$3 billion. While U.S. exports are a key concern, the U.S. interest in an agriculture agreement has other dimensions too. For example, reducing domestic farm subsidies could help reduce the U.S. budget deficit. Resistance to reducing domestic farm programs unilaterally is strong, however, partly because the programs help offset the price-reducing effects of other countries' farm subsidies.

The United States could increase the efficiency of its economy by unilaterally reducing the degree of protection in agriculture. Indeed, as described in Chapter 4, the United States has already taken important steps toward farm policy reform. However, if the United States reformed its agricultural policies in concert with others, U.S. farmers would face more open export markets and more favorable market prices. One study estimates that world market prices would have been roughly 20 percent higher in 1986-87 in the absence of subsidies and trade barriers worldwide.

Textiles

Trade in textiles and clothing accounts for about one-tenth of all manufactured exports. This trade is particularly important to de-

Box 7-3.—Export Subsidies: Who Gains and Who Loses?

If the Uruguay Round fails, an increase in the subsidization of agricultural exports, especially by the European Community (EC) and the United States, is a distinct possibility. Indeed, the Congress has already authorized an additional \$1 billion for U.S. export assistance, to be used to offset EC subsidies, should the round fail.

Who gains and who loses when a country imposes export subsidies? Its domestic farmers gain, since they secure higher prices and greater exports. Its taxpayers lose, since they pay for the subsidies. Its consumers can also lose because the subsidies typically raise domestic food prices. That is because export subsidies encourage farmers to sell more to foreign markets, making less available at home. Adding up the gains and losses to farmers, taxpayers, and consumers, the subsidizing country as a whole is usually worse off.

Other nations that export agricultural products may have to counter with expensive export subsidies of their own or risk being squeezed out of world markets. Consumers in countries that import the subsidized exports may welcome the lower food prices that result, but farmers in those countries would be harmed. Many food importers are developing countries with relatively large shares of their populations working on farms. By depressing food prices in importing countries, subsidized exports can create an artificial disincentive to agricultural investment.

Despite their high domestic costs, countries may be willing to bear the burden of export subsidies in the short run. If U.S. subsidies, for example, counter EC subsidies effectively by displacing EC sales in export markets, the European Community may agree to reduce its subsidies and return trade to a freer basis. The risk of this strategy is that a "subsidy war" may occur, which can send food prices in international markets down and taxpayer costs at home up.

veloping nations, since it accounts for almost a quarter of their manufactured exports. The continued existence and increasing restrictiveness of the global management of textile trade has eroded the confidence of many developing nations in the GATT system.

One of the goals of the United States and other nations in the Uruguay Round is to phase out the policies that currently control textile and clothing trade. The negotiations are aimed at establishing a mechanism to return trade in this sector to the regular rules of GATT over a certain period of time. The transition mechanism

being considered in the negotiations would use the basic structure of the Multi-Fiber Arrangement for those textile and apparel products currently under quota. During the transition the growth rates of these quotas would be increased, and certain products would be progressively integrated into GATT. Furthermore, a special procedure would allow new quotas to be placed on uncovered products and suppliers to keep these imports from disrupting domestic production. If the Uruguay Round talks succeed in phasing out textile and clothing protection, U.S. consumers would save billions of dollars annually.

Services

In 1989 American companies exported over \$100 billion of services, making the United States the world's largest exporter of services. International trade in services, such as insurance, banking, and tourism, accounts for about one-fifth of world export earnings. One important aim of the Uruguay Round is to include in the GATT system a multilateral agreement on principles and rules for trade in services, as well as to eliminate progressively impediments to trade in services. The talks have focused on obtaining a services agreement consisting of three parts: a broad framework agreement—called the General Agreement on Trade in Services—that would lay out principles and rules governing services trade; a set of annexes that would discuss particular service sectors in detail; and a list of commitments by countries to open their services markets to foreign firms.

Negotiations in this area are so new that even the definition of trade in services had to be addressed. The proposed agreement defines services trade as the supply of a service by a firm from one country to a consumer from another country. This definition covers cases in which the firm is located in the consumer's market (such as in banking), the consumer travels to another country to purchase services (such as in tourism), or the firm and consumer are located in different countries (such as telecommunications). The proposed agreement also had to define what constitutes a barrier to trade in services. The proposed definition states that countries should not discriminate among foreign service companies and should treat foreign service firms no less favorably than domestic firms. Any deviation from this standard would constitute a trade barrier. An example of a barrier to trade in services under this definition would be a law that makes it difficult for an insurance firm from one country to set up in another country. One other important principle that would be established by the proposed trade-in-services agreement involves "transparency." This principle would require countries to publish all laws and regulations that affect trade in services.

Intellectual Property Rights

In 1989 U.S. export earnings from royalties and licensing fees amounted to \$12 billion. In the United States and most other industrialized nations, the rights of knowledge creators to earn profits on their creations are protected by laws that make it illegal to pirate patents, software, books, records or tapes, or to sell counterfeit goods. In many countries, particularly in the developing world, laws to protect these rights, known as intellectual property rights, do not exist or are not well enforced. As a result, piracy and counterfeiting of trademark goods and services are widespread. The U.S. International Trade Commission estimated that U.S. industry loses many billions of dollars a year to piracy and counterfeiting. The aim of the United States in the Uruguay Round has been to negotiate a set of international rules governing trade-related intellectual property rights and to erect an effective system to ensure that obligations under GATT and other agreements to protect these rights are enforced.

Investment

The globalization of modern companies means that barriers to foreign investment act as barriers to trade. Because companies investing in foreign countries tend to import many of the inputs they use in production and to export a significant portion of their output, restrictions on investment directly affect the flow of trade. The Uruguay Round has included negotiations on new rules that would restrict the use of investment policies that inhibit or distort trade.

There is no generally accepted definition of what constitutes such a trade-related investment measure (TRIM). Examples include government requirements that foreign multinational corporations use specific amounts of locally produced goods in their products, that foreign corporations export a certain share of their output, and that foreign investors may only use a limited amount of the foreign exchange they earn to purchase inputs. Current GATT rules indirectly cover a few of these measures, but the rules are neither comprehensive nor clear, and their application to developing countries has never been tested.

The U.S. position, shared by most industrialized countries, is that GATT should prohibit TRIMs that inherently restrict or distort trade, establish a test to discipline those nonprohibited TRIMs that can have adverse trade effects, and develop a timeline to phase out existing prohibited TRIMs. The negotiations have been hindered, however, by deep differences of opinion between developed and developing countries. Many developing countries, which are largely host countries for foreign direct investment, insist that control of

such investment through TRIMs is crucial to achieving their development objectives.

In the long run, given the increasing overlap between investment and trade activity, it is desirable to have strong GATT rules covering all aspects of foreign investment—not merely trade-related foreign investment—analogueous to those that cover trade. Even if the Uruguay Round adopts rules regarding trade-related investment measures, nothing comparable to GATT's rules on goods trade would exist for investment. Establishing common, multilateral rules for investment throughout the world is a high priority for the United States because differences in foreign investment policies across countries reduce the benefits that stem from the global production networks of multinational corporations.

Dispute Settlement

An effective and reliable dispute settlement mechanism is an important component of the GATT system. One of the most significant ways in which the Uruguay Round may strengthen the rules-based international trading system is by improving the GATT mechanism that is used to settle many trade disputes among nations. The current procedure establishes a panel of experts that decides the merits of the dispute and announces its findings. While this system has performed reasonably well in many cases, in recent years some nations have complained that the process is too slow and unreliable. These shortcomings reduce the credibility of the multilateral dispute settlement procedure and erode confidence in the GATT system as a whole. Procedural changes that have resulted from the ongoing negotiations have already improved the process. The final goal is a dispute settlement procedure that is swift, reliable, and effective.

Safeguards

GATT recognizes that countries may need to impose new import restrictions to allow import-sensitive industries time to adjust to shifts in competitiveness. Temporary import restrictions for this purpose, so-called safeguard measures, can be imposed if increased imports cause, or threaten to cause, serious injury to an industry. As a general principle, GATT indicates that import restrictions should be tariffs, rather than quotas or other quantity restrictions, and that these measures should be applied equally to all trading partners. GATT also allows all countries affected by the safeguard measures to retaliate or request compensation from the country that imposes them.

These conditions have discouraged the use of GATT's safeguard provisions. As a consequence, countries often rely on bilateral arrangements, such as voluntary export agreements, to limit imports. The EC is by far the leading user of these arrangements, but the

United States, Japan, Canada, Sweden, Switzerland, Norway, and Finland have also used them. These arrangements are not subject to GATT rules of any kind. Their use allows political pressures, rather than market forces, to influence trade flows. These arrangements also tend to favor old suppliers over new suppliers, and to exclude third countries (which may be indirectly affected) from discussion of the design, implementation, and removal of the restrictions. Uruguay Round negotiators are seeking new rules to clarify the conditions under which safeguard measures may be taken and to discourage the use of voluntary export agreements.

Antidumping

The term “dumping” can describe selling a product at lower prices in some countries than in others or selling a product below cost. GATT allows a country whose industries are injured by the dumping of imports to impose a special tariff called an antidumping duty. In the Uruguay Round the United States and other nations seek to update GATT’s antidumping rules to match modern commercial realities and to standardize and clarify procedures for investigations of alleged dumping.

SUMMARY

- The United States and other nations are endeavoring to strengthen, extend, and modernize GATT’s rules governing international trade, as well as to reduce trade barriers worldwide.
- Long-run U.S. goals of multilateral trade liberalization are embodied in the positions taken by the United States in the Uruguay Round. These include extending GATT discipline to trade in agriculture, textiles, services, and intellectual property; ensuring that developing countries take on the full obligations of GATT; establishing explicit international rules for foreign investment; and making the GATT dispute settlement mechanism swift, fair, and effective.
- Successful completion of the Uruguay Round is important to the future growth and prosperity of the United States and the world.

U.S. PRO-TRADE INITIATIVES IN THE AMERICAS AND ELSEWHERE

The primary thrust of U.S. trade policy is to use multilateral discussions and fora such as GATT and the Organization for Economic Cooperation and Development to promote free, rules-based trade. Indeed, the multilateral Uruguay Round negotiations are the President’s top trade priority. The Administration, however, has made

substantial progress toward promoting trade via other channels. This progress is evident in a number of regional and bilateral pro-trade initiatives, as well as in the avoidance of increased protection and a reduction of the overall level of tension in our trade relationships.

U.S.-MEXICO FREE-TRADE AREA

In June 1990 the Presidents of the United States and Mexico strongly endorsed the goal of a comprehensive free-trade agreement between the United States and Mexico (Box 7-4 and Chart 7-2). Such an agreement would progressively eliminate impediments to trade in goods and services and to investment, as well as protect intellectual property rights. The United States already has free-trade agreements with Canada (signed in 1988) and Israel (signed in 1985). In addition, the United States, Mexico, and Canada have been consulting on the possibility of a trilateral negotiation.

Mexico has reduced its trade barriers as part of its across-the-board market reform effort (described in Chapter 6). Since 1985 Mexico has reduced by roughly 70 percent the product coverage of a form of import restriction known as import licensing. Mexico has also lowered its tariffs from an average of roughly 30 percent in 1985 to about 10 percent in 1989. However, this 10-percent average is still much higher than the 4-percent average tariff that the United States has on imports from Mexico. A free-trade agreement would eventually bring both numbers to zero on U.S.-Mexico trade and would eliminate many nontariff measures.

A free-trade agreement would boost the international competitiveness of both U.S. and Mexican firms. To reduce costs, companies often allocate phases of a manufacturing process among a number of nations. A free-trade agreement with Mexico would further encourage this natural international division of labor. By lowering the overall costs of U.S. manufacturing firms, a free-trade agreement would make U.S. firms more competitive against imports in the United States and against other countries' exports in the world market. This gain in manufacturing competitiveness encourages productivity and higher wages. The proposed free-trade agreement would similarly boost the competitiveness of Mexican firms. Additionally, the two-way reduction in trade barriers would benefit Mexico by supporting its market reforms and encouraging economic growth.

INITIATIVES FOR THE AMERICAS

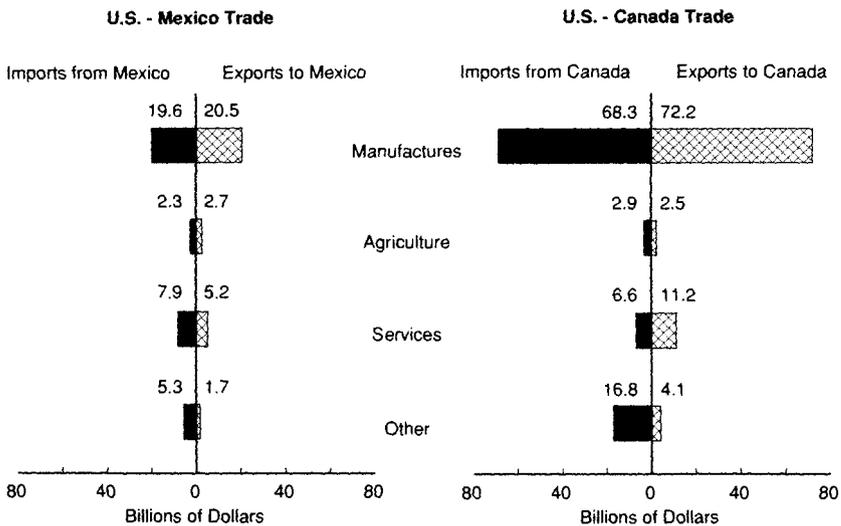
In June 1990 the President unveiled his Enterprise for the Americas Initiative, which will, among other things, pave the way to free trade throughout the Western Hemisphere. The proposed legislation addresses three issues: trade, investment, and debt. Chapter 6

Box 7-4.—The Composition of U.S.-Mexico Trade

Mexico is the third largest trading partner of the United States, after Canada and Japan. About 6 percent of U.S. exports went to Mexico in 1989, while about 5 percent of U.S. imports came from Mexico. The composition of trade with Mexico is quite similar to the U.S.-Canada trade pattern, as can be seen in Chart 7-2. Most U.S.-Mexico trade is two-way trade in manufactured goods. A closer look at the manufactures category reveals that much of this trade is two-way trade in similar products. The four largest U.S. exports to Mexico in 1989 were auto parts, processed food, electronic components, and electrical switchgear. The four largest imports from Mexico were autos and auto parts, electrical distributing equipment, telecommunications equipment, and electrical switchgear. Trade between the United States and Mexico in the manufacturing sector is almost balanced, due largely to Mexico's *maquiladora* program. *Maquiladoras* are export-oriented plants, most often located close to the U.S.-Mexico border, that are exempt from paying import duties on raw materials and parts that are used in making final products. In 1988 about 45 percent of U.S. merchandise imports from Mexico originated in the *maquiladoras*.

Chart 7-2 U.S. Trade with Mexico and Canada, 1989

Two-way trade in manufactured goods dominates U.S. bilateral trade with both Mexico and Canada.



Source: Department of Commerce.

discusses the investment and debt aspects of the Enterprise for the Americas Initiative. *On the trade side, the Enterprise for the Americas Initiative would establish a process that would eventually lead to a hemisphere-wide system of free trade.* As a first step in this direction, the United States would sign bilateral framework agreements with any interested country or group of countries in the region. These agreements facilitate discussion of means to eliminate impediments to trade and investment. The United States has entered into these agreements with Bolivia, Colombia, Chile, Ecuador, Honduras, and Costa Rica. Negotiations have begun bilaterally with Venezuela, Peru, and Nicaragua, as well as with Argentina, Brazil, Uruguay, and Paraguay as a group. Framework agreements are also a possibility in the near future with El Salvador, Guatemala, Panama, Jamaica, and several other Caribbean countries. The next step is to negotiate free-trade agreements with individual countries and groups of countries. Chile, which has a history of open markets, has expressed strong interest in pursuing a free-trade agreement with the United States.

In October 1990 the President sent the Andean Trade Preference Act to the Congress. This proposal would eliminate U.S. import duties on many products imported from Bolivia, Colombia, Ecuador, and Peru. A major goal of this unilateral market-opening initiative is to help these countries battle the production, processing, and shipment of illegal drugs by offering them opportunities to expand production and trade of products that are legal. Passage of this legislation early in 1991 is an important priority for the President. It will help in the fight against drugs and also help promote trade and prosperity in the hemisphere.

STRUCTURAL IMPEDIMENTS INITIATIVE

One of the most significant developments in U.S. international economic policy in recent years is the U.S.-Japan Structural Impediments Initiative. This initiative is a new, cooperative approach to opening markets. Instead of focusing on specific sectoral trade barriers, the initiative is aimed at identifying and removing more basic impediments to trade, market competition, and balance of payments adjustment. The initiative produced a joint report in June 1990. On the Japanese side, the joint report focused on a number of areas, including the aggregate saving and investment balance; laws regarding land use; the structure of the Japanese distribution system, which restricts the establishment and operation of large retail stores in Japan; the organizational behavior of Japanese conglomerates known as *keiretsu*; enforcement of Japan's anti-monopoly laws; improved financial disclosure by Japanese firms; and improved procedures for awarding patents. In the joint report, the United States recognized that priority issues for U.S. policy in-

clude reducing the Federal budget deficit, stimulating private saving, and improving education and training of U.S. workers.

SUMMARY

- In addition to pursuing market opening through multilateral fora, the United States has undertaken several regional and bilateral pro-trade initiatives such as the proposed U.S.-Mexico free-trade agreement, the Enterprise for the Americas Initiative, and the Structural Impediments Initiative.
- The proposed U.S.-Mexico free-trade agreement would boost the international competitiveness of both U.S. and Mexican firms, as well as increase efficiency, flexibility, and growth in both economies.
- The ultimate goal of the trade liberalization components of the Enterprise for the Americas Initiative is a hemispheric system of free trade.

MULTINATIONAL CORPORATIONS AND THE TRADE-INVESTMENT LINKAGE

The 1990s are likely to be marked by the increased globalization of companies, a trend that began in the early post-World War II years and continued throughout the 1980s. The greater global integration of the operations of multinational corporations is the result of increasing foreign direct investment—defined as the development of a new business or acquisition of an established business in a foreign market. It complements the globalization of markets engendered by the expansion of trade.

Indeed, the globalization of companies results in a close connection between trade and investment. This connection can be seen quite clearly in the remarkable extent to which border-spanning companies are involved in trade. About 25 percent of all U.S. exports and 15 percent of all U.S. imports, for example, are actually transfers between parents of multinational corporations and their affiliates abroad; that is, the goods are transferred within the same company, even though they cross international boundaries. The internationalization of operations underlying such “intrafirm” trade often means that a new product marketed globally is the fruit of research and development performed in one country, engineering carried out in a second, and production performed in a third.

The globalization of companies is a two-way street; many countries in which U.S. multinationals are most active are also the ones that are the most active investors in the United States (Box 7-5 and Chart 7-3). The global nature of companies has so progressed that sometimes it is difficult to decide which firms are foreign.

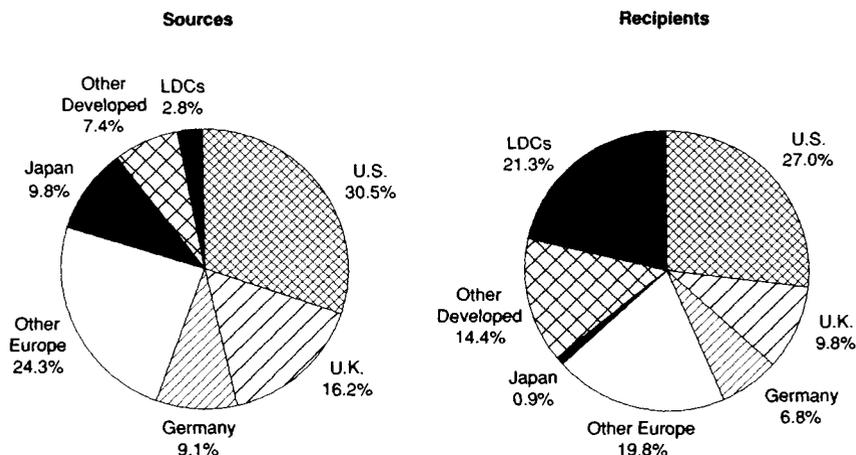
Honda, for example, sells more cars in the United States than it does in Japan. In fact, some Hondas sold in Japan are actually made in Ohio. Whirlpool, while headquartered in Michigan, employs about 39,000 people, most of whom are non-American, in 45 different countries.

Box 7-5.—Foreign Direct Investment: Who Invests and Where?

For most of the period immediately following World War II, only companies based in the United States and in a few other countries developed or acquired businesses in other countries. Such foreign direct investment was mostly in one direction. Countries that did the investing were rarely the recipients of foreign direct investment. Today, the United States not only continues to be the leading source of foreign direct investment, with \$373.4 billion held abroad in 1989, but, as Chart 7-3 shows, it is also the largest recipient of foreign direct investment.

Chart 7-3 **World Stocks of Foreign Direct Investment, 1988**

Many countries that provide large amounts of foreign direct investment are also large recipients. Indeed, the United States is both the largest source and the largest recipient.



Note: Data are based on world stocks of direct investment.
Source: Department of Commerce.

Statistics on foreign direct investment reflect historical purchase prices, not current market values. Thus, comparisons of stocks of foreign direct investment can be quite misleading. For instance, the reported stock of foreign direct investment in the United States reached \$400.8 billion at the end of 1989 and exceeded the reported stock of U.S. direct investment abroad by \$27.4 billion. But much of U.S. direct investment abroad was made in the 1950s and 1960s, while the bulk of foreign direct investment in the United States was made more recently. Because prices have risen considerably since the 1960s, it is likely that the current value of U.S. holdings abroad exceeds the current value of foreign direct investment in the United States.

THE BENEFITS OF FOREIGN DIRECT INVESTMENT

Foreign direct investment in the United States is a sign of strength in the economy, not of weakness. It is also a sign of the increasing internationalization of the economy through which U.S. firms will be strengthened and made more competitive. This investment and the global orientation of companies benefit the United States. The unhindered flow of foreign direct investment leads to additional productive resources in the United States and facilitates the realization of cost-efficient scales of business by consolidating under one corporate roof separate, but related, operations. These boost the productivity and international competitiveness of the United States, create jobs, and promote innovation and productivity. The inflow of foreign capital helps to sustain U.S. investment, despite the current low U.S. national saving rate, and thus contributes to economic growth.

When U.S. multinationals first set up in Europe during the 1950s and 1960s, many Europeans feared that Europe was being bought out by Americans and that their economies were being Americanized. In retrospect, these concerns were unfounded. U.S. direct investment has benefited the European economies. The recent increase in foreign direct investment in the United States will similarly benefit the U.S. economy.

U.S. direct investment abroad also benefits the United States. Extensive production networks of U.S. multinational corporations confer several advantages. One is the ability of such companies to compete more effectively in foreign markets by locating production facilities there, rather than by exporting to those markets. Profits generated by such activities can flow back to the United States, and U.S. affiliates abroad often create demand for exports of U.S. production inputs, services, and technology. Foreign direct investment also provides insurance against the risk of new "host" country restrictions on trade. Finally, U.S. direct investment abroad

contributes to the economic health of our trading partners, which, in turn, fosters greater U.S. economic growth.

U.S. multinational corporations—from computer and electronics companies to pharmaceutical companies—are often at the cutting edge of technology creation. Moreover, they perform the vast majority of their research and development activities in the United States. U.S. multinationals are also major employers of American workers. The ratio of manufacturing jobs to service and wholesaling jobs was about one-fifth higher in U.S. multinationals' parent operations than in their foreign operations in 1988. In general, U.S. multinational corporations today orient their operations toward the U.S. market. Indeed, according to the most recent figures, about three-fourths of total worldwide assets of U.S. multinationals are located in the United States. This share has increased from a decade earlier despite the growth of U.S. direct investment abroad.

It has been claimed that overseas production by U.S. multinational corporations displaces U.S. exports and, in effect, American jobs. A related concern is that U.S. multinationals produce goods abroad and import them into the United States, rather than producing them domestically. Underlying these claims is the mistaken presumption that if U.S. direct investment abroad did not take place, production would have been maintained at home and U.S. exports to foreign markets would have continued. In most cases, if U.S. multinationals did not establish affiliates abroad to produce for the local market, they would be too distant to have an effective presence in that market. In addition, companies from other countries would either establish such facilities or increase exports to that market. In effect, it is not really possible to sustain exports to such markets in the long run. *On a net basis, it is highly doubtful that U.S. direct investment abroad reduces U.S. exports or displaces U.S. jobs.* Indeed, U.S. direct investment abroad stimulates U.S. companies to be more competitive internationally, which can generate U.S. exports and jobs. Equally important, U.S. direct investment abroad allows U.S. firms to allocate their resources more efficiently, thus creating healthier domestic operations, which, in turn, tend to create jobs.

Another issue raised about multinational corporations is that the exports and imports they trade internally do not adjust as completely in the short run to exchange-rate changes as do goods that are traded between unrelated firms. Because of the long-run cost efficiencies associated with maintaining extensive global production networks and because some percentage of a multinational's plant and equipment may not be completely salvageable if facilities are moved, some intrafirm trade flows may well not adjust rapidly to shifts in exchange rates.

Of course, like all trade flows, intrafirm exports and imports do adjust to changes in exchange rates over time. Even in the absence of multinational enterprise, however, the open market for many of the types of products traded internally by multinationals is likely to be dominated by long-term contracts. That is because international business investments typically are economically risky and involve large commitments of capital and highly specialized assets. Thus, any apparent temporary rigidities in multinational corporate trade behavior reflect the fact that these firms have established efficient configurations of operations in the global marketplace. Nonetheless, relatively slow responses of internal exports and imports of multinational corporations to changes in exchange rates may subject U.S. economic policymakers to significant pressure to place restrictions on the way these firms build and maintain their networks of operations. *Imposing such investment-restricting measures will result not only in corporate efficiency losses, and thus potentially lower employment and a decline in profits, but also in a decrease in U.S. competitiveness.*

Foreign multinationals operating in the United States act in ways that are similar to U.S. multinationals in America. Table 7-1 shows that in terms of paying their employees and the value added per employee, these two types of multinationals are roughly the same.

TABLE 7-1.—*Parents of U.S. Multinational Corporations vs. U.S. Affiliates of Foreign Multinational Corporations: U.S. Operations in 1988*

[Dollars]

| | Parents of U.S. multinationals | U.S. affiliates of foreign multinationals |
|---|--------------------------------|---|
| Average compensation per employee | 33,154 | 30,517 |
| Gross product per employee ¹ | 54,229 | 47,117 |
| U.S. intrafirm exports per employee..... | 4,491 | 6,637 |
| U.S. intrafirm imports per employee..... | 3,777 | 31,045 |

¹ Data are for 1987.

Sources: Department of Commerce and Council of Economic Advisers.

In the area of intrafirm trade, however, there are pronounced differences. U.S. affiliates of foreign multinationals export and import more per employee than U.S. multinationals operating in America. While the difference in export behavior is appreciable—exports per employee are 48 percent higher for U.S. affiliates of foreign multinationals than for parents of U.S. multinationals—the more than eightfold difference in import behavior is particularly striking. The difference in import behavior is explained in part by the fact that a significant number of the U.S. affiliates of foreign multinationals act primarily as wholesale marketing offices for their parent companies. The higher import propensity is also a nat-

ural outcome of the relative newness of foreign multinationals in the United States. When U.S. multinationals first set up in Europe during the 1950s and 1960s, they also tended to import more than local companies.

Judging from history, it seems likely that foreign multinationals operating in America will tend to become more "local" with time. As Table 7-2 shows, the importance of imports in the input purchases of U.S. affiliates of foreign multinationals has been decreasing. Correspondingly, foreign multinationals are increasing the extent of vertical integration in their American operations, producing in the United States more of the inputs they use. Moreover, the local content of products made in the United States by foreign multinationals is quite high and has been rising.

TABLE 7-2.—*Parents of U.S. Multinational Corporations and U.S. Affiliates of Foreign Multinational Corporations: Input Supply Choices, 1977 vs. 1987*

[Percent]

| | 1977 | 1987 |
|---|------|------|
| Vertical integration (ratio of gross product to sales) | | |
| Parents of U.S. multinationals..... | 37 | 37 |
| U.S. Affiliates of foreign multinationals..... | 18 | 21 |
| Import propensity in input purchases (ratio of imports to total purchase of inputs) | | |
| Parents of U.S. multinationals..... | 9 | 8 |
| U.S. Affiliates of foreign multinationals..... | 27 | 24 |
| Local content (ratio of local inputs to sales) | | |
| Parents of U.S. multinationals..... | 95 | 95 |
| U.S. Affiliates of foreign multinationals..... | 79 | 81 |

Sources: Department of Commerce and Council of Economic Advisers.

Although foreign direct investment in the United States has increased greatly in recent years, the involvement of foreign firms in America is low by international standards. Indeed, foreign multinationals account for only about 4 percent of U.S. jobs and business output. Moreover, the recent rise in foreign direct investment is not unique to the United States but part of the worldwide trend toward the international integration of markets and companies. Another visible manifestation of this trend is the rise in joint ventures, technology- and production-sharing arrangements, and other forms of international alliances. Such partnerships are found in many industries, such as medical equipment and computer chips.

U.S. FOREIGN DIRECT INVESTMENT POLICY

The complex linkages between trade flows and production operations of multinational corporations underscore the importance of not creating barriers to the free flow of foreign direct investment into the United States. Such barriers would subvert the natural forces of the global marketplace and reduce efficiency and growth. *The benefits engendered by the global production and trade networks of modern multinational corporations point to the undesirability of devising policies aimed at restricting foreign investment.*

Questions raised about what differentiates a "domestic" firm from a "foreign" firm, while conceptually interesting and important, distract from policy questions about how to maintain the strength and flexibility of the U.S. economy. The Administration supports maintaining an open foreign investment policy, with limited exceptions related to national security. This policy produces the greatest possible national benefits from all investments made in the U.S. economy. The United States has long recognized that unhindered international investment is beneficial to all nations, that it is a "positive sum game."

The growing importance of foreign direct investment in the United States has raised concerns about the adequacy and quality of the Federal Government's statistics on foreign direct investment in the United States. The Foreign Direct Investment and International Financial Data Improvements Act, signed by the President in 1990, significantly upgrades government information on this score. Among other things, the new legislation provides for greater coordination among Federal statistical agencies in the collection, sharing, and assessment of data on foreign direct investment in the United States; permits analysis of such data at a more disaggregated level than was previously feasible; and requires the Secretary of Commerce to report annually on the role and significance of foreign direct investment in the United States. These improvements will be accomplished with no additional reporting requirements on businesses and by preserving the principle of nondisclosure of confidential information.

SUMMARY

- The 1990s are likely to be marked by greater global integration of the operations of multinational corporations as a result of increasing foreign direct investment. Concomitantly, the flow of international trade carried out by multinational corporations, especially intrafirm trade, is growing.
- Foreign direct investment in the United States benefits the Nation by providing additional productive resources, thus helping to create jobs and increase productivity. U.S. direct investment abroad benefits the United States by enhancing the competitiveness of U.S. companies, by generating exports, and by contributing to the economic health of our trading partners.
- U.S. affiliates of foreign multinational corporations operate very similarly to U.S.-based multinationals, except that they tend to export and import more. However, this pattern is typical of businesses of such young vintage, and over time this difference is expected to diminish.
- Maintaining an open U.S. and multilateral foreign investment policy, one that results in the greatest possible benefits of in-

vestment without regard to the nationality of investors, remains an important U.S. economic policy objective.

CONCLUSION

International trade and investment have promoted growth and prosperity not only in the United States, but throughout the world. Although largely the product of natural economic forces, trade growth has also been encouraged by the reduction of trade barriers brought about by multilateral, bilateral, and regional market-opening initiatives. Multilateral market-opening talks organized by GATT have been instrumental in reducing trade barriers. Markets in the Western Hemisphere have also been opened by the U.S.-Canada Free-Trade Agreement, and will be opened further if the proposed U.S.-Mexico free-trade agreement and the hemisphere-wide free-trade system envisioned in the President's Enterprise for the Americas Initiative are realized.

In the Uruguay Round, the United States and other countries are seeking to extend, modernize, and reinforce GATT rules, and to reduce trade barriers further. Successful completion of the round and the continued openness of markets worldwide are important. A failure of the Uruguay Round might encourage protectionist pressures that could lead to rising trade barriers around the world. Just as falling trade and investment barriers stimulated growth in trade and incomes, a retreat away from open markets could decrease growth and prosperity. Indeed, if the resulting closing of markets were abrupt and severe enough, it could contribute to a worldwide recession.

The expansion of trade is complemented by the greater globalization of corporations. Indeed, imports and exports between the parents of multinational corporations and their affiliates abroad now account for a significant portion of international trade flows. As a result, today's highly integrated world marketplace is one in which the benefits of trade are generated worldwide by rapid diffusion of new technologies, lower production costs, and greater product choice for consumers. The presence in the U.S. economy of multinational corporations—both U.S.-owned and foreign-owned—is in the Nation's interest. An important U.S. economic policy objective is to maintain open markets for both trade and foreign investment.