CHAPTER 6

Open International Markets and Prosperity

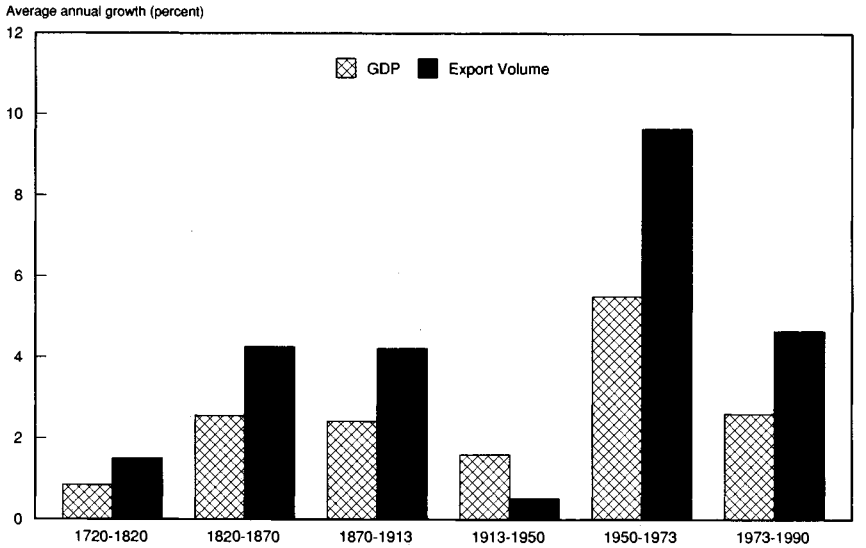
INTERNATIONAL TRADE AND INVESTMENT make important contributions to U.S. and world prosperity. In the broad sweep of history, rising prosperity and rising international trade have gone hand in hand. Indeed, international trade has grown much more rapidly than domestic production in all major periods of the past 300 years, with one notable exception—the period that includes the Great Depression of the 1930s and the two World Wars (Chart 6-1). Domestic economic growth contributes to the rapid growth of international trade; as people have more income to spend, they spend part of it on foreign goods and services. At the same time, increases in trade and investment are powerful engines contributing to efficiency and growth.

Several major developments are under way that could open international markets further and boost worldwide prosperity. These developments come as many countries of the world face the prospect of temporarily slower economic growth. Although such periods often lead to renewed calls for protection, now is not the time for the United States or its trading partners to turn inward: There is simply too much at stake. *Retreating from a focus on open international markets now would undermine opportunities to promote a growing and efficient world economy.*

Foremost among these opportunities is the Uruguay Round of multilateral negotiations under the General Agreement on Tariffs and Trade (GATT). These negotiations, which were initiated at Punta del Este, Uruguay, in 1986, involve more than 100 countries and address a wide array of issues from the reduction of tariffs to the safeguarding of intellectual property rights. The gain to the United States and to the world from a successful Uruguay Round would be large, but the costs of a failed round are potentially enormous: The prospect of a successful round has kept many trade frictions from becoming full-blown trade disputes. The alternative to a successful Uruguay Round is therefore the possibility of an increase in trade disputes and a proliferation of retaliatory tariffs, voluntary restraint arrangements, and other restrictions on trade, which could lead to a period of contracted world trade and slower world economic growth.

Chart 6-1 **GDP and Export Growth Trends, 1720-1990**

Historically, GDP growth and export growth have reinforced each other. Trade has generally grown more rapidly than output.



Note: The figure for first period GDP uses 1700-1820 data. Data are for France, Germany, Italy, Japan, the United Kingdom, and the United States. Not all countries are represented in the first two periods.
Sources: Department of Labor, International Monetary Fund, the World Bank, and Maddison, Phases of Capitalist Development.

Regional initiatives to further liberalize trade and investment are also under way. The United States has entered into negotiations with Mexico and Canada to form a North American free-trade area, which will build on the U.S.-Canada Free-Trade Agreement of 1988 and provide for freer trade and investment throughout the North American continent. These negotiations offer a historic opportunity to create a market with 360 million consumers and a total annual output of more than $6 trillion. Further market openings could come from the hemisphere-wide system of freer trade and investment envisioned in the Administration's Enterprise for the Americas Initiative.

The economies in transition also present new opportunities for trade and investment. The collapse of communism and central planning in Central and Eastern Europe and the former Soviet Union is only the most obvious and recent event in a ground swell of changes to political and economic systems around the world. The reorientation of economic systems toward greater dependence on market forces has become more apparent in other parts of the world as well. Providing open international markets is perhaps the most important single thing that the West can do to help the economies in transition, particularly the countries of the old Soviet bloc, in their efforts to build democratic and market-oriented soci-

eties. While aid—particularly technical assistance—can play a constructive role during the transition, trade, not aid, is the most important force for integrating these economies into the world market.

MUTUAL GAINS FROM TRADE

The case for an open trading system is even stronger today than in 1817, when the English economist David Ricardo first argued for the benefits of free trade on the basis of comparative advantage.

Ricardo argued that countries could gain from specialization and trade by taking advantage of their differences. He showed that whenever the same products sold at different prices in different locations, the possibility of mutually beneficial trade between countries arose. For example, as long as wine was relatively more expensive in England and cloth in Portugal, each country could gain by exporting some of the product that was inexpensive at home in exchange for imports of the product that it found relatively expensive to produce. Through the process of free international trade, the world's resources would be directed to their most efficient uses and the standard of living of each country would be enhanced. With this insight, the basic case for free trade had been established.

Today, as in Ricardo's time, people engage in trade to improve their standards of living. This is true whether the trade is among individuals, among States, or among nations.

States or countries often specialize to take advantage of their distinctive climate or natural resources. Thus, it is the fertile land and plentiful rain that leads Iowa farmers to produce corn; it is the warm climate that induces farmers in Florida to grow oranges. If Iowans sell corn to Floridians in exchange for oranges, both sides gain. Similarly, if the United States sells wheat to Brazil in exchange for coffee, both countries gain. Special skills or technology can likewise lead to specialization; advanced technology enables U.S. companies to manufacture many sophisticated goods more cheaply than foreign countries and to pay high wages while doing so.

Economies of large-scale production provide an additional reason for specialization, even among regions that are broadly similar. It would be enormously inefficient for each American State to attempt to become self-sufficient in every variety of manufactured good and specialized service. For many products, research and development (R&D) costs are significant; their production may also require complex and costly machinery. By extending their production runs, firms can spread their overhead costs and lower the cost of producing each unit.

Thus, in the United States, airplane production is concentrated in the Northwest, automobiles in the Midwest, and motion pictures on the West Coast. Each industry produces for a larger market than any single State could sustain, and exports to other States. Similarly, by exporting to other countries, American aircraft companies can lengthen their production runs, lower their costs, and increase their profit margins; this, in turn, can increase the return to innovation and lead to greater investment in R&D, higher growth, and greater choice for domestic consumers.

For many other countries with much smaller domestic markets than that of the United States—which, after all, is the largest economy in the world—economies of scale provide an even greater incentive to engage in international trade. The Swiss pharmaceutical industry, for example, is dependent upon export markets for its prosperity.

In addition to the gains from trade associated with economies of scale and specialization, reducing barriers to imports of goods and services may produce important investment-enhancing and procompetitive effects, especially in countries with high tariffs and relatively closed markets. The doubling of foreign direct investment in Mexico in the past 5 years, for instance, came largely in response to Mexico's unilateral trade and investment liberalization beginning in the mid-1980s. Moreover, although the lower cost of imports that comes with an open trading system can eliminate some import-competing jobs, an open trading system promotes exports and creates export-related jobs. Export growth accounted for 25 percent of the growth in private industry jobs in the United States between 1986 and 1990.

Just as open international markets permit countries to enjoy the mutual gains from trade, protectionism interferes with the ability to realize these gains. Trade barriers not only raise the price of imported goods to consumers but also the price of domestically produced goods that compete with those imports. Such barriers may help import-competing producers, but they do so by hurting other domestic industries. By encouraging domestic production of import-competing goods, protection acts to discourage a nation's resources from reorienting toward exporting sectors. And where scale economies are important, import barriers can fragment the market in ways that diminish the ability of firms to achieve the benefits of large-scale production.

In practice, the costs of protection can be substantial. Between 1981 and 1985, for example, U.S. imports of Japanese automobiles were restricted by a voluntary restraint agreement (VRA), under which Japan agreed to reduce its exports of automobiles to the United States. According to one study, the higher prices brought about by this VRA cost U.S. consumers $5.8 billion in 1984, while

U.S. automakers gained only $2.6 billion. VRAs on imports of steel into the United States, which will expire on March 31, 1992, have also been costly to the U.S. economy. One study estimates that the elimination of VRAs and tariffs on U.S. steel imports would have saved U.S. consumers more than $800 million in 1988; maintaining this protection provided less than $300 million in benefits to U.S. steel producers.

In agriculture, import quotas for commodities such as peanuts and sugar keep domestic prices high at the expense of U.S. consumers. The sugar import quota, for example, maintains domestic prices that are often two to three times the world price. Losses to U.S. consumers were estimated at $1.9 billion in 1987. The current peanut quota is set at 1.7 million pounds, less than one-tenth of 1 percent of total U.S. peanut production. A recent study estimates that the effects of the peanut quota is equivalent to as much as a 90-percent tariff on peanut imports. Another study estimates that the losses to U.S. consumers because of the peanut import quota totaled over $400 million in 1987. These losses are disproportionately shared by lower income groups who spend a larger share of their income on peanut butter. Higher peanut butter costs affect government domestic feeding and child nutrition programs such as the Temporary Emergency Food Assistance Program.

Losses to U.S. consumers from the sugar and peanut quotas are partially offset by the gains to U.S. producers, through higher prices. Sugar and peanut producers are estimated to have gained $1 billion and $370 million, respectively, from import quotas in 1987. Over time, however, these benefits become capitalized into higher land prices. Thus, farmers who lease land and new entrants into farming pay for much of the "benefit" of import quotas through high rental rates and higher land prices.

While the costs of protection can be substantial, new justifications for protection continue to emerge. The recent focus on industries with scale economies, for example, has raised new questions about the possibility of gains from government intervention designed to "create" comparative advantage in such industries. Academic research on this question, however, has generally reinforced the basic case for free trade and the arguments against government intervention (Box 6–1).

If trade barriers are reduced and market forces allowed to act, countries will export the goods for which they are the relatively efficient, low-cost producers and will import other goods in exchange. As the world economy changes, so too will efficient patterns of international specialization and trade, but gains from specialization and trade remain. Such international specialization promotes low-cost, efficient production and contributes to the economic well-being of all trading nations.

Box 6-1.—Economies of Scale and Trade Policy

As discussions of trade policy have broadened to include industries where scale economies are prevalent and a small number of firms dominate the market, one school of thought has argued that government should intervene to "create" a comparative advantage in such industries, in the expectation that they will provide attractive rates of return.

Far from providing a strong case for government intervention, studies of so-called strategic trade policy generally illustrate more than anything else the pitfalls associated with such a policy. The form of intervention cannot be prescribed without detailed knowledge of industry information, such as the nature of competition among firms, the nature of the research and development process, details of the production technology, and entry conditions in the industry. These information requirements make successful government intervention on a case-by-case basis virtually impossible. Moreover, targeting one favored, "winning" industry to help it achieve large-scale production would typically mean shifting resources away from other industries. Thus, successful intervention in one case is not enough: Anything less than a comprehensive program that *correctly* identifies and implements the prescribed intervention for a wide range of industries is likely to do more harm than good. That makes successful intervention even less likely.

In practice, evidence suggests the futility of a government attempting to "pick winners." The case of Japanese steel has been widely cited as the classic example of successful Japanese industrial policy in the 1960s and early 1970s, yet the very low returns on Japanese investment in steel suggest that this government policy was anything but successful.

Economies of scale are often suggested as a reason for government intervention, including trade barriers to keep out imports that will spoil the home market. But there is a fundamental paradox here. When economies of scale are present, the gains to the world as a whole from open international trade are particularly great. Open world markets permit firms to extend their production runs and lower their costs. Rather than suggesting that governments should attempt to create comparative advantage in selected industries, economies of scale underline the importance of multilateral commitments to refrain from such attempts and the trade-distorting policies that accompany them.

DISTRIBUTIONAL EFFECTS OF TRADE LIBERALIZATION

Even though each country as a whole enjoys lasting gains from the general reduction of trade barriers, some individuals and firms may nevertheless lose, particularly in the short run.

As the tariff on a good comes down, the domestic price of the good generally falls, to the benefit of the consumer. The owners of the firms in this industry generally lose in the short run as the value of their investment declines, and workers may face wage reductions and temporary job dislocations. Protecting the industry in an attempt to avoid this dislocation, however, typically imposes a large ongoing cost on domestic consumers. The annual consumer cost per job saved by U.S. protection against imports of specialty steel in 1988, for example, was estimated to be more than $340,000.

Those who lose in the short run from tariff reductions are relatively easily identified, but the permanent impact of trade liberalization on the distribution of income is difficult to predict. As affected workers and firms find new opportunities in other sectors, their relocation can affect the structure of wages and returns to investment throughout the economy in ways that are complex and indirect.

Finally, a tariff reduction creates lasting gains, but the gainers are often diffuse or hidden. They are the large group of consumers—who often are unaware of the price decrease that lower tariffs cause—and the workers and owners in export industries, who gain as trade barriers fall and export markets increase.

Because the reduction of trade barriers leads to increased efficiency and improved standards of living for the population as a whole, the possibility that some individuals may lose from trade liberalization is therefore not a reason for a country to resist movement toward more open markets. Rather, it is a reason to allow a gradual phase-in of trade liberalization, to give those who will be adversely affected a better chance to adjust. In fact, gradual phase-ins are a standard feature of international trade agreements. Adjustment programs, which in the United States include programs such as Economic Dislocation and Worker Adjustment Assistance, are also available to reduce the burdens and speed the relocation of workers and firms in trade-impacted industries. Finally, the ability to reimpose temporary protection, which is also a standard feature of international trade agreements, provides an important avenue to prevent or remedy serious injury due to increased imports.

THE NEED FOR STRONG TRADING RULES

While each country has much to gain from trade, the temptation to deviate from open trade policies can be very strong. The readily identifiable distributional effects of trade liberalization in the short

run can create strong lobbying interests who resist the removal of trade barriers even when their removal benefits the nation as a whole. And in times of increasing unemployment, the temptation to use protection to stimulate domestic employment at the expense of foreigners may be especially strong.

The presence of such temptations, which all countries are likely to face, does not justify going ahead with that protection, however. Rather, these temptations signal the need for strong international rules to avoid the reciprocal trade wars that would result if all countries shortsightedly pursued such policies (Box 6-2).

Box 6-2.—A Lack of Discipline: The Case of Agriculture

Agriculture has effectively been beyond the discipline of the General Agreement on Tariffs and Trade. This has allowed a web of national policies to evolve that has distorted production patterns and trade. For example, the agricultural export subsidy war being waged by the United States and the European Community (EC) cost EC taxpayers over $11 billion in direct export subsidies in 1988. In the United States, export subsidies totaled more than $1 billion in 1988.

The export subsidies are a direct consequence of agricultural support programs within the EC and the United States. The EC supports high internal prices by subsidizing the export of surplus production. In response to deteriorating market share, some of which was caused by its own high support prices, the United States began subsidizing exports in 1985. Since then, U.S. support prices have been lowered substantially, and new U.S. export subsidies are focused on combating EC subsidies.

The clear winners of the EC-U.S. trade wars have been consumers in the importing countries. At times, U.S. subsidies have been as high as 30 to 40 percent of the world price to counter EC export subsidies, which have been as high as twice the world price. The losers are consumers and taxpayers within the EC and the United States, and producers in nonsubsidizing exporting countries who cannot easily compete with subsidized exports.

In practice, protectionist actions have evoked similar reactions from trading partners. The most notorious episode of "beggar-thy-neighbor" trade policy is the well-known tariff war that erupted with the onset of the Great Depression. Driven by the misguided view that the short-term imposition of tariffs could alleviate the growing unemployment experienced in the U.S. manufacturing and agriculture sectors by "switching" expenditure from foreign to domestic products, the Smoot-Hawley Act of 1930 raised the average

tariff rate on dutiable imports in the United States to 60 percent. Rather than benefiting the U.S. manufacturing and agriculture sectors, the Smoot-Hawley tariffs had the opposite effect by provoking foreign trade partners to adopt retaliatory tariffs. More than 60 nations responded with tariffs of their own within 2 years. A breakdown in world trade followed, contributing to the global depression.

SUMMARY

- The case for an open trading system is even stronger today than when David Ricardo first argued for the benefits of free trade on the basis of comparative advantage. Comparative advantage provides a reason for countries to gain from specialization and trade by exploiting their differences, while economies of large-scale production provide an additional reason to specialize, even among regions that are broadly similar.
- By exporting to the world, American companies can lengthen their production runs, lower their costs, and increase their profit margins. This, in turn, can increase the return to innovation and lead to greater investment in research and development, higher growth, and a greater variety of goods and services for consumers.
- Even though each country as a whole enjoys lasting gains from the general reduction of trade barriers, some individuals and firms may nevertheless lose, particularly in the short run. Rather than serve as a reason to maintain trade barriers, however, this is a reason to provide for a gradual phase-in of trade liberalization and to have effective adjustment programs.
- While each country has much to gain from trade, the temptation to deviate from open trade policies can sometimes be strong. Such temptations signal the need for strong international trading rules.

INTERNATIONAL INVESTMENT

Along with the flow of trade, greater international investment over the past four decades has increased the global integration of markets. International investment takes two forms. Some is *direct* investment, where the investing foreign party exercises control over the management of a business; this is judged to occur when foreign ownership reaches at least 10 percent of the voting equity of the business. The remainder is *portfolio* investment, passive foreign ownership of financial instruments, including corporate stocks or bonds, government securities, or bank deposits.

Worldwide, foreign direct investment flows, which are manifested in the operations of multinational corporations, have grown

since 1983 at an unprecedented rate of 29 percent a year, roughly four times that of the growth of output (with output and investment both being measured at current prices). For the United States, in recent years foreign direct investment has become more significant relative to foreign portfolio investment. Foreign direct investment's share of total foreign investment flows into the United States increased from 13 percent in the 1970s to 23 percent in the 1980s; by 1990, direct investment accounted for 43 percent of total foreign investment flows into the United States. Today, the United States is the world's largest recipient of foreign direct investment. In the other direction, 58 percent of U.S. investment flows abroad during 1990 was direct investment.

THE CLOSE TIES BETWEEN TRADE AND FOREIGN DIRECT INVESTMENT

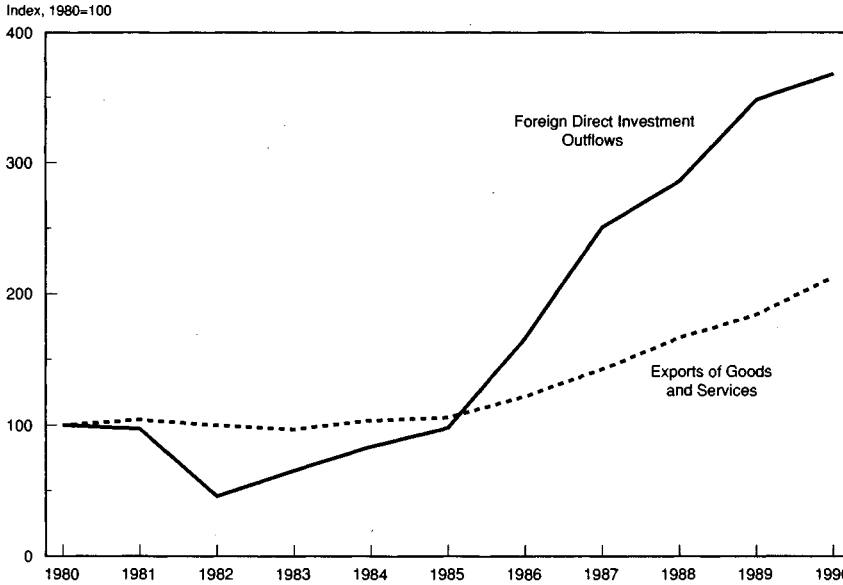
Although foreign direct investment flows are not a new development—the advent of the multinational enterprise dates back several centuries—they are far less extensive than international trade. As Chart 6-2 shows, however, foreign direct investment has grown faster than trade in recent years. By integrating national markets, the recent dramatic increase in foreign direct investment could foster greater trade flows, setting the stage for a new era of global economic growth. Direct investment stimulates companies to be more competitive internationally, which can generate exports. Also, plants established abroad often rely on inputs exported from the home country.

In general, trade and investment do not substitute for one another; direct investment is not likely to displace exports. In many cases, if a firm does not establish an affiliate abroad to produce for a local market, it is likely to be too distant for an export strategy to give it an effective, sustainable presence in that market in the long run. Moreover, in these circumstances, it is likely that companies from *other* countries would ultimately attempt to establish production facilities in the market. Thus, in general it is a mistake to presume that if direct investment abroad did not take place, production would be maintained at home and exports to the foreign market would continue.

Still, there are similarities between trade and investment. As with trade, both "home" and "host" countries gain from foreign direct investment. Indeed, the mutual gains from trade tend to be reinforced by flows of foreign direct investment. The benefits of foreign direct investment also stem from comparative advantage, and many of the factors that determine the flow of trade are similar to those that influence investment. Through their international production networks, multinational corporations move inputs and out-

Chart 6-2 **Foreign Direct Investment Outflows and Exports of G-7 Countries**

Since 1985 foreign direct investment outflows have grown much more rapidly than exports, measured in nominal dollars.



Note: The G-7 countries are Canada, France, Germany, Italy, Japan, the United Kingdom, and the United States.

Source: Organization for Economic Cooperation and Development.

puts among geographically dispersed plants, providing for cross-country specialization, economies of scale, and greater competition.

On a global basis, multinational corporations play a significant role in trade. For example, 28 percent of all U.S. exports go to, and 20 percent of U.S. imports come from, U.S. firms abroad. Generally, in the countries where they operate, foreign-owned multinationals engage in trade more extensively than do their local counterparts.

The rapid growth of worldwide foreign direct investment has been accompanied by a change in its composition. During the 1950s foreign direct investment was concentrated in raw materials and natural resource-based manufacturing; today, it is increasingly in technology-intensive manufacturing and in services, such as banking, insurance, and telecommunications. The shift toward services has been particularly pronounced. Services accounted for 16 percent of cumulative U.S. direct investment abroad in 1982 and for 31 percent in 1990.

The growing importance of the high-technology and service sectors enhances global economic integration. Downsized, high value-added, sophisticated products made from multifaceted, interchange-

able components can be shipped easily for processing. Today, more trade takes place in computer chips and less in heavy machinery.

Openness in trade and openness in investment work hand in hand to enhance prosperity and competitiveness. Both increase the efficiency of resource allocation and raise living standards. There is an important synergy between open trade and open investment flows: Cross-border corporate linkages increase pressure to keep open markets for goods and services as well as for capital. Continued progress toward an open international investment regime can contribute to strong worldwide growth in the 1990s.

THE BENEFITS OF FOREIGN INVESTMENT

International flows of capital through foreign direct and portfolio investment affect growth and the standard of living in several ways. They have kept U.S. interest rates lower than they would have been, thereby helping to sustain private investment and growth despite the Nation's low saving rate. Moreover, they have reduced the interest cost of financing the U.S. Federal budget deficit.

Of course, capital inflows mean that the United States will have to make interest and dividend payments to foreigners in future years. Raising domestic saving is essential to achieving the high levels of investment on which long-run economic growth depends. *A goal of Administration policy is to increase national saving to support a higher level of domestic investment that is sustainable over the long run—a level that can be achieved regardless of future flows of international capital.*

International capital flows in the form of direct investment are also important avenues for transferring technology. Early in this century, such investment emerged as a major conduit for technological know-how, especially between the United States and Europe. More recently, capital flows to developing countries—ranging from Hong Kong to Mexico to Thailand—have increased the diffusion of technology.

Foreign direct investment involves the investment not only of financial and physical resources, but also of entrepreneurial and managerial skills. Indeed, the presence of foreign companies results in "spillover" improvements in the efficiency of local firms through the diffusion of state-of-the-art, productivity-enhancing activities. These transfers are no longer viewed as flowing predominantly in one direction—with a net transfer of American expertise to other nations; there is much that the United States has learned, and will continue to learn, from other nations.

FOREIGN INVESTMENT IN THE UNITED STATES IN PERSPECTIVE

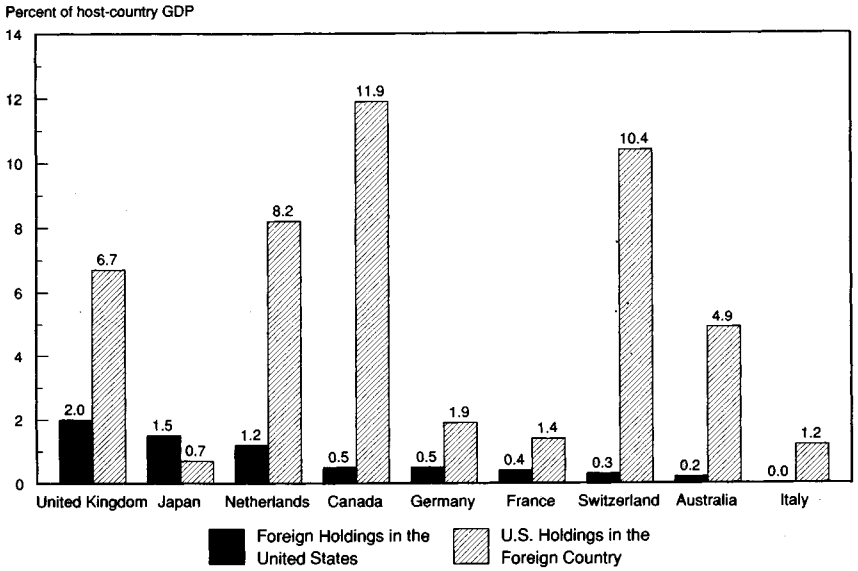
The increase in total foreign investment in the United States reflects both the worldwide trend toward greater economic integration and the American economy's underlying dynamism and attractiveness.

Although flows of foreign direct investment into the United States decreased in 1990 and 1991—due, in part, to the U.S. recession and competing investment opportunities abroad—cumulative foreign direct investment in the United States, as measured by market value, reached $530 billion at the end of 1990, having increased at an average annual rate of 18 percent since 1985.

Still, on a comparative basis, foreign direct investment in the United States remains modest (Chart 6-3). Indeed, foreign multinationals account for only about 5 percent of U.S. jobs and U.S. gross domestic product.

Chart 6-3 **Foreign Direct Investment, 1990**

In most industrialized countries, U.S. holdings of direct investment represent a substantially larger share of host country GDP than the respective foreign country's holdings in the United States.



Note: Japan data based on GNP. German output is for former West Germany.
Source: Department of Commerce and Organization for Economic Cooperation and Development.

As discussed in detail in last year's *Economic Report*, foreign multinationals in the United States generally appear to operate in a manner similar to U.S.-owned companies. On average, however, foreign multinationals do spend more than U.S. firms on wages and on plant and equipment per worker. Available evidence also indicates that R&D spending per dollar of gross product by foreign

manufacturing multinationals in the United States appears to be significantly higher than that by all U.S. manufacturing firms.

Until recently, statistics on stocks of foreign direct investment were quite misleading, primarily because they were based on historical purchase prices, not current market values. Much of U.S. direct investment abroad was made decades ago, while the bulk of foreign direct investment in the United States was made more recently. Because prices have risen over time, historical valuation understates the current value of U.S. holdings abroad relative to that of foreign direct investment in the United States. New valuation measures have rectified this problem (Box 6-3 and Chart 6-4).

Box 6-3.—Measuring International Investment

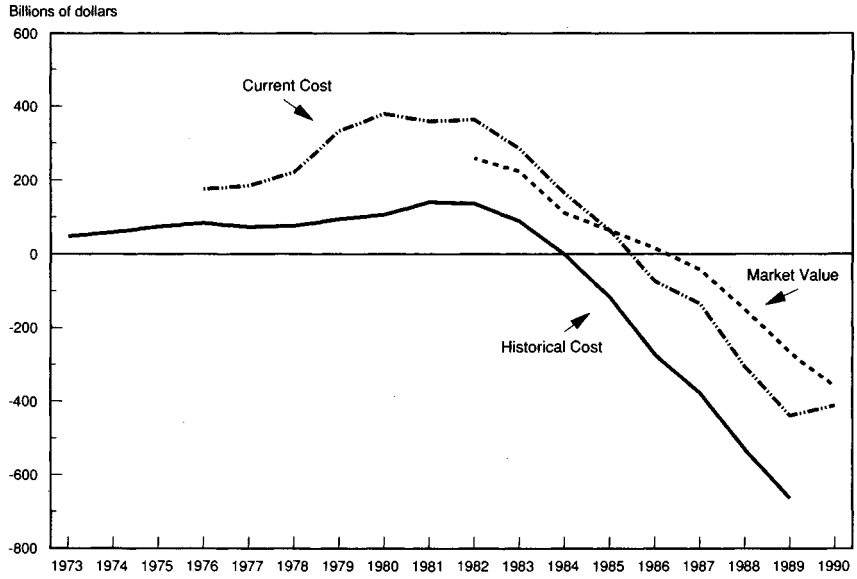
Until last year, data on U.S. direct investment abroad were valued at historical cost, that is, at the original price paid for the investment. These data greatly understated the value of U.S. investments abroad. As a result, the negative U.S. net international investment position was overstated.

In 1991 data were revised to count U.S. direct investments abroad and foreign direct investments in the United States at current cost, or what they would cost to replace. Since much of U.S. direct investment overseas occurred between the 1950s and 1970s, while most foreign direct investment in the United States has taken place in the last two decades, the adjustment from historical cost to current cost increased the value of U.S. investments abroad more than the value of foreign investments in the United States. With the revised method, these international data are now consistent with other fixed investment data, such as the Bureau of Economic Analysis's fixed reproducible tangible wealth and the Federal Reserve Board's estimates of U.S. domestic wealth.

Chart 6-4 shows the net international investment position using historical cost and current cost. It also shows a third estimate for the net position that uses stock market prices to value direct investments. The net position—subtracting foreign direct and portfolio investment in the United States from U.S. direct and portfolio investment abroad—remains negative regardless of how assets are measured. Nevertheless, total income received by the United States on foreign investment is still somewhat larger than total income earned by foreigners on their U.S. holdings.

Chart 6-4 **Net International Investment Position**

On a current cost or market value basis, the negative U.S. net international investment position is significantly smaller than on a historical cost basis.



Source: Department of Commerce.

POLICY TOWARD FOREIGN INVESTMENT

Official U.S. policy toward foreign investment, as reaffirmed in a statement by the President in December 1991, recognizes that unhindered international flows of capital are beneficial to home and host countries alike. The basic principle underlying this open investment policy is that all countries should provide "national treatment" for foreign investment, so that foreign investors are able to make the same kinds of investments, under the same conditions, as local investors. Exceptions to this principle should be few and generally related to national security. The United States has limited foreign investment restrictions in certain sectors as a result of such considerations. These sectors include aviation, nuclear energy, telecommunications, broadcast communications, shipping, and defense. The interagency Committee on Foreign Investment in the United States is authorized to investigate foreign investments to determine their effects on national security and, under certain circumstances, recommend that the President suspend or prevent acquisitions by foreigners.

Despite the growing worldwide recognition that flows of foreign direct investment produce benefits for all countries, national foreign investment policies differ significantly, particularly with respect to rights of establishment, local content restrictions, export

performance requirements, regulations on profit remittance, and protection of intellectual property. *The increased globalization of both markets and corporate production networks is forging an international consensus on the need for multilateral rules governing national policies toward foreign direct investment.* This issue will be considered in more detail below, in the discussion of the Uruguay Round negotiations.

SUMMARY

- The internationalization of companies through increased foreign direct investment complements the global integration of markets through the expansion of trade.
- All countries—both sources and recipients—benefit from investment flows, in terms of greater economic growth, increased competitiveness, and enhanced technology development.
- The increase in foreign investment in the United States reflects not only the worldwide trend toward greater economic integration, but also the attractiveness of the American economy. The volume of foreign direct investment in the United States is modest by international standards.
- The United States' open investment policy is based on the principle of national treatment: Foreign investors should not be treated differently from domestic investors. This policy promotes growth and prosperity.

MULTILATERAL AND REGIONAL APPROACHES TO LIBERALIZATION

The world is currently witnessing a number of major initiatives to reduce barriers to international trade and investment. The United States and 107 other countries are working toward the completion of the Uruguay Round, the eighth round of multilateral negotiations under GATT. At the same time, there are a number of important regional initiatives to reduce barriers to trade and investment below the level that would currently be possible on a multilateral worldwide basis. An important issue is how multilateral and regional approaches to liberalization fit together.

THE MOST-FAVORED-NATION PRINCIPLE AND GATT

Nondiscrimination, or the most-favored-nation (MFN) principle, is the cornerstone of the GATT system. Under MFN, a GATT member undertakes to apply its trade policies in a uniform and like manner to all of its GATT trading partners; it applies the same tariff to imports of a specific product, regardless of which GATT member exported it.

There are two major reasons for abiding by the MFN principle. First, it promotes worldwide efficiency. Under an MFN regime, a country will import from the lowest cost foreign source. In contrast, if tariffs are applied in a discriminatory manner, low tariffs in themselves may be enough to induce importers to choose a less-efficient, higher cost source of supply. Second, MFN greatly facilitates international negotiations to reduce trade barriers. Indeed, the MFN principle was partially based on U.S. experience with the Reciprocal Trade Agreements Act of 1934. Under this act, the United States negotiated 20 bilateral trade agreements between 1934 and 1939. The negotiated tariff reductions in each of the agreements were relatively small, but all the agreements provided for MFN treatment. Such treatment was deemed necessary to move the bilateral negotiations along, since it ensured that each individual negotiating country would receive the benefits of any further tariff reductions that might later be negotiated between the United States and other countries.

EXCEPTIONS: FREE-TRADE ASSOCIATIONS AND CUSTOMS UNIONS

GATT, however, recognizes several exceptions to the MFN rule. First, GATT allows industrialized countries to extend preferential tariff treatment to less developed countries under the Generalized System of Preferences. Second, GATT permits the creation of free-trade areas (a set of countries that eliminate internal tariffs but maintain their independent external trade barriers) and customs unions (which also eliminate internal tariffs but adopt a set of common external tariffs) but only under certain conditions. The two principal conditions are (1) that the formation of a free-trade area or customs union must not result in barriers that are more restrictive to outside exporters than preexisting barriers, and (2) that trade barriers must be eliminated on substantially all trade within the region. If these two conditions are met, the predominant effect of the preferential trading area is likely to be the creation of new, efficiency-enhancing trade among the members. Such trade creation is likely to exceed trade diversion—the redirection of trade from a low-cost supplier outside the region to a higher cost, less-efficient source of supply within the region, simply because the inside supplier escapes the tariff that is applied to the more efficient outside producer. Such trade diversion reduces worldwide efficiency and is particularly harmful to outside countries who lose their markets within the customs union or free-trade area. It is to avoid the harmful trade-diverting effects of preferential trading arrangements that GATT places conditions on free-trade associations and customs unions.

The view embraced in the GATT articles and shared by the Administration is that bilateral and multilateral initiatives can both contribute to international economic efficiency. Free-trade associations that are predominately trade-creating stimulate efficient trade within the region. By demonstrating the prosperity that comes with the elimination of trade barriers, they can also stimulate further steps toward multilateral liberalization.

Although regional free-trade areas can enhance the prosperity that comes from more open international markets, continued multilateral cooperation on trade and investment issues becomes even more crucial in their presence. The absence of such cooperation could lead to increased rivalry and friction among the free-trade areas, to greater barriers to trade and investment among regions, and to reduced prosperity worldwide (Box 6–4). U.S. trade policy is guided by a primary emphasis on multilateral initiatives but sees a beneficial role for bilateral and regional initiatives that are consistent with GATT.

SUMMARY

- There are two major reasons for abiding by the principle of MFN: It promotes worldwide efficiency, and it facilitates international negotiations to reduce trade barriers.
- GATT, however, recognizes an exception to the MFN rule by permitting the creation of free-trade areas and customs unions under certain conditions aimed at ensuring continued access for imports from countries that do not participate in regional trade agreements.
- The view embraced in the GATT and shared by the Administration is that bilateral initiatives can complement multilateral initiatives, by stimulating efficient trade within the region and by stimulating further steps toward multilateral liberalization as well.

THE URUGUAY ROUND

Since its inception in 1947, GATT has proved remarkably successful in orchestrating the reduction of world tariff rates. Through successive negotiating rounds, world tariffs have fallen from an average of 40 percent in 1947 to 4 percent today. However, the expected completion of the Uruguay Round, by far the most ambitious of the eight rounds of GATT negotiations to date, comes at a time when GATT faces great challenges.

A number of developments that have become increasingly clear since the mid-1970s have defined the scope of the round. First, the inadequacy of established GATT rules covering agriculture and textiles has become apparent. Second, several new areas not previous-

Box 6-4.—The Role of Regional Free-Trade Initiatives

Although the benefits of the most-favored-nation (MFN) principle are generally acknowledged, economists disagree about the advisability of allowing exceptions from MFN in the case of customs unions and regional free-trade agreements. One point of disagreement concerns how the existence of such regional free-trade areas might alter the cost of a trade war.

The answer to this question depends in part on which kind of trade—trade based on traditional comparative advantage or trade based on the exploitation of scale economies—is dominant. Regional integration may lead to greater similarity among the resulting free-trade regions—in terms of natural resource availability and overall level of development—than existed among the individual countries. If this occurs, and if trade stems primarily from differences between trading partners as in Ricardo's world of comparative advantage, then free trade among countries within each free-trade area could diminish the need for trade between regions, and the cost of any subsequent trade wars between regions could be small. Where scale economies are important, however, the formation of regional free-trade areas and the creation of large unified markets can increase the potential gains from trading between regions and increase the damage that would result if these regions were to engage in trade wars.

Because specialization and trade based on economies of scale are clearly important in today's economy, even free-trade regions that are broadly similar have much to gain from trading with each other, and therefore have much to lose from the outbreak of a trade war. Avoiding trade frictions through strengthened multilateral trade relations is therefore essential to assure that the formation of regional free-trade areas contributes to greater world welfare.

ly covered in detail by GATT rules have grown in importance and are increasingly in need of international rules—trade in services, international investment flows, and intellectual property rights as they relate to trade in goods and services. Third, the previous success in tariff reduction has increased both the relative importance of nontariff barriers, and the need for better GATT dispute settlement mechanisms. Fourth, the rise in antidumping and countervailing duty actions and the increasing use of trade actions that fall outside GATT restrictions have led many countries to question the efficacy of GATT rules governing the use of so-called trade remedy laws.

In the Uruguay Round, negotiators are attempting to respond to these new challenges, and are also pursuing the more traditional goal of market opening, by seeking agreements in a broad range of areas. Significant progress has been made in clarifying the issues and moving toward possible agreement in a number of the areas. That progress has been slow, however, and considerable disagreement remains. To move the process along, GATT Director General Arthur Dunkel in late 1991 produced a draft agreement that built upon the negotiations over the past 5 years; this draft agreement has become the working text for continuing the negotiations and finalizing the agreement. Although the draft text covers many of the topics, several important areas not covered by the text were left to be negotiated in the coming months, most notably, specific market access commitments in goods and services. Important areas of the working text are discussed below.

AGRICULTURE

Agricultural reforms in the Uruguay Round would mark a historic departure from the costly protectionist measures that have flourished in that sector, largely outside GATT disciplines. These reforms would have significant consequences for farmers, taxpayers, and consumers in the United States and the rest of the world.

Agreements on agricultural reforms fall into four categories: market access, internal supports, export subsidies, and sanitary and phytosanitary measures. First, countries would agree to reduce agricultural tariffs by an average 36 percent from 1986 levels over the 6 years beginning in 1993. Nontariff barriers such as quotas and licenses would be converted to tariff equivalents. Also under the agreement, countries would guarantee a minimum access equal to 3 percent of consumption over the period 1986–88.

Second, countries would agree to reduce internal supports (such as deficiency payments or price supports) by 20 percent over 6 years starting in 1993. Internal supports would be measured using 1986–88 world reference prices and 1986 policies as a base. Government assistance would be permitted under categories of internal support agreed upon as non-trade-distorting. These permitted, or "green box," policies would include, for example, conservation measures, crop insurance and disaster assistance, extension programs, and income payments that are not based on current production levels. Third, under the export subsidies reforms, countries would agree to reduce the volume of subsidized exports by 24 percent and budgetary expenditures by 36 percent from 1986–90 levels over the 6 years beginning in 1993.

Last, the rights of countries to protect human, animal, and plant life and health through sanitary and phytosanitary measures would be recognized. Countries would be prevented, however, from

erecting protectionist trade barriers under the guise of health and safety measures.

These reforms would allow the United States to export more grains to replace subsidized exports of the European Community and allow U.S. consumers to enjoy lower prices for some dairy products and peanuts. Japan and other highly protectionist agricultural markets would begin to open their doors to commodities such as rice. With lower internal supports, disposal of surplus stocks on world markets would be less likely. This, coupled with the gradual reduction of export subsidies, would begin to halt the costly and distortive trade subsidy wars between the United States and the EC.

TEXTILES

Since 1961 world trade in textiles has, like agriculture, effectively taken place outside the discipline of GATT through a series of negotiated side-agreements. These agreements established a special regime of quotas to limit exports of textile and apparel products from developing to developed countries. The accords were ultimately put together to form the Multi-Fiber Arrangement (MFA). At the same time, many developing countries placed exceptionally high tariffs on textile and apparel imports or banned them altogether.

A major objective of the Uruguay Round has been to open world textile and apparel markets and reintegrate these products into the normal GATT regime. Under the working text, this would be done via two channels during a 10-year transition period, which would begin in 1993. First, an increasing percentage of textile and apparel products would no longer be subject to quotas; by the end of the transition period, 51 percent of the volume of those products currently covered by the MFA would have been freed of quotas. Second, during the transition period, the products still subject to quotas would have their quota levels expanded at an accelerated rate. Finally, at the end of 10 years, MFA coverage on the remaining 49 percent of textile and apparel products currently covered by the MFA would be terminated, and all textile and apparel trade would once again be subject to normal GATT rules. In addition, all countries would promote improved access to markets for textiles and clothing through such measures as tariff reductions, reduction or elimination of nontariff barriers, and facilitation of customs, administrative, and licensing formalities. Consumers worldwide would gain billions of dollars annually.

SERVICES, INVESTMENT, AND INTELLECTUAL PROPERTY

Several changes in the global trading environment have combined to place on the table a number of important issues that have never before been the subject of explicit and systematic GATT negotiations. In recent years the importance of services in world trade has become increasingly recognized. Trade in services is now about one-quarter as large as trade in goods. At the same time, the globalization of modern companies and the accompanying intrafirm trade mean that barriers to foreign direct investment act increasingly as barriers to trade. The trend toward globalization has also brought to the forefront the degree to which inadequate protection of intellectual property can serve as a barrier to trade. For example, the inadequacy of a country's patent or copyright protection can permit "pirated" versions to replace exports of legitimate products and can deter foreign direct investment. Together, these changes underlie the efforts of negotiators to formulate international rules governing trade in services, trade-related investment measures and trade-related intellectual property rights.

Services

The General Agreement on Trade in Services (GATS) contained in the working text rests on three pillars. The first is the Articles of the Agreement, which provide legally enforceable rules governing trade and investment in services covered by country commitments. The second pillar consists of several annexes that elaborate the principles as they apply to various sectors such as telecommunications and financial services. The third pillar of the GATS agreement will set out the initial commitments made by each country concerning market access and national treatment.

The creation of GATS would provide the framework for further beneficial liberalization of services in the future, much as the creation of GATT did for goods 45 years ago. Moreover, the initial commitments to liberalization, which will be negotiated in the coming months, should translate into immediate benefits for the United States.

Investment

Companies that invest 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 therefore directly affect the flow of trade. The Uruguay Round has included negotiations on new rules that would discipline 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 firms use specific amounts

of locally produced goods in their products (local content requirements), that foreign multinationals export a certain share of their output (export performance requirements), and that foreign investors use only a limited amount of the foreign exchange they earn to purchase inputs (foreign exchange restrictions). Current GATT rules indirectly cover a few of these measures, but the rules are neither comprehensive nor clear.

The U.S. position, shared by most industrialized countries, is that GATT should explicitly prohibit all TRIMs that inherently restrict or distort trade and develop a timeline to phase out prohibited TRIMs already in existence. Deep differences of opinion between developed and developing countries have hindered these negotiations, however. Many developing nations, which are largely host countries for foreign direct investment, insist that control of such investment through TRIMs is crucial to achieving their development objectives. The proposed Uruguay Round text embodies systematic, explicit prohibitions of some TRIMS. Importantly, however, it does not cover export performance requirements, which are not currently treated even indirectly in the GATT articles.

In the long run, given the increasing links between investment and trade, it is desirable to have strong rules covering all aspects of foreign investment—not merely trade-related foreign investment—analogous 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 continues to be 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.*

Intellectual Property

The current system for protecting international property rights consists of a number of conventions and agreements. Its inadequacy stems from a number of factors. First, not all countries adhere to the existing conventions and agreements. Second, the coverage of the rules themselves is incomplete, permitting, in some cases, exceptions from patent coverage for foods, drugs, and chemicals. Third, these conventions and agreements rely on the principle of national treatment: Each country must afford to others the same intellectual property protection it provides its own citizens. The weak standards of protection within many countries, however, make national treatment an inadequate standard for protection. Fourth, existing conventions and agreements contain no enforcement and dispute settlement mechanisms.

The working text addresses many of these deficiencies by providing a comprehensive set of rules governing trade-related intellectual

property rights. The draft agreement sets new and higher standards for the protection of a full range of intellectual property rights, including patents, copyrights, trademarks, and trade secrets. It also provides for strengthened enforcement of those standards both within countries and at the border. It would subject these standards and enforcement obligations to effective multilateral dispute settlement. The draft agreement would provide substantial benefits to the computer software, pharmaceutical, sound recording, semiconductor, and equipment manufacturing industries.

MARKET OPENING

The working text does not include specific market access commitments, which are to be negotiated in the coming months. If the round is successful, however, participants in the round are likely to reduce their average tariffs by about one-third. This includes a U.S. initiative to create 10 free-trade sectors, where tariffs would be eliminated altogether: Sectors covered by this initiative include electronics, steel, construction equipment, and pharmaceuticals, among others. Under the Zero-for-Zero Initiative, the United States has offered to cut its tariffs to zero in particular sectors provided that other countries agree to cut their tariffs to zero in the same sectors. *To place the importance of the round's market access negotiations in perspective, the 10 free-trade sectors would reduce tariffs to zero on a greater value of U.S. exports than that covered by the U.S.-Canada Free-Trade Agreement and by more than three times the value of U.S. exports to Mexico covered by the North American free-trade negotiations.*

TRADE REMEDIES

The case for open trade does not deny a potentially legitimate role for the use of various trade remedies that allow limited, temporary deviations from open trade. When used appropriately, such trade remedies can actually enhance the benefits of trade and strengthen the international trading system by encouraging countries to reduce their trade barriers and other trade-distorting measures. When used for protectionist purposes, however, these remedies can undo open trade policies and threaten the international trading system. A major focus of the Uruguay Round has been to make changes in the GATT rules governing the use of safeguards, antidumping actions, and countervailing duty actions to ensure that these trade remedies serve their intended purposes.

Safeguards

By allowing countries to impose temporary import restrictions when increased imports cause or threaten to cause serious injury to an industry, safeguards act as an escape clause in trade agreements. An important part of any agreement to which countries

accede voluntarily, safeguards provide some degree of flexibility in what might otherwise be a rigid commitment to liberalization. With appropriate design, the existence of such a safety valve can encourage countries to enter into liberalizing agreements that they might not otherwise. Once countries have entered into such agreements, safeguards can provide them with an agreed-upon avenue to respond to protectionist pressures that might otherwise lead to a breakdown of international cooperation and the outbreak of a trade war. Finally, safeguards can allow for some flexibility while staying within the existing rules, so that extraordinary actions can be taken without sacrificing all the restraining effects that the international rules place on protectionist pressures at home.

The challenge is to design safeguards that are neither inadequate nor too readily available. Safeguard provisions that err on the side of stringency risk the possibility that fissures will develop in the workings of the trade agreement that lead either to trade wars or to "solutions" that in effect operate outside the rules of the agreement. Provisions that err on the side of permissiveness risk the possibility that liberalization embodied in the trade agreement will be undone by frequent safeguard actions. *The changes to GATT safeguard provisions that are contained in the working text represent a balance between these conflicting considerations.* One crucial change would eliminate the loophole that allowed so-called grey-area measures—such as voluntary export restraints, orderly marketing arrangements, and other similar measures—to be applied outside GATT rules (Box 6-5). In addition, the existing requirement that compensation be provided to trading partners when a safeguard action is taken would be waived, provided that the safeguard action lasts 3 years or less. This change would increase the incentive to use safeguard actions only as short-term, temporary measures.

Antidumping and Countervailing Duty Laws

Whereas safeguard actions are designed to remedy a kind of "no-fault" injury claim, antidumping and countervailing duty laws are intended to address unfair trading practices of foreign exporters and their governments, respectively. Under antidumping laws, duties may be imposed on a firm's imports when that firm is found to be "dumping," that is, exporting its product at a price that is below either the selling price in its home market or the cost of production. Countervailing duty law allows the imposition of duties on imports to offset government subsidies.

From the viewpoint of economic efficiency, the circumstances that warrant the imposition of antidumping or countervailing duties are quite narrow. Dumped or subsidized imports have their clearest detrimental effect on economic efficiency if they allow foreign firms to drive out domestic suppliers and monopolize the

Box 6-5.—The Cost of Weak Multilateral Rules

A major objective of the Uruguay Round has been to reinforce General Agreement on Tariffs and Trade (GATT) principles and to strengthen GATT rules that delimit the use of extraordinary measures of protection. The stronger rules would help prevent such aberrations as the Multi-Fiber Arrangement (MFA), which operates under GATT but has deviated from some of GATT's most important principles. The MFA is the latest in a string of "temporary" textile arrangements that began in the early 1960s.

Under the MFA, participants negotiate bilateral quotas that exporters promise to respect. The bilateral nature of the negotiations undermines GATT's fundamental most-favored-nation principle. This has allowed some high-cost countries to continue exporting textiles and apparel while the trade of competitive countries is limited. The negotiation of quotas contravenes GATT Article XI, which states that quantitative restrictions should be avoided. The quantitative restrictions have prompted some countries to export more expensive products, thereby further distorting trade flows. The cost to U.S. consumers of protection in the textile and apparel sector has been high, while the gains to U.S. producers have been much smaller. One estimate put the cost to U.S. consumers at about $11 billion in 1987, while U.S. producers gained slightly more than $4 billion.

The MFA itself would be phased out under the proposed Uruguay Round text. Stronger GATT rules governing the use of safeguards would help to prevent the development of any successor agreements.

market, or if they are sporadic and interfere with the ability of the domestic industry to undertake investment in capital equipment and R&D, and thereby lead to higher prices or lower quality for consumers.

However, antidumping and countervailing duty laws are primarily motivated not by economic efficiency concerns, but by concern for fairness to the import-competing industry. This concern is embodied in the criterion under which dumping is actionable under GATT: A finding that dumped products have injured the domestic industry is both necessary and sufficient to permit the imposition of antidumping duties, regardless of the effect on consumers. An analogous criterion applies for subsidized imports under GATT countervailing duty rules.

A concern for fairness to the import-competing industry is appropriate; however, the abuse of antidumping or countervailing duty

laws for protectionist purposes by any country is unfair to consumers and to exporting firms. The challenge to negotiators in the Uruguay Round has been to strengthen the GATT antidumping and countervailing duty rules, particularly in the area of effective anticircumvention provisions, while at the same time ensuring that such trade remedies are not misused for protectionist purposes (Box 6-6).

Box 6-6.—Strengthening GATT Antidumping Rules

Important changes in the GATT rules governing antidumping procedures are under consideration in the Uruguay Round. These changes could strengthen the ability of the law to prevent injury to import-competing industries from dumped imports at the same time that they could reduce the likelihood that antidumping actions would be used for protectionist purposes.

Several changes under negotiation that have been proposed by the United States are aimed at including provisions against the circumvention of legitimate antidumping orders. Negotiators are attempting to ensure that exporting firms that face antidumping duties may not easily circumvent those duties by, for example, setting up "screwdriver" operations in the importing country. Such operations could allow an exporting firm to circumvent an antidumping duty by exporting the parts and components for final assembly rather than exporting the final product on which an existing antidumping duty has been imposed.

Among numerous changes to methodology offered by other countries and included in the proposed text is the addition of new rules governing the use of exchange rates in the calculation of dumping margins. This change would reduce the chance that normal business practices—specifically, the use of forward exchange contracts tied directly to export transactions—might lead to a mistaken finding of dumping.

DISPUTE SETTLEMENT PROCEDURES

An essential element of any effective trade agreement is the threat of retaliation, or other penalty, if a country does not live up to its end of the agreement. The enforcement mechanism is typically contained in the dispute settlement procedures of the agreement. Without a workable enforcement mechanism, international trade agreements, like any other agreement, would become meaningless.

Section 301 of the Trade Act of 1974 also provides the authority and procedures for the President unilaterally to enforce U.S. rights

under international trade agreements and to respond to certain unfair foreign practices where no trade agreement exists. The inclusion of section 301 in the 1974 Trade Act and subsequent amendments reflects a growing concern that GATT's existing dispute settlement mechanisms are not sufficient and that its inadequate coverage has left policies in important areas of trade and investment undisciplined. This raises a quandary for U.S. trade policy, as it does for all countries that take up unilateral enforcement. On the one hand, negotiating trade agreements without the ability to enforce them is meaningless. On the other hand, unilateral enforcement can weaken the international trading system. The difficulty lies in ensuring that unilateral action is used in a constructive manner. Outside of GATT, there is a risk that conflicts can degenerate into either escalating protection, or "resolutions" that diverge from market principles.

The challenge negotiators face has been to make the GATT dispute settlement mechanism prompt, reliable, effective, and fair. *The working text would provide for tight procedural time limits on the formation and operation of dispute settlement panels, automatic adoption of panel reports, and broad provisions for retaliation should the panel recommendations not be implemented (or compensation not be paid).* With these changes, the new dispute settlement mechanism contained in the working text should become the central means of enforcing trade agreements under GATT. At the same time, by extending comprehensive GATT coverage to include areas such as services and intellectual property, the working text should obviate the need for unilateral actions in those areas.

SUMMARY

- GATT has proved remarkably successful in orchestrating the reduction in world tariff rates over the past 45 years. The expected completion of the Uruguay Round, however, comes at a time when GATT faces great challenges.
- A number of developments have defined the scope of the round, including the increasing inadequacy of GATT rules covering agriculture and textiles; the growing need to extend international rules to trade in services, international investment flows, and intellectual property rights as they relate to trade in goods and services; the need for better GATT dispute settlement mechanisms; and the desire for better GATT disciplines on the use of so-called trade remedy laws.
- When completed, the Uruguay Round has the potential to have a profound effect on the integration of global trade and investment for many years to come, and to provide substantial and lasting benefits to the United States and the world.

THE NORTH AMERICAN FREE-TRADE AGREEMENT

The Administration is in the midst of negotiating an agreement with Mexico and Canada that will build on the U.S.-Canada Free-Trade Agreement of 1988 and provide for freer trade and investment throughout North America. By the end of 1991, the negotiations had made considerable progress in laying out points of convergence and in identifying the main problems that must be solved to reach agreement.

The talks are divided into several negotiating groups. The Administration has important objectives in the areas of market access, services, investment, intellectual property rights, and trade rules. Both within the negotiations on the North American free-trade agreement (NAFTA) and through parallel discussions, the Administration is also addressing concerns regarding the areas of labor and the environment.

MARKET ACCESS

Market access negotiations cover trade in goods among the United States, Canada, and Mexico. *The fundamental goal of the United States is the removal of all tariffs and the removal or reduction of nontariff trade barriers* (the latter include, for example, quotas and import licenses). When necessary, this liberalization should take place over a transition period to ease the adjustment pressures in sensitive sectors. Because Mexico's tariffs are, on average, significantly higher than those of the United States, U.S. exporters have a great deal to gain from these talks.

Areas such as automobiles, agriculture, textiles and apparel, and energy and petrochemicals are complicated enough to merit their own negotiating groups. A number of restrictions specific to the automobile sector have distorted automotive assembly and component manufacture investments in North America. These distortions include a web of local content provisions, export performance requirements, and restrictions on foreign ownership. Integrating the North American automobile market offers great opportunities for U.S. products that have been subject to such restrictions. The sensitive textiles and apparel sector has its own intricate system of protection. Finally, Mexico's constitution limits that country's ability to liberalize the energy sector; for example, it prohibits foreign ownership of domestic oil resources. The United States will respect Mexico's constitutional provision on energy, but there are other areas in which progress could be made to enhance cooperation in this sector.

Duty-free trade in North American goods among the three countries raises the question of what constitutes a North American

good. Because all three participants in the negotiations import raw materials and intermediate goods that are often included in final products, a rule must be formulated to distinguish between products that qualify for duty-free treatment and those that do not. U.S. negotiators are building on the rule from the U.S.-Canada Free-Trade Agreement, which uses changes in tariff classification as the principal criterion for qualifying for duty-free treatment.

TRADE IN SERVICES AND INVESTMENT

In services, the United States seeks additional market openings in Mexico in such areas as banking, securities, insurance, telecommunications, and land transportation. In these areas in particular, market entry is restricted and in some sectors U.S. firms are denied access to the Mexican market. The negotiations can be used to build upon the existing free-trade agreement with Canada to create greater services opportunities in all three countries.

The United States wants to guarantee all NAFTA investors nondiscriminatory treatment when they invest in another NAFTA country. The United States also wants access to arbitrations for the settlement of disputes, guarantees against expropriation, and the right for U.S. firms to repatriate profits from investments in Mexico.

INTELLECTUAL PROPERTY RIGHTS

The United States seeks the achievement of adequate and effective legal protection for the rights of owners of such intellectual property as patents, trademarks, copyrights, and trade secrets. U.S. negotiators are pressing for acceptance among NAFTA parties of the principle of according national and MFN treatment to holders of intellectual property rights. The establishment of measures to ensure timely and effective enforcement of laws governing intellectual property rights is another area of attention.

TRADE RULES

Issues concerning the rules of the trading system are dealt with in the groups on safeguards; antidumping, subsidies, and countervailing duties; standards; and dispute resolution.

As in the Uruguay Round, safeguard provisions are an important element of the NAFTA negotiations. In NAFTA, the United States is seeking a transitional, bilateral safeguard with Mexico similar to its bilateral safeguards with Canada in the U.S.-Canada Free-Trade Agreement. The United States also wants to retain the ability to limit NAFTA imports temporarily as part of a global safeguard action if they contribute to serious injury of a U.S. industry.

The United States is trying to ensure that remedies to unfair trade operate transparently and without unduly burdening busi-

ness in North America. In the area of product standards, U.S. negotiators are insisting on maintaining the right to impose standards more stringent than international standards, where there is a scientific justification for doing so. The agreement, however, will contain provisions to prevent the use of product standards and technological regulations as trade barriers. Finally, the NAFTA parties hope to establish an efficient dispute settlement mechanism to resolve conflicts arising from the NAFTA accord.

LABOR AND THE ENVIRONMENT

When NAFTA was proposed, concerns were raised about its potential effect on the environment and about the treatment of labor in Mexico. These are not among the primary subjects under discussion in the negotiations themselves, since the purpose of the agreement is to liberalize trade and investment. The Administration, however, has addressed and continues to address these concerns in parallel discussions. Government experts in environmental matters and in labor affairs from the United States and Mexico are consulting and cooperating on a broad range of issues. Where it is possible and appropriate, the United States and Mexico are consulting and sharing information with regard to the enforcement of labor and environmental regulations. A successful conclusion of the NAFTA talks should enhance the level of cooperation in these important areas. At the same time, the Administration is committed to working with the Congress to ensure that an effective, adequately funded worker adjustment program is in place when NAFTA takes effect.

SUMMARY

- The Administration is in the midst of negotiating an agreement with Mexico and Canada that will provide for freer trade and investment throughout North America.
- Major goals of the United States in NAFTA negotiations include the removal of all tariffs and the removal or reduction of nontariff barriers to trade in goods among NAFTA countries; nondiscriminatory treatment among NAFTA countries for a broad range of service providers; nondiscriminatory treatment for all NAFTA investors when they invest in another NAFTA country; and the achievement of adequate and effective legal protection among NAFTA countries for the rights of owners of such intellectual property as patents, trademarks, copyrights, and trade secrets.

EC 92 AND EUROPEAN ECONOMIC AND MONETARY UNION

In 1985 the 12 member states of the European Community proposed abolishing nearly all internal impediments to the free movement of goods, capital, services, and people by the end of 1992. At the Maastricht Summit in December 1991, the EC agreed to establish an economic and monetary union (EMU) with a single currency by the end of the decade. The EC also defined a new social charter and forged a closer political union, with common foreign and defense policies the primary goals. Most of the rules for EC 92 are now in place, and the outline of a European economic and monetary union is taking shape. The resulting integration of the European marketplace, the culmination of the 1957 Treaty of Rome, is intended to overcome historical, cultural, and political barriers that have separated these countries for centuries.

Since the late 1960s the EC has operated as a customs union with a common external tariff but no internal tariffs. Yet various nontariff barriers have remained, including differences among the member states in safety, health, and environmental standards; rules governing the operations of financial institutions; internal export and import licensing restrictions; border shipping taxes and customs procedures; intra-EC immigration policies; and public procurement practices. The 1992 reforms are intended to eliminate or substantially reduce barriers by liberalizing financial sector regulations, harmonizing technical standards and aspects of tax systems, and enforcing intra-European competitive bidding in public procurement.

Substantial gains could come from the 1992 reforms. Benefits will come from lower production costs, economies of scale, and reduced transportation costs. Efficiency is likely to increase from more competitive bidding in government procurement and from tax harmonization. Integration of financial services and markets is expected to lower the cost of capital to firms. EC consumers stand to enjoy greater product variety.

For both U.S. exporters and investors, EC 92 offers potential benefits, partly because it creates an integrated market, and partly because the process of integration could promote growth. As a trading partner, the United States (as well as other non-European countries) could gain through increased EC demand for imported products. The realization of these benefits, however, depends on the EC market's openness to external trade and how much more competitive European companies become.

As investors, U.S. firms could gain even more than their European counterparts from EC 92 because American multinationals frequently operate in more than one European country already and

therefore are particularly likely to gain from uniform standards and a reduction in nontariff barriers. Based on decades of foreign direct investment, American firms (in contrast to Japanese firms, other foreign companies, and even some European firms) are accustomed to serving a pan-European market. However, these gains depend on American firms located in Europe enjoying national treatment, that is, the same rights of market access as European firms. Moreover, the advantage some U.S. firms have will not last forever; Japanese automobile and electronics multinationals, for example, will be building up European production facilities, and native European firms will also establish operations in more efficient configurations.

Overall, while the market integration initiatives embodied in EC 92 should foster greater long-term economic growth, they by no means guarantee such an outcome. And, of course, it will not prevent short-term cyclical fluctuations. Europe's prosperity will depend on, among other things, guarding against establishing additional layers of bureaucracy associated with implementation of EC 92.

European monetary union with a single currency and a single central bank would complement the internal market. Monetary union would advance market integration by eliminating the nuisance and cost of switching from one currency to another as borders are crossed, and it would reduce business uncertainties associated with exchange rate variability and divergent monetary and fiscal policies in EC member countries. Monetary union, however, would also eliminate independent monetary policies, and thus limit the policy instruments available to respond to country-specific economic fluctuations. At Maastricht, EC members determined the timetable and conditions needed to move from the current system of limited exchange-rate flexibility to "irrevocably fixed" exchange rates and then to a single currency. Europe should have a single currency by the end of the decade.

Although monetary union is some years away, members of the Community have used the exchange rate mechanism of the European Monetary System to bring about some of the necessary discipline that is a prerequisite to monetary union. The exchange rate mechanism requires exchange rates among the member countries to be kept within a narrow band, which has encouraged a convergence of inflation rates and interest rates. Fiscal stance still differs markedly among the member countries, however, and will have to converge to support an EC currency.

A single currency would prevent exchange-rate adjustments among European countries from absorbing external economic shocks or differences in domestic economic policies; adjustment would have to take place instead through changes in domestic wages and prices.

Therefore, for monetary union to be sustainable, wages and prices in each country need to be flexible. If domestic performance in the member countries "converges" sufficiently, there will be less differentiation among regional wages and prices and therefore less pressure for change. In preparation for monetary union, the EC Council is monitoring the macroeconomic policies of member countries to encourage a convergence of both monetary and fiscal policies. Policies to encourage labor market flexibility in individual member states, as well as policies which may stem from Maastricht's social charter, should further reduce interregion tensions.

The dollar remains the most widely used currency for international transactions and reserves, although in recent years financial innovation and increased international capital mobility have reduced its relative importance. The single currency resulting from the EMU will likely be used along with the dollar in international transactions and world capital markets. It will be an important reserve and transactions asset in non-European countries that trade with Europe. Within Europe, the need to hold dollar reserves will decline as countries consolidate reserve holdings.

Where there is agreement on policy objectives, an EMU may facilitate greater cooperation among the Federal Reserve, the proposed European central bank, and other major central banks in setting their respective monetary policies. This, along with better coordination of fiscal policies, will likely enhance overall world growth. Moreover, because a successful move to the EMU requires flexible labor and product markets, countries have been undertaking structural reforms directed toward greater flexibility. These policies by themselves promote growth.

SUMMARY

- EC 1992 and an Economic and Monetary Union represent successive steps toward integrating the national markets of Europe. Liberalization of trade in goods is scheduled to be completed this year. Economic and monetary union, including a single currency and central bank, is scheduled to be completed before the end of the decade.
- As long as EC integration proceeds in an open manner, U.S. producers in Europe and U.S. exporters are likely to benefit from EC 92 and the EMU. Growth of the European market should be enhanced by efficiencies gained through reduction of barriers and harmonization of standards, by convergence of fiscal and monetary policies associated with the EMU, and by structural changes to labor and goods markets that increase their flexibility.

ACHIEVING MARKET-ORIENTED POLICIES AND GROWTH IN ECONOMIES IN TRANSITION

Around the globe, previously repressive political systems are turning toward democratic pluralism, and heavily controlled economic systems are being restructured to allow market forces to flourish. *Democratic pluralism and market-oriented economies do not guarantee wealth, but they do establish an environment that promotes growth and prosperity.*

Economies in transition—both developing economies with market structures in place and economies emerging from the command system—need comprehensive reforms and balanced policies, both macroeconomic and structural, to create the foundations for long-run prosperity.

The industrial economies can aid the transition with robust, noninflationary growth in their own economies and by opening their markets to encourage international trade. In turn, growth and development of economies in transition will benefit the industrial countries.

POLITICAL CHANGE AND REFORMS

The sovereignty of the Baltic nations and free elections in some of the former Soviet republics made 1991 a watershed year for political change and economic reform. These countries are only the most obvious and recent participants in a surge of change around the world.

In other countries as well, new political beginnings portend new economic eras. Zambia held its first multiparty elections in about two decades. Cambodia achieved peace and scheduled elections after nearly a generation of war. The new Colombian Constitution embraces all peoples in Colombia. The nations in the Middle East are talking instead of fighting. *To no small degree, these political changes are responses to the clear economic advantages of an open and peaceful society.*

These worldwide changes promise to settle intellectual debates that have persisted for decades. The "convergence hypothesis" that emerged in the 1950s held that the capitalist and communist systems would eventually evolve toward each other, with the final result a hybrid of the two systems. It is now unmistakably clear that this hypothesis has been rejected. The developed market economies have reversed their leanings toward socialism, and the leaders in the former Soviet Union, Eastern and Central Europe and the other countries with command-style economies in transition are turning away from these approaches. These leaders instead push market-oriented economics with individual choice and private property rights as the foundations of progress and prosperi-

ty. The failure of economic socialism and central planning have brought about a fundamental rethinking by their proponents. In many respects the model of central planning is no longer even a hypothetical ideal.

CAUSES OF THE MARKET REVOLUTION

Although pressure for market-oriented change had been increasing in many countries for a decade or more, it erupted first in the developments in Eastern and Central Europe during 1989 and 1990 and subsequently in the former Soviet Union in 1991. The fall of the Berlin Wall and the events that followed raised hopes and expectations around the world. Indeed, the unification of East and West Germany is a case study of how poor economic performance has been a major impetus for shifting centrally planned economies toward market economies (Box 6–7).

Box 6–7.—Economic Performance in the Two Germanys

East and West Germany were unified on October 3, 1990, less than a year after the fall of the Berlin Wall in November 1989. At the time of unification, the contrast between the two systems in Germany could scarcely have been more stark. Starting from a similar economic base at the end of World War II and sharing a common culture, East and West Germany went two different ways. West Germany achieved one of the highest standards of living in the world, while East Germany became an industrial wasteland with rundown, outmoded factories and a poisoned environment.

Several contrasting examples make the point. Only 7 percent of East German households had telephones in 1988; in West Germany virtually every one (98 percent) did. Moreover, only a few hundred East German phone lines stretched outside the country. In East Germany, the percentage of households with cars and color televisions was about half that in West Germany. A recent study estimated that productivity in East Germany was, at best, half that in West Germany. Another recent assessment found that, as of 1989, output per capita in East Germany was $9,670, while in West Germany, it was $15,250, almost 60 percent higher.

A fundamental motivation for change—not just in East Germany, but in the other countries dominated by central planning as well—was the failure of their economies to perform adequately. *The economic policies followed in these countries failed because they were unable to provide adequate incentives for producers to supply efficiently the goods and services that consumers wanted to buy.*

The impact of these economic regimes on living standards has been devastating. The repercussions are epitomized in the case of the former Soviet Union. By the time of the attempted coup in August 1991, the Soviet Union had most, if not all, of the generic difficulties inherent in central planning. Other inefficiencies associated with a command-and-control economy were also pervasive. For example, although estimates are imprecise, perhaps as much as a fifth of the Soviet Union's output had been allocated to the defense sector in recent years. Also, because many goods and services had been unavailable for years, Soviet citizens had stored up massive amounts of rubles.

The information technology revolution made the success of market-oriented economies and the weakness of the centrally planned countries more apparent. Ideas flowing easily across national borders spurred momentum for fundamental change. Most East Germans, for example, could receive West German television broadcasts before the Berlin Wall fell. The pressure for change that was created ultimately overwhelmed governments.

PRINCIPLES OF REFORM IN ECONOMIES IN TRANSITION

Regardless of the stage of transition, sound economic foundations and flexible markets create an environment in which individuals succeed and the economy prospers. Institution building, human resource development, and political will are always important for policy success but are especially critical in some economies in transition. Economic policy builds on these foundations to unlock the key engines of growth: productivity increases and private investment.

Three economic fundamentals underpin the market-oriented system: a stable macroeconomic environment, market-determined prices, and private sector entrepreneurship. Key complementary reforms to the legal framework, the financial sector, labor markets, and fiscal systems are necessary to unleash growth. Economies in transition around the world face challenges in each of these economic policy areas.

A stable macroeconomic environment assures people of the value of money. Because goods and services are exchanged for money in a market system, the value of money needs to be reasonably stable for the system to work well. A stable macroeconomic environment also allows savers and investors to look to the long term, by assuring them that a successful investment made today will reap a positive benefit in the future. Many of the most profitable investments take a long time to mature.

Market-determined prices encourage resources to move to sectors with the highest return. Freeing prices allows consumers, produc-

ers, and investors to read the signals of supply and demand, choose products and services that yield the most benefits for the money, maximize returns, and increase well-being. Price liberalization is complete only when the domestic economy is open to international market forces. That requires currency convertibility and liberalizing trade. Markets where prices are flexible adjust more easily to changes in the domestic and international environments.

Entrepreneurship is particularly important. Because restructuring and privatization are slow processes, and because incentives and behavior in large organizations are hard to alter, new private firms and small and medium-sized privatized enterprises are likely to be the major sources of growth and dynamism in economies in transition.

Complementary policies bring together these fundamentals. A solid legal foundation ensures that private property rights are established and respected, which is a prerequisite for entrepreneurship and innovation. A functioning financial sector channels savings to investment opportunities and is the conduit for monetary policy signals to affect the economy. A flexible labor market enables workers to build skills, find the best jobs, and reap the benefits of greater productivity. A fiscal system that raises revenues in a relatively nondistortionary way and undertakes the appropriate level of social expenditures is an integral part of the transition process. A procompetition policy fosters the small and medium-size enterprise sector. A liberal trade regime encourages competition and creates new opportunities for industry and entrepreneurs.

The success of a market economy depends on people who take opportunities that the market creates. In some transitional economies, removing government regulation will help redirect entrepreneurship toward productive activity and away from wasted efforts of jumping through bureaucratic hoops. In other economies with little experience with competition, market-responsive behavior may take time to develop.

PROGRESS AND POLICY CHALLENGES

Economies in transition in Latin America, Africa, Asia, Central and Eastern Europe, and the former Soviet Union have some of the underpinnings of a market economy, have undertaken many of these reforms, and have achieved successes in many areas, although to varying degrees. *Policymakers face different challenges in the various countries to sustain the momentum of development and promote growth.*

In recent years several Latin American countries have improved fiscal and monetary policy control and have made a commitment to trade liberalization and private ownership. Popular support and understanding of economic reforms appears stronger. They have

emerged from nearly a decade of poor performance into a new environment of lower inflation, higher investment, voluntary capital flows, and improved growth.

As the transition to an industrial market economy proceeds, policymakers in each country are focusing on particular challenges that will move the process ahead. In Mexico, for example, privatization of banks, telecommunications, and airlines is widening the private sector's role in the economy. Along with trade liberalization, this privatization will lead to increased competition and greater efficiency in domestic markets. Argentina's Decree 2284, a sweeping deregulation of domestic and international trade and liberalization of labor markets, is strengthening the market mechanism and, combined with renewed vigor in macroeconomic discipline, should create a more flexible environment for further growth. In Chile, policy attention is focused on raising the quality of life by improving education, health, infrastructure, and the environment.

Encouraging the private sector and increasing market opportunities through trade and investment are key elements of U.S. policies for Latin America. Policies include the NAFTA, Enterprise for the Americas Initiative, and the Andean Trade Preference Initiative, the latter two discussed in more detail in last year's Economic Report.

Several African countries have undertaken important reforms to improve the investment climate. Zambia rewrote its investment codes to protect investors against expropriation and to allow profit repatriation. Tanzania, only recently a Marxist regime, opened the private Investment Promotion Center. Policy reforms in many African countries need to be geared to the challenges of achieving sustained growth within the context of low and stable inflation, expanding opportunities for the private sector, and diversifying exports according to comparative advantage.

Many East Asian countries have applied the principles of market economics with great success. Real per capita output growth in the four Asian newly industrializing economies (Hong Kong, Singapore, South Korea, and Taiwan) averaged 7.5 percent annually between 1983 and 1990. Policy challenges remain for these Asian success stories, in particular to reduce government guidance in the financial sector and with respect to investment choice and direction of trade.

Transforming the economies of Eastern and Central Europe into market economies is a difficult, complex, and lengthy process. Progress has been made in economic reform. In less than two years, many of the countries have liberalized prices, and some have approached macroeconomic stability. Most have written new laws and defined property rights. Financial systems are being created,

and privatization is moving forward. While essential regulatory and institutional underpinnings are in place and the spirit of the marketplace is beginning to take hold, expectations for a quick transformation are unrealistic. It will take time for institutions to serve the objective of growth efficiently. All the countries face massive dislocation and restructuring of industry. Finally, a critical mass of citizens must seize their new economic empowerment.

Private sector development is a key element of reform in Central and Eastern Europe. The Administration has encouraged the development of small and medium-size enterprises through the Enterprise Funds (Box 6–8). The Trade Enhancement Initiative has lowered barriers to Central and Eastern European exports of agricultural, steel, and textile products to the United States and has focused on reducing these countries' impediments to exports, both of which should create new opportunities for the emerging private sector.

A range of domestic policy challenges face reformers in Central and Eastern Europe. Hungary's impressive pace of foreign and domestic investment can be sustained only if it quickly revamps its antiquated banking and telecommunications systems. Labor retraining and creation of a housing market would help Poland restructure and privatize its industries, which would also reduce pressure on fiscal balance.

In the former Soviet republics, as in Eastern and Central Europe, a credible and comprehensive economic reform program is a prerequisite for real change. Economic reformers in the former Soviet republics face some unique problems, making their challenges even greater.

Clarifying economic relations among the republics would assist the reform efforts. Continuing trade ties would significantly reduce adjustment costs and aid the overall reform process since a high degree of specialization and interrepublic trade existed in the former Soviet Union. In Eastern and Central European countries, the collapse in intraregional trade has made adjustment much more difficult. Decisions on whether to have one currency, a currency union, or multiple currencies will affect other reforms, such as the responsibilities of the central bank and other financial institutions. Clarifying responsibility for Soviet debt, dividing up Soviet assets, and property right laws are a prerequisite for new investment. Moreover, the allocation of economic decisionmaking responsibilities between republic and local authorities must be determined.

THE ROLE FOR INDUSTRIAL COUNTRIES

Economic development and the transition to pluralistic, market-oriented economies is taking place in the broader context of an interdependent global economy. The industrial countries can con-

Box 6-8.—Enterprise Funds

Creating a private sector from scratch is a daunting task. One innovative approach to help accelerate this process has been the creation of Enterprise Funds, private investment firms that channel U.S. Government grants to the fledgling private sectors in economies in transition.

Four Enterprise Funds, one each for Poland, Czechoslovakia, Hungary, and Bulgaria, have been created. All but the Bulgarian-American Fund are currently in operation. Using more than $400 million authorized by the Congress under the Support for East European Democracy Act of 1989 (the SEED Act), these private, nonprofit corporations help promote small businesses, agricultural projects, and joint ventures between the United States and host country firms. The funds typically make loans, grants, and equity investments, undertake feasibility studies, and offer technical assistance, training, insurance, and loan guarantees.

Enterprise Funds are particularly attractive because they allow private sector participants to select investments that will maximize returns. By raising additional capital from private sources and by reinvesting profits, the financial impact of the initial grant will be multiplied many times over.

About 750 serious business proposals were submitted to the Hungarian-American Enterprise Fund between July 1989, when the President announced its creation, and December 1991. Initial interest among potential entrepreneurs has been substantial. The fund has made investments and loans totaling about $27 million in a variety of projects including a music recording company, a computer and office automation equipment distributor, and a firm engaged in capital equipment leasing.

tribute to the success of the transition process through sustained, noninflationary economic growth and open international markets—actions that will also enhance the performance of their own economies. *A renewed commitment to open markets and policies that encourage competitive and undistorted markets and greater productivity are keys to growth—for both industrial countries and economies in transition.* In particular, the benefits of an open trading regime accrue gradually and build over time. A long-term commitment to free trade based on market principles guides investment at home and abroad to the sectors of greatest productivity.

Although the Uruguay Round offers the most comprehensive, nondiscriminatory approach to opening markets, the Administration has pursued bilateral market opening measures that comple-

ment the multilateral negotiations. These include the Trade Enhancement Initiative for Central and Eastern Europe, and the Enterprise for the Americas Initiative and the Andean Trade Preference Initiative in the Western Hemisphere. These multilateral and bilateral arrangements have two-way benefits. By encouraging growth abroad, they increase exports and growth in the United States.

THE ROLE FOR ASSISTANCE

Aid of several types—humanitarian, financial, and technical—can complement active policy reforms. An infusion of humanitarian and financial aid early in the adjustment process can be particularly important to prevent catastrophic declines in consumption and maintain support for reforms. As the reform process proceeds, properly designed, coordinated, and balanced financial and technical assistance programs from the international institutions and bilateral donors can support and complement private sector development.

Financial aid should be viewed as a transitional mechanism. Over the longer term, sustained growth depends on greater integration into the international trading system and increased access to private capital, both of which depend on comprehensive reforms. Financial aid is not a panacea and can, at times, reduce the momentum of reform. Financial aid that supports an unsustainable exchange rate or an unsustainable level of consumption only delays adjustments that will, in the end, be more difficult. *If policies are sound, economies can prosper without extraordinary official support; if policies are faulty, economies can fail even with abundant external finance.*

Technical assistance is an especially important form of aid that focuses on improving the environment for investment and growth. The Administration's technical assistance program has emphasized the development of the private sector through support for privatization, restructuring, and the development of labor markets and of legal, financial, and business infrastructure, to name only a few areas. The U.S. Agency for International Development provides staff and technical assistance to help design economic policies. The Trade and Development Program in the Department of Commerce finances feasibility and project planning studies to aid industrial development. Developing a partnership between the U.S. Government and the U.S. private sector to further economic development is an objective of U.S. assistance efforts.

The International Monetary Fund, the World Bank, and other multilateral institutions can play a key role, both by themselves and in conjunction with donor nations (Box 6–9). In helping to design adjustment programs for transitional economies, these insti-

tutions can draw on their experiences in other countries. Their presence helps commit governments to market-oriented reforms that will elicit private investment. They can also coordinate and participate with industrial economies in the overall effort through financial and technical assistance and training.

Box 6-9.—International Institutions

Chief among the several multilateral institutions that provide pivotal support to economies in transition are the World Bank and the International Monetary Fund (IMF). The twin financial institutions were created in 1944 to aid in reconstruction after World War II and to stabilize the world financial system. The World Bank is an investment bank. Its historical mission has been to finance specific projects, such as roads, dams, power stations, agriculture, and education, that aid in the development of the world's poorer countries. The IMF is more like a credit union where members pay fees into a pool of resources that supplements members' own foreign exchange reserves when they face problems of external adjustment.

In recent years, it has become clear that coordinated assistance reinforces reform. Development projects are more effective when countries pursue sound macroeconomic policies. Consequently, the two institutions have increasingly focused on medium- and long-term structural reform. Continued lending has been conditioned on policy variables such as money growth, tariff structure, and government deficit levels.

The Organization for Economic Cooperation and Development, the Paris Club, the European Bank for Reconstruction and Development, the Bank for International Settlements, the European Investment Bank, and the International Labor Organization are also cooperating to ensure coordinated and effective assistance. The G-24 (a group of industrial market economies) has been coordinating bilateral financial and technical assistance from its members to Eastern and Central Europe to complement that from multilateral institutions.

SUMMARY

- The dissolution of the Soviet Union is the most recent and spectacular example of the collapse of communism, the failure of central economic planning, and the move toward market principles. A fundamental motivator of change was inadequate economic performance.
- Economies in transition, both developing market economies and economies emerging from the command system, face the

economic policy challenges of establishing and maintaining a stable macroeconomic environment, encouraging competition and market-determined prices, and, perhaps most important, fostering creativity, innovation, and entrepreneurship. These policies will unleash the key drivers of growth and prosperity: productivity increases and private investment.

- The most important contribution the industrial countries can make to economies in transition is to assure robust, noninflationary world growth with open international markets. That will enable economies in transition to grow, and to develop industrial structures based on comparative advantage.
- Financial aid can play an important role at key points, but it is not a panacea. Overall programs of assistance must be properly designed and implemented to ensure that they support rather than undermine reforms. In many economies in transition, technical assistance will be the most beneficial form of aid.

CONCLUSION

International trade and investment are increasing U.S. and world prosperity. Domestic economic growth, together with the decline in transportation costs and improvements in communications, contributes to the rapid growth of international trade. At the same time, increases in trade and investment are powerful engines contributing to efficiency and growth.

An unprecedented number of major multilateral and regional initiatives designed to reduce barriers to international trade and investment are under way that could have dramatic effects on global trade and investment for many years to come. Foremost among these is the Uruguay Round of multilateral negotiations under GATT. When completed, the Uruguay Round has the potential to have a profound effect on the integration of global trade and investment, and to provide substantial and lasting benefits to the United States and the world. The United States has also entered into negotiations with Mexico and Canada to form a North American free-trade area. NAFTA will eliminate trade and investment barriers with the first- and third-largest U.S. trading partners. Additional market openings could come from the hemisphere-wide system of freer trade and investment envisioned in the Enterprise for the Americas Initiative.

At the same time, the nations of the European Community are integrating their economies more closely. The 12 member states are in the process of abolishing, by the end of 1992, remaining internal impediments to the free movement of goods, capital, services, and people.

Along with the collapse of communism and central planning in Central and Eastern Europe and the former Soviet Union, the reorientation of economic systems toward greater reliance on market forces has become more apparent in other parts of the world as well. Providing open international markets is perhaps the single most important thing that the West can do to help the economies in transition, particularly the countries of the old Soviet bloc, build democratic and market-oriented societies. The Administration is committed to achieving and maintaining open international markets for both trade and investment.