CHAPTER 6

The United States in the World Economy

SOON AFTER TAKING OFFICE, the President described the basic principles and goals of his Administration's international economic policy in a February 1993 speech at American University. He committed the United States to active global engagement to promote world trade and growth, to aid the development of less prosperous nations, to address the emerging problems of global environmental degradation, and to encourage market reform in Russia and other parts of the former Soviet empire. The President affirmed that the United States would continue to champion open markets and expanded trade: In the President's words, "We must compete, not retreat." Acting upon these words, the Administration successfully concluded two of the most important trade agreements in the Nation's history: the North American Free Trade Agreement (NAFTA) and the Uruguay Round Agreement under the General Agreement on Tariffs and Trade (GATT).

Like previous Administrations, Democratic and Republican alike, this Administration recognizes that international trade—the voluntary exchange of goods and services across national borders—is a means of increasing standards of living and economic well-being both at home and abroad. During the last half-century, world trade has grown enormously, largely as a result of American leadership in liberalizing global markets. Trade has been a major engine of growth for the world economy since World War II, in marked contrast to the 1930s, when protectionism worsened and helped spread global economic depression. As economists have long predicted, freer trade has been a win-win strategy for both the United States and its trading partners, allowing all to reap the benefits of enhanced specialization, lower costs, greater choice, and an improved international climate for investment and innovation. American industries—both their workers and their owners—have benefited from increased export markets and from cheaper imported inputs. American consumers have been able to purchase a wider variety of products at lower prices than they could have without the expansion of trade.

Recent changes in the global economy pose new challenges and new opportunities for the United States as we maintain our com-

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mitment to an open international trading system. The new opportunities come from the explosion of global markets, while the new challenges come from the development of new global competitors. During much of the last 50 years, the United States was the only global economic superpower. But now there are three: the European Union (EU, the deeper integration of the European Community), Japan, and the United States; and all increasingly interdependent as a result of trade and capital flows, and increasingly competitive. All three superpowers face both intensifying competition from and expanding market opportunities in the rapidly industrializing countries of East Asia, which continue to increase their export competitiveness even as they open their own markets to greater trade and investment. Meanwhile the global trading system is being transformed by the emergence of new democratic and market-oriented regimes in central and eastern Europe, the former Soviet Union, Latin America, and Asia—regimes that have made substantial progress in tearing down their protectionist barriers and are now actively encouraging exports, accepting imports, and seeking foreign capital for development.

This Administration is committed to a high-wage strategy to enable the United States to take advantage of the new opportunities and to meet the new challenges of the changing global marketplace. This strategy consists of two distinct but interrelated parts: trade policies that will promote trade and foster more-open markets both at home and abroad; and domestic policies that will help American companies remain the world's productivity and technological leaders, and American workers remain the most skilled and productive in the world. This two-part strategy reflects the fundamental goal of the Administration's other economic policy initiatives: higher living standards for all Americans. Realizing this goal requires that America compete not on the basis of lower wages, but on the basis of superior productivity, technology, and quality. It also requires that our trade policy be complemented by domestic policies designed to increase labor force skills and facilitate the adjustment of American workers and communities to changing economic circumstances—whatever their source. Other chapters in this *Report* have analyzed the domestic economy. This chapter addresses the international dimension.

TRENDS IN U.S. TRADE

Trade has become increasingly important to the American economy. As shown in Chart 6–1, the share of exports of goods and services in real gross domestic product (GDP) has gradually risen and now stands at a postwar high of 11.6 percent. Between 1985 and 1993, U.S. merchandise exports increased from $222 billion to

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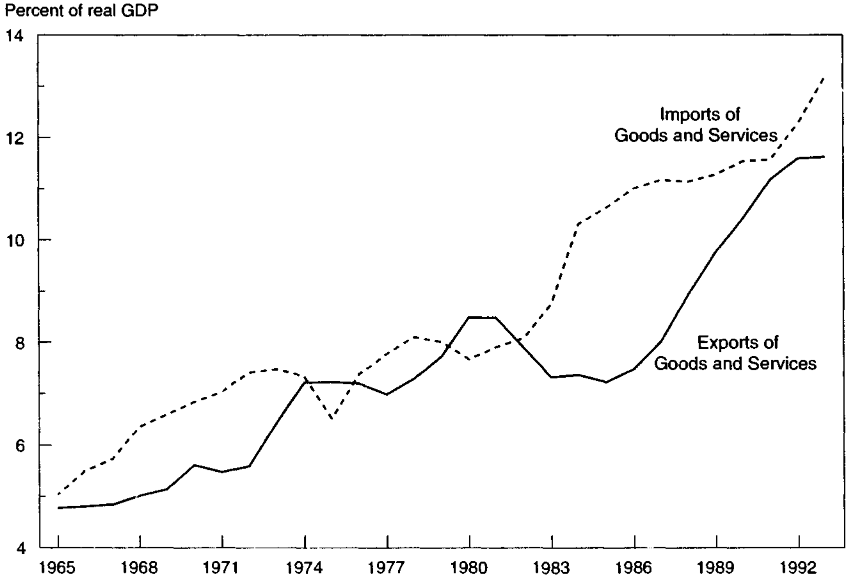
$460 billion in current dollars, and by 95 percent in real terms. By 1992, the United States had regained its status as the world's largest exporter, and one in six American manufacturing jobs was directly or indirectly related to exports.

Chart 6-1 **U.S. Trade as Share of Real Gross Domestic Product**
The importance of trade to the U.S. economy has risen more or less steadily for three decades.



Source: Department of Commerce.

Imports have also grown in significance. As Chart 6–1 shows, the share of imports of goods and services in GDP has increased steadily and is also at a postwar high of 13.2 percent. Perhaps the most striking development has been the increasing role of multinational corporations in U.S. trade and, indeed, the growing importance of intrafirm trade—cross-border trade between the separate operations of a single firm. By 1990, multinational firms accounted for over 75 percent of total U.S. merchandise trade, and around 40 percent of U.S. merchandise trade was intrafirm. And whereas intrafirm trade initially involved mainly U.S.-based multinationals, more recently it has been led by foreign-based firms, especially Japanese firms.

The impact of international trade on the national economy is not restricted to exports and imports. International trade also affects the fortunes of producers who do not directly export or import but interact with producers who do. According to input-output analy-

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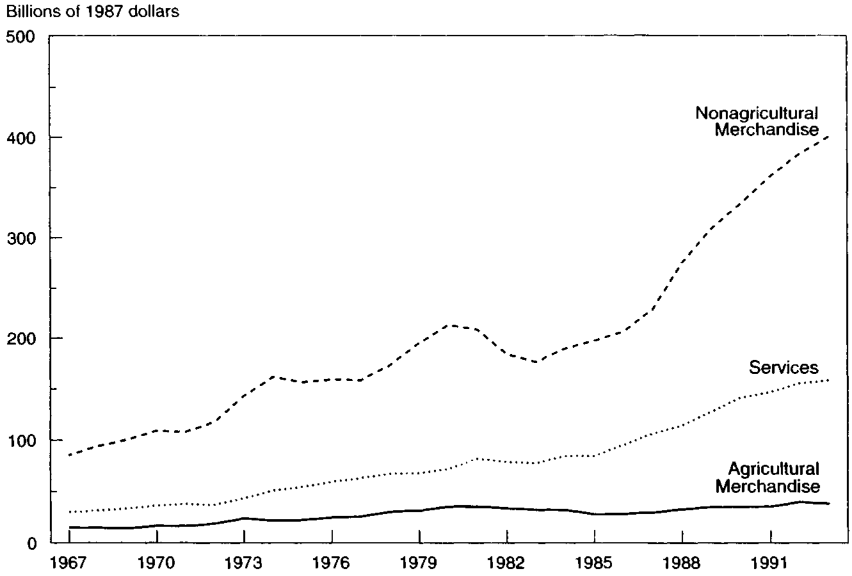
ses, which take such intersectoral or interproducer relations into account, when the indirect effects of trade are included, exports accounted for nearly four-fifths of the increase in domestic production of manufactures between 1987 and 1992. Moreover, exports have become more dependent on imports. Between 1982 and 1987, the most recent years for which data are available, the import content of exports rose from 10 percent to 14 percent. Thus exports are becoming more important for the economy, and imports are becoming more important for exports. Overall, international trade is increasingly vital to American prosperity.

The growth of U.S. trade has been accompanied by significant changes in both its sectoral and its regional composition. As shown in Chart 6–2, real exports of nonagricultural merchandise and services have grown rapidly during the past quarter-century (Box 6–1), while the contribution of agricultural exports has remained relatively small. At the same time, the relative contributions of particular sectors within nonagricultural merchandise trade have been shifting (Table 6–1).

Chart 6-2 **U.S. Exports of Goods and Services**
Exports of services and nonagricultural goods have grown rapidly since the late 1960s.



Source: Department of Commerce.

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Box 6-1.—U.S. Exports: More Than Peanuts

In 1992, American service firms exported to nonaffiliates abroad:

- over two-thirds as much in passenger fares ($17.4 billion), such as seats on U.S.-flagged air carriers, as the United States exported civilian aircraft ($24.5 billion)
- more educational services ($6.1 billion) than the United States exported corn ($5.7 billion)
- more financial services ($5.4 billion) than the United States exported wheat ($4.6 billion)
- more equipment installation and repair services ($2.8 billion) than the United States exported agricultural machinery ($2.1 billion)
- more information services, including computer and data processing and database services ($2.6 billion), than the United States exported aluminum ($1.2 billion)
- more legal services ($1.4 billion) than the United States exported vegetable oils ($1.0 billion)
- more management consulting services ($0.78 billion) than the United States exported milled rice ($0.72 billion) or peanuts ($0.21 billion).

TABLE 6–1.—*U.S. Merchandise Trade by Industry, 1972 and 1992*

[Percent of total]

Industry	1972		1992	
	Exports	Imports	Exports	Imports
Agricultural and forest products	18.5	15.4	11.7	6.2
Minerals	3.1	5.8	2.3	2.3
Fuels	3.2	8.5	2.6	11.1
Chemicals	8.4	3.6	10.4	5.4
Textiles, apparel, leather products, and footwear	3.9	8.8	3.4	10.5
Paper	1.5	2.3	1.5	1.6
Nonmetallic minerals products	1.2	2.3	.9	1.8
Iron and steel	1.7	5.3	1.0	1.9
Machinery	27.0	14.0	30.5	24.8
Transportation equipment	16.9	17.5	17.7	15.7
Furniture and fixtures	.3	.7	.9	1.4
Instruments	2.8	1.6	3.6	3.1
Miscellaneous manufactures	3.7	6.5	5.7	7.7
Other industries	7.8	7.5	7.9	6.3

Note.–The classifications are based on the SITC Revision 1 coding system. Import figures have been adjusted to net out reexports.

Detail may not add to 100 percent due to rounding.

Source: United Nations, Commodity Trade Statistics Division.

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An important sectoral development in recent years has been the growth of high-technology products and industries in both U.S. exports and imports. In 1992, the United States exported $107 billion in advanced technology products, up in nominal terms from $83 billion in 1989. Imports of these products also increased—from $56 billion in 1989 to $72 billion in 1992. Aerospace, information and communications, and electronics together contributed the predominant share of U.S. high-technology exports. These sectors, along with a few high-technology product lines within other industrial sectors, are considerably more export-intensive than U.S. manufacturing as a whole. Indeed, aircraft and computers and office equipment have the highest ratios of export sales to value added among all manufacturing industries.

Heightened foreign competition and the globalization of production (technology respects no border) have made many high-technology industries relatively import-intensive as well. In fact, the most export-intensive of America's high-technology industries (with the marked exceptions of plastics and aircraft) are now also the most import-intensive. The electronics industries have been the arena of the most dramatic penetration of the U.S. high-technology market, both because Japanese and East Asian electronics producers have become more formidable competitors, and because American electronics multinationals have spread their own production around the world.

Just as the commodity composition of U.S. trade has been changing, so has its geographical composition. As shown in Table 6–2, the shares of U.S. exports going to and imports coming from developing countries have risen, while the shares to and from industrial countries have fallen. These trends reflect the fact that the developing countries as a group have been growing more rapidly than the industrial countries.

TABLE 6–2.—*U.S. Merchandise Trade by World Region, 1972 and 1992*

[Percent of total]

Region	1972		1992	
	Exports	Imports	Exports	Imports
Industrial countries	66.8	72.4	58.5	57.7
Japan	10.0	16.3	10.7	18.0
European Community [1]	26.8	24.0	23.0	17.6
Other	30.0	32.1	24.9	22.1
Developing countries	33.2	27.6	41.5	42.3
Asia	8.9	9.6	16.6	22.8
Middle East	4.1	1.6	4.5	3.1
Western Hemisphere	14.6	12.6	16.9	13.0
Other	5.6	3.8	3.5	3.4

[1] Membership as of 1992.

Note.–Detail may not add to totals due to rounding.

Source: International Monetary Fund.

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The fast-growing countries of Asia have provided a rapidly expanding market for U.S. exports; their share of the total nearly doubled from 9 percent in 1972 to 17 percent in 1992. Indeed, by 1992 our trans-Pacific trade was 50 percent greater than our trans-Atlantic trade. The increasing importance of Asia in U.S. trade appears to contradict the common contention that the world is devolving into three trading blocs centered on Europe, Asia, and North America. Nor is such a conclusion supported by more-sophisticated evidence. When researchers have modeled the pattern of trade flows among different countries, they have found no real evidence that intraregional trade flows in Asia are unusually large once economic fundamentals are taken into account. The observed increases in intraregional flows can be explained largely in terms of differences in economic growth rates and geographical proximity. Likewise, when researchers have looked at financial flows, exchange-rate determination, and the like, there is little evidence that a "yen bloc" is developing in Asia.

In addition to leading the world in trade, the United States leads the world in the stock of foreign direct investment, both as investor and as recipient. In 1992, U.S. firms owned 25 percent, and the United States hosted 22 percent, of the world's foreign direct investment stock. The largest hosts of outward U.S. foreign direct investment (ranked in order of importance) are the United Kingdom, Canada, Germany, Switzerland, and Japan, which together account for nearly half the total (Table 6–3). Similarly, five industrial countries (again ranked in order of importance)—Japan, the United Kingdom, the Netherlands, Canada, and Germany—account for more than three-quarters of existing foreign direct investment in the United States. The predominant role of high-wage industrial countries in *both* inward and outward foreign direct investment in the United States refutes the popular notion that such investment is motivated primarily by the search for lower wages. In fact, many foreign investment decisions are motivated by other considerations, most often the need to have an active presence in large or rapidly expanding markets or the need to overcome trade and other barriers that impede access.

It is sometimes argued that outward foreign direct investment "exports" jobs. However, the parallel expansion of two-way foreign direct investment and intrafirm trade suggests that such investment is more likely to complement rather than substitute for trade, creating high-wage jobs domestically rather than destroying them. Several recent studies have concluded that foreign direct investment is more likely to create trade than reduce it. Another recent study found that inward foreign direct investment brings with it competition, new technologies, and new management techniques,

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TABLE 6–3.—*Stock of U.S. Outward and Inward Foreign Direct Investment, 1992*

Country	Billions of dollars
INVESTMENT BY U.S. FIRMS ABROAD (OUTWARD):	
United Kingdom	77.8
Canada	68.4
Germany	35.4
Switzerland	28.7
Japan	26.2
All countries	486.7
INVESTMENT BY FOREIGN FIRMS IN THE UNITED STATES (INWARD):	
Japan	96.7
United Kingdom	94.7
Netherlands	61.3
Canada	39.0
Germany	29.2
All countries	419.5

Note.—All figures are on a historical cost basis.

Source: Department of Commerce, Bureau of Economic Analysis.

each of which has contributed to the resurgence in U.S. productivity, further enhancing national competitiveness.

TRADE, JOBS, AND WAGE INEQUALITY

In the short run, both the level of output and the level of employment in the American economy depend on the level of aggregate demand. One component of aggregate demand is net exports, the difference between exports and imports. Thus, as long as there is slack in the economy, an increase in net exports will stimulate production and create jobs. For example, most scholars estimate that NAFTA will create additional American jobs over the next several years because it will boost U.S. net exports to Mexico. Once the American economy nears full employment, however, additional net exports could create upward pressure on prices as well. Even when the economy is at full employment, however, and even if trade liberalization increases both imports and exports equally, leaving net exports unchanged, the American economy still reaps the benefits of freer trade in the form of greater productive efficiency, lower prices, and higher living standards.

Despite the possible benefits of trade liberalization for the level of employment in the short run, and the certain benefits of trade liberalization for living standards in the long run, some observers worry that expanding trade with developing countries will depress the wages of low-skilled American workers. As explained in Chapter 3, wage inequality has, in fact, increased over the past two decades as the share of trade in the U.S. economy has grown. Not surprisingly, concerns have been voiced that greater international trade may be responsible for greater inequality in the wage distribution.

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Such concerns are plausible and are consistent with economic theory. Skilled labor is relatively abundant in the U.S. economy. According to theory, when the United States trades with economies in which unskilled labor is relatively abundant, we will tend to export products requiring skilled labor and import products using unskilled labor. The relative prices of skill-intensive goods will therefore rise in the United States, and U.S. production will expand in export industries and contract in industries that compete with imports. Demand for skilled labor will rise, while demand for unskilled labor falls. These changes in labor demand will raise the wages of skilled workers relative to those of unskilled workers. Thus, on *a priori* grounds, one might expect an expansion of trade with developing countries to lead to greater wage inequality in the United States.

Despite the plausibility of the theoretical argument, however, several studies find that it is difficult to discern any substantial impact of trade on wage inequality. Economists have posited a systematic relationship between the relative prices of goods and the relative returns to factors of production. If increased trade with developing countries were the cause of growing wage inequality, the relative prices of goods that use highly skilled labor would be rising relative to those of goods that use unskilled labor. However, one study has found no evidence that the relative price of skill-intensive goods has risen in the United States. Indeed, it is difficult to find any evidence of the changes in relative prices that would be required for changes in trade patterns to have altered the relative returns to different types of labor.

Similarly, if increased trade were responsible for increased wage inequality, the growth in wage differentials would lead firms in all sectors to substitute unskilled labor for skilled labor. Instead, studies find that virtually all manufacturing industries have increased their relative use of skilled labor despite growing wage differentials. Rising wage differentials along with greater use of skilled labor suggests that demand for skilled labor has been rising broadly in the economy. As expected, these wage differentials have led to an upgrading of skills in the work force, allowing firms to meet their rising demand for skilled labor.

Taken together, this evidence (little change in relative prices, and economy-wide increases in the demand for skilled labor) suggests that growing demand for skilled labor has resulted from widespread changes within industries rather than from changes in the structure of production engendered by greater trade. The preponderance of evidence indicates that the primary sources of growing wage inequality are domestic rather than foreign. As discussed in Chapter 3, the sources of wage inequality are difficult to pinpoint, but to the extent that growing inequality can be explained,

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technical change has been offered as the leading candidate. Increased trade with developing countries may have reinforced some of the changes in wages caused by technological change, but careful studies have failed to discern a sizable impact of trade on wage inequality.

Two explanations of this finding have been offered. First, although trade with developing countries has been growing, most U.S. trade—about 60 percent—still involves other industrialized countries whose skill levels and wages are similar to those in the United States. Second, while trade is a growing part of the U.S. economy, it remains a relatively small part. Only extremely large changes in the composition of trade could have a discernable impact on wages and wage disparity in the U.S. economy.

Nonetheless, the expansion of trade will inevitably disadvantage some workers in the short run. One goal of Administration policy, as described in Chapter 3, is to facilitate the adjustment of the labor force to changing economic circumstances whatever the putative source of change. It is by recognizing both the opportunities and the challenges presented by the changing global economy that the Administration seeks to achieve a productive and stable basis for U.S. engagement in the world economy.

THE ADMINISTRATION'S TRADE INITIATIVES

The Clinton Administration supports the goal of freer trade on a reciprocal basis. In pursuit of that goal, the Administration is dedicated to working with the private sector and its trading partners to open foreign markets through bilateral, regional, and multilateral trade agreements. At the same time, the Administration believes that trade policy should complement, not substitute for, domestic policies to enhance the global competitiveness of American companies and their workers and to make the United States an attractive production location for both domestic and foreign firms.

DOMESTIC INITIATIVES: THE NATIONAL EXPORT STRATEGY

The Administration's trade policy begins at home with an activist commitment to promote American exports both by reducing domestic barriers to them and by improving the efficiency of our export promotion programs. Working within the interagency Trade Promotion Coordinating Committee, created by the Congress to reduce the fragmentation of our export promotion programs, the Administration unveiled a new National Export Strategy in September 1993. This strategy reflected six underlying themes: streamlining and combining functions across agencies, allocating resources stra-

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tegically, involving the private sector and State and local governments, effectively advocating the interests of U.S. exporters abroad, measuring performance, and reducing export controls (restrictions on exports to meet national security, antiproliferation, or foreign policy objectives). Among the actions to be undertaken immediately are:

- Revising outmoded export controls on high-technology products. The specific technical revisions are expected to reduce regulation significantly on an estimated $35 billion worth of high-technology exports. For example, export restrictions that previously affected sales of even some personal computers to many foreign markets have been relaxed.
- Consolidating all Federal export promotion services in one location to facilitate "one-stop shopping." Initially, four centers will be created; more will be added until a national network has been created.
- Providing high-level government advocacy on behalf of U.S. firms pursuing major foreign government procurement opportunities through an interagency "Advocacy Network" and an "Advocacy Center" located in the Department of Commerce.
- Improving our export finance programs by combating the "tied aid" practices of other nations, increasing the limits on insurance guarantees by the Overseas Private Investment Corporation, broadening assistance to U.S. companies seeking to participate in activities funded by the multilateral development banks (such as the World Bank), and combining into one agency the infrastructure feasibility funds that are the seed money for U.S. firms' participation in major infrastructure projects abroad.

Taken together, the actions outlined in the National Export Strategy are expected to increase both the responsiveness and the efficiency of export promotion efforts.

BILATERAL NEGOTIATIONS

Along with these unilateral actions, the Administration has engaged numerous foreign countries in bilateral trade talks. The most prominent of these efforts has been with Japan.

The U.S.-Japan Framework Talks

Japan presents a special case for the United States. Japan is the world's second-largest economy, after the United States, and our second-largest trading partner, after Canada. And it is with Japan that the United States maintains its largest bilateral merchandise trade imbalance: a deficit of $49.6 billion in 1992 (Table 6–4). (In the same year, we enjoyed a $13.3 billion surplus with Japan in services trade.) Japan's large surplus with the United States is an important part of its large global current account surplus (the cur-

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rent account is a broader measure of trade that includes both goods and services), which stood at $118 billion in 1992.

TABLE 6–4.—*U.S. Merchandise Trade Balances with Selected Countries, 1987–92*

[Billions of dollars]

Year	European Community	Japan	"Greater China"				Rest of world
			Total	People's Republic of China	Hong Kong	Taiwan	
1987	-20.6	-56.3	-25.9	-2.8	-5.9	-17.2	-49.3
1988	-9.2	-51.8	-20.6	-3.5	-4.6	-12.6	-36.9
1989	1.2	-49.1	-22.6	-6.2	-3.4	-13.0	-38.9
1990	6.3	-41.1	-24.4	-10.4	-2.8	-11.2	-42.5
1991	17.0	-43.4	-23.7	-12.7	-1.1	-9.8	-16.6
1992	9.0	-49.6	-28.4	-18.3	-0.7	-9.3	-15.5

Note.—Exports are f.a.s. and imports are customs value.
China, Hong Kong, and Taiwan have been grouped together as "Greater China" for analytical convenience.
Detail may not add to totals due to rounding.

Source: Department of Commerce, Bureau of the Census.

Moreover, certain of Japan's trade patterns appear to differ from those of other major industrial countries. Japan has an unusually low share of manufactured imports in domestic consumption, an unusually low share of intraindustry trade, an unusually small stock of inward foreign direct investment, an unusually small share of domestic sales accounted for by foreign-owned firms, and an unusually high share of intrafirm trade, which is predominantly controlled, moreover, by Japanese rather than foreign-based firms.

Manufactured imports play a relatively small role in the Japanese economy, with the share of manufactured imports in consumption less than half that of the other major industrialized countries (Table 6–5). And while this measure has risen considerably in the other countries, it has remained relatively unchanged in Japan for 20 years.

TABLE 6–5.—*Selected Trade Indicators for Six Industrialized Countries, 1990*

Indicator	Japan	United States	Germany	United Kingdom	France	Italy
Import share of domestic consumption of manufactures (percent)	5.9	15.3	15.4	17.7	13.7	12.6
Intraindustry trade index	.58	.83	.73	.79	.77	.67
Foreign firms' share of domestic sales (percent)	1.2	16.4	14.0	[1] 24.1	28.4	(2)

[1] Data for 1989.
[2] Not available.

Note.—Intra-European Community trade has been excluded from the intraindustry trade and import share calculations.

Sources: Institute for International Economics; United Nations, Commodity Trade Statistics Division; World Bank; and Department of Commerce.

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Another interesting aspect of Japan's trade pattern is its relatively low level of intraindustry trade—trade in differentiated manufactures within a given industry. (One common example is trade in different makes and models of automobiles.) As economies develop and the demands of firms and consumers become more complex, individual firms become less able to produce the vastly broader range of products required to satisfy all demands. Intraindustry trade then increases, as firms penetrate each others' domestic markets to supply those particular products in which they specialize. Intraindustry trade, it is sometimes argued, is of particular importance because the adjustment costs associated with an expansion of intraindustry trade are thought to be lower than for a comparable expansion of interindustry trade—import-competing firms can retool and specialize rather than disappear. If this is so, expansion of intraindustry trade should be more compatible with trade liberalization.

Japan also exhibits an unusually high share of intrafirm trade. Intrafirm trade is important both as a major channel of trade and because intracorporate transactions may be less responsive to normal price and cost determinants than are arm's-length transactions.

This issue is of considerable interest with regard to Japan because of Japan's unusual pattern of intrafirm trade. For most countries, intrafirm trade is dominated by shipments from parent firms to their foreign affiliates. That is to say, intrafirm trade is export-oriented. Japan is unusual in that Japanese parents dominate trade in both exports *and* imports. Some researchers have attributed this dominance to the prominent role of giant trading companies and *keiretsu* relationships in Japanese trade and argue that this pattern of trade is consistent with imperfectly competitive Japanese domestic markets. (*Keiretsu* are large groups of Japanese firms that share financial, production, personnel, and other linkages.)

Table 6–6 reports data on U.S. bilateral trade with Europe and Japan. Intrafirm trade is a more important part of U.S.-Japan trade than of U.S.-Europe trade. Three-quarters of all U.S. imports from Japan are intrafirm (compared with less than 50 percent for trade with Western Europe), and 36 percent of U.S. exports to Japan are intrafirm (compared with 32 percent for Western Europe).

Japanese markets are not completely closed. Indeed, some U.S. firms excel in Japan. On the whole, however, the role of foreign firms and foreign goods is strikingly small (Table 6–5).

Explanations of Japan's apparent distinctiveness fall into two broad groups, one emphasizing direct trade and industrial policy interventions and the other emphasizing structural characteristics

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TABLE 6–6.—*Intrafirm Trade as Share of Total U.S. Exports to and Imports from Europe and Japan, 1992*

[Percent of total]

Region	U.S. exports to region	U.S. imports from region
Europe	32.4	46.3
Japan	36.2	75.0
World total	30.6	45.0

Note.—Intrafirm trade is defined as merchandise trade between "related parties" (that is, between affiliates of the same firm).

Source: Department of Commerce, Bureau of the Census.

of the economy. Domestic industrial support policies in Japan have included subsidies to producers and to research and development consortia, preferential tax treatment, preferential access to credit, government procurement preferences, establishment of producer cartels, and lax antitrust enforcement. External policies have included trade protection, restrictions on inward foreign direct investment, and control over high-technology trade. These policies have been applied to both infant and senescent industries.

With a few notable exceptions, including agriculture, Japanese tariffs and import quotas are not significant trade barriers. Yet Japan's market is regarded by many as effectively closed to imports of many foreign manufactures, especially those that directly compete with Japanese goods. Structural barriers alleged to deter imports include reliance on bureaucratic control to ensure product safety; domestic cartels, discriminatory practices by the *keiretsu*, and weak enforcement of competition policies; inadequate intellectual property protection; government procurement procedures that favor domestic suppliers; imperfect capital markets that inhibit inward foreign investment; and impediments in the distribution channels for imported products—to name a few.

Estimating the impact of the mostly overt barriers to trade in primary products is relatively straightforward. One recent study concluded that complete elimination of all agricultural trade barriers in Japan might increase the incomes of U.S. producers by 28 percent of the value of bilateral agricultural exports. This would occur through a combination of higher export volumes to Japan and higher prices on exports to all markets. Comparable figures for potential gains in minerals and, importantly, services, are not available.

What attracts the most attention, however, is the potential gain in manufactures. And here the story is far more controversial because the subtle nature of Japan's trade barriers poses difficult problems for economists trying to assess their impact. In consequence, researchers have eschewed direct measurement of these barriers and focused instead on inferring their impact indirectly by

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examining differences in predicted and actual trade volumes. These studies have been virtually unanimous in their conclusion that Japan's low volume of manufactured imports cannot be entirely explained by economic fundamentals.

In addition to examining quantities, one can look at prices. If markets were really open, traded goods should sell at "international prices" adjusted for transport costs. A number of studies have concluded that traded-goods prices are far higher in Japan than in other countries. Among these surveys were two involving exact brand and model comparisons conducted by the Department of Commerce and the Japanese Ministry of International Trade and Industry as part of the Structural Impediments Initiative talks. The 1991 survey found that two-thirds of the products covered were on average 37 percent more expensive in Japan than in the United States; the 1989 survey obtained quantitatively similar results. Additional evidence comes from Japanese researchers who used Japan's input-output table to calculate the tariff-equivalents of Japanese nontariff barriers. In some sectors they discovered tariff-equivalents of 500 percent and higher.

The question naturally arises as to why these price differences are not eliminated through arbitrage. Such large price differentials could perhaps be dismissed as the product of exchange-rate misalignment, were they temporary, but their persistence suggests that they are the product of market closure. Indeed, one recent study concluded that Japanese manufactured imports might increase by more than 20 percent if the price differentials were eliminated.

These studies, which extrapolate well beyond the historical experience and are therefore unavoidably imprecise, have reached a variety of conclusions as to the importance of economic policy in determining Japanese trade patterns. The preponderance of evidence, however, points to the closed nature of the Japanese market. According to one recent comprehensive study, if Japan were to eliminate all formal and informal barriers to trade, U.S. exports to Japan would initially increase by somewhere in the range of $9 billion to $18 billion per year.

It should be made clear, however, that even if these barriers were eliminated, the bilateral balance would not change by this full amount: Japanese imports would increase initially, but the resultant depreciation of the yen and reallocation of resources would boost Japanese exports and reduce Japanese imports, at least partly offsetting the initial change in the balance. Moreover, liberalization would occur over an extended period of time, making it potentially difficult to disentangle changes in the balance due to liberalization from those due to macroeconomic developments, even in retrospect but this in no way diminishes the desirability of obtaining

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greater access to the Japanese market, though. With more-open markets not only will American firms sell more but, because of the exchange-rate adjustments, many American firms will receive more for what they sell. Moreover, Japanese consumers will benefit—for the same reasons that American consumers benefit—from opening trade: Both will have access to a greater variety of goods at lower prices. Open markets are a win-win situation in which both sides gain.

The existence of such a large, technologically dynamic, and distinctive economy as Japan poses special trade problems for the United States. Current U.S. policy centers around the United States-Japan Framework for a New Economic Partnership, announced in July 1993. The Framework is the successor to the 1985–86 Market Oriented Sector Selective (MOSS) talks and the SII talks already mentioned. The Framework document adopted at the time of the 1993 Tokyo economic summit calls for macroeconomic, sectoral, and structural reforms and cooperation on global issues of common interest such as the environment. In particular, Japan committed itself to "actively pursue the medium-run objectives of promoting strong and sustainable domestic demand-led growth...intended to achieve...a highly significant decrease in its current account surplus...." Japan also committed to "promoting a significant increase in global imports of goods and services." For its part, the United States "will...actively pursue the medium-term objectives of substantially reducing the fiscal deficit, promoting domestic saving, and strengthening its international competitiveness."

The sectoral and structural parts of the talks are organized into five baskets: government procurement, regulatory reform and competitiveness, other major sectors (in the first instance, automobiles and auto parts), economic harmonization, and implementation of existing arrangements and measures. Topics under the government procurement basket include Japanese procurement practices in such sectors as computers, supercomputers, satellites, medical technology, and telecommunications, as well as overall government procurement policies in both countries. Regulatory issues include policies and practices relating to financial services, insurance, competition policy, retail and wholesale distribution, and U.S. export competitiveness. Economic harmonization covers foreign direct investment, intellectual property rights, access to technology, and long-term buyer-supplier relationships. The implementation basket is concerned with carrying out existing agreements between the two countries (including SII). The Framework agreement explicitly states that the United States and Japan are committed to the multilateral trading system and that "benefits under this Framework will be on a Most Favored Nation basis."

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The Framework represents a departure from previous negotiations in two substantive ways. The first is the use of "objective criteria" to assess progress. The Framework agreement states that "assessment will be based upon sets of objective criteria, either qualitative or quantitative or both as appropriate," on which the two governments will agree. In this sense the negotiation is results-oriented, with both governments agreeing that "tangible progress must be achieved." By establishing objective criteria, progress can be independently verified, allowing negotiators to agree on those areas where problems have successfully been resolved and to focus on those where progress is lacking.

The other innovation of the Framework talks is procedural: By explicitly incorporating biannual meetings between the President of the United States and the Prime Minister of Japan, the Framework dramatically raises the political profile of the negotiations. The hope is that this will significantly increase the pressure on policymakers to make steady progress on resolving outstanding issues.

Trade with China

China is also an important focus of U.S. trade policy because of its size, its reforming economy, and its large trade surplus with the United States, which reached $18.3 billion in 1992.

It is misleading to focus exclusively on China's bilateral balance with the United States. Table 6–4 reports trade balances for China, Taiwan, and Hong Kong and aggregates them as "Greater China." It becomes apparent that the increase in the U.S. deficit with China has been largely offset by declines in the U.S. deficits with Taiwan and Hong Kong. These developments are the result of large realignments in exchange rates since the late 1980s that have encouraged firms to relocate labor-intensive activities, such as the production of shoes, garments, and toys, from Hong Kong and Taiwan to China, where wage rates are lower. In other words, the growing U.S.-China trade imbalance represents in part a geographic reallocation of production, not a fundamental change in U.S. trade relations.

With regard to China, U.S. trade policy centers on prison labor and workers' rights, intellectual property rights, market access, textiles, services, and the issue of China's most-favored-nation (MFN) status. In the area of intellectual property rights, the United States and China signed a memorandum of understanding in January 1992. China agreed to provide product patent protection beginning January 1, 1993, and to adhere to international conventions on the protection of copyrights. A process has been established to enforce the memorandum, although there has been little actual progress on enforcement thus far.

In October 1992 the United States and China signed a market access agreement, under which China committed itself to increase

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the transparency of its trade regime, to remove import restrictions such as licensing requirements and quotas from hundreds of products, and to liberalize its import administration substantially. The United States agreed to liberalize restrictions that limit Chinese access to technology, providing greater opportunities for U.S. producers. China is largely in compliance with the market access agreement, although some issues remain unresolved with respect to transparency, quotas, and agricultural trade. The Administration is continuing to push for greater access in these areas, as well as for better access to the Chinese market for U.S. providers of financial, maritime, and air transport services.

A memorandum of understanding on exports to the United States produced by prison labor was concluded in 1992 and provides for prison inspections. China has begun to allow U.S. officials access to prisons to investigate allegations, and there has been a decline in such allegations since the memorandum was signed. China continues to be denied coverage under investment guarantees of the Overseas Private Investment Corporation, however. Coverage was suspended in 1990 on the grounds that China was not taking steps to extend internationally recognized workers' rights to its citizens.

In the case of textiles, conflicts have arisen over China's shortcomings in implementing the terms of the Multi-Fiber Arrangement, which regulates trade in textiles and apparel. Chinese producers have at times resorted to fraudulent practices to evade restrictions on Chinese exports of textiles and apparel to the United States. The most common technique has been to ship goods produced in China to third countries, and from there reexport them to the United States under the third countries' quotas. In January 1994 the United States and China reached a new agreement on this issue. In the long run, the transshipment problem can be solved through China's entry into GATT and the tariffication of the U.S. import control system as envisioned in the Uruguay Round agreement (discussed below). In the meantime, however, the United States will continue its two-track policy of negotiations with the Chinese government combined with criminal prosecutions for customs fraud.

The last major remaining U.S.-China issue is the annual renewal of China's MFN status. Under the terms of the Jackson-Vanik Amendment to the Trade Act of 1974, MFN status can be extended to nonmarket economies only if the President grants a waiver certifying that the country does not impede emigration. (The law was originally designed to encourage the Soviet Union to permit the emigration of Soviet Jews.) China first gained MFN status in the U.S. market in 1980, and renewal was routine until the Tiananmen Square incident in 1989. Since then, renewal of China's MFN sta-

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tus has become increasingly controversial, with renewal in 1994 tied explicitly to human rights improvements.

In each trade area, the Administration is carefully monitoring Chinese implementation of the bilateral agreements and will use all means at its disposal to ensure compliance. Successful implementation will lay the foundation for Chinese accession to GATT and a far closer economic relationship between the United States and China.

Trade and the Reform Process in the Former Socialist Bloc

Another crucial focus of the Administration's foreign economic policy is support of the reform process in the countries of central and eastern Europe and the former Soviet Union, especially Russia. Never before has a country of Russia's size and influence (with a population of 150 million, a large conventional military presence, and nuclear weapons) attempted such a rapid metamorphosis. Because of the immediate implications of Russian economic reform for world peace, world economic growth, and the U.S. economy, the President has made support of the reforms one of his top foreign policy objectives. This involves both providing assistance to domestic reforms and facilitating the integration of Russia into the world trading system.

Most of the fundamental issues in economic reform—including liberalization (the freeing of prices), privatization (the transfer of ownership to private entities), and stabilization (the reduction of inflation and the budget deficit)—are essentially Russia's domestic policy decisions. Nevertheless, outside organizations including the International Monetary Fund, the World Bank, the Group of Seven (G–7), and the U.S. Government have important roles to play. Indeed, along with its G–7 partners, the United States has been actively assisting the cause of economic reform in Russia. In April 1993 the G–7 pledged $15 billion of debt rescheduling and $28.4 billion in other assistance. By the end of November over half of this total had been approved.

Economic assistance packages such as the one presented in Tokyo constitute a significant source of finance for reform policies. But Russian exports to the West represent another, perhaps even more important, source of hard-currency revenues. Because the trade patterns of Russia and the other transitional economies were formerly based on arbitrary central planning decisions, not market forces, these countries have encountered difficulties in establishing normal commercial relations with other countries. The transition to a market economy has involved dramatic changes in both the product content and geographical composition of trading patterns. After most of these changes have been effected, Russia may be a substantial participant in world trade. Russia's share of U.S. trade is quite small (0.4 percent of total U.S. trade), but one study found

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that if the states of the former Soviet Union were like typical industrial economies, their share of world exports would eventually rise to over 10 percent, from around 4 percent in 1988. Through the first 9 months of 1993, Russia's two most important exports to the United States were aluminum ($326 million) and crude oil ($131 million), which together accounted for more than 40 percent of the total.

Expanding trade with economies in transition from socialism raises special problems for the application of U.S. antidumping laws, which divide the world into market and nonmarket economies (NMEs), with separate methodologies for assessing dumping specified for each. (Russia, for example, is classified as an NME.) For market economies, dumping is determined to have occurred when a foreign producer charges lower prices in the U.S. than in its home market (or, alternatively, prices below its costs in the home market). In the case of NMEs, since neither prices nor input costs are market determined, they are not used in dumping investigations. Instead, U.S. law instructs the Commerce Department to construct cost estimates based on costs in a "surrogate" country at a similar stage of development. In practice, the surrogates are often at quite *dis*similar stages of development, thus potentially tilting the calculation toward finding large dumping margins. For example, the Department of Commerce has used Swiss, Canadian, Dutch, French, German, and Japanese producers as surrogates for Chinese firms in antidumping petitions. Perhaps the best known example, however, is that of Polish golf carts, described in Box 6–2.

Box 6–2.—The Case of the Polish Golf Carts

In the mid-1970s an antidumping petition was filed against Polish electric golf carts. Because Poland was an NME that had no golf courses and therefore little domestic demand for golf carts, the U.S. authorities rightly concluded that it was impossible to compare the prices at which the carts were sold in the United States with prices in Poland. Instead, the authorities employed a surrogate-country approach: they attempted to estimate what golf carts cost in a country similar to Poland. Canada was chosen. Unfortunately, Canada didn't produce golf carts either, so the final determination was based on an estimate of what golf carts would have cost in Canada—if Canada had actually produced them.

Reclassification of NMEs such as Russia as market economies would not necessarily solve the problem, however, since they would then become subject to U.S. countervailing duty law at a time

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when their subsidies to state-owned producers remain sizable. As a result, either the market or the nonmarket methodology may impede imports from economies in transition.

This situation is particularly problematic since allowing Russia and other economies in transition to export the goods in which they have comparative advantage benefits both these economies (which obtain valuable hard-currency revenues as well as experience in world markets) and Western nations (which obtain goods produced relatively more efficiently than they can be produced in the West). Open market access is therefore a positive-sum means of encouraging the reform process.

REGIONAL INITIATIVES

Some issues cannot be handled on a bilateral basis, and the Administration has been deeply engaged in a number of regional efforts. The most prominent of these has been the North American Free Trade Agreement, which will solidify the ongoing reforms in Mexico and help expand U.S.-Mexican trade.

The North American Free Trade Agreement

In November 1993 the Congress ratified the North American Free Trade Agreement, which went into effect on January 1, 1994. NAFTA creates a free-trade area of 370 million consumers and over $6.5 trillion of annual output, linking the United States to Canada and Mexico, our largest and third-largest trading partners. Building on the earlier United States–Canada Free-Trade Agreement, NAFTA will contribute to productive efficiency, enhance the ability of North American producers to compete globally, and raise the standard of living of all three countries. By improving the investment climate in North America, and by providing innovative companies with a larger market, NAFTA will also increase economic growth.

NAFTA will help reinforce the market reforms already under way in Mexico (Box 6–3). Mexico's reforms have raised its rate of economic growth, making it an increasingly important export market for the United States. A stable and prosperous Mexico is important to the United States for both economic and geopolitical reasons. The United States shares a border roughly 2,000 miles long with Mexico; and as economic opportunities in Mexico improve, Mexican workers will have fewer incentives to migrate to the United States. NAFTA will help forge a lasting relationship between the two countries, based on open trade and cooperation.

In addition to dismantling trade barriers in industrial goods, NAFTA includes agreements on services, investment, intellectual property rights, agriculture, and strengthening of trade rules. There are also side agreements on labor adjustment provisions, protection of the environment, and import surges.

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Box 6-3.—Mexican Economic Reforms

Mexico is one of the outstanding economic success stories of the last decade. After the debt crisis of 1982, the Mexican government began a broad program of economic reform, which has continued through the early 1990s. Fiscal policy changes, which moved the primary budget (that is, excluding interest payments) from a deficit of about 7 percent of GDP in 1982 to a sustained surplus, were the first step. More-fundamental reform began in December 1987 when the Mexican government implemented a concerted program that combined macroeconomic stabilization with microeconomic liberalization.

Stabilization efforts in 1989–91 were pursued through a fiscal policy of tight spending controls and tax reform that broadened the tax base and lowered tax rates, while maintaining a roughly stable level of revenue. Monetary and exchange-rate policies were combined to reduce inflation while preventing large exchange-rate movements. Finally, incomes policies were used to reduce expectations of inflation and any inflationary inertia.

The microeconomic reforms were sweeping. More than 80 percent of the 1,155 public sector enterprises in existence in 1982 have already been privatized or liquidated. Privatization has enhanced microeconomic efficiency and reduced the fiscal demands imposed by badly run state-owned enterprises. In addition, Mexico joined GATT in 1986. Tariffs were cut sharply and many nontariff barriers to trade, such as quotas and import licenses, were removed. Finally, a renegotiation and restructuring of Mexico's external debt eased its debt burden and greatly reduced the uncertainty associated with debt service.

The results of these reforms have been impressive. Inflation fell from approximately 160 percent in 1987 to 12 percent in 1992. At the same time, real GDP growth rose from –3.8 percent in 1986 to 4.5 percent in 1990 before slowing somewhat to 2.6 percent in 1992. The recent passage of NAFTA should strengthen the reform effort in Mexico and make a positive contribution to its economic performance in the future.

NAFTA and Industrial Trade. As a result of NAFTA, existing duties on most goods from member countries either were eliminated on January 1, 1994, or will be phased out in 5 or 10 years (for certain sensitive items, up to 15 years). Among those industrial goods for which trade is now tariff-free are computers, medical equipment, agricultural equipment, internal combustion engines, and telephone switches, all of which previously faced tariffs of 10 per-

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cent or more in the Mexican market. Approximately 65 percent of U.S. industrial and agricultural exports to Mexico will be eligible for duty-free treatment within 5 years. NAFTA will also eliminate quotas and import licenses that are not essential for such purposes as protecting human health.

NAFTA and Services Trade. NAFTA will allow U.S. service firms to provide their services directly from the United States on a nondiscriminatory basis, with any exceptions clearly spelled out. For investors, NAFTA assures nondiscriminatory treatment: Americans will generally be able to establish, acquire, and operate firms on the same basis as Mexicans in Mexico and Canadians in Canada. NAFTA also protects U.S. investors against restrictions on their repatriation of capital, profits, and royalties, and against expropriations without full compensation. Investors can seek monetary relief from an international arbitral panel for violation of their rights.

Virtually all types of inventions, including pharmaceuticals and agricultural chemicals, are protected under NAFTA provisions that require patents to be granted for both products and processes developed by firms in member countries. The agreement also protects copyrights for computer programs and databases, and rental rights for computer programs and sound recordings. Service marks and trade secrets are also covered, along with integrated circuit masks both directly and as components of other products.

NAFTA and Agricultural Trade. NAFTA will virtually eliminate barriers to trade in agricultural commodities between the United States and Mexico over a 15-year period. All restrictions on products representing about 50 percent of U.S.-Mexico agricultural trade were lifted as soon as the agreement took effect. Products such as frozen beef, strawberries, and cut flowers—all of which previously were subject to tariffs of 20 percent or more in the Mexican market—now trade tariff-free. For the remaining products, the phaseout will take between 5 and 15 years. The phaseout for most tariffs imposed by the United States will simply involve an annual reduction in the tariff rate.

In cases where the existing trade barrier is a nontariff barrier, such as an import license or quota, the phaseout process is more complicated. First, the license or quota will be replaced by a "tariff-rate quota," allowing a limited quantity of the good to be imported at a low (or zero) tariff rate, but charging a tariff for quantities above the limit. Second, the tariff-rate quota will be phased out gradually over a 10- to 15-year period by increasing the quantity limit and/or reducing the tariff rate applied to imports above the limit.

With respect to the other bilateral flows, U.S.-Canada trade liberalization will continue as specified under the earlier free-trade agreement, with tariffs on all agricultural goods eliminated by

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1998, while nontariff barriers on a few products (poultry, eggs, dairy products, and sugar) are maintained. In a separate agreement under NAFTA, Mexico and Canada will eliminate tariffs on their bilateral trade (except for the four products listed above). All three countries agreed to work for the elimination of agricultural exports subsidies.

As a consequence of these changes under NAFTA, U.S.-Mexico agricultural trade is expected to grow significantly. U.S. corn growers, for example, can expect to export more corn to Mexico, while Mexican farmers can expect to export more fresh vegetables to the Untied States.

NAFTA-Plus: The Side Agreements. The Clinton Administration accepted NAFTA as negotiated by its predecessor, but argued that more was needed. The result was the negotiation of three innovative side agreements.

The North American Agreement on Labor Cooperation represents the first attempt to manage the terms of the potential change in labor markets brought about by an accord between the United States and a trading partner. The agreement involves such issues as restrictions on child labor, health and safety standards, and minimum wages. The supplemental labor agreement was developed around three fundamental principles: (1) enhanced collaboration, cooperation, and information exchange among the three countries; (2) increased efforts to make each country's labor laws and their implementation explicit and highly visible; and (3) increased use of effective mechanisms to encourage the enforcement of national labor laws. The agreement establishes procedural mechanisms for enforcement, including channels of public communication, exchanges of information, discussion of issues, and various levels of consultations. If a solution cannot be reached, the agreement provides for binding arbitration and assessment of penalties. In addition to signing the labor side agreement, the Mexican government has pledged to link increases in the Mexican minimum wage to productivity increases. Moreover, the United States has retained its right to use its domestic trade laws, such as Section 301 of the 1974 trade act, with respect to labor issues not covered under NAFTA.

The North American Agreement on Environmental Cooperation explicitly ensures our right to safeguard the environment. NAFTA maintains all existing U.S. health, safety, and environmental standards. It allows States and cities to enact even tougher standards, while providing mechanisms to encourage all parties to harmonize their standards upward. The environmental side agreement creates a new North American Commission on Environmental Cooperation, with a Council made up of the three countries' top environmental officials. The Commission will have a Secretariat with

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a permanent staff. There is a "layered" enforcement mechanism to ensure that countries obey their own environmental laws. The mechanism starts with "sunshine" provisions that guarantee public participation in monitoring the enforcement of environmental laws. Trade sanctions are then provided for, if other avenues are not sufficient to resolve disputes. Besides the Commission, two new institutions will be established to fund and implement environmental infrastructure projects along the U.S.-Mexican border.

The side agreement on import surges creates an early warning mechanism to identify those sectors where explosive trade growth may do significant harm to domestic industry. The side agreement also establishes that, in the future, a working group can provide for revisions in the treaty text based on the experience with the existing safeguard mechanisms.

During the transition period, safeguard relief is available in the form of a temporary snapback to pre-NAFTA duties if an import surge threatens serious injury to a domestic industry. And, unless a NAFTA member's exports account for a substantial share of total imports and contribute significantly to the injury or its threat, these exports must be excluded from safeguard actions taken by other members against imports from all countries.

Other NAFTA Issues. NAFTA preserves the right of each member to retain its own contingent protection laws (such as antidumping and countervailing duty laws), but in reviewing determination under these laws, binational panels will replace domestic judicial review (as in the case of the United States–Canada Free-Trade Agreement). The panel will apply to domestic law of the importing country, and its decision is final. Either the importing or the exporting country may request a review of a panel's determination.

In other areas, such as intellectual property rights, dispute resolution is layered. First, a country may request consultations, and should these fail to resolve the dispute, it may call a meeting of the Trade Commission, which will include Ministers from each country. If the Commission is unable to resolve the dispute, it is submitted to an arbitral panel which issues a report. If the panel upholds the complaint, but the disputants are still unable to reach a resolution, the complaining country is authorized to suspend benefits as appropriate.

The North American Development Bank (NADBank) was created to address concerns about the environment and about worker dislocation. It will serve as a major lending institution to finance, coordinate, and implement environmental, infrastructure, and community development projects, both along the border and elsewhere, related to continuing North American integration. NADBank will be organized to invest specifically in the environmental, physical, and social infrastructure that will be needed to bring about an up-

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ward convergence in environmental and social standards and practices between Mexico and the United States. In this way it will facilitate the adjustment of workers adversely impacted by NAFTA-related trade liberalization. The bank will be capitalized to provide $2 billion to $3 billion in loans and guarantees and will be able to leverage additional private and public funds, to generate an estimated total of $20 billion in project finance.

The Economic Impact of NAFTA. NAFTA may be the most thoroughly studied trade agreement in history. A review of the major studies of NAFTA's economic impact indicates a broad consensus on key points in the NAFTA debate: (1) All three NAFTA countries gain from the agreement. (2) In the United States, labor will gain from increased employment, increased wages, or both. (3) Increased investment in Mexico will not come at the expense of investment in the United States. The few studies reaching contrary conclusions have been strongly criticized by academic and other professional economists.

In a letter to the President, 286 academic economists, including 13 Nobel Prize winners, expressed their support for NAFTA, stating, "While we may not agree on the precise employment impact of NAFTA, we do concur that the agreement will be a net positive for the United States, both in terms of employment creation and overall economic growth." Nineteen out of twenty studies surveyed found that NAFTA would benefit the United States; the lone negative assessment was based on the unrealistic assumption that factories literally would be dismantled in the United States and moved to Mexico.

It has been estimated that the agreement will increase export employment in the United States by 200,000 jobs; on average Mexican export-related jobs pay wages 12 percent higher than the national average. Moreover, studies of NAFTA have found that gains would occur even among groups sometimes alleged to be adversely affected. For example, it was found that union workers will benefit from NAFTA because the growing sectors of U.S. exports to Mexico are disproportionately unionized. Likewise, African-American workers are more heavily concentrated in industries that export to Mexico than in Mexican import-competing sectors. As a result, African-Americans too may benefit disproportionately from the agreement. Finally, by contributing to the creation of more and better jobs in Mexico, NAFTA will discourage illegal immigration from Mexico to the United States.

In summary, NAFTA is an epochal agreement, and its passage was a triumph of facts over fear. It is the world's first free-trade agreement between industrial and developing countries. Its side agreements embody innovative ideas to deal with environmental and labor issues. The best available evidence shows that NAFTA

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will create good, high-paying jobs for American workers. It will strengthen the ability of U.S. firms to compete in the global marketplace. It will help the Mexican and Canadian economies as well, providing a disincentive for illegal transborder migration and other illegal activities. The Administration's trade policy can be described as "export activism"—the United States will work actively to open foreign markets, and in return we will keep our market open. NAFTA is a key component of this activist strategy.

Asia-Pacific Economic Cooperation

The Asia-Pacific Economic Cooperation (APEC) was begun in 1989 to encourage economic cooperation among countries of the Pacific region. In the past quarter-century, the United States' APEC partners—Australia, Brunei, Canada, China, Hong Kong, Indonesia, Japan, Malaysia, Mexico, New Zealand, Papua New Guinea, the Philippines, the Republic of Korea, Singapore, Chinese Taipei (Taiwan), and Thailand—have increased their combined share of world income and trade by more than half (Box 6–4). These economies now account for more than half of all U.S. trade, or more than triple U.S. trade with the European Union. Even if Canada and Mexico are excluded from the calculation, U.S. trade with other APEC countries is 76 percent greater than our trade with the EU countries.

One consequence of this rapid growth is striking: as long as the Asian countries grow faster than the United States, they will become more important in our trade while we will become less important in theirs. Therefore past trade strategies based on threats of market closure are liable to become less and less effective.

This analysis suggests that, to achieve its trade policy goals in the region, the United States will increasingly have to act in concert with other countries rather than unilaterally. Thus it may be desirable to begin establishing the appropriate institutional infrastructure for cooperation now, and APEC is the leading candidate. The United States held the rotating chairmanship of APEC in 1993 and hosted the annual Ministerial meeting in Seattle in November, which was attended by economic policymakers from each of its members. The President elevated the importance of APEC by hosting the first-ever meeting of APEC leaders in Seattle.

At the APEC Ministerial meeting, a group of private individuals previously commissioned by the APEC Ministers to serve as an Eminent Persons Group presented its report. The report described the threats to trade and investment in the region and recommended ways to promote regional trade liberalization and cooperation. The Ministers indicated that those recommendations closely linked to ongoing work in APEC should be implemented promptly. These include recommendations to achieve a common set of investment principles, harmonize standards, and create a mecha-

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Box 6–4.—The Asian "Miracle"

Per capita gross national product (GNP) in East Asia grew, on average, by over 5 percent per year between 1965 and 1990. During the same period, per capita GNP in the industrialized countries that make up the Organization for Economic Cooperation and Development (OECD) grew by less than 2.5 percent per year. What explains this relatively rapid growth in East Asia? A recent World Bank book argues that a major part of the explanation is that the average OECD member was much more technologically advanced than the average East Asian country in 1965. By adopting and adapting techniques from the industrial countries, the East Asian countries were able to increase both productivity levels and per capita GNP at a rapid pace.

This is undoubtedly true. But other countries that were poor in 1965 did not grow as fast as the successful East Asian nations. Why did East Asia experience faster growth? One key factor is almost certainly the macroeconomic environment: inflation and budget deficits were kept relatively low, and national currencies were kept from becoming overvalued. Macroeconomic policies encouraged, or at least did not discourage, high saving and investment rates as well as strong export growth. Governments also emphasized education. The focus was primarily on the quality of basic education, rather than on higher education. As a result of these policies, East Asian countries accumulated substantial physical and human capital, which spurred relatively rapid growth in GNP per capita.

The impact of other, more interventionist policies on growth in several East Asian countries remains a source of controversy. Some government interventions in the market may have improved economic performance, particularly when they were not excessively distortionary, were administered competently, were aimed at particular market imperfections, and were adapted to meet changing circumstances.

The Asian countries are expected to account for increasing shares of world income and trade. By 2000 it is likely that Asia will have surpassed North America and Europe as the world's largest economic zone. As its share of world income rises, so will its share of world trade—the Asian share of U.S. trade is projected to rise to 40 percent by the end of the decade.

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nism for resolving trade and investment disputes. Other recommendations, relating to deepening and broadening the Uruguay Round of GATT, were singled out for additional study. The APEC leaders instructed the Eminent Persons Group to elaborate on their recommendations relating to longer term trade liberalization in a report to be presented to the leaders in 1994 in Indonesia.

MULTILATERAL INITIATIVES: THE URUGUAY ROUND

The most far-reaching of the Administration's market-opening efforts has been on a global scale: the Uruguay Round negotiations of GATT, whose 116 participating countries account for approximately 85 percent of world trade. GATT was created after World War II to reduce tariffs and remove nontariff barriers to international trade. In seven rounds of GATT-sponsored multilateral trade negotiations (the Uruguay Round is the eighth), the member countries have lowered tariffs and agreed on codes of conduct for nontariff barriers.

In the Uruguay Round negotiations, effectively completed on December 15, 1993, the United States and other GATT members agreed not only to lower tariffs on merchandise trade, but also to integrate into GATT certain areas of trade and investment that had not been subject to effective GATT discipline, including agriculture, textiles, trade in services, investment, and intellectual property rights. The Uruguay Round also made progress in reforming multilateral dispute settlement procedures and other multilateral trade rules, including those dealing with nontariff measures. The Congress is expected to ratify this agreement this year.

The stakes in the Uruguay Round negotiations were enormous. In the short run, failure to complete the Round would have significantly undermined business confidence around the globe and might have contributed to the erosion of the open trading system. In the long run, the successful completion of the Round will mean a major boost to the world economy. Preliminary studies suggest that the likely gains to the U.S. economy alone are more than $100 billion but less than $200 billion annually by 2005 (Box 6–5). These efficiency gains will manifest themselves in the form of more and better jobs for American workers.

The Round achieved major reductions in trade barriers facing industrial products. Key provisions of the market access agreement include the following:

- Tariffs imposed by major industrial countries are to be eliminated, and those of many developing countries either eliminated or sharply reduced, in the following areas: construction equipment, agricultural equipment, medical equipment, steel, beer, distilled spirits, pharmaceuticals, paper, toys, and furniture.

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Box 6–5.—The Economic Impact of the Uruguay Round

Even before the Uruguay Round was completed, researchers were attempting to quantify its likely effects on the American economy. Studies based on existing formal economic models unanimously conclude that these effects will be beneficial. It is quite likely that new studies incorporating some of the Round's final accomplishments in such areas as intellectual property protection will yield even larger estimates of benefits.

The Uruguay Round will increase American output because the specialization encouraged by more-open markets will raise productivity. As foreign markets open, we will produce more of the goods that make use of the highly skilled, highly productive U.S. work force. Economic models offer a range of estimates of the output gain from greater specialization. A recent OECD study estimates those gains to be 0.4 percent of GDP for the United States. But this is almost certainly a gross underestimate of the impact of the Round, because it ignores a host of important factors, including gains from specialization *within* the manufacturing sector. Another study by World Bank and OECD economists estimates even smaller gains, but focuses on agriculture. Studies that more adequately capture gains from specialization suggest that the benefit to the U.S. economy is likely to be approximately 1 percent of GDP after the Uruguay Round tariff cuts are fully phased in.

Other important sources of benefit are not captured by the existing models, which do not quantify the impact of trade liberalization in services or enhanced protection of intellectual property rights. In addition, higher productivity will result in increased investment and innovation, providing an important additional benefit. These additional gains are difficult to quantify, but they are almost certainly sizable and may even exceed the more easily quantified gains. The total gain 10 years after implementation of the agreement begins is then likely to be more than $100 billion but less than $200 billion annually.

- Major U.S. trading partners agreed to deep tariff cuts, ranging from 50 to 100 percent, on important electronics items including semiconductors, computer parts, and semiconductor manufacturing equipment.
- Tariffs of industrial and major developing countries on chemical products are to be harmonized at very low rates (zero, 5.5, or 6.5 percent, according to product).
- The agreement significantly increased access to markets representing approximately 85 percent of world trade by reducing tariffs on certain specific items of key interest to U.S. export-

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ers. Progress in textiles and apparel was particularly significant. For decades, international trade in textiles and apparel products has effectively been exempted from GATT rules. Instead, the Multi-Fiber Arrangement establishes a procedure for limiting textile and apparel exports from developing to industrial countries. Under the final Uruguay Round agreement, products covered by the Multi-Fiber Arrangement will be free of quotas after 10 years, and textiles will be integrated into general GATT rules. Tariffs will be reduced as well.

Throughout the Uruguay Round negotiations, one of the most contentious issues was agricultural trade liberalization. The final agreement on agriculture strengthens the long-term rules for agricultural trade and sharply limits national policies that distort that trade. U.S. agricultural exports will benefit significantly from reductions in foreign export subsidies and from market opening by our trading partners.

The United States was successful in its effort to obtain meaningful rules and explicit commitments to reduce export subsidies, cut domestic subsidies, and increase market access. Agricultural export subsidies and trade-distorting domestic farm subsidies are not only to be reduced, but for the first time will be subject to explicit multilateral disciplines. The United States also prevailed in establishing the principle of comprehensive tariffication, which will lead to the eventual removal of all import quotas and other nontariff import barriers. Nontariff barriers will first be replaced by tariffs, ensuring minimum or current access, and then these tariffs will gradually be reduced.

Progress in creating a more hospitable trading system for high-technology products was achieved on two fronts. First, the United States was able to win greater protection for intellectual property rights, such as patents, copyrights, and trademarks. This is very important for a diverse set of U.S. industries, including the electronics industry (where semiconductor masks will be protected), the pharmaceutical industry (patents), and the communications industry (protection of copyrights).

Second, the Uruguay Round agreement sets forth multilateral rules governing subsidies. Because of the beneficial social spillovers associated with research and development activities, government support cannot and should not be ruled out altogether. The challenge for the multilateral trading system is to find rules that permit governments to support innovations that benefit all nations while precluding rent-shifting subsidies designed to benefit one nation at the expense of others. The Uruguay Round agreement makes progress in this respect by establishing clearer rules and stronger disciplines in the subsidies area. It also makes nonactionable certain subsidies relating to basic research, regional

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development, and environmental cleanup, provided they are subject to conditions designed to limit their distorting effects.

Negotiators were able to agree on comprehensive GATT rules governing trade and investment in services (the so-called General Agreement on Trade in Services, or GATS), such as telecommunications, professional, and financial services. The agreement contains a strong national-treatment provision: Member countries must accord to service suppliers of other countries treatment no less favorable than that accorded their own suppliers. GATS also includes a market access provision that incorporates disciplines on discriminatory measures that governments frequently impose to limit competition. These measures include restrictions on the number of firms allowed into the market, "economic need" tests, and mandatory local incorporation rules. Because of the breadth and complexity of these issues, not as much progress was made as was desirable. To realize additional progress, GATS establishes a procedural framework for further negotiation.

The Uruguay Round negotiations also yielded systematic prohibitions on trade-related investment measures. For example, the agreement prohibits so-called local content requirements, which force foreign firms to use a set amount of locally produced inputs as a condition for investment. It also prohibits "trade balancing" requirements, under which a foreign affiliate must export as much of its production as it imports for use as inputs. These requirements have bedeviled U.S. firms operating abroad in the past.

Lastly, the Uruguay Round agreement prohibits so-called voluntary export restraints and other, similar measures that are often used as safeguards outside GATT rules. It also provides specific time limits for the formation and operation of dispute settlement panels and requires the automatic adoption of panel reports (except in the case of unanimous veto). Previously, any country, including the country against which the complaint was lodged, could effectively block the implementation of a panel's decision. The new procedures will greatly expedite the resolution of international trade disputes. The members of GATT agreed to establish a new multilateral organization, to be called the World Trade Organization (WTO), to enforce these new agreements.

In summary, the U.S. negotiators in the Uruguay Round were successful in negotiating broad-ranging multilateral trade liberalization. This was accomplished by reducing existing barriers and bringing areas of trade that had been largely outside the GATT system, such as agriculture, textiles, intellectual property, and services, under the GATT rubric. At the same time, GATT procedures have been strengthened to ensure that signatories meet their obligations, without compromising our ability to implement our national trade or other laws (Box 6–6). The liberalization of global

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trade resulting from these substantive and procedural achievements will raise real incomes in the United States by billions of dollars annually in the coming years.

Box 6–6.—The Uruguay Round and U.S. Trade Laws

The Uruguay Round final agreement contains a number of provisions that will enhance dispute resolution and facilitate better enforcement of U.S. rights. The agreement both moves GATT procedures closer to U.S. laws and complements U.S. laws for dealing with unfair foreign trade practices.

Section 301 of the Trade Act of 1974 provides the basis for actions to enforce U.S. rights under trade agreements and to respond to foreign practices that impede or restrict U.S. exports. When disputes arise in areas covered by GATT, Section 301 requires the United States to use GATT dispute resolution procedures before undertaking unilateral action. The Uruguay Round brings agriculture, textiles, and services under GATT rules for the first time and enhances the speed and effectiveness of GATT dispute resolution procedures. As a result, the United States can now use GATT to accomplish objectives that formerly required unilateral action. When disputes arise in areas outside the GATT framework, the United States can still use Section 301 to combat unfair foreign trade practices.

The Uruguay Round brings GATT closer to U.S. practices in other areas. For example, in dealing with food safety measures, the Uruguay Round agreement allows countries to choose their own levels of safety but requires that each country's standards have a scientific basis and not be used as disguised trade barriers. Because U.S. laws already have a scientific basis, it is unlikely that they will be susceptible to challenge. Other countries, however, have used food safety regulations in an arbitrary manner to block imports. The agreement adopts similar provisions for dealing with technical barriers to trade, such as so-called conformity assessment procedures (registration, inspection, and laboratory accreditation procedures, among others) used to evaluate conformance with technical regulations.

Antidumping is another area in which the post–Uruguay Round GATT will become more like U.S. trade laws. The United States has a transparent process for implementing its antidumping laws. The Uruguay Round agreement will make foreign antidumping actions more transparent, which should help U.S. exporters by improving the fairness of other countries' antidumping procedures.

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THE TRADE POLICY AGENDA

By lowering tariffs and providing a framework for cooperation in international trade, GATT has contributed significantly to a more harmonious world trading regime. But new issues in trade policy are coming to the fore as the world economy evolves. Among the important new issues confronting GATT and the new WTO will be issues relating to trade and the environment, competition policies, and regionalism.

TRADE AND THE ENVIRONMENT

Trade and environmental issues have become intertwined in recent years. Some accuse GATT of being hostile to the environment, while others argue that some countries' environmental policies are thinly veiled protectionism. In reality, protectionism often contributes to environmental degradation by encouraging inappropriate patterns of production. An obvious example is agricultural protection, which stimulates agricultural production in poorly suited locations. Farmers in these areas overuse chemicals or exhaust scarce water resources to compensate for their natural disadvantages, thereby contributing to environmental degradation. Freer trade would encourage more-appropriate patterns of production and improve the environment even as it increased living standards.

Standard economic analysis suggests offsetting government action when prices fail to reflect environmental costs (Chapter 5). But trade restraints are rarely the best solution to environmental problems. If the environmental problem is limited to one country, domestic policies, not trade protection, should be employed. If pollution or other environmental problems spill across borders, international rules and cooperation will be necessary. But here again trade protection will seldom be the most effective remedy.

Sometimes trade sanctions are used (or threatened) as a way to enforce environmental agreements. For example, the 1987 Montreal Protocol, which seeks to reverse the depletion of the upper-atmosphere ozone layer caused by the release of chlorofluorocarbons and other chemicals, requires trade actions against countries that do not abide by the environmental standards in the agreement. A second example is the Convention on International Trade in Endangered Species of Wild Fauna and Flora (CITES), which aims to protect endangered species of wildlife by restricting and monitoring their trade.

During 1993, the possibility of using trade sanctions for environmental purposes was raised, pursuant to a recommendation of CITES, in the case of trade by China and Taiwan in rhinoceros and tiger parts, and in regard to Norwegian whaling practices under the Pelly Amendment to enforce the International Whaling Con-

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vention moratorium on whaling. In both cases, however, sanctions were deferred.

The founders of GATT could not have foreseen the present importance of environmental problems. Some headway in harmonizing trade and environmental concerns has already been made in the environmental side agreement to NAFTA. And the preamble to the agreement establishing the WTO recognizes the importance of environmental concerns. The WTO negotiators have also agreed to develop a work program on trade and the environment to ensure the responsiveness of the multilateral trading system to environmental objectives.

INTERNATIONAL TRADE AND COMPETITION POLICY

As tariff and nontariff barriers to trade fall and as national economies become more integrated into the world trading system, differences in national business practices and laws become more important determinants of trade outcomes. Currently there are no multilateral rules to redress possibly restrictive practices in the way companies compete—such as price fixing, price discrimination, and the preferential supplier and distributor relationships characteristic of Japan's *keiretsu*. Many nations, including the United States, rely on antitrust laws to prevent anticompetitive business practices by domestic firms in their domestic market.

National antidumping laws are the most commonly used remedy in such circumstances. But unlike domestic antitrust laws, which generally increase competition and lower prices, national antidumping laws sometimes reduce competition and raise prices. Both in the United States and elsewhere, antidumping laws go beyond preventing anticompetitive practices—which *should* be their rationale—and often have the effect of protecting domestic industries from foreign competition. For example, a recent study found that, during the Reagan Administration, nontariff barriers including antidumping actions probably reduced U.S. manufactured imports by around a fifth—largely by discouraging foreign producers from entering the U.S. market or by discouraging those that do export here from lowering their prices.

If sound competition policies were present and effectively enforced in more nations, and if such laws were more easily enforceable against foreign misconduct, they could serve as the first line of defense against restrictive business practices by both domestic and foreign firms. The United States is currently pursuing this goal through such bilateral mechanisms as antitrust cooperation agreements.

Here NAFTA is a step in the right direction. The agreement commits its signatories to cooperate in the area of competition law enforcement, and imposes discipline on certain government-des-

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ignated monopolies. It also establishes a trilateral committee to consider the relationship between trade and competition policy in the NAFTA countries. Some other free-trade areas have gone further. For example, in the European Union and the Australia-New Zealand Free Trade Area, antidumping laws do not apply to trade among member countries, since this is considered internal trade, subject to organization-wide competition policies.

Until there is greater convergence and international cooperation in the enforcement of antitrust laws against cross-border conduct, international disputes over unfair pricing between corporations of different national origins will often continue to play out in one of two ways: through the application of national competition laws, with the continuing difficulties associated with their international enforcement, or through the application of overly restrictive national trade laws. As part of the Uruguay Round, the WTO Council for Trade in Goods will consider provisions on investment policy and competition policy in the future. The OECD is also pursuing a work program in this area.

REGIONALISM

Although there may be significant benefits to trade liberalization on a regional basis, some nonmember countries could be hurt through trade and investment diversion, as trade and investment are preferentially shifted from them to the member countries. One way to mitigate these concerns is for members of a free-trade area to move toward a customs union whose common external tariff would match the lowest tariff within the region prior to the formation of the customs union. Another possibility would be to open regional arrangements to new members. It has also been suggested that GATT rules be amended to allow compensation for nonmembers hurt by regional liberalization agreements. These and other proposals to deal with regional free-trade associations may need to be discussed in GATT in order to preserve the benefits of regional trade liberalization while addressing the concerns of outsiders.

FOREIGN EXCHANGE MARKET DEVELOPMENTS

The international value of the dollar, as measured by its trade-weighted average exchange rate, rose by an astonishing 50 percent between the end of 1980 and early 1985. By mid-1988, however, the dollar had returned to its 1980 level, and since then it has continued on a slight downward trend, with much narrower fluctuations than earlier in the 1980s. The large appreciation and subsequent depreciation of the dollar had a marked impact on the com-

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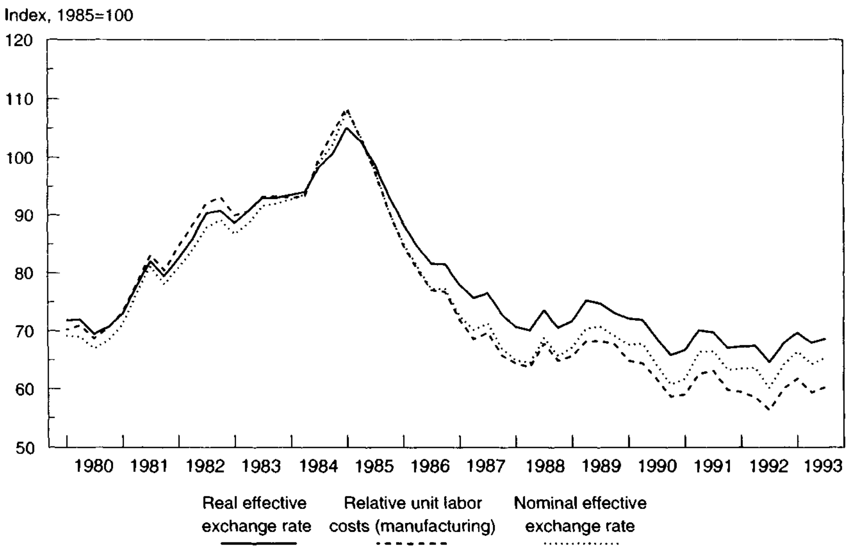
petitive position of U.S. firms. Had they been offset by differences between the inflation rates of the United States and its trading partners, these large swings in the value of the dollar would have had no impact on our competitiveness. Inflation differentials, however, were much smaller than the exchange-rate swings. As a result, the dollar appreciated and then depreciated in both real and nominal terms by roughly equal amounts.

Chart 6–3 shows indexes of the value of the dollar relative to the currencies of our major trading partners. In addition to the nominal effective exchange rate, which does not adjust for inflation differences, the chart shows two measures of the real effective exchange rate: one in which relative consumer prices are used for the inflation adjustment, and one in which relative unit labor costs are used. The chart clearly demonstrates the high correlation between nominal and real exchange-rate movements since 1980. In addition, the chart shows that relative unit labor costs in manufacturing have declined sharply since their 1985 peak. Partly as a result, U.S. manufacturing firms have become extremely competitive in world markets.

Chart 6-3 **Nominal and Real Effective Dollar Exchange Rates**
The value of the dollar has been more stable in the 1990s than during the 1980s.



Note: Indexes are based on units of foreign currency per U.S. dollar. A decline in any of the indexes indicates falling relative costs and increasing competitiveness.
Source: International Monetary Fund.

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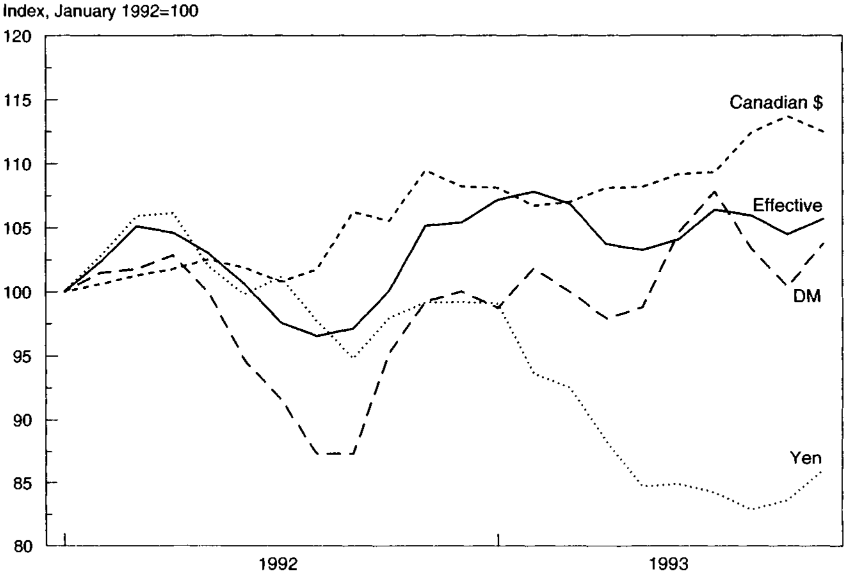
The dollar ended 1993 roughly where it began. After rising sharply in the second half of 1992, it varied in a narrow range in 1993 (Chart 6–4). The relatively small movements in the dollar's effective exchange rate masked considerable changes in the value of the dollar relative to individual currencies, however. The U.S. dollar rose relative to the Canadian dollar and most continental European currencies but declined sharply relative to the yen.

Chart 6-4 **Exchange Rates of the Dollar Against Selected Currencies**
The dollar strengthened against the Canadian and German currencies after mid-1992 but weakened against the yen.



Note: Indexes are based on units of foreign currency per U.S. dollar.
Source: International Monetary Fund.

The appreciation of the dollar relative to the European currencies occurred despite low short-term and falling (until November) long-term interest rates in the United States. Since low and falling interest rates are frequently associated with currency *de*preciations, this may at first appear puzzling. The decline in European interest rates during 1993 explains the apparent puzzle.

The stability of the dollar and the cyclical behavior of the Japanese and European economies are important in understanding the likely impact of the President's deficit reduction package on the U.S. current account. As Chapter 2 points out, deficit reduction is generally associated with an increase in net exports. This expansion in net exports provides a stimulus that partially offsets the impact of spending cuts and tax increases on domestic demand.

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The weakness in the economies of our major trading partners has, on the other hand, reduced demand for U.S. exports. Some of the boost to export demand that can be expected to result from the deficit reduction package may therefore be delayed until economic activity picks up in Europe and Japan. But by 1995 export demand should begin to rise.

THE EUROPEAN MONETARY SYSTEM

The European Monetary System (EMS) was created in March 1979 to limit exchange-rate variability among the European currencies (Box 6–7). A majority of countries in the EMS agreed to participate in the system's Exchange Rate Mechanism (ERM), under which most member countries were required to maintain their exchange rates within 2.25 percent of "central rates" between their currency and each of the other members' currencies. When an exchange rate between two members' currencies moves to the limits of the band, both central banks are required to intervene to prevent the exchange rate from moving outside the band. In the event of irresistible pressure on a member country's exchange rate, realignments of the country's central rate are permitted.

Inflation in most European economies declined by the mid-1980s, moving toward the rates of Germany and the Netherlands. Countries concentrated on maintaining their parities with respect to the deutsche mark, since Germany had for historical reasons established an unwavering commitment to price stability. Increasingly, then, the deutsche mark became the monetary anchor for the EMS. By linking their monetary policies to German policy, other ERM members brought their inflation rates down. French inflation, for example, declined from over 10 percent at the start of the 1980s to under 3 percent in 1992.

To some observers, the disinflation achieved within the EMS highlights an important rationale for pegging exchange rates. An alternative view holds that disinflation was not simply a product of the EMS but was worldwide in scope. During the 1980s, for example, inflation also declined in the United Kingdom, which did not join the ERM until 1990, and in the United States and Canada. So perhaps the relative stability of EMS parities in recent years was as much the result as the cause of a convergence in inflation rates.

Realignments took place relatively frequently in the first years of the EMS but not thereafter. Between 1979 and 1987 there were 11 realignments; these tended to be small as well as frequent and thereby occurred without major crises. After January 1987, essentially no realignments took place until September 1992.

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Box 6-7.—Exchange-Rate Volatility and International Trade

Proponents of the ERM argue that stabilizing exchange rates is important for expanding trade. Exchange-rate volatility, they argue, is a source of uncertainty to firms engaging in trade because it adds volatility to the domestic currency value of future foreign currency transactions. Firms therefore face greater uncertainty in revenues and profits from foreign sales when exchange rates are more volatile. This added uncertainty, it is claimed, discourages firms from engaging in trade and from making the investments that support trade.

Such claims seem plausible, but they enjoy little empirical support. The volume of U.S. trade did grow slightly faster between 1950 and 1971, when the dollar was fixed, than between 1973 and 1993, when the dollar floated. Relative to GDP, however, trade volumes grew more quickly in the second period. In addition, studies that have examined the extent to which greater exchange-rate volatility inhibits trade flows have generally failed to find a robust relationship. One possible explanation is that financial markets provide firms with risk management tools that can be used to hedge exchange-rate movements. For example, a firm can buy currencies forward to fix the domestic currency value of future payments. Whatever the explanation, it is difficult to find empirical support for an adverse impact of exchange-rate volatility on trade volumes.

THE EUROPEAN CURRENCIES IN TURMOIL

The EMS has experienced a series of crises since the summer of 1992. Germany adopted tight monetary policies in response to inflationary pressures that arose following German reunification in 1990. As a result, German short-term interest rates, which had been rising since 1988, continued to rise, reaching nearly 10 percent by the summer of 1992.

German policy, in turn, created a dilemma for other ERM participants. Maintaining fixed parities with the deutsche mark required them to tighten monetary policy despite stagnating or declining output, rising unemployment, and low rates of inflation.

When investors are free to choose among assets denominated in different currencies, the rates of return they expect to receive for comparable degrees of risk cannot vary too far from one currency to another. Expected exchange-rate changes are important in determining expected rates of return on assets denominated in different currencies. If, for example, investors expect the French franc to depreciate relative to the deutsche mark, they will move funds from French franc deposits into deutsche mark deposits unless they are

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compensated by a higher franc interest rate. Thus interest rates on franc-denominated assets would have to rise above the interest rate on deutsche mark assets to prevent sustained flows of capital out of franc assets and into deutsche mark assets.

Speculative pressures motivated by the possibility of a change in parities precipitated a crisis in September 1992. In the United Kingdom, where output had declined by more than 4 percent from its previous peak and the unemployment rate had topped 10 percent, pressure increased to realign or to drop out of the EMS so that interest rates could be lowered. Finland and Sweden, although not formal participants in the ERM, had been unilaterally maintaining pegged exchange rates, and so faced similar dilemmas as their economies went through deep and prolonged recessions. In September 1992, Finland, the United Kingdom, and Italy decided to allow their currencies to float, with the last two effectively leaving the ERM. Sweden followed in November. Spain, Portugal, and Ireland all devalued within the ERM between September 1992 and January 1993.

A second crisis erupted in mid-July 1993, following additional signs of growing slack in the European economies. Massive speculative capital flows occurred. Belgium, Denmark, France, and Portugal all raised interest rates and intervened heavily to defend their currencies. Nonetheless, the Belgian franc, the French franc, and the Danish krone dropped through their ERM floors. Selling pressures on these currencies continued, and on August 2, 1993, the countries participating in the ERM decided to widen the bands around the (unchanged) central parities to ±15 percent (Chart 6–5). (A separate agreement maintains bands of ±2.25 percent for the deutsche mark and the Dutch guilder.) Since all currencies were well within the wider bands, central banks were not obliged to intervene and the speculative crisis stopped.

The wider bands allow the participating countries much greater latitude to change interest rates independently. For the most part, however, the authorities have not used this ability to push interest rates down. Instead, they have sought to maintain relatively stable exchange rates with the deutsche mark and have cut interest rates only in parallel with Germany. By the end of 1993 the Belgian, Danish, French, Portuguese, and Spanish currencies were within or near the old ERM limits relative to the deutsche mark. The United Kingdom aggressively cut interest rates after leaving the ERM in September 1992.

THE MAASTRICHT TREATY ON ECONOMIC AND MONETARY UNION

In the Maastricht Treaty of 1991, the members of the European Community agreed to replace the EMS with an Economic and Mon-

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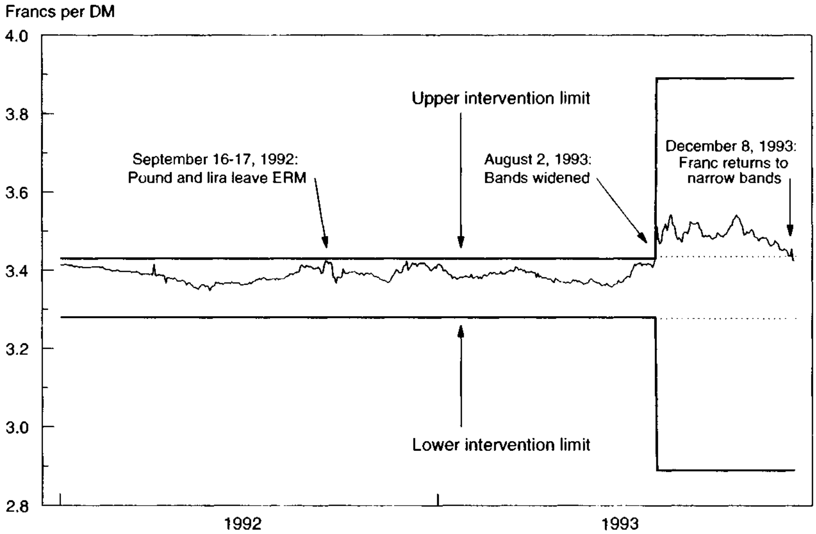
Chart 6-5 **French Franc-Deutsche Mark Exchange Rates**
Last summer's exchange-rate crisis precipitated a widening of the Exchange Rate Mechanism's intervention bands.



Note: The Exchange Rate Mechanism prescribes intervention bands for participating members of the European Monetary System.
Sources: Council of Economic Advisers and Board of Governors of the Federal Reserve System.

etary Union (EMU), a common currency, and a European Central Bank overseeing a single monetary policy. Under the treaty, progress toward EMU would take place in stages, with the final stage—under which exchange rates are fixed irrevocably—coming no later than 1999.

The treaty establishes conditions for implementing a common currency and monetary policy (Box 6–8). As of late 1993, no country in the European Union met these conditions. With reunification swelling its public sector deficit, even Germany failed to meet the criteria.

The process of ratifying the Maastricht Treaty was completed in 1993, although the timing of full implementation will depend in part on the achievement of the agreed conditions. In May 1993, Danish voters reversed the outcome of the previous year's referendum and accepted the treaty. The British House of Commons then approved the treaty in July. The final steps in the ratification process were completed when court challenges to the treaty failed in July in the United Kingdom and in October in Germany. The Maastricht Treaty entered into force on November 1, 1993, creating the European Union.

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Box 6-8.—Criteria for Joining the Economic and Monetary Union

Countries acceding to EMU must meet several strict criteria:

- The entering country's inflation rate must not exceed the average of the lowest three members' rates by more than 1.5 percentage points.
- Its interest rate on long-term government bonds cannot exceed those of the three lowest-inflation members by more than 2 percentage points.
- The country's general-government budget deficit must not exceed 3 percent of GDP, and outstanding government debt must not exceed 60 percent of GDP.
- For at least 2 years, the country's currency must have remained within its narrow ERM band without realignment.

Shortly after completing the ratification process, the EU countries selected Frankfurt as the home of the new European Monetary Institute, the forerunner of the European Central Bank. Despite their failure to complete the first stage (bringing all countries within narrow ERM bands), the EU countries are proceeding with the timetable set out in the Maastricht Treaty.

CONCLUSIONS

The year 1993 proved to be the most important year for American trade policy in half a century, thanks to developments that vastly increased the prospects for free and open trade.

During the past year, the Administration completed two landmark negotiations. The first created a North American Free Trade Area encompassing the United States, Canada, and Mexico. In many respects this agreement is historically unprecedented: It is the first free-trade agreement between industrialized and developing countries; it is the first trade agreement to incorporate environmental provisions explicitly; and it contains technical innovations in areas such as dispute settlement that may become models for the global trade regime.

The Administration did not stop there, however. It also led a successful conclusion of the Uruguay Round of GATT, the most far-reaching global trade agreement in history. This agreement will reduce trade barriers, protect the legitimate interests of U.S. producers in areas such as intellectual property rights where none existed before, and bring areas of trade such as agriculture and textiles into the multilateral system for the first time.

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Besides bringing these endeavors to fruition, the Administration launched several new trade initiatives and breathed new life into some old ones. The Administration made major progress in establishing APEC as a prominent forum for advancing our interests in the critical Asia-Pacific region. In addition, the United States reached a new bilateral agreement with Japan. Complementing the new international initiatives, the Administration also launched a new National Export Strategy to promote American exports.

This Administration understands that expanding trade relations are not only inevitable but critical to the future health of the U.S. economy. It is determined to ensure that the growing interdependence with our trading partners brings benefits to the United States. To this end the United States Government is committed to act unilaterally, bilaterally, regionally, plurilaterally, and globally to open markets to maintain the ability of U.S. firms to compete around the world. Through increasing integration into the global economy, we can achieve ever-rising living standards for all of our people.

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