1 Introduction

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1.1 Overview

Issues of international trade and trade policy have been at the center of the U.S. political system in recent years. There has been growing concern and even alarm at the size of the U.S. trade deficit and the associated difficulties being experienced by U.S. import-competing and export industries. Most economists would attribute this state of affairs in large measure to the substantial appreciation of the U.S. dollar that occurred between 1980 and 1985 in response to the sizable and continued flow of foreign financial capital into the United States. It is not surprising in these circumstances that the trade and current accounts would go into deficit to accommodate the capital inflow.

At the political level it is probably understood, though not always acknowledged in public statements, that the source of the foreign imbalance is a macroeconomic phenomenon. It is another matter altogether, however, to devise changes in macroeconomic policies that could relieve the pressures on trade-affected sectors. Although the Reagan administration and the Congress have taken some steps to reduce the existing and prospective future government budget deficits, the measures have not been decisive at the time of writing (January 1986). Since the trade effects are very real to the firms and workers involved, this failure of macroeconomic policy has been translated into a heightened sensitivity to trade issues in the Congress. Congress has been deluged in 1985 and 1986 by a spate of legislative proposals to assist trade-sensitive sectors of the economy.

These events must be seen in the broader and long-run context of a world economy that is experiencing structural adaptation. In particular the United States is now much less dominant than previously, and its traditional comparative advantage in resource-based and especially in manufacturing industries has been eroded by foreign competition. Japan and the newly industrializing countries (NICs) of Asia and Latin America have been at the forefront of the new wave of international development and competition. These long-term changes provide the basis for improvements in economic welfare in the countries undergoing structural transformation, although there may be some asymmetries involved in the process of change, especially in importing countries. Thus to the extent that import-competing firms find it difficult or impossible to withstand the pressures of increased foreign competition and workers become unemployed and experience problems in obtaining new and comparably paid jobs, this will give rise to efforts to restrict imports. These efforts will be magnified in circumstances like those experienced in the United States when dollar appreciation has resulted in unprecedented trade account deficits. For similar reasons U.S. export interests will be motivated to seek government assistance to sustain their foreign market shares.

The decline in U.S. economic predominance has resulted in greater parity between the United States and the other major nations in the industrialized world, especially Japan and the European Economic Community (EEC). The period of greatest strength and influence of the United States can be dated approximately from World War II to the late 1960s. During this time the United States took the initiative first in aiding the reconstruction of Western Europe and Japan and then fostering the liberalization of world trade and investment. The United States was also the major force in promoting political stability internationally in the Western world through its economic policies and its assumption of the greatest share of expenditures on defense. During this phase of world leadership, the United States was a strong (though not always consistent) supporter of the principles of nondiscrimination and multilateralism in world trade. Although these principles still provide the foundation for most U.S. trade policies, they have been criticized on the grounds that they encourage free riders and in themselves cannot be used as a disciplining mechanism for limiting the use of foreign government restrictions and subsidies that work to the disadvantage of U.S. producers. The United States therefore now appears more inclined than previously to pursue selective trade policy arrangements both within the General Agreement on Tariffs and Trade (GATT) and on its own. It has also adopted a somewhat more aggressive stance in threatening and actually taking actions designed to encourage or force foreign governments to change policies deemed detrimental to U.S. interests.

As the world's international economic and political relationships have been changing, the adequacy of the rules of international trade as embodied in the GATT has come under question. Important sectors like agriculture and textiles and clothing have long been exempt from GATT rules, and there has been an increasing resort by the U.S. and other major countries to nontariff restrictions, particularly voluntary export restraints (VERs), which have an ambiguous status in the GATT. All of this is evidence that the GATT is not functioning effectively since its most important members feel that they can bypass or ignore GATT authority and obligations when their national interests are on the line. The international trading system thus appears to be in disarray as the example and influence of the GATT have been eroded and the United States and other countries have become increasingly inclined to take unilateral policy actions.

There are numerous other aspects of government policies that may impinge upon trade. These include policies to correct distortions, achieve noneconomic objectives such as national defense, and influence the behavior of other nations for political purposes. The traditional analysis of distortions suggests that trade intervention is not optimal to correct distortions, except when a government has monopoly power and can impose an optimum tariff without incurring foreign retaliation. The same conclusion holds when there are noneconomic objectives, although trade intervention may be optimal when the objective is to affect trade directly. While the foregoing presumptions about optimal policies are well established theoretically, the presence of institutional and political constraints and rent-revenue–seeking behavior by different interest groups may alter the outcome and thus affect the choice of optimal policies in certain circumstances.

Trade policy may be an objective of foreign policy when international economic and political interests coincide. Trade policy may also be used as an instrument of foreign policy in order to achieve some international political objective. Both uses of trade policy have a long history in the United States and other major countries, but views differ especially on whether trade policy has been effective when used as an instrument of foreign policy. The problem is in defining criteria to evaluate effectiveness since the goals of foreign policy may be complex and therefore difficult to relate directly to specific measures of trade policy. This appears to be the case with respect to the use of economic sanctions and embargoes by the United States and other countries.

1.2 Summaries of Chapters

The preceding discussion was intended as an introduction to the range of issues of trade policy confronting the U.S. Although many of these issues have been analyzed at length over the years and are well understood at least conceptually, the changing circumstances of the United States in the world economy require a refocusing and consolidation of analytical perspective. The papers commissioned for the conference, now the chapters in this book, were designed accordingly to provide insight into current issues. Although the individual papers and the discussants' comments were not intended to pursue new directions in international trade theory and policy, readers will find ample reference to and evaluation of current developments in research.

Each chapter is summarized briefly below. The papers were revised after the conference to take into account the comments of discussants and other questions raised in the floor discussion. The discussants' comments following each chapter in this book are not included in the summaries. These comments, which were also revised after the conference, deal with both particular points and broader issues considered germane to the topic.

Deardorff and Stern: "Current Issues in Trade Policy: An Overview"

In their overview chapter Deardorff and Stern first provide information on the broad movements of global trade aggregates, the commodity and sectoral composition of net exports of merchandise and services for the United States, Japan, and the EEC, changes in exchange rates, and recent changes in protectionist pressures and actions in the United States and other industrialized countries. They note that the expansion of world trade slowed considerably beginning in the mid-1970s and that there was actually a decline in 1982 due to world recession. In the United States the post-1980 appreciation of the dollar exacerbated the structural adjustment problems that many import-competing industries were already experiencing. It is not surprising therefore that protectionist pressures have become more acute in recent years, particularly in the United States and the EEC.

Following their presentation of developments in trade and protectionism, Deardorff and Stern review the case for free trade and then address arguments in favor of trade intervention. Although some of their discussion covers familiar ground, it is nonetheless worth repetition because it focuses on optimality conditions and how various types of trade intervention may be detrimental to economic welfare. Deardorff and Stern classify the optimum tariff argument as an exploitative policy, given that the country imposing the tariff benefits at the expense of the rest of the world. They consider recent arguments for trade intervention in imperfectly competitive markets, which are designed to enable a country to appropriate monopoly profits or to achieve strategic advantage, as also being exploitative in nature rather than representing genuinely new arguments. The same is true for the use of countervailing policies, which can benefit a country only when it is able to influence its terms of trade. They note further that the classic problem of the Prisoners' Dilemma arises in strategic trade intervention when various exploitative policies are being considered. This suggests that the world might benefit if governments were precommitted to retaliation in response to exploitative policies used by others.

The final issues considered relate to trade intervention for domestic political reasons. To the extent that government officials take the interests of the nation as a whole into account, the arguments for and against trade intervention are highly pertinent. Moreover, in deciding which instruments of protection to use, there is something to be said for choosing the mildest form of intervention, which might arguably be a tariff. Unfortunately the use of the tariff instrument is subject to national and international legal constraints, and the result has been to choose much more costly measures of trade intervention such as the VER.

Dornbusch and Frankel: "Macroeconomics and Protection"

Dornbusch and Frankel begin their chapter with a factual and interpretive analysis of the macroeconomic setting in which changes have been made in U.S. tariffs and NTBs, ranging from the Smoot-Hawley tariff legislation of 1930 to the Tokyo Round negotiations of the late 1970s and events of the early 1980s. They classify the macrocyclical determinants of protectionism into those associated with aggregate demand and micro-supply variables. The variables affecting aggregate demand are domestic or foreign, and these will vary in importance depending on cyclical factors. The effects of the substantial real appreciation of the U.S. dollar since 1980 are judged to be especially important in explaining the upsurge of U.S. protectionism. They note, however, that the depreciation especially of the European currencies did not mitigate protectionist pressures there, so that the role of the exchange rate is by no means obvious in all circumstances. This is borne out in regression analysis of the determinants of employment in the U.S. auto, steel, textiles and apparel, and metal fastener industries. Although the exchange rate is important for steel and metal fasteners, the most significant variable in each case is a simple time trend. This suggests that long-run structural considerations rather than macroeconomic influences may be the root causes of changes in U.S. protection in these industries.

They identify four key micro-structural reasons for protection: (1) shifts in productivity in domestic or foreign industry, (2) sectoral imbalances that arise when favorable events in one sector put pressure on another sector through wages and/or exchange rates (the Dutch disease), (3) wage misalignments, and (4) transfer difficulties arising from the need of debtor countries to generate foreign exchange by means of increased exports and/or reduced imports.

Dornbusch and Frankel note that U.S. protectionist sentiment is directed especially against Japan, yet they find little factual reason for this sentiment since the dollar has not appreciated significantly against the yen in comparison to the major European currencies, and Japan has not increased its own trade barriers. The explanation presumably lies more in productivity differentials and wage misalignments between the United States and Japan.

Dornbusch and Frankel conclude by arguing in favor of a change in the U.S. policy mix to permit fiscal tightening and monetary expansion and to have the opposite policy changes carried out in Europe and Japan. This would result in lower real interest rates in the United States and depreciation of the dollar. Such coordinated action would serve to correct the existing U.S. trade imbalance and bring about a realignment of the tradable sector. It is to be preferred to other, possibly ill advised, measures such as a U.S. import surcharge or a tax on international capital movements.

Magee and Young: "Endogenous Protection in the United States, 1900–1984"

In their chapter Magee and Young develop a model of endogenous protection and use it to search for variables that may help empirically to explain changes in protection in the United States since 1900. The essential idea is that trade policies lie outside the control of policymakers, who function as intermediaries between the narrow interests of protectionist and proexport groups, on the one hand, and the broad interests of voters (consumers) on the other hand. Protectionism is thus regarded as the equilibrium outcome of the interactions involving political parties (Democrats and Republicans), lobbying groups (representing labor and capital), and voters. The demand for protection will depend on the importance of labor relative to capital (endowment effect), the relation between product and factor prices (magnification effect), and changes in the terms of trade (compensation effect). There will be macroeconomic influences on protection as well, stemming from changes in the rates of unemployment and inflation. Voters may oppose protection especially during inflationary periods. Since labor is the scarce factor in the United States, it will favor protection, while capital interests will oppose protection. The Democrats, whose main constituents are labor, can be expected to be more inclined toward protectionism than the Republicans.

In observing changes in protection since 1900, Magee and Young note a paradox in the way that the political parties have behaved, with prolabor Democratic administrations promoting freer trade and Republican administrators being more protectionist. They attribute this paradox to the macroeconomic policies that the two parties have used to serve their constituencies, with the Democrats choosing lower unemployment and higher inflation and Republicans the opposite.

Magee and Young fit a series of regressions in which the average tariff levels for sixteen presidential administrations (four prior to 1932 and twelve thereafter) from 1905 to 1980 are to be explained by various microeconomic and macroeconomic influences. Even taking account of the limited degrees of freedom in these regressions, Magee and Young interpret their empirical results as providing broad support for their model. In comparing the actual and predicted values of the changes in tariffs based on their preferred equation, they would expect the first Reagan term to be characterized by considerable protectionist pressure and, if unemployment were to fall and inflation rise in Reagan's second term, the protectionist pressure could be expected to abate. Magee and Young also analyze nontariff protection as provided by the U.S. antidumping statutes, and they conclude that special interest variables are the dominant influences involved.

Krugman: "Strategic Sectors and International Competition"

Krugman deals with the question of identifying strategic sectors and the extent to which international competition and national government policies may affect the returns to such sectors under conditions of imperfect competition or when externalities are present. Although the concept of strategic sectors is not meaningful when there is perfect competition because the returns to equivalent factors are equalized, particular sectors may realize excess returns when competition is imperfect. Governments may therefore be motivated to engage in international rent seeking in an effort to capture some portion of these returns for their domestic firms or residents. In exploring this possibility, Krugman cites the work of Brander and Spencer, who show in the context of a Cournot duopoly model that there may be an optimal export subsidy that will benefit a country and in effect substitute for the strategic commitment that the country's firms cannot make themselves. Krugman notes, however, that this possibility seems remote on theoretical grounds since it does not survive any of a number of changes in assumptions: if the firms compete in terms of price rather than quantity, if factors of production are in inelastic supply, if there is a significant degree of competition among domestic firms and substantial exports, and if entry barriers are potentially or actually low. He argues further that the possible gains from international rent seeking may in fact be rather limited since excess profits of firms may not translate into large gains for a nation, especially in the case of the United States where most production is domestic rather than trade oriented, and also the benefits may be once and for all rather than continuing. Finally he notes that it is not clear that the excess profits would in fact be diverted to domestic residents when account is taken of diverse ownership patterns and differences in tax regimes.

The case for identifying strategic sectors may be more compelling when there are externalities that are country or location specific. But to the extent that the products involved can be traded, Krugman notes that it may not matter where the industry is located. There is no necessary connection therefore between the availability of technology and the production of goods in a given country. Accordingly Krugman is doubtful that there is much to be gained by governments seeking to identify and capture the returns associated with strategic sectors.

Dixit: "How Should the United States Respond to Other Countries' Trade Policies?"

Dixit notes that the response that the United States might make to other countries' trade policies requires prior consideration of how these policies affect U.S. real national income and national security. The effects on real income work primarily through changes in the terms of trade and the division of excess profits between the United States and foreign countries. There may also be domestic considerations involving the distribution of income between gainers and losers from the policies of foreign countries.

If changes in the U.S. terms of trade occur because of foreign export subsidies, the United States will benefit nationally, although it may be necessary in the process to compensate any losers. Foreign restrictions on U.S. goods may be damaging, however, and the United States might consider responding with restrictions of its own, in which case both countries would be worse off. In any event the empirical evidence suggests that U.S. terms of trade movements are fairly small and probably not greatly influenced by foreign countries' policies. The existence of excess profits under imperfect competition raises the question of whether the government can employ better strategies to capture these profits than the strategies available to firms. This is the Brander-Spencer type of situation, and Dixit is doubtful that there is much to be gained here.

Foreign countries may impose embargoes or sanctions on their trade, which may threaten U.S. national security. The impact of such policies may be limited, however, if there are alternative sources of supply available, if the U.S. economy can adjust or if stockpiles can be built up for later use in time of emergency.

The United States can react to foreign countries' policies, develop precautionary policies to deal with trade disruptions, and employ or promise to introduce strategic measures in order to deter or compel changes in foreign government behavior. In designing strategic policies, Dixit stresses the importance of maintaining credibility, which may require taking action quickly, irreversibly, and automatically, being clear on what is at stake, and perhaps resorting to brinkmanship and suggestion of irrationality. He concludes that the United States is poorly situated for successful strategic use of threats and also that the United States has not had much success with threats. By the same token he notes that the United States has a good record in fostering cooperation with other countries, and accordingly it could beneficially use strategic advance responses to alter other countries' trade policies in a mutually beneficial way.

Cooper: "Trade Policy as Foreign Policy"

Cooper divides U.S. history into three periods: (1) 1765–1820, when boycotts and embargoes were instrumental in seeking to achieve independence and national sovereignty, (2) 1820–1934, when tariff policy was almost exclusively governed by domestic political considerations and the promotion of U.S. exports was a principal aim of foreign policy, and (3) 1934–1985, when trade policy has been directed in large measure to overcoming the economic and political disasters of the Great Depression by fostering an environment conducive to full employment, growth, and stability within and among nations in the world economy. In the third period trade policy has also been used on occasion to achieve other foreign policy objectives.

Cooper points out that the international trading system after World War II was premised on the ideals of nondiscrimination, multilateralism, and international dispute resolution. Foreign trade was thus intended to be insulated from domestic economic and foreign policy pressures. There have been exceptions, however, with the U.S. denial of most-favored-nation treatment to communist countries, preferential arrangements such as the U.S.-Canadian Auto Pact, the Generalized System of Preferences, the Caribbean Basin Initiative, and the U.S.-Israel free trade arrangement, and the manipulative use of trade policy, mostly by means of export controls, with the intention of influencing the behavior of other countries. The range of manipulative trade policy includes full embargoes and partial embargoes or restrictions on arms exports, strategic materials, and defense-related technologies. U.S. trade actions have been guided by a variety of foreign policy objectives, including a desire to curb nuclear proliferation, encouragement of human rights, discouragement of international terrorism, and encouragement of political and military restraint by the Soviet Union around the world.

In evaluating trade policy as foreign policy, Cooper asks what the world would be like if the action had not been taken and what other courses of action were available to achieve the particular objective of foreign policy. It seems clear in this regard that U.S. support of multilateral trade liberalization has been enormously successful in terms of foreign policy. It is more difficult, however, to evaluate the use of manipulative trade policy. Here Cooper is more convinced than many other observers that trade sanctions have been successful in achieving the desired foreign policy objective, although he cites some historical examples to illustrate how difficult it may be to evaluate particular measures when there are manifold objectives in complex situations.

Srinivasan: "The National Defense Argument for Government Intervention in Foreign Trade"

The use of trade policy for national defense objectives may involve assistance to particular industries or factors of production deemed vital to defense, as well as strategic measures designed to respond to foreign actions or to affect the behavior of foreign governments. National defense can be treated as a noneconomic objective or as an externality. Srinivasan demonstrates the familiar conclusion that a domestic tax-subsidy is optimal when the objective of policy is to increase the production, consumption, or employment involved in defense goods, while a trade tax may be optimal when the objective is the restriction of trade for defense purposes. This conclusion abstracts from the use of resources in carrying out the intervention or the diversion of resources to lobbying activities. Examples of (dynamic) externalities are that private capital accumulation may increase the need for defense expenditures in order to deter potential aggressors from seeking to acquire the nation's capital stock, a larger private capital stock may increase a nation's defense capacity, and underinvestment is possible because private investors may anticipate the imposition of controls during times of emergency. Corrective fiscal measures will be justified in these circumstances.

If a nation's security is threatened by trade restraints, embargoes, or sanctions imposed by foreign governments, the appropriate policy response will depend on whether private agents anticipate and allow fully for the time interdependence of their actions in present and future periods. In case the private decisions do not anticipate and make appropriate allowance for the relevant effects, a corrective tax-subsidy will be in order.

Srinivasan also analyzes the strategic use of policies to affect the behavior of foreign countries. He considers the case for strategic stockpiles, noting that intervention may be justified if there is an externality but not necessarily when the private agents and governments have perfect foresight and strategic interactions are taken into account. Issues of national security and global political influence are analyzed in the context of the gains from trade. Empirical evidence suggests that there is an inverse relationship between international trade and political conflict. Yet in the context of East-West relations, there is a perception, especially in the United States, that restrictions on trade and related transactions may impose substantial costs on and elicit more cooperative behavior from the Soviet Union and its satellites. Srinivasan cites a number of studies that offer conflicting conclusions in this connection, and he develops a formal model of the relation between national security and the gains from trade that permits a variety of possible outcomes in response to the imposition of trade controls. Finally Srinivasan reviews embargoes and sanctions in a historical context and concludes that they have had limited effectiveness, especially since 1973.

Jackson: "Multilateral and Bilateral Negotiating Approaches for the Conduct of U.S. Trade Policies"

Issues of alternative negotiating approaches for the conduct of U.S. trade policies must be seen in the wider context of the institutions and principles that form the basis for the international trading system. Jackson notes that although the United States had ambivalent attitudes toward GATT as an international organization during much of the postwar period, it was nonetheless a strong proponent of the GATT principles of nondiscrimination and multilateralism. At the same time, however, it appears that U.S. support of these principles has been eroding, as evidenced by the conditionality attached to the nontariff codes negotiated in the Tokyo Round, U.S. preoccupation with its trade imbalance with Japan, implementation of selective VERs and related policies designed to restrict U.S. imports, and the adoption of a more pragmatic approach to trade policy and willingness to pursue bilateral arrangements and to reward friendly countries.

Although the GATT has played a vital role in fostering trade liberalization multilaterally, its institutional structure is hampered because it is difficult to amend the articles of agreement, the EEC is able to exercise undue and often negative influence on GATT matters, the GATT secretariat is small, and its dispute settlement procedures have not been operating effectively. Further some important substantive problems have been abdicated or remain muddled within GATT because of national pressures. These include the exemption of agriculture and textiles from GATT discipline, the ambiguous rules that countries exploit in their use of VERs and other protectionist measures, and the ambiguities that limit the effectiveness and coverage of the Tokyo Round codes.

Despite these problems the principles of nondiscrimination and multilateralism are of fundamental importance. As Jackson notes, the most-favored-nation (MFN) obligation of nondiscrimination serves to minimize distortions in market principles, facilitates the formation of rules, reduces transactions costs, and limits the political side effects of policies. There are, of course, problems of foot dragging and free riders, which may counteract these benefits and therefore have to be addressed. The use of conditionality is only one way to respond to these problems. Preferential arrangments and selectivity are other options.

Trade policies in the United States are the joint responsibility of the executive branch and the Congress, and there has often been an uneasy tension on these matters. The legislative procedures of the Congress and the domestic pressures to which elected officials are subjected raise important questions about the desirability and efficacy of conducting U.S. trade policies along bilateral lines. There is a need for international rules and international institutions to help manage interdependence among nations. As Jackson concludes, the pursuit of multilateralism may certainly be frustrating. Maybe what is needed are certain tactical departures from MFN, or what Jackson calls a minilateral approach to trade liberalization.

Corden: "On Making Rules for the International Trading System"

Corden notes that a rules-based system governing international trade economizes on negotiations and power play among nations. Rules provide the benefit of certainty to transactors, although they may also entail a loss of flexibility if they cannot be readily changed. In making rules, countries should take a long view since they cannot be sure about their eventual situations. The greater is the investment in terms of negotiations concerning rules at a given time, the less need there may be for negotiations in the future. It is often argued that rules may protect relatively small and weak nations. But as Corden points out, this is not necessarily the case since nations that are weak currently and will remain so in the future are not likely to have a substantial impact in the making of rules.

In judging economic policies and systems of rules, Corden stresses the traditional criterion of Pareto efficiency and the long-term mutual gains from free international trade. There is a difficulty, however, since compensation of those harmed by changes in policies may not be possible or may be incomplete. One way to deal with this situation is to attach different welfare weights to different income recipients, as, for example, in the case of an egalitarian social welfare function that gives more weight to the poor than the rich or a conservative social welfare function that is designed to maintain the status quo. Corden also notes that rules may be justified as a means of restraining governments for the good of their countries, especially to resist pressure groups that seek to advance their narrow interests at the expense of general welfare. The problem is that governments may be the best judges of the national interest, in which case there is an argument to be made in favor of decentralized national decision making. The final point made is that rules should be devised to promote harmony in the international system, minimize costly negotiations and conflict, and yet not place unnecessary restraints on governments.

The United States has a special role to play, according to Corden: to set an example for other nations and to spread belief in the efficacy and desirability of efficiency-oriented and market-based policies while recognizing national differences concerning intervention and distributional objectives. Corden addresses two issues of current importance in the trading system: discrimination and subsidies. He notes that discrimination may be beneficial if it results in a movement toward free trade but not if it produces continuous and therefore costly opportunities for bargaining and if it works against the interests of the developing (poor) countries. The opposition to subsidies comes mainly from sectoral interests, although there may be problems when there are sudden or severe changes in trade associated with subsidies. It is difficult nonetheless to envisage comprehensive rules restraining the use of subsidies without impinging on national sovereignty.

Corden offers a package of rules for the international trading system that he believes would be desirable, though not probable, overall but with some elements that may nonetheless be possible to attain. The package includes complete free trade; a safeguards code that permits temporary, nondiscriminatory use of tariffs; restriction of the benefits of free trade and safeguards only on a reciprocal basis; subsidy freedom; complete transparency of policies; and allowance for exceptions by developing countries in transition.