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INTERNATIONAL TRADE ISSUES FOR THE 90s

by
JAGDISH BHAGWATI*

The open, multilateral trading system, centered on the General Agreement on Tariffs and Trade, is currently at risk. The threat continues to come from familiar directions. But there are new problems too.

PROTECTIONISM

Protectionism, of course, remains a problem. Like the cockroach, it is indestructible: all one can hope for is that the pressures for protection are contained. This requires continued vigilance. This is particularly so when protectionism takes ever new forms. The postwar decline of tariffs has focused our minds now on nontariff barriers. And the trade experts know that administered protection, operating through the unfair use of the "unfair trade" mechanisms such as countervailing duties (CVDs) aimed at foreign subsidies and anti-dumping (AD) levies, is now the favourite weapon of the protectionists. Of course, it is easier to secure relief from foreign competition if one can allege unfair trade than if one simply says: I cannot hack it, so grant me protection!¹

ORWELLIAN NEWSPEAK

Then again, one cannot but be depressed by the manner in which the debate on trade policy continues to be debased, permitting protectionists and the anti-multilateralist forces the space and success that an intellectually honest and informed debate would deny them. I shall concentrate on just two examples.²

Thus, consider first the important distinction between the *fix-rule* and the *fix-quantity* (or, in more popular parlance, "results-oriented" or "managed

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¹ There are several reasons, including structural changes in the world economy, which have prompted increased resort to allegations of unfair trade in recent years. I consider them at some length in JAGDISH BHAGWATI, *THE WORLD TRADING SYSTEM AT RISK* (1991).

² *Id.* In Appendix 1, I have considered several other examples of gratuitous confusion of concepts, frequently fed by inaccurate assertions made by careless economists pronouncing on matters where they frequently have no expertise.

trade") trading regimes.³ Under the former, the rules are set and then countries must accept the consequences for production and trade that follow from them: chips must be allowed to fall where they may. Under the latter, the trade quantities are preset: e.g. the semiconductor chips sold by the United States in Japan must be 20% of the Japanese market or the number of Japanese cars sold in the United States must not exceed the quota set by Voluntary Export Restraints. The distinction is best understood by considering a basketball game. Under a fix-rule system, the rules are set and then the game determines who scores what and who wins. Under a fix-quantity system, these outcomes are decided by negotiation, i.e. by horse-trading between the managers of the teams.

Evidently, the distinction is absolutely critical. But the recent debates show that the proponents of "managed trade" typically confuse the case for quantity-setting in trade with the broad case for intervention *per se*⁴ and, more frequently, with the narrow case for trade intervention.⁵ Equally, they confuse managed trade, which implies a fix-quantity regime, with "trade management" which refers to rule-making trade negotiations and enforcement of negotiated trade rights and obligations, all of which complement, sustain and expand the scope of a fix-rule regime instead!

Yet another example comes from the recent debate over the U.S.-Mexico Free Trade Area, prior to the successful renewal of fast-track authority for another two years to negotiate it. Not merely bureaucrats and politicians, but also professional economists playing amateur politics, have argued the case for the FTA as it was the same as the case for FT (free trade). But it is not. FTAs are *preferential* trade arrangements. So, unlike FT, they lower trade barriers for member states, not for others. As such, they have two faces: one is turned towards protection, looking inward for the members' markets, and the other is towards free trade. Jacob Viner thus alerted us to the fact that an FTA could *divert* trade from competitive nonmember suppliers (who continue facing trade barriers) to uncompetitive member exporters (who do

³ The phrases, fix-rule and fix-quantity, were introduced in my PROTECTIONISM (1988), to contrast sharply the two types of trading regimes.

⁴ Market failures lead to the conventional case for assisting the invisible hand. But international trade theorists in the 1960s and 1970s examined carefully different types of market failure and showed that the appropriate intervention to fix market failure need not be *trade* protection but often required instead *domestic* policies targetted at the source of the failure. Again, during the late 1970s and 1980s, international trade theorists have made another scientific breakthrough by exploring systematically the political-economy-theoretic argument that interventions in practice may be harmful rather than helpful because they are shaped by pressure groups in pluralistic systems or by predatory governments or branches thereof.

⁵ Even when trade (as distinct from domestic) intervention is appropriate, economists generally prefer price rather than quantity instruments. *E.g.* they prefer *ad valorem* tariffs to import quotas, for a variety of reasons. Sophisticated theoretical arguments can indeed be made for quantity interventions of particular varieties in specific situations, but these have little correspondence to the arguments advanced by the "managed traders".

not). A sound case for any specific FTA cannot therefore be made unless the analyst starts by confronting instead of obfuscating, at the very outset, this important implication of the FTA's being a preferential arrangement.

THE GATT-CENTERED MULTILATERAL SYSTEM

The threats to the trading system that I wish to address are more unconventional. They arise with respect to the three underlying principles of the GATT:

1. Trade should be conducted by rules, not by preset quantities;
2. Trade barriers should be removed, and new disciplines established, by mutuality of concessions rather than by coercion leading to unrequited concessions by the weak to the strong; and
3. Trade should be conducted on a nondiscriminatory basis among the GATT members, requiring therefore the extension of Most-Favoured-Nation (MFN) treatment to one another.

THE THREAT OF MANAGED TRADE

The fix-rule system, embodied in the GATT, is increasingly considered by articulate and agitated critics to be obsolete and inappropriate to current needs. The skepticism comes from two directions. It is fuelled by the notion that Japan is not capable of playing by rules, whether by wicked design or due to cultural affliction, and that only managed trade with Japan can generate gains from trade with it. Equally, it is fed by the fear that foreign nations, with more active technology and industrial policy, will take away high-tech industries from the United States.

Commentators such as James Fallows have argued that the Japanese are culturally conditioned to work with quantities because, faced with demands to open their markets, they ask: How much do you want us to import? Quite aside from the fact that this probably generalizes from a few examples, it fails to consider the fact that the Japanese experience with trade with the outside world since the 1930s has been that of initial success with exports under a rules-based regime, followed by demands for quantitative, Voluntary Export Restraints on Japanese exports. Now, these demands have spread to the import side of the ledger, with complaints that Japan's imports are too low and must be pushed up according to quantitative targets: an innovation that I have christened as Voluntary Import Expansions. Is it not possible then that, faced by these continuous impositions of quantitative limits and targets, and proliferating demands for them in political discourse, the Japanese may have come to the conclusion that a fix-rule trading system will be *denied* to them and that they must trade instead with us by quantity-setting? Is it improbable that, faced with ceaseless charges today that "low" imports are proof of closed markets, the Japanese respond: how much *should* we import to get you off our backs? In short, the Japanese preference for quanti-

tities over rules may be a consequence of *our* witting intrusion of politics into trade rather than of Japanese unwitting intrusion of culture into trade.⁶

The problem with high-tech is a complex one. Most governments are concerned with getting an "adequate" share of high-tech production because, rightly or wrongly (and most economists would argue, wrongly), they are convinced that high-tech industries have untold externalities which make one dollar worth of high tech worth several dollars. This makes them, conveniently for those in high-tech whose profits stand to gain from the spread of such convictions, highly prone to suspicion that foreign rivals, especially successful ones, are the beneficiaries of "artificial" subventions from their governments. Thus, the United States becomes prone to attacking Japan for promoting R&D consortia, for low cost of capital as a source of "unfair" advantage etc. In turn, foreign governments raise the question of the advantages that they see accruing to American aerospace and high-tech from R&D funds and contracts going out from the immense military establishment, from the support given to science and engineering at universities such as MIT and Caltech through programs such as the National Science Foundation, etc. In short, each side points the finger at the other, justifiably arguing that the other has policies that influence the market outcome, whether intended or not. My view is that the high-tech question is so sensitive because of the political fear of losing these industries, due to "unfair competition" to others, that the issue must be managed if these concerns are not to lead to "managed trade" where politicians simply say: "I *want* so much produced at home, and I shall bend trade, through targets (such as in the semiconductor chips agreement between the US and Japan), to accommodate that production". My preferred way to manage the issue is to develop multi-lateral fora where the net balance of artificial advantages to high-tech can be assessed by impartial judges, in place of the current *de facto* practice of getting the weak parties into bilateral confrontations with the strong, at the instance and insistence of the strong: a procedure that is calculated to produce political rather than judicious and fair outcomes.

AGGRESSIVE UNILATERALISM

This problem has arisen in an alternative, and more dramatic and dangerous, way in recent US trade policy, in the form of the so-called 301 and Super 301 actions. The 1988 Omnibus Trade and Competitiveness Act, through Sections 301-310, addresses the generic issues of enforcing treaty-granted US trade rights and, more controversially, creating *new* rights. It is the latter objective, where "unreasonable" practices of other trading nations, not covered by existing trade treaties and corresponding obligations, are targeted

⁶ I have examined Japan-bashing and Japan-fixation in other manifestations in *THE WORLD TRADING SYSTEM AT RISK*, *supra* note 1.

for removal by threatening tariff retaliation which, in practice, is GATT-illegal, that has raised a serious threat to the GATT system.⁷

The use of such threats to "pry open" foreign markets and establish new disciplines is, of course, the weapon of the strong against the weak. It is contrary also to the GATT approach of mutuality of acceptance of new obligations. The essential argument in its behalf is that if the strong party is benign, and uses the weapon, not to extract unrequited concessions for itself, but to advance socially desirable goals, then we should applaud this innovation.

But the problem is precisely that the assumption of a benign dictator cannot be made, especially in trade policy. Trade policy is typically influenced, at times even determined, by sectional interests, by pressure groups seeking their own profits, rather than by the guardians of larger interests, whether national or international. Thus, one cannot rule out the use of such an instrument as 301 for extraction of unrequited trade advantages or to create privileged positions in foreign markets for one's producers or to advance agendas at the GATT that reflect national interests rather than the needs of an efficient trading regime.⁸In my view, this condemns the 301 type of aggressive unilateralism as an appropriate way of creating new disciplines.

REGIONALISM

The question of "regionalism" is more debatable. Preferential trade arrangements among any subset of GATT members which eliminate trade barriers among the members but not equally for nonmembers, obviously do not extend MFN to all GATT members. Therefore, such "regional" arrangements violate the essence of multilateralism and hence its advantages.

But Article XXIV of the GATT permits such preferential arrangements as long as they take the form of full trade integration: in the form of Free Trade Areas and Customs Unions.⁹ The exception is largely a political one: if some countries wish to integrate closely by removing trade barriers altogether among themselves, then they are acquiring one key attribute of a federal nation state: after all, federal countries such as the US, Canada and India have few restrictions on interstate commerce. As such, the GATT does not stand in the way of such efforts even though, from the viewpoint of trade

⁷ That the raising of tariffs in retaliation would be GATT-illegal, and the economic issues raised by the use of such retaliation by a strong country against weaker trading partners, are matters discussed in considerable depth by several contributors to *AGGRESSIVE UNILATERALISM*, (J. Bhagwati & H. Patrick eds.). In particular, Robert Hudec provides a brilliant legal analysis while the economic implications are analysed by John McMillan and myself.

⁸ *Id.* These are precisely the kinds of questions explored by McMillan and myself in Bhagwati and Patrick.

⁹ The reason for this exception is discussed in greater depth by me in *THE WORLD TRADING SYSTEM AT RISK*, *supra* note 1.

barriers *per se*, it seems odd that the GATT should permit FTAs and CUs which discriminate fully (by reducing intermember trade barriers to nothing) while denying lesser preferential trade reductions which discriminate partially!

The US, which properly considered FTAs (and CUs, distinguished from FTAs by having a *common* external tariff) to be a mixed bag because their preferential nature implied that they were less beneficial than full multilateralism and might even be harmful if trade diversion was a principal consequence, has now changed its mind. After the US-Israel FTA, it joined Canada in one and is now engaged in negotiating one also with Mexico. Others with Chile, and possibly other nations of South America, are being considered. There is room for concern here.

The popular view is that the US can ride two horses (FTAs and FT) at the same time; but little attention has been paid to the possibility that they face different directions. But the leadership of the US in the multilateral regime implies that the simultaneous embrace of the regional route may send a signal undercutting the multilateral system. This is particularly so since many in Congress, and some among the economists, believe that the "GATT is dead" or that it should be killed; and for them, the regional route is not a complement to, but a substitute for, the multilateral route.

Besides, any perception that the US commitment to multilateralism is eroding would have unique significance and serious consequences. The leadership role of the US in creating and sustaining the postwar GATT-centered multilateral trading system is wellknown. Despite the rise of the EC and Japan as economic powers and trading nations, neither has shown any willingness or aptitude for sharing that role.

The proponents of the regional route for the US also seem to believe that regionalism will lead more surely to multilateralism than multilateralism itself, that the regional blocs provide a surer and swifter way to a shared goal because multilateralism is slow while the blocs, instead of fragmenting the world economy, will in turn coagulate into universal free trade.

Unfortunately, this optimistic scenario ignores the evidence that preferential arrangements are often fed by interests that seek privileged access to markets, and in turn spawn such interests. These interests argue forcefully that "these are *our* markets": unabashed statements to that effect are to be found in the EC as it moves ahead on its "1992" program and also in the United States as the FTA with Mexico is discussed.¹⁰ This tends to make

¹⁰ Thus, for instance, Mr. Agnelli whose complement of Italian cars run, not on gas, but on VERs against Japanese cars, has expressed such sentiments. So has Mr. Whitmore, the CEO of Eastman Kodak, when discussing the FTA with Mexico. Astonishingly, so have the economists who wrote an Eastman Kodak pamphlet where they recommended the regional route because of the "privileged access" to markets that this would open up to US corporations. See Dornbusch, et.al., *Meeting World Challenges: United States Manufacturing in the 1990s*, pamphlet sponsored and issued by Eastman Kodak Company, Rochester, New York. Also see the scathing comments on these authors'

the blocs inward-looking and not exactly desirous of cutting trade barriers on one another and sacrificing their privileged, preferential positions within member markets.¹¹

Equally, the larger a nation or a bloc, the less also tends to be its perceived need to have external trade, fostering the attitude that "our market is big enough". I have met across economists who ask: if we have a large enough trading bloc, is it worth the hassle of endless arguments with other blocs, such as the EC, over trade for the limited extra gains that inter-bloc trade would yield?

Both factors, that "these are our markets" and "our market is big enough", militate against the easy notion that nations should turn into blocs and will then turn to universal free trade. In fact, the Columbia University political scientist, Edward Mansfield, has recently produced an interesting econometric analysis of trade flows and relative group size. Estimated over a century of data, Mansfield's analysis strongly suggests that, while the two situations of one hegemon and of no hegemon but all countries of inconsequential size are each associated with liberal trade, a situation characterised by a few middle-level economic powers — which is what a few blocs would correspond to — militates against trade and an open trading system.¹²

There is, of course, nothing that requires that what happened before must happen again. But there is enough here to make us pause and ask if it is not the wiser course to stick exclusively to the multilateral route that assures nonfragmentation of the world economy, even though it is slower.

And, if we nonetheless persist in going the regional route, we must ask the "second-best" question: what can we do that would make the regional

critique of the GATT by M. Finger, *Picturing America's Future: Kodak's Solution of America's Trade Exposure*, *The World Economy*, Vol.12(4), pp.377-380.

¹¹ Also, political-economy arguments suggest that the blocs will tend to be trade diversionary fairly effectively these days. Recall that today's protectionism takes the form of administered protection: often, the "fair trade" remedies are used unfairly to harass foreign rivals and to effectively protect. Now, if the US and Mexico go through with their FTA, and if US exports of yo-yos threatens Mexican production of yo-yos. What do you think is likely to happen? In the old days, when tariffs were the protectionist weapon, Mexican producers would have had to lump it and Mexico would have enjoyed gains from US exports. *Now*, the more probable outcome is that Mexicans will start anti-dumping actions against the more efficient Far Eastern exporters of yo-yos, accommodating the US (just as the US would then accommodate Mexico: both exchanging "privileged" access to each other's markets) at the expense of others. Indeed, what *is* the point of having a preferential trade arrangement if you do not exploit its preferential nature? None of these key questions have been worried about in the recent US-Mexico FTA debate since none of the few vocal proponents of the FTA have been trade specialists and they are unburdened by the doubts that scientific knowledge must create.

¹² See Edward Mansfield, "The Concentration of Capabilities and International Trade", Paper delivered at the Annual Meetings of the American Political Science Association, San Francisco, Aug. 30-Sept. 2, 1990.

route more consonant with the objective of worldwide free trade? The architects of Article XXIV did not expect FTAs to become a major option and therefore did not devote explicit thought to this question when sanctioning them. We must now reexamine Article XXIV and add more restrictions to what it sanctions.

In particular, I have recently suggested that FTAs should not be sanctioned, but only CUs which have common external tariffs. Since the US is the hub of the new regional trade blocs being considered with South American countries, this would force these countries to lower their external tariffs also down to the US level (which is very low), thus reducing the scope of trade diversion. Also, openness to admission of other GATT members must be built in as a mandatory requirement, to countervail effectively the inward-looking tendency of preferential trading blocs.¹³

CONCLUDING REMARKS

While the threats that I have identified — managed trade, aggressive unilateralism and regionalism — are matters of serious concern, and require our sustained vigilance and creative responses, a larger and more insidious threat comes from the rise of concerns over “unfair trade” and the associated tendency to consider that gainful trade among trading nations with different institutions and myriad policies is not possible because these differences imply the absence of “level playing fields”.

This is a large topic and one which threatens to undermine the very basis for rules-based trade. For, there is no way that we can possibly hope to “harmonize” the innumerable differences in policies and institutions among countries. If we entertain this kind of objection, as we increasingly have in our Structural Impediments Initiative talks with the Japanese (where we have objected to their retail distribution system, their infrastructure spending, etc.) and with the Mexicans (who must now discuss environment, workers’ rights, safety standards etc. before the FTA will be signed), then we have given a deadly weapon to protectionists, anti-multilateralists, aggressive unilateralists, and managed traders: indeed, to all who see little virtue in a rules-based trading system such as that the GATT embodied. I see the 1990s as the decade when international economists will have to confront frontally this problem before it cripples the world trading system.¹⁴

¹³ I have discussed changes in Article XXIV in *THE WORLD TRADING SYSTEM AT RISK*, *supra* note 1.

¹⁴ I have considered analytical ways of tackling this threat in “*What is Left of Comparative Advantage?*,” Russell Sage Foundation Working Paper, 112 East 64th Street, New York, NY 10021; June 1991.