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Principles to Guide U.S. Trade Policy: Market Access and Export Promotion Policies

July 1993

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This draft was prepared jointly by the Council of Economic Advisers and the U.S. Department of Labor.

SUMMARY

This paper sets out general principles and priorities that should guide U.S. trade policy regarding export promotion and the opening up of foreign markets. In the post-war period, U.S. trade policy has been guided by three broad principles, which remain valid today: (1) the promotion of U.S. economic interests; (2) the achievement of an open, multilateral trading system operating according to a clear set of rules and international code of conduct; and (3) the promotion of economic development in less developed countries.

During the last forty years, multilateral efforts to lower trade barriers have resulted in an unprecedented expansion of world trade and significant benefits to countries that have actively promoted trade. Efforts to open markets further, however, are facing increasing resistance because remaining impediments are often associated with policies that countries pursue for non-trade-related objectives. In many countries, such domestic policy interests have combined with groups which directly benefit from current protection to create a powerful obstacle to further trade liberalization. Given limited negotiating resources, the U.S needs to set priorities in its export-promotion and market-opening efforts.

From the perspective of economic policy, the principle criterion for setting priorities in export-promotion and market-opening should be: *What is the long-run effect on the U.S. economy, taking into account the benefits to workers, producers, and consumers?* The paper considers various trade-offs in the current economic environment and sets out some priorities for market-opening policies.

BACKGROUND AND PROBLEM STATEMENT

In the post-war period, U.S. trade policy has been guided by three broad principles:

(1) the promotion of direct U.S. economic interests;

(2) the achievement of an open, multilateral trading system operating according to a clear set of rules and international code of conduct; and

(3) the promotion of economic development in less developed countries.

On various occasions, trade policy has been used as an instrument of foreign policy, pursuing non-economic objectives. Examples include the U.S. grain embargo against the Soviet Union and the international embargo of trade with South Africa. Such uses of trade policy to further non-economic interests must be judged on a case-by-case basis, evaluating the trade-off between the economic costs to the U.S. of such policies against their potential effectiveness in achieving foreign-policy goals. This paper focuses on U.S. economic interests, and will not consider the use of trade policy for non-economic goals.

With some exceptions and compromises, policies based on these principles have proved to be broadly complementary for much of the post-war period. Following these principles, the U.S. supported: the establishment of the GATT, the IMF, and the World Bank; the lowering of trade barriers through successive rounds of multilateral negotiations under the auspices of GATT; the recovery of the economies of Europe and Japan (through the Marshall Plan and other policies); the establishment and continued evolution of the European Common Market; and the growth of developing countries through preferential trade agreements and economic assistance through bilateral and multilateral agencies.

The experience of the last half-century indicates that these policies have been extremely successful. World trade has increased enormously, and this trade has generated enormous benefits. Trade has been a major "engine of growth" for the world economy, in marked contrast to the pre-war period where protectionism exacerbated and helped spread the great depression. U.S. industries —both their workers and owners— have benefited from increased exports and access to imported intermediate inputs. U.S. consumers have been able to purchase a much wider variety of products at much lower prices than would have been possible without the expansion of trade.

On average, the performance of developed and developing countries that have pursued growth strategies based on increased international trade has ranged from very good to spectacular. Both theory and practice have shown that the expansion of trade is a "win-win" proposition, with all countries participating in the world trading system gaining significantly.

In the last 10-15 years, a number of trends have led to the need to re-evaluate the role of trade in the world economy and the nature of U.S. trade policy. These trends include:

(1) Europe and Japan have completed their recovery from the destruction of World War II and have grown rapidly. They are now mature economies, largely on a par with the U.S.

(2) A number of semi-industrial developing countries have grown dramatically during this period and have come to play a significant role in world trade in manufactures. These countries either have graduated, or are on the verge of graduating, to the status of developed countries.

(3) After a period of relatively stable growth, the world economy since the mid-1970s has been buffeted by a variety of shocks, including wide swings in the price of oil, recessions, and major movements in exchange rates.

(4) The trend of liberalization of trade polices and the lowering of trade barriers, which continued through the Tokyo Round of GATT negotiations, has reversed. While formal tariff barriers are low, a number of protectionist policies have emerged that restrict trade in a number of important commodities such as textiles, automobiles, and steel. With the lowering of tariffs, non-tariff barriers have become relatively more important. These barriers have proved to be particularly difficult to deal with in the context of GATT.

(5) Trade has become steadily more important to the U.S. and virtually all other countries over the post-war period, and it is no longer possible for a country to insulate itself from the world economy.

Increasing integration of the world economy, while generating many benefits, has also led to increasing strains in trade policy, both for the U.S. and for our major trading partners. In many countries, there is now perceived to be less complementarity between the goals of pursuing direct national economic interests and the achievement of an open, rule-based, world trading system. As trade has become more pervasive, interactions between trade policy and domestic policies have become more important. For example, policies regarding sectors such as agriculture and services, which used to be regarded as purely domestic concerns, have come to have serious trade implications and are a major focus in the Uruguay Round of GATT negotiations.

In formulating trade policy, countries have increasingly come to take into account important features of their economies and those of their trading partners. These include characteristics such as the existence of significant non-tariff barriers to trade in important sectors; imperfectly competitive markets supported by non-tariff barriers to foreign competition; technological "externalities" and "spillover" effects; and dynamic gains from increasing returns, learning, and early access to markets.

In particular, the U.S. has come to recognize that our major trading partners (the EC, Japan, and some of the graduating semi-industrial countries) have economic systems characterized by more direct government involvement in their industrial sectors than is the case for our economy. These countries have sought to support their domestic industries, using a variety of instruments including sectoral subsidies and non-tariff barriers to foreign competition.

We have also increasingly come to realize that there are certain markets (*e.g.*, financial markets) in which some government intervention is strongly justified. Virtually all governments justifiably intervene in financial markets, for example, albeit in different ways. Certainly, market failures due to imperfect information, absent markets, or the existence of markets which are inherently imperfect, are common. Government intervention in such markets, which is justifiable on the grounds of domestic economic policy, may well impinge on trade policy. There is, of course, the danger that governments will use domestic concerns as a convenient excuse for pursuing policies whose real intent is to protect domestic industries from foreign competition. It is important, though in practice often difficult, to differentiate between cases where there are legitimate domestic policy concerns and instances of hidden protectionism.

In this economic environment, it has proved difficult to negotiate further trade liberalization and market access in a multilateral setting under the auspices of GATT. The Uruguay round has proven difficult to complete, and the U.S. —along with other countries— has sought alternative approaches, even while actively seeking to complete the round. Examples include separate bilateral and regional free trade arrangements (such as the completed Canadian-U.S. free trade agreement and the current NAFTA negotiation) and other bilateral negotiations (such as the current "framework" discussions with Japan).

These efforts reflect new approaches for the U.S. in opening up protected markets outside of the GATT framework. This policy paper discusses principles that should guide the formulation of trade policies seeking to promote U.S. exports and open foreign markets in our major trading partners, given the changes in the world economic environment described above.

This paper does *not* address several key issues, which will be taken up in later policy papers, including the appropriate use of trade-policy instruments and the relationships between trade policy, industrial policy, and technology policy.

SETTING TRADE POLICY PRIORITIES

The three broad principles that have guided U.S. trade policy since World War II remain valid. First, the primary goal of U.S. trade policy should be to advance U.S. economic interests. Second, in the medium to long run, U.S. economic interests are best furthered by policies that serve to maintain and extend an open and stable world trading system. Third, the U.S. gains, both economically and politically, when less developed countries are successful in achieving rapid, sustainable growth.

Assessing U.S. Economic Interests

The goal of advancing direct U.S. economic interests implies that U.S. policy should focus on cases with the biggest direct payoff for the U.S. economy. The best measure of the benefits to workers, producers, and consumers is their income.

The first criterion for evaluating trade policy should be an assessment of its total effect on U.S. national income over the long run.

One of the reasons for placing a high priority on establishing a world trade order based on open access is that it allows the U.S. (and other countries) to take full advantage of comparative advantage, specializing in those products and stages of the production process in which they have particular strength. It is precisely by permitting such specialization that international trade yields a win-win situation for all participants. Given that the U.S.'s long run strength lies in high-value activities such as research and development and skill-intensive, high-tech production processes, establishing a world trade order based on free trade is of particular value to the U.S.

In setting trade priorities, attention needs to be focused on value added and linkages through purchases of intermediate inputs. What is relevant is not whether the final assembly occurs in the United States, but the fraction of the value of the good which is produced in the United States. Thus, a car made in the United States (by either an American or foreign-owned firm) may contain components made abroad. The percentage of U.S. value added might be less than that for a computer assembled in Korea or Mexico but containing components such as a hard drive and chips made in the U.S.

In particular, the following criteria should be used to set priorities and determine the importance of pursuing a particular market-opening policy:

(1) Does the foreign protectionist practice have a significant impact on U.S. workers and high-wage U.S. employment, either directly or through linked markets for intermediate inputs?

(2) Does the foreign practice significantly affect the sales and profits of U.S. firms, either directly or indirectly?

(3) Does the foreign practice restrict access by U.S. consumers to the cheapest sources of goods and services?

In the long run, in a growing world economy, our prosperity is linked to the prosperity of others —increased trade has proven to benefit all participants. Increased imports are as important as exports in promoting our welfare. It is a serious mistake to view trade from a narrow Mercantilist perspective that sees benefits arising only from exports. In the short to medium run, however, especially if there is a problem with unemployment, a focus on exports is valid.

When there is significant unemployment, exports contribute to an increase in national income both through an increase in employment and (when the firm is domestically owned) through an increase in profits. Production for exports directly affects both the structure and volume of employment. Foreign restrictions on our access to exports markets are always damaging to the U.S.

Targeting Exports

Increases in exports in some sectors may have especially beneficial effects. In particular, in sectors characterized by spillovers and dynamic efficiency gains, the losses from trade restrictions are especially serious. These effects may be particularly marked in high-value-added and/or high-wage sectors. By the same token, increases in exports from sectors or regions with high unemployment rates, or which more generally increase the demand for unemployed workers or workers with low wages, may be particularly beneficial. These policies not only increase national income, but also have desirable distributional consequences.

Increases in trade based on long-run comparative advantage or which enable exporters from the U.S. to establish a niche in a particular foreign market are likely to be of greater value, since the benefits are likely to be more permanent. The benefits of opening up markets to products in fairly competitive areas in which U.S. exporters do not have a long-run comparative advantage are likely to accrue mostly to others who are better placed to compete in those markets.

A particularly strong case for government intervention to open markets for U.S. exporters occurs when the firms being excluded are small or medium sized. Foreign protection often represents a fixed cost that must be overcome by firms desiring to enter the foreign market. Small and medium-sized firms are the most adversely affected by such policies. If a given sector is characterized by many small and medium-sized firms, then government assistance in opening foreign markets is especially needed.

Thus, in determining priorities for opening up markets, U.S. policy needs to look at factors such as:

(1) *Permanence of the market advantage.* If U.S. exporters manage to gain market access, how long will those firms actually maintain an advantage in that market?

(2) *Existence of dynamic gains, learning, or increasing returns.*

(3) *Existence of externalities or spillovers to other sectors.* Does the sector have significant linkages to other sectors through markets for intermediate inputs? Does the sector generate significant technological spillovers?

(3) *Technological advantage.* Is the sector one in which the U.S. has a technological advantage, especially involving the use of high-wage U.S. labor?

(4) *Size of firms in the affected industry.*

(5) *Distributional considerations.* Does expansion of the sector yield favorable distributional effects?

(6) *Potential market size.* Is the market we are seeking to enter growing or shrinking?

Abuses

Some trade restrictions seem particularly objectionable, in that they represent a significant abuse. In determining trade priorities, the first focus of analysis should be on the direct effect on the U.S. economy. If two policies have equal effects on national income, however, the U.S. should direct its policy effort against the one which represents the most significant abuse.

How can one determine the magnitude of abuse contained in a protectionist practice? A number of criteria are relevant:

(1) How large is the gap between the outcome under the practice and the outcome that would have occurred with an open market? For example, if a government gives preference to its own companies (or to producers with high domestic content) in procurement when the cost differential from foreign competitors (or from producers with low domestic content) is 3%, then the gap between the distorted and free-market outcomes is small. If the cost differential is 40%, then the gap is large and the abuse is significant.

(2) How unusual is the practice? Is the practice a major deviation from acceptable practices under GATT rules or under a bilateral or regional agreement? For example, all governments give some preference to their domestic airlines (*e.g.*, requiring government employees to fly on national carriers), which has little effect on the market outcome and has become an accepted practice in a bilateral setting.

(3) Is the practice part of a pervasive and persistent pattern of policies aimed at protecting the domestic market for particular commodities? It may be important to view individual protectionist practices in a wider policy context. A particular policy may be significant because it is part of a system of mutually supporting protectionist policies.

In some cases, it may be desirable to focus attention on trade abuses which, while not common, are not unique. A successful effort at eliminating the abuse in one country may have a positive spillover, in making other countries more receptive to the elimination of the abuse.

National Treatment versus Reciprocity

The principle of "national treatment" is that all firms, regardless of nationality, are treated the same under the laws and practices of a given country. Following this principle, the U.S. would make no distinction between domestic and foreign firms operating in the U.S. Alternatively, the principle of "reciprocity" holds that the U.S. will treat foreign firms operating within our borders in the same manner as the foreign country treats U.S. firms operating in their country.

As noted earlier, trade policy today needs to be attentive to differences in national economic policies which, though perhaps not motivated by trade considerations, have important consequences for trade. Countries vary widely in the degree to which they intervene in various markets or regulate firms in various sectors. Gaining access to highly regulated markets in foreign countries under the principle of national treatment may engender far different benefits to U.S. firms than to foreign firms gaining access to differently regulated U.S. markets.

A number of considerations are relevant in formulating policies to open foreign markets in which the regulatory regime acts as a significant access barrier:

(1) Some argue that opening U.S. markets to exports from countries that maintain closed domestic markets is equivalent to "unilateral disarmament" —we put our markets at risk without gaining anything in return. This argument reflects the long-standing Mercantilist fallacy and ignores the benefits to consumers from lower prices. The fact that other countries protect domestic producers and so hurt their consumers certainly does not suffice to justify retaliation which hurts U.S. consumers. More analysis is required concerning the nature of the protected markets to evaluate the potential gains and losses from retaliation.

(2) While trade —even when one partner fails to trade "fairly"— is usually mutually beneficial, there are important issues concerning how the gains from trade are shared.

Restrictive practices by foreign countries may result in those countries appropriating for themselves more of the gains from trade.

(3) National treatment may, *in effect*, be discriminatory. Consider a situations where there has been discrimination in the past and the government imposes barriers to entry or expansion. Even if those restrictions are applied according to the principle of national treatment, and hence are applied uniformly to foreign and domestic firms, the result will be to lock in the consequences of past discrimination, since foreign firms will be effectively prevented from increasing their market share.

(4) Through regulatory and other policies, countries can often discriminate against foreign producers *in effect*. Such discrimination is often subtle and hard to detect. In cases where there is a history of discriminatory actions, affirmative policies to rectify the consequences of past market discrimination may be justified.

(5) In many cases, the best way to deal with discriminatory domestic policies which are effectively protectionist is through a multilateral process of harmonization of regulations, at least among the more developed countries.

In sum, the existence of major differences in domestic policies and practices across countries complicates the analysis of potential gains from increasing market access. In this environment, pursuing the goal of national treatment is certainly valid, but there may still be significant imbalances in the benefits from increased market access. In such cases, policies aimed at redressing the imbalance, perhaps following the principal of reciprocity, may be justified.

In setting priorities for redressing imbalances in the potential gains from increasing market access, the U.S. should emphasize those practices which most affect our economic interests and which, simultaneously, can be least well justified in terms of the legitimate economic and political objectives of the foreign countries.

APPLICATIONS OF THE PRINCIPLES

Conflicts with Domestic Policies

While today most countries recognize the importance of a liberal world trading order, there is also widespread, selective government intervention in domestic markets —interventions which, under certain circumstances, can be justified as economically beneficial. While U.S. policy should clearly oppose policies which seek to impede trade, it is not so clear what our judgement should be regarding policies pursuing other goals, but which distort trade as a side effect. Examples include domestic subsidies to sectors such as agriculture and policies aimed at protecting the environment.

One obvious answer is that all of these issues need to be addressed through multilateral negotiations. The Uruguay round of GATT negotiations is breaking new ground in seeking to devise rules regarding allowable domestic subsidy policies in sectors such as agriculture and services, and for activities such as R&D. The intent is to extend the GATT rule-based trading system to include these difficult areas.

If successful, such international agreements should limit the trade-distorting effect of domestic subsidy policies. Following the principle of national treatment, they should give all producers, regardless of nationality, equal standing with domestic producers in local markets which are subject to government regulation (*e.g.* financial markets or sectors in which there are environmental concerns). Agreements to lower or eliminate domestic subsidies to particular sectors, however, will not necessarily lead to foreign firms acquiring significantly increased market share. While access will be easier, there are still advantages for countries which are more technologically advanced, which have more developed capital markets, or which have a prior market presence in markets where there are potential barriers to entry (not related to trade policy). Changing domestic subsidy policy and regulatory practices will not necessarily lead to foreign entry.

There does not seem to be a simple principle upon which we can rely in such situations. Rather, we will need to follow a case-by-case approach, respecting the legitimate domestic concerns of our trading partners, but recognizing that such concerns are sometimes used to justify policies that serve only to restrict foreign competition.

In this case-by-case approach, certain aspects of subsidy policies and industrial structure need to be taken into account:

(1) American consumers may benefit from the subsidies provided by foreign governments, and these benefits need to be taken into account in determining how we respond.

(2) When foreign government subsidies form part of a predatory policy designed to drive out American producers so that prices can eventually be raised, then the U.S. government needs to be particularly concerned. Similarly, if such practices deprive American producers of the opportunities to benefit from technological spillovers or to gain from early entry into high-tech markets, there is a strong case for U.S. concern. Note, however, that in competitive markets, such subsidies are unlikely to be, in fact, predatory. Even if there is predatory intent, such policies are unlikely to be successful when markets are competitive.

(3) In some cases, domestic pressures from producers advancing arguments concerning technological spillovers result in parallel subsidies in several countries. While consumers may benefit from such a pattern of subsidies, the technological benefits may not justify their cost to the government. In such a case, there are gains

to be had for all sides in a multilateral agreement to restrict subsidies, or to pool investments in new technologies.

(4) Countries in earlier stages of development are more likely to have less developed capital markets and technological capacity. For developing countries, there is a strong case for government assistance to improve the operation of capital markets and develop (or borrow) new and appropriate technology, given the important role of these factors in development. The U.S. has recognized the special needs of developing countries in the past, and should continue to do so.

What are the implications for other policies of the framework used to evaluate market-access and export-promotion policies? The twin goals of advancing direct U.S. economic interests and establishing an open world trading system lead to a rejection of import protection policies on the domestic front, even for high-wage industries. Such policies are typically ineffective, economically inefficient, and violate the principle of an open trading system.

More problematic, however, are those domestic policies which serve a variety of economic and political objectives, but which, at the same time, may serve as a barrier to market access for foreign firms into the United States. It may be difficult for the United States to complain about particular practices of foreign governments which have the effect of impeding trade, while there are similar or other practices in the U.S. which have a corresponding effect.

A more nuanced approach, which recognizes the validity of domestic concerns for both the United States and foreign governments, must balance those advantages against the disadvantages of the resulting trade impediments. Such a balanced approach seeks to eliminate, in a symmetric way, both U.S. and foreign practices in which the disadvantages from the trade impediments dominate. Recognizing these nuances in international negotiations, both bilateral and multilateral, should lead to greater respect for U.S. policies and to a more rapid opening of international markets.

Ownership and Location of Production

In a world of free trade and harmonization of industrial and domestic subsidy policies, the principles of national treatment and reciprocity are essentially equivalent. In such a world, distinctions concerning the nationality of enterprises are unimportant. While we have moved a long way toward an integrated global marketplace in the past fifty years, there are still significant differences in the way national markets operate, even considering only the most developed countries. In this environment, it is still worthwhile to consider the nationality characteristics of producers in formulating policies designed to further the economic interests of the U.S.

It is not easy, however, to provide a simple definition of "foreign" and "domestic" producers that will serve as a guide for policy. National characteristics of firms that one might consider important in formulating policies include: national content of production, nationality of the majority of stockholders, nationality of the workers, country of incorporation, or location of the corporate headquarters. In many cases, using these characteristics yields conflicting criteria for defining "foreign" and "domestic" producers.

Even if one cannot settle on a simple definition of a "national" enterprises, and recognizing that there will be many special cases and exceptions, one can suggest some "rules of thumb" in setting policy priorities:

> (1) The top priority for market-opening policies should be to pry open closed foreign markets, expanding export sales of goods produced in the U.S. by U.S. firms. Such cases are likely to provide the largest economic benefit to U.S. citizens, especially when they lead to an expansion of high-wage employment in the United States, directly or indirectly, or involve sectors with potential technological spillovers.
>
> (2) The second priority should be U.S. exports of foreign-owned firms. While the profits will accrue to foreign nationals, such exports generate direct and indirect employment in the U.S.
>
> (3) The third priority should be the opening of markets for U.S. firms that are producing abroad. In this case, the profits accrue to U.S. firms, while the employment effects in the U.S. may be weak or nonexistent.

There are two broad reasons for giving priority to U.S.-owned firms exporting from the United States over non-U.S.-owned firms exporting from the United States. The first, and most obvious, is that the financial returns to U.S.-owned firms flow largely to U.S. citizens, and so add to national income. Even this presumption is subject to exceptions. For example, a corporation may have a significant number of foreign shareholders or may be highly leveraged, with its debt held by foreigners.

A second reason for giving priority to U.S.-owned firms is that ownership serves as a rough proxy, indicating where the largest number of jobs, and the highest value-added jobs, are likely to be located. Companies still tend to locate such jobs in their country of ownership, to reinvest there, and to use intermediate inputs produced there. The extent to which these linkages operate varies by industry, and these linkages are becoming weaker over time as corporate entities spread their employment worldwide. As this trend continues, it will become necessary for policy makers to examine directly the number and quality of jobs generated by specific producers, rather than rely on a proxy measure such as nationality of ownership.

Although the direct U.S. benefits are likely to be largest from policies that increase exports from the U.S. rather than assisting U.S.-owned firms that largely produce abroad, the U.S. government should still make a practice of vigorously defending the interests of U.S. firms in other countries. Policies that assist U.S. firms, even when they are not directly producing a given product in the U.S., may stimulate high-wage U.S. employment to service their overseas operations. In addition, benefits to U.S. shareholders will lead to repatriated profits and may increase U.S. investment. Finally, a policy of promoting U.S. firms even when they produce abroad helps maintain an open trade and investment system and deters attempts by host governments to expropriate foreign assets and investments.

In the discussion of the principles of national treatment and reciprocity, it was argued that the U.S. should, in certain circumstances, seek reciprocity and negotiate to establish a roughly uniform set of regulations and standards applying to all firms in all countries. Ideally, such reciprocity should be extended not only to regulatory actions, but also to trade promotion actions. If other countries treat U.S. firms symmetrically with their firms, there are strong arguments for the U.S. to reciprocate. The long-run gains from establishing an international trading order based on a common approach to domestic policies might outweigh the more immediate gains that might derive from promoting the short-run interests of U.S. firms.

U.S. Investment Abroad

An increasingly large fraction of trade occurs *within* multi-national firms. If U.S. firms are precluded from producing within a country, then U.S. producers of intermediate goods may be at a marked disadvantage in terms of market access. Thus, a policy of opening up opportunities for U.S. firms to invest abroad may be justified not only in terms of expanding the opportunities for increased profits, but also in terms of the enhanced possibilities for increased exports of U.S. goods.

The basic economic principles underlying international investment are identical to those that underlie international trade in goods and services: the principle of comparative advantage. Those who worry that U.S. capital moving abroad will deprive the U.S. of jobs fail to realize that: (1) if U.S. capital does not seize opportunities abroad, other countries will; and (2) if other countries expand their foreign investment, the linkages between that investment and the home countries will give them advantages over the U.S.

At the same time, *some* international investment is not motivated by basic economic principles of comparative advantage, but by a desire to get around trade barriers. For example, some past investment in Mexico was undertaken to give U.S. firms access to the protected Mexican domestic market. The removal of trade barriers would decrease rather than increase the flow of such investment to Mexico.

Financial Sectors

For a variety of reasons, virtually all governments intervene in financial markets. Particularly in less developed countries, such intervention is justified as a necessary part of implementing a development strategy. In many cases, government exercises its influence through moral suasion, sometimes backed up by the threat to withhold certain discretionary benefits (like the right of banks to open up additional branches). There is concern that the lending policies of foreign banks will not be as sensitive to government influence, and hence such banks will not support the country's overall development strategy.

Given the nature of the policy tools used to regulate financial institutions, there is a concern that foreign and domestic banks are not on a level playing field in most countries. Without addressing the validity of these claims, the U.S. should recognize that the perception of foreign countries that these claims are valid makes many countries particularly resistant to opening up their financial markets. Also, there are links between trade barriers and investment flows in developing countries, and they must pay particular attention to problems of sequencing of liberalization of goods and investment markets.

The priority placed on various efforts to open and liberalize capital markets abroad needs to be evaluated from the perspective of the principle that the U.S. should put the highest priority on those markets that have the greatest potential impact on U.S. national income. In some cases, opening foreign capital markets may be linked to facilitating U.S. exports. In most cases, however, the major impact will be to create jobs abroad, with little effect on U.S. labor or national income. Particularly in cases where foreign governments are especially resistant to liberalizing financial markets, we will have to expend considerable political capital to attain any results, with perhaps only limited benefits to the U.S. economy.

Structural Impediments

There are a variety of practices, in both the private and public sectors, which may serve as impediments to trade. Countries may, for instance, require safety inspections, duplicating those of the foreign producers. There should be a concerted multinational effort to reduce these non-tariff barriers, focusing on practices that have the greatest effect (intended or unintended) on international trade flows. In particular, among the members of the OECD, there should be efforts to establish common regulatory standards. Where deviations from common standards are imposed, we should require both a clear scientific rationale for such deviations and the establishment of procedures to ensure that those deviations do not serve as an impediment to trade.

For example, performance standards for customs inspections should be developed that establish clear guidelines both for costs and delays and that are monitored by independent auditing agencies. Safety and health standards should be set in a clearly defined manner, and we should direct efforts to establish international auditing processes to ensure that the standards are enforced and implemented in a fair and equitable manner.

Measuring Success

Success in opening up markets may not be reflected in overall balance-of-trade statistics. Macroeconomic forces affecting aggregate rates of saving and investment and the real exchange rate largely determine the overall balance of trade in a country. The existence of a trade surplus for a particular trading partner is not necessarily an indicator of closed markets and focusing on bilateral trade surpluses is, in general, inappropriate. Focusing on sectoral trade imbalances is even more inappropriate. In addition, opening up foreign markets very likely will not affect the overall balance of trade significantly, although it should always improve the international terms of trade facing a country.

Note that changes in macroeconomic forces, including the real exchange rate, will have major effects on trade flows. In judging whether or not market-opening or export-promotion policies have been successful, it is necessary to control for the effects of changes in macro policies and changes in the real exchange rate. Such an evaluation can be difficult, requiring careful economic analysis of a counterfactual alternative: "What would have happened if the macro environment had remained unchanged?"

In general, it is more appropriate to evaluate issues of market closure and the success of market-opening policies at the micro level. The analysis of the impact of trade impediments in particular markets is analogous to the problem in antitrust law of identifying the existence of monopoly power and of determining the extent of damages due to the improper use of such market power. The most telling evidence is direct indicators of policies and practices that are used to close markets from competition, but unambiguous evidence of this sort is often hard to obtain. Measures such as market shares and deviations between domestic and world prices provide indicators both of the existence of practices that have the effect of closing markets and of the success of efforts to open those markets.

In setting policies regarding market opening, the focus should first be on the policies and instruments used by the country to protect particular markets from foreign competition. The appropriate measure of success is the cessation of the use of such policies and instruments. In unusual circumstances, when there is evidence of persistent and pervasive trade impediments aimed at protecting a domestic market, setting quantitative targets regarding foreign sales or market shares may be the only tool available to reduce the market abuses.

POSITION PAPER ON TRADE ISSUES
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AMT - THE ASSOCIATION FOR MANUFACTURING TECHNOLOGY

AMT - The Association For Manufacturing Technology - is a trade association whose membership includes over 300 machine tool building firms with locations throughout the United States. The majority of AMT's members are small businesses. America's machine tool industry builds and provides to a wide range of industries the tools of manufacturing technology including cutting, grinding, forming and assembly machines, as well as inspection and measuring machines, and automated manufacturing systems.

Based upon President Reagan's finding that America's machine tool industry is a "small, yet vital component of the U.S. industrial base," a five-year VRA on six classes of machines took effect in 1987 with Japan and Taiwan. Upon the advice of the U.S. Departments of Defense and Commerce, and responding to requests from more than 196 members of Congress, President Bush announced late in 1991 that the VRAs would be extended two additional years. Seven years after the VRAs were implemented, the U.S. machine tool industry has regained a competitive position in the global machine tool market.

Machine tool industry data demonstrate unequivocally that the companies affected by the VRAs have responded just as President Reagan, President Bush and Congress intended. The manufacturers have made substantial investments in new, productivity-enhancing capital equipment; they have developed new products and new technology, committing heavily to R&D and engineering; and they have implemented significant efficiency in their own plants. They have done all this without raising prices beyond the rate of inflation and without substantial profits.

A survey conducted in 1993 by AMT of U.S.-based VRA-affected companies showed that respondents' capital investment to depreciation ratios more than doubled over the seven-year period from 1986 to 1992. In addition the VRA-affected firms' annual investment increased by 69%. In 1986 the VRA-affected firms were disinvesting. The ratio of their capital investments to their depreciation was less than 80 cents on the dollar. However, 1992 financial data show that VRA-affected firms now spend $1.61 on new equipment for every dollar taken in depreciation. The industry's nominal dollar investment in new plant and equipment in the past two years has not been equaled since 1981-1982 when the industry was reaping pre-tax profits of 5% to 12% (in contrast to 2.3% today).

VRA-affected companies have also developed new products and technologies, committing heavily to R&D and engineering. An AMT survey conducted in 1991 indicated that respondents spent $637.7 million on R&D/engineering over the five-year period from 1987 to 1991, an annual average increase of 10%. Based on the most recent financial data for all VRA-affected companies, R&D expenditures as a percent of sales rose from 5.2% in 1987 to 11.9% in 1992. The 10 largest VRA-affected firms' R&D expenditures climbed by 155% between 1987 and 1992 in nominal dollars based on current financial data for these publicly-held companies.

In addition, VRA firms have implemented significant efficiency in their own plants. And they have worked mightily to open new markets, although Japanese auto and other transplants located in the United States remain largely closed to U.S.-built machine tools. Today, 36% of all U.S. machine tool production is exported. Exports have doubled over the last six years. In fact, 1992 machine tool exports of $1.0 billion represented the ninth consecutive record high and a 14.8% improvement over 1991 levels. The international competitiveness of U.S. machine tool companies is most clearly demonstrated in our exports to China, the fastest-growing machine tool market. During 1987 to 1992, U.S. machine tool exports to China jumped 63% while Japanese and German machine tool exports to China fell 30% and 12% respectively.

The machine tool import penetration picture has also improved. The average import penetration for VRA-affected categories, which were on an alarming upward trend prior to the VRAs, dropped from 62% in 1986 to 49% in 1992. Imports as a percent of consumption for the overall industry dropped from 49.8% in 1986 to 48.5% in 1992.

These investments of time and capital were made without significant machine tool price increases. In fact, prices barely kept pace with the rate of inflation.

	PRICE CHANGE OVER PREVIOUS YEAR					
	1987	1988	1989	1990	1991	1992
GNP Deflator	3.3	3.4	4.1	4.6	4.1	2.6
VRA-Affected Complete Machine Tools						
Lathes	0.6	3.0	6.7	6.6	3.5	3.6
Milling Machines	2.5	3.1	2.6	6.0	5.1	4.2
Multi-function, NC *	0.9	6.3	5.9	3.2	5.2	4.1
Punching, Bending, etc.	1.0	1.0	1.8	1.9	1.8	1.4

* - Includes machining centers.

Profits in the industry also rose only slightly during this time period. Pre-tax income for VRA-affected firms in 1991 was only 1.0% of sales, compared to pre-tax income of 3.6% of sales for all U.S. manufacturers during the same period. Pre-tax income for VRA-affected firms did rise slightly in 1992 to 2.3% of sales, showing that the VRAs are beginning to have an effect on the industry's profit picture. Industry profits, however, can hardly be termed robust.

VRAs have been used wisely and effectively by the machine tool industry. Since the inception of the VRAs, affected companies have invested far more than traditional caution would dictate. Over the past seven years, the VRA-affected companies have committed themselves to the restoration of manufacturing competitiveness to the detriment of their balance sheets in the short term. As a result of the VRAs, the U.S. has significantly more capacity in the six classes of machine tools covered by the VRAs today than it did in 1986. In turn, a reliable supply of these critical elements to the defense industrial base has been greatly improved.

One area where significant improvement has not occurred has been in U.S. machine tool exports to Japan. The machine tool trade imbalance with Japan has hovered around $1 billion per year since 1985. (The highest imbalance in this period was $1.26 billion in 1989; the lowest was $781 million in 1992, but 1992 exports to Japan were actually less than in 1989.) Even more disturbing is the fact that Japanese transplants in the U.S. have imported their discriminatory procurement system to our shores and that this discriminatory procurement has extended beyond the acquisition of components to the acquisition of capital equipment.

The fact is that many Japanese companies, regardless of their location, systematically restrict their machine tool purchases to Japanese products. It is one thing for the Japanese Kieretsu system, operating in Japan, to effectively freeze U.S. machine tools out of the Japanese market; it is quite another for the Japanese transplants to freeze U.S. machine tools out of a significant portion of the U.S. market by importing the Kieretsu system to America.

To be sure, the U.S./Japan Machine Tool Cooperation Plan, administered jointly by the U.S. Department of Commerce and MITI, has resulted in some modest increases in U.S. machine tool purchases by Japanese transplants (the program resulted in $23.5 million in shipments and $17.9 million in orders in 1992 and in $11.2 million in shipments and $13.5 million in orders in the first half of 1993); but MITI has recently indicated a reluctance to provide for effective measurement of future results, and the program's continuation is in doubt as the VRAs draw to a close at the end of the year.

Based upon chronic market access problems with Japan and with Japanese transplants located in the United States, AMT calls upon the Clinton Administration to seek an arrangement with Japan that would strengthen the U.S./Japan Machine Tool Cooperation Plan by establishing goals and measurement tools for increased U.S. machine tool sales to Japanese transplants and for increased U.S. machine tool exports to Japan. The unconscionably high and persistent machine tool trade imbalance between the United States and Japan simply must be reduced. Unless the Clinton Administration takes immediate and concrete steps to do so, the economic and national security of the United States will remain at risk.

The Clinton Administration should also include machine tools in the Market Oriented Sector Specific (MOSS) Talks under the U.S./Japan Framework. MOSS Talks concerning machine tools should focus on opening the channels of sales and distribution for American-built machine tools -- both in Japan and in Japanese-owned transplants located in North America. Concrete steps -- patterned after the semiconductor agreement -- should be taken to ensure that American equipment is on an equal footing with Japanese-produced equipment. Perhaps the existing U.S./Japan Framework agreement on auto parts could provide a basis for the inclusion of machine tools in the MOSS Talks.

The Justice Department should review the application of U.S. antitrust laws to the Japanese Kieretsu and similar foreign anti-competitive practices. Congress should adopt legislation specifically authorizing such application.

Immediately upon the expiration of the machine tool VRAs on December 31st, the Commerce Department and the U.S. Customs Service should implement a procedure to monitor the transfer prices of imported machine tools, so as to provide an early warning system against foreign companies rushing into the U.S. market with dumped products and to provide a deterrent against dumping and other unfair trade practices.

In order to assure that dumping, illicit foreign subsidies, foreign industrial targeting, and other unfair trade practices are dealt with promptly and effectively by the U.S. Government, the Administration and Congress must reject any Uruguay Round GATT agreement that undermines U.S. unfair trade laws and/or the remedies currently provided for addressing unfair trade practices. Congress should re-enact "Super-301" and adopt the Trade Agreements Compliance Act.

As we approach the 21st century, the economic health of the United States and the competitiveness of traditional American industries increasingly depend on our ability to aggressively promote, market and sell our products abroad. To create new jobs and to reduce our debilitating trade deficit, the U.S. must take decisive action now to accelerate and streamline its export promotion efforts, to provide time-responsive competitive export financing, and to review and revise its out-dated export control system.

cc: LDT, MW, BC

Japanese Proposal
(Cooperation Approach)

[Basic Principles Of FW Talks With Regard To The Automotive Sector]

The Japanese side would like to define the basic principles which should apply with regards to presentation of its proposal at the FW Talks.

1. The issue of motor vehicles and auto parts is primarily the responsibility of private business.

   (Note) There is a difference in the level of government involvement in this issue, and in issues such as government procurement and mitigation of regulations.

2. Discussion at the talks is to be limited to items within the scope and responsibility of government.

   (Note) Details are clearly defined in the joint statement of July 10th regarding the FW Talks.

3. Discussions at the FW Talks are to be conducted under the basic principle of two-way dialogue.

   (Note) Details are clearly defined in the joint statement of July 10th regarding the FW Talks.

File
Japan trade

To. Alan

11/16/93

OKAMATSU Sozaburo
Vice-Minister
for International Affairs

with regards

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Ministry of International
Trade and Industry
Tokyo, Japan

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I Cooperation Approach

1. Objective criteria shall be established for evaluating activities carried out by both the Japanese and U.S. sides.

2. Japan and the U.S. periodically evaluate activities carried out by both sides, on the basis of objective criteria

3. Based on this evaluation of activities, Japanese and U.S. governments will make positive proposals as to what should be done by both sides in the future. External factors such as economic situation and market environment should be taken into account in this process.

II Objective Criteria

(Note)

(1) The following objective criteria are to be used to review activities in terms of past achievements and not to be used to establish targets, goals or expectations.

(2) The following list of objective criteria is illustrative.

1. Parts

(1) The following list of items are the criteria for evaluating activities of the U.S. side.

a. Sales activities, such as:
   - Number of times contact was made with Japanese companies
   - Number of times visits were made to Japanese companies
   - Thoroughness of product manuals
   - Number of sales offices located in Japan
   - Number of Japanese-speaking salespersons
   - R&D capability in Japan

b. Competitive capabilities, such as:
   - Cost
   - Quality
   - Capability for developing sub-assemblies

- Lead times (for development, delivery)

c. Thoroughness of after-sale support services, such as:
   - Amount of time needed to address quality problems

(2) The following items are the criteria for evaluating activities of the Japanese side:

a. Information on activities such as:
   - Design-in activities
   - Examples of supplier outreach/support programs
   - Transplant engineering and design activities

(Note) It is not appropriate to simply count the number of activities and to make an evaluation based on the total. This is because the level and the effectiveness of the activities of Japanese manufacturers differ from case to case. Qualitative information which reflects these differences should be considered.

{ Evaluation of Activities }

As to (1) and (2), data and information on the activities of the Japanese side shall be collected by the Japanese side, while data and information on the activities of the U.S. side shall be collected by the U.S. side. Japanese and U.S. governments will jointly evaluate the activities of both sides.

(3) Criteria for tracking auto parts transactions are:

a. Parts purchased in the U.S.

b. Foreign parts imported into Japan

{ Evaluation of Activities }

a. As to parts purchased in the U.S., JAMA is presently voluntarily compiling data on the amount of auto parts purchased by Japanese transplants in the U.S. Additional data cannot be collected due to the following reasons:
   - Excessive burden on JAMA
   - Additional data would infringe upon proprietary areas of corporate information

- It is unfair to have only Japanese transplants disclose data that is not disclosed by the Big 3.
- Disclosure of data on total purchases of auto parts by Japanese transplants is equivalent to indirect measurement of U.S. parts content. This raises a question as to infringement of Article 3 of GATT.

b. As to foreign parts imported in Japan, Japan and the U.S. collect data on the basis of customs clearance statistics.

2. Motor vehicle

(1) The following items are the criteria for evaluating activities on the U.S. side:

a. Dealer principals in Japan selling foreign vehicles

b. Activities related to selling in the Japanese market, such as:
   - Number of sales outlets
   - Number of Japanese-speaking salespersons, etc.
   - Advertising spending

c. Activities to develop products suited to the Japanese market, such as:
   - Number and ratio of right-hand steering wheel models introduced in the Japanese market
   - Segment-by-segment (size, engine displacement) breakdown of models introduced
   - Market research (number of researches conducted, total expenditure)

d. Price, quality and lead time, such as:
   - Price and product performance (comparisons with Japanese models)
   - PDI facilities
   - Lead time for delivery

e. After-service functions, such as:
   - Service operation centers
   - Replacement parts supply system (price, delivery time)

(2) The following items are the criteria for evaluating activities on the Japanese side:

a. Organizing import fairs and offering use of exhibition space
b. Activities related to standards and certification:
   - Promotional activities for Japanese type designation system and others

(Note) It is not appropriate to simply count the number of activities and to make an evaluation based on the total. This is because the level and the effectiveness of the activities of Japanese manufacturers differ from case to case. Qualitative information which reflects these differences should be considered.

(3) The criteria for tracking motor vehicle sales, and the degree of harmony with international standards and certification are:
   a. Foreign vehicle sales in Japan
   b. Standards and certification
      - Items to be harmonized internationally

   {Evaluation of Activities}
   Excluding data that can be obtained from official statistics, and standards and certification issues (information collected by the Japanese side based on the Japan - U.S. expert-level meeting on standards and certification issues), data and information on the activities of the Japanese side shall be collected by the Japanese side, while data and information on the activities of the U.S. side shall be collected by the U.S. side. Japanese and U.S. governments will jointly evaluate the activities of both sides.

3. Note

(1) Additional objective criteria may be added in order to further progress in cooperation between both sides.

(2) To improve the objective criteria, export promotion measures by the U.S. government, import promotion measures by the Japanese government, and the difference in the ratio of

In-house Parts Production to Purchase from Suppliers between the Big 3 and Japanese auto manufacturers should be taken into account.

4. Evaluation Period

Basically, the activities of both sides shall be evaluated by Japan and the U.S. two times per year within the framework of the FW talks. However, the timing of evaluations of activities coinciding with model changes (such as activities for design-in's) should be considered separately.

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20500

THE CHAIRMAN

October 25, 1993

MEMORANDUM FOR ROBERT RUBIN

FROM: LAURA TYSON Laura

SUBJECT: U. S.-Canada Agricultural Trade Disputes

Attached is a memo to me from CEA's agricultural and trade economists about the mounting number of agricultural trade disputes between the United States and Canada. We are very concerned that the U. S. has been pursuing a series of unilateral trade actions against Canada that undermine the spirit if not the letter of NAFTA and the U.S.-Canada FTA, and that threaten to harm our national economic interests. The proposed imposition of a section 22 quota on imports of durum wheat from Canada is only the most recent example, but it is an illustrative one. To date, the bilateral CFTA dispute resolution process has ruled in favor of the Canadians, so we are now threatening to resort to unilateral action to reduce imports from Canada. Moreover, our own subsidy programs for agricultural exports have contributed to high durum prices in the U. S. which in turn have attracted lower-priced Canadian imports. To complete the irony, if we place a section 22 quota on Canada, the most likely result will be an increase in imports from other suppliers like Italy, not a reduction in overall imports. In other words, we stand to anger Canada without realizing the goal of higher prices for the durum wheat producers in the United States. Nor, of course, is this goal an attractive one once the consumers of durum wheat are brought into the picture.

I propose that you call an NEC meeting on U.S.-Canada trade relations before the Administration announces a position on the durum wheat question. Although, perhaps not of great importance in its own right, this question takes on significance as part of a pattern of unilateral trade action by the U. S. against Canada, its largest trading partner.

MEMORANDUM

COUNCIL OF ECONOMIC ADVISERS

October 25, 1993

TO: LAURA TYSON
ALAN BLINDER
JOE STIGLITZ

FROM: ERIK LICHTENBERG
SHERMAN ROBINSON

EL
SR

SUBJECT: U.S.-Canada Agricultural Trade Disputes

Trade tensions are mounting between the U.S. and Canada over a number of agricultural issues. We are concerned that the U.S. posture in many of these disputes does not make sense economically and is souring our overall relationship with Canada. Our positions are certainly contrary to the spirit, if not the letter, of the NAFTA and the U.S.-Canada free trade agreement (CFTA), and are undermining Canadian support for both agreements. Rather than continue to pursue unilateral retaliatory trade policies, which often fail in their purpose and/or have undesirable spillover effects, it is time to work with the Canadians, and the Mexicans, to coordinate domestic and international agricultural policies. We suggest that the CEA recommend an interagency task force be convened to initiate a review of domestic and international agricultural policies in the U.S., Canada, and Mexico, with the goal of negotiating with our NAFTA partners to harmonize agricultural support policies across North America.

Agricultural trade disputes have plagued the CFTA since its inception. These disputes are symptomatic of a single underlying problem: neither the U.S. nor Canada is willing to adjust its domestic agricultural programs to better mesh with the other's. In the past, in both countries, trade policies have been designed to support domestic support programs. As the Europeans understood early on, in sectors such as agriculture, where there are extensive domestic subsidy programs, it is necessary to coordinate domestic and international policies if countries are to form a free trade area. The result in Europe was the Common Agricultural Policy (CAP). The problem is especially acute if the countries do not have a common external trade policy (*i.e.*, a customs union).

When CFTA was formed, agriculture was largely left out on the argument that changes in domestic agricultural programs would be handled under the GATT negotiations, which were expected to be completed soon after CFTA was implemented. With the delay in completing GATT negotiations, the results were entirely predictable. Given the similarities in production conditions and low transportation costs between the two countries, domestic support/protection programs have come into conflict with the patterns of trade generated by the CFTA.

USDA and USTR have consistently taken the position that Canada's domestic support programs constitute export subsidies and have supported countervailing actions on that basis. In fact, total subsidy rates in the two countries are roughly similar (*e.g.*, as measured by producer subsidy equivalents, PSE's). Problems arise because the mix of domestic and trade subsidies differ, which leads to different distortions in incentives in the two countries.

The fact that, in agriculture, most domestic support programs distort trade has long been recognized. Indeed, it is precisely this recognition that motivated the U.S. to insist on bringing domestic agricultural subsidies under the GATT in the Uruguay Round. It is bizarre for us now to argue, in the case of Canada, that some of their policies affect trade, justifying retaliation, while the trade-distorting characteristics of our domestic and export policies are somehow exempt from consideration.

In sum, what we are now seeing are policy tensions arising from the lack of coordination of agricultural trade and domestic support policies between the U.S. and Canada. The Mexicans have become involved because we have started to subsidize wheat exports into their market. Such subsidies are viewed as dumping by the Mexicans, and are very unwelcome given that Mexico is in the process of an extensive and politically delicate restructuring of its entire system of agricultural support policies. The CFTA was implemented to foster increased trade, economic integration, productivity, and growth in the U.S. and Canada. Attempts to resolve agricultural trade tensions through unilateral U.S. trade policy initiatives will require the U.S. to close its agricultural markets, defeating the purpose of the CFTA (and of NAFTA). We discuss some specific examples below.

- **Durum wheat.** U.S. imports of durum wheat have been rising rapidly over the past few years. The reason is that U.S. prices exceed Canadian prices; a gap caused by a combination of increased U.S. consumption, highly inelastic domestic production, and continued subsidization of exports by the U.S. to maintain export volume. The ITC has ruled that Canadian rail subsidies are legal under the CFTA and an audit of Canadian Wheat Board (CWB) pricing practices is under way. Having essentially lost their case in CFTA dispute resolution, a number of Plains states senators and congressional representatives are trying to exert leverage through the NAFTA debate to obtain import restrictions. at least delay

- **Wheat exports to Mexico.** Last June, the U.S. extended the EEP program to include Mexico, explicitly targeting Canada as a subsidizer on account of rail subsidies and alleged CWB pricing practices. The result of our displacing Canadian exports was increased U.S. imports of Canadian wheat —an entirely predictable result.

  In fact, the case against Canada is very weak. A CFTA dispute resolution panel has ruled that Canada was not unfairly subsidizing wheat exports to the U.S. Canada is in the process of decoupling its rail subsidies from exports by transforming them into lump-sum direct payments to farmers —a non-distorting form of support that would be allowed under the new GATT rules, if the Uruguay Round is competed. The fact that the CWB has run a deficit in its wheat account only twice in its history suggests that their pricing practices are no different than those of any grain trading company.

U.S. wheat growers have claimed that the CWB was selling feed (low-quality) wheat as milling (high-quality) wheat, but there is nothing illegal, unfair, or even unreasonable about that. Wheat use is determined by physical characteristics rather than legal designations. Moreover, one would expect that an export subsidy like EEP —which accounted for almost 60% of U.S. wheat exports last year— would result in a higher U.S. price and lower world price, making Canadian wheat more attractive in the U.S. market.

• **Barley.** U.S. barley producers have raised complaints about imports of barley from Canada that are similar to the complaints raised by U.S. wheat producers; *e.g.*, transportation subsidies and unfair pricing. Again, we EEP barley fairly vigorously, so an increase in Canadian imports might well be expected. There was some talk this summer about linking NAFTA votes to Section 22 import quotas for barley, but nothing ever materialized.

• **Hogs and pork.** The U.S. has been attempting to place countervailing duties (CVDs) on imports of Canadian hogs and pork since 1985, citing Canada's Tripartite Meat Stabilization Program as an export subsidy. The Tripartite Program applies to all meat animals and is similar to our deficiency payment programs for grains and cotton: the government guarantees a target price and pays producers the difference between the target price and market price. The Tripartite Program does not impose production controls, unlike our deficiency payment program. The predictable outcome of such a policy is increased production and a lower market price. Concern about exacerbating this dispute was one reason the CEA cited for opposing the FSU pork EEP. At present, the CFTA dispute resolution panel has overturned the CVD on pork, since it was not clear that much of the Tripartite subsidy was passed on to pork processors. The hog CVD is still being adjudicated under CFTA procedures.

• **Sugar.** Last spring, the Administration discussed imposing an emergency Section 22 quota on imports of sugar from Canada (mainly processed products that are mostly sugar like Tang, Jello, and iced-tea mix) in response to low sugar prices. Had prices remained low, producers would have defaulted on CCC loans, which would have violated the provision that the sugar program be run at no net cost to the government. USDA ended up supporting prices by imposing marketing allotments —a form of supply control.

The status of Canadian import quotas is problematic since we converted from an outright quota system on sugar to a tariff-rate quota system after the CFTA had gone into effect, at a time when we had agreed not to impose new tariffs on U.S.-Canada trade. The U.S. and Canada had reached a "gentlemen's agreement" that Canada would restrict its imports to its historical share, but that agreement has not held. Canadian imports have been growing while its quota (based on a market share of 1.1%) has been shrinking as the quota on total imports shrinks. This issue will probably resurface after the Canadian election, since the Administration still has the option of imposing a non-emergency Section 22 quota on Canadian sugar imports. While the total amount of Canadian imports is small, sugar imports are near the statutory minimum for the quota, meaning that production controls could become necessary to maintain the no-cost nature of the sugar program.

In addition, sugar has become a contentious issue in the NAFTA debate. Under NAFTA, Mexico is agreeing to establishing a common external policy regarding sugar. U.S. sugar interests are now questioning this agreement, and want to reopen negotiations with the Mexicans.

Our concern is that these types of disputes undermine support in Canada for both the CFTA and for NAFTA. We cannot insulate our markets from Canada's if we want free trade, nor can we succeed in increasing our exports to Canada without accepting greater Canadian imports. Moreover, a GATT agreement on agriculture that roughly follows the Blair House Accord will not remove the basis for disputes like these, since it allows a number of distorting policies to remain in place. The underlying problem is that the U.S. and Canada have decided to support different sectors of agriculture and to use different instruments for agricultural support, most of which affect domestic production and trade incentives.

In our view, if CFTA and NAFTA are to succeed, it is imperative to initiate an effort to harmonize agricultural policies between the U.S. and Canada, and with Mexico as well. Harmonization would:

- ensure that CFTA and NAFTA are viable;
- make our overall international trade policies (*e.g.*, our efforts to end EC agricultural export subsidies) more effective by bringing to bear more market power;
- reduce or eliminate negative spillovers from policies like EEP into domestic markets; and
- reduce the cost of carrying out trade policies and, potentially, domestic policies.

File Article.

Good and bad of managed trade

PERSONAL VIEW

There are widespread concerns that managed trade is coming to dominate US – and perhaps global – commercial policy. Some reviewers – including Michael Prowse in the Financial Times on June 25 – have attacked my new book, Reconcilable Differences? United States-Japan Economic Conflict (co-written by Marcus Noland, now senior international economist at the Council of Economic Advisers), as supporting such an approach. Some have similarly attacked Laura Tyson's book, Who's Bashing Whom? Trade Conflict in High-Technology Industries, published by the Institute for International Economics last November*.

Neither Mr Noland and I, nor Ms Tyson, chairman of the council, believe that trade policy measures can solve "the Japan problem". Japan's huge and growing global current account surplus must be reduced primarily by maintaining a strong yen and by restoring vigorous growth in Japan's domestic demand.

The US must correct its budget deficit and adopt domestic measures to strengthen its competitiveness, as the administration of President Bill Clinton is beginning to do.

Our writings flatly reject protectionism. We remain devoted to an open and multilateral trading system. We also believe that aggressive efforts to open the Japanese market are essential.

However, there is enormous confusion over both the meaning of the term "managed trade" and its recent history.

There are two different types of managed trade. The traditional version, usually implemented via voluntary export restraint agreements (VERs), restricts trade and closes markets. It raises prices, reduces competition and reinforces cartel behaviour. It is the most insidious form of protectionism, creating unholy alliances between shielded import-competing industries, which are guaranteed market share, and exporters, who are suddenly licensed to jack up prices and reap windfall profits.

The Reagan administration specialised in this type of managed trade. It negotiated VERs with Japan on cars, steel and machine tools. The then secretary of the Treasury, James Baker, proudly proclaimed that Mr Ronald Reagan had "granted more import relief to US industry than any of his predecessors in more than half a century".

The Clinton administration has adopted no such arrangements. Mr Noland and I flatly reject them, as does Ms Tyson.

The second type of managed trade, sometimes pursued via voluntary import expansion agreements (VIEs), aims to increase the participation of imports in protected foreign markets. It seeks to increase trade and open markets to new competitors. Implemented properly, it reduces prices and enhances competition.

The Bush administration employed this type of managed trade in several cases. It extended the Reagan VIE in semiconductors and pushed Japan into new VIEs in cars and car parts. Mr Clinton has negotiated no VIEs but has raised the possibility with Japan.

The judicious use of voluntary import expansion agreements can help Japanese consumers, foreign producers and the prospects for maintaining an open trading system

Mr Noland and I espouse the use of such agreements to expand exports in certain carefully circumscribed circumstances, as does Ms Tyson.

VIEs may be necessary in markets that deny access to foreigners through a web of opaque exclusionary practices that cannot be addressed by the usual tools of trade policy.

Mr Noland and I analysed 12 sectors of the Japanese economy, ranging from agriculture, high-technology and medium-technology manufacturing to financial and other services. We found a pervasive pattern of exclusionary corporate practices coupled with government intervention. Some of those interventions, especially those that curbed imports directly, have disappeared but they have left a profound legacy of market closure.

The preferred response to such market closure is to identify and abolish the offending government policy, such as discriminatory public procurement. This can be done through the multilateral procedures of the General Agreement on Tariffs and Trade – antitrust policy is the proper counter to restrictive corporate practices.

Unfortunately, tackling restrictive government policy by taking action through the Gatt is often impossible, even when Japanese access limitations can be clearly discerned. VIEs may be the only way to introduce new entrants into some closed sectors in Japan. Even Japan's former prime minister, Mr Kiichi Miyazawa, publicly solicited foreign pressure to help Japan change.

The Reagan-Bush semiconductor VIE illustrates the proper use of managed trade to promote exports. Market access was clearly limited: Japan's import share never rose above 10 per cent-12 per cent, despite the competitive position of non-Japanese companies in other markets and huge changes in all the most important economic variables. At least partly as a result of the VIE, sales to Japan from Europe, Korea, other Asian countries and the US have increased to about 20 per cent of the market.

More important, Japanese end-users sought out foreign suppliers for the first time and began to design their chips into the production process. Competition and world economic welfare have improved as a result.

Why do some free traders oppose a device that expands trade?

Some confuse policy targets and policy instruments. Both VERs and VIEs require government intervention in markets. Hence many observers instinctively denounce VIEs even though they seek, as US undersecretary of the Treasury Lawrence Summers puts it, to unmanage rather than manage trade.

There are, however, significant practical problems with VIEs. Any numerical target is bound to be arbitrary; it is far superior to use a range of qualitative and quantitative indicators rather than a single market share.

No government can control the outcome; changes in the market, in growth rates or in exchange rates can frustrate even the most faithful compliance.

A dangerous dynamic is thus set in motion: the US administration will be attacked as soft if it fails to retaliate against an unmet target – even if all parties know that the failure had nothing to do with Japanese effort – but subjects itself to legitimate counter-retaliation if it does so.

Moreover, VIEs must be used only for temporary periods. They apply only to intermediate industrial products, not consumer goods bought by millions of individuals. They must be open to all imports, unlike the Bush VIEs on cars and car parts, which are limited to US companies and are a blatant invitation to divert sales from other supplying countries – an invitation that Mr Clinton has firmly rejected.

The problems of applying VIEs are thus formidable. They should be used sparingly and only with the utmost care by the US and Japanese governments as they pursue their forthcoming sectoral negotiations.

However, it should be clear that there is an enormous difference in principle between the two types of managed trade. It is analytically incorrect to equate both with protectionism. VERs are clearly protectionist and should be resisted. But VIEs expand trade and may be needed on occasion. Their judicious use can help Japanese consumers, foreign producers and the prospects for maintaining an open trading system.

C Fred Bergsten

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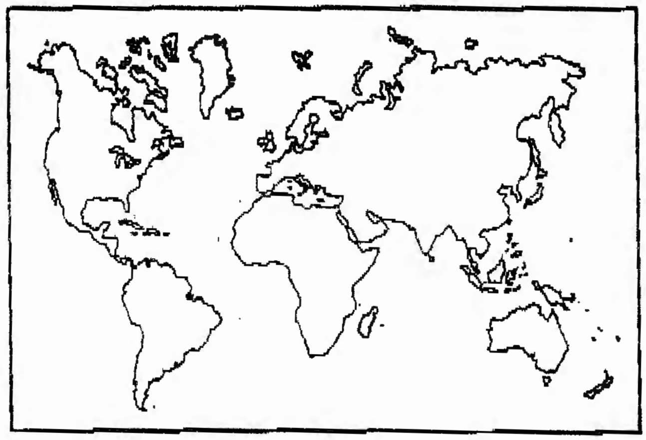

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"TRADE POLICY IN THE CLINTON ADMINISTRATION"

SPEECH BY AMBASSADOR MICHAEL KANTOR
U.S. TRADE REPRESENTATIVE

NATIONAL PRESS CLUB

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A little over two months ago, at American University, President Clinton set forth his vision of America's role in the global economy. It is a vision rooted in the belief that we are at the third great moment of decision in the 20th century.

"Will we repeat the mistakes of the 1920s and 1930s by turning inward?" he asked. "Or will we repeat the successes of the 1940s and 1950s by reaching outward?" His answer was clear: we will reach outward and adapt to the new global economy. We will compete, not retreat.

Trade occupies a central place in the President's vision of America's future in the world. Trade means money in people's pockets. Trade means jobs. Trade is not a bloodless, abstract concept based on theory. Trade means that working men and women in Raleigh, North Carolina, make and sell U.S.-made power protection products for computers in seventy countries. Trade means that a minority-owned company in Rocklin, California exports U.S.-made electromechanical products to five countries. All over this country, trade means that working people can put dinner on the table and support their families.

But the benefits of trade are not limited to the United States. As the President went on to declare in his speech at American University, the fabric of commerce will also shape <u>global</u>

prosperity. "For now and for the foreseeable future," he added, "the world looks to us to be the engine of global growth and to be its leaders."

We can't live up to the twin tasks of American prosperity and global leadership, however, unless we are competitive. What is different about trade policy in the Clinton Administration is that it designed to reinforce policies to strengthen our domestic economy. This is why we say that trade policy in the Clinton Administration is an integral part of economic policy.

Gone are the days when this nation could subordinate trade concerns to "national security" in the military sense of the term. The strategy of containment was appropriate during the Cold War, but it was basically a static strategy, aimed at halting Soviet expansionism. In those years an American magazine used to publish a picture of a "Doomsday Clock," with hands perilously close to the midnight of a nuclear war. For a long time our strategy was Mutually Assured Destruction.

Today our challenges and goals are dynamic as opposed to static: change, renewal, sustainable growth. Economic strength, founded on human resources and nourished by trade, is a pillar of national security in this new post-Cold War age. Our security interests -- and those of others -- are inextricably linked to the growth and fairness of the global trading system.

Economic policy begins with the President's domestic economic program. The challenges are enormous. Unemployment is still at seven percent. More than one in ten Americans are on food stamps. Sixteen million people are looking for full time work and having no luck at all.

We must get our house in order.

We must provide American workers with the training they need to hold down jobs in industries on the cutting edge of new technology...the industries of tomorrow.

We must provide American enterprise with the capital it needs to compete, to expand, to prosper.

And ..we must provide the American economy with the stimulus of a thriving global marketplace.

The numbers speak for themselves. Every billion dollars of exports creates twenty thousand new jobs in the United States. There are now seven million Americans whose weekly paychecks are related to and dependent on international trade. A majority of those people work in the manufacturing sector and they earn almost $3500 per year more than the average American worker makes.

Jobs in the service sector--when they are oriented toward trade, also provide workers with valuable economic incentives. The average salary for a service worker in the export field is estimated to be 20% percent higher than the average salary for a worker not producing for the export market.

So trade means the hands of the clock move forward, toward higher wages and better jobs for working Americans.

The goals of the Clinton Administration's trade policy are clear and simple. We want to open more foreign markets. We want to do more business with those whose markets are already open. We want to tear down trade barriers that are raised against us and others.

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We need to build faith in the whole rules-based international trading system. Too many people in the American public at large think that trade hurts them, that trade may take away their jobs.

The truth is the opposite. Trade brings jobs. Take Ron Thomason, a materials expediter at Caterpillar's large bulldozer assembly plant in East Peoria, Illinois. He says, "I owe my job to exports." Take the 200 out of 900 people at an IBM facility in Rochester, Minnesota, whose jobs depend on exports, or the 50 people in GE's business jet engine plant in Lynn, Massachusetts.

Americans know instinctively that we have the largest open market in the world. We take the largest share of exports from developing countries. In four major industries -- textiles and apparel, steel, autos, and footwear -- the United States imports from one to five times as much per capita as the EC and Japan. With this record, Americans want to be sure that no one is taking advantage of them, that others maintain comparably open markets.

To achieve our trade goals we will use all the negotiating tools at our disposal. We will negotiate multilaterally... regionally... bilaterally... sectorally. We insist only that foreign governments respect our rights under current and future international agreements. And we will respect theirs. That is why we expect from our principal trading partners nothing less than mutuality of obligation and comparability of action -- long words that mean real partnership and mutual responsibility.

Americans are sometimes accused of "unilateralism" when we insist on enforcement of agreements. But holding countries to their agreements is the opposite of unilateralism. Not only does enforcement build support here in the United States for an open trading system; it also strengthens the credibility of, and confidence in, the trading system as a whole.

You cannot ask people to take risks, to give something up, to change their way of doing business, unless you can guarantee that what they agree to will be carried out. The need for reliable rules is as pressing in other countries as it is here.

Today, the United States is engaged in clarifying and strengthening the rules, and expanding markets, in five major areas. I'd like to touch on each of them.

The **Uruguay Round** of multilateral trade negotiations is of primary importance because the General Agreement on Tariffs and Trade -- the GATT -- remains the foundation of the global trading system. Just as flows of capital, technology, and people have become global, so have trade flows. We need global rules more than ever.

Although we have accomplished a great deal during the Uruguay Round negotiations, much remains to be done if we are to meet the goal of completing negotiations by December 15. To restore momentum to the negotiations, we need to make progress in market access by agreeing to remove the barriers to trade in manufactures, services, and agriculture.

Some are waiting for the U.S. and the E.C. to show leadership in this area before making their own contributions. EC Commissioner Brittan and I accept our responsibility and have agreed to aim for an outline on market access that will serve as the basis for finishing an agreement in Geneva. We will only be successful in the end, however, if others, like Japan and the developing countries, are full participants.

Beyond market access, there is still work ahead of us in completing the rules agreements in the draft "Final Act." The United States and other countries have made suggestions to improve and strengthen the text while taking care not to unravel six years of hard work. I will give you only a few examples of areas where improvements are necessary: in intellectual property to address the concerns of our entertainment industry, in the environment-related texts to respond to concerns on the environment or in the unfair trade rules covering antidumping and subsidies, which are enormously important.

NAFTA, the North American Free Trade Agreement, is a second key link in the trade-and-economy chain. In anticipation of NAFTA, trade and jobs are on the rise. Exports to Canada already support an estimated 1.5 million jobs. Export jobs related to Mexico have grown from 300,000 to 700,000 over the last five years, with another 200,000 predicted by 1995 if NAFTA is implemented. These jobs pay about 12% higher than the national average. And for 38 out of the 50 states, Mexico is one of the top ten customers. Five of the ten states selling the most to Mexico are northern industrial states. Without NAFTA, the United States will be unable to lock in and extend these gains.

Current negotiations are addressing several key areas: border clean-up, commissions on labor and environment standards, import surges, stronger enforcement of national laws, and higher wages and productivity. A worker adjustment and retraining program is vital: we will not send a NAFTA package to Congress without ensuring that there is adequate adjustment assistance for workers.

Looking beyond the NAFTA, we see bright prospects for additional trade agreements with successful market-oriented economies throughout the Americas, beginning with Chile. The combination of political and economic reform in this region is breathtaking. U.S. exports to the region are expanding at a rate that is three times the rate of exports to the world as a whole.

The third -- and closely connected -- high-priority area for this Administration is the **Pacific Rim**. If you are scanning the world looking for growth, this is where you find it. We are the geographic hub connecting the Pacific Rim and the Americas, the two most dynamic regions in the world today.

In 1960 the nations of the Pacific accounted for 8.9 percent of the world's gross national product. By the year 2000 the figure will be an estimated 25.7 percent. Forty percent of current US international trade is with the Pacific Basin. Last year trade across the Pacific exceeded trans-Atlantic trade by fifty percent.

This year the United States is chairing ~~the~~ Asia-Pacific Economic Cooperation organization forum, known as APEC. Our hope is that APEC will provide the framework for libera~~lized~~ trade and an increased investment flow throughout the region. We intend to work with our Asian partners to further these goals.

When Americans look to the Pacific, we think first of Japan. There is no single country more important to our long-term interests.

For well over a century now, history has bound our two nations closely together. We have been adversaries and allies, strangers and friends. Today, our alliance is fundamental. Our common interests and our common challenges are extensive. That's why the issues that divide us must be openly acknowledged and squarely faced.

Even as I speak to you today about America's international trade policy, we are seeking to remove restrictions on access to Japan's construction and supercomputer markets. These are but two examples of deep-rooted political, social and commercial practices and attitudes that gravely distort the workings of a free and open international trading system.

When Prime Minister Miyazawa visited Washington last month, President Clinton made it clear that the time has come for Japan to take more substantial steps to open its market and play a leadership role commensurate with its economic strength. Japan's economic stimulus package is a good first step. But we need to make concrete, measurable progress on a number of sectoral and structural issues.

Japan and the United States have agreed to identify specific areas for bilateral negotiation when the Tokyo Economic Summit convenes in July of this year. Among the barriers that we believe should be addressed and removed are discriminatory government regulations, discriminatory government procurement procedures, and exclusionary business practices by Japanese business enterprises.

Government procurement also figures prominently in our trade relations with the **European Community**. Last January the EC unilaterally imposed Community-wide requirements that discriminated against non-European providers. There seemed no alternative but to impose heavy sanctions under our law.

Last month, after two days of intense talks, Sir Leon Brittan and I reached agreement to open up a major segment of that procurement market to both sides. The EC will remove the discrimination against U.S. suppliers of heavy electrical equipment. The United States will remove Buy America preferences on certain Federal power administrations, including the Tennessee Valley Authority. We will continue to negotiate on remaining barriers in hopes of averting the residual threat of sanctions under our law.

The purpose of <u>all</u> our trade actions is the same: to open markets and create trade opportunities, and in so doing to boost the global economy, strengthen the international trading system, and above all, ensure that American workers and American companies are and will remain competitive. Trade is not a zero-sum game; it is an engine of growth.

This Administration will link all the resources at our disposal to achieve these goals. Whatever programs we have -- export promotion, export finance, trade-related assistance -- are tools of a comprehensive trade promotion strategy.

Such is our short- and medium-term negotiating agenda. What of the future? How should the trading system and its supporting institutions adapt to the realities of the new global economy?

We will need new assumptions, a whole new set of attitudes on the part of the United States and its trading partners.

The fundamental fact is that the globalization of production and markets has changed the nature of international competition. Self-sufficiency is less and less realistic. "Imported" goods are no longer entirely produced in the exporting country; domestic production is often involved. Trade and investment are closely intertwined. These trends are here to stay.

Similarly, domestic policies and regulations have become more important to the future of trade than trade measures adopted at the border. Domestic policies have become major competitive factors in world trade. Governments are competing to create high-wage, high-skill jobs through a variety of domestic measures.

Three new issues in particular illustrate this link between trade and domestic policy.

The first is the **global environment**. Pollution knows no boundaries. Measures to protect the environment at home can have an effect on trade. How can we define and implement positive complementarity between trade, sustainable growth, and the environment? What institutions are most appropriate?

The second is **technology policy**. How can we incorporate into trade policy the effects of changes in technology, research and development subsidies, membership in research consortia, and industrial standards?

The third is **competition policy**, broadly defined. How can be best address government monopolies, cross-shareholding arrangements, and other policies altering the competitive climate?

Answering these questions raises the question of the adequacy of our trade institutions. Has the globalization of the world economy and the growing importance of domestic policy outstripped the pace of change within these institutions? How might they be reformed? How can we harmonize emerging <u>regional</u> institutions with the need for a strong and effective GATT?

America has always been willing to change. This is a country that embraces change, thrives on change, and depends on change. We do better in a dynamic new situation than almost anyone else on this planet.

In this emerging new world, the Clinton administration will be both pragmatic and visionary. To be visionary means simply to be aware of what the possibilities are, and to be willing and able to bring them to life.

After World War I we raised trade barriers, with disastrous results. After World War II we lowered tariffs and built global institutions to expand trade and investment even as we held communism to a standstill.

The end of the Cold War is the third moment in this century. We have a chance to build a new future, and to make it the brightest and most enduring of all. Instead of a Doomsday Clock, with hands pointing toward a nuclear midnight, we want a "growth clock," with hands pointing toward high noon. Instead of Mutually Assured Destruction we want Mutually Assured Growth.

In his American University speech the President sketched the broad significance of this historic moment. "The fabric of commerce," he said, "will also shape global prosperity or the lack of it, and with it, the prospects of people around the world for democracy, freedom, and peace." We challenge our trading partners to join us in pursuing this vision of a better world.

Thank you very much.