The Inevitability of Managed Trade

Clyde V. Prestowitz, Jr.

Pose the question to any audience, „How many here favor free trade and how many support protectionism or managed trade?“ Inevitably, an overwhelming majority of hands are raised for free trade.

In Washington, the policy of the U.S. Government is determinedly for free trade. When the Uruguay Round of GATT (General Agreement on Tariffs and Trade) talks collapsed in Brussels last December, U.S. trade representative Carla Hills proclaimed a crisis of the world economy and warned of the danger of rampant protectionism and global depression.

In the leading academic centers and think tanks, as well as in most of the press and major business organizations, the need for freer trade is constantly enjoined. And yet....

Even as Ambassador Hills was decrying the failure of the Brussels talks, President Bush was traveling through South America promoting his Enterprise for the Americas initiative – a regional trading bloc that, in his words, would eventually stretch from Alaska to Tierra del Fuego. Shortly afterward, the President asked the Congress for fast-track authority to negotiate a free-trade agreement with Mexico patterned after the one already concluded with Canada. In the Mexican, as with the Canadian deal, the central issue will be rules of origin – the basis for determining whether goods qualify for preferential treatment or not. Soon thereafter, the U.S. Government stated that while trying to get the Uruguay Round back on track it would not accept a standard national treatment approach in telecommunications services trade, but would insist, rather, on a results-oriented regime.

Many who call themselves free traders cheered this demonstration of tough-mindedness on the part of U.S. negotiators. Few remarked on the fundamental departure from traditional free trade implicit in a results-oriented approach. Finally, and most recently, the European Community, while seeking to achieve a truly integrated and free internal market, has just announced the terms of an informal deal with Japan that will severely limit Japanese penetration of the European auto market.

In short, all the world preaches free trade, but all the world practices managed trade. And the trends are toward more management, not less. In a recent paper, economist Lawrence Krause of the University of California at San Diego notes that in addition to steel, textiles, apparel, and agriculture – which are well known as sectors in which trade is managed – automobiles, petroleum, military hardware, telecommunications equipment, and aircraft are sectors in which half of all trade is already managed.

This huge and growing divergence between theory and practice is reminiscent of past eras of revolutionary change. Determined Ptolemaists ridiculed Copernicus for years, but eventually were forced by circumstances to adopt his ideas. Similarly, feudal theory had, eventually, to yield to bourgeois practice. Perhaps the most spectacular example of the consequences of diverging theory and practice is the current collapse of communism. Indeed, this event is so dramatic that it is presently overshadowing similar dynamics in the noncommunist world. On the other hand, it is also accelerating them in such a way that we will not be able to avoid addressing them much longer.

The ideal of free trade as embodied in the GATT was established in the immediate post-World War II period on the basis of overwhelming American economic dominance and as a mechanism not only for economic development but also for opposing communism and encouraging democracy. Today, the world trading system based on the GATT is eroding, as attested to by the difficulty of concluding the Uruguay Round and by the rising number of trade disputes, along with the drift toward regional trading. The erosion is occurring because the fall of the Soviet empire on the one hand and the economic decline of the United States on the other have increasingly exposed the flaws inherent in the system. For a long time, the Soviet threat made the United States willing to accept and even to promote for geopolitical purposes a trading system that was biased against it. At the same time, the great economic power of the United States enabled it to pay for this system without pain. The end of the cold war has made it unnecessary for the United States to subordinate economic to geopolitical interests, and the deterioration of the U.S. economic base has made it very costly to do so. Thus, substantial change is in order, and, indeed, is already occurring.

Two Theories

Two major theories, one dealing with the way nations work and the other with the way markets work, are at the heart of the matter. The assumption of the United States and of the GATT regime it has sponsored is (or was) that tariffs or quotas and other border measures are significant barriers to trade and that their removal will result in growth in trade and a mutual and roughly reciprocal increase in welfare among trading partners. Differences in national economic structures and policies are deemed not very important. Based on this thinking, two principles – national treatment and unconditional most-favored-nation (MFN) treatment – became the pillars of the postwar free-trade system.

Under the national treatment standard, country A agrees to treat the firms of country B that may do business within country As territory exactly as it treats domestic firms. This is conditioned on reciprocal treatment by country B. Under MFN, if country A and country B negotiate trade concessions between themselves, they immediately extend the same concessions to all other trading partners, such as country C.

What could be fairer? Nothing – so long as countries A, B, and C have similar economic structures, objectives, and policies. But what if A and B are very different? What if A is a country with an open and transparent legal and political system and an immigrant tradition of welcoming newcomers, while country B has a history of exclusivity and a tradition of granting preference to insiders? What if country A has strict antitrust laws, while country B allows or even encourages quasi-cartels and cozy business-business and business-government relationships? Obviously, it will be easier for the companies of country B to do business in country A than the reverse, and country A will tend to be an importer while country B is an exporter.

The case of MFN is similar. Country C may pocket the concessions offered by countries A and B without making any reductions in its own trade barriers. It can do this because so long as its barriers are nondiscriminatory they may be as high as country C likes. The GATT does not require reciprocity, only nondiscrimination. Thus, newcomers to the GATT have an incentive to become free riders on the system by accepting the concessions already negotiated among other trading partners while making few if any of their own.

The premise of the GATT and of free-trade doctrine is that the members of the system will be „like-minded“ and pursue similar objectives in a similar way. In fact, they aren't and they don't. The industrial policies and *keiretsu* or *chaebol* of Japan or Korea are very far, both philosophically and concretely, from the laissez faire policies and atomized structures of the United States.

This would not be so important if it weren't for the second theory about how markets work. Here the assumption is that goods and services are sold in perfectly competitive markets and that they are produced by labor, capital, and other factors hired in such markets. Under these conditions, comparative advantage arises naturally on the basis of the particular circumstances of each nation, and each nation will therefore be content to sell what nature enables it to make best while trading for its other needs. For example, the Northwestern United States has a rainy, cold climate and grows Douglas fir, which is processed into lumber. Costa Rica, in contrast, has a rainy, warm climate and grows bananas. Based on these factor endowments, the United States and Costa Rica trade lumber for bananas. It would be extremely costly if not impossible for the United States to attempt to grow bananas and for Costa Rica to try to grow Douglas fir. Under these circumstances, it certainly doesn't matter whether the United States and Costa Rica have similar or very different internal structures and policies.

So far so good. But what happens when the product is something like automobiles or semiconductors or airplanes? Comparative advantage in these fields is not determined by climate or natural resources. Many firms in many nations are potential producers. Moreover, production does not take place under circumstances of perfect competition. These products are not sold at rising marginal cost. Because steep experience curves, rapid technological change, and huge economies of scale are at work, they tend to be sold at declining marginal cost, with pricing done strategically in different markets. Because of these factors, differences in government policies and economic structures have a powerfully determining effect on leadership in world markets in such sectors. Comparative advantage can be achieved or created as well as simply recognized.

Creating Comparative Advantage

Whether attempts will be made to create comparative advantage depends on the mentality of the nations involved. In the United States, it is now official doctrine that the area of comparative advantage doesn't matter. For example, in 1985 Richard Darman asked in a high-level White House meeting, „Why do we want a semiconductor industry? We don't want to pick winners and losers in this country. We don't want some kind of industrial policy. If our guys can't hack it, let them go.“ More recently, a high Bush administration official has said, „Potato chips, computer chips, what's the difference? They're all chips.“ And even more recently, a top State Department official said he saw no difference between exporting optical fibers and exporting bushels of wheat. Thus, the United States, at least officially, does not care what it makes and sells and therefore makes little effort to create comparative advantage in particular areas.

Few other countries accept this thinking. They are not prepared for the decoupling of economics from international power considerations that such a doctrine requires. Moreover, they doubt its economic efficacy in any case. Most nations have national policies aimed at moving their industrial bases to higher levels of technology and sophistication. Thus, the Europeans subsidize the Airbus and the Japanese target supercomputers, optical fibers, and biotechnology, while the Koreans go after aircraft, VCRs, steel, and automobiles.

Furthermore, truth be told, the Americans don't in the final analysis accept the consequences of their own doctrine. As a result of the differences in economic policies and structures, trade frictions have multiplied in sector after sector, beginning with textiles in the early 1960s and continuing to automobiles, semiconductors, and

supercomputers today. In each case, the United States, after a period of neglect, has finally responded by accusing its trading partners of being unfair because they sold goods in the U.S. market below cost and targeted particular industries for expansion. After much recrimination, U.S. negotiators have usually decided to evade GATT guidelines by engaging in sleight-of-hand trade management, such as voluntary export restraints and trigger pricing mechanisms. They have done this because ultimately it is really not acceptable for U.S. firms to be driven out of a number of industries.

The truth is that the fundamental principles and premises of the GATT no longer hold true – if they ever did. Comparative advantage can be created in a number of key industries. Nations do care about what they make and will attempt to create advantage in those areas they deem desirable. In the face of such targeting policies, other nations – such as the United States – have only two choices: They can accept losing the contested industries, or they can take some kind of countermeasures that are in effect trade management devices. Virtually all nations ultimately do the latter. Thus, the United States makes a semiconductor agreement with Japan while attempting to conclude some kind of a deal with regard to the Airbus and its subsidies.

The bottom line is that as long as nations care what they make, as long as they believe that potato chips and computer chips are not the same thing, and as long as differences in national policies and industrial structures exist such that one nation's efforts in these areas are facilitated at the expense of another, trade will be managed.

Beyond GATT

Fortunately, the trade war scenario feared by many after the Uruguay Round is unlikely. Disputes will undoubtedly occur, but most have been handled outside the GATT system anyway, and such arrangements can continue. Indeed, the fear of trade war will likely encourage negotiators to redouble such efforts.

The trend toward regionalism will probably accelerate. The United States has recently implemented a free-trade deal with Canada and will probably complete one with Mexico. EC '92 is well on track, while the expansion of giant Japanese multinationals in the Pacific is rapidly creating a de facto trading bloc there. These developments are not necessarily bad. The EC has been coalescing for 30 years, while the United States and Canada have been intimately entwined for longer, yet these ties have not undercut trade and investment between Europe and North America.

Still, disputes will continue, and the world will have to work toward a sounder trading system. The United States, especially, needs to admit that it is advantageous to be a leader in industries such as aircraft and electronics, and that it cannot benignly neglect the adverse impacts of the current system on those industries.

Reciprocity should become the basis of future trade policy. That term has become a code word for retaliatory protectionist measures. It has also been interpreted as a need to balance the volume of every item traded item with every country. But a broad concept of reciprocity lay behind postwar negotiation of the GATT. The idea originally meant that U.S. and Japanese producers, say, should have roughly the same opportunities to invest, make acquisitions, distribute products, and otherwise do business in each other's markets. This would not necessarily mean forcing Japan to adopt U.S. practice or vice versa, but rather balancing the opportunities in some agreed-upon manner. It is on this principle that the United States should take its stand.

Several categories of trade may require entirely different approaches within this broad framework. First is the kind highlighted by David Ricardo in the eighteenth century and illustrated by the lumber-for-bananas example cited above. Such trade occurs naturally, and present GATT rules are probably adequate to regulate it.

A second category includes products that can be manufactured in several areas but that some countries can produce with a clear natural cost advantage. Examples are often agricultural goods and apparel. Here the issue is who is the lowest-cost producer. For example, sugar is produced cheaply from cane in the Philippines; expensively from cane, sugar beets, and corn in the United States; and expensively from sugar beets in Europe. Ideally, the United States and Europe would halt production and import sugar from the Philippines, since improving farming techniques or working harder will not enable those countries to lower costs to the Philippine level.

It was largely with this kind of trade in mind that GATT was initially established, and yet it is just here that GATT has been inoperable. That is because production of these items is often woven into a nation's economic and social fabric. Many people who make such products, including U.S. apparel workers, could find it difficult to obtain other jobs. Eliminating production would also provoke political repercussions, as the recent dispute over ending farm subsidies attests. Theoretically, a nation's entire population should not have to pay higher prices on protected goods to save the jobs of a relative few. However, as in the case of Japanese rice or European farm goods, the many may be happy to bear extra costs because of ancestral roots, national pride, or a desire to avoid putting fellow citizens on the dole.

What's more, a country that has introduced child-labor laws, a minimum wage, and other social benefits may hesitate to undermine them by allowing cheaper imports from nations without such regulations. After all, it seems unfair to promise workers a minimum wage and then throw them out of work because that wage makes their labor uncompetitive. This situation is particularly problematic when the foreign country closes its markets to prevent imports of other goods that the laid-off workers could produce. The GATT has foundered on these issues because it is unable to count intangible benefits and social costs – its goal is to open up all markets immediately.

Developing countries typically hope to build their economies through world trade in items in this category, and they must have that opportunity. But it would be unreasonable to expect one nation to reduce its standard of living voluntarily for the benefit of another. Certainly, it would be folly for countries to eliminate whole industries quickly or during a recession and thus incur enormous adjustment costs.

The United States should strive to open international markets to low-cost producers of apparel and farm products. However, the timetable for achieving these goals must be tied to concrete plans for helping those affected switch to new areas of production. The costs of these adjustments could even be assessed on an international basis. Movement toward more open markets must also be tied to minimal levels of social and environmental performance. The United States would not open its borders to goods produced by slave labor. We should work to establish standards on child labor, industrial emissions, and other areas of social concern.

Finally, any further opening of the U.S. market must be conditional on similar movement abroad. Low-wage Asian countries want access to the U.S. market for apparel, which they can produce more cheaply than U.S. manufacturers. But they are unwilling to import U.S. fiber and fabric because they are trying to subsidize backward integration into those areas. Access to the U.S. apparel market should be conditional on ceasing such practices and on actual sales of competitive U.S. textiles in those countries.

A third kind of trade is conducted between governments and includes the huge sales of military goods. Because prices and volume are completely managed, this trade occurs outside GATT. The United States has often subordinated its economic interests to political goals in pursuing such trade. Thus, in 1990 it agreed to import from South Korea 130 percent of the value of the U.S. military aircraft sold to that country and also to help Korea develop an aircraft industry of its own. More recently, the Pentagon announced that its policy is to buy globally from the cheapest sources regardless of the unwillingness of foreign defense departments to reciprocate.

Here the United States must elevate its priorities and bargain on the principle that it get back in economic terms as much as it gives. This means a halt to completing bad trade deals simply because they help diplomatic relations.

From Finger-Pointing to Negotiation

Finally, there is the trade category where most trade disputes occur and that requires the most negotiation: the industrial commodities and advanced technologies that a number of countries are capable of producing on a more-or-less equal basis. No comparative advantage stemming from climate, resources, or even wages dictates success in producing steel, semiconductors, or aircraft. Who becomes pre-eminent depends on factors such as the speed of technology introduction and the ability to achieve economies of scale. These industries usually raise a nation's overall productivity and help determine its international influence. A country that dominates world aircraft production is likely to gain both economic and political advantages that producers of shoelaces do not enjoy.

Here is where policymakers establish subsidies, import barriers, and consortia or cartels to obtain comparative advantage. Although the GATT national-treatment standard generally condones such policies, they inherently contradict free trade and are usually aimed at overcoming the leadership of some U.S. industry.

Even a country's more mundane economic practices can greatly influence comparative advantage in such industries. For example, even if U.S. and Japanese automakers attained exactly the same quality and production costs, U.S. producers would likely lose out. Why? Because it takes dealers to sell cars. Establishing a national dealer network from scratch in a country the size of the United States is an expensive and time-consuming task – as it is in Japan because of stratospheric real estate prices. But Japanese automakers selling in the United States don't have to build from scratch. They can piggyback onto existing GM, Ford, and Chrysler dealers because U.S. antitrust laws stipulate that producers must allow dealers to carry other lines. In contrast, by custom and because the Japanese do not enforce antitrust laws, outside firms find it extremely difficult to hook up with dealers in Japan. The result is predictable.

In these situations, U.S. trade policy should insist on eliminating the disadvantages to U.S. industry. Negotiators should not do this with moralistic finger-pointing: It is not unfair for other countries to have a different view of antitrust or industrial policy than the United States. If the Europeans want to subsidize the Airbus, that is their business. But the United States should be prepared to offset the negative effects of such subsidies on the U.S.

aircraft industry, taking unilateral measures if necessary.

An example of how such a policy might work already exists in the form of international airline agreements. Nearly every country has at least one domestic airline, and many are state-owned or subsidized. If the United States applied the same policy to airline service as it does to automobile and semiconductor trade, it would allow subsidized foreign airlines to fly unrestricted on both international and U.S. routes, even though U.S. carriers could not obtain reciprocal treatment. The United States would also allow foreign companies to buy total control of U.S. airlines. But the United States doesn't do that because there would soon be no U.S. airlines, and the United States has decided that retaining such an industry is important.

Thus, it has responded not by accusing other nations of cheating but by negotiating a series of reciprocal deals that stipulate the number of destinations, flights, and landing fees for airlines from each country. Within this structure, competition takes place: market shares fluctuate, passengers have meaningful choices, and subsidized airlines cannot run the others out of business. Critics have condemned this system as a deviation from pure free trade, but the system has not prevented healthy growth in international air traffic, nor has the industry seen the bitter trade disputes common in steel, automobiles, and semiconductors.

To see how such a policy might work outside the airline industry, consider the auto dealership problem. U.S. negotiators could require producers from a country with controlled dealers to establish their own outlets in the United States instead of piggybacking on U.S. company dealers. Or the United States could drop that stipulation if the other country actually (rather than theoretically) required its dealers to carry U.S. cars. Or half the dealers in each country could be controlled and half could carry both foreign and domestic lines. The nature of the deal doesn't matter – only that it result in an equivalent competitive environment.

While the United States negotiates such deals, it should also aim to restructure the GATT into a true World Trade Organization. The model for this could be the EC. The Europeans have found that it is not enough just to reduce tariffs and quotas. To create an integrated market, participating countries must have similar legal, regulatory, and social measures. The same is true in the world beyond the EC: Those who want to move toward freer trade must be prepared to yield some sovereignty and accept some homogenization. Also key would be establishing a mechanism to pressure countries that run chronic trade surpluses, as well as to help those running deficits. Keynes actually envisioned such a mechanism in 1947 – a tariff on the goods of countries with chronic surpluses would finance productivity improvements for nations running deficits.

A World Trade Organization might have several levels of membership. Some countries would adhere to all the provisions and trade freely among themselves along the lines of EC '92. Those unwilling to go that far would obtain some benefits but would be subject to different treatment.

An important question no one asks in today's trade debates is whether we want free trade or more trade. In a curious irony, the more GATT adherents have pushed for purity, the less trade they have produced. By taking a new approach, the United States could continue supporting a liberal trade regime while enhancing its economic power and boosting world trade.

Clyde V. Prestowitz, Jr., is founder and president of the Economic Strategy Institute (ESI), a private, nonprofit research center dedicated to defining a new American agenda for an era in which the United States will face unprecedented economic challenges without the benefit of past superiority in industry, technology, and finance. He was formerly senior associate at the Carnegie Endowment and a fellow at the Woodrow Wilson International Center for Scholars, where he wrote his influential book on the U.S.-Japan economic conflict. Trading Places. He has served the United States as Deputy Assistant Sectary of Commerce, Acting Assistant Secretary, and Counselor to the Secretary of Commerce, and has also had an extensive international business career.