Structural Change and Interdependence

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Let me begin this chapter by considering the impact on the rise of protectionism of the macroeconomic difficulties that ensued as the world struggled with dramatically increasing oil prices in the 1970s.

As it happens, the association between high rates of unemployment, excess capacity, recessions in general, and the growth of protectionist pressures—evident to economists since the interwar years—has been confirmed by econometric analysis. Tackacs (1981) analyzed time-series data on the number of safeguards petitions filed by industries seeking import relief in the United States between 1949 and 1979 and found that the pressure for protection, so measured, does indeed increase with adverse macroeconomic conditions. Fewer safeguards cases were initiated the higher the real gross national product, the lower the unemployment rate, and the higher the rate of capacity utilization (Tackacs 1981, p. 689).[1]

1. Cassing et al. (1986) have proposed an interesting theory as to how differences in regional interests in the U.S. can produce a tariff cycle by intensifying protectionist pressures at a cyclical trough. Their argument depends on the greater political weight in the U.S. of the old import-competing regions than of the old export-oriented regions. This creates the following dynamics: "When general economic conditions are poor, the old import-competing regions will join the protectionist coalition, and pres-

Structural Change

The protectionist forces unleashed by the macroeconomic distress of the late 1970s and the recession of the early 1980s were, however, reinforced by structural changes in the world economy.

Among these changes were the emergence of Japan and the newly industrialized countries (NICs) as important competitors in manufactures on the international scene and the decline of the United States in relation to world income and trade. The former created new problems of adjustment for specific industries, and even a general fear of deindustrialization and its mythical, metaphysical, monstrous consequences for one's well-being. The latter change created a psychological trauma in the United States. The resulting "diminished giant" syndrome made it hard for many Americans to accept the successes of the emergent trading nations, and there was a tendency to attribute those successes to unfair trading practices and underhanded, extralegal tactics. The suspicions seemed to justify retaliatory protection, and they brought demands for fix-quantity outcomes from one's trading rivals.

The Double Squeeze

The growth of exports from Japan and the Pacific "Gang of Four" (Singapore, Hong Kong, South Korea, and Taiwan),[2]

sures for tariffs will increase. Although export-oriented old regions will be joining a free-trade coalition at the same time, in a political system where old import-competing regions outweigh old exporting regions, the activation of the old regions on both sides will favor the protectionists. Conversely, during cyclical peaks, when both types of old regions desert their respective coalitions, the protectionist coalition will suffer a relatively greater loss in political strength. It is thus at the peaks that the free traders have their best winning chances." (p. 860)

2. The popular epithet Gang of Four seemed apt when I came up with it in jest, since the extraordinary performance of these Pacific nations put them

and the less spectacular but still impressive export performance of other NICs (such as Brazil) and of Newly Exporting Countries (such as Malaysia and Thailand), has created problems for *specific* industries in the OECD countries, necessitating that they adjust to these changes. (See Hughes and Newberry 1986 for a detailed analysis of the export performance of NECs.)

A country that grows more rapidly than others will, on average, export at a volume and a growth rate that are hard for the other countries to accommodate without complaints from the domestic industries that must bear the brunt of the adjustment. Japan has been up against this phenomenon since the 1930s. Even then, when Japan was not yet dominant, Japanese diplomats were scurrying around negotiating voluntary export restraints on pencils, electric lamps, safety matches, and other products with the United States, the United Kingdom, Australia, and other trading partners—partners among whom a bilateral surplus in trade with Japan was common. The present surplus situation has compounded Japan's difficulties; however, even if her surplus were to disappear, Japan would continue to attract the protectionist ire of disaffected competitors (see Bhagwati 1986b).

This problem of adjustment has been compounded by the simultaneous expansion of exports from the NICs and NECs. The double squeeze, however, constitutes double jeopardy for the pro-trade protagonists. Not only does it augment the pressure on specific industries to adjust, but it also tends to create a bimodal pressure at both ends of the manufacturing spectrum. While the old labor-intensive industries are in combat with the NECs and the NICs, the new high-tech industries are up against Japan and the more ad-

in a separate class among the developing countries. These countries are also known as the Four Tigers.

vanced NICs as well. With both sunset and sunrise industries therefore in apparent peril, the fear has grown, especially in the United States and the United Kingdom, that only the scorching sun will survive for their benefit, with arid "deindustrialization" their destiny!

Thus, in 1982 Walter Mondale complained: "We've been running up the white flag when we should be running up the American flag. . . . What do we want our kids to do? Sweep up around the Japanese computers?"[3] During his unsuccessful presidential campaign of 1984, Mondale invoked images of Americans reduced to flipping hamburgers at McDonalds while the Japanese overwhelmed the country's industries. He might have invoked, with greater irony, a picture of American kids rolling rice cakes at sushi bars.

The fear of deindustrialization has also agitated the leaders of trade unions in declining, protection-seeking industries. Sol Chaikin of the International Garment Workers' Union has protested. "Because there are relatively few well-paying jobs in the service sector, an economy devoid of manufacturing would also necessarily experience a general decline in living standards. . . . Unrestricted trade and the investment practices of the multinationals . . . can only lead to an America ultimately devoid of manufacturing." (1982, p. 848) But his lament pales beside the late Theodore White's exclamation that "the Japanese are on the move again in one of history's most brilliant commercial offensives, as they go about dismantling American industry" (1985, p. 23).

The agitation of specific industries under pressure defines the accentuation of protectionist sectional interests; the fear of deindustrialization compounds it with the protectionist redefinition of "national interest." (The latter phenomenon is widespread and important; the dubious economics of

3. *New York Times*, October 13, 1982, p. A3.

the deindustrialization complex will therefore be examined in chapter 5.)

The "Diminished Giant" Syndrome

For the United States, the problem has been complicated further by the relative decline in the national economy. While it continues to be a dominant power, the United States has witnessed the erosion of its predominant status in the world economy as Japan has risen from the ashes and as other Pacific nations have emerged onto the scene.

The parallel with Britain at the end of the nineteenth century is dramatic. In both instances, the giant's diminution produced a protectionist backlash, sorely trying the pro-trade bias of the international regime.[4] Walter Lippmann characterized this as the American Century. In the same vein, the nineteenth century was Britain's. As the century ended, Britain was gradually losing her political and economic preeminence. The twentieth century is ending similarly for the United States. Linder (1986) has already announced the arrival of the Pacific Century.

The end of the Napoleonic wars and the coming of the Industrial Revolution saw Britain emerge as the unchallenged leader among nations. The end of the Second World War, with the destruction of industrial capacity in Europe and Japan, saw the United States attain a similar position. However, neither country could seriously hope to maintain its status once other countries industrialized or regained their industrial potential. (One difference, of course, is that the United States encouraged and promoted economic recovery in Europe and Japan in the early postwar period, whereas Britain did not actively court the industrialization of Continental Europe and the United States.)

4. Here I again draw extensively on Bhagwati and Irwin 1987.

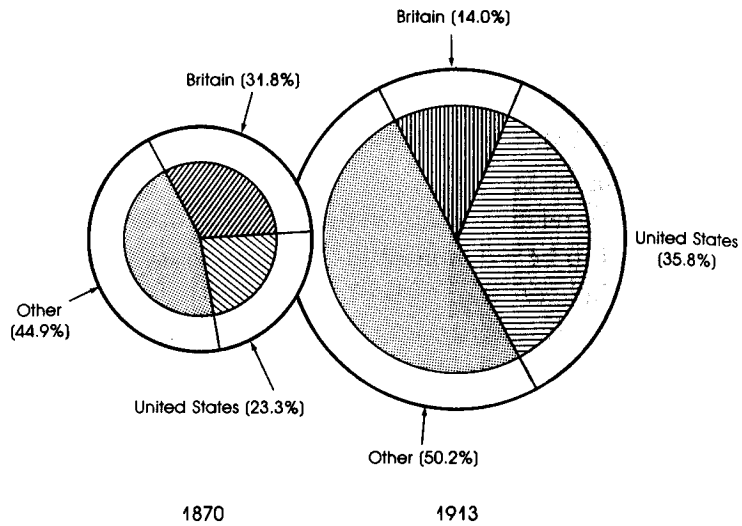


Figure 7 Shares of Britain and the United States in world industrial production, 1870 and 1913. Source: Crouzet 1982.

The inevitable relative declines of Britain and the United States were manifested in decreases in the sizes of their economies in relation to the world economy.

From 1870 to 1913, Britain's share of world industrial production fell from 31.8 percent to 14.0 percent. Over the same period, Germany's share rose somewhat and the United States expanded its share from 23.3 percent to 35.8 percent (figure 7). Similarly, the United States has seen its share of world output decline since the Second World War. In 1950 the United States accounted for 40.3 percent of total world gross domestic product; by 1980 the figure was down to 21.8 percent. Over the same period, Europe's share of the world GDP increased from 21.2 percent to 29.8 percent and Japan's from 1.6 percent to 8.8 percent (figure 8). The developing countries boosted their share from 12.7 percent to 17.9 percent over the same period. (UNCTAD 1983, pp. 446–447)

Both countries saw their shares of world trade decline as

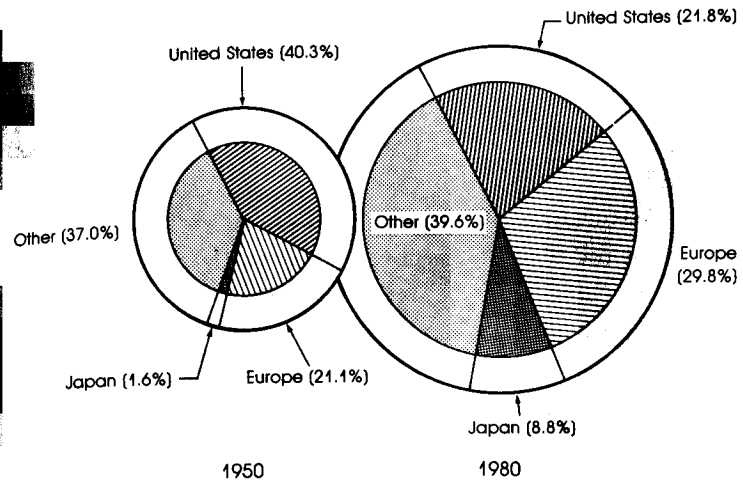


Figure 8 Shares of the United States, Europe, and Japan in world gross domestic product, 1950 and 1980. Source: UNCTAD 1983.

well. From 1880 to 1913, Britain's share of world manufactured exports fell from 41.1 percent to 29.9 percent. Over the same period, the United States expanded its share from 7.8 percent to 12.6 percent and Germany increased its share from 19.3 percent to 26.5 percent. (Saul 1965, p. 12) In 1950, U.S. exports accounted for 16.7 percent of the value of total world exports; by 1980 this share was 10.9 percent. During this period, Europe's share increased from 33.4 percent to 40.4 percent and Japan's from 1.4 percent to 6.4 percent. (UNCTAD 1983, pp. 2, 3, 35)

The diminution in Britain's preeminence in the world economy led to a rise in protectionist sentiments and to demands for an end to Britain's unilateralist embrace of free-trade principles, and the United States has similarly been witnessing protectionist pressures. The present-day movement is aimed pointedly at the newly successful rivals, just as its predecessor was. The United States and Germany were to

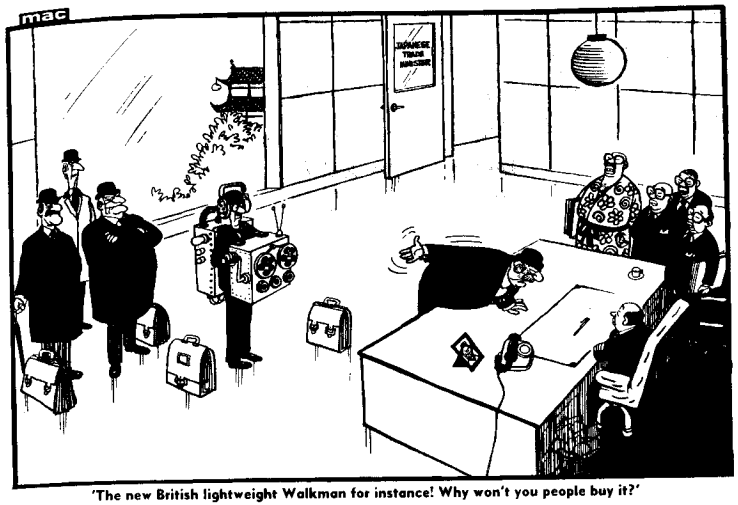
Britain what the Pacific nations—Japan in particular—are to the United States today.[5]

During the 1870s and the 1880s, Britain witnessed the rise of the National Fair Trade League, the National Society for the Defense of British Industry, and the Reciprocity Fair Trade Association. Today the United States witnesses demands for full reciprocity, for "level playing fields," and for "fair trade," all of them predicated on a self-serving "I am more open than thou" presumption against the new economically successful rivals.

Whereas the British fair-traders were trying to reverse a long-standing commitment to unilateral free trade, and fueling protectionist pressures in consequence, the American fair-traders have directed their efforts at a pro-trade executive branch that certainly is not unilateralist in ideology or in policy. The contention that "foreign markets are closed while ours are open" reflected policy and reality in the British episode. It does not for the United States today, where the advocacy of fair trade is more reflective of the psychological mood of a nation losing hegemony in the world economy. This creates the perception that, if markets are getting tighter and Japan is more successful in penetrating them, this is *ipso facto* evidence of inscrutable and asymmetric Japanese barriers to trade.

In truth, Japan's tariffs are among the lowest in the world. However, much anecdotal evidence has been cited in support of the claim that somehow, in an obscure but effective fashion, Japan has been significantly protecting her manufactures and importing less than she should—and indeed, like other nations, Japan does some foolish things that, given the intense scrutiny she has received, it is unwise to be

5. The British reciprocitarians took aim at the "deliberate and deadly rivalry" provoked by Germany and the United States, matching the recent Japanophobic sentiments on trade. See Bhagwati and Irwin 1987, p. 119.



'The new British lightweight Walkman for instance! Why won't you people buy it?'

This Mac cartoon from London's *Daily Mail* ridicules the often exaggerated and unfair allegations by protectionists against foreign rivals' unfair trading practices.

doing. For example, I have been told that the Dutch export tulip bulbs to almost every country except Japan because the Japanese insist on checking them by cutting the stems vertically down the middle, and even Japanese ingenuity cannot put them back together again. But we economists are trained not to go by anecdotal evidence. Aside from the fact that such evidence may be self-serving when the source is an interested exporter, it may simply be misleading, because inference of significant incidence and protectionist impact from anecdotes may be unwarranted.

It is important, therefore, to note that recent econometric studies are divided on the issue of Japanese protectionism. The early work of Saxonhouse (1983) and the sophisticated recent analysis of Noland (1987) conclude strongly that Japan cannot plausibly be said to be importing less than what cross-country evidence would lead us to ex-

pect her to import; Balassa (1986) modifies Saxonhouse's regressions to argue that Japan's imports-to-GNP ratio is low, and Lawrence (1987) (who looks only at intra-industry trade) also finds Japan's imports to be low. Most professional opinion, however, remains skeptical of claims that Japan is unfairly and asymmetrically denying access to its markets in manufactures. Even if Japan's imports are "low," this may be due to cultural factors rather than to underhanded and illegitimate trade practices. Nonetheless, the suspicion lingers; indeed, the belief in Japan's perfidy is often unshakable.

Thus, whereas the above-described "double squeeze" has stoked the protectionist fires directly, the "diminished giant" syndrome has done so indirectly by encouraging the notion that other countries are trading unfairly and that this calls for aggressive trade legislation, tougher and more restrictive interpretations of unfair trade practices, "hardball" international negotiations, and confrontational tactics. This is evident from the trade legislation pending in the U.S. Congress today; it also explains well the capture of the countervailing-duty and anti-dumping mechanisms by protection-seeking interests.

The "diminished giant" syndrome was accentuated by the macroeconomic difficulties, the sluggish growth, and the high unemployment rates of the 1970s. Those years also brought other events that strengthened the anti-trade forces in the United States. The recycling of OPEC funds to South America, hailed at the time as a triumph of U.S. banking and as evidence of the virtues of the marketplace, left the world economy in a debt crisis. This, and the creditor-imposed deflationary bias in debtor countries, resulted in a loss of export markets in Latin America for U.S. manufactures and a deepening of the adjustment imposed on specific sectors.

The rise of the dollar, a consequence of the expansionary

fiscal and deflationary monetary policy mix in the United States and the enormous influx of foreign funds into the United States, also levied a toll. It required, in turn, a squeeze of the traded sector: export and import-competing industries had to contract relative to nontraded sectors in consequence, deepening their distress and fueling demands for protectionism. In essence, the dollar was "overvalued" in the sense that the capital account was driving the current account; the dollar was rising because of capital influx and, in turn, affecting the trade flows.

The last-mentioned problem has now become a *systemic* one (owing to the unprecedented integration of financial markets in the major OECD countries, which creates the potential for significant capital-account-driven changes in exchange rates, with consequent pressures for protection in the countries experiencing "overvaluation"). Indeed, the close integration of financial markets across countries and the sheer volume of funds accentuate the vulnerability of the international system through the consequent volatility of exchange rates, which makes protectionist demands more likely. The choice seems to lie between managed exchange rates and managed trade.

Interdependence

The structural factors I have just sketched have surely contributed to the recent protectionist pressures. There are, however, other factors that are creating interests favorable to freer trade. They arise from the increased globalization and interdependence in the world economy, through trade and direct foreign investment. Their impact has been obscured by the protectionism of the last decade, but their emergence and their promise cannot be doubted.

The Traditional Imbalance of Interests

International economists have long been frustrated by the dissonance between the elegance of their irrefutable demonstration of the advantages of free trade and the inelegance with which practical politics embraces protection. This incongruence did not escape the keen eye of Vilfredo Pareto. In his *Manual of Political Economy* (1927), Pareto sought to explain it within an analytical framework[6] by citing the imbalance of interests that predisposes pluralistic politics toward protection:

Even if it were very clearly demonstrated that protection always entails the destruction of wealth, if that were taught to every citizen just as they learn the abc's, protection would lose so small a number of partisans and free trade would gain so few of them that the effect can be almost, or even completely, disregarded. The motives which lead men to act are quite different. (p. 377)

In order to explain how those who champion protection make themselves heard so easily, it is necessary to add a consideration which applies to social movements generally. The intensity of the work of an individual is not proportionate to the benefits which that work may bring him nor to the harm which it may enable him to avoid. If a certain measure A is the case of the loss of one franc to each of a thousand persons, and of a thousand franc gain to one individual, the latter will expend a great deal of energy, whereas the former will resist weakly; and it is likely that, in the end, the person who is attempting to secure the thousand francs via A will be successful.

A protectionist measure provides large benefits to a small number of people, and causes a very great number of consumers a slight loss. This circumstance makes it easier to put a protection measure into practice. (p. 379)

6. Pareto's analysis foreshadows the seminal work of Mancur Olson (1965).

The general failure of consumers to exercise countervailing power to oppose and offset the interests of producers (whether out of ignorance or because it does not pay any one consumer to incur the cost of lobbying for a policy whose benefits will be spread thinly over many consumers) is not the only ill that afflicts the opponents of protectionism.

One would also hope to see countervailing power exercised by the export interests that would suffer from protection, for, if protection favors the import-competing industries, it simultaneously discourages other industries, among them the export industries. Indeed, there is abundant empirical evidence that protectionist regimes exhibit dismal export performance.[7] But one must make an intellectual effort to see this connection. Indeed, it is not uncommon to find trained economists who fail to grasp the relationship. It is not surprising, therefore, that export interests have not generally been mobilized in opposition to import-competing industries' demands for protection.[8]

Interdependence and Changing Interests

The enormous growth of trade and of direct foreign investment not for host-country markets but for export into home and world markets, has begun to change the situation significantly.

7. See the recent evidence reviewed in Bhagwati 1978 and Krueger 1978. Pareto (1927, p. 381) seems to have been quite determined on this question: ". . . one obtains a practical confirmation of the assertion that protection, in reducing imports, also decreases exports. This phenomenon has been observed in a great number of cases and for many countries."

8. However, a recent statistical analysis of the U.S. House of Representatives' vote on a bill pertaining to "domestic content" in automobiles (McArthur and Marks 1988) suggests that export interests, proxied by the percentage of each state's labor force directly involved in the constituency's production of manufactures for export, increased the probability of a negative vote on this protectionist bill. But this finding almost certainly reflects, rather, the new politics of anti-protectionism arising from global interdependence, which I discuss below.

As I have already remarked, most countries' trade-to-GNP ratios continued to increase even through the sluggish 1970s. For the industrialized countries together, Michaely (1977) has estimated that the import-to-GDP ratio increased from 13.0 percent to 17.0 percent (and, excluding oil, from 11.7 percent to 13.9 percent) between 1973 and 1979. The implied 2.9 percent annual rate of increase in this index of trade interdependence was almost identical to its 2.8 percent annual rate of increase during the more prosperous years between 1960 and 1973. Along with this increase in trade, export markets and interests have diversified and have become more significant.

Moreover, direct foreign investment (DFI) in the developing countries—which at one time was geared to sheltered home markets—has increasingly shifted to multinational corporations, which invest in one market in pursuit of lower costs to export to others. This has resulted in a great deal of international criss-crossing of DFI.

We are also long past the days of one-way DFI of the sort that was alarmingly portrayed in Servan-Schreiber's 1968 book *The American Challenge*. Cross-investments between countries occur with greater frequency today. These cross-investments are not merely DFI by one country in the other country in industries different from those where the latter country undertakes DFI in the former country; often there are intra-industry cross-investments such that multinational corporations in the same industry penetrate each other's home base, and occasionally they even export back to the home market and elsewhere.[9] Joint production ventures and production-cum-marketing arrangements, which are also

9. In 1987, Honda (an early investor in the U.S.) announced a 4-year plan to expand its U.S. production so as to export roughly 50,000 cars back to Japan (*New York Times*, September 18).

increasingly common, result in incestuous cross-country relationships among multinational corporations that are otherwise in competition.

In consequence, we are faced with what might be called a "spider's web" phenomenon—production is globalized through a web of criss-crossing DFIs and lesser relationships. An important aspect of this phenomenon, recently investigated in depth by Lipsey and Kravis (1986) for the United States, is revealing and has important implications for the emergence of pro-trade interests.

Lipsey and Kravis's examination of the worldwide exports of the United States, its multinational corporations, and their majority-owned affiliates abroad for the years 1966 through 1983 reveals two dramatic facts: (1) In 1966 the "offshore" exports by the foreign affiliates were already equal to more than 25 percent of the "mainland" U.S. exports, and by 1983 this ratio had increased to nearly 75 percent. (2) The U.S. parent corporations' "mainland" exports exceeded their affiliates' "offshore" exports by 1977 (figure 9). Evidently, offshore production for global markets has become a predominant reality. But then, this phenomenon has also been observed in the case of Swedish multinationals (Blomström 1986) and in the case of Switzerland (Borner 1986).[10]

This globalization creates an increasingly important, pro-trade interest and voice in the arena where protectionist forces seek to triumph. The pro-trade activity that follows is largely a matter of undertaking prudential opposition to protectionism at home to avoid a possible outbreak of protectionism elsewhere. Such an outbreak, by closing markets everywhere, would imperil the returns to global investments designed for exports to the world's markets. Hence, this interest does not oppose specific acts of sectoral protection;

10. See also Swedenborg 1982 and Borner and Wehrle 1984.

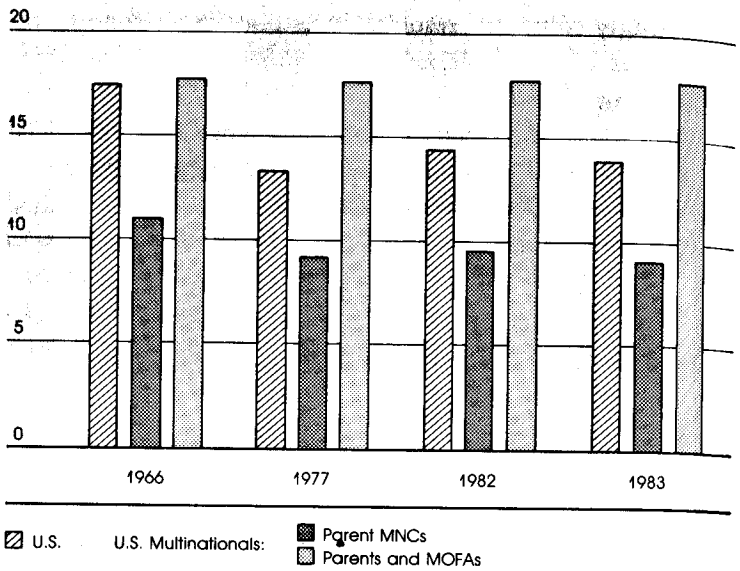


Figure 9 Percentage shares in world exports of the United States and of U.S. multinational corporations (MNCs) and their majority-owned foreign affiliates (MOFAs) for the years 1966–1983. Source: Lipsey and Kravis 1986.

rather, it operates at a high level, mobilizing opinion and lobbying against protectionism more generally. We thus witness the chief executive officers of various multinational corporations taking the high road on deploring protection; and we also find them supportive of liberal "think tanks" and of institutions (such as the Trilateral Commission) which are primarily cosmopolitan and anti-protectionist in their ideological orientation and which help to make the policy ethos favorable to the idea of keeping markets open.

To look for the pro-trade influence of multinational corporations in cases of successful opposition to particular protectionist pressures (e.g., to suggest that the Kennedy Round or the Tokyo Round tariff reductions should be greater

where there is greater DFI in the industry or greater intra-firm international trade between parents and foreign affiliates) is, therefore, to seek evidence of multinationals' influence at too low a level. It is like looking for a ham sandwich at the Lord Mayor's banquet. It is not surprising, therefore, that the attempts of Helleiner (1977) and Lavergne (1983) to do precisely this through regression analysis of U.S. data on tariff reductions in the Kennedy and Tokyo Rounds have produced dismal results.[11]

But the "spider's web" phenomenon does occasionally translate into effective opposition to specific, sectoral protectionism. For example, in 1985, when American semiconductor firms were first getting together to initiate an anti-dumping action against Japanese producers of the memory microchips known as EPROMs (erasable programmable

11. The regression approach to explaining the variations in tariff cuts in the Kennedy Round (and other rounds) by reference to variables such as adjustment costs was pioneered by my MIT student John Cheh (1974). I had been unhappy with attempts by Beatrice Vaccara, Georgio Basevi, and others who had treated existing tariff structures as the dependent variable to be so explained. I felt that the tariff structure was an accretion of many historical influences, and a good R^2 on such exercises was beside the point. However, variations in tariff *cuts* in the Kennedy Round provided an excellent approximation to a controlled experiment in getting at factors that influenced tariffs. I therefore asked Cheh in 1972 to examine the Kennedy Round from this point of view. When his findings suggested that the across-the-board tariff cuts were moderated for industries with labor-adjustment costs, I also interpreted them for him in terms of the government's having a noneconomic objective of moderating short-term labor-adjustment costs, along the lines of the theory of noneconomic objectives such as self-sufficiency, restricting luxury consumption, etc. Corden (1974) has independently formulated a related, and more restrictive, noneconomic objective: that governments seek to preserve the status quo in incomes, preventing a fall in them for any group.

Lavergne's (1983) regression exercises basically build on the approach of Cheh, but in the matter of multinationals and their influence I find this attempt not meaningful (and hence his lack of results unsurprising), for reasons explained in the text.

read-only memories), noticeably absent were Motorola and Texas Instruments, who produced semiconductors in Japan and expected to ship them to the United States (Miller 1985). The recent attempts in the U.S. Congress to punish Toshiba for its sale of sensitive propeller-milling equipment to the Soviet Union by selectively proscribing imports of its products posed great difficulty from the outset, since it was hard to exclude imports of most Toshiba products without hurting articulate domestic consumers, producers, and dealers.[12]

Furthermore, trade and direct foreign investment may drive a sector of a country's economy that is a potential target of protectionism into the anti-protection camp through the creation of "hostages." In this game, a country whose export in a given sector is threatened with barriers threatens retaliatory barriers against a potentially articulate and effective exporter in the offending country.[13] A classic instance of this is China's successful resistance to harshly restrictive quotas in the last Multifibre negotiations. China's threat to reduce

12. Even then, the final choice of the products whose importation would be curtailed prompted fresh opposition from several major American high-technology corporations on the grounds that their own production would be severely handicapped by the proposed bans. (See "Top U.S. Corporations Lobbying Against Curb on Toshiba Imports," *New York Times*, September 14, 1987.) These corporations include AT&T, General Electric, Honeywell, Hewlett-Packard, IBM, Motorola, Rockwell International, and Xerox—some of the biggest in the U.S. Paul Freedenberg, the Assistant Secretary of Commerce, is quoted as saying: "We're talking about major multinationals and consumer electronics companies. There are a whole slew of household names that have a relationship with Toshiba."

13. Although increased linkage creates the possibility of more such hostage-taking, it is not always easy to find industries that are willing to be used in this strategic game. They may reap short-term windfall profits from retaliatory protection imposed on their competing imports, but they tend to react negatively because such protection, being short-term and geared only to retaliation, only disrupts settled market conditions and may invite retaliation and retribution on themselves in turn.

grain imports from the United States galvanized the export-seeking American farm lobby into action.

DFIs and Responses to Import Competition: Increasing Alternatives

Increased trade and the *actual* globalization of the world economy through criss-crossing direct foreign investment are not the only things that create pro-trade interests. The *potentiality* of DFI is another. It undermines protectionism by providing an alternative to protection as a form of adjustment to import competition.

One frequent option for an industry faced with import competition is to shift production to the very location that gives the foreign competitor its cost advantage. This response is likely when the industry is innovative, and simply suffers from the high cost of its domestic location; it is less likely in the case of a senescent, technically stagnant, labor-intensive industry (Bhagwati 1982a, 1986a). Since, however, this is the capitalist response, rather than that of industry-specific labor unions (to which it poses the threat of job losses), the option of undertaking DFI abroad tends to weaken the occasional alliance between these two pressure groups for protectionist lobbying (see Magee 1980).

But organized labor also seems at times to have caught on to this game; it is not averse to using threats of protection to induce DFI from foreign competitors. (For example, the United Auto Workers appear to have helped induce Japanese investments in the American auto industry, although that union sides with protection in domestic politics.) We have here a generic phenomenon whereby DFI is undertaken by Japanese exporting firms to "buy off" the local pressure groups of firms and/or unions who otherwise threaten continued legislative pressures for tariffs to close the import mar-

kets. In the 1980s this type of protectionist-threat-induced, "*quid pro quo*" investment in the United States by Japanese firms appeared to be a growing phenomenon.[14] It represented yet another alternative to old-fashioned tariff-making.

Harnessing Export Interests

Thus, both the reality and the potential of increased trade and foreign investment linkages in the world economy are significant new sources of pro-trade and anti-protection politics.

Another element in the picture has been the embrace and cultivation of export interests by the Reagan administration. This strategy is aimed at countervailing and containing political pressure for protection by encouraging pro-trade interests. But it is also expected to work by deflecting the political agenda from "closing your markets" (i.e., protectionist outcomes) to "opening their markets" (i.e., pro-trade outcomes). This is another case of the ingenuity and quick-footedness of a pro-trade executive branch in coping with the rise of protectionist pressures. But this silver cloud has a black lining: Care will have to be exercised to ensure that the opening-of-markets tactic does not undermine the tenets of GATT's fix-rule, most-favored-nation-centered regime. Let me explain.

14. The term "*quid pro quo* DFI" was introduced in Bhagwati 1985b and Bhagwati 1986a. Japan's Ministry of International Trade and Industry recently completed a survey of Japanese DFI abroad and found that a large fraction of the respondents cited reasons of the *quid pro quo* variety to explain their investment decisions. (I am indebted to Professor Shishido of the International University of Japan for this information.) The subsequent dramatic shift in the yen-dollar exchange rate has made such *quid pro quo* DFI pay off substantial dividends and ushered back into the picture more conventional reasons for Japanese firms to invest in the U.S.

See the theoretical modeling of *quid pro quo* DFI in Bhagwati, Brecher, Dinopoulos, and Srinivasan 1987 and in Bhagwati and Dinopoulos 1986. For recent analyses, see Dinopoulos 1987 and Wong 1987.

There are two fundamental ways in which the co-opting of export interests has figured in U.S. trade policy: first, by multilateral attempts at liberalizing world trade in new sectors, where the United States—once lukewarm about and even opposed to freer trade—now perceives its comparative advantage; second, by bilateral attempts at opening markets in these sectors as well as in the traditional area of manufactures.

The *multilateral* efforts to liberalize trade have been centered primarily on services and on agriculture. The attempt by the United States to bring services into GATT negotiations, and even to incorporate services into GATT formally, began at the November 1982 GATT inter-ministerial meetings and finally succeeded at Punta del Este in the summer of 1986, when the Uruguay Round of trade negotiations was launched.[15] The United States' push for the inclusion of agriculture on the trade agenda is more recent. In both instances, however, the Reagan administration has identified its export interest and has correspondingly cultivated its export lobbies as much as the lobbies have cultivated the administration. Insofar as the vigorous U.S. strategy of opening markets instead of closing them puts these new sectors (which are certainly of enormous actual and potential significance in world trade) on the agenda of freer trade, and insofar as GATT-type principles such as nondiscriminatory MFN treatment for members are the outcome, this strategy has an enormous social benefit: It helps to break down old trade barriers in new sectors while preventing the creation of new trade barriers in old sectors.

15. In view of the strenuous reservations of India, Brazil, and some other developing countries, the compromise solution involved an agreement to conduct the negotiations on services simultaneously with those on goods, but not under GATT formally. See Bhagwati 1987b for an analysis of this procedural matter and its substantive significance.

Unfortunately, this cannot be unambiguously said of the *bilateral* aggressiveness that has also characterized U.S. initiatives to open foreign markets. The capture by protectionists of the countervailing-duty and anti-dumping mechanisms on the import side has its counterpart in the capture of the opening-of-foreign-markets strategy on the export side. Allegations of unfair trade practices afflicting U.S. exports can be made under Section 301 of the U.S. Trade Act, and this section has been used energetically in recent years. The trade legislation now pending before the Congress still has in it silly but dangerous "super-301" provisions aimed at countries in payments surplus and requiring harsh action against these countries.[16]

But such presumptions of unfair trade practices holding up U.S. exports have not merely led to dangerous trade legislation and to an activation of Section 301 cases. They have also contributed to an ethos in which openness of markets and fair access are judged on the basis of "results" rather than by reference to rules. If the desired quantities of exports do not show up, that is taken as sure evidence of inscrutable and unfair protection. In the case of Japan, the complaint usually degenerates further into the question: How much is the United States—not the world—managing to export to Japan in specific sectors?

The actual outcome in this unfair-trade atmosphere, with its bilateral quantity-oriented bias, is likely to degenerate into a replacement of voluntary export restraints on one's imports by what I call "voluntary import expansions" (VIEs)

16. The latest versions are milder than the early Gephardt version, which would have set up a schedule of retaliatory tariffs until the surplus disappeared (as if tariffs could do that). Again, these new versions appear superficially more reasonable in providing retribution only to the extent that the surplus is due to unfair trade practices (as if such a calculation can be meaningful).

of one's exports.[17] Both are departures from the principles of an open trading system, according to which rules matter and quantity outcomes do not. Whereas VERs restrict imports of specific goods from specific countries by getting those countries to adopt export quotas and restraints, VIEs require imports of specific goods by specific countries by all possible means. VERs reflect import-protectionism; VIEs constitute export-protectionism.

There is evidence that those who make U.S. trade policy sometimes fall into the VIE trap, under intense pressure from fair-traders and their allies in the export sectors. In the recent case involving semiconductor chips, the United States had reportedly wished to include in the pact with Japan an assurance that 20 percent of the Japanese market would be supplied by U.S. producers by a target date. Although the formal agreement reportedly did not stipulate this, the informal understanding remained that this figure would provide a way of measuring Japan's fulfillment of its commitment to open its market.[18] The failure of American producers to sell a sufficient amount of chips in Japan despite the pact was a major reason cited in the enactment by the United States of punitive measures against a wide variety of Japanese electronic products in April 1987.

Similarly, the pressure by the United States for the opening of Japan's beef market was aimed at increasing the imports of U.S. beef through larger Japanese quotas, rather than at liberalizing the Japanese import regime (the most likely consequence of which is that Australia would have outcom-

17. See Bhagwati 1987a, Bhagwati and Irwin 1987, and Box 8.6 of *World Development Report* 1987.

18. The formal agreement was concluded *ad referendum* in July 1986, with Japan agreeing to provide "fair and equitable access to its domestic market for foreign semiconductor products." It was formally signed on September 3, 1986.

peted both Japan and the United States). And a 1985 White House press release on the Section 301 case against Japan in regard to quotas on leather and leather footwear states that "Japan has responded to the GATT panel decision by offering to replace the leather quota with tariffs, but the United States has rejected that offer because it would not improve access to the Japanese leather market, and in fact could even further reduce [the U.S.'s] negligible share of the market," thus suggesting that the United States might lose to more competitive suppliers if market access were to be provided through the replacement of a quota with a nondiscriminatory tariff.

Further evidence of such bilateral, trade-diversionary, fix-quantity outcomes replacing genuine opening of foreign markets is found in South Korea's response to bilateral U.S. pressure. Cho (1987) has shown that the final settlement of the Section 301 case regarding South Korea's insurance market did not ease general entry by foreign insurance companies but rather amounted to granting a larger share of the domestic market to two U.S. companies. And when South Korea announced a plan to cut its trade surplus with the United States, there were disturbing reports of trade diversion rather than trade creation from Seoul. The *Financial Times* noted: "South Korea plans to switch almost all its imports of agricultural products, worth $719 million, over the first three-quarters of the year, to the US. Wheat, corn, soybeans and cotton imports formerly bought from countries such as Argentina and China would add about $200 million to the US import bill, officials believe. Imports of parts and raw materials worth about $250 million for the electronics, shipbuilding and steel industries are to be switched from other markets, such as Japan, to the US." (April 27, 1987)

This degeneration of the "harness export interests" approach into fix-quantity, trade-diverting solutions needs to be carefully watched and strenuously resisted. I am somewhat optimistic that the mere act of recognizing it will help trigger a corrective response. In these matters, we can count on assistance from what I call the Dracula Effect: exposing evil to sunlight helps to destroy it. Again, while economists tend to focus on learning by doing, there is also learning before undoing. And those who make U.S. trade policy have shown some resilience and alertness in drawing back from such extreme foolishnesses as the original Gephardt amendment, under which countries running trade surpluses with the United States would have been required to reduce their surpluses on a time schedule or face automatic retaliation. Furthermore, as the United States trade deficit responds to corrective adjustments of the exchange rate, to the prospective reduction of the U.S. budget deficit, and to an expansion of spending by Japan, the exaggerated recent sense that the United States is besieged by unfair foreign traders and the consequent "more open than thou" attitudes that fuel ill-considered bilateral fix-quantity export initiatives should wane.

But if panic is not warranted, neither is complacency. The latest trade bill, in both its Senate version and its House version, still carries evidence of wrongheaded bilateral approaches to the opening of foreign markets. Further purging of these *de facto* protectionist provisions is necessary.

Moreover, there are yet other disturbing signs of a weakened U.S. commitment to most-favored-nation-based multilateralism that may be harder to remedy. One may be of particular significance. I have already remarked the recent reversal of the U.S. position on the use of Article XXIV. Political considerations certainly motivated the agreement with Israel; Destler (1986) notes that the bill had 163 sponsors in the House of Representatives.[19] Political objectives also

19. I recommend Snape's (1987) analysis of trends toward bilateralism in recent U.S. trade policy.

underlie, though to a lesser extent, the recently concluded negotiations for a U.S.-Canada free-trade area. But, as recent writings of Representative Jack Kemp and Senator Phil Gramm only underline, part of the motivation here is certainly the desire to deflect protectionist pressures by pedaling rapidly on any pro-trade bicycle, by chalking up trade-expanding victories that take the political momentum away from the protectionists, and by harnessing directly the export interests of those who would find preferentially protected markets in the countries that would join free-trade areas.[20] The regrettable surrender of the United States on this important front must be ascribed to a short-sighted application of the strategy of harnessing export interests.[21]

I shall turn later to an analysis of the need for improved institutions and for responses to protectionist pressures, and of the need to exploit the opportunity to strengthen the pro-trade forces that are being released by interdependence. Here it should suffice to stress that these new forces are indeed significant. They are also likely to strengthen over time with increased integration and interdependence in the world economy. They give us cause for joy if we are for trade, and for sorrow if we are not.

20. As the U.S. Trade Representative, Ambassador William Brock was reportedly exploring free-trade-area arrangements with any politically agreeable country that might come on board. Such arrangements were allegedly offered to Egypt as well as Israel and discussed with members of the Association of South East Asian Nations.

21. The standard defense of such preferential treatments as the U.S.-Israel and U.S.-Canada free-trade areas—that they leave open the possibility that other nations will join in—does not give enough weight to the strength of trade lobbies, who would object to the entry of new members. The U.S. Congress has not seriously addressed this matter, nor has it systematically analyzed the related matter of the trade-diverting effects of these arrangements.

Ideology: Example and Ideas

5

I ended chapter 4 on an optimistic note, arguing that new pro-trade interests had been created by the increasing interdependence of the world economy and that they should endure and grow. But, as I demonstrated for the remarkable episode of postwar trade liberalization, interests do not work in isolation. I should like to argue now that ideology, in the sense of both example and ideas, also provides grounds for optimism on the part of those who favor freer trade. Once again, in the realms of both example and ideas, there are both pro-protection and pro-trade arguments. However, the pro-trade proponents seem to have the better of it. I will elaborate.

Example

Postwar Trade Liberalization

Whereas the post–World War II trade liberalization was driven by the pro-trade bias generated by the negative example of the Smoot-Hawley tariff, today's pro-trade bias can be traced to the positive example of the successful postwar liberalization. And the perception that postwar prosperity was fueled (if not led) by the freeing of trade has greatly