CHAPTER FIVE

The Politics of International Trade

TRADE IS the oldest and most important economic nexus among nations. Indeed, trade along with war has been central to the evolution of international relations. The modern interdependent world market economy makes international trade still more important, and developments in the 1980s have had a profound effect on the nature of the international political economy.

The Importance of Trade

For centuries the taxation of trade was one of the most important sources of wealth for political elites and for imperial powers. Many empires developed at trade crossroads and fought to control the trade routes of Asia, Africa, and the Middle East. Brooks Adams in *The Law of Civilization and Decay* (1895) considered shifts in trade routes and their control to be the key to human history.

In the late twentieth century economic growth, which permits domestic sources of revenue to displace tariff revenues in the financing of government, has diminished the revenue effects of trade; yet its taxation remains a major source of revenue for the political elite and the official bureaucracy of many less developed countries. Because the overdeveloped bureaucracies in many societies have an inadequate domestic tax base and because it is much easier to place the direct taxation burden on outsiders, these countries tend to have unusually high tariff rates; this increases the cost of imported goods and thus discourages economic advance (Little, Scitovsky, and Scott, 1970).

Trade has expanded in every epoch because societies have sought goods not readily available at home, and this expansion has produced many related results: (1) technological diffusion, which contributes to the economic welfare of all peoples, (2) a demand or Keynesian effect on the economy that, through the operation of the "multiplier," stimulates economic growth and the overall efficiency of the economy, (3) benefits for individual firms as trade increases the size of the market, promotes economies of scale and increases the return on investment while also stimulating the overall level of economic activity in the economy as a whole, (4) increased range of consumer choice, and (5) reduction in the costs of inputs such as raw materials and manufactured components, which then lowers the overall cost of production. Moreover, in the late twentieth century, export-led growth has itself become a major strategy used to acquire needed imports and promote economic growth. Although these many benefits of trade are most relevant to market-type economies, they can also apply to every kind of domestic economy.

Trade has another and more controversial effect, and that is its cultural effect, its impact on the values, ideas, and behavior of a society (McNeill, 1954). Liberals have generally considered this impact to be positive, since they believe contact among societies leads to the diffusion of new ideas and technological advances and that trade stimulates social progress. Economic nationalists, on the other hand, frequently regard trade negatively, believing it to be destructive of traditional values and also corrupting in its encouragement of materialism and the pursuit of luxury goods considered harmful to individuals and society. Many critics see international trade as a form of cultural imperialism that must be strictly controlled.

The effect of trade on international politics is another subject of intense controversy. Liberals consider trade a force for peace because they believe that economic interdependence creates positive bonds among peoples and promotes a harmony of interest among societies; further, it gives states a stake in the preservation of the status quo. Economic nationalists and contemporary Marxists, on the other hand, regard trade as pernicious, since economic specialization and interdependence make states insecure, dependent, and vulnerable to external developments. Trade is therefore viewed as a source of political tensions and economic leverage and as an instrument that removes from a society the ability to govern its own affairs.

Two very different theories of international trade underlie these controversies. One is found in the liberal tradition; this is orthodox trade theory, which can be traced from Adam Smith and David Ricardo to its contemporary embodiment in the Heckscher-Ohlin-Samuelson model and other neoclassical formulations. The second theory is the nationalist tradition identified with the mercantilist writers of the early modern period, the German Historical School of the late nineteenth century, and economic nationalists of the late twentieth century. These two positions differ fundamentally on the purposes, causes, and consequences of international trade.

The Liberal Theory of International Trade

Although liberal theory has changed in form and content from the simple ideas of Adam Smith to the sophisticated mathematical formulations of the present day, it rests ultimately upon the belief that economic specialization produces gains in productive efficiency and national income. Liberal theory also believes that trade enlarges consumption possibilities. International trade thus has beneficial effects on both the demand and the supply sides of the economy.

Adam Smith argued in the *Wealth of Nations* in 1776 that the key to national wealth and power was economic growth. Economic growth, he reasoned, is primarily a function of the division of labor, which is in turn dependent upon the scale of the market. Therefore, when a mercantilist state erects barriers against the exchange of goods and the enlargement of markets, it restricts domestic welfare and economic growth. Smith asserted that trade should be free and nations should specialize in what they could do best so that they could become wealthy and powerful. The advantages of a territorial division of labor based on *absolute* advantage formed the foundation of Smith's theory of trade (Ellsworth, 1964, pp. 60-61).

In his *Principles of Political Economy and Taxation* (1817), Ricardo provided the first "scientific" demonstration that international trade is mutually beneficial. His law of *comparative* advantage or cost provided a new basis for liberal trade theory and also a cornerstone for the whole edifice of liberal economics. Although his theory has been modified to take into account many complications that he did not foresee, Ricardo's law of comparative advantage continues to be one of the fundamental principles of liberal international economics along with modernized versions of David Hume's price-specie flow theory and John Stuart Mill's law of reciprocal demand.

Building on Smith's pioneering ideas, Ricardo established the law of comparative advantage as the fundamental rationale for free trade. Smith had assumed that international trade was based on an absolute advantage, that is, on an exporter with a given amount of resources being able to produce a greater output at less cost than any competitor. Such absolute advantage had, in fact, historically been the basis of international trade, and this is still the case in many commodities (El-Agraa, 1983, ch. 6). Unfortunately, if nature had been so parsimonious that a nation possessed no absolute advantages, according to this theory its trading prospects were inauspicious, to say the least. The Industrial Revolution and the growth of industry changed this situation, and it was Ricardo's genius to recognize the profundity of the transformation.

In his law of comparative advantage he demonstrated that the flow of trade among countries is determined by the relative (not absolute) costs of the goods produced. The international division of labor is based on comparative costs, and countries will tend to specialize in those commodities whose costs are comparatively lowest. Even though a nation may have an absolute advantage over others in the production of every good, specialization in those goods with the lowest comparative costs, while leaving the production of other commodities to other countries, enables all countries to gain more from exchange. This simple notion of the universal benefits of specialization based on comparative costs remains the linchpin of liberal trade theory.

No one has stated the liberal faith in the material and civilizing benefits of unfettered commerce better than Ricardo himself:

> Under a system of perfectly free commerce, each country naturally devotes its capital and labour to such employments as are most beneficial to each. This pursuit of individual advantage is admirably connected with the universal good of the whole. By stimulating industry, by rewarding ingenuity, and by using most efficaciously the peculiar powers bestowed by nature, it distributes labour most effectively and most economically: while, by increasing the general mass of productions, it diffuses general benefit, and binds together, by one common tie of interest and intercourse, the universal society of nations throughout the civilized world. It is this principle which determines that wine shall be made in France and Portugal, that corn shall be grown in America and Poland, and that hardware and other goods shall be manufactured in England" (Ricardo, 1871 [1817], pp. 75-76).

While working out and demonstrating this law, Ricardo used his famous example of Portuguese wine and English cloth. Portugal, he reasoned, could produce both wine and cloth more cheaply than England. However, since Portugal had a comparative advantage in the production of wine because its soil and climate enabled it to produce wine even more cheaply and efficiently than cotton, it would gain more by specializing in the production of wine and importing cloth from England than by producing both. England would gain by specializing in cloth and importing wine. This idea of the "gains from trade" was truly revolutionary. Paul Samuelson has called the law of comparative advantage "the most beautiful idea in economics." Ricardo conceived of international trade not as a zero-sum game, but as based on a harmony of interest founded on specialization and comparative advantage; this harmony of interest doctrine underlies the liberal view of international economic relations.

The classical theory of trade as expounded by Ricardo, John Stuart Mill, and others was based on a number of important assumptions or abstractions from reality. It omitted the cost of transportation and assumed that the factors of production were mobile domestically but immobile internationally. Comparative advantage was static, a gift of nature, and could not be transferred from one country to another. The theory was also based on the labor theory of value, that is, the belief that the amount and efficiency of labor-input is the principal determinant of the cost of production. In addition, the law of comparative advantage was based on a two-country model.

Subsequent criticisms and refinements in the late nineteenth and twentieth centuries modified classical trade theory in a number of important ways (Condliffe, 1950, pp. 173-78). Neoclassical writers have added the cost of transportation, assumed greater mobility of the factors of production among countries, and stressed the importance of increasing returns to scale as an explanation of trade. Attention has also been given to the dynamic nature of comparative advantage, and the theory has been elaborated by mathematical techniques and statistical data. Factors other than labor have been added to the cost of production, leading to the concept of relative-factor endowment as an explanation of trade flows. The concept of labor itself has been modified to "human capital" and cost has been redefined as "opportunity cost." The central ideas of neoclassical economics—marginal utility theories and general equilibrium theory—were added to explain the terms of trade and other matters.

This neoclassical reformulation has become known as the Heckscher-Ohlin-Samuelson (H-O) theory or model of international trade and is the standard liberal position in the 1980s. The theory maintains that a nation's comparative advantage is determined by the relative abundance and most profitable combination of its several factors of production, such as capital, labor, resources, management, and technology. More specifically, "a country will export (import) those commodities which are intensive in the use of its abundant (scarce) factor" (El-Agraa, 1983, p. 77). Modern trade theory has thus become more fluid, dynamic, and comprehensive than the classical theory of comparative advantage.

The H-O model continues to be the most relevant theory for explaining interindustry trade, for example, the exchange of manufactured goods for commodities. It is therefore appropriate in accounting for much of North-South trade, but it is less successful with respect to trade among the industrialized countries themselves. This type of trade has necessitated a number of crucial modifications in neoclassical theory and the formulation of other explanations (Krugman, 1981a). Whereas the H-O model emphasizes factor endowments and perfect competition, newer theories such as the "technology gap" theory and the product cycle theory emphasize technology, economies of scale, and the dynamic nature of comparative advantage (Deardorff, 1984, pp. 493-99). Although no detailed treatment of these newer theories will be attempted here, several theoretical developments and their significance need to be discussed.

Perhaps the most important recent development in trade theory is the effort to account for the rapid expansion in the postwar era of intra-industry trade, for example, advanced countries importing some models of automobiles while exporting different models.[1] These theories, which apply primarily to North-North trade, emphasize the importance of learning curves, economies of scale, and differentiated consumer preferences. They also stress the increased importance of monopolistic or imperfect competition, the application of the theories of the firm and industrial organization to trading relations, and the increasing integration of international trade and foreign investment.

A further and closely related development is the expansion of intra-firm and interfirm trade, which is trade that takes place entirely within the confines of a single multinational corporation or among several firms cooperating through mechanisms like joint ventures or the subcontracting of component parts. The theories recognizing these developments respond to the international spread of oligopolistic corporations and the internationalization of production in recent decades. They attempt to explain the strategies of multinational corporations, such as the mix of trade and overseas production or the locus of global production.

A far more controversial recent development is the concept of strategic trade policy. The basic argument of this theory is that in a highly interdependent world economy composed of oligopolistic corporations and competitive states, it is possible, at least theoretically, for the latter to initiate policies that shift profits from foreign to national corporations. Insofar as this theory has merit, it entails a significant rapprochement between the liberal and nationalist theories of trade. The significance of this and other theories as well as the emergent trading patterns that they are attempting to explain will be discussed later in this chapter and also in Chapter Six.

The essence of these novel theories is, in the words of Paul Krugman, "that trade theory is the study of international industrial organization" (Krugman, 1981a, p. 22). Its core is the increasing importance in international trade and foreign investment of oligopolistic corporations that can take advantage of increasing returns, learning by doing, and barriers to entry against rivals. As will be noted below in the discussion of strategic trade policy, a similar development took place earlier in this century *within* national economies. The current integration of global

[1] Linder (1961) is the classic work on this subject.

markets and international production, however, is taking place in a world divided among competing nation-states. The crucial difference in this increasingly interdependent world economy is that individual corporations can gain competitive superiority over foreign firms because of the demand generated by a large domestic market, because of government subsidies, especially in research and development, and by means of protectionist policies. It is precisely this new combination of international interdependence and national firms that opens up the possibility that states may pursue strategic trade policies on behalf of their own multinational corporations.

The contrast between traditional trade theory and these newer approaches is striking. Whereas the emphasis of trade theory from Ricardo to Heckscher-Ohlin was on interindustry trade, these recent theories focus on intra-industry, intrafirm, and interfirm trade. The classical and neoclassical theories assumed that labor and capital were immobile, comparative advantage was static, and only finished products were exchanged. These newer theories, on the other hand, attempt to account for a world in which capital is highly mobile and products are exchanged at every step of the production process, from technological knowledge to intermediate goods and component parts to the final product itself. Of equal importance, in contrast to the older theories, which neglected foreign direct investment and production abroad, the newer theories regard export trade and foreign production as complementary aspects of the strategies of multinational corporations. Finally, the epitome of traditional theory was the view of the economist Frank Graham that trade is between firms regardless of their location. More recent approaches attempt to incorporate the fact that trading relations are between firms of different nationalities and take place in a world where the modern state plays a much more active role than in the past.

This industrial organization approach to international trade helps explain three basic facts of international trade in the postwar era.[2] First, it accounts for the fact that most trade has been among advanced countries with similar industrial structures. More than 60 percent of their trade is among themselves. Second, it explains why this trade has tended to be intra-industry trade, that is, exchanges of similar products, and also accounts for the overseas expansion of multinational firms in particular sectors such as automobiles, consumer durables, and machine tools. Third, it explains why intra-industry trade has moder-

[2] Krugman (1981a) presents a brief and excellent summary of these developments in trade theory.

ated the distributional and conflictual aspects of trade. In contrast to the implications of conventional trade theory, the survival of whole industrial sectors has not been threatened by the increase in intra-industry trade; instead firms have shifted to specialization in particular products, thus minimizing the effects of trade on their workers.

The industrial rise of Japan and the newly industrializing countries (NICs), however, appears to be changing this situation by displacing intra-industry trade with interindustry trade. For example, the rapid advance of Asian industry has threatened whole sectors of the American electronics industry, whereas in the past, Japanese competition damaged only consumer electronics. This shift is causing intense distributional concerns in many advanced countries and is stimulating the spread of protectionist policies.[3]

Underlying this last development is an important change in the status of the concept of comparative advantage. At least in its simpler formulations, this fundamental principle of liberal trade theory has lost some of its relevance and predictive power (Corden, 1984a). Its explanation of trade patterns, based on the intensity and abundance of the factors of production, is of declining relevance to a world of intra-industry trade and rapid technological diffusion. Comparative advantage is now regarded as dynamic and is also considered to be arbitrary and a product of corporate and state policies. As the concept of comparative advantage has lost status, the argument for free trade has necessarily lost some of its efficacy and has become less relevant. This more equivocal situation has been summarized by one authority, Harry Johnson, in the following qualified defense of free trade:

> 'the case for free trade, frequently asserted with considerable dogmatism in the past, appears in contemporary international trade theory as an extremely qualified proposition, dependent on the maintenance of international monetary stability, on efficient representation of alternative social opportunity costs by money costs and prices in the domestic currency, on the social acceptability of the resulting distribution of income or the adoption of a social policy with regard to income distribution, and on the possible need for international income transfers' (quoted in Cooper, 1970, pp. 438-39).

The varying patterns of trade in the contemporary world and the proliferation of theories explaining them leads to the conclusion "that no single theory is capable of explaining international trade in *all* commodities and at *all* times" (El-Agraa, 1983, p. 85). In effect, the general and unified body of trade theory has been displaced by a number of spe-

[3] See the discussion below of the Stolper-Samuelson theorem and its implications for the rise of economic protectionism.

cific explanations for different types of trading relations. Even the H-O model, which comes closest to a unified theory, is most relevant to North-South trade. Regardless of theoretical differences, however, liberal economists maintain their basic commitment to the mutual benefits of free trade, to specialization based upon comparative advantage, and to the virtues of a global territorial division of labor (Condliffe, 1950, pp. 160-61). From the classical theorists to the present, liberals subscribe to the doctrine of free trade.

Nevertheless, liberals have become more cautious about prescribing free trade as the best policy for everyone at all times; they acknowledge that under certain circumstances free trade may actually be harmful. They also recognize that large economies and monopolists can exploit their positions through the adoption of optimum tariffs (Corden, 1984a, pp. 82-86). States may also improve their terms of trade through the use of "effective tariffs," that is, the manipulation of their tariff schedules on raw materials and finished goods (Scammell, 1983, pp. 166-68). Despite these and other caveats, however, liberal theorists believe emphatically that individual and international welfare is maximized by economic specialization and free trade.[4]

It is important to stress what liberal trade theory does *not* assert. Liberals do not argue that everyone will necessarily gain from free trade, at least not in the short run and not without adapting appropriate policies. Rather it asserts that there are potential gains. World welfare would be increased and everyone would gain in the long run if they pursue a policy of specialization based on comparative advantage. Furthermore, liberal trade theory does not argue that everyone will gain equally even if they do follow the proper policies. Instead, it maintains that everyone will gain in absolute terms, although some will gain relatively more than others due to their greater efficiency and natural endowments. The argument for free trade is based not on grounds of equity and equal distribution but on increased efficiency and the maximization of world wealth. It is regarding precisely these distributive matters, however, that nationalist theory takes issue with the liberal approach.

Liberals consider free trade to be the best policy because specialization and the international division of labor increase individual productivity and hence the accumulation of both national and global wealth; in addition, it increases consumption possibilities. They believe that the

[4] Actually, the possibility of adopting optimal tariffs and the terms of trade appear to be of little relevance for the determination of commercial policy, but domestic concern overthe unemployment level is crucial (Beenstock, 1983, p. 224).

only purpose of exports is to pay for imports. (On the many benefits of trade, see Blackhurst, Marian, and Tumlir, 1977, pp. 25-29.) If economic distortions prevent trade or mean that imports would inflict unnecessary damage on a society, the liberal's "first-best" solution is to eliminate the distortions rather than to impose restraints on trade. If this is impossible, then the next best solution is the corrective use of subsidies and taxes (Corden, 1974). After that come tariffs, because they at least preserve the price mechanism. If nontariff barriers are necessary they should be transparent and clearly acknowledged. Despite these admonitions, as this century draws to a close, nations are unfortunately failing to heed this order of preferred policy choices and the nationalist approach to trading relations has gained ground.

The Nationalist Theory of International Trade

Economic nationalists emphasize the costs of trade to particular groups and states and favor economic protectionism and state control over international trade. Their criticisms of liberal trade theory may be summarized in three broad categories: (1) the implications of free trade for economic development and the international division of labor, (2) relative rather than absolute gains (the distributive effects of trade), and (3) the effect on national autonomy and impact on domestic welfare (Blackhurst, Marion, and Tumlir, pp. 29-42).

Although the roots of economic nationalism can be found in the mercantilist writers of the seventeenth and eighteenth centuries, Alexander Hamilton's *Report on the Subject of Manufactures*, presented to the U.S. House of Representatives in 1791, contains the intellectual origins of modern economic nationalism and the classic defense of economic protectionism (Hamilton, 1928 [1791]). Hamilton modernized the eighteenth-century mercantilist thesis and developed a dynamic theory of economic development based on the superiority of manufacturing over agriculture. He set forth what we today would call an "import-substitution" strategy of economic development: "Not only the wealth, but the independence and security of a country, appear to be materially connected with the prosperity of manufactures. Every nation, with a view of these great objects, ought to endeavor to possess within itself, all the essentials of national supply. These comprise the means of subsistence, habitation, clothing, and defense" (ibid., p. 284). From Hamilton on, nationalists have argued that the location of economic activities should be a central concern of state policy.

As the economic theorist of the first colony to revolt against a European imperial system, Hamilton's ideas are worth considering in some detail. According to Hamilton and subsequent proponents of economic nationalism, governments can transform the nature of their economies and thus their position in the international economy through what are now called "industrial policies." The transfer of the factors of production from more advanced economies can be encouraged to develop particular industries. Hamilton argued, for example, that the migration, especially of skilled labor, should be encouraged to expedite industrialization. The nation should also encourage the importation of foreign capital and should establish a banking system to provide investment capital. In short, Hamilton's *Report* set forth a dynamic theory of comparative advantage based on government policies of economic development.

Like other mercantilists before him, Hamilton identified national power with the development of manufactures and regarded economics as subordinate to the fundamental task of state building. Although his ideas on protectionism were not to achieve full force in America until the victory of the rapidly industrializing North in the Civil War, they exerted a powerful influence at home and abroad. Developing nations that emphasize protectionism, industrialization, and state intervention owe more than they may appreciate to Hamilton's conception of economic development.

In the nineteenth century Hamilton's ideas had their greatest impact in Germany, where the intellectual ground had already been prepared by Johann Fichte and Georg Hegel. Friedrich List, after a number of years in the United States, carried Hamilton's views to Germany. With Wilhelm Roscher, Gustav Schmoller, and others, List helped establish the German Historical School of economic analysis, whose ideas found ready acceptance in a Germany whose traditional industries were under attack by a flood of low-cost British imports. This school's fierce and systematic attack on liberalism had a powerful influence on the development of Germany and on the world economy generally.

In his influential *National System of Political Economy* (1904 [1841]), List argued that the free trade theories of the classical British economists were the economic policy of the strong, that there was no "natural" or immutable international division of labor based on the law of comparative advantage, and that the division of labor was merely a historical situation resulting from prior uses of economic and political power. The British, List argued, had actually used the power of the state to protect their own infant industries against foreign competition while weakening their opponents by military force, and they only became champions of free trade after having achieved technological and industrial supremacy over their rivals (Condliffe, 1950, p. 71).

List believed that the British were merely seeking to advance their own national economic interests by gaining unimpeded access to foreign markets through free trade. He regarded British promotion of what is now called an "interdependent world economy" as another expression of Britain's selfish national interests and believed that a true cosmopolitan world economy as espoused by economic liberals would be possible only when other nations became equal to Great Britain in industrial power. List and other German economic nationalists advocated political unification, development of railroads to unify the economy physically, and erection of high tariff barriers to foster economic unification, protect the development of German industry, and thus create a powerful German state.

Many believed that the success of protectionism in Germany and the role of the state in German industrial development vindicated the theories of economic nationalism. As Thorstein Veblen argued in his classic study, *Imperial Germany and the Industrial Revolution*(1939), Germany was the first society to pursue a systematic industrial policy and the scientific development of its economy. The rapid advance of German wealth and military power in the latter part of the nineteenth century set an example for other societies. Whereas the economic success of Great Britain initially seemed to establish the virtues of liberalism, that of Germany legitimized the doctrine of economic nationalism as a guide to trade policy and economic development.

Proponents of economic nationalism at the end of the twentieth century again challenge the liberal assumption that comparative advantage is relatively static. They argue that the law of comparative advantage is primarily a rationalization for the existing international division of labor and advocate a trade policy that encourages the development or preservation of domestic industry. On the one hand, nationalist emphasis on industrialization has, in the less developed economies, focused on the adoption of an "import-substitution" development strategy. On the other hand, a number of advanced countries, responding to the stunning success of the Japanese economy in the 1970s and 1980s, have adopted industrial policies designed to develop specific industrial sectors. These nationalist tendencies will be evaluated below.

Whereas economic liberals emphasize the absolute gains in global wealth from a regime of free trade, economic nationalists of the nineteenth century and their twentieth-century descendants stress the international distribution of the gains from trade. Nationalists note that in a world of free trade the terms of trade tend to favor the most industrially advanced economy. The German Historical School asserted that the British pursued protectionist policies until British industry was strong enough to outcompete every other economy and that British technical superiority in manufactured products and processes enabled Great Britain to enjoy highly favorable terms of trade relative to the exporters of lower-technology products, food, and raw materials.

Economic nationalists also believe that free trade undermines national autonomy and state control over the economy by exposing the economy to the vicissitudes and instabilities of the world market and exploitation by other, more powerful economies. They argue that specialization, especially in commodity exports, reduces flexibility, increases the vulnerability of the economy to untoward events, subordinates the domestic economy to the international economy, and threatens domestic industries on which national security, established jobs, or other values are dependent. Although these arguments are frequently used to cloak the special interests of particular groups and industries, they are important in the formulation of national economic policy in all countries.

The economic nationalists of the German Historical School called attention to the ways in which the rise of a highly interdependent world economy affected national security, while nineteenth-century liberals were accurately arguing that the world had never before enjoyed a comparable era of peace and prosperity. The expansion of trade, the flow of foreign investment, and the efficiency of the international monetary system ushered in a period of economic growth that spread from England throughout the system. Perhaps never before or since has the cosmopolitan interest been so well joined to the national interest of the dominant power as under the Pax Britannica. But although all may indeed have gained, some did gain more than others, as the nationalists emphasized. The expansion of global economic interdependence created new forms of national insecurity and novel arenas of international conflict along with economic growth.

FREE TRADE VERSUS ECONOMIC PROTECTIONISM

Numerous controversies between liberal proponents of free trade and their nationalist critics have emerged with the intensification of international trade and interdependence since the 1850s. The issues are concerned with the effects of international trade on domestic welfare and industrial development, the economic and political effects of increasing interdependence, and the role of government policies and corporate power in the distribution of benefits as well as other crucial questions. Unfortunately, relatively little research has been done on many of these issues and there are serious problems in testing trade theories. As one authority put it, there is much room for disagreement over trade and its effects because most propositions have never been tested (Dixit, 1983, p. 80). Indeed, the issues may never be resolved because the assumptions and objectives of the two positions are so different.

The issue of free trade versus protectionism lies at the heart of the conflict between economic liberals and economic nationalists. This debate historically has appeared in differing forms: the "infant" industry argument for protection, the debate over the benefits and costs of international specialization, and (for lack of a better term) the "senile" or perhaps the "second infancy" industry problem (Dixit, 1986, p. 5). These three controversies are interrelated, but the following discussion will attempt to keep them separate.

Liberals believe that the historical record supports the superiority of a policy of free trade over protectionism. Great Britain, they point out, surpassed its rivals after 1848 precisely because it adopted a policy of free trade. France, an industrial leader in the eighteenth century, fell behind because it resorted to high levels of protectionism and its industry then became inefficient (Kindleberger, 1978b, ch. 3). Nationalists, on the other hand, note that Britain used force against its economic rivals and adopted free trade only after its industry had developed behind the shield of protectionism. As for Germany, it too protected its nascent industries from what has been characterized as the "imperialism of free trade," that is, the British effort to direct investment abroad away from competitive industries (Semmel, 1970).[5] The advantages of being first, nationalists argue, are so great that industrialization requires the protection of infant industry.

In principle, both liberals and nationalists accept the rationale for protecting infant industries (Corden, 1974, ch. 9). Both acknowledge that an industrial economy may have particular advantages over a nonindustrialized economy that make it very difficult for the latter to establish its own industries. In the words of John Stuart Mill, "there may be no inherent advantage on one part, or disadvantage on the other, but only a present superiority of acquired skill and experience. A country which has this skill and experience yet to acquire, may in other respects be better adapted to the production than those which were earlier in the field" (Mill, 1970 [1848], pp. 283-84).

Liberals and nationalists disagree fundamentally, however, on the specific purpose of protectionism as it relates to infant industries. For liberals, protectionism is in the nature of an experiment to test whether

[5] The concept of the "imperialism of free trade," developed by Gallagher and Robinson (1953), is that free trade is but another form of economic imperialism.

a nation really does have an inherent comparative advantage in a particular industry. Mill said "it is essential that the protection should be confined to cases in which there is good ground of assurance that the industry which it fosters will after a time be able to dispense with it; nor should the domestic producers ever be allowed to expect that it will be continued to them beyond the time necessary for a fair trial of what they are capable of accomplishing" (Mill, 1970 [1848], p. 284). Liberals regard protectionism at best as a necessary but temporary expedient and as a stepping stone to a system of free trade.

Economic nationalists, on the other hand, tend to regard protectionism as an end in itself. The nationalist's foremost objectives, at least in the short run, are not free trade and wealth accumulation but state-building and industrial power. In most developing countries industrialization is the primary goal of national policy, and the fundamental purpose of a tariff is to establish particular industries frequently without regard to the economic rationale for doing so.

Economic nationalists assume the superiority of industry over both agriculture and commodity production. Industry is believed to be not only valuable in itself because it contributes a high value-added to national production, but it is alleged to have powerful secondary effects, positive externalities, and "backward linkages" or spinoffs that stimulate the entire economy and speed overall economic development (Cornwall, 1977). Its effects on the quality of the work force, business entrepreneurship, and the overall options of the society make industrialization an objective in its own right.

In response to the nationalist argument for protection, liberals argue that every economy has a comparative advantage in something and therefore should not fear free trade. Through each doing what it can do best, regardless of what that is, everyone can gain. Thus, in anticipation of the nationalist contention that the advent of intra-industrial trade and the application of industrial organization theory to trade gives aid and comfort to the nationalist defense of protectionism, Krugman has defended letting the market determine international specialization and trade patterns:

> But who produces what? Can we say anything about the direction of trade? Obviously not: by ruling out comparative advantage we have made the question of who exports what indeterminate. In any case, it doesn't matter. To realize the gains from trade, all that matters is that countries specialize in producing different things. Whether Germany produces large refrigerators and France small ones, or vice versa, is not important; that they do not each produce both types is (Krugman, 1981a, p. 10).

For nationalists, however, who produces what is of the utmost importance. What concerns them is precisely the international location of those economic activities that, in their judgment, contribute most to the political position and overall developmemt of the economy. In a world in which comparative advantage is highly arbitrary and where, again to quote Krugman (1981a, p. 19), "the other interesting point is that the outcome of the process of specialization may depend on initial conditions. . . . History matters. A country, having once been established as an exporter in some industry, may maintain this position simply because of the economies of scale gained—unless comparative advantage moves far enough away." The nationalist can find in this statement ample support for the protection of infant industries.

The traditional nationalist defense of infant industry protection has been joined in recent years by the prospect of strategic trade policy, to be discussed later in this chapter. Whereas infant industry protection is largely defensive, strategic trade policy is essentially offensive. Its central message is "import protection for export promotion." Through the erection of entry barriers, the use of government subsidies, and the husbanding of domestic demand to give advantage to domestic firms, one's own corporations can acquire the economies of scale and other advantages that will enable them to dominate world markets. In the modern world of intra-industry trade, the line between defensive infant industry protection and strategic trade policy has become very thin indeed.

The outcome of the debate over the protection of industries is indeterminate. As List and more recent authors have noted, every country has protected its industries to some extent in the early stages of industrialization. Contemporary developments in trade theory have provided a new and additional rationale for this protectionism. Yet it does not follow that protectionism necessarily leads to the development of a viable industrial structure. Indeed, in many instances protectionism has demonstrably hindered the development of an efficient industrial base, for example, import-substitution strategies have proved bankrupt in many less developed economies. The success of strategic trade policy, as exemplified by the commercial difficulties of the European Airbus consortium, has yet to prove its worth. The whole issue of free trade versus protection does not lend itself to easy answers.

Considering only the issue of infant industry protection, one may conclude that trade can be both a destroyer and an engine of growth (Gould, 1972, ch. 4). The superior competitiveness of industry in advanced economies can wipe out economic sectors in less developed economies, as happened to the historic Indian handicraft textile industry. But as a rapidly industrializing India and other NICs have demonstrated, trade between advanced and less developed economies can also be an important source of economic growth for the latter. The developing country's response to the opportunities provided by the international trading system is critically important.

It is worth noting that nationalists are myopic in their evaluation of trade and protectionism when they stress the inequitable international distributive effects of free trade while overlooking the domestic distributive effects of protectionism (H. Johnson, 1967). The domestic consequence of protectionism is a redistribution of income from consumers and society as a whole to the protected producers and the state. Liberals correctly note that protectionism creates economic rents that these latter interests collect.[6] Economic nationalism thus may be viewed as sacrificing the welfare of the whole society to that of particular groups. It is an alliance of the state with producer interests and, for this reason, the primary proponents of protectionist doctrine tend to be state bureaucracies and domestic producers whose economic interests lie with the protected industrial sectors.

The more important consideration, however, is that liberals and nationalists have different objectives and judge the success of policies by different standards. Liberals judge trade and protectionism in terms of consumer welfare and the maximization of global efficiency. Nationalists stress what they consider to be producer and state interests.

Liberals and nationalists also divide on the benefits and costs of specialization. From Adam Smith on, liberals have believed that specialization and an expanding market lead to increased efficiencies in production and hence to a more rapid rate of economic growth. They also believe that the long-term benefits of specialization and free trade outweigh any associated costs, because national specialization based on comparative advantage will maximize both domestic and international economic welfare. Economic nationalists, stressing the costs of international specialization and increasing interdependence, believe those costs to range from the loss of national sovereignty to an enhanced vulnerability of national welfare to the negative impact of foreign developments.

[6] A "rent" is defined by economists as "a payment to a resource owner above the amount his resources could command in their next best alternative use. An economic rent is a receipt in excess of the opportunity cost of a resource" (Tollison, 1982, p. 577). They are "earned only by the owners of resources that cannot be augmented rapidly and at low cost to meet an increased demand for the goods they are used to produce" (Posner, 1977, p. 9). Land and skills are good examples. In the modern world a technological monopoly can produce rent or technological profits. This fact is central to the debate over what is called strategic trade policy.

In this debate over the benefits and costs of specialization, the fact that the industries most vital for national security and military power are frequently the ones most involved in international trade is significant (Condliffe, 1950, p. 799). Furthermore, import-sensitive industries frequently are major providers of domestic employment. Thus, specialization and changes in specialization raise fundamental issues of national concern.

The clash between liberals and nationalists over the benefits and costs of specialization, although partially based on differing economic and political objectives, also rests on differing assumptions regarding the nature of international economic relations. Liberals consider these relations to be essentially harmonious; nationalists believe that conflict is inevitable. As will be argued below, neither assumption is valid in itself. Rather, its validity rests on the larger configuration of global economic and political conditions at a particular time. The degree of harmony or disharmony is dependent upon the extent of complementarity of trade as well as the overall political relations among trading nations. Liberal trading practices flourish best when governed by a liberal hegemonic power or agreement among dominant liberal states.

Another controversy regarding free trade and protectionism may be labeled the "senile" or declining industry argument; this assumes that there are certain advantages to backwardness or disadvantages to being first (Rostow, 1980). As newly industrializing countries catch up with older industrial countries, the former enjoy the benefits of lower wage rates, of being able to adopt advanced and efficient technologies, and other advantages (Gerschenkron, 1962). Industry in the older industrial country therefore needs protection against the aggressive and "unfair" tactics of the newcomer. Whereas liberals reject the protection of inefficient declining industries as a wasteful diversion of scarce resources from investment in more promising growth industries, nationalists employ a variety of stratagems to defend declining industrial sectors. Arguments put forth include the need to protect industrial sectors vital to national security and emotional appeals to save jobs threatened by the unfair practices of foreign competitors. Although there may be occasions when such arguments have validity, in most cases the real purpose of protectionism is to safeguard particular threatened inefficient industries.

In the 1980s an effort has been made by certain economists, including some of a liberal persuasion, to develop a rationale for protecting senile industries that is complementary to the argument for protecting infant industries.[7] They argue that the usual disadvantages of being first

[7] Whitman (1981) sets forth the rationale for protecting "senile" or mature industries.

have been enhanced by the increasingly rapid rate of global changes in comparative advantage and the intensified impact of external shocks. They note that with the quadrupling of the price of energy in 1973, the existing capital stock of all advanced countries was made obsolete and consumer preferences were suddenly transformed. Further, adjustment to these rapid and massive changes has been retarded and transition costs are aggravated by low rates of economic growth, domestic economic rigidities, and market imperfections. It is argued that the transition costs of phasing out older industries in favor of newer ones have grown so much that the costs of adjusting to rapid change may exceed its benefits. Furthermore, business investment may be discouraged if overly rapid obsolescence and intense foreign competition make it impossible for a business to capture the benefits of the investment. Under these circumstances, an industry may find itself caught "in a process of change and adaptation so profound as to put it in a position akin to that of an infant industry," for example, American automobile manufacturing (Whitman, 1981, p. 22). The state, therefore, should develop an industrial policy to cushion the effects on the economy of untoward external developments.

More generally, there are those who argue that both liberalization of trade and industrial specialization have reached a point of diminishing returns, causing a shift in the benefits and costs of free trade. Although traditional trade theory maintains that the benefits of trade and specialization will always be greater than its costs, it has assumed a relatively slow rate of change in comparative advantage so that displacement of workers is gradual and associated adjustment costs are low. At the end of the twentieth century, however, the liberalization of trade, the increasing number of sellers, and the dynamic nature of comparative advantage have greatly accelerated the rate of industrial change and thus raised adjustment costs.

Some liberal economists argue that specialization based on considerations of static comparative advantage has even become extremely risky in a highly uncertain world where governments constantly intervene in the market (Brainard and Cooper, 1968). Specialization makes the welfare of the society vulnerable to the market and to political forces beyond national control. In the past this situation was applicable only to the producers of raw materials, but now it applies increasingly to industrial producers as well. Some argue that the solution to this increased uncertainty and rapid rate of change might be is for the country to develop a "portfolio" of industries and protective tariffs that will reduce the cost and risk of specialization. A major purpose of industrial policy is to ensure that the nation does not put all of its eggs in one industrial basket and does develop an optimum level of foreign trade.

To summarize, economic nationalists criticize the liberal doctrine of free trade because the doctrine is politically naive and fails to appreciate the extent to which the terms of trade and the rules governing trade are determined by the exercise of power, because the doctrine is static and slights the problem of adjustment costs, and because it ignores the problems of uncertainty in its stress on the benefits of specialization. Despite these serious limitations, however, liberal trade theory retains its essential validity; it cannot be dismissed simply as a rationalization of the interests of the strong. Although trade does tend to benefit the strong, at least in short-run terms, all *can* gain in absolute terms and some gain both relatively and absolutely, as is seen in the present-day examples of Japan and the NICs. It is important to remember that when the world has reverted to nationalist trade policies, as it did in the 1930s, everyone has lost. The ultimate defense of free trade, as Smith pointed out, is that there are benefits for *all* from a territorially based international division of labor.

As one would expect from economic theory itself, there are both costs and benefits to free trade, and tradeoffs always exist. These must be considered by every nation as it formulates its commercial policy; no nation has yet chosen to pursue either an exclusively free trade or an exclusively nationalistic policy. A nation's mix of these two policies is a function of its domestic economy and of conditions prevailing in the world economy. The interplay of these domestic and international factors has produced swings between liberal and nationalist trade regimes over the past two hundred years. In the late twentieth century, an analysis of the postwar regime of liberalized trade reveals that the pendulum is once again swinging in the direction of economic nationalism.

Until the early 1970s, the history of the postwar trading system was one of increasing liberalization. Led by the American hegemon, the major trading nations moved in the direction of the precepts of liberal trade theory. With the relative decline of American power and the development of adverse economic conditions, this movement was reversed. By the mid-1980s, economic nationalism had become a potent force in global trading relations. To appreciate this change and its significance, one must begin with the General Agreement on Tariffs and Trade (GATT).

The GATT System

The General Agreement on Tariffs and Trade, established in 1948, has provided the institutional basis for trade negotiations in the postwar era. The fundamental purpose of the GATT was to achieve "freer and fairer trade" through reduction of tariffs and elimination of other trade barriers. GATT has operated on the basis of three principles: (1) nondiscrimination, multilateralism, and the application of the Most-Favored Nation Principle (MFN) to all signatories, (2) expansion of trade through the reduction of trade barriers, and (3) unconditional reciprocity among all signatories. GATT's goal was to establish a world trade regime or universal rules for the conduct of commercial policy (Whitman, 1977, p. 28).

From the very beginning there were important exceptions to these principles, for example, the British Commonwealth, the permissibility of common markets or free trade area agreements, and Article XIX (safeguards provision) of the GATT; these exceptions recognized special economic relationships or encouraged countries to take the risk of moving even more toward completely free trade. Although the Eastern bloc and certain less developed countries (LDCs) never signed the GATT and did not accept GATT principles and a number of OECD countries never completely fulfilled their GATT obligations, the basic principles of the GATT provided the basis for the postwar liberalization of world trade (Whitman, 1977, pp. 33-35).

Under the formula of what was called in Chapter Four the "compromise of embedded liberalism," countries could accept the obligations of the GATT and join in tariff-reduction negotiations without jeopardizing their domestic economic objectives. The goal was nondiscrimination and multilateralism rather than the complete abandonment of national controls over trade barriers (Ruggie, 1982, p. 396). Moreover, the GATT contained ample escape provisions and protection against harmful domestic impact (Lipson, 1982, pp. 426-27). The guarantee of increased stability encouraged nations to move in the direction of trade liberalization (Ruggie, 1982, p. 399).

In the 1980s, the GATT principles of multilateralism and non-discrimination as well as the "compromise of embedded liberalism" have come under increasing attack. For many countries and powerful groups the legitimacy of the GATT and of its principles have been weakened by structural changes in the world economy. New challenges have raised the issue of whether the GATT or some functional substitute can continue to maintain the regime of liberalized trade and, if not, what form or forms of trade regime might possibly replace the postwar liberal trade order.

Challenges to the GATT

Following the Second World War, successive rounds of trade negotiations within the framework of the GATT led to an astounding decline of tariff barriers and growth in world trade. As a consequence of numerous GATT negotiations in the early postwar period (the Dillon Round in 1960-1962, and, most significant of all, the Kennedy Round in 1962-1967), the merchandise trade of industrial countries grew from 1950 through 1975 at an average rate of 8 percent a year, twice the growth rate of their gross national product (4 percent) (Cline, 1983, p. 5). The growing network of international trade began to enmesh national economies in a system of economic interdependence and lead some observers to speculate that a tightly integrated world economy was inexorably emerging. Then the balance between the forces of liberalization and economic nationalism began to shift; by the mid-1970s, economic nationalism had begun to tip the scales away from trade liberalization and the growth of trade slowed.

Trade liberalization was put on the defensive as early as the 1950s with the formation of the European Economic Community (EEC). The Dillon Round was initiated by the United States to counter the threat of the EEC's external tariff and the Common Agriculture Policy (CAP) of production subsidies. The sectoral or item-for-item approach of these negotiations, however, showed meager results. When tariff reductions in the early 1960s began to impinge on key industrial sectors and the interests of powerful groups, it became clear that a new approach to tariff reduction was required (Scammell, 1983, p. 172).

A new method of tariff negotiations was employed in the Kennedy Round, concluded in 1967; it produced an across-the-board tariff cut of 35 percent on 60,000 products, incorporated an antidumping agreement, and provided for food assistance to the less developed countries. Yet the round failed in three important respects; it did not deal with the increasing problem of nontariff barriers, the special problems of the LDCs, or the problem of agricultural trade (Scammell, 1983, p. 172). Despite these failures, the Kennedy Round was the high point of the postwar movement toward trade liberalization. One authority has compared it to the Cobden Treaty of 1860, which appeared to have brought the world to "the threshold of free trade" (ibid.). As in the late nineteenth century, however, the forces of economic nationalism continued to gain strength.

By the mid-1980s, the GATT regime and liberal world trade were very much on the defensive. In the words of the *Economic Report of the President* for 1985 by the Council of Economic Advisers, "the world is moving away from, rather than toward, comprehensive free trade. In major industrialized countries, for example, the proportion of total manufacturing subject to nontariff restrictions rose to about 30 percent in 1983, up from 20 percent just 3 years earlier" (1985, p. 114).

Although the total value of world trade continued to expand into the 1980s, the spread of protectionism increasingly affected the nature of the trading system and the international locus of industrial production.

Several fundamental developments in the 1970s accounted for the slowing of the growth of trade and the revival of economic protectionism: (1) the shift to floating exchange rates and the consequent erratic behavior of the rates, (2) the OPEC revolution in the winter of 1973-1974 and the massive increase in the price of world energy, (3) the intensification of Japanese competition, (4) the entry of the highly competitive newly industrializing countries (NICs) into world markets, (5) the relative decline of the American economy, (6) the increasing closure of the European Economic Community, and (7) the emergence of global stagflation. Together, these developments slowed and began to reverse the movement toward trade liberalization.

The 1973-1974 and 1979-1980 massive increases in the price of world energy had a significant impact on world trade. One consequence was that energy became a much larger factor in the dollar value of world trade and in part caused its continuing high value. By the same token, this change intensified the competition among energy-importing nations for export markets. The increased cost of energy also forced many economies in the developing world to go into debt to finance energy imports. The world's industrial plant, based on inexpensive energy, suddenly became largely obsolete, and this raised a massive adjustment problem. Furthermore, the price rise was inflationary, amounting to approximately 2 percent of the world gross product from the 1973-1974 price increase alone; it had a two-fold and contradictory impact on the international economy. First, it was highly inflationary because of the central role of petroleum in the modern economy as both a fuel and an industrial raw material. Second, the price increase also acted as a huge tax on the world economy, absorbing financial resources and depressing economic activities (Corden and Oppenheimer, 1974). The effect of all these developments was to reduce dramatically the rate of growth of world trade. The increase in the underlying rate of inflation, the shift to recessionary monetary policy, and the consequent global stagflation accelerated the spread of trade protectionism (Corden, 1984b, p. 5).

Another development transforming world trade in the 1970s was the intensification of Japanese and NIC competition. The rapid technological advance of Japan and the breaking of the Western monopoly of modern industry with the industrialization of South Korea, Brazil, and other NICs significantly increased the number of manufacturing exporters at the same time that the volume of world trade was declining and world markets were closing. In one industrial sector after another from textiles to steel to consumer electronics, the result was global overcapacity. For many in the advanced economies, the most disturbing development was that Japan and especially the NICs were combining state of the art productive techniques with the traditional low-wage advantage of developing countries. Due to these unprecedented circumstances, it was argued, protectionism against exports from Japan and the NICs was necessary to safeguard the living standards of the most advanced economies (Culbertson, 1985).

The relative decline in the size and competitiveness of the American economy also contributed to the slowing of world trade and the rise of protectionism. Between 1953-1954 and 1979-1980, imports as a share of GNP more than doubled, from 4.3 percent to 10.6 percent (Cline, 1983, p. 9).[8] In the 1980s, due to the macroeconomic policy of the Reagan Administration and the overvalued dollar, the American competitive position rapidly deteriorated as imports climbed from 11.4 percent to 15.3 percent of national goods production from 1980 to 1984, and thus intensified the level of competition in a remarkably short period (Destler, 1986, p. 101). By 1985, the American trade deficit was $150 billion, and $50 billion of that was with Japan. Even with respect to Western Europe, the United States had slipped from a $20 billion surplus in 1980 to a $15 billion deficit in 1984. In the first part of 1986, the United States had achieved the impossible: it had a deficit with almost every one of its trading partners. Not since 1864 had the U.S. trade balance been so negative (ibid., p. 100). America's relations with its major trading partners began to change in response to this increased openness and deteriorating trade situation. Previously the West European and Japanese economies had pursued aggressive export policies while simultaneously importing American goods to rebuild their own war-torn economies. In the 1970s and 1980s, the relatively smaller, more open, and less competitive American economy became highly sensitive to imports at the same time that other economies began to import relatively fewer American goods. As trade deficits and domestic unemployment rose, so did the protectionist pressures.

Another cause of rising protectionism has been the enlargement and increasing closure of the European Community. During much of the postwar period the development of the Common Market has contributed significantly to the overall expansion of world trade. Yet, since the mid-1970s, the Europeans have attempted to protect their traditional

[8] Symbolic of this change is that in 1983 the annual report of the Council of Economic Advisers moved the chapter on international developments from the end to the middle of the report.

industries and to safeguard employment against imports from Japan and the NICs. The tendency to turn inward has been enhanced by the enlargement of the Community, as the Mediterranean peripheral countries have been incorporated, the ties with the European Free Trade Association have grown, and a number of less developed countries have become associated with the Community through the Lomé Conventions of trade preferences. The West European market in manufacturing and temperate agricultural products (especially food grains) has grown more closed and the EEC has negotiated with outside powers more and more as a unified bloc. In short, Western Europe has increasingly operated as a regional trading system.

Thus, by the late 1970s, several broad changes had begun to erode the GATT system of trade liberalization. As tariff barriers within the GATT have fallen, nontariff barriers in most countries have risen. Barter or countertrade has grown rapidly, especially with respect to the less developed countries; the U.S. Commerce Department estimates that between 1976 and 1983, barter increased from approximately 2-3 to 25-30 percent of world trade (Goldfield, 1984, p. 19). Also, the state has become a more important actor in trading relations, from the sale of armaments to the negotiation of tied-aid packages and international cartels (Zysman and Cohen, 1982, pp. 42-46). Industrial and other domestic policies have increasingly influenced trade patterns. By one estimate, "the ratio of managed to total trade has increased sharply, from 40% in 1974 to 48% in 1980" (*The Economist*, December 25, 1982, p. 93). And if one includes intrafirm trade associated with the expanded role of the multinational corporations in world commerce, the percentage of controlled trade would be still greater.

The Multilateral Trade Negotiations (Tokyo Round), begun in 1973 and completed in 1979, constituted the first and foremost effort of the major trading nations to find new ways to deal with many of these changes in trading practices. Whatever its long-term significance for the regime of liberalized trade, the Tokyo Round transformed the basic framework for international negotiations over trading relations. The nature of its effect on the liberal trade regime, however, remains very much in dispute. One writer aptly entitled his own evaluation of the agreement "Tokyo Round: Twilight of a Liberal Era or a New Dawn?" (Corbett, 1979).[9]

The Tokyo Round, 1973-1979

The Tokyo Round made the first systematic attempt in the trade area to resolve the developing conflict between the increasing economic in-

[9] The definitive evaluation of the Tokyo Round negotiations is Winham (1986).

terdependence among national economies and the growing tendency of governments to intervene in their economies to promote economic objectives and domestic welfare (Whitman, 1977, p. 9). The round also dealt with a growing agenda of American complaints against its principal trading partners. The United States also wanted to reaffirm the commitment to a multilateral trading system, to codify international rules that limit domestic policies, and to eliminate discrimination against American exports by the Common Market and the Japanese (Krasner, 1979).

The vast array of subjects discussed in the Tokyo Round included the following:

(1) violations of the nondiscrimination or Most-Favored Nation Principle through preferential trading arrangements (e.g., the Lomé Convention between the EEC and certain LDCs) and the resultant increase in the fragmentation and regionalization of the world economy;

(2) resolution of issues related to unilateral imposition of import restrictions in cases of serious injury to domestic industry (Article XIX or "safeguard" provision of the GATT) and the increased use of "orderly marketing arrangements" or "voluntary export restraints" (Hindley, 1980);

(3) overall tariff reductions and the removal of nontariff barriers;

(4) liberalized trade in agriculture and increased access to the Common Market and Japan for American agricultural products;

(5) consideration of commodity agreements in wheat, coarse grains, dairy products, and meats;

(6) establishment of codes of conduct in a variety of areas, e.g., public procurement, export subsidies, and various types of government standards.

The primary goal of the Tokyo Round was to stabilize trading relations among the advanced OECD countries; this meant reformulating Article XIX (the safeguards provision), creating new codes for export subsidies, regulating countervailing duties and public procurement, and eliminating nontariff barriers. The concerns of the less developed countries for "special and differential" treatment embodied in their demands for a New International Economic Order (such as extension of "generalized preferences," access to developed countries for their manufactured exports, and formulation of commodity agreements) were partially recognized. During the 1970s the United States and other developed countries did adopt the Generalized System of Preferences, which lowered the duties on a number of LDC exports in manufactured products, and it was generally assumed that the less developed countries would benefit from measures that ensured a stable growth of world trade. The highest priority in the negotiations, however, was to deal with the expanding number of trade problems among the advanced countries themselves.

The Tokyo Round succeeded in several areas, including a further reduction of tariff barriers on industrial products of the major countries (OECD, 1985, p. 18). Its most important accomplishment was the establishment of a number of "codes of good behavior" regarding nontariff barriers (NTBs). These codes apply to such nontariff barriers and trade promotion policies as restrictions on government procurement, the granting of tax benefits, and the use of export credits. The purpose was to make the nontariff barriers at least visible if not to eliminate them entirely, to decrease the uncertainties generated by government intervention in the market, and thereby to stabilize the trading environment (Deardorff and Stern, 1984). In short, the codes were designed to limit a return to mercantilist trading practices and destructive policies of the 1930s.

The round also attempted to extend trade rules into new areas, such as safety and health standards and government procurement, and to clarify international norms in such areas as the use of export subsidies, antidumping regulations, and the use of countervailing tariffs.[10] In general, it sought to make more "transparent" and available to international scrutiny those nontariff barriers and other national practices associated with what is called the New Protectionism.

In a number of important areas, however, the Tokyo negotiations failed to reach agreement. These areas included a number of the special problems of the LDCs, the agricultural issue (which was of great concern to the United States), the provision for dispute settlement, issues of foreign investment related to trade, and the expanding trade in services and high technology. The growing use of nontariff barriers since the round indicates that the most serious shortcoming of the negotiations was its failure to revise the "safeguards" clause, which permits a country to restrict imports in order to protect an economic sector. This escape clause had been established to encourage the removal of trade barriers and to limit the damage to the regime of free trade if and when a nation imposed emergency protection to deal with actual or threatened serious injury to an industry by imports. Article XIX requires, however, that several preconditions be met: damage had to be demonstrated, the affected exporting countries had to be consulted and com-

[10] Despite its crucial importance in trade friction and negotiations, there appears to be no generally accepted definition of a subsidy.

pensated, and any restrictions had to conform to the GATT principle of nondiscrimination.

In the Tokyo Round the West Europeans wanted the right to apply restrictions selectively to the exports of particular countries (Japan and, to a lesser extent, the NICs), a modification that would have entailed a violation of the nondiscrimination principle. Japan and the NICs, needless to say, were intensely opposed to such a modification; the United States was generally indifferent. This fundamental controversy has not been resolved, and individual governments and the European Community have imposed "orderly marketing agreements" (OMAs) and voluntary export restraints (VERs) more frequently. The use of voluntary export restraints, a practice that is outside the GATT framework and violates the requirements of the "safeguards" principle, has had a growing impact on the character of the international trading system.[11]

In retrospect, it seems remarkable that the Tokyo Round succeeded as well as it did. The 1970s were a decade of economic upheaval. The problem of hyperinflation, the OPEC revolution, and the collapse of the Bretton Woods system strained international economic relations severely. With the spread of global stagflation after 1973, pressures for trade protectionism mounted. In these circumstances, the Tokyo Round and its many years of intense negotiations were indicative of the transformed nature of the international trading regime.

The round occurred during a global trend toward economic nationalism. Although its development of new codes helped to limit arbitrary government behavior and the proliferation of nontariff barriers, the new codes clearly acknowledge the extent of the retreat from international norms and the setbacks to previous GATT tariff reductions. Whereas the several GATT agreements of the 1950s and 1960s were negotiated multilaterally and followed the Most-Favored Nation or nondiscrimination principle, since the Tokyo Round the "rules" of international trade have more frequently been set unilaterally, negotiated bilaterally and, in some cases, have involved only the OECD countries. Particularist domestic interests in the advanced industrial countries have become increasingly important in the determination of these rules. Furthermore, the Tokyo codes apply only to signatory countries and in

[11] As Hindley (1980) points out, important economic and political differences exist between the invocation of Article XIX and the use of voluntary export restraints as a means of dealing with trade problems. Among other differences, the latter create rents through their allocation of market shares and the distribution of these shares are bilaterally negotiated. Yoffie (1983) is an excellent analysis of the use of VERs in the textile area by the United States against the NICs.

general have been rejected by the less developed countries. This could lead to a two-tier system of world trade composed of the OECD countries with their LDC trading partners on the one hand and all the rest of the world on the other (Curzon and Curzon Price, 1980). Despite its achievements, therefore, the overall success of the Tokyo Round was limited in important ways.

Emergent Trade Issues

Although the Tokyo Round was by far the most complex and wide-ranging trade negotiation ever, it nevertheless left untouched many complex and difficult problems that have since become increasingly significant in international economic relations. Among the important and neglected issues were those of agriculture, the expanding global role of services, particularly finance and telecommunications, and high-technology industries (R. Baldwin, 1984b, pp. 610-612). In 1986, services accounted for approximately one quarter of the $2 trillion annual value of world trade (*The New York Times*, Sept. 21, 1986, p. 1). It is important to note also that agriculture and services were never covered by the GATT. Moreover, both services and high technology industries are closely associated with foreign direct investment by multinational corporations, which also lies outside the GATT framework. All three areas are extremely sensitive politically and, for this reason, may not fit well with the GATT principles of multilateralism and unconditional reciprocity.

Since these sectors have become more important, politically if not economically, the Tokyo Round may well have been the last trade negotiation of the old industrial era. Since the conclusion of the Tokyo Round, the far more intricate exchanges of the "information" economy and the "knowledge-intensive" industries, along with agriculture, have become the key subjects of the eighth round of trade negotiations. At the least, the changing environment and patterns of world trade suggest that future trade negotiations will have to be vastly different from those of the past.

In September 1986, at Punta Del Este, Uruguay, the members of the GATT decided after intense debate to launch an eighth round of multilateral trade negotiations to deal with these issues. The strongest proponent of what one source has called the "Uruguay Round" (*IMF Survey*, September 30, 1986, p. 299) was the United States, supported primarily by the Japanese and the economies of the Pacific Basin and opposed by certain members of the European Community and the larger LDCs. With financial and other services accounting for 70 percent of the American GNP, American agriculture in serious trouble, and rising protectionist pressures in Congress, the United States demanded that other nations open their economies to American service industries (including American multinationals), remove agricultural export subsidies, and write rules preventing the piracy of patents, trademarks, and other forms of intellectual property rights. Other countries were well aware that behind these American demands was the increasing danger of protectionist legislation from Congress. There are exceptional difficulties inherent in efforts to reach a multilateral agreement on any of these issues.

The problem of world trade in agriculture almost defies solution. Global overcapacity in agricultural production has arisen because many countries have become self-sufficient in food and the high dollar of the 1980s encouraged the opening of new sources of supply in many commodities. This massive surplus (tragically existing in a world of mass famine) necessitates a restructuring of agricultural support programs in Western Europe, the United States, and elsewhere. Yet few economic sectors enjoy greater domestic political influence than does agriculture. The universal tendency, therefore, is not only to erect import barriers, but to subsidize agricultural exports. Although Japan has set some of the highest import barriers, the subsidization of agricultural exports has been most prevalent in the European Economic Community, which is cemented by the Common Agricultural Policy. The United States, which itself began extensive export subsidies in the 1980s, and certain of the less developed countries have been the principal losers from these protectionist and export policies and the foremost advocates of a reform of agriculural trade.

The trade issues in the service and high-technology sectors have important characteristics that enhance their economic and political significance and make them especially difficult to resolve. In the first place, these industries have become the primary growth sectors for the advanced economies, particularly for the United States. At the same time, a growing number of NICs such as Brazil, India, and South Korea have targeted these sectors for development and are protecting them from foreign competition. As they rapidly become the "commanding heights" of the contemporary world economy, competition and conflict are destined to be fierce. Second, these sectors (in addition to agriculture) comprise the expanding export markets of the United States and hence are of intensifying concern to American policy makers, who consider the removal of West European, Japanese, and LDC restrictions against American service industries to be the litmus test of future trading relations. Third, the service industries (finance, communications, and information processing) permeate domestic social relations and institutions, which means there is strong resistance to outside pressures for change and the opening of national markets. For example, American demands on Japan to open its economy in these areas are resisted because they are believed to threaten Japanese cultural values and national self-sufficiency in strategic sectors.

The conflict between the advanced and developing countries over services and high-technology industries has become intense. The United States and other developed countries believe that it is impossible for the developing countries to demand greater access to Northern markets for their increasing output of manufactured goods unless they are willing to reciprocate by opening their own markets to the service and high-tech industries of the advanced countries. However, for the NICs and other LDCs free trade in services and high technology would mean unrestricted access for the multinational banks and corporations of the United States to the economies of the developing countries. This would deny them the opportunity to protect and develop their own similar industries, and the LDCs argue that they would then be forever behind and dependent upon the more advanced economies in the expanding high-technology industries.

On the other hand, the United States and, to some extent, the other advanced economies have become increasingly sensitive to high-technology issues. The increased significance of technological diffusion and the increasingly arbitrary nature of comparative advantage as well as military security concerns are causing the United States to make the protection of its high-tech industries an important priority. In addition to its own efforts to slow down the outflow of industrial know-how, the United States has placed the international protection of intellectual property rights on the agenda of trade negotiations.[12] This growing effort by the United States to safeguard the competitive position of American corporations against intellectual piracy and the overly rapid diffusion of their comparative advantage runs directly counter to the desire of other countries to climb the technological ladder.

The service sectors of finance, data processing, and the like are closely associated with the overseas operation of multinational corporations and this fact raises a difficult problem. These sectors are infrastructure industries and affect the overall control as well as international competitiveness of the economy. Because they are central to the

[12] The literature on the increasing importance of technology transfer or diffusion in economic relations is enormous. Technology has in effect become an independent factor of production. Giersch (1982) is a representative collection of different views.

way in which an economy operates and to its basic mode of production, these sectors tend to be nationalized or highly regulated. Thus, the highest trade barrier to be hurdled is the role of the state in these sectors, and therefore negotiations for increased economic liberalization in the service industries and for access by foreign multinationals have become extremely sensitive politically. Increased openness raises the issue of whether or not a greater harmonization of domestic practices and institutions is necessary. The United States believes strongly that harmonization is required to enable American corporations to operate successfully in Japan and the LDCs, but the latter denounce American pressures in this direction as a new form of imperialism and a violation of national sovereignty (Diaz-Alejandro, 1983, pp. 307-308). Despite American pressures for multilateral negotiations in these areas, it is doubtful that these issues can be treated by the multilateral and MFN approach of the GATT. It is more likely that they will be negotiated bilaterally and without reference to the principles of the GATT.

The conflict between further trade liberalization and domestic economic practices has presented itself most forcefully in the case of Japan. Although Japan has reduced most of its formal trade barriers (with some major exceptions, such as agriculture and certain high-technology industries), what foreigners characterize as the illiberal structure of the Japanese economy, the "administrative guidance" role of the bureaucracy, and the economic behavior of the Japanese themselves make the Japanese market very difficult to penetrate. A case in point is the highly restrictive and inefficient (at least as judged by Western standards) Japanese distribution system, intended in part to protect small stores and the integrity of neighborhoods. Other examples of informal Japanese barriers are also frequently cited. The existence in Japan of industrial groupings and long-standing business relationships as well as the Japanese preference to do business with one another and to "buy Japanese" constitute formidable obstacles that limit foreign entry into the market. American pressures on the Japanese to harmonize their domestic structures with those of Western countries and to open up their economy obviously contribute to economic conflict, especially when Japanese formal trade barriers, at least, are lower than American barriers.

Although deregulation and privatization have become important themes of contemporary economic discourse, state intervention to protect domestic values continues to be the universal norm. Furthermore, it is exceptionally difficult for trade liberalization to proceed when resistance to increased economic openness is located in the very nature of a society and in its national priorities. Under these circumstances, it may actually be impossible to remove barriers to trade, at least through the traditional means of multilateral negotiations. The question of whether or not a liberal trade regime can exist in a world composed largely of "illiberal" states is highly problematic.

A further obstacle to success is that the GATT is no longer the American–West European club that it was in the 1960s when even the Japanese were a minor party. It has over ninety players and it is easier than in the past for a coalition to block all actions. Agreement will be very difficult to achieve. For example, the United States has demanded that liberalization of services be the key concern of the negotiations, yet the larger NICs, such as Brazil, India, and Yugoslavia, have strong reservations about the inclusion of services in the GATT. They are concerned that the advanced countries will link the opening of the latter's markets for LDC manufactured exports to concessions regarding services and multinational corporations. The major demand of most less developed countries is that the advanced countries open their markets to the manufactured goods of the LDCs without the LDCs having to make concessions on services. The West Europeans are divided and some European countries may have little to gain from the negotiations or, from their perspective, even have much to lose. Although the Japanese favor continued reduction in trade barriers, they are reluctant to make concessions in agriculture and services. Even in the United States there are basic and traditional industries that oppose concessions in their sectors in return for foreign concessions to American service and high-technology industries. Without any outstanding leadership from the United States and in the presence of strong opposition abroad, it is difficult to be optimistic regarding the prospects for the negotiations (Aho and Aronson, 1985).

Thus, developments in the 1980s suggest that the impressive advance achieved by the postwar era of successive rounds of multilateral trade negotiations ended with the completion of the Tokyo Round. In each of the three dominant centers of the international economy—Western Europe, the United States, and Japan—as well as among the LDCs, strong resistance has developed to the further removal of what some critics regard as trade barriers through multilateral negotiations based on GATT principles. Although changes in national attitudes and defined interests do not necessarily mean the termination of efforts to eliminate tariff and nontariff restrictions, they do suggest that the nature and pace of the freeing of trade have shifted significantly; in some cases national policies entail an actual retreat from the achievements of the past several decades.