

## CHAPTER 7

# **The Benefits of Market Opening**

THE UNITED STATES HAS LONG RECOGNIZED that open domestic markets and an open global trading system are superior to trade protection and isolationism at promoting broad-based growth and prosperity. For decades our open economy and successful U.S. leadership in liberalizing global trade and investment have generated important benefits for the American people, in the form of stronger growth and improved employment opportunities. The opportunity to acquire goods and services from abroad both encourages us as producers to stay competitive and allows us as consumers to raise our standard of living. In the 1990s, openness to trade and investment, combined with U.S.-led liberalization of world markets, has been essential to our economy's sustained expansion.

This contemporary picture of a prosperous America in an increasingly open world economy contrasts powerfully with the economic climate and international trade policies that prevailed at home and abroad some six and a half decades ago. In the early 1930s widespread isolationism had reduced world trade to a level only one-third that of 1929. Fortunately the Nation's leaders of that era saw that the path of economic isolation and tit-for-tat protectionism had no exit. During the 1930s and after, the Administration and the Congress worked together, through such measures as the Reciprocal Trade Agreements Act of 1934, the precursor of later fast-track legislation, to revive international trade, just as the programs of the New Deal worked to restart the domestic economy. World War II disrupted these early efforts, but after the war the U.S.-led campaign to open markets worldwide enjoyed a series of outstanding successes. Those countries that joined us in welcoming market opening, in particular through participation in the General Agreement on Tariffs and Trade, have grown and developed at impressive rates. True, these countries might have experienced growth even without open markets, but the history of this century has made it increasingly clear that strong growth is more likely in open than in closed economies.

Bearing this history in mind, this Administration's strategy for economic growth includes a campaign to foster the continued liberalization of markets worldwide. Although much has been accomplished in the postwar period, much remains to be done. As the United States currently enjoys the benefits of relatively open markets at home, this campaign reflects an export-driven agenda aimed

at opening markets abroad, reducing current asymmetries in countries' openness. This chapter surveys the primary elements of this campaign. It also reviews the impact that international trade has had on national economies including our own and on the distribution of the benefits of trade within economies (especially among workers). This discussion underscores the need for a strong commitment to trade liberalization not only by the United States, but by all of our trading partners. The chapter concludes with a presentation of recent developments in a second important dimension of open international markets, namely, foreign direct investment, and discusses the implications of the growth of U.S. direct investment abroad and of foreign investment in the United States. The chapter begins, however, with a review of recent trends in U.S. trade.

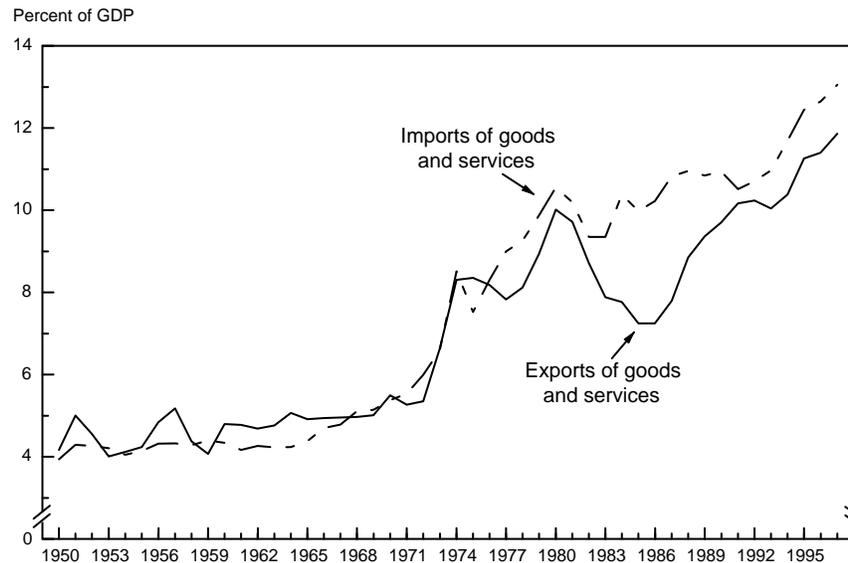
### TRENDS IN U.S. INTERNATIONAL TRADE

The role of international trade in the U.S. economy today is unprecedented. Until 1970, U.S. exports and imports combined rarely amounted to more than one-tenth of gross domestic product (GDP; Chart 7-1). Since 1970, the real volume of trade has grown at more than twice the rate of output, so that by 1997 exports alone were 12 percent of GDP, and imports were equivalent to 13 percent.

Yet trade remains a much smaller component of the U.S. economy than in most countries: in 1995 only four countries had smaller ratios of

Chart 7-1 **Exports and Imports as a Percent of GDP**

Trade is an increasingly important component of the U.S. economy, although close to nine-tenths of U.S. expenditure is still on domestic goods and services.



Source: Department of Commerce (Bureau of Economic Analysis).

trade to GDP than the United States. This does not reflect high U.S. trade barriers, but rather such factors as the size of our economy and the diversity of our endowments, which favor self-sufficiency, and our geographic location, relatively distant from most trading partners. Estimates that adjust for such factors have often found that the United States is more open to imports than are most other major countries. But the point remains that the United States feels the effects of trade and pressures for globalization much less than do most other countries.

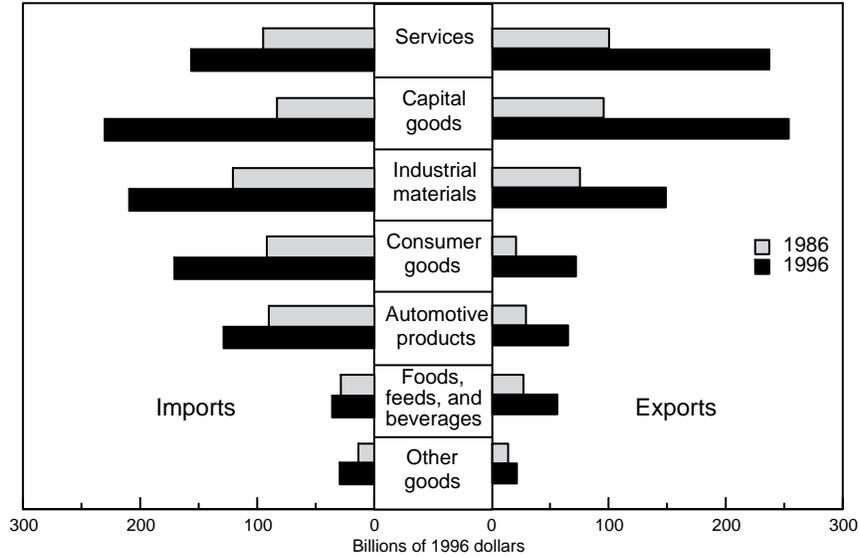
The rising importance of trade in the U.S. economy is part of a worldwide phenomenon. Technological advances in transportation and communications have contributed to a rapid expansion of the global exchange of goods and services. There is also strong evidence that policy reforms in many countries, in particular the removal of trade barriers and other protectionist measures, have played a significant role in this explosion of trade. The history of the United States during the interwar period points to the importance of policy in stimulating or inhibiting trade. In the years between 1920 and 1930, technological progress continued, but policy moved in a different direction: average U.S. tariff rates more than doubled. The fact that the volume of trade in those years fell by half rather than rose reveals the important role that government policies can play.

#### THE SECTORAL COMPOSITION OF U.S. TRADE

The composition of U.S. trade, both exports and imports, has also changed markedly. Exports of services have enjoyed particularly strong growth in recent years, rising from \$48 billion (18 percent of total exports) in 1980 to \$237 billion (28 percent) in 1996. Over the same period exports of agricultural merchandise have risen only from \$42 billion (15 percent of the total) to \$61 billion (7 percent). In part these trends reflect Engel's law (as the incomes of households rise, the share devoted to food falls) and the evolution of U.S. comparative advantage in more skill-intensive goods and services. But the impact of market opening may be discerned in these trends as well. Innovations in global communications infrastructure and the liberalization of services trade in many countries have promoted greater trade in services. Large tariff reductions on manufactured products, negotiated in a series of rounds within the General Agreement on Tariffs and Trade (GATT), have lowered export costs in that sector. However, agriculture remains relatively protected in most countries.

Exports of both consumer and capital goods have enjoyed rapid sustained growth since the 1980s (Chart 7-2). These two sectors also represent the fastest-growing components of U.S. imports. But whereas growth in exports of these goods has tended to occur relatively evenly across industries, growth of imports has been more concentrated, with especially dramatic increases in such categories as computer goods.

**Chart 7-2 U.S. Exports and Imports by Category in 1986 and 1996**  
 Both exports and imports, most notably in services and in consumer and capital goods, have grown rapidly, due in part to market opening.



Sources: Department of Commerce (Bureau of Economic Analysis) and Council of Economic Advisers.

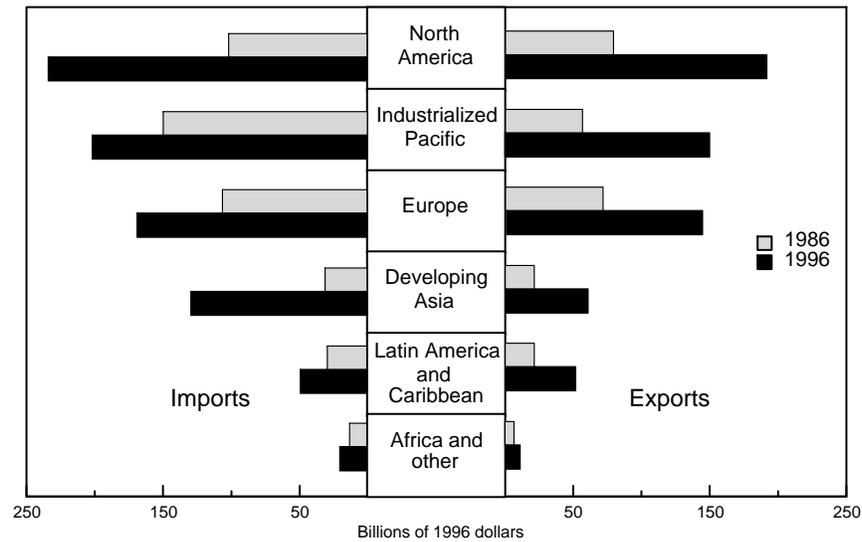
The fact that growth is occurring in both imports and exports of consumer and capital goods may seem contrary to the conventional logic of international trade theory, which is based on specialization according to countries' comparative advantage. In fact, this trend reflects the changing nature of trade. Imports and exports today often grow in tandem even within very narrowly defined product categories: that is, an increasing share of trade is intraindustry rather than interindustry. In 1996, for example, 57 percent of U.S. trade occurred within, rather than between, four-digit SITC commodity groupings (the SITC is a standard classification of goods in international trade; four-digit categories in this system represent highly disaggregated product groups), and this share has risen from 51 percent in 1989. Whereas interindustry trade (for example, the exchange of Chinese sweaters for U.S. computers) is associated with traditional notions of comparative advantage, intraindustry trade (for example, in automobiles and auto parts) is thought to arise principally from fixed costs in production and consumer tastes for variety.

#### THE GEOGRAPHIC COMPOSITION OF U.S. TRADE

Canada and Japan remain the United States' leading trade partners, together accounting for one-third of both our exports and our imports. In recent years Mexico and China have risen quickly to the third and fourth positions; together they represent about 13 percent of total U.S. merchandise trade. When trade is broken down by world region, Europe represents one-fifth of both U.S. exports and imports

(Chart 7-3). The Asia-Pacific region has experienced an explosion in growth of both trade and output over the past two decades and now accounts for more than one-third of total U.S. trade. This trade is principally with other industrial countries, although trade with developing economies in the region is also among the fastest growing anywhere. Trade with Latin America and the Caribbean is also growing but remains less than 10 percent of the total.

Chart 7-3 **U.S. Goods Exports and Imports by World Region in 1986 and 1996**  
Imports from developing Asia have risen rapidly, but are less important than growing exports and imports with industrialized partners.



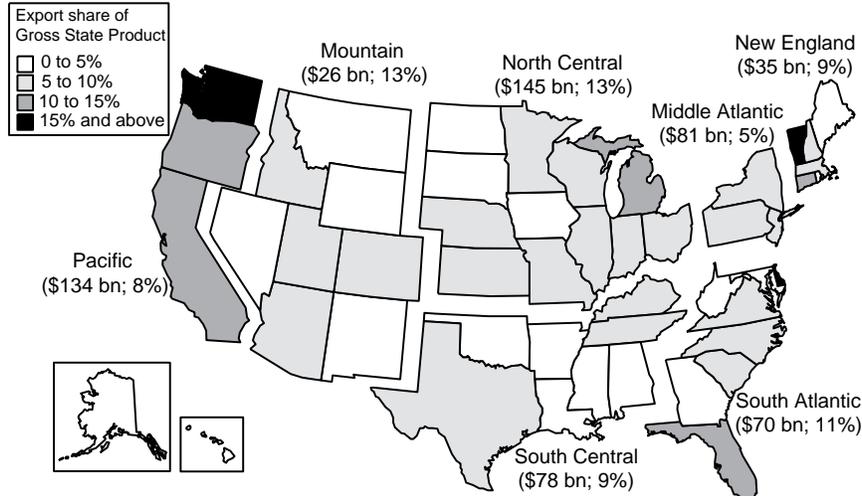
Note: Industrialized Pacific includes Australia, Japan, Hong Kong, Korea, Singapore, and Taiwan.  
Sources: Department of Commerce (Bureau of Economic Analysis) and Council of Economic Advisers.

## U.S. TRADE BY DOMESTIC REGION

In a country as large as the United States, the regional distribution of the gains from trade is a relevant concern. The North Central and Pacific States remain the largest sources of exports, and both regions continue to enjoy strong export growth (Chart 7-4). However, the highest rates of export growth have recently been recorded in regions and States in the center of the country. This is a positive sign, suggesting that the benefits of trade are being realized throughout the country, not just in the coastal and border States. The impact of the North American Free Trade Agreement (NAFTA) on regional trends in production and exporting has no doubt been significant and may be partly responsible for the rapid growth in exports from the Mountain, Southern, and North Central regions. These statistics suggest that the export opportunities presented by market-opening agreements can benefit the Nation as a whole.

**Chart 7-4 Exports of Goods by U.S. Region**

Although exports are a larger share of Gross State Product on the East and West Coasts, the fastest growth in exports has come from the central regions of the country.



Note: The first number in parentheses is 1996 goods exports in billions of dollars; the second is average annual growth in exports in the region over 1991-1996.  
Sources: Department of Commerce (Bureau of the Census and Bureau of Economic Analysis) and Council of Economic Advisers.

## INITIATIVES IN MARKET OPENING

This Administration's primary focus in its conduct of international economic relations is on the continued opening of markets worldwide to trade. However, experience has shown that there is no universal solvent for trade barriers: no single strategy works in all situations to open foreign markets. Accordingly, the Administration has pursued an active trade liberalization agenda on several fronts. While recognizing the importance of an internationally coordinated effort to reduce trade barriers on a broad multilateral and reciprocal basis, the Administration is supplementing these negotiations with liberalization efforts at the regional level. In addition, since market access impediments may be peculiar to a single country, and may not be of the type traditionally dealt with in a multilateral forum, the United States sometimes needs to pursue bilateral negotiations to remove these obstacles to trade.

As this brief survey shows, the Administration is pursuing greater market access for both U.S. and other countries' exports in a number of arenas. The importance of this undertaking is highlighted by the extent to which large portions of the world economy have previously been exempt from formal negotiations. Although the trade-liberalizing initiatives described above are generally reciprocal in nature, they tend to lower foreign barriers more than they do our own. This is the result of the relatively open position taken by the United States

throughout most of the postwar period, which has resulted in U.S. barriers that are already lower on average than those of our major trading partners. What is more, the United States has led the way toward the deregulation of domestic industries. In many cases this earlier deregulation in the United States has produced highly competitive U.S. industries, well poised to benefit from deregulation abroad.

## TRADE-NEGOTIATING AUTHORITY

The U.S. Constitution places ultimate authority to regulate international trade with the legislative branch. However, for the better part of this century the Congress has provided the executive branch considerable authority to negotiate trade agreements with foreign nations. Most recently, between 1974 and 1993, the Congress repeatedly passed legislation giving the President so-called fast-track negotiating authority. This legislation allows the President to negotiate sensitive and complex trade agreements with other countries, and commits the Congress to either accept or reject the entire agreement, without amendment. In this way the Congress retains its constitutionally mandated final authority to regulate international trade, while turning over the task of negotiating agreements to the executive branch, which is organizationally better suited for that role.

Fast-track authority lends credibility to U.S. commitments in trade negotiations. Foreign parties to a trade agreement with the United States know that the agreed-upon package cannot later be reopened for renegotiation of individual provisions, which in effect would reopen the entire package, undermining commitments made by executive branch negotiators. In the absence of fast-track authority, this possibility is real and can have the effect of preventing other countries from engaging in negotiations with the United States.

The history of executive branch trade-negotiating authority has its roots in the 1930s, a time when international trade flows were heavily restricted by high tariffs throughout much of the world. The Congress granted President Franklin D. Roosevelt power to negotiate tariff reductions. This shift in authority came in the form of the Reciprocal Trade Agreements Act (RTAA) of 1934, which allowed the President to reduce U.S. tariffs on a bilateral basis by up to 50 percent in exchange for reductions in barriers faced by U.S. exports. The RTAA was used often in the 1930s and was repeatedly renewed. The resulting agreements generated large reductions in tariff barriers and embodied some of the same principles that formed the basis for GATT after World War II and, more recently, the World Trade Organization (WTO).

Under the RTAA and later under GATT, tariffs of participating countries were reduced from more than 40 percent in the 1930s to less than 6 percent by the late 1980s. By the 1960s negotiations had expanded to cover nontariff barriers (NTBs) to trade as well. These

include price controls, quantitative restrictions (such as import quotas), and quality control measures. But because the RTAA provided no authority to reduce these barriers, complications arose in congressional ratification of the Kennedy Round GATT agreement in the late 1960s. The Congress's refusal to implement the entire agreement as negotiated undermined the credibility of the President's negotiating efforts. The Nixon Administration confronted this problem by pursuing expanded negotiating authority prior to undertaking a round of negotiations in which nontariff barriers figured prominently.

For this reason, in 1974 the Congress passed the first fast-track legislation. The primary difference between this new authority and that granted under the RTAA was that fast-track extended presidential authority to agreements covering NTBs as well as tariff barriers. Fast-track bills have also generally called for extensive consultations between the executive branch and both houses of the Congress and with private sector advisory committees during the negotiations. The Congress must also be notified in advance of the intention to conclude an agreement. In return, the Congress promises to introduce the implementing bill in both houses, with language unchanged, and to vote on the unamended bill within 60 days. Through these provisions, the Congress has historically exerted influence over the negotiations—and hence over the resulting agreements—prior to submission of the implementing legislation. Fast-track has thus proved successful at facilitating negotiations while keeping the Congress involved in the process and preserving its ultimate authority to regulate trade.

Since the inception of fast-track, two extremely successful rounds of GATT negotiations have taken place: the Tokyo Round, signed by WTO members in December 1979, and the Uruguay Round, concluded in 1993 and signed in April 1994. Agreements resulting from other negotiations have also been approved by the Congress under fast-track procedures, including the free trade agreement with Israel in 1985, the U.S.-Canada Free Trade Agreement in 1988, and the North American Free Trade Agreement in 1993.

## MULTILATERAL INITIATIVES

By the conclusion of the Uruguay Round negotiations, participants recognized that pursuing multilateral liberalization exclusively in the context of negotiating “rounds” was insufficient. Thus, the final Uruguay Round agreement included a “built-in agenda” for future, more focused talks within the WTO. This agenda provides a mandate and an opportunity to continue the liberalization process within the new organization's regular work program. In some cases the built-in agenda calls for the review and updating of the rules of the multilateral system, including its dispute settlement mechanism (Box 7-1); in other areas the goal is the further opening of markets and the reform or elimination of practices that distort or restrict trade. In the few years since the Uruguay Round agreement was concluded, negotiations toward further

liberalization have occurred—or are occurring—in several sectors. Some of these negotiations were launched as a result of commitments contained within existing WTO agreements. Others are the result of forward-looking initiatives given impetus by the United States and its trading partners within the Asia-Pacific Economic Cooperation (APEC) forum and other international organizations.

**Box 7-1.—The WTO Dispute Settlement Process and U.S. Trade Policy**

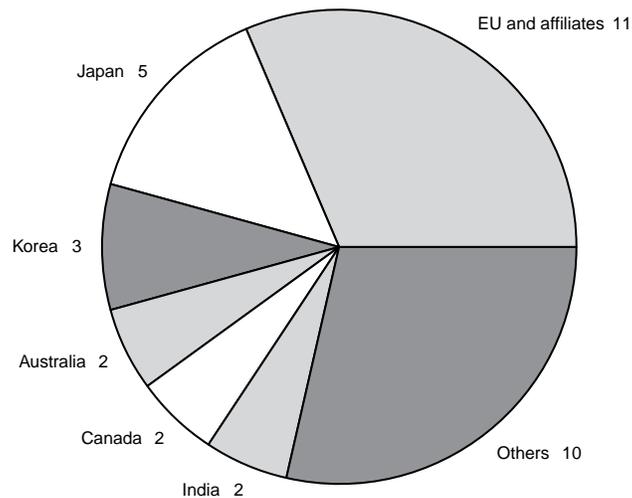
The WTO Dispute Settlement Understanding (DSU), part of the Uruguay Round package of agreements, improves on GATT dispute settlement proceedings by expediting decisionmaking and instituting an appeals process. It also establishes procedures to ensure the implementation of dispute panel rulings, one of which is the acceptance of cross-sector retaliation for countries that choose not to abide by the ruling. In the 3 years since its institution, many countries have made efficient use of the reformed dispute settlement mechanism, largely to the satisfaction of all involved.

The introduction of a strengthened multilateral dispute settlement system in the WTO, together with new WTO agreements covering the protection of intellectual property rights and trade in services, has brought about a shift in U.S. tactics for resolving trade disputes. During the 1980s the United States frequently resorted to the bilateral negotiations and unilateral sanctions authorized in Section 301 of U.S. trade law to resolve differences with other countries. This approach was used in particular in the areas of agriculture, intellectual property protection, and services, which GATT covered barely or not at all. Beginning in 1995, however, the DSU and new WTO rules have permitted the United States to use multilateral dispute settlement procedures to address the overwhelming majority of issues that have been the subject of Section 301 investigations. The results of 35 complaints filed by the United States suggest that the DSU process has proved very effective, with the United States prevailing in 9 out of 10 rulings to date. The United States has also reached a bilateral settlement prior to a formal ruling in eight cases. Seventeen petitions are still pending. Section 301 investigations can now more often make use of multilateral dispute settlement, at least for disputes with WTO members in areas subject to WTO commitments. All nine of the Section 301 investigations initiated during 1996, and three of the six investigations initiated in 1997, have involved resort to the WTO dispute settlement procedures; a fourth was terminated before WTO consultations were initiated. As Chart 7-5 shows, the DSU process has been used against a variety of countries, the majority of which are our major trading partners.

### *The Success of Single-Sector Initiatives*

The success of multilateral negotiations in the 4 years since the Uruguay Round ended has in some ways been remarkable. The traditional practice of conducting negotiations in comprehensive, multisector rounds had been based on the belief that only an agreement covering many sectors simultaneously could gain enough political support to be viable. Usually when two or more countries seek reciprocal trade liberalization, the easiest approach is to find one sector that is heavily protected in one country and another sector that is heavily protected in the other. By agreeing to liberalize both sectors simultaneously, each country can please at least one group of domestic producers.

Chart 7-5 **U.S.-Initiated WTO Dispute Settlement Cases by Target Country**  
Since their inception in 1995, the WTO dispute settlement procedures have been broadly used by the United States.



Source: Office of the U.S. Trade Representative.

However, recent WTO agreements in financial services, telecommunications, and information technology represent significant departures from this traditional negotiating format, in that each sector was negotiated separately from the others. Because the United States is believed to be highly competitive in all three of these sectors, one would have thought that U.S. concessions in some other sector would be necessary to reach an agreement. But a common element in all three sectors is that they are key inputs into production in other sectors, and are necessary for economic development and profitable participation in an advanced, information-driven global economy. Industrialists in emerging-market countries, for example, understand that a modern telecommunications infrastructure is

essential to economic development. Hence, liberalization of these sectors enjoys weighty domestic support in most countries, so that cross-sector tradeoffs proved unnecessary. As transportation services are also important inputs to trade and production in the modern global economy, it is hoped that the future resumption of single-sector negotiations in this area will bear fruit. Other sectors slated for individual negotiation under the built-in agenda are agriculture and government procurement.

### *Services*

Two of the new WTO agreements—those in financial services and telecommunications—deal with trade in service industries. For most of its history GATT did not cover trade in most types of services. Thus the conclusion of a new General Agreement on Trade in Services (GATS) was an important contribution of the Uruguay Round. The new agreement made it possible for the first time to undertake the negotiations that led to the recent financial services and telecommunications agreements, and should eventually lead to the liberalization of other services.

GATS provides for the first time a solid framework of trading rules and obligations for services and the continued expansion and refinement of those rules in multilateral negotiations. However, the pledges from WTO member countries within GATS itself to liberalize their services sectors are fairly narrow in scope. Out of some 150 individual service activities identified, most countries have committed themselves to liberalize fewer than 100. Moreover, most of these commitments are in services where countries have either little domestic production or little domestic protection. Although it is typical in trade negotiations for countries to liberalize first where the domestic impact is smallest, in this case it means that GATS as written falls well short of comprehensive liberalization. This was acknowledged by the signatories at the time. They therefore included in the agreement specific deadlines for future negotiations in key areas. Some success has been achieved in financial services and telecommunications; the maritime negotiations, on the other hand, have been suspended until more comprehensive services negotiations take place in 2000.

*Financial services.* Multilateral negotiations on a broad range of financial services resumed in April 1997. (An earlier attempt had ended in 1995 with only an interim solution, as the United States had found some other countries' offers inadequate.) In continuing these negotiations, the United States emphasized the need for agreement on four principles. Foreign-based firms should be assured of retaining any rights they had acquired prior to the agreement, of the right to establish new operations, of the right of full majority ownership, and of substantially full national treatment (that is, legal and regulatory treatment equivalent to that received by domestic firms).

These talks were successfully concluded on December 13 and produced agreement among 102 WTO member countries on broad liberalization of their banking, securities, insurance, and financial data services sectors. The commitments apply to about \$18 trillion in global securities assets, \$38 trillion in global bank lending, and about \$2.2 trillion in worldwide insurance premiums.

*Telecommunications.* On February 15, 1997, the United States and 69 other WTO members successfully concluded negotiations on basic telecommunications services, such as telephone service. The agreement commits countries to provide market access and national treatment to service suppliers from other WTO members. Sixty-five countries also agreed to a set of specific procompetitive regulatory principles. The agreement eliminates certain restrictive practices in countries that account for 95 percent of world telecommunications revenues, estimated at about \$600 billion in 1996. Before the agreement, activities representing only 17 percent of telecommunications revenues in the top 20 markets were open to U.S. companies. The opening of these markets to foreign providers offers enormous opportunities for U.S. telecommunications firms. Whereas telecommunications markets in many countries continue to be served by inefficient government monopolies, markets in the United States have been largely deregulated. Deregulation, along with a large internal market, has resulted in a position of competitive advantage and technological leadership in this area for U.S. suppliers.

### *Information Technology*

Information technology products are often “enablers” for the efficient production of goods in other sectors. Liberalization of this sector therefore takes on added importance as a source of growth worldwide. Concluded in Singapore in December 1996, the Information Technology Agreement (ITA) will liberalize trade in this half-trillion-dollar market. The agreement covers global information technology products such as semiconductors, telecommunications equipment, computers and computer equipment, and software. Signatories include countries accounting for over 90 percent of trade in this sector. The agreement also covers office machines and unrecorded electronic media (such as computer diskettes and CD-ROMs). Each of the 43 participating countries has agreed to eliminate tariffs on these products by 2000, although some countries were granted an extended phaseout of tariffs for a limited number of products. The agreement will benefit all the countries participating, but it is especially important for the United States as a major exporter of information technology products. The ITA also calls for further negotiations to extend country and product coverage and eliminate NTBs under an expanded agreement, dubbed ITA-II. These negotiations are scheduled to conclude by the summer of 1998.

### *Agriculture*

Some agricultural tariffs were reduced in various GATT negotiations over the decades, but as in the case of services, comprehensive agricultural trade barriers only recently became a central focus of GATT talks. The result was the historic Uruguay Round Agreement on Agriculture, the first comprehensive agreement to reduce barriers to trade in agriculture. Among other commitments, the agreement specifies cuts in agricultural export subsidies, reduces aggregate support to farmers, converts NTBs to tariffs, binds all tariffs at levels that imply reductions in previously existing tariffs, and provides for minimum access quotas for products whose trade had been largely eliminated by past protection. Reflecting a general interest in further liberalization, agricultural negotiations are a part of the WTO's built-in agenda, with talks scheduled to resume by January 2000.

### *Government Procurement*

Government procurement and contracting account for up to 15 percent of economic activity in some countries, yet are often subject to policies that discriminate against foreign suppliers. Many countries maintain explicit preferences for goods and services provided by domestic firms over those from foreign competitors. Bias toward domestic producers can manifest itself in many other subtle ways, for instance in limited advertising for bids and a reluctance to spell out selection criteria in advance. Governments may also specify contracts in terms of a certain process or method rather than in terms of the final product. Different firms often develop products that serve the same purpose, but by different processes. If only domestic firms use a particular process, and foreign firms another, governments can in effect exclude foreign suppliers by specifying that process.

Government procurement has historically been excluded from international trade rules; the nondiscrimination principles contained in the original GATT of 1947 do not apply. To address this situation, a group of countries consisting principally of members of the Organization for Economic Cooperation and Development (the OECD, which is composed mainly of high-income industrial countries) negotiated the 1979 GATT Agreement on Government Procurement during the Tokyo Round of multilateral trade negotiations. That agreement was renegotiated and expanded during the Uruguay Round, and the resulting WTO Agreement on Government Procurement (GPA) went into effect on January 1, 1996. The GPA requires signatories to accord nondiscriminatory treatment to the goods and services, including construction services, of other signatories and to follow transparent government procurement procedures. The agreement presently applies to government purchases estimated to be worth over \$400 billion annually.

Although the GPA was a significant achievement, only 26 countries participate in it, most of them OECD countries; many of the world's emerging markets in Asia, Latin America, and elsewhere are not signatories. Given the size of the worldwide market (with an estimated value over \$3.1 trillion) and its importance for U.S. exporters, the United States has long sought to extend rules on government procurement to all participants in the multilateral system. Largely at the United States' urging, WTO members agreed in 1996 to establish the WTO Working Group on Transparency in Government Procurement. Formal negotiations are scheduled to begin by January 1999.

## REGIONAL INITIATIVES

During the 1980s the United States turned an eye toward bilateral and regional liberalization initiatives, not with the purpose of supplanting the multilateral talks, but rather to supplement and spur progress on that front. Regional agreements can be beneficial, but they raise some valid concerns: although such agreements can generate new trade by lowering barriers between participating countries, they may also inefficiently divert trade from nonparticipants that would otherwise supply goods and services more cheaply. From the participants' perspective, whether the benefits of trade creation outweigh the costs of trade diversion depends on how the agreement is structured. There are reasons to believe trade creation will predominate when the agreement encompasses countries that geography has made natural trading partners: when costs of transportation are included, countries in close proximity are more likely to be each other's low-cost suppliers, minimizing the scope for trade diversion. But for countries on the outside, regional agreements are more likely to impose costs than provide direct benefits.

Sometimes regional agreements can exert a positive influence on the multilateral process (Box 7-2) or support the participants' foreign policy positions. For example, the benefits for the United States of the free trade agreement with Israel, negotiated in 1985, were more symbolic than economic. The agreement reinforced political ties between the two countries, and Israel did reap important economic benefits from it as well. Similarly, although economic motivations were significant in the formation of what is now the European Union, a contributing factor was the desire to engender a sense of community that might prevent another intra-European war. The promotion of democracy and political stability as well as economic stability and development is also a factor in the Free Trade Area of the Americas initiative, discussed below.

In the last 10 years the United States has initiated and signed a number of important regional initiatives. The agenda for the remainder of this century and beyond includes laying the foundation for open trade in the Americas as well as moving toward expanded trade throughout the Pacific Rim.

**Box 7-2.—Regional Trade Agreements: Building Blocks or Stumbling Blocks for the Multilateral Process?**

Does regionalism accelerate or slow the momentum of multilateral liberalization? Some compelling arguments suggest that the formation of regional blocs can serve as a building block—or act as a stumbling block—to the multilateral process.

Perhaps the most compelling theoretical argument for protectionism—and the primary mechanism by which regionalism might act as a stumbling block—is the optimal tariff argument. Imposing tariffs may enable a country to exploit some monopoly power in its import markets, and so achieve more favorable terms of trade with the rest of the world. Moreover, a group of countries setting this optimal tariff in concert may have more success, because of their combined market power, than if each acted alone. Fortunately, Article XXIV of GATT, which governs regional trading arrangements among members, prohibits increases in tariffs against nonparticipants. (GATS now extends the same principle to services.) A regional trading arrangement may also undermine the multilateral process if special interests can manipulate the arrangement's more technical aspects (such as exemptions, phaseouts, and rules of origin) to their advantage, or if regional initiatives divert political capital and energy from multilateral initiatives.

On the other hand, regional arrangements can serve as building blocks for multilateralism in several ways. They can lock in countries' unilateral reforms, simplify negotiations by reducing the number of countries involved, and set in motion a process of competitive liberalization in which reluctant countries are prodded into liberalizing by the threat of exclusion from a regional agreement.

The history of NAFTA provides an example of how regionalism can lock in reforms. By entering into NAFTA, the then-President of Mexico hoped to prevent his successors from undoing the unilateral liberalizations his government had undertaken since the mid-1980s. Mexico's reaction to the peso crisis of 1994-95 showed that this lock-in strategy worked. Unlike in the 1982 debt crisis, when Mexico raised trade barriers against all its trading partners, in the 1994-95 crisis Mexico continued to reduce tariffs for its NAFTA partners (while raising tariffs against some other countries).

Negotiating with 150 other countries over dozens of sectors, as WTO negotiators must do, can be inefficient and difficult. The process can be made more efficient if countries can join into customs unions and thus negotiate as a larger unit. Also, within

**Box 7-2.—*continued***

such a group it may be easier to test out innovative agreements in certain areas—such as services, investment, dispute settlement, and competition policy—before introducing their provisions into the multilateral negotiations.

The events of 1993 demonstrate the power of competitive liberalization. The Administration is said to have made a “triple play” that year, with the passage of NAFTA, the pathbreaking APEC summit, and the conclusion of the Uruguay Round. These not only were landmark achievements in themselves but interacted with each other in advantageous ways. By pushing NAFTA through the Congress despite strong opposition, the President revealed the political will to make free trade commitments stick. Combined with the upgrading of APEC negotiations to a high-profile leaders’ meeting in Seattle, the passage of NAFTA sent a strong signal to the Europeans that the United States had serious regional alternatives should the Uruguay Round of GATT negotiations fall apart. German policymakers have reportedly stated that this was part of their motivation for prevailing on their EU partners to make certain concessions that allowed the GATT negotiations to be successfully concluded in December 1993.

These examples show that there are both positive and negative links between regionalism and the multilateral negotiations. Every regional bloc will have its share of each. In the end, however, the evidence suggests that the recent growth of regionalism has served more to foster than hinder progress toward liberalization. Those groups of countries that have participated in regional liberalization have often tended to reduce their barriers against nonmembers at the same time that they do so internally.

*The Free Trade Area of the Americas*

The idea of a free trade area encompassing all of the Americas took its first step toward realization in December 1994, when the President of the United States and leaders of 33 other Western Hemisphere countries met in Miami for the first hemispheric summit since 1967. There they committed their governments to concluding the negotiation of a comprehensive free trade agreement no later than 2005, with concrete progress due by the end of the century. The Miami Summit led to three meetings of the countries’ trade ministers, at which 12 working groups were established to lay the foundation and begin preparations for actual negotiations toward a Free Trade Area of the Americas (FTAA).

The United States has championed this regional initiative and remains actively engaged in it, as a means of fostering closer political and economic ties with and further trade liberalization in our hemispheric neighbors. Building on unilateral liberalizations undertaken in the late 1980s, many Latin American countries have already negotiated preferential trading arrangements with each other. Examples include MERCOSUR (which includes Argentina, Brazil, Paraguay, and Uruguay), the revitalized Central American Common Market, and the Andean Community. Their dismantling of trade barriers, both unilaterally and in the context of regional agreements, reflects a significant shift away from traditionally inward-oriented trade policies toward more liberalized regimes. Although generally reflective of progressive policy programs, the preferential nature of these arrangements is of concern to the United States, because it means that other countries are gaining favored access to some of our most natural trading partners. As these arrangements proliferate, the potential benefits to the United States of participating in them—and the costs of remaining outside—are rising. Chile, for example, is now linked in preferential trading agreements with every major country in the hemisphere except the United States. For this reason, U.S. exports to Chile remain subject to tariffs averaging 11 percent, while exports from other Western Hemisphere countries increasingly enjoy duty-free access. Although Chile is only one country, it is a salient example of a growing trend.

An FTAA will bring substantial benefits to all countries in the region, which had a combined GDP of over \$9 trillion and a market of 756 million people in 1995. These benefits include not only a significant reduction of import barriers but also deeper geopolitical ties. The general lowering of trade barriers will be particularly beneficial to the United States, since our market already is much more open than most. Although this benefit could in principle be achieved through the multilateral process, regional action probably offers more immediate and complete liberalization.

### *Asia-Pacific Economic Cooperation*

Created in 1989, the APEC forum began to take on deeper significance in November 1993, when the President hosted the first-ever summit of the leaders of the member countries, in Seattle. This meeting elevated the importance of the organization and set the stage for a second summit, in Bogor, Indonesia, in 1994. There the leaders announced the goal of achieving “free and open trade and investment in the region” by 2010 for the developed-country members and by 2020 for the developing countries in the group (Box 7-3). In Osaka, Japan, the following year, an agenda was laid out for achieving that goal, and in 1996, in discussions at Subic Bay in the Philippines, implementation of the agenda got under way. The most immediate

result of the Subic Bay meeting was a call by the APEC leaders for the elimination of all tariff barriers among member countries to trade in the information technology sector. This declaration laid the foundation for the Information Technology Agreement described above.

**Box 7-3.—APEC Tariff Reductions and Other Initiatives**

Although APEC members have not yet engaged in formal negotiations over tariff reductions, many have already implemented dramatic reductions in their tariff levels. Between 1988 and 1996 the average applied tariff among APEC members fell by more than a third, from 15.4 percent to 9.1 percent (Table 7-1).

The progressive lowering of tariff barriers is only one aspect of the APEC Action Agenda. This agenda details steps that APEC members have agreed to take to promote greater economic interaction throughout the region. Other agenda items include reducing barriers to competition in the fast-growing air transport market, and a variety of measures designed to reduce the cost of doing business in the region. These include the development of an infrastructure opportunity data base, the promotion of uniform customs classifications and procedures, and advances in the harmonization of standards.

TABLE 7-1.—*Tariff Rates of Asia-Pacific Economic Cooperation Members*  
[Percent, simple average]

Economy	1988	1996
Australia.....	15.6	6.1
Brunei .....	3.9	2.0
Canada .....	9.1	6.7
Chile .....	19.9	10.9
China .....	40.3	23.0
Chinese Taipei (Taiwan).....	12.6	8.6
Hong Kong.....	.0	.0
Indonesia.....	20.3	13.1
Japan .....	7.2	9.0
Malaysia .....	13.0	9.0
Mexico .....	10.6	12.5
New Zealand.....	15.0	7.0
Papua New Guinea .....	( <sup>1</sup> )	( <sup>1</sup> )
Philippines.....	27.9	15.6
Singapore .....	.4	.0
South Korea.....	19.2	7.9
Thailand .....	40.8	17.0
United States.....	6.6	6.4
Average.....	15.4	9.1

<sup>1</sup> Not available.

Sources: Institute for International Economics.

Fundamental to relations within APEC is the pledge of “open regionalism.” APEC seeks to serve as a building block to the multilateral system of liberalization and not a stumbling block. As a start toward implementing this vision, in November 1996 APEC served as a catalyst for the ITA. APEC members are engaged in a process that builds upon the success achieved in the ITA. At the most recent summit, in November 1997 in Vancouver, Canada, the APEC leaders agreed to expand APEC’s role as a catalyst for global market opening, by endorsing liberalization initiatives in 15 sectors. Among these are environmental services and technology, medical equipment and instruments, and chemicals—sectors in which the United States is a major exporter. APEC will thus capitalize upon the fact that its collective size and importance in world trade will help in leveraging multilateral agreements that will cut trade barriers globally. The leaders’ decision recognizes the importance of taking APEC sectoral initiatives into the WTO where appropriate, and including binding global agreements, as was done with the ITA.

With its member countries now accounting for approximately half of world output and trade, the APEC region has grown in significance for the United States. Already the share of U.S. exports going to APEC members has increased from 52 percent in 1986 to 70 percent in 1996. APEC is also demonstrating its importance in other ways: in November 1997 APEC leaders embraced a strategy for dealing with the ongoing currency crisis in East Asia.

## BILATERAL INITIATIVES

As successful as these multilateral and regional initiatives have been, significant barriers to U.S. exports remain, in some countries more than others. The reduction of formal barriers to trade worldwide often exposes cross-country differences in institutions and norms that also serve to limit trade. To the extent these practices are country-specific, it is sometimes easier to address them on a bilateral rather than a multilateral or regional basis. This Administration has a record of actively pursuing remedies to trade barriers abroad. These efforts are designed not only to liberalize markets for American products, but to provide broad market access for all would-be exporters.

### *China*

China is the world’s 10th-largest trading nation and the United States’ fourth-largest trading partner. U.S. exports to China have nearly quadrupled in the last decade. However, China’s wide array of barriers to trade, together with the relocation of the source of many of our imports to China, has resulted in a U.S. trade deficit with China of over \$39.5 billion in 1996, an increase of more than \$5.7 billion from 1995. Trade data from 1996 show that, when both goods and services are included, our recorded deficit with China exceeds our

deficit with Japan. U.S. exports to China grew a slight 8 percent in 1997 (through November), compared with 21-percent growth in U.S. imports from China. Further opening the Chinese market to our exports is an important goal of U.S. bilateral and multilateral negotiations with China.

Negotiating the terms of China's accession to the WTO is a major part of the Administration's effort to address this trade imbalance. The focus of the WTO access negotiations rests on opening China's market to foreign goods and services and bringing China's trade regime into conformity with international trade rules. The United States is also pursuing an active bilateral agenda with China to resolve outstanding issues ranging from market access for U.S. agricultural exports (including citrus, wheat, and meat) to protection for intellectual property rights.

### *European Union*

The trading relationship between the United States and the European Union is important and strong, but it has had its frictions. The U.S.-EU Agreement on Mutual Recognition of Product Testing or Approval Requirements, concluded in June 1997, is evidence of this strength. When fully implemented, the agreement will require each government to recognize the results of product testing and certification requirements set by the other, thus eliminating the need for duplicative testing, inspection, and certification requirements for products in trans-Atlantic trade. The agreement reduces trade barriers in six areas—telecommunications, medical devices, electromagnetic compatibility, electrical safety, recreational craft, and pharmaceuticals—covering approximately \$50 billion in two-way trade. The agreement will allow products and processes to be assessed in the United States for conformity to European standards, and vice versa, saving U.S. exporters more than a billion dollars annually.

In recent years, however, longstanding divides between the United States and the European countries have reemerged, along with new areas of disagreement. In 1997 alone the United States has had to deal with disputes resulting from decisions made and deadlines set by the European Commission. The first involved a European ban on products made with so-called specified risk materials; these are foodstuffs that the European Union considers potentially contaminated with the agent that causes bovine spongiform encephalopathy, or mad cow disease. The other disputes involved restrictions on the imports of furs obtained through the use of leghold traps, the biogenetic alteration of corn, and the process by which wine for export to Europe is made. The fur dispute was resolved by an agreement to phase out the use of certain traps in the United States; the other issues remain outstanding.

## *Japan*

Japan is our second-largest trading partner. Our two countries share a long history of negotiated access to the Japanese market for U.S. goods. A series of agreements have sought to address a range of structural features of the Japanese economy that act as market access barriers; these include closed distribution systems, overregulation, lack of transparency in procurement practices, and exclusionary business practices. In addition, the two countries have negotiated sectoral agreements on semiconductors, wood products, cellular phones, construction, and other goods and services.

Since the beginning of this Administration the United States and Japan have negotiated 33 trade agreements. Under the U.S.-Japan Framework for a New Economic Partnership Agreement, reached in 1993, the two countries have negotiated sectoral agreements covering such sectors as automobiles and auto parts, insurance, financial services, telecommunications, medical technology, and flat glass. These are generally sectors in which the United States is competitive but in which our share of the Japanese market often lags behind our shares in the same sectors in other industrial countries' markets. These agreements included objective criteria to guide the two countries in evaluating their success. Under the Framework Agreement, bilateral agreements on structural issues including deregulation, investment, and intellectual property rights also were reached.

Although noteworthy progress has been made under many of these agreements, progress has fallen short in some areas. The United States places priority on full implementation of its bilateral agreements with Japan and believes that more vigorous enforcement is necessary to ensure that their goals are achieved. In addition, the United States continues to seek new market access agreements with Japan to address barriers in specific sectors. Market opening is consistent with a larger deregulation program currently under way within Japan. Under the Enhanced Initiative on Deregulation and Competition Policy, to which the President and the Japanese Prime Minister agreed in June, four sectors—financial services, telecommunications, housing, and medical devices and pharmaceuticals—were identified as the focus of efforts in this area.

The United States also sees the WTO dispute settlement process as useful in addressing specific Japanese market access barriers. In December 1997 the United States reached a settlement with Japan regarding Japan's compliance with a WTO decision against its discriminatory taxation of distilled spirits. The United States is also pursuing a case against Japan's varietal testing requirements for fruit. On another front, the United States challenged an array of measures that Japan has put in place over the past 30 years to restrict imports of photographic film and paper, but the WTO panel did not rule favorably.

Negotiations in both regional and multilateral fora have also generated real market opening in Japan. The WTO agreements on information technology, basic telecommunications, and financial services will increase U.S. market access to many WTO members, including Japan.

## THE EFFECTS OF MARKET OPENING

This Administration's efforts to open markets worldwide, reviewed in the previous section, are part of a long U.S. tradition of leadership in market liberalization. These efforts have been remarkably successful: barriers to international transactions, on average, are at a mere fraction of their 1930s levels. But it is not enough to measure the extent to which markets have been opened. The bottom line for the United States is the net benefits this opening brings, not just for the U.S. economy as a whole but for typical American workers and consumers. This section discusses the sources of benefit from international trade and some estimates of the impact of trade on U.S. GDP. This is followed by a discussion of international trade's impact on U.S. workers.

## THE BENEFITS OF TRADE LIBERALIZATION

The benefits to an economy from international trade are of two types: static gains provide a one-time increase in income, whereas dynamic gains result in a more or less permanent increase in the economy's rate of growth. The former can be significant, but it is the accumulation over time of the latter that can generate much larger improvements in living standards.

The primary source of the static gains from trade is specialization, which allows resources to be used more efficiently. When one country produces and exports those goods that it can produce relatively cheaply (for instance, wheat in the United States) and imports those that are relatively cheap to produce abroad (for example, coffee from Brazil), this trade can boost living standards on both sides of the transaction. Such trade can be beneficial even in cases where one country could produce both goods more efficiently. This notion, commonly referred to as comparative advantage, is straightforward when applied to individuals—each of us sometimes purchases from others some goods or services that we could make or perform even better ourselves, because we realize that our time is most profitably spent doing those things we do best. But the principle applies equally well to countries. When each country specializes in what it produces relatively more efficiently, the resources of both are put to use where they generate the greatest economic value. Free trade thus is a positive-sum, not a negative- or a zero-sum, game.

The benefits of more efficient resource allocation are augmented when economies of scale are present. For some goods, such as automobiles, the average cost of production falls as more of the good is produced. Again, opening markets to trade allows production of such goods to be concentrated in those countries that produce them relatively well. They can then produce more of those goods, exploiting these economies of scale. This helps explain why the United States trades more with similar countries (Canada and Europe, for example) than dissimilar ones: such countries presumably have similar resource endowments, and this limits the potential gains from more efficient allocation, but they can still gain from exploiting scale economies. Such trade often offers yet another benefit: besides making goods cheaper, it increases the variety of goods available to both consumers and producers.

By encouraging continuous productivity improvements, international trade can increase an economy's growth rate; this is the source of the dynamic gains from trade. Trade stimulates productivity improvements most directly through its procompetitive effects. By subjecting domestic firms to foreign competition, trade gives them an incentive not only to lower prices, but also to strive to enhance productivity, which further reduces prices by lowering average cost. These gains from increased competition differ from the other gains from trade in that they are recurring: although competition is only introduced once, it leads to a cycle of productivity improvements and quality enhancements that continue to benefit the economy indefinitely. Trade (and international investment, discussed below) can also lead to increases in the growth rate by facilitating the transfer of technology between countries. Although the protection of intellectual property rights in the short term is important for maintaining the incentive to conduct research and development, over the longer term the free flow of technological advances across borders will encourage ever more efficient utilization of the world's scarce resources.

## MEASURING THE GAINS FROM TRADE

How are the benefits from liberal trade policies to be gauged in practice? The difficulty in measuring the effects of international trade agreements is that they are but one event among many. In an economy the size of the United States, GDP both rises and falls in response to many factors, most of which have nothing to do with trade agreements.

NAFTA provides a prime example of the problems involved. NAFTA entered into force in January 1994. The following December, Mexico experienced a deep economic and financial crisis for reasons unrelated to the agreement. The result, in 1995, was a steep fall in output in Mexico, an increase in unemployment, and a drop in real wages there. A natural side effect of the crisis was a dramatic decline in Mexico's imports, brought on by greatly reduced domestic income and

demand, higher import prices due to devaluation of the peso, and, to a limited extent, higher tariff barriers against non-NAFTA trading partners. Despite this crisis-induced decline in trade with Mexico, it is possible to discuss gains for the U.S. economy derived from NAFTA. Because of the agreement, Mexico did not raise tariff barriers against the United States or Canada, but only against other countries. As a consequence, not only did U.S. exports to Mexico not decline by as much as they might have, but some believe the agreement sped the general recovery of the Mexican economy and of imports from the United States. Seeking to take the extraneous effects of the crisis into account, the Administration commissioned a report, which estimated that NAFTA increased U.S. income by \$13 billion in 1996.

Despite the difficulty of disentangling the many causes of national income growth, a large number of studies have assessed the benefits of trade liberalizations, real and hypothetical. Some have examined the potential benefits from removing existing restrictive measures. A recent study of the costs of protection in the United States, for example, suggests potential consumer gains of approximately \$70 billion in 1990 (1.3 percent of GDP) from removing existing barriers. A drawback of these studies is their inability to incorporate all the benefits of international trade enumerated above. Although they do capture the static costs of inefficient resource allocation, these studies are incapable of quantifying the value of forgone varieties, quality improvements, or productivity enhancements that would take place in the absence of trade barriers. Thus, studies of this type understate the benefits from trade.

Another approach to understanding the benefits of trade is to examine the statistical correspondence between openness and growth rates across a large sample of countries. Such cross-country studies hold constant other well-known determinants of growth, such as investment and education. The common empirical finding is that increased trade is associated with higher income. For example, one recent study, using data from 123 countries, estimated that every percentage-point increase in openness (measured as the sum of imports and exports, expressed as a percentage of GDP) was associated with a 0.34-percent increase in real income per capita between 1960 and 1985. Since 1960, U.S. openness by this measure has increased by 12.7 percent of GDP; this estimate would imply that the increase in trade was responsible for approximately a 4.3-percent increase in U.S. income per capita by 1997.

## TRADE AND THE AMERICAN WORKER

The public debate over trade liberalization tends not to focus on whether trade brings benefits for the economy as a whole. It is widely

conceded that it does. Instead, recent concerns have focused on the distributional impact of increased trade. This issue arises from the tendency of increased trade to favor some domestic industries while putting others at a disadvantage. As export-oriented industries expand, they draw resources away from the rest of the economy, resulting in a relative decline in other industries. This reallocation of resources will in all likelihood benefit some groups and injure others. Of particular concern are the impacts on workers, including average wages, the wages received by low-skilled relative to more highly skilled workers, the availability of jobs in the economy, and the extent to which workers suffer from job dislocation due to trade. This section discusses first the effects of trade on wages, and then the effects on employment. In each case we begin by discussing effects in the aggregate (on average wages and total employment) and then turn to distributional and individual effects that can be masked by the aggregates.

## TRADE AND AVERAGE WAGES

Throughout the first half of the postwar era, real average hourly wages for U.S. production and nonsupervisory workers increased at an average rate of about 2 percent per year. Between 1974 and 1996, however, this measure of real wages fell by roughly 10 percent, retreating to 1965 levels. The early 1970s also saw a dramatic acceleration in the growth of world trade, to rates that (since 1972) have consistently outpaced that of world income growth. This trend was especially striking in the United States, where growth in trade exceeded growth in output by approximately 3.5 percentage points per year following 1972. The coincidence of increasing trade and falling real average hourly earnings suggested to many that international forces were the source of this decline.

This inference is probably wrong, however. To begin with, it is more appropriate to focus on the level of total compensation (wages of all workers plus nonwage compensation) than on wages of production and nonsupervisory workers alone. Wages of production workers have recently grown less rapidly than overall wages. Nonwage compensation, which includes health care benefits, pension costs, and other fringe benefits, has grown relative to wages in recent decades—so much so that total real compensation has increased by almost 8 percent since 1974, despite the decline in real wages. Although this represents slower growth of total compensation than in the 15 years before 1974, this slowdown is more appropriately explained by factors other than international trade, in particular by a slowdown in productivity growth.

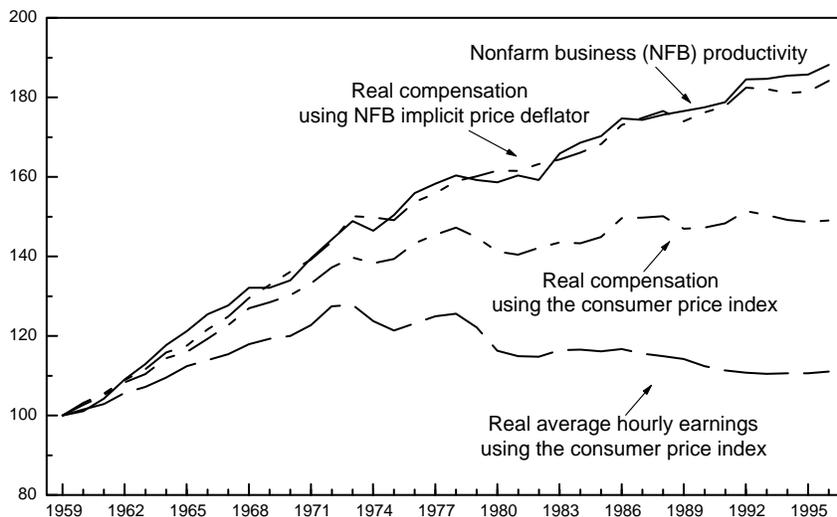
The compensation of labor is generally believed to be determined by worker productivity. Between 1959 and 1973, nonfarm business productivity (output per worker hour in the nonfarm business sector) grew at a rate of 2.9 percent per year. Productivity growth slowed, however, between 1973 and 1990 to approximately 1.0 percent per

year. Given the productivity slowdown, one would expect a slower rate of increase in real compensation during this period. Adjusting compensation by the consumer price index will not necessarily reveal this relationship: to producers—the ones making the hiring decisions—the real output of their workers must be judged only in terms of the prices received for their goods, not the prices of all goods and services that consumers buy. This implies that a more appropriate deflator is the nonfarm business implicit price deflator. And indeed when this measure of prices is used, a remarkable correlation is observed between productivity growth and growth in compensation over both periods (Chart 7-6). Policies aimed at increasing productivity growth, rather than at reducing international competition, are therefore more likely to increase the growth rate of real compensation.

**Chart 7-6 Real Wages and Labor Compensation, and Productivity**

Using the implicit price deflator, real compensation has kept pace with productivity growth. Using the consumer price index as a deflator, real compensation has lagged.

Index, 1959 = 100



Sources: Department of Commerce (Bureau of Economic Analysis), Department of Labor (Bureau of Labor Statistics), and Council of Economic Advisers.

Although total compensation is thus driven by overall productivity growth, there is an additional effect related to the industry in which workers are employed. Standard theories of wage determination assume perfectly competitive labor markets, in which workers of similar skill should earn comparable compensation even when employed in different industries. These assumptions, however, are not borne out in reality. There has long been a relationship between industry and compensation, such that individuals with similar characteristics tend to earn more in some industries and less in others (Box 7-4). This

raises the possibility that some workers could increase their pay simply by moving to another industry.

A recent study indicates that jobs associated with goods exports tend to pay wages approximately 12.5 to 18 percent higher than other jobs. As exporters typically employ relatively skilled workers, a part of this figure is due to differences in observable skills. But even after this factor is accounted for, a significant wage differential remains: the adjusted wages of unskilled workers are approximately 7 percent higher, and those of skilled workers approximately 5 percent higher, in export-oriented industries than in the rest of the economy; accounting for differences in nonmonetary compensation results in differentials that are larger still. Working in export industries thus has the potential to benefit workers—and to benefit unskilled workers even more than skilled workers.

## TRADE AND RELATIVE WAGES

Some commentators have pointed to growing differences in the relative wages of skilled and unskilled workers as an indictment of free trade. During the 1980s, a time when U.S. trade volumes were rising, the wages of skilled workers rose between 8 and 15 percent relative to those of unskilled workers (depending on how one defines “skilled”). Given the rough coincidence of these changes, it is tempting to single out international trade as responsible for this increasing wage disparity. Moreover, a significant source of the expansion in world trade has been the entry into the world marketplace of many Asian economies well endowed with unskilled workers. Thus, casual observation seems to support the claim that free trade is detrimental to unskilled U.S. workers: these workers now compete with a vast pool of unskilled workers abroad, and the expected result of this competition is a decline in their wages.

Most careful analysis of the direct evidence does not strongly support the notion that international trade is the major source of increasing wage inequality. Skill-biased technological change, for instance the use of computers and robotics, has been a more important source. The nature of this technological change has reduced demand for unskilled workers and increased demand for skilled workers. This phenomenon can be expected to reduce the wages of unskilled workers relative to those of skilled workers, and perhaps reduce them absolutely. Although the contribution of international trade to observed productivity changes has yet to be established, recent research indicates that international trade is responsible for only perhaps 10 to 15 percent of the observed increase in wage inequality during the 1980s.

Furthermore, U.S. trading patterns are inconsistent with the notion that trade liberalization is substantially depressing the wages of unskilled workers. Although the surge of imports from some low-wage

#### **Box 7-4.—Industry-Related Differences in Wages**

Basic economic theory tells us that equally productive workers ought to receive equivalent compensation. But there has long been a fairly stable pattern of differences in wages for similar workers across U.S. industries, as Table 7-2 illustrates. The table shows that a worker in the petroleum industry, for example, can expect to receive about 53 percent more in compensation than the average U.S. worker with similar characteristics (such as education, race, and geographic location). Similarly, workers employed in private household services can expect compensation that is 51 percent below the national average for similar workers.

There is no single reason for these differences in compensation levels. However, a number of possible explanations do present themselves:

- *Compensating wage differentials.* The work environment tends to differ from industry to industry. Work may be more pleasant or safe in some industries, less so in others. Workers in unhealthy or dangerous environments, for instance, may receive compensation that exceeds that in otherwise similar jobs.
- *Unobserved productivity differences.* Our ability to assess the productive characteristics of workers from survey data is limited. Workers may have skills not reflected in measures of education. In addition, firms may provide their workers with training that makes them more productive on the job, and their level of compensation may reflect this on-the-job training.
- *Efficiency wages.* Providing increased compensation may raise worker productivity, for example by increasing motivation and effort, and may reduce the probability that workers will quit. To the extent that the benefit to employers of paying higher wages differ across industries, compensation levels will differ.
- *Monopoly rents.* Competition is weaker, and therefore profitability higher, in some industries than in others. Workers may be able to extract some fraction of these higher profits in the form of higher compensation. Differences in the profitability of firms and the bargaining power of workers can thus give rise to differences in compensation across industries.

In the case of compensating wage differentials or exogenous skill differences, moving a worker from one job to another will not make that worker better off. In the first case the worker is merely being compensated for bearing an additional burden,

**Box 7-4.—continued**

and in the second for some unobservable productive capacity, in the same way that we expect workers to be compensated for higher levels of education. But in cases where positive wage differentials are due to skills acquired on the job, efficiency wages, or monopoly rents, increasing the number of export jobs has the potential of raising the standard of living for workers.

TABLE 7-2.—*Industry Compensation Premiums, 1984*  
[Percent]

Top 10 industries		Bottom 10 industries	
Industry <sup>1</sup>	Premium	Industry <sup>1</sup>	Premium
Petroleum .....	53.3	Leather .....	-11.8
Tobacco .....	42.6	Repair services .....	-12.3
Communications .....	37.1	Entertainment .....	-14.9
Public utilities .....	34.2	Apparel .....	-15.0
Transportation equipment .....	28.2	Other retail trade .....	-17.3
Mining .....	27.7	Education services .....	-19.4
Primary metals .....	26.2	Personal services .....	-22.3
Chemical .....	23.1	Eating and drinking .....	-28.3
Paper .....	19.9	Welfare services .....	-32.8
Machinery, except electrical .....	18.2	Private household services .....	-50.8

<sup>1</sup> Two-digit Census Industrial Classification industries.

Note.—The premium is calculated as the percentage by which compensation in the industry (wages plus benefits) exceeds the national average for all industries, after accounting for worker characteristics.

Source: Katz, Lawrence F., and Lawrence H. Summers, "Industry Rents: Evidence and Implications," *Brookings Papers: Microeconomics* 1989.

countries has received tremendous attention, the United States still buys the bulk of its imports from other advanced industrial countries, whose workers have similar skills and wages. If we define low-wage countries as those whose average wage is half or less that in the United States, trade with such countries in 1990 was roughly the same as it was in 1960, when Japan and much of Europe qualified as low-wage countries. Imports from low-wage countries were 2.2 percent of GDP in 1960 and rose to only 2.8 percent of GDP by 1990. In addition, the trade-weighted average hourly manufacturing wage of U.S. trade partners was 88 percent of that in the United States in 1990; this seems much too small a difference to have produced the observed changes in relative wages.

This raises a more subtle but no less valid point: in order for international trade to result in a decrease in the wages of low-skilled workers, the price of low-skill-intensive imports must necessarily fall. But prices of such imports actually rose during the 1980s and 1990s.

In short, while trade may contribute a bit to the widening wage gap between skilled and unskilled workers, the evidence does not suggest that it is the prime source of the gap, nor that it hurts unskilled workers in an absolute sense.

## TRADE AND AGGREGATE EMPLOYMENT

Much of the debate over trade has been over jobs. Critics of more open trade have claimed that trade destroys jobs; advocates often argue that trade creates them. According to basic economic theory, however, in general trade does neither. Today the United States is close to full employment. In such times, market opening means that opportunities will decrease in some industries and increase in others. The effect of export growth in this circumstance is not to increase the number of jobs but rather to increase the number of “good” jobs.

There are circumstances, however, in which trade can lead to job gains: when unemployment rates are high, the expansion in exporting industries can be accomplished by hiring unemployed workers. In January 1993 U.S. unemployment was still 7.1 percent (even though the recession had ended 2 years earlier). During the next 2 years the number of American jobs supported by exports rose by 446,000, helping reduce unemployment to its present level below 5 percent. As the economy comes closer to full employment, however, trade’s positive effect on aggregate U.S. real incomes shows up less in the form of higher employment and more in the form of higher real compensation for workers.

## TRADE AND JOB DISPLACEMENT

As reported in the 1997 *Economic Report of the President*, public opinion polls continue to reveal a low sense of job security among American workers. This is surprising in that, historically, periods of robust economic activity such as the present one have been characterized by much less anxiety over job loss. This anxiety is also evidenced by a relatively low propensity for workers to quit their jobs—a low quit rate suggests uncertainty about the prospects of finding a new job. Rightly or wrongly, workers may associate much of their concern about job security with the expansion of trade. These concerns must be addressed. This means going beyond aggregate measures of expanding employment that might mask individual hardship.

The evidence suggests that, for a variety of reasons, trade is not a primary contributor to total job displacements. Because the U.S. economy is highly dynamic, a great deal of job turnover occurs as new firms go into business or expand and others drop out or contract. Data from the 1980s reveal that trade contributed at most 10 percent of the observed displacements from manufacturing in the worst year of that

decade; in most years it contributed significantly less. Most of the job loss resulted from other forces, principally technological change.

Trade can lead to increased displacements because an increase in imports is likely to displace workers in import-competing domestic industries. However, expanded export opportunities may reduce the incidence of displacements in other sectors. Some evidence suggests that expanded export opportunities have been sufficient to offset the effect of growing imports on total displacements. When the effects of increased imports and exports over the 1980s are combined, there is evidence that changing trade patterns over this period left the total volume of displacements relatively unchanged. This is possible because, over time, the displacements resulting from imports were generally offset by expansion in export-oriented industries, which served to reduce the number of displacements. The net effect was then only a reshuffling of displacements across industries and across time.

Although trade may not have increased the number of displaced workers in the 1980s, in some cases it may have increased the hardship associated with displacement. By shifting production from one industry to another, international trade brings about a shift in employment from one industry to another. This change in the distribution of employment, although it generally increases the quality of jobs available, can lead to greater transitional hardship than some other causes of displacement, for instance the closure of an inefficient plant in an otherwise thriving industry, because it is more likely to involve finding a job in a new industry.

In recognition of the relationship between imports and labor displacements, U.S. trade laws have included provisions for trade adjustment assistance since 1962. This assistance offers cash benefits, in the form of extended unemployment insurance benefits, and retraining to workers who lose their jobs as a result of trade. It also pays for job search assistance and relocation expenses. Since the inception of these programs, about 2 million workers have been certified as eligible. A smaller number have actually received benefits, as many found jobs in the meantime.

The Administration is conscious of the need to provide support for workers injured by international trade, but also aware that not all workers deserving of such support are now getting it. Accordingly, the President has made significant reform of the existing trade adjustment assistance programs a priority. One such reform is to extend adjustment assistance to all workers displaced from firms that have shifted production to another country. The NAFTA legislation already provides such assistance to workers displaced from companies that have shut down their plants and moved production to Mexico or Canada. Also in need of assistance are displaced secondary workers—those employed as subcontractors or in businesses that provided services to plants that have moved abroad. The

NAFTA legislation offered benefits for these workers as well, but most have been unaware they were entitled to the same types of benefits as other dislocated workers. These extensions of assistance, coupled with efforts to streamline the certification process, should significantly improve the quantity and quality of assistance provided to workers displaced by trade and investment liberalization.

## THE U.S. TRADE BALANCE

A popular measure of the impact of trade policies is the trade balance, or the difference between exports and imports of goods and services. But use of the trade balance as a measure of the success of market-opening endeavors is problematic. Changes in the trade balance are seldom related to specific market-opening efforts; indeed, the trade balance is generally determined by macroeconomic factors, not microeconomic barriers to trade.

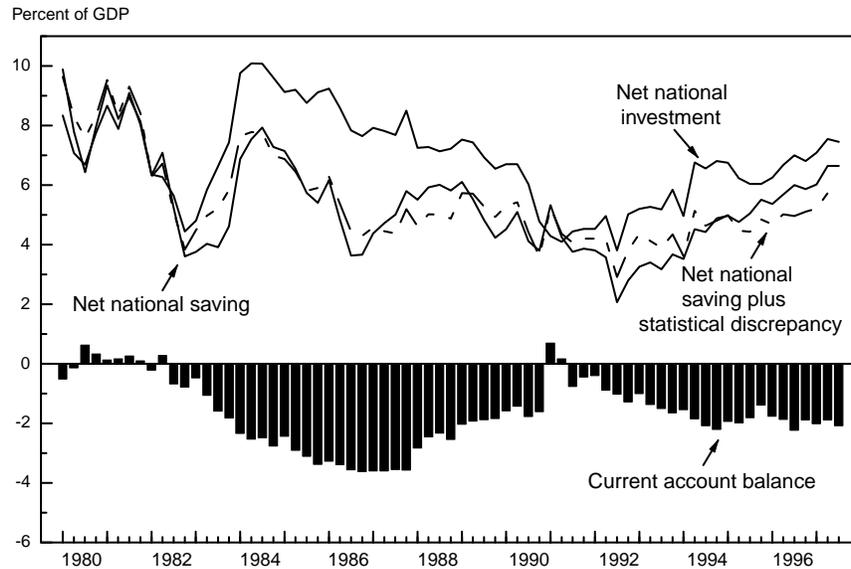
National income accounting identities demonstrate that the difference between exports and imports must equal the difference between national saving and domestic investment. In practice this relationship applies to the current account balance rather than to the trade balance. Trade in goods and services is by far the largest component of the current account, but it also includes overseas investment income and transfers. Measurement issues can also intrude to obscure the accounting identity. In particular, the existence in recent years of a large statistical discrepancy between the income- and the product-side measures of GDP has led to a situation in which the gap between official measures of saving and investment has narrowed as the current account has widened (Chart 7-7). The source of the statistical discrepancy is, by definition, unknown at present. But if, for example, the current account and investment are being measured relatively accurately, the current official measure of saving is too high.

Measurement issues aside, in periods when domestic investment exceeds national saving, the current account balance will necessarily be in deficit, whatever the state of trade policy. Whether the Nation is borrowing to finance a consumption binge or an investment boom, the current account deficit that results will represent the inevitable consequence of these aggregate borrowing decisions—not the failure of market-opening policies.

Until the 1980s the current account of the U.S. balance of payments was seldom far from balance. Since then, however, both the trade balance and the current account balance have been in substantial deficit, as growth in imports has largely exceeded growth in exports. These deficits have not arisen because we in the United States have expanded access to our markets while our trading partners have not done the same. In fact, over this period our major trading partners have

Chart 7-7 **Saving, Investment, and the Current Account Balance**

The current account deficit grew in the mid-1980s as saving fell faster than investment. In the 1990s, however, both investment and saving are increasing.



Source: Department of Commerce (Bureau of Economic Analysis).

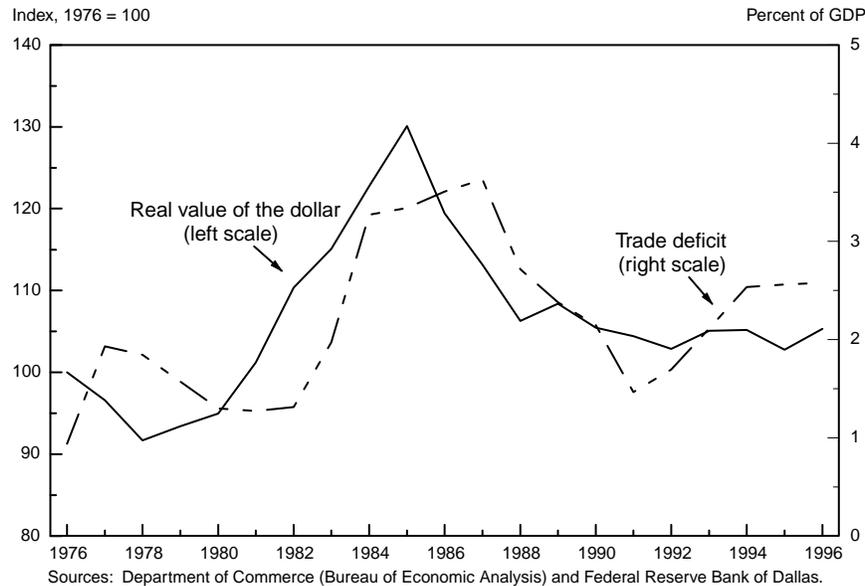
reduced their trade barriers more than has the United States. Rather, the explanation is macroeconomic. As Chart 7-8 shows, changes in the trade deficit have often closely followed movements in the real exchange rate. The exchange rate, in turn, reflects global demand for U.S. dollars by those who want to buy U.S. goods and assets, and the supply of dollars from those who want to use them to buy foreign goods and assets.

The trade deficit grew in the early 1980s as the Federal Government maintained a mix of tight monetary policy and expansionary fiscal policy. Growing Federal budget deficits were a drain on the pool of domestic saving, requiring new investment to be financed increasingly through borrowing on international capital markets. In particular, the saving shortfall and tight monetary policy raised U.S. interest rates, which in turn caused the real exchange rate of the dollar to strengthen. As the dollar appreciated, imports became cheaper for Americans and U.S. exports more expensive for foreigners, so that the U.S. trade balance went deep into deficit. The deficit was thus financed by borrowing abroad. This problem was often referred to as the “twin deficits,” emphasizing the role of the Federal budget deficit (that is, negative Federal Government saving) in the low overall national saving rate and the resulting trade deficit.

Since 1992 the Federal budget deficit has fallen steadily and national saving has increased, yet the trade deficit has once again grown. This is because of the strong boom in investment. Moreover,

**Chart 7-8 Real Value of the Dollar and the Trade Deficit**

The trade deficit is a macroeconomic phenomenon: increases in the deficit typically follow an appreciation of the dollar.



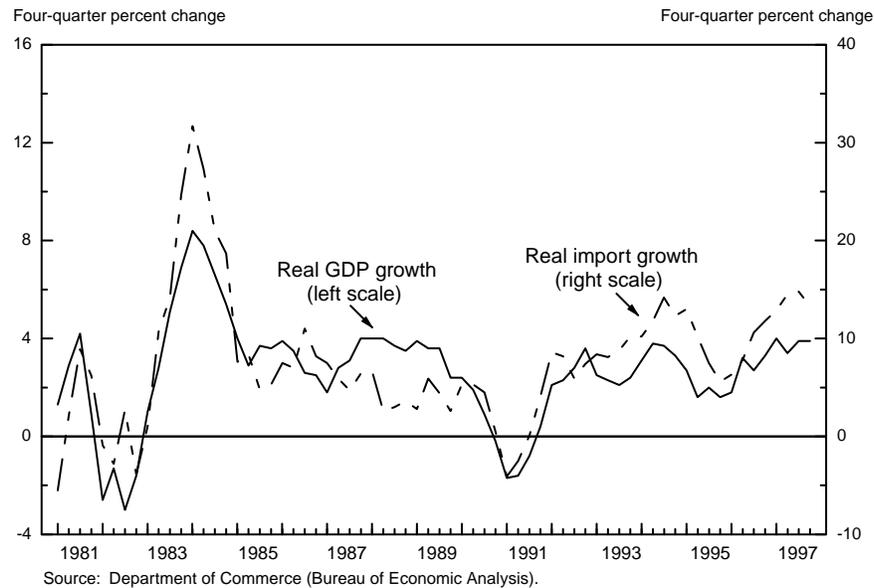
the trade deficit tends to widen when the economy is growing rapidly. As Chart 7-9 shows for the United States, import growth is strongly correlated with growth in national income (as measured by GDP)—as our incomes rise, we demand more goods and services generally, including more foreign goods and services. The faster our incomes are rising relative to foreign incomes, the more our demand for imports can be expected to accelerate relative to that for our exports (which are foreigners' imports). The result is a growing trade deficit here at home. Arguably, a current account deficit is less worrisome when it is accompanied by rising saving and investment.

At the beginning of 1997 it seemed likely that the U.S. growth rate would fall behind that of our trading partners in Asia and elsewhere, which would help reduce the U.S. trade deficit. Instead, U.S. growth and import demand remained unusually strong, while much of the rest of the world grew less rapidly than expected. However, as discussed in Chapter 2, the dollar appreciated, keeping the nominal trade deficit from widening. The currency crisis and slower growth that hit East Asia in the second half of the year suggest that the U.S. deficit is likely to grow in 1998.

The current trade deficit reflects decisions by households and businesses, policy choices, and the strength of the U.S. economy, particularly in the context of financial instability and slowing growth abroad. In theory, a smaller deficit might be realized with a different mix of fiscal and monetary policy, but it would bring problems of its

own. In particular, under current conditions of very low unemployment, an increase in the trade balance would simply crowd out growth in other sectors. The additional demand for U.S. goods and services would put upward pressure on inflation and interest rates, and other sectors would have to contract to make room for the rising net exports. In other words, the trade deficit has acted as a safety valve for the current economic expansion. Imports of goods have kept inflation low, while imports of capital have kept interest rates low, helping to sustain rapid income growth. In the strongly expanding full-employment economy that the United States now enjoys, it should be easier for Americans to see that trade deficits do not necessarily reduce output and employment.

Chart 7-9 **Growth in Real Imports and GDP**  
Growth in demand for imports is strongly correlated with income growth.



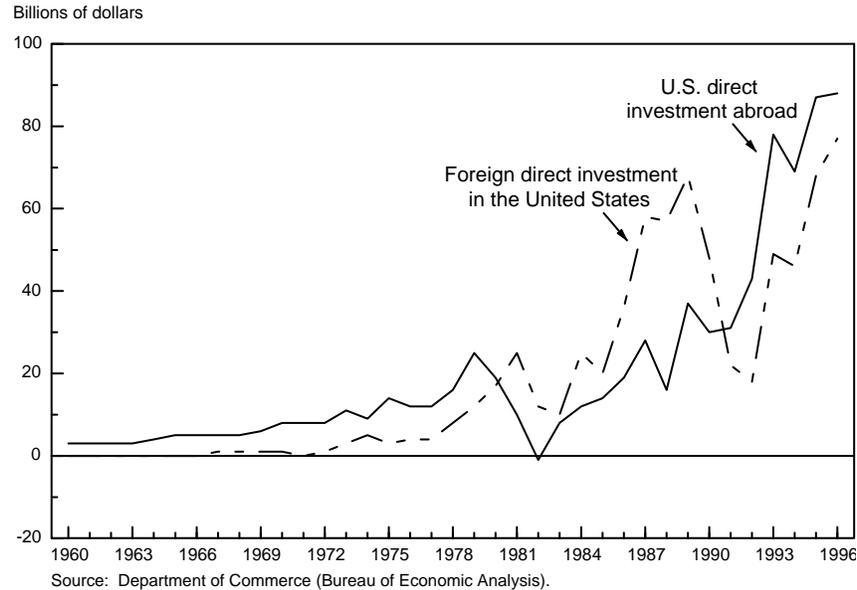
## FOREIGN DIRECT INVESTMENT

Although trade has been a primary focus of the *Economic Report of the President* since its inception, capital flows have become increasingly predominant in international transactions. A significant share of these flows has taken the form of foreign direct investment (FDI), wherein the investor acquires or increases foreign assets in which it then has some lasting interest or influence. In recent years growth in recorded FDI has outpaced even the rapid growth of trade. In the last decade nominal FDI outflows from the United States rose

an average of 17 percent per year to reach \$88 billion in 1996; growth in FDI inflows averaged 8 percent per year to \$77 billion (Chart 7-10).

**Chart 7-10 Foreign Direct Investment Flows**

The 1980s saw a surge in foreign direct investment into the United States. In the 1990s, however, outflows of FDI have once again surpassed inflows.



Commentators tend to speak in universal terms about the motivations for FDI, but in reality no single factor determines why a firm chooses to become a multinational enterprise and operate affiliates in foreign countries. It may be to take advantage of unique opportunities only available overseas (for example, to develop new oil fields), to lower production costs by exploiting international comparative advantage, or to gain or improve access to foreign markets by avoiding trade barriers and transportation costs. Although a firm always has alternatives to FDI, such as exporting or licensing foreign firms to produce its goods, sometimes it is more cost-effective to internalize operations within the firm's command-and-control structure rather than conduct arm's-length transactions. This is especially true as telecommunications technology has improved, making the coordination of foreign operations easier.

FDI and trade are interlinked in a number of ways. Often, FDI is a substitute for exporting: firms invest in operations abroad in response to tariffs or other barriers that hinder the export of goods to those markets. But FDI and trade are also complementary. In 1994 reported intrafirm trade—the cross-border transactions between affiliated units of multinational companies—accounted for one-third of U.S. exports and two-fifths of U.S. imports of goods. An understanding of the large and growing role of FDI in modern trade

patterns may be useful in assessing the benefits of this important aspect of our integrating world economy.

As the importance of international direct investment has increased, countries have moved to negotiate a set of rules for FDI along the lines of those for trade. Unfortunately, many misunderstandings remain regarding FDI, which threaten to hinder these efforts (Box 7-5). Before reporting on the progress of these efforts, this section reviews recent trends in FDI flows and the ways in which both the home and the host country benefit from FDI.

**Box 7-5.—Fears and Facts about Foreign Direct Investment**

In the 1980s concerns arose in the United States that the rapid rise in inward FDI would have adverse effects on American workers. Some feared that foreign-controlled affiliates that displaced U.S. firms might change the composition of employment, moving “good” jobs to the home country and offering only “bad” jobs in the United States. In fact, foreign multinationals in the United States pay higher than average wages, suggesting that in fact they provide good jobs. When net FDI flows turned outward during the 1990s, the concern became that U.S. companies would begin outsourcing much of their production to other countries, again at the expense of jobs and wages at home. This seeming contradiction—that inward and outward FDI would have similar effects on U.S. workers—may reflect how little was actually known about the effects of FDI.

Unlike trade, which has been the subject of study for hundreds of years, FDI has been subjected to little rigorous study until recently. As more has been learned about FDI, many of these initial fears have subsided. The following are some fears that have been recently expressed about FDI, and the facts that we now know.

**Fear:** Won't U.S. industries leave for low-wage developing countries?

**Fact:** During the NAFTA debate, some voiced concern that lowering barriers to investment in Mexico would result in a large movement of U.S. industry there, as firms exploited low Mexican wages. But since the passage of NAFTA in 1993, Mexico's share of the U.S. outward FDI position has decreased. The reason there has been no mass exodus of U.S. industry to Mexico or to other low-wage countries is simple: there is no free lunch—for multinationals as for the rest of us. Real wages may vary significantly across countries, but studies show that these differences are linked to productivity differences, just as economic theory would predict. Low wages are not a sufficient reason to move production to a foreign country, if low pro

**Box 7-5.—*continued***

ductivity there raises the labor cost per unit of output to a level close to that of the United States. The vast majority of U.S. FDI continues to be with other high-wage countries, so clearly other motivations than the potential for low-wage outsourcing are behind the greater part of FDI.

Fear: Are U.S. firms that invest abroad exporting jobs?

Fact: It may seem reasonable to suppose that a U.S. firm that hires workers in an overseas affiliate is contributing to U.S. unemployment, since the firm could be hiring U.S. workers to do the same job here. Evidence shows, however, that generally this is not the case: increases in employment in foreign affiliates of U.S. firms are often associated with increases in employment at the parent as well. What employment substitution there is seems to be occurring entirely offshore, between countries competing for U.S. FDI, not between U.S. parents and their foreign affiliates. Far from exporting jobs, it appears that creating jobs overseas creates jobs at home as well.

Fear: Doesn't U.S. FDI abroad represent domestic investment forgone?

Fact: With the surge in outward FDI in recent years, FDI outflows now amount to more than 10 percent of gross private nonresidential fixed investment. However, when a U.S. firm invests abroad, that does not necessarily mean it would have invested here instead if FDI had not been an option. It might then have chosen not to invest at all. Moreover, two-thirds of recorded outflows in 1996 were actually the reinvested earnings of foreign affiliates, not capital originating in the United States. Considering only actual capital outflows, a recent study estimated that outward FDI averaged only 0.9 percent of nonresidential fixed investment between 1970 and 1990—and the share has been trending downward. Capital outflows are also largely compensated by foreign investment inflows. Evidence suggests that a complementarity may exist between the investment decisions of domestic and foreign firms, which would imply that reciprocal direct investment between the United States and other industrial countries increases total investment in all countries that participate.

In short, opponents of FDI have incorrectly framed it as a zero-sum venture, where for one country to gain, another must lose. Both the theoretical arguments of the benefits of FDI and the evidence now available suggest that FDI can provide net gains for all parties.

## CURRENT TRENDS IN FDI

The United States remains both the largest source of and the largest host to FDI in the world. Throughout most of the postwar period the United States has been a net direct investor overseas, with FDI outflows exceeding inflows (Chart 7-10). However, in 1981 the balance of U.S. FDI flows turned inward for the first time, led by a large expansion of investment in the United States by Japanese and U.K. firms. This direct investment by foreign firms in the United States grew rapidly throughout the 1980s, peaked in 1989, and then dropped sharply in the early 1990s. Investment abroad by U.S. firms has increased tremendously in the 1990s, so that since 1991 the balance of FDI flows has once again been outward. These trends continue: in the first three quarters of 1997, FDI outflows in the balance of payments accounts rose to \$94 billion, \$14 billion more than inflows and already surpassing the level for all of 1996 (\$88 billion).

By 1996 the cumulative direct investment position of foreign firms in the United States (the inward FDI stock), measured on a historical cost basis, had reached \$630 billion, an increase of 60 percent since 1990. There are some accepted problems in measuring FDI precisely. U.S. balance of payments accounting rules define FDI as financial flows from a parent company to an overseas affiliate in which it has at least 10 percent ownership. Thus, investment in foreign affiliates not financed directly by the parent company is excluded. In addition, historical cost positions are measured at the book value of purchases each year and therefore do not adjust for capital gains (including those due to inflation). Estimates that attempt to adjust for increases in the market value of assets are almost double the 1996 historical cost measure. However, historical cost measurements do indicate the distributional changes of FDI across countries and sectors.

More than half of the reported FDI stock in the United States has come from three countries: the United Kingdom holds the largest share, followed by Japan and the Netherlands. The United Kingdom is also the largest host to U.S. direct investment abroad, followed by Canada. European countries are host to half of the stock of U.S. investment abroad. In 1996 U.S. firms directly controlled overseas assets of \$797 billion, again valued at historical cost; member countries of the OECD were home to over 73 percent of this investment. Much of the rest was in Bermuda, the Caribbean, and some Asian newly industrializing economies such as Hong Kong; this investment is concentrated in sectors such as wholesale trade, finance, real estate, and services. China, the second-largest host to worldwide FDI, still represents only a negligible share of U.S. direct investment abroad. However, between 1992 and 1996 the U.S. position in China increased at an average rate of 50 percent per year. FDI in other

Asian developing countries has been increasing as well; however, the majority of growth has come from investment in the higher income economies that are still host to 75 percent of U.S. FDI in the region.

Among developing countries, Brazil, Mexico, and Panama are the largest hosts to recorded U.S. FDI. Annual FDI flows to these countries represent about 10 percent of the total, but the stock of U.S. FDI in all of Latin America is still less than 12 percent of the total U.S. position abroad. Nevertheless, the brightening economic prospects in Latin America have been accompanied by a pronounced expansion of the U.S. direct investment position in the region. The emerging markets there are poised to become increasingly important to U.S. investors in the future, especially if investment barriers are liberalized under the proposed Free Trade Area of the Americas.

Although wages are lower in developing countries, these do not always entail the cost advantages many people assume (Box 7-5). Rather, the developing countries that receive the most FDI are usually those regarded as potentially large future markets. This suggests that companies investing in these countries hope to establish a market presence, in the expectation of profitable future sales, and are not simply outsourcing production for reexport to other markets.

Although the public image of FDI in the United States is often one of large manufacturing multinationals, manufacturing accounts for only one-third of both the inward and the outward FDI stock. Much FDI in manufacturing occurs in motor vehicles, electronic and electrical equipment, office machines and computers, and chemicals and allied products. In 1996 these sectors accounted for over half of both the U.S. FDI position abroad in manufacturing and almost half of the foreign position in the United States (Table 7-3).

The industrial composition of U.S. FDI has evolved in tandem with that of the U.S. economy. Much of U.S. outward FDI in past decades was motivated by the opportunity to use U.S. technology to extract foreign raw material resources such as oil, coal, and natural gas: in 1980 the petroleum industry accounted for roughly 22 percent of the outward U.S. FDI position. But this share has been falling steadily, and in 1996 the figure was less than 10 percent. Between 1980 and 1990 FDI became associated with the relocation of manufacturing activities abroad, in part because of the rapid expansion of foreign firms in the U.S. manufacturing sector. More recently, a growing share of FDI is in service industries—primarily finance, insurance, and real estate but also wholesale and retail trade and banking—mirroring the evolution of the U.S. economy from a manufacturing to a services economy. In 1996 service industries accounted for 52 percent of the U.S. position abroad, exceeding the share of the entire manufacturing sector. However, these figures may overstate the role of services, which include sectors such as finance where large holdings of “paper assets” are the norm.

TABLE 7-3.—*Inward and Outward Foreign Direct Investment, by Industry, Selected Years*

[Billions of dollars]

Industry	U.S. direct investment abroad			Foreign direct investment in the United States		
	1980	1990	1996	1980	1990	1996
Petroleum .....	47.6	52.8	75.5	12.2	42.9	42.3
Manufacturing .....	89.3	170.2	272.6	33.0	152.8	234.3
Food and kindred products .....	8.3	15.6	36.2	4.9	22.5	28.1
Chemicals and allied products .....	18.9	38.0	69.4	10.4	45.7	74.8
Primary and fabricated metals .....	6.3	10.5	13.6	3.6	13.7	18.7
Industrial machinery and equipment .....	16.1	30.9	35.0	2.9	11.5	16.3
Office and computing machines .....	9.3	22.2	21.7	.4	2.6	2.7
Electronic and other electric equipment .....	7.3	15.6	29.5	4.1	16.1	20.8
Motor vehicles and equipment .....	11.8	20.4	31.6	.7	3.1	12.3
Other manufacturing .....	20.6	39.3	57.2	6.4	40.1	63.3
Services .....	66.3	194.5	410.7	34.4	179.6	323.6
Wholesale and retail trade .....	25.9	50.7	84.3	15.2	60.2	92.9
Banking .....	7.3	20.7	32.5	4.6	18.4	31.9
Finance (excluding banking), insurance, and real estate ..	27.5	109.7	257.2	13.5	70.4	159.9
Other services .....	5.6	13.4	36.7	1.1	30.6	38.9
Other industries .....	12.2	13.1	37.7	3.4	19.6	29.7
Communications and public utilities .....	1.3	4.4	20.4	.1	3.3	11.4
All industries .....	215.4	430.5	796.5	83.0	394.9	630.0

Note.—Detail may not add to totals because of rounding.

Source: Department of Commerce (Bureau of Economic Analysis).

Employment in foreign-owned U.S. affiliates rose from 2 million in 1980 to almost 5 million in 1995. This represents an average annual increase of more than 6 percent, over three times the rate of growth in nonfarm U.S. employment over the same period, and led to an increase in the share of U.S. private industry employment in foreign-controlled firms from less than 3 percent to 5 percent of total employment. The share of private industry GDP accounted for by foreign-owned U.S. affiliates has increased from 3 percent in 1980 to 6 percent in 1995. However, these increases largely represent growth during the 1980s and early 1990s; in fact, by both measures the foreign presence in U.S. industry has been constant or decreasing in recent years.

#### THE BENEFITS OF FDI

The benefits of FDI to the economy as a whole seem less clear than the benefits of trade. Yet in a world where trade results from differences in relative factor abundance, capital mobility should act as a substitute for trade. This corresponds with the notion that FDI occurs in response to trade barriers and suggests that capital flows have welfare implications similar to those of trade. Capital mobility can also have macroeconomic benefits by relaxing the tradeoff

between investment and consumption. However, the benefits of FDI go beyond increased capital mobility: FDI has direct impacts on both the host and the home countries that have little in common with other types of international investment, such as portfolio asset flows.

### *Benefits to the Host Country*

The nature of the benefits of FDI to the host country is likely to depend on whether the country is developed or developing, and on the reasons why FDI is taking place. FDI in the higher income countries is often a response to market access concerns. By establishing operations closer to customers, a firm may be able to increase the quality of support services and the ability to match products to local tastes. The presence of multinationals also entails all the traditional benefits of local investment, creating jobs and fostering demand from local suppliers.

When FDI occurs in developing countries, the gains from fostering demand from local industry may be even greater. “Big push” theories of industrialization emphasize that the profitability to a single firm of adopting new technological advances often depends on other firms’ decisions to do likewise. For example, an automobile assembly plant requires dependable suppliers of parts and machinery, but these are not likely to exist locally if no automobile plants exist. In this scenario the gap between developed and developing countries occurs because the former have managed to overcome this coordination problem. By internalizing such transactions, often by using already established global supply networks, multinationals can overcome the coordination problem and provide the first step toward industrialization in a developing country.

FDI may have additional advantages in developing countries, particularly over portfolio investment. The ability to own a foreign firm directly rather than through passive stock holdings may increase the incentive to invest in countries that offer attractive opportunities but little domestic entrepreneurial experience. Furthermore, since the commitments involved in direct ownership imply greater adjustment costs than under stock ownership when conditions turn unfavorable, FDI can create a more stable investment atmosphere by discouraging capital flight like that which plagued developing economies in Southeast Asia in 1997. When investors are forced to weather financial storms, a country’s market volatility and macroeconomic instability are reduced, and this may help the storms pass more quickly.

Lastly, through direct control of their affiliates, multinationals provide crucial links in the international dissemination of technology and best practices. This promotes more efficient production and resource use in home countries and rising incomes throughout the world. The recent literature on economic growth emphasizes the

importance of an expanding common pool of ideas in increasing growth rates in all countries. As new trade and investment agreements are negotiated to strengthen global intellectual property rights, these transfers of knowledge can proceed without destroying the incentive to innovate or sacrificing the profitability of innovating firms. FDI is frequently shown to be an important vehicle for increasing productivity in host countries, in some cases contributing relatively more to growth than does domestic investment. Although developing countries that now employ outdated technologies may have the most to gain from new ideas brought in by foreign multinationals, they are not the only beneficiaries. The resurgent competitiveness of the U.S. automotive industry in the 1990s is often attributed in part to the adoption of just-in-time inventory practices used successfully by Japanese production facilities located in the United States.

### *Benefits to the Home Country*

It might seem natural that foreign investment helps foreigners, but what is less apparent is that the activities of multinationals can promote growth in their home countries as well (see Box 7-5). By developing and expanding foreign markets, multinationals provide an important benefit to the home country, because growth in a country's trade partners means growth in its export opportunities. And in many cases, as firms expand their operations overseas, they expand their management and support operations at home also, increasing employment both at home and abroad.

Moreover, multinationals create trade by moving goods and services between parents and their foreign affiliates. As already noted, this intrafirm trade now plays a significant role in total U.S. trade. Although the move from arm's-length to intrafirm transactions need not represent "new" trade, evidence suggests that FDI is likely to increase trade. This can be considered a benefit in itself, by promoting the interchange of goods. FDI often plays an important role in promoting trade when barriers to traditional exports exist. A recent study shows that, in 1992, 70 percent of U.S. exports to Japan were intrafirm exports, as were 74 percent of exports to Switzerland and 64 percent to Russia. By contrast, only 12 percent of U.S. exports to Taiwan, our seventh-largest foreign market, were intrafirm exports.

Arguably, intrafirm trade might not be beneficial if it represents the foreign outsourcing of goods for production and reexport to the home country. If this were the case, we might expect to see an intrafirm trade deficit equal to the amount of value added overseas. But U.S. intrafirm trade is in surplus: U.S. multinationals export more to their overseas affiliates than they import from them. This suggests that, on balance, shipments to foreign affiliates represent goods to be sold in the overseas market (perhaps after final assembly

there) rather than outsourcing for reexport. In a rapidly changing world environment, firms hoping to enter foreign markets are increasingly coming to realize that establishing a direct presence in those markets may be the best way to compete.

## CURRENT U.S. INITIATIVES IN INVESTMENT POLICY

Evidence has shown that a stable policy environment is a good determinant of the amount of FDI a country attracts. Countries that are prone to nationalization, corruption, and political instability are less likely to receive foreign investment, whereas those that protect foreign investors and intellectual property rights do better. This suggests that there are benefits to achieving multilateral standards for investment rules.

Under the auspices of the OECD, the United States has joined other countries in negotiations toward a Multilateral Agreement on Investment (MAI) that will set "high standards for the liberalization of investment regimes and investment protection...with effective dispute settlement procedures." The goal is to eliminate discrimination in investment by achieving a uniform set of rules for all signatories, thereby removing market distortions and facilitating the investment process.

The MAI is being negotiated principally among the 29 OECD countries that account for the vast majority of worldwide FDI flows. But the MAI is being designed as a free-standing international treaty to which other nations may accede. Even though the negotiations are primarily among similar countries with similar objectives, the negotiations have been difficult at times.

Meanwhile over 1,000 bilateral investment treaties already exist, primarily between developed and developing countries. The United States has signed 40 such treaties to date (Box 7-6). With these treaties the United States has been able to establish deeper agreements more quickly with more countries than it could by negotiating a single agreement with a large number of countries.

Another recent initiative in which the United States has been active is the international effort to combat corruption. Corruption is a particularly thorny problem for multinationals in many developing countries, and its presence may offset much of the benefit to multinationals of locating in those countries. One recent study estimated that the effects of corruption were equivalent to an increase in the marginal tax rate for foreign investors of as much as 21 percentage points. Given the benefits of FDI to both home and host countries, this strong disincentive to investment is likely to reduce the welfare of both. It has also had important legal ramifications for U.S. investors abroad, who are prohibited under the Foreign Corrupt Practices Act from bribing foreign officials. This legislation has made it even more difficult for U.S. multinationals to establish and maintain businesses in countries with pervasive corruption.

### Box 7-6.—Bilateral Investment Treaties

For much of the last decade the United States has been actively pursuing the negotiation of bilateral investment treaties with emerging-market countries around the world. The U.S. government places priority on negotiating such treaties with countries undergoing economic reform where it believes the United States can have a significant impact on the adoption of liberal policies on the treatment of FDI. The structure of these treaties has also laid the policy groundwork for broader multicountry initiatives in the OECD (the MAI) and eventually the WTO. The structure of our bilateral investment treaties provides U.S. investors with the following six basic guarantees:

- treatment that is as favorable as that received by their competitors—this implies the better of national or most-favored-nation treatment
- clear limits on the expropriation of investments, and fair compensation when expropriation does occur
- the right to transfer all funds related to an investment into and out of the country without delay, at the market rate of exchange
- limits on the ability of the host government to impose inefficient and trade-distorting performance requirements
- the right to submit an investment dispute with the host government to international arbitration
- the right of U.S. investors to engage the top managerial personnel of their choice, regardless of nationality.

In cases where national treatment is the binding standard, the treaty ensures that U.S. investors are treated in a manner equivalent to domestic investors; where it is most-favored-nation treatment, U.S. investors are assured treatment no worse than investors from any third country receive. To date, the United States has successfully negotiated bilateral investment treaties with some 40 countries (Table 7-4) and is actively engaged in pursuing a multilateral version of the treaty under the auspices of the OECD.

TABLE 7-4.—*Countries with Which the United States Has Bilateral Investment Treaties*

Country and date	Country and date	Country and date	Country and date
Albania ..... pending	Croatia ..... pending	Jordan ..... pending	Romania ..... 1994
Argentina ..... 1994	Czech Republic ..... 1992	Kazakhstan ..... 1994	Russia ..... pending
Armenia ..... 1996	Ecuador ..... 1997	Kyrgyzstan ..... 1994	Senegal ..... 1990
Azerbaijan ..... pending	Egypt ..... 1992	Latvia ..... 1996	Slovakia ..... 1992
Bangladesh ..... 1989	Estonia ..... 1997	Moldova ..... 1994	Sri Lanka ..... 1993
Belarus ..... pending	Georgia ..... 1997	Mongolia ..... 1997	Trinidad and Tobago ..... 1996
Bulgaria ..... 1994	Grenada ..... 1989	Morocco ..... 1991	Tunisia ..... 1993
Cameroon ..... 1989	Haiti ..... pending	Nicaragua ..... pending	Turkey ..... 1990
Congo (Brazzaville) ..... 1994	Honduras ..... pending	Panama ..... 1991	Ukraine ..... 1996
Congo (Kinshasa) ..... 1989	Jamaica ..... 1997	Poland ..... 1994	Uzbekistan ..... pending

Note.—Years are those when the treaty entered into force.

Source: Office of the U.S. Trade Representative.

In late 1997 the member countries of the OECD finalized a draft treaty to outlaw bribery of foreign public officials. Holding multinationals of all nationalities to similar standards will put pressure on foreign officials to abide by legal and transparent procedures in doing business with foreign companies, rather than allow them to promote a “race to the ethical bottom” among companies seeking government contracts or licensing. It is hoped that, together with the establishment of a common set of investment rules in the MAI, the reduction of corruption abroad will act as an incentive to FDI, bringing increased benefits to both home and host countries worldwide.

## CONCLUSION

Economies that are open to international trade and investment are more likely to experience a rising standard of living than are economies with significant barriers to cross-border economic activities. Consumers in open economies benefit from a wider variety of goods at lower prices than do consumers in economies that resist competition from foreign suppliers. The economy as a whole benefits from an increased ability to devote its scarce resources to economic activities that it performs relatively efficiently. Over time, through both international trade and international investment, open economies benefit from higher rates of productivity growth and innovation that result from increased participation in international markets.

Many, however, fear that international transactions will disadvantage certain segments of the economy. As this chapter has shown, it is difficult to associate cross-border interactions with declining real wages of workers, or even of particular groups of workers. Indeed, there is evidence that adjustments resulting from growth in international trade have the potential to make workers better off. In the United States, jobs with exporting firms pay between 5 percent and 10 percent more than do jobs in other sectors of the economy. At the same time, the Administration recognizes that the transition from one job to another is not always easy and that assistance must be provided to those most affected by displacement.

As the United States is already among the most open economies in the world, the Administration’s activities have been directed toward opening foreign markets to imports not only from the United States but from other exporters as well. This goal has been actively and successfully pursued in multilateral, regional, and bilateral forums. Partly reflecting these pursuits, U.S. imports and exports have increased significantly since 1993. Although much has been accomplished, the Administration maintains an active international policy agenda promoting free trade throughout the Americas, across the Pacific, and around the world.

