Part 1

Regulation of International Trade

CHAPTER I

INTRODUCTION

A. SCOPE OF THIS BOOK

1. Trade Flows

International economic relations may fruitfully be viewed as including three discrete flows: (1) goods, (2) technology and other services, and (3) capital.

The most visible and numerically significant flow is trade in goods. Finished goods produced domestically have to vie with imported products and may also be exported. Primary commodities raise different challenges--short-term price instability, long-term price trends, and supply access--and are accordingly regulated in different ways. Moreover, North-South trade poses difficult questions of the relations between the developing countries and the advanced industrial states.

The second trade flow we will consider in this book is trade in technology, chosen both because of its importance as a factor of production and because it is a form of trade in services. Trade in services of all types is becoming more important, as the United States evolves into a more service-oriented economy, and as an international regulatory regime for trade in many services continues to emerge. Economic development in the United States, after moving from the agricultural to the industrial phase, now operates in a service phase, resting on transactions in such areas as information, financial services, transportation, advertising and technology. Many of these service sectors are extremely complex and highly specialized, especially when, as in such sectors as financial services, the activity is already subject to a significant degree of domestic regulation. It is therefore impossible to deal with all of these sectors–a source of considerable frustration for the authors–but the example afforded by the technology sector will provide a point of reference. Other sectors are considered in a more summary fashion, as a basis for comparison at various points throughout this book.

Finally, we consider trade in capital. Direct investment by a home-nation firm, portfolio investment by an investor in another nation, and capital flows through the banking system raise different economic and political considerations. These flows, along with the assistance provided by national governments, are the major source of capital for the developing world, and they are central to the stability of the international economic system. They are also likely to be one of the chief sources of future political dispute.

2. Levels of Regulation

From a practical standpoint, the most important implication of the international character of a business transaction is its inordinate complexity as compared to a domestic transaction, and one result is that legal counsel is more frequently needed for

complicated international business than for parallel domestic transactions. Upon entering the international arena, traders immediately confront a welter of difficulties such as language and cultural barriers and differing national laws and regulations. Unpredictable geopolitical factors may be introduced that can jeopardize the sanctity of the proposed transaction.

Three different levels of regulation typically exist in the international trade transaction. The first level is private-party regulation through contractual relationships. The contract between the parties may "legislate" for the transaction with respect to arbitration, conflicts of laws, and other matters. This area is variously known as "international commercial law," "transnational law,"[1] or "private international law."[2] Although it underlies the activity studied in this book, this area is itself generally outside the scope of the book.

The second level of regulation includes national government laws that may bear on the transaction–those of the importing, exporting, or a third country. This is one of the areas that this book focuses upon. We emphasize the laws and regulations of the United States, because that is the authority that most of us will have to deal with most frequently, and so it presents a convenient point of reference for the study of the law of international trade and investment. The book considers the laws of other states, however, where appropriate and feasible.

The third level of regulation comprises international controls, and this is the second area that this book focuses upon. These controls are often incorporated in and enforced by the second level, but today this third level is directly administered and enforced by international organizations. Thus, the General Agreement on Tariffs and Trade (GATT), the World Trade Organization (WTO) (1994 successor to and administrator of GATT as an agreement), the European Union (EU),[3] the Organization for Economic Cooperation and Development (OECD),[4] and the United Nations are examples of the international organizations constantly spewing out rules and regulations for traders to worry about. The manager of a Belgian affiliate of a U.S. firm, for example, must worry whether his widget exports comport with EU export regulations or violate the WTO's subsidy rules. He must also worry about the increasing regulation of multinational enterprises by the OECD, the EU, and the United Nations, as well as the traditionally extraterritorial reach of U.S. trade and regulatory law.

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1. The concept of "transnational law," first popularized by the late Wolfgang Friedemann of Columbia, now has a well understood term-of-art status in international legal studies. It identifies a range of subject matter emphasizing private transactional and regulatory law in the international context, and the intersection of public and private law concerns in an internationalized economic setting.

2. The term "private international law" is very attractive, in light of its conceptual symmetry with the term "public international law." However, the use of this term can be ambiguous, because in many legal systems the term refers to what is usually called in U.S. terminology "conflict of laws" and "choice of law," *i.e.*, the body of rules regarding the choice of law governing a transaction and the determination of the proper jurisdiction and forum. A more neutral term, such as "international commercial law" or "transnational law" therefore recommends itself.

3. EU regulatory activity is somewhat hybridized, since the EU acts through its member states' national governmental level as well.

4. The OECD is a research institution and negotiating forum for 30 of the world's richest industrialized democracies.

B. INTERNATIONAL TRADE AND ECONOMIC THEORY

The core of international economic relations is the international trade transaction, a sale from one nation into another. Questions exist at both the macroeconomic and microeconomic level about such transactions. The basic macroeconomic questions are: (1) why does international trade take place between two given countries; and (2) what are the effects of trade among nations? Microeconomic questions focus on the costs and benefits of the transaction for the importer and the exporter. The purchaser, for example, must ascertain whether it is cheaper to import than to buy domestically. The answer to this question will depend on tariff levels; nontariff barriers to international trade; the tax situation; the determination of who pays for freight, insurance and financing charges; and the relative strengths of national currencies. This chapter examines the macroissues; traditional and revisionist views of the theory of international trade are considered. The "private law" of international commercial transactions is examined in the next chapter.

1. Why Does Trade Take Place? – A First Explanation[1]

To understand why trade takes place *between* countries it is useful to see why trade takes place *within* countries. In other words, using the United States as an example, why is steel produced in Pittsburgh, citrus fruit in California and Florida, and cars in Detroit? The phenomenon of *intracountry* regional specialization has traditionally been explained in terms of what are called "factor endowments." Thus, it would not make sense for the North to attempt to grow citrus since states in the snowbelt do not have the climate that is ideal for their production; similarly, it would be inefficient for steel to be produced in an area that was distant from the iron ore, coal, and capital equipment needed in the steel industry. In other words, the traditional view is that the reason for interregional trade *within* countries is that each region is abundantly supplied, compared with other regions, with certain productive resources that render it especially well-suited for the production of a particular commodity. Under the traditional theory, it is assumed that each region possesses a *comparative advantage* in the production of some items, and a *comparative disadvantage* in the production of other items. One should be careful to realize that economic models can be useful predictors of economic events and justifications of economic policies, but only to the extent that we can tolerate the simplifying assumptions imbedded in them–such as *ceteris paribus* ("other things being equal" or remaining unchanged).[2] As you read the discussion that follows, consider whether the implicit simplifying assumptions are acceptable as a matter of fact.

Turning to *international* trade, that is, trade between nation-states, the traditional economists such as Ricardo[3] hypothesized that trade takes place because substantial benefits are to be derived from countries specializing in the exportation of goods for which they are, relatively speaking, the lowest-priced producer. Some time later, Ohlin

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1. This section draws on Fisher, The Multinationals and the Crisis in United States Trade and Investment Policy, 53 B.U.L. Rev. 308, 318-323 (1973).

2. *Sed cetera paria numquam sunt*.

3. *See* D. Ricardo, On the Principles of Political Economy and Taxation (1819).

explained that the comparative advantage of different countries derives from differing relative endowments of such factors as labor, land, and capital.

The traditional theory of trade can be demonstrated by the following two-product example of hypothetical price relationships prevailing in economic isolation, assuming that $1 U.S. equals $1 Canadian:

	Canada	*United States*
Cloth (per yard)	$1	$1
Wheat (per bushel)	$2	$3

Which goods will be exported when economic contacts between the two countries in the above example are opened? The traditional answer, proffered by Ricardo, was that the goods that are exported between the two countries could be predicted in advance by knowing the differences in the relative prices. Thus, cloth is relatively cheaper in the United States than in Canada; in the United States cloth is one-third the price of wheat, while in Canada, it is one-half the price of wheat. Since the United States makes relatively cheaper cloth, it was argued, the United States would specialize in the production of cloth, and export it to Canada. A person could start with one bushel of wheat in Canada, take it to the United States and obtain three yards of cloth. Coming back to Canada, he could keep one yard as profit and use the other two to recover his original bushel of wheat.

This theory of trade was buttressed by the Heckscher-Ohlin principle of comparative costs, which states that

> a country tends to specialize in the production of, and export, those commodities requiring in their production large amounts of productive factors in relatively abundant supply in that country, and to import [from abroad] those commodities requiring in their production large amounts of productive factors in relative scarce supply at home.[4]

Over time, the Heckscher-Ohlin principle based on "factor endowments" (*i.e.*, land, labor and capital)–and qualified by eleven simplifying assumptions[5]--was further refined. Samuelson developed the factor-price equalization theory, which postulates that international trade will bring about equalization in the relative and absolute returns to homogeneous factors across nations. In other words, international trade keeps expanding until relative prices are completely equalized. Because the factor-price equalization theorem follows directly from the Heckscher-Ohlin principle, it is sometimes referred to as the Heckscher-Ohlin-Samuelson theorem.

In the real world, however, models such as Heckscher-Ohlin are contradicted by empirical evidence. The first empirical test of Heckscher-Ohlin was conducted by Leontief in 1951. The results were startlingly inconsistent with what Heckscher-Ohlin predicted and became known as the Leontief paradox. According to Heckscher-Ohlin, a nation will export the commodity which is relatively abundant and cheap and import

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4. D. Snider, Introduction to International Economics 35 (1963).

5. Heckscher-Ohlin is posited assuming: (*i*) that there are only two states, two commodities and two factors of production; (*ii*) that both states use the same technology; (*iii*) that the same commodity is labor-intensive in both states; (*iv*) that there are "constant returns to scale" (*i.e.*, amount of production is always proportional to the amount of labor, land and capital used); (*v*) that there is incomplete specialization in production; (*vi*) that there are equal consumer tastes in both states; (*vii*) that there is perfect competition in both commodities and factor markets; (*viii*) that there is perfect mobility of factors *within* each state, but no international mobility; (*ix*) that there are no transportation costs, tariffs, or other occlusions to free trade; (*x*) that all resources are fully employed within each state; and, (*xi*) that trade is balanced.

the commodity which is relatively scarce and expensive. Using 1947 data, Leontief found that U.S. import substitutes were about 30 percent more capital-intensive than U.S. exports. Since the United States is the most capital-abundant nation, this result seems inconsistent with what Heckscher-Ohlin would predict under the circumstances. Despite these conflicting results and those in subsequent studies, Heckscher-Ohlin is still used today as the starting point in examining new trade theories and explanations of international trade.

2. The Effects of International Trade

The second major question discussed by the traditional economists was the gains to be derived from international trade. The prices described in the previous section would soon change into equilibrium prices, prices established when supply exactly equals demand. Suppose these equilibrium terms of trade turned out to be one bushel of wheat equals 2.5 yards of cloth. Domestically, Canadians could obtain two yards of cloth per bushel of wheat given up (not produced); with trade, they obtain 2.5 yards of cloth per bushel of wheat given up (exported), a net gain of 0.5 yards of cloth. In the United States, without trade, each bushel of wheat produced involves a sacrifice of three yards of cloth; with trade, cloth can be obtained at the rate of 2.5 yards per bushel, a net gain of 0.5 yards of cloth the example demonstrates that with trade the world production is expanded, and each country has a greater volume of goods available to it as a result.

It does not follow, however, that each segment of society will be made better off by trade. For this to occur, each country's polity must redistribute the overall gains realized from trade among the various segments of the population; adjustment assistance might, for example, be granted to those in the disfavored factor sectors if maximum social welfare benefits are to be obtained.

In the example, U.S. farmers and Canadian textile makers might seek assistance, for they would not benefit as much as Canadian farmers and U.S. textile makers. Any artificial interference with the allocation of scarce productive sources–through barriers to international trade–will, however, reduce the *world's* total real income (*see infra* pp. ▬-▬.)

There are, nevertheless, several relatively technical cases in which free trade can disadvantage a nation and a tariff becomes actually beneficial to that nation. These technical cases, explained in the following section, are infrequently applicable. Moreover, they are all beggar-thy-neighbor situations. In free trade, national advantage is gained along with advantageous (or at worst indifferent) effects on other nations. In the special cases, the advantage is gained at another nation's expense, and that nation's effort to restore its position leaves all worse off.

3. A Diagrammatic Explanation of Trade Theory

It is possible to present the theory of free trade in a relatively simple graphic presentation that allows insight into its limitations as well as into the power of the theory.[1]

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1. The graphical approach is modeled on that of Habeler, Some Problems in the Pure Theory of International Trade in R. Caves & H. Johnson (eds.), Readings in International Economics 213 (1968).

a. Single-Nation Equilibrium

Suppose that our attention can be focused on only one economy, so small that its trade with the rest of the world will not affect prices outside its borders. Suppose, also, that there are only two commodities to be traded: cotton (labor intensive) and steel (capital intensive). The first of these assumptions makes the presentation easier, and the possibility of price effects outside the nation can easily be bought into the analysis, as will be noted below. Neither does the two-commodity approach affect the result; more commodities could be included but at the cost of requiring a multidimensional graphic presentation.

Next, assume that our nation can produce a mix of cotton and steel products according to the "production possibility function," whose curve is shown in Figure 1-1. Such a curve, which shows the total production capability of the society, is also sometimes known as a "production frontier." Our nation can produce any combination of cotton and steel products shown on the line, but cannot produce any cotton or steel products outside its production frontier. (Of course, a nation can produce within its production frontier, as might happen during a recession or through plain inefficiency. We assume here that the economy is fully employed.) At point P along the curve, for example, the nation is producing amount OC of cotton and OS of steel. Production of one of the classes of products, cotton or steel, cannot be increased without decreasing the production of the other, moreover, as more of one product is produced, the corresponding decrease in the production of the other becomes that much more severe. That is, the nation must divert more and more resources from the production of the one to the production of the other product. This is known among economists as the law of diminishing returns or the law of variable proportions and accounts for the concave shape of the curve with respect to the origin. The assumption that a production function of the type shown in Figure 1-1 actually exists is unrealistic only in one respect–it assume full employment, an assumption that will be lifted later.

Let us at this point introduce the economist's concept of utility. This will have to be done in a somewhat rough-and-ready way for, as we shall see, while the concept has a relatively clear application to an individual's behavior, it is very difficult to apply it to an entire society. With this caveat, then, let us define the utility of a good as the satisfaction the good yields to a particular consumer. Now one immediate problem with this is that there is no obvious standard of utility. It is difficult to understand what a consumer would mean if he were to say "this product gives me 2.75 times more utility than that one," *i.e.*, that he is satisfied 2.75 times more by this product than by that. What he can say, though, and where the concept of utility becomes illuminating, is that he *prefers* this combination of products to that combination of the same products, or that between these two combinations, he is *indifferent*. We can imagine him saying, looking ahead a bit, that he prefers the combination of X amount of cotton plus Y amount of steel to the combination of R amount of cotton plus S amount of steel, or perhaps that he is indifferent to which of the two combinations he chooses and that one combination will satisfy him as well as another.

This indifference concept underlies the curves in Figure 1-2. These curves are called "utility curves" (sometimes, "indifference curves"). Each curve represents, at a particular level of purchasing power, a series of combinations of cotton and steel products that might satisfy a buyer. For instance, while points A and B on curve U-2 represent different combinations of products, the individual purchasing combination A or B is indifferent to which he buys–each equally satisfies (hence, an "indifference

curve"). Such curves are always convex with respect to the origin. Suppose we move up the curve U-2 from A to B. As we move we are, in effect, passing through several different combinations of cotton and steel products, and as we move from A to B the amount of steel diminishes and greater quantities of cotton products are needed to offset the give-up on steel. A consumer must have very much clothing to give up the last bit of transportation and (say) kitchen utensils–and vice versa.

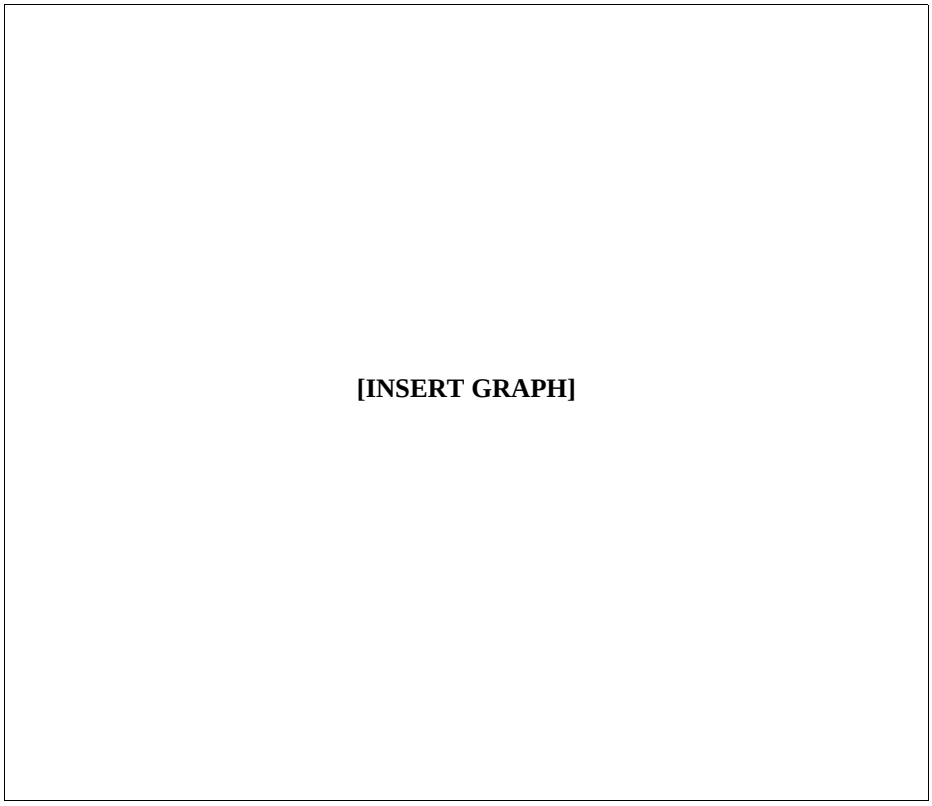

FIGURE 1-1
At point P on the production frontier the nation is producing OC cotton and OS steel

Each curve can be thought of as existing at a different level of purchasing power. All combinations on U-2 are equally appealing, as are all those on U-1, but each combination of U-2 is richer and more appealing than the combinations of U-1. Similarly, U-3 is preferable to U-2. For our individual buyer there is, in theory, a curve through each point in the diagram, although only three are shown. Economists call the totality of these curves the individual's "preference map."

As logical as these utility curves are for individuals, they become objects of controversy when it is claimed that they can be drawn for an entire society. If we hypothesize a *de minimis* society composed of just two consumers, one of whom likes

cotton products relatively more than the other, then how should the two individual curves be added together to produce the utility curve for the society as a whole? If one of the consumers has quite a bit more money than the other, that person's curve will dominate the society's apparent behavior. On the other hand, what if relative income changes during an economic process? Given the absence of any absolute standard of utility that has the assent of all, it should come as no surprise that economic theory is unable to make interpersonal comparisons of utilities. Hence, although we will assume a constant set of utility curves in our analysis, this assumption hides a complex distribution problem: in any society, those helped by trade may not have the same consumer preferences as those hurt by trade. What follows, then, is an approximation, but a useful approximation.

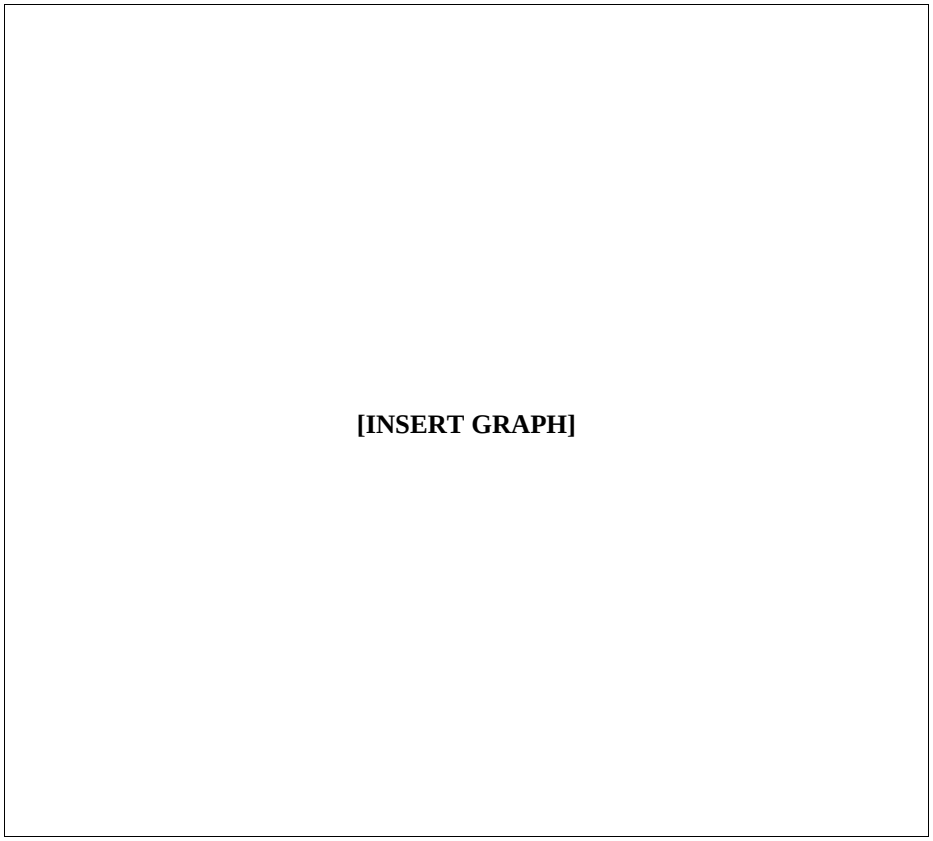

FIGURE 1-2
All the combinations on U-1 are equally satisfying to a consumer, as are those on U-2 and U-3, but the combinations on U-2 are preferable to those on U-1, and those on U-3 to those on U-2 and U-1

It is now possible to put the concepts together in a combined figure, Figure 1-3, in which the society produces at the level corresponding to the highest utility curve that

just touches (is tangent to) the production frontier. It produces OC amount of cotton and OS amount of steel.

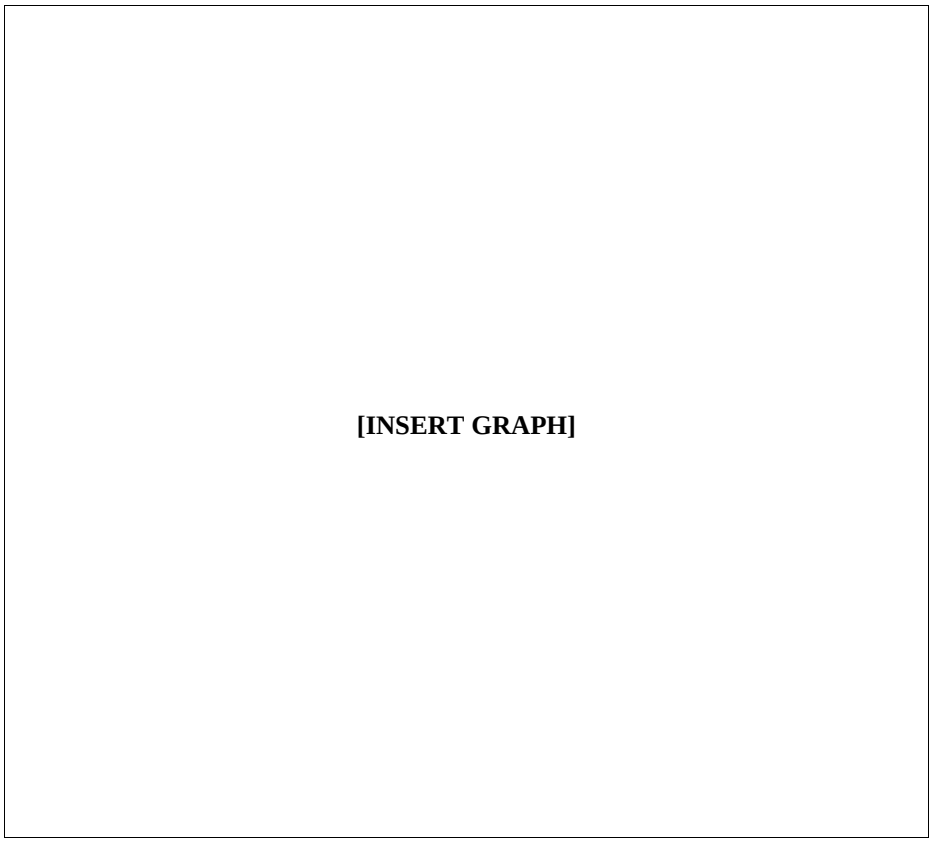

FIGURE 1-3
The nation reaches an equilibrium point when its production of commodities is just balanced by its demand for the commodities

To help understand why the society will reach this point–the equilibrium point–it will be useful to amplify an idea adumbrated earlier: in our graphical representation of the situation a price can be viewed as a *slope*. Mathematically, the slope of a curve is the ratio of a vertical change to the corresponding horizontal change of a line tangent to the curve at a particular point. What this boils down to is displayed in Figure 1-4. At any point along the production frontier of that figure the two commodities can be traded off one for the other in a proportion corresponding to the slope of a line tangent at that point. Along AA, for instance, we see that by giving up a small amount of cotton production, the society can gain a great deal of steel. Here we would say that cotton is relatively valuable or high-priced, steel is relatively low-priced. Along BB, the relationship is reversed. With this concept in hand, and looking at Figure 1-5, we can see why and how our producer-nation reaches its equilibrium point.

Suppose the society were producing at point P, which differs from the optimum corresponding to P^1. What this means is that at any price relationship between that corresponding to the slope of AA on the first utility curve (as we said, a relatively high price for cotton) and the slope BB on the production frontier (a much lower price for cotton), producers and consumers find it desirable (maximizing) to shift toward more production and consumers of cotton and away from production and consumption of steel. This process is dynamic, and the nation works along the production frontier to the point of tangency P^1, that point, that is, where the production frontier is just tangent to the next highest utility curve. The price relationship at this point is the slope CC of the common tangent–the nation has achieved its equilibrium point.

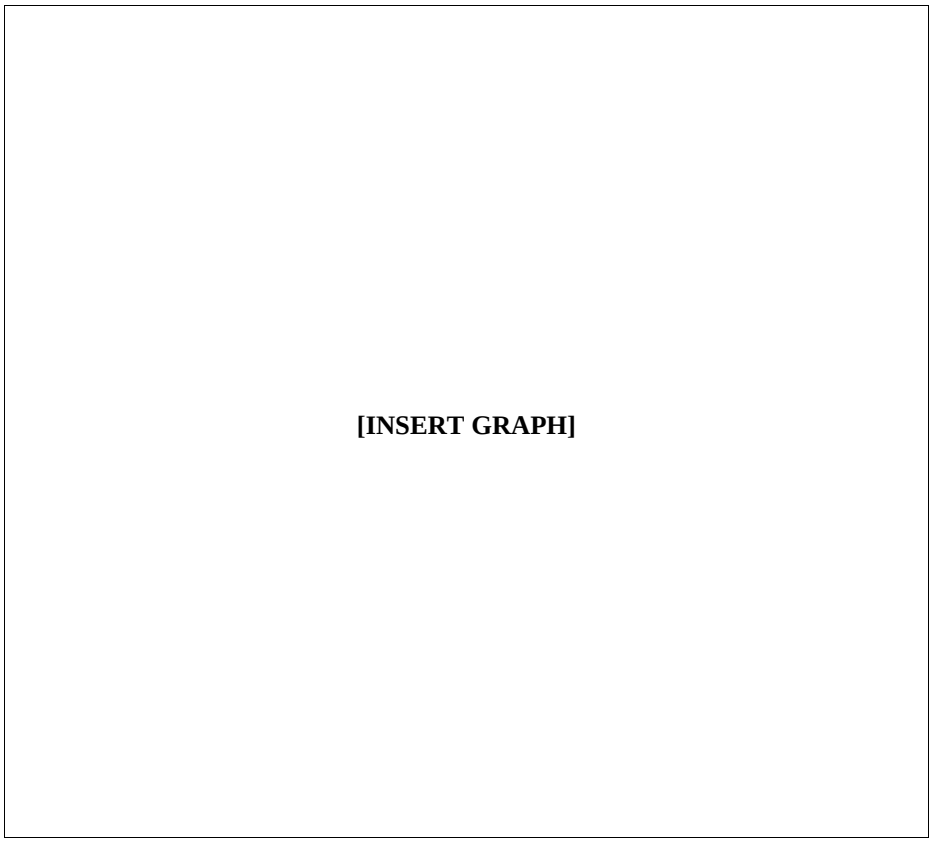

FIGURE 1-4
The commodities can be traded for one another according to a price determined by the slope of line tangent to the production frontier

b. The Benefits of Trade and the Costs of Import Protection

The admittedly intimidating, but actually quite understandable, Figure 1-6 shows the benefit of trade for our small nation-producer. Under our assumptions, the econ-

omy–absent trade–achieves its equilibrium point P, producing exactly what it consumes, the price corresponding to the tangent common to its first utility curve and its production frontier. However, in the world beyond there is the world price, corresponding to the slope WW. It is our local producers' perception of this world price that provides a stimulus to trade. Why?

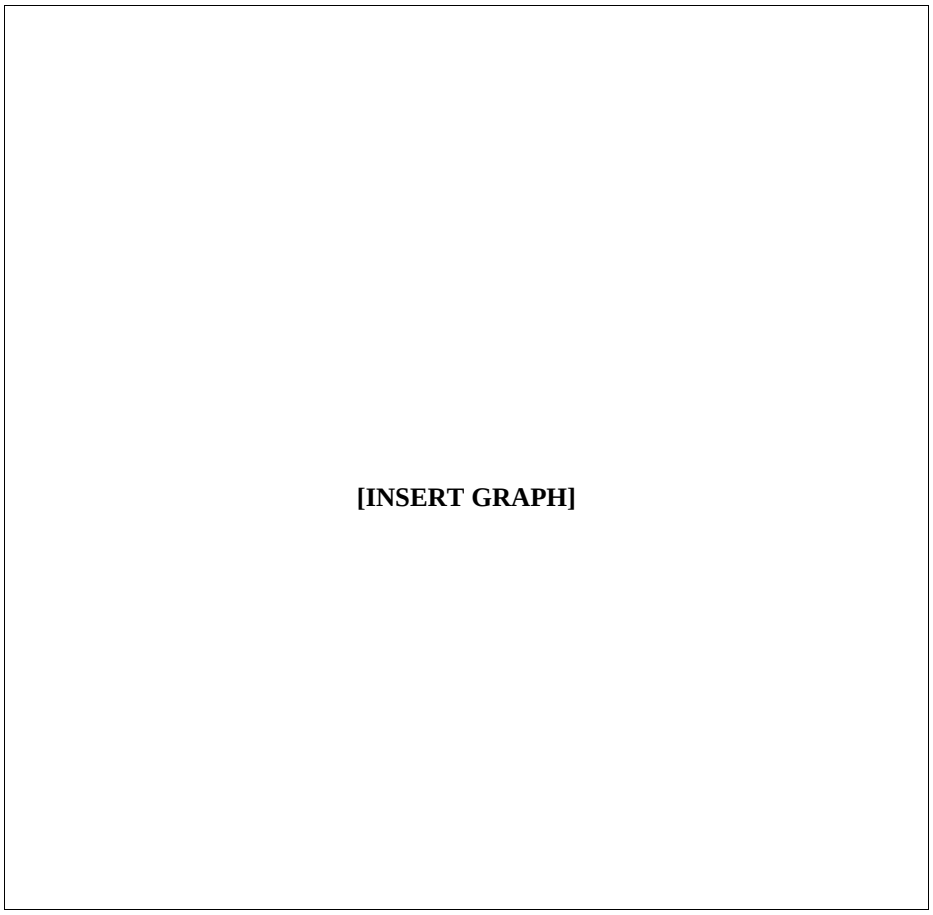

FIGURE 1-5
The nation will shift production towards the commodity having the most (relative) utility, eventually reaching the equilibrium point

If we compare the equilibrium slope with WW, it is apparent that local producers of cotton are comparatively advantaged with respect to nonlocal producers, while local producers of steel are comparatively disadvantaged with respect to nonlocal producers. Steel producers, seeing their options, shift their resources into the production of cotton and move the society to point R. MR represents now the total cotton production, with MA being the amount sufficient for the nation's internal needs.

The extra amount, AR, can be traded on the world market for the amount of AC of steel at the world price. (AN steel is produced locally.) There is, then, a net gain to the society because the consumers will consume on a higher utility curve than they would without the trade. Given the concave-convex relationship of the two sets of curves, and as long as there is a difference in the local price and the world price (which will favor one group of local producers and give them a comparative advantage), trade will be beneficial and will more than compensate for the lost production of the disadvantaged producers. Indeed, if we lift the assumption that our example economy is too small to affect the world economy, the opening of trade will affect prices there and produce benefits to other consumers. Let us now, though, introduce a next step into this account: what happens if, for whatever reason, a tariff is imposed on imported steel? As Figure 1-7 shows, the tariff will leave the nation's economy better off than in the absence of trade but not so well off as with free trade.

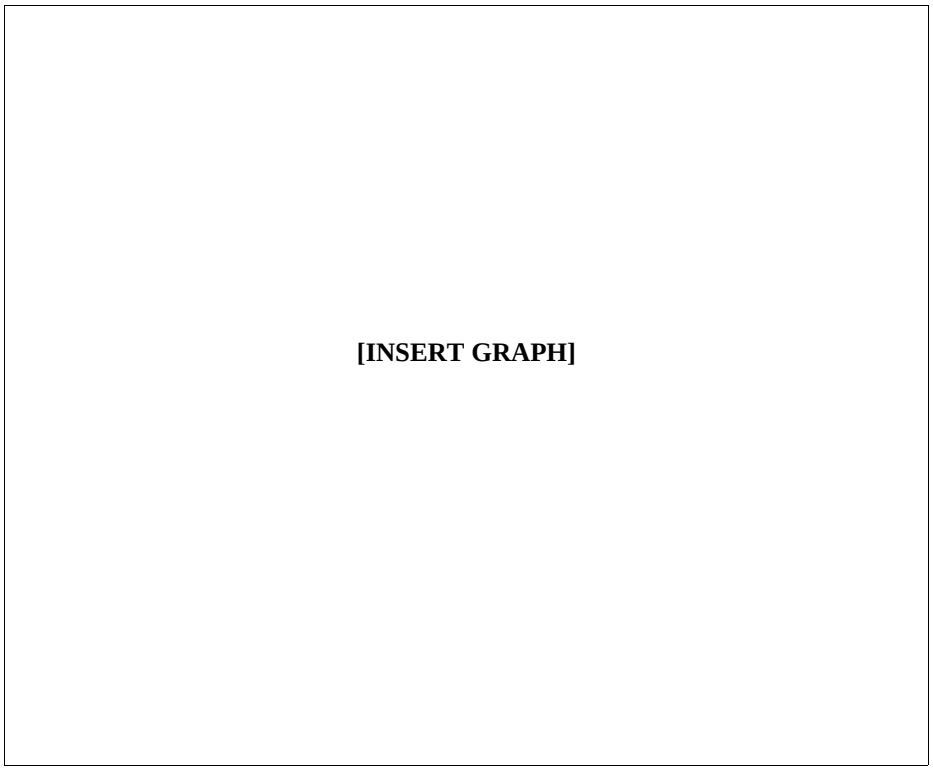

FIGURE 1-6
Producers will respond to the world price structure by devoting more resources to their comparatively advantaged commodity. Trading this commodity on the world market results in a net gain, moving the nation as a whole onto a higher utility curve

A tariff can be regarded as a way to create an artificial price. Without a tariff, the

initial higher-than-world price of steel will fall to the world price. Imposition of a tariff will arrest this fall to a point somewhere between the initial price and the world price. In effect, the tariff weakens the exporting nation's comparative advantage, *i.e.*, the comparative advantage-disadvantage gap is narrowed in favor of the importing nation's steel producers. This will benefit the local producers. However, following the no-free-lunch principle, the artificially enhanced price is purchased only at a price.

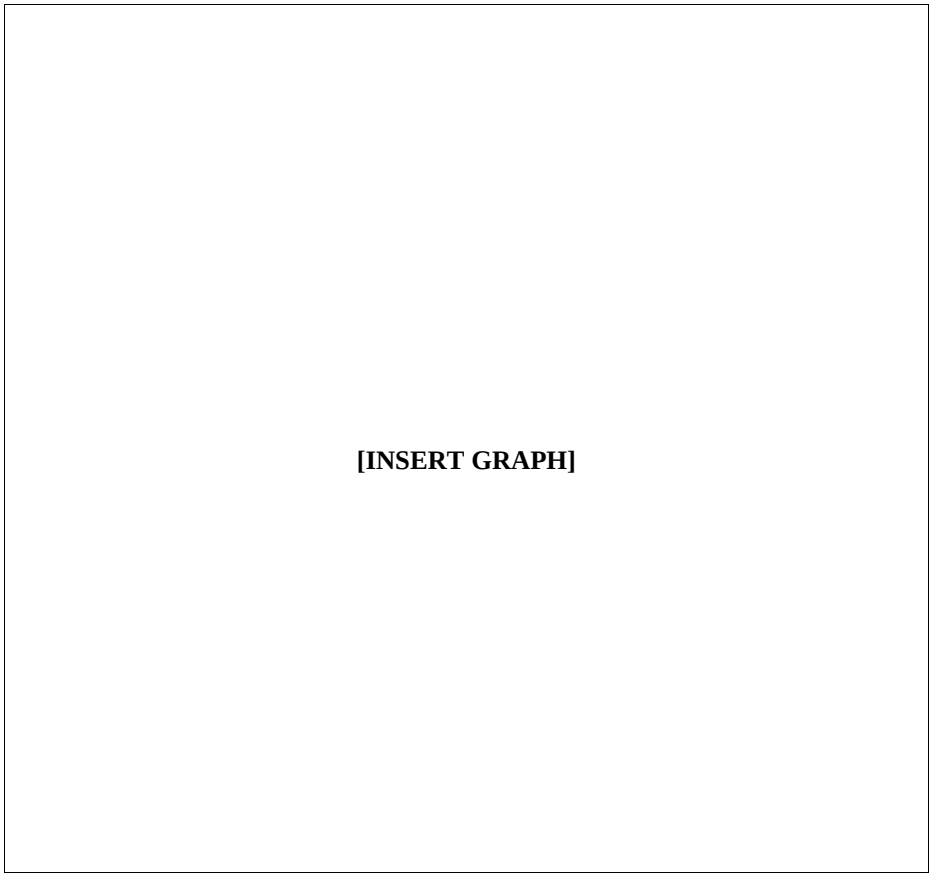

FIGURE 1-7
A tariff-induced price consigns the nation's consumers to a lower utility curve than would be the case with free trade

Suppose the tariff-produced price corresponds to the slope AA of the production frontier at point T. Since producers will optimize at the price they perceive, regardless of how that price is set, this is the point at which production will occur. The local producers benefit. But what of the nation's consumers? How does the tariff affect them? The situation here is a bit more complicated.

Consumers, too, will react to the price they perceive. Note, though, that no matter

what tariff legerdemain the nation engages in (at least for a hypothetically small nation), the world price remains unaffected. (An overstatement. For any nation, of course, the world price will be affected, and where a large nation is involved, it will be significantly affected. *See infra*.) Now, the consumers, perceiving the artificially induced price AA, will attempt to consume at that price on the world market. But their ability to acquire goods by trade is determined by the world price WW. Attempting to purchase at AA, they trade down the line TC, corresponding to WW, until a line parallel to AA becomes tangent to a utility curve, here U-2. Thus, the effect of the tariff on local consumers is to consign them to a lower utility curve than would be the case with free trade, here curve U-3 at point R. The tariff does protect the local steel industry, which does not have to reduce its production so much as it would with free trade, but the nation's consumers bear the costs of this.

In short, free trade theory implies the following effects for an economy such as that of the United States:

(a) more goods are made available to the population;

(b) consumers benefit by moving to a higher consumer utility curve, obtaining a greater diversity of choice;

(c) vigorous foreign competition serves as a prod to innovation and adjustment by producers–-such a development, while beneficial to the consumers, may cause severe unemployment in import-sensitive industries;

(d) trade serves as a deterrent to the creation of domestic monopolies and promotes a more competitive domestic marketplace; and

(e) freer trade acts as an antidote to inflation–-the presence of foreign imports prevents the price of scarce local supplies from being bid up precipitously.

c. The Logical Limitations of the Free Trade Theory

The distribution problem goes beyond the formal problem of inability to make interpersonal comparisons of utilities. Free trade will, in the model just described, move jobs from the steel industry to the cotton industry. An economic analysis will show that it is generally better to accept that shift, subsidizing, if necessary, the restraining and movement accompanying the shift.[2] Yet, in the real world, political considerations often make that subsidy impossible while leaving the tariff misallocations politically tolerable. The subsidy is part of a government budget in a capital-scarce world; the effects of the tariff are disguised in relative prices. Moreover, distribution or national security concerns may lead one to hesitate to let completely free trade impose further costs on such depressed industries as steel and textiles for the sake of the nation's winners such as service-related industries, high-tech enterprises, and agriculture. There is a combination of taxes and subsidies that would accept free trade and leave everyone better off, but it is probably politically infeasible in light of the power of organized labor and particular industries.

In addition to this point, there are several more technical limitations to the free trade theory. All are proposed much more frequently than they are really applicable–yet they exist as arguments that may have a temporary validity–and, certainly, have a great

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2. *See* W. Diebold, The United States and the Industrial World 185 (1972); C.F. Bergsten, *A New Foreign Policy for the United States*, in THE UNITED STATES AND THE WORLD ECONOMY: FOREIGN ECONOMIC POLICY FOR THE NEXT DECADE (2005).

political importance.

The first is commonly identified as the *terms of trade* argument.[3] To analyze this possibility, we must lift the assumption that trade with the nation we are analyzing has no effect on world prices. Suppose, in fact, that a buying nation is so powerful in the world market as to have significant effect on prices. As suggested in Figure 1-8, if it imposes a tariff, which will tend to reduce its own imports, that tariff will reduce world prices, corresponding to a flatter world price line. Conceivably, this price effect is so great as to leave the nation spending less for its imports than with free trade. Other nations will be less well off. As an example, consider the possibility that the United States is so major a global consumer of automobiles that a tariff on imports might significantly lower the global price of cars by decreasing global demand. The United States consumer would have to pay more for automobiles, but the proceeds of the tariff would be available to the government and fewer exports would be needed to purchase one automobile. As an argument for tariffs, the logic is only rarely applicable. It requires extensive market power–and if those affected by it can assemble comparably effective market power, they can take the benefit away from the first group, and all are worse off.

The second valid argument is the *infant industry* argument, developed by Alexander Hamilton and currently strongly urged on behalf of developing nations. The free trade logic is static and rests on the production possibilities and factor endowments of particular time–but many nations would like much broader production possibilities for the future. Hence, they would like to use tariffs to affect the relative profitabilities of different industries and to ensure that their production frontier evolves in particular (generally high-tech) directions. Tariffs can certainly do this, efficiently or not. For a period, for example, high tariffs on assembled automobiles led to the creation of small inefficient automobile assembly plants in many nations. Such a tariff can encourage the creation of an industry that would otherwise not be economical but can, after its start-up period, become economical. (There is doubt, of course, whether the political impulse will exist to remove the tariff at the later point.)

Finally, and crucially for a world marked globally by economic sluggishness, there are the *"Keynesian"* or *macroeconomic* questions of unemployment, imbalance of payments, and the monetary system. Few nations actually operate on their production frontier–most are operating well below it with significant unemployment. Governments therefore seek to increase employment.

Internationally, governments encourage their economies to export more than is imported, *i.e.*, to run a balance-of-trade surplus, and gain the employment associated with manufacturing the extra exports. Thus, as United States wheat is sold to the Soviet Union, the Midwest (and the U.S. farm equipment industry, etc.) receive a boost from this injection of demand. In contrast, if the United States imports automobiles from Japan, it is the Japanese economy that receives the benefit of the direct and indirect employment.

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3. The expression "terms of trade" is often used more broadly to describe the exchange between exports and imports, for example, the price in agricultural products that a developing nation must pay for manufactured imports or the price in terms of manufactured goods that a developed nation must pay for oil.

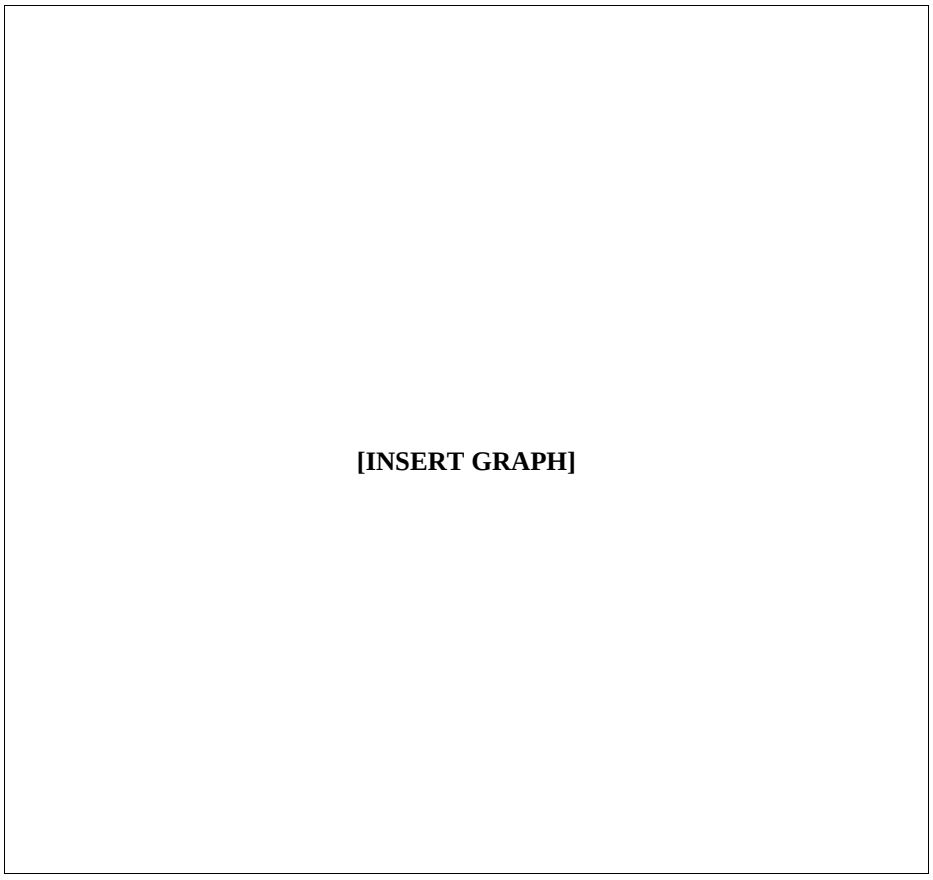

FIGURE 1-8
If a nation is economically so powerful that its buying practices affect world prices, a tariff imposed by that nation will depress world prices

As suggested by Figure 1-9, however, economies interact in such a way as to make it very difficult to pursue such policies. Most obviously, not all nations can run a surplus–one nation's surplus is another's deficit. More subtly, if a nation maintains a continued balance-of-trade surplus, it is likely to suffer the inflation that seems automatically to accompany efforts to increase employment. Its citizens will receive income corresponding not only to what is made for domestic consumption but also corresponding to what is exported. This excess demand may thus bid up domestic prices. Moreover, the nation’s currency will tend to rise in value in comparison with other currencies, as people in other nations seek to pay for the products they are buying from it. Both effects will make its products appear more expensive on world markets and tend to slow exports, increase imports, and bring the balance of trade back towards equilibrium.

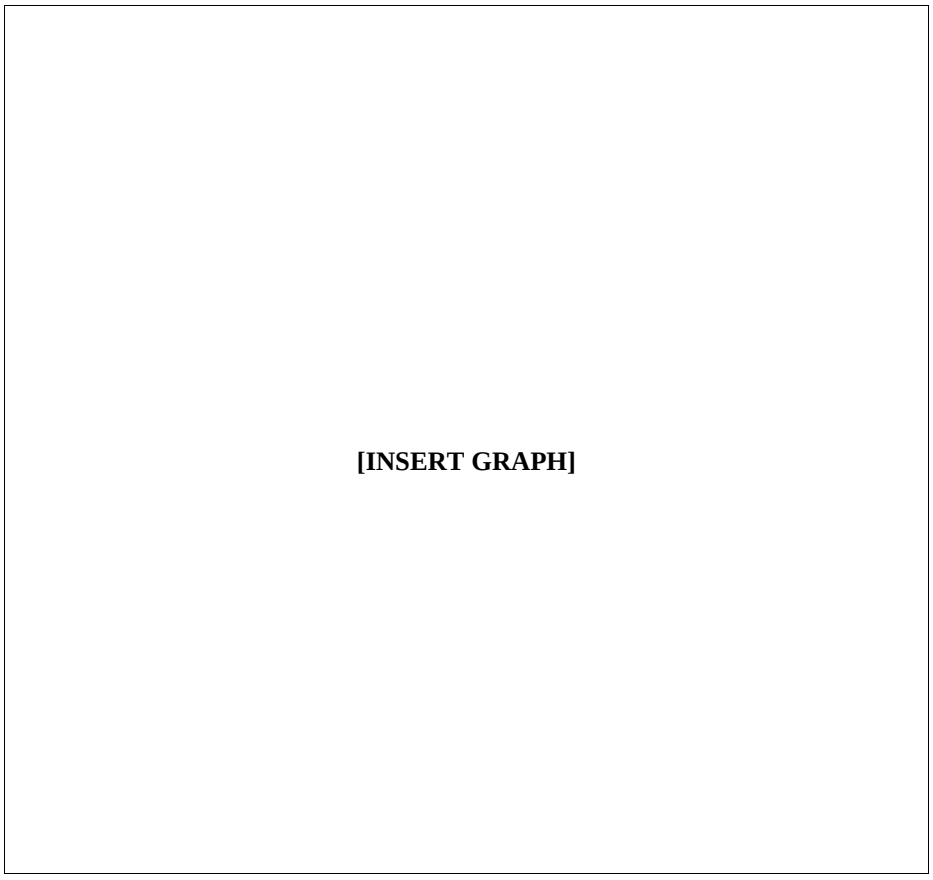

FIGURE 1-9
In a free trade environment national economies will tend towards a balance of trade

Even more complicated effects arise when effects on savings are considered. A nation in a balance-of-trade deficit is manufacturing less than it is consuming, and is therefore, on net, decreasing its savings. Interest may, therefore, tend to rise. (They are also affected by the policy decisions, in the United States, of the Federal Reserve System and in other countries by its foreign analogues). And, as interest rates rise, foreign savings are likely to be attracted in order to gain the higher return.[4] To add to the complication, investors choosing among different national currencies will also attempt to take into account the prospects of inflation in different nations as well. In this world, clearly very complex and not yet well understood, it is possible that barriers to imports can help a single economy. Almost certainly, however, competition among nations to

4. In the early 1980s, for example, the effect of high U.S. interest rates, coupled with the desirability of the United States as a "safe haven" in which to invest, was the bidding up of its currency by foreigners seeking to take advantage of these high rates and U.S. political stability. The appreciation of the dollar vis-á-vis foreign currencies sharply reduced the competitiveness of U.S. export pricing; *see* Bergsten, The Cost of Reaganomics, 44 Foreign Poly. 24, 31 (1981).

build such barriers will be harmful to all.

C. OTHER THEORIES OF INTERNATIONAL TRADE[1]

The traditional theory of international trade is elegant. Unfortunately, it does not accurately describe observed world trading patterns in manufactures. The concern that comparative costs perhaps did not explain trade patterns in manufactures first appeared in 1953, when Leontief showed that United States export industries were heavily labor-intensive.[2] This finding dramatically undermined the Heckscher-Ohlin theory of comparative costs, since the United States was generally considered to have an abundance of capital, and to be poorly endowed with labor. More recently, it was also questioned why, for example, the United States was producing and exporting such products as optical crystals, when the comparative cost advantage of scientific personnel needed to produce such crystals was to be found in Israel.[3] To cope with these observed phenomena, a new theory called the "product life cycle" theory, which attempts to consolidate and address the questions of trade and investment within a coherent model, began to surface in the business schools of the United States.[4] It has been followed by other new theories.

The major assumptions of the product life cycle theory are:

> (1) there is not an absolute flow of information across the international boundaries-–on the contrary, the information needed to make high-technology organizations run in high gear is drastically restricted through patents and other techniques;[5]
>
> (2) corporations act in the world economy as Galbraith informs us they do in The New Industrial State–they not only react to domestic demand, but also have the capacity to shape it;[6] and
>
> (3) the management of the mature corporations is astute in increasing multinational profits in the long run by adjusting to changing the national and international economic conditions such as the presence of tariffs abroad.[7]

Increasing economic "globalization"[8] has undercut the usefulness of the product life cycle model. As national economies continue to integrate and as the rules governing trade in goods, services and capital become relatively more harmonized at the international level, the assumptions on which the model rests have become progressively less reliable. This development does not mean a return to traditional Heckscher-Ohlin

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1. Parts of this section draw heavily on Wells, International Trade: The Product Life Cycle Approach, The Product Life Cycle and International Trade 3-33 (1972) and on Barton, Technology Trade, Proc. of 177th Ann. Mtg. A.S.I.L. 130 (1985).

2. Leontief, Domestic Production and Foreign Traffic: The American Capital Position Re-examined, 97 Proc. Am. Phil. Socy. 332 (1953).

3. Wells, *supra* note 1, at 11. *See also* S. Hirsch, Location of Industry and International Competitiveness (1967).

4. It was perhaps logical that the business schools should be the first to isolate the impact of economic transnationalism on international trade, since they are typically closer than economics departments of universities to what international business is doing and how it relates to the international environment.

5. Wells, *supra* note 1, at 5-6.

6. *Id*. For a trenchant analysis of the performance of large corporations in modern economic society, see J. Galbraith, The New Industrial State, 4th ed. (1985).

7. The leading description of the product life cycle has been offered in Vernon, International Investment and International Trade in the Product Cycle, 80 Q.J. Econ. 190 (1966). A five-phase model is offered in Wells, *supra* note 1, at 11-16.

8. By the term "globalization," we mean the situation in which formerly quasi-autonomous national economies integrate into a broader regional or international economy.

analysis, however, because globalization also negates many of the underlying assumptions of Heckscher-Ohlin.[9]

The product life cycle theory is not the only one that has sought to explain the difference between the real world and the free trade theory. For example, theories based on Chamberlainian monopolistic competition are now being elaborated to explain international cross-trade in such product areas as automobiles and electronics.[10] Chamberlain's underlying work,[11] going back to the 1930s, was a theory of quasi-monopolistic competition among differentiated products such as automobiles or cameras. Each brand has a quasimonopoly, for it is different from the other products. Yet, the products are substitutable enough that monopoly power is quite limited and new entry into the industry can drive profits to zero. Chamberlain's theory provided insight into these markets and into such factors as the number of semicompeting products that would be likely to emerge within a single industry.

When two such economies open trade, it is reasonable to assume that there will be cross-trade. For example, some Europeans will prefer U.S. automobiles and vice-versa. It turns out that a strong and important statement can be made under fairly general conditions: the market that was bigger in the first place is likely to export more to the smaller market than vice-versa. "[C]ountries will tend to export those goods for which they have relatively large domestic markets."[12]

This is closely related to the "learning curve phenomenon" the decrease in product cost as a firm gains experience. With semiconductor computer memories, for example, the cost per bit of storage has declined by about 30% for each doubling of production volume. Between [redacted] and [redacted], the cost of producing one bit of memory declined about [redacted]%.[13] The industry that first begins working down this learning curve has a continuing cost advantage over later competitors.

To the extent that these arguments are correct, the technical leader that is working from a larger market base can out-compete new entrants or those coming from smaller market bases. The law of diminishing returns is stood on its head. Under the high-tech arguments, the effect of a government subsidy "targeting" a particular industry or of an opportunity to develop a large protected market is thus to create an advantage that lasts "forever." With steel, a short-term advantage can be compensated for and everything will arguably work out afterwards. With semiconductors, it is plausible to suppose, a short-term subsidy–or any other protective device–can confer a lasting advantage.

A far more sinister implication of the high-tech theories is that the situation of the developing nations is much more desperate than it would seem to be on the basis of the more traditional theories. Under traditional theories, the developing nations would have a chance to catch up if only other nations gave their exports a fair chance; under the high-tech theory, their position of technological inferiority is almost irreversible.

These high-tech theories thus directly contradict the more traditional economic theories. Free trade logic would have industry distribution reflect comparative

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9. For example, in many economic sectors it is unrealistic to speak systemically in terms of only two states, two commodities and two factors of production. Further, factors of production are increasingly mobile internationally as a functional matter--capital from one state may be invested in assets obtained in another and forwarded to a third, more labor-intensive state. Globalization is reinforced by emerging legal rules at the international level that have the objective of enhancing the transparency of national borders in relation to the movement of goods, services, and capital.

10. Ethier, National and International Returns to Scale in the Modern Theory of International Trade, 72 Am. Econ. Rev. (1982). Krugman, Scale Economies, Product Differentiation, and the Pattern of Trade, 70 Am. Econ. Rev. 950 (1980).

11. *See* E. Chamberlain, The Theory of Monopolistic Competition (1933).

12. Krugman, *supra* note 10 at 950.

13. [UPDATE]

advantage. Product cycle theory would have industries move down the wage ladder to lower and lower wage nations. These new theories, however, would have industries stay in the places that pioneer them, or subsidize them to a position of leadership.

These theories must not in every instance be accurate or the United States would have long been frozen in a position of superiority. Their current force is probably strongest for rapidly changing technologies whose production facilities are capital intensive rather than labor intensive. There are clearly ways to challenge such a leader, for example, through education and underlying basic research. Moreover, there are sometimes benefits in being *second* to develop a technology–-being able to benefit from others' errors and even research, which can never be protected fully by patents. For example, it has been said that the French have much more successfully developed nuclear power for commercial purposes than the United States due to their ability to avoid errors already made by the United States. And the location of the next major technological breakthrough that brings a completely new learning curve and product is probably not predictable by any theory.

NOTES AND QUESTIONS

1. The emergence of the phenomenon of globalization has some unsettling effects on economic theories with respect to international trade. As we have already seen,[1] globalization undercuts many of the assumptions behind the product life cycle model. In addition, increasing globalization, with its tendency to obscure the parameters of national economies, makes traditional economic explanations of international trade even less practical and more abstracted from the realities of international trade. Beyond economic theory, however, globalization also affects the political dimension of international trade.

2. *Globalization and International Trade Policy*. Is globalization a good thing? Clearly, it has the advantage of confounding tidy economic theories of international trade. To the extent that it makes trade, services, and capital more mobile, it can be a useful tool for economic development. On the other hand, increased mobility of the factors of production can also cause dislocations within traditional national economies. Thus, when the United States, Canada and Mexico concluded the North American Free Trade Agreement (NAFTA), Ross Perot and some congressional critics heard a "great sucking sound" of U.S. jobs heading South, as they anticipated dislocation of U.S. labor in favor of labor-intensive Mexico. Surprisingly, a 2001 research project studying the effect of globalization on jobs in the motor vehicle industry indicated that the industry is employing an all-time high number of workers, adding 311,200 U.S. jobs between 1982 and 2000, and defying expectations that economic globalization would result in the elimination of U.S. manufacturing jobs.[2]

3. In a February 2005 report,[3] the Institute for International Economics estimated that globalization increased U.S. incomes by approximately $1 trillion per year, and that moving to completely free trade would raise U.S. incomes by an additional $500 billion a year. On the other hand, the Institute identified "dislocation costs" of global-

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1. *See supra* at 20 (discussing effect of globalization).

2. *Panelists Discuss Effects of Globalization on Employment in U.S. Automobile Industry*, Int'l Bus. & Fin. Daily, May 7, 2001, at d5.

3. INSTITUTE FOR INTERNATIONAL ECONOMICS, THE UNITED STATES AND THE WORLD ECONOMY: FOREIGN ECONOMIC POLICY FOR THE NEXT DECADE (2005).

ization–including the effects of lost jobs and adverse economic effects on U.S. businesses–of approximately $50 billion per year, while the U.S. Government annually spends only between $1 billion to $2 billion to ameliorate such dislocation. Why would the government allocate such a relatively small amount to address the negative effects of globalization? Indeed, according to a recent report in the WALL STREET JOURNAL EUROPE, Congress appears to be "increasingly skeptical of the value of free trade,"[4] despite potential income gains to the U.S. economy. What would explain congressional attitudes in this regard?

4. *Adverse Effects on Other Public Policy Values.* Internationally mandated rules requiring free movement of goods may have a markedly adverse effects on, for example, the environmental or human rights policies of individual states. Some of these consequences of globalization led to violent protests at the Seattle meeting of the WTO in November-December 1999 by an unusual coalition of environmentalists, labor advocates and public interest groups, among others. Should international trade policy take such extraneous policy values into account?

5. *Globalization and International Development Policy*. Globalization is not necessarily a "North-South" issue pitting developed and developing countries against each other. To the contrary, studies suggest that, for developing countries that adapt relatively quickly to the globalized economy, the benefits can be considerable. Furthermore, international business transactions bind nations more closely together in an economic sense, but doesn't this:

(a) make countries far more vulnerable to external economic disruptions, magnifying the possible effects of, for example, inflation or an "oil price shock"?
(b) create strong protectionist pressures due to intense foreign competition?
(c) circumscribe autonomy over national monetary and fiscal policies?

John Maynard Keynes wrote in 1933 that: "Ideas, knowledge, art, hospitality, travel, these are things which should of their nature be international. But let goods be homespun whenever it is reasonably and conveniently possible; and, above all, let finance be primarily national." Is Lord Keynes's advice relevant today? Would you support policies–perhaps a return to fixed exchange rates, or a system of "bands" limiting the upward movement of currencies–that might decouple economies from growing interdependence? If the interdependence of national economies is a reality from which there is no turning back, would you support stronger international institutions to keep national policy makers on a common track?

6. *Globalization and Mature Economies*. From the perspective of developed economies, is globalization just a superficial rationalization for rabid expansion into vulnerable developing economies? To the contrary, a 2002 report from the OECD argues that increasing trade and financial links among the industrialized economies and the increasing alignment of economic policies that results from globalization have had a stabilizing effect on the business cycle; periods of boom and bust are far less pronounced today than in past decades. Lawrence J. Speer, *Business Cycles: Globalization Has Stabilizing Effect on Global Business Cycles, OECD Says*, BNA INT'L BUS. & FIN. DAILY, June 3, 2002, at d6. Globalization fosters new trading patterns, economic sectors and the dissemination of technologies. In particular, the rapid expansion of the services

4. Naotaka Matsukata, *America's New Chief Trader*, WALL ST. J. EUROPE, Mar. 21, 2005, at A8, col. 3, 4.

sector, which the OECD views as directly connected to globalization, is a key factor in the stabilization of business cycles. As important sectors–like financial services–become deregulated, national markets increasingly link economies internationally. Of course, such linkage may also mean that economic or financial crises can also proliferate more rapidly throughout the international economy. On balance, then, is globalization a desirable development or not? According to the OECD, one of the most significant policy challenges confronting international trade policy is the risk that "significant shocks emanating in one country, sector, or industry may now more quickly spread across national borders." *Id*.

D. THE POLITICS OF INTERNATIONAL ECONOMICS

Most of this text will reflect the politics that surrounds the economic phenomena just discussed. But a very brief review here at the beginning should help the student place the economic ideas in their political context.

1. The Politics of Trade

Although it is properly subjected to minor adjustments and corrections, the free trade argument is nevertheless almost always correct in its general result: free trade is better for an economy than are trade restrictions: Yet, trade restricting policies are frequently popular. Why?

The most obvious and important reason is that each import limitation benefits a specific industry, and national political systems in free societies are almost always better at responding to the sharp complaint of a specific industry than to the diffused complaints of consumers affected by higher prices.

In addition to the political appeal of job-related arguments, legislators will be tempted towards protectionist policies promoted by self-serving coalitions of import-impacted industries. Industries are scattered through many different regions of a developed nation, and practically every legislator is interested in protecting some industry. The result, if tariff legislation comes to a vote, is a strong temptation toward log-rolling–toward trading votes to provide tariffs to help at least 51% of the legislators. In the United States this was one of the causes underlying the high Smoot-Hawley tariffs of 1930. Recognition of the risks of such a result are also one of the reasons why legislatures have delegated significant tariff establishment tasks to the administrative processes discussed later on in this book.

Sometimes, protectionism arises from opposition to what are perceived as unreasonable or "unfair" trade practices of other nations.[1] Moreover, as explained above, certain tariffs can benefit a nation at the expense of other nations, but the other nations can then retaliate. This is particularly serious when increased exports are sought in order to create employment at the expense of employment in the importing nation. And, when a nation subsidizes or otherwise favors its exports, other nations find it hard politically

1. For example, the United States and the European Union have repeatedly protested the import-limiting policies of Japan; the perception of Japan as an unfair trader has triggered protectionist sentiments against Japanese exports in these and other areas.

to resist the complaints of unfair competition and therefore impose retaliatory tariffs. In these situations, the avoidance of protectionism generally requires international agreement–nations are less likely to be taken advantage of if they obtain agreements with others that neither will take "unfair" action. Even these agreements may be politically difficult in time of recession, for they are, in a sense, a way to allocate unemployment among the various nations involved. Moreover, if a nation violates the accords, there are few effective sanctions available other than imposing new trade restrictions, which may hurt everyone.

Certain political approaches to trade go further and reject market solutions in the name of long-term goals, as global extensions of the infant industry argument. The developing world, fearful that it will always be but a supplier of raw materials, has sought to encourage industry and a "New International Economic Order" in order to expand its economic base. It argues that, as a matter of economic justice, the developed world should help in this process, and hopes, in imitation of the Organization of Petroleum Exporting Countries (OPEC), to impose higher prices on its exports to the developed world. And the developed world, seeing many of its traditional industries in decline in the face of lower cost imports from the developing world, has sought to intervene to protect these industries and to favor the expansion of new high-technology industries. An important question for students to contemplate as they read this textbook is to what degree *should* governments intervene to assist promising ("sunrise") or troubled ("sunset") industries. This is part of the "industrial policy" debate.

2. The Politics of Technology and Services

Until recently, the international flow of technology was generally unregulated, but this has changed dramatically since World War II and is likely to change even more in the future. Nations receiving technology have generally been interested in acquiring as much technology as possible as inexpensively as possible. They once sent people abroad for foreign training. This is still extremely important, as is technology transfer through international institutions and foreign assistance programs. Recent attention, however, has focused heavily on business technology licensing and direct investment. Japan's Ministry of International Trade and Investment carefully reviewed technology licenses during the 1950s and 1960s to ensure that the Japanese recipient was obtaining as favorable an arrangement as possible; developing nations are today imitating this approach and seeking to impose more favorable terms on foreign investors who bring them technology. All these efforts take place against a backdrop of debates over the desirability of "appropriate technology"–technology, typically less sophisticated, that seems more in keeping with a simpler and less sophisticated life style, and over the desirability of such advanced technologies as nuclear power or high-energy agriculture.

On the technology suppliers' side, there is more and more interest in legislation to prevent the export of technology and thus to protect the suppliers' competitive position. Most of the actual controls have covered only technologies of military significance. However, spurred by the terrorist attacks of September 11, 2001, on the World Trade Center, these concerns have broadened. Some of the military arguments may in fact be excuses for economically motivated restrictions. For example, labor unions have been pushing governments to restrict the export of technologies that might carry employment with them, and nearly all governments have sought to ensure that their own firms and economies were the primary beneficiaries of their subsidies for research in such areas as computers and bio-engineering.

The multilateral negotiations that resulted in the establishment of the WTO in 1994[2] also produced a significant international legal framework to enhance international trade in and access to services. In April 1994, the Uruguay Round of GATT multilateral trade negotiations finalized the General Agreement on Trade in Services ("GATS").[3] The GATS establishes "a multilateral framework of principles and rules for trade in services with a view to the expansion of such trade under conditions of transparency and progressive liberalization,"[4] by applying GATT nondiscrimination principles to trade in services.[5]

The financial services sector offers an interesting example of the effects of the GATS. The requirements of nondiscriminatory treatment do not prevent WTO member states from enforcing domestic regulations for "prudential reasons, including for the protection of ... depositors, ... or persons to whom a fiduciary duty is owed by a financial service supplier, or to ensure the integrity and stability of the financial system."[6] As a transitional matter, a second Annex to the GATS, concerning financial services, permitted temporary withdrawal from the GATS commitments.[7] Nevertheless, it was anticipated that inclusion of financial services under the GATS regime would "likely ... result in increased market access"[8] for international financial services firms. This expectation received a setback when the United States withdrew from the GATS transitional process with respect to the Agreement on Financial Services in June 1995. In July 1995, over 80 states–including Japan, but not the United States–concluded a transitional agreement to liberalize international trade in financial services.

In withdrawing from the transitional arrangement, the U.S. Government opted for a policy of measured reciprocity, prospectively limiting access to U.S. markets to financial services firms from home countries that provided reciprocal treatment to U.S. firms. Essentially, the government had decided to seek market-access liberalization through bilateral negotiations, rather than through the multilateral mechanism of the WTO and the GATS.

Matters remained in play, however, because the commitments of WTO member states participating in the transitional arrangement were to expire at the end of 1997.[9] Thereafter, WTO member states were expected to renegotiate GATS financial services commitments. In advance of the expiration date, however, the United States joined in the signing of a global accord to govern international trade in services. While the United States made no concessions, in light of the relatively open access to U.S. markets

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2. On the WTO, see Chapter III, *infra*, at ▬.

3. General Agreement on Trade in Services, 15 April 1994, Agreement Establishing the World Trade Organization, Annex 1B, 33 Int'l Leg. Materials 1167 (1994) ("GATS"). WTO members are not permitted to derogate from adherence to Annex 1B. Agreement Establishing the World Trade Organization, art. XVI, ¶ 5. For an excellent review of the GATS (and specifically of its implications for banking), see Kristin Leigh Case, Recent Development, *The Daiwa Wake-Up Call: The Need for International Standards for Banking Supervision*, 26 Ga. J. Int'l & Comp. L. 215 (1996).

4. GATS, preamble.

5. *See, e.g.*, GATS, art. II, ¶ 1 (applying most-favored-nation treatment to services and service suppliers); GATS, art. XVII, ¶ 1 (applying national treatment to services and service suppliers of other WTO member states).

6. GATS, Annex on Financial Services, § 2(a).

7. GATS, Second Annex on Financial Services. Case suggests that temporary withdrawal or modification is permitted in the Second Annex to allow for continued negotiation on market liberalization "because at the conclusion of the Uruguay Round, the United States was unsatisfied with other countries' commitments. The United States was not willing to lock in its own liberal policies without reciprocal guarantees of full market access on a most-favored nation basis." Case, *supra* note 3, at 220, n.32 (citing Joel P. Trachtman, Trade in Financial Services Under GATS, NAFTA and the EC: A Regulatory Jurisdiction Analysis, 34 Colum. J. Transnat'l L. 37, 54 (1995)).

8. Case, *supra* note 3, at 221.

9. Joel P. Trachtman, Trade in Financial Services Under GATS, NAFTA and the EC: A Regulatory Jurisdiction Analysis, 34 Colum. J. Transnat'l L. 37, 55 (1995).

already permitted to non-U.S. firms, the initiation of the accord should result in significant opening of banking, insurance and securities service markets in such countries as Argentina, Brazil, India and Indonesia, among others, that have traditionally been relatively opaque. However, other target markets, such as Malaysia and South Korea, have made no concessions for expansion of access. On the other hand, Japan did agree to significant concessions in terms of opening its domestic financial services markets to international competition.

The effect on international trade in financial services could be dramatic. Under the GATS, each WTO member is required to accord most-favored-nation treatment to services and service suppliers of other WTO members.[10] Current restrictions on trade in services of each member must be transparent.[11] Members are also required to administer current restrictions "in a reasonable, objective and impartial manner."[12]

A series of general exceptions do apply to GATS obligations, similar to the general exceptions under the GATT.[13] More importantly, perhaps, the GATS includes a self-judging special exception for essential security interests of member states, similar to the special security exception contained in the GATT.[14] Presumably, this exception would shield U.S. international economic sanctions measures from the requirements and strictures of the GATS.[15]

3. The Politics of Investment

Attitudes toward international investment are much more ideological, and generally reflect either a free trade or liberal economic theory on the one hand or a *dependencia* theory on the other hand.[1]

The arguments of the free trade theory in favor of the free flow of goods do not necessarily apply to the flow of capital. Indeed, within the neoclassical economic theory, the free flow of goods would make that of capital or technology or people unnecessary, and restrictions on the flow of goods are one of the explanations for the movement of capital and people. Ideologically and practically, however, free trade arguments are closely related to those for the movement of capital. Both reflect a laissez-faire sense that government intervention in the economy is generally unwise and often counterproductive. And the free flow of capital will often produce much the same economic result as the free flow of goods. If it is pursuing its economic self-interest, even the

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10. GATS, art. II, ¶ 1.

11. *See* GATS, art. III (requiring publication and reporting of restrictive measures).

12. GATS, art. VI, ¶ 1. *Cf.* GATS, art. X, ¶ 1 (requiring that any emergency safeguard measures be administered in a nondiscriminatory manner).

13. *Compare, e.g.*, GATT, art. XX (excepting from GATT requirements measures undertaken for morals, life or health, precious metals, compliance with certain regulatory laws, products of prison labor, national treasures or patrimony, conservation, certain commodity agreements, world-price adjustment, and short-supply materials) *with* GATS, art. XIV (excepting from GATS requirements measures undertaken for morals or public order, life or health, compliance with certain regulatory laws, and taxation).

14. *Compare* GATT, art. XXI (providing exceptions from GATT obligations with respect to any measure undertaken that a member "considers necessary for the protection of its essential security interests") *with* GATS, art. XIV *bis*, ¶ 1 (providing exceptions from GATS obligations with respect to any measure undertaken that a member "considers necessary for the protection of its essential security interests"). *But cf.* GATS, art. XIV *bis*, ¶ 2 (requiring reporting of certain excepted measures and of their termination to WTO Council for Trade in Services).

15. *Cf. Panel Report on Nicaraguan Complaint*, GATT ACTIVITIES 1986 58-59 (1987) (noting that GATT panel examining complaint by Nicaragua concerning U.S. trade sanctions not authorized to examine U.S. invocation of GATT, art. XXI). On economic sanctions, see Chapter XIII, *infra*, at ▬.

1. For a general overview of the main competing theories of international investment, see Gilpin, Three Models of the Future in C. Bergsten and L. Krause (eds.), World Politics and International Economics, 29 Intl. Org. 37 (1975).

multinational corporation is likely to invest in exactly the same locations and enterprises that would evolve independently under a free-trade regime. Beyond economics, many multinational theorists argue that, as a transnational institution, the multinational corporation is a force that can help the world transcend the limits of the nation-state system.

The counterargument is equally multifaceted. It tends to begin with the actual experiences of host nations with branches of multinational corporations, experiences that are, in too many cases, an analogue of the injustices that drove the labor movement in the United States during the 1930s. There is no surprise in the fact that a Marxist-style class interest argument is often made against foreign investment–and is often persuasive in the developing world. Foreign investment frequently has produced no more than a small developed enclave within a society without creating opportunities for local business. To this, one can add more political arguments. The left often makes the *dependencia* point that foreign investment is a way for developed societies to gain power in developing societies. And in at least a few cases, the right may fear that the social changes associated with foreign investment are likely to break up the power of a traditional oligarchy.

4. The Politics of Linkage and Development Theory

For convenience of discussion, we have looked at each of the preceding three themes as a separate analytical issue, but they are inextricably linked. They are linked as a matter of fact, which is reflected in the congressional findings contained in the Omnibus Trade and Competitiveness Act of 1988.[1] "[T]here has arisen a new global economy in which trade, technological development, investment, and services form an integrated system[,] and in this system these activities affect each other and the health of the United States economy."[2]

As a matter of policy, the linkage is provided by development theory. Improvement in economic and social conditions in an underdeveloped economy necessarily requires the creation of economic, as well as physical, infrastructures. That is, roads and bridges must lead somewhere, and indigenous economic activity gives the incentive for making the trip. Enhancement of industrial activity and external trade have been the traditional developmental tools for improving the economies of emerging states, but to be successful such efforts require capital and a wide range of supporting services. Ironically, efforts by a developing state to protect its economy from external ownership and control may result in the isolation of its emerging economy from external sources of capital, technology and other services, or may significantly increase the cost of obtaining the needed capital and services. At that point, development may stall out.

The complexities of development theory, and its specific applications in the trade, service, and investment sectors will be explored in a later chapter. As an introduction to these issues, the following excerpt from a report by the U.N. Secretary General will at least suggest the linkages that exist among these three sectors and the regulatory policies that apply to them.

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1. Pub. L. No. 100-418, 102 Stat. 1107 (1988) (OTCA).
2. OTCA, § 1001(a)(1), 102 Stat. at 1120.

REPORT OF THE UNITED NATIONS SECRETARY-GENERAL ON THE WORK OF THE ORGANIZATION

37 I.L.M. 913 (1998)

The Causes of Conflict and the Promotion of Durable Peace and Sustainable Development in Africa . . .

B. Sustainable development

Development is a human right, and the principal long-term objective of all countries in Africa. Development is also central to the prospects for reducing conflict in Africa. A number of African States have made good progress towards sustainable development in recent years, but others continue to struggle. Poor economic performance or inequitable development have resulted in a near-permanent economic crisis for some States, greatly exacerbating internal tensions and greatly diminishing their capacity to respond to those tensions. In many African countries painful structural adjustment programmes have led to a significant reduction in social spending and consequent reductions in the delivery of many of the most basic social services. Especially when this is coupled with a perception that certain groups are not receiving a fair share of diminishing resources, the potential for conflict is evident.

While economic growth does not guarantee stability, satisfaction or social peace, without growth there can be no sustained increase in household or government spending, in private or public capitalization, in health or social welfare. The basic strategy for achieving sustainable development through economic growth is now well established. The core components of the strategy include macroeconomic stability and a stable investment environment; integration into the international economy; a reliance on the private sector as the driving force for economic growth; long-term foreign direct investment, especially in support of export-oriented activities; adequate investment in human development areas such as health and education; a fair and reliable legal framework; and the maintenance of basic physical infrastructures. Despite the broad consensus on how development and economic growth should be pursued, however, in Africa it has been difficult to achieve rapid progress, partly because of the failed policies pursued in the past by many African countries and the difficult international economic environment in which they generally must operate.

Creating a positive environment for investment and economic growth

Creating a positive environment for investment. To produce sustained economic growth, African countries must create and maintain an enabling environment for investment. The world economic system is highly competitive and market-based, and Africa has become largely marginalized in recent years in attracting significant inflows of long-term foreign direct investment. The importance of investment in small and medium-sized businesses should also be emphasized as such enterprises are an important source of employment in Africa and contribute significantly to the continent's GDP. If Africa is to participate fully in the global economy, political and economic reform must be carried out. It must include predictable policies, economic deregulation, openness to trade, rationalized tax structures, adequate infrastructure, transparency and accountability, and protection of property rights.

Enacting needed reforms. Many Governments are in the process of successfully implementing necessary reforms, and some already enjoy stronger growth as a result. Others continue to struggle and several have yet to complete the first generation of economic reforms, which include fiscal consolidation, privatization and deregulation

programmes, trade liberalization, and policies to promote investment in human capital and economic infrastructures. These reforms need to be put in place without delay. They should be accompanied by determined efforts to stamp out corrupt practices and implement other civil service reforms that will improve the ability of government to carry out its functions.

Long-term success can be achieved only if African Governments have the political will not just to enact sound economic policies but also to persevere in their implementation until a solid economic foundation has been established. This will happen only if there is greater public understanding of the measures required, and broad-based political support for those measures. ...

Emphasizing social development

Too often, the majority of those living in the developing world appear to be incidental to development rather than its focus. Ultimately, all development strategies should be measured by the benefit they bring to the majority of citizens, while the value of particular development tactics should be measured by the extent to which they will contribute to that end. Governments should review their priorities and distribution decisions, focusing on basic human needs and placing primary emphasis on reducing poverty. The international community needs to work for social development with all of the tools at its disposal, ensuring that greater sensitivity to social development issues is matched by increased financing for anti-poverty efforts and for social development needs. ...

Reducing debt burdens

An unsustainable burden of debt. Many States in Africa lack the financial capital needed to address basic expectations and fundamental needs. This is one of the central crises of Africa today, and one that is due in large measure to the problem of Africa's public sector debt. When tensions rise or conflict threatens, many African countries do not have the basic resources to meet critical needs. In 1995, Africa's external debt totalled $328.9 billion–of which approximately 45 per cent was owed to official bilateral sources, 30 per cent to official multilateral sources, and 25 per cent to commercial lenders. To service this debt fully, African countries would have had to pay to donors and external commercial lenders more than 60 per cent ($86.3 billion) of the $142.3 billion in revenues generated from their exports. In fact, African countries as a whole actually paid more than 17 per cent ($25.4 billion) of their total export earnings to donors and external commercial lenders, leaving a total of $60.9 billion in unpaid accumulated arrears.

The need for additional action on debt. Addressing the threat that an unsustainable debt burden poses to the economic security and long-term stability of Africa requires comprehensive and decisive action by the international community. Debt relief granted by the international community should promote and reinforce economic reforms. It should be structured in ways that will not undermine Africa's future capacity to attract investment, but will instead enhance that capacity by lifting past burdens from present operations. The recent Heavily Indebted Poor Countries Debt Initiative is a promising step. The principle behind the Initiative is that the international community would reduce the debt burden of poor countries, following the implementation of internationally accepted programmes of reform, to a level that would no longer hinder their economic growth and development. The results of the Initiative have been disappointing, however. At present, only four African countries meet its requirements.

Significant movement on lifting Africa's crippling debt burden will require concerted political action at the highest levels. It is evident that in development terms Africa has

far too little to show for the burden of debt that has now accumulated. Africa cannot avoid its share of responsibility for the present debt predicament, but the international community needs to acknowledge its own role in creating this problem. During the cold war bilateral and multilateral loans were often linked mainly to geopolitical priorities, purchasing political peace and stability in areas of interest to the super-Powers or their principal allies. In many cases bilateral loans provided the funds for extensive military expenditures by African countries. Across Africa, Governments were sometimes pressured into accepting a wide range of loans which they did not need and could not productively utilize. In many cases little or no effort was made to ensure accountability for expenditures, despite clear reasons for lenders to expect that substantial sums were likely to be diverted or misappropriated. ...

Opening international markets

Access to markets. All countries are now part of an international trading system, but many remain imperfectly integrated into it while others are excessively vulnerable to its instability. Long-term sustained growth in Africa will depend largely upon the capacity of Africa to diversify exports and to achieve export-led growth in manufactures alongside the production of primary commodities. The transition to export-led growth will require not only sustained internal policy reform backed by macroeconomic stability and debt reduction, but also enhanced and guaranteed access to developed country markets as well as improved regional South-South cooperation. Africa's manufacturing competitiveness lies in part in items such as agro-based industries as well as apparel and textiles which are politically sensitive in developed countries. Although the average level of tariffs on Africa's major exports was reduced in the Uruguay Round of multilateral trade negotiations [a round of negotiations that also produced the WTO itself], more progress is needed. Particularly troubling is the problem of "tariff escalation", whereby tariffs on some agriculture–and natural-resource-based products increase in proportion to the degree of processing before export. This phenomenon serves to discourage and penalize African efforts to develop, and should be eliminated with respect to African products.

Special efforts are needed by the developed economies to ensure access for competitive African goods, even in the face of domestic political lobbies resisting increased competition. I urge that the question of eliminating trade barriers to African products be placed on the agenda of the next meeting of the group of major industrialized countries, with a view to the adoption of a common policy to be implemented on a bilateral basis and through the World Trade Organization.

Adjusting to a globally competitive trade environment. With respect to Africa's own progress on tariff reduction, the international community should be sensitive to the possible impact of tariff reduction on budget revenues, fiscal deficits, macroeconomic instability and debt service burden. Assistance will be necessary to enable African countries to sustain the tariff reductions and economic reforms on which they have already embarked. Africa also requires special support to deal with the imposition of new and emerging non-tariff barriers such as new environmental, health and labour standards. Many African economies need not only greater access to the international market but also to remove domestic constraints which limit their capacity to take advantage of existing opportunities offered through the Uruguay Round agreements. The international community should also direct its assistance to the development of productive capacity in Africa and the enhancement of the competitiveness of industries on the continent.

5. Other Political Themes

These central themes do not exhaust the politics of the international economic system. One much broader theme–whose force is extremely difficult to evaluate– should be mentioned: the question of how international political power and international economic power are linked.

In one respect, it is abundantly clear that increased economic power brings a nation (or group of nations) increased political power. The obvious example is the Organization of Petroleum Exporting Countries, which, within less than a decade, went from obscurity to the central corridors of power. This economic power perhaps transcends the power available from the weapons that the wealth can buy–the wealth itself is a form of power. If so, implications for the developing world–especially for a developing world sinking further and further into debt–are quite troublesome.

Historically, the presence of friendly trading partners has been a significant factor in the ability of a society to avoid collapse.[1] Conversely, trade routes have not always proven to be a bonanza for trading partners; sometimes they have become transmission belts for diseases such as the plague of Antoninus, which killed millions of Romans between A.D. 165 and 180, and the Black Plague epidemics of A.D. 1346 resulting from the exposure in Europe to the plague-infested areas of Central Asia.[2]

In another respect, the connection between economic and political power is much more ambiguous. Economic order *may* require political order. Many argue, for example, that the relative success of the liberal economic order of the 1950-1970 period rested in large part on the military dominance of the United States during that period, and that this military dominance was also essential to the dominance of the dollar during that period. In a new era, marked by the breakdown and withering away of the Soviet Bloc, the rise of the Peoples' Republic of China as an economic world power, and the advent of newly industrialized countries in the Third World, liberal economic arrangements may no longer seem to be the obvious choice, or even feasible. Whether or not such specific type of international economic order depends on the character of the underlying military and political order.

6. International Trade and the War on Terror[1]

Finally, what is the relationship between international trade and investment and the War on Terror? Since the tragic events of September 11, 2001, the importance of international trade and investment as possible tools to combat international terrorism has increased. International trade is not only a bridge between nations, but a tool in countering the growth of international terrorism. International trade is important to the War on Terror because terrorists are bred in the global swamp of poverty, hopelessness, and despair. Those with nothing to lose are prime candidates to become terrorists, and more likely to listen to those preaching radical doctrines. As an engine of global growth, trade can assist in draining the global swamp of poverty.

The central national security challenge now facing the United States differs from

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1. JARED DIAMOND, COLLAPSE: HOW SOCIETIES CHOOSE TO FAIL OR SUCCEED 14 (2005).

2. JARED DIAMOND, GUNS, GERMS AND STEEL 205-206 (1999).

1. This section is drawn from Bart S. Fisher, *Commentary on Homeland Defense–Controlling the Border of Trade Revisited*, 17 TRANSNAT'L LAW. 141 (2004).

what it was in the Cold War. The danger today to the United States comes not from conquering states, but rather from failed or failing states. Such states are unable to perform the most minimal tasks of governance, such as collecting taxes or feeding their own people. As a result, the 2.4 billion people around the world who live on less than two dollars a day have become an increasingly important target of U.S. trade and foreign policy. Through the Millennium Challenge Program, which focuses on increasing foreign aid to more deserving recipients; bilateral free trade agreements, such as the U.S.-Jordan Free Trade Agreement; and the Doha Round of multilateral trade negotiations, with its emphasis on market access to the economies of the developed countries by the developing countries, the United States has launched a full-court press against global poverty with the hope of diminishing the appeal of radical doctrines that foment terrorism.

Broadening the point beyond the War on Terror, John Norton Moore has pointed out that there is a very high correlation between bilateral trade and the absence of war.[2] Similarly, Thomas Friedman has pointed out that no war has yet taken place between countries each possessing a McDonald's franchise,[3] and argued, only semi-facetiously, that in the future it is unlikely that a war will take place between countries in the Dell computer global supply chain. Friedman states his Dell Theory of Conflict Prevention as follows:

> …I offer the Dell Theory of Conflict Prevention, the essence of which is that the advent and spread of just-in-time global supply chains in the flat world are an even greater restraint on geopolitical adventurism than the more general rising standard of living that McDonald's symbolized.
>
> The Dell Theory stipulates: No two countries that are both part of a major global supply chain, like Dell's, will ever fight a war against each other as long as they are both part of the same global supply chain. Because people embedded in major global supply chains don't want to fight old-time wars anymore. They want to make just-in-time deliveries of goods and services–and enjoy the rising standards of living that come with that.[4]

There is, however, a tension between *unlimited* trade and the efforts to promote global peace. In general, the facilitation of trade is positive because it removes some of the principal causes of terror. However, national security may require *less* trade because the United States may need to be more careful than ever before about what it imports, what it exports, and to whom it exports. These constraints, which we will study more in Chapter VII, on customs procedures, and Chapter XIII, on the use of trade controls for political purposes, will necessarily cut back trade. This is the current tension. Security may become a constraint on trade, and the challenge is to prevent the security factor from dragging down the global trading system.

The War on Terror highlights the importance of allowing access by the developed countries to the goods and services of developing countries. For example, Pakistan's leaders have implored the United States to eliminate its textile quotas, enabling it to export textiles to the United States. Others such as Joseph Stiglitz have pointed out the hypocrisy of the United States' insistence that developing countries open their borders,

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2. John Norton Moore, *A New Paradigm in International Relations: A Reduction of War and Terror in the World through Democratization and Deterrence*, TRANSNAT'L LAW. 83, 84 (2004).

3. THOMAS L. FRIEDMAN, THE WORLD IS FLAT 420 (2005). He refers to this as the Golden Arches Theory of Conflict Prevention.

4. *Id*. at 420-421.

while refusing to open its own borders to their exports.[5]

Thus, it can be seen that we are telling a great story in this textbook. Though some of the cases may seem technical and the document-intensive nature of the subject somewhat off-putting, the reality is that a well functioning international trade system is a crucial aspect of international relations, which can determine not only our prosperity but whether or not we shall live in peace.

QUESTIONS

1. Consider the shifting nature of power in the international economic system. What kinds of power are available to a country like Japan, which possesses a dynamic industrial system but only a small military and imports all of its oil? In the European countries, which rely on Persian Gulf oil for 70% of their energy supplies and face instability in Former Eastern Bloc states on their eastern flank? In the United States, which relies on Persian Gulf petroleum production for a significant part of its oil supplies, and which leads an increasingly shaky United Nations coalition against the rogue state, Iraq? In Saudi Arabia, which possesses huge oil reserves, a fragile political system, and limited capacity for self-defense?

2. Consider the case of steel, where governments own raw steel products enterprises in many major countries. Should state ownership be encouraged or discouraged? How should the United States respond to the argument of the steel industry that it is somehow not "fair" for private U.S. companies to have to compete against state-owned enterprises?

3. How does commercial policy relate to foreign policy? Would you support quotas on steel or auto imports more (or less) readily if you were secretary of state than if you were the U.S. trade representative, the secretary of commerce, or the secretary of defense? What would your position be if you were:

(a) president of the United Automobile Workers;
(b) president of the Consumers for World Trade;
(c) president of the American Farm Bureau;
(d) president of Ford Motor Company;
(e) president of Toyota Motor Company; or,
(f) president of the American Association of Automobile Parts Producers?

4. How convincing do you think the U.N. Secretary-General's analysis of developmental linkages is in his 1998 report? Which, if any, of his suggestions would you support if you were:

(a) Chairman of a large U.S.-based banking enterprise with substantial amounts of non-performing LDC debt in its loan portfolio;

(b) Managing Director of the International Monetary Fund, the public international financial institution charged with the responsibility of maintaining stability in the world monetary and financial system;

(c) President of the International Bank for Reconstruction and Development ("World Bank"), the public international financial institution charged with the responsibility of aiding in international development through project financing of major infrastructural

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5. JOSEPH E. STIGLITZ, GLOBALIZATION AND ITS DISCONTENTS (2002).

improvements in underdeveloped countries;

(d) Prime Minister of a small, newly independent state that was a former Soviet Republic; or,

(e) President of the United Widget Workers, whose members are employed by ten U.S. widget manufacturers facing increased competition from imported widgets?

5. Regulation is usually more acceptable if it seems to rest on a theory, such as the "free market" efficiency analysis, the concept of "freedom of contract," or the idea of the "just price." What comparable theories might be applicable to an international trade issue such as the limitation–or not–of auto imports? What types of equity and justice arguments would the different parties make? What about the politician, eager to improve the relative status of his or her nation? Or the economist, interested in avoiding misallocation of resources?

6. A battle is now brewing over the legitimacy and effectiveness of prevailing approaches to economic development. Joseph E. Stiglitz, the chief economist of the World Bank in the late 1990s, has become a fierce critic of the bank's sister institution, the International Monetary Fund (IMF), arguing that its decisions to grant "credits" and other forms of financial assistance to developing economies have been made on the basis of ideology rather than sound economic reasoning.[1] According to Stiglitz, the IMF expected developing countries to accept its prescriptions and conditions on financial assistance without question, but those prescriptions and conditions often failed to resolve the financial problems experienced by these countries and may even have exacerbated the crises facing many of them. Stiglitz argues that the prevailing assumptions about the ingredients of economic growth and development need to be reassessed. He rejects the uniform and uncritical imposition of free-market, free-trade policies by the IMF and World Bank on developing countries, and advocates an approach in which a range of policies are available for selection based upon particular conditions in each developing country. We shall have occasion to examine this growing controversy in Chapters X and XI, *infra*.

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