1-1-1985

Trade and Financial Interdependence in the World Economy

Sven W. Arndt
Claremont McKenna College

Lawrence Bouton

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The recent debate over America's involvement in the world economy has intensified as a result of economic developments in the past four or five years. These changes have placed certain sectors of the U.S. economy under severe competitive pressures from abroad. Unprecedented budget deficits, the sharp appreciation of the dollar, and the stronger performance of the U.S. economy relative to its trading partners have fueled concerns about the competitive position of the United States in the world economy.

In addition, many are concerned that the international trading order and the international financial system may not be performing their intended functions. With regard to the trading order, questions have arisen about the benefits from freer trade at a time when more countries are turning to managed trade and protectionist sentiment is on the rise. Some believe that the international financial system, for its part, no longer facilitates the transactions of goods but dominates them. This article discusses these issues and addresses the policy options available to government leaders.

The International Trading Order: Free or Managed?

The present trading system, though commonly referred to as free, is in fact not really free. Compared with many periods in history or with what might exist in the future, however, it is relatively free. There can be no doubt that trade is managed. As tables 1 and 2 show, it is influenced and guided in a thousand ways not only by policies aimed directly at the international movement of goods but also by "domestic" policies that, despite their internal focus, have international implications. They affect trade prices and volume and shape the structure of international markets. By some estimates, 50 percent or more of world trade is subject to some form of intervention.

Intervention includes tariffs, which work directly on prices, and quotas, orderly marketing agreements, and voluntary export restraints (VERs), which work in the first instance on volumes. These two types of instruments may be used interchangeably to achieve a given degree of protection for domestic producers, but quantitative restrictions are more inefficient and costly. Ironically, as the GATT (General Agreement on Tariffs and Trade) has successfully limited the use of tariffs, countries have increasingly resorted to less efficient and more costly quantitative restrictions, such as quotas and VERs. In addition, intervention by means of licensing, certification, testing, and bonding requirements has proliferated.

In contrast to such trade-targeting intervention, other practices do not discriminate explicitly between home and foreign goods. Nevertheless, they do affect the pattern of trade and the structure of the world's "markets" for traded goods. Tax, subsidy, R&D, and regulatory policies have such international effects, as do many agricultural price and income support policies. Such policies, however, are often claimed to be "domestic" and hence not subject to international negotiation.

For most countries the preferred trading regime lies somewhere between truly free trade and autarky, but there is no unanimity among countries on the optimal system. Attitudes not only vary among countries but shift within countries over time. During periods when

Sven W. Arndt is a resident scholar in international economics at AEI and director of international trade studies under the project Competing in a Changing World Economy. Lawrence Bouton is a research associate with the project.

TABLE 1
PERCENTAGE DISTRIBUTION OF TARIFFS FOR INDUSTRIAL PRODUCTS:
UNITED STATES, EUROPEAN COMMUNITY, AND JAPAN

Tariff	*United States*	*European Community*	*Japan*
Free	31.0	37.9	56.3
0.1–5	44.1	19.0	25.2
5.1–10	17.8	32.5	14.6
10.1–15	1.9	9.1	2.9
15.1–20	2.2	1.3	0.8
20.1–25	0.8	0.2	0.1
25.1–30	1.2	—	0.1
30.1–35	0.9	—	—
35.1–40	0.0	—	—
40.1–45	0.1	—	—
45.1–50	—	—	—
Over 50	—	—	—
Total	100.0	100.0	100.0

SOURCE: Bela and Carol Balassa, "Industrial Protection in the Developed Countries," *The World Economy*, vol. 7, no. 2 (June 1984).

trade liberalization is popular, the dominant perception is that more is to be gained than lost from liberalization. This, indeed, has been the prevailing attitude for most of the postwar period. Today this consensus appears to have dissolved, giving way to doubts not only about the benefits of further liberalization but also about the existing degree of liberalization. Questions of equity and fairness are raised. The benefits and costs that accrue to a given country from an act of liberalization are seen to be unevenly distributed among citizens, and the distribution of benefits among countries is also perceived as uneven, with countries accusing their partners—Japan in the current episode—of trading unfairly, of exploiting the system, of refusing to play on an "even" field.

This issue of equity and fairness, both among and within countries, is crucial and needs to be addressed. The traditional argument for free trade is simple and straightforward. It holds that free trade brings benefits to countries because it forces them to use their resources more effectively, so that a given national endowment of resources will generate the highest achievable levels of consumer satisfaction and welfare. It does not claim that countries participating in liberalization will share the benefits equally. Indeed, if the source of the benefits is a more efficient use of resources, the countries whose resource allocation had been most distorted might be expected to gain most significantly.

Further, the traditional argument evaluates costs and benefits at the country rather than at the group or individual level. It assumes that the question of how costs and benefits are shared among citizens within a country can be resolved by the political process. In practice, however, the political process and its institutions do not always find it easy to manage the distributional problem. This is especially true when the costs but not the benefits fall on large and vocal interest groups. The Western democracies now appear to be facing precisely such difficulties as they attempt to deal with declining competitiveness in a variety of traditional industries. Not only does declining competitiveness affect large numbers of citizens, but the speed and the magnitude of the implied adjustment appear to exceed levels of political tolerance. In the United States the problem is compounded by macroeconomic policies that have, by means of the dollar appreciation, further impaired the competitive position of U.S. producers.

As for how trade should be managed, therefore,

TABLE 2
PERCENTAGE OF INDUSTRIAL COUNTRIES' IMPORTS COVERED BY NONTARIFF BARRIERS

	Imports from	
Importer	Developed countries	Developing countries
United States	13.0	5.5
Japan	19.2	5.4
Switzerland	22.6	48.8
Sweden	1.0	7.0
Norway	8.2	10.9
Austria	15.0	8.1
European Community[a]	15.1	11.8
Denmark	9.4	19.2
Ireland	15.0	9.5
France	20.1	7.1
United Kingdom	14.9	14.3
Italy	12.5	7.0
Federal Republic of Germany	12.6	8.5
Netherlands	16.1	19.8
Belgium and Luxembourg	19.2	29.7

NOTE: This table is based on detailed information on nontariff barriers available in UNCTAD. The figures measure the value of imports affected by nontariff measures in relation to total imports. Import figures are from 1980, whereas the information on nontariff barriers applies to 1983. If a country's import restrictions are rigorous, it imports little, and few of its imports are affected by restrictions. Thus these figures provide little basis for comparison among countries in the total amount of restrictions.

a. Weighted average; excludes Greece.

SOURCE: The World Bank, *World Development Report*, 1983.

three approaches offer serious possibilities. First, policy management at the macroeconomic level could be improved to take more explicit and systematic account of its effects on exchange rates and competitiveness. Second, the rules of the game need to be reviewed and improved. Third, the mechanism by which the burdens and benefits of international competition are distributed domestically needs to be managed more effectively. We take up each argument in turn, beginning with the last.

Managing the Domestic Effects of International Competition. The conditions of competition in world markets are in constant flux and require continuing adjustments in resource allocation. The question is, How should that adjustment be managed? One answer is to "leave it" to the market. This is the approach typically taken by "free trade" advocates, who would look to the changes in relative prices and profitability brought about by changes in competitiveness as the signals guiding resource reallocation.

Another approach is based on the proposition that markets do not automatically provide for adjustment or do so only at great human cost and that productive alternatives for workers and capital may not always exist. To overcome these and other market "failures," various types of policy activism are proposed. Both approaches accept the maintenance of "essential" industries for national security reasons, but they disagree on the definition of "essential."

The activist approach has been encouraged at the national level, where it includes market sharing and industrial targeting, and at the international level, where producer cartels play a major role. The main features of these proposals are described below.

Market sharing. At the national level market-sharing policies are used to limit import penetration, as when auto or shoe producers insist that imports be limited to some fraction of the home market. At the regional level in Europe market-sharing or production cartels have been sanctioned by the EC Commission. Steel is one such example. At the international level efforts to control market access are exemplified by the Multi-Fibre Arrangement.

Import quotas constitute another approach to market sharing. When applied on a country-by-country rather than on a global basis, they create incentives for evasion based on shifts in import sourcing to countries that have not exhausted their quota or were not initially covered by the arrangement. Thus, when Asian countries covered by textile quotas reached their limits, production and therefore U.S. imports shifted to countries not covered by the arrangement. On the basis of this experience, one may confidently predict that enforcement of the new U.S. steel quotas with respect to existing suppliers will increase imports from countries not covered by the agreement.

Industrial policies. Industrial policies are germane to the question of managed trade because they aim to manage competitiveness. The public discussion of industrial policy has involved claims and counterclaims based on belief, imperatives, and assertions but rarely on evidence. Evidence is hard to come by, and much of it comes either from other countries and hence from different cultural, political, social, and institutional contexts or from other times in the history of this country and hence from other conditions.

While the debate on this issue continues, it is probably safe to say that a policy of comprehensive industrial targeting will not work in the American economic and political context. This is not to say that there is no room for significant improvement in the way U.S. policies, both microeconomic and macroeconomic, affect American industries and American competitiveness. As the recent discussion of tax reform shows, the influence of tax policy on industrial structure is pervasive and complex.

Industrial change is crucial to long-run competitiveness in a dynamic trade environment. To some extent the argument favoring industrial policy is based on the fear that private entrepreneurs and unions will not perceive shifts in the competitive climate or, even if they do, that they will not possess the resources to exploit them. Further, it is feared that research and development, innovation, and technological change have become so complex, costly, and risky that they will exceed the resources not only of individual enterprises but also of private capital markets.

These fears are not easily documented, especially in light of abundant supplies of venture capital and recent successes in America's Silicon Valley and elsewhere. Moreover, while American advocates of industrial and R&D policy cite the example of such policies in other countries, officials from those countries seek ways to emulate the flexibility of America's venture capital markets and private enterprises. Although there is, undeniably, strong interaction between private markets and the policy environment, in contemporary America the government is probably better at providing a supportive environment through budgetary, monetary, and regulatory policies than at managing industrial policy. And if industrial policy in general does not hold promise for the United States, then industry-specific trade policy and trade management are equally inappropriate.

The competitive position of industries, of firms, of plants, and of products is subject to shifting pressures over time. The evidence, though not entirely conclusive, suggests that the United States is most competitive in commodities based on natural resources with which the country is relatively well endowed (land-intensive agriculture, for example) and in commodities requiring scientific and engineering skills (human capital) and produced with technologies that are relatively new, have not been standardized, and cannot be quickly or easily copied. As products and their technologies become standardized and subject to imitation, international productivity differences are narrowed, and countries with abundant low-cost labor gain the competitive edge. Standardization and replication bring competitive challenges in traditional as well as in high-tech industries.

Consequently, producers in industrial countries must constantly search for new and better products and production technologies, and workers must constantly improve the quality of their skills if they wish to maintain, let alone improve, their living standards. The period in which they may expect to enjoy their lead over the encroaching competition is often quite short, meaning that flexibility and the capacity to adjust are crucial. Yet the greater the need for flexibility and adjustment, the less likely are governmental policies (such as industrial targeting) to fit the bill. Large companies, too, need to be alert to the dangers of rigidification.

These considerations suggest an approach that lies somewhere between the laissez-faire notion of "let the market do it" and the *dirigiste* method of industrial targeting. They suggest that markets and market signals must indeed be the major determinants of resource allocation in the long run but that short-run rigidities and immobilities must be recognized and accommodated through the adjustment process. Although government policies may be needed to accomplish this, those policies should be aimed at facilitating the reallocation of labor and other productive resources in ways that are compatible with long-run market forces.

Managing macroeconomic influences on competitiveness. When a country has lost competitiveness in a basic sense, refusing to recognize such developments is costly and ultimately self-defeating. Not all observed shifts in competitiveness are permanent, however. In recent years exchange rate movements brought about by monetary and fiscal policies have played havoc with the competitive positions of American producers in home and foreign markets. A dollar appreciation that is viewed as temporary does not and should not affect the strategic decisions of firms. Sourcing procedures may be altered to compensate for exchange rate changes, the timing of decisions may change, and hedging and other currency operations may be utilized more intensively, but strategic decisions about plant location and investment are generally not immediately affected.

A sustained appreciation, however, must eventually affect resource allocation and business decisions in a fundamental way. Workers on layoff are not rehired, capital spending plans are reduced, temporary shifts in sourcing from home to foreign suppliers become permanent, and firms turn seriously to the possibility of relocating plants to foreign shores.

In recent years the major threat to competitiveness in U.S. manufacturing as well as in agriculture has come from the pronounced appreciation of the dollar. As it persists, it will increasingly force structural change in the economy. But such a restructuring was neither intended nor anticipated when the macroeconomic policies that created it were formulated. That is typical: in the United States, policy making at the macroeconomic level tends to ignore exchange rate and trade effects. This is, therefore, an area of policy desperately in need of improved management.

Recently, attention has focused on the deteriorating trade balance and its relation to employment. In the absence of that \$100 billion plus import surplus, so it is claimed, many more Americans would have jobs, and gross national product would be larger. Increasingly, the government is called upon to "do something" about the trade deficit. But the government cannot do something to the trade balance without doing something as well to other parts of the economy.

Inasmuch as the trade deficit is the *result* of policies, changing it but not them will merely force some other part of the economy to accommodate those policies. An import surcharge, for example, will raise domestic prices and domestic interest rates, thereby crowding out domestic investment. Unsterilized exchange market intervention designated to "bring the dollar down" produces monetary expansion that raises the rate of inflation. Hence a serious effort to manage the trade deficit must focus on the policies that produced the deficit.

Managing the International Trading System. In the near term the major task facing policy makers is to correct a competitiveness problem created mainly by macroeconomic policies. That is principally but not wholly an American problem. In the longer run the rules, practices, and institutional arrangements in international trade need to be refurbished. That concerns all countries. There are several issues. First, the existing rules and provisions of GATT are increasingly circumvented and violated everywhere, including in the United States. Another is the dispute settlement process, which creates more trouble than it solves. Second, it is time to bring agricultural trade and the "domestic" policies that affect it under GATT surveillance. Third, issues such as services trade and intellectual property rights need to be placed in a multilateral negotiating process. (See appendix.) Fourth, in the area of industrial trade, ways must be sought to stem and then reverse the recent slide toward the use of highly distorting quantitative measures of protection.

The world trading system is riddled with distortions, some of them the result of market imperfections and externalities but most of them associated with pervasive government intervention. In such a system free trade and market-determined resource allocation constitute an ideal at best. Moreover, in a distortion-ridden world, removal of a single distortion does not necessarily lead to improvement. In such an environment it is easy to become convinced, as many recent commentators have, that the United States should abandon free or freer trade as a policy goal and stop relying on markets to allocate resources. The argument heard more and more frequently is that the United States should manage trade, using its weight and size to extract gains by means of trade intervention, and that it should manage competitiveness by means of an explicit industrial policy. The underlying perception is that the world is becoming increasingly mercantilistic and that joining the crowd is the only means of survival. While there is no doubt that the United States could use its economic size and dominance to improve its terms of trade, both theory and historical evidence suggest that protectionist binges by major trading partners ultimately reduce the volume of trade, have little impact on the terms of trade, and bring widespread welfare losses. In other words, standards of living *in general* decline although specific groups can be made better off.

Although trade wars are clearly inimical to the interests of all, a major power may be tempted to push protection just far enough to avoid retaliation from trading partners. In that case substantial gains can be extracted, but they come at the expense of others. Therein lies the dilemma for U.S., EC, and Japanese policy makers: can a major economic power ride the protectionist trend and hope to escape the consequences that both theory and historical evidence predict? Alternatively, could a major power use its economic weight and influence to coerce other countries into abandoning beggar-thy-neighbor policies? While the answer to the first option is almost certainly negative and that to the second positive, the design of appropriate strategies is by no means easy. Still, to search for ways in which economic influence might be used to create a less distorted trade environment not only is legitimate but also would help focus efforts on positive and constructive rather than on defensive approaches to management of the trade system.

What are the means by which U.S. policy makers and those in like-minded countries might seek to strengthen the international trading system? Multilateral approaches within the GATT framework have the advantage of an existing institutional setting upon which much could be built; they would protect the most-favored-nation principle and avoid the trade-distorting "third-country" effects of agreements that are not multilateral.

Unfortunately, the GATT process can be quickly stalled by inaction and foot dragging on the part of its larger and more important members. The failure of the Bonn summit in May 1985 to agree on a timetable for the start of negotiations raises questions about the prospects for multilateral negotiations and fears about delays and about the likelihood that recalcitrant members will extract concessions that will effectively preclude negotiations on important issues like trade in agriculture.

The time may indeed have come for alternative approaches. With France an important holdout at this juncture, the European Community is unlikely to move very far without French participation, and that means that the prospects for progress within GATT are extremely limited. This, in turn, creates a major policy dilemma for the United States and other countries. They may elect to wait out the coming French elections in the hopes that the prospects for negotiations would then improve. Waiting has its own dangers, however, in that it creates frustrations that would feed protectionist pressures in the United States and raises the probability that trade talks will become the victim of the next recession. Still, delaying might on balance be the preferred strategy if there existed a reasonable expectation that Europe would become a vigorous participant in multilateral negotiations. Unfortunately, the probability, though doubtless positive, is not very high that Europe will be prepared to negotiate seriously such outstanding issues as agricultural trade, trade in services, and the like. Elections will be coming up elsewhere in Europe in 1987, and recent evidence suggests the absence of broadly based European support for trade liberalization, even though such liberalization could be quite beneficial.

Hence it would appear that the United States should explore alternative approaches to trade negotiations that would exclude Europe but keep open the door for future European participation. It is, therefore, preferable that negotiations remain under the GATT umbrella, which does allow a majority the option of establishing new rules that they apply to themselves. In the design of alternative approaches, Pacific Basin nations will naturally play an important role, but it would be a mistake to ignore the potential contribution that developing nations elsewhere, and especially in the Western Hemisphere, could make.

International Financial Markets

Do International Financial Arrangements Distort Exchange Rates? The international monetary system—or nonsystem to its more severe critics—is often taken to task for failing in one way or another to perform its intended functions. In recent years two specific objections have repeatedly been raised. One concerns the effectiveness with which the system "intermediates" between lenders and borrowers or surplus and deficit countries. This issue is taken up later on.

The second complaint asserts that international capital movements and transactions that are primarily financial have increasingly come to dominate the economic relations among countries. This situation is alleged to have increased volatility and uncertainty in financial markets, but, most important, it has dominated the movement of exchange rates. As nominal exchange rates have increasingly been driven by financial market behavior, they have drifted away from relative prices and have thereby produced substantial movements in real exchange rates. Such real exchange rate movements can have far-reaching effects on competitive positions and resource allocation, particularly when they imply protracted departures from values that are sustainable in the medium term.

Several perspectives support this argument. One, with a long history, holds that only commodity transactions have economic value, because they involve the exchange of something "real" and hence create wealth and add to well-being, while international financial transactions are ephemeral, unreal, and speculative and do not add value. Hence exchange rates should be determined by the former alone. This view, which is more prevalent in Europe and elsewhere than in the United States, leads to various interventions that discriminate between commercial and financial transactions: two-tier exchange rate systems and exchange controls are examples.

On the whole, this view must be rejected as simplistic and as likely to yield policy solutions that do more damage than good. It is simplistic because it ignores very powerful links between financial and real segments of the economy, which imply that interfering with financial capital movements will have real effects. It is not relevant to policy, because the ability of the regulatory authorities to distinguish between productive and unproductive capital movements is strictly limited, thus making capital market intervention a blunt and indiscriminate instrument.

A more sophisticated argument notes that capital attracted by relatively higher rates of return on dollar-denominated assets, and to a lesser extent by safe-haven considerations, has pushed the dollar to its elevated levels. These interest-sensitive capital flows are the result of investors' decisions; to the extent that they are based on relative returns and prudential considerations, they are no less economically meaningful than decisions to buy or sell commodities that are based on relative prices and profitability. Accordingly, if prevailing exchange rates are felt to be out of line, macroeconomic policies must be changed in ways that produce exchange rates sustainable in the longer run.

That is much more easily said than done, however, as the ongoing political tug of war in Washington makes clear. The United States adopted a policy regime that paid little or no heed to its exchange rate effects. That regime has brought economic gain to substantial numbers of Americans while wreaking havoc in the tradable goods sector. With most Americans benefiting, it is politically very difficult to put through the necessary but painful correctives; meanwhile, politicians are busy searching for less painful alternatives, among which are import surcharges and other forms of selective and discriminatory intervention.

An import surcharge would certainly raise revenue with which to reduce the budget deficit, but it would have side effects, many of which are poorly understood. Hence this solution might easily aggravate long-term problems. It might provoke retaliation, and it would contribute to a deterioration in the trading game as the United States, the major monetary and trading power, justified trade intervention to compensate for poorly formulated domestic macroeconomic policies.

Moreover, while an import surcharge would provide a measure of relief to domestic producers of import-competing goods, it would do so only by worsening the situation for U.S. exporters in several ways. First, such a policy is likely to raise the value of the dollar still further, thereby making exports still more expensive abroad. Second, it might raise U.S. interest rates, thereby raising the cost of export finance. And, third, to the extent that U.S. imports and import-competing goods serve as inputs in the production of U.S. exports, the dollar cost of producing exports would rise, making them still more uncompetitive. If the import surcharge is meant to offer a measure of relief to tradable goods producers, then the revenue gathered in this way should be redistributed to export producers in the form of a subsidy.

Doubtless other aspects of this and other interventionist strategies need to be better understood, but one thing is clear already. The current American difficulties with respect to exchange rates, trade, and competitiveness are mainly the self-inflicted wounds from policies that failed to anticipate powerfully destructive side effects. To solve these difficulties with policies whose effects are equally poorly understood makes little sense.

The preceding discussion has focused on exchange rate *levels* and their effects on trade and competitiveness. In recent years, however, exchange rates have also been quite volatile, fluctuating frequently around their longer-term values. This has raised concerns among some analysts that exchange rate volatility may reduce the volume of world trade by making international transactions more risky and hence less attractive. This question has been studied extensively, the bulk of the evidence suggesting no link between exchange rate volatility and the volume of trade.[1]

Does the International Financial System Facilitate Trade and Economic Development? When OPEC dramatically altered the terms of trade between oil-exporting and oil-importing countries, it fell to international financial markets in general and to multinational banks in particular to manage an income transfer between two groups of countries that could not have been more mismatched in their economic needs and preferences. The Middle Eastern oil-exporting countries were incapable of absorbing immediately the immense wealth transfer that had come their way; they ran current account surpluses and invested the excess of income over spending in highly liquid assets denominated in U.S. dollars and in a small handful of hard currencies. The oil-importing countries, especially those in the third world, needed long-term loans to finance their deficits but offered investment opportunities that held little interest to oil exporters.

Consequently, direct financial interaction between surplus and deficit countries was impossible, giving rise to the need for international financial intermediation. Moreover, whereas financial interaction among developed countries occurs through a broad range of channels (including equity and debt markets, direct investment, and international lending), the peculiarities and preferences of the principal creditors and debtors in this case restricted the bulk of intermediation to international bank lending (and official institutions); therein lies a major explanation for the subsequent disruption and crises in the international financial system.

Most observers would agree that the banks performed their role of financial intermediaries reasonably well. Mistakes were made, of course, but many placements that look ill advised in retrospect seemed justifiable in light of conditions prevailing at the time they were made. Then, in 1979, the U.S. Federal Reserve System altered the policy signals in a fundamental way. Simultaneously the U.S. government, newly elected in 1980, embarked on a policy of fiscal expansion that turned out to be unprecedented in scope and magnitude. When it was all over, three key features of the world economic environment had changed and by

[1]See for example, Robert Solomon, "The Consequences of Exchange-Rate Variability," *Brookings Discussion Papers in International Economics*, no. 24, December 1984.

changing had totally altered the viability of debtor-creditor relationships.

Actual and expected inflation rates declined, raising the long-run burden of debtor countries, which had hoped that inflation would erode the real value of their debt. The industrial countries entered a severe and prolonged recession, which destroyed markets for debtor country exports and hence debtor country foreign exchange earnings. And world interest rates rose, making the debt burdens of developing countries substantially more onerous. The rest is history.

The judgment that international banks discharged their obligations with reasonable proficiency, given the circumstances, does not, however, imply that the international financial system was functioning as well as it could. The problem arises from the concentration of international financial intermediation in a single channel—international bank lending. In principle, and in practice as far as the relations among industrial nations are concerned, the international financial intermediation process offers a variety of channels (banks, securities markets, and direct investments among them) and proceeds by way of a broad range of instruments offering varying degrees of liquidity, maturity, and risk. In other words, it is highly diversified, offering prudent and risk-averse lenders and borrowers opportunities for asset and liability diversification. When those opportunities are eliminated, for whatever reason, any drastic change in the economic environment exposes both creditors and debtors to greater dangers.

To visualize the difference, one need merely imagine what would have occurred if the liabilities of debtor countries had been more diversified, containing bank loans as well as equity and bond finance and direct investment. Stock and bond markets would have downgraded debtor country obligations and reduced their market values, equity issuers in developing countries would have stopped dividend payouts, foreign firms with investments in those countries would have suffered reduced profits or losses, and loans from international banks would have required renegotiation. Adjustment would still have been required, but the burden of adjustment would have been diversified and easier to bring about. It is by not providing an adequate measure of diversification that the international financial system can be said to have "failed."

Why did it fail? The answer is relatively simple, but the solution is complex. The oil-exporting surplus countries had highly skewed asset and liquidity preferences, as we have already seen. On the side of oil-importing developing countries several forces were at work. The weakest and poorest among them had no access to world financial markets because they had no assets to sell; neither did they offer very attractive targets for direct investment. Bank and official (concessionary) financing really offered the only viable alternatives. For a number of other developing countries, the major Latin American debtors among them, the matter is more complicated. Poorly functioning, overregulated, and heavily distorted domestic financial systems not only kept foreign investors out but created incentives for capital flight. Tendencies for governments to dominate the allocation of capital added to the difficulties. And, finally, widespread hostility toward foreign firms and foreign investment created a climate inimical to direct investment inflows. In other words, the debtors contributed to their own difficulties by limiting the opportunities a well-diversified international financial system would normally offer. And to argue that no one could have anticipated the sharp changes in world economic conditions misses the point: diversification is prudent precisely because unforeseen and unforeseeable events do take place.

What makes this point crucial is that the problem still exists and that little is being done to deal with it. This will prolong the debt crisis, delay recovery and growth in many developing countries, and thereby threaten the political foundations of what are often very fragile democracies. It is unlikely that international banks will return any time soon to substantially larger exposure in many third world countries, so that a larger role must be given to other channels of intermediation, including direct foreign investment. But such investment is not likely to increase to the extent needed without substantial improvement in the treatment of investment. What is needed is an improved code of standards and enforcement provisions dealing with the regulation, taxation, and political treatment of foreign investment. Negotiation and installation of such a code should be high on the foreign policy agenda of the United States.

Such an effort constitutes an imposing challenge even under the best of circumstances, but the moment may nevertheless be propitious for a multilateral effort in this area. The multinational banks and the governments in many developing countries have learned the meaning of exposure and are likely to move cautiously for some time to come. That creates room in principle for alternative approaches to intermediation. Moreover, the austerity conditions that have come with IMF-sponsored renegotiation of debt packages may make those alternatives more appealing in comparison. Hence an initiative at this time may offer some hope.

As for the greater use of securities markets, nothing significant is likely to happen without serious financial reform in most developing countries. Financial markets there are underdeveloped and overregulated, rules and standards are inadequate, and the general environment creates incentives that contribute to the misallocation of capital. The flight of private capital that has aggravated the debt problem of some countries is an example. But while the problems of financial market structure are acute, they are problems, unlike many others, over which developing countries have a considerable measure of control. Serious and significant reforms are urgently needed.

Trade Talks and the Monetary System: Should They Be Linked? In the U.S. Congress and abroad, the proposition has been advanced that trade negotiations must be accompanied by discussions of international monetary issues. The proposition is noncontroversial if what is meant is simply that exchange rate misalignments have been a major cause of shifts in competitiveness and consequent pressures for protection and that a more sustainable pattern of exchange rates would clear the air and facilitate the bargaining process.

Frequently, however, the proposition is intended to suggest that trade issues cannot be negotiated except in the context of a particular exchange rate regime. And then it becomes quite controversial, because to most observers a trade-distorting practice is a trade-distorting practice, one that discriminates against and occurs at the expense of a country's trading partners regardless of the monetary regime within which it occurs. This is not to deny that exchange rate patterns may themselves affect competitiveness but simply to reflect the longstanding proscription against the use of trade-distorting practices designed to compensate for given exchange rates. A tariff is, therefore, a tariff, an export restraint agreement is just that, and an export credit is an export credit, whatever the exchange rate regime, and can thus be discussed independently of that regime.

The conclusion, therefore, must be that misalignment of exchange rates is a matter of major concern and is a proper subject for international discussions (in the OECD, IMF, World Bank, and so on) and that other countries do themselves and the United States a favor when they insist that policies be devised that will bring about a more sustainable pattern of exchange rates. But these discussions can and should proceed independently, and linking them to trade negotiations, either to achieve a certain exchange rate regime or to extract concessions in trade negotiations, introduces an extraneous and disruptive element and sets a precedent that could be used at later stages to hold trade talks hostage to further demands on exchange rates.

One aspect of international economic relations, however, may usefully be tackled by the negotiating partners, again without formal links to trade talks. It concerns pervasive barriers to capital movements and the unfriendly environment for movements of investment capital. To put the problem another way, when both commodity and capital markets are subject to distortions, should financial and trade liberalization proceed simultaneously, or should one precede the other? This is a thorny subject, and the major reason for avoiding a formal link is the complications that would be added to an already complicated problem. Still, trade and the flow of investment capital are becoming increasingly interdependent, so that trade and financial liberalization inevitably generate strong cross effects.

APPENDIX

Services Trade: An Agenda for International Trade Negotiations*

Services are an integral part of the international economy and should be subject to a framework of international agreements and institutions governing international trade. In October of 1984, Congress and the president signaled their intention to negotiate such an agreement. The Omnibus Trade Act of 1984 authorizes the president to give high priority to the negotiation of multilateral and bilateral agreements governing services trade.

The United States should now implement this policy and seek to create, in this decade, a workable and effective international system of rules and dispute settlement designed to maintain and foster liberal trade in services. This policy should be flexible so that the U.S. government can utilize every possible means to

* This section was written by a team of researchers led by AEI staff at the request of a number of members of the Service Policy Advisory Committee to the U.S. Trade Representative. In slightly amended form, it was included in the official set of recommendations presented to the Office of the U.S. Trade Representative by the overall private sector Advisory Committee on Trade Negotiations on April 15, 1985.

achieve these ends, including bilateral, multilateral, and plurilateral negotiations in various forums. The guiding principle of such a negotiating strategy should be to conclude agreements on services whenever and however possible provided that such agreements serve the objective of liberalizing trade in services.

The increasing proliferation of nontariff barriers in the service sector necessitates bold and innovative leadership by the United States. In order to have a system of rules in place and operational by the 1990s, the U.S. government should aggressively pursue a trade negotiating strategy to establish precedents of internationally agreed rules on services. Any such effort must include new negotiations and agreements to protect intellectual property rights, which are essential to fair trade in services. Although this trade policy should build upon, and derive from the existing GATT system, it should not hesitate to depart from the existing system, being innovative and bold. The United States should seek an internationally agreed system of rules respecting trade in services in which governments acquire rights and obligations after the GATT model in their regulation of services trade. Finally, the recalcitrance of some countries, particularly developing countries, should not be permitted to obstruct agreement among more developed countries for whom services trade may be more significant.

The new services trade system should take the form of an umbrella general agreement, forming a "constitution" of general services trade principles to which most developed nations should subscribe. In addition, there should be sectoral agreements, subsidiary to the general agreement, to which countries might subscribe *à la carte*. Emphasis should be placed upon those service sector agreements that form the infrastructure of services trade. An effort should also be made to amend the existing GATT nontariff barrier codes to deal with services where appropriate.

Both the international general agreement on services and the subsidiary sector agreements should adopt certain general principles from the GATT. As discussed more fully below, contracting parties should commit to halting the introduction of new services trade barriers on the date of accession. In addition, they should commit themselves to reducing existing barriers in accordance with a set schedule. They should obligate themselves to maintain transparent systems in which the balance of their concessions is maintained and to redress any subsequent change in the balance.

The principles of transparency, balance of concessions, conditional most-favored-nation (MFN) treatment, and national treatment should be adapted and borrowed from the present GATT system. In addition, however, the United States should not allow the long-standing inhibitions of the present international economic system to prevent it from breaking *new* ground in negotiating international rules on services. For example, telecommunications forms the infrastructure for services trade, much as shipping was, and is, for merchandise trade. Therefore, emphasis should be placed on the negotiation of a telecommunications sector agreement in which countries agree not to create unnecessary technical barriers to telecommunications services and to keep their regulation of telecommunications a political decision, potentially subject to international negotiation. In addition, the present system's lack of international rules on the right to market access is itself a major deficiency and inequity in the existing international regime. Accordingly, it is critical that a right of market access be recognized if a new system of international rules on services is to have any meaning whatsoever. Negotiating such principles, even on a bilateral basis, will require a willingness on the part of the United States and its trading partners to make concessions. Although this effort is likely to be politically difficult and will raise international sensitivities, the long-term economic benefit for the United States makes such an effort a necessity.

Geographic Concentration. Because some regions and nations are more advanced in the services trade area and have a larger stake in liberalizing services trade, the United States should target its negotiating efforts toward these countries. Specifically, these areas include Western Europe, North America, Japan, and various newly industrialized countries (NICs) of Asia. Agreement among the nations of these four areas would represent a major advance and generate strong pressure on other nations to join.

The top twenty-five countries with the highest service exports accounted for 87 percent of world exports in 1980. Of the top ten, excluding the United States, eight were from Western Europe (West Germany, France, Italy, the Netherlands, Belgium, Switzerland, and Spain), with Japan ranking number five. For the United States, Canada and Mexico occupy a special position, with much of their services export trade moving over our borders ($6.6 billion and $4.3 billion respectively in 1978). Finally, the service economies of the ASEAN nations are growing rapidly—matching their merchandising and manufacturing sectors—and in the next decade Korea, Indonesia, Taiwan, Singapore, and the Philippines will undoubtedly join Japan as major factors in the trading of international services.

Given these circumstances, in upcoming GATT negotiations the United States should target its initial multilateral diplomatic efforts on the nations of these areas. Should the GATT process fail to move toward a new regime in services, then U.S. negotiators should concentrate their attention on the construction of a union of like-minded nations in what Ambassador William Brock has termed a "GATT-Plus" or a "super-GATT." For services trade, if the United States could get agreements from most European and ASEAN nations, along with Japan, Mexico, and Canada, the nucleus of an alternative, more liberal services trade regime would have been created. Other nations would sooner or later fall in line in order to achieve the benefits of competing in the larger, more open market of the "GATT-Plus" nations.

Right of Market Access. The overriding goal of U.S. negotiators should be the achievement of equal access to foreign markets so that the United States and other trading nations can take full commercial advantage of the opportunities afforded in host-country markets. Equal access should be ensured through strong provisions for nondiscrimination and "national treatment," that is, the principle that imported goods and services be accorded the same treatment as domestic goods and services.

A sensible, realizable goal for services trade negotiations is to guarantee, to the largest extent possible, the equal access of foreign firms to domestic markets. The aim would be to construct a package of rights and obligations that would achieve for services the "national treatment" provisions embodied in article III of the GATT for goods.

Such a package would consist of, among other things, guaranteed access to the distribution system. A foreign supplier of services, thus, would have the right to contract with a local business to provide distribution of services. This could be accomplished through a shared joint venture, minority interest with management control or some type of licensing arrangement. Another area of coverage would deal with professional services that require a local presence. A foreign television firm, for instance, would have the right to contract with fully accredited domestic professionals such as cameramen or local film developers. Or, to turn the issue around, local professionals would also have the right to buy expertise from foreign firms. In any situation where the domestic regulatory system required a local corporate presence as a condition of doing business, then the right of establishment would become a negotiable trade issue rather than an investment issue.

Rules for Competition between Private Corporations and Government Monopolies. Because many countries provide central services through government-owned or -controlled entities—and because this situation is not likely to change in the future—one major organizing focus of the services trade negotiations should be the development of a comprehensive set of rules governing transactions between government monopolies and private firms.

To promote competition, the United States is deregulating many of its service industries, thereby allowing foreign firms to gain more freedom to compete in the United States. At the same time, the Reagan administration plans to cut Export-Import Bank funds that assist U.S. firms operating abroad in matching foreign credit subsidies. Although Canada, Britain, and Japan are privatizing and deregulating some sectors, so far these countries are exceptional. Most countries maintain government-owned or -controlled monopolies or oligopolies to provide key services. Frequently, cross subsidization is used to keep inefficient service providers competitive, and direct subsidization is used to compete for business in third countries.

Government-owned or -controlled firms may enjoy significant competitive advantages vis-à-vis private U.S. firms in the U.S. market, in their own markets, and in third countries. For example, foreign firms may gain access to the U.S. market while protecting their own markets. Or, government monopolies may try to play competing private firms off against one another, using their monopoly position as leverage. Governments will not lightly abandon their regulatory preferences; therefore, rules need to be negotiated to allow for fair competition between government-owned and -controlled firms and private firms.

Four generic problems need attention:

- *Ability to provide services to the monopoly.* This is a procurement problem. Public monopolies will frequently favor domestic service (and goods) suppliers over foreign ones. When foreign suppliers can provide quality services at competitive prices, they should not be excluded from markets through elaborate procedural, standards, or certification mechanisms.
- *Ability to purchase services from the monop-*

oly. Government-owned or -controlled firms too frequently favor their own subsidiaries or firms from their own countries, making it impossible for others to compete. For example, in Japan, freight handling regulations at airports discriminate against non-Japanese carriers, and in Europe airline reservation systems exclude schedules of U.S. carriers. A related problem is that horizontally integrated monopolies may use cross subsidies to distort their pricing, making it difficult for U.S. firms to compete. For example, governments are willing to permit state-run airlines to lose money, in order to funnel tourist dollars into the economy.

- *Ability to compete with the monopoly.* Here there are two related issues. First, unless the monopoly allows the foreign service provider to "plug in" to the underlying systems, there is no way it can compete. But, even when permission to plug in is granted, the monopoly may use its dominant position to limit competition. For example, it does U.S. data communication firms no good to receive permission to provide enhanced services if they cannot use the basic service network on a fair basis. Yet the providers of basic services are likely to be those moving into the provision of enhanced services. They can extend their monopoly by restricting access to their old services.
- *Ability to compete in third markets.* Some government-owned or -controlled service firms receive significant subsidies that allow them to undersell U.S. firms. For example, Korean construction firms are subsidized when they bid for foreign contracts; U.S. firms receive no comparable boost. Similarly, there is the possibility that the opening of the INTELSAT system to more competition, as the United States proposes to do, will help subsidized French and British satellite monopolies get a larger share of the Atlantic communication traffic while giving up very little of what they now dominate.

Intellectual Property. The United States should declare its intention to work toward the inclusion of intellectual property issues—including copyright, patent, and trademark protection—within the international framework of trading rules. Intellectual property issues are central to two new trade areas the United States has asked to be placed on the GATT agenda in the next round of trade negotiations—trade in services and trade in high-technology products. Without harmonization and codification of intellectual property rules, consolidation of institutions and the creation of consultants and dispute resolution procedures such as those provided by the GATT, increased conflict among the major trading nations is inevitable.

The inadequate protection of intellectual property rights constitutes a major and growing problem for many service industries. A survey by the Services Policy Advisory Committee of executives in the communications, publishing, and advertising industries, for example, found copyright infringement to be the most serious barrier to trade in services. Violations of industrial property rights occupy a similar position for other services industries. Yet traditionally, intellectual property issues have not been viewed as trade issues. Only the problem of counterfeit goods has received any serious attention in a trade negotiation forum.

There are now many multilateral agreements governing the protection of intellectual property rights as well as regional and bilateral agreements. The bulk of agreements designed explicitly for intellectual property protection fall under the rubric of the World Intellectual Property Organization (WIPO), although WIPO's jurisdiction is by no means all inclusive. Many important agreements exist scattered among a variety of other institutional structures.

Problems with the existing fragmented regime for the protection of intellectual property rights abound. The number of signatories to specific agreements is often far too low for them to have any substantive impact. Intellectual property agreements have failed to keep pace with technological development, leaving new and important intellectual properties unprotected. None of the existing agreements, further, establish uniform international rules for the protection of industrial properties or copyrights. They rest instead almost exclusively on the principle of national treatment and are designed principally to harmonize divergent national laws, not to eliminate the divergencies. Intellectual property laws vary widely from nation to nation and both private and public sector studies indicate that enforcement is often weak or nonexistent, particularly in the developing world. Finally, the existing body of international agreements fails to provide for enforcement powers or bodies and offers no provisions or mechanisms for the settlement of disputes.

Intellectual property issues promise to remain at the heart of trade in services problems in the future. The international trading community must, therefore, begin the process of integrating intellectual property questions into the trade regime. The United States should continue to identify trade-related intellectual property issues and actively seek their resolution in the GATT and other international trade forums.

The Centrality of Telecommunications. Because telecommunications (informatics) constitutes not only a separate service sector in its own right but also is a driving force behind world competition in many other service sectors (namely, banking, construction, professional services, insurance), issues crucial to the smooth functioning of information flows should be accorded a special priority in any trade negotiations. More specifically, the United States should pursue policies designed to encourage the maximum free flow of information across countries' borders.

An integrated international communication infrastructure is to trade in services what the integrated transportation infrastructure is to trade in goods. The technology exists to permit affordable, instant voice, data, and video communications between virtually any two points on the globe. To the extent that governments allow the establishment of such communication systems, services will become more tradable, that is, international sales of services will involve relatively more trade and less investment. As a result most service industries including banking, insurance, engineering and construction, health care, education, various professional services, reservation services for airlines and hotels, and advertising will gain if they are assured of free flows of information, at reasonable expense, through a technically compatible system. In addition, many goods-producing firms will benefit because services as an input to creating goods is on the rise and goods-producing firms are earning more of their total revenues from the sale of services.

The smooth functioning of the world information economy depends on communications flows. If the information flows in a company or between a company and its customer or competitors are cut off, the firm is crippled. Therefore, companies want to ensure that they have continued access to present communication links and at the same time work to expand their own networks.

Current problems are of two generic types: those related to conduit and those related to content. First, some countries use technical barriers involving standards, equipment, and software to prevent the creation of an integrated infrastructure. Second, countries may limit what information can flow over the network (that is, transborder data flows) or even the ability to tie into an international network.

Complete integration of national and international telecommunications is impractical because of national security and cultural sovereignty concerns. The United States should, therefore, make the nondiscriminatory access to foreign telecommunications equipment, facilities, and services for U.S. firms a chief trade policy objective. To achieve a freer international flow of information, it is also desirable to work toward:

- *Acceptance of the principle that technical integration should be encouraged.* To the extent that countries feel it necessary to monitor and control information flows for national security or sovereignty purposes, they should focus on the information that flows through the system, not on the equipment that allows for the creation of an integrated system. Countries should also recognize the special importance to an inherent right of offices of the same company to exchange information freely.
- *Ensuring that when countries choose to erect barriers that inhibit the free flow of information these barriers are made transparent.* Barriers to trade in communication and information services should not be disguised as instruments to promote cultural or national security objectives.

Dispute Settlement. Achieving a satisfactory international legal and institutional framework governing trade in services requires an effective and workable system for the settlement of disputes. Such a system might use certain principles of the GATT as a point of departure. For example, signatories to an international services agreement should assume certain rights and obligations. The GATT concept of "balance of concessions" should be adapted and employed in the context of services. Countries engaged in practices that nullify or impair the balance of concessions should be obligated to restore the balance by providing trade concessions of equivalent value (involving services, goods, or both).

The dispute resolution procedure itself could involve three stages. Where one signatory has a complaint against another, both parties should be obligated to enter into diplomatic consultations with the objective of resolving their dispute amicably. Second, if the parties are unable to resolve their dispute through consultations within a set period of time, the dispute should be referred to a standing Committee on Services composed of representatives from each of the signatories to the agreement on services. The committee will act as an arbitral body to encourage the parties to resolve their dispute. Finally, if the committee is unsuccessful at resolving the dispute within a set period, the dispute should be referred to a "GATT panel." Just as in disputes arising over trade in goods, where the GATT panel decides against one party, the committee may authorize the other party to suspend obligations under the agreement as a compensatory measure.

Conditional Most-Favored-Nation Provisions. The United States should include conditional most-favored-nation provisions in all negotiated sectoral and bilateral services agreements to facilitate the expansion of negotiated liberalizing trade terms to a multilateral framework.

Changing conditions in the international competitive environment for services require that the United States adopt a multifaceted policy stance that combines a more vigorous defense of U.S. interests in existing mechanisms with the exploration of new strategies and tactics. Multilateralism and, in particular, the GATT still provide the central framework for the pursuit of U.S. trade goals. Multilateral agreements of necessity, however, are based on compromises among conflicting governmental philosophies and do not provide the means for complete protection of U.S. concerns. Other policy vehicles—bilateral, regional, and sectoral—should be employed to defend U.S. interests in the services area. Such agreements could then serve as the basis for future multilateral accords.

To facilitate the widespread adoption of liberalizing principles established in a bilateral or sectoral agreement, the United States should combine such efforts with a conditional most-favored-nation principle. Conditional MFN would provide for the extension of negotiated benefits to all other countries willing to assume the rules and responsibilities stipulated in that agreement.

Exceptions. The agreement should incorporate certain exceptions analogous to existing exceptions to GATT rules. For instance, signatories should be allowed to deviate from their obligations under the agreement for reasons of national security and where serious injury is being done to a domestic service industry due to competition (within the domestic market) from foreign service companies. Without such exceptions, no country will find a GATT agreement on services to be politically palatable.

Capital Formation and Movement: The Human Dimension

Denis P. Doyle

Introduction

CAPITAL has two forms, physical and human. Physical capital is plant and goods, money and things; for generations it has been viewed as both the symbol and the source of wealth. It remains the symbol of wealth but is no longer its principal source. Today human capital is. Human capital is the acquired skills, abilities, and attitudes that make individuals and societies productive.

Although the term "human capital" is graceless, it forces us to think about the role of developed human intelligence in the creation of wealth. A nation's wealth is measured today by its human capital. And the "wealth of nations" remains the quintessential question of political economy, as it was when Adam Smith raised it two centuries ago. The nomenclature of physical capital helps illuminate the role and importance of human capital. How is it formed? Who should bear the costs of its formation? Who should enjoy the benefits of its formation? How do we distinguish between individual and social benefits? Under what circumstances is human capital portable? When and why do people move? Any nation that ignores these ques-

DENIS P. DOYLE is director of Education Policy Studies at AEI and director of research on human capital development under the project Competing in a Changing World Economy.