Challenges to the Liberal International Trading System, GATT and the Uruguay Round *

1. The GATT System under Stress

The General Agreement on Tariffs and Trade (GATT), which was responsible for the normalization of international trade relations in the post-war period and for the substantive tariff liberalization that followed, factors that lay behind the growth of world trade and the economic prosperity of the past four decades,[1] was under consider-ation stress throughout the 1980s. Its capacity to continue to ensure a system of trade relations based on fixed rules, agreed by its members and enforced through group pressure, has been seriously questioned.

Apparently incapable of even maintaining the free trade *status quo*, weakened by the spread of the "new protectionism" and of bilateralism in trade relations among key members, not to mention extending its rules to areas of international trade kept outside its jurisdiction – *e.g.* agriculture, textile-clothing and services, the GATT order, if not dead, as somewhat prematurely announced by a noted American economist in 1988, seemed to be in serious ill health.

Even the Uruguay Round, eight in a series of international trade negotiations conducted within the GATT framework, with its am-bitious goals and comprehensive agenda, took more and more the

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* The views expressed here are those of the author and should not be attributed to the World Bank and/or the Johns Hopkins University, with which he is affiliated.

[1] The fact that in the period after World War II world trade increased much faster than world output is indicative of the influence exerted by other factors. One of them was certainly trade liberalization, especially in the 1950s and 1960s. Later on the development of intra-industry trade became important, especially among industrial countries. The positive impact of trade on output growth is also documented. There is uncertainty about its size, but not about the direction of causality.

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connotation of a frantic and contradictory effort to remedy all at once the many difficulties plaguing the GATT order, instead of a sign of newly found vitality. The franticness became apparent after the ambiguous outcome of the Montreal Ministerial Conference in 1988 and even more clear after the failure of the Bruxelles Conference to bring negotiations to a close in December 1990. The contradiction was always that the very parties that were publicly engaged in bringing the GATT back to good health, were in practice making national trade policy decisions that weakened it.

Many GATT members, including the key ones, continued to pursue idiosyncratic and inconsistent policy paths in the 1980s, straddling between the respect of market rules and the pursuit of quantity objectives in reciprocal trade relations; at times upholding free trade and at others seeking fair trade; negotiating and implementing further tariff liberalization on the one hand, while increasing the use of non-tariff barriers to trade or of bilateral agreements on the other. The erosion in the internal cogency and clarity of purpose of the trade policies of the United States, the European Community (EC), Japan and Canada, members of the GATT on which preponderant responsibility for upholding its rules rested in the end, was clearly demonstrated during the entire decade of the 1980s.

The United States vigorously sought freer trade in agricultural products, but resorted to using subsidies to sustain its own farm exports in the name of "fairness", since the EC was doing so. It targeted foreign trade practices that were unilaterally perceived as unfair, damaging or non-transparent, threatening specific forms of retaliation against the "guilty" parties. When sheer threats did not work the United States resorted to using a variety of non-tariff measures to make domestic markets less penetrable to imports. In addition, while publicly supporting the Uruguay Round in the name of multilateralism, the United States actively pursued preferential trade agreements with its neighbors (Canada at first and then Mexico) and bilateral accords, formal and informal, with countries exporting "too much" to the US market.[2]

[2] A simple perusal of the annual Economic Reports of the President since 1982 is sufficient to get an idea not only of the contradictions affecting the trade policies of the United States, but also of the tension existing within two US administrations formally devoted to keeping the nation in the free-trade camp. For a comprehensive review of President Reagan's trade policies, see PEARSON (1989).

The European Community, at the same time, agreed to include agriculture in the Uruguay Round negotiations, knowing that its Common Agricultural Policy (CAP) would come under severe scrutiny for its trade-reducing and price-depressing external effects. Yet, the EC continued to support its farm sector with guaranteed minimum prices, kept it isolated from foreign competition with variable levies and went on subsidizing exports of surplus production. The issue of how "business as usual" in agriculture and active participation in the new GATT negotiations could be mutually compatible was never fully confronted. So the Community waited until nearly the end of the Uruguay Round negotiations before focusing on the issue of the CAP reform. By then, the fate of the GATT negotiations was already at serious risk.

The use of non-tariff barriers outside the agricultural sector also increased substantially in the EC during the 1980s, especially to contain exports of manufactures from Eastern Europe and the East Asian NICs.[3] In addition, while busily dismantling residual obstacles to the free movement of goods, capital and labor among its constituent members, and further reducing tariff barriers to trade with its European neighbors, the EC pursued trade deals with Japan and the NICs aimed at regulating on a bilateral basis their access to Community markets (Secchi, 1990).

Japan, mindful perhaps of the heavy discrimination it had suffered in the 1920s and 1930s, pursued a policy of official multilateralism, but *de facto* bilateralism in external trade relations. Formally part of GATT and an important actor in the Uruguay Round of trade negotiations, Japan manifested its traditional weak commitment to the principles of GATT and limited trust of its partners' intentions in the stubbornness with which it clung to the protection of rather insignificant portions of domestic agriculture and above all in the penchant for settling bilaterally, and outside the GATT, any trade dispute that arose with its main partners. Bilateral settlements with the United States, as in the cases of semiconductors, wood, automobiles, construction services, and more recently with the EC for motor vehicles, were the rule instead of the exception in Japan's trade policy behavior.

In these circumstances what seemed to a few ultra-optimists as tolerable variance, in an area where exceptions to the rule always

[3] Hong Kong, Korea, Singapore and Taiwan.

existed and behaviors were never totally clear-cut, appeared to most others as signs of disintegration of the consensus once surrounding GATT principles – above all that of non-discrimination in trade relations among the most important members – and a bad omen for certainty and freedom in international trade.[4]

For these reasons the outcome of the Uruguay Round has become emblematic, as a sort of acid test of the will of key players in the international trade arena to continue to live within a system of rules, agreed upon in advance by members and considered to be in their common interest. Only if such will was found to exist, could the GATT framework be successfully updated and strengthened so as to ensure a more certain and active application of its principles and their extension to important new areas of international trade.

2. The New Protectionism

The GATT order was based on the fundamental premise that freeing trade is essential to world welfare and that movements in this direction were therefore highly desirable.[5] Members had to follow certain rules in moving from encumbered to unencumbered trade, since this type of transition was recognized to be both technically and politically difficult. The most important of these rules of behavior were reciprocity in trade concessions and non-discrimination in trade relations among members.

Given that they agreed on the common objective of trade liberalization, GATT members first eliminated all the major quantitative barriers and payment obstacles to trade existing in the immediate post-World War II period. Then, they concentrated their efforts on reducing tariff barriers, by far the most important residual

[4] Exceptions to the principles of reciprocity in trade negotiations and non-discriminations had earlier been made in favor of developing countries, but not for any industrial member country.

[5] The GATT preamble is quite explicit about both the premise and the consequences: "Recognizing that ... relations in the field of trade and economic endeavor should be conducted with a view to raising standard of living, ensuring full employment and a large and steadily growing volume of real income and effective demand" it sought to achieve these objectives by "the substantial reduction of tariffs and other barriers to trade".

impediment to the international exchange of manufactures, the products on which most of the restrictions enforced in the 1930s and during World War II had fallen.

As a result of successive rounds of international negotiations, tariff obstacles to trade were progressively and aggressively reduced.[6] Growing acceptance of the GATT framework by emerging nations and the *de facto* globalization of the GATT order also became evident. The behaviors of the most important members – *i.e.* the major industrialized countries – remained broadly compatible with GATT principles in other areas of trade policies at least until the mid-1970s. Since then inconsistencies, and subsequently major contradictions, have emerged as most of these countries resorted with increasing frequency to the use of non-tariff obstacles to trade in order to deal with the adjustment difficulties they faced.

The first set of adjustment problems arose from the oil shocks and the consequent worsening of the international terms of trade of practically all the major countries. But the so-called "new protectionism" expanded further in the 1980s, propelled by lack of coordination in the macro-economic response to the inflation plaguing the industrial economies at the end of the 1970s, within an overall context characterized by high international mobility of capital, integration of financial markets and flexible exchange rates. National responses of key countries, such as the United States, taken in isolation and exacerbated by a sharply divergent policy mix – a tight monetary and an expansive fiscal stance during the first half of the 1980s – led to strong imbalances in current accounts and to wide swings in exchange rates.

These developments increased the propensity of national authorities everywhere in the industrial world to use non-tariff barriers to trade so as to protect domestic producers under stress, and to extend subsidies and other forms of public assistance to exports in order to sustain economic activity and employment at home. At stake was industrial employment during "hard times" in economies often ridden with rigidities in both good and factor markets. A positive relationship between unemployment, exchange rate appreciations and use of non-tariff barriers, long hypothesized by economists, was shown to have existed during that period (Salvatore, 1987 and Grilli, 1988).

[6] From averages of over 40% in the 1950s to less than 5% in the 1980s.

Other factors may have exerted significant influence in both Europe and the United States, as protectionist tendencies did not cease with either economic recovery or the realignment in the values of the major currencies that occurred in the second half of the 1980s.[7] Increasing competition from newly industrializing developing countries, especially those of Asia, may have been one. The export drive of many other middle-income nations saddled with enormous external debt and forced to adjust by decreasing real domestic absorption of resources and by switching more of them to the production of exportable goods, may have been another.

The use of true non-tariff barriers such as import quotas, or quasi non-tariff barriers such as variable import levies, were limited until the mid 1970s to a few areas of international trade – mostly textile-clothing and agriculture. They became more widespread in the following years both in terms of variety and areas of application. "Voluntary import restraints" (VERs), "orderly marketing agreements" (OMAs), import surveillance measures, antidumping and antisubsidy investigations, and trade-slowing custom practices were used in increasing numbers to intimidate foreign exporters and to render their access to domestic markets more uncertain and difficult (Table 1). The sector application of these measures also expanded to steel, automobiles, footwear and electronic equipment. More and more countries exporting manufactures became targets of these unfair trade practices (Grilli, 1990 and 1991), while an increasing number of importing countries such as Canada and Australia, in addition to the Community and the United States, resorted to using them (IMF, 1988).

The utilization of informal, instead of formal, measures to limit the export of competitors to domestic markets did not change the substance of things. Lables notwithstanding, the tendency was to subject the international exchange of many products to management by governments. Japanese suppliers of automobiles to the United States might have been able to capture a good deal of the economic rent created by their "voluntary" restraint on exports by charging higher unit prices and moving upscale in the type of vehicles that they sold there. Yet, the basic consequence of the VER on automobiles imposed by the United States on Japan was to quantitatively regulate trade flows, instead of letting the interplay of market forces determine it.

[7] Japan appears not to have followed this trend.

Table 1

MEASURES TAKEN BY MAIN INDUSTRIAL COUNTRIES TO RESTRICT IMPORTS

	Against Other Industrial Countries	Against Developing Countries
	(number of measures)	
– Export Restraint Arrangements[1] in 1989	120	115
– Antidumping Actions[2]: 1981-89		
by: USA	128	137
EC	40	49
Canada	154	76
– Countervailing Actions[2]: 1981-89		
by: USA	66	135
Canada[3]	11	4

[1] Excluding MFA-related export restraints.
[2] Provisional measures taken.
[3] 1984-89 only.
Source: The World Bank, *Global Economic Prospects and the Developing Countries*, 1992.

The same is true of the distorting and intimidatory use of otherwise permissible protective measures, such as anti-dumping and antisubsidy (also called countervailing duty) actions, which became the norm in both the United States and the Community during the 1980s (Finger, 1987; Finger and Nogues, 1987; Hindley, 1988; Messerlin, 1989). The fact that formally legitimate instruments were utilized did not hide the true purpose of their use: to force limits on the quantity of goods exported by foreign competitors or on prices practiced by them, *i.e.* to substitute administrative for market outcomes.

The total results of all these practices was to submit at least a quarter of world trade to non-tariff barriers (Table 2), at the exact same time as tariff obstacles to trade were being swept away and the extension of GATT rules to other areas of international trade was being publicly pursued through the Uruguay Round.

The threat of the new protectionism to the GATT order and to freedom of international trade, once underestimated even by some ardent supporters of free trade (Hughes and Krueger, 1984; Bhagwati, 1988) is now generally more recognized and appreciated (see, for example, Bhagwati, 1991). The analytical and documentary

TABLE 2

WORLD TRADE SUBJECT TO NON-TARIFF BARRIERS

	USA	Japan	EC	Total OECD
		(% shares)		
1981	11	24	13	15
1983	14	24	16	17
1986	17	24	16	18
1989	n.a	n.a.	n.a.	22

n.a. = not available.
Source: LAIRD and YEATES, *Quantitative Methods for Trade Barrier Analysis*, 1990; UNCTAD, *Trade Control Measures Information System*.

efforts of numerous students of this phenomenon, and of institutions such as the United Nations Conference on Trade and Development (UNCTAD) and the World Bank, seem to have borne some fruit, and to have at least "converted the believers", even though it apparently did little to keep the trend in check. Governments that practiced non-tariff protection failed to be guided in their decisions by the objective of maximizing national welfare, but still rationally responded to incentives coming from the domestic markets for protection and maximized short term political gains.

3. Bilateralism in Trade Policies

A second major threat to the GATT order came from the bilateralism in commercial policies pursued by some key countries, such as the United States, once a strong defender of multilateralism in trade relations, and Japan, seemingly intent on pushing exports in a fashion that appeared to many as inherently mercantilistic.[8]

[8] Japan is also alleged to have a strong anti-import bias. This has been gauged from many indicators: low and stagnant import penetration in manufactures, low intra-industry trade, multiple layers of informal protection operated by firms and government authorities. More informally, many observers have pointed to the seemingly permanent trade surpluses shown by Japan. Positive trade balances, however, do not show by themselves anything about the stance of trade policies. They are instead to be expected in a country like Japan which has a structural excess of savings. On the trade policies of Japan, see BALASSA (1986), LAWRENCE (1987) and FODELLA (1990)

Given the traditional preference of Japan for negotiated bilateral outcomes in trade and the long-standing preference of the European Community for regional integration, the most significant change with respect to bilateralism occurred in the United States. This can be traced back to the early 1970s, when the urge to counteract foreign trade practices considered to be unreasonable, unjustifiable or discriminatory with bilateral negotiations aimed at their removal, to be concluded within a given period of time and under the threat of retaliation, became manifest in Congress. This was enshrined in Section 301 of the 1974 Trade Act.

Several factors contributed to the emergence of this posture. The most important was the perception that the precariousness of the trade position of the United States was due not to a real loss of competitiveness in the industrial sector, but to the inability of domestic producers to compete as freely in foreign markets as foreign producers could in the US market. Lawmakers increasingly felt that US respect for GATT rules was not matched by other members, large or small. The price of following the rules was becoming too high, in the presence of deviant behaviors by others. As a result there was the call for *both* "free" and "fair" international exchange, and the corollary that, to induce "fairness" in the behaviors of such trade partners as Japan and some of the East Asian NICs, seemingly bent on exports only, the United States had to be in a position to undertake unilateral retaliatory actions. Without such an ability, the country would have no credible deterrent against the export bias in the trade policies of key industrial partners.

The US impulse to acquire unilateral forms of deterrence against unfair trade practiced by foreign competitors, and to use them outside the GATT framework, became even more solid in the 1980s, paradoxically under the most vocal free-market administration in recent American history (Richman, 1988; Pearson, 1989). It generated in the United States the so-called "Super 301" norms, included in the Omnibus Trade Act of 1988, which mandated US trade authorities to identify the countries following the most unfair trade practices and ordered them to take retaliatory steps whenever negotiations with the "guilty" countries do not bring acceptable changes in "unfair" practices within eighteen months.

This tendency, sometimes characterized as "aggressive bilateralism", constitutes perhaps the most radical negation of the multilateralist spirit and rules of GATT. It almost abstracts from the question of the legality (under GATT or other valid international norms) of the foreign trade practices being targeted, and thus ignores the need to have the presumed illegality or, even more simply, the damaging nature of these practices ascertained by at least a body of peers before a reaction to them can be mounted. Bilateralism also ignores the use of the protective and remedial procedures foreseen in the GATT agreements, such as the safeguard clause in Art. XIX and the nullification procedure in Art. XXIII, in favor of administering "national" or "own" justice, made possible by the strength deriving from economic size and political prominence.

Careful students of US trade policies have stressed the deep historical roots of protectionism in this country and of its preference towards bilateralism in trade relations (Riedel, 1987; Pearson and Riedel, 1990). New or old, the tendency towards bilateralism in US trade policies seems to have been exacerbated by the persistence of a large imbalance in the trade account throughout the 1980s, even if such an imbalance was largely and most consistently due to over-expansive fiscal policies and at times to a grossly overvalued exchange rate, and only minimally to the existence or worsening of trade restrictions in the main trading partners. Yet, with the consolidation of the domestic budget deficit, and the generalized reluctance to deal with it in the orthodox way, *i.e.* by a combination of expenditure reduction and tax increases, the temptation to attribute at least some of the external foreign deficit to unfair trade and industrial policies abroad became ever stronger in US political circles.

Aside from perceptions of foreign "unfairness", changes that occurred in the domain of economic ideas and in theoretical fashions may have contributed to the dilution of the consensus over multilateralism that dominated in the US political and intellectual establishment after World War II and to the respectability gained by trade policy prescriptions moving away from free trade and thus hitherto considered as second best (or less). Borrowed from the domain of industrial organization, where they had been extensively used to model the behavior of firms, assumptions of increasing return to scale and less-than-perfect competition were applied to countries considered as units engaged in the production and international exchange of differentiated goods. Some of the results concerning gains from trade so obtained seemed to reverse traditional beliefs about gains from trade and to justify policy prescriptions vastly different from those derived from orthodox trade theory.

Under these assumptions, which substituted those of neoclassical trade theory based on perfect competition and constant returns to scale, it could be shown that government intervention, via subsidies and import taxes, could in certain cases increase the benefits deriving to a nation from international trade (mostly through improvements in the country's terms of trade). That these models were based on limitative (at times stringent) and untested assumptions, and thus could not offer any basis for general policy prescriptions,[9] did not detract from the comfort that they offered to those looking for a legitimization of their penchant for active (interventionist) trade policies or of their belief that unilateralism in trade policies could indeed pay off. To be able to show that, at least in some circumstances, well-thought-out and executed "strategic" moves could bring extra benefits to a country engaged in international trade, brought comfort and legitimacy to those who advocated more direct government involvement in national trade and industrial policies.

The fact that the attainable gains were at the expense of the neighbors (or partners) did not seem to bother many of the proponents of strategic trade policies. Instead of a source of reservation, it became almost a motive of pride, a kind of testimonial to superior strategic ability. That gains in one area could be offset by losses in others to the same or different players engaged in similar behaviors was conveniently ignored. How even a large and powerful country like the United States could safely assume that it could "get away" with what would be perceived as nearly predatory behaviors by many of its trade partners was never fully explained.

Yet, the sheer possibility that active or strategic behaviors could in some circumstances be useful to the nation that practiced them came to validate the suspicion that the foreign countries, such as France and Japan, allegedly bent on them, might have intuitively fallen on something good and worth imitating by the United States. Moreover, protectionists, and particularly aggressive unilateralists in trade relations, could now be exempted from the stigma of advocating interest group policies. They could instead point to general gains deriving from their advocacy, no matter how implausible were the conditions under which these could occur. Politicians who

[9] These conclusions were stressed not only by the foes of strategic trade theory (BHAGWATI, 1988), but warnings about the practical relevance of some of the policy conclusions reached using the new models also came from some of their main proponents (KRUGMAN, 1986).

supported them, for reasons having often to do with the electoral benefits derived from interest groups affected by imports, could now assume a new aura of patriotism and respectability coming from the common concerns they could claim to represent. What could be better than to be able to say that what was "good for General Motors [owners and workers] was also good for the country"!

The point of view that liberal trade policies traditionally followed by US administrations since the end of World War II, and still officially advocated by Presidents Reagan and Bush, had not helped the national industry found support not only among those operating in "sunset" sectors, or being influenced by them, but also among Japan and EC-bashers and people obsessed by the possibility of losing high-technology industries. It also found credence in mainstream academic circles, once a bastion of Ricardian and neoclassical orthodoxy. The main reason, it was argued, was the lack of symmetry in import regimes (see, for example, Dornbusch *et al.*, 1989).

In its benign form, the often-expressed concern about "level playing fields" is no more than another way of saying that conditions of competition should be as even as possible between trading partners. A key question is how the determination of the levelness is arrived at. If unilaterally made and undetermined in content, the general premise of uneven playing fields becomes too easy a justification for aggressive trade behaviors: from retaliatory actions, to the "prying open" of foreign markets by any available means, to "result-oriented" bilateral trade arrangements imposed on weaker partners. At a basic level, the argument is about fairness: access to each other's markets should be equally easy. Asymmetric conditions of entry should be reduced and eventually eliminated (even though nations can still realize gains from asymmetric reductions of trade barriers). At another level the argument becomes a quest for special solutions, when faith in general solutions has waned, or when special interests have taken over policy making in the field of trade. In the case of some US academicians, a key premise was that in a level playing field the home team could no longer win (Dornbusch *et al.*, 1989, p. 8). But instead of advocating improvements in the home team's training to better its performance, they concluded that government should help the domestic industry beat the foreign competition in markets hitherto kept closed using, if necessary, trade discriminating bilateral and regional agreements (*ibidem*, p. 34).

Imprecise, when not outrightly faulty, premises (such as uneven playing levels, inherently weak home teams), and dubious policy conclusions (such as aggressive efforts "to pry open foreign market ahead of the competition", which no country could continue without local or general retaliation by its trading partners) were all too easy to accept for politicians. The faults in the policy messages derived from these premises were not immediately evident, while their appeals to the public, on non-economic grounds, were quite wide. And politicians liked the public appeal of strategies promising to make even weak home teams win again, no matter how.

The seeds were thus planted for numerous legislative proposals, such as those put forward by Senator Gephardt and others,[10] aimed at mandating a commercial policy based on "results", either agreed with specific trading partners or unilaterally determined by US government authorities (or by Congress), and imposed on reluctant trade partners under the threat of retaliation. The "desired results" ranged from the elimination of overall trade surpluses on a bilateral basis (as if zero balances with all its trading partners were necessary for a country to achieve overall trade equilibrium, and specialization did not exist) to trade balancing on a sectoral basis (as if in a free-market context partners could be mandated to consume more of a country's goods, against their tastes and preferences).

The irresistible impulse felt by President Bush to turn his state visit to Japan in early 1992 into a "pry open thy neighbor's market" trip has similar roots. And since proof of early success of this strategy was needed in an election year, instead of focusing on the reduction of barriers to entry in the Japanese market (for US and third country goods), efforts were concentrated on getting from the government of

[10] Senator Gephardt presented in 1987 the amendment to the Omnibus Trade Bill that would have required annual 10% trade reductions against countries with an "excessive" trade surplus *vis-à-vis* the United States. The amendment was adopted by the US House of Representatives on April 29, 1987. Though not accepted by the Senate, it finally inspired the formulation of the Super 301 clause in the 1988 Trade Bill. Senator Gephardt's most recent proposals aimed at establishing a new version of the Super 301 clause that elapsed in 1991, include reducing the President's discretion to impose sanctions on countries which continued to follow unfair trade practices. Under the new proposals, the President would have to provide Congress with an action plan including "clear and measurable milestones" for success. Once the action plan is approved by Congress, retaliation would automatically follow in case of foreign non-compliance with the milestones (*Financial Times*, 11 September, 1991 and 5 November 1991; *Washington Post*, 15 September 1991). KISSINGER and VANCE (1988) proposed a managed trade agreement with targets for overall – trade imbalances between the United States and Japan.

Japan an engagement to coax domestic manufacturers to purchase $19 billion worth of US automotive parts by 1994, and thus to discriminate in favor of US exports. That all this would almost necessarily lead to further frictions between the United States and Japan (and eventually between the US and its other main trading partners) and nudge things further in the direction of managed trade did not seem to bother even an administration that had many times extolled the virtues of free trade and the importance of the GATT order.[11]

If the trend towards bilateralism in trade relations was made more marked by the changes in US policies over the past fifteen or so years, it also found support in the behaviors of both Japan and the European Community. Japan, for example, showed its general preference for bilateral arrangements not only *vis-à-vis* the United States, but also the Community, by reaching with it yet another informal understanding over the export of automobiles. The 1991 agreement, couched in terms of "consensus" reached between the two parties, limits Japanese exports to the whole Community at a maximum of 1.2 million units between 1993 and 1999 (*Financial Times*, 24 July 1991).

More subtle, but still clear and quite significant, was the EC contribution to bilaterally managed trade. It has taken several forms. Antidumping procedures were used and abused (Hindley, 1988 and Messerlin, 1989) to force foreign exporters to specific undertakings with the Community, thus managing that portion of trade and putting countries of origin "on notice" that it was better for them to negotiate access than to take free trade "chances" in Community markets. Screwdriver factories (again unilaterally declared as such) were regulated so as to influence investment decisions and exports by competitors. EC regulations forced them to find negotiated accommodations concerning both production inside the Community (as in the case of Japanese automobiles produced in Europe) and exports to the Community of domestically produced goods (as in the case of exports of manufactures from associated developing countries in the Maghreb). Meanwhile, the not-so-hidden ambition of many in the

[11] The best known antecedents were the voluntary restraints on automobile exports from Japan negotiated in 1981 and renewed ever since, and the 1986 agreement (renewed last year) aimed at assuring that in practice a 20% share of the Japanese markets for semi-conductors would go to US firms.

Community was the transformation of "the new commercial policy instrument"[12] set up in 1984 into a true "Super 301" regulation, that could at least be used against the Asian NICs, guilty of "social dumping" (European Communities, 1989, p. 9).

4. Trade Blocs

A third threat to GATT and to the multilateral trading system it embodies has emerged over the years with the establishment of regional trading arrangements, often loosely called trade blocs, by which participating countries extend each other some preferential trade treatment, at the expense of non-members. The EC has been the oldest and most important among those that emerged in the post World War II period. It has gone from a free-trade area (when tariff and other restrictions to trade among members were abolished) to a customs union (when a common external tariff was also established) and assumed even more fully the characteristics of a unified trading bloc in 1974, when all major external trade powers began to be exercized by the common institutions.[13] Since then trade relations with the rest of the world have been conducted by the Community on behalf of the member countries. The enlargement of the EC in the 1970s and 1980s, first to Denmark, Ireland and Great Britain and subsequently to Greece, Spain and Portugal, naturally increased its relative weight in world trade.

Other regional trade arrangements among GATT members were started in Europe and elsewhere. The European Free Trade Association (EFTA) came immediately after the establishment of the EC. Then the tendency spread to other areas in the 1960s and 1970s – the Latin American Free Trade Association (LAFTA), the Central Am-

[12] At the time of its introduction the "new commercial policy instrument" was officially branded as a defensive procedure usable to counter illegal trade practices by partners, and more generally to ensure that trading partners respected the rights of the Community. Procedures under this regulation can be initiated by both firms and government authorities (EC Regulation No. 2641/84).

[13] The EC has moved in the direction of a common market with the progressive abolition of all major restrictions to the circulation of capital and labor, in addition to goods, among its member countries. Project 1992 represents the culmination of this movement.

erican Common Market (CACM), the Central African Customs and Economic Union (CACEU), the Eastern African Community (EAC), the Economic Community of West Africa States (ECOWAS) and the Association of East Asian Nations (ASEAN), just to name the most important ones. Yet, these regional trade arrangements never became a serious problem for the multilateral trading system.

As long as the EC behaved well, by reducing trade discrimination in favor of the members through progressive reductions in its common external tariffs (achieved under partner pressures within the framework of GATT), and EFTA did not go beyond a free trade area subject to much of the same peer pressure, the amount of trade discrimination against non-members (and thus of trade diversion towards members) was circumscribed.[14] The regional arrangements among developing countries that potentially mattered because of their size were either not aiming at the creation of trading blocs (ASEAN) or not planning to go much beyond the promotion of freer trade among the members (LAFTA). The others were too small and unimportant to make a difference even when they had more ambitious and openly discriminatory objectives (CACM, CACEU, EAC and ECOWAS).

Simple empirical evidence about the directions that trade has taken in the past decades, while not strongly indicative of determinants, shows at least that trade flows between the major industrial areas are still very important, when not outright preponderant in total trade. If one considers EC Europe, North America and East Asia[15] as the three major (if loosely defined) industrialized regions, available data shows that only within the Community has the share of intra-trade become greater than that of trade with the rest of the world. In North America, and especially in East Asia, intra-trade is still much below half of the total. Similarly, if one focuses on the growth of trade between these three areas in the 1980s, the data shows that intra-regional trade grew much less fast than extra-regional trade for both the Community and North America. For East Asia there were no significant differences in the rate of growth of intra and extra-regional trade (Table 3). A tendency towards greater intra-regional

[14] Dynamic gains from trade liberalization, arising presumably from increased competition among firms, economies of scale and improved R&D, occurred in the EC. They were growth-augmenting and stimulated imports from outside the Community, thus contributing to an increase in world welfare.

[15] East Asia is defined as Japan plus Hong Kong, Korea, Singapore and Taiwan and five ASEAN countries (Brunei, Indonesia, Malaysia, Thailand, the Philippines).

TABLE 3

INTRAREGIONAL AND EXTRAREGIONAL TRADE: 1980-1989

from: / to:	EC	North America	East Asia	(Share of intraregional in total trade)
	(average annual growth, % p.a.)			
EC	5.2	8.2	12.4	(56)
North America	8.2	9.7	12.8	(42)
East Asia	12.4	12.8	12.9	(28)

Source: INTERNATIONAL MONETARY FUND, *Direction of Trade Statistics* (various issues).

trade, if present, was clearly not large enough to dwarf extra-regional flows even during the 1980s.

However, two potentially important new moves in the direction of greater regionalization of trade have recently occurred. The first, involving the United States,[16] was the conclusion of the free trade agreement with Canada in 1988, which foresaw the removal over a 10 year period of all tariff barriers to trade between the two countries and a drastic reduction in the non-tariff ones. It is now in the process of becoming a complete North American Free Trade Agreement (NAFTA) with the likely inclusion of Mexico among its members. This would create a free trade area encompassing the entire North America continent and facilitate not only intra-regional trade, but also intra-regional investments and factor movements, and could help significantly in the realization of economic integration among the three member countries, which have economies in many respects complementary to each other.

The second discernible move was the conclusion of an agreement for the establishment of a free trade area among South East Asian Nations (around the ASEAN core) reached in 1992 (*Financial Times*, 29 January 1992). As in the previous case, the agreement aims first at reducing tariff barriers to trade among the members over a transitional period of 15 years, with the ultimate objectives of establishing a customs union and increasing economic integration among them.

[16] The United States had reached an earlier free-trade agreement with Israel (in 1985). Its global significance, however, was quite modest.

Whether such large and attractive integrated regional markets in North America and South East Asia will also be protected in a significant way against outside penetration (and thus be strongly trade-diverting) is not possible to foretell at the moment. Decisions in this respect are still to come. But the way in which NAFTA is being considered, particularly in the United States, as a fallback position, when not a true "strategic" alternative, should the multilateral trading system collapse (*e.g.* after a failure of the Uruguay Round), is indicative of possible future outcomes.[17] Proponents of outright protectionism (particularly strong in the automotive, steel and textile sectors), fair traders (gaining strong influence in the Democratic party) and Japan/EC bashers (a growing group, with roots both in traditional American isolationism and in new "strategic" thinking about trade relations) are promoting alternatives to free trade and multilateralism that are progressively gaining currency. They have already put the old free-trade establishment on the defensive, witness the gyrations on trade policies of the Reagan and Bush administrations.

Regional trading arrangements, be they simple free trade areas or customs unions, are not necessarily incompatible with multilateralism in trade relations. From the legal standpoint GATT accepts them (or better perhaps, tolerates them), if certain specific conditions are met. Among them is non-discrimination *vis-à-vis* third parties.[18] Free trade areas can represent a move towards freer world trade if they limit themselves to reducing tariff barriers among members and they cause no change in conditions of access to member country markets by outsiders. But their ultimate effects are far from certain. In welfare terms, the (static) allocative impact of free trade areas is indeterminate. It depends on the size of the existing tariffs, the relative costs of production of traded goods in member and third countries, and on the size of tariff cuts. Regional trade blocs can increase or decrease world trade and be either welfare enhancing or welfare reducing depending, *inter alia*, on whether the trade that they "create" is greater than the trade that they "divert" (Viner, 1950). In addition, when free trade areas are set up among large countries and

[17] Several scholars have stressed the two-track policy followed by the United States in the 1980s, when free trade agreements were pursued as a complement to, and potentially a substitute for, the multilateral trading system embodied in GATT (SCHOTT, 1989).

[18] Art. XXIV of GATT.

they induce sizeable substitution of extra-area trade with intra-area trade, they will also likely worsen the terms of trade of third countries (even when member country tariffs on imports from outside parties remain the same).

The welfare effects of customs unions are even more complicated, as they also depend on what happens to the external tariff set in common by the member countries. Customs unions can still enhance world welfare, but under more stringent conditions than free trade areas. As shown by Kemp and Wan (1976), any pair of countries forming a customs union has at its disposal a Pareto-optimal tariff schedule: one that can improve in the aggregate the welfare of their members without reducing that of the rest of the world. Customs unions, like free trade areas, can, therefore, improve overall welfare. But this is not necessarily so, as shown by both theory and the majority of choices actually made in existing customs unions. It is not inappropriate to recall here that the principle of the "second best" was formulated in the context of customs union theory (Meade,1956; Lipsey and Lancaster, 1956-57).

However, reservations regarding regional trading areas go beyond the indeterminacy of their welfare results. When behaving as trade blocs, regional groups can lead to conflicts with third parties which would likely be much smaller in their absence. A main political rationale for regional groups, now economically revalued by strategic trade theory, has always been that they increase the possibility of taking advantage of the strength coming from the union in their relations with the rest of the world. The risk is that the temptation of countries to resort to aggressive commercial policies to improve their terms of trade may increase with the perception of bloc strength and the increased probability of being able to "get away with it". The practical limit to the use of political and economic muscle in trade relations, as shown by neo-classical trade theory in the context of the optimum tariff theorem, has always been the risk of retaliation, with resulting reductions in local and global welfare. Such risks also exist in the case of strategic trade actions undertaken by groups of countries. There is no regional group strong enough to deter retaliation either from single trading partners or from other groups.

None of the possible welfare-reducing outcomes is inevitable, in the same way that none of the possible welfare-improving effects of customs unions shown by either orthodox or strategic theory is predetermined. The net welfare effects of customs unions, like the gains and losses resulting from "strategic" behaviors of trade blocs, or even the risks of increased frictions in the international trading system, cannot be determined *a priori*. They depend on the ways in which the regional trade arrangements are set up and on how they actually operate. They depend in other words on the decisions of their component members. It is the political economy of these unions that assumes overwhelming importance in determining the actual welfare consequences of trading blocs. History can teach some useful lessons in this area, but how good a predictor of the future are past political economy outcomes is an open question.

What we have learned so far about the political economy of the longest-standing among them – the European Community – is not conclusive, but none too comforting. The Community seems to have so far eschewed aggressive bilateral trade behaviors, especially *vis-à-vis* important third parties such as Japan and the United States, though it has been more prone to administratively retaliate, through the use of non-tariff barriers, against some developing countries. Even in the case of the recent arrangements concerning imports of motor vehicles from Japan after 1992, the Community does not seem to have immediately pursued other concessions aside from "temporary" quantity restraints, thus keeping to defensive requests and setting them as a deviation from accepted norms. In a more aggressive mode, the Community could have demanded from Japan bilateral preferences on its own exports in exchange for ensuring access of Japanese motor vehicles to its unified market.[19]

At the same time, however, the Community has shown increasing rigidity in trade practices and great difficulty in changing even the least sensible among them. Once agreed among the members, common trade and sectoral policies have tended to become fixed. This is the experience with both the MFAs and the CAP. Community trade policies, moreover, seem to be set on the basis of the lowest common denominator, with single member countries capable of acquiring enormous bargaining power within the group and of eventually "selling" their agreement at very high internal

[19] But this may be destined to change soon. According to recent reports, European auto manufacturers have begun to lobby directly the Japanese Ministry of International Trade and Industry (MITI) for a target of 10% of the Japanese market for European cars in 1995 and 17.5% in 2000 (*Financial Times*, 15 January 1992). If and when this quest will be assumed by official Community organs is not known, but the possibility of this happening is probably higher after the US-Japanese agreements on automobile spare parts than before.

prices. France, and more recently Portugal and Spain, have bargained for concessions from other EC members before agreeing to trade policy measures taken by the Community *vis-à-vis* Eastern Europe. France recently blocked for a while the association to the Community of three key East European countries to prevent a miniscule flow of beef imports from Poland (*Washington Post*, 7 September, 1991; *Financial Times*, 7 September, 1991 and 23-24 November, 1991). Enormous efforts are made, despite majority voting in the Council on trade policy matters, to arrive at common positions, which are often qualitatively poor and always hard to adapt to changing circumstances.

If the high transaction costs evident in the formulation of EC trade policies are not without a positive side – as they may limit Community temptations to resort to more "aggressive" trade postures – they nonetheless create problems even in relatively standard situations, such as the Uruguay Round trade negotiations. To arrive at a common position on issues such as agriculture, members have to make such large and costly efforts that once a position is reached inside the Community it has to be put on the negotiating table almost as a take-it-or-leave-it proposition.

5. The Uruguay Round Negotiations

Launched with considerable fanfare in September 1986 at the Punta del Este Conference in Uruguay, the current GATT negotiations differ substantially from the preceding ones in the objectives that they seek. Instead of being focused as in the past on the reduction of tariff barriers to the trade of manufactured products, the present round of negotiations aims at estending GATT rules to other areas that have been addressed previously, but without success, such as trade in agriculture and textiles, and to new ones such as trade in services, intellectual property rights and trade-related investment measures. It also aims at regulating more stringently the use of unilateral remedies against partners' trade practices considered damaging by member countries, such as antidumping and countervailing actions.

The Uruguay Round of negotiations could not be completed, as expected, by the end of 1991. It encountered considerable difficulties and has appeared several times to be on the verge of breaking down. Reasons for these difficulties include the sheer mass of negotiating issues, and in some cases – such as those concerning services and intellectual property rights – the novelty and technical complexity of the matters at stake. Some key members of the GATT, however, have shown a clear unwillingness to pay the short-run political costs necessary to pursue the longer-run objectives built into the negotiations, even when they are recognized as desirable from the standpoint of both national and global welfare. Organized interest groups appear to have had enormous influence over policies even when their direct interests were clearly at odds with those of their nations at large. This applies most evidently to the reform of the agricultural policies in both the European Community and Japan, and to the gradual abolition of the system of managed trade in textiles, which protect ailing sectors at very high economic costs.

The main negotiating themes of the Uruguay Round can be usefully divided in two categories: those having old roots, in some way the residue of previous negotiations, and those having a more recent origin, found in the continuous evolution of international trade and trade practices. With some approximation it is also possible to think of the first category of issues as those constituting the hard core obstacles of free trade in goods (in terms of the commodities affected or the types of barrier used to regulate their exchange) never before tackled in international trade negotiations, and to the second category as the softer core of the negotiations made up by themes whose contours are less well defined and whose relevance is much less universally accepted by GATT members than the traditional ones.

Thus, the first category can be thought of including the issues of liberalization of trade in agriculture and in textile products, of non-tariff barriers to trade in goods and of regulation of subsidies. The second encompasses such issues as the liberalization of international trade in services, the harmonization and simplification of regulations concerning trade-related investment measures (TRIMs) and the safeguard of trade-related intellectual property rights (TRIPs). This is obviously only an indicative and highly simplified categorization. There are other important items on the negotiating table, including the strengthening of GATT institutions, the dispute resolution capacity of GATT and the further reduction of existing tariff barriers.

The negotiations are currently in what appears to be their final and most critical stage.[20] If they are not completed within the current year, a general breakdown of the Uruguay Round will be difficult to avoid. Overall negotiating fatigue, the non-committal attitude of Japan, the increasing difficulties faced by the US administration in a year of presidential elections (in which trade and industrial policies have become an important issue), the worsening of economic conditions in both the United States and Europe do not leave much time and chance to the ongoing Uruguay Round negotiations. The nearly "take-it-or-leave-it" compromise package that the Secretary General of GATT put forward in December 1991 in an attempt to conclude the stalled negotiations by April 1992 (GATT, 1991) clearly reflected this sense of critical urgency.

It is interesting and quite telling that the major obstacle to an overall agreement in the Uruguay Round negotiations has continued to be the liberalization of trade in agriculture, with the United States, supported by the Cairns Group,[21] locked in battle with the European Community: the former pushing for a substantive and rapid liberalization of world agricultural trade, the latter resisting it. The spectacle of the major industrial nations of the world confronting each other over what constitutes not only the oldest form of international trade, but also the product of a tiny sector of their domestic economies[22] and the object of much public assistance,[23] is neither indicative of hard economic rationality nor of great political wisdom.

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[20] For a review of the negotiations up to 1988, see Sassoon (1990).

[21] The Group, named for the town in New Zealand where its first meeting was held, includes 13 industrial and developing countries that describe themselves as agricultural exporters not using subsidies: Argentina, Brazil, Canada, Chile, Colombia, Fiji, the Philippines, Indonesia, Malaysia, New Zealand, Thailand, Hungary and Uruguay.

[22] Agriculture constitutes only around 2% of the GDP of both the United States and the EC, 8% of total merchandise exports in the EC and 14% in the United States. By comparison, in agriculture-dependent high-income countries such as Australia and New Zealand the share of this sector is 4-6% in GDP and 40-60% in merchandise exports. In low-income developing countries – such as those of Africa south of the Sahara and India – agriculture makes up for a third (or more) of GDP and for 40-60% of total exports in all but the largest of them. Even in middle-income developing countries – such as those of South America and East Asia – agriculture makes up a substantial share of GDP – 10 to 20%, and agricultural exports still account for an even larger portion of merchandise exports – 25 to 50%. There are cases such as Argentina for which agricultural exports are as high as 70% of total merchandise exports.

[23] Government assistance to agriculture, in support of production and export, is much higher in the Community than in the United States in absolute as well as per unit of land farmed, but is still quite high in both areas: $82 and $36 billion respectively in 1990 (OECD, 1991).

The reform of the CAP has become the major bone of contention of the Uruguay Round negotiations. Japan is also being pressed to reduce its protection of domestic agriculture and to relax its virtual ban on imports of products such as rice. Three aspects of the agricultural policies of the Community are called in question: the domestic support to production (the intervention prices), the subsidies granted to exports (the export restitutions) and the system of protection (mostly the variable levies). The United States and the Cairns countries have asked for a substantive reduction of price support inside the Community, the elimination of export subsidies and the transformation of all forms of protection against imports into tariffs. At the current stage of the negotiations (Spring 1992), the major differences are on: *a)* how to reduce export subsidies (by fixing a ceiling for subsidized exports, as demanded by the United States, or the monetary amount of subsidy available each year in the budget, as preferred by the Community); *b)* how to change the forms of EC support to production, from minimum prices to direct income transfers, and *c)* the specific form of the income transfers to ensure that they do not offer any significant incentive to production.

Liberalization of trade in services is another area where different positions persist, both among industrial countries and between industrial and developing countries. Creating freer conditions for trade in banking, insurance, transport, telecommunications and construction services, which account for one sixth of world trade and are the most dynamic sector within it, has been difficult. Some countries have tried to keep parts of the service sector out of the negotiations. The United States and India, for example, have both objected to the inclusion of telecommunications in the negotiations; the United States has also pressed for an exception in the case of shipping. The United States and the Community have been at odds over audio-visual services. Developing countries have been reluctant to allow greater international competition in banking and insurance services. In general, domestic monopolies – particularly strong where economies of scale are important – have resisted foreign competition. This has been the rule in both developing and industrial countries.

Agreement over the creation of a General Agreement on Trade in Services (GATS) modelled on GATT and based on the most-favored-nation (MFN) rule hangs on the limitation of exceptions to this principle – in time and size – and on the initial liberalization commitments to be made by each participating country. These commitments constitute a form of downpayment, requested mostly by the United States, to be made by members of GATT in advance of the negotiations for the liberalization of trade in services that would take place later, within the newly created framework.

A third contested area is the improvement in GATT rules, especially regarding the use of anti-subsidy and anti-dumping procedures and of safeguard measures. Antidumping, in particular, is a critical issue for both Japan and the East Asian NICs, which in the 1980s were the preferred targets of actions taken by many industrial countries with the evident intention of harassing or intimidating them. The Nordic countries have also called for reform and strengthening of the GATT discipline in the area of anti-dumping and anti-subsidy procedures. Tighter discipline in the use of these measures, strongly in the interest of the most dynamic exporters of manufactures in developed and developing countries alike, has been resisted by the largest importing countries that have most often utilized them. The European Community and the United States insist instead on the tightening of escape routes, such as the local assembling of products from imported parts, exports from third countries, and on the right of injured importers to take protective action against selected exporters (instead of all exporters, to avoid discrimination, as mandated by GATT).

Finally there is the issue of trade in textiles and clothing, which has long been kept outside the GATT, first through the Short- and Long-term Agreements on Cotton Textiles and since 1974 via the Multifiber Arrangements (MFAs). These regulate quantitatively more than 50% of world exports of the commodities in question, which in turn constitute 10% of all merchandise trade and are of special importance to developing countries. Many of these countries derive large portions of their total earnings from exports of textiles and clothing products: India, China, Bangladesh, Egypt, the first and second generation NICs of Asia and Latin America, the countries of the Maghreb and several poor ones in Central America fall in this category. The objective was to bring this substantive part of world trade in manufactures under GATT rules over a transition period, to begin in mid-1991 after the expiration of the fourth MFA. This would have eventually led to the progressive abolition of the system of bilateral import quotas now regulating much of world trade. As the fourth MFA expired without an agreement on textile-clothing trade in the Uruguay Round, its validity has provisionally been extended by 17 months.

The differences of positions in this area are between industrial importing countries (with the major exception of Japan) and developing exporting countries. They have to do with the speed with which the integration of this type of trade into the GATT framework is to take place, on the methods for regulating trade and on the safeguards applicable during the transition period.

6. Possibilities of Success and Risks of Failure in the Uruguay Round: Consequences for the Multilateral Trading System

From the standpoint of the negotiations, the success of the Uruguay Round depends in the first instance on the possibility of finding an acceptable compromise between the positions of the United States and of the European Community over the liberalization of trade in agriculture, so as to start the process of intersectoral compensations among negotiating parties that is essential for reaching an overall agreement. Without such a compromise no final round of negotiations over the 26 draft accords now being considered can take place. As pointedly and aptly put by the US Trade Representative, Mrs. Carla Hill, "nothing can be agreed [in the final document] until everything is agreed".

Moreover, aside from the main gaps that have to be bridged in the areas previously mentioned, some important bargains are still to be struck in country-to-country negotiations: on the reductions of existing tariffs on manufactures and on the initial liberalizing commitments in services, just to mention a few.

In the complex political realities of international trade negotiations governments can only be expected to agree to a trade liberalizing package when the "gains" to be made by domestic producers of export goods compensate the "losses" to be incurred by domestic producers of import-competing goods. These are not the welfare gains and losses of the pure theory of trade. They again must instead be counted as the political support for the agreement deriving from increased exports against the opposition coming from increased imports. Governments have to use the first as political counterweights to the second. From the standpoint of pure trade theory, increased imports would constitute a key benefit of freer trade, not a cost. But,

in trade negotiations governments operate in the realm of political economy, not in that of pure theory. The key question here is whether the outcomes of these negotiations go in the direction that theory considers as desirable (*e.g.* freer trade). So far multilateral trade negotiations under GATT have yielded such desirable results.

A general Uruguay Round agreement will also require other important accommodations of political and economic interests, among industrialized countries and between industrial and developing countries. On the one hand, the most competitive among the exporters of agricultural products – the United States and the members of the Cairns group – which stand to gain the most from liberalization of trade in farm products, must support such move by the Community. This could be done by increasing the expected export "gains" and/or by diminishing the expected import "losses" of EC countries in services. The United States, for example, may have to facilitate the entry of EC banks into the home market which is now unattractive because of its regional subdivisions (due to US banking legislations). Or it may have to soften some of the demands made on EC countries "with major telecommunications markets" as a condition for accepting the application of the MFN principle in this sector (such as the immediate opening of long-distance telephone markets). Other countries that stand to gain from better access to EC agricultural markets or from less subsidized sales of EC farm products in third markets may also have to give up national monopolies in banking and telecommunications in order to ensure increased service exports from EC suppliers.

Compromises between the interests of developed and developing countries will, on the other hand, have to be shaped in the areas of trade in textiles and intellectual property rights. Most industrial countries will have to liberalize their imports of textiles and clothing products to the "advantage" of first and second generation NICs, the large Asian (China, India, Pakistan and Bangladesh) and some Southern European countries. The NICs and the major Asian countries, in turn, will have to improve their protection of foreign intellectual property rights to the "benefit" of the countries of more ancient industrialization. In exchange for better access to textile-clothing markets in industrial countries some developing countries, including many NICs, will also have to open up their own to services exported by the United States and EC countries. All developing countries, in exchange for better conditions of access for their manufactures in industrialized countries – and a tighter, internationally-agreed regulation of import safeguards – will have to offer lower tariff and non-tariff protection of their domestic markets.[24]

Finally, Japan must reduce not only its formal protection of the agricultural sector, but also ensure that institutional peculiarities and collusive practices among domestic producers and traders do not reduce the market access of foreign competitors, thus making it easier for US, EC and NIC exporters of manufactures to operate in it, and for US and EC firms to supply services to Japanese consumers. In turn Japan must be guaranteed that EC, the United States, Canada and other industrial countries will not use anti-dumping and anti-subsidy procedures to limit Japanese export of manufactures to their markets. Existing voluntary export agreements involving Japan will also have to be explicitly recognized as exceptions to GATT rules, and be given a precise time horizon.

These are some of the necessary building blocks for a general agreement in the Uruguay Round of trade negotiations. Many other political and economic interests will have to be reconciled. Reaching a general compact is certainly still possible, but remains nonetheless very difficult for the complexity of interests at stake, the little time left for negotiations and the negotiating strategies followed so far by some of the main participants. The United States, for example, seen by some as having ably outsmarted the Community and forced it into a tight corner over its outwardly inefficient and undefensible agricultural policies, has in effect done so without having either credible threats or sufficiently strong incentives to induce the EC to make the desired policy changes in the CAP. The threat of regionalization of trade implicit in NAFTA is not very credible *vis-à-vis* the EC, whose production of tradeable goods is not very complementary to that of the United States (or at least not as complementary as that of Asia). Similarly, the incentives that the United States can offer to EC Europe in the area of trade in services are not very large.

Having opted to exercise maximum pressure on the CAP, the United States has not only lost a precious ally to ensure better market

[24] Neoclassical trade theory here teaches that lower barriers on imports of textiles would improve welfare in industrial countries in the same way as lower tariffs and quotas on the imports of manufactures in developing countries would be beneficial to them. Each group of countries would gain from unilaterally freeing trade. However, if it is politically easier for them to reach this outcome by negotiating reciprocal (and non discriminatory) reductions in trade barriers, this route should be followed.

access to Japan's markets (which explains the relatively comfortable, almost detached, position that Japan could take in the Uruguay Round negotiations), but has also tied the conclusion of a general agreement to the capacity of EC members to reform their agricultural policies in the relatively short-run and even while they are busy implementing the unification of their internal markets, re-integrating Eastern Europe into the pre-World War II network of trade and financial relations with the West and negotiating among themselves on a monetary union. It is nonetheless improbable that the United States government, even if willing, could now accept a minimalist compromise in agricultural trade with the Community. The US Congress, in an election year and with protectionist sentiments fast growing in its midst, would in all likelihood refuse it, thus dooming the Uruguay Round to failure.

Would the failure of the Uruguay Round also mean the end of GATT? Probably not, at least in form. The GATT "acquis" may even have enough value for the member countries to continue to hold in the area of tariff barriers to trade in goods. Yet, in such circumstance the international trading system could hardly avoid incurring significant changes. Even the simple stabilization of the tendency toward non-tariff protectionism and the checking of the drift towards bilateralism in the trade policies of member countries would require a degree of political cohesion among members that it is difficult to envisage in case of failure of the Uruguay Round. Only a GATT reinforced in its structures, modernized in content and solidly backed by its key members – the G-10, the main Asian and Latin American NICs, India and China – could hope to achieve these results. Such would be a GATT emerging from a successful round of trade negotiations, not the GATT coming out of a failure or quasi-failure in them.

A weakening of multilateralism in trade relations would reinforce ongoing propensities toward bilateralism and regionalization of trade. Notwithstanding the support it enjoys in some circles as a possible alternative to the GATT way of achieving freer trade (Dornbusch, 1990), bilateralism is almost necessarily a risky thing, politically as well as economically. The positive results it achieved during some periods (*e.g.* in the decade that followed the Cobden-Chevalier Treaty of 1860), should not obscure the fact that bilateralism in trade relations has shown a strong tendency to change from benign to malign. It did so in the period between 1880 and 1890 in Europe under the push of German and French domestic interest groups and again in the Great depression years, under the negative influence of US protective pressures (Ellsworth, 1958). Both times the consequences on trade flows and trade relations among key industrial nations were very negative. Whatever one can say, on the contrary, about the imperfections of a system such as GATT – its free rider problem, the slowness of its negotiating process, the weak collective enforcement of its rules – one must recognize that it has been quite successful in maintaining "peace" in international exchange (Hindley and Wolf, 1990). GATT has successfully smoothed out most of the political tensions that trade among sovereign states normally generates. A switch from multilateralism to bilateralism, particularly of the aggressive kind, could cause renewed tensions and elicit non-cooperative behaviors from trading partners, thus reducing the potential for gains from cooperation.

As previously indicated, greater regionalization of trade is not necessarily a bad thing. It does not automatically lead to lower world welfare. Orthodox economists, however, tend to have negative expectations about regional trade blocs. Those entertained by Wonnacott and Lutz (1989) are fairly representative of the majority. Skepticism *vis-à-vis* trade blocs is based on two sets of considerations. The first has to do with actual experience. Regional trade arrangements have tended to become trade diverting. The exception has been the EC, but in circumstances that are hard to replicate as they included the existence of a GATT order fully supported by the United States, then the hegemonic power, from which emanated a strong push towards the liberalization of external EC trade. Still largely within the orthodox economic mold, the most sympathetic towards regional blocs have been the economists who have emphasized their "growth" advantages, through the dynamic changes that they would set in motion (Frank, 1989; Lawrence, 1991). Here again, the experience of the EC is most often quoted to support this expectation, even though it has remained quite unique. None of the other non-European trading blocs have generated any sustained economic growth among the members. Dynamic gains appear to have been very limited. These arrangements often floundered as soon as trade diversion gains became exhausted. This has been the general experience in Latin America and Africa in the post-World War II period (Robson, 1980; Tussie, 1982).

The second main source of preoccupation is that the larger a bloc, the larger is likely to be the temptation of its members to try to improve their collective terms of trade at the expense of non-members. This is a "beggar-thy-neighbor" risk which is rooted in what constitutes a main political attraction of trading blocs: the idea that union generates strength. Furthermore, it has now been shown even in the context of strategic trade models that the optimal non-cooperative behavior of trade blocs is to go toward the increase of their external tariff, *i.e.* toward discrimination against third parties (Krugman, 1989). Trade discrimination, however, breeds retaliation and is thus likely to lead to a general reduction in welfare. This basic result from the traditional theory of optimum tariff holds also under conditions of monopolistic competition and in the presence of intra-industry trade. The 1930s, moreover, were replete with disastrous experiments at discrimination followed by retaliation in the context of trade and payments' groups.

A question, now often raised by those who consider the tendency toward trading areas either as already consolidated or unstoppable, is whether they can be supportive of the multilateral trading system. Here too opinions are divided, as theory does not provide clearcut guidance. The optimists think that trading blocs, by reducing the number of players at the negotiating table, can make trade liberalization simpler to devise and easier to achieve (Schott, 1989). Some also believe that they can increase the credibility of GATT-compatible obligations taken by members (Lawrence, 1991). A commitment made by Mexico in the context of NAFTA to respect intellectual property or to permit foreign investments, would be, it is argued, more credible than a similar one made within GATT, because of the superior pact-enforcing capacity of the United States in a bilateral setting. This would reinforce, rather than weaken, the GATT order. On the contrary, the pessimists believe that regional blocs will slowdown the movement towards freer extra-group trade, as they create vested interests against it (Patterson, 1989). The internal political economy of these groups would also tend to slow down decision making inside them and to render more inflexible their negotiating positions. We would have fewer, but less flexible players at the negotiating table. Some also believe that trading blocs, by reducing the vulnerability of members to breakdowns in international cooperation, will end up undermining the rather delicate balance of political interests that has until now supported GATT. A reduction in the political hegemony traditionally exerted by the United States within the western bloc and the disappearance of the "Soviet threat" would seem to reinforce these risks. And if the GATT is truly a common good, preserving its ability to sustain cooperative solutions among its members, such as those represented by mutual liberalizations of trade, assumes vital importance.

Whatever the reasons behind their formation, trading blocs carry risks that cannot be easily underrated. They have economic consequences that cannot be surely predicted on the basis of economic theory. They are not "first best" solutions.[25] Depending on their internal political economy they can lead to relatively benign "second best" results or have strongly negative consequences on world trade and welfare.[26] Trade blocs, in addition, probably tend to be trade discriminating, and thus to generate instability, when not to increase the risks of retaliatory reactions. In these circumstances, the distance between first best and second best could be large and "making the best out of the second best" could be very difficult.

ENZO R. GRILLI

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[25] Unless, of course, through successive concentrations, the number of existing blocs would reduce to one, in which case we would have the equivalent of completely free world trade.

[26] Unless, again, they can generate enough dynamic gains to induce enough new trade to offset whatever diversion they originally created.

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