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THE TRADE OUTLOOK FOR THE U.S. ECONOMY

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The primary message I would like to leave with you today is that these are perilous and risky days in international trade and trade policy. All around the world, more open markets are threatened by political and economic instability. In Europe, a deep recession continues. The collapse of the European currency relationships reflects the weakness of the French, British and Italian governments, and the EC's unwillingness to grant market access to the sputtering regimes in Eastern Europe is a mirror image of its callous disregard for the atrocities in Bosnia. In the Far East, Japan's LDP party is crumbling, and its economy is still in a deflationary phase. In Latin America, the newly emerging export oriented states of Chile, Argentina, and Brazil await the outcome of NAFTA, seeking a signal over whether the U.S. will behave toward it as Western Europe has behaved toward the East, denying market access, and with it, growth.

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Here in the U.S., we must lead the hemisphere and the world toward more open trade. If we do not lead, we are condemned to slower growth, with direct implications for our own economy and government budget deficit.

My purpose today is to focus on three principal issues. Let me note at the outset that this is not an outlook of the sort offered by econometric consulting firms. Such forecasts, in light of the instability I have noted, are difficult to rely on in any case. Mine is an institutional outlook. The first issue is the growing importance of trade to the general health of the American economy, especially in light of the limited scope for fiscal policy stimulus arising from continued budget deficits. In light of this trade dependence, two prominent leadership issues: the fate of NAFTA, and the GATT talks, follow directly, and form the second and third questions that I will consider. First, however, let me put these economic considerations in their political context here at home.

<u>Context: Political Survival in a Small, Flat, Unhappy Place: The Congressional District</u>

The importance of trade to the global, and thus the American economy, is not news, but politicians in the largest trading nation in the world periodically forget this news and its role in job creation. The level of understanding is reflected in the following, widely held fallacy: "Trade is good; imports are bad," a view held especially in the U.S. Congress. This can be explained by the Congressional world view. In many ways, members of Congress view the world as small and flat and full of unhappiness. The boundaries of most immediate relevance run to the end of their district or, for Senators, their state. At the point where their voters become somebody else's, the world stops. That which is of concern to their district constituents is of concern to them. The "national interest" and "international affairs," while often speechified about, are essentially secondary. This adds up to the old adage that "all politics is local."

In my short stints working for and with the Congress, I have also observed a second general rule of political survival. On any issue the political survivor asks two questions in strict order. First: "who gets hurt or is made unhappy as a result of this action?" Second, and only second, "who gets helped?" This has been summarized aptly as "the squeaky wheel gets the grease." Putting this together with the local focus I mentioned and you get two fundamental theorems of political survival analogous to the two fundamental theorems of welfare economics.

> 1st Theorem of Political Survival: Serve all unhappy constituent groups first if you want to save your seat.

> 2nd Theorem: An unhappy constituent group can be made less unhappy with appropriate transfers from outside the district.

The first theorem is the "local politics" theorem; the second might be called the "disaster relief," or "supporting" theorem. Proofs are discussed below.

Enter Trade in the Macroeconomy

Trade, in this context, is good or bad depending on whether it hurts or makes unhappy any constituents. Under Theorem 1, the successful politician will attend first to these "losers," as economists indelicately call them. If trade helps some constituents, even more than it hurts, this is good, but still secondary to dealing with the hurt. The political proof is simple: a voter helped by trade will be thankful and might vote for its advocate; but it is difficult for a member of Congress to take full credit for the trade that made them happy. However, a voter hurt by trade (he who loses his job) is much more likely, if not certain, to vote against an advocate of more open trade. This might not seem like a tight proof, but its good enough for most politicians when losers from trade show up in their districts, and leads directly to the "trade is good, imports are bad" fallacy.

The first theorem is very bad news for advocates of trade liberalization if the process leads to losers. Paradoxically, this is especially true if these losers are distributed widely. In fact, it would be preferable to have them concentrated in a single Congressional district. The second theorem is a possible reprieve. If enough transfers can be brought to the unhappy losers, then a member of Congress can describe himself as a "disaster reliever." However, even the second theorem can turn ugly if relief is spelled protection. Protection of a local industry is also a form of transfer from outside the district, primarily from consumers to the protected industry in question.

In short, U.S. politics makes for rough sledding for advocates of trade liberalization. However, the huge U.S. budget deficit creates an argument for expanded trade as one of the only "ways out" for politicians seeking a program of job creation. Let me turn here to several figures which show the growing role of trade in the U.S. economy. Some estimates suggest that without export growth, the recent (and perhaps continuing) recession would have been almost twice as deep.

Figures 1, 2, 3 Here

What these figures suggest (to me) is that trade growth has made many fewer people unhappy than happy: they have kept their jobs. Trade has also created a pool of resources which can be transferred to "losers." Moreover, in a certain sense trade growth leads to market based transfers to the U.S. economy from the rest of the world, outside of <u>anyone's</u> Congressional District. So an argument can be made for liberalization which is not entirely incompatible with the two theorems of political survival, especially if budget deficits foreclose other types of transfer spending.

Let me now relate these comments to the two most important theaters of trade policy: NAFTA and GATT.

<u>NAFTA: The State of Play</u>

Four basic questions surround the current debate over NAFTA, which can be seen as variations on questions of unhappiness and transfers. First, will NAFTA cost the U.S. jobs? Second, what are likely to be its effects on environmental and labor standards? Third, what are the risks of "import surges" under the agreement? Fourth, what if NAFTA fails?

Figure 1


Total U.S. Imports and Exports
By Volume: 1980 - 1992
Billions of Dollars in 1982 Prices
600
500
400
300
200
100
0
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
Year
Exports
Imports

Figure 2

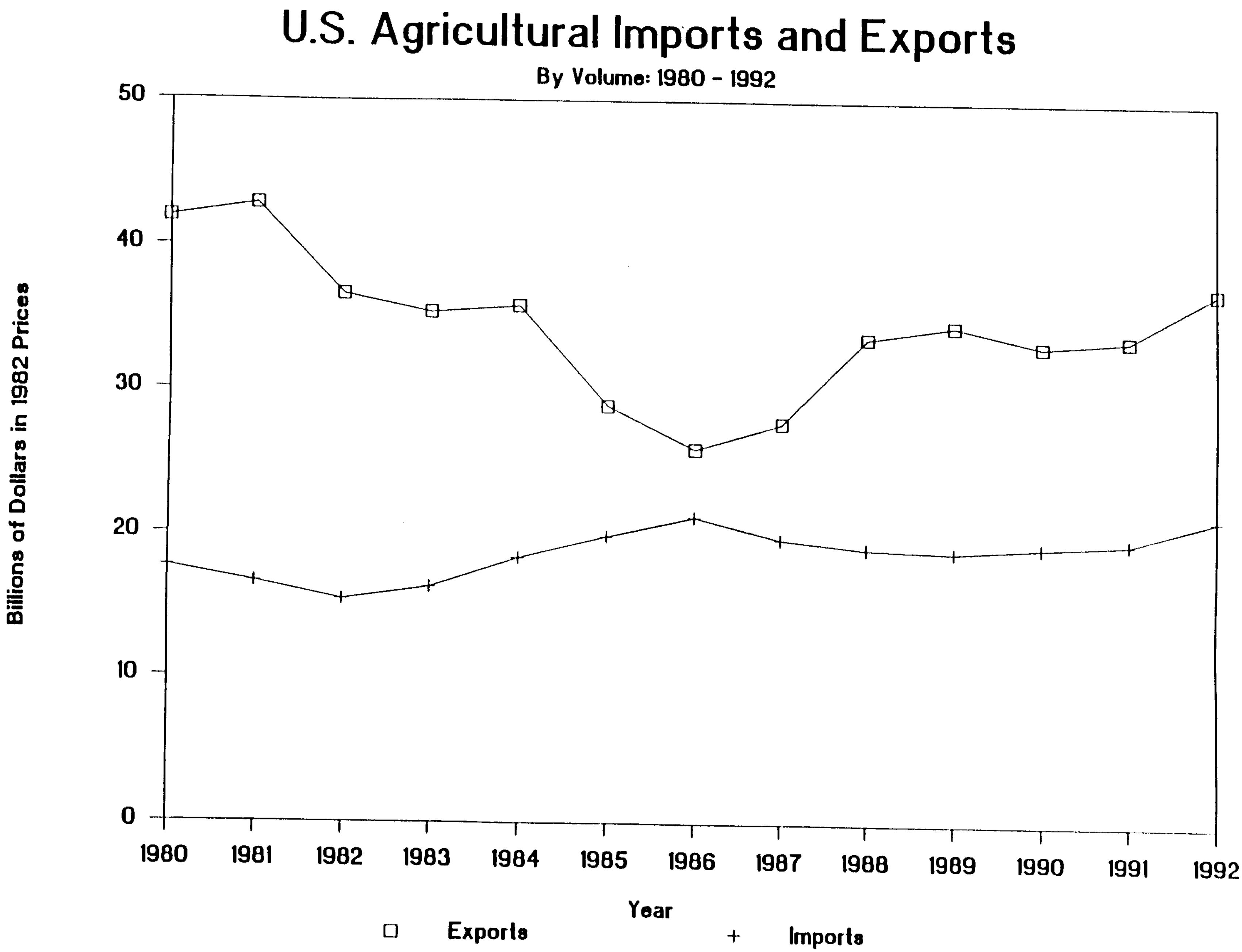
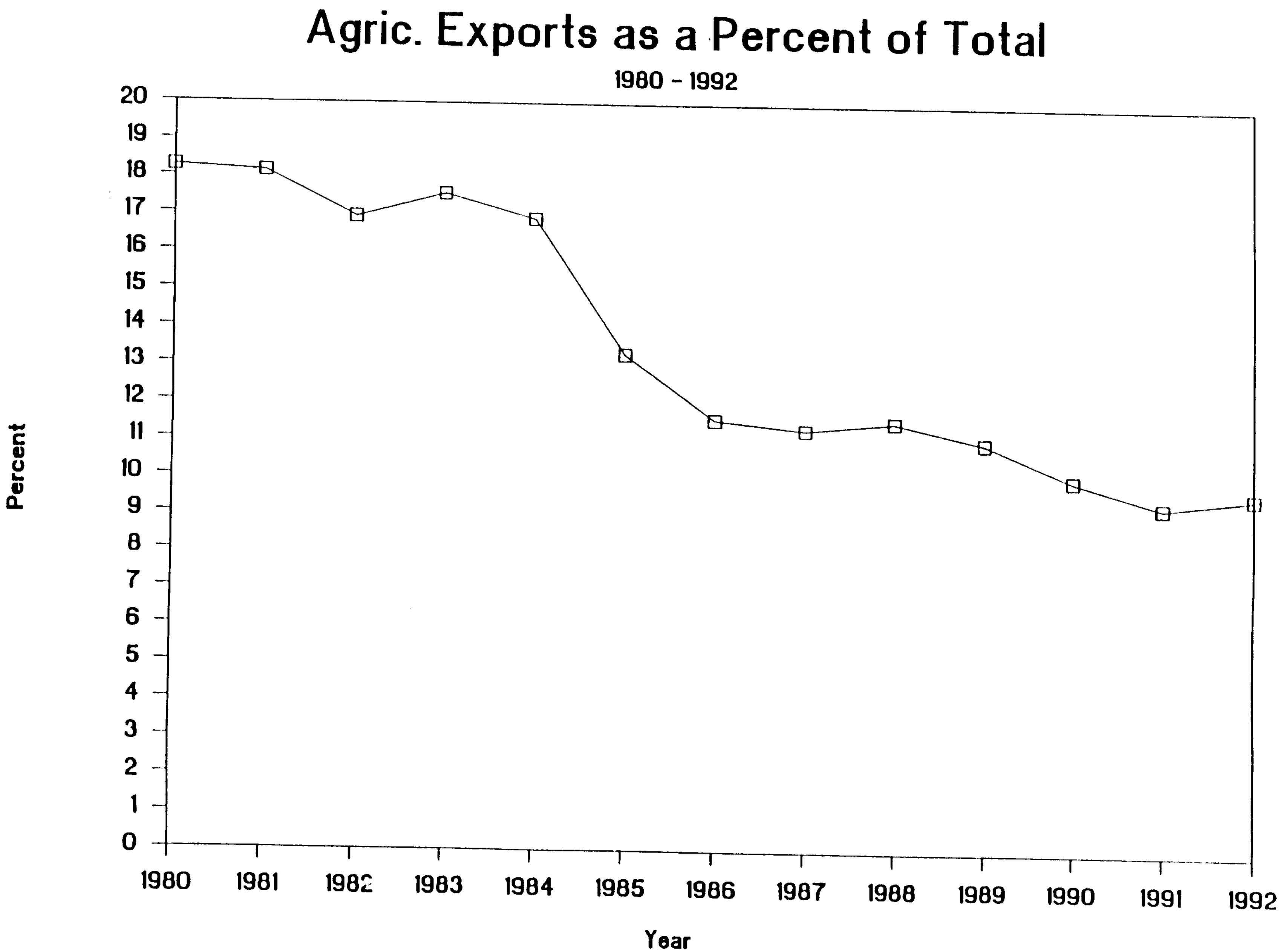

U.S. Agricultural Imports and Exports
By Volume: 1980 - 1992
Billions of Dollars in 1982 Prices
50
40
30
20
10
0
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
Year
Exports
Imports

Figure 3


Agric. Exports as a Percent of Total
1980 - 1992
20
19
18
17
16
15
14
13
12
11
10
9
8
7
6
5
4
3
2
1
0
Percent
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
Year

(1) Will NAFTA cost the U.S. jobs?

The response to this question is based on numerous estimates of the employment impacts of NAFTA in different sectors, which have been reinforced by a recent CBO study. First, because the U.S. economy is very large in comparison with Mexico's (with national income roughly 25 times as great), the impact of tariff reductions under NAFTA on the U.S. will be positive but small relative to Mexico. A second general finding is that NAFTA will contribute to a process of North American trade growth that is already underway and to which the current government of Mexico is committed; to the extent that Mexico grows more rapidly and dynamically under NAFTA, its role as an importer of U.S. exports, and generator of future U.S. jobs, will grow accordingly. Third, NAFTA's impacts on wage levels in Mexico will be positive, while those in the U.S. are barely (although positively) affected. A 1992 University of Michigan study concludes that "the narrowing of the wage gap is not accomplished at the expense of U.S. workers." Not too much unhappiness, despite wailing and gnashing of teeth. Fourth, the impacts of trade expansion with Mexico will be positively related to employment growth not only in multinational companies but in smaller U.S. businesses which have accounted for most job gains since 1988. In agriculture, the major beneficiaries will be corn, soybeans and oilseeds such as sunflowers, wheat, pork, poultry and beef, and dairy products such as cheese and butter. Even in the sugar industry, it is possible that Mexico will remain a sizeable net importer.

(2) What impacts will NAFTA have on environmental and labor standards, and on

environmental quality and working conditions on both sides of the border?

This largely depends on how certain "side-agreements," currently under negotiation, are developed to confront the serious environmental and labor issues that NAFTA poses. While the side-agreements will determine the outcome, it is clear that without them, NAFTA will face significant opposition. And if NAFTA fails, not only will the U.S. and Mexico forego employment gains, it will be much less likely that Mexico will make progress on environmental and labor issues. Most of the criticisms of NAFTA on environmental grounds project that it will make existing environmental problems worse. Yet without NAFTA, it is doubtful that these problems would have received the attention they have, or that Mexico and the U.S. would have committed themselves to environmental improvements. In this sense, while NAFTA may lead to trade patterns with negative environmental effects, it also has created an opportunity to influence Mexico's environmental policies, and to address these effects more openly than ever before. And if it succeeds in generating economic and income growth of the sort projected in Mexico, it can help create the wherewithal to expand remedial environmental efforts.

It is noteworthy that one of the sectors in which small U.S. companies are leading global competitors is in environmental technologies, such as wastewater treatment. To the extent that an environmental side-agreement to NAFTA encourages further diffusion of these technologies, the U.S. will be a beneficiary. Ironically, if NAFTA is defeated (on environmental or other grounds), a major opportunity for environmental improvements may have been lost. Environmental opponents of NAFTA, if they persist in urging its defeat rather than marshalling support for additional safeguards, will thus lose an important lever for change. The recent ruling in favor of an environmental impact assessment (EIS), in my view, is aimed at defeating NAFTA more than at protecting the environment.

Change is clearly necessary. Existing environmental problems in the border region are especially grave in the maquiladora industries where both government and industry have made insufficient investments in water treatment and hazardous waste disposal facilities. In addition to concerns of a Mexican pollution haven, other environmental issues have arisen as NAFTA was negotiated. These include pesticide residues on imported crops and increased levels of air pollution and more toxic spills due to higher levels of traffic.

These issues, together with a desire to promote trade through NAFTA, led the Clinton administration to trilateral negotiations beginning in March, 1993 on an environmental side-agreement to the NAFTA text based on a North American Commission on Environment (NACE). These negotiations are driven by the following logic. First, NAFTA as a trade measure could lead to environmental damages, or at a minimum might aggravate existing environmental conditions, notably in the maquiladora sector and border region. Second, remediating these damages requires some regulating mechanism to enforce environmental safeguards. Third, since the environmental problems include not only local but transnational problems, a coordinated trilateral response is required involving new institutional authority. In sum, improving environmental safeguards seems not only compatible with a NAFTA treaty, but probably depends on it.

On May 4, 1993, a coalition of seven national environmental interest groups announced provisional support for NAFTA, if a satisfactory environmental side-agreement containing the NACE could be successfully negotiated. The group included the World Wildlife Fund, the National Wildlife Federation, the National Audubon Society, the Environmental Defense Fund, the Nature Conservancy, Defenders of Wildlife, and the Natural Resources Defense Council.

Labor standards are the subject of the second "side-agreement" negotiations. Organized labor has maintained that NAFTA will create incentives for manufacturing to move where wages are lower. Like environmental issues, the labor side-agreement has come to the fore largely <u>because</u> of the NAFTA discussions. The results of a University of Michigan study suggest that rather than creating additional downward pressure on U.S. wages, the primary impact of NAFTA will be to raise Mexican wages, perhaps by as much as 9 percent, without lowering those in the U.S. This will reduce the incentive of U.S. firms to seek lower wage levels by relocating to Mexico. A labor side-agreement, like its environmental counterpart, can help to raise occupational, health and safety standards to U.S. levels, and compel U.S. firms to adopt similar standards in both countries. But neither process is likely without the opportunities and incentives created by NAFTA.

(3) <u>What are the risks of "import surges" under the current agreement, especially for sugar producers, and can safeguards be developed which continue to protect the sugar industry?</u>

The third "side-agreement" under discussion revolves around possible increases in imports from Mexico in commodities currently protected at the border. The most important is sugar. Currently, Mexican sugar consumption outpaces production, ranking among the highest levels in the world, at 102 pounds per capita. Population growth and economic recovery have shifted Mexico from net exporter to major net importer status, with a large share of imports coming from the U.S. as refined sugar under the U.S. re-export program, which allows U.S. refiners to import world market sugar and re-export the refined product. Total U.S. sugar exports to Mexico (including both beet and cane) were 219 thousand metric tons in 1991, 38 percent of total U.S. exports. Total U.S. imports from Mexico were 7,800 metric tons, less than one percent of total U.S. imports of 1.613 million tons, which are restricted under tariff rate quotas.

The concern of the U.S. sugar industry is that new investment in Mexican sugar production, together with imports of high-fructose-corn-syrup (HFCS) for use in food processing (especially soft-drinks), will free up sugar for export to the United States. It is held that U.S. producers will be inadequately protected under NAFTA from such import surges if and when Mexico reverts to net exporter status because of provisions granting market access for sugar to the U.S. after six years. These fears are reinforced by excess production of sugar in the U.S. in response to government subsidies. In the 1993 crop year, beginning October 1, 1992, sugar beet production is up 12 percent. This is the reason that the sugar industry has requested an additional side agreement to safeguard it from such surges. While such surges are hypothetically possible, a study tour conducted by the American Farm Bureau concluded that "Scenarios can be developed in which Mexico has sizeable exports, but there are equally plausible scenarios that leave Mexico a major net importer of sugar."

(4) <u>What if NAFTA fails?</u>

Much of the debate over NAFTA focuses on the impacts if it passes (with or without side-agreements). Relatively little attention has been given to the opposite question: What if NAFTA fails? Four possible impacts deserve careful consideration. First, because the impacts of

NAFTA are proportionately much greater for Mexico than for the U.S. and Minnesota, failure will also bear much more heavily on the Mexican economy and people. The consequences of failure will be counterproductive not only for economic growth and development in Mexico, but in Latin America generally. Latin America is one of the fastest growing markets for U.S. exports. Together, U.S. exports to Argentina, Chile, Mexico and Venezuela grew by an average of 49 percent between 1985 and 1988. Defeating NAFTA would discourage this process of expansion, lowering standards of living in Latin America and dampening exports to one of the most promising markets for U.S. exporters in the world.

Second, these job and income losses will contribute to greater political and economic instability in Mexico and Latin America, which will in turn provoke additional illegal migration of Mexican and Latin workers to U.S. markets. Half of the population of Mexico is 20 years of age or younger.

Third, NAFTA failure will almost certainly end U.S. interest in environmental problems in Mexico; even if an interest persists, both the leverage and the wherewithal to confront these problems will have been lost. NAFTA has been a key in motivating the Mexican government to upgrade its environmental standards; the North American Commission on the Environment (NACE) is one of the most exciting transnational efforts to deal with environmental problems in history. NAFTA's defeat will probably spell the end of such efforts.

Fourth, labor standards are unlikely to be addressed either; since wages in Mexico will remain depressed, the incentive to move factories south to Mexico will continue and could even accelerate, since the narrowing of the wage gap predicted under NAFTA will not occur.

Given these consequences of failure, the package of the NAFTA already concluded and the side-agreements being negotiated are more attractive than the alternative of a failed agreement.

GATT: The State of Play

What would a GATT deal contain?

First there are market-opening measures like tariff concessions, the traditional business of the GATT. Second, there are agreements which seek to strengthen the rules of the General Agreement on Tariffs and Trade. Into this category can be put stronger anti-dumping and subsidies rules but also trade in textiles -- which has been subject to a negotiated market-sharing arrangement in the GATT for the past 20 years -- and trade in agriculture which has been subject to loose and partly-ineffective GATT rules.

The third element in the package are agreements on new sectors of economic activity not previously covered by GATT -- notably, trade in services and trade-related aspects of intellectual property protection. Finally, there are understandings on institutional matters; in particular, improvements to the dispute-settlement system and the establishment of a new Multilateral Trade Organization.

GATT's new Director General, Mr. Peter Sutherland, recently visited the U.S. on a kind of "bucking up" tour, and reportedly related the following points to the MTN Coalition.

First, Mr. Sutherland clearly intends to be a "heavier" player than was Mr. Dunkel, his predecessor. Specifically, he will establish "milestones" moving toward what is hoped to be a successful conclusion in late 1993 or early 1994.

Second, the GATT Secretariat will make the meetings of the Trade Negotiating

Committee, the main formal decisionmaking body, much more open or "transparent" than in the past. This is in response to complaints that the GATT's decisionmaking process has been too closed.

Third, Sutherland does not intend to reopen the Dunkel text unless there is virtual unanimity on a given change. The Dunkel text, for better or worse, is thus the text on which the Uruguay Round will succeed or fail.

Fourth, a Uruguay Round agreement, if reached, cannot be reached because certain troublesome sectors, specifically textiles (for the U.S.) or agriculture (for the EC) are set aside. The agreement, in Sutherland's terms, must be a "substantial one," not a minimalist solution.

Finally, as everyone knows, the ultimate solution in GATT is a political one, and will require political will. This returns me to my original emphasis on political survival, and the two theorems that drive our own system. But, as I have suggested, there are still ways to win the day politically, if NAFTA and GATT are shown to be means to an end: that end is job creation, and the transfer of resources to the largest trading economy in the world. That economy is ours.