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Voluntary Export Restraint: Political Economy, History and the Role of the GATT

by

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Voluntary Export Restraint: Political Economy, History and the Role of the GATT

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ABSTRACT

Voluntary Export Restraint: Political Economy, History and the Role of the GATT

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Voluntary export restraints (VERs) are negotiated or induced trade restrictions in which the exporter administers the reduction of deliveries to a specific importing country. Their use can be traced to the international cartel activities of industrial ententes in the 1920s and 1930s and to Japanese export restraint arrangements on textile trade from 1937-1939. VERS re-appeared in the GATT period as a means of accomodating protectionist pressures while avoiding GATT constraints on discriminatory and quantitative trade restrictions. Although generally designed as "temporary" devices, the market effects of VERs tend to destabilize trade relations and generate expanding cartel agreements with increasingly detailed product coverage. A new commitment to non-discrimination in trade policy by major trading countries and improved mechanisms for promoting adjustment will be necessary in order to control the proliferation of VERS.

VOLUNTARY EXPORT RESTRAINT:
POLITICAL ECONOMY, HISTORY AND THE ROLE OF THE GATT

Introduction: The VER Problem

Despite the efforts of the GATT to eliminate the elements of both discrimination and quantitative restrictions from the trade policies of its contracting parties, these features stubbornly persist in the form of voluntary export restraint (VER) agreements. Designed to remedy import "disruption," such agreements have been applied to a large number of manufactured goods, including carbon steel products, color television sets, video cassette recorders, non-rubber footwear, automobiles, and machine tools. In addition to their direct economic welfare costs, they have distorted trade patterns, discriminated against the most efficient producers and disrupted trade relations. Export restraint agreements now represent a major threat to the world trading system and to the world economy in general.

This article offers a critique of the use of VERs and presents the issue of induced export restraint in light of its historical antecedents and the trade policy constraints of the GATT. After a brief review of the definition and political economy of VER agreements, the discussion turns to a history of VERs, their position in the GATT system and the prospects for reform.

Defining Export Restraint

Voluntary export restraint is a form of trade restriction distinguished by the fact that the exporting country controls the limitation on trade. Such action is termed "voluntary" in the sense that the exporting country formally imposes it unilaterally and could

technically modify or eliminate it. In reality, however, "voluntary" export restraint is a response to pressures from an importing country that typically threatens unilateral import restrictions against the exporter. In order to facilitate a negotiated restriction on exports, VERs contain built-in "compensation" for the exporter in that they allow exporters to raise the price of the export good and thereby capture a portion of the scarcity premium associated with the trade restriction. For this reason, domestic consumers lose more from VERs than from import tariffs, and recent empirical studies have documented their heavy economic welfare cost.[1]

Furthermore, in its most visible form, export restraint occurs as a bilaterally negotiated agreement, even if it is the exporting country that announces the policy. The announcement of ostensibly voluntary restraint by the foreign government alone has variously served the purpose of allowing the importing country to deny that it has induced the action as a protectionist policy and providing all parties with a legal fiction that helps to avoid possible charges of anti-trust violations.[2] In any case, the political economy of export restraint agreements makes clear that truly independent and voluntary export restraint would not require any agreement with other countries, since foreign governments or exporters (subject to anti-trust constraints) would initiate such measures on their own if it were in their economic interest to do so.

Export restraint may take other forms. Export forecasts, bilateral consultations, industry-to-industry arrangements, etc. provide a framework for monitoring deliveries to an import market from a specific exporter, with the clear implication that surges in

deliveries may lead to more drastic action.[3] Export restraint may also take the form of an agreement on minimum prices. Finally, the enforcement and administration of anti-dumping, countervailing duty and other trade laws, as well as threatened trade legislation, may also induce exporters to restrain deliveries through their intimidating effects. Often, such informal means of induced export restraint are precursors to formal export restraint arrangements.

Export Restraint as an Instrument of Trade Policy

History has shown, and current experience continues to show, that significant shifts in the competitive structure of the world economy create political pressure for trade restrictions as groups with incomes tied to the economic performance of declining industries seek to protect their wages and profits through reduced import competition. W.M. Corden has noted that trade policy in recent years has focused mainly on the "conservative social welfare function," assuring that economic events do not reduce the welfare of specific groups, particularly those with political power, even at the expense of overall national economic welfare.[4] In the era prior to the signing of the GATT, "old protectionism" was usually carried out with the use of directly imposed tariffs and import quotas. With the strict constraints placed by the GATT on tariffs and import quotas as instruments of trade policy, however, surges in protectionist sentiment have led to more innovative means of trade restriction. Crisis conditions and "disorderly" international markets in the industries mentioned above have created particularly strong protectionist feelings in the United States and the EEC, causing trade officials there to turn increasingly to VERs as an alternative to the

traditional instruments of trade control. In this manner, VERs and related devices have become the most significant policy tools of the "new protectionism."

Yet, notwithstanding its designation as a "new" trade policy device, VER agreements represent only a new form of long-standing protectionist practices, "old wine in new bottles" as J.N Bhagwati has put it.[5] Their appearance is part of a cycle of learning and unlearning that has characterized trade relations in this century: lessons of the economic and political damage of escalating protection seem to be acknowledged for a time, particularly in the wake of catastrophic events, and then forgotten.[6]

Specifically, VERs embody many of the disturbing characteristics of the protectionist mentality that have often dominated national trade policy formulation in the past, and which the GATT signatories had hoped to control. First, VERs represent a renewal of national tendencies towards mercantilism, the belief that national wealth is automatically enhanced by reducing imports. The political context of VER agreements suggests that governments regard the successful negotiation of reduced foreign deliveries to their markets as a victory vis-a-vis the foreigner. Closely linked with this idea is the concept that national economic power is directly related to the country's balance on current account and can be enhanced through the assertion of political power. A politically powerful country can and should, according to this philosophy, compel foreigners to reduce exports to its markets in order to redress a trade deficit. The use of political power is a necessary ingredient in concluding most VER agreements. Two hundred years of trade theory have attempted to

dispel the mercantilist arguments with the evidence of the benefits of the efficient allocation of resources under a liberal trade regime, along with the political advantages of a system of open trade. VERs show in renewed form the tenacity and political appeal of protectionism.

Secondly, VER agreements reveal the traditional preference, especially of large countries or trading blocs, for discriminatory trade policies.[7] Governments have been particularly vulnerable to this type of thinking in times of domestic or international economic instability, or when shifts in the international structure of competition result in increased import competition from specific countries. By reducing trade relations to a set of bilateral agreements, individual countries can be isolated for rewards or punishment while restricting the scope of potential retaliation. Again, political power is given an enticingly larger role when (especially smaller) trading partners can be singled out and, if need be, bullied into agreements deemed desirable by the importing country. The GATT, citing the history of escalating protection, reduced trade, and lower economic growth associated with discriminatory trade policy regimes, consciously sought to replace them with a multilateral system of rules, but VERs have successfully circumvented these provisions.

Finally, VER agreements show the underlying fascination of governments with managed trade, particularly with cartel-like agreements. Like any other market-driven phenomenon, international trade is not always predictable, and left unrestricted forces national economies to adjust to changing conditions of supply, demand, and international competitiveness. Adjustment may involve transitional

unemployment in declining sectors, regionally focused hardship, and embarrassing plant closures, events that, to be sure, can result from several sources of market disturbance, not just imports. Yet it is tempting for governments to blame foreigners for the dislocation and to attempt to reduce international competition by negotiating market-sharing agreements with foreign firms if this policy relieves the immediate political distress of adjustment. VERs typically involve such a restriction on competition by effectively requiring the exporting country to either cause or allow the formation of a cartel among existing export-supplying firms. Yet this seemingly modest initial attempt to manage markets often results in the expansion of the VER to include an entire network of exporting countries and increasingly detailed and tightened product coverage, creating a worldwide export cartel. Such cartels in manufactured goods had already been attempted in the 1920s and 1930s, to the detriment of economic welfare and trade relations. Their revival through VERs bodes ill for the consumer and for world economic growth.

Early History

The earliest documented use of export restraint as a tool of commercial policy occurred in the early 1930s, as Belgium and France transferred the rights to issue licenses on goods subject to bilaterally negotiated quotas to exporters.[8] These arrangements were an extension of the industrial ententes, or international industry-to-industry cartel arrangements, that were popular during the period and enjoyed the assent and at times co-operation of governments. Supporters of such collusive agreements viewed them as a means of establishing order in the "chaotic markets" of the 1930s. They

covered a variety of agricultural and manufactured goods as well as coal[9] but were not without controversy, as importers often protested the transfer of the quota profits to the foreign exporter. A similar export market-sharing arrangement was established for steel trade by the International Steel Cartel, an organization of major steel firms, in 1933.[10] Even during the periods covered by these early export restraint arrangements, contemporary observers recognized the dangers to consumer welfare of promoting export cartels in this manner.[11]

The first major use of voluntary export restraint as a means of settling a trade dispute appears to be the agreement concluded in 1936 limiting Japanese textile exports to the United States. Japanese deliveries of cotton textiles had risen sharply from 1.22 million square yards in 1929 to 7.29 million square yards in 1936. By the end of that year, bookings for 1937 had already reached 150 million square yards. At this point American textile producer sought a quick means by which to stem the surge in Japanese competition. Negotiations between representatives of producers from both countries, which were concluded in late 1936, resulted in a "gentlemen's agreement" between the two national industries, and apparently had the consent of both governments. It set yearly limits of 155 million square yards of cotton goods deliveries in 1937 and 100 million square yards in 1938. In late 1938 the agreement was renewed for two more years, allowing for 100 million square yards per year in 1939 and 1940. Separate quota agreements were also concluded on cotton rugs, velveteens and corduroys, and cotton hosiery. Japan negotiated similar agreements with Burma, India, Australia, and the United Kingdom during the 1930s. The arrangements reportedly involved the <u>quid pro quo</u> of tariff

reduction, pledges not to raise tariffs, and in some cases reciprocal barter agreements. In the case of India, for example, the Japanese export limit was dependent on levels of Japanese purchases of Indian goods. This was another version of the bilateral clearing arrangement that was a popular aspect of trade policy during the economic turmoil of the 1930s.[12]

J.N. Bhagwati suggests that the concept of export restraint is closely connected to the Japanese cultural trait of avoiding confrontation by means of self-initiated compromise.[13] While it has become clear over the years that the incentive structure of export restraint operates equally well outside Japanese culture, it is noteworthy that export restraint as a tool of commercial diplomacy appears to have developed primarily in Japan. An earlier precedent for export restraint had already appeared in 1907, when diplomatic tension between the United States and Japan arose over the large influx of Japanese immigrants to California. Anti-Japanese sentiment had developed there due to a combination of labor competition and racism, creating conflicts remarkably similar to those that would arise over trade decades later. Public anger had given rise to threats of unilateral actions by local authorities, including a ban on admitting Japanese immigrants to public schools. The crisis was finally settled when President Theodore Roosevelt concluded a "gentlemen's agreement" with the Japanese government limiting the number of Japanese passports issued to emigrants to United States territory.[14] Through "voluntary" emigration restraint, Japan thus avoided the unilateral restrictions on immigration that were imposed

on other countries in the years before general immigration quotas of the 1920s.

Yet the historical record of voluntary export restraint goes on to show that such "co-operative" trade agreements in no way represented lasting solutions to the underlying conflicts they sought to resolve. The Japanese government resorted to such agreements in the face of increasing frustration in gaining access to export markets, and the industrial ententes used export restraint agreements as a means of insulating weakened domestic industries from foreign competition. The worldwide state of suspicion and instability caused by discriminatory trade agreements in the 1930s, based on jealously guarded bilateral pacts and the often rigid exclusion of competitive goods through quotas, can be linked in part to the deterioration of diplomatic relations that led to the second world war. This fact was not lost on the founders of the GATT. After the cessation of hostilities, the allies had fresh memories of the disastrous international economic policies of the previous decade, and sought in the IMF and the GATT to establish institutions guaranteeing international monetary stability and a framework of multilateral trade policy rules to maintain open trading markets, respectively. Non-discrimination and transparency were to provide the foundation of an international economic order.

VERs and the GATT

The provisions of the GATT, founded in 1947, define the constraints under which the Contracting Parties can impose trade restrictions, and therefore have played a large role in the development of the VER as a tool of trade policy. The main activities

of the GATT, for example, have been to reduce the tariff levels applicable to trade among its members. In trade negotiations, each country must submit "schedules of concessions" (tariff reductions) and is bound by those schedules according to the provisions of Articles II and XXVIII. These provisions effectively prohibit GATT members from unilaterally raising tariffs, and have thereby severely restricted tariff increases as a policy option when confronted with pressure for trade restrictions.

Even in cases where a Contracting Party can claim that "emergency action" to restrict imports is necessary, the GATT rules impose strict requirements on any increase in trade barriers, including thoroughgoing consultations and compensation to affected exporters. In addition, scholarly opinion generally holds Article XIX to require MFN treatment of any temporary trade restrictions used by GATT members to protect domestic industries from injurious import surges.[15] It appears that the founders of the GATT in fact wanted to make safeguard actions politically "expensive" by exposing the importing country to requirements of across-the-board compensation for all affected exporters. For these reasons the original architects of the GATT clearly expected the escape clause to be used only on rare occasions.[16]

In view of these constraints on the use of traditional trade restrictions and their discriminatory application, governments subject to protectionist pressures have turned increasingly to induced export restraint as a means of controlling politically sensitive imports. VER agreements are, in fact, designed to circumvent GATT restrictions on the use of tariff increases and import quotas, and on the severe

constraints of the escape clause (although in some cases, VER-type agreements have also been concluded under escape clause actions[17]). At the same time, their increasing popularity has undermined the basic principles of the GATT. An examination of certain GATT articles reveals these conflicts. For example, the single most important idea of the GATT is non-discrimination, set forth in Article I, the most-favored nation (MFN) clause, which reads in part:

> ...any advantage, favor, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.[18]

In other words, access to the import market of any Contracting Party by any other Contracting Party shall be accorded on a non-discriminatory basis; all members of the GATT receive the same treatment as the "most-favored" nation. This principle is so central to the entire foundation of the GATT that it can be amended only by a unanimous vote of the Contracting Parties.

Another important aim of the GATT is the general elimination of quantitative restrictions and other non-tariff barriers (NTBs), found in Article XI:

> No prohibitions or restriction other than duties, taxes or other charges, whether made effective through quotas, import or export licences or other measures, shall be instituted or maintained by any Contracting Party on the importation of any product of the territory of any other Contracting Party or on the exportation or sale for export of any product destined for the territory of any other Contracting Party.[19]

Eliminating all NTBs was tied to the issue of <u>transparency</u>. Aside from limiting trade restrictions to the form most compatible with the price system and least damaging to economic welfare, Article XI also had the practical purpose of establishing a system of

straightforward, "visible" means of government intervention in trade that would facilitate negotiations for reductions in the level of protection.

VER agreements contradict the MFN principle and the goal of eliminating NTBs by establishing a quantitative trade restriction that discriminates against certain exporters. Article XIII (on the non-discriminatory administration of quantitative restrictions) casts further doubt on the validity of VERs under the GATT:

> No prohibition or restriction shall be applied by any contracting party on the importation of any product of the territory of any other Contracting Party or on the exportation of any product destined for the territory of any other Connecting Party, unless the importation of the like product of all third countries or the exportation of the like product to all third countries is similarly prohibited or restricted.[20]

Strict adherence to the letter of Articles XI and XIII would appear to prohibit any Contracting Party from limiting exports except by tariffs on an MFN basis. The original purpose of these provisions was to prevent countries from independently restricting exports in a discriminatory, quantitative manner, to the detriment of the targeted <u>importing</u> country. Since the GATT did not envision the use of export restrictions as a means to satisfy protectionist demands of the importing country, however, this rule has conveniently been ignored in VER agreements. In fact, enforcement of this provision would hold the victim of VER agreements (the exporting country) guilty of the infraction, whereas in reality it is the importing country that is responsible for causing it. Articles XI and XIII do not, therefore, hold much promise as a means by which VER agreements can be controlled.

GATT and the Paradigm of Discrimination

Among the many frustrations of the early GATT negotiations was the difficult task of eliminating the vestiges of discriminatory and quantitative restrictions. The provisions banning quantitative restrictions allowed exceptions in some cases for agricultural goods (Art. XI) and severe balance-of-payments deficits (Art. XII). The agricultural exemptions from quantitative restrictions, in particular, have haunted the GATT ever since its inception, and still represent a major source of conflict among its members. Thus, political constraints have compromised the original ambitious purposes of the GATT from its very beginnings.

Yet other sources of the erosion of GATT principles are contained in the GATT itself, especially regarding the principle of non-discrimination. While the erosion of the MFN principle has reached critical proportions only in recent years, the content of the GATT itself has helped to undermine it in at least three ways: (1) through the stated exceptions to the MFN rule, especially in Article VI; (2) through the view of trade liberalizing measures as "concessions" and the emphasis on reciprocity; and (3) by creating the prohibitively high political cost of escape clause protection.

The GATT compromised the principle of non-discrimination in several instances. The most prominent general exceptions to MFN dealt with the formation of customs unions and free trade areas in Article XXIV and the special treatment of less developed countries in Part IV, which provided the underpinnings for the Generalized System of Preferences (GSP). The GSP provides for preferential tariff treatment towards less developed countries and operates under a waiver of GATT

Article I.[21] In addition, Article VI allows discriminatory tariffs to be applied in cases of dumping and export subsidies. Further exceptions to MFN are outlined in Articles XIV, XXIV and XXXV.

In defense of the drafters of the GATT, these measures served the purpose of providing a political modus vivendi that was probably necessary to achieve a consensus on the final document and the subsequent adherence of new GATT members. In particular, customs unions could be viewed as a vehicle for movement towards freer trade--at least in an institutional sense--and the GSP made GATT membership more attractive to less developed countries. The various exceptions to MFN based on balance-of-payments problems or other special circumstances provided contingency measures that would not interfere with the general application of the MFN principle. Article VI formed the basis of the widely accepted rules of "fair trade" that were politically necessary in many countries to gain domestic consensus on more open trade.

At the same time, the GATT's tolerance for discrimination, however narrowly it attempted to circumscribe it, has weakened its ability to prevent the signatories from violating Article I in practice. If Article VI can allow discriminatory tariffs against "unfairly" traded goods, it is but a small step to the conclusion that discrimination should also be allowable against "unfairly disruptive" imports. And if the GATT allows countries to favor certain trading partners in customs union or free trade arrangements, is it not also justifiable to show preference towards traditional trading partners by using VERs to restrict the access of newly competitive interlopers in your domestic market? The resulting inner conflict within the GATT

appeared most clearly in its 1959 decision to use "market disruption" as a criterion for protection in textiles trade.[22]

Similarly, the GATT's emphasis on reciprocity and references to tariff "concessions" also created an internal contradiction by misstating the gains-from-trade argument. Even as economic theory shows the benefits of unilateral tariff reductions, the GATT's language suggests that the benefits are actually sacrifices, and has reinforced the traditional mercantilist view that access to domestic markets is the property right of governments, to be shared only in exchange for reciprocal measures. This makes it all the easier for governments to rationalize a "withdrawal of concessions" as a reasonable response to any increase in imports that heightens the political cost of the trade agreement. If import disruption can be traced to specific exporters, it then appears equally reasonable to discriminate against them in applying trade restrictions.

The principal means within the GATT of holding the long-standing and deep-rooted mercantilist tendencies of governments at bay fell to Article XIX, the escape clause. The purpose of this provision was to act as the main "safety valve" for protectionist pressure, guaranteeing general adherence to GATT principles while allowing for special cases of temporary protection. As noted earlier, it is generally accepted that trade protection under Article XIX must be administered in a non-discriminatory fashion, and when combined with the requirements of an injury test and compensation to affected exporters, this rule means that GATT-consistent protection comes at a high political price. The rarity of escape clause actions suggests that this price is usually prohibitive. In view of these constraints

placed by the GATT on trade policy, surges in protectionist pressures have consequently followed paths of lower resistance to the VER solution, highlighting the failure of Article XIX to fulfill its designated role as a "safety valve."

In retrospect, it is clear that the role of the MFN principle in trade relations under the GATT could be only as strong as the political will to maintain it. It was, perhaps, too much to expect that a broad, contractual arrangement among countries, in itself, could provide the means by which governments could shield trade policies from the eventual incursion of mercantilism and special interest politics. In the early postwar period, to be sure, the environment for enlightened trade policy was unusually good. Postwar recovery and rapid economic growth, with the self-confident United States dominating the world economy and leading the way on trade negotiations, facilitated the political recognition of the gains from trade among GATT member countries. Yet the international consensus on the GATT's objective of trade liberalization, and on the MFN principle in particular, began to weaken as the postwar recovery ran its course and structural change in the world economy revealed new patterns of comparative advantage. By abandoning the systematic rules of a world trading order, governments must now negotiate the minutiae of international export cartel arrangements from one crisis period to the inevitable next.

VERs in the GATT Period

During the first two decades of the GATT, serious problems of consistent and multilateral adherence to GATT principles arose over the fears of many countries regarding potential trade "disruption,"

especially from Japan, a situation that enhanced the political importance of VERs. Article XXXV allows a contracting party to remain in the GATT and yet exercise the option not to apply the GATT in its trade relationship with specific new member countries. Several countries invoked this article against Japan[23] and Italy "grandfathered" a VER agreement on Japanese automobile deliveries to its market.[24] In addition, the resurgence in Japanese textile exports in the 1950s renewed protectionist sentiment in the United States, Canada, and Europe and caused these countries to go outside the GATT framework to limit Japanese exports. Export restraint agreements were, in fact, the quid pro quo required by several (especially European) countries for a disinvocation of GATT Article XXXV.[25]

Japan continued to be perceived as the "disruptive" exporter throughout the postwar period, and the ensuing diplomatic efforts to create a "co-operative" method of trade restriction in the GATT era led to the establishment and increasingly widespread use of export restraint as a tool of commercial policy. The United States negotiated an informal textile export restraint agreement with Japan in 1956, which was in effect from 1957 to 1961. This pact was followed by the Short-Term and Long-Term Agreements negotiated by the United States, Canada, and Europe with Japan and other textile-producing countries, the forerunners of the present Multifibre Arrangement.[26]

The textile VER agreements were significant because they represented the first major instance of the abandonment of GATT principles in a dispute over trade in manufactured goods. In a declining sector of the established industrial countries,

protectionist sentiment was strong enough to override the discipline of GATT rules and focus trade restrictions against individual countries that had gained comparative advantage in the protected good. Since most GATT members had actually welcomed the discipline and international obligations of GATT rules as a useful buffer between domestic protectionist pressure and protectionist policies, the textiles case suggested that further measures to evade GATT rules would occur in disputes over trade in politically sensitive industries. The targets of such discriminatory measures would generally be those countries with emerging comparative advantage. The policy tool would be voluntary export restraint.

Following textiles, the next major industrial sector that came under protectionist pressure was steel. The United States concluded its first set of steel VER agreements with Japan and the EC in 1968, and by 1984 most steel trade was covered by a web of VERs imposed by the United States, the EC and other countries. The proliferation of VERs to other industries in recent years is remarkable. A recent GATT study lists some 130 export restraint agreements in steel, footwear, autos, machine tools, agricultural products, electronics goods, textiles, clothing and other products.[27] This tabulation does not include the thousands of detailed quota arrangements that fall under the Multifibre Arrangement (MFA). In addition to the traditional target of such restrictions, Japan, many other countries have been induced to limit exports, including newly industrializing countries such as Taiwan, Korea, and Hong Kong and many less developed countries, as well as non-market economy countries and several established industrialized countries. From the limited coverage of

early VER agreements, renewed export pacts have tended to increase the scope of restrictions and restrain trade in greater and greater detail. In the cases of textiles and steel, in fact, the VER agreement networks represent virtual cartels of international trade, covering most exports of most major suppliers to the world market.

VERs and the Spread of Trade Disputes

The record of VERs shows that such agreements in their most damaging form typically begin as government policies with modest objectives and temporary scope but grow into self-perpetuating institutional arrangements of increasingly restrictive measures. The early voluntary export restraint agreements with Japan on textiles in the 1930s and 1950s, for example, were viewed by many as a necessary expedient of commercial diplomacy that would not hamper the long-run adjustment of the industry according to market principles. The first multilateral textile arrangements, with their stated emphasis on market-driven adjustment and expanding trade opportunities, were similarly received with optimism that they would promote a world trading order based on comparative advantage.[28] Yet once the quantitative, discriminatory machinery of restricting trade was in place, the framework was established that made possible perpetual protection in textiles, with more comprehensive product coverage, trade restrictions against new suppliers, new collective "surge" provisions and lowered quota growth.

The path and evolution of particular export restraint agreements have been driven largely by the international conflict they engender. Because the agreements are by design discriminatory, restrained exporters will often seek to avoid the quota restrictions by

transshipping the goods or by setting up production and exporting facilities in countries not covered by the agreement. Similarly, the discriminatory nature of the agreement creates opportunities for non-restrained exporters to enter the protected market, a phenomenon that has been common in steel, textiles, and automobiles. Finally, VERs may cause trade diversion by re-directing exports from restrainted suppliers towards unprotected markets, leading to surges in imports of the protected good in third markets that remain open to trade. In addition to the resentment this practiced creates against the original restraint-inducing country, the "rebounding" exports tend to renew the protectionist cycle as the third country introduces trade restrictions.

These market effects imply that, if the agreement is to have any restrictive force beyond the short term, and if it is to create an "orderly" world market, it must be extended to cover all major existing and potential suppliers of the protected good. Actual or feared trade diversion was a major factor in establishing the comprehensive MFA in textiles and clothing, and has contributed heavily to the vitriolic trade relations in steel between the United States and the EC. The anticipation of rebounding auto exports from Japan was especially significant in the early 1980s, when the VER negotiated by the U.S. with Japan prompted Canada and several EEC countries to conclude "pre-emptive" (or to tighten existing) export restraint arrangements of their own with Japan. In this manner the initially "limited" protective measure typically expands into a comprehensive global arrangement.[29]

VERs have caused further distortion and conflict through their "value-escalation" effect--the shifting by exporters of deliveries from lower-value to higher-value items within the quota constraint. As this shift occurs, the latter product categories become subject to surges in the import market and new calls may arise for protection in the form of more detailed and rigidly defined quota categories. Value escalation has been observed in several export restraint arrangements, highlighting their regressive income distribution effects.[30] The accompanying escalation of VER quota coverage has been most prominent in textiles, clothing and steel, leading to highly detailed export cartels in these products.

Induced export restraint has poisoned trade relations and the integrity of the GATT in other, more subtle ways. The use of trade law petitions and administration as a method of inducing export restraint has often undermined the original purpose of those measures, which was to act as a "safety valve" for protectionist pressure. This phenomenon has been most prominent in steel trade, where governments and/or domestic import-competing firms have used trade law harassment in order to get recalcitrant exporters to the export restraint bargaining table. In many cases, anti-dumping or countervailing duty petitions filed by domestic firms over trade in a narrowly defined product category have the effect of inducing exporters to negotiate VERs covering much broader categories. Trade law thereby loses credibility as a legitimate, objective device regulating trade according to transparent, mutually recognized and accepted rules.[31]

Finally, agreements on export restraint generally represent the assertion of political and economic power of large importing countries

over smaller exporting countries, and thereby undermine the credibility of the GATT and of the goal of an orderly, non-discriminatory world trading order. VERs have locked many less developed countries (LDCs) into a system of rigid, anti-competitive export market shares. The failed prospect of equal access to opportunities for trade and growth through GATT rules has been a bitter disappointment for many LDCs, and the promise of "preferential" treatment through the GSP has been in many cases deprived of substance by VERs against goods in which LDCs have comparative advantage, particularly in textiles, clothing and steel. Even though the VER provides some compensation to the exporter in the form of a transfer of the scarcity premium of the trade restriction, for many LDCs such agreements involve a net loss in welfare because they misallocate resources and stifle economies of scale and domestic competition.[32] The distortion of market signals through VERs only compounds the problem of deficient internal economic policies in many LDCs. Moreover, the politics of trade discrimination are based on the assertion of power; small countries almost never gain from these arrangements when compared to the outcome from an orderly, non-discriminatory trading system.

Prospects for Reform

The founders of the GATT clearly did not foresee the dangers of VERs to the world trading system. Until their recent proliferation, VERs were for the most part regarded as temporary, isolated trade restrictions of limited scope that could be used from time to time to avoid larger trade disputes. In the meantime, however, their increasing popularity with governments has in fact created trade

disputes and seriously eroded the GATT's ability to regulate trade policy. The control or elimination of their use as an instrument of trade policy, combined with domestic policies to promote adjustment and diminish protectionist sentiment at home, will be necessary in order to restore the ability of the GATT to establish an orderly trading system.

Yet the intractability of the problem of selective discrimination under existing GATT measures indicates that general GATT reform--for example, a formal ban on VER agreements--is unlikely to provide a workable solution, for two reasons. To achieve enough agreement among all GATT signatories to change anything of such substance in the document would be virtually impossible. In addition, the loose nature of GATT obligations and the absence of an effective enforcement mechanism have proven the agreement to be ineffective in binding its membership to such a broad commitment. The history of deviation from GATT principles through the clever use of alternative means of trade restriction, in any case, provides little hope for optimism along these lines.

A more fruitful approach would lie in the conclusion of a formal agreement among the major economic powers--including but not limited to the United States, the EC and Japan--eliminating the use of discriminatory trade restrictions against each other.[33] This and other proposals for forming a "GATT Plus"[34] would go beyond the existing GATT by requiring MFN treatment in <u>all</u> trade policy measures (aside from selective measures provided under strictly interpreted anti-dumping and countervailing duty laws) and by preventing the substitution of other barriers to trade to circumvent the MFN

requirement. Ideally, the agreement would be structured to allow any other country to join. Once the large countries join, furthermore, the smaller countries will have a strong incentive to join also, insofar as they are most often the targets of discriminatory trade restrictions.[35]

Such an agreement would also require that many existing protectionist arrangements, especially in agricultural goods, textiles, steel and autos, be renegotiated (if not eliminated) in order to conform to the MFN rule. This objective could be accomplished through a conversion of existing trade restrictions to global tariffs, or to the less attractive alternative of competitively auctioned import quotas. Yet a general agreement on universal application on MFN would be the sine qua non of any meaningful progress in eliminating protection in these sectors anyway, so a "GATT-Plus" agreement is a logical first step towards instutitional reform in the resolution of sectoral trade disputes.

The inclusion of further measures would strengthen the attractiveness and acceptability of the "GATT-Plus" agreement. A comprehensive agreement guaranteeing liberal, non-discriminatory trade would require a broad range of specific agreements on all non-tariff barriers, dispute settlement, and anti-dumping and countervailing duty measures.[36] Agreement on unfair trade law provisions is particularly important because of the close link between their enforcement and discriminatory export restraint and because of the tendency to manipulate such laws for protectionist purposes. A package of agreements may, in fact, be necessary to assure adherents to the

treaty that substitution of other, less transparent, protectionist measures for existing policies will not occur.

An agreement requiring re-tariffication of all existing trade restrictions would provide additional economic benefits for signatories to the agreement. Aside from promoting transparency, it would make the price effects of protection more visible, increasing public pressure for tariff cuts. In addition, re-tariffication would permit countries to negotiate tariff rebates.[37] This provision would tend to foster further political incentives for trade liberalization, and at the same time would increase dramatically the benefits of adhering to the agreement. Tariff revenues could also provide a source of funds to finance adjustment assistance.

Ultimately, however, any progress towards the elimination of VERs as an instrument of trade policy will require domestic policies that diminish the motives for protectionism in general. Internal measures to promote the mobility of labor and other resources across industries and regions, along with policies supporting the process of adjustment to international competition, would prevent the conditions that so often lead to protectionist policies. Stronger efforts to educate the public on the issues would also help, especially if the cost of specific protectionist policies to consumers, including the transfers to foreign and domestic producers, were a matter of public record.

In the end, the steps required to achieve a more enlightened trade regime depend on a measure of political will that has been conspicuously absent in recent years. Until governments commit themselves to rebuild the system of rules for open trade, discrimination and quantitative restrictions in international trade

will persist in the form of VERs, and the future of the trading system will remain in doubt.

NOTES

1. See Gary L. Hufbauer, Diane T. Berliner and Kimberly Ann Elliott Trade Protection in the United States: 31 Case Studies (Washington, D.C: Institute for International Economics, 1986); David Greenaway and Brian Hindley, What Britain Pays for Voluntary Export Restraints (London: Trade Policy Research Centre, 1985); and Organization for Economic Cooperation and Development, Costs and Benefits of Protection (Paris: OECD, 1985).

2. In order to comply with antitrust regulations, current U.S. VER arrangements with foreign exporters require government-to-government agreements in which export quantities are restricted by "sovereign compulsion." Many foreign governments also require official U.S. Justice Department acknowledgement of the VER before approving the agreement. For a history and analysis of a legal challenge to the U.S. steel VER agreements of 1969-1974, see Andreas Lowenfeld, Public Controls on International Trade (New York: Matthew Bender, 1979).

3. Michael Kostecki, "Export Restraint Arrangements and Trade Liberalization," The World Economy 10 (4), 1987, at 425. Varying anti-trust laws and enforcement among countries define the types of legally permissible export restraint arrangements.

4. Trade Policy and Economic Welfare (Oxford: Oxford University Press, 1974), chapter 5.

5. "Protectionism: Old Wine in New Bottles" Journal of Policy Modeling 7 (1), 1985, at 23.

6. See Jan Tumlir, Protectionism: Trade Policy in Democratic Societies (Washington, D.C: American Enterprise Institute, 1985), at 31-35.

7. See Gardner Patterson, Discrimination in International Trade: The Policy Issues 1945-1965 (Princeton: Princeton University Press, 1966) and Richard Pomfret, Unequal Trade: The Economics of Discriminatory International Trade Policies (New York: Basil Blackwell, 1988).

8. Heinrich Heuser, Control of International Trade (London: George Routledge and Sons, 1939), at 112.

9. Id., at 119.

10. Kent Jones, "Forgetfulness of Things Past: Europe and the Steel Cartel," The World Economy 2 (2), at 139.

11. Heuser, op cit., at 114-115.

12. For details of these agreements, see Ethel B. Dietrich, Far Eastern Trade of the United States (New York: Institute of Pacific Relations, 1940) and Miriam Farley, The Problem of Japanese Trade Expansion in the Post-War Situation (New York: Institute of Pacific Relations, 1940).

13. "The Political-Economy-Theoretic Analyses of International Trade: VERs, Quid Pro Quo DFI and VIEs," International Economic Journal, 1(1) at 1.

14. Raymond A. Esthus, Theodore Roosevelt and Japan (Seattle: University of Washington Press, 1966).

15. See Kenneth Dam, The GATT: Law and International Economic Organization (Chicago: University of Chicago Press, 1970), pp. 104-105; and John Jackson, World Trade and the Law of GATT (Indianapolis: Bobbs-Merrill, 1969), p. 564. A contrary view is presented in M.C.E.J. Bronckers, Selective Safeguard Measures in Multilateral Trade Relations: Issues of Protection in GATT, European Community and United States Law (Deventer: Kluwer Law and Taxation Publishers, 1985).

16. Some GATT member countries, particularly France and Britain, have advocated reform of article XIX to allow selective discrimination. See Brain Hindley, "Voluntary Export Restraints and the GATT's Main Escape Clause," The World Economy 3 (3), 1980, at 313.

17. See Bronckers, op cit., chapters 1-2.

18. General Agreement on Tariffs and Trade, art. I (1), opened for signature October 30, 1947, 61 Stat. A3, T.I.A.S. No. 1700, 55 U.N.T.S. 187 [hereinafter cited as GATT]. Current version of the Agreement is contained in 4 GATT, Basic Instruments and Selected Documents (1969).

19. GATT art. XI (1).

20. GATT art. XIII (1).

21. Morton Pomeranz, "Legal Aspects of International Trade," in Ingo Walter and Tracey Murray (eds.), Handbook of International Business, second edition (New York: John Wiley and Sons, 1988), chapter 21, at 11-13.

22. Dam, op cit., at 269 ff.

23. Gerard Curzon, Multilateral Commercial Diplomacy; The General Agreement on Tariffs and Trade (London: Michael Joseph, 1965), at 37.

24. Organization for Economic Cooperation and Development, op cit., at 32.

25. Patterson, op cit., at 285-300.

26. A comprehensive account of negotiated textile trade restrictions in the postwar period is contained in: Vinod K. Aggarwal, Liberal Protectionism: The International Politics of Organized Textile Trade (Berkeley: University of California Press, 1985).

27. General Agreement on Tariffs and Trade, Review of Developments in the Trading System: April - September 1987, Document L/6289 (Geneva: GATT, 1987), at 99-108.

28. See, for example, Curzon, op cit., at 256-258.

29. See Kent Jones, "The Political Economy of Voluntary Export Restraint Agreements," Kyklos 37 (1), 1984, at 82.

30. The theoretical basis of value escalation analysis is contained in Rodney Falvey, "The Composition of Trade Within Import-Restricted Product Categories," Journal of Political Economy 87, at 1105. Empirical studies include Bee Yan Aw and Mark J. Roberts, "Measuring Quality Change in Quota Constrained Import Markets," Journal of International Economics 21, at 45 (covering footwear VERs), Robert C. Feenstra, "Quality Change Under Trade Restraints in Japanese Autos," Quarterly Journal of Economics, 1988, at 131 and William R. Cline, The Future of World Trade in Textiles and Apparel (Washington, D.C: Institute for International Economics, 1987), pp. 174-178.

31. These remarks are not to imply that the trade law petitions are without merit in each case, but only that strict trade law enforcement measures on "unfairly" traded goods would be less damaging to economic welfare than the VERs that often result from the petitions. For an account of how U.S. trade law petitions in steel grew into a "steel pact" VER with the EC, see Michael K. Levine, Inside International Trade Policy Formulation: A History of the 1982 US-EC Steel Arrangments (New York: Praeger, 1985).

32. A recent empirical study suggests that the costs of VERs exceed their benefits to less developed countries. See Irene Trela and John Whalley, "Do Developing Countries Lose from the MFA?" NBER Working Paper Series No. 2618 (Cambridge, Massachusetts: National Bureau of Economic Research, 1988).

33. See Gary Banks and Jan Tumlir, "The Political Problem of Adjustment," The World Economy 9 (2), 1986, at 141; and Martin Wolf, "Fiddling While the GATT Burns," The World Economy 9 (1), at 1.

34. Atlantic Council, GATT Plus: A Proposal for Trade Reform (Washington, D.C: Atlantic Council, 1976).

35. Politically, it appears that the provisions of a "GATT-Plus" agreement would have to be applied on a conditional MFN basis in order to avoid the problem of free riding. The pros and cons of this aspect of GATT reform are discussed n Wolf, op cit., at 13-14. A precedent for a conditional MFN approach has already been established in the GATT codes negotiated in the Tokyo Round. See Gary C. Hufbauer, J. Shelton Erb and H.P. Starr, "The GATT Codes and the Unconditional Most-Favored Nation Principle," Law and Policy in International Business 12 (1980) at 59.

36. Wolf, op cit., at 13.

37. One proposal would establish reciprocal rebates on all customs duties collected on deliveries of the partner's imports. See Edward Tower, "Comments on Tumlir," Contemporary Policy Issues 5 (2), at 13.

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