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FREE TRADE AREAS: REMOVING TRADE OBSTACLES AND BUCKING PROTECTION

INTRODUCTION

As calls for trade protection grow louder, a key argument made by its advocates is that protection is needed to retaliate against nations that impede the import of U.S. goods. While there indeed is considerable truth to the claim that trade barriers have been increasing, the antidote to such barriers is not protection, it is a policy that liberalizes trade.

An innovative way of doing this that now is being explored is the creation of Free Trade Areas, known as FTAs. With an FTA, two countries that wish the benefits of opened markets remove all tariffs and quota restrictions against one another, as well as other non-tariff barriers. Although this is done in a relatively short period of time, in contrast to the years taken to negotiate multinational trade accords, FTAs are phased in to allow industries to adjust to the new opened market environment. FTAs allow countries to maintain their separate trade policies toward non-FTA countries.

The U.S. would realize many economic benefits from the expanded use of FTAs. Among them:

1) **unrestricted access** for U.S. businesses to foreign markets;

2) **future trade certainty** for American entrepreneurs;

3) **lower prices** for American consumers; and

4) **more competitive** American industries.

FTAs also could further the multilateral General Agreement on Tariffs and Trade process by working out solutions to such problems as trade in services, with which the GATT is only now beginning to deal. FTAs would spur Third World economic growth by giving developing countries access to U.S. goods and markets and by creating the economic conditions in which developing countries would funnel labor and capital into productive industries and away from those money losing industries supported for political reasons.

FTAs would give the U.S. leverage for opening markets of more protectionist, non-FTA members. This is because goods from such countries entering markets linked to the U.S. in FTAs would face many trade barriers from which U.S. goods would be exempt. This would place the non-FTA countries at a competitive disadvantage. These countries then would have an incentive to lower their trade barriers to achieve market liberalization with the FTA countries. Since each FTA country still would maintain ultimate control over its own trade policy, there is little chance that FTAs would degenerate into trading blocs that act to restrict trade against others.

Israel and Canada. The U.S. currently is phasing in an FTA with Israel and negotiating an FTA with its largest trading partner, Canada. Countries expressing interest in FTAs with the U.S. include Singapore, Thailand, the Republic of China on Taiwan, and Uruguay. Prominent congressional free trade advocates suggest a North American FTA. An FTA with the six ASEAN nations--Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand--is being considered by Administration officials.

The Reagan Administration needs a coherent policy and strategy for FTAs that, among other things, would include:

◆◆ Administration "fast track" authority from Congress to negotiate FTAs and have such agreements voted on by Congress without amendments.

◆◆ A decision to pursue FTAs with any friendly country that desires completely free trade.

◆◆ Expanded staff for the U.S. Trade Representative's Office to handle the many details of FTA negotiations.

◆◆ An offer of FTAs to countries whose per capita income has grown so much that they are "graduated" out of the Generalized System of Preferences.

◆◆ A declaration that serious requests for FTAs are to be a litmus test of a country's intentions to open its market.

FREE TRADE AND ECONOMIC DEVELOPMENT

Free trade has played an indispensable role in the economic growth of the West for more than six centuries. During the Middle Ages, the merchants of the Italian city-states, the Low Countries, and Northern Germany helped break down the feudal system that had kept Europe in abysmal poverty. The American Declaration of Independence denounced Britain's King George III "For cutting off our trade with all parts of the world." The American patriots fought for the right to trade with whomever they pleased. A major goal of the U.S. Constitution was to create a complete and unrestricted free market between what had been thirteen separate states, each with restrictions against each other.

Prolonging Depression. Trade protectionism in the late 1920s and early 1930s probably triggered, and certainly deepened and prolonged, the Great Depression. After World War II, the Western allies established the General Agreement on Tariffs and Trade (GATT) to ensure multilateral trade liberalization. Their premise, which has been confirmed, was that free trade leads to peace and prosperity.

The benefits of free trade between countries derive from the same free market principles that lead to prosperity within a country. Private property, free exchange between individuals, and demand-determined wages, prices, and production allow individuals and businesses to specialize in economic activities in which they have a comparative advantage. The overall wealth and standards of living of everyone within the country increase. The same principles apply to individuals and companies trading across national boundaries. All parties to such transactions gain. Both countries "win"; neither "loses."

FREE TRADE AREAS DEFINED

Though various "rounds" of GATT negotiations have reduced tariffs significantly, tariffs still persist and other trade barriers are growing. For example, quotas, or quantitative limits on imports, which are technically illegal under GATT, are increasingly used. Here the U.S. is a prime offender. Meantime, trade in such services as accounting, advertising, data processing, banking, and construction are barely dealt with by GATT provisions.

The GATT round which convened in Uruguay in September 1986 seeks to deal with both old and new forms of market restrictions. Yet as important as the results will be, much protection will remain. These can be addressed by Free Trade Areas, which specifically are allowed by GATT.[1]

Completely Fair. Removal of all tariffs and quotas is the basic goal of an FTA. Other goals could include elimination of restrictions on trade in services or at least the establishment of standardized treatment of such services by the FTA countries. An FTA also might liberalize the flow of capital and investment funds. Finally, an FTA might deal with export subsidies and even with subsidies to domestic industries. An FTA could be phased in over a period of years, allowing producers in each country time to adjust to the new open trade arrangement. FTAs also allow limited exceptions for particularly sensitive products. An FTA is a completely fair arrangement, since both parties remove their tariffs and quotas.

An FTA differs from a customs union, such as the European Economic Community (EEC). In a customs union, all countries involved maintain a common trade policy toward other countries. For example, tariffs on imports will be the same no matter which customs union country receives the imported goods. In an FTA, each country still maintains its own

1. According to Article XXIV of the GATT, an FTA requires that "the duties and other restrictive regulations on commerce...[be] eliminated on substantially all trade" between two countries.

trade relations with other countries. Controls could prevent "trans-shipping," that is, imports entering the FTA country with the more liberal trade policy, and then being sent straight into the other FTA country to circumvent the latter's more restricted policies.

Eliminating All Tariffs. In 1985 the U.S. signed an FTA agreement with Israel, which takes effect gradually over a decade. Under the agreement, all tariffs between the U.S. and Israel will be eliminated, as will quotas on all goods except certain sensitive agricultural products. Israel has agreed to cease subsidizing exports to the U.S. Protection of intellectual property rights, such as patents and copyrights, has been reaffirmed. Liberal investment policies have been maintained. In addition, the two countries are exploring ways to liberalize substantially trade in services. Any solutions to the service trade problem can later be incorporated into the FTA agreement.

The U.S. currently is negotiating an FTA with Canada. It and the U.S. are each other's largest trading partners. Their total two-way trade is approximately $120 billion, the world's largest bilateral trade relationship. Since Canada, with 25 million inhabitants and a nearly $300 billion gross national product, is larger and richer than Israel, the provisions of this FTA are likely to be more extensive than those of the FTA with Israel.

ECONOMIC ADVANTAGES OF FTAs

The U.S. would gain a number of domestic economic benefits from FTAs. Among the most noteworthy are:

1) **Unrestricted Access** of U.S. Businesses To Foreign Markets. Tariffs, quotas, and other restrictions that currently hinder America's ability to sell in foreign markets would be lifted.

2) **Future Trade Certainty** for American Entrepreneurs. Investors commit capital and other resources well ahead of the time when the goods to be produced will be sold in the market place. Investments in plants and equipment are paid off only over many years. FTAs would eliminate considerable uncertainty for the investor by reducing significantly the chances that a foreign market for his goods would be closed to him in the future by restrictive trade measures.

3) **Lower Prices** for American Consumers. U.S. restrictions on imports currently cost American consumers tens of billions of dollars in higher prices for such products as automobiles, clothing, shoes, and sugar. Elimination of restrictions on countries wishing mutual free trade with the U.S. would lower prices for imports and give greater purchasing power to the American consumer.

4) **More Competitive** American Industries. The challenge of foreign competition gives U.S. producers incentives to increase their efficiency. Protectionism, on the other hand, allows businesses to grow lax and less competitive. FTAs give U.S. businesses incentive to improve. Further, the access to less costly sources of raw materials and semi-finished products provided by FTAs would allow U.S. businesses to cut costs, producing more goods or services for less.

FTAs AND THE GATT

Some critics suggest that GATT negotiations, involving over 90 countries, are a better vehicle for trade liberalization than FTAs, which involve only a few nations at best. There is no conflict, however, between GATT reforms and FTAs.[2] If two countries recognize the economic benefits of open markets, it makes no sense for them to forgo those benefits simply because other countries are not as wise.

FTAs in fact could help the GATT process. For one thing, the current Uruguay Round is dealing with a number of trade problems barely touched in earlier rounds, such as trade in services and subsidies. Solutions to such problems worked out in an FTA could provide precedents and formulae for GATT negotiations. For another thing, with the U.S. negotiating FTAs, other countries will conclude that Washington will not be pressured into accepting limited and half-hearted GATT reforms.

FTAs AND THE THIRD WORLD

Third World economic development would be boosted by FTAs with the U.S. by giving developing countries assured access to a developed market for their products. This access would give competitive industries incentives to expand their operations, rewarding developing countries with faster economic growth. The U.S. would gain greater market access for its higher valued manufactured goods and the developing country would be able to acquire such goods at less cost, further enhancing its economic development.

Finally, an FTA between the U.S. and a developing country would help discourage that nation from using subsidies meant to enhance exports, even if this issue were not dealt with in the original FTA agreement. Open access to the U.S. market for goods that the developing country could produce most efficiently could draw labor and capital to such industries. Third World governments would find it very costly to funnel public funds into less profitable or even money losing sectors for the purpose of export promotion when profitable alternatives are available.

FTAs AND MARKET OPENING LEVERAGE

Beyond their immediate economic benefits, FTAs would create incentives for countries that were not parties to FTAs to join them. Even the opponents of FTAs acknowledge this fact. Testifying before Congress against the FTA with Israel, Stephen Koplan of the AFL-CIO said:

> If agreement can be reached, and Congress approves, it would be the first such free trade arrangement in U.S. history. Its establishment would make future requests from other countries for free-trade areas much more difficult to refuse. The economic and political rationale given by the Administration for establishing a free-trade area with Israel will be cited as precedent by many other countries in the world. Is this initiative the start of the process where similar negotiations

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2. While GATT reforms involve more countries than do FTAs, the reforms will not be as extensive as with a bilateral FTA.

will soon commence with South Korea, the Philippines, or the European Economic Community?

The economic dynamics set in motion by the first few FTAs could lead to more FTAs and give the U.S. leverage against countries that insist on keeping their markets closed to U.S. exports. The U.S.-Israel FTA illustrates this point. Shortly before Israel and the U.S. entered FTA negotiations, Israel had negotiated substantial trade liberalization with the European Community. Without an FTA, U.S. products entering Israel subject to tariffs would have competed at a disadvantage against the European goods subject to lower tariffs. Thus, the incentive for the U.S. was not to close its markets to Israeli goods in retaliation but rather to open Israel's market further to U.S. goods, in this case through an FTA.

Pressure on Japan. The FTAs' potential dynamics were evident during Japanese Prime Minister Yasuhiro Nakasone's January 1986 visit to Canada, shortly after the U.S. and Canada announced intentions to negotiate an FTA. Publicly, Nakasone said he saw no problems for Japan from such an arrangement. Privately, Japanese officials indicated concern about how the FTA would effect Japanese sales in the U.S. and Canadian markets. This is the sort of FTA pressure that the U.S. should exploit.

To some, reciprocity would seem the most effective way to open other markets. Example: If a country maintains a 10 percent tariff on a particular U.S. product, the U.S. could impose the same tariff against the same product from that country. This, however, is prohibited by the GATT's most fundamental principle: Most Favored Nation (MFN) treatment. Under this principle, if the U.S. maintains a 5 percent tariff on certain products from one country, it must maintain a 5 percent tariff on the same products from all other GATT countries. In a world of over 150 nations, therefore, bilateral reciprocity in trade is completely unworkable.

FTAs provide an alternative. Rather than raising tariffs against a more protectionist country, the U.S. could negotiate mutual tariff and quota elimination through an FTA in the major markets of that country. This would give the offending country an incentive to open its own market in return for market openings in the FTA countries.

THE DANGER OF TRADING BLOCS

A critic of FTAs may warn that such arrangements could degenerate into trading blocs that actually would raise trade barriers against non-members. This is unlikely. First, in FTAs, unlike customs unions, each country maintains control over its own imports from non-member nations. It is unlikely that all the interests of both FTA members will coincide and lead to collective action to close both of their markets to imports.

Second, trade bloc practices are more likely to result from the protectionist measures, not from attempts to liberalize trade. For example, in reaction to the Draconian Smoot-Hawley Tariff of 1929, the British introduced tariffs on imports and gave price supports to their farmers to provide import substitutes. They then gave preferential trade treatment to imports from the British Empire and the Commonwealth and instituted a "Buy British" policy within their Empire. This, of course, further contracted world trade and deepened the Depression. This all was in reaction to protectionist U.S. policies. It is hard to imagine such a response to FTAs or other trade liberalizing measures.

AMERICA'S POSSIBLE FTA PARTNERS

A number of countries have approached Washington concerning FTAs. Priority should be given to countries friendly to the U.S. and particularly those of political or security importance.

Among the FTA candidates are:

North America

Senator Phil Gramm, the Texas Republican, and Representative Jack Kemp, the New York Republican, recently introduced legislation calling for a North American FTA. It would include the U.S., Canada, Mexico, the Caribbean, and Central America. Current negotiations for a U.S.-Canada FTA are a fundamental step in this direction. Reagan's Caribbean Basin Initiative (CBI) of 1984 was meant to promote economic growth in that region through open markets, thus preparing some groundwork for integration of this region into an FTA.[3] Mexico traditionally has had a very restricted market, which accounts in large part for its current economic difficulties. Moving Mexico away from its self-destructive protectionist policies will be difficult. Yet the recent entry of Mexico into the GATT, as well as other small market opening efforts, offers some hope, if the U.S. would press the issue.

A North American FTA commands priority for both economic and security reasons. Such an arrangement would surround the U.S. with a ring of prosperous countries better able to purchase American goods and give U.S. businesses access to markets of some 140 million people, with nearly $600 billion in GNP. By promoting prosperity, an FTA would promote political security in Mexico, Central America, and the Caribbean.

Singapore

The city-state of Singapore, with a population of 2.6 million and a GNP of $18 billion, is a small but prosperous country. Singapore has long been interested in an FTA with the U.S. Singapore has a more completely open market than the U.S.

Thailand

A country of 52 million people and a GNP of around $40 billion, Thailand has begun adopting market-oriented economic policies. The result has been impressive economic growth. Thailand has expressed interest in an FTA with the U.S. This would help the Thais and would give the U.S. early entry into a very promising and expanding market.

Republic of China on Taiwan

The Republic of China on Taiwan--or ROC--is one of the developing world's most economically successful nations. The ROC still maintains substantial trade barriers to U.S. goods, which partially is responsible for its $15 billion trade deficit with the U.S. last year. It would serve the ROC's long-term interests to open its markets completely to U.S. goods and, in turn, gain full access to the U.S. market.

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3. U.S. exclusion from the CBI of that region's major commodity, sugar, as well as other products, has dampened CBI's beneficial effects.

Uruguay

Trade protectionism is an economic illness especially widespread in Latin America. Most Latin American countries have kept their markets tightly closed to both foreign goods and direct foreign investments. This in large part has caused the debt crisis. If any region of the world needs trade liberalization, it is Latin America.

Uruguay has expressed interest in an FTA with the U.S. A country of 3 million people with a GNP approaching $7 billion, Uruguay is a particularly good candidate for such an arrangement. Uruguay long has been one of the most prosperous countries of Latin America. Its traditional open market for foreign currencies has won it the reputation as the Switzerland of Latin America. Uruguay therefore has not been as hostile as other Latin countries to economic ties with its neighbors. Latin America sorely needs a local example of a country practicing the open market alternative to protectionism. If Uruguay seeks an FTA with the U.S., negotiations should begin as soon as possible.

Association of South East Asian Nations (ASEAN)

Some Administration officials have privately considered the idea of an FTA with ASEAN, an organization for economic cooperation that includes Brunei, Indonesia, Malaysia, the Philippines, Singapore, and Thailand, with a total population of 300 million and a total GNP of over $200 billion. The strategy of an FTA with ASEAN is promising. Singapore and Thailand individually have expressed strong interest in an FTA. The Philippines at times has expressed mild interest. Indonesia and Malaysia generally have resisted the idea. To gain complete access to America's market, Singapore and Thailand would have a strong incentive to convince their fellow ASEAN members of the wisdom of free trade.

An FTA with ASEAN would open to U.S. products a market now dominated by the Japanese. With a U.S.-ASEAN FTA, the Japanese would be at a distinct disadvantage in competition with U.S. products. This in turn would give the U.S. leverage to further pry open Japan's domestic market to U.S. goods.

RECOMMENDATIONS

The Reagan Administration has acted wisely in negotiating FTAs with Israel and Canada. But those countries are just a start if FTAs are to be a major component in a bold and imaginative policy of trade liberalization. Among the key elements of such a policy would be:

1) "Fast track" authority to negotiate FTAs.

If an FTA is to gain the approval of Congress, the agreement should be voted either up or down, with no amendments. Because of the many interest groups with clout in Congress, amendments would turn into a long list of goods to which the FTA would not apply. This would gut the FTA. Recognizing this, Congress gave the Administration "fast track" authority for the Israel and Canada FTA negotiations. This runs out at the end of the year.

Reagan should seek from Congress special "fast track" authority for FTA negotiations with any interested parties. Under such provisions, the Administration would have to give notice of its negotiating intentions to the House Ways and Means Committee and the Senate Finance Committee, which oversee trade issues. The Administration would be required to solicit the opinions of Congress and interested private groups on each proposed FTA. Yet prior approval to negotiate with a given country would not be required. The completed FTA agreement would then be submitted to the trade committees of Congress for a "yes" or "no" vote and then to the full houses, again for a vote without amendments.

2) Pursue FTAs with any friendly country seeking complete free trade.

Because the FTA concept is new, the Administration has proceeded relatively slowly. Though the FTA agreement with Israel was completed in 1985, talks with Canada will be concluded at the earliest by the end of this year. This pace is too slow to deal with the many countries expressing interest in FTAs. The Administration should move more quickly to begin preliminary talks with these countries.

3) Provide extra staff for the U.S. Trade Representative's Office to negotiate the FTA.

The office of the U.S. Trade Representative (USTR), which handles most trade negotiations, is small and therefore efficient. Yet if market-opening FTAs are to be extended to many other countries, more staff may be necessary, especially for the extensive background work necessary for successful negotiations. For example, extra staff will be needed to work through the most effective use of FTAs as leverage to open the markets of more protectionist countries. Some manpower could be shifted from other federal agencies, while some may have to be hired new.

4) Offer FTAs to countries graduated out of the Generalized System of Preferences.

Under the Generalized System of Preferences (GSP), many developing countries enjoy special market access to the U.S. This is designed to promote worldwide economic development. Yet as these nations become more prosperous, they face graduation out of some or all of the GSP privileges. One of Israel's major motivations for seeking an FTA with the U.S., for example, was fear of losing its GSP status. This surely also will motivate other developing states on the threshold of GSP graduation. The U.S. should use this situation to establish FTAs. The developing states will gain access to U.S. markets. For its part, the U.S. will have a much better chance of exporting American goods to such countries, which by definition are growing and prosperous and in a good position to purchase more American products. FTAs should be offered as a matter of course to any country facing graduation from the GSP.

5) View serious requests for FTAs as a litmus test of a country's intentions to open its markets.

Even in the best of circumstances, expanded use of FTAs will take time to negotiate and time to phase in. In the interim, the Administration will face pressure from Congress to "get tough" with U.S. trading partners. The Administration should resist taking rash action against countries that truly seek more open markets.

The Administration should consider serious requests for FTAs as a litmus test of a country's commitment to an open world market, and avoid especially congressional pressure for protectionist actions against such countries.

Japan, for example, claims to want more open trade with the U.S. The American Ambassador to Japan, Mike Mansfield, has suggested a U.S.-Japan FTA. If Japan takes serious steps to consider this suggestion, it would indicate that they truly wish to reform their protectionist ways.

CONCLUSION

To deal with America's trade problems by closing American markets will only make economic problems worse, and probably lead to a destructive trade war. A better solution is to open markets to U.S. exports as quickly as possible. The Free Trade Area approach is an important means toward this end. Not only would FTAs mean more markets opened to U.S. goods, they would give incentives to countries not party to such agreements to seek trade liberalization as well.

Free trade has played a crucial part in the economic development of the West. Trade and economic difficulties in the U.S. and around the world not only pose the danger of protectionism and closed markets but offer an opportunity to utilize new and creative ways to open markets further. FTAs serve just this purpose and should be employed vigorously by the Administration.

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