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Source: *Proceedings of the Academy of Political Science*, Vol. 37, No. 4, International Trade: The Changing Role of the United States (1990), pp. 37-53
Published by: The Academy of Political Science
Stable URL: https://www.jstor.org/stable/1173771

# Managed Trade and Economic Sovereignty

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The contemporary problem of the global political economy is that nations are losing sovereignty to private economic actors, yet the very turmoil of an unregulated market intensifies the pressure of nations to secure acceptable outcomes for their citizens. Despite the impetus toward an integrated global private economy, the nation-state remains the instrument of political mediation. The state, not private corporations or banks, remains accountable to its citizens for their economic welfare, and it bears the ultimate fiscal responsibility. Moreover, the polity remains the arena in which social contracts are negotiated. Yet the growing imbalance between an integrated, unregulated global economy and a weakened set of national and supranational instruments for its governance deprives individual nations of the machinery to deal constructively with those dislocations. The Keynesian nation-state has lost most of its economic rudder – not to supranational public authority but to internationalized private capital.

The confusion about the appropriate role for the state and the market is at its most muddled in the thinking about the desirable norms for the trading system that governs cross-border commerce, where the reach of the state is weakest and that of private capital strongest. The confusion is perhaps most severe in the United States, because the United States, as guarantor of the global system and purveyor of the ideal of liberal trade, is increasingly unsure how to reconcile those twin goals with its own national interest as an economy. For the most part, official opinion seems to think that the remedy for the dislocations of laissez-faire is more laissez-faire.

The United States, as the hegemon and as the nation most ideologically committed to economic liberalism, experiences these dilemmas most acutely because it is the least conscious of them. By the lights of orthodox economics and the

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An earlier version of this essay was published by the Economic Policy Institute, Washington, D.C.

ideology of the Reagan and Bush administrations, the remedy for the range of international economic problems is the perfection of free trade. But other trading nations, lacking the effortless commercial dominance that postwar America once enjoyed, feel far less guilty about using the economic instruments of the state. Long accustomed to higher levels of both exports and imports as a share of gross national product (GNP) and lacking the American sense of special responsibility for the system as a whole, they developed survival skills and institutions of economic adjustment and development that the United States lacks.[1]

In some countries, such as Japan, South Korea, France, and Brazil, these strategies have been overtly mercantilist. These nations have been willing to use the economic power of the state to promote industrial development, to shelter home markets, and to seek trade surpluses. Other successful small trading nations, such as Sweden and Austria, while supporting a generally open trading system, have devised their own mechanisms of adaptation and indirect subsidy that violate the norms of liberal trade in more subtle ways. Still other nations, in the Pacific Basin, most of them small, have achieved rapid growth by combining entrepreneurial dynamism with very low wages and state support, turning themselves into export powerhouses by letting their domestic consumption lag their production for world markets. Though this is ostensibly a subsidy, it is better understood as a different form of free riding on the trading system, since it depresses demand nationally and hence globally and creates lopsided trade surpluses that are the reciprocal of other nations' trade deficits.

In general, the United States has been the advocate of the purest version of free trade. Most other nations have loyally given lip service to these United States–inspired norms while devising pragmatic measures necessary for their survival in a global economy. At the same time, the United States has been far from the paragon of economic liberalism that it often professed itself to be. Yet because of its fierce ideological commitment to laissez-faire, United States departures from it have typically been poorly thought out, lacking in long-term industrial goals, and generally not helpful either to the trading system or to America's own economic self-interest.

There is thus a grave dilemma, both for the global trading system and for the United States as its chief architect and sponsor. Many other nations have demonstrated, by their actions if not their words, that they are not interested in a system of pure free trade. By some calculations, more than half the cross-border trade that takes place today operates by some other standard than the norms of classical free trade.[2] Yet, curiously enough, the volume of trade continues to increase substantially faster than the growth of total world GNP. The sins against liberal trade vary from economic-development initiatives undertaken by poor countries that might be justified as variations on the traditional "infant industry" loophole, to de facto industrial policies cloaked in national defense, to covert market-closing measures undertaken by the world's richest and most successful trade-surplus nations.

A different order of problem is the institutional disjuncture between trade negotiations, debt negotiations, and the other policy-making machinery that establishes rules for the global economy. One set of diplomats, at the General Agreement on Tariffs and Trade (GATT) in Geneva, is hectoring Third World nations to open their markets to United States, European, and Japanese manufactured goods. A different set of bureaucrats, associated with the World Bank, the International Monetary Fund (IMF), and the private creditor banks, is pressing debtor nations to reduce their imports and increase export earnings. Finally, the most pressing, overarching trade questions, such as the problem of chronic Japanese and West German surpluses and United States deficits in manufactured goods, are widely acknowledged, but these issues are not part of the GATT portfolio; they seem to be on the diplomatic agenda everywhere *but* at the trade talks. Once again, the assumption of liberal economics is that if "barriers" are removed then the "correct" pattern of trade with naturally ensue. The question of Japan's chronic surplus, or of balance in the trading system, are not issues per se, except to the extent that illegitimate trading practices can be demonstrated. Desperation remedies, such as the Gephardt amendment, are then branded as illegitimate because they flout the stated norms of the trading system that the United States champions.

The GATT system, of which more shortly, has only limited criteria for differentiating "good" violations of laissez-faire from bad ones. Aside from giving nations the right to countervail and being somewhat indulgent of statist policies in developing countries, the GATT does not effectively parse out departures from free trade; it has no mechanism for ensuring rough balance in the total calculus of mercantilism. The basic GATT norm is nondiscrimination and the basic GATT goal ever-freer universal market access. All "trade distorting" subsidies are presumed to be bad. All departures from the principle of multilateral nondiscrimination are deemed regrettable. Economic-development schemes, viewed through the GATT lens, are generally damned as merely protectionist, and it is never conceded that they might have positive-sum benefits in the form of technological gains or redistributions of production.

Advocates of liberal trade tend to see themselves as possessors of special virtue, maintaining the dikes against tides of self-serving protectionism. It is presumed that more laissez-faire is invariably better than less, even though economic theory says this is not necessarily true in an imperfect world. There is no taxonomy for sorting out a world of necessary second bests in practice and little recognition of the necessity of economic management, except through the reluctant toleration of escape-clause relief and other "safeguards," in GATT jargon, which are supposed to be temporary and used sparingly.

If this is a problem for the GATT system, it is a special problem for the United States, which tends to see its own self-interest as identical to the liberalism of the trading system as a whole. The United States seems to think that its special mission is to bring laissez-faire to the world, rather than to hammer out with its trading partners a sustainable mixed system that tolerates some state involvement in the economy while maintaining a rough overall balance and providing the United States an equitable share of benefits and costs.

The prevailing United States ideology of economic liberalism eschews industrial goals for the United States. In principle, it is none of the government's business where steel or automobiles or semiconductors or videocassette recorders or civilian aircraft are produced. If production migrates, this must be the market speaking. If the invisible hand operates through the guiding hand of foreign industrial policies, this is deemed to make no significant difference. Classical trade theory holds that if other nations are stupid enough to subsidize their export industries, American consumers ought to welcome the gift. These presumptions have four consequences, all of them negative for the United States national self-interest and confusing to the trading system.

First, the lack of a set of United States industrial goals means that it is impossible to have any trade goals for United States policy, except exhorting other nations to practice laissez-faire in the American image. In practice, this makes America's industrial fate partly the captive of other nations' industrial policies. Second, because the United States continues to view itself as the political leader of the Western world, it is reluctant to play tactical hardball on trade issues, lest it alienate key geopolitical allies. Third, when exhortation fails to achieve equitable results or to open markets, the United States is reluctant to resort to explicit market-sharing remedies, because this, of course, would be a version of the managed trade it claims to disdain and would violate the very ideology it is promoting. Finally, and perhaps most seriously, its devotion to the ideal of laissez-faire means that those United States departures from liberal trade that do intermittently occur are undertaken guiltily and without strategic purpose and are seen by United States officials as unfortunate concessions to domestic politics rather than as economic-development initiatives.

The cases are legion. For example, the United States disingenuously imposed a quota regime on automobiles, disguised as voluntary export restraints (VERs). This allowed Japan to determine just what was exported to the United States and to capture the quota rents; it also exposed Americans as perfect hypocrites. The United States backed into an "industrial policy"– for motorcycles (!) – via a trade-relief case but disdained one for the far more consequential machine-tool industry. It has long had a highly protectionist regime for agriculture, which it does not know how to dismantle, except by having everyone else forswear all price regulation for farm products, which other nations regard as unrealistic and probably cynical. It has had an extensive and unacknowledged industrial policy for aircraft via the Pentagon. And because national defense is the one available loophole in the otherwise seamless ideology of laissez-faire, the Pentagon has sponsored an industrial (and trade) policy for semiconductors, high-definition television, and even an advisory body to the secretary of defense, drawing the seemingly logical conclusion that the Pentagon should widen that sole loophole and simply take over the task of modernizing all of American industry.[3]

An even more stunning example of the self-defeating cost of political hegemony married to laissez-faire economics is American export control. The United States takes a far harder line than its allies in restricting the export of advanced technologies to Soviet bloc nations. This policy not only requires extensive export controls on East-West trade but also limits the ability of United States high-tech producers to export to friendly nations (lest sensitive products be transshipped to the East). As a consequence, United States producers lose billions of dollars worth of export business—a 1988 report by the National Academy of Science conservatively estimated the 1985 annual export loss at $9.3 billion—while other nations understandably view the United States stance of promoting free commerce with one hand while tightly regulating it with the other as confusing, if not idiotic.

In the prevailing ideology, perfect laissez-faire is presumed to be not only the first best but the only defensible goal. As even most orthodox economists will admit when pressed hard enough, it is neither. But without any criteria or taxonomy for sorting out second bests in a necessarily mixed world economy that can never attain pure free trade, this self-defeating pattern keeps recurring. It is the purpose of this essay to explain and evaluate the available second bests. Contrary to the standard assumptions of free traders, the case for managed trade is not simply a set of special pleadings in behalf of retrograde industries but reflects a dissenting analysis of political economy, of the dynamics of trade, and of the interconnections between trade and geopolitics.

## *The New View*

American policy has embraced an increasingly pure devotion to free-trade principles at the precise time that some orthodox economists are having serious second thoughts about whether the traditional theory of comparative advantage is reliable, either as a description of how trade really works or as a norm for optimal policy. The New View has emerged in the work of Paul Krugman, an eminently respectable neoclassical economist at the Massachusetts Institute of Technology and once the staff trade specialist on the Reagan Council of Economic Advisers, and in related work by Avinash Dixit, James Brander, Barbara J. Spencer, and numerous others.

In order to understand the significance of the New View, it is important to recall some of the implications of the Old View, as set forth by David Ricardo in 1817.[4] According to the Old View, countries have *inherent* comparative advantages in particular products because of some intrinsic national characteristics. Ricardo himself simply assumed that international differences in resources and technology would give each country a comparative advantage in certain goods that it could produce with relatively lower labor costs. Later, the Swedish economists Eli Heckscher and Bertil Ohlin argued that comparative advantages were due to differences in "factor proportions": the relative abundance of land, labor, and capital in each country, compared with the relative intensities with which these factors are used in producing various commodities.[5] As formalized by Paul Samuelson, this theory required the assumptions of identical technology in all countries as well as perfect competition in all markets.[6] Under these and other, more technical, conditions, each country will export those goods that incorporate relatively more of its relatively abundant factors.

Whether in the traditional Ricardian or more modern Heckscher-Ohlin-

Samuelson (HOS) variant, the Old View had the powerful implication that *there is a naturally ordained pattern of trade*. The location of industries is not arbitrary: with free trade, industries will automatically be located where they can be most efficiently operated. There are some subtle differences between the two variants. The Ricardian emphasis on different technological capabilities of nations implicity admits that social institutions and public policies can potentially affect a nation's "inherent" comparative advantages. The HOS view, on the other hand, implies a more extreme bias against intervention, since this theory holds technology constant and assumes that only natural and immutable "endowments" of productive factors matter to trade. But both theories imply that there is a unique allocation of industries among countries that is economically efficient at any point in time and that this allocation can be achieved only through free trade.

The New View rejects this conclusion of the Old View. The New View asserts that the location of manufacturing production in the world is not a reflection of any inherent comparative advantages in the traditionally understood sense but is essentially the result of historical accidents. The indeterminacy of industrial location reflects several characteristics of the advanced global economy. These include increasing returns to scale and the ability of firms to "slide down the learning curve." In essence, innovators compete on the basis of entrepreneurial and technological prowess rather than factor endowments. Technological leadership can sometimes flow from such arguably "natural" endowments as a skilled labor force (which itself reflects the policy influence of education and training interventions), but it can also be the deliberate result or fortuitous by-product of more explicit national policy to promote technology.

The significance of the New View is borne out by, among other indicators, the large amount of intraindustry trade, in which trading partners both export and import similar products—a phenomenon that is not predicted by the standard theory of specialization based on comparative advantage. As Klaus Stegemann has observed in studying intraindustry specialization in the context of European integration: "Which country makes which products within any manufacturing industry . . . cannot be explained exclusively on the basis of differences in natural ability or factor proportions. Variables such as entrepreneurial initiative, investment in human capital, research and development, product design, economies of scale, and learning by doing were recognized to be crucial for the expansion of intra-industry trade."[7] These, in turn, are subject to policy intervention. Such intervention, if it leads to technological breakthroughs, may even produce positive-sum benefits.

A somewhat narrower strand of the New View holds that much international trade can be understood as a form of imperfect competition, in which some producers enjoy supernormal profits, or "rents." Contrary to standard theory, such rents are not instantly competed away but persist as innovators enjoy an array of niche positions. Since these rents are widespread, a nation that captures them gains an advantage over its competitors, both in the form of profits and in the continuation of technological dominance. Particular trade policies (tariffs, subsidies, export taxes, and so on) can, under certain circumstances, be shown to raise national income by extracting more of these rents at the expense of foreigners. The deliberate use of such instruments is referred to as "strategic trade policy." These insights embellish an older literature on imperfect competition in international trade, dating back to the early 1900s. However, it is not necessary to demonstrate the presence of oligopolistic rents to show that the capture of leading industries can produce beneficial externalities or that the location of industries may be historically contingent. These points are logically separate.

James A. Brander and Barbara J. Spencer at the University of British Columbia term the process of capturing such rents "profit shifting."[8] Work by Lawrence Katz and Lawrence Summers adds the idea that since most of industry's costs are ultimately labor costs, capturing industries that enjoy supernormal profits also benefits that nation's work force (i.e., its citizens). Workers can capture a share of the profit in the form of wage premiums, or "labor rents," and over time may earn these "rents" by becoming more knowledgeable and hence more productive.[9]

If the location of production, especially in advanced industries, is fundamentally arbitrary, it is arguably subject to manipulation by national-policy interventions, whether microeconomic ones aimed at capturing positions in emerging industries, human capital policies aimed at improving the quality of the work force, or macroeconomic ones intended to influence savings rates, capital costs, and so on. However, the more orthodox version of the New View, while it has blown a big hole in the traditional theory of comparative advantage, has stopped well short of advocating industrial policies for two reasons, one ideological and the other technical.

Ideologically, most orthodox economists remain sufficiently steadfast neoclassicists to harbor grave doubts about the competence of collective action, particularly on the part of politicians responsive to interest groups, to undertake economically optimal policies that could improve on decisions of the market. This enterprise is deemed particularly perilous for the United States, whose political system is said to be uniquely vulnerable to special-interest groups. ("The trouble with picking winners," Senator William Roth recently declared, "is that each Congressman would want one for his District."[10]) Moreover, the technical economics demonstrating the possibility of welfare-enhancing strategic trade policy are dependent on the assumptions of the particular model. Changing an assumption can change whether a particular policy instrument (e.g., tariff, subsidy) ought to be used. Since there are potentially grave informational diffculties in knowing which model can be applied to any given industry, it may be safer to do nothing than to risk using the wrong instrument.

The typical New View paper, especially by economists wishing to keep their neoclassical union cards, takes care to include the disclaimer that even if profit shifting or interventions aimed at generating positive externalities are possible in theory, they are implausible in practice. According to Krugman, most economists who subscribe to the New View are uneasy about giving aid and comfort to mercantilists. Krugman concluded a rueful essay titled "Is Free Trade Passé?" by threading his way between contradictory positions: "To abandon the free trade principle in pursuit of the gains from sophisticated intervention could . . . open the door to adverse political consequences that would outweigh the potential gains. It is possible, then, both to believe that comparative advantage is an incomplete model of trade and to believe that free trade is the right policy."[11]

Nonetheless, the New View radically alters the context of debate, for it removes the premise that nations like Japan that practice strategic trade could not, by definition, be improving their welfare. It means that orthodox economists now concede that advocates of industrial policy are not, by definition, economic illiterates. And it invites a far more subtle policy debate on the instruments and the purposes of departures from Ricardian trade, which is no longer optimal by definition, after all.

## *Free Trade versus Freer Trade*

If economic theory now admits that economic possibility is not directed by the invisible hand and that the textbook characterization of free trade as "first best" does not describe reality, then is becomes advisable to consider the possible second bests —not textbook free trade but *freer* trade. The vain attempt to pursue pure laissez-faire not only disadvantages United States industry but also leaves the world trading system with a dishonest and inefficient blend of subsidy, suboptimal investment, and subterfuge.

In practice, managed-trade modes can improve on the free-trade model, not as it exists in the textbooks but as it actually operates in a world of nation-states. Pure free trade is improbable, and different nations are likely to operate their domestic economics according to fundamentally different rules and structures. Yet it should nonetheless be possible to design a trade regime and a set of operating principles for United States policy that permit dissimilar nations to trade with one another without producing lopsided outcomes. The actual experience of three industries in which the organization of United States trade has consciously departed from the principles of laissez-faire will reveal both good and bad design elements of second-best trade regimes.

In the case of textiles and apparel, the Multifiber Arrangement (MFA) provides a good illustration of a reasonably successful managed-trade regime. The MFA seeks to manage the rate of import growth, thus allowing time for domestic producers to phase out of some production and to automate in other areas where advanced capital can compete with cheap labor. The limitation on a ruinous free-for-all has helped limit worldwide excess capacity and has given new exporting nations the ability to predict and plan for their probable share in a steadily expanding market. Far from retarding innovation, the predictability has facilitated new capital investment in both the industrial and developing nations.

The steel industry offers a good example of what happens when other nations' mercantilism coexists with the United States pretense that free trade reigns. In the 1970s, newly industrializing nations invested heavily in steel capacity. That new capacity came on line just in time for the global economic slowdown following the two oil shocks. The result was a worldwide squeeze on steel earnings and pressure to dump subsidized steel on the world's only large open market: the United States. Because of an unwillingness to admit forthrightly what was occurring, the United States government let serious damage occur before finally negotiating a *fourth*-best solution in the form of "voluntary" export restraints. This is an industry that cries out for a regime that reconciles the desire of major nations to retain some domestic steel production with a common interest in reciprocal reduction of worldwide subsidy costs and global excess capacity.

The semiconductor industry illustrates the reality that different nations simply play by different rules. The Japanese semiconductor industry is part of a conglomeration of horizontally integrated electronics firms. It epitomizes the Japanese habit of pursing technological prowess and market share, notwithstanding what in America would be unacceptable short-term losses. There is no GATT-wide conception of antitrust, and conventional antidumping remedies are not adequate to handle the complexities of semiconductor trade. Moreover, it is clear that the three major trading areas – the United States, Japan, and the European Community (EC) – consider semiconductors so important that they are determined to retain domestic production capacity. Here, even the United States put aside its principles and negotiated a quasi-cartel with Japan, although it has failed to produce the United States market share in Japan that was promised. As in steel, the national and global interest would be served by a regime that acknowledges the reality of managed trade yet promotes competition, innovation, and freer trade.

This brief review of three industries suggests that if nations wish to retain domestic production capacity and not cede their entire market to foreign suppliers, it is possible to design relatively liberal and balanced managed-trade regimes: not free trade but freer trade. However, several caveats are in order.

First, no single template fits all industries. In textiles and apparel, the "threat" to established producers is from low-wage countries; the problem of emerging worldwide excess capacity is tempered by the fact that "capacity" is rather less expensive and long lived than in steel. Moreover, there is plenty of competition among advanced nations to keep competitive pressure on one another and no reason to cartelize that portion of the industry. A regime based on limiting the total rate of increase of imports has been moderately successful – though it produces far more imports in excess of the stipulated quotas than the domestic industry wants.

In steel, on the other hand, the problem is worldwide subsidy and overcapacity, coupled with a near universal desire among nations to retain steelmaking facilities. The present nonregime is a series of purely tactical expedients. The necessary remedy may be a more explicit managed regime based on market shares. In semiconductors, though a reciprocal import-share regime would solve the problem in the home economies of producer nations, it would require an entirely new set of negotiated common principles to establish norms of behavior in third-country markets.

Second, the suitability of managed-trade regimes in some products – steel, textiles, semiconductors, and some farm products, among others – does not mean that a generic system of managed trade is wanted or needed. Ideally, the norm should be roughly that of the GATT– relatively liberal trade, based on the familar principles of multilateral most-favored-nation (MFN) nondiscrimination, national treatment, with limited tolerance for market-distorting subsidies, quotas, and market-closing devices. A GATT-like system should be the residual because that is relatively simpler and cleaner (though, as the long complex history of dumping disputes attests, it is not nearly so simple and clean as its defenders claim).

Even if a liberal trade regime is the residual, however, it is clear that some important nations do not really wish such a regime in some key products. A departure from liberal norms in those product areas need not result in net losses of allocative efficiency. Indeed, such a departure may bring net benefits, if the problems of overcapacity and glut can be frankly addressed, negotiated, and resolved (as they apparently have been in textiles).

The most logical candidates for a managed-trade regime are products for which nations are currently restraining trade and for one reason or another wish to retain or develop technological and production capacity. In that case, if there is widespread reluctance to observe the norms of liberal trade, a frankly acknowledged managed-trade regime, with a balance-of-benefits as the core principle, is vastly preferable to the current patchwork of subterfuges and imbalanced concessions. If, at some point, the members of the GATT wish to shift their managed-trade regime, say in wheat, toward freer and freer trade, that is of course their prerogative.

If managed trade in key industries is legitimate, the United States becomes much freer to press its trading partners – not simply to practice laissez-faire in their own economies (the traditional United States diplomatic goal) but to bring a balance of obligations and benefits to the trading system. The United States is also freed to define industrial goals for its own domestic economy and strategies for carrying them out. Such strategies might or might not require targeted industrial policies in any given sector. Under a managed-trade regime for semiconductors, the United States might choose to subsidize semiconductor research and development via a Sematech consortium. In the case of steel, the United States might decide that holding foreign subsidized steel to a 25 percent market share is sufficient to allow a renaissance in American steel through free market principles, with only a reinvestment quid pro quo and some retraining aid as minimalist industrial policies.

A balance-of-benefits approach is also a better way of reconciling the reality of widespread domestic economic interventions with equity and comity in the trading system as a whole. Simply countervailing against other nations' subsidies or market-closing policies is no solution. In an emerging industry, such as high-definition television, where each major region wishes to develop production capacity, a balance-of-benefits approach could attempt to calculate and negotiate limits on the total amount of subsidy. Nations that wanted their products to be freely traded would have to abide by those limits. Alternatively, a portion of each nation's domestic market could be reserved for domestic suppliers, and the rest could be available for imports, perhaps with auctioned quotas. If trading nations eventually grew weary of ruinous subsidy wars as the industry matured, reciprocal reductions in subsidies could be negotiated.

The recent United States position on farm trade is a splendid illustration of the best being the enemy of the good when it comes to reciprocal reduction of subsidy and oversupply. In the recent Montreal midterm review of the GATT round, the EC urged the United States to pursue a medium-term program of reciprocal reduction of subsidies, with some tolerance for supply and price management and a mutual respect for historical regional export markets. The United States took the position that it would agree to this interim approach only if Europe joined the United States in a grandiose commitment to absolutely free trade in agriculture by the year 2000. The Europeans rightly saw that as a cynical maneuver that the United States delegation contrived in order to seem absolutely devoted to the freest possible trade while winking to assure domestic farm interests that no capitulation was genuinely contemplated. The predictable diplomatic result was impasse. Even the nations that are the lowest-cost producers and the most committed to liberal trade in agriculture, such as Canada and Australia, shared the EC view that partially managed trade in farm products was the only conceivable route toward freer trade.

The point that free traders need to comprehend is that a regime of partially managed trade can be the route to relatively freer and more sustainable trade, as well as to a more balanced and sustainable role for the United States in the system. They should also note that this approach would inject a greater degree of multilateralism into the trading system. At present, in the mind of free traders, the ideal of "multilateralism" is irrevocably yoked to the ideal of "liberal," for both historical and ideological reasons. But these two ideals are logically separable. It is possible to have a trading regime that is slightly less liberal in that it tolerates some explicitly managed trade but is also more genuinely multilateral than the present system in which various subterfuges invariably involve bilateral side deals that do real harm both to the multilateral norms and to the flow of commerce.

There is also the question of overall balance in the trading system. Here, major nations with chronic trade surpluses need to be regarded as free riders. When a nation runs a chronic surplus, it produces more goods than it consumes. That allows the surplus nation to enjoy the benefits of a rather tight fiscal and monetary policy—low rates of interest and inflation—without suffering from a high unemployment rate, because that unemployment is exported. It means, in turn, that the surplus nation's domestic industry has lower capital costs than its competitors, which is likely to lead to a higher rate of productivity growth and hence to exacerbate the imbalance. Surplus nations are a source of exported austerity; they force other nations to depress demand to reduce their current-account imbalances.

Keynes had the right answer. Incentives should be structured into the international monetary and trading systems to encourage surplus nations to expand both their economies and their markets for imports. One approach would be to "tax" nations with chronic surpluses and to have the tax capitalize Third World development and refinancing funds. The Super-301 approach is another remedy. But skeptics are right to be somewhat wary of this remedy, because it makes the United States the aggrieved party, when in fact the aggrieved party ought to be the trading system as a whole.

Here again, if the United States can let go of the twin ideas that the trading system is its special responsibility and that the only defensible set of rules for that system are Ricardian ones, then the United States will paradoxically be in a better position to bargain for systemwide reciprocity, based on the principles of roughly balanced benefits and roughly balanced trading accounts. The European Community proposed something like this standard for the Uruguay Round, but the United States rejected it as smacking too much of managed trade.

With a balance-of-benefits approach, there are several tests of whether a particular nation is playing fair. Over time, it must have overall rough balance in its trade accounts. It is a party to one of the specific managed-trade arrangements outlined above, it must honor them. And its overall pattern of departures from free trade – such as market closings, subsidies, and cartels – must not exceed some negotiated norm. The scheme for holding nations accountable must be elevated to systemwide accountability rather than nation-by-nation retaliation; that would be a real gain for multilateralism. If, for example, Japan is party to a steel arrangement that requires it to open 25 percent of its markets to steel imports and it fails to comply, there should be some automatic consequence imposed by the GATT and not by the United States government (which is worried about military bases). A logical consequence would be that other nations close their 25 percent import markets to Japanese steel.

This essay necessarily treats the subject partly from a systemic perspective – how a managed-trade system could work while still providing the benefits of relatively open commerce and competition. It is also worth dwelling on the United States national interest in such a system. Because of its devotion to the GATT, the United States typically regards all departures from liberal trade as short-term tactical expedients, to be unilaterally given up as soon as possible. By recognizing that managed trade is sometimes the best available option, the United States will be better prepared to differentiate short-term tactical maneuvers from long-term strategic economic goals.

Some Americans willing to embrace a modest dose of planning but skeptical of mercantilism have posed the choice as "protectionism" versus "adjustment."[12] Supposedly, protection means keeping other people's products out, and adjustment means temporary restraints while labor and capital are redirected to "higher value added" sectors, using the policy tools of reskilling workers and perhaps discreetly allocating some capital or subsidizing research. The trouble with this high-sounding middle ground is twofold. First, it does not indicate what to do when other nations' mercantilism pushes the United States out of industries where it would like to maintain some self-sufficiency (steel happens to be a very high value-added industry) and where United States industry is actually or potentially very competitive. Second, while professing to reject laissez-faire purism, it in fact embraces most of the Ricardian shibboleths about trade.

## *Toward a Mixed System*

Trade theory now holds that the location of production in manufactures is not necessarily dictated by inherent comparative advantages. In an imperfect world, national policies can and do capture or create advantages. Substantial trade in which cheap labor, climate, or the presence of natural resources significantly affect relative production costs still proceeds along Ricardian lines. But semiconductors, for example, will be produced most efficiently wherever the best technology has been developed and applied. This is not only true for high-tech products; German firms have successfully applied advanced production technology to the textile industry and remain competitive in global markets on the basis of efficient capital rather than cheap labor.

Politically, the United States has pursued free trade, not because it is necessarily economically optimal either for the United States or for the world economy (though it has convinced itself that it is), but because liberal trade is a logical imperative if one cares to play the role of hegemon. This made sense in the early postwar period, when as the leading nation the United States gained from free trade because its industry was dominant and its products were superior. But America's system goals as hegemon and its national goals as an economy are no longer identical. In order to maintain its hegemonic role, the United States has tolerated asymmetries in the trading system and contorted its domestic responses to the pressures of trade in a fashion that has done serious harm to the United States domestic economy, as well as to the sustainability of the global trading system.

Laissez-faire fails, either as an empirical description of what is or as a normative ideal for what should be, on several grounds. Contrary to classical economics, economies are not self-regulating. History shows that purely private economic forces, left to their own devices, wreak social havoc, distributive injustice, and economic instability, which in turn produce political consequences that are far worse than a preventive dose of economic management. It is not even clear that free markets optimize outcomes in the narrow sense of allocative efficiency.

However, to acknowledge that laissez-faire is a false lodestar and that the costs of a hegemonic role have become economically unsustainable for the United States is not to know precisely what a mixed system ought to look like. It is tricky enough to design a mixed system within national borders, where sovereignty is a setttled question. A mixed system is far more difficult to fashion across national frontiers, in a realm where political sovereignty is widely dispersed. Clearly, a mixed system is far messier than a system of perfectly free trade — though the fairer comparison is with the existing system, which is also highly messy. And even if one could design an ideal system to regulate a global mixed economy, there remains the political problem of negotiating one's way from here to there.

In the United States trade debate, there has been a remarkable confusion of ends with means and of goals with tactics. Incredibly, advocates of tactical hardball aimed at opening closed markets overseas find themselves accused of sabotaging "free trade"—as if enforcing fair play among all trading partners were a betrayal of the principle. Thus, in discussing managed alternatives to free trade, one needs to clarify when these are merely tactical responses to other nations' refusal to honor free-trade norms, as the "Super-301" provision of the 1988 Trade Act is held to be, versus economic-development initiatives that make sense in their own terms. Because of the widespread support among American conservatives for laissez-faire, domestically as well as globally, departures from Ricardian trade are usually defended only in tactical terms and seldom as necessary measures of domestic industrial development.

This essay assumes that departures from Ricardian trade in most countries are seldom merely tactical. Moreover, there are sectors in which managed trade makes sense to achieve stabilization, to enhance productive innovation, and to get nations to operate according to rules that are at least universal and reciprocal, if not Ricardian. The United States should not manage trade in, say, semiconductors merely as a lever to win concessions that move the entire system toward freer semiconductor trade. For the moment, retaining and restoring United States capacity in that crucial sector takes priority over liberalization of markets as a trade-system goal, especially if America's major trading partners insist that they wish to develop and maintain their own semiconductor capacity. It is not helpful to disguise that goal as a tactic aimed to make Japan "play fair" and open its market to products that the United States may no longer make, thanks to earlier Japanese mercantilism.

On the other hand, there may be industries and moments when nations conclude that the sum total of interventionist subsidies and other market manipulations are imposing total costs that exceed benefits and may wish to negotiate reciprocal limits on such subsidies and greater mutual market access. Agriculture—in which trade does take place more nearly according to comparative advantages—is a case in point. One must also be clear about whether allowing room for industrial policy and complementary managed trade is to be understood as a unilateral attempt to capture advantage at the expense of other nations or whether managed trade can have positive-sum benefits for the system as a whole in the form of technological innovation, stabilization, and diffusion of productive wealth. To the extent that the United States wishes to remain an influential and well-behaved citizen of the trading system (though perhaps not its hegemon), it does not wish to revert to Japan-like unilateralism.

## *Trade Policy in the National Interest*

Much of the debate about free trade, managed trade, industrial policy, and so forth is confused by implied conceptions of the "national interest." From the perspective of traditional economic liberalism, questions of national interest are limited to narrow military and geopolitical security. There is also a supposed abstract and generalized consumer interest in free trade, which is treated in isolation from the influence of trade on domestic productive employment. To the extent that an open trading system wins friends for the United States, liberal trade complements traditional national-security goals. In this conception, there is no room for an economic national interest defined in terms of industrial objectives, nor are there geopolitical economic goals beyond those that supposedly flow naturally from free markets. By definition, the freest possible market yields results that are "natural" and hence optimal. Even if other trading nations violate those norms, the United States still allegedly gains both economic and geopolitical advantage by practicing liberal trade. The possibility of a national interest colliding with Ricardian trading norms is thus neatly excluded by definition.

This perspective, however, begs several questions. In practice, one can identify several concrete goals for the United States economy, which do not necessarily result from a conventional free-trade environment—particularly when that environment is lopsided. These goals include full employment at decent wages, rapid productivity growth, rising levels of real income distributed equitably, retention of technological leadership in a broad spectrum of major industries, maintenance of a skilled work force, and so on.

It is conventional to argue that "we" must do this or that for the economy to thrive, but it is not always clear to whom "we" refers. For example, the interests of American-based banks and multinational corporations, which are key advocates of liberal trade, are not always identical to the goals of high and rising living standards for the American people and the maintenance of technological leadership within the United States. The relative merits of different approaches to trade policy need to be weighed against true national objectives (rather than narrow corporate ones), and in the context of other United States foreign-policy objectives, with which trade objectives sometimes compete.

We now have come full circle to the aspirations of the early postwar regime: the ceding of some national economic sovereignty to supranational public authority, the better to permit individual nations to operate mixed economies at home. In the late 1940s, this vision stalled because the real supranational authority was the hegemonic supremacy of the United States. But in the 1970s and 1980s, as national sovereignty has been ceded to global private capital and the hegemonic position of the United States has weakened, the American protectorate became no longer entirely viable. The fact that the two emerging rival centers of economic power—the EC and Japan—are both more comfortable with a mix of mercantilism and liberalism makes it that much more likely that a mixed trading system is the only durable alternative and that the rules should acknowledge the reality. This essay has suggested that, by adjusting its hegemonic ambitions to its economic capacity and by modifying its concomitant devotion to laissez-faire as a standard for itself and others, the United States will be in a better position both to work toward a sustainable, multilateral trading regime and to define and advance its own national interests. But, obviously, ceasing to play the hegemonic role will involve not only a change of habits; it will involve a loss of perquisites.

Readers should not mistake this observation for the wish that the United States play a less influential global role. There was a time when the United States loomed so large that it could play the role of hegemon and serve its national economic interests as well as its goals for the trading system and for the Western alliance. And for the most part, the United States threw its economic weight around in a remarkably enlightened fashion. The issue is not whether it would be nice to maintain that role; the relative shrinkage of the United States economy makes such a role unsustainable. The issue is how best to adjust to the new realities.

Playing a different role will require a drastic revision of some foreign-policy fundamentals. If the United States ceases to function as hegemon, it will no longer be able to confer economic benefit in exchange for geopolitical foreign-policy goals. It will be more subject to the discipline of membership in a global system. It may have to defer more to European and Japanese wishes with regard to East-West issues, Third World debt, arms control, the environment, and other policy areas where the United States has generally expected that if its views do not always carry the day at least they frame the agenda. It may have to defer more to Third World interests, too. All of this might even be salutary. Fortuitously, these shifts are also happening just as the Soviet Union is becoming more respectful of pluralism.

The scholars who investigate the logic of hegemony and global economic stability are divided on the question of whether a stable global order is possible on the absence of a hegemonic nation. The interwar period is a chilling precedent. But clinging to the illusion of American hegemony in a laissez-faire world will only weaken the United States economy and the global economic order. The United States is no longer preeminent, and most other nations favor a mixed form of capitalism rather than laissez-faire. The United States had better work toward the goal of a stable, pluralist system because all the economic indicators suggest that a pluralist world now exists.

## Notes

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2. Pat Choate and Juyne Linger, "Taylored Trade: Dealing with the World as It Is," *Harvard Business Review* (January-February 1988), 91.
3. Defense Science Board Report to the Secretary of Defense (Fuhrman Report), Washington, D.C., October 1988.
4. See David Ricardo, *Principles of Political Economy and Taxation*, 3d ed. (1821; Cambridge: Cambridge University Press, 1951).
5. See Eli Heckscher, "The Effect of Foreign Trade on the Distribution of Income" (1919), in *Readings in the Theory of International Trade*, ed. Howard S. Ellis and Lloyd A. Metzler (Philadelphia: Blackiston, 1950); and Bertil Ohlin, *Interregional and International Trade* (Cambridge, Mass.: Harvard University Press, 1933).
6. See Paul A. Samuelson, "International Factor-Price Equalisation Once Again" (1949), in *International Trade: Selected Readings*, 2d ed., ed. Jagdish Bhagwati (Cambridge, Mass.: MIT Press, 1987).
7. See Klaus Stegemann, "Policy Rivalry among Industrial States: What Can We Learn from Models of Strategic Trade Policy?," *International Organization* 43 (Winter 1989): 75–76.

8. See James A. Brander, "Rationales for Strategic Trade and Industrial Policy" in *Strategic Trade Policy and the New International Economics*, ed. Paul Krugman (Cambridge, Mass.: MIT Press, 1986), 23–46; Barbara J. Spencer, "What Should Trade Policy Target?," in ibid., 69–90; and Stegemann, 75.

9. See Lawrence Katz and Lawrence R. Summers, "Can Inter-Industry Wage Differentials Justify Strategic Trade Policy?" (Cambridge, Mass.: National Bureau of Economic Research, September 1988).

10. William Roth (Speech to Chicago Council on Foreign Relations, 11 April 1989).

11. Paul Krugman, "Is Free Trade Passé?," *Journal of Economic Perspectives* 1 (Fall 1987): 143.

12. Robert B. Reich, "Beyond Free Trade," *Foreign Affairs* 61 (Spring 1983): 773–804; and Gary Clyde Hufbauer and Howard F. Rosen, *Trade Policies for Troubled Industries* (Washington, D.C.: Institute for International Economics, 1986).