Chapter 2: The Multilateral Trade System

International trade has grown rapidly since the end of the Second World War. The total number of goods exported by all countries each year has grown at an average rate of 6 percent per year since 1950. In 2000, the countries of the world traded goods and services worth a total of $7.6 trillion (WTO 2001, 9). To put this number in perspective, on average, about one out of every four dollars of income in each country in the world is either earned by exporting goods and services to foreign markets or is spent on goods and services produced in foreign countries. Not only has international trade increased over the past fifty years, it has grown consistently more rapidly than world economic output. Thus, each year a larger share of countries’ national incomes, and the production and employment that create these national incomes, becomes dependent upon international trade.

The historically unprecedented expansion of international trade since World War II is in large part a product of the multilateral trade system. The multilateral trade system is both a political process and a set of political institutions. The political process is based on negotiations between governments. Through this bargaining process, governments create trade rules to govern their behavior toward each other and open
their markets to each other’s exports. The political institutions, initially the General Agreements on Tariffs and Trade and now the World Trade Organization, provide the rules of the game, facilitate trade negotiations, and more generally promote international trade cooperation. Trade has expanded so rapidly since World War II in large part because governments have used this multilateral trade system to progressively eliminate national barriers to international trade. If we are to understand international trade politics, therefore, we need to understand the political dynamics of the multilateral trade system.

This chapter focuses on four questions about the multilateral trade system. We start by asking the simplest question: what is the multilateral trade system and how does it operate? Once we know what the multilateral trade system is, we begin to investigate why it exists. This concern leads us to two questions. First, what purpose does the multilateral trade system serve? If international trade is such a good thing, why do governments need an international political system and a specialized international institution to achieve it? Second, what are the political foundations upon which the multilateral trade system is based? The creation of this system was in no sense inevitable, and the current system represents only one of many possible ways to organize international trade. Thus, why was the multilateral trade system created in its current form, and what factors will determine how long it lasts? Our fourth question focuses on the consequences of the multilateral trade system. How has the process of trade liberalization altered the world economy, and what impact has it had on national politics? Answering these questions will provide a solid introduction to the political dynamics of the multilateral trade system.
A. The Multilateral Trade System

The multilateral trade system is an international political system. International trade institutions stand at the center of this system. Throughout most of the postwar period, the General Agreement of Tariffs and Trade (GATT) was the principle international trade institution. In 1994, the GATT was folded into a new international institution called the World Trade Organization (WTO). In contrast to the GATT, which was a treaty, the WTO is an international organization that enjoys the same legal status as other international organizations such as the United Nations, the World Bank and the International Monetary Fund. Based in Geneva, Switzerland, the WTO is a relatively small international organization. Although 141 countries belong to the WTO, it has a staff of only 500 people and a budget in the year 2000 of only about $225 million. Its functions include administering trade agreements, providing a forum for trade negotiations, providing a mechanism through which governments can resolve trade disputes, and monitoring national trade policies. Although the WTO is now the institutional center of the world trade system, the GATT has not disappeared. The GATT continues to provide many of the rules governing international trade relations. The creation of the WTO, therefore, represented an organizational change, but it did not produce a new set of international trade rules. The rules at the base of the multilateral trade system are those that were initially established in 1947 and have been gradually revised and amended since that time.

The multilateral trade system can be broken down into three individual components: an inter-governmental bargaining process, a set of rules governing international trade relations, and a dispute settlement mechanism. As an inter-governmental bargaining process, the GATT/WTO focuses on the liberalization of
international trade. Trade liberalization has been achieved through a series of bargaining rounds that have taken place since 1947. Eight such rounds have been held, and a ninth, called “The Millennium Round,” is currently being prepared (see table 2.1).

These bargaining rounds are extended affairs. The Uruguay Round, for example, was officially launched in 1986 (though it had been discussed since 1982) and was not concluded until December 1994. A bargaining round brings WTO members together to negotiate an agreement covering a specific set of trade-related issues. Negotiations under the Uruguay Round, for example, included tariff reductions in manufacturing, international trade in services, the protection of intellectual property, and trade in textiles and apparel.

(Table 2.1: Trade Negotiations within the GATT, 1947-2001)

Governments have used these bargaining rounds to progressively reduce tariffs on manufactured goods and to address other obstacles to international trade. Tariff reductions were the principal focus of the first six GATT rounds (table 2.2). At the end of the Second World War, tariffs on all manufactured goods for all GATT members averaged about 40 percent. Through successive GATT rounds, governments have progressively reduced these tariff rates. Average tariffs had fallen to 9 percent by the end of the Kennedy Round. Today, the average tariff on manufactured goods is about four percent, and some analysts have suggested that tariffs have ceased to be an important barrier to international trade in manufactured goods (Jackson 1998).

(Table 2.2: Average World Tariffs, 1947-2001)

Governments have also used the GATT/WTO process to develop multilateral rules for other trade-related issue areas. During the Tokyo Round, for example, governments addressed non-tariff barriers to trade—such things as health and safety
Table 2.1  Trade Negotiations within the GATT, 1947-1993

<table>
<thead>
<tr>
<th>Name and Year of Round</th>
<th>Subjects Covered</th>
<th>Participating Countries</th>
</tr>
</thead>
<tbody>
<tr>
<td>1947 Geneva</td>
<td>Tariffs</td>
<td>23</td>
</tr>
<tr>
<td>1949 Annecy</td>
<td>Tariffs</td>
<td>13</td>
</tr>
<tr>
<td>1951 Torquay</td>
<td>Tariffs</td>
<td>38</td>
</tr>
<tr>
<td>1956 Geneva</td>
<td>Tariffs</td>
<td>26</td>
</tr>
<tr>
<td>1960-61 Dillon Round</td>
<td>Tariffs</td>
<td>26</td>
</tr>
<tr>
<td>1964-67 Kennedy Round</td>
<td>Tariffs and Anti-Dumping</td>
<td>62</td>
</tr>
<tr>
<td>1973-79 Tokyo Round</td>
<td>Tariffs</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Non-tariff measures</td>
<td>102</td>
</tr>
<tr>
<td></td>
<td>Framework agreements</td>
<td></td>
</tr>
<tr>
<td>1986-1993 Uruguay Round</td>
<td>Tariffs</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Non-tariff measures</td>
<td>123</td>
</tr>
<tr>
<td></td>
<td>Rules</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Services</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Intellectual property rights</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Textiles and clothing</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Agriculture</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Dispute settlement</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Establishment of WTO</td>
<td></td>
</tr>
</tbody>
</table>

Table 2.2: Average World Tariffs, 1947-2000

<table>
<thead>
<tr>
<th>Year</th>
<th>Average Tariff</th>
</tr>
</thead>
<tbody>
<tr>
<td>1947: GATT Established</td>
<td>38%</td>
</tr>
<tr>
<td>1962: Pre-Kennedy Round</td>
<td>17%</td>
</tr>
<tr>
<td>1972: Post-Kennedy Round</td>
<td>9%</td>
</tr>
<tr>
<td>1987: Post Tokyo Round</td>
<td>6%</td>
</tr>
<tr>
<td>1994: Post Uruguay Round</td>
<td>4%</td>
</tr>
</tbody>
</table>

regulations and government procurement practices. During the Uruguay Round, governments created new multilateral rules in three areas. First, governments created multilateral rules to protect intellectual property (see Ryan 1998; Sell 1998). According to the World Intellectual Property Organization (one of the United Nations’ specialized agencies), intellectual property “refers to creations of the mind: inventions, literary and artistic works, as well as symbols, names, images, and designs used in commerce.” This includes such things as the Nike “swoosh”, a Hollywood film, and computer software. Intellectual property is protected through patents and copyrights that give the creator the exclusive right to profit from his or her invention or artistic work. It became apparent during the 1980s, however, that many governments were not protecting foreign firms’ intellectual property. This enabled firms and individuals to profit by making counterfeit versions of Microsoft software, American movies, Nike and Adidas sneakers, Calvin Klein and Guess jeans, pharmaceutical products, and other items. Such piracy, as this practice came to be called, reduced the earnings of the original inventors and artists and, many argued, reduced the incentive to invent new products. In negotiating Trade-Related Intellectual Property Rights (TRIPs), governments created multilateral rules that would oblige those countries that were not currently enforcing intellectual property rights to do so.

Second, international trade in services was brought into the multilateral regime. A service is an economic activity that does not involve manufacturing, farming, or resource extraction. Such a broad definition incorporates a wide range of activities, including financial services (banking and insurance), transportation services (shipping, tourism), business services (management, consulting, accounting), and communications services (telecommunications, courier services). Services accounts for about 60
percent of economic activity in the advanced industrialized countries and for about 22 percent of world trade. Moreover, during the 1980s and 1990s international trade in services grew more rapidly than did trade in manufactured goods (Hoekman and Kostecki 1995, 127). Yet, in spite of the importance of service sector activities, there were no rules governing international trade in services. The General Agreement on Trade in Services (GATS) provided a framework for a limited amount of liberalization and for negotiations aimed at further liberalization (Hoekman and Kostecki 1995, 141). Such negotiations have been ongoing in basic telecommunications, maritime transport, and financial services since 1995.

Finally, governments created a set of rules governing policies toward the foreign direct investments made by multinational corporations. Known as Trade-Related Investment Measures (TRIMs), these rules were designed to reduce governments’ abilities to impose import or export requirements on multinational corporations operating in their countries. We will examine TRIMs in greater detail in our discussion of multinational corporations in chapter five.

The multilateral trade system’s rules provide the legal framework for international trade relations. They specify how governments are to treat each other and what types of trade policy measures they can and cannot use. These rules are quite extensive; since 1947 governments have negotiated about sixty agreements that together fill about 30,000 pages. The text of the GATT alone, which spells out the basic rules governing international trade in goods, is more than fifty pages long. Four principles embodied in these rules provide the foundation upon which the multilateral trade system is based. Market-based liberalism is the broadest of these principles. According to market-based liberalism, the liberalization of international trade is a desirable objective.
because free trade raises all countries’ standards of living. We will examine the logic behind this claim in greater detail in the next section. For now it is sufficient to note that this principle provides the justification for an international institution oriented toward the creation and maintenance of a liberal trading system.

Non-discrimination is the second principle. The principle of non-discrimination is contained in Article I of the GATT, which states “Any advantage, favour, 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.” Stripped of the legal terminology, Article I requires each member of the WTO to treat all other WTO members as well as it treats its most-favored trading partner. For example, under this principle of “Most Favored Nation” (MFN) the United States cannot impose lower tariffs on goods it imports from Brazil than it imposes on the goods it imports from other countries. If the U.S. wants to reduce the tariffs it imposes on goods it imports from Brazil, it must extend these same tariff rates to all other members of the WTO.

The WTO does allow some exceptions to the principle of non-discrimination. Under the Generalized System of Preferences advanced industrialized countries can grant preferential treatment to imports from developing countries. Governments can also extend preferential treatment to countries with which they enter free trade areas or customs unions. These exceptions aside, non-discrimination is a fundamental principle of the multilateral trade system.

Third, the multilateral trade system is based on the principle of reciprocity. Reciprocity ensures that any trade concessions made by governments through the multilateral bargaining are mutually beneficial. When one country agrees to reduce
tariffs on imports from a second country, it has the right to expect the other country to make tariff concessions of equal value in return. For example, if the United States offers to reduce its tariffs on steel imported from Brazil, Brazil must offer to reduce tariffs on goods it imports from the United States, say computers rather than offer a reduction on something that the U.S. does not produce, such as coffee (except for a little bit of Hawaiian Kona). The principle of reciprocity, therefore, attempts to ensure that the concessions that each country makes in the multilateral trade negotiations are equaled by the concessions it gains from its trading partners.

Finally, multilateral trade rules incorporate “domestic safeguards.” Domestic safeguards are escape clauses that allow governments to temporarily opt out of commitments they have made when “changes in the domestic or international [economy] mean that compliance would seriously undermine the well-being of part or all of their population” (Finlayson and Zacher 1985, 290). For example, during the late 1990s and early 2000s, the world price of steel fell sharply, resulting in a surge of steel imports into the United States. This import surge hurt American steel producers who lost markets to foreign producers. The safeguards incorporated in the WTO allow the United States to raise tariffs on imported steel temporarily to protect American steel producers from these imports. Governments cannot resort to such safeguards without first undertaking an intensive investigation, however, to determine whether the difficulties experienced by a domestic industry are in fact a result of a sudden import surge. In other words, even though multilateral rules allow governments to opt out of their commitments for short periods, they limit their ability to do so.

Dispute settlement is the multilateral trade system’s third component. Trade disputes arise when one government believes that another is failing to live up to
obligations it has accepted as a member of the WTO. Such disputes can involve a violation of either the broad GATT rules or of a specific trade agreement. In February 2000, for example, Japan turned to the dispute settlement mechanism to challenge a U.S. decision to invoke the domestic safeguards rule and raise tariffs on Japanese steel imports. In such cases, the injured party can initiate a WTO process that formally evaluates the legal merits of the complaint. When a country is found to be in violation of its WTO obligations, the government is required to alter its policy to conform with WTO rules or to compensate the injured party. The dispute settlement mechanism thus provides a quasi-judicial procedure through which trade disputes between WTO members can be resolved. We will examine the WTO’s dispute settlement mechanism in greater detail in the next section.

In short, the multilateral trade system is a political system. Multilateral institutions provide rules that set parameters on governments’ trade policies. Within this multilateral framework, governments amend existing rules and create new rules through a process of intergovernmental bargaining. Throughout the postwar period, this bargaining process has progressively reduced tariffs and created new multilateral rules through which to govern international trade. Finally, the system provides a dispute settlement mechanism to enforce compliance with the rules that governments have created.

B. The Problem of Trade Cooperation

Why do governments need such an elaborate multilateral framework? If trade liberalization is something that most governments want to achieve, and the progressive reduction of tariffs during the last fifty years suggests that it is, then why don’t they just
liberalize trade? Why is it necessary to engage in complicated multilateral trade negotiations? Why must governments create an elaborate set of international rules to govern their activity, and why must they create an international tribunal through which to settle their disputes? In short, why is the World Trade Organization necessary? The WTO is necessary because even if we accept the claim that free trade benefits all countries, politics make it difficult to realize these benefits. The WTO helps governments solve these political problems and thereby enables governments to realize the gains from liberal trade.

1. Neo-classical Trade Theory and the Gains from Trade

The multilateral trade system is based on the principle that all countries are better off if they engage in trade than they are if they do not. Moreover, the system suggests that these gains are greatest—for each country and for the world as a whole—when goods can flow across borders unimpeded by government-imposed barriers. Now, we could ask whether this principle is correct (do all countries gain from trade?) and we could ask whether this principle should be the core principle of the multilateral trade system (maybe equity is a better principle than efficiency?). These are good questions, but for now let’s focus on the theoretical logic underlying this principle. Doing so will not only allow us to better understand the multilateral trade system’s core principle, but it will also allow us to consider how politics complicates trade liberalization even in the best of all possible worlds—where trade is mutually beneficial.

The claim that international trade benefits all countries is based on economic theories of comparative advantage. The theory of comparative advantage makes one very simple point: if a good costs less to buy in a foreign market than it does to produce
at home, a country is better off if it imports the good than if it produces the good itself.  
Imagine a simple barter economy (an economy without money in which one good is 
traded directly for another) with two countries that each produce two goods, say wine 
and cheese.  In this barter economy we ask how much does one good, a pound of 
cheese, cost in terms of the second good, a bottle of wine?  There are two prices for 
cheese in terms of wine.  The domestic price tells us how much wine one must exchange 
to acquire a pound of domestic cheese.  The foreign price tells us how much wine one 
must exchange to acquire a pound of foreign cheese.  If the foreign price of cheese is 
less than the domestic price of cheese, the nation gains wealth if it stops producing 
cheese, specializes in the production of wine and exchanges this wine for foreign cheese. 
In other words, by specializing in the production of one good and importing the other, 
the country can consume more wine and cheese than it could if it continued to produce 
both goods at home.

The theory of comparative advantage takes one additional step and asks why 
one good is cheaper in one country than in another.  Two different models of 
comparative advantage have been developed.  In the Ricardian model, named after 
David Ricardo who developed it in the 19th century, price differentials reflect different 
labor productivities in the two industries in the two countries.  In the example used 
above, domestic labor is relatively more productive in the wine industry than in the 
cheese industry, while foreign labor is relatively more productive in the cheese industry 
than in the wine industry.  Thus, in the domestic economy a given amount of labor 
produces more wine than cheese whereas in the foreign economy a given amount of 
labor produces more cheese than wine.  If we relate these differences in labor 
productivity back to international trade, the Ricardian approach suggests that by
specializing in the production of the good it produces with relatively little labor and exchanging it for the good it produces with a relatively greater amount of labor, a society is able to acquire more goods from a given amount of labor than it can if it continues to produce both goods at home.

The second model of comparative advantage, the Hecksher-Ohlin model, argues that comparative advantage is based on different factor endowments. Factors of production are the basic tools of production. When firms produce goods, they combine land, labor, and capital in specific amounts in order to transform raw materials into finished goods. While land and labor are relatively obvious as factors of production, capital needs a bit more explanation. Capital is the stock of society’s resources that contribute to current production (Schultze 1992, 236). Often when we think of capital we think of tangible things, like the machines and factories that are used to produce goods. Capital is not restricted to machines and factories, however, but is also human capital, which is produced through education.

Countries are differently endowed with the factors of production. Some countries, like the United States, have a lot of capital and relatively little labor. Other countries, like Mexico, are relatively abundantly endowed with labor but relatively poorly endowed with capital. Countries’ relative factor endowments determine relative factor prices. A country’s abundant factor will be relatively cheap, while its scarce factor will be relatively expensive. In the United States and other developed country economies, therefore, we should expect capital to be relatively cheap and labor to be relatively expensive. In Mexico and other developing country economies, we should labor to be relatively cheap and capital to be relatively expensive.
Because countries have different factor endowments, they have comparative advantages in different goods. A country will have a comparative advantage in goods that use their abundant factor intensively and a comparative disadvantage in producing goods that use their scarce factor intensively. An example can make this clearer. In producing automobiles payments to labor account for between 25 and 30 percent of the total cost, while the other costs of production arise from expenditures on the machines, the assembly lines, and the buildings required to build cars (Dicken 1998). In manufacturing clothing labor accounts for the largest share of the costs of production and capital expenditures are considerably less. Thus, countries with a relative abundance of capital and scarcity of labor have a comparative advantage in producing cars and a comparative disadvantage in producing clothing. While the Ricardian and Hecksher-Ohlin models highlight different determinants of comparative advantage, both reach the same conclusion about international trade. A country will be wealthier if it specializes in the production of goods in which it has a comparative advantage and trades these for goods in which it has a comparative disadvantage than it will be if it produces both goods at home.

It is important to recognize the difference between absolute advantage and comparative advantage. A country has an absolute advantage when its production costs for a particular good are lower than all other countries’ production costs. By contrast, a comparative advantage implies only that a country is relatively better at producing one good rather than another. The distinction is important because theories of comparative advantage tell us that countries need not have an absolute advantage in any good to benefit from international trade and that even a country that has an absolute advantage in all goods gains by specializing in those it makes relatively more cheaply
and exchanging them for the goods it makes at a relatively higher cost.

The importance of comparative rather than absolute advantage in determining the gains from trade can be clarified with a simple example. Suppose it takes 1 unit of labor to produce a gallon of wine and 3 units of labor to produce a pound of cheese in France (table 2.3). Suppose that in Denmark it takes 2 units of labor to produce a gallon of wine and 4 units of labor to produce a pound of cheese. In this example, therefore, France has an absolute advantage in the production of wine and cheese. It takes less labor to produce a gallon of wine and a pound of cheese in France than it does in Denmark. In spite of this disadvantage, however, Denmark gains from trading with France. In Denmark a pound of cheese buys two gallons of wine. In France, however, a pound of cheese will buy three gallons of wine. By specializing in cheese and trading with France, Denmark can consume one additional gallon of wine for each pound of cheese it produces compared to what it would be able to consume if it produced both goods at home. Thus, Denmark gains from specializing and trading with France.

(Table 2.3: Labor Costs of Production for Wine and Cheese)

And even though France has an absolute advantage in both goods, it gains by specializing in wine and importing cheese from Denmark. In France, a pound of cheese costs three gallons of wine. In Denmark, however, a pound of cheese costs only two gallons of wine. If France specializes in wine production and imports cheese from Denmark, it can consume one additional pound of cheese for each six bottles of wine it produces. Thus, even though France produces wine and cheese more cheaply than Denmark, France gains by specializing in the product that it produces relatively more efficiently, wine, and trading for Danish cheese. In short, trade based on comparative
Table 2.3: The Wine and Cheese Trade in Denmark and France

<table>
<thead>
<tr>
<th></th>
<th>Labor Cost of Production</th>
<th>Price of Wine in Terms of Cheese</th>
<th>Price of Cheese in Terms of Wine</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Wine</td>
<td>Cheese</td>
<td></td>
</tr>
<tr>
<td>Denmark</td>
<td>2</td>
<td>4</td>
<td>1/2</td>
</tr>
<tr>
<td>France</td>
<td>1</td>
<td>3</td>
<td>1/3</td>
</tr>
</tbody>
</table>

advantage makes Denmark and France better off.

In sum, theories of comparative advantage tell us that trade raises national wealth. All countries can attain higher standards of living by producing goods in which they hold a comparative advantage and trading for goods in which they hold a comparative disadvantage. Moreover, every country, no matter how poor, has a comparative advantage in something. Thus, all countries gain from international trade.

2. The Politics of Trade Liberalization

Politics make it difficult for governments to realize the gains available from international trade. The political problem has two parts, which can be briefly summarized before we examine each in greater detail. First, governments rarely open themselves to trade unilaterally. Instead, trade liberalization typically occurs through international agreements that provide reciprocal tariff reductions. The U.S. will reduce its tariffs, for example, in exchange for tariff reductions made by Japan. Second, governments are reluctant to conclude such trade agreements because they cannot enforce them. The concern that the other might cheat on a trade agreement, in conjunction with an inability to prevent such cheating can prevent governments from concluding reciprocal agreements in the first place.

Trade liberalization typically occurs through a process of reciprocal trade agreements. It does so because when governments deal with trade policy they tend to stand the logic of trade theory on its head. Trade theory suggests that imports are good because they allow societies to consume things more cheaply. And while exports are not necessarily bad, they are the price societies must pay to import. From the perspective of trade theory, therefore, societies should seek to import as much as
possible in exchange for as few exports as possible. Unilateral liberalization is perfectly sensible in this framework. Governments tend to adopt the opposite perspective. Rather than seeking the expanded consumption possibilities that result from trade, governments believe that exports are good and should be expanded as much as possible while imports are bad and are to be limited as much as possible. Unilateral trade liberalization makes no sense in this perspective.

Why do governments invert the logic of neo-classical trade theory? The answer lies in the domestic politics of trade policy, a topic we examine in greater detail in the next chapter. For our purposes here it is sufficient to note that producer interests tend to be over-represented and consumer interests tend to be under-represented in trade policy. As a result, governments care less about how trade affects consumption possibilities and care more about how it affects production. And not all producers benefit from liberal trade. Some producers do gain from trade liberalization, but others will lose. Producers based in sectors in which the country has a comparative advantage will see their export opportunities expand from trade liberalization. Producers based in sectors of the economy in which the country is at a comparative disadvantage will suffer increased competition and eventual income losses from trade liberalization. As a general rule, therefore, governments strive to open foreign markets to their competitive industries while continuing to protect their less competitive industries.

Because governments want to expand their exports and view imports as the necessary cost of doing so, trade liberalization typically occurs through reciprocal agreements. Returning to our example above, suppose that France and Denmark both impose high tariffs in their comparatively disadvantaged sectors. France imposes a high tariff on Danish cheese and Denmark imposes a high tariff on French wine. And while
neither will reduce these tariffs unilaterally, France will reduce its tariff on Danish cheese if Denmark reduces its tariff on French wine. A reciprocal agreement will allow French and Danish exports to expand at the same time. And while each will also experience an increase in imports, both recognize that this is the price that must be paid to expand exports.

Such reciprocal agreements are the standard approach to multilateral trade bargaining. In the early GATT Rounds, governments reduced tariffs by making reciprocal tariff reductions in manufacturing industries. Each government would present an “offer sheet” that listed the sectors for which it was willing to reduce tariffs and the amount by which it was willing to reduce them. It would then try to get as many tariff reductions as it could from other countries in exchange for these tariff concessions. The objective in each bargaining round was to reach an overall agreement in which the value of the total tariff concessions each government granted equaled the value of the total tariff concessions each government received from all other GATT members (Jackson 1998, 143-4). Such reciprocity also underlay the Uruguay Round agreement. Developing countries agreed to liberalize services and to accept stronger intellectual property rights protection, two areas in which their industries are at a comparative disadvantage, in exchange for commitments by the advanced industrialized countries to liberalize trade in textiles and agriculture, sectors in which developing countries hold a comparative advantage.

Of course, and as we will see in greater detail in chapter 3, domestic politics often make it difficult for governments to achieve the necessary tradeoffs. Opening a heavily protected part of the economy to international competition will spark an adjustment process that can put domestic firms out of business. If the protected
industry is politically influential, the government will be reluctant to expose it to these adjustments. For example, in Western Europe farmers are well organized and politically influential. Liberalizing trade in agriculture therefore requires EU governments to act against the interests of an influential domestic interest group, something that few governments are keen to do. In the Uruguay Round, European farmers barricaded roads and organized large protests in an attempt to block agricultural liberalization. The EU responded by digging in its heels and resisting U.S. pressure for liberalization. Moreover, European farmers enjoy much greater political influence than the firms that would benefit from access to new export markets. Therefore, EU governments cannot easily liberalize their agricultural markets in exchange for market access in other industries because the political support they lose from farmers will not necessarily be compensated for by increased support from the industries that gain in the agreement. Crafting reciprocal trade agreements, therefore, requires governments to balance political gains and losses as well as economic gains and losses.

While trade liberalization typically occurs through reciprocal agreements, governments’ ability to conclude such agreements is frustrated by the second political problem: the inability to enforce them (Keohane 1984; Conybeare 1984; Oye 1986). We can use a simple game theoretic model, called the “prisoners’ dilemma,” to see why this is the case. For ease of exposition, let’s assume that France and Denmark are using tariffs to protect their comparatively disadvantaged producers and that as a result no trade in wine and cheese takes place. Let’s also suppose that the French and Danish governments both know that a reciprocal agreement that eliminated these tariffs would make them better off. Would they be able to conclude such an agreement?
The prisoners’ dilemma tells us that they will be unable to do so. In the prisoners’ dilemma France and Denmark each have two strategy choices: each can choose to open its market to the other’s exports, which we will denote as \( l \) for liberalize, or each can choose to protect its domestic market, which we will denote as \( p \).

Two governments, each of which has two strategy choices, generates the two-by-two matrix depicted in figure 2.1. Each cell in this matrix corresponds to a strategy combination, and these strategy combinations produce outcomes. We can describe these outcomes starting in the top left cell and moving clockwise. It is important to say a word about the notation we will use before we proceed. It is conventional to list the row player’s (the player who selects its strategy from the rows of the matrix) strategy choice first and the column player’s (the player who selects its strategy from the columns of the matrix) strategy choice second. Thus, the strategy combination referred to as “\( lp \)” means that the row player, which in this instance is France, has chosen the strategy liberalize and the column player, which is Denmark, has chosen the strategy protect.

(Figure 2.1: The Prisoners’ Dilemma and Trade Liberalization)

We can now describe the four outcomes in the prisoners’ dilemma. If France chooses liberalize and Denmark chooses liberalize (\( ll \)), then the two have agreed to eliminate tariffs on wine and cheese. France begins to export wine to Denmark and Denmark begins to export cheese to France. If France chooses liberalize and Denmark chooses protect (\( lp \)), then France has reduced tariffs on Danish cheese but Denmark retains its tariffs on French wine. Denmark thus begins to export cheese to France, but France is unable to export wine to Denmark. If France chooses protect and Denmark chooses protect (\( pp \)), both countries retain their tariffs and no trade takes place.
**Figure 2.1: The Prisoners’ Dilemma and Trade Liberalization**

<table>
<thead>
<tr>
<th></th>
<th>Denmark</th>
<th>France</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Liberalize</strong></td>
<td>$l,l$</td>
<td>$l,l$</td>
</tr>
<tr>
<td><strong>Protect</strong></td>
<td>$l,p$</td>
<td>$p,p$</td>
</tr>
<tr>
<td></td>
<td>$p,l$</td>
<td>$p,p$</td>
</tr>
</tbody>
</table>

Preference Orders:
- Country A: $p,l > l,l > p,p > l,p$
- Country B: $l,p > l,l > p,p > p,l$
Finally, if France chooses protect and Denmark chooses liberalize ($pl$), then Denmark has eliminated its tariff on French wine but France retains its tariff on Danish cheese. France can therefore export wine to Denmark, but Denmark is unable to export cheese to France.

Now we must determine how each government ranks these four outcomes: which is their most, second most, third most, and least preferred outcome? France’s most preferred outcome is $pl$, where it protects and Denmark liberalizes, because this outcome allows France to export wine to Denmark while continuing to protect French cheese producers from Danish competition. France’s least preferred outcome is $lp$ because this outcome gives Denmark access to its market without gaining access to Denmark’s market in return. Where do the other two outcomes fit in? France prefers $ll$ to $pp$ because when both governments liberalize France gains from the resulting trade but when both governments use protection France does not realize this gain. It should also be clear that France prefers both $ll$ and $pp$ less than $pl$, because with $pl$ France gains access to the Danish market, as it does with $ll$, but it does not have to give Denmark access to its market. Finally, France prefers $ll$ and $pp$ to $lp$, because under $lp$ France is denied access to the Danish market, as it is in $pp$, but it has opened its market to Denmark. Thus, we have a clear preference order for France $pl > ll > pp > lp$ where the “greater than” sign means “is preferred to”. In words, France’s most preferred outcome is unreciprocated access to Denmark’s market. Its second best outcome is reciprocal tariff reductions, which is in turn better than reciprocal protection. France’s worst outcome is a unilateral tariff reduction.

The prisoners’ dilemma is a symmetric game, which means that Denmark faces the exact same situation as France. Denmark’s payoff order is therefore identical to
France’s, with one small difference arising from the notation we use. Like France, Denmark’s most preferred outcome is the one in which it gets unreciprocated access to the other’s market, but for Denmark this is the outcome $lp$. And also like France, Denmark’s least preferred outcome is the one in which it grants the other unreciprocated access to its market, which for Denmark is the outcome $pl$. Thus, Denmark’s payoff order is identical to the French payoff order, but the position of the most and least preferred outcomes are reversed: $lp > ll > pp > pl$.

We are now ready to solve the prisoners’ dilemma by determining what strategies France and Denmark will choose, and what outcome we should therefore expect. In the prisoners’ dilemma each actor has a dominant strategy—a single strategy that always returns a higher payoff than all other strategy choices. Protect is the dominant strategy in the prisoners’ dilemma; each government will always gain a higher payoff by playing protect than it will by playing liberalize. We can make this clear by working through France’s best responses to Danish strategy choices. Suppose Denmark plays the strategy “liberalize.” France now must choose between liberalize and protect. If France plays liberalize in response to the Danish play of liberalize, France receives its second most preferred outcome ($ll$). If France plays protect in response to the Danish play of liberalize, France receives its most preferred outcome ($pl$). Thus, if Denmark plays liberalize, France’s best response—the strategy that returns the highest payoff—is protect. Now suppose that Denmark plays protect. If France plays liberalize in response, it receives its least preferred outcome ($lp$). If France plays protect in response, it gets its second least-preferred outcome ($pp$). Thus, if Denmark plays protect, France’s best response is to play protect. Protect, therefore, “dominates” liberalize as a strategy choice; protect provides France with a higher payoff.
than liberalize regardless of the strategy that Denmark plays. Because the prisoners’ dilemma is symmetric, protect is also Denmark’s dominant strategy. Because both governments have dominant strategies to play protect, the game yields one outcome: France and Denmark both play protect and the game produces the pp outcome.

The protect-protect outcome has two important characteristics. First, this outcome is Pareto sub-optimal. Pareto optimality is a way to conceptualize societal welfare. An outcome is Pareto optimal when no single individual can be made better off without at the same time making another individual worse off. Pareto sub-optimal, therefore, refers to outcomes in which it is possible for at least one individual to realize a welfare improvement without any one else being made worse off. In the prisoners’ dilemma the protect-protect outcome is Pareto sub-optimal because both governments realize higher utility at ll than at pp. Thus, rational behavior on the part of each individual government, that is, each playing its dominant strategy “protect”, produces a sub-optimal collective outcome. France and Denmark are both poorer than they would be if they both liberalize trade.

Second, the pp outcome is a Nash equilibrium. A Nash equilibrium is an outcome at which neither player has an incentive to change strategies unilaterally. If France changes its strategy from protect to liberalize the outcome shifts to lp, France’s least preferred outcome. Thus, France has no incentive to change its strategy unilaterally. If Denmark changes its strategy from protect to liberalize, the outcome moves to pl, Denmark’s least preferred outcome. Thus, Denmark has no incentive to change its strategy unilaterally. Because neither France nor Denmark has an incentive to change strategies unilaterally, the protect-protect outcome is a Nash equilibrium.

Putting these two points together highlights the prisoners’ dilemma’s central conclusion:
even though France and Denmark know that they would gain from reciprocal tariff reductions, neither has an incentive to reduce tariffs. More broadly, the prisoners’ dilemma suggests that even though free trade would make all countries better off, the political dynamics of trade trap governments in a protectionist world.

Why are governments unable to conclude agreements that make them all better off? The problem arises because each fears getting the “sucker payoff.” If France and Denmark agree to liberalize trade, and France complies but Denmark does not, then Denmark has played France for a sucker. France suffers the “costs” of rising imports, but does not get the benefit of rising exports. Moreover, nothing prevents Denmark from failing to comply with the agreement, that is, there is no mechanism to enforce compliance. The recognition that the other government has no incentive to comply with any agreement that is reached and cannot be forced to comply prevents governments from concluding the agreement in the first place.

This problem could be easily solved, and France and Denmark could liberalize trade, if it were possible to enforce an international agreement. With an effective enforcement mechanism the two could agree in advance to play liberalize strategies and, because cheating would be punished, both would comply with the agreement. The international system provides no enforcement mechanism, however. Domestic political systems rely upon the judicial system to enforce contracts and other laws and regulations. The international system does not have an authoritative and effective judicial system. The international system is anarchic, that is, it is a political system without an overarching authority to enforce the rules of the game. In the absence of an enforcement mechanism, governments have no incentive to trust other governments to comply with any agreements they make. As a consequence, governments are reluctant
to conclude trade agreements and the gains from trade liberalization are unrealized.

In sum, politics makes it a difficult for governments to liberalize trade. Because governments want to maximize their exports and minimize their imports, trade liberalization typically occurs through reciprocal trade agreements. The inability to enforce international agreements, however, makes governments unable to conclude reciprocal trade agreements.

3. Multilateral Institutions and Trade Cooperation

It is against this backdrop that one must consider the WTO’s role in the international trade system. As you might already have guessed, the WTO helps governments liberalize trade by enabling them to enforce reciprocal trade agreements. To understand how, we must first understand the conditions that must be met if cooperation is to emerge in the prisoners’ dilemma. We can then look at how international institutions help create these conditions.

Cooperation can emerge in the prisoners’ dilemma if three conditions are met. First, while cooperation is unlikely in a prisoners’ dilemma played once, cooperation can emerge in an iterated prisoners dilemma, that is, in a game played repeatedly by the same set of actors (see Taylor 1976; Axelrod 1984; Keohane 1984; Oye 1986). Cooperation can emerge in an iterated prisoners’ dilemma in part because iteration changes the nature of the reward structure. Rather than making a one-time choice and receiving a one-time payoff, in an iterated game governments make repeated choices and receive a stream of payoffs over time.

Two additional conditions must be met for cooperation to emerge in an iterated prisoners’ dilemma. First, governments must use reciprocity strategies. While many
reciprocity strategies exist, the most well known is called “tit-for-tat” (Axelrod 1984). In tit-for-tat, each government plays the strategy that its partner played in the previous round of the game. Trade liberalization by one government in one round of play is reciprocated by trade liberalization from the other government in the next round. Should one government impose protection in one round (or cheat on an existing trade agreement) the other government will impose protection in the next round of play. Reciprocity strategies allow governments to reward each other for cooperation and to punish each other for cheating. In other words, reciprocity strategies provide a decentralized enforcement mechanism. Second, governments must care about the payoffs they will receive in future rounds of play. If governments fully discount future payoffs, the iterated game collapses into a single play of the prisoners’ dilemma and the threat of punishment in the next round will not promote cooperation. If governments care about the future and if they use reciprocity strategies, then cooperation in an iterated prisoners dilemma becomes rational; each government can realize a larger stream of payoffs by cooperating than it can realize if it defects.

International trade institutions provide two of the three conditions necessary to promote cooperation. First, trade institutions help iterate the game by creating expectations of repeated interaction. The WTO iterates trade interaction between governments in a number of ways. Membership in the WTO has been relatively stable. While the number of countries that belong to the WTO has increased over time, very few countries have left the organization after joining. As a consequence, WTO members know that the governments with which they negotiate today will be the governments with which they negotiate tomorrow. In addition, WTO members interact regularly within the framework the WTO provides. There have been eight formal rounds
of GATT negotiations, and a ninth, the “Millenium Round” is currently being prepared. In addition to these formal rounds, the WTO draws governments together for annual and semi-annual reviews of trade policy. By bringing the same set of governments together in a regularized pattern of interaction, multilateral trade institutions iterates inter-governmental trade interactions.

Second, the WTO provides the information necessary for effective reciprocity strategies. Reciprocity requires governments to know when their partners are complying with and when they are cheating on trade agreements. The WTO makes this easier by collecting and disseminating information on its members’ trade policies, thereby providing a centralized and relatively impartial source of information. In addition, WTO rules provide clear standards against which governments’ trade policies can be evaluated. For example, the WTO’s most favored nation clause prohibits discriminatory practices except under a set of well-defined exceptions. Finally, the WTO defines the conditions under which governments can temporarily opt out of the commitments they have entered into. These detailed rules increase transparency, making it easier to determine whether a specific action is or is not consistent with a given trade agreement. The combination of a relatively unbiased source of information about trade policy measures and the transparency provided by WTO rules allows governments to monitor the behavior of other WTO members. This improved information environment facilitates the use of reciprocity strategies.

Governments’ ability to use the WTO to enforce agreements is most clearly evident in the WTO’s dispute resolution mechanism. Successful reciprocity requires governments to refrain from retaliating against a perceived violation of a trade agreement until there exists detailed and relatively unbiased information about the alleged violation.
Once such information exists, retaliatory measures can be enacted in response to a violation and can be proportional to the injury inflicted. One way to acquire such information is to allow the WTO to review the case and reach a determination about the alleged violation. The dispute settlement mechanism is the process through which this determination is reached.

The WTO dispute settlement mechanism works in the following way. A government brings its complaint to the WTO’s Dispute Settlement Body (DSB), which is composed of the entire WTO membership. The DSB will first encourage the two governments to attempt to resolve their dispute through direct consultations. If consultations are unsuccessful, the DSB will create a Panel to investigate the complaint. This Panel is generally composed of three trade law experts from different countries who are typically selected by the DSB in consultation with the parties to the dispute. The Panel reviews the evidence in the case, meets with the parties to the dispute, and prepares a final report, which it submits to the DSB. The DSB must accept the Panel’s final report unless all members, including the government that brought the complaint, vote against its adoption. Once the DSB has accepted the report, both parties have the right to appeal the decision. If one party does appeal, the DSB creates an Appellate Body composed of three to five people drawn from a list of seven permanent members. The Appellate Body can uphold, reverse, or modify the panel’s findings, conclusions, and recommendations. The DSB must then accept or reject the Appellate Body’s report. As with the panel report, the DSB can reject the report only with the consent of all member governments. If at the end of this process the measure in dispute has been found to be inconsistent with a WTO obligation, the government must alter its policy to conform to the rule in question or it must compensate the injured
parties. The entire process, from initiation to appellate report, is supposed to take no longer than fifteen months.

A recent case concerning the European Union’s banana import regime illustrates how this system enables governments to enforce trade agreements.\(^1\) In 1993 the EU waived all tariffs on bananas imported from former French and British colonies in Africa and the Caribbean. By waiving tariffs on banana imports from these countries, the EU discriminated against bananas produced in other countries. In the mid 1990s Ecuador, Guatemala, Honduras, Mexico, and the United States alleged that the EU policy was inconsistent with a number of GATT rules. In other words, the EU was accused of cheating on its WTO obligations. Consultations between the EU and the injured parties took place in early 1996 in an attempt to resolve the dispute. When consultations failed, a Panel was established to determine whether EU policy was consistent with WTO rules. The Panel determined that while the EU could give preferential treatment to bananas from African, Caribbean, and Pacific countries, the specific arrangements that the EU used discriminated illegally against Latin American producers and the American firms Chiquita and Dole (Europe, May 1999, p. 24B). The EU appealed the Panel’s findings to the WTO’s Appellate Body, which reviewed the case and upheld most of the Panel’s findings. In September 1997 the Dispute Settlement Body adopted the Appellate Body report and demanded that the EU implement WTO-consistent policies by January 1, 1999. Thus, the EU was found to be “cheating” on a trade agreement it had entered, and was required to bring the offending policies in line with these obligations.

\(^1\)This description draws heavily on WTO summaries available at
The changes the EU made to its banana import regime in response to the WTO findings raised further concerns in the countries that had brought the original complaint. In August of 1998 these countries requested consultations with the EU to determine whether the new measures the EU had introduced were WTO compliant. Consultations were again unproductive, and in December of 1998 Ecuador requested the original WTO Panel to examine the new EU measures. The Panel found that the new measures were not fully consistent with WTO rules. Thus, the EU had “cheated” in the first place by implementing a banana import regime inconsistent with its WTO obligations, and had “cheated” again when altering these policies in response to the findings of the dispute settlement body.

Recognizing that the EU was unlikely to comply with its WTO obligations unless it was costly to not do so, the United States asked for authorization to suspend $520 million in tariff concessions it had previously granted to the EU. WTO arbitration, initiated at the EU’s request, ruled that size of the requested retaliation was greater than the damage caused by the EU’s banana regime, and authorized only $191.4 million in sanctions. In response to these sanctions the EU once again altered its banana import regime, this time shifting 100,000 tons of the EU market that had previously been reserved for African, Caribbean, and Pacific producers to producers in Latin America. In exchange for these changes the U.S. suspended its sanctions and agreed to support a waiver in the WTO that allows the broader quota-based import regime (The Financial Times 12 April 2001, p. 14).

The banana case illustrates how governments can use tit-for-tat strategies in a

highly institutionalized trade system to enforce trade agreements. An alleged defection by the EU prompted an impartial investigation by the WTO. This investigation indicated that EU policy violated WTO rules, and when the EU failed to bring its policies into line with its obligations, the United States retaliated by withdrawing concessions it had made previously to the EU. In the language of the iterated prisoners’ dilemma, the EU defected and the United States, playing a tit-for-tat strategy, defected in response. Moreover, retaliation came only after the WTO had determined that it was justified and was proportionate to the injury suffered. While the WTO’s dispute resolution mechanism focuses our attention on a legalistic version of tit-for-tat, it allows us to see in a very detailed way how multilateral institutions promote trade cooperation by helping governments’ enforce trade agreements.

The WTO is necessary, therefore, because without it, governments would be unable to liberalize trade. Because domestic politics forces governments to focus on exports rather than imports, liberalization typically occurs through reciprocal agreements. Such reciprocal agreements cannot be concluded, however, unless governments are confident that their partners will comply with the commitments they undertake. The WTO helps provide this assurance by allowing governments to monitor the behavior of their trade partners and to enforce trade agreements. In short, the WTO is necessary because without it (or something like it) governments would not liberalize trade.

C. Power, Interests, and the Multilateral Trade System

While the WTO is necessary in the sense that governments would be unable to liberalize trade without it, it is not necessary in three much broader senses. First, the
creation of the GATT/WTO was neither inevitable nor pre-determined. No such institution existed during the 19th century, and none was created following World War I. Thus, the creation of the GATT following World War II needs to be explained.

Second, the GATT/WTO is not the only possible way to organize international trade. International trade could as easily be organized on a regional as a global basis, and a commitment to global income equality rather than market-based liberalism could underlie the system. Thus, the precise structure of the GATT/WTO also needs to be explained. Finally, the continued existence of the WTO is not assured. Most political systems have finite life spans, and the multilateral trade system is no exception to this tendency. Thus, the system’s longevity must be explained.

These considerations raise three questions that we explore in this section. Why was the GATT/WTO established, why did it take the form it did, and for how long is this system likely to persist? The answers that we develop are based on the interaction between power and interests: the powerful construct political institutions that embody their interests, and these arrangements persist as long as they are able and willing to maintain them. As we will see, the multilateral trade system was established under American leadership after World War II. It was based on the principle of market liberalism because this principle reflected the interests of the United States and the other advanced industrialized countries. The system will persist as long as the world’s leading economic powers continue to believe that it represents the best way to organize world trade.

1. The Creation of the Postwar Trade System
The multilateral trade system was created under U.S. leadership in the immediate aftermath of the Second World War. In conceptualizing and establishing this system, the U.S. was motivated by two considerations. First, by the early 20th century the United States had emerged as the world’s largest economic power with a clear interest in opening foreign markets to American goods. Britain had dominated the world economy power during the 19th century. The industrial revolution occurred first in Great Britain, and by mid-century Britain was producing twenty percent of the world’s manufacturing output (Kennedy 1989, 190). France, the second largest manufacturing economy at the time, produced less than half this amount. By the end of the century, however, the U.S. had overtaken Great Britain (see table 2.4). On the eve of the First World War, the U.S. share of world manufacturing output was twice as large as Great Britain’s. American economic dominance continued to rise during the next twenty years, and by the end of World War II, the U.S. was producing close to half of the world’s manufactured goods.

(Table 2.4: Shares of World Manufacturing Production)

American economic dominance created an American interest in liberal international trade. The United States had been protectionist during much of the 19th century. Given British economic pre-eminence, the U.S. recognized that American producers would not be able to compete against British manufacturers in foreign markets. Moreover, reducing tariffs at home would allow British producers to undersell American firms in the U.S. market, thereby making it difficult to develop a strong manufacturing base in the United States. As the U.S. caught and then overtook Great Britain, however, American trade interests changed. The U.S. recognized that American producers could capture world markets and it recognized that reducing tariffs
<table>
<thead>
<tr>
<th>Country</th>
<th>1880</th>
<th>1900</th>
<th>1913</th>
<th>1928</th>
</tr>
</thead>
<tbody>
<tr>
<td>United States</td>
<td>14.7</td>
<td>23.6</td>
<td>32.0</td>
<td>39.3</td>
</tr>
<tr>
<td>Great Britain</td>
<td>22.9</td>
<td>18.5</td>
<td>13.6</td>
<td>9.9</td>
</tr>
<tr>
<td>Germany</td>
<td>8.5</td>
<td>13.2</td>
<td>14.8</td>
<td>11.6</td>
</tr>
<tr>
<td>France</td>
<td>7.8</td>
<td>6.8</td>
<td>6.1</td>
<td>6.0</td>
</tr>
</tbody>
</table>

Source: Kennedy 1988, 259.
at home would pose little threat to American manufacturing. The rise of American
economic supremacy in the first half of the twentieth century, therefore, translated into
an American interest in a liberal international trading system.

Second, the U.S. came to believe that a liberal trade system would not be
possible without American leadership. This belief was formed by the experience of the
interwar period. The international economy was unstable after World War I. The War
greatly weakened the economies of Great Britain and the other European belligerents.
While governments attempted to reconstruct the world economy during the 1920s, the
United States played little role in these efforts, choosing instead to retreat back into
isolationism. When the New York stock market crashed in 1929 and the world
economy subsequently moved into depression, the world trade system collapsed into
rival trade blocs and rising protectionism. The United States raised tariffs sharply in the
1930. Other countries formed discriminatory trade blocs. Britain created the Imperial
Preference System in the summer of 1932, a trading bloc based on one underlying
principle: “home producers first, Empire producers second, and foreign producers last”
(Richardson 1936, 138). France began controlling imports with quotas—numerical
caps for the imports of particular goods—and discriminated against American products
in favor of European and French colonial producers (Jones 1934). Germany created
similar arrangements in eastern and central Europe, as did Japan in Asia and the Pacific.
As a result, world trade fell sharply, from $35.6 billion in 1929, the year before the
depression hit, to $11.9 billion in 1933 (see table 2.5). The collapse was not due
entirely to rising protection. The Great Depression meant that there was less demand
for goods, and the decline in world trade reflected this reduced demand. Increased
protectionism contributed to the collapse of world trade, however, and made it difficult
to engineer an international recovery from the depression. The United States concluded from this experience that American leadership would be required to establish a liberal system of world trade.

(Table 2.5: Collapse of World Trade)

The U.S. began to exert such leadership in the mid-1930s. The first evidence of a change in U.S. policy came in 1934 when the Roosevelt administration asked the U.S. Congress for authority to negotiate bilateral tariff agreements. Congress granted this authority through the Reciprocal Trade Agreements Act (RTAA), under which the executive branch could reduce U.S. tariffs by as much as 50 percent in exchange for equivalent concessions from other countries. Cordell Hull, Secretary of State under Roosevelt, negotiated bilateral treaties with nineteen countries between 1934 and 1938 (Butler 1998, 183). Although these treaties did little to liberalize trade, the RTAA was significant for two reasons. The initiative was the first sign of American willingness to exercise leadership in the international trade system. In addition, two of the principles upon which these bilateral treaties were based, reciprocity and non-discrimination, became central components of the GATT. The second change in American policy occurred early in the Second World War. The Roosevelt administration used the political leverage afforded by the lend lease agreements it signed with the allied powers to commit European governments to postwar negotiations aimed at creating a non-discriminatory and liberal international trading system (see Penrose 1953, 13-31).

The U.S. and Great Britain began discussing such a system in 1942, and in 1945 these bilateral talks were extended into multilateral negotiations. By 1947, these negotiations had produced the General Agreement on Tariffs and Trade. The GATT was intended to form one component of a broader International Trade Organization
Table 2.5: Collapse of World Trade
(Average Monthly World Trade, $US millions)

<table>
<thead>
<tr>
<th>Year</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1929</td>
<td>2,858</td>
</tr>
<tr>
<td>1930</td>
<td>2,327</td>
</tr>
<tr>
<td>1931</td>
<td>1,668</td>
</tr>
<tr>
<td>1932</td>
<td>1,122</td>
</tr>
</tbody>
</table>

Source: Kindleberger 1987, 140.
(ITO). In addition to facilitating trade liberalization, the ITO was intended to draw
governments’ attention to linkages between international trade flows, employment and
economic development. The ITO Charter called on governments to achieve and
maintain full employment, and included a mechanism for inter-governmental consultation
and policy coordination to achieve this objective. The Charter also made economic
development a responsibility of the industrialized countries as well as of the developing
countries and provided developing countries significant exceptions to GATT rules on
non-discrimination and the use of quantitative restrictions. The United States Congress
objected to the employment and development features of the ITO, however, and
refused to accept American participation in the ITO (Diebold 1952; Gardner 1969).
As a consequence, the ITO was never created. The GATT, which did not require
congressional ratification, became the central trade institution.

While the GATT-based system embodied the interests of the United States and
Western Europe, it neglected developing countries’ concerns. Most developing
countries played no role in the system’s creation (many had not yet become
independent nation states by 1947). Those that did participate in the negotiations fought
hard to link trade and development in the ITO. When the ITO failed to emerge,
developing country governments became critical of the multilateral trade system, and
many ceased to be active participants in trade liberalization. We will examine
developing country criticisms of the GATT in chapter four. It is sufficient to note here
that developing country governments believed that the GATT-based system hindered
economic development. And during the next thirty years developing countries sought
fundamental reforms of the system. For much of the postwar period, therefore,
developing country governments viewed the multilateral trade system as a “rich country
club”; it embodied the interests of the advanced industrialized countries and offered few benefits to other countries.

The emergence of the Cold War in the late 1940s helped consolidate the multilateral trade system. The Cold War had two consequences for the emerging trade system. First, the United States began to assist economic reconstruction in Western Europe. The U.S. recognized that it needed a strong economic block in Western Europe to counter Soviet power and influence. Through the Marshall Plan, the U.S. provided funds that allowed Europe to import critical goods from the United States. Through the Organization for European Economic Cooperation (OEEC), which was created as part of the Marshall Plan, the U.S. encouraged European governments to begin to liberalize trade within Europe. Second, between 1948 and 1958 the United States engaged in asymmetric trade liberalization. Given their weak economic position, European countries were unwilling to open their markets to U.S. goods. As a result, the benefits from the four GATT rounds held in this period accrued largely to the Europeans. Tariff concessions were reciprocal, but because European governments relied heavily on quotas and restrictions on currency convertibility to restrict their imports, tariff reductions had little impact on U.S. exports. Thus, the U.S. opened its market to European exports, even though Western Europe continued to discriminate against American goods. By encouraging the U.S. to assist postwar reconstruction and to allow Europeans to export to the American market, the Cold War helped create an economic basis in Europe that made multilateral trade liberalization possible beginning in the 1960s.

In sum, the multilateral trade system was established under U.S. leadership in the wake of World War II. American leadership was motivated by an interest in liberal
trade as the world’s dominant economy and by a determination to not repeat the mistakes it had made during the interwar period. The trade system was based on market liberalism because this principle reflected U.S. and Western European economic interests. The emergence of the Cold War helped consolidate the trade system, by motivating the U.S. to help create Western European economies capable of withstanding, and therefore willing to engage in, liberal international trade.

2. The Evolution of the Multilateral Trade System

American economic dominance has declined since 1960, due to economic and political developments in Japan and Western Europe. During the 1960s, the Japanese economy grew at average annual rates of more than 10 percent, compared to average growth rates of less than 4 percent for the U.S. in the same period. And while Japan’s rate of growth slowed during the 1970s and 1980s, the Japanese economy continued to grow more rapidly than the American economy. These differential growth rates narrowed the economic gap between Japan and the U.S. In the early 1960s, the United States produced 40 percent of the world’s manufactured goods while Japan produced only 5.5 percent. By 1987 the U.S. share of world manufacturing production had fallen to 24 percent while Japan’s share had increased to 19.4 percent (Dicken 1999, 28). In less than thirty years, therefore, Japan transformed itself from a vanquished nation into a powerful force in the world economy.

Western Europe has also emerged as a powerful force in the world economy. Unlike Japan, however, no single European country has emerged as a global economic power. Some countries, such as Germany, have maintained a stable share of world manufacturing output throughout the postwar period, while others, such as France and
Britain, have seen their shares fall (Dicken 1998, 28, 30). But no single European country has increased its share of world output. What Western European countries have been unable to do individually, however, they have done collectively through the EU. Together, the four largest EU members (Germany, France, the United Kingdom, and Italy) produce about 22 percent of world output (Dicken 1998, 28). And, along with the other eleven members of the EU, they act as a single unit in the international trade system. There is a single EU market (the world’s largest single market) and a single EU tariff. In multilateral trade negotiations, EU countries are a single actor with a single negotiating position. Thus, by pooling the economic potential of Western European countries, the EU emerged as a powerful force in the international trade system.

How has this shift in the balance of economic power affected the multilateral trade system? Some scholars argue that this power shift, in conjunction with the end of the Cold War, has weakened the system. “At the opening of the twenty-first century,” one scholar writes, “all the elements that have supported an open global economy have weakened” (Gilpin 2000, 347). Gilpin argues that both the willingness and the ability of the United States to lead have declined. Moreover, the sense of common purpose provided by the Cold War alliance against the Soviet Union has disappeared. As a result, the EU, the U.S., and Japan are now much more likely to emphasize narrow domestic priorities rather than their shared interest in an open trading system (Gilpin 2000, 347). Others argue that the trade system remains quite strong in spite of this change. “The institutions that took hold after World War II continue to provide governance now, and the economic interests and political consensus that lie behind them are more, not less, supportive of an open world economy today than during the Cold
Which perspective is correct? A definitive answer is impossible. Political scientists are not very good at predicting the future trajectories of political systems. Our theories are not precise enough to make such predictions with much accuracy or confidence. The best that we can do is examine trends and try to reach reasonable conclusions. The problem is compounded in this instance because recent trends do not suggest clear-cut conclusions. Some trends suggest that the multilateral trade system remains quite strong, while others suggest that it has weakened.

The evidence that the system remains strong comes primarily from what has been achieved through multilateral trade negotiations during the last thirty years. Governments have completed two GATT rounds since 1970, and these rounds have strengthened the multilateral trade system in important ways. Tariffs continued to fall during this period, from the nine percent average after the Kennedy Round to an average of 4 percent after the Uruguay Round. Governments also began creating multilateral rules for new trade-related areas. During the Tokyo Round governments began to negotiate rules governing anti-dumping, countervailing duties, and domestic safeguard investigations. During the Uruguay Round, governments created new rules to protect intellectual property (TRIPs), began to liberalize international trade in services (GATs), negotiated a partial set of rules constraining government treatment of foreign direct investment (TRIMs), and made some initial steps to liberalize trade in agriculture.

Moreover, during the Uruguay Round governments created the WTO and strengthened the system’s dispute resolution mechanism. Thus, governments continue to strengthen the multilateral system’s institutional framework and extend multilateral rules into new areas.
The multilateral trade system has also been strengthened by a fundamental reorientation of developing country trade policies. As noted above, developing country governments had been highly critical of the GATT-based system throughout the postwar period. Moreover, between 1950 and 1980 developing countries participated little in the process of trade liberalization and pressed continually to supplant the GATT and replace it with an institutional structure that addressed their perceived development goals. In the mid-1980s, however, developing countries began to adopt development strategies that emphasize the important contribution international trade can make to economic development. As a consequence, developing country governments no longer press for fundamental reforms of the multilateral trade system, and most have become active participants in multilateral trade negotiations. And though it is an overstatement to say that developing countries have become enthusiastic supporters of the multilateral trade system, they no longer challenge the fundamental principles upon which the multilateral trade system is based. Thus, for the first time in its history, the multilateral trade system faces no threat of fundamental reform from a large group of countries.

Other trends suggest that the multilateral system is weakening. Three such trends are of greatest importance: recurrent trade conflicts, a resurgence of protectionism, and regionalism. Since the mid-1970s, trade conflicts among the advanced industrialized countries have occurred with considerable regularity. During the 1980s and early 1990s, conflict between the U.S. and Japan occupied center stage. Two American concerns fuelled this conflict. First, the United States began to run trade deficits for the first time since World War I during the 1970s (see figure 2.2). This trade deficit worsened substantially during the 1980s. American policymakers interpreted the deficit as evidence of declining U.S. international competitiveness,
particularly in high technology sectors. Measures of the United States’ high technology comparative advantage suggested that the U.S. was losing ground in mechanical equipment, in electronics, in scientific instruments, and in aircraft. And what the U.S. seemed to be losing, Japan appeared to be gaining. The U.S. ran its largest bilateral trade deficit with Japan. Moreover, while the United States’ share of global high technology markets fell from 30 percent to 21 percent between 1970 and 1989, Japan’s share rose from 7 percent to 16 percent (Tyson 1992, 19). Thus, the trade deficit and the apparent decline in American competitiveness seemed to point to identical conclusions: the U.S. was losing ground to Japan.

(Figure 2.2: U.S. Trade Balance, 1965-1999)

Second, there was a widespread perception in the United States that Japanese gains had resulted from government policies that gave Japanese firms unfair advantages in international competition (see, e.g., Tyson 1992; Prestowitz 1989). Throughout the postwar period Japan used industrial policy to develop specific industries. Industrial policy is the use of protection, government subsidies, and government procurement decisions to encourage certain types of economic activity and to discourage others. In the early 1970s, the Japanese government began to use industrial policy to promote high technology industries (see Okimoto 1989). Tariffs, quotas, and regulations kept American high technology products out of the Japanese market. Japanese government procurement practices provided a guaranteed market for Japanese firms’ goods. In addition, the Japanese government provided financial assistance to help defray research and development costs. Barriers created by industrial policy were reinforced by a Japanese industrial structure in which final goods producers developed long-term relationships with input suppliers. Such relationships made it hard for American firms to
Figure 2.2: U.S. Trade Balance, 1965-1999

break into the Japanese market. In short, Japanese industrial policy, critics argued, kept American goods out of the Japanese market, and gave Japanese producers an unfair advantage over American firms in international markets. Blaming its deteriorating competitiveness on Japanese industrial policies, the U.S. initiated a series of bilateral negotiations through which it sought to open the Japanese market to American exports and to eliminate those practices that the United States considered unfair.

The U.S. and the EU have also engaged in recurrent trade conflicts. Conflict over trade in agriculture is perhaps the most serious. The U.S. has sought for more than thirty years to get the EU to dismantle its Common Agricultural Policy (CAP). Created as part of the EU, the CAP protects European farmers from cheaper farm products produced outside Western Europe and subsidizes Western European farm production and exports. Farmers’ political influence in Western Europe makes European governments reluctant to dismantle the CAP. The result has been a recurrent conflict over trade in agriculture, as the U.S. pushes and the EU resists fundamental reform of the CAP. Conflict over the CAP is accompanied by other agriculture disputes concerning the EU’s reluctance to import American hormone-treated beef and the EU’s broader concerns about genetically modified foods produced in the U.S. The two also find themselves in conflict over manufacturing industries. For example, the U.S. has accused European governments of using industrial policy to support Airbus Industries, the European commercial aircraft producer, thereby enabling it to capture market share from the American producer Boeing.

Recurrent trade conflicts have been accompanied by a resurgence of protectionism, particularly in the U.S. and the EU. A number of factors lie behind this resurgence of protectionism. In the United States, the widening trade deficit and a
sharp appreciation of the dollar (the dollar rose by 50 percent between 1979 and 1985) put intense pressure on American firms. In addition, the late 1970s and much of the 1980s was a period of very slow economic growth and rising unemployment in Western Europe—economic growth rarely rose above 3 percent and unemployment climbed toward 10 percent. These cyclical developments were accompanied by longer-term structural changes in the world economy. The emergence of Asian and Latin American producers and exporters of manufactured goods (a development we will look at in greater detail in chapter 4), imposed painful economic adjustments on manufacturing firms in the United States and Europe. These developments combined to produce demands for protection by American and European industries and in many instances governments were willing to oblige.

Because the multilateral system constrains the use of tariffs, however, the U.S. and the EU have had to rely upon non-tariff barriers to provide this protection. The most popular non-tariff barriers have been “voluntary export restraints” (VERs) and anti-dumping and countervailing duty investigations (Greenaway 1983, 132). A VER is a bilateral agreement under which one country agrees to limit its exports to the other country’s market. For example, in January 1989, the U.S. and Japan concluded a VER under which the Japanese government agreed to limit the export of Japanese cars to the U.S. to 2.3 million units per year. Anti-dumping and countervailing duty investigations are unilateral measures. Anti-dumping investigations apply to cases in which foreign firms sell their goods in international markets below the cost of production. Countervailing duty investigations apply to cases in which governments subsidize their firms’ exports directly or indirectly. According to GATT rules, if a government can prove that foreigners are dumping or subsidizing exports and that these practices are
injuring domestic producers, it can raise tariffs in response.

Heavy reliance on non-tariff barriers reversed some of the trade liberalization that had been achieved under the GATT. The share of advanced industrialized trade of manufactured goods subject to non-tariff barriers increased from 4 percent in 1974 to 17.4 percent in 1980 and then increased again to 25 percent by the early 1990s (Greenaway 1983, 168; OECD 1997, 53). The U.S. and the EU negotiated VERs covering autos, steel, motorcycles, machine tools, and consumer electronics (Bhagwati 1988, 44). American and European auto producers were perhaps the most heavily protected of all industries. By the mid-1980s VERs covered almost fifty percent of advanced industrialized countries’ automobile trade (Gilpin 1987, 207). Anti-dumping and countervailing duty investigations also rose during this period. Between 1980 and 1992, the U.S. launched 345 countervailing duty and 540 anti-dumping investigations (Bhagwati 1988, 49; Krueger 1995, 40). In the EU, more than 260 such investigations were launched between 1980 and 1985. The U.S. and the EU often used a relatively liberal standard to determine what constitutes dumping or an export subsidy, however, thereby protecting domestic producers even when foreign governments were not subsidizing and foreign firms were not dumping (Krueger 1995; 33-50).

Finally, regional trading arrangements (RTAs) have proliferated during the last fifteen years. RTAs are trade agreements that discriminate between members and non-members. RTAs come in two basic forms. In a free trade area, like the North American Free Trade Agreement, governments eliminate tariffs on other members’ goods, but each member government retains independent tariffs on goods entering their market from non-members. In a customs union, like the EU, member governments agree to eliminate all tariffs on intra-union trade and they create a common tariff that is
imposed on non-member countries’ goods entering the union. Though inherently discriminatory, GATT Article XXIV allows countries to form regional trading arrangements as long as the level of protection imposed by members against non-members is no higher than the level of protection applied by the countries prior to forming the arrangement.

Regionalism is not a fundamentally new development. What has changed is the pace at which regional arrangements are being created: of the 134 RTAs in active operation today, ninety were formed between 1995 and 2001. Table 2.9 lists many of the most significant regional arrangements. The EU is the largest and longest-lived RTA in existence. The EU currently has fifteen members and is likely to expand further into eastern and central Europe during the next ten years. The most prominent of the recent creations include the North American Free Trade Agreement, created by the United States, Mexico, and Canada in 1993. MERCOSUR, one of the most prominent South American RTAs, was created by Argentina, Brazil, Paraguay, and Uruguay in 1991. Governments in East and Southeast Asia agreed to an ASEAN free trade area in the late 1990s. Many other smaller RTAs exist in Latin America and the Caribbean, including the Andean Pact (Venezuela and Colombia) and Caricom (members). Governments in the Western Hemisphere are currently discussing a Free Trade Area of the Americas, which would expand NAFTA throughout Central and South America. At present, about one-third of world trade occurs within RTAs (World Bank 2000). Regionalism has become a powerful force in the global economy.

(Table 2.9 about here)

The impact of RTAs on the multilateral trade system is unclear. Some argue that RTAs will be useful building blocks from which a global free trade system can be
created. Once all of the major trading partners are members of regional free trade arrangements (or customs unions), then the only remaining task is to eliminate trade barriers between the RTAs. Others believe that the proliferation of RTAs poses a serious challenge to the multilateral trade system. They see the emergence of three regional trading blocs, one centered upon Western Europe, one incorporating the Western Hemisphere, and one in Asia. The three will engage in trade wars that will restrict trade between the blocs and ultimately undermine the multilateral trade system. It is impossible to predict which of these two dynamics will dominate.

The trends over the last thirty years, therefore, are not easy to interpret. Some indicate that the multilateral trade system remains strong, while others suggest that it may be weakening. It is impossible to state definitively which of these trends will dominate in the future. I believe, however, that the system remains strong. The interests embodied in the WTO have never been exclusively American interests. The U.S., the EU, and Japan are all committed to market-based liberalism and its corollary of liberal trade. And even though these governments may disagree about details of trade policy, engage in trade conflicts, and periodically resort to protectionism, none of these governments disagree over the core principles upon which the multilateral system is based.

In sum, the creation, structure, and longevity of the multilateral trade system have been shaped by the interaction between power and interest. The multilateral trade system was established under American leadership in the immediate postwar years. The conceptualization and establishment of this system was motivated by an American desire to expand its exports and by lessons drawn from the interwar period. The Cold War helped to consolidate the system in the first twenty years following World War II. The GATT was based on market liberalism because this principle reflected the interests
of the United States and the other advanced industrialized countries. And while the last thirty years have brought trade conflicts, periodic surges of protectionism, and a growing network of regional trade arrangements as well as a shift in the distribution of power and the end of the Cold War, it is not clear that these developments pose a serious threat to the multilateral trade system. This system is likely to persist as long as the advanced industrialized countries continue to believe that market-based liberalism represents the best way to organize world trade.

D. Globalization and its Critics

What are the economic and political consequences of the multilateral trade system? The economic consequences are profound. The liberalization of trade has unleashed forces that are transforming the world economy. As barriers to trade have been dismantled, international competition has intensified. This intensified international competition has set in motion processes that are creating international trade and production networks and a global division of labor. This transformation of the world economy is often referred to as “globalization.” Globalization has in turn generated a political backlash targeted at the multilateral trading system in general and the WTO in particular. Since the mid-1990s, critics have argued that globalization enhances the political power of large corporations at the expense of labor and national governments, and that the WTO is undermining democracy. We conclude our discussion of the multilateral trade system, therefore, with a focus on globalization and its critics.

1. The Globalizing World Economy

Economic globalization is the result of dynamics unleashed by trade
liberalization. These dynamics are driven by international trade flows and the activities of multinational corporations in an increasingly integrated global economy. Here we look principally at the impact of trade liberalization; we examine multinational corporations in chapter five. As governments dismantled barriers to trade during the last fifty years, world trade began to grow at historically unprecedented rates. As figure 2.3 illustrates, international trade has grown steadily since 1950. What is perhaps more impressive than the growth of world trade, however, is the fact that throughout the postwar period international trade has grown more rapidly than the world economy. Figure 2.4 charts the annual rate of growth of world exports and the annual rate of world economic growth. Looking at the two series together indicates that in almost every year since 1950 world trade has expanded more rapidly than world economic output. Thus, year after year a larger share of the world’s economic output is produced in one country and consumed in another.

(Figure 2.3: The Growth of World Trade)
(Figure 2.4: Growth of World Trade and Output)

Trade openness is the standard measure of the importance of international trade to national economies. Trade openness measures each country’s total trade (its imports plus its exports) as a percentage of its gross domestic product (GDP). The statistics on trade openness since 1950 presented in table 2.6 illustrate the rising importance of international trade to many regions of the world. Western Europe’s trade-to-GDP ratio increased from 35 percent in the early postwar period to almost 50 percent by 1990. Thus, half of Western European countries’ income is either earned by selling domestic production in foreign markets or is spent on goods imported from foreign producers. While North America (the United States and Canada) is less open to international trade
Figure 2.3: World Trade, 1968-1997

$US Billions


0 2000 4000 6000

0 1000 2000 3000 4000 5000 6000

$US Billions

than Western Europe, its trade-to-GDP ratio has also increased during the last fifty years. Developing countries display a different pattern. Many were already quite open in the early postwar period, and few have become more open during the postwar period. Africa and Latin America actually became less open to trade between 1948 and 1980. We will explore the reasons for this in greater detail in chapter four.

(Table 2.6: Trade Openness, 1948-1990)

While the volume of international trade has grown tremendously since 1947, the figures on trade openness suggest that all countries have not been equal participants. Table 2.7 presents regions’ shares of world trade during the last forty years. Three points in this table are worth emphasizing. First, throughout the postwar period, international trade has been dominated by the advanced industrialized economies, which together account for about 70 percent of total world trade. Second, while developing countries account for only a small share of world trade, this share has grown during the last forty years. In the early 1960s, developing countries accounted for only about one-fifth of world trade but this share had grown to about one quarter by 1999. Third, while developing countries’ share of world trade has grown, the newly industrializing countries (NICs) of east Asia, Taiwan, Singapore, Hong Kong, South Korea, Malaysia, and Thailand, are responsible for most of this increase. These six countries’ share of world trade increased from 2.6 percent in 1953 to 10 percent in 1999. In contrast, Africa and Latin America saw their shares of world trade fall in the same period. In short, the advanced industrialized countries and, to a lesser extent the Asian NICs dominate international trade.

(Table 2.7: Regional Shares of World Exports)

The liberalization and subsequent expansion of international trade has unleashed
Table 2.6: Trade Openness, 1948-1990
(Imports+Exports/GDP)

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>World</td>
<td>22</td>
<td>22</td>
<td>22</td>
<td>35</td>
<td>34</td>
</tr>
<tr>
<td>Western Europe</td>
<td>35</td>
<td>33</td>
<td>34</td>
<td>48</td>
<td>46</td>
</tr>
<tr>
<td>North America</td>
<td>11</td>
<td>9</td>
<td>10</td>
<td>19</td>
<td>19</td>
</tr>
<tr>
<td>Asia</td>
<td>25</td>
<td>26</td>
<td>21</td>
<td>27</td>
<td>29</td>
</tr>
<tr>
<td>Latin America</td>
<td>30</td>
<td>30</td>
<td>21</td>
<td>27</td>
<td>28</td>
</tr>
<tr>
<td>Africa</td>
<td>50</td>
<td>58</td>
<td>37</td>
<td>56</td>
<td>53</td>
</tr>
</tbody>
</table>

economic forces that have restructured the global economy. Trade theory tells us that
countries open to international trade will specialize in goods that make intensive use of
their abundant factors. In a fully open international economy, therefore, we should see a
global division of labor in which each country specializes in producing goods in which
they are comparatively advantaged. As trade barriers have been reduced during the
postwar period, such a division of labor has begun to emerge, though it is far from
complete.

- The advanced industrialized countries hold a comparative advantage in capital
  and human-capital intensive goods. Producers in the advanced industrialized
countries lead the world in the production of knowledge-intensive products such
  as pharmaceuticals, computers and software, telecommunications equipment,
  commercial aircraft, and other research and development and high-technology-
  intensive products.

- The Asian NICs, especially South Korea, Taiwan, Hong Kong, and Singapore,
  hold a comparative advantage in mature and relatively standardized capital-
  intensive goods such as semiconductors and other computer components,
  automobiles, and steel. These countries have not yet become an important
  source of product or process innovation.

- The second wave of NICs, including Indonesia, Malaysia, Thailand, Mexico,
  and Argentina, hold a comparative advantage in labor-intensive goods such as
  apparel, footwear, and the assembly of finished goods from their components.
  These countries have not yet emerged as important international producers of
capital-intensive goods, but are likely to make that transition relatively soon.

- Other developing countries hold comparative advantages in land-intensive
primary commodities such as fuel, minerals, and agricultural products.

This global division of labor has not arisen spontaneously; firms have created it by beginning, ending, or relocating production in response to competitive pressures. The relocation of economic production is due in part to independent decisions taken by business people in different countries. An entrepreneur in Pakistan, for example, might recognize a profit opportunity in the labor abundant apparel industry and start a business to realize these profits. An apparel producer in North Carolina might recognize that it can no longer compete against developing country apparel producers and cease production. These independent decisions cause apparel production to shift out of the United States and into Pakistan. The relocation of production is due in part also to production decisions taken within a single firm. An American auto firm such as Ford, for example, might recognize that it must reduce its production costs to compete against Japanese producers in the American market. To do so, Ford might build an auto assembly plant, a labor-intensive aspect of auto production, in Mexico, where labor is abundant and relatively cheap. Ford’s decision might thus shift auto production out of the United States and into Mexico. The emerging global division of labor, therefore, is produced by hundreds of thousands of decisions taken by economic agents in response to the competitive challenges of the international economy.

In some respects the emerging division of labor is not a new phenomenon. A division of labor also characterized the 19th century international economy. European countries specialized in manufactured goods and what we now call the developing world specialized in raw materials. The contemporary division of labor differs from that which pertained in the late 19th century in two ways, however. First, today’s division of labor is more diverse than that of the 19th century. To the basic 19th century division between
manufacturing and raw materials, the contemporary system adds divisions within manufacturing activity. Today we see countries specializing in human capital-intensive manufacturing, other countries specializing in capital-intensive manufacturing, and still others specializing in labor-intensive manufacturing. Second, the production of individual goods has been broken down and allocated across the globe. In the 19th century, production remained national; production “was primarily organized within national economies... production, plant, and firm were essentially national phenomena” (Hobsbawm 1979, 313). In the contemporary international economy, production is increasingly an international phenomenon.

The personal computer is one example. The typical PC contains a microprocessor designed in the United States by Intel, Motorola, or Advanced Micro Devices (AMD). It contains a hard drive and memory chips that were most likely produced in Taiwan or South Korea. The multiple components were probably assembled into a working PC in yet another location, perhaps in Malaysia or in Mexico. Thus, a personal computer, and many of the other products that we use on a daily basis, are no longer produced in a national economy. Instead, the production of many individual goods is organized globally; the human capital-intensive stages of production are based in the advanced industrialized countries, the capital-intensive stages are located in the NICs, and the labor-intensive stages of production are performed in developing countries.

In sum, the liberalization of international trade unleashed economic dynamics that are transforming the global economy. As trade barriers were eliminated, international trade expanded rapidly and economic competition intensified. Firms’ responses to the profit opportunities and the competitive challenges of this global market
have shifted production away from countries where it is more costly to those countries where it can be done more efficiently. A new global division of labor is being created. Economic activity has become increasingly internationalized, and these international activities are increasingly being woven into a deeply integrated web of trade and production relations. It is this phenomenon that has been labeled globalization.

How far has globalization progressed? There is disagreement among those who study the world economy. Some argue that international economic integration has fundamentally transformed the world economy and the national economies that comprise it. As Robert Reich (1992, 3) has written, “We are living through a transformation that will rearrange the politics and economics of the coming century. There will be no national products or technologies, no national corporations, no national industries. There will no longer be national economies, at least as we have come to understand that concept.” Others suggest that this transformation has already occurred. Business consultant and author Peter Drucker, for example, writes, “the talk today is of the ‘changing world economy.’. . . The world economy is not ‘changing’; it has already changed—in its foundations and in its structure—and in all probability the change is irreversible (Drucker 1986, 768).

Others are more skeptical. Robert Gilpin, a Princeton University political economist, claims that “globalization is much more limited than many realize” (Gilipin 2001, 363). Gilpin and other skeptics point to the 19th century global economy to buttress their counter-arguments. In this first global economy, Gilpin argues, countries were more open to trade than they are today. And “although trade has grown enormously during the past half century, trade still accounts for a relatively small portion of most economies. . . [and] is still confined to a limited number of economic sectors.
The principal competitors for most firms (with important exceptions in such areas as motor vehicles and electronics) are other national firms” (Gilpin 2001, 365). Even, where globalization has progressed the furthest, in the “Triad” composed of Pacific Asia, the United States, and the EU, national barriers continue to impede the flow of goods and services (Gilpin 2000, 295).

It might be more useful to look for the middle ground in this debate. Economic processes are fundamentally changing the world economy. At the same time, however, it is important to recognize that globalization is limited in geographic scope, involving primarily the countries of the triad. Globalization is limited in industrial scope as well, with some industries, such as electronics, being more “globalized” than other industries, such as steel. As Peter Dicken (1998, 5) summarizes, “although there are globalizing forces at work we do not have a fully globalized world economy. Globalization forces can be at work without this resulting in the all-encompassing end-state—the globalized economy—in which all unevenness and difference are ironed out, market forces are rampant and uncontrollable, and the nation-state merely passive and supine.” In short, while it is premature to proclaim a fully globalized world economy, and while nothing that is created by human activity is ever irreversible, it is also misleading to claim that nothing has changed.

2. The Critics of Globalization

A political backlash against globalization emerged in the mid-1990s and continues to strengthen. Opponents of the multilateral trade system advance a number of criticisms that indict the economic dynamics of globalization and the WTO and propose a number of fundamental reforms. This backlash reflects public concerns
about the distributional and political consequences of the multilateral trade system and suggests that societal support for the multilateral trade system is weakening. This could in turn weaken governments’ support for the system.

Globalization’s opponents advance two broad critiques of the multilateral trade system. First, critics allege that the economic dynamics of globalization have strengthened the power of large corporations relative to other social groups and national governments. In an open world economy large corporations can choose where to base production. Critics of globalization argue that the resulting ability to threaten to exit a national economy provides these corporations with political leverage. Whenever a corporation faces a demand that will raise its costs, it can threaten to shift production to another country unless the demand is rescinded. According to critics, this dynamic is evident in wide range of activities. In wage negotiations with their workers, corporations can threaten to shut down a plant and move jobs to Mexico or Asia unless workers moderate their wage demands (Destler and Balint 1998, 17). Governments can be forced to weaken labor standards and environmental laws by a threat to move to developing countries where such regulations are less exacting. Economic openness, therefore, has strengthened the power of capital at the expense of labor and of national governments. As the AFL-CIO nicely summarizes, globalization has “strengthen[ed] the clout and bargaining power of multinational corporations…limit[ed] the scope of governments to regulate in the public interest, and…forced workers into more direct competition with each other” (AFL-CIO 2001).

Second, critics argue that the World Trade Organization is undermining democracy. As one critic has written, the WTO represents a “slow-motion coup d’etat over democratic governance worldwide” because it has caused a “shift in decision-
making away from democratic, accountable forums—where citizens have a chance to fight for the public interest—to distant, secretive and unaccountable international bodies” (Wallach and Sforza 1999, 1, 2). The principal mechanism through which sovereignty is alleged to have been transferred and democracy trampled is the WTO’s dispute settlement mechanism. Critics claim that the DSM has the power to “judge countries’ laws for WTO-compliance” (ibid, 4). By requiring that governments’ health and safety regulations, environmental policies, and other national laws be consistent with their obligations under the WTO, critics allege that the WTO strips governments of their ability to regulate activities to achieve the “public interest.” One prominent example is a recent WTO decision concerning a U.S. ban on shrimp imports. In the late 1980s the U.S. passed legislation that required U.S. shrimpers to use “turtle excluder devices” (TEDs) on their nets to prevent sea turtles from being caught along with shrimp. In 1989, the U.S. passed a law that banned the import of shrimp from countries where sea turtles were known to live but where shrimpers were not required to use TEDs. India, Malaysia, Pakistan, and Thailand, each of which was affected by this American law, claimed that the ban was inconsistent with the GATT and sought a WTO panel to resolve the dispute. The WTO’s dispute settlement body found in favor of the Asian countries, and the United States was required to amend its regulation. Critics see this case and others as evidence that the WTO will overturn national laws enacted through democratic processes in order to protect business interests.

The concerns have led opponents to push for changes in the multilateral trade system. Critics want labor and environmental regulations incorporated into the World Trade Organization. Moreover, they want these regulations to be enforced through the WTO’s dispute settlement mechanism (see Destler and Balint 1998; O’Brien et al
They want greater transparency of the WTO decision-making process, particularly in the dispute settlement process. And they want the right to participate in WTO decision making, including the dispute settlement process. The rationale for these reforms is quite clear. If labor and environmental standards can be harmonized, then corporations will not be able to exploit cross-national differences in regulatory regimes. If the WTO decision making process can be made more open and transparent, critics of the system will have greater opportunities to influence the system’s rules.

Public reaction to two dynamics in the multilateral trade system underlie these criticisms. One dynamic is the public perception of the distributional consequences of globalization. The deepening of globalization since the late 1970s has been paralleled by a widening income gap between low and high skill workers. In the United States, high skill workers (traditionally defined as workers who hold a college degree) earned about 50 percent more than low skill workers in the late 1970s. In 1996, high skill workers were earning 70 percent more than low skill workers (Scheve and Slaughter 2001). People have concluded that because globalization and this widening income disparity have occurred simultaneously, the one must be the cause of the other. A second dynamic is the public perception of the political consequences of the WTO. During the last seventy years advanced industrialized countries have developed an elaborate set of social regulations designed to protect consumers, the environment, and workers against unscrupulous business practices. Critics claim that this “social compact” is now being dismantled through the multilateral trade system because its specific components pose obstacles to international trade (see Aaronson 2001). In short, opposition to globalization is based on the perception that the multilateral trade system redistributes income and promotes unfettered capitalism at the expense of the
public interest.

Are these criticisms valid? By this I don’t mean to ask whether people are right to be concerned about growing income inequality and the health of democracy. What I mean is, are the critics of globalization correct to assert that the multilateral trade system widens income inequalities and undermines democracy? We will defer detailed consideration of the economic dynamics until chapter three. We can note here, however, that there is some merit in the claim that low-skill workers are losing from globalization. However, globalization is not the most important cause of the widening income gap.

It is hard to accept the claim that the WTO undermines democracy. The United States, Western European countries, and Japan, as well as all other democratic countries, practice representative democracy. In representative democracies elected officials make decisions on behalf of their constituents and are held accountable by these constituents for the decisions they make. The WTO does nothing to weaken this mechanism of accountability. Voters can hold their trade ministers accountable for whatever decisions they make within the WTO. In addition, in most democratic countries, and certainly in the United States, legislative approval is required before new trade rules become part of national policy. Thus, voters have the opportunity to affect the specific objectives that their representatives seek in the WTO, and they can attempt to influence the vote of their legislator on whatever agreement emerges from international trade negotiations. The claim that the WTO privileges business interests over other social groups also lacks merit. While it is true that labor, environmental, and other public interest groups have no voice in the WTO, it is also true that corporations have no direct voice in the WTO. National governments are the only participants in
WTO negotiations. If trade rules are biased toward business interests, the problem lies in the balance of power between business and other societal interest groups within countries and not in an imbalance in the WTO.

While there is greater merit in the assertion that the WTO’s dispute settlement mechanism undermines democracy, this system must be evaluated in a broader context. First, the dispute settlement mechanism has no authority to create new trade rules. It can only determine whether a specific policy implemented by a specific government is consistent with specific multilateral trade rules. Moreover, the decisions it renders apply only to the specific dispute under consideration. While panel decisions may create precedents for future rulings, no ruling applies to any country other than that which is named in the particular dispute. Second, the dispute settlement mechanism has no authority to initiate reviews. Dispute panels are created only in response to a specific request from a member government, and even then only after consultations between the parties to the dispute fail to resolve the complaint. While panel members are un-elected trade experts who cannot be held accountable, would we want elected and accountable officials serving in this capacity? Elected officials are susceptible to political influence. The decisions they make, therefore, are unlikely to be unbiased evaluations of cases’ legal merits. An independent judiciary like the WTO’s dispute settlement mechanism allows knowledgeable people insulated from political pressures to render decisions about the legality of specific practices. We tolerate precisely such a system in the United States Supreme Court, and most find this practice not only perfectly reasonable but also perfectly consistent with democracy.

Regardless of the merits of the arguments advanced by globalization’s critics, the backlash suggests that societal support for the multilateral trade system is
weakening. Public opinion polls consistently indicate that the American public is very uneasy about American participation in the global economy, and reluctant to embrace further trade liberalization (Scheve and Slaughter 2001). This can have profound consequences for the system’s future. In the short run, it greatly complicates governments’ efforts to launch the Millennium Round. In the long run, eroding societal support for the multilateral trade system must eventually translate into diminished support for the system by democratically elected governments in the United States, Western Europe, and Japan.

E. Conclusion

The historically unprecedented growth of international trade since World War II has been as much a political as an economic phenomenon. It was made possible through the establishment of political institutions following World War II. Under U.S. leadership, the advanced industrialized countries created a multilateral trade system centered upon the GATT to promote trade liberalization. This multilateral system made possible repeated rounds of negotiations through which governments progressively reduced barriers to trade in manufactured goods and created new rules governing other aspects of international economic activity, including trade in services and intellectual property rights. In 1994 this multilateral system was strengthened with the creation of the World Trade Organization.

The resulting growth of international trade made possible by the multilateral trade system has transformed national economies and the global economy. The elimination of barriers to trade promoted the progressive development of a global division of labor and a tightly integrated network of economic relationships among the
U.S., the EU, Japan, and the Asian and Latin American NICs. Economic production is increasingly being broken down into its distinct components and distributed across the world according to the logic of comparative advantage. The emergence of a global division of labor is necessarily disruptive to the societies experiencing these changes, particularly in the advanced industrialized countries where high-paying semi-skilled manufacturing jobs appear to be migrating to Asia and Latin America. This economic disruption has in turn generated a backlash against globalization. Critics of globalization question the priority accorded to economic interests over other interests such as the environment and workers’ rights, and they claim that the WTO is undermining democracy. While such claims are often exaggerated, they do suggest that there are clear limits to societal support for an international economic system that continually threatens established social arrangements. Moreover, the backlash against globalization represents perhaps the biggest contemporary challenge to the multilateral trade system. Only time will tell whether and how the multilateral trade system will be affected by this opposition.
References


