US Trade Policy: Successes and Failures

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* This paper elaborates on remarks made at the American Economic Association meetings, January 1995, in Washington D.C., at a Panel Discussion on the Clinton administration's trade policy. The Panel included two highly distinguished trade experts: the Chairman of the Council of Economic Advisers, Laura Tyson, and Anne Krueger, the President-elect of the American Economic Association; and Rudiger Dornbusch, the wellknown macroeconomist. I have used this occasion to raise some uncommon questions and to provide a frank and at times critical commentary on the current trends in US trade policy precisely because we have correctly applauded the policy because of its free-trade thrust while ignoring its downside which requires correction.
A common, and indeed plausible, complaint of the Clinton administration is that many of its policy successes have been discounted, even disregarded, by hostile media. In trade policy, however, I would argue that the opposite is true: the administration’s successes have been exaggerated and its failings have been ignored.

I will address the successes first, and the failures next. But before I do that, let me dissociate myself from what I regard as essentially quibbling complaints that have been directed at the President’s trade policy.

I. The Quibbles:

Much has been made of the President’s wrongheaded emphasis on “competitiveness”. You generally cannot put a politician’s precise words through the wringer of economic logic without drawing blood. But, frankly, it is a mug’s game: why do it? When Presidents talk of “competing” with other nations, they surely mean it in the broader sense of improving the rank-ordering of their nations in terms of good (and bad) indices of economic prosperity. Just recall how England and the Netherlands were engaged in rivalry in the eighteenth century. That the US and the Pacific nations saw themselves in a similar light recently is wellknown, and as I remarked (in a phraseology which caught on), the United States did suffer from a Diminished Giant Syndrome vis-a-vis these nations1. This syndrome had the good effect of fueling the search for policies to improve the economic performance of the US economy while it also had the bad effect of producing the militancy towards Japan that produced the ill-considered Japan policy that I turn to later.

Rather than quibble, as I am afraid that Paul Krugman (one of his generation’s most distinguished trade economists) did recently in Foreign Affairs about the use of the word “competitiveness” by the President, and for that matter by (former) bureaucrats such as Clyde Prestowitz and policy wonks such as Messrs. Cohen and Zysman of BRIE who are easy prey, I think that the debate ought to be about the policies that these gentlemen advocate to advance our prosperity.

In regard to these policies again, I believe that Paul Krugman's critique of the Clinton administration's focus on trade as a major area of concern is somewhat off the mark. My suspicion is that Krugman greatly underestimates both the gains that can accrue from freer trade and, its flip side, the cost of protection. Thus, in his earlier book on *The Age of Diminished Expectations*, he dismissed the cost of protection as low, with that particular part of the book highlighted in an op.ed. article by the sponsor of his book, *The Washington Post*. The fallacy of this view has been argued ably by yet another brilliant student of mine, Robert Feenstra --- Laura Tyson, Paul Krugman and Robert Feenstra, I am proud to say, are all my former MIT students --- in the American Economic Association's *Journal of Economic Perspectives* (1994). Feenstra's scholarly critique draws on a large recent literature on the subject. The Krugman view has been challenged also by the growth economist Paul Romer who argues for extremely large estimates of the cost of protection in his recent article in the *Journal of Development Economics*.²

I also worry that Krugman tends to imply, and is always understood by his lay readers to imply, that the "fundamentals" such as investment, savings and technical change are the key things to focus on rather than trade policy, and that therefore these are independent of trade opportunity and policy. But this view is fundamentally flawed. For instance, export-led investment and growth can occur and, according to most trade and developmental economists and historians, does occur. For instance, the phenomenal growth of the Far Eastern nations in the 1950s and 1960s in particular, was surely due to expanding trade opportunities, garnered by an export-promoting trade strategy, which led to increased marginal efficiency of capital, an increasing investment rate and accommodating increase in savings to "miracle" levels. To look at these huge investment and savings rates, and to say that therefore it was all a matter simply of high investment and savings rates and little else is to stay put

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² Romer's article was recently reviewed in the celebrated Economic Focus column in *The Economist*. Theoretically, of course, this cost of protection could even be 100% of GNP: thus, consider an imported factor of production to be "essential" for production as would be the case for a conventional Cobb-Douglas production function, in which case autarky would lead to zero GNP! There is therefore nothing inherently inevitable about "low" cost-of-protection estimates, as I argued way back in my 1966 Frank Graham Lecture at Princeton University.
with the hands of the clock and to forget about the clock's mechanism\(^3\). The criticism of the administration's concern with trade policy and open markets as somehow ignoring the real "fundamentals" rests on this type of "arithmetical" approach to economic policy that the administration is right to ignore.

But these quibbles and fallacies aside, let me confess that the administration economists did raise legitimate and large concerns on our part by suggesting, at the outset, that selective industrial policy was a good idea whose time had finally arrived. I raised serious doubts about this view in reviewing Laura Tyson's book, *Who's Bashing Whom?* in a long review article in *The New Republic* (May 1993); and I have seen nothing that persuades me otherwise. My attitude remains the same as that of the Nobel laureate Robert Solow who taught both me and Laura Tyson. He observed wryly once: "I know that there are industries where a dollar worth of output is really worth four; my problem is that I do not know which ones they are". But, to be fair, the Clinton administration seems to have kept reasonably away from the selectivity which was its main advisers' major obsession.\(^4\) Perhaps there was learning from the pointed criticism that I advanced (assuming that Laura read my review); perhaps it was endogenous dawning of good sense. Either way, I have few complaints.

One more thing: the President and his economists come frequently under

\(^3\) For this flawed approach to analyzing the Far Eastern growth experience, see Krugman's more recent *Foreign Affairs* (November/December 1994) article on "The Economic Miracle that Isn't". The economist Dani Rodrik of Columbia University, with whose analysis of the Far Eastern miracle I am not in entire agreement, has properly commented on this flaw in Krugman's approach; see his forthcoming letter in *Foreign Affairs*. The enormous importance of exports in sustaining South Korea and Taiwan's ever-increasing investment and savings rates has also been argued by the Oxford economist, Ian Little, who has long studied the trade and industrial policies of developing countries.

\(^4\) Perhaps I should not let Laura Tyson off so lightly. Thus, the well-informed expert on technology policy, Claude Barfield Jr. has written in *Issues in Science and Technology* Winter 1994-95, in regard to the administration's R&D subsidy to flat panel displays (FPD) which is tantamount to a production subsidy since it is conditional on starting nonexisting production, that: "...much of the impetus for the FPD initiative appears to have come from the White House, not DOD [Department of Defense]. Reports in the popular media confirmed that the administration gives credit to Council of Economic Advisers chairwoman Laura Tyson and National Economic Council leaders Robert Rubin and Bowman Cutter... Cutter stated that other civilian technologies --- robotics, ceramics, precision tools --- would be candidates for similar efforts in the future" (p.22).
attack for emphasizing the “jobs” that “exports create”. Of course, these distinguished economists (though not all who write in Washington and get quoted approvingly by the media) know that jobs are created by macroeconomic policy. But this is fine political rhetoric which creates its own reward in the form of support for good trade policy. Humorless critics exclaim: ah, but that means that imports destroy jobs, which is ridiculously funny, of course. But most people think that imports “destroy jobs” anyway, so when the President talks of exports creating jobs, he is not corrupting an already corrupted political discourse, he is only making a second-best correction.\footnote{Perhaps I should add the caveat that economists are well advised to be sparing in the use of evidently wrong arguments just because they are politically useful currently. In my experience, sloppy arguments can suddenly cause difficulties later. Thus, even the “exports create jobs” argument may have locked the administration into a disastrous post-NAFTA situation where the administration turned a blind eye to the need for timely Mexican adjustment because a Mexican devaluation and associated correction of an unsustainable current account deficit may have been seen as seriously reducing US exports to Mexico and hence handing the Perostistas and US unions a trump card prior to the November elections.}

I am inclined therefore to excuse this piece of economic illiteracy in a good cause!\footnote{Of course, one could cleverly argue that President Clinton may truly not understand that jobs are created by macroeconomic policy, the reason being that he was Governor Clinton and states do not have control over macroeconomic policy. I believe however that President Clinton is quite capable of mastering the elementary economics at issue!}

Let me then get down to the serious issues.

II. Successes: The Uruguay Round

The principal success of the administration has certainly been in seeing the Uruguay Round through. The President deserves much applause for it, even as we recognize that the initiative was Republican and the passage in the Congress would have been impossible without Republican support in the end. But the administration deserves less fulsome praise than the media, which is not able to see the fine print or to put matters in larger perspective, lets it have.

(1) Weakening of Discipline: In particular, in the final stretch, the President’s negotiators seriously weakened the disciplines that are a key part of the GATT. In particular, the Subsidies Code now accommodates “R&D” subsidies generously whereas key provisions of the anti-dumping discipline
were weakened below even the somewhat limited level that the Dunkel draft had managed to write in.

Such compromises were presumably struck in the interest of assuring passage by the Congress. But the choice of compromises from several available must itself be explained. And here I believe that the choice was excessively influenced by disregard for good economics.

(i) Thus, the R&D subsidy surely came from the Clinton advisers' desire to have one, much in line with their view of the desirability of selective industrial policy: the later action on flat panel displays by Defense (which I discussed already) is exactly the sort of selective promotion of an industry that the Clinton administration had in mind and which opens the door wider at the WTO for each Contracting Party to walk subsidies aimed at industrial policy through it.

(ii) On the other hand, the anti-dumping compromises appear to have been a concession to manufacturing interests. But administration economists cannot absolve themselves entirely from blame. For, their Japan-fixation surely must have handicapped them in fighting those who argued that it was of the utmost importance to use anti-dumping actions to prevent Japanese predatory exports. You are not exactly compelling when you agree that the Japanese are unfair traders but contend in a nuanced way that anti-dumping measures are inappropriate: you will sound a bit self-contradictory and probably a prisoner of academic theology when you do that, losing credibility in the political game. Your ability as economists to fight the good fight against the lobbying interests seeking to weaken anti-dumping discipline gets sapped, as it clearly did.

But the actual situation, and culpability of the administration's economists, may have been worse. Thus, if the recent New York Times column (December 29, 1994) by Peter Passell, based on Greg Rushford's investigative report on Eastman Kodak's legal activities, is an accurate guide, one of our most distinguished, young trade theorists wrote a brief arguing that Fuji was dumping film, apparently using "strategic trade theory" to show why. It is hard to see how this brief, which I have not seen, could have properly reached this conclusion, especially when Eastman Kodak argued in a separate anti-trust case, which it also won, that the film industry was fully competitive because of
many rivals (excluding therefore the ability of Fuji to be a predator who would raise prices, after eliminating Kodak, to monopolistic levels in a sustained fashion). But if this distinguished trade economist was presumably misled into thinking that "strategic trade theory" showed that Fuji was indulging in predation despite the evidence of substantial competition in the film industry and therefore that anti-dumping action was justified, it is not inconceivable that others (not so smart) in the administration may equally have been misled by "strategic trade theory" into deducing predation where none exists.

In fact, as Richard Clarida (who, along with Wilfred Ethier, has done pioneering work in the modern theory of anti-dumping) has recently argued, a proper judgment on the implication of modern Industrial Organization theory for anti-dumping practice would conclude, not that predation is likely, but rather that the conventional practice of deducing predation from below-cost pricing is simply wrong and that, if anything, modern anti-dumping theory is even more on the side of those who see it as a protectionist institution that cries out for reform, if not elimination.

(iii) I am afraid that I must also express my deep disappointment with the administration in succumbing to the demands for a US review panel to oversee and double-guess adverse WTO Panel rulings against the US. This absurd idea is the gift of Senator Dole and cannot be blamed on the administration. Where one can indeed fault the administration again is in not ruling it out altogether or, if a compromise had to be struck, in not broadening the review beyond three adverse rulings to a review which would also include the findings in our favour. The notion that findings must be scrutinized and WTO's "fairness" be judged only by reference to cases that the US loses is surely an outrageous one that threatens the integrity of the dispute settlement process. The President, in my view, failed to provide firm leadership on this issue, much as I appreciate that

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7 Actually, the legal requirements for establishing dumping do not require predation to occur, a fact that adds to the farcical nature of anti-dumping procedures from the viewpoint of compatibility with sound economic reasoning.

8 See his 1994 paper, "Dumping: In Theory, In Policy and in Practice" (mimeo, Columbia University) for the Project on Fair Trade and Harmonization, directed by Jagdish Bhagwati and Robert Hudec, under the auspices of the American Society of International Law and financed by the Ford Foundation.
the problem was created by Senator Dole in the first place. In consequence, he undermined possibly the most important aspect of the WTO: the clear establishment and affirmation of the rule of law, rather than the law of the jungle, in dealing with trade disputes among nations.

(2) **Environmental and Labour Standards**: I am afraid that I would also fault the administration for surrendering to the lobbies that have aggressively pushed for the inclusion of Labour Standards via a Social Clause in the WTO, and for not clearly and firmly rejecting the notion that different environmental and labour standards across countries are a ground for withholding market access to these countries.

I have argued the case for the legitimacy of diversity of standards at length in several recent writings. The case against such diversity is unsound in logic or untenable in empirical relevance. It also reflects protectionist pressures as industries scramble to raise the costs of their rivals in the poor countries.

The question of imposing specific labour standards on other countries raises other issues, chiefly of morality. But here too, the simplistic nature of the moral rhetoric, as also the fact that it is almost always focused exclusively against the poor countries (e.g. on issues such as child labour which are overwhelmingly to be found in the poor countries, even as the amply-documented transgressions such as those against migrant and immigrant labour and the sorry plight in shape of high infant mortality and exposure to serious hazards of the inner-city children in the rich countries are ignored in the clamor for a Social Clause in the WTO) must be forcefully noted. It is

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10 Many commentators have also noted the difficulties in assuming that the morality on issues such as child labour and minimum wages can be simply defined. If child labour is prohibited, and children die of starvation, is that morally right? If minimum wages lead to not-so-poor insiders gaining at the expense of the poor outsiders, is that morally desirable? Nearly all of the specific demands on behalf of labour unions are debatable in this way; but you would not know that from the self-congratulatory rhetoric about how the US is "exercising moral leadership" on these issues!
indicative of the tendency of these lobbies in the rich countries to throw stones at others' glass houses while constructing fortresses around their own, and to a tendency to exploit the white man's burden to secure the white man's gain.

I am afraid that the administration has more or less pandered to the domestic lobbies on these issues, creating an unfortunate and avoidable North-South divide on the issue at the WTO when in fact it should have stood up to them and shifted the policy debate and action away from the WTO and on to greater activism at appropriate international institutions such as the ILO for examining labour standards and at the UNEP for pushing environmental concerns. The aim should be to create a consensus on these questions, based on argument rather than threats. In regard to labour standards, in particular, where moral arguments (whose legitimacy is itself in dispute) are repeatedly invoked, the use of force rather than suasion is both reprehensible and inefficient. Surely, we should all agree that Christianity should be spread in this modern age without the use of the Inquisition; it must compete, not be hacked by the militia, to triumph in the battle for converts.

In these regards, the opposition of the Republicans to linkage between environmental and labour issues to the freeing of trade, as exemplified in their refusal to grant fast-track renewal with such linkage, is to be applauded as the triumph both of good economic thinking and of true tolerance and liberalism over self-righteous and self-serving threats and sanctions based on the unilateral assertion of the superiority of one's preferences and one's morality. Presidential leadership on these questions cannot long be deferred.

III. Failures: Japan Policy

The above failures are disappointing, though perhaps not momentous. The real failure of the Clinton administration, however, was in regard to its trade

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11 It is reprehensible because policies and actions that are morally offensive to me should not be forced on me by you just because you think that your views are morally superior to mine. It is also inefficient because, without conviction that the policies are morally right, I am unlikely to adopt and enforce them effectively simply because you have held a gun to my head and gotten me to accept them.
policy on Japan.

I have argued [in the last issue of The International Economy and also in a Foreign Affairs, 1994 article entitled "Samurais No More"] the case against the administration’s early embrace of the twin pillars of folly: the assignment of import targets (Voluntary Import Expansions, VIEs) to Japan’s private industry and the threat of Super 30I and 30I actions to whip them with trade restrictions if these targets were not met. These ideas were strongly rebuffed by the Hosokawa administration and have been rejected by the successor government as well.

The administration has finally relented, putting its ill-considered Japan policy into what looks like deep freeze. But we did lose nearly 18 months on fruitless acrimony for reasons that were predicted pretty well by some of us at the outset.

The media, deeply enthralled by the anti-Japanese rhetoric of the revisionists who were the theoreticians of the administration’s Japan policy, has failed to understand and truly acknowledge the failure. The economists who aided that policy have also escaped lightly: but then that is often the case. We economists are almost never chastised for our mistakes the way engineers have to pay if a bridge they had designed collapsed. As an economist who can only expect to profit from this indulgence towards our profession, I cannot complain!

IV: Subtle Failures: The Obsession with FTAs

Finally, let me turn to a more subtle, and wholly ununderstood, failure of the administration: namely, its continuing equation of Free Trade Areas (FTAs) with Free Trade (FT) and its persistence in pushing ahead with these trading

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12 I must say that I was happy to hear Rudiger Dornbusch come out on my side finally by criticising the "process" embodied in our Japan policy. Evidently, "process" could only mean the imposing of targets and threatening retaliation if they were not met. But would I be uncharitable to remind him that this process was precisely the one he himself (and only himself, among economists) had urged the administration to adopt? For a documentation and a convincing critique of his recommendation of this failed policy, see the fine pamphlet of Douglas Irwin, Managed Trade: The Case Against Import Targets, American Enterprise Institute: Washington D.C., 1994.
arrangements instead of concentrating on the jump-started, multilateral WTO. Anne Krueger has already declared today her deep concerns with this thoughtless pro-FTAs policy of the administration; I will reinforce her concerns.

At the outset, let me say that it is time that we realized that the phrase Free Trade Areas is Orwellian newspeak. It lulls us, indeed editorialists and columnists and politicians, into focusing only on the fact that trade barriers are lowered for members to the exclusion of the fact that, implicitly, the barriers are raised (relatively) for nonmembers. FTAs are therefore two-faced: they embody both free trade and protection. The reason is that they are inherently preferential and discriminatory. Perhaps, as economists interested in the quality of public policy discourse, we should take a pledge to rename the FTAs henceforth as PTAs (i.e. preferential trade areas).

In that regard, let me say also that, during the lobbying campaign for NAFTA --- I should really call it NAPTA if I was to act on my suggestion above ---, an incompetently drafted statement of support for NAFTA made the rounds for our signatures. It was notable for its implied equation of the case for the proposed FTA with the case for free trade, obfuscating the real issues. I was not asked to sign it and so the absence of my signature was not indicative of my views. [In fact, the media, in writing on NAFTA, occasionally described me as a notable signatory, assuming that I must have signed since I was a “free trader” or, as an irate administration economist of great distinction who was upset with my views and writings on Japan once denounced me, a “hyper-free trader”.] I have little doubt that many economists signed the ill-tutored statement of support for NAFTA simply because, once the protectionist Ross Perot had staked out his opposition to NAFTA, there seemed to be only a binary choice

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13 The debasement of the economic discourse from the opposite viewpoint comes, on the other hand, from the occasional suggestion that, to join FTAs, countries need to satisfy prior conditions on macro-stability et al. Thus, in a recent study, the well-known economists Gary Hufbauer and Jeff Schott of the Institute of International Economics in Washington appear to list several criteria for countries to be invited to join NAFTA, assigning weighted grades for this purpose. This leaves me puzzled, if I have understood them correctly. Free Trade requires no such preconditions, so why should FTAs? If it was correct to impose such prior conditions for us to let them join us in freeing trade within an FTA, then we would have to revise all our textbooks and treatises on international economics which argue that, no matter what other countries’ own policies, we will generally profit from freeing trade in a nondiscriminatory fashion. This type of thinking in fact would inappropriately slow down trade liberalization if it spread from FTAs to FT.
much like the choice from two tasteless entrees in a restaurant: support protectionism or support NAFTA. Signing the imperfect statement in support of NAFTA must have seemed the lesser of two bad choices, quite obviously.

Now that Ross Perot is out of the way, NAFTA has passed, and the Clinton administration is embarked on extending NAFTA into new countries starting with Chile and is understood also to be desirous of turning APEC into an FTA, it is surely time to subject this pro-FTA policy to fierce scrutiny. Such scrutiny, in my view, would expose this policy of the administration as a folly.

For, in essence, the proliferation of such PTAs, where countries extend preferences in different trading arrangements, creates a “spaghetti bowl” phenomenon. Thus, the EU has different types of association agreements with countries outside of the core members; the US has hub-and-spoke arrangements with free trade with Israel which, in turn, is not a partner of NAFTA; Israel has arrangements with EU and US; Mexico is a member of NAFTA and of an aspiring APEC FTA; Mercosur is about to enter into negotiations for a preferential trading arrangement with the EU, and so on. As countries reach out for special deals, not just among developing countries (as they have done for decades) but with the major trading nations as well, the analogy with an orgy, with bodies intertwined and reaching out in different directions, may be more apt in the increasingly salacious Washington.

The Spaghetti Bowl: Problems with Preferential Trading Arrangements

Such spaghetti-bowl proliferation of preferential trading arrangements clutters up trade with discrimination depending on the “nationality” of a good.

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14 The Economist, in a brilliant lead editorial in the end-of-the-year Double Issue, December 24th- January 6th, entitled “Battle Lines”, raised much the same issue, asking for an examination of the “increasing enthusiasm for regional, as opposed to global, agreements to liberalize trade” and avoiding “the mistake of unreservedly supporting everything Ross Perot attacks”. I congratulate this magazine which, along with The Financial Times, has played a distinguished and impressive role in raising the key analytical issues in regard to the world trading system in the last half a decade, while the US business magazines have done little except to play to nationalist and lobbying business viewpoints on issues such as NAFTA and Japan-bashing.

15 For a fuller analysis, see also my 1994 Wincott Lecture in London, to be published by the Institute of Economic Affairs and my Keynote Address in Tokyo in October 1994 at the Symposium organized by Nihon Keizai Shimbun and the Ministry of External Affairs in celebration of the 30th Anniversary of Japan’s accession to the OECD.
with inevitable costs that trade experts have long noted. In particular, consider the following points, some relevant only to Free Trade Areas, the others more general.

(i) Rules of origin, which are inherently arbitrary despite the Codifications we must live with, multiply under Free Trade Areas because different members have different external tariffs, making the occupation of lobbyists (who seek to protect by fiddling with the adoption of these rules and then with the estimates that underlie the application of these rules, as in the recent Canadian Honda case) and of customs officers (who can make much money by assigning goods to different origins as suggested by those fetching gifts) immensely profitable at our expense. Anne Krueger and Kala Krishna have written extensively and illuminatingly on this problem; so has the distinguished lawyer-cum-trade-commentator, David Palmeter.

(ii) More generally, it is increasingly arbitrary and nonsensical to operate trade policy of all kinds on the assumption that you can identify which product is whose. When I was a student at Oxford in the 1950s, there used to be a Who's Whose, designed to list the bondings (or “steady relationships” in our slang) among the undergraduates. Needless to say, the sexual revolution and the rise of uninhibited promiscuity put an end to it. Similarly, with the phenomenal globalization of investment and production, a Who’s Whose in defining trade policy is an increasing anomaly, tying up trade policy in knots and absurdities and facilitating protectionist capture.

Take some telling examples. We have tried assiduously to tell the Japanese that exports from their transplants in the US to Japan are not to be counted as US exports. On the other hand, when the Europeans tried to include the cars exported from these very transplants in their VER quotas on Japanese cars, Mrs. Carla Hills was up in arms! Again, just because imports from Japan are sought to be controlled, rather than imports from all sources without discrimination (as would be the case simply with a tariff or an auctioned VER), we have the EU getting into knots about whether Japanese transplants in UK are to be allowed freedom of access within the EU, and when would a car produced in Oxfordshire be British rather than Japanese.
Indeed, as the world economy increasingly muddies up the idealized picture of Japanese, American, British, Indian and Mexican goods that drives much of trade policy including particularly the pursuit of Free Trade Areas, the more we trade economists can see the wisdom of the great trade theorists of the past, Viner, Meade et al., who were strongly wedded to nondiscrimination and hence to MFN and multilateralism. As usual, a quote from Keynes, who had renounced his earlier skepticism of nondiscrimination during the British-American discussions of the design of the postwar Bretton Woods institutions, from his speech in the House of Lords in 1945, says it best:

"[The proposed policies] aim, above all, at the restoration of multilateral trade... the bias of the policies before you is against bilateral barter and every kind of discriminatory practice. The separate blocs and all the friction and loss of friendship they must bring with them are expedients to which one may be driven in a hostile world where trade has ceased over wide areas to be cooperative and peaceful and where are forgotten the healthy rules of mutual advantage and of equal treatment. But it is surely crazy to prefer that."

(iii) Again, it is frequently claimed that trade creation will be the order of the day with FTAs and customs unions (CUs); hence we need not fear trade diversion. But, as I noted some years ago, when protection is administered (in the form of VERs, anti-dumping actions etc.), it is selective and variable. The endogeneity of such protection means that trade creation can turn into trade diversion. Thus, if the US crowds Mexico in an industry, potentially creating trade in the Vinerian sense, Mexico can, and probably will, start anti-dumping action against nonmember suppliers and seek to accommodate thus both its own and the US firms at the expense of nonmember suppliers, transmuting trade creation into trade diversion.

At my suggestion a few years ago when I was Economic Policy Adviser to the Director General of the GATT and we were planning an Annual Report on Regionalism, Brian Hindley of LSE and Patrick Messerlin of Paris investigated this possibility empirically to see if the well-documented anti-dumping actions

(especially against Japan and the Far East) of the EC could be so interpreted as responses to the internal “trade-creating” competitive pressures rather than to exogenous intensification of competition from abroad. Their verdict was: yes, there is evidence in some cases that this had happened.\textsuperscript{17}

The NAFTA’s economist supporters, many untutored in any of these nuances because few had any professional competence in the complexities of trade analysis and realities, simply missed this important issue, focusing at best only on the observed trade barriers. When you combine this observation with the fact that our negotiators helped to weaken the improvement in discipline on anti-dumping at the Uruguay Round, as I observed above, the folly of our trade policy becomes obvious. Indeed, if you want to go down the PTA route, and to minimize the possibility of trade diversion, be sure that there is far more (not less) discipline on administered protection than we currently have!\textsuperscript{18}

(iv) In regard to trade diversion, furthermore, Arvind Panagariya of the University of Maryland, a distinguished trade theorist and policy analyst, has raised the question: would not Mexico, and potential future developing countries of South America seeking to join NAFTA, themselves suffer from harmful trade diversion from joining NAFTA? Arguing that the US and Canada are largely open, and comparing with the alternative of nondiscriminatory trade liberalization, Panagariya has argued that trade diversion is indeed what Mexico et.al. face, with the US and Canada gaining from the preferential trade

\textsuperscript{17} The Hindley-Messerlin paper has now appeared in a volume edited by Kym Anderson and Richard Blackhurst for the GATT and published by Harvester Wheatsheaf (UK), 1994.

\textsuperscript{18} Of course, trade diversion itself may be the principal driving force behind the choice of FTAs rather than nondiscriminatory trade liberalization as far as business lobbying is concerned. This “incentive” or “political economy” aspect of FTAs versus FT has been raised by me in “Regionalism versus Multilateralism: An Overview”, published in 1994 in the World Bank volume on the subject, edited by Panagariya and de Melo. It was also the subject of an Economics Focus column in 1993 in The Economist. That business lobbies, interested in exports, may prefer to go for preferential trade barrier reductions in their favour rather than investing efforts in opening markets for their rivals as well is what I have long been stressing, noting the differential lobbying in favour of NAFTA as against the Uruguay Round and the GATT. This idea has been analytically pursued in recent theoretical papers by my Columbia University student Pravin Krishna and by Arvind Panagariya and Ronald Findlay, the latter forthcoming in Gene Grossman and Robert Feenstra (ed.), The Political Economy of Trade Reform, Essays in Honor of Bhagwati, MIT Press: Cambridge, Mass., 1995.
liberalization of Mexico et.al. and the latter losing from it.  

One may well object: why should Mexico et.al. then want to join NAFTA? If the question is raised because it is inconceivable that the governments of these countries would not be rational in their policy choices, then that assumption itself must be clearly rejected. For one thing, as we know well from aid experience and literature, one can seek something which sounds good but actually does harm. Besides, the objectives of the leaders may be diversified. Thus, for instance, they may expect to gain political kudos by going along with NAFTA because, by granting preferential access to the US exporting interests, and through the implied underlining of Mexico's special relationship to the US, they may gain the support of the US in reaching out for prizes in a variety of unrelated political arenas. Thus, for example, in the absence of NAFTA and the willingness of President Salinas to put almost everything on the line for its passage, can one seriously imagine that the US would have gotten Mexico into the OECD\textsuperscript{20} or backed President Salinas for the important job of the Director General of the WTO\textsuperscript{21}?

(v) Perhaps the most frequently-repeated "non-economic" argument on behalf of Mexico et.al. joining a preferential trade arrangement such as the NAFTA has been that it helps to "lock in the reforms", giving them credibility. But if this means locking in trade liberalization, I have argued that acceptance of GATT bindings can equally lock in the liberalization. Besides, it is as difficult for

\textsuperscript{19} Panagariya actually makes a persuasive case that Mexico et.al. are most likely to suffer a welfare loss even if the comparison is with the initial situation rather than with unilateral trade liberalization by them. In the latter case, the loss by Mexico et.al. is certain, of course, since US and Canada are assumed to be open in all situations being compared. Cf. Panagariya, "The Free Trade Area of the Americas: Good for Latin America?", University of Maryland, \textit{mimeo.}, 1994.

\textsuperscript{20} One may wittily remark that Mexico's undistinguished, low growth rate (by the standards of most developing countries) during the 1980s qualifies it as an OECD country! Seriously, however, it is wellknown that Mexico got in because the US wanted this badly: as one of the highest officials of the OECD told me in private conversation, "Secretary Lloyd Bentsen [a major supporter of NAFTA] was very keen on it".

\textsuperscript{21} Remember that Mexico got into the GATT only in 1985, nor is it exceptional among the leading developing countries in terms of income level, sustained and high growth rates, effective assault on poverty, level of industrialization, degree of scientific achievement, and other indices that normally command one's attention. None of this, of course, is to detract from the significant accomplishments of the young Mexican leaders and technocrats, including Finance Minister Pedro Aspe, Trade Minister Jaime Serra and others in the splendid Salinas team, in moving Mexico through difficult political and economic reforms.
a small power like Mexico to get out of GATT obligations as it is to leave NAFTA once you are in.

As regards NAFTA giving credibility to Mexico's reforms, the recent crisis in Mexico lays that claim to rest just about as well as could be done. Real credibility in your reforms can come only from the credibility of your economic policies, not from an external pact like NAFTA, just as the announced commitment to a fixed exchange rate carries no credibility if the underlying macroeconomic policies are not themselves credible: it is the latter that give credibility to the announced fixed exchange rate, not the other way around!

Thus, it is obvious that NAFTA has done little or nothing to establish the credibility of Mexico's reforms at home or abroad; claims that it would and did were simply so much hype that, repeated long enough by NAFTA proponents, came to be accepted as incontrovertible truth by many.

The Problem with Present US Policy

In light of this analysis, I must confess that I find the approach taken by the Clinton administration, albeit with Republican support, in support of the pursuit of FTAs alongside the WTO to be mistaken despite its excellent intentions.

The approach seems to be, as reflected in the writings of the Treasury Undersecretary Larry Summers (one of our brightest economists and quite properly a star in the Clinton administration) and in the 1994 Report of the Council of Economic Advisers, that all forms of trade liberalization are good since they move us in the direction of free trade: unilateralism, bilateralism, plurilateralism, regionalism, multilateralism, indeed all "isms", in Summers' words, take you to liberalization.

But I wonder what Larry Summers would say if, on hearing that he wanted our spending to be cut, I went up to him and said: cut anything you want, wherever you wish, it does not matter what, as it all leads to reduced spending;

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22 See the Summers quote in Panagariya, "The Free Trade Area of the Americas: Good for Latin America?", op.cit.; and, for the Council of Economic Advisers, the following quote should suffice: "...the Administration is dedicated to working ... to open foreign markets through bilateral, regional and multilateral trade agreements", Economic Report of the President, February 1994, Washington D.C., p.214.
or, on hearing that he wanted revenues to be raised, I advised him, a wonderful public finance specialist of the neoclassical variety, to raise any and every tax in any way that he could since all taxes raised revenue. I am sure that he would get rid of me from the Department of Treasury at the earliest.

Indeed, this "GATT-plus" approach which regards all types of trade liberalization as simply separable and additive is essentially naive and wrong. "GATT-plus" economics makes about as much sense as the "marriage-plus" experiment was shown to make by Robert Redford and Demi Moore in the movie An Indecent Proposal.

Let me say, however, that there are two circumstances under which I would find the embrace of PTAs tolerable in principle:

* When a group of countries wants to develop a Common Market: in this case, not just trade but also investment and migration barriers are eventually eliminated just as in a federal state and the full economic and political advantages of such integration follow; and

* When it is not possible to move to fully multilateral free trade for all through multilateral trade negotiations (MTN), at the GATT or now the WTO, so that the only feasible way to continue reducing trade barriers is to go down the route of preferential free trade areas, seeking to spread them among as many willing nations as you can find, in the hope that this route will eventually procure worldwide free trade.

The former argument underlay the European initiative for the Common Market. The latter argument provided the original motivation for the United States, a keen opponent of PTAs and an avid supporter of multilateralism throughout the postwar period, to shift course and to embrace PTAs by initiating the Canada-US Free Trade Agreement (CUFTA) in 1983. The failure to secure agreement from Europe and the developing countries to start a new Round of MTN at the GATT Ministerial in November 1982 led Ambassador Brock to this

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23 The rest of my analysis below draws extensively on the penultimate section of my Wincott Lecture, op.cit.

24 I analyze below the empirical relevance today, and the merits generally, of this argument and reject it as good policy.
approach.; and the intention then was certainly to use a hopefully ever-expanding set of FTAs, with the US acting as both catalyst and nucleus, to achieve the worldwide free trade that could not be reached through MTN at the GATT any more.

Under Secretary James Baker, this open-ended approach, where the US-centered FTAs would be open to any nation anywhere --- they were informally discussed with Egypt and ASEAN nations at the time ---, became captured by the proponents of "regionalism" who linked it instead, and constrained it, to the Americas, as part of President Bush's initiative for the Americas. Thus grew the fears at the time that the world was dividing into three blocs: the EU, the Americas, and possibly a Japan-centered Asian bloc.

In the event, the US expanded CUFTA to NAFTA, and is now poised to go down the FTA route more energetically, promising to take Chile and then other South American nations on board. While the idea of regionalism is not dead, the Washington policymakers, in response to criticisms including mine\(^\text{25}\), have occasionally expressed the view that the earlier open-ended nonregional FTAs approach will be adopted instead. Thus, President Bush, in a major speech in Detroit at the end of the Presidential campaign, promised that he would extend NAFTA to Eastern European nations and to the Far East. And recently, the Clinton administration has tentatively suggested, according to media reports, the possibility of extending NAFTA to South Korea and Singapore.

But I must ask, in light of the many crippling defects of FTAs which I noted earlier and which Anne Krueger has also pointedly raised today: is this infatuation with FTAs\(^\text{26}\), including the pressure being exerted by the United

\(^{25}\) Cf. Jagdish Bhagwati, "President Clinton's Trading Choices: Beyond NAFTA What?", *Foreign Policy*, Summer 1993. I advocated there the position taken above that the best course was to return now to multilateralism and to give up on further FTAs. But that, if FTAs were to be pursued, then nonregional FTAs were better than regional ones because, among other reasons, the regional approach would be more likely to promote fragmentation of the world economy into preferential blocs.

\(^{26}\) It is sometimes argued that the United States is mainly responding to the desire of the South American countries themselves for an FTA of the Americas. This is misleading. There is no doubt today about the desire of the administration to proceed with such an agenda, and the catalytic effect that its desires are having currently in advancing that agenda.
States and/or Mr. Fred Bergsten to move APEC in the direction of an FTA, desirable when the multilateral trading system has already been jumpstarted with the ratification of the Uruguay Round by the major trading nations and the birth of the WTO? Would it not be wiser for the world’s only remaining superpower, and currently also its most robust economy, to take again the leadership role on multilateral free trade and to focus on converting NAFTA into a Common Market instead of seeking to extend it to more members and, given the inherently-preferential nature of such free FTAs, spreading what can be properly considered to be a stain on the now-realistic vision of a nondiscriminatory world trading system?

This in fact would seem the sensible policy, with the second of the two arguments cited earlier in support of FTAs then seen as lacking in force today. However, it has been asserted, in defense of pursuing FTAs despite the preferential nature of FTAs and the success of the WTO, that there is a benign, symbiotic relationship between FTAs and the multilateral system, and that the former is a faster process and, in turn, speeds up the process of dismantling trade barriers and making progress generally at the WTO. Pursuing my “marriage-plus” analogy, I might say that this is like the optimistic prescription for “open marriage”: adultery is seen as improving marriage. Superficially, this scenario sounds plausible. But, on closer examination, it can be seen to be an untenable view.

In particular, consider the popular argument that FTAs, at least where led by the United States, will be of the “open regionalism” variety so that, with steadily increasing members, we will arrive at full multilateralism. As Dornbusch put it today, “you get two members and the third will want to be in”, and then the fourth and, to draw on Agatha Christie, “then there will be all” in the FTA, arriving effectively at worldwide free trade just as we multilateralists want. By contrast, and by implication, the WTO cannot lead to effective and speedy liberalization on its own: it is too unwieldy.

But this contention is naive for several reasons. Take the question of speed. FTAs are at least as hard to negotiate as multilateral trade treaties like the Uruguay Round. After a decade, there are three countries in NAFTA; by
contrast, the Uruguay Round took over seven years to negotiate, with over 115 nations and negotiations over a large range of old and new issues.

To argue that NAFTA expedited or smoothed the way for the conclusion of the Round would be equally silly, though it is often done. Thus, President Clinton's success with NAFTA is supposed to have helped him with his passage of the Round through the Congress. True, President Clinton found his free-trade voice on NAFTA; but why should we assume that he would not have found it on the Round if it was the only game in town?

Also, remember the immense political divisions (far greater than over the Uruguay Round) that arose over NAFTA. The proximity of Mexico, and the fear that trade would only intensify the adverse effect that the much-noticed and feared Mexican illegal immigration was exerting on real wages of the unskilled in the United States, wound up making the freeing of trade with the poor countries a fiercely controversial issue. It is hard to imagine that, with so many issues and so many countries involved in the Round and hence diffusion of focus instead of the exclusive focus on one particular country feared by the unions and the workers as a palpable threat to their living standards, the politics would have been as difficult on the Round by itself. The baggage of the NAFTA fight was thus hurtful (in giving remarkable political salience to an issue that was almost created in the NAFTA crucible) to the cause of multilateral free trade extended to developing countries generally, and hence to the passage of the Uruguay Round and to the future functioning of the WTO (where issues such as the Social Clause have also therefore gained more credibility), not helpful.

NAFTA's passage also was subject to Mexico's acceptance of the

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27 Free trade and free immigration are indirect and direct ways, respectively, in which a poor country with abundant unskilled labour could reduce the real wages of our unskilled labour. This has long been understood, both in the theoretical literature on trade and on immigration, and was also implicit in the great debate in Britain prior to the enactment of the 1905 national legislation restricting immigration: at the time, free traders were also free immigrationists and free immigration was often called "free trade in paupers". For a detailed analysis and documentation of these questions, see my "Free Traders and Free Immigrationist: Friends or Strangers?", Russell Sage Foundation, New York, 1991. It was thus perfectly plausible to me that, during the NAFTA debate when the administration and Salinas kept talking about how NAFTA would reduce illegal immigration, the response of many was contemptuously dismissive: according to them, we needed to stop NAFTA and to stop illegal immigration directly by closing the border more effectively.
Supplemental Agreements on environmental and labour standards. But, as Anne Krueger and I have already argued, this is exactly the wrong way to go: why should such agreements be a precondition for freer trade? These demands could have been successfully resisted, as they are so far, at the GATT, whereas Salinas caved in simply because this was a superpower bargaining in a one-on-one format with a vastly inferior power. In turn, this has strengthened the environmental and labour lobbies into arguing that because NAFTA did it, so must the WTO, and the Clinton administration has not been able to stand up to these demands. In short, the NAFTA has made the WTO’s business more complex, not less.

In fact, I have argued that these and other lobbies cannot have escaped the conclusion that the smart way to go is through US-centered FTAs rather than through the WTO, since you can first get Mexico to buckle under to these demands, then tell Chile and others: this is how NAFTA is, so you must accept these “nontrade” terms and conditions if you wish to come on board. Of course, this strategy works so much better than trying to impose these extraneous, indeed harmful, conditions through multilateral trade negotiations where all these countries are together and have more bargaining power! So much then for the idea of “open regionalism” or Ambassador Brock’s idea of rapidly expanding open-ended FTAs: yes, if you agree to several extraneous, essentially trade-unrelated “side payments” (to use the terminology of John Whalley in his work on CUFTA) or “conditions” which have nothing to do with trade liberalization, you can qualify to join, not otherwise! It is like saying: my bridge club is open to everyone provided they wear mustaches, smoke pipes, wear ties and shine their shoes. This is openness indeed!

In fact, then, FTAs have become a process by which a hegemonic power seeks to (and often manages to) satisfy its multiple nontrade demands on other, weaker trading nations better than through multilateralism; the persistence of FTAs despite the success of the WTO must be traced at least partly to an awareness of this reality. And, if this analysis has an element of truth to it, then FTAs seriously damage the trade liberalization process by facilitating the

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capture of it by extraneous demands that aim, not to reduce trade barriers, but to increase them (as when market access is sought to be denied on grounds such as “eco dumping” and “social dumping”).

To sum up, my view therefore is that the FTAs, aside from being preferential trading arrangements with the economic drawbacks I outlined earlier, are a particularly damaging institutional arrangement to legitimate in the world trading system. The time has surely come for international economists to cut through the Orwellian newspeak, and the sloppy argumentation, of Free Trade Areas and begin to think the unthinkable: should FTAs really continue to qualify under Article XXIV or should it be revised to apply only to groups of countries aiming to create a Common Market?

I am afraid that the Clinton administration is unlikely to even raise these questions. It is currently wedded to the wrongheaded FTA approach as the President shuttles from one regional summit to another, blissfully unaware of these issues and applauded by a media that cannot rise above the glitter of the staged regional summits.

Meanwhile, a battle could be joined between the US (and its Latin American allies) and the Asian nations at the next APEC meeting in Osaka, Japan, over the issue of whether APEC should also become an FTA as the US seems to want. I believe that Japan and the Far Eastern superperformers could use this opportunity to play a leadership role in halting the US slide towards obsessive FTA-mindedness and restoring a principal focus on multilateralism at the WTO. Let me explain why.

Japan and the Far Eastern superperformers, known often as the new Japans, have produced supreme examples for the rest of the world by transforming their nations into world class economies in just one generation of phenomenal growth. Many talk in economics of the “Japanese miracle”: I sometimes wonder if ours is after all not truly a “dismal science” if, every time an economy does strikingly well, we call it a miracle!

True, many seek in this outstanding success the validity of their own pet

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23 As far as I know, the archival research has not been done to tell us why both FTAs and CUs were included in Article XXIV. I speculate on the original rationale of Article XXIV in The World Trading System at Risk, op. cit.
policy prescriptions. And, indeed, few things can be explained in terms of a single cause. But, even though my own pet theory is that outward-orientation produces major dividends for a country, I think there is broad agreement that Japan and the new Japans have done tremendously well by going for world markets.\footnote{In regard to imports, there has certainly been "controlled openness" in Japan; and the role of protection in her development, as of the other Far Eastern nations, is more complex than made out by ideologues on the side of either free trade or protection.}

Thus, preferential free trade areas where you set your sights low by thinking only of FTA-limited markets, instead of rooting for free trade where you are going for the world's markets, have not characterized this area. Even ASEAN, a grouping of political significance, had no economic dimension of substance for much of its life. Multilateralism came naturally with these attitudes. It may be argued that these attitudes were strengthened in turn with economic success whereas pro-FTA attitudes have often been associated with economic weakness: Imperial Preference went with Britain's fear of the newly-emerging competition from Germany and the United States, whereas the NAFTA debate betrayed a similar desire of many business groups and politicians to keep Mexico's markets for themselves instead of sharing them with Japan and the EU. This "Mexico-is-for-us" sentiment even found its way into some of President Clinton's speeches in favour of NAFTA, you will recall, playing equally to the Japan-bashing sentiment in Washington.\footnote{It was noteworthy that President Zedillo, beleagued by the peso crisis, also cited Mexico's "privileged access" to the US market as an argument for keeping confidence in Mexico's economic soundness. As I remarked, the name of the FTAs game is discrimination!}

But, while we may debate the many reasons for these Asian nations' desire to go for the world's, rather than just regional and subregional, markets, it surely provides Japan and the economically successful Far Eastern nations with a potential leadership role in world trade policy.
The post-Uruguay agenda at the WTO will inevitably involve our looking again at Article XXIV in a much more careful way than has been done to date. But more than that, the new Director-General of the WTO will have to provide leadership that seeks to shape the emerging picture of exploding preferential trade groupings and to confront its impact on WTO-centered multilateralism, instead of simply accepting their emergence as a foregone political reality. In this task, the role of countries such as Japan, and the Asian nations, which have generally and indeed properly kept away from preferential trade arrangements like FTAs, in providing countervailing support to the WTO leadership will be essential.

In the meantime, Japan and indeed the other Asian members of APEC can play a useful role at APEC itself by opposing its being turned into yet another FTA. APEC can set an example by rejecting such a muddle and using the arrangement rather as a way of coordinating policies in the region on questions such as an Investment Code and, equally important, on the new issues before the WTO (such as the Social Clause) that I have touched upon today. My informed guess is that, on those issues as well, Japan and the Asian nations have much to offer that is closer to what I have suggested. APEC, since it straddles part of Asia and part of the Americas, may well be the place for these remarkable Asian nations to bring their friends across the common ocean to greater wisdom on these new issues and thus to assist the development of the WTO in more appropriate directions.

It may be thought that, after the Indonesian meeting of the APEC where free trade within APEC was embraced as a goal for 2020, this is a lost cause. But it is not. The goal is, in fact, unattainable, without MFN extension of the
trade barrier cuts in general to other WTO members, without turning APEC into an FTA: but an FTA version of APEC has not been embraced as a goal. Equally, it is wholly improbable that this (or any) region would extend trade concessions within the region on an MFN basis to nonmembers automatically: that is simply not what trading nations, especially those belonging to preferential trading areas, do! So, despite the rhetoric from Jakarta, the issue whether APEC will turn into another FTA or alternatively become a nondiscriminatory, multilateralism-stressing institution that would buttress rather than rival the WTO, remains unsettled. The rhetoric of 2020 lacks presently the clarity of 20/20 vision. And that is all to the good, for it means that there is still hope that the APEC will not turn into another FTA on the world trading scene.

When APEC meets next year in Osaka, Japan in particular will have the opportunity to provide leadership on its future role and its relationship to the new WTO, helping to reshape and shift our trade policy on FTAs and multilateralism in the right direction. I suggest that it do so by:

* working with the United States and the European Union towards, and announcing at the next G-7 meeting, a new follow-up multilateral trade negotiation at the WTO, with the agenda of this new Round to be worked out in a specified time frame;

* seeking agreement among the Asian APEC members (including prospective new Asian members such as India) that APEC would not become a preferential FTA, while ensuring that the American members of the APEC (led by the United States) are confronted clearly on the broader issue of the utmost importance, i.e. whether multilateral free trade, not a spaghetti bowl of preferential free trade areas, is to be the centerpiece of the newly emerging
* at the same time, embracing an APEC agenda that includes coordination of policies and positions at the WTO and the new Round on matters such as the wisdom of inclusion at all of labour standards and the optimal nature of the inclusion of environmental matters in the WTO; and

* transforming President Suharto's call for free trade in the APEC region by 2020 explicitly into a concerted effort to achieve this goal by a succession of, not APEC-alone liberalizations, but focused APEC initiatives, in conjunction with G-7 (whose non-European members are members of APEC), to launch multilateral trade negotiations to reduce trade barriers worldwide on a nondiscriminatory (MFN) basis.

This can be Asia's central contribution to the design of the new world trading system, in keeping with Asia's commitment in the postwar period to a nonregional, nonpreferential approach to world trade. Whether Japan and Asia can rise to the leadership role that is required now on these central questions of the design of the new world trading system, undertaking a pro-active policy, or whether they will continue to play a reactive role that leaves leadership and hence the architecture of the new world trading system entirely to others, is a key issue now. If the architecture of the new world trading system is left to the United States on its current course, and to the European Union which too has proliferated all kinds of preferential arrangements with other countries not in the core of the Common Market, it is likely that the dilution of the multilateral trading regime by the spaghetti bowl of preferential trading arrangements will be our fate. That would be a tragedy.
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