A Review of The Wind of the Hundred Days: How Washington Mismanaged Globalization" by Jagdish Bhagwati.

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Jagdish Bhagwati ranks among the country's -- indeed the world's -- most eminent economists. He is also one of the most consistent and successful at bringing the lessons of international trade theory to the public, in particular, at explaining the virtues of free trade. Most international trade economists despair at the quality of the public debate – for example, at the common failure to understand the principle of comparative advantage, and at the common instinct that imports are bad even though exports are good. Many have thus given up the attempt to communicate with the general public. But Bhagwati has tirelessly debated the opponents of free trade. He was at Seattle in November 1999, explaining why the campaign to bring issues of environmental protection and labor rights into the World Trade Organization was detrimental, not just to the trade interests of the rich, but especially to the world's poor, who need the opportunities offered by trade in order to develop their economies and raise their living standards. In a sense he is an heir to Milton Friedman, in his heroic and indefatigable efforts to explain through ordinary prose arguments that, while second-nature to economists, often strike those who have not encountered them before as obscure or even outlandish.

The Wind of the Hundred Days (MIT Press) collects many of his influential newspaper columns, speeches and articles written between 1996 and 1999. The book is an impressive sequel to his earlier collection of public policy essays, A Stream of Windows (MIT Press: 1998). It touches on, and advances our understanding of, the major policy issues in the international economy in the last few years. It is highly readable and enlightening. Yet it is packaged as a review of the Clinton Administration's international economic policy, and here its line of argument is idiosyncratic.

TARGETS AND INSTRUMENTS

A nice recurrent theme is the principle of targets and instruments, also known as the principle of goals and policies. One of Bhagwati's most important early contributions to trade theory [together with V.K. Ramaswami] was to show that rationales offered for trade barriers are often claims of market failure that, if valid, would be more appropriately addressed by some targeted intervention other than a trade barrier. One must choose a tool that is appropriate to the job. For example, a desire to protect a natural resource would be optimally addressed by a tax on all use of that resource, not by one country's imposition of a limit on imports from abroad. Countries' propensity to reach for the trade weapon is in part due to a failure to understand the principle of targets and instruments, and in part due to domestic producer interests that are benefited by protection -- the true hidden goal.

In this book the principle of targets and instruments is explained with the common sense proposition that someone who tries to hit two birds with one stone is likely to miss both of them. In one chapter the birds are the two objectives of maximizing GDP and protecting the environment. The former should be achieved by trade policy and the latter by appropriate environmental incentives. In another chapter, the two birds are free trade and a global social agenda. The former goal should be tackled by efforts via the WTO, and the latter should be left to other proactive policies. (The natural venues for proactive policies are multilateral institutions such as the ILO, UNICEF, and UNEP – beefed up to whatever extent there is political support to do so). The point is that an attempt to use the WTO to establish standards addressing environmental and social goals at the same time as setting the rules for trade so as to promote economic growth would more likely, rather than achieving all its objectives, fail at achieving any.

Even leaving aside the goal of economic growth, conflicting objectives have motivated the demonstrators at Seattle and subsequent gatherings: environmentalists want regulation that will require -- for example, in the case of greenhouse gas emissions -- multinational agreements and institutions along the lines of the Kyoto Protocol, while labor unions oppose this kind of infringement on national sovereignty. Thus the two supposed allies in fact disagree about what direction they wish global governance to move. A well-designed set of international institutions can achieve a good balance of goals within the global marketplace. But an unthinking mass movement to tear down multilateral institutions in general is likely to achieve none of the varied goals of the demonstrators, or of anyone else. There is nothing wrong with the demonstrators' ultimate goals. It is their instrument that is wrong.

FREE TRADE, BUT NOT FREE TRADE AREAS OR FREE TRADE IN CAPITAL

The sub-title of the book is "How Washington Mismanaged Globalization." The author wastes no time making it clear that by "Washington" he means the Clinton White House. There is nothing surprising in a critic's publishing an unfavorable appraisal of an administration's approach to international economic policy at the end of its second term. (Nor is there anything surprising in a former official in that Administration defending it, though that is not my primary purpose in this review.) If one were entirely unfamiliar with the author, one would need to read the book to find out whether the attack comes generally from the pro-globalization or anti-globalization direction. Attacks on the Clinton Administration from the latter direction are of course very common. Anyone who is at all familiar with Bhagwati's work will know that his critique comes from the pro-globalization direction: The Administration stands accused of not doing enough to advance the cause of free trade. The argument is that it is not the fault of Congress that it refused to give President Clinton the fast-track negotiating authority that he sought, but rather the President's fault for failing to convince Congress to give it to him. But if we are choosing targets and instruments, an attack on the Clinton Administration's international economic policy is a poor instrument for the goal of advancing the free trade ideal.

Most readers, except for those of us who are very familiar with the author, will be surprised at two of the major counts in the indictment. (1) *Pursuit of regional Free Trade Areas, such as NAFTA and the proposed Free Trade Area of the Americas.* Bhagwati objects to the Clinton Administration's support for Free Trade Areas because he considers it inconsistent with the multilateral pursuit of free trade, in particular via the WTO. (2) *Pursuit of open financial markets, as were urged on Asia and other emerging markets.* He believes that the rapid opening of emerging financial markets caused the crises of Mexico (1994), East Asia (1997-98), and others. In effect, the author is taking exception to the broad strategy of seeking to remove barriers to cross-border flows wherever possible.

Many outside of the economics profession will be surprised that a pure free-trader could be strongly opposed to Free Trade Areas or to freedom of financial flows. That is, they will be surprised that one who supports the removal of global barriers to trade in goods and services would be opposed to removal of such barriers among a regional sub-set of countries or to removal of barriers to trade in financial assets. But these positions in fact have a firmer basis in mainstream economics than might appear.

Consider, first, regional trading arrangements. These are Bhagwati's bete noir. Free Trade Areas (FTAs) are often confused with Free Trade, but should not be, as Bhagwati has persistently pointed out. He would prefer the term "preferential" or even "discriminatory" trading arrangements to describe FTAs. These terms make clear the danger that these trade arrangements can distort some price incentives (vis-à-vis the products of countries that are not members) at the same time as removing existing distortions in other incentives (pertaining to trade among the members). This distinction between trade diversion and trade creation is a staple of trade textbooks. The textbooks say that the net effect on economic well-being depends on the specifics. Bhagwati thinks the net effect is bad. Because Mexican barriers were initially much higher than American barriers, the reduction in Mexican barriers associated with NAFTA was greater than the reduction in US barriers. He worries that the resulting 45 % increase in US exports to Mexico between 1993 and 1996 represented trade-diversion: goods that Mexico really should have purchased from low-cost suppliers elsewhere, but bought instead from American producers because of the reduced Mexican tariffs on imports from the north.

Trade creation and diversion among members of a FTA are only part of the story. Trade theory cannot purport to say whether FTAs will encourage or discourage members' trade barriers vis-à-vis the rest of the world. This is a question of political economy. Whatever the answer is, it is likely to outweigh the direct effects of trade diversion and trade creation. Bhagwati worries that the regional initiatives will use up political capital and energies, and thus divert momentum from multilateral efforts. He coined the phrase "spaghetti bowl," to describe the complications for businesspeople and negotiators alike in dealing with hundreds of confusing regional deals instead of a single multilateral trade regime. Others of us see evidence from recent decades that the political forces behind regional trading arrangements tend often to be consistent with political forces working in favor of the removal of trade barriers more generally, which would justify this strategy. It is a matter of fine judgment. Even enlightened pro-globalizers can differ on the optimal trade-off. But, leaving aside an anti-globalization minority in Mexico, Bhagwati is almost alone in seeing harm in the rapid growth of US exports under NAFTA.

Consider, next, the freedom of capital flows. Arguments are readily made that countries can better themselves through free and unfettered capital markets, analogous to the arguments for gains from free trade in goods and services. Indeed many free-market purists subscribe to a form of this philosophy. But Bhagwati is far from alone in concluding that the case for free capital movements is weaker than the case for free trade. The 1944 architects of the Bretton Woods system to govern the world economic system believed clearly in the distinction between the virtues of international trade and finance.

Even today, it is striking how many of the major figures in international economics, including those whose names are almost synonymous with globalization and free markets, have in fact expressed strong doubts that international financial markets in practice behave in the benign way that economic theory predicts. Jeff Sachs's name in the former Soviet world connotes free-market philosophy. George Soros has become a generic symbol of unrestrained financial speculation. Larry Summers, Robert Rubin and Paul Volcker are each considered, during their respective times at the helm of US financial policy, to have been leaders of US-style capitalism, preaching the discipline of the international free market. But what else do these five figures have in common? Each of them is on record saying that financial markets regularly engage in excessive volatility, and that some government intervention is required. Jagdish Bhagwati, apostle of free trade, has joined this distinguished list.

The "Wind of the Hundred Days" in the book title refers to the turbulence of the East Asia financial crisis. Bhagwati sees its origins in pressure from the U.S. Treasury on Asian countries, to persuade them to let in foreign money and foreign financial institutions. "I am of the view that the U.S. administration really blew it. In fact, it is not unfair to say that Messrs. Rubin and Summers may well have presided over the largest manmade disaster in the world economy since Smoot Hawley!" [p.57]. The mistake was "imprudent financial liberalization." Bhagwati's widely noted May 1998 <u>Foreign Affairs</u> article, "The Capital Myth," is reproduced here. It alleges a " 'Wall Street-Treasury complex'….Wall Street naturally wished to enlarge its sphere of operations: the U.S. Treasury reflected that lobbying pressure while also succumbing to the 'ideology' of the market while forgetting that the capital funds market is not as innocuous as goods markets and needs to be monitored and regulated carefully." [p.56]

My own view is that some of his claims are justified, if stated in more moderate form. (i) International financial markets are indeed prone to waves of excessive optimism or pessimism from time to time. (ii) Countries as they develop will nonetheless probably have higher growth rates with access to international capital markets than without them, even averaging in the effects of periodic crashes. (iii) Well-targeted interventions in the freedom of international capital flows -- such as the famous Chile-style penalties on short-term inflows, or the imposition of high reserve requirements on banks' borrowing in foreign currency -- can sometimes produce marginal improvements in the direction of stability, without throwing away all the benefits of international capital flows, (iv) The Reagan, Bush and Clinton Treasuries pushed more strongly for opening Asian financial markets than was optimal. (v) The level of energy invested in opening

Asian financial markets can indeed be attributed in some degree to the fact that the financial community is a constituency of the Treasury and that in a democracy governments represent their constituencies.

But where I disagree is: (vi) none of this necessarily would have made the key difference in causing the 1997-98 crisis. Short of the unattainable perfection of maintaining ideal macroeconomic and structural policies, or perhaps short of maintaining harmful prohibitions against all portfolio capital flows, occasional crises may be an inevitable price of economic development.

There are clear advantages to financial integration. Capital-poor countries are able to finance investment more cheaply by borrowing abroad than if they were entirely dependent solely on domestic saving. International financial markets provide discipline on macroeconomic policy. International banks and securities dealers are often the only source of competitive pressure for oligopolistic and inefficient domestic banks. Another advantage, at least in theory, is that access to international financial flows allows countries to stabilize the economy in the face of fluctuations. Here is where reality begins to diverge from theory, however, as international financial markets seem to be a source of fluctuations or an exacerbating factor at least as often as a stabilizing factor. After the international debt crisis of 1982-89, Mexican peso crisis of 1994, and East Asia crisis of 1997-98, it has become difficult to maintain that financial markets always work as smoothly as economic theory says. But trading off the advantages of open financial markets with the disadvantages of occasional crises is a tricky endeavor. Again, even enlightened thinkers can judge the optimal trade-off differently.

POLITICAL PARTIES AND PENNSYLVANIA AVENUE

That its support for regional free trade areas and for open financial markets should form the basis of an attack on the Clinton Administration is surprising. It is not just that the most common attack comes from those who view the Administration as having been too strongly pro-globalization, and that those opposing free trade areas and free capital movements are mostly anti-globalizers. The most surprising aspect of this line of argument is historical: each of these two goals was pursued by the preceding Reagan and Bush administrations as vigorously as by the Clinton Administration, perhaps more so. Both of the goals are likely to be pursued by the second Bush Administration as well. Even accepting that a free trader dissents from the generic brand of globalization that includes free trade areas and free capital flows, why single out the Clinton Administration for unique opprobrium?

In 1982, the Reagan Administration, frustrated with European resistance to the proposal to launch a new round of multilateral liberalization, reversed the existing US position against regional trading arrangements. It announced a readiness to discuss bilateral or regional agreements to reduce trade barriers with any willing partners. The outcome was the establishment of the Israel-US FTA and Canada-US FTA, the negotiation of NAFTA, and preliminary plans to expand regional trading arrangements to the entire Western Hemisphere. The Clinton Administration during its tenure continued this approach, persuading Congress to approve the NAFTA in 1993, supporting APEC, and beginning negotiations for a Free Trade Area of the Americas. The new Bush Administration looks inclined to pick up precisely where Clinton took off.

Each of these administrations has pursued multilateral liberalization at the same time as the regional initiatives. The Uruguay Round of negotiations, which among other things established the World Trade Organization, was continued by the first Bush Administration and concluded successfully by Clinton. Although the Clinton Administration was denied fast track authority, it succeeded in negotiating multilateral single-sector agreements in such areas as information technology products and telecommunications services. The strategy all along has been to pursue liberalization at both levels simultaneously, seeking progress on the regional front when the multilateral path is politically infeasible.

Bhagwati's distaste for the regional negotiations is an intellectually respectable position. My own view is that, because we are going to have to fight the same political battles, e.g., regarding labor rights and the environment, for regional agreements as for multilateral ones, we might as well have the political debate at the global level, rather than at the bilateral or regional level, wherever possible. But it is not always possible. A multilateral round may turn out to be infeasible politically, either because of traditional US-EU disagreements or because of newly critical North-South disagreements. If that happens, but the FTAA is feasible, then we should go for it.

In any case, Clinton was remarkably effective, given the political opposition on both the right and left, at steering through the shoals to find a path of market-opening agreements. Things may be easier for George W. Bush: Congress is less likely to deny him fast-track authority to negotiate market-opening agreements or to block use of the Treasury's Exchange Stabilization Fund in managing financial crises, as it did to Clinton. But it seems clear that the strategy of liberalization, to be pursued simultaneously at the regional and multilateral levels, will be the same under George W. Bush as under his three predecessors. Indeed, one of the few good things about the year 2000 election campaign is that the two major-party candidates shared an internationalist philosophy, and that the two fringe candidates, Nader and Buchanan, garnered surprisingly little support for their isolationist positions. With this perspective, for a pro-globalizer like Bhagwati to single out support for FTAs as a key indictment of the Clinton Administration is a novel viewpoint, to say the least.

A similar story applies to international financial policy. The Reagan and Bush Treasuries badgered countries in East Asia and elsewhere to remove capital controls and let in foreign financial institutions. Throughout the 1980s and 1990s, the interests of banks and securities dealers were pursued in bilateral discussions. In 1984, the Reagan Treasury bullied Japan into financial liberalization in the Yen/Dollar Agreement. The Reagan and Bush Administrations then applied the same strategy to Korea and other Asian countries. To be sure, the Clinton Treasury continued along this path. To take but one example cited by Bhagwati, even after the ravages of the 1997-98 East Asia crisis, insufficient progress on opening up to foreign financial institutions was the reason given by the Treasury and White House in April 1999 when premier Zhu Rongji was sent away without an agreement on Chinese accession to the WTO.

Bhagwati does not want to count the White House's agreement with China supporting its accession to the WTO as a success, on the grounds that the economic terms were too tough on China. ("The terms were so totally biased in favor of the United States that it was a no-gainer." p.xvi.) It is true that in these negotiations we have denied China certain accommodations that have been granted to all other developing countries, of which China is assuredly one. More generally, after years of seeking to persuade other countries of the virtues of an open market system, the United States has been reluctant to "take yes for an answer," and has turned to a strategy of playing "hard to get" in international dealings of all kinds. But Bhagwati's version of free trade philosophy has led him to an unusual policy position – in essence that US negotiators have achieved an unfairly rapid or asymmetric opening of the Mexican and Chinese markets. This puts him in a political constituency smaller than the set of Americans who base their policy preferences on ownership of Chihuahuas and Pekinese.

The relevant distinction is not between Republican and Democrat presidential administrations. Their differences on trade policy in recent decades have been quite minor in the scheme of things. The relevant distinction is rather between the executive and the legislative branches of government. The attitude toward trade changes as one moves down Pennsylvania Avenue, and that is true regardless of which political party occupies the White House. The Congress has consistently been the primary obstacle to the sort of internationalism that is necessary to effective US leadership of the global trading system. Certainly congressional hostility to Clinton's trade policy has not been based on a belief that we have been too tough with the Mexicos and Chinas !

I do not argue that the Clinton Administration made no mistakes in international economic policy. It is true, as Bhagwati says, that some of its members came in with initial naïveté regarding how much progress could be made by a "get tough" trade policy with China and Japan.[1] A number of protectionist US steps, notably in the steel industry, risked emulation and retaliation abroad. The US Trade Representative was unable adequately to prepare the groundwork for the 1999 WTO Ministerial in Seattle. President Clinton's famous comment at that time to an interviewer -- that he would like eventually to see international agreement to back up social standards with trade sanctions -- departed from the carefully thought out US position; it was understandably interpreted by the delegates from poor countries as a message with adverse protectionist implications, and thus helped torpedo the Ministerial. That most of these steps may have been the product of political pressures does not change that they were mistakes when considered strictly as economic policy.

But these are exceptions to the general pattern. In my view they are far outweighed by the overall record of progress achieved by the Clinton Administration's international economic policy. The most notable successes were the successful completion of the Uruguay Round and NAFTA in the first term, management of the Mexican peso crisis in 1995 and the East Asia crisis in 1997-98, achievement of PNTR with China in 2000, and management of the dollar (with a very light touch) throughout. More generally, the Administration was remarkably successful at pursuing an economic agenda that brought material gains to all segments of American society. It is more remarkable still that a Democratic president was able to accomplish so much of the globalization agenda despite political obstacles, especially from Congress, that would have crippled most men.

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[1] The same aggressive application of Section 301 was practiced by the preceding Bush Administration, for which Bhagwati (who, incidentally, is a Democrat) roundly criticized it at that time.

Bhagwati's writings play an important role in helping shape a better trade policy. His points regarding FTAs and financial flows make provocative and instructive reading. But I suspect they may find little resonance with readers as a verdict on the Clinton Administration.

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