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The proposed FTAs with Chile and Singapore, which are discriminatory trade agreements and hence fall into the class of what are now universally called Preferential Trade Agreements (PTAs) so that public discourse is not contaminated by confusing them with (multilateral) Free Trade, raise several questions for both scholars and policymakers. I will concentrate however on the few that the Chairman, Congressman Peter T. King, has asked me to focus on.

I: **Importance of Free Trade and the Role of FTAs**

The Case for Free Trade: Despite recurrent recent attacks on free trade, both by anti-globalizers and in a less vociferous but still populist mode by a few, indeed very few, economists (chief among them Dani Rodrik of Kennedy School at Harvard and my new colleague Joseph Stiglitz), the case for freeing trade remains overwhelming.

The relationship of outward orientation in trade policy to economic prosperity has been demonstrated in several projects, one of which I co-directed for the National Bureau of Economic Research in the late 1960s, and by several in-depth research projects since. The objections are not serious.

Take just three criticisms. First, that the gains from outward trade orientation are exaggerated and come instead from sound macroeconomic policies. But if you are going to have sustained outward trade orientation, you better have sound macroeconomic policies! The commitment to sound macroeconomics is a precondition for a successful outward trade strategy; the gains from the former are therefore to be attributed to the latter.

Second, we are told that trade might be good for prosperity but misses out on eradicating poverty; that "trickle down" does not work. But the experience of China and India, two countries with massive poverty, shows that the growth strategy is more aptly described as a "pull up" strategy: growth pulls the poor up into gainful employment. It also affects poverty indirectly by generating tax revenues without which health and education cannot be financed adequately to help the poor. Upto early 1980s, when both countries grew in a lackluster fashion, with India exhibiting over a quarter of a century an abysmal growth rate of 3.5%, there was predictably little impact on poverty. After both countries began so-called "neo-liberal" reforms, including outward orientation, growth rates picked up dramatically and poverty has declined significantly in the last 15 years, if not more.

Third, even the effect on social agendas such as reduction of child labor and the advancement of gender pay equality has been shown to be favorable, rather than harmful as often alleged by the anti-globalizers. Econometric studies find that child labor declines as incomes grow with removal of export restraints, for example. Again, in the United States, gender wage gap has declined faster in globally competitive industries because these industries cannot afford the luxury of paying men more than women, even when equally qualified, because every penny now counts!

Adjustment Assistance Programs in Poor Countries: Freer trade therefore is a virtuous policy, whether you are focusede on economic gains or on social agendas. It truly deserves bipartisan support. Yet, when it comes to the poor countries, while they have come to appreciate market access for their exports, they remain fearful of imports --- a phenomenon not entirely unfamiliar to our Congress where steel protection, textile

quotas and tariffs, farm subsidies, the Byrd Amendment which makes a yet further mockery of anti-dumping actions, and much else still mars our profession of free trade.

But where we have managed to ease the potential adjustment costs, for political and economic reasons, by building into virtually every trade legislation some provision for adjustment assistance --- this is true of the NAFTA legislation and also of the latest fast-track legislation ---, I am afraid that the poor countries which are opening up to trade more ambitiously do not have such programs. They simply do not have the funds to dod so. For some years now, therefore, I have been suggesting that the World Bank be asked by the major donors, such as the United States, to do exactly this, instead of spending its limited resources on all kinds of programs that spread its resources thin, in an unfocused way. It is not for nothing that Mr.Wolfensohn has been compared to Evita Peron: spreading money around, buying popularity with each throw of funds, but doing little to support in a robust and creative way the economic globalization that is the most important driver of prosperity and the most lethal scourge of poverty.

Bilaterals: Why USTR Ambassador Zoellick is Wrong: Today, there is a remarkable divide between politicians who for the most part like bilateral FTAs and economists who by a vast majority consider them to be a plague on the world trading system. Mr. Pascal Lamy, the articulate and intellectually exciting Frenchman who is the EU Trade Commissioner, recently wrote with British understatement that "half the world's" trade economists are hostile to bilateral FTAs!

Ironically, bilaterals are known as the "European disease": they went well beyond the European core to sign all kinds of bilaterals around the world. We have only followed the Europeans, having renounced our firm embrace of multilateralism in trade and

implacable hostility to bilateralism beginning with almost negligible success with Secretary Baker and Mr. Zoellick in tandem as his deputy. Now that Mr. Zoellick is the USTR, he wants to make up for lost time!

Today, these bilaterals have created a massive "**systemic problem**", with preferences multiplying worldwide through varying tariff schedules based on origin and also with varying rules of origin. This phenomenon, and problem, is now called the "**spaghetti bowl**" problem, with preferences like noodles criss-crossing all over the place. With over 200 such bilaterals in place, and growing by the week as Asia follows in out footsteps now, we can confidently expect that they will grow to well over 400 by the end of the year. The great economists who warned us against preferences during the 1930s when competitive tariff-raising was creating fragmented markets worldwide would have been horrified to see that, in the name of free trade, we are now re-enacting such fragmented markets on a parallel scale, and feeling virtuous about it!

Ambassador Zoellick is nonetheless passionately behind these bilaterals, arguing that they lead to competitive liberalization" which will benefit multilateral liberalization over time. But this is a scenario that is shared by hardly any serious international economist. As the bilaterals multiply, especially when one's main markets are taken care of and preferences granted to oneself, the willingness to invest more lobbying effort into pushing the multilateral envelope begins to weaken. Again, from the viewpoint of the smaller countries that sign on to a bilateral FTA with us, a superpower, there are reciprocal obligations and preferences they must grant us in exchange for the preferential access to our market. Thus, the Singapore and Chile FTAs repeat the requirement that their garments ands textiles must use our fabric if they are to qualify for the preferential

entry to our market! This cuts into the benefits they enjoy, compared to an MFN reduction of barriers to our market at Geneva/Doha ! The preferences also erode as the MFN tariff is reduced; so, to maintain the preference, these small countries become opponents of MFN tariff reductions: a phenomenon we have witnessed time and again in textiles and in agriculture.

Then again, bureaucratic and political attention is diverted to these bilaterals rather than to Doha since it has become customary to equate every trade agreement with every other, regardless of its scope and merit. Ambassador Zoellick typically writes in this vein, equating the Uruguay Round Agreement at Marrakesh with piffling bilaterals when he argues that we have done only two agreements --- these being the huge NAFTA and the Uruguay Round --- whereas Mexico has done several more: the comparison is ludicrous on the dimension that he is comparing the United States with Mexico, having the tail wag the dog! At the Waco Presidential Summit that I attended, the President actually said to Mr.Zoellick: I have gotten you the fast track; now go out and get me some trade agreements!

But the chief argument against bilaterals is something that is relevant to the question of capital controls that is at the heart of the Hearing today. The bilaterals, between us and small countries like Jordan, Singapore, Chile and Morocco cannot be judged on the basis of trade alone. They are increasingly used to establish "templates" by different lobbies which then proceed to argue, both to Congress and then at the multilateral negotiations, that this template must logically be extended to the multilateral trade negotiations and agreements. Since, in many cases, it is the developing countries who hesitate ands oppose these lobbying demands at the multilateral talks, and since

bilaterals with the developing countries are used to create the templates, the process has also been described realistically, perhaps cynically, as an application of the Leninist policy of "divide and rule": the lobbies use the strategy to break up the coalitions of the developing countries against their lobbying demands. This (along with punishments threatened or carried out by use of Special 301 provisions of the 1988 trade legislation), was the strategy used with Mexico over NAFTA: intellectual property protection, as we wanted it, was built into NAFTA and Mexico basically deserted the ranks of the developing countries which saw this as an extraneous, non-trade issue, as a royalty-collection rather than as a trade question.[1] With Jordan, which had literally no bargaining power vis-à-vis us, the Clinton administration, responding to its core constituencies in the labor and environmental communities, used this FTA to move the labour standards and environmental requirements into the text of the agreement as distinct from their being Annexes in the NAFTA agreement. That in turn led to the fast track legislation where the Jordan template was used to put similar requirements into any trade agreement, including multilateral. And now, the same game was being played in the case of Chile and Singapore, evidently by the Wall Street lobbies, to set up a template that says: you cannot use capital controls.

This strategy may work. If it does, the only question is whether we are not turning the WTO, a trade institution, into an institution where our lobbies, whether good or bad, park their agendas and capture, and distort, the working of that important institution to

[1] To argue that intellectual property protection (TRIPs) does not belong to the WTO is not to say that it should not be granted or that trade sanctions should not be applied as a remedy. A self-standing treaty like Kyoto or CITES could have been negotiated for TRIPs instead of its being pushed into the WTO. As it happens, when the AIDs crisis broke out, and the poor countries and the rich-country NGOs began to attack TRIPs agreement, it was the WTO that became the focus of worldwide opprobrium when in fact the complaints would have been properly directed to Washington if the matter had not been worked in a draconian fashion into the WTO.

the detriment of the institution and even to harm the developing countries and disillusion them at a time when they have finally turned to it as interested members.

And, if the strategy does not work, and the developing countries continue to raise spirited objections as they have regarding labor standards inclusion, for instance. At the multilateral level, we will then hold up multilateral trade liberalization, while the bilaterals where we intimidate or seduce them one-on-one will multiply. And so we must caution Mr. Zoellick on his excessive enthusiasm for bilaterals, even though he dismisses all these widely shared objections as coming from "purists"!

II. **Capital Controls and Trade Restrictions: Asymmetries**

Now, free capital flows and free trade have similarities: capital controls and trade restrictions will both segment markets and therefore incur efficiency, what economists call "deadweight" losses; they will also reduce "economic freedom". But the asymmetries are more important; and they are regularly conceded, indeed taught, in the classroom.

The problem is illustrated by an analogy. If I exchange some of my toothbrushes for some of your toothpaste, and we remember to brush our teeth, both of us will have whiter teeth; and the chance of our teeth being smashed in the process is negligible. But capital flows are like fire. If Tarzan uses it to roast his kill, he is ahead. But when, as the Earl of Basingstoke, he returns to his ancestral home in England, the fire can burn it down if he is not careful.

And that is exactly the problem. It is easy to say: follow sound macroeconomic policies, adjust your exchange rates, improve your banks, eliminate cronies; etc. There has been no dearth of such advice. But can anyone seriously maintain that these

conditions can be fulfilled or that, even if they are, panic-fed outflows of huge quantities of capital in the absence of controls will not materialize? Both empirical evidence and theoretical models strongly indicate that we have to be less gung-ho and more prudent than was the case in the years prior to the Asian financial crisis and its spread through contagion. Three different situations need to be distinguished.

First, consider the case where a developing country has never been on capital account convertibility. The question is: should it be pressured to go to such convertibility? The answer is that we have to be prudential about this. Developing countries can experience panicky outflows of capital, which can be swift if all spigots are open in the absence of capital controls. Such panic can arise because these economies may be perceived to be fragile; or their politics may be considered to be knife-edge. It is noteworthy that both India and China escaped the Asian financial crisis; they did not have capital account convertibility. So, the not-so-gentle pressure from the IMF and the Treasury to have developing countries open up fast on capital account was an error of judgment.

It is often claimed that the East Asian crisis was because of internal problems: crony capitalism and inefficient banks. But one may well ask: what do we pay the IMF and the bureaucrats at the Treasury for? Was it not their job to alert themselves to these drawbacks before they put the pressure on these countries? It seems evident that when countries are economically and politically fragile, letting capital move in and out freely is to bet the company. The consequences of large-scale outflows can be disastrous.

A different, second question is whether, if you have basically opened your system to capital flows, should you then not be using taxes on capital inflows to moderate their

amount if the inflows seem to be getting uncomfortably large and the probability of a panic occurring rises? Chile did this to advantage, though there are questions as to how effective this was. Such taxes are applicable only as used; they differ from quantitative controls which would normally be in place continuously. Most economists agree that such taxes are a useful tool. Remember that their use does amount to the use of differential exchange rates for capital ands current transactions: and this seems to be ruled out in the draft FTAs before us!

But consider a yet different, third question: you have gone to capital account convertibility, like Malaysia had and capital starts <u>leaving</u> in huge amounts due to panic. Do you then clamp down capital controls? So, we are then considering using capital controls when capital is leaving, not to moderate its size when it is <u>entering</u>. Here, again, there seems to be a sound body of opinion that Malaysia did well to use capital controls. The reason is that, by segmenting the capital markets (as noted by many economists at the time, including Paul Krugman and Dani Rodrik), Malaysia managed to lower interest rates compared to what would have been necessary otherwise because of rising interest rates elsewhere, and thus Malaysia managed to follow an expansionary policy that enabled it to escape the deflation that followed rising rates in other afflicted countries which followed the wrongheaded deflationary conditionality imposed by the IMF in the first year of the Asian crisis. Again, for Russia, the Russian scholar Padma Desai of Columbia University has argued that Russia would have done better in the aftermath of the Asian crisis if de facto capital account convertibility had been immediately suspended temporarily.

In all three types of situations, it is clear that good policymaking requires that the developing countries in question must be allowed the freedom to exercise their discretion and use capital controls (or taxes). In the latter two cases, clearly the use of capital controls/taxes would be temporary. In the first case, the country has a longstanding lack of capital account convertibility and the transition to more openness is slow simply because such a transition requires prior transition to economic and political stability in a manner which is credible.

A final thought: is it true that capital controls must be eliminated to attract direct foreign investment into the developing countries? I.e. is the United States doing Chile and Singapore a favor by getting them to use capital controls only with the greatest difficulty? Not a chance, I am afraid. I have seen no persuasive evidence that full capital account convertibility is necessary to bring in direct foreign investment. A very limited guarantee of convertibility for profits and repatriation of principal is often offered for Greenfield investments: and that seems to be enough. I am afraid that many such assertions are made by interested lobbies: the pharmaceutical firms made this argument for TRIPs even as they were investing in countries such as China where no intellectual property protection was being offered. All that happens is that the latest technology, which might diffuse in the absence of such protection, is not used; but investment with less-than-the-latest-vintage technology does not seem to be deterred.

The Capital Control Provisions in the Singapore and Chile FTAs

The inclusion of capital control provisions in the Chile and Singapore FTAs is therefore difficult to understand in terms of economics. Even the IMF, including in its

latest report from its Chief Economist Ken Rogoff and associates, concedes the case for prudence rather than haste in dismantling capital controls and in occasional but cautious use of them when necessary in otherwise capital-wise open economies. The inclusion of provisions in this regard in these FTAs seems therefore to be ideological and/or a result of narrow lobbying interests hiding behind the assertion of social purpose. I see, in particular, the following problems with these FTAs as a template:

1.The provisions are overly ambitious in extending to all kinds of "investments", including "futures, options and derivatives", instead of being confined to direct foreign investment. I see this as a potential problem with the NGO community which has become properly sensitive to financial flows and crises, and to the havoc they cause, especially on the poor in the afflicted countries. It will simply play into the hands of the many anti-globalization critics who see trade treaties as being captive to financial and corporate interests. At a timed when trade liberalization itself has become difficult to manage, the inclusion of such provisions into a trade agreement is to invite gratuitous criticism.

2. The limitations put on what can be demanded by way of compensation for use of capital controls and their effects on the value of investments by foreign entitities go some way towards assuaging the early concerns. But they still amount to roadblocks. I do not see how it can lead to anything but political objections when invoked, just as the ultra-conservative view of "takings" that was slipped into Chapter 11 provisions of NAFTA has led to fierce political objections.

3. As I read the text of the agreements, it appears that the traditional protections built in for "balance of payments" situations, which would have been invoked automatically to suspend "free transfers", have been removed and been replaced by a

separate Dispute Settlement mechanism when capital controls are invoked. This is more restrictive for Chile and Singapore; it also constitutes a tightening of the restrictions being imposed on these countries' ability to use capital controls as they see fit.

None of this is good news. It also seems to me that few other countries will be prepared to accept such a template. Such restrictions, which are to be deplored in any event, are best left to be handled through investment agreements, rather than fastened on to trade agreements where they will bring trade liberalization, a policy which is far less controversial, into disrepute.