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Free-Trade Agreements

Steppingstones to a More Open World

by Daniel T. Griswold

Executive Summary

Since securing trade promotion authority in 2002, the Bush administration has launched an aggressive campaign to negotiate bilateral and regional free-trade agreements (FTAs). FTAs have been reached with Singapore and Chile and are under negotiation with Australia, Morocco, Bahrain, and nations of the Central American Common Market and the Southern African Customs Union.

None of those countries is among our top 10 trading partners, but considered together, the proposed FTAs would cover a major segment of U.S. trade. As a group, the FTA countries would constitute the world's ninth largest economy and would be America's sixth largest trading partner.

Free-trade agreements deviate from the multilateral principle of nondiscrimination, and they can divert trade from more efficient to less efficient but favored import producers. But under the right conditions, FTAs can inject new competition into our domestic economy, lowering prices for consumers and shifting factors of production to more efficient uses, while leveling the playing field for U.S. exporters.

FTAs provide institutional competition to keep multilateral talks on track. If other members of the World Trade Organization become intransigent, the United States must have the option of pursuing agreements with a "coalition of the willing" in pursuit of trade liberalization. FTAs can spur regional integration and blaze a trail through difficult areas for broader negotiations in the future. As a foreign policy tool, FTAs can cement ties with allies and encourage countries to stay on the trail of political and economic reform.

To maximize the benefits of free-trade agreements, the administration should seek agreements with countries that can provide import competition in our domestic market and export opportunities abroad and that are reform leaders in regions of the world where models of successful reform are most needed. Judged by those criteria, the FTAs proposed by the Bush administration deserve to be pursued.

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As a group, the FTA countries would constitute the world's ninth largest economy and would be America's fourth largest export market.

Introduction

Since final passage of trade promotion authority in 2002, the Bush administration has launched an aggressive campaign to negotiate bilateral and regional free-trade agreements (FTAs). In May 2003 the United States signed an FTA with Singapore, and in June 2003 it signed one with Chile. Congress could vote on those agreements by late summer or early fall.

Meanwhile, the administration has begun negotiating FTAs with Australia; Morocco; Bahrain; the five Central American Common Market nations of Guatemala, Honduras, El Salvador, Nicaragua, and Costa Rica; and the five Southern African Customs Union nations of South Africa, Botswana, Namibia, Lesotho, and Swaziland. Negotiations initiated in 1994 continue with 33 other Western Hemisphere nations on a Free Trade Area of the Americas. On May 9 President Bush proposed "the establishment of a U.S.–Middle East free-trade area within a decade, to bring the Middle East into an expanding circle of opportunity, to provide hope for the people who live in that region."[1] Egypt could join Morocco and Bahrain on the list of potential FTA partners. Other potential FTA partners proposed by members of Congress include Taiwan, New Zealand, and the United Kingdom.

Those agreements already negotiated or in the pipeline are sure to spark the usual debate about free trade versus fair trade, environmental standards and working conditions in poor countries, jobs and wages in the United States, and the other issues that inevitably swirl around any trade agreement before Congress.[2] But bilateral and regional trade agreements also raise a peculiar set of policy issues, economic and noneconomic alike, that are generally neglected when deals are debated and voted on.

Even for supporters of trade expansion, not every bilateral and regional free-trade agreement proposed is necessarily good economic policy. Despite the name, free-trade agreements do not always promote more trade, nor do they necessarily leave parties to the agreement or the rest of the world better off. Beyond the economic ambiguities of FTAs are a number of important strategic and foreign policy considerations that cannot be ignored.

None of the countries we are negotiating with is among our top 10 trading partners, but together the FTAs would cover a major segment of U.S. trade. Combined, Singapore, Chile, Australia, Morocco, Bahrain, the Central American Common Market, and the Southern African Customs Union have a total population of 157 million and annual economic output equivalent in purchasing-power parity to $1.4 trillion. As a group, the FTA countries would constitute the world's ninth largest economy. They would be America's seventh largest source of imported goods and fourth largest export market—they sold $42 billion to Americans in 2002 and bought $45 billion in American-made goods. In terms of two-way trade, the group would be America's sixth largest trading partner, behind only Canada, Mexico, Japan, China, and Germany. Eliminating barriers to trade with so many people would be a positive step for U.S. trade policy.

This paper examines the merits of negotiating free-trade agreements. It analyzes both the economic and noneconomic implications of FTAs, weighs the costs and benefits of the specific agreements put forward by the Bush administration in light of those implications, and proposes guidelines for future negotiations to maximize the benefits and minimize the costs to both the U.S. economy and our broader national interests.

On balance, the bilateral and regional agreements proposed by the Bush administration would further our national interests. If crafted properly, those agreements would strengthen the U.S. economy by injecting new import competition into domestic markets and opening markets abroad more widely to U.S. exports. More important, they would encourage economic reform abroad and cement economic and foreign policy ties between the United States and key allies.

The Peculiarities of FTAs

For anyone who supports free trade, support for free-trade agreements would at first glance seem to be automatic. Such agreements by definition lower barriers to trade between participants, and lowering or eliminating barriers alto-

gether has been the aim of the whole trade liberalization movement. Yet regional and bilateral trade agreements raise legal and economic questions that should be addressed.

Departing from Multilateral Trade

FTAs are an exception to the basic legal principle of nondiscrimination in international trade. Article III of the basic charter the World Trade Organization (the General Agreement on Tariffs and Trade 1947 as amended by the 1994 Uruguay Round Agreement) declares as a fundamental principle that market access should be extended to all members on a most-favored-nation, or nondiscriminatory, basis. Specifically, "any advantage, favor, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties."[3]

Of course, FTAs explicitly deviate from that principle. They grant an advantage (lower or zero tariffs) to parties to an agreement that are not granted to other members of the WTO that are not parties to the agreement. But free-trade agreements and customs unions, when properly crafted, are consistent with GATT rules.

When the GATT was originally signed in 1947, its founding members carved out an exception for free-trade areas. Article XXIV of the GATT allows customs unions or free-trade agreements between members,[4] recognizing "the desirability of increasing freedom of trade by the development, through voluntary agreements, of closer integration between the economies of the countries parties to such agreements."[5] Such agreements are allowed provided they (1) do not result in higher trade barriers overall for WTO members outside the agreement,[6] (2) eliminate "duties and other restrictive regulations of commerce" on "substantially all the trade between the constituent territories . . . in products originating in such territories,"[7] and (3) do so "within a reasonable length of time."[8] Article XXIV can be waived entirely by a two-thirds vote of WTO members.[9]

The most obvious exception under Article XXIV has been the European Union, which began in the 1950s as the six-member European Economic Community. Other well-known FTAs or customs unions among WTO members are the European Free Trade Association, the North American Free Trade Agreement, the Southern Common Market, the Association of Southeast Asian Nations Free Trade Area, and the Common Market of Eastern and Southern Africa.

In fact, free-trade agreements have been proliferating among WTO members. Today more than 150 such agreements are in effect, and the trend has been accelerating in the last decade. In the first 46 years of the GATT, between 1948 and 1994, 124 such agreements were signed (many of which have since expired), an average of 2.7 per year. Since 1995 the WTO has been notified of 130 such agreements, an average of more than 15 per year.[10] Today an estimated 43 percent of international trade occurs under free-trade agreements, and that share would reach 55 percent if agreements currently being negotiated worldwide were to be implemented.[11]

Despite Article I, free-trade agreements are a legal fact of life in international trade. More and more WTO members are choosing to negotiate FTAs. The question for U.S. trade policy is whether we should join or resist the trend.

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The Messy Economics of FTAs

The economics of FTAs is more ambiguous than the legalities. Even though FTAs by definition result in lower trade barriers between member countries, they do not necessarily result in economic gains for all members or the world as a whole.

Economists have been investigating this phenomenon since 1950, when Jacob Viner published his seminal study, *The Customs Union Issue.*[12] Viner noted that customs unions can promote new trade among members, but they can also divert trade from more efficient producers outside the agreement.

If signed with a low-cost foreign producer, an agreement can result in *trade creation* by allowing the low-cost producer to enter the domestic market tariff free, reducing domestic prices, and displacing higher-cost *domestic* pro-

ducers. But if signed with a relatively high-cost foreign producer, an agreement can result merely in *trade diversion* by allowing the higher-cost importer to displace lower-cost *foreign* importers simply because producers in the new FTA partner can import tariff free. As Viner concluded, customs unions are likely to yield more economic benefit than harm when "they are between sizeable countries which practice substantial protection of substantially similar [that is, competing] industries."[13]

To maximize trade creation, FTAs should unleash real competition in previously protected markets. From an economic perspective, the essential purpose and principal payoff of international trade is expanded competition within the domestic economy and expanded markets abroad for domestic producers. Increased import competition results in lower prices for consuming households and businesses, more product choice, higher quality, and increased innovation. By stimulating more efficient production, import competition increases the productivity of workers, real wages, living standards, and the long-run growth of the economy.

If an FTA does not result in lower prices for the importing country but merely reshuffles imports from the rest of the world to FTA partners, the importing country can suffer a welfare loss. Its government loses tariff revenue, but its consumers do not reap any gain from lower prices. In effect, the importing country's treasury subsidizes less efficient production in the partner country. If global prices outside the FTA fall because of the diverted demand, then the rest of the world loses from lost producer surplus.

The best free-trade agreements allow a large and competitive foreign producer to displace domestic producers in a large and protected domestic market, thus delivering lower prices and higher real incomes to workers and families.

To minimize trade diversion, the best FTAs allow a large and competitive foreign producer to displace domestic producers in a large and protected domestic market, thus delivering lower prices and higher real incomes to workers and families. The worst allow less competitive foreign producers to replace more competitive foreign producers in a large and protected domestic market, costing the treasury tariff revenue without delivering lower domestic prices or more efficient domestic production.

Free-trade economists argue among themselves about whether trade creation or trade diversion usually predominates under free-trade agreements. Settling that dispute definitively is beyond the scope of this paper.[14] But we do know that the evidence is mixed and that the short-term, static economic impact of a free-trade agreement is only one factor in deciding whether a particular FTA meets the test of good public policy. The possibility of trade diversion is not sufficient reason to reject the Bush administration's policy of pursuing FTAs.

How FTAs Advance Trade Liberalization

Even if trade diversion occurs, free-trade agreements can advance the goals of expanding free markets, individual liberty, and more peaceful cooperation among nations. In addition to their short-term economic effects, free-trade agreements can advance American interests in several ways.

A Safety Valve for the Multilateral System

One, FTAs provide an important safety valve if multilateral negotiations become stuck—an all-too-real possibility. Multilateral negotiations through the GATT and now the WTO can be long, tortuous, and uncertain. Since the Kennedy Round concluded in 1967, only two other comprehensive multilateral agreements have been reached—the Tokyo Round Agreement in 1979 and the Uruguay Round Agreement in 1994. And because of the need for consensus, it takes only one of the 146 nations in the WTO to scuttle a new agreement.

To cite one plausible scenario, the French government could prevent completion of a Doha Round Agreement because of its long-standing objections to liberalization of agricultural trade. Negotiators have already missed a March 31, 2003, deadline for preliminary agreements on agriculture, and doubt is widespread that the round will be concluded by 2005 as agreed in the 2001 agreement that launched it. The Uruguay Round, it should be remembered, almost foundered on the subject of agriculture. Given the history of multilateral negotiations, it would be unwise to put all of our tradable eggs in the Doha Round basket.

FTAs provide institutional competition to keep multilateral talks on track. If other WTO

members become intransigent, the United States should have the option of pursuing agreements with a "coalition of the willing" in pursuit of trade liberalization. Negotiating FTAs, or at least retaining the option to do so, can send a signal to other WTO members that, if they are unwilling to negotiate seriously to reduce trade barriers, we retain the right to find bilateral and regional partners who will. Knowing that WTO members, including the United States, can pursue FTAs outside the multilateral process can focus the minds and wills of negotiators to reach an agreement.

Fears that FTAs could divert attention from the multilateral track are unfounded. Most WTO members that have pursued regional and bilateral FTAs have not abandoned their commitment to multilateral negotiations. The U.S. government signed agreements with Israel, Canada, and Mexico during the Uruguay Round negotiations from 1986 to 1994 without reducing its commitment to a final multilateral agreement. And there is no evidence that pursuit of FTAs today has distracted the Bush administration from the ongoing Doha Round of WTO negotiations. Indeed, U.S. Trade Representative Robert Zoellick has been leading the charge in the Doha Round with aggressive proposals to liberalize global trade in manufactured goods, agricultural products, and services.

A Level Playing Field for U.S. Exporters

Two, FTAs can level the playing field for U.S. exporters who have been put at a disadvantage by free-trade agreements that do not include the United States. The United States is party to only 3 of the 150 or so FTAs currently in force around the world—NAFTA and bilateral agreements with Israel and Jordan. Even though American producers may be the most efficient in the world in a certain sector, our exporters may not be able to overcome the advantage of rival foreign producers who can export tariff free to countries with which their governments have signed an FTA.

In Chile, for example, U.S. exporters encounter a uniform 6 percent tariff. Competing exporters in the European Union, Canada, and Brazil, in contrast, sell duty-free in the same market because their governments have signed free-trade agreements with Chile. According to the National Association of Manufacturers, U.S. exporters have lost market share in Chile since its government began to aggressively pursue free-trade agreements with its non-U.S. trading partners in 1997. Especially hard-hit by the tariff differential have been U.S. exports to Chile of wheat, soybeans, corn, paper products, plastics, fertilizers, paints and dyes, and heating and construction equipment.[15] All those sectors have seen their market share drop significantly in the absence of a U.S.-Chile free-trade agreement.

Institutionalizing Reforms Abroad

Three, FTAs can help less-developed countries lock in and institutionalize ongoing economic reforms. A signed agreement prevents nations from backsliding in times of economic or political duress. Agreements assure foreign investors that reforms mark a permanent commitment to liberalization. For example, when Mexico suffered its peso crisis in 1994–95, its NAFTA commitments kept its market open to U.S. exports. The assurance of an FTA also works the other way, guaranteeing that exporters in the partner country will enjoy duty-free access to the large American market. By signing an FTA with the United States, less-developed countries signal to the rest of the world that they are serious about embracing global competition. That signal, combined with access to the U.S. market, can help to attract foreign investment and spur faster development.

Blazing a Trail for Broader Negotiations

Four, FTAs can provide useful templates for broader negotiations. As the members of the WTO grow in number and diversity, reaching consensus among all 146 members becomes more difficult. Negotiators can be forced to consider only the lowest common denominator acceptable to all members. Negotiating with only one country or a small group of like-minded countries can allow more meaningful liberalization in areas such as sanitary and phytosanitary (i.e., animal and plant) regulations, technical barriers to trade, service trade and investment, electronic commerce, customs facilitation, labor and environmental standards, dispute settlement, and market access for politically sensitive sectors.

Those agreements, in turn, can blaze a trail

Negotiating FTAs, or at least retaining the option to do so, can send a signal to other WTO members that, if they are unwilling to negotiate seriously to reduce trade barriers, we retain the right to find bilateral and regional partners who will.

for wider regional and multilateral negotiations. The U.S.-Chile FTA provides an example of how to incorporate labor and environmental standards into the text of an agreement without threatening to hold trade hostage to rich-country demands for higher standards in less-developed countries. FTAs can provide creative solutions to sticky political problems that can then be adapted in other agreements.

Internal Competition and Integration

Five, FTAs can spur internal reform and consolidation within member states, enhancing economic growth and support for more liberalization. By encouraging regional integration, FTAs hasten the consolidation of production within the FTA, increase economies of scale, and create a more integrated production process. Consolidation may be most pronounced in more heavily protected service sectors such as telecommunications, financial services, and transportation. More efficient industries and infrastructure can yield dynamic gains year after year, boosting growth, investment, and demand for imports from FTA partners as well as the rest of the world.

For all those reasons, the Bush administration's agenda of negotiating free-trade agreements is worth pursuing. Under the right conditions, FTAs can inject new competition into our domestic economy, lowering prices for consumers and shifting factors of production to more efficient uses, while leveling the playing field for U.S. exporters. Beyond those immediate benefits, FTAs can provide institutional competition for multilateral talks, spurring integration among FTA countries and liberalization abroad and blazing a trail through difficult areas for broader negotiations in the future. As a foreign policy tool, FTAs can cement ties with allies and encourage countries to stay on the trail of political and economic reform.

On the Docket: Singapore and Chile

On May 6, 2003, the Bush administration signed a free-trade agreement with the government of Singapore, and on June 6 it signed an FTA with the government of Chile. Both agreements are now awaiting action by Congress. Both are comprehensive, covering not only market access for goods, including farm products, but also services, investment, intellectual property, and nontariff barriers. Neither agreement excludes any goods from free trade, although they provide phase-in periods of as long as 12 years for certain politically sensitive products.

What follows is a brief survey of the major strengths and weaknesses of the two completed agreements now awaiting congressional approval.[16]

The U.S.-Chile FTA

The United States and Chile have been discussing a free-trade agreement for almost a decade. Of all the countries of Latin America, Chile has traveled the furthest along the road of economic reform. Since the 1970s its government has liberalized trade and foreign investment, cut taxes and regulations, and privatized its pension system. According to the *Economic Freedom of the World* survey, Chile's economy is one of the freest in the world, ranking 15th out of 123 economies rated.[17]

Of all the countries of Latin America, Chile has traveled the furthest along the road of economic reform. A free-trade agreement would, among other benefits, recognize Chile's commitment to free trade and free markets.

Chileans have reaped the rewards. Until the recent global slowdown, economic growth in Chile had averaged more than 8 percent a year since the late 1980s.[18] The share of people living in poverty has been cut in half.[19] Chile is the only South American country that has earned an investment grade on its government bonds. As other Latin American countries have suffered through political and economic turmoil, Chile has been a model of stability. A free-trade agreement with Chile would, among other benefits, recognize Chile's commitment to free trade and free markets.

The strength of the U.S.-Chile FTA is its comprehensiveness. No sector is excluded from liberalization. The Office of the U.S. Trade Representative notes that 87 percent of two-way trade in goods will be tariff free upon enactment of the agreement, with most of the remaining tariffs and quotas eliminated after four years.[20] The qualifier is that liberalization for the sectors most likely to provide the most vigorous import competition—and hence provoke the most political reaction—has been postponed for up to 12 years.

The full economic benefits of the U.S.-Chile

FTA will be delayed by the relatively slow phaseout of our most damaging trade barriers. For example, the amount of sugar that can be imported from Chile is set at a small 2,000 metric tons a year and is allowed to grow by only 5 percent per year during the extended phaseout period. Quotas on imports of highly protected commodities such as butter, milk powder, and cheese are maintained for 7 to 12 years. Beef quotas are maintained for 3 years.[21]

Quotas on avocados, one for imports from January through September, another for imports from October through December, expand 5 percent per year before expiring after 12 years. Poultry, tires, copper, and "hotel and restaurant china" will all be subject to tariffs for up to 10 years after enactment of the agreement. No cuts will be made in tariffs on imported wine from Chile for the first 7 years of the agreement and will be eliminated entirely only after 12 years. So any trade advocates who want to toast enactment of the agreement with imported Chilean wine will still need to pay a tariff for the experience.

From the mercantilist point of view, according to which imports are the price a nation pays for the privilege of exporting, postponing the liberalization of more competitive imports such as wine will be touted as a selling point of the agreement. But in terms of America's national welfare, postponement of liberalization only delays the economic payoff of the agreement. Those delays increase the odds at least in the short run that trade diversion will predominate over trade creation.

On services, the U.S.-Chile FTA is far-reaching and breaks new ground. In general, the FTA guarantees Americans the right to sell services across the border and to establish, acquire, and operate investments in Chile on an equal footing with domestic and other foreign investors, while extending reciprocal rights to Chilean service providers. The agreement wisely incorporates a "negative list" approach: all sectors are liberalized unless specifically excluded.

Specifically, the agreement will fully open the Chilean market to such competitive U.S. service sectors as tourism, advertising, computers and telecommunications, construction and engineering, express delivery, distribution and retailing, adult education, and professional services. The Coalition of Service Industries, the main American lobbying group for trade liberalization in services, pronounced the agreement a "milestone" that will set a high standard for future trade agreements that seek to liberalize what remains a highly protected and regulated international services sector. According to CSI, the U.S.-Chile FTA is "the first trade agreement that has ever committed another country to apply the same high standards of regulatory transparency that we enjoy in the U.S."[22]

Chile

Population (2002):
15.5 million

Economy (2001, purchasing power parity):
$153 billion GDP
$10,000 GDP per capita

Economic Freedom (1999):
8.0 (out of 10.0), ranks 15th

U.S. Services Imports from Chile (2001):
$840 million

U.S. Services Exports to Chile (2001):
$1.31 billion

U.S. Goods Imports from Chile (2002):
$3.78 billion

Top Imports from Chile (2002):
Fruits, frozen juices ($828 million)
Copper ($723 million)
Fish/shellfish ($508 million)
Shingles/wallboard ($341 million)
Lumber ($172 million)
Chemicals–organic ($139 million)
Wine ($138 million)

U.S. Goods Exports to Chile (2002):
$2.61 billion

Top Exports to Chile (2002):
Computer accessories ($222 million)
Excavating machinery ($171 million)
Industrial engines ($97 million)
Computers ($95 million)
Other household goods ($88 million)
Materials handling equipment ($81 million)
Chemicals–other ($74 million)

U.S.-Owned FDI in Chile (end of 2001):
$11.7 billion

Sales by U.S.-Owned Affiliates in Chile (2000):
$3.1 billion

On the related matter of capital controls, the agreement affirms and protects the right of foreign investors to enjoy the same rights as domestic companies. Investors are guaranteed the right, among others, to repatriate profits and capital and to do so "in a freely usable currency at the market rate of exchange prevailing on the date of transfer."[23]

In a problematic clause, the agreement does grant the Chilean government the right to impose capital controls on short-term flows under certain conditions. Investors who lose money if their funds are "substantially impeded" would be able to use the dispute settlement mechanism to recover damages after a cooling-off period of 6 to 12 months.[24] Ideally, capital should be as free to flow across international borders as goods or services,[25] but even with this exception, the agreement grants stronger transfer rights to investors than are currently granted under the International Monetary Fund Articles of Agreement, the General Agreement on Trade in Services, and the General Agreement on Tariffs and Trade.

Another problematic section allows the imposition of fines and other punishments if either party fails to adequately enforce labor and environmental standards. The agreement asserts, "A Party shall not fail to effectively enforce its labor laws, through a sustained or recurring course of action or inaction, in a manner affecting trade between the Parties, after the date of entry into force of this Agreement." The agreement continues: "The Parties recognize that it is inappropriate to encourage trade or investment by weakening or reducing the protections afforded in domestic labor laws."[26] (The chapter on the environment contains almost identical language.)[27] Failure to comply can result in monetary fines and, eventually, trade sanctions.

Supporters of free trade rightly worry that enforcing labor and environmental standards through trade agreements could create a lofty-sounding pretext for protectionism. And by raising trade barriers as a method of enforcement, such arrangements can actually undermine the growth and development that make higher standards possible.[28] But the U.S.-Chile FTA contains several layers of protection to guard against abuse of those provisions. First, the agreement does not require a specific level of environmental and labor regulations that would be inappropriate for a country at Chile's stage of development. It does require that existing regulations be enforced and not "weakened" to gain an alleged advantage in promoting exports or attracting investment. Second, the rules prohibit a sustained pattern of violations, not isolated incidents. Third, the dispute settlement provisions emphasize consultation over litigation and monetary fines over trade sanctions. The advantage of fines is that they do not undermine the central purpose of the agreement, which is wealth creation through expanding trade.

Singapore is the leading free-trade nation in its region. An FTA would strengthen America's economic ties to Southeast Asia and create opportunities for U.S. investors and exporters in a populous and economically promising region of the world.

The U.S.-Singapore FTA

Tiny Singapore, population 4.5 million, boxes far above its weight in the global economy. The island entrepôt ranks 16th in the world as a source of imports to the United States and 11th as a destination for U.S. exports. It is also one of the top destinations for U.S. direct foreign investment abroad. The Singapore economy is one of the freest and most open in the world, which largely explains why its citizens enjoy a first-world standard of living.

Singapore is the leading free-trade nation in its region. An FTA with Singapore would strengthen America's economic ties to Southeast Asia and create opportunities for U.S. investors and exporters in a populous and economically promising region of the world. Southeast Asia is especially strategic because it is home to 20 percent of the world's Muslims. The government of Singapore has been a steadfast ally of the United States in the war against international terrorism.

The U.S.-Singapore Free Trade Agreement commits both nations to comprehensive liberalization of bilateral trade in goods and services and guarantees protection of foreign investment. Even though tariffs on most trade between the United States and Singapore are already low or have been eliminated, the agreement will guarantee duty-free access.

With a few of the usual exceptions (beef, dairy products, and sugar among them), the United States commits itself upon enactment of the agreement to reduce tariffs on goods imported from Singapore to zero. Tariffs on products exempted from immediate liberaliza-

tion will be phased out within 10 years.[29] Singapore's commitment on goods liberalization is a model of elegance and simplicity: The few categories of goods subject to duties "will be duty free on the date this Agreement enters into force." There are no exceptions.[30]

The agreement guarantees market access for a broad range of service sectors, whether the service is delivered across the border or by investing in a local presence. Like the U.S.-Chile FTA, the agreement follows the "negative list" approach of liberalizing all sectors except an explicit few. Among the more competitive U.S. service sectors that will enjoy nondiscriminatory treatment in Singapore under the agreement are tourism, express delivery, telecommunications, advertising, construction and engineering, and financial services, including banking and insurance. Specifically, Americans will be allowed to own and operate full-service banks in Singapore within 18 months of enactment, and unlimited branches and automatic teller machines within two years. U.S. insurance firms will be able to offer full services, including the supply of insurance across the border from the United States.[31]

The agreement guarantees the right of cross-border investors to enjoy secure property rights and nondiscriminatory treatment. The agreement removes certain performance-related restrictions on foreign investment and guarantees the right to repatriate capital and profits. Like the agreement with Chili, it acknowledges that capital controls can be imposed under certain circumstances but also requires that compensation be paid to injured parties if the controls "substantially impede transfers" of funds or remain in place for more than 364 days.[32] As are those of the FTA with Chile, such provisions are less than ideal, but they do not undermine what is in fact an almost total liberalization of capital flows.

One innovative feature of the agreement is a provision allowing producers in Singapore to source more labor-intensive work to special zones in neighboring Indonesia. That provision, called the Integrated Sourcing Initiative, allows certain finished products and intermediate inputs produced in the Indonesian islands of Bintan and Batam to be exported to the United States as if they were of Singaporean origin for benefits under the agreement.[33] This is not a loophole but recognition that producers in Singapore have already integrated suppliers in Indonesia into their production process. The goods covered by the ISI already enter the United States duty-free even without the U.S.-Singapore FTA, so no new trade privileges are being granted to Indonesia. Allowing Indonesia to contribute to the production process will help to raise worker productivity and overall living standards in that country as well as in Singapore and the United States.

Singapore

Population (2002):
4.5 million
Economy (2001, purchasing power parity):
$106 billion GDP
$24,700 GDP per capita
Economic Freedom (1999):
9.3 (out of 10.0), ranks 2nd
U.S. Services Imports from Singapore (2001):
$2.01 billion
U.S. Services Exports to Singapore (2001):
$4.08 billion
U.S. Goods Imports from Singapore (2002):
$14.8 billion
Top Imports from Singapore (2002):
Computer accessories ($7.30 billion)
Semiconductors ($1.27 billion)
Pharmaceutical preparations ($1.21 billion)
U.S. goods returned ($881 million)
Telecommunications equipment ($429 million)
Medicinal equipment ($408 million)
Chemicals–organic ($357 million)
U.S. Goods Exports to Singapore (2002):
$16.2 billion
Top Exports to Singapore (2002):
Semiconductors ($2.18 billion)
Civilian aircraft ($2.15 billion)
Computer accessories ($1.32 billion)
Industrial machines, other ($765 million)
Electric apparatus ($670 million)
Engines–civilian aircraft ($590 million)
Fuel oil ($570 million)
Measuring, testing, and control instruments ($534 million)
U.S.-Owned FDI in Singapore (end of 2001):
$27.3 billion
Sales by U.S.-Owned Affiliates in Singapore (2000):
$5.4 billion

The U.S. government should resist domestic political pressure to exclude or delay liberalization of Australian imports that are most competitive in the U.S. market.

Next in Line: Australia, Morocco, Central America, and Southern Africa

In line behind the two completed agreements are negotiations with a dozen other potential FTA partners. The Bush administration has begun negotiations with Australia, Morocco, Bahrain, the five members of the Central American Common Market, and the five members of the Southern African Customs Union. What follows is a brief analysis of the major opportunities and challenges that are likely to arise during the negotiation of the individual agreements.[34]

Australia

Of all the free-trade agreements in the pipeline, the one being negotiated with Australia is arguably the most economically meaningful. Australia is a major producer of products that are protected in the U.S. market, such as beef, sugar, dairy products, and wine. Enactment of a comprehensive FTA with Australia would inject real competition into the U.S. domestic market, creating rather than merely diverting trade and delivering the competition and lower prices that are the principal payoff of trade.

Investment and services will be an important part of an FTA with Australia. Like Singapore, Australia is not only a major trading partner but also a major investment partner of the United States. At the end of 2001 U.S. companies owned $34 billion in direct investment in Australia[35] and U.S.-owned affiliates sold $15 billion of services in Australia in 2000.[36] An FTA would more securely protect the rights of U.S. investors to establish a commercial presence in Australia.

In negotiating an FTA with Australia, the U.S. government should resist domestic political pressure to exclude or delay liberalization of Australian imports that are most competitive in the U.S. market and hence most politically sensitive. The Australian government, for its part, should accommodate legitimate concerns about its sanitary and phytosanitary regime on agricultural imports and its government-run Australian Wheat Board, which acts as a central market for Australian wheat.

Australia

Population (2002):
19.5 million

Economy (2001, purchasing power parity):
$466 billion GDP
$24,000 GDP per capita

Economic Freedom (1999):
8.5 (out of 10.0), ranks 6th

U.S. Services Imports from Australia (2001):
$3.50 billion

U.S. Services Exports to Australia (2001):
$4.70 billion

U.S. Goods Imports from Australia (2002):
$6.48 billion

Top Imports from Australia (2002):
Meat products ($1.08 billion)
Wine and related products ($461 million)
U.S. goods returned ($445 million)
Crude oil ($433 million)
Chemicals–inorganic ($322 million)
Passenger cars, new, used ($311 million)
Steel-making materials ($217 million)

U.S. Goods Exports to Australia (2002):
$13.08 billion

Top Exports to Australia (2002):
Civilian aircraft ($2.66 billion)
Computer accessories ($464 million)
Pharmaceutical preparations ($421 million)
Telecommunications equipment ($401 million)
Automotive parts and accessories ($400 million)
Excavating machinery ($310 million)
Industrial machines, other ($303 million)

U.S.-Owned FDI in Australia (end of 2001):
$34.0 billion

Sales by U.S.-Owned Affiliates in Australia (2000):
$14.9 billion

Central American Common Market

A free-trade agreement with the five members of the Central American Common Market would be a logical geographical extension of the already established North American Free Trade Agreement. It would open protected markets to more vigorous competition and encourage economic reform and stability in what has been an especially troubled region of the Western Hemisphere.

The combined economic output of CACM members is small, less than one-third the size of Australia's GDP. But their two-way trade with the United States is relatively large because of proximity and their comparative advantage in products popular in the U.S. market, such as apparel, semiconductors, bananas, and coffee.

An FTA would guarantee access for Central American producers to the otherwise heavily protected U.S. market for imported apparel and textiles. Producers in the five member countries already send more than $7 billion in cotton clothing and textile imports to the United States.[37] Granting those imports permanent duty-free access will be politically sensitive in the United States, most predictably with the protectionist textile lobby.

Rejecting the agreement because of textile and apparel imports would not serve our national interest and would be shortsighted for the textile industry itself. Textiles are one of the major exports from the United States to Central America. In 2002 the top U.S. export category to the CACM countries was textiles for household apparel, and four of the top seven export categories were textiles or cloth.[38] By opening our market to finished apparel from Central America, we would likely be encouraging the export of textiles and other semifinished inputs from the United States.

Because of the region's widespread poverty, opponents of the FTA will argue that trade will encourage "sweatshops" and will not adequately protect environmental and labor standards. Such arguments ignore ample evidence that trade and development make higher standards possible. What is considered a "sweatshop" by American standards can, to workers in less-developed countries, represent relatively good-paying jobs with good benefits and working conditions. By refusing to grant market access because of lower environmental and labor standards, the United States would be depriving poor workers abroad of one of the most powerful engines for raising their overall living standards.[39]

Central American Common Market

Members:
Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua

Population (2002):
35.1 million

Economy (2001, purchasing power parity):
$138 billion GDP
$4,000 GDP per capita

Economic Freedom (1999):
Costa Rica: 7.8 (out of 10.0), ranks 24th
El Salvador: 7.9 (out of 10.0), ranks 20th
Guatemala: 6.7 (out of 10.0), ranks 56th
Honduras: 6.6 (out of 10.0), ranks 60th
Nicaragua: 7.5 (out of 10.0), ranks 34th

U.S. Services Imports from CACM (2001):
N/A

U.S. Services Exports to CACM (2001):
N/A

U.S. Goods Imports from CACM (2002):
$11.9 billion

Top Imports from CACM (2002):
Apparel, household goods–cotton ($4.95 billion)
Apparel, textiles, nonwool or cotton ($1.93 billion)
Fruits, frozen juices ($1.05 billion)
Semiconductors ($449 million)
Green coffee ($373 million)
Medicinal equipment ($340 million)
Fish and shellfish ($324 million)

U.S. Goods Exports to CACM (2002):
$9.84 billion

Top Exports to CACM (2002):
Apparel, household goods–textile ($1.61 billion)
Semiconductors ($848 million)
Cotton fiber cloth ($820 million)
Finished textile supplies ($352 million)
Plastic materials ($343 million)
Newsprint ($334 million)
Manmade cloth ($331 million)

U.S.-Owned FDI in CACM (end of 2001):
N/A

Sales by U.S.-Owned Affiliates in CACM (2000):
N/A

An FTA with Morocco could help to build a core of Arab nations that would support trade liberalization and economic integration with the global economy—and eventually create more favorable conditions for political and civil freedom in the Muslim world.

An FTA with Central American countries would advance important U.S. foreign policy goals. During the 1980s the region was torn by war and civil strife stoked in part by communist insurgents. Today all five members are fledgling democracies that have expanded the economic freedom of their citizens as they have expanded their political and civil freedoms. A comprehensive free-trade agreement with the United States would recognize and reward that progress. It would help those nations to reduce poverty and strengthen the foundations of freedom and representative government.

Morocco

Morocco is not a major U.S. trading partner, but it is considered a moderate and pro-reform regime within the Arab world. Like the U.S.-Jordan FTA enacted in 2001, an FTA with Morocco would be more of a foreign policy than an economic initiative for the United States.

Because Morocco's economy is relatively small, the economic impact of the agreement will be much greater on the North African nation than on the United States. To extend the maximum benefit to both countries, any agreement should rapidly eliminate tariffs and quotas on each country's goods that are most competitive in the other's market. Moroccan exports in that category would be fruits such as clementines and textile and apparel goods.

A trade agreement with Morocco could duplicate the success of the U.S.-Jordan Free Trade Agreement enacted in 2001. That FTA has had a measurable impact on the ability of Jordanian producers to sell in the U.S. market: Jordan's exports to the United States jumped more than 10-fold from $31 million in 1999 to $412 million in 2002.[40] By far the largest category of exports has been textile and apparel goods, a labor-intensive and thus competitive industry for many developing countries.[41]

The FTA has also helped to transform Jordan into a proponent of free trade and globalization among Arab countries. An FTA with Morocco could help to build a core of Arab nations that would support trade liberalization and economic integration with the global economy—and eventually create more favorable conditions for political and civil freedom in the Muslim world.

After Morocco, the two most likely prospects in the Middle East for free-trade agreements are

Morocco

Population (2002):
31.1 million

Economy (2001, purchasing power parity):
$112 billion GDP
$3,700 GDP per capita

Economic Freedom (1999):
6.2 (out of 10.0), ranks 72nd

U.S. Services Imports from Morocco (2001):
N/A

U.S. Services Exports to Morocco (2001):
N/A

U.S. Goods Imports from Morocco (2002):
$392 million

Top Imports from Morocco (2002):
Semiconductors ($96 million)
Sulfur and nonmetallic minerals ($85 million)
Apparel, household goods–cotton ($35million)
Apparel, textiles, nonwool or cotton ($34 million)
Vegetables ($30 million)
Fish and shellfish ($18 million)
Fruits, frozen juices ($13 million)

U.S. Goods Exports to Morocco (2002):
$565 million

Top Exports to Morocco (2002):
Civilian aircraft ($281 million)
Corn ($39 million)
Soybeans ($35 million)
Oilseeds, food oils ($16 million)
Wheat ($11 million)
Animal feeds ($10 million)
Engines–civilian aircraft ($10 million)

U.S.-Owned FDI in Morocco (end of 2001):
N/A

Sales by U.S.-Owned Affiliates in Morocco (2000):
N/A

Bahrain and Egypt. Bahrain, although small in size and population, has become a key financial and petroleum-processing center in the Persian Gulf. Economic reforms have created the most liberalized economy in the Arab world (ranking 28th in economic freedom out of 123 countries worldwide). Compared to Bahrain, Egypt is much larger in population (71 million vs. 656,000) and in economic output ($258 billion vs. $8.4 billion), but its economy is less liberalized (ranking 52nd in economic freedom).

Southern African Customs Union

The countries of the Southern African Customs Union are a rare success story on a continent where economic stagnation and political upheaval are the norm. Per capita GDP within the union is far higher than in the rest of sub-Saharan Africa, and democracy has gained a more secure foothold.

The powerhouse within the SACU is South Africa, which accounts for more than 90 percent of the union's GDP and trade with the United States. An FTA with SACU members would fully open this important African market to U.S. exports of goods and services. It would safeguard U.S. direct investments, which are already a considerable $3 billion in South Africa.[42] Total two-way trade in goods and services between the United States and SACU members in 2002 was about $9 billion, comparable to U.S. trade with Chile.[43]

Just as important, an FTA would guarantee SACU producers duty-free access to the U.S. market. One of the many hurdles that have confronted Africans is the generally high level of trade barriers in rich countries to those products—namely textiles, apparel, and agricultural products—that Africans are comparatively efficient at producing.

The African Growth and Opportunity Act passed by Congress in 2000 took a big step toward reducing those barriers by allowing a number of products from more than 30 African nations to enter the United States duty-free. The early results have been promising. For example, textile and apparel exports to the United States from SACU-member Lesotho tripled from $100 million in 1998 to $321 million in 2002.[44] A U.S.-SACU FTA would build on the success of AGOA by making that access permanent, by extending free trade to almost all products and services, and by requiring a reciprocal commitment to liberalization from our African trading partners.

Like the proposed FTA with Morocco, an FTA with the SACU countries would have a modest positive impact on the U.S. economy. The real

Southern African Customs Union

Members:
Botswana, Lesotho, Namibia, South Africa, Swaziland

Population (2002):
50.3 million

Economy (2001, purchasing power parity):
$442 billion GDP
$8,800 GDP per capita

Economic Freedom (1999):
Botswana: 6.9 (out of 10.0), ranks 50th
Namibia: 6.9 (out of 10.0), ranks 50th
South Africa: 7.0 (out of 10.0), ranks 46th

U.S. Services Imports from South Africa (2001):
$891 million

U.S. Services Exports to South Africa (2001):
$1.22 billion

U.S. Goods Imports from SACU (2002):
$4.55 billion

Top Imports from SACU (2002):
Precious metals ($1.18 billion)
Gem diamonds ($504 million)
Apparel, household goods–cotton ($482 million)
Passenger cars, new, used ($267 million)
Steel-making materials ($260 million)
Nonferrous metals, other ($218 million)
Automotive parts, accessories ($148 million)

U.S. Goods Exports to SACU (2002):
$2.63 billion

Top Exports to SACU (2002):
Civilian aircraft ($250 million)
Passenger cars, new and used ($135 million)
Chemicals–organic ($111 million)
Petroleum products, other ($105 million)
Excavating machinery ($88 million)
Chemicals–other ($72 million)
Plastic materials ($70 million)

U.S.-Owned FDI in South Africa (end of 2001):
$3.0 billion

Sales by U.S.-Owned Affiliates in South Africa (2000):
N/A

strength of the agreement would be as a foreign policy initiative that would encourage economic reform and institutional development in a region of the world where both have been rare and fragile.

Conclusion

As a tool for expanding freedom and prosperity, regional and bilateral free-trade agreements are useful if less than ideal. They complicate the international trading system by deviating from the most-favored-nation principle of nondiscrimination, and they can blunt the benefits of international trade by diverting it from the most efficient foreign producers to those that are favored but less efficient. But FTAs can produce compensating benefits by opening domestic markets to fresh competition, encouraging economic liberalization abroad, cementing important foreign policy and security ties, integrating regional economies, opening markets to U.S. exports, and providing healthy institutional competition for multilateral negotiations.

If crafted according to sound principles, free-trade agreements can serve America's economic and foreign policy interests.

To maximize the economic benefits of free-trade agreements, the U.S. government should focus its efforts on negotiations with countries that provide new opportunities for U.S. exporters and whose producers would be most likely to enhance competition in our own market. That approach requires that U.S. negotiators not duck politically sensitive sectors through long phase-in periods for or exemptions from liberalization. Instead, they should tout the immediate liberalization of those sectors as offering the best opportunities to reap the benefits of trade.

As a broader foreign policy tool, free-trade agreements should reward and solidify market and political reform abroad. If FTA partners are not major export markets or significant producers of goods that compete in our domestic market, they should be moving decisively toward free markets and representative government. They should be reform leaders in regions of the world where models of successful reform are most needed. In this way, free-trade agreements can serve as carrots to encourage the spread of political and economic freedom abroad.

Judged by those criteria, the FTAs proposed by the Bush administration deserve to be pursued. Australia and Singapore both meet the first criterion. Australia and Singapore are, respectively, major suppliers of agricultural and manufactured goods that, under free trade, would provide real competition in our domestic economy and large markets for U.S. exporters. Chile, Morocco, Bahrain, and the five SACU nations, while small in market size, all serve to one degree or another as examples of economic and political reform in their regions. A Central American FTA would be a "twofer," permanently opening the overly protected U.S. market to imported apparel and other labor-intensive manufactured goods, while further institutionalizing the historic market and political reforms taking root in Central America.

Despite their peculiarities and incremental nature, free-trade agreements can serve the cause of freedom and development by breaking down barriers to trade between nations. If crafted according to sound principles, free-trade agreements can serve America's economic and foreign policy interests.

Notes

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