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Trade Problems and Trade Policies

Sven W. Arndt

The contemporary protectionist furor in the U.S. Congress is not only unprecedented in the post–World War II era but also anomalous. It is anomalous because it occurs in the context of an economic recovery and one of the most extended recoveries at that. Although unprecedented and anomalous, it is not difficult to explain for it occurs during one of the most unbalanced economic recoveries on record.

This recovery has been shaped by macroeconomic policies that precipitated a large and sustained appreciation of the dollar and thereby compromised the international competitive position of U.S. producers. As a result, exports of manufactured and of agricultural products have stagnated while imports have soared. Economy-wide employment has grown, much to the satisfaction of the administration; but employment in manufacturing has fallen, not only in traditional, smokestack activities, but across a broad cross section of industries.

The U.S. trade balance has deteriorated sharply, but the dollar has stayed high, surprising those who believed that a large and growing trade deficit would bring down the currency. This situation has nurtured doubts about the system of floating exchange rates in general. Although the deterioration of the American trade position has affected many products and trading partners, much of the protectionist furor has focused on Japan and on several newly industrializing countries whose large trade surpluses have come to be seen as the ill-gotten gains from unfair trading practices.

All of these developments are set against the background of growing concern about the apparent erosion of the once preeminent and seemingly impregnable competitive position of the United States. That position appears to be under siege, not only in the more traditional smokestack sector but also in the high-tech market for computer chips, a development that has Americans worrying about becoming a nation of hamburger peddlers.

The confluence of these developments, some macroeconomic and others sector-, industry-, and even product-specific, has given the present protectionist surge its scope and intensity, for protectionist action seems to promise solutions to a range of diverse policy concerns.

> *"This recovery has been shaped by macroeconomic policies that precipitated a large and sustained appreciation of the dollar and thereby compromised the international competitive position of U.S. producers."*

Macroeconomic Influences on Trade and Competitiveness

Sometime in the middle of 1985 the international investment position of the United States turned negative as the country became an international debtor. The investment position declined under pressure from growing current-account deficits. These deficits in turn were the proximate result of an imbalance between the private sector's savings rate and the budget deficit of government.

In a closed economy, such an imbalance between output and absorption would raise interest rates to crowd out private demand. In an open economy, the current-account deficit is the safety valve that lets in the needed resources, while domestic interest rates rise in relation to those abroad to attract the necessary financing. The real appreciation of the dollar is part of the process that facilitates the resource transfer.

The impact of the dollar's appreciation on U.S. competitiveness has been pronounced indeed, as shown by

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the 40 percent rise between 1980 and 1985 in U.S. unit labor costs in manufacturing and U.S. prices relative to a weighted average of America's principal trading partners. This rise in relative costs and prices holds for the economy as a whole and for many industries and sectors, and it affects many of America's trading partners. The deleterious effects of the currency appreciation have been pervasive. The consequences for the U.S. trade balance in various product categories are clearly visible in table 1, which shows the dramatic deterioration across product groups. As competitiveness has suffered and trade has worsened, output and employment in the affected areas have stagnated or declined.

"But why is trade policy emphasized when the main culprit would appear to be exchange-rate policy or the macroeconomic policies that most directly determine exchange rates? Intervening in trade is not only a very indirect means of addressing the problem but may quite possibly be counterproductive."

In the recent debate on trade policy, protectionist proponents have often espoused the objective of stemming the loss of jobs to foreign competition. But why is trade policy emphasized when the main culprit would appear to be exchange-rate policy or the macroeconomic policies that most directly determine exchange rates? Intervening in trade is not only a very indirect means of addressing the problem but may quite possibly be counterproductive. A general import surcharge, for example, will certainly offend our trading partners because it violates the spirit and the letter of various international undertakings. It will make life even tougher for U.S. exporters to the extent that it raises the cost of imported inputs. And it may raise rather than lower interest rates and hence strengthen rather than weaken the dollar. Thus, if trade intervention is intended to compensate for the harmful consequences of dollar appreciation, it is quite probably misguided and inappropriate.

As the real dollar rises, import prices fall thereby forcing domestic producers to cut prices to preserve market share, while exporters cut their dollar prices to remain competitive in terms of foreign currencies. Nontradables producers (construction, services, and government), however, are relatively sheltered from such price shocks. Hence, a currency appreciation reduces the price of traded goods in relation to nontraded goods, thereby creating incentives for resources (labor, capital, and land) to be shifted from tradables into nontradables production. Such reallocation is costly and hence will be undertaken with caution; resource owners will wait to be certain that observed price changes are more than temporary. With the passage of time, however, a sustained appreciation will find employment rising and capital formation surging ahead in nontradables relative to tradables. (Capital formation will be subject to two kinds of pressure. One is to shift capital into nontradables; the other is to upgrade the quality of capital in tradables to enhance competitiveness. Both have the effect of reducing employment in tradables, but the net effect on capital formation depends upon their relative strengths.)

The effect, therefore, of the macroeconomic policies that brought the dollar appreciation has been contraction or at least reduced growth in the tradables sector. This result was neither intended nor anticipated. Indeed, the debate leading up to the crucial monetary and fiscal policy decisions of 1979 and 1981 paid scant attention to their exchange rate implications.

This indifference to the external consequences of domestic economic policies is characteristic of postwar U.S. policymaking; and, as the most recent episode shows, the consequences of such neglect may be anything but benign. Some of the current troubles in U.S. agriculture can be traced to these policies, as can some of the difficulties in manufacturing. As the adverse consequences have come to be understood, moreover, the government has failed in several attempts to improve the mix of policies. The recent surge in protectionist activity in Congress is at least in part driven by frustration over this failure.

But does this mean that the present difficulties will fade and disappear with a return to more balanced macroeconomic policies? Will America be able to recapture export shares and reverse the inroads of imports in the home market? Will the concern about declining com-

TABLE 1: CHANGES IN U.S. TRADE BALANCES, 1973–1984
(billions of dollars)

	1973–1981	*1981–1984*
Agricultural goods	16.3	−14.8
Capital goods	31.8	−33.5
Chemicals	8.8	− 3.4
Military equipment	2.2	0.3
Consumer goods	−14.4	− 4.6
Automotive products	− 7.2	−21.1
Fuel	−65.0	18.4
Other industrial supplies	− 7.5	− 4.6

SOURCE: U.S. Bureau of the Census, Department of Commerce, *Highlights of U.S. Export and Import Trade* (Washington, D.C.: Government Printing Office, 1985), pp. B-16, C-20.

parative advantage in many industries and unfair foreign competition turn out to have been but a bad dream?

Probably not. Although there can be little doubt that macroeconomic events are responsible for the bulk of our trade difficulties, the international division of labor is changing indeed, and the trading system is becoming increasingly distorted as governmental intervention grows around the globe.

A Changing International Division of Labor

At the end of the Second World War, the United States was the unrivaled economic power, dominating world markets to an extent that went beyond comparative advantage and reflected the devastation in Europe and Asia. Postwar reconstruction gradually restored a global division of labor that was more in tune with underlying comparative advantage. The first twenty-five years after the war represent a period of rapid economic growth fueled in no small measure by the unprecedented expansion in trade, an expansion especially in intra-industry trade among industrial nations. Trade and specialization go hand in hand, and countries specialized by using advantages derived from abundance of resources and by exploiting opportunities, especially in intra-industry trade, provided by economies of scale, product differentiation, and consumer preferences.

The United States, with its abundant supplies of natural resources, turned out to be highly competitive in agricultural trade. To the extent that the country was also relatively well endowed with capital, its exports would be expected to be capital intensive and its imports labor intensive. The early evidence was not entirely consistent with this presumption, leaving a number of paradoxes and unresolved issues.

These issues, however, involved the *levels* of resource content, while our interest here is in *changes* that have occurred over time. Consequently, these paradoxes and puzzles need not detain us. Whatever the capital to labor ratio of U.S. exports and imports at a given time, it is reasonable to suppose that the U.S. position would change if the rest of the world accumulated capital faster. Capital abundance may continue to grow in the United States in absolute terms; but the gap between the United States and other countries in capital abundance will narrow, and the demand for U.S. capital as embodied in its exports will decrease.

Thus a decline in the U.S. share in the world's stock of productive capital suggests that the capital per labor content of U.S. exports will decline. This means not that U.S. exports of capital-intensive products must decline, but that the U.S. share in world trade in such products will diminish.

Analogous considerations hold for the U.S. share in the world stock of skilled labor. The United States may continue to upgrade the quality of its labor force, through education, training, and other types of human capital formation, so that the skill abundance of the U.S. economy rises in absolute terms. But if the rest of the world accumulates human capital even faster, albeit from a lower level, the gap in labor skill endowments will narrow over time, reducing the need for other countries to import skilled labor from the United States through trade.

What does the evidence show? Allowing for considerable definitional and measurement problems, there is some evidence that capital formation in the 1970s was low in the United States in relation to many countries, implying a long-run decrease in the gap in capital abundance and with it a decline in America's trading edge in products with high capital per worker. A similar narrowing in the gap favoring the United States appears to have occurred in human capital and skill abundance during the 1970s, with the evidence suggesting that the ratio of skilled to other labor is declining in U.S. exports.

Again, these developments do not mean that skilled workers in the United States are about to lose their markets and their jobs. It does suggest, however, that their position of dominance is being challenged by rising competition worldwide. As the world stock of skilled labor grows, the increase in competition eliminates rents and thereby imparts a new and different character to price and wage behavior. If this enhanced degree of competition is unpalatable to American workers, as well it might be, one way out is to stay ahead of the pack in labor quality improvements.

"Capital abundance may continue to grow in the United States in absolute terms; but the gap between the United States and other countries in capital abundance will narrow, and the demand for U.S. capital as embodied in its exports will decrease."

Does the accumulation of skilled labor in low-income countries threaten the living standards of skilled workers in the United States? Has the threat from "cheap foreign labor," traditionally a concern for semiskilled and unskilled workers, moved up-scale? The answer, supported by economic theory and America's earlier experience with European competition, is that particular jobs and activities may indeed be so threatened, but not skilled labor as a whole. The growth of incomes in the traded-goods sectors at home and abroad will continue to be governed and constrained by productivity growth (witness the rapid rise in labor incomes in Singapore, Taiwan, and elsewhere), and the international di-

vision of skilled labor will increasingly take on an intra-industry pattern.

As the world supply of skilled labor rises and its distribution covers more and more countries, intra-industry trade is likely to become increasingly important. For the United States this situation means that import penetration will necessarily rise in many areas of manufacturing and that the totally integrated firm, producing every product along a given industry's spectrum, may fade. But it does not mean that U.S. firms cannot find important areas of specialization and play a significant role in world exports. Still, such a development represents a major departure from past U.S. experience, with its

"There can be little doubt that market intervention has increased in recent years; by many estimates more than half of world trade is subject to some form of official manipulation."

relatively closed economy and a habit of viewing comparative advantage as applying across entire industries. Even in the high-tech sector, where the United States is likely to continue as a major player, it will no longer dominate the sector in all product categories. Recent slippage in competitiveness of U.S. producers of mainstream computer chips is an example but in no way implies that the United States is about to lose its comparative advantage in the high-tech sector.

As the American economy becomes more open and exposed to foreign competition, its place in and interaction with the rest of the world are changing. This process inevitably provokes a shakeout of products and producers, so that not all existing firms and establishments will survive in their present form. But what is the likely shape of future trading arrangements? A partial answer to this question may be found in recent developments.

Among tradable goods industries, U.S. agriculture has consistently demonstrated its ability to compete, in spite of interventionist policies at home and abroad. The relative abundance of natural resources in the United States suggests that agricultural trade will continue to play a strong and positive role. The U.S. trade balance in products of the extractive industries as well as in many processed materials and semiprocessed products, however, has been deteriorating and is likely to continue along this path.

That leaves trade in manufactures and trade in services. In the latter the United States has a dominant position but is likely to be restrained by protectionist barriers in the rest of the world unless recent protectionist tendencies can be reversed and the performance of the trading system can be improved.

As for trade in manufactures, it is convenient for present purposes to think it as composed of two categories: mature products that are well established with respect to design, production technology, and market; and newer products, absorbing significant amounts of research and development and requiring sophisticated technologies and abundant skilled labor for their production. The former are technically known as Heckscher-Ohlin goods, while the latter are alternatively known as product-cycle goods.

The U.S. trade balance in the former has been deteriorating in recent years, suggesting a decline along trend in U.S. competitiveness. This decline has occurred because such products can be manufactured abroad by producers who acquire blueprints, technological know-how, and even factories on world markets, whose quality-control is superior and whose production costs are dominated by relatively cheap production labor. Japan was the first country to challenge the United States in this area; and Japan and other industrialized countries will be challenged increasingly, first by the newly industrializing countries in East Asia and then by those in Latin America and elsewhere. Relatively higher-priced U.S. workers using technologies that are available to their cheaper competitors, cannot long compete especially if their quality-control is inferior. They must find ways either to improve productivity and process technology or to offer new and better products.

It is in the latter realm—in the invention, design, and marketing of new and better products—that the United States has been especially successful and must seek its future. Indeed, the U.S. trade balance in this type of commodity has run strongly positive on trend and is likely to continue to do so. These are products intensive in research and development (R&D) and in human capital, two inputs with which the United States is relatively abundantly endowed.

Trouble in the Trading System

The international division of labor may be changing, but in the view of many Americans it is doing so under coercion from unfair foreign trade practices. According to this view, the international competitive game is not being conducted on a "level playing field," international trade is managed rather than free, and the United States had better respond by developing a more "realistic" policy than one based on free trade.

There can be little doubt that market intervention has increased in recent years; by many estimates more than half of world trade is subject to some form of official manipulation. Although several multilateral negotiating rounds since the end of World War II have succeeded in reducing tariffs on manufacturing trade, other components of world commerce, including agriculture, are

heavily controlled; and new forms of protection have been deployed in manufacturing. This new protectionism relies on quantitative devices like quotas and voluntary export restraints and uses administrative guidelines as well as standards and testing procedures as means of restricting market access. The nature of nonprice restraints like these is to do more damage to economic efficiency and productivity than their tariff counterparts.

The first point to note about the unfair trade complaint is, of course, that no country is without sin, not even the United States. But more important is the question regarding the proper response to demonstrated unfair overseas trade practices. Although the litany of complaints is limitless, a few broad principles cover most of the objections and need to be observed as "new" trade policies and trading systems are fashioned:

• The case for competition and free trade holds unilaterally and does not require reciprocity. We benefit from competition and free trade as a nation irrespective of policies in place elsewhere! Unrestricted trade brings benefits to the nation because it forces greater efficiency and hence greater productivity on the nation's resources and because it expands the set of choices and hence the purchasing power of the nation's buyers. The alternatives being compared are liberal and restrictive national trade policies and, with exceptions of mainly academic interest, the former generate higher levels of national welfare than the latter. This statement implies that the nation improves its overall welfare when it liberates trade and reduces overall welfare when it restricts trade. Reciprocal liberalization abroad may bring further benefits, but it is not required to make liberal trade superior to restricted trade on welfare grounds.

• When free trade takes place in the context of perfectly competitive and undistorted markets, it generates resource allocations that cannot be improved in terms of their welfare implications. In such an environment, government intervention cannot make anyone better off without making someone else worse off. Since, under these conditions, intervention cannot be justified for allocative reasons, it must be intended for purposes of income redistribution. And, indeed, distributive objectives are typically behind trade policies, thereby violating the general rule that distributive objectives can be achieved at lower cost to efficiency by means of taxes and subsidies rather than trade policies.

• The real world, is, of course, far from perfectly competitive and far from free of distortion. When distortions are present, the second-best principle holds that elimination of a single distortion does not necessarily reduce and may even raise inefficiency.

Further, the existence of distortions has long been understood to represent a *prima facie* justification for intervention, namely, to offset or neutralize the distortion. In this context, a distortion is a discrepancy between private and public costs and benefits that generates resource allocations that underproduce some commodities while overproducing others. Typical sources of distortions are imperfect competition and economies of scale, externalities, uncertainties, and government policies themselves.

Externalities, for example, may arise in the context of national security and defense, where markets underproduce a product because private considerations do not—and should not—account for the defense service inherent in a product or activity. Externalities also arise in connection with research and development and with on-the-job training, where a firm may underinvest in research and training because it may not be able to capture the benefits before competitors appropriate the research results and hire away the newly trained worker. In both cases, intervention of the right sort could improve the allocation of resources and hence increase national welfare.

The free trade argument in its ideal form assumes that resources are mobile and that wages and prices are flexible, so that the adjustment process may occur with-

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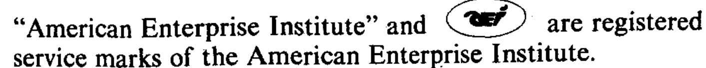
"American Enterprise Institute" and  are registered service marks of the American Enterprise Institute.

out distortions. In the real world, the adjustment process itself may be imperfect due to distortions in, for example, information, housing, and education. In this event, a case exists for "adjustment assistance" that offsets the distortions. (Unlike existing adjustment assistance programs, this approach does not limit adjustment assistance to those displaced by foreign competition. It would provide intervention designed to rid the adjustment process of distortions regardless of the competitive challenge involved and is hence less discriminatory than existing programs.)

"In comparison with the direct approach, which aims squarely at the distortion in production or in consumption, trade policy hits both producers and consumers even though only one side of the market may be subject to failure."

Although free trade can be shown to increase national welfare, gains to the nation may be unevenly distributed among its citizens. The free trade argument assumes that the political process is capable of handling whatever distributional disputes may arise by means of appropriate tax/subsidy policies. Such an assumption implies that citizens can reach a consensus on the required redistribution. The history of trade policy shows, however, that trade intervention may be used to achieve income redistribution that would never be approved by a majority of voters if they had to vote on taxes and subsidies. Trade policy for distributive purposes is surreptitious income redistribution; it is less transparent than subsidies and the taxes that pay for them and is therefore preferred by the interest groups desiring income enhancement. It is easier to put into practice, because it can be couched in chauvinistic rhetoric and because it can be made to appear as placing the major burden on foreigners.

• The foregoing states the general case for intervention: namely, to deal with market failures. But in most instances *trade* policy will not be the most efficacious instrument of intervention. The general principle here is that intervention policies should be as direct as possible and aimed as squarely at the given distortion as possible to minimize undesirable side-effects. Thus the externality should be addressed with domestic tax/subsidy policies rather than with trade restraints. The distortion in the adjustment process should be handled in a similar manner. In comparison with the direct approach, which aims squarely at the distortion in production or in consumption, trade policy hits both producers and consumers even though only one side of the market may be subject to failure. These considerations lead to the conclusion that trade policy is the wrong remedy for market failures in the domestic economy.

• Trade policy may also be the wrong means of addressing nondomestic distortions and interventions. Trade restrictions are sometimes advocated as retaliation for anticompetitive foreign practices (it needs to be borne in mind that not every intervention is anticompetitive). To be successful, retaliation must either lead to a cessation of the targeted practice or offset its undesired consequences. Otherwise retaliation may actually make a bad situation worse, adding costs without bringing benefits. The U.S. experience with trade sanctions has in general not been very successful, and many current proposals of retaliation promise to be as fruitless.

It has been proposed, for example, that the United States reciprocate Japanese practices restricting market access. If an access-denying action succeeds in opening up the Japanese economy and does so without undue delay, the outcome may justify the costs. The costs depend, of course, on the means employed; in the case of a tariff, costs include higher import prices paid, not merely by final consumers, but by American export industries for imported inputs. If the retaliatory policy fails, efforts to improve the competitiveness of Americans selling in Japanese markets will have raised the costs and hence impaired the competitiveness of all U.S. exporters.

Subsidies and credits extended by foreign governments to their exporters have come under attack in the United States. That such measures frequently violate international standards of good conduct (as well as running counter to the *general* interest of the countries imposing them) is not in doubt; only the efficacy of the proposed countermeasures is. Foreign export subsidies increase world productive capacity and hence lower world prices. Retaliation by similar means will not reduce and may increase world capacity even more, hence depressing prices still further. Examples, running from agricultural commodities like wheat to manufactures like steel, abound. In such cases, a country's taxpayers carry the burden of policies the benefits of which, if they exist at all, do not match the costs. (Predatory pricing policies, designed to destroy competitors to pave the way for future monopolistic price setting, are important exceptions requiring different treatment.)

Indeed, in interventions of this type, the cost per job saved often exceeds by wide margins the wages paid to incumbents, thereby reflecting the waste of economic resources and suggesting that outright income transfers would have been more efficient and less costly.

Trade disputes in recent years have arisen over industrial piracy and intellectual property rights. From the innovating country's perspective, the distortion is due to an externality, leading domestic firms to underinvest in R&D because international piracy prevents them from

fully appropriating the returns. There is a legitimate case here for government intervention (or for cooperative intervention by two or more governments), but for intervention of a type that deals directly with the problem. A subsidy where R&D is undersupplied is direct because it achieves the production goal without disturbing consumption decisions. A tariff or an export duty is not direct, and hence is inefficient because it does indeed distort consumption decisions.

Anticompetitive trade practices not only exist around the globe but seem to have increased with the emergence of the "new" protectionism and its reliance on quantitative and other trade barriers. Such practices create difficulties for American producers and are inimical as well to the interests of significant groups in the imposing countries. The foregoing discussion, however, suggests the paucity of unilateral policy options for eliminating or neutralizing the undesired effects of such practices. Retaliation, trade sanctions, and more managed trade in general have been advocated; but all promise to do more harm than good to U.S. interests.

A more promising approach may be along multilateral lines through international bodies like the General Agreement on Tariffs and Trade (GATT). The recent record, however, is not encouraging, with large segments of international trade entirely beyond the reach of GATT regulations, with dispute settlement procedures ineffective and in disarray, and with the shape and prospects of future negotiations hostage to the implicit veto of powerful GATT members. These obstacles notwithstanding, the multilateral approach offers the best hope precisely because the unilateral options are so limited.

The multilateral negotiating process is seriously complicated by the sheer number of issues on the global agenda. Those issues include intellectual property rights; trade in agriculture, manufacturing, and services; and practices ranging from tariffs to quantitative restrictions and administrative and customs procedures. Of two main negotiating strategies—one focusing on general principles like most-favored nation and nondiscrimination, the other favoring item-specific horse trading—the former appears more promising and manageable, but the latter is the chosen approach of governments. The ultimate outcome is far from certain.

Conclusion

Trade has become a major issue on the U.S. policy agenda and for good reasons. Large and growing trade deficits and a severely distressed tradables sector have forced the issue. Despite the jingoistic rhetoric of politicians, however, the major part of the problem is homemade and will not be put right until America returns to a more balanced mix of macroeconomic policies.

Beyond the macroeconomic influences, changes in the underlying international division of labor are challenging some in the tradables-producing sector. America's competitive strength continues to reside in so-called product-cycle goods; but to safeguard that position, the United States must improve the quality of its capital and labor and the efficiency of its production processes.

Finally, action is required to stem the rising tide of anticompetitive, beggar-thy-neighbor trade practices. The room for unilateral action, however, is limited because such action often does more damage than good, leaving multilateral approaches as the more promising. Unfortunately, the obstacles to successful multilateral resolution of these trade disputes are many, especially under the item-specific negotiating approach favored by most countries.

Two Statements on Foreign Trade

Joint Statement on Trade Policy*

Robert Crandall, *The Brookings Institution*
Edward Hudgins, *The Heritage Foundation*
William Niskanen, *The CATO Institute*
Herbert Stein, *The American Enterprise Institute*

Today, as individuals associated with leading policy research organizations in Washington, we are joining together to express our concern over the growing calls for trade protectionism. We support the efforts of the President and all those within Congress who seek to maintain and expand international trade. We share a common belief in the value of free and open trading arrangements among the nations of the world and oppose the "solutions" of the protectionists.

Support for free trade is almost universal among economists and others who have studied the issue. Yet, special interest groups, finding themselves losing out in the marketplace, have been all too successful in their lobbying efforts, gaining special "protection" and thus limiting consumer choice. Such protectionist policies impose major costs on American consumers and unfairly restrict their ability to purchase those products they prefer. Rather than expanding employment, trade restrictions save some jobs at the expense of others. Further, closed markets generally weaken the most dynamic, productive industries, thereby weakening the

*The following statement represents the views of its signatories and not necessarily those of the institutions with which they are associated.