Rising Protectionism and U.S. International Trade Policy

By Keith E. Maskus

Protectionist sentiment has become popular again. Calls for increased government intervention in international trade are now common, ranging from pleas for isolated policies to cope with the problems of specific groups to proposals for comprehensive programs to manage trade.

Formulating international trade policy is difficult in such an atmosphere. Free trade yields substantial benefits to most of the economy through lower prices and improved productivity. Yet specific groups would gain if the government gave them some protection from import competition. Policymakers must consider these varied interests in determining the best course for U.S. trade policy.

This article argues that enacting more protectionist policies would substantially reduce both the welfare of U.S. citizens and the efficiency of the world economy. The first section puts the current protectionist movement in perspective by reviewing the reasons for its resurgence. The second section discusses the costliness of protectionist policies and argues that these policies are inappropriate for dealing with trade problems. The third section then critically examines some current arguments for protectionism. The fourth section suggests that short-term policy be aimed at reducing the federal budget deficit to help restore the international value of the dollar to sustainable levels and that long-term policy continue to be aimed at liberalizing world trade and providing for effective economic adjustment.

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Reasons for increased protectionism

Demands for relief from imports have been on the rise for several years. Several factors have contributed to the increase in protectionist sentiment. Among the most important are the increased number of workers and firms affected by international trade, recent macroeconomic performance, and the belief that other countries are engaging in unfair trade practices.

Rising dependence on trade

One reason for the concern over import competition is that the United States is becoming more dependent on world trade. From 1960 to 1983, the ratio of imports to GNP rose from 4.6 percent to 10.4 percent while the share of exports in GNP increased from 5.7 percent to 10.2 percent.[1] These trends were part of a rising global economic interdependence as virtually all countries are engaging more intensively in trade.

One implication of this growing international orientation is the increase in the proportion of the labor force that depends on international trade for employment and income. Specifically, the proportion of manufacturing employment facing import competition rose from 8.4 percent in 1970 to 14.7 percent in 1980, and the proportion of manufacturing employment related directly and indirectly to exports rose from 8.1 percent to 14.5 percent. Other productive factors also have an increasing stake in foreign trade. The import-related share of manufacturing value added increased from 8.3 percent to 14.4 percent, and the export-related share increased from 8.5 percent to 15.1 percent.[2]

Moreover, increasing trade has had a disproportionate impact on certain sectors of the economy. The effects have been concentrated in the tradable goods sectors—industries that export a sizable portion of output, industries that compete with imports, and their suppliers. Thus, many of the recent calls for protection can be traced directly to the difficulties experienced by several major industries.

These difficulties stem largely from long-run losses in international competitiveness due to shifts in comparative advantage. While such shifts benefit the general economy by allocating resources to more productive uses, they are difficult and costly in the short run. Protectionist pressures arise to forestall these costs.

The importance of changes in comparative advantage can be seen by examining changes in sectoral trade balances over time. Table 1 shows the difference between U.S. exports and imports for selected sectors in 1958 and 1980. Even though adjusted for inflation, both exports and imports generally increased over the period in a way that increased the magnitudes of sectoral trade balances. More important, though, the changing trade balances demonstrate that increasing dependence on trade has had uneven impacts across sectors.

Some sectors have benefited substantially from increased international trade. Those sectors in which the United States has a clear comparative advantage have seen exports rise faster than imports. Thus, the United States has attained a marked advantage in agricultural trade, due to the abundance of U.S. farmland and the technology used in U.S. agriculture. The country's growing advantages in chemicals, industrial machinery, and scientific instruments are due to the highly trained workers and innovative technologies used in these industries. The United States is also quite competitive at providing international services, as is clear from the growing surpluses on this account, which includes not only net receipts for services but also income on past foreign investments.

Industries that have lost comparative advantage have suffered from increasing trade. Growing disadvantages have occurred in the following industries: footwear, apparel and

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[1] Department of Commerce, *Survey of Current Business*, various issues.

[2] Robert Z. Lawrence, "Is Trade Deindustrializing America? A Medium-Term Perspective," *Brookings Papers on Economic Activity*, 1983:1, pp. 129-61. While these figures relate to manufacturing, it is clear that the trade orientations of agriculture, primary commodities, and services also have increased.

TABLE 1
U.S. real trade balances by selected sectors, 1958 and 1980

Sector	Exports minus imports (millions of 1967 dollars) 1958	1980
Services and Investment Income	351	26,081
Agriculture	1,808	11,230
Industrial Machinery	2,298	4,623
Chemicals	311	2,928
Scientific Instruments	204	1,157
Electronic Goods	346	-1,527
Basic Iron and Steel	351	-1,721
Footwear, Apparel, and Textiles	-171	-4,337
Motor Vehicles	728	-6,649

SOURCES: Developed from various issues of *Survey of Current Business, U.S. Commodity Exports and Imports as Related to Output*, Department of Commerce, and *Wholesale Prices and Price Indexes*, Bureau of Labor Statistics.

textiles, basic iron and steel, electronic goods, and motor vehicles. The growing trade deficits in these sectors largely reflect shifts in comparative advantage to other countries. Production techniques in these industries have become fairly standardized, with the result that these goods can be produced by relatively unskilled workers. Over time, the higher productivity of U.S. workers producing these goods has disappeared and high domestic wages have made U.S. costs uncompetitive. Capital, therefore, has moved to countries with comparatively low wages. As a result, imports now claim a significant part of U.S. markets for these products.

The losses in comparative advantage in these industries have prompted protectionist initiatives on their behalf. Government has acted to protect workers and firms in several specific products within these industries. The government's receptivity to such action reflects the historical importance of these industries in domestic employment and the disproportionate public attention they command. Because long-run import competition will continue to change the structure of U.S. industry, additional pressures for trade restraints are inevitable.

Macroeconomic factors

Another reason for resurgent protectionism is the effect economic downturns have on employment. Recessions encourage calls to "save American jobs" by restricting imports. The belief is that higher trade barriers will promote domestic employment by substituting domestic production for imports without restricting export-related employment through foreign retaliation. If all countries tried to export their unemployment, of course, the result would be stagnation in world trade and even higher unemployment.

Much of the recent protectionist pressure is undoubtedly related to the high unemployment in 1981 and 1982 and to subsequent macro-

economic events. Due in part to U.S. policymakers' efforts to reduce inflation, significant slack developed in the economy in 1981. Widespread unemployment created protectionist sentiment across an array of industries and intensified pressures for import relief in steel and automobiles.

Moreover, the recession was accompanied by rapid appreciation of the dollar, which induced more stagnation in the tradable goods sectors than in the general economy and generated further protectionism. Success in reducing both actual and expected inflation in the United States attracted significant increases in foreign purchases of dollar-denominated assets, forcing up the dollar. The counterpart of these rising net capital inflows was growing trade deficits. The real trade-weighted exchange value of the dollar rose 32 percent from the beginning of 1981 to the end of the recession in late 1982, making imports cheaper and U.S. exports more expensive.

The recent recovery has not moderated protectionist pressures because the dollar has continued to appreciate. Early this year, the dollar was up another 6.5 percent in real terms over its previous high in November 1982. This added strength, due primarily to relatively high real interest rates in the United States, further eroded U.S. price and labor cost competitiveness. As a result, tradable goods sectors have not shared equally in the recovery.[3] Despite the buoyant general economy, several import-sensitive industries are seeking trade relief.

Two other macroeconomic influences also have helped shape recent trade performance. One is that the recovery began earlier in the United States than in the other industrial countries and has been stronger, causing a relative increase in U.S. import demand. The other is that high interest rates made debt financing more difficult for some developing countries, forcing them to reduce imports. Because these countries, particularly in Latin America, have been an important market for U.S. exports, the problem presents another instance of trade restricted by high interest rates.[4]

If current trends continue, the combination of these macroeconomic factors points to further increases in the trade deficit. Since large trade deficits are often seen as indicating stress in tradable goods sectors, it becomes more likely that long-term trade policy may be used to offset short-term macroeconomic effects.

Unfair trade

Still another reason for protectionist sentiment is the view that other countries are not fair in promoting their exports and restricting their imports. Those holding this view advocate explicit protectionist threats to force other countries to remove or forestall their trade restrictions.[5] Since such threats are against specific countries or on specific commodities, they represent a retreat from the tradition of multilateral trade relations. For many, the ideal of free trade has been replaced by the

[3] One analyst reports that U.S. price competitiveness deteriorated 27 percent between 1980 and the third quarter of 1983, while labor cost competitiveness declined 36 percent. Shafiqul Islam, "Currency Misalignments: The Case of the Dollar and the Yen," *Quarterly Review*, Federal Reserve Bank of New York, Winter 1983-84, pp. 40-60.

[4] The U.S. trade balance with Latin America shifted from a $7.5 billion surplus in 1981 to an estimated $13.9 billion deficit in 1983. *Economic Report of the President*, Washington, February 1984, p. 49.

[5] Some go beyond this to suggest using trade restrictions as a tool for achieving political or military objectives. Obvious examples include the embargo on Soviet wheat purchases and restrictions on exports of sensitive technologies to certain countries. Whatever their political merits, such actions are clearly distortionary in an economic sense and may heighten fears about the reliability of the United States as a supplier.

idea of "fair trade," which would make the government responsible for forcing other countries to provide a "level playing field."

Evaluating protectionism

The factors discussed above have rekindled interest in protectionism. As this section demonstrates, however, trade restrictions are harmful to the general economy.

Benefits of free trade

Free trade is generally best for the economy as a whole. The benefits of free trade are the benefits of competition. Whether from domestic or foreign sources, competition forces firms to follow lowest cost, highest productivity practices to satisfy consumers at the lowest prices. Competition also allows the price mechanism to allocate resources by drawing labor, capital, and other resources into their most productive uses. By extension, free trade induces every country to export the goods it is comparatively most suited to produce and import the goods it is least suited to produce. Society as a whole gains because free trade increases both the quantity and quality of the goods available for consumption.

Not only is economic welfare greatest under free trade, but free trade is also fundamentally a growth policy. The need to compete at world prices dictates the need to be efficient and innovative. In contrast, by shielding domestic producers from foreign competition, trade barriers block effective resource allocation, restrict choices, make products more expensive, and reduce economic growth. Society is correspondingly worse off.

Costs to individual groups

If the situation were as simple as this description, there would be little dispute with the desirability of free trade. Unfortunately, important problems of income distribution arise from efforts to promote free (or freer) trade.

Workers in industries facing stiffer import competition due to freer trade find their living standards lowered, both through higher unemployment and lower real wages.[6] Although consumers and workers in other industries become better off, workers in these industries suffer a reduction in living standards.

That there are both losers and gainers from a reduction (or increase) in trade barriers poses a problem. Proponents of protectionist policies are not impressed by the fact that freer trade generates benefits to consumers greater than costs to some producers and workers. They do not accept an ethical standard in which the benefits of one group are weighted equally with the costs of another in a social cost-benefit calculation. Thus, for example, advocates of textile quotas discount the interests of exporters and textile consumers. From the standpoint of equity, it is impossible to refute such a position. There is no "correct" standard of equity.

The difficulty with this argument is that while import restrictions may, for a while, protect certain industries from making painful economic adjustments, the delay comes at high cost to society. It would be cheaper to secure the benefits of free trade and promote rapid adjustment of displaced workers through manpower policies. This means that free trade generates enough extra output that the gainers

[6] Actually, those displaced skilled workers that are well suited for producing in the export industries, which would expand under free trade, would suffer only short-run costs and would be permanently better off after absorption into the expanding sectors. Relatively unskilled workers would suffer a permanent decline in real income, however, unless they obtain training for higher paying jobs.

could compensate the losers enough through income grants so that no group suffered a loss of income. In other words, trade barriers are so costly that dismantling them and coupling their removal with adjustment grants would raise incomes in all groups.

Weighing the benefits and costs

The costs to society of trade barriers outweigh the benefits to individual groups because restricting free trade causes substantial economic inefficiency. The costs are the higher prices domestic consumers must pay for goods shielded from foreign competition. These higher prices are, in effect, hidden taxes. Part of the hidden tax goes to domestic workers and firms that produce the protected goods in the form of higher profits, wages, and employment. Some of the tax, however, is dissipated in lower economic efficiency, which benefits no one. Because only a portion of the cost to consumers benefits workers and producers, the costs of trade barriers are bound to exceed their benefits.

Empirical estimates show that recent U.S. trade barriers have indeed been inefficient means of increasing the incomes of workers in tradable goods sectors. As shown in Table 2, the estimated ratio of costs to benefits ranges from 3.5 for barriers on carbon steel to 10.1 for those on citizens' band transceivers.[7] These estimates show that eliminating the trade barriers and compensating the workers in the affected industries for their lost income would be cheaper for the economy. For example, both consumers and workers would be better off if import restrictions on footwear were replaced by an explicit tax on footwear purchases, the proceeds of which were used to compensate workers who lost their jobs as a result of increased footwear imports. Assume, for instance, that the explicit tax is set high enough to pay all displaced workers $10,000 per year. The workers would benefit from the increase in income from $8,340 to $10,000; consumers would benefit because lower footwear prices would reduce their costs per job from $77,714 to $10,000. Thus, such an explicit tax would be lower than the implicit tax associated with trade barriers. Improved economic efficiency from elimination of trade barriers can, therefore, benefit everyone if the resulting gains are distributed between consumers and workers.[8]

It might be argued that increased income is not the only relevant consideration, though. Jobs themselves are important beyond the income they furnish workers. Even on this score, however, trade barriers are ineffective

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[7] No estimates have been made of the benefits of avoiding idle capacity in these industries. In Table 2, the benefits to workers are clearly overstated since workers displaced by free trade eventually find jobs. The true benefit per worker would be the difference between his protected earnings and his new earnings, plus net unemployment costs. Costs, on the other hand, are understated. A tariff or quota raises the domestic price of imported goods over their world price, which, in turn, pushes up the prices of competing domestic goods. Consumer costs, therefore, include income transfers from consumers first to producers and workers through higher prices and then to government through tariff revenues. (If the restriction is not a tariff, the revenues are likely to go to groups other than the government, such as foreign exporters in a voluntary export restraint program.) They also incorporate so-called "deadweight efficiency losses," which reflect national wealth that is sacrificed for protection. (Some economists focus strictly on the deadweight losses in computing the costs of protection, since the other components are simply transfers among groups within the economy. These transfers are, however, generated artificially by the trade restrictions and consumers should be made aware of the implicit tax they represent, so this article considers total consumer costs. In any event, deadweight losses per job protected are still typically larger than average earnings.) These static welfare costs, however, do not include the dynamic costs that build up over time through losses in productivity, innovation, and economic growth. If protection lasts long, as it usually does, these dynamic costs exceed the typical cost estimates.

[8] By one estimate, the total static costs of protectionism to U.S. consumers in 1980 were $58.5 billion, or $1,020 per family of four. M. Weidenbaum and M. Munger, "Protection at Any Price?" *Regulation*, July/August 1983, pp. 14-18.

TABLE 2
Estimated annual costs to consumers per job protected by various trade barriers

Product and Restriction	Jobs Protected	Average Earnings	Cost Per Job	Ratio of Cost to Earnings
Citizens' Band Transceivers (tariffs, 1978-81)	587	$ 8,500	$85,539	10.1
Apparel (tariffs, 1977-81)	116,188	6,669	45,549	6.8
Footwear* (tariffs and quotas, 1977)	21,000	8,340	77,714	9.3
Carbon Steel* (tariffs and quotas, 1977)	20,000	24,329	85,272	3.5
Autos* (proposed local content law, 1986-91)	58,000	23,566	85,400	3.6

*In 1980 dollars.

SOURCES: Figures for transceivers and apparel adapted from M. E. Markre and D. G. Tarr, *Effects of Restrictions on United States Imports: Five Case Studies and Theory*, Federal Trade Commission, Washington, 1980. Figures for footwear and carbon steel from M. Weidenbaum and M. Munger, "Protection at Any Price?" *Regulation*, July/August 1983, p. 16, and R. W. Crandall, "Federal Government Initiatives to Reduce the Price Level," *Brookings Papers on Economic Activity*, 1978:2, p. 431. Figure for jobs protected in autos adapted from "Impact of Local Content Legislation on U.S. and World Economies," Wharton Econometric Forecasting Associates, July 1983. Compensation and consumer costs taken from Weidenbaum and Munger, "Protection at Any Price?" *Regulation*, July/August 1983. The years listed refer to periods over which the estimations were made. In most cases, some form of restriction continues.

because they typically eliminate more jobs than they save. One study estimates that by 1991 the proposed domestic content law for automobiles would eliminate 88,000 U.S. jobs in the importing, servicing, and selling of imported cars—with another 335,000 jobs lost to the effects of inflation, restricted growth, and reduced exports. Accounting for the 58,000 jobs protected, the content law would eliminate a net 365,000 jobs.[9]

One import restriction of current interest is the voluntary export restraint (VER) agreement on Japanese cars. This agreement has been quite costly in terms of its price effects. A recent study estimates that VER's raised the average price of imported cars by $851 (and of domestic cars by $324) over 1981-82, with even larger price increases forecast for 1983.[10]

[9] "Impact of Local Content Legislation on U.S. and World Economies," Wharton Econometric Forecasting Associates, July 1983.

[10] No estimates are available of the jobs saved by the program. "Special Analysis: The Japanese Quota," Wharton Econometric Forecasting Associates, January 1983.

These price hikes amount to significant income transfers from car buyers to producers here and in Japan. Moreover, since VER's restrain the quantity of cars that can enter the United States, Japanese automakers have shifted the composition of their exports to more expensive models, making their cheaper cars more scarce.

With all the disadvantages of trade intervention, it is sometimes difficult to understand why it is used. Those benefiting from intervention, however, argue that their livelihoods depend on import relief. Consumers do not strongly resist the argument in part because, being diffuse, they are not affected much by conditions in a particular industry. Moreover, the costs of protectionism are hidden because tariffs and quotas are embedded in the prices of goods. Policymakers, therefore, face few political restraints in responding to demands for protection.

Some current arguments for protectionism

Beyond the basic desire to avoid painful adjustments to freer trade, several more subtle protectionist arguments have recently been advanced. These arguments, which are examined below, are generally ill founded.

Noneconomic objectives

The government may wish to support a high level of domestic production in particular industries for noneconomic reasons. Because the steel industry, for example, is considered important to national security, it is argued that domestic steel production above what would result from free trade is in the national interest. Even if true, this does not make costly tariffs or quotas on steel imports valid. A better policy would be a direct subsidy to the U.S. steel industry. A direct subsidy could be devised that would induce the same level of production as would occur under import protection. This would have the advantage of not simultaneously raising steel prices to automakers and other steel users.

This explicit subsidy—financed by an explicit tax—would, therefore, be smaller than the implicit subsidy in a tariff or quota. If a subsidy would not be acceptable to taxpayers, there is no evidence that the public prefers to absorb the higher implicit costs associated with import protection. In other cases where import protection has been suggested as a way of promoting noneconomic objectives or offsetting market failures, a tax and subsidy scheme is nearly always better than a tariff or quota.[11]

Overvalued dollar

Many tradable goods sectors claim they deserve import relief or help in exporting because they have been unfairly penalized by the high value of the dollar. Their complaint is that the dollar is "overvalued" because of an inappropriate domestic fiscal-monetary policy mix or a conscious effort by foreign governments to undervalue their currencies, most notably the yen. As a result, those in tradable goods sectors argue they have unfairly borne the brunt of government policies. They advocate trade actions to offset their loss of competitiveness.

Most analysts agree that the dollar has appreciated well above the long-run equilib-

[11] Proponents of tariff protection fear that voters would be unwilling to accept higher taxes (or budget deficits) in order to provide direct subsidies. But if voters will not finance a relatively low-cost but explicit means of achieving a goal, it is wrong to claim they are willing to finance it at higher cost through hidden means. That consumers tolerate trade intervention means that its effects are less well understood than the effects of direct taxes and subsidies.

rium level suggested by underlying exchange market fundamentals.[12] In large part, the strength of the dollar has resulted from higher real interest rates in the United States, which have attracted huge capital inflows from abroad. The consensus among economists is that high real interest rates reflect success in bringing down inflation and upward pressure on nominal rates resulting from large structural federal budget deficits.[13]

One unfortunate result of the rising dollar is that tradable goods sectors have been hurt. The stronger dollar has reduced the prices of U.S. imports and raised the prices of U.S. exports. As a result, both import-competing sectors and export sectors have suffered considerably. For example, the volume of U.S. merchandise exports fell more than 15 percent from the fourth quarter of 1980 to the fourth quarter of 1983. Much of this decline reflected losses in competitiveness brought on by appreciation of the dollar.[14] The reduction in exports was spread across a range of goods, including agricultural products. Unfortunately, the longer exports remain depressed the more difficult it becomes to regain the markets to which the exports were shipped previously.

Using protectionist trade policies, however, to address the problems resulting from dollar appreciation would be a mistake. Rather than attacking the problem directly, import restrictions and export subsidies would cause further distortions in the economy. They would only redistribute production and income from other sectors of the economy and impede future growth. The redistribution would come about through price distortions and through a decline in foreign capital inflow, which would remove some of the savings available to finance budget deficits. The resulting increase in interest rates would substitute crowding out of investment and other domestic spending for the implicit crowding out of tradable goods sectors that has already occurred.[15] For these reasons, use of long-term trade policy to remedy short-run macroeconomic problems makes little sense.

The appropriate policy action is, rather, to reduce structural budget deficits, which would allow both declining real interest rates and a depreciating dollar. "Measures to reduce the budget deficit would...lower the real value of the dollar and thus allow the exporting and import-competing sectors to share in the recovery as well."[16] All other policy options force a choice between rising interest rates and a declining dollar, which amounts to choosing between relative stagnation in the domestic versus the tradable goods sectors. The worst choice would be trade restraints.

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[12] For a discussion of market fundamentals and why exchange rates may diverge from their suggested values due to short-run market conditions, see Craig S. Hakkio, "Exchange Rate Volatility and Federal Reserve Policy," *Economic Review*, Federal Reserve Bank of Kansas City, this issue.

[13] See, for example, *Economic Report of the President*, pp. 51-62. A few economists question the link between budget deficits, interest rates, and the dollar. See Paul Craig Roberts, "Economic Watch," *Business Week*, May 21, 1984, p. 22.

[14] By one estimate, more than half of the deterioration in the U.S. current account balance was caused by dollar appreciation. "Our Internal and External Deficits and the Relationship Between Them," remarks by Lyle E. Gramley, Member of the Board of Governors of the Federal Reserve System, June 14, 1984. It should be noted that there is no evidence the Japanese have intervened to depreciate the yen relative to the dollar. The yen has appreciated notably against the German mark and the French franc. Thus, dollar appreciation against the yen reflects U.S. circumstances, not active Japanese yen sales. See Shafiqul Islam.

[15] Similar comments apply to efforts to use international capital controls to reduce capital inflows and depreciate the dollar. These would impose a distortion on the economy that would penalize domestic investment without attacking the fundamental problem of budget deficits.

[16] *Economic Report of the President*, p. 62.

Deindustrialization

Another current argument for protectionism is based on fear that manufacturing is on the decline in the United States—that the country is becoming "deindustrialized." Because manufactured imports have displaced a portion of domestic production in certain industries, some argue that further loss of industrial capacity could be prevented by reducing imports.

Figures show, however, that the United States is not deindustrializing. Real manufacturing output doubled from 1960 to 1980 and increased from 23.3 percent of total production to 23.8 percent. Employment and capital stock in manufacturing also rose. As a proportion of the total stock, capital in manufacturing declined only marginally. Manufacturing employment fell from 31.0 percent of the total in 1960 to 22.4 percent in 1980, but this drop was well within the bounds of typical declines due to productivity growth. Thus, rising imports over this period simply did not reduce the size or strength of aggregate U.S. manufacturing.

There have been important shifts in the composition of manufacturing, however, as Table 1 implies. Production has shifted away from heavily capital-intensive industries using relatively unskilled labor, such as basic iron and steel, toward industries using advanced technology, such as scientific instruments. Between 1960 and 1980, the "high-tech" industries increased their share of manufacturing value added by 41 percent and their share of manufacturing employment by 22 percent.[17] They also accounted for a significantly higher share of manufacturing exports. These trends were to be expected, because high-tech industries make heavy use of the well educated U.S. workers. Viewed in this way, the increase in trade over the past two decades has actually been a positive force for U.S. manufacturing by providing export markets for highly productive sectors.

Fears about deindustrialization rest on a misconception of current U.S. industry. The popular notion is apparently that manufacturing is limited to huge plants where tremendous amounts of physical capital are combined with unskilled labor to produce such basic items as autos and steel. Such plants in the United States, however, can no longer compete effectively on an international basis. Efforts to prevent their decline through intervention in trade would be costly to the economy as a whole. Indeed, to prevent scale reductions in basic sectors through trade restrictions could contribute to aggregate deindustrialization in the long run by limiting growth of more efficient and, therefore, more dynamic sectors.

Bilateral reciprocity to ensure fair trade

Some argue that protectionism is warranted because international trade is currently conducted under unfair rules. Amid allegations that other countries interfere to capture or preserve markets they would lose under free trade, some policymakers advocate a tough negotiating posture to place trading conditions on a more equal footing. This primary source of current protectionism is reflected in calls for bilateral reciprocity.

Bilateral reciprocity means that the markets of a foreign country should be as open to U.S. products as U.S. markets are open to the products of that country. If a comparable degree of access is not granted through lower import barriers in a given country, the United States would enforce comparability by raising its own import barriers. This type of reciprocity

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[17] *Economic Report of the President*, p. 89.

would be sought either on a sectoral basis or on an aggregate trade basis, focusing on countries running large trade surpluses with the United States.

Much of the impetus for reciprocity stems from frustration over the U.S. trade deficit with Japan. Some observers accept this deficit as evidence that the Japanese market is closed to U.S. products. There is little evidence that this is true, however, except for some agricultural products and for a few other goods. Indeed, several studies have found that, on average, Japanese markets are at least as open to imports as markets in the United States and Western Europe.[18] These studies have found that the Japanese trade surplus results from basic economic factors, such as dollar appreciation and relative cost advantages in many Japanese manufacturing sectors.

In any case, trade policy based on bilateral trade balances makes little sense. The United States typically runs a large surplus with Western Europe, but this country would strongly object to European accusations that the U.S. market is unduly closed based on this evidence. Bilateral trade balances imply very little about relative protectionism. Instead, they reflect fundamental international economic relationships. Trying to achieve balanced trade with each trading partner would sacrifice the considerable welfare gains from liberal multilateral exchange in favor of the much smaller benefits of highly restricted trade.

Reciprocity is more commonly sought in the trade of a specific range of products. For example, much of the recently proposed legislation seeks reciprocal Japanese treatment of U.S. telecommunications equipment and other high-tech goods. The basis for this legislation is the perception that the Japanese telecommunications industry unfairly discriminates in its purchasing practices and that official Japanese subsidies to research and development give Japanese firms a competitive edge. In retaliation, the United States would close its markets to similar Japanese products and perhaps also to other products in which Japan is competitive.

On the surface such sectoral reciprocity seems reasonable. It is dismaying when U.S. industries face roadblocks in potential export markets and also experience import competition from firms in the same countries. Credible threats of reciprocity may cause foreign countries to reduce their barriers rather than risk losing important export markets.[19]

Nevertheless, there are significant problems with reciprocity. First, the uncertain benefits to exporters from reciprocity threats must be weighed against the high consumer costs resulting from any trade barriers enacted. Moreover, since the reciprocation is limited to a target country, say, Japan, production for export to the United States may be diverted to higher cost third countries, such as Taiwan. If so, imports would cost more, with little or no benefit to U.S. exporters.

Second, reciprocity is not likely to work. To be credible, the threat of reciprocity must be carried out automatically when the target country does not comply. The country being threatened has three choices. It can capitulate, not respond, or counterretaliate. Only in the first case can the protection be avoided. The

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[18] See, for example, Gary R. Saxonhouse, "The Micro- and Macroeconomics of Foreign Sales to Japan," in William R. Cline, ed., *Trade Policy in the 1980s*, Institute for International Economics, Washington, pp. 259-304.

[19] Japan announced several significant unilateral trade liberalization measures in 1982 and 1983, due mainly to the Nakasone administration's sensitivity to criticism of Japanese practices. Since reciprocity is not yet officially part of U.S. trade policy, it is not clear what role it played in these decisions.

other cases, which are more likely than the first because of political pressures to respond to the unilateral U.S. warning, force the United States to carry out its threat. The result would be reductions in the welfare of both the United States and the target country and greater chances for further escalation of trade barriers. Japan, for example, has considerable latitude for retaliation since it is the largest individual foreign market for U.S. agricultural products.

Third, reciprocity invites third-country participation. If reciprocity directed at Japan diverted U.S. agricultural exports to European countries, for example, those countries would be certain to retaliate with higher import barriers. More fundamentally, passage of U.S. reciprocity legislation would signal this country's abandonment of multilateral trade relations in favor of aggressive unilateral actions. Other countries would undoubtedly follow suit.

Industrial policy

Protectionist arguments form a central component of calls for more pervasive government intervention in the economy. Such intervention is frequently termed industrial policy. Industrial policy, if targeted at specific industries, would provide incentives for selected industries to grow or contract, depending on the overall policy objectives.

Industrial policy is most visible in the proliferation of government subsidies affecting trade. For example, Japanese support of research and development is commonly thought to have helped Japanese high-tech companies compete with U.S. and European firms. Furthermore, the European Community subsidizes agricultural exports to dispose of surplus production. These exports have displaced U.S. farm products in several countries, causing U.S. policymakers to threaten retaliation. Such actions have clearly complicated international economic relations by helping unravel the international integration and cooperation that have developed over the last few decades.[20]

Considerations of unilateral industrial policy have spurred an increasing tendency for countries to impose trade restrictions that lie outside the guidelines of the General Agreement on Tariffs and Trade (GATT). The fundamental principle of postwar trade under GATT has been the equal treatment of all countries under the Most Favored Nation (MFN) provision. For example, U.S. tariff concessions to Japan would automatically be extended to all other MFN countries. In contrast to the principle of equal treatment of all countries—a principle that has been a major stimulus to world trade—current trade policies tend to target specific countries and specific commodities. Such targeting, moreover, is concentrated in nontariff barriers rather than tariffs because tariff changes require MFN action. The VER's on Japanese autos and the quotas on European steel are cases in point. Nontariff barriers tend to be more restrictive over time than tariffs because they impose limits on the quantity of trade. Because both the frequency and restrictiveness of trade distortions are rising, the consequent welfare costs will be correspondingly greater.

Recommended policy approaches

The rising pressures for protectionist policies pose difficult problems. The United States must decide where it wants to be on a spectrum from complete passivity toward world

[20] No country can be overly accusatory. Every nation has policies that distort trade. Other governments are quick to note that the traditional U.S. policy of subsidizing higher education has "unfairly" promoted U.S. technology-based advantages.

trade at one extreme to total management of foreign trade and investment at the other. Passivity is different from free trade. It means keeping all U.S. markets open but allowing foreign distortionary actions. A policy of open markets regardless of foreign actions does have advantages. For example, a foreign subsidy that drives down the price of a good shipped here amounts to an income transfer from foreign taxpayers to U.S. consumers. But support for passivity can hardly be expected, since it allows foreign governments to use trade policy with impunity, often to the detriment of U.S. interests. Totally managed trade, on the other hand, is often simply a euphemism for highly restricted trade, the costs of which are high.

Rather than either of these extremes, the aim should be a realistic policy that allows for adjustments to changing international conditions, but does not retreat too much from the goal of freer trade. A balance must be struck between the domestic and foreign interests that influence trade policy. Some general suggestions are offered here for basic principles that could guide the formulation of specific policies.

The most important step to be taken in the short run is to relieve protectionist pressures by reducing budget deficits. This is the only policy that allows both depreciation of the dollar and declines in real interest rates. Reduction of deficits would allow a more balanced recovery, including tradable as well as nontradable sectors of the economy, and would give export-oriented sectors an opportunity to begin regaining foreign markets. Lower interest rates and a depreciated dollar would also ease the debt burdens of several developing countries, enabling them again to become large and growing markets for U.S. exports.

Over the longer term, the government should resist costly protectionist policies. The United States, therefore, needs to pursue ongoing negotiations with its trading partners to ease tensions that could further restrict trade. There are several critical components of such negotiations. Because frequent multilateral negotiations are difficult, more limited bilateral and trilateral talks could be pursued, as long as they do not unduly controvert the MFN principle. Discussions focusing on why countries impose trade-distorting policies would allow other countries to determine how to respond. In particular, official distinction could be made between policies that raise potential world real income, such as temporary subsidies to facilitate adjustment, and policies that worsen resource allocation for nationalistic purposes. Discussions could also determine acceptable responses by countries that feel they have been unfairly harmed by the trade policies of foreign governments. Ideally, such responses would be temporary and well publicized.[21] Most important, the trend toward adoption of quantitative trade restrictions outside the GATT mechanism should be discouraged. To the extent that current GATT procedures are not adequate, a new agreement should be negotiated to establish guidelines for future trade policy.

If negotiations succeed in keeping markets substantially open to international trade, ways need to be found to ease domestic adjustments to continuing displacements from import competition. Such adjustments in an economy are desirable.[22] Effective reallocation of resources

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[21] One suggestion is to allow countries to respond with tariffs limited to three to five years, with the severity of the tariffs declining over time. Robert Baldwin and T. Scott Thompson, "Responding to Trade-Distorting Policies of Other Countries," *American Economic Review*, May 1984, pp. 271-76.

[22] Despite existing protection, the U.S. steel industry has achieved notable successes in transforming itself into a smaller, more cost-efficient industry specializing in high-value-added products with significant high-technology content.

is crucial to growth in income and employment. Government may, therefore, have a legitimate role in easing economic adjustments to dislocations resulting from changes in trade patterns. Government programs can be justified on the grounds of both equity and efficiency.

From the standpoint of equity, policies can be devised to provide temporary support to workers who lose their jobs because of import competition. Equity considerations come into play because these workers tend to be members of disadvantaged groups; they are for the most part less educated, older, and less well paid than the average U.S. worker. A disproportionate number are blacks or women. Because of these demographic factors, displaced workers may have difficulty in finding other jobs. As a result, social goals regarding equitable income distribution could be promoted by manpower policies to help workers who suffer from import competition.

Government policies to facilitate adjustment can also be justified as a means of promoting economic efficiency. Labor and capital markets are imperfect. For a variety of institutional reasons, workers laid off from their jobs are often unwilling to take employment paying less than they had been making. The downward rigidity of wages is itself the ultimate cause of extended unemployment, not foreign competition.[23] In such cases, it may be cheaper for the economy to provide temporary retraining and relocation subsidies that allow displaced workers to move into new jobs than to accept the costs of substantial unemployment. There also could be benefits to promoting capital mobility by subsidizing reductions in uneconomic capacity, as the English and French claim to be doing in their inefficient steel industries.

The United States has extensive experience with only one such adjustment policy, the Trade Adjustment Assistance (TAA) Program. Adopted in 1962, TAA pays temporary income supplements to workers whose job losses have been certified to be substantially related to reductions in import barriers. Foremost among the objectives of the program was to facilitate adjustment in the economy.[24]

TAA has generally not been effective in promoting adjustment, however. This failure has been due to the benefits not being tied closely to adjustment activities. Payments typically have been cash grants to supplement unemployment compensation without providing for retraining and relocation. Rather than complementing pressures to adjust, TAA moderated them.[25]

Despite shortcomings in TAA, some form of manpower program deserves reconsideration as a means of promoting labor adjustment in a broader framework of fostering efficient resource allocation. Such a framework could be constructed to aid in overcoming impediments to efficient resource allocation caused by market imperfections, without counteracting the basic signaling pressures of market

[23] Wage-price rigidity is only one private impediment to market adjustments. Others include imperfect information about opportunities, uncertainty, imperfect factor mobility based on geographic or other ties, and insufficient access to capital markets that would finance acquisition of efficient human and physical capital.

[24] Other objectives were to gain support of import-sensitive sectors for trade liberalization by providing potential cash subsidies to those that might suffer from the liberalization and to compensate those injured by freer trade policy on equity grounds. The TAA program was generally successful in meeting these two objectives through the 1970s. Political problems have resulted in a vastly reduced budget in the 1980s, however, and the program is slated to expire soon.

[25] There are many studies of the TAA program. See especially C. Michael Aho and Thomas O. Bayard, "American Trade Adjustment Assistance After Five Years," *The World Economy*, November 1980, pp. 359-76.

prices. While this can be done many ways, the basic thrust of the programs should be to tie benefits to adjustment. Workers certified for TAA, for example, could receive temporary income supplements but more long-lasting education grants. Employers could be given tax advantages to cover the costs of recruiting employees from areas that have suffered from imports. The program could also promote equity—for example, through grants to displaced workers that because of age have no prospects for adjustment—but these could be formulated in a way that did not worsen resource allocation.

If such policies were adopted, they should be clearly articulated and defended before the international community. Subsidies for adjustment or equity purposes may be misconstrued as official efforts to improve the price competitiveness of domestic producers at the expense of foreign interests. For example, GATT guidelines allow for countervailing tariffs in the importing country to offset foreign export subsidies. While this response might be legitimate if the subsidy is an unfair and distortionary scheme to promote exports, it would impede any adjustment the subsidy was designed to encourage. Unfortunately, because official explanations for trade-distorting subsidies are rarely given, it is difficult to determine which subsidies are intended to promote adjustment. At a minimum, therefore, the United States and its trading partners need to adhere to well understood guidelines in formulating adjustment policies.[26]

The need for effective economic adjustment is especially important today because international trade is increasingly a source of instability as comparative advantage and currency values shift rapidly among countries. The result is often sudden surges in imports, which are more difficult to cope with than are gradual movements in production and trade. In this sense, government adjustment policies can be considered special insurance programs against the riskiness of international trade. These social insurance benefits could be at least partially funded through payroll taxes.[27]

Conclusions

The primary objective of trade policy should be to to keep world markets open to international specialization and exchange. The benefits of free international trade far outweigh the advantages that narrow sectors gain through protectionism. Economic change is not to be feared but welcomed as a natural consequence of healthy growth. The U.S. economy is increasingly producing high-value output based on technical advantages and providing valuable services to other countries in such forms as engineering and finance. Economic welfare will be greater if the changes are allowed without government restrictions based on an outmoded view of the economy. The government does, however, have a legitimate role in distributing the gains from free trade among workers in a way that promotes both equity and efficiency.

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[26] Agreement on the Subsidies Code in the Tokyo Round of multilateral negotiations was a start, but much remains to be done in the defining of offensive subsidies and the appropriate policies for redress. See Gary C. Hufbauer, "Subsidy Issues After the Tokyo Round," in William R. Cline, ed., *Trade Policy in the 1980s*, pp. 327-61.

[27] An alternative is to levy a temporary tariff on the affected product and use the proceeds to fund adjustment. While this has the advantage of directly linking adjustment to its source of funding, the welfare costs of a tariff are much higher than a visible tax and subsidy scheme. Besides, tariffs are rarely temporary once they have been imposed.