Economic stagnation and the resurgence of trade restrictions

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The recession that has plagued the global economy during the past three years has given rise to a worldwide wave of protectionism. Confronted with stagnant economic activity and high and rising unemployment, many countries have turned increasingly to restrictions on imports, or to special subsidies that increase the price competitiveness of their products in international markets. The immediate concerns of policy makers about depressed output and high unemployment have contributed to the diversion of their attention toward trade-distorting policies. These policies are perceived by some as remedies for the economic ills of unemployment and under-utilization of plant and equipment, but at best such policies only mask the symptoms and are likely to be met by offsetting distortions by another country's government.

Meanwhile, the underlying rationale for why countries engage in international trade is lost. The economic basis for trade is that by specializing in the production and export of goods for which a country has a comparative advantage and importing those goods for which it does not have a comparative advantage, the trading countries may each increase their total income.

A view of the world that supports the restriction of trade has a long history and in fact was a basic tenet of economic thought during the mercantilist period of the 16th-18th centuries. Governments sought to acquire wealth (gold and silver) through the export of high value goods and through restrictions on imports. In more recent history, protectionism became an important component of trade policy in the early 1900s and reached a peak in 1930 with the Smoot-Hawley tariff. Smoot-Hawley was initially conceived prior to the Great Depression as a means of protecting U.S. agriculture, which during the 1920s had become depressed relative to the rest of the economy. With the onset of the Depression, the narrowly conceived legislation became a "Christmas tree" on which to hang greatly increased tariff rates to protect the domestic employment and output of other industries. Foreign competitors responded with increased protectionism of their own. Widespread unilateral attempts to stimulate employment and income by restrictions on trade failed and contributed to a marked deterioration in world trade, thus exacerbating the effects of the Depression worldwide.

Current economic conditions and pressures for protection do not compare with those of the late 1920s and early 1930s. However, the prolonged economic stagnation currently being experienced by the world's economies and the resulting consequences for employment and income have brought to a standstill, and threaten to reverse, the post-World War II trend toward freer trade. Recent examples of trade-restrictive actions include: Japan's imposition of import duties on U.S. aluminum allegedly "dumped" in the Japanese market; imposition of "voluntary" limits on car exports from Japan to Canada, the United States, and several European countries; restrictions on imports of steel by the European Common Market (EC); tightening of restrictions on textile exports from the developing countries to the industrial countries under the provisions of a recent revision in the international textile agreement; increases in export subsidies on surplus agricultural commodities by the EC; a marked increase in non-tariff trade barriers within the

EC; and many others.

The United States has not been immune to these pressures. In the recent past, numerous bills calling for restrictions on imports have been introduced in the Congress. Where administrative actions are permitted by existing legislation, pressures for using them have intensified. In several instances, these pressures have resulted in action. Of particular note are three measures taken by the U.S. government in recent months.

U.S. quotas on sugar imports

In May 1982, the President ordered quotas on imports of sugar into the United States. Under this quota system, the administration determines the total amount of sugar to be admitted into the country. Each foreign country exporting sugar to the United States is allocated a share of that total based on the average annual shipments into the United States for the years 1975 through 1981.

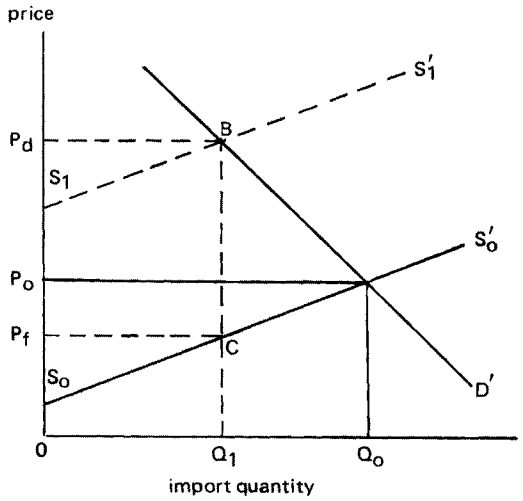
The quota system is in addition to existing import duties that, at the President's discretion, can range up to 2.81 cents per pound on raw sugar, and fees, set by the Secretary of Agriculture. The administration's decision to impose sugar quotas was triggered by a series of domestic events, combined with the developments in the world's sugar markets in late 1981 and early 1982.

The Agriculture and Food Act of 1981 established a price support program for U.S.-produced sugar that set a floor under the price received by U.S. producers. The government set the floor by agreeing to purchase raw sugar through the Commodity Credit Corporation (CCC) at a price of 16.75 cents per pound from December 22, 1981, through the first quarter of 1982. The legislation also directed the CCC to extend nonrecourse loans to cover sugar production during the 4-year period from October 1982 through September 1986. Loans to sugar producers were to be secured by the commodity and based on a support price for sugar that would increase gradually from 17 cents per pound in the first year of the program to 18 cents per

Tariff and quota restrictions on trade

Import restrictions fall into two categories: 1) tariffs and 2) nontariff barriers to trade, which are divided into a) quantitative restrictions, typically quotas, and b) other non-tariff barriers to trade. Since World War II a series of seven multilateral trade negotiations have reduced tariff rates to such a degree that they are comparatively minor impediments to trade. Partly as a result of the reduced protection afforded by tariffs, more of the pressure for protection from imports has been applied in the area of nontariff barriers—quotas and other nontariff barriers such as "buy domestic" legislation and domestic content requirements.

Theoretically, for every quota there is a tariff that would provide the same degree of protection. (As a matter of practice, it is difficult to ascertain precisely the level of the tariff that would achieve this result.) In a simple case, the figure below shows what happens when import restrictions are imposed on a product. The relationship be-



tween the quantity of the product imported and its price (demand) is represented by the curve DD′ and the relationship between the quantity supplied by the exporting country and price (supply) is shown by curve $S_0'S_0$. The quantity demanded equals the quantity supplied at the equilibrium point A, resulting in a market price of P_0 and a quantity of Q_0.

Assume now that it is desired to reduce the quantity of the product imported from Q_0 to Q_1. This could be achieved either by setting an import quota of Q_1—i.e., forbidding imports greater than that amount—or by imposing a tariff, BC, which raises the price to domestic consumers to P_d and reduces the price received by exporters to P_f. In effect, imposition of the tariff would shift the supply curve up from S_0S_0' to S_1S_1'.

A major difference between a tariff and a quota providing equivalent protection is the beneficiary of the "rent" represented by the area BCP_fP_d. (It should also be recognized that the trade restriction results in a net loss to the system, shared by exporters and domestic consumers represented by the area ACB.)

If the restriction is a tariff, the government imposing the restriction gains the revenue BCP_fP_d. If the reduction in imports is attributable to a quota, the distribution of the rent depends on how the government imposing the quota chooses to implement it. If the government sells importers the right to buy abroad, the government either will capture all of the rent itself or will share it with the importers, depending on the price at which the right was sold. If the government gives the import licenses away, the importers will obtain all of the rent. Finally, if the government gives export licenses to foreign governments or exporters, then they will capture the rent.

The negotiated or "voluntary" quotas favored by governments in recent years do not allow the importing country to capture the rent resulting from the restriction. Rather, the foreign government, which in this case controls the licensing of exports, reaps all or a portion of the rent by selling export licenses to exporters. It can, alternatively, give the licenses to exporters, allowing them to capture all of the rent. Thus, under quotas, consumers in the importing country face the worst of several possible worlds. They not only pay higher prices, but are prevented from increasing their consumption of the imported goods regardless of their willingness to pay. Still worse, they may actually be subsidizing foreign exporters.

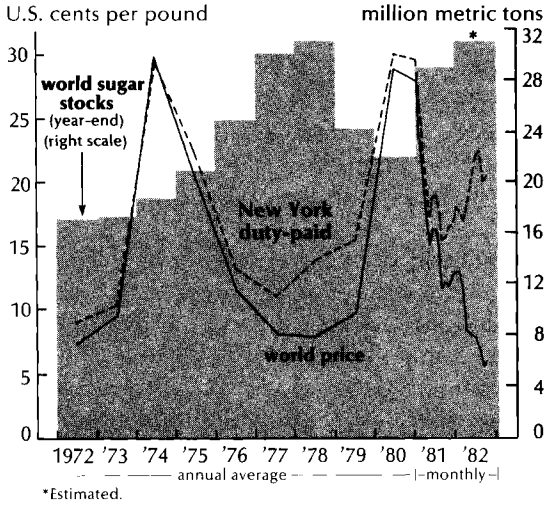
Quotas possess several other characteristics that are particularly distasteful to most economists. Effective quotas eliminate the impact of market forces on the output of the product. An upward shift in demand or an increase in efficiency in supply would affect only the price of the product—the quantity is fixed by quota. Thus, only the comparatively inefficient protected firms reap the benefits of an increase in domestic demand. Finally, quotas insulate domestic producers from world market forces and tend to promote the continuation of inefficient operations.

Offsetting these negative factors somewhat, at least from the importing country's perspective, are the short-term gains that may occur in domestic employment in the affected and related industries. The use of import quotas clearly involves political as well as economic considerations.

pound in fiscal year 1985-86.[1] However, because the Congress failed to appropriate funds for the program in the 1982 federal budget, the Office of Management and Budget directed the CCC not to purchase surplus sugar.

The failure of the government to implement the floor price for domestically produced sugar left the price of U.S.-produced sugar to be determined in the world market. In the meantime, world sugar production soared to a record 105.6 million short tons in 1981 and year-end stocks increased 32 percent from 1980 to 1981. As a result, the world price of raw sugar fell from a high of 41 cents per pound in October 1980 to 6 cents per pound in October 1982. The landed New York price (including duties, fees, and freight) declined from 41½ cents per pound in October 1980 to 15½ cents in September 1981. In an attempt to protect comparatively high cost domestic sugar producers from falling prices, the President raised import duties on raw sugar in December 1981 to their legal maximum of 2.81 cents per pound. The import duties and fees brought the total import tax on raw sugar up to 4.95 cents per pound, and the New York duty-paid price stabilized around 17-18 cents per pound.[2] Fees were raised further and in April 1982 the total import tax was 6.88 cents per pound. Given the state of the world's sugar markets in early 1982, the tariff was not high enough to maintain the U.S. price of sugar above the legislated floor price in the absence of a viable, well-funded purchase program.

Figure 1: U.S. and world sugar prices diverge in 1981, as protectionist policies take hold



*Estimated.

The administration was left with three choices: 1) abandon the price support program; 2) obtain a budgetary allocation to fund it; or 3) impose additional restrictions on foreign suppliers as a means of raising domestic prices. The first course was deemed undesirable for political reasons—the termination of the price support program would alienate the powerful sugar producers' lobby in the Congress. The second choice would have been difficult to implement because of the tight budget. So the administration chose the last alternative and imposed import quotas.

The quota increases the price that U.S. consumers will pay for sugar. In effect, it transfers the cost of the sugar support program from the taxpayer to the sugar consumer. Early estimates by the U.S. Department of Agriculture indicated that the quotas would add 2 to 4 cents per pound to the price of sugar. Assuming domestic consumption holds at the 1981 level of 9.8 million tons, the additional cost to consumers would be $400 million to $800 million per year. In addition to

[1]With a nonrecourse loan, the sugar producer acquires a loan from the CCC based on the loan rate per pound of sugar. The sugar is held as collateral for the loan. If, during the course of the year, the market price of the sugar under loan sufficiently exceeds the loan rate, the farmer may pay off the loan and sell the sugar on the open market. If, by the end of the year, the market price remains below the loan price, the farmer may choose to turn over the title to the sugar to the CCC, thus canceling his obligation to repay the loan. The CCC must then assume storage costs of the sugar and may not sell its holdings in the open market unless the market price exceeds the loan rate by a specified percentage.

[2]In 1981 one-quarter of the nearly 5 million short tons of sugar imported were eligible for duty free treatment under the Generalized System of Preferences (GSP) applicable to U.S. imports from developing countries. During the first half of 1982 nearly 60 percent of the 1.2 million tons imported were eligible for GSP treatment.

higher sugar prices, the prices of nonsugar sweeteners are expected to increase, further boosting the consumer's costs.

In addition to the consequences for domestic prices of sweeteners, the imposition of the quota system may have important international repercussions. Approximately 50 percent of the sugar consumed in the United States came from foreign sources in 1981. Except for Australia, the major supplier countries are low- or middle-income developing countries.

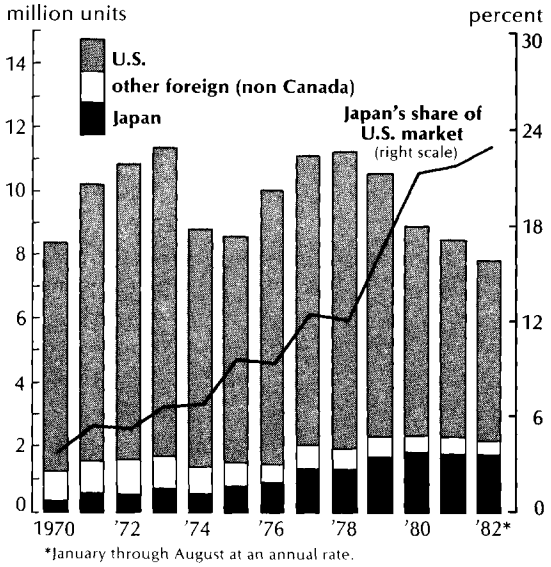
Brazil and Argentina, among the more advanced developing countries, provided nearly 30 percent of U.S. sugar imports in 1981. Lower-income developing countries in Central America and the Caribbean islands, where sugar is a major export commodity, provided nearly one-third of U.S. sugar imports. In 1980, sugar accounted for nearly 40 percent of the Dominican Republic's and nearly 30 percent of Panama's exports to the United States. The quota system may create severe problems for these countries.

"Voluntary" restraint on exports of Japanese cars to the United States

For one year beginning April 1, 1981, the Japanese government limited exports of automobiles (including vans and station wagons) to the United States to 1.76 million units. In light of the continued depressed state of the U.S. auto market in 1982, the restraint was extended at the same level for a second year. In October 1982 the U.S. government requested that the limits be extended for a third year.

The decision of the Japanese government to reduce car exports (from 1.91 million units in 1980) to the United States came after months of growing political pressure within the United States to temporarily restrict auto imports as a means of providing some support to the industry. It was assumed that such temporary protection would assist the industry as it went through a transition phase of production reallocation towards smaller and more fuel-efficient cars and attempted to adjust its production to a more efficient mix of labor and capital, better enabling the U.S. auto industry to compete.[3]

Figure 2: Japanese imports increase their share of a declining U.S. auto market



*January through August at an annual rate.

The restraint would give the U.S. auto industry a "breathing spell" from foreign competition during which it could restore profitability and reduce its unemployment. It was estimated that a restriction-induced increase in sales of U.S.-produced autos would increase before-tax revenues for U.S. auto companies by about $1.9 billion per year, thus generating additional funds to aid the recovery and long-term viability of the industry.[4]

Employment in the auto industry was expected to increase over what it otherwise

[3]Although the U.S. International Trade Commission (ITC) had previously issued a ruling that growing auto imports were not the principal cause of the plight of the U.S. auto industry, the movement toward restraining imports gained considerable momentum.

[4]"CEA Calculations of the Impact on the Economy of a Japanese Automobile Import Restraint," *The Effect of Expanding Japanese Automobile Imports on the Domestic Economy*, Hearings before the Subcommittee on Economic Stabilization of the Committee on Banking, Housing, and Urban Affairs, United States Senate, April, 1980, 96th Congress, 2nd Session (Government Printing Office, 1980), p. 83.

would be in the absence of the import cutback. According to studies conducted by the U.S. Department of Labor and the United Auto Workers (UAW), an increase in auto production by five units adds one employee to the work force, directly and indirectly. The anticipated 150,000 unit reduction in Japanese imports (assuming that it translated into a one-for-one increase in U.S. auto production) was expected to reduce U.S. automotive unemployment by about 30,000 workers.

On the other hand, the restraint was expected to impose costs on U.S. consumers. In principle, the "voluntary" export restraint imposed by the Japanese government would have the same impact as legislated import quotas by the U.S. government: a restriction on the number of autos allowed to enter the U.S. market tends to increase the prices of autos bought by U.S. consumers and to limit their choice of available models.

Furthermore, economists generally expected that the Japanese producers would change their product mix and increasingly concentrate their shipments to the U.S. market in the higher-priced, higher-profit models at the expense of less expensive models, thereby limiting U.S. consumers' choices and raising the average price of landed imports. Moreover, the limited supply of imported cars, especially the lower-priced models, was expected to make it possible for dealers to increase the delivered price of these autos.

The available statistics tend to bear out those expectations. During the first year of restrictions, Japanese car makers sold 1.81 million units in the U.S. (versus 1.91 million units in 1980). The excess over 1.76 million primarily reflected a drawdown in inventories built up in anticipation of the imposition of restrictions. During the first six months of 1982, sales ran at an annual rate of 1.77 million units, only marginally above the restriction ceiling.

Japanese manufacturers have sought to maintain sales revenues by raising prices and by increasing the proportion of higher-priced cars in their export mix, confirming the predictions of many economists when the restrictions were introduced. The average unit value of Japanese cars at U.S. ports of entry was about $4,700 in 1980, about $5,300 during the first six months of 1981, and almost $5,600 during the first half of 1982.[5]

Sales reports by the major Japanese auto companies confirm the shift toward more expensive models. During the first six months of 1982, the number of cars priced at $6,500 or less sold by the two largest Japanese manufacturers declined 30 percent from the same period in 1981. During the same period the number of cars priced between $6,500 and $11,000 increased 15 percent. Sales of cars priced at more than $11,000 rose by 60 percent.[6]

Despite the export restrictions and the shift in the export mix toward more expensive cars, Japanese car makers have continued to hold their own in the depressed U.S. market. Japanese cars accounted for about 22 percent of all cars sold in the United States in both the first half of 1981 and the first half of 1982. In the April-August 1982 period, they had a 26 percent share.

A much more severe restriction on trade in cars would occur if some form of domestic content requirement legislation such as that introduced in the 97th Congress were to become law. In its most restrictive form, the proposed legislation would require that by 1985 companies selling cars in the United States have a minimum of 25 percent local content if annual sales ranged between 100,000

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[5]From April 1981 to mid-October 1982, the dollar appreciated by about 18 percent in terms of the yen. Together with an increase of about 6 percent in the average U.S. price of a Japanese car, this exchange-rate change has meant that the average yen price of a representative Japanese car exported to the United States has risen more than 24 percent since April 1981. Clearly, this increase has materially aided profit margins of Japanese manufacturers.

[6]According to *Ward's Automotive Reports*, during the period in question, sales by these two manufacturers of cars priced at $6,500 or less declined from about 349,650 units to 213,450 units; sales of those priced between $6,500 and $11,000 increased from about 164,680 units to 189,320 units; and sales of those priced in excess of $11,000 increased from about 53,650 to 85,770. Total sales by these manufacturers declined from about 567,980 to 488,540 units.

and 150,000 units. Local content requirements would range up to 90 percent for car manufacturers with annual sales of 500,000 units or more.

Such legislation would effectively preclude major foreign auto makers from selling in the U.S. market. Foreign auto makers that establish plants in the United States typically do not produce all models in their U.S. facilities and it is unlikely that they would be willing to source such a high proportion of auto components domestically. Even U.S. auto companies commonly source major components such as engines and transmissions abroad and sell foreign-assembled cars under U.S. nameplates.

Such restrictions are bound to limit consumers' choices and raise car prices. Auto makers would be forced to accept the higher domestic production costs that have 1) led U.S. firms to foreign sources for components in the first place and 2) discouraged foreign firms from locating facilities in the United States. U.S. Trade Representative William Brock has condemned the bill as a serious threat to the international trading system and to the well-being of the U.S. economy. Nevertheless, the bill gained strong support in the Congress during 1982 as the U.S. economy remained stagnant and the expected recovery of the depressed auto industry was pushed further into the future. More importantly, the strong support for such legislation reflects a widespread mood that protecting domestic industry from import competition is necessary to generate more jobs in this country.

Restrictions on steel imports and the U.S. steel industry

On October 21, 1982, officials of the United States government and the European Economic Community reached an agreement limiting EC steel producers' exports to the United States of carbon and alloy steel and steel pipe and tube to 5.46 percent and 5.90 percent, respectively, of the projected U.S. market for these products. The quotas went into effect November 1, 1982, and extend through 1985. The agreement by the EC to accept "voluntary" export quotas short-circuited by only one day the U.S. government's imposition of countervailing duties on steel imports from the EC and may have forestalled the imposition of anti-dumping duties later in the year. The imposition of these quotas is the latest development in a troublesome controversy over "unfair trade practices" in the world steel market.

Foreign competition in the steel industry has long been a sensitive issue worldwide. During most of the period 1969 through 1974 agreements to restrict steel shipments "voluntarily" were negotiated between the U.S. and Japan, the U.S. and the EC, and the EC and Japan. These agreements protected the U.S. industry from Japanese and European steel and the European industry from Japanese steel. When world steel demand soared in the mid-1970s the agreements were allowed to lapse except for the import quotas imposed by the U.S. on specialty steel imports from the EC in 1976. At the same time, Japan agreed to a voluntary restriction on shipments of specialty steel to the United States.

World demand for steel slowed later in the 1970s. Rates of capacity utilization fell, employment declined, and new pressures for restrictions on trade began to appear. In June 1977, the U.S. Steel Corporation filed a countervailing duty petition against European steel producers charging that the Europeans were providing illegal export subsidies. In September 1977 anti-dumping charges were filed against Japanese steel exporters. That same month, the U.S. government granted trade adjustment assistance to about 15,000 steel workers who were certified as having lost their jobs because of increased imports. Additional dumping charges were filed later in the year. In 1977 steel imports surged to 19.3 million short tons from 14.3 million tons in 1976.

The trigger price mechanism

In December 1977 the administration announced plans for a "trigger price mechanism" (TPM) which provided a schedule of

Price for hot rolled sheet by source, 1981*

	Germany	France	Italy	Netherlands	Other areas	United States
			dollars per ton			
Average f.a.s. import price	$313	301	296	313	325	—
Estimated c.i.f. price (cost, insurance and freight)	343	330	325	343	357	—
General import tariff at 7.1 percent on f.a.s. price	22	21	21	22	23	—
Estimated price in New York	365	351	346	365	380	416**

*Price comparisons for steel products are open to question because of a lack of publicly available data for comparable products. Industry sources indicate that hot rolled sheet comes close to being a uniform product although even in this category quality and size variations occur that make price comparisons tenuous.

**Mill base price at midwestern locations—price does not include discounts or premiums.

minimum prices at which steel imports would be admitted into the United States.[7] The U.S. industry received the TPM coolly, primarily because the trigger prices were tied to the estimated costs of production in the more efficient Japanese industry. Consequently, the level of protection was low. Nevertheless, the U.S. industry agreed to withdraw dumping charges. Dissatisfaction with the TPM continued to build, however, and came to a head in March 1980 when domestic steel producers filed antidumping petitions against European producers once again.[8] The Commerce Department responded by suspending the TPM.

Under an agreement with the domestic industry reached in October 1980 the U.S. government reinstated the TPM, at somewhat higher minimum prices, with the stipulation that the dumping petitions be withdrawn. At about the same time the EC imposed production quotas on its steel industry, which suffered from excess capacity, in an attempt to restructure the industry and weed out inefficient capacity. The EC also took action to re-

[7]These minimum prices were based on the dollar cost of steel production by the Japanese steel industry—the world's most efficient steel producers. So long as foreign steel met the trigger price level, according to the TPM, the domestic industry would refrain from making dumping charges. If imports came in at a price below the trigger price, the U.S. authorities would initiate a dumping investigation. The TPM went into operation in early 1978. Despite the trigger prices, steel imports increased to a record 20.8 million tons in 1978. From the beginning, the U.S. steel industry was unhappy with the TPM. Because trigger prices were based on Japanese costs of production, it was asserted that the less efficient European producers could sell steel in the U.S. market at a price above the trigger price, thereby being in compliance with the TPM, and still be in technical violation of antidumping laws—that is, foreigners selling in the U.S. market at less than their costs of production.

[8]Dumping is defined in U.S. statutes as the practice by a foreign exporter of selling goods in the U.S. market at less than "fair value." This means that the goods must not be sold in the export market at a price lower than in the home market. The statutes also state that if the home market price does not realistically reflect the cost of production, plus a reasonable profit margin, the home market price may be disregarded and a cost of production plus profit figure may be constructed and used in place of the home market price to determine whether dumping is taking place. The Commerce Department has responsibility for determining whether dumping is taking place. Before antidumping duties can be imposed, providing dumping is found, the dumping must be shown to be causing "material injury" to the U.S. industry. The investigation and determination of injury are the responsibility of the U.S. International Trade Commission (ITC).

strict steel imports in 1981, renewed these restrictions for 1982, and recently extended the restrictions through 1983.

Nonetheless, by the end of 1981 the U.S. industry was again complaining about rising imports and administration of the TPM. Steel imports increased to 20 million tons in 1981, only about 1 million tons less than the 1978 record. The strength of the dollar in foreign exchange markets tended to nullify the protectionist effects of the TPM.[9] In an attempt to forestall a broad-scale "unfair trade practices" petition by the steel industry, the Commerce Department in November 1981 began an investigation of steel imports from Romania, Belgium, Brazil, France, and South Africa.

Nonetheless, in January 1982 several U.S. steel companies brought an "unfair trade practices" suit against 14 countries. In response to the petition the Commerce Department again suspended the TPM on the affected products. During the next several months domestic producers filed additional charges covering a broader range of products and expanded the country list to 15—Austria, Belgium, Brazil, France, West Germany, Italy, Japan, Luxembourg, the Netherlands, Romania, South Africa, South Korea, Spain, Sweden, and the United Kingdom.

The June 1982 countervailing duty decision

On June 11, 1982, the U.S. Department of Commerce announced that nine foreign governments—Belgium, Brazil, France, West Germany, Italy, Luxembourg, the Netherlands, South Africa, and the United Kingdom—were subsidizing their steel exports. Pending a final determination of whether the U.S. steel industry had suffered "material injury" as a result of the subsidies, Commerce announced countervailing duties on the appropriate steel imports to offset the subsidies.[10] In the final determination reported in August the Commerce Department substantially reduced its estimates of the export subsidies. The countervailing duties were correspondingly reduced to marginal levels for German steel and from a maximum of 40 percent for U.K. steel to 20 percent. Further complicating the issue, the Commerce Department ruled in August that EC steel was being "dumped" in the U.S. market.

In October 1982, the International Trade Commission ruled that the EC's subsidies to steel producers caused "material injury" to the U.S. steel industry. Consequently, the countervailing duties determined by the Commerce Department investigation were scheduled to be imposed beginning October 22, 1982. The ITC's ruling on injury due to dumping was scheduled for December.

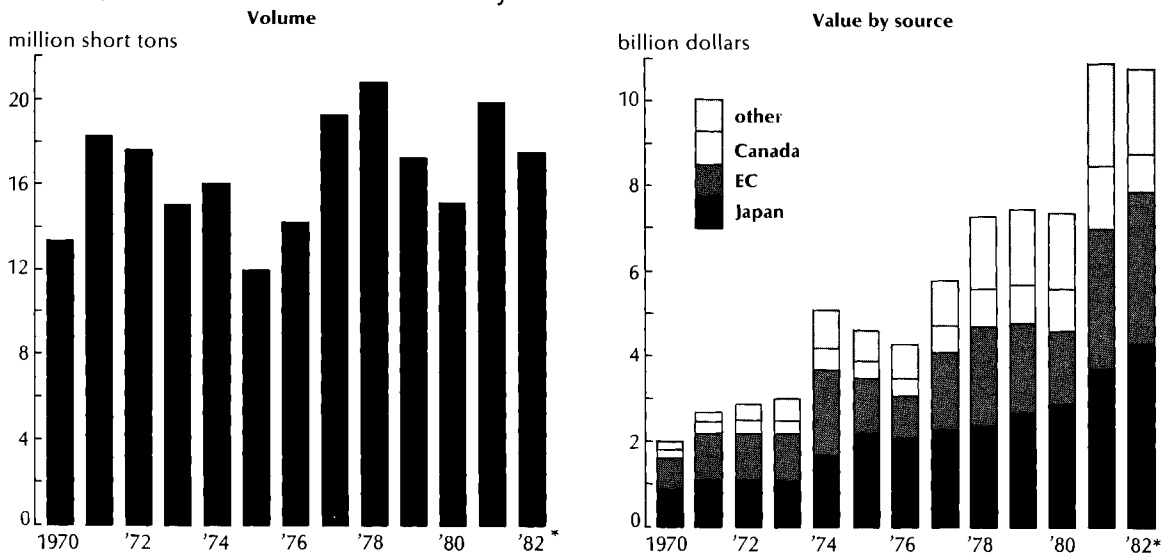
Response by the steel exporting governments

The initial response of the EC's top trade officials to the countervailing duty decision was to announce that the EC would develop a list of imports of industrial goods from the United States that benefit from U.S. tax breaks and other subsidies, such as the Domestic International Sales Corporations (DISCs), so that the EC could retaliate against the United States by imposing its own set of countervail-

[9]In October 1980 the average trigger price for steel imports was about $400 per ton. This was equivalent to about 1,700 French francs per ton at the then prevailing exchange rate. The average price of French steel at that time was about 1,800 francs per short ton or about $420—well above the trigger price. The French franc price of steel increased about 27 percent to 2,300 francs per ton between October 1980 and the end of 1981. However, because of the more than 30 percent appreciation of the dollar during the year, the average dollar price of French steel had declined to about $400 per ton at the end of 1981—just at the threshold of the trigger price.

[10]The Tariff Act of 1930, as amended, is the basic legislation governing the imposition of countervailing duties (the Trade Agreement Act of 1979 contains the most recent revisions of the provisions). Countervailing duties may be imposed to offset a foreign government's subsidy on exports that result in "material injury" to the comparable U.S. industry. The U.S. Department of Commerce is responsible for determining whether an export is subsidized and by how much. The International Trade Commission determines whether U.S. industry suffers "material injury" as a consequence of the subsidized exports.

Figure 3: The volume of imported iron and steel products declines in 1982, while their value holds steady



*January through September at an annual rate.
SOURCE: American Iron and Steel Institute and U.S. Department of Commerce

ing duties.[11] Alternatively, officials indicated that such a list might be used to help convince the U.S. government that it too has much to lose in a trade war.

On July 22 the EC countries offered to reduce steel exports to the U.S. voluntarily, but the U.S. rejected the proposal. In mid-August U.S. and EC officials reached agreement on quotas limiting EC carbon steel to an average of 5.75 percent of the U.S. market for the covered products. However, U.S. steel producers refused to drop their unfair trade practice suits and, consequently, the agreement did not go into effect.

Negotiations resumed and on October 21, the day before the U.S. countervailing duties were to be imposed, U.S. and EC officials reached an agreement on quotas that was acceptable to the U.S. steel industry. The Europeans agreed to limit shipments of carbon and alloy steel and steel pipe and tube products to 5.46 percent and 5.90 percent, respectively, of the projected U.S. market. That the U.S. steel industry accepted the revised agreement and agreed to withdraw the unfair trade practice charges was, in part, the result of the EC's acceptance of a slightly smaller market share for carbon steel (5.46 percent versus 5.75 percent in the August 1982 agreement) and the inclusion of quotas on tube and pipe, which had been excluded from the earlier agreement.

In addition, from the U.S. steel industry's viewpoint the quotas apparently provide greater relief from imports than would the increase in import duties, especially considering the downward revised countervailing duties. Consider, for example, Germany, the largest European exporter of steel to the United States. Quotas will be more effective than countervailing duties in reducing German steel shipments to the U.S. because government subsidies to the German steel industry are negligible and, consequently, the countervailing duties would have been only marginal.

[11]Domestic International Sales Corporations (DISCs) are special corporate entities whose sole purpose is to channel goods into the export market. Their establishment was authorized by the Revenue Act of 1971 in the hope of stimulating U.S. exports. The act gives DISCs certain tax advantages that make it attractive for U.S. companies engaged in exporting to establish such corporations and use them as conduits for foreign sales.

The situation in the U.S. steel industry

During the first nine months of 1982 the U.S. capacity utilization in the production of raw steel averaged 51 percent. This compares with an average of 82 percent during the same period in 1981. Current demand is low by historical standards and inventories are being worked down. Imports (which were at high levels during the first two months of the year) have declined about 9 percent from a year ago. Raw steel production, which totaled 120 million short tons in calendar 1981, was down to an annual rate of 75 to 80 million tons during the first nine months of 1982. Total blast furnace and foundry employment, which averaged 710,000 in 1981, declined from 714,000 in January 1981 to less than 550,000 in July 1982.

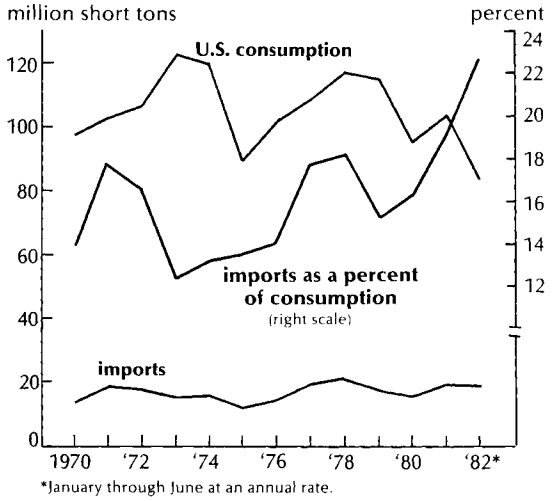
Impact of the quotas

In 1981, EC countries shipped about 6.4 million tons of steel to the United States and supplied 6.1 percent of U.S. steel consumption. At a comparable level of consumption, the new agreement would limit EC shipments to about 5.7 million tons.

The state of steel in the Seventh District

Seventh Federal Reserve District states accounted for an estimated 34 percent of U.S. steel production, or about 41 million short tons, in calendar 1981. Employment in District states is in about the same proportion. Thus, current steel industry employment in District states is estimated to be about 190,000—down about 50,000 workers from January 1981. Despite the substantial decline in steel output and employment in the District states, these states appear to have been hit less hard by plant closings than some other areas. As a result, the District's share of output and employment has risen several percentage points during the past two or three years.

Figure 4: As U.S. steel consumption dropped, import share rose



*January through June at an annual rate.

Despite the weak steel market, the quota restrictions will put some upward pressure on prices paid by U.S. steel consumers. Imported steel will continue to enter the U.S. market under the umbrella of higher U.S. prices. The restrictions on shipments from the EC will tend to push the foreign steel supply curve back so as to "slide up" the U.S. demand curve for foreign steel, thereby producing higher steel prices. Prices for non-EC imported steel as well as for U.S. steel might be expected to strengthen as a result of the quotas. Alternatively, given the large amount of unused capacity in the steel industry worldwide, non-EC steel producers might choose to increase production to fill the void left by reduced EC shipments, holding prices near current levels, or they could opt for a combination of higher prices and somewhat higher production. In the United States higher prices will probably take the form of smaller discounts from the list price than are currently in force. Higher list prices are not expected until there is a marked improvement in the overall demand for steel.

The increased prices paid by consumers of steel will be transferred, in the form of

increased revenues, primarily to steel producers, both foreign and domestic. The overall cost of the quota restrictions to the residents of the U.S. can be expected to be somewhat higher than if the same degree of protection for the industry had been achieved by increasing duties. Higher prices for imports resulting from higher duties would have produced increased tax revenues to the U.S. government. Under quotas, in particular those imposed by exporting nations, higher prices for imported steel typically result in a transfer of revenue from U.S. consumers to foreigners.

The negotiated settlement has tempered a potentially explosive trade conflict between the United States and its major trading partners. Nonetheless, protectionist pressure, fostered by worldwide economic stagnation and growing unemployment, continues to build.

Whether unilaterally imposed or negotiated, import/export quotas still constitute restrictions on trade and result in higher prices to consumers and misallocation of resources. It appears, moreover, that the U.S.-EC agreement is not the end of the steel controversy. After the argument was concluded, the EC announced that it will restrict its own imports of steel in 1983 by an additional 10 percent, or more, in order to help its domestic producers whose sales will be reduced by lower shipments to the United States. In addition, U.S. steel industry representatives have indicated that they will press for restrictions on imports of steel from both Japan and third-world countries. These countries have increased their penetration of the U.S. market substantially during the past decade and are in a position to fill the gap left by reduced EC shipments.

To the degree that increased trade tensions might result in a succession of trade restrictions, Seventh District states would suffer from the secondary effects of these restrictions. EC retaliation against industrial and capital goods and agricultural shipments would potentially have an adverse impact on a much broader segment of the Midwest economy than is encompassed by the steel industry. Exports are a major factor in the economic output of the area. About 8½ percent of the District's industrial production is estimated to have been exported in 1980 and exports of agricultural products accounted for one-third of the cash receipts from farm marketings in 1980.

U.S. measures in perspective

Trade barriers to "protect" domestic interests from foreign competition exist in all countries. Indeed, an assertion often encountered in the current drive to protect the U.S. steel industry from European competition is that the U.S. industry is simply retaliating against foreign governments' alleged subsidizing of their domestic steel industries. Nonetheless, the quotas on exports by the Europeans serve to distort the market by masking the economic signals necessary to enable the U.S. steel industry to adjust to underlying market conditions so as to compete in the world market.

Other governments have a long history of protectionism with respect to agriculture, an industry where the United States, on the whole, is highly competitive. Japan, for example, sharply limits imports of U.S. produced beef and citrus products. These restrictions have been a persistent source of conflict between the two governments.

The European Economic Community, through its common agricultural policy, supports the prices received by its domestic grain and livestock farmers at levels well above world market levels. Imports of competing farm commodities are taxed at the border to prevent them from undercutting domestic prices. In turn, excess domestic production encouraged by the EC's high price supports is sold on the world market with the aid of government subsidies, which enable EC producers to compete with the other more efficient foreign agricultural producers, such as those in the United States, Canada, and Australia. The EC's export subsidies on farm products have recently provoked increasing pres-

sures by U.S. agricultural interests for retaliation in kind.

Measures restricting trade are often presented as reasonable and necessary actions taken to protect certain domestic industries that are, for whatever reason, experiencing hardship. Restricting imports that compete with such industries appears to be a simple solution. But, as shown in the three examples analyzed above, such solutions have distinct costs attached to them, costs that must be borne by the society as a whole.

The question then arises whether another means of aiding the depressed industry, perhaps less costly than trade restrictions, may be a more efficient way of dealing with the problem of an industry having difficulty adjusting to foreign competition. Such a question is especially relevant when other indirect but very real costs are taken into consideration. These costs may arise from retaliation by the affected countries abroad.

The likelihood of such retaliation increases in direct proportion to the degree of distress being experienced by the world economy: the more depressed the economic conditions abroad are, the greater is the chance that countries that lose markets because of restrictions imposed on their exports, will attempt to redress the setback by imposing restrictions on the offending country's goods. When that happens, the benefits gained (at some cost) from trade restriction in one segment of the economy may be more than offset by losses suffered by other segments whose exports are restricted by retaliation. In the end everybody loses as international trade diminishes and economic efficiency deteriorates under the impact of restrictions.

In recent years international trade has become increasingly important to the U.S. economy. In 1981 U.S. exports of merchandise as a proportion of the production of goods (measured by final sales adjusted for changes in inventories) stood at 18 percent, compared with less than 10 percent in 1970. Imports were equivalent to 20 percent of final goods sales in 1981, compared with less than 10 percent in 1970. While these figures are well below those for the trade-intensive countries of Western Europe, where the proportions are 50 percent or more, they are nonetheless substantial.

A more dramatic picture of the importance of international trade to the overall economy emerges when changes in net exports—that is, exports minus imports—are related to changes in GNP. In any given year, international trade will tend to either stimulate or retard overall economic activity, depending on whether net exports are in surplus (assuming less than full employment) or deficit, respectively. Moreover, year-to-year changes in net exports affect GNP, regardless of whether the overall trade balance is in surplus or deficit. It is the marginal impact that is important.[12]

In 1981, for example, real net merchandise exports (i.e., exports valued in constant 1972 dollars) declined $7.9 billion from the 1980 level. Real GNP increased $28.6 billion. Various econometric studies have indicated that the impact on GNP, or multiplier effect, of a change in net exports may range from plus two to plus three. Thus, at the margin, the impact of a $7.9 billion decline in real net exports may have reduced real GNP growth in 1981 by $16 billion to as much as $24 billion.

Had net merchandise exports in 1981 remained unchanged from the 1980 level, real GNP would have increased between $45 billion and $53 billion, rather than by the less than $30 billion actually recorded. Instead of a real GNP growth rate of 1.9 percent, as recorded, GNP would have increased by 3 to 3.7 percent.

Clearly, the impact of international trade on U.S. GNP is of potentially great significance. Government policies which reduce trade flows and affect net exports may, at the margin, induce substantial secondary changes in the nation's output, employment, and growth.

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[12]If there is no change in the size of the balance from one period to the next then clearly there is no marginal impact on GNP. Even in this case, however, there may be economic efficiency gains as a result of an increase in trade or losses due to a reduction in trade.