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## PROTECTIONISM

# International Consequences of US Trade Policy

by Raimund Medrisch, Munich\*

**Data on the US economy and the political climate in the USA make it probable that the trend towards trade restrictions in the United States will further intensify. What would be the consequences of an escalation of trade conflicts among the western economies? How might an internationally co-ordinated strategy to avoid such a development look?**

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The USA and its international trading partners are facing a record US trade deficit (\$156.2 billion in 1986). Despite the tremendous depreciation of the dollar in the last two years, it has not been possible yet to curb or reverse the rise in the deficit. The policy of dollar devaluation as a means of eliminating the foreign trade imbalance has therefore failed to work so far. That being the case, the inclination towards trade protectionism is increasing; in American eyes the cause of the US trade deficit now lies in "unfair trade practices" by the United States' main trading partners, the more so the higher the bilateral US deficit with individual countries. The "main culprits" are Japan, other countries in the Far East (South Korea and Taiwan), Canada and the Federal Republic of Germany.

There are two main protagonists in US trade policy:

- ☐ the Reagan Administration is responsible for the introduction of discretionary protectionist measures, in other words measures of fixed duration designed to affect individual trading partners;
- ☐ the Congress is aiming to pass legislation imposing trade restrictions on a broad front.

A Trade Act initiated by Congress will be passed before the end of this year. There are clear majorities in both the House of Representatives and the Senate for their respective Bills, which the conciliation committee will have to meld into a single Act (the Omnibus Trade and Competitiveness Act). Under the proposals of the House of Representatives there is a danger that President Reagan will be shorn of many of his previous

powers to initiate and take action. The Senate Bill would still leave the President freedom of action, but the new Trade Act will undoubtedly make future decisions regarding tariffs and quotas more bureaucratic than in the past or even automatic. American industry will probably be given an actionable right to protection against imports and to adjustment aid. Even the possibility of a veto by President Reagan can do little now to change the likely outcome.

For that reason the Reagan Administration is attempting to bring the latent trade conflict with the United States' main trading partners – especially Japan – out into the open now rather than later. Japan is accused of dumping and hindering market access for US products that are in themselves competitive. It all seems very martial at first sight, if one thinks for example of the 100 % special duty imposed on Japanese semi-conductors in April 1987, but such special duties serve more to exert moral pressure on Japan; the value of the imports involved – \$300 million – is minuscule in comparison with the US-Japanese trade deficit of \$51.4 billion, and in any case the United States announced a partial lifting of the sanctions at the world economic summit. The so-called "spaghetti war" with the European Community also symbolises more the endeavour of the Reagan Administration to remove the potential for trade conflicts from the scope of the forthcoming Trade Act.

It should nonetheless be noted that free world trade is increasingly coming under threat from protectionism. There is a danger that the American example will be copied. Protectionism appears in many guises, ranging

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\* Bayerische Motoren Werke AG.

from voluntary restraint agreements via non-tariff trade restrictions to customs surcharges at rising rates of tariff. Once introduced on one side, such measures generally lead to retaliation. The more severe the import quotas or duties and the larger the number of products affected, the greater the damage to trade. If the escalation of measures and countermeasures gets out of hand, leading to a trade war, trade between the warring parties comes virtually to a standstill.

The further nations advance through the various stages of protectionism, the greater the danger of escalating trade restrictions into a trade war. History shows that wars are won by one of the belligerents, but not so in the case of trade wars, where there are only losers, as we learnt from the example of the Great Depression in the thirties.

### **Causes of US Protectionism**

Protectionism has many causes, but generally it serves to protect an economy or particular sectors from foreign competition. It is justified on the grounds of preserving and modernising sectors that are no longer competitive (the jobs argument) or by invoking strategic considerations (the key industry argument). In the USA the apparent reason for the current protectionist trend is the abnormally high foreign trade deficit. However, this in turn is due to a number of structural problems that can be traced to economic policy errors in the past and

aberrations in the way in which industry has developed. These include:

- ☐ The US budget deficit, which amounted to \$221 billion in 1986 and has been due mainly to the sharp increase in armaments expenditure in the last five years.
- ☐ As a consequence of the above, the existence of an inflated armaments industry with a high concentration of qualified and highly-paid manpower that is lacking in civilian industry, given the underlying shortage of this resource.
- ☐ A high concentration of US research and development expenditure on the armaments and space sectors; R & D spending on civilian projects amounts to only 1.9 % of GNP in the USA, compared with 2.6 % in Japan and 2.5 % in Germany.
- ☐ Structural deficiencies in US industry: poor product quality, inadequate productivity growth (with too slow assimilation of new technologies into production processes as well as training deficiencies), short-term thinking on the part of management and excessive relocation of US production abroad.

In particular, the overvaluation of the dollar for most of the last forty years owing to its role as a key and reserve currency has stimulated greater American direct investment abroad than the US economy could stand; the resulting "underindustrialisation" of the United States has led to a high volume of imports – for

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example, IBM currently reimports around 70 % of its computers from abroad – and a “lower than normal” volume of exports, since foreign demand is met by local subsidiaries of American producers. The overdeveloped services sector in the USA has admittedly created an impressive number of jobs, but it cannot make good the shortfall on trade in manufactures.

### **Objectives of US Protectionism**

While it is true that the main purpose of the existing and anticipated US trade restrictions is to eliminate the trade deficit quickly, they also have a strong domestic political dimension. Those hardest hit by the trade deficit at present are still the farmers and mass production industries with a low level of technology (steel, textiles, footwear). If economic activity turned down, however, the producers of consumer and capital goods with a high technology content would also suffer.

Since presidential elections are due in 1988, politicians in the USA cannot ignore the calls coming from these industrial groupings. The trade unions and a large section of industry are pulling in the same direction. Moreover, the election of another Republican President could not be reconciled with a recession in the USA or high unemployment before 1989. Salvation from both dangers is sought in greater protectionism.

Besides this penchant for trade restrictions for domestic political reasons, what counts for the USA is the rapid effect the measures will have on the balance of trade. The risks appear slight to many American politicians, since they have little fear of retaliation by trading partners. For example, the USA is already virtually in the position of a monopsonist in relation to many Japanese exporters, since it takes 40 % of Japanese exports; Japan would therefore probably think long and hard before taking retaliatory measures.

Many in the USA therefore seem to regard protectionism as an appropriate solution to the problem facing the country. The deep-rooted American predilection for short-term solutions also favours protectionist measures rather than painful long-term remedies involving budget cuts, deflation and curbs on consumption. Ultimately, however, protectionism will not solve the more fundamental structural problems of the US economy but will reinforce and prolong them.

If American protectionism does significantly increase, the economic and political scene will change markedly at both national and international levels. Inflation in the USA will undoubtedly accelerate, leading to an increase in interest rates. Over the longer term, American

businesses can be expected to face a price/cost spiral and investment activity is likely to be adversely affected.

International economic repercussions are also likely; a deep recession, possibly even leading to a depression, will be unavoidable in countries that are heavily dependent on world trade. Highly indebted developing countries, which are already approaching the limit of their debt servicing capacity, will probably be unable to continue servicing their debts, with all the consequences that would have for the western banking system.

All manner of retaliatory measures are conceivable and probable; one would have to expect not only trade retaliation against the USA but possibly also a capital boycott by the Japanese. As the main creditor of the United States, Japan has the means to trigger financial crises in the USA.

Common to all the effects stemming from US protectionism is the fact that they are incalculable in extent, though not in direction. With substantially higher inflation in the USA, the structurally too low US investment ratio would probably remain low and the international competitiveness of US industry would continue to be impaired. Cumulative adverse effects and international reactions could plunge the entire world economy into a recession or depression; the probability of crises would increase.

### **Costs of Protectionism**

If protectionism is proposed as a means of saving jobs, the question arises as to the cost in terms of real national income. Several direct and indirect effects of protectionism must be taken into consideration here; measures to ward off imports lead to higher domestic prices for the goods involved, causing losses for the consumers and industrial users of such products, since particular items are either unavailable or cost more than the world market price. This leads to reduced prosperity for consumers, reduced efficiency in industry and a further loss of competitiveness in international markets.

It is difficult to quantify the costs of protection, since they are “forgone profits”. However, all the calculations carried out to date show that every kind of protection, be it non-tariff obstacles to trade or tariff barriers, leads to a loss of efficiency far in excess of the increase in output generated by the saved jobs.<sup>1</sup> Hence job preservation is not a tenable argument in favour of protectionism.

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<sup>1</sup> See for example World Bank: World Development Report 1986, Washington, D. C., 1986, pp. 26 f.

Not only is protectionism costly, but the price rises caused by import restrictions have the same effect as a turnover tax. Calculations for the United States show that the relatively mild import restrictions imposed between 1980 and 1985 were equivalent to levying a surcharge of up to 66% of the income tax paid. Furthermore, since such a percentage surcharge is particularly high for families on a low income, "taxation" through protectionism distorts income distribution.<sup>2</sup>

Another estimation of the costs of protectionism<sup>3</sup> shows that removal of all the import barriers currently in force worldwide over the next ten years would hypothetically lead to a 2 percentage point increase in the annual average rate of growth in the OECD. This demonstrates the possible scale of the growth potential that cannot be exploited because of existing protectionism.

The costs of protection are thus higher than its supposed benefits; growth potential remains unexploited, the pace of innovation is curbed and the population suffers a reduction in prosperity. If one considers that an increasing proportion of world trade consists of "intra-firm trade" by multinational corporations, trade restrictions may even block direct investment and international capital flows. This would open the door to a process of disintegration of the world economy.

### **Economic Policy Alternatives**

The reaction of western financial markets to the escalation of the trade conflict between the USA and Japan (semi-conductors) showed clearly that protectionism cannot be a suitable answer to foreign trade disequilibria. Share price losses on international stock exchanges, the weakness of the dollar and increases in interest rates in the USA indicated the direction in which the western economies will move in the face of escalating protectionism: an acute dollar crisis, rising interest rates, a slump in share prices and ultimately recession.

Hence the only sensible course in economic terms is a form of crisis management that relies on the conventional methods of eliminating economic disequilibria. For economic policy-makers in the USA, this entails:

□ giving priority to reducing the budget deficit by cutting armaments expenditure and introducing or raising turnover taxes (instead of taxing turnover indirectly by means of protectionism). A "slimming-down" of the

armaments sector and reduced consumption must be accepted over the longer term.

□ introducing a package of measures to strengthen the competitiveness of American industry; increased investment in product quality and the rationalisation and modernisation of production facilities require a much higher investment ratio than in the past. The measures should also include investment in raising the level of training of the US labour force, which is extremely low by comparison with Japan and Germany.

□ promoting the targeted transfer of qualified manpower from the armaments sector to civilian industry, so that civilian industrial sectors could once again benefit more from American business's high innovative capacity. A policy of détente involving arms controls or reductions can serve this purpose.

The contribution of the United States' main trading partners towards preventing protectionism should take the following form:

□ An increase in the import capacity of countries in western Europe and the Far East by means of an expansionary growth policy consisting of further interest rate reductions and fiscal incentives to boost consumption and investment. Remaining restrictions on market access that have hitherto blocked competitive American imports would have to be removed (e.g. in the telecommunications field).

□ Distortions in competition in the world market in agricultural products, which mainly harm US exporters of farm products, should be eliminated by reforming the agricultural markets in the EC and Japan.

□ The currencies of South Korea and Taiwan, which have depreciated hitherto in the wake of the dollar, should be revalued considerably.

In the international context, the above contributions by all countries to preventing protectionism imply a necessity for the permanent co-ordination of monetary and fiscal policies, trade policies and not least exchange rate policies. Even now, the Uruguay Round of GATT negotiations should be being conducted in a climate generated by the expectation that the GATT institution will be strengthened. "Standstills" and "rollbacks" should be swiftly replaced by extended multilateral trade rules. Unless the industrial countries close ranks, the tide of protectionism will be almost impossible to turn, even over the longer term.

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<sup>3</sup> Carried out at the Institut für Weltwirtschaft in Kiel; see B. Heitger: Import Protection and Export Performance, Kiel Working Papers No. 260, Kiel 1986.

<sup>2</sup> Cf. World Bank, loc. cit.