

## ECONOMICS U\$A LESSON #27

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(MUSIC PLAYS)

Stasio: Economics U\$A, one of a series of programs designed to explore Twentieth Century micro and macro economic principles. The subject of this edition is International Trade. Our guest is Robert Lawrence, Senior Fellow at the Brookings Institution. I'm Frank Stasio.

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Stasio: Twelve thousand miles separates the People's Republic of China from the United States, but there was an even greater distance that had kept the two countries apart for decades that preceded Richard Nixon's historic trip to China. Ideological differences between the capitalist United States and the communist China made the possibility of Sino-American trade politically impossible. But because of changing foreign and domestic priorities in both the U.S. and China, trade became a possibility in the early Nineteen Seventies, but for Richard Nixon who had built part of his career on a hard-line anti-communist stance, announcing a visit to the world's largest Communist country was risky. Chinese leaders too faced opposition within the Communist party for opening the doors to a nation they frequently denounced as imperialist and exploited. Why were both sides willing to gamble? The simple answer is that they both believed they had

something to gain. It may be easy to see why the United States wanted to export to China. With its nine hundred million people, China is the largest market in the world, an irresistible prospect for the world's biggest producer. But what would the U.S. import from China? The United States can make almost anything it wants more cheaply than China. In this sense, the United States is said to have an absolute advantage over China, but to see the benefits of free trade, we need to look at more than the efficiency of one country's industry compared with another. We need to see the relative benefits of allowing one country to supply a portion of our needs to free resources for more productive purposes. Robert Lawrence is a Senior Fellow at the Brookings Institution.

Lawrence: In fact, there were two kinds of competition that are revolved in international competition. On the one hand, country...um, industries within an economy are competing with one another in order to attract resources into their sector. Uh, our computer industry and our textile industry both must hire labor, and therefore, they compete with one another in attracting that labor into their industries. On the other hand, our computer industry also competes with computer industries abroad. So there are actually two uh, forms of competition going on simultaneously, and therefore, it's not only how our computer industry competes with computer industries abroad that will determine international...success international competition, but it's also the comparative advantage or how well our computer industry does rela...in international trade relative to how our textile industry does in international trade that will influence the outcome.

Stasio: The question in determining comparative advantage is what does a non-trading country have to give up by producing everything itself. Suppose the United States could trade one computer to China for three thousand shirts. Now let's say that to produce the

same three thousand shirts in the United States it would take the resources needed to make one and half computers. Even if sure production in the United States was more efficient than in China, it would be in our best interest to put more of our resources into computer production and buy our shirts from China. Lawrence says that when a country discovers it has a comparative advantage, market forces will drive the country towards specialization.

Lawrence: If the computer industry can afford to pay workers say fifteen dollars an hour in order to work in the computer industry, and if the computer industry can still make a profit in...in paying those workers fifteen dollars an hour, the textile industry is gonna have to try to match that wage. If they're unable to do that, what we'll find is a textile industry that shrinks and a computer industry that grows, and indeed that's why over time we found our labor being allocated to the more efficient industries and away from the less efficient industries and it's how international competition, which is one force which leads us to specialize say, in the production of computers rather than the production of textiles, reinforces this allocation of our resources within our labor market.

Stasio: Lawrence says differences in comparative advantage can be attributed to a number of factors.

Lawrence: Some economies like those in the Middle East have a lot of oil. Other economies have climates that are favorable to produce one product or another, so one major source of comparative advantage comes from the natural resource endowments of the economy. A second reason may be...comes from what are called the factors of production available in that economy. Some economies are very rich and they have a lot

of equipment and/or capital. Other economies have a lot of labor, and therefore, factor endowments will also tend to influence the comparative advantage of countries. In countries which tend to have a relatively large amount of capital equipment will tend to specialize in products that require a lot of capital equipment. So a second major source of comparative advantage comes from the factors of production, land, labor, capital, which an economy has been endowed with. A third source of comparative advantage may well come from knowledge available in one economy that's not available in a second. The United States may possess technological know-how, which other economies don't possess, and therefore, one would expect to see the United States specializing along the lines of...in areas where it has a particular kind of know-how. And then finally country's overall environments may allow them to produce products which other countries would not permit, and so we can actually...we actually find that government regulations or social regulations may well influence what a country can specialize in. If we Americans have...do not wish to have a lot of pollution in our economy, we can put stringent regulations against pollution and what we'll find is that we will tend to import products from countries that have a greater tolerance for pollution than we do.

Stasio: Because of their size and productivity, American industries had at one time considered themselves invulnerable to foreign competition, but as labor costs increased in the U.S. and other countries gained technological know-how once limited to the United States, foreign products began to penetrate the American market. The steel, auto, and textile industries were the most severely affected. Labor leaders and management officials warned that allowing cheap imports into the United States would force

Americans to lower their standard of living as market forces pushed wages and prices lower. However, economists like Robert Lawrence believed just the opposite occurs.

Lawrence: Let's imagine that over night in the United States we were to discover a huge amount of oil in this economy. Well clearly what we would say is that our economy would be made better off. We'd be better off. Let's ask what would happen in a second case if the Canadian's discovered a huge amount of oil, three times the current world supply and were willing to sell it to us. Well, it's true we'd have to pay the Canadian's something for that oil, but again, we'd sit back and say, our living standards would be raised as a result of the ability to obtain that oil cheaply from another country. Now, of course, we would also agree that some citizens in our economy, in particular, the Texas oil magnets would be made worse off as a result of the availability of that oil, but we as a nation would be made better off potentially because now we would be able to take the resources that we are currently devoting to oil production and put them to some other use. The proof requires though a very important assumption and that is that we can take those resources, which were once in oil, or we can take those workers who once produced textiles and put them to work in some alternative activity. If they simply lay idle, then we couldn't be so sure that we would be better off. So, the proposition that trade makes our nation better off hinges critically on our ability to re-employ the resources that are freed up when we obtain what they once produced from the rest of the world.

Stasio: But shifting trade patterns that cause structural change can cause hardship and practical difficulties. It might require geographic relocation for workers. Older workers may find it difficult to be retrained in a new industry, and there will be a time when workers in older industries will be out of a job. Some are laid off indefinitely. The

painful short-term adjustments caused by shifts in trade patterns often create political pressure to protect declining industries against foreign competition.

Male Voice: Well, there's no question about it. We're in deep trouble, and specifically right here in Tarrytown where about two thousand people will be laid off. They're in deep trouble. I don't know anyplace in the State of New York where there's anybody gonna hire two thousand people.

Stasio: But economists argue that efforts to stand in the way of free trade result in higher costs for consumers. Some of those costs are obvious, some are hidden. In Nineteen Eighty when it appeared that Congress was about to impose rigid barriers aimed at controlling Japanese auto imports, the Japanese agree to place a voluntary limit on the number of cars they would send to the United States.

Lawrence: The estimates are that those restraints raised the cost of a car in the United States by something like six hundred dollars, and in fact raised the costs of the imports of Japanese cars by something like two thousand dollars. Well, clearly some of the benefits of raising the um, some...some of the costs of raising the...of the costs of automobiles domestically in this country, the costs to consumers were then benefits to our producers, so they weren't lost to the nation but they were a redistribution from consumers to producers. On the other hand, by putting on quotas we also provided benefits to foreigners as well. Now a second way of looking at protection is to ask, what were the costs to consumers of each job that we saved in our industry, in our auto industry, and there the estimate suggests that the cost to consumers was something like a hundred and sixty thousand dollars for each job we saved in the auto industry. So what you can see is

that by using trade protection in order to increase employment we have a very inefficient mechanism. Standing back, consumers would have been much better off to simply provide the salaries of those workers who would have otherwise been laid off than doing it indirectly through trade protection.

Dingle: This kind of fellow looks at the problem that uh, a consumer has in terms of paying a little more for the goods.

Stasio: John Dingle is a Democratic Congressman from Michigan and Chairman of the House Commerce Committee. His district was deeply affected by falling sales in the auto industry caused in part by the success of foreign imports.

Dingle: At this particular time, he doesn't look at the future increases are gonna be loaded on once our American automobile industry and other industries are down the tube, nor does he look at the economic consequences of being dependent on goods abroad. He doesn't look at the other costs that are associated with this. In a consequence he is breeding himself a splendid future and present disaster because he's not looking at the world as it really exists.

Stasio: Dingle was one of the leaders of a movement in Congress to impose restrictions on foreign auto imports. The most direct way to restrict imports is by quotas. Quotas are restrictions on the number of units a foreign manufacturer may bring into the country. Another effective way to reduce the impact of foreign competition is to impose a tariff or a tax on imported goods. The effect is to raise the price to consumers neutralizing its price advantage over domestic products. Dingle and others argue that many foreign manufacturers have gained trade advantages with the help of their government.

Government subsidies offset production costs and allow foreign competitors to sell their products at very low prices. Protectionist's say, that without similar help from the U.S. government, American industry will fall victim to unfair competition.

Dingle: Almost every country has quotas on importation of Japanese automobiles. The French say that they can bring in any number but only two or three percent will leave the dock, the Italians allowing twenty-three hundred, the British allowing approximately ten percent, Germans approximately ten percent, and the Japanese, however, will set up automobile industries around the world in the full expectation that those automobile industries as well as their own are going to be exporting into the United States. So I felt that it was absolutely necessary in view of the grotesquely unfair trade practices of our trading partners, especially the Japanese that real quotas and domestic content requirements equal to those voter nations should be laid in place by the United States.

Stasio: Dingle says that foreign competitors are not playing fairly. He argues that world trade is, in effect, not played on a level field. It's a persuasive argument for erecting barriers to free trade, but Robert Lawrence warns that such barriers should be imposed selectively.

Lawrence: What we have to acknowledge is that we live in a world of very diverse economies, and it's very difficult for us, in fact, ever to get a level playing field in international competition in the same way that we have it in domestic competition. After all two firms competing domestically exist in the same environment. It's the very reason why international trade occurs economists teach us is that those environments differ. So in my view the playing field of international trade will always be sloped one way or the

other. The best we can do actually is to agree on the rules of the game. Now let's look at what our international trade laws actually say. What they say is that we...we do not agree that subsidies should be...we do not allow subsidies and we don't agree to them, but nonetheless, if we find that a foreign is subsidizing exports to this country and we don't find though that our domestic industry is being injured, we will allow those to take place. On the other hand, if that industry can prove that it is being injured as a result of those subsidies and it can do so to the satisfaction of our international trade commission, then we will put on a countervailing duty. We will put on a tariff that offsets the effect of the subsidy. Now that seems to me a reasonable way to deal with the problem, to provide the benefits to consumers provided that there is no massive injury or injury in some sense to our producers.

Stasio: Lawrence says that if trade barriers must be imposed the quota is not the most efficient way to protect workers against economic hardship due to foreign competition.

Lawrence: You can get the same amount of protection by a tariff as you could by an equivalent quota. You could set the price or the tax on imports at exactly the same so that you would bring in the same quantity as you might under a quota. So you can obtain initially the same amount of protection, but the effects of a tariff are subtly different from those of a quota in a number of ways. Firstly, what a quota does is to restrict the quantity that foreigners can sell in the home market but allow them to raise their price. So, in fact, a quota provides increased profits per unit for a foreigner selling in the protected market. On the other hand, the tariff taxes that foreigner and doesn't permit him to enjoy those increased profits. That's why typically foreigners are more likely to agree to quotas than they are to tariffs, and uh, indeed over...that's why we've been able to persuade the

Japanese if you will and others, to agree to what are called voluntary export restraints because while they now can sell smaller quantity, they can raise the price against us and capture increased monopoly profits. And really if we sit back and we say, if the reason for providing that quota protection, is to provide our own industry a chance, a breathing space to modernize, we can see that actually quotas by channeling profits to foreign producers aren't a very sensible way of...of doing that.

Stasio: Protectionists sometimes argue that without trade barriers like tariffs and quotas to protect some industries, our national defense could be compromised. Here again, Lawrence and other economists that we may do better to be more selective in deciding whom we protect.

Lawrence: A free market system in which countries specialize along the lines of comparative advantage, may well render a country vulnerable in terms of its national defense requirements. If, for example, it turned out that the United States lost its comparative advantage in the steel industry, if we simply allowed the free market to allocate resources, we may discover that we have no domestic steel industry. We're simply importing our steel from the rest of the world. Purely from an efficiency standpoint, that may be a good and a desirable change, but viewed from a national defense perspective, that may be an undesirable change. Well, some people have argued that since we may be rendered vulnerable as a result of international trade, what we ought to do is to interfere or intervene with a trade process in order to protect our national defense industries. I would argue that that is not the appropriate response, because it's likely to be a very inefficient one. Let's take the case of steel as a case in point. It turns out that at the moment only seven percent of our steel production really goes into national

defense. Now, it would really, therefore, be quite...quite inefficient to protect the entire steel industry in order to maintain what's essential for the national defense base. I believe it would be much more efficient if we met that need by insisting that our defense planners subsidize the production of products which they think are critical for the national defense need. Let's meet the national defense need if you will through our defense budget. That way we are likely to have a much more efficient mechanism for meeting our national defense needs. We're unlikely to subsidize plants that are required for some other kind of purpose.

Stasio: Protectionism also gains support when the goal is to nurture infant industries. Developing countries wanting to build industrialized economies may choose to erect trade barriers to give their domestic industries a chance to become competitive with their trading partners.

Lawrence: That case has some merit for developing countries, which have potential in particular areas, but their industries require some time to get on their feet. Typically, however, we are from the point of view of the United States, we're a mature country. Our industry's if you will have already developed to the point where if they are viable they should be able to stand on their...on their feet. New industries which are at the frontier don't...don't face international competition from those who are more advanced than they are. So the infant industry argument in my view has some...there is some merit to that in the case of developing economies. But in fact what some of our industries want are protection while they're senescent or...or in their old age rather than while they're infants, and I don't think there is as a good argument in support of those kinds of industries.

Stasio: As Lawrence has said, advanced countries would be better off adjusting to shifts in comparative advantage, allowing resources to shift from older, less efficient industries to more productive pursuits, but as we have seen there can be serious political obstacles to free trade. Lawrence says the amount of resistance to structural change is determined in part by the rate of change and the ability of the economy to absorb displaced workers.

Lawrence: If structural change occurs gradually you see, then it will have much less pain, because instead of firing existing workers, basically it's possible for industries and firms to shrink just through voluntary attrition. The fact that people retire, the fact that people voluntarily leave jobs means that the society can accomplish quite a lot of structural change without any dislocation at all. That's one part of it is the rate of the structural change. Perhaps even more significant is what's going on more broadly in the overall economy. What we find is that structural change is very difficult to accomplish in an economy which is growing slowly. When workers are displaced in a slow growing economy they don't have other opportunities, and therefore, they tend to resist the structural change and becomes very power...and it becomes much more painful, and I think, in fact, that that's why structural changes become more difficulty over the last decade in the United States. It's not actually, if you look at objective measures that we increase the amount of structural change that we've actually had in the economy. It's simply that the overall growth rate has slowed down, and therefore, it's become more difficult to accomplish our structural change. We actually had much more structural change in the Nineteen Fifties. In deed, when we were moving large numbers of people off farms and into northern cities, then we did in the Nineteen Seventies and early Nineteen Eighties, but in the Eighties growth was much...growth was much slower.

Stasio: For Lawrence and other economists, trade is best left free of artificial barriers because short-term cost of adjusting to changes in trade patterns would be outweighed by the long-run benefits to society as a whole. Now, let's look back at some of the key ideas in our discussion about trade. International trade allows countries to specialize and increase their standard of living. When one country can produce a product more efficiently than another, it's said to have an absolute advantage over the other country in those goods. However, specialization in trade even occurs when a country has only a comparative advantage. Comparative advantage exists when it is more profitable for a country to specialize in the production of goods with relatively higher value and import those of relatively less value. Trade may benefit a country even if the country has an absolute advantage in the production of high and low value products. Economists like trade to take place free of artificial barriers because they believe free trade leads to the most efficient use of resources and lower prices for consumers, but free trade can be politically difficult to support when foreign competition threatens to force workers in some industries out of jobs. Resistance to structural changes caused the influx of cheaper imports is determined by how fast the change takes place and the ability of the economy to absorb displaced workers. There are many kinds of trade barriers. The most common are quotas which set a limit on the number of units a manufacturer may bring into the country and tariffs which tax imports to offset the price advantage they enjoy over domestic products. In general, economists believe that in the long run barrier free international trade benefits all trading nations and their people.

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Stasio: You've been listening to Economics U\$A, one of a series of programs on micro and macro economic principles. Our guest has been Robert Lawrence, a Senior Fellow at the Brookings Institution. Economics U\$A has been produced by the Educational Film Center in Annandale, Virginia. I'm Frank Stasio.

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