For Release on Delivery
1:00 P.M., EDT
October 15, 1987

Address by

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Board of Governors of the Federal Reserve System

before the

International Trade Club of Chicago

and the

Mid America Arab Chamber of Commerce

Chicago, Illinois

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It is a pleasure to be here in Chicago to address such an influential group. With your business and international interests, I know you appreciate the importance to the U.S. economy of trade and exchange among nations. Anyone familiar with the economy of the mid-west also understands the importance of export markets to this region.

This is certainly an opportune time to be discussing trade policy. So many very important trade policy issues are being debated and many important decisions regarding trade are about to be made. The United States and Canada, for example, have just concluded an historic agreement in principle reducing a wide range of barriers to trade and investment between the two countries that already share the world's largest bilateral trading relationship. At the same time, a U.S. Congressional conference committee has just begun work on trade legislation -- unfortunately, with a protectionist thrust.

Trade policy, because it necessarily involves competing economic interests, is inextricably bound with both domestic and international political considerations. Although I am certainly aware of these considerations, it would be a serious mistake to lose sight of the economic merits of a relatively free and open trading system.

This afternoon I would like briefly to mention these merits and then discuss some important problems of protectionism.

Economists have been aware of the economic benefits of free international trade for about 200 years, since the time of Adam Smith and David Ricardo. While economists disagree on many issues, they do agree that free international trade raises living standards and benefits all parties who participate in such exchange. However, the persuasive power of arguments for free trade arises not from abstract economic reasoning, but from real world comparisons of the achievements of open trade arrangements against those of protectionism. The conclusions from such comparisons over the last two hundred years are unambiguous. Countries that have followed freer trade practices have experienced more rapid economic progress and enabled the greatest proportion of their populations to improve their living standards.

The U.S. economy itself has worked to improve living standards for its citizens in part because we have had free trade among states and regions of our country. In this bicentennial anniversary of our Constitution, it is noteworthy to point out that the debilitating effect of protectionism among the original states under the Articles of Confederation was an important factor contributing to the need for a new constitution.

The framers of our Constitution forbade individual states from levying tariffs. The constitutional ban on state tariffs was crucial to the development of the U.S. economy because it established a free trade area among the 13 original states, and it also ensured that the free trade area would expand automatically as new states joined the Union.

But relevant evidence in support of free trade does not stop with the historical record of the U.S. economy. Since World War II, multilateral trade liberalization has demonstrated the power of freer trade through almost four decades of world economic growth. And in general developing countries that have pursued relatively free trade policies have also experienced more rapid economic growth. While certainly not perfectly open economies, Hong Kong, Taiwan, South Korea, and Singapore serve as examples of this.

The evidence demonstrating that free trade promotes economic growth, however, is not the only evidence supporting the pro free trade position. There is plenty of evidence showing that protectionist measures have severely harmed economic growth and, in particular, adversely affected consumers. The most obvious example, of course, is the Great Depression of the 1930s. It is well known that the Depression was exacerbated by the imposition of tariffs both in the United States and elsewhere.

While this evidence is persuasive, arguments in favor of protection initially often sound reasonable. And these arguments seem to continue to reappear. Protectionism is one example of what economists and political scientists have come to call rent-seeking behavior. This kind of behavior occurs when firms or industries (sometimes assisted by organized labor) find it easier and more profitable to devote resources towards obtaining favorable protectionist measures from their elected representatives rather than to devote the same resources to productive investment and product innovation. While such activity may be profitable for the firm or industry, particularly in the short-run, it has a negative effect for the economy as a whole.

Since 1955 there have been 4 rounds of multilateral trade negotiations under the auspices of the General Agreement on Tariffs and Trade (GATT). These negotiating rounds have generally been very successful, as average tariffs on both U.S. exports and imports declined from about 15 percent of value in 1964 to about 3 percent in 1986.

However, an increase in non-tariff barriers has often offset these gains from tariff reductions. For the United States, between 1975 and 1986 the total proportion of U.S. imports restricted by non-tariff barriers tripled to about 22 percent, including restraints on imports of agricultural products, motor vehicles, and textiles and other apparel. Comparable data are not available for U.S. exports, but qualitative information suggests that a large and growing proportion of U.S. exports are also restrained in one way or another by non-tariff barriers.

Protection worsens resource allocation by distorting price signals and in the long run will make an economy less competitive. Tariffs have a direct effect on raising prices; quantitative (non-tariff) barriers a more indirect, but potentially stronger effect. Under a system of tariffs the maximum difference between the world price and the domestic price (abstracting from transportation costs) is the tariff rate. Under quotas, excess demand by domestic users will not generate any additional imports above the quota and thus will spill over into large price increases by exporters, by competing domestic producers, and by domestic producers who use these imports in their production process.

The impact of quantitative restraints on domestic prices can be seen from the recent case of textiles and apparel. In the second half of 1986 bilateral agreements were signed with Japan, Korea, Hong Kong, and Taiwan which significantly tightened the quantitative restraints on U.S. imports of textiles and apparel. (These countries account for nearly half of our imports of these products).

Between the fourth quarter of 1986 and the second quarter of 1987 the average prices of textile and apparel imports rose 16 per cent (at an annual rate), after having declined slightly on average over the two preceeding years. This price increase accounted for two-thirds of the substantial rise in the value (dollar-amount) of textile imports.

While some of the price increase was associated with currency appreciation against the dollar, I suspect that the quantitative limits (which were binding in all cases) played a significant role in raising prices, or at the very least in accelerating the passthrough of changes of exchange rates to domestic prices, which has generally been much less in other areas. All of this works to hurt the consumer and lower living standards.

Inflationary pressures emanating from any source are always unwelcome, but given the current circumstances in the U.S. economy such pressures caused by increases in U.S. protectionist policies would be particularly unwelcome. Further upward price pressures, to the extent they occured, would require a tighter monetary policy than would otherwise be desirable. This in turn would jeopardize continued U.S. economic growth and would raise dollar interest rates. Slower U.S. growth and higher dollar interest rates would reinforce the negative impact of protection on the prospects for exports from highly-indebted developing countries.

Protection results in microeconomic distortions, as well. The distorting effects of protection can be felt by domestic producers in a variety of ways. Upward pressures on intermediate inputs will make U.S. firms less competitive in producing for export markets as well as competing against potential imports in cases where the producer of the import is able to purchase the intermediate input free of the costs of trade restraints.

Trade policy, whether designed to restrict specific imports or imports more broadly, may well be counterproductive in improving the U.S. trade balance. Restraining imports of specific goods or services will be ineffective in reducing total imports if aggregate domestic demand continues to exceed aggregate domestic supply. If imports of one group of goods and services are restrained by tariffs or quotas, some of the excess demand will simply spill over into imports of other items that are unprotected. With a large federal budget deficit, unmatched by an excess of domestic savings over domestic investment, the United States will by definition experience some deficit in our current account. If not, the budget deficit will likely cause higher interest rates to compete for reduced savings. In any case restraining imports by selective controls is a dangerous way to restore balance in our national savings and investment accounts. Continued reduction in the federal deficit and enhanced incentives for domestic saving are more appropriate ways to deal with that problem.

Quantitative restraints can actually worsen the U.S. trade position over the long run. Under quantitative restraints, exporters fortunate enough to obtain shares of the quotas are able to raise prices and profit margins on items subject to the quotas. Where the demand for the item is not especially sensitive to price, the increase in the price will more than offset the decrease in quantity, so that total dollar payments to foreign exporters will actually increase.

Quantitative restraints can lead to particularly high profit margins for foreign suppliers during periods when the dollar has appreciated to a high level as it did in 1980-1985. More recently, as the U.S. dollar declined in value, these foreign firms were in a position to retain their market share by reducing their home-currency profit margins on the same quantity of exports by holding the dollar price constant. In this case the quantitative restraints severed the link between exchange rate movements and price and quantity adjustments; they have impeded adjustment to exchange rate changes and added to the persistence of trade imbalances.

Having noted distortions and inefficiencies caused by <u>import</u> restraints, it is also important to note that <u>export</u> controls can also cause problems and should be avoided whenever possible. A case in point is the prohibition on the export of Alaskan crude oil (partly addressed in the U.S.-Canadian understanding) which adds to total transportation costs in the international oil trade without any commensurate benefit to the U.S. economy. Currently approximately one-quarter of U.S. non-agricultural exports (to countries other than Canada) require some sort of export license. While there is a real need to protect legitimate national defense interests, the time and expense involved in securing these export licenses acts as a tax on exports which conflicts with our goal of reducing our trade deficit.

Protection may also have other indirect effects that are undesirable. Trade restraints reduce the efficiency of the economy, which could discourage net inflows of foreign investment on which we remain dependent as long as our budget deficit remains large and domestic saving low. Trade protection might also be followed by restraints on the inward flow of capital. Indeed, the proposed trade legislation already contains disincentives for foreign investment into the United States.

Protection is not only an inefficient and undesirable way to correct the U.S. trade deficit, I believe it is unnecessary. We have witnessed an improvement in the real trade position of the United States, obscured to some extent by developments in oil imports. We expect further significant improvements in real terms, and more gradual improvement in nominal terms, as consumers and producers adjust to pricing changes brought on by the decline in the exchange value of the dollar. This expected improvement would benefit from stronger growth abroad, and a better balance in the U.S. economy that would result from further reductions in the federal budget deficit. A reduced federal deficit would allow domestic U.S. savings to finance domestic investment without having to rely as heavily on a net inflow of foreign capital.

Aware of the dangers and problems associated with protection, the real question is how do we foster a world trading system that is in the interests of all major trading nations. Some view protection not as a way of reducing our deficit but as a strategic bargaining technique to pressure other countries to reduce their trade barriers. While perhaps a logical approach in the political arena, this tactic runs the risk of generating a trade war that would jeopardize the entire global trading system. A more dependable way to foster an open trading system would be to further promote free trade using the examples of successful arrangements such as the Canadian/U.S. agreement, the free trade area being developed between Argentina and Brazil, and closer to my own responsibility, the negotiations that the Federal Reserve has had with officials from the United Kingdom, Japan, and other industrial nations to achieve more uniform standards for bank capital, in large part to remove competitive advantages to particular banks operating with relatively low levels of capital.

In conclusion, on reviewing the evidence there can be little doubt that free trade improves the use of a nation's resources, promotes economic growth, and ensures higher living standards for all trading participants.

In spite of the evidence, we are currently witnessing strong pressures to move away from an open trading system largely as a result of special interests seeking special favors from government. Free trade is in the national interest not just because it looks good on the classroom blackboard, but because we see that it works in the real world. I believe strongly that negotiations based on mutual advantage offer a better prospect for success than negotiations based on threats.