This is the short version actually used by JJ on 4/22/93

On the Political Economy of Trade Restraints

I am not going to make the case for the superiority of markets in the efficient allocation of resources before this audience tonight.

I will merely suggest that when historians write about "How the Cold War Was Won" they will say that in the great 20th century contest of ideas, democracy and capitalism triumphed over dictatorship and socialism.

It is sometimes said that if you laid all the economists end to end you still could not reach a consensus. At least on one issue that is not accurate. On the subject of trade there is very little disagreement. Virtually all economists advocate a freer trading environment. They may disagree about the political feasibility of achieving a free trade environment. But, that does not come from their economic analysis. Economists embrace free international trade because they understand that a liberal world trading order can make *all* nations better off.

Over 200 years ago, Adam Smith saw that free trade is essential to achieving the potential wealth of nations. That view has not changed even though this ideal has never been realized.

Instead, history charts a continual rising and falling of protectionism. A major global depression early in this century was at least substantially worsened by restraints. Also, some political historians have argued that major wars had their roots in barriers to trade. As well said in the nineteenth century, "when goods cannot cross borders, soldiers do". Indeed, much of the original political motivation behind the creation of the European Community in the post World War II era was to achieve economic integration so as to lessen the threat of military aggression. For much of the western industrialized world, this was an important lesson.

There also have been lessons from the experience of individual countries. We can point to countries, rich in natural resources, that have withered behind trade barriers. At the same time, other countries, lacking such endowments of natural resources, that have traded their way to world prominence.

Over the last fifty years, Western nations have largely held the persistent, corrosive effects of protectionist tides in check, and have even reclaimed some lost ground. Unfortunately though, it is now an open question whether we have seen the low water mark.

The Uruguay Round of the General Agreement on Tariffs and Trade (GATT), which has been the primary vehicle for advancing the ideal of free trade for the past 46 years, is now stalled. Trade relations among the United States, Japan, and the European Community are strained. Movements toward trading blocks in North America and Europe, *under some circumstances*, could raise ominous possibilities for future conflicts.

It is sad as well as ironic that so early in the post-cold War era we have seen some political leaders turn their attention from the hostile threats of the evil Soviet Empire to what they perceive as the threat of economic rivalry from our political allies. Indeed, a national business publication reported the results of a survey indicating that 2/3 of the respondents viewed

economic success of other countries to be a threat to our own economic well being.
The extraordinary diversity of world trade flows, together with misunderstanding of what creates comparative advantage, causes some observers to argue that the instruments of industrial policy can modify the international pattern of trade to the national advantage. One nation then gains at the expense of another. Recent choice of jargon, such as "managed trade," "aggressive unilateralism," and "comparable access," suggests that some political leaders are entertaining such possibilities.

There are many levels on which one can challenge the policy prescriptions based of these so-called strategic-trade models. However, their greatest shortcoming arises from their idyllic view of governments and the political process. They portray the government as a referee that acts only in the face of specific and identifiable market failures to maximize the nation's collective welfare. The government then imposes taxes, tariffs and subsidies that address the particular market failure, **without** creating distortions elsewhere in the economy. Political officials next apportion the financial rewards resulting from their actions evenly across all segments of society. Finally, the policy recommendations typically assume that foreign governments sit passively by while all this occurs.

These are **not realistic** assumptions about the nature of democratic processes. To an economist violations of these assumptions are a form of ***government failures***.

There are only two ways to allocate resources--markets and politics. Both have been used since ancient times. Both have their shortcomings. The case for free trade rests not on an argument that private markets function perfectly, but on the proposition that failures within political institutions pose a far greater threat to our personal freedom and to our economic achievements than the failures of the private markets.

III. POLITICS

That shifts the nature of the debate between politicians and economists. Namely, the relevant question is: would substituting government failures for market failures make us better off?

Political rhetoric related to trade and capital flows often includes assertions of unfairness. The

"us versus them" aspect creeps into all proposals to do something.

There are four types of assertions that are worth exploring:

1) "foreigners are buying too few of our goods"
2) "foreigners are selling us too many of their goods"
3) "Americans' opportunities to invest in foreign economies are too limited"
4) "foreign investments in the U.S. are too large" ("they are buying up America").

In none of these assertions is it really a case of **us** versus the **foreigners.** Rather, it is a case of **some** Americans versus **other** Americans. Sometimes it is a case of domestic consumers versus domestic producers. Or, **some** producers versus **other** producers. Or, **some** consumers versus **other** consumers. Sometimes there is a time dimension involved--**current** domestic consumption versus **future** domestic consumption.

All these trade and investment issues involve the interests of some people versus other people. For an economist the question comes down to: who do you want making decisions of this type--individuals in the marketplace voting their own interests, or politicians in smoke filled rooms voting what they perceive to be someone else's interests?

Let's look at whose interests are tied to each of these assertions of unfairness, and the likely political pressures to "do something".

1) The first assertion of unfairness is made by domestic producers of potentially exportable goods who complain about restricted access to foreign markets. The workers of such firms, as well as the investors, want their own government to "pry open" external markets. Certainly, a larger market is always better, and the more so the greater the "economies of scale" in the production of certain goods.

It does not seem that there would ever be much domestic political opposition to arguments that foreign barriers to our exports should be reduced because the domestic consumers cannot perceive that they might be made worse off by seeing our resources being used for someone else's benefit.

2) Assertions that foreigners are selling us too many of their goods comes from domestic import-competing industries. The idea of fewer domestic

workers employed in the production of goods available from foreign producers has long been a powerful political force. Increasingly, the interests of domestic consumers of foreign imports has served as somewhat of a counter balance to the influence of import-competing producers. Nevertheless, when the domestic economy is operating at less than its perceived full-employment capacity, the political pressures to "create jobs" often brings attention to imports. I view this as a highly cyclical issue that arises in economic downturns and diminishes as recovery progresses. However, when an economy is undergoing a major economic restructuring such as the present shift of productive resources away from defense industry applications, the temporarily underutilized capital and labor can be expected to appeal for political intervention.

3) The claim that U.S. investors are treated unfairly in foreign economies has not enjoyed much political influence. To the contrary, in times of domestic economic weakness politicians are likely to view investments abroad as a loss of job-creating capital formation at home. They ignore that our capital goods exports are heavily associated with economic development abroad that

may be enhanced by U.S. investment in foreign economies.

4) Until the second half of the 1980s, the claim that foreigners are "investing too much" in our country was not a major political issue. Certainly, the recipients of the foreign capital inflow had no cause to complain. The workers in the foreign-owned businesses felt they benefited. Nevertheless, the false notion of the U.S. "becoming a debtor nation" seemed to have the makings of a national political issue. It is not yet clear whether foreign ownership of productive resources can be developed into a national political issue.

All of these arguments are about the allocation of resources, not the efficiency or productivity of the endowment of resources.

Economic policies implemented by governments inevitably redistribute income. Consequently, the influence of rival interest groups, not arguments about economic growth or average standards of living, dominate governmental policy making. Trade restraints exist because they confer substantial financial benefits on certain segments of society.

Restraints benefit some at the expense of others, with a net loss to all because of the induced economic inefficiencies.

With the benefits of trade interventions so highly skewed, it is little wonder that politicians are amenable to protectionist pressures. Those expecting to profit from industrial policies have strong incentives to lobby and to use up real economic resources to secure such market privileges.

When a society demonstrates a willingness to allocate resources through the political arena instead of through the market, individuals are encouraged to reduce their investments in private economic activities and to increase their investments in political speculation. Through this unfortunate arbitrage, we are eventually made poorer.

IV. CHECKS AND BALANCES

Although democratically elected governments seem predisposed to interventionist, beggar-thy-neighbor policies--particularly when such policies have some intellectual credence--two important factors seem to check this inclination, albeit tenuously at times.

The first factor is internal. Trade restraints place costs on society which, although diffused and difficult to measure, do add up as trade restraints proliferate. Even the most ardent mercantilist of the seventeenth century realized that a nation cannot export if it does not import. A substantial portion of our industry either sells foreign goods or uses them in their production processes, and virtually every American household benefits from some foreign products. The costs of additional trade restraints build until, at some point, elected governments will not impose them.

But, this "equilibrium" point changes. Perhaps the most important internal factor explaining the waxing and waning of protectionism is the business cycle. When economic activity slows and unemployment increases, protectionist sentiments rise. When the economy once again approaches full potential, such sentiments abate. During the recessions of the 1930s, the mid 1970s, the early 1980s, and the past few years, protectionist sentiments in the United States grew.

Other constraints on protectionism are external. After a devastating trade war in the early 1930s contributed to the Great Depression, most industrialized countries came to accept that free trade offers the only positive-sum game for nations to play. That is, it is the only feasible trading arrangement among countries with the potential to enhance their economic well-being simultaneously. At any point in time, an individual country might temporarily improve its economic lot through trade restraints, but if many more countries follow suit, each will be made much worse off than if all had maintained free trade.

Because of this "free rider" aspect of trade policy, it is imperative that each country repeatedly signal its commitment to liberal markets, and its willingness to solve trade disputes within a multilateral framework. Since 1947, the GATT has provided just such a forum, through its on-going trade rounds of negotiations and its twin principles of reciprocity and most-favored-nation status. Within an ongoing commitment to GATT, the world can more readily tolerate the inevitable, temporary deviations from the ideal of liberal trade, knowing that a transgressor has not abandoned the ideal and having a mechanism within which to judge and sanction his actions collectively.

Unfortunately, many trade specialists now believe the GATT is in trouble for reasons that go beyond the immediate problems of the Uruguay round. The proliferation of non-tariff barriers and "voluntary" export restraints, often not explicitly prohibited in the GATT, is given as one reason. Moreover, the threat of communism, which was an important catalyst to Western cohesion and may have encouraged multilateral trade negotiations, has faded. Whatever the causes, multilateral trade agreements seem increasingly difficult to achieve.

In part, because of the difficulties of working within GATT, interest in preferential trading agreements, like NAFTA and the European Community, is growing. Although there is potential for these trading arrangements to be a two-edged sword, there is no question that they enhance the benefits of specialization and trade to countries that join the trading blocks and remove trade barriers. I am not especially concerned that they will reduce economic well-being by diverting trade away from efficient producers outside of the trade bloc. Moreover, the positive incentives for market-oriented reforms by countries just outside the bloc are impressive. The domestic political resistance to regulatory and tax reforms is diminished in the face of pressures to become prepared to enter the neighboring bloc. [importing capitalism]

V. CONCLUSION

The United States is the most prosperous industrial nation on earth. We have maintained that status not because we have more natural resources, not because we have a more powerful army, not because our children are brighter or our businesses more clever than elsewhere in the world. We have done so because, more than any other large nation in history, we have relied on market mechanisms, despite their imperfections, rather than on political decisions, to allocate our resources.

Many contend that Germany and Japan--our current rivals for economic pre-eminence--have managed to close the economic gap through industrial policies and managed trade, which we should now imitate. While both of these countries have made advances, arguably with more government involvement than the United States, I question the now fashionable conclusion that industrial policy and managed trade are the sources of their success. No one seriously suggests that the United States should follow an industrial policy like those of Britain and Sweden, or the managed trade policies of the former Soviet bloc. I suggest, therefore, that the post-war advances in both Germany and Japan have more to do with the willingness of their people to embrace economic liberalism and to compete vigorously on a global scale than with their governments' interference with markets.

Markets, like political systems, do not function perfectly, but markets unlike political systems offer the only game in which all can be made better off. This is not a theoretical point, but an observation on history.

In recent years, much of the political rhetoric related to trade has focused on exports. But, foreign investment has also received some attention. Imbalances--both in trading accounts and capital accounts--are often portrayed as undesirable. Sometimes politicians lump budget deficits and trade deficits together. That is wrong. What we call the "balance of payments" is always balanced. A deficit in one sub-component--such as merchandise trade--must be matched by a surplus in another sub-component--such as services or capital accounts. That will be true until we repeal double-entry bookkeeping.