

What Does Protectionism Protect?

One of the hindrances to a wider acceptance of free-market economic views is the hypocrisy of some of its ardent supporters. For example, businessmen often support the general idea of a free market, but then they favor and lobby for special consideration for their own industries or firms.

On a national level, after World War II, the United States took the lead among nations in seeking freer trade. Why not? This Nation then was in a highly favorable competitive position, and policymakers could expect clear benefits to accrue to U.S. citizens from such a situation. U.S. businessmen and labor union leaders fully supported efforts toward freer trade.

Many things have changed markedly since the late 1940's with reference to international dealings. After decades of inflating and the overconsumption it has fostered in the United States, the competitive position of this country in world markets no longer is unchallenged — at least within some major industries. Consequently, and as one might expect, businessmen and labor union officials in these industries have begun to clamor for favored treatment from the Government, and politicians increasingly have heeded and acted on their requests with threats of or actual legislation to change the market patterns of international trade.

No longer is "free trade" a popular phrase to some U.S. businessmen and labor union leaders; it has been replaced with the call for "fair trade." Of course, what one person might deem "fair" may be considered quite the opposite by others, and likewise among countries. Therefore, concern about trade imbalances has increased, and along with it a fear of the imposition of protectionist policies. The danger of protectionism is especially large during times such as these, when there is perceived inadequate economic growth within many major nations.

The general economic relationships associated with international trade and protectionism often are lost among the pro and con arguments about trade policies for particular industries; yet, the general relationships should serve as the guide for policies. In this report we focus on the economics of international trade and trade restrictions, and we offer some comments about the possible outcome of the recent widespread concern about the U.S. international trade imbalance.

The Economics of International Trade

Trade — international or domestic — is economically desirable because not all economic units produce goods with the same efficiency, and by specializing in production and then trading, all units can improve their scale of living. Whenever an economic unit can produce one good with greater relative efficiency than it can produce another good, such a unit can advantageously specialize in the production of that good and trade with an economic unit that is

relatively more efficient at producing some other good. Specializing in this manner is undertaken according to the comparative advantage in production that one producer has over another. The economic advantage of such specialization can be better achieved when international trade is not prohibited or restricted.

To illustrate the potential advantage of international trade, let us use a hypothetical example. Suppose that during a week of work an American farmer can produce *either* 100 bushels of wheat or 75 bushels of corn and a French farmer can produce *either* 50 bushels of wheat or 25 bushels of corn with equal cost and effort. In this example, the American farmer obviously is more efficient at producing both goods; he has an absolute advantage in the production of both wheat and corn. However, note that compared with the French farmer, the American farmer is relatively more efficient at producing corn (75 bushels against 25 bushels; a 3-to-1 advantage) than wheat (100 bushels against 50 bushels; a 2-to-1 advantage). Thus, the American farmer has a comparative advantage in the production of corn. Therefore, the American farmer should produce corn and trade with the French farmer, who should produce wheat.

Let us see how such specialization and trade would benefit both parties. If the French farmer worked 1 week to produce 50 bushels of wheat and the American farmer worked 1 week to produce 75 bushels of corn, the French farmer could trade the product of his effort (50 bushels of wheat) for 30 bushels of corn from the American. After the trade, for his effort of 1 week the French farmer would have corn (or the equivalent in purchasing media) which would have taken him 1.2 (30/25) weeks to produce. What about the American farmer? After the trade mentioned above, for his 1 week of effort he would have grain (or the purchasing media equivalent) equal to an effort of about 1.1 (45/75 + 50/100) weeks. He, too, would have benefited, although he had an absolute advantage in the production of both goods.

One should remember that the benefits of trade are not limited to those directly involved in the trade. From the American viewpoint, the American farmer presumably would spend all or most of the added income he received. His expenditures would be additional income to firms that would employ additional labor to produce the additional product the farmer would purchase. In this way the benefits of international trade would be distributed throughout the economy.

Conditions Change

The illustration above is intentionally very simple; nevertheless, the point of the illustration is relevant to the trade that flows across national boundaries even today. Why, one might reasonably inquire, do nations have a

comparative advantage in the production of particular products? In some cases the reason is obvious, as it is when a nation lacks specific natural resources. For example, the United States has to import all or nearly all of its tin, nickel, natural rubber, bauxite, cobalt, manganese, and chrome, among other things. The fact that the United States could not produce a single jet engine if it imported nothing at all illustrates how world trade is essential even for a nation as "rich" as the United States.

Another condition that can give one nation an advantage in production over another is an abundance of labor. Those nations with large populations and relatively free labor markets should enjoy a comparative advantage in labor-intensive industries. One should not be surprised that much of the world output of goods requiring a large unskilled labor input (for example, curios, handicrafts, etc.) should be produced in those nations that have large unskilled labor forces.

Nearly as obvious is the comparative advantage that some nations have because of a large available supply of a particular type of capital equipment. Of course, this is true mainly for highly industrialized nations. In such cases, the capital-intensive industries (such as computer, motor vehicle, electrical equipment, chemical, construction equipment, etc.) should play a more important part in the economy. Underdeveloped nations obviously have a disadvantage in the production of such goods. Just as clearly, well-developed nations should expect to have a disadvantage in the production of goods requiring a different make-up of labor skills.

As the world becomes more developed, an advantage that is becoming clearer is that associated with product research and innovation, and marketing capabilities. New product development requires large investment and skilled labor. The worldwide marketing of new products allows the innovative firm to enjoy the economies of large-scale production, which makes it difficult for new firms to enter that field. Such is the advantage the United States for many years enjoyed in fields such as computers, petrochemicals, telecommunications, aircraft, etc. Over time, as the productive techniques for such products has become simpler and the availability of the product becomes so widespread that marketing is not a significant problem, the U.S. advantage in the production of these things should have been expected to erode. In their place, the United States should have achieved an advantage in the production of new products.

Thus, comparative advantages are enjoyed for many different legitimate reasons. If these comparative advantages can be utilized through unrestricted international trade, the citizens of all nations should benefit.

Some Effects of Trade Restrictions

From the viewpoint of laborers, international trade contributes to higher real wages in general. International trade, which allows firms within a nation to specialize in those goods that can be produced most efficiently and are demanded in world markets, offers higher profit opportunities than would be available in the absence of such trade. Higher profits provide firms with the wherewithal to offer higher wages to attract the laborers they need to take advantage of the profitable opportunities. In short, because laborers are more productive due to the advantages of specialization, they are more valuable to employers and, accordingly, would be paid more, other things being equal.

Although the general level of real wages would rise, wages of laborers in industries having a comparative disadvantage would decrease, and some of these laborers

would have to find other work. Such changes are similar to those resulting from technological developments and changes in consumer demand that are unrelated to international trade. No doubt the application of computer technology eliminated some jobs, but it created many more, which, in general, involve higher wages than did the jobs lost. If anyone were to allege today that computers should be eliminated, one of the arguments against such a proposal probably would be that it would put many persons out of work. Thus, when workers ask that their jobs be protected against international competition, they are seeking to withhold better opportunities from other laborers and, perhaps, themselves.

An even more negative aspect of trade restriction involves the matter of individual freedom. When imports are restricted, voluntarily or mandatorily, a special privilege is granted to some members of society at the expense of others. Such restrictions replace consumer sovereignty with worker sovereignty. As a result of tariffs and import quotas, consumers are forced to provide a subsidy to the workers employed in the production of the protected product. In other words, import restrictions force the consumer to pay more for a product than he otherwise would have to pay, and the difference is funneled to the workers and firms in the protected industry. However, where does the consumer obtain the purchasing media to pay for the items he buys? The answer is obvious: he works for them. Work, of course, usually involves the sacrifice of time and effort by the worker, for only rarely are individuals in a position to combine their vocations and avocations. Thus, when consumers are forced to pay higher prices for restricted items, they are denied the freedom to use their time as they choose and, in effect, are forced into slavery for the benefit of the laborers in the protected industry.

An illustration may clarify the point that trade restrictions deny a basic freedom. Assume that in the interest of protecting the domestic vacation and recreation industry, the Government prohibited all overseas travel by Americans. There probably would be widespread opposition on the grounds that every American has the right to travel where he wishes, to physical freedom. Similarly, the consumer of a protected product is denied the freedom to use his time as he wishes (physical freedom) when he is forced to work longer in order to buy the protected product. We cannot imagine that such an outcome can be considered "fair."

That trade restrictions involve preferential treatment can be seen in another manner. If import restrictions result in retaliatory restrictions against exports, the workers in the export industries suffer for the benefit of the workers in the protected import industries. On what grounds can reward for the noncompetitive and punishment for the competitive be justified?

What About Unfair Foreign Competition?

The recent U.S. moves toward protectionism have been defended in part with the argument that Japanese trade policies are highly restrictive toward importation of foreign products, while actively favoring export industries. Proponents of "fair" competition assert that such favored treatment of Japan's domestic producers must be eliminated, or U.S. authorities should take retaliatory steps. Indeed, U.S. officials have demanded that Japanese officials take all steps required to eliminate the U.S. trade deficit with Japan (about \$7 billion during 1976) within 2 years.

We shall not assert that Japan is innocent of charges of restrictive trade practices, for evidence conclusively demonstrates quite the opposite. In spite of this situation, for the

U.S. to retaliate with like policies would simply compound the problem. Let us examine why.

As we described above, the benefit of free trade is the production (and availability for consumption) of goods in the most efficient manner according to comparative advantages held by the competing productive units. Any policies that block such functioning of the economic system, force adjustments to second-best, more costly alternatives. Thus, Japan's restrictions on imports entail a cost to the Japanese as well as to foreigners (including Americans). The goal of officials should be the elimination of such barriers, so that the best, most efficient arrangement of production might occur.

If Japanese authorities refuse to remove these barriers and U.S. authorities retaliate with their own barriers, what would be the probable result? Aside from the possibility of escalating retaliation, the result would be further forced adjustments to third-best alternative means of production, with consequent further higher costs of production and reduced standards of living. This hardly seems to be a course of action favorable to the interests of U.S. citizens.

But should the U.S. let Japan "get away" with favoring its domestic industries at the expense of U.S. producers? This question presupposes that there is only a set amount of production that can take place and that if Japanese producers "keep" more of theirs while attracting some of the U.S. output, there will be less production and employment in the United States. That supposition is totally without warrant. If Japan will subsidize shipments of goods to the United States, all the better for U.S. citizens. They can benefit from the lower cost of such goods, and U.S. producers can commit resources to the production of other things to satisfy other wants.

Strangling the Economy

The economics of international trade and trade restrictions described above are widely understood — we suspect even by the labor union leaders, businessmen, and politicians now pleading for protection. In spite of this, they can recommend protective policies because they are concerned about *their own* members (in the case of unions), profits (in the case of businessmen), and reelection (in the case of politicians with constituents who immediately might be harmed). These leaders desperately want their members to avoid the temporary hardship associated with industry and employees having to adjust to changing economic conditions. For example, those involved in the steel industry want to avoid the contraction in U.S. steel output that worldwide steel competition is forcing.

That such individuals seek protection is understandable, but from an economic viewpoint, to grant the protection they seek would be suicidal. Universal application of the policies these persons seek would straitjacket the economy at the current level of advance. It would guarantee that no further progress would occur in living standards, for progress requires change. The willingness and readiness of U.S. labor and businessmen to lead the way for progressive change seem to have vanished, as has the mirage of perpetual prosperity promised by Keynesians.

We submit that the danger to the economy in the years immediately ahead will come from increasing pleas for policies to protect first one special interest group and then another from the rigors of competition — both domestic and international. If these pleas are heeded, stagnation almost surely will be the result. The cost to society associated with the end of economic progress will be far greater than that cost of required adjustments to changing patterns of trade.

STATISTICAL INDICATORS

Among the primary leading indicators of business-cycle changes, the ratio of manufacturing and trade sales to inventories increased during October, and the 2 month moving average of this series increased for the first time since reaching an apparent cyclical peak 6 months earlier. Nevertheless, we continue to appraise this ratio as probably contracting cyclically. Thus, the percentage of primary leaders (for which a cyclical trend is evident) appraised as expanding cyclically remains 67.

Manufacturing and trade sales in constant dollars increased during October; nevertheless, its cyclical status remains indeterminate. All of the primary roughly coincident indicators except this series are expanding cyclically.

Manufacturing and trade inventories in constant dollars decreased slightly during October, but this series remains appraised as expanding cyclically. All of the primary lagging series are appraised as expanding cyclically.

That two-thirds of the primary leading indicators (for which a cyclical trend is evident) are appraised as expanding cyclically warrants the conclusion that general business activity probably will continue to expand during the next few months at least.

BUSINESS CONSTRUCTION

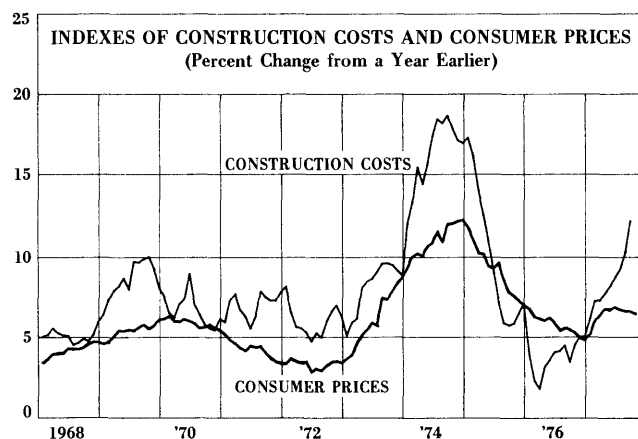
Note: All data are seasonally adjusted.

The current-dollar value of construction put in place during the 3 months ended with September was \$43.1 billion, according to the Department of Commerce. This amount was 0.5 percent more than that during the preceding 3 months and 19.4 percent more than that during the 3 months ended in September 1976.

The composite index of construction costs prepared by the Department of Commerce was 162.0 (1972=100) for September. This level was 3.7 percent more than that 3 months earlier and 12.1 percent more than that a year earlier. Chart 1 shows the percent change from a year earlier in this index and in the Consumer Price Index (CPI). As the chart reveals, during the latter months of 1976 and the early months of 1977, construction costs were increasing at about the same rate as that of the CPI. During recent months, however, construction costs have increased markedly, while the rate of increase in the broadly based CPI has changed little. The higher construction costs were primarily attributable to marked increases in the prices of lumber (especially plywood) and bricks.

The physical volume of construction activity can be estimated by dividing the current-dollar value of construction put in place by the index of construction costs. This

Chart 1

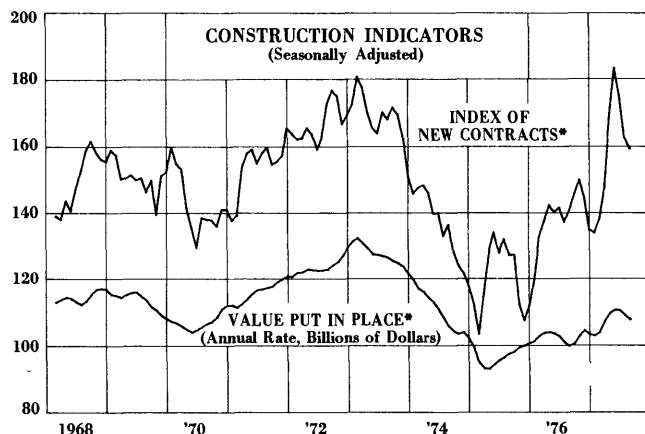


estimate is the constant-dollar value of construction put in place. During the 3 months ended with September, the physical volume of construction activity so estimated was 2.7 percent less than that during the preceding 3 months but 8.0 percent more than that a year earlier. The 3 month moving average of this series is shown in Chart 2. That this average has decreased during each of the most recent 3 months for which data are available raises some doubt about the continued cyclical expansion of the physical volume of construction activity. However, as the chart indicates, this series fluctuated considerably during 1976 and 1977, reflecting in part problems of seasonal adjustment. When the seasonal factors are revised on the basis of recent experience, the recent portion of the series might be as smooth as that during earlier years. Therefore, while some doubt regarding the continued expansion of this series now exists, there is not yet sufficient evidence to warrant the conclusion that the upward trend of this series has reversed.

The 3 month moving average of the index of new construction contracts (deflated by the index of construction costs) also is shown in Chart 2. In spite of erratic fluctuations, cyclical trends in this series seem to change in advance of changes in the value of construction put in place, and the index of new construction contracts may provide some indication of the near-future trend of construction activity. The new contracts series increased substantially during the first half of 1977, but it subsequently decreased during June, July, and August. This may have unfavorable implications for the near-future trend of construction activity.

The accompanying table shows the current-dollar value of construction put in place during the 3 months ended in September (at annual rates) for various categories of construction. Also shown for each category is the change in the physical volume (constant-dollar series) from the preceding and year-earlier 3 month periods. Most of the increase in the physical volume of construction activity since the cyclical trough of that series in mid-1975 has been attributable to increases in the construction of private residential buildings. As data in the table indicate, single-family houses comprise the largest portion of construction activity. During the 3 months ended in September, such activity was 2.2 percent less than the record volume reached during the 3 months ended in May but 19.5 percent more than the volume during the year-earlier 3 month period. Construction of new single-family houses recently accounted for about 32 percent of all construction activity.

Chart 2



* Three-month moving averages of constant-dollar series.

VALUE OF NEW CONSTRUCTION PUT IN PLACE (During 3 months ended with September)

	Amount*	Percent Change† From Preceding 3 Month Period	Year-Earlier 3 Month Period
Private			
One-family houses	\$54.8	-2.2	+19.5
Multi-family houses	10.6	-10.0	+28.1
New Housing	\$65.4	-3.5	+20.8
Other residential	14.3	-15.8	+28.4
Residential	\$79.8	-6.0	+22.1
Nonresidential bldgs.	29.3	+2.9	+2.2
Other private	24.4	-2.2	+1.8
Total Private	\$133.4	-3.4	+12.9
Public			
Public buildings	\$13.3	+2.8	-9.6
Highways and streets	9.4	-8.5	-6.7
Other public	16.2	+2.4	-1.1
Total Public	\$38.9	-0.3	-5.6
Total Construction	\$172.3	-2.7	+8.0

* In billions of current dollars, seasonally adjusted annual rates.

† Percent changes based on constant-dollar values.

Construction of private multi-family houses (apartments and condominiums) during the 3 months ended in September was 10.0 percent less than that during the preceding 3 month period but 28.1 percent more than that during the year-earlier 3 month period. These large percentage changes were attributable to moderate volume changes on a small volume base; the recent volume of multi-family house construction was about 65 percent less than that during 1973.

Private nonresidential construction, which includes office buildings, factories, and other structures used by businesses, increased slightly during the 3 months ended in September from the volumes during both the preceding and year-earlier 3 month periods. That such construction activity has remained near the trough volume of mid-1975 is the principal symptom of the widely reported "weakness" of business capital spending, inasmuch as capital outlays by business for equipment now are at near-record amounts.

The trend of public construction activity has been gradually downward since 1968. The construction of highways and streets, which comprised about one-third of total public construction activity during the 1960's, has decreased by about 50 percent (in constant dollars) during the past 5 years. The rate of construction of public buildings recently has been about one-third that of the record amount during 1973. The one area of public construction that has increased substantially since 1973 is construction of sewer systems. During recent months the rate of such construction was about twice that of 1973 and the volume of public sewer construction during 1977 probably will be another record high.

Recent increases in the index of construction costs and decreases in the index of new construction contracts have unfavorable implications for the near-future trend of construction activity.

PRICE OF GOLD

	1976 Dec. 23	1977 Dec. 15	Dec. 22
Final fixing in London	\$132.35	\$158.85	\$159.40

Research Reports is published weekly at Great Barrington, Massachusetts 01230 by American Institute for Economic Research, a nonprofit, scientific, educational, and charitable organization. Second class postage paid at Great Barrington, Massachusetts 01230. Sustaining membership: \$9 per quarter or \$35 per year.