FRBSF Weekly Letter

September 12, 1986

Ominous Trade Winds

Recurring deficits in the United States' trade with the rest of the world have generated pressure on the Administration and Congress to redress the imbalance. Trade disputes with the European Community, Canada, Japan and other nations have become commonplace, and Congress is awash in trade legislation that, if passed into law, could dramatically alter the "rules of the game" by which the U.S. conducts business with other nations. This *Letter* outlines major features of recent trade policy actions and analyzes the content, and potential economic consequences, of the major omnibus trade legislation pending in the Congress.

Background

Since 1982, the U.S. has incurred increasingly large deficits in its international trade accounts (see Chart). As yet, there is no sign of improvement despite the more than 25 percent decline in the trade-weighted value of the dollar over the past year and a half. Instead, the trade deficit in constant dollars has grown from $108 billion in 1985 to a record annualized level of $150 billion in the second quarter of 1986. Behind these burgeoning trade deficit numbers are workers and firms in the export and import-competing sectors that have lost jobs and sales to stiff foreign competition.

Continued deterioration of the U.S. trade position has distressed policymakers and put increasing pressure on the Administration to protect domestic industry from foreign competition. It has also put pressure on Congress to initiate and carry forward legislation designed to slow imports, raise exports, and reduce the trade deficit.

Within the past several months, the U.S. has increased protection of domestic industry through a variety of formal and informal measures. Some of the major actions include increased tariffs on shingles and shakes imported from Canada, an agreement that sets minimum prices on a variety of Japanese computer chip imports, and negotiation of "voluntary" limits to the import of machine tools and textiles.

Protectionist pressure is not confined to the Administration, however. Congress is presently considering dozens of bills dealing with various aspects of the international trade issue. Most recently, President Reagan vetoed — and the House of Representatives failed to overturn — a major textiles bill (1985 Textile and Apparel Trade Enforcement Act) that would have cut back textile imports from the major producing countries (South Korea, Taiwan and Hong Kong). The bill would also have held the growth of textile imports from most countries to one percent a year while explicitly relating import growth to the growth of the U.S. market.

HR4800

Even more sweeping and potentially important in its implications for U.S. trade policy is an omnibus trade bill (HR4800) that was overwhelmingly passed by the House in May despite strong opposition from the Reagan Administration.

The Trade and International Policy Reform Act of 1986 is 458 pages long and quite complex. Six committees in the House contributed various portions of this trade legislation. HR4800, if passed into law, would restrict Presidential discretion in trade matters, vastly broaden the definition of "unfair" trade practices, and could force negotiations with countries such as Japan and Taiwan to cut "excessive" trade surpluses with the U.S. Moreover, several of the bill's provisions apparently violate GATT (General Agreement on Tariffs and Trade) — the basic international trade agreement between the U.S. and most of its trading partners.

Present law (1974 Trade Act) permits the President to make the final determination as to whether a foreign trading practice is unfair and what, if any, retaliatory action is in the national interest. The Office of the United States Trade Representative (USTR) investigates complaints of unfair foreign trading practices and makes re-

commendations to the President. HR4800 would sharply curtail the President's discretionary power and expand the role of the USTR.

In particular, the bill would transfer authority to determine whether a foreign trading practice was unfair from the President to the USTR and require the President (1) to retaliate when the practice violates existing trade agreements (unless the USTR specifies that retaliation is not in the national interest), and (2) to offset fully the practices of foreign governments of subsidizing or otherwise favoring export industries through industrial or other policies (so-called "export targeting").

The President would also be required under HR4800 to negotiate with nations to reduce "excessive" bilateral trade surpluses — defined as bilateral exports to the U.S. exceeding bilateral nonpetroleum imports by 175 percent or more — arising from a "pattern of unjustifiable, unreasonable, and discriminatory policies or practices." Presidential action would again be required if the bilateral trade negotiations were not successful. This provision would presumably have immediate implications for U.S. trade with Japan, Taiwan, and others.

The omnibus trade bill also extends the present definition of an "unreasonable" trade practice to include denial of certain workers' rights, such as collective bargaining, stipulations of child labor laws, and health and safety standards. The President would be permitted to take retaliatory action against nations — which would presumably include a large number of developing and Soviet bloc countries — that do not conform to these international labor standards.

Present U.S. trade law — in conformity with GATT's "escape clause" — allows the President to impose tariffs or quotas on imports, or provide adjustment assistance, if the U.S. International Trade Commission (ITC) finds that a domestic industry is materially hurt by foreign imports even in the absence of unfair trade practices. HR4800 would transfer the authority to impose import restrictions in these "relief" cases from the President to the USTR, and would also remove Presidential discretion by requiring automatic consideration of trade adjustment assistance under expedited procedures if the ITC makes an injury ruling. Also, and apparently in conflict with GATT, the proposed legislation would allow emergency import relief before a final ITC injury ruling has been made if circumstances exist where a delay in relief would significantly impair its effectiveness.

Other major provisions in the bill would expand the types of foreign export subsidies and dumping subject to retaliation, change tariffs on more than sixty individual commodities, expand controls on U.S. exports of crude oil, and require the Treasury to calculate "competitive" exchange rates and to report regularly to Congress on progress toward achieving them. The trade bill also contains a wide variety of provisions concerning monetary reform, telecommunications markets, retraining and employing displaced workers, and foreign violations of intellectual property rights.

Economic costs

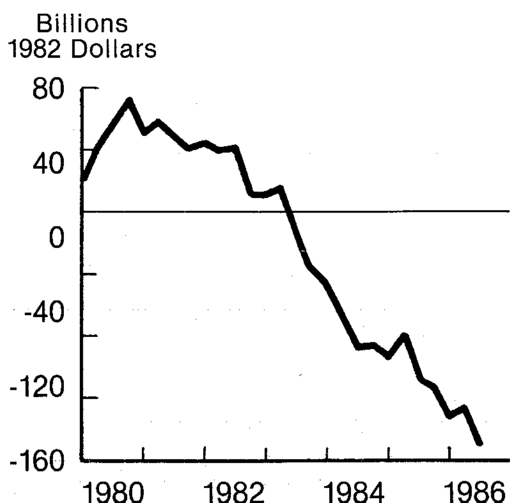
Recent trade actions and pending legislation in the Congress, if passed into law, could reduce trade deficits, at least initially. Higher tariffs, quotas, and "marketing agreements" designed to limit imports and raise exports, however, also could increase foreign retaliation and thereby reduce our exports. The resulting net effect on the trade balance would be ambiguous.

Are the measures then worth the cost? The consumer cost of trade restrictions is very high. Trade restrictions on clothing, sugar and automobiles alone forced consumers to spend between $14-20 billion more on these products in 1984, according to a recent study by the Federal Reserve Bank of New York. And the major increase in restrictions on imported steel products imposed less than two years ago is conservatively estimated to have cost U.S. consumers $2 billion in 1985 alone. The consumer cost of all existing trade restrictions combined with the restrictions that would be in force if HR4800 became law and were vigorously enforced could be enormous.

Other costs to society are more difficult to quantify but potentially even more important. Beyond raising costs to consumers and limiting consumer choice of products, increased protection of domestic industry from foreign competition also reduces incentives for U.S. firms to operate efficiently and hinders their long-run international competitive position.

Protectionist moves by the U.S. also run the risk of escalating retaliatory actions by other nations and closing off markets to U.S. exporters. Two

Real Net Exports or Imports(-) of Goods and Services



recent examples illustrate this danger. The European Community (EC) raised tariffs on U.S. citrus exports in response to the U.S. tariff on imported pasta last November. Similarly, Canada increased its "compensating duties" on certain U.S. published material, computer parts, and semiconductors in response to the 35 percent duty imposed by the U.S. on Canadian cedar shingles and shakes.

Escalating tensions of this nature threaten to undermine both the new round of GATT trade liberalization talks starting this month in Punta del Este, Uruguay, and negotiations presently underway to establish a "free-trade" area between Canada and the U.S. The provisions of HR4800 therefore could further undermine the environment for a liberal trading order and, at worse, ignite a major trade war.

Conclusion

A liberal trading order allowing largely unfettered trade among nations has some major economic advantages, including specialization in production by relatively low cost producers; greater competition among firms, which would generate long-term gains in efficiency and innovation; greater consumer choice; and lower prices. At times, a nation facing foreign competition must, however, endure large adjustment costs as firms and workers move to produce those products in which they have a comparative advantage. This adjustment is often painful, time-consuming, and may weigh on certain regions of the nation disproportionately. Nevertheless, our history with trade protectionism (e.g., the Smoot-Hawley legislation raising tariffs in 1930 caused immediate foreign retaliation, a massive reduction in international trade, and exacerbated the severity of the Great Depression) suggests that the longer term benefits of free trade far outweigh the costs.

The U.S. has actively pursued the benefits of free trade through successive GATT trade liberalization rounds for the greater part of the post-war period, but some current reactions to the successive string of unprecedentedly large U.S. trade deficits threaten these past efforts. They have put growing pressure on the Administration and the Congress to protect domestic industry from foreign competition.

Although politically expedient, the reduction of trade deficits through heightened import restrictions is clearly a "second best" solution to the trade problem. The rise in U.S. trade deficits since 1981 was not caused by increasing protectionist moves abroad that shut out U.S. exports. Rather, it was caused by the 1980-85 appreciation of the dollar in the foreign exchange markets and the more rapid growth of the U.S. economy than economies abroad.

Time delays between a change in exchange rate movements and improvements in the trade balance are long and variable. Nonetheless, virtually all economists and forecasters are predicting significant reductions in U.S. trade deficits in the months to come due both to the falling dollar and the slowdown in U.S. economic growth. If the U.S. could withstand political pressures, its trade balance and the competitive conditions facing U.S. firms should improve of their own accord.

Michael Hutchison

Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, or of the Board of Governors of the Federal Reserve System.

Editorial comments may be addressed to the editor (Gregory Tong) or to the author . . . . Free copies of Federal Reserve publications can be obtained from the Public Information Department, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 974-2246.

Research Department
Federal Reserve
Bank of
San Francisco

Alaska Arizona California Hawaii Idaho
Nevada Oregon Utah Washington

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 8/20/86	Change from 8/13/86	Change from 8/21/85 Dollar	Percent[7]
Loans, Leases and Investments[1] [2]	200,974	870	6,807	3.5
Loans and Leases[1] [6]	182,107	102	6,529	3.7
Commercial and Industrial	50,546	225	– 273	– 0.5
Real estate	67,361	23	2,995	4.6
Loans to Individuals	39,354	167	2,637	7.1
Leases	5,501	0	86	1.5
U.S. Treasury and Agency Securities[2]	11,161	782	– 383	– 3.3
Other Securities[2]	7,706	– 14	660	9.3
Total Deposits	204,871	– 582	7,931	4.0
Demand Deposits	51,193	– 576	5,423	11.8
Demand Deposits Adjusted[3]	46,763	–1,248	4,640	11.0
Other Transaction Balances[4]	16,824	6	3,172	23.2
Total Non-Transaction Balances[6]	136,854	– 13	– 663	– 0.4
Money Market Deposit Accounts—Total	42,182	–4,658	– 2,871	– 6.3
Time Deposits in Amounts of $100,000 or more	34,914	– 242	– 3,226	– 8.4
Other Liabilities for Borrowed Money[5]	23,135	– 522	– 173	– 0.7

Two Week Averages of Daily Figures	Period ended 8/11/86	Period ended 7/28/86
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	3,582	79
Borrowings	13	35
Net free reserves (+)/Net borrowed(–)	3,569	43

[1] Includes loss reserves, unearned income, excludes interbank loans
[2] Excludes trading account securities
[3] Excludes U.S. government and depository institution deposits and cash items
[4] ATS, NOW, Super NOW and savings accounts with telephone transfers
[5] Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
[6] Includes items not shown separately
[7] Annualized percent change