# International Trade and Finance

## Readings

## Third Edition

**Robert E. Baldwin**
**J. David Richardson**

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# Preface

As interdependence in the world economy continues to increase, the distinction between domestic and international economic issues becomes less and less meaningful. No longer can the typical business, labor, or political leader devote minimum attention to international trade and financial policy issues. There is, for example, scarcely a part of the country where profits and employment in some local industry have not been adversely affected in recent years by the high international value of the dollar. With increased international financial flows and greater product competition from foreign suppliers, businesspersons, labor leaders, and elected officials now must become familiar with such issues as the adequacy of the current exchange-rate systems, managing the debt problems of developing countries, and offsetting "unfair" foreign trade.

This book of readings deals with the above topics and other key monetary, commercial and investment issues that we face in the late 1980s, and with important analytical developments that help illuminate these problems. A selected list of topics is examined in detail rather than providing brief coverage of every issue arising in international economics. Although this approach necessitates the omission of some topics and causes some overlapping among the papers, the advantages of permitting readers to examine the views of different authors in some depth was thought to outweigh these costs. Textbooks must necessarily be brief on many topics; the purpose of a book of readings should be to delve more deeply into matters of special importance.

We selected a particular analytical or policy issue by asking ourselves whether there was wide or growing interest in it among trade economists. We then looked for papers by authors especially knowledgeable on the subject which were written in a straightforward, interesting style that could be easily understood by students, even those taking their first course in international economics. In the more controversial policy fields, we also tried to include papers that represented divergent views. Although we have had varying success in meeting these standards for each topic, we believe that the readings supplement the material covered in trade textbooks in a way that can enrich and enliven courses in international economics.

We have written introductions to each part in order to place the various selections in better perspective as well as to sometimes supplement, synthesize, or critique different viewpoints. Some of the material covered in these introductions may need to be updated because of the rapid pace of developments in international economics, but we are confident that students will benefit considerably from reading them. We have further tried to help students by providing an index (unlike most books of readings) and by including the bibliographical references listed by the various authors.

The readings are divided into ten parts with all but two of the thirty-four selections new to this edition. Part I consists of two papers that analyze the competitiveness of U.S. producers in international markets and consider the question of whether the United States is deindustrializing. The readings in Part II examine evidence on the costs and benefits of protection and various policies for facilitating adjustment in import-injured industries. A selection that compares various political-economic explanations of protection is also included. Part III deals with recent analytical work that explores how interventionist trade policies may increase a country's welfare if international markets are imperfectly competitive. In addition, the nature of industrial policy in Japan and other countries is discussed and evaluated. Part IV traces shifts in U.S. trade policy over the past forty years and then considers some of the new issues for negotiation in the next GATT-sponsored multilateral negotiating round as well as proposals for strengthening the existing set of international trading rules. Trade policies in the developing countries are analyzed in Part V, particularly the effectiveness of export-promoting versus import-substitution policies. Part VI concerns multinational corporations (MNCs). The selections indicate both how many countries that at one time were only hosts to such corporations are themselves now forming MNCs and how the bargaining relationships between these firms and governments have been changing. The important question, "Are current exchange-rate systems working?" is explored in Part VII in macroeconomic and microeconomic terms. Besides evaluating the systems, the authors of the various papers suggest ways to improve the operation of these systems. Part VIII addresses the issue of whether fundamental changes are needed in the international monetary order and presents selections with a wide range of opinion on this matter. The causes of the recent international debt crisis are examined in Part IX together with the actions taken to deal with the crisis. On this issue there is also a wide range of opinion, represented in the readings, about how well the crisis was handled and whether it is likely to emerge again. Part X concludes the readings with selections that describe the structural and institutional changes in international financial markets that are at the root of current problems with exchange-rate systems and international debt.

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# I

# Can America Compete? Is the United States Deindustrializing?

Is the United States deindustrializing and becoming a service economy? Is a major reason for the deindustrialization the increasing inability of American industries to compete in world manufacturing markets? The papers in Part I by Robert Z. Lawrence and Rachel McCulloch address these questions. If, as some have recently argued, the answer to the two questions is yes, important policy questions must be faced. Is it possible for the United States to continue to be a superpower with high and rising income levels if this country loses much of its industrial base because it is unable to compete effectively against other countries? If not, then is there not a need for major changes in government policies aimed at preventing continued decline in the manufacturing sector and at improving the competitive ability of U.S. industries in international markets?

By examining economic evidence from the 1970s and earlier, Lawrence argues that the United States is not deindustrializing, if what is meant by this term is an absolute decline in manufacturing employment or output. However, there has been a small decline in the share of total real output produced in the manufacturing sector between 1950 and 1980 (from 24.5 to 23.7 percent) and an appreciable drop in the employment share of this sector (from 35.9 to 22.4 percent) as productivity has grown rapidly. Still, recent U.S. growth in manufacturing compares favorably with that of other industrial countries. Between 1973 and 1980 the growth rate of U.S. manufacturing production was considerably above that of Germany, France, and the United Kingdom, although not as high as that of Japan. The comparison between the United States and other industrial countries in manufacturing employment is even more favorable for this period, since employment actually declined in Europe and Japan, whereas it increased in the United States.

Lawrence also finds that foreign trade was not an important deindustrializing force in the 1970s. Value added in the manufacturing sector increased by $2 billion between 1970 and 1980 due to the trade balance. Although for the entire decade there was a decline of 10,000 jobs attributable to foreign trade, trade increased job opportunities in manufacturing by nearly 400,000 from 1972 to 1980.

Lawrence then shows that the United States has been developing a comparative advantage in high technology and resource-intensive goods, while its comparative advantage in labor-intensive and capital-intensive products has been eroding. Foreign trade in the former categories of goods has been contributing to employment and output in the manufacturing sector, whereas trade in the latter two has tended to cause net job and output displacement.

McCulloch asks whether the massive trade deficits of 1984 and 1985 reflect a decline of U.S. industrial competitiveness and whether the many recent proposals aimed at improving industrial competitiveness by raising productivity, combatting unfair foreign trade practices, and promoting exports will in fact reduce the deficit. Her answer to both questions is negative. The deficit, she points out, is largely determined by macroeconomic conditions at home and abroad that have little to do with microeconomic policies aimed at improving the competitiveness of individual firms or industries.

Her point about macroeconomic conditions is based on the following equality that must hold between a country's aggregate investment and aggregate saving:

$$X - M + I = S - (T - G)$$

where $X - M$ is exports minus imports of goods or net U.S. investment abroad, $I$ is private domestic investment, $S$ is private saving, and $T - G$, taxes minus government expenditures, is public saving. As McCulloch says, the current trade deficits have their roots in the recent fall in saving brought about by the increase in federal government expenditures *(G)* relative to taxes *(T)*. Since private saving has not increased, the effect of the increased government deficit must be to crowd out or decrease either domestic investment or net U.S. investment abroad. The rise in interest rates that has occurred as the government has bid for funds to finance the federal deficit has not only tended to discourage private domestic investment but has led to a return of U.S. funds previously invested abroad and an inflow of new foreign funds. Consequently, the trade balance has turned significantly negative as the demand for dollars and thus the value of the dollar has increased sharply. Policies that increase exports or reduce imports in a particular industry will increase employment in that industry but also will reduce employment elsewhere as the higher value of the dollar due to the larger net demand for dollars either discourages exports or increases imports in other industries.

As McCulloch points out, however, this does not mean that measures to improve competitiveness are worthless. By raising productivity in export industries such measures increase our real gains from trade as they increase the volume of imported goods that can be obtained from a given collection of domestic resources devoted to export production. But this is quite a different matter from improving the balance of trade. The trade balance is determined by macro-

economic policies and the current microeconomic policies recommended as the means of improving U.S. competitiveness are doomed to failure if success is defined in terms of the U.S. trade balance.

# 1

# Changes in U.S. Industrial Structure: The Role of Global Forces, Secular Trends, and Transitory Cycles

*Robert Z. Lawrence*

## INTRODUCTION

For the first time in postwar history, employment in U.S. manufacturing has fallen for three consecutive years. The 10.4 percent decline in the number of workers in U.S. manufacturing from 1979 to 1982 is the largest since the wartime economy was demobilized between 1943 and 1946. The current slump is also unusual because international trade has made an important contribution: normally the volume of manufactured goods imports falls steeply in a recession — yet from 1980 to 1982, it rose by 8.3 percent; normally U.S. manufactured exports reflect growth in export markets abroad — yet despite a 5.3 percent rise in these markets from 1980 to 1982, the volume of U.S. manufactured exports dropped 17.5 percent.

Are these developments the predictable consequences of three years of demand restraint and a strong dollar, or do they result from deep-rooted structural changes?

There are widely held views that the recession has simply dramatized a secular decline in the U.S. industrial base. One of these views blames U.S.

This paper draws upon research undertaken for a . . . book . . . published by the Brookings Institution entitled *Can America Compete?* and upon a paper, "Is Trade Deindustrializing America? A Medium Term Perspective," *Brookings Papers on Economic Activity*, 1:1983. . . .

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producers for the trend. Americans fail to produce quality goods because managers are myopic and care only about short-term profits, workers lack discipline and are shackled by work rules, and labor and management look on one another as adversaries. Others blame the U.S. government. On the one hand are those who fault it for excessive interference — for restrictive regulatory practices which have raised production costs, for faulty tax rules which have discouraged investment, savings, and innovation, and for trade protection, which has slowed adjustment to international competition. On the other hand are those who blame government neglect. The U.S. has failed to plan and coordinate its industrial evolution. It ought to have policies to promote industries with potential and to assist those in decline. Finally, there is also the more fatalistic view of the decline in U.S. manufacturing as the inevitable result of the rapid international diffusion of U.S. technology.

While some argue that particular U.S. deficiencies have become worse over time, others point to changes in the environment which have made U.S. structural flaws increasingly costly. As long as competition was primarily domestic, U.S. weaknesses were obscured. As global trade expanded, however, U.S. firms were forced to meet foreign competitors staffed with superior workforces and managers and backed by superior government policies.

Even before the recession and the recent decline in the U.S. manufactured goods trade balance, the erosion of the U.S. international competitiveness had become a national obsession. As an award-winning article in *Business Week* observed in 1980, "U.S. industry's loss of competitiveness has been nothing short of an economic disaster."

The perceived effect of international competition has now grown to the point that it is frequently cited as the major source of structural change in the U.S. economy and the primary reason for the declining share of manufacturing in U.S. employment. This shift of U.S. production away from manufacturing is viewed with some alarm, both because manufacturing activity is considered intrinsically desirable and because of the adjustment costs associated with the shift. In addition, some argue that this decline in comparative advantage does not result from an inevitable process of technological diffusion or from changes in factors of production, but rather from the industrial and trade policies adopted by other nations. Without similar policies, some contend that the United States will eventually become an economy specialized in farm products and services — "a nation of hamburger stands."

Yet, while the role of the deficiencies in U.S. policies and practices in retarding U.S. productivity growth over the past decade remains unresolved, the links between these deficiencies, U.S. trade performance and shifts in our economic structure have not been convincingly demonstrated. . . .

Given the radical changes in the world economy after 1973, the period from 1973 to 1980 is the most relevant sample for current policy discussions. The data for this period measure performance in the new international environment that is marked by stagnation, volatile exchange rates, and increasing government

intervention in trade; and it is during this period, it is alleged, that foreign industrial policies have damaged the U.S. manufacturing base. The data for this period also allow a comparison of U.S. industrial performance with those of other major industrial countries in a period in which comparative performance is less heavily influenced by relative stages of development.

Observations for the 1973–80 period, however, may be unduly influenced by the different cyclical positions prevailing in the end point years. Because capacity utilization in manufacturing was similar in 1970 and 1980, U.S. data for the entire decade are used to provide a second, cyclically neutral, measure of structural changes.[1] Observations for 1970–80 are still influenced by changes in the real exchange rate of the dollar in these years. As measured by the International Monetary Fund, relative U.S. export prices for manufactured goods were 13.5 percent lower in 1980 than in 1970. In evaluating the results, therefore, it should be kept in mind that the U.S. trade performance during the 1970s depended in part upon this price-adjustment process.

In this paper I analyze the changing role of manufacturing in the U.S. economy and structural change within U.S. manufacturing. . . .

## THE MYTH OF U.S. DEINDUSTRIALIZATION

The contention that declining U.S. international competitiveness has induced the deindustrialization of America is wrong on two counts. First, in the most relevant sense, the United States has not been undergoing a process of deindustrialization; and second, over the period 1973 to 1980, the net impact of international competition on the overall size of the U.S. manufacturing sector has been small and positive.

The term "deindustrialization" requires further elaboration for precise communication. First, what is industry? Does it, for example, include the construction and mining sectors or refer more narrowly, as we will interpret it here (partly for reasons of data availability), to the manufacturing sector alone? Second, does "deindustrialization" refer to a drop in the *output* of industry, or to the *inputs* (e.g., capital and/or labor) devoted to industry? And third, does "deindustrialization" refer to an *absolute* decline in the volume of output from (or inputs to) manufacturing, or simply a *relative* decline in the growth of manufacturing outputs or inputs as compared to outputs or inputs in the rest of the economy?

Since industrial policy is generally concerned with facilitating adjustment, absolute deindustrialization with respect to factors of production would probably be the definition appropriate to current policy concerns about the manufacturing sector as a whole. While a declining *share* of output or employment could change the relative power of industrial workers, or the character of a society, an absolute decline in industrial employment entails much greater adjustment difficulties. Absolute deindustrialization at rates in excess of normal voluntary quits by workers and depreciation of capital requires the reallocation of workers and capital to alternative sectors in the economy with all of the attendant costs

TABLE 1

Share and Size of U.S. Manufacturing Sector

| | TOTAL | | | | | | SHARES | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | GNP (1) | IPMAN (2) | EMP (3) | EMP-MAN (4) | NCAP (5) | NCAP-MAN (6) | Real output | Employment | Capital | Expenditure* |
| 1950 | 535 | 131 | 42.50 | 15.24 | n.a. | n.a. | 24.5 | 35.9 | n.a. | 29.2 |
| 1960 | 737 | 172 | 54.19 | 16.80 | 543.2 | 104.4 | 23.3 | 31.0 | 25.8 | 28.4 |
| 1965 | 939 | 237 | 60.77 | 18.06 | 662.9 | 158.1 | 25.5 | 29.7 | 23.8 | 28.6 |
| 1970 | 1086 | 261 | 70.88 | 19.37 | 860.1 | 202.2 | 24.0 | 27.3 | 23.5 | 25.4 |
| 1973 | 1255 | 325 | 76.79 | 20.15 | 971.1 | 215.3 | 25.9 | 26.2 | 22.2 | 24.5 |
| 1975 | 1232 | 290 | 76.94 | 18.32 | 1033.7 | 232.7 | 23.5 | 23.8 | 22.5 | 23.1 |
| 1979 | 1479 | 367 | 89.82 | 21.04 | 1184.6 | 275.1 | 24.8 | 23.4 | 23.2 | 23.3 |
| 1980 | 1474 | 351 | 90.56 | 20.3 | 1226.3 | 293.6 | 23.7 | 22.4 | 23.9 | 22.1 |
| 1981 | 1503 | 359 | 91.54 | 20.2 | 1268.5 | 311.8 | 23.7 | 22.1 | 24.6 | 21.9 |
| 1982 | 1477 | 338 | 89.62 | 18.9 | n.a. | n.a. | 22.9 | 21.1 | n.a. | 20.7 |

GNP = GNP (in billions of 1972 dollars)

IPMAN = Value added in manufacturing (in billions of 1972 dollars)

EMP = Employees in nonagricultural payrolls (in millions)

EMPMAN = Employees in nonagricultural payrolls, manufacturing (in millions)

NCAP = Net fixed nonresidential business capital (in billions of 1972 dollars)

NCAPMAN = Net fixed nonresidential business capital in manufacturing (in billions of 1972 dollars)

* = Ratio of GNP to value-added in manufacturing in current dollars

*Sources:* National Income Accounts: Bureau of Economic Analysis; *Employment and Earnings*, Bureau of Labor Statistics (March 1972); *Statistical Abstract of the United States*, 1981, U.S. Department of Census, 1981, p. 562; and *Survey of Current Business*, October 1982.

associated with such dislocations. Relative deindustrialization, on the other hand, is far less costly to accomplish, for it may entail simply devoting less resources to manufacturing in the future.[2]

As indicated in Table 1, these distinctions are relevant for characterizing U.S. deindustrialization:

Measured by the size of its manufacturing labor force, capital stock and output growth, the U.S. has not experienced absolute deindustrialization over either 1950–73 or 1973–80. Employment in U.S. manufacturing increased from 15.2 million in 1950 to 16.8 million in 1960, 19.4 million in 1970, 20.1 million in 1973 and 20.3 million in 1980.[3] The capital stock in manufacturing grew at an annual rate of 3.3 percent from 1960 to 1973, and 4.5 percent between 1973 and 1980. And output in manufacturing increased at a 3.9 percent annual rate between 1960 and 1973, and a 1.1 percent annual rate from 1973 to 1980.

Judged by the output share of goods, the United States was virtually no more a service economy in 1980 than it was in 1960. In 1960, 1973, and 1980 the ratio of goods to GNP measured in 1972 dollars was 45.6, 45.6, and 45.3 percent, respectively. Similarly, the ratio of value added to manufacturing (in 1972 dollars) was actually somewhat higher in 1973 than it was in 1950. Nonetheless, from 1950 to 1973, the *shares* of expenditure, employment, capital stock, and R&D devoted to the manufacturing sector declined. Factors on both the demand and the supply side account for manufacturing's diminishing share. As incomes have risen, Americans have allocated increasing shares of their budgets to items in the service sector such as government services, education, medical care, finance, and real estate services. At the same time, productivity in manufacturing has increased more rapidly than elsewhere in the economy. Although the more rapid growth in manufacturing productivity has resulted in slower increases in manufacturing prices, the demand stimulated by the relative decline of manufacturing goods prices has not been sufficient to offset the fall in the share of resources devoted to value added in manufacturing. As a result, overall real industrial output has risen about as rapidly as GNP, but the share of employment and capital in manufactured goods has declined.[4]

From 1973 to 1982, there was a marked acceleration in the rate at which the share of manufacturing in output and employment has declined. But this should have been expected, given the slow overall growth in GNP and the fact that labor productivity growth (output per man-hour) fell less in manufacturing than in the rest of the economy. (See Table 2.) The demand for manufacturing output is particularly sensitive to fluctuations in income. The demand for goods, particularly durables, is inherently more sensitive to short-run income fluctuations than the demand for services because many such purchases can be easily postponed. In slack periods the demand for consumer durables and plant and equipment products slumps, while during booms consumers allocate much of the transitory increases in their incomes to the purchase of consumer durables and housing, while producers invest in plant and equipment. Thus the generally slow growth in U.S. GNP from 1973 to 1980 was reflected in disproportionately slow growth in the manufacturing sector.

The relationship between the growth of manufacturing and the overall growth of the economy can be summarized statistically by regressing industrial production on GNP. Such an equation confirms that industrial performance is a magnification of that of the overall economy. If GNP grows at 1.7 percent per year, there will be no increase in manufacturing production. However, for each percentage point increase (decrease) of GNP growth above 1.7 percent, manufacturing output will rise (fall) by 2.2 percentage points. As indicated below, when an equation such as this, fitted using data from 1960 to 1973, is used to forecast industrial production for the period 1973 to 1982 given actual GNP, it does so with remarkable accuracy. Thus, there is no puzzle in explaining aggregate manufacturing production: It is almost exactly what one should have expected given the performance of the total economy. . . .

TABLE 2

Bureau of Labor Statistics Estimates of Average Annual Rates of Growth in Output per Hour, the Contribution of Capital Services per Hour and Multifactor Productivity 1968 to 1980*

| Private nonfarm business | (1) 1968 to 1973 | (2) 1973 to 1980 | (3) Slowdown (1)–(2) |
|---|---|---|---|
| Output per hour | 2.5 | 0.5 | −2.0 |
| Minus: Contribution on capital services per hour† | 0.8 | 0.5 | −0.3 |
| Equals: Multifactor productivity‡ | 1.7 | 0 | −1.7 |
| Manufacturing: Output per hour of all persons | 2.9 | 1.3 | −1.6 |
| Minus: Contribution of capital services† | 0.7 | 1.0 | +0.3 |
| Equals: Multifactor productivity‡ | 2.2 | 0.3 | −1.9 |

*Average annual rates leased on compound rate formula.

†Change in capital per unit of labor weighted by capital share of total output.

‡Output per unit of combined labor and capital input.

*Source:* United States Bureau of Labor Statistics USDL-83-153

## THE MYTH OF INFERIOR U.S. INTERNATIONAL COMPARATIVE PERFORMANCE

A comparison of the performance of U.S. manufacturing with that of other major industrial countries should be useful for separating the problems that are shared by other countries, and are therefore reflective of broader global forces, from those unique to the United States. A comparison might also assist in gauging comparative U.S. strengths and weaknesses. Proponents of a radical change in industrial policies contrast the ad hoc and laissez-faire policies of the United States with the systematic, interventionist practices abroad. While conceding that there are marked differences in the degree to which foreign practices have succeeded, they argue that the conscious policy of managing the decline of older industries and the rise of new industries has been superior to the U.S. approach, which has been marked by malign neglect. Similarly, the broader provision of social services in European economies, the more extensive rights to their jobs enjoyed by workers, and the greater restrictions on plant closings have all been held up as worthy of emulation. On the other hand, opponents of such policies argue that they will delay adjustment, for the government is most likely to be captured by forces seeking to preserve the status quo, and strictures on mobility are likely to retard adaptation.

It is particularly important that international comparisons be made on the basis of performance since 1973, for policies that enjoyed success in an environment of strong global growth and economic expansion might not be appropriate for the current era of stagnation.