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In Defense of Cheap Imports

Advocates of protectionism assert that trade restrictions are needed to protect U.S. businesses and jobs against "cheap" imports and to force foreigners to open their markets to U.S. goods. However, such policies deny consumers the opportunity to choose from the largest selection of items at the lowest available prices, and they encourage scarce resources to be channeled to less productive uses. The result is that a favored few are "protected" at the expense of everyone else.

Although it has been said that if you placed all the economists in the world end to end they would not reach a conclusion, most economists agree that free trade is a good thing. The academic argument they usually make in support of free trade involves "comparative advantage" — the notion that countries mutually benefit by trading, even if one country is absolutely more efficient than the other at producing everything, because trade enables each country to specialize in producing the things it is relatively more efficient at making. This notion is not intuitive, however, and although it can be clarified with examples (and the gains to hypothetical traders can even be demonstrated mathematically), it generally fails to convince skeptical people of the benefits of trade.

Trade is Voluntary

There is another argument in defense of free trade that is easier to grasp. It is simply this: Free trade is voluntary trade. It represents voluntary transactions between buyers and sellers of goods and services. Buyers and sellers *both* benefit from these transactions — otherwise they would not engage in them. No one forces consumers to buy imports. In contrast, when governments restrict foreign trade, they keep consumers from buying cheaper products and, more generally, prevent them from doing what they want to do.

Critics of free trade overlook, or forget, the voluntary nature of trade. They tend to portray it as something which benefits foreigners at the expense of Americans, and they argue that special policies are needed to "protect" Americans against an "invasion" of cheap imports. Henry George, one of the most eloquent defenders of free trade, pointed out the fallacy of this argument a hundred years ago in *Protection or Free Trade*:

> ...[T]rade, from which "protection" essays to preserve and defend us, is not, like flood, earthquake, or tornado, something that comes without human agency. Trade implies human action. There can be no need of preserving from or defending against trade, unless there are men who want to trade and try to trade. Who, then, are the men against whose efforts to trade "protection" preserves and defends us?
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> If I had been asked this question before I had come to think over the matter for myself, I should have said that the men against whom "protection" defends us are foreign producers who wish to sell their goods in our home markets. This is the assumption that runs through all protectionist arguments — the assumption that foreigners are constantly trying to force their products upon us, and that a protective tariff is a means for defending ourselves against what *they* want to do.
>
> Yet a moment's thought will show that no effort of foreigners to sell us their products could of itself make a tariff necessary. For the desire of one party, however strong it may be, cannot of itself bring about trade. To every trade their must be two parties who mutually desire to trade, and whose actions are reciprocal. No one can buy unless he can find some one willing to sell; and no one can sell unless there is some other one willing to buy. If Americans did not want to buy foreign goods, foreign goods could not be sold here even if there were no tariff. The efficient cause of the trade which our tariff aims to prevent is the desire of Americans to buy foreign goods, not the desire of foreign producers to sell them. Thus protection really prevents what the "protected" themselves want to do. It is not from foreigners that protection preserves us and defends us; it is from ourselves.[1]

In other words, protectionist policies restrict the freedom of people to buy and sell what they want to buy and sell. By doing so, they force both parties to forego gains.

Who Pays for "Protection"?

Protectionists also tend to argue that foreign producers, rather than American consumers, bear the cost of tariffs and other trade barriers. However, for a tariff to succeed in the goal of discouraging imports and encouraging domestic production, it must raise the price of the protected product by an amount sufficient to enable less efficient U.S. producers to make a profit. This increase in price is paid by the buyer. Moreover, the total cost of a tariff is more than the tariff revenue collected by the Government on foreign-made products. It also includes the higher prices paid by consumers for domestically-produced items. Thus, although foreign producers may be hurt by reduced sales, consumers pay the largest price for "protection."

If this is so, why does popular sentiment so often side with protectionists? Probably because the costs of trade restrictions are hidden in the prices of products and usually are spread among many people, who individually may pay only a few cents or dollars more for products. In contrast, the benefits of trade restrictions are more visible and concentrated among a relatively small number of industries. These favored few have a strong self-interest in emphasizing to politicians and the public the gains to their workers from protection against "unfair" foreign competition.

These jobs are not unimportant. But it is important to realize that in a dynamic economy, some jobs are always being lost, not only to foreign competitors but to domestic competitors, new technology and

[1] Henry George, *Protection or Free Trade* (New York: Robert Schalkenbach Foundation, 1944), pp. 45-46.

changes in consumer tastes. When the government tries to "preserve" these jobs, the effect is to raise prices and limit choices. In effect, the majority are forced to work harder to satisfy their wants, in order to keep a minority employed in selected, relatively inefficient, industries. The result is that the standard of living is lower than it otherwise would be.

As Milton Friedman wrote, "Employment is a means to an end. It is a means to the production of goods and service that we can enjoy. Full employment is an empty objective if it means employment at unproductive jobs, digging holes for others to fill. The true goal is widely shared *productive* employment, and again, the more output we can get from a given amount of work, the better."[2]

The only way to increase the nation's standard of living is to use resources more efficiently, not less. In the case of trade, a lower price for a foreign-made good indicates that it is more efficient to obtain the good by importing it than by making it at home. This frees society's resources to produce other useful things. In contrast, keeping people employed in less productive jobs encourages the second-best use of resources.

But What About Dumping?

A common argument is that free trade is fine but only if foreign countries do not give their industries an "unfair" advantage by giving them tax breaks and other subsidies that enable them to "dump" their goods here at lower prices. However, if foreign authorities want to subsidize their export industries, they hurt their own citizens (who finance the subsidies), not us. From the standpoint of the United States, it does not matter why the foreign goods are cheaper than comparable domestically-made goods. As long as it costs us less to import something than to make it, foreign trade works to our advantage.

A related argument is that the United States should trade only with countries that do not impose restrictions on our exports, and that we should use the threat of tariffs to force other countries to open up their markets to U.S.-made products. Aside from the possibility that any such effort might encourage retaliation, the result would be to make it more costly for Americans to obtain goods. Higher trade barriers would hurt foreigners, but they would hurt American consumers even more, by limiting their choices and forcing them to pay higher prices. As Henry George wrote, "for any nation to restrict the freedom of its own citizens to trade, because other nations so restrict the freedom of their citizens, is a policy of the 'biting off one's nose to spite one's face' order."[3]

Foreign Investment

Related to the concern that foreigners do not buy "enough" of our products is the notion that a trade deficit is a bad thing. Critics assert that our trade deficit with, say, Japan is evidence that Americans are sending dollars abroad to buy Japanese goods and the Japanese are "keeping our money" instead of using it buy U.S. goods.

But dollars have no value to the Japanese and other foreigners unless they do one of two things with them: buy U.S. goods and services, or invest in U.S. assets, real or financial. If we run a current-account deficit (*i.e.*, if the value of the goods and services we export to foreigners is less than what we import), this deficit is matched by a capital-account surplus, or a net inflow of investment capital.

In 1994, for example, Americans paid $954 billion to foreigners for imports. We gave them another $36 billion in gifts and government grants for which nothing tangible was received in return. From this total of $990 billion, foreigners used $839 billion to buy U.S. exports. The difference, $151 billion, was the current-account deficit.

Foreigners invested $291 billion in the United States in 1994, while Americans invested $126 billion in foreign assets. The difference, $165 billion, was the net inflow of capital into the United States. Theoretically, this capital-account surplus should exactly equal the current account deficit; in practice the two figures usually do not match, and the resulting discrepancy ($14 billion in 1994) is attributed to the statistical difficulties of estimating the value of millions of international transactions.

Some argue that this capital inflow is evidence of economic decline, that it shows that the United States is "for sale" and foreigners are "buying it up" at bargain prices. The magnitude of these investments often is exaggerated, however. From 1980 through 1994, foreign ownership of U.S. assets increased from $394 billion to $2.5 trillion. The total value of private U.S. assets increased from $11.7 trillion to $23.3 trillion during the same period and foreign holdings amounted to under 11 percent of total domestic wealth in 1994. In addition, American ownership of foreign assets increased during this period from $673 billion to $1.6 trillion.[4]

Presumably, these investments were made by willing parties, and those who sold assets in return for foreigners' dollars received what they considered to be fair prices. Government restrictions on the ability of foreigners to invest in the United States would simply shrink the pool of potential investors available to bid on U.S. assets, and force sellers to settle for the lower bids of domestic investors. As for foreigners buying up U.S. assets at "bargain" prices — well, try telling this to the Japanese, who have lost their shirts (in terms of yen) on U.S. Treasuries and even more (in terms of dollars) on U.S. real estate, notably on Rockefeller center.

In an ideal world, capital would flow from the United States and other developed countries to less developed countries where, by definition, the potential returns to investments are great. Such a capital outflow would be offset by a current-account surplus. That we instead have a current-account deficit and a capital-account surplus mainly reflects conditions in the rest of the world. These include not only foreign restrictions on U.S. exports but foreign impediments to capital inflows, including capital controls, political instability and insecure property rights.

American policies should encourage foreigners to open up their markets and strengthen personal and property rights, but they should not do so by erecting barriers to foreign trade and investment. This would increase government restrictions on individuals' freedom to buy, sell, invest, employ, and work as they choose. Such interference would hurt foreigners but it would hurt Americans more.

Who Decides?

Aside from the costs of protectionist policies in terms of lost freedom and a lower standard of living, there is the question of which industries deserve to be protected from market forces. Practically speaking, government officials will decide, largely on the basis of information supplied by those who hope to benefit from special treatment. As Henry George observed, "to introduce a tariff bill into a congress or parliament is like throwing a banana into a cage of monkeys. No sooner is it proposed to protect one industry than all the other industries that are capable of protection begin to screech and scramble for it."[5] George predicted the likely outcome:

> The making of a tariff, instead of being, as the protective theory requires,

[2] Milton Friedman, *Bright Promises, Dismal Performance* (New York: Harcourt Brace Jovanovich, 1983) pp. 362-363.

[3] George, p. 151.

[4] These estimates, from the Federal Reserve, include tangible assets and public sector debt in the totals for Private U.S. assets, while the international holdings count financial claims other than equities.

[5] George, p. 168.

> a careful consideration of the circumstances and needs of each industry, is in practice simply a great "grab" in which the retained advocates of selfish interests bully and beg, bribe and logroll, in the endeavor to get the largest possible protection for themselves without regard for other interests or for the general good. The result is, and always must be, the enactment of a tariff which resembles the theoretical protectionist's idea of what a protective tariff should be about as closely as a bucketful of paint thrown against a wall resembles the fresco of a Raphael.[6]

It is far preferable to allow markets, rather than political forces, to determine how labor and capital are used. The market signals of prices, profitability, and wages represent the preferences of millions rather than a select few. By overriding market signals, protectionist policies encourage resources to be channeled to less productive uses. They stifle the changes in employment and production that are unavoidable in a dynamic economy, and that are essential to a rising standard of living. In short, they protect a favored few at the expense of everyone else. ❑

[6] George, p. 92.

BUSINESS-CYCLE CONDITIONS

The economic outlook improved slightly this month, but not enough to relieve concerns about the next recession. Both the percentage of leading indicators expanding and AIER's cyclical score are at or close to the point where a recession is just as likely to occur as continued expansion.

Among our 12 primary leading indicators, *contracts and orders for plant and equipment* and the *index of common stock prices* reached new all-time highs (these two series, and all other dollar-denominated series, are reported in constant dollars). Both are appraised as clearly expanding. The *M2 money supply* (revised back to 1959) increased in January and is the only other leading indicator with a clearly expanding trend.

The M2 series has been revised, to incorporate updated benchmarks and seasonal factors and a slight change in its definition, as two minor bank liabilities, overnight wholesale repurchases and overnight eurodollars, were removed from the calculation of M2. According to the Federal Reserve, these relatively small components of M2 are difficult to measure accurately and are quite volatile. Both of these components, however, still are included in M3, a broader measure of the money supply. The revisions to M2 lowered its level for all years after 1969.

Both the base data and the moving average of the *index of new housing permits* decreased this month, but the series remains appraised as probably expanding. After a significant (presumably weather-related) decrease in January, the base data for the *average workweek in manufacturing* rebounded to 41.6 hours. Its 3-month moving average also increased slightly, but it is well below its high and the January low will keep it there through next month, at least. Two more months' worth of data are required before the drop in January is not calculated into the most recent moving average figure. Nevertheless, the slight increase this month and the strong possibility of a rebound during the months ahead is sufficient to warrant changing the series' cyclical status from probably contracting to indeterminate.

The latest batch of data for *initial claims for state unemployment insurance* (inverted) and *new orders for consumer goods* did not reveal any identifiable trends. The cyclical statuses for both of these series remain indeterminate. Again due to a lack of timely data, the cyclical status of the *ratio of manufacturing and trade sales to inventories* remains indeterminate. The latest data for this series is for last September, as the Department of Commerce is still "catching up" from last year's shutdown of the Federal Government.

After 5 monthly decreases, the moving average of the 3-month *change in consumer installment debt* rose to 2.82 percent. However, it still appears that consumers are taking on installment debt (comprised mostly of credit-card debt and automobile debt) at slower rates than they were in the past several months. The series remains appraised as probably contracting.

Both the *change in sensitive materials prices* and the *M1 money supply* decreased again and remain appraised as clearly contracting. *Vendor performance* (the percentage of purchasing managers reporting

Statistical Indicators of Business-Cycle Changes

Change in Base Data					*Cyclical Status*		
Nov.	*Dec.*	*Jan.*	*Feb.*	***Primary Leading Indicators***	*Jan.*	*Feb.*	*Mar.*
-	-	-		M1 money supply	-	-	-
+	+	+		M2 money supply	+	+	+
+	+			Change in sensitive materials prices	-	-	-
-	nc	+		New orders for consumer goods	+?	?	?
+	+	+		Contracts and orders for plant and equipment	+	?	+
+	+	-		Index of new housing permits	?	+?	+?
				Ratio of manufacturing and trade sales to inventories	-?	?	?
-	+	-		Vendor performance	-	-	-
+	+	-		Index of common stock prices (constant purchasing power)	+	+	+
nc	-	-	+	Average workweek in manufacturing	?	-?	?
-	+	-		Initial claims for unemployment insurance (inverted)	?	?	?
-	+	-		Change in consumer installment debt	-?	-?	-?
				Percentage expanding cyclically	44	38	50
				Primary Roughly Coincident Indicators			
+	+	-	+	Nonagricultural employment	+	+	+
+	+	-		Index of industrial production	+	+	+?
+	+	-		Personal income in manufacturing	?	-?	-?
+				Manufacturing and trade sales	+	?	?
-	-	+	+	Civilian employment to population ratio	?	-?	?
+	+			Gross domestic product (quarterly)	+	+	+
				Percentage expanding cyclically	100	60	75
				Primary Lagging Indicators			
-	+	+	-	Average duration of unemployment (inverted)	+?	+	+
				Manufacturing and trade inventories	+	?	?
-	+			Commercial and industrial loans	+	+	+
+	+	+		Ratio of consumer installment debt to personal income	+	+	+
+				Change in labor cost per unit of output, manufacturing	+?	?	?
-	-	-	-	Composite of short-term interest rates	-	-	-
nc No change.	r Revised.			*Percentage expanding cyclically*	83	75	75

Under "Change in Base Data," plus and minus signs indicate increases and decreases from the previous month or quarter and blank spaces indicate data not yet available. Under "Cyclical Status," plus and minus signs indicate expansions or contractions of each series as currently appraised; question marks indicate doubtful status when shown with another sign and indeterminate status when standing alone.

Net Job Growth in February
(in thousands)

	1996	*1995*	*1994*	*1993*	*1992*	*Average (1992-1995)*
Goods-Producing	153	31	48	101	-43	34
Mining	6	-2	-3	-8	-4	-4
Construction	121	12	26	89	-25	26
Manufacturing	26	21	25	20	-14	13
Durable goods	18	26	14	11	-1	13
Nondurable goods	8	-5	11	9	-13	1
Service-Producing	552	282	227	261	40	203
Transportation & public utilities	16	27	25	18	4	19
Wholesale trade	16	24	16	-5	-6	7
Retail trade	166	34	84	111	35	66
Finance, Insurance & Real Estate	25	2	17	9	2	8
Other services*	287	176	82	113	15	97
Government	42	19	3	15	-10	7

* Includes health and business services. Source: BLS

slower deliveries from their suppliers) increased slightly this month, but it remains appraised as clearly contracting.

Overall, 50 percent (4 out of 8) of the leading indicators with an apparent cyclical trend are expanding. This improvement from last month's 38 percent expanding is not sufficient to conclude that a recession is now unlikely to occur soon. At 50 percent, a recession is statistically about as likely to occur as not. The cyclical score, AIER's unique measure of the leading indicators, rose slightly above 50 to 51. Last month we reported that the cyclical score finally dipped below 50. Since then, three of the leading indicators have been updated and revised. Unlike the percentage of leaders expanding, the cyclical score incorporates all the most current revisions to the data. The revised score shows that last month and the month before, the cyclical score was at 50 — also the point where a recession is just as likely as continued expansion — and never fell below it.

Both of these diffusion indexes indicate that the economy is still on shaky ground. Although the popular press, which usually puts more emphasis on the latest data observation instead of overall trends in the data, seems fairly confident that a recession has been successfully avoided, our methods suggest that this confidence is not warranted. Our indicators, far from showing certain continued expansion, show an economy with the potential to dip into a recession.

Among the six primary roughly coincident indicators, both *nonagricultural employment* and *gross domestic product* reached new highs and are appraised as clearly expanding. The net increase of 705,000 jobs in February more than compensated for the 188,000 net loss of jobs in January. However, it is likely that this atypically large increase in February was due in part to the seasonal adjustments to the data, which can overstate February's employment growth.

The table above breaks out February's employment data and compares it to data for the past 4 years of the current expansion. The table indicates how dramatic the latest employment figures were, especially in the sectors that do not typically do well this time of year, such as construction and retail trade. The average February job growth for the construction industry was 26,000 jobs in previous years — compared with this February's 121,000 new jobs. Retail trade also reported a surprising 166,000 new jobs —compared with the average 66,000 new jobs.

Overall, both the goods-producing and the service-producing sectors reported much higher job creation this February then they did at this time in past years. It is hard to estimate how much of this is due to economists tinkering with the numbers, but there are many grounds to suspect that February's favorable report has as much or more to do with statistical technique than what is happening in the labor market.

After leveling off somewhat in 1995, the *index of industrial production* decreased 0.7 points in January to 121.9. Its status was downgraded from clearly expanding to probably expanding.

A two-month increase in the base data and a one-month increase in the moving average of the *ratio of civilian employment to population* were sufficient to upgrade its cyclical status to indeterminate from probably contracting. The status of *manufacturing and trade sales* (for which no data are available after last September) also is indeterminate.

The only coincident indicator that appears to be contracting at this time is *personal income in manufacturing*. After remaining "flat" for several months, annualized personal income fell $3.3 billion to $416.9 and remains appraised as probably contracting. Overall, 75 percent (3 out of 4) of the coinciders for which a trend is evident are expanding.

Among the primary lagging indicators, the *ratio of consumer installment debt to personal income* reached another new high, as did *commercial and industrial loans*. After last month's new high, the *average duration of unemployment* (inverted) decreased slightly to 16.3 weeks, but this decrease was not enough to alter the series' cyclical status. All three series are clearly expanding.

The cyclical status of the *change in labor cost per unit of manufacturing output*, which was revised back to 1947, remains indeterminate as does the cyclical status of *manufacturing and trade inventories* (again, the latter has not been updated since September).

The *composite of short-term interest rates*, the only lagger with a clear contracting trend, decreased again this month to 5.18 percent from 5.44 percent. Overall, 75 percent (3 out of 4) of the lagging indicators for which a trend is evident are expanding — the same as last month.

Most of the available evidence suggests slow economic growth in the months ahead, which may develop into an outright recession. But, despite the weak economic data, the stock market remains strong. Typically the behavior of the stock market, which is driven largely by investors' expectations, leads the economy by about 6 months. Based upon the stock market alone, it would appear that continued growth is assured. However, it is important not to ignore all the other available evidence. There is no assurance that a recession is imminent, nor is there any assurance that we are out of the woods. ❑

PRICE OF GOLD

	1994	*1995*	*—— 1996 ——*	
	Mar. 17	*Mar. 16*	*Mar. 7*	*Mar. 14*
Final fixing in London	$383.40	$383.70	$393.90	$395.50

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