Statement of
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NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EDT), Tuesday, June 2, 1987.

Mr. Chairman, I am pleased to appear before this Subcommittee. My testimony today considers the circumstances under which trade protection could reduce costs for firms, but why in practice this process could also break down. It then discusses the effect of trade protection on both the domestic textile and apparel, as well as footwear industries.

Free and open trade increases the wealth of a nation. It enables a country to specialize in producing those goods and services that it makes efficiently and to purchase those that other nations produce more cheaply. The United States has long been a global leader in creating a liberal trade environment.

Imports increase competition in domestic markets to the clear benefit of consumers. On the other hand, imports sometimes displace the output of domestic manufacturers. As a result, resources are idled and workers employed in these industries must find new jobs. To reduce these adjustment costs, the United States, as well as other countries, have restricted imports to ease the competitive pressures on domestic firms. Indeed, throughout the post World War II period, the United States has used quotas to limit imports of a variety of products. Sometimes the restrictions have not been effective in reducing imports, but even when they were they have not had much effect on the industry's competitiveness.

PROTECTION AND MODERNIZATION: WHAT IS THE RELATIONSHIP?

A recent Congressional Budget Office (CBO) study prepared for this Subcommittee considered the effect of trade protection in restoring the competitiveness of domestic firms in four cases--textiles and apparel, footwear, steel, and automobiles. Rising sales of foreign produced products led the United States to limit imports in each of these industries. Some, like textiles and apparel, received several episodes of protection. In no case, however, did CBO find that trade protection made a significant improvement on the industry's long-run ability to compete in international trade.

The difficulties of domestic firms competing internationally frequently stem from their higher costs. The key to reducing these costs often requires adopting a new production process and investing in new plant and equipment. Thus, trade protection may help to revitalize an industry if it increases the rate at which firms would adopt new cost-reducing technologies.

But trade protection only indirectly encourages firms to adopt a new production process. Trade restraints initially increase the prices of imports

by restricting their supply. The higher prices for imports increase demand for domestically produced substitutes. Greater demand allows domestic firms to increase production and raise their prices, thus increasing their profits. These higher profits may help the firms finance new plant and equipment leading to cost reductions that would be otherwise unobtainable.

This sequence of events rarely occurs without a hitch. To begin with, trade protection will only help an industry with high costs if new technologies are available, but firms do not have the resources to acquire them. Thus, if the sequence is valid, capital markets must be unable for some reason to provide the requisite funds, or investors must not perceive that the new investments will be profitable. Moreover, firms will probably not use the additional funds resulting from protection for new equipment if other investments — perhaps diversification away from the industry -- can be expected to yield a higher rate of return. Furthermore, trade restraints often do not lead to significant increases in the profitability of domestic firms. Quotas on shipments of foreign exporters are the most common type of restraint. Since quotas rarely apply to all of the world's producers, firms in countries not covered by the quotas often increase exports to cover part of the shortfall. In addition, producers of the restrained products often shift production either to related products that are not covered by the quotas or to higher valued products that are. Since higher priced products tend to be

more profitable, product upgrading by foreign producers often limits the effect of protection on profits of domestic firms.

Even if it increases industry profits, protection can nonetheless reduce firms' incentives to invest in a new technology. Since investments involve more or less certain expenditures in the present for uncertain returns in the future, they are risky, and firms are often reluctant to invest without the threat of competition. Hence, by limiting competition, protection may significantly reduce the firm's incentives to adopt a new production process.

Saving jobs is a frequent goal of trade protection, but these new technologies generally use less labor per unit of output than the technologies that they replace. Thus, even if protection does assist in modernizing an industry, it may lead to lower total employment. In fact, if a firm elects to locate a new plant in a different part of the country, the workers in its existing facility would not receive much benefit from the increased employment.

PROTECTION IN THE TEXTILE AND APPAREL INDUSTRIES

The textile and apparel industry has received increasing amounts of trade protection since restraints were first imposed in the mid-1950s. While each additional increment provided the industry with some benefit, the responses of foreign producers, changes in the value of the dollar, and the development of new products quickly limited the impact of protection. These effects led to more and stricter restraints that led to further reactions by foreign producers. But overall trade protection had only a small effect on profits and investment of domestic firms. Moreover, employment in both the textile and apparel industries still declined throughout the period.

The first restraints were imposed on Japanese cotton textiles in 1956. These restraints encouraged firms in other countries -- most notably Hong Kong, Korea, and Taiwan — to increase their exports to the United States. In 1961, a conference of major textile and apparel importing and exporting countries convened to consider the implications of the expanding trade in these products. The conference produced a procedure by which an exporting country and an importing country could limit textile and apparel shipments of specific products made primarily of cotton in particular circumstances. The following year another conference modified these procedures and produced the Long-Term Agreement (LTA) that covered the trade in cotton textiles until 1974.

Just as the growth in exports from unconstrained sources limited the effectiveness of the original restraints on Japanese imports, the increasing use of synthetic fibers limited the impact of the LTA. Between 1960 and 1970, U.S. imports of products made from synthetics increased 10-fold, and synthetic apparel often substitutes for apparel made from cotton. Consequently, beginning in 1971, the United States negotiated voluntary restraint agreements with four major exporters of apparel and textiles made from synthetics. Two years later still another conference of exporters and importers of textile and apparel agreed to the Multifiber Arrangement (MFA), which added synthetics and wool to the products whose trade could be limited.

Both the Long-Term Agreement and the subsequent Multifiber Arrangement applied to imports from developing countries and Japan to the major developed countries. Neither covered trade among developed countries. Moreover, both agreements gave exporters considerable potential to expand. Participants at the conferences recognized that these industries provided significant growth opportunities for many developing nations. They, therefore, agreed that quotas could only be placed on specific products after a developed country demonstrated that imports were harming its producers. Further, quotas negotiated under the agreements were flexible -- exporters had some discretion to shift quota rights both

among different products and between years. The quotas also grew over time. Under the MFA, negotiated quotas increased by at least 6 percent a year.

Since its original ratification, the MFA has been renewed three times and, in each case, the ability of developing countries to expand their exports of textile and apparel products to the developed countries has been curtailed. Moreover, in the most recent renewal in the summer of 1986, ramie, silk, and linen became subject to the MFA.

As originally conceived, the restraints in the textile and apparel industries were not designed to preserve the size of the industries in developed countries, but rather to prevent any sudden contraction. In fact, since the MFA was first ratified, the domestic output of both industries has remained roughly constant. The average annual contraction of the industries' emloyment of roughly 2 percent during this period is almost entirely explained by growth in productivity.

The major reason for adopting the MFA was to restrict imports of textile and apparel made of synthetic fibers. Yet, through the 1970s, the restraints continued to limit primarily imports of cotton products. While clearly some imports of some synthetic products as well as total imports

from some countries were limited, the overall amounts of synthetic textiles and apparel were not much affected by the quotas. The lead of domestic producers in developing new synthetic blends and the weakness of the dollar played were important in the relative success of domestic producers during this period.

Imports of textiles and apparel increased dramatically following the rapid appreciation of the dollar and the improvement in the quality of foreign-made products in the 1980s. Despite this rapid growth, the effectiveness of the MFA in limiting imports probably increased. Moreover, this rapid growth supports the view that the MFA did not provide the domestic industry with much protection during the 1970s. If imports had been constrained by the quotas in the 1970s, they would not have been able to grow so rapidly in the 1980s. In addition, during the past five years, there have been sharp increases in shipments from Europe, which have never been restricted, as well as imports of unconstrained products such as silk, ramie and linen. Since the MFA did not apply to these imports, their growth indicates that the quotas negotiated under the MFA had become more significant in reducing cotton and synthetic imports from developing countries.

As I have already mentioned, output of both the textile and apparel industries have remained relatively constant since the MFA was negotiated. One should note that this has been true in the 1980s, despite the rapid increase in imports. The after-tax profits of the textile industry have also remained relatively stable, and its profitability — after-tax profits as a percent of stockholder's equity -- has actually improved when compared with the profitability of all manufacturing. There are no comparable data for apparel manufacturers.

If domestic firms are to be able to reduce their costs, they must adopt new production techniques. This step invariably requires new plant and equipment. Yet increasing protection in the industry has not seemed to stimulate increased capital expenditures. In both industries, investment (adjusted by the GNP deflator) has not increased since the MFA went into effect. In fact, real capital expenditures peaked in the early 1970s, when domestic production of synthetics expanded even as imports rapidly increased. Moreover, during the import surge of the 1980s, the industry's long-term debt as a percentage of stockholder's equity fell below the average of all manufacturing. These factors indicate that the industry could have acquired additional funds from the capital markets, and that a lack of resources has not been limiting their investment.

PROTECTION IN THE FOOTWEAR INDUSTRY

The footwear industry also received trade protection because of increased imports. Unlike textile and apparel, protection lasted for only four years and affected imports from only two countries -- Taiwan and Korea. But like the textile and apparel industry, increased imports from other countries and the changing composition of output from constrained countries limited the impact of the restraints on domestic producers.

Nevertheless, the restraints may have had a positive impact on the industry's profits, especially during the last two years of the restraints. Moreover, investment in new plant and equipment by the domestic industry increased during the quotas' final years. Because the industry historically has had a relatively high amount of long-term debt and relatively low profitability, footwear producers may have had difficulty securing funds for new plant and equipment. Thus, the increased profits while the quotas were in effect may have contributed to the increased investment.

Despite the increased investment, trade protection did not appreciably improve the competitive position of the footwear industry. Its labor

productivity declined while the restraints were in effect and increased at one-half the rate of all manufacturing after they lapsed. More significantly, footwear imports increased rapidly when the quotas expired.

OPTIONS

If the Congress believes that these industries need more assistance, additional protection must be weighed against its costs. By preventing the nation's resources from being used in their best uses, protection imposes significant costs on the economy. Retaliation by other nations would also impose additional costs. Moreover, such protection may not achieve the fundamental objective of lowering the costs of domestic producers. Even if further protection significantly increased firms' profits and a new cost-reducing technology existed, firms would only invest in the new equipment if it offered a higher expected return than alternative investments.

If the case is made that a lack of resources is limiting the industry's investments in new plant and equipment, there are policy options other than protection that are available. A direct subsidy, such as loans or loan guarantees, avoids the costs to consumers of the protected product and imposes fewer costs on the economy as well.

Competition among firms and industries generally provides for the best use of a nation's resources, though it invariably imposes costs on some firms and on some workers. To the extent that the Congress wants to reduce these costs, it is best to help displaced workers directly, say by some type of trade adjustment assistance. Since increased imports are not the only reason that workers lose their jobs, the Congress might also consider programs that are aimed more at the problems of worker mobility.