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Mr. Chairman, I am pleased to participate in these hearings on the Fair Trade in Steel Act of 1984, H.R. 5081. At this subcommittee's request, the Congressional Budget Office is now analyzing the forces shaping the U.S. steel industry's prospects, the economic effects of restraints on imports--particularly the quota proposed in H.R. 5081 and its companion bill in the Senate, S. 2380--and the policy options that might improve the steel industry's performance. As part of this effort, CBO has estimated the effect of a quota that would limit steel imports to the United States to 15 percent of the U.S. market, as H.R. 5081 proposes to do.

In my testimony this morning, I will concentrate on the following questions concerning the proposed quota:

- What are the causes of the domestic steel industry's current difficulties?
- How would a 15 percent import quota affect the domestic steel industry?
- How would such a quota affect the rest of the economy--especially the overall price level, the gross national product (GNP), and employment?
- Would the proposed quota lead to a long-term improvement in the U.S. steel industry's performance?

The United States' steel industry has benefited from some form of trade restraint for most of the past 16 years, although the proponents of restraints have argued that each of the trade programs pursued thus far has

been inadequate. H.R. 5081 has been designed with these arguments in mind.

H.R. 5081 IN THE CONTEXT OF CURRENT MARKET CONDITIONS

The U.S. steel market is only now beginning to recover from the very depressed conditions of 1982 and 1983--in many ways, the worst years for the American steel industry since the 1930s. Recent data, though, show that domestic shipments have risen 30 percent above the level of a year ago. Accordingly, the annual rate of steel shipments has risen from 68 million tons in 1983 to about 80 million tons. This current level of output, however, would still be well below the 100 million tons shipped in 1979, the last peak year in the U.S. steel market. The severity of the industry's current problems reflect not only a cyclical downturn but also long-term trends as well.

The recent weakness in the domestic steel market was exacerbated by record levels of import penetration--more than 22 percent in 1982 and 20 percent in 1983. Through the first four months of 1984, imports have averaged more than 25 percent of apparent U.S. consumption, 1/ and these

1. Apparent consumption equals domestic shipments minus exports plus imports.

conditions have again raised the issue of trade restraints in the steel market. The industry has continued to file countervailing duty and dumping cases against foreign producers before the International Trade Commission (ITC). These cases have led to several commitments by foreign producers to restrain their shipments to the United States--most notably, the current arrangement limiting the European Community to slightly below 6 percent of U.S. consumption. On another front, the Bethlehem Steel Corporation and the United Steelworkers of America, using Section 201 of the 1974 Trade Act, have filed a petition before the ITC requesting that imports be restricted to 15 percent of the U.S. market. Last week, the ITC ruled that imports were a source of injury in five of nine product categories, accounting for more than 70 percent of total U.S. steel consumption. The ITC will propose remedies for those products, and the President must then decide whether or not those or other measures should be imposed for the products involved. Finally, both H.R. 5081 and S. 2380 would establish a similar 15 percent quota through legislative means.

Unlike the restraints preceding it, H.R. 5081 is highly product-specific, so that foreign producers could not respond by shifting toward higher-valued products. Furthermore, it would apply to all importers, so that restraint on the part of some countries could not be offset by increased imports from others. In addition, H.R. 5081 would also provide relief to the U.S. iron-mining industry, limiting imports of iron ore to 25 percent of

domestic supply, compared with an average of almost 30 percent from 1979 to 1982. The bill would also require that virtually all the cash flow generated by steel operations be reinvested in steel. Finally, although the bill seeks to reverse the U.S. steel industry's long decline, the quota is designed to last for five years only. The Secretary of Commerce could, however, extend it for an additional three years.

FACTORS CONTRIBUTING TO THE CURRENT PREDICAMENT

In the past quarter century, the U.S. steel industry--consisting mostly of the so-called "integrated firms"--has lost the strong competitive advantage it enjoyed through the 1950s. By and large, the competitive problems of traditional American steel companies reflect adverse cost trends and a shift in comparative advantage away from the United States. The primary causes of the United States' deteriorating performance are to be found not in "unfair" foreign competition, unfavorable tax treatment, or excessive government regulation but in three more fundamental trends.

First, as a mature economy, the Unites States has been consuming less steel per dollar of GNP than have economies that are at earlier stages of maturity. This divergence seems to be increasing. Between 1950 and 1981, for instance, the United States' steel consumption grew at an annual rate of 1 percent. In the same period, Japan's steel consumption grew by 10 percent

a year, although demand growth has now slowed in Japan as well. The U.S. industry has had difficulty in accepting the poor overall growth prospects that prevail in its home market and in compensating for the advantages that more rapid growth gives its foreign competitors.

A second factor is that significant technological developments have led to the emergence of the so-called "minimills." Such firms hardly existed 25 years ago, yet they now account for about 18 percent of domestic steel output. Being technologically advanced, minimills are highly efficient and can compete favorably against both domestic integrated producers and foreign suppliers. The minimills' success stems largely from their reliance on production methods that do not require the massive investments that the integrated firms claim they need for competitiveness. Though minimills now make a limited range of products, they have proven quite successful at expanding the range of markets in which they compete. This trend seems unlikely to diminish.

Finally, steel production and consumption have gradually shifted away from their traditional centers in Europe and North America to developing countries. Since demand prospects are relatively strong in such countries, their steel industries are likely to grow. Not surprisingly, low employment costs combined with advanced technology and in some cases a strong resource base makes countries such as Korea, Brazil, and Mexico increas-

ingly formidable competitors. Particularly in unsophisticated high-volume products (plates, for example), developing countries are commonly the low-cost suppliers not only to the U.S. market but to Europe and 3apan as well.

No government policy is likely to reverse these trends. Thus no policy can spare the U.S. industry and its labor force from the need to adapt. The American steel industry is likely to be smaller in the future, reflecting the maturity of its market. The minimill sector is likely to be much larger, and integrated firms are likely to succeed by adopting many minimill characteristics. Finally, integrated firms are likely to move gradually toward technologically sophisticated products, avoiding direct competition with lower-cost foreign producers in commodity-grade products.

Policies toward the steel industry--including quota bills--are best judged in terms of whether they could ease this transition. If not, they are likely not only to impose a substantial burden on the rest of the economy but also to hamper the eventual adjustment of the steel sector.

PRO3ECTED EFFECTS OF H.R. 5081 ON THE STEEL MARKET

CBO has estimated the effects of H.R. 5081 on the domestic steel market. These results, displayed in Table 1, were generated by an econo-

TABLE 1. STEEL MARKET TRENDS, ACTUAL 1983 AND PROJECTED 1985 THROUGH 1989: BASE-CASE a/ COMPARED WITH H.R. 5081, 1983-1989

	1983 Actual	Projected 1985	1986	1987	1988	1989
		IN DOLLARS PER TON b/				
Average Price						
Base case	484	564	607	648	679	706
H.R. 5081	484	613	657	697	736	773
		IN MILLIONS OF TONS				
U.S. Demand						
Base case	83.04	106.37	109.05	112.19	114.32	114.59
H.R. 5081	83.04	103.97	106.64	109.77	111.54	111.47
		IN MILLIONS OF TONS				
U.S. Shipments c/						
Base case	67.18	83.64	86.42	89.65	90.25	89.29
H.R. 5081	67.18	90.42	93.30	96.54	98.12	98.11
		IN PERCENTS				
Import Share						
Base case	20.5	23.2	23.1	22.9	23.9	24.9
H.R. 5081	20.5	15.0	15.0	15.0	15.0	15.0
		IN THOUSANDS OF STEEL INDUSTRY JOBS				
Steel-Industry Employment						
Base case	336	425	424	424	415	399
H.R. 5081	336	452	452	452	446	433

SOURCE: Congressional Budget Office.

a. Projected using CBO economic projections, holding the real price of inputs constant.

b. Weighted average of import and domestic price in nominal terms (that is, not adjusted for inflation).

c. Includes projected exports.

metric model that describes the factors that influence prices, demand, imports, exports, and so on. The details of this model will be made available to the subcommittee. This morning, I will illustrate CBO's results by discussing the estimates for 1989, since these are quite comparable with the estimates for other years.

If a quota were imposed, import prices would tend to rise significantly, because import competition would be constrained. The limit on imports would also increase the demand for domestically produced steel, causing domestic prices to rise. As a result, average steel prices in the U.S. market by 1989 would be 9 percent higher with the quota than without it--a difference of $67 per ton in that year. Import prices would rise more, in proportion, than would domestic prices, since they start from a much lower base. CBO assumes that the imposition of H.R. 5081's highly product-specific and country-specific quota would eliminate the differential that now distinguishes domestic and import prices, though one cannot test this assumption against the historical record.

These price increases would have a dampening effect on U.S. steel consumption. CBO estimates that apparent steel consumption in 1989 would be 111.5 million tons with the quota and 114.6 million tons without it--a difference of about 3 percent. By 1989, the quota would raise domestic output significantly, from 89 million tons without the quota to 98 million

tons with it. This reflects a reduction in the 1989 import share from the projected 25 percent without the quota to the quota's limit of 15 percent. According to CBO's estimates, this increase in domestic output would raise 1989 steel employment by 34,000 workers--9 percent above the no-quota level. With or without the quota, however, the number of future jobs provided by the steel industry is projected to decline owing to slow demand growth and productivity increases. Moreover, increased steel employment would probably be offset by decreased employment in other sectors of the economy.

H.R. 5081 AND THE U.S. ECONOMY AT LARGE

Predictably, the effects of the quota on the domestic steel industry would be positive--at least in terms of output and employment. The costs of the bill, however, would show up not in the steel market but in the rest of the economy, largely through higher prices and a resulting misallocation of resources. Nonetheless, the role of the steel industry in the overall U.S. economy is small enough that the quota would not greatly affect the general price level, the GNP, or total domestic employment. With each of these factors--though the aggregate net impact of the quota might well be injurious--the effect would be too small to capture definitively in a macroeconomic model.

The effects of H.R. 5081 would show up mainly in substantial income transfers and related efficiency losses. In 1989, the quota would probably cost U.S. consumers roughly $7.7 billion. The exact amount of these costs--as well as its distribution among domestic steel producers, foreign producers, and uncaptured efficiency losses--would depend on the extent to which the quota raises import prices. On the assumption that import prices approximate domestic prices after the quota is in place, CBO estimates the 1989 effects of the quota as follows:

- About $4.5 billion would be transferred from consumers to the domestic steel-producing sector;
- Roughly $2.1 billion would be transferred from consumers to foreign steel producers--although the government could conceivably capture this amount by selling import licenses; and
- About $1.1 billion would represent an efficiency loss, since U.S. resources would have to be used to produce steel that could be purchased more cheaply from abroad.

Assuming that foreign producers captured the available revenues attributable to higher import prices, the loss to the U.S. economy would amount to roughly $3.2 billion--the sum of the transfer to foreign producers and the efficiency loss. These estimates include the costs borne by the rest of the economy.

Although the quota's aggregate price effect would be small, its most noticeable negative effects would be on output and employment in those industries that consume significant quantities of steel--automotive production, machinery, construction, and the like. This danger would be particularly pronounced for industries that face international competition. Current steel prices in the U.S. are about 20 percent above the world price, so they already represent a competitive disadvantage for many U.S. industries. Any increase in steel prices engendered by the quota would exacerbate this problem. In time, such developments, might, in fact, encourage the industries affected to follow the steel industry's example in seeking protectionist solutions to their difficulties.

Finally, H.R. 5081 could invite retaliation, which is particularly important since the bill does not conform to the terms of the General Agreement on Tariffs and Trade (GATT). The GATT permits the imposition of trade restraints only under certain conditions, and these are incorporated in U.S. trade laws. Unlike H.R. 5081, the steel 201 case on which the ITC ruled last week is an example of a GATT-sanctioned procedure. Though the likelihood and magnitude of any retaliation are matters of conjecture, retaliation by trading partners would clearly imply further offsets to any benefits that accrue to the steel industry as a result of the proposed quota.

H.R. 5081 AND THE PROSPECTS FOR IMPROVED PERFORMANCE IN THE AMERICAN STEEL INDUSTRY

The last issue I would like to address concerns the extent to which H.R. 5081 might contribute to improved performance in the U.S. steel industry. Two provisions are particularly relevant in this regard:

- o The restrictions on iron-ore imports, and
- o The reinvestment condition.

The inclusion of controls on iron-ore imports would work against H.R. 5081's underlying goal of improving the steel industry's cost competitiveness. Several foreign countries, such as Australia and Brazil, have reserves of iron ore that are far richer than U.S. reserves. As a result, continued reliance on U.S. ore is likely to increase the U.S. steel industry's competitive problems. Domestic ore costs range from 30 percent to 50 percent above those of the most efficient foreign producers, and Brazilian ore is now competitive with U.S. ores even in the Great Lakes region. Hence, H.R. 5081's iron ore provisions run counter to the bill's main objectives.

The consequences of the reinvestment provision are more difficult to estimate. In 1980, the American Iron and Steel Institute, the Steel Tripartite Committee, and the Office of Technology Assessment separately estimated that, to restore its competitiveness, the industry would require a

minimum annual investment of between $5.5 billion and $6.5 billion (in 1983 dollars, as are all of the investment figures I will cite). (The figures cited here explicitly disregard nonsteel investment and spending for capacity increases.) Since the publication of those estimates, capital expenditures in the steel industry, as tabulated by the iron and steel institute, have averaged only $2.2 billion per year.

Why do the integrated firms have such difficulty achieving the level of investment they claim they need? The problem cannot be blamed on capital markets, since U.S. minimills have had little difficulty raising investment funds. Instead, the problem involves the integrated firms' choice of investments, many of which have been very capital intensive, dispersed among numorous plants, and lacking market focus. As a result, integrated firms' investments often earn low rates of return--the underlying reason for the persistence of alleged capital shortfalls.

CBO's analysis indicates that imposition of a H.R. 5081's import quota would provide the domestic steel industry with additional profits of roughly $1.8 billion (after taxes), which according to the bill would have to be reinvested in steel operations. However, since the steel industry has already been reinvesting more than the net cash flow from its steel operations, future investment might not rise by the full amount of potential new profits.

Even if it did, it would still fall short of the industry's estimated capital requirements for modernization.

The relevant question, however, concerns the extent to which the new investment generated by the quota would represent a socially desirable use of capital resources. At present, various factors tend to encourage steel investment--including import restraints now in force, relaxed environmental regulations, and the ability to lease unused tax benefits to profitable firms. But the rates of return on steel investment have remained low, and capital has been invested more profitably elsewhere in the economy. By themselves, the import restraints would have at best a small effect on the industry's investment decisions, since the limits would be removed after five years, and since major investments in production facilities would take from two to four years to become operational.

The case for overriding the judgments of capital markets by mandating that each steel firm's cash flow be locked into steel capital has yet to be made. Only if investment strategies were grounded in the underlying trends that shape the steel market--which I sought to describe earlier in my testimony--would the modernization goals of H.R. 5081 be achievable. Without such a focus to new investment, the passage of H.R. 5081 offers little prospect of finally resolving the steel import problem. Indeed, pressure for a perpetual import quota would be a more likely outcome.