THE FUTURE OF THE AUTOMOBILE

THE AUTOMOBILE AND U.S. TRADE POLICY: WHERE DO WE GO FROM HERE?

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James A. Dunn, Jr.
Alan A. Altshuler

Research Paper
International Policy Forum
Eagle Lodge, Pennsylvania, U.S.A.

28 June - 1 July, 1981

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Future of the Automobile Program

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Introduction

The spirited debate over import protection for the U.S. auto industry reached a climax with the May 1, 1981 announcement that Japan had agreed to impose voluntary export restraints on her automobile manufacturers. There was a widespread feeling in the United States that this agreement has achieved its short-run political aim: to take the steam out of the protectionist pressure that had been building in Congress, thus avoiding a potentially damaging executive-legislative clash over the issue. At the same time, because Japan was "voluntarily" restraining her exports, it permitted the administration to retain "technical virginity" as far as sinning against its free trade principles was concerned.

But there was no consensus about whether the agreement will achieve the economic aims that many hoped for, or about its significance as a directional indicator for future U.S. trade policy actions. Does the agreement represent a defeat for the forces of free trade within the Reagan administration, as *New York Times* economic correspondent Leonard Silk asserted?[1] Or was it just an exercise in symbolism, a "mythical auto restraint policy" as David B. Yoffie claimed in the *Wall Street Journal*?[2] Is the protection afforded likely to be of significant help to the U.S. auto industry as it struggles to make the transition to a more competitive posture, or will it prove too little, too late? What, exactly, is wrong with the U.S. auto industry? Do its present problems represent just a temporary setback or an irreversible step toward permanent decline? What if there is continued stagnation and a resurgence of protectionism in the auto sector, as has been the case in other sectors where "voluntary" restraints have been tried? If further protectionist measures are adopted, what forms are they likely to take - more voluntary quotas, tariffs, local content requirements, or what?

This paper will offer a preliminary assessment of the political and economic prospects of the May 1 agreement. It will relate the agreement to the arguments and expectations of the different parties to the trade debate. It will examine the political bases of the major current policy positions, free trade and protection, as well as a more activist trade policy position that might emerge as a focus of debate if the industry's recovery is delayed or aborted. Finally it will suggest some lines of research that might usefully inform future auto sector trade policy discussions.

The Voluntary Restraints Agreement as Politics: Who Won?

Struggles in the arena of bureaucratic politics are not like boxing matches or baseball games. There is not necessarily a clear winner and an unambiguous end to the contest, since most decisions are the product of compromise and the actual consequences of a given policy are not always the ones anticipated by either side. Nonetheless, it is appropriate to examine interim resolutions for evidence as to which constellations of forces are in the ascendant and which are declining.

The May 1 agreement was a clearcut defeat for the forces of free trade only in the relatively narrow realm of bureaucratic politics. As Murray Weidenbaum, Chairman of the Council of Economic Advisors and a leading free trade advocate within the administration, commented in the immediate aftermath of the agreement: "It was not an economic decision, it was a political decision. I'm not so naive as to think economic advice is the only basis for our policy."[3] Still, the concessions made were quite modest in practical terms. The Japanese government "voluntarily" agreed to a limit of 1.68 million vehicles on exports to the U.S. in the 12 month period from April 1, 1981 to March 31, 1982. This represented a drop of 7.7 percent from the 1.82 million Japanese cars sold in America during calendar 1980. In the second year of the agreement Japanese exports may rise by 16.7 percent of the increase in total U.S. car sales. The third year target was left open for future discussion and determination.[4]

Some voices within the administration actually called the agreement a victory for free trade, since the U.S. government took no official protectionist action, and the harsher measures being proposed in Congress have been shelved. Thus the agreement can be seen as the minimum necessary concession - enough protectionist rhetoric to diffuse public pressure but not enough actual restriction to seriously impede competitive forces.

The Free Trade Position

One reason that free trade seems to be perennially under assault is that today it represents the status quo. It is the prevailing ideology, the dominant intellectual paradigm for U.S. international economic policy.[5] Naturally, in a society as diverse and contentious as our own the status quo will be challenged. One of the strengths of free trade policy has been its flexibility, however; it has been able to accommodate the most insistent of the challenges without losing its overall thrust.[6]

The dominance of the free trade paradigm rests on at least six intellectual and institutional pillars:

1. Classic market economic theory and a near consensus of liberal and conservative macroeconomists on the virtues of free exchange and the law of comparative advantage. Thus Murray Weidenbaum and his predecessor, Charles L. Schultze, find themselves in unaccustomed agreement in their opposition to auto import protection.

The macroeconomists stress that, on balance, the U.S. economy is strong. Even the merchandise trade deficit is offset on current account by the return of profits from overseas investments, sales of services, etc. Protection will slow the normal, healthy adaptation of the U.S. economy to a high technology, service-oriented post-industrial economy.[7]

In addition, national economic policy makers and their advisors see international trade as an important means of restraining inflation in the domestic economy, particularly in oligopolistic sectors. They argue that letting the auto industry escape the discipline of international competition would be doubly inflationary. Not only would auto prices increase but a dangerous precedent would be set for other oligopolistic industries with high cost labor and/or inefficient equipment.[8]

2. The predominant view among foreign policy professionals, both in and out of government, that a liberal trading order is essential to American geopolitical interests. Economic isolationism is but one aspect of political isolationism. And an isolationist "free world" is one that is disunited. The U.S., as natural leader of the free world, is perceived as having a special responsibility to act in ways conducive to cooperation. Japan, moreover, is the key bulwark of free world values in the Far East. The auto import issue, in this view, must be treated within the overall framework of U.S. interest in good relations with a democratic, prosperous, politically stable Japan.[9]

3. The continuing political strength of economic sectors that remain internationally competitive and export-oriented. Business Week has recently suggested that the U.S. economy is comprised of five broad sectors: energy, high technology, agriculture, services, and old line industry. The first four remain, by and large, enthusiastic supporters of free trade.[10,11] Many businesses even in the automotive field -- such as imported car dealers, parts distributors, and service establishments -- profit heavily from free trade, it should be noted.

4. Rooted in both (2) and (3) are key foreign policy support and opinion leadership groups such as the Council on Foreign Relations, the Tri-lateral Commission, the Committee for Economic Development, and the United Nations Association. They can muster an array of intellectual talent and professional credentials that is difficult even for the auto industry (let alone footwear manufacturers or avocado growers) to challenge successfully.[12]

5. Most of the media, "good government" organizations, consumer advocacy groups, etc., accept the proposition that free trade serves the overall national interest. They tend to oppose special business privileges in any case.

6. Finally, many features of American law and institutions tend to inhibit protectionist initiatives and thereby strengthen free trade. These range from the

ambiguous provisions of the Trade Act, which can be interpreted as prohibiting the President from negotiating trade restraints without a prior ruling from the quasi-autonomous U.S. International Trade Commission, to provisions of anti-trust law that prevent foreign companies from agreeing among themselves on export ceilings unless required by their governments to do so. (The U.S. Attorney General has ruled that the Japanese auto manufacturers find themselves so required in the wake of the May 1 agreement.) More broadly, the fragmented, veto group character of American politics generates a very high level of inertia. After half a century of policy evolution in a free trade direction, the results are (a) to inhibit legislative efforts to enact special protectionist measures for threatened industries, and (b) to heighten skepticism that such measures, if once allowed through the policy screen, will in fact prove temporary.[13] Stated another way, few believe that fine-tuning of the balance between free trade and short term, stabilizing protectionism is feasible in the American system. For most free trade advocates, it follows that all proposed "special" exceptions should be vigorously opposed.

In short, the support base of the free trade position is highly formidable. It dominates the foreign and economic policy agencies of the executive branch, the most dynamic sectors of the U.S. economy, the media, and the relevant branches of academia. Thus far, it has been strong enough to keep the sectoral problems of declining industries largely isolated from one another. It loses some individual battles, but no broad-front challenge to the liberal orientation of U.S. trade policy has achieved great prominence in recent decades. How far any given sector can deviate from the dominant liberal norm is, of course, determined within this context by a wide range of factors including the severity of the threat it faces, the numbers of workers and communities affected, and the effectiveness of its mobilization effort.

The Protectionist Position

If free trade arguments are usually couched in the general language of broad macroeconomic principles, protectionist pleas tend to be made with reference to specific problems in relatively narrow economic sectors. Few advocates of protectionism call for across-the-board import quotas or tariff hikes. There is also very little of the xenophobic rhetoric or legislative logrolling among industries that was such a colorful feature of American politics in the late 19th and early 20th centuries.

In their classic study of trade politics, American Business and Public Policy, Bauer, Pool, and Dexter note that already by the 1950s protectionist positions had softened substantially from pre-New Deal days.[14] The protectionists were on the defensive, and had to formulate their demands within a dominant liberal framework. Broad tariff increases and strict import quotas fell decidedly out of favor, to be replaced by the variety of less stringent (and generally less effective) methods: "voluntary" export restraints by foreign governments, orderly marketing agreements, trigger price mechanisms, etc.[15] Adoption of any of these methods as public policy in a given industry is invariably accompanied by assurances that the measure is a temporary one to provide stability while the domestic industry adjusts to competitive pressures.

The upsurge of protectionist sentiment in the U.S. auto industry fit this pattern closely. Virtually all those calling for protection stated that what they really desired was for the President to negotiate a "temporary" and "voluntary" export restraint agreement with Japan. This was the explicit recommendation of the U.S. automobile companies.[16] The UAW called for tariffs and local content requirements in its petition to the International Trade Commission, but president Douglas Fraser stated publicly that its actual objective was a negotiated settlement.[17] Even the legislators who sponsored quota bills in Congress indicated that they were merely striving to prod the executive into action.[18] All parties made clear, finally, that they supported foreign investment in the U.S., and counted as imports only those vehicles predominantly produced abroad.

In pursuing negotiated quotas focused solely on the number of assembled, foreign-produced units sold in the U.S., the advocates of protection seem carefully to have ignored evidence from other sectors that such restraints leave numerous loopholes for competitors bent on continuing to expand their share of the domestic market (see below). Recognizing this, Third World countries in particular generally require that overall balance of trade targets be achieved, that all vehicles marketed contain at least a specified percentage of local value added, and/or that vehicle importers pay prohibitive tariffs. Why did the U.S. advocates of protection put forth such timid demands?

In part, clearly, the reason was as follows. "Voluntary" restraints, negotiated with the U.S. but enforced exclusively by foreign governments, and defined in terms of simple product categories so as to facilitate monitoring without any new administrative apparatus, present the least explicit threat of any protectionist measures to the nation's official free trade orientation. For this reason, they have become the favored American instrument for use in those situations where some protectionist action is deemed necessary. Their utility is primarily political, not technical -- that is, as convenient points of compromise between free trade and protectionist forces, rather than as effective means of insulating American producers from foreign competition.

From the standpoint of the largest U.S. manufacturers, GM and Ford, it is also significant that "voluntary" restraints entail the least risk of encouraging new protectionist initiatives by governments elsewhere in the world. As multinational producers, they are already required to accommodate multitudes of national protectionist policies within their global systems of production and marketing.

An additional factor that may have helped shape this hesitant pattern of protectionist demand making is that disagreements among the major actors themselves persisted until early 1981. The auto companies and the UAW were pillars of the postwar free trade coalition until the mid-seventies. The UAW was the first to defect, during the 1974-75 recession. But its central aim at that time was simply to ensure that the U.S.-based multinational firms would meet federal fuel economy standards (enacted in 1975) with domestically produced vehicles, rather than by increasing the number of "captive imports" that they marketed.[19] Then, and again during the early months of 1979-80 downturn, the union was alone in calling for protectionist action. During 1980 Chrysler, and then Ford, began actively petitioning for import quotas, but GM still remained aloof. It was able to maintain its share of the U.S. domestic market during 1980, and its financial position remained very strong; thus it was under less pressure than the other American manufacturers to abandon its historic free trade position. It may also have hoped to obtain some protection without having to request it. Following the negative decision by the International Trade Commission (I.T.C.) at the end of 1980, however, GM apparently felt compelled to reappraise its position. In March 1981 it joined the campaign for "voluntary" quotas on Japanese imports.[20]

This emerging consensus among the U.S. manufacturers and the UAW was reflected in Congress. A Congressional Auto Caucus (CAC), composed mainly of Senators and Representatives from auto-producing states, took shape in 1980. Seventy-seven percent of auto manufacturing employment is concentrated in eight states (Michigan, Ohio, Indiana, Illinois, Missouri, Pennsylvania, New York, and Wisconsin),[21] but 27 other states had at least 1,000 manufacturing jobs in 1978.[22] At first, CAC activities were directed mainly toward publicizing the extent and gravity of the industry's problems. Early in 1981, however, as the newly-elected Congress was organized, numerous import restraint bills were filled. That which emerged as the most significant, co-sponsored by Senators Lloyd Bentsen of Texas and John Danforth of Missouri, proposed a ceiling of 1.6 million vehicles on Japanese imports for each of the next three years. It was accorded an excellent chance of passage if the

Japanese failed promptly to announce a "voluntary" restraint program of their own.[23]

Within the executive branch, the agencies most willing to consider protectionist action have been those with sectoral or domestic clientele mandates rather than those with broad macroeconomic or foreign policy responsibilities. Most notably, these have included the Departments of Transportation, Labor, and Commerce.[24] The Office of the Special Trade Representative (S.T.R.) also moved into this camp in 1981. Congress created S.T.R. in 1962, placing it in the Executive Office of the President rather than the State Department, in the belief that State had given too little weight to domestic economic concerns in trade negotiations.[25] The Trade Representative, with his limited mandate, has traditionally been committed in general to the aim of trade liberalization, but less inclined to reject specific protectionist measures out-of-hand than State, Treasury, the Council of Economic Advisors, and the Office of Management and Budget.

The Voluntary Restraints Agreement As Policy: How Effective Will It Be?

The proponents of protection had a variety of aims as they pressed the executive branch to negotiate export restraints with Japan in 1980-81. The companies, of course, wanted to prevent further losses of market share to the Japanese, and if possible roll back the Japanese share of the U.S. market from the 21 percent level achieved in 1980. They believed that this would lead to improved sales of domestic models, especially as the economy recovered from the 1980 recession and as larger numbers of small, fuel efficient U.S.-built cars became available. The UAW sought to regain some of the jobs its members had lost since the downturn in mid-1979. Public officials from auto manufacturing states and cities hoped that increased domestic auto sales would enhance tax revenues and alleviated social service burdens in their hard-pressed areas. Policy makers in the federal executive branch hoped to facilitate auto industry recovery, to reduce the nation's automotive product trade deficit, and perhaps to encourage Japanese investment in this country. How likely is the May 1 agreement to fulfill these goals?

Let us first consider the question of reducing the Japanese market share and absolute number of vehicles sold. How many fewer Japanese imports will be sold in this country because of the agreement? Senator Danforth estimated that, if the 1.68 million vehicle limit is strictly adhered to over the next 12 months, Japanese sales will be 250,000 to 300,000 units lower than they otherwise would have been.[26] A simulation conducted by Chase Econometrics indicated that Japanese auto sales in this country might be reduced by as many as 700,000 units over a two year period.[27] Thus it is clear that, if the agreement works as expected, it can inflict some loss of vehicle sales on Japanese auto makers.

How much good will it do the U.S. manufacturers?

The Chase study forecast that the import limits would lead to increases of about 3 percent in average new car prices, with a resulting loss of total sales in the 24 month period of more than 500,000. Additionally, some of the sales lost by the Japanese would go to European producers, leaving the U.S. manufacturers only about 110,000 additional sales (less than a one percent increment) as a result of the May 1 agreement. Thus, the primary short-run benefit to the U.S. producers will be in the form of reduced pressure to hold down prices, rather than in the form of increased sales. And the employment effects hoped for by organized labor will be "negligible".

These estimates are based on the premise that the restraints will work as planned. But past experience with "voluntary" quotas suggests that they do not, in practice, achieve the target levels of import reduction for which they were designed. David B. Yoffie has studied the effect of "voluntary" export restraints on other sectors of the American economy such as textiles, apparel, steel, color televisions, and especially footwear. He concludes that "voluntary restraints have never been an efficient way to reduce imports; implementation problems always undermine the[ir] effectiveness."[28] Yoffie points out a number of "loopholes" in the May 1 agreement which may prevent it from reducing import sales very far. In the first place, it leaves the door open to auto makers in countries outside Japan to increase their shipments to the U.S. Renault, in particular, is known to be planning a major campaign to penetrate the American market.[29] Second, by excluding inventories of vehicles already in-country, the agreement leaves open the possibility that Toyota, Nissan, Honda et al. could draw down their stocks and push 1981 sales to record highs. Other devices for circumventing quota restrictions that have been used in the past are shipping in vehicles as disassembled parts and transshipping them in through unrestricted ports such as Guam or Mexico.

The most serious drawback of voluntary restraint measures, however, is that they create perverse incentives for adjustment. Orderly marketing agreements in the textile and footwear industries stimulated far eastern producers to upgrade their product lines out of the low-cost, low-profit margin end of the spectrum and into the very mainstream of the U.S. market where the higher returns were.[30] It is very likely that Japanese auto makers will adopt a similar strategy. They will substitute more expensive cars for the ones they are currently selling. Additionally, they may intensify their efforts to increase component sales to U.S. manufacturers. In the end, even while selling fewer vehicles than they would have in the absence of the May 1 agreement, they may well earn as many dollars. And the U.S. companies may find that they have exchanged a small increase in sales and prices at the lower end of the market for greater competition "up-scale".

It is no surprise, therefore, that the reaction of many partisans of protection to their May 1 "victory" was tepid. Douglas Fraser approved of the principle of voluntary restraint but said the negotiated import ceiling was "too high". Phillip Caldwell pointed out that Japanese car makers were certain to up-scale their product line. Senator Donald W. Riegle, Jr. of Michigan felt that the administration "could have achieved a tougher agreement". And Arvid Jouppi, an auto industry analyst with John Muir & Company of Detroit, felt that the agreement would not have much impact on the industry because "the numbers are so small, far less than the number of new energy-efficient vehicles that the United States would throw against the Japanese this year anyway".[31] Thus there seems to be a broadly-held feeling that that the voluntary restraint program will definitely not, in itself, make a large contribution to the restoration of U.S. auto industry prosperity.

What remains is the possibility that the May 1 agreement may prove extremely important as a precedent and warning -- a precedent for follow-on protectionist measures that could be even more stringent, and a warning to foreign producers that investments in export capacity and U.S. marketing are more perilous than heretofore believed. Precise estimation of these effects is of course impossible, but it seems highly plausible that uncertainty about the former may significantly affect future decision making with respect to the American market by foreign, and especially Japanese, auto manufacturers.

More immediately, however, it appears that, if good times are to return to the U.S. industry, they will have to be the result of other factors than the May 1 agreement: a general economic upswing, declining interest rates, and a revival of confidence by American consumers in the quality of U.S. cars by comparison with imports.

The great remaining question is this: can even such favorable developments as these bring real prosperity back to the U.S. auto industry in the absence of long-term, stringent import controls? Estimates of the answer hinge, of course, on judgments about the fundamental sources of the industry's current problems. And such judgments vary widely. Let us now turn to a summary of the most important among them.

What is the Nature of the Auto Industry's Problem? Three Views

1. Cyclical Downturn and Bad Luck

In this view, the key explanatory factor is simply that Detroit was caught with the wrong product mix in 1979. The dramatic gas lines and price increases that in spring and summer led to a sudden shift in consumer demand toward more fuel-efficient vehicles. U.S. auto makers were caught short of small car production capacity and the demand was met by foreign, mainly Japanese producers.[32] This bad luck was compounded by a cyclical downturn in the overall economy. Auto sales are unusually sensitive both to the state of the economy and to the cost and availability of credit. Hence a GNP decline of less than 3 percent between 1973 and 1975 produced a drop of 24 percent in auto sales. The recession of 1980 was milder than that of 1974-75, involving a GNP decline of only about 1.5 percent, but it was accompanied by extraordinarily high interest rates. In consequence; total domestic passenger car sales ran 26.1 percent below the 1978 level. As the domestic manufacturers also lost 9 percentage points of market share during this two year period, total U.S. motor vehicle production was down 37.9 percent from two years earlier.[33]

The sales decline produced a calamitous cash flow situation for the industry because it coincided with the need for unprecedented levels of investment to bring attractive, fuel-efficient, new models on line. Just as foreign manufacturers lost fewer sales to the downturn, they also faced less extraordinary investment requirements -- because they had long produced for conservation-oriented markets. The U.S. manufacturers, by contrast, felt compelled to implement a dramatic change in their product lineup even as they experienced the greatest losses in the nation's industrial history.

Some analysts fear that, even if this historic interpretation is correct, the American producers may never fully recover from the present episode. At very least, their financial capacity to engage in recurrent rounds of product innovation and competitive price-cutting may have been impaired for many years to come.

Optimists who view the current episode as a mere cyclical downtown maintain, however, that 1980-81 should be the bottom of the trough. Each year thereafter the domestic manufacturers will have a more attractive model lineup and more ample production capacity. Responding to the intensification of global competition, moreover, the U.S. companies will adjust their management practices, employee compensation rates, and procurement policies to achieve greater cost and quality parity with the Japanese. By the mid-1980s they should be able to push the import market share back to the range that prevailed in the years just before 1979 (15-18 percent), and protectionist pressure will evaporate.[34]

2. Product Cycle Maturity

This view is based on the notion that there is an "international product life cycle" that influences the geographical location of production for many manufactured goods. In the model suggested by Raymond Vernon there are four stages to the typical life cycle.[35] First, a new product is introduced in the home market. Next, it is exported abroad as the domestic market approaches saturation. In the third stage, the product has become standardized and production begins in foreign countries (usually by affiliates of home country firms) to serve overseas markets. Finally, foreign producers, enjoying lower costs (especially for labor), invade the original home market. Eventually, in the absence of protectionism, domestic production may fade out altogether.

The automotive product cycle appears to have stalled for a long while, prior to the Japanese invasion of the U.S. market during the 1970s, in stage 3. That is, viewing the United States as the point of industry origination, most production for overseas markets occurred abroad by the 1920s. But U.S. consumers demanded quite different vehicles, on the whole, than those in other countries, and most foreign production was by U.S. affiliates with little disposition to compete for the home market. The American manufacturers remained quite able, moreover, to confine import thrusts by the "independents," such as Volkswagen, to a small portion of the market (5-7 percent through most of the 1960s).

Product cycle analysts maintain that this pattern was able to persist for many decades because (a) foreign manufacturers could not hope to achieve massive penetration of the U.S. market with the same vehicles they sold at home, (b) so much foreign production was controlled by the U.S. companies, and (c) the American manufacturers were able to avert aggressive price competition among themselves. It was easier, safer (given the risks of political instability abroad), and politically more attractive (within the U.S.) to produce for the American market at home -- so long as these conditions prevailed.

But they no longer do. The energy shocks of the 1970s, combined with rising incomes in Japan and Western Europe, have led to a substantial convergence of demand patterns in the developed world. The U.S. companies control a rapidly diminishing share of world production. And the Japanese, who are both aggressively independent and enjoy significant cost advantages, have assumed price leadership in the small car market -- at levels that prevent the American companies from earning adequate rates of return except at very high levels of capacity utilization.

Faced with this challenge, the American companies will have to move aggressively toward component production in Third World nations and/or toward procurement in Japan if they are to remain fully competitive without government protection. They are becoming increasingly able to do so, moreover: that is, to separate elements of the production process that are suitable for offshore procurement, and to integrate them within a worldwide production system. It is far from clear where the long-term limits to this "offshore drift" lie. Current law provides that vehicles counted toward the sales-weighted fuel economy average of U.S. manufacturers must contain at least 75 percent domestic value added. If as seems likely, however, government fuel economy standards fail to keep pace with the actual market mix, even this constraint may decline in significance after 1985.[36]

3. Japan as Number One

This view is a particular elaboration of that set forth immediately above. It takes off from the apparent fact that the U.S. manufacturers remain fully cost-competitive with those in all other countries but one. What has changed over the past two decades has been the emergence of a new world-scale competitor blessed with remarkable business acumen, great technical skill, and a labor force that works more conscientiously, with equal or greater skill, and for much less money.[37] Within a few years, the Japanese have managed to shatter the preexisting patterns of comparative advantage among the industrialized nations -- thereby conferring great benefits on consumers but at the cost of acute insecurity for many enterprises and employees in the older developed countries.

Given the depressed or negative profit levels of the American companies, their vast capital requirements, and the likelihood of continuing rapid pressure for adaptation after 1985, it may be more appropriate to view the current U.S. auto industry crisis as a landmark in a war of attrition, which is being lost to the Japanese, rather than as a cyclical trough <u>or</u> as a problem with which the American companies will be able to cope by increasing their offshore investment after 1985.

The Japanese auto companies, earning high profits throughout the current period, are much better positioned than their American competitors to make the vast investments likely to prove necessary over the 10-15 years following 1985. In order to minimize protectionist reaction, they are likely to pursue expansion more subtly than in the past -- by moving up-scale in their product mix and pushing sales of components to domestic manufacturers rather than striving to maximize the number of assembled Japanese vehicles marketed, by constructing assembly plants abroad, and by joint ventures with foreign companies. But their capacity to expand indefinitely seems clear, except as governments provide effective protection or foreign companies achieve heroic economies. For the U.S. companies, achievement of cost parity would involve, minimally, halving the labor cost content of U.S. production and <u>then</u>

keeping up fully with the Japanese rate of productivity improvement. Even this accomplishment would leave the Japanese, moreover, with a variety of significant cost advantages outside the arena of direct labor cost.

* * *

Of these three interpretations of the current plight of the U.S. auto industry, the first (cyclical downturn) is clearly most compatible with the free trade position. It projects a happy outcome without any government intervention at all. Many free traders concede, however, that the industry's problems are more fundamental and long-term. They sustain their position by arguing that the U.S. should not strive to maintain supremacy in every industrial sector. The nation's comparative advantage lies in high technology industries, agriculture, and services. Any effort to sustain declining industries will simply divert resources from more fruitful opportunities and impede efforts to control inflation. Moreover, the U.S. balance of payments situation, on a current account basis, is considerably better than Japan's.[38] Indeed, it is better than that of virtually all other countries except the major oil exporters. In such a situation how can the U.S., which has led the campaign for a more liberal world trade order since World War II, plausibly maintain that it must resort to protectionism.

Advocates of protection likewise find the cyclical downturn theory most convenient, but with the twist that interim protection is required to facilitate the re-acquisition of full competitiveness. The latter two interpretations (product cycle maturity and Japan as number 1), by contrast, imply that only long-term, increasingly stringent protection can save the domestic industry.

Even the most vigorous campaigners for protection, however, recognize that they face an uphill battle if Japan's "voluntary" restraint proves inadequate to stem the U.S. auto industry's decline. The long-term threat is offshore production by the American and European manufacturers, not simply competition from the Japanese. And it may prove highly difficult to restrain, even putting domestic political considerations aside. By way of illustration, Mexico is among the most favored offshore production sites. The U.S., needing Mexican oil and natural gas, having a major stake in Mexican political stability, and anxious to minimize pressures for increased migration by Mexican workers, has overwhelming reasons to avoid erecting major new barriers against Mexican manufactured imports. The result may be a sort of "privileged sanctuary" for manufacturers seeking convenient proximity to the American market, and security against protectionist initiatives, without having to pay high U.S. labor costs and taxes or having to comply with U.S. regulations.[39] Taking both Japanese competition, offshore procurement, and domestic automation all into account, it is easy to imagine scenarios in which U.S. auto manufacturing employment as of 1990 will be half or less the 1978 level.[40]

The Road Not Yet Taken: The "Corporatist" or "Social Contract" Strategy

Suppose the automotive product trade balance continues to worsen, domestic employment continues to decline, and the financial situation of the U.S. manufacturers continues to deteriorate over the next several years. Are the only alternatives stronger protectionism or passive acceptance? Or, can limited protection, which tends normally to impede adaptation, in some circumstances form part of an effective strategy to accelerate the pace of competitive adjustment?

Those who claim that it can generally advocate strategies that we label "social contract" or "corporatist". The distinguishing feature of these strategies, which vary widely in detail, is their reliance on tripartite bargaining among business, labor, and government representatives, with the aim of mutual agreement (the "social contract") on concessions to form part of an overall recovery program. The government role is to facilitate adaptive agreements that the parties would be unable to achieve by themselves, or could achieve only at the cost of lengthy delays and bitter turmoil. Its tangible contribution is to provide "sweeteners" in the form of trade restraints, tax incentives, regulatory changes, etc.

Advocates of this approach note that the government is now providing many of these "sweeteners" in any event, and that it is profligate to do so <u>without</u> demanding concessions in return. In the current period, they argue, labor is being asked to accept wage restraint, rapid progress in the application of labor-saving technologies, and intensified efforts to boost productivity -- all in an environment of overall employment contraction. And management hopes that the workforce will become more enthusiastic to boot! On the other side of the table, managers are being called upon to restrain their own compensation and perquisites, to alter their basic orientations toward labor, and simultaneously to adapt to fundamental changes in the character of their market. Additionally, if successful adjustment is possible at all, it will probably require major concessions from stockholders (in the form of profit-sharing and dividend deferral) and creditors (in the form, at very least, of long-term credit expansion).

The transition required to achieve cost-competitiveness with the Japanese is too sharp, in this view, to be accomplished within a few years by normal bargaining among the private parties. The essence of bargaining is that consensus must be achieved among the negotiators, and then sold to their followers. Given sharp differences of perspective among the key negotiators, and the very doubtful ability of some (especially labor leaders) to obtain ratification of painful agreements, the process is ill-suited to extract major concessions that are not offset by major new benefits. In the typical declining industry situation, exemplified by autos right now, the private parties have few benefits to offer. But the government has many. And by bargaining (rather than simply giving) them away, it can greatly enhance the probability of agreement on painful but adoptive steps by the private parties. The potential of this government role is greatest, of course, where business and labor leaders personally accept the need for unpalatable change, and are disposed to stress the value of government "sweeteners" to their constituencies.

Recent applications of this model in the U.S. include the New York City and Chrysler financial crises. In both, federal officials obtained leverage by holding out the carrot of assistance, and utilized it to press for painful decisions by the parties most immediately involved. In New York the managers were public officials, but this merely compounded the difficulty. The city officials sat even more uneasily on their perches than their counterparts on the labor side of the table. And, while it was quite "thinkable" that federal officials might eventually stand aside in the face of a long strike or financial collapse at Chrysler, it was scarcely believable that they could do so if confronted by similar developments in New York City. Nonetheless, the spectre of court-imposed or federal receivership, combined with the lure of modest federal aid, sufficed to generate agreements among the parties that would doubtless have entailed chaos in the streets only a year or two earlier.

In the final months of the Carter administration, as the Chrysler assistance program was being implemented and evidence was accumulating of the magnitude of the Japanese cost advantage vis-a-vis American auto manufacturers,[41] some federal officials became quite enamored of the "social contract" approach. Most notable among them was Transportation Secretary Neil Goldschmidt, who explicitly favored the use of interim protection as one source of government leverage.[42] The President, it should be emphasized, never accepted Goldschmidt's ideas, though he proposed and implemented a version of the "social contract" approach in the Chrysler case. And President Reagan has made clear that, although he will continue to administer the Chrylser legislation, as a matter of principle he vigorously opposes the notion of government intervention in private sector bargaining.

The basic arguments against the "social contract" approach are presently compelling for most American policy makers, though they recognize that it has been widely utilized in Japan and Western Europe. It entails a significant potential increase in government direction of the economy. Additionally, because bargaining systems work best when the negotiators can reliably deliver on their commitments, there is a powerful thrust in corporatist systems toward centralizing power and insulating leaders from democratic controls (such as worker referenda on collective bargaining agreements).

Finally, there is a risk that the public officials will become impassioned advocates of their sectoral clienteles, losing sight of the overall national interest in such policies as free trade, inflation control, environmental protection, and preservation of a competitive market economy. This risk is compounded in any system by the fact that the sectors most involved in tripartite bargaining tend to be those which are least able to compete successfully in the marketplace. And it is doubly compounded in the American system because constituency pressures on Congress loom very large in the policy process, rendering decisions to abandon declining sectors extremely difficult. The U.S. system has dealt with this problem historically by striving to minimize government intervention as a matter of general ideology and policy. The barriers to intervention have been falling in recent decades, but competitive capitalism remains a central theme of American policy, and the new federal administration is committed to giving it higher priority than any other in the past half-century.

Nonetheless, it is easy to imagine the following scenario. Interim protection has, two or three years from now, clearly failed to stem the decline of the domestic auto industry. The administration is searching desperately for a way to prevent the collapse of some of the nation's largest corporations and/or a rush by them to offshore production. The potential direct unemployment impacts, and reverberations throughout the economy, are enormous. Thus, having negotiated trade restraint with the Japanese in 1981, the administration considers more stringent protectionist action in 1983 or 1984. And it begins to consider more aggressive strategies for enhancing industry competitiveness over the long run.

We do not suggest that this is a probable scenario, simply that it is quite possible. Governments regularly revise or ignore their theories when confronted with problems for which they seem inadequate. The explicit theories of the new administration should have precluded negotiation of the May 1 agreement -- and the President's key foreign and economic policy advisors reportedly opposed it. But the pressure for some positive action in the face of rapid import growth over the past two years prevailed.

Should similar pressures become irresistable in future, the "social contract" approach may look quite appealing, just as it did in the Chrysler case. To the industry and its workers, it offers policy actions that they desperately want. To the opponents of protectionism and other forms of assistance to industries in trouble, it offers a guarantee that the private beneficiaries of public aid will have to pay a heavy price -- one designed to minimize future claims by others, to reduce the inflationary impact,and to provide some hope that it may be possible to phase out special assitance within a few years.

Concluding Remark

Given previous experience with voluntary trade restraint in other sectors, it seems likely that the issue of protection for the U.S. auto industry will remain on the policy agenda for some time to come. Though it may be hoped that the May 1 agreement will prove an isolated, temporary protectionist act, it seems at least equally likely that it will prove "a foot in the door." Almost certainly, some of the groups that pressed for protection in 1981 will view it as such.

If and when the issue of auto industry protection emerges again, it will probably involve more aggressive demands than those of 1980-81. There are two reasons for this. First, the precedent of protection will already have been set. Second, the return of the issue will itself be a symptom of the inadequacy of industry adjustment under the umbrella of the May 1 agreement.

It seems unlikely that stronger protection will be acceptable to very many outside the industry unless accompanied by credible promises of major concessions by business and labor. The establishment of such credibility is likely to require some form of tripartite bargaining, even if informal and disjointed. (Much of the bargaining in the New York City case, it should be recalled, involved Congressional committee pressures rather than formal negotiation.)

At the same time, free trade sentiment remains extremely strong. If the auto industry proves unable to hold its own without long-term protection, many will argue that it should be allowed to die. In such a situation we may anticipate a great debate about the relevance of a strong domestic auto industry (together with such related industries as steel, rubber, and machine tools) to a strong national defense, as an overlay to the more conventional arguments about free trade vs. protection. At that point, if it arrives, the nation's postwar commitment to a more liberal trading order will receive one of its most challenging tests.

Notes

1. Leonard Silk, "Free Traders' Defeat on Cars," New York Times (May 6, 1981), p.D2.

2. David B. Yoffie, "Reagan's Mythical Auto Restraint Agreement," Wall Street Journal (May 18, 1981), p.26.

3. The Weidenbaum quote is from the informative article by John F. Stacks, "The Administration's Split on Auto Imports," Fortune (May 4, 1981), p.162. Other reports on the debate inside the Reagan administration over auto import policy can be found in Time ["In Search of a Trade Policy," (March 23, 1981), p.68 and "Tough Tangle Over Trade," (March 16, 1981), p.71] as well as numerous articles in the New York Times and Wall Street Journal.

4. "Detroit Is Fighting Back," Time (May 11, 1981), p.56.

5. For an analysis of how this free trade dominance came about see Charles S. Maier, "The Politics of Productivity: Foundations of American International Economic Policy After World War II," International Organization (Autumn, 1977), pp.607-634.

6. Susan Strange, "The Management of Surplus Capacity: or How Does The Theory Stand Up to Protectionism 1970s Style," International Organization (Summer, 1979), pp. 303-334.

7. See Richard Blackhurst, Nicolas Marian, and Jan Tumlir, Trade Liberalization, Protectionism and Interdependence (Geneva: GATT, 1977).

8. For the anti-inflation argument against auto import protection see Charles L. Schultze, "Against Auto Import Protection," Wall Street Journal (March 20, 1981), p.3.

9. Two articles that analyze trade frictions as a factor in diplomatic relations with Japan are: Douglas D. Mitchell, "The Political Impact of U.S. Economic Relations with Japan," U.S. Role in a Changing World Political Economy: Major Issues for the 96th Congress. A compendium of papers submitted to the Joint Economic Committee, Congress of the United States, 96th Congress, 1st Session (June 25, 1979), pp.386-402, and Isaac Shapiro, "The Risen Sun: Japanese Gaullism?," Foreign Policy 41 (Winter, 1980-81), pp.62-81.

10. "America's Restructured Economy: One Country, Five Separate Economies," Business Week (June 1, 1981), pp.56-87.

11. For a slightly different but compatible discussion of the domestic economic support for free trade see Robert Gilpin, "The Crises of World Political Economy: Contrasting American Perspectives," U.S. International Trade Strategy. Hearings before the Subcommittee on International Trade of the Committee on Finance, U.S. Senate, 96th Congress, 2nd Session (July 28, August 1, September 10, 1980), pp.163-190.

12. See Trade Policy Issues: Global Structural Changes and the U.S. Economy (New York: United Nations Association, 1979).

13. I.M. Destler, Making Foreign Economic Policy (Washington, D.C.: Brookings, 1980), pp. 143-190.

14. Raymond A. Bauer, Ithiel de Sola Pool, and Lewis A. Dexter, American Business and Public Policy: the Politics of Foreign Trade (New York: Atherton Press, 1963).

15. See Strange, "Surplus Capacity," for a discussion of the new protectionism's techniques. See also David B. Yoffie, "Orderly Marketing Agreements As An Industrial Policy: The Case of the Footwear Industry," Public Policy 29 (Winter, 1981), pp.93-119.

16. Ford took the lead in pressing the case for negotiated import restraints. See "Statement of F.G. Secrest Before the House Ways and Means Committee" (March 7, 1980); and also "The Automobile Crisis and Public Policy." An interview with Philip Caldwell," Harvard Business Review 59 (January-February, 1981), pp.73-82.

17. Douglas Fraser, "Statement before the Subcommittee on Trade, House Committee on Ways and Means on the Auto Import Situation" (November 18, 1980).

18. See Stacks, "The Administration's Split," p.162. See also: Clyde H. Farnsworth, "Tokyo's Car Curbs Hailed in U.S. But Japanese Makers are Angered: Congress Move Now Unlikely," New York Times (May 2, 1981), p.1.

19. This union opposition to "captive" imports was apparently a highly emotional issue with the rank and file. See "Statement of Joseph Reilly, President, United Auto Workers of America, Local #906, Mahwah, N.J.,; accompanied by Joseph Desmond, Bernard Jackson and Thomas Keefe," Energy Conservation and Conservation Act of 1975. Hearings before the Committee on Finance, United States Senate, 94th Congress, 1st Session (July 10,11 and 14, 1975).

20. "GM's Chairman Call for Automobile Import Restrictions," Philadelphia Inquirer (March 16, 1981), p.3.

21. Calculated from data in: Motor Vehicle Manufacturers Association, MVMA Facts and Figures '79, p.69.

22. Ibid, p.14.

23. Stacks, "The Administration's Split," p.162.

24. Ibid.

25. See Destler, Making Foreign Economic Policy, for a review of the past two decades of change in the bureaucratic machinery.

26. Farnsworth, "Tokyo's Car Curbs," p.1.

27. Douglas A. Campbell, "Chase: Auto Limits Won't Boost Sales," Philadelphia Inquirer (May 31, 1981), p.D1.

28. Yoffie, "Reagan's Mythical Auto Restraint," p.26.

29. Robert Ball, "Renault Takes Its Hit Show on the Road," Fortune (May 4, 1981), pp.274-286.

30. Yoffie, "Orderly Marketing Agreements," p.102.

31. The reactions cited in this paragraph are as described in Farnsworth, "Tokyo's Car Curbs," p.1.

32. The market shift and lack of small car capacity argument is laid out in U.S. Congress, House Committee on Ways and Means, Subcommittee on Trade, Auto Situation: 1980, 96th Congress, 2nd Session (June 6, 1980).

33. The argument for the impact of the downturn and of high interest rates was made by the anti-protection majority of the International Trade Commission. See U.S. International Trade Commission, Certain Motor Vehicles and Certain Chassis and Bodies Therefor: Report to the President (Washington, D.C.: USITC Publication 1110, December, 1980, especially the views of Chairman Bill Alberger at pp.4-36. Figures on the decline of motor vehicle production are from Standard & Poor's Industry Surveys: Autos and Auto Parts, January 22, 1981, page A127.

34. This was the position taken by George C. Eads of President Carter's Council of Economic Advisors. See "Statement of George C. Eads," World Auto Trade: Current Trends and Structural Problems. Hearings before the Subcommittee on Trade, Committee on Ways and Means, House of Representatives. 96th Congress, 2nd Session (March 7,18, 1980), pp.247-250; and it seems to have been the position taken by Murray Weidenbaum, Chairman of President Reagan's Council of Economic Advisors, in debates within the administration. See Stacks, "The Administration's Split," p.162.

35. See Raymond Vernon, Sovereignty at Bay: The Multinational Spread of U.S. Enterprises (New York: Basic Books, 1971), pp.65-77.

36. For an analysis that largely accepts the product cycle maturity assumptions and predicts that, barring political action, most auto manufacturing will have moved offshore within 10 to 15 years, see William J. Abernathy, "The Competitive Status of the U.S. Automotive Industry: Import Implications," Statement to the Subcommittee on Economic Stabilization of the Senate Committee on Banking, Housing and Urban Affairs (April 3, 1980).

37. Ezra Vogel's Japan as Number One (Cambridge, Massachusetts: Harvard University Press, 1979) is the best known general statement of this thesis. In the auto sector the view that Japan is the major problem has been articulated many times by U.A.W. President Douglas Fraser. Indeed, while singling out the Japanese for criticism, Mr. Fraser has praised "the responsible example of VW and Renault" in establishing production facilities. And he has expressed appreciation to the European auto makers generally for not taking advantage of the U.S. industry's time of troubles. See: Douglas A. Fraser, "Statement before the Subcommittee on Trade, House Committee on Ways and Means on the Auto Import Situation" (November 18, 1980).

38. On a current account basis (the broadest measure of international trade, including services and short-term capital flows as well as merchandise trade), the U.S. enjoyed a $4 billion surplus in 1980 while Japan experienced a $12 billion deficit. New York Times (January 25, 1981), Section 3, p.1.

39. For background to this argument see Douglas Bennett and Kenneth E. Sharpe, "Transnational Corporations and the Political Economy of Export Promotion: The Case of the Mexican Automobile Industry," International Organization 33 (Spring, 1979), pp.172-202; see also "'Little Detroits' Boom in Mexico," New York Times, (March 3, 1980), p.D1.

40. In his Senate testimony William J. Abernathy warned that absent some kind of government action, "there are very few barriers to a virtually complete displacement of the U.S. automobile industry by foreign-based production sources..." See Abernathy, "The Competitive Status of the U.S. Automotive Industry." The U.S. Department of Transportation took a more moderate position on loss of jobs, but, when productivity improvements are taken into account, it suggested figures that would mean that in a bad sales year in the late 1980s auto employment could fall to around 500,000 or below - roughly half of its 1978-79 peak of 950,000. See U.S. Department of Transportation, The U.S. Automobile Industry, 1980 (Washington, D.C.: January, 1981), pp. 85-86.

41. Remarkably, Japanese industry costs were *terra incognita* to public officials until at least the final quarter of 1980. A new consensus began to emerge about then in consequence of analyses by staff of the DOT Transportation Systems Center in Cambridge and by Professors William Abernathy and Kim Clark of the Harvard Business School. Industry executives, who had never put forth estimates of their own (thereby displaying the standard reluctance of businessmen to discuss costs publicly), confirmed that the TSC and Abernathy-Clark estimates were roughly in accord with their own. Subsequently, they began to use these in some of their own speeches.

42. Perhaps the most explicit expression of the corporatist position is to be found in the long message to the President with which former Transportation Secretary Neil Goldschmidt opened his report on The U.S. Automobile Industry, 1980, pp.1-11.