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I want to spend some time with you today discussing American trade policy and our future in a more competitive world. And I want to begin by remembering Benjamin Disraeli's statement in 1843, reflecting on British trade policy: "Free trade is not a principle. It is an expedient." These days, unfortunately, Disraeli's insight has been forgotten, not entirely in Europe and not at all in Asia, but certainly in the United States. From the Roosevelt Administration onward we have espoused a free trade philosophy.

That made sense when the world was recovering from depression and then from war. During the 1950's and early 1960's America's great strength allowed it to absorb economic blows -- which for it were modest -- in the interest of maintaining the trading system and sustaining economic recovery in war-ravaged Europe. And as long as the total pie was expanding, sacrifices were easy. The cost was small and political and economic gain immediate and real.

That was then and this is now, as the saying goes. Our pursuit of principle now defies reality rather than accommodates it. The report of the President's Commission on Industrial Competitiveness, which appeared last January summarized:

Beyond our $123 billion trade deficit, we are losing market share in industry after industry, and not just in 'old' industries like steel and textiles. In high technology, for example, we have lost world market share in 7 out of 10 categories.

The National Association of Manufacturers has concluded that virtually all of the increase from 1983's $69 billion deficit to 1984's $123 billion was accounted for by a $50 billion increase in the deficit for manufactured goods. Only three years earlier, in 1981, we had a $5 billion surplus in that sector. The significance of these developments for our economy cannot be underestimated. According to the President's Commission:

"Our ability to compete in world markets is declining . . . . The U.S. position as a world leader ... depend(s) on the ability of American industry to compete both at home and abroad."

In short, our policies over the last several years are leading to the destruction of our manufacturing sector with all the political, economic, and national security consequences that implies. The fact that we have created 6-8 million new service jobs is good news, but it should not permit us to forget that 2 million largely manufacturing jobs have been permanently removed.

These changes represent the first point I want to make. The world today is very different from the world of thirty, or even twenty, years ago, and the United States does not play the same dominant role. The second point is that the world economy does not operate the way economics textbooks tell us it should, and nations do not always act in the rational way economists tell us to expect.

My conclusion from this is that we have to act more aggressively if we are to preserve both the international trading system and our own interests. I am not one of those prepared to walk away from the system, but neither am I prepared to simply assume that preserving it without change should be the only basis for our trade policy.

The Changing Economic World

Although the events and policies of the last four years have led us to a trade crisis, that crisis has its roots in changes in the world trading system that we have failed to address over a much longer period.

-- the integration of many national markets into a true world market.

-- the new importance of that market as domestic growth slows.

-- growing demands for international rules that enforce free market discipline and fair trade principles.

-- the failure of older industries to adjust to new competition.

-- the growth in importance of non-Western trade players with different standards and rules.

-- the devastating effect of the overwhelming debt of LDCs

These changes and others mean that our underlying policy premise in the post-war era -- unilateral free trade -- is no longer relevant. It may be ideal, but we are not living in an ideal world. And in a second-best world, you don't insist on first-best policies. Or, as my collegaue Jack Danforth has said, when you have a $123 billion trade deficit, maybe it's time to cheat a little.

Unfortunately, the Administration's economists are still telling us to play by the old rules. They have lost their way in seeing our transition to a new economic world, but they have not lost their baggage -- it is still the classic free trade theology of the past, textbook theory that bears little resemblance to the reality of a complex trading system.

Redefining Free Trade

It seems to me that the high priests of free trade make two mistakes. They focus exclusively on imports into the United States, and they persist in adhering to an artificial model rather than standing eye to eye with the all too human reality of trade.

In fact, free trade means, or ought to mean, the operation of free market principles in the movement of goods, services, and capital across national borders.

Of course, that means removal of barriers to access, lowering of tariffs, and resistance to new protectionist devices by all governments.

But it also means the operation of the free market in the production process -- an end to arbitrary standards and testing requirements, looking the other way at patent piracy or other intellectual property infringements, and protectionist government procurement policies. It also means removal of constraints on services and capital transfers. In short, it means permitting the most efficient allocation of economic resources globally and operating all economies on the basis of comparative advantage.

If this definition seems out of reach, try looking at it in light of nations with interventionist governments to "create" comparative advantage by means of subsidy, growth management and restriction of competition, both foreign and domestic. Like Japan.

One nation practicing this system is a problem. If every nation practiced it, commerce would be paralyzed completely. Yet the trend, at least in Asia, is to copy the system, given its obvious success.

The second mistake free traders make is to approach the trading system as if it were a finely balanced clock instead of a Rube Goldberg contraption. In this mechanical view, all problems are caused by the high value of the dollar, which in turn is due to the federal budget deficit and the failure to cut spending.

In fact, the dollar has declined 31.3% against European currencies since its February peak and 22.2% against the yen, even though we have --unfortunately -- done very little about the budget deficit or cutting spending. Some may complain that the dollar's decline has been produced with "smoke and mirrors". That may be true, but it demonstrates the value of smoke and mirrors in the exchange markets.

If the truth be known, exchange rate movements are more complicated and more susceptible to psychological influences than textbook theory suggests. Had the Administration better understood that, it could have done a great deal to "talk the dollar down" at an earlier stage. It also could have moved earlier than September to improve coordination of macroeconomic policies among the major trading nations, which is absolutely essential to balanced exchange rates. Major challenges now will be to make sure the dollar continues to move in the right direction and that it drops against European currencies as well as the yen.

Even if the dollar continues to drop, that will not solve the entire problem by itself. We have to do a better job of recognizing the complexities of the trading system instead of relying on theories that ignore them. That may not lead to different conclusions about what needs to be done about the budget deficit, interest rates, or the dollar, but it will lead to a realization that those are not the only things that need to be done.

To say that we are not there yet is to break new ground in the field of understatement. But we are slowly beginning to recognize how the modern trading system works and how creative and determined governments and individuals can quickly invent new means of distorting the free market to serve their short term political or economic ends at the expense of others.

A Free Trade Policy for the 1980's

To respond to these trends, let me suggest some guidelines for a free trade policy for the 1980s. Many of them are embodied in a new Senate trade initiative, the Trade Enhancement Act, which Jack Danforth, myself and a total of 30 senators introduced on November 20.

The first is Adjustment.

A healthy economy is a changing economy; yet a changing economy creates victims -- people and companies left behind as competitiveness is lost. Victims of change caused by dumped imports or blocked market access abroad are particularly angry since their unemployment is not due to market forces. These victims are lobbyists for protection, and they rarely distinguish among themselves as victims of "free trade" or "unfair trade".

Good trade policy means attacking unfair trade. But it also means knowing when comparative advantage is slipping away and helping our industries adjust to the new competition. The Senate trade initiative creates a balanced quid pro quo system that makes import relief available to industries that will plan and commit to a changes that will help them adjust. This is essential to our long term economic health, our political interest in reducing the constituency for protection in this country, and our continued leadership of the world trading system.

The second principle is reform of the system.

It is not news to suggest that the GATT is a weak reed when it comes to preserving our markets. The dispute settlement process is extremely slow and often ineffective as "losing" countries block adoption of panel reports. Currently there are five cases where the U.S. has won favorable panel reports; yet nothing has happened. The Trade Enhancement Act will provide for mandatory retaliation in cases like these much earlier in the process.

This is not the time to go into an extended discussion of reform, but probably the two most useful changes that could be made are to permit a less than unanimous vote to take action, and to expand and refine GATT code coverage by plugging loopholes and ambiguities left over from the Tokyo Round of trade negotiations.

The third is getting a grip on the dollar.

There are those who want to go back on the gold standard or back to fixed rates, but I believe that our current problems do not lie in the system, but in our lack of careful, foresighted management of it, and an understanding that good management depends upon a mix of policy tools. Obviously cutting spending and the federal budget deficit is a necessary step. Better psychological management is also a criticial element. The results of Secretary Baker's efforts over the past ten months are a clear illustration of that reality. The Trade Enhancement Act establishes procedures to keep that movement going in the right direction.

The fourth guideline is making the free market work.

I could spend 20 more minutes giving you examples of market distorting practices by virtually every country we trade with. We need to insist on their elimination. That means not only "classic" protectionism like extraordinarily high tariffs or other barriers to market access, but also phasing out subsidies, state control of enterprises, and government-set prices, and encouraging competition.

Those steps are painful in the short run, but they will do two very important things: they will bring countries more in line with their international obligations, and they will promote healthier, more balanced growth. And this is good for us as well as them. By providing for mandatory retaliation in a wide variety of cases, the Senate trade initiative will help us better enforce our trading rules.

The fifth guideline is to <u>be more aggressive.</u>

My theme through all these comments has been the need not simply for new policies but for new <u>tactics</u>. When other nations pursue policies that impose costs on us, we should pursue policies of our own that balance the costs. That may seem self-evident, but our government has not been paying attention. International institutions are not currently in any condition to fight for us, no matter how right we are. Of course we should continue to work within those institutions. But our follow up policies, when we are found to be right, should enforce our rights and strengthen the system in the process. Not to do that is to be an international patsy -- a reputation we have already acquired on trade issues in numerous countries, particularly Japan.

Everyone agrees that subsidies and protectionist barriers ought to be eliminated. The question is how to achieve it. Our experience in the last ten years demonstrates that threat and complaint alone won't do the job. On occasion we will simply have to retaliate. Good negotiators know some effective tricks. They know that agreement is rarely reached until the night before the deadline. And they know agreement will not be reached unless there is a clear cost to the other side of not agreeing. Those are principles we need to adopt in our international negotiations, and they are embodied in the Senate bill.

The final guideline is <u>promoting exports</u>.

One area where tactics are particularly important is in the area of export financing. Subsidized export financing has long been one of the most offensive -- and effective -- forms of market distortion. We stopped part of the problem two years ago after Congress was close to enacting a "war chest" to match foreign subsidy offers. That drove the French, Italians, and Japanese to the bargaining table. The Administration has since reversed itself several times but now again supports using a war chest as leverage for a better international agreement. The Senate trade initiative contains this proposal, and my International Finance Subcommittee has already begun work on the bill.

I suspect some of you may have noticed that these principles do not include avoiding protectionist actions at home -- the favorite remedy of the <u>Wall Street Journal</u>. The omission is intentional, because that approach addresses symptoms, not causes. If we can pursue what I have recommended -- adjustment at home, trading discipline abroad, and free market policies everywhere -- pressures for protectionism will diminish. My differences with others do not relate to these policies. They relate to how we achieve them -- to the tactics we employ. We must be willing to use the resources we have to act in our own interest. The time is long past when we can afford to do anything else.