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Statement of

Allan I. Mendelowitz

Senior Associate Director, National Security and

International Affairs Division

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Subcommittee on International Trade

Senate Committee on Finance

on

The Impact of Exchange Rate Changes on U.S. Trade Laws and The GATT System

Mr. Chairman and Members of the Subcommittee:

We are pleased to be here this morning to discuss how exchange rate movements influence the effectiveness of U.S. trade laws and how floating exchange rates affect the goals and principles of the international trading system. As you requested, we examined the compatibility of U.S. trade laws, specifically the antidumping and countervailing duty provisions of the Tariff Act of 1930, as amended, and section 201 of the Trade Act of 1974, as amended, and the rules of the international trading system with the floating exchange rate regime. We have reviewed the literature on this topic, discussed the issues with government and private sector experts, and analyzed selected trade cases to identify the consequences of exchange rate movements for trade law remedies. We will submit our final report after we have had the opportunity to fully consider comments on it by the agencies involved in administering the U.S. trade laws.

Exchange rates do have an impact on the effectiveness of tariffs in protecting domestic industries. If the dollar were to appreciate or grow in value relative to other currencies after imposition of a tariff, for example, the effective protection is diminished.

However, exchange rate changes do not reduce the effectiveness of the antidumping and countervailing duty provisions. Industries that petition for relief from dumped or subsidized imports could still be injured by exchange rate changes, but that same possibility exists for other industries that compete with fairly traded imports. The unique disadvantage that these industries face--the dumping or subsidy--remains offset by the imposed duty. Exchange rate changes do add a complication to the administration of the antidumping law, however.

On the other hand, when an exchange rate appreciation impairs the ability of tariffs to protect industries that have obtained relief under the safeguard or escape clause provisions of section 201, it hinders efforts to achieve the law's objectives of providing temporary relief to facilitate an industry's adjustment. Quotas or other quantitative restrictions on imports will provide a level of protection that is not as directly affected by exchange rate changes. The greater certainty of quantitative restrictions in the face of exchange rate or other changes explains in part their frequent use in section 201 and other safeguard actions. Quantitative restrictions do impose considerable economic costs, however, and recognition of that fact has led to proposals that they be auctioned to the highest bidder rather than allocated administratively. A quota auction offers a number of potential benefits, including reducing the distortions of trade patterns and allowing the government to derive at least some revenue. Some proposals call for this revenue to be spent on some form of aid to the industry granted relief to facilitate its adjustment.

Experience with auctioned quota rights to administer safeguard actions has not been sufficiently extensive to assess whether potential benefits would be realized or whether there might be significant problems in using them. Australia and New Zealand have used such auctions and have encountered administrative problems, but in our view their experience does not provide useful lessons for the United States because of the differences between the U.S. economy and regulatory system and those of Australia and New Zealand. We believe, however, that the potential advantages of auctioned quota rights, relative to the known disadvantages of allocated quotas and of tariffs and import duties under floating exchange rates, warrant consideration. We therefore propose experimenting with auctions in selected cases and evaluating the results, to establish their effectiveness, administrative feasibility, and potential for wider application. The Department of the Treasury should have primary responsibility for these auctions, since it has experience in auctioning government securities and since the auctions would be a source of government revenue. Treasury should coordinate its actions with other agencies involved in section 201 cases.

The agenda for the next round of multilateral trade negotiations is generally expected to include reconsideration of a code or agreement governing international use of safeguard actions to temporarily protect domestic industry from injury in order to facilitate adjustment. Efforts to draft a safeguards code failed during the Tokyo Round.

While quantitative restrictions offer the advantage of greater assurance of protection in safeguard actions, the General Agreement on Tariffs and Trade favors tariff protection, since it creates less trade distortion, is less burdensome, and is generally a less ambiguous or hidden form of protection. Efforts to negotiate an agreement governing international use of these safeguard actions will have to balance these competing interests. We propose that the U.S. Trade Representative explore the auction of import rights to administer quantitative restrictions in the safeguard code negotiations.

ANTIDUMPING AND COUNTERVAILING DUTIES

A major goal of U.S. trade law is to protect domestic industries from unfair import competition. If foreign firms receive subsidies enabling them to underprice their products in the United States, countervailing duties (CVDs) may be imposed to offset this unfair advantage. Similarly, foreign firms found to be dumping their products in the United States are subject to antidumping duties (ADDs). The antidumping and countervailing duty laws do not give U.S. firms absolute protection against foreign competition and were not intended to do so. Their design and scope limits them to offsetting the unfair foreign practice.

An exchange rate appreciation that occurs after a CVD or ADD is imposed may prevent a domestic industry from being competitive with imports. Relief provided by unfair trade laws can only restore the industry to the same position as other U.S. industries that are faced with fair import competition after exchange rates change. The dumping or subsidy margin that would have put the industry at an unfair disadvantage remains offset by the imposed duty.

Exchange rate movements can play a major role in determining whether an ADD or CVD will be imposed. For example, an appreciating dollar could be the major reason why a foreign firm can undersell domestic competitors. The International Trade Commission (ITC) has never rejected an industry petition on the grounds that exchange rate fluctuations are the source of injury rather than the foreign subsidy or dumping practice. The ITC, however, is divided on whether an ADD or CVD should be imposed when the injury attributable to a subsidy or dumping violation is negligible. Some commissioners argue that if a strong dollar allows a foreign firm to undersell a U.S. competitor by a much greater margin than attributable to subsidies or to dumping, imposing an import duty would do little to lessen the injury to the domestic industry. Other commissioners contend that such analysis oversteps the ITC's legal authority. They argue that the law requires that countervailing or antidumping duties be imposed if the subsidized or dumped imports are injuring the U.S. industry, even if the duties are imposed at trivial or de minimis rates and cannot, by themselves, end the injury to the domestic industry. (De minimis standards for less than fair value margins and net subsidy margins have been established by administrative practice at Commerce; this standard is presently set at 0.5 percent of selling price.)

Exchange rate variations can create significant procedural complications in dumping cases, because the calculated dumping margin could be significantly affected by the exchange rate used by Commerce in calculating the margin. In cases when the foreign nation has a high inflation rate or when the exchange rate between the dollar and the foreign currency is changing rapidly, for example, the date of the sale, which establishes the proper exchange rate, becomes more important than it would be if exchange rates were constant. Commerce has rules for handling these situations, but it still must rely heavily upon the expertise of its investigators in these cases. If Commerce determines that a dumping margin seems to exist only because of temporary exchange rate fluctuations, it may use the exchange rate from an earlier, more stable period to determine the dumping margin, if any. However, Commerce has used this regulation in only one case. (Melamine in Crystal Form from the Netherlands, 45 Fed. Reg. 29691 (1980).)

SECTION 201 RELIEF

Domestic industries that are seriously injured by imports can receive temporary relief from import competition under section 201 *et seq*. of the Trade Act of 1974, as amended. The question of whether the imports causing the injury are fairly or unfairly traded is not an issue in section 201 proceedings. Granting relief is an explicit Presidential decision that the nation's interests are best served by temporarily protecting a domestic industry from further injury from imports and allowing a period during which it may adjust to import competition by lowering production costs, transferring resources to alternative uses, or, in extreme cases, leaving the industry in an orderly manner. In these cases, an exchange rate appreciation could effectively nullify the program if tariff relief were granted. Exchange rate depreciation, such as the recent dollar depreciation, however, will have the effect of increasing the level of any tariff protection provided.

Current law does not specify the form of relief that should be granted under section 201. The ITC may recommend a tariff, quota, or other form of relief. The President may adopt the relief recommended by the ITC, substitute an alternative, or decide against granting any relief. Desirable goals of trade policy and GATT principles argue in favor of providing tariff relief rather than quantitative restrictions to protect an industry. Tariffs are preferred because they are considered to be the type of trade barrier that is least distorting to trade patterns and international prices and because their price effects generally are clearly visible while those of a quantitative restriction are less transparent. It is generally easier to hide the full extent of protection provided by a quantitative restriction.

In many cases where industries have been granted relief under section 201 or have received other protection after filing under section 201, however, an import quota or other quantitative restriction, such as a voluntary restraint agreement (VRA) or orderly marketing agreement, has been negotiated to limit imports into the United States. In recent years, the United States and other nations have frequently provided such temporary protection outside the formal channels of GATT Article XIX, which governs international use of safeguard actions. In the United States, the auto and steel industries have received such protection. Our September 23, 1985 report, Current Issues in U.S. Participation in the Multilateral Trading System (NSIAD-85-118), discusses safeguard actions. Unlike tariffs, these relief mechanisms provide a level of protection that is not directly affected by any subsequent exchange rate movements.

Quantitative restrictions that limit imports generally result in higher U.S. prices and higher foreign profits. The experience of the automobile VRA with Japan illustrates these consequences. Since 1981, Japan has limited its auto exports to the United States. By most independent analyses, the VRA has been effective in granting the domestic industry breathing room and in increasing employment in the industry. But the cost to the American consumer has been considerable. Studies have estimated that the price of an imported car was approximately $1,000 more than it would have been if the VRA had not been in place. Much of that price increase went to Japanese automakers and their U.S. dealers in the form of higher profits.[1]

The potential for foreign firms to receive substantial benefits from U.S. import relief to domestic industries and other problems with administered quotas has led to proposals to auction licenses granting the right to import products covered by quotas under section 201 or other safeguard actions. By auctioning quota rights rather than allocating them, the U.S. government,

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[1] Robert Crandall, "Import Quotas and the Automobile Industry: The Costs of Protection," Brookings Review, Summer 1984; and ITC, A Review of Recent Developments in the U.S. Automobile Industry, Including an Assessment of the Japanese Voluntary Restraint Agreements, USITC Pub. 1648, Feb. 1985.

rather than foreign producers, would capture the excess profits created by the quota. Under some proposals, the auction revenues would be used to fund industrial adjustment plans. Auctioned quota rights, furthermore, might generate less distortion of price competition than allocated quotas. If the quota rights are regularly auctioned, the barriers to entering the U.S. market would be less than if the quota rights were allocated on the basis of historical production levels or market shares. As we noted earlier, however, there are potential administrative problems with auctions and there is a possibility that auctioning would be challenged as incompatible with U.S. obligations under GATT. This issue is not explicitly addressed in the GATT General Agreement or Agreement on Import Licensing Procedures, however, and some experts believe that auctioning quotas would fall within the bounds of permissible safeguard actions under GATT Article XIX.

The limited experience with auctioned import licenses does not provide an adequate basis for recommending their widespread use. However, their potential advantages in some situations relative to the known disadvantages of current measures are sufficient to warrant experimenting with them in selected cases and evaluating their effectiveness, administrative feasibility relative to other forms of relief, and potential for wider application. Products in which international trade is governed by specific agreements to which the United States is a party, such as the Multi-Fiber Arrangement, would likely be poor candidates as test cases. Ideally, import licenses would first be auctioned in safeguard actions covering imports from several competing foreign suppliers.

One other alternative advanced as a means to avoid the influence of exchange rate changes on relief without resorting to quotas is to index the tariffs imposed under section 201 for changes in exchange rates. Although this proposal would protect an industry from further injury, most observers regard this alternative as administratively problematic and that it would increase the uncertainty of international trade. If tariffs were indexed monthly, for instance, transactions might be pushed ahead at the end of a month if the indexed tariff would increase in the next month or delayed if the tariff would drop. Because tariffs imposed under section 201 typically apply to imports from several countries, another problem would be in selecting the appropriate indexing scheme. Having a different tariff for each country based on bilateral exchange rates might be challenged as a violation of the GATT principle of nondiscrimination, since an index based on bilateral rates would treat nations differently.

GATT PRINCIPLES AND FLOATING EXCHANGE RATES

Some observers question whether the current international trading system, based on the rules embodied in the GATT, can continue to serve U.S. interests as long as floating exchange rates influence trade patterns. They believe that floating exchange rates exacerbate other problems frequently seen in the trading system. Trade problems attributable to exchange rates, furthermore, have weakened support for the GATT system.

The central goal of the international trading system is to foster trade to enable all nations to benefit from access both to larger markets for their products and to goods and services produced in other nations. A central element in the strategy to accomplish this goal is to eliminate trade barriers that interfere with free trade. While trade barriers are artificial determinants of trading patterns, however, exchange rates are a fundamental determinant because they change the underlying cost and production advantages for specific products. Such movements underscore the limits of trade policy in determining trade patterns. The effects of trade policy instruments --U.S. trade laws and the GATT-- cannot outweigh the effects of overall U.S. economic policy that could cause a misaligned dollar or an economic recession. As recent experience with the strong dollar demonstrated, however, the trade effects of exchange rates can damage support for an open trading system.

Despite its inherent limitations, the GATT system has basic goals and features that serve U.S. interests equally as well under floating rates as they would under fixed rates. The basic goals of the international trading system's rules, which include limiting trade barriers and avoiding unwarranted government interference in international trade, are no less important. In addition, many GATT agreements (such as those that seek to limit the use of discriminatory product standards to restrict trade or that govern government procurement practices) and multilateral trade negotiations are no less valuable under floating exchange rates. Although the role of the GATT is limited in many trade disputes because nations are unwilling to agree to and adhere to international rules, countries also ignored these rules under fixed exchange rates.

One aspect of the GATT system that is sensitive to exchange rate movements, however, is the issue of safeguard or escape clause actions. Countries, including the United States, have not usually observed the rules of GATT Article XIX in protecting their industries from imports. Negotiations toward a safeguards agreement were not concluded during the Tokyo Round, but the issue is expected to be considered during the next round of negotiations.

As I indicated earlier in my comments on section 201, tariffs can be less effective in protecting industries than quantitative restrictions if the dollar strengthens. If current efforts to coordinate macroeconomic policies and intervention in foreign exchange markets are unsuccessful in reducing misalignments, the impetus for quantitative restrictions will increase and conflict with the GATT principles, which favor tariffs as the preferred form of relief, will continue. This conflict will exacerbate the difficulty of negotiating a safeguards code that remains consistent with the GATT goal of minimizing trade distortions. An auctioned quota might be a less disruptive way to protect industries than administratively allocated quotas in safeguard actions. We propose that the U.S. Trade Representative explore the auction of import rights to administer quantitative restrictions in the safeguard code negotiations.

This concludes my statement. I would be happy to respond to any questions that you may have at this time.