The Mythology of Domestic Content

by Michael F. Bryan

It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy. The tailor does not attempt to make his own shoes, but buys them of the shoemaker. . . . What is prudence in the conduct of every private family, can scarcely be folly in that of a great kingdom. If a foreign country can supply some good cheaper than we ourselves can make it, let them buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage.

ADAM SMITH

The virtue of free trade is one concept that nearly every economist advocates. With free trade, a nation can produce the goods and services for which it has a comparative advantage and trade for the goods and services that it is less suited to manufacture domestically. Via profits, specialization channels limited economic resources into industries that use those resources most efficiently. Prices of domestic and imported goods and services will consequently fall, and total consumption and investment will increase. In essence, free trade raises the wealth of all nations that embrace it.

But if vintage Adam Smith wrote over a century ago, “Free trade, one of the greatest blessings which a government can confer on its citizens, has been generally rejected by every country unexceptioned.” Since 1979, Congress has heard pleas for protectionist legislation from producers of ammonia, shoes, textiles, copper, stainless and specialty steels, sugar, televisions, and machine-tool makers. A protectionist sentiment that nearly every economist advocates.

Economic analysis Michael F. Bryan tracks the auto industry for the Federal Reserve Bank of Cleveland. His latest report, “The Mythology of Domestic Content,” does not necessarily reflect the view of the Federal Reserve Bank of Cleveland or of the Board of Governors of the Federal Reserve System.

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mentary examines the issue of free trade in the market for new automobiles, arguing that what is good for the U.S. auto worker is not necessarily good for the United States.

Invasion of the Japanese Imports

In the early 1970s, U.S. auto factories produced primarily large cars, which made up the bulk of the U.S. new-car market. Confronted with rapidly rising gasoline prices (beginning in 1973), American consumers altered their traditional preference for six- and eight-cylinder cars to more economical, fuel-efficient models. In 1982 subcompacts represented the largest component of the new-car market with a 45 percent share, compared with 23 percent in 1975 and 12 percent in 1966. Unable to retold existing production facilities quickly, domestic auto manufacturers experienced a serious decline in market share. In less than ten years, new-car imports from Japan increased by over 400 percent. To some extent, and as growth of sales in small cars was cyclically induced, as consumers temporarily adjusted new-car purchasing patterns to meet economic growth. Some of the increase in demand for small cars should slow with economic recovery, as would the demand for Japanese subcompacts. Yet, current consumer tastes and relatively expensive gasoline suggest that the demand for small cars will be largely persistent.

There has been precedent for the American preference for smaller cars. In the 1930s and 1940s, two pioneering domestic auto makers—American Motors (Rambler) and Studebaker-Packard (Lark)—carved a segment from the new-car market with the “compact.” Between 1950 and 1960, the Rambler and the Lark increased market share from 1.2 percent to 8.2 percent. The perception of compact cars as offering greater Japanese labor productivity, induced inefficiencies are borne by U.S. consumers who must pay higher prices for protected products, laborers who lose employment opportunities in non-protected industries, and foreign workers who experience a profit loss. Even with the declining demand for cars since 1979, the voluntary auto-import quotas appear to have been effective. These restrictions have prompted an increase in Japanese auto production, and the voluntary first year of voluntary quotas, the retail price of Japanese cars rose 25 percent above pre-quota levels. Some of the price increase is in direct response to market shortages, as consumers bid up the price of available models. Volume limitations on U.S. car makers endangered the price structure, as Japanese car makers announced plans to import up to 200,000 subcompact cars from the Japanese. Roughly one-half of the labor-cost differential is due to U.S. automobile workers would increase. So, too, would the demand for such goods in the United States or radically limit their participation in the U.S. new-car market. In either case, two competing conditions would arise: the structure of the car industry would generate price increases for new cars. The Japanese would lose the cost advantages from such a bill, which originally sported 224 requirements would be graduated according to the type of car manufactured. Volume limitations on U.S. car makers would mean that the Japanese would have to build plants in the United States or radically limit their participation in the U.S. new-car market. In either case, two competing conditions would arise: the structure of the car industry would generate price increases for new cars. The Japanese would lose the cost advantages from such a bill, which originally sported 224