Office and Plant:
2800 South 61st Court
Cicero, Illinois 60804-3091

(708) 735-8000
(800) 323-2750

Corey
STEEL COMPANY

Mailing Address:
P.O. Box 5137
Chicago, Illinois 60680-5137

Facsimile:
(708) 735-8100

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Free Trade Theory in Today's World - - Confronting Reality

According to classical economic theory, free international trade will result in higher incomes for all countries. In past letters, we have pointed out that, whatever the worth of the theory in the abstract, it will not work as advertised in a world of subsidies, dumping and other trade distorting practices undertaken by governments and private companies.

We have recently run across a study showing that, even if trade distorting practices did not exist, classical theory does not adequately recognize that, in today's world, free trade can harm the interests of individual countries. Indeed, that study, *Global Trade and Conflicting National Interests* (by Ralph E. Gomory and William J. Baumol), presents tools of analysis that could assist in determining when support for free trade might be outweighed by our national interests.

The traditional case for free trade is based on the proposition that all countries will improve their economic lot if each is free to exploit its natural competitive advantages. The paradigm often used is England making wool cloth and Portugal making wine. Because each country enjoys a natural advantage in making its own product, it behooves each to stick to its last and to buy the other's product. The net result is that England gets more and better wine than if it tried to make it at home and likewise for wool cloth in Portugal. Trade has increased the total income of both countries.

Gomory and Baumol point out that two factors have changed since the classical theory was developed by David Ricardo in the early 19th Century: First, it does not consider the effects of industries that now present huge barriers to entry. One hundred years ago, even making automobiles could be almost an amateur activity, with a host of producers vying for a very small market. Today, entry into the automotive industry requires vast capital, experience, management, know-how and skilled labor. Getting into industries like aviation, computer chips, and biomedicine simply cannot be compared to starting up a new vineyard or wool cloth mill.

The second change is the question of productivity, which is a combination of the efficiency of production equipment and the cost of labor. Where there are no very high barriers to entry – as with shoes, textiles, toys and electronics assemblies – the countries with low wages are likely to prosper. This is particularly true where the production is started up by a company with experience in making the product in a high wage country. That company can provide know-how, cutting edge equipment and a sales network for the new enterprise, and quickly become more competitive courtesy of lower wage rates of its new workers. (As an example, by 2004, Portugal had become an international supplier of some €300 million worth of wool cloth.)

Analyzing the implications of these changes, Gomory and Baumol show that free trade can benefit both trading partners when one is industrialized and the other is less developed. Thus, buying shoes from Indonesia or the Philippines is probably good for us, even if the seller was originally an American manufacturer. Improvement of the national incomes of those countries will enable us to sell more to them, off-setting the loss of income to our economy.

However, when analyzing trade between developed countries, the authors find an entirely different picture – there, our trade interests are likely to conflict with those of the supplying country. Increases in imports from them reduce our own national income and adversely affect our wage rates.

Recall that this analysis assumes no distorting trade practices. When those practices (which abound in the world today) are layered atop the underlying economic principles, the picture can become bleak. For a member of the steel industry, where imports are almost exclusively from "conflict" countries, the implications are sobering.

The message is clear: Our country must begin to adopt realistic trade policies for the world as it is, not how it was thought to be 200 years ago.

Now, for some specifics on costs:

- Scrap and Pig Iron. Prices for #1 dealer bundles and #1 busheling (Chicago) eased by $10 per mt to $320 and $322, respectively. These are still the highest prices of all but four of the last eighteen months. After seven months of stability, pig iron prices went up to a record high – the spot price for Brazilian product (cif New Orleans) climbed to $400 per mt. Pig iron and ore producers are reportedly seeking large increases for 2008.

- Natural Gas. After three months of decline, the Nymex contract price jumped $1.36 to $7.01 per mcf. Increases are typical as the winter months approach, but we are still below the price levels of February through June this year.

- Exchange Rates. The dollar has continued to have problems. As of this writing, the euro is up a penny to $1.42, the pound is steady at $2.04, and the Canadian dollar is up two cents to $1.02.

We are always interested in hearing from you with your thoughts and suggestions. This letter will be posted on our website, www.coreysteel.com and on the international site, www.steelonthenet.com.