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Whence World Trade in an Economic Maelstrom

Of course, this month's biggest news is the state of the economy. You have already been treated to acres of news copy on the whys and wherefores of our problems, so we would be reluctant to add to the pile, even if we had some special insight (which we don't) on the subject. However, we do think that there have been some developments in attitudes toward international trade, as it affects world economies.

A number of commentators and officials have warned against the possibility of increasing protectionism that could add to the world's economic woes. They harken back to the Depression, when, in 1930, the Congress passed the Smoot-Hawley tariff act, which sought to protect American producers by erecting very high barriers to foreign goods. Most economists and historians believe that that fit of protectionism made the crisis much worse and did little to help the United States.

Should we be concerned? Certainly a return to the Smoot-Hawley approach would be devastating enough to warrant great care to prevent it from happening. The distinctly unpromising results of the current international trade talks known as the "Doha Round," do not inspire confidence. We have written of the travails of the Doha Round several times – the failures to agree on agricultural subsidies, the "death" of the talks, their resurrection, and efforts by the Bush Administration to reach a deal this year. Most recently, there has been more bad news as the EU's chief negotiator, Peter Mandelson, announced that he was going back home to London to join the Brown cabinet. Mandelson was a driving force for completing the Round quickly, and his departure makes it impossible to achieve anything solid before a change in administrations in the U.S., with the inevitable delays for transition.

Other whiffs of protectionism might be said to come from the Obama camp, which has promised to seek changes in NAFTA and opposed the proposed free trade agreement with Columbia. No matter which candidate is elected, he will likely be facing an imminent recession or one already underway. Those are not promising conditions for expanding trade. And, we have already seen some attempts to go it alone by countries confronting the financial crises.

Notwithstanding these developments, our advice to those who fear a return to 1930's protectionism, or anything close: take a deep breath. Compared to that world, where reciprocal and conditional trade deals were the only way to hop high tariff barriers, today's trade moves remarkably freely, where practically all goods enter most countries on "most favored nation" treatment subject to relatively minor duties. (As a result of the last international trade deal (the "Uruguay Round") average tariffs on industrial products went from 6.3% to 3.8%, and duty free treatment is accorded to 44% of those products by developed countries. Forty countries have no duties on information technology products.) Over the years 2000-2006, world trade in manufactured goods increased an average 10% per year; for agricultural products, the average was 9%. And we are constantly reminded that the world economies are so intertwined today that any significant segmenting would be a practical impossibility. (One example: we tend to fixate on the amount of U.S. debt held by the Chinese, but that very relationship gives them an important reason to promote the health of our economy. As in the old saying, "If I borrow a thousand dollars, the bank owns me; if I borrow a million dollars, I own the bank.")

To be sure, new trade deals will be subject to heightened scrutiny if times are bad. That might not be entirely bad, since there is a growing belief that the standards of congressional review and oversight of our national trade policies have paid excessive homage to classical notions of the benefits of any and all free trade arrangements. Like any other international pacts, trade agreements can have defects, and the Congress should do its best to weed them out.

The message here is that the state of world trade today is a far, far cry from the Depression era. Agreements, political mindsets and, even more importantly, deep financial relationships are in place that would make back-sliding into autarchic policies of the 1930's simply impossible. We have lots of things to worry about in the present economic maelstrom, but a return to Smoot-Hawley or anything like it is not one of them.

Before turning to data on the specific cost items that we have been monitoring, we want to offer a short observation on what has been occurring with those prices. As you will see, they have dropped precipitously in the last couple of months as the economy has turned south and uncertainty rules the day. While declining costs are usually welcome, the recent ones carried a haymaker: companies (yours and ours) have been buying material their operations require at prices that have suddenly been devalued. Rather than being able to work through higher cost inventories of raw materials and finished goods as costs gently decline, we (and you) have been pushed off a cliff, and unlike Bugs Bunny, we cannot keep running on the air.

This factor will present a major challenge to our industry and many others in future months. As we work out of what looks to be a serious recession, this aspect of the downturn could weigh heavily on our financial results.

Here are those specifics:

- Scrap and Pig Iron. The bottom fell out last month. Number 1 dealer bundles and #1 busheling (Chicago) were at $280 and $290 per mt, respectively, or *one-third* of what they were only two months ago. The drop in pig iron prices is almost as steep. Three months ago, the spot price for Brazilian product (cif New Orleans) was $920 per mt; this month it stood at $420.

- Natural Gas. One product not kept in inventory is natural gas, and for those users not tied to a long term purchase contract at an elevated price, the recent collapse is good news. The Nymex contract price this month was $6.87 per mcf, just over half what it was three months ago.

- Ocean Freight. Another swooning act this month was the Baltic Capesize Index. It now stands at 4310, about a third of what it was in July and less than a quarter of the June level.

- Foreign Exchange. The dollar did some serious strengthening this month. At this writing, the euro stands at $1.25, down 18 cents from last month; the pound is at $1.56, down 26 cents; and the Canadian dollar brings just 78 cents, down 16 cents.

These are very “interesting” times (in the sense of the old Chinese curse), and we are all very busy coping. But we still want to hear from you, so let us have your thoughts. This letter, as usual, will be on our website, www.coreysteel.com and on the international site, www.steelonthenet.com.