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Franz Peter Lang\*

## Does the New Protectionism Really Harm All Trading Countries?

*The following article considers the effects triggered by exporting countries' reactions to the new protectionism. It demonstrates that if the analysis is broadened to take account of macro-economic interdependence the assessment of the trade interests, for instance, of "new" exporting countries such as the NICs must be revised.*

**T**he high cost of protectionism makes the campaign for a return to freer trade a high economic priority." This sentence reflects the tenor of the political debate about the overdue reform of the GATT.<sup>1</sup> The assertion that action to overcome the current wave of protectionism is in the fundamental interests of all trading nations is made not only in the Leutwiler Report<sup>2</sup> of 1985, which describes and assesses the current situation regarding world trade, but also in the steadily increasing body of anti-protectionist analyses and position papers.<sup>3</sup>

The convictions they express reflect the prevailing view that obstacles to trade – and especially the non-tariff barriers of the "New Protectionism", such as orderly market arrangements, textile agreements, voluntary export restraints, and so forth – lead to welfare losses and undermine economic growth.<sup>4</sup> They attempt to provide empirical evidence both for the "protected" importing countries and for the world economy as a whole,<sup>5</sup> blaming the escalation of protectionism on a number of factors, including:

- ☐ the increasing "pressure of competition" exerted in world markets by newly industrialising countries (NICs),
- ☐ rising unemployment in the industrialised countries as a result of increasing productivity,
- ☐ an inability to adapt to the product cycle in industrialised countries, and, recently,
- ☐ the need to curb high US imports (balance-of-payments equilibrium and the international debt problem).

The principal targets of this free-trade agitation include the USA and the European Community, whose

growing trade restrictions can be proved statistically (see Table 1).

Since quantitative import restrictions are identical to export restraints imposed by exporting countries, protectionist measures lead to a loss of output and employment in the export sector of the countries concerned. These negative effects are, at best, eased if the exporting country shares in the benefits in the form of induced increases in export prices,<sup>6</sup> for example via quota rents in the case of non-tariff measures.

A rapidly expanding export sector is of great macro-economic importance for newcomers among the exporting countries, such as Taiwan, Hong Kong and South Korea. It was and still is the power behind their transformation from underdeveloped countries into newly industrialising countries. Since this group of exporting NICs are among the primary targets of the

<sup>1</sup> H. Hesse: Schwierige achte GATT-Runde, in: WISU, No. 11, 1988, pp. 157 ff.; M. Frenkel: Protektionismus: Viele Begründungen – falsche Versprechungen, in: Wirtschaftswoche, No. 48, 1988, pp. 92 ff.

<sup>2</sup> Cf. GATT: Trade Policies for a Better Future. Proposals for Action, Geneva 1985; OECD: Costs and Benefits of Protectionism, Paris 1985.

<sup>3</sup> Cf. inter alia C. F. J. Boonekamp: Voluntary Export Restraints, in: Finance & Development, December 1987, pp. 2 ff.; W. M. Corden: The Theory of Protection, Oxford 1971; A. V. Deardorff, R. M. Stern: Current Issues in Trade Policy: An Overview, in: R. M. Stern (ed.): U. S. Trade Policy in a Changing World Economy, Cambridge Mass. 1987, pp. 15 ff.; W. Gaab, A. Gieseck: Freiwillige Exportbeschränkungsabkommen, in: WISU, No. 8, 1988, pp. 485 ff.; D. Greenway: International Trade Policy: From Tariffs to New Protectionism, London 1983; C. Hamilton: Economic Aspects of Voluntary Export Restraints, in: D. Greenway (ed.): Current Issues in International Trade, Theory and Policy, London 1985, pp. 99 ff.; C. Hamilton: Restrictiveness and International Transmission of the "New" Protectionism, Seminar Paper No. 367, Institute for International Economic Studies, Stockholm 1986.

<sup>4</sup> Cf. H. Herberg: Welfare Effects of Non-Tariff Barriers: A General Equilibrium Analysis, Discussion Paper No. 78/88, Institut für Theoretische Volkswirtschaftslehre, Kiel 1988; D. Salvatore (ed.): The New Protectionism and the Threat to World Welfare, in: Journal of Political Modelling, Vol. 7, No. 1, 1985; F. P. Lang: Neo-Protectionism and Economic Growth, in: INTERECONOMICS, Vol. 19, 1984, No. 3, pp. 129 ff.

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escalating new protectionism of the United States and the European Community, it is generally assumed that they attach the highest priority to dismantling protectionist barriers.

### The Situation of the Exporting NICs

The world trade situation of this group of exporting countries has not really been analysed sufficiently and thoroughly up to now, however. Assessments have been based mainly on analyses of protectionism that assume the existence of a uniform export market, whereby protectionist restrictions on the volume of exports induce not only a change in the value of exports but also a decline in the output of the export sector, with adverse consequences for employment and development opportunities.

In fact, it is generally possible to identify several segments in the NICs' main export markets. For example, Taiwan, South Korea and Hong Kong supply a large proportion of their economically important textile exports to the USA and the EC. The same applies to South Korea's car exports.<sup>7</sup> These market segments can be differentiated according to such factors as geographic distance, differences in consumer preferences and competitive conditions.

In these circumstances, an exporting country that encounters export restrictions in, say, the EC can divert excess exports to market segments that are relatively free from protectionist measures, such as the USA or third countries. If demand for the goods is price-elastic in these alternative markets, the increase in supply will have virtually no effect on the export price. The loss of export earnings in the protected market segment will then be more or less offset by an increase in value terms in the free market. This assumption describes the conditions for a "small" exporting country that cannot

influence the price in its "large" free export market by manipulating the volume of exports.

The NICs threatened with protectionist measures do, however, exercise market power in their important export markets and their policies with regard to the volume of exports do influence their export prices. They operate as "major players" in this context, whereas in their import markets (mostly raw materials and food but also industrial products they cannot yet produce competitively at home) they can only act as "minor players", obliged to accept the prices demanded. If they have market power, the price of their exports in the free segment of the market will be depressed by the diversion of exports from the protected segment. Export earnings may then change, to varying degrees depending on the price elasticity of the demand for the additional goods.<sup>8</sup>

### The NICs' Dependence on the World Market

Broadening the analysis in this way to take account of export market segments and to consider the market power of the exporting country produces a more realistic assessment, but it still cannot reflect macro-economic interdependences.<sup>9</sup>

**Table 1**  
**The Escalation of the New Protectionism**

	Against all countries		Against NICs	
	1976-80	1981-85	1976-80	1981-85
Number of neo-protectionist measures by the USA				
Product group:				
Textiles	9	11	2	10
Leather goods	8	0	7	0
Wood, paper	2	4	0	0
Chemicals, rubber	9	10	5	6
Steel, metals	9	73	4	48
Transport equipment	3	3	1	1
Machinery	6	10	3	2
Other	15	41	7	20
Total	61	152	29	87
Number of neo-protectionist measures by the EC				
Product group:				
Textiles	6	7	3	4
Leather goods	1	2	1	2
Wood, paper	8	9	4	4
Chemicals, rubber	15	30	3	10
Steel, metals	24	18	15	12
Transport equipment	1	3	1	2
Machinery	8	6	2	1
Other	7	22	4	12
Total	70	97	33	47

Source: GATT-Statistics, various years.

<sup>5</sup> Cf. C. C. Coughlin, K. A. Chrystal, G. E. Wood: Protectionist Trade Policies: A Survey of Theory, Evidence and Rationale, Federal Reserve Bank of St. Louis, January/February 1988, pp. 12 ff.; J. Wemelsfelder: The Short-Term Effect of Lowering of Import Duties in Germany, in: the Economic Journal, Vol. 70, 1960, pp. 94 ff.

<sup>6</sup> Cf. inter alia B. Hindley: Voluntary Export Restraints and Article XIX of the GATT, in: J. Black et al. (eds.): Current Issues in Commercial Policy and Diplomacy, London 1978, pp. 52 ff.

<sup>7</sup> Cf. F. P. Lang: Sanctions under GATT Article XIX versus Voluntary Export Restraints, in: INTERECONOMICS, Vol. 23, 1988, No. 4, pp. 178 ff.; D. Greenway: International Trade Policy, op. cit.; OECD: The Newly Industrialising Countries, Paris 1988.

<sup>8</sup> The possible changes in the value of exports are described in detail in F. P. Lang: Sanctions under GATT Article XIX versus Voluntary Export Restraints, op. cit.

<sup>9</sup> M. Frenkel: Makroökonomik des Protektionismus bei festen und flexiblen Wechselkursen, Hamburg 1985; M. Frenkel: Gesamtwirtschaftliche Effekte globaler protektionistischer Maßnahmen, in: Jahrbuch für Sozialwissenschaft, Vol. 37, 1986, pp. 200 ff. Here it is the effects on importing countries that are considered.

This is particularly true if the NICs in question are trading in a context of floating exchange rates.<sup>10</sup> In these circumstances export earnings are one of the key exchange rate determinants, being a component of the supply of foreign exchange. If export earnings rise, so too does the supply of foreign exchange and the exporting country's currency appreciates. Conversely, if export earnings decline, the contraction in the supply of foreign exchange tends to lead to a depreciation of the currency. Since exchange rate movements influence export and import prices in the exporting country's currency, they should not be ignored when assessing the new protectionism.

If the prices of exports decline in the free export market as an indirect consequence of escalating protectionism in another segment of the market and if the exchange rate rises at the same time, the export price expressed in the exporting country's currency may move in either direction. If the NIC consumes the export goods as domestic products alongside imports, market forces and/or exchange rates will cause movements in export and import prices.

Hence it cannot be ruled out that neo-protectionism will affect consumer prices in the exporting country, so that reactions by total demand and thus changes in the domestic market of the exporting economy must also be expected.

## Characteristics of the NIC Economies

A systematic analysis of this problem must take account of the above-mentioned interdependence between export markets, the foreign exchange market and the domestic market in conjunction with the particular characteristics of the NICs. These can be recapitulated as follows:

- ☐ The export market can be divided into a protected segment and one relatively free of protectionist measures. The US market and the EC market can be taken as an example.
- ☐ The export industry's policy with regard to the volume of goods exported influences the export price. The exporting country wields market power ("major exporting country").
- ☐ In its import market the exporting economy is a price taker without market power ("small importing country").
- ☐ The exporting country's export and import

transactions are both invoiced in the same foreign currency (primarily the US dollar).

- ☐ Imports and domestic products are not substitutes one for the other. The import substitution sector is not developed.
- ☐ Supply depends on the price of the goods in the exporting country's domestic currency, but the price itself is determined internationally by the export market and exchange rates. Economic activity in the economy in question is therefore governed almost exclusively by world market forces.
- ☐ The following considerations apply to economies with a responsive domestic market; this implies capacity reserves that allow suppliers to adjust to price movements.
- ☐ It is also assumed that nominal wages respond little to changes in consumer prices. The countries in question are typical low-wage countries where trade unions have little power.
- ☐ The exporting country operates within a system of floating exchange rates. All of these assumptions are typical of the NICs.
- ☐ In order to make the analysis realistic it is assumed that the protection-free segment of the export market in question has a low price elasticity. Increasing the volume of exports induces a sharp fall in the market price, and reducing it has the opposite effect.

The cause of such market rigidity may lie on the demand side in inadequate scope for substitution, or the product in question may be a standardised basic good for which demand is limited irrespective of price.

On the supply side, home produced goods to compete with imports may not be available in specific markets, owing to predominant demand preferences for example. For instance, in the USA the supply of American-made medium-sized cars is traditionally limited; the supply from NICs therefore merely complements the limited domestic output. In other cases the effects of the product cycle already threaten domestic suppliers with extinction owing to competition from imports from NICs. The competitiveness of what remains of the industry is sustained by government support, such as subsidies, public procurement for military purposes, and so forth. Domestic supply is therefore unaffected by falling prices, as in the case of steel production in the EC or the manufacture of computer hardware in the USA.

Non-tariff protectionist curbs on supply in a segment of an export market normally cause the price to rise in

<sup>10</sup> Disregarding the pegging of currencies to currency baskets. Cf. D. B e n d e r : Monetary Stability, Export Promotion and Exchange Rate Policy, in: Asean Economic Bulletin, Vol. 2, 1986, pp. 196 ff.

that segment. The price elasticity will be very high if competing domestic suppliers have spare capacity or if there is effective competition from third countries. This is the situation with regard to exports of textiles from Hong Kong and Taiwan and medium-sized cars from South Korea to the EC. The fact that there are efficient producers of textiles in some EC countries (such as Greece and Portugal) and of cars in others (Germany, Italy and France, for example) ensures high supply flexibility in the EC markets. In such circumstances the positive impact of prices on the exporting country's export earnings (and hence on the supply of foreign exchange) is outweighed by the adverse volume effect of the export restrictions. Foreign exchange earnings decline.

Price elasticity is low if there are supply bottlenecks, so that the rise in the free export price is relatively steep. This situation obtains, for instance, in the market in medium-sized cars in the USA, where there is little competition from domestic suppliers. In these circumstances the effect of the rise in price on export earnings outweighs that of the decline in volume. Foreign exchange earnings rise.

### Interaction of Effects

In the protection-free segment of the export market the effects do not stem solely from the diversion of exports from the protected segment of the market. Macro-economic interdependence means that changes occur in supply and demand in the exporting country and hence in its total exports, changes that can be explained only in terms of the interaction of export and domestic market effects.

□ *Falling Export Prices, Rising Consumer Prices, Employment Gains.*

If protectionism increases in an export market with high price elasticity, the fall in foreign exchange earnings causes the exporting country's currency to depreciate. This is the case, for example, if quantitative import restrictions in the EC lead to the diversion of exports of cars or textiles to the USA or to third markets.

Consumer prices in the exporting country rise, since imports have become more expensive in domestic currency. If demand reacts normally, the demand for domestic and imported goods declines, since the two product categories cannot be substituted for one another in the NIC.

The fall in demand releases export capacity, which seeks an outlet in the free export market, thereby causing an increase in supply over and above that due to the diversion of exports. The free export price falls.

Foreign exchange earnings decline owing to the low price elasticity in the free segment of the export market, accentuating the depreciation of the currency.

The exchange rate movement stimulates supply if it leads to an increase in the prices of domestic goods in domestic currency. Since the various foreign exchange supply components are moving in the same direction,<sup>11</sup> it is probable that the currency will depreciate sharply, perhaps sufficiently to outweigh the fall in the free export price in foreign currency. Hence both supply and demand factors widen the scope for expanding the NIC's total exports. The volume of goods sold in the free segment of the export market increases by more than the simple diversion effect. The sharp depreciation of the currency has beneficial employment effects.

In this scenario, escalating protectionism places the exporting NIC with a falling export price in foreign currency in the position described by the conventional analysis of protectionism. The strong exchange rate effect has an expansionary employment impact, although consumers are faced with rising retail prices.

The supply-side lobby will probably welcome escalating protectionism, whereas the demand-side camp will view it in a negative light. Since experience has shown that supply-siders are predominant in the NICs in question, it is debatable whether in such circumstances these countries will adopt a markedly anti-protectionist stance in trade policy.

This finding is of great importance for the current eighth round of GATT negotiations; it portrays the realistic case of growing protectionist tendencies in the EC and a relatively favourable US policy towards free trade.

□ *Falling Export Prices, Rising Consumer Prices, Job Losses.*

Let us assume that the USA practises more severe neo-protectionism and that the affected NICs channel their excess exports into an EC market that is more liberal from the point of view of trade policy but where prices are equally rigid. The growing protectionist tendencies are now occurring in a relatively rigid segment of the export market, in other words one with low price elasticity. In this situation the positive price effect outweighs the negative volume effect. The value of the country's exports rises, and so too do its foreign exchange earnings.

<sup>11</sup> The effects of international capital flows are disregarded. Very short-term, interest-rate-induced exchange-rate effects are thus excluded from the analysis, as are long-term sectoral shifts in the composition of production and demand.

The diversion of the free exports into the relatively protection-free EC segment of the market causes the free export price in that region to fall. The positive volume effect of higher exports is more than offset, and foreign exchange earnings from this market decline. Here the exchange rate may move in either direction.

If the protected segment of the export market (the USA in this example) is of little quantitative importance for the exporting NIC, the reaction of the free market segment will predominate. The currency therefore depreciates, as in the scenario examined above, although less sharply owing to the opposing changes in the value of exports.

Consumer prices also rise owing to the movement in the exchange rate. As a result, demand for both home produced and imported goods contracts in the exporting country. By releasing additional goods for export, reduced domestic consumption tends to depress prices in the free segment of the export market and to accentuate the currency's downward tendency in the foreign exchange market.

Expansionary supply-side effects can only occur, however, if the weaker depreciation of the currency outweighs the fall in prices in the protection-free segment of the export market. Hence it cannot be ruled out that contractionary supply effects will occur.

In these conditions, it is probable that anti-protectionist trade measures will attract broad support in NICs.

□ *Rising Export Prices, Falling Consumer Prices, Job Losses.*

The situation changes if the escalation in protectionism occurs in a segment of the export market that is unresponsive to changes in prices and is at the same time of great quantitative importance for the exporting NIC.

If the inelastic US market is of relatively high quantitative importance for the export sector the effect of the fall in the value of exports in the protected segment will predominate over developments in the foreign exchange market.

If the protected export market segment has low elasticity the positive price effect prevails over the adverse volume effect. The value of exports rises and the associated increase in foreign exchange earnings leads to an appreciation of the currency.

This reduces the level of consumer prices, with the consequence that demand for home produced and

imported goods increases in the exporting country. Increased consumption of home produced goods leads to a decline in exports and tends to cushion the fall in prices in the free segment of the export market; this in turn accentuates the appreciation of the exporting country's currency. Goods that would previously have been exported are now consumed in the country itself and the situation of consumers improves.

If these developments cause the volume of goods supplied to the free export market to fall below its initial level, the free export price rises. Hence non-tariff protectionism against an NIC can also lead to a rise in the free export price, to the benefit of suppliers from third countries.

The rise in the free export price expressed in foreign currency is not very large, however, owing to the countervailing volume effects. Nevertheless, these same effects cause the exporting country's currency to appreciate owing to the general inelasticity of the export markets, an appreciation that is counteracted only by the import-induced demand for foreign exchange.

The relatively sharp appreciation of the domestic currency thus outweighs the modest increase in export prices in foreign currency. The price of home produced goods falls in domestic currency, triggering a contraction in supply and negative employment effects.

In these conditions diverging interests are again evident. The supply-side lobby will vote against escalating neo-protectionism, whereas consumers in the exporting country and possible competing exporters from third countries will judge the consequences of protectionism positively.

## Conclusion

The above scenarios of escalating, non-tariff protectionism show that broadening the analysis of protectionism to cover the typical exporting countries while at the same time taking a differentiated view of export markets and considering macro-economic interdependence reveals aspects that have been largely ignored so far in theoretical and empirical examinations of protectionism.<sup>12</sup> This defect of systematic research is particularly conspicuous, given the vehement trade policy debate that is going on in the context of the eighth round of GATT negotiations. This may be a further reason for the failure of the Montreal conference.

<sup>12</sup> With regard to the theoretical analysis, see F. P. Lang: Exchange-rate, Price and Supply-side Effects of Voluntary Export Restraints: A Macroeconomic Analysis, (mimeo, Ruhr University, Bochum 1988), to be published in 1989 in Zeitschrift für Wirtschafts- und Sozialwissenschaften.