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Article — Digitized Version

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Intereconomics

Suggested Citation: Lang, Franz Peter (1990) : The counter-effects of market regulation, Intereconomics, ISSN 0020-5346, Verlag Weltarchiv, Hamburg, Vol. 25, Iss. 2, pp. 72-76, <https://doi.org/10.1007/BF02924785>

This Version is available at:

<https://hdl.handle.net/10419/140231>

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viewed as a tax on adjustment efforts which could impede the implementation of better policies."³⁰ *Thirdly*, the willingness of the private sector in these countries to hold domestic securities decreases, in other words domestic saving declines. *Fourthly*, foreign lenders will not be willing to grant new loans as long as they see that

the debtor is not even capable of meeting its existing obligations.

In this situation, as shown by a Laffer debt curve, debt servicing reductions or a renunciation of claims would increase the probability that the governments of debtor countries would fulfil the conditions imposed by the IMF and the World Bank. An increase in the scope for additional investment could help enable a country to service its remaining debt in full by increasing its debt servicing capacity. The market value of developing country debt could recover, thus giving them access to the credit markets.³¹

It is therefore a question of breaking the vicious circle whereby the burden of rising debt stunts growth, which in turn further reduces the country's creditworthiness. If the damaging financial gap is not closed, it is to be feared that the debt problems will be further exacerbated.

³⁰ IMF: World Economic Outlook, April 1989, p. 53.

³¹ For the counter-theory that debtors are instead cut off from the international capital market if their debt is reduced, see Peter N u n n e n k a m p : Capital Drain, Debt Relief and Creditworthiness of Developing Countries, Kieler Arbeitspapiere No. 379, Kiel 1989. In principle, the question is whether the low investment ratio in problem countries was caused by the debt overhang acting as an additional tax on investment or by the drying-up of new lending, in other words, a scarcity of capital. Neither the balance-of-payments statistics nor the net transfer concept reveal anything about the determinants of investment behaviour. It should be borne in mind, however, that in view of high debt service/export ratios the direction of the net transfer could reverse abruptly if there were a further inflow of resources, but that this would further increase future obligations. For this reason debt relief appears to be indispensable. See also Karl S t e i n i n g e r : Der Nettotransfer als Umschuldungsindikator, in: Quartalshefte der Girozentrale, Vol. 25, No. 2, 1989, p. 67.

Franz Peter Lang*

The Counter-effects of Market Regulation

Regulation can have counter-effects that work against the interests of those who advocate it, in both centrally-planned and market economies. Little research on these effects has been carried out so far, with the result that they have been ignored by policymakers.

Free market solutions are being increasingly accepted by institutions that had previously tended to reject them; this is as true of the debate about a new, market-oriented international trade order as it is of the moves towards market-oriented reforms in the countries of Eastern Europe. On the other hand, it is also evident that countries are trying increasingly to ensure that market forces are constrained by tighter regulation. Examples of this range from neo-protectionism within the context of "free world trade" to the efforts of the "reform-minded" Eastern bloc countries to retain political control of markets by preserving a significant centrally-planned sector. In practice this leads to

systems in which markets are subject to a greater or lesser degree of regulation.

Economic analysis takes only partial account of the impact of such regulation on the real economy, however, so that it remains largely ignored in the political discussion about the controllability of markets. In order to draw attention to the substantial real economic effects of regulation, the following article analyses two systems for the world economy, both entailing a high level of regulation.

The first is the system for regulating world trade, which has been discussed recently primarily in terms of "neo-protectionism"; here quantitative trade restrictions lead to an upgrading of product quality. The other system of interest relates to efforts to carry out market-

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oriented reforms in state-trading countries;¹ here there is a downgrading of product quality owing to the existence of regulatory measures aimed at ensuring political control of the market by maintaining certain aspects of economic planning.

Traditional Protectionism

Importing countries traditionally fend off unwanted competition from exporting countries by imposing customs tariffs and import quotas. Such protectionism is a form of market regulation for the benefit of domestic industries that have lost or are in danger of losing their comparative cost advantages in world markets; in the Federal Republic of Germany and other mature industrialised countries this is true, for instance, of the coal, steel, textile and car industries.²

The advocates of protectionism argue that barriers to foreign competition work, at least in the short and medium term. They claim it protects the domestic economy against direct damage (such as that caused by dumping by foreign suppliers) and provides time to prepare countermeasures; it can allow new industries to become internationally competitive (infant industry protection) or facilitate a socially acceptable structural adjustment to new conditions in the world economy (for example, plant closures, retraining and the development of alternative industries).

The protection effect is considered highly questionable over the long term, since the protected sectors have no market stimulus to regain their competitiveness. They become used to market regulation and avoid economically necessary adjustments. Moreover, experience shows that once protectionist arrangements have been established they are usually difficult to remove for bureaucratic and fiscal reasons.³

One of the certain effects of protectionism is to raise the prices of imported goods. The use of imported inputs also increases the cost of domestic products, including exports. The ability of the entire economy to adapt to

world economic conditions may be impaired. These negative effects are at best mitigated by a judicious use of customs receipts.⁴

Neo-Protectionism

Since in principle countries that are party to the General Agreement on Tariffs and Trade are forbidden to use the traditional forms of tariff protection, import duties may be imposed only in exceptional cases under Article XIX of the GATT and on publicly justified grounds.⁵

To avoid customs duties and the associated spectacular negotiations under the auspices of the GATT, countries are increasingly agreeing on the quantitative restriction of international trade by means of "voluntary export restraints" (voluntary restraint agreements, orderly marketing arrangements and so forth⁶). Under such arrangements, the exporting country voluntarily reduces the volume of its exports and helps avoid the introduction of a customs duty and open discussion of its disadvantages in the importing country. Because of its "voluntary" nature, this variant of neo-protectionism can be reconciled with the GATT. Restricting supply in the importing country allows the prices of the protected goods to rise there and provides the desired protection for the industries threatened by imports. Exporters also benefit directly from the rise in prices, thereby receiving some compensation for restricting the volume of their exports (the rent from voluntary export restraint).⁷

Upgrading as a Strategic Response

Since voluntary export restraints only limit the volume of exports to the market of the importing country whereas the price continues to be set by the market, exporters have the possibility of increasing the value of their exports by raising the prices of their specific products. In this context, improvements in the quality of the exported goods and product differentiation are used as instruments of marketing policy.

One example of the practical impact of this strategy is the restriction of Japanese car exports to the USA to 2.3 million a year, a limit first set in 1981 and recently

¹ Cf. F. P. Lang: Hat die Chinesische Wirtschaftsreform noch eine Zukunft?, in: Institut für Entwicklungsforschung und Entwicklungspolitik (ed.): Materialien und kleine Schriften, Vol. 122, Bochum 1989.

² Cf. inter alia 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.; OECD: Costs and Benefits of Protectionism, Paris 1985.

³ Cf. C. C. Coughlin and K. A. Chrystal: Protectionist Trade Policies: A Survey of Theory, Evidence and Rationale, in: Federal Reserve Bank of St. Louis 1988, pp. 12 ff.

⁴ Cf. G. Gandolfo: International Economics I, The Pure Theory of International Trade, New York 1987.

⁵ Cf. F. P. Lang: Sanctions under Gatt Article XIX versus Voluntary Export Restraints, in: INTERECONOMICS, Vol. 23, 1988, No. 4, pp. 178 ff.

⁶ Cf. F. P. Lang: Neo-Protectionism and Economic Growth, in: INTERECONOMICS, Vol. 19, 1984, No. 3, pp. 129 ff.; F. P. Lang: Does the New Protectionism Really Harm All Trading Countries?, in: INTERECONOMICS, Vol. 24, 1989, No. 1, pp. 12 ff.; M. Frenkel: Protektionismus: Viele Begründungen – falsche Versprechungen, in: Wirtschaftswoche, No. 48, 1988, pp. 92 ff.

⁷ Cf. F. P. Lang: Sanctions under Gatt Article XIX versus Voluntary Export Restraints, op. cit.

renewed.⁸ The EC imposes similar restrictions on its exports of cars to Japan.

Since the introduction of these quantitative export restrictions there has been a shift in the qualitative composition of Japanese cars available in the US market. This stemmed initially from an improvement in specifications and a widening of the range of small and medium-sized cars, the market segment the Japanese originally dominated. In this way the Japanese car industry enhanced its image in the American market to such an extent that it was able to make autonomous price increases. The improved image also enabled the Japanese manufacturers to break into the market in luxury cars. Although the number of cars exported remained the same, the accent shifted from relatively low-value small and medium-sized cars to relatively high-value luxury cars.

This improvement in the quality of the export range is termed "upgrading".⁹ It increases the turnover on a constant volume of exports. In the example outlined above it was the result of quantitative export restrictions; it was therefore not the consequence of an autonomous marketing strategy but was actually induced by neo-protectionism.¹⁰

This strategy has been further refined by the new variant of "national product differentiation". For example, the market segments being vacated by the Japanese at the lower end of the quality spectrum are now being filled by Japan's "East Asian competitors", primarily South Korea.¹¹ Their shipments are not subject

to the Japanese export quotas, even though they are manufactured by subsidiaries of Japanese companies. The discriminatory regulation of trade with particular trading partners therefore encourages the emergence of "new" competitors to the domestic producers of import substitutes.

The textile market in the EC, in which import volumes are largely regulated under the Multi-Fibre Arrangement, provides another example of a comparable shift in product quality.¹²

Secondary Upgrading Effects

Upgrading is therefore an enhancement of the quality of imports induced by regulation of the import market. It is a manifestation of the corporate strategy of increasing turnover where the volume of sales is restricted by protectionist measures. First discovered as an empirical phenomenon, it is now also explained theoretically as a marketing strategy on the part of foreign exporters. However, its effects on competition in the regulated market continue to be largely disregarded.

Upgrading improves the competitive position of the exporters affected by protectionistic regulation of the market and to some extent eliminates the disadvantages they suffer. It reduces their antipathy towards obstacles to trade in the importing country, provided these take the form of quantitative export restrictions. This could explain why some exporting countries from East Asia were unenthusiastic about rigorous action to curb neo-protectionism in the recent GATT Round.¹³

Upgrading thwarts the intention of the protectionist lobby in the importing country to limit competition, since

⁸ Cf. R. Feenstra: Voluntary Export Restraints in U.S. Autos, 1980-81, in: R. Baldwin and A. Krueger (eds.): The Structure and Evolution of recent U.S. Trade Policy, Chicago 1984.

⁹ Cf. J. De Melo and P. A. Messerlin: Price, Quality and Welfare Effects of European VERs on Japanese Autos, in: European Economic Review, Vol. 32, pp. 1527 ff.

¹⁰ This suggests that curbing the volume of supply without being under the threat of protectionism may have the same effects. It could serve as the starting point for a strategic export policy vis-à-vis particular segments of the export market. Cf. P. R. Krugman: Import Protection as Export Promotion, in: H. Kierzkowski (ed.): Monopolistic Competition and International Trade, Oxford 1984.

¹¹ Cf. IMF: Issues and Developments in International Trade Policy, Occasional Paper No. 63, Washington 1988, pp. 114 ff.

¹² Cf. inter alia M. Wolf: Handmaiden under Harassment: the Multi-Fibre Arrangement as an Obstacle to Development, in: H. Giersch (ed.): Free Trade in the World Economy, Tübingen 1987, pp. 252 ff.; IMF, op. cit.

¹³ Cf. H. Hesse: Schwierige achte GATT-Runde, in: WISU, No. 11, 1988, pp. 157 ff.

PUBLICATION OF THE HWWA-INSTITUT FÜR WIRTSCHAFTSFORSCHUNG-HAMBURG

Annual subscription rate
DM 120,-
ISSN 0023-3439

KONJUNKTUR VON MORGEN

The short report on domestic and world business trends and raw material markets published every fortnight by HWWA-Institut für Wirtschaftsforschung-Hamburg

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restricting the supply of a particular good forces domestic firms to compete more fiercely with their foreign competitors in terms of quality in order to maintain their market positions. Upgrading therefore benefits the consumer and firms importing inputs. In the car industries of the USA and the EC it has thus led to an appreciable improvement in the quality of products competing with imports.

In contrast to "upgrading", neither the causes nor the effects of the related phenomenon of "downgrading" have yet been researched. This does not mean, however, that it is of minor importance to the socialist economies affected.

The market-oriented reforms¹⁴ in the socialist countries are aimed at enabling them to apply the allocation mechanisms of the market economy and hence to achieve greater production efficiency in the short term and to satisfy a higher proportion of demand with goods of better quality.¹⁵ Over the longer term these countries aim to expand their production capacity and to develop a product range that will give them access to world markets in high-value goods. In practice, the reforms have had effects that even the Western "experts" behind the reformers had not foreseen.¹⁶

Duality of Market Forces and Economic Planning

In order to achieve their objectives, the economic reformers have granted greater autonomy to enterprises that were previously managed solely in accordance with the plan. Considerable freedom of decision and the profit motive should induce them to employ scarce resources economically and to adjust more quickly to the needs of the consumer. This has given rise to a "dual economic system", in which a state-controlled, planned sector exists alongside a sector governed by market forces.¹⁷

In view of the shortages of production capacity, the retargeting of enterprises towards profitable market niches that can be supplied at rising prices occurs at the expense of customers dependent on the plan (mostly state enterprises, the military, the party machine, etc. – generally termed "the state"). Since they are bound by the plan, this category of purchasers cannot remain in the market if prices rise; they are crowded out by free

purchasers, such as individuals, collectives and autonomous state enterprises. As a consequence of the unplanned rise in prices or the shortage of goods the plan cannot be fulfilled, so that unforeseen revisions of the plan become unavoidable. In this dual system the market is in competition with the plan, in that it paralyses the centrally-planned sector or forces it to be as flexible as the market itself.

Since the planned sector of the economy is regarded as essential to safeguarding political control by the party, the reformers attempt to counter the crowding-out effect by means of regulatory interference with market mechanisms. These are justified partly on the grounds of the need to combine the allocative advantages of the market with the social advantages of the planned economy.¹⁸

The market autonomy of enterprises is therefore curtailed by requiring them first to meet the demands of the planned sector at fixed prices. Only then may any remaining output be sold on the free market.¹⁹ Where strategically important goods are concerned (almost all capital goods fall into this category in the countries in question), enterprises are only free to dispose of products of inferior quality; the high-quality goods are reserved for the state at fixed prices.

Downgrading as a Corporate Strategy

If supply is restricted by such forms of market regulation, free market prices rise above the purchasing prices set by the state. The induced shortage of goods in the free market therefore reinforces the inflationary pressures already developing from both the supply and demand sides.²⁰ Since market prices are rising, enterprises that have become profit-oriented as a result of the reforms will supply the state with inferior goods and sell the higher-quality products in the more lucrative private market. The primary reduction in product quality caused by market regulation impinges first and foremost on the state.

In addition, enterprises are encouraged to expand production more quickly. In most enterprises, however, this leads to the overloading of existing plant, which is accompanied by a general decline in product quality. This is the "downgrading effect" that purchasers of capital and consumer goods experience as an

¹⁴ Cf. D. H. Perkins: Reforming China's Economic System, in: *Journal of Economic Literature*, Vol. 26, 1988, pp. 601 ff.

¹⁵ This applies especially to countries such as China, Cuba and the USSR.

¹⁶ Cf. F. P. Lang: Hat die Chinesische Wirtschaftsreform noch eine Zukunft?, op. cit.

¹⁷ *Ibid.*, pp. 12 ff.

¹⁸ Cf. H. Ma: Neue Strategie für Chinas Wirtschaft, Beijing 1985, pp. 29 ff.

¹⁹ Cf. L. Zhai: Vom Volkseigentum zur Aktiengesellschaft?, in: *Die Betriebswirtschaft* (to be published shortly).

²⁰ Cf. F. P. Lang: Hat die Chinesische Wirtschaftsreform noch eine Zukunft?, op. cit., pp. 12 ff.

unwelcome side-effect of reform, along with rising prices.

In response to the first of these effects, additional quality requirements are often imposed for goods to be supplied to the state. If this happens, profit-maximising manufacturers will maximise their output of lower-quality products, for only in this way can they get round the state's demands and sell the greater part of their output in the more profitable free market. The downgrading of product quality has placed a serious brake on the reform process and is increasingly hampering the infant export sector.

Secondary Downgrading Effects

In the reforming countries both the critics and advocates of reform are using downgrading as an argument in the political debate. Critics see it as a symptom of capitalistic degeneration and a final warning to turn back. Advocates, on the other hand, suspect that the cause lies in the widespread political corruption in the party machine and the organs of the state. Both reactions cause political unrest that ultimately jeopardises the achievement of the reform objectives.

Downgrading also has direct economic consequences for the development process, however. In the case of capital goods, for example, it has serious long-term implications, since the lower quality of newly-produced equipment reduces the performance and economic life of the future stock of real capital. Inferior machines can produce only limited quantities of poorer-quality goods at excessive cost. The economy's growth potential is therefore reduced.

Downgrading limits the ability of enterprises to compete internationally in terms of quality. Firstly, poor quality prevents domestic enterprises from winning a share of potential export markets or soon causes them to lose any market share they have gained on price grounds. Secondly, domestic consumers buy better-quality imports in preference to domestic products. This lays the basis for a deterioration in the economy's foreign trade position.

The indirect accompaniments to downgrading include rising demand for foreign capital to finance the resulting current account deficits (foreign indebtedness), a high reinvestment requirement due to the overloading of scarce existing plant and, contrary to the very objectives of reform, increased pressure to introduce yet more regulation of the economy as a result of the competition between the market and the plan.

No matter what the economic system involved, regulation has an impact that should not be ignored by

policymakers and which private enterprises should take into account when planning their market strategy.

Upgrading is a counter-effect of market regulation by means of non-tariff trade restrictions, in that it circumvents the intention to restrict competition by inducing heightened competition in terms of quality in the regulated market. The traditional analysis of protectionism cannot explain this, since it assumes "perfect markets".

This is highly important for the policy of protectionism, for it reveals that the various forms of neo-protectionism offer no effective protection against foreign competitors, even in the short or medium term. Indeed, in certain circumstances they may lead to increased competitive pressure rather than the protection their advocates had expected.

It is also becoming clear that positions in the political debate about free trade may quite easily be reversed. Exporters and exporting countries are beginning to advocate neo-protectionism, whereas importers and importing countries are becoming increasingly sceptical. The traditional naive perception of national positions with regard to regulated world trade must therefore be critically reviewed. Moreover, upgrading is giving rise to deliberations as to whether and in what circumstances strategic restrictions on trade with particular importing countries may be a beneficial trading policy on the part of exporters.

Downgrading is a counter-effect of limited economic reform aimed at regulating the nascent market by giving certain priorities to the planned sector. The markets respond by reducing product quality, which has far-reaching consequences for economic development.

Downgrading not only causes political dissatisfaction on the part of consumers, it also puts the reforming country's current account into deficit, increases its external indebtedness and reduces the economy's chances of establishing itself as an efficient competitor in expanding world markets. Over the long term it reduces the country's development prospects by undermining growth, in that it helps create an inferior manufacturing sector with a high reinvestment requirement.

Downgrading is a consequence of the dual economic system in which the free market and the planned economy are supposed to co-exist, in other words it is the consequence of an imperfect reform concept. It is therefore an effect that should not be disregarded in connection with the reforms currently being undertaken in the USSR, the GDR, Hungary and Poland.