

Donges, Juergen B.

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Trade protectionism and international monetary order: Recalling the relevance of past experience

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TRADE PROTECTIONISM AND INTERNATIONAL
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by
Juergen B. Donges

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Düsternbrooker Weg 120
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TRADE PROTECTIONISM AND INTERNATIONAL MONETARY ORDER

- Recalling the Relevance of Past Experience -*

1. Introduction

After World War II, all industrial countries have reached a level of prosperity unprecedented in history; many developing countries and several socialist countries have experienced notable economic growth too. The post-war multilateral trading and monetary systems have been singled out by politicians, businessmen and academic economists as main institutional pillars for these achievements; they permitted positive net effects on resource allocation, economies of scale, international capital movements and the transfer of technology.

And yet, these achievements have been threatened in recent years: Not only is evidence mounting on creeping protectionism almost everywhere; there is also a strong surge of protectionist sentiments in the United States, the country which had led the trade liberalization process in the first two post-war decades. Moreover, trade disputes among the leading nations' governments are becoming the order of the day, with clashes being concentrated on farm policies, industrial targetting, and regulations in services. Furthermore, the exchange-rate formation is being disturbed by arbitrary policy decisions aiming at "bringing the dollar down", or keeping it at a specific level, be it cooperatively (as both the "Plaza Agreement", of September 1985, and the "Louvre Accord", of February 1987, intended) or unilaterally through correspondingly strong official statements. In a sense, the worldwide turmoil in stock exchange markets in October 1987 might be ascribed to these policy-induced uncertainties.

* This paper was presented at an International Conference on "Protectionism and International Banking", organized by the Institut der deutschen Wirtschaft (IW) and the Permanent Advisory Committee (P.A.C.E.), held on 29-31 October 1987 in Frankfurt (Main).

What makes recent developments in the international economic order so embarrassing is that governments go on debating over trade matters and currency affairs in an emotional mood, and this debate is bedevilled by prejudices and confusion about how that order works. It seems to be very difficult to resist the temptation to blame current domestic economic problems on the perfidy of foreigners, regardless of whether the problem is a chronically huge trade deficit (as in the case of the United States), deep-seated structural mal-adjustments (as in the case of the European Community), or recurring balance-of-payment crises (as in the case of debt-ridden developing countries). Though history does not have to repeat itself: have the lessons of the twenties and thirties been forgotten?

I understand that my task here is to review the major decisions and events which have driven the world trading and monetary systems into the present situation. As central aspects of the overall problem, in particular with regard to banking, will be taken up in other papers presented to this conference, I shall focus more generally on those historical events which are instructive for understanding the present situation and for appraising possible paths of the international trade and monetary order in the future. The next section recapitulates the historical background which influenced decisively the thinking of the architects of the post-war international economic order. Subsequently, the different phases through which this order went will be described. This is followed by a discussion of the relationships between the stance in trade policies and the handling of external debt problems, invoking also experiences which some countries have had in the past.

2. Early Institution Building

Fourty years ago, in March 1948, 54 nations, accounting for about 90 percent of world trade at that time, adopted

the so-called Havana-Charter. This Charter was to establish a new trade order based on the principles of open markets and price competition as well as of multilateralism and non-discrimination. An international agency, the International Trade Organization (ITO), was to be set up with the declared purpose to enforce discipline in commercial relations among countries. This was expected to give rise to the production of an international public good: stability and predictability of trade rules. Policy-induced uncertainties, which could not but inhibit investment decisions in internationally oriented enterprises, were to be reduced to a minimum.

Though the ITO was to never come into being (see below), the political awareness - immediately after the end of World War II - of the need for, and the virtues of, an open world economy sharply contrasted with developments in the inter-war period (Isaacs, 1948; Chalmers, 1953). It should be recalled that, after World War I had ended, trade protectionism was maintained and even intensified, particularly in Europe. Signs of moderation did not appear before the mid-twenties. Later on, during the thirties, the international trading order had even broken down. The culprit was not only the United States which enacted the Smoot-Hawley Tariff Act in 1930, thereby raising prevailing tariffs to unprecedented levels and imposing a multitude of new duties. Also Great Britain abandoned its traditional free-trade policy in 1932, passing a full-fledged protective Import Duties Act (which increased tariff rates by 10 percent on average) and introducing imperial preferences within the Commonwealth at the Ottawa conference. As could have been expected, many continental European countries retaliated (mainly through import quotas and export subsidies) and practised strict bilateralism in mutual trade (mostly making special reciprocal tariff concessions and barter deals). The consequences are well-known: world trade performance suffered a setback under such disorderly circumstances, lowering its share in world output and even shrinking (albeit temporarily: 1929-33) in

absolute terms; moreover, economic recovery from the Great Depression was unduly delayed and, in a sense, the emergence of totalitarian political regimes was favoured. The error of not having dismantled protectionism following World War I as well as the ensuing unhappy experience with the autarchic and discriminatory trade policies of the thirties might explain why the architects of the new international trade order, which was to emerge from the ashes of World War II, placed so much emphasis on an agreed multilateral system of stable market-oriented rules under which trade liberalization could take place, with most-favoured-nation treatment being granted to all countries subscribing to the system.

No doubt the new economic thinking in the mid-fourties on trade matters had its (preceding) parallel on the monetary side of the world economy. At the Bretton Woods Conference in July 1944, 44 countries had decided to create an international monetary system under the direction of the International Monetary Fund (IMF). Compromising between the ideas devised in the "Keynes Plan" (of February 1942) and in the "White Plan" (of April 1942), the new system was to provide for fixed, albeit adjustable exchange rates; though currency convertibility and the freedom of capital flows among countries did not yet rank high as objectives at that time, in fact they were to be striven for in a not too distant future. Unlike the Havana-Charter, the Bretton Woods Agreement was ratified rapidly and could come into force by the end of 1945.

The new monetary arrangement, too, resembled a reaction against the legacy of monetary disorder which had been inherited from the past. As should be remembered, the gold standard was formally restored in the twenties, but functioned thereafter very poorly. Apart from strains associated with reparations payments and hyperinflations, disruptive pressures originated in the pegging of parities at levels which were incompatible with international differences in

inflation rates; this periodically provoked currency overvaluations (in particular the pound sterling) as well as currency undervaluations (the French franc, for example), with undesired effects on the domestic economies. Once Great Britain abandoned the gold standard in 1931, as most Commonwealth countries along with the Scandinavian nations and Japan did, competitive exchange-rate depreciations became the rule during the thirties in an attempt by the governments to export their own domestic unemployment. A sticky web of exchange controls on trade as well as on current account transactions, specific restrictions on capital movements, and the spread of multiple exchange rates and bilateral clearing arrangements, further contributed to the final collapse of the international monetary system - with quite adverse repercussions on world trade and foreign investment.

The Bretton Woods System, as it was conceived, explicitly recognized that there are close links between trade issues and monetary matters. Neither the new international trading system nor the new monetary order could be expected to stand on their own, but together they could allow for a freer exchange of goods and for freer capital movements than the ones witnessed in the inter-war period. Hence, the Havana-Charter and the Fund Agreement envisaged co-operative consultation and actions between the ITO and the IMF, after these agencies had come into being (Hexner, 1950). Cooperation was felt at the time to be particularly needed in cases in which a member country considered the unilateral imposition of import restrictions and/or exchange controls in order to cope with balance-of-payments difficulties (and a nominal devaluation of the own currency was discarded, for whatever reason). Without cooperation, the corrective measures could easily become excessive in extent and duration or just be ineffective (in solving the problem, not in creating distortions!).

~~This basic idea of the inter-relatedness of the real side and the monetary side of the world economic order is still valid today, though much too frequently overlooked by governments. They infringe on trade rules and thus impair the functioning of the market mechanism; at the same time they complain about sizeable variations in exchange rates and attribute them to market failures.~~ As a matter of fact, government decisions on trade and monetary policies are hardly often well coordinated. Trade (economic) ministers and finance ministers (and central bankers) used to stick to what they regard as their immediate responsibilities, eventually being driven by interest groups which differ from each other both in nature and power. The institutional separation of the two areas offers ample scope for a mutually "benign neglect" of underlying inter-relations, eventual incompatibilities and undesired feedbacks, if doing so fits one's own analyses, conceptions and perceptions of the issues at stake.

The Havana-Charter never took effect, and the ITO was still-born. No country which had participated in the Havana Conference (and in the previously held preparatory sessions) ratified the Charter, thereby revealing an unresolved antagonism of economic doctrines and policies. In some cases, politicians felt that the provisions for liberalizing trade on a multilateral basis (after a transition period) went too far; this was the British position, out of deference to the Commonwealth Preferences. This was also the view-point of Brazil, India and other developing countries, which regarded government controls over trade as indispensable for promoting economic developments (via industrialization based on across-the-board import substitution). On the other end of the spectrum, several countries were uneasy about the agreed provisions not going far enough. This position was most distinctly taken by the United States.

In the United States, President Truman withdrew the Draft Charter from Congress (in December 1950), after the enthusiasm of the early post-war times had faded away and an unholy alliance between protectionists in several import-competing sectors and the more cosmopolitan business community emerged (Diebold, 1952): the protectionist simply kept on stressing the familiar and generally misconceived arguments against free trade; the cosmopolitans emphasized a number of grave defects in the document, such as the considerable scope left for a discriminatory use of import quotas (beyond an ambiguously defined period of transition), the special treatment to be given to developing countries (implying for them less obligations to remove trade barriers and secure foreign investment), and the possibilities offered for the conclusion of international commodity agreements (which could induce comprehensive government interference with foreign trade). Recalling those concerns in the context of today's trade policy debates, the irony of the fate is obvious: Had the Americans succeeded in incorporating their conception of a system of multilateral trade into the Havana-Charter, and had the ITO been set up to enforce liberal trade rules, how could they now legitimate their recurrent departures from the principle of non-discrimination and their growing insistence on bilateral reciprocity as to mutual market access conditions?

Fortunately, the failure of the ITO did not leave a vacuum for the emergence of a new trade system, as a substitute - in essence - already existed. In August 1948, 23 countries which conducted about two-thirds of world trade at that time, had signed the General Agreement on Tariffs and Trade (GATT), reproducing the main rules of the Havana-Charter regarding trade liberalization under the most-favoured-nation clause. Shortly afterwards, rules for the needed cooperation between GATT's contracting parties and the IMF were formally adopted. What started as a provisional

agreement, pending the creation of the ITO, was to become a framework for achieving remarkable movements towards freer international trade, which probably none of the founders anticipated and which today's most fervent critics of the GATT must admit.

3. From Virtuous to Vicious Circles

a) The "Golden" 50s and 60s

When the post-war world economic order was created (albeit incompletely), hopes for renewed and sustained economic dynamism were high. These hopes were to come true during the first two post-war decades, as can be seen from Table 1. Both industrial and developing countries registered an impressive economic growth at that time. World trade also expanded fast, in fact faster than gross domestic product and manufacturing production, thereby indicating that the market (not just institutional) integration of the world economy was making headway. The increased foreign competition on domestic markets improved the allocation of resources and accelerated productivity growth in the advanced countries. And many of the latecomers, most spectacularly Japan, South Korea and Taiwan, also made a leap forward in their economic development once they embarked upon outward-oriented growth strategies (from the early sixties onwards).

In historical terms, the fifties and sixties seem to resemble a "virtuous circle" of trade and capital liberalization. Trade liberalization was pursued in six successive rounds of multilateral negotiations under the auspices of the GATT, running between 1947 and 1967 (when the Kennedy Round was completed), supplemented by bargaining in the framework of the OEEC (the predecessor of today's OECD). In

Table 1: Trends in growth and trade during the inter-war and the post-war period
(average annual percentage change, constant prices)

	Inter-war period	Post-war period	
	1925-38	1955-73	1973-85
<u>Gross domestic product</u>			
Industrial countries	1.4	4.6	2.6
Developing countries	n.a.	5.1	4.5
World ^a	n.a.	4.7	3.0
<u>Manufacturing production</u>			
Industrial countries	0.9	5.3	1.5 ^b
Developing countries	n.a.	7.1	4.8 ^b
World ^a	0.8	5.5	1.9 ^b
<u>Merchandise exports</u>			
Industrial countries	0.6	8.0	3.1
Developing countries	n.a.	5.2	-3.1
(non-oil countries)	(n.a.)	n.a.	(3.9)
World ^a	0.5	7.6	3.4
<u>Trade elasticities^c</u>			
Industrial countries	0.90	1.77	1.06
Developing countries	n.a.	1.25	0.40
World ^a	n.a.	1.63	1.05
^a Centrally planned economies excluded. - ^b 1973-84. - ^c Change in export volume with regard to GDP growth.			

Source: Société des Nations, Annuaire Statistique, various issues. - B.R. Mitchell, European Historical Statistics 1750-1975 (London 1980). - United Nations, Monthly Bulletin of Statistics, various issues. - UNCTAD, Handbook of International Trade and Development Statistics. - Own calculations and estimates.

that period, quantitative import restrictions were eased or eliminated to a large extent (mainly with regard to manufactured goods) and import tariffs went down, on an m.f.n. basis, by some 80 percent in relation to the levels prevailing before the establishment of GATT, as can be derived from Table 2. Moreover, the escalation of nominal tariff rates with the stage of processing was moderated somewhat. In addition, there were episodes of unilateral import liberalization measures ahead of agreed schedules; a case in point is West Germany, where an increase in import competition was regarded by the government as an important tool to maintain price stability. Finally, a first code on non-tariff barriers, the Anti-Dumping Code, was reached (in the Kennedy Round).

To be sure, the process of trade barriers disarmament during the fifties and sixties was anything but a perfect and clean one, as various economists already deplored at that time (Balassa, 1967, among others). For instance, this process was largely confined to trade in manufactured goods among industrial countries. Agriculture remained largely excluded, with protective levels firstly continuing at high wartime levels (as advocated by the United States in favour of its domestic farm price-support programmes), then rising (once the Common Agricultural Policy of the EEC took shape), and ultimately becoming the source of the first serious transatlantic trade dispute (known as "chicken war", in the early sixties). Moreover, markets in the services area were kept quite closed for foreign suppliers (mainly the result of national regulations in transportation, telecommunications, insurance, and banking). As to trade liberalization in manufactures, the depth of the agreed tariff cuts was lower than average for imports from developing countries (a side-effect of the then dominating reciprocal bargain approach); in turn, most developing countries rarely applied any tariff reduction at all, but they increased protectio-

Table 2: Import tariff rates in industrial countries as yielded in GATT Rounds, 1947-79
(weighted averages^a)

GATT Rounds	Raw materials (SITC 2)	Semi-manufactures (SITC 5+6)	Finished manufactures (SITC 7+8)	All goods (SITC 2, 5-8)
Pre-GATT (1947)	n.a.	n.a.	n.a.	35
Geneva Round (1947)	n.a.	n.a.	n.a.	28.3
Annecy Round (1949)	n.a.	n.a.	n.a.	27.7
Torquay Round (1950-51)	n.a.	n.a.	n.a.	26.5
Geneva Round (1955-56)	n.a.	n.a.	n.a.	26.0
Dillon Round (1961-62)	3.2	12.9	15.0	11.5
Kennedy Round (1963-67)	2.2	8.3	9.1	7.2
Tokyo Round (1973-79)	0.3	4.0	6.5	4.7
^a Rates shown are not strictly comparable due to changing country sample, weighting method, and coverage of the imports affected.				

Sources: Müller (1983, p. 57). - GATT, The Tokyo Round of Multilateral Trade Negotiations, vol. II (Geneva 1980), and FOCUS-Newsletter no. 44, March 1987. - UNCTAD, The Kennedy Round estimated effects on tariff barriers (New York 1968). - Own estimates on the basis of press reports.

nism substantially, after embarking upon ambitious import-substituting industrialization strategies. And not less noteworthy, from today's perspective, is the challenge posed on the most-favoured-nation principle by discriminatory devices. The best example is the "Short-Term Arrangement on Cotton Textiles (of 1961), followed by the "Long-term Arrangement Regarding International Trade in Cotton Textiles" (of 1962); both were to become the predecessors of the - in the meantime infamous - Multi-Fibre Arrangement (enacted in 1974 with the explicit intent to be of only temporary nature, but now - after a third renewal - even more encompassing than back then).

What all this means is that formal principles and rules on their own do not secure their effectiveness unless there is a disposition among countries to apply them or there is a suitable mechanism to enforce them (also through national courts, if necessary). In the past, the disposition to liberalize frequently collided with needs to cope with balance-of-payments crises or fears about the achievement or maintenance of full employment - as nowadays. And after the failure of the ITO, there was no legal international organization which could have imposed sanctions against countries violating the terms of GATT, and this is still the case¹. But disappointments about some results falling short of what was hoped for must not obscure the fact that the record of trade liberalization during the first two post-war decades was remarkable. At least there was a sense of continuity on trade liberalization objectives, which today is less evident.

¹ The Eisenhower Administration had attempted, in 1955, to create an institutional body for the GATT, the so-called Organization for Trade Cooperation, but without success. This weakened the GATT and so did the fact that, until the late sixties, the U.S. Congress was not willing to provide explicitly and permanently financial and political support to the GATT Secretariat.

Noteworthy were also the rapid accomplishments in the monetary field. After the realignment of (mostly West European) currencies in September 1949, embracing nominal devaluations in the order of 30 percent from the parities set in 1946, at unrealistic levels, the advanced countries experienced a 17-year-period of relative exchange-rate stability under a de facto dollar standard¹. Similarly significant was that they eliminated the multiple exchange rates which had been in wide use in the immediate post-war period. And most important for the functioning of a multilateral trading system was the readiness of these countries to gradually remove payments restrictions and to restore, by the end of 1958, the (external) convertibility of their currencies.

In retrospect, it is difficult to judge whether trade liberalization assisted the dismantling of exchange restrictions, or vice versa. It is also difficult to assess whether trade liberalization was possible because of the relative exchange-rate stability, as those concerned with the contemporary system of floating rates perhaps would suggest (more on this below). The best guess is to regard the attainments in the real and the monetary sides of the international order as intertwined with each other in a "virtuous circle" of market openness and economic growth. Without multilateral trade liberalization the specialization of countries based on comparative advantage would not have gone far; and without the multilateral payments system and the currency convertibility, international trade, investment and banking could not have been coordinated through the best mechanism one can conceive of: the market.

¹ It may be recalled, however, that Canada maintained a floating rate for its dollar from 1950 to 1962. Other episodes of currency adjustment include the devaluations of the French franc in 1958 (by 14.9 percent) and of the Spanish peseta in 1959 (by 42.9 percent) as well as the appreciation of the D-mark and the Dutch guilder in 1961 (by 5 percent each). Both the frequency and the magnitude of exchange-rate adjustments were much smaller in industrial IMF member countries than in developing member countries in the period under consideration.

b) The "Stormy" 70s and 80s

From the late sixties onwards the international monetary order came under increasing strain and finally collapsed in March 1973, in spite of several courageous salvage efforts by IMF officials and member country governments.¹ Failure of these efforts led the industrial countries to adopt the present exchange-rate system of managed floating. It should be recalled that the "dollar shortage" (of the late forties and early fifties) had given way to "dollar glut" (magnified in the context of financing the Vietnam War) and that, in the sixties, national monetary authorities had begun to excessively accelerate the money supply (targeted on defending the currency parities, creating jobs, raising the level of capacity utilization, and/or financing ambitious welfare programs). These two events fueled inflation over time in most industrial countries, albeit at different rates reflecting varying values attached to the objective of price stability as compared to other goals.

Nominal exchange rates were not adjusted sufficiently and at a proper timing to reflect inflationary differentials. Countries experiencing relative price increases (e.g. the United States, the United Kingdom, France) recurrently accepted a real appreciation of their currencies, mainly in order to keep wage-price spirals under control; this squeezed exports and favoured imports and led, sooner or later, to unsustainable current account deficits. By con-

¹ As major decisions one should recall (i) the devaluation of the pound sterling (by 14.3 percent), along with that of other currencies, in November 1967; (ii) the establishment of a two-tier gold market in March 1968, following high speculative flights from the U.S. dollar into gold; (iii) the temporary floating of exchange rates for key currencies, such as the d-Mark (in 1969 and 1971) and the Canadian dollar (in 1970); (iv) the U.S. suspension of the dollar convertibility in August 1971; and (v) the realignment of currencies through the Smithsonian agreement in December 1971, which proved to be unsustainable.

trast, in countries which typically are wary of inflation (most prominently West Germany, Switzerland, Japan) the reluctance to revalue caused their currencies to depreciate in real terms and their current account to run huge surpluses, as the price competitiveness of their exports and import-competing industries was artificially raised; West Germany became even "overindustrialized" when the shares of its industry's value added and employment in gross domestic product and total employment, respectively, were compared with a hypothetical country at a similar level of economic development (Fels and Weiss, 1978).

This hesitancy to adequately adjust parities - an earlier form of what has come to be termed "exchange-rate protection" (Corden, 1980, pp. 177-181) - was not only unsound on efficiency grounds. It was also counterproductive because of the stimulating effects on large-scale private speculation, which was offered "one-way bets" about the direction of the overdue exchange-rate changes; attempts to calm the massive speculative waves, mainly by imposing controls to stem capital outflows (in deficit countries) and taxes to repel capital inflows (in surplus countries), generally failed under these circumstances. Would this be different in case that the present exchange-rate system is driven back to a kind of adjustable-peg, now euphemistically called "target zones"?

In a sense, the deficiencies of the late adjustable-peg system were reflected in worldwide swings in trade policy events. Surplus countries could (and occasionally did) liberalize trade ahead of agreed schedules, whereas deficit countries could (and sometimes did) delay such actions as much as possible, they even introduced quantitative or other non-tariff restrictions on imports for balance of payments purposes (invoking GATT Article XII). It was, and still is, a misconception prevailing among policy makers to believe

that trade restrictions are an effective tool to overcome persistent and growing current account deficits. At best, the external balance will improve in the short run - and then only temporarily. This is because the deficit, at prevailing exchange rates, ultimately reflects the degree to which domestic expenditure exceeds domestic saving and it is not clear at all that a government could, by imposing restrictions on imports, reduce the level of expenditure and/or increase the rate of savings. As theory explains and reality shows, current account disequilibria can only be corrected by macro- and microeconomic policy adjustments in conjunction with realistic exchange rates.

Whether or not the widely practised move towards managed floating since the early seventies has brought the international monetary system into line with the fundamental conditions prevailing in the various countries and whether or not it has eliminated the temptation to impose trade restrictions for balance of payments reasons, is a highly controversial issue. One can see strengthening elements in the fact that the system has become resilient just at a time in which the world economy has been subject to substantial shocks; remind the two oil price hikes in the seventies and the deep fall in the mid-eighties, the upsurge of new and aggressive competitors on the world markets, further changes in the international division of labour as result of the microelectronics revolution, massive portfolio shifts across national frontiers, and the emergence in the early eighties of severe debt-servicing problems in Eastern Europe and throughout the Third World (in particular Latin America). All this produced dramatic swings in payments balances and required relative prices in the national product and factor markets to adjust profoundly. It is hard to believe that the old adjustable-peg system, had it not broken down prior to these turbulences, could have survived, given the political resistance against parity changes and the apparent sticki-

ness of prices and nominal wages. A less resilient exchange-rate regime would perhaps have induced governments to impose more restrictions on trade and capital movements than they actually did (Obstfeld, 1985).¹

4. Exchange-rate Instability and Protectionist Pressures

In the money-trade context, it has been argued that the current exchange-rate system carries a substantial potential to trigger intense protectionist pressures, by permitting, contrary to what the advocates of flexible exchange rates augured, substantial short-term volatility of nominal and real exchange rates (in excess of changes in money supply), along with policy-induced misalignments of key currency parities for prolonged periods (e.g. Bergsten and Williamson, 1983). Short-term volatility of exchange rates is said to generate additional financial uncertainty and thereby to curtail investment in the tradables sector; the resulting threat to employment may induce trade unions to seek some form of protection from the government. More attention, however, do the critics pay to episodes of sustained overvaluation of a currency on the grounds that this undermines the price competitiveness of both the import-substituting industries and the export activities; they would suffer, perhaps irreversibly, losses of market shares which may force them to scrap part of their production capacities and to lay off workers. The position of these industries is assumed to be even more precarious when the real appreciation of the currency coincides with a cyclical downturn of domestic demand, caused by a contractionary monetary policy (Witte, 1987). This supposedly leads on the political mar-

¹ Whether or not one of the alternative exchange-rate regimes which have been proposed recently would have provided, or could provide now, the needed resilience is an open question. For a survey of those proposals, see Dornbusch and Frankel (1987).

ket to the formation of broad coalitions in favour of trade restrictions (and subsidies); if these coalitions succeed, there is allegedly little chance for a removal of public help when the exchange-rate equilibrium subsequently is restored.

The argument has been taken further by Bergsten and Williamson (1983, pp. 102-103) to include also the reverse case of currency undervaluation. Now the problem is that resources are shifted into activities which do not have a comparative advantage at the equilibrium exchange rate and which therefore will cease to be competitive once the undervaluation has been corrected, leading them to call for trade protection and subsidies. In a historical context this argument contrasts with what was the way of thinking and acting in this field in the twenties: at that time, a real depreciation of the currency was perceived in several countries (e.g. Germany, Austria, France) as a potential source of acute shortages of basic goods on the grounds that domestic production would be "sold out" to foreigners ("Ausverkauf"); the preferred recipe consisted in imposing export restrictions (Chalmers, 1953, p. 9).

The volatility of real exchange rates has increased notably since the advent of managed floating, and so did the medium-term movement of these rates, particularly in recent years (Crockett, 1985). But the empirical evidence about adverse effects of the observed short-term exchange-rate fluctuations and associated risks on trade flows, domestic investment and employment opportunities is weak (IMF, 1984; Bailey, Tavlas and Ulan, 1986). It is hard to establish an unequivocal link between short-term exchange-rate volatility and protectionist pressures and policies.

Nor is the empirical support for the "ratchet-effect" hypothesis, though intuitively appealing, as clear cut as

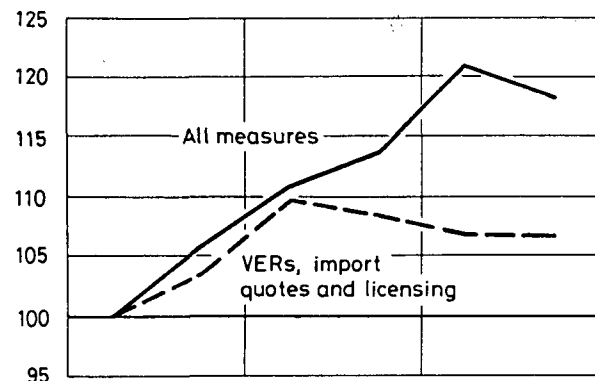
their advocates claim. To be sure, Bergsten and Williamson (1983, pp. 109-115) found some instances in which periods of growing overvaluation of the U.S. dollar gave rise to new protectionist pressures and measures in the United States.¹ Some refer to the pre-1973 period, such as the Mills bill (of 1970) and the Burke-Hartke proposals (in 1971). In the floating-rate period, the best known case is perhaps the "trigger-price mechanism" in the steel industry, introduced early in 1978 after the dollar became overvalued in the mid-seventies; recent pushes for reciprocity legislation in the U.S. Congress, which permeates much of the Trade and Tariff Act of 1984 (the so-called "omnibus trade" bills) and is intended to impose unilaterally new trade barriers against countries whose own markets are perceived as relatively closed for U.S. exports (Japan and several NICs are the main targets), could be associated with the sharp real appreciation of the dollar in 1981-85. "Fair trade" is the name of the game, a popular slogan also one hundred years ago in Great Britain (Bhagwati and Irwin, 1987). Casual observation in contemporary Europe seems to point into the same direction. For example, the restrictive customs regulations for imports of videocassette recorders which the French government decreed in 1982 (the "Poitiers device") may be related to the increasing franc overvaluation in the context of far-reaching socialist experiments (accompanied by severe exchange controls) on which the country embarked under the newly elected President Mitterand.

And yet, the index-series given in Chart 1 do not reveal strong correlations between the recent movements of non-tariff measures and those of real exchange rates, certainly not for the EC and Japan. There is, of course, the problem that the available indicator of protectionism shows

¹ See also Clifton (1985) for supporting evidence derived from an analysis of the import-penetration ratios in the United States, the United Kingdom, and West Germany during the period 1963-80.

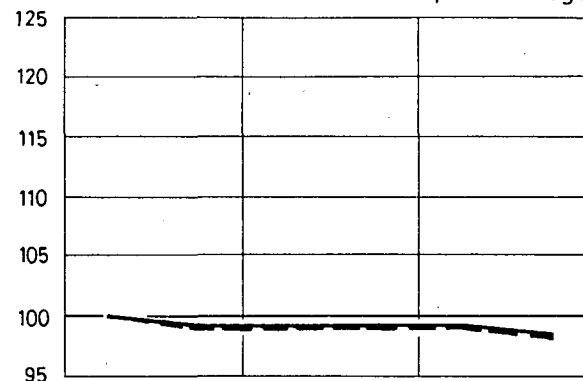
Graph 1: Movements of Non-tariff Measures and Real Exchange Rates, 1981 - 1985

European Community¹

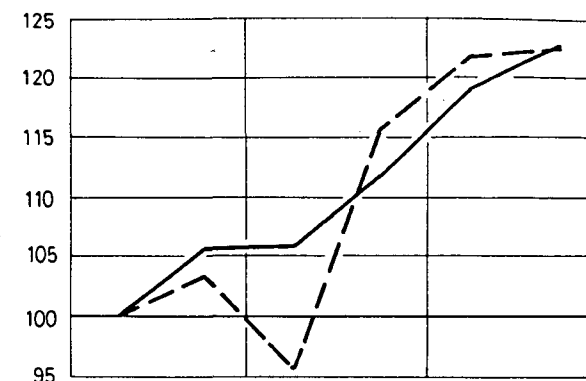


Japan

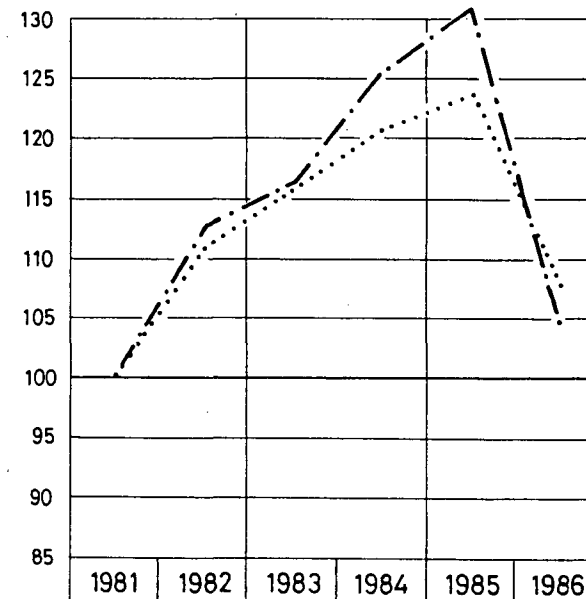
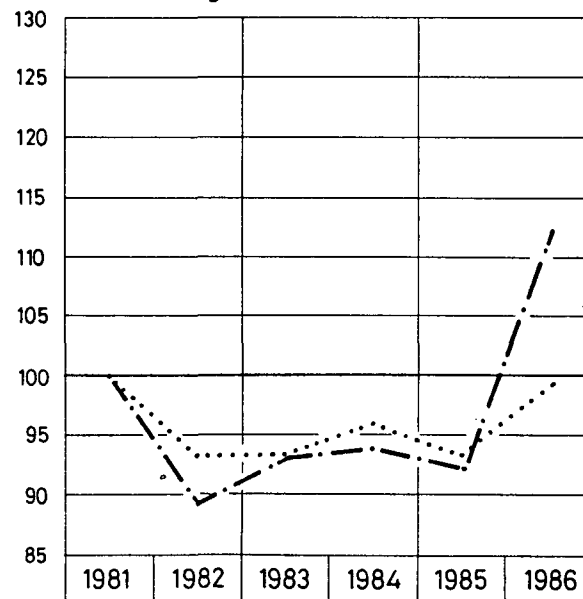
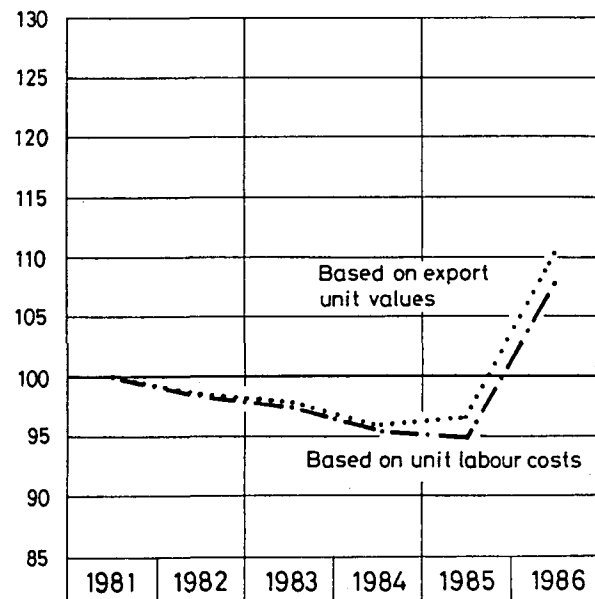
Non-tariff measures: Indexes of import coverage²



United States



Real effective exchange rates: Indexes of annual average value³



¹EC-10 for the NTB indexes; EC-9 for the exchange rate indexes. - ²As applied by 18 industrial countries on all products excluding fuels. - ³As derived from the IMF's Multilateral Exchange Rate Model (including 17 industrial countries).

the extent to which imports are subject to NTBs but may fail to capture the true degree of restriction (available information unfortunately does not allow to be more precise). This reduces the instructive value of the Chart. However this may be, the "ratchet-effect" hypothesis of exchange-rate misalignment in the floating period should be viewed in a global context of trade policymaking. Then it appears that during the seventies there was a new attempt for multilateral trade liberalization under the GATT (the "Tokyo Round", completed in 1979), in which tariffs were cut once again (Table 2, p. 10). Though not all initial expectations were fulfilled, in particular with regard to a dismantling of non-tariff barriers, the root causes of this have been other than exchange-rate swings. They range from food supply security concerns (agricultural protectionism) through long-term shifts in comparative advantage (protectionism in clothing and textiles, steel-making, shipbuilding) to strategic considerations (high-tech protectionism). Some of these protectionist measures, as mentioned earlier, were taken well before the system of managed floating started.

Moreover, the severe economic recession throughout the OECD member countries in the early eighties, and subsequently the sluggish economic growth in conjunction with unprecedented high unemployment rates in the EC, is hardly an environment in which comprehensive trade liberalization is easy to accomplish - even if the exchange rates of the key currencies were considered to be in equilibrium.¹ Though

¹ It should be noted that observed exchange-rate swings cannot all be defined as misalignments. They can also reflect an adjustment of the real currency value to changes in the fundamental conditions for investment and growth in a particular country relative to its major trading partners (Giersch, 1985). There is no unambiguous method for disentangling empirically the efficient component of a real exchange-rate adjustment from an inefficient one. The concept of equilibrium exchange rate in Grilli's econometric treatment of the political economy of protection (1987) leaves this question open.

protectionist pressures and actions have intensified in recent years and though, even worse, protectionism has become more discriminatory among countries and more selectively tailored to individual goods or sectors (Finger and Olechowski, 1987), some observers wonder that there is not much more trade policy protection.

Perhaps one explanation for this in our context is that governments and central banks from the onset of the new monetary system never have allowed a clean floating but have intervened in the foreign-exchange markets for several reasons, thereby accelerating or slowing down changes in the real exchange rate. Exchange-rate protection (in the Corden sense) thus could become, from the tradables sector's point of view, an acceptable (and conveniently disguised) substitute for the more conventional trade policy measures. Well-known cases in point of such exchange-rate protection include (i) the Japanese and German intervention in 1977-78 and 1986-87, respectively, against a "too fast" real appreciation of the yen and the D-mark, which was thought to harm unduly their own export and import-substituting industries; (ii) the "talking-down" (or "valuta dumping") of the U.S. dollar by Secretary Baker in 1985-86, who apart from encouraging American tradables tried to force Japan and West Germany to apply more expansionary macroeconomic policies; and (iii) the Plaza Agreement of G-5 (of September 1985), by means of which the Reagan Administration hoped to tame the protectionist forces in the Congress.

Hence, the relationship between the exchange-rate system and the trade policy stance is rather complex. This is not to say that exchange-rate swings cannot generate protectionist pressures. They did in some cases as mentioned. But the point to make is that observed swings are one among many factors at work. This notwithstanding, exchange-rate variations are often referred to by interest

groups seeking government assistance, if doing so strengthens their case and if exchange-rate protectionism on its own does not provide as much import relief and export stimulus as they desire.

Despite the ambiguity in the interaction between exchange-rate developments and the stance of trade policies since the seventies, the cumulative effect of both might have contributed to the emergence of a "vicious circle" of increasing market entry obstacles for foreign suppliers and decreasing dynamism in the world economy. Indeed (as Table 1 on p. 9 shows) economic growth has slowed down and world trade expansion has lost momentum since the early seventies (both becoming also more erratic); the trade elasticity declined. The oil price shocks, along with recurrent recessions, might be one explanation for the change in performance; deep-seated structural rigidities, particularly in Europe, might be another. But when the rules for the conduct of international trade become less stable and less predictable, this will probably have a negative impact on medium-term investment decisions in the tradables sectors. Though difficult to measure accurately, it is instructive to see that such an impact has shown up in a cross-section regression analysis by Heitger (1986): based on data for the sixties and seventies, trade protection appears as having lowered the rate of economic growth by 1.9 percentage points a year in the world economy as a whole, by 1.3 percentage points for the group of industrial countries and by 2.3 percentage points for the developing country group.¹

¹ The other variables included to explain economic growth are (i) the rate of growth of population as a proxy for the labour supply; (ii) the rate of adult literacy as a proxy for the countries' endowment with human capital; (iii) the share of investment in GDP; and (iv) the per-capita income of each country relative to that of the United States as a proxy for technological catching-up potentials.

5. Protectionism and Debt Problems

a) The Overall Setting

Developing countries have a long tradition in pursuing protectionist trade policies. Most of them never gave up their rejection of the liberal-trade provision of the Havana-Charter, subsequently carried over into the GATT. They always insisted, for various reasons, on the right (and the need) of "special and more favourable treatment" within the international trading system, even if this only meant winning Pyrrhic victories. Not only that industrial countries received a pretext for keeping restrictions against imports from developing countries. Note should also be taken of the fact that the process of economic development in the Third World typically (and, at first sight, paradoxically) run up against severe balance-of-payments constraints, unless trade restrictions were eased in due time, as many empirical studies have shown (for a recent survey, see Lal and Rajapatirana, 1987).

The point to be emphasized in the context of this paper is straightforward: The capacity of the economy to adjust without excessive losses of output, employment and capital, when the international trade environment deteriorates, is handicapped considerably in countries that adhered to protectionist policies in the past. It now has become apparent that much of the investments undertaken behind high import barriers do not yield a rate of return near the rate of real interest prevailing in the international capital markets. The more those investments were financed by borrowing abroad, the greater the likelihood that the countries, which have been protecting themselves at will, will face debt-servicing crises.

The resulting requirements for balance-of-payments adjustment, if not adequately supported by macroeconomic policy changes (especially cuts on unsustainable budget deficits) and realistic exchange rates, are bound to trigger new protectionist pressures, to prolong or even tighten existing exchange controls, and to revive old-fashioned policies of import substitution. GATT Article XVIII (B), which sanctions for developing countries the balance-of-payments exception to the general prohibition of import quotas, gives protectionist measures the air of legitimacy; and IMF Article XIV is interpreted by many governments as the right to (at least) maintain exchange restrictions. As under these circumstances neither the allocation of resources nor the x-efficiency at the firm level will improve (both worsen), and as capital flight rather than capital repatriation is prompted, the debt problem is exacerbated over time. This is (at least part of the) experience made after the outbreak of generalized debt crises in the early eighties (Balassa, 1986).

But even if indebted developing countries were prepared to pursue a more sensible approach: consisting of strong internal adjustment plus external adjustment based on import liberalization and export expansion, the prospects of overcoming the crisis can become quite gloomy. This is the case when protectionism increases abroad, in particular in the industrial countries which in a sense provide the markets of last resort. A major danger for the indebted countries is that they promote exports of goods in which they have no comparative advantage, just because the access to major buyer markets seems to be easier; thus they incur considerably domestic resource costs. Alternatively, debtor countries may sink straight into export pessimism and feel tempted, once again, to pursue inefficient import substitution. Losses in foreign exchange earnings from exports makes external adjustment more difficult and this, in turn, adds a burden to the internal adjustment because the governments

get less tax revenues from exports. The frustration (and eventual political upheaval) associated herewith is likely to spur sentiments in favour of debt repudiation. This is another reason for being concerned about the resurgence of protective attitudes in industrial countries in recent times.

These concerns should not be belittled, as sometimes done, on the grounds that industrial-country imports from the South have been increasing at remarkable rates even in the sensitive areas, which proves that the NTBs are not watertight. Rather, protection needs not rely on concrete actions to be effective; threats frequently are a good substitute, in particular when made to countries which lack the economic and/or political strength to eventually retaliate. Most NTBs against developing countries are unbound. Hence, would-be exporters in debtor countries run the incalculable risk that interest groups in the industrial countries claim, and governments accord, a tightening of such barriers whenever import competition rises too strongly. To produce for the domestic market will appear as the most reasonable thing to do in such circumstances.

b) Four Country Episodes

Going further back in history, there are many episodes from which instructive lessons can be drawn to understand the interaction between trade protectionism and debt crises. For instance, Germany produced such episodes twice, one in the inter-war period and the other in the years following World War II. In the first case, Germany underwent a transformation from a major international lender to the world's largest debtor as result of war debts and the reparation payments exacted by virtue of the Treaty of Versailles (of 1919) and subsequent arrangements. Debt service as a propor-

tion of exports rose to 40 percent in 1924 and improved only slightly thereafter. According to the then prevailing view the country would be able to create the budgetary prerequisites¹ and to bring about the internal adjustment, including cuts in real wages (by other means than a currency devaluation, which was strictly forbidden by the Dawes Plan of 1924). There was also widespread confidence that German producers would face abroad a reasonably price-elastic demand. Both were necessary conditions for Germany running the needed export surplus. But they were not sufficient. In addition, open markets into which Germans could export were urgently required. In this regard, some reparations claimants (particularly France and the United States) took a protectionist stance against imports from Germany (Chalmers, 1953). This could not but give rise to a real transfer problem in the early twenties, just as it may affect developing countries in the eighties. Only when Germany received fresh loans, predominantly from private U.S. creditors which thereby honoured the country's return to international creditworthiness after a spectacular shock treatment ended its hyperinflation in 1924, the transfer problem became more manageable; in some years (1925, 1927, 1928), Germany paid reparations and run a trade deficit at the same time. But the transfer problem worsened again when capital inflows began to decline drastically in the wake of the Great Depression, while protectionism increased, as mentioned above. Neither the reduction of the annual reparation quotas along with the extension of a new loan to Germany under the Young Plan of 1929, nor the Hoover Moratorium of 1931 could prevent (Hitler-) Germany from terminating this protracted

¹ Initially, the sources of finance were a newly introduced wealth tax ("Reichsnotopfer") and a forced government loan ("Zwangsanleihe"). But soon the government took resort to the inflation tax; the accelerating money creation was to lead the country into the hyperinflation of 1922-23. This traumatic experience has been the root of the Germans' aversion to inflation until today.

episode by repudiating all debt in 1933.¹ In a sense, the memorable 1929 Keynes-Ohlin-controversy about the feasibility of German reparation payments was "decided" as Keynes had feared - something which should be kept in mind in discussions about how to solve today's debt crises.

The second German episode, in the early post-World War II times, offers a quite different, and more persuasive, pattern. This time, the victorious Western Allies renounced direct claims to financial reparations, and they were largely content with dismantling and seizing (until 1951) parts of Germany's industrial equipment (which shortly later was to become technologically obsolete anyhow). Moreover, defeated (West) Germany could benefit from the U.S. Marshall Aid Plans, which provided substantial balance of payments relief. Also, the newly revived liberal sentiments in trade policies bred optimistic expectations among the German industry for running an export-led growth (which was to become a reality shortly). This relatively bright international environment, together with the comprehensive currency reform of 1948 and the market-oriented shaping of economic policy, allowed Germany to make significant headway in the restoration of its economy and to improve notably its standing in world capital markets (Wallich, 1955). It was also helpful that the Federal Government right from the start had recognized the pre-war foreign debts, and the moral obligation to indemnify the Israelis and other foreigners affected by Nazi persecutions. Thus the time soon became ripe for all parties to reach a definite, and mutually satisfactory, settlement in the London Debt Agreement of 1953 (which also included

¹ Whatever the role of ideological concerns, it should be recalled that Germany just joined the wave of debt defaults which most Latin American countries had initiated two years earlier, with several European countries following suit (Eichengreen and Portes, 1986). Prior to Germany's decision several European creditors led by the United Kingdom and France had reached in the Lausanne conference of 1932 an agreement that the reparation payments should cease; the United States did not concur with this procedure.

the debts due to the post-war aid). Hence, the episode produced in West Germany a "virtuous circle" of world market integration and sustained economic revitalization (later often called a "miracle"), which, as a by-product, made a significant contribution to the process of rebuilding a functioning international financial system. To be sure, this is not irrelevant to the problems of protectionism and over-indebtedness of the eighties.

Of a different kind but nevertheless equally instructive are episodes that occurred at the two geographical extremes of Southern Europe: in Spain (in the end-fifties) and in Turkey (around the late seventies). Spain was virtually bankrupt early in 1959. This was the result of a long period of excessive (and inefficient) import-substituting industrialization with its inherent negative bias against exports (Donges, 1971). An extraordinary protective trade regime combined with a chronically overvalued exchange rate of the peseta had recurrently triggered balance of payments crises which could only temporarily be mitigated by capital inflows and earnings from nascent tourism. When the country finally faced a complete economic collapse, the government undertook a radical shift in its policies in mid-1959, basically overhauling and liberalizing both the trade regime and the complex system of bureaucratic regulations, correcting the currency misalignment, and opening up the economy to private foreign investors and tourists. In return for this policy shift Spain obtained spectacular rewards in terms of industrial catching-up, export diversification and real per capita income increases (thereby providing another case of "economic miracle", as frequently argued in the literature). The country rapidly regained international creditworthiness through its own actions (a status it has not lost since then). But improved economic policies at home might have benefitted a great deal from the international process of trade liberalization which was under way at that time, and which backed a rapid expansion of world trade, - conditions which today's indebted developing countries do not enjoy.

The Turkish story revolves around the same theme as in Spain, it only took longer until the country was plunged into a traumatic external debt crisis in 1978-79. (Kopits, 1987). It is interesting to recall that Turkey's crisis broke out at a time when the well-known adverse external shocks that are generally emphasized to explain the outburst of the Latin American debt crisis in the early eighties had not yet occurred. Thus, Turkey's debt problem was mainly self-inflicted. That is, it was the economic consequence of its long tradition of autarchy and "étatisme" which had fed lasting public overspending, generated a prolonged inflationary dynamic, kept the productivity of investment very low, severely hurt export activities, and impaired notably the growth potential of the economy. When a full-scale economic crisis is largely self-inflicted, the way out of the impasse has to be effected by the national government in the first place. Starting in 1980, the Turkish government embarked upon a comprehensive program of macroeconomic stabilization and market-oriented economic reforms, the core of which on the external side were import liberalization, export promotion and a more realistic exchange-rate policy. The country achieved remarkable economic growth and export expansion, despite the adverse external conditions prevailing during the early eighties (by contrast, inflation declined only slowly and is still in the two-digit range because the new fiscal policy stance has not been sufficiently tight). As the Turkish government acted with determination and as rapid success in the trade performance could be shown the reform package became a solid basis for eliciting sizeable financial support from abroad.¹

¹ Geopolitical considerations, associated with Turkey's proximity to the Soviet Union and with the uncertainty about the consequences of the Khomeini Revolution and the Iran-Iraq war for Turkey's internal political stability, might also have made official creditors especially inclined to provide financial aid.

These stylized episodes suggest a number of implications for understanding the interaction of trade policies and debt manageability. First, own protectionism is an important factor underlying the development of external debt crises. Secondly, foreign protectionism is a serious obstacle for indebted countries to service the debt. Thirdly, the strengthening of market incentives in indebted countries, which inexorably requires trade liberalization and realistic (and flexible) exchange-rate policies, is a necessary (albeit not sufficient) condition for these countries to get out of the financial impasse, to achieve economic growth and to keep unavoidable adjustment costs within limits. Fourthly, net capital inflows (from private investors, commercial banks, foreign-country donors and international organizations) are crucial for strengthening domestic investment, support the balance of payments, and provide credibility to the policy reform package.

6. Concluding Remarks

The issues discussed so far form part of a highly complex set of relationships that will be examined in greater detail in the other papers. The main message of this paper is that neither in trade policies nor in exchange-rate policies do governments have much scope for continuous interventions against market forces - and achieve stated objectives. To pretend otherwise is to risk inefficient resource allocation, substantial productivity losses, and an impoverishing process of disintegration of the world economy. Though historical analogies are imprecise forms of analysis and policy guidance, the experience of the thirties carries a clear warning.

Hopefully, disquieting current events on the real and the monetary side of the world economic order may ultimately not undo the important achievements made in the post-war

period. For this we do not need either a new trading system nor a new exchange-rate system in the first place. To be sure, the better the exchange-rate system works the better the trade system will function. But it does not lead us very far if we denounce observed distortions in commercial and capital flows just as market failure although they may reflect government failure. Therefore, what is to be called for in the first place is a firm political commitment of governments to abide by the basic rules of the game in both systems.

At the monetary front, the inexorable requirement is the pursuance of credible and predictable macro- and micro-economic policies. Ad-hockery along with arbitrary foreign-exchange market interventions (which politicians and central bankers so frequently seem to like), let alone the imposition of taxes on short-term capital movements or the institution of dual exchange-rates with fixed rates for trade and flexible rates for capital account transactions (as advocated in some respectable academic circles), are quite imperfect substitutes; nor is a mismatch of domestic monetary and fiscal policies likely to stabilize exchange rates. With appropriate macro- and microeconomic policies, which provide for smooth structural adjustment to continual shifts in comparative advantage and for a sustained non-inflationary economic growth at high levels of employment, the danger of destabilizing speculation dominating foreign-exchange markets and creating large exchange-rate fluctuations and misalignments might be low.

At the trade policy front, the task ahead consists of a determined return to the basic principles of multilateralism and non-discrimination. Present-day variants of selective protection (and subsidization) must be phased out and new ones must be prohibited. Quantitative import restrictions for balance-of-payments reasons are unnecessary under floating exchange rates and should no longer be permitted by

the GATT. The ongoing "Uruguay Round" of multilateral trade policy negotiations under the auspices of GATT might be the last chance for settling these matters. As at the moment none of the major players seems to be prepared, or able, to assume vigorous leadership in the negotiations, it may be more important than ever since World War II that free-trade-minded forces, which could help to contain the quite active protectionist pressure groups, are brought in bear. Apart from domestic consumers and producers, such (potentially) countervailing forces include the multilateral corporations and the commercial banks. For the former the openness of world markets is a necessary condition for successfully integrating the investments made abroad into their international operations. Commercial banks would also seem to have a vested interest in advocating open markets, and be it only because then developing countries would find themselves in a better position to earn the foreign exchange they need for debt-servicing.

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