Protectionism: Old Wine in New Bottles

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This paper addresses some new types of arguments that have recently arisen in defense of protectionism in developing and developed countries. The new sources of protectionism in developing countries discussed are: (1) recession-debt-crisis costs; (2) protection in the world economy; (3) wages and labor markets; (4) political requirements. The new arguments for protectionism in developed countries discussed are: (1) shift to the service economy; (2) defense; (3) threat of protection to induce foreign investment.

Protectionism has always reared its familiar head when unemployment has risen and competition has gotten tough. Both these reasons have certainly contributed to the recent resurgence of the threat to the postwar environment of freer trade that generated rapid growth in both trade and incomes for nearly three decades. The major recession in the first Reagan term and the continuing high levels of unemployment in European countries despite the revival of the United States economy are the source of the macroeconomic threat. Moreover, the vast debt carried by Latin America fuels their need for more exports and adds to the difficulties of specific industries in the mature economies that must adjust to the relatively more rapid growth of outward-oriented economies of the Far East. Indeed, the growth of Japan "squeezes" the industries at the upper end of the technological spectrum whereas the growth of the Gang of Four (Taiwan, South Korea, Hong Kong, and Singapore) has been pressuring the industries at the lower end of that scale, resulting in a "pincer movement" that has fed the demands for protection from these industries.

This paper, however, does not address the specifics of the current protectionist situation as they reflect these economic phenomena. Instead, I choose to discuss here certain new types of arguments in defense of protection that have recently arisen. I divide these arguments into two classes: the ones that have arisen in the developing countries

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(Section 1); and those that have surfaced in the developed countries (Section 2).¹

1. ARGUMENTS IN THE DEVELOPING COUNTRIES²

The arguments in favour of protection in the developing countries arise essentially in the form of a resurrection of the assertion that the import-substituting (IS) strategy is preferable to the export-promoting (EP) strategy. Raised at the outset of the postwar period, and indeed forming the basic core of the debate over the ideal developmental strategy for the developing countries, this issue was settled in favor of the EP strategy by the remarkable success of the countries (in the Far East) that followed its precepts. Numerous studies, organized by several distinguished economists, led therefore to the demise of the notion that the IS strategy was the appropriate one, among the principal such studies being that done at the World Bank by Bela Balassa (1982), that done at the OECD by Ian Little, Tibor Scitovsky, and Maurice Scott (1970), and those done at the NBER by Bhagwati (1978) and Krueger (1978).

Recently, however, questions have been raised, with influential impact in some developing countries, concerning the advisability of the EP strategy, thus implying the desirability of an inward-looking, protectionist policy stance by the developing countries. As argued below, these are legitimate, though somewhat misplaced, doubts in my view. Their currency, however, is partly due to the "nationalistic" reaction that intellectuals in some of these countries have to the fact that the EP strategy has been turned into an important component of conditionality at the World Bank at a time when many countries are seeking help from the international institutions.

The new sources of protectionist sentiments are basically fourfold.

A. Recession-cum-Debt-Crisis Costs

During the postrecession years of the late 1970s and early 1980s, it is asserted that the EP countries must have suffered a greater adverse

¹There are also a few *theoretical* arguments that have been advanced in the literature, based essentially on the introduction of market structures such as oligopoly and imperfect competition. In my judgment, their empirical relevance is not great, and several key results supportive of protection are critically dependent on absence of free entry into the market studied. A proper examination of these arguments, however, would take me far beyond the scope that I have defined for the present paper.

²The structure of the argument advanced in this section closely follows a recent discussion of the subject in my contribution to the *Festschrift* for Saburo Okita: see Bhagwati (1985).

impact than the IS countries in view of their exposure to the external environment. Insofar as the EP countries were also on a debt-led growth path, the debt crisis and the adjustments imposed by the collapse of the world credit markets would have forced yet greater costs on these countries. IS proponents would therefore feel vindicated.

However, the fact remains that the Far Eastern economies that were into EP strategy in the most pronounced fashion remained the best growth performers even as they slowed down with the rest of the world. In fact, Bela Balassa's (1982) cross-sectional analysis of comparative performance of the EP and IS countries during this lean period suggests little to confirm the suggestion that outward orientation has made countries fare worse. Moreover, the EP countries grew so much better during the many years preceding this lean period that any proper cost-benefit calculus would have to take into account earlier successes and set them off against the later losses (if there were any).

B. Protection in the World Economy

If the world-trade environment is being overwhelmed by protection, would that not be a ground for retreating into the IS strategy? There are really several levels at which this argument can be addressed. First, adjusting for the income effects of the last recession, it is not clear that the *actual* protectionist effect on trade has been sufficiently severe to make us fear that the world trade order has begun to collapse. There are good reasons to infer rather that world trade has shown remarkable resilience in the face of these fears and threats, that the bark has been more evident than the bite, and that the revival of export pessimism may be premature.³ Second, even if the world markets do not expand rapidly, this does not mean that developing countries will necessarily face, for *individual* decision making, a less than perfectly elastic offer curve: the offer curve may be fully elastic at any point of time while shifting steadily over time toward the developing country's offer curve. In that event, the case for an IS strategy does not legitimately derive from the traditional optimal-tariff-for-a-large-country argument. Third, I should like to emphasize that I do not find persuasive the frequent contention that the Far Eastern economies' EP model cannot be exported because if every developing country exports like them, the world cannot possibly absorb the resulting exports. This argument is often buttressed by raising all

³On this point, see the interesting paper of Bela and Carol Balassa (1984) in *The World Economy* which takes, consistently also with work by Anne Krueger and Helen Hughes at the World Bank, an optimistic view of world trade trends in the teeth of protectionist voices and actions.

developing countries' exports to the same share of GNP as in the Far Eastern economies. But the EP strategy simply implies eliminating the bias against exports. There is *no reason* to conclude that this would yield, for every country, the same share of trade to GNP as for the small group of current EP countries. Moreover, such extrapolations ignore the fact that trade can occur in all kinds of differentiated products and in unpredictable ways. Export pessimism in the 1950 was in no small part a result of the inability of planners in developing countries to think up, in their armchairs, the possible sources and composition of trade expansion. For example, before the trade in similar products seized our empirical and theoretical attention, who could have not thought that "similar economies" would have less, rather than more, trade with one another? Again, devaluations are often successful in promoting exports of "miscellaneous" items that no bureaucrat or economist can predict but which the opportunity for gainful trade seems often to galvanize. Finally, the fact that rapid trade expansion, if many more countries chose the EP strategy, could put pressure on specific sectors in specific countries cannot be denied. But interestingly, the reaction need not be simply protectionist but may also be to pressure one's rivals into freer trade as, in fact, is happening in the case of Japan at the insistence of Europe and the United States. Expanding trade needs may therefore ensure that the Western leadership may redouble its efforts to keep doors open *and* to open other people's doors.

C. Wages and Labor Markets

A recent argument against the adoption of the EP strategy has been advanced by Gary Fields (1984). Contrasting the Far Eastern economies principally with the countries of the Caribbean, Jamaica included, he has argued in effect that these countries have suffered from excessively high wages that make protection desirable, and that their reliance on the EP strategy has therefore been harmful rather than helpful.

However, Fields does not establish, I am afraid, the basic contention that these countries have an EP strategy in the first place. As has been explained systematically in the Bhagwati (1978) and Krueger (1978) synthesis volumes from the NBER project, the EP strategy simply consists in eliminating the *bias against exports* implied by the (over-valued exchange rates, protection, etc. resulting in the) IS strategy. As far as one can tell, Fields has not produced the evidence on the relative effective exchange rates on exports (EER_x) and on imports (EER_m) that would support his contention that these are EP countries, i.e. that they

are characterized by $FER_x \approx EER_m$ rather than by $EER_m > EER_x$ as with the IS countries. In fact, for Jamaica at least, I am assured that my presumption that it is really a classic case of an *IS strategy* is corroborated by such evidence. Fields, like many other commentators who are unfamiliar with the careful analytical concepts in the literature, seems to have confused the island nature and smallness (with associated high ratios of trade to GNP)⁴ of these countries with the altogether different concept of what is an EP strategy.⁵

Besides, note that the theoretical contention that labor market imperfections *may* require a departure from the EP strategy is well known from the work of trade theorists, including Richard Brecher, V.K. Ramaswami, T.N. Srinivasan, Harry Johnson, myself, and others, during the 1960s. Their demonstration that the optimal policy intervention in these cases is to intervene in the factor markets directly—see my synthesis (1971) in the Kindleberger *Festschrift*—may of course not be feasible where political or institutional factors inhibit the implementation of such policies. If this case is persuasively established, then a protectionist departure from the EP strategy may well make sense. But I see no such case plausibly established for Fields' Caribbean countries either.

Fields' reliance rather on the argument that wages are kept under control in the Gang of Four countries seems to me to point to a very different general-equilibrium-theoretic argument of microeconomics. The Gang of Four countries appear to have used authoritarian methods to keep trade unions under control and to build on this a successful macro policy of low inflation. The good microeconomics of EP strategy has then been built on the necessary macro foundations without which one would likely lapse into repeated overvaluations, occasional exchange controls, and the attendant inefficiencies of implied import substitution. I have already hinted at this explanation in my NBER synthesis volume (1978), but it is a thesis that requires intensive empirical analysis for validation.

D. Political Requirements?

Many critics of EP strategy have been worried about the association of this strategy with the authoritarian regimes of the Far East.

⁴On four alternative ways of defining these ratios, and their conceptual underpinnings, see the important recent paper by Padma Desai (1984).

⁵Thus, an EP strategy is wholly consistent with a "low" ratio of trade to GNP, however defined.

countries. Does this not imply that the iron fist is essential for the adoption and successful implementation of this strategy?

Of course, since many developing countries are unfortunately authoritarian, this would not constitute a barrier to the adoption of the EP strategy. Less cynically, however, the argument simply ignores the fact that many totalitarian countries (e.g. the USSR) have been on the IS strategy, whereas within the Far Eastern economies, the degree of authoritarianism varies, and not necessarily monotonically with respect to their economic performance. It is possibly safe to say that there are no necessary or sufficient conditions to be found here.

I would venture, however, to suggest the modest hypothesis that it has been hard for democratic countries such as India to transit from their early IS strategy, and easy for the less democratic and more authoritarian countries of the Far East to embrace the EP strategy after a brief IS phase, simply because pluralistic democracies may find it much harder to dismantle the controls, protection, etc. that inevitably accompany the IS strategy—because, in turn, these policy instruments carry patronage and confer on the politicians the power to collect funds for their reelection, so that the economic regime under the IS strategy tends to become a critical source of political power. By contrast, in authoritarian regimes, the political power is seized directly, freeing the rulers to shift to the EP strategy with its diminished patronage potential.⁶

A “satisficing” political theory has recently been advanced by John Ruggie (1983) and his associates, all distinguished political scientists, suggesting that the advantages of an EP strategy cannot be exploited by political regimes that cannot successfully address the distributional conflicts and tensions that would follow from this strategy. Fundamentally, this appears to me to be a persuasive argument as far as the acceptance or political feasibility of any developmental strategy is concerned. Where I part company from Ruggie and his associates is in the implied contention that the EP strategy leads to *more* such demands on the political system. An IS strategy, while relatively insulating the system from external disturbances, may create yet more tensions if the resulting loss of income expansion accentuates the zero-sum nature of the other policy options in the system. Therefore, I would rather convert the Ruggie thesis from its current version into the necessary and valid caveat that, in pursuing *any* developmental strategy, one must consider its compatibility with the political structure and resilience of the country.

⁶I have advanced this hypothesis in Bhagwati (1978), drawing on elements of the argument in Bhagwati and Krueger (1973).

And this particular caveat is, I would stress, not one that I would address only to EP-strategy proponents.

The caveat does imply, in my view, that those who seek to include the EP strategy as a necessary ingredient of conditionality imposed by the World Bank or the IMF, as is, for example, the case with many Structural Adjustment Loans from the Bank, should be urged to exercise some caution lest their prescriptions be counterproductive because of ignored political prerequisites. The unduly harsh witicism aimed at the distinguished Nicholas Kaldor, that political upheavals follow his advisory missions, is an excellent corrective to those who fail to place their economic prescriptions in their political context.

2. ARGUMENTS IN THE DEVELOPED COUNTRIES

Let us turn now to the arguments for protection that have arisen in the developed countries.

A. Shift to the Service Economy

Interestingly, the rise of modern service industries, reflecting the rapid growth of the information technologies, has led to two protectionist arguments, each in fact diametrically opposed to the other in its intellectual foundations.

On the one hand, we have the demand, especially from Nicholas Kaldor and his associates in Cambridge, for "reindustrialization", a sentiment supported in the United States by the sociologist Amitai Etzioni. The main contention of Kaldor seems to be that there are externalities associated with industrialization that would be lost otherwise. In particular, Kaldor's (1966, 1975) views seem to rest on the so-called Verdoorn (1949) finding that growth of productivity is higher in the manufacturing sector, a finding that also led him to recommend the Selective Employment Tax to Chancellor of the Exchequer Mr. Callaghan to shift employment into manufactures. I am afraid, however, that this argument erroneously identifies low productivity with services as against manufactures, reflecting the identification by British economists of services with inefficient retailing and other traditionally low-productivity sectors in their economy. The argument is totally misleading when it comes to modern, highly progressive service sectors.

⁷I have discussed this issue, and the possible reasons underlying the prevalence of the views in Britain, in an article in *The World Economy* (Bhagwati 1984). I might warn the reader that there is also a macro-theoretic rationale advanced in Cambridge, England, for protection; but that has been considered at length elsewhere in this Symposium.

On the other hand, many intellectuals and policymakers in the developed countries have begun identifying high-tech and information industries-cum-services as the cutting edge of the modern age, and this has led to the demand that, no matter what the market dictates, governments should assure that their nations get these activities established domestically through implicit or explicit protection. This is reminiscent of the demand for protection of manufactures in the developing countries in the postwar years: few developing countries would have been willing to let the market, i.e. comparative advantage assign them to a purely primary-product specialization! For this reason, I find this to be a potentially difficult area for GATT to monitor effectively. Politicians will simply be obdurate, I am afraid, in the face of advice from economists on this question.

B. Defense

Surprisingly, the traditional argument for protection in order to promote defense industries has recently been revived by Paul Seabury (1983), a distinguished political scientist, in the context of the basic or smokestack industries and therefore in favour of "reindustrialization", for the United States. It is best to let him talk:

Indeed, in light of the deteriorating state of its basic industries, the United States has a clear need for a coherent industrial policy, but for reasons wholly unrelated to those usually offered. The necessity for a U.S. industrial policy arises not from domestic economic considerations—however large these may currently loom—but rather from strategic-military concerns. As the only genuine guarantor of security for both itself and the Free World as a whole, the United States simply cannot afford to allow its industrial base to wither away . . . The American industrial base constitutes the strategic core of Free World defenses. Those who, whether in the interests of free trade or a "high tech" boom, are content to remain untroubled by the demise of U.S. basic industry would do well to remember Solon's stern warning to Croesus: *Sir, if any man hath better iron than you, he will be master of all this go'd.* (1983, pp. 5-6)

This argument sounds wholly implausible to me, even though Seabury examines in detail the ways in which lack of domestic capacities in the basic industries might impact on conflagrations between the super-powers. He really would have to discount the possibility of drawing on supplies from the U.S. allies during such episodes. He would also have to ignore the possible policy option of storing supplies that may not be so accessible: nuts and bolts, not just tanks and oil, are capable of being stored. And if the shift to high-tech and modern services is indeed advantageous, I doubt immensely that the storage costs of "sensitive"

basic-industry items would outweigh the costs of foregoing such a shift of specialization in response to shifting comparative advantage. Besides, there is also the "systemic" point that the United States cannot invoke this argument for protecting its basic industries without having serious impact on the "rule of law," as embodied in GATT. Can anyone seriously believe that the other GATT members would accept such an argumentation by the United States without cynicism? GATT is under enough pressure as it is without the United States, a principal actor on the scene, resorting to protection on such an implausible argument.⁸

C. Threat of Protection to Induce Foreign Investment

A rather remarkable development in the developed countries in recent years has been the use of the *threat* of protection to induce foreign competitors in specific industries to invest in one's own country. This is reminiscent of the developing countries, especially those following the IS strategy, using *actual* protection to induce such investment inflows into specific sectors.

This type of direct foreign investment (DFI) is evident from the GM–Toyota deal in the United States, apparently prompted by the threat of domestic-content protection—which was very real prior to the imposition of VERs (voluntary export restrictions) on exports of autos by Japan to the United States. The quid pro quo for Toyota in this deal, which benefits General Motors and creates jobs for the United Auto Workers (UAW) union, is evidently the conversion of General Motors to a free-trader stance in local U.S. politics: this is manifest from the fact that GM alone among the U.S. automakers has been arguing against the extension of the auto VERs.⁹

⁸Since Seabury does not really go into the question of alternative ways in which such protection may be provided, I should remind the reader that the theory of noneconomic objectives recommends that defense industries be protected not by tariffs but by domestic production subsidies.

⁹It may be of interest to the readers to note that this kind of mutual-gain deal, which promotes joint investments and hence is a specific DFI "type," may be contrasted with another DFI "type," which I developed in Bhagwati (1972) in a review of Vernon's work and which I have later elaborated in Bhagwati (1982). This type of DFI, which I christened the MPI (Mutual Penetration of Investment), involves mutual investment by GM in Toyota to produce the small cars the Japanese are better at, and by Toyota in GM to produce the large cars the Americans are better at, for reasons of historical specialization. This idea was suggested to me by the Dunlop–Pirelli DFI deals where each bought into the other's specialization. I was contrasting the MPI model with Vernon's celebrated "product cycle" model and predicting that the MPI model would be the wave of the future, just like *trade* in "similar products." For the time being, however, it seems to be partly displaced

This model has its attractions and, I am afraid, it will draw in more imitators, as unions try to protect their specific jobs by threatening protection as an inducement to the foreign producers to manufacture here rather than there.

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from the center stage by the model-type that I am discussing in the text, where the foreign competitor's quid pro quo comes not from their investing in your specialized knowhow, but rather simply from getting you on their side in an otherwise difficult to avoid threat of protectionist actions.

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