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The international trading order at the crossroads

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THE INTERNATIONAL TRADING ORDER
AT THE CROSSROADS

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I. Introduction

As economic theory shows and experience underlines, international trade and the specialization associated herewith is one important source of economic growth, employment creation and technological innovation in participating countries. In awareness of this potential for increasing economic prosperity throughout the world, the architects of the international trading system, which was to emerge from the ashes of World War II, envisaged a framework of rules leading to, and securing, open markets. The General Agreement on Tariffs and Trade (GATT), which came into being in 1948, laid down such trade rules, basically the principles of non-discrimination and multilateralism in world trade. The aim was not to establish free trade, without any government intervention. What was meant is liberal trade, in which governments may interfere, but using price measures which are transparent and do not rule out competition (i.e. non-prohibitive tariffs rather than quantitative restrictions or subsidies). Adherence by the member countries to the principles of multilateralism and non-discrimination was expected to give rise to the production of an international public good: stability and predictability of trade rules.

This system worked reasonably well up to the early seventies. Tariffs were reduced substantially in successive rounds of multilateral trade policy negotiations, especially with regard to manufactured goods. The stimulus to world trade was, by any historical standard, remarkable indeed: In the

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period 1955-73, world exports of manufactures expanded in real terms at an average annual rate of 9.2 percent, as compared to an annual rate of growth of world manufacturing output of 6.6 percent.[1] This pace of integration not only allowed the advanced countries to further increase real income. It also permitted other countries, most spectacularly Japan and various Asian and Latin American developing countries, to progress up the scale of economic development. And the fast expansion of trade made an important contribution to peaceful relations among societies.

This contrasts sharply with the deterioration which the global framework for trade has been undergoing during the last ten years or so. Parallel to the 1973-79 Tokyo Round of trade policy negotiations under the GATT, which was supposed to substantially reduce tariff and non-tariff barriers to international trade and to make the fundamental rules of the world trading system clearer and more predictable, protectionism has increased. Even worse, protectionism has become more discriminatory among countries and more selectively tailored to individual goods or sectors, by-passing GATT's trade rules.[2] By now, more than one fifth of world trade in manufactures is subjected to non-tariff restrictions, in some cases covering industrial branches as a whole (textiles and clothing, iron and steel, shipbuilding, automobiles, consumer electronics, for instance). World trade in agriculture is still heavily interfered with (about three fifths of trade value). Not suprisingly, the rate of growth of world exports, in real terms, has been declining in recent years and became negative in 1982 (which had occurred hitherto only in 1958 and 1975). World exports of manufactures increased by only 4.5 percent per annum in the period 1973-82.

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[1]The data reported here and subsequently have been calculated from GATT, International Trade, various years.

[2]See B. Balassa, "The New Protectionism and the International Economy", Journal of World Trade Law, Vol. 12 (1978), pp. 409-436. - J. Tumlir, "The New Protectionism, Cartels, and the International Order", in: R.C. Amacher et al. (eds.), Challenges to a Liberal International Economic Order (Washington, D.C.: AEI, 1979), pp. 239-258.

This current trend of events is discouraging for at least two reasons: One is that it describes developments which make for serious policy-induced uncertainty, adversely affecting long-term investments and retarding the revitalization of the world economy. The other reason for being concerned is that political frictions between countries, which lead to formal disputes and uncontrollable resentments, are generated; the current controversies within the European Community (EC), between the EC and the United States, between these two and Japan, and between industrial and developing countries are rooted to some degree in a competitive process of government protection (including subsidies).

Against this background, I shall address three questions:

- First, what are the causes underlying the spread of new protectionism?
- Second, what are the consequences both for the protectionist countries themselves and for the world economy as a whole?
- Third, what are the prospects for restoring a functioning world trading system?

II. Causes of Increasing Protectionism

When talking about the causes of increased protectionism it may be worthwhile to differentiate among countries. To simplify matters, I shall deal first with the socialist countries, then with the developing countries and thereafter with the industrial countries (always taken as a group).

1. In the Socialist Countries

The socialist (or centrally-planned) countries have, for systemic reasons, always been highly protectionist and hence have not added much to the contemporary disorder of the world trading system. These countries regulate their external trade bilaterally according to their own plan criteria, to their availability of convertible currencies or to foreign policy considerations. Though five of them (Czechoslovakia, Hungary, Poland, Romania and Yugoslavia) are contracting parties to the GATT, they all feel that they need not open their market to foreign suppliers according to the most-favoured-nation principle; by the same token they cannot expect as exporters a non-discriminatory treatment abroad. It should be noticed, however, that faced with the need to service huge foreign debt at high real rates of interest several countries (mainly Poland, Hungary and Yugoslavia) imposed new quantitative restrictions on imports recently.

2. In the Developing Countries

The developing countries (LDCs), whose membership in GATT has grown from 11 (including the Republic of China) in 1948 to 59 (excluding Mainland China and Taiwan) in 1983 (out of a total of 90 countries), have also a long tradition in pursuing protectionist trade policies, but for different reasons.[1] Until the sixties, most LDCs (including present-day newly industrializing countries or NICs) promoted economic development by policies of industrialization based on across-the-board import substitution behind high trade barriers in combination with severe exchange controls. Comparative cost criteria were deliberately neglected almost everywhere (the outstanding exceptions were South Korea and Taiwan) as governments believed that otherwise a rapid and sustained rate of economic growth at high levels of employment would not be achieved.

It was only when the escessive emphasis on import substitution, due to the many distortions which it imposed on the economy, became a serious impasse in the development process

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[1] For surveys see B. Balassa, "The Process of Industrial Development and Alternative Development Strategies", Princeton University Essays of International Finance, No. 141, December 1980. - J.B. Donges, "Re-Appraisal of Foreign Trade Strategies for Industrial Development", in: F. Machlup et al. (eds.), Reflections on a Troubled World Economy (London: Macmillan, 1983), pp. 279-301.

that development policies became more sensible and outward-oriented in a growing number of countries up to the mid-seventies. The most important changes took place with regard to trade policies: numerous quantitative import restrictions were eased, tariffs were lowered and, in some cases (including Taiwan), free trade zones were established. The more open framework provided for faster rates of growth and enlarged the employment opportunities in the countries concerned, in addition to expanding considerably the potential of manufactured exports. It should be noted, however, that trade of the now outward-looking LDCs became liberal mainly by own historical standards. When compared to OECD countries, the levels of protection remained high (Hong Kong and Singapore apart). Moreover, many governments objected to the principle of non-discrimination and made almost no significant progress in liberalizing trade among LDCs along the lines of a respective Protocol within the GATT, which entered into force in 1973.[1]

During the last decade, which was characterized by two drastic increases of oil prices (in 1973-74 and 1979-80) and two deep world economic recessions (in 1974-75 and 1980-82) only a few NICs - most prominently South Korea and Taiwan, apart from Hong Kong and Singapore - continued to apply outward-looking policies or, as in the case of Chile, even shifted for the first time to such policies. The other LDCs responded to the external shocks either by continuing with import-substitution strategies or, if they had become more outward-oriented (as Brazil or Israel), by re-imposing restrictions on imports.[2]

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[1] See R.J. Langhammer, "Multilateral Trade Liberalization among Developing Countries", Journal of World Trade Law, Vol. 14 (1980), pp. 508-515. See also O. Havrylyshyn and M. Wolf, "Trade among Developing Countries: Theory, Policy Issues and Principal Trends", World Bank Staff Working Papers, No. 479, August 1981.

[2] See B. Balassa, "The Newly-Industrialising Developing Countries after the Oil Crisis", Weltwirtschaftliches Archiv, Vol. 117 (1981), pp. 142-194. - J. Cauas and S. de la Cuadra, "The Economic Policy of Open Trade in Chile", in: L.A. Sjaastad (ed.), The Free Trade Endeavour in Latin America (London: Macmillan, forthcoming).

Failures of this approach, manifested by a continuing slowness of economic growth and run-away foreign debt, could conveniently be attributed to adverse policies of the advanced countries, including their protectionist measures against the exports of the Third World.

3. In the Industrial Countries

However distorting trade policies of LDCs (and for that matter, of the socialist countries) may be, the functioning of an open and multilateral world trading system is much more affected by the policies of the industrial countries, in particular those of the United States, the EC and, increasingly, Japan. These countries are the pillars of the world economy. In 1982, together they accounted for 51 percent of total world exports and for 66 percent of world exports of manufactures;[1] almost half of the world production originated there; and the share of imports in apparent consumption of manufactured goods amounted to about 6 percent in Japan, 10 percent in the United States and 30 percent in the EC. Thus, the major industrial countries have the responsibility for keeping the global trade policy environment stable and predictable, irrespective of what other countries do.

When protectionism by the industrial countries gained momentum ten years ago, it was thought by many to be a temporary device to solve the balance-of-payments problems which were caused by the quadruppling of oil prices. But as so often happens, the "temporary" restrictions have become permanent, and more severe, in many cases. This lends support to the hypothesis that contemporary protectionism in the industrial world is far more deeply rooted. Its sources go back into the sixties and they are related to delays in the adjustment of the industrial (in particular the Western European) countries to the structural changes which invariably accompany economic growth because

[1] If trade within the EC were excluded, the shares would still amount to 40 and 48 percent, respectively.

technological progress, the accumulation of physical and human capital, changes in the supply of labour, changes in consumer preferences and changes in the international division of labour all take place at different rates.

In retrospect, market forces seem to have brought about a considerable amount of structural change. Country-specific peculiarities apart, the general pattern was in the direction of shifting away from the production of traditional, relatively labour-intensive goods (mainly consumer goods) towards the manufacture of relatively capital-, skill- and research-intensive goods (mainly investment goods). When Japan and some NICs emerged as strong competitors on world markets, many firms in the United States and the EC reacted successfully with product and process innovations or transferred production to locations abroad (mainly LDCs) where unit costs were lower.

But there have also been serious retarding factors during the sixties. Without going into details, at least seven troublesome developments should be recalled:

- First, labour migration from labour-surplus, capital-poor North Africa and Southern Europe to Central Europe and Scandinavia, from several Commonwealth countries to Great Britain, and from Mexico and the Caribbean Islands to the United States kept the supply of (unqualified) labour in the advanced countries excessively elastic.

- Second, effective rates of tariff protection for labour-intensive activities were kept two to four times above the average for the manufacturing industry. Particularly sensitive sectors, such as the textile and clothing industry, were further sheltered from foreign competition by quantitative import restrictions (as provided for by the Long-Term Agreement on Cotton Textiles of 1962).

- Third, companies facing serious competition from imports in spite of protection frequently resorted to defensive investment to render their production, which originally was relatively labour-intensive, more capital-intensive and thereby to regain lost comparative advantage. Hence, a reversal of factor intensities occurred. This reaction repeats itself at present in connection with the attempt by trade-impacted firms to substitute microelectronics and robots for unskilled and expensive labour (particularly in textiles).

- Fourth, expansionary demand-management policies by governments and the rising inflation associated herewith artificially depressed real interest rates and thus contributed to inefficient investment and capital waste. Marginal firms or industries were required to decline only relatively, rather than to shrink in absolute terms.

- Fifth, countries (such as West Germany) which attached a higher priority to price level stability than their major trading partners could, under the post-war Bretton Woods system of adjustable exchange rates, keep their currencies undervalued time and again and thus raise artificially the price competitiveness of their exports and import-substitutes.

- Sixth, in the course of creating the modern Welfare State (particularly in Western Europe) an ever increasing number of labour market laws and regulations, in addition to various social components introduced in collective wage bargaining, led to sticky minimum wages (which became too high), they unduly narrowed the wage structure (in spite of existing differences of skills in the labour force) and they made it unattractive for employees to change jobs between firms and regions (in order to avoid losing accumulated benefits).

- Seventh, the creation of the Welfare State also changed the attitudes of the people in the sense that the responsibility of the individual for his own economic progress was replaced by rising expectations about the capacity of governments to secure full employment at increasing real income and at a more equal income distribution.

All these developments, coming together, reduced considerably the flexibility of the advanced economies and the adaptability of production and employment to structural change. The many rigidities which were built into the economic system during the sixties remained largely unnoticed because the national economies were expanding rapidly. To put it in another way: when the first oil price crises occurred, most industrial countries had already lost their previous dynamism because much of the needed structural adjustment was suppressed. The oil shocks of the seventies, along with the various recessions and recurrent real appreciations of some currencies (especially the US dollar relative to the yen), certainly have exacerbated the difficulties, but a flexible economy would have been able to adjust successfully (as Japan has demonstrated). The loss of flexibility in a changing environment, by contrast, could not but lead to a slowing down of economic growth and an ever increasing unemployment (as it happened most persistently in Western Europe since the early seventies). In such circumstances, sectoral pressures for public assistance arose almost everywhere and one government after the other, in an attempt to avoid popular discontent and to stay in power, has given way to such demands by granting trade protection (inter alia).[1] Even in West Germany, which is the most important European trading partner of Taiwan and which for many observers abroad appears to resemble largely the textbook model of a free-trade economy, protectionist sentiments and policies have recently gained ground too - and one explanation may also be derived from the delay which the process of structural adjustment has suffered

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[1] For a neat discussion of these interrelated issues, see L. Dunn et al., In the Kingdom of the Blind. A Report on Protectionism and the Asian-Pacific Region (London: Trade Policy Research Centre, 1983).

in this country.[1]

The increasing structural rigidities, in conjunction with the widespread belief in the omnicompetence of governments, have been major forces behind the trend towards bilateralism and sectoralism in trade policy. Old-fashioned tariffs are no longer important means of keeping imports at bay. As result of the tariff reductions achieved in the Tokyo Round, the average level of nominal tariffs on manufactured imports will be 4.4 percent in the United States, 4.7 percent in the EC and 2.8 percent in Japan (to become effective not later than 1 January 1987, through annual cuts which began in 1980). Moreover, the dispersion of nominal tariff rates will be reduced. Nowadays, trade restrictions have become a tool of structural policy. Therefore, they are designed to regulate trade in specific items by non-price measures and they deliberately discriminate against the most competitive suppliers from abroad (which in various cases include Taiwan). The policy variants which seem to best meet the needs of sunset domestic branches or firms are the bilaterally negotiated "voluntary" export restraints, the orderly marketing agreements and the concession of direct financial aids (mainly subsidies). They all are incompatible with GATT rules and the Tokyo Round failed to settle them.[2]

4. The Rhetoric of Protection

At a conceptual level, there are a number of dangerous misconceptions involved in the ongoing debate in the industrial countries about the need for protection. To beginn with, govern-

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[1] See G. Fels and F. Weiss, "Structural Change and Employment: The Lesson of West Germany", in: H. Giersch (ed.), Capital Shortage and Unemployment in the World Economy (Tübingen: J.C.B. Mohr, 1978), pp. 31-53.

[2] The list of non-tariff measures is much longer, however. See GATT, Inventory of Non Tariff Measures, Geneva, currently. Some observers expect that the new "Codes of Conduct" that have been agreed in the Tokyo Round (on customs valuation, subsidies and countervailing duties, import licensing procedures, and technical standards) will make for a reduction of trade-distorting effects; but their rather vague drafting can lead governments, if they wish so, to apply the codes in a restrictive manner. A code on the application of selective safeguards, which originally was also on the agenda of the negotiations, could not be achieved due to the opposition of the EC. The code on anti-dumping measures, which was agreed during GATT's Kennedy Round (1964-67), has so far not prevented abuses on the part of importing country governments (in particular the United States and the EC).

ments in countries with persistent and growing deficits in the balance of payments on current account are frequently tempted to consider additional import restrictions as an appropriate means to relieve the situation (instead of a real devaluation of the currency). In the very short-run, the current account balance may improve. But in the medium-run it is unlikely that this happens. The reason is that a chronic current account deficit, at the given real exchange rate, ultimately reflects the degree to which domestic investment exceeds domestic saving and it is not clear at all that a government could, by imposing restrictions on imports, reduce the level of investment and/or increase the level of savings.[1] Particularly tailor-made import restrictions are more likely to influence the structure of domestic expenditures (investment and consumption) rather than their level.

Another flaw of protectionism is to consider imports as a source of serious market disruption. In a fundamental sense all imports which are not complementary to local production disturb the market position of individual firms and jobs. This is in the nature of competitive, market-oriented economies, of which international trade is only one dimension. It is analogous to the nature of the flow of goods from one region to another within a particular country. That is, international trade is commonly the means by which comparative advantages and disadvantages are transmitted between countries. Just as countries or regions can export best what they can produce cheapest, they will import goods that are cheaper than domestic output. When foreign supplies are cheaper, the exporters normally do not exert "abnormal" or "unfair" competition, as is so often argued, but just exploit their comparative advantage. This comparative advantage often derives from lower wage costs than those prevailing in the importing countries. If, for instance, our workers in the textile and clothing industry or in shipbuilding are to be paid wages amounting to, or exceeding, the national average, whereas productivity in these industries is lower than the national average, and if wage costs are several times higher

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[1] See GATT, International Trade 1982/83 (Geneva: GATT, 1983), pp. 15-17.

than abroad as a result, then international competitiveness cannot be maintained.

The contention that increased manufactured imports from Japan and the NICs have led to the increasing levels of unemployment, especially in Western Europe, does not hold either. In a growing economy, import competition - or for that matter competition from within - is only one of various sources of change in employment opportunities. The other sources are shifts in domestic and foreign demand (exports) as well as the increase in labour productivity. As a matter of fact, the last has been by far the most important source of labour displacement in Western manufacturing industry.[1] To conclude that productivity should not have increased would be incorrect. Correct would be to conclude that if productivity had not increased so much employment would have decreased even more at given real wages. This even holds for branches such as textiles, clothing, footwear and leather products where import penetration from the NICs (and from other developing countries too) has risen sharply in recent years. When firms have been driven out of the market, it was often by the more efficient domestic competitors rather than by imports (whatever their country of origin).

That import competition initially leads to a loss of the least viable jobs and industrial capacities, or slows down their expansion, is only one side of the coin. The counterpart of this pressure to adjust is the creation of new jobs and productive capacities in higher productivity lines which embody more skilled labour and more sophisticated machinery, including the manufacture of goods being exported to countries in which the competitive imports originate. It is fallacious to think that foreign countries (in particular Japan and some NICs) can supply everything more cheaply than West European or North American industries can (taking due account of quality differ-

[1]For an overview see OECD, The Impact of the Newly Industrialising Countries on Production and Trade in Manufactures (Paris: OECD, 1979).

entials) because in this case they would not export at all. In fact, most of the industrial countries' foreign trade in manufactures is of an intra-industry type, i.e. the countries both export and import very similar goods. In trade relations with developing countries (as well as with the centrally-planned economies) inter-industry specialization predominates so that trade-induced job displacement and job creation takes place in quite different branches and regions. Yet, even within declining industries, firms which are not able to compete with imports co-exist with those which actually do (or could by reducing costs if it were a matter of survival). Textiles and clothing, in which product variety was substantially reduced and production was sharply up-graded, constitute one example; another is shipbuilding, in which several medium-sized firms have specialized on technology-intensive vessels and marine equipment and given up the production of oil tankers and bulk carriers.

Another misconception lies behind the widespread concern in the United States and the EC about the persistent and growing deficit in trade with Japan (as with South Korea and Taiwan). This has given rise in the United States to feelings about the need of a new, "aggressive reciprocity" in bilateral trading arrangements, in the sense that new import barriers are imposed against a country which is considered to be protectionist itself.[1] However, in a multilateral trading system bilateral trade balances are of no economic significance. Moreover, it is doubtful to assume, as the advocates of the aggressive reciprocity do, that the Japanese market is more or less closed for foreign suppliers of manufactures. Indeed, import tariffs in Japan are lower than in the United States or in the EC and there is in Japan nowadays much less use of non-tariff measures than ten years ago. It is

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[1] For a broad discussion of this issue and of the corresponding activities of the US Congress see W.R. Cline, "Reciprocity: A New Approach to World Trade Policy?" In: Cline (ed.), Trade Policy in the 1980s (Washington/D.C.: Institute for International Economics, 1983), pp. 121-158.Incidentally, the call for reciprocity aiming at securing a mutually equal market access would require the western industrial countries to abolish protective devices against imports from Hong Kong as this country is really an open economy.

possible that the internal retailing system in Japan favours domestic products in accordance with the customs and attitudes of the population much more than is the case in the United States and Western Europe. But there are examples of North American and European firms making the determined marketing effort which is required to sell in Japan - and being successful.[1]

A final example of misconception relates to the quest for protection or subsidies in order to counteract foreign subsidized competition. The point here is that if a foreign country subsidizes the export of products in which it has a comparative advantage and the complaining country has a comparative disadvantage (take various kinds of clothes, textiles, furniture, consumer electronics, ships, steel, for instance), the latter will be better off in welfare terms than it would in the absence of subsidized foreign supplies, at least as long as the currency of the subsidizing country does not appreciate. It should also be noted that the subsidies which foreign governments grant to their export industries do not necessarily provide a competitive edge on the world market. Frequently, and most prominently in LDCs, these subsidies are intended to neutralize a competitive disadvantage which derives from the domestic system of import protection and the overvalued currency.

The advocates of protection usually claim that government support allows domestic industries to adjust to import competition more easily. The evidence does not support this notion. If anything, experience with industry-specific protection has shown that such "breathing spaces" reduce the incentives to adjust in an efficient manner. Sooner or later, firms adhering

[1]Despite all talk about Japan's closed market for foreign manufactures, recent empirical analyses suggest that the import intensity of this country corresponds to what might have been expected of a hypothetical economy of similar natural resource endowment, capital stock, labour supply and geographical location. See S.R. Saxonhouse, "The Micro- and Macroeconomics of Foreign Sales to Japan", in: W.R. Cline (ed.), Trade Policies in the 1980s, op. cit., pp. 259-304.

to a mere survival-by-protection strategy encounter serious problems, in some cases (particularly in textiles, clothing, consumer electronics, steel, shipbuilding) ending in bankrupcy. Evidently it is an illusion to believe that protection by itself transforms underlying comparative cost disadvantages into advantages. This explains why so many protectionist measures which are announced as temporary have endured over time.

By the same token, there is no reason to expect that protective assistance granted to certain industries which are supposed to have a considerable growth potential (i.e. technology-intensive industries) could be easily phased out after some time. If the investment in these industries is a success, governments of other countries may be prone to emulate, providing vigorous support now themselves. Attempts by the forerunners to keep their lead in the so-called growth industries may founder in retaliatory escalation or competitive subsidization. If, on the contrary, the industries chosen for encouragement fail, the government will be made liable for protecting the capital invested and the jobs created and, therefore, continue the assistance, which in fact would become the familiar maintenance assistance.

III. The Consequences of Protectionism

The essence of protection, as standard economic theory shows and empirical evidence confirms, is the distortion in the allocation of resources, both in a static and a dynamic sense and nationally as well as worldwide. Selective protectionism has particularly high costs since it delinks economic development from market conditions and reduces progressively the structural adaptability of the economy to internal or external unpredictable opportunities and setbacks. This is also true of those LDCs which overemphasize import substitution; in general, the protectionist policies serve to favour more or less systematically the comparatively less efficient and less essential industries. The cost-raising argument even holds if one takes into account that, to some degree, protectionist measures have been circumvented in practice by various forms of legal and illegal acts. In the public debate, as I have indicated earlier, there is the mistaken belief that protection would suit the needs of the protecting country and that the benefits outweigh the costs. The international repercussions too often escape attention. By contrast, I am going to argue that the protecting country suffers most from its own interventions and that in a global perspective the dangers of the new protectionism are grave.

1. Domestic Repercussions

The costs which protection poses on the protecting countries themselves have various dimensions. On the one hand, there is a direct increase of the costs to consumers as domestic prices of both imports and their local substitutes become more expensive than they would be under free(r) trade conditions. Particularly the "voluntary" export restraint agreements in such important sectors as steel, synthetic fibres, automobiles and textiles are said to embody considerable price-raising effects (up to 10 percent on average, depending on the overall market situation). Hence, protective devices are regressive in nature and hurt especially low-income groups in the protecting country. Moreover, they increase the burden placed on the national central banks committed to price-level stability. In course of time the protecting country thus runs the risk of having to accept more recession and, correspondingly, more unemployment whenever inflation has to be curbed.[1]

On the other hand, protection distorts the structure of production, reduces allocative efficiency and curtails the growth potential of the country. As the domestic prices of the protected goods are raised beyond the level they would reach in the case of free(r) entry of imports, and relative to the prices of other (less protected) goods, too much labour, capital and entrepreneurship is kept in uncompetitive industries. Factor costs are pushed in an upward direction under these circumstances, and the national currency becomes overvalued (other things being the same). Other industries, especially the export sector which cannot easily pass the protection-induced higher costs on to foreign buyers, are penalized and this the more so the higher the elasticity of substitution, in production and consumption, between import-substitutes and non-tradeable home goods. The protection thereby acts as a tax on exports; available evidence suggest that the amount of the import protection which is shifted through the equilibrium price adjustment onto the export sector generally range between one-half and two-thirds.[2] This means, for instance, that when the EC grants protection to the textile and clothing industries (via the Multi-fibre Arrangement), or to the steel industry (via cartelization according to the Davignon-Plan), or to shipbuilding (via subsidies), she in fact is taxing additionally the manufacturing activities which reveal a comparative advantage, such as export-oriented producers of chemicals, machinery, automobiles and other knowledge-intensive goods. Similarly, the protectionist trading regimes as applied

[1] The advocates of protective measures try to refute the inflation argument by referring to official statistics which show that wholesale or retail prices of the protected products frequently move in a downward direction or rise more slowly than those of other products. Nowhere is it said, however, that without protection these prices might have fallen more or, in the case of an increase, lagged even more behind other prices.

[2] See L.A. Sjaastad and K.W. Clemens, "The Incidence of Protection: Theory and Measurement", in: Sjaastad, The Free Trade Endeavour in Latin America, op.cit.

in many LDCs also lead to a considerable anti-export bias. Hence, in order to secure jobs in declining industries, the creation of new jobs in growth industries is discouraged. The net effect of an increase of protection may actually be to reduce the general level of employment. The outcome for the protecting country is still worse when other countries retaliate or when their supplies are diverted to third markets where they compete with the exports of the protecting country.

In addition to allocative inefficiencies, sectoral protectionism has sheltered also X-inefficiencies at the firm level. Typically, cost-reducing efforts are relaxed in a restrictive trade policy environment. The management of the firms does not feel compelled to continuously improve the internal organization as well as the marketing and distribution system and to carry out product and process innovations; one may content oneself with a "quiet life"; and it pays to invest resources in lobbying for protection. No firm could afford such a behaviour under conditions of competition - and survive. The accumulation of X-inefficiencies generally leads to a situation in which the country progressively misses the opportunities for exploiting economies of scale and fails in sharing, or catching up with, technological advances. The society as a whole is bound to become impoverished.[1]

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[1]Estimates for a number of industrial countries indicate that the loss in real income for each job saved through protection is substantially higher than the average annual wage in the protected industry. The available evidence on LDCs points into the same direction.

2. International Repercussions

Whereas for the socialist countries and the LDCs as suppliers of manufactured goods the "small country" assumption holds, large trading units such as the United States or the EC can influence world market prices and may, therefore, improve their terms of trade through protection. The result for the world economy as a whole is going to resemble a negative-sum game, i.e. the loss inflicted to the other countries outweighs the gain accruing to the major countries which pursue protectionist policies.

Among the losers are many LDCs which typically lack the (economic and/or political) strength to retaliate effectively against protectionist devices of the major trading powers. It is true that most LDCs enjoy trade preferences in their favour; but it is equally true that the preferences have always been limited in both scope and coverage, that there is a myriad of safeguard clauses for the application of "emergency" protection and that the preferences have tended to be inversely correlated with the export potential of the LDCs.[1] Especially sectoral protectionism which aims at saving jobs in sunset industries in the advanced countries can prevent LDCs from making full use of their comparative advantage in labour-intensive products.

The most conspicuous example is textiles and clothing, which for most LDCs represent the first step in the ladder of orientating their industrial sector towards exports.[2] These

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[1] See R.J. Langhammer and A. Sapir, "The Economic Impact of Tariff Preferences", forthcoming as Thames Essay of the Trade Policy Research Centre, London.

[2] See D. Keesing and M. Wolf, Textiles Quotas Against Developing Countries (London: Trade Policy Research Centre, 1980). - M. Wolf, "Managed Trade in Practice: Imlications of the Textile Arrangements", in: Cline (ed.), Trade Policy in the 1980s, op. cit., pp. 455-482.

countries are deprived of an important source of foreign exchange earnings, which narrows their capacity to import and thus slows down economic growth. At the same time they import unemployment from the industrial countries.[1] More generally, these countries may promote, at high domestic resource costs, exports of goods for which they do not face trade discrimination because they have a comparative disadvantage; or they may sink straight into export pessimism and feel tempted to pursue inefficient import substitution. Efforts to improve national economic policies are certainly undermined. Taiwan, though also hit by the textile protectionism in the West, managed to avoid such mistakes; other countries did not (as India). It goes without saying that the increasing sectoral protectionism of industrial countries against LDCs clashes with the official commitment of the US and EC governments to contribute through trade expansion to economic development in the Third World.

That the LDCs are hurt by the protectionism of the industrial countries should not obscure the fact that considerable costs emerge also within the OECD area.

- Substantial trade diversion occurs, not only in the sense that imports shift from lower- to higher-cost sources, but also in the sense that the relatively more open countries become a convenient target for foreign exporters which face unsurmountable import barriers elsewhere; the inroads of foreign suppliers of automobiles, consumer electronics, steel products or textiles, into the West German market may serve as an illustration.

- Concomitantly to trade diversion there may also be a considerable distortion of international investment patterns. Faced with increasing sectoral protectionism foreign exporters are encouraged to substitute capital exports

[1] See the empirical estimates, based on a comparison between West Germany and Malaysia, by H.H. Glismann and D. Spinanger, "Employment and Income Effects of Re-locating Textile Industries", The World Economy, Vol. 5 (1982), pp. 105-109.

for commodity exports, so that the shaping of trade policies, rather than differences in the marginal efficiency of investment, determines the direction and size of capital flows.

- Moreover, sectoral protectionism leads to income transfers among industrial countries and to shifts of the adjustment burden, which are uncontrollable and have nothing to do with the strength or weakness of particular economies; current developments in the policies on agriculture, textiles, steel or shipbuilding are cases in point.

- All this is bound to lead to trade disputes among governments, as in fact has been increasingly happening in recent years. Such disputes absorb scarce resources, not only in the administrationsof the countries involved, but also in private sectors which lobby for specific government actions. Much worse, the disputes create an unnecessary and uncalculable uncertainty for investors, exporters and importers as it is hard for them to predict the outcome of the settlement procedures and to assess the risk that governments resort to retaliation and counterretaliation. An investment-led revitalization of the industrial economies, which seems to be particularly urgent in Western Europe, can be unduly retarded under such circumstances.

Another issue which has to be addressed in this context refers to the implications for the functioning of the international financial system. The current discussions about the sources and the cures of the problem of massive external debt (both sovereign and corporate debt) which many LDCs and various East European countries are currently facing revolve in general around high real rates of interest, world economic sluggishness, depressed raw material prices, imprudent lending by the banking system and misdirected economic policies in the debtor countries (including the accumulation of high public budget deficits). No doubt, these are important causes of increased international indebtedness; the requisite actions of dealing with the problem will have to focus on those causes. It should be noted, however, that protectionist policies in the industrial countries have compounded the problem. The industrialized world provides the markets of last resort for many LDCs. When the access to important buyer markets is obstructed, it becomes difficult for indebted countries to achieve an expansion of their export earnings which keeps pace with their debt-servicing requirements, even if these countries do reduce aggregate expenditure relative to output and even if they possess an export potential. Although LDCs should not be expected to run a surplus on current account, rapidly expanding exports are a necessary condition for regaining and maintaining their capacity to borrow and thereby promote their economic development. Moreover, although policy reforms which make for greater economic efficiency have to be undertaken in the debtor countries in order to get out of the financial impasse, the success of such efforts will be undermined if at the same time trade opportunities for them are cut down by protectionist policies in the major creditor countries. Debt repudiation could become an attractive policy option in some countries and, once this comes about, it may even trigger a general destabilization of the world financial system. These strains should be taken seriously, even allowing for the fact that the debt-servicing problem would not just vanish with a reduction of protectionism; and for the fact that, in case of default by one or more debtors, it would be technically feasible to avoid a repetition of the worldwide disaster of the early thirties, as every national central bank has the power to act as "lender of last resort" to the domestic banking system.

IV. The Prospects for Restoring Open World Markets

From all this it is safe to conclude that the current protectionist policies and ideas are false remedies to resolve economic problems; they are short-sighted, counter-productive and a manifestation of economic nationalism which already once, in the thirties, led to a disintegration of the world economy. There is a fundamental misunderstanding of the impact of restrictive practices on both the protecting country itself and its trading partners, and international trade is unnecessarily politicized.[1]

Whether or not the trend towards selective protectionism will continue into the future is impossible to predict. In all major industrial countries the interaction between the profit-maximizing behaviour of sectoral interest groups and the vote-maximizing behaviour of policy makers (and the aligning behaviour of bureaucrats) has built a producer bias, rather than a consumer bias, into the political market. Therefore, there is a danger that new barriers (overtly or covertly, directly or as a by-product) will be erected if

- the domestic economy does not recover on a sustained basis and unemployment does not decline strongly;
- market-penetration by foreign suppliers rises too fast in the price-sensitive labour-intensive products;
- the domestic business community and the labour unions feel that reciprocity in market-access opportunities is weak;
- the society is convinced that the strength of the country requires self-sufficiency in so-called strategic goods (food, steel, ships) and does, therefore, not accept a shift of comparative advantage to other countries;

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[1] In this connection, see J. Tumlir, "International Economic Order: Can the Trend Be Reversed?" The World Economy, Vol. 5 (1982), pp. 29-41.

- governments commit themselves to promote high-technology activities and invoke the "infant-industry" argument for this.

The factors which may stem the protectionist tide in industrial countries include

- the determination by domestic industries to innovate in products (manufacturing new goods which face a high income elasticity of demand), in processes (lowering costs and saving non-renewable resources) and in locations (transferring production to countries where efficiency wage levels and environmental costs are lower than at home);
- the strategy of many multinational enterprises to geographically diversify production in the horizontal and the vertical direction and to operate with "footloose" subsidiaries;
- the diversification and up-grading of manufactured exports from highly competitive countries (mainly NICs);
- a progressive liberalization of trade in manufactures among LDCs;
- the financial constraints imposed by the budget, when industries are to be assisted via subsidies and similar Treasury outlays.

What is most required for turning the protectionist-liberal balance towards liberalism is political leadership, and the first responsibility lies on the governments of the major industrial countries (United States, EC, Japan). Some governments may want to wait until unemployment decreases markedly. But this would be a self-deception, if not just a pretext for passiveness, because that very sectoral protectionism delays structural adjustment in the industrial countries and thereby impairs the chances for their economic revitalization. The case for trade liberalism, therefore, must be built upon its own merits. As much of the current protectionism reflects the excessive intervention (however well-intended) of the state in the domestic economy, it is now time for western governments to recognize that their economies, and hence the world economy as a whole, can only prosper in a framework of open markets with international competition which, as experience unequivocally has proved time and again, is the most powerful source of innovation and productivity growth.

The objective, therefore, must be to arrest and then reverse selective protectionism and to restore the principle of multilateral and non-discriminatory trade. Several proposals have been made in the literature to tackle this objective. A low-track approach is to legitimize existing protectionist practices through amendments of the GATT and to renounce the imposition of any further restrictive measures. However, if existing selective protectionism is legalized, governments may find it even more difficult than hitherto to resist new protectionist pressures. In my view, it is time for a high-track approach, by which all known variants of "organized trade" are phased out and new ones are prohibited. On the top of the list for actions, I would like to see firm political commitments that the Multi-fibre Arrangement would not be renewed once again (in 1986, when the present term expires), that the many other product-specific export-restraint measures imposed on foreign suppliers are removed quickly, that subsidies will be strictly restricted to "infant industry" cases (the burden of proof being on the aid-demanding sectors) and that national agricultural policies will allow liberal trade in agricultural products.

The failure of the GATT Ministerial Meeting, held in November 1982 (the first since 1973), in reaffirming the rules for a liberal trade order are indeed not encouraging. But public discussion on central economic issues in some major countries (such as the United States, the United Kingdom and West Germany) makes evident an increasing perception that hitherto equity considerations might have been paid excessive attention at the expense of efficiency, individual initiative and risk-taking; that the workers' desire of employment security might have mistakenly been interpreted as a right to keep one's particular job, and that government involvement in the economy might have led to an overregulation in many fields. This discussion, if it continues, could enhance the influence of liberal forces in trade policies too. Moreover, the upswing in demand and production, which is underway in the United States, Japan, the United Kingdom and West Germany, among other countries, since mid-1983, should moderate protectionist pressures in no small degree (despite the uncertainty over the longevity of the current economic expansion).

Once there is movement towards liberalization of trade within a multilateral framework, it will be necessary for the LDCs to play their part. Their governments should not insist so much on a "special and differentiated treatment", as they achieved in the Tokyo Round. Taiwan and other East Asian countries know quite well that any departure from the principle of non-discrimination not only allows for preferences but also for selective discrimination by industrial countries. What LDCs must recognize is that they also have a long-term interest in integrating their economies in the international division of labour, with the concomitant intensification of trade relation both in north-south and south-south direction.

Especially the NICs should take the lead in dismantling import protection in a gradual and predictable manner. Some of the countries (most prominently South Korea and Taiwan) are no longer labour-surplus economies. Therefore, they should further diversify out of the simple labour-intensive items, thereby making room for the laggards within the industrializing Third World, and they should include in their export assortment more sophisticated, higher-quality products. Several of the East Asian NICs are already shifting their composition of output in accordance with their changing comparative advantage, and Taiwan's determination to set up, in 1980, a high-technology industrial park (near Hsinchu) is an interesting example of how far-reaching such shifts can attempt to become over the longer term. The still considerable protection which some of these countries (including South Korea and Taiwan) grant to their textiles and other mature industries does not suit, for reasons discussed earlier, such a forward-looking pattern; ultimately it plays into the hands of the advocates of an aggressive reciprocity in the major advanced countries.

V. Final Remarks

To conclude: there is a mutual interest in strengthening the functioning of the world trading system based on market principles. The challenge ahead is to find ways for making multilateral negotiations more productive. The governments should not approach them in terms of what has to be conceded to other countries but rather in terms of the lasting economic and political advantages which can be reaped for the own society in the first place. It is for the governments to inspire confidence in an open world economy. The elaboration of a programme which is credible and which shows how and in what time we will get there, would certainly improve world trade prospects, including the future prospects for continued economic growth in the Asian-Pacific region.

According to various current forecasts by international organizations, world trade could perhaps expand at an annual rate of 4 to 5 percent in real terms during the remainder of this decade, provided that protectionism is not increased. This would be less than in the healthy fifties and sixties, but greater than in the troublesome seventies. The world economy would resume the path of integration, and the NICs and other LDCs could be expected to increase their participation in international trade (particularly in manufactures). But in order to sustain integration it will be essential for most industrial as well as developing countries to foster structural adjustment within the domestic economy. In addressing this task, governments face the challenge of controlling monetary growth and thereby checking inflation; of reducing existing structural budget deficits through curtailment of expenditures (including subsidies); of cutting marginal income tax rates; and of deregulating the product and factor markets, so that saving and investment is enhanced and the relative price incentives deriving from government policy become more suitable to an efficient allocation of resources. A few industrial countries and some LDCs have already taken some measures of this nature. They now have to show perseverance in the effort to bring about the requisite adjustments, while the other countries plagued with structural rigidities still face the need to change economic policies fundamentally.