**FOR AGENDA**

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To: Members of the Executive Board

From: The Secretary

Subject: Protection and Liberalization - A Review of Analytical Issues

The attached paper that reviews analytical issues relating to protection and liberalization has been scheduled for Executive Board consideration on Friday, March 13, 1987. Issues for discussion appear on pages 33-35.

Mr. Corden (ext. 8980) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

# Protection and Liberalization: A Review of Analytical Issues

Prepared by the Research Department

(In consultation with the
Exchange and Trade Relations Department,
and other Departments)

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## I. Introduction

This paper deals with trade policy issues of particular interest to the Fund. It is motivated both by the revival of protectionist attitudes in the industrial countries and the prevalence of liberalization proposals for developing countries. In view of Fund concerns both with the functioning of the international monetary system and with individual countries' macroeconomic policies the paper focuses on the areas where macroeconomic policy, and especially exchange rate issues, relate to protection. Thus its discussion of the more standard microeconomic effects of protection is rather brief.

It supplements the paper "Trade Policy Issues and Developments" (SM/85/60) which was discussed by the Board on March 18, 1985, and especially its background material, later published as Trade Policy Issues and Developments (Occasional Paper No. 38, July 1985). The latter paper contains a comprehensive survey of recent developments in the field. The present paper does not go over the earlier ground and is primarily concerned with policy-relevant analytical issues.

The Fund's position is to favor an open trading system, in general to oppose the use of trade restrictions for balance of payments and other purposes, and to support trade liberalization. Some Fund programs specifically include trade liberalization as an objective. Governments have also committed themselves to embark on negotiations for further liberalization in the recent Punta del Este Declaration of the GATT Contracting Parties. Furthermore, there is a wide consensus among professional economists about the benefits of free or freer trade. Nevertheless, protectionist beliefs are widely held and many arguments for protection persist even though a vast theoretical literature has pointed out their weaknesses. Arguably, it is these beliefs, rather than complexities of trade negotiations, that underlie the persistence of protection and the difficulties in bringing about liberalization.

The purpose of this paper is to analyse these arguments so that either they can be more effectively refuted or that any kernel of truth in them can be better understood and taken into account in policy proposals.

It has to be accepted that in particular cases, provided certain assumptions are actually believed to be applicable, certain protectionist arguments can have some validity. The theory of second best has been widely applied in this field and has helped to define more precisely the assumptions required to support certain arguments. The distinction between "first best", "second best", and so on runs right through this paper. 1/ But actual policies are not necessarily

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1/ The paper, especially Sections IV and V, draws on an extensive theoretical literature. See Johnson (1965) and Corden (1974 and 1984) which also contain further references.

determined by sound "second-best" logic from a national interest point of view. As will be noted below, sectoral pressure groups play a role and, to quote the staff survey of protectionist policies reported in SM/85/60, "an underlying reason for the continued drift towards protectionism is a lack of full appreciation of the costs of protection and the economic arguments for liberal trade".

Protection in this paper refers to all devices that restrict or distort trade, notably tariffs, import quotas and other non-tariff barriers, such as voluntary export restraints, preferential procurement arrangements and export taxes. At various points reference will also be made to protection of industries by subsidization.

The paper is inevitably limited in its coverage. Specifically it does not deal, other than peripherally, with issues of trade discrimination, with measurement problems (i.e., the satisfactory measurement of the costs or benefits of various protective devices), and is not concerned with details of proposed trade negotiations and the various negotiating proposals that are being put forward. These are all large subjects of their own.

Section II of the paper presents a very brief overview of recent protectionist trends and "what the facts show". The main discussion begins with Section III, which deals with protection and macroeconomics, especially exchange rate issues, focusing on topics that have been discussed primarily with respect to industrial countries. Can protection improve the current account in a floating rate system, does exchange rate instability justify protection, is there a case for protection when unemployment is caused by real wages being too high, and so on?

Section IV reviews critically various popular arguments for protection in both industrial and developing countries and also discusses the use of trade taxes for fiscal purposes, bearing in mind that such taxes may have protective effects as by-products. Section V looks at some broader issues, namely the "rent-seeking" effects of protection, how protection is likely to affect the rate of growth as distinct from the level of real income, and the distributional problem in assessing intervention policies.

Section VI is concerned with macroeconomic policy in developing countries. What is the role of protection in a short-term policy package designed to improve the current account? What are the main issues involved in trade liberalization, and how do they relate to capital market liberalization? Finally, a particularly important question is discussed: does protection by industrial countries justify protection by developing countries?

## II. What Do the Facts Show?

Occasional Paper No. 38 contains a full review of policies, the facts about actual protectionist measures, available evidence on the costs of protection, discussion of negotiating issues, and also extensive further references. Hence the present paper deals purely with analytical issues. Nevertheless, before launching into the main discussion, something should be said about recent protectionist trends and "what the facts show". 1/

As usual, the "facts" on their own are rarely conclusive. Nevertheless, at the risk of over-simplification, one can summarize the situation as follows.

1. Protection in industrial countries has increased since 1980, the extent of the increase being difficult to measure. But a higher proportion of imports is now covered by non-tariff barriers of some kind and one can identify particular product areas where there have been increases. In trade in manufactures, the most important and prospectively most adverse development is probably the 1986 tightening up (through expansion of coverage) of the Multifiber Arrangement. From the point of view of many developing countries, including not just actual but also potential exporters of clothing and textiles, this is clearly the biggest problem.

2. Industrial country markets for manufactures are still pretty open. A high proportion of consumption consists of goods where there are no non-tariff barriers (NTBs) at the borders (in 1983, 84 percent of manufactured imports and 64 per cent of agricultural imports, though that does not allow for subsidies). Imports from developing countries have continued to increase, though there are indications that the share of exports from developing countries in non-oil world trade has declined since 1980. Tariffs are generally very low, the result of the several GATT rounds of multilateral tariff reductions (though they tend to be relatively higher on developing countries' industrial exports). Protection is concentrated in limited areas, notably agriculture, clothing and textiles, and steel. Japan's market may well be roughly as

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1/ Occasional Paper No. 38 goes up to early 1985, and needs to be supplemented for this purpose with the Annual Report on Exchange Arrangements and Exchange Restrictions (1986), and with OECD (1985), Olechowski and Winters (1986) and Finger and Olechowski (1987). The latter three publications provide information on the extent of non-tariff barriers in industrial countries and recent changes. In addition, the World Development Report 1986 contains an extensive review of agricultural protection in both developed and developing countries. The World Development Report 1987 will contain a similarly extensive discussion of industrial protectionism. Finally, there is an extensive analysis of protection in Japan, especially intangible protection, in Bergsten and Cline (1985).

open as the U.S. market, which makes it (aside from agriculture) a fairly open market.

Thus, while there has been some increase in protection, the revival of protectionism in the industrial countries, notably in the United States, at least outside clothing, textiles, steel and agriculture, is more of a threat than an actuality. The current issue, of course, is whether threat will be translated into actuality.

3. There is a special, and possibly increasing, problem of competitive subsidization of agriculture by the European Community and the United States. Agricultural protection is also high in a number of other developed countries, including Japan. This presents a particular problem for other agricultural exporters at a time of weak commodity markets.

4. Protection in developing countries is generally much higher than in developed countries, covering a much broader range of imports, and often being extremely high by any measures. In almost all cases it is biased against agriculture. On the other hand, there is no evidence of an overall increase in protection in developing countries in general, and in some countries there have been significant moves to liberalization.

5. Only the roughest estimates can be made of the cost of protection by non-tariff barriers. In particular cases (clothing, textiles, agriculture, motor vehicles) the cost has sometimes been shown to be very high in relation to the value of protected output. Since tariffs are no longer the main instrument of protection the usual cost of protection measures are no longer adequate. Most comprehensive measures are rather limited, simply measuring either the coverage of protection--e.g., what proportion of imports is subject to NTBs of some kind--or the presumed effects on trade flows. 1/

6. There is extensive evidence that countries with outward-looking regimes (which is not the same as complete free trade) have higher growth rates. This evidence is summarized in Balassa (1985). Of course, growth rates also depend on other considerations. In particular, there seems to be some correlation between export growth, following upon a shift towards a more outward-looking regime, and the aggregate growth rate.

7. Finally, a hopeful indication is the Punta del Este Declaration of the GATT Contracting Parties launching the eighth round of multilateral trade negotiations. The declaration, adopted by consensus, states, among other things, that negotiations shall aim to "bring about further liberalization and expansion of world trade", to "strengthen the role of GATT", and "improve the multilateral trading system based on the

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1/ Many calculations are reported in the references listed in the previous footnote.

principles and rules of the GATT and bring about a wider coverage of world trade under agreed, effective and enforceable multilateral disciplines". The full Declaration is reproduced in the report to the Board by the Fund observers October 16 1986 ( SM/86/256).

## III. Protection and Macroeconomic Issues

### 1. Can protection improve the current account?

It is a popular misconception that protection in the form of tariffs or import quotas must improve a country's current account. This view is sometimes put in connection with the U.S. deficit. Similarly it is often argued that if Japan opened up her economy more (i.e., reduced protection, whether explicit or implicit), the Japanese current account surplus would be reduced.

This view could be based on the assumption that exchange rates are fixed or, at least, that the country's exchange rate will not change endogenously as the result of a change in protection levels. Alternatively, it could be based on an essentially partial equilibrium view.

Even at the partial equilibrium level there are two immediate qualifications. Firstly, tariffs and import quotas may raise the costs of some export and import-competing industries which use imports or their close substitutes as inputs and so affect adversely their contributions to the balance of payments, even though there may be favorable effects for the industries that are directly protected. Secondly, if protection takes the form of voluntary export restraints, import quantities will indeed fall, but prices charged by exporters who obtain the monopoly or cartel profits, are likely to rise (the best known example being Japanese autos in the United States). Hence, depending on the elasticity of demand, the value of imports could rise.

In spite of these considerations it is likely that a widespread system of tariffs and import quotas would improve the current account if the exchange rate stayed fixed, if there were excess capacity, and if there were not an offsetting rise in wages. The key qualification is that in the United States or Japan the exchange rate would not stay fixed. It is endogenously determined in a floating rate system. It is likely to appreciate when protection is increased, unless at the same time there are changes in fiscal or monetary policy. The essential point is that, at a constant value of the dollar, an increase in protection by the United States would reduce the demand for foreign currencies relative to the demand for dollars, and so, in the absence of changes in capital flows, the dollar would have to appreciate. This appreciation will increase imports and reduce exports in due course, so that finally the reduction in those imports where there is protection will be offset by increases in other imports and by reduction of exports. The current account may not change at all.

In the absence of a change in foreign exchange reserves resulting from intervention, the current account can only improve if there is reduced net capital inflow. But net capital inflow depends on the balance between savings and investment (private and public). One must then ask whether there is any reason for savings or investment to change. There are various possibilities, and on balance the current account could improve--or it could worsen--but, in any case, the effects of the exchange rate change that results from an increase in protection cannot be ignored. The final outcome must be consistent with the savings and investment changes that can be expected.

It has been suggested that a uniform ad valorem tariff (import surcharge) might deal with the U.S. current account problem. 1/ The argument is that, because the tariff would be uniform, it would not distort resources within the import competing sector, being a market device. It would, of course, favor import replacement relative to exporting, and this is presumably not denied by the advocates. It should also be noted that a uniform nominal tariff would not necessarily lead to uniform effective protection (protection related to value added) even if all imports were covered by the tariff, which is unlikely. This is because domestically-produced inputs that are close substitutes for exports would still have their prices determined in world markets, so that effective protection for import-competing activities that use exportables as inputs would be greater than nominal protection. But this is a minor point.

The central issue is whether the uniform tariff would improve the current account and whether it would be an efficient way of doing so. The answer is that it would probably improve the current account provided the revenue raised were used to reduce the budget deficit. With reduced public dissavings, there would be a change in the national savings-investment balance in the required direction. Of course there could be offsetting effects. For example, private investment in the protected industries could rise.

But the uniform tariff would not be an efficient policy instrument. It would have the disincentive effects that are generally associated with taxes, and in addition would distort the pattern of resource allocation as between import substitution and exporting in the familiar way. If commodity taxes are to be preferred to direct taxes then it could be shown that a given amount of revenue can be raised with less distortion cost by means of a general tax on consumption or output (e.g., a uniform value added tax) than a uniform tariff. Indeed, the only argument for using a uniform tariff to reduce the budget deficit, rather than some other more general tax, such as a value added tax or a rise in income tax rates, is that it might be more popular.

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1/ The proposal has been put forward by Professor Branson of Princeton University and others. See Branson in Stern (1987).

## 2. Does exchange rate instability justify protection?

Seen from the narrow point of view of a particular import-competing or export industry which has lost competitiveness as the result of a real appreciation caused by macroeconomic developments, protection seems the natural counter measure. It can indeed offset the consequences on this industry of an exchange rate change. In this way one can to some extent explain recent protectionist pressures in the United States. But an increase in protection would cause the exchange rate to appreciate more. Hence the benefits for particular protected industries will be achieved by making the problem worse for other import-competing or export industries.

The exchange rate will appreciate more if macroeconomic policies, including the fiscal balance, are given. As noted above, if the exchange rate did not change, protection would normally improve the current account. For given capital flows--resulting from given macroeconomic policies determining the national saving-investment balance--appreciation would then be needed to restore equilibrium in the foreign exchange market. Thus protection that is provoked by real appreciation will bring about even more real appreciation and concentrate the adverse effects more on those tradable industries that do not get protection, usually the export industries. If an industry both competes with imports and exports it may gain at one end and lose at the other.

Even if an exchange rate is in some sense wrong or "misaligned" it does not mean that a wrong or distorting tariff rate is justified. If the real exchange rate is too appreciated, non-tradables are favored unduly relative to tradables, and that can be described as a distortion or wrong price signal. A tariff or a set of import quotas similarly favors the protected industries relative to other industries within the tradable sector, and creates further distortions. Under certain circumstances a tariff could be offsetting in some of its effects (a second-best argument) but broadly one can say that an optimal allocation or non-distorted allocation of resources within the tradable sector is still desirable even when the sector as a whole is too small or too large because of a "misaligned" exchange rate.

The various arguments for or against protection are not really affected by medium-term real exchange rate instability. For any given current account balance and average price of tradables relative to non-tradables there is still an optimal allocation of resources within tradables and, subject to various qualifications (some of which will be discussed later in this paper), this will be attained by free trade. Specifically, the real appreciation of the dollar 1980-85 which reduced the competitiveness of U.S. industries, and which can be explained by the interaction of macroeconomic policies in the United States with those of other industrial countries, does not generate valid new arguments for protection.

The conclusion is thus that real exchange rate "misalignment" (i.e., medium-term instability) does not justify protection. Nevertheless, it may well generate protectionist pressures. Indeed, it has been pointed out that whenever the dollar appreciates, especially relative to the yen, there is an increase in protectionist pressure (and, to some extent, in actual protection) in the United States. 1/ There have been three occasions when the United States has lost competitiveness namely 1969-71, 1966-77 and since 1981. The argument is that large real exchange rate fluctuations raise the average protection level over a longer period owing to an asymmetry or ratchet effect. Protection increases when the dollar appreciates and this is not reversed when the dollar depreciates later.

Leaving aside the assymetry, it is clear enough that the appreciation up to 1985, and possibly also the current account imbalance itself, have been elements in the revival of protectionism in the United States. The explanation lies not with short-term exchange rate fluctuations but with medium-term real exchange rate instability. From this connection between exchange rate instability and protectionist pressures follows a frequent justification for macroeconomic policies that are designed to stabilize real exchange rates, and in the conditions of 1985 and possibly later, designed to bring down the dollar. This is quite apart from all the other reasons for seeking to reduce medium-term real exchange rate instability. But it has to be repeated here that from a national (though not sectoral) point of view protection of particular industries is an irrational response to real appreciation.

The question also arises what it is that really generates protectionist pressures. Is it truly the real appreciation or is it rather the current account imbalance, as is sometimes asserted? The two do not necessarily go together. Alternatively the main explanation could be the level of import penetration (share of imports in domestic absorption) either overall or in specific sectors only. This could increase even when current account balance is being maintained provided exports expand at the same time.

If the Japanese economy grows fast relative to other countries but Japan maintains current account balance (or something near that) the growth in Japanese exports, possibly induced by real depreciation of the yen, may also generate resistance in other countries in the form of protectionism. It has done so in the past. Industries in the United States and elsewhere that compete with Japan's exporters are adversely affected even when Japanese imports grow at the same time. The resistance to Japanese export expansion is not a new phenomenon and predates the large Japanese current account surpluses.

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1/ Bergsten and Williamson (1983).

## 3. Macroeconomic policy coordination and protection

It is clearly not necessary to solve the world's macroeconomic problems in order to liberalize world trade or to prevent a protectionist resurgence. But, for the reasons given above, avoidance of medium-term real exchange rate instability would help, and macroeconomic policy coordination is meant to contribute to this objective. Furthermore. for reasons discussed below, high employment levels and high growth rates in the industrial countries will also help, and macroeconomic policy coordination is also meant to contribute to these objectives.

Looking at the obverse relationship, it is also not necessary to have world free trade or even a movement in a liberalizing direction in order to have successful macroeconomic policy coordination. Nevertheless, there is an important relationship between protection and exchange rate fluctuations and hence possibly the need for coordination. Widespread protection by means of quantitative measures (as distinct from given tariffs, export taxes or export subsidies) will lower overall elasticities of substitution in international trade. To that extent, any given divergence in fiscal policies, for example, will lead to more real exchange rate instability than would result from a non-restrictionist regime, and hence the need for policy coordination may be greater.

## 4. Do unemployment and recessions justify protection?

High employment and growth make widespread liberalization much more acceptable and easier. This is widely recognized. It seems reasonable to conclude that post-war prosperity in Western Europe was not only helped by the gradual internal liberalization in manufacturing trade associated with establishment of the European Community but was also a precondition for its political acceptability. The same applies to the liberalization embracing the larger world industrial community associated with the various tariff reduction rounds under the auspices of GATT. High employment and growth are beneficial in any case, but the opportunities they allow for liberalization represent a bonus.

The reverse also applies and is borne out by many historical episodes. Unemployment and recessions give rise to protection or pressures for protection. The question then arises whether proposals for protection can be justified by the existence of widespread unemployment.

If a recession is caused by a domestic contraction of demand and the recession is not desired, the obvious remedy is to expand demand by macroeconomic policy. Protectionist measures are inappropriate. In the absence of real wage rigidity and if the exchange rate were fixed, an increase in protection--which would switch demand away from foreign on to domestic goods--would normally moderate the domestic effects of a recession, but it would be a second-best device.

General unemployment may be caused by a deliberate policy of demand contraction designed to reduce the rate of inflation, as from 1979 in the industrial countries. If this is so, it does not make sense for particular industries to be protected or subsidized in order to shelter them from the consequences of macroeconomic policies. The demand contraction may be designed to moderate wage increases, the aim possibly being to lower real wages. Protection will then defeat this objective in the protected industries. One arm of policy will be standing in the way of the objective of another arm, and in the process a new distortion will be imposed. While the contractionary macroeconomic policy is likely to be only short-term, protection once imposed is difficult to remove, so that the distortion cost may be long term.

If a recession is imported from abroad through a decline in export demand, leading also to a current account deficit, optimal policy is likely to involve real depreciation. The role if any, of increases in protection when there is such a current account problem will be discussed below in connection with developing countries, bearing in mind that in the nineteen thirties many countries did respond to the decline in demand for their exports with increased protection.

Unemployment may be caused by levels of real wages that are too high. This is "classical" unemployment. It is well accepted that it cannot be overcome by demand management policies unless these actually manage to reduce real wages. Similarly, it cannot be overcome by protection except in special cases. Tariffs or quotas would increase employment in protected industries but would also raise costs of industries using protected goods as inputs, and hence reduce employment there. More important, they would raise the cost of living. The latter effect would lead to an increase in nominal wages so as to maintain the original level of real wages, and this rise in costs would lower employment in those industries where protection has not increased.

Thus there are both positive and negative employment effects. On balance overall employment could rise or fall. If the protection or subsidization were primarily for labor-intensive industries a net employment gain would be likely. But even in that case the indirectness of the subsidization process would still impose distortion costs that must be set against these gains. Furthermore, the question arises whether the real wages sought and obtained by trade unions would not rise if employment increased, so that some of the possible employment benefits of protection or subsidization in particular industries would disappear.

On balance, one might well conclude that protection designed to increase employment when unemployment is caused by real wage rigidity is not justified. It also follows that trade liberalization should not necessarily be postponed because there is classical unemployment. Policy should concentrate on the "first-best" objective of reducing real wages, at least in the short run. In the longer run the growth of the capital stock will make higher real wages compatible with growing employment.

Finally, a related question might be considered. Can increases in protection cause a depression? The coincidence of the world depression with the highly protectionist Smoot-Hawley tariff in the United States--and the increases in protection which it provoked in other countries--suggests the possibility that a resurgence of protection can indeed cause a depression.

Depressions depend on aggregate demand contraction, and explanations in these terms--focussing especially on inadequacy of monetary policy--seem quite sufficient for explaining the Great Depression. This is a matter which is being currently researched, but a provisional view can be stated here.

It is likely that the vast increases in protection in the 1930s had adverse confidence effects and also stimulated defaults of some commodity exporters. Furthermore, declines in real incomes were exacerbated. But in general it seems implausible to place the primary blame for the depression on the increases in protection. To some extent the increase in protection was already in the pipeline when the depression started, and to some extent it resulted from the depression. Both the depression and the protectionist surge of course greatly reduced world trade, essentially a symptom of two distinct and highly adverse developments where the depression caused higher protection much more than the other way around. 1/

## IV. Current Arguments for Protection: A Review

Numerous arguments for protection have been put forward at various times. Some have already been discussed, namely those resting on the belief that protection improves the current account and that it increases employment.

An argument which goes right back to the nineteenth century in the United States and has had a recent revival is one based on "fairness" or a "level playing-field". It used to be argued that it is unfair to import products from cheap-labor countries. This was called the "pauper-labor argument for protection". It is fallacious since it ignores the principle of comparative advantage. Furthermore, if the concern is a humanitarian one, it has to be remembered that if protection by developed countries reduces the demand for the products of cheap labor industries in developing countries it will probably reduce wages and employment even more in these industries.

1/ A fuller discussion of this issue is in Eichengreen (forthcoming).

Currently the "fairness" argument is concerned more with protection by other industrial countries, where labor costs may be similar or even higher. This raises the question whether one country's protection can be justified by the protection policies of its trading partners. This subject will be discussed more fully at the end of this paper in connection with protection by developing countries. The broad answer is that, aside from negotiating considerations, protection by one country damages not just its trading partners but also itself, and this is true even when the other country practises protection.

One might consider many other protectionist arguments. The "anti-dumping" argument is well-known, and may have some validity when the dumping is "predatory" but not when it just means that a foreign supplier's exports are subsidized on a long-term basis. In that case the net effect is to cheapen the cost of imports and hence improve the terms of trade of the importing country. Three further arguments which are particularly relevant for developing countries will now be considered in some more detail.

1. The infant industry argument

This is the classic argument for temporary protection in developing countries. A major objection is that protection once provided is often not removed. Leaving that aside, this argument can rest on either of two bases.

First it could be based on imperfections of the capital market--i.e., an inability to raise capital to finance initial losses for an enterprise or industry that will eventually be profitable. Such imperfections do exist in developing countries, but hardly apply to the subsidiaries of multinational companies which can finance their initial losses from profits elsewhere in their companies or on the world capital market. In any case, a preferable policy when these capital market inadequacies cannot be removed would be subsidized loans.

Secondly it can rest on the presumed existence of external economies of a dynamic kind applying to a group of firms, perhaps through the mutual creation of an "atmosphere" favorable to new kinds of activities, usually thought of as manufacturing. Protection of one industry is always at the expense of others (through general equilibrium effects to be discussed below), and it has to be asked not just whether the firms or potential firms in the industry generate external economies, but whether they do so to a greater extent than some other enterprises might. In developing countries the infant industry argument is usually used to justify protection of manufacturing industry. But it is hard to see why the possibilities of spill-over effects through learning by doing should be greater in manufacturing than in agriculture.

The infant industry argument is also used to justify protection of high-technology or other new industries in industrial countries. While it is undeniable that such industries--or, more precisely, the development of particular products--may need to incur losses for prolonged periods before getting firmly established and earning the returns required to justify the investment, it is difficult to defend subsidization by consumers or from the public purse in such cases. After all, capital markets in industrial countries are highly developed, and, in addition, large companies can finance losses of new activities out of profits from their other activities. Conceivably there may be externalities, but it would have to be shown that they are greater than when similar public funds are applied to other uses.

Finally, modern analysis has added an important qualification to the use of tariffs or quotas for infant industry protection. If an infant industry is to be protected (or, a better word, "promoted") it should be protected not just for sales to the home market but also for exporting. Most developing countries have very small home markets so that if production is to be at adequate scale levels it should eventually, even if not at the very beginning, aim for the world market. Thus assistance, if it is to be provided, should not be by tariffs or quotas but rather by other forms of assistance that do not discriminate between home and foreign sales (for example by the provision of subsidized infrastructure or expenditures on education to build up a suitable work force). Alternatively, protection might take the form of some combination of tariffs and export subsidies.

2. *Terms of trade argument*

This is another classic argument: restricting trade (possibly through export taxes or export controls) may improve a country's terms of trade, its gains being achieved at the expense of other countries. The large economies need to take the possibility of retaliation into account when directing such protection against each other, and as major actors and trend setters must also bear in mind the effects on the world system.

The major objection is that small economies--and almost all developing countries are relatively small in world trade--can hardly affect their terms of trade by supply or demand restriction, other than in the very short run. Of course, there are cartel possibilities, as the OPEC experience shows, and the gains may last for some time, though eventually the benefits are eroded since long-term elasticities of demand and supply are higher than the short-term ones.

The modern version of export restrictions which improve the terms of trade is the acceptance of voluntary export restraints by exporting countries such as Japan and various developing country clothing and textile exporters. These restraints do tend to improve their terms of trade, particularly if the alternative that is avoided is the imposition of import quotas imposed by some importing countries, which would force the exporters to unload their products at low prices in other markets.

## 3. Tariffs and export taxes for revenue

Taxes on trade that are imposed for fiscal purposes may have protective effects as by-products. This is particularly relevant for the design of Fund programs. In many of the low-income developing countries, especially in Africa, and also in some of the middle-income ones, tariffs or export taxes are important sources of government revenue. Collection costs of taxes on trade are often relatively low. Historically (as in the 19th century in the United States) this has also been the primary role of tariffs in the now-developed countries.

From a short-run fiscal point of view it may well be convenient to maintain or even raise such taxes. Indeed, this is often a concern when the immediate macroeconomic problem hinges on an excessive budget deficit. But there are likely to be long-term adverse effects through encouraging uneconomic import-competing production and discouraging more socially efficient export production. There are important issues here because it is a matter of balancing the short-term versus the long-term interest.

The imports on which tariffs for revenue purposes are levied may be luxury consumption goods of which there is initially little or no local production. In the absence of adequate income taxes such import taxes may have a favorable distributional effect. But local production of similar, if not identical, goods is likely to be encouraged, so that protection would be an undesired by-product of tariffs designed for revenue--and the revenue itself would gradually decline as import substitution progresses.

The desirable policy is then to supplement the tariffs with taxes on local producers at the same rate, the net result being to convert tariffs into consumption or sales taxes. There will then be no special or distorting incentive for import-substituting production. The taxation of exports is similar in its effect to a tariff on imports. Production for exports becomes less profitable, and is discouraged. Indirectly, through general equilibrium adjustment, import-competing production is stimulated. Reduced exports resulting from the export taxes may require the exchange rate to be more depreciated than otherwise in order to maintain balance of payments equilibrium, and this depreciation will then stimulate import-competing production; or wages and other factor costs may fall (or rise less than they otherwise would) as export production becomes less profitable, and the lower costs and readier availability of labor will then stimulate import-competing production.

A general equilibrium adjustment designed to maintain employment is, of course, desirable, given that export taxes have been imposed.

But the net result is to reduce the volume of trade and to replace economic export production with less economic import-competing output.

The adverse effects on long-term resource allocation, and hence possibly on growth, of such trade taxes must thus be borne in mind. Tariffs should be supplemented by taxes at the same rate on domestic production of similar goods (converting the tariff, in effect, into a non-discriminatory consumption tax), or modest levels of export taxes should be supplemented by taxes on domestic output of all kinds sold at home. But the qualification has to be noted here that in some countries there may be obstacles, at least in the short run, to the efficient collection of sales taxes or taxes on domestic production.

Numerous considerations enter into the construction of an optimal taxation system, notably distributional effects and relative collection costs. Here attention is drawn to the distorting effects on resource allocation of trade taxes, and that consumption taxes (of which import tariffs may be a component) are likely to be preferable to tariffs on their own.

It should be noted that tariffs which were imposed primarily to raise revenue and which appear to be at modest levels may actually represent high degrees of protection and thus have marked protective effects eventually. This follows from the distinction between the nominal rate of tariff protection and the effective rate of protection (ERP). The latter refers to protection provided for value added.

It is common for inputs or components to enter at low rates of duty, or possibly not to pay any tariffs at all, while final goods, or goods at later stages of processing pay a revenue tariff. In that case the ERP will be considerably greater than the nominal rate of protection. For example, if the nominal rate is 20 percent, if the share in cost of an imported input at free trade prices is 50 percent and if this input is not required to pay any tariff, then the ERP is 40 percent. The same applies if the input is produced locally and is potentially exportable, with its domestic price determined by the world market price. Since the shares of imported inputs in the cost of production of local products are likely to vary a great deal, a uniform rate of nominal tariff designed for revenue may yield very uneven rates of ERP and thus create uneven incentives not only relative to exporting but also between protected industries.

## 4. True explanation of protection: sectoral income maintenance

There are obviously numerous possible reasons for trade policy measures, and some of the most commonly used arguments for protection have just been discussed. But often the arguments given are couched in terms of the national interest when better explanations for various measures can be found in a concern for sectoral interests, possibly a response to particular political pressures.

In mature industrial countries the principal explanation for recent protectionist pressures and actual increases in protection appears to be a concern to preserve industries that would otherwise decline or, at least, to slow up or ease the decline. The potential decline may be caused by shifts in comparative advantage or other structural factors, or (in the United States) by real appreciation induced by macroeconomic policies. The concern is to preserve regional or industry-specific incomes, even though this will be at the cost of some loss of national income overall, i.e., at the cost of a national efficiency loss.

One might say that trade policy is, to some extent, used as a system of social insurance, the idea being to help industries in trouble at the cost of the rest of the community. The implication is that investors and employees in other industries which bear the current loss from protection would also get some help if they ever needed it. This reason for protection no doubt also applies in some developing countries.

Sometimes the original explanation for protection lies elsewhere--in a balance of payments crisis or an infant industry argument--but the original justification has disappeared and the continuance of protection is caused by a concern for sectoral income maintenance. One could argue that it is simply the result of sectoral pressures combined with a general failure to appreciate the costs of protection, especially the long-term costs, in the form of a loss of aggregate national output. Alternatively, it could be given a "social insurance" rationale.

When the objective is to prevent severe declines in sectoral incomes, owing possibly to exogenous shocks, adjustment assistance would be preferable to trade protection. The latter is clearly not first-best both because it has various by-product distortion effects and because it is rarely temporary. At the same time, aside from political considerations, there is little justification for adjustment assistance that deals only or specifically with trade-related shocks. Presumably unemployment benefits, assistance in retraining, education, and so on, can be justified irrespective of the source of the shocks. Another obvious difficulty is the fiscal cost of adjustment assistance. On the other hand there is the political factor: if adjustment assistance can avoid protection, or make possible a liberalization that would not otherwise take place, there could be a net benefit from trade-related adjustment assistance. 1/

1/ This view, with respect to the current protectionist threat in the United States, is put in Lawrence and Litan (1986).

## V. Some Broader Issues

### 1. Rent seeking and other costs of protection

The orthodox costs of protection result both from distortions in the pattern of production and the use of inputs into production, and from distortions in the pattern of consumption, brought about by price signals that do not correctly reflect the trading opportunities open to a country. Mostly the effect of protection is to lead to excess production of import-competing relative to export production as well as to distortions within the import-competing sector as a whole resulting from effective rates of protection not being uniform. Such costs result even from a system of fixed and well-defined tariffs. But the actual costs of protection are usually much greater than these "orthodox" costs essentially because trade interventions are often very complicated and are flexible, responding to pressures of various kinds. In particular, they involve licensing and ad hoc bureaucratic decision-making.

Three kinds of costs in addition to the "orthodox" costs of protection then arise. These are (1) costs of administration and compliance, (2) "rent-seeking" costs, and (3) disincentive costs of made-to-measure systems.

Administration and compliance costs can be very high when there is an elaborate licensing system. This is a particularly important argument for preferring firmly-fixed tariffs to import quotas in developing countries. The complexities and inequities in quota (and exchange control) systems multiply, and scarce administrative talent in government and industry is diverted into non-productive channels.

Rent-seeking costs (which have received much attention in recent analyses) result from efforts devoted to obtaining scarce import or foreign exchange licences, and from lobbying legislators to obtain or to reduce protective tariffs or quotas. Rent seeking does not refer to pure redistribution effects (which result from bribery) but rather refers to actual resource costs (principally labor costs) involved in the various activities, notably lobbying. The scope for rent seeking is particularly great with quotas (unless they are auctioned) and provides another argument for preferring tariffs to quotas.

Protection systems are made-to-measure, or attempt to be so, when they are frequently adjusted to reflect the profitability of import-competing activities. In systems that try to be made-to-measure the more profitable local production is, the more protection would be reduced, while a rise in domestic costs for whatever reason--causing local industry to become less competitive--leads in such a system to an increase in protection. Systems that are based on quantitative targets for imports (for example, when there is a provision that a given share of local absorption should be imported) have this effect. Such systems reduce or possibly even eliminate the incentives to improve efficiency and to cut costs, and are thus clearly undesirable.

2. How does protection affect growth?

The provision of protection for a particular industry or category of industries may well, for a time, lead to higher growth of these industries. Thus a country that provides infant industry protection for manufacturing is quite likely to find that the rate of growth of manufacturing does accelerate as a result. But the protection is at the expense of other industries (perhaps agriculture) which are likely to grow less fast; hence there is no presumption that overall growth would be higher. A correlation between sectoral growth and protection rates tells one nothing about the overall growth effects.

The central question is whether the various protectionist devices improve or worsen the overall efficiency of the economy both in terms of the orthodox resource allocation concept and the other considerations (rent seeking, etc.) just discussed. The general presumption which follows from the discussion so far is that they worsen efficiency. In that case, growth is also likely to decline because the efficiency of investment will decline. A given amount of savings when invested will yield lower output gains. The capital output ratio rises. Thus the growth effect is a by-product of the static efficiency effects.

While the principal implication for growth of various microeconomic interventions is through capital accumulation--which becomes more productive the more efficient the economy becomes--there are other growth implications of protection, additional to this capital accumulation effect. Five might be noted here.

Firstly, any change in efficiency is likely to develop gradually. For example, removal or simplification of a system of protection will raise the efficiency of the economy (i.e., the productivity of given factor inputs). This may take place over a period of years and during this period, though not indefinitely, the rate of growth will be higher than otherwise.

Secondly, protection policy may affect the relative prices of investment goods, and this could affect the growth rate. If protection raises the domestic cost of investment goods, or forces local industries to use domestically-produced equipment of lower quality, the growth rate is likely to be reduced as a result.

Thirdly, "made-to-measure" systems of intervention which compensate industries in trouble by providing more tariffs or subsidies when their profits fall, and which reduce protection when the industries are successful, reduce the incentive to innovate and are thus likely to lower the growth rate.

Fourthly, rent seeking, referred to above, can lead to a serious diversion of entrepreneuiral effort and hence reduce the rate of growth.

Fifthly,the overall growth rate will decline if protection preserves old-established industries which have relatively low rates of technological progress at the expense of potential high-growth industries.

Extensive research on the relationship between growth rates and outward-looking policies versus inward-looking policies has been done at the World Bank and elsewhere. More and more evidence seems to be emerging that developing countries which have been outward looking have also enjoyed high growth rates. 1/ Higher export growth resulting from some trade liberalization combined with appropriate exchange rate adjustment has been associated on average with higher overall growth. Outstanding examples here are Korea, and, for a limited period, Brazil. There are also examples from the earlier history of now-developed countries, such as Sweden. Of course other factors, such as investment ratios, have also been important in explaining relative growth rates.

Outward-looking policies can be defined as policies that do not discriminate significantly against exports and allow market forces to determine (to a reasonable extent) the degree of openness, while inward-looking policies are those that create a bias in favor of import substitution. Outward-looking countries have never been completely free trade, and governments have usually played an important role in development policy, but the bias in incentive systems has not been against exports during their high growth periods. In some cases there has simply been some reduction in the import-substitution bias of the incentive system. This has stimulated export growth, and in turn an increase in overall growth seems to have resulted.

### 3. Some gain and some lose: the distributional problem

Intervention policies usually benefit some sections of the community at the expense of others. Trade liberalization in industrial countries would for example, reduce profits and employment in the clothing and textile industries while benefiting consumers at large as well as other industries (through the exchange rate depreciation or labor cost adjustment with which it would be associated).

Some of the benefits to the gainers spill over fairly directly to the losers, so providing partial compensation, especially if there is an

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1/ The large literature analysing this issue and giving strong support to this conclusion is surveyed in Balassa (1985) and Balassa (1986).

effective taxation and social welfare system. Thus, if trade liberalization has the net effect of raising aggregate national income it will raise the tax base, and some of the revenue may be spent on transfers or extra public facilities that benefit present and former employees in the losing industries.

Nevertheless, on balance there are likely to be some net losers since full compensation rarely takes place. It has been frequently calculated that the potential gains from removing protection on particular industries, notably clothing and textiles, are so large that it would actually be possible to compensate most generously employees in those industries, and yet still leave consumers better off. 1/ But in practice full compensation rarely takes place, primarily because it is difficult to identify losers precisely. Further, if compensation policies became customary and hence rationally expected, there would be an incentive for protected industries to stay in existence and even expand, even if they knew that their protection is unlikely to last.

Given that there will be gainers and losers from liberalization or protection, can anything really be said about "national" gains or losses? There are three possible approaches.

a. The traditional answer of economic theory has been to focus on the concept of potential welfare which allows for the possibility of compensation. If gainers could compensate losers and yet have something left over, there is a national gain--i.e., the policy change represents an improvement in national efficiency. It is accepted that actual compensation may not take place, but the potential exists, and if nations choose not to compensate fully then they must be satisfied with the income distribution that has resulted.

b. A second approach is to argue that there is a presumption in favor of trying to foster national efficiency, but that particular measures that have well defined distributional effects which are thought to be adverse should be accompanied by appropriate compensating measures. Various calculations have shown that the potential efficiency gains from liberalization are often very great. There is then a strong argument for pursuing liberalization combined with compensation of losers, if only to make the liberalization politically acceptable. Various methods of compensation which might also improve efficiency are available, for example retraining and relocation grants.

c. Finally, there is the "long-term mutual gain approach", which probably represents more closely the views of those who advocate efficiency-oriented policies. The argument is that policies which

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1/ Cost of protection figures and further references can be found in Occasional Paper 38 and in OECD (1985), Balassa and Michalopoulos (1985) and the World Bank (1987). Figures with regard to clothing and textiles protection in the United States will appear in Cline (1987).

consistently foster national efficiency will eventually, in the long run, make everyone better off. There is a long-term mutual gain, or at least it is probable that there would be. While particular individual steps that improve national efficiency may make some parts of a population worse off, other, further, steps will make them better off, and so finally all will be better off.

It must be emphasized that this distributional problem--almost a philosophical problem--does not create any presumption in favor of protection even if one dismisses the "long-term mutual gain" approach. It would still have to be shown that protectionist regimes in practice actually have favorable distributional effects when judged by some kind of objective criterion. In many developing countries protection benefits the urban population relative to the rural one, and average incomes in the latter are usually lower so that the overall distributional effect may be regarded as adverse.

## VI. Developing Countries: Protection, Liberalization and Macroeconomic Policy

### 1. Protection, the exchange rate and real wage rigidity in developing countries

We now come to a central issue in the design of policies (and of Fund-supported adjustment programs) to deal with balance of payments problems. In view of the importance of this subject it will be dealt with at some length here even though there is some repetition of analysis presented earlier.

What, if any, is the role of trade restrictions when a current account deficit needs to be reduced ? When the exchange rate is fixed but adjustable, are trade restrictions ever to be preferred to real devaluation? The Fund's position is clear: restrictions should not be increased and, if possible, should be reduced. The exchange rate should be used as the required device that switches the pattern of demand away from foreign on to home-produced goods, supplementing the necessary reduction in real expenditures.

But others often do not agree. Many of the issues discussed earlier enter here. One might accept the proposition that for maximization of national efficiency in the medium and long run the best policy is liberal trade (with perhaps some exceptions on infant industry and other grounds discussed earlier). But is such a liberal policy also best for the short run? The former Cambridge group in Britain, for example, did not agree, and similar views have been propounded in Latin America and elsewhere. 1/

It is worth analyzing in some detail the case for short-run protectionism when the current account has to be improved. Such a protectionist argument comes often almost instinctively to policy makers and others. It is explicitly or implicitly an argument against devaluation, or at least against sufficient devaluation. Hence one is really concerned with import restrictions (or, more rarely, tariffs) versus devaluation as switching devices to accompany the necessary and inevitable reduction in real expenditure.

The familiar "orthodox" analysis is that a devaluation raises the prices in domestic currency terms of imports and of exports. This will switch the pattern of domestic demand away from imports. In addition, it will increase profitability of import-competing and export industries provided nominal wages do not rise, or do not rise much. This higher profitability will then, in due course, lead to expansion of tradable goods output, which is the desired objective. At the same time, if output was at full capacity initially, demand for non-tradables should decline--absorption should fall--so as to free resources for extra production of tradables.

A short-term argument against this approach--i.e., an argument for import restrictions in preference to devaluation at a time of balance of payments crisis--is that the effects of devaluation work with a lag, so that initially very high devaluation (to an extent that cannot be calculated in advance) may be required to achieve a desired reduction in imports. Quantitative restrictions may then appear preferable.

Here it has to be borne in mind that quantitative restrictions also take time to implement and create administrative problems. If they are associated with price-control on restricted imports excess demand will be generated and powerful pressures can build up to ease the restrictions. If there is no effective price control the restrictions will yield the familiar monopoly profits for import licence holders (who may be local manufacturers using imported inputs). In both cases vigorous rent seeking may result.

Nevertheless, such a short-run case cannot be completely ruled out. The main objection is that restrictions once imposed are not readily removed. There would then be medium and long-run adverse effects through failure to stimulate exports (hence producing too much import compression) as well as distorting the pattern of imports as the

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1/ The Cambridge Economic Policy Group produced their argument for protection when a country has a current account problem in Cambridge Economic Policy Group (1976) and elsewhere, and the argument is analysed in detail in Corden (1985), on which the discussion here is based.

result of using a non-market method of discriminating among imports to be restricted.

Leaving this very short-run argument aside, a deeper, more sophisticated argument (the "Cambridge argument") should now be considered. This could apply to a somewhat longer short run. It hinges on the possibility that there is a tendency to real wage rigidity brought about by formal or informal indexation. It is likely that for a devaluation to be effective it is necessary that real wages fall. And this creates the problem that the rise in the domestic price level brought about by devaluation would cause nominal wages to rise, possibly sufficiently to destroy the benefits of the devaluation.

At this point the suggestion comes forward that import restrictions or tariffs might be used instead on the grounds that they do not require declines in real wages. But these devices will also raise the domestic price level. The suggestion that import restrictions would not do so at all can be rejected since shortages usually cause some price rises. The element of validity in the argument is that tariffs might raise the price level less than devaluation if there is domestic consumption of exportables and, even more, if the revenue raised were offset by equivalent reductions in indirect taxes. In that case the initial real wage declines and hence the subsequent increases in nominal wages would be less.

The essential feature of a devaluation compared with the other devices is that it increases profitability of exporting, which should in due course--as supply expands and foreign markets are exploited--bear fruit in higher export income (in terms of foreign currency). A measure that makes exporting more profitable might tend to reduce real wages more--and so in due course bring about more compensating rises in nominal wages--than measures that are purely import compressing.

In the medium and long run export promotion through exchange rate adjustment is clearly what is needed. Tradable goods production should expand both on the import-competing and the export front if the non-discriminatory signals of the market are to be accepted as a guide to resource allocation, and if excessive import compression is to be avoided. But in the short run export supply is often quite inelastic, especially if exports are primary products or if new manufactured products have to be developed, so that the rise in export profits resulting from devaluation can be regarded as a windfall which could be dispensed with for the sake of reducing the adverse effect of the switching policy on nominal wages.

Compared to the free market solution of devaluation, the use of import restrictions is a way of taxing profits of exporters so as to sustain real wage levels when, in the short-run, real wages really need to fall. Alternatively, one might argue that tariffs and devaluation have the same or similar effects on the cost of living and real wages, as well as on profits of import-competing industries, but that tariffs bring in revenue to the government (which it may or may not offset with the reduction of other taxes) while devaluation brings in the equivalent revenue to exporters.

Thus sometimes, with rigid real wages, trade restrictions of particular kinds could make the short-run problem easier. This would be so particularly if the restrictions were focussed on goods not consumed by wage earners, and if the distributional shift implied by the particular pattern of restrictions (for example, on imports of so-called luxury goods) were thought desirable.

This is a sympathetic summary of the Cambridge argument for import restrictions as part of a policy package to deal with a current account problem. It involves damaging medium and long-run prospects for the sake of possible short-run gains, though this trade off is not usually pointed out by the proponents. Furthermore, in the medium and long run protection by developing countries is likely to reduce growth in employment as well as slowing up real wage increases. The reason is that developing countries have a comparative advantage in labor-intensive products, so that export expansion resulting from outward-looking policies would tend to be in labor-intensive industries. Growth of labor-intensive industries relative to capital and resource-intensive industries will tend to raise real wages by increasing demand for labor, and may also increase overall employment. The experiences of the newly-industrializing countries of East Asia bear this out.

The distributional effects of the policy choices must also be considered. A rise in the domestic prices of exports brought about by devaluation (but avoided by tariffs or import restrictions) may increase incomes of the poorest sections of the community if exports are produced by peasants. The distributional effects of the choice of "switching" device depend on the particular structure of the economy, and in countries with peasant export sectors proposals for preferring import restrictions over devaluation imply unfavorable income redistribution. With real wage rigidity in the urban sector, import restrictions have then an equivalent effect to a combination of devaluation and taxation of rural incomes to subsidize urban employment.

## 2. Terms of Trade Effects in the Short Run

So far it has been assumed that if exporting were made more profitable by devaluation, supply might not increase much in the short run, even though it would increase in the long run. Thus in the short run the extra profits would simply be rents which could be taxed away or foregone by use of the alternative device of import restrictions.

It is also possible that, even if supply did increase, world demand may be inelastic, possibly because of restrictions (including imposition of "voluntary" export restraints) abroad. Extra exports may be excluded from some industrial country markets by protection, and hence would have to be unloaded at substantially lower prices elsewhere. Hence the country's terms of trade would deteriorate as a result. Even in the absence of protection abroad, short-run demand elasticities are often low, so that increased export supply may well lead to declines rather than increases in the value of exports.

Looking purely at the short run, and even without any wage indexation, there appears then to be a case for preferring tariffs or import quotas to devaluation, this being simply a version of the terms of trade argument for protection. It hinges completely on estimates, implicit or explicit, of elasticities of demand for exports. In the nineteen fifties and sixties elasticity and export pessimism were one basis for the import substitution bias of development policies in Latin America, India, and elsewhere (but not in East Asia) and this view can still be encountered.

*The element of justification is that if voluntary export restraints* are imposed upon a country then, in effect, its own optimal policy is to impose export taxes on the particular products affected when directed to the particular markets concerned. But, apart from that, there are two objections to this line of approach as an argument for conventional protection.

Firstly, insofar as it has some validity, it might justify export taxes or restrictions, the rates of tax being higher where the demand elasticities are believed to be lower. In other words, the first-best short-term policy (ignoring the medium and long run) is to impose export taxes or restrictions differentially between different exports. Some exports, especially of manufactures, may face very high elasticities of demand and no foreign restrictions, so that even significant expansion of exports by many developing countries at the same time would require only taking up a small share of a very large industrial country market. In these cases there would be no significant terms of trade effect and hence the optimal tax would be zero. In other cases, where a country is a significant world supplier of a product, there might be some short-run benefit from export restriction.

The objection to the use of import restrictions or tariffs in order to restrict a country's own exports is that these devices are clearly second best. Devaluation would provide a general stimulus (like a uniform export subsidy) while the use of import restrictions or tariffs would avoid this and hence, relative to the devaluation solution, would, in effect reduce exports. The objection is that the required differentiation among exports would not be obtained. Even those exports where there is no scope for terms of trade improvement would be reduced.

The second objection is simply that, whatever the short-run case, the evidence has shown that elasticities tend to be high in the medium and long run. Thus there has been a very significant expansion of exports of manufactures from developing to industrial countries during the sixties and continuing after the first oil shock. This has not just been a volume but also a value expansion. Hence medium-run elasticity pessimism is not a justified assumption on the basis of recent experience. 1/

It is then a matter of balancing possible short-run gains from import restrictions against the medium and long-term losses that result from failure to seize export opportunities. If fundamental or structural improvements are sought it is clearly necessary to bear in mind adverse medium-run effects of policies.

## 3. Trade liberalization in developing countries: the exchange rate and timing

The most important point about large scale trade liberalization is that it must be associated with real devaluation if the current account is not to deteriorate and if the employment losses in protected import-substituting industries are to be compensated by employment gains elsewhere, especially in export industries. Normally nominal devaluation will be needed. The appropriate exchange rate adjustment will be hard to judge in advance, but it is important to bear in mind that the longer-run equilibrium real exchange rate does depend on the degree of trade liberalization.

The sequencing of liberalization and the associated exchange rate adjustment is also a matter of some complexity. A choice, essentially political, has to be made between gradualism and sudden measures, and how much advance announcement there should be. 2/

The exchange rate should be adjusted early even at the cost of generating temporarily excess profits in export industries and in import-competing industries that are not protected. The beneficial effects of depreciation on exports are likely to develop with a lag, while an increase in imports resulting from liberalization could be quite quick. A firm, credible assurance that a program of liberalization will be followed should discourage the flow of resources out of non-tradables into highly-protected industries during the transitional period when the exchange rate has already been devalued while the liberalization process is not complete.

Is a time of balance of payments difficulties the right time to liberalize trade? This important issue arises currently and needs to be considered in relation to Fund programs. It is, of course, not possible

1/ See Balassa (1985), Balassa and Michalopoulos (1985) and World Bank (1987).

2/ The issue of the process of trade liberalization and how it relates to macroeconomic and other policies is currently being researched in a World Bank project involving the study of 37 liberalization episodes in 19 countries. For a preliminary report, see Papageorgiou, Michaely and Choksi (1986).

to resolve this issue here or arrive at conclusions appropriate for all countries but some considerations can be set out.

From the narrow but popular partial view it certainly appears to be the wrong time. Traditionally, a balance of payments crisis has led to the imposition or tightening of import restrictions since it is non-economists' commonsense that when imports are too high in relation to exports the proper policy is to restrict imports.

Two immediate answers can be given. Firstly, liberalization will allow, possibly for the first time, the ready availability of cheap imported inputs required for exports. This aspect of liberalization would improve the balance of payments even if the exchange rate stayed constant. There may be a lag before the benefits come through since it takes time to expand exports, find new markets, and so on, but at least there is a favorable and direct balance of payments effect.

The more important answer is that the alternative to import restrictions is not to do nothing but to depreciate the exchange rate. Hence one is back to the choice already highlighted several times in this paper between two "switching" devices one of which is discriminatory as between imports and in favor of import substitution relative to export expansion, the other--exchange rate adjustment--being non-discriminatory.

It is possible that restrictions are so widespread, complex and dislocating that their removal or tidying up can have fairly immediate beneficial effects on incentives and output. It would then also become easier to solve the balance of payments problem. This would particularly be so when imported inputs for manufacturing production with export potential are subject to licensing. In other cases the beneficial effects of removing restrictions combined with adequate devaluation would only show up in the medium run, as new investment is directed into more productive channels, as rent seeking declines, and so on. In the short run, liberalization associated with exchange rate adjustment may give rise to dislocations and to localized or industry specific unemployment as profitability of some industries declines while that of others improves. The question then arises whether the short-run problems of liberalization should be added to the problems involved in restoring macroeconomic stability--i.e., in reducing real expenditures.

In considering whether to liberalize at a time of balance of payments crisis it is then a matter of trading off additional short-term problems against medium or long-run benefits. Given that some countries seem to have continuous difficulties it may be best to focus on getting the medium and long run sorted out; but at least it is necessary to bear in mind that there may be short-run adjustment costs.

4. A special problem: liberalization by countries with fixed exchange rates

A special problem arises with countries that are part of a currency zone and where, therefore, the nominal exchange rate cannot be unilaterally devalued. Such countries are short of a policy instrument. It is assumed here that even a once-for-all exchange rate adjustment is ruled out. Trade liberalization will still require real devaluation, but this cannot be brought about by nominal devaluation.

There are then two possible approaches to the problem. The first is to rely on gradual liberalization keeping down the domestic rate of inflation below the inflation rate in trading partner countries. Liberalization would, in the first instance, reduce demand for domestically-produced goods, and the moderation of increases in domestic wages and prices that might result would then rstore competitiveness, bringing about the required real devaluation. To avoid significant output losses it would be necessary for the liberalization to be gradual.

This approach is likely to work if there is significant inflation abroad. In the absence of inflation abroad some downward flexibility of domestic nominal wages and prices would be needed.

The second approach is to reduce or eliminate distortions not by removing trade restrictions but rather by establishing a uniform ad valorem tariff combined with a uniform ad valorem export subsidy at the same rate. This package of policies would have effects similar to that of a devaluation, at least on trade and output of goods (given that usually it cannot be applied to services). It may also present administrative problems. Furthermore, it might be difficult to attain complete uniformity and to resist pressures from sectoral interests to provide lower or higher tariffs in particular cases.

Quantitative restrictions might at first be replaced by tariffs and then the tariffs might be adjusted either quickly or slowly in the direction of uniformity. At the same time, export subsidies would be necessary to avoid an import substitution bias. The revenue from tariffs would finance the export subsidies and, if there is a trade deficit, there would still be a net revenue yield from the tax-subsidy system. If the system could not be applied to services some distortion would remain. Possibly the whole level of tariffs and subsidies could be gradually reduced in time, and even eliminated eventually, if there is reasonable flexibility of domestic wages and prices.

We now return to the more usual cases, where exchange rates can be altered.

## 5. Capital market liberalization and trade liberalization

A matter that has been much discussed has been the relationship between trade liberalization and capital market liberalization. This discussion has been stimulated by the experiences of Argentina, Chile and Uruguay where some degree of liberalization of both kinds took place in various orders. In Argentina capital market liberalization (for a limited period) came first and in Chile trade liberalization. 1/

It is clear that it is possible to have one kind of liberalization without the other. Some countries have very open capital markets but restrictive trade regimes while others have extensive international capital controls but relatively free trade. Among industrial countries during the Bretton Woods era controls on international capital movements were the norm while trade was being progressively liberalized, and this has also been true until very recently within the European Community.

There are two important links between the two kinds of liberalization.

Firstly, capital market liberalization involving the freeing of domestic interest rates and the removal of controls on inward and outward capital flows may lead to greater capital inflows than before. Not only would removal of controls on inflows, including direct investment, encourage this, but removal of controls on outflows (provided the liberalization is expected to last) would also, since it would reduce the risk that capital cannot be repatriated. With greater availability of foreign capital it is then particularly desirable that the relative profitability of domestic industries gives a true indication of social profitability, so that investment is directed in optimal directions. Hence some trade liberalization should ideally precede capital market liberalization if the existing protection system is very distorting.

The need to get the signals right also applies when new investment is wholly domestically financed, but the argument is strengthened when major capital inflows are in prospect. It is unfortunate if foreign capital flows primarily into heavily protected industries so that low benefits to the country result, and possibly there could be a social loss, the local consumers in effect subsidizing foreign capital. In addition, foreign companies become yet another interest group in support of maintaining protection.

Secondly, capital market liberalization is likely to affect the real exchange rate, possibly quite sharply for a limited period, as a portfolio adjustment takes place. If domestic interest rates had been held down by controls and are now raised, capital will flow in, or at least there will be pressures in that direction. This effect will be

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1/ See Edwards (1984).

strengthened if investors' perceptions of the security (and opportunity to repatriate) of investment in the country improve. The nominal exchange rate may then appreciate. Alternatively, if the nominal rate is kept fixed, the money supply will increase, (assuming no sterilization), domestic prices will rise and so the real exchange rate will also appreciate.

It is also possible that the exchange rate depreciates, rather than appreciating. On balance the portfolio adjustment may involve net capital outflow if controls on outflow were initially severe or if decontrol were expected to be temporary.

If the real exchange rate appreciates it will be moving in the opposite direction to that which is required when there is to be trade liberalization with current account balance. The adverse effects on import-competing industries will be intensified: on top of the trade liberalization effect which inevitably reduces the profitability of import-competing industries the temporary real appreciation resulting from capital market liberalization will also affect import-competing industries adversely. Of course it will be temporary, but it does create problems. Furthermore, exporting becomes less instead of more profitable.

If the tendency is for capital to flow out the exchange rate will move in the right direction (i.e., will depreciate) but will overshoot, since the extent of depreciation required for the current account to be maintained with trade liberalization is less than what is required when the current account needs temporarily to go into surplus to accommodate capital outflow.

To sum up, opening the domestic capital market to the world market is likely to make it more difficult to manage the exchange rate. The rate will be put under capital market-determined pressures, and this presents problems if it is desired to fine tune the exchange rate as part of a major trade liberalization exercise. On the other hand, there seems little reason to slow down capital market liberalization if trade liberalization is piecemeal and gradual. Furthermore, sometimes capital market liberalization may be inevitable because of the breakdown or high administrative costs of controls.

## 6. Does protection in industrial countries justify protection by developing countries?

The argument is often heard in developing countries that the recent revival of protectionism in the industrial countries justifies a reluctance to liberalize by the developing countries. Does protection in the industrial countries, combined with the need to improve current accounts because of the debt situation, call for inward-looking policies by the developing countries ? This involves the general question whether protection in one group of countries can justify or even necessitate the protection policies of another group.

In very broad terms, protection overall is much higher in almost all developing countries than in industrial countries. On the other hand, again in broad terms, protection in industrial countries has been increasing, at least since 1980, and the threat is of further increases, while protection in developing countries has on the whole not changed much (with some exceptions, where there has been liberalization) and all the proposals, if not prospects, are for further liberalization.

The question has then been raised whether there are or will be "inequities in global liberalization". Why should one part of the world move in one direction--a direction that is favorable for the world system--when another part (where most of the preaching comes from) is moving in the opposite direction?

One approach to this question focuses on prospective current accounts. It is said that industrial countries as a group are not willing to live with non-interest current account deficits, especially if the United States eliminates her deficit; hence the developing countries cannot have or sustain the non-interest surpluses required to meet their interest obligations and eventually even repay some of their debts. So there is no point in developing countries pushing exports, and growth will have to be associated with import substitution.

The argument is fallacious on the basis of the discussion earlier: once the possibility of exchange rate adjustment is allowed for, current accounts do not depend on protection; rather, protection determines whether a given current account outcome is obtained with more or less *import substitution relative to export expansion.*

If industrial countries do not allow developing countries to improve their current accounts, a choice still has to be made between expanding exports and hence being able also to import more, or (taking a particular case) keeping exports constant and also then keep imports constant, lowering the ratio of imports to GNP in the process of growth. And this choice raises the familiar protection issues that have nothing to do with current accounts. For any given current account balance, choices can still be made between inward-looking and outward-looking growth, and, as noted earlier, the empirical evidence as well as economic analysis suggest that outward-looking growth is generally better for developing countries.

It should also be borne in mind that industrial country markets are still quite open for most products. So far, their protectionism has not in fact stopped a steady rise in the share of developing countries' exports of manufactures in total consumption of manufactures in industrial countries (even in clothing and textiles). Furthermore, except in clothing, the share is generally quite small, so that the scope for expansion is considerable. In 1983 in the United States the share was only 3 percent for all manufactures and 15 percent for clothing. In 1973 the percentages were respectively 1.1 and 5.6 (Balassa and Michalopoulos, 1985).

The morality argument (as it might be called) should also be dismissed. Liberalization by developing countries would benefit industrial countries and the world system, just as liberalization by industrial countries would benefit developing countries and the world system. It is then asked why developing countries should generate these benefits when the industrial countries are failing to do so, and, in fact, are moving in the opposite direction. The answer is that liberalization by developing countries may also benefit the developing countries themselves, and most debates, like the discussion in this paper, are concerned with this very issue, i.e., to define these benefits.

The broad point can be put as follows. Protection by industrial (developed) countries reduces the gains from trade in both parts of the world. It damages both the residents of the industrial countries in the aggregate (though particular sectors may benefit) and it damages the developing countries, especially when the protection discriminates against their exports. Adding protection by developing countries further reduces the gains from trade in both parts. It is this broad point that is the key one: even if protection in industrial countries does increase, a bad example being set and the interests of the developing countries being damaged as a result, it would not be in the developing countries' interests to forego their own liberalization for that reason.

The adverse effects on developing countries of a significant increase in protection by the industrial countries need hardly be restated. The developing countries' terms of trade would deteriorate as a result and the task of attaining fiscal balance would become more burdensome. A current account improvement would require more import compression than otherwise. If there is some rigidity of real wages, unemployment would probably increase.

The question remains as to how the benefits to the developing countries of liberalization (or possibly of protection) by the developing countries themselves are affected by the protection policies of the industrial countries.

Firstly, protection by developing countries can conceivably be used as a bargaining device to reduce industrial country protection. Sometimes it may then be justified to postpone unilateral liberalization if there is a chance that a good reciprocal bargain could be struck. But the possibility of using a system of protection as a bargaining chip is a doubtful argument for providing protection in the first place. Protection generates domestic interest groups that will oppose liberalization and that will not be happy to see the basis of their profits and employment transformed into a bargaining chip, even if scope for such bargaining exists.

Secondly, the threat of import restrictions by industrial countries can justify voluntary export restraints (VERs), which are themselves a form of trade-restricting intervention. VERs are acceptable to developing countries either because they provide a means of improving the terms of trade or--more commonly--because the alternative is the imposition of import restrictions by the importing countries themselves. With VERs the excess profits at least go to the developing countries' exporters or, alternatively, to their governments in the form of revenue from export taxes or the sale of quota rights.

As noted earlier, there is no argument here for the imposition of general restrictions on imports by developing countries. Nor is there an argument for general restriction of exports to all destinations. The argument is only for restraints in particular cases where there is a threat of import restrictions by developed countries.

Returning to the main issue and leaving aside the voluntary export restraint cases, which apply only to a limited group of products, if *tariffs and import restrictions in industrial countries are* given and unaffected by how much protection there is in developing countries, they do not alter the case for liberalization by developing countries.

This conclusion ignores terms of trade effects, which may produce some gains for one group at the expense of the other group. But such gains for developing countries would only be short-term, since developing countries are relatively small in supplying total world consumption, other than in the case of a limited number of products. The major exception, of course, is oil. Hence one should not expect much medium-term gain in the terms of trade to result from their intervention policies.

## VII. Issues for Discussion

The issue that runs right through this paper is whether there are valid arguments for protection from a national (as distinct from a sectoral or an international) point of view. Since actual policies are often claimed to be motivated by national interest considerations this has also been the main focus of this paper.

Even when protection might be in the direct national interest it may well not be in the international interest, for example, when it succeeds in improving one country's or one group of countries' terms of trade on a long-term basis, so that the benefits are obtained at the expense of other countries. The widespread concern about a protectionist revival in major industrial countries is that it will affect the world system leading to a cycle of retaliation and breakdown of orderly trading arrangements and especially of the GATT system (which has already happened in agriculture and clothing and textiles). But if such a revival of protectionism is to be prevented, and movement towards liberalization encouraged, there has to be an acceptance by governments and legislators that free or freer trade generally yield rather direct national benefits.

Given, then, a concern with national interest considerations, the following selection of issues might be of particular interest:

1. Issues concerning protection by industrial countries (in a floating exchange rate system)

a. Would an increase in protection (notably in the United States, where this argument is currently prominent) improve the current account? If, as suggested in this paper (Section III.1), there is no strong presumption that with floating exchange rates it would do so, should the Fund lay stress on the weakness of this particular macroeconomics-based argument for protection in its discussions of current account issues? The central point has been made many times, and perhaps the question is what more the Fund could do to increase general understanding of this issue.

b. The point has been made in this paper (Section III.2) that from a national interest point of view protection cannot be justified even when, in a floating rate system, the exchange rate is in some sense "misaligned" (i.e., departing from a presumed medium- or long-run equilibrium) or is unduly unstable. The Board may wish to discuss this argument. But the further issue arises that, if unstable or misaligned exchange rates do in practice lead to more protection there may be an argument for fostering more real exchange rate stability and avoiding misalignments (if the latter could be defined) than otherwise. In other words, should the threat of a protectionist revival influence macroeconomic policies and, in particular, policies that affect exchange rates?

c. Directors may wish to discuss the popular argument (discussed in Section III.4) that protection can be justified by a need to maintain employment, and thus that liberalization would generate unemployment - i.e., that jobs lost in some industries would not be compensated by jobs gained elsewhere. This issue is also, of course, relevant for developing countries.

d. Agriculture and clothing-and-textiles stand out as areas of high protection by developed countries. Agricultural protection (which includes subsidization of exports) is very damaging to some developing countries, notably, though not exclusively, exporters of sugar. Of course, it is also damaging to developed country exporters that have a comparative advantage in temperate zone products. The Multifiber Arrangement actually discriminates against developing countries, and is especially harmful to new and potential exporters. In addition, protection in these areas imposes considerable costs on domestic consumers (and the implicit consumption taxes tend to be regressive). Can any arguments be advanced in defence of these particular areas of protection, bearing in mind that they clearly offend against the principle of comparative advantage and that the infant industry argument surely does not apply? Perhaps the main explanation can be found in the successful pursuit of sectoral interests at the expense both of the national interest and of the interests of relevant foreign suppliers. Can effective ways be found to reduce protection in these priority areas?

2. Issues concerning protection by developing countries

a. Are tariffs and export taxes acceptable for fiscal reasons even though they may have protective effects as by-products? It has been noted (Section IV.3) that there could be conflicts between short-term revenue-raising and long-term resource allocation objectives. If protective effects are to be avoided, tariffs need to be supplemented by taxes on domestic import-competing production.

b. Are tariffs or import quotas for infant-industry reasons still acceptable? Here note might be taken of the argument (in Section IV.1) that, even if there is to be infant-industry protection (or "promotion") it should not just be for sales to the home market but should also foster exports. Methods of assistance which are not trade-restricting should be used. There may be a case for export subsidies or, preferably, other forms of more direct assistance.

c. Is there any role for tariffs and import quotas when the current account needs to be improved in a developing country, or should full reliance be placed on exchange rate adjustment combined with real expenditure reduction? Note should be taken here of the short-term argument concerned with real wage rigidity and of the medium and long-run costs involved. This is perhaps the most important single issue raised in this paper (in Sections VI.1 and VI.2).

d. What is an opportune time for trade liberalization and, in particular, should it take place at a time of balance of payments difficulties? Should it be gradual or sudden? What should be the sequencing of devaluation relative to trade liberalization? It has been suggested in this paper that the exchange rate should be adjusted first. How can trade liberalization be brought about when membership of a currency zone makes it impossible to alter the exchange rate? Finally, how should trade liberalization be related to capital market liberalization? (All these liberalization issues are discussed in Sections VI.3, VI.4, and VI.5).

e. Does protection in industrial countries justify protection by developing countries? It has been argued in this paper (in Section VI.6) that it does not. Industrial countries certainly set a bad example, though their protection is generally not as wide-ranging as that by most developing countries and their markets are still quite open.

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