

# III Protection and Macroeconomic Issues

## Impact on Current Account

It is a popular misconception that protection in the form of tariffs or import quotas must necessarily improve a country's current account. This view is frequently put in connection with the U.S. current account deficit. It 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. In the United States, however, the exchange rate is endogenously determined in a floating rate system. It can be shown that, in due course, 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, unless capital flows (or short-term expectations, as discussed below) change, 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.

Unless official intervention in the foreign exchange market leads to a change in foreign exchange reserves, the current account deficit can only improve if there is reduced net capital inflow, since the ex post current account deficit must be equal to the capital account surplus. But net capital inflow depends on the balance between savings and investment, private and public. A major factor influencing this balance is, of course, fiscal policy. One must then ask whether there is any reason for savings or investment to change as a result of an increase in protection.

There are various possibilities. For example, an increase in protection might stimulate investment in protected industries more than it discourages investment in industries that are adversely affected by appreciation, so that overall private investment would rise, and for this

reason the current account might worsen. Of course, overall investment may decline so the current account could improve. Similarly, savings might rise or fall, either improving or worsening the current account. It will also be noted below that, with the receipt of more tariff revenue, the fiscal position might improve, and this would tend to improve the current account. If the overall level of demand for home-produced goods increases and there were initially underutilized labor and capital—so that real incomes would rise as a result—savings would be likely to increase, and this would also tend to improve the current account. While protection will indeed normally increase the demand for home-produced goods, appreciation will have the opposite effect, so this effect might go one way or the other, holding macroeconomic policy constant. The conclusion is then that the current account outcome could go either way and must be consistent with the savings and investment changes that can be expected.

There is a qualification to the conclusion that protection must lead to appreciation of the exchange rate. This qualification applies purely in the short run, before protection has any sizable effect on imports. The exchange rate depends in the short run above all on expectations in asset markets. Indeed, such shifts in expectations are usually the causes of the exchange rate instability that may have given rise to the protectionist pressures. An increase in protection, or the prospect of such an increase, could bring about changes in expectations—whether rational or not—which then depreciate the exchange rate for a time. But in due course the factors discussed above, bringing about appreciation, are likely to come into play, and it is surely more likely that an increase in unilateral protection would lead to the expectation of appreciation (relative to what might have happened to the exchange rate otherwise), and hence, in anticipation, to some immediate appreciation. Of course, if protection were expected to lead to foreign retaliation or, for some reason, to a reduced demand for the country's bonds and equities relative to foreign claims, the expectation of depreciation, or of lesser appreciation, might be rational.

It has been suggested that a uniform ad valorem tariff (import surcharge) might deal with the U.S. current

account problem.<sup>5</sup> The argument is that, because the tariff would be uniform, it would not distort resources within the import-competing sector. It would, of course, favor import replacement relative to exporting, and this is presumably not denied by the advocates. The central issues are 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 rather than leading to reductions of other taxes or to greater government expenditures. Any measure that reduces the budget deficit and does not have offsetting effects on private savings or investment would improve the current account. It represents a change in fiscal policy. 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, and this would tend to worsen the current account.

But the uniform tariff would be a highly inefficient policy instrument. First, it would have the disincentive effects that are generally associated with taxes, effects that cannot be avoided if there is to be a rise in taxes of some kind or other. Second, it would distort the pattern of resource allocation between import substitution and exporting and hence reduce the gains from international trade.

A more complex consideration is that it 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. In other words, uniform nominal protection would yield a system of effective rates that would not be uniform and that would thus lead to misallocation of resources within the import-competing sector. This issue is discussed further below with respect to revenue tariffs. If commodity taxes are to be preferred to increases in income tax rates, then it could be shown that a given amount of revenue can be raised with less distortion by a general tax on consumption or output (such as a uniform value added tax) than a uniform tariff.

To all this must be added the important consideration that a wide-ranging increase in U.S. protection is highly likely to provoke retaliation from other countries, as well as setting an undesirable precedent, especially at a time

when a new round of multilateral trade negotiations has recently been launched.

It is worth considering the case of implementing a protectionist policy when the exchange rate is fixed, or at least is not readily adjusted, though this case will be discussed more fully in Section VI in connection with balance of payments policies of developing countries. In this case an increase in protection is more likely to improve the current account even when the fiscal deficit does not change. Of course, either an increase in savings, or a reduction in investment or the budget deficit would be required for a current account improvement to result.

Since protection switches the pattern of demand toward home-produced goods, if there is initially excess capacity and underutilization of labor, aggregate output and hence incomes would rise. This would, in turn, lead to a rise in savings as well as tax revenues, and if this is not offset by a rise in investment induced by the greater profitability of import-competing industries or by an increase in government expenditures, it would then lead to a current account improvement. If there is initially no excess capacity and readily available extra labor supply, excess demand would arise when protection switches demand toward home-produced goods. If domestic prices rise as a result there will have been a real appreciation—an increase in the level of domestic relative to foreign costs—which would offset the effects of protection on the current account just as in the case of a flexible nominal exchange rate discussed above.

But it seems more reasonable to suppose that in these circumstances macroeconomic policy would prevent the excess demand or inflation, and that fiscal or monetary policies would reduce demand for home-produced goods to offset the greater demand for home-produced goods resulting from the increase in protection. As far as possible, a net rise or fall in the pressure of domestic demand would be avoided. This might be described as maintaining the domestic macroeconomic outcome (or “internal balance”) unchanged. Aggregate demand would be reduced either by a fiscal contraction or by a monetary contraction that reduced private investment or consumption. It follows that there would again have to be a rise in savings or fall in investment, public or private, if the current account were to improve.

Finally, two qualifications to the previous discussion might be noted. First, tariffs and quotas imposed on imports that are components or materials used in other industries will raise the costs of the latter. Thus some export- and import-competing industries which use these imports or their close substitutes as inputs will find that their costs have increased, and thus their contributions to the balance of payments will be affected adversely. This may, of course, be offset by favorable effects for the industries that are directly protected. Second, if protection takes the form of voluntary export restraints by

<sup>5</sup>The proposal has been put forward at various times in the public arena, as also by Professor Branson of Princeton University. See Branson in Stern (1987). The proposal is analyzed in detail by Klein, Pauly, and Petersen, using Project LINK, in Salvatore (1987).

suppliers, 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 prices of Japanese autos in the United States). The conclusion is that, even if the exchange rate stayed fixed, the current account may conceivably not improve as a result of an increase in protection and the exchange rate may not appreciate in a floating rate system. But these complications are unlikely to have a dominant effect on the outcome when a widespread system of tariffs and quotas is introduced.

## Protection and Exchange Rate Instability

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 countermeasure. 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, for reasons discussed above, an increase in protection is likely to cause the exchange rate to appreciate more.

Thus protection provoked by real appreciation will bring about even more real appreciation. Hence the benefits for particular protected industries will be achieved by making the problem worse for other import-competing or export industries. Protection will concentrate the adverse effects of the appreciation more on those tradable industries that do not get protection, usually the export industries. If an industry competes both with imports and exports, it may gain at one end and lose at the other. In addition, because of the distortion of resource use caused by protection, there will be a net loss for the economy as a whole.

Even if an exchange rate is in some sense wrong or "misaligned" (perhaps because the market has misjudged the implications of macroeconomic policies) it does not justify protection. If the real exchange rate is too appreciated, the supply of nontradables is 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, notably the export industries, and creates further distortions. Under certain circumstances a tariff could offset some of the distortionary effects of the misalignment (a second-best argument), but broadly one can say that an optimal or nondistorted allocation of resources within the tradable sector as a whole (which combines export and import-competing industries) 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 exchange rate misalignment or by

medium-term real exchange rate instability. For any given current account balance and average price of tradables relative to nontradables there is still an optimal allocation of resources within the tradables sector and, subject to various qualifications to be discussed later in this paper, this will be attained by free trade. Specifically, the real appreciation of the dollar in 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 appear to have generated valid new arguments for protection.

The conclusion is thus that neither real exchange rate "misalignment" nor medium-term instability justifies protection. Nevertheless, they 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.<sup>6</sup> There have been three occasions when the United States has lost competitiveness, namely 1969–71, 1976–77, 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, as protection increases when the dollar appreciates, and this is not reversed when the dollar depreciates later.

Apart from the asymmetry, it is clear enough that the appreciation up to 1985, and possibly also the current account imbalance itself, has been an element in the revival of protectionist pressures 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 to stabilize real exchange rates, and in the conditions of 1985 and possibly later, 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 or even of all import-competing 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

<sup>6</sup>Bergsten and Williamson (1983).



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.

### Protection and Macroeconomic Policy Coordination

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. The more that severe real appreciations can be avoided in the short run, the less pressure will exist for protection. One important role of macroeconomic policy coordination is to moderate or even avoid such medium-term real exchange rate instability. Furthermore, for reasons discussed below, high employment levels and high growth rates in the industrial countries will also help, and macroeconomic policy coordination should also contribute to these objectives.

Conversely, it is not necessary to have world free trade or even liberalization 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 tariffs, export taxes, or export subsidies) will make trade less responsive to exchange rate changes because the impact of relative price changes will be reduced. Bigger exchange rate changes than otherwise would be needed to achieve any particular desired or required effect on trade volumes. If a country moves into budgetary deficit and this then requires an increased current account deficit to avoid crowding-out of domestic investment, the exchange rate appreciation that will be needed will be greater when there are widespread quotas than when the effects of a relative price change are allowed full reign. Any given divergence in fiscal policies between countries will thus lead to more real exchange rate instability than would result from a nonrestrictionist regime. Hence the need for policy coordination to avoid fiscal policy divergences becomes greater.

### Protection, Unemployment, and Recession

High employment and growth make widespread liberalization much easier and more acceptable. This is

widely recognized. It seems reasonable to conclude that postwar prosperity in Western Europe was not only helped by the gradual internal liberalization in manufacturing trade associated with the 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. This would be the first best approach because it is the most direct approach to the problem. Protectionist measures are inappropriate. With flexible real wages and a fixed exchange rate, an increase in protection—which would switch demand away from foreign and toward domestic goods—would normally moderate the domestic effects of a recession, but it would be a second-best (or worse) device because it would engender further distortions by favoring import-competing relative to export industries, as well as generating the other costs of protection to be discussed later.

General unemployment may be caused by a deliberate policy of demand contraction designed to reduce the rate of inflation, as occurred after 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 aspect of policy will be obstructing the objective of another aspect, and in the process a new distortion will be imposed. While the contractionary macroeconomic policy is likely to be only short term, once imposed, protection is difficult to remove, so that the distortion cost may be long term.

A recession may be imported from abroad through a decline in export demand, leading also to a current account deficit. The appropriate policy response is likely to involve real depreciation. The role, if any, of increases in protection in these circumstances will be discussed below in connection with developing countries, bearing in mind that in the 1930s many countries did respond to the decline in demand for their exports with increased protection.

Unemployment may be caused by 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 in industries using protected goods as inputs, and hence reduce employment there. More important, they would raise the cost of living. If indexation policies are in effect there would then be an increase in nominal wages so as to maintain the original level of real wages, and the rise in wage costs, in turn, would lower employment in those industries where protection has not increased.

Thus both positive and negative employment effects would result from protection. 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 (via tariffs or quotas) would still impose distortion costs that must be set against these gains. Furthermore, it is possible that the real wages sought and obtained by trade unions would rise if employment increased, so that some of the possible employment benefits of protection or subsidization in particular industries would disappear.

On balance, protection designed to increase employment when unemployment is caused by real wage rigidity is hardly justified. Protection may not succeed in increasing overall employment even if it does increase or preserve employment in protected industries. And if it does increase overall employment, it is normally an

inappropriate way of achieving this outcome. It also follows that trade liberalization should not necessarily be postponed because there is classical unemployment. Policy should concentrate on the first-best method 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 higher protection cause a depression? The coincidence of the world depression with the highly protectionist Smoot-Hawley tariff in the United States in the 1930s—and the increases in protection which it provoked by way of retaliation 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 are probably sufficient for explaining the Great Depression. It is likely that the vast increases in protection in the 1930s had adverse effects on confidence and also stimulated defaults of some commodity exporters. Furthermore, declines in real incomes were exacerbated. This was particularly so in the commodity-exporting countries. 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 probably caused higher protection, at least outside the United States, more than the other way around.<sup>7</sup>

<sup>7</sup>A fuller discussion of this issue is in Eichengreen (1986).