IMF WORKING PAPER

WP/88/101

INTERNATIONAL MONETARY FUND

Research Department

Trade Policy and Macroeconomic Balance in the World Economy

Prepared by W. Max Corden 1/

Authorized for Distribution by Jacob A. Frenkel

November 23, 1988

Abstract

The paper explores the relationship between trade policy and current accounts. The effect on the current account of a change in protection at home and then abroad is analyzed, assuming that the exchange rate floats. The "savings-and-investment approach" is used. It shows that there is no presumption that protection would reduce a deficit. With a fixed exchange rate, the effect on savings and investment is brought about by the reduction in absorption that is required to maintain internal balance when restrictions are imposed. A current account deficit or real appreciation may generate protectionist pressures stimulated by "conservative resistance."

JEL Classification Number:
JEL 322

1/ Paper presented for the Symposium in Honor of Isaiah Frank, held at the School of Advanced International Studies of the Johns Hopkins University in Washington, D.C. on October 21, 1988.

Contents

Summary

The paper is concerned with the relationship between trade policy and the current account. First, it asks whether protection can be presumed to improve a country's current account given a floating exchange rate regime. Increased protection would normally lead to appreciation and can affect savings and investment in various ways. Notably, a tariff brings in revenue, which, if not spent, can reduce the budget deficit. Because of other possible effects (e.g., higher investment in protected industries), however, the presumption that the current account will improve is not necessarily valid. Furthermore, even if lowering protection abroad (say, in Japan) reduced the surplus there, this reduction would be likely to diminish the U.S. current account deficit only by shrinking U.S. investment.

If the exchange rate is fixed and the country is initially in "internal balance," protection will improve the current account because of its effects on savings and investment through the reduction in expenditure required to maintain internal balance when import restrictions are imposed.

A current account deficit may increase pressures for protectionism because of "conservative resistance,"--that is, pressure groups in the tradable-producing sectors will resist losses in real incomes. Through the real appreciation that results, protection than tends to put at a disadvantage producers of tradables who are unable to obtain adequate protection. But it is possible that conservative resistance is stimulated not so much by a current account deficit as by real appreciation--and these may not go together--or by a boom in exports from particular countries, especially if these exports are concentrated in particular products not associated with current imbalance at all.

The paper goes on to other questions. Is a current account deficit, as such, a problem? How should its possible stimulation of protectionism affect macroeconomic policy? Finally, the paper sketches various ways in which trade tensions may originate in macroeconomic developments in the future.