Trade Liberalization, Protectionism and Interdependence is published today by the GATT secretariat as a staff paper in the series "GATT Studies in International Trade".

For nearly three decades following World War II, the international economy enjoyed unprecedented growth and prosperity. Much of the credit for this has been attributed to the reversal of the inward-looking economic policies followed in the 1930's. The key feature of the successful international economic policies applied in the postwar years, according to the study, was the liberalization of national economies within a global system of rules designed to promote trade and investment. Recently, however, faith in these policies has been undermined. Increasingly, it is being suggested that the growth of international economic interdependence may have reached a point where it brings more problems than benefits.

The purpose of the study is to consider whether these doubts about the benefits of interdependence are justified. The authors recognize the reasons that have led to present calls for a halt to trade liberalization and even to outright demands for new trade restrictions. But they conclude that the case for a continued growth in interdependence - in their view only a new expression for Adam Smith's 'international division of labour' - is still compelling.

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"Trade Liberalization, Protectionism and Interdependence" is divided into three main sections. The first reviews and explains long-term trends in world production and trade. It points out that the relative importance of international trade in domestic economic activity has tended to be exaggerated by the ratios traditionally used to measure it, and concludes that the scope for further growth in mutual trade exchanges is very substantial. The second section of the study outlines the case for further trade liberalization, paying particular attention to the contribution of liberalization to efficiency and growth, to its auxiliary role in the fight against inflation, and to its impact on employment and macroeconomic stability. The final section, "The Economics and Politics of Protectionism", is largely concerned with current protectionist pressures. It argues that these pressures, reflecting a refusal to adjust to changing patterns of supply and demand, are as much a cause as a consequence of the recent economic difficulties of the advanced economies. "By accepting the view that only a more vigorous growth of these economies will make it possible for them to return to freer trade, we might be locking ourselves into a vicious circle."

The study concludes that "the main danger of protectionism is that it exploits and fosters a misconception of a society's internal and external interests which, properly defined, cannot be in conflict; and that it feeds on a misunderstanding of the true consequences of the different policies by which governments try to secure these interests".

The study's authors, Richard Blackhurst, Nicolas Marian and Jan Tumlir, are senior economists of the GATT secretariat.

The aim of GATT Studies in International Trade is to make publicly available the results of some of the work undertaken by the staff of the GATT secretariat. They are published on the initiative of the secretariat. The views expressed are those of the authors alone and do not necessarily reflect the views of contracting parties to the General Agreement on Tariffs and Trade or of the secretariat of GATT. The purpose of the studies is to contribute to the discussion and understanding of current issues in the field of international trade.

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The following is a brief guide to the contents of the study:

Introduction

Scepticism about the benefits of economic interdependence has spread since the late 1960s. One reason has been the experience of the worst world recession in forty years. A second is the concern about the security of essential supplies.
Third is a more general fear that the growth of international trade may have reached a point at which it erodes the ability of governments to pursue desired goals and policies: the study links this fear with growing uncertainties about the working of the rules and disciplines which are essential if economic growth is to be sought through international specialization.

I. Long-term trends in production and trade: causes and implications

This chapter of the study notes that 1913 was a turning point after a long period of world economic progress. Over the following 35 years, to 1948, world production increased in volume at an average annual rate of around 2 per cent, while world trade grew only about one-quarter as fast. World trade per person actually declined, and with it the degree of specialization in the world economy. This trend was strikingly reversed after 1948, and from 1948 to 1973 the long-run growth rate of world trade considerably exceeded that of production. However, most of the growth in the ratio of trade to national income in the post-war period "only offset its decline between 1915-1948".

Three major, interacting, and still-influential factors go far to explain the postwar expansion of trade. Institutional developments - the early establishment of the IMF and GATT, and subsequent liberalization of trade and payments - provided an environment in which international traders were offered a degree of security and predictability in world markets that was unknown in the inter-war period. Technological advances, both reducing costs and increasing the variety of goods, also encouraged international trade and specialization. Trends in manufacturing employment in industrial countries have favoured a rapid growth in their imports of labour-intensive manufactures from developing countries.

The study notes that a feature of trade in the postwar period has been the increasing importance of imported inputs in production and - by implication - in exports. A rising import content means, it points out, that the domestic value added content of exports is declining. Because of this trend, the traditional use of the ratio of exports to national income as a measure of dependence on trade is unsatisfactory, since the export figure includes both previously-imported inputs and also some exports which, in altered form, may later be re-imported. It thus overstates the relative importance of trade in domestic economic activity. It is also an unreliable guide to the relative trade-dependence of different countries and to trends over time.
Nearly two-thirds of the total increase in world trade in manufactures between 1955 and 1973 is accounted for by the expansion of trade within Western Europe and within North America. Trade between Western Europe, North America and Japan accounted for less than 25 per cent of the total increase, and imports by industrial countries from developing countries for only 11 per cent. This implies that there remains considerable potential for greater specialization between the three major industrial areas, and between them and the rest of the world. "When it is further noted that for most countries trade in manufactures continues to represent a relatively small proportion of total domestic production of manufactures, the untapped opportunities for greater international specialization appear truly impressive. And the pressure will be there, for the technological and demographic trade promoting factors will be at work for the foreseeable future."

II. The issue of further reductions in barriers to international trade

This chapter begins by considering the benefits to be expected from further trade liberalization, and then analyzes four arguments commonly employed to question or oppose efforts to increase the international division of labour.

The study stresses that it is misleading to approach the question of protectionism versus trade liberalization in terms of their impact on exports and on imports, or on employment. What counts is the extent to which resources are, as a result, more productively used: changes in trade barriers affect the efficiency with which resources are used, but not the level of their utilization. It is also pointed out that the importance of trade liberalization is independent of whether exchange rates are fixed or floating; however, it is crucial to progress on trade liberalization that rates should not be manipulated to prevent effective balance of payments adjustment or gain unfair competitive advantage.

The study notes five sources of gain from trade liberalization. Three are familiar: consumption gains (the total net gain to consumers exceeding the transfers from other groups), production gains through allocation of domestic resources into more efficient employment (often, however, remaining in the same industry because of specialization), and economies of scale. A fourth type of gain is from a more competitive domestic economy, in which national producers can reach optimum efficient size while still being subject to desirable competitive influences. Fifth, liberalization - and continuing competition from imports - contributes to domestic price stability.
The authors believe that the decline in interest in trade liberalization owes little to the traditional "terms of trade" and "infant industry" arguments for protection. They identify four major arguments used today, of which the first two seem particularly important:

(i) effects of liberalization on domestic income distribution. As far as adjustment effects are concerned, the study argues at some length that these are transitional, and that the main solution lies in appropriate adjustment policies. It notes however certain major biases in the political process which result in undue weight being given to adjustment difficulties when trade policies are being considered by governments. Trade liberalization is recognized as having permanent effects on income distribution (for example by lowering food prices in general while reducing the incomes of landowners), but it is argued that more efficient methods than protection exist for achieving desired permanent redistribution effects.

(ii) the impact of 'openness' to trade on macroeconomic stability. This argument for protection involves a fundamental questioning of the longer-run economic benefit of further trade liberalization to society as a whole, because of the resultant increasing vulnerability to imported macroeconomic disturbances. The authors conclude that in general a large foreign trade sector normally acts as a buffer against economic disturbance, and that the exceptional recent experience of a synchronized international trade cycle seems unlikely to recur. This argument for protection is also undermined, in their view, by the abandonment of fixed exchange rates.

(iii) excessive dependence on imports. This traditional argument has gained greater currency because of worries about embargoes and the future adequacy of world supplies. Among points reviewed are the relative costs of stockpiling rather than permanently protecting an inefficient industry, the likely effectiveness and relevance of cartels and the general desirability of maintaining decentralized and competitive sources of supply.

(iv) protecting a national way of life. The study notes that this non-economic argument has a long tradition. However, in its present form it tends to stress the need, not for preserving a quiet semi-rural or pastoral lifestyle, but for having a large industrial sector; the study concludes that trade-restrictive policies are not the best way of achieving this particular end.

III. The Economics and Politics of Protectionism

This final chapter develops two sets of arguments, the first economic and the second concerned more with political dynamics, to suggest why the present strong protectionist pressures are likely to persist.
In the first part of the chapter, the authors identify the main products affected by recent trade restrictions, and note that although it is impossible to measure the extent or degree of these restrictions, the most frequently used have been the bilaterally-negotiated exporter’s ‘voluntary’ self-restraint and the orderly marketing agreement. While the sudden increase in protectionist pressures is clearly related to the inadequate recovery from the 1973/75 recession, the malaise seems to have its roots in a number of structural weaknesses and maladjustments of much earlier origin.

The coincidence of high rates of inflation and unemployment, indicating adjustment difficulties, dates from the 1960’s; at the same time the growth of real wages overtook that of productivity in most industrial countries, and the growth of manufacturing employment and investment decelerated. The authors consider that trends in the growth and composition of the labour force in industrial countries make it unavoidable that employment in some of their industries will undergo absolute decline. The study focuses on the role of wages in the process of international adjustment, arguing that too much attention is given to the gap in wage levels between exporting and importing countries, and not enough to the rigidity of wage differentials within the importing country. This rigidity increases the vulnerability of declining industries to foreign competition, and hampers dynamic industries in attracting skilled labour needed for expansion.

The authors trace the evolution of a number of major difficulties encountered in international trade since the early 1960’s, and argue that these have loosened the system of rules under which the postwar economic expansion took place.

They consider that these developments have in common a refusal to adjust to change. While initiated by private interest groups, this resistance to change has been made effective through the support of governments which have introduced protective measures whose effect has been to avoid adjustment, which in turn has inhibited economic growth. The study suggests that in introducing these measures governments have overestimated their ability to direct the economy so as to produce a desired rate of growth, and have underestimated the effects of such measures in creating vested interests and bad precedents as well as in damaging the position of developing countries.

The second part of the chapter, on "Equity issues and domestic politics of protection" develops the argument that tariff protection, provided it is not increased over time, is less damaging to economic growth than protectionism: "a policy of increasing the level of protection, relying heavily on quantitative restrictions, and often creating additional uncertainty by imposing and administering these obstacles to trade in a non-uniform, discriminatory manner."
Three major and interacting equity issues raised by protection are discussed. The first concerns the distribution of the domestic costs of protection over society. It is pointed out that these costs fall unevenly on particular consumers and industries, including export industries, and that the problem of inequity will grow as protection is increased. The second issue arises from the reactions of other industries to the grant of protection to one industry. The study argues that, in the absence of objective criteria to determine the degree of protection an industry requires, any grant of protection leaves a government defenceless against claims by industries less favoured. The same argument leads to the view that the concept of "organized free (or liberal) trade" implies a large degree of centralized government planning. Finally, external equity problems arising where protection takes the form of bilaterally negotiated restraints are considered. The study suggests that such restraints involve economic and political costs to both the protecting and the exporting country.

The study concludes that the over-all stability of economies depends on their spontaneous and speedy adjustment to the inevitable constant changes in economic conditions. "Non-adjustment cumulates, maladjustments grow, until a correction is enforced by a more or less severe breakdown, the repercussions of which often spread far beyond the particular industry, sector, or even economy." Structural change is also necessary to create a supply of jobs "matching the talents, educational attainments and the changing occupational preferences of the population." Without adequate and spontaneous growth, the study argues finally, peaceful co-existence of nations would become increasingly difficult.

To cope with the new protectionism, the study suggests, will require government policies directed towards reducing economic uncertainty, a key factor affecting investment and prospects for economic growth. These policies should include "an affirmation and clarification of the rules to be observed in policies governing international transactions."

In the longer run, there will be scope for a more direct rôle of government in providing incentives to adjustment. And, "last but not least", governments have a responsibility to help the public understand the consequences of different trade policies.