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The New Protectionism and the Nature of World Trade*

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1. INTRODUCTION

Despite multilateral efforts since World War II to lower barriers to trade among countries, there is ample evidence that protectionism is still a powerful force serving to inhibit the exchange of goods and services. It is the case that tariff levels have been drastically reduced–for industrial countries from an average of 40 percent in 1947 to less than 5 percent today.[1] However, in recent decades a variety of non-tariff barriers to trade has mushroomed in popularity and the tendency to favour regional trading areas implies discrimination among countries in trading relationships, counter to the basic multilateral approach and most-favoured-nation treatment sponsored by the various GATT negotiating sessions. The increased pressures for protectionism have in recent years been fueled by the world recession, on occasion utilising the rhetoric of the "new trade theory", with its emphasis on the existence of imperfectly competitive markets.

It is a common observation that the volume of world trade has expanded rapidly in the past half century–even relative to world output.[2] This could be taken as *prima facie* evidence that protectionism is fighting a losing battle. Such a conclusion would not be supportable if there are forces in the world tending naturally to lead to more open trade, in which case protectionism may only be slowing this trend. This is indeed the case, and I wish to argue that the nature of world trade is systematically changing: The fraction of trade represented by final consumer goods is becoming smaller, replaced by increased trading activity in goods-in-process, raw materials, and capital goods. Some estimate the share of intermediate goods and capital goods in trade now as high as 80 percent.[3] In what follows I wish to discuss

*Owing to unavoidable circumstances, the second discussant's comments on this paper have not been received.

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[1] *The Economist*, Feb. 20, 1988, p. 81.

[2] Yearly data from 1983 show growth in world trade exceeding growth in world output by more than 30 percent on average. See GATT, *International Trade 90-91*, vol. II, p. 1.

[3] See Jacob Kol, "Allyn Young Specialisation and Intermediate Goods in International Trade" (1988), unpublished. Kol cites a Cairncross set of estimates for the first half of the 20th century whereby the share of consumer goods in trade fell from around 60 percent in 1899 to less than 33 percent in 1950.

moderated once it is realised that a (large) country can often gain by restricting trade, a standard observation in traditional trade theory. In a competitive setting the country's firms cannot individually gain by such a move–they are too small–so it is up to the government to intercede. By contrast, a large imperfectly competitive firm is capable on its own of cutting exports. In the Brander/Spencer scenario the firm is too exuberant in restraining trade; the role of government is once again to see that trade is restricted optimally, but this now entails a subsidy to encourage a slightly less restrictive posture by the country's firms.[7] At the practical level governments are often encouraged to pick national "winners" to support by subsidies. I shall come back to this point below.

Two major trading blocs are now developing: the Economic Community in Europe, which keeps attracting new entrants while suffering difficulties in getting agreements on monetary union and other provisions of the Maastricht Agreement, and the proposed North American Free Trade Area, which would add Mexico to the agreement entered into by Canada and the United States in 1988. (For Canadians this was a bitter issue, dividing family against family in the Federal elections that year.) Some commentators fear that Japan will form yet a third group, but at this date there is no evidence of such a move. The relevant question, to which I shall return later, is whether the attraction of regional arrangements betrays yet another form of protectionism, or whether it should be treated as a step towards freer trade.

3. THE RECENT AMERICAN RECESSION

During the recent American recession probably no event served to crystallise in the popular mind the connection between trade policies, balance of payments deficits, unemployment, and the changing nature of trade more than the trip in January, 1992, of President Bush to Japan. The American public was getting saturated with the phenomenon of "Japan-bashing", encouraged partly out of envy of the persistent growth performance of the Japanese economy, especially in penetrating the American market in automobiles, and partly because perennial bilateral trade deficits with Japan suggested there was something "unfair" about Japanese trade policies. Ironically, on the way to Tokyo President Bush made a stop-over in Australia, where criticism levied against the United States might have been taken from one of President Bush's speech writers complaining about the Japanese: The United States was running a trade surplus with Australia and American regulations were keeping Australian food products (mainly beef) out of the American market. Many trade economists are puzzled by the insistence that a bilateral balance be

[7]As pointed out by Jonathan Eaton and Gene Grossman in "Optimal Trade and Industrial Policy under Oligopoly", *Quarterly Journal of Economics*, 1986, vol. 101, pp. 383–406, other forms of imperfect competition could call for the government to supplement private action by taxing trade. In all these cases the net outcome is still restrictive trade as compared with the free-trade competitive outcome.

achieved with each country, in each time period. The advantages of trade lie precisely in the exchange of one product for another, and this can balance multilaterally *and* intertemporally. Narrow bilateral balances would kill many of the gains from trade. In the case of the automobile industry the concern for bilateral balance seemed to go further–that the Japanese should purchase more American cars and parts to make up for the Japanese having claimed around 30 percent of the American market.

As President Bush left for Japan he emphasised that he was concerned about "jobs, jobs, jobs". In my view trade economists have always been at a disadvantage when the link between trade restrictions and employment is raised, since a tariff or other restriction designed to protect a firm or industry has an obvious effect in saving the jobs of those there employed. With general equilibrium spectacles, the economist can see what the public only dimly perceives–that trade restraints also hit exporting sectors, and indeed may invite retaliation. The trade wars of the 1930s clearly illustrate the point. But the changed nature of trade, with more exchanges of intermediates and the global fragmentation of the production process, has served to confuse old-fashioned protectionists. An interesting example occurred in a suburb of Rochester, N.Y. at the time of President Bush's trip. During the previous winter the Rochester area had been hit by a tremendous ice storm that damaged a large fraction of trees in the area and called for huge removals of debris. The town government had planned to purchase a Komatsu excavator, but changed its mind in the midst of the publicity over the President's trip to Japan. Instead, it decided on a machine made by the John Deere company. You can imagine its embarrassment when it found out that the John Deere was made in Japan–and most of the Komatsu was made in the state of Illinois.[8] At about the same time, the *Wall Street Journal* made a survey of automobiles to find which was most American. The answer was the Honda, with a big plant in Marysville, Ohio, and accounting for *exports* of 40,000 units. Famous American-brand names, such as Pontiac, Chevrolet, and Dodge, have a higher foreign content. The *Economist* displayed a picture of local labour unions picketing a Honda sales outlet with "Buy American" signs. It becomes more difficult to decide what to be against when in a global economy foreign brand names may contain more local content.

4. GROWTH AND TRADE IN INPUTS: THE CHALLENGE TO COMPARATIVE ADVANTAGE

Underlying the great expansion in trade in intermediates, capital goods, and

[8]See the report in the *Economist*, Feb. 1, 1992. In the event, the town rented the Komatsu, and six months later purchased two Kubota tractors, made in Japan. (See the *Rochester Times-Union*, July 10, 1992.)

raw materials is the process of globalisation whereby production processes get increasingly fragmented. This is partly a reflection of economies of scale–as growth proceeds, certain tasks can be separated from others, *a la* Adam Smith's concept of the division of labour. To utilise the terminology which Henryk Kierzkowski and I recently introduced, growth in a firm's output leads to a fragmentation of "production blocs", connected and coordinated by "service links". This allows the mutual harnessing of gains from comparative advantage and economies of scale.[9] At low levels of output, such fragmentation may entail making use of purely local or national markets, but as output expands, the possibility of taking advantage of foreign production facilities with relative wages and rents quite different from those prevailing locally serves as an inducement to have some of the production blocs located abroad. Ownership may be retained by the firm as it goes multinational, or arms-length transactions involving separate foreign firms could represent a preferred route. Since some of the major technological changes in the past few decades have been in the information and communications sectors, these changes have had a significant effect in lowering the costs of coordinating production blocs in many distant locations. In addition, the great increase in trade feeds back upon itself as firms acquire greater knowledge of foreign business practices and legal procedures, thus further encouraging a lowering of the costs of service links.

Such a process of fragmentation holds out new hope for developing countries which may not have the resources, skills, or technical knowledge to establish a comparative advantage in fully integrated production processes. To the extent that fragmentation is possible, there may be some parts of the process that can be hived off to less-developed areas, thus providing labour in these areas the opportunity to acquire skills which may in the future be of advantage in other production blocs. Labour forces in Bolivia, Taiwan, and Brazil, *inter alia*, have been so used to process computer-generated data and assemble clothing or electronic output.

Although this sketch of growth and trade in inputs in the world economy may sound plausible, what is often overlooked is how far from the standard Ricardian concept of comparative advantage it leads. Much of classical trade theory, from Ricardo to Heckscher-Ohlin to specific factors models, makes a sharp distinction between inputs, which are assumed *not* to enter world markets, and outputs, which may be traded if transport costs and commercial policy impediments allow. Consider the Ricardian case, with labour trapped behind national barriers. As is standard knowledge, the absolute levels of efficiency of the labour force do not matter in determining trade patterns. This applies as well to country characteristics

[9]See Ronald W. Jones and Henryk Kierzkowski, "The Role of Services in Production and International Trade: A Theoretical Framework", Ch. 3 in R. W. Jones and Anne Krueger (eds.), *The Political Economy of International Trade* (Blackwell, 1990).

such as the amount of social overhead capital, levels of taxation and the attitude of government towards interfering in private transactions, as long as such characteristics do not have a sectoral bias (e.g. one sector taxed and the other not). But in a world in which any inputs have world markets, these national characteristics become of first-rate importance in determining which countries can attract footloose inputs. To the untrained ear this does not sound surprising, but it does serve to highlight that the Ricardian concept of *comparative* advantage for nationally-trapped factors must be supplemented by the concept of *absolute* advantage for those factors or raw materials which have extra-national market domains.[10] And the message for developing countries is mixed. On the one hand, as discussed above, fragmentation may allow entry into part of the production process. But this will not likely happen if the net productivity of internationally mobile factors is rendered too low compared with alternative production sites in the world economy. Although the doctrine of comparative advantage guarantees that every country can produce and trade *something*, this does not suffice to guarantee that it can attract production processes that make intensive use of internationally mobile factors.

In discussing what difference it makes to arguments about protection to have a world trading pattern consist in large part of inputs, a useful starting point is that of the "tariff factory". Popular for years, this is an argument that points out that if a country impedes inflows of final goods, foreign investment will be attracted, in order to "get behind" the tariff walls. Consider the benefits of such a policy for a country that is too small to affect its terms of trade, that already has imposed a tariff on such imports, and is contemplating increasing such protection (in order to attract foreign investment). Suppose real capital movements are unimpeded (no taxes on inflows of capital levied by the home country) and that the home tariff-levying country is also too small to affect capital's rate of return in world markets. If capital were immobile, an extra tariff would hurt the small country, since it reduces the volume of trade when the country buys at world prices that are lower than consumers are willing to pay at home. But, if capital is allowed to move internationally, it is attracted to the home country and imports are reduced even further. Result: an extra loss of welfare. The higher tariff sends a false signal as to productivity of mobile capital, and the small home country pays a penalty. Incidentally, if capital had been mobile in the nation's export sector, the same kind of welfare loss is incurred: the higher prices in the domestic import-competing sector serve to drive up local wages and squeeze rates of return to capital used in the export sector. Hence capital flows out, exports (and imports) fall, and the cost of protection

[10]This idea is developed in R. W. Jones, "Comparative and Absolute Advantage", *Swiss Journal of Economics and Statistics*, 1980, vol. 3, pp. 235–260.

becomes larger.[11]

This argument, although simple, fails to capture the second-best flavour of the real world in which host countries usually get first chance at taxing revenue generated by foreign investment. Thus the losses described above could be more than offset by tax revenue. This is especially the case if instead of tariff protection aimed at attracting foreign capital to produce for the (protected) domestic market, subsidies are provided which make location of production facilities at home more attractive to the foreign firm than its alternative possibilities. Such subsidies make no sense unless they are more than recovered in income tax revenues, as indeed could be the case.

5. VERTICALLY LINKED EXPORT MARKETS AND STRATEGIC BEHAVIOUR

If a country produces and exports an intermediate good or raw material that is used by foreign firms to produce commodities in which the country wishes to compete, what commercial policies should it pursue? This is a typical situation faced by many developing countries which have clear advantages in exporting at lower ends of the production process, but wish to establish secondary industries or processes further on in the production chain. It raises real questions of "strategic behaviour", both for firms that are vertically integrated and for their government's commercial policy. Suppose markets are imperfectly competitive, that a country has a decided advantage in the production or extraction of an intermediate good or raw material, and is also competing internationally in the market for a "final" good which makes use of this intermediate input. If the firm (or government) decides to raise the price it charges for the raw material, this puts the foreign firm at a disadvantage (and the national firm at a competitive advantage) in the final market. But such opportunistic behaviour comes at a cost: it restricts sales of the intermediate, and profits may be earned in this market.

Recently Barbara Spencer and I investigated this issue of appropriate policy behaviour both for a vertically integrated firm (or country) selling in two markets, in one of which it supplies its rival in the other market, and for the country (or firm) which is dependent on foreign sources of supply for some crucial input. The case which prompted our initial interest concerned the 35 percent tariff the United States imposed in 1986 upon imports of cedar shakes and shingles from Canada, destined mostly for the California housing market. The view expressed by some of the American negotiators was that this was an attempt to loosen up Canadian exports of

[11]The argument is easier to follow in a specific-factors framework, but holds as well in a Heckscher-Ohlin world. Details are found in R. W. Jones, "Protection and the Harmful Effects of Endogenous Capital Flows", *Economic Letters*, 1984.

raw cedar bolts (or logs). (American firms in the states of Oregon and Washington have access to some local cedar, but the costs of obtaining the raw resource are greater than north of the border.) A much larger market at that time also provided an example: the Japanese had developed a great advantage in computer chips, which were used as inputs both by their computer industry and by those in the United States. By raising the price of inputs to American producers, the Japanese could gain an advantage in the final goods market, albeit at the expense of semiconductor sales. Ironically, the United States complained of Japanese dumping and, as a consequence, prices of the chips were steeply raised by the Japanese. Not surprisingly, the details of any "optimal" solution depend in large part on the nature of the imperfect market, e.g. whether Cournot or Bertrand if duopolists share the final goods market. But general in any such analysis is the relationship between the market for world-traded intermediate goods and that for world-traded final goods.[12]

To cast the issue more broadly, suppose a country achieves a technological breakthrough which serves to lower the cost of an input which enjoys a world market. For example, an American firm may come up with a new development in an automobile part that is used both by American automobile firms and by those in Japan. If the "part" were really a final good directly consumed, there would be little question that the United States would gain by the increase in exports. But since it *is* a "part", questions can be raised as to the welfare spillovers between countries as foreign firms now have access to cheaper inputs used in their products competing with ours. My purpose here is to raise these questions of optimal strategic behaviour, not to answer them.

In a world in which firms and governments are concerned with strategic behaviour, what is the appropriate role for government? In particular, should governments indulge in industrial policy, trying to pick "winners" from the host of competing local industries? Americans fear that Europeans (e.g. in the aeronautics field) and Japanese are doing just that. Should they follow suit? Most analyses centre on how good a job government does in picking winners as compared to the private market. I wish to raise a different question: Suppose a government does select well–a firm or industry is subsidised and substantial sales and profits are made on world markets. This can happen. What concerns me is that in a world of fairly rapid technological change, today's winners may not be doing so well tomorrow. Then the difficult question arises–how does the government disentangle itself

[12]The papers referred to are R. W. Jones and B. Spencer, "Raw Materials, Processing Activities and Protectionism", *Canadian Journal of Economics*, 1989, pp. 469–86; B. Spencer and R. W. Jones, "Vertical Foreclosure and International Trade Policy", the *Review of Economic Studies*, Feb., 1991, pp. 153–70, and B. Spencer and R. Jones, "Trade and Protection in Vertically Related Markets", *Journal of International Economics*, Feb., 1992. Recent developments whereby Americans are regaining an advantage in the computer chip market are reported in the *Wall Street Journal*, Dec. 14, 1992.

from its former support? In the United States I suspect this would be difficult–the terrain is littered with senescent industries still receiving some form of government assistance.

When seeking explanations for the seeming pervasive presence of protection, economists are frequently found to turn to their sister discipline, political science. Indeed, there is currently a booming interest in the intersection of these two fields: political economy. The argument familiarly found suggests that producer groups are more concentrated than consumer groups, and that when the benefits of protection are thus focussed on a few and the costs spread over an atomistic body of consumers, the interests of the few are bound to prevail. But to the extent that trade patterns now heavily favour the exchange of producer goods, intermediate goods and raw materials at the expense of final consumer goods, protection of imports imposes costs on other producer sectors just as it benefits the import-competing ones. The asymmetry suggested above between producers and consumers is then replaced by producers versus producers, and this may strengthen the forces opposed to protection.

Legions of counter-examples can be cited, however. One of my favourites involves the 17 percent tariff that the United States imposes on imports of fishnets.[13] There is a local industry that produces fishnets, and employs around 1,000 labourers. By contrast, there are an estimated 193,000 labourers involved in commercial fishing. Protection wins out even with close to 200 to 1 odds against! An older example, popular in the 1950s and 1960s, concerns a different kind of protection–export subsidies. American clothing and textile producers used to complain that their foreign rivals had an unfair advantage–they could purchase American cotton at lower prices. And with all the complaints against foreign competition voiced by the American automobile industry, little seems to have been expended railing against the effect of import constraints (and VERs) in protecting the American steel industry and thus raising cost to auto producers. Despite these examples, I expect that a producer vs. producer fight over trade policy has a better chance of leading to less protection than a producer vs. consumer one. In my concluding remarks I shall claim there is perhaps a more powerful argument, of relevance to developing countries, which may tilt the balance in favour of freer trade.

6. REGIONAL TRADING ARRANGEMENTS: MORE OR LESS PROTECTION?

One of the challenges typically faced by an economist teaching a class in

[13]This example is cited in James Bovard, *The Fair Trade Fraud* (St. Martin's Press, 1991), p. 11.

international trade is how to convince an audience of relatively untutored but not unintelligent students that regional trading arrangements in the form of free trade areas and customs unions can represent a departure from freer trade even if no tariff barriers are increased to the outside world and internal trade obstacles are removed. The distinction put forth by Jacob Viner forty years ago, between the concepts of trade creation and trade diversion, may no longer represent the appropriate tool to investigate this issue, but is often used to convey the notion that a partner country, by lowering a tariff in a discriminatory manner (i.e. only for its partner), may lose real income. This could be the outcome if its action "diverts" trade away from a low-cost world producer (who previously supplied its imports) towards its partner who is a higher-cost supplier, but with the cost discrepancy less than the tariff rate that still applies to the producer outside the union. The loss stems from the fact that the importing country no longer collects the tariff revenue. Of course, valuable trade may be "created" when countries lower barriers on trade between themselves that does represent purchases from lowest-cost sources of supply. Thus traditional battle lines are drawn: regional trade associations may or may not represent a move towards freer trade.

A recent argument put forth by Anne Krueger illustrates along somewhat different lines how, in a world in which trade in productive inputs is important, provisions of a free trade area such as NAFTA in North America may in reality prove protectionist. Let me outline the scenario:

Suppose that Mexico has established production facilities for some product that it exports as a final consumer (or producer) good to the United States, and that in producing this good it uses as an input an item which it imports from Japan, because the Japanese are the world's lowest-cost source of supply. Furthermore, suppose that Mexico imports this input duty-free. Now Mexico joins the United States and Canada in a free-trade area. The United States has a protected industry that can provide the same input as the Japanese firm, but before a NAFTA deal is struck Mexico opts for the cheaper Japanese product. The key to altered behaviour by the Mexican firm after NAFTA is the "Rules of Origin" provision that bedevils regional arrangements which stop short of becoming customs unions. Members of a customs union impose a uniform external barrier to trade so that an item from abroad pays the same duty regardless of the port of entry. Not so with members of NAFTA. The firm in the United States is protected from its Japanese competitor by an import duty, but Mexico has access to this input duty-free (from either Japan or the United States). But suppose that the Mexican firm can now export its product duty-free to the United States only if it can satisfy a requirement that some (high) percent of the value of its product originates somewhere in NAFTA. In order to export its product to the States without paying duty, the Mexican firm decides to switch its purchases of the intermediate from low-cost Japan to the higher-cost

supplier within NAFTA. To quote Krueger directly, "FTAs (free trade areas) have a built-in bias toward increasing the average protection received by producers within the FTA."[14]

Implicit in this scenario is the possibility that an arrangement that lowers some trade impediments raises others. Without a free trade area, each country's border officials slap on whatever the required duty may be. With the free trade area, the scope for bureaucratic interference at the border expands–the customs official wishes to know where the various components of the item being imported were manufactured. In a special section devoted to describing the potential for NAFTA, the *Wall Street Journal* (September 24, 1992, p. R19) describes the plight of a manufacturer of hats in Montreal. His firm uses materials from a number of sources, some local, but some from Europe. If all the documentation were carefully done, this firm could export its hats to the New York market at a low rate of duty specified in the Canada-U.S. Agreement of 1989. However, such documentation is too costly (it must include a country breakdown of materials used in the inputs it buys from other sources as well)–the manufacturer does not bother and just pays the higher rate applicable to hats from the rest of the world!

In appraising the net effect of the European Community, or NAFTA, or possible new regional arrangements, it is important to keep in mind that countries are countries for a reason. A country is like a "club", in which its members have agreed to abide by a set of rules which include the right to restrict contact with the outside world. Yet the outside world beckons–with dreams of gains from trade if national markets are converted to world markets. Typically nations do open up *some* markets, but they are reluctant significantly to open up others since they feel that their national way of life would thereby be threatened. In the 1988 elections in Canada this was a popular fear. (By contrast, the United States seemed less "threatened" by its neighbour to the north, one-tenth its size, although with Mexico the fears are more evident.) Many industrial countries have learned to live with fairly free trade in may products, but exhibit more restraint at lower levels of the production process. Labour markets are typically very closed, although the European Community has allowed significant internal labour mobility, albeit it has been quite edgy recently about immigrants from Eastern Europe. In any case, the point I wish to make is that a nation, in pursuit of potential gains by trading with those outside its borders, may be willing to open up its markets on a *selective* basis, with other countries with which it feels it shares some common aims and attitudes, rather than to plunge into full open exchange on a wide global basis. In my view the debate over regional arrangements *vs.* multilateral trade negotiations is ill-cast. There is

[14] Anne O. Krueger, "Free Trade Agreements as Protectionist Devices: Rules of Origin", unpublished manuscript, 1992.

room for both to proceed simultaneously, with countries willing to go further in lowering barriers in some markets, but only with a few other nations.

All this discussion reeks of "second-best" analysis. But even if every nation in the world imposed nothing but non-discriminatory impediments to trade with every other nation, and perhaps at the same rate for all items, the world would still exhibit "second-best" market features since each such country is itself a customs-union.

7. CONCLUDING REMARKS

Protectionist attitudes are pervasive. Every firm would like less competition, not more. But one consequence of nationhood is that instruments are available to help discriminate between "us" and "them", and this encourages groups and firms to blame foreigners for their woes when the trouble may ultimately be coming from domestic sources. In the international trade area a phrase has been introduced in recent years that serves to capture much of what I wish to say in conclusion: the "Dutch disease". The name comes from the consequences for the Dutch economy flowing from their discovery of large reservoirs of natural gas. Although this must be viewed in a positive light for the Netherlands as a whole, it created difficulties for many traditional export sectors, which found wage rates and other costs bid up. The phrase came to typify much of what is involved when various firms or sectors in an economy are interconnected through input markets and face a common outside world economy.

To illustrate, let me return to the trip to Japan made by President Bush in January, 1992. Although the party accompanying the President was composed primarily of a blue-ribbon panel of automobile executives, the mission seemed to be to try to open Japanese markets generally in hopes of promoting American exports. One such market is Japanese agriculture, especially rice. By some accounts the price of rice in Japan exceeds world levels by 400 percent to 600 percent. The Japanese have their own reasons for protecting this sector of their economy, and will probably be as reluctant as the Europeans (and many other countries) to see this protection go. But how should the United States, and especially its auto-makers, computer manufacturers, and other non-framing sectors, feel about a possible lowering of these barriers? They would be hurt. By protecting Japanese agriculture to such an extent, these restrictions have managed to keep food prices high and drive nominal wages and other costs to Japanese manufacturers higher than would otherwise be the case. We have an historical analogy: the Corn Laws in England in the 19th century. This protection granted to British agriculture was repealed in 1846, heralding a boom period for British manufacturers. So also, it is hard to imagine that free trade in agriculture for Japan would not result in substantial increases in Japanese exports of products such as automobiles.

For a domestic firm to feel the pinch of foreign competition in the product which it makes may seem to justify some kind of commercial protective action–at least to the afflicted domestic firm. But what about a domestic firm which finds its costs rising because some other local firms are succeeding in world markets by technological breakthroughs and subsequent growth? Whom to blame then? One of the realities of international trade is that a country tends to export those items it is better at producing, relative to world standards, and import items further down the productivity scale. A firm may lose its place in the pecking order through no fault of its own, merely because others in its society have improved.

Let me conclude with a remark about policies to promote growth in less developed areas, and how they are affected by the increasing importance of trade in intermediates, raw materials, and producer goods. The policy of import-competition as a way of promoting development was tried, and found wanting, by many countries in the decades after World War II. The more recent success stories are typified by the "tigers" of East Asia–Hong Kong, Taiwan, Singapore, and South Korea (and earlier by Japan). These economies are all export-oriented. Some simple basic arithmetic helps explain part of the story: the world market in any item is much larger than any national market, and a country can increase its own output by a large amount by taking over a small share of the world market. If the competition is greater in the world arena, so also are the rewards. Under a policy of import substitution it would be possible to protect, say, the textile industry. The clothing industry, as well, could be protected as long as it receives more than enough to compensate for the higher input costs imposed by textile tariffs. Escalating tariff structures seemed to afford a whole vertical panoply of industrial activity a measure of protection. But suppose the strategy changes, and the clothing sector wishes to compete in world markets. Any protection given to its textile producers harms it–unnecessarily increasing costs. The desire for export-led growth unleashes a natural antipathy to standard protectionist arguments. Furthermore, it is now commonly understood that although firms may not enjoy competition, competition seems to encourage more productive performance. For a small less developed country, exposure to world markets also gives it more experience with competition, a feature relatively lacking at home. On this account as well, trade and growth in an ever more global economy may be natural allies.

Comments on "The New Protectionism and the Nature of World Trade"

Professor Jones has presented a very stimulating and wide-ranging paper replete with considerable insights into various aspects of both trade theory and policy. Most of what he says I have no disagreement with; what I will have to say will mostly be in the nature of clarification and amplification.

The focus of Professor Jones's paper is on the rapidly growing trade in intermediate inputs and its implications for standard trade theory and protectionism, including regional trading arrangements or free trade areas. While noting the rapid growth in recent years in world trade in intermediate inputs, it should be emphasised, however, that a large part of this trade in intermediate inputs is in the nature of intra-firm trade, often within the multinational or transnational corporations. About 30 percent–40 percent of world trade in manufactured goods is in the nature of intra-firm trade. To the extent that this is so, trade becomes closely interlinked with international investment, i.e., location across countries of enterprises owned by multinational or transnational companies. The factors which govern the pattern of international investment under these circumstances have a dominant influence on the composition of trade, especially trade in intermediate inputs.

As Professor Jones suggests the pattern of specialisation is no longer be a simple function of the relative endowments of primary factors of production but depends upon a host of other considerations, such as availability of social overhead capital, as well as transport, communications, electric power, nature of the financial and taxation systems, and rules and regulations governing the operations of foreign corporations, etc.–considerations which also influence the flow of foreign direct investment. Moreover, the cumulative advantages enjoyed by a firm or a country that happens to be first in the field, that aggressively undertakes investment in research and development and becomes a pioneer in capturing the economies of a scale–assume an important role in determining the pattern of specialisation in trade. However, it should be emphasised that this is relevant not only to trade in intermediate inputs as the article by Professor Jones seems to convey, but also that in finished products.

The strategic trade theory which, in any case, interjects the theory or principles of industrial organisation or strategy into the theory of trade, suggests that in an imperfectly competitive industry in which firms located in different countries are engaged in monopolistic or duopolistic competition, taxes and subsidies could be

used by one of the partner countries in order to obtain a greater share of profits and of the world market. This theory to the extent that it is valid applies to monopolistically competitive enterprises in general, whether they produce final or intermediate products. In other words, this applies to competition in the aircraft industry, i.e., between Boeing and Airbus company as much as in the semiconductor industry.

What are the implications for developing countries of the emerging pattern of trade in intermediate inputs including close interlinkages between international trade and investment. They certainly have a much wider range of choice in manufactured goods that they can produce or specialise; they can specialise in "production blocks", as Professor Jones calls them, so to speak, linked across countries through global communications and information technology. This choice is not necessarily always linked with foreign direct investment; components or inputs produced in a particular country can be used in enterprises in another country, which are not owned by a transnational/multinational corporation, through contractual arrangements with enterprises abroad. What is needed is a high level of organisation and managerial ability and greatly developed infrastructure, i.e., transport and communication systems within and across nations. Under these contributions, a major part of the components needed for the production in B of a final output which is imported by Country A may have been produced in Country A; similarly, a major part of the components of an export product from Country A to B may have been imported in the first instance from Country B. The definition of the national origin of the final product under these circumstances becomes very blurred.

Should the government pick a 'winner', i.e., an industry or a part of an industry which it perceives to have the potential to compete in the world market and then provide it temporarily, i.e., for a short period, assistance which ranges from protection in the home market to credit and export subsidies? In this scenario a protected import substitution industry eventually gains sufficient competitive strength on the basis of successful operation in the home market and is thus able to graduate to a profitable export industry. There are examples of this kind in different countries.

Two objections are often voiced against this strategy. First, the government is unlikely to be able to identify or decide ahead of time which industry will in the long run succeed in the competitive struggle in the world market. In this view, what is needed is the provision of infrastructure, appropriate regulatory framework needed for a well functioning market, investment in human resource development, including training, education, etc. The free play of market forces would do the rest, i.e., pick the 'winner', provided a liberal trade and exchange rate regime neutral between the production for the home market and that for the export market exists. It is argued that private enterprise, be it foreign or domestic, is more conversant than the bureaucracy with the details of market possibilities, be it for components or for

finished products; they are always better "pickers". If private enterprise fails, it goes bankrupt and losses imposed by the market on private enterprises do not impose a cost on the government. Second, even if one justifies a temporary provision of subsidies or protection, they tend to become permanent. The vested interests receiving subsidies become entrenched and powerful enough to ensure their continuation long past the period when they are considered necessary. Therefore, they impose substantial social costs in the long run.

Professor Jones's objections to the government's picking the 'winner', is based on the second set of arguments, i.e., reluctance of the recipients of special privileges or subsidies to surrender them, even after they succeed and earn high profits or rents.

In this respect, the experience of the East Asian countries may be relevant. Frequently, the interpretation of the East Asian experience seems to lie in the eyes of the beholder. Both interventionists and free marketeers quote Korea in support of their case. Increasingly, a substantial group of observers of the Korean scene, including most Korean economists, seem to have reached the consensus that Korea successfully picked the 'winners' and provided them with a variety of assistance, including subsidies and protection, until they established themselves in the world market. Many successful export industries started out as import substituting industries under protective walls; they received export aid of various kinds as they entered the export market. What was more important was that Korea succeeded in removing special assistance, i.e., protection or subsidies, as the industries became successful in the world market.

Korea had a lower average level of tariffs–lower than most developing countries today, and the tariff rates or degrees of trade restrictions were more uniformly distributed or much less widely dispersed across activities/industries. Protection was provided with an advance notice of their intended decline over time and this policy was enforced effectively. On the whole, policies were skewed more in favour of production for the export market than for the home market.

How did the Koreans succeed in picking the winners and withdrawing support as they became successful? It is suggested that Korea, unlike many developing countries of today, was not a "soft state"; the government could overcome pressures from entrenched interests, enjoying rents from protection, and could withdraw assistance when it was no longer needed. Secondly, whenever mistakes were made in "picking" the winners either because world market conditions did not justify the establishment of such an industry in the first place, or because circumstances in the world market subsequently changed so that the initial success could not be sustained, the Korean government followed the changes in market signals and let the losers go down; it moved on to pick and support the next in the line considered to be the potential winner. The response to market signals was implemented with

considerable skill and speed; losses incurred due to past mistakes were not allowed to accumulate. In other words, the government of Korea was a "nimble" government demonstrating considerable pragmatism, vigilance, and flexibility in the design and implementation of policies.

It is alleged that the success of this policy depended on the discipline and efficiency of a competent bureaucracy and a political/administrative leadership devoted to the cause of Korean's development. The present day developing countries, it is suggested, do not have the kind of efficient and development oriented administrative and political leadership which Korean had. This is a proposition which is considered plausible. The underlying circumstances, historical and cultural, which led to the emergence of a development-oriented bureaucratic and political leadership need further analysis. In recent years, many developing countries have come increasingly to accept advantages of a liberal trade and exchange rate regime. They have sought membership of the GATT–long considered a "rich men" club and accepted the rules and disciplines of GATT in their trade regime. They have become active participants in the ongoing GATT negotiations under the Uruguay Round. Advantages of competition, and scale economies emanating from export oriented development strategy, are being gradually recognised. Many of them have undertaken unilateral liberalisation of trade while at the same time developed countries continue to persist in a high degree of protectionism.

Professor Jones suggests that trade in components tends to discourage protection for high cost input supplying industries since such protection puts the producer of the final or finished product at a competitive cost disadvantage. There is indeed an incentive for the producer of the finished/final product to oppose the protection of input supplying industries. However, both of these groups–the final product and the input supplying industries–are small in number and often have adequate organisational strength to secure protection for both of them at the expense of consumers who are diffused and unorganised. The producers of final product seek compensation against protection for input supplying industries by raising the rate of protection on their products so that it offsets the high cost of inputs. What matters to them is the rate of effective protection rather than that of nominal protection. Similarly, export industries which rely upon protected domestic inputs seek exemption through tax rebates and subsidies to offset the cost disadvantage. Many countries seek to ensure that export industries obtain inputs at world prices, by providing them with drawbacks on duties/taxes on imported components as well as tax rebates/subsidies to offset the high cost of domestic components. Thus, the tension between the competing interests of producers of final products and of those producing inputs and components is often partially resolved by raising the general level of protectionism and subsidies across the economy. This resembles the case of appropriate degree of protectionism for agriculture *vis-á-vis* industry. Industrial protec-

tionism hurts agriculture by raising the costs of inputs to agriculture and by diverting resources away from agriculture to the manufacturing sector. The agricultural pressure groups, instead of demanding reduction or elimination of industrial protectionism, seek even higher degree of protection for themselves.

Professor Jones's example of restrictions on rice imports in Japan leading to high wage costs and, therefore, high costs of manufacturing industries is not quite comparable with the example of corn laws in England in earlier centuries. This is primarily because the relative importance of corn in the consumption expenditure of the average British worker in 18th century England was much higher than the importance of rice in the consumption expenditure of the average Japanese worker. At the present time, the contribution of high rice price to the high wage costs in the manufacturing industry in Japan is unlikely to be substantial. Similarly, the case of the expensive Japanese rice leading to higher wage costs in Japan is not comparable to high costs of components/inputs which place the manufacturer of a finished product at a competitive disadvantage in the world market. The high input costs affect only the industries which use a high proportion of the protected inputs whereas expensive rice to the extent it is an important element in the determination of wages, affects wage costs in the whole range of manufacturing exports. While it is true that the elimination of protection to rice production would divert resources from rice production to other sectors, especially the industrial sector, agriculture uses a very small proportion of resources in Japan. Its overall impact on the Japanese economy is unlikely to be significant.

Professor Jones is right to emphasise that the trade in inputs provides a protective bias to the regional trading arrangements since it has a trade diverting effect on trade in inputs. If, for example, cheaper inputs from outside the free trade area are surrendered by Country A in favour of higher priced inputs from the partner Country B, the cost structure of the Country A, producing the finished product, goes up. Since in a free trade area the external tariffs or trade restrictions of the partner countries are not uniform, this provides incentive to the Country A faced with higher cost of inputs and, therefore, higher costs of its finished product to seek trade restrictions on imports of finished products from the third countries. However, since the free access of Country A's finished product to the partner Country B remains unchanged, its costs advantage within the free trade area remains undiminished if the high cost of input does not offset the price advantage Country A enjoys in Country B because of its free entry in B's market.

The advantages of free trade area, however, go beyond static gains derived from trade creation offsetting trade diversion; it facilitates economies of a scale, efficient division of labour, and competitive efficiency–all of which liberal trade regimes offer. Moreover, as income growth is stimulated in the partner countries through a more efficient allocation of resources within and between the partner

countries, their imports from third countries may go up as well. Regional free trade arrangements could be a first step in the way towards a global trade liberalisation for countries concerned. As the countries within a free trade area are exposed to competition within a larger regional market beyond their own domestic borders, they gain competitive strength, and are able to venture into the world market.

Much has been said about the relative advantages and disadvantages of developing countries having free trade arrangements with a dominant developed partner country rather than among themselves. This is the case with North American Free Trade Area. It is argued that this type of encouragement offers greater advantages for developing countries. Firstly, there is a possibility of greater trade creation because of potential divergences in economic structure between developed and developing partner countries are greater than among poorer developing countries with similar economic and trade structures. To date, developing countries have not undertaken free trade arrangements among themselves to any significant extent. Hence, experience so far is very limited to evaluate their effects. Furthermore, the access to larger markets of developed partner countries provides economies of a scale to an extent not otherwise available in a free trade arrangement among developing countries, each with a relatively small domestic market. Thirdly, free trade arrangement with developed countries facilitates access to technology and external capital, much needed for their development. Not only direct investment from the developed partner country may move to the partner developing country to take advantage of lower wage costs, but also third countries outside the free trade area may invest in the developing country to gain access to the larger domestic market of the developed partner country.

In the particular case of Mexico, an additional incentive for joining North American Free Trade area was to ensure that outward looking trade and economic liberalisation policies, introduced by Mexico after many years of protectionist policies followed in the past, become irreversible by tying them within the Free Trade Area arrangement with the U.S.A.

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