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The Political Economy of Trade Policies: Origins, Effectiveness, and Limitations

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Abstract

The history of trade policy is one of the longest among all forms of economic interventions of government. Different economic schools and their vanward scholars have various opinions, creating a conflict between free-trade literature and protectionism. This essay compares the different perspectives of protectionism, the incentives of government to set up protectionist policies, and an evaluation of both. It also compares the costs and benefits, effectiveness and limitations of representative economies which introduced such policies.

Key Words: Trade, globalisation, public economics, government policies, protectionism, political economy

Introduction

From the 1st century B.C., the Silk Road connected two continents, enabling trade to flourish and forming the foundations of what we know as globalisation today. While trade usually benefits both exporters and consumers, governments' protectionist policies de facto have shown a contrasting idea (Vanham, 2019). From tariffs to quotas, governments around the world engage in a multitude of explicit or discrete protectionist actions, with the tariff trade restrictiveness indices of Africa and South Asia being 9 and 8.5 per cent in 2020, proving that high import restrictions are set up in these two areas. Furthermore, some tariffs in China and South Korea on specific industries are higher than 3 per cent (UNCTAD, 2021).

Yet, these behaviours go against efficiency arguments in economics, as the theory of comparative advantage (CA) by David Richard states that protection creates opportunity costs by impeding specialisation (Do, Levchenko, and Raddatz, 2015). Hence, this essay explores potential arguments bolstering protectionist policies, referring to domestic market conditions and the nuanced considerations of international politics and foreign interests.

Infant Industry Argument

The theory of CA was developed under the condition that there was little significant difference between countries, and each of them could achieve self-sufficiency during Richard's time. Hence, a key point of contention with the theory is that it assumes that countries are satisfied with their areas of comparative advantage, which might be practical in the past as countries were hardly overspecialised; however, this may face problems when international competition has significantly reduced working opportunities and development of an economy today, as observed from the substantial efforts to bolster infant industries.

The government may set up trade restrictions to protect industries with high potential to grow in the hopes of achieving greater economies of scale similar to those in developed countries (Oatley, 2019). Tariffs, quotas, and subsidies for domestic firms are just some of the conventional approaches to protect infant industries with the hope of engendering a new comparative advantage that can promote economic growth, boost employment, and encourage investment. Additionally, this approach can promote the development of other industries by providing better resource choices, proven by He's (2018) Granger causality test that investment in sunrise industries exert the same impacts on the economy as would investments in labour or capital.

A case in point is the protectionist package introduced in South Korea in the 1970s under the dictatorship of Park Chung-hee (Chang, 2008). To solve the problem of a prospering light industry but faltering heavy industry, Park introduced subsidies to leading domestic firms that can overcome the need for massive capital investment, also known as the Heavy-Chemical Industry (HCI) Programme. Not only did HCI manage to rapidly boost living standards and GDP per capita through the phenomenal growth of heavy industries but also balanced the domestic industrial structure (SaKong and Koh, 2010; Lane, 2021).

Unfortunately, the government' subsidies for the big companies led to the formation of oligopolies, which gave them both monopolist power to increase prices and monopsonist power to suppress the costs of raw materials (Lim, 2012). They reduced industries' incentives to become more efficient since there was less pressure on surviving under the supplementation of debt-free subsidies (Myers, 1998). The higher price this created increased the cost for downstream industries and, thus, hindered economic growth. Hence, the government subsidies given to growing industries may not be effective in the long run.

Sunset Industry Argument

Apart from the drive to nurture infant industries, governments could also implement protectionist measures to protect sunset industries, which are less competitive and likely to fail due to international competition (Amable, 2000). Although the Ricardian model shows that the power of comparative advantage increases the efficiency of economies, it may also bring costs, such as a rapid increase in unemployment rates due to foreign competition (Maneschi, 1998). Cheaper and higher-quality goods from abroad could induce unemployment in whole industries, thereby pushing governments to implement protectionist policies to cushion the negative repercussions of trade on specific sectors.

This idea has been put into practice by the United States to fight against Eastern steel firms, which had higher competitiveness due to lower wages and higher investment. Antidumping and Countervailing Duties were introduced to stop cheaper imports, which sacrificed downstream producers' efficiency for those in the steel industry (International Trade Administration). This is undesirable for the economy as the benefits accrue to the minority while costs are borne by the majority – higher prices and lower quality of steel would lead to higher costs of production. Instead, a more desirable approach to help sunset industries is encouraging business owners to adopt innovation and giving them confidence about adopting them to renew the sunset industries, which is proven to be more efficient than subsidies (Adnan, Nordin and Ali, 2018).

The Collective Power of Trade Blocs

Furthermore, although the domestic market and labour unions have significant sway over government policies, policymakers may sometimes join trade blocs to raise the strength of trade restrictions. These intergovernmental agreements can give small economies' investments and savings greater influence on the world interest rate, which then leads to a greater impact on the change of net export caused by the same trade policy. According to the IS-LM model for open economies, an open economy with less influence on the world economy would be more sensitive to a change in interest rate (Figure 1). Hence, the blue line represents a smaller economy and the orange line represents a larger economy. It is shown that with the same trade policies, which cause the same change in investment and saving ceteris paribus, a larger economy would have a greater change in net output, making its protectionist policy more effective.

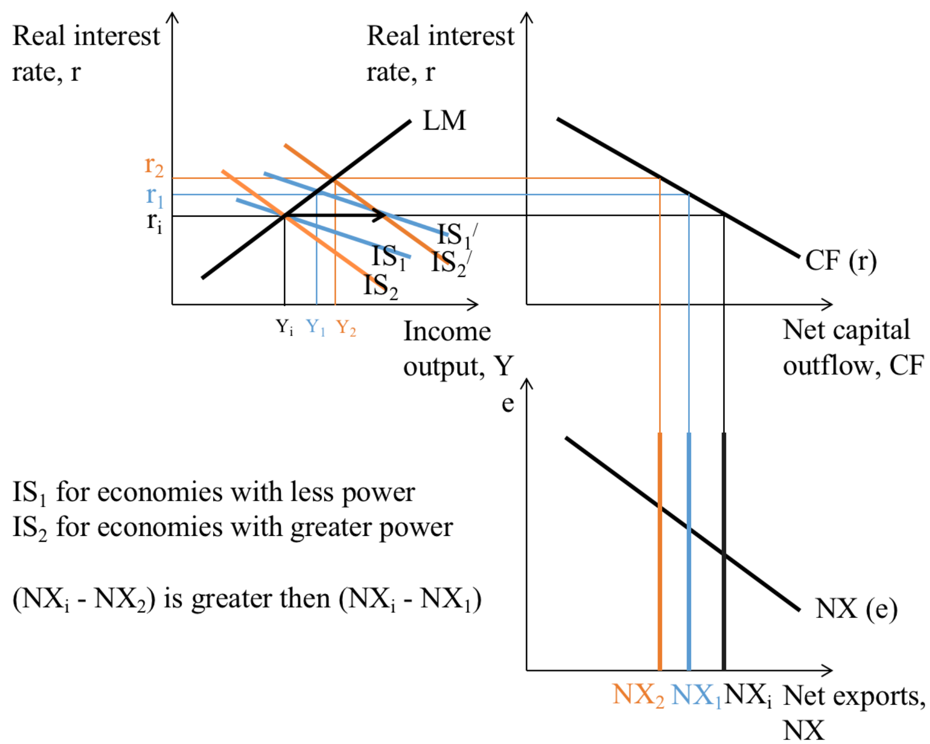

FIGURE 1. IS-LM for an open economy

The European Union in the 1960s is a prime example. The European countries signed the Common Agricultural Policy (CAP) to protect themselves from the world price lower than farmers' needs (Fennell, 1997). As a result of tariffs and industrial policies, the higher influence of member countries pushed up the world price, allowing producers to receive more income (Rudloff and Brüntrup, 2018; Pettinger, 2021). This led to a much higher positive effect on employment and economic growth, including a 5.2% increase in employment in Greece between 2007 and 2013 due to CAP (Lillemets, Fertő, Viira, 2022). Although CAP was blamed for exacerbating environmental degradation, the maintenance of farmers' livelihoods established a more stable society, which far outweighed the costs of environmental damage (Forgrave, 2015).

Oligopolistic Power to Trade Policy

However, it must be recognised that policies are not always efficient or utility-maximising – governments are prone to be influenced by powerful domestic firms (Coughlin, Mueller and Murrell, 1990). If specific policies could be beneficial to an oligopolistic industry, oligopolists may persuade or force the government to set up such policies to exploit abnormal profits, as Figure 2 shows (Horn, Persson, 2001).

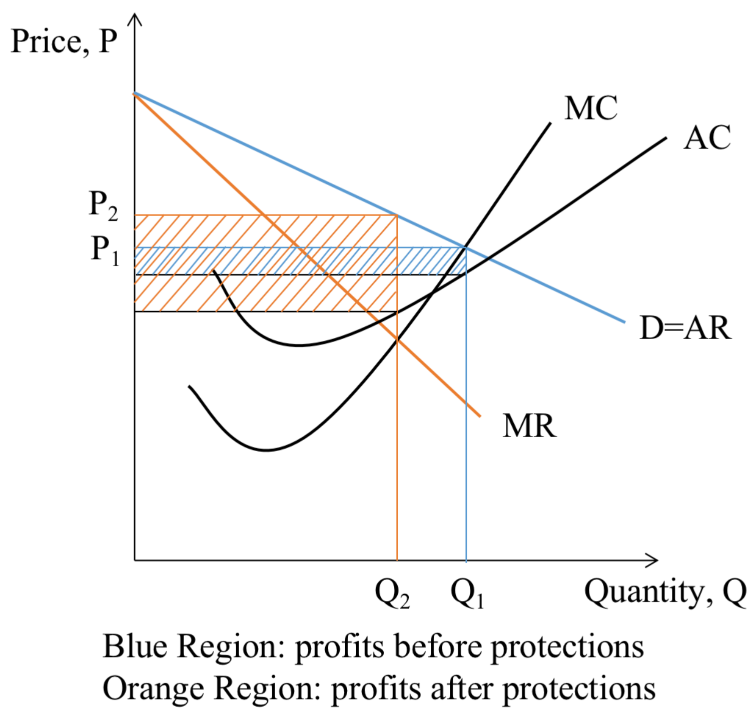

FIGURE 2. Profits gained by oligopolistic industry

The oil production quota set up by the Organization of the Petroleum Exporting Countries (OPEC) was a typical example of oligopolistic power's influence on policies. In 2022, due to the forecast of decreased demand for oil resources, OPEC set up an agreement to produce less oil in the year by cutting more than 1.1 million barrels a day, nearly 1% of global production (Ziady, 2022; Reed, 2023). As a result, the world price for one barrel of oil rose by nearly 30%, while the revenue of exporting oil has increased by 50% to reach $850bn (Ingram, 2023). However, oil is a special case as there are few alternatives and the price elasticity of demand and supply are both extremely inelastic. In general, however, if oligopolists keep the price of goods high, people may seek to develop substitutes, which could ultimately reduce net export revenue in the long run. Thus, the restrictions due to oligopolistic power may only benefit a country in very limited conditions.

Balance of Payment Argument

Apart from economic reasons, governments may impose restrictions on trade due to political issues. The government may seek to set up trade barriers to reduce the trade deficit. Politicians may argue that high trade deficits are harmful to the economy, and hence impose restrictions on trade to gain votes from the public, especially during a time when the economy is declining (Ocampo, 2016).

This was the argument behind the US's trade restrictions on Chinese goods – since America's industry is declining and unemployment is rising, trade with China became less popular as it had taken more than $400b in deficits (Tankersley, 2018). Hence, tariffs, ranging from 30% for solar panels to 50% for washing machines (Eckhouse, Natter, and Martin, 2018; USTR, 2018) were slapped on Chinese imports, covering imports from raw materials to final products (Swan, 2018).

Nevertheless, protections predicated on this idea are largely unhealthy for the economy, as illustrated by the aftermath of the US-China Trade War: the US's real GDP declined by $1.4b per month due to the tariffs in 2018, the CPI of tariffed goods rose rapidly, and, ironically, the US's trade deficit actually rose to its highest level since 2008 in 2019 (McGee, 2016; Amiti, Redding, Weinstein, 2019; Fitzgerald, 2019; Zarroli, 2019). As it has been observed that the most significant cause of the trade deficit is the capital account deficit instead of the current account, more practical solutions could have been found in promoting domestic investment and restricting foreign investors, for example, reducing investment tax and raising taxes on international money flow (Pettis, 2021).

Sanctions and Embargoes

While the previous arguments were made based on the assumption that governments are trying to improve one or several aspects of their economy, in reality, protectionist policies could be implemented for purely political reasons such as supporting allies. If the government considers the trade policy as a powerful way to gain strength in the international arena, it may impose restrictions with less consideration for economic costs (Kastner, 2007).

For instance, the embargo and trade restriction against Russia after the start of the Russo-Ukraine war are attempts to reduce the financial and material reserves that Russia had access to. The European Council, USA, and the UK all set up several import trade barriers including embargoes to Russia's natural resources trading and an aeroplane ban that stopped Russian aircraft from entering European airspace (Aljazeera, 2023; European Council). Meanwhile, financial sanctions stopped Russian operations in the world finance market and froze oligarchs' money in their foreign accounts (FCDO, HMT, 2023).

Yet, every action has a reaction – these protectionist policies induced rapid increases in import prices, pushing up the cost of living and the cost of production (Mbah, Wasum, 2022). As a result, the expected growth rate of the EU, USA, and the UK in 2023 are 1.0%, 1.4% and -0.6%, which are all lower than previous years (European Commission, 2023; Fleck, 2023). Thus, unless it yields significant benefits for governments to apply protectionist policies as political weapons, it is usually unwise to wield them.

Conclusion

Although the above arguments may show benefits created by trade restrictions, doubts should be cast on whether the short-run benefits can outweigh the long-run costs and vice versa. Taking research on endogenous growth theory based on three decades of data, it has been proven that trade and FDI would be beneficial to an economy's growth since they can transfer technology and encourage domestic investment by increasing FDI (Makki, Somwaru, 2004). Hence, the optimal approach for countries is to open their borders to stimulate growth and competition, even if it means higher costs in the short run.

A word of caution for governments is the possibility of government failure due to miscommunication, corruption, and ineffective implementation of policies, which could result in vastly different outcomes from free trade policies. Government policies may be misunderstood and erroneously practiced, or contorted to align with personal interests by low-level bureaucrats, according to the principal-agent problem (Stiglitz, 1987). Thus, the negative results of these examples may not necessarily deny the protectionist ideas. However, since this problem is typically more significant in low-income countries and welfare economies, and the root causes are far more fundamental and must be addressed through the enactment of more inclusive, transparent, and accountable political and economic institutions, which are out of the scope of this essay (Hauner, Kyobe, 2008).

In conclusion, governments may impose protectionist policies due to both economic and sociopolitical reasons. However, despite their possible effectiveness in the short-run, governments should bear in mind the negative impacts they bring for future economic growth. To maintain a long-term picture, governments should aim to facilitate free trade through multilateral trade agreements to reap its benefits.

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