WILL AN EYE FOR AN EYE MAKE THE WHOLE WORLD BLIND, AGAIN? AN ANALYSIS OF THE GLOBAL FINANCIAL CRISIS AND PROTECTIONISM

AOIFE CUNNINGHAM

Senior Sophister

In the current economic climate, many fear a return to the old days of protectionism. In this essay, Aoife Cunningham outlines the arguments for and against this economic (and political) policy; she examines the possibility of a trade war; and she discusses what the correct solution is considering today's context. Throughout, she makes use of both historical and contempory examples of protectionist actions; all examples highlight the need for a more long term and cooperative strategy by the world's governments.

Introduction

The global epidemic, dubbed the 'credit crunch', has caused widespread pandemonium as countries battle to save their economies. No longer is there speculation as to whether we will enter a recession; instead fears are mounting as to whether a depression will ensue. The similarities between the current Global Financial Crisis (GFC) and the Great Depression are undeniable. In both instances there was not a sudden total collapse of the system, but rather a gradual build-up, leading to a sequence of major financial catastrophes. Stock markets crashed; assets devalued; defaults rose; liquidity diminished; credit dried up; and consumer spending plunged.

Yet, unlike the Great Depression of the 1930s, the GFC need not be a prolonged decade of suffering and economic loss. History has taught us the widespread implications of letting banks fail and world leaders today have aggressively pursued policies to prevent a repeat of our mistakes. However, after the infamous Smoot-Hawley Act in 1930, we have also learnt that protectionism can trigger a domino effect that causes retaliation and counter-retaliation responses among trading partners. And yet recently this lesson appears to have been forgotten. Will an eye for an eye make the whole world blind, again?

This paper examines the age-old argument for protectionism in the wake of the recent 'Buy American' clause put forth by the US government's stimulus package (McGrogan, 2009). Section one provides a background of the basic economic arguments for protectionism, giving an overview of the learning curve and the infant industry argument. Section two examines protectionism's fundamental flaw –retaliation - and gives a historical overview of past protectionist policies in global economic downturns. Section three investigates retaliation further, exploring the reason why trade wars can occur using a prisoner's dilemma. Finally, section four conceptualises some of the current protectionist measures countries are undertaking and concludes that cooperation, not protectionism, will aid global economic recovery.

Tariffs, Infant Industries, and the Theory of Protectionism

The basic economic rationale for protectionism is the Infant Industry Argument (IIA). The IIA asserts that protectionism is necessary to allow higher priced domestic producers time to learn by doing, so as to achieve the economies of scale of production necessary in order to lower unit costs and prices (Smith & Todaro, 2009). The learning curve, first introduced by Wright (1936), demonstrates that labour inputs decrease with a cumulative increase in output (Argote et al., 1990).

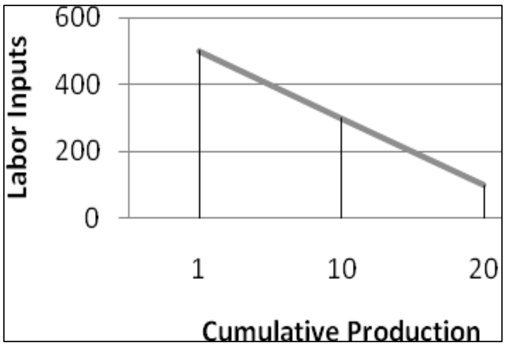
$y = ax-b$

y = input cost for the x^{th} unit

x = cumulative number of units produced

a = input cost for the first unit

b = progress rate



FiFigure 1: the learning curve

Additionally, protectionist policies artificially alter the demand and supply in the market through tariffs (taxes on imports) or quotas (limits on the quantity of imports), creating barriers to entry and altering the price clearing condition of the market. The objective of such protectionism is to incentivise a nationalistic move to buy goods made in the domestic country, thus creating employment for its citizens and fuelling economic growth (Chang, 2002). Advocators of the IIA believe that, given time, the industry will grow up, barriers to entry can be removed, and it will be able to compete globally.

The counter to this is that in practice this form of protectionism is largely unsuccessful. Through protective tariffs, an industry is not subject to competitive pressures; therefore some industries remain inefficient and costly to operate (Smith & Todaro, 2009). Moreover, by protecting infant industries, countries are not allocating resources in the short run based on comparative advantage. Based on the Ricardian and Heckscher-Ohlin models of trade it could be argued that resources are allocated most efficiently if countries produce those goods in which the before-trade prices are lower than in the rest of the world (Kenen, 2000). Furthermore, domestic producers and their employees benefit at the expense of domestic consumers. Without protectionism, consumers can benefit from the low price of imports and the greater quantity of imports purchased, whereas tariffs equate to higher prices and reduced demand. Effectively consumers are penalised as a result of subsidising the infant industry.

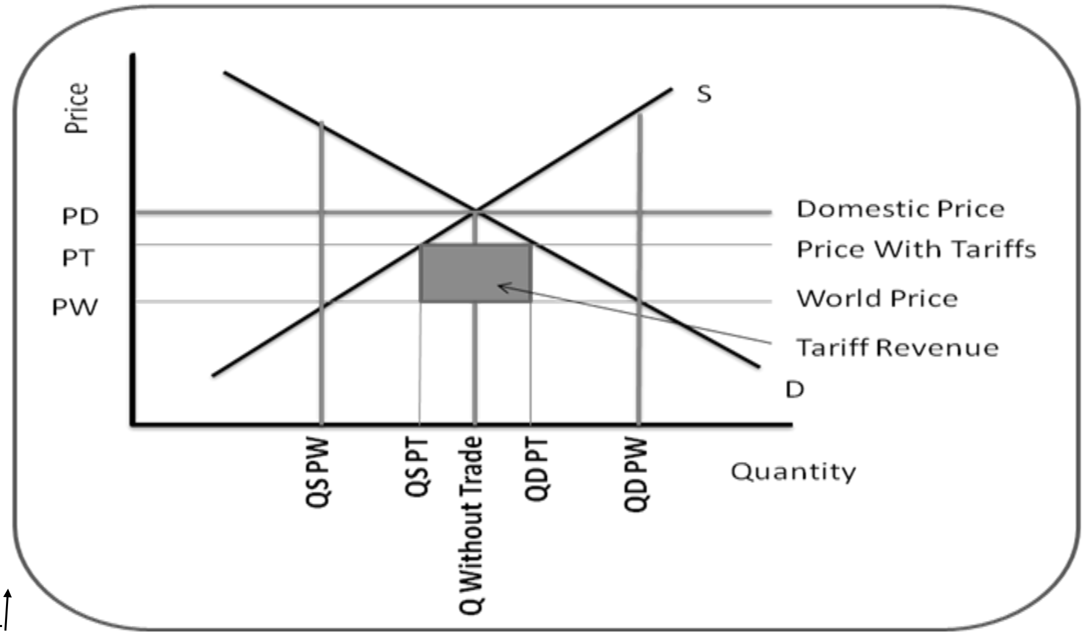


Figure 2: the operation of tariffs in the market

Protectionism's fundamental flaw

The IIA is generally applied to industries within the developing world that need a grace period before being subjected to the rigorous competition of developed countries. It is arguably an effective way of raising government revenue and useful if a domestic industry is in a nascent state and would otherwise be overrun by superior industrial goods from more developed countries (Smith & Todaro, 2009). However in the current GFC it is not developing countries but developed countries, the crusaders of free trade, which are turning protectionist. Though protectionism can benefit them as it would developing countries, there is one fundamental flaw to this approach. It can make economic sense for a country to impose these measures - but not if other countries retaliate by imposing protective tariffs themselves. As Mahatma Gandhi said, 'an eye for an eye can make the whole world blind' (Melik, 2009).

International trade is a driver of economic growth. It expands market access for producers and helps control price inflation for consumers. In times of economic uncertainty, however, the enthusiasm for free trade can dampen (Erixon & Sally, 2009). This worries advocates of free trade, because historically protectionism has done more harm than good. The 'beggar-thy-neighbour' attitude in the U.S. after the Wall Street Crash of 1929 resulted in the implementation of the Smoot-Hawley Act in 1930 (Melik, 2009). The idea was to boost the domestic growth rate; but imposing tariffs, devaluing the currency, controlling outward flows of capital, and subsidising exports were all at the expense of the other world economies (Drezner, 2008). Other leading economies retaliated, imposing tariffs of their own. This period was catastrophic for economic growth. U.S. imports from Europe decreased from $1.33 billion USD in 1929 to $330 million USD in 1932; U.S. exports to Europe declined from $2.34 billion USD to $784 million USD in the same period (Vaidya, 2005). It seems the meltdown of the international monetary system triggered the epidemic and though some economists like Paul Krugman postulate that the high tariffs had no effect on the decrease in world trade during this period (Elliot, 2009), many scholars believe that they played an integral role in the decline in world trade. (Melik, 2009; Vaidya, 2005; Kindleberger, 1987).

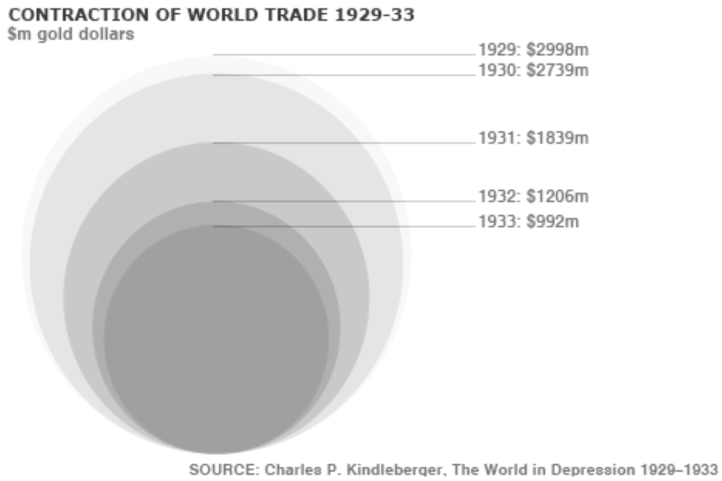


Figure 3: The decline in world trade after the Great Depression

The protectionism of this period may have contributed to the rise in national hostilities that would eventually lead to World War Two. As noted twentieth century economist Ludwig von Mises famously said ‘what generates war is the economic philosophy of nationalism: embargoes, trade and foreign exchange controls, monetary devaluation etc., the philosophy of protectionism is a philosophy of war’ (Miller & Elwood, 1988). The years after the war ushered in a new era of free trade and in 1947 the General Agreement on Tariffs and Trade (GATT) was established with the purpose of reducing tariff barriers and prohibiting other forms of trade discrimination.

Unfortunately two major events at the beginning of the 1970s contributed to the destruction of this golden age and the re-emergence of protectionism. Firstly, the international monetary system of fixed exchange rates collapsed. The international gold standard was replaced with a system whereby currencies could be freely exchanged on the market, and the U.S. dollar devalued greatly due to the large deficit America accrued in the 1960s (Vaidya, 2005). Secondly, in 1973, OPEC curbed oil supply, causing prices to shoot up considerably from $10 USD per barrel to $36 USD per barrel (Zycher, 2008). Combined, these shocks led to another economic slowdown in both the U.S. and in Europe (whereas Japan flourished in this period).

Industries, waning under the decrease in consumer spending and increased competition from Japan, called for government subsidies to protect them from foreign competition. This shepherded in a new era: an era of ‘new protectionism’. Many companies in this period were nationalised or bailed out by their home nations. The automotive industry for instance, then as now, faced bankruptcy. In 1979 the U.S. Congress bailed out Chrysler and shortly thereafter the British and French governments bailed out Rolls Royce and Renault respectively (Erixon & Sally, 2009). Subsidies to domestic firms were implemented in conjunction with quota restrictions limiting the number of Japanese cars that could be exported to the U.S. and Europe. This essentially created a protectionist backlash against Japan in the 1980s and government intervention only served to ‘exacerbate economic stress and prolong the period of stagnation’(Erixon & Sally, 2009: 30).

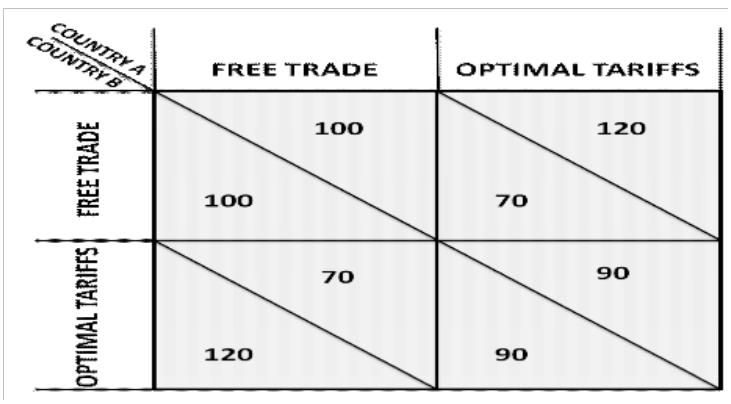
Trade Wars?

The current GFC has the world again reeling from an economic slowdown. Once more, governments are being pressurised to return to an era of economic nationalism. President Obama proposed a $787 billion USD stimulus package with a ‘Buy American’ clause which stipulated that the projects financed by the bailout should favour American iron and steel. This provision has caused major controversy with some people speculating that it could mandate an American preference for all manufacturing goods.

Opinions are clearly divided over Obama’s massive economic stimulus package. The President of the United Steelworkers Union, Leo Gerard, says ‘it’s about putting stimulus cash, American taxpayers’ dollars, towards American jobs’ (Thomas, 2009). He is not alone; it appears that this clause has strong backing in Congress from Democrats who represent the big steel states such as Ohio, Pennsylvania, and Indiana. Ohio Democrat, Tim Ryan, has even estimated that this clause will yield an additional 77,000 jobs across America (ibid.). However opposition against this protectionism is mounting, especially amongst self-interested American companies like General Electric, Boeing, and Caterpillar Incorporated. Caterpillar Inc., the world’s largest mining and construction equipment manufacturer, is justifiably concerned, as 60% of its 2007 revenue came from foreign sales and it fears these provisions will devastate the company’s bottom line (Lee, 2009).

The opposition’s concern stems from apprehension that this type of protectionist signalling will trigger a trade war. A drop in demand due to protectionist policies in one country causes a reduction in production from foreign companies and hence a decline in their profits (Kenen, 2000). Thus a tariff can reduce world welfare through increased prices, declining aggregate demand and increased unemployment. Facing potential losses after protectionism incentivises all those affected to rally behind trade restrictions in their own countries, as it is seen as an effective way to mitigate the loss in national welfare.

Hillman (2003) gives a simple example of this using game theory whereby two countries, CA and CB, make up the world economy. CA imports goods (1,2,3) from CB, and CB imports goods (4,5,6) from CA. Both countries can choose between free trade and optimal tariffs for their nation. If they both choose free trade (FT), then each derives 100 units of welfare and world welfare (WW) will be 200; if CA chooses FT but CB chooses tariffs (OT) then CA receives 70 units CB receives 120 units, and WW is 190; and if they both choose to implement OT then each receives 90 units and WW will be 180.



- CA(FT) + CB(FT) = 200 WW
- CA(FT) + CB(OT) = 190 WW
- CA(OT) + CB(FT) = 190 WW
- CA(OT) + CB(OT) = 180 WW

If CA and CB can cooperate with each other, then the world's welfare is maximised at 200; however, if we assume CA and CB are both interested in maximising their nation's welfare then they will be incentivised to erect barriers. If CA erects barriers on the goods of CB, then CB will naturally retaliate by erecting trade barriers against the goods of CA, as 90 > 70. This non-cooperative play results in a Nash Equilibrium which is an inferior outcome, with each player's welfare reduced by 10 units and world welfare reduced by 20 units. Therefore in non-cooperative play, all parties lose and this prisoner's dilemma demonstrates that a trade war will ensue.

Conclusion: Current Climate

Gordon Brown, the Prime Minister of Britain, has pledged to create 'British jobs for British workers' (Helm, 2007). Russia's Prime Minister, Vladimir Putin, has erected import tariffs on dozens of products. The EU have resumed subsidising dairy exports, imposed high tariffs on Chinese screws and bolts, and quota restrictions on American chicken and beef. America has restricted bidding on projects with its 'Buy American' provision. It has also lashed back at the EU by imposing tariffs on French cheese and Italian water and levied new tariffs on Chinese goods it believes are being dumped onto the American market. Egypt has increased tariffs on sugar imports. The list continues to grow (Miller, 2009). Tensions within the EU are also growing. The EU's enlargement into Eastern and Central Europe has made it the world's largest integrated economic bloc accounting for 30% of global economic output and 17% of world trade (Almunia & Rehn, 2009); however many fear that the pressure of the GFC will force a renewed east-west divide as the 'old' partners can afford to subsidise failing industries whereas the 'new' smaller partners cannot.

It appears that the 'olive' is once more gaining precedence over Thomas Friedman's infamous 'lexus' (Friedman, 1999). However, as Pascal Lamy, Director of the World Trade Organisation, recently said, 'we need joint actions in resisting isolationism. This is the collective responsibility of all countries, big or small, strong or weak. Maintaining an open, fair and transparent global trading environment is vital for the economic recovery' (Lamy, 2009).

Bibliography

Almunia, J. & Rehn, O. 2009. 'EU Commission Hails Enlargement'. Retrieved from BBC News at: http://news.bbc.co.uk/1/hi/world/europe/7902579.stm

Argote, L., Beckman, S., & Epple, D. 1990. 'The Persistance and Transfer of Learning in Industrial Settings'. *Management Science* 36:2:140-154.

Chang, H. 2002. *Kicking Away The Ladder: Development Strategy in Historical Perspective.* London: Anthem.

Drezner, D. 2008. 'Beggar Thy Neighbor, Take One'. Retrieved from Foreign Policy at: http://drezner.foreignpolicy.com/category/wordpress_tag/beggar_thy_neighbor

Elliot, L. 2009. ‘Protectionism: Is Free Trade The Best Way To Beat A Recession?’ in *The Guardian*, 4th February 2009.

Erixon, F. & Sally, R. 2009. ‘Fighting The Urge For Protectionism’. *Far Eastern Economic Review* 172: 1: 28-31.

Helm, T. 2007. ‘Gordon Brown Pledges Jobs for British Workers’ in *The Daily Telegraph,* 11th September 2007.

Hillman, A.L. 2003. *Public Finance and Public Policy: Responsibilities and Limitations of Government.* Cambridge: Cambridge University Press.

Kenen, P. 2000. *The International Economy* (4th ed.). Cambridge: Cambridge University Press.

Kindleberger, C. 1987. *The World In Depression, 1929-1939* (revised ed.). Harmondsworth: Penguin.

Lamy, P. 2009, February 23. ‘Keeping trade open: Resisting isolationism’. Retrieved from the World Trade Organisation at: http://www.wto.org/english/news_e/sppl_e/sppl115_e.htm

Lee, C. 2009. ‘Obama Back Off “Buy American”’. Retrieved from Politico at: http://www.politico.com/news/stories/0209/18809.html

McGrogan, D. 2009. ‘“Buy American” and the WTO’. Retrieved from the International Law Observer at: http://internationallawobserver.eu/2009/02/17/buy-american-and-the-wto/

Melik, J. 2009. ‘The Dangers Of Trade Protectionism’. Retrieved from BBC News at: http://news.bbc.co.uk/1/hi/business/7866930.stm

Miller, J.W. 2009. ‘Nations Rush To Establish New Barriers To Trade’. Retrieved from the Wall Street Journal at: http://online.wsj.com/article/SB123388103125654861.html

Miller, V. & Elwood, J. 1988. ‘Free Trade or Protectionism? The Case Against Trade Restrictions’. Retrieved from the International Society For Individual Liberty at: http://www.isil.org/resources/lit/free-trade-protectionism.html

Smith, S. & Todaro, M. 2009. *Economic Development* (10th ed.). Essex: Pearson Education Limited.

Thomas, P. 2009. ‘Will U.S. Stimulus Package Trigger a Trade War?’. Retrieved from BBC News, Washington at: http://news.bbc.co.uk/1/hi/world/americas/7868631.stm

Vaidya, A. 2005. *Globalization: Encyclopedia of Trade, Labor, and Politics.* New York: ABC-CLIO.

Zycher, B. 2008. ‘The Concise Encyclopedia of Economics: OPEC’. Retrieved from the Library of Economics and Liberty at: http://www.econlib.org/library/Enc/OPEC.html