Self-Protectionism: The Economics and Politics of Trade

*By Ronald A. Cass**

Although the basic arguments of trade were established more than two centuries ago, they continue to be debated. Protectionism is in the news again as nations struggle with rapidly mounting job losses and plunging industrial production. Almost without exception political leaders and their top-level economic advisers across the globe have publicly endorsed "free trade" principles and warned of the risks to all economies if countries raise trade barriers and cause international trade to fall faster than it would from the effects of declining demand alone. In particular, they have emphasized that such actions would be especially dangerous in the current setting.

Unfortunately, the politics of trade and the economics of trade work to a significant degree at cross-purposes. Politicians may say they embrace free trade, but their fingers are often crossed all the while. Part of the reason for that is an inescapable bias in democratic politics. But another, perhaps very large part is a failure of understanding. Simple as the case for open trade is, its essence escapes most political leaders. The essay that follows explains the basics of trade economics, trade politics, and the problems endemic in making the two fit in the current world economy.

Back to Basics

"I've got a terrible problem with the grocery store—I give them money all the time, and all I get in return is groceries. It's totally unfair!" That's not a conversation you're likely to have with anyone, but it captures the thought behind most politicians' views on international trade. The mercantilist position that dominated seventeenth, eighteenth, and much of nineteenth century thinking about trade saw money as the measure of a nation's wealth. Imports were a source of concern because they had to be paid for with money, which then flowed out of the national treasury. Exports, on the other hand, were good because they brought money into the economy from someone else's treasury.

Adam Smith famously debunked that analysis in *The Wealth of Nations* back in 1776, and his conclusion—that wealth should be measured by the things we have and the value we place on them, not the money we have to buy things with—has long been accepted. Indeed, it is the one proposition about which economists of all stripes agree. The notion that there are "gains from trade" recognizes that we are better off when we trade to get things we value more than what we spend for them. While that costs us money, such trades increase, not decrease, our wealth. We understand that instinctively in our everyday lives. That is why we do not complain about our relationship with the grocery store.

Although at some level everyone now understands that money is not the best measure of wealth or well-being, public conversations about trade proceed as if it were. From a political standpoint, little has changed from the heyday of mercantilism: we hear that exports are good, imports are bad, and having more exports than imports is a terrible thing, presumptively showing that someone is behaving unfairly to produce that awful result. When politicians talk about "unfair" trade, they strictly mean trade that increases *our* imports or decreases *our* exports: it is unfair if someone winds up with more of our money and we only get more things.

But, of course, *things* are what we want; they are what we work to have. The sensible goal for people or nations is not to have a pile of money you do not spend, but to have what it takes to get what you want. We do not buy things so we can work—we work so we can buy things. The international trade corollary of this proposition is that we *want* imports, and we export to earn money to pay for imports. Imports are things we get to keep, like groceries, and exports provide a flow of money that the people we buy our imports from will accept in exchange. Even in a world where floating currency values are influenced more by economic performance than by stocks of precious metal, the logic of the case for valuing imports and supporting free trade holds true, and it essentially the same for the United States or the European Union as it is for Burundi or Bangladesh.

The Economics of Trade Politics

Yet this is not the way that most politicians understand trade. They view imports with suspicion and support open trade only when persuaded that opportunities for increased exports more than offset the harm from allowing imports. To a great degree, the politics of trade looks a lot like the economics of trade circa 1750.

While political discussions often seem stuck in the mercantilist mindset, the typical political view of trade is not wholly without analytical basis. For one thing, money does matter. While bilateral trade flows do not matter anymore than my bilateral trade flow with the grocery store, overall trade flows do have consequences. A sustained imbalance of imports over exports has implications for the value of a nation's currency as well as for its foreign currency reserves (which in turn affects a nation's ability to make purchases from abroad). Even though the rest of the world has been willing to lend America vast quantities of their people's savings at low cost, U.S. trade imbalances have produced debts that will have to be paid off in the future. Those debts could be paid down by earnings from productivity increases (including increases made possible by capital investments financed through borrowing). More likely, payments will come from taxing future generations to retire debt or from erosion of the currency's value, which then limits economic options in other ways.

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Yet this cost of trade imbalances is poorly understood and plays an exceedingly small part in trade politics. The far larger concern for politicians is that trade affects employment. The typical political view is this: imports compete with domestically produced goods and hence replace domestic production; exports, on the other hand, increase employment by expanding domestic production. Both conclusions are mainly wrong. Domestic employment depends on total demand for labor, what our workers do especially well, how our productivity compares with that of other workers, how our capital investments fit with labor needs here, and a host of other factors not captured in the simplistic model of employment and trade common to politics. Since the days of Adam Smith and David Ricardo, we have operated from the basic economic insight that letting everyone specialize in what they do best and facilitating exchange so that everyone has access to the widest array of products is the best way to expand markets, spur competition, and improve output. That produces the best use of our own resources, including the energies of our workers, and ultimately produces the highest incomes and best employment opportunities for our workers. Exports are a part of this—often an important part. Exports tend to be the most efficient, world-class products, and export industries often provide valuable employment opportunities for workers. Look at the world markets for global brands such as Caterpillar, Coca-Cola, Intel, Microsoft, or any number of others. The mechanism by which export success contributes to overall economic success is part and parcel of a competitive process that rewards the most efficient and innovative firms—it is not the result of an "add on" to other economic activity.

The case for open trade, however, is not absolute. Two important economic arguments urge exceptions to the general rule. First, nations with large internal economies can at times improve their position through trade restrictions that decrease the prices charged to their consumers, essentially extracting better "terms of trade." This is the international equivalent of Wal-Mart using its economic muscle to negotiate better terms for what it buys. While theoretically sound if it could be done without repercussions, politicians almost never advocate trade restrictions best explained on this ground.

Second, economic writing over the past three decades has explored ways in which trade restrictions might create world-beating businesses by helping domestic firms capture economies of scale. These facilitate lower prices and better sales of goods with high up-front costs—research and development, for instance—and low marginal costs. Many high-technology markets have substantial economies of scale. Some also show "network effects"—making products more valuable as more people use them (think of telephones or shared computer software, for example). In certain specific settings, trade restrictions *could* assist highly efficient domestic firms to succeed in the "winner take all" (or winner-take-most) markets with these characteristics.

But trade restrictions, even in these markets, do not assure success (especially in a world where others can adopt retaliatory restraints of their own) or guarantee that any jobs gained for domestic firms will be in the domestic market. And the theory does not match up well with the trade restrictions nations actually have, even in the "right" markets. Mainly, trade restrictions in winner-take-most markets prop up inefficient firms rather than facilitating gains by efficient ones—in part because firms that are not as efficient or innovative in product markets often are better at the tasks needed to secure protection against competitors.

While much academic time and energy has been devoted to the theory, in the political realm these explanations are more often excuses seized on to justify restraints prized on other grounds. Generally, economic analysis supports the position that free trade tends to generate more employment and more value for workers as well as for consumers.

The Politics of Trade

Real world trade restrictions most often have a different explanation: they preserve inefficiencies at the expense of job growth and economic advantage to serve narrower political interests. Politicians are notoriously responsive to the concerns of groups most intensely interested in specific issues. These are the people who will raise money to influence political decisions, speak out on those issues, and turn out to vote for or against politicians based on their positions on those issues. This asymmetry tends to favor producers over consumers. We all want access to a wide array of foods at low prices—more choices, better products, lower cost is the set of interests consumers would demand if we were organized and motivated. But it is easier to get a relatively small group of farmers or workers organized and motivated; their interests typically are served by reducing choices and increasing prices. As a rule, no one, not even those at the most successful enterprises, *wants* competition. Successful businesses tolerate it, adapt to it, and profit from being better than their rivals. They invest in innovating and marketing both products and processes to get ahead. Less successful enterprises invest in reducing competition.

Trade is the ultimate form of competition. While, overall, competition brings benefits no other system has been able to match, that is scant comfort to anyone forced to make difficult, sometimes personally devastating changes to adapt to competition. Political forces incline to insulating potentially losing parties against those changes, especially when competition has a foreign face. Tariffs, relatively visible trade barriers, still are used by many developing nations to protect domestic industries. Most other hurdles to open trade are harder to see. Both developed and developing nations impose special licensing requirements on imported goods, tailor technical standards to disadvantage market-leading foreign products, and use competition law regimes to discourage competition by strong foreign firms. They encourage exports through rebate programs, impose health and environmental standards that lack scientific support, limit protections for the intellectual property of innovative firms, and exploit other regulatory and financial tools to favor domestic producers over more efficient foreign competitors. Even where legal regimes look neutral on their face, administrators often tilt their application toward domestic favorites.

Protectionism in Difficult Times

Politicians support these restrictions on trade even while inveighing against protectionism. The threat of reciprocal trade restrictions haunts discussions of steps nations should take to combat the current economic crisis, with a 1930s style global trade contraction—trade fell by two-thirds in just five years—as the nightmare scenario no one wants to repeat. Look at the joint pronouncements issued after the November 2008 meeting of G-20 presidents and prime ministers or the April 2009 G-20 summit in London. But few of the leaders mean quite what they say in group settings like this, and fewer yet will take the hard steps needed to back up their rhetoric.

Far from evaporating in the face of financial distress, the protectionist instinct grows stronger in bad times. Thus, the World Bank found that, in the first few months following agreement among G-20 leaders to eschew protectionist measures so they could combat the global economic crisis together, at least 17 of the 20 nations imposed new protections for domestic industry and agriculture. Argentina imposed new licensing requirements on auto parts, toys, and leather goods. Indonesia limited imports of clothes, shoes, electronics, and food to just a few ports. The United States adopted a "Buy American" provision, though less sweeping than originally proposed, as part of its most recent stimulus plan. Russia placed new tariffs on auto imports. China banned Irish pork imports and limited other food imports. India banned toys from China. Both India and China increased export subsidies. France made it harder for foreign firms to take over French ones. And nearly every nation has given subsidies to industries to stave off the effects of the downturn, with finance and auto industries prominent recipients of new state aid.

As governments invest vast amounts of public resources in propping up weak businesses and trying to end the downward spiral of de-leveraging, credit contraction, job losses, and reduced consumption, leaders face both popular anger at perceived misuse of taxpayer funds and intense pressure from powerful domestic constituencies—not least, workers who see their jobs at risk. Everyone wants public funds spent where they will be most effective in combating the current crisis—and, even more, where the money has greatest prospect of coming back to them. Few voices express sympathy for spending that advantages foreigners. The thought is that we're spending *our* money to fix *our* economic problem—let them take care of their own. The public is not clamoring to cut off trade, and does not want to spark a trade war, but both the broader public and intensely interested groups strongly support measures to tilt public money their way. The Buy American provision and President Nicolas Sarkozy's call for French automakers receiving government funds to safeguard jobs in France are examples. With governments increasingly intertwined with once-private firms, new requirements at odds with open trade—even if not boldly violating international legal obligations—inevitably proliferate.

Paradoxically, these steps are being taken at a time when the economic case for trade protection has grown weaker. Expanded international trade and finance over the past half century, and especially the past quarter century, have largely undermined the plausibility of seeing competition in us-versus-them terms. World trade has grown every year since 1982; today it is nearly double what it was a half century ago relative to world GDP and roughly 120 times as great in nominal terms. Global trade and finance flows reflect the way businesses work. Firms routinely disperse production across nations. American companies rely on output from China and Japan, Germany and Mexico, Canada and Korea, Ireland and India and Italy to fill out product lines and provide components for "American made" products. Likewise, American firms supply equipment, services, and parts to firms based overseas. It is entirely common today to have components from three or four or five nations assembled in another country based on design work from yet another. Finance flows make investors from many nations stakeholders in almost any global business's success—or, as current events show, partners in its failures. The concept of a uniquely American or French or Japanese product is largely an anachronism.

Yet sensitivity to job losses in industries visibly competing with imports still prompts protectionist responses. Job losses are growing everywhere, and the cascade of protectionist reactions is growing as well. Most political leaders want to keep trade open only as needed to maintain export opportunities and protect jobs in export industries. That is *a* reason to promote open trade, but it does not provide a secure base for fighting against protectionist impulses. Few political leaders understand why trade should matter to ordinary people and to the broad array of workers whose jobs depend on letting markets work—not just to those who benefit directly from open trade but also to those who benefit in a thousand less visible ways from the increased choices, improved products, and reduced costs that competition spurs. Promoting growth in highly advanced economies and generating growth in developing ones are goals almost always synonymous with more open trade. But politics follows economics only so far. While common sense may protect us from cutting off trade with our grocery store for its "unfairness," that is not enough to guarantee the right outcome at the national level, especially when economies are teetering and popular passions are simmering. More than 230 years after Adam Smith, keeping protectionism at bay remains a challenge far more serious than getting a good press statement at a summit.