

# Protectionism

**Protectionism** = Policy of sheltering domestic industries from foreign competition through the imposition of trade barriers on imports

## Methods:

- Tariffs
- Quotas (have tariff-like effects)
- Export subsidies/Subsidise domestic firms
- Forex controls (limit amount of foreign currency made available to importers and investors who wish to conduct FDI overseas)
- FTAs
- New protectionist measures (e.g. technical specifications/standards, administrative regulations, preferential treatment)

## Advantages

### 1. Improve economic performance

- When:
  - To address weak economic growth
    - Plus there are often limited policy options
      - Fiscal policy → Requires funding which is difficult in times of recession
      - Monetary policy (i/r) → Firms and households likely to be pessimistic of future ⇒ C, I unlikely to increase despite ↓i/r
      - SS-side → Likely to require funding as would generally be looking at ↓COP
    - To offer temporary protection for sunset industries → Loss of CA in a particular industry due to the emergence of a more competitive country with greater CA in the industry
    - To address worsening BOP
- How:
  - Draw Tariff Diagram
    - ↑P of foreign imports to domestic consumers to  $P_{M+Tariff} \Rightarrow \uparrow Q_s + \downarrow Q_d \Rightarrow \downarrow Q_m \text{ demanded} \Rightarrow$  Consumers switch to relatively cheaper domestic goods and services (consumption effect) ⇒ Domestic producers increase production to meet ↑DD by employing more factors of production including labour (production effect) ⇒ ↑AD due to ↓M since  $AD = C + I + G + (X-M) \Rightarrow$  m.t.p. ↑ real NY via multiplier effect + ↓ cyclical UnN + Improve BOP
  - Avoid large scale structural UnN in sunset industries → Hope is that this buys sufficient time for country to switch resources into other industries

2. Improve budget position
  - Government able to earn  $\uparrow$  tariff revenue especially for low-income countries that have no other sources of tax revenue OR in times of recession in order to fund Fiscal/SS side policies
  - Show tariff revenue on tariff diagram
3. Nurture infant industries
  - Protect infant industries from foreign competition as there are often high fixed costs which cannot be completely recovered by small initial output  $\rightarrow$  Give infant industries enough time to  $\uparrow$  {output  $\Rightarrow$  Reap  $\uparrow$  EOS  $\Rightarrow$   $\downarrow$  AC in the LR  $\Rightarrow$   $\downarrow$  P in the long run  $\Rightarrow$   $\uparrow$  price competitiveness in the LR}, reputation (quality, branding), develop skilled workers and technology
4. Prevent over-reliance on certain industries and on foreign imports for necessities
  - Purely specialising based on Theory of CA may lead to over-specialisation in certain industries and neglecting of key industries which produce necessities (e.g. food, water)
  - Protectionist measures help to protect domestic producers in key industries that have lower CA from foreign competition in order to prevent domestic producers from being forced out of the market  $\Rightarrow$  Diversify the economy to prevent over-reliance on certain industries + Prevent over-reliance on foreign imports for necessities even though the country is likely to never develop CA in these industries
5. Protect against unfair trade practices & dumping
  - **Dumping** = Sale of goods in an overseas market below the marginal cost of production
  - Purpose is to drive out domestic producers in the importing country so that exporter can eventually monopolise the market
  - Dumping brings about market distortions which are damaging to the domestic economy in the long term  $\rightarrow$  After collapse of domestic firms,  $\uparrow$  P,  $\downarrow$  AD,  $\uparrow$  UnN (esp structural)

## Disadvantages/Limitations

1. Goes against Theory of CA
  - Specialisation and free trade would lead to  $\uparrow$  world output with all trading partners benefiting  $\rightarrow$  Protectionism prevents the country from reaping the benefits
  - Perpetuates allocative inefficiency  $\rightarrow$  Prolongs inefficient use of the country's resources
  - See International Trade
2. Beggar thy neighbour
  - $\downarrow$  Imports of country practising protectionism =  $\downarrow$  Exports of trading partners  $\Rightarrow$   $\downarrow$  Export revenue of trading partners  $\Rightarrow$  m.t.p.  $\downarrow$  real NY of trading partners  $\Rightarrow$   $\downarrow$  ability of trading partners to consume including imports  $\Rightarrow$   $\downarrow$  Exports of country practising protectionism  $\Rightarrow$   $\downarrow$  AD  $\Rightarrow$  m.t.p.  $\downarrow$  real NY

3. Negatively affects export industry
  - $\downarrow M \Rightarrow \downarrow SS$  of domestic currency  $\Rightarrow$  Appreciation of domestic currency, c.p.  $\Rightarrow$   $\uparrow P_x$  in terms of foreign currency but constant in terms of domestic currency  $\Rightarrow$   $\downarrow Q_x$  by foreign consumers  $\Rightarrow \downarrow X \Rightarrow$  Moderates  $\uparrow AD$  due to  $\downarrow M$
  - In addition, may lead to retaliation by other countries who now adopt protectionist measures against their exports
    - $\downarrow X$  of country practising protectionism
4. Inflation
  - $\uparrow P_m$  from  $P_M$  to  $P_{M+tariff} \Rightarrow \uparrow P$  of imported goods +  $\uparrow P$  of imported raw materials  $\Rightarrow \uparrow CPI + \{\uparrow COP \Rightarrow \downarrow AS \Rightarrow \uparrow GPL + \downarrow \text{real NY}\}$
  - $\uparrow COP \Rightarrow \uparrow P_x \Rightarrow \downarrow$  price competitiveness  $\Rightarrow \downarrow X \Rightarrow \downarrow AD \Rightarrow$  m.t.p.  $\downarrow$  real NY
  - $\uparrow P$  of imported goods  $\Rightarrow \downarrow mSOL$  as domestic consumers able to consume less imported goods for the same income level
5. Difficult to identify infant industries that the country could potentially have CA in
  - May lead to perpetual infants that require continued protection in order for the industry to survive  $\Rightarrow$  These industries may remain inefficient due to complacency
  - Opp costs associated with subsidies in these industries which could have been better use in education, R&D etc
6. Does not address root cause of the problem of BOP deficit
  - e.g. Could be due to high inflation, unfavourable terms of trade

## Conclusion

- Countries that have strong domestic DD and close domestic substitutes can consider protectionist measures
  - However, still detrimental to the country as  $\downarrow X$  if retaliation, sacrifice  $\uparrow$  world output, may snowball in the LR due to dynamic gains from trade
- Countries such as Singapore that depend greatly on X and M, resource-poor should not consider protectionist measures
- Protectionism often only a temporary solution
- In the end, countries should employ other measures (e.g. SS side policies) to address the fundamental cause of their problems