POLICY AND PERFORMANCE IN INTERNATIONAL TRADE

Papers of the Sixth Annual Conference of the International Economics Study Group

Edited by

John Black and L. Alan Winters

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Introduction

This volume publishes the papers presented at the International Economics Study Group's Sixth Annual Conference, held at the University of Sussex Conference Centre in September 1981. The object of the conference was to examine, mainly in empirical terms, the links between economic policy and trade performance, and hence economic performance in general. Economic policy is interpreted broadly to stretch from tariff policy through exchange rate policy to policies concerning the general economic climate. Similarly performance is viewed both broadly, in terms of GDP growth, and narrowly, in terms of the balance of payments, and a great variety of economies are considered. The result is a wide-ranging assessment of the impact that policy and competitiveness have on international economic performance.

The book opens with a paper by Forrest Capie on tariff policy in the nineteenth century. Many authors have resorted to historical data to try to discover the effect of protection on economic growth. The upshot of their research usually seems to be the confirmation of their initial view whether that is that protection is good or bad! Dr Capie briefly surveys the field, covering all the major nineteenth century economies, before presenting his own thesis. The latter is that basically the evidence is inconclusive. This conclusion is based partly on regressions of growth rates on tariff levels for four major countries, which reveal little or no systematic relationship either way. More important, however, are the data themselves which reveal that in fact tariffs were generally relatively low throughout Europe during most of the nineteenth century. Hence the differences between 'free-trade' and 'protectionist' countries, or between 'free-trade' and 'protectionist' phases for a single country, were generally far too small to account for the large differences in growth rates or the initiation of industrialisation. Tariffs in Russia and America were in general rather higher than in Europe, but even here, Capie argues, the timing of the various phases of protectionism and economic growth suggests that no significant relationship exists between them.

An important methodological issue identified by Capie is that if protection were to have stimulated or hindered industrialisation the important dimension would have been effective protection (protection for value added) rather than nominal protection. This further supports the general thesis, for the evidence suggests that nineteenth century tariffs schedules showed much less escalation than today's and that therefore effective rates approximately equalled nominal rates. Indeed Capie adduces some evidence that they may even have been lower.

Dr Capie's paper should caution the economics profession against casual empiricism or sweeping generalisation. The nineteenth century economy was just as complex a phenomenon as today's and the data on it, despite their paucity, require just as careful handling. Just as we rarely uncover simple universal economic truths today, so Capie shows we are unlikely to find them in the nineteeth century also.

Brian Hindley's paper concentrates on trade policy and economic performance in the UK. It opens by observing that empirical evidence can only refute generalisations, not prove them, and hence shows by reference to historical experience that in general protection is neither necessary nor sufficient for the acceleration or deceleration of economic growth. Overall, he argues, history tends to weaken rather than strengthen the case for protection. Hindley then considers current pressure for protection within Britain, examining the views of the Trades Union Congress and the Cambridge Economic Policy Group. The former's plan - for selective protection of ailing industries - is likened to the pressure for the Corn Laws, and while possibly misguided does have some basis in economic theory. The prescription of latter, on the other hand, which involves universal protection for manufactures is argued to be entirely fallacious.

The debate between the CEPG in Cambridge and the more neo-classical practitioners of international economics has often been marred by the failure to recognise that the two sides start from fundamentally different assumptions, see especially the CEPG complaint that they do not assume (or predict) full employment whereas the neo-classics do. Hindley has, therefore, performed a considerable service first by meeting the CEPG on their own, under-employment, ground, and second by carefully identifying the assumptions that take them there and from there to their radical policy position. Hindley shows that assuming real wage rigidity in an otherwise neo-classical model is sufficient to produce CEPG type results, but he goes on to show that under such a regime, while protection may increase employment in the short-run, it does so at the expense of capitalists' incomes. This, he argues will eventually and inevitably reduce investment and hence real wages relative to the free-trade alternative. Hindley then shows that if one additionally assumes mark-up rather than competitive pricing, the CEPG result on employment necessarily obtains, but that there are no deleterious effects on investment. From this he identifies pricing as the crucial element of the CEPG's radical position.

On protectionism in general Hindley ends on an agnostic note. He argues that Britain's poor economic performance is intimately connected with her poor productivity record, and since we have little understanding of the latter we have little idea how to cure the former. It does seem, however, improbable that protection alone can transform British industrial practice and hence usher in a period of rapid economic growth.

The third paper - by Alan Deardorff and Robert Stern - switches from broad assessments to a particular issue: namely an assessment of the protective effects of domestic tax structures. For the UK, the USA and Japan the authors present data on taxes levied on labour, capital and domestic sales for twenty-nine sectors. Then using a generalisation of the theory of effective protection they calculate the protective effects of each tax separately and then all three together. The results are finally compared with the protection stemming from tariffs proper.

The protective effect for a sector from a particular tax is defined, as traditionally, as the proportionate increase in value added that the tax occasions. The novelty of Deardorff and Stern's paper is that they calculate this from a full general equilibrium model, rather than from the degenerate form usually adopted in the effective protection literature. Hence the effect of a tax on, say, steel in the USA depends not only on the share of value added in steel production and the share of steel in other industries' inputs, but also on factors like the response of consumers to changing prices, the effects on employment and hence on incomes of changing input prices, the responses abroad to the reduction in the demand for steel and the effect on the exchange rate.

We examine protection to get an indication of the reallocative effects of various taxes. Hence of more importance than their levels is the variability of tax rates over industries. In all three countries Deardorff and Stern consider labour taxes are relatively uniform whereas capital and sales taxes show considerably variability. Hence it is the latter which are of significance in their protective effects: for instance the range between the highest and lowest changes in value added in the UK is 4.3% for the system of labour taxes compared with 10.2% for capital taxes and 16.5% for sales taxes. The corresponding statistic for the tariff system is 3.4%, and tariffs also have least effect in the other countries. This suggests that our concentration on tariffs as an impediment to trade is misplaced: it appears that after the Kennedy round, except for a few obvious exceptions, they varied so little as to be of almost no effect.

The next two papers - McAleese and Marsden and Hollander - address the problem of measuring competitiveness in a small open economy. Dermot McAleese examines carefully the recent competitiveness of the Irish economy, concluding that the turn of the decade found it very uncompetitive and identifying several unfortunate consequences of this. McAleese argues strongly in favour of measuring competitiveness in terms of relative costs rather than relative prices, or worse still unit values, and he also considers several different methods of combining competitors' costs into a single index. These are important questions in empirical work and McAleese shows that in the Irish case different measures of competitiveness tell quite different stories.

Having found a measure McAleese then examines the course of competitiveness over the last twenty years. Until 1978 Irish competitiveness improved relative to continental Europe but worsened relative to the UK and North America. Then in 1978 Ireland joined the EMS and broke parity with sterling, and since then Irish competitiveness has declined relative to everywhere except the UK. Among the consequences have been a severe squeeze on profitability, declining trade performance, and most interestingly, a curtailment of inflows of direct investment. McAleese attributes the last particularly to uncompetitiveness relative to Europe (for Ireland had previously attracted investment oriented towards serving continental, not British, markets) and also to Ireland's high inflation rate in local currency terms. McAleese argues that domestic inflation reduces competitiveness and the attractions to inward investment, in a way that cannot be immediately off-set by equi-proportional depreciation. Hence he is rather pessimistic about the future unless the inflation of labour costs can be quickly contained; otherwise, he fears Ireland will experience declining growth and rising unemployment.

The fifth paper - by John Marsden and G. Hollander - is concerned with Australia. Overall the Australian economy has been more successful than the Irish economy just considered, but this is in large part due to its primary sector. The manufacturing sector has experienced considerable switches in competitiveness, a substantial tariff cut and a large increase in import penetration. It is these that Marsden and Hollander examine.

Taking manufacturing as a whole Marsden and Hollander decompose changes in competitiveness (in price terms) into components due to changes in foreign prices, tariffs, the exchange rate and domestic prices. They find, roughly speaking, that the foreign and domestic price components cancel out (despite being measured in different currencies), that tariffs have little effect, and that the overall change in competitiveness is well represented by the change in the nominal effective exchange rate. Furthermore they show that even for a relatively small manufacturing sector like Australia's there are substantial and long-lived swings in competitiveness - the competitiveness index rises from 96 in 1970 to 124 in 1974, then falls to 93 in 1979, whence it starts rising again. This, and other, evidence leads Marsden and Hollander to doubt the validity, or certainly the relevance, of the so called 'law of one price', and its analogue in exchange rate theory - the purchasing power parity theory of exchange rates - which held considerable sway in Australia over the seventies.

Marsden and Hollander next consider the effects of changing competitiveness on imports. They argue the importance of disaggregation here, for about two-thirds of Australian imports are non-competitive industrial inputs and a further 10% are subject to quantitative restrictions. Hence adjustment to competitiveness is concentrated heavily onto a few industries; this firstly results in considerable potential stress in these industries and secondly makes imports as a whole rather unresponsive. Examining the 1974-5 surge of manufactured imports they argue that it was due more to a (persistent) shortage of capacity in Australia than to price effects, for had the latter been important the penetration would have been reversed as competitiveness subsequently improved and import restrictions returned.

Pursuing the disaggregation Marsden and Hollander repeat the decomposition of competitiveness on a sectoral basis. The aggregate results are replicated - protection hardly matters, but exchange rates are important. The latter are measured here by 'industry specific exchange rates' - effective rates constructed with industry specific weights. These assume that the patterns of Australian trade are not drastically changed by relative exchange rate changes among competing nations, for otherwise the industry specific weights would be too variable to be useful. While this is obviously not precisely true, the new concept is useful in highlighting the differential sectoral effects of macro economic shocks.

The next paper turns to less developed economies. Vasilis Panoutsopoulos examines and contrasts the export performance of the main Latin American and East Asian economies over the 1970s. The contrast is very marked - the Latin Americans generally increased their trade with the industrialised countries relatively slowly, while the East Asian countries raced ahead, especially in the area of labour intensive manufactures. Latin America showed greater commodity concentration and less geographical flexibility than East Asia, tending to concentrate on traditional industries (primary processing) and markets (especially the USA). Panoutsopoulos presents a careful disaggregated analysis of the two regions' manufactured exports, making use of a one dimensional shift-and-share analysis. The difficulties of this method are well recognised, but the results are sufficiently stark for us to accept them: the contribution of changes in their share of developed markets was six times larger for East Asia than for Latin America over 1970-4 and about the same over 1975-8.

Panoutsopoulos concludes his paper by trying to draw policy conclusions from the different experiences of these two areas. He presents very many hypotheses as to why East Asia should have fared much better. Among the possibilities he mentions are: the better infra-structure (a legacy of colonialism compared with Latin America's independent efforts), greater reliance on price signals from the world economy, conservative fiscal policy coupled with open banking, 'less progressive' labour policies, the lower (though not generally absent) level of protection, a more pragmatic attitude to foreign investment, and a less inward looking attitude to regional economic integration. One could add others - for instance the different nature of inward investment from Japan (into Asia) and the USA (into South America), the different nature of agricultural output, or different stages of development - but one can not deny the force of Panoutsopoulos' position. He quotes supporting evidence for his various proposals (usually from secondary sources and often of a somewhat circumstantial nature) and builds up an overwhelming feeling of the dynamism of the East Asia economies compared with the rather hidebound attitudes of Latin American (and mature Western?) economies.

The importance of this paper lies not in the logical necessity of its explanations, but in the stark way it identifies an intellectual puzzle and the shopping list it presents for further research into its solution.

The final paper of the volume is a complete change from its predecessors and pulls us up with a start. Borkakoti investigates the methodology underlying so much of our current pure theory of international trade. The analysis of the determinants of trade performance, the effects of tariff, the measurement of competitiveness etc, are all unlikely to be empirically fruitful if their underlying basis in pure theory is not well justified. It is Borkakoti's thesis that it is not. After a brief excursion into the philosophy of science Borkakoti considers the Ricardian and Heckscher-Ohlin models of trade. Both, he argues, are sophisticated artefacts constructed to give a spurious logical foundation to intuitive explanations of trade rather than the results of building upwards from a sensible and plausible set of axioms characterising the world as we know it. Furthermore, he says, the empirical evidence for the Ricardian theory is ambiguous while that for the Heckscher-Ohlin theory is worse. Borkakoti then introduces the neo-technology theories of trade - stemming largely from Posner. He argues that they have been developed in a rational fashion out of the empirical ruins of the earlier theories and that they have not yet been empirically refuted.

Borkakoti concludes with two comments on economic policy. Firstly he considers the theorems on the gains from trade. Because of the failings of the predominant modes of theorising, Borkakoti says, these are very poorly justified in fact. Economists may be aware of their theoretical pitfalls and empirical irrelevance, but the politicians who quote them are not. Secondly he considers more general policy issues and his conclusion, very crudely, is that if you have the wrong model you can't hope to get good policy.

The essays printed in this volume are very diverse in the economies they examine and in the methods they use. However certain themes recur fairly often and the present collection offers a considerable body of evidence on them. The first is the irrelevance, or at least small relevance, of tariffs to economic performance. Deardorff and Stern show that other taxes are more important, Capie suggests they were too low and steady to explain very much in the nineteenth century, Marsden and Hollander show they were dominated by exchange rate changes more recently and both Hindley and Panoutsopoulos suggest that other factors are more important.

These other factors constitute a second theme running through the volume. Trade performance, and through it economic performance, depends on more than mere relative prices. McAleese suggests that domestic cost inflation is important while Panoutsopoulos produces a whole list of other factors encouraging economic dynamism.

A third theme is that one must be careful over data. Capie reassesses nineteenth century data carefully and with fairly radical results. Marsden and Hollander show the importance of disaggregation while McAleese shows the importance of chosing the right competitiveness index. Too often in economics radical policy prescriptions are advocated unreservedly on the basis of statistics that are, quite plainly, not up to the task asked of them.

While, as editors, we would not necessarily agree with all that follows, we feel that the essays published here contribute substantially to the debate on the determinants of trade performance.

The editors would like to thank all those who contributed to discussion at the conference, especially the discussants, Ms L. Briscoe, Mr H. Katrak, Dr F. V. Meyer, Dr R. F. Owen, Mrs S. A. B. Page, Prof. M. A. M. Smith and Mr D. Vines. They would also like to thank the Social Science Research Council for financial support for the conference (the SSRC is not of course responsible for any of the views expressed) and for the work of the International Economics Study Group.

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