1-1-1986

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DEC 1 1986

EXCHANGE RATES, PROTECTIONISM AND FREE TRADE

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for Dr. Martallero
ECON 497H Fall 1986
December 1, 1986

Introduction

Since the end of World War II, Japan has restructured its economy and has fast become a world leader in economics. After the destruction brought about in World War II, it has managed to bring itself up to par with the rest of the more advanced nations of the world. Japan is now a power to be reckoned with.

Let us consider some reasons for Japan's economic ascension. Compared with other nations after World War II, Japan would have seemed the least likely to succeed. With generous American aid and stringent industrialization policies as well as controls on imports and exports, economic, political and social democracy and a new constitution as overseen by General MacArthur, Japan has caught up with the Western nations.

Since Japan is a small country with few natural resources, it must import huge amounts and varieties of raw materials with which to produce. At the same time, stringent controls on "unnecessary" imports were and continue to be imposed so as to keep much needed financial resources at home. Also, any foreign currency earnings from exports can then be used for priority objectives. "In this way, export earnings served as a key source of growth, both for foreign currency generated and as a means of spurring the development of higher value-added goods."[1]

As Japan grew and became more competitive in the world market, other nations began to see what was happening and eventually mutual concerns emerged between Japan and the advanced nations. "Japan's export growth, highly concentrated in a small number of industries and markets, has strained the ability of competing producers in other countries to adjust."[2] The United States has especially been hit hard by Japan's competitiveness; member nations of the European Economic Community are effectively protected from Japan's major exports because to their protectionist policies. In recent years, interest groups in the United States have begun to clamor for U.S. protectionist policies against Japan's aggressive and competitive industries. The question now raised is: should protectionism or free world trade be chosen as governments' policies towards Japan? The legislators must debate this question and come up with a satisfactory answer to hopefully pacify the majority of the interest groups clamoring for attention. The purpose of this paper is twofold, to:

1. examine the effects of foreign exchange rates on imports and exports between Japan and the United States in recent months, and

2. see what has been developing and in the process shed some light as to the possible merits of protectionism or the desirability of free world trade.

Effects of Foreign Exchange Rates on Imports and Exports

In recent years, as the world came out of the recession of the early 1980s, the strong prevailing dollar led to a slump in the U.S. export industries and a boom in imports. As a result, the United States has carried a large trade deficit with many countries of the world, especially West Germany, Japan, Taiwan and South Korea. Early in May 1986, leaders of the Western European countries, North America, and Japan met in Tokyo for a summit meeting to discuss world affairs, including, among other issues, terrorism and economic policies. This "Group of Seven" came up with a statement of objectives; among them (1) opening the international trading and investment system and (2) fostering greater stability in exchange rates.[3] The leaders agreed to coordinate their economic policies, and in doing so manage their currencies, giving rise to the term "managed float." The new agreement "relies on the willingness of governments to negotiate mutually beneficial economic goals and to put pressure on a country to change its course when its economy falls out of step. The new order rests on bargaining, not on binding commitments."[4]

Through efforts made by all governments concerned, Japan has let its currency appreciate, while the dollar was allowed to lose value, generating mixed reactions from critics on both sides. The Japanese businessmen complain that Japan was too generous to the other nations in letting the yen appreciate. They say: "the yen's appreciation has gone too far, and now threatens economic slowdown and possible ruin for small export-oriented businesses."[5] Indeed, as later evidence indicates, many important, large industries have been hurt by the stronger yen, just as, on the other side, the United States, Great Britain, and the other Western nations had taken their losses to the weaker yen long ago. In June 1986, an average 4.2 percent decline in unconsolidated profits was declared by major companies in all industries for the year ending March 31. However, sales had grown by 2.7 percent. Among those included in the average were the shipbuilders, electric and electronic goods, steel companies, and the automakers. Yet, some industries profited from the yen's rise. Oil company profits rose 1300 percent, and electric power company earnings increased 19 percent.[6] These benefits will be passed on to the consumers in the form of lower rates.[7]

Although the Japanese economy has felt the effects of the fluctuating exchange rates, the same cannot be said for the U.S. economy, or at least to the same extent. Many critics opine that the drop in the dollar value is not enough to bring down the trade deficit with Japan, nor can it help businesses already sunk and those sinking now in the U.S. Douglas Sease, of the Wall Street Journal claims that "Japanese manufacturers aren't about to give up their big shares of the U.S. market without a struggle. Many are absorbing the currency savings in reduced profits or even losses from their sales here rather than surrender to U.S. competitors. Others are launching crash efforts to cut their costs, either through overhauls of products and factories in Japan or by leaving Japan for lower-cost manufacturing facilities in countries like Taiwan or Korea."[8] Another critic writes that automakers will ship just as many cars to the U.S. as they did before because they are on voluntary quotas and they fear losing thier quota allocations for 1987. Hence the volume of trade of cars hasn't changed, but they have become more expensive, so that the trade gap, instead of shrinking, will widen even more.[9]

The latest evidence found suggests that the stronger yen has had an impact on the trade balance; Japanese exports to the U.S. have declined 13 percent, and its imports have declined 23 percent.[10] These reductions have taken their toll on Japanese unemployment. In July and August, it reached 2.9 percent, and there is a possibility that it will reach and exceed 3 percent before the end of the year. Although seemingly small, those percentages are considered high because companies try to keep their employees on the payroll, with layoffs only as the last resort. The government is trying to help by giving loans to manufacturers with surplus labor to keep them employed, or for manufacturers to try to shift into another line of business. Economists foresee a mismatch now beginning in the Japanese labor market, because skills are not easily transferrable between industries and people cannot just shift from one job to another in totally different industries.[11] The adjustment process will most probably take a few years until the economy is in balance again.

Economists are worried that if the imbalance between the U.S.

deficits and the surpluses of West Germany and Japan continue "there is a genuine danger that the dollar will start a precipitous slide like the one in 1978."[12] The chairman of the Federal Reserve Board, Paul Volcker, "has expressed concern in the past that the dollar's decline could accelerate into a free fall that would dissuade Japanese and other foreign investors from buying American securities and foster higher U.S. interest and inflation rates."[13] From these conditions we can foresee a recession, resulting in even higher protectionist pressures, with the global debt problem worsening, "and a worldwide slump would be almost inevitable."[14]

With these enormous pressures on the U.S. government to do something about the trade deficit, and the devaluation of the dollar not providing sufficient relief, protectionist groups are and have been on the rise. To oppose these, free-traders also exist, and each side believes that theirs is the best solution. Let us examine both sides of the argument to see possible merits as well as demerits of each.

Protectionism

"Protectionist measures are usually intended to meet two broad objectives: to provide visible and immediate relief to industries experiencing severe difficulties, and notably to their workforce; while allowing ongoing adjustment to changed circumstances."[15] In the U.S., the automobile industry had been clamoring for protection, and the government has pressured Japan into imposing voluntary export restraints on its automobile exports to the United States in the form of quantitative restrictions. "By reducing imports, protection seeks to raise the market share of domestic producers and the price they receive for their goods. Greater output and profitability in the domestic industry is presumed to increase employment and promote modernization."[16] We can observe the efforts on the part of the U.S. automobile industry to achieve this modernization, but it does not seem to be very successful. Various product promotion attempts have been made, but in the end, the automakers had to drastically reduce their finance rates on 1986 models in order to clear their stock before 1987 models arrived. Even with the quantitative restraints and resulting price increases, Japanese cars have been very competitive in U.S. markets.

An argument stemming from the basic one discussed above is that protectionism is justified when dealing with infant-industries and merit-industries. GATT (The General Agreement on Trade and Tariffs) exempts from free trade such measures designed "to protect public morals," "to protect human, animal or plant life or health," and to conserve a "national treasure" or "exhaustible resources."[17] The infant-industry argument has it that newly formed, "infant" industries should be protected to allow for their growth and development into more world-competitive industries. Once this development has taken place, the protection would be lifted and the no-longer infant-industry would have to be strong enough to survive the competition.

A final argument for protectionism is non-economic; it is the question of national security.[18] A nation would not want to become overly dependent on certain imports that, if interrupted, might endanger national security. Items such as camera lens, electronics or space equipment, that are easily convertible to defense, may be recommended for protection. In the case of Japan, it has imposed restrictions on imports of agricultural products because it wishes to become self-sufficient in the production of certain products such as rice, so that it will not have to rely on food imports to the extent that it would become too vulnerable to outside threats.

There are a number of arguments against protectionism; the theory that supports protectionism may sound logical and acceptable, but there are many issues which can be raised to refute the desirability of protectionism. "Numerous, recent investigations by international organizations such as the OECD and

GATT, have pointed to the costs of protectionism. Economic losses are caused by an inefficient employment of resources and unplanned and unintentional reallocations of production factors across economic sectors. Similarly, protectionism leads to a gradually emerging uncertainty in decision-making that may hinder risk-taking and long-term investments."[19]

One of the intentions of trade restrictions is to allow weaker industries to adjust and become competitive again. However, protection tends "to reduce competition and efficiency within the protected industries. Too many firms may coexist in any line of production, or too many product lines may be produced; freer trade would, by limiting the number of firms or product lines, make scale economies possible, substantially raising average productivity."[20] Thus, in practice, protection fosters inefficiency and reduced competition.

Also, restrictions are imposed to keep employment steady in the protected industries. However, the argument does not take into account the effect on the export industry. With restricted imports, there will be an increased domestic demand for the import-competing product, raising the demand for labor, which will increase the wage rate for the entire economy. The rises in costs can be passed on to consumers by the import-competing industry, but the export industry, in order to remain competitive, must absorb the costs and suffer a cutback in profits. If this continues, the export sector will no longer be able to hold on to all of the factors of production it held before the protection. Since labor has become more expensive, it is the first factor to be let go. "Employment gains in the sector producing import substitutes are thus largely offset by losses on the export side, with resources throughout the economy used at a lower level of efficiency."[21]

There are other reasons to believe that protectionism can cause a decrease in employment in the economy. Following through from the previous argument, as labor becomes more costly, firms will accelerate capital-labor substitution, resulting in reduced industry employment.[22] Another reason is that "protection sufficiently extensive to have a major impact on imports and employment in a wide range of industries is likely to lead to currency appreciations reducing total exports, thus curtailing employment in other sectors of the economy."[23] Instead of protectionism saving jobs, it has a backlash leading to reduced employment in other sectors of the economy.

The infant-industry argument also has its problems. First of all, it is not always possible to identify whether the conditions under which protectionism for an infant industry would be beneficial actually exist or not.[24] Moreover, "protection itself becomes less effective in promoting adjustment when-as a result of the repeated renewal of protectionist measures-the firms being protected have no reason to expect that they will ever be exposed to the full challenge of international competition."[25] Many times, it is intended that the barriers will be lifted when the industry has developed into a more mature and competitive one, capable of dealing with foreign competition. However, the firms claim over and over again that they are not fully adjusted yet, or that they are still weak and need continued protection. Thus, the barriers are never broken down, and the firms have no incentive to ever truly become competitive. The "infant industry" never grows up.

"Protectionist measures have complex and pervasive effects throughout the economy, so that the outcome of such policies frequently differs from the original intentions and objectives."[26] One such case is that protection is supposed to benefit certain employees in certain industries. But it has been found in a number of cases that those who benefitted were not those at whom the protection was originally aimed.[27] This is because of "shifts in the regional and occupational composition of employment within the protected country...Protection has done little for those workers who face the most difficult adjustment problems. Rather, whatever jobs have been created have gone to fairly mobile, better trained employees."[28] One noble intention for protectionism is to preserve jobs while allowing the industry to be shielded from foreign competition in order to become more modernized and able to compete. However, "the objectives of industry modernization and job preservation are frequently incompatible. More rapid modernization usually involves shutting obsolete plants and reducing the industry's labour force."[29]

Although both objectives are acceptable, they are incompatible with each other.

A final cost of protectionism that ought be added is one from a global point of view; resources will be utilized much more efficiently without trade barriers than in the existence of trade barriers. "With a dismantling of the obstacles to the free flow of goods, the collective application of the principle of comparative advantage will lead to an increasingly effective specialization and division of labor. Countries with rich as well as poor factor endowments will benefit as all countries concentrate their exports to their most efficiently produced goods."[30] In this type of environment, all countries stand to gain from free trade.

Free Trade

Now that all of the arguments against protectionism have been presented, it can be seen that free trade seems more beneficial to all countries. "According to the logic of the free trade theory, all governmental intervention is dysfunctional and impedes an optimum use of factors, from a global point of view."[31] However, free trade also presents its own set of problems. As mentioned before, with free world trade, each country would find its own niche according to its comparative advantage, leading to an international division and specialization of labor. But Keynes has pointed out that "the more a country is specialized, the more its growth will be dependent on the rise in exports...If integration with the world economy leads to lower levels of overall capacity utilization, the traditional argument in terms of greater efficiency of resource utilization is no longer necessarily valid."[32] There may be too much dependence on exports for economic growth, and not every country can expect its exports to lead in economic growth. There is also a home market for which to provide, which can lead to growth just the same, and be less dependent on forces outside the country for this growth.

Another argument against free trade has it that the absence of any restraints brings the world into a vicious cycle of deflation and competition. "Under the present trading and financial regime, each national attempt to achieve a payments balance or to reduce inflation by deflating its economy pushes

The major argument against free world trade has to do with depressed wages, Walras' Law, and Hecksher and Ohlin's factor price equalization theory. "Under conditions of free trade, labor markets are *de facto* integrated. This follows from Walras' Law which says that if one factor market and the goods market are integrated, the second factor market is *ipso facto* integrated."[36] Thus, the labor market is integrated and workers around the world are in competition with each other. The labor market around the world is in surplus, and free world trade will depress wages. Although locally some scarcities may exist, resulting in higher wages, they cannot alter the global situation.[37] Hecksher and Ohlin predicted that factor prices tend to equalize world-wide with free trade, and their predictions seem to be coming true, except that wages are moving in a downward trend towards the lowest prevailing wage.[38] This depressing of wages will contribute to the worldwide vicious circle in deflation discussed previously.

A final argument against free world trade concerns non-economic factors. It seems that free world trade would lead to increasing interdependency between countries, with national security being compromised, as well as political and cultural autonomy, and the traditional life-styles will be threatened as there is increased communications between nations and certain features of other cultures are "imported." These are all important values worthy of being conserved, and free world trade would threaten their preservation.[39]

Conclusion

Thus, it can be seen that free world trade can also have its disadvantages, which are not to be taken lightly. It seems that any trade policies between nations would have to be based on a compromise between free trade and protectionism.[40] More cooperation between nations is needed in order to establish a stable trade regime that is acceptable and hopefully beneficial to all. With no cooperation, a nation suffering from foreign trade restrictions may wan to itself restrict imports. Then, neither country would gain from these bilateral restrictions.[41] Cooperation seems a much better alternative.

The recent economic summit in Tokyo seems a step in the right direction. The countries agreed to coordinate economic policies and to put pressure on each other to change if one nation falls out of step with the others. This would result in more bargaining between the countries. It has been suggested that every issue should be put on the table, to be negotiated and discussed, so that countries will receive and make concessions in turn. Then perhaps a balanced agreement can be made. A refutation to this suggestion is that countries would be bargaining with reciprocity as a basis, thus raising the question about the economic rationality of the whole idea. Bargaining, it seems, has generally led to satisfactory results in the past.[42] Perhaps it is impossible for the world to have free trade, with the division of labor between countries and specialization. The alternative is to negotiate towards a "managed" approach to the world economy. Protectionism has led to more costs than benefits, but with the right conditions it can possibly be beneficial. As long as the protection is genuinely designed to help industries become more competitive, with intentions that this protection is only temporary, it seems that protectionism can be beneficial to world trade.

The economic summit in Tokyo also led to the countries agreeing to a currency system of a "managed float." This agreement seems a good idea, provided that these countries really do as they pledged and cooperate with each other. This system of managed float will help stabilize currency fluctuations and the world economy. Since protectionism is not such a viable policy, seeing its costs, perhaps exchange rate management would be a better alternative. The appreciation of the yen has helped in reducing the trade deficit that the U.S. carries with Japan. Because effects so far have not been substantial, it cannot be expected that the deficit will disappear or be tremendously reduced overnight; it will probably take a few years for balance to be more or less restored.

It must be recognized that "the impact of a sharp change in the U.S. monetary environment carries important implications for financial markets in Japan, just as actions affecting the monetary environment and financial markets in Japan affect U.S. markets."[43] Thus, there is a need for coordination in monetary policies between countries. As mentioned before, the economic summit in Tokyo was a step in the right direction, and if more of such summits can be held, then they would pave the way towards cooperation between all countries and a smoother world economy.

FOOTNOTES

[1] Thomas Pepper et al., The Competition (New York: Praeger, 1985), p. 21.

[2] Ibid., p. 24.

[3] "Test for Nakasone," New York Times, 6 May 1986, Sec. I, p. 13, cols. 5-6.

[4] "The Economic Centerpiece of the Summit," New York Times, 8 May 1986, Sec. I, p. 6, cols. 1-3.

5 "Test for Nakasone," op. cit., p. 13.

[6] "Unconsolidated Profit of Japanese Concerns Falls an Average 4.2%," Wall Street Journal, 3 June 1986, p. 32, col. 3.

[7] "Japan Adopts Steps to Cushion Impact that Strong Yen is Having on Economy," Wall Street Journal, 2 June 1986, p. 21, col.2.

[8] Douglas Sease, "As Japanese Yen Grows Stronger Why Aren't Import Prices Soaring?," Wall Street Journal, 30 July 1986, p. 21, col. 4.

[9] Kenichi Ohmae, "Rising Yen but No Falling Trade Gap," Wall Street Journal, 1 July 1986, p. 26, col.3.

[10] "Uncertain Climate: Japan Trade Surplus Widening Despite Yen's Appreciation," Asian Wall Street Journal Weekly, 27 Oct. 1986, p. 18, cols. 1-4.

[11] "Japanese Unemployment Rising to Record Level as Strong Yen Forces Companies to Slim Down," Asian Wall Street Journal Weekly, 27 Oct. 1986, p. 10, cols. 1-4.

[12] "Heading into an Economic Box," Wall Street Journal, 16 June 1986, p. 1, col. 5.

[13] "Baker Says that U.S. Has No Dollar Target," New York Times, 14 May 1986, Sec. IV, p. 2, col. 5.

[14] "Heading into an Economic Box," op. cit., p. 1.

[15] OECD, Costs and Benefits of Protection (Paris: OCDE, 1985), p. 21.

[16] Ibid., p. 21.

[17] Kozo Yamamura, Policy and Trade Issues of the Japanese Economy (Seattle: University of Washington Press, 1982), p. 18.

[18] Robert Carbaugh, International Economics (Belmont, CA: Wadsworth, 1985), p. 88.

[19] Gunnar Sjostedt and Bengt Sundelius, Free Trade-Managed Trade? (Boulder: Westview Press, 1986), p. 4.

[20] Jan Tumlir, Protectionism, Trade Policy in Democratic Societies (Washington D.C.: American Enterprise Institute for Public Policy Research, 1985), p. 5.

[21] Ibid., p. 6.

[22] OECD, op. cit., p. 15.

[23] OECD, op. cit., p. 16.

[24] Tumlir, op. cit., p. 4.

[25] OECD, op. cit., p. 22.

[26] OECD, op. cit., p. 10.

[27] OECD, op. cit., p. 15.

[28] OECD, op. cit., p. 16.

[29] OECD, op. cit., p. 21.

30 Sjostedt and Sundelius, op. cit., pp. 1-2.

31 Sjostedt and Sundelius, op. cit., p. 23.

32 Sjostedt and Sundelius, op. cit., p. 162.

33 Sjostedt and Sundelius, op. cit., p. 146.

34 Sjostedt and Sundelius, op. cit., p. 119.

35 Sjostedt and Sundelius, op. cit., p. 23.

36 Sjostedt and Sundelius, op. cit., p. 86.

37 Sjostedt and Sundelius, op. cit., p. 87.

38 Sjostedt and Sundelius, op. cit., p. 48.

39 Sjostedt and Sundelius, op. cit., p. 21.

40 Sjostedt and Sundelius, op. cit., p. 5.

41 OECD, op. cit., p. 196.

42 Tumlir, op. cit., p. 56.

[43] Yamamura, op. cit., p. 301.

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