ECONOMIC VIEWPOINT

Protectionism: A brake on economic growth

Following decades of trade globalization, protectionism now seems to be more fashionable, particularly with the arrival of Donald Trump in the White House. Should we be worried about the new trend? Because liberalizing trade had generally positive effects on the global economy, closing markets would inevitably be bad. Moreover, a rise in tariffs and trade barriers does not only hurt the targeted countries: it hurts the national economy as well. Generally, such policies domestically trigger price increases, declines in real income, a drop in productivity and currency appreciation that largely cancels out the desired impact on the trade balance. The worst scenario would, of course, be the start of a trade war in which tariffs, restrictions and reprisals would spread to several major countries. However, the benefits of free trade should not mask the problems experienced by the sectors and communities affected by globalization. Better public management there would help convince the public that protectionism is not a good solution.

Globalization in recent decades

It can be said that the globalization trend started at the end of World War II, when several international institutions such as the United Nations, International Monetary Fund (IMF) and World Bank were founded, and the General Agreement on Tariffs and Trade was introduced. The movement intensified later, with the establishment of the European Common Market in 1957, and the Organisation for Economic Co-operation and Development (OECD) in 1961. After that, the implementation of bilateral and regional free trade zones and the creation of the World Trade Organization (WTO) in 1995 accelerated the trend. In the 1990s, about 30 free trade agreements were signed a year. The proportion of global GDP covered by free trade agreements went from just under 10% in 1980 to 25% in 2015.

This trend triggered a widespread decline in tariffs on imports, and a drop in other types of trade barriers.[1] In the advanced nations, average tariffs went from about 10% in the early 1980s to less than 5% since the mid-2000s. During the same period, tariffs in emerging nations went from more than 30% to about 10%.

Rising protectionism since the 2008–2009 recession

The globalization trend weakened in the 2000s. Led by the WTO, the Doha round of negotiations for further multinational trade liberalization ended in failure in 2006, especially as a result of agricultural issues. The financial crisis and recession killed the 2008 attempt to revive negotiations in utero.

The economic problems that plagued the whole planet in 2008 cooled free trade enthusiasm for many countries. The crisis prompted many governments to institute stimulating budget policies that were also more nationally focused. Several trade restriction measures were implemented, which may be tariff-based, but are frequently regulatory. The famous "Buy American" clause in the Obama administration's 2009 economic stimulus program is one example of this type of more protectionist policy, designed to give the stimulus maximum impact domestically. In the United States, the trend persisted. According to the Centre for Economic Policy Research, 636 discriminatory trade measures have been introduced since 2008.[2] According to the OECD, 1,263 new discriminatory measures were implemented from 2009 to mid-October 2016 in the G20.[3]

[1] Examples of non-tariffs barriers include, among others: import quotas, local content requirements, public procurement practices, domestic subsidies, antidumping laws, Licensing, packaging, and labeling requirements, sanitary and environmental rules and requirements based on objectionable fishing, hunting, harvesting or resources extracting methods.

[2] Simon J. EVENETT and Johannes FRITZ, Global Trade Plateaus: The 19th Global Trade Alert Report, Global Trade Alert, CEPR Press, July 13, 2016, 120 p.

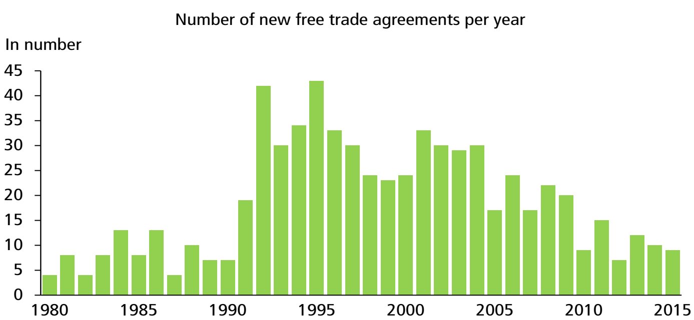
[3] 16th report on G20 trade and investment measures, Organisation for Economic Co-operation and Development, November 2016, 115 p.

François Dupuis, Vice-President and Chief Economist • Francis Généreux, Senior Economist

Desjardins, Economic Studies: 514-281-2336 or 1 866-866-7000, ext. 5552336 • desjardins.economics@desjardins.com • desjardins.com/economics

It is also now harder to have new free trade treaties adopted, either because of a lack of interest on the part of government authorities, or due to the political difficulties involved in getting them ratified. The number of free trade agreements is still rising, but much more slowly; from around 30 per year in the 1990s, the number of new agreements has dropped to about 10 per year since the crisis (graph 1). However, some of the more recent agreements sometimes have broader coverage in terms of the goods and services covered or the number of countries involved.

GRAPH 1
New free trade agreements are scarcer



Sources: Design of Trade Agreements Database and Desjardins, Economic Studies

Impact on the global economy

The recent surge in protectionism is damaging for growth by global trade. The trade in goods plunged during the crisis, of course, due to a drop in economic activity and tighter financial conditions, especially for export financing products. However, since the recovery, global trade growth has been fairly slow, both a symptom and cause of the international economy's weak advance (graph 2).

GRAPH 2
Slow growth by international trade

Sources: CPB Netherlands Bureau for Economic Policy Analysis and Desjardins, Economic Studies

According to OECD estimates, if trade liberalization had maintained its 1990s pace, global trade would have been boosted by 1% to 2% per year.[4]

If the rise in protectionism continues, and particularly if it spreads, it would have a bigger impact on the global economy. According to the OECD, "trade, and the related expansion of global value chains, boosts growth through increased productivity by improving resource allocation, increasing scale and specialisation, encouraging innovation activities, facilitating knowledge transfer, fostering the expansion of more productive firms and the exit of the least productive ones."[5]

The productivity aspect is especially important. The growth of an economy's output potential is a function of two elements: productivity growth, and demographic growth. Stronger productivity is therefore essential to an economy's health. The IMF identifies three ways in which international trade can have a positive impact on productivity: 1) imports increase competition for domestic businesses; 2) imported inputs can increase the variety and quality of the intermediate products available to business; 3) exporters can learn from their activities in foreign markets, directly or indirectly.[6]

By curbing international trade and, in turn, limiting all of the positive factors global trade offers for growth, including productivity, protectionism has direct negative effects on global economic growth in the near term, and over the long range. According to the OECD's estimates, one additional U.S. dollar in tariff revenue would trigger a US$2.16 loss in global exports and US$0.73 loss in global income.[7] Better international economic growth would therefore require globalization to keep going rather than stop. Moreover, liberalizing trade can help poverty decline in emerging and developing nations[8], which is not a trivial matter when we consider how much catching up they still have to do.

Impact on the national economy

Generally, when government authorities elect to implement a new protectionist measure, it is to help the domestic economy.

[4] David HAUGH et al., *Cardiac Arrest or Dizzy Spell: Why is World Trade So Weak and What can Policy Do About It?*, Organisation for Economic Co-operation and Development, OECD Economic Policy Paper No. 18, September 23, 2016, 39 p.

[5] *Ibid.*, 39 p.

[6] *Subdued Demand: Symptoms and Remedies*, International Monetary Fund, World Economic Outlook, October 2016, 289 p.

[7] *Trade, policy and the economic crisis*, Organisation for Economic Co-operation and Development, May 2010, 12 p.

[8] *Global Trade Liberalization and the Developing Countries*, International Monetary Fund, November 2001; Masato HAYASHIKAWA, *Trading Out of Poverty – How Aid for Trade Can Help*, Organisation for Economic Co-operation and Development, November 2008, 28 p.

The politicians are convinced that the economic, financial, social or political advantages will outweigh the disadvantages. It's true that certain measures may occasionally have had a positive impact, in the area of infant industries, for example, or sectors that are essential to a country's security.

However, economic theory says that protectionism is rarely a good idea. As early as the writings of Adam Smith in the 18th century and David Ricardo in the 19th century, economic thought argued in favour of free trade. In opposition with these classical economists, even Karl Marx made arguments against the idea that protectionism would save the workers.

What is the fallout for a country that opts for protectionism?

An increase in protectionism has a direct negative impact on a country's real GDP growth. According to an IMF estimate, a permanent 10-point increase in U.S. tariffs on imports from all regions would trigger a permanent 1% drop in real GDP.[9] Tariffs and other protectionist measures can impact an economy negatively in several ways. Here are the key ones:

Increase in import costs

Tariffs increase the prices importers pay for equipment and intermediate products. In the short term, even prices for similar goods manufactured domestically should go up, due to a sudden surge in demand. The rise in input prices could trigger a drop in business investment or decline in corporate profits. According to the same IMF estimate, a widespread, permanent 10% increase in U.S. tariffs would trigger a 6% jump in import prices, which would then partly resolve into a permanent 2% increase.

Increase in consumer prices

Higher import prices would, in the short term, lead to an increase in consumer prices, either directly or indirectly due to impact on input costs. The price increase would lower households' real disposable income. We can therefore see an increase in tariffs or restriction on the supply of imported products as a consumption tax paid by the entire population. The impact on inflation also has repercussions for monetary policy, as it reduces the leeway of central banks that are grappling with an artificial price increase. Lastly, we can also be concerned about the effect of protectionist policy on income redistribution. Globalization has helped bring down prices for many goods, often the consumer staples that are more heavily used by poorer households (for example, imports from China). This consumption "tax" is therefore particularly regressive.

Reduced economic efficiency

As we saw earlier, protectionism has a negative impact on an economy's productivity by discouraging competition, specialization, innovation and knowledge transfer. The economy is therefore less able to adapt to technological change or cyclical downturns. Weaker productivity growth leads to weaker advance by an economy's potential.

Currency impact

This is probably the most underestimated impact. By cutting real imports, the tariff increase triggers expectation of an improved trade balance. However, to balance this change with a fixed level of foreign investment, the currency will appreciate. The higher exchange rate will play against exports in foreign markets and support imports in the domestic market. In the end, it generally wipes out the initial goal: improving the trade balance. The IMF believes that a generalized 10% increase in U.S. tariffs would lead to a short-term improvement to the trade balance, followed by a permanent erosion of about 0.1%, as a proportion of GDP. However, currency appreciation will limit the initial pressures on import and consumer prices.

Reprisals and trade wars

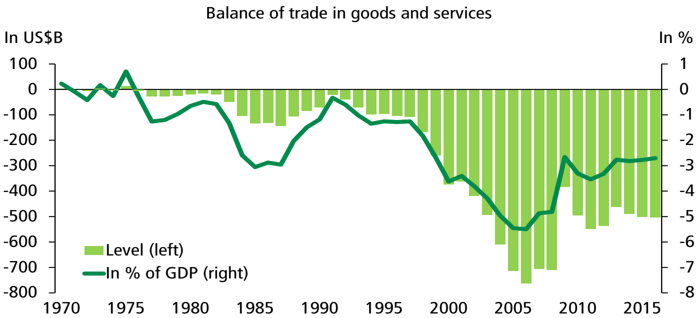
The negative effects listed so far affect the national economy, even without subsequent offences by the countries that are targeted by the new protectionist measures. The risk of payback is great, however. Given that globalization was a fairly widespread source of prosperity, a multilateral trade war can only be harmful to the global economy and would, of course, affect the country that fired the first round. Here, we can take a lesson from the generalized increase in U.S. tariffs (Smoot–Hawley Act) at the start of the crisis in the 1930s: it exacerbated the Great Depression in the United States, and made its consequences international. A trade war touched off by the protectionist aims of the U.S. government or another country is currently one of the main risks to the global economy and financial markets.

What about a trade deficit?

Is protectionism bad if it allows a country to go from a trade deficit to a surplus? According to mercantilist economic policy, no. Mercantilism looks at world trade in terms of winners and losers, with the winners benefiting from a positive trade balance. In the election campaign, Donald Trump seemed to be appropriating this simplistic analytical framework to criticize China, Mexico and all free trade agreements. True, the United States has had a major trade deficit for nearly three decades now (graph 3 on page 4). But is that a bad thing? In fact, a trade deficit reflects some economic realities: whether it is the relative strength of the domestic economy, the value of the currency or the fact that the United States continues to attract foreign investment input while U.S. national savings is relatively low. It is this foreign money that allows Americans to buy goods outside the country and that finances the trade deficit. A negative balance is not necessarily bad for an economy. This perception primarily stems from the usual way that national accounts are calculated, in which exports are added to domestic demand and imports are subtracted from it. It is important to

[9] Derek ANDERSON et al., *Getting to Know GIMF: The Simulation Properties of the Global Integrated Monetary and Fiscal Model*, International Monetary Fund, IMF Working Paper WP/13/55, February 27, 2013, 66 p.

GRAPH 3
The United States has recorded a consistent trade deficit since the 1970s



Sources: Bureau of Economic Analysis and Desjardins, Economic Studies

remember, however, that this subtraction is done solely to avoid double counting; consumption, residential investment, business investment, the inventory change and government expenditures can already include imported goods and services.

Moreover, can an increase in protectionist measures help improve the trade balance? As we saw earlier, the changes triggered by such a policy would instead tend to increase the value of the currency, reversing the effects on import prices and increasing export prices in foreign markets, putting the trade balance back close to where it was at the start.

Advantages, drawbacks and remedies

In most cases, the costs of the protectionist measures described above are often fairly diffuse. The drop in disposable income created by higher prices is shared by a large proportion of the population. The decline in business competitiveness generally becomes evident over the longer term, and has a bigger effect on the economy's potential than on near-term real GDP growth.

However, the problems caused by globalization or open trade are often more visible. The closing of a company that is unable to adapt, or the decline of an entire sector of industry can easily be represented by economic and social problems in one region, community, or category of workers. For example, opening up the markets had major repercussions in manufacturing in most advanced nations, particularly in the United States. The need for workers in manufacturing fell, because activities were moved outside the country and, especially, because of greater productivity (innovation and robotization). A problem situation that is very regionally concentrated often has more media and political weight than a gain that is greater, but more diffuse.

It is therefore important to allow the sectors and communities affected by open markets to adapt. Globalization's poor reputation and the comeback by protectionism could no doubt have been avoided if the authorities had paid more attention to potential problems and tried to resolve them, for example with business conversion and adaptaton programs, worker training, support for communities, or mobility assistance for available labour. However, it is not too late to learn some lessons from the past few decades. It would be good for the global economy to keep developing through more open markets, while supporting those who will inevitably be affected.

Francis Généreux, Senior Economist