DISCUSSION PAPERS

EXPORT ASSISTANCE, TRADE LIBERALISATION, STRATEGIC TRADE THEORY AND THE 'NEW DEVELOPMENT CONSENSUS'

Nicholas Gruen
DISCUSSION PAPER NO. 288
April 1993

G.P.O. Box 4, Canberra 2601, Australia
EXPORT ASSISTANCE, TRADE LIBERALISATION,
STRATEGIC TRADE THEORY AND THE
'NEW DEVELOPMENT CONSENSUS'

Nicholas Gruen*

DISCUSSION PAPER NO. 288

April 1993

ISBN: 0 7315 1615 X
ISSN: 0725-430 X

* Many people have helped me in developing my thinking on this issue. Those people include Bob Gregory, Fred and David Gruen, Ross Garnaut, Harvey Anderson, David Charles, Bill Carmichael, Neil Vousden, Neville Stevens and Rod Falvey. I am grateful to them all. Naturally their preparedness to offer comments on the arguments contained herein should not be taken as an endorsement by them of any or all of the contents of this paper. The author was an advisor to the Treasurer from January 1990 to April 1993, and is now Associate Commissioner at the Industry Commission. The views expressed in this paper are those of the author.
CONTENTS

I. Introduction
   1.2 The New Development Consensus and Trade Liberalisation  2
   1.3 Strategic Trade Theory and Trade Liberalisation  3
   1.4 Two Policy Questions  5
   1.5 Political Considerations  6
   1.6 'First' and 'Second Best' and Gradual Reform  7
   1.7 A Simple Analytical Framework  8

II. 2.1 Illustrating the Economics of Specialisation and Intra-industry Trade  11

III. 3.1 Price Competitiveness Shocks and Product Differentiation Shocks  15
     3.2 Industrial development and 'market widening policies'  17
     3.3 Australia and Compensatory Export Assistance  19

IV. 4.1 Conclusion  21

References

List of Discussion Papers  24
Summary

This paper explores some policy implications of 'new' or 'strategic trade theory' and the 'new development consensus' in favour of export oriented industrial development. In the context of gradual trade liberalisation, we briefly review the case for compensatory export assistance to alleviate the inward orientation of traditional protection. A simple heuristic diagram is developed to illustrate

- The economics of intra-industry trade
- The benefits of protection regimes which are export oriented and which permit intra-industry trade with or without economies of scale.
1.1 Introduction

This paper explores some policy implications of two bodies of literature in recent economics - 'New' or 'strategic trade theory' and what will be called the 'new development consensus'. The 'new development consensus' holds that trade and industry development policies which are outwardly oriented are superior to those which are inwardly oriented. Traditional protection - which we define here as tariffs and/or quantitative restrictions on trade - provides assistance by raising domestic prices. It is accordingly inherently inwardly oriented. In the context of gradual trade liberalisation, we briefly review the case for 'compensatory' export assistance to remove the inward orientation of traditional protection. The paper develops a simple analytic apparatus and diagram for discussing the worth of export assistance and in doing so is a companion piece for a subsequent paper which offers an introductory sketch of the economics of a curiously neglected instrument for ameliorating some of the worst features of traditional protection - the import/export link.\(^1\)

The paper has its origins in the trade liberalisation debate in Australia - a small, isolated, hitherto inwardly oriented country - which has an uncommonly large amount to gain from adapting the 'new development consensus' to its own circumstances and to its current unilateral trade liberalisation strategy. Nevertheless, in principle, the issues discussed here are relevant wherever trade barriers are used. They accordingly have some significance for policy making in developed countries, particularly in those areas where trade barriers - generally non-tariff barriers - are greatest such as in steel, textiles, apparel, and certain consumer goods including automobiles. The issues are also relevant to developing country policy makers seeking to make a practical and efficient transition to export orientation and/or to rationalise trade and industry policies which are already export oriented but haphazardly so.

\(^1\)Krugman (1981), p 3.
\(^2\) An import/export link provides exporters of products from a protected industry with entitlements to import products into that industry duty free to the extent of their export earnings. In contrast to the situation with by-law-for-export and duty drawback schemes, imports under an import/export link need not be re-exported to gain freedom from duty. The instrument is discussed at greater length in Gruen, (1993).
1.2 The New Development Consensus and Trade Liberalisation

For some time now it has been widely believed that export oriented development strategies strongly out-perform inwardly oriented strategies. Economic liberalisation and free trade remain a long term desideratum for many protagonists of the new development consensus, but the newly recognised importance of export orientation within industries - particularly manufacturing industries - has re-ordered policy priorities. In particular, where trade barriers will not be removed immediately, the case arises for replacing them with assistance such as bounties - which assists export at the same rate as assistance to import replacement, or for supplementing existing instruments with 'compensatory' export assistance sufficient to remove existing inward orientation within traditionally protected industries. This 'widens the market' in which firms operate and so is likely to facilitate faster productivity growth as firms expand their activities into those segments of the world market in which they have, or are seeking, competitive advantages. In this sense, the 'new development consensus' has an eye for the static and dynamic economies of scale available through intra-industry specialisation.

1.3 Strategic Trade Theory and Trade Liberalisation

Note that 'new' or 'strategic trade theory', which also focuses on the gains from specialisation within industries, can lend some intuitive support to the new development consensus. Most new trade literature is organised around the familiar polarity of free markets - in this case free trade - versus intervention. This ensures that whatever light might emerge from the new field, it is attended by more than its fair share of heat. The 'interventionist' results of strategic trade theory are notoriously brittle to the assumptions which produce them. And the whole field is riven with the perplexities which might be expected to arise from exploring the way in which gains from specialisation can support the case for restrictions on trade. In general, gains from specialisation could be expected to strengthen rather than weaken the case for free trade.

3 Export orientation in any particular sector may be defined as a situation in which export production receives at least as much assistance as import replacement. Rhee calls this 'extended neutrality' for exporters. [Rhee (1985)]. Of course free trade is a subset of those policies which provide 'extended neutrality' within industries or sectors of the economy.
4 Such as Anne Krueger, Bela Balassa and others associated with the World Bank for instance.
5 Balassa, (1989), 'Subsidies and Countervailing Measures', p. 43.
7 Krugman (1990), p. 2.
But the choices facing many policy makers are not those between free trade and 'intervention'. As Barry put it recently with regard to developing countries:

We need to focus on how to deal with the transitional issues - ... it is less important whether you think that free trade or strategic trade is the ideal than how you get out of the mess you are in now.  

Given this transitional perspective, a point emerges from the 'new trade' perspective which is arguably more robust than most conclusions about the circumstances in which 'intervention' should be preferred to free trade. Where we focus on the reform path towards free trade, and a consideration of the relative merits of different instruments of industry assistance, 'new trade theory' provides plenty of support for a trade liberalisation path which incorporates equality of assistance between import replacement and export as a worthwhile policy objective. If international intra-industry specialisation is increasingly a source of gain, then assistance which discourages it will be inferior to assistance which does not.

Amongst those 'new trade theory' models which generate 'interventionist' conclusions, few would justify the conclusion that, where assistance is provided, it should be available to import replacement only. In models which justify intervention with a view to capturing monopoly rents, maximising scale economies and/or international market share, assistance will achieve any given increase in output at lower cost if it is offered equally to all production within an industry. Where monopoly rents come from research, development, learning and innovation, then likewise, one would expect a form of assistance which was not restricted to production for the domestic market to be more efficient at capturing rents than one which did.

'Intra-industry trade theory' represents a specialised perspective within the new trade literature within which these issues emerge, if anything, even more clearly. Greenaway's extensive survey of the policy implications of intra-industry trade concludes that the various 'imperfections' in competition which give rise to intra-industry trade can also give rise to various possibilities for beneficial deviations.

---

9 Traditional protection discourages international specialisation. It offers assistance to firms to the extent that they do not engage in international specialisation, but supply their local market (often involving them in uneconomic diversification).
from free trade for a single country acting unilaterally. He comments that for many of the models in which the imposition of a tariff improves welfare, the tariff is actually correcting a domestic distortion. If so, then as he points out, other policies, particularly subsidies, could usually correct the domestic distortion at lower cost. Nevertheless Greenaway’s survey reflects the ambivalent spirit which pervades much respectable new trade theory today. He counsels against any generalisations, including the conclusion that subsidies are generally superior to tariffs.

However, a more simple point can be made. If intra-industry trade is increasingly a source of potential gain, then if we are to assist industries for whatever reason, we should use assistance instruments which do not penalise intra-industry trade. Traditional protection obstructs all trade including intra-industry trade. It imposes costs on the production of goods in direct proportion to the extent to which they involve intra-industry trade and specialisation.

1.4 Two Policy Questions

All this raises two policy questions. Firstly, what are the characteristics of assistance instruments which do not discriminate against international specialisation within industries? One characteristic will be that they offer assistance in such a way that production for export does not receive less assistance than production for import replacement. This rules out traditional protection. At the same time it underlines the standard result that bounties are to be preferred to traditional protection. They will generally not discriminate against international specialisation. Export assistance on its own - such as straight subsidies, concessional export finance and tax holidays for exporters - will discriminate in favour of international specialisation. In the absence of externalities it can be expected to lead to over-specialisation. Policies such as assistance to research and development, favourable financial and tax arrangements for certain producers are unlikely to discriminate against specialisation. They may have some pro-specialisation bias as firms direct subsidised resources towards developing specialised competitive advantages in the world market. Indeed such schemes are often developed with this in mind.

12 Greenaway, (1985), pp. 87-8, 90.
14 Note that these costs do not simply accrue to imported inputs into finished products. Traditional protection would generally impose costs on a company which chose to specialise in the manufacture of finished products (for domestic and export markets) at the same time as importing other finished goods to sell under its own brand name to satisfy domestic consumer demand for variety. See Section 2.2.
Secondly, what policy instruments alleviate the anti-export bias of traditional protection most effectively? By-law-for-export and duty drawback schemes address this issue, by seeking to exempt exporters from the direct cost burdens imposed by traditional protection. However they can do so only partially. Such schemes can remove some of the direct costs of protection which exporters face, but they generally leave production for export less assisted than production for import replacement. Where we seek to fully equate assistance between import replacement and export we can replace quotas and tariffs with subsidies. Where this is not practical, tariffs and quotas can be supplemented by 'compensatory' export assistance. A particularly effective means of doing this is by way of an import/export link, which can also replace and rationalise existing by-law-for-export and duty drawback schemes.

1.5 Political Considerations

Of course one can concede the strictly economic case for compensatory export assistance in a transitional context and yet reject such a policy on the grounds that, once provided, export assistance, becomes a new avenue for rent seeking pressure groups which might jeopardise further trade liberalisation. We do not discuss this at length here. However some summary comments are in order. Assuming unilateral free trade to be an attractive ultimate goal for a country, the attractiveness of the trade liberalisation path incorporating 'compensatory export assistance' will be a function of the direct economic gains to which it gives rise and the risk that it fosters political circumstances inimical to further trade liberalisation.

Where 'compensatory' export assistance is complex, and ad hoc it may be particularly vulnerable to subversion by pressure group politics. Perhaps partly because of the complexity of export assistance available in countries like Korea and Taiwan, economists have feared that effective 'neutralising' policies would be complex and unsystematic affairs. Rhee argued as recently as 1985 that 'neutralising' the inward orientation of barrier protection required a variety of piecemeal policies. He concluded that it was "clearly not simple to achieve".16 We

---

argue in the companion paper to this that it is simple to achieve 17 - with import/export links.

In any case it is not clear that compensatory export assistance would serve necessarily to increase an assisted industry's capacity to extract rent from the community as a pressure group. If the import competing sector of that industry is contracting while the export sector of the same industry is expanding, it may well become harder for the import replacers to call for assistance as imports increase. Here Porter's comments are suggestive. "Companies often attribute the success of foreign rivals to 'unfair' advantages. With domestic rivals there are no excuses". 18 As Krueger and Dervis and Petri suggest, export success can be and often has been a crucial ingredient in galvanising domestic political support for trade liberalisation. 19

1.6 'First' and 'Second Best' and Gradual Reform

It is worth noting the extent to which the very language in which these matters have been discussed has hampered clear deliberation about existing policy choices. 20 Where the issue is explicitly addressed, the reform path suggested by the new development consensus is frequently stigmatised as 'second best'. 21 In this context the traditional alternative - declining tariff only assistance - is often taken to be 'first best'. Yet this is not the case. The end point of both trade liberalisation paths - free trade - is the same and some would call it 'first best'. But for the duration of any gradual reform program, neither policy is 'first best'. Indeed, the very point of the theory of the second best was to show that what we now call 'first best' policies (and what James Meade originally called "Utopian policies"?) are not

---

17 In fairness to Rhee, his assertion appears in a paper on developing economies. His comment may refer also to policies designed to re-orient a wide variety of domestic economic institutions.
20 The specification of the ultimate objective - the removal of all trade restrictions - is regularly conflated with the means of making the transition to that end. Thus Takacs suggests that [R]emoving or phasing out quantitative restrictions, returning to trade based on tariffs alone, and then in turn reducing these tariffs over time, is still a worthwhile ultimate goal.
21 Despite the promising title of Takacs article - 'Transitional Measures in Trade Liberalization' - export assistance does not rate a mention. [Takacs, (1990), p. 154]
22 Rhee, (1985), p. 4 - 5. Note that Rhee suggests that 'second best' policies are justified by the particularly acute market failures in developing economies. According to our argument here, their application is more general than that. See also Moore's letter to the Australian Financial Review, 22nd January, 1991.
best in 'second best' situations. Second best policies are best! And we are in a second best situation for as long as we are making the transition out of it! 22

As a matter of form, the new development reform path is superior to the simple reduction of tariff or quota protection because it tackles two distortions at once. It tackles the intra-industry inward orientation of traditional protection, at the same time as winding down the extent of that protection as envisaged in the traditional trade liberalisation agenda. A tariff plus an export subsidy is higher on Corden's hierarchy of interventions than a simple tariff because it involves one fewer distortion.23

1.7 A Simple Analytical Framework

In what follows we scrutinise the case for export assistance to protected industries in the context of gradual trade liberalisation. In a typical 'second best' situation any policy will make some things worse and some better.24 One way into the problem is thus to nominate what gets worse and what gets better with the policy to be considered. Jacob Viner did this for customs unions by distinguishing on the production side between trade creation - which makes things better - and trade diversion - which makes things worse.25 The case for compensatory export assistance can be scrutinised in an analogous way. Assume that protected industries produce more than their optimum - free trade - level. Where export assistance is given to a protected industry, there will be an improvement in resource allocation given to production within that industry as it sheds its inward orientation.26 At the same time, however, compensatory export assistance is likely to increase the size of an already oversized industry.

22 It should go without saying that this argument does not mean that second best policies should always be adopted in transitional contexts. They may involve costs such as administrative messiness and/or unhappy political consequences which must be weighed against their benefits.
26 Thus the Australian Industry Commission noted that export assistance in the Australian automotive industry, "provided an unequivocal improvement in the intra-industry efficiency of resource use". Industry Commission, Draft Report, (1989), p. 74.] Note there are at least two ways to define the efficiency of intra-industry resource allocation for our purposes. Here we are concerned with export intensity. The first would be to define it as that export intensity which would be achieved by the industry at free trade. The second would be to make the optimum export intensity a function of the level of assistance received. According to this definition, if the industry receives assistance in a non-discriminatory way, its export intensity - its intra-industry allocation of resources - is optimal for any given level of assistance. Note that the 'optimal' export intensity specified by both definitions is the same as the level of assistance to an industry approaches zero. For simplicity's sake, the reasoning used in the text uses the latter of the two definitions of efficiency of intra-
Accordingly the worth of compensatory export assistance is a function of the intra-industry gains and inter-industry losses it involves. This gives us what we will call the "weak" case for compensatory export assistance where intra-industry gains outweigh inter-industry losses. It can be argued that the Garnaut Report embraces this case for export assistance where it comments that if the complete removal of tariffs were not possible, "compensating export subsidies would be better than continued inward orientation." Garnaut has subsequently emphasised this aspect of his report drawing particular attention to the dynamic gains from "market widening" export assistance.

My report placed special value on balancing incentives for export and import-competing production. The removal of the bias in conventional protection, favouring production for the domestic over export markets, would facilitate expansion of Australia's most productive industries. The East Asian experience indicated that the gains from removing the domestic market bias [are] much greater than is suggested by conventional economic analysis, based on static resource allocation gains.

Note, however that the contrast between intra-industry gains and inter-industry losses is the product of a static analytical perspective. In a transitional context, the case for a trade liberalisation path incorporating compensatory export assistance may not need to be built on any trade off between intra-industry gains and inter-industry losses. If, for instance, an immediate transition to free trade is economically best, but politically unavailable, then a gradual trade liberalisation path involves inter-industry losses from protection, albeit at a declining rate, for the duration of any trade liberalisation program.

Accordingly, where trade liberalisation is to proceed by way of simply winding back the extent of traditional protection, it will generally be possible to improve that trade liberalisation path by ensuring that compensatory export assistance is accompanied by larger reductions in traditional protection than would otherwise take place. Providing increases in the amount of export activity from the protected industry are offset by equal reductions in the amount of import replacement.

---

industry resource use. The difference between the two approaches is only likely to be significant where assistance is relatively high and can be expected to remain so for some time. These circumstances are dealt with briefly in section VI.

activity which would otherwise have taken place, then, other things being equal, this reform path is unambiguously superior to its alternative. Intra-industry gains are made without being offset by inter-industry losses. And we may generally expect some dynamic gains from accelerating the achievement of export orientation within the protected industry.

Ross Garnaut embraced the logic of this approach in 1990.

One cannot dismiss the possibility of a general system of export subsidy yielding net benefits, within the context of winding down the levels of import protection substantially more rapidly than would otherwise be possible. I presume that the search for a feasible scheme that yields net benefits will continue within parts of the bureaucracy.29

And if the constraint on the rate of reform is the rate at which a given protected industry contracts, then it is possible to lower the level of assistance further and faster where assistance is not offered on a discriminatory basis. Figure One provides an indicative illustration of the traditional reform path and the proposed improvement upon it.

Figure One:

![Graph of Rate of Assistance]

---

2.1 Illustrating the Economics of Specialisation and Intra-industry Trade.

In this section we develop a simple illustration of the economies of intra-industry specialisation and trade. Its purpose is to function as an 'heuristic' for subsequent use in exposition rather than as a 'model'. The point is not to generate or justify novel or unusual results, so much as to provide a simple illustration which will enhance the clarity of an already plausible and uncontroversial schema. The diagram is a simple variant of the usual Marshallian partial equilibrium supply and demand diagram for an importable into a small country. It has an upwardly sloping domestic supply schedule, a downwardly sloping domestic demand schedule and a horizontal schedule representing infinitely elastic supply and demand around the world price. Our focus is long run partial equilibrium. Our unit of analysis is 'the industry' rather than a firm.

We make the following changes to allow the diagram to illustrate intra-industry trade.

1) Instead of dealing with discrete products we invoke the more general aggregative perspective of macro-economics. We map aggregate long run supply and demand in a domestic 'industry' producing a complex range of products selling at various prices. It is not important for our purposes to define the 'industry' particularly rigorously. All that is necessary for us to render our subsequent exposition coherent is for there to be two sectors in the domestic economy - 'the industry' and 'other activities'. Of course by 'industry' we have in mind a collection of activities which have relatively close relationships of substitutability and complementarity in both production and consumption - such as the 'automotive' industry, or the 'power tool' industry for instance. However most of the analysis which is to follow will apply where 'the industry' is a larger aggregation of activity - such as 'manufacturing' for instance.

By analogy with macro-economic aggregate supply and demand analysis, the axes of our industry diagram measure 'aggregate prices' and 'aggregate physical output' across the industry as measured by appropriately weighted indices.\(^\text{30}\) We make the same assumption for the industry considered as an

\(^{30}\) The index measured by the vertical price/cost axis would be a consumer price index for the industry or sector. It would be a weighted average of the prices in 'constant domestic currency' of a
aggregate that macro-economists make when they define an aggregate supply function for an economy: namely that though there are imperfections in competition there is sufficient competition to ensure that we are reasonably justified in mapping aggregate supply and demand schedules independently of each other.

2) We assume that the industry may both import and export. This requires a second supply schedule - the supply (export) schedule \( S_e \) - which we assume is independent of the supply (domestic) schedule \( S_d \). Like the \( S_d \) schedule, we assume that the \( S_e \) schedule is responsive to price signals and so upwardly sloping. Exporters take the 'world import price' for their exports, but must pay transport and tariff costs. This ensures that supply to the domestic market for any product within the industry commences at a lower price than supply to export markets. Superimposing the supply (export) schedule onto the diagram and translating it sufficiently to the right to make its origin touch the \( S_d \) curve gives us the basic diagram as follows.

"representative' basket of goods from the industry. The representative basket of goods would include domestically manufactured goods and imports. The index measured by the horizontal axis would be a proxy for physical amount of produce manufactured or imported in the industry or sector in question. If the diagram is developed further it may be appropriate to consider the ways of dealing with changes in the price level within the industry or sector itself, but for our purposes no confusion will be created by considering the horizontal axis as 'physical units of output' which in the automotive industry could be measured in 'average sized cars.' Both indices suffer from the usual problem of indices through time as products and preferences change. The methodology used here is, accordingly, subject to the same kinds of limitations to which it is subject where it is used in macro-economics.
As output rises beyond the point at which exports begin to be profitable - the point where the supply curve bifurcates - there is 'double counting' in the diagram. Total output in figure two at free trade equals production for the domestic market (given by the distance O-B) plus production for the export market which is given by A-C. The quantity of goods imported equals D - B. Figure Five shows an industry in trade deficit as (D - B) > (C - A).

3) Note that we now have a way of representing the costs of inward orientation. We assume that as output for the domestic market rises, beyond some point the industry will take on 'diversification costs' associated with diversifying production into products which it produces less competitively. Beyond the point at which they become significant, 'diversification costs' continue to rise with output for the domestic market making the $S_d$ curve progressively steeper. (In the Australian and American automotive industries for instance, as increased tariff and/or quantitative restrictions were imposed in response to Japanese import penetration the domestic industries took on progressively...
heavier diversification costs to enable them to manufacture a wider range of products and so service a larger share of the domestic market than they would otherwise have done.)

4) We assume that the domestic industry has a significantly lower market share in export markets than it does domestically, and that, accordingly it does not experience any incentives to diversify production for export any further than it has already diversified production in the domestic market. Thus the \( S_e \) schedule commences at a higher price level than the \( S_d \) schedule, but there is no point beyond which it becomes progressively more inelastic as is the case with the \( S_d \) schedule. Thus, if we are seeking to increase output, beyond the stage at which 'diversification costs' become significant for supply to the domestic market, there are 'diminishing returns' to inwardly oriented assistance but not for assistance which is available for all production.

Note there are two circumstances in which the scenario we have been presenting falls back to the standard case in which there is no intra-industry trade. Firstly the export supply schedule can commence above \( P_w \) in which case there are no exports. Secondly if the domestic market supply schedule commences above \( P_w \) (or \( P_w + t \) where there are tariffs), there is no domestic production at all. Note also that it may be the case that 'diversification costs' are not significant in the portion of the illustration which is of concern to policy makers in a particular case. Although in this paper we generally take it to be 'normal' that diversification costs have begun to be significant for supply to the domestic market, this need not be the case, and the analysis which the diagram facilitates assumes only that domestic supply to the domestic market and export supply are sensitive to price signals - that the corresponding supply schedules are upward sloping.

Note two simplifications which have been made to eliminate interdependencies between the schedules.

1) We have made 'diversification costs' a function of output for the domestic market. It would be more realistic to say that diversity increases with the domestic industry's share of the domestic market. However this renders our \( S_d \) curve interdependent with domestic consumption.

2) Where an industry takes on 'diversification costs' we can think of this as taking on the production of products with unfavourable factor input prices. Much intra-industry trade is indeed driven in this way by
traditional comparative advantage, and this produces no problems for our diagram. Should we want to use the diagram to illustrate the gains to intra-industry trade and specialisation from economies of scale however, we should recognise that this would produce interdependencies between the $S_d$ and the $S_e$ curves.

In what follows we ignore the possibility of both of these potential interdependencies which tend to complicate the exposition without adding a great deal of interest to the essence of the story we are trying to tell. Taking them into account is accordingly left to another time.

III

3.1 Price Competitiveness Shocks and Product Differentiation Shocks

The diagram enables us to clearly distinguish two kinds of trade shock. Domestic output can fall because a domestic industry has become less internationally competitive. This would be illustrated by a falling world price line or rising supply schedules. But imports can rise because domestic consumers demand greater product variety. This can happen gradually as production becomes more specialised with the evolution of the division of labour and increasingly affluent consumers seek increasing variety. It can also happen suddenly as technological change or new economic circumstances stimulate increased demand for imported product types. The increased penetration of Japanese vehicles into the American and Australian markets in the 1970s had elements of both kinds of trade shock. Japanese vehicles were price competitive. But such a simple analysis misses an important feature, which, had it been made a focus of policy making could have improved policy outcomes. Rapid import penetration in the mid 1970s was, to a considerable extent, a 'product variety' shock. In the wake of dramatic price increases in fuel, consumer demand shifted towards smaller vehicles which were unavailable from local manufacturers.

Assuming for the sake of illustration that the product variety shocks experienced above did not effect aggregate physical demand in the industry - only the composition of that demand - the change in consumer taste raises the cost of achieving former levels of domestic market share. This can be captured as a

---

leftward shift of the upper portion of the $S_d$ curve. Figure Three captures such a shock - see the changes labelled with a "1". It also illustrates how expensive and quixotic an inwardly oriented response to a 'product variety' shock can be. Assuming that policy is constrained to return domestic production to its 'pre-shock' levels, a tariff or quota is introduced producing the changes labelled with a "2". The result is achieved at much higher cost than would be necessary if assistance was offered which was not inwardly oriented.

Figure Three

The inwardly oriented policy tools used to address the trade shock in automobiles in the 1970s - voluntary export restraints by the Japanese in Europe and America, and quotas and higher tariffs in Australia - provide an illustration of the costs for policy where economic discourse focuses too narrowly on the choice between free trade and ‘intervention’. Economic discourse at the time provided what resistance words and analysis could offer those seeking to resist interventionist pressures. But that having proved inadequate, it provided less clear guidance than one might have hoped, for the conscientious policy maker seeking to accept the political constraints placed upon them but to seek nevertheless whatever intervention would best enhance prospects for adjustment and growth. Liberal economists might have done better service by continuing their campaign against protectionism at the same time as insisting that any deviations from freer trade
which might have been economically desirable, or (more likely) politically inevitable as a result of the trade shock in automobiles, should not have obstructed what scope there was for trade and adjustment within the industry.

3.2 Industrial development and 'market widening policies'.

We can develop some 'dynamic intuition' based on these diagrams by suggesting that the incentive to product innovation will be related to the slope of the supply curve faced by the domestic industry. As the supply curve becomes steeper, the market in which individual products are sold is becoming narrower - they are being produced at lower volumes. If a particular product innovation permits the industry to improve its profits per unit for that product, the greater the volume being achieved by the product, the higher the profits. Such considerations increase the urgency with which a country will seek to flatten the supply curves its industries operate on - widen the market in which they operate.

Our bifurcated supply curves also permit a simple illustration of the way in which the inward orientation of traditional protectionism is important in direct relation to the size of the domestic market. $S_d$ curves associated with small markets can be expected to diverge sooner and more steeply from their $S_p$ curves than the $S_d$ curves associated with large markets.

---

33 This assumes that the industry takes its profits by increasing prices to the level which will leave its volume in the particular product unchanged.
$S_{ds}$ is the supply schedule of a domestic industry operating in a small domestic market.

$S_{dl}$ is the supply schedule of a domestic industry operating in a large domestic market.

This discloses the particular importance of 'market widening' policies for small countries with traditional protection. Several immediate market widening - S curve flattening - strategies can be envisaged.

1) Policy can embrace the 'new development consensus' by directly ensuring that exporters receive at least as much assistance as those replacing imports. This can be done:

1.1) as in Hong Kong and Singapore, by eliminating all traditional (market narrowing) instruments of protection, or

1.2) as in Taiwan and Korea and other newly industrialising countries by using direct 'market widening' or 'compensatory' export assistance to offset remaining protection.

2) The market can also be directly widened by forming, and/or joining free trade areas. This can be represented as a flattening of the $S_d$ curve or as a lowering of the $S_e$ curve. The two approaches - equalising domestic incentives to import replacement and export and joining a large free trade area - are clearly
not mutually exclusive. They can and generally should be pursued together in such a way that each complements the other.\textsuperscript{34}

3.3 Australia and Compensatory Export Assistance

Whatever general appeal the issues raised in this paper might have, they have particular relevance for Australia. A variety of factors have led to considerable inward orientation in Australia's tariff and quota assisted manufacturing sector.\textsuperscript{35} In terms of the diagram, many of our manufacturing industries are too high on their \( S_d \) curves and too low on their \( S_c \) curves.

- Of the three possible 'direct market widening' strategies set out above, Australia and New Zealand are alone amongst the developed countries and the NICs in following none of them. Closer economic relations between Australia and New Zealand hardly make up for the antipodean countries' absence from either of the really large free trade areas.\textsuperscript{36}
- Australia is geographically isolated from major markets \textsuperscript{37} and has compounded that isolation with high tariffs which will remain significant into the medium term.

Australia is one of the few developed countries in which the new development consensus is beginning to gain some influence. Garnaut's comments have already been cited. And after fifteen years of trenchant opposition to import/export links in the automotive industry, the Industry Commission recommended that the automotive industry export facilitation scheme be extended and rationalised,\textsuperscript{38} in the context of continuing tariff reform for the industry. In late 1990 an ambitious scheme which sought to generalise the kind of approach developed here for all tariff assisted manufactures was developed as part of the industry policy statement which was subsequently announced by the Prime Minister on March 12 1991. The scheme, dubbed ATLAS - Accelerated Trade Liberalisation Adjustment Scheme -

\textsuperscript{34} The fact that these measures can be pursued in a trade restricting way as well ought not of itself remove them from the trade liberal agenda.

\textsuperscript{35} Kaspar, W., (1987) p. 106.

\textsuperscript{36} Until quite recently, the growth rate of both Australia's and New Zealand’s manufactured exports and the extent to which they participated in intra-industry trade has been unusually low in comparison with other small developed countries. [Industries Assistance Commission, Annual Reports, 1975/6, p. 72; \$22 - 4, 1976/7, p. 23-4, p. 94]

\textsuperscript{37} In 1974-5 the average c.i.f./f.o.b. margin on all imports into Australia was 12.4%. [Lloyd, (1978), 'Coordination', p. 300.]

\textsuperscript{38} The trenchant opposition mentioned here was offered by the Industry Commission's predecessor, the Industries Assistance Commission.
has yet to be implemented because of concern about its GATT consistency, although an import/export link was introduced into the Textiles Clothing and Footwear industries to accompany an acceleration of the reduction of tariffs in that area.

The ATLAS scheme and the kind of policy explored in this paper were strongly endorsed by the Financial Review’s Michael Stutchbury in these terms:

The great tragedy is that no one acted on this much earlier, particularly when Fortress Australia retreated further behind higher manufacturing import protection walls in response to the Asian challenge. . . . If export facilitation had been used instead, Australia would have been better placed to participate in the big intra-industry growth area of world trade. By now we would have had a much more efficient and export oriented economy.39

The new political ascendancy of trade liberalising sentiment in Australia suggests that, properly handled, an improved trade liberalisation path offers relatively little risk of rekindling protectionism. This is not to suggest that those with a vested interest in protection will not continue to argue and lobby for it. It is not to suggest that some reversal of our current trade liberalisation reform path is not possible, particularly where macroeconomic circumstances create the soil for protectionism to grow. We suggest only that in the context of declining rates of protection, ‘compensatory’ export assistance will not put protectionists in a position to derail trade liberalisation which is any stronger than it otherwise would be. Indeed, as already suggested, causation may well go the other way. Export success in traditionally protected industries is likely to increase the confidence with which the community embraces trade liberalisation.

Changing attitudes are already evident in the Australian automotive industry. Throughout the late 1970s and 1980s most industry participants, and particularly the parts manufacturers had trenchantly opposed an import/export link - export facilitation - which permits automotive exporters access to duty free imports.40 They did so largely because of its capacity to bring about rationalisation within the industry. In 1990 there was almost unanimous support for export facilitation within the industry,41 not only, as we might expect, because it provides export

40 Import/export links are explained at greater length in Gruen, (1993).
assistance, but also precisely because it could promote rationalisation within the industry. Thus the parts manufacturers argued that reducing the uncertainty with which the export facilitation scheme operated by extending it "could result in more restructuring and specialisation as EFS [the export facilitation scheme] was used to develop export markets for more highly competitive products replacing those less competitive with imports".42

IV

4.1 Conclusion

It is worth re-iterating that export assistance in the context of trade liberalisation offers nothing inconsistent with a 'de-regulationist' or 'free trading' perspective. In so far as we seek to be rigorous about choosing the best available path towards freer trade, a path which includes assistance to exports, occupies the neoclassical high ground. It is superior to a declining 'tariff only' regime. To those who allege that 'compensatory' export assistance is 'second best', let them only concede that, until free trade is achieved, restricting policy to gradually reducing tariffs is 'third best'.


42 A Submission to the Industry Commission by the Federation of Automotive Products Manufacturers, 1990. (Emphasis added.)
References


Krugman, P.R., Rethinking International Trade, Massachusetts Institute of Technology, Massachusetts, 1990.


Discussion Papers, which are free of charge, are available from The Publications Office, Centre for Economic Policy Research, Research School of Social Sciences, Australian National University, Canberra ACT 0200. (Tel: (06)2492247; Fax: (06) 2571893). A full list of papers is available on request. Photocopies of out of print papers can be supplied at a charge of $10.00 each.

1992

261 Blundell-Wignall, Adrian

262 Pitchford, John
Current Account Deficits, External Liabilities and Economic Policy.

263 Pitchford, John

264 Wallis, Kenneth F.

265 Dwyer, Larry and Peter Forsyth
The Case for Tourism Promotion: An Economic Analysis

Discussion Papers Nos. 266-269 contain the papers presented to the Consumption Tax Conference, Centre for Economic Policy Research, ANU, 24-25 February 1992,

266 Paper 1: Dwyer, Terence
Consumption Tax: A Solution or New Problems?
Paper 2: Freebairn, John
Economic Arguments for a New Consumption Tax.

267 Paper 1: Quiggin, John
Borrowing, Saving and Taxation
Paper 2: Harding, Ann
Consumption Tax, Compensation and the Distribution of Income

268 Paper 1: Bolland, Alan
New Zealand's Experience with Consumption Tax
Paper 2: Wood, Alan
Lessons from New Zealand

269 Paper 1: Murphy, Chris
GST and the Inflation Rate
Paper 2: Piggott, John
The Consumption Tax Conference: Summary and Assessment

270 Applegate, Craig
The Australian Foreign Debt Debate
271 Chapman, Bruce J. and David Pope
   Government, Human Capital Formation and Higher Education

272 Bourassa, Steven C. and Patrick H. Hendershot
   Over-Investment in Australian Housing: Implications for Tax Policy

273 Hawke, Anne
   How Do Australian Part-Time Workers Compare to Their United States
   Counterparts?

274 Chapman, Bruce J., P.N. Junankar and Cezary A. Kapuscinski
   Long Term Unemployment: Projections and Policy

275 Dowrick, Steve
   A Review of New Theories and Evidence on Economic Growth: Their
   Implications for Australian Policy

276 Quiggin, John
   Food and the GST

277 Dowrick, Steve and John Quiggin
   International Comparisons of Living Standards and Tastes: A Revealed
   Preference Analysis

278 Forsyth, Peter
   Public Enterprises: A Success Story of Microeconomic Reform

279 Apps, Patricia
   Impact of the Fightback! Tax-Mix Change on Working Families

280 Fane, George and Applegate, Craig
   The Social Cost of Foreign Debt in the Presence of Sovereign Default Risk

281 Makin, Tony
   Open Economy Measures of Wealth and Hicksian Income: The Australian
   Example

1993

282 Forsyth, Peter; Dwyer, Larry; Burnley, Ian and Murphy, Peter
   The Impact of Migration on Tourism Flows to and from Australia

283 Pitchford, John
   Trade Price Shocks and Insulation: Australia’s Experience with Floating
   Rates

284 Chapman, Bruce, J
   Fightback! Some Observations on the Higher Education Policies of the
   Coalition.

285 Chapman, Bruce J. and Peter N. Smith
   Predicting the Long-Term Unemployed: A Primer for the Commonwealth
   Employment Service

286 Applegate, Craig
   Sovereign Interference in Private Sector Foreign Debt. Examples in the
   1980's

287 Chapman, Bruce J. and Ann Harding
   Australian Student Loans
285 Chapman, Bruce J and Peter N. Smith
Predicting the Long-Term Unemployed: A Primer for the Commonwealth Employment Service

286 Applegate, Craig
Sovereign Interference in Private Sector Foreign Debt. Examples in the 1980s

287 Chapman, Bruce J and Ann Harding
Australian Student Loans

288 Gruen, Nicholas
Export Assistance, Trade Liberalisation, Strategic Trade Theory and the 'New Development Consensus'

289 Gruen, Nicholas
The Economics of Import/Export Links