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How Best To Move Towards Freer Trade - Some International Perspectives

Anne Krueger

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HOW BEST TO MOVE TOWARD FREER TRADE:  
SOME INTERNATIONAL PERSPECTIVES  
Anne O. Krueger*  

There have been three major prototypes of experience with movements toward freer trade among countries in the period since World War II. They are: (1) the reciprocal reduction of barriers to international transactions taking place under the Marshall Plan and the EPU, the KEC, and the Kennedy and Tokyo Rounds; (2) the increased interdependence that has occurred more or less as a consequence of the increased importance of trade flows, successful expansion of exports, and the consequence diminution in importance of restrictions placed for balance-of-payments reasons; and (3) the experience of individual countries, as decisions have been taken deliberately to reverse trade and payments policies previously in effect. These moves have involved actions aimed at the current account (or freeing of trade) on one hand, and liberalisation of payments regimes, removal of restrictions on convertibility, and greater mobility of capital flows on the other.  

In Section I of this paper, some simple concepts are set forth which are useful in interpreting of different experiences. In Section II, each of the three prototypes is discussed, along with the experience of some particular countries. In Section III, some tentative lessons are drawn. No attempt is made to assess the applicability of the other cases to the Australian situation; one of the important lessons of other countries'  

* Professor of Economics, University of Minnesota. I am indebted to W.M. Corden and Peter Jonson for their helpful comments. Ephraim Kleiman called my attention to some mistakes in an earlier draft with regard to the Israeli experience for which I am grateful. Responsibility for any remaining errors is mine.
experience is that each situation is different in both internal political and economic circumstances and structure, and in the ways in which the impact of the international environment will affect its particular efforts to move toward freer trade. Nonetheless, focus is upon movements toward freer trade in goods and services, since Australia's capital flows are relatively free.

I. SOME USEFUL CONCEPTS AND DISTINCTIONS

Opening Up vs. Freer Trade

An underappreciated distinction in discussions of attempts to shift trade and payments policies has been between opening up an economy and moving toward freer trade. The distinction has its uses in analysis of shifts in both current and capital account, although focus here is on current account.

Consider first current account transactions. Suppose a country has in effect a quantitative restriction limiting imports of, say, automobiles, to $x$ units per year. For ease of exposition, assume that the foreign supply of autos facing the country is perfectly elastic and that the domestic

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1 In the world of the 1980s, it is probably impossible to have free trade on current accounts and severely to impede capital flows: over- and under-invoicing and other mechanisms will be used to evade capital controls.

2 Such a restriction, if binding, will probably induce imports of autos with a higher average value than if there were an alternative restriction (e.g. on the total value of auto imports). Moreover, if the demand for autos in the country in question increased while the quota remained constant, it is likely that there would be some impact on the composition of imports and their value as more Mercedes and fewer Hondas were included in the cars legally imported. For purposes of the present argument that particular qualification is not of great importance. Likewise, I ignore the possibility of legal and illegal evasions of quotas: if enough of those occur, the quota is not binding.
market-clearing price associated with these x units of imports is initially $p_0$ per domestically-produced car. Then, as long as the quota is binding, the domestic price of automobiles and structure of production will not be affected by changes in the international economy, but shifts in domestic demand and supply will be reflected in changes in domestic prices and output levels. In such a case, the domestic economy's response to shifts in the domestic demand and supply for automobiles (and any other commodity subject to a binding quota) will be as if there were no international trade in the commodity in question. One can analyze the impact of a shift in demand or supply in terms of a closed economy model. For example, an upward shift in the domestic supply curve of an automobile (due, perhaps, to a union-negotiated wage increase) will be felt partly in a higher domestic price of automobiles and there will be a reduction in the volume of production only insofar as domestic demand is sensitive to price changes.

If, instead, the country imposes a tariff at an ad valorem level sufficient to make the domestic price equal to $p_0$, the situation with respect to domestic and external shifts will be quite different. In particular, an increase in the world price of automobiles will be directly reflected in the domestic market. Moreover, any upward shift in the domestic supply schedule will result in an increase in the volume of automobiles imported and a reduction in domestic production, with a constant price ($p_0$).

In the case of a quantitative restriction, therefore, the domestic economy is fairly well insulated from changes in the international environment and production, consumption, and domestic prices respond to shifts in domestic supply and demand conditions. It behaves as a closed economy in the case of tariff, the domestic economy responds to changes in the international
environment, and shifts in domestic supply and demand result in increased or decreased volumes of imports and exports. In that sense, it is an open economy.

By contrast with the degree of openness, which relates to the sensitivity of domestic variables to the international environment, there is free trade (and free capital movements).\(^1\) Obviously, free trade could not occur in the presence of binding quantitative restrictions but, in addition, it requires the absence of tariffs and other artificial impediments to trade.\(^2\)

The economic advantages of free trade are obvious: since prices in different lines of production generally reflect the marginal value of domestic resources used in producing a unit’s output, employing resources in an activity subject to a high degree of protection implies that the country could instead employ them elsewhere, trading internationally for the high-cost commodity, and have available to it a larger basket of goods for domestic utilization in consumption and investment.

Bias

Insofar as tariff or quota protection generates higher domestic prices for one class of commodities or activities than would arise under free trade, there is another class of commodities or activities whose relative price is lower than it would be at free trade. This fundamental and basic point is often overlooked in popular discussions of the issue: If protection is provided through tariffs, it would generally not be feasible to remove

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\(^1\) It should be noted in passing that a country can employ only tariffs, but impose them at a sufficiently high level so that the domestic price is below the international price plus the tariff. In that case the “water” in the tariff makes the behaviour of the market identical to that in a closed economy.

\(^2\) With free trade, some economies (e.g., the Netherlands) would still be more open than other free-trade economies (e.g., the US) because of differences in transport costs.
all protection\(^1\) and leave the exchange rate unaltered; normally some
depreciation of the exchange rate would be called for. Such a depreciation
would result in a higher price for the previously unprotected commodities,
while removal of protection would offset part, all or more than all of the
exchange rate change for commodities previously protected.\(^2\)

The "bias" of a trade and payments regime refers to the extent of
discrimination between import-competing and exportable activities. In general,
trade and payments regimes resorting to high levels of tariffs (or their
quota equivalents) are biased toward import-competing industries. That is,
they tend to encourage production of import-competing commodities, by virtue
of the relatively higher price of those commodities than would occur at
free trade, while discouraging production of exportable commodities by
generating a lower price than at free trade.

Almost always the presence of any sizeable set of economic activities
protected by quotas is evidence that the trade regime is biased toward
import-competing industries and against exportable industries. While it
is in principle possible to have a few tariffs (and even quotas on some
luxury items not employed in the production of exportables) and still have

\(^1\) I assume here that protection is higher for final products than for inter-
mediate goods and raw materials. If that is not so, it is possible to
remove protection and leave the exchange rate unaltered (or perhaps even
appreciated). The point that protection discriminates against some
activities remains valid.

\(^2\) It should be noted that industries subject only to tariff or quota
protection cannot be export industries (unless they are discriminating
monopolists). However, protection can also occur through export subsidies,
in which case protected commodities can be exportable. In general, it is
rare to find large volumes of exports subject to high export subsidies.
The costs of such policies are only too painfully evident to Finance
Ministers.
an overall bias toward exportable industries (through export subsidies or other interventions), that rarely happens.\footnote{In South Korea, there are a few import-substitution industries that are encouraged along with exportable industries. The mechanisms of encouragement basically take advantage of distortions in the capital market and are probably not feasible for any sizeable segment of economic activity in most countries.}

II. EXPERIENCES OF INDIVIDUAL COUNTRIES WITH MOVES TO FREE TRADE

European Integration

It will be recalled that, at the end of World War II, the European economies were so destitute that imports were vital for survival while production capacity had been so diminished that exports simply could not be increased rapidly enough to finance import demands. Almost every European country was forced to resort to severe quantitative restrictions, relying largely upon US aid under the Marshall Plan and running down reserves for such imports as they were able to obtain.

Starting from that initially highly disrupted and restrictive situation Western Europe has been moving, virtually without interruption toward freer trade ever since. In its early stages, the European Payments Union provided the momentum to move from bilateral clearing arrangements to a multilateral (within Europe) system. This permitted some expansion of trade even as the American dollar remained the currency in considerable excess demand.

Momentum then continued under the Common Market. To be sure, a Common Market is not completely synonymous with free trade. However, the moves of individual European countries to bring down their trade barriers vis-a-vis each other have generally been much more trade creating than trade diverting. Indeed, as the EEC has continued to integrate its internal markets, many external trade barriers have also simultaneously been lowered or removed.
Removal of those barriers has happened in a variety of ways: (1) success in expanding trade flows has led to an imperative for smoother payments flows, and countries have removed restrictions upon convertibility and capital account transactions in response to their perceived self-interest as trading nations; (2) rapid growth of international trade flows has removed one major source of excuse for protectionist pressures (balance of payments needs) and simultaneously increased the importance of export interests within each sector - those interests have often fought for removal of trade barriers which they perceived to affect adversely their competitive position; and (3) the European countries have experienced extremely rapid economic growth, and that success has been attributed in large part to the growing importance of trade flows. Political pressures for increased protection have therefore been met by growing public understanding of the dependence of free flows of their country's exports on free flows of imports from other countries.  

Several points should be noted. First and foremost, European integration has implied resource reallocation within agriculture (with more political dispute about many commodities, such as butter, milk, and so on), within manufacturing, and within other sectors. Resource flows between sectors have probably not been appreciably different from what they would have been had economic growth at the same rate been internally generated.  

1 This is not to say that there have been no protectionist pressures. It is simply to assert that the success of the policies which have resulted in fewer intra-European trade has made those pressures somewhat easier to resist than they would have been under other circumstances.

2 To the extent that Western Europe as a whole is a net exporter of manufactures the above statement should be qualified, but reference here is to within-European trade.
resistance to a lowering of trade barriers has been much less than was anticipated when the Common Market was formed. In fact, initial forecasts of prospects for the market were generally pessimistic, as it was anticipated that the dislocations of firms and industries would result in politically divisive splits within the Community.\(^1\) Instead, the apparent gains from moving toward freer trade within the group have been so great that the political imperative has been to resolve differences and to maintain the momentum of integration. In this regard, it is important to note that consumer gains were large and readily visible, and also that dislocations were far smaller than was anticipated initially.

Third, while it is true that a common external tariff was adopted by the members of the Community, tariff rates were generally lower than the average of the individual tariffs preceding union; moreover, the tariff was falling during the period of integration, and European trade with the rest of the world grew almost as rapidly as intra-European trade. Thus, success of the EEC has not been at the expense of trade with the rest of the world to any appreciable extent. Fourth and last, when adjustment problems arose in particular industries, there were offsetting gains in other industries. The fact that a given country was losing share in one market (within, say, the manufacturing sector) was offset by gaining share in another market in that sector. Thus, intrasectoral mobility helped to absorb much of the burden of adjustment.\(^2\)

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1 An escape clause was included in the Treaty of Rome in the expectation that dislocations would be severe. It was never evoked.

2 In Europe, the sector which has presented the most difficulties is agriculture; it is in that sector that policies have moved least toward free trade and where there are net pressures for contraction.
Multilateral Tariff Negotiations

In common with the moves toward freer trade within the EEC, the Kennedy and Tokyo Rounds have been based upon the premise that there are mutual gains to be achieved by a simultaneous lowering of barriers to free trade by several negotiating parties. Countries have been able to offset some of their own internal pressures for protection by finding exporting interest groups that would gain by reciprocal tariff reduction in other commodities.

The general tendency toward freer trade among the industrialized countries which has accompanied the rapid expansion of international trade in the postwar period meant that, by the early 1960s, tariffs were already at relatively low levels. The Kennedy Round nonetheless provided the impetus for further substantial cuts, with resulting average tariff rates on dutiable nonagricultural products cut by more than 35 percent (by the US, the EEC, the United Kingdom and Japan), and average tariff rates on agricultural products cut by about 20 percent.¹

Despite the greater intractability of negotiating reductions in nontariff barriers to trade, their increased importance (because of the reduction in the importance of tariffs) led to an intensified search for means of jointly reducing them in the Kennedy Round. The protocols on government procurement and subsidy policies may be vaguely worded, but they nonetheless constitute an important first step in the direction of further moves toward freer trade through reaching agreement on "fair" and "unfair" behaviour affecting competitive positions of individual exporting industries.

It is probably fair to say that the major contribution of the Kennedy and Tokyo Rounds was to provide apparent gains that could be used as arguments to convince individuals that the losses from reduced protection were necessary. In fact, after all the Kennedy Round tariff cuts, it is of interest that there were so few cases in which reduced tariffs stirred controversy. In part, this was because tariff negotiators avoided cuts in areas (such as textiles) where it was believed that political resistance could not be offset. In part, however, it seems unarguable that the "damage" from tariff cuts has been considerably less than opponents of those cuts forecast in opposing them.

Two major themes appear to emerge from consideration of the EEC experience and the multilateral tariff negotiations. First and foremost, the fears of "damage" with deprotection are almost always overstated. Secondly, those fears are most easily offset when there are other identifiable groups, preferably within the same sectors of the economy, that stand to gain. In this regard, it should be noted that the GATT has been a useful instrument for defending against protectionist pressures, in addition to its role in the Kennedy and Tokyo Rounds. Fears of damage are allayed because of "safeguard" procedures, and if those procedures are invoked, other concessions of "equal value" to the exporting nations must be made in their stead. This mechanism on one hand insures that injury clauses cannot be indiscriminately used gradually to increase levels of protection and on the other hand provides countries' politicians with needed assurances that, in the event worst forecasts are realized, redress will be at hand.

Individual Countries' Experiences

A large number of countries have attempted to alter their trade and payments regimes. In some cases, the intent has been to control
inflation and correct an unsustainable deficit in the balance of payments. Some other governments have set out deliberately to alter the bias of their trade and payments regime, intending to reduce or eliminate protection to import-competing sectors and to stimulate the rapid growth of exports. In some instances, focus has been on moving toward freer trade on current account while in other cases, freezing capital movements was of equal or greater importance.

It may or may not be coincidental that all the industrialized countries (except perhaps Australia and New Zealand) have had relatively low levels of protection and that experience with opening up and with moving toward freer trade (of which opening up is surely a first step) on a unilateral basis has generally been confined to relatively poor countries with relatively low levels of per capita income. 1 Thus, any effort to infer lessons

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1 At the time of writing, Argentina is attempting to open up the economy and move toward free trade, as are Chile and Uruguay. While the Argentine experience is perhaps somewhat closer to what might arise for a relatively advanced, but net primary-commodity exporter country, it is not discussed here. It can cogently be argued that much of Argentina's failure to keep pace as a developed country (which it was around 1900) can be attributed to trade and related policies which moved the country away from free trade and toward a closed economy. The Argentine experience is not covered here because: (1) the effort is still going on and not yet resolved; (2) the experiment started when inflation was running at 750 percent annually, and thus reducing the rate of inflation has been a major part of the effort; and (3) there was sizable, but unrecognized water in the tariff which implied that the Argentine economy was considerably more closed than anyone realized when the policy shift began. It is only in the past year that levels of protection have begun to decline.

It should be noted, however, that the world of the 1970s was one of vastly increased capital mobility contrasted with the world of the 1950s and 1960s. In Argentina, Chile and Uruguay, "opening up" the capital account has occurred much more rapidly than opening up the current account. This raises a number of thorny issues for analysis which are not yet well understood. Since capital mobility in Australia is already fairly high, these issues are probably not of primary concern for considering Australia's policy alternatives and their probable consequences.
must be taken from the experience of developing countries. The fact that they were developing must be borne in mind when considering the relevance of the experience for a developed country.

Three countries' experiences deserve individual comment: Brazil\(^1\), Israel\(^2\), and South Korea\(^3\). The Brazilian experience is noteworthy for a variety of reasons. Brazil had grown fairly rapidly during the 1950s with a trade policy highly biased toward import substitution and stagnant export earnings. Failure of export earnings to grow was offset in large part by the Brazilian economy's ability to attract private foreign investment for its import-competing industries, especially automobiles and chemicals.

By the early 1960s, however, foreign investment was diminishing, the rate of inflation was soaring, and the growth rate had diminished so that per capita incomes were declining slightly. Export earnings in 1964 were still below their 1953 level, and primary commodities continued to dominate exports.

In 1964, a military government came to power, and began a series of reform efforts. Initial reforms included monetary and credit measures to reduce the rate of inflation and to make real rates of interest positive through indexing them. From the outset, the stated intent was to open up

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1 The reader interested in more details of the Brazilian experience can refer to Jose Carvalho and Claudio Haddad, "Brazil", in A. Krueger, H.B. Lardy, T. Monson and N. Bressanare (editors), Trade and Employment in Developing Countries: Individual Studies, University of Chicago Press, forthcoming.

2 A thorough analysis of the Israeli experience, on which the discussion is based, is in Michael Michayl, Foreign Trade Regimes and Economic Development: Israel, Columbia University Press, 1975.

3 For a full account of the Korean transformation, see Charles R. Frank, Jr., Kwang Soo Kim and Larry Westphal, Foreign Trade Regimes and Economic Development: South Korea, Columbia University Press, 1975.
the economy, and to move toward export-oriented growth. Opposition within Brazil centered upon the perceived inability of manufacturing industries to compete in international markets. For three years, tariffs were cut, the exchange rate was adjusted (but not in line with the rate of inflation, which declined from a rate of around 90 percent in 1963 to about 20 percent annually in 1968), and the balance of payments improved. This last occurred in part because export earnings began growing moderately, but largely because stagnation in the level of economic activity domestically resulted in reduced import demand.

As of 1967, the situation appeared fairly bleak: although the rate of inflation had fallen, real incomes had not risen in per capita terms during the 1960s. In light of Brazil's relatively low per capita income, this was serious. Late in 1967, a series of further measures were implemented. It was announced that henceforth the exchange rate would be altered with the rate of inflation, by sufficiently small increments and at irregular intervals so that speculators could not gain. Thus, a crawling peg exchange rate was adopted and potential exporters were assured that the real exchange rate would not deteriorate markedly. Simultaneously, a policy which was tantamount to subsidizing all exports (except the traditional primary commodities) in amounts up to about one-third of their domestic price, was announced. This was done by providing tax exemptions on exports and by exempting profits from taxation in proportion to foreign sales. Tariffs had already been lowered to rates of 25-30 percent, so that incentives to produce for sale in the domestic market in protected industries were approximately equal to incentives to export manufactured goods.
In 1967, exports stood at $1.6 billion, of which $705 million was coffee, while manufactured exports were only $99 million. In 1973, exports were $6.2 billion, of which $864 million was coffee, and manufactured exports were $1,685 million. Thus, both non-traditional primary commodity exports (including the emergence of Brazil as a major exporter of soybeans) and manufactured exports boomed under Brazil's policies. Simultaneously, the rate of growth of real GDP accelerated sharply, averaging about 10 percent per year from 1967 to 1974.1

Despite substantial prior opposition from all sectors to the Brazilian move toward freer trade, the agricultural, mineral, and manufacturing sectors all expanded more rapidly after the 1967 policy changes than they did prior to that time. Migration from the rural areas of northeast Brazil to the more prosperous and industrial south continued, and even accelerated after 1967, but that was in response to the higher rate of economic growth.

Key ingredients of Brazil's success were the adoption of the sliding peg exchange rate and the altered bias of the economy. All observers agree that rapid growth of exports was an important factor in the improved rate of growth of real income.

South Korea was, as of 1960, substantially poorer than Brazil was in 1967. Her reversal of trade policies was probably even more pronounced than that of Brazil, because South Korea had been heavily dependent on foreign economic and military aid after the Korean War. By 1960, exports

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1 Brazil sustained the impact of the oil price increases in 1974-74 by borrowing massively from abroad. Debt-servicing became a major problem, and inflation accelerated as the government abandoned its commitment to the crawling peg (in order to avoid even larger cruzado-denominated debt payments). The rate of growth of exports and real income fell sharply. Since December 1979, the government has been embarked on an effort to resume the outer-oriented strategy.
were a small fraction of imports, equaling only 2 percent of GNP, while imports stood at 13 percent of GNP. South Korea had few visible natural resources (although primary commodities constituted about 88 percent of what few exports there were) and the highest population density of any country in the world. In 1957, the American government had announced that it would gradually reduce its aid levels. Facing poor prospects for economic growth in the absence of growth of export earnings because of the poor raw material base, the South Korean government, beginning in 1960, began an export promotion drive. In the initial phase, the exchange rate was sharply devalued. As inflation (which had run at rates as high as 100 percent annually in some years of the 1950s) eroded the real proceeds to exporters over the following year, the government gradually introduced export subsidies in a variety of forms which offset the effect of inflation. Thus, the "real effective exchange rate" for exports was held more or less constant. Meanwhile, with domestic inflation and a fixed exchange rate, import-competing producers were under increased pressure, as the government shifted from quotas to tariffs.

By 1964, the government realized that credit markets within Korea would require transformation if the rapid growth of exports (which had quadrupled in four years) was to be sustained. Interest rates were realigned to levels above the rate of inflation that provided incentives for domestic savings. They also provided an attractive rate of return for foreign investors. As a matter of policy, the government was not anxious to encourage foreign equity investment, but it did encourage foreign borrowing to supplement domestic savings as a source of capital.

The phenomenal success of the Korean economy is well known. Per capita income rose at an average annual rate in excess of ten percent over the entire period. Korea emerged as one of the most affluent developing countries in Asia in the mid 1970s, having been among the poorest fifteen years earlier. Exports, which had constituted 2 percent of GNP in 1960, amounted to over 30 percent of GNP by the mid 1970s. Imports, too, have grown, and South Korea has remained a net borrower from abroad to the time of writing. It is noteworthy that, dependent on foreign oil as she is, South Korea nonetheless was able to promote exports (including construction in the Middle East) in such a way that the impact of oil price increases on her rate of growth was substantially less than that on most oil-importing countries, both developing and developed.

In the South Korean case, the absence of domestic raw materials implied that growth of exports would be concentrated in manufactured exports, which rose from 12 percent of the (tiny) total in 1960 to 90 percent of the total by the late 1970s. The manufacturing sector has increased in relative and absolute importance, but agricultural output has also grown: primary commodity exports did "poorly", only quadrupling in value while manufactured exports fared far better. Even in this case, therefore, all sectors experienced resource reallocation, and fared better after moving toward freer trade than they had before.

1 Foreign equity investment increased somewhat in importance after 1970.
The Israeli experience represents yet a different case. In the mid-1950s, the Israeli economy was enmeshed in a complex network of quantitative controls over all economic activity, domestic and international. The opening up of the economy began with a series of domestic and exchange rate reforms in the 1952-55 period and then was followed by a second phase of shifting from quantitative restrictions to tariff protection in the early 1960s. Quantitative restrictions had been largely replaced by tariffs about 1965 and thereafter were gradually lowered. Thus, in the Israeli case, the opening up process proceeded over a period of more than a decade.

In the first phase, most quantitative restrictions on domestic transactions were removed, and the exchange rate was devalued massively. Imports of raw materials and intermediate goods were consequently freed, although quantitative restrictions remained on consumer goods imports competing with domestic production. The liberalization was, at that stage, relatively painless, as the effect of freeing raw material imports was in fact to increase effective protection.

The second stage of the transition, starting in 1962, was a further devaluation and the establishment of a commission to determine appropriate tariff rates to replace existing quantitative restrictions. After 1962, export subsidies were extended to nontraditional exports, so that the real effective exchange rate for exports was held fairly constant. Over the following four years, tariffs were set, usually at fairly high levels, to replace quotas.

In the final phase, tariff rates were gradually reduced, as production subsidies (especially investment credits) tended to replace tariff protection.
It is perhaps significant that many Israelis believe that considerable protection to domestic industry still exists, and that the long period of time over which the transition was made may have permitted resistance to liberalization to thwart further opening up of the economy.

Nonetheless, the reforms were followed by a substantial increase in the rate of growth of export earnings and also of industrial output. It would appear that, in the Israeli case, moving toward freer trade meant in part increasing the levels of effective protection and then substituting domestic subsidies to industry for trade and tariff protection. An important component was the constancy of the real effective exchange rate for exports, which was a necessary condition for their rapid expansion. Although there are grounds on which one can be critical of the failure of the opening up to eliminate protection, it certainly reduced the bias toward production for domestic consumption and permitted a more rapid rate of growth of real GNP during the 1960s than would otherwise have been possible.

III. LESSONS

In the last Section, focus was on some of the moves toward freer trade that have been successful. It was not mentioned that there have been many instances of countries attempting to open up or move toward freer trade that have ended in failure. Tracing the history of these failures would carry us far beyond the scope of this paper, but several patterns emerge and are worth noting.

First, many attempts to open up or to move toward free trade have foundered because of mounting political opposition in response to a recession that has ensued following liberalization. In many instances,
the recession was more the result of efforts to reduce inflation rates than of the attempted liberalization, but there was strong political opposition to the liberalization component (and often, too, the anti-inflation component) of the policy measures nevertheless. Political opposition weakens a government's resolve to carry through its policies, but it also affects the expectations of individuals within the country and abroad that the realigned incentives emerging from the policy moves taken will be lasting.

If there is one more lesson that emerges clearly from the successful and unsuccessful moves toward freer trade taken together, it is that individuals must expect that the realigned incentives will be permanent. In instances where it is anticipated that the country will, within a short period of time, reverse policies (either because of political decisions in response to pressures - including possibly changes in governments - or because it is believed that inflation will result in balance of payments difficulties and reimposition of protection) moves toward freer trade have generally been abortive.

Second, many of the failures to move toward sustained freer trade have resulted from balance of payments pressures which have emerged from unanticipated increases in imports which could not be financed from export earnings. These unanticipated increases in imports, beyond the ability of the country to finance through borrowing or running down reserves, have come about either because policy makers did not realise the extent to which the trade regime had been restrictive, or (more frequently) because adoption of a fixed exchange rate led to an
overvalued exchange rate with continuing protection.\footnote{At the time of writing (March 1980), this is the danger which confronts the current Turkish attempt to open up the economy: the liberalization cannot be sustained without an increased flow of imports. But imports cannot increase without increased export earnings, which in turn cannot increase unless imports increase to provide needed raw materials and spare parts. Inability to borrow further may thus prevent an increased flow of imports, which automatically means protection is not reduced.}

In this regard, it seems clear that the strength of the government and its commitment to move toward freer trade are of considerable significance in affecting the likelihood of a successful (and pain-minimizing) move toward freer trade. This is, of course, closely linked to the extent of political opposition to the move, but it goes beyond that. In instances where most broad groups in society are convinced of the desirability of moving toward freer trade, the chances of success are substantially better.\footnote{Ernest Sturc clearly believes that this factor is of paramount significance. For his views, and account of three major moves in the 1950s, see his "Stabilization Policies: Experience of Some European Countries in the 1950s", IMF Staff Papers, July 1968.}

Third, there are no instances on record where a successful move toward freer trade on a sustained basis has occurred with an unrealistic exchange rate.\footnote{There are, of course, instances where good fortune has enabled a country to maintain an overvalued exchange rate with relatively few impediments to imports for a period of time. This apparently happened to Chile in the late 1960s.} In some cases of failure, an initially realistic exchange rate became unrealistic as domestic inflation at a rate in excess of the world rate made exporting increasingly unprofitable and importing increasingly more attractive.
In other instances, the initially chosen exchange rate was simply too unattractive to induce the necessary resource allocation.1

Turning then to successful moves to freer trade, what additional lessons are there? Perhaps most important is that a realignment of incentives has come about, not only by reducing the profitability of some activities (by reducing tariffs and other forms of protection), but also by increasing the attractiveness of alternate activities. This is perhaps why devaluation, as part of a package of policy moves toward freer trade, generally seems to have made the transition easier: reduced tariff rates for import-competition industries were at least partly offset by the exchange rate realignment while simultaneously the domestic price of exportable commodities, actual and potential, increased. It was thus not a case of cutting profitability in some activities and increasing it in none, which is what happens when the "recession" model is followed.2

To be sure, measures other than exchange rate realignment can facilitate resource reallocation. As mentioned above, the Brazilian government increased the relative and absolute attractiveness of exporting by providing numerous tax rebates on an across-the-board basis to all exporters. These incentives were fairly uniform across industries and sectors, and hastened the expansion of the exportable industries. Indeed, the EEC experience and the Kennedy and Tokyo Rounds, can all be regarded

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1 There are also a number of instances where a move toward freer trade was aborted where it would appear that the government really had no intention in the first place of moving toward freer trade. Some IMF-imposed devaluations have been of this nature, including the Egyptian devaluation of 1962 and probably the Indian devaluation of 1966.

2 If one starts from the premise that resources are mobile within, but not between sectors, but that nominal wages are rigid downwards, the assertion that the profitability of some activities has to increase is tantamount to indicating that in the absence of such increases, the price level in a particular sector will have fallen (as tariffs or quotas are cut and no prices are increased) thus generating unemployment in that sector.
as instances in which profitability of some activities was increasing to offset the decrease in others. In some instances, the reduction in protection on intermediate goods and raw materials can increase the profitability of a particular industry, but it is rare that this alone provides sufficient incentives.

An additional lesson of considerable importance is that there have been no successful moves substantially closer to free trade that have been accompanied by any sizeable retention of quantitative restrictions on trade. In all cases, countries moving closer to free trade (and especially those moving away from a bias toward import-substitution and toward encouragement of exports) have found it impossible to permit exporters to obtain free and rapid access at international prices for raw materials, intermediate and capital goods, while restricting their importation for purposes of domestic utilization. On one hand, if there are quantitative restrictions on the importation of certain goods but exporters are exempted, the likelihood is great that exporters will import quantities large enough to divert some imports to the domestic market. If the authorities attempt to prevent such diversion, the necessary bureaucratic procedures for verifying valid export use are sufficiently cumbersome as to constitute a major cost and delay for exporters.\(^1\) On the other hand, if quantitative restrictions are imposed upon all uses of some raw materials and intermediate

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\(^1\) In Korea, a compromise was adopted under which exporters were given estimated "usage ratios". These ratios were computed on the basis of observed production processes, but they permitted a "wastage allowance". Estimates of these allowances were generous, and exporters were permitted to sell their excess in the domestic market. In this way, profitability of producing for export was increased, although there were undoubtedly misallocation costs of the wastage allowance system. These costs increased over time, although the volume of materials which were subject to control diminished.
goods, comparative advantage among potential exporting firms is distorted as exporters' costs rise above those of their foreign competitors, and the likelihood that exporting industries will find it profitable to expand diminishes substantially.

In this regard, it should be noted that one way in which profitability of some activities can be increased is if imported materials become relatively cheaper (through deprotection). Thus, freeing raw material and intermediate goods imports is essential for permitting the consequence and expansion of the right mix of industries and, in addition, it increases incentives for those industries.

Finally, there is the question as to whether it is better to proceed "rapidly" or "slowly". Arguments can be made on both sides of this question and the answer probably depends in large part upon the situation in an individual country, including the size of the previously protected activities within each sector and the height of protection which they had. Nonetheless, there is a fair presumption, I believe, that the transition should be rapid: (1) the longer the transition period, the greater the uncertainty about the probability that it will be carried out, and the slower the responses to the altered incentives will be; (2) a longer transition period gives those groups believing themselves adversely affected in the process more time to mount political opposition; and (3) the benefits of moving toward freer trade are likely to be delayed even more than are the costs.¹

¹ For a consideration of the issues involved in "fast" versus "slow" in a different context, see Alfred E. Kahn "Applications of Economics to an Imperfect World", American Economic Review, May 1979, for a discussion of why deregulation of the American airline industry was probably best carried out rapidly.
These, then are the elements of a policy package designed to move a country toward free trade: (1) a fairly strong commitment on the part of the government to carrying out the transition, which will of course be facilitated if there is broad societal consensus in favour of the move; (2) accompanying that, the conviction on the part of individuals, and especially those with responsibility about major decisions with regard to resource allocation, that the realigned incentives will endure; (3) removal of all impediments to trade in raw materials, intermediate goods, and capital goods; (4) adoption of a realistic exchange rate, whose level will move more or less in accordance with differentials in inflation rates; and (5) either through the exchange rate realignment or through other measures, policies to insure that there are beneficiaries, as well as losers, within each sector of the economy, as the transition to freer trade is completed.

Finally, a major lesson that emerges from all instances of moves toward freer trade is that the benefits of carrying out the policy have substantially exceeded the estimates even of the optimists, while the costs have generally been less than the pessimists believed they would be.
COMMENTS BY DISCUSSION OPENERS

1. J.N. Corden

My comments are divided into two parts. Firstly, I shall discuss the extent to which Australia's own liberalisation experience is similar to that of other countries, as summarised by Anne Krueger. Secondly, I shall make a few remarks on the relevance of the experience of other countries.

My impression is that Anne Krueger's generalisations apply remarkably closely to Australia. If the Bhagwati-Krueger National Bureau project had included an Australian case study it would, broadly, have confirmed her conclusions.

The Australian liberalisation experience is reported in the Anderson-Snape paper at this conference; the consequences are recorded in more statistical detail in I.A.C Annual Reports and in Gregory and Martin (1975); while the debates behind the celebrated 25 per cent uniform tariff cut are discussed in Gruen (1975). Australia's liberalisation experience has consisted essentially of the 25 per cent tariff cut of 1973 and the subsequent tariff reductions associated with the devaluation of 1976. There have also been some reductions as a result of the adoption of the I.A.C. Reports.

Running through the factors listed in the last Part of Anne's paper, I note the following:

1. There was the unfortunate coincidence of the 1974-75 recession following upon the 25 per cent tariff cut. This was clearly not caused by our trade liberalisation, but certainly led to severe criticism of it. Adverse employment effects, which were in fact spread throughout Australian industry, were attributed by the ignorant or the biased as being primarily caused by the tariff cuts. It must be said that the recession was not
expected by policy-makers or advisers when the tariff decisions were decided upon (nor, presumably, was it expected by the Treasury which had, surprisingly, not favoured the liberalisation). If the advisers had expected the recession they would no doubt not have advised such a move. Thus from the point of view of the short-term interests of the politicians it turned out not to be a wise move. On the other hand, in my view, even in retrospect, it was a good decision. In spite of quotas for textiles, clothing, footwear and motor cars, the effects were fundamentally not reversed afterwards. Outside these four sensitive industries, the net result has been a substantial fall in protection which would not have taken place otherwise. The beneficial effects of this are only likely to emerge gradually as new investments are made with less distorted signals.

2. In Australia exchange rate policy has been vital to the liberalisation issue. This has long been stressed in Australia. Tariff reductions must be associated with devaluations or with a favourable balance of payments situation. (See, principally the Vernon Report (1965) and Corden (1966)). The 25 per cent tariff cut was primarily justified by the favourable balance of payments situation at the time and by the need to bring in more imports in order to reduce inflation. The second-stage liberalisation was directly associated with the 1976 devaluation.

3. Anne notes that generally fears of damage from liberalisation are excessive. The effects are never as drastic as expected, and tend to emerge, rather, in the longer-run. This is certainly so in Australia. Here it must be added that the claims of damage done to particular industries or to overall employment have been overstated after the event, the work of Gregory and Martin (1975) on the effects of the uniform tariff cut as compared with the appreciation being ignored by critics of the original decision.
4. Public opinion is certainly important. Front-bench politicians cannot lead public opinion on this subject in view of the strength of the interest groups. Leadership has to come from journalists, academics and perhaps back-benchers. In Australia there has been a vast amount of discussion of the protection issue, and a number of journalists and academics — as well as one lonely but heroic politician, Bert Kelly — have played an important role here. It is interesting to consider what influence they have had. Do academic writings make a difference? My own inclination is to believe that the biggest influence of academics is through their students. It is when their students rise to positions of some power that their teachings begin to matter. A special and intriguing feature of the Australian case is the remarkable role of the I.A.C. In recent years its consistent and highly professional application of standard economic concepts and ideas to this issue, and its production of numerous well researched reports must have had some influence — even though it has obviously provoked vigorous opposition, sometimes in the highest places.

5. In Australia critics of liberalization have always argued that positive measures, not negative ones, are needed. It is clear enough that reductions in protection are best associated with a positive measure such as devaluation. But there have also been strong advocates of export subsidies, credits, and so on, notably Clive Edwards in various papers, (for example, Edwards 1980), and more recently the Crawford Committee. This question of whether piece-meal positive measures are needed is related to the tariff-compensation issue, and has been a key part of the more recent Australian debate. I think there can be little doubt that purely from a public relations point of view specific positive measures such as export subsidies are helpful in bringing about reductions in protection against imports. The economic efficiency arguments, in terms of the theory of the second-best, have been thoroughly explored in Australia.
6. There has also been a debate in Australia as to whether the approach should be fast or slow. The tariff review procedure laid down by the government for the I.A.C. is the slow approach, while the 25 per cent tariff cut was the one major example of the fast approach. In view of the political effects of the 25 per cent tariff cut I cannot see the fast approach being tried again.

I now turn to the question of whether lessons can be learned from other countries. I suppose that we have thought and written so much about this issue, and tried so much—including the 25 per cent tariff cut and the I.A.C. system—that there is little we can learn from other countries on liberalisation procedures. What we can learn is that it is possible to have a high level of employment, a high standard of living, and a high growth rate without much protection—but most economists hardly need to learn that. In any case, of the three countries discussed at some length by Anne, perhaps Brazil is the most relevant case for us. I doubt that there is much to be learnt from the Korean and Israeli cases. Brazil is a resource-rich country which had engaged in an import-substituting industrialisation in the 1950's and early 1960's leading to the development of a manufacturing base of a similar size to that of Australia. The earlier history of manufacturing is also similar to that of Australia. The economic liberalisation which took place under the auspices of a military dictatorship involved more than trade liberalisation, and perhaps the economic boom that followed can be attributed to the broader package. Brazil has now become a significant exporter of manufactured goods, though the proportion of her manufacturing production that is exported is still quite small, certainly much smaller than in the case in Korea. Brazil has, of course, a larger home market than Korea.

It seems to me that two other countries to which Anne has only referred to briefly, have significant lessons for Australia, namely France and Argentina. Before the establishment of the EEC, France was a highly
protectionist country. Her manufacturers felt that they certainly could not compete freely with Germany. All the protectionist attitudes which are so prevalent in Australia were prevalent in France. Policies were governed by what I have called the "conservative social welfare function" (Corden, 1974). The idea of France forming a zone of free trade with Germany was thought of rather like the idea of Australia forming such a zone with Japan. The Common Market was, of course, motivated by political reasons. Nevertheless, the EEC was established. It should be noted that the process of tariff reduction was gradual, pre-announced and across-the-board. Subsequently France had a remarkable growth experience, with one of the highest growth rates in the OECD world, even higher than Germany, at least in more recent years. Undoubtedly France is a tremendous economic success story. It can be argued that this high growth rate made liberalisation and the consequences of the EEC acceptable. But it is also possible that the incentive and "cold shower" effects of free trade with Germany and other EEC members played some part in generating the high growth rate. Of course there were other factors - possibly the persistence of moderate conservative governments and strong rule by high quality bureaucrats. Under the Fourth Republic the latter attained much power owing to the continuous turnover of political leadership (though, at the same time, there was no change in the fundamental political orientation). In any case, this is an example worth studying for us - an economic success story associated with trade liberalisation in a country with protectionist attitudes similar to ours. It differs, of course, from us in at least two respects. Firstly, there was a strong political motive; and to a great extent intra-industry trade was generated, while in the Australian case one would expect more inter-industry effects and hence more sectional strains.

Before moving on to Argentina, I should also note that Sweden is a country with which an interesting comparison could be made. In that case
the liberalisation took place much earlier than in the case of France. Originally Sweden was, like us, a country exporting natural-resource goods and protectionist; and it is now very close to free trade.

The other country that has a lesson for us is Argentina. This is a warning of what can go wrong. Argentina should always be studied by people in Britain and Australia. It has been heavily protectionist, weak on macro-economic policy and strong on trade unions. Argentine economists have always been interested in Australia to see how their country might have developed if things had gone better for them - given that at the turn of the century our two countries were very similar and both among the richest in the world. We should look at Argentina to see how things can go wrong in spite of a good resource base. Certainly resources are not enough. Protectionism, excessive trade union power, weak macro-economic policies and a lack of social cohesion can ensure low growth and high inflation even for the luckiest countries. Of course there are also important differences. Income distribution is much more unequal in Argentina (as also in France) than in Australia, and this has set up social strains.

REFERENCES


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2. P.D. Jonson

1. Introduction

Professor Krueger’s paper is interesting, well written and useful - but I am an amateur in the field of protection policy and both this judgment and my subsequent comments must be evaluated accordingly. I should also note at the outset that my views are not necessarily shared by my employer, or by several colleagues who have kindly provided assistance with these comments.

Since the paper discusses experience overseas, I thought it appropriate to address my remarks to the Australian debate on protection. This is done in three main parts covering respectively: some facts; the presumptions of economic theory and current opinion; and some comments on ways to achieve further changes in the climate of opinion.

2. Some facts

Successive Annual Reports of the Industries Assistance Commission have presented facts and the results of calculations which appear to be largely unchallenged. They include the following:

- Australia has a relatively low ratio of trade to GDP (by comparison, for example, with other small OECD countries);
- in per capita terms, Australian incomes have grown more slowly in the post-war years than most OECD countries, and considerably more slowly than the successfully industrialising countries such as those whose experience is discussed by Professor Krueger;
- during the inflationary recession from the mid 1970s, the more highly protected industries did worse in terms of
output and employment than the average for all industry, despite the provision of considerable extra "temporary" assistance;

- structural change in Australian industry appears to be no faster in the 1970s than in the second half of the 1950s and the 1960s - and the rate at which structural change occurs in Australia appears to be generally slower than that in countries which grow faster.

3. Theory and Opinion

The hypothetical economic theorist from Mars would not be surprised by this concatenation of facts. Australia has followed a general industrial strategy of import replacement - apparently well beyond the point where satisfactory economies of scale can in many activities be obtained from the domestic market. We failed to reduce tariffs to the same extent as other industrial countries,¹ and in recent years even higher levels of protection have been provided to the less competitive industries by way of quotas and other non-tariff barriers to trade.² As a result, we have failed to achieve the maximum possible growth of Australian incomes.

As documented in Chapter 2 of the IAC's Annual Report for 1978-79, there is widespread official agreement with the arguments of the trade theorists. Several reports on industry and trade policies have been initiated in the past decade and the government's views have been presented in a 1977 White Paper on Manufacturing and in the August 1979 statement on the Crawford report.

¹. The main exception was the 25 per cent tariff cut in 1973. This nevertheless left tariff rates well above those in other industrial countries.
². As Professor Krueger points out quotas, as distinct from tariffs, effectively close the economy.
by the Minister for Industry and Commerce. As recently as
21 March 1980, the Minister for Foreign Affairs reiterated the aim of
the government "to have a manufacturing sector which can operate with
the minimum level of protection". He also stressed "that in the
widest political and strategic sense, we would be wise to continue to
provide as much opportunity as possible to the exports of our Asian
neighbours".1

Paraphrasing Saint Augustine, the prevailing view can
be stated as: "Make us efficient, but not just yet". The Crawford
report argued that protection should not be reduced while unemployment
was above "say, 5 per cent". Yet, as argued in a recent review2 of
this report, there is a "Catch-22" involved. This is because "there
is a substantial probability that unemployment levels above 5 per
cent will continue for the next few years", and (quoting Crawford)
"... if the threat of long-term unemployment at very high levels ...
is to be lessened, manufacturing industry in Australia will need to
become more competitive ...". It seems clear that the focus of debate has shifted.
Arguments now centre on the issues of:
. timing; and
. incentives.3

On the subject of incentives, I have nothing to add to the
arguments of the IAC and others on the pros and cons of so-called
"positive adjustment policies". Economic theorists can say little

1. The Minister quotes the Harries report on Australia's relations
   with the Third World. This is one of the few official reports
to argue for decisive action now to cut tariffs and to restructure
industry.
2. Kingma and Volker, Structural Adjustment in the Manufacturing
about questions of timing. However, if, as seems widely accepted, "trade liberalisation policies can make an important contribution to promoting non-inflationary growth"¹ hesitation and delay may not be in the national interest. Factors such as prospects for the balance of payments may be more relevant than current unemployment rates for the timing of reductions in protection. Although I have not seen it demonstrated formally, adjustment may be smoother if made when the balance of payments is likely to be strong. In this context, it is interesting that the Minister for Foreign Affairs² and the Secretary to the Treasury³ have both recently focussed on the possibility that the Australian balance of payments will be strong in the 1980s in the context of arguments for reducing protection of industry. Mr Moore's comments at this Conference about the need to release resources for the incipient investment boom (discussed at the first session) are also relevant.

4. How to get reductions to protection policy

As I have remarked elsewhere,⁴ the very high quality theoretical and empirical work on Australian protection policy has not produced a workable program for reduction of protection. Although the climate of opinion seems to have changed considerably in recent years, the Augustinian view prevails in practice. This could be because Australians want a quiet life with slowly growing material standards, although I doubt it. More influential obstacles to change are likely to be the adverse effects of changes on

1. Ibid, p. 26. It should be noted that the effect of tariff cuts on inflation depends on the monetary and budgetary policies which accompany them. If tariff cuts raise the growth of real income and monetary growth is unchanged, inflation should in the long run be lower.

2. Op Cit., p. 6


particular groups (e.g. the current holders of import quotas)\(^1\) and fears that unemployment could rise in the short run. How can these fears be allayed or overcome? I distinguish four approaches.

**More careful calculations.** This is the approach followed by the IAC, and it is no doubt the most important in an intellectual sense. It is the basis for the IMPACT project, and calculations such as those done by Professor Dixon\(^2\) illustrate yet again the large potential gains from reducing protection. It has been frequently argued, for example, by Dr Parry, that the IAC focusses too much attention on the likely gains for efficiency and too little on gains for consumers. A similar point was made at this Conference by Mr McLaughlin when he suggested that more attention be paid to the costs of not adjusting industry policy. His argument that the ability of the economy to absorb change is higher than normally believed also seems worth further consideration.

After receiving the Crawford report, the Government asked the IAC to report - within 18 months - on approaches to general reductions in long term protection.\(^3\) More calculations are being made. Yet it must be noted that repeated requests for bigger and better reports is an effective way of delaying the need to make decisions.

It must however be acknowledged that there is serious and legitimate concern at the unknown costs of changes to industry policy. As Mr McCawley argued at this Conference, economists often

don't take them seriously enough. If changes in policy are not to be based on acts of faith, economists will need to do more work quantifying the likely costs and benefits of changes to policy. In this work, much more attention needs to be paid to the question of the likely adjustment path; also, since changes to policy will involve losses of rents for some, economists may need to devise practical ways to compensate the likely losers. For example, what should be done to compensate owners of real estate in country towns where textiles are the only industry if decisions are taken which severely affect property values?

Overseas experience. One way to short-circuit the complexities is to point to the experience of countries which have successfully changed their industrial policies. The argument in Professor Krueger's paper, that European experience confounded the Jeremiahs, seems to be a fact which should be published widely. (And the point that the early gains were for consumers is important.) It should be noted in passing that Professor Kasper and associates have worked hard to publicise overseas experience of successful reductions in protection.¹ Perhaps they should be encouraged to do more.

Future Shock. An interesting attempt to change community attitudes has been provided in the form of a book with the arresting title Australia at the Crossroads.² This discusses prospects for the remainder of the century under two scenarios - "the Mercantilist Trend" and "the Libertarian Alternative". The authors claim to be surprised "to what extent our living standards and our life in the year 2000 will be decided by whether Australia adopts a risk-averse,

¹ See, for example, W. Kasper and T.G. Parry (eds), Growth Trade and Structural Change in an Open Australian Economy, CAER, Sydney, 1983.
inward-looking, defensive stance to conserve past structures or a risk-accepting, outward-looking, "open" stance, adapting existing structures to new challenges and opportunities" (p. 92).

Satire. Building on the ideas in the "Crossroads" volume, a useful way to change attitudes to protection might be to write a novel which explored the life of an Australian waiter in the year 2000, on the assumption that the "Mercantilist Trend" is continued. The waiter would be surly as he catered reluctantly for the needs of rich Korean tourists - indeed the surliness and strange food (meat pie and three veg.) would be one of the features of a visit to the industrial museum of Adelaide. Sydney would be making brave attempts to swim against the protectionist tide, but the high crime rates associated with a large underground economy would make Sydney a place to visit only briefly while switching to an ageing Airbus for the slow flight to Adelaide.

While it may be necessary to invent the novelist I have in mind, Australia is not short of resident satirists. In the debate on protection, we have been blessed with the "modest member", now the "modest farmer" and author of One More Nail. I refer of course to Mr Bert Kelly, who has carried the flag of freer trade in the parliament and the pages of our newspapers for many years. His is an important contribution to the changing views which seem evident at this Conference and in many other places.

5. Concluding remarks

Although there is evidence of changing views about protection, I suspect that in practice steady progress will be hard to make. More needs to be done to convince people that the benefits of reduced protection will outweigh the costs, and in particular that the path of adjustment will not be too painful. In this respect, Professor Krueger's paper provides some useful material on overseas
experience. But on the general subject of further changing community attitudes to protection three questions may be worth considering. They are:

1. Is it simply a matter of producing more impressive theoretical analysis and ever more general equilibrium calculations?
2. Do we need to explore new ways to change Australian views?
3. Should we ask Professor Corden to write a novel?
FURTHER COMMENTS

W. Kasper

Professor Kasper disagreed with the notion of a link between tariff cuts and exchange-rate devaluations, that seemed widely accepted in this conference and was part of the Australian economics folklore. Overseas experience with tariff cuts certainly supported the expectation that a removal of import restrictions led, in the short run, towards a trade deficit, whereas the productivity-raising effects of specialisation which boosted export competitiveness took a few years to come through. However, trade specialisation after tariff cuts opened up many new profit opportunities in industry which — in a stable country like Australia — would immediately attract internationally mobile capital, so that the temporary trade deficit was automatically self-financed. This desirable mechanism would only be defeated by xenophobic capital controls and by expected devaluations. This is why the notional tariff-exchange rate link was so dangerous.

Devaluations also tended to create inflationary pressures and posed an extra burden on monetary-fiscal restraint if a change in the nominal exchange rate was to change the real exchange rate. Both inflation and monetary-fiscal restrictions were not conducive to fostering restructuring and the search for new long-run market opportunities, whose success decided whether tariff cuts would improve the nation's economic welfare. He therefore concluded that the microeconomic supply policy of tariff reform should not be mixed up with the macroeconomic demand policies of internal and external monetary management.

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