MARKET DISTURBANCES AND PROTECTION: EFFICIENCY VERSUS THE CONSERVATIVE SOCIAL WELFARE FUNCTION

W.M. Corden

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MARKET DISTURBANCES AND PROTECTION: EFFICIENCY VERSUS THE
CONSERVATIVE SOCIAL WELFARE FUNCTION*

ABSTRACT

Market disturbances tend to give rise to protectionist measures. The central theme of this paper is that these measures are concerned primarily with the adverse effects of the disturbances on sectoral incomes. Protection is the manifestation of a "conservative social welfare function". This is compared with the "efficiency approach" usually employed by economists, the logic of which is the "long-term mutual gain argument". Various interventionist policies (temporary or permanent protection, adjustment assistance, quotas, voluntary export restraints) are compared, taking both the efficiency approach and


I am particularly indebted to Carl Hamilton and Gary Sampson for comments and discussion. I owe to Gary Sampson the suggestion that I tackle the issues considered here, with the particular aim of illuminating aspects of the Multi-Fibre Arrangement and the logic of safeguard measures.

Readers familiar with my own work should note that most of the ideas of the first four sections (and especially the concept of the "conservative social welfare function") can be found in my book, Trade Policy and Economic Welfare, Oxford University Press, 1974. Some of the ideas of the last section are developed in more detail in "Relationships between Macroeconomic and Industrial Policies", The World Economy, 3, September 1980, 167-84. The present paper is related to, and overlaps with, a much longer paper prepared in 1983 for UNCTAD.
the conservative social welfare function into account. The international aspect (as distinct from the point of view of the protecting country only) is considered, and it is noted that one concern may be for a Harmonious International System — a concept itself possibly implying a conservative social welfare function.
MARKET DISTURBANCES AND PROTECTION: EFFICIENCY VS. THE CONSERVATIVE SOCIAL WELFARE FUNCTION

The recent revival of protectionism in developed countries seems to be mainly concerned with safeguarding industries against market disturbances of various kinds. This has led to policies or devices which are essentially conservationist in their objective. The purpose of this paper is to examine in rather general terms some of the basic principles concerning such policies towards market disturbances.¹

A market disturbance is a significant shift in demand or supply conditions in a particular market. It will lead to various price, output and income distribution changes. There will be gainers and losers (actual or expected) and those who expect to lose will seek protection of some kind. This is the main feature of a market disturbance. In addition, its origin may be at home or abroad, it may or may not be caused by explicit domestic or foreign policies, it may be macroeconomic or microeconomic, and the disturbance may be expected to be short-term or long-term.

THE EFFICIENCY APPROACH

The usual approach of economists is to focus on national efficiency and to argue that there is a presumption against government intervention in response to market disturbances. For the moment I leave aside income distribution issues.

The point is simply that a market disturbance sends out signals in the form of price changes which are likely, in due course, to lead to various adjustments, and these market responses are likely to be efficient. If the disturbance is expected to be temporary there will be few, if any adjustments; investment in an industry for which demand has fallen may not decline and employment will be maintained. On the other hand, if the fall in demand is expected to be long-lasting or permanent, investment will fall, there may be disinvestment, employment in the industry will fall and workers will move out, or new members of the labour-force will be diverted to other industries.

Since there are many inefficient or incompetent firms and persons in any community, these responses to market disturbances may not, of course, always be sensible. When one says that the system is efficient one means that correct signals are sent out, and if individual firms and persons react efficiently so as to maximize their profits or utilities, the "national cake" will also be maximized.

It is not claimed that the market is "perfect"; subject to some possible qualifications to which I come in a moment, it is argued only that there should not be any intervention specifically in response to shifts in demand and supply.
conditions. Presumably there are all sorts of externalities, distortions, and causes of market failure, some of which may have been corrected or offset by policies, and others will not.

Some possible qualifications to the general presumption against intervention in response to market disturbances should now be noted.

1. Moving from one industry to another, possibly in another part of the country, involves an investment for workers. If loans were readily available for this kind of investment they might make socially efficient decisions, bearing in mind both the costs of movement and the benefits obtained once they have moved. But the capital market is not always ready to finance such movement, and thus some government intervention in the form of adjustment assistance may sometimes be justified.

2. There may be a tendency to under-adjust owing to a lack of foresight, knowledge or experience, or just a natural (but economically inefficient) conservatism. Government intervention might then lead to an improved result. Sometimes it may be sufficient if the government provides more information; it does not actually have to subsidise people to follow the implications of the information, since persons and firms can make their own decisions. On the other hand it may be quite rational for people to be conservative in their ways and reluctant to change their places of work or living.

3. Real wage resistance may also be a cause of efficiency losses resulting from market disturbances. The wage may fall to fall in response to a decline in demand for particular kinds of labour, and this may then lead to unemployment. But it does not
follow that protection is the appropriate device to deal with this problem.

Quite apart from the efficiency considerations, there may be a presumption against government intervention in a more general sense. It may well be that intervention by a high-minded well-informed, intelligent ruler could improve social welfare. But against market failure must be set government failure — whether the result of the political process, bureaucratic interest groups, lack of competence, or just the inevitable characteristics of governments the world over. Governments could make things better — thus obtaining an "optimal" outcome — but they may actually make it worse.

There is a particular danger in complex arrangements — in made-to-measure subsidies, in import quotas that are frequently varied in size and where the licences to import are not allocated on the basis of firm rules. All these devices provide opportunities for corruption, for inefficiency, for the waste of bureaucratic resources and talent, and for the implementation of policies that favour special interest groups rather than the nation as a whole. This consideration suggests that, if there is intervention, it should be simple and transparent. There should be rules, with an attempt to minimise discretion.

II  THE SECTORAL INCOME DISTRIBUTION ISSUE

I now come to the central issue of this paper. The efficiency approach neglects effects of market disturbances on the distribution of factorial incomes. It is concerned only with
maximising the size of the "national cake" as a whole. It neglects the very consideration that has been central to the revival of protectionism, namely that market disturbances are likely to impose sectoral losses, and that protection could avoid these, even though this would be at the cost of imposing national losses.

Possibility of Compensation

One defence of the orthodox efficiency approach is that compensation of losers by gainers can always take place, so that an efficiency-improving policy that gives two dollars to A while taking one dollar from B could be associated with taxing A and recompensing B such that finally they are both better off. Thus policy recommendations that ignore the sectoral or other income distribution effects of policies may imply that, quite independently, income is being redistributed appropriately through the fiscal system. If it is desired, losers from a policy will be compensated out of the taxes on gainers. In practice the question then arises what the probability is that compensation will actually take place. In many countries there is some automatic compensation resulting from a given progressive tax.

2. The term "efficiency" in this paper refers to Pareto-efficiency. A policy is "Pareto-efficient" if it could make at least one person better off without anyone becoming worse off. In a Pareto-efficient situation it is not possible to make one person better off without making another worse off. A policy that actually makes at least on person better off without making anyone else worse off - such as a Pareto-efficient policy combined with actual compensation designed fully to compensate the initial loser - is a Pareto-improvement.
system, so that the gains of A are partly redistributed to B, but not necessarily sufficiently to ensure that finally B is not worse off than before the original policy.

**Long-term Mutual Gain Argument**

A better way of justifying the orthodox approach of focusing policy judgements on economic efficiency seems to me the following. I shall call it the *long-term mutual gain argument*. It is conceded that any policy that raises national income is likely in the short-run to make some people better off and others worse off. But if such policies are consistently followed over a longer period, it is probable that eventually everyone will be better off. This is the justification for following efficiency and growth-orientated policies consistently.

**Allowing for Distributional Effects**

An alternative approach is not to accept the likelihood of compensation, nor the optimistic growth-orientated approach just mentioned. Explicit and differential weights may be attached to different incomes.

The question then is: what should the weights be? And who should choose the weights? Whose social welfare function is to be the basis for policy? Presumably this depends on who the policy

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3. The terms “social welfare function” used in this paper originated with Bergson and was popularised by Samuelson. See *Trade Policy and Economic Welfare*, p 106. It might be regarded as a concept that summarises the value judgements, and especially judgements or weightings with regard to income distribution, either of actual policy-makers or of groups in the community, or, more conventionally, of the community as a whole.
makers are. One can imagine two interest-groups, each with its own social welfare function. Each gives a high weight to its own income. Policy may be the result of the interaction of these two interest groups, with the weights possibly shifting as a result of changes in governments. There is presumably no objectively correct or morally appropriate weighting.

In spite of these difficulties, it is interesting in the case of particular policy decisions to deduce what the implicit weighting must have been. Furthermore, it is surely helpful for the actual policy-makers to be clear in their own minds what the weights are that influence or determine their decisions. This is so even though they may not find it expedient to make their implicit welfare weight structure public.

In practice producer interests directly affected by a policy tend to be given heavier weights than either consumer interests or those producer interests that are more indirectly affected - e.g. through an exchange rate adjustment. But the implicit social welfare function may also be more complex, and a particular example - one which does seem to be implicit in much thinking about optimal policies and in many actual policy decisions - will now be expounded.

III CONSERVATIVE SOCIAL WELFARE FUNCTION

Policy reactions to market disturbances are frequently influenced or governed by implicit values that could be summarized in a "conservative social welfare function". It is not advocated here, at least not as a dominating criterion. But it
seems to be implicit in much policy-making, so it may help in the understanding of actual policies to make it explicit. If governments are, to some extent, committed to following such a social welfare function, it is useful not only to explore its implications but also to show how it can be pursued most efficiently, i.e. at minimum cost to aggregate income.

The conservative social welfare function says that one (or the) objective of policy is to prevent significant falls in real incomes of any significant sector of the community. It is concerned with income protection. It is a form of social insurance, since it means that any sector of the community feels safeguarded against large real income losses, knowing that the rest of the community will come to its rescue if necessary, even at the expense of foregoing larger increases in national income. Of course, if some developments have an initially adverse effect on all the main sectors of the nation, such a conservative social welfare function cannot be implemented.

This welfare function means that at the margin heavier welfare weights are always given to losers than to gainers. A policy that takes one dollar from A and gives two dollars to B is regarded as a deterioration, just as a policy that took one dollar from B and gave two dollars to A would be. In both cases an associated redistribution from the gainer to the loser would reduce the social loss, possibly turning it into a gain. In the first example a higher marginal welfare weight is attached to A and the second example to B, these two differential weights coming out of the same welfare function.

The function need not be interpreted in the extreme way of
wishing to preserve all existing real incomes, but rather of moderating declines, or avoiding large declines. Furthermore, it might be interpreted as referring only to the short-run, the aim being to avoid sudden and large declines in real incomes. After a market disturbance the weights attached to losers may at first be much higher than those attached to gainers, so that the principles of the conservative social welfare function dominate policy. Gradually the weights may change, with less weight being given to the initial losers, until eventually marginal weights are equalised, so that only efficiency considerations (maximising the national cake) become relevant for policy makers.

It seems to me that the main reason why governments intervene in response to market disturbances and why "safeguard" arrangements are widely regarded as desirable has to do with some kind of implicit conservative social welfare function that is widely accepted. The aim is to protect existing incomes, or at least to avoid drastic declines in response to unexpected disturbances. Of course there are many versions of such a conservative social welfare function; more emphasis may be placed on the maintenance of some people's incomes than of others, depending on the strength of pressure groups and, perhaps, various implicit value judgements.

The key aspects of this function are two. Firstly, intervention is provoked by changes, the function being essentially dynamic in nature. In a static situation - i.e. an equilibrium that has existed for a long time - this function provides no basis for intervention. Secondly, there is a
willingness to forego some potential efficiency gains - to accept a somewhat lower aggregate national income - for the sake of the requirements of this function.

I shall now use this concept to examine various policies practised by governments in response to market disturbances.

IV THE CHOICE BETWEEN THREE INTERVENTION POLICIES

Let us now take the conservative social welfare function motive for safeguard arrangements as given and consider the problem of minimising the cost of such protection. While one might have doubts about intervention at all, and the policy will not be optimal by the efficiency criterion, there is still the matter of making the policy "cost-effective", i.e. achieving a target at minimum efficiency cost. I shall have in mind here the simple case where cheaper imports of a particular product become available owing to a long-term change in comparative advantage abroad, and where - in the absence of intervention - this would have an adverse effect on the domestic import-competing industry.

Let us now consider three alternative types of policies.

(1) Long-term Protection The first set of policies involves protecting or subsidising the factors of production in their existing employment, and doing so on a long-term basis. Such measures could achieve the purpose of maintaining incomes of the factors concerned. On the other hand, by subsidising the factors to stay in the industry, adjustment is discouraged and there will be a long-term efficiency loss. The loss will be long-term rather than short-term because the factors might not have moved out in the short-term in any case.
(2) Adjustment Assistance. A second set of policies involves subsidising the factors if they move out, normally by actually subsidising their moves in some way. This is adjustment assistance. This means, of course, that the factors get no subsidy if they do not move, so that not all factors benefit from the subsidies. Thus the conservative income preservation aim is not fully satisfied, assuming that the capital that remains will earn lower profits as a result of the market disturbance. Furthermore, the workers that remain may receive lower wages. But in the presence of real wage resistance the latter problem does not arise.

Subsidising factors to move may or may not have beneficial effects on economic efficiency. On the one hand, if there is a tendency to under-adjust for reasons discussed earlier, adjustment assistance has a desirable efficiency effect, as well as achieving at least part of the conservative income distribution objective. On the other hand, efficient adjustment might take place in the absence of any intervention - and in that case adjustment assistance is likely to induce over-adjustment. Efficiency may be maximised when the factors are neither subsidised to stay in the industry by permanent protection nor subsidised to move out by adjustment assistance.

As suggested earlier, the reasonable judgment could be made that, in the absence of intervention, there would be a tendency to under-adjust. In that case adjustment assistance becomes clearly preferable to protection of existing output and factor use.
(3) Temporary Protection The third set of policies involves compensating the losing factors directly so that no inducement either to stay or to adjust is provided. Presumably once-for-all (lump-sum) payments would be the appropriate method of adjustment. But it is interesting to note that temporary protection would come close to achieving the same objective provided it is definitely believed that the protection will be temporary. The factors will, in the short-run, stay in the industry in any case, with adjustment taking place with a lag, so that genuinely temporary protection would not affect resource allocation and thus efficiency.

The important issue is what signals about the future pattern of rewards are sent out by the policy response. There is always the danger that the protection will not be believed to be temporary, and in fact it may turn out to be permanent because of the activities of pressure groups that manage to defeat the original intention.

It is thus desirable to ensure that temporary "safeguard" arrangements send out the right signals and that the possibility of temporary protection turning into permanent protection is avoided. This can be done by building time-limits into the original safeguard schemes. If one wishes to rely on rules rather than discretion it must be ensured that subsidies and tariffs are gradually reduced and eventually eliminated as part of the scheme itself (and quotas gradually expanded until they become redundant). There needs to be a built-in "sunset" system, allowing a gradual transition from income maintenance to efficiency as the guiding light of policy in the particular case.
Underlying the choice of policies is the issue of the short-term versus the long-term. The implicit use of (1) the conservative social welfare function for short-term policy and (2) the efficiency approach for longer-term policy seems to be the logic behind safeguard arrangements that are conceived to be temporary. The danger is that interest groups will impose the conservative social welfare function for too long, so that the switch to the efficiency approach is delayed, if it takes place at all.

V  TEMPORARY MARKET DISTURBANCES

So far I have been concerned with market disturbances that are not expected to reverse themselves in the short-term. Let us now consider the effects of a market disturbance (such as a fall in the price of imports of a product) that is expected to be temporary.

Obviously, the various effects are likely to be not only shorter-lasting but also less even in the first period. Firms will make less adjustments in their outputs and employment if they expect the need for these adjustments to be reversed again soon; consumers, or firms that purchase intermediates, will increase their consumption less.

In addition, there will be stabilising speculation. It may moderate the fall in the import price itself, as speculators build up stocks of the import good in order to sell it when the price rises. For each price in the economy that is expected to
change there can, in principle, be some stabilising speculation provided there is scope for stocking and destocking. This is true, above all, of the price of foreign exchange - i.e. the exchange rate - where stabilising capital movements may moderate a temporary depreciation. If private speculation does not take place, or is not allowed to take place owing to exchange controls, it will be profitable for the central bank to do the job itself, running down foreign exchange reserves when the exchange rate depreciates, and rebuilding the reserves later, when the exchange rate is expected to appreciate. This activity will then smooth out the exchange rate movements as well as making profits for the central banks.

Labour services cannot be stocked and destocked, so that predictable wage fluctuations cannot be stabilised through speculation. But it is likely that wages would, in fact, be stabilised by the knowledge that labour market conditions will be reversed soon, the natural price rigidity in the labour market being strengthened by the knowledge that the market shock is only temporary.

If a market disturbance is clearly expected to be temporary, there is then no need for adjustment. The only problem is that there will be a temporary loss in incomes to the relevant factors of production. Given the conservative social welfare function objective, a temporary subsidy to import-competing production would be appropriate, though subject to the inevitable efficiency costs of raising extra taxes. A temporary tariff would also be non-distorting provided the quantities purchased of the
product concerned would not have changed in any case in response to a temporary fall in import prices.

But one should not jump too readily to protectionist policy conclusions from these remarks, even given the conservative social welfare function. There are several qualifications: if every disturbance that is believed to be temporary comes to be expected to lead to temporary subsidisation, then the average profitability of industries subject to fluctuations will be artificially raised and there will be long-term over-investment in such industries. In other words, a resource bias in favour of industries expected to have above-average fluctuations will be introduced. Thus the disturbance must not only be expected to be temporary but must have been clearly unexpected. Since few events are ever utterly unexpected it seems inevitable that a temporary-protection policy would have adverse long-term resource allocation effects. The other qualification is that, as noted already, temporary protection is always in danger of being converted by interest groups into permanent protection.

VI THE INTERNATIONAL DIMENSION

So far the effects of protection only on the protecting country itself have been considered. It has been argued that non-intervention is generally efficient from the point of view of the country which is subject to the market disturbance. Furthermore, it has been implicitly assumed that the social welfare function, whether an orthodox "efficiency" one or the conservative social welfare function, gives positive weights only to residents or nationals. Thus the approach has been nationalistic. Let us now
consider the international aspect and specifically the effects of home country policies on foreigners.

**International Retaliation**

Firstly, with regard to any policy, the possibility of international retaliation must be considered. Clearly the likelihood of retaliation may depend on the adverse welfare effects of policies on foreign countries or on sectional interests in these countries. But these welfare effects need not enter the home country's social welfare function directly. They are only relevant insofar as retaliation does take place, and insofar as retaliation has an adverse effect on the welfare of people in the home country. Thus a concern with adverse effects on foreigners because of the possibility of retaliation does not imply more than a nationalistic welfare function.

**Altruism**

Secondly, there could be a concern with effects on foreigners because welfare effects on them do enter the national social welfare function. A plausible social welfare function might be basically nationalistic, but modified for some altruism. In that case it might give zero weights to welfare effects in countries that are richer than the home country, or equally rich, but positive weights to welfare in poorer countries.

**World Efficiency**

Thirdly, there may be a concern for world efficiency. If this were the only consideration, equal weights would be given to incomes of people everywhere; thus the aim would be to maximise
the "world cake."

It is hardly possible to justify such a policy on the basis of the "compensation argument" mentioned earlier. Internationally, mechanisms of redistribution and compensation are not in place and, obviously, compensation cannot be assumed. The only justification can be the long-term mutual gain argument. In the world as a whole, as within a nation, efficiency and growth-orientated policies, if consistently pursued, are eventually likely to make every nation better off. If countries narrowly protect their own interests at the expense of their neighbours, they will finally all be damaging each other. The pursuit of world efficiency is a positive sum game.

Harmonious International System

Fourthly, there may be a concern for the international system. This is slightly different from the objective of world efficiency, and seems to me a realistic objective. It may be desired to have a harmonious international trading system where political tensions generally are minimised, and economic policy warfare is avoided. Countries do not feel aggrieved about each others' policies, and certainly do not retaliate.

The objective of a harmonious system is somewhat less ambitious than the consistent pursuit of world efficiency. At the minimum it avoids severely negative effects of policies on other countries. It represents the idea of the conservative social welfare function interpreted across borders. The policies of a country should not have significant adverse effects on significant sectors in other countries. Thus positive welfare weights must be attached to foreign losers from policies, even
though zero weights might still be attached to foreign gainers. In other words, a country is not particularly interested whether it makes foreigners better off (so that both altruism and efficiency considerations do not enter the social welfare function now), but it is concerned not to make them worse off.

In a sense we are here again concerned with the possibility of retaliation, so that the social welfare function is still nationalistic, but the interpretation is broader; the concern is not just with immediate and direct retaliation but with the preservation of the rules and customs of a system, which is always in danger of eventually breaking down, to everyone's cost.

Introducing the International Dimension into Policy

The "international dimension" can be fed into policy-making in three ways.

Firstly, one might rely on the national policy-makers to do so. They act, of course, subject to domestic pressures, so the question is to what extent domestic pressure groups are available to provide the "international dimension". There may be pressure groups concerned with helping developing countries, and they may succeed in introducing the altruism element. There will be a Department of Trade as well as pressure groups directly representing exporters; and they will warn against the dangers of retaliation against national policies that damage foreigners.

Secondly, bilateral negotiations and contacts between governments on an ad hoc basis could ensure that the impact of various policies on other countries is kept continuously before national policy-makers. One can normally observe a continuous
bargaining situation, with retaliation, and threats of retaliation, as major instruments of policy. The danger with this situation is that the interests of the system as a whole are likely to get lost, and that the transaction costs of such a "political market" may be rather high. The costs are particularly high when the "market" fails and leads to economic warfare in the form of mutual destabilising retaliation.

The third approach to the reconciliation of national interests in response to market disturbances is the establishment of mutually agreed international rules designed to preserve the system and to ensure that national decision-makers automatically take into account the interests of peoples in other countries when reacting to market disturbances. Such rules are designed to reduce both national discretion and the transaction costs of ad hoc bilateral bargaining. The question is what sorts of rules are appropriate.

**International Rules for Safeguard Arrangements**

Clearly no set of simple rules can cover all cases satisfactorily.

Presumably the starting point should be the principle that intervention to deal with market disturbances by one country is likely to hurt other countries. Each country's interest is that the other minimises intervention. It follows that the simplest rule would be that all safeguard measures should be temporary, even though the disturbances with which they are meant to deal may be expected to be permanent. A "sunset clause" should be built automatically into all safeguard arrangements. This may
also be first-best from the point of view of the protecting country itself.

A second rule might be that - to justify intervention at all - the adverse effects of the market disturbance on domestic sectional interests must be significant - though it is not clear how this should be measured.

A third rule would be that the adverse effects abroad of safeguard measures should not be excessive; if they are, compensation should be provided. Essentially this rule represents an international extension of the conservative social welfare function. Further thought would have to be given to the definition of "excessive". At the minimum, all safeguard measures should be open and transparent, with full information provided to all parties that may possibly be interested. This then provides them with an opportunity to provide information about possibly adverse effects.

With regard to such international rules, a further distinction might be made. One possibility is to set up international conventions which set out the rules in great detail and allow very little room for discretion. Some international body of a judicial kind may still be needed to ensure that the rules are obeyed - that the letter of the law is followed - but there would be little place for an international organisation engaging in discretionary decision-making. The alternative is to allow much more room for discretion, and to delegate to an international organisation - e.g. GATT - the exercise of this discretion on behalf of the world community.
Finally, something should be said about the international implications of the choice between various protective devices.

Quotas versus Tariffs

From an international point of view tariffs, taxes and subsidies at fixed, well-defined rates are probably preferable to quotas, as well as to ad hoc or indirect subsidies. The adverse effects on other countries are greater - and the possibilities of mitigating them less - when the protective devices are unclear, untransparent, frequently changed, and, like quotas, allow much room for discretion.

Foreign suppliers of imports naturally prefer quotas to tariffs if they have an opportunity to obtain the import licences. In that case they obtain some built-in compensation for the enforced reduction of imports. In fact, on balance they may even gain from the restriction of imports, since import restriction might create a monopoly situation for importers that did not exist initially. If importers are competitive, the losses to them from being restricted in their exports to the country concerned have to be set against the gains from the rents received from the licences.

The Logic of Voluntary Export Restraints

It is possible here to see a logic in voluntary export restraints (VERs). There are, of course, particular objections to them, namely that they are not at all transparent, and that, by being bilateral, they introduce discrimination between sources of supply of a rather inexplicit kind, creating a variety of trade diversion effects, additional to the protectionist distortions
The logic of VERs is that they reduce the adverse effects on foreign suppliers of a given trade restriction. By a given trade restriction is meant here a restriction that achieves a given level of protection for domestic import-competing producers. To some extent the effect of a VER is similar to that of a tariff, if the revenue from the tariff were paid as compensation to foreign suppliers. This is also the same as an equivalent import quota, with the licences allocated to the foreign suppliers, a case already discussed.

From the purely national point of view it seems irrational to let the foreigners have the monopoly rents from licences, or allow them to implement the restrictions through VERs. After all, such a method worsens the importing country's terms of trade. But from the point of view of reducing the damage to foreigners the VER may be a sensible device, bearing in mind that the objective of the policy is not to improve the terms of trade or to raise national welfare in the efficiency sense.

The protecting country thus gains by achieving its purpose of implementing a conservative social welfare function, even at the cost of its own consumers and other producers, while it minimises the possibility of retaliation and adverse foreign reactions by letting the foreigners - who may be the most adversely affected group - obtain the benefits of the monopoly rents that are generated. While this may not be the main reason why VERs have become so common, it does provide one logic for this device.
VII MACROECONOMIC DISTURBANCES

Some of the severest market disturbances have a macroeconomic origin. At many times throughout history, as recently, recessions and depressions have given rise to increases in protection. In practice, the reaction to macroeconomic disturbances is often to impose microeconomic trade-restrictive policies. The familiar argument is put that, if there is unemployment, any measure that maintains or increases employment in an industry must be beneficial, since the labour will not be diverted from other industries. This argument must be examined further.

Policy Responses to a Recession

Consider first macroeconomic disturbances that originate domestically. We can begin with the simple case where there is a recession that is not the result of deliberate macroeconomic policy, but is explained, in one way or another, by a fall in private consumer or investment demand, with given monetary and fiscal policies. Demand for goods and services in general falls, including demand for imports. Because of the balance of payments improvement that would result at a given exchange rate, the exchange rate is likely to appreciate if the country is pursuing a flexible exchange rate policy. The appreciation, in turn, will reduce the competitiveness of tradeable goods industries, and so reduce the demand for import-competing goods even more.

Since the effects of the recession on the economy are widespread, the obvious remedy is to restore demand or competitiveness by a macroeconomic device. If piecemeal subsidies
are provided instead, then a distortion will be established between the industries that are subsidized and those that are not because, even though there is unemployment, it is highly likely that there would be some potential movement of resources between industries.

The same argument applies against piece-meal tariffs or quotas. Even if a uniform tariff were imposed - a policy that is sometimes advocated at times of recession - a distortion would be established relative to export industries: labour would be drawn into import-competing industries not only out of the unemployment pool - which is desirable - but also out of export industries - which is a distortion. The general imposition of import quotas would create additional distortions within the import-competing sector since it is unlikely that a set of quotas could be established that would raise the domestic prices of goods by a uniform proportion.

Competitiveness of the tradeable sector can be restored uniformly by devaluation, brought about in this case by intervention in the foreign exchange market. If the monetary effects of the intervention are sterilised there will be no effects on aggregate demand, but at least demand for domestically-produced tradeable goods will be restored or even raised.

While distortions within the tradeable goods sector will be avoided by the use of the exchange rate instrument in preference to the usual protective devices, the question remains why demand for tradeables should be kept up or increased by depreciation while demand for non-tradeables is allowed to fall. Clearly, if
the source of the disturbance is an undesired macroeconomic contraction, affecting in the first instance both the demand for tradeables and for non-tradeables, the appropriate remedy is to restore demand by macroeconomic measures.

The Relationship between Macroeconomic and Protection Policies

So far we have assumed that the macroeconomic disturbance was not policy-induced. Relevant for recent developments in many industrial countries is the situation where there is a deliberate monetary contraction (relative to an initial rate of price increase) designed to reduce price inflation and inflationary expectations, with the inevitable by-product of generating unemployment, at least in the short-run. Let us now consider this case.

The rise in unemployment and the fall in profits are costs which the policy-makers have chosen to impose on society - often with widespread public support - for the sake of the longer-run benefit of reducing inflation. Sometimes, as in 1982 in many countries, the cost has turned out to be greater than many people expected, though the effects on inflation of a given monetary contraction may also have been better. Technically, there is a short-term non-vertical Phillips curve, and countries have moved along it rather sharply, more sharply perhaps than they intended, so that unemployment has gone up more and inflation has gone down more than policy-makers expected.

In this situation there have been inevitable pressures for protection to mitigate the adverse effects of the recession. It must be added that in the case of some countries, notably
Britain, with above-average domestic monetary contraction, a severe appreciation of the exchange rate resulted, accentuated by expectational effects, and this reduced competitiveness of tradeable industries greatly.

If the effects of the policy-induced recession were mitigated by protection, so that firms in the import-competitive sector would not feel compelled to reduce their wage offers, inflation would also decline less. Not only the adverse effects of the recession but also the favourable effects - i.e. the reduction of inflation - would be modified. We would have a situation (actually to be found in many countries) where one side of the government - the Ministry of Finance and Central Bank - is imposing a recession for the sake of reducing inflation, while other arms of the government - the Ministries of Industry and Trade - are being urged to offset the effects of these very same macroeconomic policies.

Protection and the Exchange Rate

As we have seen, protectionist pressures may result from general recessions that may be associated with appreciation of the exchange rate if the source of the recession is a monetary contraction in real terms, as in Britain in 1980 and 1981. In addition, appreciations of the exchange rate can be caused by macroeconomic policy mixes at given levels of aggregate demand that lead to high domestic interest rates. Such appreciations can also give rise to pressures for protection based on the philosophy of the conservative social welfare function.

The best example comes from the United States recently.
Interest rates were raised by tight US monetary policy combined with lax US fiscal policy. These high US interest rates drew capital into the US, and thus appreciated the dollar—which in turn worsened the competitive position of US export and import-competing industries and so generated pressures for protection. The clear remedy was to change the monetary-fiscal policy mix.

It has been observed that protectionist pressures in the United States tend to vary with the yen-dollar rate. There have been three occasions at least when the dollar has appreciated sharply relative to the yen (and in some cases also relative to other major currencies). One was in 1971-72, a second in 1977-78 and a third recently. The explanations have been complex, but most recently a major explanation has been the tight monetary policy combined with the easy fiscal policy in the United States, with a tendency to the opposite in Japan. The swing in the yen-dollar rate have also reflected swings in expectations about macroeconomic policies, as well as political factors.

It seems inappropriate that the response to macroeconomic disequilibria or fluctuations is to alter microeconomic policies in the form of levels of protection, especially when some of these microeconomic policies may not be reversed when the macroeconomic situation changes. To some extent the exchange rate changes are temporary; exchange rates that are severely out of line on the basis of purchasing power parity considerations are unlikely to last, so this is a case for simply letting out the effects. The more important consideration is that, if the effects are as adverse as claimed, macroeconomic remedies should be
The Response to World Recession

Macroeconomic market disturbances may also originate abroad. In this case piecemeal protectionist devices are also inappropriate reactions.

Suppose that there is a world recession which filters through to a particular small country by reducing demand for its exports and increasing competition for its import-competing producers. Its terms of trade may well deteriorate. It will have to accept a real fall in income owing to this terms of trade deterioration. But the general recession need not multiply throughout the whole economy, reducing employment and profits, unless there is real wage resistance. Provided there is some real wage flexibility the country can practise standard Keynesian offsetting macroeconomic policies, in this case a combination of monetary expansion and exchange rate depreciation.

The reason why countries hesitate to follow such offsetting policies in order to insulate themselves from disturbances originating abroad is real wage resistance. The required monetary expansion and depreciation will only be effective in restoring output if the rise in prices to which they lead is not offset by a subsequent rise in nominal wages; in other words, a fall in real wages must be accepted.

The point to stress is that protection cannot be expected to overcome the problem. If a world recession and the resultant terms of trade deterioration for the small country lead to a protectionist response — say import quotas — then the exporters
will be adversely affected twice, first by the decline in the terms of trade, and then by the pull of resources into import-competing industries. From the point of view of total national income, the distortion cost of protection will be added to the unavoidable loss resulting from the terms of trade deterioration.
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