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Protectionism by stealth

By Kunal Kumar Kundu

BANGALORE - Should Ohio's recent decision to banning outsourcing of government information technology work and back-office projects to offshore locations such as India be treated as mere public posturing or does this indicate a clear change in mind set as politics take precedence over economic decision making?

The latter seems to be more likely, as President Barack Obama recently lamented that voters who are disgruntled with the state of the US economy might allow that feeling to influence their voting decisions. With the Congressional mid-term election round the corner, the fear in Washington may not be misplaced.

With the US economy desperately trying to come to terms with the after-effect of one of the most severe recessions since the Great Depression, and with unemployment remaining stubbornly close to double digits, protectionism might be viewed as a feasible option, politically that is. The Ohio decision comes quick on the heels of the US levying tax on IT companies in the form of higher visa fees (between US$2,000 and $2,500 for firms having a higher proportion of non-American workers) to fund stricter immigration controls, and a statement by Democrat Senator Charles E Schumer wherein he likened Indian IT companies to chop shops.

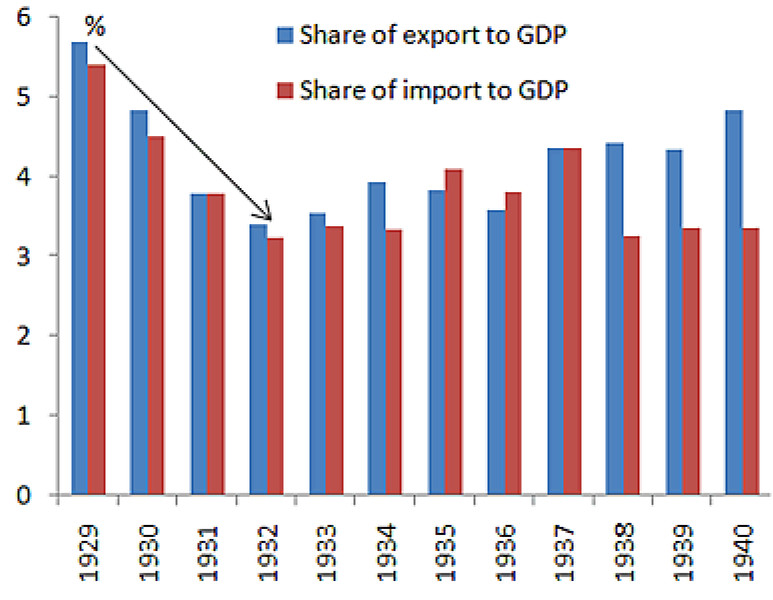
In fact, this trend seems to be a re-run of what was experienced during the decade after the end of World War I, when the United States embraced high tariffs to appease domestic constituencies. To provide protection for American farmers, whose wartime markets in Europe were disappearing with the recovery of European agricultural production, and for US industries that had been stimulated by the war, Congress passed the temporary Emergency Tariff Act in 1921, followed a year later by the Fordney-McCumber Tariff Act of 1922.

The Fordney-McCumber Tariff Act raised tariffs above the level set in 1913; it also authorized the president to raise or lower a given tariff rate by 50% in order to even out foreign and domestic production costs. One unintended consequence of the Fordney-McCumber tariff was that it made it more difficult for European nations to export to the United States. This meant that they had fewer avenues to earn dollars with with they could have services their war-time debts.

Yet despite the Fordney-McCumber tariff, the plight of the American farmer continued. The wartime expansion of non-European agricultural production had led, with the recovery of European producers, to overproduction during the 1920s. This, in turn, led to declining farm prices during the second half of the decade. During the 1928 election campaign, Republican presidential candidate Herbert Hoover pledged to help the farmers by raising tariff levels on agricultural products. The problem was, once there was an express desire to raise tariffs, there was a clamor for an across-the-board increase and this proved impossible to stop.

Soon a bill that was meant to provide relief to the farmers became a means to raise tariffs in all sectors of the economy. Subsequently, congress produced a piece of legislation, the Tariff Act of 1930, which was more commonly known as the Smoot-Hawley tariff in which the envisioned protectionism of the Fordney-McCumber tariff was finally entrenched.

Smoot-Hawley became a symbol of the "beggar-thy-neighbor" policies of the 1930s. Such policies were adopted by many countries during this time and contributed to a drastic contraction of international trade. As the data shows, US exports contracted from US$5.9 billion in 1929 to a mere $2 billion in 1932. The fact that this was not all handiwork of the Great Depression can be understood when one realizes that the share of export to gross domestic product (GDP) also declined substantially.



Source: BEA, Infosys Research

US imports from Europe declined from a 1929 high of $1.33 million to just $390 million in 1932, while US exports to Europe fell from $2.34 million in 1929 to $784 million in 1932. Overall, world trade declined by about two-thirds between 1929 to 1933 - from $5.3 billion to $1.8 billion.

Not surprisingly, the protectionist wind that was blowing helped push the world into a great depression. In fact, in *Lessons from Great Depression*, Dr Thomas C Rustici, Freedom Professor of Economics at George Mason University, demolished the notion that free-market failure caused the Great Depression. He presented evidence that clearly demonstrated that government policies sabotaged the workings of the free market.

Coming back to the present scenario, Group of 20 (G-20) leaders pledged at first crisis-related summit in November 2008 to fight protectionism. Yet according to the World Trade Organization (WTO), 18 out of these 20 economies have since taken measures to restrict trade. With the global economy struggling to recover, political pressures demanding protection from import competition to sustain domestic employment are intensifying.

Several countries have implemented a variety of measures that on the surface do not appear to be restrictions on trade but in effect restrict trade at the expense of other countries, and this is across developed and developing nations.

According to the 5th report of Global Trade Alert, since that 2008 G-20 summit, governments have together implemented 496 beggar-thy-neighbor policy measures. Add to that another 86 implemented measures that are likely to have harmed some foreign commercial interests, and the total reaches 582. Not surprisingly, under the World Trade Organization regime, a tariff increase is the least-applied protectionist measure. The most frequent source of discrimination against other nations' commercial interests has been the state bailout. Many governments have taken the opportunity of the crisis to bail out manufacturers and farmers.

The following table makes for an interesting reading:

Rank	Metric, Country in specified rank, Number			
	Ranked by number of (almost certainly) discriminatory measures imposed	Ranked by the number of tariff lines (product categories) affected by (almost certainly) discriminatory measures	Ranked by the number of sectors affected by (almost certainly) discriminatory measures	Ranked by the number of trading partners affected by (almost certainly) discriminatory measures
1.	EU 27* (140)	Russian Federation (487)	Algeria (54)	Indonesia (165)
2.	Russian Federation (48)	Brazil (440)	EU 27 (52)	EU 27 (163)
3.	Argentina (37)	Ukraine (389)	Indonesia (31)	China (152)
4.	Germany (28)	EU 27 (371)	Ecuador (30)	Argentina (145)
5.	India (27)	Indonesia (346)	China (26)	India (144)
6.	UK (22)	China (335)	Russian Federation (25)	Russian Federation (137)
7.	Indonesia (20)	Ecuador (316)	Mexico (24)	Belgium (132)
8.	China (19)	Argentina (299)	Argentina Belarus (23) Belgium	UK (128)
9.	Italy (18)	India (282)		Germany (124)
10.	Austria (17)	Belgium (203)		France (121)

Source: Global Trade Alert

It should be noted that there is no single metric to evaluate harm. Different policy measures affect different numbers of products, economic sectors, and trading partners. Global Trade Alert reports four measures of harm. In the table above, EU 27 refers to the sum of all of the measures taken by the 27 national governments of the European Union and the measures taken by the European Commission. To be included in this total, a state measure must have involved discrimination against the commercial interests of another state, including potentially another member of the EU.

It is important to realize the imports and exports are not two mutually exclusive activities, but competitive imports play a very important part in a country being able to retain its competitiveness in its exports.

An excessive obsession with balance of trade may lead to another round of economic disaster as was caused by Smoot-Hawley. The fact is, during a global recession, every country intends to boost the demand for its domestically produced goods. This leads to a "prisoners' dilemma". While such jingoistic policies are a good way of keeping the political constituencies happy, the world is worse off when everybody indulges in the same. However, given that no one country would benefit by refraining from it when others are not, it sets off a chain reaction that leads to a sub-optimal solution.

A case in point is a series of reactions which, though not WTO incompatible, is leading to a trade war of a different sort. This concerns the increasing number of countries aiming at competitive devaluation of their currency through market intervention. So far, market intervention was considered to be the refuge of the developing world and was looked down upon by the developed countries. This time, however, these are also entering the fray, and how.

The Swiss government has been intervening in the currency market for quite some time now as the Swiss franc appreciated against euro. Japan sold an estimated $20 billion worth of yen to depreciate its currency, as the appreciating yen perceptibly threatened to halt the economy in its tracks. Even Singapore, South Korea and Taiwan joined the fray. China, India, Malaysia and many others continue to be the flag bearers from the developing world. Recently, the Brazilian central bank purchased nothing less than $10 billion over a fortnight to prevent its currency from appreciating.

China, which was always seen as a country that manipulates its currency, continues to intervene. While so far it has been getting away with it (albeit with some flak) because of the potential opportunities it offers, its policy prompted the US House of Representatives last week to overwhelmingly pass a bill that would enable the Obama administration to impose punitive tariffs on almost all Chinese imports into the United States.

The move is aimed at punishing China for refusing to revalue its currency. While it may not become a law as it faces stiff opposition in the Senate, it is another reminder that the much-avowed coordinated approach (remember the G-20 commitment) to fight global recession is more of a pipedream, as protectionism holds forth.

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