# Tariffs benefit few, at cost to all

Transparency at home is needed to counter protection seekers' arguments, writes **Daniel Ikenson**.

Australia can teach President Barack Obama and his economic advisers a lesson on how to defeat protectionism in the US and elsewhere. At their Washington meeting in November 2008, leaders of the Group of 20 nations made a commitment to "resist" protectionism. At their London summit in April 2009, they undertook to "reject" protectionism.

And at the Pittsburgh meeting in September 2009 – just days after Obama neither "resisted" nor "rejected" but put a 35 per cent tariff on Chinese tyres – the G20 vowed to "fight" protectionism.

What we really need is a plan to defeat protectionism. That plan, in two words, is "domestic transparency". Australia used the domestic transparency provided by its Productivity Commission to expose the true cost of protecting inefficient industries and they transformed their economy from the highly protected, productivity laggard of the 1970s and 1980s to one of the fastest-growing developed economies. Here is what domestic transparency entails.

Defeating protectionism will require a domestic policy focus, not high-profile pledges of international fraternity. After all, politicians are accountable to domestic constituencies, not their counterparts in foreign governments – as Obama's tyre decision made perfectly clear.

But domestic accountability doesn't have to mean acquiescing to protectionist demands. It just so happens that the current incentive structure encourages activism from those seeking protection and quiescence from those who bear its costs, skewing perceptions of what it means to be accountable at home.

Protectionism still flourishes – even in our deeply integrated global economy and even though economists almost unanimously find it short-sighted – because there is an asymmetry of information between stakeholders, which produces an asymmetry of motivations.

Protection seekers have a reasonably good idea of the windfall to expect if their proposals are implemented. A steel tariff of 20 per cent, for example, might enable domestic producers, through higher prices and greater market share, to increase profits by an aggregate $100 million a year. However, the typically larger costs associated with a steel tariff are borne by a mostly unwitting public, whose

**Australia used its Productivity Commission to expose the true cost of protecting inefficient industries.**

incentives to lobby against the tariffs are muted by the fact that those large costs are spread across millions of consumers. These costs include: higher prices for automobiles, appliances, housing, and transportation; lost export sales on account of foreigners having fewer exchange dollars or because of trade retaliation; and forgone opportunities to grow businesses that require affordable steel.

Protection seekers individually have much more to gain than the average consumer has to lose individually. But the cost of protectionism to the broader economy can be substantial.

When protection seekers come asking of politicians, there is rarely compelling, countervailing pressure from other interests to reject their request. There is usually some dissent about adverse economic consequences, but rarely is it packaged coherently with an emphasis on the political consequences that await policymakers who impose restrictions. Instead, the politician sees little downside in obliging protection seekers.

The solution is to borrow from Australia's experience and establish an independent, politically neutral, domestic institution to analyse objectively the costs and benefits of any proposed trade restrictions. The results would be made available to policymakers and the public before decisions are taken with respect to the proposed measures. The results would not have to bind policymakers to any particular course of action, but would ensure that their ultimate decisions were rendered in a transparent environment.

Domestic transparency would likely increase the political cost of allowing protectionism. The public would have foreknowledge of the costs of protectionist measures, which would help ensure that the domestic constituencies to whom policymakers are accountable were more diverse than in the tyres case.

In the steel tariff example, the "institution" might publish results that indeed show a $100 million benefit for steel producers, but also a $300 million overall cost to the economy. Having such information reported in a transparent manner from a credible, objective source would not only energise domestic interests to oppose the tariff, but it would also serve as a tool to help decision makers overcome the leverage exerted by protection seekers.

An institution devoted to domestic transparency would certainly be in the public interest and it would likely be welcomed by politicians, who are often pressured to support protectionist measures. As a result of his tyre decision, Obama is likely to be confronted with more requests for protection from other industries over coming months. The rapidly approaching 2010 elections give protection seekers additional leverage over the President.

The existence of a politically independent, credible, and objective institution to expose publicly the costs of protectionism could provide the counter-leverage Obama might need to reject demands for protection. That would be a crucial victory in the battle to defeat protectionism.

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**Hong Kong used excess inflows to import investment goods: a new airport and a superb mass-transit network.** Photo: REUTERS

# Road map for global 'currency peace'

There is a middle path away from export dependence, writes **Stephen Grenville**.

Hand-wringing over exchange rate pressures is normal, but traditionally the worry has been about depreciation. Now the Brazilian finance minister says that there is a "currency war" under way in which countries are trying to stop their currency from appreciating. Fear of losing international competitiveness is promoting a "beggar thy neighbour" attitude.

The concerns are understandable enough. In a world of deficient demand, every country is trying to get a leg-up by exporting more than it imports.

The idea that an undervalued exchange rate brings advantages is not new. In East Asia, a succession of countries have benefited from an export-led growth strategy. Technological transfer (often through foreign direct investment) and the experience of competing in global markets promoted productivity, efficiency, and growth.

Japan was the pioneer, with its super-competitive exchange rate up until the breakdown of the Bretton-Woods exchange rate arrangements at the beginning of the 1970s. Taiwan, Singapore, Hong Kong and South Korea followed. Further back, in "flying geese" formation, another echelon followed: the countries of South-East Asia, China and Vietnam.

But not every country can play this game at the same time, any more than every student can top the class. This is all about relativities.

Even if a country wants to maintain a super-competitive exchange rate, there are forces that will frustrate this. A super-competitive exchange rate produces current account surpluses and attracts foreign capital inflow. Under these circumstances a freely floating exchange rate would appreciate, wiping out the competitive advantage. And if appreciation is resisted through intervention and amassing foreign exchange reserves, the increase in reserves soon causes problems.

Reserves are often a poor investment, comprising low-yielding, depreciating US dollars, yen or euro while this investment is funded by issuing domestic debt, often at a higher interest rate. The authorities are, in effect, on the wrong side of the carry trade, borrowing in the high-interest-rate currency and investing in the low-interest-rate currency. Worse still, the exchange rate is moving against them. To the extent that the upward pressures can't be resisted, the holder of the US dollars makes capital losses on the depreciating currency.

In some countries of Asia, the reserve accumulation that is a byproduct of these export-oriented strategies has now become so large that the poor investment return matters. Hong Kong and Singapore both have reserves equal to more than their annual gross domestic product. China, Thailand and Malaysia have reserves equal to half their GDP.

Looking at the experience during the past decade, the currencies of these countries appreciated against the dollar by about 2 per cent a year on average. A country holding reserves equal to half its GDP loses an amount equal to 1 per cent of GDP a year because it has chosen to invest in an asset with such a poor return. It could, instead, have used

**A country holding reserves equal to half its GDP loses 1 per cent of GDP a year.**

the excess to import investment goods (as Hong Kong did in the lead-up to the handover in 1997: a shiny new airport and a superb mass-transit network).

The prospect is for the situation to get worse. Even if current account surpluses shrink, foreign capital flows seem likely to increase substantially. Interest differentials will widen as Asia resumes full-speed growth while the reserve-currency countries – US, Japan and Europe – remain mired in government debt, with lethargic growth.

Meanwhile these emerging countries are becoming more integrated into the global economy, with better credit ratings, so the inflows will be larger. Intrinsically, their productivity and profit prospects are better. Portfolio managers in the US and Europe will look at the pathetically low interest returns being earned at home, and decide to put some of their money in countries with good growth prospects.

If these emerging countries abandon attempts to hold down their currencies and let them float, the change is likely to be large and painful, especially for their tradables sector. The exchange rate is sure to overshoot its long-term equilibrium, pushed upward by the ongoing prospect of high productivity as these emerging countries move towards the technological frontier – the journey Japan took in the decades after World War II. Japan is a reminder of how painful is the transition from export dependence to a more domestic consumption-based production structure. At least some of the "lost decade" reflects this transition, initiated by a sharp appreciation of the yen.

There is a middle path for this transition. For those Asian countries where investment is still below the pre-Asian Crisis levels (that is, all except China), encouraging more investment will shift the current account towards deficit. They should aim to achieve an exchange rate consistent with this deficit (which will involve some appreciation). They should accept foreign direct investment but discourage short-term pro-cyclical foreign capital inflows.

Some foreign exchange reserves will be useful to cope with the volatility of foreign capital flows. But the experience of Indonesia and Korea during the global financial crisis suggests that markets look more at the *change* in reserves than at the absolute level. Thus large holdings may not be an efficient insurance against capital flight.

Instead, the various reserve-sharing facilities – principally the International Monetary Fund, Chiang Mai Initiative, and inter-central-bank swaps – should become more attuned to the needs of these countries.

These countries will still get more capital inflow than they want. The excess will bid up asset prices, especially those investments favoured by foreigners – equities and high-end property. It may be inevitable that such assets will be overpriced and volatile. This might keep investment portfolios and capital flows in some kind of tenuous equilibrium, with the foreigners holding high-return assets, but which are risky because of their over-pricing and volatility.

Whatever the equilibrium configuration of exchange rates, current accounts and capital flows, the current conjuncture does not seem sustainable.

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