CHAPTER .3.
PROTECTONISM vs. FREE TRADE.

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PROTECTIONISM.

- **Protectionism** is the economic policy of restricting imports from other countries through methods such as tariffs on imported goods, import quotas, and a variety of other government regulations.
- Protectionism is a practice of nations to protect domestic industries and their workers by providing subsidies for their production and imposing tariffs on competing foreign products.
- Protectionist believe that infant industries must be protected in order to allow them to grow to a point where they can fairly compete with larger mature industries established in foreign countries.
- They believe that without this protection , infant industries will die before they reach a size and age where economies of scale, industrial infrastructure and skill in manufacturing have progressed sufficiently to allow the industry to compete in the global market.

Arguments in favor of protectionism.

- Infant industry argument.-(protection needed in initial stages)
- Diversification argument.
- Improving the terms of trade.-(how much unit of imports can get for a unit of export of goods)
- Improving balance of payments.-by restricting imports….
- Anti-dumping.
- Bargaining.
- Employment argument.(-employment opportunities.)
- Key industry argument.(country should develop its own key industries)
- National defence
- size of the home market.(enlarge market for agricultural products domestically)
- Equalization of cost of production.(imposing import duties helps to equalize low costs of foreign products)
- Patriotism.(every citizen prefer domestic goods)

Arguments against protectionism.

- Commodities at higher price.
- Producers and sellers less quality conscious.
- Encourage domestic monopolies.
- Discourage innovation.
- Open to corruption.
- Reduce the volume of foreign trade.
- Uneconomic utilization of worlds resources.
- Protected industries tent to become negligent.

Role of protectionism in developing countries.

- Infant industry argument assumes greater importance in developing countries.
- For backward agricultural countries to develop their industrial potentialities rapidly, foreign competition should be minimized through protection.
- Most of the developing countries have secured their independence very recently. They must have a strong defence and diversification of their industries through protection.
- Protection is important tool for planned economic development.
- Due to **Demonstration Effects(consumption habit of people to imitate consumption trend adopted by other people.**), the propensity to import being very high in developing countries.

Protective Devices.

- Tariffs
- Quotas
- Exchange control
- State trading
- Subsidies.
- Dumping.
- Commodity agreements.

Free Trade.

- According to Adam Smith ,the term free trade is used to denote that system of commercial policy which draws no distinction between domestic and foreign commodities and therefore neither imposes additional burden on the latter, nor grants any special favor to the former.
- Unrestricted purchase and sale of goods and services between countries without the imposition of constraints such as tariffs, quotas , and other restriction
- The policy of free trade does not require the removal of all sorts of duties on commodities in international exchange . it insist that duties may be imposed exclusively for revenue and not all for protection.

Features

- Trade of goods without tax or other trade barriers.
- Trade in services without taxes or other trade barriers.
- Absence of trade distorting policies.
- Unregulated access to markets.
- Trade agreements which encourage free trade.

Difference Between Protectionism And Free Trade.

Protectionism

- Restriction of trade with other nations in order to protect domestic industries.
- Protect local firms from international competition and economic changes such as technological innovation.
- **Examples of protectionism**: tariffs,quotas,trade legislations ,subsidies etc.
- Less competitive.
- Lead to economic declines may lead to wars.

Free Trade

- Elimination of barriers to trade to create large open markets for goods and services.
- Allows a country to focus on its compet.adv and import where it is weak.
- Free trade agreements,
- Negative impact on culture.
- Economically beneficial.but the benefits may be unevenly distributed leading to social unrest.

- Since second world war it has been stated policies of most first world countries to eliminate protection through free trade policies enforce by international treaties and organizations such as WTO.
- WTO regulates free trade agreements among member countries.
- Free trade in the real sense means ;
- International taxes are comparable.
- There exist single monetary system.
- Uniform business laws.
- Similar business ethics.
- Uniform wage rates.
- Maximum labour mobility.
- Freedom from threat of wars.

TRADE BARRIERS.

- Trade barriers are the measures that Govt. or public authorities introduce to make imported goods or services less competitive than locally produced goods and services.
- Types of Trade Barriers.

1. Tariff Barriers-Tax imposed on imports or exports.
2. Non Tariff Barriers.-Barrier other than tariff.

Tariffs;

- Word Tariff derived from;spanish town of ‘Tarifa’
- Tarifa was the first port in history to charge merchants for the use of its docks.
- Name Tarifa derived from the name of Berber warrior ‘Tarif ibn Malik’.
- Other source assume that origin of tariff is italian word Tariffa. translated as list of prices, books or rates.

Tariff Barriers.

- **Specific duty-** based on physical characteristics of the goods. when a fixed sum of money, keeping in view the weight or measurement of a commodity is levied as tariff.
- **Ad valorem duty**-these duties are according to value. when a fixed percentage of value of a commodity is added as tariff is known as ad valorem duty. it ignore consideration of weight ,size or volume of commodity.
- **Combined or Compound Duty** ;combination of specific and ad valorem duty.
- **Sliding scale duty;(seasonal duties**); the import duties which vary with price of commodities are called sliding scale duty. historically these duties confined to agricultural products as their prices frequently vary due to natural factors.

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- **Countervailing duty**; it is imposed on certain imports where products are subsidized by exporting governments. as a result of government subsidy ,imports become cheaper than domestic goods. To nullify the effect of subsidy this duty imposed in addition to normal duties.
- **Revenue tariff;** a tariff which is designed to produce revenue to home govt. is called revenue tariff. generally a tariff is imposed with a view of earning revenue by imposing duty on consumer goods ,particularly on luxury goods whose demand from rich is inelastic.
- **Anti dumping duty**; at times, exporters attempt to capture foreign markets by selling goods at rock bottom prices, such practice is called dumping. as a result of dumping, domestic industries find it difficult to compete with the imported goods. To offset anti dumping effects, duties are imposed in addition to normal duties.

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- **Protective tariff**; in order to protect domestic industries from stiff competition of imported goods, protective tariff is levied on imports. Normally a very high duty is imposed, so as to either discourage imports or to make the imports more expensive as that of domestic products.

Non-Tariff Barriers.

- **Quota system**; under this system a country may fix in advance, the limit of import quantity of a commodity that would be permitted for import from various countries during a given period.
- **Quota system divided in to the following categories**.

1. **Tariff/custom quota**; certain specified quantity of imports is allowed at duty free or at a reduced rate of import duty. additional imports beyond the specified quantity are permitted only at a increased rate of duty. Here combines the feature of tariff and an import quota.
2. **Unilateral quota**; The total import quantity is fixed without prior consultation with the exporting countries.
3. **Bilateral quota**; quotas are fixed after negotiation between the quota fixing importing country and exporting country.
4. **Multilateral quota;** a group of countries come together and fix quotas for exports as well as imports for each country.

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- **Product standards;** most developed countries impose product standards for imported items. if the imported items do not conform to the established standards, the imports are not allowed.eg; pharmaceutical products must conform to pharmacopoeia.(an official publication containing a list of medical drugs with their effects and directions for their use.)
- **Domestic content requirements;** Govt. impose domestic content requirements for boosting domestic production.eg; the DCR category was instituted in Jawaharlal Nehru National Solar Mission from the beginning of 2010 in an effort to create a healthy and robust indigenous manufacturing base and to elevate India's status as a solar hub.

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- **Product labeling**; certain nations insist on specific labeling of the products. For instance European Union insists on product labeling in major languages spoken in E.U. such formalities create problem for exporters.
- **Packaging requirements**; eg; EU. insist on recyclable packaging materials
- **Consular formalities;** are documents or procedures required by some countries before their customs authorities will permit goods produced in other countries to enter their markets , such as invoices approved by a consul or other officials of the importing country.
- **State Trading**; in some countries like India , certain items are imported or exported only through canalizing agencies. Individual exporters or importers are not allowed to import or export canalized items directly on their own.

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- **Preferential arrangements**; some nations form trading groups for preferential arrangements in respect of trade amongst themselves. import from member countries are given preference, whereas those from other countries are subject to various tariffs and other regulations.
- **Foreign exchange regulations;** the importer has to ensure that adequate foreign exchange is available for importing goods by obtaining a clearance from exchange control authorities prior to the concluding of contract with the supplier.
- **Other non tariff barriers**; health and safety regulations, technical formalities ,environmental regulations, embargoes etc.
- Purpose of both tariff and nontariff barriers are same. That is to impose restrictions on import but they differ in approach and manner.

TERMS OF TRADE(TOT)

- Terms of Trade is a measure of how much imports an economy can get for a unit of exports of goods.
- Terms o Trade measures a country's export prices in relation to its import prices.
- Expresses as ;
- **Index of Export Prices /Index of import prices *100.**
- For Eg ; if over a given period , the index of export prices rise by 10% and the index of import prices by 5%, the terms of trade are;
- 110/105*100=104.8.
- This means that the terms of trade have improved by 4.8%.when the terms of trade rise above 100 they are said to be improving and when they fall below 100 they are said to be worsening.

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- **Improving Terms of Trade.**
- It is a relationship between what we are gaining from exports and what we are giving for imports.
- If a country terms of trade improves , it means that for every unit of exports sold it can buy more unit of imported goods.
- **Worsening Terms of Trade.**
- Country has to export more to purchase a given quantity of imports.

Balance Of Payment.

- BOP is a double entry system of record of all economic transactions between the resident of one country and rest of the world carried out in a specific period of time.
- All economic transactions means transactions of both visible goods(merchandise)and invisible goods.(services)
- BOP is broken in to three important subcomponents.

1. Current Account Balance.
2. Capital Account Balance.
3. Financial Account Balance.

- BOP= Current Account + Capital Account +Financial Account.

Current Account.

- **Current Account**; all transaction arising from trade in currently produced goods and services. It contain debit and credit.
- Credit of current account includes export of trade(Income from sale of goods or services in to foreign).
- Debit of current account includes import of trade or services.(Expenditure from purchase of goods or payment to services in to foreign)
- Current Account divided in to Three Parts;

1. Visible Account.
2. Invisible Account.(services .)
3. Unilateral Transfers.; are receipts which resident of a country receive payments without giving anything in return. Eg; Govt Grants, Reparations ,Private Remittance, Disaster relief.
4. Non monetary movement of gold.

Capital Account.

- **Capital account ;**Shows transactions relating to international movement of ownership of financial assets such as Shares ,Property, Direct Acquisition Of Companies, Bank Loans, Govt Securities.
- Capital Account divided in to three parts.

1. Private capital

a) Long Term.

b) Short Term

2. Official capital
3. Banking capital

Official Settlement And Reserve Account.

- Official sale of foreign currencies (Cr) and official purchase of foreign currencies(Dr).
- Direct investment
- Portfolio investment.

Balance of payment accounting

- Export of goods-Import of goods.=BOT.
- Balance of Trade+ Net earnings on invisibles=Balance of Current account.
- Net inflows by foreign exchange on account of investment inflows(FDI + portfolio),foreign loans, banking transactions and other capital transactions=Balance of Capital Account.
- Balance of Current Account + Balance Of Capital Account + Errors And Omissions=Overall Balance Of Payment.

Equilibrium, Disequilibrium, and Corrective Measures.

- Equilibrium of BOP.
- Situation in which all external receipts of a country over a period of time will be equal to all external payments made by country with rest of the country over a period of time.
- Receipts are happened through exports, grants or unilateral transfers received from rest of the world, or from foreign investment.
- Similarly payments are made by nations with rest of the countries over a period of time includes imports,unilateral transfers made by country.
- When Bop is in equilibrium means demand for foreign exchange is equal to supply of foreign exchange in that particular nation.

- .ie , there is no excess demand and supply of foreign exchange over a period of time.
- Bop is not necessarily in equilibrium always.
- There will be a possibility of BOP in disequilibrium.
- Receipts are not equal to payments.
- Receipts are greater than or less than payments.
- Demand for foreign exchange will not equal to supply.
- Receipts are greater than payments=surplus position
- Supply of foreign exchange is greater than demand.
- Value of domestic currency appreciates.
- BOP deficit situation;
- Receipts are less than payments.
- Demand for foreign exchange is greater than supply.
- Currency value depreciate.

Causes of Disequilibrium in BOP.

- Population Growth.
- Development Programs.
- Demonstration Effects.
- Natural Factors.
- Cyclical Fluctuations.
- Inflation.
- Poor Marketing Strategies.
- Flight Of Capital.
- Globalization.

Types of Disequilibrium in Bop

- **Cyclical disequilibrium**; fluctuations in import and export due to business cycle.(depression,revival,prosperity,boom,recesssion.)
- **Cyclical disequilibrium in the balance of payments may occur because:**
- i. Trade cycles follow different paths and patterns in different countries. There are no identical timings and periodicity of occurrence of cycles in different countries.
- ii. Income elasticity of demand for imports in different countries are not identical.
- iii. Price elasticity of demand for imports differ in different countries.

Structural Disequilibrium.

- It emerges on account of structural changes occurring in some sectors of the economy at home or abroad which may alter the demand or supply relations of exports or imports or both. Suppose the foreign demand for India's jute products declines because of some substitutes, then the resources employed by India in the production of jute goods will have to be shifted to some other commodities of export. If this is not easily possible, India's exports may decline. whereas with imports remaining the same, disequilibrium in the balance of payments will arise. Similarly, if the supply condition of export items is changed, i.e., supply is reduced due to crop failure in prime commodities or shortage of raw materials or labour strikes, etc. in the case of manufactured goods, then also exports may decline to that extent and structural disequilibrium in the balance of payments will arise.

Short-run Disequilibrium.

- A short-run disequilibrium in a country's balance of payments will be a temporary one, 'lasting for a short period, which may occur once in a while. When a country borrows or lends internationally, it will have short-run disequilibrium in its balance of payments, as these loans are usually for a short period or even if they are for a long duration, they are repayable later on; hence the position will be automatically corrected and poses no serious problem.

Long run disequilibrium(Secular Disequilibrium.).

- In short, true disequilibrium is a long-term phenomenon. It is caused by persistent deep-rooted dynamic changes which slowly take place in the economy over a long period of time. It is caused by changes in dynamic forces/factors such as capital formation, population growth, territorial expansion, technological advancement, innovations, etc.
- it is due to increase in imports consequent upon highly aggregate demand.

Consequences of BOP Disequilibrium

- **<u>Domestic company;</u>**
- Pressing need for corrective action.
- Due to low business confidence foreigners are reluctant to invest in such economy.
- Fewer stocks, variety of exotic goods as imports are limited and heavy protection policies will be used.
- High unemployment reduced economic growth etc.
- **<u>External economy;</u>**
- Put pressure on government to edit protectionist policies.
- Devaluation of exchange rate.

Corrective Measures.

- **1. Trade Policy Measures: Expanding Exports and Restraining Imports**:
- Trade policy measures to improve the balance of payments refer to the measures adopted to promote exports and reduce imports.
- Exports may be encouraged by reducing or abolishing export duties and lowering the interest rate on credit used for financing exports. Exports are also encour aged by granting subsidies to manufacturers and exporters.
- Besides, on export earnings lower in come tax can be levied to provide incentives to the exporters to produce and export more goods and services. By imposing lower excise duties, prices of exports can be reduced to make them competi tive in the world markets.

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- On the other hand, imports may be reduced by imposing or raising tariffs (i.e., import duties) on imports of goods. Imports may also be restricted through imposing import quotas, introducing li censes for imports. Imports of some inessential items may be totally prohibited.
- Before the economic reforms carried out since 1991. India had been following all the above policy measures to promote exports and restrict imports so as to improve its balance of payments position. But they had not achieved full success in their aim to correct balance of payments disequilibrium.

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- **2.Expenditure-Reducing Policies:**
- The important way to reduce imports and thereby reduce deficit in balance of payments is to adopt monetary and fiscal policies that aim at reducing aggregate expenditure in the economy. The fall in aggregate expenditure or aggregate demand in the economy works to reduce imports and help in solving the balance of payments problem.
- **The two important tools of reducing aggregate expen diture are the use of:**
- (1) Tight monetary policy and
- (2) Concretionary fiscal policy.

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- **Tight Monetary Policy:**
- Tight monetary is often used to check aggregate expenditure or demand by raising the cost of bank credit and restricting the availability of credit. For this bank rate is raised by the Central Bank of the country which leads to higher lending rates charged by the commercial banks. This discourages businessmen to borrow for investment and consumers to borrow for buying durable consumers goods.
- This therefore leads to the reduction in investment and consumption expenditure.

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- **Contractionary Fiscal Policy:**
- Appropriate fiscal policy is also an important means of reduc ing aggregate expenditure. An increase in direct taxes such as income tax will reduce aggregate expenditure. A part of reduction in expenditure may lead to decrease in imports. Increase in indirect taxes such as excise duties and sales tax will also cause reduction in expenditure.
- **3. Expenditure – Switching Policies:**
- A significant method which is quite often used to correct fundamental disequilibrium in balance of payments is the use of expenditure-switching policies. Expenditure switching policies work through changes in relative prices. Prices of imports are increased by making domestically produced goods relatively cheaper. Expenditure switching policies may lower the prices of exports which will encourage exports of a country. In this way by changing relative prices, expenditure-switching poli cies help in correcting disequilibrium in balance of payments.

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- The important form of expenditure switching policy is the reduction in foreign exchange rate of the national currency, namely, devaluation. By devaluation we mean reducing the value or exchange rate of a national currency with respect to other foreign currencies. It should be remembered that devaluation is made when a country is under fixed exchange rate system and occasionally decides to lower the exchange rate of its currency to improve its balance of payments.

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- **4.Exchange Control:**
- Under it, all the exporters are ordered to surrender their foreign exchange to the central bank of a country and it is then rationed out among the licensed importers. None else is allowed to import goods without a licence. The balance of payments is thus rectified by keeping the imports within limits.

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- **In short, correction of disequilibrium calls for a judicious combination of the following methods:**
- (i) Monetary and fiscal changes affecting income and prices in the country;
- (ii) Exchange rate adjustment, i.e., devaluation or appreciation of the home currency;
- (iii) Trade restrictions, i.e., tariffs, quotas, etc.;
- (iv) Capital movement, i. e., borrowing or lending aboard; and
- (v) Exchange control.