Protectionism

Protectionism involves protecting domestic industries from foreign competition. It restricts free trade and the methods used often seek to increase domestic industries' relative price competitiveness.

Methods of protection and their impact: Tariffs

Tariffs are taxes usually on imports but may also be imposed on exports. There are two key motives behind taxing exports- raise revenue and to increase supply of the product on the domestic market. Revenue raising may also be the reason for taxing imports. The other motive is to discourage consumption of imports. A tariff can be specific, that is a fixed sum per unit, or ad valorem, which is a percentage of the price. A tariff imposes an extra cost on the supplier which usually pushes up the price. A tariff will be more effective in raising revenue if demand for imports is price inelastic. It will be more effective in protecting the domestic industry if demand for imports is price elastic.

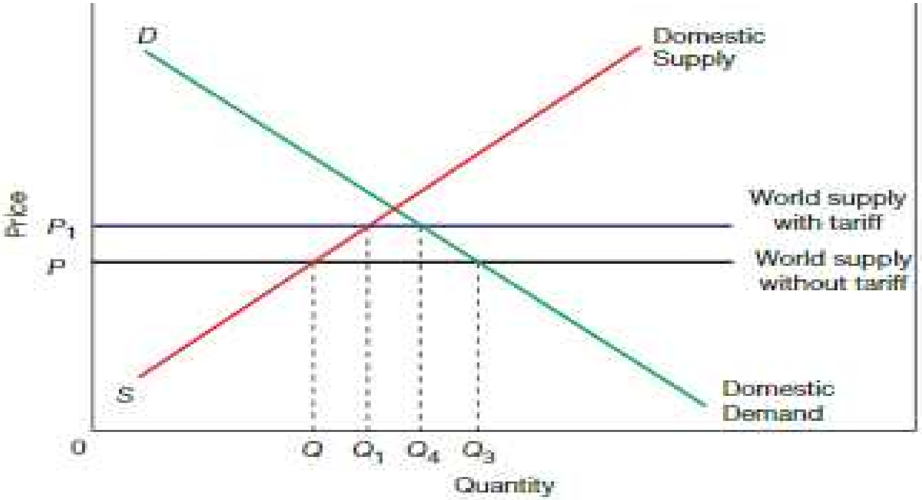

Figure 4.26 The effect of imposing a tariff

Methods of protection and their impact: Quotas

Quotas are limits on imports. The limits are usually imposed on the quantity of imports but are also sometimes imposed on the value of imports that can be purchased each year. Restricting the supply of imports is likely to drive up their price. Unlike tariff s, quotas usually do not raise revenue for the government.

Methods of protection and their impact: Exchange controls

Instead of limiting the imports directly, a government may place limits on the amount of foreign exchange that can be purchased in order to buy imports, travel abroad or invest abroad.

Methods of protection and their impact: Export subsidies

Subsidies may be given to both exporters and to those domestic firms that compete with imports and their costs will fall. This will encourage them to increase their output and lower their price. This may enable them to capture more of the markets at home and abroad.

This will encourage them to increase their output and lower their price. This may enable them to capture more of the markets at home and abroad. The losers will be the foreign firms and domestic taxpayers. Domestic producers will gain. Consumers will also benefit in the short run. In the long run, however, they may lose if the more efficient foreign firms are driven out of business and the subsidied domestic firms raise their prices.

Methods of protection and their impact: Embargoes

An embargo is a complete ban either on the imports of a particular product or on trade with a particular country. A ban on trade with a particular country may arise from political disputes.

Methods of protection and their impact: Voluntary export restraints/ restrictions

They are an agreement by an exporting country to restrict the amount of a product that it sells to the importing country. The exporting country may be pressured into signing such an agreement or it may agree in return for the importing country also agreeing to limit the exports it sells of another product.

Methods of protection and their impact: Economic and administrative burdens (‘red tape’)

A government may seek to discourage imports by requiring importers to fill out time consuming forms. It may also set artificially high product standards to restrict foreign competition.

Methods of protection and their impact: Keeping the exchange rate below its market value

A government may manipulate the country's exchange rate in order to give its producers a competitive advantage. Th is may lead to other governments lowering their exchange rates.

The arguments in favour of protectionism

Despite the potential advantages of free trade, most countries impose import restrictions. There are a number of arguments that may be put forward for doing this.

To protect infant industries

Firms in a new industry may find it difficult to survive when faced with competition from more established, larger foreign firms. This may be because the foreign firms are taking advantage of economies of scale and benefiting from their names being well-known. Protecting a new infant industry may give it time to grow and so benefit from economies of scale and to gain a global reputation. It is, however, difficult to identify which new industries will develop and gain a comparative advantage. There is also the risk that an infant industry may become dependent on protection.

To protect declining industries

If declining industries, which have lost their comparative advantage, go out of business quickly there may be a sudden and large rise in unemployment. If the industry is granted protection and that protection is gradually removed, unemployment might be avoided. As the industry reduces its output, some workers may retire and some leave for jobs in other industries. There is again, however, a risk that the industry may resist reductions in the protection it receives. This can lead to considerable inefficiency.

To protect strategic industries

Some governments seek to protect industries that produce products they regard as strategic, such as weapons, fuel and food. They may not want to be dependent on foreign supplies of these products.

To prevent dumping

There may be an economic justification for imposing trade restrictions in the case of dumping as this practice may be regarded as unfair competition. Dumping involves selling products at below their cost price. In the short run, home consumers will benefit from dumping as they will enjoy lower prices. In the long run, however, if the foreign firms drive out the domestic firms, they may gain a monopoly and then raise their prices. Indeed, foreign firms may engage in dumping with the specific intention of gaining control of a market in another country by destroying existing competition and preventing new domestic firms from becoming established. Foreign fi rms may be able to engage in dumping by covering losses with previous supernormal profi ts, by charging high prices in their home markets or because they receive subsidies from their governments.

To improve the terms of trade

If a country purchases a large proportion of another country or countries’ exports of a product, it may be able to force down its price. By imposing trade restrictions, it can lower demand and as its demand is signifi cant this may lead to a lower price. Th is will improve the country’s terms of trade and allow it to purchase more imports for the same quantity of exports.

To improve the balance of payments

A government may impose trade restrictions in order to improve its current account position. For instance, imposing tariff s may encourage consumers to switch from buying imports to buying domestic products. Trade restrictions would only provide a short-term boost to the current account.

Other reasons

- There are a number of other reasons why a government may impose trade restrictions. Tariff s may be used to raise revenue.
- A government may also engage in trade restrictions to try to persuade another government to reduce its trade protection.
- In addition, a government may seek to protect a range of industries to avoid the risks attached to overspecialisation.