PJC 2017 H2 Prelim Exam Paper 2 Question 6

Question:

Protectionism is the deliberate attempt by governments to limit imports or promote exports by putting up barriers to trade.

Assess the effects of protectionism on consumers, producers and government. [25]

Protectionism is a policy of sheltering the domestic industries from foreign competition through the imposition of trade barriers/ protectionist measures on foreign goods and services. There are tariff and non-tariff trade barriers. Examples of protectionist measures that are commonly used are import tariffs, import quotas and export subsidies.

Due to the negative effects that globalisation would bring about, some economist would argue the use protectionist measures to protect the economy from the harmful effects. Thus both the benefits and costs of protectionism should be considered from the perspectives of economic agents.

Protection can be given to industries that have lost their competitiveness or comparative advantage. Without any trade barriers, foreign imports which are cheaper and possibly of better quality will do better than the domestically produced substitutes which are more expensive. Massive unemployment will happen if these are large industries. Governments may use protectionism to prevent this massive unemployment which can lead to loss of income and a drastic fall in the standards of living. For example, restrictions on imports can slow the decline of such industries, providing time for labour to be retrained for other growing industries. This reduces the incidence of structural unemployment and helps sustain or at least ameliorate the impact on living standards. Hence, temporary protection for declining industries may be justified to prevent rising unemployment in the short run.

Imports can be limited through tariffs or quotas. A tariff is a tax imposed on imported goods. Tariffs raise the price that domestic consumers pay for imported goods. Many countries protect their agricultural sector through imposing tariffs, such as the US, Japan and China.

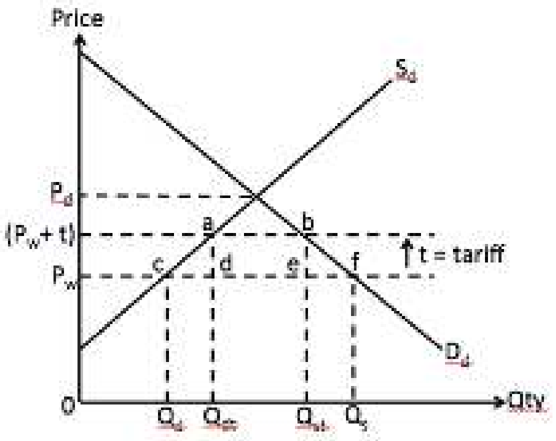

Figure 1

Tariff increases the price of imports compared to domestic goods. With reference to Figure 1, assuming a tariff of t is imposed on imported sugar in the US. This will increase the price of imported sugar from Pw to Pw+t. Without tariff, the US economy spends QdQsfc on imported sugar. After tariff, the economy will now spend QdtQstba on imported sugar. Tariffs reduce the demand for imports as consumer switch to the relatively cheaper domestic goods. As seen in Figure 1, domestic spending on sugar increases from 0PwcQd to 0(Pw+t)aQdt.

An import quota is a policy of only allowing a limited quantity of goods to be imported. Limiting the quantity of imports leads to a shortage of imports at the world price, this will drive up domestic prices to clear the market. For instance, the US government imposes import quotas on a wide range of goods, such as textile and sugar, the imposition of such quotas protects domestic producers.

An export subsidy is given when the government decides to subsidise an industry as a mean of helping to improve the competitiveness of the industry in the global market. For example, the Indian government's subsidy on raw sugar export. The subsidy will reduce cost of production for domestic sugar producers and hence shift the supply curve rightwards, allowing them to export their raw sugar at a relatively lower price as compared to other world exporters. A subsidy can also be given when the government decides to subsidise an industry as a mean of protecting the producers from competition of lower-priced foreign goods. The subsidy will reduce cost of production for domestic firms and hence shift the domestic supply rightwards, leading to a fall in the price of domestically produced goods to a price that is relatively cheaper than imports. This means that the country would import less of such goods and domestic firms would be able to produce higher quantities in the domestic market.

All the above will bring about higher consumption expenditure (C) or export earnings (X) and lower import expenditure (M), AD will increase and national income will increase k times via the multiplier effect. Higher real output means that there will be higher derived demand for factors of production, leading to lower unemployment rate. The government benefits from collecting higher revenue as national income rises, and from the imposition of tariffs. Domestic producers benefit from the protection given by the government, and will be able to increase their revenue. However, consumers will be disadvantaged in terms of consumer welfare and consumer surplus as tariffs result in higher prices and less variety of goods.

Governments make use of protectionism to protect domestic industries. As explained above, trade barriers increase domestic quantity supplied and domestic price. Domestic producers will then enjoy higher revenues and profits. On top of that, higher quantity supplied means larger scale of production, some of these producers from protected industries may be able to enjoy cost savings as they reap the benefits of economies of scale.

Protectionism benefits consumers in terms of employment opportunities. If the protected industries are leave to decline rapidly, it will lead to massive unemployment and many social problems, especially if these are dominant industries in the economy. Therefore the government needs to protect these industries for a while to allow the workers time to be retrained and re-employed by emerging industries. However, protectionism also means that the protected industries can continue to charge high prices to locals and consumers suffer lower-quality goods, higher prices and limited variety of goods. As a result, consumer surplus and consumer welfare will fall as consumers are forced to buy more expensive goods from the inefficient protected local industries.

Sometimes, a government may put in place protectionistic measures as a measure to deal with a worsening balance of payments, so as to prevent continuous depletion of its foreign reserves. A balance of payments deficit occurs when international payments are greater than international receipts and a balance of trade deficit (X<M) is a problem in many developed countries. Hence, the government may resort to protectionism by introducing import duties, import quota or exchange control to reduce imports and thus improve the balance of trade and balance of payments. However, protectionism will reduce exports of trading partners, leading to beggar-thy-neighbour effects. Retaliation and beggar-thy-neighbour effects not only cause a fall in the country's exports causing the country to face the same BOP problems as before, it will eventually affect the employment and national income of the country as well.

Advantages of protectionism can outweigh benefits of free trade in the short run. Governments may protect large industries which are in direct competition with other countries and are losing out in terms of cost of production, this is particularly likely in developed countries such as the US. However, in the long run it protects inefficiency and ultimately depresses the standard of living of a nation. Therefore, it will be better to let the industry decline if it has already lost its comparative advantage and subsidise retraining and investment in the new efficient industries as a solution for the longer term. In this way, unemployment is avoided and the consumers do not suffer. Furthermore, a country that imposes tariffs in an attempt to create domestic jobs risks starting a 'trade war' with its trading partners. This could lead to lower X and thus lower AD which is detrimental to the growth of the country.