HSC Topic One - The Global Economy

Protection

Students learn about:

Protection

- reasons for protection – infant industry argument, domestic employment, dumping, defence
- methods of protection and the effects of protectionist policies on the domestic and global economy – tariffs, subsidies, quotas, local content rules, export incentives

Students learn to:

Examine economic issues

- discuss the effects of protectionist policies on the global economy

Australian Manufacturing: A Brief History of Industry Policy and Trade Liberalisation
Source: Australian Parliament House, 1999

Industry policy in Australia has been subject to a major transformation over the last 30 years. Barrier protection to manufacturing industries, mainly via tariffs, has been reduced from 35 per cent to five per cent in 2000-01, thus moving Australia a long way towards the Asia-Pacific Economic Cooperation (APEC) goal of free trade access to developed countries by 2010. At first glance, the protection debate appears to have been largely won by trade liberation supporters and to be on the brink of becoming a non-issue.

However, protection remains a controversial issue. There are strong arguments for continuing to treat barrier protection, and the broader aspects of industry policy, as important and dynamic economic policy issues. The cost of assistance to manufacturing remains substantial at $3.3 billion in 2000-01 and this assistance is unevenly distributed with about 40 per cent going to the textile, clothing and footwear (TCF) and passenger motor vehicle (PMV) industries.

Tariffs in Australia, and in most other Western countries, have declined over a two to three-decade period. Australia lagged behind most of its trading partners in the early stages of this process but has now caught up and has average tariff levels comparable to those in the United States, European Union and Japan.

With the declining importance of tariffs, it is important that policymakers pay more attention to the alternative tools for achieving industry policy objectives, namely non-tariff barriers, anti-dumping measures and assistance through the Budget (sometimes referred to as State aid or Public Support for Industry). Compared with other Western countries, Australia is an almost negligible user of non-tariff barriers but a major user of anti-dumping measures.

Budgetary assistance to manufacturing in Australia peaked in 1994-95 and declined significantly in the next four years. The current level of Budget assistance is equivalent to 2.3 per cent of value added in Australian manufacturing, or $1319 per person employed in manufacturing. In the European Union, there was also a distinct downward trend in Budget assistance to manufacturing over recent years. Another feature of European Union assistance is that over half of it is directed at regional objectives while this accounts for a very minor component of Commonwealth Budget assistance in Australia. This may well change given the renewed interest in rural and regional Australia.

The history of Australia's trade liberalisation shows that it has been a slow and politically sensitive process. It is a process that can easily 'run off the rails' as it did with the massive increase in quota and other protection to the TCF and PMV industries in the late 1970s and early 1980s at a time when the average level of assistance to other manufacturing activities was declining. While protection continues to provide large benefits to a few industries, these industries, supported by the affected unions and State governments, will continue to resist further liberalisation.

The Tariff Board, and its successor bodies, have played an important role in opening protection issues for public scrutiny, for providing well-researched background on the costs and benefits and for persuading the Government to take a more comprehensive (less ad hoc) approach to industry assistance measures.

The last period of Labor Government, and in particular the Button Plans, demonstrated that major structural change can be facilitated, and supported by the major players, where sufficient effort is made to spell out the rules of the game and to establish closer partnerships between Government and industry. This was also an era when industry policy was increasingly seen in a broader economic and social context. One reason why the strong move to trade liberalisation in the late 1980s and 1990s was politically acceptable was that it was part of a much wider reform movement to open up the Australian economy and make it internationally competitive. These economic reforms were supported with a strengthening of the safety net to retrain and assist displaced labour.

There are several aspects of the current situation which suggest the need for particular sensitivity in handling industry protection issues. One is the narrowing time frame for achieving the APEC goal of free trade by 2010. With the freezing of PMV and TCF tariffs to 2005, the window of opportunity for further major adjustments in these industries has been greatly reduced.

At the same time, there has been a re-emergence of protectionist pressures both in Australia and overseas. This forms part of the mounting criticism of the broad approach which Australians commonly term 'rational economic policies' which include smaller government, lower taxes, more open economy, greater domestic competition and a strong emphasis on economic efficiency and cost cutting. In this climate, the trade liberalisation verses protection debate remains alive and relevant.

Reasons for protection

1. Distinguish between 'free trade' and 'protection' .

_____

_____

_____

2. Complete the table below on the reasons for protection

Reason	Description	Example
Infant industry argument		
Domestic employment		
Dumping		
Defence		

Methods of Protection

3. Complete the table below on methods of protection, and the effects (this goes over two pages).

	Description	Diagram
Tariffs		
Subsidies		
Quotas		
Local content rules		
Export incentives		

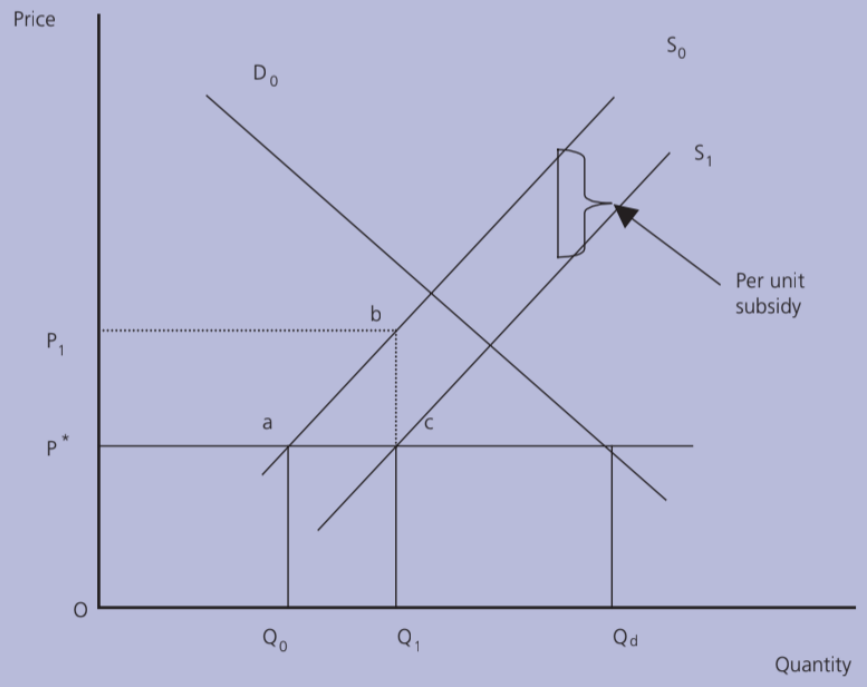
Methods of Protection Cont.

	Effects on Domestic Economy	Effects on Global Economy
Tariffs		
Subsidies		
Quotas		
Local content rules		
Export incentives		

Figure 1 - Trade effects of production subsidies

Source: World Trade Organisation (WTO), 2006

In the diagram below domestic supply is given by S_0, domestic demand by D_0 and world price of the product is given by P^*. Since the world price is below the price that would clear the domestic market, the total quantity demanded of the product OQ_d would be satisfied by OQ_0 units of domestic production and Q_0Q_d of imports.



If the government, for political or redistributive reasons, decides that the level of domestic production should be OQ_1 instead of OQ_0, it has to then decide whether or not to use a tariff or a subsidy to expand production. If it uses a subsidy, and assuming it cannot affect world price, domestic supply will shift from S_0 to S_1 causing domestic production to expand to the desired level and imports to fall by Q_0Q_1.

Prior to the subsidy, domestic output was at point Q_0. Since additional domestic output beyond that level would cost less to source from the world market, the government will have achieved the desired level of output, but the resource implications for the economy will be negative. The additional cost to the economy is represented by the area abc.

The Economic Effects of Trade Protectionism

Focus Economics, Professor Arthur S. Guarino, MBA, MSSc, JD, Rutgers University, 2018

Trade protectionism is re-emerging as a controversial tactic among policymakers and economists in enhancing a nation's economic well-being. Trade protectionism has been used with the intent of helping a nation recover from an economic downturn. However, in many instances the opposite effect occurred in which not just one but many nations suffered economic setbacks such as a recession or even a depression.

Despite the intent of certain economists and policymakers, trade protectionism has certain long and short-term effects on a nation's macro-economy and often the global economy. These effects include:

Consumers' limited choice and pay more for goods and services. A key effect of trade protectionism is that consumers will have a limited choice of products and goods since there may be quotas on how much may be imported. Due to these quotas, consumers will have a very limited choice as to the quantity, quality, and type of product that would otherwise be available to them without trade protectionism. Protectionist policies that intended to safeguard industries, companies, and jobs actually mean that consumers are limited in the availability of products and goods and may have to settle for poor quality instead. Another problem that consumers will face is that they will have to pay more for the limited quantity of goods and products, thus causing inflation to possibly greatly increase. If consumers have a limited choice, must settle for lower quality, and pay more for a particular product, then they may either pay that amount, purchase less of that product, or not make a purchase at all. Domestic firms may also be hurt financially since they may have to purchase parts to make their products and then pass the increased cost on to the consumer. Overall, global competition is a key factor in keeping the price of numerous goods and products down and give consumers the ability to spend.

Infant industries may never grow up due to government trade protection policies. The key questions are: When will an infant industry no longer need protection from its home government? When will it be regarded as a mature company that has a comparative advantage against foreign companies and in overseas markets? A nation can use the policy of protecting its infant industry, but for how long is a key concern. The protection of an infant industry may actually end up costing a government significant amount of money and financial resources in order to protect its infant industry. This may actually promote inefficiencies by the infant industry and have no incentive to make efficient, intelligent, long-term investments by borrowing funds or issuing common stock from the domestic international capital markets. This type of protectionism may hinder the growing pains and maturation process that are vital for an infant industry to experience in the short and long-term if it is to be successful and competitive in global markets and eventually have a comparative advantage.

Exchange rate controls that causes long-term inflation since the domestic nation has kept the value of its currency low. By having its currency decrease in value so that it can sell its products and goods at cheaper prices in foreign markets, any foreign products sold in its market will actually see prices increase. Consumers will be forced to pay higher prices for goods, products, and commodities they need to survive. The problem is that a nation may have a good intention of helping its industries be competitive abroad while its citizens pay higher prices at home.

A trade war among nations. A serious problem with trade protectionism is that nations will take reciprocal action if there are trade protection policies put into effect. The problem here is that nations will retaliate if they cannot sell their goods and products in markets where they normally could. No matter if those nations are political and military allies, nations will impose countervailing tariffs, quotas, subsidies, and exchange rate controls, to name a few, in order to deal with another nation's actions. For example, the United States and Japan, long-time allies, both politically and militarily since the end of World War II, have invoked tariffs and administrative trade policies against each other. This has ended up costing the consumers of the respective countries billions of dollars in increased costs and limited consumer choices. A trade war will ultimately mean increased import costs as manufacturers and producers must pay more for equipment, commodities, and intermediate products from foreign markets. This will also affect a nation's real GDP growth. According to a study by the International Monetary Fund (IMF), a permanent 10 percent increase in American tariffs on imports from all parts of the globe will result in a permanent 1 percent decrease in real GDP. The most famous trade war reprisal that occurred in the history of the United States was the Smoot-Hawley Act in June of 1931. Here, President

Herbert Hoover signed a tariff bill that raised taxes on many agricultural products and goods causing retaliation by other nations. While the act was intended to protect American companies and industries, it increased tariffs by an average of 20 percent on more than 20,000 imported products and goods. This ultimately caused global trade to drop by 67 percent and American exports to fall as much as 75 percent.

While some economists and policymakers feel that trade protectionism will help a nation's economy, many others feel the damage could be severe. For example, Willem Buiter, chief economist at Citi stated that trade protection policies could cause a global trade war "which could easily trigger a global recession." Others such as Ajay Rajadhyaksha, the head of macro research at Barclays feel that, "If tariffs are more punitive and lead to a public trade spat with China, markets will get nervous, especially if a sharp, retaliatory, [Chinese yuan] depreciation looks like a realistic response." In sum, trade protection should be considered very carefully due to the dangerous repercussions it could have on a domestic economy and globally

A quick guide to the US-China trade war
BBC News, September 2019

The US and China are locked in a bitter trade battle.

Over the past year, the world's two largest economies have imposed tariffs on billions of dollars worth of one another's goods.

US President Donald Trump has long accused China of unfair trading practices and intellectual property theft.

In China, there is a perception that the US is trying to curb its rise.

Negotiations are ongoing but have proven difficult. The two sides remain far apart on issues including how to roll back tariffs and enforce a deal.

The uncertainty is hurting businesses and weighing on the global economy.

What tariffs have been imposed?
Mr Trump's tariffs policy aims to encourage consumers to buy American by making imported goods more expensive.

So far, the US has imposed tariffs on more than $360bn (£296bn) of Chinese goods, and China has retaliated with tariffs on more than $110bn of US products.

Washington delivered three rounds of tariffs last year, and a fourth one in September. The latest round targeted Chinese imports, from meat to musical instruments, with a 15% duty.

Beijing has hit back with tariffs ranging from 5% to 25% on US goods.

Its latest tariff strike included a 5% levy on US crude oil, the first time fuel has been hit in the trade battle.

What's next?
Both sides have threatened to take more action with new tariffs and hikes to existing duties in the coming months.

On 1 October, the US plans to raise an existing 25% tariff on some Chinese products to 30%.

Washington then plans to deliver a wave of new tariffs on Chinese goods, ranging from footwear to telephones, on 15 December.

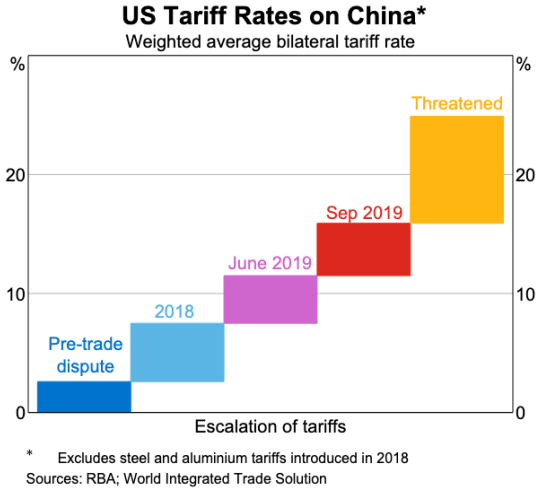
If this happens, effectively all Chinese goods imported to the US will be subject to tariffs.

China also plans to hit another 3,000 American products with tariffs by the end of the year.

The US–China trade dispute

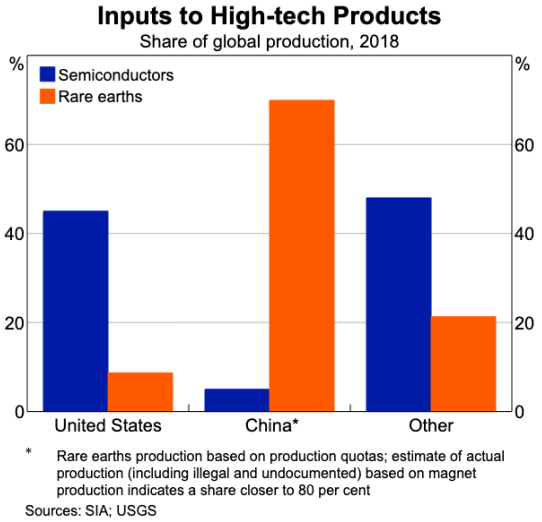
Source: Reserve Bank of Australia, 2019

The US–China trade dispute has escalated over recent months after negotiations between the two countries stalled. In June, the United States increased tariffs from 10 to 25 per cent on US$200 billion of imports from China and China retaliated with higher tariffs on US$60 billion of imports from the United States. About half of US imports from China are now covered by a 25 per cent tariff rate and most Chinese imports from the United States are covered by 5–25 per cent tariffs (Graph 1.2); average US tariff rates on Chinese imports are now 12 per cent, which is substantially above those on other US trading partners at around 1 per cent. More recently, the US administration announced it will impose a 10 per cent tariff on almost all remaining imports from China from 1 September and further tariff increases have been threatened. A decision by the US administration on increasing tariffs on automotive imports from a number of countries has been delayed to November. Trade tensions have broadened in recent months, with some countries using them to address political disputes. For example, the United States threatened, but then suspended, higher tariffs on imports from Mexico in response to a dispute over immigration flows.

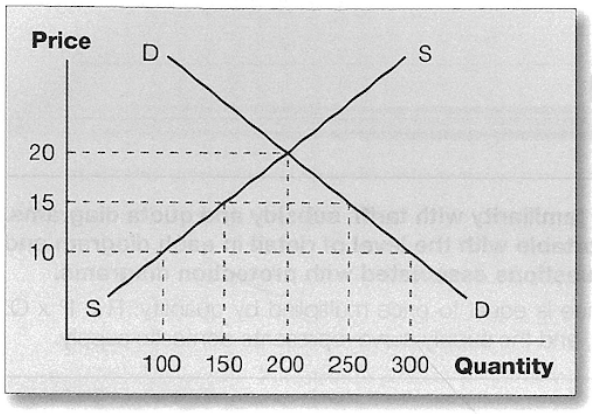


The escalation in the trade dispute is weighing on global economic activity. The direct impact of the measures currently in place is relatively small, but the indirect effects of uncertainty on investment have been more significant. The risk of further escalation also poses a major downside risk to global growth, particularly through adverse effects on business investment and confidence more generally, and the potential for amplification through highly integrated global supply chains. Nonetheless, some economies that provide a competitive production alternative to China, such as Vietnam, appear to be benefiting from trade diversion due to the trade dispute.

The US–China technology dispute has also escalated in recent months. The United States imposed export and transfer controls that restricted access to key US technologies for certain Chinese entities, particularly targeting advanced semiconductor integrated circuits; the United States is the dominant global producer of advanced circuits (Graph 1.3). The Chinese Government is reportedly considering controlling exports of rare earth minerals; China is the largest global producer of these minerals, which have various uses in high-technology processes. The economic effects of the technology disputes are uncertain and are likely to play out over a long period.



Skills Revision - The Tariff Diagram



Calculate the following (with free trade):

World price .....

Quantity supplied at world price .....

Quantity demanded at world price .....

Quantity of imports before the tariff .....

Domestic supplier revenue before the tariff .....

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Calculate the following (after the tariff):

Size of the tariff .....

Price after the tariff .....

Quantity supplied after the tariff .....

Quantity demanded after the tariff .....

Quantity of imports after the tariff .....

Price received by domestic firms after the tariff .....

Price received by foreign producers .....

Domestic supplier revenue after the tariff .....

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Impacts of the tariff:

Loss of consumer choice (fall in quantity demanded) .....

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Gain to domestic producer revenue .....

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Government revenue .....

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Decrease in imports .....

Extension: Loss of revenue to foreign producers .....

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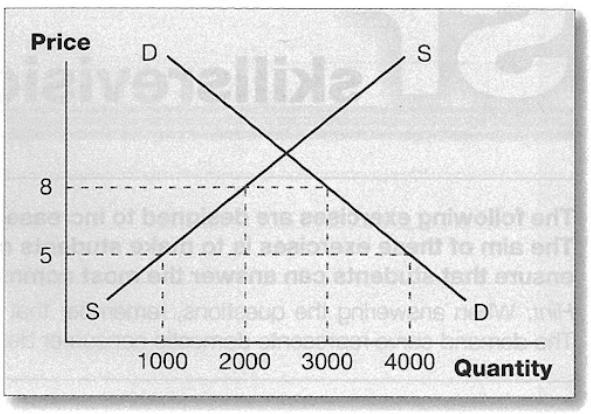

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Extension: Loss of revenue to foreign producers .....

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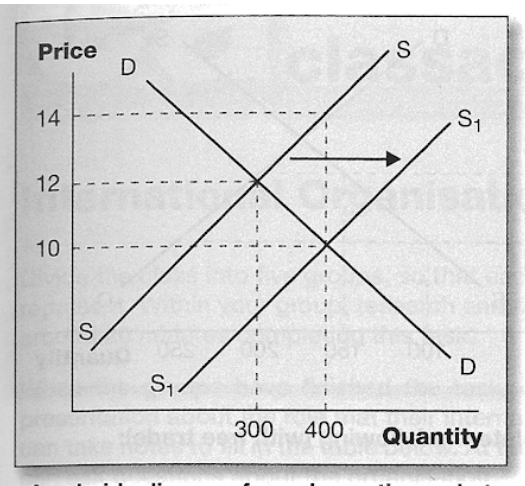
Adapted from Australia in the Global Economy Workbook 7th Edition, p. 24 - 27

Skills Revision - The Subsidy Diagram



A subsidy diagram for a domestic market

Calculate the following:

Equilibrium price before the subsidy.....

Equilibrium quantity before the subsidy.....

Equilibrium price after the subsidy.....

Size of the subsidy.....

Equilibrium quantity after the subsidy.....

Increase in quantity due to the subsidy.....

Government expenditure on the subsidy scheme in the market
(*Hint:* Expenditure = Price of Subsidy x Quantity)

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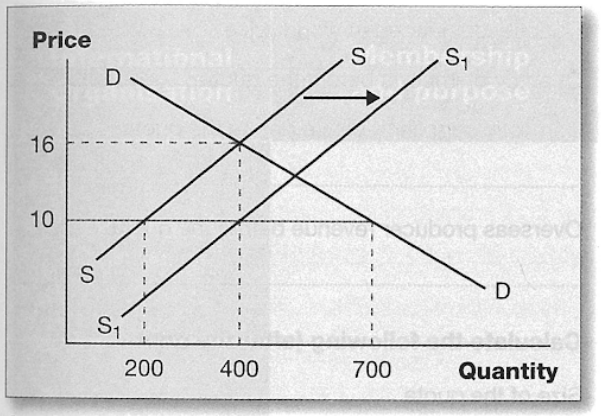

A subsidy diagram for an import-competing market

Calculate the following:

World price.....

Quantity demanded at world price.....

Quantity supplied before the subsidy.....

Imports before the subsidy.....

Calculate the following (after the subsidy):

Size of the subsidy.....

Quantity supplied after the subsidy.....

Imports after the subsidy.....

Impacts of the tariff:

Government expenditure on the subsidy.....

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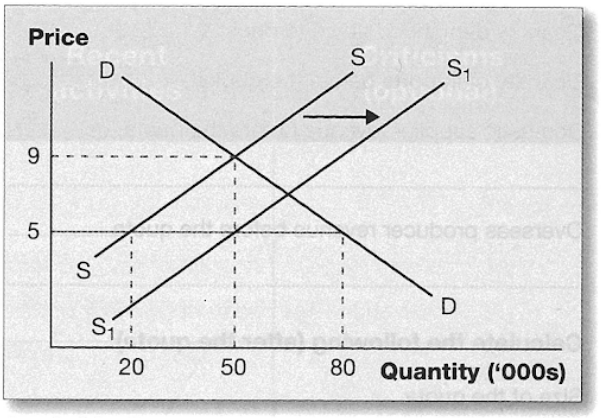
Increase in domestic market share.....

Decrease in imports.....



A subsidy diagram for an import-competing market

Calculate the following:

World price.....

Quantity demanded at world price.....

Quantity supplied before the subsidy.....

Imports before the subsidy.....

Calculate the following (after the subsidy):

Size of the subsidy.....

Quantity supplied after the subsidy.....

Imports after the subsidy.....

Impacts of the tariff:

Government expenditure on the subsidy.....

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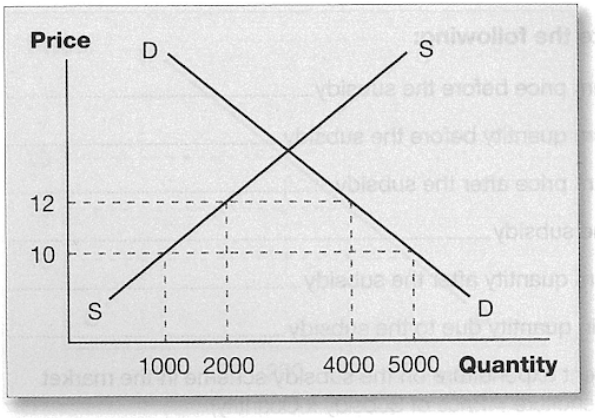
Increase in domestic market share.....

Decrease in imports.....

Adapted from Australia in the Global Economy Workbook 7th Edition, p. 24 - 27

Skills Revision - The Quota Diagram



Calculate the following (with free trade):

World price.....

Quantity supplied at world price.....

Quantity demanded at world price.....

Quantity of imports before the quota.....

Domestic supplier revenue before the quota.....

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Overseas producer revenue before the quota.....

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Calculate the following (after the quota):

Size of the quota.....

Price after the quota.....

Increase in price due to the quota.....

Quantity supplied after the quota.....

Quantity demanded after the quota.....

Domestic supplier revenue after the quota.....

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Overseas producer revenue after the quota.....

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Impacts of the quota:

Loss of consumer choice (fall in quantity demanded).....

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Gain to domestic producer revenue.....

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Decrease in imports.....

Loss of revenue to foreign producers.....

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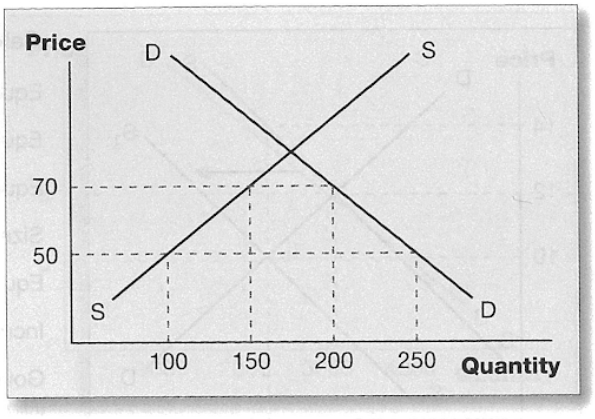

Calculate the following (with free trade):

World price.....

Quantity supplied at world price.....

Quantity demanded at world price.....

Quantity of imports before the quota.....

Domestic supplier revenue before the quota.....

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Overseas producer revenue before the quota.....

.....

Calculate the following (after the quota):

Size of the quota.....

Price after the quota.....

Increase in price due to the quota.....

Quantity supplied after the quota.....

Quantity demanded after the quota.....

Domestic supplier revenue after the quota.....

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Overseas producer revenue after the quota.....

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Impacts of the quota:

Loss of consumer choice (fall in quantity demanded).....

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Gain to domestic producer revenue.....

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Decrease in imports.....

Loss of revenue to foreign producers.....

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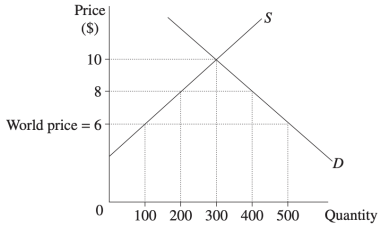
Adapted from Australia in the Global Economy Workbook 7th Edition, p. 24 - 27

2018 HSC, Q20 - 1 Mark

20 The diagram shows domestic demand and supply curves for a hypothetical economy.



As a result of a change in trade policy in this economy, government revenue increases by $400, the revenue of local producers declines by $1400 and the revenue of foreign producers increases by $1600.

Which of the following is most likely to describe the change in trade policy that occurred?

A. A tariff of $0 has been replaced with a tariff of $2.
B. A tariff of $4 has been replaced with a quota of 200.
C. A quota of zero has been replaced with a tariff of $2.
D. A quota of zero has been replaced with a quota of 200.

2017 HSC, Q9 - 1 Mark

9 A government decides to reduce the import quota for a product.

Other things being equal, which of the following is most likely to occur in the domestic market?

A. The revenue of foreign producers will increase.
B. The domestic price of the product will increase.
C. Domestic firms will produce less of the product.
D. The market share of foreign producers will increase.

2015 HSC, Q1 - 1 Mark

1 Assume that foreign producers are selling canned tomatoes in Australia at below their cost of production. Domestic producers ask the government to impose a tariff on these imports.

What is the most likely reason for this request?

(A) To prevent dumping
(B) To improve national defence
(C) To support an infant industry
(D) To maintain domestic employment

2015 HSC, Q6 - 1 Mark

6 A government wants to increase the efficiency of its domestic industries in order to improve their international competitiveness.

Which combination of trade policies would be most likely to achieve this?

	Import quota	*Subsidy to domestic producers*
(A)	Decrease	Decrease
(B)	Increase	Increase
(C)	Increase	Decrease
(D)	Decrease	Increase

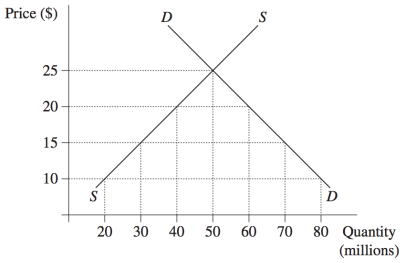
2013 HSC, Q2 - 1 Mark

2 What is the most common reason given for a country to increase tariff protection?

(A) To increase trade volumes
(B) To maintain domestic employment
(C) To reduce the rate of domestic inflation
(D) To lower the level of domestic interest rates

2014 HSC, Q19 - 20 - 2 Marks

Use the following demand and supply diagram to answer Questions 19 and 20.



19 Consider an economy in which there is a tariff of $15 in addition to the world price of $10.

If the government reduces the tariff from $15 to $10, what will be the change in tariff revenue?

(A) $100 million
(B) $200 million
(C) $400 million
(D) $600 million

20 Consider an economy that operates a free trade policy.

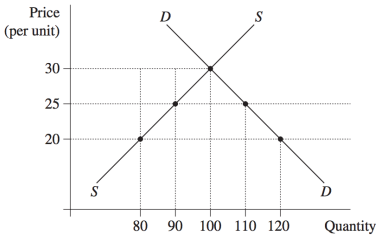
The government is proposing to introduce a $5 tariff in addition to the world price of $10.

What import quota could the government introduce to have the same effect on domestic output as a $5 tariff?

(A) 20 million units
(B) 30 million units
(C) 40 million units
(D) 60 million units

2013 HSC, Q20 - 1 Mark

20 The diagram shows the effect of a tariff on domestic supply (*SS*) and demand (*DD*). The free trade price is $20. The current tariff is $10.

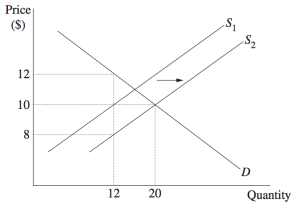


If the government reduces the tariff to $5, which combination of outcomes is correct?

	Tariff revenue	*Domestic output*
(A)	Rises	Rises
(B)	Falls	Falls
(C)	Falls	Rises
(D)	Rises	Falls

2012 HSC Q18 - 1 Mark

18 The diagram shows the impact of a subsidy paid to domestic producers on the price and quantity of beach towels. Assume that the equilibrium price of beach towels with the subsidy is $10 per towel.



From the diagram, what is the subsidy (per towel) paid to domestic producers?

(A) $2
(B) $4
(C) $8
(D) $12

2017 HSC, Q21 (a) - 2 Marks

(a) Why can dumping be used as a justification for trade protection?

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2017 HSC, Q21 (b) - 4 Marks

(b) Explain the difference between *subsidies* and *local content rules* in discouraging dumping.

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2014 HSC, Q21 (a) - 2 Marks

(a) Distinguish between *local content rules* and *export incentives*.

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2014 HSC, Q21 (b) - 4 Marks

(b) The United States Government gives a subsidy to its farmers.

Explain the likely effects of this policy on farmers and consumers in Australia.

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2014 HSC, Q21 (c) - 4 Marks

(c) Discuss the reasons that a domestic industry could give to argue for its protection.

2012 HSC, Q21 (a) - 2 Marks

(a) Distinguish between *import tariff* and *import quota*.

2018 Trial HSC, Q27 (20 Marks)

Analyse the methods of protection and the effects of protectionist policies on the global economy.