Protectionism coupled with recovery as an alternative to liberalism and stagnation?

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Recent debate about the evils of protectionism seems to be strongly at odds with the belief that free trade and free capital movements are unambiguously good for economic development and growth. Nevertheless, the common belief that liberalism (often mistakenly understood as absolute freedom) is beneficial for all in all circumstances and at all times (as preached for instance by the OECD), has not always been the preferred recipe for policymakers and has had its supporters as well as its detractors.

Supporters of any of these two opposite ideas (and any opposing ideas for that matter) are divided into (a) those who are well-informed on the subject and have no vested interests, (b) those who have vested/personal interests for one idea to prevail above the other, and (c) another group that has neither the appropriate information on the issue nor any interest in particular but whose voice may end up being reflected in public opinion.

Just like in any balanced and sane debate, the view held by the majority should not be used as a weight for the degree of "truthfulness" of an argument, nor should the validity of an argument exclusively rely on its quality, as advanced by some of its advocates[1]. Instead, it should be based on the logic of the idea itself, while taking into account the point of view of those who oppose it. Therefore, such debate should ideally take place exclusively among those who belong to the first group. Of course, beyond the lack of representation this would imply for non-experts, the deeper issue lies in identifying who belongs or "deserves" belonging in the expert group.

A debate is even more complicated when the predominant idea under discussion is neither defensible nor does it happen to have a competent group of advocates. Even more complicated is to accept the fact that the issue at stake is a logical response to previous trends that have been pushing in a single direction and have been in some (major) ways harmful to the system.

Today, this is the case of the protectionist policies the Trump administration and other right and far-right political parties around the globe promote. Another layer of complexity of the protectionism vs liberalism debate in the current context is the fact that along with these protectionist measures being already implemented, the long-time expected reflation is also taking place, and this has the potential to bring about positive outcomes in terms of employment and growth in the U.S. and in other countries.

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[1]In which case the idea may be simply not well defended, although it may make sense.

The irony is that such success could be attributed to the xenophobic economic policies put in place by a political party with a shady and dangerous political agenda and that happens to be in power while all this is happening, regardless of its aim and will. At the same time, if the protectionist policies are deemed successful, liberalism *by itself* may be considered by some, even some of its previously fervent supporters, the main culprit behind high unemployment and the growing income/wealth inequalities that prevail today. Furthermore, rapid discredit of a long promoted policy recommendation may further strengthen its nemesis.

Inertia

The number of detractors of a particular ideology grows exponentially as the idea they oppose gains momentum against the will of the majority. This seems to be the case today of protectionism which, since at least the end of WWII, has been considered as the root of short-sighted diplomatic disputes that, in the extreme, can lead (and has led) to armed conflicts among leading military powers (as it was the case in Europe for at least a few centuries before the signing of the Treaty of Rome).

The two extremes of this debate are (1) absolute freedom, supported by extreme liberals, and (2) extreme protectionism, today supported by right wing political parties and other political extremists (both on the right and the left). Of course, reality and the majority view lie somewhere between these two poles, and the overall trend is for these two to *tilt* towards one or the other extreme depending on several factors that may sometimes change at an incredible speed.

Reality and the majority view may be disconnected from each other at some points and this, in itself, may be a major source of problems when it comes to policy-making. Following this logic, the ideal situation takes place when reality and the majority view overlap. Nonetheless, the majority view sometimes takes longer to change than reality, and one of the reasons why this is so may simply be a sort of inertia.

This phenomenon may be due to the fact that ideas take time to be communicated, although today this may be the case less and less thanks mainly to the internet. Another possible cause of inertia is that provoked by habits of thought, which may often have at its root the way in which a person was taught how to reason about a particular subject.

An extreme form of this kind of inertia is indoctrination, and it often makes its way through in the collective memory a generation or two after a given change starts taking place, and it often takes a toll proportional to the contradictions between reality and the majority view. The strongest the opposition between the opposing ideas, the more drastic and lasting the change.

Ideology and exchange rate policy

Not all policy decisions are popular. Some of them may be more popular than others depending on the "policy preferences" of a "median voter", as the public choice literature has it. These preferences may be affected, among other factors, by the environment of the individual. Some others may be judged politically incorrect simply because of the time in which they are promoted or implemented (i.e. when society considers it incompatible with respect to its time).

The Smoot-Hawley tariff (SHT) is an example of how unpopular a (protectionist) policy may be when implemented at an inappropriate time and against the will of a large fraction of the population. Another example is the New Deal itself, which may not be deemed popular nowadays, at least when it comes to deficit spending (nowadays considered a major evil by free-market supporters). Yet, both the SHT and the New Deal had their logic. The logic of the first was plainly absurd given the context, whereas the logic of the second had the desired effect of ending the Great Depression.

Two more policy-making examples in the past may be useful here: the price controls implemented in the U.S. following the end of gold-dollar convertibility and the liberalization of trade and financial flows in Latin America.

Following Nixon's announcement of the end of gold convertibility (which marked the end of the Bretton Woods system of fixed nominal exchange rates), then Secretary of the Treasury John Connally and then chairman of the Federal Reserve Arthur Burns advocated for price controls. Back then the problem was the overvaluation of the dollar in real terms, which implies that the dollar had to be debased in order to restore competitiveness, and this was achieved by ending convertibility.

To the dislike of other policymakers of the time, price controls were implemented from mid-August 1971 to January 1972 and, despite the fact that this interventionist/protectionist measure was seen positively by regular citizens (Irwin, 2013, p. 38), when these controls expired the dollar depreciated sharply against other major currencies (the mark and the yen mainly). I have argued in another note that following this accelerated dollar depreciation oil exporting countries (whose prices were set in dollars) suffered important losses and they ended up retaliating a year after with a major oil embargo that led to the energy crisis.

As inflation grained momentum in the decade of the seventies with the help of two major oil shocks, extreme measures were increasingly needed to solve the opening of Pandora's Box (i.e. Bretton Woods' collapse). These measures came in the form of the Volcker shock, which other than ending the inflationary pressures of the seventies, paved the way for a hard-landing not only in the U.S. but elsewhere. This was the case for Latin America.

Several countries in Latin America were highly indebted during the decade of the seventies. This is comprehensible given that (1) oil (which some of them produce and export) was in high demand back then, (2) dollars were cheap (thanks to inflation) and (3) banks were willing to lend to private and public companies in the region. But when the Volcker shock hit and the dollar revaluation forced U.S. prices and Latin American currencies down, the debt and interest loads of these countries strongly increased, so that they were forced to declare insolvency.

Following these troubles, international organizations (some of them having bailed out these countries, such as the IMF) recommended trade and capital account liberalization, privatization of public enterprises, wage and public spending restraint, and a series of other measures that aimed at what we now know as 'austerity'. For the very nature of these policies, they were unpopular. For they brought about rising unemployment, poverty, criminality and informal job rates, coupled with lower economic growth rates. Nonetheless, these measures were carried out in full in the eighties, making these countries' financial systems more (rather than less) fragile and dependent on foreign capital.

These two cases show that liberalization is not necessarily beneficial for all in all circumstances at all times. On the contrary, when carried out too far, liberalization may have dire consequences. In order to avoid these, some form of protectionism may be necessary, even if it is uncomfortable for some industries, policy-makers or regular individuals.

For instance, the price controls implemented in the U.S. in the second half of 1971 were necessary to avoid a drastic devaluation of the dollar, and if these would have been renegotiated under a softer form (instead of expiring abruptly, as it was the case) perhaps the oil shocks would not have even take place. In the case of liberalization in Latin America, capital controls (another form of non-extreme protectionism) could have been desirable in order to avoid the currency crises of the 1980s and beyond.

Now, because liberalism has been considered the *only* alternative for the past thirty-seven years, which unfortunately have brought about high unemployment, low growth and several financial crises, protectionism comes almost as a natural alternative to the excesses of short-sighted and unilateral policy-making. Even worse, the liberalism-stagnation couple is now being replaced by the protectionism-recovery one, but in the hands of political extremists (in the U.S. and in some parts of Europe at least). Bottom-line, when it comes ot policy-making black and white alternatives are simple to understand, but 'greys' may be worth considering.

References

Irwin (2013) *The Nixon shock after forty years: the import surcharge revisited* in World Trade Review.