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Think before ‘just doing it’

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SOME commentators believe that countries should “just do it” when it comes to unilateral trade liberalisation. It is argued, perhaps correctly, that the World Trade Organisation negotiations have become too complex, with too many players, for significant liberalisation to occur through this “multilateral” process. The answer, apparently, is unilateral tariff reductions. The assumption behind this is that free trade will simply lead to higher growth.

If only things were that simple.

Free trade has always been the preferred option for most economists. The case for this is built upon some rather basic, but powerful, theory.

Protection leads to what economists term a “deadweight loss”. This is a net loss to the economy as a whole because the benefit to producers, who can charge above the international price, is always less than the cost to consumers, who are forced to pay more than international prices for a particular product.

Protection also distorts the economy by shifting capital and labour resources to unproductive sectors. Free trade, by ensuring that an economy produces only the goods in which it has a comparative advantage, makes the economy use its resources most efficiently. This static analysis shows that free trade is the optimal policy, but unfortunately the gains are not that large. Most gains from trade occurs from dynamic processes. For example, in the absence of protection, local firms have to upgrade their technology, work practices or quality of service to compete with imports. Imports, or just the threat of imports, can reduce the market power of local firms.

However, the real-world evidence does not fit the theory. No country — not the US, the UK, or any of the other leading advocates of free trade — industrialised without tariff protection. Moreover, despite the attempts of many of the best economists, there has been no conclusive empirical evidence linking freer trade to growth. Also, some countries’ experience with trade liberalisation suggests that developing countries are prone to being locked into colonial trade patterns, with emphasis on trade in basic commodities, which potentially leads to deindustrialisation and poor economic performance. This reasoning is pertinent to SA where, notwithstanding substantial trade liberalisation in the mid to late 1990s, the trade basket remains dominated by basic raw material exports.

This may lead one to think that the best policy is protection of industry. Once again, if only things were that simple. Those countries that have managed to develop the quickest — such as east Asian tigers Japan, China and India, as well as Ireland — have done so through a combination of tariff protection and selective trade liberalisation carefully sequenced so as not to disrupt domestic productive capacity. There can be little doubt that, particularly for small, developing economies, the most effective development strategy is to build a strong export presence. The more pertinent question is how best to achieve this.

Tariffs certainly play a role. Economic theory suggests that tariffs are equivalent to a tax on exports; reducing tariffs is therefore complementary to a policy of export-driven growth. The problem is that simply liberalising tariffs does not inevitably lead to growth and development. SA's recent economic history bears this out.

From 1996 to 2000, SA's unweighted average import tariff declined from 17,3% to 10,7%. Exports increased, but more slowly than imports, though the rand depreciated steadily throughout the late 1990s. Despite this liberalisation episode, SA remains an exporter of (mainly) precious metals and resources, with an unemployment rate of more than 40%. It is interesting to note that the manufacturing exports that have grown fastest — in the motor industry — have had the most direct government support. This suggests that the "just do it" liberalisation model has some shortcomings.

Nonetheless, tariffs were liberalised because it was an easy, measurable way to indicate government's commitment to economic reform. Unfortunately, programmes to boost the supply side of the economy were largely ineffective and suffered from problems. Even once implemented, uptake thereof was generally poor. Further, our companies had to face international competition, despite domestic economic problems such as high input costs due to poor regulation, and in some cases collusion, and inefficient ports and railways.

Other factors such as high real interest rates, the lack of skilled workers, and new rigidities, perceived or real, in the labour market, reduced our exporters' competitiveness. SA clearly was not ready for tariff liberalisation and the effect has been a shift to skill- and generally capital-intensive manufacturing for export with little new job creation.

It is no surprise, then, that the most successful exporters are those with either dedicated export facilities, such as coal and iron ore, or large enterprises, often multinationals, that have been able to address the supply-side constraints more effectively than smaller enterprises.

Further tariff liberalisation is not viable at the moment, due to the rand's strength. That does not mean that the policy of export-led growth should be abandoned. Instead, government should focus on the supply side of the economy and liberalise further once key rigidities have been resolved. For instance, telecommunications and financial services are vital inputs in the modern economy, but in SA remain below international standards in price and quality of service. One way of addressing the problems in the telecoms sector would be to introduce more competition. As much as SA has suffered from high telecoms costs, the slow pace of the roll-out of technologies such as asynchronous digital subscriber line and broadband may have done more to set SA back.

Commentators often point to China as an example — one of the world's leading backers of freer trade. The Chinese example further illustrates the point. China began liberalising its economy in 1979 but significant liberalisation of tariffs began only in the mid-1990s. A gap that long would be excessive in SA's case, but the crucial point remains: tariff liberalisation should happen after, not before or during, supply-side reforms.

The main reason why tariff liberalisation has not been entirely successful in SA is because there was little effective industrial policy attached to the trade policy and because the sequencing of policy was suboptimal. We should not make that mistake again. We must beware of the quick-fix, “simple” solutions that often cause more problems than they solve. Do not “just do it”; think about it first. Tariffs should be liberalised further, but only once the supply side of the economy has been strengthened and is better equipped to respond to international competition, and only if the rand is stable, or better still, depreciating.

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