Learning the Correct Lesson About Protectionism

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War-ravaged East Asian economies briefly used protectionist policies to revive their economies. Developing countries today should not misinterpret history, however. Only when Japan, South Korea, and Taiwan opened their markets to imports did their economies realize enduring rapid expansion. The remaining protectionist barriers only detract from those huge successes.

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Economists can show that Japanese productivity has gone up as imports increased and protectionist barriers decreased.

After the Second World War, East Asia rose from grinding poverty to spectacular prosperity. In retrospect, Japan, South Korea, and Taiwan are sometimes depicted as historical posters for fostering growth through protection. Indeed, to varying degrees, all these countries adopted protectionist policies in the first decade of their postwar ascent. If protection worked for them, free-trade skeptics ask, why should the poorest countries of Africa, Asia, and Latin America not adopt the same approach today?

The Theory

The theoretical case for trade protection rests on market failures that can be corrected by government intervention. Here are a few examples:

- If the activities of firm A benefit firm B at no cost—for example, by creating a trained labor force that firm B can hire—firm A will likely invest too little in training. Government subsidies to help pay for firm A's training efforts could benefit the entire production system.
- If learning-by-doing is critical for success, a firm can become internationally competitive only by acquiring extensive production experience. However, during its learning period, the firm may sustain large financial losses. Unless far-seeing capital markets provide ample credit, government help may be necessary to give the firm a start.
- Firm A (for example, a mining enterprise) will be profitable only if firm B (for example, a railway) is established, and vice versa. The government could help coordinate the two firms' business relationship.

These three examples illustrate market failures that potentially justify policy intervention. The real question, however, is whether such theoretical possibilities are important in practice. After all, plenty of theory can

South Korea's boom in technology-intensive production followed the country's shift away from high trade barriers.

be cited on the other side of the protection debate: economist David Ricardo's theory of comparative advantage, the proven power of competition to boost efficiency, and the widely recognized danger that protection will foster corruption.

Case: Japan

In the first phase of its economic recovery, between the end of the Second World War and the Korean War (1945-1955), Japan enjoyed rapid growth. The government protected key sectors as part of a wider industrial policy aimed at restoring pre-war industrial levels. Government policy concentrated on heavy industries that were badly damaged, such as steel, chemicals, and transportation equipment.

In retrospect, Japan's recovery was easy because pre-war know-how, managerial talent, and industrial networks were largely intact. Missing were domestic savings and foreign exchange to reconstruct the stock of physical capital and to buy inputs and technology from abroad. Government intervention undoubtedly increased savings and marshaled foreign exchange. Achievement of these goals likely accelerated, rather than generated, the postwar recovery process.

In the second phase (mid-1950s to mid-1980s), the Japanese economy was gradually liberalized (except for agriculture) yet continued to enjoy rapid economic growth, and Japan soon became an international leader in technology. Trade restrictions played little role in sustained Japanese success. In fact, on an industry-by-industry basis, economists can show a negative relationship between effective protection and export performance in Japan.

Similarly, for 1955 to 1990, economists can show a negative relation between effective protection rates and changes in productivity. The same scholars find a positive association between the level of imports and the growth of productivity. At least two mechanisms explain this finding. Imports of new and improved intermediate inputs increase the efficiency of local firms. Further, imports expose local firms to competition, stimulating management to improve performance. Japanese growth, good as it was, would have been even better if government had given less protection to domestic firms.

Case: South Korea

The Korean War (1950-1953) devastated South Korea's plant and equipment, but surviving workers carried their skills into the postwar era. For the following decade, the government maintained a protectionist outlook, not only imposing high trade barriers but also maintaining an overvalued exchange rate. Starting in the mid-1960s, Korean leaders shifted the policy mix toward outward orientation. A combination of trade, tax, credit, and exchange-rate incentives gave the Korean economy a pro-export tilt.

During 1961-1980, Korean exports grew by almost 24 percent per year in real terms, while the share of exports in Korea's economic output soared from about 5 percent to 33 percent. While the initial phase of industrial development focused on labor-intensive sectors, in the early 1970s Korea moved to a second phase of capital-intensive and technology-intensive production. Today, of course, Korea has become a premier exporter of electronics, machinery, steel, and autos.

But residual protection detracted from overall Korean performance. Data for 38 Korean industries over 1963-1983 demonstrate a negative correlation between protection and productivity growth. "The Korean data present evidence that less intervention in trade is linked to higher productivity growth," says economist Jong-Wha Lee of Korea University in Seoul. In fact, plain old special interests better explain the pattern of Korean protection than calculations of economic gain.

Case: Taiwan

Taiwan's economic renaissance can be divided into two phases. In the first phase, extending from the end of the Chinese civil war in 1949 until the late 1950s, the Taiwanese government erected high tariff and nontariff barriers to limit imports and promote domestic industrial expansion.

In the second phase, during the 1960s and 1970s, Taiwan's leaders shifted to outward-oriented policies, significantly liberalizing imports and correcting an overvalued currency. Leaders realized that Taiwan's inward orientation limited the country's growth prospects, owing to the small size of its domestic market.

During its outward-orientation phase, Taiwan's exports increased very rapidly. The export share of economic output exploded from 8.5 percent in 1952 to 44.5 percent in 1976; manufactured exports accounted for less than 8 percent of total exports in 1955, but more than 91 percent in 1976.

During the second phase, Taiwan retained some trade barriers (particularly important in agriculture), but residual protection was a concession to special interests, not a contribution to economic growth. Taiwan's growth took place in spite of, not because of, restrictive measures. Several studies found that the Taiwanese trade protection was driven by political considerations rather than by market failures.

Lessons Learned

The lesson emerging from the postwar experience of Japan, South Korea, and Taiwan is clear: The prolonged era of remarkable growth was associated with progressive liberalization, not enduring protection. After an initial phase of inward orientation, all three countries opened their economies to international competition. By doing so, they achieved rates of economic growth rarely seen in world history. Protection was not eliminated overnight, and evidence suggests that residual protection detracted from stunning overall performance.

Those who embrace high barriers to trade may argue that East Asian growth began under protectionist policies. While true, the argument fails to distinguish between the start of the growth process and its continuation over long periods. In all three cases, development began in the aftermath of destructive war. Economic growth in the earliest phase simply returned the East Asian economies to their pre-war levels.

A leading advocate of export-led growth, the late Béla Balassa of Johns Hopkins University, recognized the positive role played by import substitution in the early years of Korean and Taiwanese growth. However, the positive role for protection was limited to a short phase when domestic production was substituted for imports of consumer goods. Once this process was completed, the East Asian economies needed to open to world markets—both to acquire intermediate inputs and to sell on a much larger scale. In terms of per capita growth in economic output, the years of outward orientation outperformed the years of import substitution. In the case of Korea, for example, the annual growth of per capita economic output was 2.2 percent between 1955 and 1965 and 8.2 percent over the following 10 years.

Virtually all developing countries have long since passed the stage of easy import substitution. The clear lesson of the East Asian experience for developing countries in 2006 (not 1946) is that sustained growth requires progressively lower barriers to world trade. ■
