Protectionism
The hidden persuaders

Protectionism can take many forms, not all of them obvious

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LAST SUMMER FRED HOCHBERG, head of America’s government-backed Export-Import Bank, joined the chief of Westinghouse on a sales trip in the Czech Republic. A Czech official, he recalls, told him they would not even consider Westinghouse’s bid to expand a nuclear power plant without finance from his bank. Russia’s state-owned nuclear-energy company, Rosatom, had already offered to fund half the project. Mr Hochberg promised to do the same if Westinghouse, an American unit of Japan’s Toshiba, won the bid.

“It’s time to drop the fantasy that a purely free market exists in the world of global trade,” Mr Hochberg told an American audience shortly after returning from Prague. “In the real world our private enterprises are pitted against an array of competitors that are often government-owned, government-protected, government-subsidised, government-sponsored or all of the above.” Russia was particularly active, pledging $38 billion to finance Rosatom’s global ambitions.

The rival loans from America and Russia to win the Czech Republic’s business do not fit the usual definition of protectionism. Indeed, conventional protectionism of the tariff and quota kind has been remarkably, and blessedly, quiescent in recent years. In the past decade the number of incidents when countries have punished dumping (selling below a “fair” price) by slapping tariffs on imports from the offending trade partner has been running at about 200 a year, fewer than in the late 1990s.

One reason for the decline in traditional protectionism is that countries hit by recession are able to let their exchange rates fall. In the 1930s countries on the gold standard did not have that option, so they resorted to tariffs instead to ward off imports. The WTO can also take some credit. Since its creation in 1995 big trading countries have regularly brought cases to it, and have respected its rulings when they have lost.

Beyond tariffs and quotas

But another reason why there is less overt protectionism is that the practice has crept back in other guises, often to avoid running foul of WTO rules. The WTO concentrates on measures designed to keep out imports. Global Trade Alert (GTA), a monitoring service operated by the London-based Centre for Economic Policy Research, defines protectionism more broadly as anything that hurts another country’s commercial interests. It thus includes government bailouts of domestic companies, wage subsidies, export and VAT rebates, export credits and financing from state-owned banks. For example, it classifies France’s loan guarantee to the financing arm of PSA Peugeot Citroën, a carmaker, as protectionist because, by helping sales of the company’s cars, it hurts their competitors’ sales. It reckons that at least 400 such “beggar-thy-neighbour” policies have been put in place each year since 2009, and that the trend is on the rise.

GTA’s Simon Evenett, who is also a business professor at Switzerland’s University of St. Gallen, thinks the WTO undercounts protectionist activity, both because of its narrow definition and because many countries do not complain about covert
protectionism because they are guilty of it themselves: “The reaction of many trading partners to illegal subsidies is to have subsidies of their own.”

GTA’s data start only in 2009, making it hard to prove that such protectionism is on the rise, and some experts are sceptical of Mr Evenett’s alarmist take. Researchers at the European Central Bank point out that a small number of countries, accounting for only 13% of G20 imports—Argentina, Brazil, India, Indonesia, Russia, South Africa and Turkey—were responsible for 60% of the measures recorded by GTA since 2009. But GTA’s data do make it clear that countries have found ways other than traditional protectionism to help domestic industry, keep out imports and boost exports, often under the guise of industrial policy.

Brazil has perfected the art. Last year, looking for a way to reduce car imports, it introduced a new programme to encourage innovation, Inovar-Auto. Designed to stay within WTO rules, this requires Brazilian car manufacturers (all foreign-owned) to invest in local innovation and engineering and to meet certain fuel-efficiency standards by 2017, or else face higher excise taxes and import tariffs on domestic sales. This has boosted domestic investment in engineering and fuel-saving technology.

Brazil has also used state-controlled companies and banks to encourage domestic innovation and industry. Over the past decade it has required Petrobras, the state-controlled oil company, to meet ever tougher domestic-content requirements. BNDES, the state-owned development bank, has expanded its lending and equity investment since 2007 by 140%. Recepta, a biotech company, has received a grant, a low-interest loan and, last year, a direct equity investment by BNDES worth about $15m. José Fernando Perez, who founded Recepta in 2006, does not like the Brazilian government’s propensity to meddle in markets, but he makes an exception for innovation policy, noting that Australia, Britain and America all subsidise basic biotech research. “I could not have survived if I’d paid commercial interest rates.” Even so, he complains about the thickets of red tape that make it hard for his company to develop and test its new drug.

It is no surprise that the BRIC countries figure prominently in GTA’s record of covert protectionism. Thanks to their embrace of state capitalism, the line between industrial policy and export subsidy is blurred or non-existent. China has long used compulsory joint ventures, technology transfer and access to cheap land and loans from state-owned banks to boost companies in strategic sectors. In the mid-2000s it invited foreign manufacturers, including Germany’s Siemens and Japan’s Kawasaki, to supply locomotives for its high-speed rail network. Later it switched to Chinese companies, which now compete with Siemens and Kawasaki in foreign markets.

A similar story unfolded in wind power. A decade ago foreign companies such as Spain’s Gamesa had a significant share of China’s market for wind-power turbines, but now Chinese companies, many using skills acquired as partners or subcontractors to Western suppliers, along with subsidised land and credit, dominate the Chinese market and compete fiercely with those original Western suppliers.

Let the sunshine in

When the same thing started to happen in solar power, China’s competitors hit back. In 2012 America, embarrassed by the bankruptcy of Solyndra, which had received federal loan guarantees, slapped tariffs on Chinese solar-panel exporters for offering illegal subsidies and dumping. Karel De Gucht, the EU’s trade commissioner, has linked China’s illegal exports to its pervasive industrial policy, pointing out that to discover which industries are dumping, “you read the last five-year plan.” In June the Commission threatened to impose tariffs of up to 47.6% on Chinese solar panels. But China said it would retaliate and had its hand strengthened when Germany questioned the Commission’s case. Eventually the two sides reached a settlement stipulating a minimum price for Chinese solar panels.

The tangle illustrated how difficult it is to identify and punish protectionism in an industry where industrial policy is the rule, not the exception. “Solar energy is subsidised in almost all countries,” says He Weiwen, of the China Association of International Trade, a Beijing think-tank. “The important thing is not whether we have subsidies but whether they are illegal,” and that question is best determined by negotiation.

Whereas the solar-panel dispute was carried out in the open, the battle over cheap export loans has been fought behind the scenes. For decades rich countries have financed exports within guidelines laid out by the OECD, but in recent years much
more business has been conducted outside those guidelines. They do not cover non-OECD countries such as Russia, Brazil and, of greatest concern to the rich world, China, which has used export finance to turn its construction-equipment manufacturers into world leaders. But OECD countries, too, have found ways to offer loans that are not covered by the guidelines, such as floating-rate loans. The ExIm bank reckons that last year export credit regulated by the OECD guidelines amounted to $120 billion, unregulated credit by OECD countries to $110 billion and lending by Russia, Brazil, India and China to $70 billion.

America has been no slouch itself. The ExIm bank made new loans of $31 billion last year, up from $8 billion in 2007, and has been focusing on key industries: oil and gas; mining and agriculture equipment; agribusiness; renewable energy; medical technology; construction; aircraft; and power generation.

Although export promotion and industrial policy are less likely to trigger retaliatory action and trade wars than import suppression, that does not make these subtler methods less distortionary or damaging, says GTA’s Mr Evenett. If country A’s exports to country B benefit from generous export credit, country B can complain. But he notes the real damage is being done to the exports of other countries that are being hit indirectly.

And just like import tariffs, export subsidies cause many distortions. Delta Air Lines, for example, has complained it was hurt by ExIm Bank’s financing of the purchase of Boeing jets by Air India, which competes with Delta on certain routes. And should a loan go bad, taxpayers would have to foot the bill.

Industrial policy also often has unexpected consequences. In 2010 India required central-government solar-power projects that used crystalline modules and, later, cells to source them locally. Since India has a limited capacity for producing such technology, many developers imported American-made thin-film transistor technology instead, taking advantage of low-interest loans from ExIm bank.

Brazil’s industrial policy, too, is riddled with problems. Buy-local requirements have hampered Petrobras’s ability to exploit new deep-sea oil deposits because the country’s capacity for producing oilfield equipment is limited. Idiosyncratic fuel standards mean the new engines spurred by Inovar-Auto have restricted export potential. Brazilian businesses appreciate the help they get from the government but would prefer more growth-friendly policies on taxes, investment and pay.

Earlier this year Romi, a manufacturer of machine tools, plastic processing machinery and castings near São Paulo, got a low-interest loan of 27m real from the Brazilian government to invest in innovation and process design. R&D is integral to the company’s success. Its senior managers say it spends 4% of its sales on this, gesturing to the ranks of designers and engineers sitting behind glass walls above a spotless factory floor. But, they add, that R&D would proceed even without the loan. What Romi really needs is stronger investment growth, but the government has put most of its efforts into boosting consumption.

Hidden protectionism and industrial policy may boost specific industries or exports, but that does a country no good if other policies stifle private enterprise and cause underinvestment in human and physical capital. Brazil and India have been held back because their governments funnelled state resources to preferred sectors and constituencies instead of boosting their economies’ underlying potential, slowing down their growth.

In China, covert protectionism helped domestic manufacturers achieve formidable market share at home and abroad, but excessive lending by state-owned banks to state-owned enterprises and local government caused investment and property bubbles. The country’s leaders say they want to reinvigorate the role of private enterprise, but whether that extends to foreign companies remains to be seen.

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