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The International Economy of Free Trade

From reduction of tariffs to full integration of markets

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O presente trabalho foi apresentado na Universidade de Londres, em Março de 2007.

1. Introduction

Because of the dynamic nature of international business, due in large part to advances in technology, logistics, and communications, the world trade markets consist of countries that virtually have no borders. Trade agreements between various nations, in this so-called era of globalization, have created an interesting mosaic of trade activity, which is supposed to benefit both parties in the trade agreement.

The aim of this brief paper is to analyze the conditions that compelled most of world countries to venture in free trade, either in the form of simple tariff reduction or by full integration, and to provide a mean to understand how a reduce in trade barriers leads to increasing wealth and welfare for the countries concerned (or have the opposite effect).

2. Trade Protection policies

During periods of instability and change, the political impetus for protectionist policies may prove unstoppable. It is sometimes a general sentiment that a country's health and welfare is best ensured by denying foreign advantage.

Based on the Mercantilist paradigm, many politicians and economists advocate securing trade gains at the expense of other countries, by erecting barriers against imports and aggressively promoting exports. But this feeling is more apparent in some moments and places than others. When the world economy is booming it becomes less relevant since all are becoming richer; when economic growth slows, become stagnant or even shrinks, the protectionist barriers go up and then one country's economic fortune can be at the expenses of another's.

At such times, it requires considerable diplomatic effort to prevent trade restrictions from spreading. A general collapse in world trade, everyone agrees, is bad for all, but what does it matter if my country alone subsidizes its export and protects its vital industries? Such is the argument of the "free-rider" – who benefits most if everyone else agrees to the rules.¹

¹ Cleaver, 2007, p.93

The balance of payments problems that many countries experienced after the oil crisis of 1973 and the recession of the early 1980s led many politicians around the world to call for trade restrictions. Although a “trade war” was turned aside, there was a gradual increase in non-tariff barriers, such as subsidies on domestic products, the prohibition of imports that did not cope with particular specifications, severe administrative delays in customs clearance, limits on investment by foreign companies, and governments favouring domestic firms when purchasing supplies.

3. The opening of the Markets

Following the end of the Second World War, international leaders were anxious to erect institutions into the international system capable to protect the world from a possible repetition of such disastrous events. The US took the lead in advancing the view that free trade would represent an important mechanism for consolidate world peace.

The Allies, particularly the United States and United Kingdom, began discussions about the reconstruction of the world economic order. In 1944, at the Breton Woods conference, those countries signed an agreement that provided the outline for a post-war economy. Three pillars, therefore, were foreseen for the purpose of maintaining international economic cooperation: The International Monetary Fund, the World Bank and the International Trade Organization (ITO never came into existence, however, but its aim is the base of the following GATT and afterwards the WTO).

4. The theory of Comparative Advantage

How is that reducing trade barriers should lead to increasing wealth and welfare for the countries concerned?

The economic theory of international trade and comparative advantage is central in this debate and it is important to analyze it in order to understand the different types of bilateral and multilateral trade liberalising agreements. It was first establish by economist David Ricardo, in 1817. In his writings, he provided the example of trade between Portugal and England. It can be seen in the following table² that Portugal can produce both wheat and wine more cheaply than England (i.e. it has an absolute advantage in both commodities). What David Ricardo saw was that it could still be mutually beneficial for both countries to specialise and trade.

² Taken from http://iang.org/free_banking/david.html

	Wheat	Wine
Co		
	Cost Per Unit In Man Hours	Cost Per Unit In Man Hours
En	15	30
Por	10	15

A unit of wine in England costs the same amount to produce as 2 units of wheat. Production of an extra unit of wine means foregoing production of 2 units of wheat (ie the opportunity cost of a unit of wine is 2 units of wheat). In Portugal, a unit of wine costs 1.5 units of wheat to produce (ie the opportunity cost of a unit of wine is 1.5 units of wheat in Portugal). Because relative or comparative costs differ, it will still be mutually advantageous for both countries to trade even though Portugal has an absolute advantage in both commodities.

Portugal is relatively better at producing wine than wheat: so Portugal is said to have a comparative advantage in the production of wine. England is relatively better at producing wheat than wine: so England is said to have a comparative advantage in the production of wheat.

Countries have, as we seen, different endowments of factors of production. Their differences may be either of natural order or of socio-organizational character. Population density, labour skills, climate, raw material and type of technology are specific of each country. The relative costs of producing goods or services will therefore be different from country to country. The theory of comparative advantage evokes that

provided opportunity costs of various goods differ in two countries, both of them can gain from mutual trade if they specialise in producing and exporting those goods that have relatively low opportunity costs compared with the other country.³

In other words, instead of each country trying to provide for their domestic needs independently, all countries benefit by specializing in what they are best at and then trading with others in order to purchase, at less cost, what others produce. Free trade

³ Sloman, J. 2004, p.419

therefore enables specialization and increased production. The process may lead to higher standards of living for all participants. It is this important feature of comparative advantage which determines the direction of trade. Once this is understood, a country is on its way to concentrate its resources, defining to whom to trade and pursue economic growth.

5. Trade Agreements

There are various levels of relationship between countries – or groups of countries – concerning to trade: from negotiating a limited reciprocal reduction on tariffs on specific goods, to a full integration of economies.

Cleaver ⁴ categorizes the spectrum of choices by the following way:

<i>Independence</i>	A country may opt not to join any regional trade grouping but choose to arrange its own policies on a bilateral, country-by-country basis. In this level there are minimum levels of commitment and sovereignty loss.
A Free Trade Area	Here a number of countries may agree to reduce tariffs and quotas on designated items between them, but leave each individual country to pursue independent policies. Tariffs may be reduced on some items.
A Customs Union	In addition to free trade between member countries, a common external tariff may be erected against outside trade. What makes a custom union different from a free trade area is that it has a common trade policy for all member countries with respect to all external parties.
A Common Market	This involves free trade not only in goods and services between member-countries, but also in the unrestricted movement and employment of labour and capital. Usually implies an increasing number of common policies (e.g. the European CAP).
Economic Union	Many common policies are pursued at this stage, in particular a common currency and a monetary policy. Involves, therefore, a common central bank and other economic institutions, coordinated fiscal policies and convergent financial performance.

6. Gains from Trade Liberalization

Five major kinds of gains from were identified by Hufbauer and Kotschwar⁵:

I. *Static Gains*

⁴ Cleaver (2007), op.cit, p.94

⁵ Hufbauer and Kotschwar, 1998.

Free trade allows countries to export those goods and services that they can make efficiently, and to import those goods and services that they make inefficiently. "Efficiency" is measured in relative terms, not in absolute terms. For example, while the United States has an *absolute* advantage in the production of both aircraft and apparel by comparison with China—in the sense that the United States requires fewer man years to produce either a civilian airplane or a container load of blue jeans than China—both countries gain when the United States concentrates its higher-skilled workforce on producing and exporting aircraft, and China specializes in producing and exporting apparel.

The static gains from free trade—the gains that would come from the free exchange of goods and services when each country uses the same technology before and after freer trade—are typically estimated at less than two percent of GNP.

II. *Consumer Savings*

Trade results in lower prices, enabling consumers to buy more. Estimates published by the Institute for International Economics suggest that totally free merchandise trade would save American consumers about 1.2% of U.S. GNP; Japanese consumers about 5% of Japanese GNP; and Korean consumers about 4% of Korean GNP. Trade also introduces more competition into domestic markets, undermining anti-competitive practices that usually prevail when domestic producers face few foreign challenges. Industries shielded from foreign competition often charge higher prices, have little incentive to hold down costs and often indulge slack management style. By injecting greater competition into sheltered domestic markets, international commerce forces national producers to live up to their potential.

III. *Higher wages and more stable employment*

Over the last decade, jobs supported by US exports rose four times faster than overall private-industry job creation. Consequently, 12 million Americans now owe their jobs to exports, out of a civilian labour force of 67 million people. Evidence shows that both production and non-production workers in US exporting firms receive on average about 14 percent higher pay than workers in firms that do not export. Export-oriented firms tend to have more stable employment patterns.

IV. *Gains in total factor productivity*

Free trade exposes countries to new production and management technologies that foster higher productivity at both the firm and industry level. Twenty years ago, American auto firms began learning from Japan how to produce cars more cheaply. Today, financial institutions in Tokyo are learning from the United States how to run banks and pension funds. These gains are closely linked to cross-border direct investment (foreign direct investment).

V. Catch-up benefits

One of the biggest gains from freer trade in goods, services and capital is the opportunity for poorer countries to raise their productivity and income toward the levels already reached by richer countries. Freer trade helps close the income gap between poor and rich countries at a rate of about one-half of one percentage point per year faster than might otherwise occur. The catch-up largely reflects the acquisition of better technology, and improved management, and the spur to productivity that accompanies keen competition and foreign direct investment.

7. Losses from Trade Liberalization

Many authors are skeptical about the gap between theory and practice, in the free trade debate. They stress that along with unquestionable benefits, some losses are to be expected in the course. A form of globalization and global trading where all nations prosper and develop fairly and equitably is probably what most people would like to see. However, it is not what is happening.

Criticisms in current forms of free trade are normally the following (and some of them overlap with globalization as a whole and not only with free trade)⁶

I. Increasing “Unaccountable” Concentration of Power and Decision-Making

There has been growing concern at the increasing corporate power and their influence in the industrialized countries and international trade agreements, while their accountability is very small.

II. Environmental Degradation

⁶ Adapted from <http://www.globalissues.org/TradeRelated/FreeTrade/Criticisms.asp#Growingcriticisms>

The effect on the environment is argued to be detrimental due to the over-consumption/throw-away model of most developed nations not allowing for much sustainable development.

III. Eroding Worker's Rights

The stability of jobs, is feared to continue to fall as less regulation in the pursuit of "free" trade means that corporations can easily move from country to country in search of cheapest costs (and labor forces are often very expensive).

IV. Brain drain from poor countries to rich countries

There is the phenomena of "brain drain" whereby the poor countries educate some of their population to key jobs such as medical areas and other professions only to find that some rich countries try to attract them away.

V. Protectionism for the Rich, Open Markets for the Poor.

Another concern is that most developing nations complain that the western nations themselves are very protectionist but want the developing countries to completely remove barriers to free trade which would cause an imbalance in the favor of the industrialized countries. While there have been recent statements to address such concerns, nothing has really happened. This further suggests that the current world system being pushed is not "free trade" in the sense that is typically understood.

8. Conclusions

Some protesters might believe there is a growing international backlash against globalization, in general, and free trade in particular. But the countries venturing in free trade are increasing and the queues to join the WTO and other trade institutions, from the most populous and the largest to the smallest and economically weakest, are proof that a significant part of the world believe that their economic future lies in set down the barriers to trade (at least some).

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