FREE TRADE IN A CHANGING GLOBAL MARKETPLACE: A THEORETICAL AND PRACTICAL ASSESSMENT

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Abstract

As a result of significant structural changes in the competitive environment of the global marketplace, major industries have requested and received increased trade protection in the form of voluntary export restraints, countervailing duties, and antidumping lawsuits. Such protectionist tendencies have partly arisen because of the perception that liberalized trade leads to domestic unemployment. This paper presents the theoretical and practical aspects surrounding free trade. Despite some theoretical exceptions to arguments for free trade, the evidence suggests that free trade has worked best in practice.

Introduction

The U.S. share of the global income has steadily declined since the end of World War II, while U.S. trade with the rest of the world has increased. Some believe that these two trends are not coincidental. U.S. firms that once dominated automobile, steel, and consumer electronics industries face stiff competition from Japan and increasingly from South Korea and other industrializing countries. In response to the changing pattern of world trade, the automobile, steel, semiconductor, and other industries have requested and received increased trade protection in the form of voluntary export restraints, countervailing duties, and antidumping lawsuits. The trend toward trade liberalization, beginning with the General Agreement on Tariffs and Trade (GATT) in 1947, appears to be changing as the U. S. and other countries escalate their use of protection to limit imports -- particularly imports from developing countries.

The perception that liberalized trade contributes to unemployment has led to the rise in protection. Indeed, much of the debate surrounding the North American Free Trade Agreement (NAFTA) has focused on the question of whether free trade with Mexico will take jobs away from the U. S. Does free trade cause unemployment, or does it enhance economic growth? The purpose of this paper is to examine the theoretical and practical issues related to free trade in the light of recent experience.

Comparative Advantage and International Trade

The strongest argument for international trade is that it enables a country to expand the quantity of goods and services it consumes. With imports, a country can obtain goods and services that it either cannot produce at home or can produce at home only at a cost that is greater than the cost of obtaining them indirectly by exchanging them for the exports it produces. In other words, through trade, a country can obtain goods and services with greater efficiency by specializing in those activities in which the country has a *comparative advantage.* For example, the U.S. can spend its unique talents in developing computing and communications technology while Japan devotes its efforts to consumer electronics. If Japan did not perform these tasks, the U.S. would have to shift resources from other activities into the production of camcorders, flat-panel displays, TV sets, and other items that the U.S. currently imports.

What matters for trade is that within countries different industries are more productive than others. It is unavoidable that each country has industries with both higher than average and lower than average productivities. Because a country's high-productivity industries need only pay that country's competitive market wage, these industries will have lower relative costs and will be able to compete in world markets. This principle is the basis for trade. For example, the U.S. has higher wages than Mexico, but this difference does not prevent the U.S. from exporting products to Mexico. On the contrary, U.S. industries with higher than average productivities, such as the computer industry, can export substantial amounts to Mexico at a lower cost than Mexico can produce them. Likewise, Mexico will export goods and services from its industries with higher than average productivities because these industries will have a cost advantage in the United States.

Even though we usually think of the benefits of international trade as limited to the exchange of goods and services, perhaps the greatest benefit of international trade results from the transmission of ideas. Throughout history, international trade has served as the principal means by which new goods (compact disc players), services (such as intercontinental airline flights), and processes (such as Japanese just-in-time manufacturing) have spread around the globe.

The Impacts of Protectionism

Indeed one of the best natural tests of whether free trade works can be found in the experience of developing

countries. In the 1950s and 1960s, many developing countries adopted the *import substitution industrialization policy* expounded by Raul Prebisch (1972). The idea, also known as the *dependency theory,* was that if poor countries wanted to develop, they would have to start producing manufactured goods rather than continue to rely on imports of these goods from developed countries in exchange for exports of primary products. The fear was that as income rose, the demand for manufactured products would increase relative to primary products, and this change would lead to a lower relative price for primary products in international markets. In other words, if the poor countries were ever to become rich, they would have to substitute their own locally produced manufactured goods for manufactured imports. This policy was implemented by imposing high trade barriers on imports from developed countries.

However, thirty years later, the evidence points to the failure of highly protected import substitution trade regimes and the success of outward-oriented (or pro-export) trade regimes. Countries that have pursued highly protectionist policies, such as Tanzania, Nigeria, and Ghana, grew much more slowly than the relatively open economies of Southeast Asia, such as Hong Kong, South Korea, and Singapore (Dollar 1992; Summers and Heston 1991). In twenty-nine episodes of trade liberalization analyzed by Michaely, Papageorgiou, and Choksi (1991), growth increased in both the manufacturing and agricultural sectors after liberalization. Moreover, they found that growth in most agricultural sectors increased not only after the liberalization period but also during the process of liberalization. In other words, for many countries, the benefits of liberalization have been widespread and immediate. This suggests that market economies are sufficiently flexible in most countries to allow the liberalized sectors to expand more quickly than the once-protected sectors.

Another problem with the import substitution theory is the implicit assumption that international competition does not matter to a thriving and strong manufacturing sector. In countries with an inward-looking import substitution policy, firms have no incentive to innovate. The lack of competition leads to high-priced, poor-quality products and retards economic growth. For example, in 1870 Argentina had a larger per capita income level than Japan or Germany. But after more than one hundred years of intense government intervention and high protection, Argentina was at the lower end of the world distribution of income. Until the late 1980s, a 1968 Ford Falcon was one of the finest, most luxurious cars available in Buenos Aires.

The lesson is that outward-oriented international trade policies are a much stronger conduit for economic growth and advancement than protectionist import substitution policies. In highly protected regimes, resources are attracted to industries that do not reflect the comparative advantage of the country (Dollar 1992). Moreover, protected industries, because they lack the incentive to innovate, produce high-cost, inferior products.

Some Common Misperceptions

Public understanding of international trade issues is often hampered by an array of misperceptions. In this section, some logical and empirical underpinnings of several common arguments are evaluated.

Exports are Good, Imports are Bad

In discussing a country's balance of trade, we often hear terms that are filled with value judgements. For example, a *worsening* trade balance implies that imports are growing faster than exports, while an *improving* trade balance implies that exports are growing faster than imports. However, by itself, a trade surplus or deficit is not inherently bad or good. Looking at trade balances this way it is easy to see that the cost of imports are exports. When a country exports something, it gives up the products of its resources; when a country imports something, it adds to the quantity of goods it can consume. What a country can consume at home equals what it produces *plus* its imports *minus* its exports. Thus, from the standpoint of what a country can consume, imports are good. The proper concept is what economists call the *terms of trade,* the quantity of imports a country receives in exchange for a given quantity of its exports. The larger the terms of trade, the better. This basic truth was discovered many years ago by David Hume, Adam Smith, and David Ricardo as they developed a rationale to counter the doctrine of mercantilism.

We often are guilty of Orwellian doublethink when it comes to exports and imports. Trading with a friendly nation like Japan, it is considered bad to export less to them than we import. But when we consider trade with an enemy, such as the former Soviet Union at the height of the Cold War or Saddam Hussein's Iraq, it is considered treason to export anything at all to them. For some reason, in times of war or tension, we can see through the flows of money and focus on the flows of goods. Consider the imports of food into starving Somalia. Are the Somalians worse off? Obviously not. A trade "deficit" is perhaps best thought of as a surplus: the value of goods coming into a country exceeds the value of goods leaving the country. It should be noted, however,

that in most instances, this perspective may not be relevant.

Trade and Economic Powerhouses

Another reason some observers consider trade deficits bad stems from the notion that a country with a huge trade surplus is an economic powerhouse. Japan is one such candidate. This concept is flawed because trade deficits or surpluses today are the consequence of a country's current and historical position in the international flow of capital. International lending and borrowing allow countries to buy now and pay later, just as domestic lending and borrowing allow individuals to buy now and pay later. What must be true is that the imports of goods and services now must be paid for by the exports of goods and services later.

For example, in 1992 the United States had a merchandise trade deficit of $96 billion and net unilateral (mostly government) transfers to foreigners of $31 billion. To finance this outflow of $127 billion, the U. S. received about $10 billion in net investment income from foreigners, had a $55 billion surplus in service transactions (travel, license fees, insurance, and so forth), and borrowed approximately $62 billion. The reason the U. S. has a trade deficit is because it earns large amounts from direct investments abroad, has a comparative advantage in selling services, and is considered by many foreigners to be a good place to invest capital. The U. S., therefore, does not have a trade deficit because it cannot compete in world markets.

Recent discussion of the U.S. trade deficit has focused on the United States' billion-dollar bilateral trade deficit with Japan. To a large degree, Japan has a trade surplus because Japanese savings are relatively large compared with investment opportunities in Japan. In the same manner, the U. S. has a trade deficit because its savings are relatively low compared with investment opportunities in the United States. Strong prospects for growth and investment opportunities in the United States can increase the U.S. trade deficit but this deficit is not impoverishing. Without international capital flows, U.S. rates of interest would be much higher than they actually are. Indeed, Americans who borrowed to build U.S. factories and homeowners who refinanced their homes in 1992 and 1993 at low rates of interest were beneficiaries of these international capital flows.

The Level Playing Field

We often say we believe in free trade, but we want trade to be "fair" because foreigners protect or subsidize some of their producers. This argument is convincing at the political level because it appeals to the sentiment in all of us to deal with others as they deal with us, but it is a red herring. One flaw is its reliance on the misperception that we benefit from exports and lose from imports. However, the core idea is the claim that the benefits of free trade only accrue if free trade is followed in other countries.

A country can still gain from free trade even if free trade is not followed elsewhere. Although protection in other countries can reduce a country's benefit from trade, a country will continue to gain from trade because it can obtain certain goods on cheaper terms by importing them rather than producing them at home. It makes little difference to the free trade country why it is getting the goods on cheaper terms. If it is because another country is subsidizing those exports, the free trade country is simply being provided a gift. In practice, the fastest growing countries of the world tend to have the most open markets, despite high protection elsewhere in the world (Gould, Ruffin, and Woodbridge 1993).

Foreign Wages Are Too Low

Perhaps the most subtle argument against free trade is that it is unfair to compete with countries paying wages that are far below domestic standards. To a textile company in the U. S., it may seem unfair to lose business to a Mexican company that is far less efficient. Should efficiency not be rewarded?

Efficiency is rewarded, but in a different way. The U.S. comparative advantage lies in areas in which our productivity advantages outstrip the disadvantages of having higher wages. Import-competing industries in the U.S. cannot meet the pace set by our most productive industries. In 1992, the U.S. had a trade surplus of nearly $5 billion with Mexico, even though Mexico had higher tariffs than the U.S., and the U.S. had wages that were about seven times higher than Mexican wages. In industries that manufacture and market machine tools, electrical machinery, and high-tech business equipment, Mexican workers have difficulty competing with highly skilled U.S. workers. Low wages are not the key to exporting; if they were, countries with low wages like Bangladesh and Haiti would be great exporting nations. The truth is exactly the opposite: Germany and the United States are the world's largest exporting countries.

American Goods Create American Jobs

Critics of free trade often claim that protection of domestic industries saves jobs. This rationale proceeds at two levels. First, the economically sophisticated argument holds that the benefits of free trade are derived

from theoretical models that assume the economy has full employment. Because there is unemployment in the economy, free trade is not necessarily optimal because unemployment might actually increase.

Arguments for free trade, however, should not be based on jobs claims. Free trade is not about the number of jobs, but about the types of jobs and standards of living. U.S. experience shows that unemployment changes substantially over the course of business cycles but, over time, the number of jobs roughly equals the size of the working-age population (Wayne 1992). What matters in the long run is the type of future jobs that are available. If the goal of U.S. policy were to keep jobs, today we would have thriving horse-drawn carriage and blacksmith industries. By keeping the same jobs we have always had we discourage the development of new high-skill jobs that add to the stock of knowledge and generate innovation and growth.

A second argument simply holds that imports of textiles, consumer electronics, and automobiles cost domestic textile workers, electronics workers, and auto workers their good jobs and force them to take bad jobs. In other words, imports supposedly displace domestic workers. The slogan, "American goods create American jobs," has become a rallying cry, but often such sentiments are rooted in the fallacy of composition. What is true for the part is not necessarily true for the whole. It may be possible that imports of textiles or cars can diminish the number of American textile or automobile jobs. But it is not always true that imports reduce the number of jobs in a country. In some situations, a big increase in imports may lead to an increase in exports or foreign investment. In other words, if Americans suddenly wanted more Japanese cars, eventually American exports would have to increase to pay for these goods. The jobs lost in one industry are replaced by jobs gained in another industry.

A Country Can Gain From Strategic Trade Policy

New theories of international trade that emphasize monopolistic competition and international oligopolies have led some researchers to think that free trade may be out of date (Krugman 1986). The new theories of trade have emphasized the importance of economies of scale, learning curves, and innovation. These new theories are incompatible with the assumption of perfect competition that lies behind the classical argument for free trade. Thus, in a real world environment, some have argued, a country might be able to follow an activist trade policy that promotes domestic industries at the expense of foreign competitors.

Strategic trade policy is usually based on one of two key ideas. The first is that a domestic industry is part of a world industry that earns monopoly profits. Subsidizing a domestic firm can secure more of the world's monopoly profits for a country. The second is that a particular industry, such as semiconductors, may confer spillover benefits on other domestic industries by lowering their costs and raising their rates of return. In this latter case, subsidizing the industry generating the spillover benefits may improve a country's total real income. For many years, trade theorists have recognized the possibility that through a tariff a large country may be able to raise revenue by, in effect, getting smaller foreign countries to pay indirectly into the national treasury. This rationale has been called the *optimum tariff argument.*

The difficulties with all such trade policy arguments are threefold. First, such policies assume that foreign governments will not retaliate. Foreign retaliation can reverse any potential gain anticipated from domestic protection. Second, most arguments for protection assume that tariffs and subsidies are imposed by a benevolent dictator, rather than political parties representing special interest groups. Most trade policy decisions, however, are not determined by what is in the best interests of the whole country; usually they are the result of political lobbying. Finally, strategic trade policy conclusions are based on theoretical models, but the implementation of the policy relies heavily on empirical estimates of industry demand and supply that can vary substantially over time. Given these problems, it is unlikely that any government could, even if it had the power to do so, implement the optimal policy (Grossman 1986).

The Politics of Protectionism

If free trade maximizes a country's income and allows its citizens to achieve greater average welfare, why do governments implement policies that inhibit flows of goods and services between nations? Although government intervention is not necessarily inconsistent with the objective of maximizing national income (for instance, in the optimal tariff case), we rarely observe trade policies implemented to meet this objective. Trade policy usually reflects the lobbying efforts of special interest groups.

Economists increasingly are recognizing that trade policies are usually not designed to improve economic performance but, rather, aim to alter the distribution of income (Quibria 1989). This consensus is based on the observation that trade policy is an endogenous outcome of the political process. In a democratic system in which politicians must achieve or maintain political office, special interest lobbying groups exert strong influence. Lobbying, either by informing the government of the

support for a policy or by directly funding the election of a particular party, can influence electoral success and, hence, trade policies. Mindful of this, special interest groups, whose economic welfare can depend on the outcome of a particular trade policy, have an incentive to lobby for legislative outcome in their own favor.
Because almost every change in policy produces winners and losers, the political contest is competitive. Pro-protection forces are predominantly industry-based coalitions of capital owners and labor organized through industry associations and labor unions. The losers from import protection are consumers who face higher prices and the owners of factors of production employed in exporting industries that face the possibility of reduced access to foreign markets through retaliation. Consequently, trade policy is the outcome of the political contest between these opposing forces, which is primarily determined by the lobbying expenditures of the two groups.

The total cost of a particular trade policy often exceeds the gains and the costs tend to be widely dispersed over a large group of consumers who individually have little incentive to lobby against the policy. For example, in 1984 the U.S. Federal Trade Commission estimated that import quotas and tariffs on sugar benefited U.S. sugar producers by $783 million, while costing U.S. consumers $1.266 billion (Tarr and Morkre 1984). While the losses far exceeded the gains, the loss of $5 per average consumer was hardly enough to motivate these individuals to actively resist the policy. The political contest is biased in favor of the pro-protection coalitions because the benefits of trade policy are concentrated, while the costs are diffuse.

Because trade policy is typically used to alter the distribution of income rather than to increase national income, resources devoted to lobbying are wasted. Moreover, as pointed out by Magee, Brock, and Young (1989) and Olson (1982), the value of resources expended on these unproductive activities can approach the size of the transfer itself. The reason is that lobbyists have an economic incentive to expend resources as long as potential benefits exceed their lobbying costs. Olson (1982) argues that these costs have limited the economic growth of nations. These findings are of concern to those mindful of the economic costs of trade policy.

Conclusion

It is difficult to overestimate the advantages a country derives from international trade. Every person can enjoy the technological and geographical advantages that exist anywhere in the world. A villager in Nigeria may listen to local broadcasts on a Sony radio running on batteries produced in Korea. Americans and Europeans enjoy their coffee breaks and tea times, using South American coffee or Indian tea.

The case for free trade can be made not only in terms of basic economic principles, but also in terms of the experience of countries that have followed protectionist policies. High-wage countries not only compete with low-wage countries, they in fact dominate world trade. Trade deficits or surpluses simply reflect consumption and investment decisions over time: they are not inherently bad or good. Moreover, there is no evidence that imports cause systematic unemployment or that exports create systematic employment. Both arguments are based on the fundamental fallacy of composition that what is good or bad for one is good or bad for all. Highly protected economies tend to grow slower than open economies, and industrial policies designed to promote particular industries usually backfire.

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