14 Revision – Free trade and protectionism

Free trade: Trade that takes place between countries when there are no barriers to trade put in place by governments or international organizations.

Protectionism: The putting into place of trade barriers by governments or international organizations to restrict imports into a country.

Dumping: The selling by a country of large volumes of a commodity, at a price lower than its production cost, in another country.

Tariff: A tax that is charged upon imported goods.

Subsidy: An amount of money paid by the government to a firm, per unit of output.

Quota: A physical limit on the number or value of goods that can be imported into a country.

World Trade Organization (WTO): An international organization that sets the rules for global trading and resolves trading disputes between its member countries.

Arguments for protectionism

- To protect domestic employment – this argument is not very strong, since it is likely that the industry will continue to decline and that protection will simply prolong the process.
- To protect the economy from low-cost labour – this argument goes against the whole concept of comparative advantage.
- To protect an infant (sunrise) industry – developing countries, without access to sophisticated capital markets, can use the infant industry argument to justify protectionist policies.
- To avoid the risks of over-specialization – there are no real arguments against this view. It does not promote protectionism, it simply points out the problems that countries may face if they specialize to a great extent.
- Strategic reasons, e.g. in times of war – in many cases, it is unlikely that countries will go to war or, if they do, that they will be completely cut off from all supplies. Then, it is likely that the argument is being used as an excuse for protectionism.
- To prevent dumping – it is very difficult to prove whether or not a foreign industry has actually been guilty of dumping, or whether there is just a comparative advantage.
- To protect product standards – a valid argument, as long as the concerns are valid.
- To raise government revenue – not an argument for protectionism, but a means of raising government revenue.
- To correct a balance of payments deficit – this will only work in the short **run**.

Arguments against protectionism

- Protectionism may raise prices to consumers and producers of the imports that they buy.
- Protectionism leads to less choice for consumers.
- Competition will diminish if foreign firms are kept out of a country and so domestic firms may become inefficient, because

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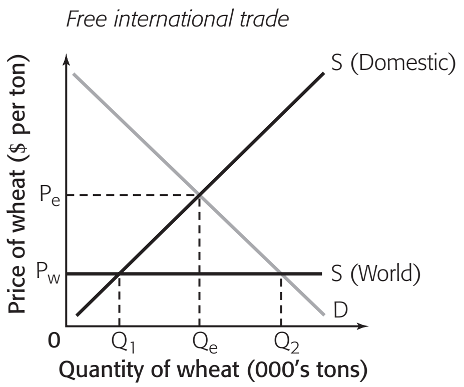
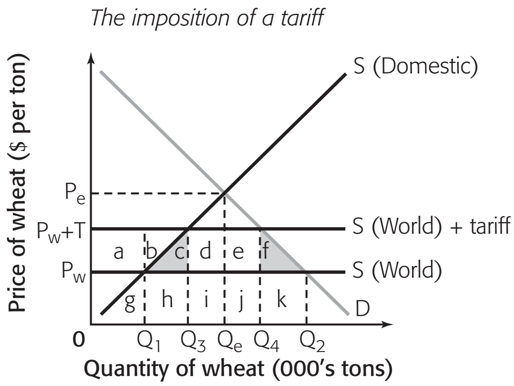
they do not have an incentive to minimize costs. In addition, innovation may be reduced for the same reason.

- Protectionism distorts comparative advantage, leading to the inefficient use of the world's resources. Specialization is reduced and this would reduce the potential level of the world's output.
- For the reasons listed above, protectionism may hinder economic growth.

Types of protectionism

The situation where free trade is taking place in a country and there is no protectionism is shown below.





A tariff is a tax that is charged on imported goods. In the case of a tariff, it will shift the world supply curve upwards, since it is placed on the foreign producers of the good and not the domestic producers. This is shown above.

Domestic producers are able to sell more at a higher price and domestic employment will increase. Domestic producers will pay higher prices and consume less. The government will receive revenue from the tariffs paid by the foreign producers. The foreign producers end up selling less at the same price. This will affect employment in the foreign countries.

There is a dead-weight loss of consumer surplus for domestic consumers and there is a dead-weight loss of welfare, because inefficient domestic producers take the place of efficient foreign producers.

A subsidy is an amount of money paid by the government to a firm, per unit of output. In this case, the government is giving a subsidy to domestic producers to make them more competitive and so the effect will be to shift the domestic supply curve downwards by the amount of the subsidy. This is shown below.

Domestic producers are able to sell more at a higher price and domestic employment will increase. Domestic producers will consume the same amount at the same price. The government will have to find the money to pay the subsidies. The foreign producers end up selling less at the same price. This will affect employment in the foreign countries.

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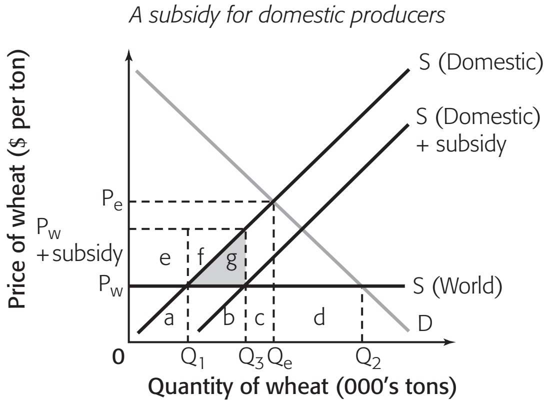
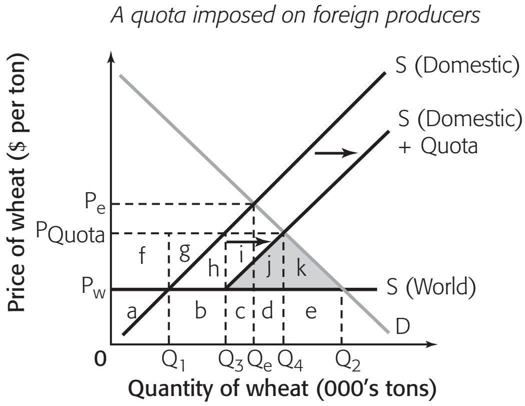
There is a dead-weight loss of welfare, because inefficient domestic producers take the place of efficient foreign producers.





A quota is a physical limit on the numbers or value of goods that can be imported into a country. For example, the EU imposes import quotas on Chinese garlic and mushrooms. The imposition of a quota has a peculiar effect on the free trade diagram and this is shown above.

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Administrative barriers – when goods are being imported, there are usually administrative processes that have to be undertaken. This may be known as dealing with '*red tape*'. If these processes are lengthy and complicated, then they can act as a restriction to imports.

Health and safety standards and environmental standards – this is where various restrictions are placed upon the types of goods that can be sold in the domestic market, or on the methods used in the manufacture of certain goods. These regulations will apply to imports and may restrict their entry.

Embargoes – in effect, an embargo is an extreme quota. It is a complete ban on imports and is usually put in place as a form of political punishment. For example, the USA has a trade embargo on products from Cuba. Complete embargoes are rare.

Nationalistic campaigns – governments will sometimes run marketing campaigns to encourage people to buy domestic goods instead of foreign ones in order to generate more demand for domestic goods and preserve domestic jobs.

The World Trade Organization (WTO)

The WTO is an international organization that sets the rules for global trading and resolves disputes between its member countries. The WTO was established in 1995 and now has 149 members.

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It replaced the General Agreement on Tariffs and Trade (GATT). The WTO, along with its predecessor the GATT, is largely credited with the fact that since 1947, average world tariffs for manufactured goods have declined from approximately 40% to 4%.

All WTO members are required to grant 'most favoured nation' status to one another, which means that, usually, trade concessions granted by a WTO country to another country must be granted to all WTO members.

The aims of the WTO are to administer WTO trade agreements, to be a forum for trade negotiations, to handle trade disputes among member countries, to monitor national trade policies, to provide technical assistance and training for developing countries and to cooperate with other international organizations.

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