International Journal of Economics & Management Sciences

Sulaymonov, Int J Econ Manag Sci 2017, 6:3
DOI: 10.4172/2162-6359.1000426

Opinion

OMICS International

Privileges of Free Trade, Factors and Arguments towards Protectionism

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Trade has always been a routine everyday business activity since ancient times. Today it is important source of wealth for nations, governments and businesses. Most developed and developing countries are trying to achieve trade liberalization which includes open markets, lower tax rates for businesses and free trade in order to maintain and increase their competitiveness. Free trade is a policy where governments intervene in neither exports nor imports.

Today there are extensive amount of literature analyses on the theoretical and empirical effect of free trade. But history of first classical international trade theories goes back to eighteenth century, Adam Smith in his Wealth of nations, later David Ricardo in his theory of comparative advantage, argued that free trade would increase wealth and improve standard of living of all trading nations. Although free trade creates winners and losers in international trade, in broad sense, majority of economists` consensus is that it brings a large and definite net gain for society.

In practice, despite free trade`s impressive success, governments are tempted to protect their fragile businesses from foreign competition. A number of priorities and interests make governments use some course of action to intervene to trade and maintain economic policy that is designed to limit imports and avoid from company and local markets` take-over from foreigners. However, as all modern economists state, the cost of protectionism policy outweighs the benefits and it slows down growth of economy.

Practicing Free Trade: As an Advantage

Free trade is a system where lack of government-imposed interventions and restrictions in which trade of products within or among countries moves unhindered [1]. First classic economists- David Hume, Adam Smith, David Ricardo- recognized the importance of free markets and free trade that stimulates the efficient use of economy`s resources and brings economic prosperity. These assumptions and insights argue that gains from free trade come due to country`s specialization to particular products and comparative advantage [2]. Today in existence of numerous countries and products, Smith, Ricardian and Heckscher-Ohlin models are strong simplifying assumptions, as they didn`t take into account that difference among countries affects productivity and technologies [3], even though gains-from-trade and comparative advantage theories are general and gives robust results. Nonetheless, fundamental perceptions of classic international trade theories continue to predict and explain benefits of free trade [4].

According to the British economist, Alfred Marshal [5], "The causes which determine the economic progress of nations belong to the study of international trade". There are mainly two types of gains from free trade: static and dynamic [6] which are main economic motivations of why economies engage in trade [4]. Static gains come from increased specialization and reallocation of resources based on comparative advantage, while dynamic gains increase the potential of production and productivity with FDIs. The former produces an increase in income but in accumulation of time of the latter which makes improvements in living standards.

In Figure 1 the lines S1 and D, are supply and demand curves for particular product. Their equilibrium intersects in Q1 and P1. Assuming that country has a comparative disadvantage in the production of product, world price will be lower than this country. If world supply curve is S2 and country allows for free trade, two effects can be expected. First, consumers of this country will increase their consumption to Q2. Second, country`s producers contract their production. Consumers gain in two ways, first, they can purchase in lower prices. This gain is represented by the rectangle P1 BE P2. Moreover, lower price enables consumers to increase their margin of purchase from Q1 to Q2, which is represented in triangle BCE. On the other side, lower prices cause reduction in production of local firms from Q1 to Q22. Total loss of producers is P1 BF P2. As a whole, nation gains from free trade, because total consumer gains of P1 BC P2 exceed producer losses of BFC. Vice versa of this analysis, if country has a comparative advantage in particular product, because of free trade from export of the goods producers may gain which will be higher than consumer losses [7].

The benefits of free trade have long been understood by economists, thus the faster trade distortions are removed, the sooner gains from free trade will be enjoyed, as market accelerates growth and stimulates industrialization. In particular, to consumers who are winners in broad sense, free trade gives liberty to buy from a worldwide market, greater choices, lower prices and high quality in available goods. It also enables consumers to improve their individual welfare through the least cost alternatives and buy products that are produced according to their ethical and philosophical preferences [8].

Foreign competition force local firms offer competitive prices, to be productive and innovative, while free trade gives them opportunity to

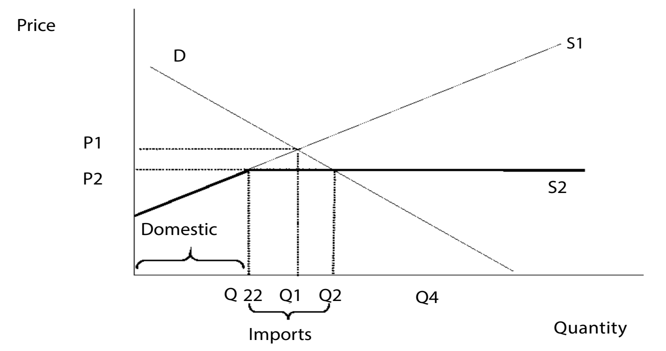

Figure 1: Gains from free trade.

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Received April 28, 2017; **Accepted** May 04, 2017; **Published** May 05, 2017

Citation: Sulaymonov A (2017) Privileges of Free Trade, Factors and Arguments towards Protectionism. Int J Econ Manag Sci 6: 426. doi: 10.4172/2162-6359.1000426

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expand their market and stimulate domestic growth. Thus as exporters, firms, in order to serve the worldwide customers, hire new workers who enjoy from higher wages and incomes in export industries, because of sales in larger markets as well as in higher prices. Moreover, another advantage of free trade for producers is that, it opens cheap unexploited resources that reduce unit costs and gain scale economy, in turn internationalize [9].

According to Beaulieu et al. [10], recent surveys show that skilled labour in 29 out of 31 countries are more supportive of free trade than unskilled labour. Because free trade benefits countries with abundant factors in production compared to remainder of the world, in first world countries where literacy rate is very high, skilled workers benefit more from open trade which increases demand for them [11]. Due to import competition although less skilled workers will be damaged which may cause the shift of jobs across sectors and dislocation of workers, as indicated in CEA`s 2002 Economic Report of the President, it should not be an excuse for discouraging trade. Because trade restrictions hinder the development of innovations and prevent the creation of job vacancies in other sectors, as Fouda points out, free trade creates more jobs than it destroys.

In addition, free trade enhances specialization of production in countries or sectors based on comparative advantage, it broadens the export markets, thus in turn generates growth of export, but in order to avoid constrains on trade balance, exports should surpass imports. Furthermore, recent studies indicate that countries with more open market have higher rate of growth. In addition, by lowering price of fixed capital and increasing rate of return on capital and savings rate, trade liberalization raises rate of capital formation. In turn it will lead to the growth of real outputs and real incomes [12].

Overall, according to standard economic models, free trade increases national welfare and its net economic benefits are substantial. At the world level, open markets have bilateral benefits for each country, because countries enjoy from demand increase, raising real incomes and total imports. Permanent growth of world GDP over the past 25 years indicates that there is clear correlation between trade liberalization and global growth effects.

Protectionism: If Free Trade is Efficient Why isn`t it Universal?

The power of government is often used by special interests in order to be protected by import competition, even though mercantilist economic policy is out of date these days. Protectionism is "attitudinal, structural, operational and other constrains that hinder the firm`s ability to initiate, develop, or sustain international operation" [13], as a form of governmental privilege, it gives safety and competitive advantage to domestic industries over foreign counterparts. Protectionist strategies are unsuited with a system of free trade and WTO rules [14], however it serves to the government to achieve specific goals, such as overcoming free market`s perceived inadequacy and generate maximum social benefit. Taking in an account that firms and individuals are more interested in their own benefit and costs, rather than those of foreign counterparts, it is fully rational behavior for them to support protection of trade for their industries [15].

Generally, there are two arguments for the intervention of government in international trade: political and economic. Intervention of government covers a number of political factors including protecting jobs; industries which are important for national security (e.g., aerospace, semiconductors); outflow of natural resources; fighting against unfair foreign competition (e.g., US government threatened China with 100% tariffs due to Chinese companies` violation of intellectual property rights towards Microsoft which lost millions of dollars); consumer protection from dangerous products (e.g., high tariffs on genetically modified foods in EU); supporting human rights of exporting countries and foreign policy objectives [16].

The oldest economic argument for the intervention of government, proposed by Alexander Hamilton in 1792, is protecting infant industries until they are capable of competing in international trade. Strategic trade policy comes as the second argument in government intervention. In this situation governments support local promising firms which may gain first-mover advantage in emerging industry by taking appropriate actions, such as subsidies. For instance, from the late 1970s, the beginning of liquid crystal display screens era, Japanese government gave substantial R&D grants to local electronic companies. As a result, Japanese companies, not US firms where these screens were invented, got control first-mover advantage in this field [17,18]. Another attribute of this policy, firms may use government to deal with barriers created by first-mover companies. As an example, Airbus break into commercial aircraft market by threatening Boeing`s dominance where market share rose from 5% in 1975s to 45% in 2006 is achieved by $15 billion R&D and export subsidy from governments of Spain, Germany, France and Great Britain.

Due to market imperfections, such as monopoly (when competition is not within similarly-prepared companies, big foreign firms create monopoly by either running out of small firms or swallowing them) and technological spillovers, in order to have growth and development, and enjoy from benefits of intenational trade, there should be combination of gradual trade liberalization and pervasive presence of government. Namely, according to changing needs and capabilities if a mixture of protection and open trade is employed, country may enjoy from economic development.

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