

Reasons for trade

Absolute advantage - A nation has an absolute advantage in the production of a particular commodity if it can produce that commodity using fewer resources than other nations

- **The importance of absolute advantage:**
 - one country cannot produce sufficient quantities of a particular commodity
 - one country finds it cheaper to import certain commodities than to produce them domestically.
 - The country which exports is at an absolute advantage

Comparative advantage - even if one of two countries has an absolute advantage in the production of all goods, both nations will benefit from trade if they specialise in the production of those commodities in which their comparative advantage is greatest

- **Sources**
 - country's factor endowments; technology; exporter's acquisition & development of technologies.
- **Importance:**
 - explains why countries import G&S which they could produce more cheaply
 - relative efficiencies - **opportunity cost** of domestic production relatively high.
 - Just as relevant to domestic trade and specialisation
- **The allocation of resources to minimise opportunity costs.**
 - To show that both countries gain in the consumption of both products even if one country has an absolute advantage at both products. International specialisation is still beneficial.

Advantages and disadvantages of free trade - situation in which there are no artificial barriers imposed by governments upon the movement of commodities across their national boundaries.

- **The benefits of free trade**
 1. specialisation - derived from comparative advantage.
 - Allows each nation to make full use of its relative factor endowments and specialise.
 - increased global output of all G&S → higher living standards, real incomes & growth
 2. economies of scale - larger market → introduction of G&S which would not have been produced
 3. increased competition: reduces market power of local producers, forcing spread of technology
 4. Higher living standards: imports increase variety of G&S available; more exports → employment
 5. Better international relations: trade flows build sense of mutual interdependence.
 6. Specific benefits for small nations such as Australia:
 - Economy too small to subsidise commodity producers
 - Since domestic market so small, need trade to achieve economies of scale.

Protection: all those government actions designed to give local producers some kind of artificial advantage over their foreign competitors

Reasons for protection

è **valid economic arguments:**

- è The infant industry Argument - It is valid to protect industries in the early stages of development to allow establishment, then to remove protection when the industry is viable.
 - The protection usually comes as a tariff, remaining until new industries take advantage of economies of scale and operate efficiently becoming cost competitive.
 - Valid if domestic industry eventually supplies products at a lower price than imports.
 - Problems: Identification of promising infant industries.
 - Protection breeds inefficiency due to lack of foreign competition.
 - Entrepreneurs will establish industry anyway if it capable of competing in long run,
 - Prospect of increased unemployment makes it difficult to reduce protection.

è “Strategic trade theory”: By diverting resources to high-tech goods that use skilled labour, governments can create a competitive advantage.

- James Brander & Barbara Spencer showed theory can work when an industry is
 - not perfectly competitive; subject to economies of scale; dominated by a few firms,
 - Depends on the assumption that there will not be retaliation
- prior to Airbus consortium, US possessed comparative advantage in airliners over Europe.
 - Damien Neven & Paul Seabright: successful entry to market through government backing

è Prevention of dumping to protect domestic industries

- dumping: sale of output on foreign markets at a price that may even be below production costs: to dispose of excess production or establish a monopoly. WTO & EU prohibit dumping.

è **Invalid economic arguments**

è Promoting domestic employment: used during recessions & times of high unemployment

- For: consumers buy locally produced substitutes when imports prices raised by protection.
- Against: By exporting unemployment, retaliation likely
 - protection reallocates resources to less efficient industries, lowering economic growth.
 - ineffective way of reducing unemployment compared to macro & micro policies.

è protect domestic incomes:

- For: inability to compete with cheap foreign labour.
- Against: Costs rely on incomes & productivity. Some countries have low wages & productivity.
 - true problem: domestic labour producing goods which should be made overseas.
 - Leads to higher domestic prices, reducing real incomes & lowering living standards.

è Diversification:

- For: spreads risks, making economy less susceptible to price & output fluctuations.
- Against: Nations are diverting scarce resources to inefficient industries.

è **Non-economic arguments:**

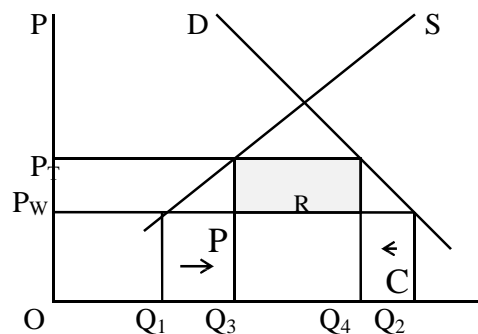
è political arguments.

è self sufficiency for defence - protecting strategic goods, purely a military and political argument.

Methods of Protection

è **Tariffs**: tax levied on imported goods.

- Increases price of imported product, making local goods more competitive on domestic markets.
- Since domestic producers are allowed to increase prices, supply increases, as does employment:



- Initially, world price P_w , At P_w , $D=Q_2$, $S=Q_1$ Imports = $Q_1 - Q_2$
- Impose a tariff: Price becomes P_T
 1. Domestic producers increase price to P_T , ie. Gain benefit of higher price.
 2. Domestic supply expands to Q_3 : greater output, greater employment
 3. Domestic demand contracts to Q_4
 4. Imports fall from Q_2-Q_1 to Q_4-Q_3
 5. Government revenue: $(P_T - P_w)(Q_4-Q_3) = \text{tariff} \cdot \text{imports}$
- T is transfer, P is protection, R is revenue, C is consumer satisfaction

- è **Quotas**: legal limit upon quantity of a particular good which can be imported over a period of time.
 - effect: increases price of imported product, through competition, allows domestic producers to increase prices also leading to increased supply & employment.
 - i) More control over Q of imports than tariffs
 - ii) no direct government revenue except the sale/auction of import licences.
- è **Subsidies**: cash payment made by government to local firms in order to encourage local production.
 - Price falls, output rises: offers protection by reducing prices of domestically produced goods.
- è **Tariff-quotas**: goods are imported at normal rates of duty up to a specified level and any imports above this level are subject to a penalty tariff.
- è **Embargoes**: import ban, quota of zero on a particular commodity
- è **Import Licensing**: used by governments to regulate & monitor flow of goods into their countries
- è **Local content rules**: certain imported goods must be constructed with a minimum percentage of locally produced components.
- è **International commodity agreements**: preferential treatment for each other's product on market.
- è **Technical specifications**: for health of safety reasons
- è **landing charges, quarantine regulations, tax concessions and export incentives**
- è **voluntary restraint**: agreements between governments and foreign suppliers restricting trade.

Effects of protection

1. **retaliation**: may cause retaliation against our exports abroad
 2. **misallocation of resources**: by supporting inefficient industries
 - Nations imposing protection are running contrary to their comparative advantage
 3. **inflationary effects**: higher prices detrimental to the welfare of consumers
 4. **redistribution of income**: from consumers to domestic consumers and the government
 5. **reduced incentive to innovate**: shields domestic industries from competition
 6. **decreased welfare**: leads to falling living standards and lower economic growth.
 7. **More foreign investment**: foreign producers can bypass the tariff.
- è **The effective rate of protection**: (as % of prices without protection)
 - **nominal rate of protection**: per unit price rise of locally produced goods rises due to protection.
 - **Effective rate of protection**: value added increases as a result of protection.

The extent of protection in Australia

- è **Australia's present protection policy**: aims of Australia's policy of reductions in tariffs
 1. force domestic industries to become more competitive
 2. encourage redistribution of resources to more competitive industries
 3. promote beneficial structural change in economy with aim of encouraging world efficient firms.
- è Recent government initiatives regarding protection
 - all general tariffs reduced to 5% by 1996
 - TCF under 25% by 2000, PMVs under 15% by 2000.
 - Average effective rate of protection in manufacturing from 36% in 1968/69, to 5% by 2000.
- è **The implications of a reduction in domestic protection levels for the Australian economy**
 - **short term**: structural unemployment; adverse action of automatic stabilisers; CAD deterioration
 - **Long term**: CAD reduction: micro-economic reform in tariff policy only "real" long term solution
 - Increased export earnings; Diversification of our export base
 - Consumers: lower prices & increased product choice
 - Employment: exploitation of comparative advantage leading to employment growth
 - Increased business investment: due to more efficient allocation & lower business input costs.
 - Primary industries: the most to gain - NFF strong advocate.

Protectionist policies and their implications for Australia

è **Protectionist policies of other countries** - Us Export Enhancement Program (response to CAP)

è **Protectionist policies of international organisations**

- EU Common External Tariff on imports from non-member countries.
 - Under CAP, agricultural producers within EU receive higher prices.
 - 1992, CAP reform: reduce subsidies for grain, beef & butter by 29%, 15% & 5% by 95-96.
- Initial loss of key European export markets counteracted by recent improvement.
 - EU single market - presents Australia with a major opportunity to expand trade with EU.

International attempts to reduce protection

1. unilateral: 5% by 2000
2. **Bilateral**: NAFTA; ASEAN; EU; **CERTA**: ANZ Closer economic Relations Trade Agreement.
è ASEAN - Thailand, Malaysia, Philippines, Singapore, Indonesia & Brunei - formed Asian Free Trade Area. 1994, Keating proposed joining AFTA & CER - Malaysia & Singapore support.

3. **Multilateral**: GATT, WTO

è **Outcomes of Uruguay GATT round**

- agreement of agriculture to be implemented:
 - export subsidies reduced by 36% as well as a 21% fall in volume of protected produce
 - all import quotas converted to tariffs and these then reduced by 36% - monitoring easier.
 - Closed markets opened to free trade: access to Japanese and Korean beef & rice markets
- Other important agreements:
 - Trade in Intellectual Property Rights Agreement
 - agreement on Trade in Services - under WTO rules for first time
 - establishment of WTO, expanding issues covered by **GATT**

è **WTO, successor to GATT**

- January 1995, 'to develop an integrated, more viable & durable multilateral trading system'.
- Main operational changes:
- much wider than **GATT** - New issues covered by WTO:
 - incorporation of the Multifibre Agreement, regulating trade in textiles & clothing.
 - Trade-related investment measures
 - trade in services, trade-related aspects of intellectual property rights
 - introduction of a trade policy review mechanism
 - trade agreements in civil aircraft, government procurement, dairy products & bovine meat.
 - Committees on trade &: environment, competition policy, labour standards, investment.
- can put substantial limits on any anti-dumping action - insists upon full investigation
 - more effective dispute settling mechanism - will have enforceable sanctions.
- Weakness: no former USSR states, Taiwan or China.
 - A conflict has developed between the EU and the USA over conditions for China's entry in particular due to a continuing bi-lateral dispute over intellectual property rights.

è **Asia-Pacific region trade relations** 77% of Australia's merchandise exports go to APEC nations

- November 1994 - 2020 free trade target, 1010 for developed nations
- Osaka Meeting in November 1995 confirmed 1994 declaration & following principles:
 - Comprehensiveness: forum members to address impediments to free trade & investment
 - Consistency: with WTO & non-discrimination
 - Comparability of trade & investment liberalisation should be achieved
 - Transparency of laws and procedures - avoid hidden trade barriers
 - timetables will vary between nations
- APEC - Christchurch, 15 July 1996, 18 trade ministers. Australia has a strong commitment
 - Mr Renato Ruggiero, director general of World Trade Organisation told them APEC has a key responsibility to help trade liberalisation measures converge with multilateral initiatives.