STUDY QUESTIONS AND ANSWERS

NB. Questions in the same colour coding are essentially similar in content

Describe the evolution of trade theory from mercantilism to new trade theories.

Mercantilism

Between 1600 and 1800 most of western Europe pursued a policy of mercantilism. What was mercantilism? Belief that exports should exceed imports. Bullionism – the belief that the economic health of a nation was measured by the amount of precious metals (gold and silver) it possessed. Colonialism – colonies were viewed as sources of raw materials. Heavy government control of trade, with the goals of trade being the goals of governments.

Classical Trade Theories

Absolute Advantage

Producing a good with fewer inputs (capital, labour, land, raw materials, etc.) per unit of output than other countries. If input prices are the same in two countries, the country with an absolute advantage in a good will have a lower unit cost of production for that good. Adam Smith, The Wealth of Nations, 1776A: a country should produce and export products in which it has an absolute advantage. A country should import products in which it has an absolute disadvantage. What if a country has an absolute advantage in everything? How can it possibly produce enough of everything for the entire world? A country's inputs are limited in supply. What if a country has an absolute disadvantage in everything? How can it earn income to buy anything if it's not producing anything?

Comparative Advantage

Producing a good at a lower opportunity cost than another country. Inputs used in the production of one good aren't available for the production of other goods. When a country produces a good, what does it give up in foregone production of other goods? David Ricardo, The Principles of Political Economy and Taxation, 1817A country should produce and export products in which it has a comparative advantage. A country should import products in which it has an comparative disadvantage. Even a country at an absolute disadvantage in everything will have a comparative advantage in at least one good. Sub-Saharan Africa: comparative advantage in many agricultural products. Each country specializes in the production and export of what it does relatively well. Prices of goods and inputs in a free-market economy will adjust in order to lead to this outcome. Countries rely on imports to meet consumer demands for goods in which they don't have a comparative advantage. A country can achieve consumption levels beyond what it could achieve on its own. Government policy can alter free-market outcomes (import tariffs, import quotas, export subsidies, etc.)

Factor Proportions Trade Theory

A country that is relatively abundant in a factor of production should export goods that use a lot of that factor in the production process, and import other goods. Example: a country with a lot of labor should export labor-intensive goods. Relative = compared to other countries. Why? If a factor is relatively abundant, it will be relatively cheap, and a country will be more globally competitive in products that use a lot of that factor.

New Trade Theory

Economies of Scale

Internal economies of scale: A company's average cost of production per unit declines as its production increases.

External economies of scale: A company's average cost of production per unit declines as production within its industry increases. Critical mass of firms exchanging ideas and with workers moving among firms.

Strategic Trade Theory

Trade can permit companies to realize economies of scale in production. But exploiting economies of scale takes a country's resources (capital, labour, etc.) away from other companies and industries, thus abandoned product ranges. Companies in other countries expand globally to realize economies of scale and fill abandoned product ranges.

Porter's Diamond
Innovation drives and sustains a country's global competitiveness. Comparative advantage is created by technological change, not inherited from a country's natural endowments. Four components of global competitiveness: Factor conditions, Demand conditions, Related and supporting industries and Firm strategy, structure and rivalry.

Compare and contrast the classical and new trade theories

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Compared to Classical trade theories, the New trade theories are better able to explain the rationale for trade. Discuss.

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Explain in detail the following observations or lessons from international trade theory:

- The main support for free trade arises because free trade can raise aggregate economic efficiency.
- Trade theory shows that some people will suffer losses in free trade.
- A country may benefit from free trade even if it is less efficient than all other countries in every industry.
- A domestic firm may lose out in international competition even if it is the lowest-cost producer in the world.
- Protection may be beneficial for a country. Although protection can be beneficial, the case for free trade remains strong.

b) Describe administrative barriers that may be used by countries as a means of protection.

Administrative protectionism occurs when rules and regulations make importing certain goods more difficult than they otherwise would have been thus reducing imports by putting their costs up. Administrative barriers become more significant as free trade organisations reduce tariffs, quotas and subsidies. Examples are:

- **Customs procedures - bureaucracy etc**
- **Technical regulations, standards, etc. -** for example for the purpose of consumer protection, health protection, protection of the environment, etc
- **Veterinary and phytosanitary measures -** barriers based on health and safety regulations
- **Restrictions on access to primary products** - for example in the form of export levies (taxes) that drive up prices artificially or special export prices that are higher than the price of the same primary products for use in national processing industries
- **Insufficient protection of intellectual property rights -** both with respect to the scope of protection and with respect to the possibilities of legal protection. This includes, for instance, protection of patents, copyrights, trademarks and geographical indications of origin
- **Barriers to trade in services -** for example in the form of discriminatory conditions
- **Restrictions on access to investment -** for example through national participation requirements or restrictions on access to repatriation of profits
- **Unfair application of state aid and other forms of subsidies**

Using Zimbabwe as an example, give a detailed description of the rationale / reasons for trade.

- Different factor endowments - some economies are rich in natural resources while others have relatively little. Trade enables economies to specialise in the export of some resources and earn revenue to pay for imports of other goods.
- Lower prices - one of the principal gains from trade is lower prices. The goods and services that consumers want are often available internationally cheaper than they would be domestically. The lower prices may arise as a result of the different factor endowments countries have. Comparative advantage helps to explain these lower prices.
- Increased welfare - specialisation and trade allow countries to gain a higher level of consumption than they would do domestically, e.g. consume beyond their PPC.
- To gain economies of scale - with trade a country can get access to a larger market, and can therefore produce on a larger scale at a lower average cost. The process of specialisation within trade will often help countries to become increasingly skilled at production and therefore gain further economies of scale.
- Diversity of choice -through trade a country can provide a greater variety of goods and services therefore more choice to domestic consumers.
- Increased competition -global competition will encourage domestic firms to innovate, improve productivity and improve their products. This will benefit consumers through lower prices.
- Trade may be an 'engine for growth' - increased trade may encourage economic growth and drive further improvements in living standards, for instance improving the standards of living for millions of Chinese families.
- Availability of foreign exchange - by trading, countries can acquire foreign exchange. This is particularly important for countries like Ghana, North Korea and Cuba whose currencies are not convertible on international markets. The only way they can pay for imports is to export goods and be paid in foreign exchange. This can then, in turn, be used to purchase imports.

Justify why, despite the arguments for free trade, most governments' trade policies are a blend of free trade and protectionism.

Discuss the arguments in favour of trade protectionism and the justifications given by most Governments for installing barriers to free trade.

- the protection of domestic jobs,
- national security,
- protection of infant industries,
- the maintenance of health, safety and environmental standards,
- anti-dumping and unfair competition,
- a means of overcoming a balance of payments deficit and
- a source of government revenue.

Governments use the following arguments to justify protectionism:

- To safeguard domestic employment - protectionist policies reduce the level of imports and increase aggregate demand [AD = C + I + G + (X-M)], resulting in a higher level of national output and employment.
- To protect strategic industries - a particular product or industry might be of strategic importance to a country, e.g. agriculture or coal or defence, and protectionism may be justified on the grounds that it is keeping alive an industry which plays a vital part in the security of the economy.
- To safeguard infant industries - The new industries need some protection from the power of already established competitors to be able to grow and achieve economies of scale.
- To prevent dumping - which is where economies sell goods in overseas markets at a price below the cost of production. Domestic consumers pay more than those buying overseas. Such low prices are part of a policy to destroy rivals in export markets.
- To correct balance of payments disequilibrium - as imports are discouraged, and exports encouraged, the balance of payments improves.
- Source of government revenue - where protectionism takes the form of a tariff, this will also raise revenue for the government, like any other tax.
- To prevent labour exploitation in developing economies - preventing import of goods produced by exploiting cheap labour in developing countries will prevent this labour exploitation. However, it might also reduce export income and job opportunities for some of the poorest economies in the world.
- To enable a developing country to diversify - Many developing countries are heavily dependent on exports of primary commodities. This can leave them very exposed to changes in international commodity prices. If they want to diversify and develop new export revenue streams, they may need to protect these new industries from full exposure to international competition for a while.

Describe in detail how the Zimbabwean Government employs the following trade policy tools:

- Bureaucratic barriers / Red-Tape Barriers
- Export Subsidies
- Export Taxes
- Government Procurement Policies
- Import Quotas
- Import Tariffs
- Phytosanitary and Safety Standards
- Health and Safety Standards
- Voluntary Export Restraints (VERs)
- Voluntary Import Expansions (VIEs)

"The World Food Summit in 1996 declared that trade is a key element in securing both availability of and access to food. However, analysts argue that, in reality, international agricultural trade has yielded a mixture of positive and negative impacts on food security." Discuss this argument under the following points:

- Industrialized countries are the biggest exporters and importers of most raw agricultural commodity products.
- The ability of corporate monopolies and cartels to influence world market prices:
- Subsidisation of production in industrial countries:
- Industrialized countries produce the bulk of global food and agricultural commodities but only export a small proportion of their production.
- Food and agricultural products have a low price-elasticity of demand

Imports and exports of developed and developing countries

The theory of comparative advantage would thus predict that the industrialised countries should produce and export processed and manufactured goods. Raw materials including agricultural products would therefore be imported. However, industrialised countries are the major exporters of most traded agricultural products. Industrialised countries dominate exports of wheat, coarse grains, soybeans, meat and dairy products. Industrial countries are also the major importers of agricultural products, with the exception of wheat and coarse grains.

Developing countries therefore import staples and export other agricultural products. Overall, industrialised countries dominate international trade in food, and they account for a greater percentage of exports than the theory of comparative advantage would predict. One reason for this is that most developed countries protect their agricultural industries. More detail on this will be presented later, in the discussion on the World Trade Organisation (WTO) and the EU's Common Agricultural Policy (CAP).

International agricultural trade thus does not work as the theory predicts it should, and there are a number of reasons for this.

- *The ability to influence world market prices:*

  World prices should reflect the balance of world demand and supply. However, there are a number of barriers to this. For some products, individual countries have such a large number of buyers or sellers that they can have a disproportionate effect on world market prices. This is related to tendencies towards monopolisation or "cartelisation" of branches of agriculture. While consumers should benefit from cheaper imports, they may stand to lose in the long run if trade liberalisation gives more power to monopolies.

  This refers to the influence of corporate hegemony – the "unmentioned agenda" of the ownership, control and concentration of the food and agricultural industry. This concentration of ownership and control leads to distortions in the structure and price mechanism of the world market. An important aspect of this is "planned scarcity" to stabilise food prices at the highest possible level over a prolonged period, thus allowing multinationals to accrue the largest profits possible.

- *Subsidisation of production in industrial countries:*

While it is assumed food commodities will be sold on world markets at the price of production, industrial countries subsidise production to undermine this.

The result of subsidised oversupply is to drag the world market price below the costs of even the most efficient producers. Government policies and resource transfers to producers gives industrialised countries the "competitive advantage". This means that developing country producers are unable to compete regardless of their efficiency. Therefore, available resources to provide support to producers become critical in determining whether a country will be a net exporter or a net importer of agricultural products.

- *International trade in agriculture is problematic in terms of pricing.*

Exports make up only a **small proportion of most food and agricultural commodities,** as discussed above. Countries usually produce first for their domestic markets and then export what is left. Thus, in years of shortage they will export less than normal, and in years of surplus they will export more than normal. If there is a variation of 5% from the norm year to year in a market where only 10% of the product is exported, this can result in a 50% increase or decrease in export volumes from year to year.

Since food and agricultural products have a **low price elasticity of demand**, prices will be highly volatile. This means that a small drop in the volume being traded can result in a rapid increase in the price, and that a small rise in volumes traded can result in a rapid drop in the price.

Industrialised countries dominate international trade in food, and they account for a greater percentage of exports than the theory of comparative advantage would predict. International agricultural trade thus does not work as the theory predicts it should. Explain the reasons for this phenomenon.

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Explain the contradiction between the Theory and Reality of Free Trade with regards to global food and agricultural commodity trade.

Free trade is based on the principle of supply and demand. Accordingly, a demand for a commodity is apparently best met through the mechanism of the free market not controlled by government intervention.

However, the demand itself is always qualified when dealing with the market, since the market only responds to "effective demand", i.e. the ability to pay for the commodity at prevailing prices. This 'effective demand' excludes most of the world's population that lacks a "market-based entitlement" and is unable to purchase food as a commodity.

Indeed, the market system is more likely to remove food from areas where the needs for it are greatest, since "effective demand" comes from those able to pay for the food, and not those unable to pay. Therefore, using current economic mechanisms, trade fails to distribute food to where it is really needed. Since the market is based on ownership rights, legal exchanges and so on, "the law stands between food availability and food entitlement".

From a production point of view, theoretical comparative advantage and incentives for higher production are fairly meaningless when the conditions for increased production are not present, and the resources necessary for production are inaccessible.

International trade in food may end up only benefiting those with access to productive resources at scale, and those who are in the market to purchase food. Therefore, trade liberalisation may – and does – result in greater power to larger producers including multinational corporations, at the expense of small and resource-poor producers and consumers.

Food security requires the sustainable use of productive resources, because unsustainable use means that production will decline in the long term. From an ecological perspective, sustainable agriculture rests on the preservation of the productive capacity of natural systems, and the minimisation of non-renewable resources.

However, there is a growing contradiction between trade and sustainable resource use. It is increasingly difficult to meet the requirements of sustainable agriculture the further physically removed food production and consumption are from one another. This is because to retain high production levels with minimal use of non-renewable resources, agriculture must be based on optimal use of locally available resources. Large-scale production based on regional specialisation and long distance transport undermines this possibility.

There are many consequences of international trade in food as it happens in practice. It has an influence on both exports and imports. Since "effective demand" dictates what should be produced, production is skewed towards the requirements of those with resources.

Simply put, producers in developing countries are more likely to produce cash crops for export to lucrative markets in industrialised countries (or even domestically) than produce staples. Government subsidisation of producers in the industrialised countries reduces the world price. This has a negative effect on producers in the countries without subsidies, since developing countries have to compete against subsidised products. At the same time, subsidised exports from industrialised countries results in the dumping of surpluses in developing countries, mainly to the long-term detriment of local primary as well as secondary (processing) production.

There has been a strong move within mass-based peasant and small farmer movements as well as the global civic society in general to remove agriculture from new rounds of WTO negotiations.
a) Explain the reasons for this call for a new paradigm shift
b) Outline the demands of this anti-corporate (perhaps anti-WTO) movement calling for alternative globalization

There is a strong move within global civil society to remove agriculture from the WTO negotiations. This is a position being adopted by mass-based peasant and small farmer movements around the globe, spearheaded by Via Campesina. Amongst progressive organisations in civil society, there is a strong disagreement with the aims of a new round of trade negotiations. Given the history and outcomes of previous rounds, where inequality and marginalisation for the majority have increased, there is a strong drive for an alternative form of globalisation where democratic, bottom-up and participatory agreements are reached between people around the world.

As it stands, the "consensus' system of decision-making in the WTO operates to prevent democratic decisions based on 'one country-one vote" or population size criteria. It was deliberately constructed to ensure that the Quad – the US, Canada, the EU and Japan — must agree before major decisions can be taken. This calls into question the argument in favour of a fair rules-based approach, which also fails to acknowledge that unilateralism by the powerful continues despite the rules, with the strongest countries ignoring the rules when these do not favour them.
The fundamental imbalance of power, and the shaping of the rules by the most powerful countries cannot be changed within the existing framework.

Far from the return of the law of the jungle if a new round is not forthcoming, a number of democratically developed alternatives exist. Regarding trade, and without underplaying the problems of GATT itself, one of the basic proposals is to revert to the GATT approach of facilitating rather than forcing international trade.

Another proposal is to use other international agreements, that have been arrived at more inclusively, to deal with specific areas (such as environment, women's rights or food security) on their own terms. Trade, as it relates to each of these areas, would then be discussed as a subordinate component of these areas rather than as the overarching imperative. Since trade under capitalism is fundamentally based on competition between nations and peoples, it should not serve as the overarching basis for international agreements. Rather, agreements that stress co-operation and mutual interest should take precedence.

More broadly, alternatives are perceived to be separate from the corporate-driven agenda and processes of the WTO and other existing multilateral agreements. The alternative is necessarily based on a decentralisation of decision-making, and the recognition of the need to maintain and enrich diversity. It also recognises the multiplicity of knowledges that cannot simply be reduced to one knowledge system perceived to be the most economically efficient.

It is important to note from these demands that the opposition is not so much against international negotiations and agreements in principle. Rather, they are against the inclusion of some key aspects in trade negotiations, and in favour of an overarching framework for any international conventions or agreements based on democracy and justice. It is a misrepresentation to consider the current global civil society movement as "anti-globalisation". Rather it is opposed to the particular form of corporate-led globalisation based on neo-liberal hegemony.

The aim of a significant section of civil society is to radically limit the power of the WTO, reducing it "to simply another institution in a pluralistic world trading system with multiple systems of governance". This aligns with the approaches of diversity, decentralisation and democratisation. Others see the "chaos" of the previous system apparently so feared by Minister Erwin as an indicator of diversity and necessary flexibility in global governance.

This opens up a whole arena of discussion and practice on alternative political forms. Consequently, one of the five pillars of the "Right to Food" campaign, led by the Food International Agrarian Network (FIAN), is "a broader debate on the need to develop an understanding of democracy which includes economic and social rights". This indicates that the issue of food security cannot be separated from the broader issues of democracy and political power.

In response to the move by industrialised country governments to push for a new round at the WTO, economists linked to the global anti-corporate movement called the Association for the Taxation of Financial Transactions for the Aid of Citizens (Attac) put out an appeal to the WTO to define five points, in place of the points of Singapore:

- maintenance and development of public services in essential sectors like water, education, health;
- definition of limits on genetically modified organisms, which have not been proven safe to health and the environment;
- an end to patents on plants, animals, micro-organisms and genes;
- proclamation of water and genetic patrimony as common assets of mankind;
- modification of intellectual rights on drugs to favour poor countries

From this alternative list we can see that food, health and the environment are key concerns. All of these are interlinked when considering food security, since access to productive resources, the nutritional value of food and the ability of people to physically absorb the nutrients provided by the food need to be considered holistically when talking about food security. There are reams of suggestions from around the world supporting these and other basic demands. Another international network of organisations argues that "WTO Agreements must not apply to issues critical to human or planetary welfare, such as food and water, basic social services, health and safety, and animal protection". The fear is that including these social rights and needs in trade agreements opens the space for further corporate control over the basic necessities of life.

The argument from resource poor producers around the world to remove agriculture from the WTO negotiations is primarily based on the reality of increasing control of corporations over food production and trade. This control consequently undermines local production both by cheaper imports of poor quality subsidised food and the reorientation of production away from meeting local food needs and towards cash crops for export. At the core of this alternative position is the concept of food sovereignty, which has been defined quite simply as "the supremacy of food production and consumption over trade and economic policies".

The basic demands, therefore, are:

- No new round of trade negotiations, and a proper review of the influence of the previous agreements;
- The protection of basic social rights and needs, and their permanent exclusion from trade negotiations;
- The exclusion of production sectors relating to basic needs from the realm of trade negotiations, including food and fibre production;
- The prioritisation of international agreements dealing with environment, health, development, human rights, safety, indigenous people's rights, food security, women's rights, workers' rights and animal welfare over trade agreements;
- Use of the precautionary principle when introducing new processes and agreements;
- The raising of special and differential treatment in favour of developing countries to a principle for all agreements;
- The deconcentration, decentralisation and democratisation of institutional power and decision-making.

"International agricultural trade has yielded much less benefit than it has potential for. Each successive GATT or WTO round of talks has practically treated agriculture as an exception to GATT or WTO rules. The WTO Agreement on Agriculture concluded during the Uruguay Round was not ambitious enough and has failed in its goal of a fair and a market-oriented system." Explain the major distortions in international trade of agricultural products that deny a level playing field to farmers from developing countries?

- First, it's the subsidies given by OECD countries to their farmers which could add up to an estimated one billion dollar a day. Such subsidies cannot be matched by the poorer countries, with the result that their farmers cannot compete globally. The Doha Round has to ensure that these subsidies are non-trade distorting and are substantially reduced.
- Secondly, high tariffs hinder developing countries from exporting their surplus produce. Tariffs on the import of agricultural commodities into OECD countries average about 14%, compared to tariffs on industrial goods which average only 3%. The tariff levels on agricultural products have to be reduced to about the same level as for manufactured products.

- Third, tariff escalations (where tariffs increase on processed products with the degree of processing) ensure that developing countries are unable to export processed and more value-added goods. On average, tariffs on processed products are 2 to 3 times higher than on unprocessed commodities. All tariff escalations should be addressed in a manner so as to ensure that developing countries share more of the value added of their produce.
- Fourth, tariffs are not the whole story. Agricultural exports to OECD countries face several kinds of non-tariff barriers as well. Some studies indicate that non-tariff protection is double that of tariffs. Furthermore, the standards applied by some OECD members for imports into their countries are much more difficult to meet than the international ones. As standards have been gradually becoming more onerous to all trading partners, they have become particularly difficult to meet for countries with less advanced food systems.
- Fifth, there is the undisciplined bilateral food aid especially at times of low prices. Many donors buy food in their own countries and dump it in developing countries which prevent farmers in those countries from earning enough from their agricultural products.
- Finally, there are no binding disciplines on restricting exports or giving huge subsidies to convert food crops to biofuels even at the time of food crisis. The potentially large detrimental effect on international food security calls for reform in these areas.

While the Doha Round will be a step forward to correct some of these distortions, it may not fully achieve a reduction in the current applied level of domestic support or improve the objective of market access. This is because the cuts in trade distorting subsidies being negotiated are not in the actual applied levels but the bound levels which are much higher than the current levels. In the case of tariffs too, the tentative agreement to cut them by an average of 54 per cent for developed countries would not apply across board. They could be much lower for many important products of export interest to developing countries which would nullify any additional market access. Furthermore, for most other issues such as non-tariff barriers, restricting exports from developed countries and diverting food crops with the help of subsidies for industrial usage such as biofuels even at the time of food crises, there seems to be no solution in sight.

Finally, more emphasis has to be placed on achieving long term goals rather than merely reacting to emergencies. UN's Food and Agriculture Organization has the objective of improving agricultural productivity. Its budget is a fraction of that of the World Food Programme, whose main mission is emergency aid. If a lasting solution is to be found, the global community has to adopt a long-term outlook on agriculture, and more resources have to be provided for achieving this.

Explain the rationale for economic integration and differentiate the different degrees of economic integration:

- ***Preferential Trade Agreement (PTA)***
- ***Free Trade Area (FTA)***
- ***Customs Union***
- ***Common Market***
- ***Economic Union***
- ***Monetary Union***

For a variety of reasons, it often makes sense for nations to coordinate their economic policies. Coordination can generate benefits that are not possible otherwise. A clear example of this is shown in the discussion of trade wars among large countries. There it is shown that if countries cooperate and set zero tariffs against each other, then both countries are likely to benefit relative to the case when both countries attempt to secure short-term advantages by setting optimal tariffs. This is just one advantage of cooperation. Benefits may also accrue to countries who liberalize labor and capital movements across borders, who coordinate fiscal policies and resource allocation towards agriculture and other sectors and who coordinate their monetary policies.
Any type of arrangement in which countries agree to coordinate their trade, fiscal, and/or monetary policies is referred to as economic integration.

Obviously, there are many different degrees of integration.
Preferential Trade Agreement (PTA)
A preferential trade agreement is perhaps the weakest form of economic integration. In a PTA countries would offer tariff reductions, though perhaps not eliminations, to a set of partner countries in some product categories. Higher tariffs, perhaps non-discriminatory tariffs, would remain in all remaining product categories.

This type of trade agreement is not allowed among WTO members who are obligated to grant most-favored nation status to all other WTO members. Under the most-favored nation (MFN) rule countries agree not to discriminate against other WTO member countries. Thus, if a country's low tariff on bicycle imports, for example, is 5%, then it must charge 5% on imports from all other WTO members. Discrimination or preferential treatment for some countries is not allowed. The country is free to charge a higher tariff on imports from non-WTO members, however. In 1998 the US proposed legislation to eliminate tariffs on imports from the nations in sub-Sahara Africa. This action represents a unilateral preferential trade agreement since tariffs would be reduced in one direction but not the other. [Note: a PTA is also used, more generally, to describe all types of economic integration since they all incorporate some degree of "preferred" treatment.]

Free Trade Area (FTA)

A free trade area occurs when a group of countries agree to eliminate tariffs between themselves, but maintain their own external tariff on imports from the rest of the world. The North American Free Trade Area is an example of a FTA. When the NAFTA is fully implemented, tariffs of automobile imports between the US and Mexico will be zero. However, Mexico may continue to set a different tariff than the US on auto imports from non-NAFTA countries. Because of the different external tariffs, FTAs generally develop elaborate "rules of origin". These rules are designed to prevent goods from being imported into the FTA member country with the lowest tariff and then transshipped to the country with higher tariffs. Of the thousands of pages of text that made up the NAFTA, most of them described rules of origin.

Customs Union

A customs union occurs when a group of countries agree to eliminate tariffs between themselves and set a common external tariff on imports from the rest of the world. The European Union represents such an arrangement. A customs union avoids the problem of developing complicated rules of origin, but introduces the problem of policy coordination. With a customs union, all member countries must be able to agree on tariff rates across many different import industries.

Common Market

A common market establishes free trade in goods and services, sets common external tariffs among members and also allows for the free mobility of capital and labor across countries. The European Union was established as a common market by the Treaty of Rome in 1957, although it took a long time for the transition to take place. Today, EU citizens have a common passport, can work in any EU member country and can invest throughout the union without restriction.

Economic Union

An economic union typically will maintain free trade in goods and services, set common external tariffs among members, allow the free mobility of capital and labor, and will also relegate some fiscal spending responsibilities to a supra-national agency. The European Union's Common Agriculture Policy (CAP) is an example of a type of fiscal coordination indicative of an economic union.

Monetary Union

Monetary union establishes a common currency among a group of countries. This involves the formation of a central monetary authority which will determine monetary policy for the entire group. The Maastricht treaty signed by EU members in 1991 proposed the implementation of a single European currency (the Euro) by 1999. The degree of monetary union that will arise remains uncertain in 1998.

Perhaps the best example of an economic and monetary union is the United States. Each US state has its own government which sets policies and laws for its own residents. However, each state cedes control, to some extent, over foreign policy, agricultural policy, welfare policy, and monetary policy to the federal government. Goods, services, labor and capital can all move freely, without restrictions among the US states and the Nations sets a common external trade policy.

Discuss the roles of Trade Multilateralism and Trade Regionalism

In the post World War II period many nations have pursued the objective of trade liberalization. One device used to achieve this was the GATT and its successor, the WTO. Although the GATT began with less than 50 member countries, the WTO claimed 132 members by 1997. Since GATT and WTO agreements commit all member nations to reduce trade barriers simultaneously, it is sometimes referred to as a *multilateral* approach to trade liberalization.

An alternative method used many countries to achieve trade liberalization includes the formation of preferential trade arrangements, free trade areas, customs unions and common markets. Since many of these agreements involve geographically contiguous countries, these methods are sometimes referred to as a *regional* approach to trade liberalization.

The key question of interest concerning the formation of preferential trade arrangements is whether these arrangements are a good thing. If so, under what conditions. If not, why not.

One reason supporters of free trade may support regional trade arrangements is because they are seen to represent movements towards free trade. Indeed, Section 24 of the original GATT allows signatory countries to form free trade agreements and customs unions despite the fact that preferential agreements violate the principle of non-discrimination. When a free trade area or customs union is formed between two or more WTO member countries, they agree to lower their tariffs to zero between each other but will maintain their tariffs against other WTO countries. Thus, the free trade area represents discriminatory policies. Presumably the reason these agreements are tolerated within the WTO is because they represent significant commitments to free trade, which is another fundamental goal of the WTO.

However, there is also some concern among economists that regional trade agreements may make it more difficult, rather than easier, to achieve the ultimate objective of global free trade.

The fear is that although regional trade agreements will liberalize trade among its member countries, the arrangements may also increase incentives to raise protectionist trade barriers against countries outside the area. The logic here is that the larger the regional trade area, relative to the size of the world market, the larger will be that region's market power in trade. The more market power, the higher would be the region's optimal tariffs and export taxes. Thus, the regional approach to trade liberalization could lead to the formation of large "trade blocs" which trade freely among members but choke off trade with the rest of the world. For this reason some economists have argued that the multilateral approach to trade liberalization, represented by the trade liberalization agreements in successive WTO rounds, is more likely to achieve global free trade than the regional or preferential approach.

There is much that has been written on this subject recently. Here we have merely scratched the surface. For a good overview of the issues from an historical perspective see Bhagwati (1992) and Irwin (1994). For a review of the recent literature regarding the merits of regionalism versus multilateralism see Winters (1996).

Explain in detail the economic argument regarding Trade Diversion and Trade Creation. Give reference to the determination of Aggregate Welfare Effects of a Free Trade Area.

These concepts are used to distinguish between the effects of free trade area or customs union formation that may be beneficial from those that are detrimental. As mentioned above, preferential trade arrangements are often supported because they represent a movement in the direction of free trade. If free trade is economically the most efficient policy, it would seem to follow that any movement towards free trade should be beneficial in terms of economic efficiency. It turns out that this conclusion is wrong. Even if free trade is most efficient, it is not true that a step in that direction necessarily raises economic efficiency. Whether a preferential trade arrangement raises a country's welfare and raises economic efficiency depends on the extent to which the arrangement causes trade diversion versus trade creation.

Trade Diversion

In general, trade diversion means that a free trade area diverts trade, away from a more efficient supplier outside the FTA, towards a less efficient supplier within the FTA. In some cases, trade diversion will reduce a country's national welfare but, in some cases, national welfare could improve despite the trade diversion.

Trade Creation

In general, trade creation means that a free trade area creates trade that would not have existed otherwise. As a result, supply occurs from a more efficient producer of the product. In all cases trade creation will raise a country's national welfare.

Aggregate Welfare Effects of a Free Trade Area

The analysis considers the welfare effects upon participants in one particular market in one country that is entering into a free trade area. However, when a free trade area is formed, presumably many markets and multiple countries are affected, not just one. Thus, to analyse the aggregate effects of a FTA, one would need to sum up the effects across markets and across countries.

(NB. Refer to the handouts for a more detailed diagrammatic illustration of trade creation and trade diversion).

Discuss the evolution of international trade agreements:

- **From Mercantilism to Multilateral Trade Liberalization**
- **The Deterioration of Multilateral Trade**
- **The Rise of Multilateral Regionalism**
- **The Modern Approach**

Ever since Adam Smith extolled the virtues of the division of labor and David Ricardo explained the comparative advantage of trading with other nations, the modern world has become increasingly more economically integrated. International trade has expanded, and trade agreements have increased in complexity. While the trend over the last few hundred years has been toward greater openness and liberalized trade, the path has not always been straight. Since the inauguration of the General Agreement on Tariffs and Trade (GATT), there has been a dual trend of increasing multilateral trade agreements, those between three or more nations, as well as more local, regional trade arrangements.

From Mercantilism to Multilateral Trade Liberalization

The doctrine of mercantilism dominated the trade policies of the major European powers for most of the sixteenth century through to the end of the 18th century. The key objective of trade, according to the mercantilists, was to obtain a "favorable" balance of trade, by which the value of one's exports should exceed the value of one's imports.

The mercantilist trade policy discouraged trade agreements between nations. That's because governments assisted local industry through the use of tariffs and quotas on imports, as well as the prohibition of exporting tools, capital equipment, skilled labor or anything that might help foreign nations compete with the domestic production of manufactured goods.

One of the best examples of a mercantilist trade policy during this time was the British Navigation Act of 1651. Foreign ships were prohibited from taking part in coastal trade in England, and all imports from continental Europe were required to be carried by either British ships or ships that were registered in the country where the goods were produced.

The whole doctrine of mercantilism would come under attack through the writings of both Adam Smith and David Ricardo, both of whom stressed the desirability of imports and stated that exports were just the necessary cost of acquiring them. Their theories gained increasing influence and helped to ignite a trend towards more liberalized trade — a trend that would be led by Great Britain.

In 1823, the Reciprocity of Duties Act was passed, which greatly aided the British carry trade and made permissible the reciprocal removal of import duties under bilateral trade agreements with other nations. In 1846, the Corn Laws, which had levied restrictions on grain imports, were repealed, and by 1850, most protectionist policies on British imports had been dropped. Further, the Cobden-Chevalier Treaty between Britain and France enacted significant reciprocal tariff reductions. It also included a most favored nation clause (MFN), a non-discriminatory policy that requires countries to treat all other countries the same when it comes to trade. This treaty helped spark a number of MFN treaties throughout the rest of Europe, initiating the growth of multilateral trade liberalization, or free trade.

The Deterioration of Multilateral Trade

The trend toward more liberalized multilateral trading would soon begin to slow by the late 19th century with the world economy falling into a severe depression in 1873. Lasting until 1877, the depression served to increase pressure for greater domestic protection and dampen any previous momentum to access foreign markets.

Italy would institute a moderate set of tariffs in 1878 with more severe tariffs to follow in 1887. In 1879, Germany would revert to more protectionist policies with its "iron and rye" tariff, and France would follow with its Méline tariff of 1892. Only Great Britain, out of all the major Western European powers, maintained its adherence to free-trade policies.

As for the U.S., the country never took part in the trade liberalization that had been sweeping across Europe during the first half of the 19th century. But during the latter half of the century, protectionism significantly increased with the raising of duties during the Civil War and then the ultra-protectionist McKinley Tariff Act of 1890.

All of these protectionist measures, however, were mild compared to the earlier mercantilist period and in spite of the anti-free trade environment, including a number of isolated trade wars, international trade flows continued to grow. But if international trade continued to expand despite numerous hurdles, World War I would prove to be fatal for the trade liberalization that had begun in the early 19th century.

The rise of nationalist ideologies and dismal economic conditions following the war served to disrupt world trade and dismantle the trading networks that had characterized the previous century. The new wave of protectionist trade barriers moved the newly formed League of Nations to organize the First World Economic Conference in 1927 in order to outline a multilateral trade agreement. Yet, the agreement would have little effect as the onset of the Great Depression initiated a new wave of protectionism. The economic insecurity and extreme nationalism of the period created the conditions for the outbreak of World War II.

The rise of Multilateral Regionalism

With the U.S. and Britain emerging from World War II as the two great economic superpowers, the two countries felt the need to engineer a plan for a more cooperative and open international system. The International Monetary Fund (IMF), World Bank, and International Trade Organization (ITO) arose out of the 1944 Bretton Woods Agreement. While the IMF and World Bank would play pivotal roles in the new international framework, the ITO failed to materialize, and its plan to oversee the development of a non-preferential multilateral trading order would be taken up by the GATT, established in 1947.

While the GATT was designed to encourage the reduction of tariffs among member nations, and thereby provide a foundation for the expansion of multilateral trade, the period that followed saw increasing waves of more regional trade agreements. In less than five years after the GATT was established, Europe would begin a program of regional economic integration through the creation of the European Coal and Steel Community in 1951, which would eventually evolve into what we know today as the European Union (EU).

Serving to spark numerous other regional trade agreements in Africa, the Caribbean, Central and South America, Europe's regionalism also helped push the GATT agenda forward as other countries looked for further tariff reductions to compete with the preferential trade that European partnership engendered. Thus, regionalism did not necessarily grow at the expense of multilateralism, but in conjunction with it. The push for regionalism was likely due to a growing need for countries to go beyond the GATT provisions, and at a much quicker pace.

Following the breakup of the Soviet Union, the EU pushed to form trade agreements with some Central and Eastern European nations, and in the mid-1990s, it established some bilateral trade agreements with Middle Eastern countries. The U.S. also pursued its own trade negotiations, forming an agreement with Israel in 1985, as well as the trilateral North American Free Trade Agreement (NAFTA) with Mexico and Canada in the early 1990s. Many other significant regional agreements also took off in South America, Africa and Asia.

In 1995, the World Trade Organization (WTO) succeeded the GATT as the global supervisor of world trade liberalization, following the Uruguay Round of trade negotiations. Whereas the focus of GATT had been primarily reserved for goods, the WTO went much further by including policies on services, intellectual property and investment. The WTO had over 145 members by the early 21st century, with China joining in 2001. (

While the WTO seeks to extend the multilateral trade initiatives of the GATT, recent trade negotiations appear to be ushering in a stage of "multilateralizing regionalism." The Transatlantic Trade and Investment Partnership (TTIP), the Transpacific Partnership (TPP), and the Regional Cooperation in Asia and the Pacific (RCEP) comprise a significant portion of global GDP and world trade, suggesting that regionalism may be evolving into a broader, more multilateral framework.

The modern approach:

The history of international trade may look like a struggle between protectionism and free trade, but the modern context is currently allowing both types of policies to grow in tandem. Indeed, the choice between free trade and protectionism may be a false choice. Advanced nations are realizing that economic growth and stability depend on a strategic mix of trade policies.