

ECONOMICS

Outline the main advantages and disadvantages of free trade. Analyse recent developments in global free trade negotiations and discuss Australia's role in promoting free trade.

Trade is the exchange of goods and services between various countries, with an objective of seeking and promoting economic growth. The concept of Free trade revolves around the reduction of protectionist policies and has been increasingly prevalent in major and developing economies. Free trade occurs as a result of the increasing social and economic integration of countries (known as Globalisation). The condition under which free trade can occur is that there must be no barriers to trade (e.g. tariffs, quotas and subsidies) enforced by the government. There are a variety of arguments which promote free trade, whilst there are some arguments substantiating the need for protection.

The basis of the argument promoting free trade is the theory of comparative advantage which states that each nation will benefit from trade by specialising in production of goods that make the most efficient use of resources due to lower opportunity costs. This will result in a competitive advantage for that particular country.

There are many advantages to free trade, primarily related to efficient production of goods and reallocation of resources. The efficient production of goods leads to a general increase of the production of goods as economies of scale is achieved due to reallocation of resources due to comparative advantage.

Also, due to the reallocation of resources, production efficiencies are observed. This promotes greater competition within the international market and hence provides incentives for domestic producers to innovate and lower their costs.

Under the "capitalist" economy it is said that free trade results in improved consumer sovereignty (consumers determine what goods are produced). This results in a greater variety and quantity of products, and may also improve the quality of goods produced. The benefits to consumers are seen due to the lack of protection placed on imports, which allows goods to be purchased at the lowest prices. Also, the foreign exchange Australia gains from exports can be used to purchase imports.

Increased employment can result due to the reallocation of resources and increases in export industries due to structural changes in the economy. However, these benefits may only be observed in the long term, in the short term unemployment may increase (discussed later).

Improvements in the standard of living are observed as efficiency is improved and the reallocations of results result in low opportunity costs. This results in an increase in income levels, and consumers demand more products as they will be purchasing goods at a lower costs. This results in increased savings levels and in turn is a driver for investment opportunities.

The disadvantages of free trade mainly are to do with the reasons promoting protection, and are due to economic and political arguments. The main disadvantage of free trade is known as 'dumping'. Dumping is the act of importers selling goods in the domestic market at a price lower than the production cost for the purposes of reducing excess stock, gaining market share and eliminating local producers. This results in negative implications for domestic producers as they are not able to match the price levels of the importers, hence they lose market share and damage profits. This is bad for consumers as it results in less competition and potentially higher prices due to monopoly.

Another economic disadvantage to free trade on the domestic market is known as the "Infant Industry argument" which states that newly established firms in the domestic market will not be able

to achieve economies of scale due to high costs and as a result will not be able to compete with larger, well established foreign competitors.

A non economic (socio-political) disadvantage to free trade is the impact it will have on domestic employment levels. The cheaper imports result in a reduced market share for the domestic producers. Naturally, consumers prefer the cheaper import; this takes away market share from domestic producers and harms profits, resulting in increased unemployment.

A less sustained argument for reducing free trade is defence and “self sufficiency” which states that a country should be able to meet its own needs and wants in the event of war. This is valid in instances such as defence and transport, but generally not substantiated.

These advantages and disadvantages are considered during the feasibility, negotiation and implementation processes of free trade agreements such as ASEAN, Australia’s bilateral agreements and the World Trade Organisation agreements.

The ASEAN (Association of South East Asian nations) is a multilateral agreement (involving more than 2 countries) to promote free trade and improve international competitiveness, mainly within developing nations.¹ Member countries of ASEAN include Singapore, Malaysia, Indonesia, Thailand and Vietnam. The aim of ASEAN is to remove protection by eliminating tariffs between member nations and to attract foreign investment.

After the Asian Financial crisis of 1997, the benefits of free trade within member nations were realised. An upward trend was seen for two successive years, with exports out of the region amounting \$US408 Billion². However, as a result of the Global Financial Crisis beginning in 2008 and the downswing in the business cycle export earnings have declined, primarily as the two largest export markets (for ASEAN), the USA and EU are in recession.

The impact of this economic downturn has mixed effects on member nations. As most member nations are developing nations, they have shown resilience as they have high levels of domestic consumption and government intervention.

Singapore is the only country in the ASEAN group which has forecasted recession for 2009, as the drop in exports cannot be countered with domestic consumption due to its small population.

A recent development in the ASEAN trade agreement is the inclusion of Australia in the free trade agreement. On 27th February 2009, Trade Minister, Simon Crean had signed a free trade agreement with ASEAN nations. The deal involves trade currently estimated to be valued at \$A80bn per year³. The signing of this agreement signalled a reverse from an increasing trend to increasing protection as a result of the 2008-2009 financial crisis. The signing of the agreement will potentially encourage domestic producers to innovate and become more competitive. As the SE Asia region has been less affected by the crisis, it could potentially encourage foreign investment in Australia. However, negative aspects of globalisation and free trade have been realised in the recent announcement of Pacific Brands to partake in outsourcing⁴, as domestic producers were less competitive. The jobs were sent to the ASEAN region, as they were able to produce more efficiently. As such, the signing of this agreement can have short term costs, but will have long term benefits.

Another form of free trade agreements are bilateral agreements. A bilateral free trade agreement is a free trade agreement involving only two countries with the aim of lowering protection on trade. Recently, bilateral agreements have become more common as compared to multilateral

¹ Cambridge HSC Economics

² ASEAN – Overview of Free Trade. <http://www.aseansec.org/12021.htm> Accessed 3/3/09

³ <http://www.abc.net.au/pm/content/2008/s2503649.htm> Accessed 7/3/09

⁴ FTA Challenges Global Forces <http://www.theaustralian.news.com.au/story/0,25197,25117219-5013871,00.html> Accessed 7/3/09

agreements. Multilateral agreements such as the European Union and NAFTA have not been successful in their aim of improving international competitiveness. There have been negative implications due to the ratification of the NAFTA agreement, such as increased unemployment rates, reduction in real income and inefficient production in the agricultural industry.

The advantage of partaking in bilateral agreements is that countries may choose to enter the agreement at their own will, in order to make the most gains from it. Theoretically a global, multilateral free trade agreement may appear to be more beneficial, but issues such as dumping can have a greater impact on the domestic producers as compared to bilateral agreements. Consequentially, Australia's stance on multilateral agreements had changed, with the Howard Government (1996-2007) promoting the ratification and implementation of bilateral agreements. Free trade agreements implemented by the Howard Government include the Australia- United States free trade agreement. The signing of bilateral free trade agreements is a trend continued by the Rudd government (2007- present); agreements with Malaysia and China are under negotiation.

The introduction of the Australia-United States free trade agreement in 2004 saw the abolishment of barriers to trade for Australian and American exporters. It also implemented the elimination in tariffs of the export of manufactured goods. Tariffs were removed on approximately 66% of agricultural goods such as beef, dairy and avocados.

This was advantageous to Australia as it has a comparative advantage in the production of agricultural goods as compared to the United States.

The implementation of the free trade agreement with the United States of America has had implications for the Australian economy, some of which are beneficial. As the United States is one of Australia's major trading partners, accounting for around 7.1% of exports⁶, the elimination of tariffs allows Australian producers to be more competitive in the United States market. Australia would be the larger beneficiary of this agreement as it would allow for improvements in living standards due to increased choice. However, there are environmental consequences and potential job losses in industries that Australia is uncompetitive. Also, the amount of exports will increase relative to imports, hence improving the Current Account Deficit. ⁷ The trade agreement has not only benefited exports of goods, but service areas such as the "open skies" aviation agreement and telecommunications reforms.

Another entity involved in global free trade negotiations is the World Trade Organisation. The main goal of the organisation is to promote free trade and reduce barriers such as tariffs and quotas. The World Trade Organisation is involved in the promotion of multilateral agreements. Theoretically this allows for expansion of trade, however political and social factors diminish the effectiveness of these. Globalisation is one of the key outcomes as a result of its policies.

The reduction of protection has allowed for East Asian economies such as China and South Korea increase their market share in more developed countries as they are more efficient. This, for consumers results in improved standard of living and other advantages (as outlined previously). As the main aim of the World Trade Organisation is to promote global growth, not individual economies and their specific issues, hence there can be consequences on individual economies as they are forced to undergo structural changes.

Australia, as a member of the World Trade Organisation has seen various impacts due to its membership. Australia has been involved in the World Trade Organisation's Doha round negotiations⁸ since 2001 and has been involved in strategies to reduce the level of barriers to trade. As Australia is a primarily resource and agriculturally driven economy, it is the major participant and

⁵ United States Trade Representative

⁶ Department of Foreign Affairs and Trade (Australia) www.dfat.gov.au Accessed 4/3/09

⁷ Predicted by the Centre for International Economics, Canberra (pdf on DFAT website)

⁸ www.dfat.gov.au Accessed 7/3/09

promoter of reducing tariffs in agricultural exports. This is because Australia is internationally competitive in the production of agricultural goods and would seek to gain the most from free trade.

The role of the World Trade Organisation can be debated. It has not made any significant gains since the 2001 Doha round. Also, the larger and more developed member nations have a significant input into decisions made regarding global free trade agreements, and as such may implement policies which are designed to benefit those nations. Although multilateral agreements involve free trade between many countries, they can cause problems such as unemployment in countries which cannot compete and produce as efficiently. As a result bilateral agreements are more favourable. The role of Australia specifically has focused on these rather than multilateral agreements.

Australia has had an increasingly prevalent role in the promotion of free trade and is demonstrated through its membership of the WTO. Until recently, Australia has had high levels of protection. Free trade has been promoted through unilaterally reduced tariffs. Tariff levels in Australia were relatively high (approx 30%) until the election of the Whitlam government which had reduced tariff levels by about 25%.⁹ This strategy of reducing protection has been continued by successive governments (in particular the Hawke and Howard government). However some industries such as the car industry and textiles industry continue to have high levels of protection.

The increased exposure to free trade promotes structural changes (a change in the way goods are produced) and efficiency as resources are reallocated. For example industries such as electronics have discontinued their presence in Australia and moved overseas, as it was not efficient to produce in Australia. As a result, Australia has reallocated its resources to industries in which we can produce more efficiently, such as mining and agricultural goods. It has promoted economic growth since the reduction of tariff levels, with annual GDP growth averaging around 2-3%, which was above the OECD average. However, as of March 2009, as a result of the financial crisis the GDP growth has fallen to -0.5%.¹⁰

As a result of the financial crisis, the amount of protectionist policies has been slightly increased, and initiatives to support domestic producers have been introduced. However, the government still promotes the implementation of free trade agreements as international competitiveness is promoted by trade.

The results of these changes to protectionist policies have had effects on firms, individuals and governments. A reduction in tariff levels can see domestic producers closing in the short term (as seen in electronics) as they won't be able to compete. However, as stated in the advantages of free trade, they will improve efficiency and be more competitive. The absence of protection provides firms with incentive to innovate and invest.

The impact on the capital and financial account is a reflection of the removal of protectionist policies. Export growth has averaged 8% per year, compared to an average of 5.5%.¹¹ However, this has also resulted in more imports, resulting in an increased Current Account Deficit. However, generally the impact of reduced protection has been positive, resulting in increased foreign investment in Australia and increased Australian investment overseas.

The effect on individuals has been mixed. Production efficiencies from the reallocation of resources have resulted in job losses in the TCF and automotive industry. As these forms of employment are generally low skilled, future employment opportunities were restricted. However, individuals as consumers have benefited from lower costs and other advantages of free trade (outlined previously).

⁹ http://www.pc.gov.au/data/assets/pdf_file/0017/31544/sub047.pdf. Accessed 4/3/09

¹⁰ Australia on the Brink of Recession, <http://www.theaustralian.news.com.au/business/story/0,28124,25137687-36418,00.html> Accessed 4/3/09

¹¹ Leading Edge Education- Australia's Place In the Global Economy

The impact on the government is that it has reduced revenue from tariffs. Also, the government agreement with the World Trade Organisation prevents support in inefficient industries such as the automotive industry and the security of the domestic workforce.

Hence, it can be seen that the arguments for free trade influence the implementation of free trade agreements. These agreements have implications on economic growth and development, and are considered when partaking in agreements. Australia has had an increasingly important role in the promotion of free trade.

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