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Trade and Globalization

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Trade and Globalization

Introduction

The tremendous growth of international trade over the past several decades has been both a primary cause and effect of globalization. The volume of world trade increased twenty-seven fold from \$296 billion in 1950 to \$8 trillion in 2005.¹ Although international trade experienced a contraction of 12.2 percent in 2009—the steepest decline since World War II—trade is again on the upswing.²

As a result of international trade, consumers around the world enjoy a broader selection of products than they would if they only had access to domestically made products. Also, in response to the ever-growing flow of goods, services and capital, a whole host of U.S. government agencies and international institutions have been established to help manage these rapidly-developing trends.

Although increased international trade has spurred tremendous economic growth across the globe—raising incomes, creating jobs, reducing prices, and increasing workers' earning power—trade can also bring about economic, political, and social disruption.

Since the global economy is so interconnected, when large economies suffer recessions, the effects are felt around the world. When trade decreases, jobs and businesses are lost. In the same way that globalization can be a boon for international trade; it can also have devastating effects.

The following Issue in Depth is designed to help you understand some of the fundamental economic principles behind international trade, familiarize you with some of the technical terms, and offer some insight into a few of the controversies surrounding international trade policy both in the United States and abroad.



¹ Source: http://www.wto.org/english/news_e/pres07_e/pr502_e.htm

² Source: http://www.wto.org/english/news_e/pres10_e/pr598_e.htm



[A Snapshot of U.S. Trade](#)

In the year 2010, Americans sold \$1.84 trillion in [goods and services](#) to corporations and consumers in other countries. Goods and services sold to other countries are called exports. In 2010, Americans also bought roughly \$2.34 trillion in goods and services from other countries.³ Purchases from other countries are called imports. The sum of U.S. exports and imports, \$4.18 trillion, represents the total of U.S. international trade for 2010.

Each day, in fact, Americans buy and sell more foreign goods and services than are produced annually in more than 80 countries around the world. That means that U.S. companies, and the average American citizen, are avid consumers—we buy a lot from other countries. We also produce a great deal to sell to other countries; the U.S. is one of the top five exporters worldwide.⁴ Below we take a closer look at some of the data and trends that describe the recent trade performance of the United States and the rest of the world.

Figure 1: Exports for 2010⁵

³ Source: <http://www.census.gov/foreign-trade/statistics/historical/gands.txt>

⁴ Source: <https://www.cia.gov/library/publications/the-world-factbook/rankorder/2078rank.html?countryName=United%20States&countryCode=US®ionCode=na#US>

⁵ Source: <http://www-958.ibm.com/software/data/cognos/manyeyes/visualizations/6e82fbe450e711e09c33000255111976/>



Visualizations : Top Trading Partners for Year End 2010

Uploaded by: Eileen Dwyer
 Description:

Created at: Mar 17 2011

Legend

Click to select,
 Ctrl-Click: multiple
 Shift-Click: range

Canada	249
China	91.9
Mexico	163
Japan	60.5
Federal Republic of ...	48.2
United Kingdom	48.5
Korea, South	38.8
France	27
Taiwan	26
Brazil	35.4
Netherlands	35
India	19.2
Singapore	29.1
Venezuela	10.7
Saudi Arabia	11.6

Exports (YTD). Total=894

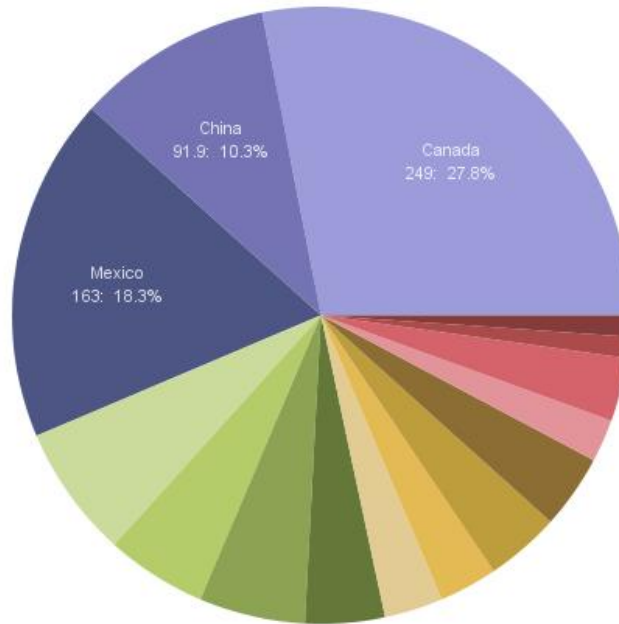


Figure 2: Imports for 2010⁶

⁶ Source: <http://www-958.ibm.com/software/data/cognos/manyeyes/visualizations/6e82fbe450e711e09c33000255111976/>



Visualizations : Top Trading Partners for Year End 2010

Uploaded by: Eileen Dwyer
 Description:

Created at: Mar 17 2011

Legend

Click to select,
 Ctrl-Click: multiple
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Canada	276
China	365
Mexico	230
Japan	120
Federal Republic of ...	82.7
United Kingdom	49.8
Korea, South	48.9
France	38.6
Taiwan	35.9
Brazil	23.9
Netherlands	19
India	29.5
Singapore	17.5
Venezuela	32.8
Saudi Arabia	31.4

Imports (YTD). Total=1,401

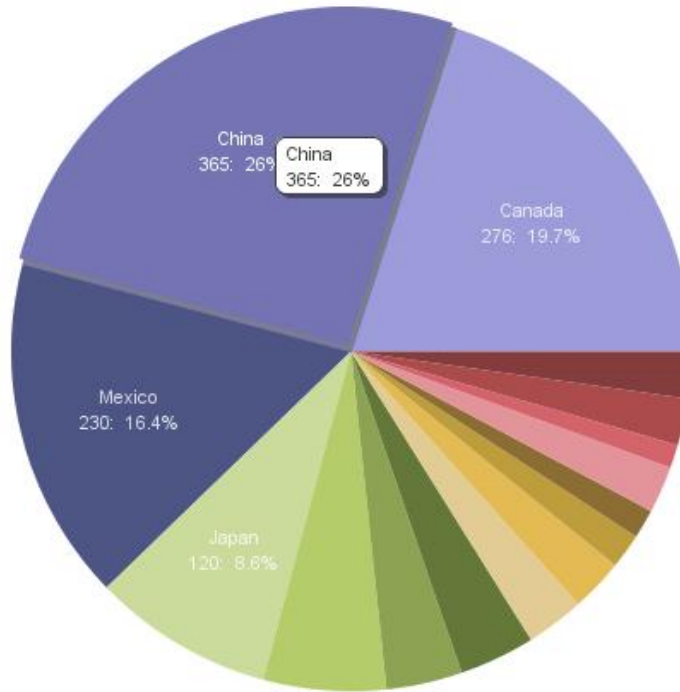




Figure 3: Top Trading Partners for Year End 2010⁷

Visualizations : Top Trading Partners for Year End 2010

Uploaded by: Eileen Dwyer
Description:

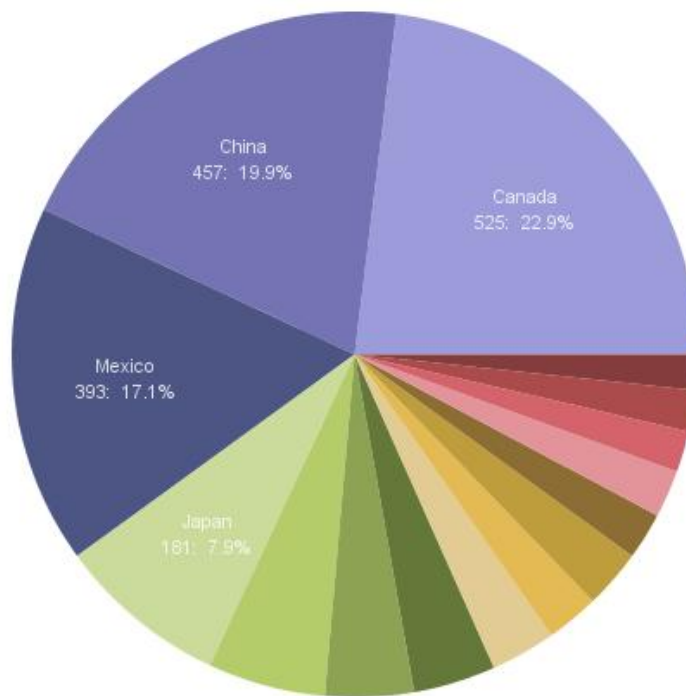
Created at: Mar 17 2011

Legend

Click to select,
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Shift-Click: range

Canada	525
China	457
Mexico	393
Japan	181
Federal Republic of G...	131
United Kingdom	98.3
Korea, South	87.7
France	65.6
Taiwan	61.9
Brazil	59.3
Netherlands	54
India	48.8
Singapore	46.6
Venezuela	43.4
Saudi Arabia	43

Total Trade (YTD). Total=2,296



Let's start by comparing Figures 1 and 2. These two pie charts illustrate our trading relationships with our largest trading partners. Looking at Figure 1, we can see that Canada is our largest buyer—in relation to other countries buying our goods and services, they consume the most. After Canada, Mexico is our next largest buyer. So, geographically, our neighbors are buying the majority of our exports.

Looking at Figure 2, the breakdown of US imports for 2010, you can see that the vast majority of our imports are bought from China. This probably comes as no surprise given the ubiquitous 'Made in China' label. After China, we also purchase a great deal from Mexico and Canada.

In contrasting these two pie charts, one can observe that—for the majority of our trade relationships—there is no one-for-one trading occurring. Over time this leads to trade imbalances, where one country buys much more than it sells to another

⁷ Source: <http://www-958.ibm.com/software/data/cognos/manyeyes/visualizations/6e82fbe450e711e09c33000255111976/>



country. The U.S. currently has a trade imbalance with China. In 2010, the U.S. trade imbalance with China was valued at approximately 270 million⁸.

The fact that the U.S. economy is so large (it contains so many products and consumers) leads some to wonder whether the United States actually needs to trade with other countries at all. This Issue in Depth addresses the questions of:

- Why do nations choose to trade with other nations?
- How do they decide which goods to export, which to import—and with whom?
- What impact does trade have on the economies of other nations?
- How do governments cope with these impacts?
- How has trade changed over the past few decades?
- What concerns do Americans have about international trade?

The United States will be the focus of the discussion, but many of the key ideas apply equally well to other countries.

To gain a deeper understanding of the fundamentals of international trade, a [short primer on the economic theory behind imports and exports follows this section](#). Concepts such as comparative advantage, exchange rates, trade specialization, and trade restrictions are explained in detail in this section.

Readers who feel well-grounded in these concepts may wish to [skip to the section on trade liberalization](#), which explores efforts to promote international trade and some of the ongoing controversies about trade policy.

⁸ Source: <http://www.census.gov/foreign-trade/balance/c5700.html>



Primer 1: The Economics of International Trade

International Trade in History

Before we begin a discussion about why nations trade, it would be helpful to take a moment to consider the character and evolution of trade. It is important to keep in mind, first, that although we frequently talk about trade "between nations," the great majority of international transactions today actually take place between private individuals and private enterprises based in different countries. Governments sometimes sell things to each other, or to individuals or corporations in other countries, but these comprise only a small percentage of world trade.

Trade is not a modern invention. International trade today is not qualitatively different from the exchange of goods and services that people have been conducting for thousands of years.

Before the widespread adoption of currency, people exchanged goods and some services through bartering—trading a certain quantity of one good or service for another good or service with the same estimated value. With the emergence of money, the exchange of goods and services became more efficient.

Centuries before the [Industrial Revolution](#), in which we saw the advent of powered ships, trains, and gas-powered vehicles, merchants braved the hazards of land and sea travel to bring their goods to buyers in distant lands. But Industrial Era transport and communications made the exchange of large quantities of goods at great distances a safer, and thus increasingly common part of economic life.

Developments in transportation and communication revolutionized economic exchange, not only increasing its volume but also widening its geographical range. As trade expanded in geographic scope, diversity, and quantity, the channels of trade also became more complex. The earliest transactions were conducted by individuals in face-to-face encounters. Many domestic transactions, and some international ones, still follow that pattern. Over time, however, the producers and the buyers of goods and services became more remote from each other.

A wide variety of market actors—individuals and firms—emerged to play supportive roles in commercial transactions. These "middlemen"—[wholesalers](#), providers of transportation services, providers of market information, and others—facilitate transactions that would be too complex, distant, time-consuming, or large for individuals to conduct face-to-face in an efficient manner.

The Rise of the Middleman

It would have been very difficult, for example, for an English blacksmith to sell hand-made metal tools directly to craftsmen in France. But an English or French firm that specialized in the purchase and sale of tools could serve as an intermediary between the blacksmith and the craftsman, enabling both to engage indirectly in international trade without having to meet their counterpart face-to-face, making the exchange possibly more efficient and convenient.

International trade today differs from the economic exchanges of the past in its speed, volume, geographic reach, complexity, and diversity. Yet its fundamental character—the exchange of goods and services for other goods and services or for money—remains unchanged.



Why do Nations Trade?

That brings us to the question of why nations trade. Nations clearly trade a lot, but it is not quite obvious why they do so. Put differently, why do private individuals and firms take the trouble of conducting business with people who live far away, speak different languages, and operate under different legal and economic systems, when they can trade with fellow citizens without having to overcome any of those obstacles?

To answer these questions, it is helpful to think about exports and imports separately.

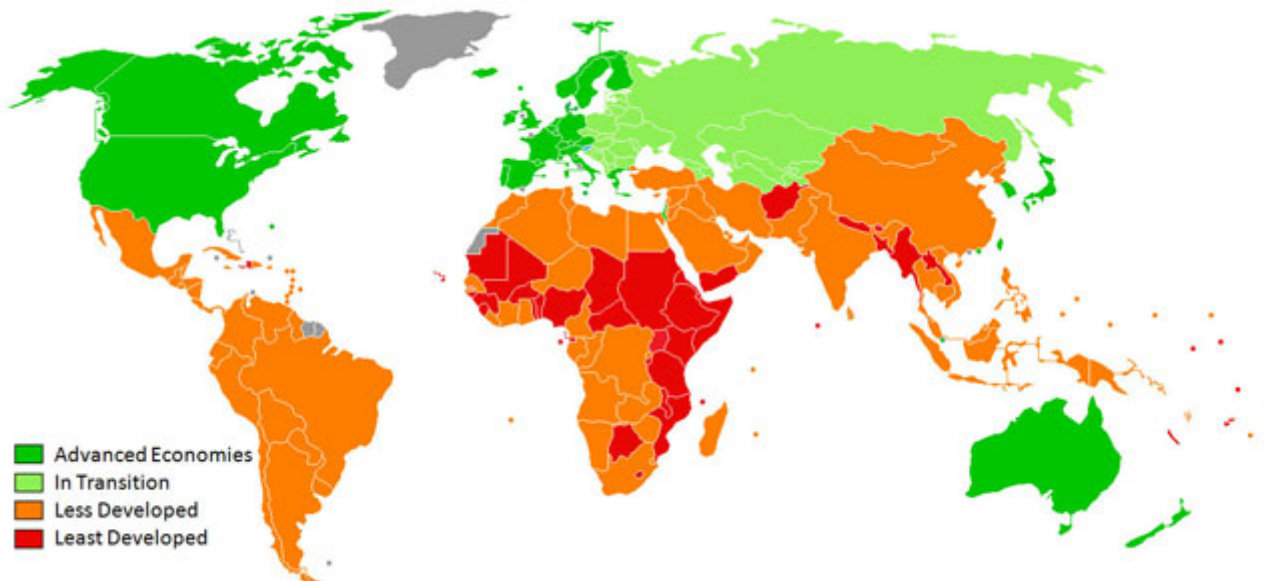


Why Do Nations Export?

Exports are easier to explain than imports. At least since the beginning of the industrial era almost three centuries ago, countries have exported goods and services because:

1. Individuals and firms have been able to produce more goods and services than can be consumed at home. This prompted a search for foreign opportunities to sell the "excess" production;
2. Individuals and firms have been able to sell goods or services to other countries at prices higher than the prices they can obtain domestically.

In today's global economy, exporting serves somewhat different purposes for developing and industrial countries.



9

Developing Countries

Although the economies of [developing countries](#) are typically not as productive as the economies of industrial countries, developing countries nonetheless produce some goods and services in amounts they are unable to use or consume at home. This is called a production surplus.

For example, some developing countries produce vast quantities of agricultural products, like cocoa in Cote d'Ivoire and coffee in Latin America, which their own populations are not large enough to consume. Other developing countries produce quantities of industrially valuable minerals, like oil or iron ore, that their own economies are too small or not yet industrialized enough to use.

⁹ Source: http://www.worldhealthimaging.org/images/Developing_world_map.jpg



For many developing countries, exports also serve the purpose of earning foreign currency with which they can buy essential imports—foreign products that they are not able to manufacture, mine, or grow at home. Developing countries, in other words, sell exports, in part, so that they can import. Exporting goods and services can also further advance developing nations' domestic economies.

Interconnectivity through global trade can be problematic, though. For example, up until 2008, Japan had a booming export business with the United States. When American consumers became unable to buy Japanese products, Japanese companies lost a large portion of their consumer base.¹⁰

Industrial Countries

Exports are also more than just an outlet for "excess" production for industrial countries. Because their economies are more diverse, industrial countries tend to:

1. Export a much wider variety of products than do developing countries; and
2. Export a larger proportion of their total production of goods and services.

Export sales help maintain high employment levels for the work force of the United States and many other industrial countries.

In 2006, the United States had an estimated six million people holding jobs that were either directly or indirectly involved in the production of goods or services sold to other countries.¹¹ For the United States and other countries with highly productive, diverse economies, exports have become essential to economic stability and prosperity.

As the economic crisis started in 2007, many countries tightened their (economic) belts. Productive countries saw a decline in export sales and a heavy loss of jobs. According to some estimates, U.S. exports decreased by 15 percent in 2009. Additionally, American goods are more expensive because the U.S. dollar has risen against the Euro and other currencies (see next section).¹² All of this means fewer jobs for the American workforce.

Figures 6 and 7 illustrate the composition of world trade in goods and services in 2008.¹³

¹⁰ Source: <http://www.rieti.go.jp/en/papers/contribution/wakasugi/02.html>

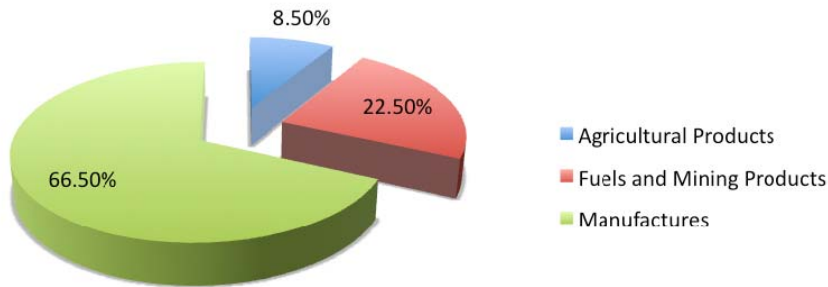
¹¹ http://www.ita.doc.gov/td/industry/OTEA/jobs/Reports/2006/jobs_by_state_totals.html

¹² <http://www.npr.org/templates/story/story.php?storyId=102733452>

¹³ Source: http://www.wto.org/english/res_e/statis_e/its2009_e/its09_toc_e.htm

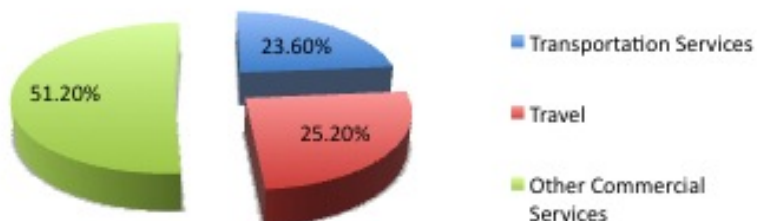


Figure 6: World Merchandise Exports by Major Product Group, 2008



Manufactures include iron and steel, chemicals, office and telecom equipment, automobiles, textiles, and clothing.

Figure 7: World Exports of Commercial Services by Category, 2008



Currencies and Exchange Rates

To understand why countries export, let's start by looking at the idea of *exchange rates*. Have you ever thought of the idea how there is no universal currency? Instead, different countries have different currencies (also called 'monetary units') and each currency has its own value. This value is not set, but fluctuates based on a variety of factors.

The exchange rate is determined by the ratio of sum A—an amount of domestic currency compared to a sum of B—an equivalent amount of foreign currency. For example, the ratio of the domestic prices for a basket of goods and the foreign prices for the same basket of goods is a good approximation for the exchange rate of the domestic currency and foreign



currency.

Another example: in 2009 one U.S. dollar had the buying power of roughly 31.5 rubles in Russia. Imagine that in the United States, a can of soda from a vending machine costs one U.S. dollar. In Russia, if you are thirsty and want to purchase a can of soda from a vending machine, how much should you have? Since we are comparing the same thing from the basket of goods both countries have, you should have the equivalent of one U.S. dollar in Russia's currency, or 31.5 rubles.

Thus a single ruble is worth about \$0.03 U.S.—that is, 3 cents. The exchange rate of dollars to rubles is .03.



Sometimes, however, the exchange rate doesn't tell the whole story. For instance, a U.S. dollar in 2009 was worth about 34 Thai baht. Still, a Big Mac (which cost about \$3.57 in the United States) could be purchased for as little as 60 to 80 baht in Thailand, the equivalent of \$1.75 to \$2.34.¹⁴ Why would the same Big Mac have a different price in Thailand?

This difference in price is due to the fact that exchange rates reflect both the local market conditions and the calculations of currency traders about the overall prospects of an economy. For example, when currency traders predict that a nation is going to undergo a bout of inflation in the near future, making their currency less valuable, they are likely to sell their holdings of that currency, just like any other [commodity](#).

Because exchange rates are comprised of these two factors, economists sometimes measure the value of a currency according to the Purchasing Power Parity (PPP) Index. The PPP rate of a currency can be calculated by comparing the cost of a basket of goods in one country to the cost of that same basket of goods in another country.

[The Economist](#) magazine publishes an annual "[Big Mac Index](#)", which measures the price of a Big Mac hamburger sold at the McDonald's restaurants around the world, and then compares those prices to the exchange rate of other currencies. Many observers find that their index proves to be a surprisingly accurate predictor of exchange rate changes.

¹⁴ Source: <http://www.orientexpat.com/thailand/cost-of-living>

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The exchange rate is a key determinant of international trade. When a company in one country wants to import goods from a company in another country, it typically must pay for the exporting either in that country's currency or in the currency of one of the world's major economies. These currencies--the United States dollar, the European euro, the British pound sterling, the Japanese yen, and the Swiss franc--are collectively known as hard currencies. Most countries do not use a hard currency in their domestic economy; you could not use them to buy a Big Mac in Thailand or a soda in Russia. In order to participate in the international economy, however, countries must have some stock of a hard currency.

The Zambian kwacha is rarely used outside of Zambia. So, when Zambia wants to buy goods from the United States, it cannot pay with kwachas. Americans not living in Zambia have no use for kwachas. Rather, when Zambia exports goods it will be paid in dollars, yen, euros, or another hard currency. It can then use these hard currencies to purchase imports from other countries.



Why do Nations Import?

The motivation for a country to *import* goods and services from other countries is perhaps less obvious than its motivation for selling exports (making a profit on goods not consumed by the domestic market). As with exports, the purposes served by imports vary from country to country. Let's explore these various purposes by starting with asking why a country like the United States, with its massive and extraordinarily diverse economy, would need to import anything from other countries.

In fact, there are only a handful of goods or services that the United States absolutely must import from other countries. With a land area spanning several climatic zones, immense natural resources, and a dynamic workforce, the United States is able to produce, mine, or grow almost every item its citizens need to lead reasonably prosperous lives.

Yet no country today, including the United States, can be totally self-sufficient without suffering a high cost. All countries need to—or choose to—import at least some goods and services for the following reasons:

1. Goods or services that are either a. essential to economic well-being or b. highly attractive to consumers but are not available in the domestic market
2. Goods or services that satisfy domestic needs or wants can be produced more inexpensively or efficiently by other countries, and therefore sold at lower prices.

It is helpful to illustrate these points by looking at the case of the United States, precisely because it comes closer to being self-sufficient than any other country for the reasons mentioned above (several climatic zones, resources, able workforce). Coal, copper, iron, silver, and nickel are just a few of the natural resources the United States possesses in large quantities that other countries do not possess.

There are some economically essential goods, such as tungsten and oil, which the United States either does not produce at all or does not produce in sufficient quantities to serve domestic needs at a reasonable price.

The United States cannot meet its oil consumption needs exclusively through domestically produced oil; in 2009 the U.S. consumed roughly 18 billion barrels of oil per day¹⁵. However, the U.S. only produced about five billion barrels of oil per day¹⁶. This means that the U.S. had to import 72 percent of its oil to meet its consumption needs in 2009. Most of these imports come from Saudi Arabia, Mexico, Canada, Nigeria, and Venezuela.

The United States could, in theory, abandon foreign oil imports, but it would be a costly decision because:

1. It is not clear that domestic reserves of oil, both those that are known and those that have yet to be discovered, could satisfy current domestic demand;
2. Even if U.S. oil reserves were adequate, generating the extra oil necessary to fill the gap now filled by imported oil would be extremely costly. Many foreign countries are able to produce oil much more cheaply. Besides, accessing the additional U.S. reserves would require many years of research and development.
3. Other energy sources—for example, coal, nuclear power, or hydro-electric power—could conceivably be substituted for oil imports, but complying with the respective environmental regulations, along with the cost of producing additional energy from these sources, would be very expensive. After all, oil currently satisfies more than 40 percent of America's energy needs (including more than 99 percent of the fuel for cars and trucks) precisely because other

¹⁵ Source: https://www.cia.gov/library/publications/the-world-factbook/rankorder/rawdata_2174.txt

¹⁶ Source: http://www.eia.gov/energyexplained/index.cfm?page=oil_home#tab2



domestic sources of energy are either not sufficiently abundant to cover demand or are significantly more expensive to produce than oil.¹⁷

Of course, energy conservation measures could also reduce the need for oil imports by decreasing the energy consumption of the average American citizen. Energy conservation would be prudent, regardless of which energy supply the United States favors in the future; however, foreign producers would still be able to produce the oil more cheaply, regardless of the level of production. In addition, the scale of energy-saving measures needed to substantially reduce U.S. imports of oil would require dramatic changes in economic activity and lifestyles, and thus far have not been politically viable.

	<p>Electricity produced by hydropower plants built into dams is another example of an essential resource that the United States does not produce in sufficient quantity to meet its consumption needs. The United States imports large quantities of hydropower from Canada.</p>
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The United States will continue to depend upon imports to meet its energy needs into the foreseeable future. This, however, is not the same as saying that the United States has *no* choice but to import oil from other countries. As the preceding discussion suggests, there are alternatives. Unfortunately those alternatives are less economically and politically feasible than simply continuing to import oil from countries endowed with generous petroleum reserves.

The same logic applies to any resource or product whose domestic supply is limited although domestic demand is high. The United States—though not most other countries—can often find ways to increase the production of a commodity, reduce domestic consumption, or identify domestic substitutes. These alternatives often prove more costly than continuing to import from other countries, though.

The United States and other nations choose to import many other products that, unlike oil, are not economically essential, but differ in quality or features from equivalent products made at home. One prominent example is foreign-made cars which, starting in 2007, accounted for more than 50 percent of all cars sold in the United States.¹⁸

Americans do not buy imported foreign cars because foreign manufacturers produce certain kinds of vehicles that American manufacturers do not; U.S. carmakers produce an extraordinary variety of vehicles at a wide range of price levels. Many Americans have demonstrated, through their purchases, that they will opt for Asian and European cars. These imported cars possess a combination of qualities or features that satisfy their preferences more so than vehicles manufactured by U.S. carmakers.

The same holds true for simpler products like wine, cheese, or shoes and so on. All of these and thousands of other items that the United States imports from other countries are available through the domestic market. Some American consumers believe imported versions of these items offer a level of quality that American varieties do not.

¹⁷ Source: <http://www.energy.gov/energysources/oil.htm>

¹⁸ Source: http://www.wto.org/english/res_e/statis_e/its2009_e/its09_toc_e.htm



The United States has almost entirely stopped producing some goods because of foreign competitive efficiency. In other words, firms in other countries are able to produce these goods faster, more cheaply, and of possibly better quality. This is the case with many types of clothing because clothes can be produced at a much lower cost in other countries. Clothes can be manufactured more cheaply in developing countries due to the low cost of labor. Imagine that you are a t-shirt manufacturer. You can have your t-shirts made in a developing country with abundant cheap labor—workers who you only have to pay the equivalent of pennies an hour. This allows you to maintain large profit margins (by not spending so much on paying workers), and to sell your product at a cheaper cost (making consumers happy as well). This practice is a source of controversy that we will discuss later.

The goods that the United States has almost ceased to produce because of foreign competitive efficiency include not only low-tech products, but also some electronic equipment. For example, the United States used to produce VCRs, but it completely abandoned their production because of the superior efficiency of foreign competitors (most notably Japan).

It is worth noting that the country where a good is produced need not be the same as the country where the corporation that manufactures and sells the good is established. Several American clothing companies, such as The Gap, manufacture most of their clothes in developing countries.

Closet Check: Grab a pen and paper and go to your closet. Take out the items that you wear the most and see what percentage is made in other countries. How many items from China? India? How many made in the U.S.?

Trade Specialization

So far we have considered two broad categories of goods and services and identified the reasons why countries like the United States import them. These include:

1. Economically essential goods and services that are either unavailable at home or not available at a reasonable cost;
2. Goods and services from abroad that may be similar in function and price to those available at home, but which differ in quality or features.

A large number of other goods and services imported by the United States and many other countries would probably fit into two additional categories:

1. Goods and services that native companies, farms, and individuals can produce, but which foreign countries can produce more cheaply; and
2. Goods and services that can be produced more cheaply domestically, but which native companies, farms, and individuals have chosen not to produce in favor of producing more sophisticated (and hence more expensive) goods and services.

Many items in both of these categories—indeed, a large share of the total U.S. imports—are parts, semi-finished products, components, and other items that are assembled into finished products in the United States. A quick look at these two categories of imports will help introduce the important principle of international trade specialization, which is the key to understanding not just *why* countries trade, but *how* different countries end up trading the goods and services that they do.



Country-by-country differences in the cost of producing goods and services have a major influence on the direction and content of trade. Production costs are, in turn, influenced by the national endowments of three key production inputs: labor, capital (shorthand for equipment and technology), land and natural resources.

Goods and services that mainly require low-skilled labor can be produced at a lower cost in developing countries, where such labor is abundant and, thus, cheap. (Remember the term 'cheap labor' from before?) Since wage levels and productivity are generally higher in the United States and other industrialized countries, it makes fiscal sense for certain goods and services to be made by workers in those countries where wage levels are lower. Additionally, the cost of transporting the goods from the developing country to the United States should not exceed the difference in the production price of the two countries.

In contrast, equipment and technology tend to be relatively scarce and expensive in developing countries. Goods and services whose production requires larger amounts of capital can be produced more cheaply in countries like the United States, where capital is more abundant and less expensive.

Comparative Advantage and the Mutual Gains from Trade

Countries have a mutual interest in specializing in the production of the goods and services that their unique combination of labor, capital, and land will enable them to produce most efficiently and cheaply. They can then trade goods and services that they are relatively well-equipped to produce for goods and services produced by other countries. Countries seek goods and services from other countries that they may not be able to produce efficiently or do not have the capacity to produce.

One of the most important and somewhat unexpected features of this principle of specialization is that it applies even in cases in which a particular country has an efficiency or cost advantage over other countries in all the products they are both able to manufacture. Economists call this the theory of [comparative advantage](#).

For example, even if U.S. companies could make both bicycles and computers more efficiently and at a lower cost than foreign firms, the theory of comparative advantage tells us that the United States should specialize more in the production of the good—in this case, computers—where its efficiency and cost advantage is greatest.

The implication of the theory of comparative advantage is that all countries will benefit from trading with each other regardless of how well-endowed they are in labor, capital and land, and regardless of how efficiently they can produce any particular good.

The key to securing these mutual gains from trade is for all countries to specialize as much as possible in the production of those products in which their efficiency and cost advantages are greatest. The idea, then, is that countries should devote as much of their national endowments (labor, capital, land) as they can to those things they do best. All countries should specialize in the thing they make the best, and then we can all buy one another's best product.



The Theory of Comparative Advantage

It seems obvious that if one country is better at producing one good and another country is better at producing a different good (assuming both countries demand both goods) that they should trade. What happens if one country is better at producing both goods? Should the two countries still trade? This question brings into play the theory of comparative advantage and [opportunity costs](#).

The everyday choices that we make are, without exception, made at the expense of pursuing one or several other choices. When you decide what to wear, what to eat for dinner, or what to do on Saturday night, you are making a choice that denies you the opportunity to explore other options.

The same holds true for individuals or companies producing goods and services. In economic terms, the amount of the good or service that is sacrificed in order to produce another good or service is known as *opportunity cost*. For example, suppose Switzerland can produce either one pound of cheese or two pounds of chocolate in an hour. If it chooses to produce a pound of cheese in a given hour, it forgoes the opportunity to produce two pounds of chocolate. The two pounds of chocolate, therefore, are the opportunity cost of producing the pound of cheese. They sacrificed two pounds of chocolate to make one pound of cheese.

A country is said to have a comparative advantage in whichever good has the lowest opportunity cost. That is, it has a comparative advantage in whichever good it sacrifices the least to produce. In the example above, Switzerland has a comparative advantage in the production of chocolate. By spending one hour producing two pounds of chocolate, it gives up producing one pound of cheese, whereas, if it spends that hour producing cheese, it gives up two pounds of chocolate.

Thus, the good in which a comparative advantage is held is the good that the country produces most efficiently (for Switzerland, its chocolate). Therefore, if given a choice between producing two goods (or services), a country will make the most efficient use of its resources by producing the good with the lowest opportunity cost, the good for which it holds the comparative advantage. The country can trade with other countries to get the goods it did not produce (Switzerland can buy cheese from someone else).

The concepts of opportunity cost and comparative advantage are tricky and best studied by example: consider a world in which only two countries exist (Italy and China) and only two goods exist (shirts and bicycles). The Chinese are very efficient in producing both goods. They can produce a shirt in one hour and a bicycle in two hours. The Italians, on the other hand, are not very productive at manufacturing either good. It takes them three hours to produce one shirt and five hours to produce one bicycle.

Figure 8:





Number of Hours to Produce One Unit	1	2
Opportunity Cost (of producing one unit)	$\frac{1}{2}$ bicycle	2 shirts

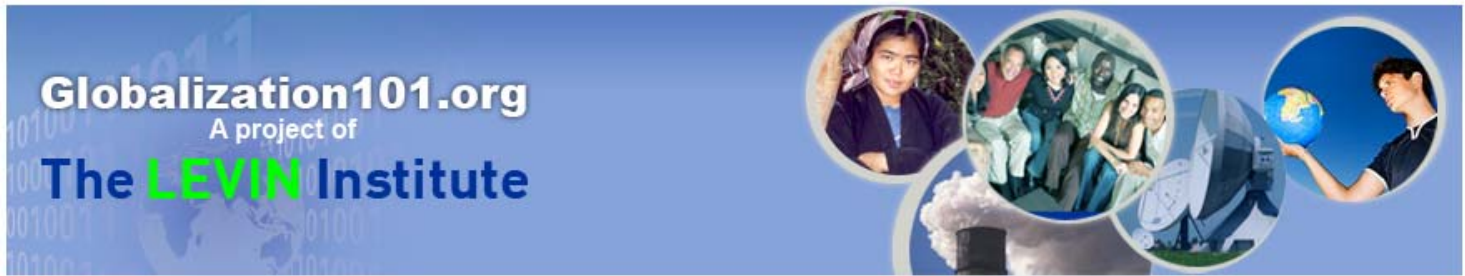
Italy



	SHIRTS	BICYCLES
Number of Hours to Produce One Unit	3	5
Opportunity Cost (of producing one unit)	$\frac{3}{5}$ bicycle	$\frac{5}{3}$ shirts

The Chinese have a comparative advantage in shirt manufacturing, as they have the lowest opportunity cost ($\frac{1}{2}$ bicycle) in that good. Likewise, the Italians have a comparative advantage in bicycle manufacturing as they have the lowest opportunity cost ($\frac{5}{3}$ shirts) in that good. It follows, then, that the Chinese should specialize in the production of shirts and the Italians should specialize in the production of bicycles, as these are the goods that both are most efficient at producing. The two countries should then trade their surplus products for goods that they cannot produce as efficiently.

Comparative advantage not only affects the production decisions of trading nations, but it also affects the prices of the goods involved. After trade, the world market price (the price an international consumer must pay to purchase a good) of both goods will fall between the opportunity costs of both countries. For example, the world price of a bicycle will be between $\frac{5}{3}$ shirt and 2 shirts, thereby decreasing the price the Italians pay for a shirt while allowing the Italians to profit. The Chinese will pay less for a bicycle and the Italians less for a shirt than they would pay if the two countries were manufacturing both goods for themselves.



Comparative Advantage Versus Absolute Advantage

As you can see from the example above, a country can have a comparative advantage in producing a good even if it is absolutely less efficient at producing that good. To understand this more clearly, think of an example of a doctor in private practice:

A young doctor opens her own practice, working by herself, and within a few months has developed a substantial clientele. At first, she was performing all her clerical work—filing, typing, and answering the phone—by herself. With an ever-busier schedule however, she realizes that she could spend more time seeing patients, and thus see a greater number of patients, if she hired an assistant.

As it turns out, the young professional is not only a brilliant doctor, but is also lightning-fast at typing and filing. She is, in fact, better at doing both jobs than the clerical assistant she hires. In other words, she has an [absolute advantage](#) at both tasks: medical diagnosis and clerical work.

Does it make sense then for the doctor and her assistant to share both tasks, each spending part of the day diagnosing patients and doing clerical work? The answer is no. By having the assistant perform all the clerical work, the doctor is able to maximize her specialization and see more patients. The patients are undoubtedly better off too.

In other words, even though the assistant is worse at performing both tasks, an economist would say that he nonetheless has a comparative advantage at clerical work. As you can see, by working together – trading their services – the doctor and the assistant are able to maximize their skills, making both better off.

As these examples show, trade allows countries to specialize in the production of what they do best and make the most efficient use of their resources, thereby decreasing the price of both goods. No matter how inefficiently a country produces every kind of good, it can always be said to have a comparative advantage in at least one of those goods.

That is the theory of comparative and absolute advantage. It helps explain what happens in the real world of international trade, and it offers broad guidance to countries as they decide which goods and services to produce and subsequently export, and which, in turn, to import.

Trade in Theory and Practice

In reality, of course, trade specialization does not work precisely the way the theory of comparative advantage might suggest, for a number of reasons:

- No country specializes exclusively in the production and export of a single product or service.
- All countries produce at least some goods and services that other countries can produce more efficiently.
- A lower income country might, in theory, be able to produce a particular product more efficiently than the United States can but still not be able to identify American buyers or transport the item cheaply to the United States. As a result, U.S. firms continue to manufacture the product.

Generally, countries with a relative abundance of low-skilled labor will tend to specialize in the production and export of items for which low-skilled labor is the predominant cost component. Countries with a relative abundance of capital will tend to specialize in the production and export of items for which capital is the predominant component of cost.



Many American citizens do not fully support specialization and trade. They contend that imports inevitably replace domestically produced goods and services, thereby threatening the jobs of those involved in their production.

Imports can indeed undermine the employment of domestic workers. We will return to this subject a little later. From what you have just read, you can see that imports supply products that are either 1) unavailable in the domestic economy or 2) that domestic enterprises and workers would be better off not making so that they can focus on specialization of another good or service.

Finally, international trade brings several other benefits to the average consumer. Competition from imports can enhance the efficiency and quality of domestically produced goods and services. In addition, competition from imports has historically tended to restrain increases in domestic prices.

Discussion Questions:

- Name a product/business where labor would be the comparative advantage for a poor country.
- Name a product/business where capital would be the comparative advantage for a rich country.
- Name a product/business where natural resources would be the comparative advantage.

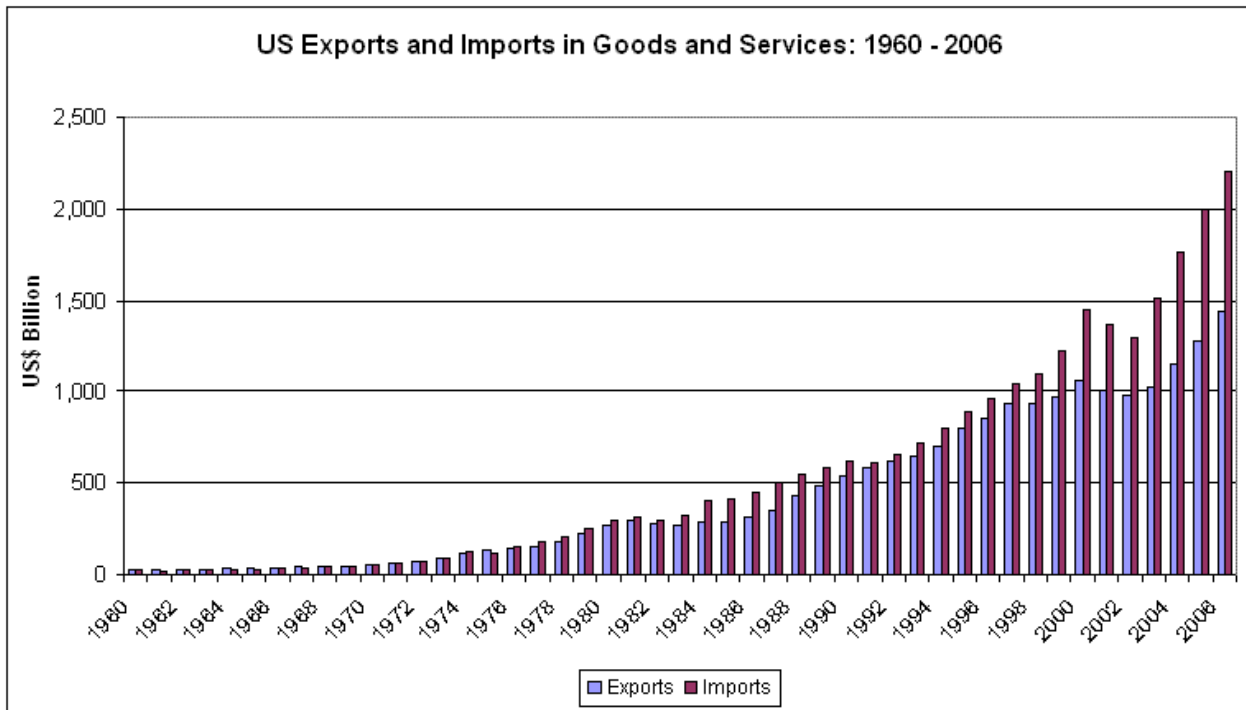


The Trade Balance

The trade balance for any country is the difference between the total values of its exports and imports in a given year. When a country's total annual exports exceed its total annual imports, it is said to have a *trade surplus*.

If a country exports \$10 billion in goods and services and imports \$7 billion in the same year, it will have a trade surplus of \$3 billion. If it exports \$12 billion and imports \$19 billion, it will have a trade deficit of \$7 billion.

The United States is the world's biggest trading nation. Figure 8 (below) depicts the course of U.S. exports and imports over the past half-century, demonstrating quite clearly that, although exports increased from 1995-2000, imports increased more, producing a sizeable trade deficit by the end of the decade.¹⁹

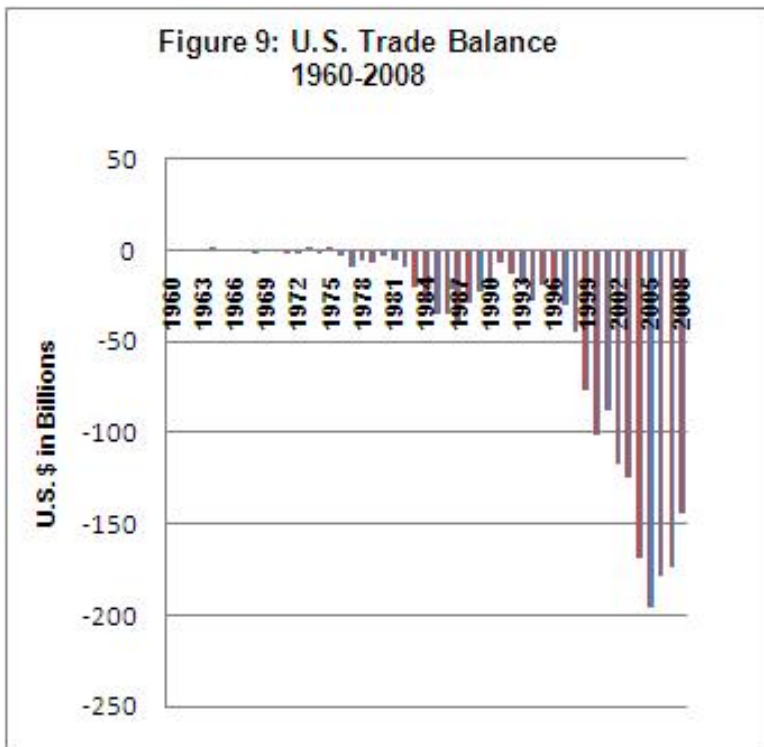


¹⁹ Source: <http://www.globalpolicy.org/soecon/crisis/tradedeficit/tables/trade.htm>



When imports exceed exports, a country has a trade deficit. The United States has recorded history's largest trade deficits. In 2009, the United States measured a trade deficit of \$378.6 billion (\$1.6 trillion in exports minus \$1.9 trillion in imports)²⁰. After recording relatively large trade deficits during the 1980s, U.S. trade deficits declined substantially during the first half of the 1990s. At the end of the twentieth century, however, the deficit began increasing again, and peaked in 2005. It has since slowly been reduced. As of May 2011, the U.S. has a trade deficit of 50.2 billion USD.²¹

Figure 9 (below) focuses on the annual changes in the U.S. trade balance during the past half-century. It illustrates the sharp increase in the U.S. trade deficit between 1980 and 2000 in contrast with the trend of the preceding three decades (1950 to 1980, not shown).²²



[U.S. Trade Data Available Online](#)

The U.S. Census Bureau monitors trends in foreign trade, such as historical data by product category, U.S. trade balance by country, and trade of different products by country.

Significance of the U.S. Trade Deficit

²⁰ Source: U.S. Bureau of Economic Analysis, "U.S. International Transactions: Fourth Quarter and Year 2009," <http://www.bea.gov/newsreleases/international/transactions/transnewsrelease.htm>

²¹ Source: <http://www.tradingeconomics.com/united-states/balance-of-trade>

²² Source: <http://research.stlouisfed.org/fred2/data/BOPBGS.txt>



For decades, economists and citizens in the U.S. and other countries have debated the significance of trade balances. Many argue that it is better for countries to have trade surpluses—to export more than they import—than to have deficits. They believe that trade deficits are harmful for a number of reasons:

1. Trade deficits are often interpreted as a sign of a nation's economic weakness. They are said to reflect an excessive reliance on products made by others, and to result from deficiencies in the home country's economic output. In the eyes of many labor supporters, an excess of imports over exports comes at the expense of domestic production and jobs. Some people argue that the loss of millions of manufacturing jobs in the United States over the past several decades is due to the trade deficit.
2. Trade deficits represent a sacrifice of future growth. Because a nation with a trade deficit is purchasing more than it produces, investment in future growth is being traded for consumption in the present.
3. Large trade deficits create an environment conducive to financial crises that could damage the U.S. economy.

According to this view, when the United States runs a large trade deficit, foreign sellers of goods and services simultaneously accumulate large amounts of U.S. dollars. These dollars cannot be spent inside their own countries, so they need to be invested somewhere. Much of this trade deficit-driven accumulation of dollars is used to purchase American stocks and bonds, pieces of American companies, and other U.S. assets.

U.S. Trade Deficit Review Commission: In order to understand the nature, causes and consequences of the U.S. trade deficit, Congress established the [U.S. Trade Deficit Review Commission](#) in 1998. The commission ultimately could not reach a consensus on the significance of the U.S. trade deficit nor what to do about it. Nonetheless, the Commission's final report, "The U.S. Trade Deficit: Causes, Consequences, and Recommendations for Action," offers valuable background material on the importance of trade to the U.S. economy and on the two main opposing perspectives on the significance of the trade deficit.

The potential for instability arises if foreign investors in U.S. assets begin to worry that a persistent trade deficit is going to make the U.S. dollar less valuable relative to currencies in other countries. If this concern prompts a lot of foreign investors to sell their U.S. assets at the same time (in the hope of reinvesting the proceeds somewhere else), then the value of the U.S. dollar could fall substantially in a short period of time.

Others doubt the importance of these risks, and counter that:

1. Consumers, particularly in the United States, can enjoy a higher living standard than they would if limited to domestically produced goods and services;
2. Trade deficits have rarely sparked financial crises in advanced industrial countries; and
3. Trade deficits can be a sign of economic strength, as imports tend to increase rapidly during times of economic growth when consumers and firms have more money to spend on foreign as well as domestic goods.

This argument is consistent with the experience of the United States during the second half of the 1990s, when a booming economy and rising employment were accompanied by record import levels and trade deficits.

Questions for Discussion:

1. What is the current U.S. trade balance?
2. You have just read arguments for and against sustaining a trade deficit—which do you find more persuasive and why? Does your answer change depending on the country you think about (i.e. would you give one answer for the United States, another for Japan, and another for Peru?).
3. What is the relationship between trade deficits and the potential for financial crises?
4. How can trade deficits have a positive economic effect in a country? Again, does a state's ability to sustain trade deficits depend on the size and/or strength of its economy?



Primer 2: Government Regulation of Trade

Efforts to Manipulate Trade Flows

As we have seen, there are many good arguments for allowing free trade among states. Trade helps economies grow and facilitates the most efficient production of goods and services across the globe. One might think that governments would want to encourage this efficiency and would agree to let trade occur unregulated.

In practice, however, governments often try to manipulate trade in a variety of ways. They do this to achieve a wide array of economic, political, and diplomatic objectives. Government regulation of trade—as well as efforts over the past five decades to minimize that regulation—have had a significant impact on global trade flows, economic growth, and prosperity. For this reason, it is useful to consider the main ways that governments have tended to regulate trade and, more recently, to deregulate it.

Governments have traditionally tried to manage trade flows in two basic ways:

1. By restricting imports; and
2. By encouraging exports.



Import Restrictions

Restrictions on imports generally take two forms: tariffs and quantitative restrictions.

Tariffs are taxes on imported goods upon their entry into a country.

Tariffs, or import taxes, are usually calculated as a percentage of the value of a given imported product. If the United States imposes a 10 percent tariff on imports of Danish ham, for example, then a merchant bringing a \$100 shipment of Danish ham into the United States would be required to pay 10 percent of \$100, or \$10, to the U.S. government.

Tariff fees are collected for most governments by what is known as a "customs" agency—in the American case, the U.S. Customs Service, a division of the U.S. Department of the Treasury.

Tariffs restrict or discourage imports by making imported goods more expensive than domestic goods. If a company importing \$100 in Danish hams into the United States must pay a \$10 tariff at the U.S. border, that company will be likely to increase the price of those hams in the United States, to make up for the cost of the tariff. Consumers can be expected to consume fewer Danish hams if they cost more than domestic hams, even if the Danish hams are thought to be superior in quality to the domestic hams.

Tariffs vary widely from country to country and from product to product within countries. Most countries impose no tariffs at all on some imports, but most imports are subject to at least minimal tariffs. Most U.S. tariffs are very low—less than 3.5 percent, on average.

Quantitative restrictions seek to limit access to imports by making them scarce, which, according to the laws of supply and demand, makes them more expensive. Most countries in the world apply quotas to the import of certain goods and services (although applying tariffs is much more common).

Why would governments want to alter the natural flow of international trade by imposing tariffs and quotas? Governments restrict imports for four basic reasons:

1. For some governments, particularly in the developing world, tariffs provide a significant source of government revenues.
2. Every country in the world, including the United States, maintains high tariffs on at least a handful of products for which domestic producers are thought to be vulnerable to foreign competition. This so-called tariff protection is typically imposed early in an industry's life or at moments of weakness or decline, when the threat from more efficient foreign producers is thought to be particularly severe. Once imposed, tariff protection is very difficult to remove, because the enterprises and workers who benefit from it work hard to keep it in place.
3. Governments use import restrictions to protect domestic health or safety. A government sometimes bans all imports of a particular good when it has reason to believe it could harm public safety or health. For example, in March 2001 the United States prohibited all European imports of livestock to protect U.S. livestock herds from foot and mouth disease, which had afflicted large numbers of animals in Europe.
4. Governments also restrict imports and exports for political reasons. This kind of governmental restriction on trade is called a sanction. Countries wishing to punish or influence the behavior of another country for human rights violations or for an act of aggression, for example, will sometimes restrict imports from the "misbehaving" country. In times of war, adversaries will often prohibit *all* imports from each other, a measure known as an **embargo**.



During and since the Cold War, the United States and its allies have maintained restrictions on the export of weapons, military technology, and civilian technologies with potential military uses to Communist countries and countries suspected of developing weapons of mass destruction. Figure eleven lists the countries against which the United States currently maintains the most restrictive trade sanctions and the reasons for those sanctions.

Figure 10: U.S. Trade Sanctions

Country	Year first imposed	Reason for sanctions	Sanctions active
North Korea	1950	Hostile actions during the Cold War	Yes
Cuba	1963	Hostile actions of the Cuban government during the Cold War	Yes, but relaxed in 2000
Libya	1986	Libya's repeated use of terrorism against the United States, other countries, and innocent persons, such as the terrorist attacks against the Rome and Vienna airports in 1985	No. Lifted April 2004
Iran	1984	Iran's support for international terrorism and its aggressive actions against non-belligerent shipping in the Persian Gulf	Yes
Iraq	1990	Iraq's invasion of Kuwait, which started the Gulf War	No. Lifted May 2003
Balkans	2001	Blocking property of those seeking to undermine international stabilization efforts in the Western Balkans	Yes
Zimbabwe	2003	Targeted sanction against those trying to undermine Zimbabwe's democracy	Yes
Sudan	2006	Human rights violations in Darfur	Yes
Belarus	2006	Blocking property of persons trying to undermine democratic processes or institutions	Yes
Cote D'Ivoire	2006	Human rights violations against civilians during ongoing political crisis and civil unrest	Yes
Syria	2006	Assassination of the former Prime Minister of Lebanon, Rafik Hariri and consequent report pointing to Syrian and Lebanese involvement	Yes
Democratic Republic of Congo	2006	Widespread violence and atrocities, including targeting of children in armed conflict and sexual violence	Yes
Burma / Myanmar	2007	Burma's continued repression of the democratic opposition	Yes



**Former Liberian
Regime of Charles
Taylor** 2007

Targeted sanctions against the regime of former President
Charles Taylor

Yes, but relaxed in
2003 and 2006 to
allow some
diamonds, and
timber products

For each of the countries subject to U.S. sanctions, there are a few products for which trade is permitted. These products usually include informational material, such as publications, and goods intended to relieve human suffering, such as food and medicine. In addition, goods valued under \$100 can usually be sent as a gift or brought to the United States by authorized travelers. The Office of Foreign Assets Control in the Department of the Treasury is in charge of administering and enforcing U.S. sanctions against targeted foreign countries.

Questions for Discussion:

1. What are three different reasons why a government would decide to impose tariffs?
2. What are the differences among tariffs, embargoes, quotas, and sanctions? What are the different political motivations for using each? What are the economic ramifications for the home and target countries of using each tactic?
3. Do you think sanctions are an effective foreign policy tool for the purposes of changing the target state's behavior?



Export Subsidies

Governments also regulate trade by providing various kinds of support for export producers. Export subsidies come in a variety of forms, but they share the trait of benefitting from government funds. These funds enable them to offer their products or services to other countries at lower prices. The objective of this support is to enable domestic producers to “win” sales by undercutting the prices charged by producers in foreign countries.

The Case of Agricultural Subsidies

For many years, the governments of wealthy industrial countries, including the United States, Canada, Japan, and much of Europe, have subsidized exports of farm products. These subsidies were initially implemented to bolster domestic farmers in their competition with farmers from other wealthy countries, where agricultural production costs tend to be uniformly high.

These subsidies have been a source of distress for developing countries. Although they may have a comparative advantage in agricultural production, they have difficulty competing on the world market against subsidized prices. Developing countries, therefore, have also subsidized their agricultural sectors, further distorting the market and creating the protectionist stand-off that has polarized negotiations on the issue. Reasons that countries may instate export subsidies in the agriculture sector include making sure that enough food is produced to meet the country’s needs; shielding farmers from the effects of the weather and swings in world prices; or preserving rural society.



Consequences of Trade Restrictions

A combination of tariffs, quotas, and subsidies can serve economic, and sometimes political, objectives, but they can also impose significant costs.

Tariffs or quantitative restrictions protect domestic industries and workers from foreign competition by raising the prices of imported goods. In this respect, some argue that import restrictions should be viewed as a tax on domestic consumers. According to some experts, the costs of protecting the jobs of workers in vulnerable industries, which are ultimately borne by taxpayers or consumers, far exceed the potential cost of retraining and finding new jobs for those workers.

According to the [Institute for International Economics](#), trade barriers cost American consumers \$80 billion a year, or more than \$1,200 per family, in increased prices for goods such as sugar (and foods made with it) and appliances made from steel. The Organization for Economic Co-operation and Development estimated that in 2004, American consumers paid \$1.5 billion because of U.S. sugar policies.²³

A similar analysis can be applied to export subsidies. Subsidizing exports can cost governments much more money than would programs designed to shift uncompetitive production into more efficient or internationally competitive sectors.

Another criticism of import restrictions and export subsidies is that they discourage the protected firms and industries from making the changes necessary to challenge foreign competition. Once the protected companies have received government support in the form of import restrictions or export subsidies, they may have less incentive to improve their efficiency and management, eventually even becoming dependent on government support for their survival.

Finally, trade restrictions are a major impediment to development efforts. Developing countries are unable to sell their products abroad because of high tariffs and quotas. Additionally, their domestic markets are flooded by cheaper, subsidized products from abroad.

In response to the known problems associated with trade restrictions, the World Bank offers three suggestions that the G20 countries could adopt. These leading countries could:

- “1) Commit to greater transparency by agreeing to provide quarterly reports on new trade restrictions, and industrial and agricultural subsidies to the WTO;
- 2) Advocate greater Aid for Trade for low income countries; and
- 3) Seize the opportunity to support global trade in a time when it desperately needs to be supported.”²⁴

²³ Source: <http://cei.org/gencon/005,05314.cfm>

²⁴ Source: <http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:22105847~pagePK:64257043~piPK:437376~theSitePK:4607,00.html>



Tariff Debates in U.S. History

The controversies over "protective" tariff rates are not at all new, and long precede the debate about globalization. From almost the earliest days of American history, protective tariffs have aroused some of the fiercest debates within the U.S. political system. A brief look at how controversies over tariffs have shaped American history can help clarify some of the concerns raised in the previous sections of this issue brief.

Following the war of 1812, the young United States government enacted a tariff to help protect domestic industries, which were located mostly in the New England states. Three arguments were made on behalf of the tariffs:

1. Domestic industrial production had grown considerably as a result of the British embargo during the war, and the tariffs were deemed necessary to help keep these "infant industries" alive.
2. Some of the founders came to regard the tariffs as necessary to the defense of the nation by helping retain the factories that could produce war material.
3. Finally, the tariffs were to become the principal source of revenue for the United States federal government in its early days.

In 1841, tariffs collected from the port of New York City alone accounted for more than half of the revenue collected by the U.S. federal government.

Over the course of the next several decades, these tariffs emerged as one of the hottest political controversies within the United States, next to the issue of slavery. Northern states, which were highly industrial, wanted to keep the protections of the tariffs, shutting out cheaper goods from Europe.

Southern states complained bitterly about the tariffs. They observed that these "protective" measures made them pay much higher prices for manufactured goods. The resulting decrease in imports from Europe meant that European markets had fewer dollars available with which to buy the raw materials (such as tobacco and cotton) produced in the American South. Southern leaders argued that the tariffs resulted in a significant transfer of wealth from the South to the North.

South Carolina's legendary Senator John Calhoun argued vociferously against tariffs on imports of manufactured goods throughout the 1820s and 1830s. Calhoun articulated the "40 bales theory," which spelled out southern concerns about the high federal tariffs. According to this theory, a 40 percent tariff on imported cotton fabrics led to 40% higher consumer prices—which benefited New England's less efficient textile producers. This translated to 40 percent fewer purchases by consumers. A 40 percent reduction in cotton fabric purchases meant that manufacturers would purchase 40 percent less of the South's cotton.



In reality, the economic trade-offs and consequences were probably not this precise. The economic premise was valid, however. The imposition of the tariff meant that American consumers were forced to pay higher prices for finished textiles—whether produced domestically or imported.



Another more complex question is the extent to which the tariffs supported "infant industries" in the North. That is, did the tariffs provide northern industries with protection against goods that could be produced cheaper in Europe, so that these domestic industries would have time to develop? Others may argue that tariffs shielding American industries from competition only allowed them to remain less efficient, and that the added costs to all American consumers—for the benefit of a handful of manufacturers—sapped consumers' purchasing power and outweighed any benefit to these producers.

This debate from the 19th century closely parallels some of the debates about tariffs that take place today. Although the average price for tariffs has come down considerably, the United States still maintains substantial tariffs on goods such as textiles and apparel, steel and agricultural products. The ultimate question remains the same: do the benefits to producers and workers in these industries outweigh the costs added to all consumers? If they are more costly than beneficial, do the tariff protections serve other interests that do not contribute to overall economic well-being?



Liberalization: The “Deregulation” of International Trade

Given the dislocations and controversies, some people question the importance of efforts to liberalize trade and wonder whether the economic benefits are outweighed by other unquantifiable negative factors. It is important to remember, however, that the original impetus for the process of trade liberalization was undertaken for reasons that went far beyond economic concerns.

The Origin of Recent Trade Liberalization Efforts

Following World War II, the leaders of the world's largest industrial economies set about to create institutions such as the General Agreement on Tariffs and Trade (GATT), to promote trade liberalization, and the World Bank and the International Monetary Fund to better coordinate global economic policy. The world leaders who established these organizations did so out of what they believed to be a bitterly learned lesson about the costs of not coordinating economic policy and of not safeguarding free trade.

This generation had just emerged from the greatest conflict the world had ever seen, whose origins could be traced to the fascist dictatorships that sprang up as a result of the worldwide Great Depression.

In the late 1920s economies around the world stumbled and fell, causing widespread unemployment and slashing economic production. The U.S. government, like many others, saw its revenues falling and domestic production increasingly endangered by now-cheap foreign imports. In response, the U.S. Congress passed the Smoot-Hawley Tariff Act, which raised tariffs on imports by nearly 60 percent. This was done as a means of both raising revenue and curbing imports. In response, 60 other countries retaliated against the United States, raising their own tariff barriers. Nations also began to devalue the exchange rate of their currencies, to make their exports cheaper to their trade partners.

These mutual increases in tariffs and competitive devaluations are often referred to as "beggar-thy-neighbor" policies. As we have described earlier in this brief, the gains from trade are, on balance, beneficial to both parties. Unlike most economic policies that seek to promote mutual gains, however, mutual increases in tariffs and competitive devaluations tend to only make matters worse for all concerned.

As a result of these devaluations and newly erected tariff barriers, the volume of world trade dropped dramatically, and served to deepen and lengthen the Great Depression.

President Franklin D. Roosevelt's Undersecretary of State Sumner Welles later concluded, "The high tariff [of Smoot-Hawley] rolled up unemployment in Great Britain and in Western Europe.... [It] encouraged the German government to adopt its autarchic economic policy, which in turn was a contributing factor in bringing about the second World War"

Indeed, the disaster created by Smoot-Hawley was so quickly and clearly evident that it led to a strong reversal by way of the Reciprocal Trade Agreement Act of 1934. For the first time, Congress gave the president the authority—albeit for three years only, then subject to renewal—to negotiate tariff cuts on a bilateral, reciprocal basis with other countries. These cuts could be implemented by Executive Order, i.e., without the need for Congress's permission. This authority was renewed repeatedly in the ensuing years and by 1945, 25 reciprocal agreements had been negotiated. Most importantly, this meant that the ability to implement protective trade policy was now constrained by international agreements committing the United States to lower trade tariffs.



After World War II, global leaders sought to put permanent agreements and institutions in place to ensure that economic chain reactions, like the one triggered by Smoot-Hawley, never took place again. One of their goals was the creation of the International Trade Organization, with a very ambitious agenda that not only covered trade but also extended to include rules on employment, commodity agreements, restrictive business practices, international investment, and services.

The proposed agreement turned out to be more than the U.S. Congress was prepared to swallow, so the ITO became stillborn. Instead, the leading nations, including the United States, settled upon the GATT, which was not a permanent organization and had a narrower focus limited to the reduction of industrial tariffs (the United States insisted on the exclusion of agricultural goods).

At almost any given time, no matter how prosperous the world economy may be overall, there are usually a few countries undergoing some kind of economic shock. Every time a country suffers an economic downturn, it is very tempting for political leaders to try to "export" their problems onto their trading partners by raising tariffs or devaluing their currencies.

Many economists make the analogy that the pursuit of free trade is a bit like riding a bicycle: If you don't continue to make forward progress, you are in danger of falling off. Governments around the world are under almost constant pressure to protect domestic industries—either because of an economic downturn, changes in technology, or any of the myriad forces behind the "creative destruction" of the free market.

Trade agreements that are vigorously enforced are the most powerful ways to prevent governments from succumbing to these pressures. Although many valid criticisms can be levied against the current world trading system, it is the view of the author that critics should remember the precedent that led to its creation, and the global turmoil that was caused by the absence of international rules.

Time Line of Events

1929	Great Depression begins
1930	Smoot Hawley Tariff Act: Raises tariff of imports by 60 percent
1934	Reciprocal Trade Agreements. President (executive) authorized to eliminate tariffs with bilateral agreements
1939-1945	World War II
1947	GATT created to reduce industrial tariffs worldwide

Questions for Discussion:

1. Why do you think the U.S. Congress opposed the International Trade Organization?
2. Do you think the international regulation of trade benefits countries overall? Does it help particular countries more than others?
3. How do governments balance the need to respond to domestic demands for protection of particular sectors (agriculture, manufacturing, etc.) and international demands for open markets?



Liberalization of International Trade

Since World War II, governments have cooperated on a wide variety of efforts to reduce or eliminate import restrictions and export subsidies. They have been motivated by the conviction that deregulating, or liberalizing, trade would increase the volume of trade, promote economic growth, and improve living standards worldwide.

Trade liberalization initiatives have been pursued at the country-to-country level (bilateral level), among groups of neighboring countries (the regional level), and in the GATT, which was established in 1947 and included eight major, multiyear rounds of negotiations among a broad cross-section of countries (the multilateral level—see Figure 11). A ninth round of discussions is currently underway. Two critical principles have guided post-World War II trade liberalization efforts and have contributed significantly to their success:

1. The nondiscrimination principle stipulates that both trade restrictions and proposals to reduce trade restrictions should apply to all of a country's trading partners equally, and that imported goods and services will not be treated differently than domestic ones.
2. The principle of reciprocity dictates that all participating countries offer to reduce some of their own import barriers or export subsidies in exchange for comparable steps by their negotiating partners.

Agreements liberalizing trade at the bilateral, regional, and multilateral levels have been highly successful over the past five decades. The eight major rounds of multilateral trade talks since World War II have reduced average global tariffs from 40 percent to five percent.²⁵ This reduction in tariffs has helped promote economic efficiency and saved consumers billions of dollars of income through lower prices. Unfortunately, during worldwide recessions, like the one in 2009, countries are prone to increase tariffs to protect domestic industries and raise revenue.

While tariffs were low, and there was no thought of recession, the attention of trade negotiators turned to a range of more complicated barriers to trade. Development became a top priority. The most recent round of global trade talks, known as the Uruguay Round, was launched in 1986. The ninth and as-of-yet uncompleted "Doha Round" began in 2001.

Figure 11: Major Post-World War II Global Trade Rounds

Round	Participants	Key Achievements
1947	23	Tariff reduction
1949	13	Tariff reduction
1951	37	Tariff reduction
1956	26	Tariff reduction
1960-61, "Dillon Round"	26	Tariff reduction
1964-67, "Kennedy Round"	62	Tariff reduction, agreement on anti-dumping practices

²⁵ Source: *The Rise of the Global Economy*, Michael Veseth, Louis Uchitelle, 2002



1973-79,"Tokyo Round"	102	Tariff reduction, elimination of non-tariff barriers, "framework" agreements
1986-94,"Uruguay Round"	123	Tariff reduction, agreement to eliminate quotas in agriculture, agreement on intellectual property , agreement on dispute settlement, integration of textile and apparel products into the agreement, creation of the World Trade Organization (WTO)
2001-present "Doha Round"	146	Dubbed the "Development Round," these negotiations focus on agriculture, trade of services, market access, intellectual property rights, investment, competition, transparency in government procurement, trade facilitation, and WTO rules, and have so far been characterized by conflict between developed and developing countries

Questions for Discussion:

1. What are the arguments given in favor of trade liberalization? What are the arguments against it?
2. How does trade liberalization affect a developing country differently from an industrialized country?
3. What changes have you noticed over the past few years with respect to the organization of trade relationships? Are they becoming more regional? Bilateral? Global? What ramifications result from this trend?

Multilateral Trade Liberalization: The Uruguay Round and the World Trade Organization

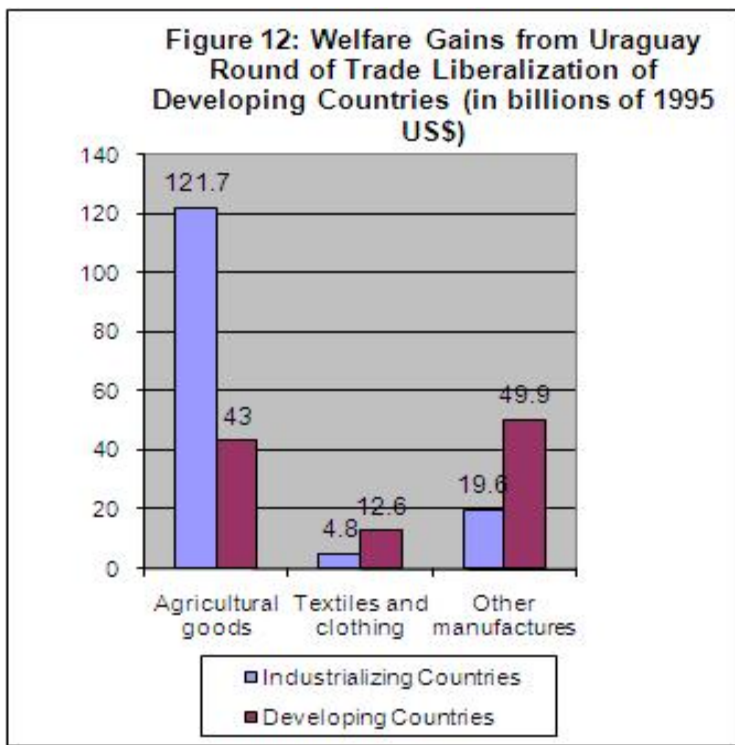
The Uruguay Round, which concluded with a series of multilateral agreements in 1994, addressed a number of issues that had never been discussed before in global trade negotiations. The first few rounds of GATT (as demonstrated in Figure 12) were focused on reducing or eliminating tariffs. In the Uruguay Round, however, two key agreements established new rules liberalizing trade in services and protecting copyrights, trademarks, and other forms of intellectual property. Other agreements clarified the relationship between sanitary regulations and trade and, for the first time ever, reduced agricultural trade restrictions worldwide.



The Uruguay Round also created the World Trade Organization (WTO), an international institution designed to ensure that trade between nations flows as smoothly as possible. The WTO acts as a forum for multilateral trade negotiation, administers multilateral trade agreements, decides trade disputes, and reviews national trade policies. It was the belated birth of the International Trade Organization, 50 years after the first effort in 1946.

Convinced of the benefits that would flow from participation in this rules-based multilateral trade system, dozens of countries, including many that only recently emerged from Communist rule, have joined or applied to join the WTO in the first six years of its existence. Seventy-six countries have been members of the WTO since its inception in January 1, 1995. As of June 2011, the WTO's membership stands at 153.²⁶ Russia is the largest country that has yet to become a WTO member, though it is currently quickly rising in status and power. China and Taiwan entered the WTO at the end of 2001. Current membership of the WTO accounts for more than 95 percent of world trade.

The trade liberalization achieved during the Uruguay Round is expected to be beneficial both to developed and developing countries, as Figure 12 illustrates. One attempt to quantify the impact of the Round concludes that the aggregate welfare gains are around \$96 billion per year in the short run. Despite these global gains, the authors identify some developing countries that lose from the Round in the short run. In the long-term, almost all countries gain from the Uruguay Round agreement. The Doha Round will also allow developing countries to make further gains through their own unilateral liberalization.



²⁶ Source: http://www.wto.org/english/thewto_e/whatis_e/tif_e/org6_e.htm



[The Doha “Development” Round: The World Trade Organization’s Controversial Agenda](#)

The Fourth WTO Ministerial Conference was held in Doha, Qatar, 9-14 November 2001. While members were again moving toward negotiations, the round stalled and was not completed by 2005, as was previously scheduled. Foremost among the accomplishments of the negotiations so far is the Declaration on the TRIPS agreement and public health, which gives countries affordable options for addressing public health crises, such as the HIV/AIDS epidemic in southern Africa, without violating patents on treatment drugs. This marks a rare issue on which the developed and developing countries could reach agreement.

Other issues on the agenda, especially the reduction of trade barriers in the agriculture sector, put a divisive wedge between a group of developing countries and the industrialized European Union and United States. While the power dynamics in the WTO may be shifting as a result of the strong and unified position the developing world took at the talks in Cancun (see below), the potential to complete a productive round persists as countries look toward setting a realistic agenda for future negotiations in the round.

Negotiations during the 2003 Cancun talks focused primarily on agriculture, trade of services, customs, and industrial products. Later talks in 2004 in Geneva produced an agreement; the United States, the European Union, Brazil, and Japan agreed to end export subsidies, decrease tariffs, and decrease agricultural subsidies. Talks and conferences in Paris, Hong Kong, Geneva (2006), and Potsdam have shown few improvements since then. The Doha round is marked by disagreements over liberalizing agricultural and industrial markets, as well as ending agricultural subsidies.²⁷

Unfortunately, in July 2006, the talks came to a close with no substantive goals met.²⁸ Subsequent attempts in 2007 (Potsdam) and 2008 (Geneva) have failed. A mini-ministerial meeting was held in India on September 3-4, 2009. It resulted in a pledge to complete the Doha round by the end of 2010.²⁹

The issues that the Doha Round was supposed to have addressed remain crucial, and many organizations have been trying to get the talks back on track. In the wake of the worldwide recession, it is even more important to prioritize development initiatives in countries that will suffer from the economic downturn.

²⁷ Source: <http://www.opencrs.com/document/RL32060/>

²⁸ Source: <http://www.globalissues.org/article/663/wto-doha-development-trade-round-collapse-2006>

²⁹ Source: http://news.xinhuanet.com/english/2009-09/16/content_12061873.htm



Regional Trade Liberalization

During the past two decades, nearly every country that participated in GATT or the WTO has also joined with neighboring countries in some form of regional trade arrangement. These regional trade arrangements differ in structure and in the issues that they negotiate, but they have a common objective: to increase trade and prosperity through the mutual reduction of barriers to the exports of neighboring countries.

A key premise of these regional trade arrangements is that neighboring countries, which sometimes share cultural and language ties, can expand trade more rapidly than can countries separated by great distances. It is also sometimes easier for small groups of countries in the same region to agree on ways to reduce trade barriers than it is for more than 140 countries across the globe to do so in a broad multilateral trade round.

Regional trade agreements have proliferated in recent years. Bilateral and regional "free-trade agreements" have also played a larger role recently, seeking not only to reduce but also to eliminate nearly all restrictions on trade among participating countries. Arrangements that partially or fully embrace free trade among countries within a given region have been established in North America, Europe, Southeast Asia, the southern part of South America, the Andean region of South America, Central America, and in several African sub-regions.

The United States participates in several of these regional and bilateral arrangements and, through the [Office of the United States Trade Representative](#), is currently negotiating several more. Under the North American Free Trade Agreement (NAFTA), which took effect in 1994, the United States, Mexico, and Canada are phasing out barriers to each other's imports. The United States is also engaged in an ambitious set of negotiations aimed at concluding a free trade agreement covering the entire Western Hemisphere, called the [Free Trade Area](#) of the Americas. Thus far, these negotiations have been delayed by some of the same issues facing the Doha round; agriculture and the trade of services remain staple issues. As of 2005, the FTAA has not been signed. Critics argue that the FTAA only serves to propagate global poverty and inequality. The FTAA has not reported any news on major proceedings since 2006.

Member States of Selected Regional Trade Agreements

Andean Trade Preference Act: Bolivia, Colombia, Ecuador, Peru, Venezuela

Arab Maghreb Union: Algeria, Libya, Mauritania, Morocco, Tunisia

ASEAN: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam

CARICOM: Antigua and Barbuda, The Bahamas, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, St. Kitts and Nevis, Saint Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago

Central American Common Market: Guatemala, El Salvador, Honduras, Nicaragua

Central European Free Trade Agreement: Croatia, Albania, Montenegro, Serbia, Macedonia, Moldova, Bosnia and Herzegovina

COMESA: Angola, Burundi, Comoros, Democratic Republic of Congo, Djibouti, Egypt, Eritrea, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Namibia, Rwanda, Seychelles, Sudan, Swaziland, Uganda, Zambia and Zimbabwe

Cooperation Council for the Arab States of the Gulf: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, UAE

Economic Community of West African States: Benin, Burkina Faso, Cameroon, Cote d'Ivoire, Congo, Gabon, Gambia, Ghana, Guinea Bissau, Liberia, Mali, Mauritania, Niger, Nigeria, Senegal, Sierra Leone, Togo

EU: Austria, Belgium, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, The Netherlands, Poland, Portugal, Slovakia, Slovenia, Spain, Sweden, and United Kingdom

Greater Arab Free Trade Area: Kuwait, Bahrain, Morocco, Egypt, Jordan, Oman, Iraq, Lebanon, Libya, Sudan, Syria, Saudi Arabia, Tunisia, the United Arab Emirates, the State of Palestine, Yemen, Qatar

MERCOSUR: Argentina, Bolivia, Brazil, Chile, Paraguay, and Uruguay

NAFTA: Canada, Mexico, and United States

South Asia Free Trade Agreement: India, Pakistan, Bangladesh, Nepal, Sri Lanka, the Maldives, Bhutan



The equivalent of NAFTA in East Asia is the Association of South East Asian Nations (ASEAN), which comprises ten members (Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, The Philippines, Singapore, Thailand, and Vietnam), but not China and Japan. The European Union (EU) differs from both NAFTA and ASEAN because it deals not only with trade preferences but also includes political arrangements, policies on immigration, and a common currency, the euro (introduced on January 1, 2002).

Beyond the Western Hemisphere, the United States has announced or completed bilateral trade agreements with members of the [Middle East Free Trade Area](#), Asia-Pacific Economic Cooperation, Southern African [Customs Union](#), and the Manufacturing Free Trade Area with Australia. Each of these groups was formed to liberalize trade between countries in the same region, with whom they do the most business. Most countries trade with their neighbors, and also with the United States and the European Union.

Read about past controversies over multilateral vs. bilateral or regional agreements: "[Proliferation of Bilateral and Regional Free Trade Agreements May Threaten Multilateral Talks](#)." Read about the Central American Free Trade Agreement: in "[U.S. Lawmakers Approve CAFTA](#)."



The Changing Composition of Trade

Thanks in part to the progressive deregulation of trade achieved in multilateral, regional and bilateral trade agreements, global trade flows have grown 22 times in size since 1970, more than twice the rate of economic growth during the same period. It is generally believed that the massive growth of trade has led to higher productivity, thereby improving living standards and promoting prosperity worldwide.

International flows of imports and exports have changed as dramatically in content and direction over the past five decades as they have in size. The United States began and ended this period as the world's largest and most technologically advanced economy, but other countries have experienced astonishing increases in their level of development and technological sophistication, and their trade with the United States and other countries has changed as a consequence.

The prevailing pattern of international trade in the first decade following World War II looked like this:

- The United States and Western European countries produced most of the world's industrial machinery, such as major manufactured products like vehicles or washing machines, and technologically sophisticated goods like electronics.
- These wealthy industrial countries exported manufactured goods (along with plenty of grains and minerals, in the case of the United States) to less-wealthy developing countries.
- Developing countries exported back to the industrial countries raw materials like minerals and timber, agricultural products, and simple, manufactured goods like toys or clothing.

However, in just the past four decades, dozens of poor countries took major strides in developing their economies. Exports produced in developing countries are generally still dominated by raw or semi-processed materials and agricultural products, but light and heavy manufacturing has a steadily growing share of these countries' economic output and exports.

In the first few decades following World War II, several developing nations became major industrial powers, producing manufactured goods equal and sometimes superior in quality and sophistication to products made in the United States. One such nation was Japan, whose per capita income at the end of World War II was less than it was in 1925.

For the United States and several countries in Europe, the emergence of new manufacturing capacities has been a mixed blessing. The growth of developing economies and the post-war recoveries of Europe and Japan have helped turn poor and devastated countries into massive markets for U.S. exports and investment. American companies, farmers, and workers have benefited immensely from these new commercial opportunities. Had the rest of the world not developed and grown as much as it has since World War II, American living standards would not have improved as much as they have.



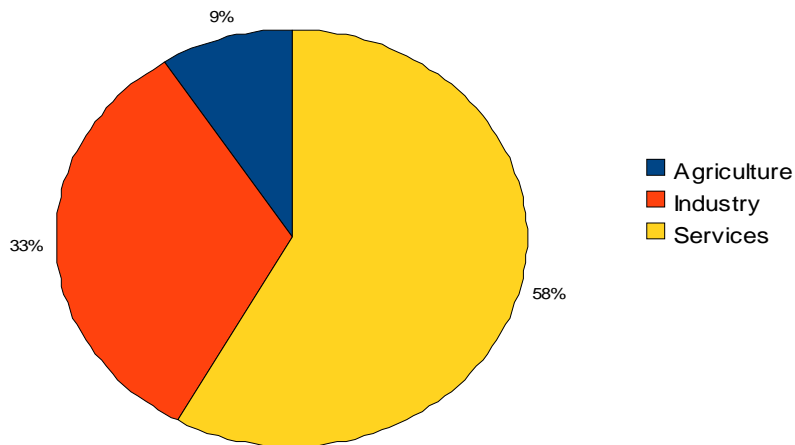
Trade Challenges for the United States

Changes in the structure of global production and trade have been difficult for certain sectors of the U.S. economy, especially for workers in these affected sectors. As other countries have developed new manufacturing capacities, the lower wages of workers in those countries have given them a cost advantage relative to manufacturing in the United States. This has led to a steady increase in U.S. imports of manufactured goods that are cheaper than equivalent domestic goods. It has also prompted a number of U.S. companies to close factories in the United States and build new ones in developing countries, where they can take advantage of lower wages and improved manufacturing skills.

Combined with technological changes and other factors, these developments in trade have:

1. Contributed to a gradual shrinkage in the share of the U.S. workforce holding secure, manufacturing jobs with decent wages; and
2. Spurred a long-term decline in the inflation-adjusted income of workers in the manufacturing sector. (Figures 13 and 14 illustrate the changes in the structure of the U.S. economy between 1960 and 2007.)³⁰

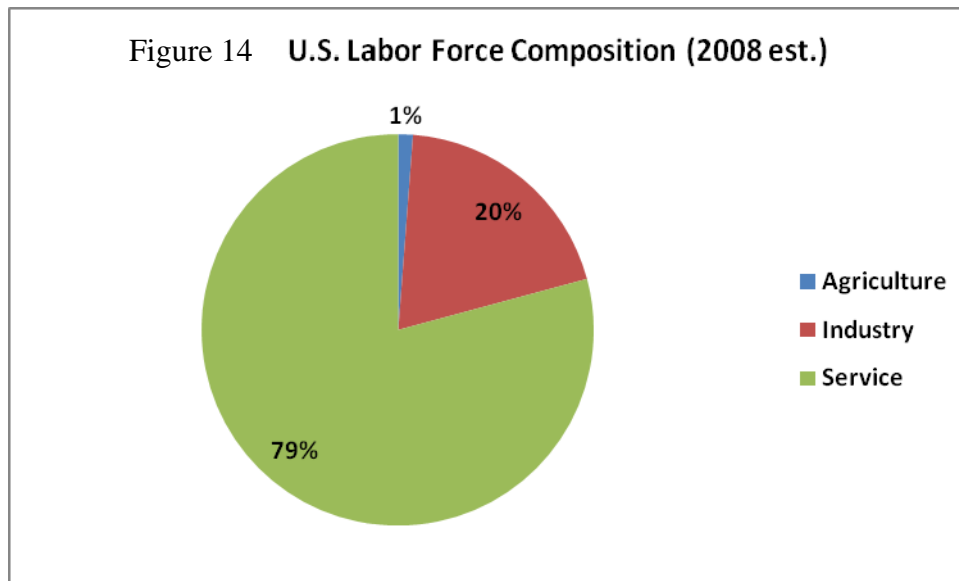
Figure 13 : U.S. Labor Force Composition (1960 est.)



³⁰ 2007 labor force composition statistics found at the CIA World Factbook.



Figure 14 U.S. Labor Force Composition (2008 est.)



American workers with a low degree of skills have been hit hardest by foreign imports and plant closings, because they tend to work in the industries in which emerging industrial countries are most competitive. Over the past few decades, as employment and wages have declined in traditional U.S. manufacturing sectors, many more jobs have been created in higher-tech manufacturing industries and in the service sector. These jobs are often higher paying than the manufacturing jobs that have been eliminated. Many workers with manufacturing backgrounds lack the training and education necessary to transition into these new fields.

The U.S. federal government and state governments all sponsor programs designed to help workers displaced by economic change to acquire new skills. One of the largest of these programs is the [Trade Adjustment Assistance](#) program, run by the U.S. Department of Labor. Some analysts and labor advocates claim that government support for such programs has been inadequate.

The changing structure of American trade over the past few decades is in many respects a reflection of a larger set of changes in the structure of the U.S. economy. The relative shares of U.S. economic output accounted for by each of the three major forms of economic activity (manufacturing, services, and agriculture) are constantly changing.

At the beginning of the 20th century, the dominant trend was the decline of agricultural production and the rise of manufacturing. In recent decades, the dominant trend has been the decline of manufacturing and the rise of the high technology and service sectors.

These long-term changes in the structure of an economy can be marginally shaped by policy. To a large extent, though, they are the inevitable result of the routine operation of a capitalist economy.

The Austrian economist Joseph Schumpeter, in his book *Capitalism, Socialism and Democracy*, famously characterized capitalism as a process of "creative destruction." That is, a free market economy will naturally eliminate firms and industries



that are less efficient or produce inferior goods. When these companies are eliminated, their more efficient competitors are allowed to maximize the advantages they bring to the market. Efforts to keep these old industries propped up not only inhibit the operations of better firms, but they usually come at the great expense of taxpayers.

Rather than trying to delay or prevent such trends, the alternative would be to offer assistance to those individuals or communities that experience difficulty.

To learn more, read news analyses [“U.S. Congress Grants President Trade Promotion Authority”](#) and [“Long-Running Trade Dispute over U.S. Tax Break May Be Ending.”](#)

Questions for Discussion:

1. How has the American economy changed over the past 20 years? Who benefits and who loses from this transition?
2. What role has the U.S. government played in trying to smooth this transition for American workers? What additional measures do you think the government could implement to help workers? What can be done at the federal, state, and local levels?
3. What changes have you seen in your schools and universities that reflect the changes that are taking place in the economy? What sorts of classes are offered today that would not have been a decade ago? What sorts of companies are hiring students today? Is this different from before?



Public Concerns about Trade

International trade has often been a target of those who have been adversely affected by economic disruption. As noted earlier, there is little doubt that increased trade, especially with developing countries, has increased the vulnerability of lower-skilled jobs in the United States.

Most economists believe that technological changes—which have also tended to improve overall living standards—have played a much larger role than trade in the decline of manufacturing jobs in the United States and other countries. As an occasionally painful agent of change, however, technological progress is a much more elusive target for criticism than are trade and foreign investment, in which federal or corporate actors are more easily identified. Concern about the impact of trade on jobs and wages is but one of several major sets of public concerns about trade's impact on social welfare in the United States and other countries. These concerns have fueled complex and unresolved debates about U.S. trade policy.

CSIS Meeting of Four Former United States Trade Representatives

Recent public debate over trade issues has centered on outsourcing, the practice of moving some or all business operations overseas to take advantage of lower costs and lower wages. As discussed in "The Changing Composition of Trade," most economists believe that outsourcing is a natural reaction that will benefit Americans down the line. However there are costs to Americans in the short run, such as high unemployment in the sectors where outsourcing is most prevalent. On March 10, 2004, four trade experts analyzed the facts, myths, and potential policy responses to global outsourcing. The remarks of the former US Trade Representative's (USTRs) are recorded here:

<http://csis.org/schollchair/040213ustr.pdf>

The concluding sections of this Issue Brief will review two of these policy debates: the debate on the relationship between [trade and international labor standards](#), and the debate on the relationship between [trade and the environment](#).



Trade and International Labor Standards

With respect to trade and labor standards, many labor unions and labor activists such as the AFL-CIO have argued that the United States should promote improved labor protections in any country with which it negotiates a new agreement aimed at liberalizing trade. The [International Labor Organization](#) of the United Nations upholds a series of labor recommendations and conventions that are intended to be recognized everywhere in the world.

There is universal consensus that all countries must respect the following fundamental rights:

- Freedom of association and the effective recognition of the right to collective bargaining;
- Elimination of all forms of forced or compulsory labor;
- Effective abolition of child labor; and
- Elimination of discrimination in respect to employment and occupation.

The International Labor Organization's [Declaration on Fundamental Principles and Rights at Work](#), adopted in Geneva in 1998, stresses these principles in greater detail. According to many labor advocates, workers in many developing countries lack basic labor protections—such as the right to organize unions, and healthy and safe workplaces—that most American workers take for granted.

Weak and poorly enforced labor standards in developing countries are said to be unjust to workers. Since weak labor standards are often accompanied by low wages, they are also said to harm workers in the United States and other industrial countries who compete with developing country workers through trade and investment.

To address these problems, many labor advocates propose that new trade agreements include special provisions that permit one country to restrict the imports of another country if the country is found to be in violation of internationally accepted standards of labor protection. Proponents say that this threat of trade penalties or sanctions will encourage developing countries to improve their labor laws and strengthen their enforcement of those laws. This could help both developing and [industrial country](#) workers. Currently, the U.S. has economic sanctions on a number of countries that violate human rights or basic tenets of American government, such as Cuba and Iran (see section on Import Restrictions).

Proposals to include labor provisions in new trade agreements have been opposed by developing country governments and businesses for one or more of the following reasons:

- Developing country governments and businesses worry that those trade agreements that seek to raise labor standards will be manipulated for [protectionist](#) purposes—that their exports will be blocked on the ground that their labor standards are not sufficiently acceptable when the true motivation is to protect uncompetitive firms in industrial countries.
- Many developing country governments and economists also argue that international pressure to improve labor standards detracts from developing countries with only one big advantage: a cheap supply of labor. They make the case that pressure to raise labor costs takes away from their comparative advantage, and that this pressure only benefits workers in rich countries.
- Still others argue that trade sanctions are an imprecise and unwieldy means for improving developing country's inferior labor conditions, which often have complex economic and social causes. They argue that labor conditions can best be improved over time by promoting development that improves productivity. By increasing the size of a nation's labor force, economic trends tend to pull up wages and working conditions automatically.



Efforts to introduce the issue of labor standards into the WTO, which have been led primarily by the United States and other industrialized countries, have been fiercely opposed by other member states, particularly developing countries. These representatives invoke all of the above concerns to argue that efforts to promote labor standards tend to inhibit their economic development.

Questions for Discussion:

1. What do you think of the suggestion that the United States includes labor and/or environmental provisions in its bilateral trade agreements? What are the trade-offs associated with including such provisions?
2. Why do developing countries oppose strong labor regulations? How do you evaluate their arguments?



Trade and Environmental Standards

A similar debate has surrounded the question of whether and how to link trade rules with efforts to improve environmental protection. Environmentalists and others argue that increased trade, if not properly regulated, can cause environmental damage. They believe that countries will do one of the following:

1. Reduce or fail to enforce their own environmental protections to attract foreign investors seeking lower-cost production sites; or
2. Invalidate existing national laws or regulations designed to protect the environment; or
3. Undermine multilateral efforts to address environmental problems when they conflict with the existing agreements and rules of the international trading system. Like the labor advocates, some environmentalists endorse new trade agreements with provisions, backed by the threat of trade sanctions, which prohibit countries from lowering their environmental protections to attract trade or investment.

The [World Wildlife Fund](#) and the [National Wildlife Federation](#) are two of the major environmental groups that back such measures. Opponents of these measures argue that increased trade and the economic growth it stimulates will have long-term consequences for the environment. They also argue that trade liberalization can simultaneously expand trade and improve environmental conditions in certain economic sectors, such as fisheries, in which many countries subsidize environmentally harmful levels of production to increase their international trade.

To learn more about the concerns about trade and the environment, take a look at Globalization101.org's Environment Issue Brief.



Comparative Advantage Quiz

With the cost of production of two goods in two different countries, it is possible to calculate how much the two countries could gain from trade.

Imagine that country A can produce a unit of product A for \$2 and a unit of product B for \$3. Country B can produce a unit of product A for \$1 and a unit of product B for \$2, which means that country B is more efficient in the production of both goods. Country A has \$60 available for production. Country B has \$36 available for production. If the two countries do not trade and use half of their resources on the production of each good, how many units of each good would they produce?

[The student can fill out the following sentence on the Web]

Country A can produce 15 units of product A and _____ [10] units of product B
Country B can produce _____ [18] units of product A and 9 units of product B

[If the student enters the correct response, a window pops up with the second part of the exercise]

Now, if the two countries concentrate on the production of what they do best, they could produce:

Country A: _____ [20] units of product B
Country B: _____ [36] units of product A

The two countries can then trade goods so that both countries could end up with:
_____ [18] units of product A
_____ [10] units of product B



Glossary

Absolute advantage: A person or company has an absolute advantage when it can best perform a task or produce a product.

Balance of trade: The balance of trade is the difference between a country's total imports and exports. When exports exceed imports, there is a trade surplus; the converse yields a trade deficit.

Capital Goods: Plants and heavy equipment (vehicles, generators, and metal works) used in the production of goods. As opposed to consumer goods, capital goods require a large investment to obtain, and are used for an extended period of time.

Comparative advantage: A country/business/entity is said to have a comparative advantage in producing whichever good has the lowest opportunity cost. (See **opportunity cost** definition.) That is, it has a comparative advantage in whichever good it sacrifices the least to produce.

Customs Union: A customs union is any group of nations that has agreed to eliminate tariffs on goods traded among members, while imposing common external tariffs on goods entering from outside the group. The European Union is the best-known example.

Developing countries: The World Bank classifies countries according to their Gross National Income (GNI) per capita as either low income, middle income, or high income. Low income and middle income economies are referred to as developing economies.

Dumping: A company is said to be dumping a product when it exports the product at a price lower than the price it charges in the home market. Dumping is problematic for businesses in the importing country because they have to cope with a foreign competitor that sells products very cheaply. Dumping is considered an unfair business practice. With the WTO anti-dumping agreements, governments can appeal to the WTO to retaliate against countries where companies break dumping laws.

Firm: A firm is an independent unit that uses the factors of production to produce goods and services.

Free trade area (FTA): A free trade area is characterized by a cooperative arrangement among two or more countries to eliminate tariff barriers among themselves while not applying a uniform external tariff on imports from non-participant countries.

Goods and services: A good is a tangible item that someone has made, mined, or grown. Goods include naturally occurring substances (e.g. oil, iron ore), agricultural products (e.g. grains, livestock), and manufactured or processed products (e.g. packaged foods, toys, timber, furniture, computers, machine parts). A service is a form of work, assistance, or advice that provides something of value to someone else but does not produce a tangible item. Air, rail, or sea transportation are services. Communication by telephone or Internet is a service. So is the work done by engineers, doctors, lawyers, architects, and entertainers. Tourism is a service, too; the money spent by foreign visitors at Disney World, the Grand Canyon, and other attractions inside the United States represents earnings from the export of tourism services. The distinction between goods and services can sometimes be blurry. When a musician plays a concert, for example, he or she provides entertainment services to those who attend. If the performance is recorded and turned into a CD though, the musician also has created a tangible good.



Industrial country: Industrial countries are those countries whose society has shifted from an agricultural based economy to a modern industrial economy.

Industrial Revolution: The Industrial Revolution refers to the social and economic changes that occurred in Great Britain from the 18th to the 19th century. British society shifted from a primarily agricultural society to a modern industrial society. Other countries quickly followed the British transition.

Intellectual property: Intellectual property refers to the creations of the mind, such as inventions, literary or artistic works, and the symbols, names, and designs used in commerce. Intellectual property is divided into two categories: industrial property, which includes inventions and trademarks; and copyrights, which include novels, plays, films, and paintings, among many other things. Intellectual property can be a cause of trade disputes when standards for protection of intellectual property differ in different countries. For instance, it is in the interest of U.S. companies to have intellectual property rights on items such as music respected in China. The Chinese government is not as strident in its enforcement of copyright as the U.S. is, so this can cause some friction. IP has also played a controversial role in the ability of developing countries to provide their citizens with affordable pharmaceuticals.

Multilateral: If something is multilateral, it means that more than two countries participate in it. A multilateral agreement is an agreement that at least three countries have signed. A multilateral institution is an organization in which at least three countries participate. If just two countries reach an agreement between themselves, that agreement is said to be bilateral. The United States, for example, has a bilateral free trade agreement with Israel. But NAFTA, a free trade agreement among three countries—the United States, Canada, and Mexico—is a multilateral agreement. When people use the term multilateral, however, they usually have in mind something involving more than three countries. The post-World War II multilateral trade rounds, for example, have involved dozens of countries.

Non-tariff barriers (NTB): Import quotas, burdensome customs formalities, foreign exchange controls, or other measures or policies (other than tariffs) that restrict or prevent trade.

Opportunity cost: In economic terms, opportunity cost is the amount of good or service that is sacrificed or given up in order to produce another good or service.

Protectionism: Protectionism refers to the establishment of barriers to the importation of goods and services from foreign countries to protect domestic producers.

Quantitative restrictions: Quantitative restrictions seek to limit access to imports by making them scarce, which, according to the laws of supply and demand, makes them more expensive. Most countries in the world apply quotas to the import of certain goods and services (although applying tariffs is much more common).

Quotas: Quotas are quantitative restrictions on the import of certain goods and services. Rather than imposing tariffs, governments wishing to limit access to or raise the prices of certain goods or services will sometimes specify in laws or regulations that total yearly imports of a particular good or service may not exceed a certain quota, which may be expressed as a quantity of exports or as a dollar value of exports. The United States maintains import quotas on imported clothing, sugar, peanuts, and several other items. Under an international agreement governing trade in clothing and fabrics, the United States applies different import quotas to the clothing produced by different developing countries.

Tariff: Tariffs are a list of taxes or customs duties payable on imports or exports.

Wholesalers: A wholesaler is an agent that sells goods in large quantities to retailers, who then sell those goods to the general public.



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