Free trade and Protectionism

Nowadays, globalisation has made the world such a smaller place. International trade between countries becomes more and more frequent. Therefore governments would likely to decide an act of opening up economies which is known as "free trade".

Free trade allows traders to transact without interference from government. Thus, goods and services from everywhere can compete with domestic products and services. It works by bringing down trade barriers such as tariffs. Under this policy, the prices are the sole determinant of resource allocation, and they are a reflection of true supply and demand.

However, in order to protect domestic industries and reduce the trade deficits, some governments make policy to keep out foreign goods, which is called “protectionism”.

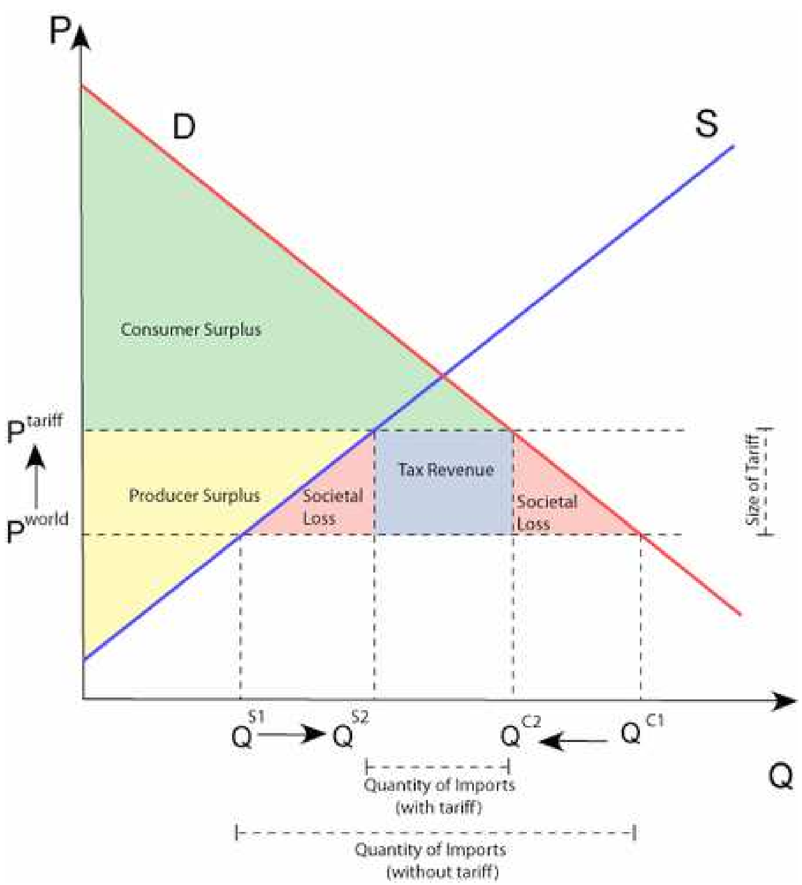
Contrast with free trade, protectionism is a policy where the allocation of goods and services between the trading countries are determined by artificial prices that adjusted by governments and do not reflect the true nature of supply and demand.

Use of tariff

Tariff is the most wide used trade barrier for protectionism. It is a tax usually imposed on imports. As prices of imports increase after being taxed, they might be more expensive than domestic goods, and therefore stop people buying them. In that way, ailing domestic industries will have a chance to recover and prosper, the unemployment might be cured, and the trade deficits will be reduced.

There are several types of tariffs,

- An ad valorem tariff is a set percentage of the value of the good that is being imported. It could cause problems as fall in the international price of a good will lead to a decrease in the tariff. This makes the domestic industries more vulnerable to competition.
- A specific tariff is a tariff of a specific amount of money that does not vary with the price of the good. However, it is difficult to decide the amount at which to set a tariff, and it may need to be updated frequently due to changes in the market or inflation.
- A revenue tariff is a set of rates designed primarily to raise money for the government. A tariff on a kind of import imposed by countries which do not have this kind of good at all can raise a steady flow of revenue.
- A protective tariff is intended to artificially inflate prices of imports and “protect” domestic industries from foreign competition. For example, a 30% tax on imported steel raises the price from £100 to £130. Without a tariff, the local manufacturers could only charge £100 for the same amount of steel, now they may charge £129 without losing customers. So the consumers have to pay in the end for use of this type of tariff.
- A prohibitive tariff is a tariff which is so high that no one will import any of those items.



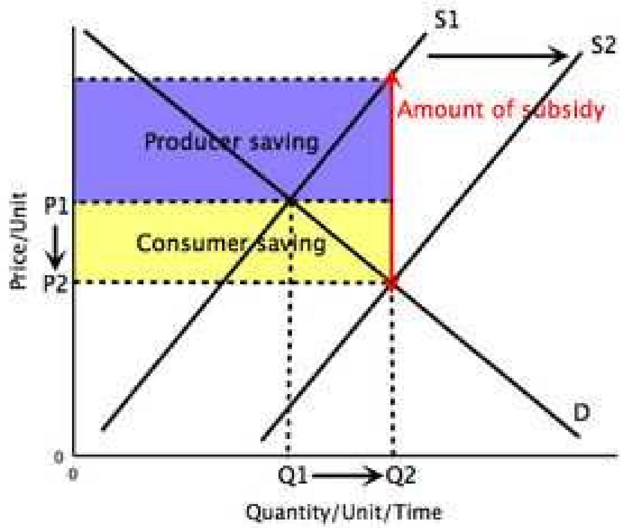
A diagram can be used to analyses the impact of an introduction of a tariff on the economy. In this graph, the price and quantity equilibrium which is at the intersection of the demand and supply curves can only be gained in a closed economy without trade. When we incorporate free trade into the model, the price of the good in the world market is P^{world}. At this price, the amount UK firms supplied will be Q^{S1}, and the level of imports will be in the range of Q^{S1} to Q^{C1}. Then the imposition of a tariff will increases the domestic price to P^{tariff}. This will cause an increase in the UK production from Q^{S1} to Q^{S2} and will reduce consumption from Q^{C1} to Q^{C2}, therefore reduce the imports. With the introduction of tariff, consumers are made worse off because the consumer surplus (green region) becomes smaller. Producers are better off as the producer surplus (yellow region) is made larger. The government will also gain revenue from the tariff equivalent to the blue region. However, from the graph, we can see that the loss to consumers is greater than the gains by producers and the government, and this societal loss is equal to the two pink triangles.

In this graph, we assume that the world price remains unchanged, and therefore the domestic price must rise by the full amount of the tariff. However, in some cases, the fall in demand from the world market causes the world price to decrease, although the decrease is normally smaller than the tariff. It implies that the domestic price rises by less than the tariff. Therefore, since the price increase is smaller, both the loss to consumers and the gains by producers are reduced, whereas the tariff revenue is not reduced. The societal loss of the tariff in these cases can therefore be positive.

If a tariff is set as a prohibitive tariff, it need only be as large as the difference between its equilibrium price (the intersection of the demand and supply curves) and the world price. In this case, it is the same that consumers lose and producers gain. However, there is no tariff revenue as imports are zero, and as a result the net loss to society caused by the prohibitive tariff is maximized.

Non-tariff methods

Subsidies can also be regarded as a form of trade barrier by making domestic goods and services artificially competitive against imports, and they are expected to protect local jobs.



When a subsidy is applied to an industry, the supply curve will shift to the right because the cost of production is made lower, hence lower the prices of the goods and encourage consumers to purchase more rather than buying imports. From the diagram, we can find that the introduction of a subsidy is good for both consumers and producers, since both the consumer surplus and the total revenue the producers gain increase.

Another method of protectionism is exchange rate manipulation. The government sells its currency in the foreign exchange market so as to lower the value of Pound. Therefore, the cost of imports will be higher than before, and exports seem more sensible. This leads to an improvement in the balance of payment. For consumers, the prices of imports seem higher, so the demand for domestic goods might be increased.

The government can also use import quotas as a trade barrier. It is a limit on the quantity of imports, hence increase the price. The effects of an import quota on the economy are similar to that of a tariff, although the tax revenue gain from a tariff will be replaced by a payment of import licenses.

The arguments for and against the use of protectionism

Protectionism is expected to save jobs. Some protective policies such as tariff and quotas work by raising the price of imports and make the UK industries more competitive in the domestic market. Therefore, the firms may increase labour, and jobs for workers will be spared and expanded.

Protectionism can protect infant industries from the perils of foreign competition. As these industries are just at the beginning, the products will have higher prices compare with foreign firms, so the domestic companies will be unable to sell their goods. Tariffs or other forms of protection can be used to make foreign goods more expensive and so allow infant industries to grow. The government will gain more revenues since some trade barriers such as tariff and quotas are imposed on the imports.

The supporters of protectionism also argue if other countries use trade barriers, it is unfair for us not using the barriers. Hence we do have a right to impose similar unfair trade barriers to make the trade between countries level.

In addition, protectionism can prevent dumping which occurs when one country floods the market in another country with a product at a price far less than it costs to produce in order to force rival firms in that country out of business.

At last, protectionism can also prevent overspecialisation. Free trade encourages countries to specialise in the goods which they have a comparative advantage (the ability of a person or a country to produce a particular good at a lower opportunity cost than another person or country). However, specialisation in one or two products can be dangerous as the demand for goods and services is always changing. If a country's economy relies on the production of just one or two goods, its domestic income might fall sharply when the demand of these goods decrease in the world market. Protectionism makes countries keep a wider range of industries and therefore prevent overspecialisation.

On the other hand, protectionism is frequently criticised by economists support free trade as harming the people it is meant to help, instead of aiding them.

Protectionism imposes tariffs and quotas on the amount of imports enter into a country. It does not only restrict consumers' choices, but also contribute greatly to both the cost of consumption and the cost of production. For instance, Japanese consumers pay five times the world price for rice because of import restrictions protecting Japanese farmers. European consumers pay dearly for EC restrictions on food imports and heavy taxes for domestic farm subsidies. Furthermore, protectionism that reduces consumer spending will actually end up destroying jobs. Since the demand for products decrease, firms are going to produce less and therefore cut labour.

As I mentioned before, if a country impose trade barriers to restrict imports from other countries, those countries might also do this in retaliation. Hence, a trade war may be created. For example, The US Semiconductor Trade Pact, which pressured Japanese producers to cut back production of computer memory chips, caused a serious worldwide shortage of these widely used parts. Companies which use these components in the production of electronic consumer goods, in various countries around the world, were badly hurt. As a resort of trade wars, the economy growth of the whole world will slow down.

However, nearly all mainstream economists are supporters of free trade. This is because the gains from free trade outweigh any losses. As free trade allows countries to specialise in the production of goods and services in which they have a comparative advantage, both consumers and producers will get benefits. And more jobs will be created in a competitive market.