Committee: Special Conference on the Consequences of Brexit

Topic: The question of free trade

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Summary

Free trade aims to promote international trade by limiting restrictions on trade through methods including tariffs and quotas. Advocates for trade argue that it benefits countries by allowing them to specialize in producing goods for which they have a comparative advantage, which increases efficiency and leads to more goods available overall. However, there are also notable disadvantages to free trade. For example, new or struggling industries where there is no comparative advantage will likely be outcompeted by the global market and decline to extinction, which results in a country losing jobs and income. Critics of free trade argue that these disadvantages disproportionately affect developing countries. The opposing idea to free trade is protectionism, which involves placing high tariffs on imports and limiting the number of foreign goods to protect local businesses, but these policies are generally regarded as having more disadvantages than free trade. Therefore, an ideal solution to the question of free trade would use trade protectionism methods to combat the negative consequences of free trade, whilst still promoting international trade overall.

Definition of Key Terms

Free trade – unrestricted international buying and selling of goods, without limits on the amount of goods countries can exchange or special taxes on goods bought from a foreign country.

Mercantilism – an economic system of trade based on the idea that a nation's wealth and power are best served by increasing exports and so involves increasing trade.

Protectionism – the restriction of international trade for the benefit of a single domestic economy.

Free market - an economy with unobstructed competition and only private transactions between buyers and sellers, where only voluntary exchange and the laws of supply and demand provide the basis for the economic system, without government intervention.

Tariff - a tax imposed by one country on the goods and services imported from another country.

Quota - a government-imposed trade restriction that limits the number or monetary value of goods that a country can import or export during a particular period.

Imports - goods and services produced in a foreign country and bought by domestic residents.

Exports - goods and services that are made in a country and sold outside its borders.

Background Information

Trade agreements are when two or more nations agree on the terms of trade between them, by determining the tariffs and duties that countries impose on imports and exports. Free trade is a policy that eliminates any tariffs, quotas, subsidies or prohibitions on goods and services applied by governments. However, in reality, few free trade agreements between countries result in completely free trade. Often the term 'free trade' may refer to removing or lessening some of a country's restrictions on trade with another country.

The idea behind free trade is linked to the concept of a free market, as both promote economic freedom for buyers and sellers. However, free market refers to the conditions within a domestic market, whereas free trade is concerned with international trade between countries. A free market is where only the laws of supply and demand govern an economic system, and there is no government intervention or conditions on transactions between economic entities. No strictly 'free markets' actually exist; however, economists have found a generally positive relationship between free markets and measures of economic wellbeing. The opposite economic system to a free market is a command economy, where government central planners own or control the means of production and determine the distribution of output. In a command economy the government, rather than the free market, determines what goods should be produced, how much should be produced, and the price at which the goods are offered for sale.

A command economy is a key feature of communist societies, and examples of command economies include Cuba, North Korea, and the former Soviet Union. China maintained a command economy for decades before transitioning to a mixed economy (with both communistic and capitalistic elements). Command economies suffer from the incentive problem, because state officials make decisions in their own interest which are harmful to national interest, and the problem of economic calculation, because supply and demand cannot operate so central planners are left with no rational method to align the production and distribution of goods which often leads to shortages and surpluses of consumer goods. These drawbacks to a command economy mean countries' economic systems tend to lean more towards free market.

Just as nations recognise the benefits to promoting free market economies, they do too the benefits to promoting free trade, which can be summarised as follows:

Comparative Advantage

Some countries are better at producing certain goods in comparison to others, so when they produce the goods, they are best suited to make they have a comparative advantage. Countries can then trade the goods they are specialized in for other goods they require, and less time and resources are wasted so there are more goods available overall.

Economies of scale

Economies of scales occur when increasing production and output of an individual good leads to lower average costs in the long run. There are many reasons for this, for example, in large scale operations workers can do more specific tasks which enables greater efficiency, and larger outputs allow firms to buy in larger quantities (bulk buying), which makes their average costs lower because of lower transport costs and less packaging is required. Free trade allows countries to specialise in certain goods and benefit from economies of scale.

Trade creation

Removing or lowering tariffs reduces the price of imports and therefore results in trade creation. When trade creation occurs consumption switches from high-cost producers to low-cost producers leading to lower prices for consumers.

Making use of surplus raw materials

Free trade allows countries to trade raw materials they have a surplus of, otherwise these raw materials would have no use.

The positive consequences of international trade have led experts to argue that free trade is an effective engine of economic growth. However, some economists have pointed out several problems that can arise when free trade policies are introduced, for instance:

Infant industry argument

If developing countries have new emerging industries and few restrictions on trade, these industries struggle against international competition. However, if infant industries are protected by stricter trade restrictions, they can progress ad gain experience, which may mean they are able to gain a comparative advantage in the future, which would benefit the developing country's economy. This has led to some arguing that free trade makes it harder for countries to develop from poor to rich.

Lack of diversity in an economy

Many developing countries' economies rely on producing primary products (often agricultural) in which they currently have a comparative advantage. However, this strategy is risky and unreliable because prices of these goods can vary due to environmental factors and they have a low-income elasticity of demand, meaning that as the economy grows and the average income increases, individuals will spend less on these products and demand will decline.

The Senile industry argument

If industries are declining, they may require significant investment to make them efficient again, which would not occur under free trade rules (as goods produced by these industries would simply be sourced from other countries instead). Whereas, protection of these industries would act as an incentive for this investment and allow declining industries to reinvent themselves.

Dumping

Dumping is when a country has excess stock of a particular good and so sells it below cost on global markets. This can have a disastrous effect on other producers where free trade policies are in place, as they become unprofitable and go out of business.

Furthermore, free trade is increasingly being used as a political weapon. Rebecca and Jack Harding's *The Weaponization of Trade* argues that the roles of economics and politics in trade policy must be balanced, with neither dominating the other. When too much focus is payed on politics there will be economic damage overall. The weaponization of trade occurs when aggressive language used to talk about trade feeds excessive nationalism and promotes the idea that trade can and should be used to coerce and influence other nations. Nations and organizations may then try to use elements of international trade in this way. For example, US President Donald Trump threatened to impose tariffs on Mexico (the US' second biggest trading partner) if it does not curb illegal immigration from Mexico into the United States in May 2019.

Individuals and organizations who try to use trade as a political weapon may be doing so to divert attention from the issues in their domestic economies, because it is easier to blame a foreign country. The authors of *The Weaponization of Trade* call this phenomenon "trade attention deficit disorder".

Major Countries and Organizations Involved

The World Trade Organisation

The WTO is the primary international body that aims to promote free trade. The main principles of the WTO are *Non-discrimination* (all nations should be treated equally, so any trade concessions offered to one nation should be offered to others, and it is unfair to favour domestic companies over foreign ones),

Reciprocity (nations should try to provide similar concessions to each other), Transparency (negotiations and process must be fair and open), and '*Special and differential treatment'* (developing countries may require positive discrimination because of historic unequal trade).

The European Union

The European Union is the world's largest free trade area and free trade among its members was one of the European Union's founding principles. The European Single Market is an entity created by a trade agreement between the members of the European Union and the four non-EU countries that are members of the European Free Trade Association: Iceland, Liechtenstein, Norway and Switzerland. The Single Market is built upon four freedoms:

Free movement of goods – Members of the single market can import and export goods between each other without any border restrictions.

Free movement of citizens- European Union citizens can move freely between member states for whatever reason and reside in any member state they choose if they aren't an undue burden on social welfare system or public safety.

Free movement of capital - Currencies and capital can flow freely between member states and EU citizens can use financial services in any member state.

Free movement of services - Professional services such as pensions, architecture, telecoms and advertising can be offered in any member state.

The United States of America

The United States of America is the highest importing country in the world and the third highest exporting country. As of 2015 the US is part of 14 free trade areas with 20 countries. In addition, the US and UK are currently negotiating a "very substantial" trade deal. This will be particularly significant because the United States of America is the United Kingdom's top trading partner and the total trade (imports and exports) between the United Kingdom and United States was worth £183.2bn in 2017.

Furthermore, the United States and China are currently locked in a bitter trade war. The President of the United States of America, Donald Trump, has long complained about China's trading practices and the United States launched an investigation into Chinese trade policies in 2017. They then proceeded to impose three rounds of tariffs on more than $250bn worth of Chinese goods, and China retaliated by imposing tariffs on $110bn of American products. Since then the trade war has escalated, although the leaders of both nations have agreed to resume talks.

Timeline of Events

16th century to the end of the 18th century

Mercantilism was first popularised in Europe during the 1500s and was the dominating economic system in Europe from the 16th century to the end of the 18th century, during which time many European nations attempted to accumulate the largest possible wealth, for example by collecting precious metals like gold and silver. Mercantilism states that the objective of trade is for the value of one's exports to exceed the value of one's imports. Mercantilism involved increasing trade to increase a country's exports but discouraged trade agreements between nations because governments used tariffs and quotas to assist local industries, whilst prohibiting any tools that might help foreign nations compete with the domestic production of manufactured goods. Some key events from this period include:

- **1651 –** The British government pass the Navigation Act to prevent foreign vessel from trading along the British coast, which reduces foreign trade and therefore benefits Britain's local industries.
- **1764 –** The British government introduce the Sugar Act, which raises duties on foreign refined sugar and molasses imported by the colonies, to help British sugar growers.

The 19th century

During the 19th century the economic policies of the European powers tended more towards more liberalized trade. After the writings of Adam Smith and David Ricardo, which emphasized the desirability of imports, gained influence, a number of significant changes in law in Great Britain reduced restrictions on importing goods. These include:

- **1823 –** The Reciprocity of Duties Act which allowed Britain to sign trading agreements with foreign nations on an individual basis.
- **1846 –** The Corn laws, which had previously imposed restrictions on imported grain, are repealed.
- **1849 –** The Navigation Laws are repealed.
- **1853 –** The Chancellor of the Exchequer, William Ewart Gladstone, repeals or reduces duties on 250 articles in his published budget.
- **1860 -** The Cobden-Chevalier Treaty between Britain and France reduces tariffs on trade between the two countries and contains a non-discriminatory policy requiring countries to treat trade with all other countries equally, known as a most favoured nation clause.

Similar treaties were signed between other nations across Europe, and the continent moved towards a system of multilateral trade liberalization (free trade).

The late 19th century

From 1873 until 1877 the world economy fell into a severe depression which increased pressure for greater domestic protection. Numerous nations in Europe, including Italy, Germany and France, re-introduced protectionist measures such as tariffs and multilateral trade between countries deteriorated. World War I then created a rise in nationalist ideologies, which triggered a new wave of protectionist trade barriers, as did the Great Depression. Some examples of the deterioration of multilateral trade in Europe include:

- **1879 –** Germany's "iron and rye" tariff imposes moderate import duties on grain and raises the duties on livestock products.
- **1892 –** France introduces the Méline tariff, which marks an end to the period of free trade between England and France which begun in 1860 with the Cobden-Chevalier treaty.
- **1932 –** Britain introduces the Import Duties Act, which places a ten per cent tariff on all imports.

The late 20th century

After World War II, the emerging world powers (in particular Britain and the US as economic superpowers at the time) began to create a more open and cooperative system of international trade in a movement known as Multilateral Regionalism. Some of their key initiatives include:

- **1944 –** Delegates from 44 countries negotiate Bretton Woods Agreement and create a new international monetary system that lasts from the mid-1940s to the early 1970s. This is achieved by comparing the value of other nations' currencies to the U.S. dollar, which is pegged to the price of gold, fixed at $35 an ounce. At the conference member countries also pledge to make their currencies convertible for trade, and overall the Bretton Woods Agreement encourages open markets between sovereign nations.
- **1945 –** The International Monetary Fund is formally introduced to monitor exchange rates and lend reserve currency to certain nations where necessary.
- **1945 -** The World Bank Group (initially called the International Bank for Reconstruction and Development) is established to provide assistance to countries financially devastated by World War II.
- **1948 -** The General Agreement on Tariffs and Trade (GATT) is formed to aid economic recovery after the war through increasing international trade by eliminating or reducing quotas, tariffs, and subsidies.

- **1951 –** The European Coal and Steel Community is formed by Belgium, France, Italy, Luxembourg, the Netherlands, and West Germany to regulate their industrial production under a centralised authority. The Treaty creates a common market for coal and steel among its member states and eventually evolves into the European Union.

The actions of these nations further encouraged regional trade agreements in Africa, the Caribbean, Central and South America.

Relevant UN treaties and Events

United Nations Resolution 69/115

United Nations Resolution 66/94

United Nations Resolution 67/196

Previous Attempts to solve the Issue

Ever since international trade began nations have been trying to devise the perfect system of restrictions on trade to maximise their economic growth and reap the benefits of free trade. For this purpose, in recent times countries have agreed on free trade agreements which create free trade areas between a small group of nations. A free trade area is where there are no important tariffs or quotas on products from one country entering another. Examples of free trade areas and agreements that have been implemented to in order to encourage free trade include:

North American Free Trade Agreement (NAFTA) - Between 1994 and 2008, NAFTA gradually phased out most tariffs on trade between Mexico, Canada and the United States of America, particularly those on agricultural goods, textiles and automobiles. However, President Trump campaigned on a promise to repeal NAFTA, believing it was unfair to the United States, and in November 2018 the three countries signed the United States of America-Mexico-Canada Agreement in replacement of NAFTA.

Association of South East Asian Nations (ASEAN) - ASEAN promotes the economic growth of 10 countries located south of China: Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam. ASEAN has lowered tariffs on 99% of its products to 0.5% between the first six countries that joined (known as the ASEAN-6) and its newer members are not far behind. In 2016, the combined economies of ASEAN nations is 4.8% and in 2017 its gross domestic product was

the fifth largest in the world, which is proving integral in helping its members to compete with the world's largest economy – China.

The European Economic Area (EEA) Agreement - The European Economic Area Agreement creates a single market between the European Union member countries and the three European Free Trade Association states: Iceland, Liechtenstein and Norway by removing trade barriers and imposing equal conditions of competition between them. The EEA agreement requires the free movement of goods, services, persons and capital throughout its member states, as well as cooperation in other areas known as flanking and horizontal policies.

Possible solutions

The opposing idea to free trade is protectionism, which involves restricting international trade to benefit a single domestic economy. The goal of this policy is usually to improve economic activity within the domestic economy, but protectionist policies can also be implemented to ensure the safety and quality of goods. Some common trade protectionism methods include:

Import Tariffs

A tariff is a tax imposed on goods traded between countries. Import tariffs are charged to the importing country and raise the price of imports for a country, and there are three main types. Scientific tariffs are imposed on an item by item basis, and they result in higher prices for the buyer. Peril point import tariffs are focused on a specific industry. Retaliatory tariffs are tariffs imposed on goods as a response to excessive duties being charged by trading partners.

Import Quotas

Import quotas limit the number of products that can be imported over a set period of time, and lead to a higher demand for domestic businesses to cover the shortfall. The most severe type of quota is an embargo, where the importation of a specific product is completely prohibited.

Product Standards

Product standard requirements restrict imports and lead to a higher volume of product production domestically.

Government Subsidies

Government subsidies are economic benefits, usually in the form of a cash payment or tax reduction, given to an individual, business, or institution by the government. Direct subsidies provide businesses with cash payments. Indirect subsidies come in the form of special savings such as interest free loans

and tax breaks. Government subsidies given to local industries allow producers to lower the prices of their goods or services so they can complete in the global market.

However, it is important to note that there are significant disadvantages to protectionism, its policies and methods. These include the following examples:

- When limiting trade leads to a less competitive system of pricing, domestic companies are able to raise their prices without raising the quality of their goods, and consumers can be forced to pay more.
- By limiting exports from other countries, trade protectionism can limit consumer's access to foreign goods and non-domestic companies which offer unique products and services.
- If one country implements protectionist policies, it can cause a retaliation reaction from other nations and end up ruining vital relationships between nations.

In addition, moving towards protectionism would result in countries missing out on all the benefits of free trade. A likely compromise to the debate between free trade and protectionism would be to restrict tariffs and limitations of trade just as free trade suggests but introduce measures to reduce the problems it could create.

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