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BENEFITS AND THREATS OF FREE TRADE

Summary: The aim of the paper is to prepare common approach to trade liberalization with reference to theoretical review on the main benefits and threats of free trade. Several objectives are discussed: trade liberalisation concept, feasible benefits and advantages of free trade, potential threats and disadvantages of free trade, common approach to trade liberalization at country's, organisation's, and consumer's levels. Judging from recent economic crises, free and open markets will be a necessary precondition for a sustained economic recovery; therefore, addressing policies with both direct and indirect impacts on trade will be of an immense importance. The main task is to liberalise trade reasonably and avoid as many drawbacks as possible.

Keywords: free trade, liberalization, benefits of free trade, threats of free trade.

1. Introduction

Trade liberalization, the reduction of tariffs, the removal of quotas and restrictions on capital flows was an integral part of a broader series of economic reforms launched after World War II. The popularity of trade liberalization and neoliberal theories has grown in recent years, which indicates priority of a market-driven approach to economic and social policy. While there is a large variety of literature on the theory of international trade and its presumed advantages, much less is written about the threats of free trade. Trade liberalization brought both economic benefits and costs, but there is no consensus among economists if the benefits of trade liberalization outweigh the costs and threats. The majority of authors writing about trade liberalization evaluates it positively, but never in contrast to the disadvantages that it may cause.

The main goal of this paper is to carry out an in-depth theoretical analysis of two contradictory approaches to trade liberalization in economic literature and try to identify which views are dominant and more justified. To achieve this goal four objectives were chosen: to introduce trade liberalization concept, to highlight advantages and disadvantages of trade liberalization, to make a distinction between different levels of trade liberalisation impacts. A systematic review of literature was made to identify, appraise, select, and synthesize all the research evidence relevant to the benefits and threats of free trade. A differentiated approach on trade liberalization

was applied at three different levels (country's, organisation's, and consumer's level) to show the complexity of benefits and threats of free trade.

2. Trade liberalization concept

Free trade is defined as a policy of unrestricted foreign trade with no tariffs or subsidies on imports or exports and no quotas or other trade restrictions. A free trade policy can be adopted unilaterally or on a bilateral basis by joining a free-trade area which is a group of countries without any tariffs or other trade restrictions between them, but remaining free to control their trade with non-members of the area [Black *et al.* 2009]. Trade liberalisation refers to the relaxation of previous government restrictions, usually in the areas of social or economic policy [Melnikas 2008]. In some contexts, this process or concept is often, but not always, referred to as a de-regulation [Sullivan *et al.* 2002]. The main argument for trade liberalization is that exposing country's economy to international competition leads to greater efficiency [Black *et al.* 2009].

3. Benefits of free trade

Free trade occurs when there are no artificial barriers put in place by the governments to restrict the flow of goods and services between trading nations. Such trade results in a range of benefits for the trading partners:

- **Open market access.** An obvious advantage of free trade is that members obtain a better access to the market of other members [APEC 2001]. The results of trade openness can be tangibly measured in terms of economic growth, productivity, a higher standard of living, further innovation, stronger institutions and infrastructure, and even promotion of peace [OECD 2010].
- **Trade creation** means that a free trade area creates trade that would not have existed otherwise. As a result, supply occurs from a more efficient producer of a product. This will raise country's national welfare [Suranovic 1998]. Trade creation occurs when consumption switches from high cost producers to low cost producers. The magnitude of this increase depends upon the elasticity of supply and demand. If demand is elastic, consumers will have a big increase in welfare.
- Openness to trade and investment has been treated as a major catalyst of **economic growth**. Trade alone explains a quarter of the productivity gains witnessed across Europe [EC 2006]. Open economies grow three times faster than closed economies [OECD 2010]. But trade is only one of many factors. A wide array of policies is needed to enable this growth, from education and health to infrastructure and innovation [Love, Lattimore 2009]. However, some studies show that openness has a weak but negative impact on economic growth [Ugurlu 2010].

- **Comparative advantage** of the increased specialisation of modern production and the increased number of stages through which materials are transformed prior to reaching the final consumer [APEC 2001]. By specialising in goods where countries have a lower opportunity cost, an increase in economic welfare for all countries can be achieved [Edge 2010].
- **Employment.** The data on industry employment proved consistent with arguments that increasing exports enhance employment [Love, Lattimore 2009]. Employment will rise in exporting industries and workers will be displaced as import competing industries close down in the competitive environment. As prices fall, consumer's purchasing power increases in a variety of sectors, leading to job creation [EC 2006].
- **Improvement of investment climate.** Enhanced trade opportunities lead to the improvement of investment climate, which gives way to investment. Increased investment leads to growth, which in turn results in consumer welfare [Mehta, Smita 2007].
- **Monopoly prevention.** Free trade can be one of the measures for monopoly prevention [Lovasy 1941]. With more trade, domestic firms will face more competition from abroad; therefore, there will be more incentives to cut costs and increase efficiency. It may prevent domestic monopolies from charging too high prices.
- **Exchange of raw materials.** Free trade makes favourable conditions to exchange surplus raw materials. It opens opportunities for mutual welfare gains, but also presents daunting challenges. The uneven distribution of raw materials among countries can be a source of international tension, but it is also the main reason why countries gain from trade [WTO 2010].
- **Intra-industry trade.** Free trade inter-industry trade modifies intra-industry trade, which provides more benefits from international trade than comparative advantage because intra-industry trade allows countries to benefit from larger markets [Bernatonyte 2009].
- With a specialisation resulting from free trade, countries are able to take advantage of efficiencies generated from **economies of scale** and increased output. International trade increases the size of a firm's market, resulting in lower average costs and increased productivity, ultimately leading to increased production [Akerman, Forslid 2009]. This is especially true in the sectors with high fixed costs or requiring high levels of investment [Pukeliene, Maksvytiene 2008].
- **Foreign exchange rate gains.** Countries with stable exchange rates have seen imports and exports grow rapidly [Malpass 2005]. The welfare ranking of fixed and flexible exchange rate regimes depends on the interplay between the degree of exchange rate pass-through and the elasticity of international substitution. Flexible exchange rates with respect to the euro yield higher welfare levels than fixed exchange rates [Hoffmann, Holtemoller 2010].

- **Production efficiencies.** Exposure to foreign competition forces a domestic industry to become more efficient and competitive [EC 2006]. A more efficient use of resources leads to higher productivity and increase of domestic output of goods and services. Increased competition promotes innovative production methods, the use of new technology, marketing, and distribution methods [Edge 2010].
- **Higher collaboration.** As a result of free trade, the competition between organisations grows and necessitates a search for new contact points, which switch them to concentration and consolidation. The intensification of international networks for production and marketing, in turn, leads to strong growth in trade and investment [OECD 2008].
- **Rising standard of living.** The countries involved in free trade experience raise living standards, increase real incomes because of higher rates of economic growth. This is due to more competitive industries, increased productivity, and efficiency. The countries that have opened their economies have experienced larger poverty reduction [Dollar 2004].
- Free trade leads to the increase in **greater variety of products** [Butkeviciene *et al.* 2008]. Consumers benefit as they can now obtain a greater variety of goods and services [Gustafsson, Segerstrom 2010; Edge 2010].
- **Lower prices.** Free trade can bring short-term benefits in terms of lower import prices [APEC 2001; EC 2006; Mehta, Smita 2007]. Whether the influence of low prices is good or bad depends on how you look at things. Cheap products may be good for a consumer, but not for people who make and sell them [Love, Lattimore 2009].

4. Threats of free trade

Although free trade has benefits, there are a number of arguments against free trade and trade liberalization. However, where many see the disadvantages of free trade often, it has not so much to do with the concept of free trade, but its implementation. Free trade implementation brings about both positive and negative results. These include:

- **Aggressive market entry policy.** The domestic firms that face aggressive import competition from foreign firms must choose to either meet the foreign competition by lowering price in order defend their market share or hold firm and use non-price based strategies to retain sales [Feaver 2004].
- **Trade diversion** may be, but not necessarily, a welfare-reducing factor. Generally speaking, the larger is the difference between prices in the free trade area and in the rest of the world, the more likely it is that trade diversion will reduce national welfare [Suranovic 1998]. Regardless of that, low trade barriers are more likely to lead to trade creation rather than trade diversion [APEC 2001].

- **Trade imbalance.** Each country has to have the right demand for goods and services produced by the other and the demands of both countries need to be somewhat equal. When free trade results in an imbalance of goods traded, someone suffers. It may be detrimental to sectors development in the long run [OECD 2010]. Poorer and less diversified economies have difficulties in capturing the opportunities arising from a more liberal trade environment [Confronti, Salvatici 2004].
- Free trade also increases the **complexity of the international trading system** and can raise transaction costs for business; for example, complicated rules of origin are required to prevent third country product entering via the other party. With different rules negotiated under different agreements, the enforcement of these rules and compliance with them by business can be a complicated task [APEC 2001].
- As a result of free trade, **economic instability** increases because of the high dependency on global markets. This means that businesses, employees, and consumers are more vulnerable to downturns in the economies of trading partners [Edge 2010]. While increasing external market access for industrialized countries, free trade also increases political instability in developing countries [Moonhawk 2006].
- **Economic underdevelopment.** Free trade may also impact some regions more than others in terms of the level of economic development. Some areas of a region may attract a greater level of economic development than others, resulting in the economic underdevelopment of some areas within the free trade zone. Unstable currency tends to cause underdevelopment, limiting a country's imports and exports [Malpass 2005].
- **Inflexibility.** Specialization entails focussing on a narrow area of knowledge or skills, or activity. It hinders an adaptation to volatile free market with high competition. The institutional challenge of responding in a timely way to the needs of a dynamic multilateral trading system in which over 150 countries are now participating appears [OECD 2008].
- **Structural unemployment.** The increase of imports reduces employment. With the removal of trade barriers, structural unemployment may occur in the short term. Often it can be difficult for these workers to find employment in growth industries and government assistance is necessary [Edge 2010].
- **Difficult establishment of developing and new industries.** Developing or new industries may find it difficult to become established in a competitive environment with no short-term protection policies by governments according to the infant industries argument [Edge 2010].
- A high competition level can lead to **corporate restructuring**. Unless companies that are at a competitive disadvantage restructure their operations, they may not be in a position to catch up with their competitors. Corporate restructuring eliminates a lot of jobs, many of which belong to professionals and managers,

but at the same time it creates many different kinds of jobs [Shirmer, Goetz 1996].

- **Environmental concerns.** Producing goods, consuming goods, and moving goods all have an environmental cost that is rarely included in the price that we pay [Edge 2010]. But it is by no means always the case that a locally sourced product is more environmentally friendly than one that has travelled a long distance. It is argued that free trade can harm the environment because least developed countries may use up natural reserves of raw materials to export. Also countries with strict pollution controls may find consumers import the goods from other countries where legislation is lax and pollution allowed [Economics help 2010].
- **Exports of primary products.** Many developing countries rely on the production of primary products in which they currently have a comparative advantage. This has several disadvantages, for example, prices can fluctuate due to environmental factors, these goods have low income elasticity of demand and, with economic growth, demand will only increase a little [Economics help 2010].
- **Higher competition.** A higher level of competition on the domestic market brings efficiency gains and lowers prices, but uncompetitive firms are likely to fail or downsize and this leads to job losses [EC 2006]. All countries within a free trade zone would be competing with one another for the same consumers. It is difficult to develop economies of scale in the face of competition from large foreign investors [Edge 2010].
- **Dumping.** Countries with surplus products may dump them on world markets below cost. Some efficient industries may find it difficult to compete for long periods under such conditions [Edge 2010]. Furthermore, countries whose economies are largely agricultural face unfavourable terms of trade whereby their export income is much smaller than the import payments that they make for high value added imports, leading to subsequently large foreign debt levels.
- **Export concentration.** The commodity concentration appears as a significant variable in explaining the export earnings instability [Hamid 2010]. When the country is fully oriented on exports, it is dependent on partner country's economic, political, and social conditions, which might be hardly predictable. High dependence on foreign markets for investments poses risks that could reverse macroeconomic gains.
- **Unfair competition.** With a high competition level on the national market, organisations may undertake some unfair steps in order to discover competitor's plans. Trade shows are one of the premier opportunities for market intelligence gathering. Corporate intellectual property owners record lost sales, lowered profits, and damaged brand reputations [Palumbo 2008].
- **Cultural identity.** Many countries wish to protect their countries from what they see as an americanisation or commercialisation of their countries [Economics help 2010]. Goods market integration causes a phenomenon of cultural divergence, whereby the distributions of cultures become more dissimilar across

countries and one of the cultures that existed under autarky ultimately disappears [Olivier *et al.* 2008].

- **Misrepresentation.** A huge amount of goods and services on the market enforces producers to create exclusive goods or services, but this requires a lot of additional costs and investments. In hard competition, producers may try to mislead the consumers, bring them not correct information on the product, imitate well-known trade marks, etc. [Malcolm, Krievina 2008].
- **Lower quality.** Opening the market to the production of the third countries brings many doubts about the quality of the products. Quality standards are quite different in separate countries and not unified for the open market. There appears a possibility of protecting domestic market by means of introducing higher quality standards for various products.

Every benefit of free trade is linked to the specific threat. All the impacts can be divided into several groups to demonstrate the complexity of trade liberalisation. Positive as well as negative effects are visible at country's, organisation's, and consumer's level (see Table 1).

Table 1. Free trade benefits in contrast with threats

Level	Benefits	Threats
Country	Open market access	Aggressive market entry policy
	Trade creation	Trade diversion, trade imbalance, trade complexity
	Economic growth	Economic instability Economic underdevelopment
	Comparative advantage	Inflexibility
	Employment	Structural unemployment
	Improved investment climate	Difficult establishment of developing and new industries
	Monopoly prevention	Corporate restructuring
	Exchange of raw materials	Environmental concerns
Organisation	Intra-industry trade	Exports of primary products
	Economies of scale	Higher competition
	Foreign exchange rate gains	Dumping
	Production efficiencies	Export concentration
Consumer	Higher collaboration	Unfair competition
	Rising standard of living	Cultural identity
	Greater variety of products	Misrepresentation
	Lower prices	Lower quality

Source: authors' own study.

5. Conclusions

The review of economic literature revealed that there are no simple answers to many of the questions raised by international trade. Trade can be a powerful force for constructive developments, but it can also bring problems and uncertainties. The main task is to liberalise trade reasonably and avoid as many drawbacks as possible.

The literature analysis revealed that the most significant impact of trade liberalisation is observed at country's level. Open market access, trade creation leads to faster economic growth, which is the main factor of welfare increase. It also creates favourable conditions for business start-up and development, which is additional impetus for investments and production growth. There is a need for further trade-offs for developing countries in order to intercept trade imbalance. This might be attained through the encouragement of bilateral trade agreements.

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WOLNY HANDEL. KOSZTY I KORZYŚCI

Streszczenie: Celem pracy jest przygotowanie wspólnego podejścia do liberalizacji handlu, które uwzględni przegląd teoretyczny głównych zysków i zagrożeń płynących z wolnego handlu. Przedyskutowano rozmaite kwestie: koncepcję liberalizacji handlu, dające się uzasadnić mocne i korzystne aspekty wolnego handlu, jego potencjalne słabe strony i związane z nim niebezpieczeństwa oraz wspólne podejście do liberalizacji handlu na poziomach kraju, organizacji i konsumenta. Wnosząc z ostatnich kryzysów ekonomicznych, wolne i otwarte rynki będą niezbędnym warunkiem trwałej odnowy gospodarczej. Dlatego też istotne znaczenie będzie miało podniesienie kwestii bezpośredniego i pośredniego wpływu rozwiązań politycznych na handel. Głównym celem będzie przeprowadzenie liberalizacji handlu w sposób przemyślany i pozwalający w jak największym stopniu na uniknięcie możliwych zagrożeń.