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Economics

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Q2. *Does unilateral free trade serve a nation's economic interests? (Professor Donald Boudreaux, George Mason University)*

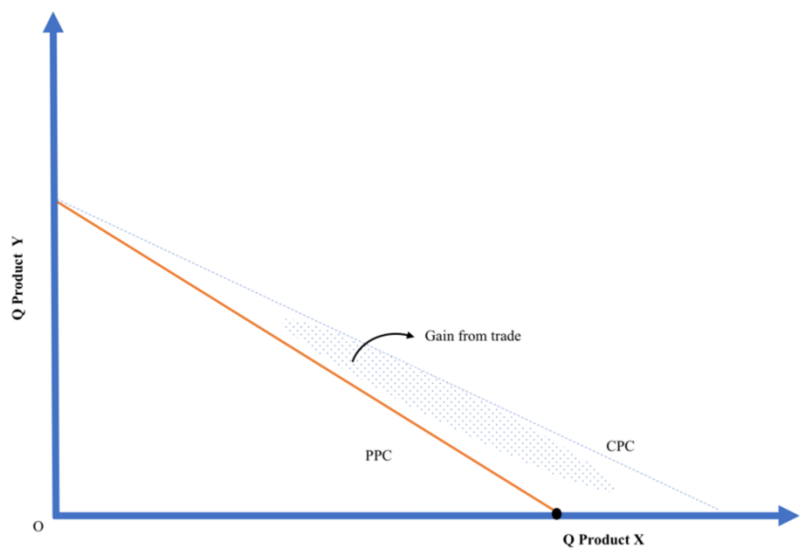
The notion of globalisation, at its core, begins with a vision of free trade, shared prosperity and a sense of internationalisation. One such aspect of this globalisation is unilateral free trade: when a country does not impose any trade barriers on the imports of a second country, without any similar reciprocation by this second country. In this scenario, one country offers free trade, regardless, and in some cases despite, existing restrictions on imports by the other country. For example, the United States of America, as part of its Generalised System of Preferences, has unilateral trade agreements, which were enacted on January 1, 1976, as part of the 1974 Trade Act. This arrangement offers duty-free status for 5,000 imports from 120 countries, including least developed countries like Afghanistan, Bangladesh, and Yemen. (McElwain, 2020) In this arrangement, the United States does not necessarily expect the same duty-free status on its exports to these countries (an arrangement that would be known as bilateral free trade). Instead, they hope to reap the economic benefits of unilateral free trade.

The benefit of duty-free export to developing nations is evident: a larger market and increased demand for their exports, which leads to an export surplus. However, unilateral free trade also entails significant economic benefits to the country adopting the policy. Firstly, unilateral free trade enables consumers to have a wider variety of choices due to increased import stemming from lower price. Inexpensive imports further drive down prices, because the domestic firms face stiff competition, which forces them to become more efficient in terms of cost reduction, innovation and better-quality products. This explains why low-cost retailers in the United States, such as Wal-Mart, have succeeded while offering a wider variety of products at a significantly lower cost. They depend on the tariff-free production from these trade partners.

Unilateral free trade can also lead to better quality goods and services. The exporting partner can specialise in the production of goods and services in which it has absolute or comparative advantages, leading to increased exports to other countries. For example, India currently provides a sizeable portion of the software and related services to the United States, by exporting the expertise and human resources from its pool of highly-trained software engineers. Due to the availability of labour, India also has a comparative advantage in developing and maintaining software at low cost. Similarly, India has a strong foothold when it comes to exporting generic medicines to the United States. Higher export leads to higher income, which in turn leads to an increase in aggregate demand. The trade partners' exports meet a part of this demand; in this case, exports from the United States. For example, India is a large buyer of defence equipment from the United States. This has been made possible through India's increased income due to exports to American markets.

Developing countries typically export less and import more from developed countries. Thus, the larger trade partner generally has a trade surplus with smaller economies. In the cited case, the US has a trade surplus with India. Hence, it results in a win-win relationship for both trading partners. The smaller trading partner gains a larger market for its exports, duty-free, and the larger trading partner benefits from an overall trade surplus. A country adopting unilateral free trade can also consume at a point higher than the production possibility curve after free trade.

Diagram-1



PPC before trade and CPC after free trade based on comparative advantages

Unilateral free trade leads to other indirect economic benefits, as well, by engendering good social and political relationships between the trade partners. Through unilateral free trade agreements, countries can also advance their foreign policy goals. For example, the United States' trade partners must abide by U.S. worker rights and intellectual property rights, in turn helping to protect American companies' patents, software, and proprietary processes.

However, by allowing unilateral free trade, the country makes itself and its industries vulnerable to certain disadvantages as well. Firstly, nascent industries which are operating at very early stages and are yet to experience economies of scale, cannot compete with overseas large scale manufacturers who have a distinct advantage in some factor of production, scale of production or technology. Thus, by allowing free trade in these sectors, the domestic emerging industries cannot grow and will be forced out of business. To prevent such a situation, the state must protect nascent industries through certain policies like tax concessions, or price preference in government purchases.

On the other end of the spectrum, domestic sunset/senile industries will also fall prey to foreign MNCs, because they use outdated technology, which needs to be replaced with advanced technology requiring massive capital investment. Like the nascent industries, they also require protection from foreign competition, until such time that they earn enough profit for such capital investment, to be able to compete. Without such restrictions on free trade, these industries cannot earn enough profit to change their production methods. They will be unable to compete against foreign firms, and will eventually be forced to close down. This occurred, for example, when the American domestic automobile industry collapsed after it could no longer compete with the efficiencies of foreign competitors. The shuttering of both nascent and sunset industries will have an overall negative impact on a country's economy, as it will lead to higher unemployment and lower real GDP.

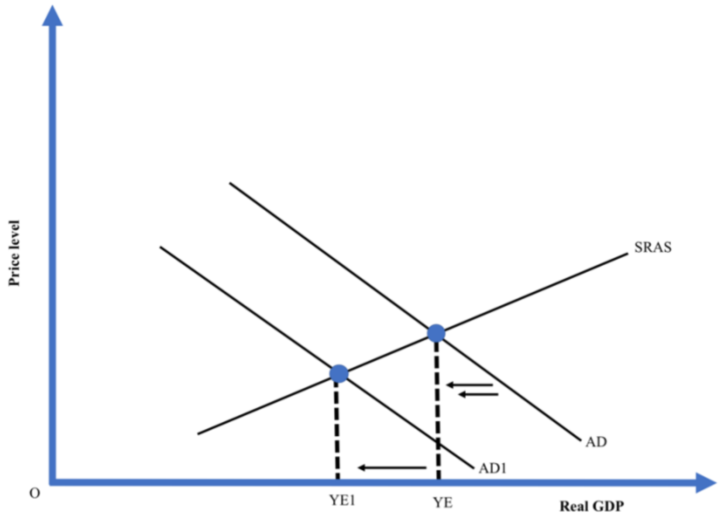
From the point of view of consumers, competition from foreign players is excellent. They get better quality products at lower prices. While this is good for consumers, there should be a level playing field for the domestic players to compete with foreign players. There are countries where the government promotes exports by providing various types of financial and non-financial incentives. If the host country has no such support system for domestic players, particularly nascent and senile industries, they will be at a significant disadvantage in the market. This will lead to other detrimental consequences, including adversely affecting entrepreneurial zeal, and indirectly affecting employment.

Furthermore, unilateral free trade policies, such as tariffs, only work best in the shorter time frame. Tariffs will eventually increase the price of imports. Consequently, the prices of locally made products will seem lower, by comparison. This, generally speaking, will boost the economic growth rate and create jobs. However, as time goes on, these advantages will start to diminish. This is usually the case when other countries retaliate and add their own tariffs. Here we see, subsequently, that the domestic companies' exports drop. With decreased export demand, companies, at some point, are forced to reduce costs by laying off recently hired workers. Global trade, therefore, begins to slow down, which is disadvantageous to all parties.

In another scenario, foreign trade partners may resort to dumping certain products that are produced in excess of their domestic consumption, at very low prices. In this case, the domestic producers of the importing country would be adversely affected because they cannot compete with the low prices. Again, these producers may be forced to close down their business, leading to rising unemployment in those sectors.

With the recent U.S.-Chinese trade war, one has also seen how, if one country continues to import without restriction, while the partner country continues to impose trade barriers, then exports for the first country will decrease while imports simultaneously increase. In the process, the net exports will decrease. As a component of aggregate demand, AD will also decrease, further resulting in the slowdown of economic growth (fall in real GDP) and rise in structural unemployment.

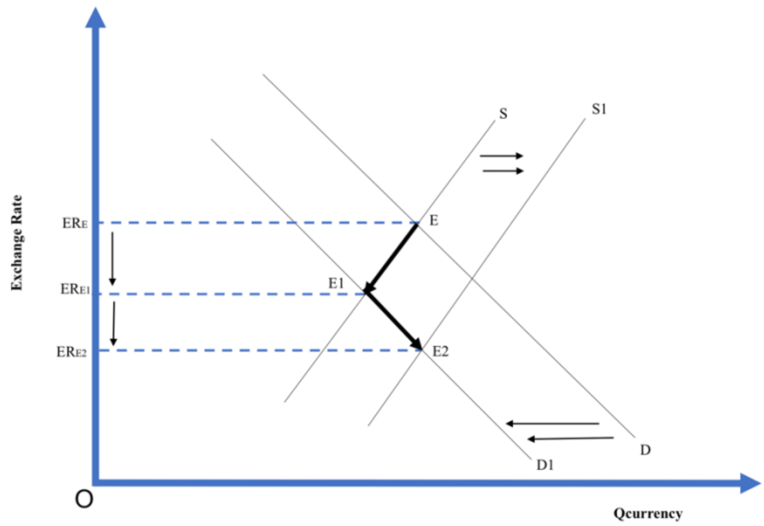
Diagram-2



Falling AD

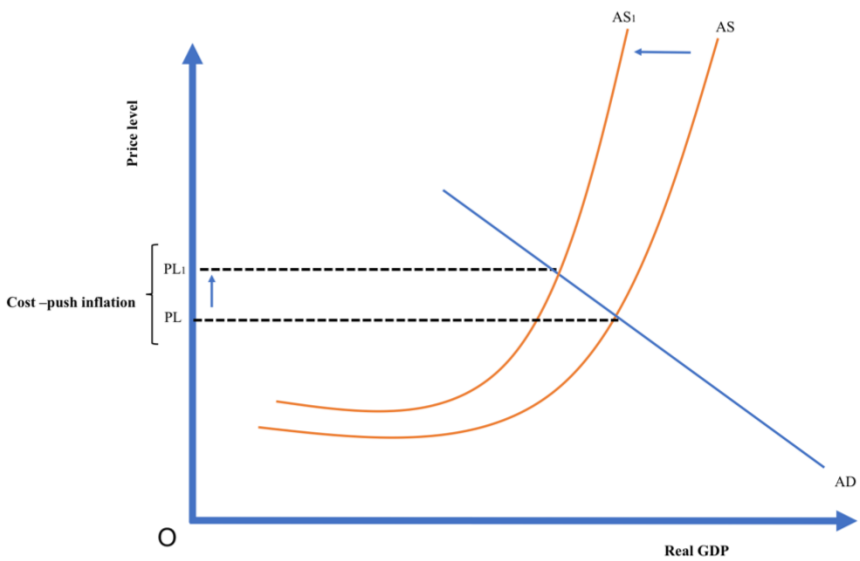
Finally, due to a decrease in exports, the demand for domestic currency will decrease. In contrast, due to an increase in imports, the supply of currency in the foreign exchange market will increase. This will depreciate the value of the domestic currency and adversely affect the cost of imported raw materials, as well as the cost of imported oil, leading to a decrease in AS causing cost-push inflation. Furthermore, the external debt burden will increase due to a weaker currency.

<u>*Diagram-3*</u>



Decrease in demand for currency and an increase in the supply of currency leading to a decrease in Exchange Rate

<u>*Diagram-4*</u>



Fall in AS causing cost-push inflation

Unilateral trade liberalisation is beneficial only if the optimal tariff is zero. In other words, there is no national monopoly power in trade, and the reduction in barriers does not drop so far below the optimal tariff as to actually bring a welfare loss (Bhagwati, 2002).

Unilateral trade liberalisation, in other words, transferring from autarky, or economic independence, to unilateral free trade, will usually lead to an increase in the competition levels in domestic markets, and result in two main effects on the domestic welfare in a country. First and foremost, the increase in competition will result in lower prices in the domestic market and thus, a definite increase in the consumer surplus levels. Secondly, the increase in competition will lead domestic firms to reduce their output, and the effect of the lower price and the lower output is to reduce the profits of the domestic firm. There are gains from trade if the increase in domestic consumer surplus is more substantial than the reduction in the profits of the domestic firm. Unless the domestic firm is sufficiently uncompetitive, the loss of profits will exceed the gain in consumer surplus for domestic consumers. Hence, there will be a resultant welfare loss from unilateral free trade. Thus, a country will only gain from unilateral free trade if the foreign firm that is involved in the trading has a significant cost advantage (Collie, 2020)

Despite unilateral free trade's potential to adversely impact domestic industries, it is also one of the most effective means of Industrial Strategy to boost productivity. It, further, sends a message of global leadership by expanding access for developing countries. Additionally, unilateral free trade provides other benefits of free trade, including more competitive prices, better goods and services, and even foreign diplomacy benefits.

In while taking into account the many nuances of welfare economics and free trade, one can safely conclude that, for any participating nation-state, the monetary benefits of free trade are nearly always higher than its costs. This, in short, translates to the conclusion that most individuals do benefit from free trade; and that, broadly speaking, unilateral free trade does, in fact, serve a nation's economic interests.

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