

# **TRADE LIBERALIZATION**

*Encyclopedia of Global Business in Today's World*

*by*

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The purpose of this entry is to provide descriptions and explanations of basic concepts on trade liberalization, and briefly introduce the main issues. Trade liberalization is a very broad subject, connected to virtually every aspect of the domestic economy, as well as economies of trading partners. In the entire literature of globalization, liberalization of trade constitutes a significant part. However, due to binding restrictions on the entry, the coverage will be restricted to two major eras of liberalization, protectionism and trade agreements.

## TRADE LIBERALIZATION

Trade liberalization refers to a significant reduction or removal of trade barriers that restrict a country's international trade. These trade barriers include tariffs, non-tariff barriers (such as quotas and other government-imposed regulations), subsidies (such as those on production and exports), and other restrictive trade instruments.

In general, the liberalization of trade entails a greater integration with global markets. In the 1980s, many developing countries implemented trade liberalization as a part of a structural adjustment program offered by the International Monetary Fund (IMF) and the World Bank (WB). Following the oil crisis of the 1970s, countries that had run high debt-to-GDP ratios and high current account deficits, such as Argentina, Brazil, Colombia, Mexico, and Turkey, were unable to continue their development strategies that relied heavily on foreign investments. Along with the fiscal restraints and currency devaluation, trade liberalization was an integral part of the structural adjustment programs. According to the IMF, developing countries now account for up to one third of world trade compared with a quarter in the early 1970s.

Trade liberalization is expected to increase a country's welfare through efficiency gains from specialization, exchange, higher competition, and access to a larger availability of intermediate and final goods. Moreover, Marc Melitz showed that, once an industry is exposed to international trade, only the more productive firms will enter while the least productive firms will be forced to exit. As a result, the overall productivity of the industry will increase. There is also a large literature on the impact of trade liberalization on GDP growth rates. In their seminal

paper, Jeffrey Sachs and Andrew Warner examined the impact of post-war trade liberalization and showed that countries with open economies tend to grow faster than closed economies. On the other hand, Francisco Rodriguez and Dani Rodrik argued that liberal trade is no guarantee for faster growth rates, and emphasized the importance of other regulations, especially fiscal and monetary policies.

## PROTECTIONISM

Almost every country has used protective trade barriers at some point in time. Following the Industrial Revolution of late 1800s and early 1900s, today's developed nations, such as United States, Canada, England, and Germany, protected their manufacturing industries against global competition. Developing countries used protection as an industrialization strategy when their primary export markets slowed down due to the Great Depression in the 1930s. Argentina, Brazil, Mexico, and Chile have all used import restrictions in order to keep out competing imports for manufactured goods.

If trade liberalization is welfare improving, why do countries choose to implement protectionist policies? If a country has the potential advantages, such as lower labor costs and abundance of resources to be competitive in the world market, but it lacks experience or scale in production, then a temporary protection of that industry may improve the long-term welfare of the country. This oldest and most popular rationale of protectionism is also called the *infant industry argument*. The first known reference to the argument was written by John Stuart Mill in 1848, who laid out two conditions under which it would be successful. First, the industry should have the potential to be able to eventually operate without protection. Second, the protection should be removed once the industry achieves competitiveness. The first condition, as simple as it may sound, is quite difficult to accomplish. For example, the petrochemical industry of Colombia, the textile industry of Kenya, and the automobile industry of Malaysia were protected for a long time, without ever being competitive in the international arena. The difficulty in finding good candidates for protection rendered many economists skeptical about the infant industry argument. The second condition is also hard to implement. Once the protection is granted, a

government may be unwilling to remove it. In many countries, the protected industries engage in heavy lobbying in order to ensure permanent protection from foreign competition. We see examples of this in the agricultural sectors of the developed nations, such as the United States and the European Union countries.

## TRADE AGREEMENTS

In the last two decades, instead of lowering trade barriers against all trading partners uniformly, countries increasingly applied differential treatment with their trading partners. Preferential Trade Agreements (PTAs) are the most common way of economic integration, where members of the group lower the trade barriers on each other's products, but can maintain these barriers on non-members. These multilateral trade agreements fall under the complex multilateral rules and laws of the World Trade Organization (WTO), formerly known as the General Agreement on Trade and Tariffs (GATT). According to the WTO, there are 205 PTAs in force as of 2008, and about half of these PTAs came into existence after 1995. Some of the best-known PTAs are the European Free Trade Area (EFTA), the North American Free Trade Agreement (NAFTA) and the Southern Common Market (MERCOSUR).

In essence, the broad objective of the WTO is global trade liberalization. Will these regional agreements help or hinder further trade liberalization? In Jagdish Bhagwati's words, are these trade blocs 'stumbling blocks' or 'stepping blocks' for the global freeing of trade? Proponents of PTAs argue that integration allows member countries to specialize and trade according to their comparative advantage, increase their scale of production slowly, and give domestic industries a chance to adjust international competition. Others express doubt about the long term benefits of PTAs. Countries that already benefit from trade blocs may be reluctant to lower trade barriers further if they do not expect significant returns. Also, these preference systems may distort production by diverting trade *away from* a potentially more efficient supplier outside of the PTA and *towards* a less efficient supplier within the PTA.

Over the past two decades, the average growth of world trade was six percent a year, which is twice as much as the growth of world GDP. However, further liberalization of trade is needed in both industrialized and developing countries, especially on areas where developing countries have comparative advantage.

SEE ALSO: Bilateral Free Trade Agreement; General Agreement on Tariffs and Trade (GATT); Trade Barriers; Trade Bloc, World Trade Organization

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