OPENNESS TO IMPORTS AND THE DYNAMIC BENEFITS

Dobre I. Claudia

"Ovidius" University, Constanța, Faculty of Economic Sciences, Constanța, Aleea Universității no. 1, dobre_claudia@yahoo.com***, 0241.511000, int. 146***

Anghel Gabriela

"Ovidius" University, Constanța, Faculty of Economic Sciences, Constanța, Aleea Universității no. 1, gabi_eforiesud@yahoo.com, 0241.511000, int. 146

Abstract. *Despite major reductions in trade barriers, protectionism continues to be a major drag on our economies and a barrier to lifting developing countries out of poverty. The political difficulty of dismantling protectionist mechanisms means they tend to persist long after they have ceased to be economically justified. With the benefits so clear, and the costs so substantial, why is there not a greater constituency for further progress in reducing barriers to trade? Why is the current round of trade talks in the WTO failing to make faster progress? Part of the answer lies in the mercantilist approach which some participants take to trade negotiations. While opening new export markets is rightly seen as a success, opening economies to imports is often (wrongly) seen as a 'concession'.*

Key words*: protectionism, benefits of free trade, economic reforms*

Introduction

International trade has been a major driver of global growth and prosperity over the last fifty years. As trade has expanded, global incomes have grown. Open economies have been able to harness the power of trade to boost competitiveness and productivity, helping improve living standards and sustain economic growth. Protectionism imposes a double burden on tax payers and consumers. In the case of European agriculture, the cost to tax payers is about €50 billion a year, plus around €50 billion a year to consumers via artificially high food prices – together the equivalent of over £800 a year on the annual food budget of an average family of four. Furthermore huge distortions in international agriculture markets prevent the world's poorest countries from trading in the products they are best able to produce. Continuing barriers to trade are costing the global economy around $500 billion a year in lost income.

The importance of open economies

It is imports which bring direct benefits to consumers and producers through access to a wider range of goods and services at lower cost. Of course exports are vital to our economy. But imports matter too. The EU should show leadership. The EU has, as a result of recents reforms already taken steps to tackle trade distorting domestic support, and should continue to do so. We warmly welcome Pascal Lamy and Franz Fischler's recent proposal to put all export subsidies on the table for negotiation.

But we believe the EU can and should go further. The EU should agree to furthersignificant further agricultural reform so that border protection is substantially reduced and export subsidies are no longer an issue for world trade by 2010 by: making a unilateral commitment to end all export subsidies, setting a clear enddate now; and committing to the elimination of all agricultural tariff peaks, towards the maximum level for non-agricultural products. Not all countries will benefit in the short term from a multilateral reduction in trade barriers. For some the costs of this preference erosion will be substantial. The IMF has already taken an important step in establishing a new facility to help countries which face balance of payments problems as a result of preference erosion. We should seriously consider supplementing this with additional grant resources, designed to help the most vulnerable countries adapt and reap the benefits of more open global markets.

More broadly, some of the world's poorest countries will face serious constraints in managing the transition to more open markets and capturing their benefits. They need carefully designed and sequenced trade reform packages, integrated into development and poverty reduction strategies and supported by aid flows, in order to ease capacity constraints and help manage change. Trade negotiations should not be seen as a game in which we win only where others lose, but as a collaborative effort to reduce barriers to trade to the advantage of us all.

The expansion in the volume of world trade over the last years has been supported by a steady decline in trade barriers, helping to sustain global growth and enable economic development. As trade barriers have fallen, the structure of international trade has also changed. New information and communication technologies have had, and continue to have, a profound effect. Some services which previously could only be provided domestically can now be traded internationally.

Finer differentiation between products designed to meet specific consumer needs has led to a rise in intra-industry trade – where countries exchange goods which fall into the same broad industrial classification but differ in their specialized features. In addition, technological advances have allowed companies to slice up production processes, locating different stages of production in different regions or countries. These developments offer major new trading opportunities for all economies. They also imply change. Resources are shifting away from traditional industries and into new ones; and the process of change will continue, as developing countries increase their share of world trade. The global benefits from the continued expansion of world trade are potentially substantial. The complete elimination of all agricultural and manufacturing tariffs could yield benefits of over $1,000 billion annually.

However, doubts about the advantages of greater openness to trade are feeding a persistent protectionism and putting these benefits at risk. While expanding export markets are widely accepted as beneficial, increases in imports can be seen as threatening, replacing domestic production with goods and services from abroad. Governments are often under pressure to respond by protecting sectors from international competition. At a global level, progress on the current multilateral trade round has thus far been slow.

Both economic theory and countries' experience show that economies which trade more tend to grow faster. Income growth depends importantly on a country's capacity to raise its productivity. Openness to trade – both exports and imports strengthens the drivers of productivity by: enabling a more efficient allocation of resources; providing greater opportunities to exploit economies of scale; by exposing the domestic economy to greater competitive pressures; rewarding innovation and providing access to new technologies; increasing incentives for investment.

Taken together, these factors mean that openness to trade can play an important role in raising the long-run sustainable rate of productivity growth in the economy. Notwithstanding the approaches of many trade negotiators, the dynamic effects of openness derive from exposure to imports as well as from opportunities to export. It is the extra competition and innovation which imports bring that helps boost productivity. Moreover, openness to imports increases choice and reduces costs not only for consumers (where the benefits can be considerable), but also for producers. In short, restrictions on imports penalize exporters. It follows from this that the mercantilist approach in which many trade negotiations proceed – a zero-sum game where success is defined solely as accessing as many new export markets as possible, while opening home markets is seen as a "concession" – is so misguided.

Openness to trade has helped promote structural change in the UK economy, enhancing processes already underway due to technological advances, and allowing domestic resources to shift from less productive to more productive uses. In Europe too reductions in trade barriers have boosted economic performance: EU GDP is estimated to be nearly 2 per cent higher as a result of the creation of the Single Market. But the EU still has a long way to go in reducing barriers to trade with the rest of the world, particularly in agriculture. Increased external openness is an integral part of the Lisbon Agenda to promote economic reform within the EU.

Globally, countries which have moved more rapidly towards more outwardlooking trade policies have found it easier to sustain high rates of productivity growth. Different countries have pursued different approaches to trade reform. But while the precise mix of policies have varied from country to country, the key is to move clearly and consistently towards greater openness – imports as well as exports. Despite the manifold benefits of openness to trade, trade protection remains a significant problem. Although barriers to trade have fallen significantly over the last half-century, particular sectors and products remain subject to high levels of protection. Average import tariffs between OECD countries are around 3 per cent; but tariff peaks reach 506 per cent in the EU, and 350 per cent in the US. The highest tariffs are typically levied on goods from the developing world.

Agriculture is heavily protected worldwide, imposing substantial costs on both developing countries and our own economies. Industrial countries' total support to agriculture exceeds $300 billion annually. In Europe alone the Common Agriculture Policy (CAP) costs taxpayers some €50 billion a year, plus another €50 billion in extra consumer costs through higher food prices. The global benefits of significant agricultural liberalisation could be as high as $350 billion by 2015.

The stated objectives of protectionist policies can almost always be achieved more cheaply and effectively though alternative policies. Targeted income support and retraining for those leaving declining industries can achieve the same objective as import restrictions (i.e. preventing unemployment) at much lower cost, and with much greater benefits in terms of labour market flexibility and the productivity of the economy as a whole. Additional incentives for R&D-intensive sectors provide a more direct means of compensating companies for spillover benefits than protection.

The global welfare gains from significant liberalisation in agriculture alone could reach $350 billion. The estimated gains from reducing protection on manufactured goods range from $190 billion for partial liberalisation to $644 billion for full liberalisation. The impact of further opening up of services trade is harder to quantify, but could be extremely significant. In short, while estimates vary according to different models used, the order of magnitude is compelling. Reducing protection would make a very substantial contribution to global welfare.

Changes in the structure of production and employment are an intrinsic part of capturing the benefits of greater openness to trade. This requires flexibility in labour, product and capital markets; and social policies which, while providing adequate support, help manage change rather than preventing it. The relationship between flexibility and openness is mutually reinforcing: openness can help increase flexibility in the economy. The European Union in particular must press forward with its economic reform agenda, alongside greater openness to trade, as part of the drive to improve productivity and competitiveness.

Governments have a vital role to play in creating flexibility – equipping their economies to benefit from the dynamic opportunities which openness to trade generates. Investment in education and training enables individuals and firms to respond positively to change. Economic reforms which reduce the regulatory burden on business, encourage competition and promote enterprise and innovation have a strong mutually reinforcing relationship with trade openness.

Flexibility and fairness should be advanced together. Social safety nets are very important in supporting individuals dislocated by trade reform, and can help maintain support for change through difficult transition periods. But social protection should contribute to flexibility – by linking it to opportunities to acquire new skills, forexample. The focus should be on enabling individuals to re-enter the labour market as quickly and smoothly as possible. Trade has the potential to lift millions of people out of poverty. Developing countries stand to gain substantially from further reductions in trade barriers. A significant reduction in developed country barriers to trade in agriculture could benefit developing countries by up to $75 billion a year – significantly more than total annual aid flows.

But developing countries have to overcome significant capacity constraints in order to capture the benefits of more open trade. In many low-income countries, low levels of human, physical and institutional capital seriously constrain their economies' capacity to respond to the signals from international markets. High transaction costs – for example transport, insurance, customs procedures, communication costs – often dwarf the impact of formal trade barriers. Low-income countries also typically have much higher barriers to the entry and exit of firms, and poor access to financial services.

Overcoming these capacity constraints will require significant resources in addition to current aid flows. Given the public good nature of many of these investments (especially those in education and health), it is unlikely that private investment will fill the gap. It is therefore critical that trade reform in developed countries is accompanied by increases in aid flows through mechanisms such as the International Financing Facility. Aid and trade will then reinforce each other, with a substantial impact on development and poverty reduction.

Developing countries also face specific problems in managing the transition to more open markets in their own economies. For those dependent on preferential access to rich country markets, erosion of the value of those preferences through multilateral reductions in trade barriers could have a significant effect, necessitating profound structural change. Low-income countries also tend to be more heavily reliant on tariff revenue; and they are more vulnerable to balance of payments short-falls.

This suggests carefully designed and sequenced trade reform packages, which are integrated into development and poverty reduction strategies, and supported by significant additional international aid flows for investment in physical, human and institutional capital would help ease capacity constraints and help manage change. Eliminating quota restrictions and customs exemptions, reducing non-tariff barriers and reducing tariff dispersion to the minimum are likely to be sensible first steps in most developing countries' trade reform programmes.

Developed countries have an important role to play in providing the resources for the investment needed. This includes direct assistance to facilitate adjustment in those countries badly affected by the loss of preferential margins; and substantial additional resources to allow countries to build a pro-trade infrastructure, and boost their social spending in education and health.

Openness to trade strengthens the drivers of productivity through six important (and mutually reinforcing) routes:

- *more efficient allocation of resources* - trade enables each country to specialise in the production of those goods and services which it can produce most efficiently. Countries can raise overall consumption by exchanging their surplus production for the surplus production of other countries which have a different comparative advantage;
- *economies of scale* **-** in the absence of trade, economies of scale are constrained by the size of the domestic market. Trade removes this constraint, allowing industries and firms to produce on a more efficient scale than would otherwise be possible;
- similarly, trade *increases incentives for firms to innovate*, because the rewards from successful innovation will be proportionately greater if firms are selling in larger (i.e. export as well as domestic) markets. Where highly productive firms expand as a result of exports, this boosts the productivity of the economy as a whole;
- *greater competition* - trade openness exposes domestic firms to greater competition. This helps to encourage exit from the marketplace of the least productive firms; reduces monopoly rents; drives down margins; and reduces prices for consumers. Competition further reinforces incentives to innovate, helping to create more competitive firms which can then compete more effectively in world markets;
- *access to new technology* - trade can provide direct access to goods and services that incorporate new technologies, particularly where more open trade regimes have led to different stages of the production process being undertaken in different countries;
- *incentives for investment*. Better access to imports and to export markets increases the scope for productive investment by creating new business opportunities. Foreign direct investment (FDI) enables technology and innovation developed abroad to be applied to domestic production, enhancing competition and leading to a faster diffusion of more efficient and innovative processes.

Conclusions

We need urgently to open our own markets, and put an end to unfair subsidy practices which distort world markets particularly in agriculture and labour-intensive goods where protection is highest and developing countries are most competitive. We need to face our historical responsibilities and help those developing countries whose export revenue has become increasingly dependent on our byzantine preferential regimes, and who could face significant adjustment costs during the transition to a fairer world trading system. And we need to assist developing countries to design carefully sequenced trade reform packages, integrated into development and poverty reduction strategies and supported by international aid flows to help them overcome serious capacity constraints and capture the potential benefits of more open markets.

Bibliography

1. Dobre I. Claudia, (2006), Firma în economia mondială actuală, in „Globalizarea, încotro? Realizări – Tendințe – Consecințe", Ed. Cartea Studențească, Bucureşti
2. Krugman, P. R., and M. Obstfeld, (2003), International economics: theory and policy, 6th edn, Addisonwesley, Boston
3. Leamer, E. E., and J. Levinsohn, (1995), International trade theory: the evidence, in Handbook of international economics, ed. by G.M. Grossman, and K. Rogoff, vol. 3 of Handbooks in economics, Elsevier
4. Mussa, M., (1993), Making the practical case for freer trade, American Economic Review, 83(2)
5. Rodrik, D., (1992), The limits of trade policy reform in developing countries, Journal of Economic Perspectives, 6(1)