

Trade Policies and Economic Growth

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Abstract

This paper aims to examine the relationship between trade policies and economic growth. In order to test whether restrictive trade policies have a positive impact on economic growth, we investigate America, Australia and China, and, analyse how their economic performance varies between a free trade environment and a relatively protective trade environment. In this paper, we focus on comparative advantage and use various data such as tariff rate, GDP growth rate, unemployment rate, etc. to test the influence of trade policies on economic growth. We find some support that less restrictive trade policy leads to better economic growth; however overall tariff rates do not seem to have a strong effect on economic growth rates.

1. Introduction

Trade policy refers to a set of rules concerning the global exchange of goods, including tariffs, quotas, import and export regulations, etc. The purpose of trade policy is to make sure that trade between different countries go smoothly and is beneficial. (Helleiner, 1995) As international trade has become increasingly important today, it is widely believed that countries with less restrictive trade policies enjoy faster economic growth compared with those that insist on trade protectionism (Okuyan, Ozun and Erbayka, 2012). Under such opinion, the majority of nations have gradually reduced trade barriers in recent years. Free trade agreements have rapidly spread worldwide, across from the Americas, Europe, China to East Asia (Cheng, 2008). However, the accuracy of the argument that trade openness could positively affect the economic growth has been questioned by some economists (Madsen, 2009).

This research paper provides two opposite hypotheses: ‘countries with less restrictive trade policies will enjoy better economic growth’ and ‘countries with more restrictive trade policies will enjoy better economic growth’. After analysing the literature and data, the hypothesis of countries with less restrictive trade policies will enjoy better economic growth is accepted.

The rest of this paper is structured as follows: the literature review section provides evidence which theoretically supports the hypotheses. In the data analysis section, various figures show the removal of trade barriers will have a positive impact on a country’s economy. The conclusion shows the key results, as well as the limitations of the research.

2. Literature Review

Existing literature generally examines the correlation of an individual country’s level of openness and the growth rate of that country. In this paper, we use data from China, Australia and United States in terms of several economic aspects in order to illustrate the correlation. Among existing empirical studies no consensus has yet been reached with regards to the impact of trade openness on a country’s growth of economy. Dollar and Kraay (2004), Frankel

and Romer (1999), Sachs and Warner (1995), and Dollar (1992) show that free trade has a positive effect on economic growth by applying various measurement of openness. Wacziarg and Welch (2008), Rodrik, Subramanian, and Trebbi (2004) and Rodriguez and Rodrik (2001) articulate that free trade has negative impacts on growth and more trade restrictions benefit the economy.

On the one hand, it is argued that increased degree of trade openness benefits a country's economy. The theory of international trade is based on the concept of comparative advantage, which is introduced by David Ricardo. Comparative advantage states by specialising in goods that have lower opportunity rather than only financial costs, there will be an increase in global production and an increase in economic welfare of all nations. Therefore, unlike in a protectionist economy, free trade reflects the true picture of a market's demand and supply. Furthermore, global production would be increased by free trade as countries specialise in goods where they have the highest comparative advantage rather than protecting weak industries from foreign competition by imposing trade restrictions. Organisations such as the OECD and the World Bank often promote that openness of trade generates positive and predictable results for economic growth(OECD, 1998). Therefore, given the benefits of international trade, many countries enter bilateral free agreements. Hur and Park (2012) assert that the number of free trade agreements have risen dramatically since 1975.

On the other hand, economists also argue that countries with more restrictive trade policies enjoy better growth. Structural unemployment might occur in the short run if trade barriers are removed. The removal of barriers would also increase the instability of the domestic economy due to increased dependence on the global market. The increased instability means that domestic businesses and consumers are vulnerable to downturns of the trading partner's economy (Okuyan, Ozun and Erbayka, 2012). Furthermore, considering the high level of competition under international trade, infant or developing industries may find it difficult to be established in such environment without the government's short-term protection policies. In regards to tariffs, it is also argued that tariffs have positive effects on growth performance in

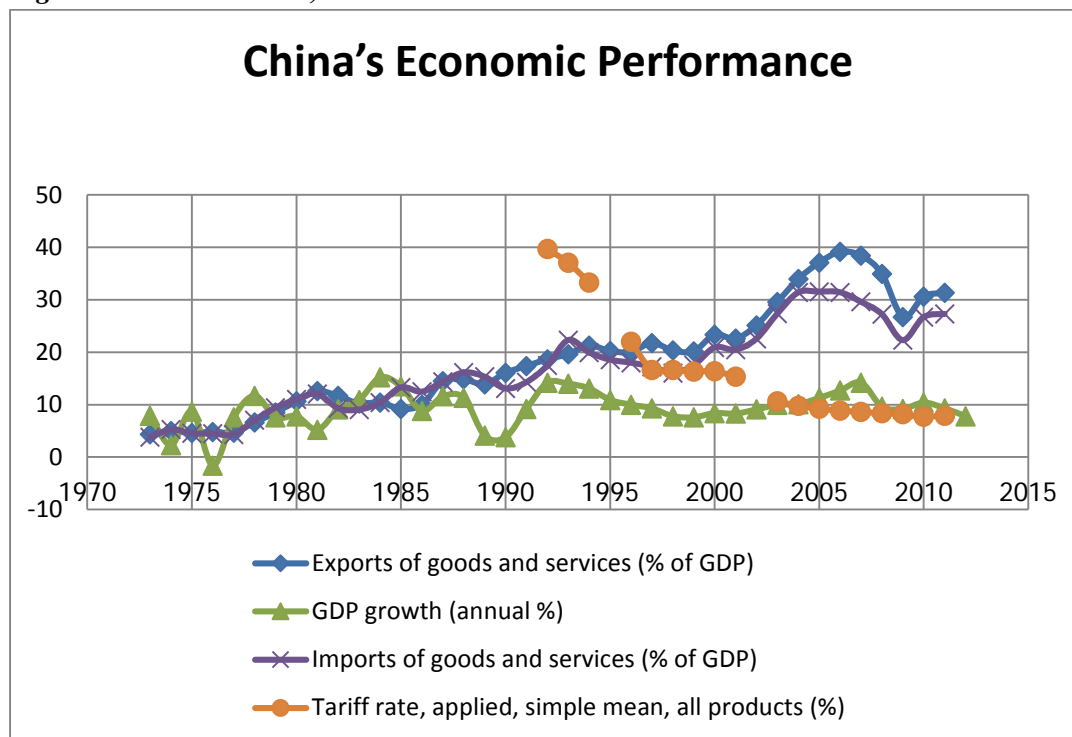
terms of job protection and government benefits. Tariffs secure jobs by keeping domestic corporations competitive which prevents them from reducing work forces and closing plants, but the costs that arise from tariffs are high (Madsen, 2009). For example, Moffatt (2013) showed that when the USA raised tariffs to save steel worker in 2000, it is cost over \$400,000 per job saved.

3. Analysis

We use data from China, Australia and America. We look at the following variables: level of export and import of goods and service, tariff rate, unemployment rate, GDP growth rate and GDP level. The time interval for the data is from 1973 to 2012.

3.1 China

In the late 1970s, China reversed the Maoist economic development strategy and, by the early 1980s, had committed itself to a policy of being more open to the outside world and widening foreign economic relations and trade. As shown in Figure 1, the percentage of import and export started to increase in the early of 1980's, it rises from 5% to 22% until the early 1990's. Meanwhile, the GDP growth rate increased around 8% to 14% during 1980s to 1993. This suggests that a better trade environment generates better economic performance. China has cut tariffs five times between 1992 and 1999, lowering the average import tariff level from 43% to 17%. As a result, the import and export level continues at 20%, while the GDP growth rate began to taper off until 2000, where it increased again. Moreover, China joined to WTO in 2002, according to the average tariff level of all WTO members is now about 6 per cent. It stands at 3 per cent in developed countries and 10 per cent in developing ones. Li (2010) claimed that China cut import tariffs to 9% after 2002, and as a member of WTO, China has more opportunities to stimulate the national economy. The import & export level continually increased from 2002 to 2006, and then rapidly decreased because of the financial crisis, suggesting that lower tariffs will promote a better economic growth.

Figure 1: Data on China, 1973-2012

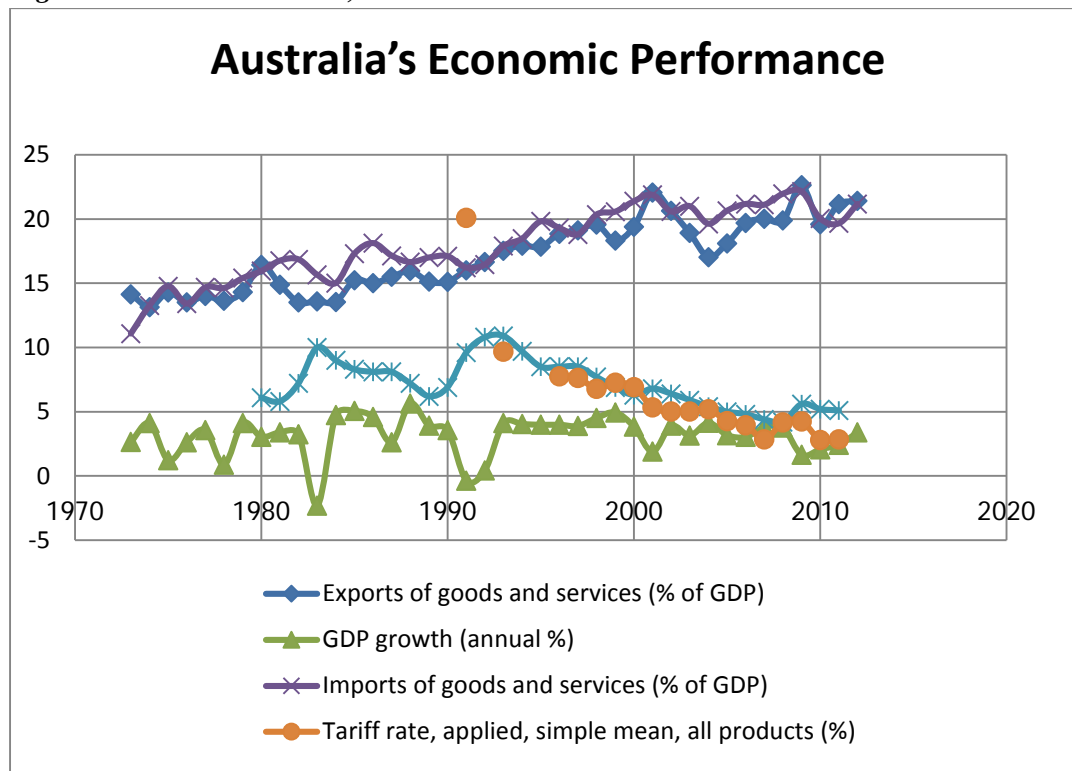
Source: The World Bank group (2013)

3.2 Australia

The largest tariff cut occurred in 3 periods, which is 1973, 1988 and 1991. Significant tariff reform happened in 1991, when a deep recession was affecting the world economy, The Hawke Government set up the tariff cuts schedule that continued from 1988 along with an overall economic reform program for recovering economic growth and job creation (Kennedy, 2002). As can be seen in Figure 2, at the time of 1991, the level of tariff stood at 20% while the GDP

growth dropped below 0% due to the recession. But after 2 years, the tariff cut policy reduced tariff above 10%, and GDP growth returned to around 5% in 1993.

Figure 2: Data on Australia, 1972-2012



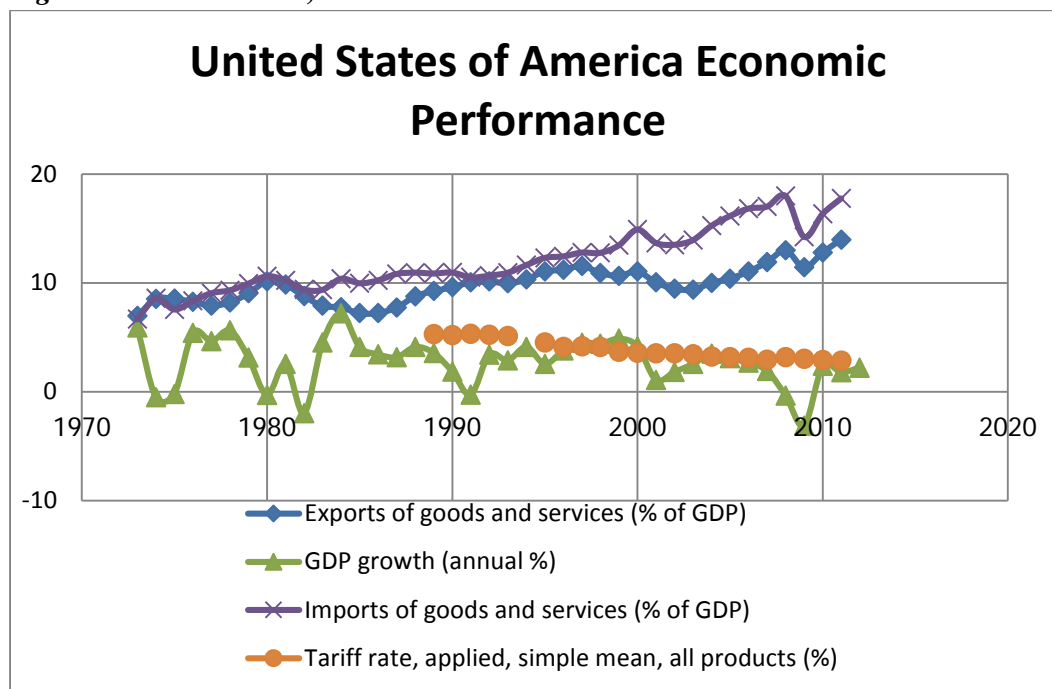
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3.3 United States of America

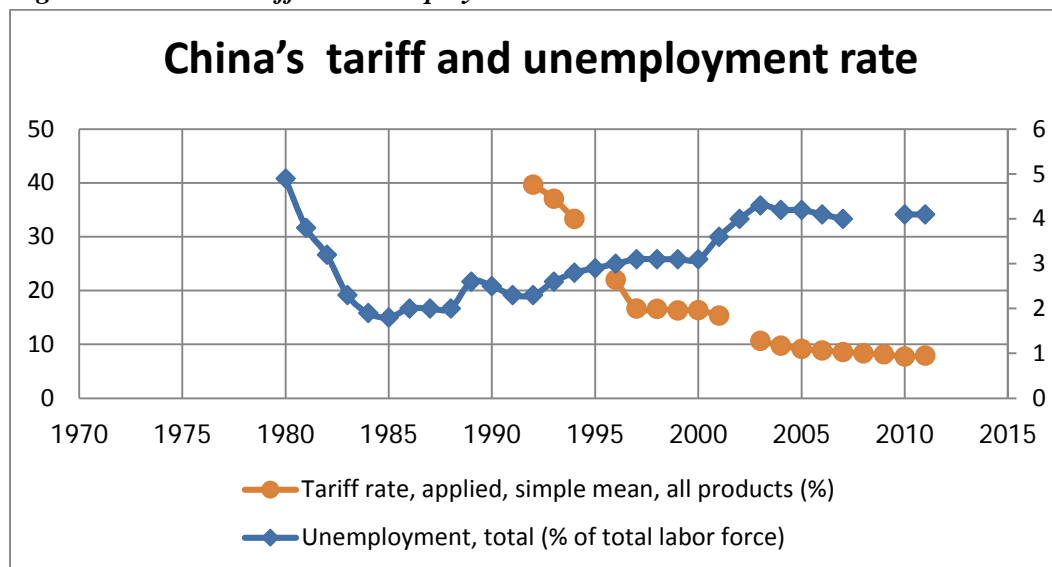
The USA experienced recessions in 1973, 1981, 1990, 2000 and 2009 while the tariff in USA also gradually declined over time. According to the U.S. International Trade Commission, the

1967–86 periods was that USA tried to balance between tariff cut and Voluntary Export Restraints (VER). US's GDP growth is decreased from nearly 8% to 3%. From Figure 3, the numbers of export and import level were improved to over 12% of GDP in 1999. The GDP growth rate has been trending downwards after 1999, making it unclear if there are any long-term effects of trade barrier removal.

Figure 3: Data on U.S.A, 1973-2012



Source: The World Bank group (2013)

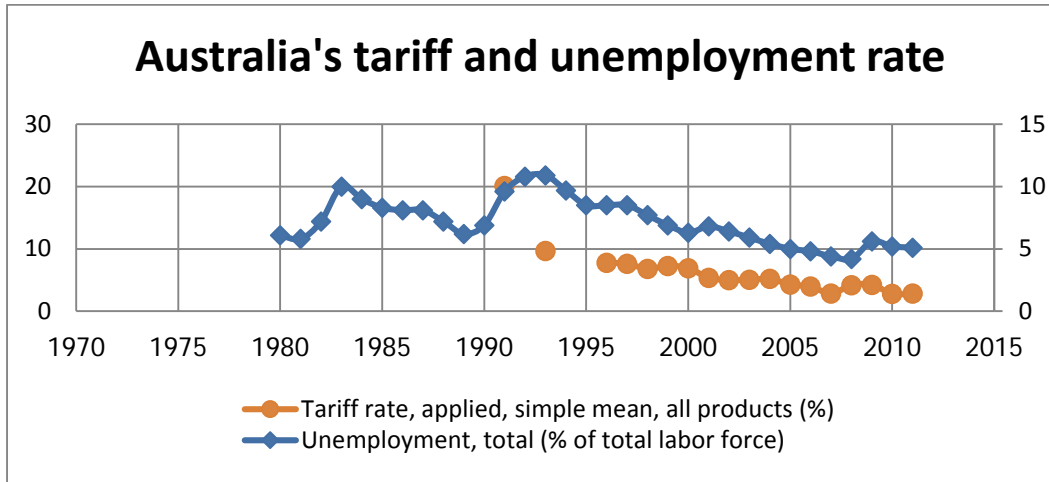
Figure 4: China's tariff and unemployment rate

Source: The World Bank group (2013)

3.4 Alternative Hypothesis Analysis

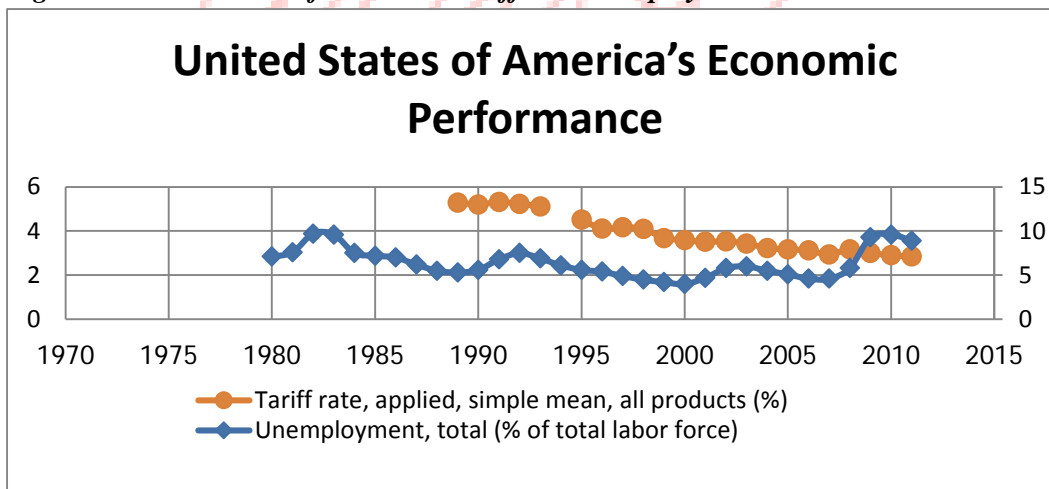
In contrast, even if the trend of those indicators points out that free trade encourages economic growth, economic growth could come at the cost of high short-term unemployment. For example, China reduced about 6% of tariff rate during 1996-1997 but unemployment continued to grow; this is in contrast with Australia that change tariff rate from 3.59% to 3.17% during 2000-2005 and experienced a fall in unemployment (Figures 4 and 5). However, the other side argument stated that trade barrier could be used to protect job and domestic competitive advantage, but the cost that rises from trade barrier is high. For instance, the trend of unemployment rate of Australia show that after tariff cut in 1991 the trend raised from below 10 % to about 10.8% in 1992. This, however, could reflect a lagged effect on employment. For the U.S. it seems that tariff changes do not have strong effects on unemployment (Figure 6).

Figure 5: Australia's tariff and unemployment rate



Source: The World Bank group (2013)

Figure 6: United States of America's tariff and unemployment rate



Source: The World Bank group (2013)

4. Conclusion

On the basis of the analysis, we suggest that trade openness has a positive impact on economic growth. However, there are exceptions in the data where increased trade did not result in more economic growth. In the graph of China's economic performance it is clear that during the period of 1979 to 1981, China's exports and imports were increasing while the GDP was decreasing. With respect to the Australia and US data, exceptions occurred in the period of 1999 to 2001 and 1978 to 1980 respectively. These exceptions suggest a much more nuanced analysis is required before any strong conclusions can be made.

4.1 Limitations of the analysis

There are some limitations that should be considered. Firstly, the sample data represented only 3 countries. The trend can be different in different countries due to differences in political and geographic factors.

Secondly, the indicators that were used to identify level of economic growth and free trade may represent only one perspective and miss some important point. For example, the tariff rate ignores nontariff barriers such as (VER).

Thirdly, economic growth is clearly not influenced on by trade policies, and moreover, trade policies may be changed for political rather than economic reasons.

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The image shows the word 'dpibe' written in a red, cursive, handwritten style. The letters are connected and fluid. From the end of the word, a red arrow extends upwards and to the right, pointing towards the top right corner of the page.