Free trade impacts – pro-trade

This is an article looking back at the US/Canada free trade deal. It's useful because sufficient time has passed to allow the outcome to be seen. It is quite long, so may be best to focus attention on key questions:

Before free trade began what was the situation in Canada in terms of protected industries?

What happened to the protected sectors when free trade was introduced?

What happened to employment in the long run? Why?

What happened to wages once competition increased?

What happened to productivity? Why?

Looking at the table, what seems to be the story in other countries?

How can this be shown using AD/AS diagrams?

What Happened When Two Countries Liberalized Trade? Pain, Then Gain

ECONOMISTS argue for free trade. They have two centuries of theory and experience to back them up. And they have recent empirical studies of how the liberalization of trade has increased productivity in less-developed countries like Chile and India. Lowering trade barriers, they maintain, not only cuts costs for consumers but aids economic growth and makes the general public better off.

Even so, free trade is a tough sell. “The truth of the matter is that we have one heck of a time explaining these benefits to the larger public, a public gripped by free trade fatigue,” the economist Daniel Trefler wrote in an article last fall in The American Economic Review.

His article, “The Long and Short of the Canada-U.S. Free Trade Agreement,” uses detailed data on both Canadian industries and individual companies to address these gaps. The study looks at the effect of tariff reductions, the simplest kind of liberalization.

Before the agreement went into effect in 1989, more than one in four Canadian industries were, in fact, protected by tariffs of more than 10 percent. Those industries included not only businesses known for their protectionism, notably apparel makers, but manufacturers of a wide range of products, from beer and pretzels to coffins, plastic pipes and paper bags.

Before the agreement, imports from the United States faced an average tariff of 8.1 percent and an effective tariff of 16 percent. The effective rate included import taxes on the final product and tariffs paid on raw materials. Someone importing a chair could face a direct tariff on furniture, for example, but could also pay indirect tariffs on wood and upholstery fabric.

Not surprisingly, the Canadian industries that had relied on tariffs to protect them “were hammered” when those barriers disappeared, Professor Trefler said. “They saw their employment fall by 12 percent,” he said, meaning one in eight workers lost their jobs. In manufacturing as a whole, the trade agreement reduced employment by 5 percent.

“Employment losses of 5 percent translate into 100,000 lost jobs and strike me as large,” he wrote, “not least because only a relatively small number of industries experienced deep tariff concessions.”

No wonder free trade agreements touch off so much opposition.

As painful as those layoffs were, however, the job losses were a short-term effect. Over the long run, employment in Canada did not drop, and manufacturing employment remains more robust than in other industrialized countries.

“Within 10 years, the lost employment was made up by employment gains in other parts of manufacturing,” Professor Trefler found.
While low-productivity plants shut down, high-productivity Canadian manufacturers not only expanded into the United States but further improved their operations. Along the way, they hired enough new workers to make up for losses elsewhere.

“The average effect of the U.S. tariff cuts on Canadian employment was thus a wash: the employment losses by less-productive firms offset the employment gains by more productive firms,” Professor Trefler wrote in an e-mail message, citing further research.

Nor, contrary to predictions, did Canadian wages drop because of competition from less-educated, nonunionized workers in the southern United States. Quite the opposite: using payroll statistics, he found that “for all workers, the tariff concessions raised annual earnings” by about 3 percent over eight years.
Admittedly, that is not a lot. “A 3 percent rise

in earnings spread over eight years will buy you more than a cup of coffee, but not at Starbucks," he wrote. "The important finding is not that earnings went up, but that earnings did not go down." In addition, he said, "there is absolutely no evidence" that the trade agreement worsened income inequality.

The big story is that lowering tariffs set off a productivity boom.

Formerly sheltered Canadian companies began to compete with and compare themselves with more-efficient American businesses. Some went under, but others significantly improved operations.

The productivity gains were huge. In the formerly sheltered industries most affected by the tariff cuts, labor productivity jumped 15 percent, at least half from closing inefficient plants. "This translates into an enormous compound annual growth rate of 1.9 percent," he wrote.

But closing plants is not the whole story, or even half of it. Among export-oriented industries, which expanded after the agreement, data from individual plants show an increase in labor productivity of 14 percent. Manufacturing productivity as a whole jumped 6 percent.

"The idea that a simple government policy could raise productivity so dramatically is to me truly remarkable," Professor Trefler said.

And the long-run increase in productivity did not result mostly from shutting down inefficient plants. It came from better operating practices. "That's not coming from natural selection," he said. "That firm's actually doing business differently."

Thanks in part to the trade agreement, he sees a shift in attitudes among the younger generation of Canadian managers. They are less content to be the best in Canada's relatively small market.

"They're thinking the competition isn't here in Toronto," he said. "The competition is there in the U.S. To succeed in U.S. markets, you have to play like the Americans do, which is innovate and upgrade."

Source:

http://www.nytimes.com/2005/01/27/business/worldbusiness/what-happened-when-two-countries-liberalized-trade-pain-then-gain.html?_r=0

ANNUAL GROWTH AND TRADE LIBERALIZATION

Country	Trade Liberalized	GDP growth Before (%)	GDP growth After
Brazil	1965	2.90	3.43
Korea	1965	5.77	10.40
Singapore	1968	1.60	4.20
Portugal	1970	5.32	6.48
Average of 31 nations		4.45	5.57