Does Free Trade Promote Prosperity?

Dr Sok Sina analyses the view that free trade is not a panacea for economic development. Different theoretical approaches are discussed. As Cambodia engages with the globalised world, the process of free trade is moving on. Members of the World Trade Organisation (WTO) will have to compete with each other. Advantages and disadvantages can apply at the same time, and the outcomes depend primarily on the competitive position of each nation.*

Globalisation[1] and concerns about poverty and inequality have become some of the most discussed issues in academia and the media. But there are different views on the effects of globalisation. Anti-globalisation protesters chant that globalisation makes the rich richer and the poor poorer, while the supporters claim globalisation promotes prosperity. Even among economists there are serious differences of opinion on the effects of free trade on an economy. If there is no common view on the relative value of gains from free trade, why then do countries around the globe, even poor countries, decide to enter the WTO? When Cambodia joined the WTO in 2004, it did so like many other developing countries with the hope that the WTO would benefit the export sector, especially garment production. To achieve this goal, the costs of energy, transportation and bureaucracy need to be reduced and worker's productive capacity must be promoted.

This brief article examines how Cambodia can obtain benefits from WTO membership. The first section discusses the classical theory of international trade and the second highlights some counter-arguments. An analysis of the Cambodian situation and some policy recommendations follow.

The Classical Theory of International Trade

According to this theory, trade is a source of prosperity. Absolute and comparative advantages are the two important mechanisms by which international trade can be created. This section examines how the benefits of trade can be achieved through the two mechanisms.

Shortages of goods cause trade

Trade between nations generally takes place when there is a shortage of goods in one country. Trade brings benefits by helping to remove shortages of consumer and investment goods in the importing country. For developing countries, which do not have the capacity to produce industrial equipment to process agricultural goods, the import of such equipment is very important. Thus, new products can be created. At the same time, the exporting country can reduce its surplus and the gains from exports can be used for other purposes. This can also help to create new products in the exporting country.

Differences in production costs also cause trade

Goods exist in countries participating in trade but the production costs are different. Through trade, welfare in those countries can be increased by reducing production costs. Countries in which production costs are high can replace domestic goods with imported goods produced at lower cost. Therefore, trade enables a country to specialise in its production methods. The improvement in production methods leads not only to reduction in production costs but also to the invention of new products.

Counter-Arguments

The classical theory of international trade, however, has long been criticised. Friedrich List, the German-born economist and one of the most important founders of the theory of tariffs, strongly criticised the arguments of Adam Smith, who appealed for free trade. According to List, trade brings an even distribution of prosperity only if the participating countries are at the same level of development. Otherwise, trade causes winners and losers. The former are generally the richer countries, since their production methods are more developed. The latter are the poorer ones. Correspondingly, trade is not a panacea for development.

Advocates of dependency theory (e.g. Paul Baran 1957) even argue that developing countries should sever their ties with developed countries. According to this theory, deepening integration into the world market can undermine development. The main reason for this is uneven exchange between developed and developing countries. This argument has been supported by Dieter Senghaas (Hein 1996). According to Senghaas, an emerging country needs some form of protectionism to help infant industries survive. He argued that economic development in western Europe was due to protectionism rather than to free trade.

The development strategies of newly industrialised countries (NICs) show a similar path. For example, export promotion and import substitution were the combined strategies that helped South Korea and Taiwan rise to be among the most successful economies of the 20th century. Their success is continuing into the present century. One strategy of protectionism is to permit foreign direct investment only if it does not jeopardise the existence of domestic infant industries. Protection lasts until the infant industry matures and becomes competitive, then

* This article is based on classical theory of international trade, counter-argument and the analysis of the Cambodian situation. Dr Sok Sina is a research associate at CDRI.

is lifted step by step in order to let domestic products compete with foreign products.

The strategy of protectionism assumes strong state intervention in the economy, which is in contrast to the classical theory of international trade and to mainstream monetarists who regard strong intervention by the state as harmful to economic growth. Advocates of the theory of tariffs, however, argue that it is not protectionism per se that is harmful, but a lack of focus of protectionism and a delay in realising the negative effects of protectionism that are harmful.

The Cambodian Situation

The theoretical approaches discussed above suggest that free trade is by no means a guarantor of prosperity. One of the poorest countries in the world, Cambodia was admitted to membership of the WTO in September 2004. Entry into the WTO reflects the commitment of the government to poverty reduction through trade, which is regarded as a key initiative to stimulate employment in all sectors. Although trade volumes have increased dramatically since the formation of the coalition government in 1993, foreign trade has been heavily dependent on just one sector, the garment industry. For example, the export of garment products accounted for 70 per cent of total export volume in 1998–2002.[2] The garment industry's exports rose from USD20 million in 1995 to almost USD2 billion in 2004.

The growth of the garment industry was due to three crucial factors: (1) the direct investment law, (2) the MFN (most favoured nation) and GSP (generalised system of preferences) benefits provided by the USA and the European Union, and (3) cheap labour. The export industry of Cambodia came to life in the midst of the liberalisation of textile trade, which was regulated by the ATC (Agreement on Textiles and Clothing). Under this agreement, trade in textile products was subject to bilateral agreements. Import quotas and tariffs were set by the importing country. The ATC lasted until the end of 2004. Since then, there have been no quotas for trade in textile products for WTO members; export and import of textile products are not restricted but are subject to normal tariffs. In order to keep the garment industry employed, Cambodia needs WTO membership. That is a plausible argument. Free trade, however, means that domestic products must compete with foreign products on both the world market and the domestic market.

It is almost impossible to calculate the real gains and losses of free trade. But one can analyse the effects of free trade through the consumer effect and the producer effect. These effects can be different. If domestic products are more expensive than imports, the demand for the latter increases. The consumer effect is positive in this case because the consumer consumes more goods at the same cost. But the producer effect is negative as the demand for domestic goods decreases. A positive consumer effect comes at the cost of production. Thus, an increase in imports can cause a drop in employment. Taking the producer effect into account, the integration of the Cambodian economy into the WTO does not offer a very bright perspective in the short term. It may, however, be positive in the long run. But it is important to recognise that future prospects are strongly determined by the concrete situation in the present as future is the continuum of the present.

The garment industry of Cambodia is very young. By the end of 2004, more than 50 per cent of garment products exported to the US and EU benefited from MFN or GSP. As preferential treatment does not exist any more, the garment industry very much depends on its competitiveness. There are at least three main factors determining the competitive position of an enterprise: price, quality and management skills. With regard to product quality and management skills, the competition on the world market is not very problematic because approximately 80 per cent[3] of garment enterprises are foreign owned and most of them have long experience in the business. The key issue is the cost of production. Since China is also a member of the WTO and one of the leading exporters of textiles, Cambodia faces strong competition from that country. The production costs of garments in Cambodia are about 15–20 per cent higher than in China (IMF 2003: 48). Cambodia therefore needs to lower its production costs to remain competitve. In some cases, however, it is impossible to lower production costs. A large proportion of production input consists of imported goods. The costs of those materials can not be reduced domestically because they depend on world market prices. The garment industry monthly minimum wage of USD45 clearly lies under the subsistence level of USD 80. This wage can not be reduced for the sake of lowering production cost. There is, however, an opportunity to reduce costs of domestic inputs.

The costs of energy, transportation and bureaucracy need to be reduced. Energy in Cambodia costs USD0.12–0.16/kWh, four times higher than in Thailand and Vietnam.[4] The transport of one container to the seaport costs about USD500, 4.1 times more than in Vietnam.[5] Another major cost the garment industry faces is bureaucracy. The impact of this cost can be described by quoting Van Sou Ieng, the president of the Garment Manufacturers Association: "Again, I repeat, and I'm tired of repeating the same thing: bribery, bureaucracy and corruption are impeding the industry" (*Cambodia Daily*, 13 February 2004, p. 1).

Conclusion

The WTO is not a problem per se for Cambodia. Rather, it poses the challenge of how Cambodia can benefit from

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