

Market Monitor

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Turning Down a Free Lunch

Last week negotiations collapsed on the latest round of world trade talks. These negotiations, known as the “Doha Round” for the city where the initial talks took place, held the potential to make world trade freer and the world itself richer. Unfortunately, because farmers and other protected groups stood to lose if the talks succeeded they may have been able to block a deal. This is hardly an unknown occurrence, but it illustrates the significance of trade in the world economy and world markets. This week, we concentrate on two themes:

- Why free trade is good for the world
- Why investors like free trade

It is often said that economists can't agree on anything. President Truman was reputedly heard to say that he wished for a one handed economist because all the economists he knew said: “On the one hand, on the other hand ...” When it comes to trade, however, every economist is famously one handed. Free trade is one the few unambiguously good things.

Free trade is based on the idea of comparative advantage. This means that a country, a company, or a person concentrates on what they do best. For

instance, if a product – say sugar – can be produced cheaper in a foreign country than it can be produced domestically, then we should buy sugar from overseas and use our domestic resources to produce something else like a new computer chip or even pension management.

Today, most commodities freely trade around the world. This allows resources to flow to their best use. Countries and companies that have embraced this message have thrived and prospered. Those that tried to close themselves off from this trend have not.

There is one major sector that is an exception to the trend of freer world trade. That sector is agriculture. Throughout the world, but especially in the richest countries in the developed world, farmers are protected and shielded from world competition. Taxpayers pay tens of billions of dollars and euros and yen each year to a tiny number of farmers. On average, these farmers earn more – especially after subsidies provided by their taxpayers – than do the citizens paying the taxes to subsidize them.

Several consequences follow from these barriers and subsidies. One is that consumers pay higher prices for food than they would if trade in agricultural products was more open. Another is that farmers in developing countries – unable to sell as much as they could to the developed world – remain poorer than they would otherwise be. This is a pernicious result of agricultural protectionism. Not only are resources allocated inefficiently, some experts believe that freeing up agriculture trade would spur more development around the world than all of the world's foreign aid put together.

If free trade is such an unambiguously good thing, then why did the trade talks

fail? There was a lot of finger pointing and blame to go around for everyone but essentially, each country holds a portion of the blame because of their unwillingness to give a little to get a little. Trade negotiations are a protracted process of give and take, whereby a country agrees to open up its markets in exchange for access to markets around the world.

As a general rule countries do not decide to open up their markets unilaterally. Any country, however powerful, would make itself better off by deciding in favor of free trade and opening up its markets regardless of whether other countries did the same. This is because open markets are a favor a country can grant to itself. Consider the case of the two Koreas. At the end of the Korean War a half century ago South Korea had per capita income on par with Sudan. It is now a thriving modern economy, thanks largely to embracing free trade. North Korea, which actually was the richer half of the peninsula at the end of the war, is now an impoverished prison.

The story is similar when we focus not on broad economies, but more narrowly on investments. The South Korean stock market has a capitalization of

approximately \$330 billion. There is no stock market in North Korea. The areas that have raised the highest barriers to free trade and investment are the least favored in the eyes of global investors, with correspondingly negative implications for companies and citizens in those areas. For example, as an investment opportunity, China is not nearly as transparent as the U.S. or Western Europe. But its trade rules are far more open than many other developing countries and it has become one of the world's leading destinations for foreign direct investment. This has made a major contribution to the stunning growth and rapid rise in living standards in China. By contrast, on China's southern border, the country of Myanmar (formerly Burma) has largely walled itself off from the outside world. It attracts virtually no foreign investment and its populace remains poor.

In sum, investors around the world vote with their dollars, and can increasingly invest their capital all over the world. Countries and companies in need of investments need to make themselves desirable destinations for global capital. Those with free trade are much more likely than those with trade barriers to be attractive places to invest. Because of free trade, both the investor and the country can then enjoy a free lunch!

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