Theoretical Debate on Free Trade and Fair Trade*

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Introduction

A steady sequence of upheavals in international economic relations has continued since the 1970s. The fixed exchange rate system, established in Bretton Woods in 1948, was inevitably abandoned in favor of a managed float system in 1971. A booming international capital market has not only forged new links among financial centers of the world, but also raised new unease about international financial stability. Newly industrializing economies (NIEs) have seized an important share of exports in manufactured goods in the world market from the developed economies. Most recently, macroeconomic imbalances, combined with structural shifts in trade patterns, have generated political pressures that gravely threaten the open international trading system, a system built up so painstakingly after World War II.

Economists often refer to trade barriers as administered protection, because these barriers typically do not imply legislative enactment of each act of protection. The expansive trend in world trade resulting from declining tariffs was rudely interrupted in the middle of 1970s. An offsetting growth in these trade barriers followed. With these respect to negotiated tariff reductions, continued in GATT negotiations, their incremental effect in loosening the restraints on the world trading system was seriously compromised by the growth of non-tariff barriers (NTBs). These restrictions are customarily applied through institutions and processes set up to regulate imports, including the exercise of political power by the executive branch in making trade-restraining arrangements with other countries.

Non-tariff barrers can be classified into two different categories with wholly different implications. One type of barrier is that which bypasses GATT's rule of law ; the other type of barrier is that which acknowledges the rule but pervert it. The former type consists of "high-track"[1] restraints on exports by trading partners ; the latter type

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1) The distinction between the "high-track" and "low-trak" processes of admistered protection is drawn in Finger et al. 1982. The terminology itself is attributed to Richard Cooper.

consists of "low-track" restraints, such as countervailing duties and anti-dumping provisions.

Recent trade friction has generated various types of bilateral and multilateral negotiations. In order to establish an international economic order, one that would promote mutual development through trade and investment, it is the most important to theoretically analyze the points of friction and suggest a clear-cut direction for policy implementation.

The purpose of this research is to derive new implications from the existing theories of free and fair trade. The persistent trade disputes between the United States and Japan have aroused a debate over the issue of free trade verses fair trade in both the policy arena and the academia. However, there has not yet been a thorough discussion comparing the two contrasting notions. In this research, I will clarify the relationship between the notions of free trade and fair trade, compare the merits and demerits of each, and propose an alternative, economically desirable policy.

I will define free trade as a theory or an argument which focuses on the benefit arising from the free movement of goods and services due to the differences of factor endowments, and calls for the minimization of the impediments against free movement of goods and services across borders in order to achieve a maximization of gains among all countries involved. Fair trade, on the other hand, will be defined as a theory or an argument justifying calls for fairness in terms of opportunity, capability and outcome among all countries involved in trade.

The content of my argument will be based on the equilibrium and partial equilibrium chart that are often used for analysis on gains from trade. The existing studies of trade has been primarily static in its analysis and explanation (in other words, a static explanation was applied to a static result). In this research, I will attempt to conduct a dynamic analysis and explanation, and to derive new implications. I will also inquire into its policy implications.

I. Free Trade and Gains from Trade

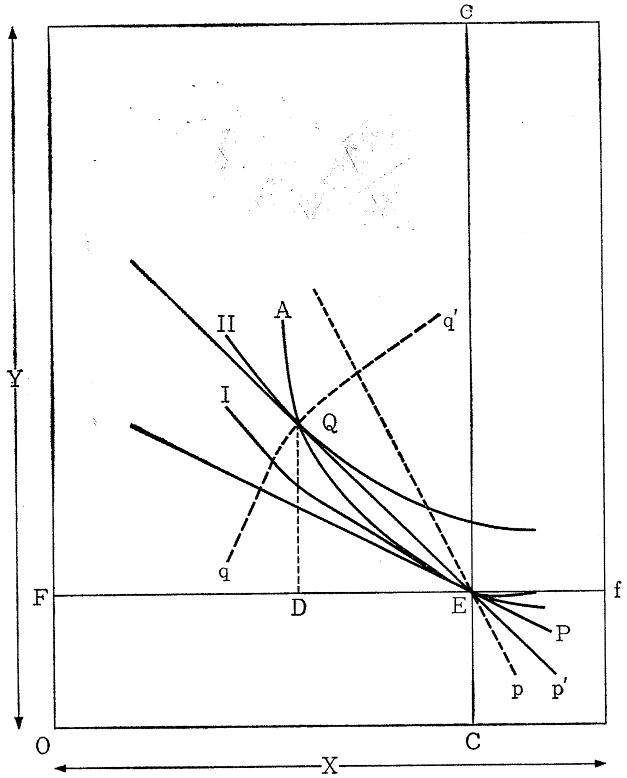
1. New Theoretical Approach to Free Trade Theory

The Ricardian approach (focusing on comparative cost of produced goods, etc.) has been the basic approach to the theory of free trade for a long time. In this paper, however, since a minutely constructed traditional trade theory is very static, We consider consumption economic trade theory[2] where trade is defined by consumer preferences in the two countries and their demand-function.

This proposition has a lot of value, and it suggests the following important political implications: (1) All gains from trade will raise the level of welfare for the consumers ; (2) trade regarding the comparative cost of produced goods increases the total welfare

2) Professor Kiyoshi Kojima used this term in his articles (Kiyoshi Kojima, "Kokusai Boeki Toshi-ron", *International Economic Review*, No. 4-5, 1979 ; Kiyoshi Kojima, "Kako Boeki-gata Keizai Hatten Model", *International Economic Review*, No. 10-11, 1979).

Chart— 1



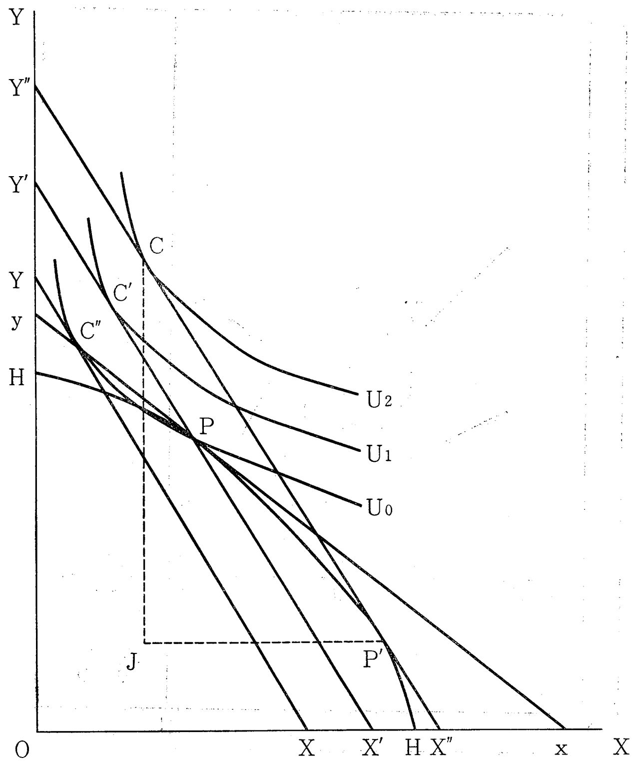
of the consumers of countries involved in trade ; and (3) free trade maximizes consumer welfare compared to the situation in which tariff and other artificial impediments exist. These propositions together constitute the core of the free trade principle and these all involve universal propriety in so far as produced goods are concerned. First, we should rightly evaluate the free trade principle.

However, the request for protected trade comes from supply-side economics. According to this position, the kind of good that a country produces and the way of producing the good are important. Free trade principleand the request for protected trade belong to different dimensions. Therefore, free trade principle accomplishes universal propriety independently.

2. Pure Exchange Model

Chart-1 indicates a pure-exchange-model with an offer-curve. It is hypothesized here that one country which places its primary point at point-***O*** holds a volume ***OC*** of good-***X*** and a volume ***OF*** of good-***Y***. Each country faces the international market and has trade relations with a foreign country whose volume of goods, value of utility and comparative prices are different. One country exports a volume ***ED*** of good-***X*** and imports a volume ***DQ*** of good-***Y***. As a result of this exchange, the indifference-curve

Chart—2



shifts from ***I*** to ***II*** and consumer welfare increases.

Pure exchange is defined as a rearrangement of goods in stock. This definition does not include changes in production. This model offers an important conclusion to the debate over the essence of gains from trade. That is to say, trade profit means consumer profit and the increasing of welfare through rearrangement of goods in stock. Consumer profit is provided through the import of cheaper and increased amount of foreign goods. In short, gains from trade can be explained as "gains from import." Since the export of goods decreases the availability of consumption goods and reduces welfare, export in itself is not a source of trade profit. This conclusion contradicts the opinion that importing is a "loss" and exporting is a "gain" in recent trade negotiations.

Furthermore, according to this model, we can understand that trade equilibrium in a pure exchange is determined by consumer taste, which is explained by the demand function. Therefore, we can understand that traditional trade theory must be a "consumption economic trade theory." Even when trade is accompanied by production adjustment, the situation is essentially the same. This is explained in the next section.

3. Gains from Trade in the Case of Trade Accompanied by Production Adjustment

Chart–2 shows the case of trade accompanied by production adjustment in the beginning of trade. (1) The production point shifts from $\boldsymbol{P}$ to $\boldsymbol{P'}$ on $\boldsymbol{HH}$ (production-frontier)-curve (production adjustment or specialization), (2) the consumption point shifts from $\boldsymbol{P}$ to $\boldsymbol{C}$ (consumption adjustment) and (3) by exporting a volume $\boldsymbol{JP'}$ of good-$\boldsymbol{X}$, and by importing a volume $\boldsymbol{JC}$ of good-$\boldsymbol{Y}$, trade is balanced. In accordance with (1), (2) and (3), (4) indifference-curve shifts from $\boldsymbol{U_0}$ to $\boldsymbol{U_2}$ (consumer-welfare is increased by a large margin). This is the gain from trade in case of trade accompanied by production adjustment.

On chart-2, the pure-exchange-model can be explained as consumer welfare rising on the indifference-curve from $\boldsymbol{U_0}$ to $\boldsymbol{U_1}$ by producing goods at $\boldsymbol{P}$ and consuming them at $\boldsymbol{C'}$. Therefore, when trade is accompanied by production adjustment, it means that consumer-welfare is further increased on the indifference-curve from $\boldsymbol{U_1}$ to $\boldsymbol{U_2}$. This is usually called "gains from specialization" and differs from "gains from exchange" that are introduced by pure-exchange-model. "Gains from exchange" create consumer profits. Therefore we should focus on the nature of the "gain from specialization."

"Production-frontier" is the locus of a combination of optimum output of two goods, when production factors (labour and capital) are the most efficiently (satisfying Pareto-optimality) allocated to producing two goods, and full-employment is maintained. Therefore, point $\boldsymbol{P}$ and $\boldsymbol{P'}$ on $\boldsymbol{HH}$-curve (production-frontier) are "indifferent." If this "indifference" means no gain and no loss, it means that the process of production adjustment from $\boldsymbol{P}$ to $\boldsymbol{P'}$ does not produce any gain for production-side.

In short, when production adjustment accompanies the beginning of trade, more profit from trade is gained than the case of pure-exchange-model. However, production adjustment does not produce any profit for production-side, but only increases consumer-welfare. Therefore, all gains from trade result in "profit" on the consumption-side. In sum, traditional trade theory incorporates production adjustment and gives consideration to the production-side, still, this is essentially a "consumption economic trade theory." Furthermore, as long as trade is indifferent to the production-side, free trade always increases consumer-welfare, not only in case of pure exchange, but also in the case where production adjustment is included. The legitimacy of the free trade principle and its universal propriety are thus demonstrated.

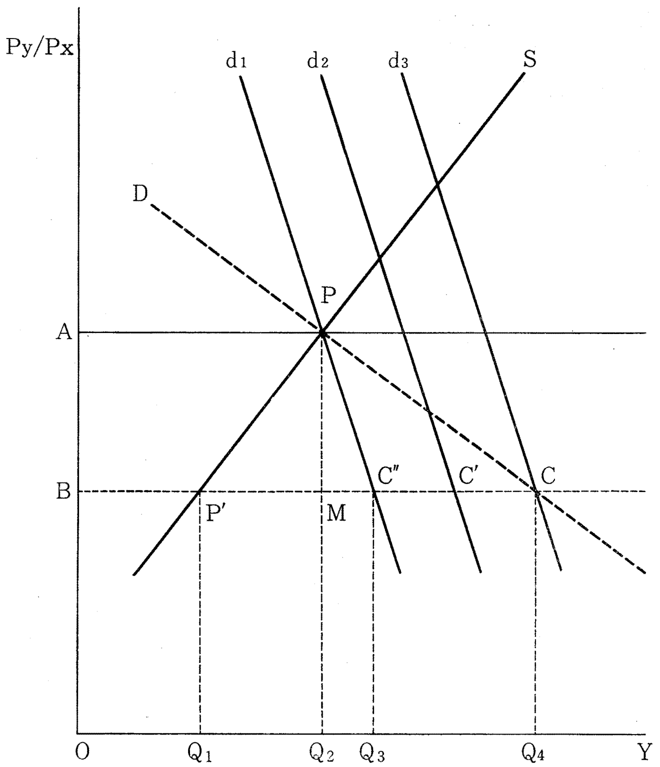
II. Economic Analysis on Fair Trade

1. The Friction in Production Adjustment

Foundation of Protected Trade

In terms of produced goods, free trade is supported by the former argument and the consumption economic trade theory because free trade always increases consumer welfare. However the calls for protected trade comes from production (supply)-side. The major reason for advocating anti-free trade is the friction, it causes through the production adjustment (specialization) process. The interests of consumers who gain large gains from free trade (imports) are not organized and therefore powerless. In contrast, the

Chart— 3



difficulty and loss that producers (corporations and their workers) face are visible and seem urgent. These factors drive people to protected trade. In the next section, I will explain the fallacy of protected trade[3)].

Partial Equilibrium Analysis

When dealing with the case of conflict over the gain and loss of consumers versus producers, one usually uses a partial equilibrium chart instead of a general equilibrium chart. This is because the explanation is complicated if we use a general equilibrium chart for that case. Since a partial equilibrium chrat is drawn without confirming accurate relations corresponding to a general equilibrium chart, the conclusion is likely to support anti-free trade. Therefore, in this section, we shall firstly deal with the

3) Comparative arguments between free trade and fair trade are offered the following articles;

1) William R. Cline, "Imports and Consumer Price : A Survey Analysis," *Journal of Retailing*, 1979.

2) W. R. Cline, *The Future of World Trade in Textiles and Apparel*, Institute for International Economics, 1987, Revised 1990.

3) Robert E. Scott and Thea M. Lee, *Reconsidering the Benefits and Costs of Trade Protection : The Case of Textiles and Apparel*, Workig Paper No. 105, Economic Policy Institute, April 1991.

relationship between a partial-equilibrium-chart and a general equilibrium chart.

Melvyn B. Krauss introduced $\boldsymbol{S}$-curve and $\boldsymbol{d}_1$-curve on Chart-3 from Chart-2 of this paper[4]. The spindle is defined by the comparative price of good-$\boldsymbol{Y}$ that is measured by good-$\boldsymbol{X}$. Krauss explained that we can introduce not just a partial equilibrium demand-supply-curve, but a general equilibrium demand-supply-curve in accordance with this definition[5]. However, his explanation indicates only the relationship between demand and supply of one good, and the relations between this good and a different good is not clearly indicated in his explanation. Therefore, Chart-3 can not yet be defined as a general equilibrium chart. The spindle of a partial equilibrium chart is generally defined by the price of good-$\boldsymbol{Y}$. Krauss's chart, in that senes, is a partial amendment of partial equilibrium chart, but is still essentially the same as a partial equilibrium chart. Furthermore, Chart-3 is introduced to use the same method as a partial-equilibrium.

Krauss's explanation using Chart-3 has some problems. First, he introduces $\boldsymbol{S}$-curve (supply-curve of good-$\boldsymbol{Y}$) of Chart-3 from $\boldsymbol{HH}$-curve (production-frontier) of Chart-2. This is correct, because $\boldsymbol{HH}$-curve (production-frontier) is given and there is only one-curve. Next, he intorduces $\boldsymbol{d}_1$-curve (demand-curve for good-$\boldsymbol{Y}$) of Chart-3 by rotating a comparative-price-curve parallel to the $\boldsymbol{U}_0$-curve (trade-indifference-curve). However, gains from trade can not be indicated by this method, because consumer-welfare has not increased on indifference-curve $\boldsymbol{U}_0$ and the gain from trade is zero.

Therefore, we need the follwing amendment to rectify Krauss's explanation. First, we draw not only the demand-curve $\boldsymbol{d}_1$ of Chart-3 that is introduced by the indifference-curve $\boldsymbol{U}_0$ of Chart-2, but also the demand-curve $\boldsymbol{d}_2$ or $\boldsymbol{d}_3$ of Chart-3 that is introduced by the indifference-curve $\boldsymbol{U}_1$ or $\boldsymbol{U}_2$. Next, we draw $\boldsymbol{D}$-curve that links $\boldsymbol{d}_1$-curve, $\boldsymbol{d}_2$-curve and $\boldsymbol{d}_3$-curve like Chart-3[6]. This $\boldsymbol{D}$-curve is the correct demand-curve that involves an income-effect and a substitution-effect.

Krauss's mistake is due to the way he measures gains from trade. Krauss tends to measure gains from trade via a comparison of producer's surplus with producer's surplus for one good. This method could be an adequate way to measure gains from trade making the gain more tangible. However, the basis of the analysis according to this method does not follow the essentials of trade theory based on comparative cost of production and relative competition. Instead, the basis of the analysis is an analysis of one good based on absolute costs of production and absolute competition in a world without national borders. We should be free ourselves from these assumptions.

According to the explanation using a partial equilibrium chart, imports of good-$\boldsymbol{Y}$ result in a gain in consumer's surplus (indicated by a space $\boldsymbol{APC''B}$) and loss in producer's surplus (indicated by a space $\boldsymbol{APP''B}$). Affirming the comparison between gain and loss, imports of good-$\boldsymbol{Y}$ introduce a net surplus. This conclusion offers an affirmative view of free trade.

4) Melvyn B. Krauss, *A Geometric Approach to International Trade*, Basil Blackwell, Oxford, 1979.

5) Professor Taro Watanabe uses the same explanation in his article (Taro Watanabe, *Kokusai Keizai*, 3rd-edition, Shun-Ju-Sha, 1980).

6) Takashi Negishi, *Boeki Rieki to Kokusai Shushi*, Sobun-sha Publishing, 1971.

A regular chart of partial equilibrium is used in this explanation. In this explanation, the producer's surplus indicated by price is compared with a consumer's surplus indicated by utility. However, price and utility are quite different, and this is an important problem. Generally speaking, equating the two is possible when the marginal utility of money is constant[7]. However, the important problem, the essential difference between price and utility, is still not solved.

Furthermore, Krauss points out that it is possible to compare price with utility under the assumption that consumers and producers are identical on his revised partial equilibrium chart. However, a consumer of one good is actually different from a producer of the same good, and consumer's surplus is quite different from producer's surplus. Therefore, although free import increases an invisible surplus for the consumers, independent import industries suffer a visible loss, and consequently, they will strongly defend their profit against import. Their loss includes not only the producer's surplus (indicated by a space $\boldsymbol{APP'B}$), but also a decrease in the selling income (indicated by a space from $\boldsymbol{APQ_2}$ to $\boldsymbol{BP'Q_1O}$).

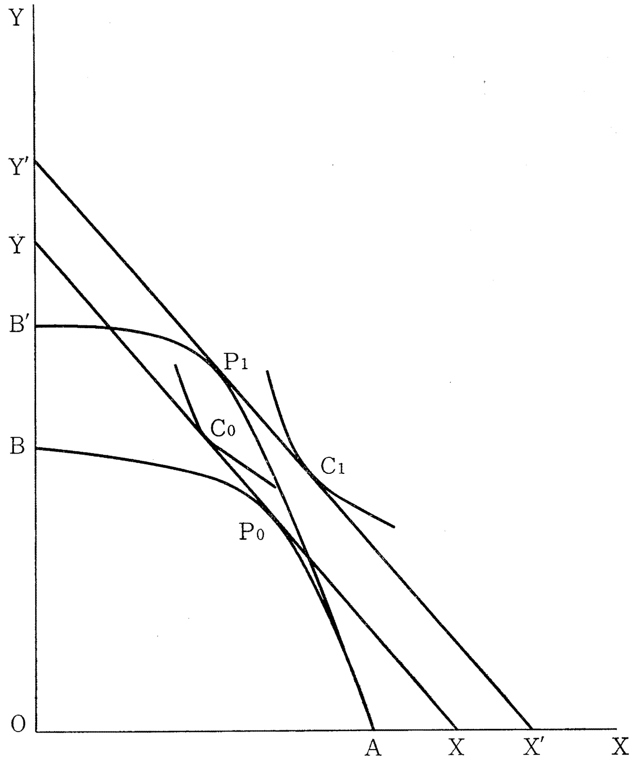
In order to persuade the assertions of anti-free trade from the production-side, we return to a general equilibrium approach in Chart-2 and attempt to correctly explain a partial equilibrium chart on Chart-3. First, as the $\boldsymbol{S}$-curve (supply-curve) of Chart-3 is introduced by a given production-frontier of Chart-2, production factors that produced a volume of decrease in the selling income of importing good-$\boldsymbol{Y}$ as a whole could be reconverted to increase production of exporting good-$\boldsymbol{X}$ without any gain or loss. Therefore, there is no reason for production-side to push for protected trade. This conclusion can be further clarified if we recall a pure-exchange-model. In a pure-exchange-model, because goods-in-stock is a given, and $\boldsymbol{S}$ (supply)-curve of Chart-3 is drawn as a perpendicular. According to this model, imports of good-$\boldsymbol{Y}$ decrease income accompanied by a decline of price in the production-side, but imports of good-$\boldsymbol{Y}$ do not produce any impact such as production reconversion.

Second, a correct demand-curve is not $\boldsymbol{d_1}$-curve, but $\boldsymbol{D}$-curve, if we correctly derive it from a general equilibrium chart. This introduces a large consumer's surplus(indicated by a space $\boldsymbol{APCB}$), but we must deduct the volume of decreasing consumer's surplus on exporting good-$\boldsymbol{X}$ from this surplus. In addition, in term of exporting good-$\boldsymbol{X}$, we can understand that the comparative price is higher than $\boldsymbol{OA}$, with defining the spindle of Chart-3 as $\boldsymbol{X}$ and the axis of Chart-3 as $\boldsymbol{Px/Py}$. Thus, the inclination of $\boldsymbol{D}$-curve will be more modest than that of $\boldsymbol{d_1}$-curve, and accordingly, the volume of decrease of consumer's surplus will be also smaller. Therefore, the increase of consumer's surplus in import will always be greater than decrease in export. This net increase of consumer's surplus indicates the elevation of indifference-curve from $\boldsymbol{U_0}$ to $\boldsymbol{U_1}$ as indicated in Chart-2.

After all, if production adjustment is smoothly carried out on the production-frontier (also, in the case that there is no gain or loss in the production-side), consumer welfare will always be increased. Therefore, there is no reason to argue against free trade.

7) S. Yamamoto, *Boeki Seisaku no Riron*, Toyo Keizai Publishing, 1974.

Chart— 4



Production adjustment is the most effective method and it is carried out in a long term. However, in the short term, in order to train employers and workers for new industries and renovate capital instruments, there are chances of coming difficulties, such as unemployment and unfavorable balance of trade. In such a situation, in order to maintain consumer welfare, we should not implement any policies that prevent free exchange and circulation. Instead, we should adopt industrial adjustment assistance policies, such as re-training for employers and workers and low interest rate financing, to directly support and promote production adjustment. Since these necessary production adjustment processes are very large in scale and radical, these processes raises issues related to the Safeguard Clause of GATT (section-19)[8]. If it is an emergency and if the term of import restriction is expressed clearly, the adjustment policies are acceptable. However, at the same time, the country that opts to use Safeguard Clause must also adopt progressive adjustment policies.

2. Infant Industry Argument

Theoretical Argument on Infant Industry Policy

8) In Safeguard Clause (section-19) of General Agreemet on Tariffs and Trade, GATT Permits member countries to adopt temporary import restriction until end of adjustment.

Policies of protection for the nurturing of infant industries are endorsed to a certain extent among many scholars[9]. However, we must recognize that this infant industry argument and the free trade principle introduced from traditional trade theory belong to quite different dimensions ; the infant industry argument is an over-time dynamic trade expansive theory, and it is quite different from the static trade equilibrium theory that was previously stated.

In this paper, the infant industry argument is explained as an expansive process of the production-frontier as indicated in Chart-4. It is hypothesized here that one country places its primary production-frontier on the $\boldsymbol{AB}$-curve in a system of given consumption indifference-curves, so that trade equilibrium is realized, terms of trade are defined by the inclination of $\boldsymbol{XY}$-curve, and places its primary production point and consumption point at point-$\boldsymbol{P}_0$ and point-$\boldsymbol{C}_0$. In addition, good-$\boldsymbol{X}$ is defined as export good and good-$\boldsymbol{Y}$ is defined as import-good.

Under this hypothesis, if the production-frontier is expanded by some dynamic power from the $\boldsymbol{AB}$-curve to the $\boldsymbol{A'B'}$-curve and terms of trade are maintained at the same inclination (but shifted from $\boldsymbol{XY}$-curve to $\boldsymbol{X'Y'}$-curve), the production point shifts to $\boldsymbol{P}_1$ and consumption point shifts to $\boldsymbol{C}_1$. Based on this change, trade pattern of this model (country) will change and the nature of good-$\boldsymbol{X}$ and good-$\boldsymbol{Y}$ will go by contraries (good-$\boldsymbol{X}$ will pe an import good and good-$\boldsymbol{Y}$ will be an export good). Initiating these changes is the policy goal of infant industry policies. Additional explanation follows.

(1) Dynamic power towards the expansion of the production-frontier :

Several different scenarios are explored below. (a) There is the case that internal economies based on learning process come into existence in the firms manufacturing good-$\boldsymbol{Y}$[10]. In this case, production-frontier shifts from $\boldsymbol{AB}$ to $\boldsymbol{AB'}$ (expansion of production-frontier is inclining toward good-$\boldsymbol{Y}$). (b) In the case that good-$\boldsymbol{Y}$ is more capital intensive that good-$\boldsymbol{X}$, if capital accumulation rate is higher than the growth rate of labour force, we come to the same conclusion as case-(a). However, point-$\boldsymbol{A}$ also shifts slightly toward the right-side in this case. (c) In the case where technological progress is accomplished only in the industries of good-$\boldsymbol{Y}$, we reach the same conclusion as case-(a). (d) In the case that industries of good-$\boldsymbol{Y}$ receive foreign direct investment and more surpassing production-function are transplanted to those industries, this case reaches the same conclusion as case-(a) and case-(c).

(2) Argument on Vent-for-Surplus :

The argument here also coincides with an argument on the expansion on the production-frontier. When there is a lack of entrepreneurs, shortage of capital, technology and market, the potential of natural resources or the labour force lies idle and the production point remains inside the optimal production-frontier. In this case, if the factors in shortage are supplemented, it will be possible to shift the production point toward the optimal production-frontier. This is the typical case where development by foreign

9) Herbert G. Grubel intoroduces infant industry and protected trade argument systematically in an article (Herbert G. Gruble, *International Economics*, Richard D. Irwin, Inc., 1977).

firms is effective.

(3) In short, the shift of the production point from the primary production-frontier to a newly expansive production-frontier, or from inside of the optimal production-frontier to the optimal production-frontier, entails a not gain for the national economy and economic development. The forces motivating these shifts are original means of economic development, such as accumulation of capital, technological progress and activities of entrepreneurs (including learning process). Therefore, the protective measures for trade (exchange), such as tariffs, are fundamentally ineffective[11]. It is indispensable for international relations that factors in shortage, such as capital, technology, and the ability of entrepreneurs and markets be complemented. Therefore, there emerges a new issue : international complement of national production processes. The main issues here are aid (assistance), foreign direct investments and technological transfer is also necessary to establish rules on these activities.

Analysis with a Partial-Equilibrium-Chart

The following is an analysis of the propriety of the infant industry argument with a partial equilibrium chart[12]. In this analysis, a partial equilibrium demand-curve and some upward short-term supply-curves are drawn, and it is explained that positive producers' surplus, without protection (such as tariffs), accompanied by shifting these short-term supply-curve are introduced. In this explanation, it is attempted to introduce one of appreciations for or against infant industry argument, by deducting the loss of consumers' surplus from over-time net amount of producers' surplus (converting and discounting each surplus into current value). Even if the entrepreneur suffers a primary loss due to costs higher than the world price, if their profit in the future exceeds their loss, private firms will expand their production and learn by themselves. Deriving from she fromer explanation, one of conclusion is the unnecessity of protection. This conclution requires as a precondition the existence of mature firms. In addition, there is no denying the fact that import restriction by tariffs is better for firms from expanding their production. However, we can not deny the fact that productive measures are not original means of production.

3. Fair Trade Argument

Fair Trade Argument is Negotiating Position

The United States has advocated free trade strongly, criticized protective trade practices

10) Shiro Yabushita, "Protection of the infant industry : A Note," *The Economic Record*, September 1975.

11) If one country uses tariffs in trade and does not use any measure for econonic development, this country can not attain more welfare than free trade. According to a general elucidation of static effect of tariffs, this conclusion is clear.

12) Kiyoshi Kojima, *Gaikoku Boeki*, 5th-edition, Shun-Ju-Sha, 1981.

of trade partners and pressed partner countries for trade liberalization. Since the end of the 1960s, the United States has begun to use a multivocal notion of "fair trade" and begun to criticize partner countries, especially Japan and NIEs countries with this notion[13][14][15]. However, this fair trade argument that the United States advocated seems to have been a building block for protected trade.

The notion of fair trade is quite different from the traditional free trade argument and sometimes contradictory, the fair trade argument was introduced as a method for trade negotiation of the United States. It was linked with reciprocity,[16][17] which was a policy that the United States had traditionally used is trade negotiations. The United States has considered export as gain and import as loss in all trade negotiations (GATT negotiations and bilateral negotiations), and it has been the negotiation philosophy. This philosophy is quite contradictory to the traditional free trade argument, but it is an effective measure to demand trade liberalization of partner countries in trade negotiations.

However, recent trade problems have heightened to the extent that it is no longer enough to solely demand trade liberalization in other countries. Since international competitiveness and export promotion has increased in partner countries of the United States, foreign imports of the United States increased. Under such a situation, requesting open markets from partner countries will not be a solution. Therefore, the United States took a countermeasure to cope with such situation and introduced "fair trade" as a new strategy. According to this strategy, the United States criticizes trade partners as being unfair, and demands voluntary export restrictions. In this case, this strategy is a defensive reaction. This strategy involves an important and fundamental problem with the notion of "fairness"[18][19]. In addition, this strategy reflects the decline of international

13) Fair trade law was introduced in the state of California in 1931. After that, almost of the states introduced fair trade law, and some parts of these fair trade laws became the Federal law. The original purpose of fair trade law was to maintain resale prices, but after that, quality stabilization was also added to the purpose of fair trade law. The United States has begun to apply fair trade law to foreign countries since the end of 1960s (*Roth Report on Future Trade Policy*, Submitted to the President on January 14, 1969).

14) Stephen D. Krasner, "The Tokyo Round : Particularistic Interests and Prospects for Stability in the Global Trading System", *International Studies Quarterly*, Vol. 23, No. 4, December 1979.

15) Shigeo Oka, "Shin Kokusai Code Seiritsu no Igi to Shin Code Taisei-ka no Sekai Boeki", Economic Bureau, Ministry of Foreign Affairs of Japan (ed.), *Tokyo Round ga Sekai Boeki Taisei to Waga Kuni no Boeki ni oyobosu Eikyo*, 1980.

16) Robert O. Keohane differentiates between two types of reciprocity, specitic and diffuse. Specific reciprocity refers to the situation in which specific partners exchage items of equivalent value in a strictly delimited sequence. Diffuse reciprocity involves conforming to generally accepted standards of behavior. What we refer to here as "reciprocity" is equivalent of Keohane's "specific reciprocity" (Robert O. Keohane, *International Institution and State Power : Essays in International Relations Theory*, Westview, 1989).

17) Stephen D. Krasner has applied Keohane's definitions to U. S.-Japan relations (Stephen D. Krasner, "Trade Conflicts and the Common Defense : The United States and Japan," *Political Science Quarterly*, Vol. 101, No. 5, 1986).

18) John Rawls offers a theoretical approach to the concept of "fairness" in his article (John Rawls, *A Theory of Justice*, Harvard University Press, 1971).

competitiveness of the United States. In order to increase exports, the United States needs to adopt progressive export promotion policies as well as this strategy. However, the United States must make these policies similar to fair trade. The fair trade argument of the United States is lost in a maze ; the United States has lost sight of a real solution.

Relationship Between the Fair Trade Argument and Reciprocity

The United States, as a leader, reduced tariffs of developed countries and decreased some NTBs (including import restriction in quantity) through several GATT negotiations. In addition, the United States introduced the international code system at the Tokyo Round negotiation[20].

The GATT negotiation multiple and indifferent trade originally, but the United States introduced reciprocity into GATT negotiations. This reciprocity is a source of the fair trade argument. However, there is a problem, because reciprocity belongs to a quite different theoretical system from the traditional free trade argument.

According to our previous argument, the traditional free trade principle is based on a static consumption economic trade theory and indicates gains from import. Therefore, this argument advocates that one country abolishes its artificial impediments for import and realizes free trade without regard to the system of its partners. It is usually called "unilateralism." However, reciprocity indicates that one country requests an equal system and situation from its partners. If the United States reduces its own tariffs, other countries will have to reduce their tariffs equally. In this case, it is said that reciprocity might be a effective measure to promote global trade liberalization[21]. At the same time, it is also said that the reciprocity position of the United States delayed GATT negotiations[22]. The establishment or reduction of tariffs depends on national interest. Therefore, a country that cannot offer equal concessions to the United States can not attend negotiations by itself and will look forward to gains from free-riding on the decided system after negotiation. Thus, the GATT system was planned to switch into a clear-cut system at the Kennedy Round negotiation. In addition, reciprocity, such as an equalization of total value of trade and list of exceptions was also carried out, and the United States requested to introduce overall reciprocity for unmeasured NTBs on Kennedy Round negotiation.

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19) The Rand Corporation offers an interesting argument on the empirical concept of "fairness" (Roger Benjamin, Loren Yager, Micheal Shrires and Mark Peterson (ed.), *The Fairness Debate in U. S.-Japan Economic Relations*, RAND/R-4100-CUSJR, 1991).

20) Stephen D. Krasner, "The Tokyo Round : Particularistic Interests and Prospects for Stability in the Global Trading System," *International Studies Quarterly*, Vol. 23, No. 4, December 1979.

21) J. S. Goldstein and J. R. Freeman, *Three-Way-Street : Strategic Reciprocity in World Politics*, the University of Chicago Press, 1990.

22) Harry G. Johnson, *Trade Negotiation and the New International Studies*, Geneva and the Trade Policy Research Centre, London, September 1976.

Sharing of Import Burden

It is important to understand that reciprocity is a bargaining measure of the United States to reduce trade impediments. Furthermore, is also more important that reciprocity is introduced by a quite different [thought or theory from the traditional free trade principle. Reciprocity consists of the following two ideas : (1) the increase of imports is a burden ; and (2) exports are a gain. These idea are quite different from the traditional free trade principle, and they might be called neo-mercantilism or employment-oriented policies.

The idea that the increase of imports is a burden is opposed to traditional free trade principle and denies the value of free trade. If it is correct, the reason to demand open trade for partnere does not exist from the first place. The burden accompanied by, the increase of imports is expressed via temporal unemployment or aggravation of the terms of trade. However, these burdens are inevitable in the production-adjustment process accompanied by trade. Reciprocity requests to share these burdens of increasing imports equally.

This claim from reciprocity is clearly unfounded and incorrect. Firstly, if increasing imports is a burden, to request open trade brings the same burden on partners and cannot be permitted. Secondly, even if increasing import brings temporal unemployment or aggravation of the terms of trade, to reduce import impediments and to adjust production (in order to get cheaper and more imports) introduces gains from trade.

Equalization of Export Opportunity

It is impossible to justify the idea that regards export as a gain by a static consumption economic trade theory, but it is possible to justify the idea by a dynamic economic development theory. Increasing exports expands employment and income (of production factors) over time. These, in themselves, are visible and tangible gains. These export margins can elevate consumer welfare through expanding and cheaper imports, but we can count these export margins, in themselves, as independent national economic gains over time.

It is very important for the United States to establish the idea that exports as a gain. If it is established, the United States will be able to promote its own exports through criticizing the import restrictions of its trade partners and pressing for open trade. The United States can advocate the equalization of export opportunities between trade partners and the United States.

It was very effective for the United States to press for open trade with its trade partners using reciprocity until the middle of the 1960s. When the international competitiveness of the United States was relatively strong, the reciprocally equal reduction of trade impediments was very advantageous for the United States and it played a role of progressive export expansion policies for the United States. In this sense, it is said that the strong rules in free trade[23][24].

The United States still adopts reciprocity as a measure for trade negotiations. In fact, the reciprocal import liberalization and open market which the United States has pursued contributed to the expansion of the United States export market at a certain stage. However, this is a policy that depends on the cooperation of trade partners of the United States is not always so effective for the United States as a measure to promote import liberalization of its partners, and its role is very limited as an export promotion policy[25].

Equalization of International Competitive Conditions and Defensive Fair Trade

The notion of fair trade has played an important role for the United States during period of its decline in international competitiveness. During this time, the United States changed the nature of the fair trade argument into a defensive nature and, at the same time, the United States expanded its sphere of application. It is important for the United States to understand how to restrict its imports and how to defend its domestic industries. However, the United States finds gains (its national interest) from free trade, the United States can not adopt measures of anti-free trade (=protected trade). As a result of such a situation, the United States adopts a fair trade stance and presses its trade partners on trade negotiations. There are three stages to the fair trade argument in the United States.

(1) In the 1930s, many countries introduced new types of trade measures including import restraint in quantity as well as traditional measures represented by import tariffs. In addition, export promotion policies were also introduced. The appearance of this export competition introduced a new stage beyond traditional free trade in the world trading system. This new stage in the world trading system was a source of fair trade. The typical measure of export promotions was to dump the price of goods such as exchange rates dumping and social dumping, in the 1930s[26]. In traditional free trade theory, it is explained that there is no reason for importers to criticize dumping, except predatory dumping. However, in the fair trade argument, dumping is criticized as an "unfair" trade practice. Indeed, dumping prevention and countervailing duties are instituted in GATT rules and the Federal trade act.

Labor-intensive goods represented by textiles were exported in concentration from Japan and the NIEs to the European and American markets ; after that, steel, electric goods and automobiles. These exports from Japan and NIEs countries were considered

23) Samir Amin, *Le developpement inegal : essal sur les formations sociales du capitalisme peripherique*, Les Editions de Minuit, 1973.

24) Arghiri Emmanuel, *Unequal Exchange : A Study of the Imperialism of Trade*, Monthly Review Press, 1972.

25) Tom Peters points out that American headlong rush to protectionism throughout the 1980s cost the America 1, 200 dollars per family per year (*San Jose Mercury News*, January 27, 1992).

26) Shigeru Fujii, *Keizai Hatten to Boeki Seisaku*, Kunimoto Shobo, 1958.

a factor in market disruptions by the European countries and the United States. The export promotion policies of Japan and NIEs countries were also called "unfair." Therefore, the long-term agreement no textiles was concluded, and exporters, such as Japan and NIEs countries, were pressed into voluntary export restraints (VER)[27] and an orderly marketing agreement by Europe and the United States.

(2) The terms of export competition consist of transfer costs, and exchange costs as well as prices of export goods. Therefore, the terms of export credit of Japan and the loan rate margin of multinational banks were called "unfair." In addition, the Japanese government was criticized as "unfair" in sharing the burden of adjustment, because the Japanese government did not rapidly adjust its own international balance of payments through the liberalization of the exchange rate market and the control of total demand.

(3) The argument escalated more irrationally and emotionally. Since the goods of the countries whose wages are unreasonably low, and whose labor conditions are malignant, cause unemployment in certain American industries and reduce the level of wages in the United States, it is claimed that the United States should defend its own industries against these unfair competitions This opinion is called the "pauper labor" argument, and it has been around for a long time[28][29]. The request from trade unions of the United States to establish a fair labor standard for foreign countries is very strong. Some Americans criticize Japan for its attributes : living conditions, "workaholic rabbit hutches," life-time employment system, Japan Inc. and free-riding on defense, among other things[30][31].

In sum, the defensive fair trade argument indicates that the United States requests its trade partners to equalize their fundamental competitive conditions to the United States. Therefore, we can summarize the defensive fair trade argument as an equalization of international competitive conditions.

Ⅲ. Integration

Gains from Free Trade

Accordind to previous argument, pure exchange is defined as a rearrangement of goods in stock. This definition dose not include changes in production. This model offers an

27) C. Fred Bergsten offered an interesting argument on VER in his article (C. Fred Bergsten (ed.), *On the Non-Equivalence of Import Quotas and Voluntary Export Restraints : Toward a New Trade Policy*, The Maidenhead Papers, Lexington Books, 1973.

28) D. Greenaway and C. Milner, *Protectionism Again*……?, Hobert Paper 84, The Institute of Economic Affairs, 1979.

29) Everett Hagen, "An Economic Justification of Protection," *Quarterly Journal of Economics*, November 1958.

30) *Task Force Report on United States-Japan Trade*, The United States House of Representatives, Committee Print, January 2, 1979.

31) *United States-Japan Trade Report*, The United States House of Representatives, Committee Print, September 5, 1980.

important conclusion to the debate over the essence of gains from trade. That is to say, trade profit means consumer profit and the increasing of welfare through rearrangement of goods in stock. Consumer profit is provided through the import of cheaper and increased amount of foreign goods. In short, gains from trade can be explained as "gains from import".

When production adjustment accompanies the beginning of trade, more profit from trade is gained than the case of pure-exchange-model. However, production adjustment does not produce any profit for production-side, but only increases consumer-welfare. Therefore, all gains from trade reselt in "profit" on the consumption-side. In sum, traditional trade theory incorporates production adjustment and gives consideration to the production-side, still, this is essentially a "consumption economic trade theory." Furthermore, as long as trade is indifferent to the production-side, free trade always increases consumer-welfare, not only in case of pure exchange, but also in the case where production adjustment is included. The legitimacy of the free trade principle and its universal propriety are thus demonstrated.

If production adjustment is smoothly carried out on the production-frontier (also, in the case that there is no gain or loss in the production-side), consumer welfare will always be increased. Therefore, there is no reason to argue against free trade. Production adjustment is the most effective method and it is carried out in a long term. However, in the short term, in order to train employers and workers for new industries and renovate capital instruments, there are chances of coming difficulties, such as unemployment and unfavorable balance of trade. In such a situation, in order to maintain consumer welfare, we should not implement any policies that prevent free exchange and circulation. Instead, we should adopt industrial adjustment assistance policies, such as re-training for employers and workers and low interest rate financing, to directly support and promote production adjustment. Since these necessary production adjustment processes are very large in scale and radical, these processes raises issues related to the Safeguard Clause of GATT (section-19)[32]. If it is an emergency and if the term of import restriction is expressed clearly, the adjustment policies are acceptable. However, at the same time, the country that opts to use Safeguard Clause must also adopt progressive adjustment policies.

Free Trade and International Complement

In addition, we should deal with the relationship between free trade principle and infant industry argument. Free trade is introduced as an institution to exchange produced goods from the view of the static free trade principle, and protected trade is requested as a measure to expand the production-frontier (dynamic development of national production process) from the view of the infant industry argument. It is especially problematic that they (the static reduction of artificial impediments and the dynamic development of national production processes) are mutually promotive or contradictory

32) In Safeguard Clause (section-19) of General Agreement on Tariffs and Trade, GATT permits member countries to adopt temporary import restriction until end of adjustment.

to each other.

In order to examine this problem, we will consider the follwing points. There is international complement that introduces and promotes dynamic development of every national production process, such as a construction of infrastructure through foreign direct investment, technological transfer and aid. If this international complement expands and strengthens potentially comparatively advantageous industries, differences of comparative cost of production will be expanded. Futhermore, free and harmonized trade will be introduced. If this hypothesis is correct, international complement (introduced by infant industry argument) will promote structural adjustment and the economic development of the two countries with no contradiction of the free-trade-principle.

Developing economies should promote development and growth of industries which possess possibilities for comparative advantage based on their stage of economic development. It is better for developing economies to abide by this rule, like product-cycle industrial development, in their industrialization. However, it does not necessarily follow that developing economies will abopt these desirable development policies. In such cases, investor countries should offer guidance to them in order to achieve desirable international complement. In this sense, rules for international complement as well as foreign direct investment are keenly required, but these rules have never been established. In addition, most investment works substitutively, not complementarily, for trade. Industries of the United States are the prime examples[33]. Foreign direct investment by American firms caused the deindustrialization of the American economy and became a source of protectionism. Therefore, these foreign direct investments are contradictory to the notion of a national economy.

International economic relations are becoming intimate, and activities of firms disregard national borders. However, in reality, sovereignty is maintained and national borders have not disappeared. Therefore, economic development must be pursued within the framework of the national economy, and international economic relations should be still considered within the framework of relative competition and international division of labour based on comparative cost of production. International complement is a marginal part of national economic development, and international complement should be pursued accompanied by over-time comparative cost of production.

The Fair Trade Argument is not a Trade Theory

There are several fundamental criticisms against the fair trade argument. Firstly, the fair trade argument regards American competitive conditions, such as production, business and trade union, to be the best condition, and the fair trade argument requests that the trade partners of the United States incorporate American ways of competitive conditions. However, this argument is not reasonable and lacks foundation.

Secondly, both mutual liberalization policies of trade for the export promotion of the

33) Foreign direct investment of the United States has taken place in the industries of highest comparative advantage, such as high-technology industries (Kimio Takanaka, *Takokuseki Kigyo Ron*, Tanizawa Shobo publishing Co., 1991).

United States and equalization policies of international competitive conditions of trade partners to the United States depend on the reactions of trade partners. In addition, since the United States has never defined the notion of "fairness," the United States cannot look forward to good results from these requests. This is because it is correct that exporters have reduced their production and exchange costs, and that these reductions of costs promote a free trade system. That is affirmed by traditional free trade principle.

Thirdly, the United States may try to drive its own policies, such as strengthening of its international competitiveness and export promotion, but these policies have been despised. If the United States adopts these [policies, it will indicate that the United States will adopt the policies that the United States criticizes as "unfair." In this sense, the fair trade argument involves a self-contradiction.

Fourthly, the requests based on the fair trade argument, such as equalization of export opportunities and equalization of international competitive conditions, cannot be realized in a present international system that has national borders. Therefore, fair trade can only be realized within a single national economy, where (1) free movement of all production factors, (2) uniformity of the public sector, (3) homogeneity of value systems, (4) absolute comparison of production costs is possible, and where absolute competition takes place.

The difference between a customs union, such as European Community (EC) and a free trade zone is that the former requires an equalization of the terms of competition vis-a-vis areas outside of the region (whereas in a free trade zone where national borders cease to exist, this is no longer an issue). However, such equalization is difficult even in the EC.

The international division of labor or trade is implemented and is profitable only because comparative advantages arise from the differences in the term of production and/or terms of competition. Fair trade, however, is not based on such gains. We should once again return to the principle of free trade principle and the principle of dynamic international complement (factor flows).

Conclusion

Based on the previous arguments in this paper, I can introduce the following conclusions :

(1) Free trade is desirable for the exchange and/or distribution of produced goods, because free trade always increases consumer welfare. This is a true free trade principle that is introduced by traditional static trade theory.

(2) The beginning and/or continuing of trade increases imports and introduces some kind of friction, such as unemployment. Therefore, we need production adjustments. However, even with a loss from free trade, it is incorrect to advocate protected trade. Under this situation, we should promote and finish production adjustment in order to

realize full-employment and optimal allocation of production factors.

(3) The idea presented by infant industry argument belongs to the dynamic industrial trade theory that is quite different from a static consumption economic free trade theory. It explains that expanding the production-frontier by the activities of entrepreneurs and original means of development capabilities, such as capital accumulation and technological advance, always introduces national economic gains and leads infant industries to export industries.

(4) In the process of expanding the production-frontier, while temporal protection against foreign competition is promotive for the process, but protection is not essential and effective for the process. Because what is needed is not a protection, but an original means of development capability. If some of the capabilities are deficient, making up for the deficient factors by foreign direct investment and technological transfer is more effective measure of the infant industries encourage policy and economic development policy.

(5) If international supplement is put into practice in accordance with potential patterns of comparative advantage, international supplement will not be contradictory to free trade and international complement and free trade will mutually realize the hamonious development of a global economy. Therefore, it is very important for us to study the international supplement argument theoretically.

(6) Fair trade that the United States advocates is only a measure for trade negotiations, and it is impossible to justify fair trade theoretically. When the competitiveness of the United States was strong, the United States requested trade liberalization for the other countries and pressed for the equalization of export opportunities. However, when the cometitiveness of the United States has been relatively weak, the United States has requested the equalization of international competitive conditions according to its own condition. This can be termed a "defensive fair trade." The policies that are essentially needed for present stage of the United States are to strengthen its own international cometitiveness and export promotion. However, if these policies are adopted, the logic of fair trade will fall into self-contradiction.

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