

POLITICAL ECONOMY OF TRADE POLICY

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Abstract

The paper deals with an explanation of the trade policy paradox which is a contrast between international trade theory and the reality of trade policy. The vast majority of economic schools of thought have realized general benefits of free trade. The advantages of free trade have been known from economic theory for more than two centuries. However the reality of trade policy is governed by various forms of protectionism. The protectionism has spread worldwide, in both developed and developing countries.

In the first chapter of this paper, we sketch out the development of international trade theory from mercantilism to current economic theory. The second part is devoted to real trade policy of the most important economic centres of the world, i.e. the EU, the United States and Japan, and developing countries as well. We illustrate a practical contravening of the generally shared theoretical approach to trade policy on these examples. The most visible protectionist examples are the CAP in the EU, antidumping laws in the USA, non-tariff barriers in Japan and open protectionism in many developing countries. We offer four possible explanations of this situation: the discrimination of foreigners, invisibility of benefit from free trade, the pressure of interest groups and the turn to rigidity.

Introduction

The defence of the free trade principle is an integral part of general economic theory. It is one of a few areas that almost all economists agree on. On the other hand, the reality of trade policy is completely different and even in countries with relatively liberal economic policy there are many examples of flagrant contravening of the free trade principle.

The aim of this paper is to identify the contrast between trade theory and reality of trade policy and try to explain possible causes of this situation.

1. International Trade Theory

International trade theory tries to identify conditions, causes and effects of international trade among countries. It deals with an impact of international trade on a country's economic growth and income distribution within a country and an international allocation of production factors as well.

Theory of Protectionism

Protectionism is theoretically based on mercantilism. Mercantilists advocated a balance of trade surplus because that was the only way how to ensure influx of gold to a country and, according to their opinion, the growth of wealth in this country. In connection with a balance of trade surplus, mercantilists laid stress on the structure of a country's foreign trade. The exertion of mercantilist trade policy led to protectionism based on limiting imports and subsidising exports by high import tariff rates, exports subsidies, export monopolies etc.

One of the most important representatives of mercantilism was Thomas Mun¹ who supported the idea of active trade balance. In his opinion, it is not necessary for a country to have an active trade balance with each country, but generally. In contrast to early mercantilists, he refused the

¹ Mun solved questions of international trade in his *Discourse on England's Treasure by Foreign Trade* (1664).

strict prohibition of gold export from a country. The gold export is good, in his view, when it guarantees larger influx of gold than the volume of primary efflux.

Except of Mun, Alexander Hamilton² participated on the development of protectionist theory. The core of his approach formed his advocacy of self-sufficient industry whose evolution from the stadium of infant industry should be ensured by the system of grants and subsidies. In his view, governments ensure temporary protection of a domestic industry from foreign competition, and these industries may increase the volume of production and consequently produce as cheap as foreign competition due to it.

Friedrich List³ linked on Hamilton's critique of free trade. He advocated the exercitation of trade protectionism on grounds of the different level of maturity of international exchange participants as well. This different level influences their mutual trade, especially in the country's transformation process between levels of maturity. If an industry is situated on the infant industry level, it cannot be exposed to foreign competition because its production would be driven out by more advanced foreign producers and consequently the evolution of the industry to the superior level of maturity would be made impossible. According to List, first it is necessary to build a large market, in which the industry will achieve economies of scale, thereupon it becomes more competitive and consequently the domestic market can be open to foreign competition.

At present, protectionist supporters use List's argumentation as well. The infant industry argument is a theoretical reason for interventions into free international trade that are supposed to lead to an increase of country's wealth. "Tariffs and other forms of government intervention sometimes improve social welfare, then, because of a disjuncture between the social and private returns from a particular industry may prevent the shift of factors out of relatively low-return industries into relatively high-return industries."⁴

Classical International Trade Theories

Since the 18th century the classical international trade theories have started to develop as a critical reaction on the mercantilist approach to international trade. Classical economists criticized mercantilist protectionism and their view of international trade as a zero-sum game because, according to the classical opinion, both parties concerned on international exchange gain due to international division of labour and better utilization of production factors.

David Hume⁵ aimed at a critique of mercantilist concept of trade balance surplus. He demonstrated, on the basis of his specie flow mechanism, that it is not possible to increase the relative share of a country on world precious metal reserves without raising the share on world's production⁶.

Adam Smith took up Hume in free trade advocacy. International trade allows each country to participate on international division of labour due to which each participating country's welfare rises regardless of their trade balance. Each country should focus on production with absolutely lowest labour costs. This theory of absolute advantage became the keystone of the classical trade theory⁷. Its limitation consists in a situation when a country has an absolute advantage in all traded goods. In such a case, according to Smith, there is no international trade.

David Ricardo has developed the theory of absolute advantage into his theory of comparative advantage that creates more possibilities for international trade formation. A less developed country is not behind in all products in the same way, and a country specializes right on the basis

² The key Hamilton's work on protectionist advocacy is his Report on Manufactures (1791).

³ List integrated his critique in his National System of Political Economy (1841).

⁴ A quotation of Balassa and Associates (1971), p. 93 in Oatley (2005), p. 94.

⁵ Hume's free trade advocacy is mentioned in his Political Discourses (1752).

⁶ This statement is known as Hume's law.

⁷ The theory of absolute advantage is a part of his Inquiry into the Nature and Causes of the Wealth of Nations (1776).

of the relative difference in labour costs. Then, a less effective country specializes on production and export of goods where its absolute disadvantage is smallest⁸.

As Ricardo said, “our enjoyments should be increased by the better distribution of labour by each country producing those commodities for which by its situation, its climate, and its other natural or artificial advantages, it is adapted, and by their exchanging them for the commodities of other countries, as that they should be augmented by a rise in the rate of profits.”⁹

Trade depends on relative, not absolute, efficiencies.¹⁰ According to the classical international trade theory, a country gains from free trade regardless of the fact if her trade partners promote free trade policy or protectionism.

Modern Theoretical Approaches

In the 20th century, the theory of comparative advantage dominated, even if some approaches looked for an alternative way. First, J. M. Keynes inclined to mercantilist theories because the trade balance surplus ensures employment, thus solves the insufficiency of the propensity to consume.

Since the 1970s many economists have been trying to explain the difference between predictions of the free trade theory and the reality of international trade. The mystery was that trade grew faster among similar industrial countries. The so-called “new trade theory” has originated and extended the neoclassical international trade theory by imperfect competition, economies of scale and strategic behaviour including game theory.¹¹

New trade theory is linked to many economists but we focus only on two modern economists, P.R. Krugman and J. Bhagwati. Krugman has overcome the previous presumption of trade analyses, namely perfect competition. In his view, imperfect competition in international trade is a consequence of economies of scale. He emanates from the fact that large firms have an advantage in face of smaller ones when profits increase. Hence markets direct to the situation when one or a few large firms control a market. Monopolistic competition in international trade leads to charging different prices for the same product in home and foreign market, which is called “dumping”. Antidumping measurements that are saddled by a country when price discrimination is found out, often work as a form of protectionism because in practice they are presumed on widely.

In the 20th century, the strategic trade policy occurred. This policy tries to justify the using of industrial policies for the benefit of high-tech industries theoretically. “Like the infant-industry case, strategic trade theory asserts that government intervention can help domestic firms achieve economies of scale and experience in order to become efficient and competitive in global markets.”¹² There are some problems associated with this case for protectionism. First we can discuss the ability of government policy to find out the right, potentially profitable, industry, and there is a danger of retaliatory policy of foreign governments.

Krugman claims that potential gains from interventionist trade policies could be large but they “are limited by uncertainty about appropriate policies, by entry that dissipates the gains, and by the general equilibrium effects that insure that promoting one sector diverts resources from others. The combination of these factors limits the potential benefits of sophisticated interventionism.”¹³

Jagdish Bhagwati has defended free trade in connection with environmentalism and refused the opinion of environmentalists that trade harms the environment. Bhagwati is a supporter of

⁸ In such an industry, a country has its comparative advantage.

⁹ Ricardo (1821), p. 88.

¹⁰ Krugman (2003), p.23.

¹¹ Deraniyagala – Fine (2001), online.

¹² Oatley (2005), p. 100.

¹³ Krugman (1987), p. 143.

multinational approach to international trade because, in his view, current bilateral and regional free trade agreements put chaos into world trade system.

On the other hand, according to Bhagwati, free trade would have a positive effect only in case when price mechanism works correctly and prices reflect real social costs. But if markets do not work properly, then invisible hand puts the economy up to wrong way and free trade cannot be supposed as the best policy.¹⁴ Next, Bhagwati's concept of directly unproductive profit-seeking activities developed in the 1980s was used to describe "the generic set of activities that use resources and produce income but zero output."¹⁵

Present-day free trade opponents in developed countries object that trade with developing countries where wages are usually lower and working hours longer will hurt lower-paid workers. Many politicians argue that free trade is not sufficient and they claim the so-called "fair trade". However, the term "fairness" is very vague and its interpretation depends on the angle. Besides, opponents of free trade forget that lower wages represent lower labour productivity.¹⁶

According to most international trade theories, countries prosper when specializing on activities where they have a comparative advantage and using their income to fulfil other needs. Benefits from specialization are widely accepted within a country and there is no reason why advantageousness of division of labour and specialization should desist from holding when crossing borders.¹⁷ Free trade leads on the basis of specialization to efficiency growth and consequently to the growth of wealth of a country.

Although the conclusions of international trade theory are unambiguous, real international trade faces new challenges from many interest groups. Most of trade policy instruments are primary aimed at protection of profits for certain interest groups, so it does not reflect costs and benefits from the social view.

Reality of International Trade

Even if the theoretical conclusions advocating free trade are generally shared, the reality of international trade was and is absolutely different. Diversion from free trade is not a question only of the 20th and of course the beginning of the 21st century. For example in Britain, protectionism represented the Navigation Acts and the Corn Laws, repealed in 1846.

Post-war trade liberalization was connected with both bilateral and multilateral trade agreements on free trade zones. Since the 1950s, and especially in the 1990s, many free trade agreements have come up. "A naive view would be that since free trade is a good thing, any move toward freer trade should be welcomed"¹⁸. In relation with free trade areas, there is a problem of trade diversion, beggar-thy-neighbour effects and a danger of trade warfare. Krugman's conclusion on free trade areas is that "prospects of trade diversion from free trade areas are limited, because the prospective trading blocs mostly fall along the lines of "natural" trading areas."¹⁹

On the following examples from present we demonstrate fundamental contravening of the free trade principle, even in case of countries with relatively liberal economic policy. World trade is tied with quite a number of protectionist measurements and in reality there are only a few countries with absolutely free trade, e.g. Hong Kong²⁰. World trade system fluctuates between a period with free trade and a period when strict barriers on international trade are in force. Even in many liberal developed countries protectionism plays a role as an instrument of fight against

¹⁴ Bhagwati (2002), p.12.

¹⁵ Bhagwati (1989), p. 104.

¹⁶ Krugman (2003), p. 24.

¹⁷ Šťastný (2000), p. 20.

¹⁸ Krugman (1991), online.

¹⁹ Krugman (1991), online.

²⁰ Krugman (2003), p. 218.

unemployment. It is based on Keynesian approach where tariffs could divert country's aggregate demand from foreign to domestic goods and reduce unemployment.

EU

The Common Commercial Policy of the EU is a political question. Even if the EU belongs to developed and rich areas of the world, it is not open to free trade. "As an alternative to free market the EU has developed the policy of "single market" as a large economic bloc, subject to unified regulation, a bloc that competes with other blocs in the amount of GDP and rate of global political power."²¹

In the case of the EU, the most flagrant case of the free trade breaking is the Common Agriculture Policy of the EU, the CAP. The CAP was set primary in order to ensure high prices to European farmers. In case of price decline under a given level, the EU bought back agricultural surpluses. At the same time, the European agricultural market was protected against large influx of foreign agricultural products by tariffs that offset the difference between European and world price.

Since the 1970s the subsidized prices have been so high that while with free trade the EU would import most agricultural products, this way the EU produced more than consumers wished and had to buy back huge volume of agricultural products. Subsidized prices in the EU are higher not only than world prices but also than prices that would set in the European market without imports. Subsidized European prices push down world prices whereby claims on higher subsidies grow because of the increase of the difference between the world and the European price. Globally, costs for European consumers and taxpayers surpass benefits for agricultural producers.²²

The close of the European market harms especially developing countries that would have better economic growth due to international trade. At present, their participation on international trade is refused and they have become reliant on international aid. Furthermore, liberalization of agricultural trade would benefit the environment because agricultural production would move to countries with comparative advantage in this production (due to kindly weather). Herewith, the abuse of chemical agents in agriculture declines automatically.

United States

In case of the United States, the most prominent example of the free trade contravention is the abuse of antidumping measurements. American firms that feel up to be harmed by dumping of foreign producers ask for help the Commerce Department that imposes an antidumping tariff after proving justification. The tariff range depends on the difference between the current and the fair price²³ of imports. According to American laws, dumping is a situation when a foreign firm charges different prices on the domestic and American market regardless of the reason of price difference.²⁴ Costs of antidumping measurements are high because their operating period is measured in years.

Dumping is a price discrimination that is not bad unless it leads to distortion of competition. Predatory pricing makes sense for firms only in case when a firm is able to achieve and hold a monopoly position. Foreign firm must increase the price above the previous level after putting competitors away to cover losses caused by the previous low price level. If there are not any administrative barriers to enter the market, then price increase triggers other firms off entering the market.

²¹ Mach (2005), online, own translation.

²² Krugman (2003), pp. 198-199.

²³ We could ask what a fair price is.

²⁴ Prices in various markets can differ because of exchange rate fluctuation etc.

On the other hand, we must admit that even if the United States is the most criticized country for the US anti-dumping laws, other countries have become users of massive anti-dumping measurements as well. In the following table, we can compare the United States and the EU.

Table 1: AD Initiations by Reporting Member (1995-2005)

Reporting Member	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	Totals:
USA	14	22	15	36	47	47	75	35	37	26	12	366
EU	33	25	41	22	65	32	28	20	7	30	24	327

Source: WTO.

Japan

Japan is an example of a country that used active industrial policy to promote economic growth. Japanese state centralized power in its hands and domestic interest groups had a limited way how to influence state decisions.²⁵ The MITI and the Japan Ministry of Finance were responsible for the active industrial policy. They focused on sectors required for economic growth. In the 1950s, it concerned heavy industry, in the 1970s their attention was converted to high-tech production. Active pro-export and structural policy brought indisputable gains to Japan. Although Japan benefited from the active industrial policy, it was a free-trade contravention. Opponents of the Japanese sophisticated industrial policy criticize the using of protectionist measurements and refer to mistakes that were made by the MITI in a process of the perspective-industry seeking.

Developing Countries

After the World War II, many developing countries tried to accelerate their economic growth by limiting imports to protect domestic producers²⁶. This frequently used strategy was theoretically based on the infant industry argument. According to this argument, a developing country has a potential comparative advantage in industry but developing industrial branches cannot compete with established producers from developed countries effectively. Governments must provide temporary help to developing branches in order to be able to face foreign competition. Tariffs and import quotas were introduced within import-substitution strategy in most developing countries. But trade policy could not solve internal problems of developing countries. Besides domestic markets of developing countries are usually not large enough to allow effective size of production and developing countries forfeit import necessary supply, new technology and technological improvements.

2. Why such a contrast between theory and practice?

Protectionism persists contrary to its high costs in real trade policies of most countries. Many studies have dealt with causes of persisting protectionism, e.g. Hilman, Grossman and Helpman etc.

From our point of view, the main causes of the contrast between trade theory and real trade policy are these factors:

²⁵ Oatley (2005), p. 97.

²⁶ On the contrary, developed countries did not favour liberalization of agricultural trade after the WW2 because of strong influence of agricultural lobby. Bhagwati (1989) called this process as “agriculturalization“, which is a contradiction to industrialization of developing countries.

1) Discrimination of foreigners

Introducing of protectionist measurements harming foreigners is politically attractive because of many reasons. First, a short-term benefit is obtained by domestic subject and foreigners are harmed. It is always easier to obtain gains from foreigners than to introduce new tax programs paid by domestic taxpayers as well. Foreigners are “outsiders”, they do not participate in formulation and implementation of a domestic economic policy.

In connection with trade policy, it is possible use nationalism of citizens very successfully and to advocate national interests or national firms and to protect working positions against “alien” competition. In case of need, real or supposed sins are ascribed to competition from abroad (dumping, unfair trade practice, too low wages, unsatisfactory standards) and the way for introduction of a “fair” protectionist measurement on behalf of a domestic subject is ready. In history of politics, we can trace quite a number of successful campaigns for discrimination of foreign traders, producers, Jews etc. There are many pre-justices connecting with the perception of foreigners – racism, xenophobia, menace, instead of foreigners being taken as possibility to learn about him.

On the other side, it is difficult to define the term “foreigner” within the context of growing importance of integration. However in Europe, where the stress is laid on the so-called “European citizenship”, common life remains unchanged and a foreigner is judged according to his nationality²⁷. We can regard the term “foreigner” as the distinction between “We” and “They”. ””We“ means a group that we, as we feel, belongs to and understand. On the contrary, “they” represents groups that we do not have access to or we do not want belong to.”²⁸

Enforcement of protectionism in international trade is related to the understanding of “international environment” as an arena where antagonistic interests of particular countries interfere. Just this dialectics stems from supposed, or real, rivalry of nations. According to the theory of conflict, the division of the world and conflicts are connected with the fact that countries can promote their interests only at the expense of others. The fundamental presumption is the non-removable contrariness of interests that is a result of product limitation and the diversity of professed national values. It holds that the further people (then foreigners), the more standardized awareness we have.

2) Invisibility of benefits from free trade

To open a country to international trade is, in the eyes of general public, connected above all with the anxiety that particular industries will not be able to compete with foreign producers or that the living standard in developed countries will decrease. The other side, which is the benefit from free trade, is not accented enough. Imports bring cheaper goods for other industrial processing. Besides, the important benefit from free trade is “fierce” competition in a market that leads domestic firms to higher efficiency and to a price decrease for domestic consumers. It is like having higher income because they can buy more goods from the same budget. The costs from tariffs and quotas are not seen as a hidden taxation of consumer’s income²⁹. If a country tries to be self-sufficient, and hence it protects the domestic market against a foreign firm entering, then the country loses, because it has to expend scarce resources in production in which the country is not efficient enough. Besides, particular firms have to invest costly time and finance to lobby for holding protectionist measurements.

Except the economic benefit from free trade, it is necessary to mention the benefit in the area of cooperation among countries. Specialization is the keystone of international trade, and that is why

²⁷ A nation is characterized by common language, similar practice etc.

²⁸ Bauman. - May (2004), p. 43, own translation.

²⁹ Harberger and Johnson estimated costs of protectionism measured as a dead-weight loss on 2-3 % of GDP Bhagwati (2002), p. 33.

free trade, unlike protectionism, is based on mutual cooperation of countries. International division of labour and free trade impede a rise of serious disputes that could overgrow into significant conflicts. Matters of the first half of the 20th century confirm that protectionism, that was a result of The Great Depression, led only to isolationism and a destruction of international trade owing to the promoting of beggar-thy-neighbour trade policies³⁰, which in consequence created fruitful ground for the World War II unleash.

3) The pressure of interest groups

International trade raises wealth of countries through the international division of labour and the accompanying growth of productivity. On the other hand, international competition harms specific groups. Protectionism in trade policy is usually aimed at a specific production type, thus it is connected with structural policy. For that reason, there is a large space for activities of all sorts of pressure groups. Firms facing foreign competition have two possibilities how to solve this situation. The former is innovation of the own production, putting near consumer's needs or price lowering. The other is to invest into lobbying for protection of the industry where a firm works. "Legislators cannot easily escape from this logrolling dynamic. While all may want to limit the amount of protection granted to industries outside their own district, each recognizes that a refusal to support protection for industries in other districts will cause other legislators to refuse to support protection for industries in his or her own district."³¹

Firms try to influence the formulation of economic policy to self-profit because free trade helps everybody but little, while protectionism helps little number of people but a lot. Indeed, it leads to a "shouting minority" and a "silent majority". Other way round, it is accepted that costs from international trade are usually concentrated on a relatively small group, while benefits from free trade (lower prices for consumers above all) are spread over a large group, where each individual has only a small share of this benefit. In case when trade policy was formulated through the direct decision-making of voters, then the voice of consumers would overweigh particular producers. Direct decision-making of voters concerning charging or not charging of tariffs would overweigh benefits from not charging a tariff because of its costs (both time and on acquiring information). Besides, small groups of producers are better organised than a group of consumers. Generally, it holds that smaller groups can prevail over large groups that are usually said to be dominant in democracy. The so-called "privileged groups" often overplay large groups because while small groups are usually organised and active, large ones are not organised and inactive.³² Consumers would be engaged more in questions of trade policy, if they had information about (often hidden) costs of protectionism.

"In case when the benefit from a charged tariff or subsidy was captured by interest groups and redistributed to politically influential sectors, it would be better to promote free trade, even if on purely economic grounds free trade need not be the best conceivable policy."³³

4) The turn to rigidity

Free trade is linked to dynamic market environment. Continuous changes need ability and willingness above all to conform to new market conditions. Protectionist tendency serves as a form of "preservation" of current situation and it protects a particular industry against "hostile" external environment. Once a measurement is introduced, it is extremely difficult to remove it because of the rigidity of subjects practising economic policy of a country and "encapsulation" of interest groups that are concerned with it.

³⁰ Countries tried to solve problems with unemployment through limiting imports.

³¹ Oatley (2005), p.81.

³² Olson (1998)

³³ Krugman, p. 221.

There is an asymmetry between aversion to introduce and aversion to remove any measurement. In general, people prefer known and do not like changes. Aversion to changes is even more expressive if a small group benefits from a particular measurement at the expense of a large group (in case of trade policy at the expense of consumers). Producers gain from the introducing of a tariff on their production. Domestic producers have the domestic market protected due to a tariff and they can raise prices. Owners of the firms and employees in protected industries better. That is why they try to hold the existing protection of the domestic market. To remove a measurement is more difficult than to introduce it.

Concluding Remarks

International trade theory predicts that countries prosper when specializing on activities where they have a comparative advantage. On the examples from present we demonstrated fundamental contravening of the free trade principle, even in case of countries with relatively liberal economic policy. World trade is tied with a number of protectionist measurements and in reality there are only a few countries with absolutely free trade.

We offer four possible explanations of the contrast between trade theory and the existing trade policy of countries. First, it is discrimination of foreigners that is very attractive when we emphasize “we” over “they”. Second, it is the invisibility of benefits from free trade that is linked to hidden costs of protectionism and the area of cooperation among countries. Third, the influence of interest groups leads to a “shouting minority” and a “silent majority”. Fourth, the turn to rigidity of subjects means an asymmetry between aversion to introduce and to remove any measurement.

What could be done? Does integration contribute to free trade? It is hard to say but generally, regional trade agreements to lead to two effects: trade creation and trade diversion. In principle, trade diversion is like protectionism because it enables the forming of international trade by virtue of comparative advantage.

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