CHAPTER 2
LITERATURE REVIEW

2.1 International Trade Theory

Based on International Trade theory, the main motivation to do International Trade is reaches *gains from trade* to increase revenue and decreases cost. International Trade provides access is cheaper to goods for consumer and owner for resources have increases revenue due to decreases cost of production (Appleyard et. All. 2006).

International trade had provided positive effect on a country, through some ways:

1. Increasing welfare of society through reciprocity process;
2. By the specialization and division of labor, a country can export commodities which their production are cheaper to exchange by the other country commodities, which is more expensive to produce itself.
3. The impact of the expansion of market product, one country could the output and the rate of economic growth.
4. To stimulate investment and increase saving through the allocation of resources more efficient.

The indirect benefit of trade is as the desire to produce a commodity with better quality, creating climate of good competition, infrastructure foreign capital income, increasing technology and so on. (Jhingan, 1994 in Mulyanto, 1999).

The there are two International trade theories which usually use as the basic explanation of the driver of international trade: comparative advantage theory and endowment factors theory. David Ricardo has improved the absolute advantage theory from Adam Smith by restate the comparative advantage theory. The comparative advantage theory has mention in *free trade* condition, if one of a countries comparing with another countries is less efficiency on both of goods production, so, that both countries has possibility to do the trade and get benefit from both side. The first state has to do is specialization in commodity productions where have a smaller of the absolute disadvantage (that's called comparative advantages and doing the import commodity if the comparative disadvantage is bigger (that's called the comparative disadvantages (Salvatore, 2004).

Heckser-Ohlin mentions that countries do the international trade because of endowment differences. Differences opportunity cost of a goods between countries could occur because there are differences quantity or proportional of owned production factor (endowment factor) of each countries. The countries that have relatively more on the factor will produce of production will produce export the goods that used the abundant doctor. Conversely, each country will import for certainty goods which jus scarcity in production factor and expensive in production: (Salvatore, 2004).

According to Krugman and Obstfeld (2000) trade between countries will occur because two reasons: (1) all the countries is different between one and another (eg. Comparative Advantage and Hecksher-Ohlin Theory), and (2) each countries is doing trade to reach economy of scale. International trade is providing advantage to each country if they made trade with different product. If a country produces its goods with limited variant, so that country can produce in bigger production. Thus, it's to be more efficient if doing the trade with other countries than if it produces all goods.

In Meilani (2008) there are several assumptions that can be classified into 3 parts that need to be underline from balance of international trade, as following: *1. Technology assumption* : a) the production function is homogeneous at the first level, constant return to scale, both country have equal access to technology; b) factors of production capital and labor in the production of interchangeable so that production function is normal category; c) no reciprocals intensity factor; d) Adjustment that occur with the propose the equilibrium in economics. *2. Several simultaneously assumption which can guarantee that after the trade, prices will apply the same in the country like the others country.* That means that not accounting for transport costs, free of trade, perfect competition in all markets including market input. *3. Assumptions who made to simplify the problem,* namely that there are only 2 country in the world (developing and developed countries), 2 commodities and 2 production factors (Salvatore, 2004).

2.2 Free Trade Agreement (FTA)

Many literatures discussed about liberalization that often equated with openness the economy of country or a country is being the liberalization policy if the implemented policy is causing the economy become outward-oriented and openness.

The aim of liberalization policy is trade policy taken a country that reflected the movement toward a more neutral, liberal or openness. In particularly, the changes in direction of the neutral include incentive equation (on average) among the sectors trade. A policy regime considered to implement liberalization policy when the overall level of intervention diminished. In addition, the policy of liberal can also be marked by more importance role of trade in the economy. The liberalization policy can be achieved through several ways such as reducing barriers in trade or enforcement of export of subsidies (Santos-Paulino, 2005).

FTA or Free Trade Area is a form of regional economic cooperation which is original trading products of member countries is free of import duty or duty-free entry. In other says “internal tariff” among member countries to be 0 %, meanwhile each countries have own “external tariff” (Stephenson, 1994).

FTA discussion comprise goods and services trade intensity enhancement that has benefits to increase market access, attracting potential investors, non-tariff barrier elimination, how to avoid re-test and certifications on chapter mutual recognition agreement (MRA), and custom procedure simplification. It consists of tariff removal (tariff concessions and preferential tariff) to eliminate tariff for “substantially all trade” including bound rate and MFN tariff, remove non-tariff barriers and trade barriers minimization to reach maximum trade level (Budhianto, 2005).

Rules of Origin mechanism identify the nationality of product to ensure that only the FTA product receive tariff preference and tariff remedy. If dumping practice is found, anti-dumping mechanism will be conducted. So is subsidy, it will be mitigated by counter-veiling duty. In case of imported flood, safeguards action such as mutual recognition agreement (MRA), customs procedure and paperless trading and Investment will be implemented (Budhianto, 2005).

Linnan (2003) mentions the understanding of bilateral Free trade Agreement (FTA) is the expansion of exclusion regional free trade; because it does not qualifications have a minimum size for distance the two countries geographically. In addition, Budhianto (2005) mentions the main principle of agreement in free trade agreement is tariff and non tariff barrier reduction among members, even as specific in article XXIV GATT / WTO, member countries cannot increase trade barriers to non-member countries. For example, the customs tariff for India 'A' for example, 20 percent. With AFTA, Indonesia lower tariff will be zero percent for members, but with non-member countries, tariff products' A 'should not be higher than 20 percent.

The agreement of FTA (Free Trade Area) expected to restore the competitiveness of products in importer countries market.

According to Ballasa (1969), in international trade to establish an economic integration there are some process which have to pass by country, FTA *(Free Trade Area)* is the first step in conducting economic integration process. The next step is CU *(Custom Union)*, and then CM (Common Market), the last step is EU *(Economic Union)*. Therefore, in order to form an economic integration of established of an international trade organization namely WTO (World Trade Organization).

Figure 2 shows the process of economic integration. The first step begins with the FTA *(Free Trade Area)*, free movement of good intended to eliminate trade barriers caused by tariff barriers and non tariff barrier for member countries or inter-countries of FTA agreements and impose different tariff and non- tariff to non member countries. By doing FTA is intended to increase the volume and value of trade among member countries or inter-countries of FTA agreements. The next step is moving to CU *(Custom Union)*, is intended after removing trade barriers that affect the increasing volume and value of trade is expected to create investment between member countries or inter-countries of CU agreement beside that impose the same tariff to member and non member countries. The policy of economy which performed at this stage is the economy policies of member countries that joined in one group and groups act as one body in the negotiation of all trade agreements with non-members countries. The third step is to CM (Common Market), at this stage beside the criterion on CU intended for the movement production factor such as labor and capital between member countries or the country of CM agreements. Finally is the EU (Economic Union), in this stage of political integration, the meaning is the economic integration have created an economy in which trade barriers are not there at all, including political barriers to member countries whereas integrate monetary policy and harmonized fiscal policy. However, for each country as the independence can still impose tariff and non tariff in negotiating with non-member countries.

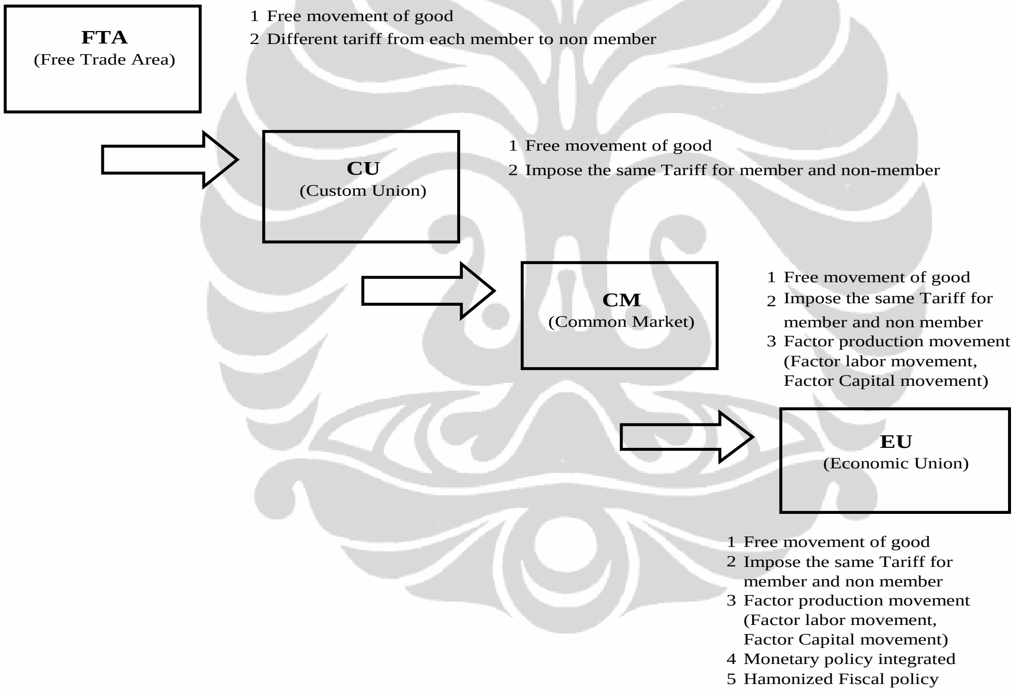

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Figure 2 Economic Integration

2.5 Non-Tariff Barriers to Trade

There are some kinds of instrument of trade policy, According to Bowen, Hollander, and Viaene at least there are three instruments that could be categorized as instrument of trade policy, one of is Non-Tariff Barriers. Non Tariff barriers cover all actions except tariffs that restrict transactions between foreign and domestic residents.

These can include both trade related restrictions as well as government intervention in domestic markets via taxes or subsidies and also bureaucratic regulation. According to Bowen, Hollander and Viaene, the type of NTBs are mentioned as follows.

Quantitative Restrictions

Quantitative restrictions could be form as import and export quotas. An import quota sets a limit on the amount of good that can be imported over specific periode of time. And export quota sets a limit on the volume of good that can be exported over given period time. As instrument to restrict the volume, export and import licensing are established.

Voluntary Export Restraints (VERs)

This instrument is restriction through 'voluntary' action by exporting country. In other word, the exporting country agrees to limit its exports because of the request of the importing country. However, the GATT now covers all sectors as subject of prohibition the use of VERs.

Performance Requirements

Some of importing countries require exporting countries to meet objective that may or may not apply to domestic firms. The examples of this requirements are; domestic content and export performance requirements. A domestic content requirement is used to derive the capacity of domestic factor of production and to induce foreign firms to locate some or all of their production facilities in the importing countries. An export performance deals with requires foreign firm in host country or other domestic firm, to export a certain percentage of their output. However, the GATT now prohibits most types of domestic content and export performance scheme.

Other Issues

Other issues that will be popular in the next several years to restrict the trade are explained by Prof. Tarmidi. Those are: environmental protection, violation of humans Rights and freedom of religion, social clauses (labor rights), intellectual property-related trade barriers, and investment barriers.

However, for the two last issues above has already been arranged under the Agreement at the WTO. The agreements are Trade-related Intellectual Property Rights (TRIPs) and Trade-related Investment Measures (TRIMs). (Tarmidi, 2007).

2.6 Trade Diversion and Trade Creation

According to Suranovic, (1998), Trade Diversion assumed that in general, trade diversion means that a free trade area diverts trade, away from a more efficient supplier outside the FTA, towards a less efficient supplier within the FTA. In some cases, trade diversion will reduce a country's national welfare but in some cases national welfare could improve despite the trade diversion.

Meanwhile, Trade Creation his assumed that in general, trade creation means that a free trade area creates trade that would not have existed otherwise. As a result, supply occurs from a more efficient producer or the product. In all cases trade creation will raise a country's national welfare.