Chapter Six

The Political Economy of International Trade

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Adapted by R. Helg LIUC 2007

Opening Case

- Since 1974, international trade in the textile industry has been governed by a system of quotas known as the Multi-Fiber Agreement
  - Designed to protect textile producers in developed nations from foreign competition
- The World Trade Organization agreed to let the MFA expire on December 31, 2004
  - In 2003 China was making 17% of the world's textiles
  - By 2007 the WTO expects that China may make up to 50% of the world's textiles

Opening Case

- Trade associations from more than 50 textile-producing nations signed the 'Istanbul Declaration' in 2004
  - Requested that the WTO delay the removal of quotas
  - The request was denied
- The result of the removal of quotas is that China's increased production could cripple the economies of countries like Bangladesh
- Even though China has increased export tariffs, many see this as a token gesture
- In the first three months of 2005, imports of Chinese textiles into the US surged 62% compared with the same period in 2004

Instruments of trade policy

Two major categories:

a) Tariffs barriers: the tariff
b) Non-tariff barriers: every barrier to trade which is not a tariff

Instruments of trade policy: tariffs

- Tariffs - oldest form of trade policy
  it drives a wedge between the international (import) price and the domestic price
  - Specific (sp)

    $$P_D = P_{INT} + t_{sp}$$

  - Ad valorem (av)

    $$P_D = P_{INT} + t_{av} * P_{INT} = (1+ t_{av}) * P_{INT}$$

Economic effects of a tariff

- Good for government (increase revenues)
- Protects domestic producers
  - Reduces efficiency
- Bad for consumers
  - Increases cost of goods

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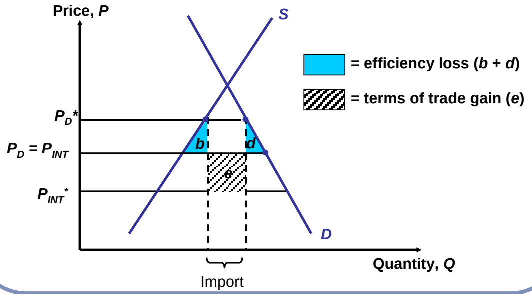
Economic effects of a tariff (big country case)



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Economic effects of a tariff

When a tariff is introduced the economic effects are (big country case):

$t_{sp} \uparrow \rightarrow P_{INT} \downarrow$

$\rightarrow P_D \uparrow$

$\rightarrow Q_D \downarrow$

$\rightarrow Q_S \uparrow$

$\rightarrow$ IMP $\downarrow$

$\rightarrow$ GR $\uparrow$

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Economic effects of a tariff: gainers and losers (big country case)

- At home:

Gainers: producers
government

Looser: consumers

- Abroad:

Gainers: consumers

Looser: producers

Economic effects of a tariff: gainers and losers (small country case)

The effect of a tariff in a “small country” are similar to those in a “big country”, but for the fact that the international price is doesn’t change.

As a consequence it is possible to show that country economic welfare is reduced by the introduction of a tariff.

Instruments of trade policy: non-tariff barriers (NTB)

- The most common NTBs are:
- Quotas
- Voluntary export restraints (VER)
- Export subsidies
- Local content requirements (LCR)
- Administrative trade policies
- Standards

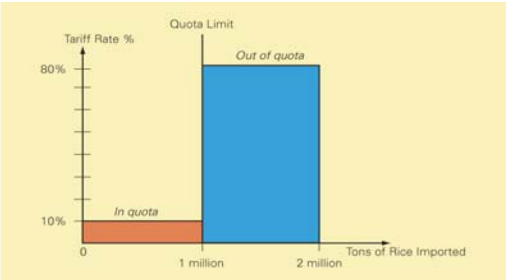
Instruments of Trade Policy: Export Subsidies

- Government payment to a domestic producer
  - Cash grants
  - Low-interest loans
  - Tax breaks
  - Government equity participation in the company
- Subsidy revenues are generated from taxes
- Subsidies encourage over-production, inefficiency and reduced trade

Instruments of Trade Policy: Quotas

- **Import quota**
  - Restriction on the quantity of some good imported into a country
- An hybrid of a quota and a tariff is the **tariff rate quota:** a lower tariff is applied to imports within the quota than those over the quota (highly utilized in agriculture)

Instruments of Trade Policy: Tariff Rate Quota



Instruments of Trade Policy: VER

- **Voluntary export restraint (VER)**
  Quota on trade imposed by exporting country, typically at the request of the importing country (ex. cars, semiconductors, sugar)
- Benefits producers by limiting import competition: ex. US-Japan VER on auto
  - Japan – limited exports to 1.85 m vehicles/year
  - Cost to consumers - $1b/year between '81 - 85.
  - Money went to Japanese producers in the form of higher prices
  - Encourages strategic action by firms in order to circumvent quota

Instruments of Trade Policy: Local Content

- Requires some specific fraction of a good to be produced domestically
  - Percent of component parts
  - Percent of the value of the good
- Initially used by developing countries to help shift from assembly to production of goods.
- Developed countries (US - Buy American Act) beginning to implement
- For component parts manufacturer, LCR acts the same as an import quota
- Benefits producers, not consumers

Instruments of Trade Policy: Administrative Policies

- Bureaucratic rules designed to make it difficult for imports to enter a country
  - France – video tapes
- Japanese 'masters' in imposing rules
  - Tulip bulbs
  - Federal Express

Instruments of Trade Policy: Standards

- Usually introduced to protect the consumer: for ex. health standards
- Controversial because they might have the effect of discriminating against foreign products (ex. GMO food)

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Instruments of Trade Policy: Antidumping Policies

- Anti-dumping policies usually are tariffs imposed on imports
- Dumping is defined as
  - Selling goods in a foreign market below production costs
  - Selling goods in a foreign market below fair market value
- Dumping is the result of
  - Unloading excess production
  - Predatory behavior
  - Profit maximization
- Remedy: seek imposition of tariffs

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Arguments in favour of policy intervention

Two group of arguments:

- **Political arguments**: concerned with protecting the interests of certain groups within a country
- **Economic arguments**: concerned with boosting the overall wealth of a country

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Political Arguments for Intervention

- Protecting jobs and industries
  - CAP (Europe) and VER
- National security
  - Defence industries - semiconductors
- Retaliation
  - Punitive sanctions

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Political Arguments for Intervention

- Protecting consumers
  - Genetically engineered seeds and crops (GMO)
  - Hormone treated beef
- Furthering foreign policy objectives
  - Helms-Burton Act
  - D'Amato Act
- Protecting human rights
  - MFN

Economic Arguments for Intervention

- **Infant industry argument**
  - Oldest argument - Alexander Hamilton, 1792
  - Protected under the WTO
  - Only good if it makes the industry efficient (Brazil auto-makers - 10th largest - wilted when protection eliminated)
  - Requires government financial assistance
    - Today if the industry is a good investment, global capital markets would invest

Economic Arguments for Intervention

- **Strategic trade policy**
  - Government should use subsidies to protect promising firms in newly emerging industries with substantial scale economies (oligopolistic markets)
  - Protected firm is obviously better off
  - Also national welfare might increase if the firm successfully enters the new market and reap part of the extra-profits (ex. Airbus case)
  - Good theoretical argument – Difficult to implement

The revised case for free trade

Previous theoretical argument in favour of protectionism are subject to the following criticisms:

- **Retaliation**: even a theoretically motivated government intervention might produce losses for national welfare if it generates retaliation abroad.
- **Domestic politics:** government can be *captured* by domestic interest groups (lobbies) that derail government policies
- **Lack of information**: in many cases the government doesn't have the necessary set of precise information to design and implement the policy correctly

Development of the World Trading System

- Intellectual arguments for free trade
  - Adam Smith and David Ricardo
- Free trade as government policy
  - Britain's (1846) repeal of the Corn Laws
- Britain continued free trade policy
  - Fear of trade war

Development of the World Trading System

- **Great Depression**
  - US stock market collapse
  - Smoot-Hawley tariff (1930)
    - Almost every industry had its "made to order tariff"
    - Foreign response was to impose own barriers
    - US exports tumbled
    - Trade war exploded

Development of the World Trading System

- **GATT** - multilateral agreement established in 1948 under US and UK leadership
  - Objective is to liberalize trade by eliminating tariffs, subsidies, and import quotas
  - 19 original members grew to 151
- One basic principle: **Non discrimination**
- Two applications of this principle
  - **Most favored nation** clause
  - **National treatment** clause

Why do we need the GATT/WTO ?

The creation of GATT allowed to solve a sort of *prisoner dilemma.*

In fact, international negotiations can help avoiding a trade war. Consider the following example

TABLE 9-4 The Problem of Trade Warfare

U.S. \ Japan	Free trade	Protection
Free trade	10 / 10	20 / −10
Protection	−10 / 20	−5 / −5

Why do we need the GATT/WTO ?

- This is a non-cooperative game. The only Nash equilibrium is "Protectionism-Protectionism"
- Note: both country would be better off in the "Free trade-Free trade" situation (prisoners' dilemma), but this cannot be an equilibrium given the characteristics of this game.

This example tries to mimic the trade war escalation between the two world wars.

In this set up on can interpret the role of the GATT in terms of a change of the rules of the game: from a non-cooperative game to a cooperative one

Development of the World Trading System

- Used 'rounds of talks' to gradually reduce trade barriers
- Uruguay Round (1986-93)
  - Creation of WTO
  - Mutual tariff reductions negotiated
  - Dispute resolution only if complaints were received

Disturbing Trends in the World Trading System

- During the '80s pressure for greater protectionism due to
  - Increase in the power of Japan's economic machine and relatively closed Japanese markets
  - US trade deficit
  - GATT circumvented by many countries
    - through use of NTB (mainly VER)

The World Trade Organization

- The WTO was created in 1994 during the Uruguay Round of GATT to police and enforce GATT rules
- Most comprehensive trade agreement in history
- Formation of WTO had an impact on
  - Agriculture subsidies (stumbling block: US/EU)
  - Applied GATT rules to services and intellectual property (TRIPS)
  - Strengthened GATT monitoring and enforcement

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The WTO

- 151 members as of September 2007
- Represents more than 90% of world trade
- 9 of 10 disputes satisfactorily settled
- Tariff reduction from 40% to 5%
- Trade volume of manufactured goods has increased 20 times

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The WTO

- Policing organization for:
  - GATT
  - Services
  - Intellectual property
- Responsibility for trade arbitration:
  - Reports adopted unless specifically rejected
  - After appeal, failure to comply can result in compensation to injured country or trade sanctions

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WTO at Work

- 351 disputes brought to WTO between 1995 and October 2006
- 196 handled by GATT during its 50 year history
- US is biggest WTO user
  - Big wins: beef - bananas
  - Big loss: Kodak

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The WTO -Achievements

- Telecommunications (1997)
  - 68 countries - 90% of world telecommunications revenues
  - Pledged to open their market to fair competition
- Financial Services (1997)
  - 95% of financial services market
  - 102 countries will open their markets to varying degrees

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WTO in Seattle

- Millennium round was aimed at further reduction of trade barriers in agriculture and services
- WTO meeting disrupted by
  - Human rights groups
  - Trade unions
  - Environmentalists
  - Anti globalization groups
- No agreement was reached

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Doha Agenda -WTO

- Cutting tariffs on industrial goods and services
- Phasing out subsidies
- Reducing antidumping laws
- WTO regulation on intellectual property should not prevent members from protecting public health
  - TRIPS agreement

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The Doha Round

- The **Doha Round** officially started at Doha, Qatar in November 2001, after the collapse of the Seattle meeting two years before.
- The contrasts among the various countries have produced a series of failures at the Ministerial Meetings of Cancun (September 2003) and Hong Kong (December 2006).

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The Doha Round

- One of the tables on which the negotiation stalled has been that of agricultural liberalization.

  The European Union with the Common Agricultural Policy and the United States with their agricultural subsidies have opposed the request of substantial liberalization advanced by a group of emerging economies with a comparative advantage in that sector.

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Looking Ahead to Chapter 7

- Foreign Direct Investment in the World Economy
- Horizontal Foreign Direct Investment
- Vertical Foreign Direct Investment
- Implications for Managers

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