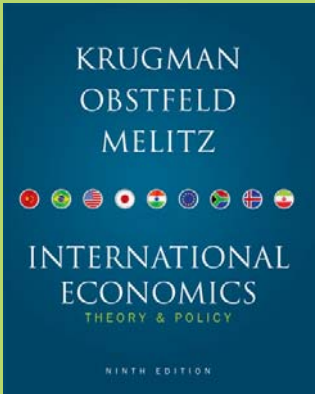


Chapter 10

The Political Economy of Trade Policy: international negotiations



Addison-Wesley
an imprint of
PEARSON
Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

Preview

- International negotiations of trade policy and the World Trade Organization
- Preferential Trade Agreements

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-2

International Negotiations of Trade Policy

- After rising sharply at the beginning of the 1930s, the average U.S. tariff rate has decreased substantially from the mid-1930s to 1998.
- Since 1944, much of the reduction in tariffs and other trade restrictions has come about through international negotiations.
 - The **General Agreement of Tariffs and Trade** was begun in 1947 as a provisional international agreement and was replaced by a more formal international institution called the **World Trade Organization** in 1995.

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-3

Fig. 10-5: The U.S. Tariff Rate



Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-4

International Negotiations of Trade Policy (cont.)

- Multilateral negotiations mobilize exporters to support free trade if they believe export markets will expand.
 - This support would be lacking in a unilateral push for free trade. The multilateral approach counteracts the support for restricted trade by import-competing groups.

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-5

International Negotiations of Trade Policy (cont.)

- Multilateral negotiations also help avoid a trade war between countries, where each country enacts trade restrictions.
- A trade war could result if each country has an incentive to adopt protection, *regardless of what other countries do*.
 - All countries could enact trade restrictions, *even if it is in the interest of all countries to have free trade*.
 - Countries need an agreement that prevents a trade war or eliminates the protection from one.

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-6

Table 10-3: The Problem of Trade Warfare

		Japan	
		Free trade	Protection
U.S.	Free trade	10	-10
	Protection	20	-5

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-7

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 one 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

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

6-9

GATT/WTO

- One basic principle: **Non discrimination**
Two applications of this principle
 - **Most favoured nation** clause
 - **National treatment** clause

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

6-9

International Trade Agreements: A Brief History

- In 1930, the United States passed a remarkably irresponsible tariff law, the Smoot-Hawley Act.
 - Tariff rates rose steeply and U.S. trade fell sharply.
- Initial attempts to reduce tariff rates were undertaken through bilateral trade negotiations:
 - U.S. offered to lower tariffs on some imports if another country would lower its tariffs on some U.S. exports.
- Bilateral negotiations, however, do not take full advantage of international coordination.
 - Benefits can “spill over” to countries that have not made any concessions.

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-10

World Trade Organization

- In 1947, a group of 23 countries began trade negotiations under a provisional set of rules that became known as the General Agreement on Tariffs and Trade, or GATT.
- In 1995, the **World Trade Organization**, or **WTO**, was established as a formal organization for implementing multilateral trade negotiations (and policing them).
- In December 2013, 159 members (end of January 2014 Yemen will enter)

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-11

World Trade Organization

- WTO negotiations address trade restrictions in at least 3 ways:
 1. **Reducing tariff rates** through multilateral negotiations.
 2. **Binding tariff rates**: a tariff is “bound” by having the imposing country agree not to raise it in the future.

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-12

World Trade Organization (cont.)

3. Eliminating nontariff barriers: quotas and export subsidies are changed to tariffs because the costs of tariff protection are more apparent and easier to negotiate.

- Subsidies for agricultural exports are an exception.
- Exceptions are also allowed for "market disruptions" caused by a surge in imports.

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-13

World Trade Organization (cont.)

• The World Trade Organization is based on a number of agreements:

- *General Agreement on Tariffs and Trade (GATT)*: covers trade in goods.
- *General Agreement on Tariffs and Services (GATS)*: covers trade in services (ex., insurance, consulting, legal services, banking).
- *Agreement on Trade-Related Aspects of Intellectual Property (TRIPS)*: covers international property rights (ex., patents and copyrights).

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-14

World Trade Organization (cont.)

- *The dispute settlement procedure*: a formal procedure where countries in a trade dispute can bring their case to a panel of WTO experts to rule upon.

- The panel decides whether member countries are breaking their agreements.
- A country that refuses to adhere to the panel's decision may be punished by the WTO allowing other countries to impose trade restrictions on its exports.

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-15

World Trade Organization (cont.)

- The GATT multilateral negotiations in the Uruguay Round, ratified in 1994:
 - agreed that all quantitative restrictions (ex., quotas) on trade in textiles and clothing as previously specified in the Multi-Fiber Agreement were to be eliminated by 2005.
- Quotas on imports from China had to be temporarily reimposed due to surge in Chinese clothing exports when MFA expired.

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-16

World Trade Organization (cont.)

- In 2001, a new round of negotiations was started in Doha, Qatar, but it has been very difficult to reach an agreement
 - Most of the remaining forms of protection are in agriculture, textiles, and clothing—industries that are politically well organized

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-17

World Trade Organization (cont.)

- In December 2013, at the Bali Ministerial Conference a first agreement has been reached: the most significant is the [trade facilitation](#) part of the package, which is about cutting red tape and speeding up port clearances.

The trade facilitation decision is a Multilateral deal to simplify customs procedures by reducing costs and improving their speed and efficiency.

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-18

Table 10-4: Percentage Distribution of Potential Gains from Free Trade

Economy	Full Liberalization of:			
	Agriculture and Food	Textiles and Clothing	Other Merchandise	All Goods
Developed	46	6	3	55
Developing	17	8	20	45
All	63	14	23	100

Source: Kym Anderson and Will Martin, "Agricultural Trade Reform and the Doha Agenda," *The World Economy* 28 (September 2005), pp. 1301-1327.

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-19

Do Agricultural Subsidies in Rich Countries Hurt Poor Countries?

- We learned in Chapter 9 that subsidies lower the *world* price of products.
 - Since importing countries benefit from cheaper food, why would poor countries want rich countries to remove their agricultural subsidies?
 - Subsidies harm farmers in poor countries who compete with farmers in rich countries.

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-20

Table 10-5: Percentage Gains in Income under Two Doha Scenarios

	Percentage Gains in Income under Two Doha Scenarios	
	Ambitious	Less Ambitious
High-income	0.20	0.05
Middle-income	0.10	0.00
China	-0.02	-0.05
Low-income	0.05	0.01
World	0.18	0.04

Source: See Table 10-4.

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-21

Preferential Trading Agreements

- Preferential trading agreements are trade agreements between countries in which they lower tariffs for each other but not for the rest of the world.
- Under the WTO, such discriminatory trade policies are generally not allowed:
 - Each country in the WTO promises that all countries will pay tariffs no higher than the nation that pays the lowest: called the “most favored nation” (MFN) principle.
 - An exception is allowed only if the lowest tariff rate is set at zero.

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-22

Preferential Trading Agreements (cont.)

- There are two types of preferential trading agreements in which tariff rates are set at or near zero:
 1. A **free trade area**: an agreement that allows free trade among members, but each member can have its own trade policy towards non-member countries.
 - An example is the North America Free Trade Agreement (NAFTA).

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-23

Preferential Trading Agreements (cont.)

2. A **customs union**: an agreement that allows free trade among members and requires a common external trade policy towards non-member countries.
 - An example is the European Union.

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-24

Preferential Trading Agreements (cont.)

- Are preferential trading agreements necessarily good for national welfare?
- No, it is possible that national welfare decreases under a preferential trading agreement.
- How? Rather than gaining tariff revenue from inexpensive imports from world markets, a country may import expensive products from member countries but not gain any tariff revenue.

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-25

Preferential Trading Agreements (cont.)

- Preferential trading agreements increase national welfare when new trade is created, but not when existing trade from the outside world is diverted to trade with member countries.
- Trade creation
 - occurs when high-cost domestic production is replaced by *low-cost imports from other members*.
- Trade diversion
 - occurs when low-cost imports from nonmembers are diverted to *high-cost imports from member nations*.

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-26

Summary

1. Multilateral negotiations of free trade may mobilize domestic political support for free trade, as well as make countries agree not to engage in a trade war.
2. The WTO and its predecessor have reduced tariffs substantially in the last 50 years, and the WTO has a dispute settlement procedure for trade disputes.
3. A preferential trading agreement is beneficial for a country if it creates new trade but is harmful if it diverts existing trade to higher-cost alternatives.

Copyright © 2012 Pearson Addison-Wesley. All rights reserved.

10-27
