International Business
Global Edition

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(adapted for LIUC2013 by R.Helg)

Chapter 7

The Political Economy of International Trade

What Is The Political Reality Of International Trade?

- Free trade occurs when governments do not attempt to restrict what citizens can buy from another country or what they can sell to another country
  - many nations are nominally committed to free trade, but intervene to protect the interests of politically important groups

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Instruments of trade policy

Two major categories:

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

- Subsides
- Import Quotas
- Voluntary Export Restraints
- Local Content Requirements
- Administrative Polices
- Standards
- Antidumping Policies
- Etc.

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Tariffs

Tariffs – oldest form of trade policy.

They are taxes levied on imports that effectively raise the cost of imported products relative to domestic products.

They drive a wedge between the international (import) price and the domestic price. Two kinds:

- Specific (sp) tariffs are levied as a fixed charge for each unit of a good imported

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

- Ad valorem (av) tariffs are levied as a proportion of the value of the imported good

$$P_D = P_{INT} + t_{av} * P_{INT} =$$

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

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Economic effects of a tariff

- Good for government (**increase revenues**)
- Good for domestic protected producers
- Bad for consumers
  - Increases cost of goods

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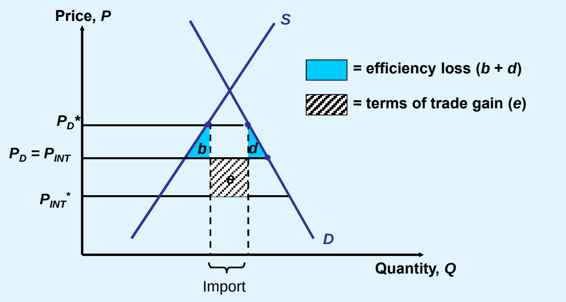
Economic effects of a tariff (big country case)



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Economic effects of a tariff

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

t_{sp} ↑ → P_{INT}↓
→ P_D↑
→ Q_D ↓
→ Q_S ↑
→ IMP ↓
→ GR ↑

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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

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Economic effects of a tariff: (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 doesn't change.

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

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How Do Governments Intervene In Markets?

2. Subsidies - government payments to domestic producers
   - Subsidies help domestic producers
     - compete against low-cost foreign imports
     - gain export markets
   - Consumers typically absorb the costs of subsidies

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How Do Governments Intervene In Markets?

3. Import Quotas - restrict the quantity of some good that may be imported into a country
   - Tariff rate quotas - a hybrid of a quota and a tariff where a lower tariff is applied to imports within the quota than to those over the quota
   - A quota rent - the extra profit that producers make when supply is artificially limited by an import quota

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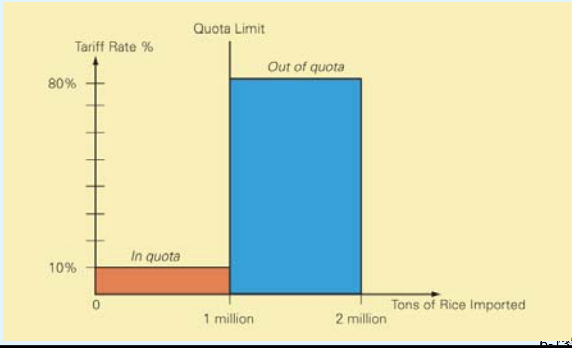
Instruments of trade policy: Tariff Rate Quota



How Do Governments Intervene In Markets?

4. Voluntary Export Restraints - quotas on trade imposed by the exporting country, typically at the request of the importing country's government
   - Import quotas and voluntary export restraints
     - benefit domestic producers
     - raise the prices of imported goods

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How Do Governments Intervene In Markets?

5. Local Content Requirements - demand that some specific fraction of a good be produced domestically
   - benefit domestic producers
   - consumers face higher prices
6. Administrative Policies - bureaucratic rules designed to make it difficult for imports to enter a country
   - polices hurt consumers by limiting choice

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How Do Governments Intervene In Markets?

7. Antidumping Policies – aka countervailing duties - punish foreign firms that engage in dumping and protect domestic producers from "unfair" foreign competition
   - dumping - selling goods in a foreign market below their costs of production, or selling goods in a foreign market below their "fair" market value
     - enables firms to unload excess production in foreign markets
     - may be predatory behavior - producers use profits from their home markets to subsidize prices in a foreign market to drive competitors out of that market, and then later raise prices
8. Standards

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Why Do Governments Intervene In Markets?

- There are two main arguments for government intervention in the market

1. Political arguments - concerned with protecting the interests of certain groups within a nation (normally producers), often at the expense of other groups (normally consumers)
2. Economic arguments - concerned with boosting the overall wealth of a nation – benefits both producers and consumers

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What Are The Political Arguments For Government Intervention?

1. Protecting jobs - the most common political reason for trade restrictions
   - results from political pressures by unions or industries that are "threatened" by more efficient foreign producers, and have more political clout than consumers

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What Are The Political Arguments For Government Intervention?

2. Protecting industries deemed important for national security - industries are often protected because they are deemed important for national security
   - aerospace or semiconductors

What Are The Political Arguments For Government Intervention?

3. Retaliation for unfair foreign competition - when governments take, or threaten to take, specific actions, other countries may remove trade barriers
   - if threatened governments do not back down, tensions can escalate and new trade barriers may be enacted
   - risky strategy
4. Protecting consumers from "dangerous" products – limit "unsafe" products

What Are The Political Arguments For Government Intervention?

5. Furthering the goals of foreign policy - preferential trade terms can be granted to countries that a government wants to build strong relations with
   - trade policy can also be used to punish rogue states
   - the Helms-Burton Act and the D'Amato Act, have been passed to protect American companies from such actions

What Are The Political Arguments For Government Intervention?

6. Protecting the human rights of individuals in exporting countries – through trade policy actions
   - the decision to grant China MFN status in 1999 was based on this philosophy
7. Protecting the environment – international trade is associated with a decline in environmental quality
   - concern over global warming
   - enforcement of environmental regulations

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What Are The Economic Arguments For Government Intervention?

1. Tariff in a big country (terms of trade argument) - as seen before, a proper tariff might increase national welfare in a big country
2. The infant industry argument - an industry should be protected until it can develop and be viable and competitive internationally
   - accepted as a justification for temporary trade restrictions under the WTO

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What Are The Economic Arguments For Government Intervention?

- Question: When is an industry “grown up” ?
- Critics argue that if a country has the potential to develop a viable competitive position, its firms should be capable of raising necessary funds without additional support from the government

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What Are The Economic Arguments For Government Intervention?

3. Strategic trade policy - first mover advantages can be important to success

- governments can help firms from their countries attain these advantages
- governments can help firms overcome barriers to entry into industries where foreign firms have an initial advantage

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Revised Case For Free Trade

Restrictions on trade may be inappropriate in the following cases:

- Retaliation and Trade War
- Domestic Politics (lobbies activity)
- Lack of information

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Retaliation And Trade War

- Paul Krugman argues that strategic trade policies aimed at establishing domestic firms in a dominant position in a global industry are beggar-thy-neighbor policies that boost national income at the expense of other countries
- Countries that attempt to use such policies will probably provoke retaliation

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Domestic Policies

- Krugman also argues that since special interest groups can influence governments, strategic trade policy is almost certain to be captured by such groups who will distort it to their own ends

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Lack of information

- in many cases the government doesn't have the necessary set of precise information to design and implement the policy correctly

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How has the current world trading system emerged?

- Until the Great Depression of the 1930s, most countries had some degree of protectionism
  - Smoot-Hawley tariff (1930)
- After WWII, the U.S. and other nations realized the value of freer trade
  - established the General Agreement on Tariffs and Trade (GATT) - a multilateral agreement to liberalize trade
- In the 1980s and early 1990s protectionist trends emerged
  - Japan's perceived protectionist (neo-mercantilist) policies created intense political pressures in other countries
  - persistent trade deficits by the U.S
  - use of non-tariff barriers increased

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How has the current world trading system emerged?

➢After WWII, the U.S. and other nations realized the value of freer trade, and established the General Agreement on Tariffs and Trade (GATT)

- The approach of GATT (a multilateral agreement to liberalize trade) was to gradually eliminate barriers to trade

-Very successful:

* 19 original members grew to 159 (Oct. 2013)
* Represents more than 90% of world trade
* Tariff reduction from 40% to 5%

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GATT/WTO

➢One basic principle: **Non discrimination**

Two applications of this principle

- **Most favoured nation** clause
- **National treatment** clause

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Why do we need the GATT/WTO ?

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

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

TABLE 9-4 The Problem of Trade Warfare

U.S. \ Japan	Free trade	Protection
Free trade	10, 10	−10, 20
Protection	20, −10	−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 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

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GATT/WTO

- The Uruguay Round of GATT negotiations began in 1986 focusing on
  1. Services and intellectual property
     - going beyond manufactured goods to address trade issues related to services and intellectual property, and agriculture
  2. The World Trade Organization
     - it was hoped that enforcement mechanisms would make the WTO a more effective policeman of the global trade rules

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GATT/WTO

- The WTO encompassed **GATT** along with two sisters agreements
  - the General Agreement on Trade in Services (**GATS**)
  - the Agreement on Trade Related Aspects of Intellectual Property Rights (**TRIPS**)
- The WTO has emerged as an effective advocate and facilitator of future trade deals, particularly in such areas as services
- So far, the WTO's policing and enforcement mechanisms are having a positive effect
- Most countries have adopted WTO recommendations for trade disputes

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What Is The Future Of The World Trade Organization?

- The WTO has become a magnet for various groups protesting free trade
- The current agenda of the WTO focuses on
  - the rise of anti-dumping policies
  - the high level of protectionism in agriculture
  - the lack of strong protection for intellectual property rights in many nations
  - continued high tariffs on nonagricultural goods and services in many nations

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What Is The Future Of The World Trade Organization?

- The WTO launched a new round of talks at Doha, Qatar in 2001
- The agenda includes
  - cutting tariffs on industrial goods and services
  - phasing out subsidies to agricultural producers
  - reducing barriers to cross-border investment
  - limiting the use of anti-dumping laws

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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). In July 2008 the negotiations failed again. As of August 2012 negotiations are not yet concluded.

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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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What Do Trade Barriers Mean For Managers?

- Managers need to consider how trade barriers affect the strategy of the firm and the implications of government policy on the firm

1. Trade barriers raise the cost of exporting products to a country
2. Voluntary export restraints (VERs) may limit a firm's ability to serve a country from locations outside that country

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What Do Trade Barriers Mean For Managers?

3. To conform to local content requirements, a firm may have to locate more production activities in a given market than it would otherwise

- Managers have an incentive to lobby for free trade, and keep protectionist pressures from causing them to have to change strategies

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