

EC3355 International Trade

Problem Set 7: The political economy of trade

Consider three countries: Norway, France, and Brazil. In autarky, Norway would pay \$10 for beef, while under free trade it can import beef for \$6 from Brazil and \$8 from France. Norway however has a beef tariff of \$6.

1. Let's say that Norway joins the EU. How will this affect trade? Is there trade creation or trade diversion?

Answer: Prior to joining the EU, Norway will consume Norwegian beef as its price is lower than the price of both Argentinian and French beef including the tariff. When Norway joins the EU, the beef tariff will no longer apply to the French beef. This means that Norway can (and will) import French beef for \$8, which is lower than the domestic price. Thus there will be trade creation.

2. Consider the case where the Norwegian beef tariff is \$3. If Norway joins the EU, will there be trade creation or trade diversion?

Answer: Similar to the last question, Norway joining the EU will mean that Norway can import beef from France for \$8. However, prior to Norway's EU membership it would have imported beef from Argentina for \$9. In this case there will be trade diversion.

3. Suppose that Montenegro imports 30 tons of steel per year from Russia, subject to a 100% tariff. After a trade agreement with the EU Montenegro imports 70 tons of steel per year from other E.U. member states and none from Russia. Did Montenegro gain by becoming an EU member?

Answer: We can't really tell with this data. We do know that there has been both trade creation and diversion: 30 tons of imports are diverted from Russia to the EU, and additionally 40 tons of trade has been created. The fact that there has been more trade creation than diversion doesn't tell whether this development has been beneficial. Consider the diagram shown during the seminar. c_R is the cost of steel from Russia, and c_E is the cost of steel from the EU. It must be the

case that $c_R < c_E$ since Montenegro was importing from Russia and not the EU when they both faces the same 100% tariff. For similar reasons $2c_R > c_E$ since otherwise Montenegro would still import from Russia even with 0 tariffs on EU steel.

4. Recently the Angolan government imposed a number of tariffs on different products ranging from ice cream to cars. Can we explain the existence of these tariffs using median voter theorem?

Answer: Median voter theorem is potentially useful here: The tariffs mainly hurt the expat community in the capital Luanda. Since a large share of Angola's labour force works in the agricultural sector they might benefit from the higher prices as long as it doesn't affect the prices of the goods they consume.

5. The sugar quota in the U.S. leads to sometimes large discrepancies between domestic and world prices for sugar. In general, consumers are worse off because of these import quotas. How could we explain the existence of this and other similar seemingly hurtful policies?

Answer: This is similar to the collective action example given in the lecture about CAP.

6. We can analyse trade policies by looking at economic self interests or examining social concerns. Explain the difference between these two approaches.

Answer: The main difference here is that the social concerns approach accounts for factors that are neglected when using the economic self interest approach, i.e. things that are not necessarily driven by rational behaviour. Examples of this that were given during the lecture include the preference of consumers for fair trade products, or domestically manufactured products.

7. Over the past 20 years there has been a sharp global increase in trade regionalism. From an economic perspective, do you think that this a good thing or not?

Answer: My take on this is that RTAs can bring short term gains, and in some cases even increase stability, but it does hamper the long term prospects of multilateral free trade.

8. Sometimes countries use trade as a foreign policy tool. Explain why and how countries can do this.

Answer: Answer to this is given in the lecture slides.

9. The Ukraine crisis has lead to what many experts call a new Cold War between Western countries and Russia. In the earlier stages of the crisis both Russia, and the U.S. and E.U. imposed a number of economic sanctions on each others exports. Discuss the effects of these sanctions and whether or not they are or will be effective in achieving their aims.

Answer: This is an open question.

10. Suppose that you find yourself in a conversation about trade with someone who happened to have studied economic in Chicago. The person in question argues that free trade is a good thing, amongst others because it leads to a reduction in international conflict. Would you agree with this statement or not, and explain why.

Answer: This again is an open question. For keypoint jsut consult the lecture slides for some empirical results on the link between trade and conflict. Also here the proliferation of RTAs is important. Note that the trade-conflict literature mainly focuses on interstate conflict and not so much on civil conflicts.