

# Political economy of international trade

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Economists are nearly unanimous in opposition against protectionism

- ▶ Save some heterodox economists

Yet protectionist measures persist

- ▶ EU's Common Agricultural Policy
- ▶ Steel tariffs in the US

Protectionism is mainly used for producers.

Governments generally prefer tariffs and import quotas over production subsidies which is peculiar since

1. Lump-sum tax transfers are more efficient
2. Avoids consumption costs of production

What explains the discrepancy between research results and implemented policy?

Two things to keep in mind when analysing trade policies

1. Economic self interests

- ▶ Individuals favour or oppose trade policies based on the effects on real income

2. Social concerns

- ▶ The government's concern for welfare and the desire to promote national and international goals

Let's consider a standard Heckscher-Ohlin where the imported good is labour intensive.

Will there be free trade or protectionism?

- ▶ Workers will favour tariff
- ▶ Capitalist will favour free trade

Under majority voting rule protectionism will be the more likely outcome

$$\textit{Number of Workers} > \textit{Number of Capitalists}$$

Under some circumstances free trade can be the preferred option

- ▶ The gains from trade can be redistributed to compensate the losers, while still being better off than under protectionism

So protectionism will be chosen when

$$\text{Redistribution costs} + \text{Compensation costs} > \text{Capitalists gains}$$

Voting costs can also lead to protectionism

- ▶ Think of situation where the benefits from free trade are relatively small for many individuals



Let's consider a Specific Factors model where capital and labour are the industry-specific factors and where

- ▶ The sector subject to competition under free trade incurs losses larger than voting costs
  - ▶ The sector that benefits from free trade has gains and protection costs smaller than voting costs
1. A comparatively small number of people in the hurt industry will vote in favour of protection
  2. Large number of people in other sector might not be bothered to vote

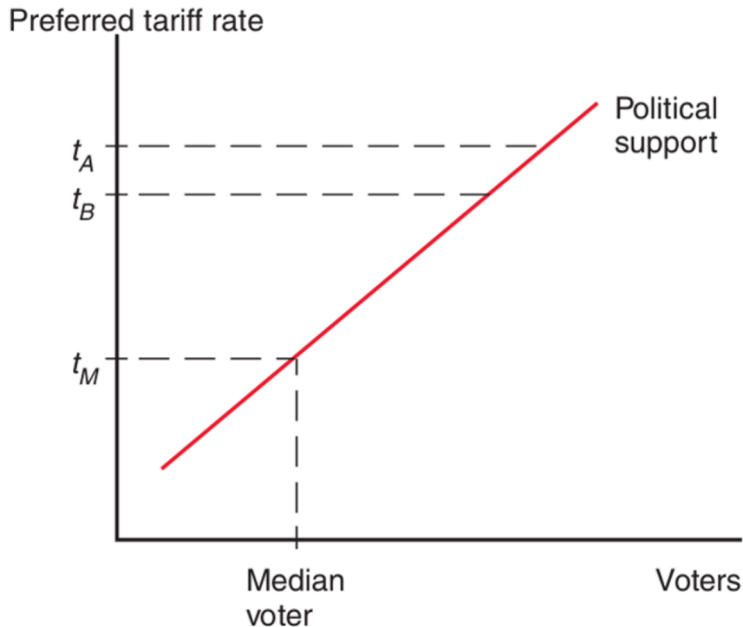
We can explain the existence of protectionism using two approaches

1. Median voter theorem
2. Collective action

Let's assume that we have a two-party system with Conservatives  $C$  and Labour  $L$  and a continuum of voters with size  $N$ .

- ▶ Voters are lined up by their preferred tariff rate: uniform distribution between  $0 - T$
1. Choose party closest to preferred tariff rate
  2. Party takes tariff position to maximise support

## Median voter theorem



Median voter theorem predicts that both parties will pick the same median voter supported trade policy.

This contrasts with observed trade policies

- ▶ Typically trade policies help industry a lot, but hurts everyone a little

Collective action might offer a better explanation considering that trade policy is a public good.

Let's consider the EU's Common Agricultural Policy which means that every EU consumer pays too much for most of their food. From the perspective of the average consumer

- ▶ Benefit from having subsidy removed is relatively small
- ▶ Probability of collective action having an effect is relatively small

Although the cost of taking action is also small, the average consumer won't take actions

Things look different from the perspective of the average farmer

- ▶ Benefit from keeping subsidy is relatively large
- ▶ Probability of action having effect is relatively large

Given that the cost of taking action is relatively small, the farmer will take action

## Farmers' collective action





Policies with a large aggregate loss but small individual losses are difficult to change. Whereas small groups with concentrated losses are more willing to pay the effort-fixed cost. This leads to a free rider problem with public goods

- ▶ Consumer believes its contribution is too small to affect policy outcome
- ▶ Dominant strategy is not to bother
- ▶ Everyone ends up worse

Policies also persist due to the incentives faced by the politicians who win elections by

1. Advocating popular policies (median voter theorem)
2. Have funds to run campaigns (collective action)

As a result trade policy is influenced by well-organised groups with concentrated gains who are more likely to overcome the free rider problem

Let's have a look at a country's economic self interest. Consider two countries: San Marcos and Nambutu

- ▶ Each country can protect its producers by setting a tariff
- ▶ A country's reaction depends on the other country's policy

	San Marcos	
Nambutu	Free trade	Tariff
Free trade	100, 100	-100, 200
Tariff		

	San Marcos	
Nambutu	Free trade	Tariff
Free trade		
Tariff	200, -100	-50,-50

	San Marcos	
Nambutu	Free trade	Tariff
Free trade	100, 100	-100, 200
Tariff	200,-100	-50, -50

In setting the tariffs the countries can have a cooperative equilibrium, but there is also a non-cooperative equilibrium leading to the risk of prisoner's dilemma

- ▶ Tariff will be the dominant strategy
- ▶ Results in global welfare costs

This illustrates the need for trade negotiations

- ▶ Can help avoid trade wars as countries enact trade restrictions

Using trade negotiations there are two ways to liberalise trade

1. Bilateral or regional agreements
2. Multilateral agreements



Consider three countries — Germany, Brazil, and Japan — with the following bargaining goals

1. Germany wants to reduce Brazil's pharmaceutical tariff
2. Brazil want to reduce Japan's wheat tariff
3. Japan wants to reduce Germany's car tariff

The first option is to hold bilateral negotiations

1. Germany-Brazil: GER wants to reduce BRA pharmaceutical tariff but has nothing to offer
2. Brazil-Japan: BRA wants to reduce JPN wheat tariff but has nothing to offer
3. Japan-Germany: JPN wants to reduce GER car tariff but has nothing to offer

Likely outcome is that nothing will happen.

A second option is to hold multilateral negotiations in which

1. BRA will reduce the tariff on GER's pharmaceutical products
2. In return GER will convince JPN to reduce the wheat tariff on wheat from BRA, promising that GER will reduce the car tariff for JPN

Likely outcome is that each country achieves its goals.

Bargaining between multiple countries can lead to better deals.

Another example

1. Spain, which produces olive oil
2. Italy, which produces olive oil
3. Germany, which consumes olive oil

Let's assume that bilateral negotiations between Italy and Germany led to a reduction in the tariff on Italy's olive oil

- ▶ Following some quid pro quo principle

If Germany has market power, the reducing the tariff on Italian olive oil will increase world prices

- ▶ Due to an increase in German demand

This price increase will benefit Italy but also Spain, the other olive oil producer: This is a positive externality

- ▶ The effect of tariff reduction is large than accounted for during the trade talks
- ▶ Meaning that Germany will actually get less in return, and therefore won't reduce the tariff by much

A solution to this is to internalise the externality, by including Spain in the trade talks.

**EU-Japan trade deal:** agreed in July 2017, bringing together economies accounting for 19% of global GDP

- ▶ Negotiations took 4 years, taking 18 rounds
- ▶ Includes tariff cuts, cooperation on standard and regulations, and opening up of public procurement markets

Has also been called the "cars for cheese" deal

- ▶ EU sought to reduce Japanese tariffs on meat, wine, and dairy products
- ▶ Japan wanted end to EU import duties on cars

In the end, the deal was decided by a reduction in EU market demand for soft cheese.

**Comprehensive Economic and Trade Agreement**, between Canada and EU, signed October 2016, eliminates up to 99% of tariffs

- ▶ Took 7 years to complete
- ▶ Almost failed at last minute due to objections of regional parliament of Wallonia

Agreement removes customs duties on bilateral exports

- ▶ For industrial goods and most agricultural products
- ▶ EU companies can bid for public contracts in Canada
- ▶ Agreement does not remove non-tariff barriers

Canada does not have to pay into EU budget, sign up to four freedoms, or abide by European court of justice rulings.

Some historical background on trade negotiations and the creation of the World Trade Organisation.

The 1930s saw tariffs raised to high levels in reaction to the Great Depression.

- ▶ Famously the US Smoot-Hawley tariff act which raised tariffs on 890 items

Retaliation by other countries also raising tariffs



Following the Second World War the Bretton Woods institutions were created

- ▶ IMF, World Bank
- ▶ General Agreement on Tariffs and Trade (GATT)

GATT governs trade policy

Main purpose of GATT

1. Set rules for trade policy
2. Provide platform for negotiations, on policies and rules

Major negotiations take place during Negotiating Rounds

**Round 1-5 (1947-61):** Reduced tariffs

**Round 6 (1964-67):** Kennedy round, reduced tariffs and anti-dumping rules

**Round 7 (1973-79):** Tokyo round on tariffs and NTBs

**Round 8 (1986-94):** Uruguay round which created the WTO

- ▶ Besides the usual this round also discussed intellectual property, tariffs concerning textiles and agricultural goods, and it discussed dispute settlement

Currently we are in round 9 (2001-) or the Doha round, which failed.

How do these negotiations take place? Let's focus on tariffs: In early rounds tariff cuts were negotiated between principal supplier and principal demander countries

- ▶ Cuts were extended to all member states but large countries tended to dominate this process

## Number of ways to reduce tariffs

1. Single rate
2. Flat-rate percentage reduction, e.g. cutting all tariffs by 25% over 5 years
3. Uruguay round approach
  - ▶ Cut tariffs on agricultural products by 36% over 6 years, min. of 15% on each product of the period
4. Harmonising reductions

Harmonising reductions are aimed at making steeper cuts for higher tariffs, for instance different percentages for different tariff bands

- ▶ No cuts on tariffs between 0-10%, 25% cuts for tariffs between 11-50%, etc.

Or can use the Swiss formula

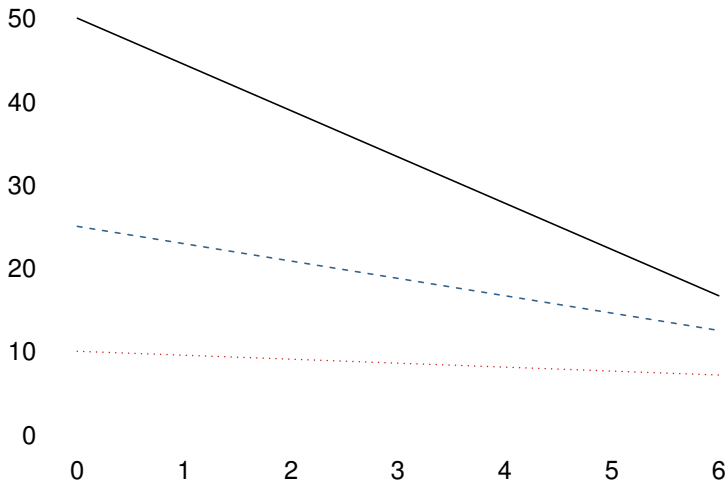
$$Z = \frac{AX}{(A + X)}$$

$X$  is original tariff

$A$  coefficient and maximum tariff rate

$Z$  resulting lower tariff rate, at end of period

- ▶ Proposed by the Swiss during the Tokyo round
- ▶ Swiss now prefer Uruguay round method



Swiss formula reduces high tariffs more than low tariffs.

Concerning trade rules, negotiations take place in country groupings who draft proposals and then try to persuade others

- ▶ Again a process that is dominated by the larger countries.

Is the WTO bad for smaller countries?

1. They do benefit from rule-of-law
2. Can increase bargaining power by collaborating



WTO consists of three parts

1. GATT (core business)
2. GATS: General Agreement on Trade in Services
3. TRIPs agreement: Trade Related aspects of Intellectual Property Rights

The WTO was established by the 1995 Uruguay round

- ▶ Which removed quotas on textiles and clothing.

The last negotiation round — Doha — failed

- ▶ US blaming Brazil and India for protectionism
- ▶ US and EU unwilling to reduce agricultural subsidies

The aim of the WTO is to gradually eliminate trade barriers addressing existing trade restrictions via three channels

1. Reduction of tariff rates
2. Binding tariff rates, i.e. no future increases
3. Elimination and prevention of non-tariff barriers

WTO has two basic principles

1. Most Favoured Nation (MFN)

- ▶ Member state should treat each other member states as it treats its MFN

2. National Treatment

- ▶ No discrimination between imports/importers and domestic products/producers

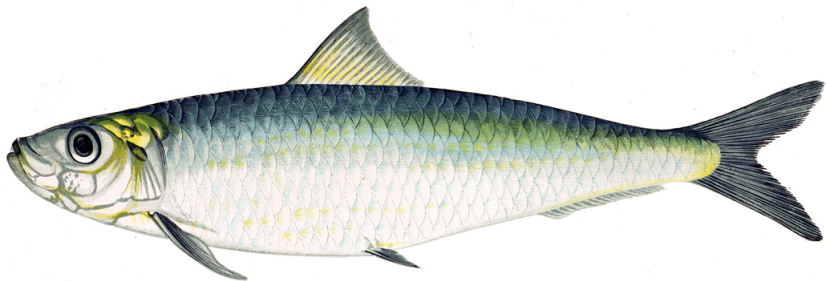
Both principles have permitted exceptions

The basis of negotiations, which covers everything from tariffs to technical norms, is a reciprocity objective

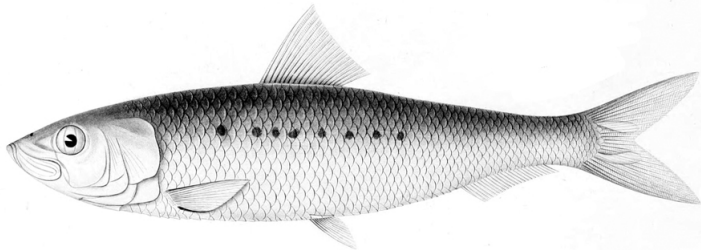
- ▶ Allows balanced deals and emergence of free-trade coalitions

Despite the efforts made by the WTO there of course still exist preferential agreements as well as non-tariff barriers. The WTO therefore also has a role in dispute settlement.

## Sardina Pilchardus Gervais



# Sardinops Sagax Sagax



Fish determination according to the EU:

*Sardina Pilchardus Gervais* → Sardine

*Sardinops Sagax Sagax* → Definitely not a sardine



Peru exported the *sardinops sagax sagax* as sardines to the EU's common market.

- ▶ EU claimed however that this species of fish wasn't a sardine and therefore couldn't be traded under that name.
- ▶ Peru appealed to the WTO in 2001 claiming that this was a barrier to trade and a breach of the non-discrimination principle

The WTO panel concluded that indeed the EU regulation was inconsistent with WTO regulation and that the ban should be lifted

- ▶ In 2003 the EU lifted the import ban on Peruvian sardines, as well as other countries exporting the same fish

Next to the agreements set out by the WTO there are such things as preferential trade agreements

- ▶ Countries lower tariffs for each other but not third countries

This is a big no-no according to the WTO's MFN principle, save one exception

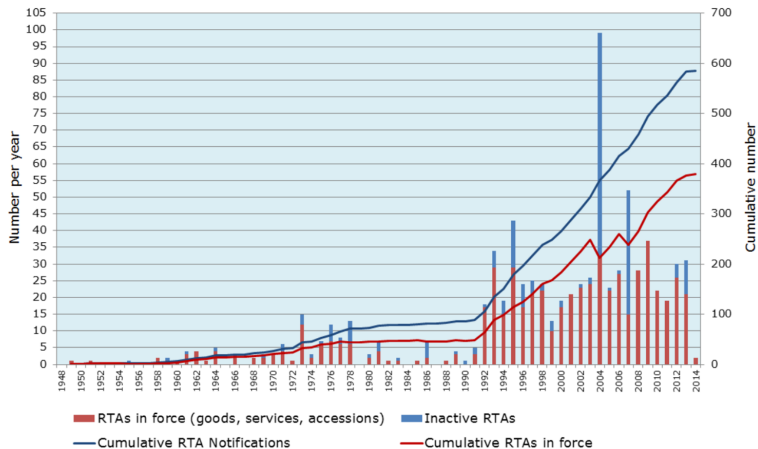
1. When the tariff is set to zero

There are three types of preferential trade agreements

1. Free trade area, where there is free trade among members but a different policy towards non-members
2. Customs union, where there is free trade among members and a common policy towards non-members
3. Common market, which is a customs union combined with free movement of labour and capital

# Proliferation of regional trade agreements

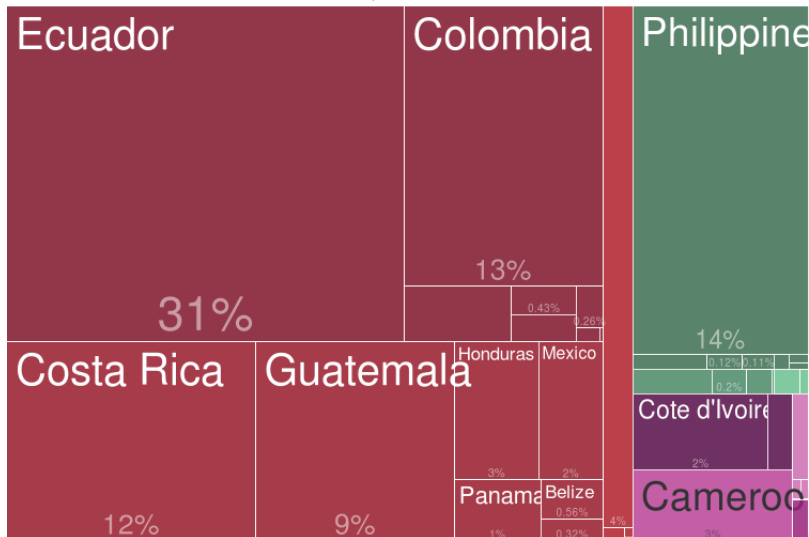
source: WTO



Regional trade agreements can have two divergent effects on trade

1. Trade creation, as lifting barriers allows cheaper imports from within region
  - ▶ If prices are lower in partner countries compared to rest of the world
2. Trade diversion, as lifting barriers discourages trade with rest of the world
  - ▶ When prices are actually lower in the rest of the world

\$10.5B USD



In general most countries import bananas from Central America

- ▶ Ecuador, Costa Rica, Guatemala, etc.

The EU in contrast prefers to buy bananas from former colonies, the so called ACP countries (African, Caribbean, and Pacific)

- ▶ Belize, Cameroon, etc.

In order to protect the ACP imports, countries such as France and the UK imposed import quotas on Central American banana imports.

In contrast, Germany did not import from these former ACP colonies initially, but was forced by EU rules to import the ACP bananas instead of the cheaper bananas from Central America; this upset some countries.

- ▶ Producing countries such as Ecuador and Guatemala
- ▶ and the USA because of corporate interest: Chiquita, Dole

The USA was actually the country to file a complaint with the WTO which lead to what is now called the 20 year Banana War.



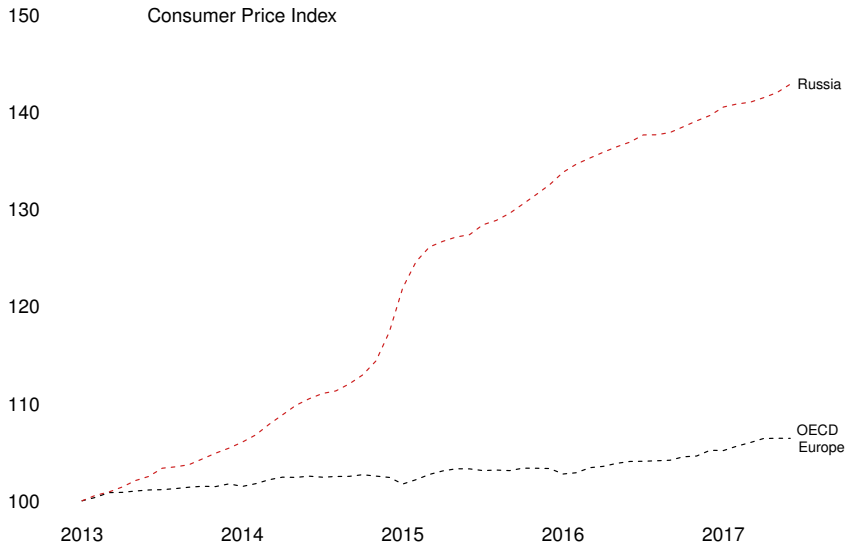
In 1997 the WTO ruled that EU policy violated international trade rules, and in 2001 the EU and US agreed on phasing out banana quotas

- ▶ In 2005 the EU eliminated all import quotas but also tripled the tariffs
- ▶ The US retaliated by imposing 100% import duties on a range of European products

In 2007 the WTO rules that the EU move was illegal and in 2009 the EU reduced the tariff from €176 per tonne to €114 per tonne

- ▶ In 2012 the EU and 10 Latin American countries signed an agreement to gradually reduce tariffs

## Consumer Price Index



EU imposed economic sanctions on Russia in July 2014 in response to its destabilising actions in Eastern Ukraine.

- ▶ This followed the March annexation of the Crimea

The EU's economic sanctions focus predominantly on

1. Financial transactions
2. Import/export of arms and military technology
3. Exports of energy-related equipment and technology

In response Russia banned fruit and vegetable imports from the EU

- ▶ As well as all food imports from the USA

Trade sanctions and bans often take the form of action taken by one state, or by a group of states, to influence another state to change its behaviour. These actions generally involve restrictions on foreign trade or asset freezes and seizures.

- ▶ US sanctions against Cuba or Iran
- ▶ UN sanctions against South Africa
- ▶ EU arms embargo on China

Sanctions can be preferred over straight military intervention as it is low cost and causes fewer deaths, but there are some disadvantages

- ▶ Probability of success might be low
- ▶ There are unintended consequences and indiscriminate effects which hurt innocent elements of society

International trade can be used as a foreign policy tool given that trade is important for many countries

- ▶ Contributes substantially to GDP
- ▶ Countries can be dependent on trade for food and energy

It can be used both as a carrot and a stick.

1. Coercive policy tool to change certain behaviour of a state
2. Influence domestic policy making, by intensifying trade relations

For instance China uses trade as an instrument to influence foreign policy of foreign countries on issues that are important to China

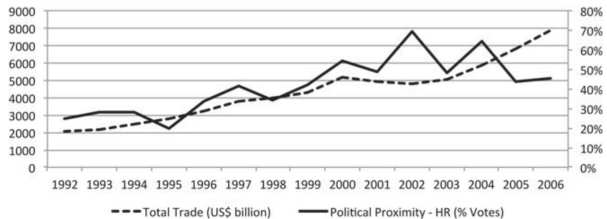
- ▶ Recognition of Taiwan
- ▶ Human rights

For Latin American and African countries larger trade flows with China correspond with convergence on key foreign policy issues in UN voting.<sup>1</sup>

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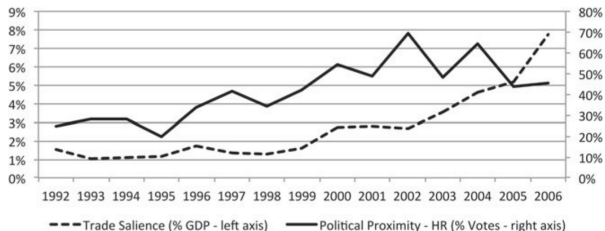
<sup>1</sup>"The Foreign Policy Consequences of Trade: China's Commercial Relations with Africa and Latin America, 1992–2006", Flores-Macia & Kreps, 2013, The Journal of Politics.

**FIGURE 1 Africa and Latin America's Average Trade Flows and Convergence on Country-Specific Human Rights Votes with China, 1992–2006**



*Source:* Based on United Nations General Assembly Voting Data from Voeten and Merdzanovic 2009. Trade Data from COW Dyadic Trade Data and World Bank World Development Indicators.

**FIGURE 2 Africa and Latin America's Average Trade Salience and Convergence on Country-Specific Human Rights Votes with China, 1992–2006**



*Source:* Based on United Nations General Assembly Voting Data from Voeten and Merdzanovic 2009, and Trade Data from COW Dyadic Trade Data and World Bank World Development Indicators.



The USA has used both overt and covert interventions to create larger foreign markets for American products. These interventions installed and supported political leaders that were supportive of the USA<sup>2</sup>

- ▶ Intervention was followed by an increase in US imports, but not exports

Moreover, the surge in imports is concentrated in sectors in which the USA had a comparative disadvantage

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<sup>2</sup>"Commercial imperialism? Political influence and trade during the cold war", Berger *et al.*, 2013, American Economic Review.

There is a conventional wisdom that trade has a pacifying effect and promotes peace

- ▶ EU result of preventing another war between France and Germany
- ▶ MERCOSUR was created to curtail military power in Brazil and Argentina

Since the end WW2 there has been an increase in trade openness and decrease in interstate conflict. International trade entails that countries can obtain resources without having to control territories. So question is whether more trade leads to fewer conflicts?

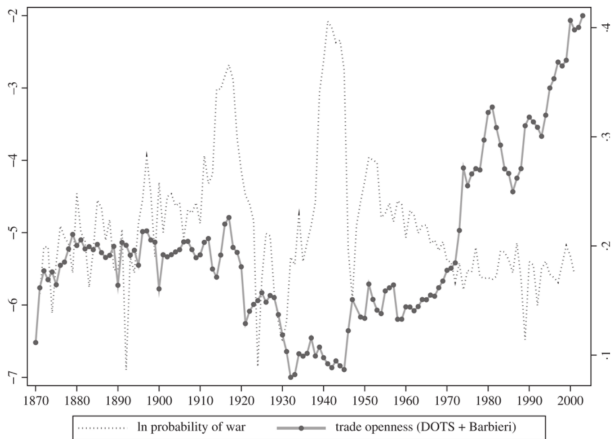


FIGURE 1  
Militarized conflict probability and trade openness over time

Conflict between countries is costly as it harms the economy, so bilateral trade certainly has the potential to reduce conflict probability

- ▶ Makes conflict costly as it creates dependence between countries

Research suggests that for proximate countries bilateral trade reduces conflict risk by about 20%. However, the trade-conflict nexus is asymmetric as multilateral trade increases the probability of interstate war

- ▶ Multilateral trade reduces bilateral dependence
- ▶ This reduces the cost of conflict and thus increases the probability

There is some evidence that RTAs promote peaceful regions by increasing the opportunity cost of conflict and interestingly country pairs with a violence history are more likely to sign an RTA

- ▶ Larger pay-offs from signing a RTA

There are two types of peace promoting security gains from a RTA

1. Offering a political forum which facilitates settlement of future disputes
2. Increase in opportunity costs of future potentially trade-disrupting wars

Nonetheless, there does seem to be a larger conflict risk between member and non-member states

- ▶ A RTA also harms the multilateral trade system as it creates trade distortions for excluded members