

# EC3355: International Trade

## The political economy of trade

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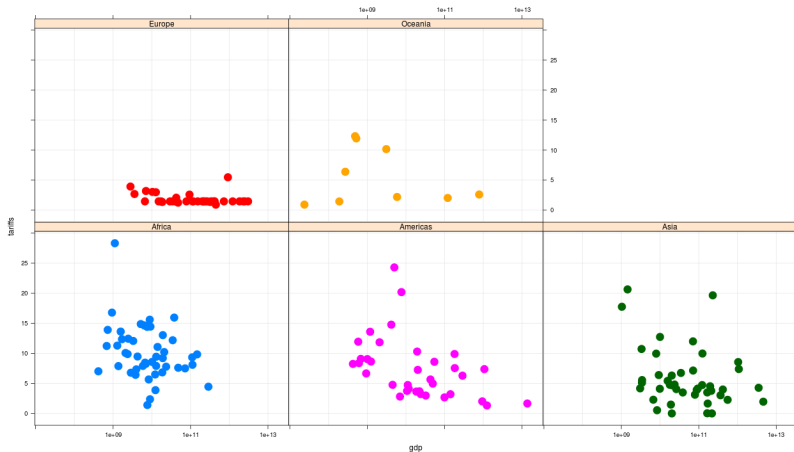
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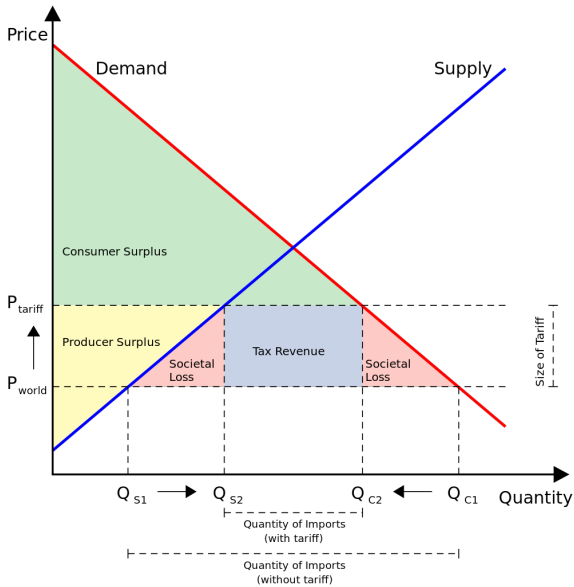
# Last week

- ▶ Various reasons for trade policy
  - ▶ Manipulating terms of trade
  - ▶ Protecting industries
  - ▶ Fiscal role of tariffs
- ▶ Protectionism can be wasteful
  - ▶ Consumers always experience a decrease in surplus
  - ▶ Producers always gain
  - ▶ Only tariffs generate government revenue

# Last week

Average tariff rate by countries per continent 2007-2013 (*Source: WDI*)





# Today

- ▶ Explaining protectionism
- ▶ International trade negotiations
- ▶ Trade regionalism
- ▶ Trade policy as foreign policy

# Explaining protectionism

## Research-policy discrepancy

- ▶ Economists are nearly unanimous in opposition against protectionism
  - ▶ Save some heterodox economists
- ▶ Yet protectionist measures persist and sometimes experience increases
  - ▶ Common Agricultural Policy in the E.U.
  - ▶ Steel tariffs in the U.S.

# Explaining protectionism

## Research-policy discrepancy

- ▶ Protectionism is used to redistribute income to producers
- ▶ Governments generally use tariffs and import quotas rather than production subsidies
  - ▶ Lump-sum tax transfers are more efficient
  - ▶ Avoids consumptions costs of production
- ▶ How can we explain the neglect of economic advice on international trade?

# Explaining protectionism

Analysing the political economy of trade policies

## 1. Economic self interests

- ▶ Individual favours or opposes trade policy based on effect on its real income

## 2. Social concerns

- ▶ Government's concern for welfare and desire to promote national and international goals



# Economic self interest

## Free trade or protectionism

- ▶ Consider standard two commodity two factor HO-model
- ▶ Imported good is labour intensive
- ▶ Will there be free trade or protectionism?

# Economic self interest

## Free trade or protectionism

- ▶ Workers will favour import tariff, capitalist will favour free trade
- ▶ Under majority voting rule protection will be outcome if  $Workers > Capitalists$
- ▶ If redistribution is costless, free trade will be chosen
  - ▶ Gainers under free trade can more than compensate the losers and still be better off than under protection

# Economic self interest

## Redistribution and voting

- ▶ If costs of redistribution + compensation costs  $>$  capitalist gain from trade, protection will be selected
- ▶ Voting costs can also lead to protectionism
  - ▶ Think of situation where benefits from free trade are relatively small for many individuals

# Economic self-interest

## Redistribution and voting

- ▶ Consider Specific factors model with capital and labour as industry specific
  - ▶ Sectors subject to competition under free trade with losses larger than cost of voting
  - ▶ Sectors that gain from free trade with potential small gains and protection costs smaller than voting costs
- ▶ Comparatively small number of people in hurt industry will vote in favour of protection, large number of people in other industries might not vote at all

# Economic self-interest

Explaining existence of protectionism

1. Median voter theorem
2. Collective action

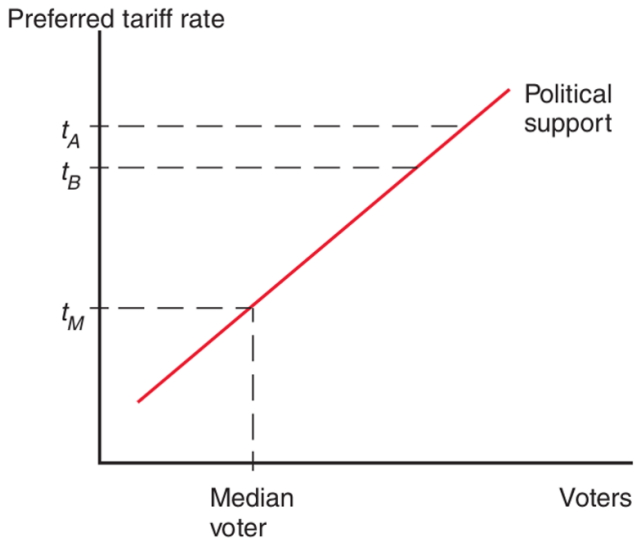
# Economic self-interest

## Median voter theorem

- ▶ Two parties: Conservatives ( $C$ ) and Labour ( $L$ )
- ▶ Continuum of voters with size  $N$
- ▶ Voters are lined up by their preferred tariff rate
- ▶ Voter chooses party closest to her preferred tariff rate
- ▶ Parties take tariff position to maximise support
- ▶ Assume voters have uniform distribution over tariff between 0 and  $T$

# Economic self-interest

## Median voter theorem



# Economic self-interest

## Median voter theorem

- ▶ Both parties will choose same median voter supported trade policy
- ▶ What happens with more than two parties?
- ▶ Theorem predictions contrast with observed trade policies
  - ▶ Typical trade policy helps industry a lot, but hurts everyone a little



# Economic self-interest

## Collective action

- ▶ Trade policy is a public good
- ▶ Nearly everyone in EU is hurt by agricultural export subsidy
- ▶ Why does the Common Agricultural Policy still exist?

# Economic self-interest

Collective action: Average consumer

- ▶ Probability of action having effect is relatively small
- ▶ Benefit from having subsidy removed is relatively small
- ▶ Cost of taking action is relatively small
- ▶ Won't take action

# Economic self-interest

Collective action: Average farmer

- ▶ Probability of action having effect is relatively larger
- ▶ Benefit from keeping subsidy is much larger
- ▶ Cost of taking action is relatively small
- ▶ Will take action

# Economic self-interest

Collective action: Average farmer



# Economic self-interest

## Collective action

- ▶ Policies with large aggregate loss but small individual loss are difficult to change
- ▶ Small groups with concentrated losses are more willing to pay effort fixed cost
- ▶ Free rider problem of public goods
  - ▶ Consumer believes its contribution is too small to affect policy outcome
  - ▶ Best not to contribute, which is the dominant strategy
  - ▶ Outcome is that all end up worse than if they contributed

# Economic self-interest

## Persistence of policy

- ▶ Politicians win elections because:
  1. They advocate popular policies (median voter theorem)
  2. They have funds to run campaigns (collective action)
- ▶ Trade policy is influenced by well-organised groups with concentrated gains
  - ▶ More likely to overcome free rider problem

# Economic self-interest

## Tariffs and trade wars

- ▶ Consider two countries: San Marcos, Nambutu
- ▶ Each country can protect its producers by setting tariffs
- ▶ Country's reaction depends on partner's policy

# Economic self-interest

## Tariffs and trade wars

<b>Nambutu</b>	<b>San Marcos</b>	
	Free trade	Tariff
Free trade	100,100	−100,200
Tariff		



# Economic self-interest

## Tariffs and trade wars

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

# Economic self-interest

## Tariffs and trade wars

	<b>San Marcos</b>	
<b>Nambutu</b>	Free trade	Tariff
Free trade	100,100	−100,200
Tariff	200,−100	−50,−50

# Economic self-interest

## Tariffs and trade wars

- ▶ Can have cooperative equilibrium
- ▶ Can also have a non-cooperative equilibrium
- ▶ Risk of prisoner's dilemma
  - ▶ Tariff will be dominant strategy
  - ▶ Results in global welfare costs
- ▶ Illustrates need for trade negotiations
  - ▶ Help avoid trade wars as countries enact trade restrictions

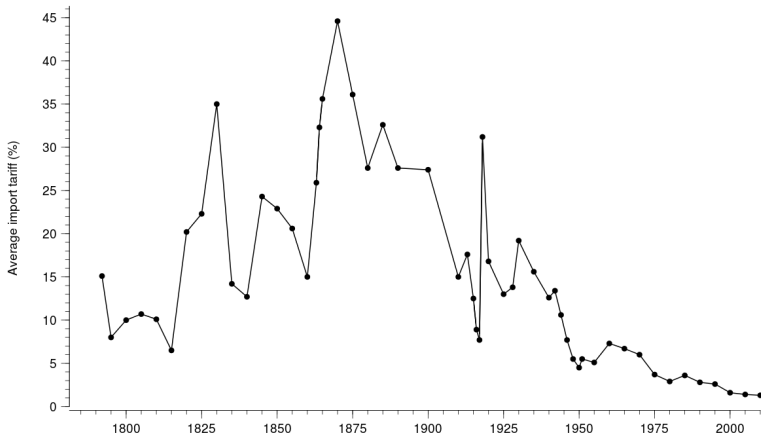
# Trade negotiations

Historical overview: 19th and early 20th century

- ▶ 19th century
  - ▶ Germany: Zollverein (1834)
  - ▶ UK: abolition of Corn Laws (1846)
  - ▶ France: free-trade under Louis Napoléon; Cobden-Chevalier treaty of 1860 with Britain; Méline law in 1892 on agricultural tariffs
  - ▶ US: McKinley tariffs (1890)
- ▶ Early 20th century
  - ▶ Protectionist reactions to Great Depression; Smooth-Hawley tariffs in US (1930)

# Trade negotiations

## US tariffs over time



# Trade negotiations

Historical overview: post-WW2 period

- ▶ General Agreement on Tariffs and Trade (GATT, 1948)
  - ▶ Objective is to (gradually) eliminate trade barriers
  - ▶ Initially focussed on tariff cuts among developed countries
  - ▶ Wider scope since the 1980s
  - ▶ Replaced by World Trade Organization in 1995
- ▶ Regional preference tolerated (e.g. EU)
- ▶ US and Europe have opened manufacturing markets but still protect their agriculture
- ▶ Developing economies have implemented manufacturing export-led growth strategies (which they are reconsidering only now, more about this in following lecture)

# Trade negotiations

Two ways to liberalise trade

1. Multilateral agreements
2. Bilateral or regional agreements

# Trade negotiations

## Example

- ▶ Consider three countries: UK, Brazil, Japan
- ▶ Bargaining goals
  1. UK wants to reduce Brazil's pharmaceutical tariff
  2. Brazil wants to reduce Japan's wheat tariff
  3. Japan wants reduce UK's car tariff



# Trade negotiations

## Option 1: Bilateral negotiations

- ▶ UK-Brazil: UK wants to reduce the Brazilians pharmaceutical tariff but has nothing to offer
- ▶ Brazil-Japan: Brazil wants to reduce Japanese wheat tariff but has nothing to offer
- ▶ Japan-UK: Japan wants to reduce UK's car tariff but has nothing to offer
- ▶ Outcome: Nothing will happen

# Trade negotiations

## Option 2: Multilateral negotiations

- ▶ Brazil will reduce the tariff on UK's pharmaceutical products
- ▶ In return, UK will convince the Japanese to reduce the tariff on Brazilian wheat
- ▶ It accomplishes this by promising to reduce its own tariff on Japanese cars
- ▶ Outcome: Each country achieves its goals
- ▶ Bargaining between multiple countries can lead to better deals

# Trade negotiations

## Other example

- ▶ Consider three countries:
  1. Spain (olive oil producer)
  2. Italy (olive oil producer)
  3. UK (olive oil consumer)
- ▶ Bilateral negotiations between Spain-UK
  - ▶ UK reduces tariff on Spanish olive oil
  - ▶ Quid pro quo principle

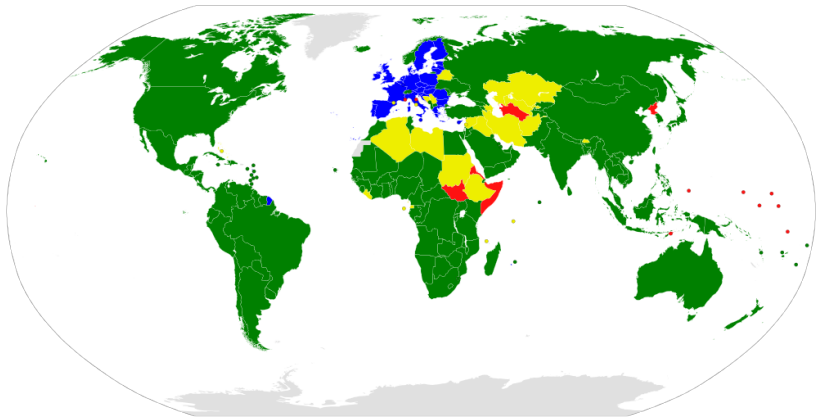
# Trade negotiations

## From bilateral to multilateral

- ▶ **Externality**
  - ▶ If UK has market power, reducing tariff on Spanish olive oil will increase world price
  - ▶ Price increase benefits Spain as well as Italy
  - ▶ Positive externality: effect of tariff reduction is larger than accounted for during trade talks
  - ▶ UK will get less in return, will not be willing to reduce the tariff by much
- ▶ **Internalise externality**
  - ▶ Include Italy in the trade talk

# Trade negotiations

Members of World Trade Organization



# Trade negotiations

## World Trade Organization

- ▶ WTO negotiations addresses trade restrictions via three channels
  1. Reducing tariff rates
  2. Binding tariff rates (i.e. no future increases)
  3. Eliminating/prevention of non-tariff barriers

# Trade negotiations

## World Trade Organization

- ▶ 1995 Uruguay round
  - ▶ Established the WTO
  - ▶ Removed quotas on textiles and clothing
- ▶ Currently in the Doha round
  - ▶ 1999 Battle of Seattle
  - ▶ No agreement yet
  - ▶ US blaming Brazil and India for protectionism
  - ▶ US and EU not willing to reduce agricultural subsidies

# Trade negotiations

## World Trade Organization

- ▶ Non-discrimination principle
  - ▶ Most Favoured Nation: any decrease of towards a country must be extended to other countries
  - ▶ Equal treatment between domestic and foreign products
- ▶ Reciprocity objective
  - ▶ Basis of WTO negotiations, covers everything from tariffs to technical norms
  - ▶ Reasons: allows balanced deals, allows emergence of free-trade coalitions
- ▶ Exceptions
  - ▶ Preferential agreements
  - ▶ Non-tariff barriers remain



# Trade negotiations

Dispute settlement: EU vs. USA over steel tariffs

- ▶ 2002: US imposed 30% tariff on steel imports
- ▶ Attempt to make US steel industry more competitive
- ▶ EU (plus 8 other countries) complained to WTO and threatened to impose retaliatory tariffs
- ▶ 2003: US dropped tariffs

# Trade negotiations

Dispute settlement: Peru vs. EU over sardines

- ▶ 2001: Peru appealed to WTO to review EU labelling
- ▶ Labelling prevented Peru from exporting certain species of sardines (*Sardinops sagax*) as sardines to EU
- ▶ 2003: EU lifted the import ban on Peruvian sardines

# Trade regionalism

## Preferential trade agreements

- ▶ Countries lower tariffs for each other but not others
- ▶ Not allowed by the WTO (MFN principle)
- ▶ Exception is allowed if tariff is set to zero

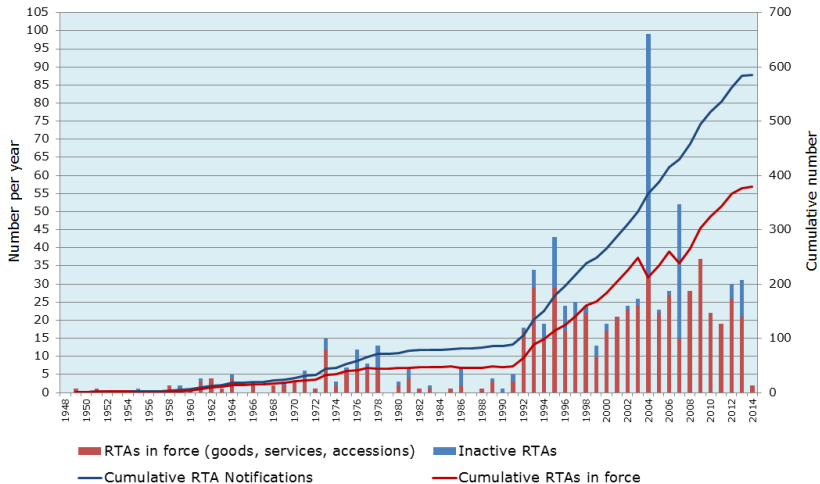
# Trade regionalism

## Preferential trade agreements

1. Free trade area: free trade among members but different policy towards non-members
2. Custom union: free trade among members and common policy towards non-members
3. Common market: custom union + free movement of labour and capital

# Trade regionalism

Regional Trade Agreement (*Source: WTO*)



# Trade regionalism

## Impact of regionalism on trade

### 1. Trade creation

- ▶ Lifting barriers allows import of cheaper products from within union
- ▶ Valid if prices are lower in partner countries than rest of the world

### 2. Trade diversion

- ▶ Lifting barriers discourages trade with rest of the world
- ▶ Valid if prices are higher in rest of the world

# Trade regionalism

Example: the 20 years banana war

- ▶ In general countries import bananas from Central America
  - ▶ Ecuador, Costa Rica, Guatemala and Honduras (Banana republics)
- ▶ EU prefers to buy from former colonies (ACP countries)
  - ▶ Belize, Cameroon, Windward Islands
  - ▶ To protect ACP countries France and UK imposed quotas on Central American imports
  - ▶ Germany did not import from colonies (didn't really have any) and was forced by EU to import higher-priced ACP bananas
- ▶ This upset some countries
  - ▶ Latin American producers such as Ecuador, Guatemala, Honduras, and Mexico
  - ▶ USA because of corporate interests (Chiquita, Dole)

# Trade regionalism

Example: the 20 years banana war

- ▶ 1997: WTO ruled that EU policy violated international trade rules
- ▶ 2001: EU and US agreed on phasing out banana import quotas
- ▶ 2005: EU eliminated import quotas, but also tripled tariffs
  - ▶ USA retaliated by imposing 100% import duties on range of European products
- ▶ 2007: WTO ruled that EU move was illegal
- ▶ 2009: EU reduced tariffs from €176 per tonne to €114 per tonne
- ▶ 2012: EU and 10 Latin American countries signed an agreement to gradually reduce tariffs



# Social concerns

## The role of the government

- ▶ Concerns for welfare of certain social and economic groups
- ▶ Desire to promote various national and international goals

# Social concerns

## Consumer behaviour

- ▶ Most economic models rely on self-interest
- ▶ Consumers take actions that are not in their own interest
  - ▶ Fair trade products
  - ▶ Buy domestic made products (e.g. Buy America Act)

# Social concerns

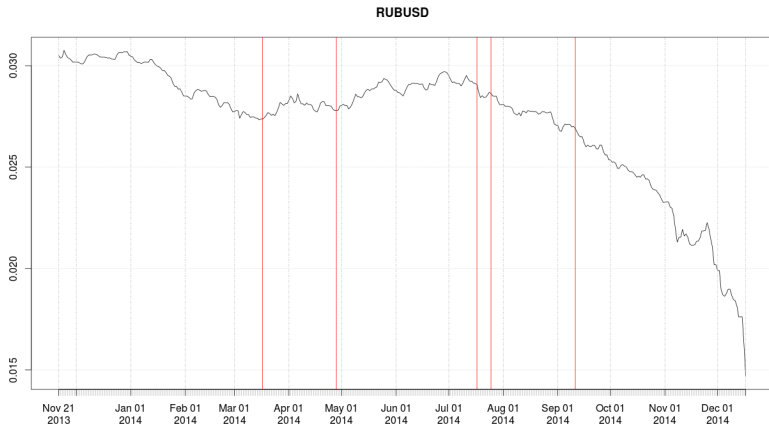
## Changing distribution of income

- ▶ Temporary protection for industries hurt by rapid increases in imports
- ▶ Voluntary export restraint of Japanese cars in the US in the 1980s
- ▶ Protectionist measures can help reduce adjustment costs
- ▶ Mean of creating higher living standards for certain workers, i.e. unskilled labour

# Trade policy as foreign policy

Exchange rate Russian Ruble versus US Dollar

Source: OANDA



# Trade policy as foreign policy

## Trade as a tool

- ▶ Trade is important for many countries
  - ▶ Contribution to GDP
  - ▶ Securing population's living standard and welfare
- ▶ Trade can be used as carrot and stick
  - ▶ Influence domestic policy making by intensifying trade relations
  - ▶ Use as a coercive foreign policy tool to change certain state's behaviour

# Trade policy as foreign policy

## Sanctions and bans

- ▶ Sanctions and bans often take the form of action taken by one state or by collective action to influence another state to change its behaviour
- ▶ Generally involve restrictions on foreign trade or asset freezes/seizures
- ▶ Reasons to use sanctions rather than military intervention
  - ▶ Low cost
  - ▶ More humane
- ▶ Downsides of the use of sanctions
  - ▶ Low probability of success
  - ▶ Indiscriminate effects, targets innocent elements of society
  - ▶ Unintended consequences

# Trade policy as foreign policy

## Notable examples of international sanctions

- ▶ **1950:** US sanctions on North Korea due to human rights abuses and nuclear program
- ▶ **1963:** UN sanctions against South Africa as protest against apartheid
- ▶ **1960-62:** US embargo on exports and imports from Cuba
  - ▶ Lifted 2014
- ▶ **1979/2006:** US sanctions against Iran following seizure of embassy and Tehran and more recently UN sanctions because of illicit nuclear activities
- ▶ **1989:** EU arms embargo on China as result of Tienanmen protests
- ▶ **1990:** UN sanctions against Iraq following the Gulf War

# Trade policy as foreign policy

## Influencing policy decision making

- ▶ USA used covert (Berger et al., 2013) and overt (Bove et al., 2013) interventions to create larger foreign markets for American products
- ▶ Interventions installed and/or supported political leaders
- ▶ Increase in US imports after intervention, but not exports
- ▶ Surge in imports concentrated in sector in which US had comparative disadvantage



# Trade policy as foreign policy

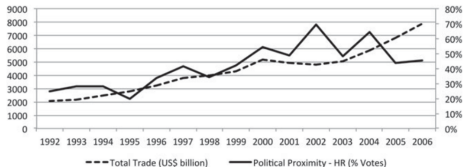
## Influencing policy decision making

- ▶ China uses trade as instrument to influence foreign policy of partner countries
- ▶ Issues such as human rights and recognition of Taiwan
- ▶ For Latin-American and African countries larger trade flows correspond with convergence on key foreign policy issues (Flores-Macías & Kreps, 2013)

# Trade policy as foreign policy

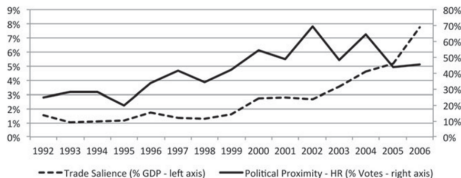
"The Foreign Policy Consequences of Trade: China's Commercial Relations with Africa and Latin America, 1992–2006", Flores-Macías & Kreps (2013)

**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.

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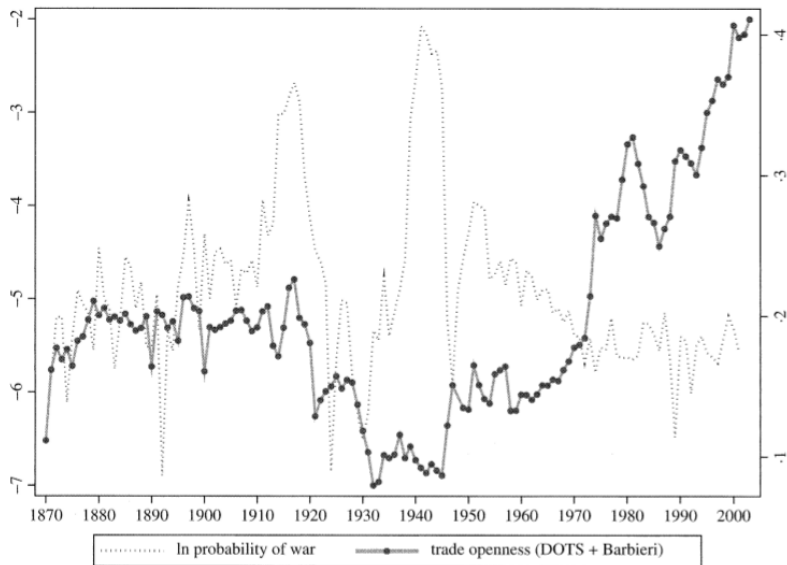
# Trade policy as foreign policy

## Pacifying effect of trade

- ▶ Conventional wisdom that trade promotes peace
  - ▶ European Union was established to tie France and Germany
  - ▶ MERCOSUR was created to curtail military power in Brazil and Argentina
- ▶ Over time increase in trade openness, decrease in interstate conflict
- ▶ International trade also means countries can obtain resources without having to control territories
- ▶ Does more trade lead to less conflict?

# Trade policy as foreign policy

*"Make trade not war?", Martin et al. 2008*



# Trade policy as foreign policy

## Pacifying effect of trade

- ▶ Conflict between countries is costly as it harms the economy
- ▶ Bilateral trade reduces conflict probability
  - ▶ Makes conflict more costly
  - ▶ Creates dependence between countries
  - ▶ For proximate countries conflict risk is reduced by about 20%

# Trade policy as foreign policy

## Pacifying effect of trade

- ▶ Asymmetric link between trade and conflict
- ▶ Multilateral trade increases probability of interstate war
  - ▶ Multilateral trade reduces bilateral dependence
  - ▶ Reduces the cost of conflict, higher probability of conflict

# Trade policy as foreign policy

## Pacifying effect of trade

- ▶ RTAs promote peaceful relations by increasing opportunity costs of conflict
- ▶ Country pairs with higher frequency of past wars are more likely to sign RTAs
  - ▶ Larger gains from signing a RTA
- ▶ RTA provides two types of peace promoting security gains
  1. Offering a political forum which facilitates settlement of future disputes
  2. Increasing the opportunity cost of future and potentially trade-disrupting wars

# Trade policy as foreign policy

## Pacifying effect of trade

- ▶ RTAs harm the multilateral trade system
- ▶ Create trade but also trade distortions for excluded members
- ▶ There is a larger conflict risk between members and non-members