International Trade

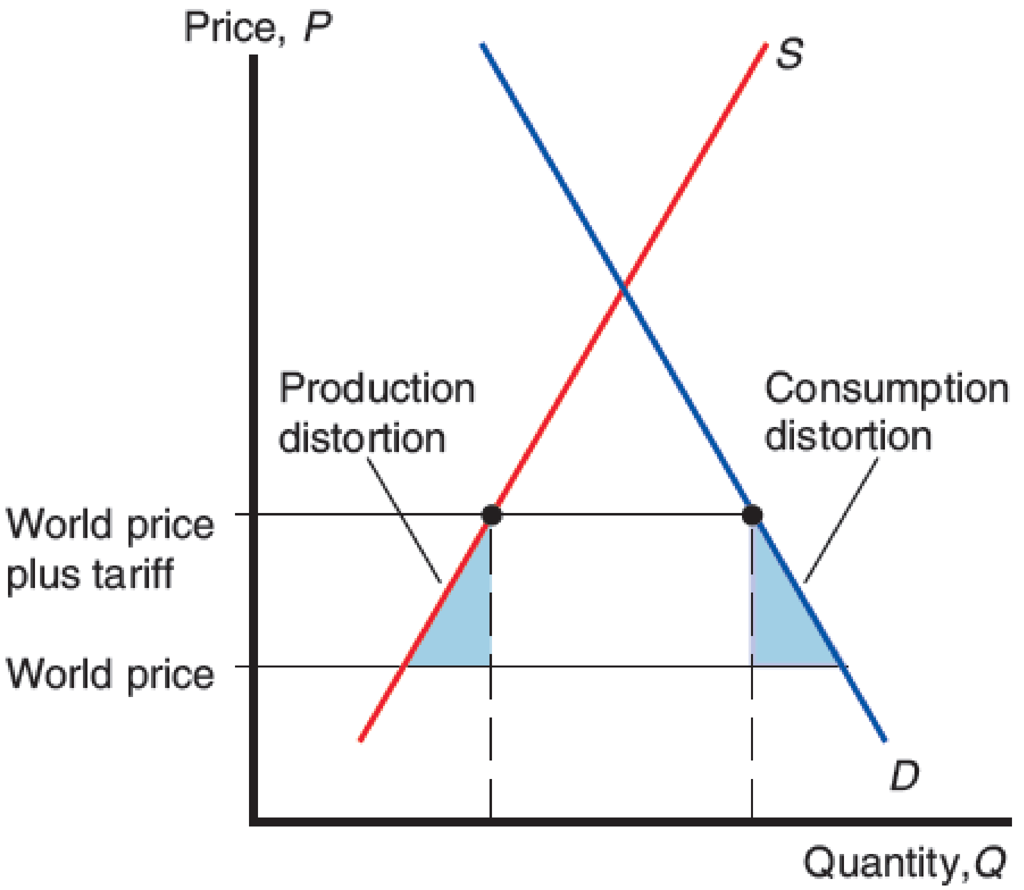
L18

Free Trade

- Hong Kong
- Singapore

Free Trade and Efficiency

- FT and efficiency argument is the reverse of cost-benefit analysis of tariff
- A tariff causes a net loss to the economy measured by the area of the two triangles; it does so by distorting the economic incentives of both producers and consumers. Conversely, a move to free trade eliminates these distortions and increases national welfare.



Arguments in favor for free trade

- **Gains** from free trade are smaller for advanced economies and **larger** for **developing** economies
- **Protectionism**- **blocks gains from economies of scale**-firms in closed economies face narrow domestic market-scale of production of each firm becomes inefficient.
- **Free trade** –improves healthy **competition-**incentive to seek new ways to export or compete with imports-results in **innovation**
- **Protectionism- Quota-**increase **rent seeking** behaviour-to get license –costly process-substantial productive resources wasted

Rent Seeking:

- India in the 1950s and 1960s: Import license as a quota method
- At that time, Indian companies were allocated the right to buy imported inputs in proportion to their installed capacity.
- This created an incentive to overinvest—for example, a steel company might build more blast furnaces than it expected to need simply because this would give it a larger number of import licenses.
- The resources used to build this idle capacity represented a cost of protection over and above the costs shown as producer and consumer distortion in the Figure

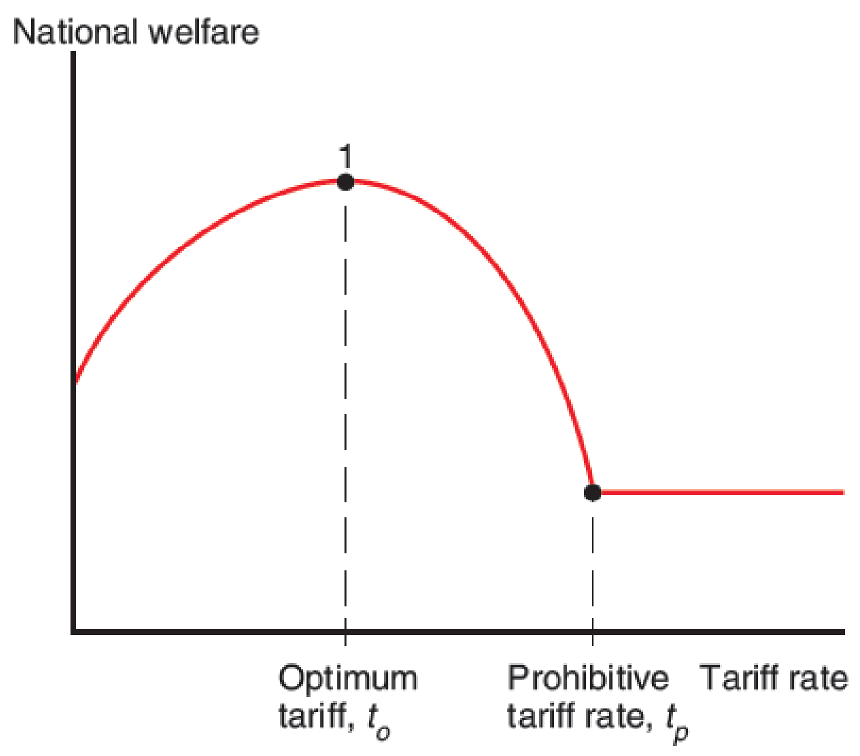
Arguments in favor for free trade

- **Political argument for free trade**:
- Most tariffs, import quotas, and other trade policy measures are undertaken primarily to protect the income of **particular interest groups-** though politicians claim policies are for the interest of the nations
- Any government agency attempting to pursue a sophisticated program of intervention in trade would probably be captured by interest groups and converted into a device for redistributing income to politically influential sectors.
- If this argument is correct, it may be better to advocate free trade without exceptions even though on purely economic grounds, free trade may not always be the best conceivable policy.

National Welfare Arguments against Free Trade : ToT

Terms of trade argument for an import tariff-

- For a large country that is able to affect the prices of foreign exporters, a tariff lowers the price of imports and thus generates a terms of trade benefit.
- At small tariff rates, a large country's welfare is higher than with free trade
- However there is an optimum tariff (rate till which tariff is beneficial for the large economy) which always positive but less than the prohibitive tariff rate (that would eliminate all imports



National Welfare Arguments against Free Trade: ToT

Terms of trade argument for export sector

- Since an export subsidy worsens the terms of trade-it reduces national welfare out of import tariff based terms of trade
- Optimal policy in export sector is negative subsidy- i.e. tax on export-raises price of export to foreigners
- Like the optimum import tariff, the optimum export tax is always positive but less than the prohibitive tax that would eliminate exports completely
- Ex: The policy of Saudi Arabia and other oil exporters has been to tax their exports of oil, raising the price to the rest of the world. Although oil prices have fluctuated up and down over the years, it is hard to argue that Saudi Arabia would have been better off under free trade.

Limitation of ToT and free trade counter argument

Limitation of ToT argument against free trade

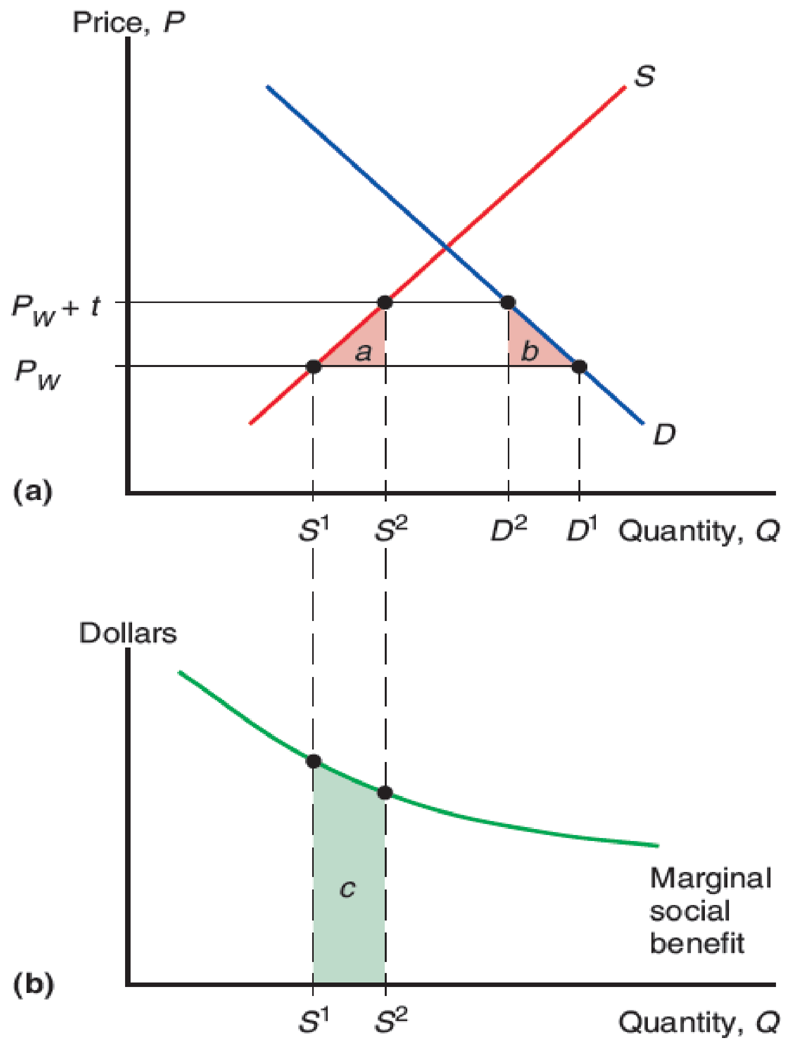
- Most small countries have limited or little ability to affect the world prices of either their imports or thoer exports- hence TOT benefits of tariff only for advanced countries
- For large countries like US- ToT based benefit would be like using national monopoly power to extract gains at other countries expense
- Such policy could bring retaliation from other countries (esp. large economies)
- Cycle of retaliatory trade moves- disrupt international trade policy coordination

Argument against Free Trade: Domestic Market Failure

- Domestic Market Failures- include unemployment/ underemployment; less spillover effect
- Labour used in domestic industry would otherwise be unemployed
- Also protectionism bring new innovative domestic industries that can have more technological spillovers

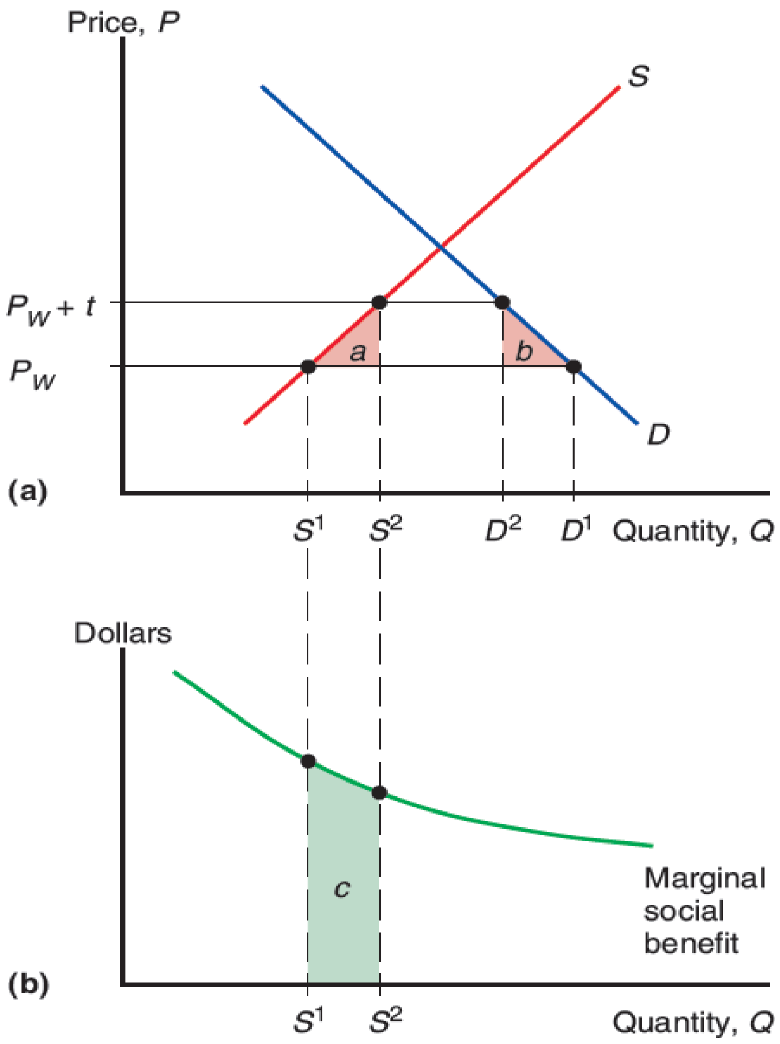
Argument against Free Trade: Domestic Market Failure

- Tariff- production distortion –area ‘a’ and consumption distortion –area ‘b’.
- If only consider consumer and producer surplus lost-cost of tariff exceeds benefits of tariff.
- Additional benefit of tariff- increase in production –yields social benefits (increase employment for instance)-measured by the area under social benefit curve from S1 to S2-(area –’c’)



Argument against Free Trade: Domestic Market Failure

- Similar to ToT argument**, if the tariff is small** enough, the area c must always exceed the area a+b.
- There is some welfare-maximizing tariff that yields a level of social welfare higher than that of free trade.



Domestic Market Failure and Free trade counter argument

- MF argument – more attractive to developing countries/ poorer nations- as they face more market imperfections.
- Large unemployment, huge wage gap between rural and urban areas, inability of innovative firms to churn full benefit of their innovation etc.
- Free trade counter argument: **Domestic MF should be corrected by domestic policies aimed directly at the problem sources.**
- Domestic MF- calls for domestic policy changes- not international trade policies
- If additional production achieved through tariff can be achieved via production subsidy rather than tariff- the price to consumers would not increase and consumer surplus loss b could be avoided

Domestic Market Failure and Free trade counter argument

- Production subsidy- avoid some of the side cost of tariff
- It is always preferable to deal with MF as directly as possible because indirect responses lead to unintended distortions of incentives elsewhere in the economy.
- Hence Free trade advocates argue that tariff policies justified by domestic market failure are never the most efficient response- always the second-best policy.
- Any proposed trade policy should always be compared with direct domestic policy- if domestic policy appears too costly or has side effects- then trade policy is even less desirable-with large costs that are less apparent

Political economy of trade policy

- The advocates of trade policies usually claim that the policies will benefit the nation as a whole.
- When looking at the actual politics of trade policy, however, it becomes necessary to deal with the reality that there is no such thing as national welfare; there are only the desires of individuals, which get more or less imperfectly reflected in the objectives of government.
- It’s hard to make sense of actual trade policy if you assume governments are genuinely trying to maximize national welfare. On the other hand, actual trade policy does make sense if you assume special-interest groups can buy influence.

Political economy of trade policy

- Two crucial votes in US-North American Free Trade Agreement (NAFTA) vote in 1993 and General Agreement on Tariffs and Trade (GATT) vote in 1994
- Vote – business versus labor : Business groups strongly in favor and labor unions against.
- Both cases- backed by free trade position, business side won
- Trade policies- often dominated by interest group politics

International Negotiations

- Post world war trade liberalization was achieved through **international negotiations-** i.e. Govts. Agreed to engage in mutual tariff reduction
- Agreements implies- reduced protection for import competing industries in both countries
- Trade agreements
- - a**) Mutual benefit with less welfare distortion-more free trade**
- Both country exporters get access to foreign markets with lower tariff or quota policy
- B) **Govts can avoid destructive trade wars**

Trade war

- two countries in the world, the United States and Japan, and these countries have only two policy choices: free trade or protection.
- Suppose the governments can assign definite numerical values to their satisfaction with any particular policy outcome.
- The payoffs given are:

U.S. \ Japan	Free trade	Protection
Free trade	10, 10	–10, 20
Protection	20, –10	–5, –5

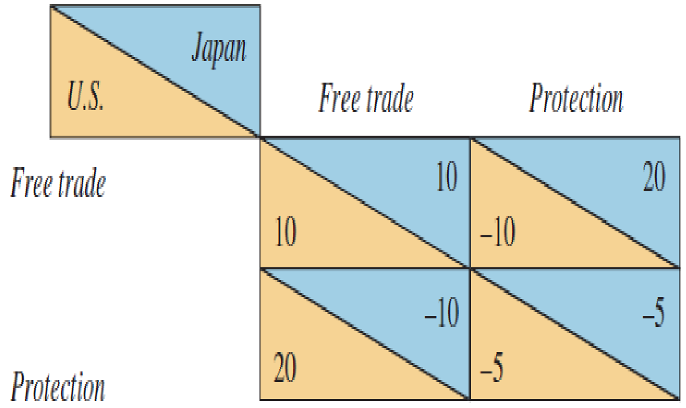
Trade war

- Whichever policy Japan chooses, the U.S. government is better off with protection and vice versa
- Prisoner's Dilemma case:
- Each government acting individually would be better off with protection, they would both be better off if both chose free trade.

U.S. \ Japan	Free trade	Protection
Free trade	Japan: 10; U.S.: 10	Japan: 20; U.S.: –10
Protection	Japan: –10; U.S.: 20	Japan: –5; U.S.: –5

Trade war

- Each government, making the best decision for itself, will choose to protect. These choices lead to the outcome in the lower right box of the table.
- Yet both governments are better off if neither protects: The upper left box of the table yields a payoff that is higher for both countries.
- By acting unilaterally in what appear to be their best interests, the governments fail to achieve the best outcome possible.
- If the countries act unilaterally to protect, there is a trade war that leaves both worse off.



Economic Integration

- EI is important for economic growth (GDP growth)
- Countries pursue Trade agreement to stimulate economic growth and foster international partnerships,
- Major reason- it is a form of alliance building and bringing foreign strategic partners
- Nations choose different levels of economic integration based on variables such as the strength of their national economy and trade relationships and forecasted trade prospects.

Free Trade Area (or Agreement)

- Free trade agreements are agreements that state that goods and services can be exchanged between countries or regions without tariffs, quotas, or other trade restrictions being levied.
- Ex: NAFTA – Canada, US and Mexico; AFTZ ,
- Free trade agreements may be limited to a business or industry sector or be applied to all levels and types of international trade.

- FTA in India?
- Multilateral FTAs

Custom Union

- Free Trade Area=No tariff rates for members ; but country specific policies for trade with non- members
- Custom Union= FTA with members + same tariff rates for non-member trade partners
- Customs unions, which are free trade areas that also establish a common tariff and other shared trade policies with non-member countries, require trade policy harmony and cooperation between member nations. Customs unions establish a common external tariff (CET) and import quotas on products entering the region from third-party countries

Common Market

- CM= CU + Mobilization of labour and capital
- Seamless border
- EU is a common markert-labour movement without any restrictions;
- CM are customs unions with provisions to liberalize movement or mobility of people, capital and other resources and eliminate non-tariff barriers to trade such as the regulatory treatment of product standards.
- Common markets are a significant step toward economic integration for member nations.

Economic Unions

- Economic Union= CM+ Integrate on the level of monetary policy
- Same currency and one central bank controlling the monetary policy of the region
- Economic unions, as the final stage of economic integration, are common markets with provisions for the harmonization of certain economic policies such as macroeconomic and regulatory policies.
- The European Union is one example of a large-scale effective economic union

Economic Integration

- EI is important for economic growth (GDP growth)
- Trade diversion and trade creation: Impact of economic integration on trade partners:
- Trade creation refers to the shift of consumption of the importable good from a high-cost domestic producer to a lower-cost external foreign producer.
- Trade diversion refers to a switch from the lowest-cost external producers to a higher-cost producer- Result in higher costs for consumer and net economic loss