Lesson 2: Trade and Capital Flows: Restrictions and Agreements

TRADE RESTRICTIONS

Arguments for Trade Restrictions

- Protection of established domestic industries from foreign competition.
- Protection of new (infant) industries from foreign competition until they mature.
- Protection of employment in the country.
- Generation of revenue from tariffs.
- Retaliation against trade restrictions imposed by trading partners.

Tariffs

Tariffs are taxes levied on imports.

When a large country (that is a large consumer) imposes a tariff on imports:

- The exporting country may lower its price in order to retain its share of the market in the importing country.
- This reduction in price represents a redistribution of income from the exporting country to the importing country.
- A large country can increase its own welfare if the improvement in terms of trade from the imposition of the tariff outweighs the associated deadweight loss, and if its trading partners do not retaliate.
- However, there will always be an overall reduction in welfare as the increase in welfare in the large country cannot outweigh the welfare loss to its trading partner.

Quotas

Quotas are restrictions on the quantity of a good that can be imported into a country for a specified period. When a quota is in place, each importing firm receives an import license, which specifies the quantity that it can import.

The main difference between tariffs and quotas is that the government earns direct revenue through tariffs, but this is not the case with quotas. With a quota, foreign producers may raise their prices to earn higher profits than they would in the absence of the quota. These profits are known as quota rents.

Voluntary Export Restraints

Voluntary Export Restraints (VERs) are restrictions on the quantity of a good that can be exported. While quotas are imposed by the importing country, VERs are imposed by the exporting country.

Export Subsidies

Export subsidies refer to payments made by the government to domestic exporters of certain goods.

- While they aim to stimulate exports, export subsidies interfere with the free market mechanism and may result in trade patterns that diverge from those dictated by comparative advantage.
- Further, domestic producers would be more inclined to export their output rather than selling it in the domestic market.

If the exporting country is a large country (or price searcher) export subsidies will result in a reduction in the world price as global supply increases.

- The local economy will incur a welfare loss, but the decline in world price will increase welfare in other countries (a part of the subsidy will be transferred abroad).

If the exporting country is a small country (or price taker) the domestic price will rise by the per-unit amount of the subsidy.

- However, the total loss in welfare in the exporting country will be less than the loss that would occur were the country a price searcher.

CAPITAL RESTRICTIONS

Capital restrictions are defined as controls placed on foreigners' ability to own domestic assets and/or domestic citizens' ability to own foreign assets. Capital controls may take the following forms:

Price controls

- Special taxes on returns on international investments.
- Taxes on certain types of transactions.
- Mandatory reserve requirements i.e., foreign parties wishing to deposit money in a domestic bank must first deposit a certain amount at the central bank at zero interest for a minimum period.

Quantity controls

- Ceilings on borrowings from foreign creditors.
- Requiring special authorization for borrowings from foreign creditors.
- Requiring government approval for certain transactions.

Outright prohibitions on international trade in assets

Benefits of Free Movement of Financial Capital

- Allows capital to be invested wherever it will earn the highest return.

- The economy's productive capacity can grow at a higher rate than possible based on domestic savings alone.

- Foreign firms may enter domestic industries, bringing competition to local firms which may:
    - Encourage local firms to increase the quality of their goods and services.
    - Lead to better prices.
    - Bring in new technology.

- However, local firms that are not mature enough to face foreign competition may be forced out of business.

Effectiveness of Capital Controls

An IMF study found that:

- Controls on capital inflows require significant administrative costs to make them effective.
- Imposition of controls on capital outflows during times of financial crisis have produced mixed results:
    - They have only provided temporary relief to some countries, but offered others (e.g. Malaysia in 1997) enough time to restructure their economies.

In times of financial crisis, when there may be a flight of capital from the country, fixed exchange rates (when combined with capital controls) afford the central bank a degree of monetary policy independence that would not be possible without capital controls.

Regional Trading Agreements (RTAs)

Members of a regional trading agreement (RTA) agree to eliminate barriers to trade and movement of factors of production among the members of the bloc. Members may or may not have similar policies regarding trade restrictions against non-member countries. Depending on the level of integration, there are different types of trade agreements.

Members of a **free trade area (FTA)**, for example NAFTA, eliminate almost all barriers to free trade with each other. However, each member still maintains its own policies regarding trade with non-member countries.

A **customs union** (e.g. Benelux) is very similar to an FTA, but all member countries have similar policies regarding trade with non-member countries.

A **common market** (e.g. MERCOSUR) incorporates all the provisions of a customs union, and also allows free movement of factors of production among the member countries.

An **economic union** (e.g. EU) incorporates all the aspects of a common market and also requires common economic institutions and coordination of economic policies among member countries. If the members of the economic union decide to adopt a common currency, it is also referred to as a **monetary union**.

Countries usually prefer regional integration over multilateral trade negotiations under the World Trade Organization (WTO) because regional integration is:

- Easier to achieve.
- Takes less time.
- Politically less contentious.

Regional integration usually results in trade creation and trade diversion, and only if trade creation is larger than trade diversion, is there a positive net effect on welfare from forming the trade bloc.

- Trade creation occurs when higher-cost domestic production is replaced with lower-cost imports from fellow members of a trade bloc.
- Trade diversion occurs when lower-cost imports from non-member countries are replaced with higher-cost imports from member countries (because tariffs are imposed on imports from non-member countries but not on imports from member countries).

Advantages of Trade Blocs

All the benefits of free trade (greater specialization, reduction in monopoly power due to competition, economies of scale, learning by doing, knowledge spillovers, technology transfers, better quality intermediate inputs, etc.) apply to trade blocs as well. Aside from these benefits, trade blocs also offer the following benefits to their members:

- Reduce the potential for conflict among members.
- Give members greater bargaining power in the global economy as they form a united front.
- Offer new opportunities for trade and investment.
- Typically, growth in a member country tends to spill over into other members as well.

Challenges in the Formation of an RTA

- Cultural differences and historical conflicts may complicate the process of integration.
- Free trade and mobility of labor limit the extent to which member countries can pursue independent economic and social policies.