

International Economics - B.Sc. IB
7. International Trade Theory:
Political Economy of Trade Policy. Globalization
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Plan for Today

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Chapter 9 :

- ▶ Income Distribution and Trade Policy
- ▶ International Negotiations

Chapter 10 :

- ▶ Import Substituting Industrialization
- ▶ Free Trade
- ▶ Export Oriented Industrialization

Chapter 11:

- ▶ Arguments for an Activist Trade Policy
- ▶ Trade & Labor
- ▶ Trade & Environment

Chapter 9. Income Distribution and Trade Policy

Political Models of Trade Policy

Models related to trade policy:

1. Median voter theorem
2. Collective action
3. A model of trade policy that combines aspects of the median voter theorem & collective action

Median Voter Theorem

Electoral competition can be modeled as:

- ▶ two parties
- ▶ t_m : equilibrium tariff
- ▶ Both want majority \Rightarrow both parties will offer the same tariff policy to court the median voter
- ▶ **BUT** this model does not work well for trade policy (e.g. small groups/lobbies influence tariff, see Box at page 225)

Fig. 9-4: Political Competition

91.pdf

Median Voter & Tariffs

mediumvoter.pdf

Collective Action (1)

Model introduced by Mancur Olson. Main assumptions:

- ▶ Political activity on behalf of a group is a *public good*
- ▶ Policies with large aggregate/ total loss but small individual loss are difficult to change
- ▶ Collective action is required

Collective Action (2)

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A Model of Trade Policy

- ▶ Politicians may win elections partly because they advocate popular policies (median voter theorem), but they also require funds to run campaigns (collective action)
- ▶ funds may especially come from groups who do not have a collective action problem and are willing to advocate a special interest policy
- ▶ models of trade restriction policy try to measure the trade off between the reduction in welfare of constituents as a whole and the increase in campaign contributions from special interests.

Which Industries are Protected?

- ▶ Agriculture (Europe and Japan)
- ▶ Clothing (USA, about 14 \$ billion)

Chapter 9. International Negotiations

International Negotiations

- ▶ 1930: Smoot-Harley Act
- ▶ 1932: Bilateral negotiations
- ▶ 1947: Multilateral negotiations (GATT)
- ▶ 1995: WTO

Fig. 9-5: The U.S. Tariff Rate

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Multilateral Negotiations

- ▶ Multilateral negotiations mobilize exporters to support free trade if they believe export markets will expand.
- ▶ Multilateral negotiations also help avoid a trade war between countries, where each country enacts trade restrictions.
- ▶ A trade war could result if each country has a political interest (due to political pressure) to protect domestic producers, regardless of what other countries do.

Trade War

		European Union	
		Free Trade	Protection
US	Free trade		

Trade War

		European Union	
		Free Trade	Protection
US	Free trade	10B	20B

Trade War

		European Union	
		Free Trade	Protection
US	Free trade	10B	<u>20B</u>

Trade War

		European Union	
		Free Trade	Protection
US	Free trade	10B	<u>20B</u>
US	Protection	-10B	-5B

Trade War

		European Union	
		Free Trade	Protection
US	Free trade	10B	<u>20B</u>
US	Protection	-10B	<u>-5B</u>

Trade War

		European Union	
		Free Trade	Protection
US	Free trade	10B	<u>20B</u>
US	Protection	-10B	<u>-5B</u>

Trade War

		European Union		
		Free Trade		Protection
US	Free trade	10B	10B	<u>20B</u>
US	Protection	20B	-10B	<u>-5B</u>

Trade War

		European Union	
		Free Trade	Protection
US	Free trade	10B 10B	<u>20B</u>
US	Protection	<u>20B</u> -10B	<u>-5B</u>

Trade War

		European Union			
		Free Trade		Protection	
US	Free trade	10B	10B	<u>-10B</u>	<u>20B</u>
US	Protection	<u>20B</u>	-10B	<u>-5B</u>	<u>-5B</u>

Trade War

		European Union			
		Free Trade		Protection	
US	Free trade	10B	10B	<u>-10B</u>	<u>20B</u>
US	Protection	<u>20B</u>	-10B	<u>-5B</u>	<u>-5B</u>

"Ulysses and the Sirens" (1)

But if you wish to listen, let the men tie you in the lugger,, hand and foot, back to the mast, lashed to the mast, so you may hear those harpies' thrilling voices...[Homer, Odyssey]

uly.pdf

"Ulysses and the Sirens" (2)

If countries can establish a binding agreement to maintain free trade, both can avoid the temptation of protection and both can be made better off. \Rightarrow World Trade Organization (WTO)

1. Reduction of tariff rates
2. Binding
3. Prevention of non-tariff barriers

Preferential Trade Agreement (1)

1. **free trade area:** an agreement that allows free trade among members, but each member can have its own trade policy towards non-member countries (e.g., NAFTA)
2. **custom unions:** an agreement that allows free trade among members and requires a common external trade policy towards non-member countries. (e.g., European Union)

Preferential Trade Agreement (2)

	UK	F	US	UK import from
p	8	6	4	US
1 st case				
$p + t$	8	11	9	-
CU with F	8	6	9	F (trade creation)
2 nd case				
$p + t^2$	8	9	7	US
CU with F	8	6	7	F (trade diversion)

Chapter 10. Import Substituting Industrialization

Chapter 10: Trade Policy in Developing Countries

Developing Countries

Developing countries:

- ▶ many low and middle income countries
- ▶ not precise definition

Import Substituting Industrialization

Developing countries:

- ▶ trade policy adopted by many developing countries before the 1980s (e.g., in Latin America 1950-60)
- ▶ encourage domestic industries (*infant industries*) by limiting competing imports
- ▶ common belief: poor countries would be exploited by rich countries through international financial markets and trade.

but

1. comparative advantages
2. firms could be uncompetitive
3. market failures

Infant Industries and Market Failures

Two arguments for how market failures prevent infant industries from becoming competitive:

1. Imperfect financial asset markets
2. The problem of appropriability

Chapter 10. Free Trade

Trade Liberalization

There is some evidence that low and middle income countries which had relatively free trade had higher average economic growth than those that followed import substituting industrialization (after mid-1980s).

Table 10-3: Effective Rates of Protection for Manufacturing in India and Brazil

table1.pdf

Fig. 10-1: The Growth of Developing-Country Trade

graf1.pdf

Has Trade Liberalization Promoted Development?

- ▶ Mixed evidence (free trade bad for Latin America).
- ▶ but difficult to disentangle trade from financial crises
- ▶ more income inequality (prediction from Heckscher-Ohlin model)

Export Oriented Industrialization

- ▶ "high performance Asian economies" adopted trade policies that promoted exports in targeted industries
- ▶ Although evidence suggests that these economies did have less restricted trade than other low and middle income countries, some trade restrictions were sometimes still in effect.
(causality or correlation ?)

Table 10-4: Average Rates of Protection, 1985 (percent)

tab2.pdf

Chapter 11. Controversies in Trade Policy

Chapter 11: Controversies in Trade Policy

Chapter 11. Arguments for an Activist Trade Policy

Arguments for an Activist Trade Policy

1. market failure
2. infant industry
3. technologies & externalities
4. imperfect competition

Technology & Externalities

Governments may want to actively encourage investment in technology when externalities in new technologies create a high marginal social benefit. Problem: Governments ability to target the right thing

1. Which industries do R&D (high-tech industries (!?))
2. Screening.
3. Jones and Williams (1998): *[The results] imply a conservative estimate of optimal/actual of about 4*

Imperfect Competition and Strategic Trade Policy

- ▶ Imperfectly competitive industries are typically dominated by a few firms that generate monopoly profits or excess profits (or excess returns).
- ▶ In an imperfectly competitive industry, government subsidies can shift excess profits from a foreign firm to a domestic firm.

Profit Stealing (1)

Suppose Boeing enters the market first and it decides to produce

		Airbus			
		Produce		Not Produce	
Boeing	Produce	-5	-5	<u>100</u>	<u>0</u>
Boeing	Not Produce	0	100	0	0

Profit Stealing (2)

- ▶ EU subsidize production by 25
- ▶ Airbus will also produce independent of Boeing's decision
- ▶ Boeing knows that and decides not to produce
- ▶ $125 > 25 \Rightarrow$ social benefit

		Airbus			
		Produce		Not Produce	
Boeing	Produce	-5	20	100	0
Boeing	Not Produce	<u>0</u>	<u>125</u>	0	0

Profit Stealing (3)

- ▶ "beggar-thy-neighbor"

		Airbus			
		Produce		Not Produce	
Boeing	Produce	<u>5</u>	<u>5</u>	125	0
Boeing	Not Produce	0	125	0	0

Chapter 11. Trade & Labor

Trade & Labor

- ▶ Compared to rich country standards, workers who produce these goods are paid low wages and may work under poor conditions.
- ▶ Some have opposed free trade because of this fact.
- ▶ Predictions: Ricardo vs. Heckscher-Ohlin model

Chapter 11. Trade & Environment

Trade & Environment (1)

- ▶ Compared to rich country standards, environmental standards in low and middle income countries are lax.
- ▶ Some have opposed free trade because of this fact.

Trade & Environment (2)

- ▶ As poor countries grow richer, possibly partly due to trade, they produce more and can consume more, leading to more environmental degradation.
- ▶ But as countries grow richer, they want to pay for more stringent environment protection.
- ▶ **environmental Kuznets curve**

Fig. 11-1: The Environmental Kuznets Curve

kuz.pdf

Figure: VER and Pollution (Source: Feenstra and Taylor (2010))

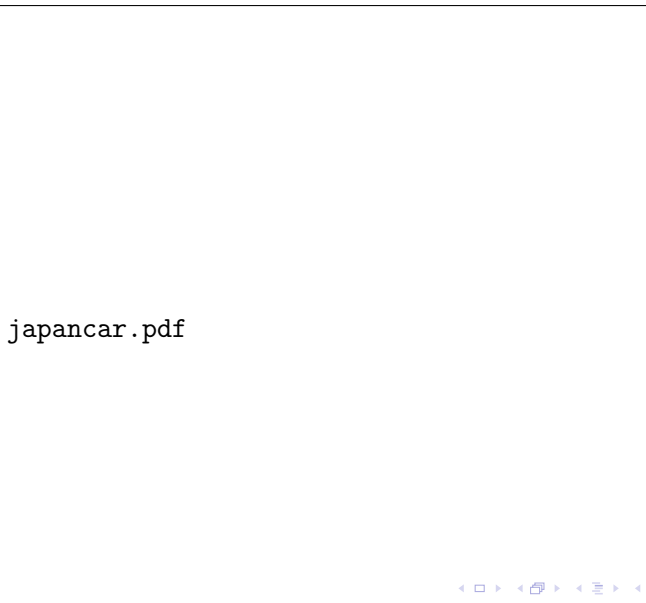


Figure: Trade in Bufalo (Source: Scott Taylor (2007))

bufalo.pdf

Suggested Articles



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Ulysses and the Sirens: Studies in Rationality and Irrationality
Cambridge Paperback Library, 1987



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Measuring the social return to R&D,
The Quarterly Journal of Economics, vol. 113(4), pages 1119-1135,
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Ostrom, Elinor

Governing the Commons: The Evolution of Institutions for Collective Action
Cambridge University Press, 1990