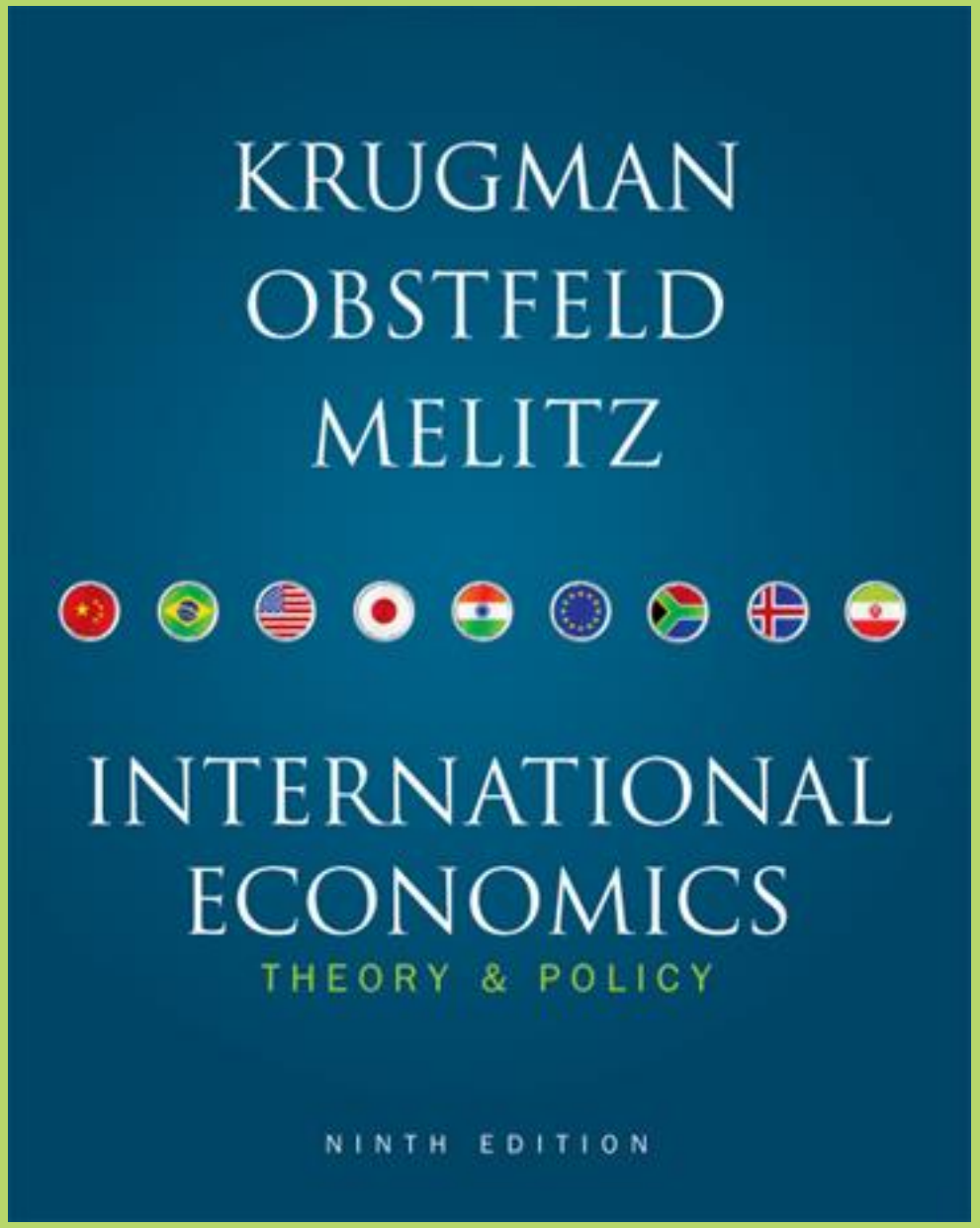
Chapter 10

The Political Economy of Trade Policy

(adapted by Guido Baldi)



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International Negotiations of Trade Policy

- After rising sharply at the beginning of the 1930s, the average U.S. tariff rate has decreased substantially from the mid-1930s to 1998.
- Since 1944, much of the reduction in tariffs and other trade restrictions has come about through international negotiations.
  - The **General Agreement of Tariffs and Trade** was begun in 1947 as a provisional international agreement and was replaced by a more formal international institution called the **World Trade Organization** in 1995.

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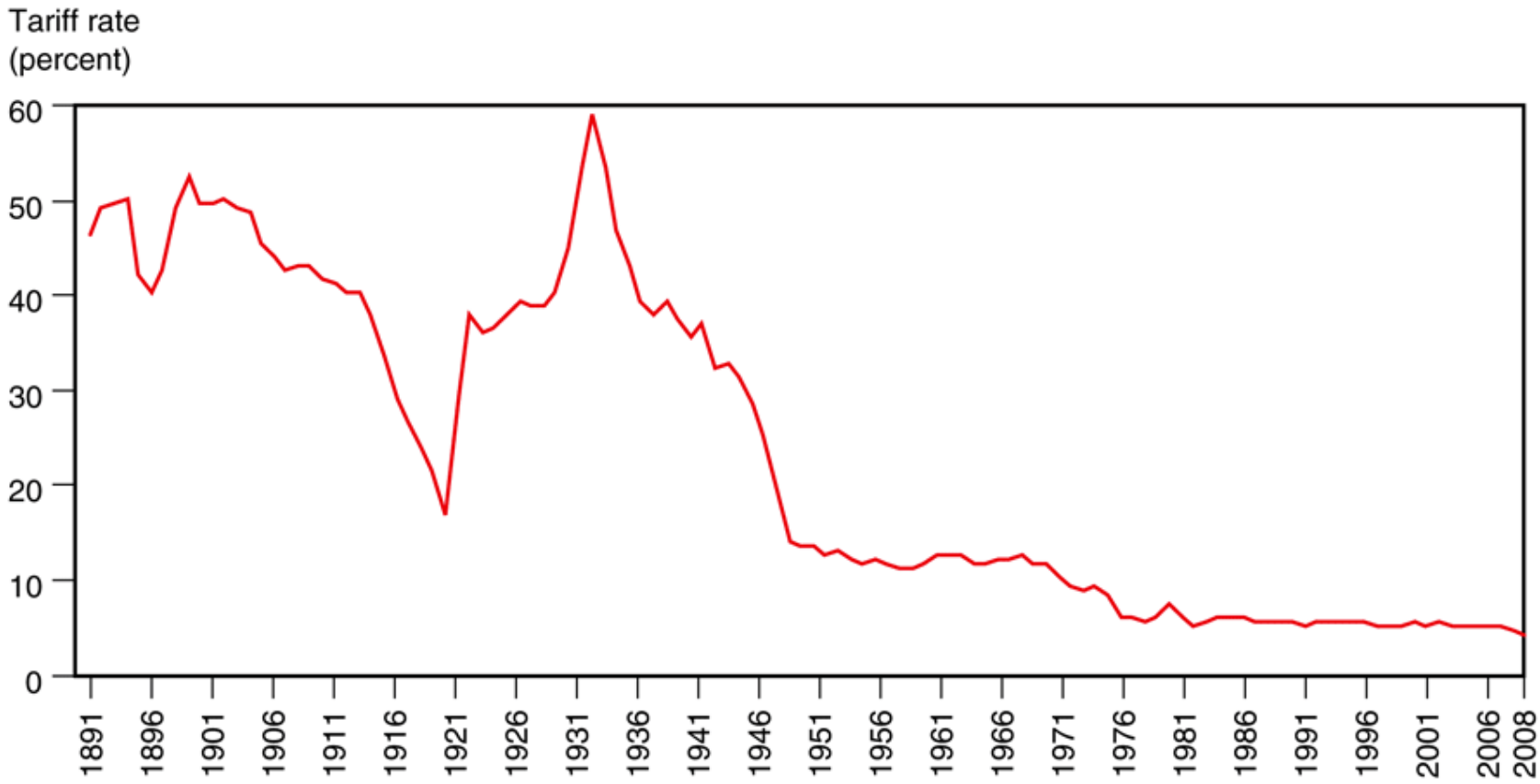
Fig. 10-5: The U.S. Tariff Rate



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International Negotiations of Trade Policy (cont.)

- Multilateral negotiations mobilize exporters to support free trade if they believe export markets will expand.
  - This support would be lacking in a unilateral push for free trade. The multilateral approach counteracts the support for restricted trade by import-competing groups.

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International Negotiations of Trade Policy (cont.)

- 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 an incentive to adopt protection, *regardless of what other countries do.*
  - All countries could enact trade restrictions, *even if it is in the interest of all countries to have free trade*.
  - Countries need an agreement that prevents a trade war or eliminates the protection from one.

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Table 10–3: The Problem of Trade Warfare

TABLE 10-3 The Problem of Trade Warfare

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

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International Negotiations of Trade Policy (cont.)

- In this example, each country acting individually would be better off with protection (20 > 10), but both would be better off if both chose free trade than if both choose protection (10 > –5).
- If Japan and the U.S. can establish a binding agreement to maintain free trade, both can avoid the temptation of protection and both can be made better off.
  - Or if the damage has already been done, both countries can agree to return to free trade.

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International Trade Agreements: A Brief History

- In 1930, the United States passed a remarkably irresponsible tariff law, the Smoot-Hawley Act.
  - Tariff rates rose steeply and U.S. trade fell sharply.
- Initial attempts to reduce tariff rates were undertaken through bilateral trade negotiations:
  - U.S. offered to lower tariffs on some imports if another country would lower its tariffs on some U.S. exports.
- Bilateral negotiations, however, do not take full advantage of international coordination.
  - Benefits can "spill over" to countries that have not made any concessions.

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World Trade Organization

- In 1947, a group of 23 countries began trade negotiations under a provisional set of rules that became known as the General Agreement on Tariffs and Trade, or GATT.
- In 1995, the **World Trade Organization,** or **WTO**, was established as a formal organization for implementing multilateral trade negotiations (and policing them).

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World Trade Organization

- WTO negotiations address trade restrictions in at least 3 ways:

1. **Reducing tariff rates** through multilateral negotiations.
2. **Binding tariff rates**: a tariff is "bound" by having the imposing country agree not to raise it in the future.

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World Trade Organization (cont.)

3. **Eliminating nontariff barriers**: quotas and export subsidies are changed to tariffs because the costs of tariff protection are more apparent and easier to negotiate.
   - Subsidies for agricultural exports are an exception.
   - Exceptions are also allowed for "market disruptions" caused by a surge in imports.

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World Trade Organization (cont.)

- The World Trade Organization is based on a number of agreements:
  - *General Agreement on Tariffs and Trade:* covers trade in goods.
  - *General Agreement on Tariffs and Services:* covers trade in services (ex., insurance, consulting, legal services, banking).
  - *Agreement on Trade-Related Aspects of Intellectual Property:* covers international property rights (ex., patents and copyrights).

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World Trade Organization (cont.)

- *The dispute settlement procedure:* a formal procedure where countries in a trade dispute can bring their case to a panel of WTO experts to rule upon.
  - The panel decides whether member counties are breaking their agreements.
  - A country that refuses to adhere to the panel's decision may be punished by the WTO allowing other countries to impose trade restrictions on its exports.

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World Trade Organization (cont.)

- The GATT multilateral negotiations in the Uruguay Round, ratified in 1994:
  - agreed that all quantitative restrictions (ex., quotas) on trade in textiles and clothing as previously specified in the Multi-Fiber Agreement were to be eliminated by 2005.
- Quotas on imports from China had to be temporarily reimposed due to surge in Chinese clothing exports when MFA expired.

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World Trade Organization (cont.)

- In 2001, a new round of negotiations was started in Doha, Qatar, but these negotiations have not yet produced an agreement.
  - Most of the remaining forms of protection are in agriculture, textiles, and clothing—industries that are politically well organized.

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Table 10-4: Percentage Distribution of Potential Gains from Free Trade

TABLE 10-4 Percentage Distribution of Potential Gains from Free Trade

Economy	Full Liberalization of: Agriculture and Food	Textiles and Clothing	Other Merchandise	All Goods
Developed	46	6	3	55
Developing	17	8	20	45
All	63	14	23	100

Source: Kym Anderson and Will Martin, "Agricultural Trade Reform and the Doha Agenda," *The World Economy* 28 (September 2005), pp. 1301–1327.

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Do Agricultural Subsidies in Rich Countries Hurt Poor Countries?

- We learned in Chapter 9 that subsidies lower the *world* price of products.
  - Since importing countries benefit from cheaper food, why would poor countries want rich countries to remove their agricultural subsidies?
  - Subsidies harm farmers in poor countries who compete with farmers in rich countries.
- In 2015, WTO members adopted a historic decision to abolish agricultural export subsidies and to set rules for other forms of farm export support (has also implications for Switzerland).

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Table 10-5: Percentage Gains in Income under Two Doha Scenarios

TABLE 10-5 Percentage Gains in Income under Two Doha Scenarios

	Ambitious	Less Ambitious
High-income	0.20	0.05
Middle-income	0.10	0.00
China	−0.02	−0.05
Low-income	0.05	0.01
World	0.18	0.04

Source: See Table 10-4.

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Trade Facilitation Agreement (TFA)

- Negotiations were concluded in 2013 in Bali.
- Entered into force in 2017.
- Bureaucratic burdens lead to trade costs when moving goods across borders.
- The Trade Facilitation Agreement aims at simplifying export and import processes.
  - For instance, reduced fees and formalities connected with the import/export of goods or faster clearance procedures.

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Preferential Trading Agreements

- Preferential trading agreements are trade agreements between countries in which they lower tariffs for each other but not for the rest of the world.
- Under the WTO, such discriminatory trade policies are generally not allowed:
  - Each country in the WTO promises that all countries will pay tariffs no higher than the nation that pays the lowest: called the "most favored nation" (MFN) principle.
  - An exception is allowed only if the lowest tariff rate is set at zero.

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Preferential Trading Agreements (cont.)

- There are two types of preferential trading agreements in which tariff rates are set at or near zero:

1. A **free trade area**: an agreement that allows free trade among members, but each member can have its own trade policy towards non-member countries.
   - An example is the North America Free Trade Agreement (NAFTA).

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Preferential Trading Agreements (cont.)

2. A **customs union**: an agreement that allows free trade among members and requires a common external trade policy towards non-member countries.
   - An example is the European Union.

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Preferential Trading Agreements (cont.)

- Are preferential trading agreements necessarily good for national welfare?
- No, it is possible that national welfare decreases under a preferential trading agreement.
- How? Rather than gaining tariff revenue from inexpensive imports from world markets, a country may import expensive products from member countries but not gain any tariff revenue.

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Preferential Trading Agreements (cont.)

- Preferential trading agreements increase national welfare when new trade is created, but not when existing trade from the outside world is diverted to trade with member countries.
- Trade creation
  - occurs when high-cost domestic production is replaced by *low-cost imports from other members*.
- Trade diversion
  - occurs when low-cost imports from nonmembers are diverted to *high-cost imports from member nations.*

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Switzerland and Free Trade Agreements (FTA)

- Agreement between two or more countries
- Swiss FTA often between EFTA countries & a third party (exceptions, for example, China, Japan)
- Covered domains
  - Goods & Services (reduction of tariffs and other trade restrictions)
  - Foreign direct investment (preventing discrimination)
  - Intellectual property (protection of IPR)
  - Public procurement (market access)

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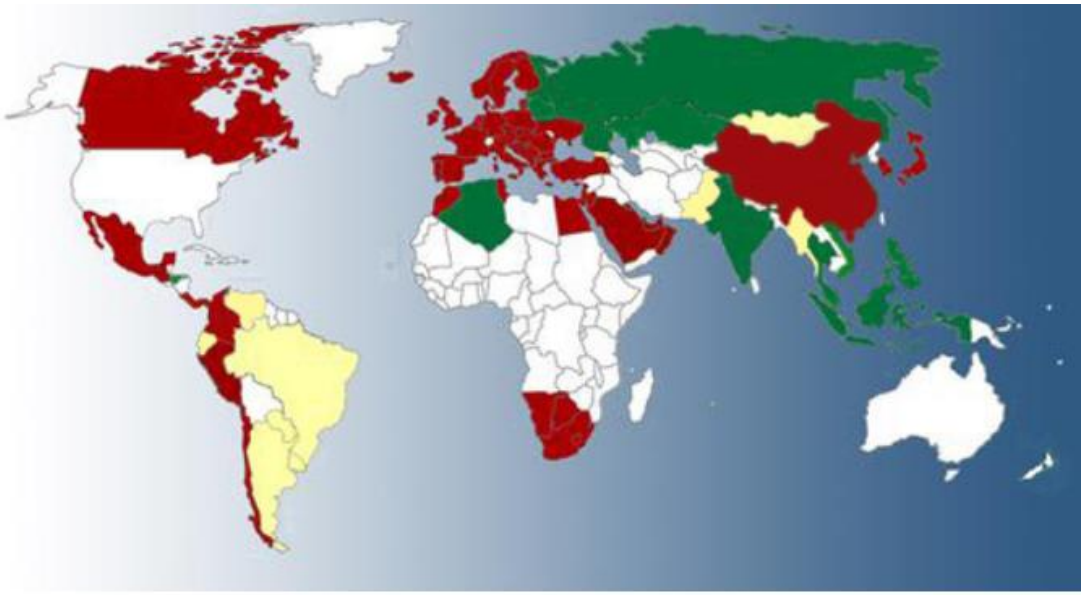
Regional coverage of Swiss FTA

Currently 28 Agreements with 38 Partner outside the EU



Existing FTA

EFTA collaboration declarations

Negotiations ongoing / in preparation

Preliminary studies / exploratory contacts

Negotiations completed in the beginning 2016: Georgia, Philippines

Negotiations ongoing: Thailand, Indonesia, India, Vietnam, Malaysia, Customs Union Russia-Belarus-Kazakhstan, Algeria

Source: SECO

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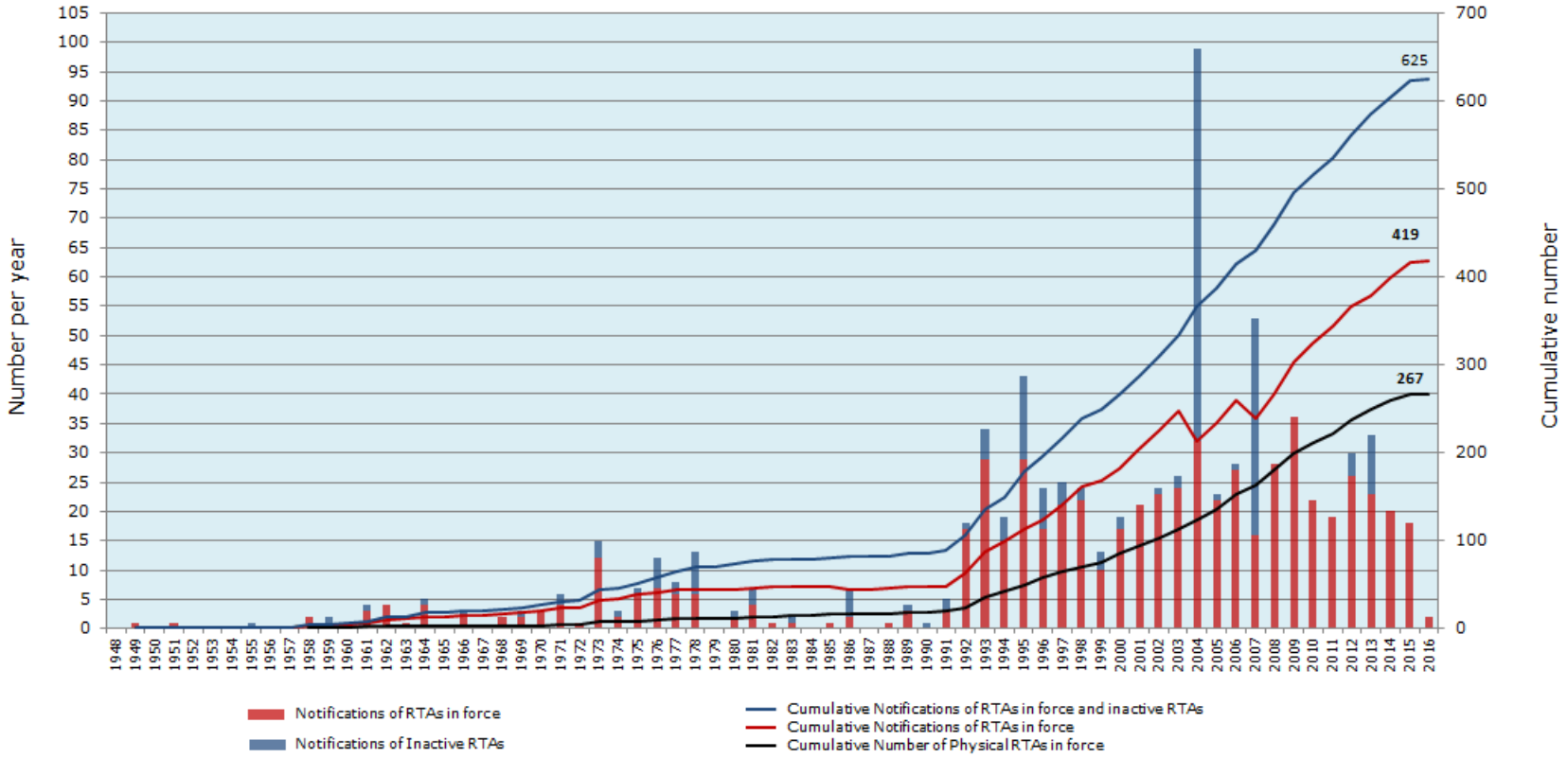
Global FTAs

Notified Regional Trade Agreements 1948-2016



Note: Notifications of RTAs: goods, services & accessions to an RTA are counted separately. Physical RTAs: goods, services & accessions to an RTA are counted together.
Source: WTO Secretariat.

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Challenges regarding FTA

- Limited benefits of FTA
  - Limited coverage (agriculture!)

- Limited utilisation of FTA
  - Costs of information and time, restrictiveness of rules of origin, logistics

- General criticism of free trade
  - Collective action problem → FTA represent particular interests
  - Protection of environment and labour standards (e.g. TTIP & genetics, meat products from cattle treated with certain hormones for growth, etc.)
  - Unequal negotiation capacities

- FTA and 3rd countries (i.e. rules of origin affecting 3rd countries like CH)

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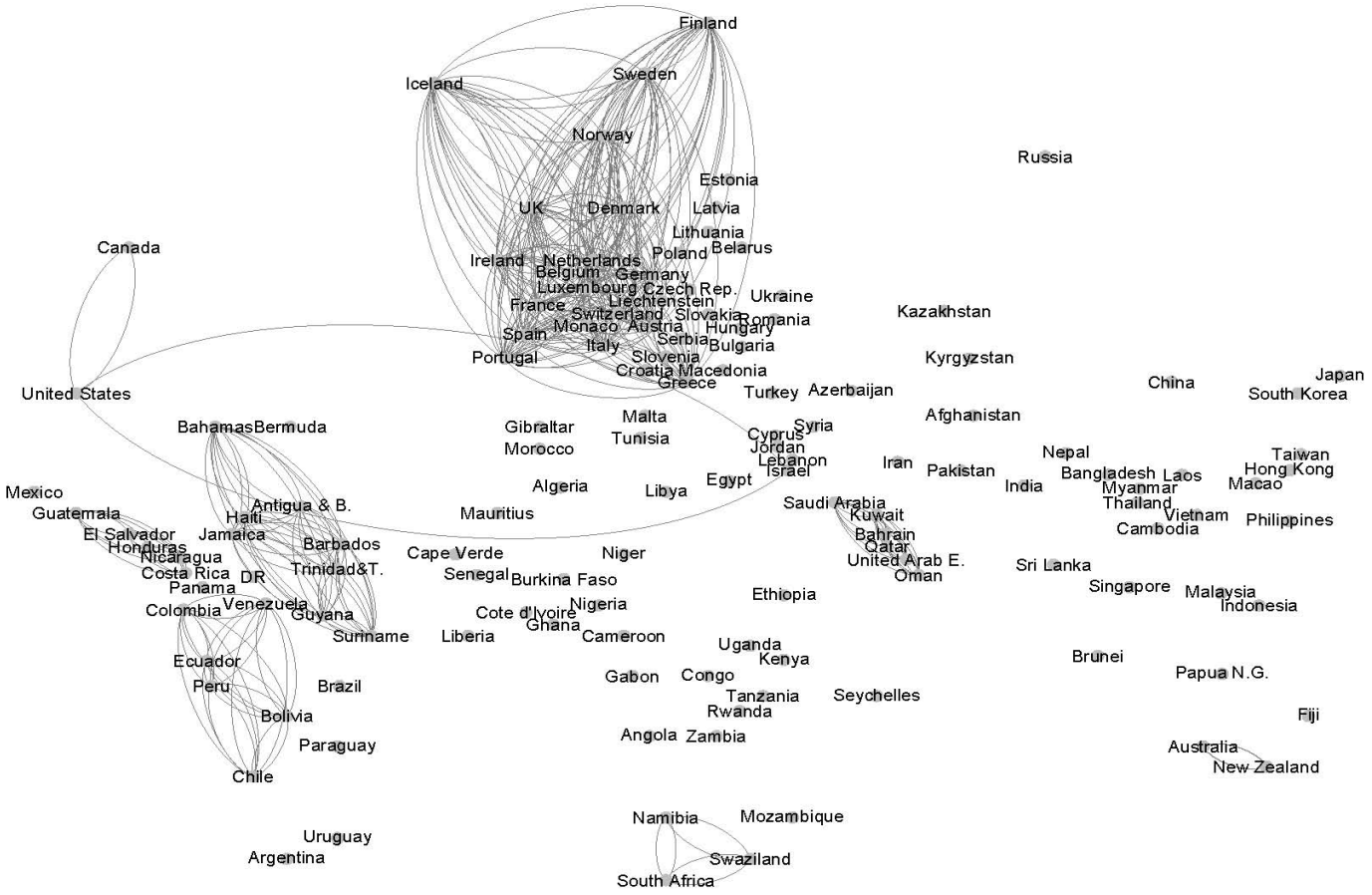
FTA – Spaghetti Bowl

Regional Trade Agreements 1990



Source: Inter-American Development Bank

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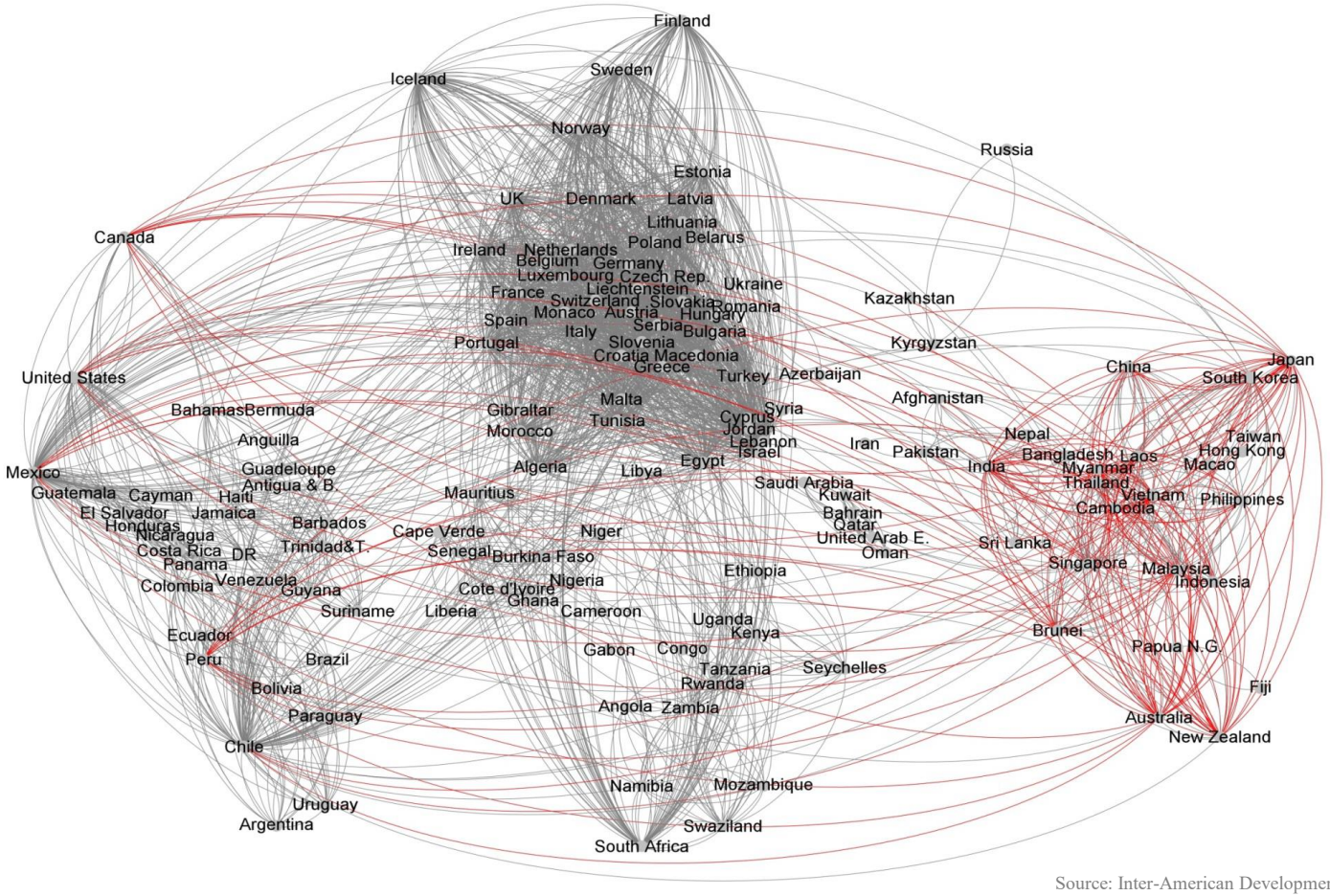
FTA – Spaghetti Bowl

Regional Trade Agreements 2014



Source: Inter-American Development Bank

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List of Free Trade Agreements of Switzerland (Source: Seco)

Europe	Status / comments
EFTA-Convention	Entry into force: 3 May 1960
European Community (EC)	Entry into force: 1 January 1973; bilateral CH-EC
Faeroe Islands	Entry into force: 1 March 1995; bilateral CH-Faeroe
Macedonia	Entry into force: 1 May 2002
Albania	Entry into force on 1 November 2010
Serbia	Entry into force on 1 October 2010
Ukraine	Entry into force on 1 June 2012
Montenegro	Entry into force on 1 September 2012
Bosnia-Herzegovina	Signed on 24 June 2013
Customs union Russia -Belarus-Kazakhstan	In negotiations
Croatia	FTA terminated on 01.07.2013 (accession of Croatia to the EU)

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List of Free Trade Agreements of Switzerland (Source: Seco)

Worldwide	
Mexico	Entry into force: 1 July 2001
Singapore	Entry into force: 1 January 2003
Chile	Entry into force: 1 December 2004
Republic of Korea	Entry into force: 1 September 2006
SACU[2]	Entry into force: 1 May 2008

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Canada	Entry into force: 1 July 2009
Japan	Entry into force: 1 September 2009. Bilateral CH-Japan
Colombia	Entry into force: 1 July 2011
Peru	Entry into force: 1 July 2011
Hong Kong	Entry into force: 1 October 2012
Cooperation Council for the Arab States of the Gulf (GCC)[3]	Signed on 22 June 2009, in ratification process on the GCC side
Central American States[4]	Signed on 24 June 2013 (Panama and Costa Rica)
China	Signed on 06 July 2013, bilateral CH-China
Thailand	In negotiations
Indonesia	In negotiations
India	In negotiations
Vietnam	In negotiations
Malaysia	In negotiations

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List of Free Trade Agreements of Switzerland (Source: Seco)

Mediterranean basin	
Turkey	Entry into force: 1 April 1992
Israel	Entry into force: 1 July 1993
Palestinian Authority	Entry into force: 1 July 1999
Morocco	Entry into force: 1 December 1999
Jordan	Entry into force: 1 September 2002
Tunisia	Application since 1 June 2005 ; Entry into force: 1 June 2006

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Lebanon	Entry into force: 1 January 2007
Egypt	Application since 1 August 2007. Entry into force: 1 September 2008
Algeria	In negotiations

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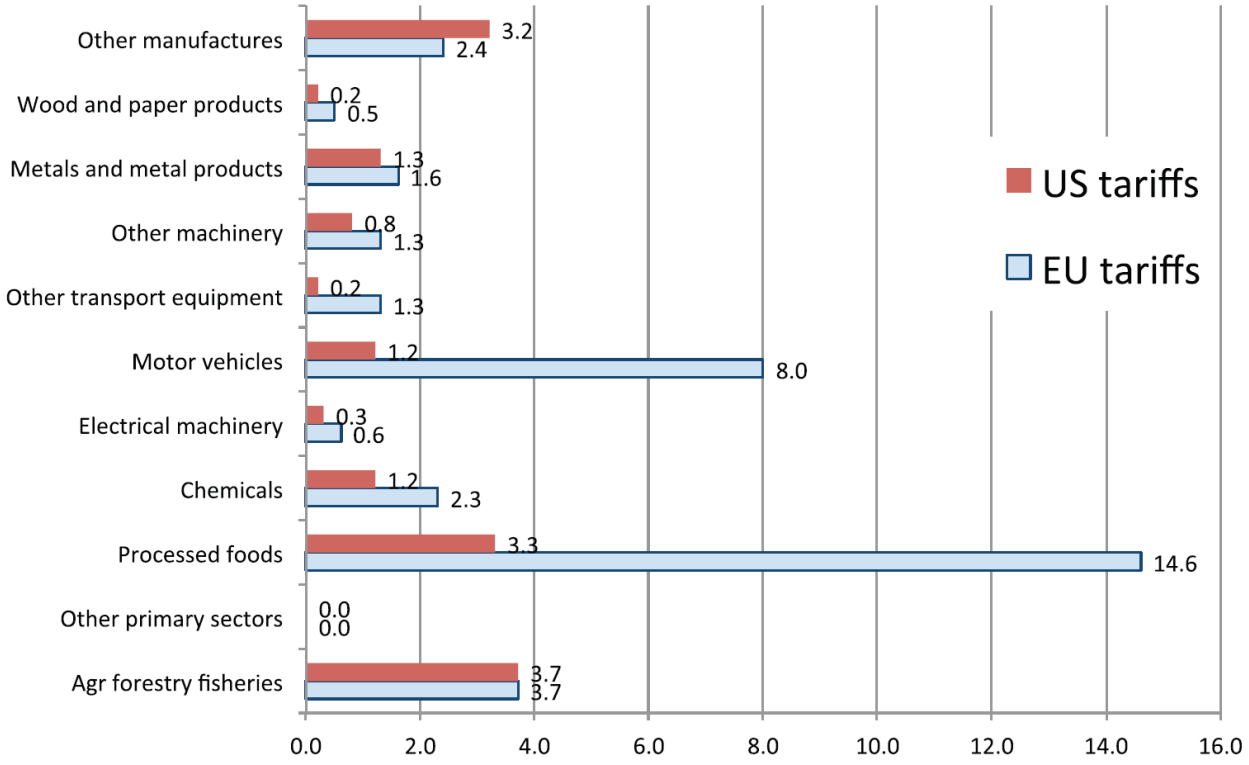
Tariffs between the EU and the US: the current situation (Source: Francois et al.)

Figure 9 Trade Weighted Applied (MFN) average tariff rates 2007



Source: WTO, CEPII, UNCTAD mapped to GTAP8

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Non-tariff barriers index by business (index between 0-100)

Table 1 Perceived NTB index by business (index between 0-100)

Sector	EU exports to the US	US exports to the EU
Services Sectors:		
Travel	35.6	17.6
Transport	39.9	26.3
Financial Services	29.7	21.3
ICT	20.0	19.3
Insurance	29.5	39.3
Communication	44.6	27.0
Construction	45.0	37.3
Other Business Services	42.2	20.0
Personal, Cultural and Recreational Services	35.8	35.4
Goods Sectors:		
Chemicals	45.8	53.2
Pharmaceuticals	23.8	44.7
Cosmetics	48.3	52.2
Biotechnology	46.1	50.2
Machinery	50.9	36.5
Electronics	30.8	20.0
Office, Information and Communication Equipment	37.9	32.3
Medical, Measuring and Testing Appliances	49.3	44.5
Automotive Industry	34.8	31.6
Aerospace and Space Industry	56.0	55.1
Food and Beverages	45.5	33.6
Iron, Steel and Metal Products	35.5	24.0
Textiles, Clothing and Footwear	35.6	48.9
Wood and Paper, Paper Products	30.0	47.1

Source: Ecorys (2009)

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Free Trade Agreemnts, Bilateral Investment Treaties, and Foreign Direct Investment

- Growing number of Bilateral investment treaties (BTI) since the 1960s. Aim: protection of foreign direct investment (FDI).
- More recently, free trade agreements (FTA) also include chapters on FDI.

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Bilateral investment treaties

- Three topical areas
  - Rules on investment protection
  - Rules on market access
  - Rules aimed at serving the economic and social development dimension

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Bilateral investment treaties

- From the 1960s through the 1980s, a few advanced economies accounted for most of outward FDI. Developing economies received inward flows.
- BTIs were designed against this backdrop. *Investment protection* in developing economies was important for advanced economies.

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Bilateral investment treaties

- Since the 1980s/1990s, a growing number of emerging or developing economies have become the source of outward investment.
- In addition, emerging economies have become important markets for foreign firms.
- These developments made rules concerning *market access* important.

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Bilateral investment treaties

- At the same time, social and environmental concerns have become more important. What kind of social and environmental guidelines/rules should multinational corporations follow in their host countries?
- As a result, rules concerning social and environmental sustainability have become more important.

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