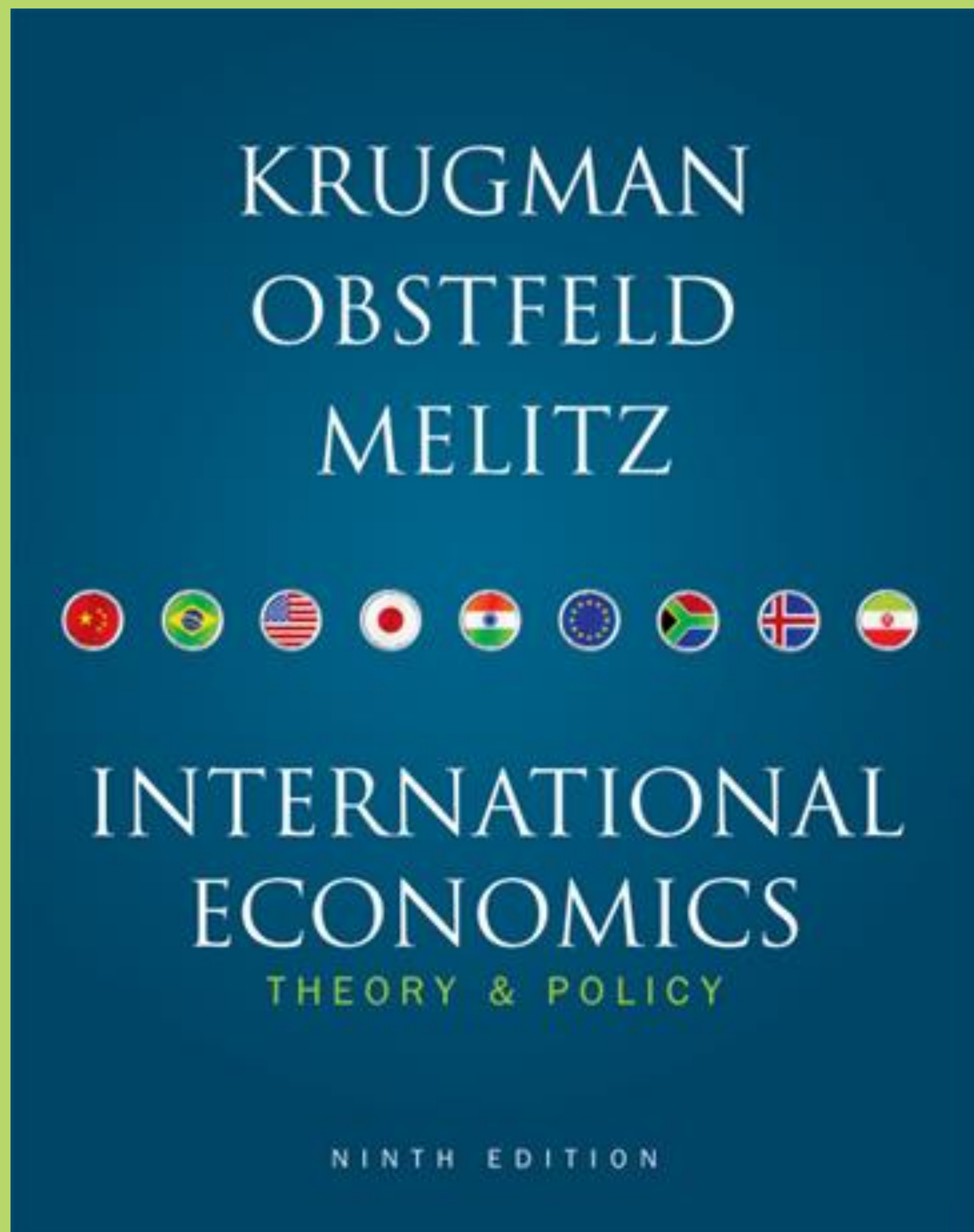
Chapter 12

Controversies in Trade Policy

(adapted by Guido Baldi)



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Arguments for an Activist Trade Policy

- An activist trade policy usually means government policies that actively support export industries through subsidies.
- Arguments for activist trade policies use an assumption of market failure.
  - Externalities or an appropriability problem
  - Imperfect competition that results in revenues that exceed all (opportunity) costs: "excess" profits.

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Technology and Externalities

- Firms that invest in new technology generally create knowledge that other firms can use without paying for it: an appropriability problem.
  - By investing in new technology, firms are creating an extra benefit for society that is easily used by others.
  - An appropriability problem is an example of an **externality**: benefits or costs that accrue to parties other than the one that generates it.
  - An externality implies that the marginal social benefit of investment is not represented by producer surplus.

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Technology and Externalities (cont.)

- Governments may want to actively encourage investment in technology when externalities in new technologies create a high marginal social benefit.
- Should a government subsidize high- technology industries?

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Technology and Externalities (cont.)

- Some argue that the United States or European countries should have a deliberate policy of promoting high-technology industries and helping them compete against foreign rivals.

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Imperfect Competition and Strategic Trade Policy

- Imperfectly competitive industries are typically dominated by a few firms that generate monopoly profits or **excess profits**.
  - Excess profits are revenues that exceed all opportunity costs: profits higher than what equally risky investments elsewhere in the economy earn.
- In an imperfectly competitive industry, government subsidies can shift excess profits from a foreign firm to a domestic firm.

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Imperfect Competition and Strategic Trade Policy (cont.)

- Example (called the Brander-Spencer analysis):
  - Two firms (Boeing and Airbus) compete in the international market but are located in two different countries (U.S. and EU).
  - Both firms manufacture airplanes, but each firm's profits depends on the actions of the other.
  - Each firm decides to produce or not depending on profit levels.

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Table 12-1: Two-Firm Competition

TABLE 12-1 Two-Firm Competition

Boeing \ Airbus	Produce	Don't produce
Produce	Boeing: –5, Airbus: –5	Boeing: 100, Airbus: 0
Don't produce	Boeing: 0, Airbus: 100	Boeing: 0, Airbus: 0

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Imperfect Competition and Strategic Trade Policy (cont.)

- The predicted outcome depends on which firms invest/produce first.
  - If Boeing produces first, then Airbus will not find it profitable to produce.
  - If Airbus produces first, then Boeing will not find it profitable to produce.
- But a subsidy by the European Union can alter the outcome by making it profitable for Airbus to produce *regardless of Boeing's action.*

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Table 12-2: Effects of a Subsidy to Airbus

TABLE 12-2 Effects of a Subsidy to Airbus

Boeing \ Airbus	Produce	Don't produce
Produce	Boeing: –5; Airbus: 20	Boeing: 100; Airbus: 0
Don't produce	Boeing: 0; Airbus: 125	Boeing: 0; Airbus: 0

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Imperfect Competition and Strategic Trade Policy (cont.)

- If Boeing expects that the European Union will subsidize Airbus, Boeing will be deterred from entering the industry.
  - Thus, the subsidy of 25 will generate profits of 125 for Airbus.
  - The subsidy raises profits more than the amount of the subsidy itself due to its deterrent effect on foreign competition.

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Imperfect Competition and Strategic Trade Policy (cont.)

- A government policy to give a domestic firm a strategic advantage in production is called a **strategic trade policy**.

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Imperfect Competition and Strategic Trade Policy (cont.)

- Criticisms of this analysis include:

1. Practical use of strategic trade policy requires more information about firms than is likely available.
   - The predictions from the simple example differ if the numbers are slightly different.
   - What if governments or economists are not exactly right when predicting the profits of firms?
     - For example, what if Boeing has a better technology that only it can recognize, so that even if Airbus produces, Boeing still finds it profitable to produce?

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Imperfect Competition and Strategic Trade Policy (cont.)

2. Foreign retaliation also could result:
   – If the European Union subsidizes Airbus, the U.S. could subsidize Boeing, which would deter neither firm from producing, start a trade war, and waste taxpayer funds.
3. Strategic trade policy, like any trade policy, could be manipulated by politically powerful groups.

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Trade policy and growth in emerging economies: Import-Substituting Industrialization

- Import-substituting industrialization was a trade policy adopted by many low- and middle-income countries before the 1980s.
- The policy aimed to encourage domestic industries by limiting competing imports.

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Import-Substituting Industrialization (cont.)

- The principal justification of this policy was/is the *infant industry argument:*
  - Countries may have a potential comparative advantage in some industries, but these industries cannot initially compete with well-established industries in other countries.
  - To allow these industries to establish themselves, governments should temporarily support them until they have grown strong enough to compete internationally.

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Problems with the Infant Industry Argument

1. It may be wasteful to support industries now that will have a comparative advantage in the future.
2. With protection, infant industries may never "grow up" or become competitive.
3. There is no justification for government intervention unless there is a market failure that prevents the private sector from investing in the infant industry.

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Infant Industries and Market Failures

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

1. Imperfect financial asset markets
   - Because of poorly working financial laws and markets (and more generally, a lack of property rights), firms cannot or do not save and borrow to invest sufficiently in their production processes.
   - If creating better functioning markets and enforcing laws is not feasible, then high tariffs would be a second-best policy to increase profits in new industries, leading to more rapid growth.

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Infant Industries and Market Failures (cont.)

2. The problem of appropriability
   - Firms may not be able to privately appropriate the benefits of their investment in new industries because those benefits are public goods.
   - The knowledge created when starting an industry may not be appropriable (may be a public good) because of a lack of property rights.
   - If establishing a system of property rights is not feasible, then high tariffs would be a second-best policy to encourage growth in new industries.

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Import-Substituting Industrialization (cont.)

- Import-substituting industrialization in Latin American countries worked to encourage manufacturing industries in the 1950s and 1960s.
- But economic development, not encouraging manufacturing, was the ultimate goal of the policy.
- Did import-substituting industrialization promote economic development?
  - No, countries adopting these policies grew more slowly than others.

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Import-Substituting Industrialization (cont.)

- It appeared that the infant industry argument was not as valid as some had initially believed.
- New industries did not become competitive despite or because of trade restrictions.
- Import-substitution industrialization involved costs and promoted wasteful use of resources:
  - It involved complex, time-consuming regulations.
  - It set high tariff rates for consumers, including firms that needed to buy imported inputs for their products.
  - It promoted inefficiently small industries.

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Trade Liberalization

- Some low- and middle-income countries that had relatively free trade had higher average economic growth than those that followed import substitution.
- By the mid-1980s, many governments had lost faith in import substitution and began to liberalize trade.
  - Dramatic fall in tariff rates in India and Brazil, and less drastic reductions in many other developing countries.

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Trade Liberalization (cont.)

- Trade liberalization in developing countries occurred along with a dramatic increase in the volume of trade.
  - The share of trade in GDP has tripled over 1970–1998, with most of the growth happening after 1985.
  - The share of manufactured goods in developing-country exports surged, coming to dominate the exports of the biggest developing economies.
- A number of developing countries have achieved extraordinary growth while becoming more, not less, open to trade.

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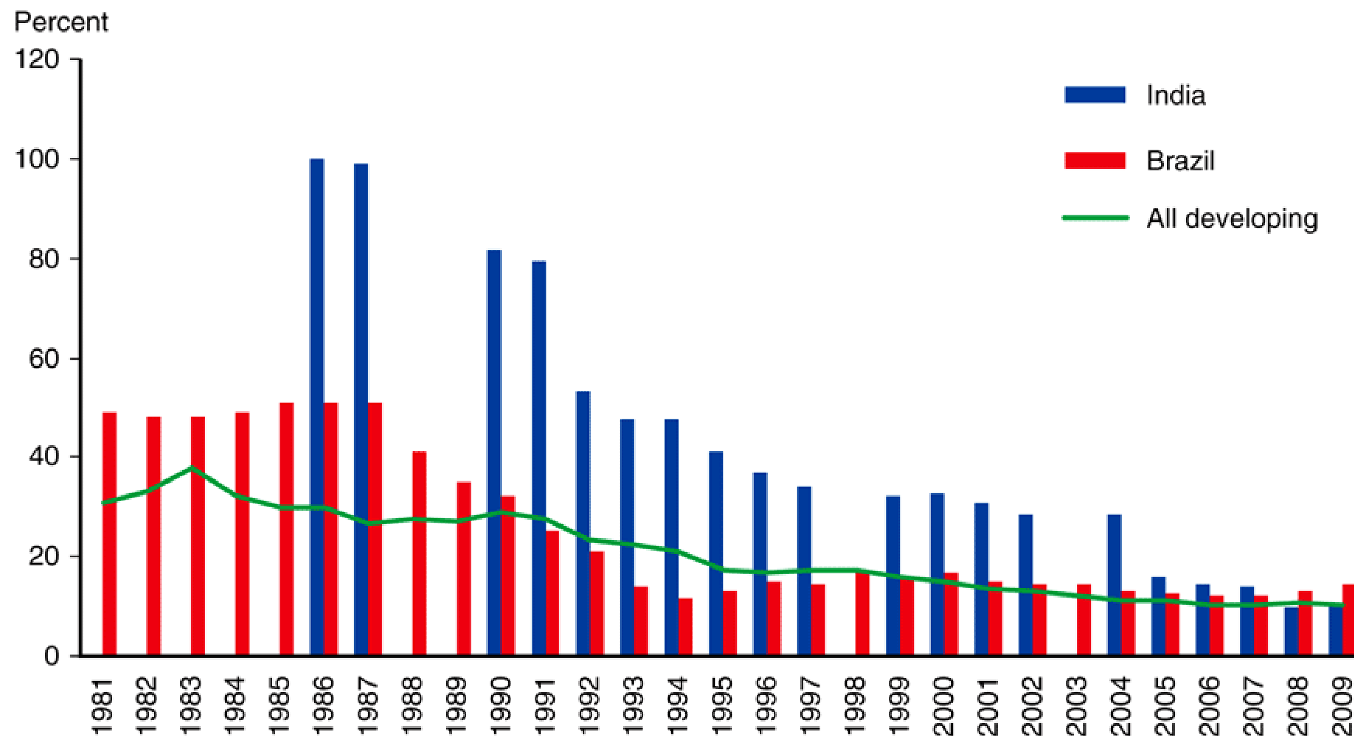
Fig. 11-1: Tariff Rates in Developing Countries



Source: World Bank.

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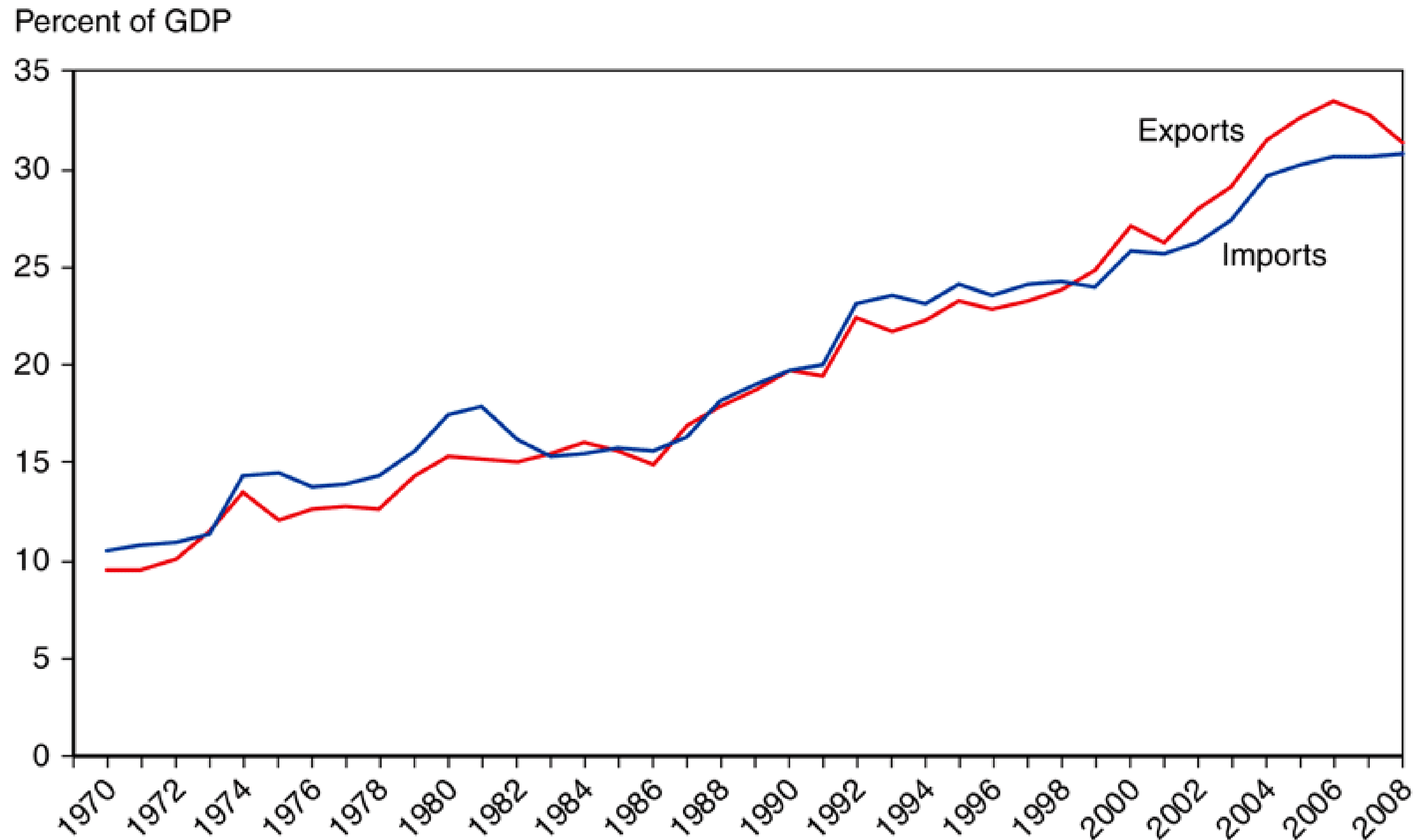
Fig. 11-2: The Growth of Developing-Country Trade



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Trade Liberalization (cont.)

- Has trade liberalization promoted development? The evidence is mixed.
  - Growth rates in Brazil and other Latin American countries have been slower since trade liberalization than they were during import-substituting industrialization.
    - But unstable macroeconomic policies and financial crises contributed to slower growth since the 1980s.

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Trade Liberalization (cont.)

- Other countries like India have grown rapidly since liberalizing trade in the 1980s, but it is unclear to what degree liberalized trade contributed to growth.
- Some economists also argue that trade liberalization has contributed to income inequality, as the Heckscher-Ohlin model predicts.

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Trade and Growth: Takeoff in Asia

- Instead of import substitution, several countries in East Asia adopted trade policies that promoted exports in targeted industries.
  - Japan, Hong Kong, Taiwan, South Korea, Singapore, Malaysia, Thailand, Indonesia, and China have experienced rapid growth in various export sectors and rapid economic growth in general.

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Trade and Growth: Takeoff in Asia (cont.)

- These high-performance Asian economies generated a high volume of exports and imports relative to total production.
- Their policy reforms were followed by a large increase in openness, as measured by their share of exports in GDP.
- So it is possible to develop through export-oriented growth.
- However, Latin American nations such as Mexico and Brazil, which also sharply liberalized trade and shifted toward exports, did not see comparable economic takeoffs.
- These Latin American results suggest that other factors must have played a crucial role in the Asian miracle.

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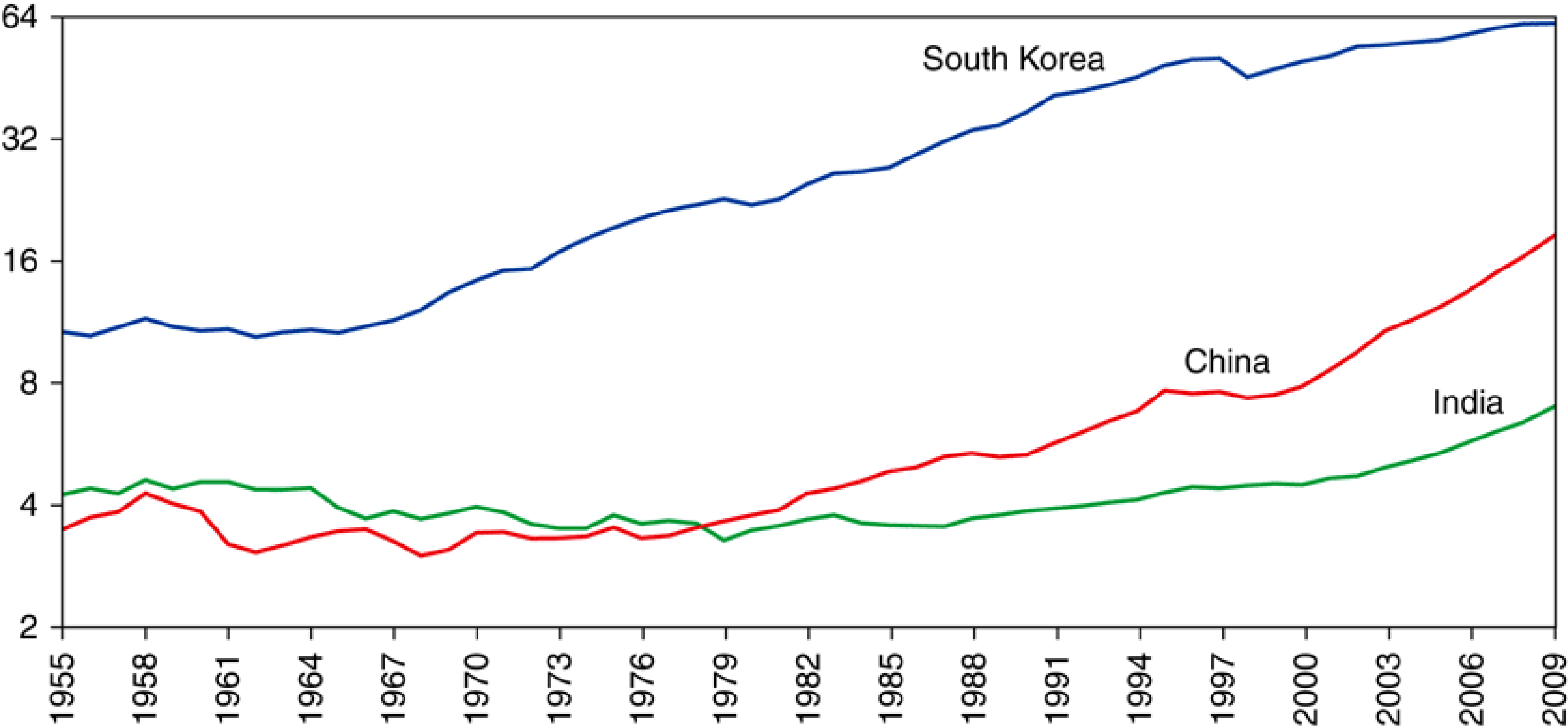
Fig. 11-3: The Asian Takeoff



Source: Total Economy Database.

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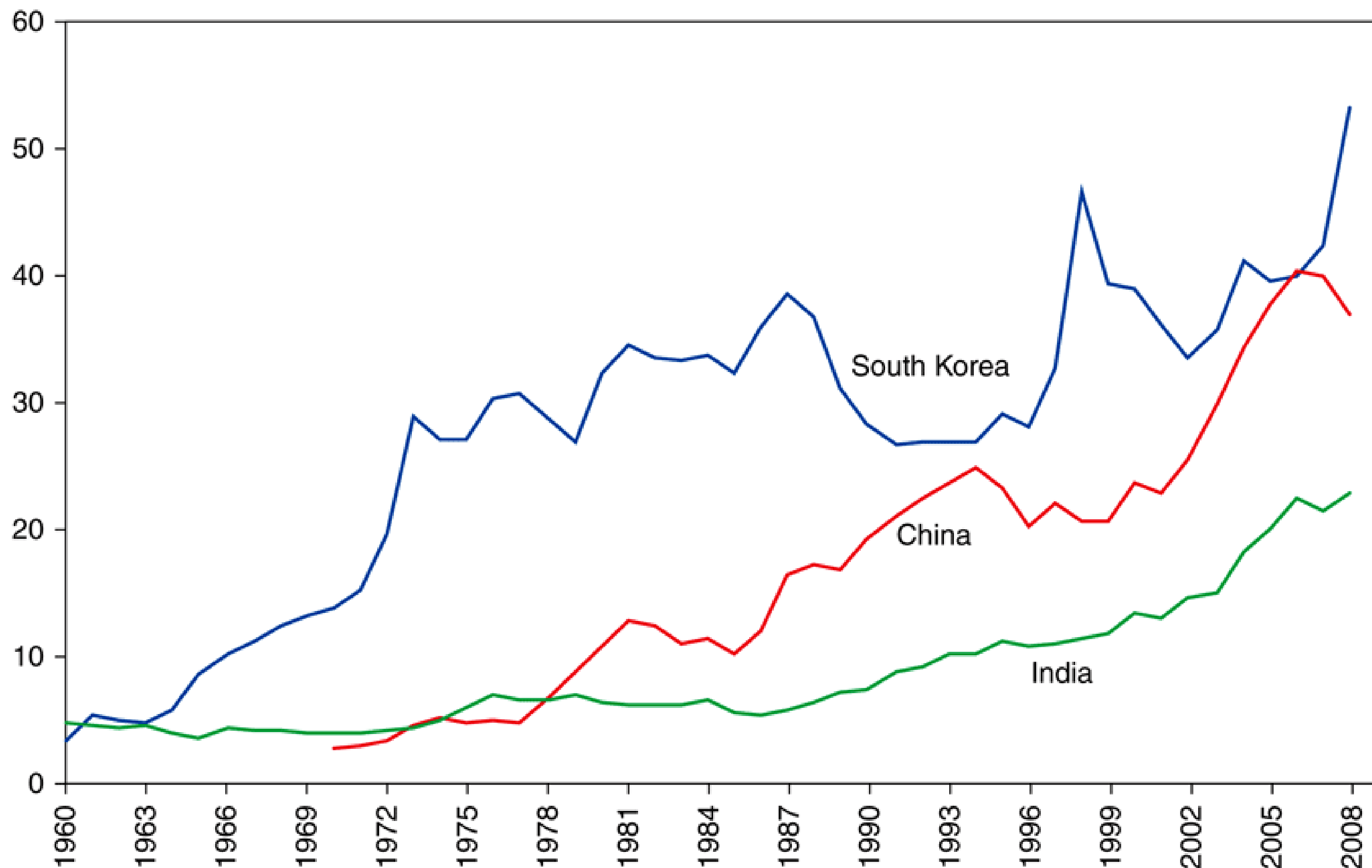
Fig. 11-4: Asia's Surging Trade



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Trade and Growth: Takeoff in Asia (cont.)

- It's unclear if the high volume of exports and imports *caused* rapid economic growth or was merely *correlated* with rapid economic growth.
  - High saving and investment rates could have led to both rapid economic growth in general and rapid economic growth in export sectors.
  - Rapid growth in education led to high literacy and numeracy rates important for a productive labor force.
  - These nations also undertook other economic reforms.

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