8. Political Economy of International Trade

Learning Objectives

- Become familiar important periods and episodes in the history of international trade.
- Become familiar with the institutional arrangements that currently govern international trade and finance.
- Review the broad categories of arguments against free trade / trade liberalization (in favor of protectionism).

Readings

Paul Krugman and Maruice Obstfeld, International Economics, Theory and Policy, 8th ed. (2009), chapter 9, "The Political Economy of Trade Policy".

Although you are not required to read the following, I draw some information from:

Jagdish Bhagwati, Free Trade Today (2002), lecture 1, "Confronting Conventional Threats to Free Trade: The Postwar Revolution in the Theory of Commercial Policy."

Outline

1. Brief history of the political economy of world trade

    a. "Pre-history":

        1) 1818: Ricardo's Principles and the notion of comparative advantage

        2) 1830s: "Corn law" debates in the U.K. demonstrate the benefits of unilateral adoption of free trade

        3) Late 1800s: Expansion of world trade, following England's lead

    b. 1900-1914: Culmination of a remarkable period of trade liberalization (including an amazing amount of labor migration).

    c. 1914-1920: World War I breaks down the international trading system.

    d. 1921-1930: Uneven recovery (robust in the U.S., less so elsewhere) only partially restores international trade to pre-war level.

    e. 1930-1945: The Great Depression and World War II seriously damage the international trading system

        1) Smoot Hawley tariff. The Smoot-Hawley Tariff Act of June 1930 raised U.S. tariffs to historically high levels. The original intention behind the legislation was to increase the protection afforded domestic farmers against foreign agricultural imports. Massive expansion in the agricultural production sector outside of Europe

during World War I led, with the postwar recovery of European producers, to massive agricultural overproduction during the 1920s. This in turn led to declining farm prices during the second half of the decade. During the 1928 election campaign, Republican Presidential candidate Herbert Hoover pledged to help the beleaguered farmer by, among other things, raising tariff levels on agricultural products. But once the tariff schedule revision process got started, it proved impossible to stop. Calls for increased protection flooded in from industrial sector special interest groups and soon a bill meant to provide relief for farmers became a means to raise tariffs in all sectors of the economy. When the dust had settled, Congress had agreed to tariff levels that exceeded the already high rates established by the 1922 Fordney-McCumber Act and represented among the most protectionist tariffs in U.S. history.

The Smoot-Hawley tariff represents the high-water mark of U.S. protectionism in the twentieth century. Thereafter, beginning with the 1934 Reciprocal Trade Agreements Act, American commercial policy generally emphasized trade liberalization over protectionism. The United States generally assumed the mantle of champion of freer international trade, as evidenced by its support for the General Agreement on Tariffs and Trade (GATT), the North American Free Trade Agreement (NAFTA), and the World Trade Organization (WTO). [From U.S. State Department, http://www.state.gov/r/pa/ho/time/id/17606.htm]

2) Retaliation

The Smoot-Hawley Tariff was more a consequence of the onset of the Great Depression than an initial cause. But while the tariff might not have caused the Depression, it certainly did not make it any better. It provoked a storm of foreign retaliatory measures and came to stand as a symbol of the ‘beggar-thy-neighbor’ policies (policies designed to improve one’s own lot at the expense of that of others) of the 1930s. Such policies contributed to a drastic decline in international trade. For example, U.S. imports from Europe declined from a 1929 high of $1,334 million to just $390 million in 1932, while U.S. exports to Europe fell from $2,341 million in 1929 to $784 million in 1932. Overall, world trade declined by some 66% between 1929 and 1934. More generally, Smoot-Hawley did nothing to foster trust and cooperation among nations in either the political or economic realm during a perilous era in international relations.

f. July 1944: Delegates from 44 nations gather at Bretton Woods, a small resort town in New Hampshire to deliberate upon and agree to a system of rules and international institutions for governing commercial and financial relations among the major industrial states. The Bretton Woods system regulated international trade and finance from the late 1940s until the early 1970s.

The chief features of the Bretton Woods system were, first, an obligation for each country to maintain its exchange rate within a fixed value—plus or minus one percent; and, secondly, the provision emergency international finance to bridge temporary payments imbalances. Key institutions included the International Monetary Fund (to provide financing to countries experiencing balance of payments imbalances) and the World Bank (to orchestrate development assistance).

A third key institution envisioned by some of the delegates – an international trade organization – did not become a reality until 1994, when the World Trade Organization came into existence. Between the late 1940s and 1994, the General Agreement on Tariffs and Trade (GATT) evolved through successive rounds to lower trade barriers and move slowly toward realization of the WTO.

In face of increasing strain, the system eventually collapsed in 1971, following the United States' suspension of convertibility from dollars to gold.

g. 1947 – 1994: GATT moved world trade back to pre-WWI prominence, while parallel bilateral and multilateral arrangements like NAFTA further facilitated trade liberalization.

1) Main constraints of GATT on domestic trade policy:

a) Forbade the use of export subsidies, except in the area of agricultural goods (an exception promoted by the U.S. and the EU)

b) Limited the use of import quotas to the case of domestic "market disruptions"

c) Limited the use of tariffs by requiring that new tariffs be offset by barrier reductions in other areas

2) Last phases of GATT focused on trade liberalization in agriculture and textiles, and the movement toward the creation of the WTO.

h. 1994 – present: Creation of the WTO and the anti-globalization backlash.

2. Current institutional governance of international trade and finance

a. *The International Monetary Fund* (IMF, 1945). From "A Global Institution: The IMF's Role at a Glance", http://www.imf.org/external/pubs/ft/exrp/what.htm#glance:

The IMF is a central institution of the international monetary system—the system of international payments and exchange rates among national currencies that enables business to take place between countries. It aims to prevent crises in the system by encouraging countries to adopt sound economic policies; it is also—as its name suggests—a fund that can be tapped by members needing temporary financing to address balance of payments problems. The IMF's statutory purposes include promoting the balanced expansion of world trade, the stability of exchange rates, the avoidance of competitive currency devaluations, and the orderly correction of a country's balance of payments problems. To serve these purposes, the IMF:

1) Monitors economic and financial developments and policies in member countries and at the global level, and provides policy advice to its members.

2) Lends to member countries with balance of payments problems.

3) Provides governments and central banks of its member countries with technical assistance.

b. *The World Bank* (1945). The "World Bank" is the name that has come to be used for the International Bank for Reconstruction and Development (IBRD) and the International Development Association (IDA). It is not a "bank" in the common sense. Instead, it is a specialized United Nations agency that provides low-interest loans, interest-free credit, and grants to developing countries, under the assumption that infrastructure, education, and healthcare are fundamental to economic growth. As one of the world's largest sources of development assistance, the World Bank supports the efforts of developing countries to build schools and health centers, provide water and electricity, fight disease, and protect the environment.

c. *The World Trade Organization* (WTO, 1994). The World Trade Organization (WTO) is the only global international organization dealing with the rules of trade between nations. Its predecessor organization, GATT, the General Agreement on Tariffs and Trade worked through various rounds of *multilateral negotiations* to reduce levels of protectionism around the globe. At its heart are the WTO agreements, negotiated and signed by the bulk of the world's trading nations and ratified in their parliaments. The goal is to help producers of goods and services, exporters, and importers conduct their business. An important part of its mission includes mechanisms for dispute resolution between countries so that retaliatory trade policies and trade wars do not disrupt the flow of goods and services among nations.

3. Political arguments in favor of free trade (K&O, 215), with some references to Bhagwati's commentary in <u>Free Trade Today</u>.

   a. The conventionally measured costs (efficiency losses) of deviating from free trade are large. See Bhagwati's discussion of rent-seeking activity, or what he calls *directly unproductive profit seeking* (31 – 41).

   b. There are other benefits from free trade that add to the costs of protectionist policies. Bhagwati alludes to this debate as follows:

   > …one may grow more ambitious and look for yet other good things in life that might follow from free trade. For instance, does free trade also promote democracy? (43)

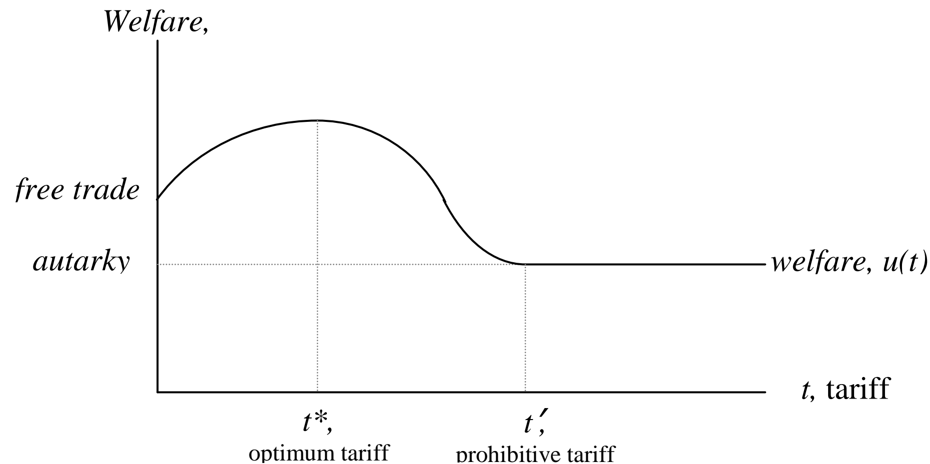
4. Interventionist arguments (supportive of protectionist measures)

   a. Terms of trade arguments (K&O list these under "National Welfare Arguments Against Free Trade," 218)

   Bhagwati (14 – 15) places this within the context of *international* monopoly power, by which he means that a *country* (not a firm) possesses monopoly power in international markets when its output decisions affect world prices. He traces this argument to Torrens (1844).

Figure 1 illustrates the general concept of a welfare-improving tariff. If a country is large enough to generate favorable terms of trade effects that more than offset the distortionary effects of the tariff (via creation of price incentives to alter consumption and production patterns from the free-trade optimum), then welfare as a function of the tariff rate will initially be increasing. Eventually, as higher tariff levels reduce the level of imports, the terms of trade effect shrinks, leaving only the distortions. Hence the function decreases. This pattern continues until the tariff becomes prohibitive and returns the economy to autarky, at which point only the distortionary losses (from the free trade optimum) remain. Hence, for a large country, the optimum tariff may be greater than 0.

Figure 1



b. Domestic market failure arguments – what Bhagwati calls the "conventional dissent from within" (Bhagwati, 11). Krugman and Obstfeld (219) cite two potential forms of market failure arguments – excess capacity due to factor immobility and technological spillovers.

   These arguments usually assume that there are spillover effects (positive externalities or additional social benefits) that are not captured in the traditional cost-benefit analysis of protection.

   Bhagwati's first lecture is an extended argument against intervention / diminution of free trade and rests on his two "propostitions" and a sweeping survey of traditional arguments.

   1) Bhagwati's "propositions":

      a) Proposition 1 (13): In the presence of market failure (distortion), free trade is not necessarily the best policy.

      b) Proposition 2 (28): Where the distortion is domestic, a domestic policy targeting it will be appropriate; where the distortion is external, free trade must be departed from.

   2) Some specific other arguments (mentioned by Bhagwati in his first lecture) that combine one or more of the preceding:

a) Infant industry arguments (15)

b) "Keynesian" diversion of aggregate demand from foreign to domestic goods (17)

c) Imperfect competition and the divergence of market prices from social costs (18)

d) Economic dualism in developing economies (21)

c. Distributional arguments

1) Internal distribution of income

2) External (world) distribution of income

5. Preferential Trading Agreements (Bhagwati's "spaghetti bowl" of international trade)

a. Free trade areas, customs unions, etc.

b. Trade creation vs. trade diversion

6. Can protectionism resolve a current account deficit? At least four problems:

a. The welfare losses from production and consumption distortions.

b. The terms of trade effect. For a large country, protectionism increases terms of trade, thereby *increasing* pressure on a trade deficit, not decreasing it.

c. The exchange rate effect. To the degree it is successful, protectionism will increase the relative demand for its own currency (as it demands less of the rest of the world's currency. A strengthening currency will increase the tendency toward deficit, not reduce it. (This is just another version of point b.)

d. The argument that protectionism can resolve a current account deficit ignores the possibility of retaliation.