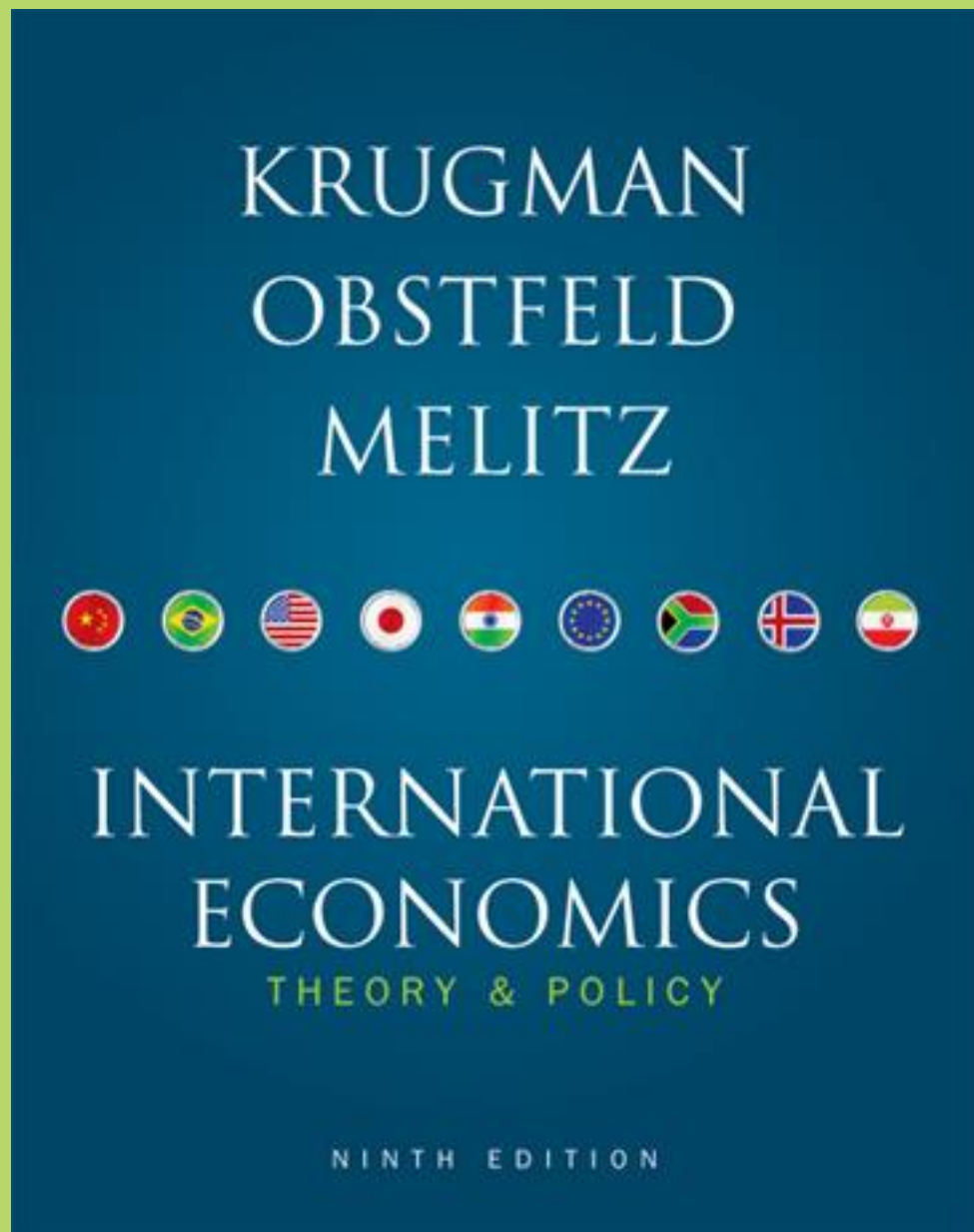


Chapter 12

Controversies in Trade Policy

(adapted by
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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.

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.

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?

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.

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.

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.

Table 12-1: Two-Firm Competition

TABLE 12-1 Two-Firm Competition

		Airbus	
		Produce	Don't produce
Boeing	Produce	-5 / -5	100 / 0
	Don't produce	0 / 100	0 / 0

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*.

Table 12-2: Effects of a Subsidy to Airbus

		Effects of a Subsidy to Airbus	
		Produce	Don't produce
Boeing	Produce		
	Don't produce		

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.

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**.

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?

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.

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.

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.

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.

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.

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.

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.

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.

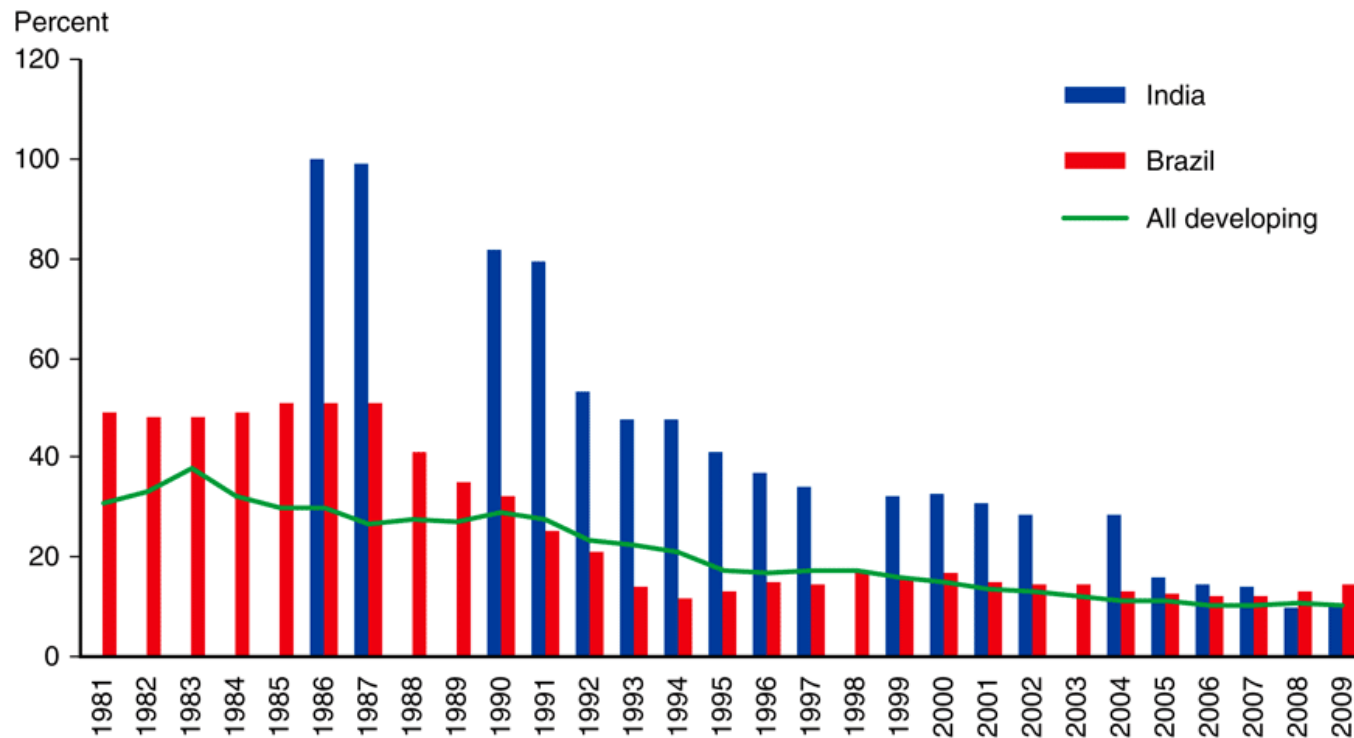
Trade Liberalization

- 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.

Trade Liberalization (cont.)

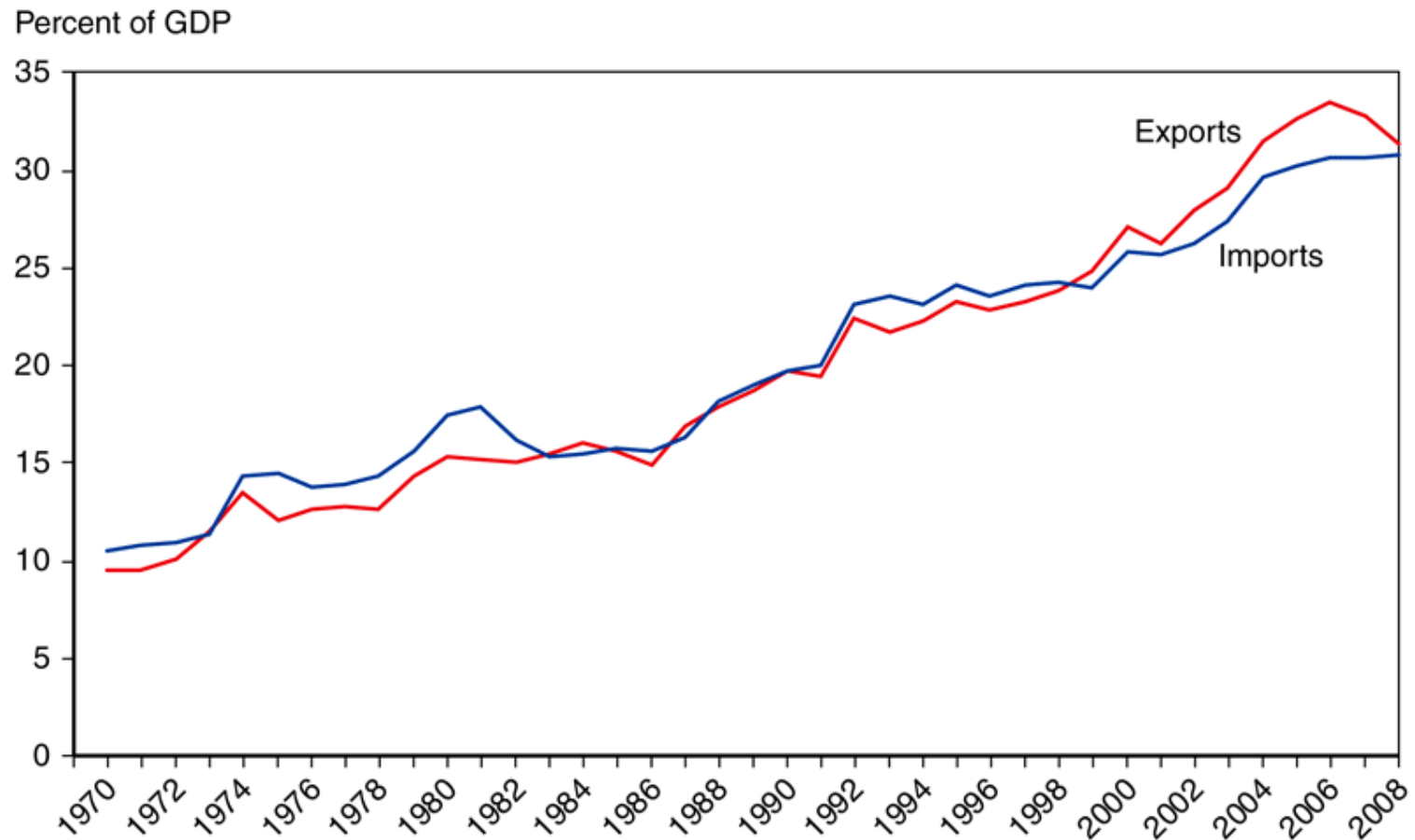
- Trade liberalization in developing countries occurred along with a dramatic increase in the volume of trade.
 - The share of trade in GDP has tripled over 1970–1998, with most of the growth happening after 1985.
 - The share of manufactured goods in developing-country exports surged, coming to dominate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

Fig. 11-1: Tariff Rates in Developing Countries



Source: World Bank.

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



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.

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.

Trade and Growth: Takeoff in Asia

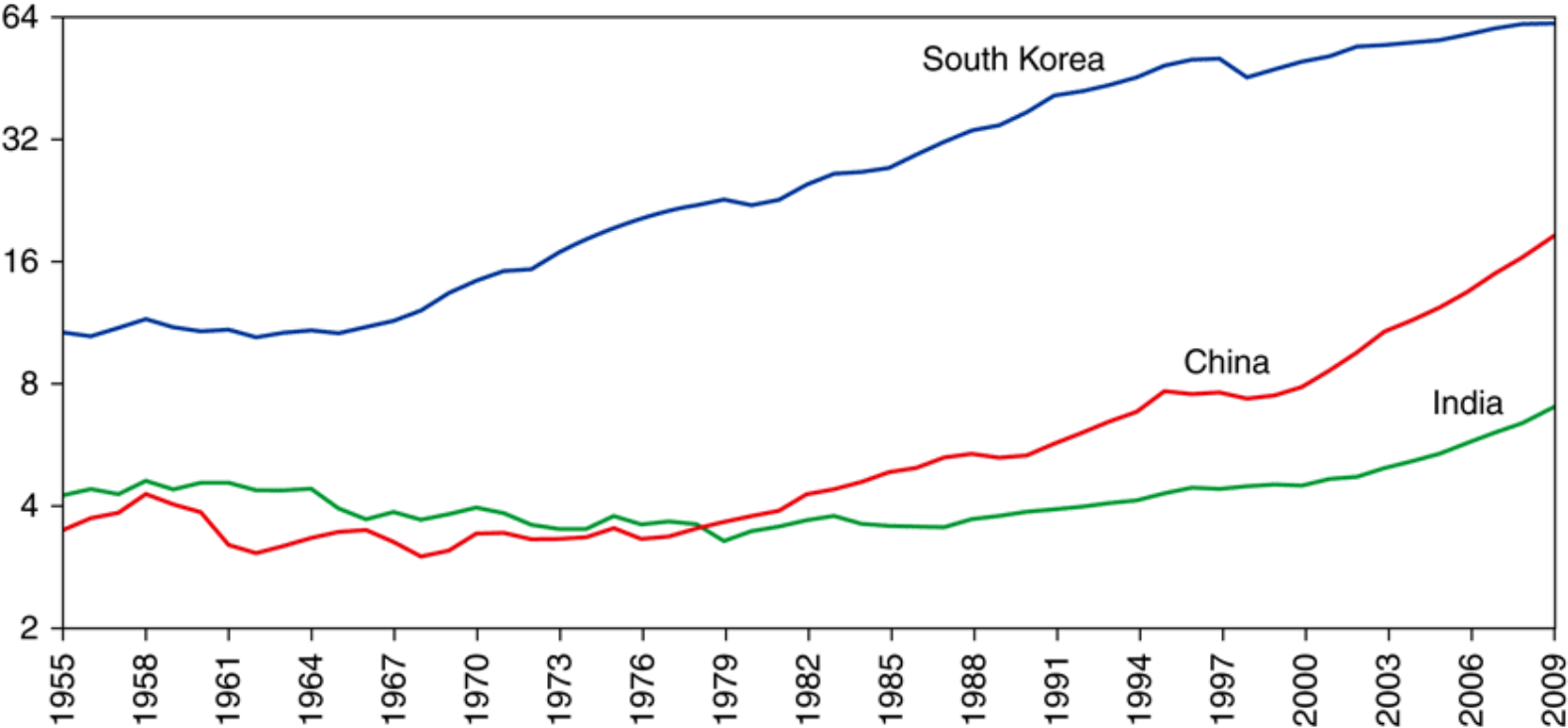
- Instead of import substitution, several countries in East Asia adopted trade policies that promoted exports in targeted industries.
 - Japan, Hong Kong, Taiwan, South Korea, Singapore, Malaysia, Thailand, Indonesia, and China have experienced rapid growth in various export sectors and rapid economic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

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.

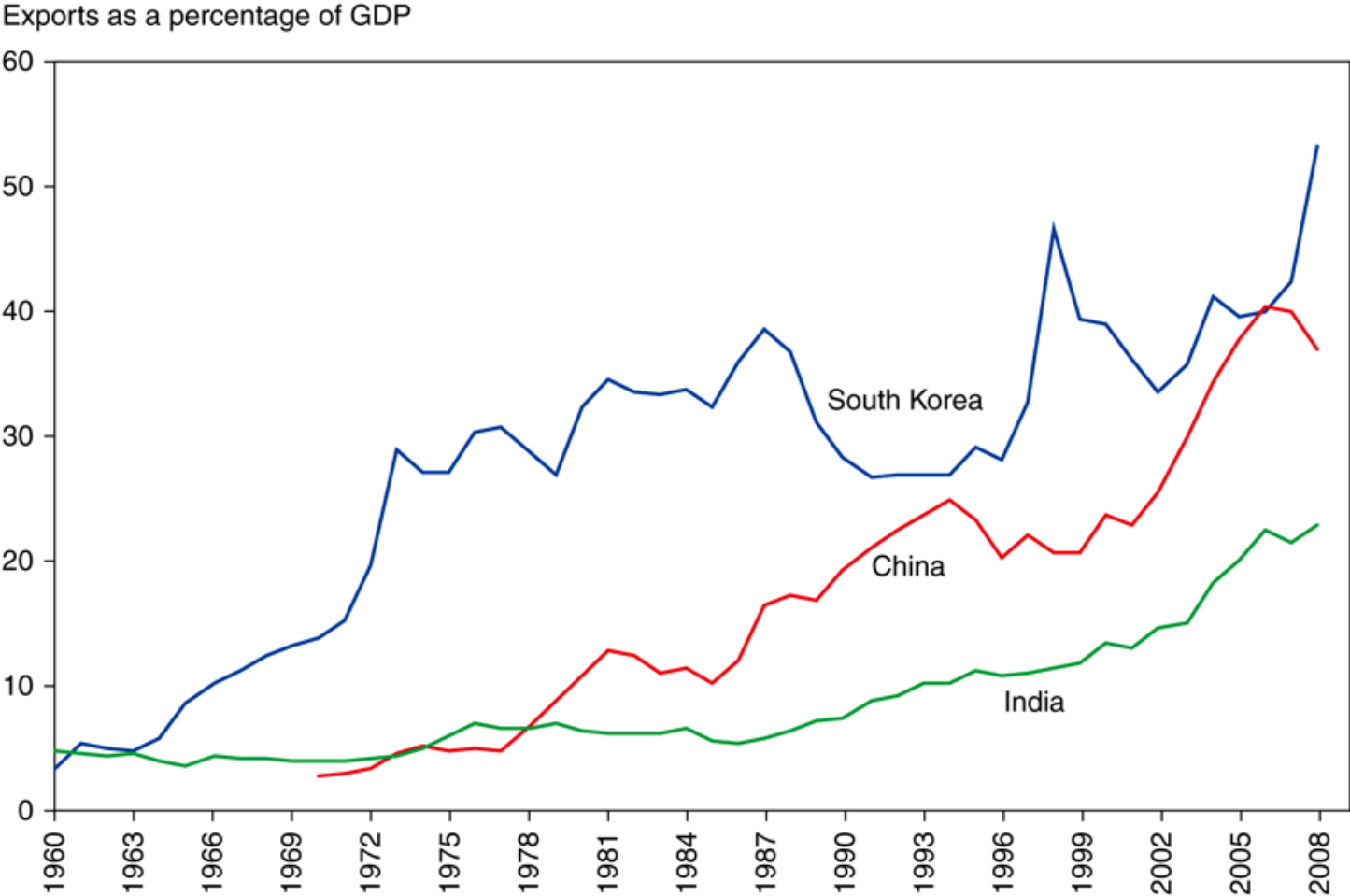
Fig. 11-3: The Asian Takeoff

GDP per capita as % of U.S. level



Source: Total Economy Database.

Fig. 11-4: Asia's Surging Trade



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.