

TRADE POLICY

Lecture 1

Introduction

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Who am I?



Ari Kokko

- “Nordic”
- Graduated from Stockholm School of Economics in 1992
- Professor at Abo Akademi 1999-2001, SSE 2000-2010, CBS 2009-
- Core research areas: International trade, FDI, development, IB
- Worked extensively in Southeast Asia (Vietnam), Japan, and China
- Outside academia: assignments for Sida, Swedish MoF, Vietnamese ministries, H&M, SAAB, etc.
- Recent paper: “Who Uses the EU’s Free Trade Agreements? A Transaction-Level Analysis of the EU–South Korea FTA” World Trade Review, 2021 (with J. Kasteng and P. Tingvall)

Agenda for today

- Why do we bother about the international economy?
- Effects of globalization and internationalization
- The coming week: learning objectives and schedule
- Trade theory and trade policy: the neoclassical view

Why bother?

- To get goods that are not available at home
- To get goods that are cheaper abroad than at home
- To earn money
- To benefit from scale economies
- To grow faster
- To access foreign resources

Why bother?

- To get goods that are not available at home. Salt
- To get goods that are cheaper abroad than at home. English cloth
- To earn money. *Or gold – mercantilism*
- To benefit from scale economies. Lower cost, competitiveness, import capacity
- To grow faster. Dynamic effects: competition, R&D, technology transfer
- To access foreign resources. *FDI*

Different theories, policies, and strategies depending on motives

What is globalization?

Features of a globalized world:

Features of a globalized world:

- Improved communications
- Free trade
- Convertible currencies and capital mobility
- Multinational companies
- Technology flows
- Export growth

Globalization at the turn of the century (around 1900)

- Improved communications
 - Steam engine, telegraph, telephone
- Free trade
- Convertible currencies and capital mobility
 - Gold standard
- Multinational corporations
 - Many of today's giants
- Technology flows
 - World Fairs
- Export growth
 - Agricultural commodities, manufacturing

Globalization at the turn of the century (around 2000)

- Improved global communications
 - ICT: telecom and internet
- Free trade
 - WTO and regional integration
- Convertible currencies and capital mobility
 - Even Monetary Unions
- Multinational corporations
 - Even relatively small firms go MNC
- Technology flows
 - Science and education
- Exports essential

Differences between then and now

- Value chains can be fragmented
 - Global production systems and deeper specialization within multinational firms
- Services are part of the global economy
 - And increasingly important both for trade and FDI
- Global markets
 - Global competition in most industries
- Global environmental problems
- Global consumers
 - Pressure for ethical behavior

Effects of globalization: countries

- Restructuring
 - Fast technical change, specialization, division of labor
- Enormous opportunities
 - High return on good policy: growth can be boosted by inflows of foreign capital and technology
- Substantial threats
 - Hard punishments for bad policy: even domestic firms may move out
- Is the state becoming more important even as the market takes center stage?
 - Free trade, capital mobility, and harmonization mean that remaining policy differences become more significant

Challenges for political decision makers

- Need to adjust rules and institutions
- New instruments of policy making becoming more important
 - Diminishing role for trade policy and foreign exchange policy?
 - Industrial policy more important: standards, taxes, labor market, education, environment, health
 - Paradox: the local business environment becomes more important when the world is becoming more globalized

Effects of globalization: firms

- Opportunities
 - Unlimited market
 - Access to cheaper factors of production
- Threats
 - Competition from all the best
 - Butterflies in Beijing

Challenges for firms

- How to handle the international business dimension
 - Market selection and market entry: what countries should we target and how?
 - Business operations: just like at home, or...?
 - Institutions: how to handle formal and informal rules and regulations
 - Competitors: both at home and abroad
 - Risks: economic as well as political
 - Remaining obstacles: transportation cost

The coming week

- Eight lectures
 - Introduction
 - Trade policy in the neoclassical world
 - "New" trade theory
 - Regional integration and bilateral trade agreements
 - New themes: firm level trade
 - Factor mobility and foreign direct investment
 - International competitiveness
 - Industrial upgrading: the Swedish model

Trade Theory 1: agenda

- Classical trade theories
 - Main conclusion: every country gains if autarky price ratios are not identical
- Neoclassical theory
 - The Heckscher-Ohlin model
- Policy consequences
 - Institutions for global trade

Gains from trade: the simple view

- Classical models of trade
 - Adam Smith 1776: absolute advantage and specialization
 - David Ricardo 1815: comparative advantage and specialization
- Clear gains from trade if countries are strong in different areas: *absolute advantages*
- Less obvious - but undisputed - gains from trade even if one country is “better” in all areas: *comparative advantages*

Simplest classical models

- Assumptions
 - Two countries, two products
 - Labor is the only factor of production
 - Countries have different technologies: the labor requirements for producing one unit of output differ between the two countries
 - No money, only relative prices

(constant returns to scale, no transport costs, no policy distortions + other simplifications)

Absolute advantages

	Wine	Cloth
England	20	10
Portugal	10	20

Labor requirements for one unit of output

Absolute advantages

- Relative price for cloth in England: 0.5 wine
 - Relative price for cloth in Portugal: 2 wine
- => Trade is beneficial if England specializes in cloth production while Portugal focuses on wine, and the two countries trade cloth for wine in the international market

Trade is interesting for both countries if the international price ratio lies between the autarky prices

$$0.5 \text{ wine} < 1 \text{ cloth} < 2 \text{ wine}$$

Comparative advantages

	Wine	Cloth
England	20	30
Portugal	10	20

Labor requirements for one unit of output

Comparative advantages

- Relative price for cloth in England: 1.5 wine
 - Relative price for cloth in Portugal: 2 wine
- ⇒ Trade is beneficial if England specializes in cloth production while Portugal focuses on wine, and the two countries trade in the international market

Trade is interesting for both countries if the international price ratio is

$$1.5 \text{ wine} < \text{cloth} < 2 \text{ wine}$$

$$(0.5 \text{ cloth} < \text{wine} < 0.67 \text{ cloth})$$

Comparative advantages

- Trade is attractive as soon as the relative prices in the two countries are not identical
 - Differences drive trade
- Basic rule of international trade: specialize in activity with comparative advantages (i.e. sector with lower opportunity cost than in partner country)
- But the models say little about how the gains from trade are shared. Does England or Portugal gain more? And what will English wine producers think about international trade?

Problem

- We showed that trade can be attractive for the individual if prices differ. But is it good for national income and wealth?
- Assume that each country has 1000 units of labor, with half used for wine production and half for cloth production in autarky. Technologies are given by the coefficients in the previous examples. Then there is a possibility to specialize and trade. Show that there are gains from trade both with absolute advantages and with comparative advantages.

Neoclassical models

- In classical models, price differences are related to differences in technology. But are technology differences the only reasons for trade?
- By the late 19th century, modern technology had started to diffuse: improved communications and conscious technology transfer projects –World Fairs – led to the dissemination of knowledge across the globe.
- With converging technology levels, new trade models were needed. The *Heckscher-Ohlin model*, formulated in the 1920s, provided an alternative explanation.

The Heckscher-Ohlin model

- Two countries, two goods, two production factors (labor and capital)
- No technology differences between countries
- Differences between industries: technologies can be relatively capital intensive or labor intensive
- Differences between countries: countries can be relatively capital rich or labor rich

The Heckscher-Ohlin model

- Relatively labor rich countries will have relatively cheap labor, which gives comparative advantages in industries with labor intensive technologies
- Useful general equilibrium model: shows correspondence between factor endowments, factor prices, goods prices, and trade
- Assumptions: constant returns to scale, no transport costs, no government intervention, no differences in demand

Policy conclusions from classical and neo-classical models...

- All countries can benefit from international trade
- More trade means more benefits: free trade is better than protectionism
- ...but it's hard for a country to engage in unilateral trade liberalization
- Need to establish mechanisms for multilateral trade liberalization: ITO, GATT, WTO

...and policy conclusions from history

- First golden age of internationalization (1870-1914) replaced by protectionism during interwar period (1920-1939)
 - Did isolationism contribute to WW2?
- Need to establish more open international environment after WW2
 - Avoid mistakes from interwar period
 - International trade needed for European recovery

International architecture after WW2

(Bretton-Woods institutions)

- IBRD
 - To reconstruct war-torn countries
- IMF
 - To create currency convertibility and financial stability
- ITO
 - To set the rules for global free trade
- Commodity Fund
 - To stabilize prices for important commodities