

TRADE POLICY

Lecture 3

“New” trade theory and policy

Fulbright School of Public Policy and Management
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Ari Kokko

Copenhagen Business School

Previous lectures

- Trade Theory 1: Classical and neoclassical trade models
 - Comparative advantage
 - Differences in technology, factor endowments, factor intensities
- Policy conclusions
 - ITO, GATT, WTO

Results of the Uruguay Round

- World Trade Organization
- Further tariff reductions
- Agriculture
- Textiles and Clothing
- Services
- TRIPS and TRIMS
- Dispute resolution

After Uruguay

- Biannual ministerial meetings
 - Seattle 1999: meeting stopped by antiglobalization protests
 - Doha 2001: development agenda
 - Cancun 2003: failure to reach agreement
 - Hong Kong 2005: hmmm....
 - Geneva 2009: more hmmm...
 - Geneva Dec 2011: still not much...
 - Bali Dec 2013: finally! Bali Package
 - Nairobi Dec 2015: Nairobi package
 - Buenos Aires Dec 2017: not much
 - Geneva June 2022: still not much

But why are there som many other trade institutions?

- OPEC, other commodity agreements
- UNCTAD, UN regional commissions: ECE, ESCAP, ECLAC, ECA, ECWA
- Regional integration agreements: ECSC, EEC, EC, EU, EFTA, EEA, Euro-Mahgreb, Visegrad, US-Canada Auto Pact, CUSFTA, NAFTA, LAFTA, CACM, Andean Pact, CARICOM, LAIA, MERCOSUR, G3, COMECON, CBI, EAC, CEMAC, COMESA, IOC, SADC, SACU, UEMOA, WAEMU, CEAO, ECOWAS, PTA, UDEAC, CEPGL, ACM, ECO, GCC, ASEAN, AFTA, APEC, and many more
- Bilateral trade agreements (US with lots of countries, EU with lots of countries, Japan with lots of countries)

Today: "New" trade theory (Trade Theory 2)

- Problems with neoclassical theory
 - Assumptions
 - Predictions
- Modern trade theory
 - Economies of scale
- Policy consequences from modern trade theory
- Regional integration

Problems with neoclassical theory

- Some of the assumptions in the H-O model are not realistic
 - the world does not have perfect competition, identical preferences, constant returns to scale
- Empirical findings have contradicted the predictions of the H-O model
 - lots of trade between similar countries, large amounts of intra-industry trade (exports and imports of the same goods)

“New” trade theory

- Relaxes central assumptions of H-O theory
 - identical preferences
 - economies of scale and perfect competition
 - externalities
- No consistent theory yet, but important building blocks
 - The Linder-hypothesis: demand matters
 - Models with economies of scale
 - Strategic trade policy
 - Reciprocal dumping

The Linder Model

- Staffan B. Linder (1961), *An Essay on Trade and Transformation*
 - Demand – not only supply – will determine trade patterns
 - Domestic demand determines what product varieties a country manufactures
 - These varieties can mainly be sold in countries with similar demand
 - Hard to measure demand: preferences have therefore been proxied with income levels
 - Prediction: lots of trade between countries at similar income levels

Economies of scale and competitive strategies

- Not easy to compete head-on with bigger companies from bigger countries
- Alternative 1. Product differentiation
 - Create a product that is a little bit different, and that can be priced a little bit higher than the incumbent
 - Result: specialization, intra-industry trade
 - Consequences for policy?

Economies of scale and competitive strategies

- Alternative 2. Make sure that the firm grows large as soon as possible
 - government intervention: strategic trade policy
 - export subsidization or infant industry protection
 - Boeing vs Airbus
- Also applied when all industries are not of equal value
 - some industries may have *strategic value* because of better growth potential or positive externalities
 - the first location of an emerging industry may determine future production patterns: path dependency and cluster development

Consequences for economic policy

- Temptation to be strategic
 - Free trade and WTO may be good for *potato chips*...
 - ...but other solutions look tempting for *micro chips*
- Problems with strategic trade policy
 - Hard to identify industries with strategic value: How do you pick the winners?
 - Not WTO consistent: others will complain or retaliate

Economies of scale and competitive strategies

- Difficulties in implementing strategic trade policy have led to:
- Alternative 3. Become a big country
 - Free trade agreements and regional integration can create a big home market
 - EC White Paper on the Common Market: regional integration will allow European firms to grow as large as US and Japanese firms

Regional integration

- Big difference between *old* and *new* integration
 - *Old* integration is based on neoclassical trade theory. Small gains from simple agreements.
 - *New* integration is based on modern trade theory. Economies of scale create big effects, but agreements become more complex

Regional integration and competition

- A larger home market means tougher competition and structural change
- The number of firms will diminish, but those that survive – the regional champions – will be larger
- Politically sensitive process: who will get the regional champions, and who will lose?
- Need to create *level playing field*
- More on regional integration next time