TRADE POLICY

Lecture 2
Trade policy in the neoclassical world

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Today's agenda:
From trade theory to trade policy

- Classical trade theories
  - The theory of comparative advantage
  - Technology differences as drivers of trade
- Neoclassical theory
  - The Heckscher-Ohlin model
  - Different endowments as drivers of trade
- Policy consequences
  - Institutions for global trade

Comparative advantages

- Trade is attractive as soon as the relative prices in the two countries are not identical
  - Differences in ”technology” explain differences in relative prices
- Basic rule of international trade: specialize in the activity with comparative advantages
  - Exports from the sector with lower relative prices (lower opportunity cost)

Limitations?

- Classical trade theory says that everyone will gain from international trade.
- But why is not everyone interested in taking part in international trade?

Limitations

- How are the gains from trade are shared? Does England or Portugal gain more?
- Specific interest driving policy. What will English wine producers think about international trade? What if the King of England is the main wine producer in England?
- Fixed factors of production. What if some Portuguese farmers are unable to learn wine production technology?

- Plus restrictive theoretical assumptions

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 neoclassical models…

- All countries can benefit from 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

International Trade Organization

- 1947: GATT signed by 23 countries
- 1948: ITO established in Havana. Agreement signed by 53 members
- 1950: US Congress refused to ratify ITO Charter. Led to collapse of ITO…
- …but continued GATT negotiations

GATT –
General Agreement on Tariffs and Trade

- Provisional arrangement after ITO collapse. No permanent institutional base until establishment of WTO in 1995
- Voluntary contract (around 30 articles) between 100++ states on the rules of international trade
- Strengths: yes. Tariff reductions
- Weaknesses: yes. No sanctions

GATT functions

- To define mutually accepted ***rules of conduct*** for international trade
- To provide a ***forum for trade negotiations*** in order to liberalize world trade
- To act as an international court for ***dispute settlement***

GATT principles

- Non-discrimination and MFN
- Transparent protection: tariffs
- Gradual tariff reductions
- Reciprocity

=Fair Trade

Exceptions from GATT principles

- Safeguards and waivers
  - Right to introduce temporary trade restrictions in certain situations
- Developing countries
  - Special treatment
- Regional integration
  - Article XXIV

GATT developments

1947	GATT established, 23 countries
1949-61	Bilateral tariff negotiation rounds, few participants
(1955	*US withdraws agriculture)*
1964-67	Kennedy round, linear tariff reductions (~35%). 62 participants
1973-79	Tokyo round, tariff reductions (~33%), NTBs, 102 participants
(1974	*Textiles and clothing drop out: MFA)*
1986-94	Uruguay round, tariff cuts (~33%), agriculture, services, WTO, 116 participants

GATT results before Uruguay

- Average developed country tariffs for industrial products down from over 80% to ~ 5%
  - Politically sensitive liberalization easier to motivate in a package that also contains benefits – reciprocity important
- Higher average tariffs in developing countries
  - Special treatment

GATT results before Uruguay

- Weak results for textiles, garments and agriculture until Uruguay round
  - Limited role for developing countries to push their agenda
- No agreements on service trade
- Weak dispute settlement mechanism
  - Need for consensus in GATT council
  - = no risk of retaliation

Results of the Uruguay Round

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

Tariff reductions

- Developed country tariffs reduced by a third, to about 3%
- Tariff binding - national lists to include almost all products

- Eliminated tariffs
  - Pharmaceuticals
  - Paper
  - Steel
  - Construction machinery
  - Agricultural machinery
  - Medical equipment
  - Furniture
  - Toys
  - Beer & brown alcohol

Agriculture

- Tariffization of protection in agricultural sector
- Tariff reductions
  - 36% average reduction in first round
- Market access guarantees
  - Imports to cover at least 3% of domestic consumption
- Reductions in public subsidies
  - Cuts by 20-36 % of subsidy levels

- … but agricultural protection remains the main obstacle for further free trade. Why?

Textiles and clothing

- Phasing out of MFA by 2005
- Liberalization of remaining quotas during transition process

- But what happened when quota liberalization started?

GATS – General Agreement on Trade in Services

- Framework of GATT-related rules
  - National treatment, MFN, transparency, progressive liberalization, disputes
- Annexes with rules for specific sectors
- National schedules
  - Liberalization commitments
  - Exceptions from GATS principles
- Successfully completed negotiations on telecom and finance after Uruguay round

TRIPS and TRIMS

- Protection of trade-related intellectual property (TRIPS) - copyrights, trade marks, patents
- Trade-related investment measures (TRIMS) included under GATT rules
  - Prohibitions for investment rules that distort trade patterns, e.g. local content requirements

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: hmmmm….
  - Geneva 2009: more hmmmm...
  - Geneva Dec 2011: still not much...
  - Bali Dec 2013: finally! Bali Package. Or…?
  - Nairobi Dec 2015: Nairobi package
  - Buenos Aires Dec 2017: not much
  - Geneva June 2022: still not much

Doha Development Agenda
(initiated 2001)

- Agriculture and services
  - Implementation of Uruguay round decisions + further tariff reductions
- Development perspective
  - Particular concern for interests of developing countries, e.g TRIPS in pharmaceuticals
- Working groups for tough questions
  - environment
  - competition policy
  - investment rules
  - social issues

Bali Package (2013)

- Trade facilitation
  - Simplification and transparency
  - Aggregate benefits: 1 trillion per year, 21 million jobs
- Agriculture
  - Reduced export subsidies
  - Food security
  - Cotton
- Development
  - Increased market access for developing countries: both goods and services
  - Simplified rules of origin

Nairobi Package (2015)

- Reduced ***export subsidies*** in agriculture
- Stronger market access and level playing field in ***cotton*** for least developed countries
- Simpllified ***rules-of-origin*** for Least Developed Countries
- Preferential ***market access*** in services for Least Developed Countries

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, EVFTA, ASEAN, AFTA, APEC, CPTPP, and many more