TRADE POLICY (PART 2)

EE 462 Development Macroeconomics

Semester 1/2014

Trade Strategy and Industrial Policy (1)

- Industrial policy – a broad set of interventions (such as undervalued exchange rates and EPZs) which governments may use to favor one set of economic activities over another.
- Rodrik and others see industrial policy as a part of a developing nation's trade policy.
  - The government's role beyond traditional areas (ensure macro stability & provide public goods).
  - Government needs to facilitate the structural change inherent in the development process.

Trade Strategy and Industrial Policy (2)

- Rodrik suggests that the problem in moving away from traditional production is one of "self-discovery" (i.e. what particular product should entrepreneurs produce).
  - Governments need to intervene to *encourage the process of self-discovery.*
- Question: why can't we leave the self-discovery up to individual entrepreneur?
  - Think about *public good* problem
- Other economists argue for partnership between the public and the private sectors in resoling the constraints facing entry into the new markets.

TRADE, GROWTH, AND POVERTY REDUCTION

Trade and Growth (1)

- Trade and growth can have bi-directional relationship.
  - Trade could generate economic growth and reducing poverty.
  - Income and productivity growth can make a country more competitive in world markets.
- In the paper "Does Trade Cause Growth?," Frankel and Romer study this relationship by using the portion of trade due to geographic characteristics (which are weakly correlated with determinants of growth).
  - This geographical component of trade has a large and positive effect on income.
  - Supports the direction of causality running from trade to growth, but the results are not highly statistically significant.

Trade and Growth (2)

- One issue is that Frankel and Romer use **trade volumes** (the ratio of X+M to GDP) as their measure of trade.
- But trade volumes are not the same as trade policies (e.g. reducing tariffs, managing exchange rate, etc.).
  - ➢Trade volumes are consequence of trade policies and other policies.
- Harrison and Rodriguez-Clare find **<u>no</u>** significant relationship between lower tariff levels on final goods and country performance.
  - So, does this mean that trade liberalization is not a good idea?
  - In practice, different countries have different policy mix, so it’s hard to identify what steps of trade liberalization each country should take.

Trade and Growth (3)

- Alternative measure of trade policies is “*trade openness*”.
- Jeffrey Sachs and Andrew Warner find that countries with *more open policies* and less-biased exchange rates *grew about 2 percentage point faster* than did closed economies.
  - A country is considered to be “open” if it passed 5 criteria:
    1. Its average tariff rate was less than 40%.
    2. Its nontariff barriers covered less than 40% of imports.
    3. The premium on the unofficial parallel market exchange rate did not exceed 20%.
    4. There were no state monopolies on major exports.
    5. It was not a socialist economy.

Trade and Growth (4)

- Sachs-Warner's openness index was subjected to a number of criticisms, because some criteria are more likely to improve macroeconomic policy than to liberalize trade.
- So, what do we know about the impact of trade and trade policy on economic growth?
  - Economists believe that increased trade confer benefits, but the steps necessary to stimulate economic growth and increased trade go beyond simply reducing tariffs and quotas.
  - Also, one single approach in liberalizing trade does not fit all nations.

Trade Reforms and Poverty Reduction (1)

- Mechanisms by which increased trade can reduce poverty:
  - Greater openness and faster growth in labor intensive manufacturing can potentially create substantial employment opportunities → increase income → reduce # of people living below the poverty line
  - Prices of imports decrease → many of the poor can benefit as consumers
  - Trade can increase government revenue and improve spending on the poor.

Trade Reforms and Poverty Reduction (2)

- But trade have some negative impacts as well:
  - It can eliminate jobs in *import-competing sectors* → rising levels of unemployment & increasing poverty
  - Although urban consumers are better off from lower price, domestic producers in rural areas are generally worse off (e.g. corn producers in Mexico).
- The factor endowment models assume that labor is mobile between sectors. However, if workers cannot easily relocate (why?), then the gains from trade may not be transmitted as predicted.
- Thus, trade reform *alone* cannot be used to reduce poverty.

KEY ISSUES ON THE GLOBAL TRADE AGENDA

Increased Global Competition & The Rise of China (and India)

- China and India are emerging global giants, creating concerns about tougher competition and falling prices for export products.
- However, there could still be room for other countries.
  - Global production networks allow firms from many different countries to contribute to the production of one finished good each firm specializing in a phase that it has comparative advantages.
  - China and India need to import inputs from others.
  - Countries, such as Mexico, still has *locational advantage* in exporting to the US.

Does Outward Orientation create Sweatshops? (1)

- Some writers have argued that outward orientation and globalization creates global sweatshop economy and race to the bottom to those who will accept the lowest wages, benefits and environmental standards.
- This is also true for firms producing local markets such as agricultural workers in USA, especially emigrants.
- But low wages are a reflection of the extent of poverty in low-income countries.
  - Wages are different across countries reflecting *differences in the average level of economy-wide productivity*.
  - i.e. Market wages are based on productivity.

Does Outward Orientation create Sweatshops? (2)

- Some argue that the opportunity to work in a steady factory job is an *improvement* over other options.
- The concern about the race to the bottom also includes *working conditions* and *labor standards*.
  - **Core standards**: abolishing forced labor, child labor, gender discrimination, ethnic discrimination and permitting freedom of association
  - **Cash standards**: other improvements in work and safety conditions
- In general, evidence suggests that working conditions tend to improve as economic growth proceeds in outward-oriented countries.

Expanding Market Access

- Q: Can developing countries sell in European Union, North American, and Japanese Markets?
- These countries have greatest trade barriers on products for which developing countries have comparative advantages such as *textiles, apparel, and agricultural products* .
  - Tariff peaks: relatively high tariffs amid generally low tariff levels.
    - Example: US charges a 32% tariff on sweaters from Bangladesh, but no tariff on artwork imported from France.
  - Tariff escalation: having no or low import duties on raw materials and higher duties on the finished goods that use these raw materials.
    - This makes it harder for firms in developing countries to compete in the markets for finished goods.

Textiles and Apparel

- For decades, the exports of textiles and apparel from developing countries were restricted by a system of quotas and tariffs under the Multi-Fiber Agreement (MFA), which later became the Agreement on Textiles and Clothing (ATC).
  - Each industrialized country allowed only a certain amount of imports from each developing country.
  - These agreements were gradually *phased out and eliminated in 2005* as a part of the Uruguay round of WTO negotiations.
    - This creates winners or losers. (Who are the winners?)
    - National tariffs and nontariff barriers on textiles and apparel imports still remain.

Overall Protection in Agriculture (% tariff equivalent)

TYPE OF PROTECTION	UNITED STATES	CANADA	EUROPEAN UNION	JAPAN
Tariffs	8.8	30.4	32.6	76.4
Subsidies	10.2	16.8	10.4	3.2
Total	19.9	52.3	46.4	82.1

Source: William Cline, *Trade Policy and Global Poverty* (Washington, DC: Center for Global Development, 2004).

Agricultural Exports & Imports

- US, Canada, EU, Japan provide significant protection to their agricultural products through direct barriers and subsidies.
  - The Magnitude is quite high ranging from 20% in the US to over 80% in Japan.
  - Crops protected include cotton, dairy products, maize, peanuts, soybean, sugar, rice, wheat and others.
- Trade protection provides farmers in industrialized countries with a significant advantage, and weakens incentives for increased production in developing countries.
- Subsidies depress world prices for agricultural products (e.g. rice, sugar, and dairy products).
  - ➢ Farmers in LDC receive *low prices* and have *lower income*.

WTO and Multilateral Trade Negotiations

- After WWII industrial countries began to reduce tariffs. Between 1947 - 1994, eight round of trade negotiations took place through General Agreement on Tariffs and Trade (GATT) which became the World Trade organizations (WTO) in 1995.
- The Uruguay Round of trade negotiations began in 1986 and ended in 1994 involving 123 countries that took part.
  - The industrialized countries promised: (1) significant reduction in tariffs, (2) the end of Multi-Fiber Agreement, and (3) reduction in agricultural subsidies.
  - LDCs also committed to large reduction in their tariffs, agreement in new rules of investment, services, and Trade-Related Intellectual Property Rights (TRIPs), and support for the new WTO.

The Outcome of Negotiation of the Uruguay Round

- Global average tariff on manufactured goods were reduced by one-third, and LDCs have increased access in some industrialized country markets.
- But there are some concerns:
  1. Industrialized countries pledge to reduce agricultural subsidies did not happen.
  2. The new agreements on investment, services, and TRIPs were more complicated than reducing tariffs, and created large burden on many low-income countries.
  3. TRIPs resulted in LDCs paying higher prices for medicine and pharmaceutical products covered patents.

Other Trade Negotiations

- Began in 2001, the latest round of trade negotiations among the WTO members is the Doha Round (or the Doha Development Agenda), which were intended to served the needs of developing nations.
- The Doha Round collapsed in 2008 after failing to reach a compromise on agricultural import rules. The main dispute was among the US, China, and India.
- More recently, nations have turned away from multilateral talks and entered into bilateral and regional agreements.
  - Disadvantage – they did not allow for global comparative advantage
  - Advantage – they take the pressure off the government to compromise on multilateral agreement.

Temporary Migration: Another Dimension of International Trade

- One dimension of trade negotiation that has received relatively little attention is to increase the movement of people across borders.
- Lant Pritchett argues that an increase in temporary migration could be one of the most effective instruments to alleviate poverty.
  - Proponents – immigrant workers can take on what many natives find too "dirty, dangerous, or difficult."
  - Opponents – worries about native jobs being taken away, lower wages, or more burden to taxpayers.