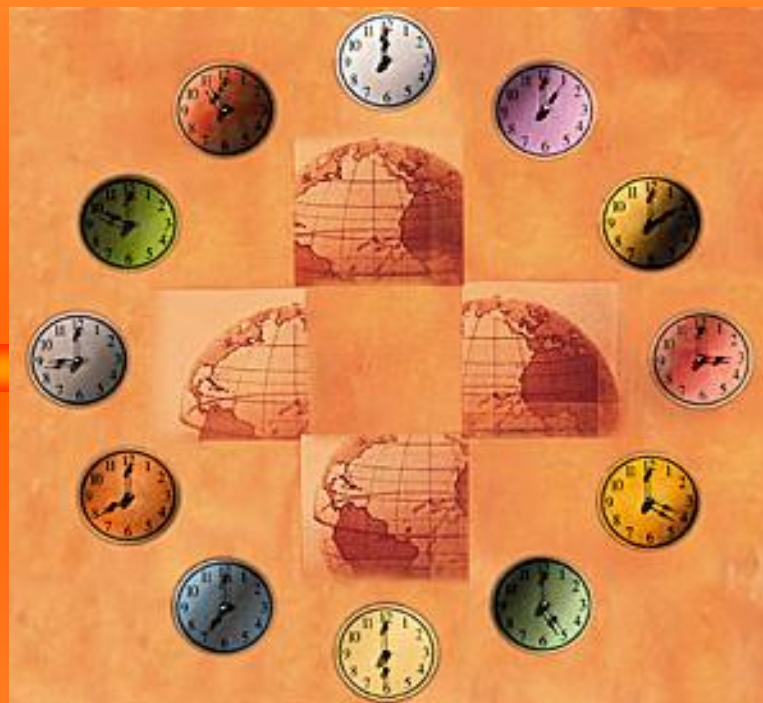


# Chapter 11

## Controversies in Trade Policy



Prepared by **Iordanis Petsas**

To Accompany

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by **Paul R. Krugman and Maurice Obstfeld**

# Chapter Organization



- Introduction
- Sophisticated Arguments for Activist Trade Policy
- Globalization and Low-Wage Labor
- Summary

# Introduction



- Two controversies over international trade arose in the 1980s and 1990s.
  - In the 1980s a new set of sophisticated arguments for government intervention in trade emerged in advanced countries.
    - These arguments focused on the “high-technology” industries that came to prominence as a result of the rise of the silicon chip.
  - In the 1990s a dispute arose over the effects of growing international trade on workers in developing countries.

# Sophisticated Arguments for Activist Trade Policy



- There are two kinds of market failure that seem to be present and relevant to the trade policies of advanced countries:
  - Technological externalities
  - The presence of monopoly profits in highly concentrated oligopolistic industries

# Sophisticated Arguments for Activist Trade Policy



## ■ Technology and Externalities

### • Externalities

- Firms in an industry generate knowledge that other firms can also use without paying for it.
- In high-tech industries firms face appropriability problems.
  - Example: In electronics, it is common for firms to “reverse engineer” their rivals’ designs.

# Sophisticated Arguments for Activist Trade Policy



- **The Case for Government Support of High-Technology Industries**
  - Subsidize the activity with externalities, not all activities in an industry.
    - For instance, R&D (as opposed to manufacturing) should be subsidized.
- **How Important Are Externalities?**
  - Externalities are hard to measure empirically.
  - Problems of appropriability at the level of the *nation* (as opposed to the firm) are less severe but still important even for a nation as large as the United States.

# Sophisticated Arguments for Activist Trade Policy



- Imperfect Competition and Strategic Trade Policy
  - In some industries where there are only a few firms in effective competition:
    - The assumptions of perfect competition will not apply.
    - Firms will make **excess returns** (profits).
    - There will be an international competition over the excess returns.
    - A subsidy from the government to domestic firms can shift the excess returns from foreign to domestic firms.

# Sophisticated Arguments for Activist Trade Policy



- **The Brander-Spencer Analysis: An Example**
  - There are only two firms (Boeing and Airbus) competing, each from a different country (United States and Europe).
  - There is a new product, 150-seat aircraft, that both firms are capable of making.
  - Each firm decides either to produce the new product or not.

# Sophisticated Arguments for Activist Trade Policy



**Table 11-1: Two-Firm Competition**

		<b>Airbus</b>	
		<b>Produce</b>	<b>Don't produce</b>
<b>Boeing</b>	<b>Produce</b>	-5	0
	<b>Don't produce</b>	0	0

Equilibrium outcome is  $A=0$  and  $B=100$ : Airbus does not produce and Boeing produces.

# Sophisticated Arguments for Activist Trade Policy



**Table 11-2: Effects of a Subsidy to Airbus**

		<b>Airbus</b>	
		<b>Produce</b>	<b>Don't produce</b>
<b>Boeing</b>	<b>Produce</b>	20 -5	0 100
	<b>Don't produce</b>	0 125	0 0

A subsidy of 25 to Airbus given by Europe results in  $A=125$ ,  $B=0$ .

# Sophisticated Arguments for Activist Trade Policy



- **Problems with the Brander-Spencer Analysis**
  - Insufficient information to use the theory effectively
    - The exact payoffs of the firms cannot easily be obtained.
  - Industries in isolation
    - A policy that succeeds in giving U.S. firms a strategic advantage in one industry will tend to cause strategic disadvantage elsewhere.
  - Foreign retaliation
    - Strategic policies are **beggar-thy-neighbor policies** that increase our welfare at other countries' expense.

# Sophisticated Arguments for Activist Trade Policy



**Table 11-3: Two-Firm Competition: An Alternative Case**

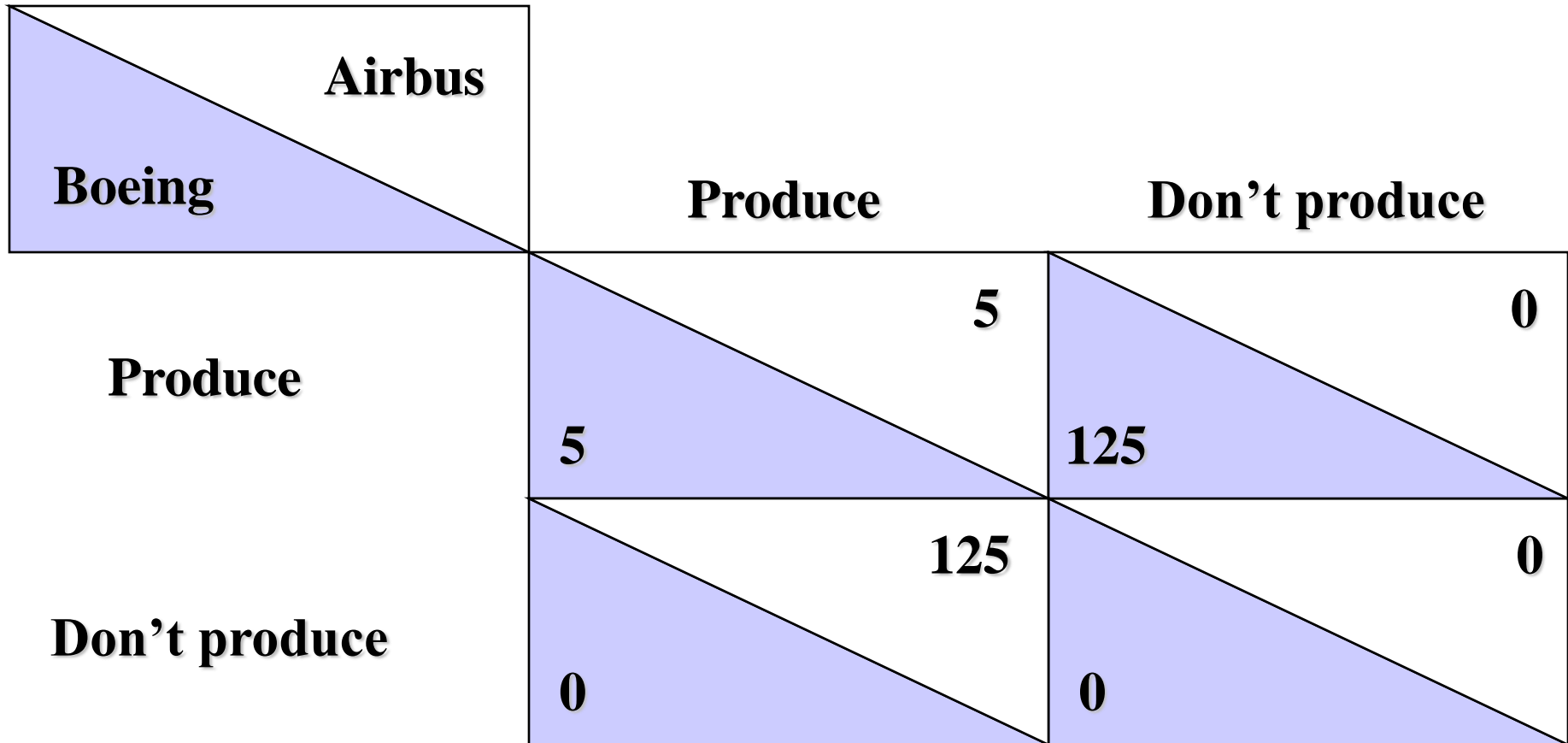
		<b>Airbus</b>	
		<b>Produce</b>	<b>Don't produce</b>
<b>Boeing</b>	<b>Produce</b>	-20 5	0 125
	<b>Don't produce</b>	100 0	0 0

Equilibrium outcome is  $A=0$  and  $B=125$ ; Boeing produces and Airbus does not.

# Sophisticated Arguments for Activist Trade Policy



**Table 11-4: Effects of a Subsidy to Airbus**



A subsidy of 25 to Airbus given by Europe results in  $A=5$ ,  $B=5$ .

# Globalization and Low-Wage Labor



- The rise of manufactured exports from developing countries is one of the major shifts in the world economy over the last generation.
  - The workers who produce these goods are paid low wages and work under poor conditions.

# Globalization and Low-Wage Labor



## ■ The Anti-Globalization Movement

- It became a highly visible presence chronologically:
  - 1980s
    - Alleged threat of competition from Japan in the United States
  - Early 1990s
    - Substantial concern in both the United States and Europe over the effects of imports from low-wage countries on the wages of less-skilled workers at home.
  - Second half of the 1990s
    - Alleged harm that world trade was doing to workers in the developing countries.
  - 1999
    - Demonstrations disrupted the meeting of the World Trade Organization in Seattle.

# Globalization and Low-Wage Labor



## ■ Trade and Wages Revisited

- Activists argue that globalization makes workers in developing-country export industries worse off.
  - Example: Wages in Mexico's *maquiladoras* were below \$5 per day, and conditions were appalling by U.S. standards.
- Economists argue that despite the low wages earned by workers in developing countries, those workers are better off than they would be if globalization had not taken place.

# Globalization and Low-Wage Labor



**Table 11-5: Real Wages**

**(A) Before trade**

	<b>High-tech goods/hour</b>	<b>Low-tech goods/hour</b>
United States	1	1
Mexico	1/8	1/2

**(B) After trade**

	<b>High-tech goods/hour</b>	<b>Low-tech goods/hour</b>
United States	1	2
Mexico	1/4	1/2

# Globalization and Low-Wage Labor



## ■ Labor Standards and Trade Negotiations

- International trade agreements can improve wages and working conditions in poor countries by incorporating:
  - A system that monitors wages and working conditions and makes the results of this monitoring available to consumers.
  - Formal labor standards
    - They are conditions that export industries are supposed to meet as part of trade agreements.
    - They have considerable political support in advanced countries.
    - They are strongly opposed by most developing countries.

# Globalization and Low-Wage Labor



## ■ Environmental and Cultural Issues

- Environmental standards in developing-country export industries are much lower than in advanced-country industries.
- The incorporation of environmental standards in trade agreements can cause:
  - Improvements in the environment
  - Potential export industries in poor countries to shut down
- Globalization has led to a homogenization of cultures around the world.
  - Example: McDonald's is now found almost everywhere.

# Globalization and Low-Wage Labor



- **The WTO and National Independence**
  - Free trade and free flow of capital has undermined national sovereignty.
  - WTO monitors not only the traditional instruments of trade policy, but also domestic policies that are de facto trade policies.

# Summary



- New arguments for government intervention in trade emerged in the 1980s and 1990s.
- In the 1980s the new theory of strategic trade policy offered reasons why countries might gain from promoting particular industries.
- In the 1990s a new critique of globalization emerged, focused on the effects of globalization on workers in developing countries.

# Summary



- There are two sophisticated arguments for activist trade policies:
  - Governments should promote industries that yield technological externalities.
  - Brander-Spencer analysis.
- With the rise of manufactured exports from developing countries, a new movement opposed to globalization has emerged.
  - Low wages paid to export workers.