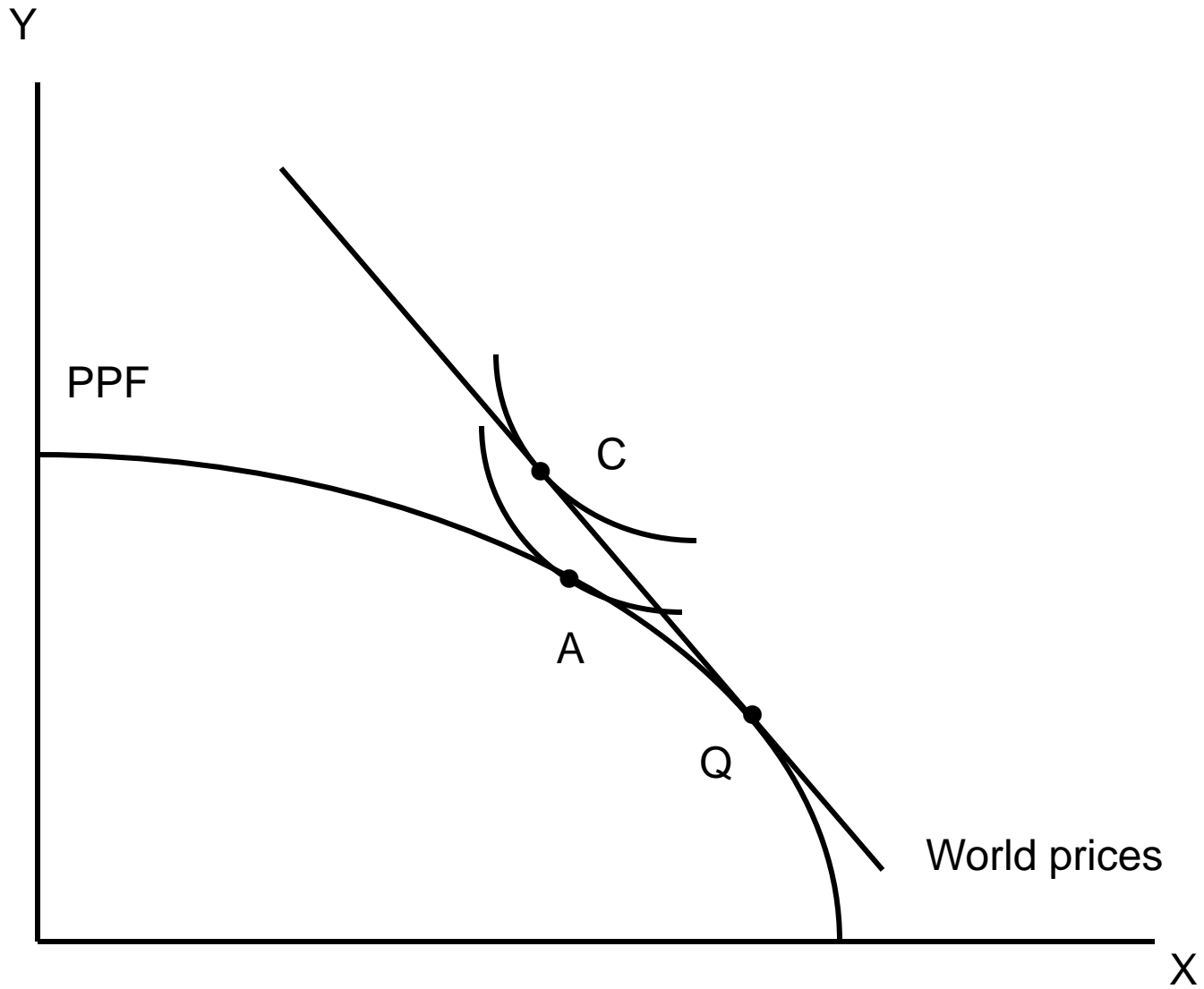


The one-minute trade policy theorist

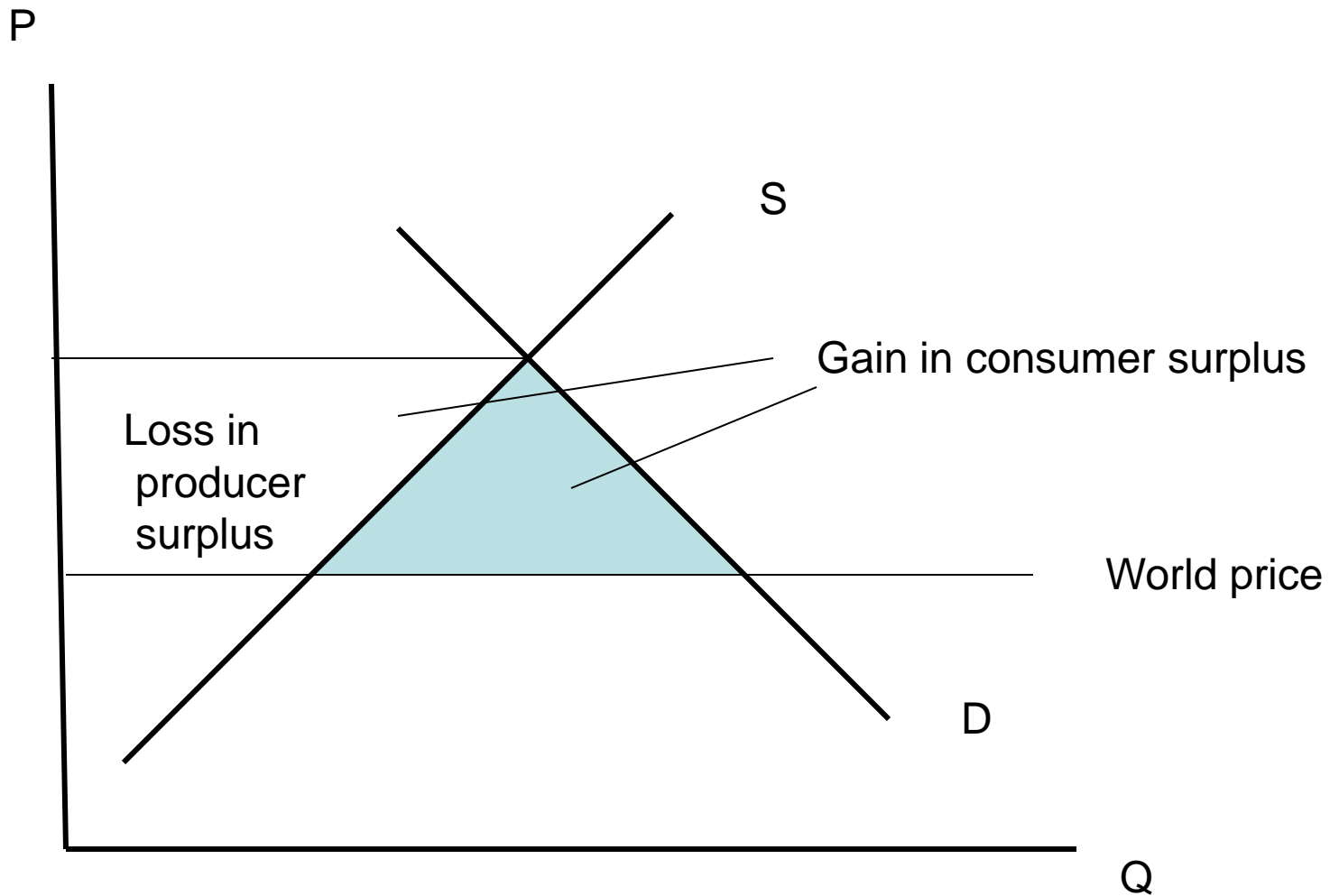
(most of what you need to know)

Trade theory is a broad, deep, rich field with a long intellectual history. We're still adding to that theory, and especially to its empirical basis. BUT ... most trade policy analysis is based on a relatively simple set of concepts.

In this slide show (since I need to show diagrams, I'll use dreaded Powerpoint) I'll walk quickly through those concepts, and say a few words about what they leave out.



Gains from trade: the “sacred diagram”



Gains – and losses – from trade: partial equilibrium

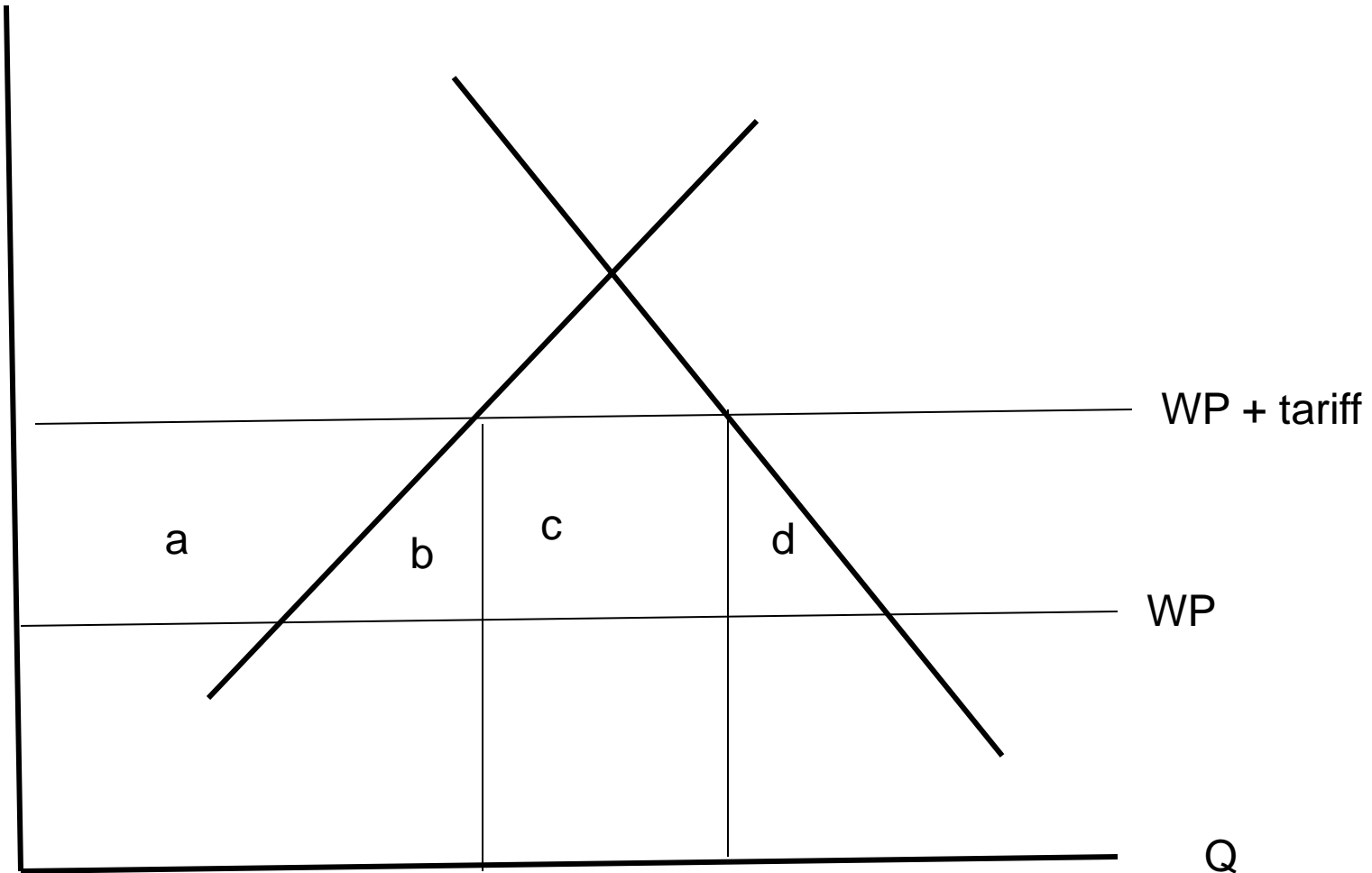
What's missing?

- Economies of scale
- Dynamic effects
- Realistic distributional issues

But broad picture seems right: overall gains, but losers as well as winners *within* countries

P

Tariff analysis (partial equilibrium)



Producer gain = a

Consumer loss = a+b+c+d

Revenue = c

Deadweight loss = b+d

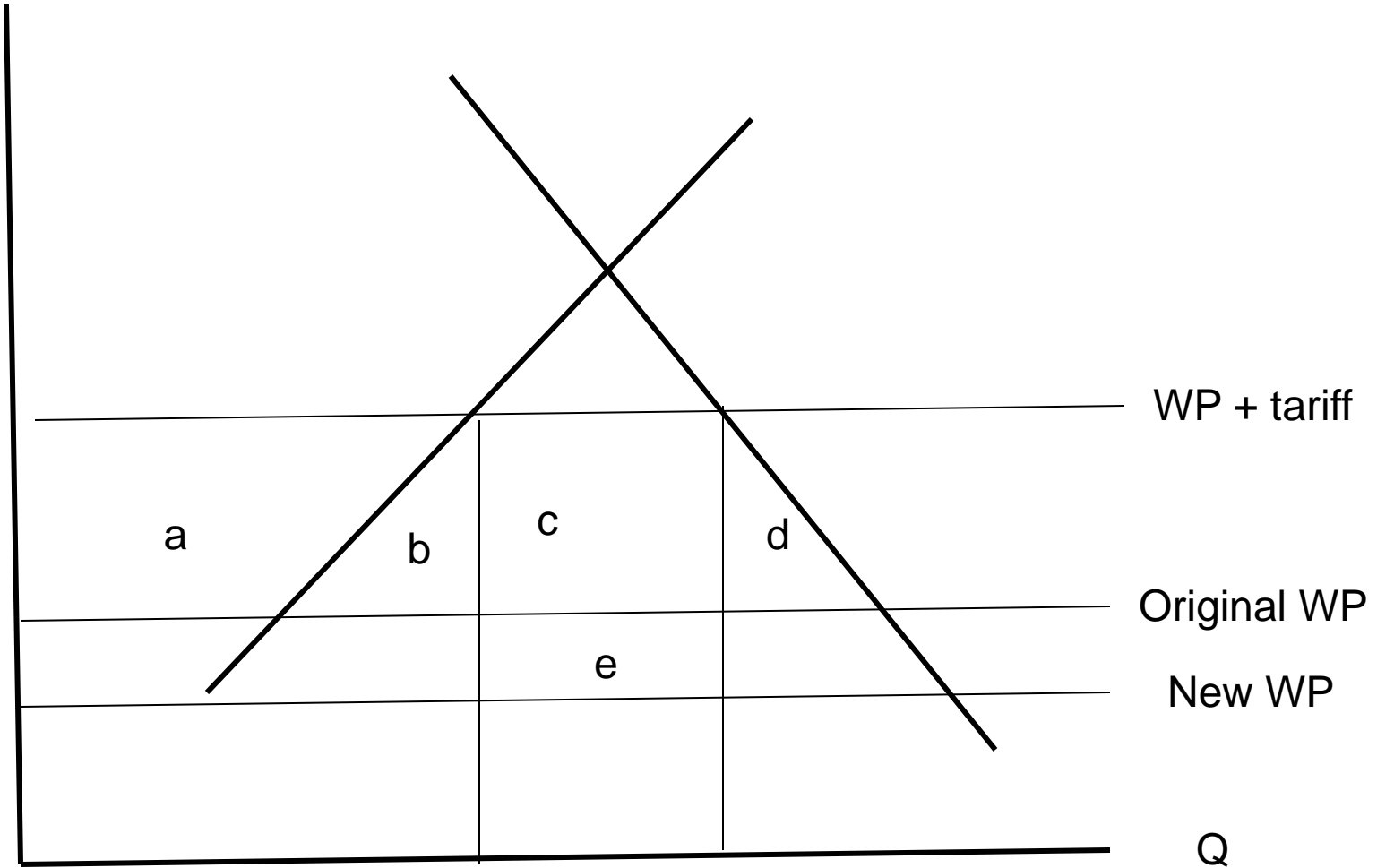
What's missing?

- “Lerner symmetry”: an import tariff is an export tax
- Terms of trade effects
- Economies of scale, dynamics, yada yada
- Market power issues

P.S.: We can do quotas too. Just call “c”, government revenue, quota rent.
A lot depends on who gets this rent.

P

Tariff analysis (with market power)



Producer gain = a

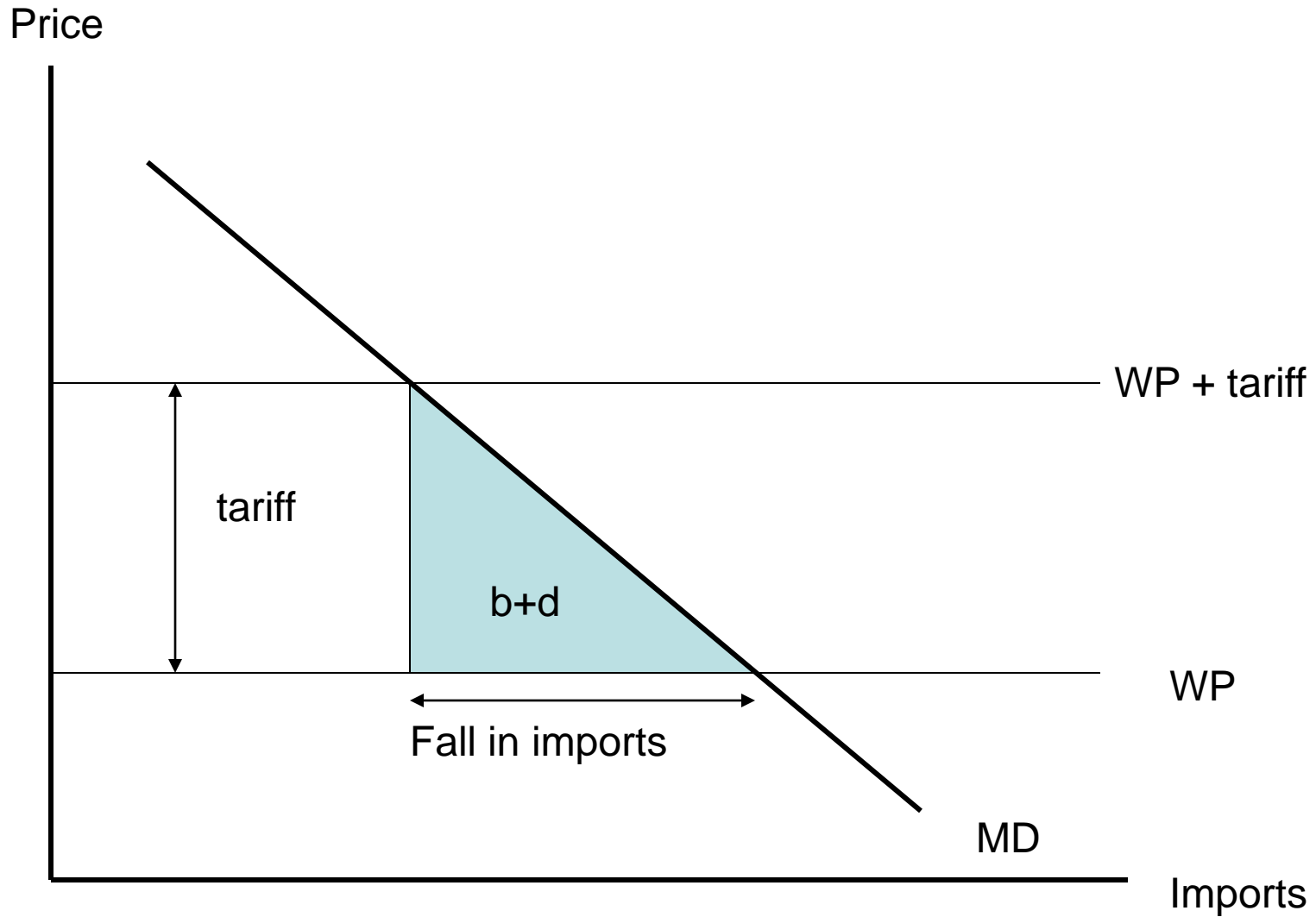
Consumer loss = a+b+c+d

Revenue = c + e

Deadweight loss = b+d

Terms of trade gain = e

Efficiency losses from protection: alternative view



Efficiency loss $\approx \frac{1}{2} \times \text{tariff} \times \text{fall in imports}$

Let's consider an example. Suppose imports are 20% of GDP, and a country imposes a 100% tariff (raising the price of imports to domestic consumers from 1 to 2 – we're ignoring GE issues). Suppose that the result is to cut imports, and hence all foreign trade, in half.

Then the efficiency loss is $\frac{1}{2} \times 1 \times 10$, where 1 is the tariff, 10 the fall in imports. So the net loss is 5% of GDP.

That's not much, considering that this is a very protectionist policy. It's equivalent to 0.5% on the growth rate over a decade.

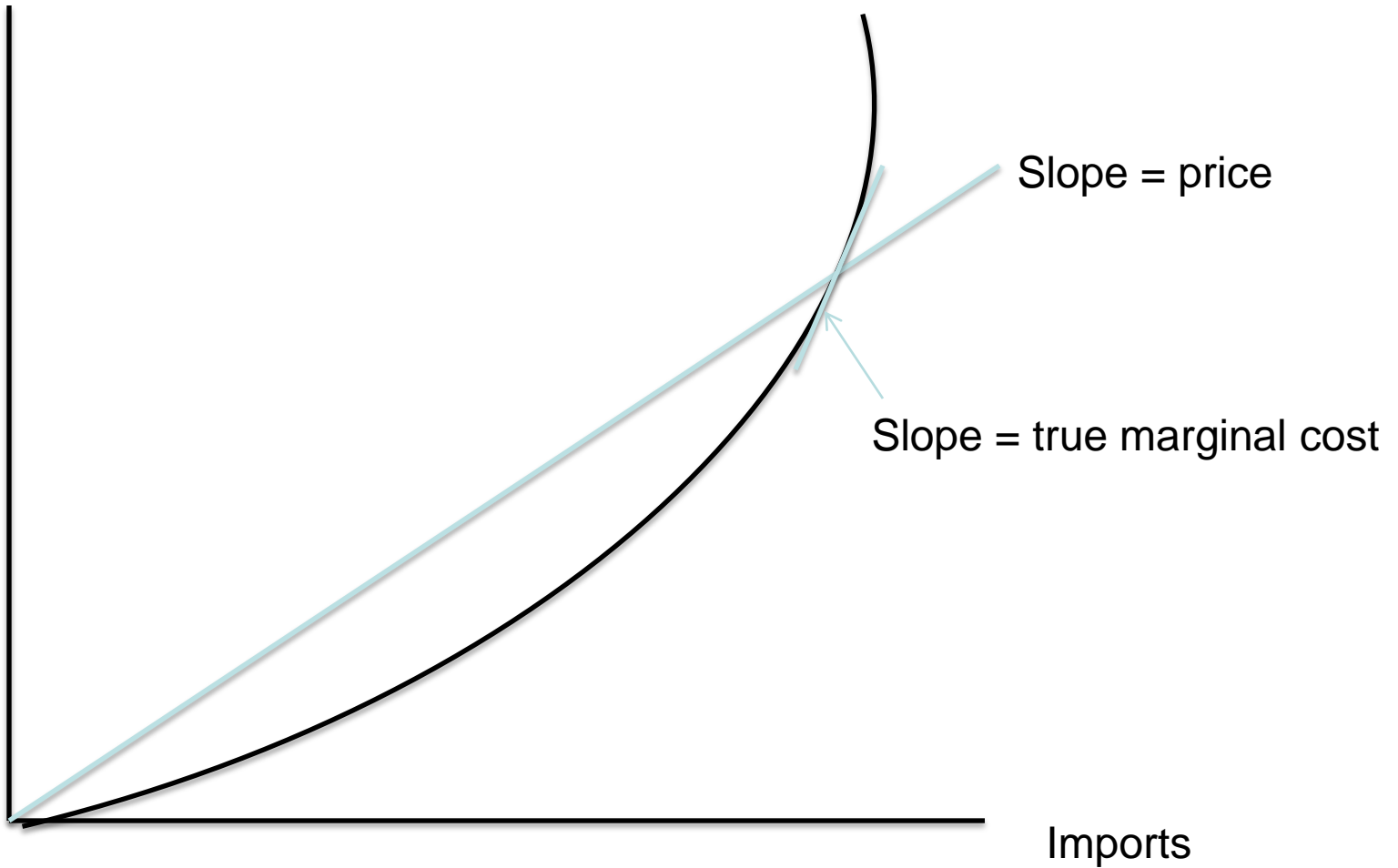
Two big lessons:

1. Major growth effects from trade policy, if they exist, must come from unconventional channels. Conventional trade theory DOES NOT justify claims of huge positive payoffs from free trade.
2. In the politics of trade policy, distributional effects can easily swamp concerns about efficiency.

The optimal tariff argument

Exports

Foreign offer curve



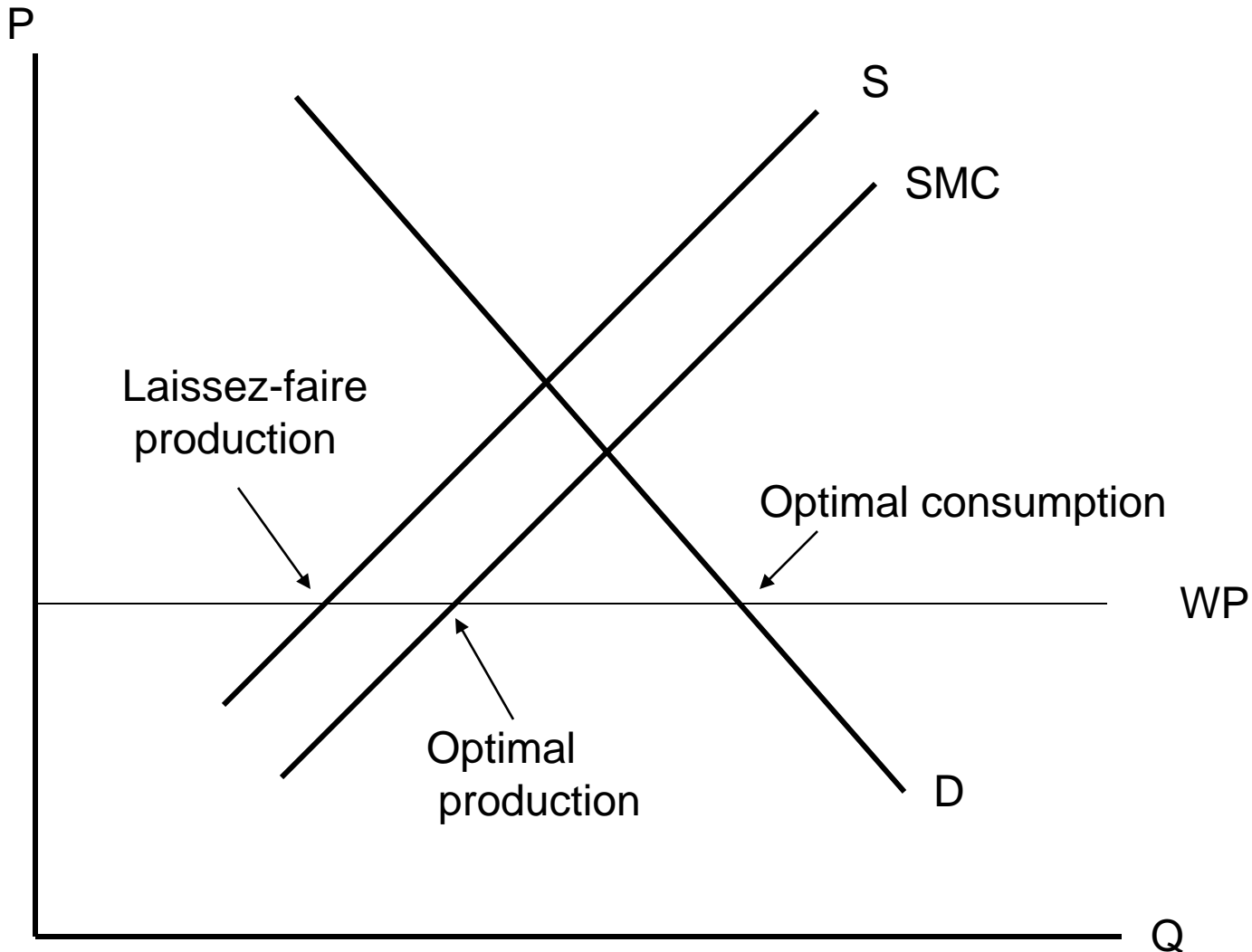
The optimal tariff argument: a country that is “large” can affect its terms of trade: the more it exports, the lower the price of its exports relative to its imports.

This implies that the true social cost of a unit of imports is higher than its market price, because the volume of additional exports required to buy that unit of imports reflects both the direct cost and the deterioration of terms of trade

So optimal policy would drive a wedge between the world relative prices and domestic – a tariff or export tax

But This is optimal only if the foreigners don't react. Unilateral optimal tariffs can lead to “optimal tariff warfare”, which makes both countries worse off

This is one possible justification for international trade negotiations. Is “GATT-think” really driven by optimal tariff considerations?



Domestic distortions and optimal policy

Implications: *if* domestic distortion leads to smaller social marginal cost than private,

1. Laissez-faire leads to suboptimal output
2. Production subsidy can lead to optimal output
3. Tariff can move output in “right” direction, but only by distorting cons.
4. Trade policy is second-best answer

When distortion is in factor markets, production subsidy becomes second best, trade policy third best (import quotas fourth best, etc.)

Harry Johnson: Second-best policies are usually recommended by third-best economists working for fourth-best politicians ...