

Notes on Strategic Trade

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Arguments in favor of protection

- National security/defense
- Optimal tariff to take advantage of market power
- Avoid distributional costs to disadvantaged factors or regions
 - But could have this argument against every potential economic change- better to have safety net and well-functioning capital markets, and to have protection reduced gradually
- Strategic trade/Infant industry/Import-substitution industrialization/Externalities/Rent-shifting/Bargaining power

Infant industry argument and import-substitution industrialization (ISI)

- The argument:
 - Economic growth depends on growth in productivity
 - Productivity growth can be rapid in manufacturing
 - Manufacturing does not grow because foreign firms more efficient or because of domestic market failure (in credit market)
 - Must protect domestic firms from foreign firms
- Latin America, India, and China especially pursued these policies (among others) from 1950s-1980s
- Terribly difficult to evaluate

ISI not terribly successful in LA, China, India

- Did have substantial economic growth
- But very skewed distribution of income
- Labor aristocracy?
- Neglect of rural areas (where poor majority lived) so little productivity growth there
- Protection at the expense of consumers who have to pay more, and at expense of other national industries, who have to pay more for labor and other inputs

ISI not terribly successful in LA, China, India

- Many times, protected industry turns into privileged monopoly extending protection, rather than growing and learning
- Sometimes when ISI abandoned, got rapid economic growth in other industries that were not previously protected

ISI not terribly successful in LA, China, India

- Because of low productivity growth in larger population, low growth of effective demand, and slow growth of domestic market for manufactured goods, so no economies of scale- foreign firms remained more productive
- If domestic market failure (capital markets do not work), then try to correct that directly

Agricultural productivity can grow very fast

- “For the LDCs this may be more relevant only for recent decades following the spread of the Green Revolution (it would probably not apply to minerals such as copper). But it may be noted that in the USA for the last 50 years agricultural productivity per manhour has significantly outpaced the productivity growth in the rest of the economy. (Between 1950-90 output per hour worked in US agriculture rose by 95 percent, while it rose by only 84 percent in the non-farm business sector.)”
- Source: <http://www.economics.stراث.ac.uk/PDF/464-rs1.doc>

Counter domestic market distortion

- Because capital markets do not work well, private sector cannot make big investments unless have ‘guaranteed profits’ for medium term
- Because labor market does not work well, need to encourage peasants to move into city, or unemployed to get jobs, by making more profits available in manufacturing
- But why not counter distortion directly
- Distortion can work both ways- e.g. NAFTA implies less agriculture in California because of Mexican imports, but this is good, because Calif. Farmers will reallocate their subsidized water to less wasteful uses

Bargaining power

- Free trade implies specialization
- Specialization to trade with very large neighbor may change bargaining power in non-economic issues
 - Hawaii and Pearl Harbor
 - Nazi Germany and the Balkans
 - Canada and CUFTA – Judge Bowker (the abrogation clause leading to renegotiation)

Positive knowledge externalities

- Some industries generate non-appropriable ‘spillovers’ that benefit the rest of the economy
 - New knowledge or ideas, like fast food, assembly lines
- But if government already knows what knowledge externalities likely to be, then seems like little room for extra spillover
- Knowledge crosses international boundaries anyway

Examples abound of failed/ or costly/ or proposed ‘national’ industrial projects

- Concorde/SST
- Airbus/Boeing
- MITI and Japan
- HDTV
- Semi-conductors
- What is the ‘selection criteria’?

Positive agglomeration externalities

- Presence of large pool of skilled labor generates lower costs of recruiting labor for other firms, encourages more entrepreneurship, investments in specialized human capital (because of high likelihood that will get another job)
- Trade policy clearly the wrong tool to try to manipulate this- industrial/regional planning

Positive ‘learning by doing’ externalities

- Countries without much manufacturing lack depth in whole range of specialized labor (from machine operators to accountants)
- Need practice in large scale production
- Protected firms are like schools – training grounds for other industries/firms
- Subsidies less costly than protection

Rent-shifting – Brander-Spencer model

- Some industries are increasing returns to scale
- Only room for a few firms in equilibrium
- Sometimes have first-mover advantage
 - First firm in takes all of the profits because has lowest costs
- So subsidy/tariff policy can be strategic- try to deter foreign entry

Problems with Brander-Spencer

- Information requirements are very high, especially at the ‘sectoral’ level
 - ‘High-value added’ sector?
 - Hi-tech sector?
 - Are committing your country to judgments and experiences of other countries? Always looking to the other guys?
- Subsidies always have distortionary costs themselves
- Risks trade war – better to retaliate rather than initiate?

Why be in favor of free trade generally?

- While externality/strategic trade arguments have merit, can easily sway public to generate disguised protectionism for undeserving industry
- Trade protection always a more costly and less transparent instrument
- Economic growth not closely associated with trade anyway – high savings and investment, sound macro and good governance, more important

Strategic trade in U.S. (following Krugman in Pop Internationalism)

- to maintain standard of living, America needs high productivity in sectors that compete with foreign countries... ‘competitiveness’ is key. Government should be targeting leading sectors with subsidies and protection. These high value-added sectors will produce high paying jobs and are a dynamic engine for the economy.
- The Atari democrats.... comes from management theory; establish growth position in star industry using cash cows to finance, get rid of dogs

Strategic trade in U.S.

- Several fallacies of this approach:
 - Trade is still only 14% of US economy, and has not been growing since 1980s
 - International trade is exchange, not competition: export so you can import
 - Productivity determines standard of living, not competitiveness; even though you are less productive than others, that fact does not change your standard of living, even if you grow less fast than others, you still grow by your standard of living. In fact, you want others to grow faster than you, so you can import their products!

Strategic trade in U.S.

- Several fallacies of this approach:
 - Manufacturing is declining because are getting very productive but income elasticity of demand is low-people want services
 - 70% of US output is non-traded services, so more important to have productivity growth there than in manufacturing
 - 'competitiveness' connotes the idea of a winner getting a prize, but in the global trade 'race' there is no prize for being higher or lower ranked, the reward depends on how fast you run with regard to the clock, not with regard to the other runners. Consider, for instance, whether it is better to be last in the class A runners, or first with the class C runners?

Can you respond to the arguments?

- The costs of displacement are too high
- In our industry first-mover gets all the rents- don't you want a national firm to get them?
- Our industry generates tremendous spillovers, it must be encouraged