

EC246-2-AU – Lecture 1
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Introduction to Trade Theory, Policy and History: ITO

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Plan of talk

- **Introduction:** aim and learning outcomes
- 1. Multidisciplinary nature** of the course/subject
 - 1. Trade policy \Leftrightarrow socio-political, institutional/legal issues
 - 2. Trade theory \Leftrightarrow why an economic approach
- 2. The grand doctrines:** free trade vs protectionism
- 3. Historical background** to the course/subject
 - 1. Economic lessons of the inter-war period
 - 2. The Havana Charter and the failure of ITO
- **Wrap-up:** what we have learnt, where we go next

Aim and learning outcomes

- **Aim:** introduce trade theory and policy within the context of the evolving world trading system
- **Learning outcomes**
 - understand the multidisciplinary nature of course/subject
 - justify an economic approach to it
 - compare costs and benefits of major trade doctrines
 - know historical roots of multilateral trade negotiations
 - set the stage for next lectures

The multidisciplinary nature of trade (policy)

- People trade within a community/society, economies/countries trade among themselves => an international, **socio-political** phenomenon
- Implicit or explicit rules/institutions govern internal and external transactions => **legal** aspects
- Trade directly affects real income/utility/welfare of agents => interests => **political economy** issues
- Trade among countries involves negotiations and treaties => **economic diplomacy**, IR, IPE aspects

Why trade policy: socio-political context

- **Political economy** approach to trade policy: within a *heterogeneous* community, government intervention results in both *winners* and *losers* =>
- **Special-interest groups**: some are for and others against a particular trade measure =>
- **Rent-seeking**: rents as profits from “directly unproductive profit-seeking” (DUP) activities =>
- **(Counter-)Lobbying** \Leftrightarrow costs: waste of resources
- (International) **politics & economics** interplay

Why trade policy: legal context

- Trade across borders \uparrow as % in GDP \Leftrightarrow **interdependence** among nation states $\uparrow \Rightarrow$
- *Wealth* \uparrow , due to increased choice and improved efficiency, but also *vulnerability/anxiety* \uparrow
- **Managing** interdependence: the problem of international economics today \Rightarrow regulation
- **Rules, treaties** \Leftrightarrow *international (economic) law* and I(E)R: legal, constitutional, institutional and political realities that constrain commercial policy

Why an economic approach to trade policy and institutions?

- Trade and trade policy are, in essence, **economic phenomena**
- Economic theory provides an elegant (although extremely simplified) **analytical framework** to organise thinking about such complex realities
- *Without theory*, **policy** would be “uninformed”, thus often **directionless** and inconsistent
- We, as **economists**, are mostly equipped to approach the subject from an economic viewpoint

Why trade: the exchange model

- **Exchange model:** 2 good(-type)s endowed to each of 2 countries – figures 2.1, 2.2, 2.3 and 2.4 in CFJ
- **Gains from trade** to *both* economies: welfare ↑
 - *IntRA*-industry trade: if relative good(-type) prices differ b/n the two countries in autarky, opening up to trade at any intermediate price ratio leads to gains
 - *IntER*-industry trade: if *varieties/brands* within good *types/aggregates* possess individual characteristics and consumers like diversity, further gains
- Fundamental result: trade is a **positive-sum** (not zero-sum) **game**

Why trade: comparative advantage

- **Ricardian model:** a richer set-up which allows for *production* and trading opportunities to result
 1. in production possibility shifts \Leftrightarrow *scale economies*, and/or
 2. in resource reallocation \Leftrightarrow *comparative advantage*
- The above two channels correspond to **two new sources of gains from trade**, in addition to what was found in the oversimplified exchange model
- Sources of gains from trade are **additive**: Fig. 3.7, CFJ

Why trade: imperfect competition

- Up to here, *perfect* product and factor *markets* assumed
- **Market structure**, in particular production, may instead be characterised by *imperfect competition*
- Then, opening to trade brings about **pressure** on domestic monopolies/oligopolies
 - Via *import competition* by competitive foreign importers
 - By offering, if comparative advantage for monopolies, *export opportunities* in competitive world markets

The grand trade policy doctrines: benefits and costs of free trade

- **Arguments in favour**
 1. If relative commodity prices differ b/n two countries in autarky, opening up to trade at any *intermediate* price ratio leads to gains in both countries in terms of increased welfare
 2. Economic response to cost 1: *compensation*
- **Counter-arguments**
 1. If a country is *not* populated by *identical individuals*, opening up to trade may hurt some => resistance to FT, political economy/trade policy issues, anti-WTO protestors: Fig. 2.7, CFJ
 2. Benefit 2 *difficult to implement*: controversies

The grand trade policy doctrines: benefits and costs of protectionism

- **Arguments in favour**
 1. Protect import-competing sectors (or infant industries)
 2. Promote economic growth
 3. Attract (“tariff-jumping”) FDI
 4. Save jobs
- **Counter-arguments**
 1. Inefficient allocation
 2. Not if small economy; if big, danger for ToT worsening
=> export losses =>
“immiserising growth” (Bhagwati) and/or retaliation
 3. Irony: dependence on foreign supply even rises
 4. Jobs not created in more efficient sectors with FT

The multilateral trading system

- **No central authority** in international relations
- Multilateral cooperation among sovereign nations often occurs through creation of **institutions**
- **Regime** \equiv “sets of implicit or explicit principles, norms, rules and decision-making procedures around which expectations converge in a given area of international relations”, Krasner (1983)
- Such principles and procedures imply **obligations**, even if not enforceable through a hierarchical legal system
- Regimes reflect patterns of cooperation based on existence of **shared interests** \Leftrightarrow the MTS is an example w.r.t. trade

Multilateral trade negotiations

- Communication and **exchange of information** of national policy objectives: the *basis* of cooperation
- Bargaining and **negotiation**: the main *instruments*
- **MTNs**: mechanisms to facilitate the reciprocal exchange of market access commitments
- **MTNs**: a **barter market of trade policy**
 - No numéraire (money)
 - Exchange of “apples against oranges”: tariff reductions for iron against market access commitments for cloth

A historical introduction: economic lessons of the inter-war period

- Mistakes in economic policy blamed as a major cause of the disasters that led to **World War II**
 - the harsh reparations policy toward Germany
 - the Great Depression
- World-wide **protectionist measures** in response to the Smoot-Hawley Tariff Act of 1930 in US seen as having choked off international trade
- Trade issues excluded from the Bretton Woods Conference in 1944
 - but ideas for an **institution** comparable to IMF/WB had been discussed earlier
 - e.g., **Keynes** suggested *commodity price stabilisation* and the *financing of international buffer stocks* as its **major functions** in a memorandum of 1942
- A wave t/d international cooperation to regulate the world economy

The Havana Charter

- Dec 1945: US “Proposals for the Expansion of World Trade and Employment”, inviting 15 countries to conclude **multilateral agreement** for mutual tariff reduction
- Feb 1946: UN’s Economic and Social Council (EcoSoC) 1st meeting adopts a *resolution* calling for a conference to draft a charter for an **ITO** (complementary to IMF/WB)
- 4 meetings of a **preparatory committee**
 - Oct 1946, London: a *draft charter* suggested and circulated by US
 - early 1947, New York: the *New York Draft* published
 - spring-autumn 1947, Geneva: negotiations in *three parts* – (i) ITO, (ii) multilateral tariff cuts, (iii) general clauses on tariff obligations
 - from (ii)-(iii) a single document, *GATT 1947*, came into existence (18 Nov)
 - and a Protocol of its *Provisional Application* was signed (Oct) by 23 CPs
 - 21 Nov 1947, Havana, conference opened: *ITO Charter* completed, and signed, 28 Mar 1948, by 53 nations... but never ratified...

Failure of the ITO

- 1947 US elections: **Republicans**, critical to ITO proposals, gain over Democrats (but with Presidency remaining with the Democratic Party) who negotiated and ratified IMF/WB
- Jun 1947: General Marshall proposes the policy package known as the **Marshall Plan**, to help rescue Europe from economic weakness and potential social unrest leading to gains for communist parties
- Late 1947: an ideological **cold war** is already under way
- 1948: ITO Charter **submitted** for approval by the US Congress
- A major pro-liberal trade **lobby** in US shifted position **against** ratification of ITO, fearing too much state intervention
- 1950: **President Truman** announced he would no longer seek congressional approval of the charter
- US being an economic power, **other countries** lost interest

Concluding wrap-up

- **What we have learnt**
 - Why there is trade, trade policy, multilateral trade negotiations and international trade institutions
 - What are the pros and cons of competing trade policy doctrines at a *national* level
 - Why from the viewpoint of *world* welfare free trade is in the long-run interest of the global society
 - How the economic lessons of the inter-war period gave origin to the MTNs leading to the failure of the ITO
- **Where we go next:** to the early GATT rounds