ECO 407
Competing Views in Macroeconomic Theory and Policy

Lecture 10
Is Trade Liberalization Good or Bad for the Economy?

The Argument for Free Trade

- ***Mercantilists*** believed that a nation's ***wealth*** was represented by the accumulation of gold and silver (i.e., ***money***)
  - ***Exports*** increased wealth (because they brought home gold) and ***imports*** decreased it
  - Therefore, international trade was a ***zero-sum*** game

- ***Adam Smith*** demonstrated that each country could benefit from trade due to a more ***efficient allocation*** of resources
  - His reasoning was based on the concept of ***absolute advantage***

- ***David Ricardo*** showed that what was important was ***relative costs*** and not absolute costs
  - His reasoning was based on the concept of ***comparative advantage***

Comparative Advantage

- A country should **specialize** in the production of those goods in which it has a ***comparative advantage***
  - Those goods with ***lower opportunity cost***
  - Those goods whose production use intensively the relatively ***abundant factor of production***

- The ***benefits*** from both ***specialization*** in production and ***trade*** appear quite obvious:
  - An expansion of each country's ***consumption possibilities***

- But are all the ***assumptions*** of the model actually satisfied?
  1. Every country produces on its ***production possibilities frontier***
  2. Goods can move across borders but ***factors of production*** cannot

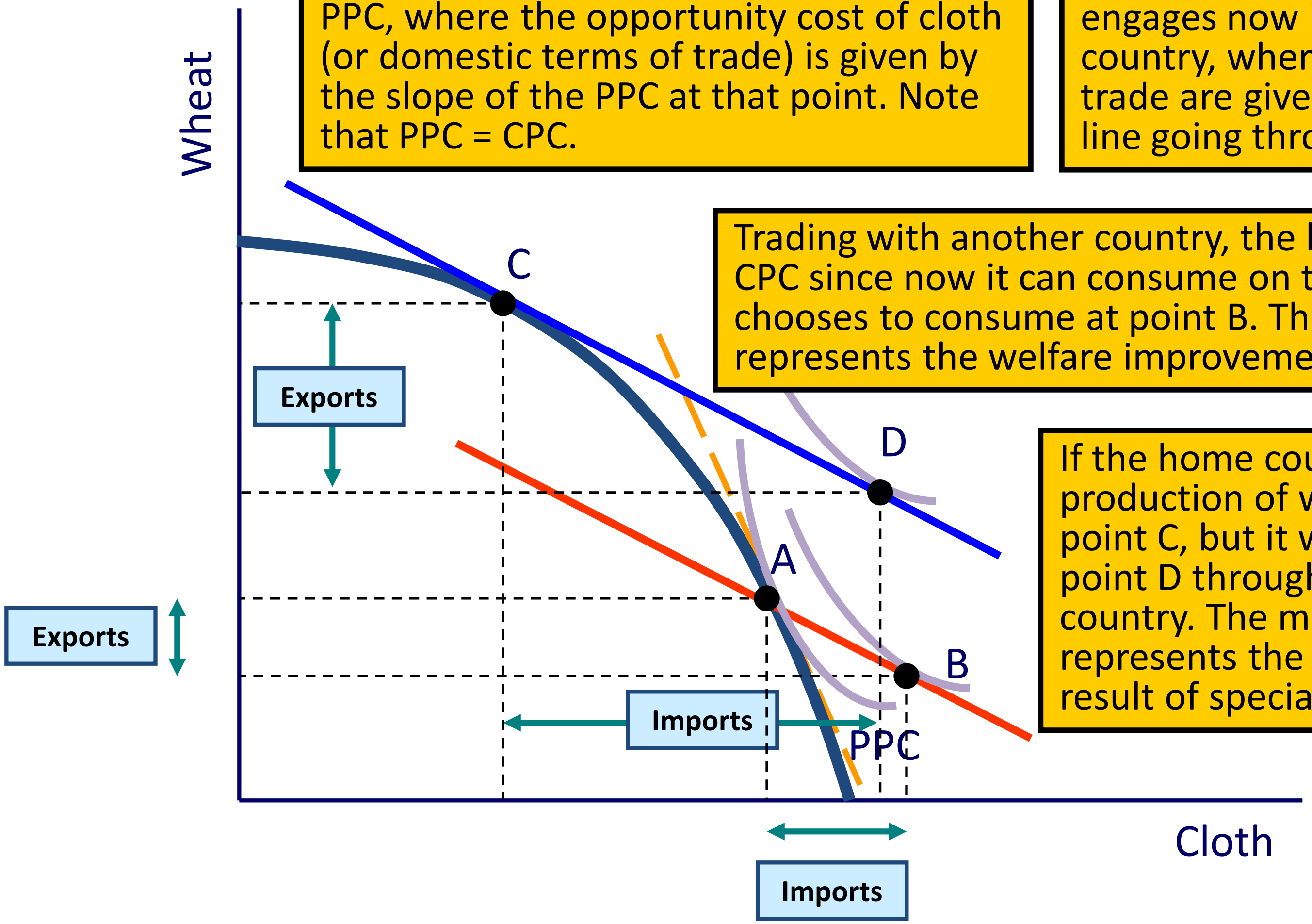
Gains from Specialization and Trade

Suppose that under autarky, the home country is producing at point A on the PPC, where the opportunity cost of cloth (or domestic terms of trade) is given by the slope of the PPC at that point. Note that PPC = CPC.

Suppose that the home country continues producing at point A but engages now in trade with another country, where the international terms of trade are given by the slope of the red line going through point A.

Trading with another country, the home country expands its CPC since now it can consume on the red line. Suppose that it chooses to consume at point B. The movement from A to B represents the welfare improvement as a result of trade.

If the home country specializes in the production of wheat it will produce at point C, but it will be able to consume at point D through trade with the other country. The movement from B to D represents the welfare improvement as a result of specialization.



The Assumptions of the Comparative Advantage Model

- No ***externalities***
  - Therefore, prices reflect opportunity costs
- ***Full employment*** is sustained
  - Always producing on the PPC
- Rising trade does not increase ***income inequality***
  - There is only one type of labour
- Trade remains ***balanced***
  - International trade is basically barter
- Short-term efficiency gains cause higher long-run (world) ***growth***
  - Increasing returns to scale in all industries

What Happens When the Assumptions of the Model Are Not Met?

- ***Absolute advantage*** determines trade when there is ***unemployment***
  - Increasing the production of one good does not require decreasing the production of another
- ***Absolute advantage*** determines trade when there is ***capital*** mobility
  - A country may have a surplus in the ***current account*** and a deficit in the ***capital account*** or vice versa
- Labour-saving ***technological change*** may occur as a result of trade/foreign investment
  - Therefore, ***unemployment*** will likely arise in less-developed, labour-abundant countries

The Political Economy of Free Trade Agreements

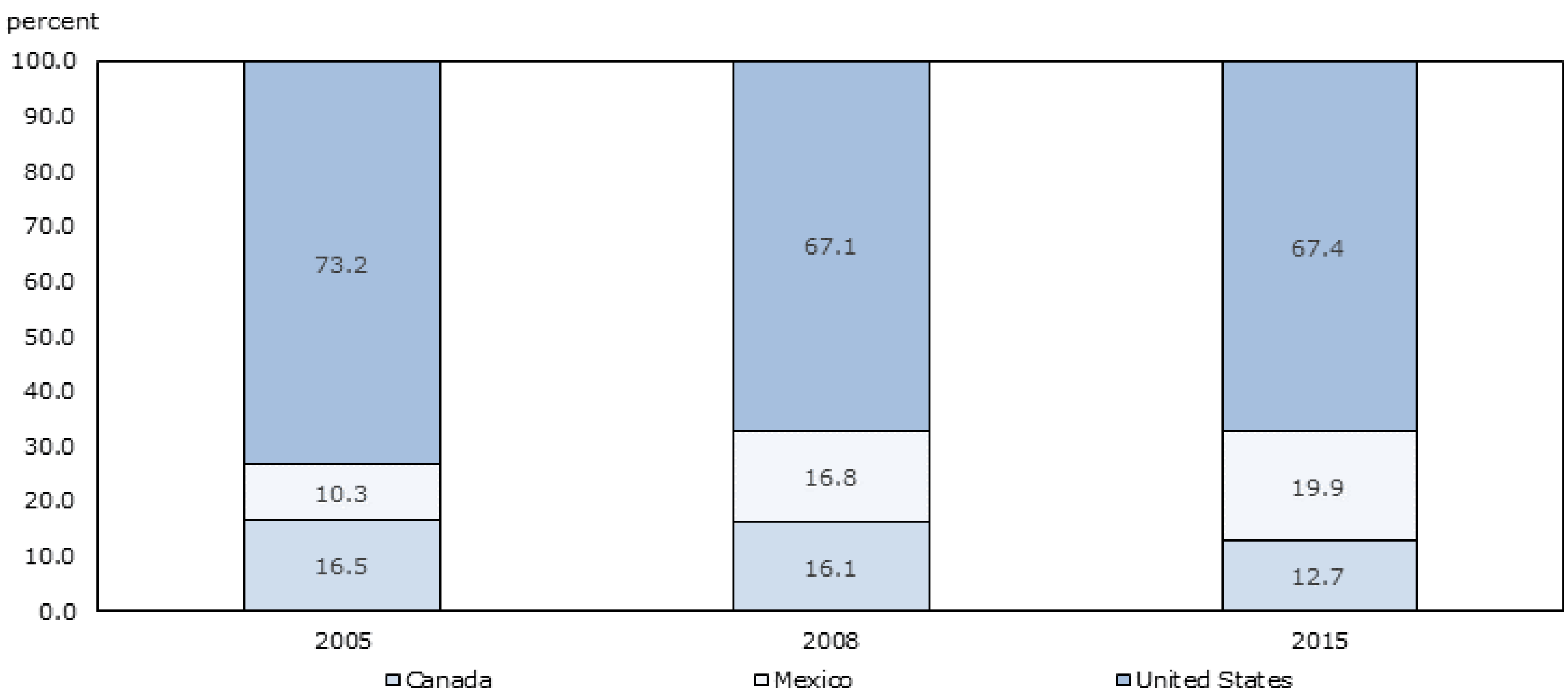
- ***Trade agreements*** involve more than just the exchange of goods and services
  - They include finance, investment, intellectual property, dispute settlement, government procurements, etc.
  - They intrude in areas of ***social policy*** and ***economic management***

- Mainstream analysis focuses on ***efficiency effects*** related to overall ***consumer*** and ***producer surplus***

- It also downplays redistributive effects of trade
  - It ignores ***displacement of employment*** between industries or regions
  - It assumes that ***gains*** outweigh ***losses***

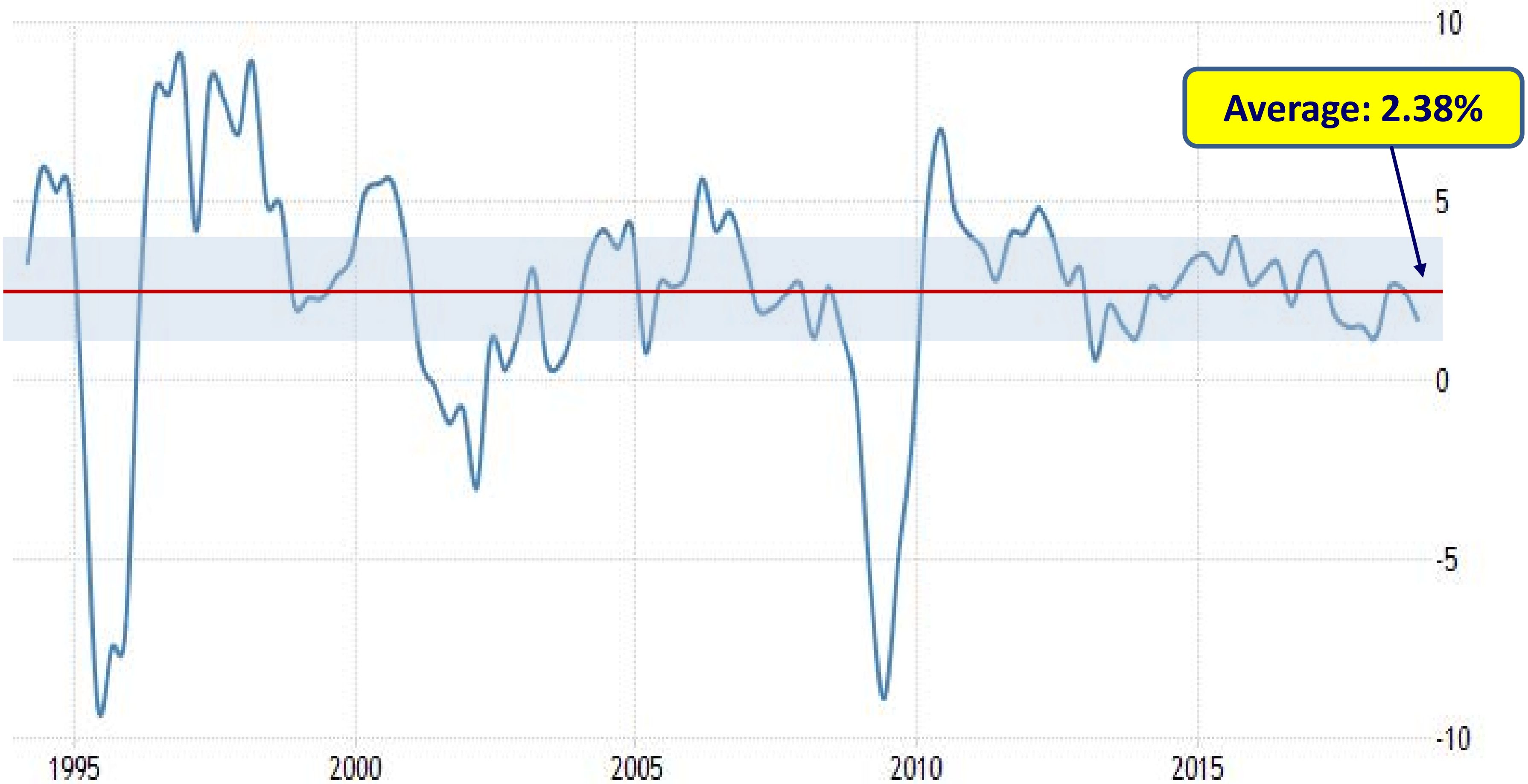
NAFTA and the Car Industry

Share of North American Production of Transportation Vehicles



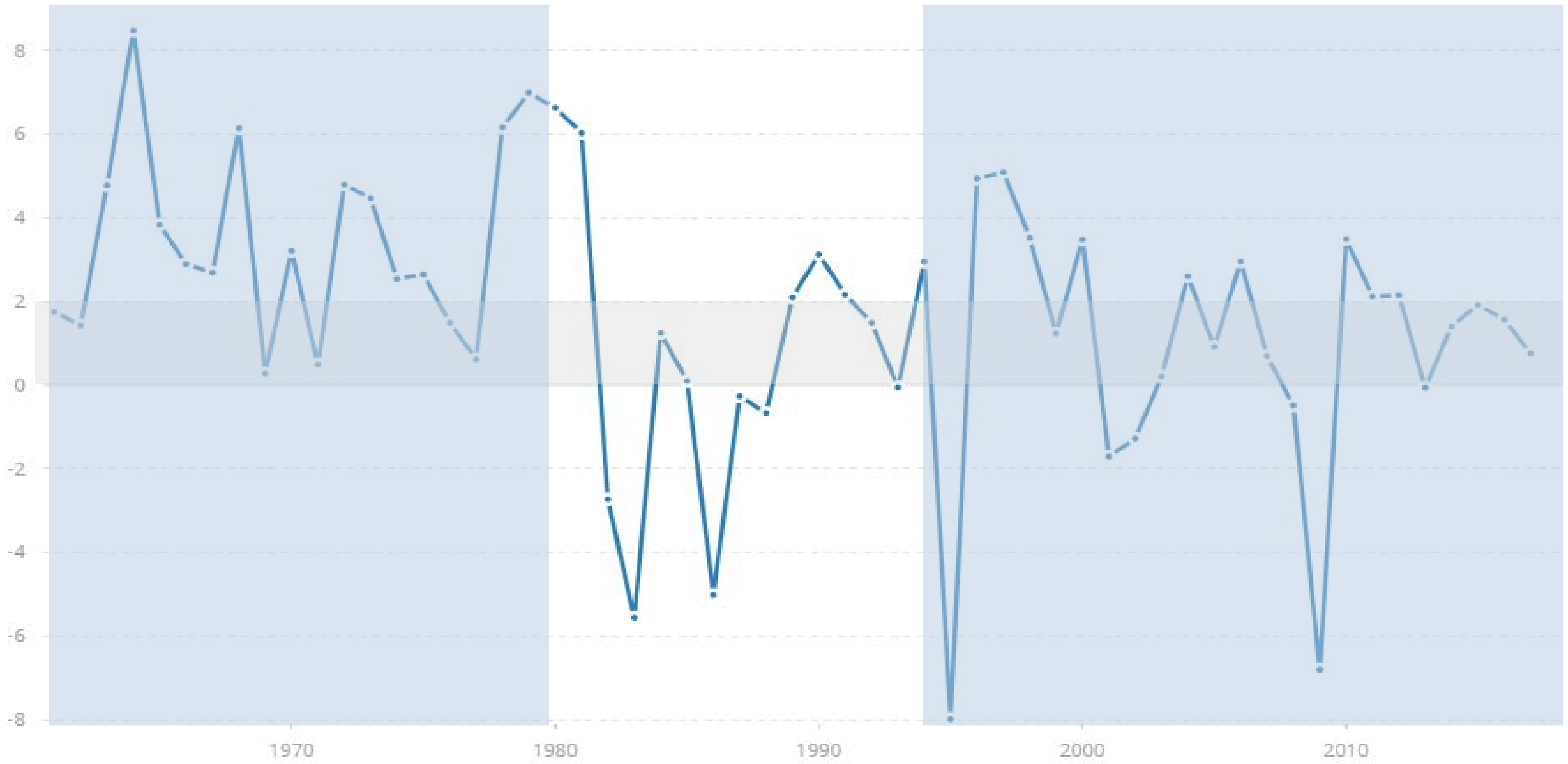
Source: E. Richards, "Differences in Post-recession Performance for Auto Manufacturers and Service Industries," Economics Insights No. 067, Statistics Canada, March 2017.

Mexico: GDP Growth Rate (1994-2018)



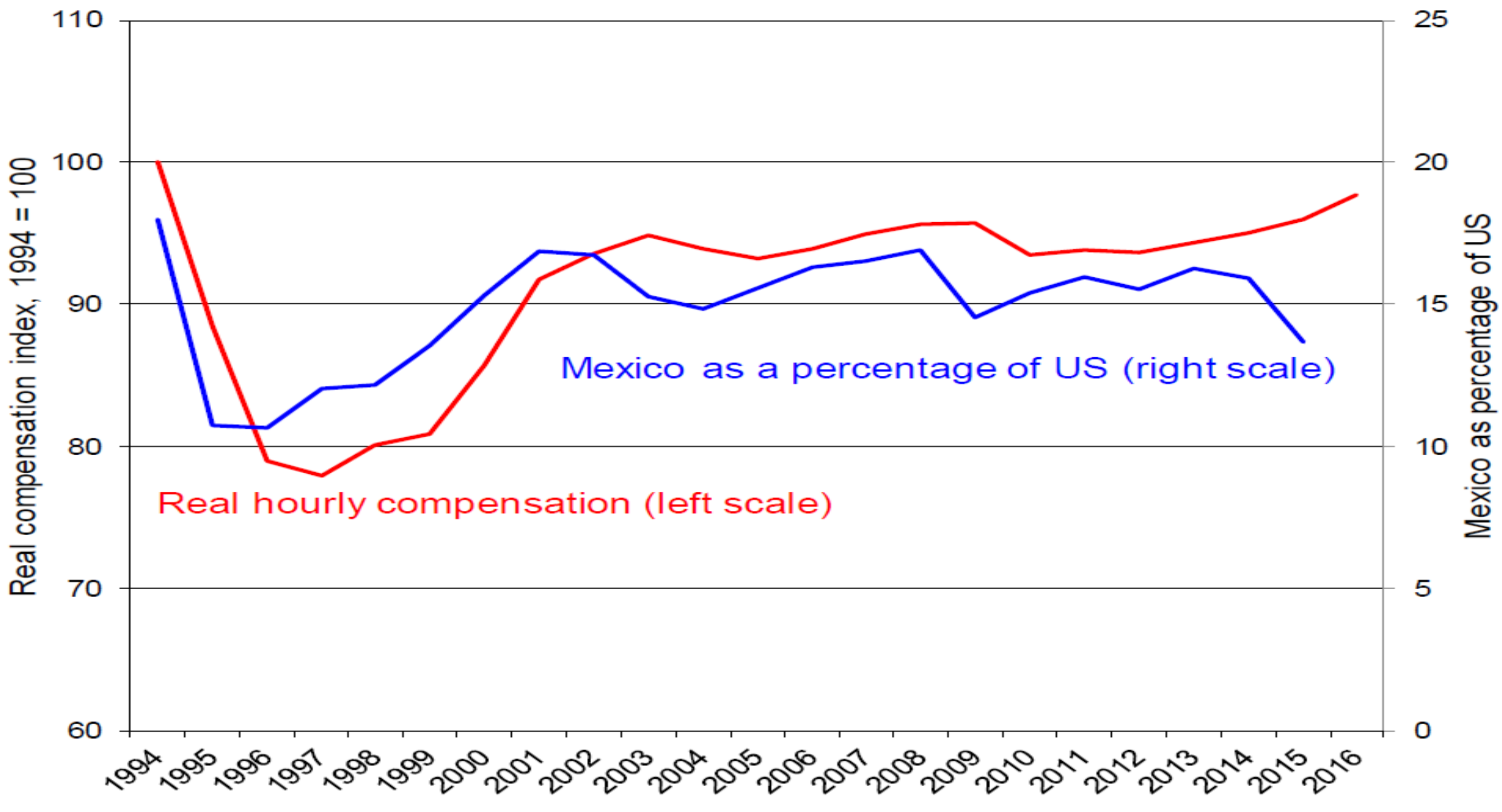
Source: Tradingeconomics.com and INEGI.

Mexico: GDP Per Capita Growth Rate (1961-2017)



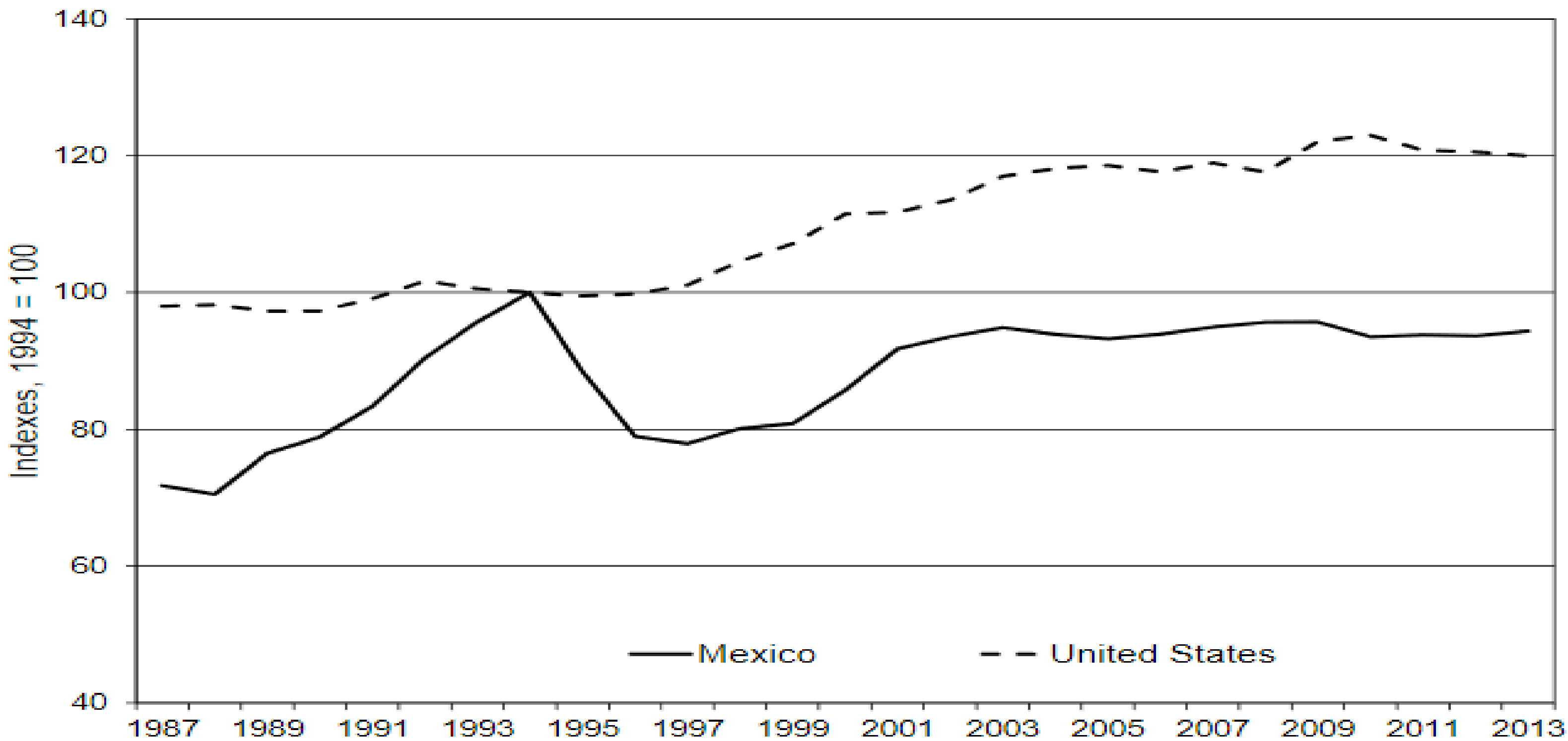
Source: World Bank.

Hourly Compensation of Mexican Production Workers (1994-2016)



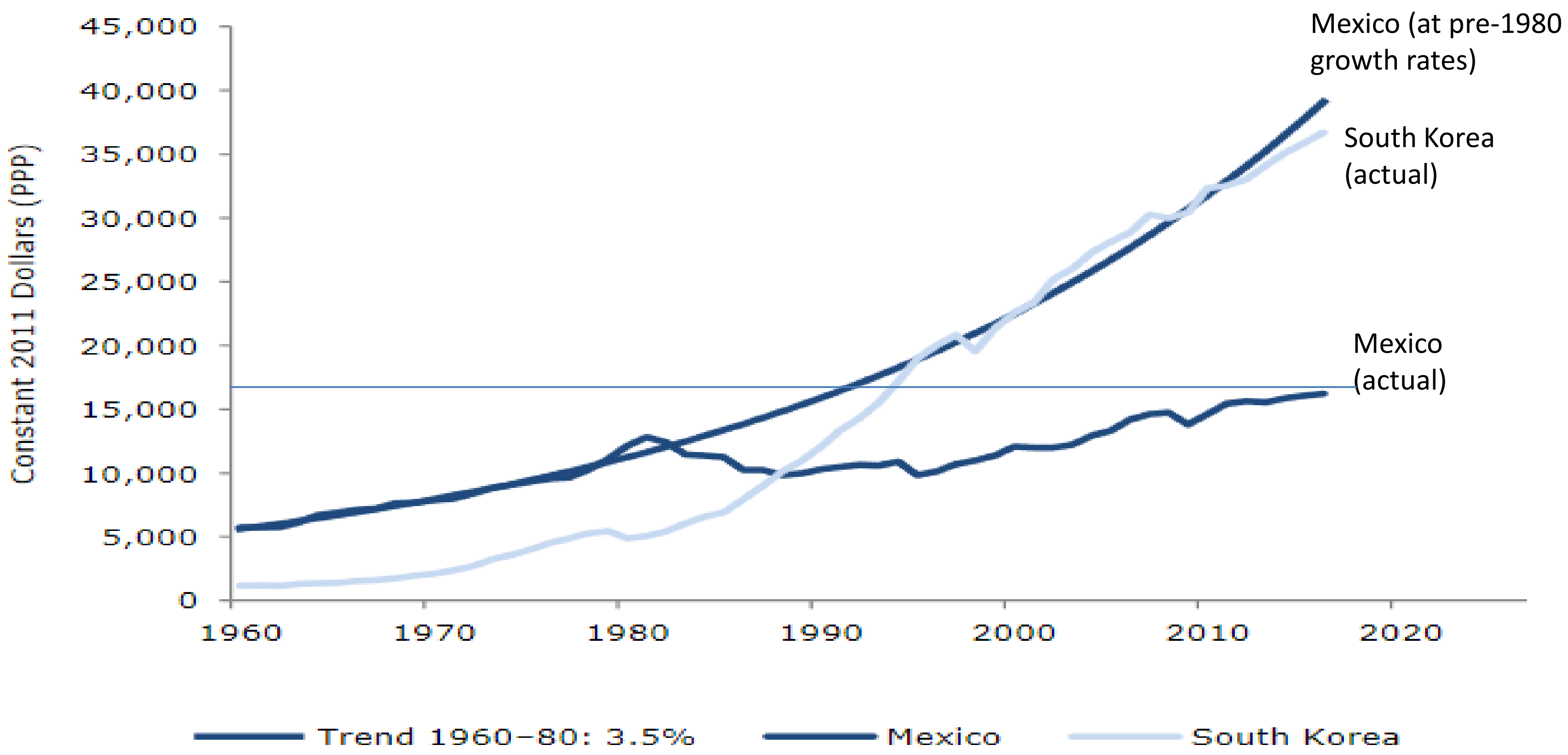
Source: R.A. Blecker, J.C. Moreno-Brid and I. Salat, "NAFTA Renegotiation: An Alternative Approach to Foster Upward Economic Convergence," *WEA Commentaries*, Volume 7, Issue 5, October 2017.

Mexican and U.S. Real Compensation per Worker Hour in Manufacturing
(1987-2013, 1994 = 100)



Source: R.A. Blecker, "The Mexican and U.S. Economies After Twenty Years of NAFTA, International Journal of Political Economy, 43:2, Summer 2014, pp. 5-26.

Mexico and South Korea: Real GDP Per Capita, 1960-2013



Source: M. Weisbrot, S. Lefebvre, and J. Sammut, "Did NAFTA Help Mexico? An Assessment After 20 Years," CEPR, February 2014 (updated March 2017).

What Is the Optimal Trade Policy?

- The argument for ***free trade*** might hold when all markets are efficient
- The argument for ***free trade*** cannot hold when:
  - Markets are riddled with ***market imperfections*** (e.g., unemployment in the labour market)
  - Trade involves ***negative externalities***
  - Government ***subsidies*** promote production and exports
- ***Free trade*** versus ***greater*** but ***managed trade***
  - Free trade implies ***static*** comparative advantage, i.e., maintaining the status quo
  - Greater trade may be used as an instrument to achieve ***structural changes***
  - The objective might be to acquire ***new*** comparative advantages

Globalization versus Internationalism

- ***Globalization*** is frequently conflated with ***internationalism*** but is something quite different
- ***Globalization*** refers to the global ***integration*** of many national economies into one global economy
  - It implies the necessary ***disintegration*** of the national economy
  - It's achieved through globally integrated capital markets, labour pools and trade agreements
- ***Internationalism*** refers to nations relying on each other and working together towards common goals
  - It's achieved through international trade, treaties, protocols, alliances and other structures
  - But the nation remains the basic unit of policy and decision-making

The Importance of Industrial Policy

- ***Industrial policy*** is a set of policies aimed at improving the ***global competitiveness*** of domestic firms or industries
  - It refers to policies that promote ***structural change*** by stimulating specific economic activities
  - It attempts to create ***new*** comparative advantages in ***increasing-returns*** industries
  - It is based on the understanding that ***economic development*** is ***activity-specific***
- Industrial policy is not about "industry" per se
  - It can also be applied to the agricultural sector or to any other sector
- Industrial policy is directed to ***non-traditional sectors*** of the economy
  - That is, to sectors that do ***not*** presently enjoy ***comparative advantages***

Two Views of Industrial Policy

- ***Neoliberal approach* –** The best policy to facilitate economic development is to liberalize
  - Specialization in production based on the principle of ***comparative advantages***
  - Only role of the state is to provide stable ***macro-economic environment*** and ***infrastructure***
  - Particular interpretation of the success of East Asian tigers

- ***Structuralist approach* –** Governments should intervene in order to complement markets
  - Many markets are ***imperfect*** or do not exist
  - Greater reliance on markets requires a more ***proactive*** role of the government
  - Free markets do not account for success of East Asian countries and of presently rich countries

Kicking Away the Ladder

- Mainstream economists present a misleading account of the history of capitalist development

- All presently developed countries actively used ***industrial policies*** to promote ***infant industries***

- Once they developed, they tried to pull away from competitors by controlling the transfer of ***technology*** and forcing developing countries to ***open their markets***

  > ➢ Trade liberalization is the ***result*** of development and ***not*** its ***cause***

- ***International financial institutions*** put great pressure on developing countries to adopt ***"good policies"*** and create ***"good institutions"***

Main Differences in Industrial Policy Between East Asia and Latin America

- ***Selectivity*** rather than promotion of all industrial activities
- Picking activities that offer ***technological benefits*** and ***linkages***
- Forcing protected industries to ***move early*** into world markets
- Give lead role to private enterprises but use public enterprises to fill gaps and enter exceptionally risky areas
- ***Investing*** massively in skill creation, infrastructure, and support institutions
- Using ***selectivity*** in FDI to build local capabilities
- Improving the quality of ***bureaucracy*** and ***governance***

Jim Stanford: Some Conclusions Regarding Canada's Trade Account

- Lack of access to foreign markets is not the main factor holding back Canada's exports
  - Therefore, the solution is not the signing more FTAs

- The solution must include:
  - Development of innovative, technology-intensive domestic firms
  - Fostering development of large firms (rather than small and medium firms) to compete globally
  - Implement fiscal and exchange rate policies to enhance competitiveness
  - Trade policy should be implemented on a case-by-case basis (not FTAs)