

Lesson 3: Trade Restrictions, Costs and Benefits

Do you believe that:

“Consumption is the sole end and purpose of all production; and the purpose of the producer ought to be attended to only so far as it may be necessary for promoting that of the consumer. The maxim is so perfectly self evident that it would be absurd to attempt to prove it. But in the mercantile system, the interest of the consumer is almost constantly sacrificed to that of the producer, and it seems to consider production and not consumption, as the ultimate end and object of all industry and commerce.”

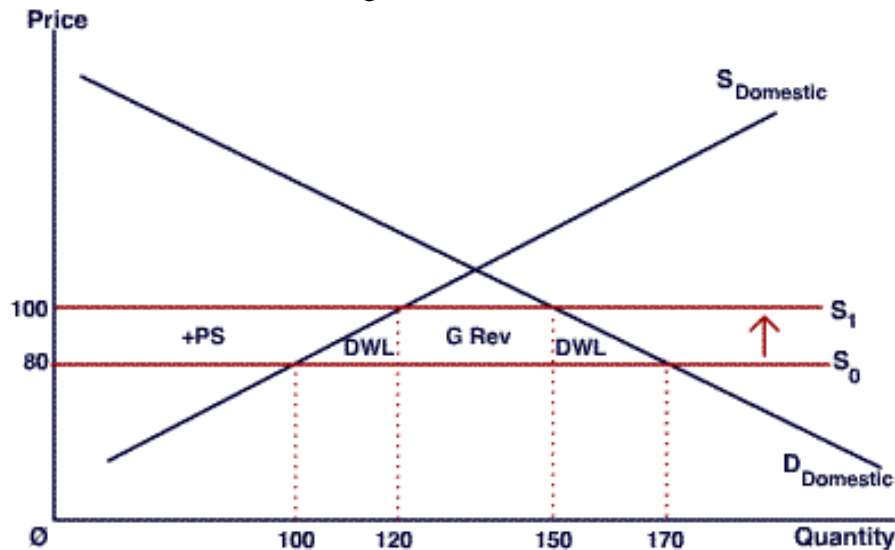
Adam Smith

I. On wealth & the purpose of economic activity

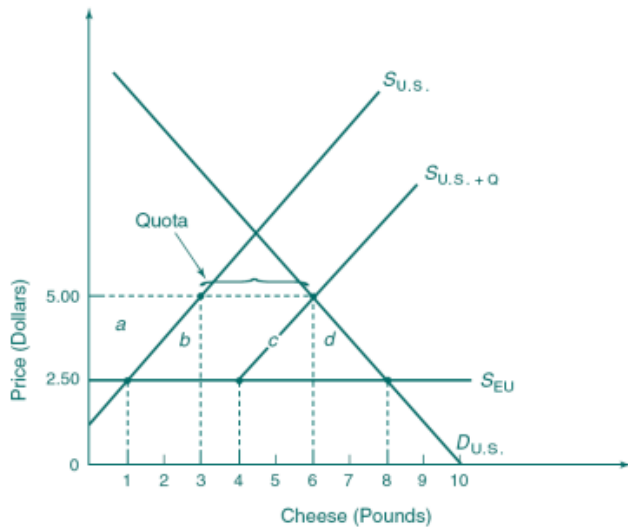
- A. The wealth of a nation?
- B. Producers or consumers? Who are you? Which do you care about? Which should public policy care about?
- C. If we protect producers of agricultural products, who gains, who loses?
- D. What if:
 1. Protect producers, costs consumers 5X the gain?
 2. Protect producers, costs consumers = to the gain?
 3. Protect producers, costs consumers 1/5 the gain?
 4. What is actually the case when looking at costs and benefits.
- E. A little political economy – the real reason why things get done.
- F. Wealth shifts (see C above)

II Tariffs & Quotas

- A. Definitions.
- B. Effects of a tariff:
 1. CS
 2. PS
 3. OC
 4. DWL
 5. Gov't revenues
 6. Show it in the diagram and calculate:



- C. Effects of a quota:
 1. CS, PS, DWL, Revenue? Quota Rents?
 2. The diagram:
 3. Show and calculate the parts.



- D. The differences between a tariff and a quota
1. Tariff – government collects the majority of the difference between the US & world price.
 2. Quota – instead of government revenue, foreign producers collect quota (scarcity) rents.
 - a. the allocation of quota rights fosters corruption in producing countries.
- E. Tariff rate quota: a two tier tariff system in which a certain amount of a good comes in at a lower tariff rate and any amount above this is charged a higher tariff. E.g., sugar.
- F. Examples
1. E.g. 1, auto quota rents in the US (1980's) helped foreign producers compete with US producers.
 2. E.g. 2, Japan semiconductors – increased revenues to Japanese producers because prices rose and they had quota rights.
 3. Also, dairy products, beef, tobacco, peanuts, leather, steel, shipping services, lumber, and many more.
- G. Who benefits and who pays:
1. Domestically, consumers pay and producers benefit.
 2. Foreigners: depends.
 3. The costs far outweigh the benefits.

IV. Direct Costs of Trade Restrictions

- A. Consumers pay more, producers receive higher prices and larger government support.
1. Sugar. 33 farms get 33% of the benefits from sugar quotas
 2. Impoverished farmers elsewhere must turn to other crops.

V. Indirect Costs of Trade Restrictions

- A. Import barriers and exports

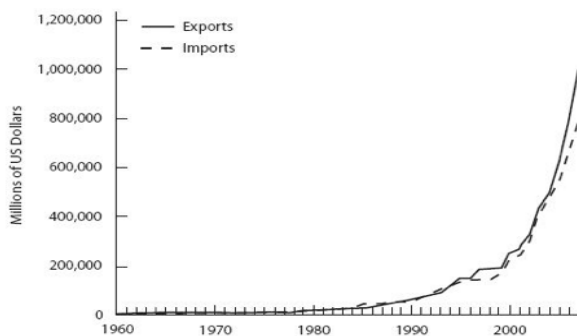


Figure 3.1

China's Exports and Imports, 1960–2007.

1. Reduced exports (Exports are the flip side of imports.) Why does anyone sell something?
2. Lerner symmetry theorem – a tax on imports is functionally the same as a tax on exports!

3. Did the Hawley-Smoot tariff of 1930 increase US employment? No, because...
 4. If imports increase, the Fx markets assure that exports will increase.
 5. Aside to the Fx markets.
- B. Import barriers and downstream industries
1. Import restrictions destroy jobs in downstream industries. It increases the cost of intermediate goods to domestic producers who compete with foreign producers who are able to purchase these intermediate goods cheaper.
 2. Examples:
 - a. Candy producers – move to Canada. In 2002, employment in sugar growing & harvesting was 61,000. Employment in sugar-using industries was 987,810! (\$826,000 per job saved!!)
 - b. Flat screen displays – laptop makers moved and then imported laptops freely to the US.
 - c. DRAM memory – same result.
 3. US manufacturers formed a coalition to oppose the trade restrictions
 - a. In memory chips
 - b. In steel VRA's (Voluntary Restraint agreements)
 - c. These seem to be relatively effective – someone represents the other side of the equation.

VI. The Foreign Exchange Markets

_A Determining Foreign Exchange Rates

1. Supply and demand for a currency
 - a. The demand for a currency in the foreign exchange markets is derived from...
 - b. The supply of a currency is derived from...
 - c. To demand one currency is the act of supplying the other in the foreign exchange market
 - d. Why demand curves slope downward.
 - e. Change in quantity demanded vs. a change in demand.
 - f. Shift factors (anything that affects trade besides the exchange rate):
 - i. Relative income changes
 - ii. Relative inflation
 - iii. Tastes and preferences
 - iv. Relative interest rates
 - v. Trade policies
 - vi. Political risk
 - g. Why supply curves slope upward
 - h. Change in quantity supplied vs. a change in supply
2. Equilibrium
3. Diagrams and examples
 - a. Some event:
 - b. Is it a credit or debit transaction?
 - c. In which account?
 - d. Does this affect the supply or demand for dollars?
 - e. Does it increase or decrease?
 - f. Which appreciates, which depreciates?

_B Appreciation & depreciation

1. Rate of appreciation - the percentage change in the exchange rate
2. $(\text{New} - \text{Previous}) / \text{Previous} \times 100$ (it's a %)
3. E.g., If the opening value is 3.758 SOCs per dollar and the close is 3.845 SOCs per dollar. What is the rate of change? Which is appreciating and which is depreciating?

VII. The Political Economy of Trade Protection

- A. Pareto, "a protectionist measure provides large benefits to a small number of people, and causes a very great number of consumers a slight loss." Benefits narrow and large, costs wide and small.
1. Sugar benefits \$1 billion (42% to 1% of producers). Costs at least \$1.9 B but only \$7 per person per year. Sugar producers are big campaign contributors.

2. Wire coat hangers. Only a penny more - \$120 million cost to consumers – total employment in the coat hanger industry 564 (\$28000 ea) so the cost of each job saved is \$212,000!
3. Why aren't consumers a special interest group?
 - a. Many consumers – difficult to organize.
 - b. Free rider problems.
4. The benefits of trade restrictions are very clear, immediately. The costs are uncertain and not so immediate or clear.
5. Once trade restrictions are in place, the protection is difficult to withdraw – mohair goat producers & the Korean war
6. **Activities to redistribute (vs. create) wealth are wasteful (and corrupting).**

VIII Beneficial Trade Restrictions?

- A. Restrictions that improve the terms of trade.
 1. When a country or group of countries has the power to increase the world price, restricting exports or imports will benefit the restricting country – at the expense of other countries.
Eg's oil, cotton, copper
- B. Promote positive externalities
 1. Positive externalities def.
 2. Subsidize industries that will create these positive externalities – semiconductors, HDTV, lasers, etc.
 3. Problems determining which industries.
 4. It is particularly difficult for the United States, where policy is determined largely by lawyers who are responding to self-interested producers, to discern impartially which industries exhibit such dynamic externalities and which do not, let alone the degree to which the knowledge spills over to foreign firms.”
- C. Capture economic rent.
 1. A strategic trade policy in which the government subsidizes a firm in a concentrated world market, reduces the foreign firms' output and earns more economic rent. Airbus.
 2. There are problems:
 - a. It is difficult to know exactly which situations call for this intervention.
 - b. Governments make decisions in a politically charged environment in which special interest groups significantly influence these decision.

Tools:

CS
PS
DWL

Activities to redistribute (vs. create) wealth are wasteful (and corrupting).

Terms:

Tariff

Non-tariff Barriers – quotas, exchange restrictions, exchange controls, health/safety/environmental requirements

Taxes:

Progressive
Regressive
Proportional

Economic Rent

Marginal

Secondary effects – unintended consequences and trade-offs

