

# 2.8 — Trade Agreements

ECON 324 • International Trade • Spring 2023

Ryan Safner

Associate Professor of Economics

 [safner@hood.edu](mailto:safner@hood.edu)

 [ryansafner/tradeS23](https://github.com/ryansafner/tradeS23)

 [tradeS23.classes.ryansafner.com](https://tradeS23.classes.ryansafner.com)



# Outline



The Strategy of Trade Agreements

History of Recent Trade Liberalization

The Economic Effects of Trade Agreements

# Where We're At



- **What We've Learned:**

- Predict & understand why and what countries trade (Trade Models)
- Consequences of trade barriers (tariffs, quotas, subsidies, etc)
- Intellectual history of free trade & protectionist arguments

- **What's Left:** for good or bad, **why** do countries have the trade policies they have today?

- A theory of how politics interacts with economics: **political economy**



# Where We're At



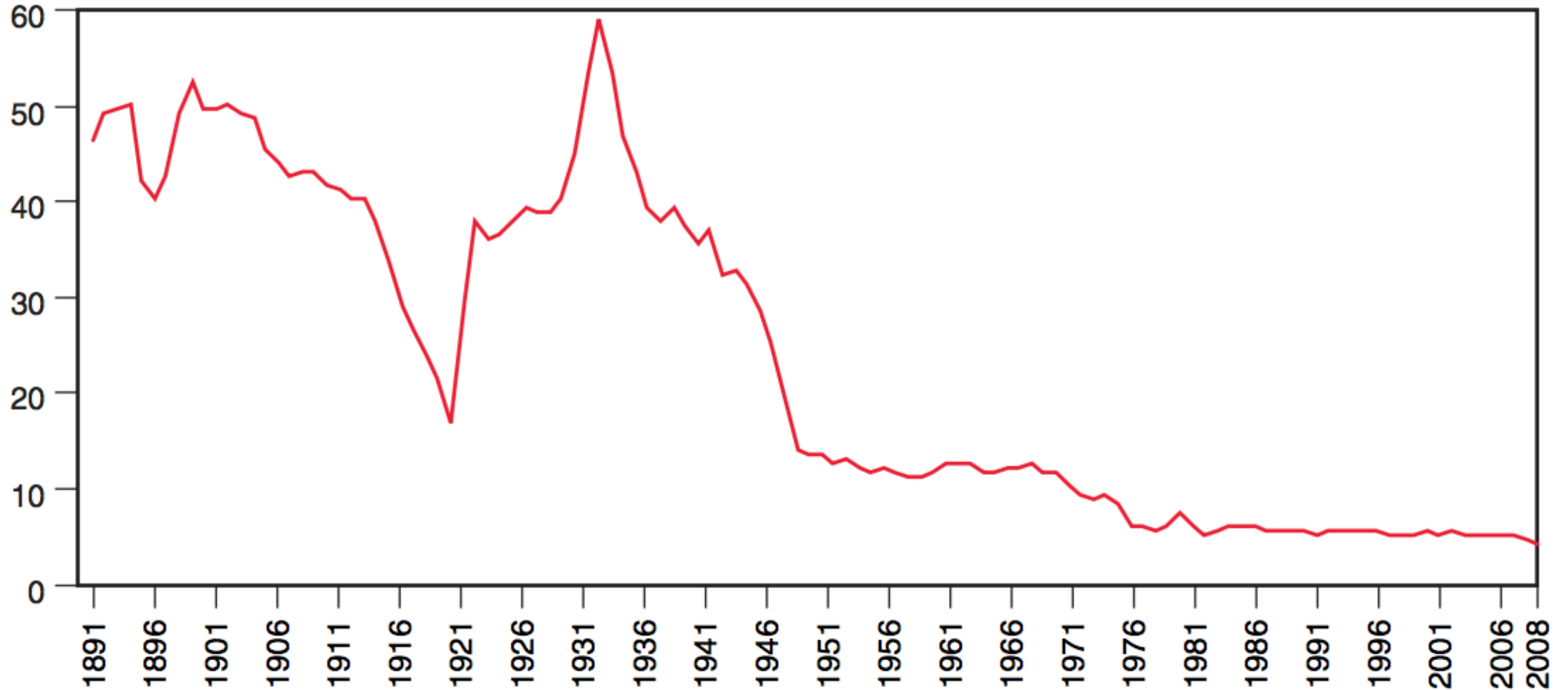
- If you agree with the following premises:
  1. Trade barriers are on in general harmful and inefficient on net for a society
  2. Trade barriers *do* benefit specific groups of people
- We need to answer two questions:
  1. Why do trade barriers that are often inefficient and welfare-reducing *persist*?
  2. How is it possible to get groups or countries to *agree to reduce* trade barriers?



# International Trade Negotiations



Tariff rate  
(percent)





# The Strategy of Trade Agreements

# The Strategy of Trade Agreements



- Unilateral free trade is the theoretically ideal strategy
  - we immediately drop all tariffs
  - economists continuously recommend this, dispersed benefits outweigh concentrated costs
- But this is not good politics!

The New York Times

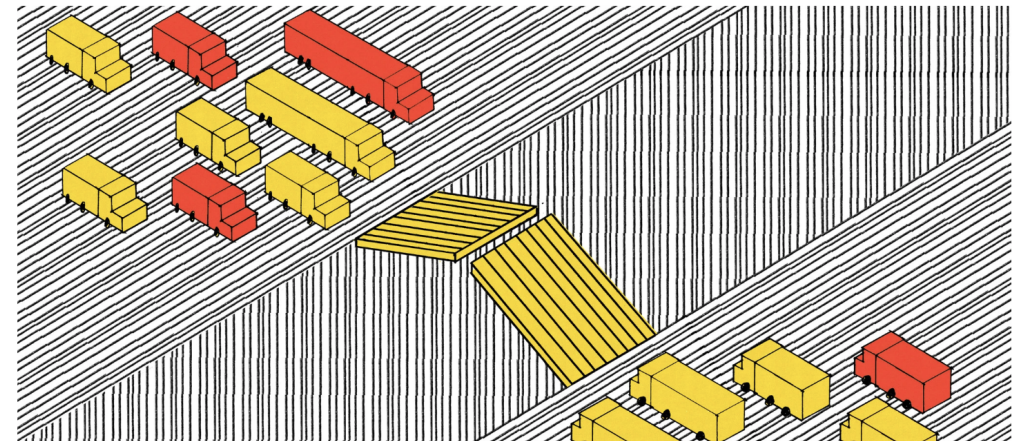
Opinion

## Why the U.S. Should Drop All Tariffs

By Veronique de Rugy

Ms. de Rugy is a senior research fellow at the Mercatus Center at George Mason University.

June 20, 2018



[Source](#)

# The Strategy of Trade Agreements

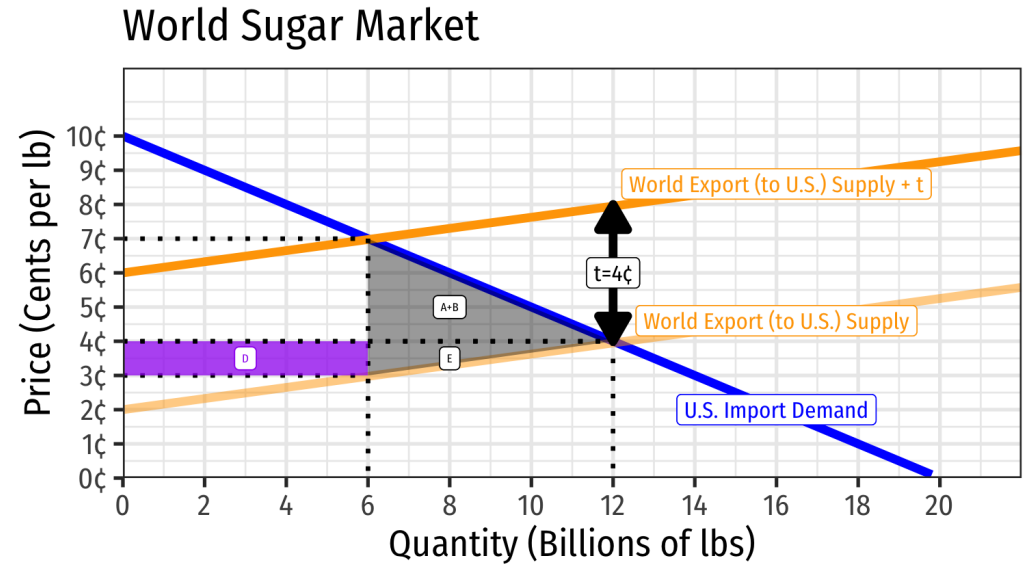
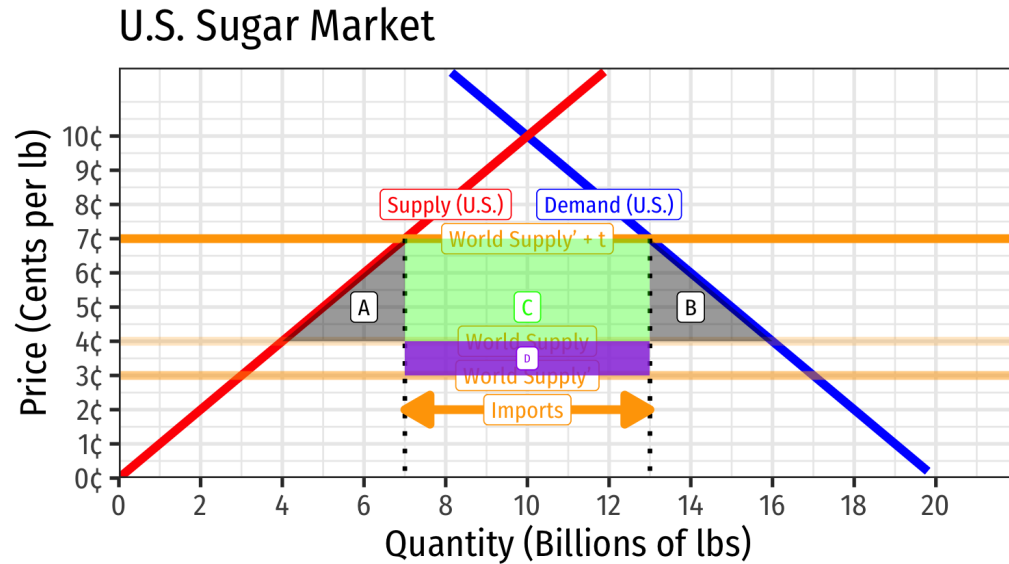


- Political infeasibility of unilateral free trade
- Note: opposite of politically stable policy: dispersed benefit, concentrated cost!
- Domestic import-competing industries are best-organized political group, stand to *lose* a large concentrated benefit with free trade





# The Strategy of Trade Agreements



- Recall effects of a large country's tariffs on world trade
- Compared to no-tariff, U.S. gains  $D - (A + B)$  from tariff
- Foreign country loses  $D + E$  from U.S. tariff

# The Strategy of Trade Agreements



- Now consider two big countries: **U.S.** and **China** negotiating with one another
- If one has a tariff, they gain  $D - (A + B)$  and the other loses  $-(D + E)$
- If both have tariffs, both lose  $A + B + E$
- If neither have tariffs (free trade), they earn 0

		China	
		No Tariff	Tariff
U.S.	No Tariff	0	$-(D+E)$
	Tariff	$D-(A+B)$	$-(A+B+E)$

# The Strategy of Trade Agreements



- Now consider two big countries: **U.S.** and **China** negotiating with one another
- If you're having trouble keeping track, let's simplify

		China	
		No Tariff	Tariff
U.S.	No Tariff	0	-5
	Tariff	5	-2.5

Payoff matrix for U.S. and China. The matrix shows payoffs for both countries under two scenarios: No Tariff and Tariff. The U.S. payoff is on the left, and the China payoff is on the right.

# The Strategy of Trade Agreements



- Now consider two big countries: **U.S.** and **China** negotiating with one another
- If you're having trouble keeping track, let's simplify
- **Nash Equilibrium:**

		China	
		No Tariff	Tariff
U.S.	No Tariff	0	-5
	Tariff	5	-2.5

Payoffs are listed as (U.S., China). In the 'No Tariff' scenario, if both choose 'No Tariff', both get 0. If the U.S. chooses 'No Tariff' and China chooses 'Tariff', the U.S. gets 0 and China gets 5. If the U.S. chooses 'Tariff' and China chooses 'No Tariff', the U.S. gets 5 and China gets -5. If both choose 'Tariff', the U.S. gets -2.5 and China gets -2.5.

# The Strategy of Trade Agreements

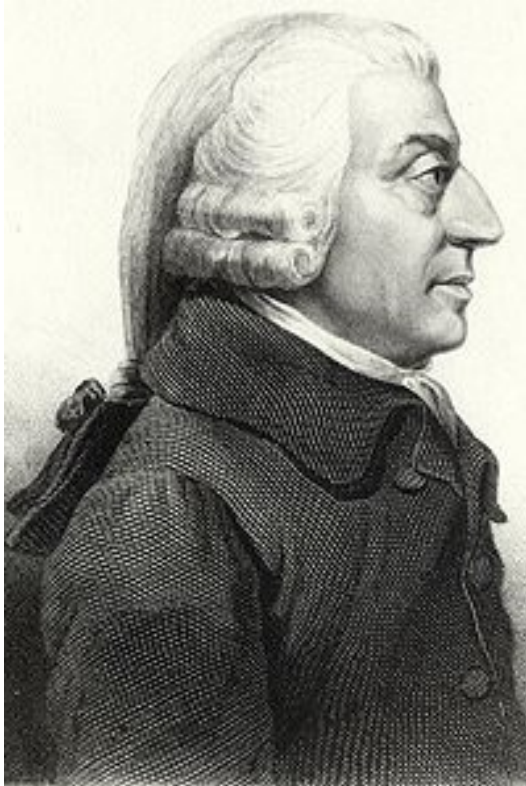


- Now consider two big countries: **U.S.** and **China** negotiating with one another
- If you're having trouble keeping track, let's simplify
- **Nash Equilibrium:** (**Tariff**, **Tariff**)
- Each country has a dominant strategy to give in to political pressure for protectionism

		China	
		No Tariff	Tariff
U.S.	No Tariff	0	-5
	Tariff	5	-2.5

Payoff matrix for the U.S. and China. The matrix shows the payoffs for each country based on their choice of Tariff or No Tariff. The U.S. payoffs are shown in red, and the China payoffs are shown in blue.

# Adam Smith: Strategic Trade Policy



Adam Smith

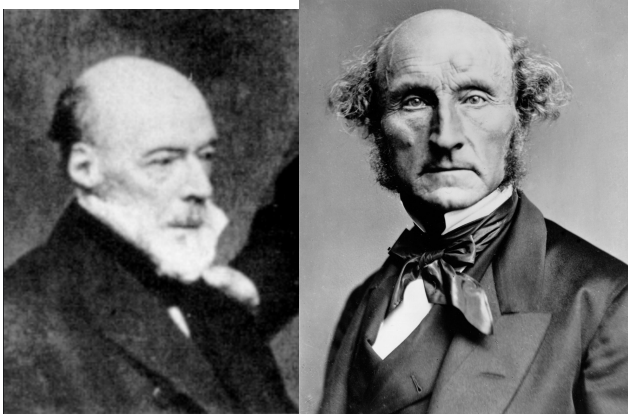
1723-1790

“[I]t may sometimes be a matter of deliberation [how to remove tariffs] when some foreign nation restrains by high duties or prohibitions the importation of some of our manufactures into their country. Revenge in this case naturally dictates retaliation, and that we should impose the like duties and prohibitions upon the importation of some or all of their manufactures into our country...nations accordingly seldom fail to retaliate in this manner.”

“There may be a good policy in retaliations of this kind...The recovery of a great foreign market will generatly more than compensate the transitory inconveniency of paying dearer during a short time for some sorts of goods. To judge whether such retaliations are likely to produce such an effect...[belongs] to the skill of that insidious and crafty animal, vulgarly called the statesman or politician, whose councils are directed by the momentary fluctuations of affairs.”

Smith, Adam, 1776, *An Enquiry into the Nature and Causes of the Wealth of Nations*, (Book IV, Chapter 2

# Torrens & Mill: Strategic Trade Policy



L: Col. Robert Torrens (1780—1864)

R: John Stuart Mill (1806-1873)

“[Reciprocity] would hold out to [foreign countries] a powerful inducement to act upon the principles of reciprocal freedom” - Torrens

“[C]onsiderations of reciprocity...are of material importance when the repeal of duties...is discussed. A country cannot be expected to renounce the power of taxing foreigners, unless foreigners will in return practise towards itself the same forbearance. The only mode in which a country can save itself from being a loser by the duties imposed by other countries on its commodities, is to impose corresponding duties on theirs.” - Mill

# Finding Commitments: Bilateral Agreements



- **Bilateral/multilateral trade agreements** provide **commitment strategies** for each nation to reduce tariffs
- Traditionally, it's concentrated benefits to domestic importers who lobby politicians to put up tariffs
- With a trade agreement, domestic *exporters* (who *want* free access to foreign markets) act as a concentrated political force fighting to lower tariffs
- Creates *multiple* groups in *multiple* countries with vested interest in keeping trade open (tariffs down)
- More concentrated & strongly interested groups fighting *against* tariffs than *for* tariffs!
  - Less incentive for domestic politician to cater to protectionist interests



*Odysseus and the Sirens* by John William Waterhouse, Scene from Homer's *The Odyssey*



# The Strategy of Trade Negotiations



- Why aren't all trade negotiations a single sentence:

“We hereby eliminate all tariffs”

- Trade agreements are often hundreds or thousands of pages long!



# The Strategy of Trade Negotiations



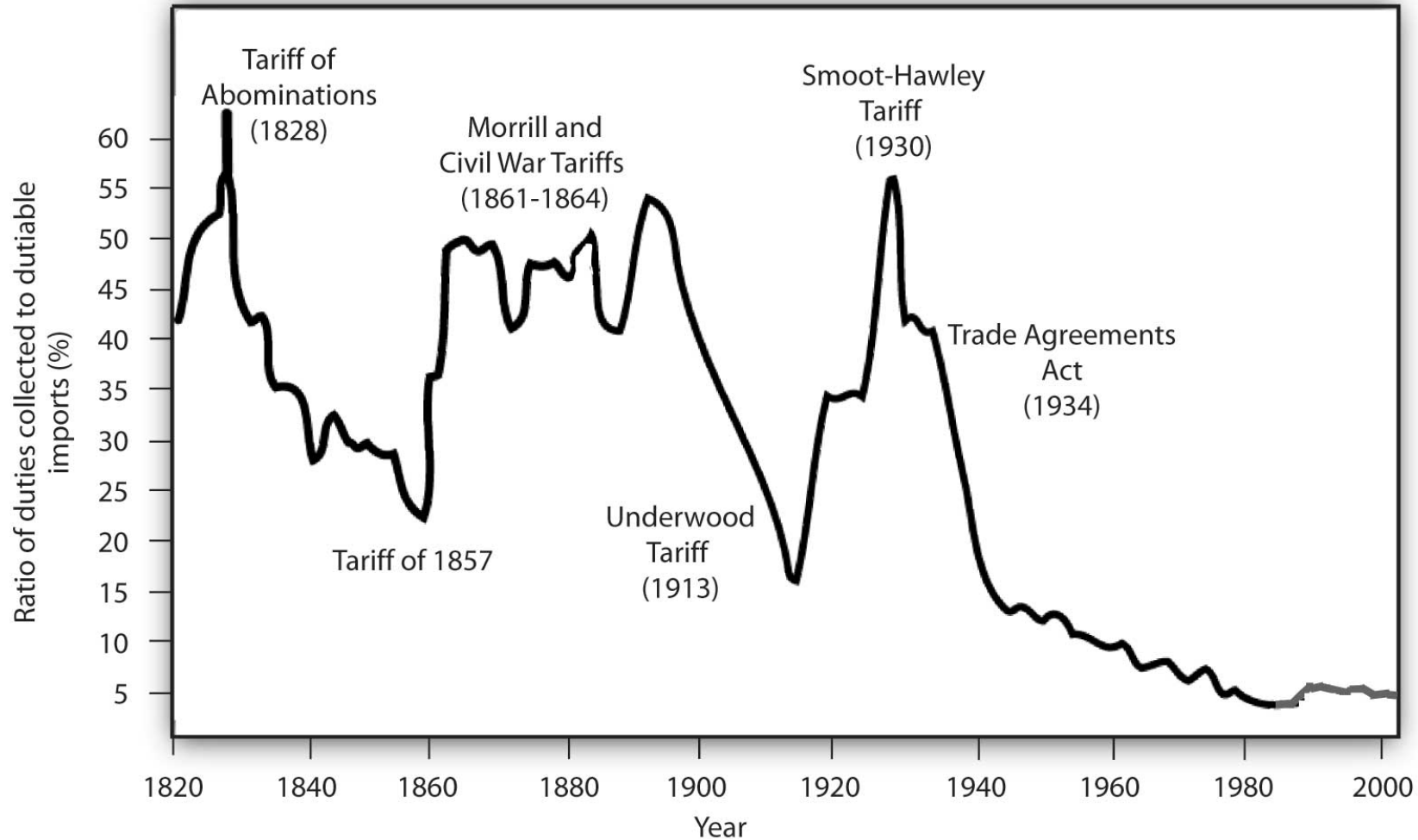
- There is a reason the public is not allowed into the "room where it happens"
  - there's a reason *Congress* does is not allowed into the room!
- If negotiations were public, or open to Congress:
  - Different interest groups would try to grab their own carve outs and exemptions





# History of Recent Trade Liberalization

# Smoot-Hawley Tariff Act and “Beggar Thy Neighbor”

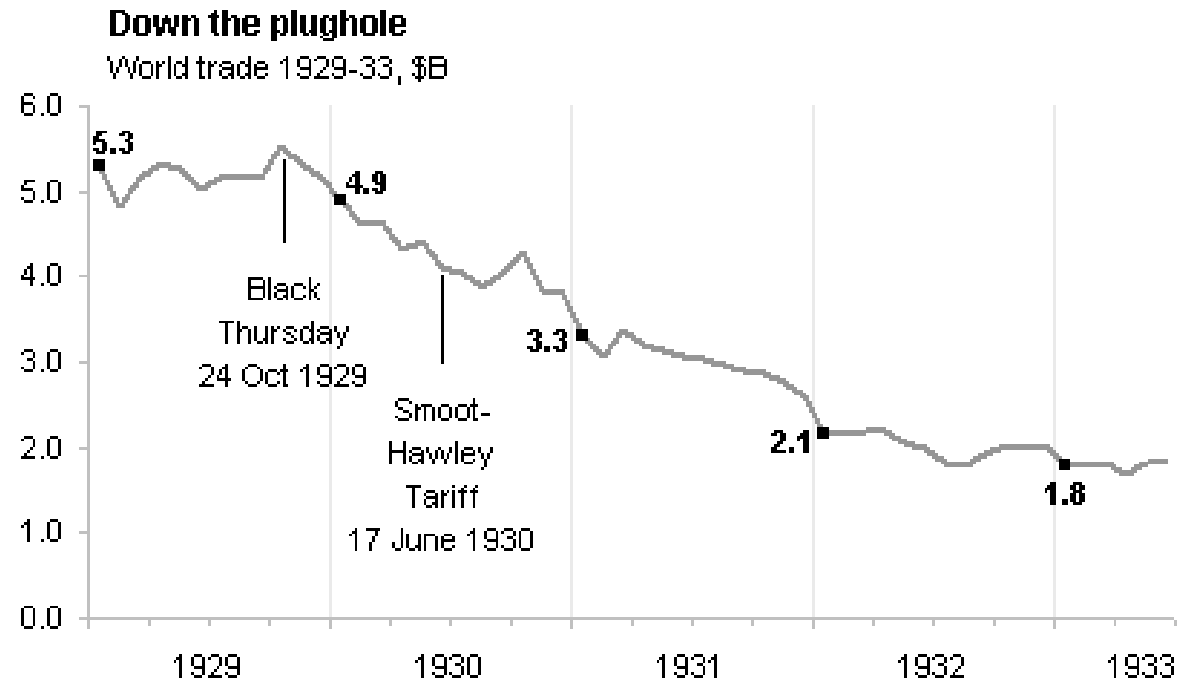


# Smoot-Hawley Tariff Act and “Beggar Thy Neighbor”



L: Rep. Willis C. Hawley

R: Sen. Reed Smoot



*League of Nations' World Economic Survey 1932-33*

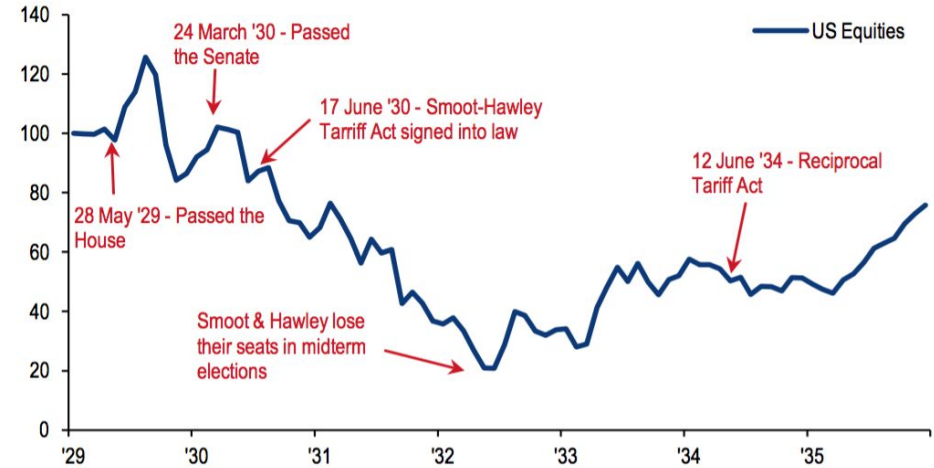
# Smoot-Hawley Tariff Act and "Beggar Thy Neighbor"



**The New York Times**  
 Copyright, 1930, by The New York Times Company.  
 \*\*\*\*\*  
 NEW YORK, MONDAY, MAY 5, 1930.

<p><b>WOMAN LEADS FIGHT ON LAUNDRY GANGS TO END TERRORISM</b></p> <p>Mrs. T. H. Whitney is Chosen as Dictator in Move to Clean Up Brooklyn Industry.</p> <p><b>TO WIPE OUT "RACKET"</b></p> <p>M. T. Director Will without Pay as a possibility."</p> <p>00 TRIBUTE</p>	<p><b>*1,028 Economists Ask Hoover To Veto Pending Tariff Bill</b></p> <p>Professors in 179 Colleges and Other Leaders Assail Rise in Rates as Harmful to Country and Sure to Bring Reprisals.</p> <p><i>Special to The New York Times.</i></p> <p>WASHINGTON, May 4.—Vigorous opposition to passage of the Hawley-Smoot tariff bill is voiced by 1,028 economists, members of the American Economic Association, in a statement presented to President Hoover, Senator Smoot and Representative Hawley by Dr. Claire Wilcox, associate professor of economics at Swarthmore College, and made public here today. They urge the President to veto the measure if Congress passes it.</p> <p>Economists from forty-six States and 179 colleges among them Irving</p>	<p><b>ROOSEVELT SUBMITS LONG-RANGE PLAN TO AID EMPLOYMENT</b></p> <p>Governor, in a Letter to Local Executives, Advises Preparing for Fall and Winter.</p> <p><b>"CORNER NOT YET TURNED"</b></p> <p>He Offers a Five-Point Program for Fact-Finding and Stimulation of Industry</p> <p><b>BUILDING GAIN</b></p>
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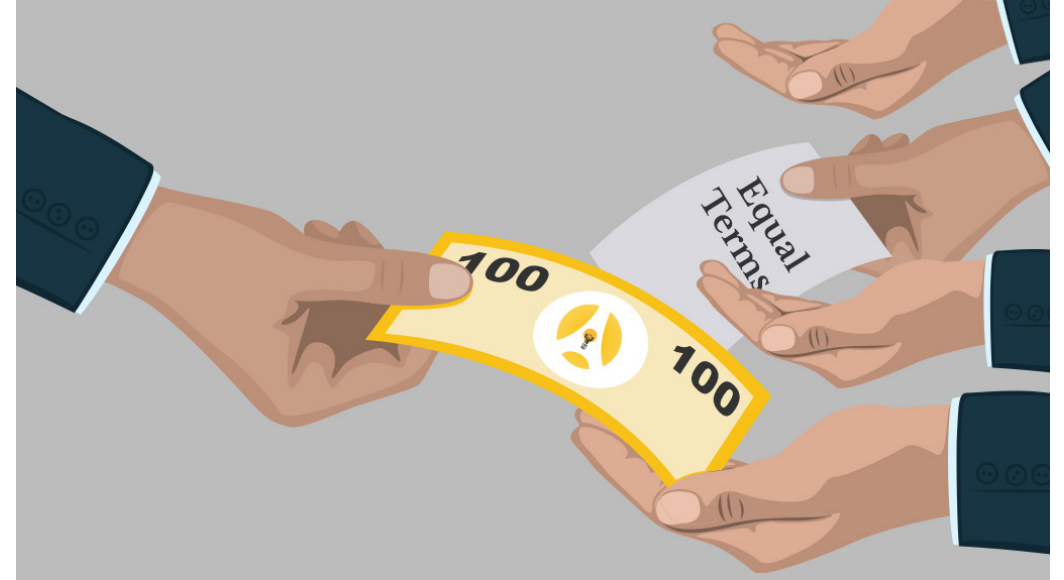
Chart 7: When protectionism failed ...impact of 1930 Smoot-Hawley Tariff Act on US equities



# Most-Favored Nation



- 1934 Trade Agreements Act
- Authorized the president to negotiate *mutual* tariff reductions with other countries by up to 50% from Smoot-Hawley tariff
- Based on **most favored nation (MFN) principle**: requires a country to provide any concessions, privileges, or immunities granted to *another nation* in a trade agreement also to the U.S. (and vice versa)



# GATT



- 1947 **General Agreement on Tariffs and Trade (GATT)**
- First major multilateral agreement
- Set in motion 9 major “rounds” of negotiations through 2001







- 1947 **General Agreement on Tariffs and Trade (GATT)**
- **Principle of nondiscrimination:**
  - **Most Favored Nation** principle again: any better bilateral trade agreement made between two members must also be applied to all GATT members
- **“Binding” of tariffs:** countries may lower tariffs, but are not allowed to *raise* tariffs (except in exceptional cases)
- Resolution of trade disputes through GATT institutions





- Protectionist measures in U.S. in 1950s:
  - “Peril-point provisions”
  - “Escape clause”
  - “National security clause”
- 1962 Trade Expansion Act: created Trade Adjustment Assistance (TAA)





- **“Uruguay Round”** (8th of GATT, 1986-1993, concluded 1994)
  - Tariffs
    - Industrial products fell from 4.7% on average to 3%
    - Share of goods with no tariffs increased from 20-22% to 40-45%
    - Tariffs removed on pharmaceuticals, construction equipment, medical equipment, paper products, steel





- **“Uruguay Round”** (8th of GATT, 1986-1993, concluded 1994)
  - Quotas
    - Quotas on agricultural products to be replaced with less restrictive tariffs by 1999
    - Quotas on textiles to be replaced with less restrictive tariffs by 2004





- **“Uruguay Round”** (8th of GATT, 1986-1993, concluded 1994)
  - Antidumping: Doesn't outright ban countervailing duties, but focuses more on tougher action through GATT institutions
  - Subsidies
    - Volume of subsidized agricultural products to be reduced 21% by 1999
    - Government subsidies for industrial research to be limited to 50% of cost





- **“Uruguay Round”** (8th of GATT, 1986-1993, concluded 1994)
  - Safeguards
    - Countries banned from using health and safety laws not based on scientific research
    - Temporary tariffs allowed to protect domestic industry against temporary import surges

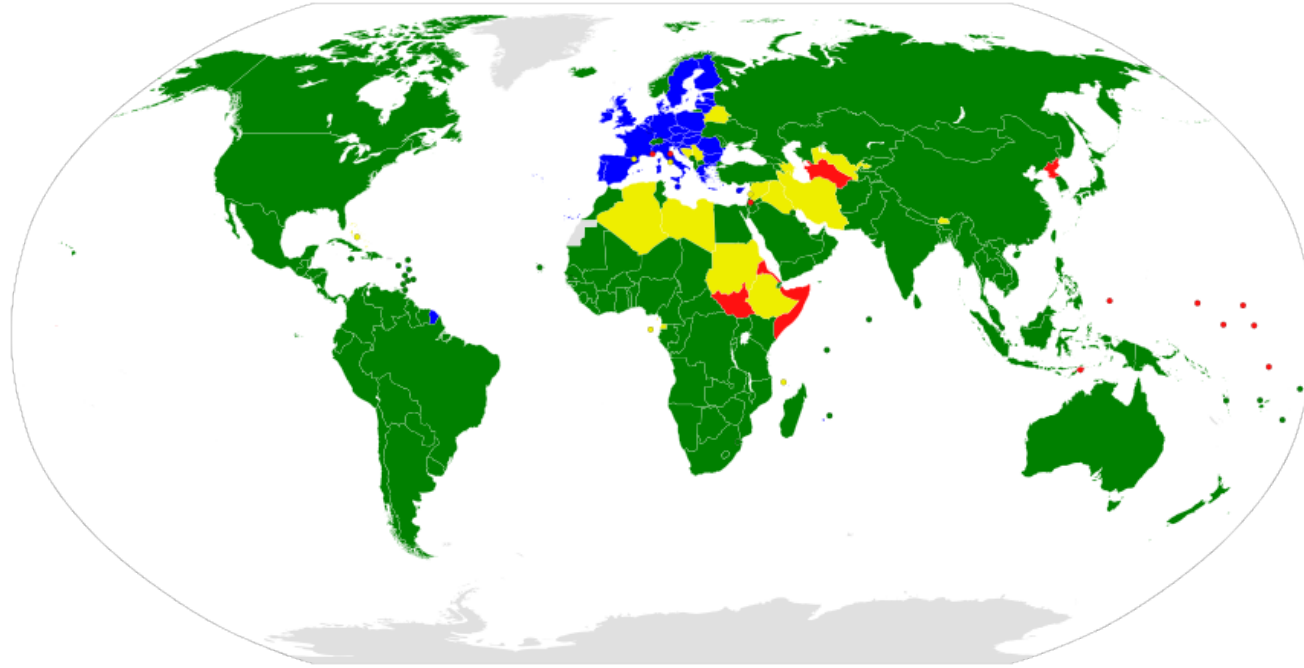


# GATT → WTO



- **“Uruguay Round”** (8th of GATT, 1986-1993, concluded 1994)
  - Intellectual property
    - 20 year protection of patents, trademarks, and copyrights
    - 10 year phase-in period allowed for developing countries' pharmaceuticals
- **World Trade Organization (WTO)**
  - GATT Secretariat is replaced and extended by institutions of the WTO





WTO Members, WTO Members dually represented by EU, Observer nations, Non-members





- WTO principles:
  - Nondiscrimination
  - Reciprocity
  - Binding and enforceable commitments
  - Transparency
  - Safety Valves
- Organization: Councils for Trade in Goods, Trade-Related Aspects of Intellectual Property Rights (TRIPS), Trade in Services, Trade Negotiations Committee
- Dispute Resolution Mechanisms

WORLD TRADE  
ORGANIZATION





- Estimated that Uruguay Round:
  - increased the volume of world trade by 20% (25% from manufacturing, 75% from agriculture)
  - increased world income gains by \$349 billion (\$164 billion from agriculture, \$130 billion from manufacturing, \$55 billion from services)
  - developing countries receiving 42% of the gains - double their share of world GDP

WORLD TRADE  
ORGANIZATION



# WTO



- 2001 China admitted to WTO
- 2002 Congress granted President “fast-track authority” to negotiate trade deals, expired in 2007

WORLD TRADE  
ORGANIZATION





- Doha Round (9th of GATT, 2001-?, failed so far)
- Disagreements over agricultural subsidies
- Debates about GMOs, health and safety issues, environmental protection

WORLD TRADE  
ORGANIZATION



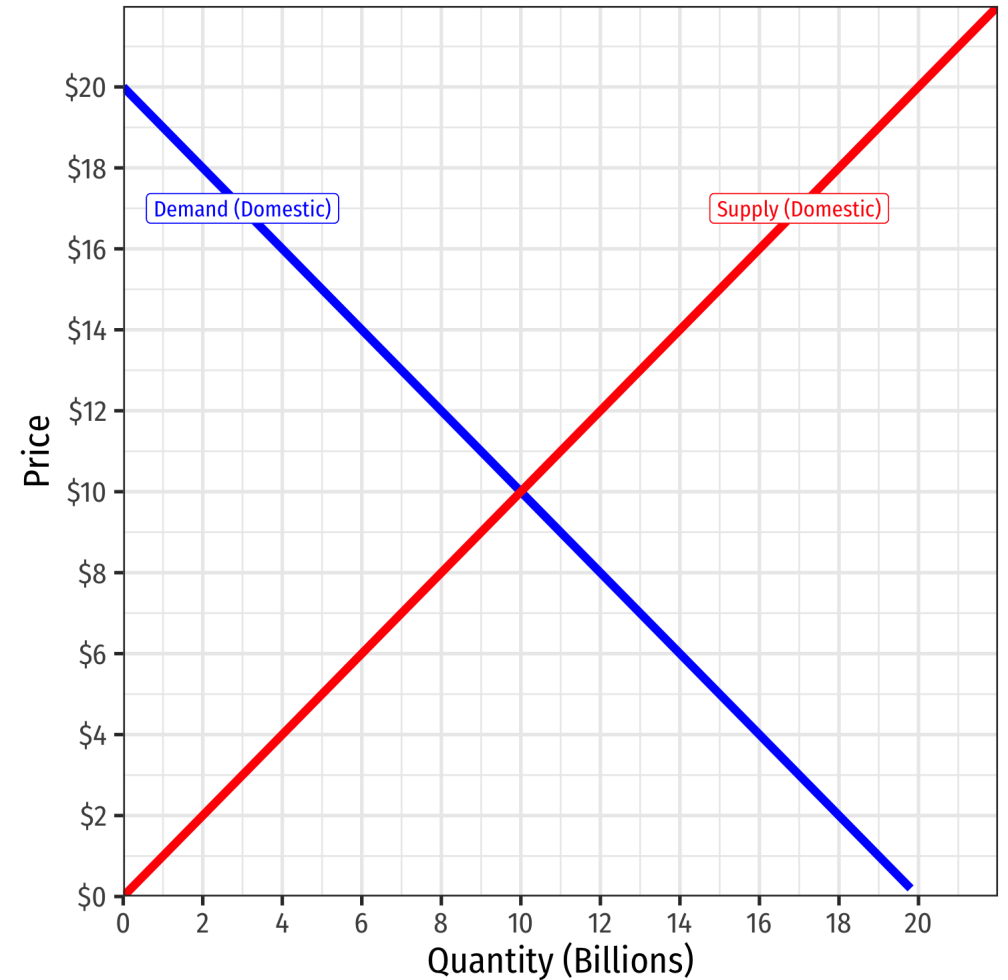


# The Economic Effects of Trade Agreements

# Trade Creation & Trade Diversion



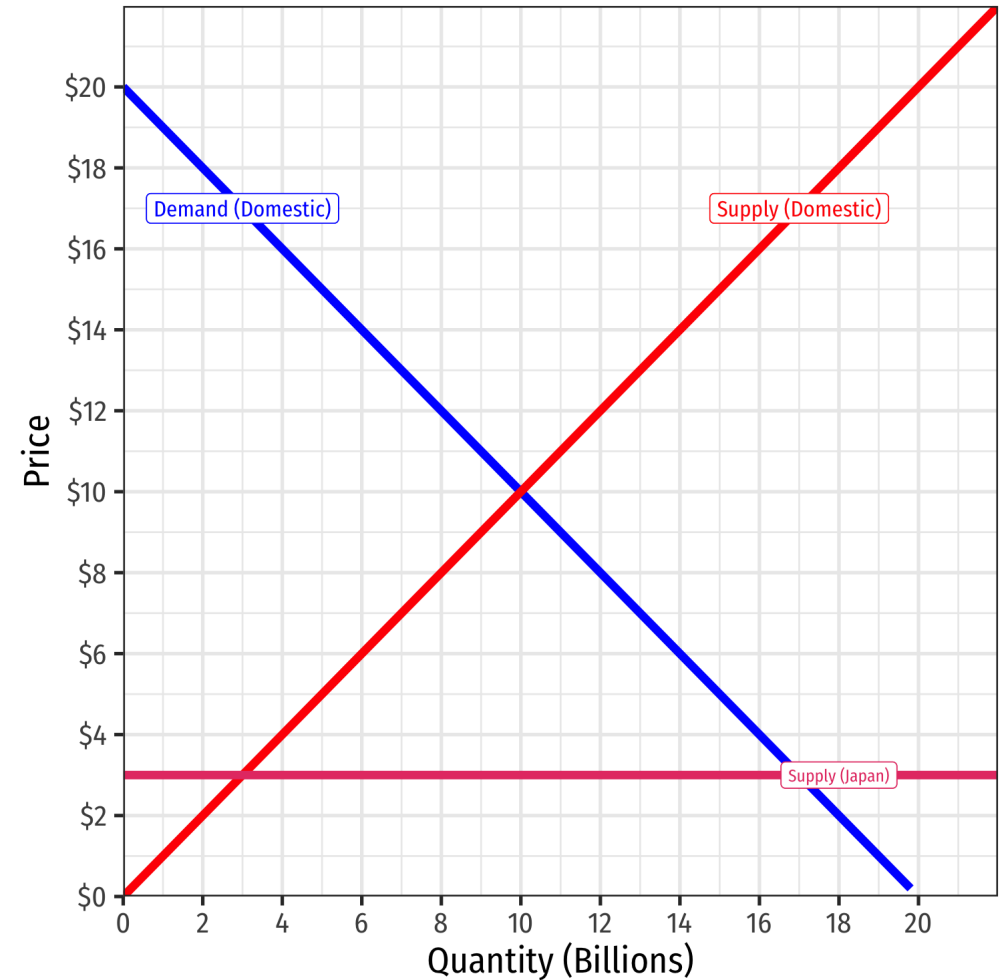
- Consider the market for T-shirts in the United States



# Trade Creation & Trade Diversion



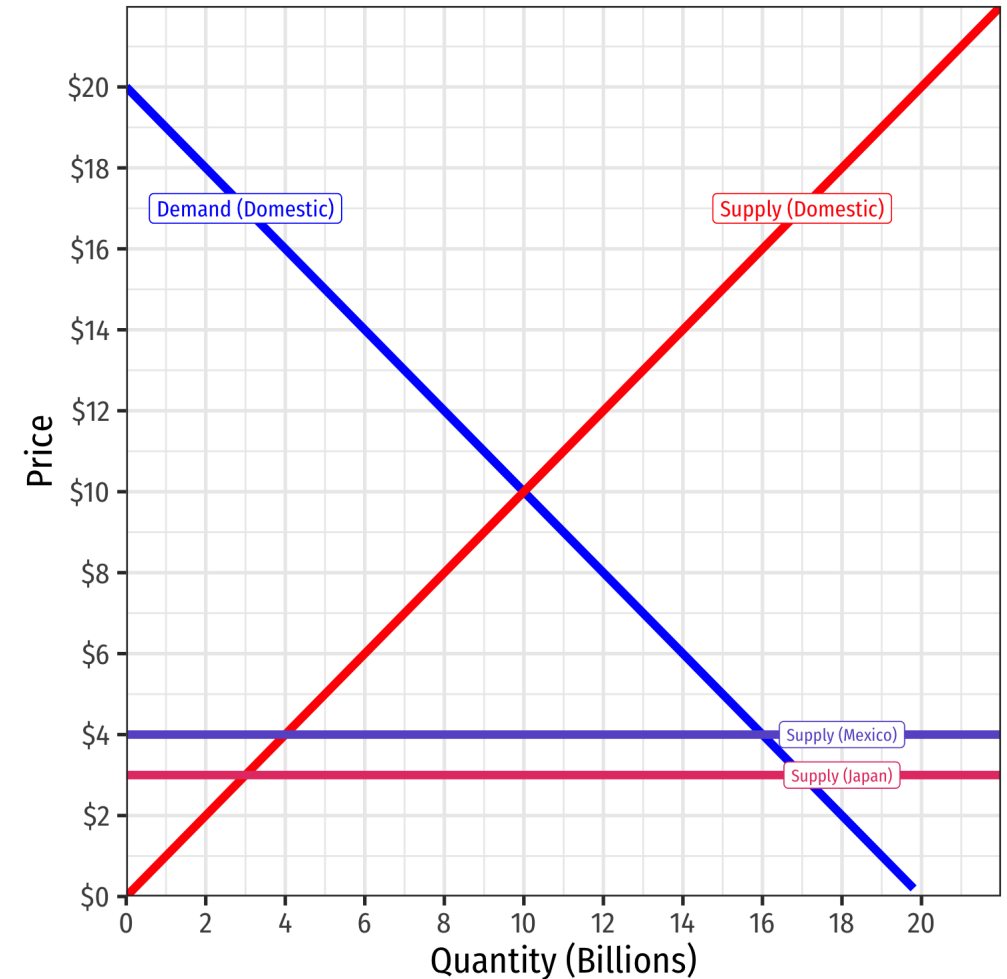
- Suppose the United States can import T-shirts from **Japan**



# Trade Creation & Trade Diversion



- Suppose the United States can import T-shirts from **Japan** or **Mexico**
  - **Japan** is more efficient (\$3/shirt) than **Mexico** (\$4/shirt)

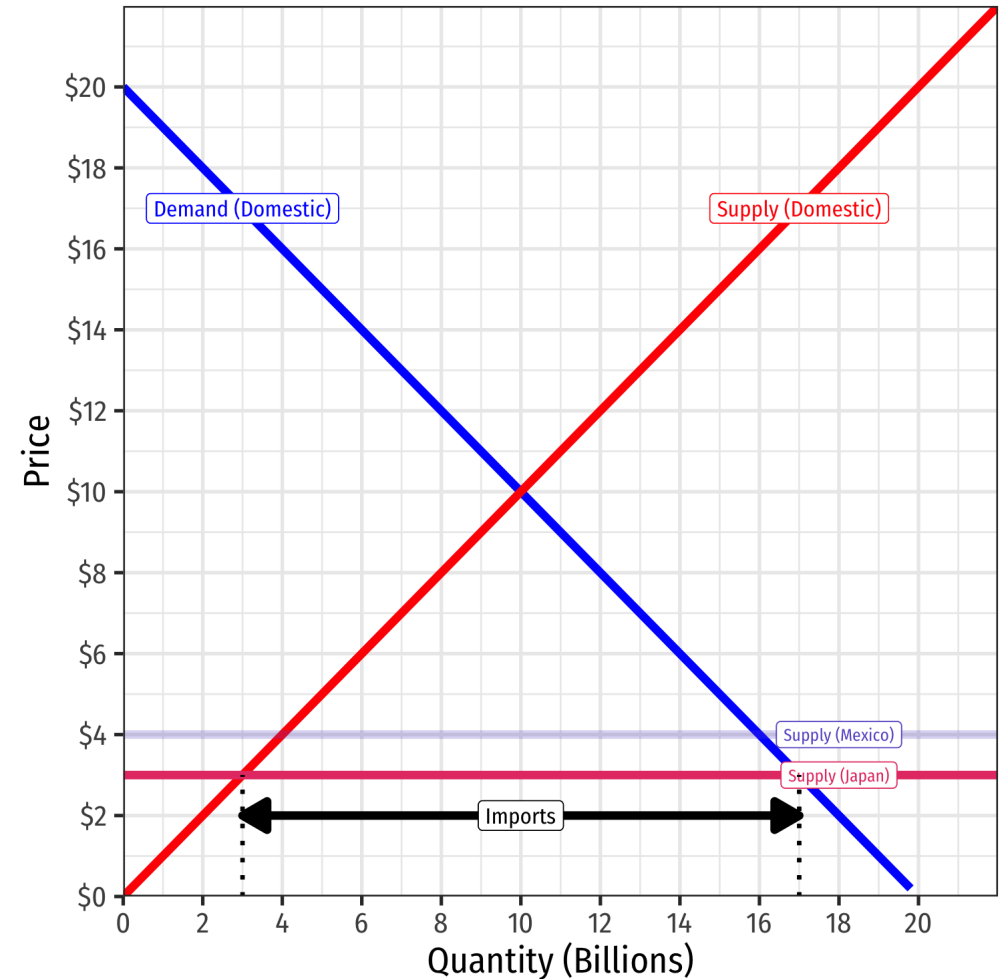




# Trade Creation & Trade Diversion



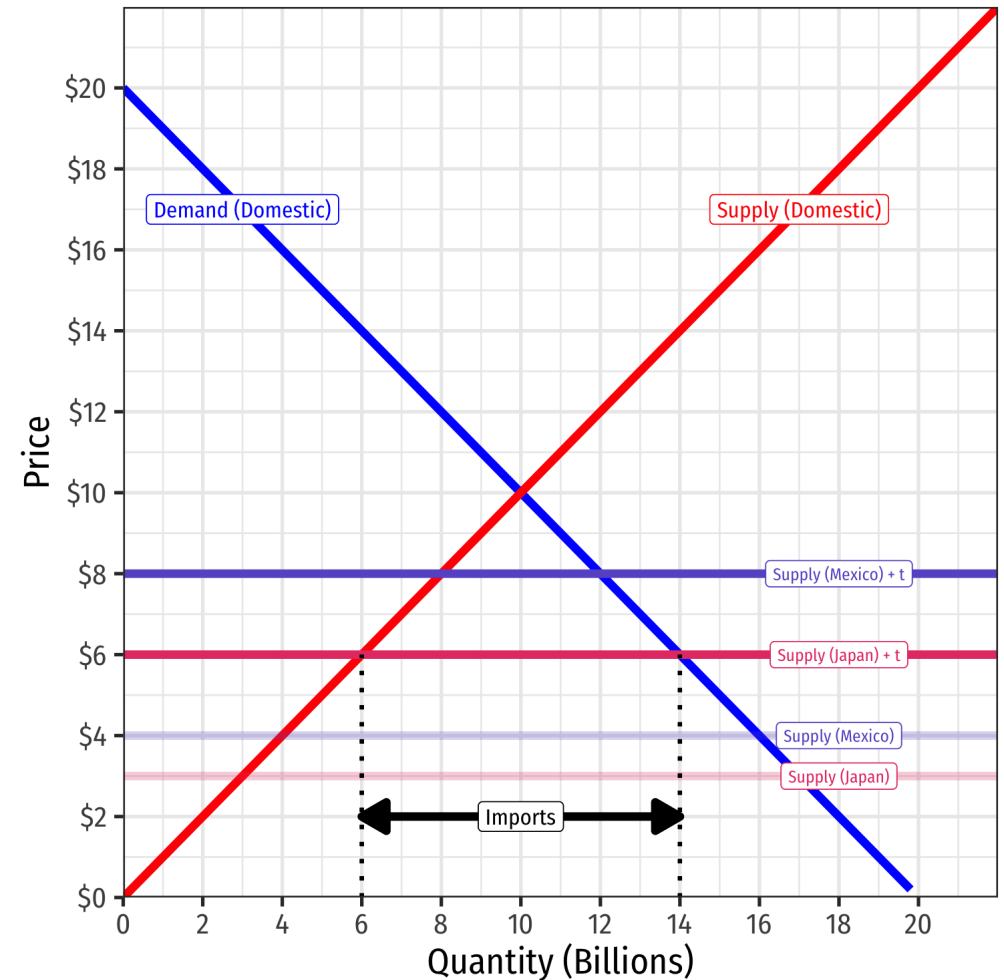
- Suppose the United States can import T-shirts from **Japan** or **Mexico**
  - **Japan** is more efficient (\$3/shirt) than **Mexico** (\$4/shirt)
- Under free trade, U.S. would import 14 Bn from **Japan** (cheapest), and 0 from **Mexico**



# Trade Creation & Trade Diversion



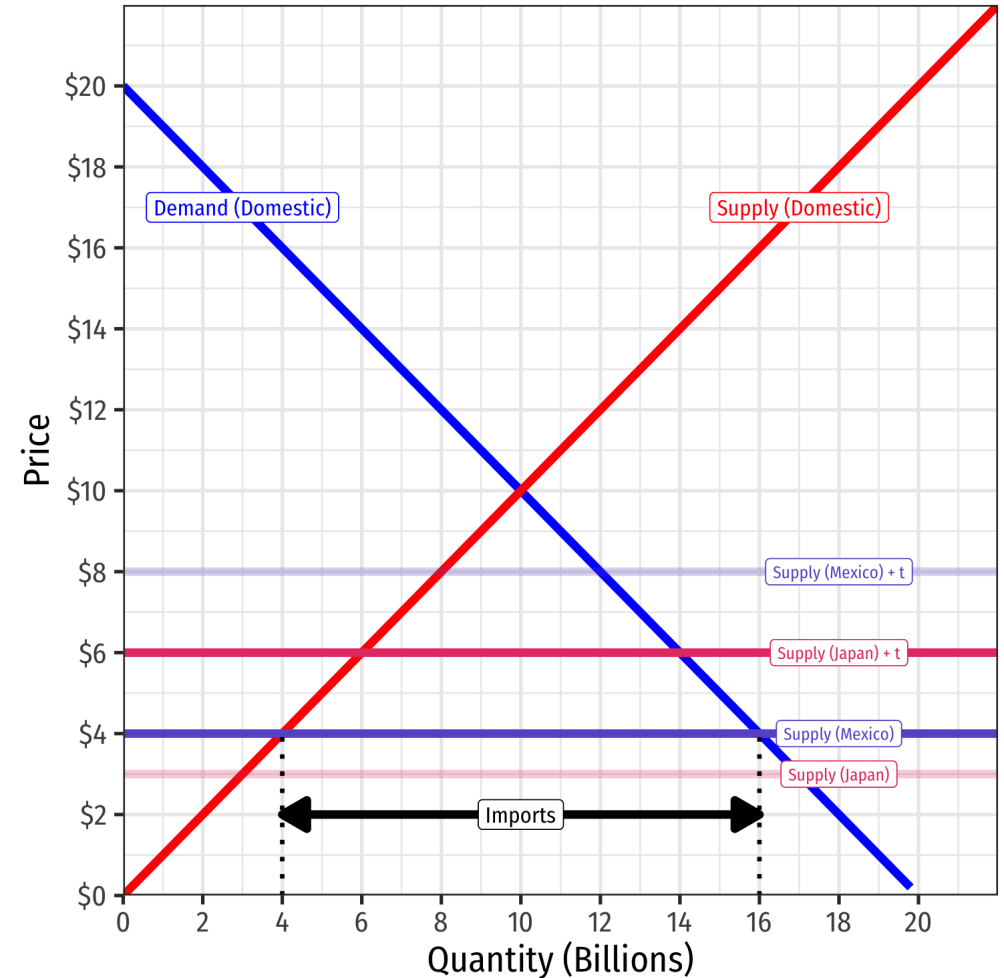
- Suppose the United States can import T-shirts from **Japan** or **Mexico**
  - **Japan** is more efficient (\$3/shirt) than **Mexico** (\$4/shirt)
- Suppose instead the U.S. has a 100% tariff on *any/all* imported T-shirts
  - **Japanese** imports are still cheapest (but at \$6/shirt now, vs. \$8 **Mexican** shirts)
  - Imports 8 Bn from **Japan** and 0 Bn from **Mexico**



# Trade Creation & Trade Diversion



- Now suppose the U.S. and Mexico enter a free trade agreement
  - U.S. drops tariffs on Mexico to 0%
  - Keeps tariff on Japan
- Now Mexican T-shirts (with no tariff) are cheaper at \$4/shirt compared with Japan (still with tariff) at \$6/shirt!
  - U.S. imports 12 Bn from Mexico, imports 0 Bn from Japan



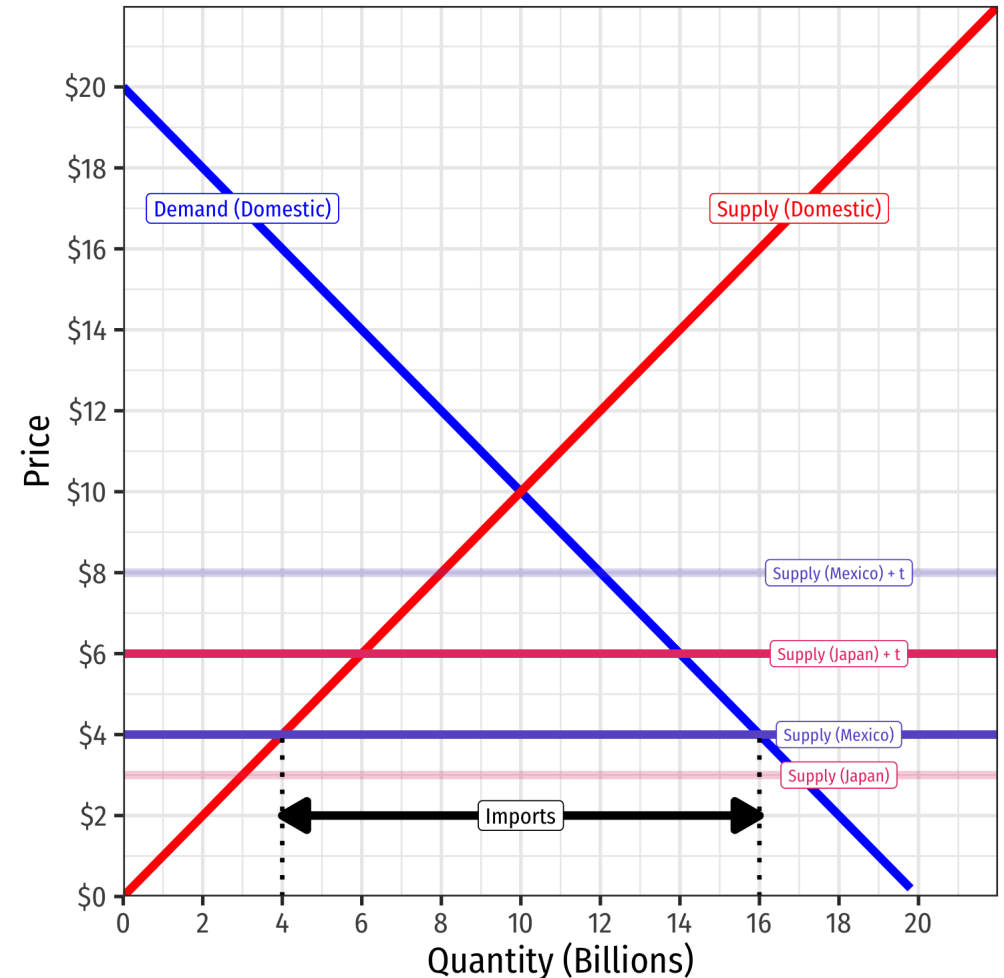
# Trade Creation & Trade Diversion



- **Effects from the free trade agreement**

(with Mexico):

1. **Trade creation:** U.S. imports more T-shirts (compared to under *equal* tariffs), all from Mexico
2. **Trade diversion:** Japan is actually a more efficient producer than Mexico (if no tariffs), but U.S. only trades with Mexico because Japan is outside free trade zone
  - U.S. trade diverted from Japan to Mexico



# Dynamic Benefits of Free Trade Agreements



- Increase competition, limit domestic monopoly power
- Access to larger markets creates economies of scale
- More investment by outside countries to FTA-member countries (to take advantage of larger market) and avoid tariffs
  - **“tariff factories”**: Foreign firms from non-FTA-member countries set up shop *inside* countries with agreement



# NAFTA

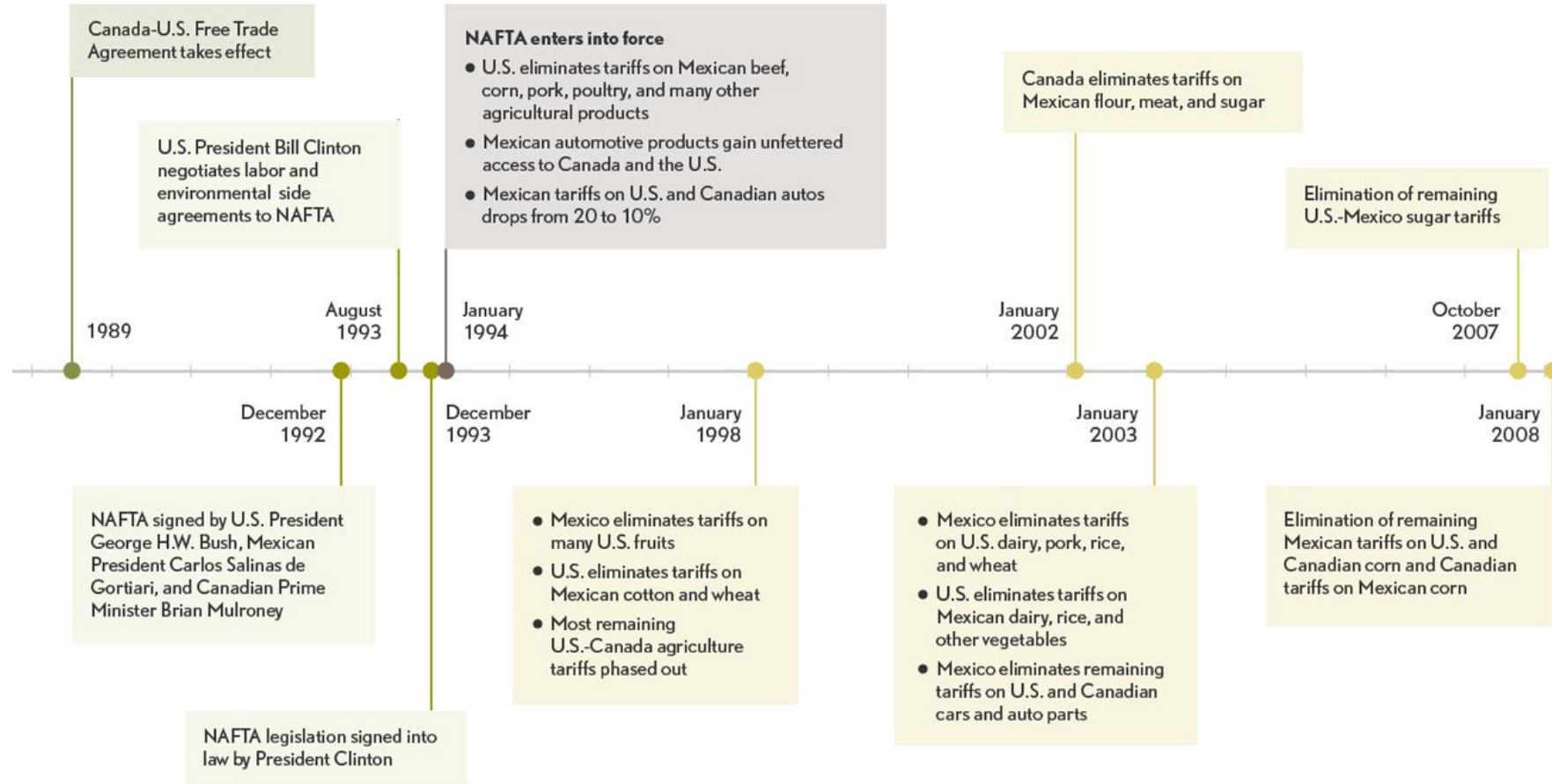


- **North American Free Trade Agreement (NAFTA)** between U.S., Canada, and Mexico since 1994
- U.S. had a free trade agreement with Canada since 1988/9, wanted to bring Mexico into the fold
- 2018: rebranded as **U.S.-Mexico-Canada Agreement (USMCA)**





## NAFTA MILESTONES



# Trade Creation & Trade Diversion: NAFTA



Cost of Importing an Automobile Part to the U.S.  
**U.S. Tariff**

	<b>0%</b>	<b>10%</b>	<b>20%</b>
From Mexico, before NAFTA	\$20	\$22	\$24
From Asia, before NAFTA	\$19	\$20.90	\$22.80
From Mexico, after NAFTA	\$20	\$20	\$20
From Asia, after NAFTA	\$19	\$20.90	\$22.80
From the United States	\$22	\$22	\$22

Feenstra & Taylor, pp.555-556



# Effects of NAFTA



- Tripled trade between U.S., Mexico, and Canada
  - \$290 billion in 1993 → \$1.1 trillion in 2016
- U.S. foreign investment in Mexico increased from \$15 billion to \$100 billion



# Maquiladoras



- **Maquiladora:** factories in Mexico that import goods from U.S. or abroad, manufacture output, and then export to the U.S. (or elsewhere)
  - Often located near the border with U.S.
- Lower wages and lower tariffs
- Before NAFTA: 47% maquila employment growth (564 new plants)
- After NAFTA: 86% over next five years (1460 new plants)



# Effects of NAFTA



- Effects on U.S.: modest, increased GDP by 0.5%, or \$80 billion
- Concentrated costs (U.S. manufacturing & automobiles) but dispersed benefits to consumers
- Est. 14 million jobs depend on trade with Canada and Mexico, 200,000 export related jobs created annually, paying 15-20% more on average than jobs lost to NAFTA
- Companies moving many factories to Mexico, U.S. auto sector lost 350,000 jobs since 1994; Mexican auto sector increased from 120,000 to 500,000 jobs
- Est. 15,000 net jobs lost each year but economy gains \$450,000 in higher productivity gains and lower consumer prices



# USMCA/NAFTA 2.0





The Washington Post  
Presenting the Postwire


## The Finance 202: USMCA isn't expected to have a big impact on the economy

Analysis by [Tory Newmyer](#)  
Staff writer  
December 11, 2019 at 7:37 a.m. EST

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with Brent D. Griffiths

**THE TICKER**



President Trump is **on track** to secure a political victory by forging a breakthrough with congressional Democrats to update the North American trade pact. But in a sign the agreement has more to do with rebranding than substance, economists project the deal will provide a minimal macroeconomic boost.

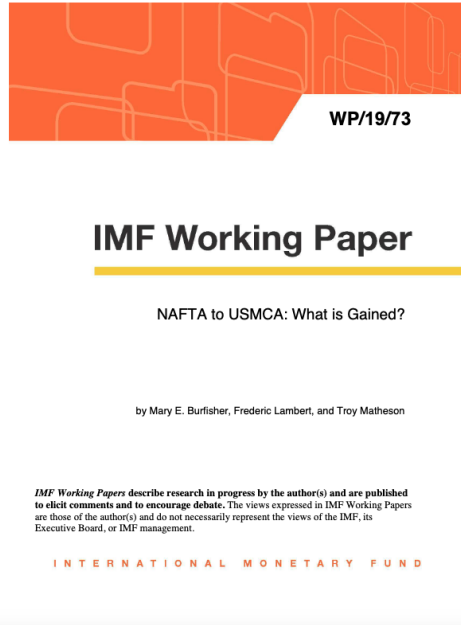
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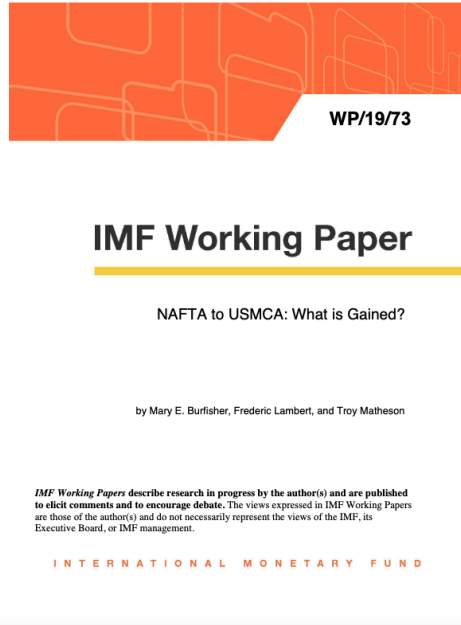
“Studies by both the International Monetary Fund and the International Trade Commission conclude the revamped pact won’t meaningfully goose economic growth: The ITC projects it will raise GDP by 0.35 percent after six years; and the IMF says its broad effects will be “negligible.”

“Indeed, economists say the agreement may be most important for what it prevents. Trump had threatened to pull the United States out of NAFTA if the three countries couldn’t reach a deal. That would have spelled a disastrous breakdown in cross-border commerce with the two most important U.S. trading partners. “At a time when slower global growth, rising protectionism, lingering policy uncertainty and a strong dollar are constraining activity, the deal prevents a negative impact worth 0.5% of GDP from a dissolution of Nafta,” Oxford Economics chief U.S. economist Gregory Daco writes in a note to clients.”

Newmyer, Tory, 2019, [“The Finance 202: USMCA isn't expected to have a big impact on the economy,”](#) *Washington Post*, December 11

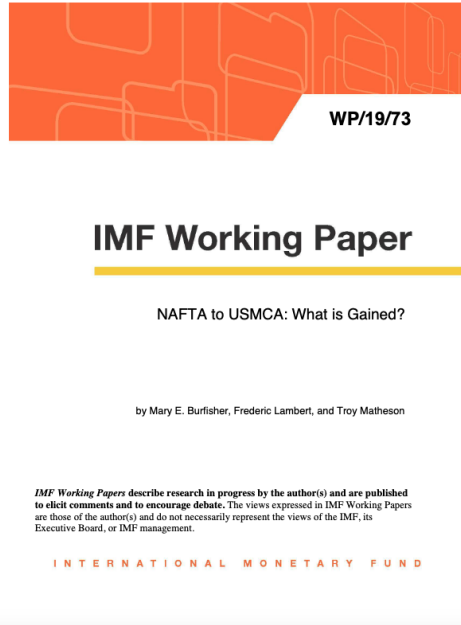


“The North-American Free Trade Agreement (NAFTA) between Canada, Mexico, and the United States has been in force since January 1994. When NAFTA negotiations were concluded in 1992, it was the most comprehensive free trade agreement ever negotiated, creating the world’s largest market for goods and services. The agreement eliminated almost all tariffs between the three countries and incorporated numerous other innovative provisions. NAFTA influenced other free trade agreements that the United States later negotiated and multilateral negotiations. It also initiated a new generation of trade agreements in the Western Hemisphere and other parts of the world, influencing negotiations in areas such as market access, rules of origin, intellectual property rights, foreign investment, dispute resolution, worker rights, and environmental protection.”



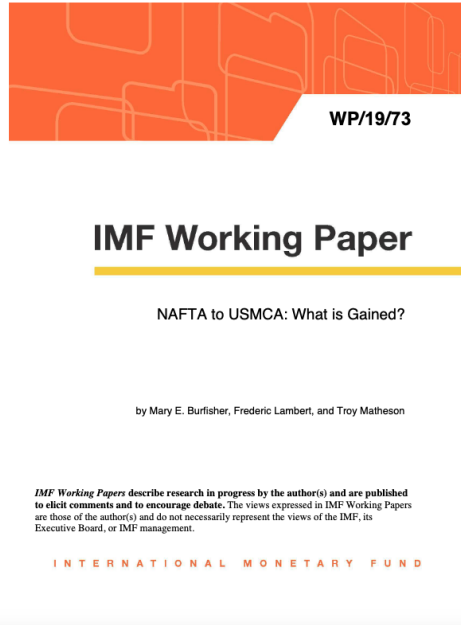
“NAFTA fundamentally reshaped North American economic relations, driving unprecedented integration between Canada, the United States and Mexico and encouraging a dramatic increase in regional trade and cross-border investment between the three countries. Since the agreement came into effect, trade between the three NAFTA parties has increased from US\$ 290 billion in 1993 to over US\$ 1.1 trillion in 2017.”

Burfisher, Mary E, Frederic Lambert, and Troy D Matheson, 2019, [“NAFTA to USMCA: What is Gained?”](#) *IMF Working Paper*



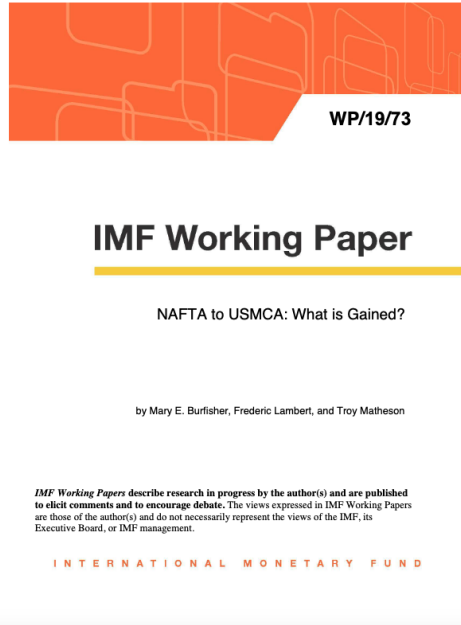
“Most economists agree that NAFTA has provided benefits to the North American economy by expanding trade and economic linkages between countries, creating more efficient production processes, increasing the availability of lower-priced consumer goods, and improving living standards. However, it has proven difficult to isolate the agreement’s beneficial effects from other factors, including rapid technological change, expanded trade with other countries such as China, and unrelated domestic developments in each of the countries. Debate also persists regarding NAFTA’s legacy on employment and wages, as some workers and industries have faced painful disruptions amid increased competition while others have gained from new market opportunities. This debate is evidenced in the fact that, after more than a quarter of a century, the impact of NAFTA remains a perennial topic of discussion in the broader debate over the benefits of free trade.”





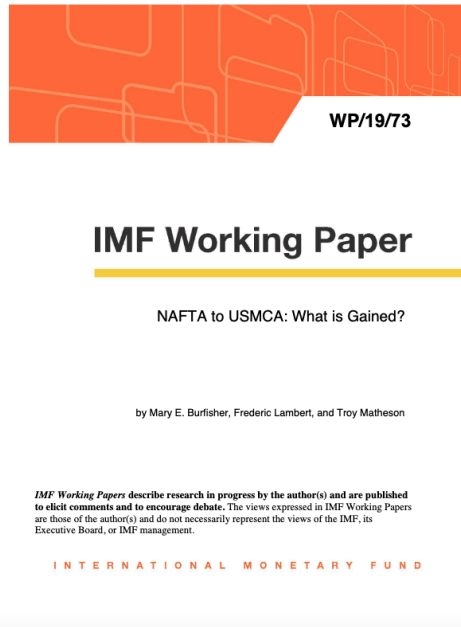
“Against this backdrop, the United States launched new trade negotiations with Canada and Mexico soon after President Trump’s inauguration in 2017, with the aim of supporting higher-paying jobs and growth. Those culminated in a new trilateral United States – Mexico – Canada trade agreement (USMCA) signed by U.S. President Trump, Canadian Prime Minister Trudeau, and Mexican President Peña Nieto, on November 30, 2018...It includes tighter rules of origin in the automobile, textile, and apparel sectors, a new labor value content requirement in the auto sector, higher U.S. access to Canadian supply-managed markets, further goods trade facilitation, updated provisions related to financial services, as well as a new currency provision and a provision about entering free trade agreements with non-market economies.”

# USMCA/NAFTA 2.0



“The conclusion of USMCA is occurring in a dynamic trade environment for Canada and Mexico. In March 2018, they joined 9 other countries in the Asia Pacific region in signing the Comprehensive and Progressive Agreement for a Trans-Pacific Partnership (CPTPP). This agreement will provide preferential access by Canada, Mexico, Japan and other CPTPP members to each other’s markets. Also, in May 2018, the United States imposed import tariffs of 25 percent on steel and 10 percent on aluminum due to national security concerns, to which U.S. major trade partners (including Canada and Mexico) responded with surtaxes on imports of selected U.S. products. Finally, in April and August 2018, the United States levied additional tariffs on a combined US\$ 50 billion of imports from China, which immediately triggered retaliation by China. The impact of USMCA is analyzed within this context”

Burfisher, Mary E, Frederic Lambert, and Troy D Matheson, 2019, [“NAFTA to USMCA: What is Gained?”](#) *IMF Working Paper*



“This paper uses a global, multisector, computable-general-equilibrium model to provide an analytical assessment of five key provisions in the new agreement, including tighter rules of origin in the automotive, textiles and apparel sectors, more liberalized agricultural trade, and other trade facilitation measures. The results show that together these provisions would adversely affect trade in the automotive, textiles and apparel sectors, while generating modest aggregate gains in terms of welfare, mostly driven by improved goods market access, with a negligible effect on real GDP. The welfare benefits from USMCA would be greatly enhanced with the elimination of U.S. tariffs on steel and aluminum imports from Canada and Mexico and the elimination of the Canadian and Mexican import surtaxes imposed after the U.S. tariffs were put in place.”