Macro II/Aussenwirtschaft
Lecture Slides No 8

Gerald Willmann
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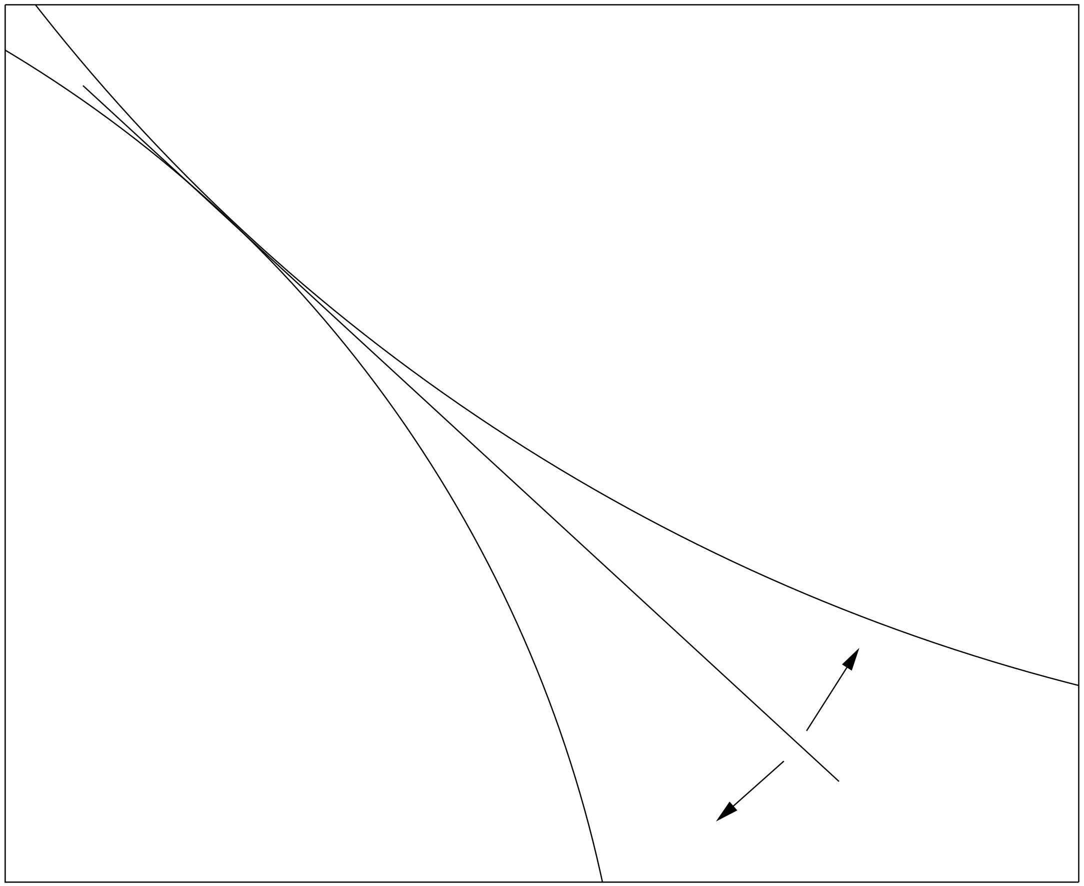
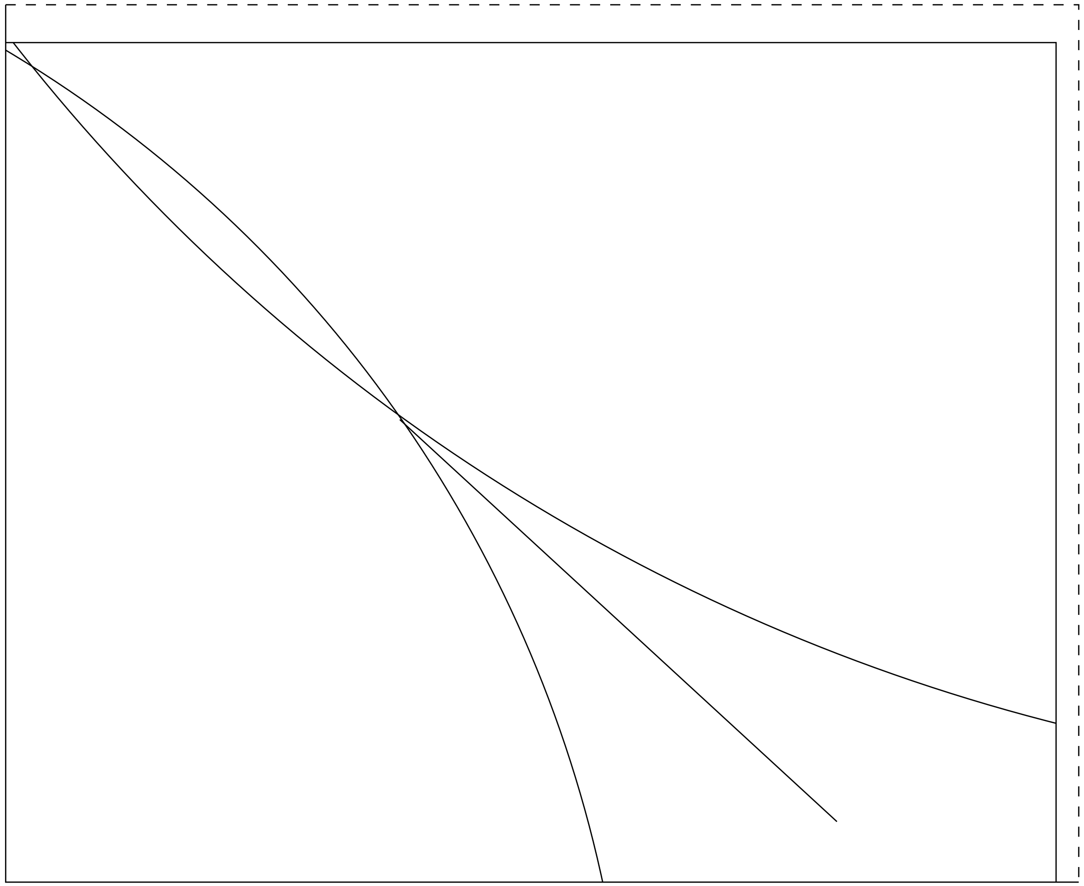
Trade policy with many players

- so far we have analyzed trade policy from a unilateral perspective
- now we consider international policy interaction and cooperation
- there are two sides: multilateral vs preferential
- we will study them in turn, starting with multilateral



Struggle to improve terms of trade

- with two large players, it's impossible for both to improve their terms-of-trade
- each side might try do so using for example an optimal import tariff
- if one side succeeds, the other side loses
- for simplicity, suppose they are equally 'strong'
- their opposing attempts leave terms-of-trade unchanged



Prisonners' dilemma

	free trade	opt tariff
free trade	$W_1(t_1 = 0, t_2 = 0)$,$W_2(t_1 = 0, t_2 = 0)$	$W_1(t_1 = 0, t_2^*)$,$W_2(t_1 = 0, t_2^*)$
opt tariff	$W_1(t_1^*, t_2 = 0)$,$W_2(t_1^*, t_2 = 0)$	$W_1(t_1^*, t_2^*)$,$W_2(t_1^*, t_2^*)$

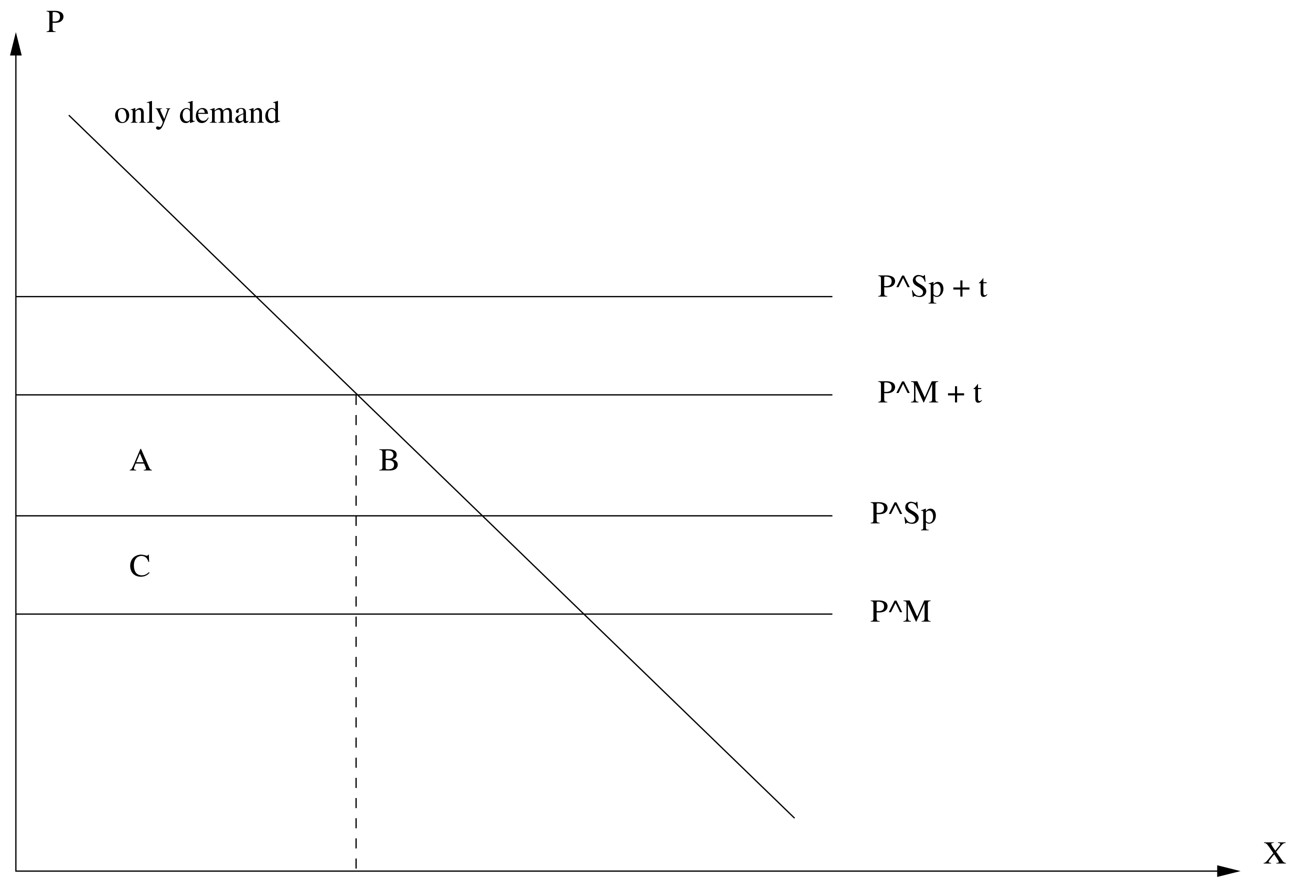
- individually optimal behavior leads to an inefficient Nash
- cooperation needed to achieve Pareto superior free trade outcome
- WTO can be viewed as such cooperation

WTO — world trade organization

- started as General Agreement on Tariffs and Trade
- negotiation rounds achieved ever more multilateral liberalization
- Uruguay round led to the creation of the WTO in 1995
- guiding principles of the GATT/WTO: most favored nation (MFN) and national treatment, ie non-discrimination and also reciprocity
- regional agreements (discriminatory) allowed as exception in article 24

Preferential liberalization

- group of nations forming a regional/preferential agreement
- WTO requires notification and external tariffs don't increase
- two types of PTA: customs union and free trade area
- both shall have free trade internally
- CU has common external tariff whereas FTA members keep individual tariffs
- problem of FTA: trans-shipment requires rules of origin
- problem of CU: political coordination, no multiple memberships


P
only demand
P^Sp + t
P^M + t
A
B
P^Sp
C
P^M
X

Assessment of PTAs

consumers	$+A$	$+B$	
gov't	-A		-C
		$+B$	-C

- trade creation: $+B$
- trade diversion: -C
- since members agreed to form the PTA — likely beneficial for them
- however, outsiders might lose