Strategic Trade Policies in Advanced Countries

Chapter 11
Intermediate International Trade
International Economics, 5th ed., by Krugman and Obstfeld
Arguments for strategic trade policy

• **strategic trade policies** are those that promote exports or discourage imports in particular sectors

• advanced countries use strategic trade polices in order to improve their economic performance: *overall growth slowed after the early 1970s in the advanced world*

• the proper use of strategic trade policies involves the identification of **market failures** that justify active intervention of government policy
• two main market failures justify strategic trade policy in advanced countries:
  
  (1) technology and externalities:
  high-technology industries are unable to capture the benefits of their contribution to knowledge that spills over to other firms

  (2) imperfect competition:
  there are highly concentrated oligopolistic industries that earn monopoly profits

• these two market failures make industrial policy desirable
Technology and externalities

**fact:** advanced countries are characterized for the existence of high-technology industries, which main purpose is to generate knowledge.

**problem:** when knowledge is generated, there are externalities, i.e. benefits that accrue to other firms other than the firm producing them: in the production of knowledge there is a marginal social benefit that is not reflected on the incentives of the firm.

**policy:** subsidize high-technology industries to allow them to appropriate the benefits they produce, as a way to give incentives to the production of more knowledge.

**difficulties in applying the policy:** in practice, it is difficult to determine exactly who is producing “knowledge”, and also to quantify the size of the externality.
Imperfect competition

**fact:** some industries in advanced countries have a small number of firms and they monopolize the excess returns that exist due to the lack of competition

**problem:** there will be international competition among countries over who gets these excess profits: governments would like to shift the excess returns from foreign to domestic firms

**policy:** in principle, the policy is to subsidize domestic firms to deter production by foreign competitors: this strategic policy is a beggar-thy-neighbor policy in the sense that it increases domestic welfare at other countries’ expense

**difficulties in applying the policy:** this beggar-thy-neighbor policy can initiate a trade war between countries, where other countries retaliate by applying subsidies themselves, and leave every country worse off
Examples of strategic trade policy

The case of Japan

1950-1970: the Ministry of International Trade and Industry had control to allocate resources to what they thought were Japan’s future comparative advantage: steel and shipbuilding.

since the mid 70s: the main policy has been subsidies for research and development to encourage high-technology industries: the most important example is the production of semiconductor chips.
The case of other countries

**France:** the creation of “national champions” or firms that can compete on world markets, has been encouraged through: (1) merging of smaller firms into large firms; (2) demand privileges for domestic telecommunication products; (3) government subsidies for aircraft production

**U.S.:** the two areas of strategic trade policy are:
- **agriculture:** promotion of production through: (1) research in agricultural techniques; (2) dissemination of improved techniques; (3) large-scale projects for irrigation facilities
- **defense:** U.S. dominates the production of fighter aircrafts that involve large economies of scale