

LIMITS AND DIFFICULTIES IN IMPLEMENTING THE STRATEGIC TRADE POLICY

Liviu-George **Maha**
Alexandru Ioan Cuza University of Iași, România
mlg@uaic.ro
Andreea-Nicoleta **Donici**
Alexandru Ioan Cuza University of Iași, România
doniciandreea@gmail.com
Andreea **Maha**
Alexandru Ioan Cuza University of Iași, România
andreea_maha@yahoo.com

Abstract: *This paper provides a critical analysis of the strategic trade policy, in terms of limitations and difficulties involved in its implementation. Even there are many arguments used by its supporters for justifying the importance of this type of measures, it is impossible for the state to formulate useful interventionist policies, given the empirical difficulties involved in modeling markets with imperfect competition. Also, any potential gain created by government intervention can dissipate through the entry of new firms, stimulated by the possibility of such profits, while the need of a general equilibrium increases the difficulty of interventionist process. There are also some risks induced by using strategic trade policy, the risk of retaliation and a trade war with the country affected by the measure and the diversion of government intervention by certain interests, transforming it into an inefficient income redistribution national program.*

Keywords: strategic trade policy, free trade, retaliation, trade war, general equilibrium, interest groups
JEL Classification: F12, F13, F42, E61, E20

INTRODUCTION

From classics to the eight – nine decade of the 20th century, the idea that a country gains from international trade, no matter what the conditions are, was one of the truths to which all economic specialists have been reporting (Krugman, 1987, p. 131). The international trade theory relied, almost entirely, on *comparative advantage* – the distinguished feature that advantages countries involved in commercial trade. But the traditional theory of international trade, especially the Ricardian Model, imposed a series of restrictive conditions to the international trade analysis, like the hypothesis of perfect competition and constant yields, the majority of economists considering that they can formulate conclusions regarding the international trade by reporting to perfect competitive environments (Richardson, 1990, p. 108). But in most of the cases the reality contradicts this kind of presumptions. Most of the markets are not in perfect competition, rather in imperfect competition (e.g.: monopolistic competition, oligopoly and monopoly). Under these conditions, firms achieve economies of scale; they register increased yields, increased incomes higher than the growth rate of the production volume (Burnete, 2007, p. 137).

In the last decades, specialists have turned their attention towards the reconfiguration of international trade theory, by taking into consideration the growing yields (respectively, of the economies of scale) and the imperfect competition, the quantitative side being emphasized through the creation and use of operational models. Among them, we can mention: Lancaster (1980), Krugman (1979, 1981), Dixit and Norman (1980), Helpman (1981) and Ethier (1982), the new theory of international trade entering with models that use imperfect competition in order to show that economies of scale can create trade and that they can be the source of some trade winnings, with comparative advantage, a first synthesis of these ideas being made by Helpman and Krugman (1985) (Krugman, 1989, p. 1).

The new trade theory offers some reasons for which the governmental intervention in international trade can be attested as being beneficial (Krugman, 1989, p. 2). The rhetorical question *Has the time of free trade passed?* launched by Krugman (1988) seems to be a challenge addressed to the classical theory, underlying a fundamental change of the vision and arguing, somehow, about the necessity of elaborating a new theory, adapted to the structures and characteristics of the contemporary international trade (Burnete, 2007, p. 136). As long as the imperfect competition and increased yields are becoming indispensable notions in explaining the international trade, “today we live in a world of second grade optimum, in which governmental intervention can, in principle, improve market results” (Krugman, 1987, p. 134).

In essence, according to the new theory of international trade, the optimality of free trade must not be generalized; the benefits level gained from free trade depending on the economical structure, on the existence or non – existence of distortions. If distortions exist, the well – being can be enhanced if governments apply some measures such as custom taxes, contingency, subsidies etc., in order to counter the negative effects of the distortions (Burnete, 2007, p. 136).

1. ARGUMENTS IN IMPLEMENTING THE STRATEGIC TRADE POLICY

Some could be suspicious and consider that it is all about a mercantilist resumption tight to the optimal tariffs, to incipient industries, to the strategic importance of the industry, all decorated under the new shape of the international strategic competitiveness. Indisputable all this old arguments are admitted. But new ones appear, like the strict analyses of threat and commitment power, models more compressive regarding the entry and exist of the firms on the market; the research – development activity, incentives, economic evolutions, etc.; educative generalizations on coalition formation, retaliations, negotiations etc.; the challenging evidence, maybe even

convincing, regarding the role of the government in the promotion of what, for example, the gain of the most important national cooperation from Japan and the new industrialized countries mean. (Richardson, 1990, p. 111)

The vision of the new international trade considers that in the explanation of the international trade, a more important role than the comparative advantage is the one of the economies of scale, while the international markets are characterized, mainly, through imperfect competition. This new approach suggests two arguments against free trade, a new one, regarding the *strategic trade policy* (states that the governmental policy can influence the conditions under which the competition on a oligopoly market takes place, determining that a share of foreign companies profits to go towards household companies), and a old one, according to which the state should favor those branches that create *externalities*, especially through knowledge generation, something that firms could not do it in an appropriate way.

The strategic trade policy is defined as being the governmental policy (use of simple subsidies, low interest rate loans, the promise of buying a big share of production, but also the establishment of quality standards that support the autochthonous firms) applied on the international oligopolistic markets, which try to forward high profits towards local markets. Cohen and Zysman (1987) tie the strategic trade policy to industrial policy, including it in the multitude of industrial policy analyzed variants; together with Lipsey and Dobson (1987) and Krugman`s representative papers (e.g. the one from 1986), represent a consistent introduction to the political economy of strategic trade policy and of industrial policy (Richardson, 1990, p.110).

Brander and Spencer, in two of the pioneer papers relevant for the current paper (1983, 1985), proved that state measures, e.g. export subsidies and import restrictions, can in some conditions prevent foreign firms to compete for markets that offer the possibility of some potential profits. In this context, government policy plays the same role as the strategic action of the company plays (investment in additional production capacity, allocation of substantial amounts for research – development, etc.) in the oligopolistic competition models. In Krugman`s vision (1987, p. 135) this is how the strategic attribute can be associated to commercial policy.

The idea that it is desirable to divert from free trade in order to encourage activities that bring additional benefits and that the protectionism can bring in such circumstances benefits is not new to the conventional international trade theory (Corden, 1974). Eventually, it can be appreciated that the new theory offered, at least, the appearance of a greater concreteness of the theoretical approach concerning the government intervention in order to obtain external benefits. The arguments of strategic trade policy are preferred especially to those without economic studies, taking into account

that some condemned ideas that are considered wrong by the majority of the international trade theoreticians seem to have sense (Krugman, 1987, p. 136). In defense of free trade, many economists underlined the weakness of the strategic trade as a basis for the government intervention in this field.

The positive approach within the consumer's new theory, according to which a huge part of the international trade presents increased economies of scale and numerous international markets being characterized by imperfect competition forms, has enjoyed a rapid acceptance among economic specialists and theoreticians. In the same time, however, the normative side, a greater degree of government intervention in international trade, has generated opposition and criticism, even from some of the creators of the new international trade theory (Krugman, 1987, pp. 138-139).

2. DIFFICULTIES IN IMPLEMENTING THE STRATEGIC TRADE POLICY

According to Krugman (1987), the critical perspective underlines three main components. The *first* one is connected to the fact that it is impossible for the state to formulate useful interventionist policies, given the empirical difficulties that a market with imperfect competition implies. The *second* set of critics argues that the possible gain obtained due to government interventions will dissipate through the entry of a new firm, attracted by the possibility of such a profit. *Third*, it is argued that those considerations tight with the general equilibrium increase the difficulty of interventionist policies process and make it unlikely for those policies to produce more good than harm.

The reality is that the economists do not have at their disposition safe and trustful models, concerning the behavior of such markets in different situations. For example, the commercial policies effects applied in industries with imperfect competition may depend on the behavior of cooperative or uncooperative companies, as Eaton and Grossman (1986) stated. Moreover, on many oligopolistic markets, firms take decisions in a multi-level game context, whose rules and objectives are complex and hidden even from the decision makers. The lack of this kind of information can make governments to invest in a disastrous and costly grant program, e.g.: as the Airbus A300 grant against Being 767. The European authorities have given to this European company a subsidy in a form of a low interest loan - \$ 1.5 billion, but it came as a loss regarding the launch of the A300 (DeeCarlo, 2007, p. 4).

Starting from the premise that the government would be able to overcome the empirical difficulties in formulating a interventionist policy, the taken measures could remain without effect,

an increase corresponding the national income will not be reached if these gains will dissipate through new market entries. In the previous example regarding the commercial strategic policy used to ensure the achievement of increase returns, the market allowed the existence of a single market producer, which made that the reasoning be simpler. Let us assume that the market can support more bidders, four or five, enough so that the constraint would not have any effects, and the free entrance of the market to set aside the potential over profit afferent for a monopoly position. In this situation, as Horstmann and Markusen (1986) and Krugman (1987) showed, even if subsidies succeed with discouraging the foreign competition, it will be transmitted to foreign consumers rather than ensuring additional gains to national producers.

One of the contemporary realities, a constant presence of debates caused by the recent economical – financial crisis and by the sovereign debts, is the fact that the national budget is a limited one, the induced constrains putting a mark on the government's ability to apply measures proposed by the new theory of international trade. A country will never be able to protect or subsidize all economic sectors. Any intervention measure in an industry, whether it is related to strategic character motivation or to externalities creation, will use resources that are diverted from other possible uses in other sectors. This makes the state more responsible in formulating only those policies that do more good and harm.

In terms of strategic trade policy, when a particular sector receives a subsidy, companies in this sector have a strategic advantage against foreign competitors. However, the expansion of the favored sector will attract new production factors, increasing the price of utilized resources in other branches, placing the firms that activate inside in a strategic disadvantaged against foreign competitors. The gained increased yields in the favorite sector will be, in a certain way, offset through the decreased efficiency in other industries. If the government chooses wrong the branch that will be favored (the extra gain will not compensate the efficiency from other sectors), everything will lead, actually, to a national income decrease (Krugman, 1987, p. 140).

In essence, we can say, that in order to formulate a successful strategic policy, a government should understand not only the effects of such policy over the concerned industry, something that is difficult anyway. The good understanding of all branches that form that specific national economy it is also necessary so that the fact that a winning advantage in an industry attracts a cost disadvantage in another branch can be understood. Therefore, the difficulty or the informational burden increases even more. Commercial policy measures related to a good affect inevitably other goods (McKay and Milner, 1997, p. 1898).

The governments do not have complete information, but they also do not lack any data. Note that in addition to the lack of information regarding the effects of their own measures, data regarding the possibility of governmental intervention from the competing state are also missing (Brainard and Martimort, 1992, p. 29). But surely, the requirements concerning the general equilibrium must increase the attention and precaution level concerning the formulation of such policies. But to say that is hard to formulate correct interventionist policies is not a sufficient argument in favor of free trade (Krugman, 1987, p. 141), this being only a part of what new interventionism criticism means. But what if we would have enough information, would not then the problem of how governments obtain this information be underlined? It is important to underline the concerning model and mechanism character through which companies give this information to the government (Creane and Miyagiwa, 2008, pp. 230-231).

Krugman (1987, p. 143) considers that the limits presented by the new international trade theory from the benefits point of view, brought by the state intervention, justifies a return to free trade, which would be recommended not because markets work efficiently, but because the policies can be as imperfect as markets. If the profits obtain from government intervention would be high, it would be hard to explain why is not good to put all efforts in obtaining this gains. The limits analyzed above make that this potential gain be limited with the price of a sophisticated interventionism.

3. RISKS INVOLVED IN USING THE STRATEGIC TRADE POLICY

One of the most important concerns of the economists is tight to the reality that when we discuss about policies that affect the income distribution, the decision – making process will be dominated about the distribution aspects and less about efficiency (Krugman, 1987, p. 141).

Krugman (1987, p. 141) states that in case of interventions related to trade, this concern is manifested at two levels. *First*, if the policies are reliable, there is a retaliation risk and a commercial war with the less favored country because of the measure taken. *Second*, internally, the effort of being efficient through governmental intervention can be hijacked by certain interests and transformed in an inefficient redistribution program of national income.

The strategic trade policy aims to ensure increased returns of national firms and to support branches believed to bring important benefits to the national economy. Since all these gains are achieved at the expense of other states companies, there is a risk that the use of this kind of instruments can cause retaliation. In many cases, although not in all the situations, a trade war

between two countries taking such measures will bring them both in a much unfavorable situation than in the situation in which none of the countries would get involved.

Krugman (1987, p. 142) suggests as an example the case of European telecommunication equipment industry, one characterized through oligopoly and as a potential source of positive externalities in favor of other branches. It is a sector in which the company's acquisitions owned by the state obviously favor the national products, being able to speak about protectionist measures, which do not violate the international agreements regarding international trade. The result of this kind of measures is, most of the time, unfavorable to all the market actors. In an attempt to cover the domestic production as much as possible from the necessary of equipments, each country prevents therefore specialized companies to register economies of scale, possible if firms could address to the European market as a whole. Therefore, the reports between European countries, from the telecommunication market equipment point of view, as in other similar sectors, is similar to *prisoner's dilemma*, where each country decides to interfere by favoring the acquisition of goods produced on the domestic market, than to remain the only country that does not interfere, although it is clear that they will win if nobody will interfere.

The solution to avoid this kind of traps, as in *prisoner's dilemma*, is to establish rules of the game for policies, in order to maintain the potential unfavorable actions impact at a minimum level. To function, these rules have to be simple enough and clearly defined. The free trade is a simple rule, being easy to see it when a country practices custom taxes or imposes trade barriers for the movements of goods. The new international trade theory considers that this is not the best rule to choose. Still, it is really hard to elaborate simple rules that offer the best results. Therefore, as long as the gains from applying sophisticated interventionist measures are small - the critic brought to the new protectionism, it is obvious that free trade is more reasonable, hence the risk of a new trade war can be prevented (Riveiro, 2008, p. 1184).

It is well known that public authorities do not serve always the national interests, especially when the economic interventions take place at a microeconomic level, where the influence of pressure groups is much stronger. The intervention types proposed by the new international trade theory that implicitly a strategic trade policy presumes - said to increase national income, are most likely to significantly increase the welfare of small groups, on the expense of larger and diffuser groups. Therefore, in the case of such interventions, it may happen that an excessive measure or, even a wrong one, to be taken just because potential beneficiaries are more informed and have a bigger influence than those who lose. Krugman (1987, p. 142) brings into attention, e.g., the case of commercial policy applied by USA of sugar and timber, but it is certainly not a singular case.

How can be solved the problem of interest groups and the influence exercised by them in the decision – making process regarding the governmental intervention regarding the strategic trade policy purposes? The answer is simple, as in the cases analyzed in the previous section; the solution is to establish the rules of the game which are not too inefficient and sufficiently simple in order to be applicable. To ask a trade authority or other responsible authority to ignore certain interests with political character when they form commercial policies is unrealistic. The best solution is the establishment of free trade, as a general rule, possible to be violated under extreme pressure conditions, which may not be the optimal from the new international trade theory point of view, but it would be the best solution in the risks mentioned above would be present.

CONCLUSIONS

In the new international trade theory, the role of the state was redefined, most adherents of this view considering that the government should be involved in supporting those industries that create positive externalities, favoring companies that operate in that industry, and in changing the reports between national and foreign companies on the oligopoly markets through strategic trade policy. It is important to underline that the strategic attribute it is not tight to the importance that some certain branch would have in a national economy of a certain state, but to the fact that the state interferes in the competition between companies, the measures taken by the governmental authorities having the same effect as a strategic move that a company makes on the market. It can be noticed that a relationship with strategic character is a prerequisite for the successful implementation of the strategic trade policy, meaning that the company profits are directly affected by the strategic decision on the market.

Using the strategic trade policy is not such a simple approach as it seems the literature and the experience underling the existence of some uncontested limits concerning its implementation. Among them, the most important, are the empirical difficulties regarding the measurement of the impact that this kind of measures would have on a oligopoly market. Hence, it becomes very important the access to the information, but sometimes not even that is enough. On one hand, there is no guarantee that the stimulation of a producer on a market will have the desired effects. Likewise, the company interaction on an oligopoly market is based on game theory, the firms being put in the situation to decide as a response to strategies chosen by competitors and so on. There also exists the possibility that other governments would interfere with stimulation measures of national

firm exports, situation that changes the date's problem and cancels the accuracy of any calculation made above.

It is possible that the action of such influences would affect the choosing reasoning of the branch that would be supported so that the resources would not be utilized in an optimum way. The existence of these risks require a careful analysis of whether to use the strategic trade policy opportunity, often free trade and the avoidance of losses from the above mentioned reasons being more efficient.

REFERENCES

- Brainard, S.L. (1992) *Strategic Trade Policy with Incomplete Informed Policymakers*, NBER Working Papers Series, Working Paper No. 4069. Available at: http://www.nber.org/papers/w4069.pdf?new_window=1.
- Brander, J., Spencer, B. (1983) *International R&D Rivalry and Industrial Strategy*, Review of Economic Studies, 50, pp. 707-22. Available at: <http://www.nber.org/papers/w1192>.
- Brander, J., Spencer, B. (1985) *Export Subsidies and International Market Share Rivalry*, Journal of International Economics, 18, pp. 83-100. Available at: <http://strategy.sauder.ubc.ca/spencer/1985JIE-ExportSubsidies.pdf>.
- Burnete, S. (2007) *Elemente de economia și politica comerțului internațional*, București: Editura ASE București.
- Cohen, S., Zysman, J. (1987) *Manufacturing Matters: The Myth of the Post-Industrial Economy*. New York: Basic Books.
- Corden, W.M. (1974) *Trade Policy and Economic Welfare*. Oxford: Clarendon.
- Creane, A., Miyagiwa, K. (2008) *Information and disclosure in strategic trade policy*, Journal of International Economics, 75, pp. 229-44, available at: <http://ideas.repec.org/a/eee/inecon/v75y2008i1p229-244.html>.
- DeCarlo, D. (2007) *Industrial Policy as Strategic Trade Policy in a Global Economy*. *Undergraduate Economic Review*, vol. 3, issue 1, Article 9. Available at: <http://digitalcommons.iwu.edu/cgi/viewcontent.cgi?article=1028>.
- Dixit, A., Norman, V. (1980) *Theory of international trade*, Cambridge: Cambridge University Press.

- Eaton, J., Grossman, G. (1986) *Optimal Trade and Industrial Policy under Oligopoly*, Quarterly Journal of Economics, CI (2), pp. 383-406. Available at: <http://pascal.iseg.utl.pt/~depeco/summerschool2007/Optimal%20Trade.pdf>.
- Ethier, W. (1982) *National and international returns to scale in the modern theory of international trade*, American Economic Review, 72, pp. 389-406. Available at: http://www.sbu.ac.ir/Desktopmodules/Sbu_ProfessorsPage/Upload/608/Papers/10.pdf.
- Helpman, E. (1981) *International trade in the presence of product differentiation, economies of scale, and monopolistic competition: A Chamberlinian-Heckscher-Ohlin approach*, Journal of International Economics, 11, pp. 305-40.
- Horstmann, I., Markusen, J. (1986) *Up the Average Cost Curve: Inefficient Entry and the New Protectionism*, Journal of International Economics, vol. 20, issue 3, pp. 225-48, available at: <http://ideas.repec.org/a/eee/inecon/v20y1986i3-4p225-247.html>.
- Krugman, P. (1989) *Introduction to "Empirical Studies of Strategic Trade Policy*, in P. Krugman și A. Smith, ed. 1994. *Empirical Studies of Strategic Trade Policy*. Chicago: University of Chicago Press, pp. 1-10.
- Krugman P. (1987) *Is Free Trade Passe?*, The Journal of Economic Perspectives, vol. 1, issue 2, pp. 131-144, available at: <http://bss.sfsu.edu/jmoss/resources/Is%20Free%20Trade%20Passe.pdf>.
- Krugman, P. (1981) *Intraindustry specialization and the gains from trade*, Journal of Political Economy, 89, pp. 959-73. Available at: <http://www2.econ.iastate.edu/classes/econ655/lapan/Readings/Intraindustry%20Specialization%20and%20the%20Gains%20from%20Trade%20Krugman.pdf>.
- Krugman, P. (1979) *Increasing returns, monopolistic competition, and international trade*, Journal of International Economics, 9, pp. 469-79, available at: http://www.princeton.edu/pr/pictures/g-k/krugman/krugman-increasing_returns_1978.pdf.
- Lancaster, K. (1980) *Intraindustry trade under perfect monopolistic competition*, Journal of International Economics, 10, pp. 151-75. available at: <http://ideas.repec.org/a/eee/inecon/v10y1980i2p151-175.html>.
- McKay, A., Milner, C. (1997) *Strategic Trade Policy, Learning by Doing Effects and Economic Development*, World Development, vol. 25, issue 11, pp. 1893-9. Available at: <http://ideas.repec.org/p/not/notcre/97-4.html>.
- Richardson, J.D. (1990) *The Political Economy of Strategic Trade Policy*, International Organization, 44, pp. 107-135, available at:

<http://www.jstor.org/discover/10.2307/2706811?uid=3738920&uid=2129&uid=2&uid=70&uid=4&sid=21101011675713>.

Riveiro, D. (2008) *Environmental policy and commercial policy: The strategic use of environmental regulation*, *Economic Modelling*, 25, pp. 1183-95. Available at: <http://www.sciencedirect.com/science/article/pii/S0264999308000370>.