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Strategic trade policies under instability

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Abstract

Countries often use a host of policies, such as buffer stocks or variable levies, in order to stabilize their own market or protect themselves against external instability. These policies may transfer domestic price instability to their trading partners.

We study a two-country partial equilibrium model in which price variability, triggered by fluctuations in supply, provides the main motive for trade and for the application of appropriate trade policies.

While both countries are likely to gain from the stabilizing effects of free trade, the country that intervenes to regulate its trade may reap extra gains at the expense of its trading partner. This may lead, however, to an open "trade war" from which all countries may lose.



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