Principles of Microeconomics-II
L7: International Trade Theory

August - December 2025

Ananya Iyengar

Review: The Production Possibility Frontier

Production Possibility Frontier

Locus of all points showing combinations of output that can be produced by an economy when inputs are combined efficiently.

For example, Frank has 8 hours in which he can produce meat or potatoes. He takes 60 minutes to produce one ounce of meat and 15 minutes to produce one ounce of potatoes. Self-sufficiency: consume the output of self-production!

Frank + Ruby

- Frank: 60 mins/meat and 15 mins/potato
- Ruby: 20 mins/meat and 10 mins/potato
- Ruby can produce both better i.e. with fewer resources: Absolute Advantage
- Should Ruby produce both and let Frank buy from her?

Assume: Both produce both goods with different efficiencies and there are no barriers to trade.

Comparative Advantage

Producing a commodity at a lower opportunity cost!

- What is the opportunity cost of producing meat in terms of potatoes
  1. For Frank? 4
  2. For Ruby? 2
- What is the opportunity cost of producing potatoes in terms of meat
  1. For Frank? $\frac{1}{4}$
  2. For Ruby? $\frac{1}{2}$
- They decide to trade –

– at what price? Between the opportunity costs!

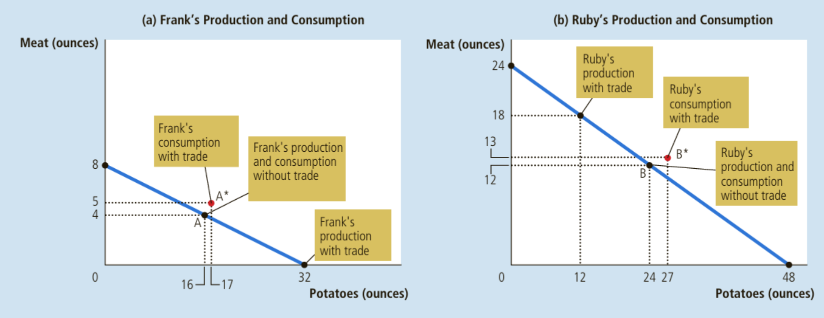

Figure: Comparative Advantage and Gains from Trade. *Source:* Chapter 3, Mankiw (2018)

Prices encapsulate opportunity cost!

For any country,

- The domestic price of a commodity is the domestic opportunity cost of producing that commodity in terms of all other commodities.
- The world price of a commodity is the rest of the world's opportunity cost of producing that commodity in terms of all other commodities.
- If domestic price $>$ world price, domestic opportunity cost is higher $\implies$ import!
- If domestic price $<$ world price, domestic opportunity cost is lower $\implies$ export!

A small economy –

– that has no influence on international prices i.e. a price-taker!

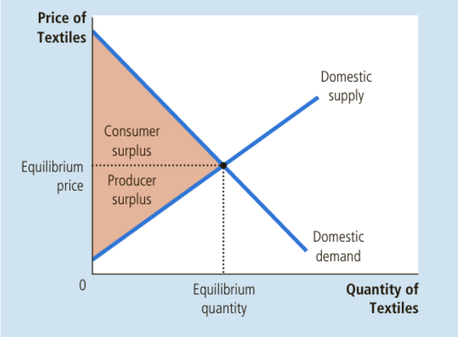

Figure: Initial Condition. *Source:* Chapter 9, Mankiw (2018)

Gains from Exports

- Sellers gain (B+C+D);
- Domestic buyers lose out (A).

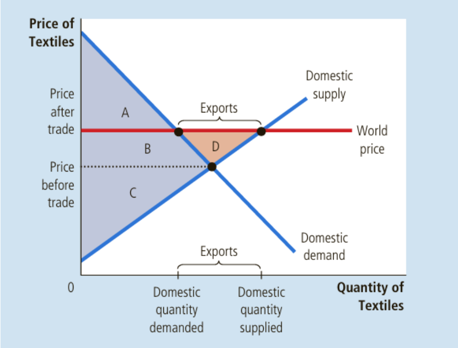

Figure: Welfare Analysis: Exports. *Source:* Chapter 9, Mankiw (2018)

Gains from Imports

- Buyers are better off (A+B+D);
- Sellers lose (C).

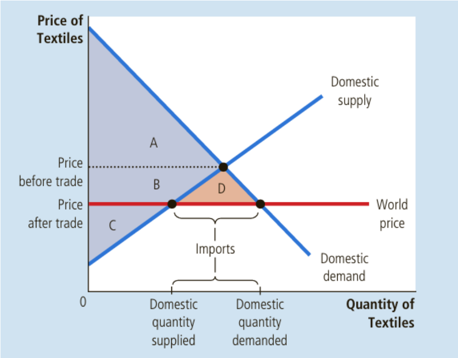

Figure: Welfare Analysis: Imports. *Source:* Chapter 9, Mankiw (2018)

Tariffs

A tax on imports $\implies$ raises price over world price $\implies$ sellers produce more & buyers demand less $\implies$ misallocation of resources!

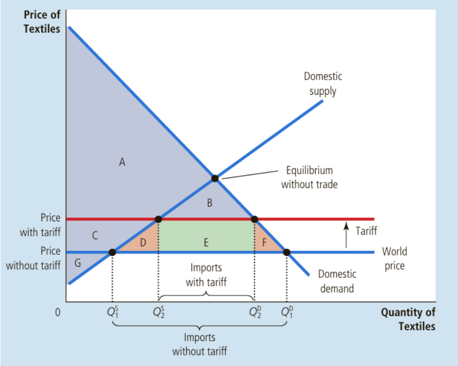

Figure: Tariffs. *Source:* Chapter 9, Mankiw (2018)

The Case for International Trade

1. Increase in product variety;
2. World markets help realise economies of scale;
3. Increased competition and lower market-power related deadweight losses;
4. Technological and knowledge transfer.

Can you think of situations wherein some of the above may adversely impact the outcomes of developing countries?

The Case against International Trade

1. Labour market implications and job loss.
2. Infant industries cannot immediately adjust to global markets.
3. Unfair competition.
4. Tariffs as tools of international policymaking.

What about necessary goods? Indigenous production? Intellectual property rights? World price volatility? Human capital formation?