

International Trade: Theory and Policy

Elective for PGP, PGP-FABM and FPM

Instructor: Shruti Sharma

Given that most big firms today are globalized, and those that succeed are able to adapt to changes in international policy, it becomes imperative for decision makers in the corporate world to have a strong background in the theory of international trade and a comprehensive understanding of the tools and repercussions of trade policy. The main objective of this course is to provide a thorough understanding of international trade and how models have developed to explain why nations trade, and what impact trade has on welfare of participating countries. In addition, there will be a strong emphasis on empirical studies that either corroborate or dispute the predictions of these models. Finally, we will delve into instruments of trade policy, placing trade in a political context, especially that of developing countries.

Evaluation in this course will be based on assignments, one final exam, and in-class presentations. The structure is as follows:

Individual assignment#1: 10%- to be submitted on January 22
Individual assignment #2: 10%- to be submitted on February 27
Final Exam: 35%- held on March 11 after in-class presentations
In-class presentations- 35%- March 11
Class participation: 10%

The main reading for this course is

“International Economics: Theory and Policy”, Paul R. Krugman and Maurice Obstfeld , Eighth Edition

Additional readings are highlighted topic-wise in course coverage.

Course Coverage

February 8: Session 1: **World Trade: An Overview**

- The Gravity Model- the logic of the Gravity Model
- Using the Gravity Model
- Impediments to Trade: Distance, Barriers and Borders
- The Changing Pattern of World Trade: What do we trade? Services Outsourcing

Readings: Krugman and Obstfeld, Chapter 2

Suggested further readings:

1. Alan S. Blinder. "Offshoring: The Next Industrial Revolution?" Foreign Affairs, March/April 2006
2. Keith Head, "Gravity for Beginners"
3. Frances Cairncross, "The Death of Distance" London: Orion, 1997

February 8, Session 2: **What explains trade? The case of Babe Ruth**

Labour Productivity and Comparative Advantage: The Ricardian Model

- Comparative Advantage: Explaining using a one factor economy- production possibilities, relative prices and supply
- Comparative Advantage in practice: The Case of Babe Ruth
- Comparative Advantage with Many Goods
- Adding Transport Costs and Non-traded Goods
- Empirical Evidence on the Ricardian Model

Readings: Krugman and Obstfeld, Chapter 3

Suggested further readings:

1. Donald Davis. "Intraindustry Trade: A Heckscher-Ohlin-Ricardo Approach." Journal of International Economics, November 1995
2. Rudiger Dornbusch, Stanley Fischer and Paul Samuelson. "Comparative Advantage, Trade and Payments in a Ricardian Model with a Continuum of Goods." American Economic Review 67 (December 1977), pp. 823-839
3. Giovanni Dosi, Keith Pavitt, and Luc Soete, "The Economics of Technical Change and International Trade." Brighton: Wheatsheaf 1988

February 9, Session 3: **International Trade and Income Inequality**

Resources, Comparative Advantage, and Income Distribution

- A Model of a Two-Factor Economy- prices and production, Choosing the Mix of Inputs, Factor Prices and Goods Prices, Resources and Output
- Effects of International Trade Between Two Factor Economies: Relative Prices and the Pattern of Trade, Trade and the Distribution of Income, Factor-Price Equalization, Trade and Income Distribution in the Short Run
- The Political Economy of Trade: A Preliminary View- The Gains from Trade (revisited), Optimal Trade Policy, Income Distribution and Trade Politics
- Empirical Evidence on the Heckscher-Ohlin Model

Readings: Krugman and Obstfeld, Chapter 4

Suggested further readings:

1. Donald Davis and David Weinstein. "An Account of Global Factor Trade." National Bureau of Economic Research Working Paper No.6785, 1998.

2. Alan Deardoff. "Testing Trade Theories and Predicting Trade Flows." In Ronald W. Jones and Peter B. Kenen, eds. "Handbook of International Economics." Volume 1. Amsterdam: North Holland, 1984
3. Gordon Hanson and Ann Harrison. "Trade and Wage Inequality in Mexico." *Industrial and Labour Relations Review* 52 (1999), pp 271-288
4. Ronald W. Jones. "Factor Proportions and the Heckcher-Ohlin Theorem." *Review of Economic Studies* 24 (1956)

February 9, Session 4: **The Standard Trade Model of the Trading Economy**

- A Standard Model of a Trading Economy: Production Possibilities and Relative Supply, Relative Prices and Demand, The Welfare Effect of Changes in Terms of Trade Determining Relative Prices, Economic Growth: A Shift of the RS curve, Growth and the Production Possibility Frontier, Relative Supply and the Terms of Trade, International Effects of Growth
- International Transfers of Income: Shifting the RD Curve: The Transfer Problem, Effects of a Transfer on the Terms of Trade, Presumption About the Terms of Trade Effects of Transfers
- Tariffs and Export Subsidies: Simultaneous Shifts of RS and RD: Relative Demand and Supply Effects of a Tariff, Effects of an Export Subsidy, Implications of Terms of Trade Effects: Who Gains and Who Loses?

Reading: Krugman and Obstfeld, Chapter 5

Suggested further reading:

1. Harry G. Johnson. "Economic Expansion and International Trade." *Machester School of Social and Economic Studies* 23 (1955), pp 25-112
2. J.R. Hicks. "The Long Run Dollar Problem." *Oxford Economic Papers* 2 (1953), pp 117-135

February 10, Session 5: **Other Explanations For Why We Trade**

Economies of Scale, Imperfect Competition, and International Competition

- Economies of Scale and International Trade: An Overview
- Economies of Scale and Market Structure
- The Theory of Imperfect Competition
- Monopolistic Competition and Trade- The Effects of Increased Market Size, Gains from an Integrated Market, Economies of Scale and Comparative Advantage, Why Intraindustry Trade Matters
- Dumping- Economies of Dumping, Reciprocal Dumping
- The Theory of External Economies- Specialized Suppliers, Labour Market Pooling, Knowledge Spillovers, External Economies and Increasing Returns
- External Economies and the Pattern of Trade, Trade and Welfare with External Economies, Dynamic Increasing Returns

Reading: Krugman and Obstfeld, Chapter 6

Further Reading:

1. Frank Graham. "Some aspects of Protection Further Considered." Quarterly Journal of Economics 37 (1923), pp 199-227
2. Elhannan Helpman and Paul Krugman. "Market Structure and Foreign Trade." Cambridge: MIT Press 1985
3. Staffan Burenstam Linder. "An Essay on Trade and Transformation." New York: John Wiley and Sons, 1961

February 10, Session 6: **International Factor Movements**

- International Labour Mobility: A One-Good Model Without Factor Mobility, International Labour Movement, Extending the Analysis
- International Borrowing and Lending- Intertemporal Production Possibilities and Trade, The Real Interest Rate, Intertemporal Comparative Advantage
- Direct Foreign Investment and Multinational Firms- The theory of the Multinational Enterprise, Multinational Firms in Practice

Reading: Krugman and Obstfeld, Chapter 7

Further Reading:

1. Richard A. Brecher and Robert C. Feenstra. "International Trade and Capital Mobility Between Diversified Economies." Journal of International Economics 14 (May 1983), pp 321-339
2. Wilfred J. Ethier. "The Multinational Firm." Quarterly Journal of Economics 101 (November 1986), pp. 805-833

Feb 22, Session 7: **The Instruments of Trade Policy**

- Basic Tariff Analysis: Supply, Demand and Trade in a Single Industry, Effects of a Tariff, Measuring the Amount of Protection
- Costs and Benefits of a Tariff: Consumer Surplus and Producer Surplus, Measuring the Costs and Benefits
- Other Instruments of Trade Policy: Export Subsidies

Reading: Krugman and Obstfeld, Chapter 8

Further Reading:

1. Kala Krishna. "Trade Restrictions as Facilitating Practices." Journal of International Economics 26 (May 1989), pp. 251-270
2. W. M. Corden. "The Theory of Protection." Oxford: Clarendon Press, 1971.

Feb 22, Session 8: **The Political Economy of Trade Policy**

- The Case for Free Trade: Free Trade and Efficiency, Additional Gains from Free Trade, Rent-Seeking, Political Argument for Free Trade
- National Welfare Arguments Against Free Trade: The Terms of Trade Argument for a Tariff, The Domestic Market Failure Argument Against Free Trade, How Convincing Is the Market Failure Argument?
- Income Distribution and Trade Policy: Electoral Competition, Collective Action, Modeling the Political Process
- International Negotiations and Trade Policy: The Advantages of Negotiation, International Trade Agreements (a brief history), The Uruguay Round, Trade Liberalization, From the GATT to the WTO

Reading: Krugman and Obstfeld, Chapter 9

Further Reading:

1. Robert E. Baldwin. "The Political Economy of U.S. Import Policy." Cambridge: MIT Press, 1985
2. Robert E. Baldwin. "Trade Policies in Developed Countries," in Ronald W. Jones and Peter B. Kenen, eds. "Handbook of International Economics. Vol 1. Amsterdam: North-Holland, 1984.

Feb 23, Session 9: **Trade Policy in Developing Countries**

- Import-Substituting Industrialization: The Infant Industry Argument, Promoting Manufacturing Through Protection, Problems of Import-Substituting Industrialization, Trade Liberalization Since 1985, Export-Oriented Industrialization: The East Asian Miracle

Reading: Krugman and Obstfeld, Chapter 10

Further Reading:

1. W. Arthur Lewis. "The Theory of Economic Development." Homewood, IL: Irin 1955
2. I.M.D. Little, Tibor Scitovsky, and Maurice Scott. "Industry and Trade in Some Developing Countries." New York: Oxford University Press, 1970.
3. Dani Rodrik. "Imperfect Competition, Scale Economies and Trade Policy in Developing Countries," in Robert E. Baldwin, ed "Trade Policy Issues and Empirical Analysis." Chicago: University of Chicago Press, 1988
4. Alwyn Young. "The Tyranny of Numbers: Confronting the Statistical Realities of the East Asian Growth Experience," Quarterly Journal of Economics 110 (August 1995), pp, 641-680

Feb 24, Session 10: **Controversies in Trade Policy**

- Sophisticated Arguments for Activist Trade Policy: Technology and Externalities, Imperfect Competition and Strategic Trade Policy

- Globalization and Low-Wage Labour: The Anti-Globalization Movement, Trade and Wages Revisited, Labour Standards and Trade Negotiations, Environment and Cultural Issues, The WTO and National Independence
- Globalization and the Environment

Reading: Krugman and Obstfeld, Chapter 11

Further Reading:

1. James A. Brander and Barbara J. Spencer. "Export Subsidies and International Market Share Rivalry." *Journal of International Economics* 16 (1985), pp 83-100
2. Elhanan Helpman and Paul Krugman. "Trade Policy and Market Structure." Cambridge MIT Press, 1989.

Feb 25, Sessions 11 and 12: Review Session

Feb 29- March 2: Sessions 13-20: In-class presentations