Learning Module 6: International Trade

LOS 6a: describe the benefits and costs of international trade

Most economists agree that the advantages of international trade overweigh the disadvantages. Below are the main benefits and costs associated with international trade.

Benefits of International Trade

- **Countries gain from exchange and specialization**: Countries receive high prices for exports and pay lower prices for imports (instead of producing them at a higher cost), which in turn enables a more efficient resource allocation as a country will increase its production of the goods it exports and reduce its production of the goods it imports.
- **Trade liberalization increases real GDP**: efficient resource allocation, learning by doing, higher productivity, knowledge spillovers, and trade-induced changes in policies that affect incentives for innovation are all factors that can increase a country's GDP.
- **International trade offers a platform for exchanging ideas and for the free flow of technical expertise.**
- **International trade can lead to the development of better-quality institutions and policies that encourage domestic innovations.**
- **Greater efficiency** in that countries that have a comparative advantage in the production of a specific commodity will specialize in the production of the said commodity.
- **Industries experience economies of scale**: Many industries, for instance, the automobile industry in Europe, experience economies of scale. As these industries grow and have larger market sizes, their average production costs per unit decrease.
- **Increased competition**: Foreign competition can reduce the monopoly power of

domestic firms, pushing them to become more efficient.

Costs of International Trade

- **Loss of jobs and inequality in income in developed countries** caused by competition from importing from other countries.
- **Less efficient firms may exit the market** as a result of resource reallocation in an industry depending on whether it is exporting(expanding) or facing import competition(contracting). As the less efficient farms exit the market, unemployment rates increase in developed countries and there may be need to retrain the displaced workers for jobs in expanding (exporting) industries.

Question

Among the following, which one is *least likely* a cost of international trade?

A. Loss of jobs.

B. Inequality in income.

C. Availability of products.

Solution

The correct answer is **C**.

Due to the removal of tariffs and restrictions, companies produce and ship various goods across the globe. The consumer can then choose among all of these products.

A and B are incorrect. Some costs, such as inequality in income and unemployment, can be incurred. This has been seen in the past few decades, where most manufacturers have moved from Western to Eastern countries. Westerners have been able to buy goods at cheaper prices, but many manufacturing firms have closed shop simultaneously, leaving workers unemployed.

LOS 6b: compare types of trade restrictions, such as tariffs, quotas, and export subsidies, and their economic implications

Governments may enact policies that limit the free exchange of goods and services between countries. Such policies are known as trade restrictions or trade protections and include tariffs, import quotas, voluntary export restraints (VER), subsidies, embargoes, domestic content requirements, and capital restrictions.

Trade restrictions are used to: Protect already established domestic industries from foreign competition, protect new domestic industries from foreign competition until they get established, protect and increase domestic employment, generate income from imposed tariffs, retaliate against the restrictions imposed by another country, and to protect certain industries/sectors for national security purposes.

Different trade restrictions are discussed below:

Tariffs

A tariff is a type of tax that imposes additional costs on imports. Tariffs primarily aim to protect the domestic industries that produce similar goods and to reduce trade deficits.

The economic impact of tariffs is reduced demand for imported goods as they will be trading at a price above the free trade price.

We need to define “small” and “large” countries in the context of tariffs. A small country is a price taker and cannot influence market prices whereas a large country is a large importer of goods and can influence the world market price.

Tariffs imported by large countries will force exporters to reduce the price of goods/services to retain their market share in the importing country, thereby altering the terms of trade and redistributing income from the exporting to the importing country.

As such, theoretically, a large country can only increase its welfare through tariffs if its trading partner does not retaliate and if the benefits of improving the terms of trade are greater than the deadweight loss resulting from the tariff.

In summary, the net welfare effects of tariffs are:

- Loss of consumer surplus due to price increase.
- A gain in producer surplus as local producers can sell their output at higher prices.
- Gain of tariff revenue to the government.

Note: The loss in consumer surplus is greater than the gain from producer surplus and increased tariff revenue to the government, thereby resulting in a deadweight loss to a country's welfare.

Import Quotas

Import quotas refer to the regulations set by a country that restrict the amount of a specific good that can be imported into the country, usually for a specified period. On the other hand, import licenses specify the quantity of goods that can be imported into a country.

As compared to tariffs where the government of the country imposing the tariff gains tariff revenue, the effect of quotas on the government is uncertain. Foreign producers can raise their prices after a country imposes a quota to gain higher profits than they would without the quota. These profits are known as quota rents.

The welfare loss to an importing country after imposing import quotas is greater than that under an equivalent tariff. However, the loss can be similar to that of an equivalent tariff if the government of the importing country can capture the quota rents by auctioning import licenses at a fee.

Voluntary Export Restraints (VER)

As opposed to an import quota that is created by the government of an importing country, a VER is created by the government of the exporting country to limit the number of goods it can export to its trading partner. A VER allows the quota rent resulting from the decrease in trade to be captured by the exporting country, resulting in a welfare loss to the importing country.

Export Subsidies

An export subsidy is when the government pays a firm for each unit it exports in a bid to stimulate exports.

Export subsidies disrupt the functioning of the free market and distort trade away from comparative advantage, thereby reducing welfare.

Importing Countries may impose countervailing duties, which are taxes levied by an importing country on subsidized goods entering the country.

Export subsidies may create an incentive for domestic producers to shift their sales from the domestic to the export market to benefit from higher prices (international price plus the export subsidy), increasing the price of the goods in the domestic markets by the amount of the subsidy for a small country.

For a large country, the world price will decline as the large country increases exports. As such, the net effect in both the large and small countries is negative, with large countries experiencing a higher decline.

Capital Restrictions

Capital restrictions refer to the measures a government or central bank takes to control the flow of capital. This could be capital flowing in and out of the economy. Controls include taxes, tariffs, volume restrictions, etc., whereas regulations include foreign exchange, tax regulation, credit regulation, and investment restrictions.

They have similar effects as trade restrictions – protect domestic industries – but capital restrictions can slow growth, and more restrictions can mean higher domestic prices for goods.

Controls are useful when they enable a government to deal with currency exchange rates and interest rates. The government benefits from tariffs since they are a type of revenue (tax).

Industries benefit from reduced competition since import prices are high. On the flip side, consumers do not benefit because the increase in import prices means higher prices. The most apparent difference between trade restrictions and capital restrictions is that trade restrictions limit access to a wide range of goods and services. In contrast, capital restrictions limit access to financial markets.

Other Restrictions

- **Domestic content provisions** specify that some proportion of the value added or components used in production should be of domestic origin.

- **Embargo** is a government order that restricts trade or commerce with a specified country or the exchange of specific goods. Embargoes are typically enacted due to unfavorable political or economic circumstances between nations.

Summary of Effect of Trade Restrictions on Producer and Consumer Surpluses

	Tariff	Import Quota	Export Subsidy	VER
Impact on	Importing Country	Importing Country	Exporting Country	Importing Country
Producer Surplus	Increases	Increases	Increases	Increases
Consumer Surplus	Decreases	Decreases	Decreases	Decreases
Price	Increases	Increases	Increases	Increases
Domestic Consumption	Decreases	Decreases	Decreases	Decreases
Domestic Production	Increases	Increases	Increases	Increases
Trade	Imports decrease	Imports decrease	Exports decrease	Imports decrease

Summary of Effect of Trade Restrictions on Government Revenue and National Welfare.

	Tariff	Import Quota	Export Subsidy	VER
Government Revenue	Increases	Mixed (depends on whether quota rents are captured by the importers or exporters)	Decreases	No change
National Welfare	Decreases in small countries and increases in the larger country.	Decreases in small countries and increases in the larger country.	Decreases	Decreases

Question

Which of the following trade restrictions will *most likely* increase the revenue of the country imposing the restriction?

A. Tariffs.
B. Import Quotas.
C. Export subsidies.

Solution

The correct answer is A.

The government of the country imposing tariffs (taxes that impose additional revenue on imported goods) gains the tariff revenue.

B is incorrect. Import quotas will only benefit the government if it sells import licenses. Import quotas majorly benefit foreign producers as they sell their produce at a higher price to capture the quota rent.

C is incorrect. Export subsidies decrease revenue to the government as the government spends to pay firms for each unit they export.

LOS 6c: explain the motivations for and advantages of trading blocs, common markets, and economic unions

A trading bloc is a group of countries that have mutually agreed to reduce and progressively eliminate barriers to trade and the movement of factors of production among the members of the bloc.

Regional barriers to trade, such as tariffs, within members of a trading bloc are usually low or non-existent. Examples of trading blocs include the Asia-Pacific Economic Cooperation (APEC) and the Association of Southeast Asian Nations (ASEAN).

Types of Trading Blocs

Free Trade Area (FTA)

In FTA, all barriers to the flow of goods and services among the members have been removed. Each member within the FTA retains its trade policies against non-members.

An example of an FTA is the United States-Mexico-Canada Agreement (USMCA).

Customs Union

The Customs Union is an improvement of the FTA. It allows the free flow of goods and services among the members and has a common trade policy against non-members. An example of a customs union is Belgium, the Netherlands, and Luxemburg (Benelux) of 1947.

Common Markets

Common markets incorporate all features of the customs union and also allow the free movement of factors of production among its members. Examples include the East African Common Market and The Southern Cone Common Market (MERCOSUR) of Argentina, Brazil, Paraguay, and Uruguay.

Economic Union

The economic union has a higher economic integration level than the common market. It includes all features of the common market and additionally incorporates common economic institutions and coordination of economic policies among members.

If the members of the economic union agree to have a common currency, then it is also called the monetary union. An example of an economic union (also a monetary union) is the European Union (EU).

Regional Integration

We can view regional integration as a move towards freer trade, where members get preferential treatment as compared to non-members. Members eliminate or reduce trade barriers against each other, resulting in a more efficient resource allocation.

Trade creation and trade diversion are the two static effects directly resulting from the creation of the customs union.

Trade creation: This is when regional integration results in member countries replacing higher-cost domestic production with lower-cost imports from other members.

Trade diversion: This is when member countries replace lower-cost imports from non-member countries with higher-cost imports from member countries. The higher-cost imports from member countries will be cheaper because of the elimination of trade barriers (tariffs on imports) between member countries.

The net welfare to a country is positive if trade creation is larger than trade diversification.

Advantages of Trading Blocs

- **Improved specialization based on comparative advantage:** Trading blocs allow member countries to focus on producing goods where they have a cost advantage, leading to efficient resource utilization.

- **Reduction in monopoly power due to foreign competition:** With more players in the market, monopolistic power diminishes, leading to competitive prices and enhanced product quality.
- **Economies of scale from larger market size:** larger markets provided by trading blocs enable firms to produce on a larger scale, leading to reduced costs per unit.
- **Learning by doing:** As countries trade and produce more, they gain experience and expertise, resulting in improved production methods and efficiencies.
- **Technology transfer:** Trading blocs facilitate the sharing of technology between member nations, leading to modernization and improved production capacities.
- **Knowledge spillovers:** Ideas and innovations are easily shared within a trading bloc, promoting creativity and fostering innovation.
- **Greater foreign investment:** Member countries often see an influx of foreign investment due to the attractive and larger market provided by the bloc.
- **Better quality intermediate inputs at world prices:** Trading blocs often provide access to high-quality raw materials and intermediate goods at competitive global prices.
- **Higher interdependence among members of the regional trading bloc results in reduced potential conflicts:** As countries trade more with each other, their economies become intertwined, making conflicts less likely due to mutual economic interests.

Disadvantages of the Trading Blocs

- **Potential Harm to Low-skilled Workers**: There can be negative impacts on low-skilled workers, especially if there's an influx of low-skilled labor-intensive imports from other member countries.

- **Adjustment Costs**: As import competition might cause inefficient firms to shut down, workers in these firms may become temporarily unemployed until they find new opportunities.
- **Long-term Employment Losses**: Workers displaced due to regional integration might face enduring wage losses if they don't secure jobs that pay as much as their previous ones or if they remain unemployed for extended periods.
- **Concerns Over National Sovereignty:** There are apprehensions about national sovereignty, especially when countries of varying sizes and economic strengths are part of the same trading bloc. This can create power imbalances and challenges in decision-making.

Challenges to Greater Integration

- **Cultural and Historical Barriers**: Cultural differences, along with historical considerations such as wars and conflicts, can interfere with the social and political processes required for deeper integration.
- **Restrictions on Independent Economic and Social Policies**: A significant degree of economic integration can restrict member countries from pursuing their economic and social policies independently. With free trade, as well as the mobility of labor and capital, policies aimed at controlling relative prices or quantities within a country can be countered. Moreover, in a monetary union, countries can't control monetary policy, and currency devaluation or revaluation isn't an option to address persistent imbalances. When such imbalances occur, they can lead to crises that have repercussions for other countries, as seen in the Greek fiscal crisis in 2010.

Investment Implications

From an investment perspective, regional integration offers new opportunities for trade and investment. However, differences in culture, tastes, and competitive conditions that exist within member countries may limit the potential benefits of investments within a trading bloc. Problems faced by individual members within a trade bloc may also rapidly spread to other members within the bloc.

Question

If Columbia and Ecuador have free trade between themselves and a common policy excluding non-members from this free trade, then they are a part of a:

A. Customs union.
B. Free trade area.
C. Common market.

Solution

The correct answer is A.

Customs unions allow free movement of goods and services and also form a mutual policy against non-members.

B is incorrect. A free trade area is a grouping of countries where trade barriers are abolished.

C is incorrect. A common market is a free trade area with relatively free movement of capital and services.