The World Economy: Trade Theory

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Free Trade

International trade which goods and services could be exchanged *freely* between countries:

1. with no barriers of any kind would be imposed upon entry of the goods to any market.
2. Price should be "*economists price*" which selling price covers all the costs relating to production and transportation + normal profit

Absolute advantage

- One country can produce a particular good or service to a pre-determined quality with less resources or cheaper than another country.

Example

UK can produce cars more cheaply than Brazil Brazil can produce coffee more cheaply than UK.

- Theoretically, each country can gain from specialization

Comparative advantage

- A country has a lower opportunity cost to produce a good or service.
  - Opportunity cost: when scarce resources are used to produce a commodity, an opportunity is foregone to use them to produce another commodity.
- exists even when one country has an absolute advantage.
- is considered basis for international trade.

Comparative advantage

Example

Germany and India each has 10 units of resources. Each country devotes 5 units to produce tractors and 5 units to produce wool.

	Tractors	Wool	Wool/Tractor
Germany	100	1000	10
India	50	750	15
Germany/India	2	1.33	

- Germany has absolute advantage in both commodities
- Germany has comparative advantage in tractor
- India has comparative advantage in wool.

Comparative advantage

Example

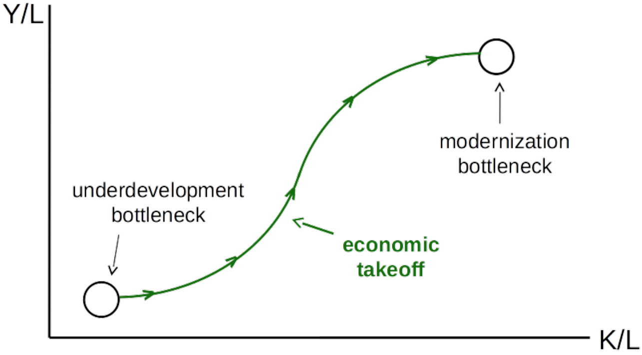
	Tractor	Wool	Wool/Tractor
Resource Allocation	5	5	
Germany Output	100	1000	10
India Output	50	750	15
Total Output	150	1750	

	Tractor	Wool	Tractor	Wool
Germany Input	10	0	8	2
India Input	0	10	0	10
Germany Output	200	0	160	400
India Output	0	1500	0	1500
Total Output	200	1500	160	1900

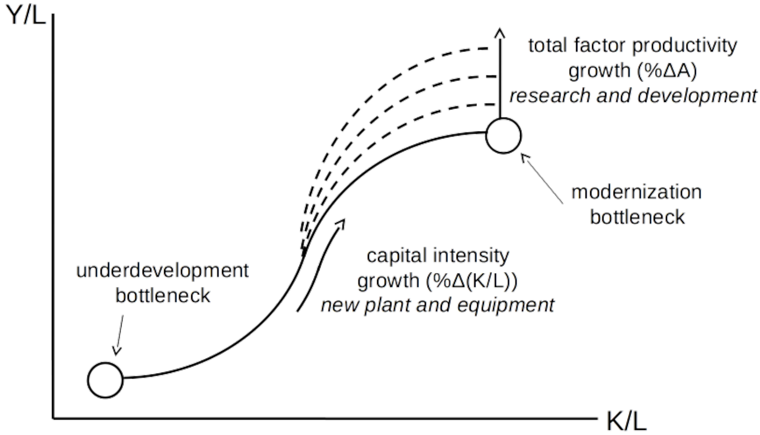
Changes in comparative advantage - UK

- In the past: specialized in manufacturing.
- Now: more competitive in "knowledge Industries", such as software, business service, and pharmaceuticals.
- Why?
  - can achieve/sustain long term growth
  - cannot compete with cheap labor in developing countries

Comparative advantage



Comparative advantage



Qualification to the concept of comparative advantage

- Transportation and tariff may modify the gains from trade due to increased cost.
- Opportunity costs may change as resources are moved from on industry to another.
- Increased specialization may bring economies of scale to generate increased profits.
- Specialization may be risky if there are sudden changes.
- Exchange rates fluctuation may affect opportunity cost.
- Imperfect competition may cause price to not reflect opportunity costs.

Benefits of international trade

- Specialization increases world-wide output
- Goods and services produced at lower cost
- Lower price for consumers
- Greater consumer choices
- Overall increase in standard of living (employment and wage increase as well as consumer choice)
- Producers may obtain economy of scale

Barriers to trade

- *Tariffs*: taxes or custom duties imposed on foreign products to artificially raise their prices in order to suppress domestic demand.
- is the most common type of trade barrier. (most well known)
  - Ad valorem: % of price
  - Specific: a tax per unit of weight or quantity, e.g. raw material

Non-tariff barriers

- Quota
  - physical limitation
  - revenue can be raised through license, which needs to be renewed annually
- Embargo
  - no import allowed
  - is used when there are serious disputes between countries
- Exchange control
  - exporters must surrender foreign currencies to the central bank
  - importers must apply to the central bank for the currency needed
  - central bank can control exports and imports by controlling the quantity of foreign currencies

Non-tariff barriers

- Import deposit
  - importers must deposit
  - no interest with central bank time consuming and expensive (reduced liquidity of the importer)
- Voluntary export restraints
  - exporting country is too successful
  - it feels restrictions may be imposed
- Product standard procedures
  - setting standards and procedures which may be very difficult for importers to meet
  - health and safety reasons are sometimes used to impose restrictions

Non-tariff barriers

- Complex custom procedures
  - create laborious and bureaucratic systems to cause frustration to importers
- Government contract policy
  - buy domestic products and services, even when imported ones are better and cheaper
- Subsidies
  - government payments to domestic producers
  - to protect specific industries from competition
- Campaign
  - protest goods and services from other countries

Non-tariff barriers

- Dumping and antidumping
  - Dumping: a country sells surplus in the open market at a greatly reduced price, even below cost or "fair" market value
  - Government may levy antidumping measures such as countervailing duties or fines

Why protectionism

- Raise revenue from tariffs and quotas
- Protecting domestic employment
- Protect industries (sunrise/sunset)
- Protect against dumping (reasonable case)
- Protect strategic industries (military, agriculture)
- Protect against over specialization
- Cure persistent Balance of Payments deficit