LM 7 - International Trade and Capital Flows

CFA Level 1 - Economics

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Learning Outcomes

The candidate should be able to:

1. compare gross domestic product and gross national product;
2. describe benefits and costs of international trade;
3. contrast comparative advantage and absolute advantage;
4. compare the Ricardian and Heckscher–Ohlin models of trade and the source(s) of comparative advantage in each model;
5. compare types of trade and capital restrictions and their economic implications;
6. explain motivations for and advantages of trading blocs, common markets, and economic unions;

Learning Outcomes

The candidate should be able to:

7. describe common objectives of capital restrictions imposed by governments;
8. describe the balance of payments accounts including their components;
9. explain how decisions by consumers, firms, and governments affect the balance of payments;
10. describe functions and objectives of the international organizations that facilitate trade, including the World Bank, the International Monetary Fund, and the World Trade Organization.

GDP vs. GNP

- Gross Domestic Product (GDP):
  - Measures the market value of all final goods and services (G&S) produced by factors of productions located within a country during a given period of time;
  - Includes the production of G&S by foreigners within that country;
  - Excludes the production of G&S by its citizens outside the country.
- Gross National Product (GNP):
  - Measures the market value of all final G&S produced by factors of productions supplied by residents of a country;
  - Excludes the production of G&S by foreigners within that country;
  - Includes the production of G&S by its citizens outside the country.

Benefits and costs of international trade

- Benefits:
  - Lower cost to consumers of imports;
  - Higher employment, wages and profits in export industries.
- Costs:
  - Displacement of workers;
  - Lost profits in industries competing with imported goods.

Comparative Advantage vs. Absolute Advantage

- Absolute advantage: Refers to a lower cost in terms of resources used;
- Comparative advantage: Refers to the lowest opportunity cost to produce a product;
- Law of comparative advantage:
  - Trade makes all countries better off;
  - Each country specializes in goods they produce most efficiently and trades for other goods.
- Outcome: Increased worldwide output and wealth with no country being worse off

Models of Trade

- Ricardian model
  - Labor is the only factor of production.
  - Comparative advantage depends on relative labor productivity for different goods.
- Heckscher-Ohlin model
  - Two factors of production: capital and labor.
  - Comparative advantage depends on relative amount of each factor possessed by a country.
  - With trade, the price of the more abundant factor increases in each country.

Trade Restrictions

- Tariff is a tax imposed on imported goods.
- Quota is a limitation on the quantity of goods imported.
- Export subsidies are payments by government to domestic exporters.
- Minimum domestic content specifies required proportion of product content to be sourced domestically.
- Voluntary export restraints (VERs) are agreements by exporting countries to limit the quantity of goods they will export to an importing country.

Reasons for Trade Restrictions

- Two primary goals:
  - 1. Protecting domestic jobs.
  - 2. Protecting domestic producers.
- Other reasons include countering foreign trade restrictions and export subsidies, anti-dumping, and revenues from tariff for domestic government.
- A large country could actually decrease the world price by imposing a quota or tariff.

Trade Restrictions

Effect on Importing Country	Tariff	Import Quota	Voluntary Export Restraint	Export Subsidy
Consumer	Loses	Loses	Loses	Loses
Producer	Gains	Gains	Gains	Gains
Government	Gains	Depends*	No Change	No Change
Welfare	Loses**	Loses***	Loses	Loses

*Depends on whether the government captures quota rents
**Possible gain in theory in a large country if i) no retaliation and ii) gains from lower world price outweigh deadweight loss.
***Possible gain in theory in a large country if i) government captures quota rents, ii) no retaliation, and iii) gains from lower world price outweigh deadweight loss.

Objectives of Capital Restrictions

- Reduce volatility of domestic asset prices due to large inflows and outflows of capital
- Maintain exchange rate target while using monetary and fiscal policy for domestic goals
- Keep domestic interest rates low by restricting outflows of capital to higher-yielding foreign investments.
- Protect strategic industries (e.g., defense) from foreign ownership.

Balance of Payments (BOP) Accounts

- Current Account: Merchandise/services purchases, foreign dividends and interest, and unilateral transfers.
- Capital Account: Sales/purchases of physical assets, natural resources, intangible assets, debt forgiveness, death duties, and taxes.
- Financial Account: Domestic-owned financial assets abroad (official reserve, government, private) and foreign-owned domestic financial assets.

Question 1:

- Suppose three countries produce bananas and pencils with output per worker per day in each country as follows:

	Bananas	Pencils
Mexico	20	40
Brazil	30	90
Canada	40	160

- Which country has the greatest comparative advantage in the production of bananas?
  - A. Canada.
  - B. Brazil.
  - C. Mexico.

Question 2

- Germany has much more capital per worker than Portugal. In autarky each country produces and consumes both machine tools and wine. Production of machine tools is relatively capital intensive whereas winemaking is labor intensive. According to the Heckscher–Ohlin model, when trade opens:
  - A. Germany should export machine tools and Portugal should export wine.
  - B. Germany should export wine and Portugal should export machine tools.
  - C. Germany should produce only machine tools and Portugal should produce only wine.

Question 3

- According to the Heckscher–Ohlin model, when trade opens:
  - A. The scarce factor gains relative to the abundant factor in each country.
  - B. The abundant factor gains relative to the scarce factor in each country.
  - C. Income is redistributed between countries but not within each country.

Question 4

- Which of the following trade restrictions is likely to result in the greatest welfare loss for the importing country?
  - A. A tariff.
  - B. An import quota.
  - C. A voluntary export restraint.

Question 5

- The sale of mineral rights would be captured in which of the following balance of payments components?
  - A. Capital account.
  - B. Current account.
  - C. Financial account.

Question 6

- Patent fees and legal services are recorded in which of the following balance of payments components?
  - A. Capital account.
  - B. Current account.
  - C. Financial account.

Question 7

- Which of the following most likely contributes to a current account deficit?
  - A. High taxes.
  - B. Low private savings.
  - C. Low private investment.

Question 8

- Which of the following international trade organizations regulates cross-border exchange among nations on a global scale?
  - A. World Bank Group (World Bank).
  - B. World Trade Organization (WTO).
  - C. International Monetary Fund (IMF).