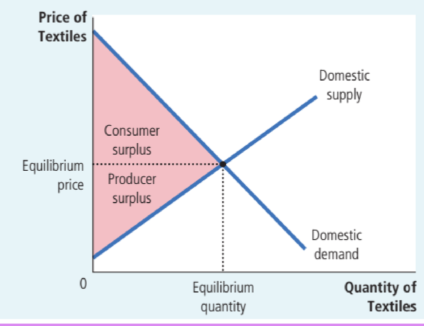
Chap 9 Application: International Trade

- The Determinants of Trade
  - The Equilibrium without Trade
    - FIGURE 1

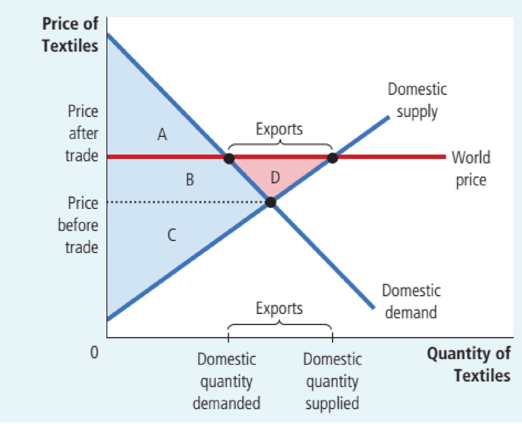
      The Equilibrium without International Trade

      When an economy cannot trade in world markets, the price adjusts to balance domestic supply and demand. This figure shows consumer and producer surplus in an equilibrium without international trade for the textile market in the imaginary country of Isoland.

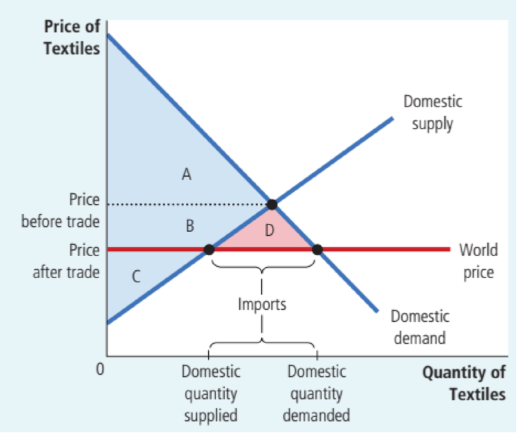
    - Questions
      - If the government allows Isolandians to import and export textiles, what will happen to the price of textiles and the quantity of textiles sold in the domestic textile market?
      - Who will gain from free trade in textiles and who will lose, and will the gains exceed the losses?
      - Should a triff (a tax on textile imports) be part of the new trade policy?
  - The World Price and Comparative Advantage
    - world price: the price of a good that prevails in the world market for that good
    - Comparing the world price with the domestic price before trade reveals whether Isoland has a comparative advantage in producing textiles.
- The Winners and Losers from Trade
  - The Gains and Losses of an Exporting Country
    - No seller of textiles would accept less than the world price, and no buyer would pay more than the world price.
    -
	Before Trade	After Trade	Change
Consumer Surplus	A + B	A	−B
Producer Surplus	C	B + C + D	+ (B + D)
Total Surplus	A + B + C	A + B + C + D	+ D

      The area D shows the increase in total surplus and represents the gains from trade.

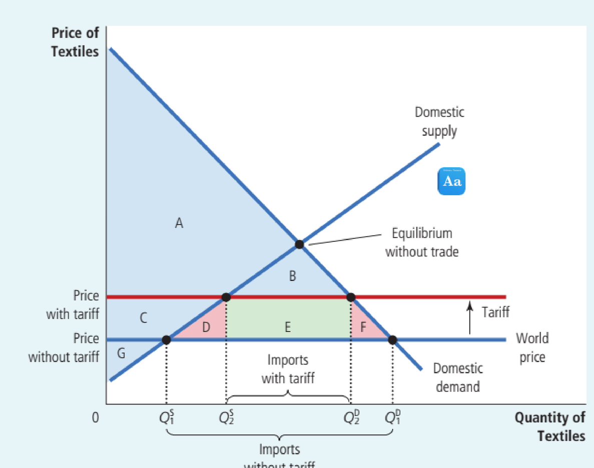
      - When a country allows trade and becomes an exporter of a good, domestic producers of the good are better off, and domestic consumers of the good are worse off.
      - Trade raises the economic well-being of a nation in the sense that the gains of the winners exceed the losses of the losers.
  - The Gains and Losses of an Importing Country
    -
	Before Trade	After Trade	Change
Consumer Surplus	A	A + B + D	+ (B + D)
Producer Surplus	B + C	C	−B
Total Surplus	A + B + C	A + B + C + D	+ D

      The area D shows the increase in total surplus and represents the gains from trade.

      - When a country allows trade and becomes an importer of a good, domestic consumers of the good are better off, and domestic producers of the good are woese off.
      - Trade raises the economic well-being of a nation in the sense that the gains of the winners exceed the losses of the losers.
    - The gains of the winners exceed the losses of the losers, so the winners could compensate the losers and still be better off.
    - In pratice, compensation for the losers from international trade is rare. Without such compensation, opening an economy to international trade is a policy that expands the size of the economic pie, but it can leave some participants in the economy with a smaller slice.
  - Effects of a Tariff
    - tariff: a tax on goods produced abroad and sold domestically
    -
	Before Tariff	After Tariff	Change
Consumer Surplus	A + B + C + D + E + F	A + B	−(C + D + E + F)
Producer Surplus	G	C + G	+ C
Government Revenue	None	E	+ E
Total Surplus	A + B + C + D + E + F + G	A + B + C + E + G	−(D + F)

      The area D + F shows the fall in total surplus and represents the deadweight loss of the tariff.

      - When the tariff raises the domestic price of textiles above the world price, it encourages domestic producers to increase production from Q1s to Q2s. Even though the cost of making these incremental units exceeds the cost of buying them at the world price, the tariff makes it profitable for domestic producers to manufacture them nonetheless.
      - When the tariff raises the price that domestic textile consumers have to pay, it encourage them to reduce their consumption of textiles from D1d to Q2d.
  - The Lessons for Trade Policy
  - Other Benefits of International Trade
    - Increased variety of goods: Good produced in different countries are not exactly the same.
    - Lower costs through economies of scale: Some goods can be produced at low cost only if they are produced in large quantities -- a phenomenon called economies of scale.
    - Increased competition: A company shielded from foreign compatitors is more likely to have market power, which in turn gives it the ability to raise prices above competitive levels.
    - Enhanced flow of ideas: The transfer of technological advances around the world is often thought to be linked to the trading of the goods that embody those advances.
- The Arguments for Restricting Trade
  - The Jobs Argument
    - Opponents of free trade often argue that trade with other countries destroys domestic jobs.
      - Free trade creates jobs at the same time that it destroys them. When Isolandians buy textiles from other countries, those countries obtain the resources to buy other goods from Isoland.
    - Under free trade, they might argue, Isolandians could not be profitably employed in any industry.
      - The gains from trade are based on comparative advantage, not absolute advantage. Even if one country is better than another country at producing everything, each country can still gain from trading with the other.
  - The National-Security Argument
    - Economists acknowledge that protecting key industries may be appropriate when there are legitimate concerns over national security. Yet they fear that this argument may be used too quickly by producers eager to gain at consumers' expense.
  - The Infant-Industry Argument
    - New industries sometimes argue for temporary trade restrictions to help them get started. After a period of protection, the arguement goes, these industries will mature and be able to compete with foreign firms. Similarly, older industries sometimes argue that they need temporary protection to help them adjust to new conditions.
      - To apply protection successfully, the government would need to decide which industries will eventually be profitable and decide whether the benefits of establishing these industries exceed the costs of this protection to consumers.
      - Once a powerful industry is protected from foreign competition, the "temporary" policy is sometimes hard to remove.
    - In addition, many economists are skeptical about the infant-industry argument in principle.
      - Firm owners should be willing to incur temporary losses to obtain the eventual profits. Protection is not necessary for an infant industry to grow.
  - The Unfair-Competition Argument
    - If firms in different countries are subject to different laws and regulations, then it is unfair(the argument goes) to expect the firms to compete in the international marketplace.
    - For instance, suppose that the government of Neighborland subsidizes its textile industry by giving textile companies large tax breaks.
      - The gains of the consumers from buying at the low price would exceed the losses of the producers. Neighborland's subsidy to its textile industry may be a bad policy, but it is the taxpayers of Neighborland who bear the burden.
  - The Protection-as-a-Bargaining-Chip Argument
    - Many policymakers claims to support free trade but, at the same time, argue that trade restrictions can be useful when we bargain with our trading partners.
    - The problem with this bargaining strategy is that the threat may not work. If it doesn't work, the country faces a choice between two bad options. It can carry out its threat and implement the trade restriction, which would reduce its own economic welfare. Or it can back down from its threat, which would cause it to lose prestige in international affairs.
- Trade Agreements And The World Trade Organization
  - In most markets, producers are fewer and better organized than consumers -- and thus wield greater political influence.
    - The textile companies would oppose free trade, and the buyers of textiles who would benefit are so numerous that organizing their support would be difficult.