



**Course: Foundations of Economics**  
**Lecture 11: Introduction to International Trade**

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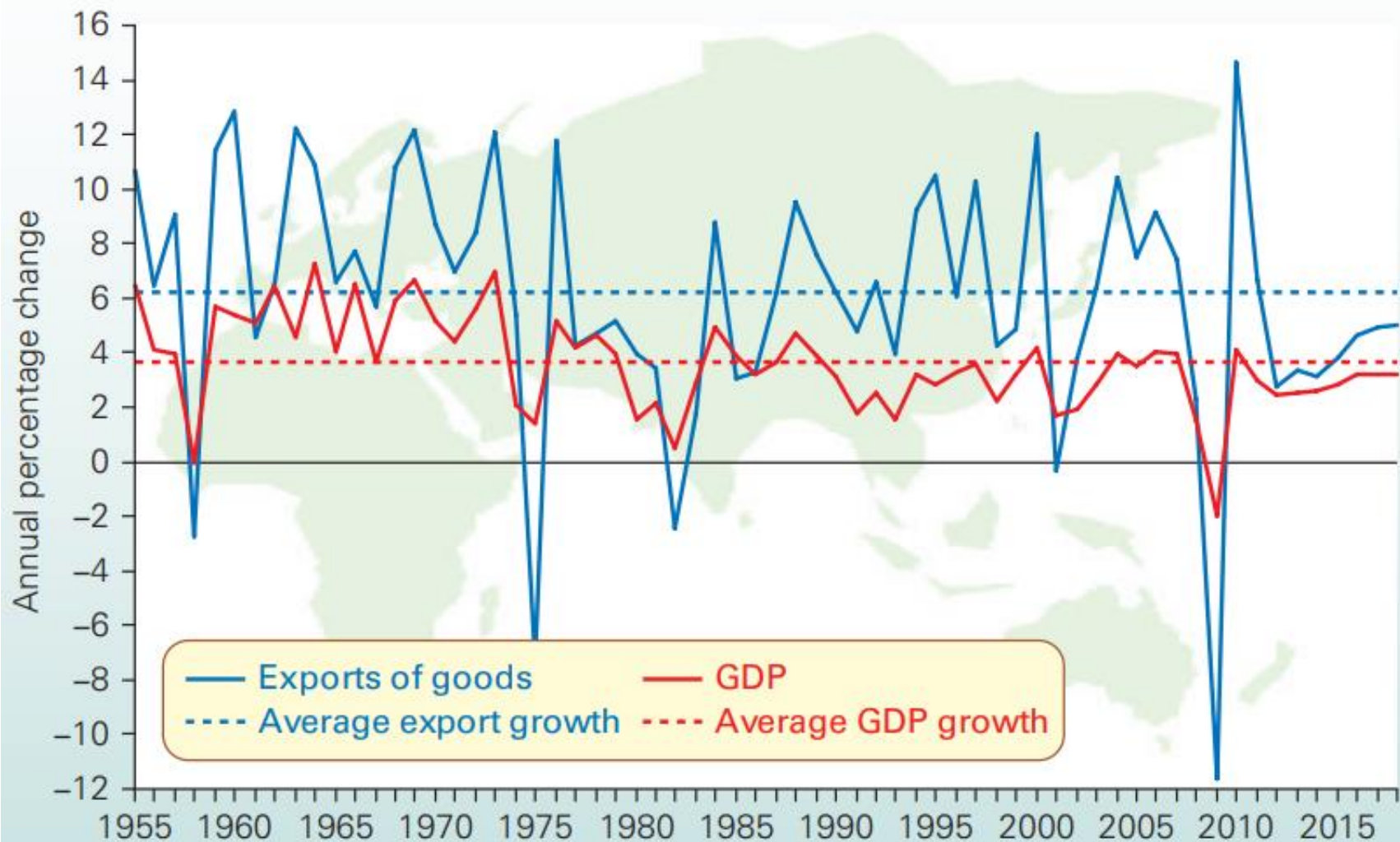
# Topics covered

- Globalization
- International trade
- Free trade vs trade restrictions
- Trade agreements and trading blocks

# Globalization

- ▶ National economy nowadays is thoroughly integrated with the rest of the world
- ▶ Reduction in trade barriers, fall in transportation costs and technological breakthroughs led to increased international economic exchanges
- ▶ We consume imported products in everyday life

## Annual growth in global output and exports of goods



Note: Data from 2015 onwards are based on IMF forecasts; averages relate to the 60-year period 1955–2014

Source: 1955–79 based on data from *International Trade Statistics*, 2014 (WTO); 1980 onwards based on data from *World Economic Outlook Database*, April 2015 (IMF)

# International vs. Intranational Trade

- ▶ Reasons why we study international trade

Many currencies

- ▶ Need to deal with variability of exchange rates

Impediments to the mobility of labor and capital

- ▶ Immigration quotas, laws restricting hiring foreign workers
- ▶ Laws limiting foreign ownership of capital
- ▶ Political risks

# Why Trade?

- ▶ Some reasons for trade
  - ▶ Resources distributed unequally across planet
  - ▶ Natural endowments - climate, terrain - differ
  - ▶ Skills of labor force
- ▶ Main reason is to exploit advantages of specialization
  - ▶ A country devotes its energies and resources to only a small proportion of the world's productive activities
- ▶ International trade greatly enhances living standards for all parties involved

# Why Trade?

- ▶ Mutual gains from trade
  - ▶ Old view: one country gains at the expense of another
  - ▶ How would Adam Smith respond?
    - ▶ Both countries must gain from voluntary exchange
    - ▶ Otherwise, what's the point of trading
  - ▶ Trade allows each party to get goods better suited to their tastes

# Trade Is A Win-Win Situation

- ▶ Both parties must expect to gain from any voluntary exchange.
  - ▶ Trade brings about mutual gains
  - ▶ Redistributes products so that both parties end up holding more preferred combinations of goods than they held before.

# The Law of Comparative Advantage

- ▶ Absolute advantage
  - ▶ The ability of one country to produce a good using smaller quantities of resources than another country
- ▶ Comparative advantage
  - ▶ The ability of one country to produce a good relative to other goods less inefficiently than another country

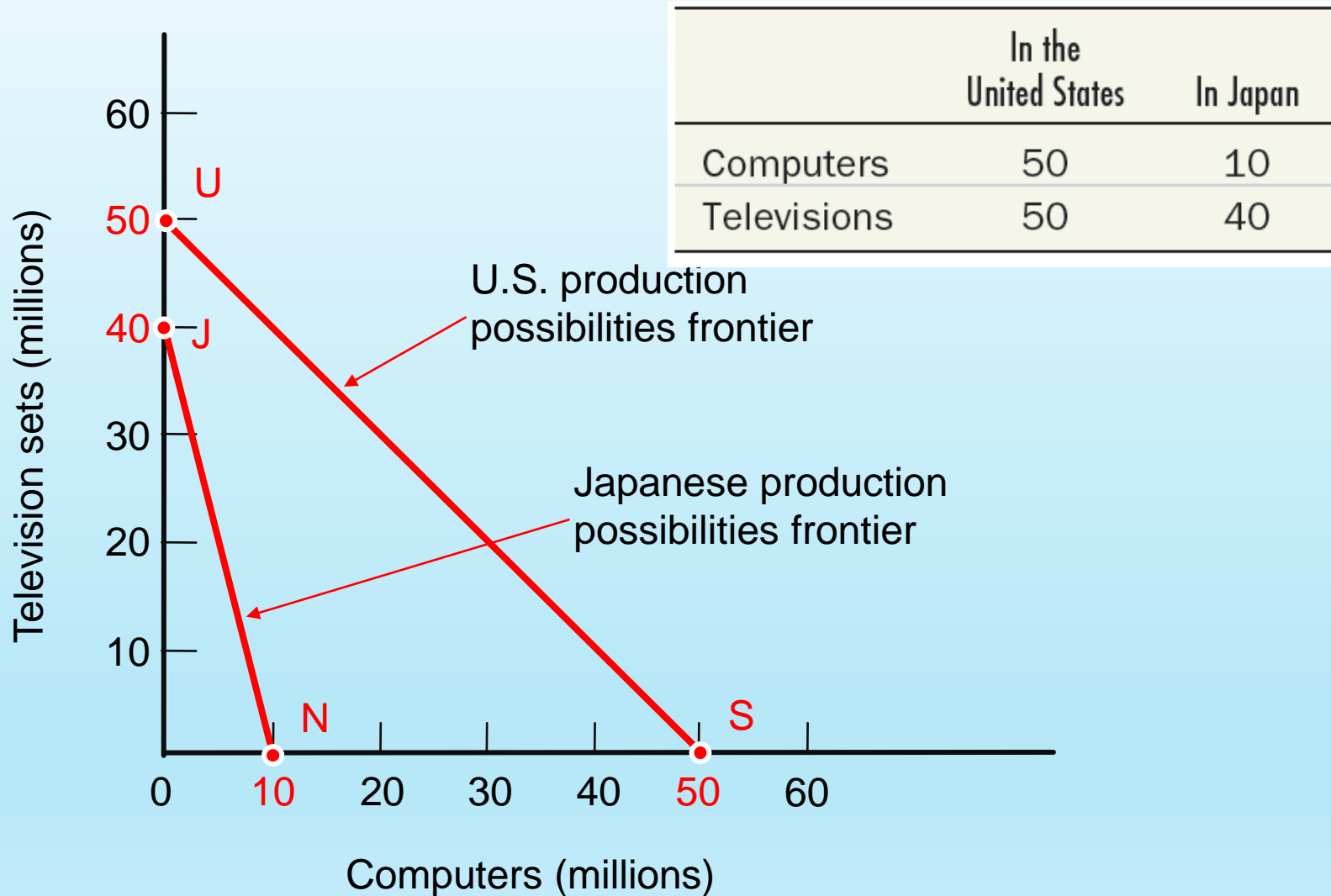
# The Law of Comparative Advantage

- ▶ Surprising Principle of Comparative Advantage
  - ▶ Even if one country has an absolute *disadvantage* in the production of *every* good
  - ▶ it still has a comparative advantage in making the good at which it is least inefficient
  - ▶ Comparative advantage determines the patterns of production

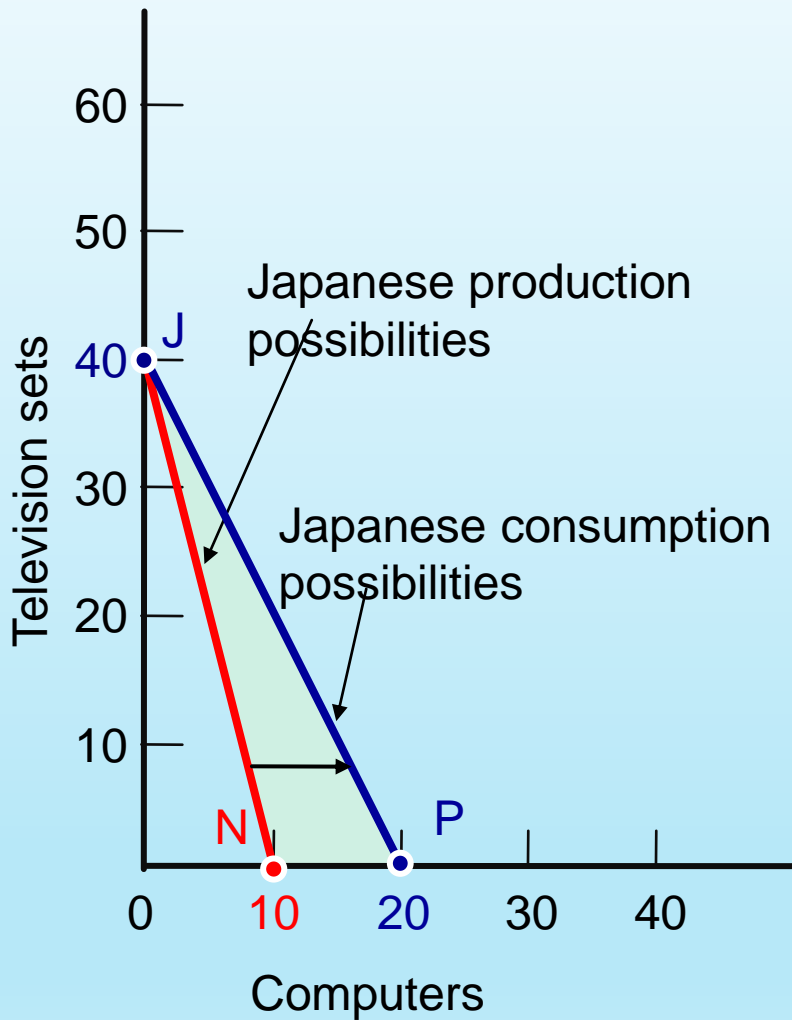
# The Law of Comparative Advantage

- ▶ Surprising Principle of Comparative Advantage
  - ▶ A country can gain by importing a good even if it can produce it more efficiently at home.
  - ▶ Such imports make sense if they enable the country to specialize in producing goods at which it is even more efficient.

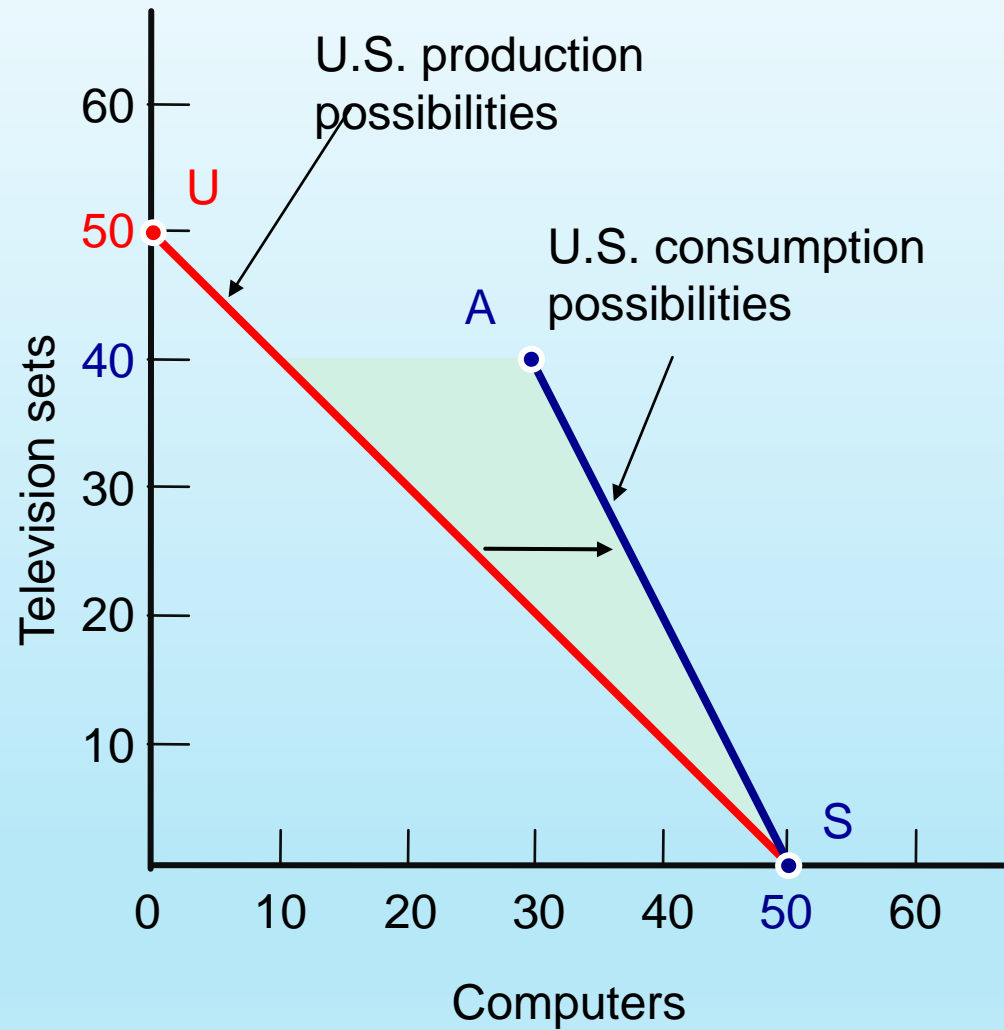
# Production Possibilities Frontiers for Two Countries (per million person-years of labor)



# The Gains from Trade



(a) Japan



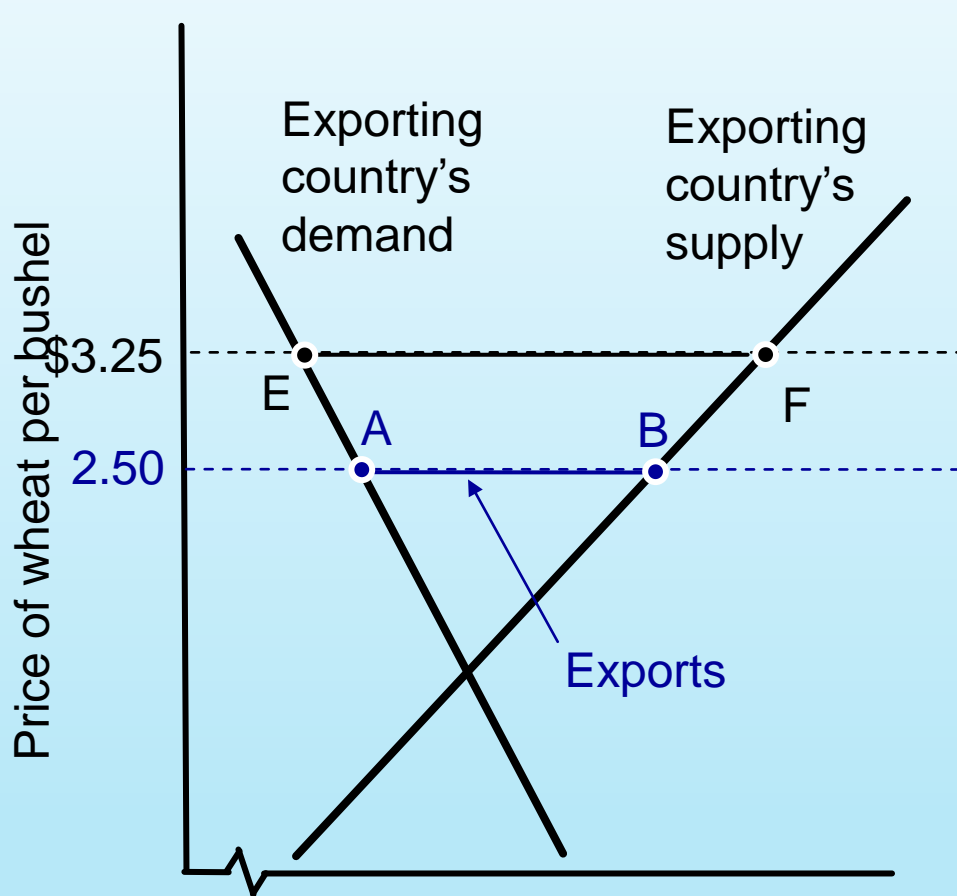
(b) United states

Source: Baumol & Blinder, (2009), MACROECONOMICS, 11th ed, Cengage Learning, page 346.

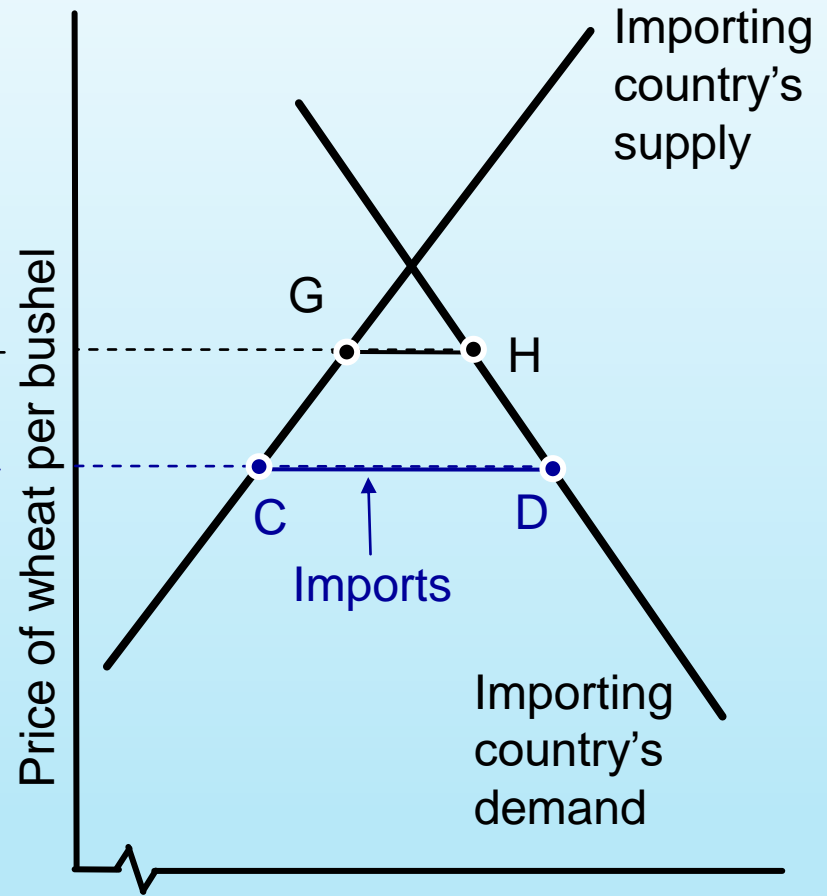
# Arithmetic of Comparative Advantage

- ▶ Specialization will not be complete
  - ▶ Some countries too small to provide the world's entire output
  - ▶ Production possibilities frontiers are curved
    - ▶ As a country produces more and more of one good, the opportunity cost gets larger and larger

# Supply-Demand Equilibrium in the International Wheat Trade



Quantity of Wheat  
(a) Exporting country



Quantity of Wheat  
(b) Importing country

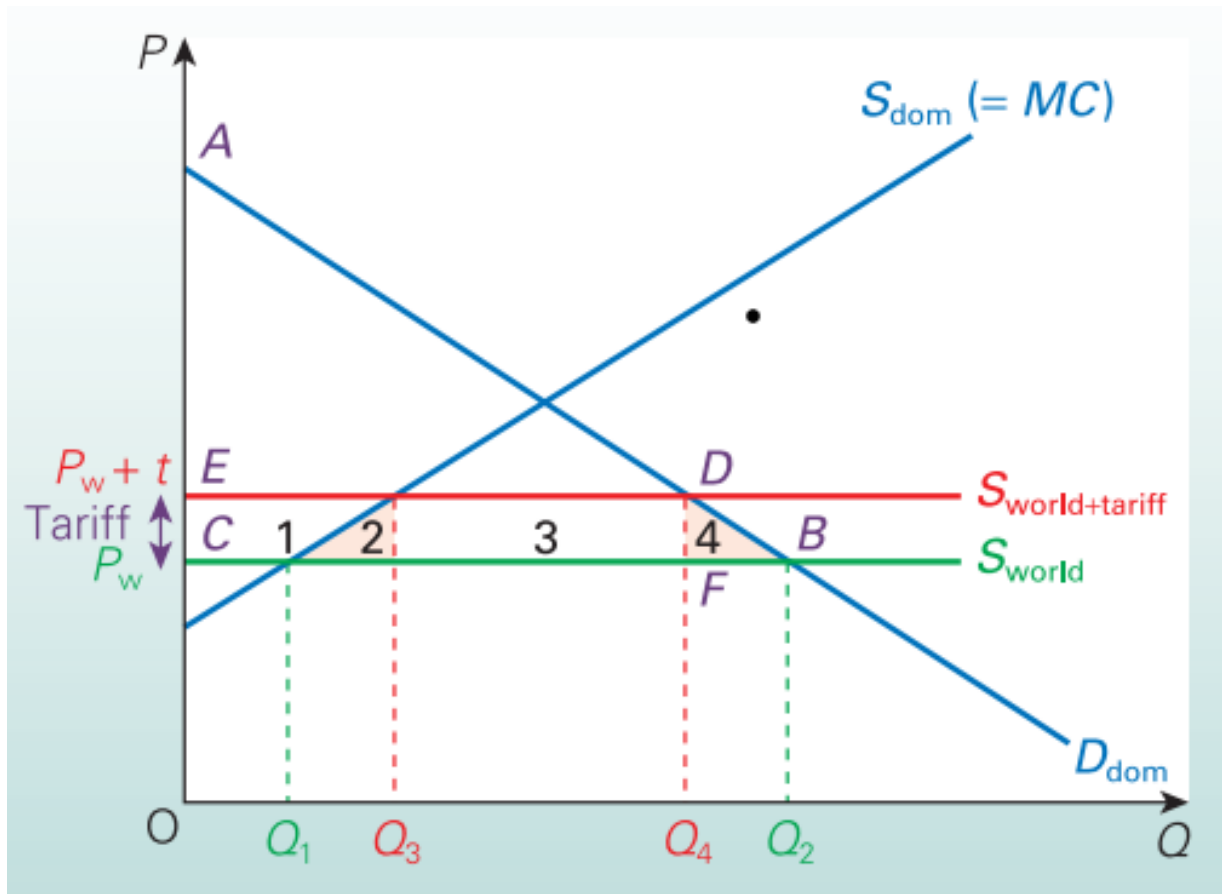
# Interferences with Trade

- ▶ Three main ways governments control trade
  - ▶ Tariffs - Tax on imports
  - ▶ Quotas - Legal limit on imports
  - ▶ Export subsidies
    - ▶ Government payment to exporter so they can lower prices and compete in foreign markets

# Interferences with Trade

- ▶ Tariffs vs. Quotas
  - ▶ Both reduce international trade and increase prices
  - ▶ Quotas: profits go to both foreign and domestic sellers
  - ▶ Tariffs: some of the profits end up as tax revenue
  - ▶ Tariffs offer greater benefits to more efficient exporters
  - ▶ Are tariffs or quotas preferable?

# Cost of production: import tariff



*Areas 1+2+3+4 are consumer losses due to increased price after tariff.*

*2+4 are deadweight losses*

# Why Restrict Trade?

## Protecting particular industries

- ▶ Preserve employment - protected industry
- ▶ Rescue firms too inefficient to compete with foreign exporters
- ▶ Cost to consumers and the economy

# Why Restrict Trade?

National defense and other non-economic reasons

- ▶ Produce own national defense equipment
  - ▶ True in some cases, but can lead to some unreasonable claims for protection: eg. watchmakers
- ▶ Political grounds
- ▶ Endangered species: seals

# Why Restrict Trade?

## Infant-industry argument

- ▶ New industries need protection from foreign competition until they develop and flourish
- ▶ Stands up only if the prospective future gains are sufficient to repay the up-front costs of protectionism
- ▶ But, then why doesn't private capital take advantage

# Why Restrict Trade?

## Strategic argument for protection

- ▶ A nation may sometimes have to threaten protectionism to induce other countries to drop their own protectionist measures

# Can Cheap Imports Hurt a Country?

- ▶ Dumping
  - ▶ Selling goods in a foreign market at lower prices than those charged in the home market
  - ▶ Isn't this good?

# International Trade Agreements

- ▶ WTO
- ▶ Free trade areas
- ▶ Customs unions
- ▶ Direct effect of regional trade agreements

# WTO

- ▶ Multinational organization established in 1994. Covers more than 160 countries.
- ▶ Establishes rules for trade among its members
- ▶ Acts as a court for resolving trade disputes among members
- ▶ Forum for trade negotiations
- ▶ International instrument for trade liberalization

# WTO principles and rules

- ▶ Non-discrimination
  - ▶ MFN
  - ▶ National Treatment
- ▶ Reciprocity
- ▶ General prohibition of quotas
- ▶ Fair competition

# Trading blocks and economic integration

*Preferential trading arrangement is a trading arrangement whereby trade between the signatories is freer than trade with the rest of the world.*

- ▶ Types of preferential trade agreements
- ▶ Free trade areas
- ▶ Customs unions
- ▶ Common markets

# Free trade areas

- ▶ A free-trade area is where member countries remove tariffs and quotas between themselves, but retain whatever restrictions each member chooses with non-member countries. Some provision will have to be made to prevent imports from outside coming into the area via the country with the lowest external tariff.

# Customs unions

- ▶ Customs union is like a free-trade area, but in addition members must adopt common external tariffs and quotas with non-member countries.

# Common markets

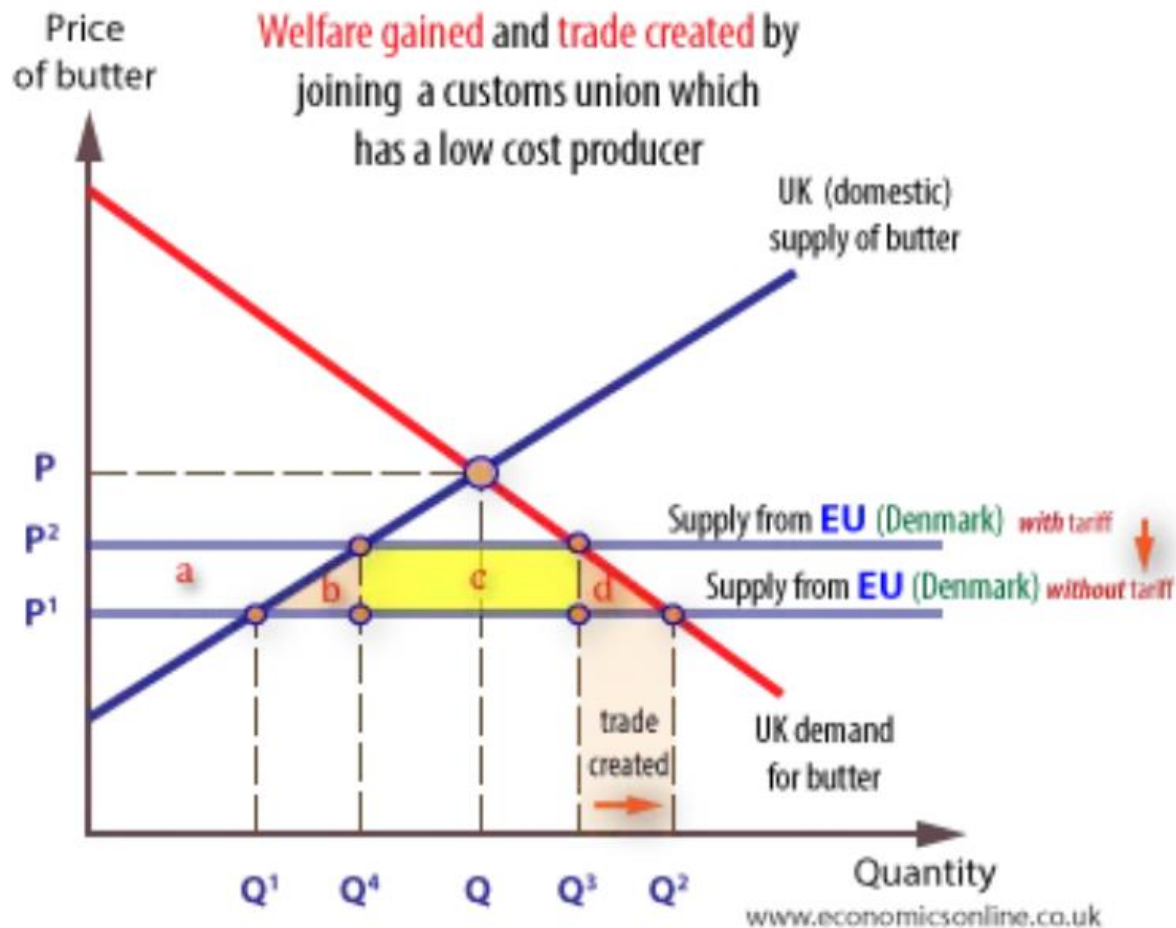
CM member countries operate as a single market. Like a customs union there are no tariffs and quotas between member countries and there are common external tariffs and quotas. But a common market goes further than this and entails:

- ▶ A common system of taxation.
- ▶ A common system of laws and regulations governing production, employment and trade.
- ▶ Free movement of labour, capital and materials, and of goods and services.
- ▶ The absence of special treatment by member governments of their own domestic industries.

# Direct effects of a regional trade agreements

- ▶ Trade creation
  - ▶ Customs union leads to greater specialisation according to comparative advantage and thus a shift in production from higher-cost to lower-cost sources.
- ▶ Trade diversion
  - ▶ Customs union diverts consumption from goods produced at a lower cost outside the union to goods produced at a higher cost (but tariff free) within the union

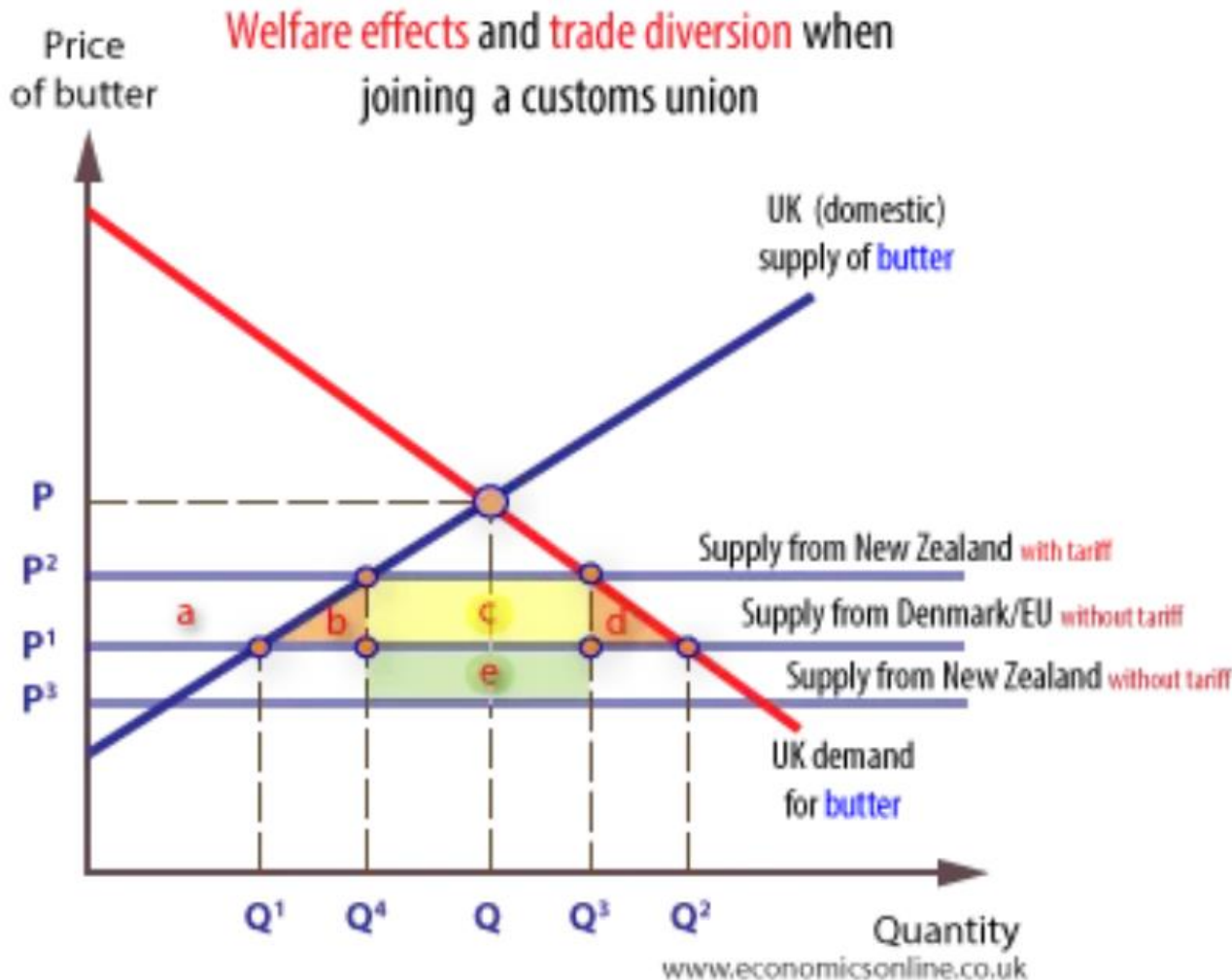
# Trade creation effect illustrated



*Areas  $a+b+c+d$  are consumer gains;  $b+d$  are trade creation effects;  $c$  - government loss from trade creation.*

*Note gains  $(a+b+c+d)$  outweigh loss  $(c)$ .*

# Trade diversion



Areas  $a+b+c+d$  are consumer surplus;  $c+e$  - government loss from NZ import duties.

Note that trade has been diverted from NZ to EU producers. Only if  $b+d$  is greater than  $e$ , then net gain from trade diversion is positive.

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