Contents

Reasons for trade

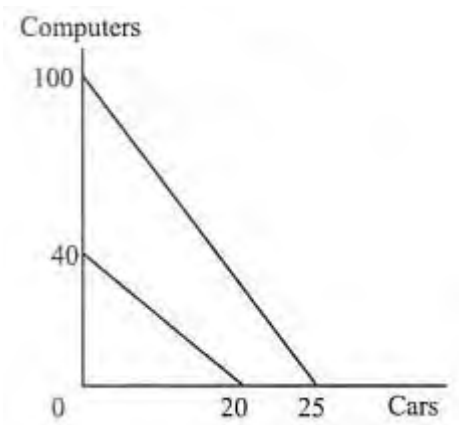
- There is an improvement in economic welfare if countries **specialise** in the products in which they have a **comparative advantage** and then trade with other nations.
- Trade allows firms to exploit **scale economies** by operating in larger markets - the European Union has over 450 million consumers with a massive purchasing power. Economies of scale lead to lower average costs of production that can be passed onto consumers.
- **International competition** stimulates higher efficiency - particularly for domestic monopolies. Free trade provides greater choice for consumers and competition helps keep prices down.
- Imports can help to **satisfy excess demand** from consumers - acting as a safety valve for the economy to stop overheating. A trade deficit during an economic boom helps to reduce demand-pull inflation.
- Trade in ideas stimulates product and process **innovations** that generate better products. This includes the spread of technology.
- Increased **consumer choice**. Country can import goods that it cannot produce domestically, e.g. oranges in cold climates.
- There are also **political** and **social** gains of trade. Increased trade between countries reduces the likelihood of war as countries rely on each other for certain goods. This was one reason for the creation of the European Economic Community (EEC) after WW2, which included Germany and some previously occupied countries including France, Belgium and the Netherlands. There is enormous political significance in the increased trade between China and the rest of the world.

Absolute Advantage

Absolute advantage exists if a country can produce a good using fewer resources than another country.

Comparative Advantage

Comparative advantage exists if a country can produce a good at a **lower opportunity cost** than another country. Countries have different factor endowments and if countries specialise in goods in which they have a comparative advantage then world output will increase and countries will be able to consume beyond their Production Possibilities Frontier (given certain assumptions). Even if a country has an absolute advantage this will still be true.



	Computers	Cars
X	100	25
Y	40	20

Both the diagram and the table above show the production possibilities of countries X and Y with a given set of resources. Country X has an absolute advantage in both goods. From the graph we can see that the opportunity costs of production of each good differ in each country because the PPFs are not parallel. X has a comparative advantage in computers and Y has a comparative advantage in cars.

In X:

The opportunity cost of producing 1 computer is ¼ of a car (100/100 -> 25/100)

The opportunity cost of producing 1 car is 4 computers (20/20 -> 40/20)

In Y:

The opportunity cost of producing 1 computer is ½ of a car (40/40 -> 20/40)

The opportunity cost of producing 1 car is 2 computers (20/20 -> 40/20)

If country X can buy cars from Y for less than 4 computers and Y can sell cars to X for more than 2 computers, then both countries will gain from trade. If country Y can buy computers for less than ½ car and country X can sell computers for more than ¼ car then both countries will gain from trade.

The **terms of trade** will be 1 car : 3 computers.

However, the above model is based on the following assumptions:

- There are only two countries involved and only two products.
- Each country has a given set of resources and cannot increase or change them.
- Perfect factor mobility (ignoring costs of retraining, moving workers from one industry to another, etc).
- No transport costs.
- Constant returns to scale.
- No externalities from production.
- No barriers to trade put up by other countries.
- Does not allow for uncertainty and risk, e.g. when specialising in commodity production.
- Full employment.
- Prices reflect opportunity cost.
- No consideration of who within the countries gain from trade.

In real life, these assumptions do not hold true and may be way off the mark.

Free trade and Protectionism

Free trade is the international exchange of goods and services without any artificial barriers to trade (no government imposed restrictions on trade).

Protectionism is the act of imposing trade barriers to protect the income of domestic producers.

Tariffs

Tariff: A *tax imposed on imports.*

- Increases price of imports, making local products comparatively cheaper (more competitive). Leads to lower quantity of imports.
- It raises revenue for the government.

WTO preferred, as any producer willing to pay the tariff can compete openly →global efficiency

INSERT TARIFF DIAGRAM

Quota

Quota: *A set limit on the amount of imports allowed into a country, in terms of quantity or value.*

- Guarantees local producers a proportion of the market.
    - Quota allocated by *import licences*, which are auctioned off to highest overseas bidders (raises revenue for government).
    - Overseas producers without licence cannot compete at all – *barrier to entry.*

INSERT QUOTA DIAGRAM

Restricting the quantity of imports (imposing a quota) raises the price, lowers demand and increase domestic supply due to the higher price. It therefore has the same effect as a tariff but it restricts competition so it is less economically efficient than tariffs and less transparent.

Subsidy

Subsidy: *A payment made by government to local producers on each unit produced*

- Gives local producers advantage over importers by effectively reducing costs of production

INSERT SUBSIDY DIAGRAM

Voluntary Export Restraint

Voluntary export restraint: *A self-imposed limit on the amount of exports the country sends to another country.*

- Guarantees local producers market share in the other country.
- Usually applied when exporter faces threats of more formal protection measures.

However, this does not always work to the importer's advantage. One such case is when Japan imposed VERs on its automobile exports to the US. The bilateral nature of VERs contributes to a