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MIDOCEAN
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Introduction to Economics

Lecture 10

MGM112

International Trade

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After studying this chapter, you will be able to

- What is the relationship between international trade and the nation's standard of living
- Which country produces which good(s)?
- Analyze Tariffs, and Non-Tariff Distortions to Trade

The relationship between international trade and the nation's standard of living

1) The relationship between international trade and the nation's standard of living

The relationship between international trade and the nation's standard of living

- Some countries rely on international trade to obtain many products that it does not produce and some minerals of which it has no reserves.
- So, Interdependence in the world economy is reflected in the flow of goods, services, labor, and capital across national boundaries, which lead to increase the nation's standard of living.

2) Classical International Trade Theories

Classical International Trade Theories



Classical International Trade Theories

1) Mercantilism.

- ❖ The doctrine of Mercantilism Believed that a country's wealth was based on how much gold and silver was held,... Because gold and silver circulated as money
- ❖ A country could increase its wealth by: Exporting more goods than it imported. (EX>IM) because:
 - Exports created inflows of gold and silver
 - Imports created outflows of gold and silver.
 - So, when a country's exports exceeded its imports (EX>IM), its stock of **gold and silver rose**, and the country's.

Classical International Trade Theories

1) Mercantilism.

❖ A Favorable Trade Balance:

- The Mercantilists advocated regulating international trade in a way that would promote **large exports and small imports** to increase wealth by using restrictions as **Tariffs and Quotas**

❖ They assumed Trade is:

- **Zero-Sum-Game**
- **Win-Lose- Game**



2) Absolute Advantage (Adam Smith)

❖ It is the ability of the country to produce goods using:

- Fewer resources
- Lower cost (Cheaper)

Classical International Trade Theories

2) Absolute Advantage (Adam Smith)

❖ Main Assumptions:

1. two-nation
2. two-commodity
3. two-factor world
4. no trade restrictions
 - Adam Smith and other classical economists advocated **policy of laissez-faire, or minimal government interference** with economic activity.
5. perfect mobility of factors within the nations but no international mobility
6. perfect competition in all commodity and factor markets
7. no transportation costs

Classical International Trade Theories

2) Absolute Advantage (Adam Smith)

Table 1 : One Labor per day produces

	Machines	Cloth
U. S	5	10
India	2	15

Machines:

- In U.S: 1 labor produces 5M
- In India: 1 labor produces 2M

Cloth

- In U.S: 1 labor produces 10C
- In India: 1 labor produces 15C

Classical International Trade Theories

2) Absolute Advantage (Adam Smith)

- U.S has
 - an absolute advantage in **machine production (M)**
 - an absolute disadvantage in **cloth production (C)**
- India has
 - an absolute advantage in **cloth production (C)**
 - an absolute disadvantage in **machine production (M)**

	Machines	Cloth
U. S	5	10
India	2	15

2) Absolute Advantage (Adam Smith)

- So, Trade occurs between U.S and India according to absolute advantage as:
 - US specializes in producing machines
 - Exports (M) to India
 - Imports (C) from India
 - India specializes in producing cloth
 - Exports(C) to U.S
 - Imports (M) from U.S

Classical International Trade Theories

2) Absolute Advantage (Adam Smith)

- Both nations can gain from specialization, as
 - Gains from Trade as World output increase by **3 machines**, and **5 yards of cloth**

	Machines	Cloth
U. S	+ 5	-10
India	- 2	+ 15
Change in world output	+3	+5



2) Comparative Advantage (David Ricardo)

If one country has an absolute advantage in the production of both products, and the other country has absolute disadvantage in the production of both products.

- According to Adam Smith, No Trade occurs between two countries and No Gains.

But According to **David Ricardo** a country could have an **absolute disadvantage** in the production of a product relative to another country and **still has a comparative advantage** in the production of the product, so **Trade occurs**

2) Comparative Advantage (David Ricardo)

	Machines	Cloth
U. S	5	15
India	1	5



- According to an absolute advantage (Adam smith)
 - U.S has an absolute advantage in **both goods (M) and (C)**
 - **India** has an absolute disadvantage in **both goods (M) and (C)**
 - **So, there is No Trade occurs between U.S and India and No Gains.**
- **But According to comparative advantage theory and David Ricardo, trade will occur.**
- How?**

2) Comparative Advantage (David Ricardo)

It is the ability of the country to produce goods at :

○ **Lower opportunity cost** which is:

- amount of one good that a country must forego to produce each additional unit of another good

لما انتج سلعة واحدة _ هضحي باد ايه من السلعة الاخرى ???

Classical International Trade Theories

2) Comparative Advantage (David Ricardo)

	Wheat	Cloth	<i>opportunity cost of Wheat:</i> $5W=15C$	<i>opportunity cost of Cloth</i>
U.S	5	15 $(\div 5)$	$1W = 3C$ $(\div 3)$	$1C = 1/3 W$
U.K	1	5	$1W = 5C$	$1C = 1/5 W$

According to a comparative advantage (David Ricardo):

- U.S has
 - A comparative advantage in **wheat production (W)**
- U.K has
 - A comparative advantage in **cloth production (C)**

Classical International Trade Theories

2) Comparative Advantage (David Ricardo)

	Wheat	Cloth	<i>opportunity cost of Wheat:</i> $5W=15C$	<i>opportunity cost of Cloth</i>
U. S	5	15 $(\div 5)$	$1W = 3C$ $(\div 3)$	$1C = 1/3 W$
U.K	1	5	$1W = 5C$	$1C = 1/5 W$

○ So, **Trade occurs** between U.S and U.K according to A comparative advantage as:

▪ US specializes in producing wheat

- ✓ Exports (W) to U.K
- ✓ Imports (C) from U.K

▪ U.K specializes in producing cloth

- ✓ Exports (C) to U.S
- ✓ Imports (W) from U.S

■ Although U.K has an absolute disadvantage in both goods, U.K has a comparative advantage in cloth production

Think

The Mercantilists believed:

- A. that international trade was a zero-sum game.
- B. that international trade was an n-sum game.
- C. that maximizing a country's imports would improve its welfare.
- D. that exports were detrimental to a country's economy.

The Mercantilists did not support:

- A. Free trade
- B. Increase exports
- C. Increase accumulation of precious metals (gold and silver)'
- D. All of the above



THINK

Chapter

10

Think

The Mercantilists advocated that each country should try to create balanced trade by having exports equal to imports.

False

The Mercantilists believed that international trade was a zero-sum game.

True

The Mercantilists believed that imports were “bad” because they led to an outflow of gold and silver from the country.

True



Think

Specialization and trade by countries based on absolute advantage results in:

- A. A faster depletion of the world's resources.
- B. Products produced at higher cost.
- C. The world using its resources more efficiently causing an increase in world output, and welfare.
- D. The world using its resources more efficiently causing a decrease in world output.

Absolute advantage is a trading principle that states that:

- A. differences in resource endowments determine comparative advantage.
- B. differences in incomes determine comparative advantage.
- C. absolute cost differences determine the basis for trade.
- D. relative cost differences determine the basis for trade.



Think

When country A uses fewer resources to produce a product than another country, then:

- A. country A has a comparative advantage in the production of the product.
- B. country A has an absolute advantage in the production of the product.
- C. country A has a comparative disadvantage in the production of the product.
- D. country A has an absolute disadvantage in the production of the product.

Smith's theory of absolute advantage is based on:

- A. the labor theory of value. (Labor are productive so they use lower resources)
- B. opportunity costs.
- C. absolute theory of value.
- D. capital theory of value.



THINK

Think



According to the table, Which of the following statements is correct?

- (A) Japan got absolute advantage in both corn and juice**
- (B) Korea got absolute advantage in both corn and juice
- (C) Both Korea and Japan got disadvantage in the two goods
- (D) Neither Korea nor Japan has absolute advantage in any good

Table: Production of one working day

	Japan	Korea
Corn	4	1
Juice	3	2

Specialization and trade increase the world's output of goods and services. True

Think

Opportunity cost is:

- A. the dollar cost of producing the goods.
- B. the dollar price paid for final goods and services.
- C. the dollar price associated with using one good in place of another.
- D. the alternative that must be given up in order to get something else.

According to the theory of comparative advantage, which of the following is not a reason why countries trade?

- A) Costs are higher in one country than in another.
- B) Prices are lower in one country than in another.
- C) Exports give a country a political advantage over other countries that export less
- D) The productivity of labor differs across countries and industries.



Think

A country's ability to produce a specific good with fewer resources than another country determines whether it has a comparative advantage in producing the good. False

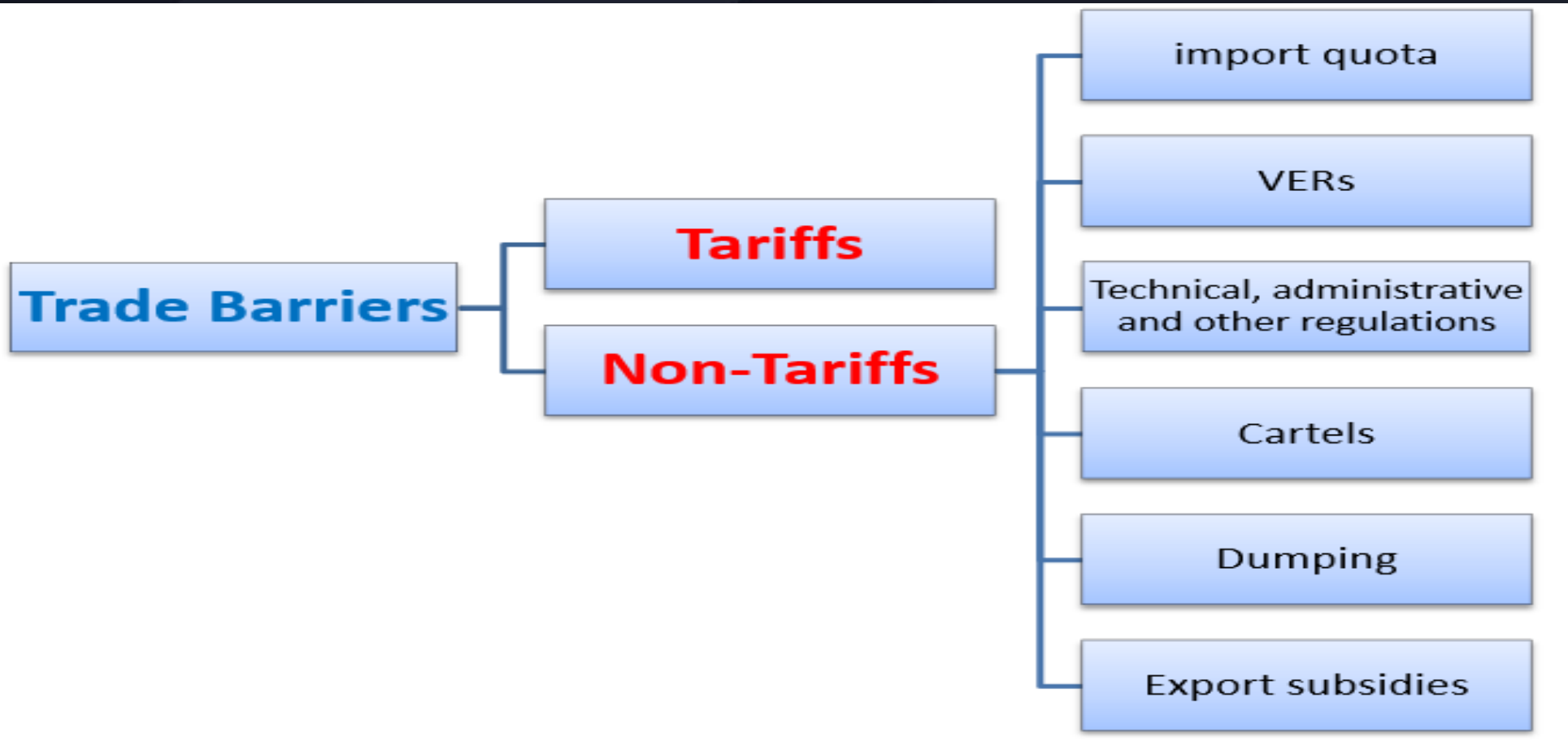
If a country has an absolute advantage in the production of all products, then it makes no sense for it to trade with other countries. False

Comparative advantage is based on the opportunity costs of producing particular goods. True



3) Trade Barriers

Classical International Trade Theories



1) Tariffs

Definition:

- is a tax levied on the traded commodity as it crosses a national boundary
- There are two types of tariffs

Import Tariffs	Export Tariffs
An import tariff is a tax or duty levied on imported commodities. This is the most common form of tariff.	An export tariff is a tax on exported commodities. Prohibited by the U.S. Constitution, but occasionally practiced in developing countries to generate government revenue.

Trade Barriers

1) Tariffs

Functions of tariffs:

Revenue tariff	Protective tariff	Prohibitive tariff
-An import tax levied on a good that is not produced domestically <u>to raise money (revenue)</u>	- a tariff designed <u>to protect a domestic industry</u> from foreign competition	It is so high tariffs <u>to keep Imports = 0</u>
-It is used in <u>developing countries</u> because: The alternative methods are income tax or sales which require a certain level of efficiency to be effectively collected.	It is used in <u>a middle- & high-income country</u> to: Protect comparative advantage industries from import competition.	

Trade Barriers

1) Tariffs

Types of tariffs:

	Specific tariff	Ad valorem tariff	Compound tariff
Definition	A <u>per unit</u> tax on imported goods. (Fixed)	A <u>percentage</u> of the value of the imported good. (Change)	A <u>mixed</u> of both (Fixed+ Change)
Example	• <u>6\$ per Car</u>	• <u>4% of the value or price of a car</u>	• <u>6\$ + 4%</u>
advantages	-Easy to administer -Work best on Homogenous/ same products	-Not Regressive in nature: (Fair) as poor pay less than the rich as tariffs is a (%) of the value of a good.	-Common on products whose prices fluctuate (Agricultural products)
Disadvantages	- Regressive in nature (Unfair) because the impact of specific tariffs on poor will be more than rich people <u>as:</u> - price of good↑ - The impact of tariffs↓	- Not easy to administer It requires valuation of the good	

2) Non-Tariff Distortions to Trade

1- Import Quota:

- A direct **quantitative restriction** on the amount of a commodity allowed to be imported, imposed **by importing countries**
- are used to protect:
 - domestic **industry**
 - domestic **agriculture**,
 - and/or for **balance of payments reasons**.

2) Non-Tariff Distortions to Trade

2- Voluntary Export Restraints (VERs):

- It is a voluntary quota imposed **by exporting countries** to reduce its exports voluntarily, **under threat of higher trade restrictions**
- VERs allow industrial nations to appear to support **the principle of free trade.**
- **Less effective in limiting imports than import quotas** because exporters tend to fill the quota with higher quality, higher priced goods over time.

2) Non-Tariff Distortions to Trade

3- Technical, Administrative, Other Regulations:

- Domestic country's national standards for
 - **Health** regulations
 - **safety** regulations
 - **Labeling** requirements
- that the country uses to raising the costs of imported products to protect domestic industries.

2) Non-Tariff Distortions to Trade

4- International Cartels:

- Organization of suppliers from different nations that agrees to restrict output and exports of a commodity with the aim of maximizing or increasing total profits.
- For example, OPEC (the Organization of Petroleum Exporting Countries) quadrupled the price of crude oil between 1973 and 1974 by restricting production and exports.

2) Non-Tariff Distortions to Trade

5- Dumping:

Dumping is the export of a commodity **at below cost**, or the sale of a commodity **at a lower price** abroad than domestically.

2) Non-Tariff Distortions to Trade

5- Dumping:

Types of dumping:

Persistent dumping	Sporadic dumping	Predatory dumping
The continuous tendency of a domestic monopolist to maximize total profits by selling the commodity at a higher price in the domestic market.	The occasional sale of a commodity at below cost or lower price abroad to unload surplus of the commodity without reducing domestic prices.	The temporary sale of a commodity at below cost or a lower price abroad to drive foreign producers out of business.

2) Non-Tariff Distortions to Trade

6- Export Subsidies:

- the Payments and incentives offered to export producers,
- or subsidized loans to foreign buyers
- intended to raise the nation's exports.
- Export subsidies are illegal by international agreement

Think

The purpose of a protective tariff is:

- a.to protect domestic consumers from harmful products.
- b.to protect the international laws of commerce.
- c.to protect the foreign country from anti-trust actions.
- d.to protect domestic producers from foreign competition.**

Specific tariffs are collected:

- a. only on industrial products.
- b. only on pharmaceutical products.
- c. only on products that arrive by train.
- d. as a fixed amount of money per unit traded.**



Think

A tariff of 20% on imported goods is called:

- a. a specific tariff.
- b. a percentage tariffs.
- c. **an ad valorem tariff.**
- d. a compound tariffs.

A tariff of (\$250/import + 15% of the C.I.F. value/import) is known as a(n) _____ tariff.

- a. nonspecific
- b. ad valorem
- c. **compound**
- d. specific



THINK

Think

Limitations on the number of specific products that may be imported from certain countries during a given time

- A) quotas
- B) free trade
- C) specialization
- D) factor endowments

Dumping by a firm can be defined as:

- a. a firm selling a product at a price **below its cost** of production in a foreign market.
- b. a firm selling a product in a foreign market at a **price lower than** the price charged in its home market.
- c. the discharge of waste products into the environment.
- d. **both a and b**



THINK

Think

Which of the following is not a type of dumping?

- a. A sporadic dumping
- b. predatory dumping
- c. **complex dumping**
- d. persistent dumping

Which of the following does not cause lasting?

- a. **sporadic dumping**
- b. persistent dumping
- c. predatory dumping
- d. all of the above



THINK

Think

Like tariffs, quotas result in:

- a. additional government revenue.
- b. an increase in consumer surplus.
- c. a higher imported price.**
- d. more imports.

If Canada imposes a tariff on bananas and if none are grown in Canada, this tariff has

- A. only revenue effects**
- B. only protective effects
- C. both protective and revenue effects
- D. neither protective nor revenue effects.



THINK

Think

The purpose of a protective tariff is:

- A) to protect domestic consumers from harmful products.
- B) to protect domestic producers from foreign competition.**
- C) to protect the international laws of commerce.
- D) to protect the foreign country from anti-trust actions.



Chapter

10

Think

Which country has an absolute advantage in the production of corn?

a. Japan

b. Korea

Korea must specialize in the production of -----

a. Corn

b. Juice

Table: Production of one working day

	Japan	Korea
Corn	4	1
Juice	2	3



Think

True or False

Predatory dumping is a foreign firm pricing its product in such a manner to drive domestic firms out of business. True

A quota restricts the imports of a product to a certain quantitative level. True

VER is a direct quantitative restriction on the amount of a commodity allowed to be imported, imposed by importing countries False (Quota)



Summary outlines

- The relationship between international trade and the nation's standard of living
- Classical International Trade Theories
 - Mercantilism
 - Absolute Advantage (Adam Smith)
 - Comparative Advantage (David Ricardo)
- Trade Barriers
 - Tariffs
 - Non-Tariff Distortions to Trade





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Thank You

