III. INTERNATIONAL TRADE

A. Gains from Trade -- a history of thought approach

1. The idea of mercantilism (1500-1750) argued that a country’s well-being is directly tied to the accumulation of gold and silver. Therefore, a country should promote exports and restrict imports to generate a trade surplus.

   a. A trade surplus brings about a flow of payments back to the country.

   b. Mercantilism provided the economic motivation behind colonialism of the 17th and 18th centuries.

2. Adam Smith (1776) argued that a country’s well-being depends upon its income and what it can consume. He proposed a policy of free trade so each nation can gain from trade.

   a. Mutual gains from voluntary exchange of existing goods allows for people to choose their preferred combination of goods and thus achieve higher utility.

   b. Increased competition from foreign firms lowers market prices.

   c. The division of labor reduces costs since each worker can specialize in a certain area or task.

   d. Countries can gain by exporting goods in which they are skilled at producing and importing goods in which another country is skilled at producing. It was this idea that David Ricardo picked up and formalized.
3. David Ricardo (1817) developed the theory of comparative advantage that shows that each country can increase its consumption possibilities through voluntary trade.

a. An individual or country is said to have a comparative advantage if it can produce a good at a lower opportunity cost than the other.

b. An individual or country is said to have an absolute advantage if it can produce more of every good than the other.

c. If each country specializes in the production of the good in which they have a comparative advantage, then both countries benefit from increased consumption possibilities.
d. An example of comparative advantage and gains from trade:

<table>
<thead>
<tr>
<th>United States</th>
<th>France</th>
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<tbody>
<tr>
<td>Action Films</td>
<td>Action Films</td>
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<tr>
<td>Art Films</td>
<td>Art Films</td>
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<td>0</td>
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<td>40</td>
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Production Possibilities for United States

![Production Possibilities for United States graph]

Production Possibilities for France

![Production Possibilities for France graph]
Q: Why would the United States willingly trade action films for art films? Why would France willingly trade art films for action films?

Q: If France decides to consume 40 action films and the United States decides to consume 60 action films, then what is the flow of trade?
4. The Heckscher and Ohlin (1950s) model explains why a country has a comparative advantage in the production of a certain good.

a. Suppose that output is produced by two factors -- labor and capital.

b. Some countries are abundant in labor, while others are abundant in capital.

_\textit{Q: Which countries will have low returns on labor (wage rates) and high returns on capital and which will have high returns on labor (wage rates) and low returns on capital?}_

c. Those countries that are capital abundant will have a comparative advantage in the production of capital-intensive goods, while those countries that are labor abundant will have a comparative advantage in the production of labor-intensive goods.

d. An important implication of Heckscher and Ohlin model is that trade will equalize returns on labor and capital (factor prices) across countries.

_\textit{Q: Explain how this factor price equalization occurs?}_
B. Trade Policy

1. The types of trade restriction and their effects

   a. The market for imported cars

   

   The Import Car Market

   ![Graph of the Import Car Market]

   i. The import demand curve is the quantity of imports that domestic citizens are willing to buy at each price.

   ii. The export supply curve is the quantity of exports that foreign firms are willing to sell at each price.
b. A tariff is a tax imposed on an imported good.

The Import Car Market with a Tariff

Q: What is the price paid by U.S. consumers and the price received by foreign car manufacturers?

c. A quota sets a limit on the amount of a good that can be imported.

The Import Car Market with a Quota

Q: What is the price paid by U.S. consumers and the price received by foreign car manufacturers?
2. The debate on trade policy -- should globalization be helped or stopped?

Q: What exactly is globalization? How does globalization show up in the economic statistics around the world?

Q: What type of goods and services are being produced by the Developed nations? What type of goods and services are being produced by the Third World nations?

Q: Why are workers in the Third World paid such low wages, while the workers in the Developed nations paid such high wages?
Q: If the Developed nations insisted on higher wages and better working conditions in the Third World, would this benefit all workers in the Third World?

Q: Does globalization and foreign competition pose a threat to the independence and prosperity of the United States?

Q: Should the United States be concerned over its unilateral trade deficit with Mainland China?
C. Exchange Rates

1. The nominal exchange rate
   a. The value of the dollar
   b. It is measured as yen per U.S. dollar

2. The impact of the nominal exchange rate on foreign trade

   \[ Q: \text{What would happen to the market for imported cars if the value of the dollar increased?} \]
3. The balance of payments is the record of transactions of the residents of a country with the rest of the world.

   a. The current account records trade in currently-produced goods & services, along with transfer payments.

   b. The capital account records purchases & sales of assets, such as stocks, bonds and land.

   c. The sum of the current and capital accounts must equal zero.

   Q: Why must a current account deficit be matched by an equal capital account surplus?

4. Exchange rate determination

   a. In the long-run, the purchasing power parity (PPP) condition determines the nominal exchange rate.

      \[
      \text{nominal exchange rate} = \frac{P_{\text{Japan}}}{P_{\text{U.S.}}}
      \]

   b. In the short-run, the interest rate differential determines the nominal exchange rate.

      \[
      \text{nominal exchange rate} = f \left( r_{\text{U.S.}} - r_{\text{Japan}} \right)
      \]

5. Fixed versus flexible exchange rate system

   Q: What are the pros and cons of a fixed exchange rate system like the European Monetary Union?