III. INTERNATIONAL TRADE

A. Gains from Trade -- a history of thought

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.

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.

3. David Ricardo (1817) developed the theory of comparative advantage that shows that each country can gain 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. Comparative advantage and the gains from trade
   d. 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.
4. Heckscher and Ohlin (1950s) developed a model where the output of the two countries is produced by two factors -- labor and capital. They showed that 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.

An important implication of their model is that trade will equalize the factor prices across countries.

5. New trade theory (1980-1995) showed that international trade benefits both countries by reducing the unit cost of production.

B. Trade Policy

1. The economic effects of trade restrictions
   a. The market for imported cars
   b. A tariff is a tax imposed on an imported good. A tariff raises the price of both the imported good and the domestically-produced good.
   c. A quota sets a limit on the amount of a good that can be imported. A quota raises the price of both the imported good and the domestically-produced good.
   d. A voluntary restraint agreement (VRA) is where one country asks another country to voluntarily to restrict its firms exports. A voluntary restraint agreement has the same effect as a quota except that the revenue goes to the foreign firms.
2. The debate on trade policy -- should globalization be helped or stopped?

   a. What exactly is globalization? How does globalization show up in the economic statistics around the world?

   b. What type of goods are being produced by the Developed nations? What type of goods are being produced by the Third World nations?

   c. Why are workers in the Third World paid such low wages, while the workers in the Developed nations paid such high wages?

   d. 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?

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

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

1. The nominal exchange rate

2. The impact of exchange rates on foreign trade

3. Balance of payments is the record of transactions of the residents of a country with the rest of the world.
   a. Any transaction that involves a flow of funds out of the U.S. (payment by a U.S. citizen) is a debit or deficit item. Any transaction that involves a flow of funds into the U.S. is a credit or surplus item.
   b. The current account records trade in currently-produced goods & services, along with transfer payments.
   c. The capital account records purchases & sales of assets, such as stocks, bonds and land.
   d. The sum of the current and capital accounts must equal zero.

4. Exchange rate determination
   a. In the long-run, the purchasing power parity (PPP) condition determines the nominal exchange rate.
   b. In the short-run, the interest rate differential determines the nominal exchange rate.

5. Fixed versus flexible exchange rate system