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Application: International Trade

PRINCIPLES OF ECONOMICS FOURTH EDITION

N. GREGORY MANKIW

Premium PowerPoint® Slides
by Ron Cronovich

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Modified by Joseph Tao-yi Wang

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In this chapter, look for the answers to these questions:

- What determines how much of a good a country will import or export?
- Who benefits from trade? Who does trade harm? Do the gains outweigh the losses?
- If policymakers restrict imports, who benefits? Who is harmed? Do the gains from restricting imports outweigh the losses?
- What are some common arguments for restricting trade? Do they have merit?

CHAPTER 9 APPLICATION: INTERNATIONAL TRADE

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Introduction

- Recall from Chapter 3:
A country has a **comparative advantage** in a good if it produces the good at lower opportunity cost than other countries.
Countries can gain from trade if each exports the goods in which it has a comparative advantage.
- Now we apply the tools of welfare economics to see where these gains come from and who gets them.

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The World Price and Comparative Advantage

- P_W = the **world price** of a good, the price that prevails in world markets
- P_D = domestic price without trade
- If $P_D < P_W$,
 - country has comparative advantage in the good
 - under free trade, country exports the good
- If $P_D > P_W$,
 - country does not have comparative advantage
 - under free trade, country imports the good

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The Small Economy Assumption

- A small economy is a **price taker** in world markets: Its actions have no effect on P_W .
- Not always true – especially for the U.S. – but simplifies the analysis without changing its lessons.
- When a small economy engages in free trade, P_W is the only relevant price:
 - No seller would accept less than P_W , since she could sell the good for P_W in world markets.
 - No buyer would pay more than P_W , since he could buy the good for P_W in world markets.

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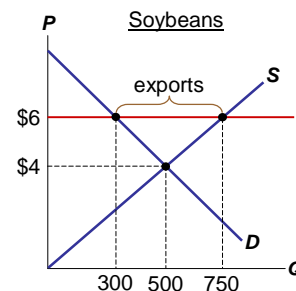
A Country That Exports Soybeans

Without trade,

$P_D = \$4$
 $Q = 500$

$P_W = \$6$
Under free trade,

- domestic consumers demand 300
- domestic producers supply 750
- exports = 450



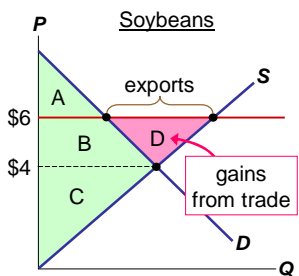
CHAPTER 9 APPLICATION: INTERNATIONAL TRADE

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A Country That Exports Soybeans

Without trade,
 CS = A + B
 PS = C
 Total surplus
 = A + B + C

With trade,
 CS = A
 PS = B + C + D
 Total surplus
 = A + B + C + D



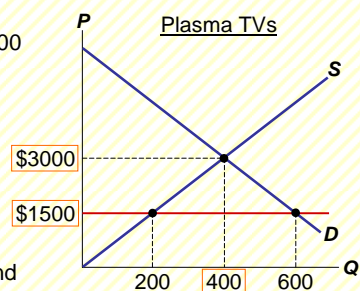
ACTIVE LEARNING 1: Analysis of trade

Without trade,
 $P_D = \$3000$, $Q = 400$

In world markets,
 $P_W = \$1500$

Under free trade,
 how many TVs
 will the country
 import or export?

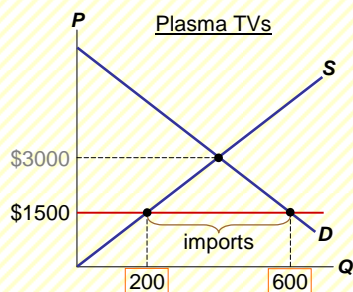
Identify CS, PS, and
 total surplus without
 trade, and with trade.



ACTIVE LEARNING 1: Answers

Under free trade,

- domestic consumers demand 600
- domestic producers supply 200
- imports = 400

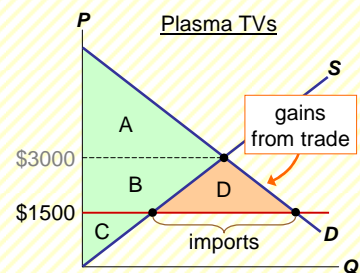


ACTIVE LEARNING 1: Answers

Without trade,

CS = A
 PS = B + C
 Total surplus
 = A + B + C

With trade,
 CS = A + B + D
 PS = C
 Total surplus
 = A + B + C + D



Summary: The Welfare Effects of Trade

	$P_D < P_W$	$P_D > P_W$
direction of trade	exports	imports
consumer surplus	falls	rises
producer surplus	rises	falls
total surplus	rises	rises

*Whether a good is imported or exported,
 trade creates winners and losers.
 But the gains exceed the losses.*

Other Benefits of International Trade

- Consumers enjoy increased variety of goods.
- Producers sell to a larger market, may achieve lower costs by producing on a larger scale.
- Competition from abroad may reduce market power of domestic firms, which would increase total welfare.
- Trade enhances the flow of ideas, facilitates the spread of technology around the world.

In the News: Textile Imports from China

On 12/31/2004, U.S. quotas on apparel & textile products expired.

During Jan 2005: The U.S. textile industry & labor unions fought for new trade restrictions. The National Retail Federation opposed any restrictions.



November 2005: Bush administration agreed to limit growth in imports from China.

Arguments for Restricting Trade

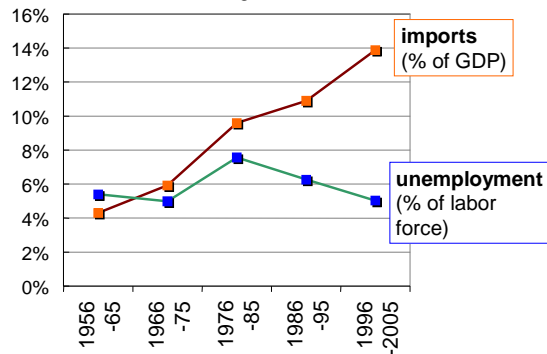
1. The jobs argument

Trade destroys jobs in industries that compete with imports.

Economists' response:

Look at the data to see whether rising imports cause rising unemployment...

U.S. imports & unemployment, decade averages, 1956-2005



Arguments for Restricting Trade

1. The jobs argument

Trade destroys jobs in the industries that compete against imports.

Economists' response:

Total unemployment does not rise as imports rise, because job losses from imports are offset by job gains in export industries.

Even if *all* goods could be produced more cheaply abroad, the country need only have a *comparative* advantage to have a viable export industry and to gain from trade.

Arguments for Restricting Trade

2. The national security argument

An industry vital to national security should be protected from foreign competition, to prevent dependence on imports that could be disrupted during wartime.

Economists' response:

Fine, as long as we base policy on true security needs.

But producers may exaggerate their own importance to national security to obtain protection from foreign competition.

Arguments for Restricting Trade

3. The infant-industry argument

A new industry argues for temporary protection until it is mature and can compete with foreign firms.

Economists' response:

Difficult for gov't to determine which industries will eventually be able to compete, and whether benefits of establishing these industries exceed cost to consumers of restricting imports.

Besides, if a firm will be profitable in the long run, it should be willing to incur temporary losses.

Arguments for Restricting Trade

4. The unfair-competition argument

Producers argue their competitors in another country have an unfair advantage, e.g. due to govt subsidies.

Economists' response:

Great! Then we can import extra-cheap products subsidized by the other country's taxpayers. The gains to our consumers will exceed the losses to our producers.

Arguments for Restricting Trade

5. The protection-as-bargaining-chip argument

Example: The U.S. can threaten to limit imports of French wine unless France lifts their quotas on American beef.

Economists' response:

Suppose France refuses. Then the U.S. must choose between two bad options:

- A) Restrict imports from France, which reduces welfare in the U.S.
- B) Don't restrict imports, and suffer a loss of credibility.

Trade Agreements

- A country can liberalize trade with
 - unilateral reductions in trade restrictions
 - multilateral agreements with other nations
- Examples of trade agreements:
 - North American Free Trade Agreement (NAFTA), 1993
 - General Agreement on Tariffs and Trade (GATT), ongoing
- World Trade Organization (WTO) est. 1995, enforces trade agreements, resolves disputes

CHAPTER SUMMARY

- A country will export a good if the world price of the good is higher than the domestic price without trade. Trade raises producer surplus, reduces consumer surplus, and raises total surplus.
- A country will import a good if the world price is lower than the domestic price without trade. Trade lowers producer surplus, but raises consumer and total surplus.
- A tariff benefits producers and generates revenue for the govt, but the losses to consumers exceed these gains.

CHAPTER SUMMARY

- Common arguments for restricting trade include: protecting jobs, defending national security, helping infant industries, preventing unfair competition, and responding to foreign trade restrictions.

Some of these arguments have merit in some cases, but economists believe free trade is usually the better policy.

Application: International Trade

- Imports benefit consumers
- Exports benefit producers
- Trade benefit the entire economy

- Read Mankiw, ch. 25, p.567, "In the News"
- Homework:Mankiw, ch. 9, pp. 197-199, Problem 5, 10, 12