Lecture 6 outline

International Trade

- Comparative advantage and trade.
- Sources of comparative advantage.
- Winners and losers from trade.
- Tariffs, import quotas and inefficiency.
- Trade protection and international trade agreements.

The Importance of International Trade

U.S. Imports and Exports as a Percentage of GDP, 1959-2007

Comparative Advantage and Gains from Trade: Tom and Hank
Comparative and Absolute Advantage

- **Absolute advantage**: if he or she can do it better than other people. You can produce more than someone else.

- **Comparative advantage**: the opportunity cost of producing the good is lower for that individual than for other people. You can produce something at less cost relative to another person.

- Tom has an absolute advantage in the production of both fish and coconuts.
- Hank has a comparative advantage in the production of coconuts.

Comparative advantage identifies the area where a producer’s absolute advantage is relatively greatest, or where the producer’s absolute disadvantage in productivity is relatively least.

Even though Tom is better at everything than Hank, there are nevertheless gains from trade.

Specialization and Trade

Comparative Advantage and the Production Possibility Frontier

Outcomes with Trade
The Gains from International Trade

Remember, there will be gains from trade even if one country has an absolute advantage in both activities.

Sources of Comparative Advantage

- Differences in climate
  - There's a reason why Columbia is a good place to purchase roses for Valentine's Day.
- Differences in factor endowments
  - A country will have comparative advantage in a good whose production is intensive in abundantly available factors
    - Clothing in China: US: products that use high-skilled workers.
- Differences in technology
  - Japan and automotive innovation and manufacturing.

Do the Simple Examples Apply to the "Real World"?

- Trade lets each country take advantage of a lower opportunity cost of production in the other country.
- The examples just show that both countries can be better off with specialization.
  - But it does not say who will receive what share of the total benefit.
  - The examples show two countries and two goods: the world has more than 200 countries and tens of thousands of goods.
  - This is a model. Differences in opportunity costs can allow trade to benefit all participants.
- In the real world, particularly for a country as large as the U.S., it will be inexpensive to produce many different goods.
  - With trade, countries should give up only the more costly ways of producing certain products.
  - Specialization need not be extreme.

If the Logic of Trade is So Compelling, Why is there Intra-industry Trade?

- Much intra-industry trade "splits the value chain," meaning it takes particular features of the process to create the good, and allows these pieces to be produced in different places.
  - With technological improvements in communication and transportation, the manufacturing process can be broken up.
- The second consideration has to do with scale economies and variety.
  - Consumers may like different varieties of products, and the efficient scale of production may ensure that many producers are needed to satisfy market demand.
Consumer and Producer Surplus in Autarky

The Domestic Market with Imports

Consumer and Producer Surplus with Imports

The Domestic Market with Exports
An economy has **free trade** when the government does not attempt to reduce or increase exports or imports that result from supply and demand.

Policies that limit imports are known as **trade protection or protectionism**.

The two most common protectionist policies are tariffs and import quotas.

In some (rare) cases, governments will subsidize export industries.

What is a tariff?

- A tariff is a tax imposed on imported products, making them more expensive to consumers.
- Import quotas are numerical limitations on the quantity of products that can be imported.
- Nontariff barriers are rules, regulations, inspections, and paperwork that make it more costly or difficult to import products.
- In a 1911 (satirical) book, Ambrose Bierce defined tariff as "Tariff, noun, A scale of taxes on imports, designed to protect the domestic producer against the greed of his consumer."

The Domestic Market with Tariffs

- CS falls by A+B+C+D.
- PS rises by A.
- The government collects tariff revenue of C.
- Total surplus, therefore, falls by B+D.
The Effects of an Import Quota (rather than tariff)

- An import quota is a legal quantity limit on imports (a country, for example, is allowed to import no more than a specific amount).
- Its effect is that of a tariff, except that revenues – the “quota rents” – accrue to the license-holder (the person or importer) granted the quota, not to the domestic government that is able to set the tariff.

The Political Economy of Trade Protection

- Tariffs increase producer surplus of domestic producers.
- The benefits are concentrated, the costs are diffuse.
  - Sometimes see additional arguments made based on a) national security, b) job creation, or c) an “infant industry” argument.
- Trade liberalization is done through international trade agreements.
  - NAFTA, the GATT (and the WTO), and the European Union are examples.

Declining Tariff Rates

What Arguments Do You Hear Against Free Trade?

- Imports are killing the domestic industry: we need to save jobs.
- Protection surely saves jobs in the protected industry.
  - But if consumers are paying more for product from the protected industry, they have less money to spend for goods in other industries, costing jobs elsewhere.
  - The costs of saving jobs can be very, very high. Estimates range from $360,000 to $933,000 per job saved. Why? Higher profit, salaries for managers and existing workers, advertising, etc.
Arguments Against Free Trade, slide 2

- Trade depresses wages – how can we possibly compete with country X where wages are a tiny fraction of American wages.
- Workers in industries with stiff import competition will be harmed. But…
  - 1) Inter-industry trade with other rich countries makes up more than half of U.S. trade.
  - 2) Many low-skill service jobs are not subject to international competition.
  - 3) Low-income individuals benefit from lower-price goods and services that trade can create.
- A central issue is the productivity of American workers compared to workers in other countries.

Arguments Against Free Trade, slide 3

- Trade partners, particularly in the developing world, have abysmal labor standards.
- I’d raise two considerations, though I recognize there are complications.
  - Exceptionally low wages in the exporting industry (by U.S. standards) may be high from the perspective of workers in the developing country.
  - U.S. worker protections are, in some dimensions, much less stringent than European standards. Should Europe cease trading with the U.S.?
- The “Globalization’s Reality: The Wheel That Turns” reading is a thoughtful reflection (in my view) on these issues.

Arguments Against Free Trade, slide 4

- New industries need protection
  - It always imposes costs on domestic consumers.
  - Why is protection better than direct government payments, loans, targeted tax breaks, government R&D subsidies? Alternatives policies might work better.
  - If it’s done
    - Focus on a few key industries where the country has a chance of being a world-class producer.
    - Don’t protect an industry that many other domestic industries depend on, since that will raise the costs of many other sectors.
    - Have well-defined plans to end the protection at some point.

Arguments Against Free Trade, slide 5

- Other countries are “dumping” – selling internationally traded goods below their cost of production.
- Low prices are good for domestic consumers!
- The fear is that domestic industries will be harmed, and then the foreign supplier will raise prices. There are no examples where the latter has happened.
Arguments Against Free Trade, slide 6

- Trade is causing us to destroy the environment.
  - The "race to the bottom" – multinationals shift production to countries with weak environmental standards to reduce costs and increase profits. Other countries need to loosen their standards.
    - Environmental standards in both high- and low-income countries have been improving, despite the increase in trade.
    - Greater prosperity in developing countries should lead to improvements in environmental standards.
- National interest in specific products.
  - Almost always bogus – mohair is protected for national security reasons...

Summing up

- Economists generally believe that it is better to embrace the gains from trade and then deal with the costs and tradeoffs with other policy tools, rather than cutting off trade to avoid the costs and tradeoffs, but also losing the benefits of free trade.
  - It is particularly important to provide retraining (and assistance) to workers displaced by trade.