presentation 23
international flow of goods & trade

Trade

Trade is an exchange of goods

Reason: economies trade because there are gains and it is a source for growth for a number of economies when net exports are positive (i.e. E > H) shift the AD.

Goods traded: typically, economies trade in those industries where there is excess productive capacity .... but not only.

There are four main explanations as to what goods/services can be traded:

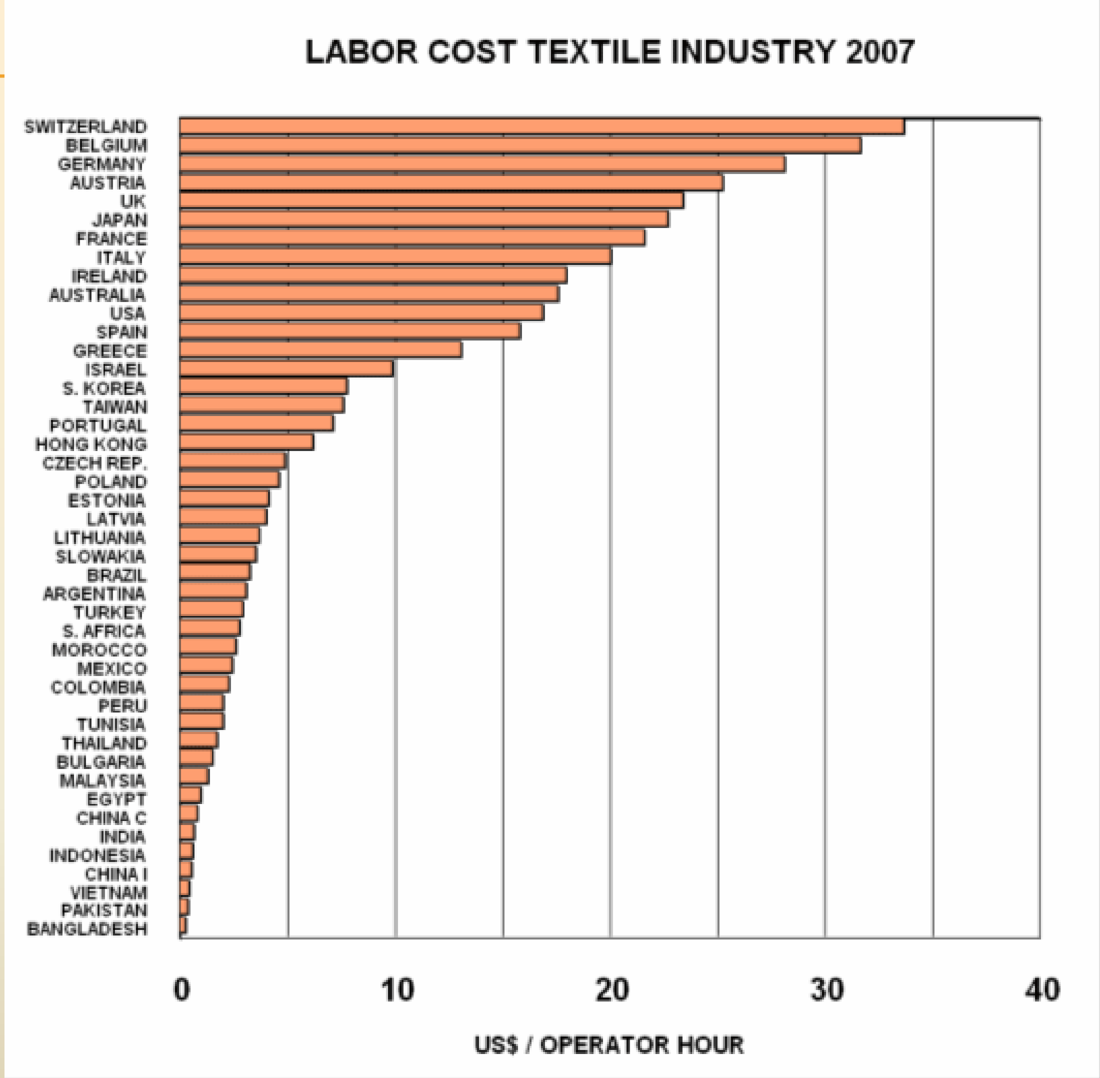
One

<u>Absolute advantage</u>

Adam Smith

It costs fewer resources to produce commodities in the domestic economy rather than abroad

This is a typical situation when labor costs are low



Two

Comparative advantage

David Ricardo

When the opportunity cost of producing a unit of commodities in terms of other commodities forgone is lower in the domestic economy than it is abroad.

Three

Endowments

Hecksher-Ohlin

An economy with abundant endowments (i.e. stocks of skilled and unskilled labor, capital, land and other resources of the economy) will tend to export these and with the lowest will import them.

Thus a capital-abundant country will export the capital-intensive good (e.g. cars, oil, wood) whereas a labour-abundant country will export the labour-intensive good (e.g. tourism, services).

However, the Leontief paradox based on empirical studies in the 1950s shows that the Heckscher–Ohlin model does not always apply:

A capital-abundant economy can export labor-intensive commodities and imported capital-intensive commodities

But if one makes the distinction between skilled and unskilled labor, the Heckscher–Ohlin model tends to hold: an economy (e.g. CH) tends to export skilled-labor-intensive goods (e.g. watches), and tends to import unskilled-labor-intensive goods (e.g. toys).

Four

Competitive advantage

Michael Porter

Economies trade on those industries and firms which are internationally competitive, regardless of being capital or labour-intensive (e.g. Swiss-made label).

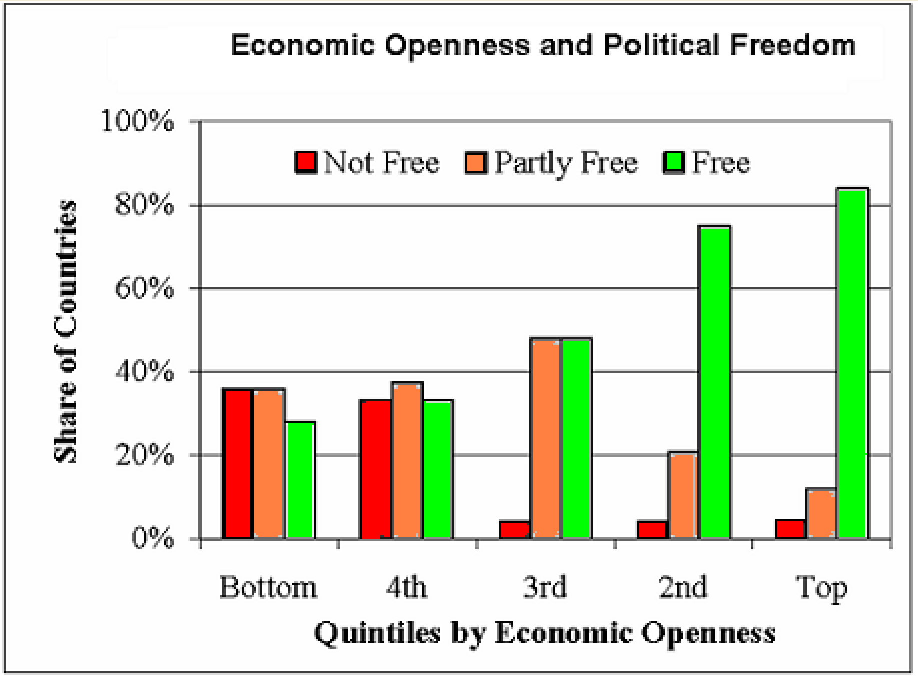
Trade barriers

Trade barriers are aimed to reduce the mobility of goods and services; it is a question of economic openness and freedom

Reasons include:

- Protecting domestic employment
- Protecting domestic industries from foreign competion based on low wages
- Protecting infant/sunrise industries
- Protection againt wage and price dumping
- Limiting overspecialization in the export industries = that the economy exports only a handful of products

- Protecting product standards (e.g. Switzerland has banned imports when they do not comply with expected standards)
- Raising state revenue
- Correcting a BOP imbalance by reducing import expenditure thus reversing a CA deficit – effective in the short run



Protectionist measures affecting goods that are produced by various economies and which are likely to be traded:

- Tariffs = a tax on imports => render imported goods more expensive
- Subsidy = a benefit on exports => render exports less expensive
- Quotas = a restriction on the quantity imported

As well as:

- Import prohibitions = total restriction of particular goods

Tariffs

To better capture the effect of tariffs (import duties), we consider the Swiss market for garlic and the presence of Chinese garlic in these markets – a WTO effect – as it is cheaper.

We compare the situation with and without tariffs:

a/Without:

Chinese garlic being cheaper, is likely to be preferred by Swiss consumers, thus domestic production suffers.

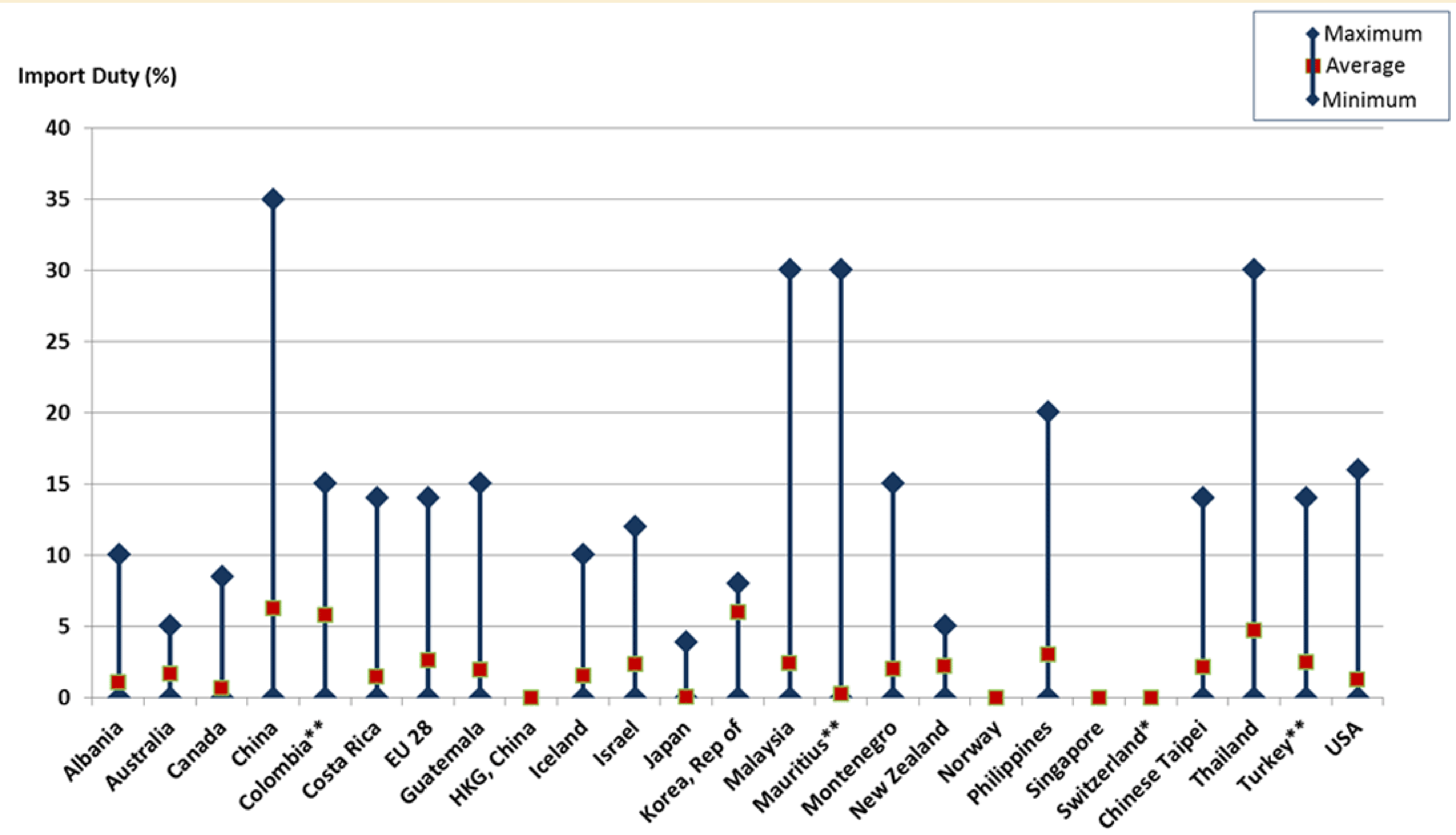
b/With:

Imported garlic being more expensive, the domestic produce is attractive.

However, welfarists will argue that the tariff beings about a distortion in the market since the protectionist measure does not allow consumers to purchase a garlic at a competitive price; CS is lower compared to a situation without tariff. The state gains from this situation as the tariff is a source of revenue.

Ultimately it is not only a question of price but also of quality

Tariffs compared



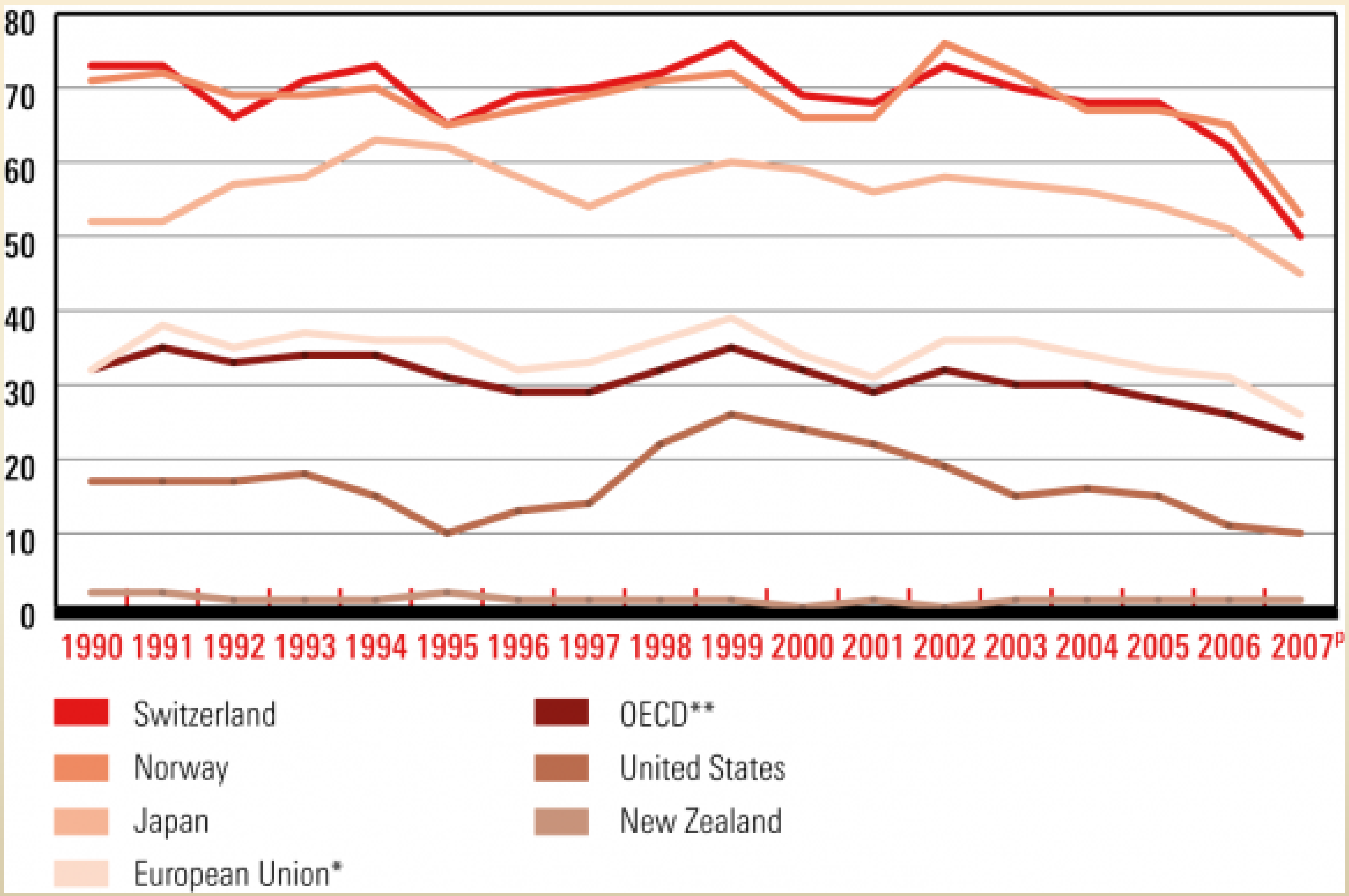
Subsidies

Subsidies affect the price in the same manner as tariffs do.

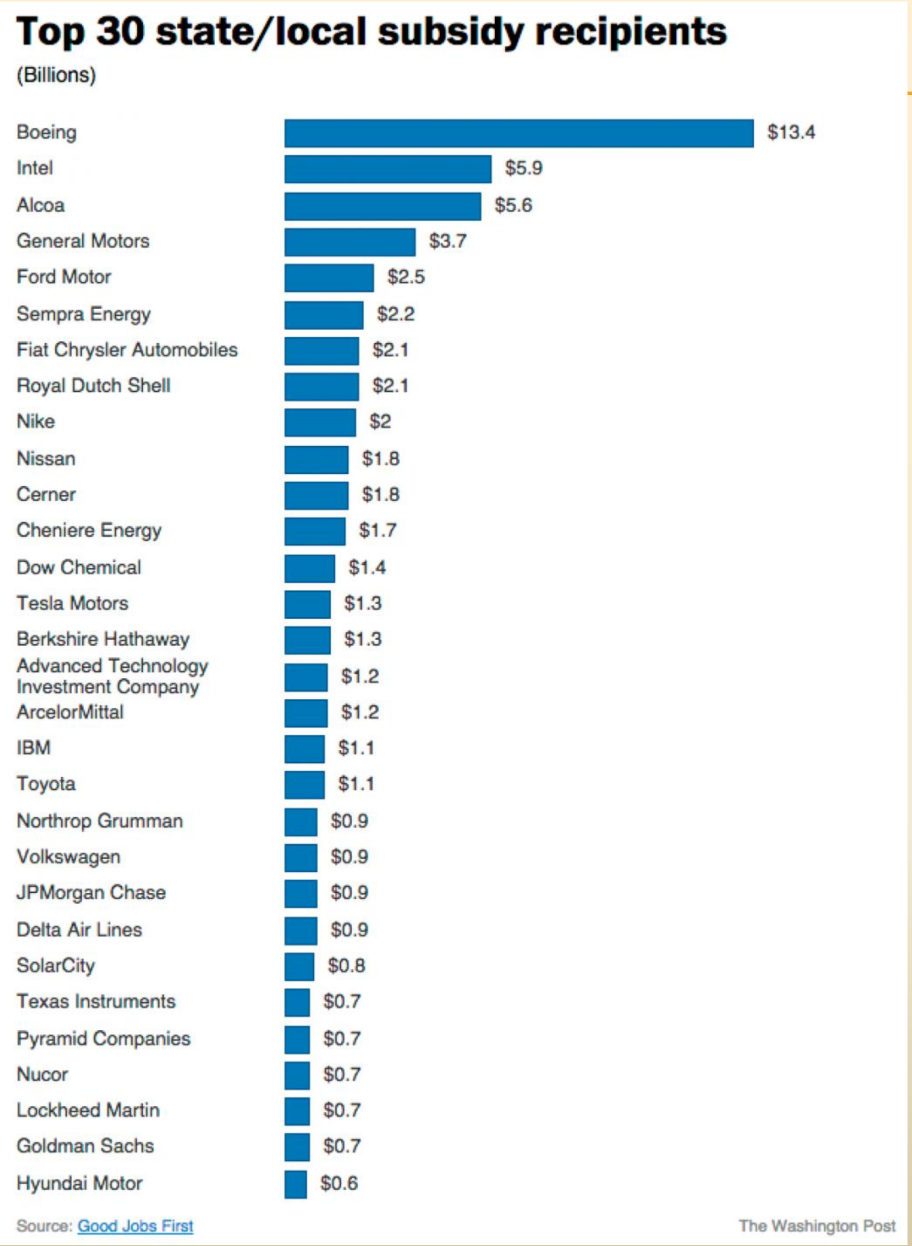
Rather than affecting imports as tariffs do, they concern exports in that the price of exported goods is lower compared to a situation without a protectionist measure. The subsidised goods are thus imported cheaper compared to the domestic products.

Unlike tariffs that constitute state revenue, subsidies are state expenditure thus politically controversial

Subsidies compared.



Subsidies compared.



Quotas

Quotas directly affect the quantity to be imported; thus only a limited number of goods can be supplied in a market, a situation of scarcity driving prices up. But does it?

Considering that prices are set by firms and not by markets – this is true even in price-taking industries – we could have a situation of a low quantity supplied with a low price.

Example: quotas on imports of Japanese cars in the 1980’s & 90’s to allow the tech development of EU car manufacturers – response of Japanese car manufacturers: implementation in the UK!

Overall, the effects of barriers include:

- Reduce free trade
- Raise prices to consumers
- Reduce consumer choice
- Reduce international competition
- Distort comparative advantages
- They bring about or worsen trade deficits
- Welfarists consider them Pareto inefficient (welfare losses)
- Could hinder economic growth and development

Considering the negative effects (and reputation of barriers) what effect has trade liberalization brought about?

Before answering: to what extent has there been trade liberalisation?

For the period 1990 1998 (WTO era), there is an average fall in tariffs by 3% thus an increase in the volume of trade (shown by the second figure) and we could conclude that trade liberalization has increased – this is also visible in consumer choices. The effect, however is not entirely clear: GDP has not increased dramatically as a result.

Figure 11: Tariff liberalisation since 1947: RTAs, MTNs and unilateralism.