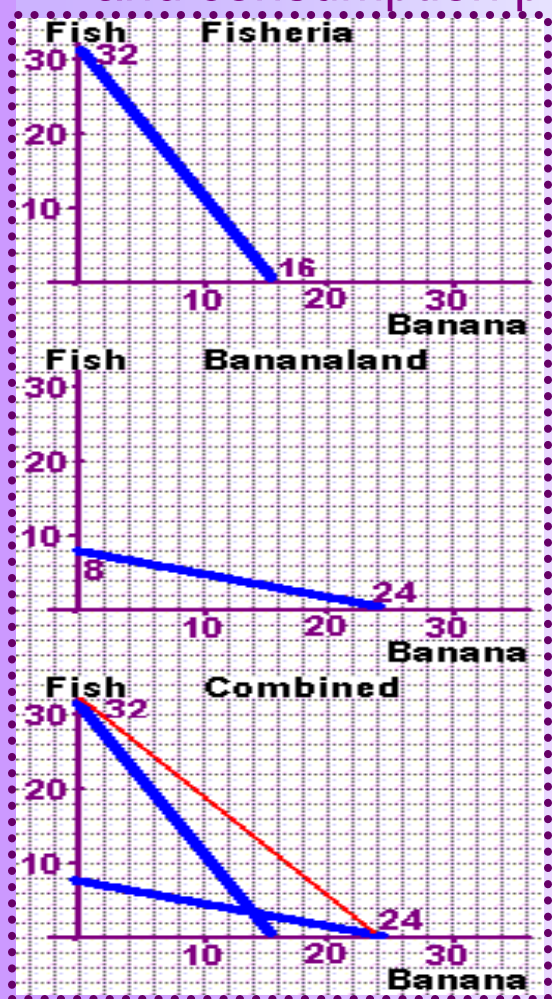


# Comparative Advantage

- Each country will benefit if it **specializes** in the production and exports of those goods that it can produce at relatively low cost
- Under free trade countries shift production towards their areas of **comparative advantage**
- **Gains from trade:** each country can obtain a larger quantity of goods for the same amount of work. Specialization, division of labor, and trade increase productivity and consumption possibilities



➤ A country can benefit from trade even **if it is absolutely more efficient** than other countries in the production of every good

➤ Free trade allows the world to move to the higher PPF

➤ **Bilateral** vs. **Multilateral** trade

➤ **Two qualifications:**

- ✓ perfect competitive markets
- ✓ income distribution

*Two Islands: Bananaland & Fisheria*  
Work - 8 hours/day

Rate (per hour)	Fisheria	Cocoland
- Fish	4	1
- Bananas	2	3

Fisheria		Bananaland	
Fish	Bananas	Fish	Bananas
32	0	8	0
24	4	6	6
16	8	4	12
8	12	2	18
0	16	0	24

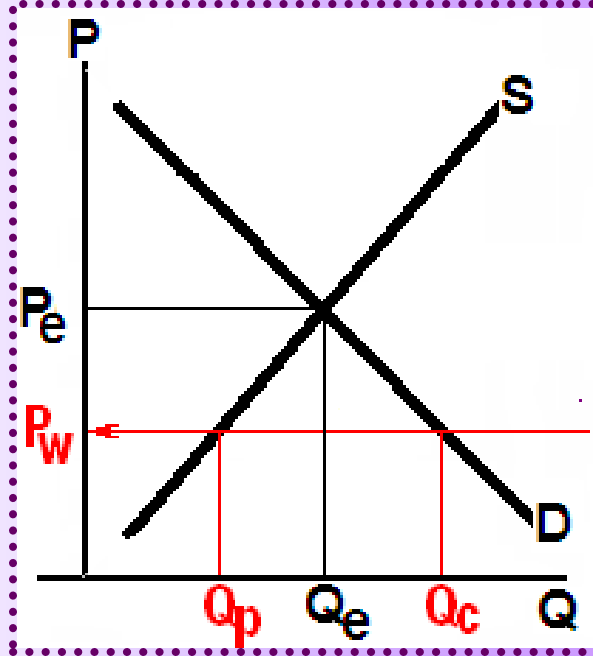
**Main Concepts:** Trade (**gains from trade**), Autarky Production, Comparative Advantage, Specialization, Terms of Trade (**4F/3C** - **Exchange Rate**), Price

# Free Trade: S&D Analysis

2

## ➤ No Trade vs. Free Trade:

- ✓  $P_e$  – no-trade equilibrium with higher P & domestic production, lower consumption
- ✓  $P_w$  – free-trade equilibrium with lower P & domestic production, and higher consumption

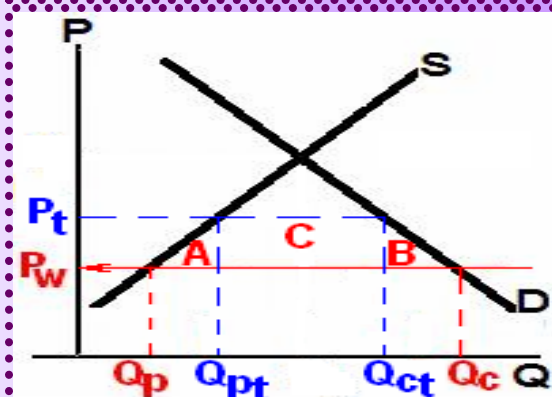
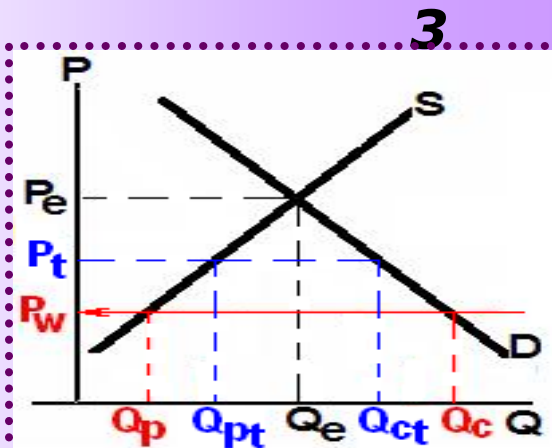


➤ Without foreign trade market supply and demand are balanced at a domestic market equilibrium price  $P_e$  and quantity  $Q_e$ . Cheaper foreign goods enter the market at a lower price  $P_w$  so local producers are willing to supply less ( $Q_p$ ), but local consumers can afford to buy more ( $Q_c$ ) due to the lower price, and the difference ( $Q_c - Q_p$ ) is imported from the outside.

- Economies that engage in international trade are called **open economies** as opposed to **closed economies** with no international trade.
- **Openness to trade** is usually measured by *the sum of exports and imports as a fraction of GDP* and more open countries are expected to develop faster
- Under free trade in markets generally goods flow from low-price regions to high-price regions
- Completely free trade equalizes prices of tradeable goods at home with those in the world markets
- **The law of one price**: identical goods must sell at the same price in all markets across the globe unless there are restrictions to trade

# Trade Barriers

- **Tariff** is a tax levied on imports. A tariff raises the domestic prices of imported goods: domestic consumption & imports decrease, domestic production increase:
  - ✓ **Prohibitive** tariff is high enough to prevent all trade
  - ✓ **Non-Prohibitive** tariff is a lower tariff restricting trade
- A tariff causes economic waste (decreased domestic consumption & waste of resources on goods lacking comparative advantage). The losses generally exceed government revenues from the tariff.
- **Quota** (*prohibitive* or *non-prohibitive*) is a limit on the quantity of imports. **Tariff vs. Quota:**
  - ✓ Same qualitative effect;
  - ✓ Difference in distribution of benefits: a tariff gives revenue to the government, a quota leaves profits to traders
- **Non-Tariff Barriers** consist of informal restrictions or regulations (*import licensing, sanitary standards, labeling requirements, etc.*) that inhibit trade.



**Protectionism:** a policy to protect domestic industries against competition from imports. Arguments for protection:

- **Invalid** arguments:
  - ✓ Mercantilistic argument
  - ✓ Tariffs for special-interest groups
  - ✓ Cheap foreign labor
  - ✓ Retaliatory tariffs
  - ✓ Import relief

- **Valid** arguments:
  - ✓ Optimal-tariff (terms-of-trade) argument
  - ✓ Tariffs for "infant" industries
  - ✓ Reduction of unemployment

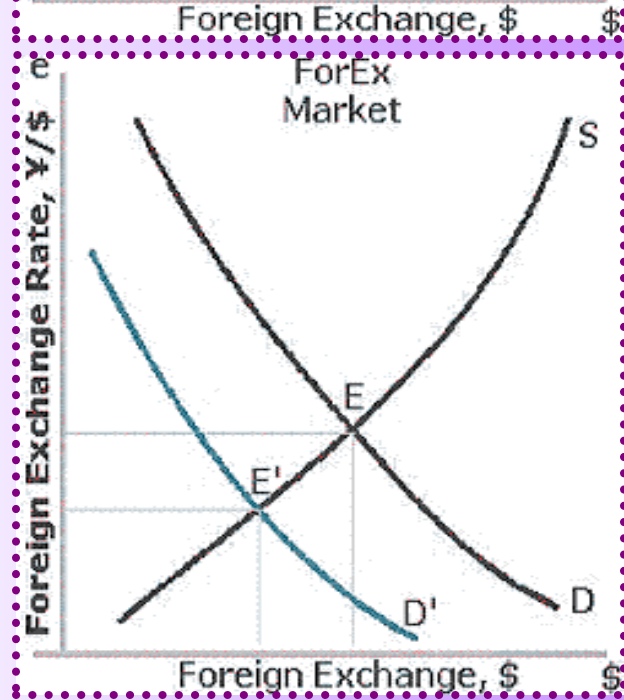
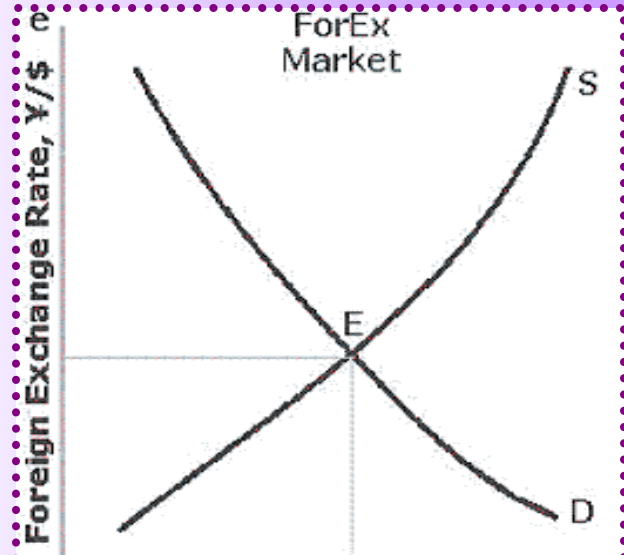
- **3 effects** of a tariff:
  - ✓ **A** – the net loss due to inefficiency of more costly domestic production
  - ✓ **B** – the tariff revenue gained by the government
  - ✓ **C** – the net loss in consumer surplus from inefficiently high price



# Foreign Exchange Rates. Exchange Rate Changes

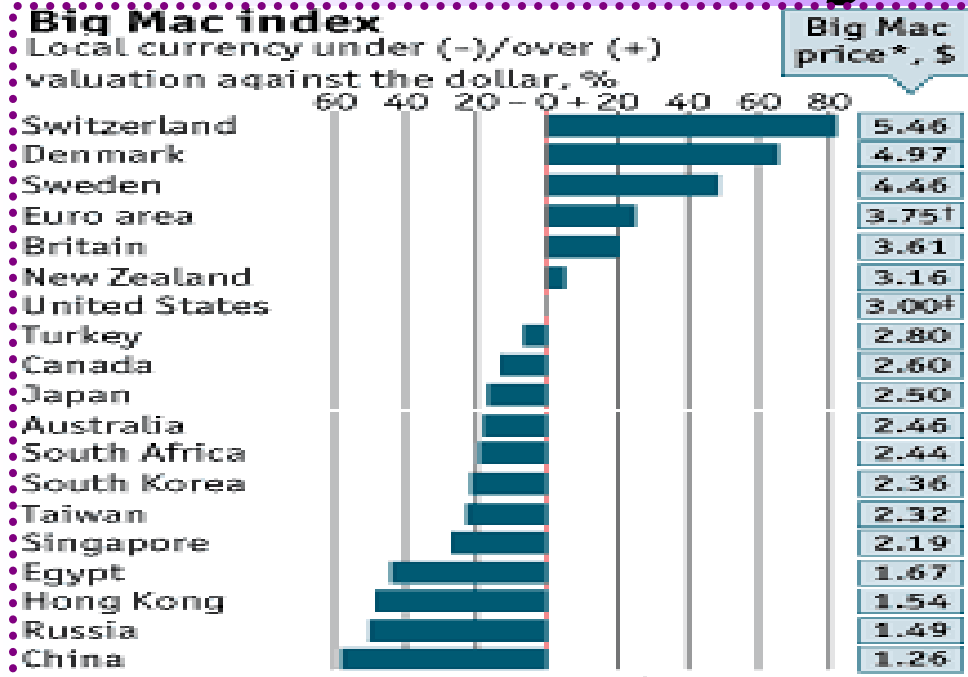
4

- The **foreign exchange rate** ( $e$ ) is the price of one currency in terms of another currency.
- **Exchange rates** are measured as the amount of foreign currency that can be bought with 1 unit of the domestic currency:  $\$/AED$ ,  $\pounds/AED$ ,  $\yen/AED$ .
- **Foreign exchange market** is the market in which different currencies are traded & foreign exchange rates are determined:
  - ✓ Americans supply \$\$ when they buy Japanese goods, services & assets
  - ✓ Japanese demand \$\$ when they buy American goods, services & assets
- **Depreciation**: a fall in the price of one currency in terms of one or all other currencies. **Appreciation**: a rise in the price of one currency in terms of one or all other currencies.
- **Devaluation**: pegged rate or parity is changed by lowering the price of the currency. **Revaluation**: raise in official price.
- **Example** - effects of changes in trade:
  - ✓ Recession or protectionism in Japan  $\rightarrow$  decrease in demand for \$\$  $\rightarrow$  \$ depreciates,  $\yen$  appreciates  $\rightarrow$  Japanese goods become more expensive  $\rightarrow$  \$ supply decreases



# Purchasing Power Parity. Balance of Payments

- Exchange rates are determined by the relative prices of goods in different countries (*in the long run*):
  - ✓ a nation's exchange rate will tend to equalize the cost of buying traded goods at home with the cost of buying those goods abroad (law of one price – identical goods must sell at the same price in all markets)
- **PPP**: exchange rate that equates the price of a basket of identical traded goods and services in two countries
- Countries with high inflation rates will tend to have depreciating currencies
- **The Balance of Payments** is the set of accounts that measures all the economic transactions between a nation and the rest of the world:
  - The major **components** of the Balance of Payments are:
    - ✓ **Current Account** – merchandise trade, services, investment income, transfers.
    - ✓ **Capital Account** – private, government, & official-reserve changes.
  - If a transaction earns foreign currency for the nation, it is called a **credit** and is recorded as a **positive item**. If a transaction involves spending foreign currency, it is called a **debit** and is recorded as a **negative item**.
  - The balance of payments as a whole must by definition show a **final zero balance**:
    - ✓ Current Account + Capital Account = 0



Source: The Economist using McDonald's price data  
<http://www.economist.com/markets/Bigmac/>

- ✓ comparative & absolute advantage, Ricardo's example
- ✓ open vs. closed economy
- ✓ free trade, benefits & economic gains, conditions for gains
- ✓ protectionism, trade barriers: tariffs, quotas, non-trade barriers
- ✓ the economic costs of protectionism
- ✓ valid & invalid arguments for protection
- ✓ balance of payments: current account, capital account
- ✓ foreign exchange rate, foreign exchange market
- ✓ purchasing power parity

## ***Course Web Support:***

- <http://www.skylinecollege.info/mosesov/macro/>
- [www.mhhe.com/economics/samuels17/students/Ch15.mhtml](http://www.mhhe.com/economics/samuels17/students/Ch15.mhtml)