

Syllabus Items: 78-81

See Webnote 507 for reading schedule

Items: HL only: 80

# 3.1 Big Ideas

# Why do countries trade?

## The 4 big reasons....

1. Growth: macro growth through higher gdp
2. Growth: firm increase in size and profitability
3. Cost reduction (economies of scale)
4. Specialisation

See  
Webnote  
211

# 3.1 Big Ideas

- Macroeconomic objectives of government (webnote 211)

## *What Objectives for Gov.?*

Economic objectives:

- 1) Economic growth
- 2) Employment
- 3) Inflation- stable prices
- 4) Balance of trade +BoP
- 5) Economic development/  
Rising standard of living/  
Redistribution of wealth

### **Others:**

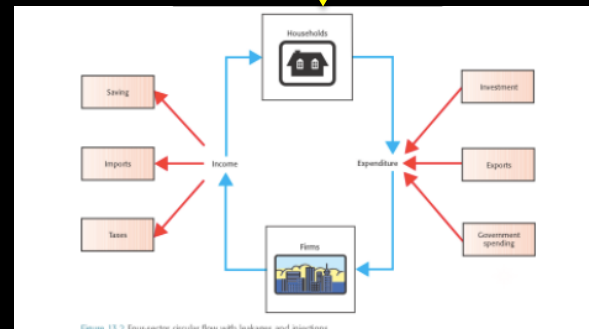
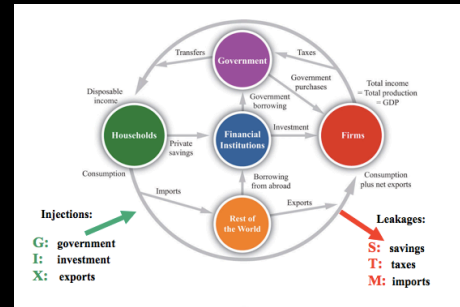
- Regional development
- Balanced budgeting
- Stable currency

Growth as a result of trade  
e.g. more exports  
means... more growth.... which means more jobs

# 3.1 Big Ideas

- **Key Diagrams**

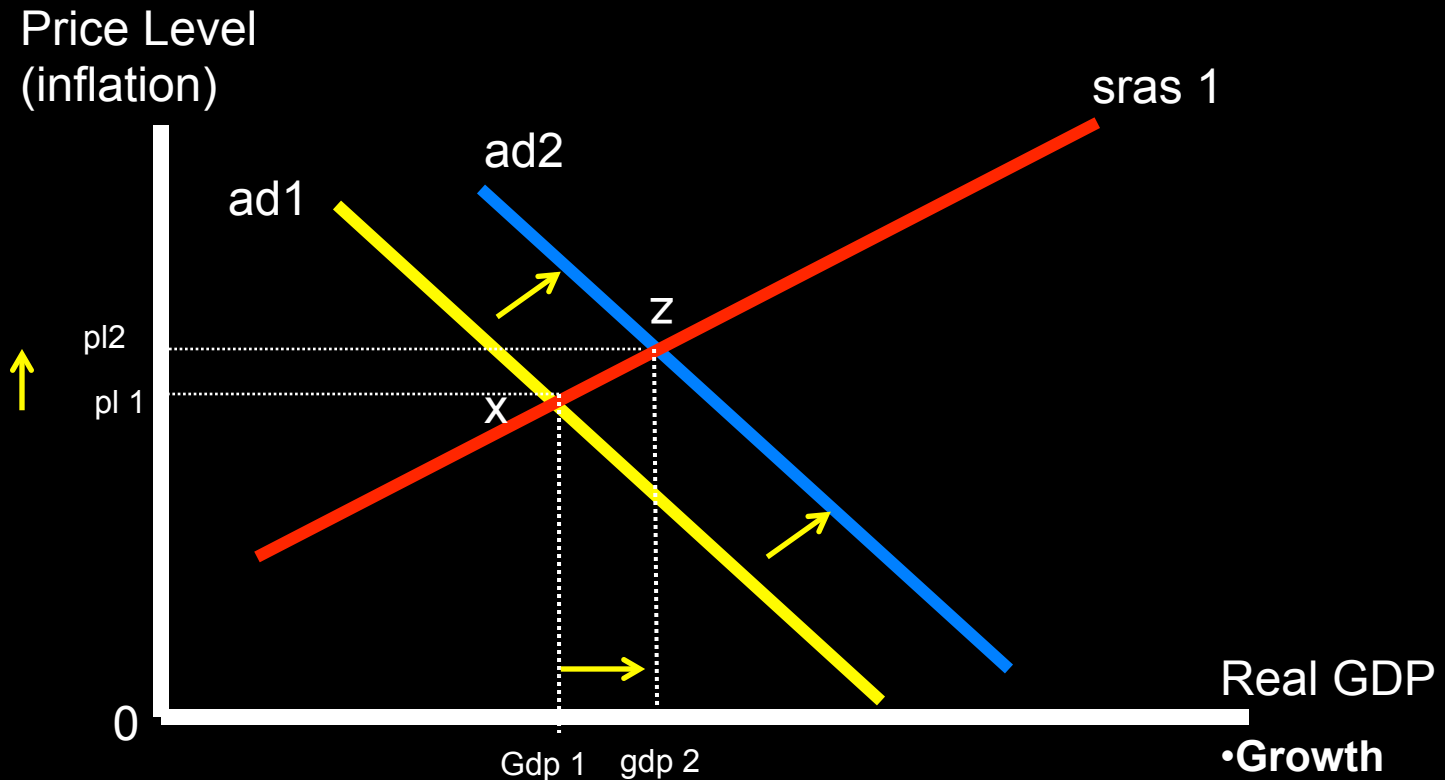
1. Circular flow of income
2. As/Ad
3. Supply and demand to show free trade+protectionism (see slide 5)
4. PPF (for comparative and absolute advantage)



# Diagram A: Aggregate Demand + Aggregate Supply Management

e.g. shows growth from eXports based on:

$$AD = C + I + G + X - M$$

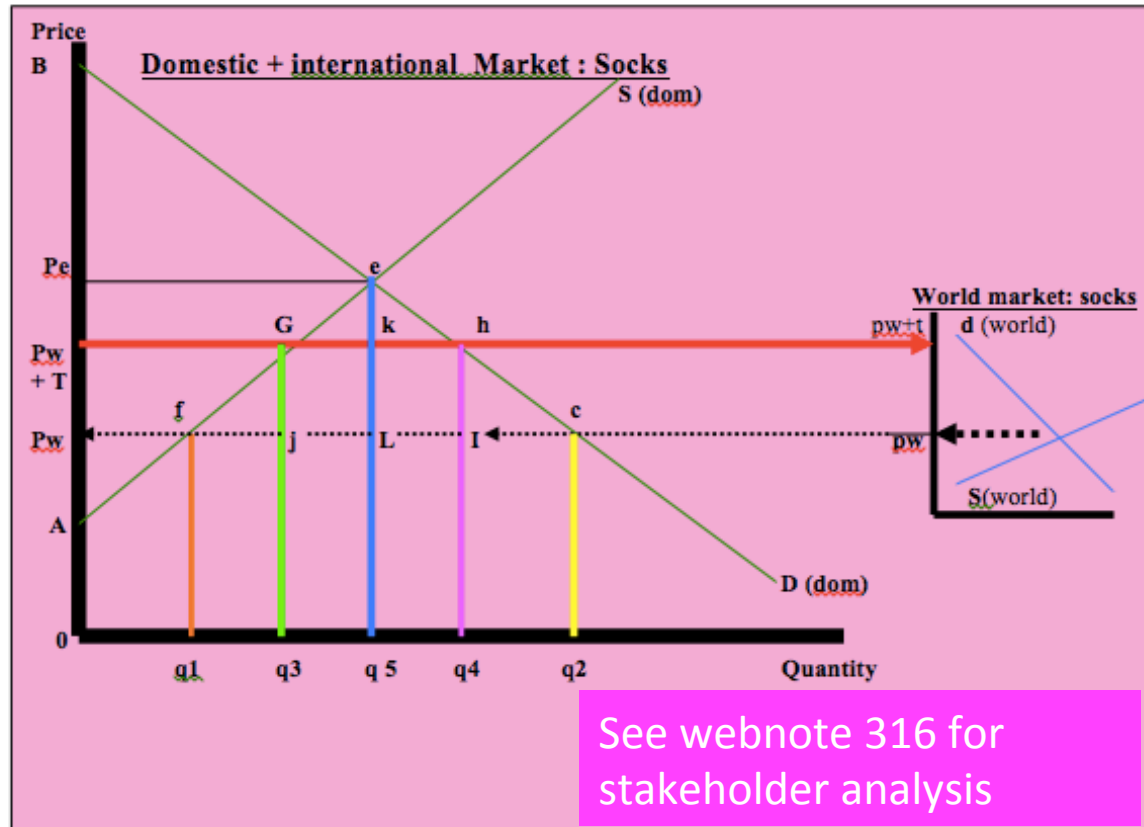


- Growth
- Employment
- National Income

# Does free trade work?

## Free Trade + Protectionism (embargo)

Source: Rees + Smith Economic Development pp. 121-122

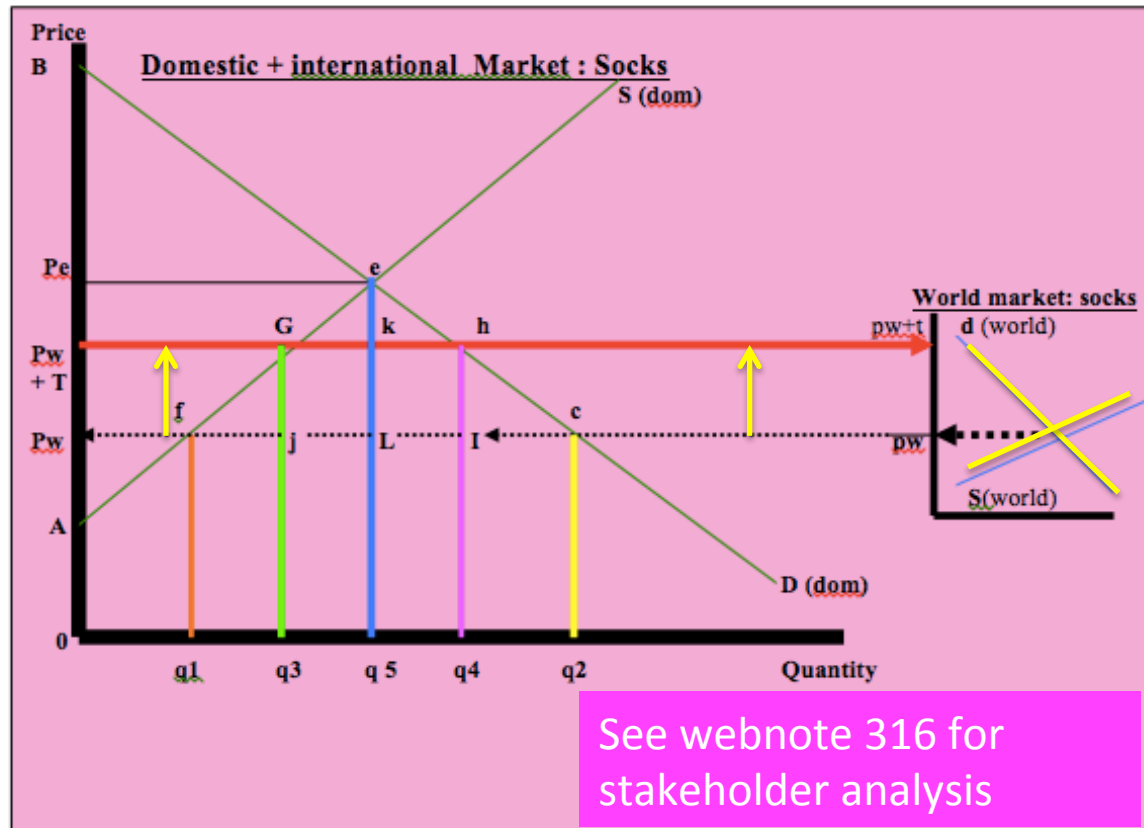


See  
Webnote  
313+316

# Does free trade work?

## Tariff

Source: Rees + Smith Economic Development pp. 121-122



Tariff = rise in price for imports illustrated by red line. Who wins and who loses?

See webnote 316 for stakeholder analysis

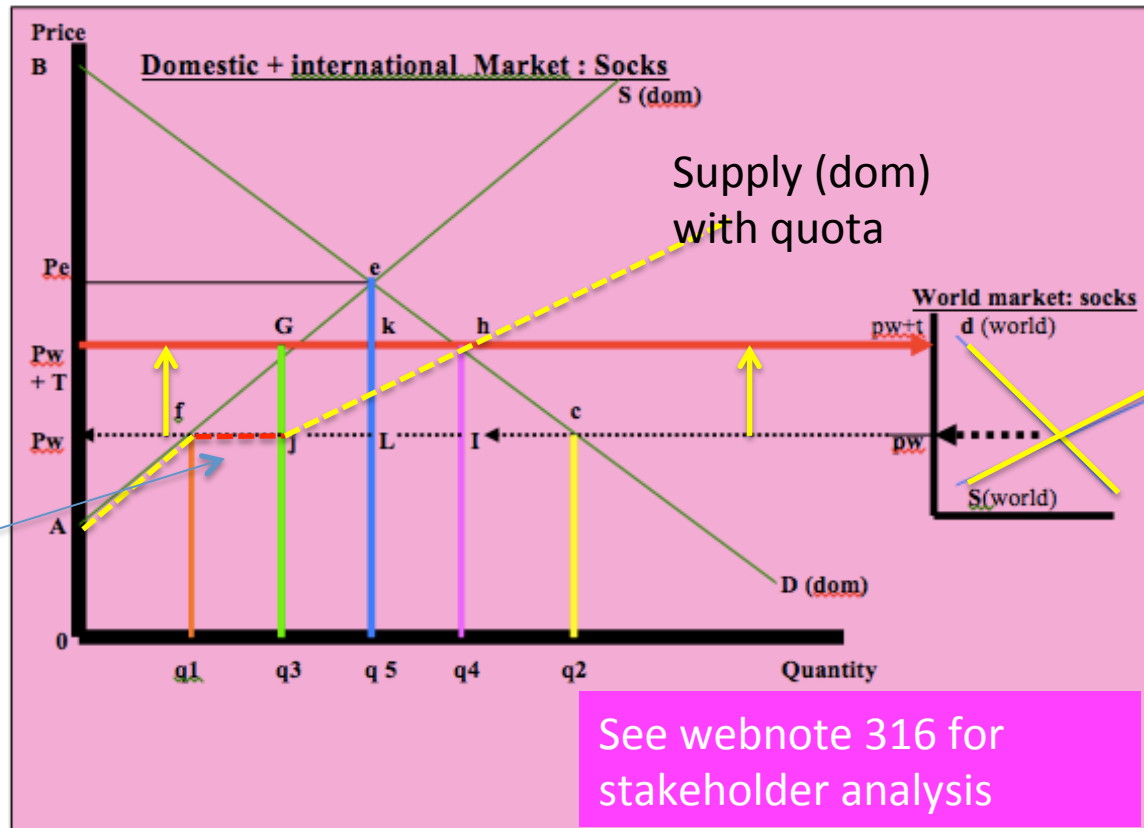
See  
Webnote  
313+316

# Does free trade work?

## Quota

Quota = rise in price for imports illustrated by red dotted line. Who wins and who loses?

Source: Rees + Smith Economic Development pp. 121-122



Quota = quantity of imports at world price shown by dotted red line.

See slide 9 below or Blink p 275 for full analysis



See  
Webnote  
313

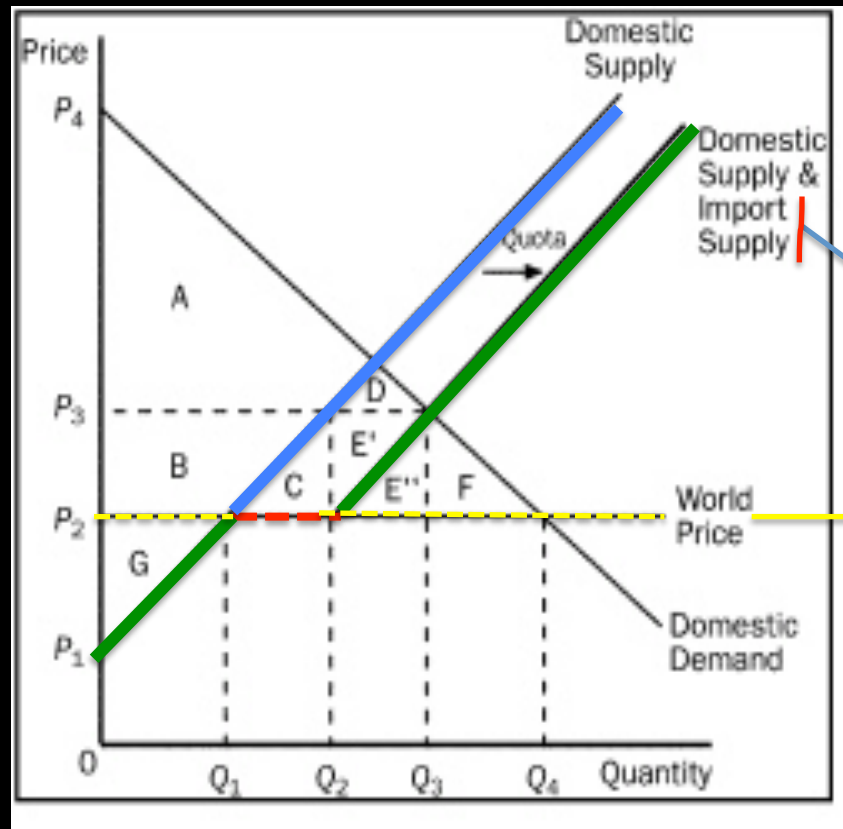
# Does free trade work?

## Quota

Quota is equal to quantity  $q_1 - q_2$ .

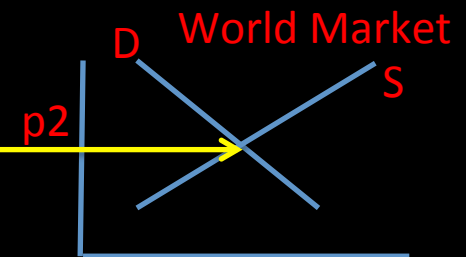
Stakeholders:  
2 Deadweight losses:

- (1) F = lost of CS to domestic consumers
- (2) E = loss to society due to inefficient domestic producers



See Blink  
page 275 for  
a nice  
summary of  
Quota with  
focus on  
stakeholders

= quota. See  $q_1 - q_2$  -----



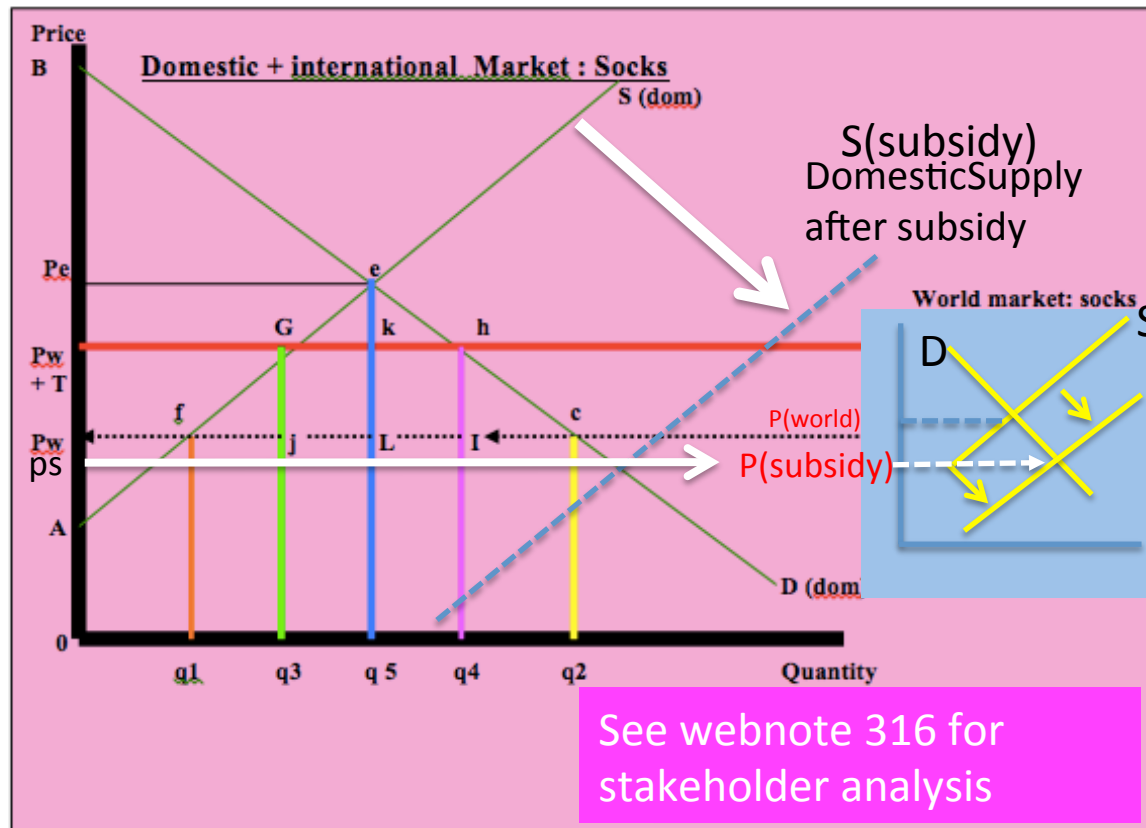
See webnote 316 for  
stakeholder analysis

# Does free trade work?

## Subsidy

**Note:**  
Subsidy is significant and pushes world price downward below  $P_w$  causing foreign firms to complain about the inability to compete. Difficult to prove and particularly in relation to 'dumping' or below cost selling.

Source: Rees + Smith Economic Development pp 121-122



# Absolute Advantage

1. UK is better at producing **CARS**
2. Portugal is better at producing **WHEAT**

Theory implies then that **Specialisation + Trade will benefit both nations**

Syllabus Weight: 4

Syllabus item(s): 134 (HL only)

Webnote 314

## INTERNATIONAL TRADE

Theory of ABSOLUTE ADVANTAGE

**ASSUMPTIONS OF THE MODEL:**

- 1 ALL FIRMS HAVE CONSTANT RETURNS TO SCALE AS OUTPUT CHANGES
- 2 PERFECT FACTOR MOBILITY WITHIN THE COUNTRY
- 3 NO TRANSPORT COSTS IN INTERNATIONAL TRADE
- 4 PERFECT COMPETITION EXISTS IN PRODUCT AND FACTOR MARKETS.
- 5 NO BARRIERS TO TRADE SUCH AS TARIFFS OR QUOTAS

NO TRADE (10 x on each)

UNITS OF OUTPUT PRODUCED WITHOUT SPECIALISATION: UK AND PORTUGAL

	KILOS OF WHEAT	NO OF CARS
UK	100	50
POR	200	40
TOTAL	300	90

**PRODUCTION POSSIBILITIES FOR WHEAT AND CARS, UK AND PORTUGAL:**

	KILOS OF WHEAT PER X RESOURCES	NO OF CARS PER X RESOURCES
UK	10 (2)	5 (5)
POR	20 (5)	4 (2)

Key  
UK: 1 w = .5 cars; 1c = 2 wheat  
Por: 1w = .2 cars; 1c = 5 wheat

TRADE: 20 x on each

UNITS OF OUTPUT PRODUCED WITH SPECIALISATION, UK AND PORTUGAL:

	KILOS OF WHEAT	NO OF CARS
UK	0	100
POR	400	0
TOTAL	400	100

**PRODUCTION POSSIBILITY CURVE AND A TRADING POSSIBILITY**

CURVE FOR THE UK:

**Task 1:** Calculate opportunity cost of:

1. 1 car (uk)
2. 1 car (por)
3. 1 wheat (uk)
4. 1wheat (por)

**Answers:**

1. 1c (uk) = 2 w
2. 1c (por) = 5w
3. 1w (uk) = 0.5 c
4. 1w (por) = 0.2 c

**Task 2:** Find an exchange rate which works for both countries. Use Opportunity Cost to guide you. E.g 1 car = 6 wheat???

**Key words:**  
opportunity cost + absolute advantage

**NOTE:** ASSUME EACH COUNTRY HAS 20 X OF RESOURCES

**Syllabus Reference ; 4.1 Absolute Advantage**

# Comparative Advantage

**INTERNATIONAL TRADE  
COMPARATIVE ADVANTAGE**

**PRODUCTION + TRADING  
(IM) POSSIBILITIES FOR THE UK:**

**A: NO TRADE**

UNITS OF OUTPUT PRODUCED WITHOUT SPECIALISATION, UK AND PORTUGAL: ie SELF SUFFICIENCY

KILOS OF WHEAT	+	NO OF CARS
UK 200		50
POR 100	+	20
TOTAL 300		70

**B: Full TRADE**

UNITS OF OUTPUT PRODUCED WITH SPECIALISATION, UK AND PORTUGAL:

KILOS OF WHEAT	+	NO OF CARS
UK 0		100
POR 200	+	0
TOTAL 200		100

**C: Partial TRADE**

UNITS OF OUTPUT PRODUCED WITH PARTIAL SPECIALISATION BY THE UK AND FULL SPECIALISATION BY PORTUGAL:

KILOS OF WHEAT	+	NO. OF CARS
UK 120 (6x)		70 (14x)
POR 200 (20x)	+	0
TOTAL 320		70

**PRODUCTION POSSIBILITIES FOR WHEAT AND CARS, UK AND PORTUGAL:**

KILOS OF WHEAT PER X RESOURCES	OR	NO OF CARS PER X RESOURCES
UK 20 (4)		5 (.25)
POR 10 (5)		2 (.2)

NOTE:: UK HAS ABSOLUTE ADV IN BOTH GOODS

NOTE: ASSUME EACH COUNTRY HAS 20 X OF RESOURCES

**KEY WORDS:**  
TERMS OF TRADE  
OPPORTUNITY COST  
SPECIALISATION  
ABSOLUTE ADVANTAGE  
PRODUCTION POSS. CURVE  
TRADING POSS. CURVE  
RETURNS TO SCALE:  
CONSTANT, INCREASING + DECREASING

**1**

**TRADING EXAMPLE:**  
EXCHANGE RATE = 1 CAR FOR 4.5 WHEAT  
UK SELLS 41 CARS TO PORTUGAL FOR 184.5 W  
THIS LEAVES THE UK WITH 304.5 W AND 29 CARS  
PORTUGAL HAS 15.5 W AND 41 CARS  
RESULT: BOTH COUNTRIES ARE BETTER OFF AS A RESULT OF SPECIALISATION + TRADE. TOTAL WEALTH HAS INCREASED.

**DOMESTIC OPP COST RATIOS**  
UK = 1 CAR FOR 4 WHEAT  
POR = 1 CAR FOR 5 WHEAT  
EACH COUNTRY WILL BENEFIT AS A RESULT OF TRADE + SPECIALISATION.  
CALCULATE THE SITUATION WITH AN EXCHANGE RATE OF 1 CAR FOR 4.5 KILOS OF WHEAT  
NOTE: DRAW ALSO A PRODUCTION + TRADING POSS. CURVE FOR PORTUGAL.

1. Opportunity Cost of car production is lower in UK
2. Opportunity cost of wheat production is lower in Portugal

Theory implies then that Specialisation + Trade will benefit both nations

Answers:

1.  $1c(uk) = 4w$
2.  $1c(por) = 5w$
3.  $1w(uk) = 0.25c$
4.  $1w(por) = 0.2c$

# 3.1 Big Ideas

- Definitions; Know the following:
  1. protectionism (employment+ domestic economic activity)
  2. Free trade
  3. Tariff, quota, VER, embargo
  4. Dumping (below cost selling)
  5. 'infant industry' argument for protectionism
  6. WTO
  7. Absolute and comparative advantage

# 3.1 Big Ideas

## **Big Questions for webnote 99:**

### **Big Questions for webnote 99:**

1. Why do countries trade?
2. Explain 3 types of protectionism.
3. Using diagrams show how stakeholders are affected when trade protection / free trade is introduced.
4. Show a welfare loss when protectionism is introduced or a welfare gain when free trade is introduced. Or use a producer/consumer/society loss analysis to show the winners and losers.

# IBQ

- IBQ
- Data Response part (d):  
May 2016

(d) Using information from the text/  
data and your knowledge of economics,  
discuss the possible impact of the US  
steel tariffs on the different economic  
stakeholders. (8 marks)