

Syllabus Reference 4.2<sup>1</sup> Syllabus Reference 197-207

Grade weight = 4

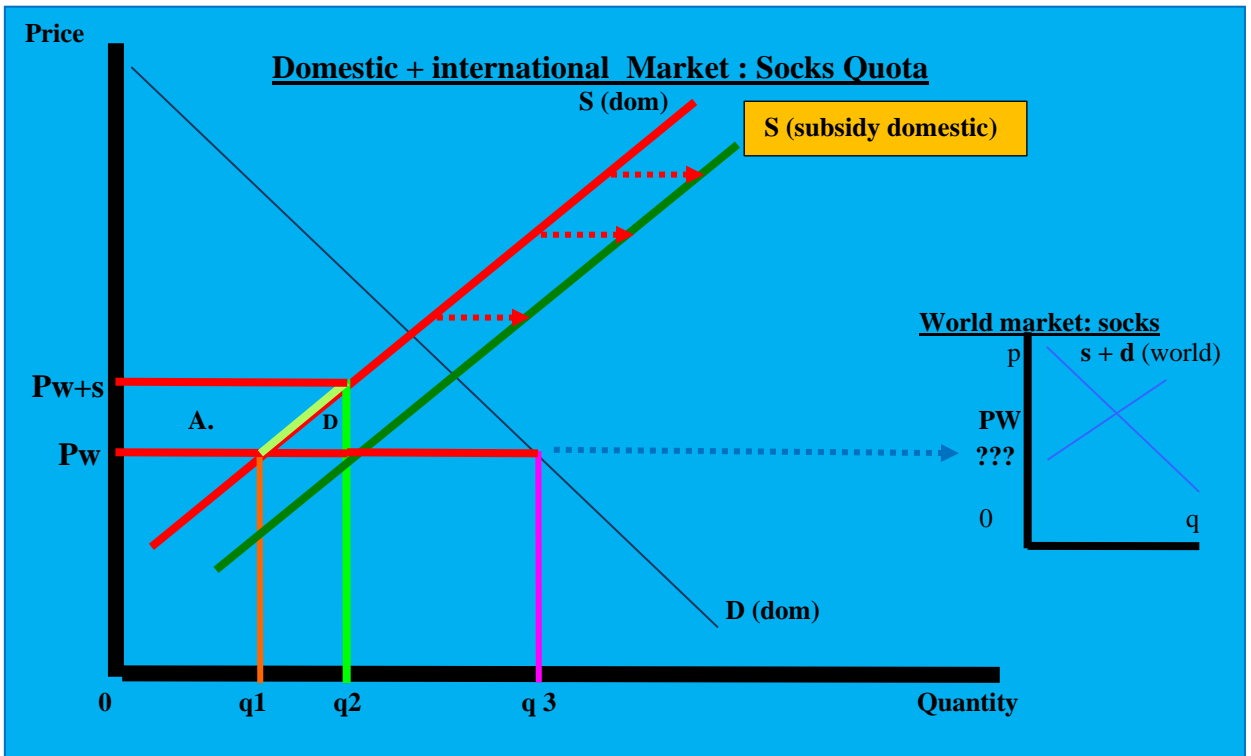
Source: Rees + Smith Economic Development pp 121-122

Type of economy:	Closed economy: no trade	Protected economy: quota	Free Trade
Equilibrium P + Q			
Domestic consumer Surplus			
Domestic producer Surplus			
Welfare loss			
Imports with tariff			
Government revenue			

Example :  
The welfare implications of a Quota in a Closed, Protected and Free Trade

Quota supply curve =  
  
S1-2-3-4

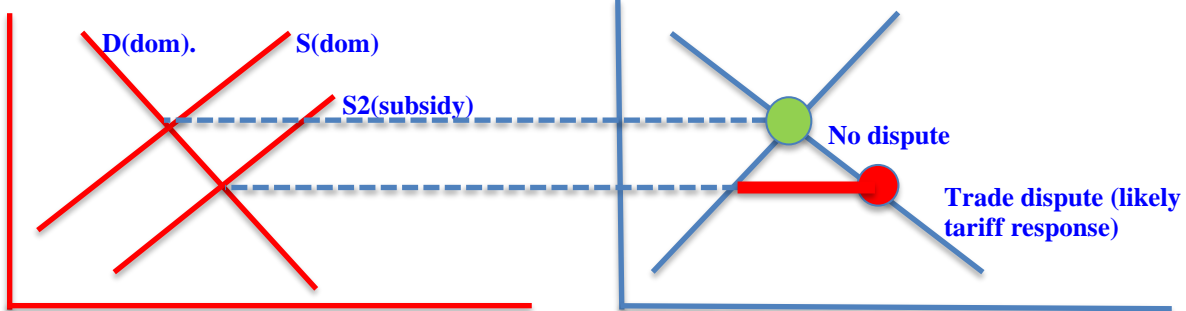
FIG 1



Export subsidies result in higher prices in domestic markets (see analysis on Cambridge p457) and as a result a greater quantity is exported to foreign markets. If this is below the world price a trade dispute is likely as foreign producers will argue unfair competition. See also VID 3 from Mike Moore highlighting the trade dispute element. Note that FIG 1 + 2 represent the subsidy on a domestic market. The full export subsidy diagram is shown on FIG 4

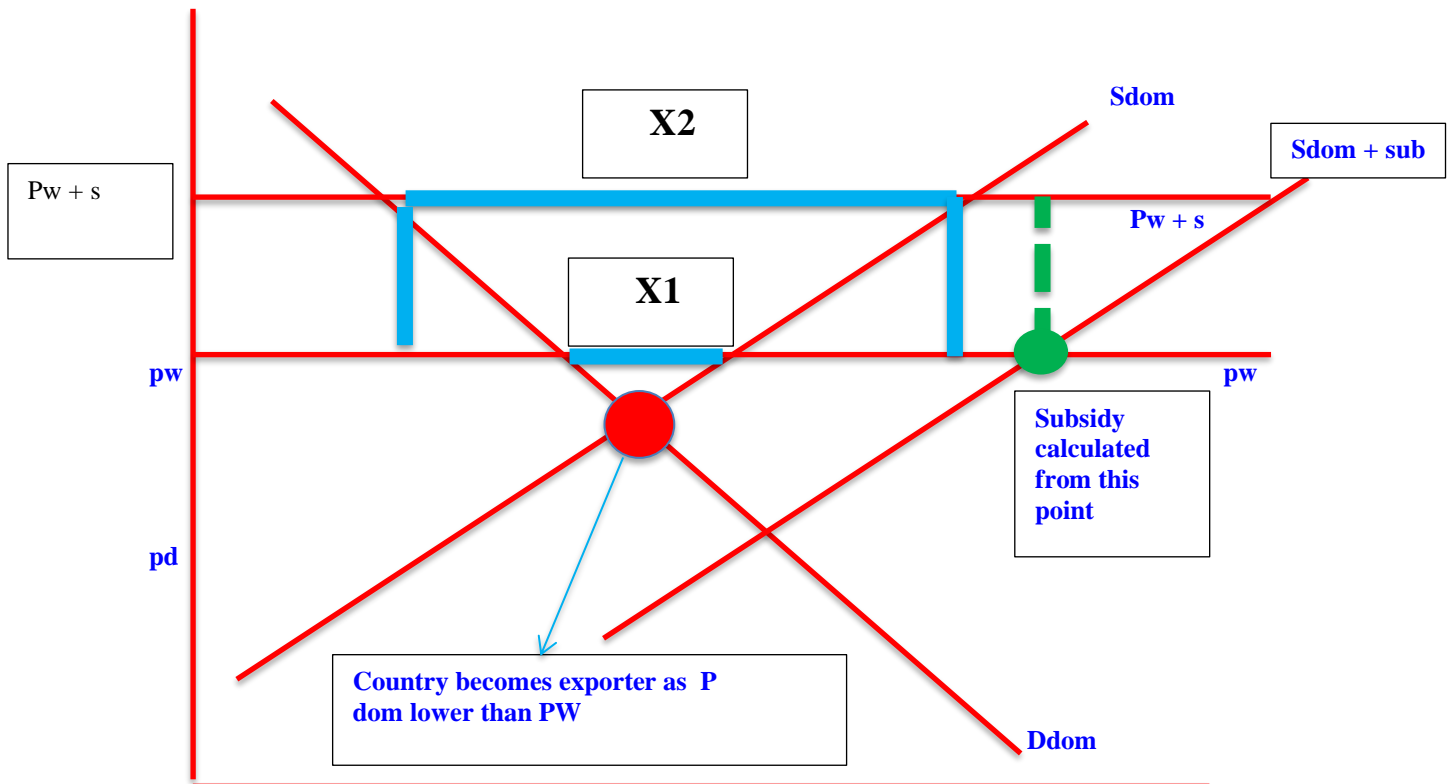
FIG 2: Domestic subsidy results in lower priced exports(S2)

FIG 3: Domestic without/with subsidy (S2)



**FIG 4: Domestic subsidy drives up domestic price ( assuming domestic prices lower than world price). Domestic market shrinks and quantity X2 is exported to foreign markets. Foreigners unhappy and react to unfair competition by imposing tariffs on the lower priced exports coming out of the domestic economy**

Diagram shows domestic prices increasing and a greater quantity of exports to foreign market driving world prices down (USA, large country exporter) and creating a trade dispute.



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**Example ii: The welfare implications of a Free Trade Economy**

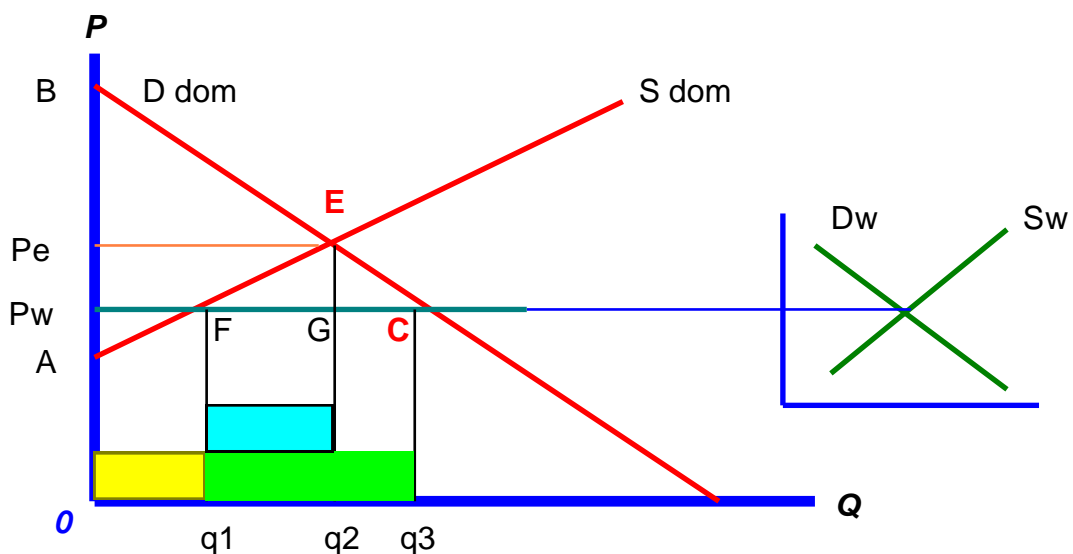
**Key:**

- $S_{dom}$  = supply in the domestic market without competition from imports
- $D_{dom}$  = domestic demand curve
- $P_e$  = Equilibrium in the domestic market without imports
- $P_w$  = world price i.e. free trade
- $D_w$  = world demand curve
- $S_w$  = world supply curve in the world market

**Points to Note:**

1. World price ( $P_w$ ) is lower than  $P_{dom} / P_e$  on the assumption that the foreign

Market for socks in a LDC



producers are more efficient over some but not all of the domestic producers. This would most probably be an economies of scale problem for some domestic producers in an LDC

2. Horizontal supply curve in the domestic market as a result of the imports – see  $P_w$   $S_w$  – suggests that the LDC is a ‘price taker’ and cannot produce quantities to influence the world price
3. The domestic producers face a serious threat as the world market can satisfy the entire domestic demand
4. Producer Surplus falls from  $APeE$  to  $APwF$
5. Consumer Surplus rises from  $PeBE$  to  $PwBC$
6. Wider selection of goods in domestic market and standard of living has improved because of the price fall and the selection of socks.
7. The end result is that  $P_w$  acts as a ceiling price and therefore efficiency is a must if domestic producers are to survive.<sup>i</sup> Unemployment occurs in LDC as a result of loss of production /output  $q_1 - q_2$ .

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<sup>i</sup> FEG = CS due to transfer of production abroad. GEC = no win no loss area, socks are cheaper and  $Q_d$  has increased