Exam study guide on international trade theory

Economics, Trade

MKT 310 : Exam 2 Study Guide BOOK Ch. 5 : International Trade Theory An Overview of Trade Theory: * The Benefits of Trade – Some international trade is beneficial, exchange products you can produce at a low cost for some products you cannot produce at all * Free Trade – The absence of government barriers to the free flow of goods and services between countries. * International trade allows a country to specialize in the manufacture and export of products it can produce most efficiently while importing products that can be produced more efficiently in other countries. Climate and natural resources explain why Ghana exports cocoa, and Saudi Arabia exports oil * Product Life-Cycle Theory – Early in their life cycles, most new products are produced in and exported from the country in which they were developed. As the product becomes accepted internationally, production begins to start in other countries. Thus suggesting that the product may ultimately be exported back to the country of its original innovation. New Trade Theory – Theory that sometimes countries specialize in the production and export of particular products not because of underlying differences in factor endowments, but because in certain industries the world market can support only a limited number of firms. Mercantilism: * Mercantilism – Originated in England, An economicphilosophyadvocating that countries should simultaneously encourage exports and discourage imports. It was in the countries best interest to maintain a trade surplus, to export more than it imported. Also advocated government intervention to achieve a surplus in the balance of trade. Zero-Sum Game – A situation in which an economic gain by one country results in an economic loss by another. The flaw with Mercantilism is that it is viewed as a Zero-Sum Game. * Critics

think China is pursuing a neo-mercantilist society, deliberately keeping its currency value low against the U. S. dollar in order to sell more goods to the U. S. , thus creating a surplus and foreign exchange reserves. Absolute Advantage: * Absolute Advantage – A country has an absolute advantage in the production of a product when it is more efficient than any other country in producing it. According to Smith countries should specialize in the production of goods for which they have an absolute advantage and then trade these for goods produced by other countries. (Countries should never produce goods at home that it can buy at a lower cost from other countries. Comparative Advantage: * Comparative Advantage – It makes sense for a country to specialize in the production of those goods that it produces most efficiently and to buy the goods that it produces less efficiently from other countries, even if this means buying goods from other countries that it could produce more efficiently itself. Basic Message of Comparative Trade – Potential world production is greater with unrestricted free trade than it is with restricted free trade. * Immobile Resources – Resources do not always shift easily from on activity to another, some friction is involved. Belief that a country will produce less of some goods but more of others, however not everyone has the skills and knowledge to produce the greater good, thus some people may lose their jobs. * Diminishing Returns – When more units of a resource are required to produce each additional unit.

First not all resources are of the same quality, and different goods use resources in different proportions. * Constant Returns to Specialization – The units of resources required to produce a good are assumed to remain constant no matter where one is on a country’s production possibility

frontier. * Dynamic Effects and Economic Growth – Opening an economy to trade, might increase a countries stock of resources as increased suppliers of labor and capital from abroad become available for use within the country, and free trade might increase the efficiency with which a country uses its resources. When a rich country(U. S.) enters in free trade with a poor country(China) the lower prices that U. S. consumers pay for goods imported from China may not be enough to produce a net gain for the U. S. economy if the dynamic effect of free trade is to lower real wage rates in the U. S. * Evidence for the Link between Trade and Growth – Countries that adopt a more open stance toward international trade enjoy higher growth rates than those that close their economies to trade. Heckscher-Ohlin Theory: Comparative advantage arises from differences in national factor endowment, and by factor endowment they meant the extent to which a country is endowed with such resources as land, labor, and capital.. The Heckscher-Ohlin Theory predicts that countries will export those goods that make intensive use of factors that are locally abundant, while importing goods that make intensive use of factors that are locally scarce. * The Leontief Paradox – Since U. S. was relatively abundant in capital compared to other nations, the U. S. would export capital intensive goods and import labor-intensive ones. However he found that the U.

S. exports were less capital intensive than the imports. The Product Life-Cycle Theory: * Most new products were initially produced in the U. S. and sold in the U. S. markets first, the wealth and size of the U. S. can them strong incentives to develop new consumer products. , in addition the high cost of U. S. labor gave U. S. firms an incentive to develop cost-savings

process innovations. These expensive goods are only appealing to the wealthy of other nations, thus there isn’t that much overall global interest, so no other countries feel it is necessary to start producing the product as well. New Trade Theory: The ability of firms to attain economies of scale might have important implications for international trade. * Economies of Scale – Unit cost reductions associated with a large scale of output * New Trade Theory makes 2 important points: * 1) Through its impact on economies of scale, trade can increase the variety of goods available to consumers and decrease the average costs of those goods. * 2) In those industries where the output required to attain economies of scale represents a significant proportion of total world demand, the global market may be able to support only a small number of enterprises. First-Mover’s Advantage are the economic and strategic advantages that accrue to early entrants into an industry. The ability to capture scale economies ahead of later entrants, and thus benefit from a lower cost structure, is an important first mover’s advantage. * Implications of New Trade Theory – generates for government intervention and strategic trade policy, a nation may befit from trade even if they do not differ in resource endowments ortechnology, trade allows a nation to specialize in the production of certain products---attaining scales of economy and lowering cost.

National Competitive Advantage: Porter’s Diamond * Porter theorizes that 4 broad attributes of a nation shape theenvironmentin which local firms compete, and these attributes promote or impede the creation of competitve advantage. These attributes are…… * Factor Endowments – A nations’ position in factors of production such as skilled labor or the infrastructure

necessary to compete in a given industry (Advanced factors are the most significant competitive advantage.) * Demand Conditions – the nature of home demand for the indutry’s product or service. Relating and Supporting Industries – the presence or absence of supplier industries and related industries that are internationally competitive. * Firm strategy, Structure, and Rivalry – The conditions governing how companies are created, organized, and managed and the nature of domestic rivalry. * He argues that firms are most likely to succeed in nindustries or industry segments where the diamond is most favorable.. The diamond is a mutually reinforcing system – meaning the effect of one attribute is contingent on the state of others. -- Ch. 6 : The Political Economy of International Trade Instruments of Trade Policy: * Tariffs – A tariff is a tax levied on imports (or exports.) In most cases tariffs are placed on imports to protect domestic producers from foreign competition by raising the price of imported goods. Tariffs also produce revenue for the government. The government and the domestic producers gain from having tariffs, whereas the consumers lose. * 2 conclusions can be made about tariffs: First, tariffs are pro-producer and anti-consumer.

Second, import tariffs reduce the overall efficiency of the world economy. (Tariffs encourage domestic products to be sold at home when they could be more efficiently sold in the global market.) * Export tariffs raisemoneyfor the government, and they reduce exports from a sector, often for political reasons. * 2 Types of Tariffs: * Specific Tariffs – Levied as a fixed charge for each unit of a good imported (ex. $3 per barrel of oil) * Ad Valorem Tariffs - Levied as a proportion of the value of imported goods. Subsidies – A subsidy

is a government payment to a domestic producer. By lowering production costs, subsidies help domestic producers in 2 ways: 1) competing against foreign imports and 2) gaining export markets. * Agriculture is the largest beneficiary of subsidies. * Non-Agriculture subsidy ex. Money given to Boeing and Airbus * The main gains from subsidies accrue to domestic producers, whose international competiveness is increased as a result. * Subsidies protect the inefficient and promote excess production. Import Quotas and Voluntary Export Restraints – An import quota is a direct restriction on the quantity of some good that may be imported into a country * Tariff Rate Quota – The process of applying a lower tariff rate to imports within the quota than those over the quota. * Voluntary Export Restraint – A quota on trade imposed by the exporting country, typically at the request of the importing country's government. Ex. Limitation on auto exports to the U. S. enforced by the Japanese automobile producers. * Quota Rent – The extra profit producers make when supply is artificially limited by an import quota. Local Content Requirements – A requirement that some specific fraction of a good be produced domestically. Ex. Buy America Act specifies that government agencies must give preference to American products when putting contracts for equipment out to bid unless the foreign products have a significant price advantage. * Administrative Policies * Administrative Trade Policies – Bureaucratic rules designed to make it difficult for imports to enter a country, as it has been argues that the Japanese are masters of this trade barrier. * Antidumping Policies Dumping – Selling goods in a foreign market at below their costs of production or below their “ free” market value. Ex. 2 South Korean manufacturers of semiconductors were accused of selling

microchips in the U. S. market at below their cost of production. * Anti-Dumping Policies – Policies designed to punish foreign firms that engage in dumping and thus protect domestic producers from unfair foreign competition. * Countervailing Duties – Antidumping duties. Political Arguments for Intervention: * Protecting Jobs and Industries – Tariffs placed on steel in 2002 by G.

W. Bush were supposed to do this. * National Security – Protect the area of technological advancement, and the defense industries. * Retaliation – Use threat to intervene in trade policy as a bargaining tool to help open foreign markets and force trading partners to " play by the rules. " Ex. U. S. has used threat of punitive trade sanctions to try and get the Chinese government to enforce its intellectual property laws – China cost Microsoft hundreds of millions of dollars per year in lost sales revenues. * Protecting Consumers – Ex.

Many countries decided to ban imports of American beef after one case of Mad Cow Disease was found. * Furthering Foreign Policies Objectives – Governments sometimes use trade policy to further support their foreign policy objectives. * Helms-Burton Act – This act allows American to sue foreign firms that use property in Cuba confiscated from them after the 1959 revolution. * DAmato Act – Act passed in 1996, similar to the Helms-Burton Act, but this one is aimed at Libya and Iran. * ProtectingHuman Rights– Ex.

Debate over many years on whether to grant the " Most Favorable Nation" to China -- this is controversial bc many think China doesn't regard human rights per the Tiananmen Square Massacre. * Protecting the Environment – Strong relation between income levels and

environmentalpollution/degradation. Ex. Carbon Emissions Tariff, etc. Economic Arguments for Intervention: * The Infant Industry Argument – New industries in developing countries must be temporarily protected from international competition to help them reach a position where they can compete on world markets with the firms of developed nations. Skepticism because protection of manufacturing from foreign competition does no good unless the protection helps make the industry efficient. Second, the infant industry argument relies on an assumption that firms are unable to make efficient long term investments by borrowing money from the domestic or international capital market. * Strategic Trade Policy – A Government policy aimed at improving the competitive position of a domestic industry or domestic firm in the world market. It is argued that by appropriate actions, a government can help raise national income if it can somehow ensure that the firm(s) that gain first-movers advantage within an industry are domestic rather than foreign enterprises. * The second component of the strategic trade policy is that it might pay a government to intervene in an industry by helping domestic firms overcome the barriers to entry created by foreign firms that have already reaped the benefits of first-movers advantage. Development of the World Trading System , GATT, WTO: (Look in PPT slides for this info.)