

## Chapter 7

# INTERNATIONAL TRADE AND TRADE POLICY

*Principles of Economics in Context* (Goodwin, et al.), 2<sup>nd</sup> Edition

### Chapter Overview

This chapter presents different perspectives on the important subject of international trade. It begins by presenting the classical economic contributions to economic theory of Adam Smith and David Ricardo. It shows the reasoning behind why free markets promote specialization and, in turn, efficiency and comparative advantage. As will be shown, comparative advantage, is the logical argument behind why free trade is desirable—it is beneficial to both countries.

The chapter then discusses other important advantages of trade, but also equally important disadvantages. These illustrate that trade is a much more complex topic than may appear just from looking at the logic of the comparative advantage model. Next, the idea of protectionism—or restrictions on trade—is introduced, with examples such as tariffs and quotas. We look at some reasons why countries sometimes pursue protectionist policies, and also briefly discuss some of today’s trade institutions like the World Trade Organization, the European Union, and the North American Free Trade Agreement. Finally, the chapter discusses some political economy considerations that influence the “fairness” of free trade or protectionism.

### Objectives

After reading and reviewing this chapter, you should be able to:

1. Describe how specialization, productivity, and trade are related.
2. Discuss how trade can expand a society’s consumption opportunities.
3. Explain the law of comparative advantage.
4. List the advantages and disadvantages of free trade.
5. Describe the likely effects of protectionism.
6. Explain why countries sometimes follow protectionist policies.
7. Discuss how trade and protectionism relates to issues of fairness.

### Key Terms

absolute advantage  
comparative advantage  
capital-intensive production  
race to the bottom  
globalization  
import substitution  
tariffs  
trade-related subsidy  
World Trade Organization (WTO)

free trade  
labor-intensive production  
factor-price equalization  
exporting pollution  
protectionism  
infant industry  
trade quotas  
administrative obstacles  
dumping

## Active Review Questions

### *Fill in the Blank*

1. According to Adam Smith, free trade led to specialization, which in turn increased \_\_\_\_\_.
2. Comparative advantage refers to a country's ability to produce some good or service at a lower \_\_\_\_\_ than other countries.
3. A productive method that employs a high ratio of labor to capital is known as \_\_\_\_\_ production.
4. A race to the \_\_\_\_\_ refers to when countries compete with each other by providing low-cost business environment.
5. Tariffs and quotas are both examples of \_\_\_\_\_ policies.
6. A government policy undertaken to reduce reliance on inputs and encourage development of domestic industry can be referred to as an import \_\_\_\_\_ policy.
7. The principle of comparative advantage says that a producer should specialize in producing goods for which its opportunity costs are relatively \_\_\_\_\_.
8. The practice of selling products at prices below production costs is known as \_\_\_\_\_.

### *True/False*

9. Suppose Costa Rica and Panama both produce two goods: bananas and beans. According to the principle of comparative advantage, if Costa Rica produces both bananas and beans less efficiently than Panama, it should simply buy both goods from Panama.
10. The principle of comparative advantage applies only to decisions concerning international trade.
11. Increasing capital mobility decreases the likelihood of a "race to the bottom" in social, health, and environmental standards among countries.
12. Adam Smith is known for having promoted the principle of comparative advantage.
13. Specialization in production always increases the prosperity of a country.

14. Relying excessively on other countries for petroleum imports increases vulnerability to free trade.

15. Relying excessively on other countries for pistachio imports increases vulnerability to free trade.

16. Lock-in is one of the key strategies followed by countries to achieve prosperity.

17. The chief mandate of the World Trade Organization is to provide lending assistance and grants to countries with poor terms of trade.

18. Exporting pollution is when all countries increase their pollution levels in order to gain a competitive advantage over trading partners.

*Short Answer*

19. Explain Adam Smith's reasoning for why free trade would lead to economic prosperity.

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20. List and describe at least three disadvantages of free trade.

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*Problem*

21. Suppose that by devoting all its resources to coffee production, Ethiopia can produce 6 tons of coffee, while if it devotes all its resources to peanut production, it can produce 2 tons of peanuts. Senegal can produce 2 tons of coffee if it devotes all its resources there, or 4 tons of peanuts if it grows only peanuts.

a. Draw the PPFs for Ethiopia and Senegal. (Put the quantity of coffee on the vertical axes.)

b. Which country is the more efficient producer of coffee? Explain how you got your answer.

c. Suppose that Ethiopia would like to consume 4 tons of coffee and 1 ton of peanuts, while Senegal would like to consume 2 tons of coffee and 3 tons of peanuts. Could either country consume their desired consumption bundle, without trade? Show on your graphs above.

- d. If the countries trade, could they each get their desired consumption bundle?  
If so, how?

### **Self Test**

1. Adam Smith referred to specialization in production as...
  - a. the division of labor.
  - b. laissez-faire.
  - c. sweat and toil.
  - d. the invisible hand.
  - e. the essence of comparative advantage.
  
2. According to Adam Smith, productivity gains could be brought about through...
  - a. factor-price equalization.
  - b. labor-intensive production.
  - c. diversification.
  - d. market expansion.
  - e. protectionism.
  
3. David Ricardo is most well-recognized for his...
  - a. advocacy of the GATT and the WTO.
  - b. theory of comparative advantage.
  - c. theory of absolute advantage.
  - d. development of capital-intensive modes of production.
  - e. Slavonic approaches to trade.

4. According to the principle of comparative advantage:
- Each country should specialize in the good it can produce most efficiently compared with its trading partner.
  - Buyers should compare goods before signing a contract.
  - Wealthier countries have significant advantages compared to poorer countries.
  - Each country should produce at least some quantity of every important consumer good.
  - Some countries should act strictly as consumers and not as producers.

**Use the table below, showing the maximum quantities of two items that two countries could produce if they each specialized entirely in one good or the other, to answer Questions 5-8.**

<u>Country</u>	<u>Industry</u>	
	Wheat	Copper
United States	5 bushels	7 tons
Zambia	1 bushel	2 tons

5. The opportunity cost of a bushel of wheat in the United States is...
- $7/5$  ton of copper.
  - 7 tons of copper.
  - 5.7 tons of copper.
  - $7/5$  bushels of wheat.
  - $5/7$  tons of copper.
6. The opportunity cost of a bushel of wheat in Zambia is...
- $1/2$  ton of copper.
  - $1/2$  ton of wheat.
  - 2 bushels of wheat.
  - 2 tons of copper.
  - None of the above.
7. Which country has the comparative advantage in producing copper?
- The United States
  - Zambia
  - both
  - neither
  - you can't tell from the information given

8. If it follows the principle of comparative advantage, which item should the United States specialize in producing?
- a) wheat
  - b) copper
  - c) both
  - d) neither
  - e) you can't tell from the information given
9. Which of the following is not cited as an advantage of specialization and exchange?
- a. incentives to be productive
  - b. gains from trade
  - c. non-coercion
  - d. power differentials
  - e. creation of common interests
10. According to the infant industry argument:
- a. Government should sometimes protect domestic firms from foreign competition until they can compete on their own.
  - b. Tariffs may be justified to protect an industry until it becomes more competitive.
  - c. Quotas are never justified in an international trade situation.
  - d. Both a and b
  - e. Both b and c
11. Which of the following is a disadvantage of import substitution policies?
- a. Decreased likelihood of lock-in
  - b. Loss of potential gains from trade in the short run
  - c. Loss of infant industry advantages
  - d. Loss of long run comparative advantage
  - e. Diversification of production
12. Which of the following is not a potential drawback to specialization and exchange in international markets?
- a. Creation of common interests.
  - b. Excessive dependence on another nation for crucial inputs.
  - c. Loss of domestic food security.
  - d. A "race to the bottom" in environmental standards.
  - e. Wars sparked by the need for products or raw materials provided by another country.

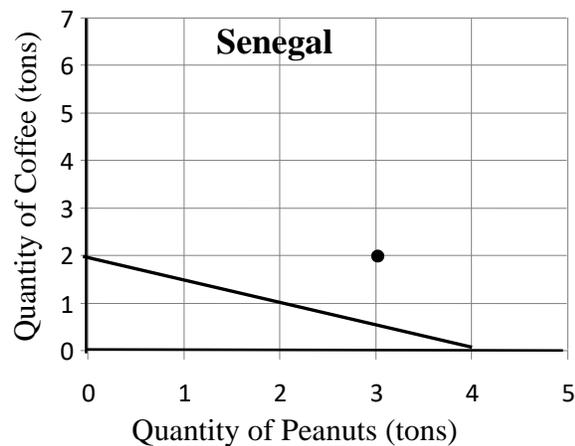
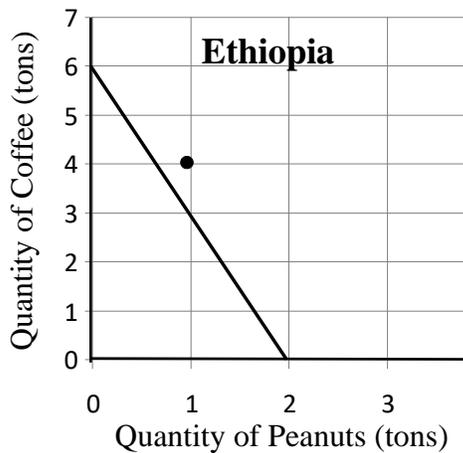
13. Which of the following is an example of a protectionist policy?
- Ensuring equal pay for men and women.
  - Social Security.
  - An excise tax on cigarette consumption.
  - A quota on imports of sugar.
  - None of the above.
14. In theory, free trade enables countries to...
- consume at points within their production possibilities frontiers.
  - consume at points on their production possibilities frontiers.
  - consume at points beyond their production possibilities frontiers.
  - shift their production possibilities frontiers outward.
  - Trade has nothing to do with production possibilities.
15. Which of the following is *not* among the listed advantages of free trade?
- Efficiency
  - Fairness
  - Incentive for hard work
  - Non-coerciveness
  - Promotes common interests
16. A tariff is...
- a tax paid by suppliers in the exporting country.
  - a subsidy paid to suppliers in the exporting country.
  - a subsidy paid to importers.
  - a tax paid by importers.
  - a tax paid by consumers from the exporting country.
17. The World Trade Organization...
- provides emergency assistance to countries in financial crisis.
  - issues project-specific loans to developing countries.
  - rules on trade disputes between countries.
  - (b) and (c)
  - None of the above are true.
18. Which one of the following statements is false?
- A “race to the bottom” can lead to lower environmental standards.
  - By “exporting pollution” a country can reduce its domestic pollution levels.
  - Currently about 50% of world economic output is traded internationally.
  - Expanded trade can exacerbate existing inequalities in a country.
  - Tariffs have generally been declining in recent decades.

19. Economists say that a process that is highly automated is...
- a. capital intensive.
  - b. labor intensive.
  - c. labor scarce.
  - d. capital abundant.
  - e. None of the above are true.
20. The theory of factor-price equalization states that...
- a. for both trading partners to benefit, factor prices should be equalized.
  - b. free trade tends to equalize returns on productive factors across countries.
  - c. returns on all of a country's productive factors should be the same in the long run.
  - d. specialization inhibits the equalization of factor price.
  - e. None of the above are true.
21. The issue of trade in genetically-modified organisms is fundamentally one about...
- a. efficiency.
  - b. global governance.
  - c. tariffs.
  - d. comparative advantage.
  - e. fairness.

*Answers to Active Review Questions*

1. productivity or efficiency
2. opportunity cost
3. labor intensive
4. bottom
5. protectionist
6. substitution
7. low
8. dumping
9. False
10. False
11. False
12. False
13. False
14. True
15. False
16. False
17. False
18. False
19. Smith believed that free trade increased the extent of the market, which would increase gains to specialization, which would motivate a greater degree of specialization, leading to greater economic productivity and, in the long run, greater national prosperity.
20. Vulnerability, lock-in, coercion and power differentials, tension between government and corporate interests, race to the bottom, inequality, and commodification of fundamental social needs are among potential disadvantages of free trade.

21.  
a.



b. Ethiopia is the more efficient producer of coffee. Ethiopia can produce 1 ton of coffee at an opportunity cost of only 1/3 ton of peanuts, while the opportunity cost of a ton of coffee in Senegal is 2 tons of peanuts.

- c. No. (See the points marked on the graphs above—they are outside the PPFs.)
- d. Yes. If Ethiopia produces 6 tons of coffee and sells 2 tons to Senegal in exchange for 1 ton of peanuts, while Senegal produces only peanuts (keeping 3 tons, and using the fourth to buy 2 tons of coffee from Ethiopia), both countries will get their desired consumption bundle.

*Answers to Self Test Questions*

1. a
2. d
3. b
4. a
5. a
6. d
7. b
8. a
9. d
10. d
11. b
12. a
13. d
14. c
15. b
16. d
17. c
18. c
19. a
20. b
21. e