

Topic 13 – Small Country Trade Model



Agenda

- Trade Equilibrium
 - How to look at trade in a supply/demand graph
- Trade Barrier Justifications
- Effects of a Trade Barrier
- Removing Barriers to Trade
 - A brief history of the World Trade Organization



Motivating Questions

- What happens when your country is too small to affect world prices?
- If trade is so great, why do we have tariffs, import quotas, and lots of bureaucratic red tape involved in importing?



Trade Equilibrium

Once again it's all about supply and demand

Trade
Equilibrium

Trade Barrier
Justifications

Effects of a
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First, some definitions

- Just in case you haven't been paying attention...
- Exports: Goods and Services that are produced domestically and sold abroad
- Imports: Goods and Services that are produced abroad and sold domestically

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Small countries are simple cases to look at

- We'll make the following assumptions about a small country:
 1. Whatever amount they demand can be supplied.
 2. Demand doesn't affect world prices.
 3. Supply first comes from domestic firms, while the remainder comes from foreign firms.

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Example

- Let's do this on the whiteboard

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When world price is lower than domestic price

- The gains of the winners (consumers) exceed the losses of the losers (producers)
- What exactly are the **benefits of imports to consumers**?
 1. Increased consumption: Obviously if the price is lower, consumers will demand more.
 2. Increased variety of goods: there are more goods available now!

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When world price is lower than domestic price

- More benefits
 3. Lower costs through economies of scale: the reason they are paying lower prices is that the goods cost less to make in the foreign country!
 4. Increased competition: domestic firms may work harder to innovate now.
 5. Enhanced flow of ideas

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Trade Barrier Justifications

... and their counter-arguments

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So why do some argue that we should limit imports?

1. The Jobs Argument

- If a country imports a cheap product, domestic producers of the product will have to lay off workers because they decrease domestic output
- BUT, free trade will create job opportunities in other industries where the country has a comparative advantage.
- e.g. Japanese automakers: become mechanic instead of plant worker. Comparative advantage is in high-skill work.

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More justifications

2. National-Security Argument

- Suppose a steel industry representative says we have to keep the domestic industry strong because steel is used for weapons, which is used for national security.
- Should we believe the representative? We can probably trust the argument when it comes from the military, but not from industry reps.

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More justifications

3. Infant Industry Argument

- “Young industries” need trade restrictions to help them get started
- BUT it’s hard to decide when competition is finally okay, so tariffs often persist after industry is mature
- A related argument is an industry needs temporary protection (e.g. Bush imposed temporary tariffs on steel in 2002)

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More justifications

4. Unfair-Competition Argument

- Not fair to expect firms to compete with foreign firms facing less regulation, or who get subsidies.
- e.g. Mexican corn-growers might complain of the U.S. subsidy for corn-farming
- BUT is this so bad for Mexico? While Mexican corn producers would suffer, Mexican consumers benefit, and U.S. taxpayers bear the burden

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More justifications

5. Protection As A Bargaining Chip

- Suppose Canada puts an import tariff on U.S. automobiles. We can threaten to put a tariff on Canadian lumber.
- BUT if Canada doesn't budge, we have to follow through on the threat or look weak. Following through means less economic welfare for Canada AND U.S. (we import a lot of lumber from Canada)

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More justifications

5. Efficiency vs. Equality

- Some people gain a lot from trade, while some lose a little. Is trade widening the income gap?
- YES! There is no counter-argument for this one. Economists worry about this one.

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Effects of a Trade Barrier

What kinds of trade barriers are there? What do they do exactly?

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How do countries implement a trade barrier?

1. Tariff: a tax imposed by a nation on an imported good

e.g. \$100 tariff on every imported car

- a. Revenue Tariff:** designed to produce income for government
- b. Protective Tariff:** designed to protect certain producers from foreign competition

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How do countries implement a trade barrier?

- 2. Import Quota:** A limit imposed by a nation on the quantity (or total value) of a good that may be imported during some period of time
e.g. “10 GWatts of electricity a month”

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How do countries implement a trade barrier?

3. Non-Tariff Barriers

- unreasonable licensing requirements
- unnecessary bureaucratic red tape*.
- Voluntary export restriction: foreign firms “voluntarily” limit their exports to a particular amount (e.g. 1990 Canadian lumber producers agreed to VER on exports to USA, under threat of a permanently higher tariff)

* http://en.wikipedia.org/wiki/Red_tape

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Let's return to Botswana

Suppose, when the world price is \$3.00, that the government imposes an **import tariff** of \$1.50 per GWatt. What's the equilibrium price and quantity of electricity? Imports/Exports?

Back to the whiteboard!

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Effects of a Trade Barrier against imports

1. Decline in imports (that's the reason for the barrier)
2. Tariff Revenue (not true for import quota)
3. Increased domestic production (b/c prices increase)
BUT
4. Maybe decline in exports if foreign country increases tariffs too
5. Decreased consumption (b/c prices increase)
6. Higher cost through lost economies of scale
7. Decreased variety of goods

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To sum up

- Barriers usually hurt some people while benefitting others, just like trade itself
- Even if overall effects of barriers are more negative than positive, some people will of course argue for trade barriers.

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Removing Barriers to Trade

All about the World Trade Organization (WTO)

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WTO History in a Nutshell

- Started out as the Reciprocal Trade Agreements act, became the General Agreement on Tariffs and Trade (GATT), mostly among developed nations.
 - Provides a venue for 153 nations to come together, all at once, and discuss trade barriers
 - Reduce tariffs, lower tariffs, trade complaints. (95% of world trade) What it doesn't do: Labor complaints: ILO, environmental: Sovereign rights, UN.

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