

# Introduction

## International Trade

Prof. Harris Dellas

Lecture Slides

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# Outline

- 1 Overview
- 2 Review of trade models
- 3 Trade policy
- 4 Some important issues

# Rise of populism and demagoguery throughout the industrial world



Figure : A bunch of demagogues from all over the political spectrum

## Donald Trump's inauguration speech

- 1 From this day forward, a new vision will govern our land. From this day forward, it's going to be only America first, America first.
- 2 Every decision on trade, ... will be made to benefit American workers and American families. We must protect our borders from the ravages of other countries making our products, stealing our companies and destroying our jobs...
- 3 Protection will lead to great prosperity and strength.
- 4 We will follow two simple rules: Buy American and hire American

# Overview

There are few other areas in economics where ignorance is so great.

Examples:

## 1 International competitiveness

People talk about the competitiveness of a nation as if a nation were a corporation. For the need to improve productivity in order not to be priced out of the world marketplace,

BUT unlike the beliefs contained in the statements above

International trade is not about zero sum competition but about mutually beneficial exchange of goods, services, ideas, practices.

## 2 Protectionism

Commercial policies are typically presented as serving the national interest while in reality they only benefit special interest groups and harm the national interest.

## Subject of this course

To help participants understand:

- 1 why and how much countries trade,
- 2 whom they trade with,
- 3 what goods they import and export,
- 4 how trade affects the allocation of resources and the distribution of income,
- 5 whether countries benefit from international trade, how and how much.

1. and 2. are easy.

- 1 Specialization pays off, even for large countries.
- 2 Trade costs (transportation, information.)  
Gravity: Trade mostly with rich neighbors  
 $T_{ij} = f \{ Y_i, Y_j, D_{ij}, AY_i = \text{income in country } i, D_{ij} = \text{Distance between } i \text{ and } j, A = \text{Country size} \}.$
- 3 Looks sometimes “obvious” (bananas, skiing). But there are many cases where it is not (why is Switzerland and not Germany the major exporter of watches? Why is Belgian beer the best in the world?)  
Much of the course will be devoted to this question.
- 4 Depends on the model of trade (see below).
- 5 Is easy for economists but not so easy for politicians...

## Key questions

What are the implications of international trade for

- the allocation of resources across industries,
- the level and growth of income,
- the level and growth of productivity,
- economic prosperity (national and individual),
- the distribution of income within and across countries.



## Gains from trade

Trade increases consumption opportunities:

- Direct effects (get goods that would have been either unavailable or more expensive)
- Indirect effects (changes in the composition of production, efficiency, productivity, ...)
- Static versus dynamic effects
- Winners and losers (some groups of the population may be hurt from international trade)
- **Key assertion:** In general, free trade makes countries almost always and everywhere better off.
- Pretty much in the same way that trade makes an individual better off.

Many exceptions to this have been claimed in the literature, but their practical relevance seems quite limited.

## **A. Comparative advantage –CA– based models**

The concept of CA involves a comparison across activities across individuals (countries).

Agents A, B, goods (activities),  $x$ ,  $y$ : A has a CA in  $x$  if he has to sacrifice less  $y$  in order to produce it than B.

Different theories about the source of CA

## A.1 Ricardian model

- ▶ CA arises from international differences in technology (productivity).
- ▶ Important point: Comparative vs. Absolute advantage!
- ▶ Key implications:
  - ★ Production specialization
  - ★ International differences in wages reflect differences in productivity.
  - ★ Both high and uniformly low productivity countries benefit from trade.  
The low productivity may even benefit more.
- ▶ Useful for addressing questions like: How can a high wage country compete against a low wage country? Has the ascent of China and India hurt the high wage rich countries?

## A.2 Heckscher-Ohlin model

- ▶ CA arises from differences in the cost of production (which is due to differences in factor endowments: If a country has a lot of unskilled labor, unskilled labor will be relatively cheap and goods that need a lot of unskilled labor will be relatively cheap).
- ▶ Key implications:
  - ★ Incomplete production specialization
  - ★ Trade in goods is a perfect substitute for factor mobility (factor price equalization)
  - ★ Trade has dramatic effects on the distribution of income

### A.3 *Specific factors model*

As in the H-O model, but with some factors being activity specific in the short run.

- ▶ Implications for the distribution of income
- ▶ The Dutch disease
- ▶ Understanding political coalitions
- ▶ Interesting implications that may seem paradoxical. (South Africa under apartheid)

## B. Non CA based models

- Economies of scale
- Imperfect competition
- The role of "luck"

Trade occurs even without CA  $\Rightarrow$  Intra-industry trade.

## Commercial policy

- (a) Effects on national welfare. Distinction between small and large countries
- (b) Effects on the distribution of income and the allocation of resources
- (c) The political economy of protection: Typically special group interest is masqueraded as national interest
- (d) Imperfect competition and free trade: Industrial policy (Air Bus - Boeing)

## Key question:

- Suppose that there exist market failures. Or, that the govt wants to preserve/change income distribution.
- Are trade restrictions a good way to correct market failures/achieve desired income distribution goals?
- A clear NO
- The case of the Swiss farmers
  - ① Trade restrictions (tariffs, quotas,..)
  - ② Production subsidies
  - ③ Direct income support



# Some other important issues

The mechanics and political economy of trade protection.

*Trade, unemployment and the distribution of income in the developed countries - the threat (?) from the NICs (newly industrialized countries).*

- Unemployment has increased during the last 50 years along side trade and capital liberalization. The income distribution has become more uneven.
- Is free trade to be blamed for these developments? Are your wages set in Shanghai?
- Key concept: Footloose, relationship-free jobs.
- Why so much opposition to free trade? Protectionism is bad economics. But pollsters say protectionism is good politics because the few people whose jobs may be affected care very much (so have an incentive to organize and oppose), whereas the scores of millions whose standard of living is improved by trade are not particularly aware of it.

## *Trade and economic growth (development)*

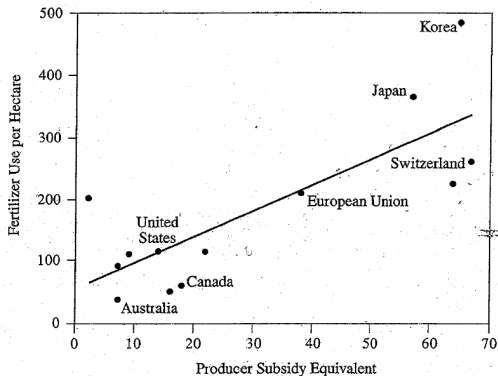
- Strong presumption but it has been difficult empirically to establish it (see the Figs at the end).

## *Trade and the environment*

- Pollution haven vs comparative advantage in manufacturing
- Trade seems to have contributed to cleaner environment by making countries richer.

## Employment Effects of U.S. Trade Protection in Steel in 1984

Industry	Change in employment	
	Percent	Absolute
Primary metal industries	3.61	31,003
Mining	0.34	3,280
Electric, gas, and sanitary services	0.14	1,244
Tobacco manufactures	0.12	78
Finance, insurance, and real estate	0.11	6,108
Printing and publishing	0.09	1,234
Wholesale and retail trade	0.08	12,720
Communication	0.07	965
Transportation	0.07	2,055
Services	0.07	16,177
Leather and leather products	0.06	120
Petroleum and coal products	0.06	117
Government	0.01	2,015
Chemicals and allied products	0.01	125
Textile mill products and apparel	0.01	204
Agriculture, forestry, and fishing	-0.02	-276
Paper and allied products	-0.02	-155
Food and kindred products	-0.03	-480
Instruments and related products	-0.11	-756
Miscellaneous manufacturing industries	-0.19	-746
Stone, clay, and glass products	-0.21	-1,248
Rubber and miscellaneous plastics products	-0.24	-1,882
Lumber and wood products	-0.27	-1,929
Construction	-0.36	-15,763
Electric and electronic equipment	-0.40	-7,464
Fabricated metal products	-0.59	-8,602
Transportation equipment, except motor vehicles and equipment	-0.63	-6,497
Machinery, except electrical	-0.67	-16,914
Furniture and fixtures	-0.70	-3,417
Motor vehicles and equipment	-1.31	-11,311



**Figure 2.6**

Protection of producers and use of fertilizers in agriculture, 1998. (Data from Organization for Economic Cooperation and Development 2000a, table III.5; Food and Agriculture Organization 1998, table 14.)

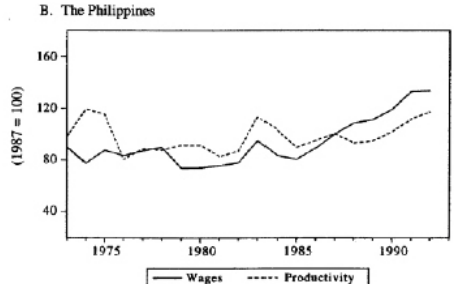
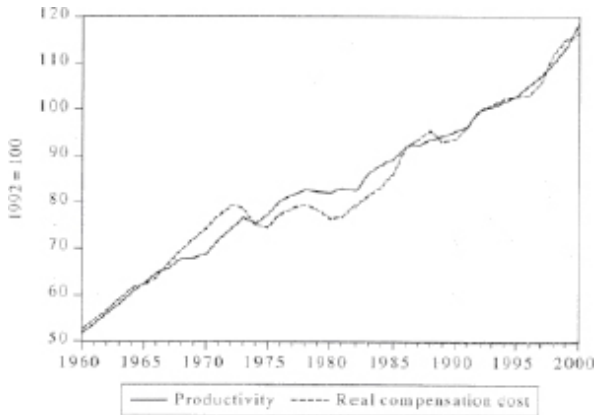
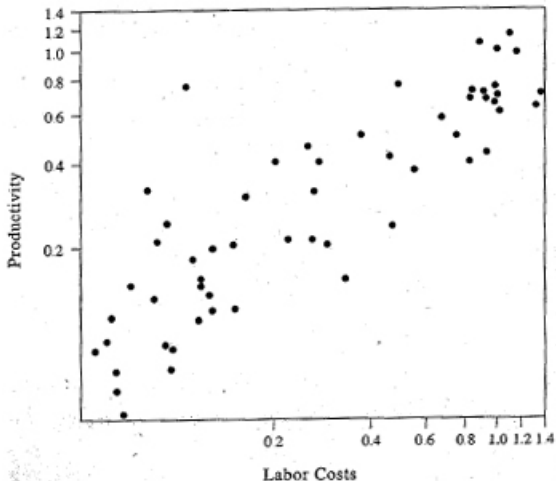


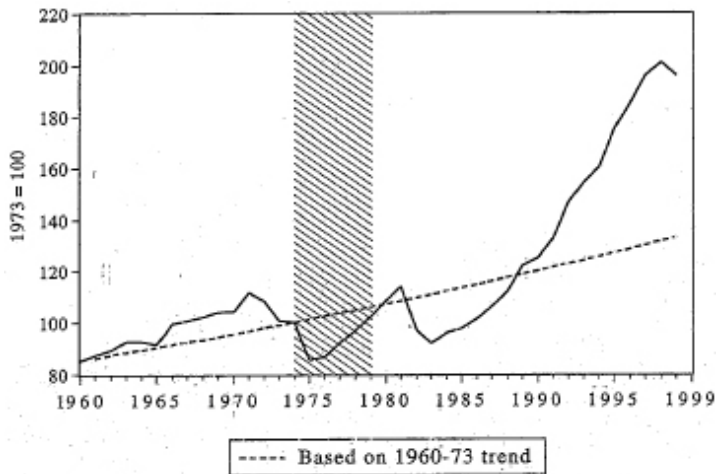
Figure : Real wages and labor productivity in manufacturing, South Korea and the Philippines, 1972-93 (1987=100). (Data from World Bank World Tables.)



**Figure :** Labor productivity and labor compensation costs in the United States, 1960-2000. Productivity is output per hour of all the persons in the business sector. Real compensation is compensation per hour divided by the producer price index of total finished goods. (Data from Council of Economic Advisors, 2001, tables B-49, B-65.)



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**Figure :** Per capita GDP in Chile, 1960-99. The shaded area (1974-79) indicates a major trade reform. (Data from International Monetary Fund 2000.)



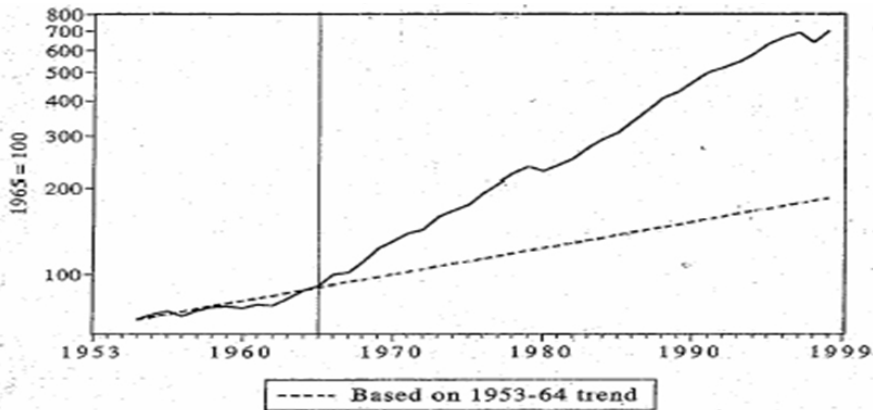
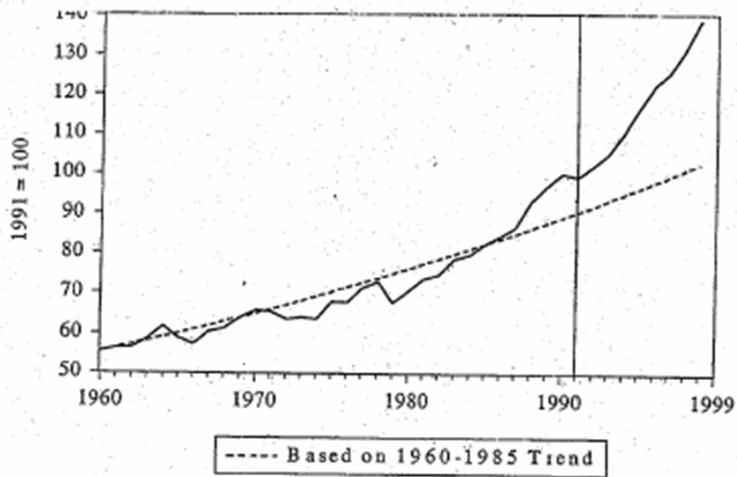


Figure : Per capita GDP in South Korea, 1953-99. A major trade reform was initiated in 1964-65. (Data from International Monetary Fund 2000.)



**Figure :** Per capita GDP in India, 1960-99. The vertical line in 1991 indicates a major trade reform. (Data from International Monetary Fund 2000.)