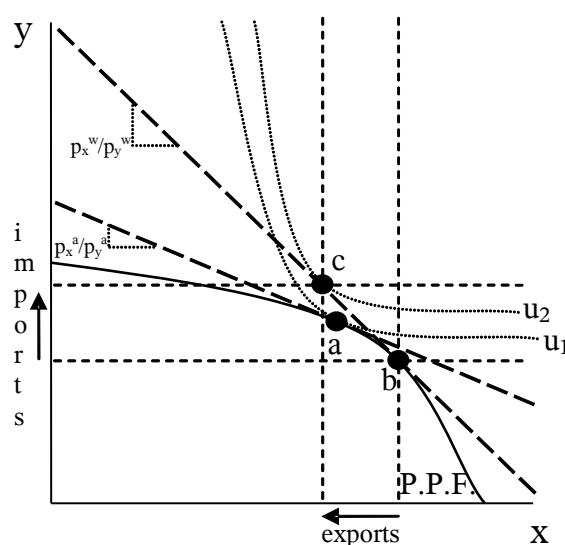


International Trade and Trade Policy

1. Show geometrically how trade liberalization can lead to a society's welfare.

Suppose that there are two goods produced by each country and tradable on the world market (the analysis will generalize to N goods, but we can get a long way by thinking about two goods, say manufactured goods, y , and raw materials, x). It is usual to assume that a country's production possibilities frontier is concave because the marginal cost of producing a good becomes higher as more of it is produced. This is because factors of production are scarce. For example, as all the good farm land and mines are used up, the marginal cost of raw materials will rise, and as all the best sites for factories and skilled workers are used up, the marginal cost of producing manufactured goods will rise. The slope of the P.P.F. is the marginal rate of transformation (MRT) which is the ratio of the marginal cost of good x to the marginal cost of good y (MC_x/MC_y).

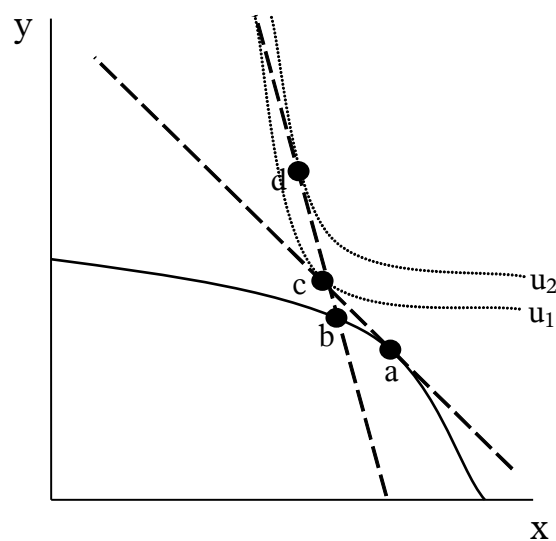
The diagram below illustrates the benefits for a country moving from autarky (no foreign trade) to trading on the world market, where the world prices for the two goods are p_x and p_y respectively. Initially the country produces at point a , yielding utility level u_1 . By producing at point b and trading, the country can consume at point c , yielding the higher utility level u_2 . This country has a **comparative advantage** in producing raw materials at the prevailing world prices. This means that when it is able to trade, it further specializes in producing this good in order to sell it on the world market. The country still produces some manufactured goods domestically, but less than in the autarkic equilibrium; it then imports the rest to get to point c , using its earnings from selling raw materials. Note also that in this particular example, the country consumes less raw materials in the trading equilibrium than it does in the autarkic equilibrium, but more manufactured goods. This would not necessarily have to be the case (i.e. with a different indifference curve map a new optimal bundle could have been chosen close to the bottom of the u_1 curve where more raw materials and less manufactured goods are produced in the trading equilibrium compared to the autarkic equilibrium). Clearly, though, the consumption of at least one of the two goods must increase when the economy is opened to trade, and the country must be raised to an equal or higher indifference curve, since point a is always still available.



2. "Since economic theory implies that countries benefit from free trade, it is hard to understand why anyone might oppose it." Discuss.

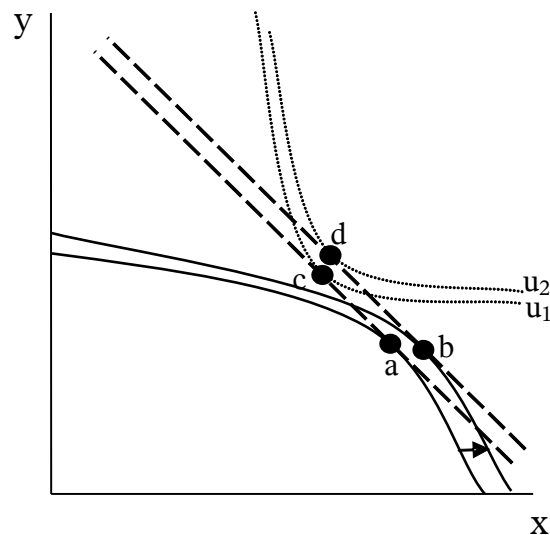
The analysis in question one showed that liberalizing trade will increase national welfare. This suggests that a nation should always support free trade. However, the issues surrounding free trade and globalization are extremely controversial. Even if the opponents of free trade are wrong, we need to explain why some economic actors (whom we should give the benefit of the doubt and assume are rational) would oppose it. Clearly the story told so far is inadequate in some way. The model presented above relied on a number of problematic assumptions. The first is that all individuals in a nation can be aggregated and their preferences represented by a single indifference curve map. This is in fact extremely problematic because actors have different preferences and interests. Therefore changes in trade policy generally create winners *and* losers. In particular, since the opening of trade changes the domestic price ratio from the autarkic p_x^a / p_y^a to the higher world ratio p_x^w / p_y^w then it decreases the relative price of the manufactured goods (good y). This means that any domestic producer of manufactured goods suffers a drop in the price they receive for their goods, and therefore their income and welfare drop. Although in theory the domestic economy could compensate the losers and still make everyone better off, this is more complex to achieve in practice (e.g. how do we help the losers whilst not blunting their incentives to adjust to the new world prices – more benefits certainly won't do it, although government funded retraining schemes might).

The second problematic assumption is that the world prices are unaffected by whether or not the domestic economy is opened up to trade. If a country provides a significant proportion of the world demand, then by restricting output below the free trade competitive equilibrium it may be able to increase national utility. In the diagram below, by restricting its output of raw materials from point a to point b, the country is able to drive up the relative price of raw materials sufficiently to lead to increased welfare u_2 , by moving the consumption bundle from c to d. This scenario may have some relevance to third world economies producing raw materials (it may not be in their national interest to fully specialize as much as the world market prices would suggest because this will make the raw materials prices too low and reduce national welfare). It is probably especially useful for understanding the situation of oil producing Arab nations. It is in their interest to restrict their production of oil below capacity in order to keep world prices higher than they would otherwise be.



Another factor that has been missed out is the effect of liberalising capital markets and the impact this can have on national productivity. We would expect allowing international capital movements to improve the productivity of all countries

by leading to a more efficient allocation of capital. This would thus cause an expansion of the domestic P.P.F. If world prices are unaffected by the change in domestic supply, then expanding the P.P.F. cannot harm a country, because every consumption option that was previously available is still available, plus more are also available. If the new P.P.F. lies strictly above the old one at every point, then national welfare will unambiguously increase:



Suppose, on the other hand, that opening up the domestic economy would cause foreign investment to lead to an increase in productivity in the raw materials sector. This would be represented by a “biased” expansion of the P.P.F. If the domestic country was supplying a large proportion of the world market for that particular good, then this output expansion could also lead to a decrease in the relative world price of the raw materials (good x). If this price decrease was large enough, the domestic economy could actually be made worse off by being opened up to international investment. For example, in the diagram below, the expanded P.P.F. leads to an increased output of raw materials (movement from a to b), which also causes a drop in the world price of good x. Whereas consumption point d was affordable before the productivity improvement, only point c is available after.

