International Trade Policy, Comparative Advantage and Outsourcing

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Chapter Goals

* Present some important data of trade

- Explain the principle of comparative advantage
- Discuss three determinants of the terms of trade
- Explain why economists' and laypeople's views of trade differ

Chapter Goals

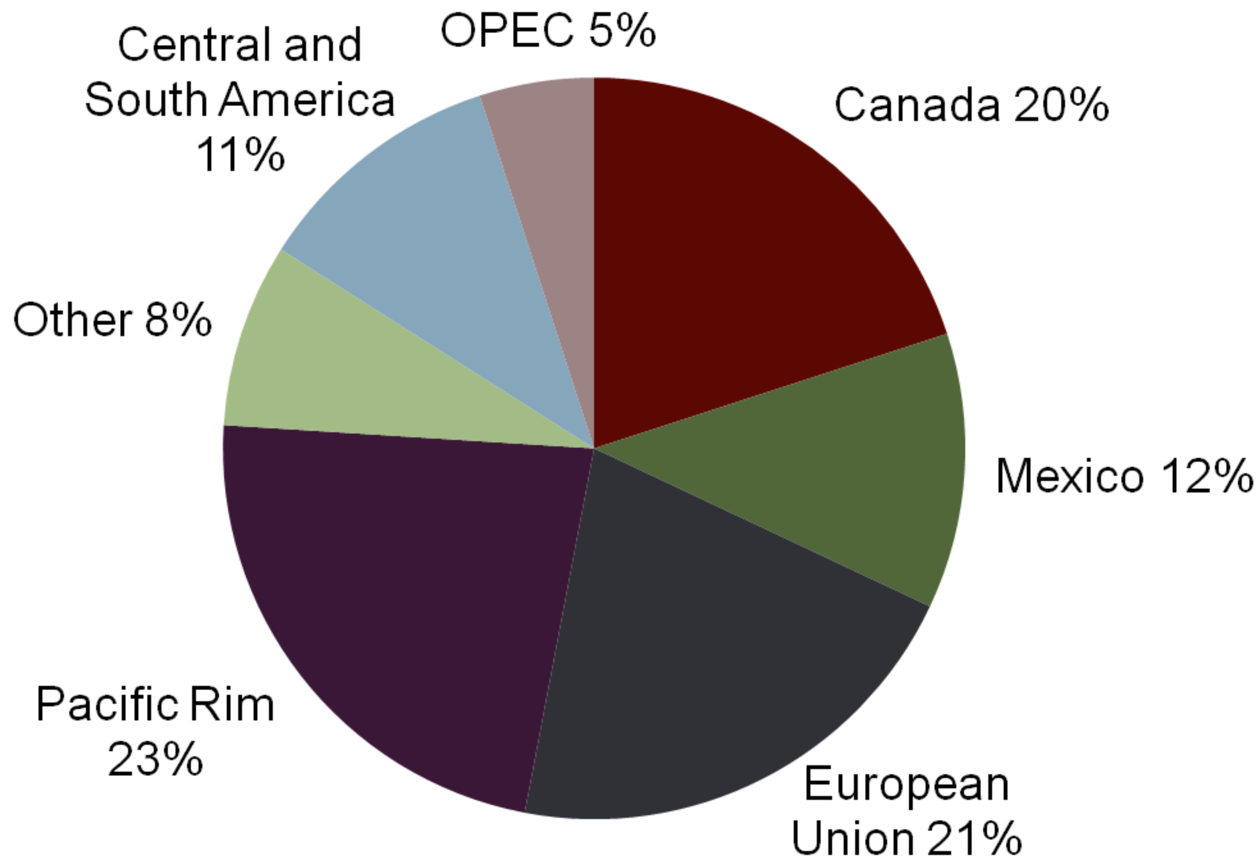
- Distinguish between inherent and transferable comparative advantages
- Discuss three policies countries use to restrict trade
- Explain why economists generally oppose trade restrictions
- Explain how free trade associations both help and hinder international trade

Patterns of Trade

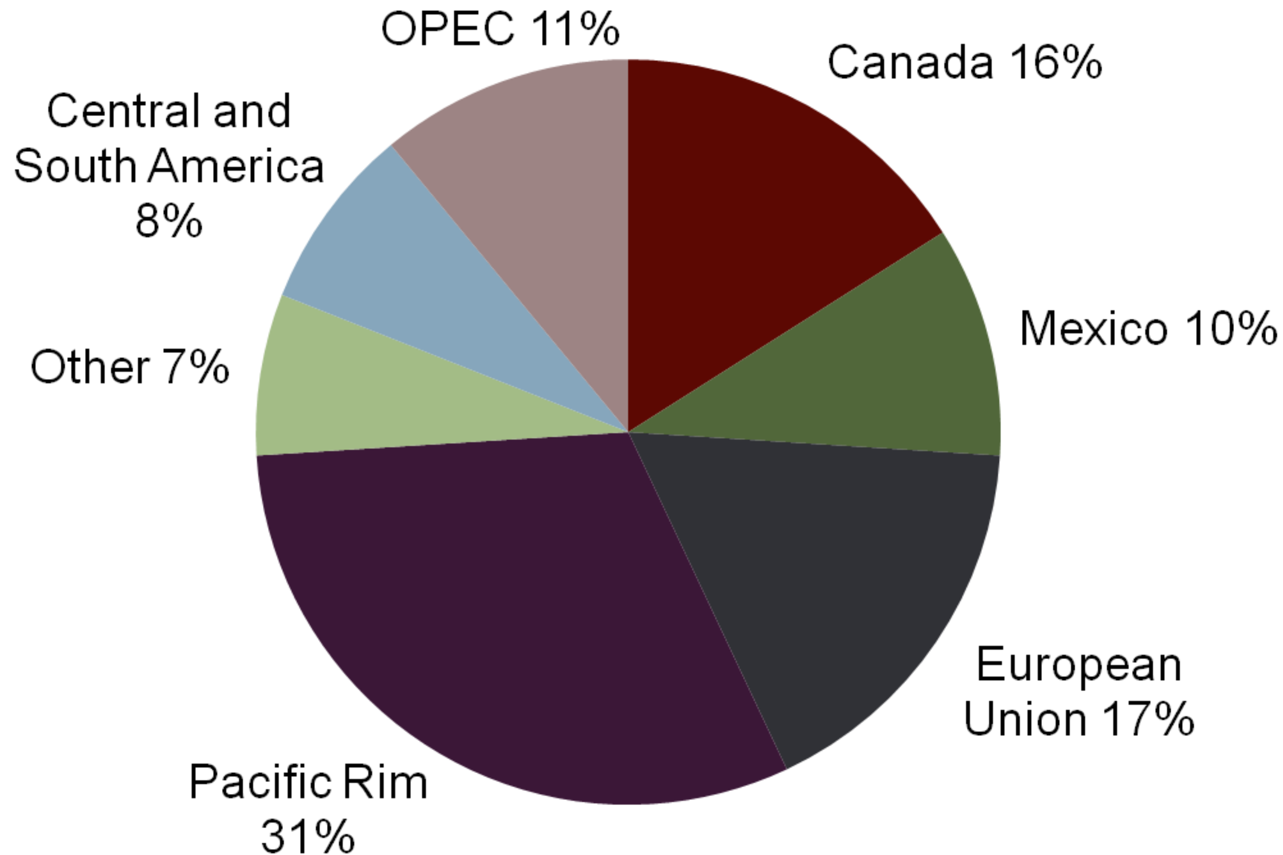
Differences in the importance of trade

	Total Output ($)	Export Ratio (%)	Import Ratio (%)
Netherlands	754	74	66
Germany	3,279	45	40
Canada	1,326	38	34
Italy	2,107	28	29
France	2,562	27	28
United Kingdom	3,280	29	33
Japan	4,377	14	13
United States	14,264	11	16

U.S. Exports by Region, 2008



U.S. Imports by Region, 2008



The Changing Nature of Trade

* As technological changes in telecommunications reduce costs, foreign countries will be able to provide more services
  - The nature of trade is continually changing, both in terms of the countries with which the U.S. trades and the goods and services traded
  - Customer service calls for U.S. companies are now more frequently answered in India
  - This trade in services is often called **outsourcing**

The Changing Nature of Trade

* Using overseas suppliers is not a new development in trade

Is Chinese and Indian outsourcing different than previous outsourcing?

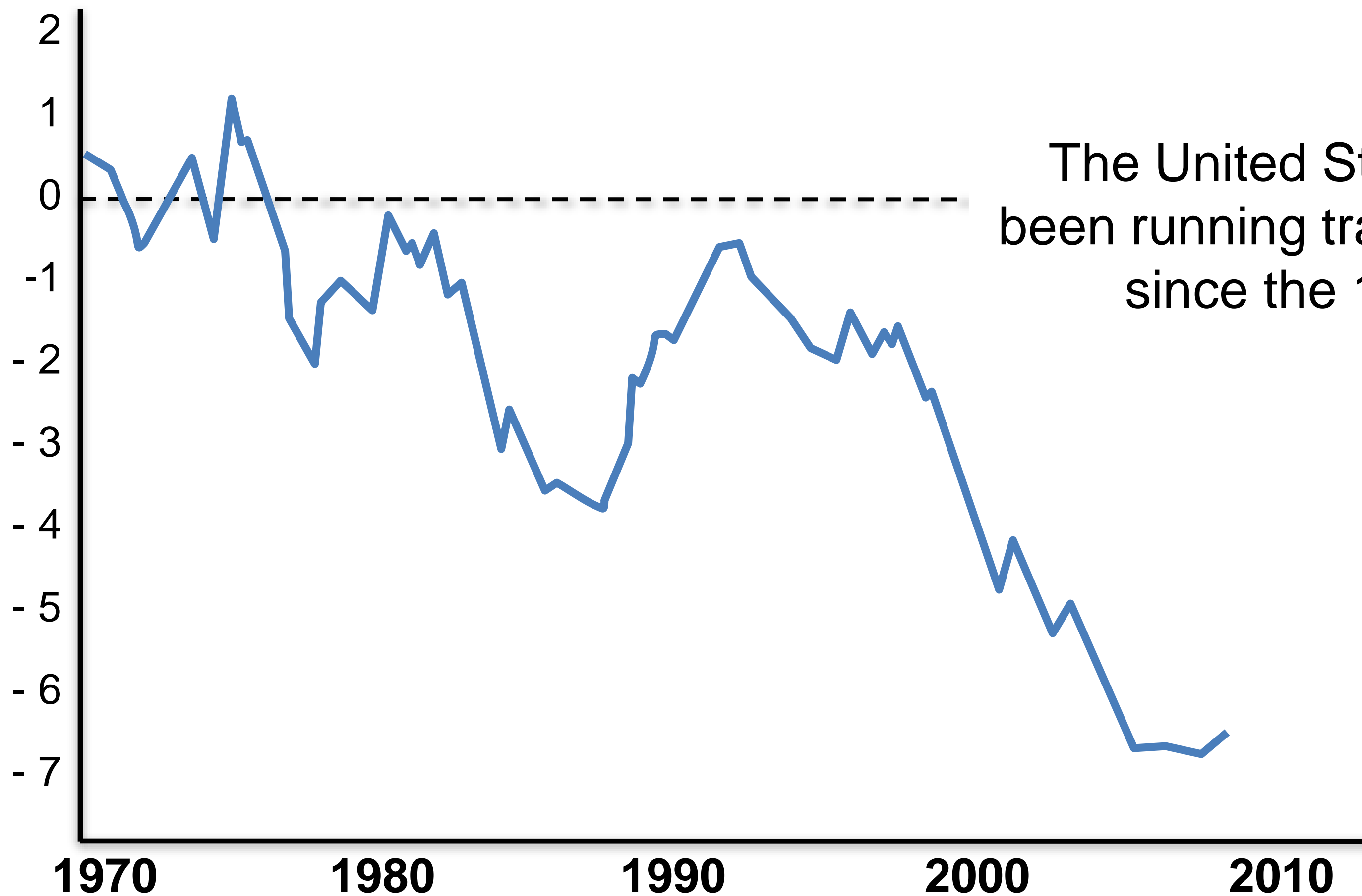
- The difference is the potential size of outsourcing to India and China with combined populations of 2.5 billion people
- Because technology is growing in these countries, the U.S. economy must develop new technologies to remain competitive

Balance of Trade

* Trade deficit = exports < imports
* Trade surplus = exports > imports

- The **balance of trade** is the difference between the value of exports and the value of imports
- The U.S. has a significant trade deficit of approximately $820 billion which is 5.5% of GDP
- The U.S. is financing its trade deficit by selling off financial assets, stocks and bonds, and real assets, corporations and real estate

Balance of Trade



The United States has been running trade deficits since the 1970s

Debtor and Creditor Nations

* The U.S. is currently financing its trade deficit by selling off assets

  - Running a deficit isn't necessarily bad

  - The U.S. has not always had a trade deficit, following WWII, it had trade surpluses

  - The U.S. has gone from a large creditor nation to being a large debtor nation, international considerations have been forced on the nation

The Principle of Comparative Advantage

* **Opportunity cost** is what must be given up in one good in order to get another good

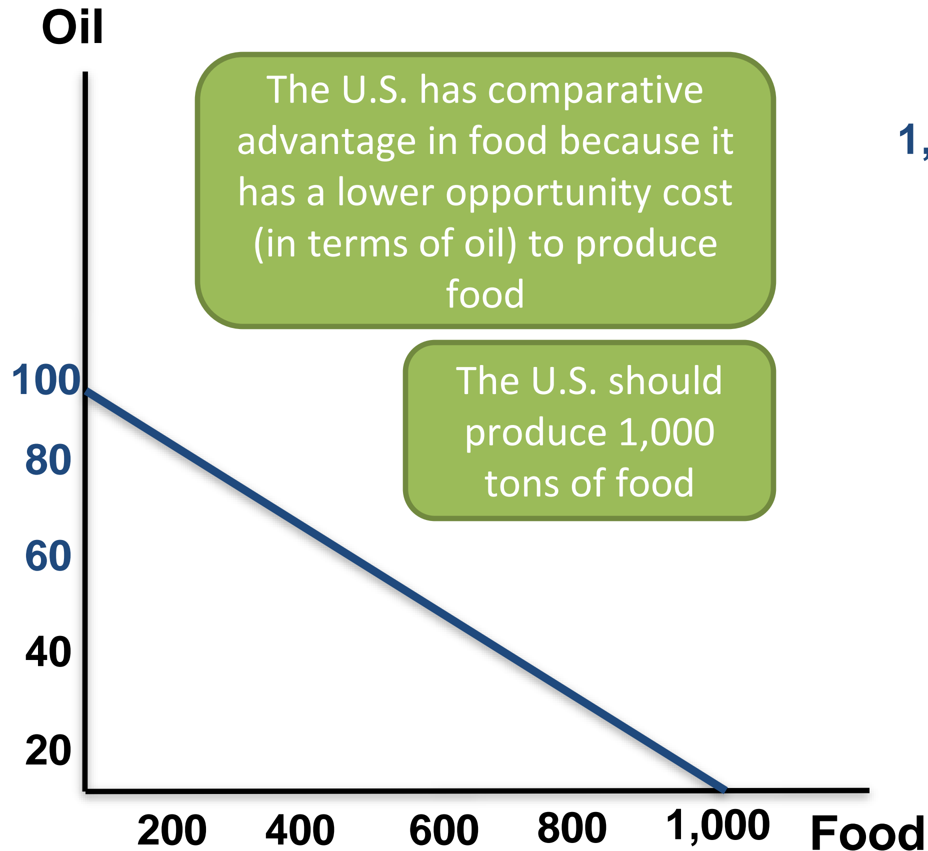
  - The principle of **comparative advantage** is that as long as the relative opportunity costs of producing goods differ among countries, then there are potential gains from trade

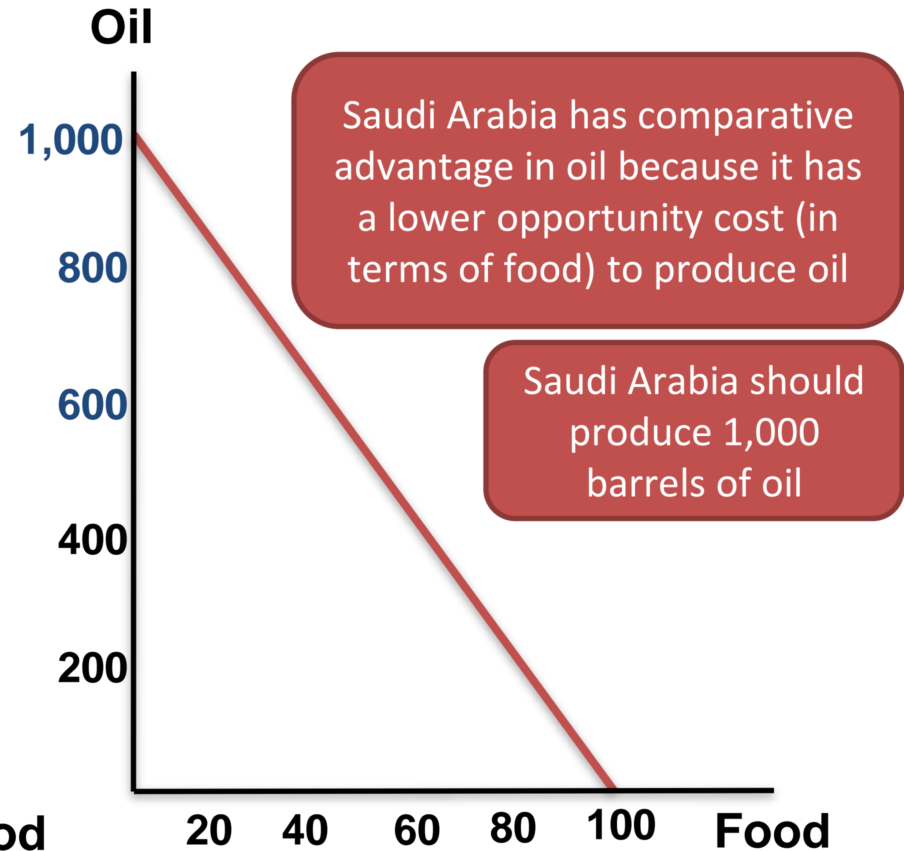
Application: Comparative Advantage

United States			Saudi Arabia		
% of resources devoted to oil	Oil produced (barrels)	Food produced (tons)	% of resources devoted to oil	Oil produced (barrels)	Food produced (tons)
100	100	0	100	1,000	0
80	80	200	80	800	20
60	60	400	60	600	40
40	40	600	40	400	60
20	20	800	20	200	80
0	0	1,000	0	0	100

Who has comparative advantage in production of oil? Food?

Application: Comparative Advantage



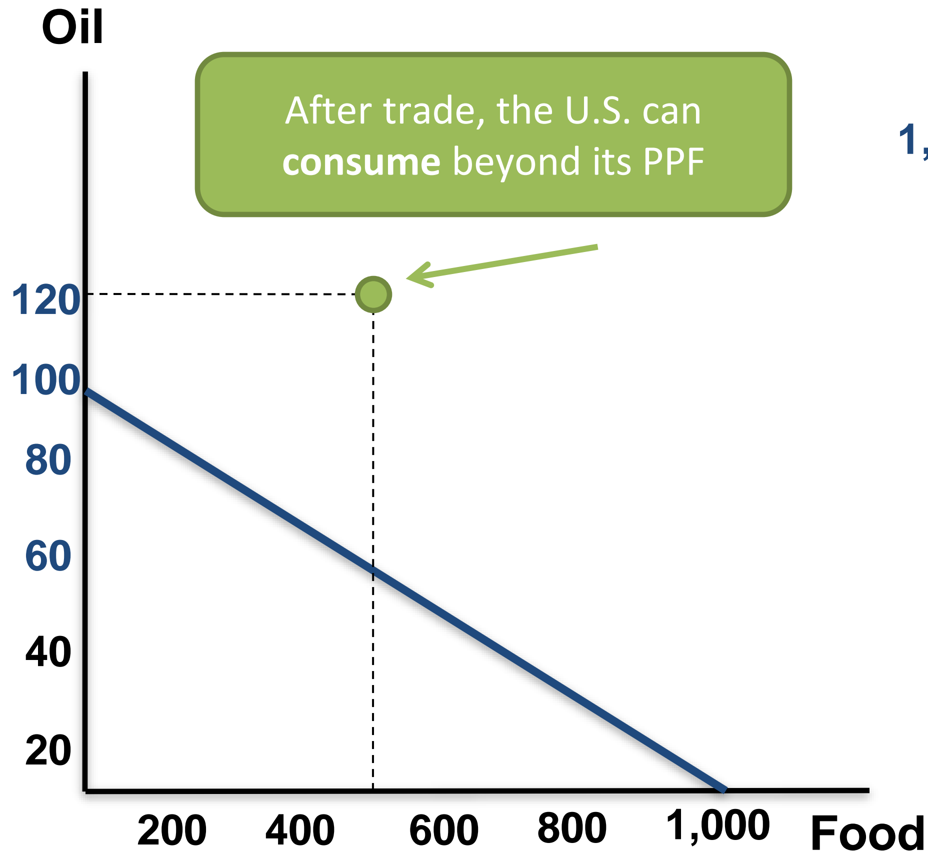


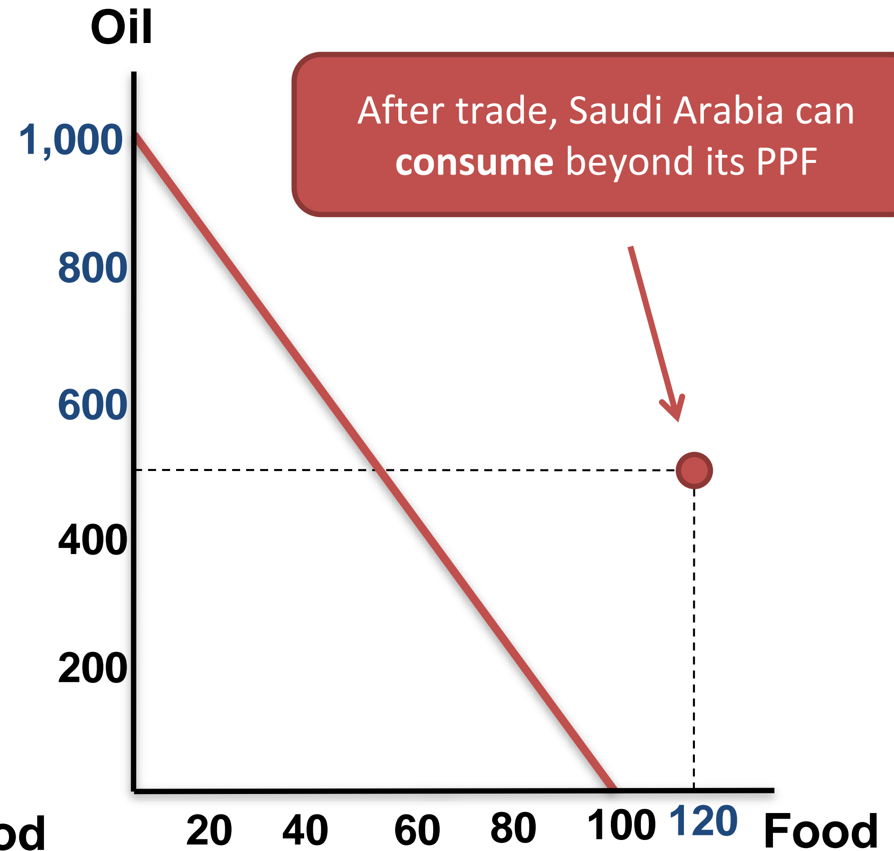
Application: The Gains from Trade

	Production		Consumption		
	U.S.	Saudi Arabia	U.S.	Saudi Arabia	I.T.
Oil (barrels)	0	1,000	120	500	380
Food (tons)	1,000	0	500	120	380

- I.T. keeps 380 barrels of oil and 380 tons of food
- A trader, I.T., arranges for Saudi Arabia to trade 500 barrels of oil to the U.S. for 120 tons of food
- The U.S. will trade 500 tons of food to Saudi Arabia for 120 barrels of oil

Application: The Gains from Trade





Dividing Up the Gains from Trade

Three determinants of the terms of trade are:

1. The more competition among traders, the less the trader gets
2. Smaller countries get a larger proportion of the gain than larger countries
3. Countries producing goods with economies of scale get a larger gain from trade

Comparative Advantage in Today's Economy

* The gains of trade, lower prices, are harder to see than the cost, lost jobs

If trade is good, why do so many people oppose it?

- The public believes that lower wages in other countries give them the comparative advantage in everything, so we will lose all jobs
- Laypeople often think of trade as trade only in manufactured goods

Comparative Advantage in Today's Economy

* Trade increases income abroad, increasing demand for U.S. exports
- The U.S. has a comparative advantage in facilitating trade, which generates jobs in the United States in research, management, advertising, and the distribution of goods
- The concentrated nature of the costs of trade and the dispersed nature of benefits present a challenge to policy makers

Other Sources of Comparative Advantage

* U.S. physical and technological infrastructure is the best in the world

- Wealth from past production and borrowing allows the U.S. to be the world's largest consumer
- U.S. companies hold a large number of intellectual property rights
- The U.S. has a relative open immigration policy

Some Concerns about the Future

* **Transferable comparative advantages** are based on factors that can change relatively easily, such as capital, technology, and types of labor

Inherent and transferable comparative advantage

- **Inherent comparative advantages** are based on factors that are relatively unchangeable, such as resources and climate
- Whether a country can maintain a much higher standard of living in the long run depends in part on whether its comparative advantage is inherent or transferable

Some Concerns about the Future

* If factor prices aren't equal, firms reduce costs by reorganizing production in countries with lower factor prices

The law of one price

- **The law of one price** means that in a competitive market there will be pressure for equal factors to be priced equally
- **The convergence hypothesis** is the tendency of economic forces to eliminate transferable comparative advantage.

Some Concerns about the Future

* Wages rise in the surplus countries, making their goods more expensive

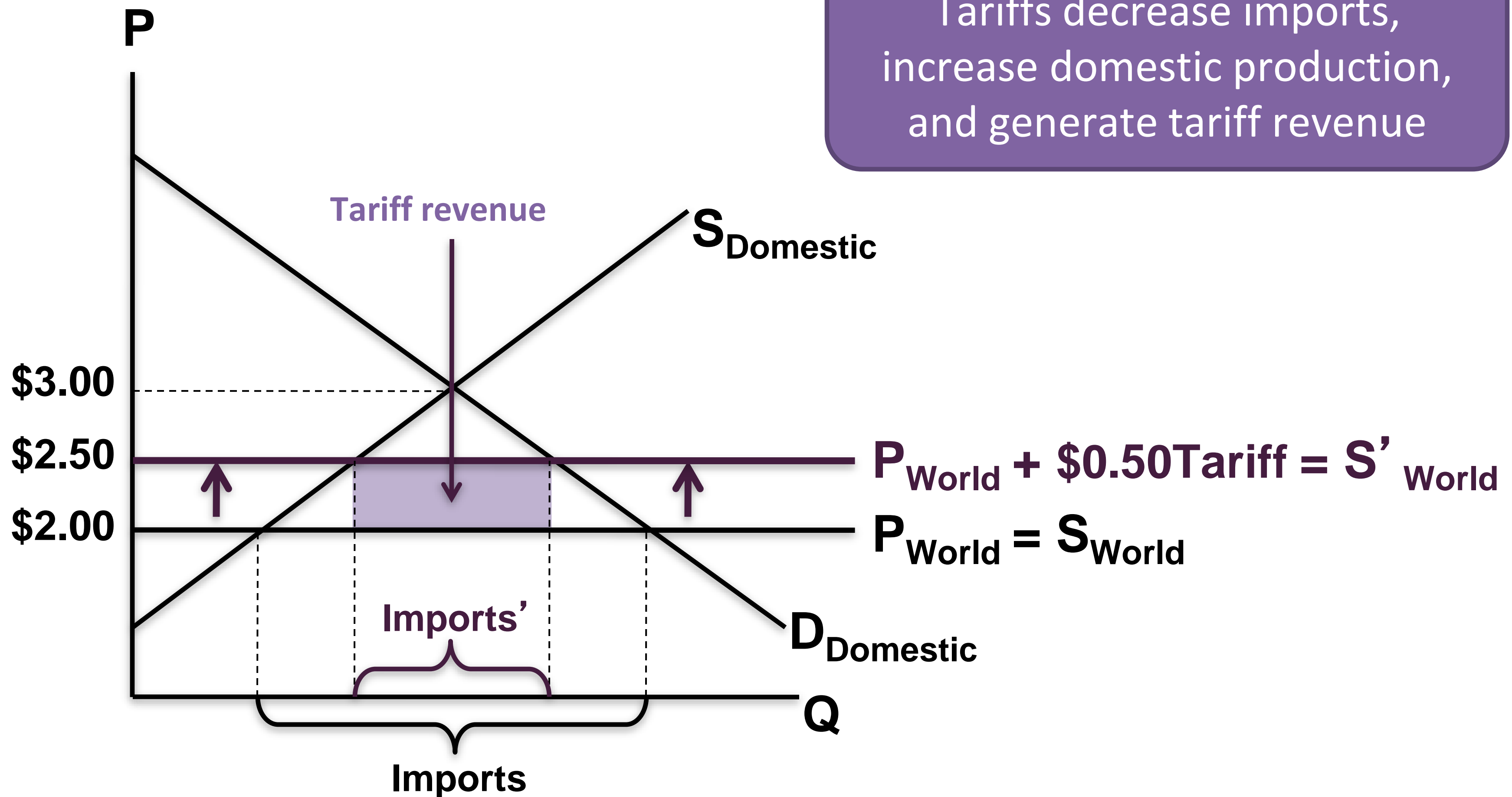
Methods of equalizing trade balances

- Adjustments eventually occur to make surplus countries less competitive and deficit countries more competitive
- The exchange rate of the deficit country falls and makes its goods less expensive

Varieties of Trade Restrictions

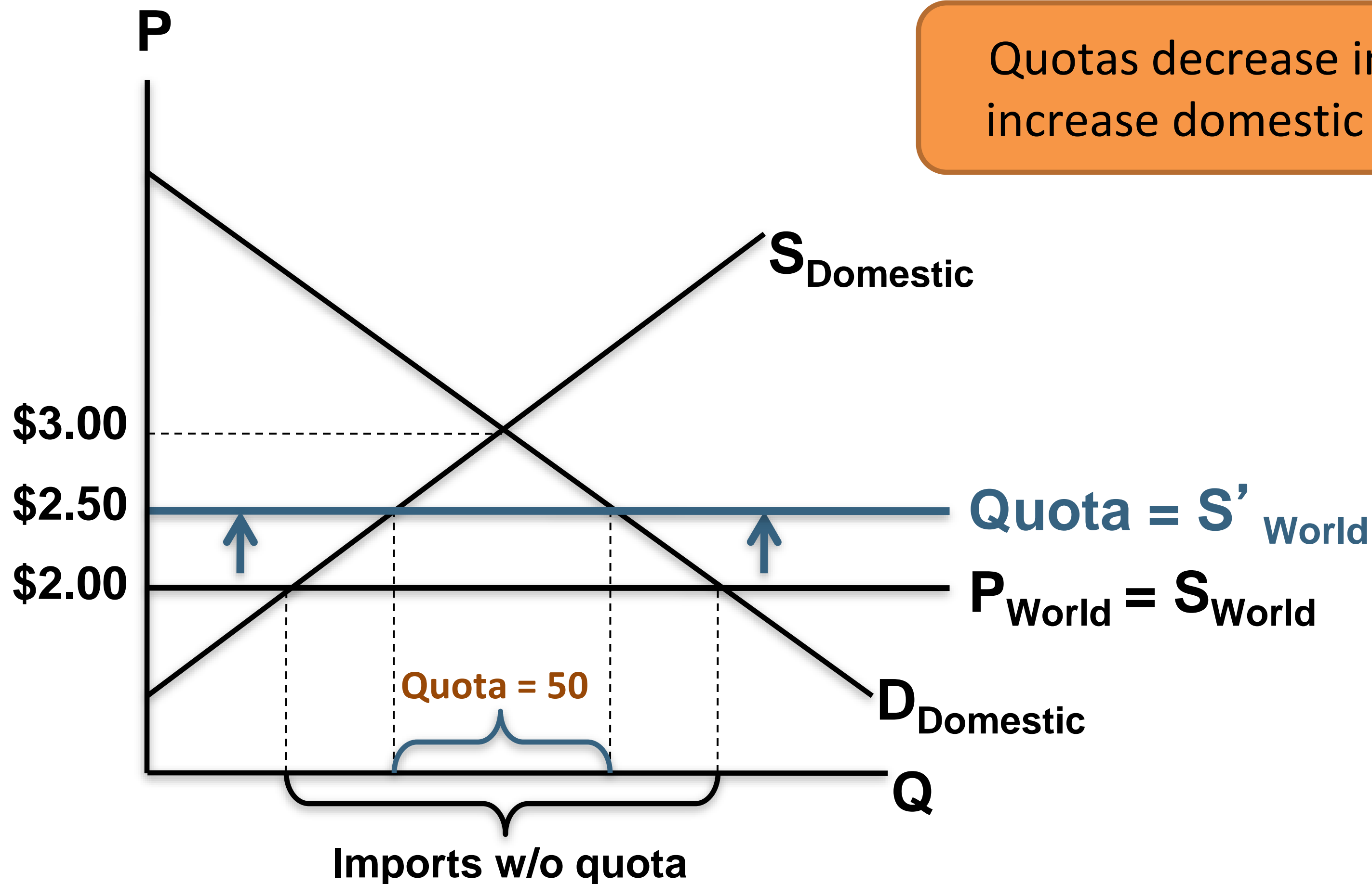
- **Quotas** are quantity limits placed on imports
- **Tariffs** are taxes governments place on internationally traded goods (generally imports)
- **Voluntary restraint agreements** are when countries voluntarily restrict their exports
- An **embargo** is a total restriction on the import or export of a good
- **Regulatory trade restrictions** are government-imposed procedural rules that limit imports
- **Nationalistic appeals**, such as "Buy American" can help to restrict international trade

Application: Tariffs when the domestic country is small



Application: Quotas when the domestic country is small

Quotas decrease imports and increase domestic production



Reasons for Trade Restrictions

* Haggling by companies over the gains from trade

- Unequal internal distribution of the gains from trade
- Haggling by countries over trade restrictions
- Specialized production
- Learning by doing and economies of scale
- Macroeconomic aspects of trade
- National security
- International politics
- Increased revenue brought in by tariffs

Why Economists Generally Oppose Trade Restrictions

* International trade provides competition for domestic companies

- From a global perspective, free trade increases total output
- Restrictions based on national security are often abused or evaded
- Trade restrictions are addictive

Institutions Supporting Free Trade

* E.g. the European Union (EU) and the North American Free Trade Association (NAFTA)

- **The World Trade Orgainization (WTO)** has about 150 members
- **Free trade associations** are groups of nations that allow free trade among members and put up trade barriers against all other nations.
- Countries strengthen trading relationships with **most-favored nation status** – those countries will be charged as low a tariff on exports as any other country

Chapter Summary

- The nature of trade is continually changing
- The U.S. is importing more and more high-tech goods and services from India and China and other East Asian countries
- Outsourcing, a form of trade, is a larger phenomenon today compared to 30 years ago because the countries where jobs are outsourced – China and India – are much larger

Chapter Summary

- According to the principle of comparative advantage, as long as the relative opportunity costs of producing goods differ among countries, there are potential gains from trade
- The more competition exists in international trade, the less the trader gets and the more the involved countries get
- Once competition prevails, smaller countries tend to get a larger percentage of the gains from trade than do larger countries
- Gains from trade go to countries that produce goods that exhibit economies of scale

Chapter Summary

- The gains from trade in the form of low consumer prices tend to be widespread and not easily recognized, while the costs in jobs lost tend to be concentrated and readily identifiable
- The United States has comparative advantages due to its skilled workforce, its institutions, and its language, among other things
- The U.S. established comparative advantages during the two world wars, which are slowly eroding

Chapter Summary

- Trade restrictions include tariffs and quotas, embargoes, voluntary restraint agreements, regulatory trade restrictions, and nationalistic appeals
- Economists generally oppose trade restrictions because of the history of trade restrictions and their understanding of the advantages of free trade
- The World Trade Organization is an international organization committed to reducing trade barriers
- Free trade associations, such as the European Union, help trade by reducing barriers to trade among member nations