


MACRO  
**31**  **International Trade Policy**

After studying this chapter,  
 you will be able to

- Explain how markets work with international trade and identify its winners and losers
- Explain the effects of international trade barriers
- Explain and evaluate arguments used to justify restricting international trade

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### ◆ Global Markets in Action

iPods, Wii games, and Roots sweaters are just three of the items you might buy that are not produced in Canada.

In fact, most of the goods that you buy are produced abroad and transported here in container ships or cargo jets.

And it's not only goods produced abroad that you buy—it is services too.

All these activities are part of the globalization process that is having a profound effect on our lives.

Why do we go to such lengths to trade and communicate with others in faraway places?

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### ◆ How Global Markets Work

Because we trade with people in other countries, the goods and services that we can buy and consume are not limited by what we can produce.

**Imports** are the good and services that we buy from people in other countries.

**Exports** are the goods and services we sell to people in other countries.

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How Global Markets Work

International Trade Today

Global trade today is enormous.

In 2008, global exports and imports were \$35 trillion, which is more than half the value of global production.

In 2008, total Canadian exports were \$535 billion, which is about 34 percent of the value of Canadian production.

In 2008, total Canadian imports were \$503 billion, which is about 32 percent of the value of Canadian production.

Services are 13 percent of total Canadian exports and 18 percent of total Canadian imports.

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How Global Markets Work

What Drives International Trade?

The fundamental force that generates trade between nations is *comparative advantage*.

The basis for comparative trade is divergent opportunity costs between countries.

*National comparative advantage* as the ability of a *nation* to perform an activity or produce a good or service at a lower opportunity cost than *any other nation*.

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How Global Markets Work

The opportunity cost of producing a T-shirt is lower in China than in Canada, so China has a comparative advantage in producing T-shirts.

The opportunity cost of producing a regional jet is lower in Canada than in China, so Canada has a comparative advantage in producing regional jets.

Both countries can reap gains from trade by specializing in the production of the good at which they have a comparative advantage and then trading.

Both countries are better off.

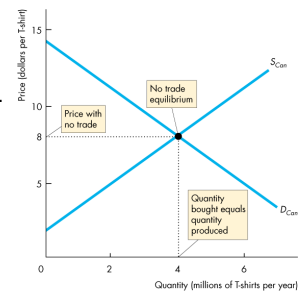
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How Global Markets Work

Figure 7.1(a) shows Canadian demand and Canadian supply with no international trade.

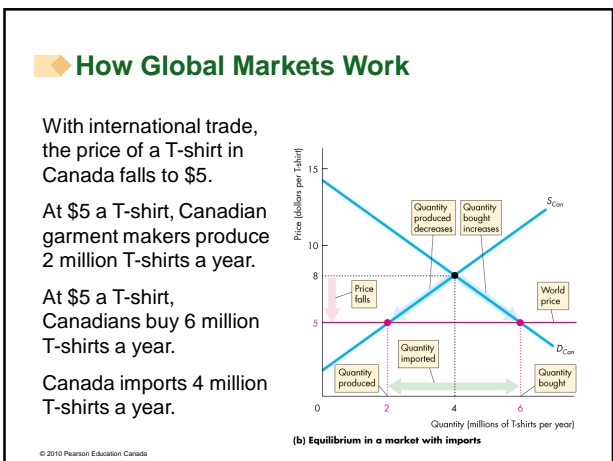
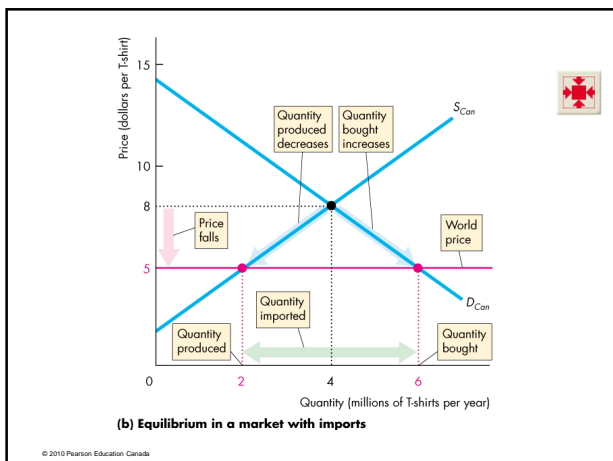
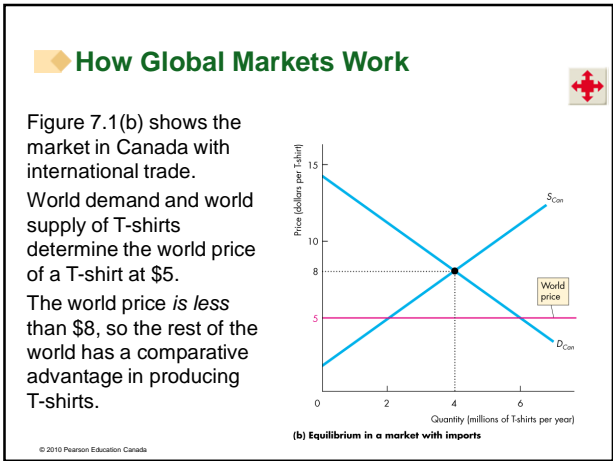
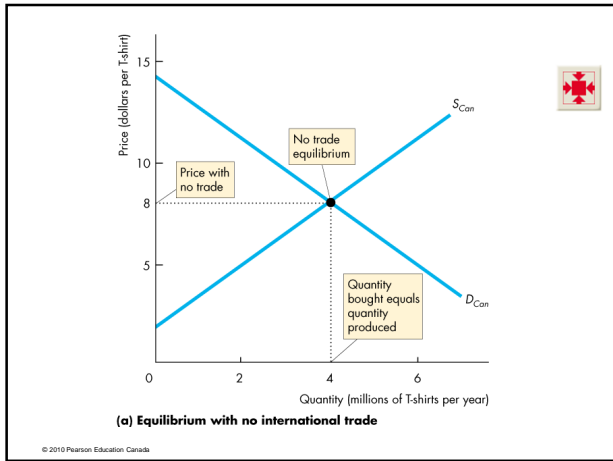
The price of a T-shirt at \$8.

Canadian firms produce 4 million T-shirts a year and Canadian consumers buy 4 million T-shirts a year.



(a) Equilibrium with no international trade

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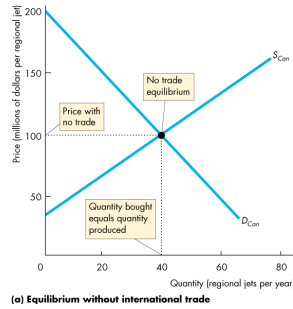
How Global Markets Work

Why Canada Exports Regional Jets

Figure 7.2(a) shows Canadian demand and Canadian supply with no international trade.

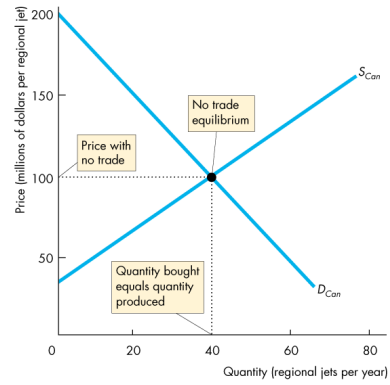
The price of a jet at \$100 million.

Bombardier produces 40 regional jets a year and Canadian airlines buy 40 a year.



(a) Equilibrium without international trade

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(a) Equilibrium without international trade

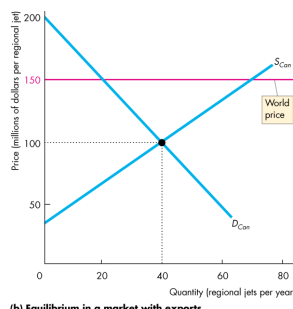
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How Global Markets Work

Figure 7.2(b) shows the market in Canada with international trade.

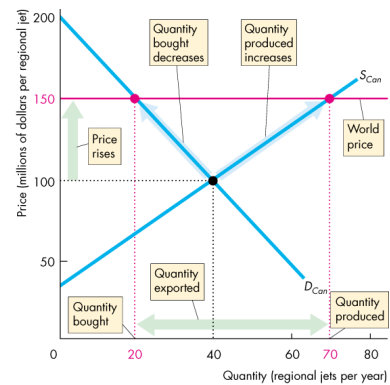
World demand and world supply of jets determine the world price of a regional jet at \$150 million.

The world price exceeds \$100 million, so Canada has a comparative advantage in producing regional jets.



(b) Equilibrium in a market with exports

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(b) Equilibrium in a market with exports

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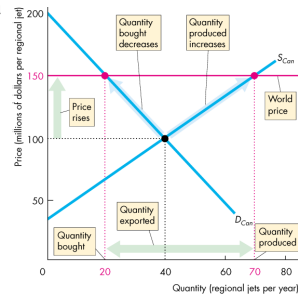
How Global Markets Work

With international trade, the price of a jet in Canada rises to \$150 million.

At \$150 million, Canadian airlines buy 20 jets a year.

At \$150 million, Bombardier produces 70 regional jets a year.

Canada exports 50 regional jets a year.



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(b) Equilibrium in a market with exports

How Global Markets Work

Winners and Losers from International Trade

International trade lowers the price of an imported good and raises the price of an exported good.

Buyers of imported goods benefit from lower prices and sellers of exported goods benefit from higher prices.

But some people complain about international competition: not everyone gains.

Who wins and who loses from free international trade?

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How Global Markets Work

Gains and Losses from Imports

We measure the gains and losses from imports by examining their effect on

- The price paid and the quantity bought by domestic consumers
- The effect on the price received and the quantity sold by domestic producers.

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How Global Markets Work

Consumers' Gain from Imports

A country freely imports something when the rest of the world has a comparative advantage at producing that item.

With free trade, the price paid by the consumer falls and the quantity bought increases.

The consumer gains.

The greater the fall in price and increase in quantity bought, the greater is the gain to the consumer.

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### ▶ How Global Markets Work

#### Domestic Producers Lose from Imports

Compared to a situation with no international trade, the price received by a domestic producer of an item that is imported falls.

Also the quantity sold by the domestic producer of an item that is imported decreases.

Because the domestic producer of an item that is imported sells a smaller quantity and for a lower price, this producer loses from international trade.

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### ▶ How Global Markets Work

#### Gains and Losses from Exports

We can measure the gains and losses from exports by looking their effect on

- The price paid and quantity bought by domestic consumers
- The price received and quantity sold by domestic producers

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### ▶ How Global Markets Work

#### Domestic Consumers Lose from Exports

A country exports something to the rest of the world when it has a comparative advantage at producing that item.

With free trade, the price paid by the consumer rises and the quantity bought in the domestic economy decreases.

The domestic consumer loses.

The greater the rise in the price and decrease in the quantity bought, the greater is the consumers' loss.

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### ▶ How Global Markets Work

#### Domestic Producers Gain from Exports

Compared to a situation with no trade, the price received by a domestic producer of an item that is imported rises.

Also, the quantity sold by the domestic producer of a good or service that is also exported increases.

Because the domestic producer of an item that is exported sells a larger quantity and for a higher price.

This producer gains from international trade.

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## How Global Markets Work

### Net Gain

Producers of exported goods and consumers of imported goods *gain*.

Consumers of exported goods and domestic producers of imported goods lose.

But the gains exceed the losses. Net gain is positive.

With imported goods, the consumer gains what the producer loses and even more on the cheaper imports.

With exported goods, the producer gains what the consumer loses and even more on the items it exported.

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## International Trade Restrictions

Governments restrict international trade to protect domestic producers from competition.

Governments use four sets of tools:

- Tariffs
- Import quotas
- Other import barriers
- Export subsidies

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## International Trade Restrictions

### Tariffs

A **tariff** is a tax on a good that is imposed by the importing country when an imported good crosses its international boundary.

For example, the government of India imposes a 100 percent tariff on wine imported from Canada.

So when an Indian wine merchant imports a \$10 bottle of Ontario wine, he pays the Indian government \$10 import duty.

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## International Trade Restrictions

### The Effects of a Tariff

With free international trade, the world price of a T-shirt is \$5 and Canada imports 4 million T-shirts a year.

Imagine that Canada imposes a tariff of \$2 on each T-shirt imported.

The price of a T-shirt in Canada rises by \$2.

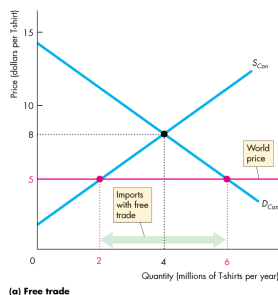
Figure 7.5 shows the effect of the tariff on the market for T-shirts in Canada.

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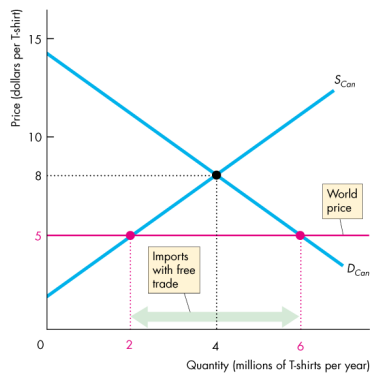
### International Trade Restrictions

Figure 7.5(a) shows the market before the government imposes the tariff.

The world price of a T-shirt is \$5.  
 With free international trade, Canada imports 4 million T-shirts a year.



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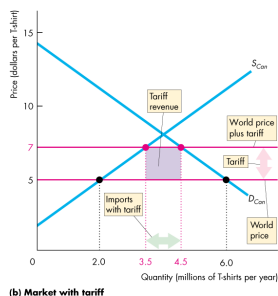
### International Trade Restrictions

Figure 7.5(b) shows the effect of a tariff on imports.

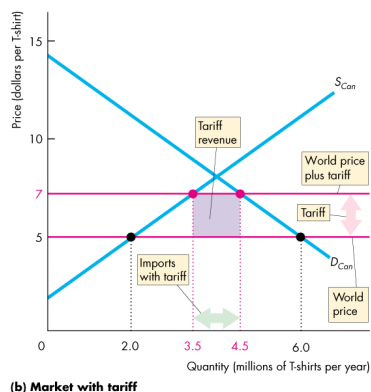
The tariff of \$2 raises the price in Canada to \$7.

Canadian imports decrease to 1 million a year.

Canadian government collects the tax revenue of \$2 million a year.



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## International Trade Restrictions

### Winners, Losers, and Social Loss from a Tariff

When the Canadian government imposes a tariff on imported T-shirts:

- Canadian consumers of T-shirts lose.
- Canadian producers of T-shirts gain.
- Canadian consumers lose more than Canadian producers gain.
- Society loses.

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## International Trade Restrictions

### Canadian Consumers of T-shirts Lose

Canadian buyers of T-shirts now pay a higher price (the world price plus the tariff), so they buy fewer T-shirts.

The combination of a higher price and a smaller quantity bought decreases consumer surplus.

The Canadian consumer loses from the tariff.

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## International Trade Restrictions

### Canadian Producers of T-shirts Gain

Canadian garment makers can now sell T-shirts for a higher price (the world price plus the tariff), so they produce more T-shirts.

But the marginal cost of producing a T-shirt is less than the higher price, so the producer gains.

Canadian garment makers gains from the tariff.

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## International Trade Restrictions

### Canadian Consumers Lose More than Canadian Producers Gain: Society Loses

Consumers lose from the tariff because

- 1.They pay a higher price to the domestic producer.
- 2.They buy a smaller quantity.
- 3.They pay a tariff revenue to the government.

*Social loss* arises because part of the higher price paid to domestic producers pays for the higher cost of domestic production and from the smaller quantity bought at the higher price.

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### International Trade Restrictions

#### Import Quotas

An **import quota** is a restriction that limits the maximum quantity of a good that may be imported in a given period.

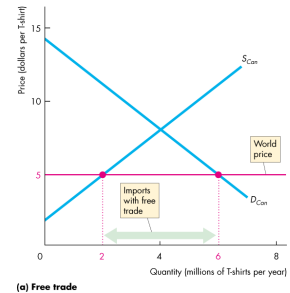
For example, Canada imposes import quotas on food products such as meat, eggs, and dairy products and manufactures such as steel.

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### International Trade Restrictions

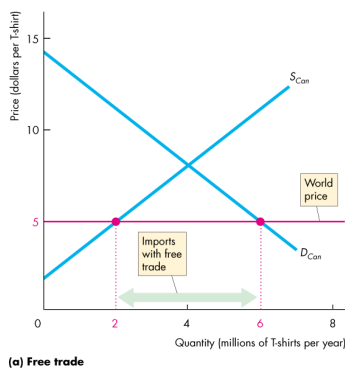
Figure 7.7(a) shows the market before the government imposes an import quota on T-shirts.

The world price is \$5 and Canada imports 4 million T-shirts a year.



(a) Free trade

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(a) Free trade

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### International Trade Restrictions

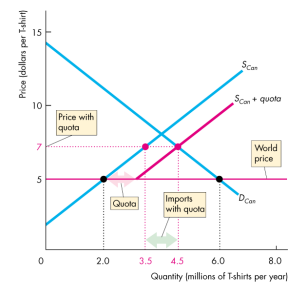
Figure 7.7(b) shows the market with an import quota of 1 million T-shirts.

With the quota, the supply of T-shirts in Canada becomes  $S + \text{quota}$ .

The price rises to \$7.

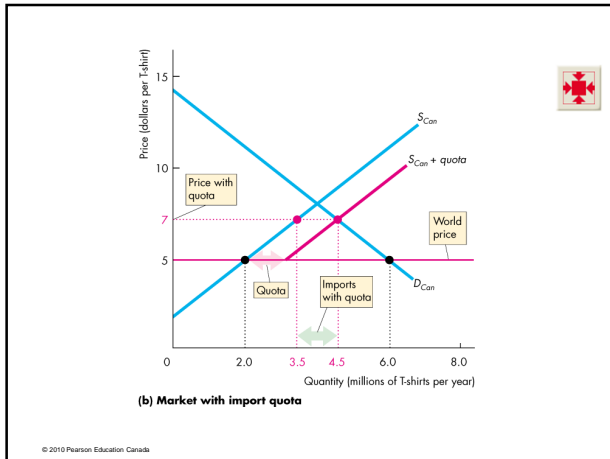
The quantity produced in Canada increases and the quantity bought decreases.

Imports decrease.



(b) Market with import quota

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## International Trade Restrictions

### Winners, Losers, and Social Loss from an Import Quota

When the Canadian government imposes an import quota on imported T-shirts:

- Canadian consumers of T-shirts lose.
- Canadian producers of T-shirts gain.
- Importers of T-shirts gain.
- Society loses.

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## International Trade Restrictions

### Canadian Consumers of T-shirts Lose

The price of a T-shirt in Canada rises, so they buy fewer T-shirts.

The combination of a higher price and a smaller quantity bought makes consumers worse off.

The Canadian consumer loses from the import quota.

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## International Trade Restrictions

### Canadian Producers of T-shirts Gain

Because the price of a T-shirt rises, Canadian garment makers produce more T-shirts.

Canadian garment makers sell a larger quantity and sell it at a higher price, so producers gain.

Canadian garment makers gain from the import quota.

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### International Trade Restrictions

#### Importers of T-shirts Gain

Importers buy the T-shirts at the world price and sell them at the domestic price

Because the domestic price exceeds the world price, importers gain from the import quota.

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### International Trade Restrictions

#### Society Loses

Society loses because the loss to consumers exceeds the gains of producers and importers.

*Social loss* arises because part of the higher price paid to domestic producers pays for the higher cost of domestic production and from the smaller quantity bought at the higher price.

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### International Trade Restrictions

#### Other Import Barriers

Thousands of detailed health, safety, and other regulations restrict international trade.

#### Export Subsidies

An *export subsidy* is a payment made by the government to a domestic producer of an exported good.

Export subsidies bring gains to domestic producers, but they result in overproduction in the domestic economy and underproduction in the rest of the world and so create a deadweight loss.

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### The Case Against Protection

Despite the fact that free trade promotes prosperity for all countries, trade is restricted.

Two classical arguments for restricting international trade are

- The infant-industry argument
- The dumping argument

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### ▶ The Case Against Protection

#### The Infant-Industry Argument

The **infant-industry argument** is that it is necessary to protect a new industry from import competition to enable it to grow into a mature industry that can compete in world markets.

This argument is based on the concept of *dynamic competitive advantage*, which can arise from *learning-by-doing*.

Learning-by-doing is a powerful engine of productivity growth, but this fact does not justify protection.

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### ▶ The Case Against Protection

#### The Dumping Argument

**Dumping** occurs when foreign a firm sells its exports at a lower price than its cost of production.

This argument does not justify protection because

1. It is virtually impossible to determine a firm's costs.
2. Hard to think of a global monopoly, so even if all domestic firms are driven out, alternatives would still exist.
3. If the market is truly a global monopoly, better to regulate it rather than restrict trade.

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### ▶ The Case Against Protection

Other common arguments for protection are that it

- Saves jobs.
- Allows us to compete with cheap foreign labour.
- Penalizes lax environmental standards.
- Prevents rich countries from exploiting developing countries.

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### ▶ The Case Against Protection

#### Saves Jobs

The idea that buying foreign goods costs domestic jobs is wrong.

Free trade destroys some jobs and creates other better jobs.

Free trade also increases foreign incomes and enables foreigners to buy more domestic production.

Protection to save particular jobs is very costly.

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### ▶ The Case Against Protection

#### **Allows Us to Compete with Cheap Foreign Labour**

The idea that a high-wage country cannot compete with a low-wage country is wrong.

Low-wage labour is less productive than high-wage labour.

And wages and productivity tell us nothing about the source of gains from trade, which is comparative advantage.

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### ▶ The Case Against Protection

#### **Penalizes Lax Environmental Standards**

The idea that protection is good for the environment is wrong.

Free trade increases incomes and poor countries have lower environmental standards than rich countries.

These countries cannot afford to spend as much on the environment as a rich country can and sometimes they have a comparative advantage at doing “dirty” work, which helps the global environment achieve higher environmental standards.

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### ▶ The Case Against Protection

#### **Prevents Rich Countries from Exploiting Developing Countries**

By trading with people in poor countries, we increase the demand for the goods that these countries produce and increase the demand for their labour.

The increase in the demand for labour raises their wage rate.

Trade can expand the opportunities and increase the incomes of people in poor countries.

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### ▶ The Case Against Protection

#### **Offshore Outsourcing**

A firm in Canada can obtain the things it sell in four ways:

- Hire Canadian labour and produce in Canada.
- Hire foreign labour and produce in another country.
- Buy finished goods, components, or services from firms in Canada.
- Buy finished goods, components, or services from firms in other countries.

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### ▶ The Case Against Protection

**Outsourcing** occurs when a firm in Canada buys finished goods, components or services from firms in Canada or buys finished goods, components, or services from firms in other countries.

**Offshoring** occurs when a firm in Canada hires foreign labour and produces in other countries or buys finished goods, components, or services from firms in other countries.

**Offshoring outsourcing** occurs when a firm in Canada buys finished goods, components, or services from firms in other countries.

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### ▶ The Case Against Protection

#### Why Is International Trade Restricted?

The key reason why international trade restrictions are popular in Canada and most other developed countries is an activity called rent seeking.

**Rent seeking** is lobbying and other political activity that seeks to capture the gains from trade.

You've seen that free trade consumers of the import good gain but domestic producers of that good lose.

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### ▶ The Case Against Protection

Those who gain from free trade are the millions of consumers of low-cost imports.

But the benefit per individual consumer is small.

Those who lose are the producers of import-competing items.

Compared to the millions of consumers, there are only a few thousand producers.

These producers have a strong incentive to incur the expense of lobbying *for* a tariff and *against* free trade.

The gain from free trade for any one person is too small for that person to spend much time or money on a political organization to lobby *for* free trade.

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### ▶ The Case Against Protection

Each group weighs benefits against costs and chooses the best action for themselves.

But the group against free trade will undertake more political lobbying than will the group for free trade.

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