

Trade in the Global Economy

2

Multiple Choice Answers

1	D	6	D	11	A	16	A
2	C	7	C	12	D	17	D
3	A	8	B	13	B	18	A
4	C	9	C	14	A	19	A
5	D	10	C	15	A	20	A

Short Answer Questions

Question 1

- a) A tariff is a tax on imports.
- b) Government revenue = size of the tariff x quantity of imports
 $= 4 \times (20,000 - 15,000)$
 $= 4 \times 5,000$
 $= \$20,000$
- c) A subsidy is a cash payment to local producers. It artificially boosts the competitiveness of local producers and increases their supply. A quota is a limit on the quantity of imports. By limiting the quantity of imports, the price of imports increases and local producers can raise their prices and increase their market share. A local content rule requires that a certain proportion of a product must be made locally. This will ensure that some level of local production occurs as import levels increase.
- d) A tariff will raise the price of imported products, reducing the quantity of imports. This will allow domestic firms to increase their prices and increase their output. Import competing firms will be able to increase their market share and their domestic revenue by raising price and output. However, protection tends to encourage inefficiency within import-competing firms, which have no incentive to improve efficiency. A tariff will also raise the price of imports, which will increase the business costs to firms which use imports in their production. E.g. a tariff on steel will increase the business costs to all firms which use steel in production. Individuals who are employed within the import-competing industry will benefit from being able to stay in employment within an inefficient firm. However, labour productivity is likely to be lower. Consumers, on the other hand, will face higher prices and reduced consumer choice due to the reduction in the quantity of imports. The government will gain an increase in government revenue from the tariff in the short term. However, in the long term, the imposition of a tariff tends to result in greater inefficiency in the economy, which will reduce economic growth in the long run and reduce government revenue. The government may also face global political sanctions with possible retaliation from overseas economies, and a reduced ability to achieve trade concessions in overseas economies.

Question 2

- a) Free trade is a situation where governments impose no artificial barriers to trade of goods and services.
- b) Opportunity cost of cloth = $\frac{\text{Wine}}{\text{Cloth}}$
 $= \frac{20}{25}$
 $= 0.8$
- c) New Zealand
- d) Protection could be imposed to protect infant industries from foreign competition. Protection could be used in the short term to help infant industries achieve economies of scale and compete on a global level. Protection could be imposed to prevent foreign producers from dumping products on the domestic market. Dumping is the practice of selling goods at unrealistically low prices, potentially driving local producers out of business. Protection could also be imposed for defence and self-sufficiency purposes to ensure the economy has locally made products in times of emergency or war, particularly in the agricultural sector.
- e) Free trade has many long term benefits which come with short term costs. In the long term, free trade leads to a greater variety of products available in an economy for a cheaper price. More imported products will be available at a lower price than locally made products, benefiting local consumers and businesses which use imports as an input into production and raising living standards. Local producers will be able to specialise in products in which the economy has a comparative advantage leading to greater economies of scale, higher efficiency levels and an improved allocation of resources. This should improve international competitiveness and create new jobs in the long run. However, in the short run, inefficient import-competing firms will be forced to close down in the face of global competition, increasing structural unemployment. Also, with higher levels of global competition, infant industries may find it more difficult to gain economies of scale and establish export markets in the global economy.

Question 3

- a) A trade agreement is a formal agreement between two or more economies to reduce trade barriers between those economies.
- b) The World Trade Organisation (WTO) promotes multilateral free trade, providing a forum for the negotiation of global trade agreements. The Doha round, launched in 2001, aims to improve upon the reductions in protection achieved at the previous Uruguay round. The WTO also helps to resolve global trade disputes. If an economy refuses to comply with a WTO decision, they may face trade sanctions from WTO members.
- c) Regional free trade agreements can be seen as stepping stones to global free trade, leading to reductions in protection within a regional group. With the stalling of the Doha round in recent years and the failure to achieve multilateral free trade, regional free trade is seen as a politically feasible way to achieve substantial reductions in protection. However, regional free trade agreements can be seen as stumbling blocks to free trade. Trade blocs impose protection on non-member states and thus achieve no global reduction in protection. Also, trade agreements often result in the exclusion of developing nations from free trade. For example, the African nations are rarely included in regional trade agreements.
- d) The International Monetary Fund (IMF) is responsible for the maintenance of international financial stability. It can intervene in a financial crisis, offering a rescue package to inject liquidity into a damaged financial market. However, the IMF often requires that economies accepting their rescue package implement a series of structural adjustment policies, known as the 'Washington Consensus,' which can harm the domestic economy. For example, in the 1997 Asian Financial Crisis, the IMF required the south-east Asian economies to raise interest rates and return their budgets to surplus, both of which would restore financial stability but harm the domestic economy. As a result, the IMF is accused of protecting the interests of rich investors at the expense of the local economy. In addition, the IMF is increasingly seen as ineffective, particularly in light of its inability to prevent or affect the global economy in the 2008 global financial crisis. The World Bank is responsible for improving global levels of economic development. The World Bank's programs include initiatives such as debt relief to poor countries (such as the Heavily Indebted Poor Countries initiative) and soft loans to finance infrastructure projects in developing economies. The World Bank is guided by the Millennium Development Goals in forming its policy. The World Bank, however, makes up only 10 per cent of all capital flows into developing economies, which makes it difficult for the World Bank to make a substantial difference to global economic development levels.

Skills Revision

The Market with Free Trade

An import-competing market

Price without free trade: **\$20**

World price (the price with free trade): **\$10**

Quantity supplied without free trade: **400**

Quantity supplied with free trade: **200**

Quantity demanded with free trade: **600**

Quantity of imports with free trade: **400**

Supplier revenue without free trade: **\$8,000**

Supplier revenue with free trade: **\$2,000**

Extension: Why is this an import-competing market?

Because the world price is below equilibrium.

An export-competing market

Price without free trade: **\$8**

World price (the price with free trade): **\$12**

Quantity supplied without free trade: **150**

Quantity supplied with free trade: **200**

Quantity demanded with free trade: **100**

Quantity of exports with free trade: **100**

Supplier revenue without free trade: **\$1,200**

Supplier revenue with free trade: **\$2,400**

Extension: Why is this an export-competing market?

Because the world price is above equilibrium.

The Tariff Diagram

Calculate the following (with free trade):

World price: **\$10**

Quantity supplied at world price: **100**

Quantity demanded at world price: **300**

Quantity of imports before the tariff: **200**

Domestic supplier revenue before the tariff: **\$1,000**

Calculate the following (after the tariff):

Size of the tariff: **\$5**

Price after the tariff: **\$15**

Quantity supplied after the tariff: **150**

Quantity demanded after the tariff: **250**

Quantity of imports after the tariff: **100**

Price received by domestic firms after the tariff: **\$15**

Price received by foreign producers: **\$10**

Domestic supplier revenue after the tariff: **\$2,250**

Impacts of the tariff:

Loss of consumer choice: **50**

Gain to domestic producer revenue: **\$1,250**

Government revenue: **\$500**

Decrease in imports: **100**

Extension: Loss of revenue to foreign producers: **\$1,000**

Calculate the following (with free trade):

World price: **\$5**

Quantity supplied at world price: **1,000**

Quantity demanded at world price: **4,000**

Quantity of imports before the tariff: **3,000**

Domestic supplier revenue before the tariff: **\$5,000**

Calculate the following (after the tariff):

Size of the tariff: **\$3**

Price after the tariff: **\$8**

Quantity supplied after the tariff: **2,000**

Quantity demanded after the tariff: **3,000**

Quantity of imports after the tariff: **1,000**

Price received by domestic firms after the tariff: **\$8**

Price received by foreign producers: **\$5**

Domestic supplier revenue after the tariff: **\$16,000**

Impacts of the tariff:

Loss of consumer choice: **1,000**

Gain to domestic producer revenue: **\$11,000**

Government revenue: **\$3,000**

Decrease in imports: **2,000**

Extension: Loss of revenue to foreign producers: **\$10,000**

The Subsidy Diagram

Subsidy diagram for a domestic market:

Equilibrium price before the subsidy: **\$12**

Equilibrium quantity before the subsidy: **300**

Equilibrium price after the subsidy: **\$10**

Size of the subsidy: **\$4**

Equilibrium quantity after the subsidy: **400**

Increase in quantity due to the subsidy: **100**

Government expenditure on the subsidy scheme in the market: **\$1,600**

Subsidy diagram for an import-competing market:

World price: **\$10**

Quantity demanded at world price: **700**

Quantity supplied before the subsidy: **200**

Imports before the subsidy: **500**

Calculate the following (after the subsidy):

Size of the subsidy: **\$6**

Quantity supplied after the subsidy: **400**

Imports after the subsidy: **300**

Impacts of the subsidy:

Government expenditure on the subsidy: **\$2,400**

Increase in domestic market share: **200**

Decrease in imports: **200**

Subsidy diagram for an import-competing market:

World price: **\$5**

Quantity demanded at world price: **80,000**

Quantity supplied before the subsidy: **20,000**

Imports before the subsidy: **60,000**

Calculate the following (after the subsidy):

Size of the subsidy: **\$4**

Quantity supplied after the subsidy: **50,000**

Imports after the subsidy: **30,000**

Impacts of the subsidy:

Government expenditure on the subsidy: **\$200,000**

Increase in domestic market share: **30,000**

Decrease in imports: **30,000**

The Quota Diagram

Calculate the following (with free trade):

World price: **\$10**
 Quantity supplied at world price: **1,000**
 Quantity demanded at world price: **5,000**
 Quantity of imports before the quota: **4,000**
 Domestic supplier revenue before the quota: **\$10,000**
 Overseas producer revenue before the quota: **\$40,000**

Calculate the following (after the quota):

Size of the quota: **2,000**
 Price after the quota: **\$12**
 Increase in price due to the quota: **\$2**
 Quantity supplied after the quota: **2,000**
 Quantity demanded after the quota: **4,000**
 Domestic supplier revenue after the quota: **\$24,000**
 Overseas producer revenue after the quota: **\$24,000**

Impacts of the quota:

Loss of consumer choice: **1,000**
 Gain to domestic producer revenue: **\$14,000**
 Decrease in imports: **2,000**
 Loss of revenue to foreign producers: **\$16,000**

Extension: Further Diagrams

An increase in a quota:

Imports under the original quota: **120,000**
 Imports under the new quota: **200,000**
 The increase in the quantity of imports: **80,000**
 The decrease in price: **\$100**
 Identify whether this increase in the quota represents an increase or a decrease in protection levels.

A decrease in protection.

Impact of an export subsidy:

World price: **\$10**
 Quantity demanded at world price: **150**
 Quantity supplied before the subsidy: **350**
 Quantity exported before the subsidy: **200**
 Size of the subsidy: **\$2**
 Quantity supplied after the subsidy: **600**
 Quantity exported after the subsidy: **450**
 Increase in exports due to the subsidy: **250**
 Increase in supplier revenue: **\$2,500**

Calculate the following (with free trade):

World price: **\$50**
 Quantity supplied at world price: **100**
 Quantity demanded at world price: **250**
 Quantity of imports before the quota: **150**
 Domestic supplier revenue before the quota: **\$5,000**
 Overseas producer revenue before the quota: **\$7,500**

Calculate the following (after the quota):

Size of the quota: **50**
 Price after the quota: **\$17**
 Increase in price due to the quota: **\$20**
 Quantity supplied after the quota: **150**
 Quantity demanded after the quota: **200**
 Domestic supplier revenue after the quota: **\$10,500**
 Overseas producer revenue after the quota: **\$3,500**

Impacts of the quota:

Loss of consumer choice: **50**
 Gain to domestic producer revenue: **\$5,500**
 Decrease in imports: **100**
 Loss of revenue to foreign producers: **\$4,000**

A decrease in a quota:

Imports under the original quota: **9,000**
 Imports under the new quota: **5,000**
 The decrease in the quantity of imports: **4,000**
 The increase in price: **\$25**
 Identify whether this decrease in the quota represents an increase or a decrease in protection levels.

An increase in protection.

Advanced: A market protected by a tariff and a subsidy

Calculate the following (with free trade):

World price: **\$20**
 Quantity supplied at world price: **50**
 Quantity demanded at world price: **800**
 Quantity of imports with free trade: **750**

Calculate the following (after the tariff):

Size of the tariff: **\$10**
 Price after the imposition of the tariff: **\$30**
 Quantity supplied after the tariff: **250**
 Quantity demanded after the tariff: **750**

Calculate the following (after the subsidy):

Size of the subsidy: **\$15**
 Quantity supplied after the subsidy: **500**
 Increase in supply due to the subsidy: **250**

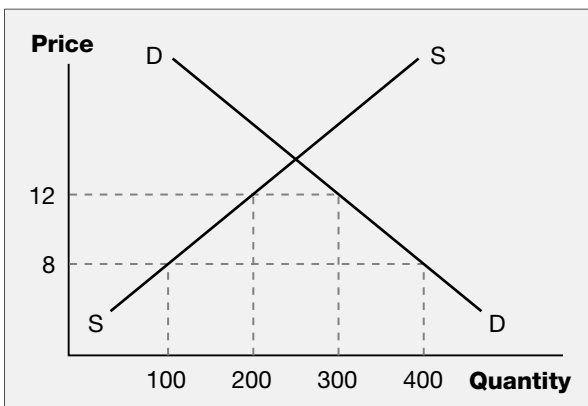
After the tariff and the subsidy:

Final price: **\$30**
 Final quantity supplied: **500**
 Final quantity demanded: **750**
 Final quantity of imports: **250**

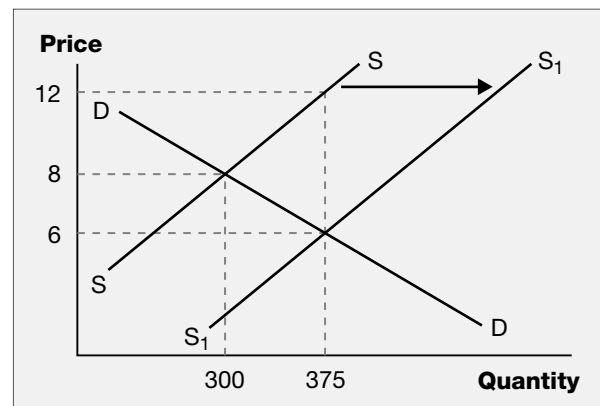
Impact of the tariff and the subsidy:

Size of the tariff: **\$30**
 Quantity of imports: **250**
 Government revenue from the tariff: **\$2,500**
 Size of the subsidy: **\$15**
 Quantity of domestic production: **500**
 Government expenditure on the subsidy: **\$7,500**
 Loss of consumer choice: **50**

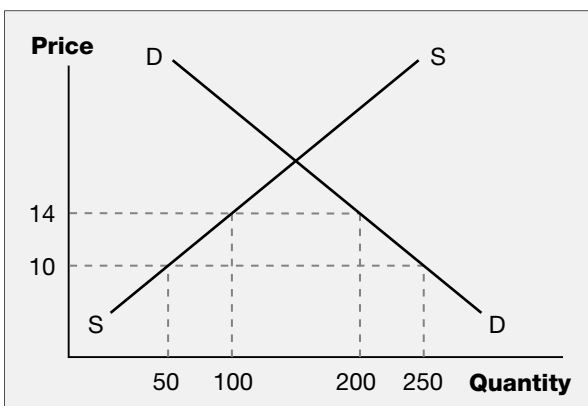
Constructing Protection Diagrams



Tariff Diagram



Subsidy Diagram



Quota Diagram