## <u>Topic 1</u>: Overview.

What main questions shall we study in this course?

1. What market forces lead two economies to trade with each other?

2. What are the costs and benefits of trade:

    - to the two economies taken together?
    - to each economy separately?
    - to different groups within each economy?

3. What are the costs and benefits of typical government measures to restrict (or indeed, promote) trade?

    - tariffs,
    - quotas and VERs,
    - production subsidies,
    - export subsidies.

4. Why do governments intervene in trade and what determines the nature of this intervention *i.e.* what is the political economy of trade policy?

**Broad answers:**

1. (a) Trade improves productive efficiency:

    i. comparative advantage:

    - countries specialize in goods which they are '***comparatively*** better' at producing (*i.e.* lower costs and/or better quality),
    - we shall see that 'comparatively better' refers mainly to other goods, not necessarily to other countries,
    - wool for Scotland, financial services for UK, electronics for Japan, clothes for China;

   ii. economies of scale:
       - some goods require a minimum level of production to break even,
       - more efficient for one or a few countries to specialize in such a good and then export,
       - steel for Japan and Korea; mobile phones for Finland.

   (b) Trade can also arise as companies seek profits:
       - in industries with oligopoly or monopoly, there is room for *extra-economic* profits,
       - in such industries, companies can move outside their own borders to capture some of the local profits,
       - usually, by introducing a slightly different brand, such as Toyota vs. Vauxhall; Sony vs. Phillips, Nokia vs Motorola.
       - Such trade often takes place *within* an industry (intra-industry trade).

2. On the whole, free trade is a good thing for each country (*gains from trade*). But:
   - the gains from trade may not be equal, either between countries or within each country;
   - some groups in each country lose out;
   - if trade is *not* based on comparative advantage, it might make not make each country better off.

3. In most situations and most countries, the trade restrictions that are commonly applied help a minority (those who are hurt by free trade) and hurt the majority within a country;
   - in these situations it is better to help the minority through direct compensation rather than trade restrictions;
   - but direct compensation might be difficult to implement;
   - within the class of restrictions that are often applied, some are less harmful to the majority than others.

4. Governments intervene in trade because

    (a) in some cases, trade restrictions can in fact help the majority of a country's citizens, but

        - these situations are difficult to identify in practise;
        - the appropriate policy is difficult to design and implement;

    (b) large economies like the USA, Japan and the EU can (and do) in fact make themselves better off by practising restrictive trade policies:

        - their gain comes at the expense of other economies, in particular those of the developing world.
        - this leads to peer and moral pressure in developing countries to not open themselves completely to free trade;

    (c) governments face lobbying and influence peddling by special interest groups which stand to lose from free trade.

    (d) Hence to implement free trade requires multinational determination and effort.