“Today the world is in a period of punctuated equilibrium—which is being caused by the simultaneous movements of five economic plates. In the end, a new game with new rules requiring new strategies will emerge. Some of today’s players will adapt and learn how to win in this new game. They will be those who understand the movement of the economic tectonic plates. They will become the top-of-the-food-chain, "fittest" individuals, business firms, or nations. Historically, they will come to be seen as the economic equivalent of the mammals”.


Vince Sammut
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Summary

Ever since the publication of Adam Smith’s the ‘Wealth of Nations’ in 1776 and its promotion of the global “harmony of interests”, the perfectly competitive market model has served as a very powerful tool and inspiration to those who, like Lester Thurow (1996), believe that socio-economic development follows similar evolutionary patterns as those of biophysical development.

As the competitive forces of nature bring about a finely tuned and delicate ecological equilibrium, so too it is believed, would the competitive market forces of demand and supply bring about – through the price mechanism, the so-called “invisible hand” – an economic equilibrium where individual and social welfare are maximised at the least possible economic costs. In other words, given the right conditions and given a “learning” process of adaptation in which the “fittest individuals, business firms, or nations become the top-of-the-food-chain”; the perfectly competitive model would attain the allocative efficiency of scarce resources.

In line with economic theory and the principle of comparative advantage, international trade is said to lead to a more efficient allocation of scarce resources. It facilitates the exploitation of economies of scale, stimulates competition and can lead to the transmission of technology, capital and knowledge on a global level.

In terms of socio-economic development, the phenomenon of globalisation – the process by which markets and production in different countries become increasingly interdependent due to the dynamics of trade in goods and services, as well as the flows of capital and technology has many implications for developing countries. The need for structural adjustment, openness to global trade and the new political economy of market-oriented development are giving rise to many questions regarding trade liberalisation, the role of transnational corporations and the performance of markets.

Thus, the increasing importance of the global economy is eliciting calls for the expansion of the World Trade Organisation’s traditional agenda beyond ‘market access’ concerns to concerns over competition, trade facilitation, institutional capacity and transparency in government procurement, investment and environmental degradation. Indeed, strategies that are aimed at achieving sustainable levels of economic growth must be inter-related with policies that support the operation of the market and also allow governments to intervene in strategic areas such as employment, technological transfers, capital flow movements and the environment.

These notes attempt to analyse the relevance of international trade theory to developing countries striving to attain economic growth and development while at the same time facing the threat of greater poverty and marginalisation resulting from globalisation.

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¹ Lester Thurow is a Professor of Management and Economics at Sloan School of Management, MIT.
Why do countries trade?

It is the underpinning belief in a free market economy that forms the basis of most the ‘International Trade’ models that have been developed since the emergence of the classical ‘absolute’ and ‘comparative’ advantage trade theories. The logic of free trade is in fact quite simple. If two countries have different comparative advantages in, for example, the production of wheat and cloth and they each make both wheat and cloth for themselves, the total pile of wheat and cloth for the two countries will be less than if they specialised. Of course, the extra output from specialising and trading has to exceed the costs of negotiating the terms of trade as well as sending and transporting the items; but if it does, than both sides can get more from trading than not. Free trade, then, is simply trade without taxes, tariffs, or other barriers or restrictions.

<table>
<thead>
<tr>
<th>Production possibilities for two countries</th>
<th>Kilos of wheat</th>
<th>Metres of cloth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less developed country</td>
<td>Either</td>
<td>2</td>
</tr>
<tr>
<td>Developed country</td>
<td>Either</td>
<td>4</td>
</tr>
</tbody>
</table>

Pre-trade exchange ratios

- Less developed country: 2 wheat for 1 cloth
- Developed country: 1 wheat for 2 cloth

International trade exchange ratios

- Less developed country: 1 wheat for 1 cloth
- Developed country: 1 wheat for 1 cloth

*Open* economies that *specialise* and trade their *surplus* outputs of goods and services on the global market place are more prone to attain high levels of economic growth and development than *self-sustaining* autarkies.
Data published by the World Trade Organisation (WTO), the International Monetary Fund (IMF), the World Bank (IBRD), the Organisation of Economic Cooperation and Development (OECD) and a host of other institutions and organisations that promote a free and liberalised global economy attest to a positive correlation between trade and economic growth.

In the eyes of these organisations, trade and foreign direct investment are major engines of growth in developed and developing countries alike. Trade has over the years, consistently outperformed domestic output and the volume of world merchandise trade is sixteen times greater today than it was in 1950, as compared to a six-fold increase in the volume of world production; or to put it in other words, world trade in goods and services rose from barely one-tenth to about one-third of world GDP. This, according to WTO reports, reflects the dismantling of import and export barriers:

‘The economic case for an open trading system based upon multilaterally agreed rules is simple enough and rests largely on commercial common sense. But it is also supported by evidence: the experience of world trade and economic growth since the Second World War. Tariffs on industrial products have fallen steeply and are now close to 4% on average in industrial countries by 1 January 1999. During the first decades after the war, world economic growth averaged about 5% per year, a high rate that was partly the result of lower trade barriers. World trade grew even faster, averaging about 8% during the period.’

‘Trading into the Future’, WTO April 1999

As the indicators below illustrate, the trend in globalisation or worldwide inter-connectedness is on an exponential growth path and the current extent and depth of world wide economic integration is unprecedented. It is also, of course, a natural extension of people’s universal and age-old quest for trade and commercial opportunities beyond village, regional and national boundaries, limited only by the technology and capital available to them. Thus, except for a comparatively brief period embracing the two world wars, growth in world trade has indeed consistently exceeded aggregate economic growth for two centuries or more.

![World trade and output trends, 1950 to 1999 (Index 1950 = 100)](image)

Data source: WTO
Due to the relatively small size of their domestic markets and the lack of capital and skilled human resources, as well as infrastructural resources, the developing countries are themselves heavily reliant on exports, mainly of primary products; and on imports, typically of machinery, capital goods, intermediate producer goods, and consumer products. Yet, as illustrated by the figures below, the share of developing countries’ exports on the world market has actually fallen from a dismally low 2.9% in 1970 to an even lower figure of 0.65% in 1997\(^2\).
The share of LDCs exports, the world’s 49 least developed countries have, according to WTO figures, declined from 0.48% in 1990 to 0.4% in 1999, a clear indicator that rather than enjoying the benefits of ‘globalisation’ these countries are becoming more and more ‘marginalised’. Moreover, while global economic wealth increased, so too did the income gap. Annual GNP per capita income for low-income developing countries remains stagnated below $2,000 while that of high-income countries may be 1000% as high!

According to non-government organisations such as Oxfam, over the past ten years the number of people earning $1 a day or less has remained static at 1.2 billion, while the number earning less than $2 a day has increased from 2.55 billion to 2.8 billion people. The 20% gap in incomes between of the richest and the poorest countries has grown from 30 to 1 in 1960 to 82 to 1 in 1995. By the late 1990s, the one fifth of the world’s people living in the highest-income countries had:

- 86% of world GDP—the bottom fifth just 1%.
- 82% of world exports markets—the bottom fifth just 1%.
- 68% of foreign direct investment—the bottom fifth just 1%.
- 74% of world telephone lines, today’s basic means of communication—the bottom fifth just 1.5%.

All this indicates that the most developed countries (MDCs) are the major beneficiaries of the world’s current economic order, and this in spite of the fact that MDCs make up less than one fifth of the world’s population.

While agreeing with the view that “international trade can be a powerful engine for poverty reduction”, Oxfam ([http://www.oxfam.org/what_does/advocacy/trade.htm](http://www.oxfam.org/what_does/advocacy/trade.htm)) strongly criticises the current situation and has embarked on a global campaign to “make trade fair”:

“International trade rules are loaded against the poor. Despite the huge expansion of international trade and foreign direct investment within the global economy, the benefits are far from equally distributed between the rich and the poor; be they countries, companies or people.

Indeed the poorest of the poor are increasingly marginalised and locked out of the benefits of trade. In fact, global trade rules contribute to the violation of one of most essential human rights: the right of every individual to a sustainable livelihood and secure employment…”
Oxfam goes on to criticise the WTO stating that:

“… the declaration of the last WTO Ministerial conference in Doha approves a broad negotiation agenda, which could prove detrimental to poverty reduction and development.”

Hence, what are the prospects of LDCs in a converging global economy and what role does the WTO play in this regard?

The Gains from Trade

- The law of comparative advantage

  - specialisation as the basis for trade
  - absolute advantage
  - comparative advantage
  - the gains from trade based on comparative advantage
Economic Theory

Traditional economic theory on trade and development is based on the Ricardian principle of comparative advantage and on the neo-classical model of relative factor endowments and international specialisation, better known as the Heckscher - Ohlin model.

But the early logic that free trade could be advantageous for countries was based on the concept of absolute advantages in production. Adam Smith wrote in The Wealth of Nations:

"If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage." (Book IV, Section ii, 12)

The idea is simple and intuitive. If one country can produce some set of goods at lower cost than a foreign country, and if the foreign country can produce some other set of goods at a lower cost than the other country can produce them, then clearly it would be best for both countries to trade their relatively cheaper goods. In this way both countries may gain from trade.

David Ricardo's Numerical Example

In its most simple form the model assumes:

- Two countries producing two goods using labour as the only factor of production.
- Goods are assumed homogeneous (identical) across firms and countries.
- Labour is homogeneous within a country but heterogeneous (non-identical) across countries.
- Goods can be transported free of any cost between countries.
- Labour can be freely reallocated between industries within a country but cannot move between countries.
- Labour is always fully employed.
- Production technology differences across industries and across countries and are reflected in labour productivity parameters.
- The labour and goods markets are assumed to be perfectly competitive in both countries.
- Firms are assumed to maximise profit while consumers (workers) are assumed to maximise utility.

In his example Ricardo imagined two countries, England and Portugal producing two goods, cloth and wine, using labour as the sole input in production. He assumed that the productivity of labour (i.e., the quantity of output produced per worker) varied between industries and across countries. However, instead of assuming, as Adam Smith did, that England is more productive in producing one good and Portugal is more productive in the other; Ricardo assumed that Portugal was more productive in both goods. Based on Smith's intuition, then, it would seem that trade could not be advantageous, at least for England.
However, Ricardo demonstrated numerically that if England specialised in producing one of the two goods and if Portugal produced the other, then total world output of both goods could rise! If an appropriate terms of trade (i.e., amount of one good traded for another) were then chosen, both countries could end up with more of both goods after specialisation and free trade, then they each could have had they remained autarkies. This means that England may nevertheless benefit from free trade even though it is assumed to be technologically inferior to Portugal in the production of everything.

Ricardo showed that each country should specialise in that good in which it has a comparative advantage in production. To identify a country's comparative advantage requires a comparison of production costs across countries. However, one does not compare the monetary costs of production or even the resource costs (labour needed per unit of output) of production. Instead one must compare the opportunity costs of producing goods across countries.

A country is said to have a comparative advantage in the production of a good (say cloth) if it can produce cloth at a lower opportunity cost than another country. The opportunity cost of cloth production is defined as the amount of wine that must be given up in order to produce one more unit of cloth. Thus England would have the comparative advantage in cloth production relative to Portugal if it must give up less wine to produce another unit of cloth than the amount of wine that Portugal would have to give up to produce another unit of cloth.

Note that trade based on comparative does not contradict Adam Smith's notion of advantageous trade based on absolute advantage. If as in Smith's example, England were more productive in cloth production and Portugal were more productive in wine, then it can be said that England has an absolute advantage in cloth production while Portugal has an absolute advantage in wine. If one was to calculate comparative advantages, then England would also have the comparative advantage in cloth and Portugal would have the comparative advantage in wine. In this case, gains from trade could be realised if both countries specialised in their comparative, and absolute, advantage goods.

The modern version of the Ricardian model and its results are typically presented by constructing and analysing economic models of an international economy.

The Heckscher - Ohlin Model

The H-O theorem predicts that the pattern of trade between countries is based on the resource characteristics of the countries. A capital-abundant country will export the capital-intensive good while the labour-abundant country will export the labour-intensive good. The "standard" H-O model\(^3\) refers to the case of two countries, two goods and two factors of production.

The diagram below depicts ‘free trade equilibrium’ in the H–O model. Country X is assumed to have an abundance of capital and skews its production possibility boundary (PPF) in the direction of manufacturing capital-intensive goods. Country Y is labour intensive and skews its PPF in the direction of agriculture, the labour intensive sector. In an international free market, each country faces the same terms of trade. Both countries produce at points \(P_x\) and \(P_y\) respectively. The tangent lines at these points represent the national income lines for both countries, in money terms\(^4\), while the slope of the income lines is the free trade price ratio\(^5\).

\(^3\) There are actually four main theorems in the H-O model: the ‘standard’ two countries, two goods and two factors of production Heckscher-Ohlin theorem, the Stolper-Samuelson Theorem, the Rybczynski theorem, and the factor-price equalization theorem. The Stolper-Samuelson and Rybczynski theorems describe relationships between variables in the model while the H-O and factor-price equalization theorems present some of the key results of the model.

\(^4\) The equation for the income line is \(P_M Q_M + P_A Q_A = NI\); where \(P = \text{Price}, Q = \text{Quantity}, M = \text{manufacturing}, A = \text{Agriculture}\).

\(^5\) The free trade price ratio or ‘terms of trade’ is determined by the gradient \((P_M/P_A)\).
Consumption in both countries occurs where their respective aggregate indifference curves, representing consumer preferences, are tangent to the national income lines at \( C_x \) and \( C_y \).

To reach these consumption points\(^6\), both of which lie beyond the production possibility boundaries, both countries have to undertake trade with each other. Consumption levels at \( C_x \) and \( C_y \) indicate that, according to this model, open economies that maximise the productive capacities of the factors with which they are generously endowed and carry out international trade amongst themselves, can maximise their consumptive welfare at higher levels than autarkic economies.

Again, this neoclassical model is based on a number of assumptions that deserve close scrutiny, assumptions that do not reflect real world situations, namely:

- Fixed resources, full employment, and international factor immobility;
- Fixed, freely available technology and consumer sovereignty;
- Internal factor mobility and perfect competition;
- Balanced trade and international price adjustments;
- Trade gains accruing to nationals;
- Governmental non-interference in trade.

In other words, the theory - suggestive as it may be for developing countries - is only an idealistic model. It does not explain how economies evolve over time and how they change the composition of their output, their consumption and their trade.

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\(^6\) Note that since both countries have the same aggregate *homothetic* preferences and since they face the same terms of trade, then consumption for both countries must lie along the same ray from the point of origin \( O \). In other words the trade triangles of both countries and both national income lines must be equal.
Scrutinizing the Ricardian Model’s Assumptions and Results

The primary issue in the analysis of this model is what happens when each country moves from autarky (no trade) to free trade with the other country. In other words what are the effects of trade? The main things we care about are trade's effects on the prices of the goods in each country, the production levels of the goods, employment levels in each industry, the pattern of trade (who exports and who imports what), consumption levels in each country, wages and incomes, and the welfare effects both nationally and individually.

Using the model one can show that, in autarky, each country will produce some of each good. Because of the technology differences, relative prices of the two goods will differ between countries. The price of each country's comparative advantage good is lower than the price of the same good in the other country. If one country has an absolute advantage in the production of both goods (as assumed by Ricardo) then real wages of workers (i.e., the purchasing power of wages) in that country will be higher in both industries compared to wages in the other country. In other words, workers in the technologically advanced country would enjoy a higher standard of living than in the technologically inferior country. The reason for this is that wages are based on productivity, thus in the country that is more productive, workers get higher wages.

The next step in the analysis is to assume that trade between countries is suddenly liberalised and made free. The initial differences in relative prices of the goods between countries in autarky will stimulate trade between the countries. Since the differences in prices arise directly out of differences in technology between countries, it is the differences in technology that cause trade in the model. Profit-seeking firms in each country's comparative advantage industry would recognize that the price of their good is higher in the other country. Since transportation costs are zero, more profit can be made through export than with sales domestically. Thus each country would export the good in which they have a comparative advantage. Trade flows would increase until the price of each good is equal across countries. In the end, the price of each country's export good (its comparative advantage good) will rise and the price of its import good (its comparative disadvantage good) will fall.
The higher price received for each country's comparative advantage good would lead each country to specialise in that good. To accomplish this, labour would have to move from the comparative disadvantaged industry into the comparative advantage industry. This implies that one industry goes out of business in each country. However, because the model assumes full employment and costless mobility of labour, all of these workers are immediately gainfully employed in the other industry.

One striking result here is that even when one country is technologically superior to the other in both industries, one of these industries would go out of business when opening to free trade. Thus, technological superiority is not enough to guarantee continued production of a good in free trade. A country must have a comparative advantage in production of a good, rather than an absolute advantage, to guarantee continued production in free trade. From the perspective of a less developed country, the developed countries' superior technology need not imply that LDC industries cannot compete in international markets.

Another striking result is that the technologically superior country's comparative advantage industry survives while the same industry disappears in the other country, even though the workers in the other country's industry have lower wages. In other words, low wages in another country in a particular industry is not sufficient information to know which country's industry would perish under free trade. From the perspective of a developed country, freer trade may not result in a domestic industry's decline just because the foreign firms pay their workers lower wages.

The movement to free trade generates an improvement in economic welfare in both countries, both individually and nationally. Specialisation and trade will increase the set of consumption possibilities, compared with autarky, and will make possible an increase in consumption of both goods, nationally. These aggregate gains are often described as improvements in production and consumption efficiency. Free trade raises aggregate world production efficiency because more of both goods are likely to be produced with the same number of workers. Free trade also improves aggregate consumption efficiency, which implies that consumers have a more pleasing set of choices and prices available to them.

Real wages (and incomes) of individual workers are also shown to rise in both countries. Thus, every worker can consume more of both goods in free trade compared with autarky. In short, everybody benefits from free trade in both countries. In the Ricardian model trade is truly a win-win situation.

**Defending Against Sceptics: The True Meaning and Intuition of the Theory of Comparative Advantage**

Many people who learn about the theory of comparative advantage quickly convince themselves that its ability to describe the real world is extremely limited, if not, non-existent. Although the results follow logically from the assumptions, the assumptions are easily assailed as unrealistic. For example, the model assumes only two countries producing two goods using just one factor of production. There is no capital or land or other resources needed for production. The real world, on the other hand, consists of many countries producing many goods using many factors of production. Each market is assumed to be perfectly competitive, when in reality there are many industries in which firms have market power. Labour productivity is assumed fixed, when in actuality it changes over time, perhaps based on past production levels. Full employment is assumed, when clearly workers cannot be immediately and costlessly moved to other industries. Also, all workers are assumed identical. This means that when a worker is moved from one industry to another, he or she is immediately as productive as every other worker who was previously employed there. Finally, the model assumes that technology differences are the only differences that exist between the countries.

With so many unrealistic assumptions it is difficult for some people to accept the conclusions of the model with any confidence, especially when so many of the results are counterintuitive.
Indeed one of the most difficult aspects of economic analysis is how to interpret the conclusions of models. Models are, by their nature, simplifications of the real world and thus all economic models contain unrealistic assumptions. Therefore, to dismiss the results of economic analysis on the basis of unrealistic assumptions means that one must dismiss all insights contained within the entire economics discipline. Surely, this is not practical or realistic. Economic models in general and the Ricardian model in particular do contain insights that most likely carry over to the more complex real world.

**Interpreting the Theory of Comparative Advantage**

The Ricardian model shows that if humanity wants to maximise total output in the world then:

- **first**, all resources worldwide must be fully employed;
- **second**, resources within countries must be allocated to each country's comparative advantage industries; and
- **third**, the countries must be allowed to trade freely thereafter.

In this way the well being of all individuals might rise despite differences in relative productivities. In this description, one cannot predict that results of a theoretical model would definitely carry over to the complex real world. Instead one must transpose the logic of comparative advantage to the real world and ask how things would have to look in order to achieve a certain result, in this case, maximum output and benefits.

In the end, one should not say that the model of comparative advantage describes what **will** happen when two countries begin to trade; instead one should say that what the theory does is to state what **can** happen.
The Interlinkages between Trade and Development

In order to understanding the interlinkages between trade and development, a number of fundamental questions have to be answered, namely:

1. **How does international trade affect economic growth?**

   While the successful experience of countries such as Taiwan, Singapore, Malaysia, Thailand, Brazil, Chile and South Korea indicates that access to the markets of developed nations can be a very important stimulus to economic growth along the lines suggested by traditional theory; the rapid growth of export-oriented industries is by itself no guarantee that LDCs will benefit to any significant extent in terms of socio-economic development. This is particularly so if an export oriented strategy does not cater for the real needs of the local population or when a large proportion of export earnings accrue to foreigners. Therefore, the impact of trade on development depends a lot on the nature of the export sector, the distribution of its benefits, and the linkages with the rest of the economy.

2. **How does trade alter the distribution of income?**

   While the fact that the benefits of world trade are disproportionately in favour of the rich nations and in favour of foreign residents and a minority of wealthy nationals within the poor countries themselves, one cannot construe this as an indictment against the inherent nature of trade.

   It is true however that the world’s resources are controlled by a few powerful nations and multinational companies and this reflects a highly inequitarian institutional, social and economic order. But in no way does this detract from the theoretical construct of traditional trade theory. The conclusion that free trade tends to equalise incomes is no truer than the hypothesis that education tends to balance out social inequalities. Unfortunately, trade like education, may actually reinforce existing inequalities, particularly in the short to medium term.

   Furthermore, international institutions such as the WTO and IMF are no supranational governments. Unlike national governments, they cannot use their legislative and executive powers to redistribute the gains from trade and invest them in the promotion of development in under privileged regions. The WTO is merely a forum where governments voluntarily agree to abide by a set of principles to preserve and develop an open trading system. It does not write trade rules at its own discretion. Its members, sovereign states, do this through negotiation and consensus; at least that is what the organisation’s legal statute prescribes.

3. **How can trade promote development?**

   The answer to this question depends very much on the ability of LDCs to extract concessions from the most developed countries (MDCs), particularly in the form of eliminating tariff and non-tariff barriers to their exports. It is in this field, as attested by the encouraging, though as yet uncompleted task, of dismantling worldwide tariff barriers initiated by GATT, that the WTO has an important role to play.

   Also, the extent to which LDC exports can effectively utilise scarce capital resources while at the same time maximising the use of abundant but presently underutilised labour resources will determine the degree to which export earnings will benefit ordinary citizens. For example, export earning from capital-intensive manufacturing industries are less likely to filter down into the hands of ordinary citizens than the export earnings of small farm agricultural exports. While the latter would probably expand the demand for income elastic, locally produced household goods and services, the former are more likely to find their way back to rich nations as payment
for luxury items made by wealthy individuals or as expatriated capital investments (M.Todaro: 2000). Ironically, it is precisely the agricultural sector of these developing countries that faces the toughest and most unfair competition from the MDCs. Minimum guaranteed payments by protective governments, export subsidies and all sorts of imaginable non-tariff barriers resulting from the political pressures exerted by powerful farming lobbies in the MDCs, make it a practically impossible task for LDC agricultural exports to penetrate such markets as those of the EU and the USA, unless of course, they succeed in attaining preferential trade agreements\(^7\).

The ability of LDCs to influence and control multinational companies in guaranteeing a fair share of the benefits to local citizens, is also extremely important. With the help of new information, communication, and transportation technologies, today’s multinational corporations can, for the first time in history, make their products wherever in the world it is cheapest to do so; and sell them everywhere else. Indeed, multinational corporations accounted for an estimated 25 per cent of the value of global output in 1998 and their intra-firm trade accounts for a third of world trade. The chart below highlights the dominance of transnational corporations, particularly in developing economies.

**Transnational Corporations - Numbers and Location**

*Number of TNCs, Domestic and Foreign, By World Areas*

[Chart highlighting the distribution of transnational corporations by world areas.]

*Source: UNCTAD 1999 World Investment Report*

\(^7\) Market-access and other issues are currently being discussed by the latest round of multilateral trade negotiations, launched in Doha, Qatar, in November 2001, also known as the Doha Round.
Globalisation has therefore radically altered the bargaining power between labour and capital. By threatening to move to cheaper locations, businesses have gained the upper hand over their unionised and non-unionised employees, not to mention their bargaining powers over host governments themselves.

“Of the one hundred largest economies in the world today, fifty-one are not countries but huge global corporations. These corporations can move their operations around the world with the greatest of ease. So they can pit workers, communities, and entire countries off against each other to see who will provide the lowest wages and the cheapest environmental and social costs. The result is what has been called a ‘race to the bottom’. It’s not just unskilled labour that is being pulled into the race to the bottom. Computer programming, data entry, and other white-collar jobs are also being done all over the world via computer and satellite.”


As Ralph Nader, the well-known American consumer activist puts it:

“There is a growing understanding of what corporate globalization is all about. And as more people understand this, they understand what coalitions have to be built between labour, environment, consumer, and children's groups. They understand the march of democracy against the juggernaut of autocratic corporate globalism.” ‘Global Village or Global Pillage?’

This so called ‘race to the bottom’ 8, a phrase synonymous with ‘game theory’ and with the economist John Nash, who developed micro-economic models describing the behaviour of firms competing in imperfect market structures, reflects the fears that emerge from new intra-industry trade theories, theories based on the concepts of economics of scale and product differentiation. Hence, in their urge to attract foreign investment and technology, developing countries may actually be competing away the potential social benefits offered by international private investment by suppressing their own labour markets.

4. Can LDCs determine how much they trade?

As the experience of a number of countries such as the People’s Republic of China, Albania and North Korea indicate, any attempts to embark into self-sufficiency policies by closing up one’s borders to the outside world are not realistic. Even Malta’s experiment with some import substitution projects in the 1970s; have proved to be ineffective and short-lived. Developing countries and small islands in particular, have no option but to trade. Not only do these countries lack the resources and market size to be self sufficient, but also their very survival depends on their ability to secure foreign goods and services. As stated by G.Chichilnisky and G.Heal, the issue is not the choice between trading and remaining in isolation; all countries trade. The issue is:

“…whether or not to expand exports, and if so which exports to promote. The question is often the right balance between the domestic sectors and the international sectors of the economy...The neo-classical theory of gains from trade provides little guidance on such policy questions.”

The Evolving International Economy (New York: CUP, 1986) P.44

The perception that neo-classical trade theory provides ‘little guidance on such policy questions’ is attested by the fact that very contrasting views are expressed in relation to ‘openness’ in trade. While Dani Rodrik (1999), in a policy-oriented analysis, laments that:

“First, openness by itself is not a reliable mechanism to generate sustained economic growth. Second, openness will likely exert pressures that widen income and wealth disparities within

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8 A prime example of the ‘race to the bottom’ has been the global growth of sweatshops -- factories that exploit low paid labour working under inhuman conditions.
countries. Third, openness will leave countries vulnerable to external shocks that can trigger domestic conflicts and political upheavals” (pp. 13-14).

Anne Krueger in her presidential address (1997) to the American Economic Association, entitled “Trade Policy and Development: How We Learn,” recalled that in the past, import substitution of manufactured goods was often considered as being synonymous with industrialisation, which in turn was seen as the key to development. She goes on to state that:

“Growth prospects for developing countries are greatly enhanced through an outer-oriented trade regime and fairly uniform incentives (primarily through the exchange rate) for production across exporting and import substituting goods...It is generally believed that import substitution, at a minimum, outlived its usefulness and liberalisation of trade is crucial for both industrialisation and economic development. While other policy changes also are necessary, changing trade policy is among the essential ingredients if there is to be hope for improved economic performance”

Perhaps, a long term balanced and diversified development strategy for LDCs would be better served through the creation of regional trading blocs similar to the original Common Market, than thorough the current almost exclusive reliance on the very unequal trading relations that they individually engage in with the developed countries. If interregional political rivalries can be transcended, increased regional cooperation among developing countries of roughly the same stages of development, probably offers the most viable alternative to their present pursuit of separate and very unequal relationships with the rest of the world. Thus it may still be possible for LDCs to capture some of the benefits of specialisation and trade while minimising the risks that may be incurred from some of the development inhibiting effects of a contemporary world economy and trading system dominated by a small group of rich nations and their powerful transnational corporations. (M. Todaro: 2000)

As illustrated by the figures below, although trade among LDCs only represents 7% of total world trade, twice its share in 1970; its rapid growth rate reached 33% in 1990. Much of the growth of these inter-LDC exports has helped compensate for the weak demand that resulted from protectionism in the developed world.

As illustrated by the figures below, although trade among LDCs only represents 7% of total world trade, twice its share in 1970; its rapid growth rate reached 33% in 1990. Much of the growth of these inter-LDC exports has helped compensate for the weak demand that resulted from protectionism in the developed world.
## World Attitudes towards Trade and Protection

### History of protection
- Pre-war growth in protection
- Post-war reduction in protection and the role of GATT
  - the growth in world trade

### Re-emergence of protectionism in 1980s
- the increasing use of non-tariff barriers

### The Uruguay Round
- aims of the negotiations
- problems in reaching agreement
- the agreement
- assessing the agreement

### The World Trade Organisation
- WTO more powerful than GATT
- WTO rules
  - non-discrimination
  - reciprocity
  - general prohibition of quotas
  - fair competition
  - binding tariffs
- attitudes of the WTO
- WTO activity in recent years
  - resistance from various groups to unfettered trade
Arguments for Restricting Trade

- **Methods of restricting trade**
  - tariffs
  - quotas
  - administrative barriers
  - other

- **Arguments for restricting trade**
  - infant industry argument
  - changing comparative advantage
  - to prevent dumping

- to prevent establishment of a foreign-based monopoly
- to spread risks
- externalities
- pursuing national interests (but against world interests)
  - exploiting monopoly power
  - protecting declining industries
- non-economic arguments

- **Problems with protection**
  - protection as ‘second best’
  - world multiplier effects
  - retaliation
  - cushions inefficiency
  - bureaucracy

- **Measuring the efficiency loss from protection**
Trading Blocs

- Types of preferential trading arrangement
  - free trade areas
  - customs unions
  - common markets
    - features of a full common market
- Direct effects of a customs union
  - trade creation
  - trade diversion

- Long-term effects of a customs union
  - longer-term advantages
    - internal economies of scale
    - external economies of scale
    - better terms of trade
    - increased competition between members
  - longer-term disadvantages
    - certain regions of the union may suffer
    - possibility of oligopolistic collusion
    - administrative costs

- Preferential trading in practice
  - the EU
  - the EEA
  - NAFTA
    - the advent of NAFTA
    - experience to date
    - proposals to extent to an all Americas free trade area
  - the Asia-Pacific Economic Co-operation forum (APEC)
  - other free trade areas / customs unions
The European Union

- Historical background
- The economic nature of the EU
- Development of common EU policies
  - Common Agricultural Policy
  - regional policy
  - competition policy
  - tax harmonisation
  - social policy
  - trade policy

- The single market
  - historical background
  - the Single European Act
  - completing the single market
- The benefits of the single market
  - trade creation
  - reduction in the direct costs of barriers
  - economies of scale
  - greater competition

- Criticisms of the single market
  - radical economic change is costly
  - adverse regional effects
  - development of monopoly / oligopoly power
  - trade diversion
  - political objections: loss of sovereignty
- Developments of the single market
  - evidence of economic benefits
  - eliminating remaining barriers
    - Internal Market scoreboard
  - effects of expansion of the EU
The World Trade Organisation (WTO) provides a framework of rules for international trade; a framework established in 1947 by 23 countries signing the General Agreement on Tariffs and Trade (the GATT). In spite of a somewhat shaky start, the GATT evolved through eight successive rounds of negotiations to cover goods, services and trade-related aspects of intellectual property. It thus provided a framework for multilateral trade until the conclusion of the ‘Uruguay Round’ of negotiations and the establishment of the WTO 47 years later.

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The ‘Table of contents’ of the “Results of the Uruguay Round of Multilateral Trade Negotiations: The Legal Texts” consists of sixty agreements, annexes, decisions and understandings. It includes:

- Countries’ commitments to lower tariffs and other trade barriers and to open services markets, and
- It sets procedures for settling disputes; prescribe special treatment for developing countries; and require governments to make their trade policies ‘transparent’.

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9 A supposedly interim arrangement pending a wider agreement to form an International Trade Organisation never came to fruition.

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Prepared by Vince Sammut
All in all, the main functions of the WTO, which currently has 149 member countries, are to:

- Administer and implement the trade agreements which together establish the WTO;
- Provide a forum for multilateral trade negotiations;
- Handle trade disputes;
- Monitor national trade policies;
- Assist developing countries through technical assistance and training programs; and,
- Cooperate with other international institutions involved in global economic policy making.

The WTO embodies many reciprocal rights and obligations for trading countries, and its core principle is the Most-Favoured-Nation (MFN) clause. Under this, trade must be conducted on the basis of non-discrimination -- all members are bound to accord each other treatment in tariffs and trade as favourable as they give to any other member-country.

A second principle is that, to the maximum extent possible, trade protection should be given to domestic industries not through non-tariff measures such as quantitative restrictions, arbitrary technical standards, and health regulations, etc., but only through customs tariffs, so that the extent of protection is clear and competition is still possible. Other basic provisions are "national treatment" (non-discrimination), transparency of trade rules, and general prohibition of quantitative restrictions or quotas.

http://www.wto.org/

11 As on 11 December 2005

12 Customs duties include: antidumping duties, countervailing duties, specific duties and escape clause actions. (Countervailing duties are a means to restrict international trade in cases where imports are subsidized by a foreign country and hurt domestic producers. According to WTO rules, a country can launch its own investigation and decide to charge extra duties. Since countries can rule domestically whether domestic industries are in danger and whether foreign countries subsidize the products, the institutional process surrounding the investigation and determinations has significant impacts beyond the countervailing duties. A Specific tariff is an import tax expressed in terms of a fixed amount per unit of the dutiable item. For example, $50 on each ton of wheat. An Escape clause or a Safe Guard Action is a clause in a legal text allowing temporary derogation from its provisions under certain specified emergency conditions.)
In spite of what one may consider as clichés regarding anti-globalisation campaigns, such as for example, the loss of sovereignty and the dilution of national cultures by the likes of the Hollywood entertainment industry or the fast food industry; there is little doubt that economic globalisation is threatening the viability of local communities 13.

Globalisation strongly favours economies based on export, with global corporations in control. This brings destruction of local livelihoods, local jobs, and community self-reliance. Many academics and NGOs strongly believe that it is therefore necessary to reverse directions and create new rules and structures that consciously favour the local, and follow the principle of subsidiarity 14. Globalisation should give way to internationalisation; with global institutions seeking only to do what cannot be done at lower levels of government. In other words, global institutions should not undermine national rules, unless those rules violate fundamental human rights. Hence, a global trade body should not have the power to rule that a nation's environmental law is an "unfair barrier to trade." No global body should challenge a nation's imposition of capital controls. At the same token, countries that allow slavery or bonded labour should not be able to trade freely goods made under those conditions.

Thus, while stronger global institutions are needed to fight global harms such as global warming or the international exploitation of natural and human resources, more limited powers and mandates for the IMF, World Bank, and WTO would invariably create more space for healthy local development 15. While these institutions have been promoting a development model that places a premium on maximum trade and investment, alternative models that emphasise domestic production for domestic markets and that refocus trade and investment on serving national needs might prove to be more resilient and sustainable.

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13 A high percentage of people on the earth still survive through local, community-based activities: small-scale farming, local markets, and local production for local consumption. This has enabled them to remain directly in control of their economic and food security, while also maintaining the viability of local communities and culture. Even in developed countries, most jobs have traditionally been connected to local economic production.

14 This means that whatever activities can be undertaken locally should be. Whatever power can reside at the local level should reside there. Only when additional activity is required that cannot be satisfied locally, should power and activity move to the next higher level: region, nation, and finally globalised trade and communications. Economic structures should be designed to move economic and political power downward toward the local, rather than in a global direction.

15 Walden Bello points out that many countries actually experienced their most vibrant development (Latin America in the 1930s; East Asia in the 1960s) when global economic institutions were weak or non-existent.
Perhaps, as pointed out by the Indian scholar/activist Vandana Shiva, the mandate and powers of the WTO should be significantly curtailed:

“The future is possible for humans and other species only if the principles of competition, organized greed, commodification of all life, monocultures, monopolies, and centralized global corporate control of our daily lives enshrined in the WTO are replaced by principles of protection of people and nature, the obligation of giving and sharing diversity, decentralization and self-organization enshrined in our diverse cultures and national constitutions.”

On its part, the WTO - while boosting the benefits of its trading system in its public relations campaigns - also recognises the fact that “trade alone” cannot be relied upon as a means of alleviating poverty. As stated by Mike Moore, the WTO’s Director General, in an article published in the Financial Times entitled ‘How to lift the barriers to growth: A conference starting today in Brussels will explore ways to help poor countries to benefit from globalisation’ (Financial Times; May 14, 2001):

“The problems facing LDCs are deep-rooted and trade alone will not lift them from poverty. Sound macroeconomic policies, solid infrastructure, debt relief and good governance are essential. Realistically speaking, governments that run big deficits, that are burdened with external debt, or that spend more on guns than on schools or hospitals, will not benefit much from better access to rich countries’ markets.
But trade is an important part of the effort required to help these countries…”

http://www.wto.org/
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Multiple Choice Questions

1. International economics deals with:
   a. the flow of goods, services and payments among nations.
   b. policies directed at regulating the flow of goods, services and payments.
   c. the effects of policies on the welfare of the nation.
   d. all of the above.

2. Adam Smith stated that trade was:
   a. of no benefit to small countries.
   b. to be controlled by government to maintain a surplus.
   c. beneficial to all countries.
   d. beneficial to large countries that can reduce costs.

3. The economic philosophy that favours strict limits on imports and strong support for exports is called:
   a. zero sum.
   b. autarky.
   c. mercantilism.
   d. comparative advantage.

4. An economy without international trade is an economy in a state of:
   a. disequilibrium.
   b. economic depression.
   c. autarky.
   d. economic expansion.

5. Autarky means that:
   a. a country’s consumption possibilities are the same as its production possibilities.
   b. equilibrium has been reached with the maximum gains from specialisation and trade.
   c. equilibrium has been reached with the maximum amount of international trade.
   d. the nation has such a high standard of living that there are technically no poor people.

6. In autarky, a country will maximise its standard of living when:
   a. its production point is on the production possibilities frontier.
   b. its productions point is inside the production possibilities frontier.
   c. its production point is outside the production possibilities frontier.
   d. none of the above.

7. Specialisation and trade by countries based on absolute advantage results in:
   a. a faster depletion of the world’s resources.
   b. products produced at higher cost.
   c. the world using its resources more efficiently causing an increase in world output.
   d. the world using its resources more efficiently causing a decrease in world output.

8. Which of the following is not an assumption generally made in the study of international economics?
   a. two nations
   b. two commodities
   c. perfect international mobility of factors
   d. perfect mobility of factors domestically

9. The theory of absolute advantage developed by Adam Smith was based on the assumption that:
   a. capital was the only factor of production.
   b. labour was the only factor of production.
   c. capital and labour were the only factors of production.
   d. absolute advantage was a myth.

10. Which of the following economists discovered the basic idea of comparative advantage?
    a. John Maynard Keynes
b. David Ricardo  
c. Paul Samuelson  
d. Milton Friedman

11. Over time, the economic interdependence of nations has:  
a. grown  
b. diminished  
c. remained unchanged  
d. cannot say

12. A rough measure of the degree of economic interdependence of a national is given by:  
a. the size of the nations’ population  
b. the percentage of its population to its GDP  
c. the percentage of a nation’s imports and exports to its GDP  
d. all of the above

13. Economic interdependence is greater for:  
a. small nations  
b. large nations  
c. developed nations  
d. developing nations

14. When economists talk about the gains from trade, they mean that:  
a. no one ever gets hurt by trade.  
b. the benefits of trade outweigh the losses.  
c. business firms benefit from trade but not necessarily individuals.  
d. trade increases government revenue through taxes on imports.

15. The gains from trade are due primarily to the fact that:  
a. the wealth of large, industrialised nations can be spread throughout the world.  
b. total world output increases when each country specialises.  
c. countries can boost their economies by increasing exports.

16. The source of gains from trade is:  
a. tariffs.  
b. self-sufficiency.  
c. autarky equilibrium.  
d. comparative advantage.

17. Mutually beneficial trade cannot occur:  
a. when each country has its own comparative advantage.  
b. if one country has absolute advantages in the production of every good.  
c. when the opportunity costs of producing each good are equal for both trading partners.  
d. if total world production equals total world consumption.

18. To maximise worldwide gains from trade, the country which should produce a good is the country that:  
a. has the lowest opportunity cost of producing that good.  
b. can produce that good using the fewest resources.  
c. will produce that good using the most expensive resources.

19. Comparative advantage:  
a. exists only when one producer can make the product using fewer resources than any other producer  
b. leads to the most efficient allocation of resources and the greatest combined output  
c. eliminates specialization, so that each country produces all of its own needs independently
20. Comparative advantage is the idea that:
   a. A country should produce the goods and services it can produce at a lower cost than other countries.
   b. It is not the absolute but the relative productivity differences that matter in deciding what a country should produce.
   c. Opportunity cost should determine the goods that should be produced by a given country.
   d. Both b and c.

21. According to the theory of comparative advantage, the most important benefit of trade is:
   a. more jobs.
   b. a more efficient allocation of resources.
   c. trade surpluses.
   d. increased exports.

22. If a country has an absolute advantage in two products and has a comparative advantage in only one product, what should it do?
   a. produce both products and export them to maximise its returns.
   b. specialise in the product it has a comparative advantage in and import the other.
   c. produce both products and export the cheapest and import the most expensive.
   d. produce both products and export the most expensive and import the cheapest.

23. If Dutch labour can produce 3 soda bottles or 5 yogurt cones in a day, while British labour can produce 2 soda bottles and 4 yogurt cones, then _____________ has a comparative advantage in yogurt cones.
   a. the U.K.
   b. the Netherlands
   c. both the U.K. and the Netherlands
   d. There is not enough information to answer this question.

24. Utopia can produce 8 units of food per day or 12 units of clothing per day. Valentians can produce 5 units of food per day or 10 units of clothing per day. Which of the following is true?
   a. mutually beneficial trade is not possible.
   b. to maximize world production, Utopians should produce only food, Valentians should produce only clothing, and they should trade.
   c. both countries should produce both goods and they should trade.

25. Opportunity cost is:
   a. the monetary cost of producing the goods.
   b. the monetary price paid for final goods and services.
   c. the monetary price associated with using one good in place of another.
   d. the alternative that must be given up in order to get something else.

26. A nation’s consumption possibilities frontier is:
   a. always the same as its production possibilities frontier.
   b. never the same as its production possibilities frontier.
   c. the same as its production possibilities frontier only if there is advantageous trade.
   d. the same as its production possibilities frontier only if there is no international trade.

27. If two countries are of unequal size:
   a. the larger country gains more from trade.
   b. the smaller country gains more from trade.
   c. the terms of trade will equal the smaller country’s opportunity costs of producing the two products.
   d. none of the above

28. Which of the following is not one of the dynamic gains from trade?
   a. a higher rate of growth of real GDP
   b. lower product quality
   c. higher product quality
   d. a very effective way to promote competition
29. The terms of trade are given by:
   a. the prices paid for all imports.
   b. the prices received for all exports.
   c. the price paid for all domestically produced goods.
   d. the prices received for exports and paid for imports; that is, the exchange rates of two goods.

30. Which of the following is not an economic reason for international specialisation?
   a. some countries have educated, trained workers, while other countries have unskilled workers.
   b. tastes and preferences tend to be different in different countries.
   c. the world price of a good is determined by the world supply and demand for the product.

31. When the world price of an internationally traded product is greater than a country’s domestic equilibrium price:
   a. the domestic price will prevail, and the world price is irrelevant.
   b. the country’s import line is horizontal.
   c. the country’s exports of the product will increase.

32. The world price is in equilibrium when:
   a. half of the individual countries’ domestic prices are higher and half of the individual countries’ domestic prices are lower.
   b. the desired level of total world exports of the good equal the desired level of total world imports of the good.
   c. each countries’ exports of this good equal its import of this good.

33. Producer surplus is the:
   a. excess supply which exists when price is maintained above the world price.
   b. difference between the marginal benefit of a product and the marginal cost producers incur in supplying the product.
   c. difference between the actual revenue a producer receives and the minimum sum they would accept for a quantity of a good.

34. Consumer surplus results when:
   a. the quantity demanded of a product equals the quantity supplied of that product.
   b. the quantity demand of a product is greater than the quantity supplied of that product.
   c. a consumer buys a good for less money then he was willing to pay.

35. With international trade:
   a. producer surplus increases in both the exporting and importing countries.
   b. consumer surplus increases in exporting countries and decreases in importing countries.
   c. consumer surplus increases in the importing countries and producer surplus increases in the exporting countries.

36. International trade:
   a. benefits countries which export goods and hurts countries which import goods.
   b. benefits poor, undeveloped countries and hurts wealthy, industrialized countries.
   c. increases both producer surplus and consumer surplus throughout the world.
   d. has a net beneficial effect only for countries with an autarky equilibrium.

37. In order for two countries to gain from specialisation and trade:
   a. The opportunity costs of producing the goods to be traded must be different between the countries.
   b. Each country must specialise in the production of the good for which it has a lower opportunity cost.
   c. Each country must specialize in producing the good for which it has a comparative advantage.
   d. All of the above.
38. The following statement refers to the graph below. Fill in the blanks with the appropriate letter. The United States has _______, and Mexico has _______.

a. an absolute but not a comparative advantage in the production of apples; an absolute but not a comparative advantage in the production of oranges.
b. a comparative but not an absolute advantage in the production of apples; a comparative but not an absolute advantage in the production of oranges.
c. an absolute advantage in the production of apples, but a comparative advantage in the production of oranges;
d. an absolute advantage in the production of oranges, but a comparative advantage in the production of apples.
e. an absolute and a comparative advantage in the production of apples; an absolute and a comparative advantage in the production of oranges.

39. The following statement refers to the graph below. Fill in the blanks with the appropriate letter. The United States should specialise in the production of _______________, and Mexico should specialise in the production of _______________, because both countries have a _______________ in the production of these goods, respectively.

a. apples; oranges; comparative advantage
b. oranges; apples; comparative advantage
c. apples; oranges; absolute advantage
d. oranges; apples; absolute advantage

40. The following statement refers to the graph below. Both countries are made better off if the terms of trade are as follows:

a. The United States can obtain an additional apple for less than five oranges; Mexico can sell an additional apple for more than 1/4 of an orange, or 4 apples to obtain 1 orange.
b. The United States can obtain an additional orange for less than five apples; Mexico can sell an additional orange for more than 1/4 of an apple, or 4 oranges to obtain 1 apple.
c. The United States can obtain an additional orange for more than five apples; Mexico can sell an additional orange for less than 1/4 of an apple.
d. None of the above. The terms of trade cannot be established.

41. All of the statements below are associated with the sources of comparative advantage, but only one is correct. Which one?
   a. The Heckscher-Ohlin Theorem is inconsistent with the idea of comparative advantage.
   b. It is impossible to gather a list of factors that account for comparative advantage as a source to explain most world trade patterns.
   c. A country has a comparative advantage in the production of a product if that country is relatively well endowed with the inputs used intensively to produce it.
   d. Evidence suggests that economies of scale in small industries are substantial and account for a great part of comparative advantage and world trade patterns.

42. The H-O model extends the classical trade model by:
   a. explaining the basis for comparative advantage.
   b. examining the effect of trade on factor prices.
   c. both a and b.
   d. neither a nor b.

43. In the H-O model, international trade is based mostly on a difference in:
   a. technology.
   b. factor endowments.
   c. economies of scale.
   d. tastes.

44. Which of the following is not an assumption of the factor-proportions theory on which the H-O model is based?
   a. Perfect competition in the product and factor markets.
   b. Homogeneous labour and capital in both countries.
   c. Different tastes and preferences between countries.
   d. Constant returns to scale.

45. A country is said to be relatively abundant in capital if it has:
   a. a greater absolute amount of capital.
   b. a smaller absolute amount of labour.
   c. a higher capital-to-labour ratio.
   d. a lower capital-to-labour ratio.

46. The H-O model is a general equilibrium model because it deals with:
   a. production in both nations
   b. consumption in both nations
   c. trade between the two nations
   d. all of the above

47. The H-O model is a simplification of a truly general equilibrium model because it deals with:
   a. two nations
   b. two commodities
   c. two factors of production
   d. all of the above

48. The factor-proportions theory of international trade implies that countries would tend to:
   a. export products that intensively utilise their scarce factor of production.
   b. import products that intensively utilise their abundant factor of production.
   c. export products that intensively utilise their abundant factor of production.
d. import products that intensively utilise their unknown factor of production.

49. The factor-proportions theory of international trade states that:
   a. a country should export the good with the highest output per unit of labour.
   b. a country will export the good that requires more intensive use of its abundant factor.
   c. a country should import the good that uses capital most intensively.
   d. a country should export the factor that receives a higher wage in the other country.

50. If a country is abundant in labour then it would tend to:
   a. import labour-intensive products.
   b. export labour-intensive products.
   c. export capital-intensive products.
   d. both export and import labor-intensive products.

51. If the amount of capital and labour in Country A are $100 million and 100 million workers, and the amount of capital and labour in Country B are $50 million and 25 million workers, then:
   a. Country A is capital abundant compared to Country B.
   b. Country B is capital abundant compared to Country A.
   c. Country B is labour abundant compared to Country A.
   d. both a and c.

52. We say that commodity Y is Capital (K) intensive with respect to X when:
   a. more K is used in the production of Y than X.
   b. less L is used in the production of Y than X.
   c. a lower L/K ratio is used in the production of Y than X.
   d. a higher K/L ratio is used in the production of X than Y.

53. Trade restrictions in the real world:
   a. are extremely rare, due to the economic benefits of specialization and trade.
   b. hurt domestic producers and benefit foreign consumers.
   c. hurt domestic producers and benefit domestic consumers.
   d. hurt domestic consumers and benefit domestic producers.

54. A tariff is:
   a. a tax on imports only.
   b. a tax on exports only.
   c. a tax on either imports or exports.
   d. a luxury tax.

55. A tariff on imports in a small country will lead to:
   a. a loss in consumer surplus, a gain in producer surplus and a loss in government revenue.
   b. a gain in consumer surplus, a loss in producer surplus and a loss in government revenue.
   c. a loss in consumer surplus, a loss in producer surplus and a gain in government revenue.
   d. a loss in consumer surplus, a gain in producer surplus and a gain in government revenue.

56. Which of the following groups gain from a tariff on imports?
   a. consumers.
   b. producers of the import substitutes.
   c. labourers in the export sector.
   d. all of the above.

57. If a country can influence world prices by levying a tariff on its import:
   a. it is a small country.
   b. it is a large country.
   c. any tariff will improve its welfare.
   d. it can only decrease, but not increase the world price of its import good.
58. The difference between a specific tariff and an ad valorem tariff is that a specific tariff:
   a. is a set amount of money per unit of a product, while an ad valorem tariff is a set percentage of
      product price.
   b. is a set percentage of product price, while an ad valorem tariff is a set total amount
   c. names a particular good to which the tariff applies, while an ad valorem tariff applies to large classes
      of products.

59. Which of the following is not an effect of a specific import tariff?
   a. the domestic price is higher after the tariff is imposed.
   b. there is no net welfare loss to society as a whole.
   c. government collects revenue from the tariff.
   d. the country’s imports of the product decline.

60. An import quota is a:
   a. legal limit on the quantity of a good that can be imported per year.
   b. legal requirement that a specified percentage of a final good’s value must be produced domestically.
   c. legal requirements that exports to a specific country must exceed a specific value before the
      country’s product may be imported.

61. To be effective, an import quota must:
   a. reduce the price and increase the quantity of imports.
   b. set the price of the imported good higher than the domestic equilibrium price.
   c. restrict imports to less than would be imported under free trade.
   d. restrict imports to less than exports in trade with that particular country.

62. An effective import quota:
   a. increases consumer surplus and reduces produces surplus.
   b. increases producer surplus and reduces consumer surplus.
   c. increases both producer surplus and consumer surplus.

63. The primary difference between an import tariff and an import quota is that:
   a. tariffs cause prices to rise, but quotas do not.
   b. quotas cause prices to rise, but tariffs do not.
   c. tariff revenues go to government, but quotas benefit those with the right to sell foreign goods
      domestically.

64. Which of the following is not a type of trade restriction?
   a. low-interest loans to foreign buyers.
   b. export subsidies for domestic firms.
   c. domestic content requirements.
   d. economies of scale.

65. Economists generally prefer the use of subsidies instead of protective tariffs because:
   a. subsidies create smaller deadweight losses.
   b. subsidies can be targeted more carefully.
   c. the visible cost of subsidies creates an automatic incentive to phase out protection.
   d. all the above.

66. The industrial landscape is littered with infants that never grew up. This refers to infant industries that:
   a. require protection from import competition indefinitely.
   b. remain labour-intensive instead of adopting modern technology.
   c. are not successful in the export market.
   d. cannot earn profits even with protection from import competition.
The following four questions refer to the diagram below.

67. Referring to the graph, state the quantity supplied by domestic producers and the quantity imported at the world price, before a tariff is imposed:
   a. 20, 50
   b. 30, 30
   c. 20, 10
   d. 60, 10
   e. 20, 70

68. Referring to the graph, state the quantity supplied by domestic producers and the price they will charge after the tariff is imposed:
   a. 20 units at $0.10 each.
   b. 30 units at $0.10 each.
   c. 30 units at $0.15 each.
   d. 60 units at $0.15 each.
   e. 50 units at $0.15 each.

69. Referring to the graph, state what the quantity of imports would be, after the imposition of a tariff:
   a. increase by 10.
   b. decrease by 10.
   c. decrease by 20.
   d. decrease by 30.
   e. decrease by 50.

70. Referring to the graph below, government revenue collected from the tariff equals:
   a. $1.5
   b. $3
   c. $9
   d. $4.5
   e. $15
71. What was GATT?
   a. An international organisation that oversaw multilateral trade negotiations and tariff policies.
   b. A voluntary export-restriction agreement governing international trade in textiles.
   c. A free-trade area in Southeast Asia.
   d. An eastern European trading bloc that disbanded in the early 1990s.

72. The General Agreement on Tariffs and Trade (GATT) was established in:
   a. 1870 to protect U.S. industries and decrease world trade.
   b. 1921 to manage legal and accounting requirements for U.S. tariffs and quotas.
   c. 1947 to reduce trade restrictions among 23 countries.

73. The World Trade Organization (WTO):
   a. became, in 1995, the institutionalised and more comprehensive successor to the General Agreement on Tariffs and Trade (GATT).
   b. was established in 1947 to reduce trade restrictions among 23 member countries.
   c. was established in 1980 to oppose and counteract the policies of the General Agreement on Tariffs and Trade (GATT).

74. The most-favoured nation clause of the World Trade Organization requires that each member must:
   a. offer to all member countries the same trade concessions offered to any member country.
   b. choose one foreign member as its most-favoured trading nation, and give that country its most generous trade concessions.
   c. offer some trade concession to any other member country offering it a trade concession.

75. Regional trading bloc agreements:
   a. are required by World Trade Organization rules.
   b. exist primarily in Russia, Africa, and South America.
   c. make special trade deals between countries in that region and discriminate against countries outside the region.

76. Which of the following is not used as an argument for trade restrictions?
   a. Emerging domestic industries, especially those with economies of scale, could not gain entry in some world markets without protection during the early years.
   b. Trade restrictions are required to prevent some countries from exporting a commodity at a price below its cost of production.
   c. Consumer surplus is maximised only when strict import tariffs and quotas ensure that exports exceed imports.

77. The most comprehensive and complex multilateral trade agreement in history was the "Final Act" of the Uruguay Round of negotiations. This agreement is part of which of the following trade initiatives?
   a. The Sherman Antitrust Act of 1890.
   c. The Smoot-Hawley tariff in the 1930s.
   d. The 1974 Trade Act.
   e. The General Agreement on Tariffs and Trade (GATT).

78. Protectionism to save jobs in declining industries in the industrial countries hurts whom?
   a. Consumers in the industrial countries.
   b. Export industries in the industrial countries.
   c. Export industries in the developing countries.
   d. All the above.

79. International trade maximises world welfare, as the gains from trade cause:
   a. a more efficient allocation of world resources.
   b. a decrease in price of non tradable goods.
   c. more democracy in foreign countries.
   d. a decrease in overall world production.
80. Which of the following industries are more likely to be protected?
   a. Industries with few firms.
   b. Industries that produce an intermediate product.
   c. Industries with a comparative disadvantage.
   a. All of the above.

81. Which of the following is not a form of administered protection?
   a. Antidumping duties.
   b. Countervailing duties.
   c. Specific duties.
   d. Escape clause actions.

82. Dumping occurs when a firm:
   a. sells too much of a good in a foreign country.
   b. sells in a foreign country at prices that are below true value.
   c. sells in its home market at prices that are below the average price charged by its competitors.
   d. sells in a foreign market at prices that are below the price charged in the home market.

83. From the late 1940s until the creation of the WTO, the treaty (organisation) that was primarily responsible for conducting multilateral trade negotiations was the:
   a. World Bank.
   b. GATT.
   c. ITO.
   d. United Nations.

84. The international organization that serves as a forum for trade discussions and the development of trade rules is called the:
   a. WTO.
   b. World Bank.

**True / False Questions**

85. According to the theory of comparative advantage, specialisation and free trade may not benefit countries that are absolutely less efficient producers. TRUE / FALSE

86. A country enjoys a comparative advantage with another country if it uses fewer resources to produce a product than the other country does. TRUE / FALSE

87. A country enjoys a comparative advantage with another country if it can produce a product at a lower cost in terms of other goods. TRUE / FALSE

88. The ratios at which two currencies are traded for each other affect the relative attractiveness of foreign goods to domestic buyers and of domestic goods to foreign buyers. TRUE / FALSE

89. Free markets drive a country to shift resources to those sectors in which it enjoys a comparative advantage. TRUE / FALSE

90. Having a higher endowment of a resource used to produce a particular good does not appear to be the reason why a country has a comparative advantage in the production of that good. TRUE / FALSE

91. Export subsidies are considered as a trade barrier. TRUE / FALSE