

# Benefits of International Trade

4.1





**Do you think countries benefit from trade? Why or why not?**

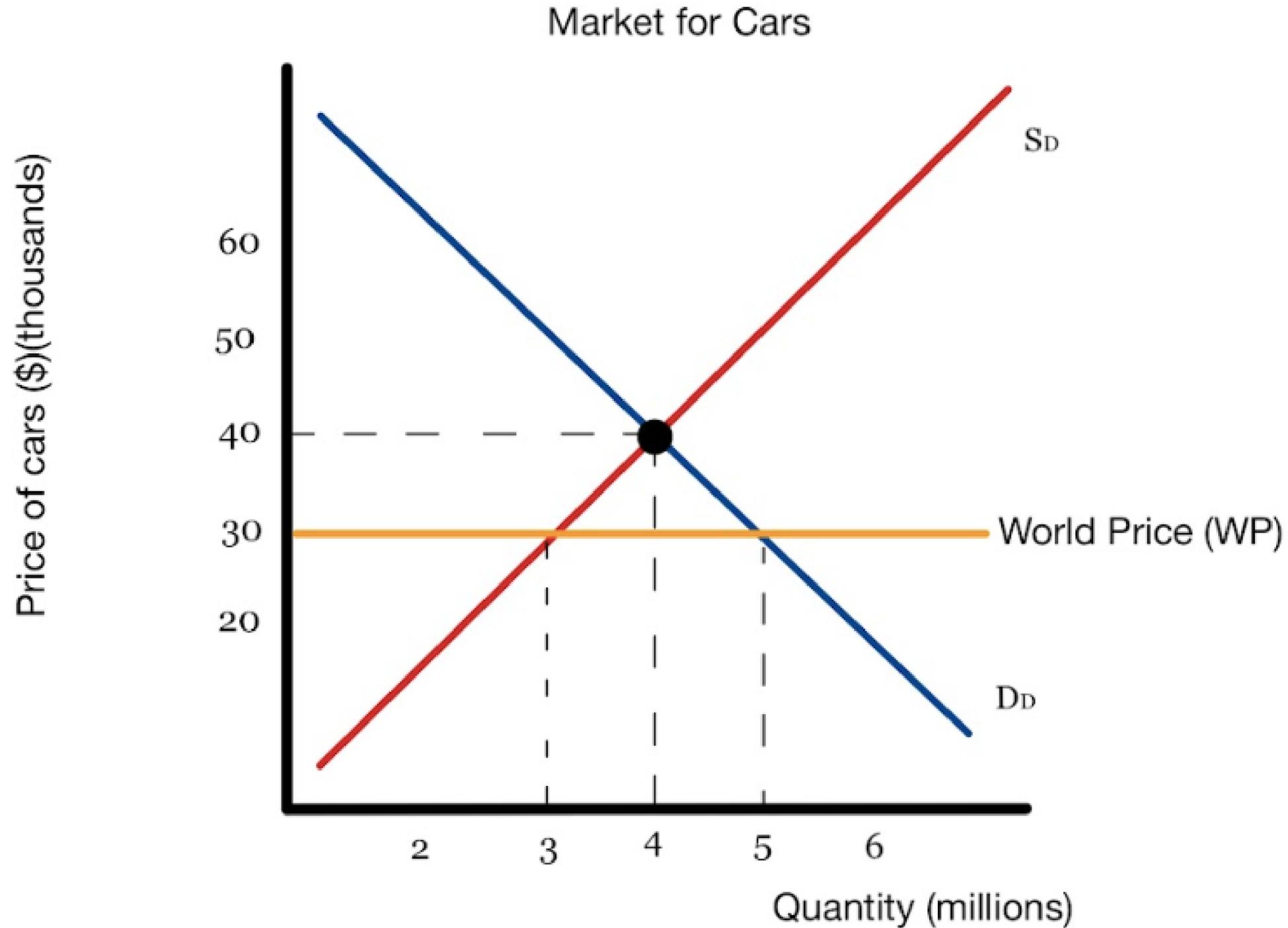
# Definition

## Free Trade

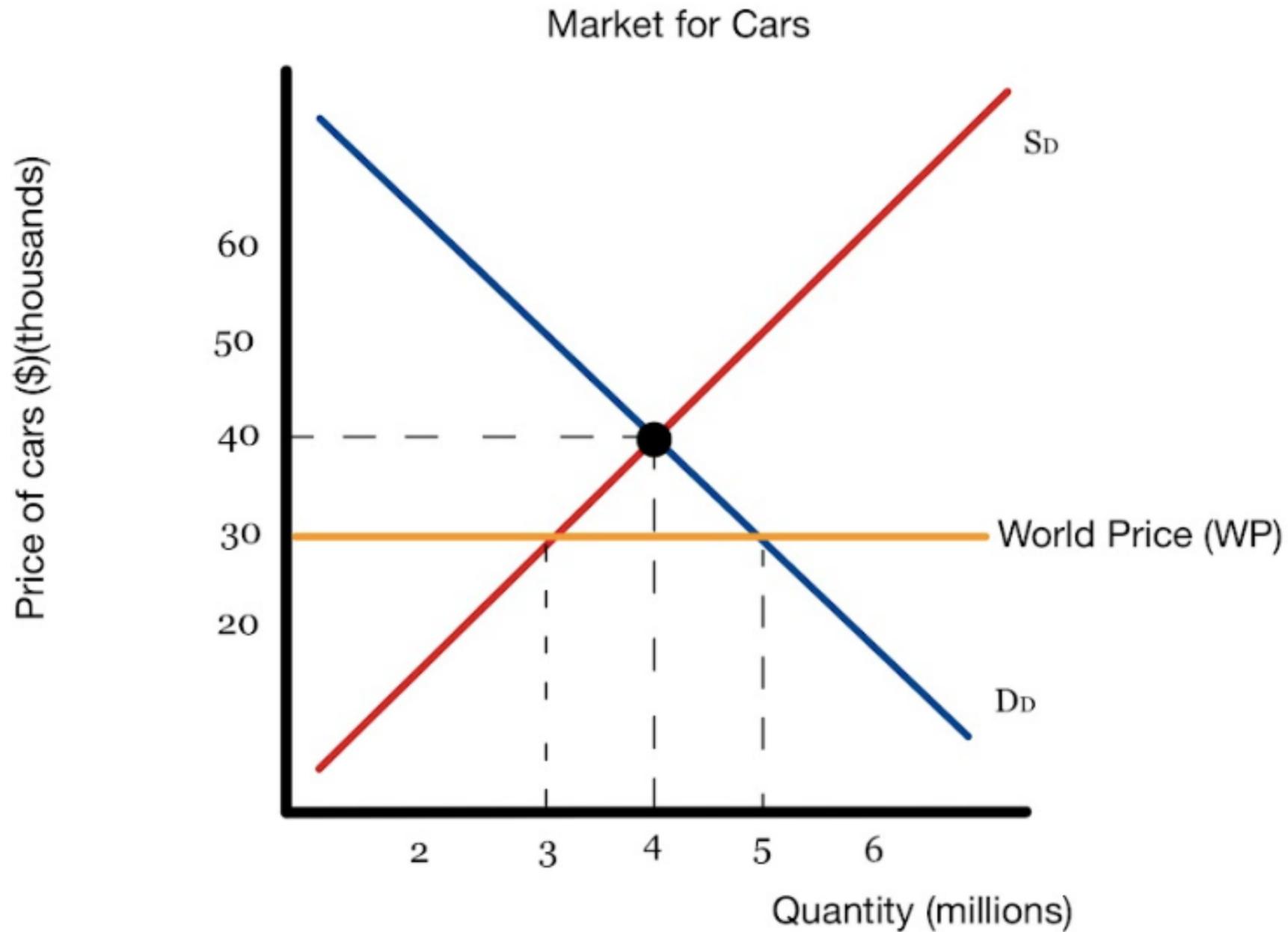
No barriers to trade between countries



# Free Trade Diagram



# Free Trade Diagram



## Before Trade

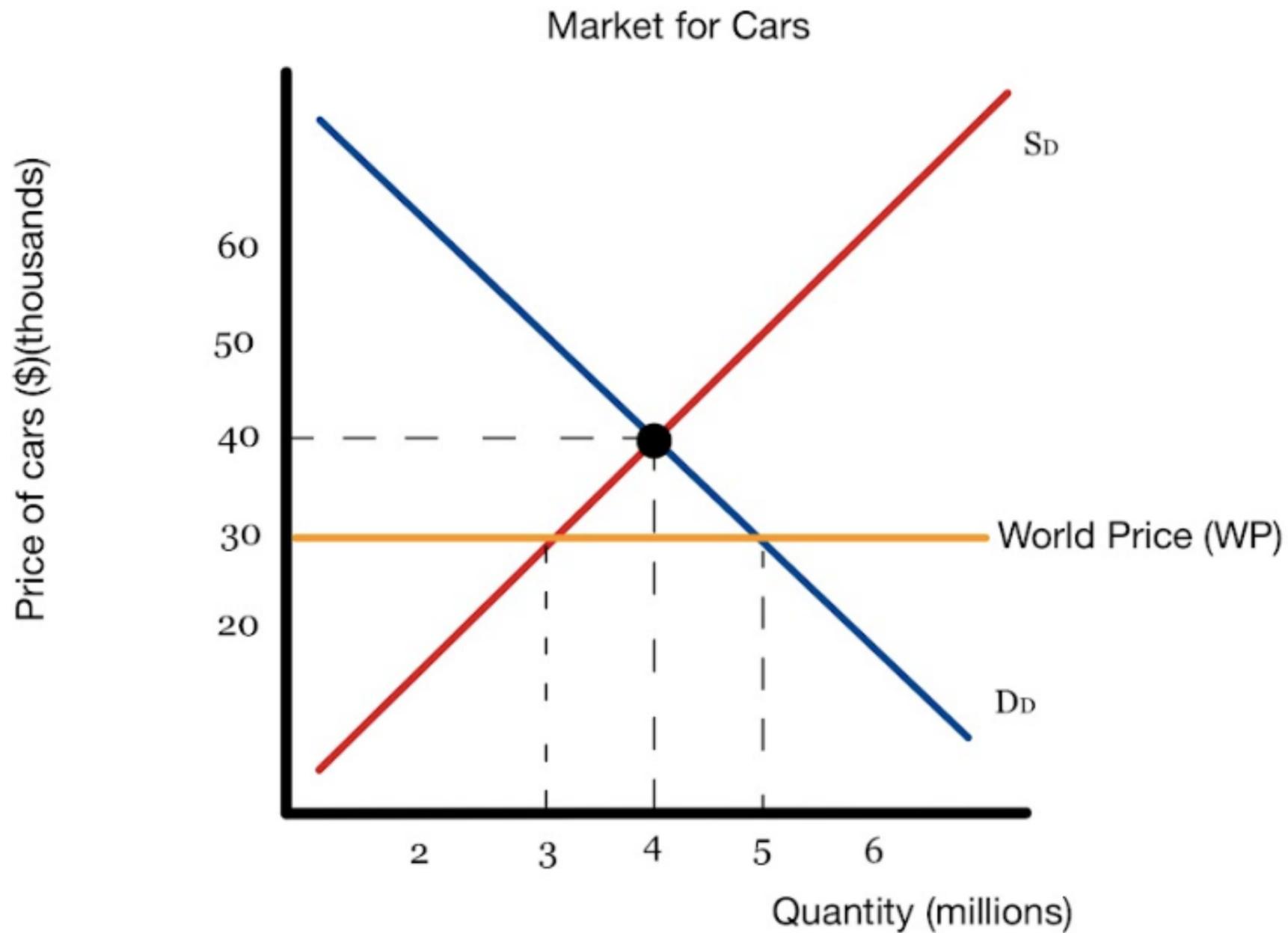
How much did domestic firms make from selling cars?  
How much was the domestic consumer surplus? Domestic producer surplus?

## After Trade

What happened to price level?  
What quantity is being sold domestically?  
What quantity is being imported?  
How much did domestic firms make from selling cars?  
How much did foreign firms make from selling cars?

What happened to the domestic consumer and producer surplus? Is there more total surplus before or after trade?

# Free Trade Diagram



## Before Trade

What quantity is being sold domestically?

**4 (millions)**

How much did domestic firms make from selling cars?

**160,000 (millions)**

## After Trade

What happened to price level?

**Decreased to 30 (thousands)**

What quantity is being sold domestically?

**3 (millions)**

What quantity is being imported?

**2 (millions)**

How much did domestic firms make from selling cars?

**90 (millions)**

How much did foreign firms make from selling cars?

**60 (millions)**

What happened to the domestic consumer and producer surplus?

Is there more total surplus before or after trade?

# Benefits of International Trade



# Benefits to International Trade

**Increased competition**

**Lower prices**

**Greater choice**

**Acquisition of resources**

**More foreign exchange earnings**

**Access to larger markets**

**Economies of scale**

**More efficient resource allocation**

**More efficient production**



# Increased Competition

International trade allows for firms in other countries to compete with one another, leading to increased competition and higher quality.



# Lower Prices

Countries are able to specialize and use economies of scale to decrease their costs of production and sell their products at a lower price.



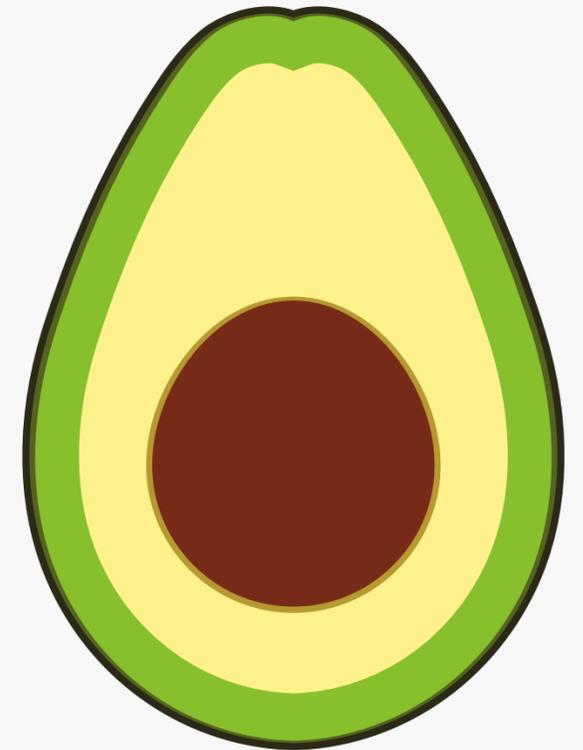
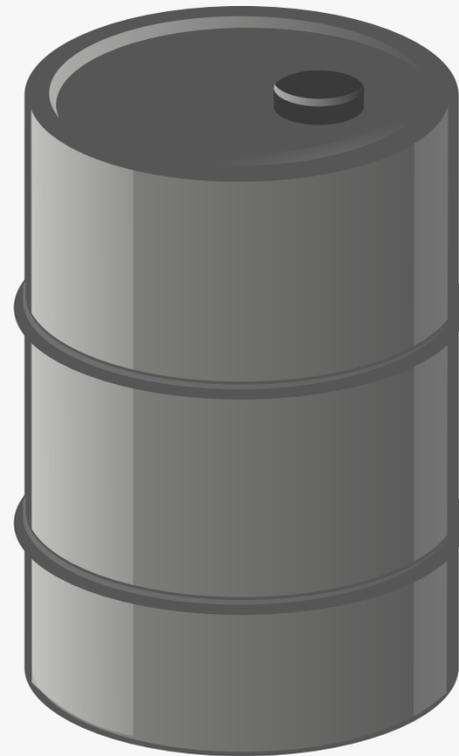
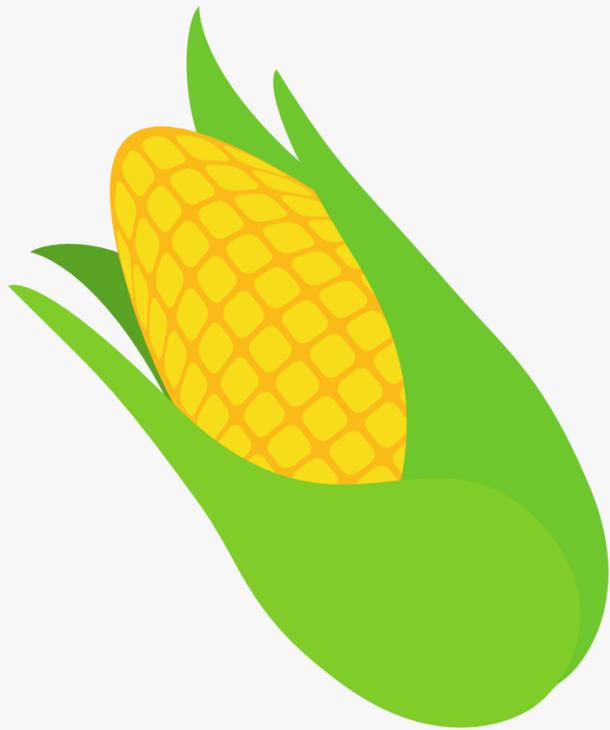
# Greater Choice

Free trade enables domestic consumers to have a greater choice as they are able to select goods/services domestically and internationally.



# Acquisition of Resources

Each country has access to specific natural resources. Free trade allows for countries to sell their resources for production in other countries.



# Foreign Exchange Earnings

Foreign Exchange earnings refer to financial gains made by currencies exchanging on the global market.



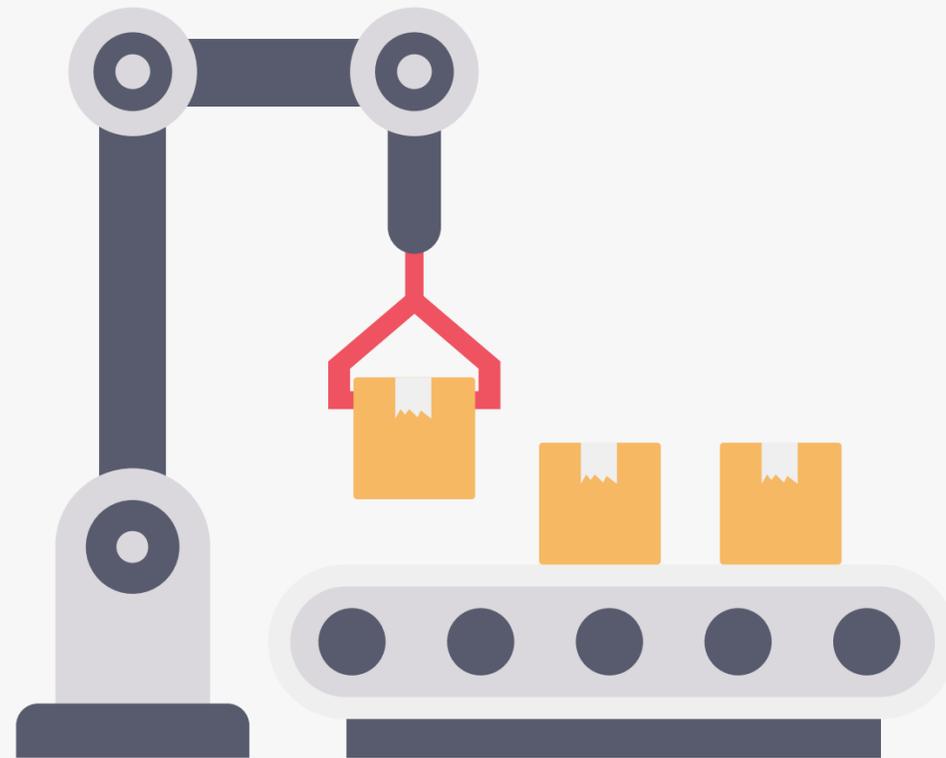
# Access To Larger Markets

Individual firms would have access to a global market instead of being limited to their domestic market. Free trade allows companies to become multi-national and gain more consumers.



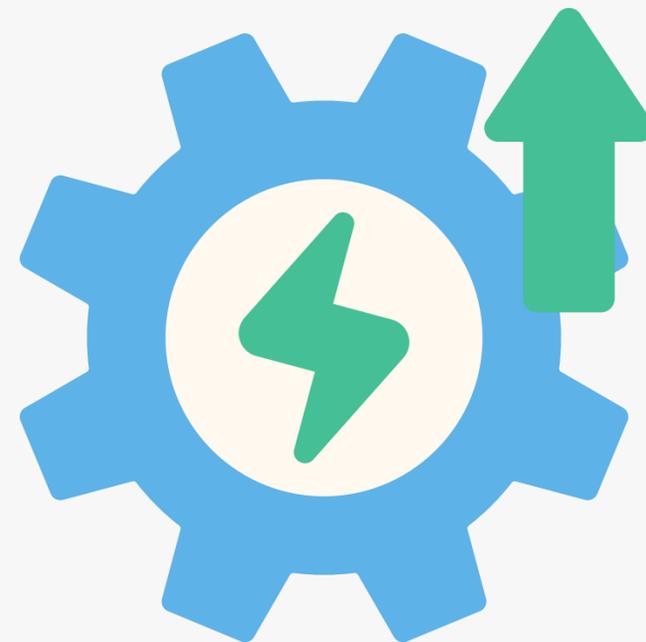
# Economies of Scale

Larger markets allow firms to gain larger revenue. Firms have the option to invest that revenue into increasing efficiency and lowering costs.



# Efficient Resource Allocation and Production

Free trade allows countries to allocate their resources as efficiently as possible and gives firms access to raw materials that ensure their production costs are as low as possible.



# Comparative and Absolute Advantage



# Definitions

## **Absolute Advantage**

When a country can produce more with equivalent resources.  
(They are absolutely better at producing it).

## **Comparative Advantage**

When a country can produce a good at a lower opportunity cost compared to another country.  
(Comparative advantage helps countries determine what they should trade)



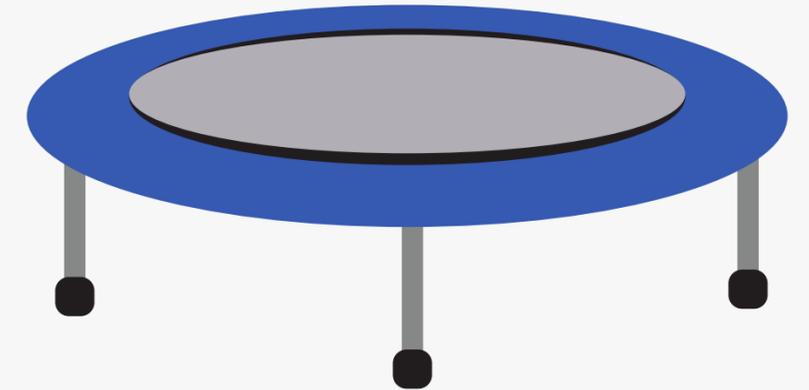
# Two Types Scenarios

## The advantage with a focus on Output

Which country can produce the highest quantity?

Ex: China can make 60 trampolines while the USA can only make 50.

Who is more efficient?



## The advantage with a focus on Input.

Which country can make a quantity of a good with the lowest amount of resources.

Ex: Joe takes 2 hours to mow the lawn while it takes Carl 4 hours.

Who is more efficient?

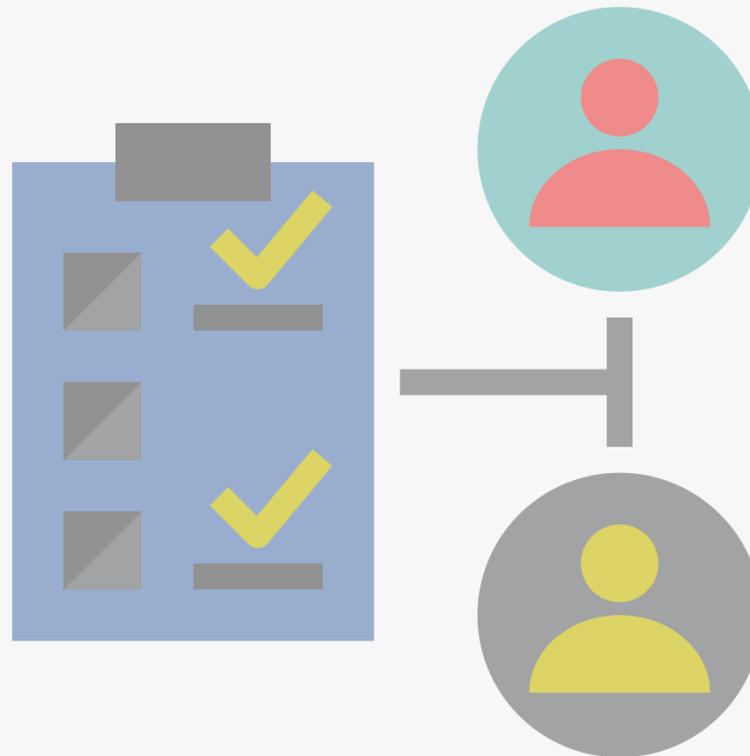
# Sources of Comparative Advantage

## Factor/Resource Endowment

Some countries have access to resources that makes production easier.

## Levels of Technology

Some countries have access to technologies that make them more efficient in the production of certain goods.



# Calculating Comparative Advantage

In order to determine the comparative advantage, you must calculate the opportunity cost for producing one of each good.

Output: Other (#) goes Over (OOO)  
Input: Other (#) goes Under (IOU)



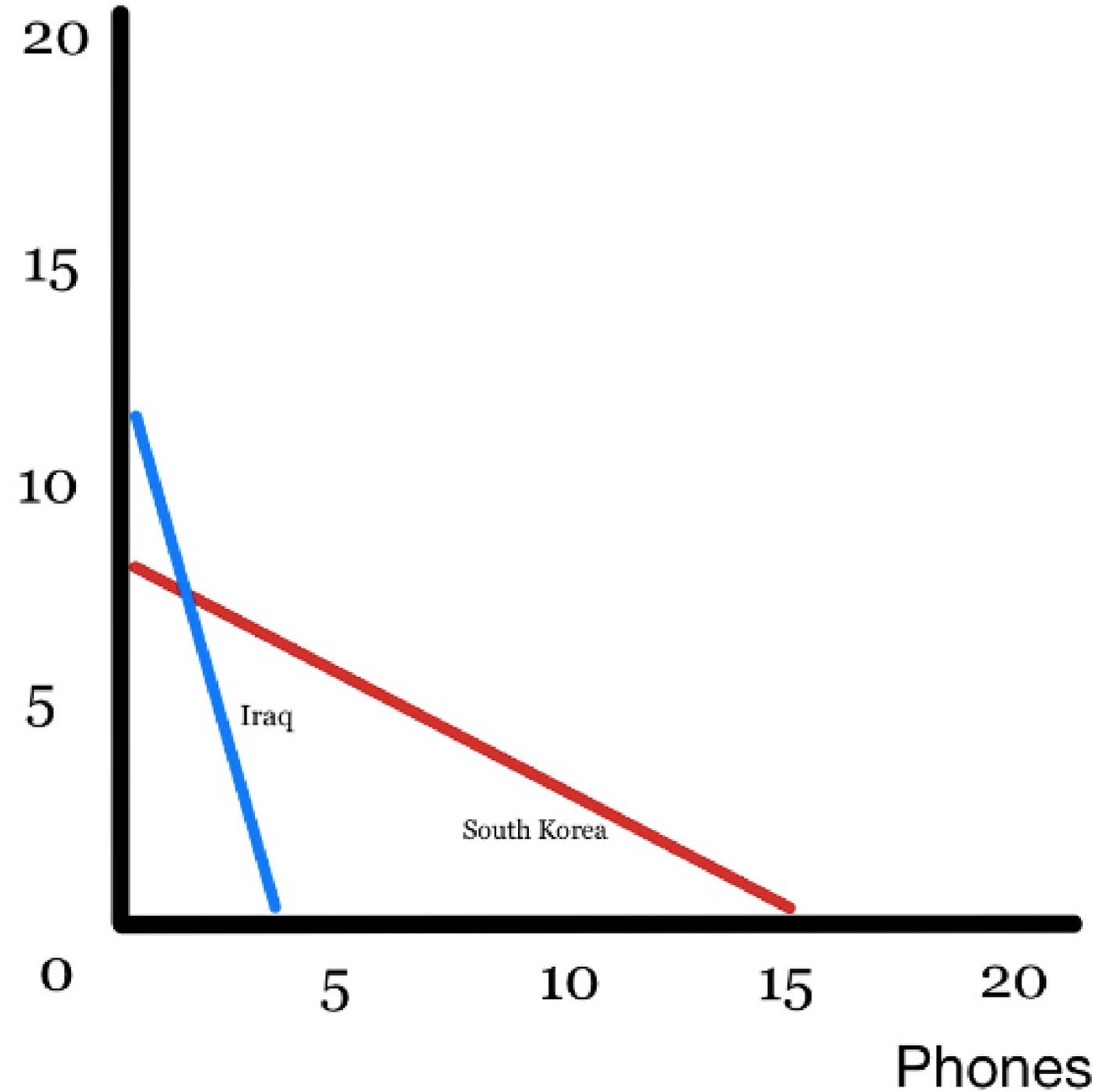
# Example



	Phones	Oil
South Korea	16	8
Iraq	4	12



Oil 20



# Practice

## Absolute Advantage

Who has an absolute advantage in producing phones?

Who has an absolute advantage in producing oil?

## Comparative Advantage

Who has an absolute advantage in producing phones?

Who has an absolute advantage in producing oil?

	Phones	Oil
South Korea	16	8
Iraq	4	12

# Example

## Absolute Advantage

Who has an absolute advantage in producing phones? **South Korea**

Who has an absolute advantage in producing oil? **Iraq**

## Comparative Advantage

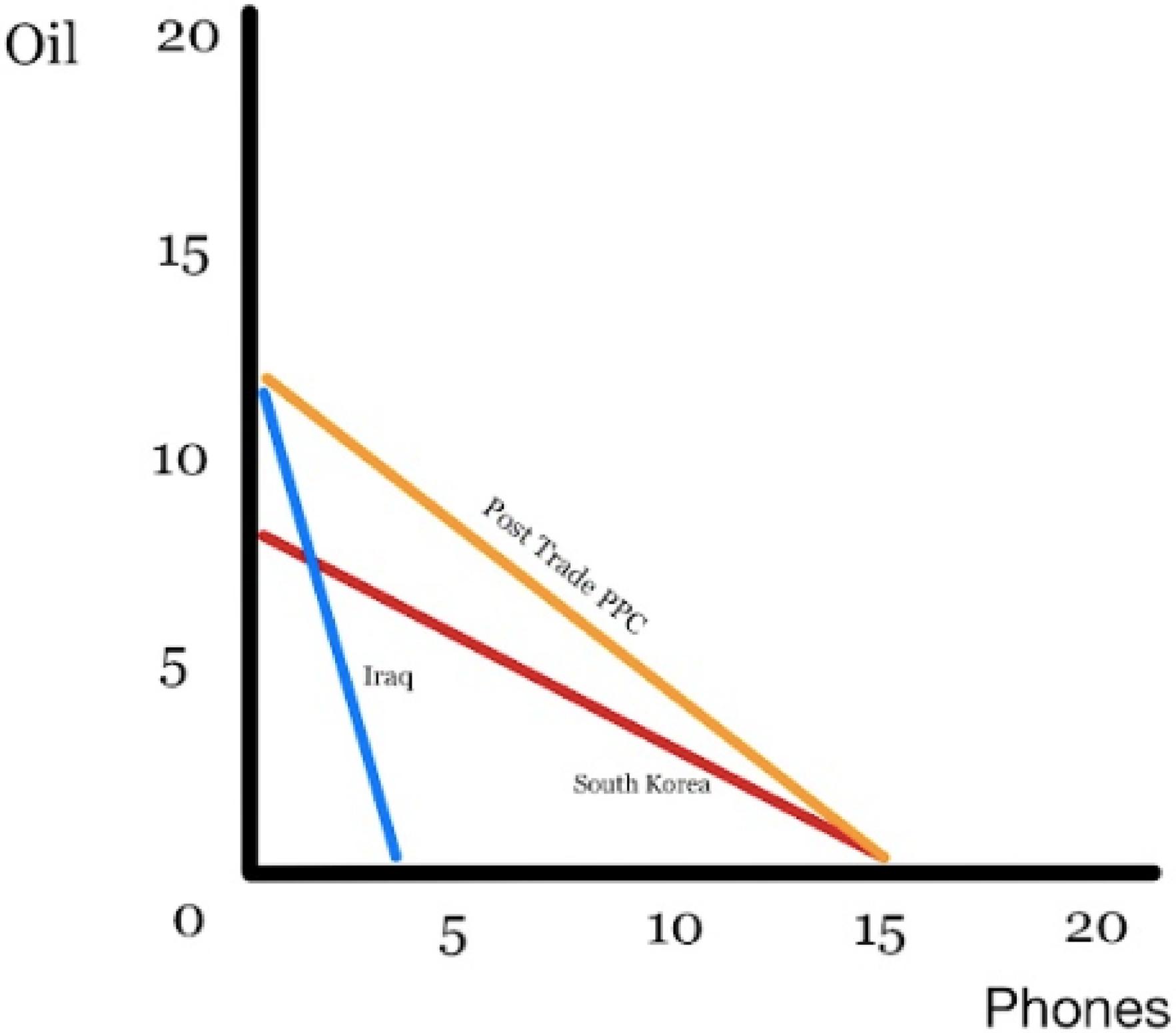
Who has an absolute advantage in producing phones? **South Korea**

Who has an absolute advantage in producing oil? **Iraq**

**South Korea should export and specialize in phones while Iraq should export and specialize in Oil.**

	Phones	Oil
South Korea	16 (1P : 0.50)	8 (10: 2P)
Iraq	4 (1P : 30)	12 (10: 0.3P)

# Before Trade & After Trade PPC



# Opportunity Cost Calculation Cheat

NOTE: This cheat is only to assist you with quick calculations or to check your work. It should never be used in an answer

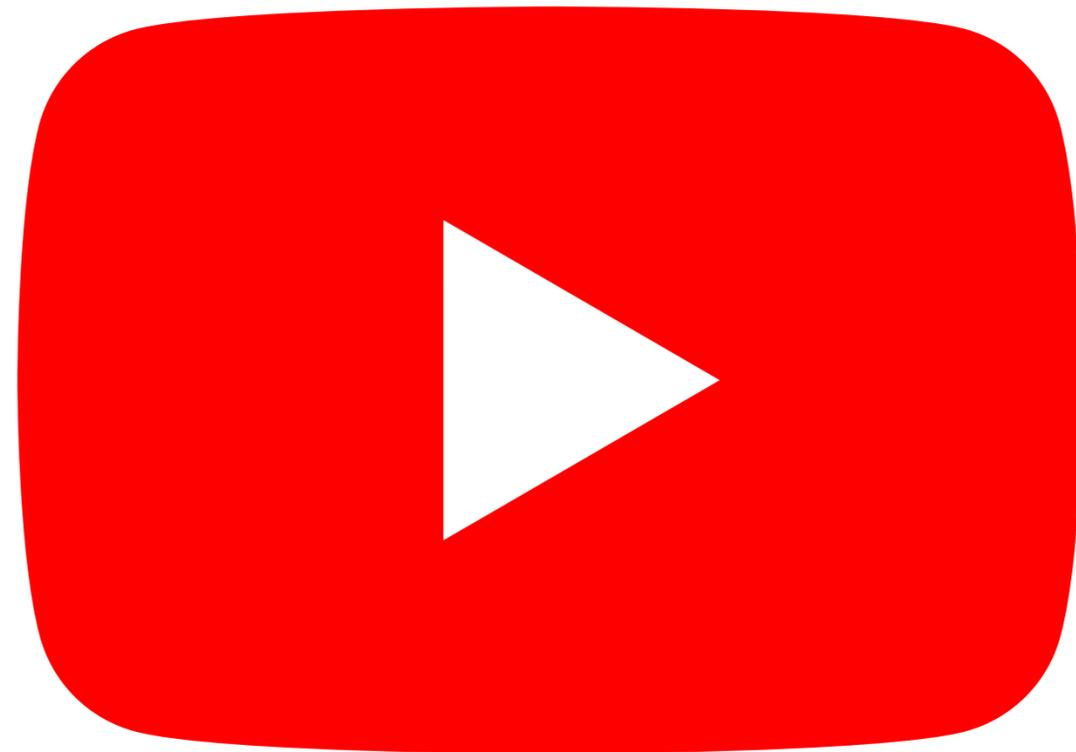
Cross multiply numbers in the box to quickly determine competitive advantage.

Output problem: take the number that gives you the most production (highest)

Input problem: take the number that requires the fewest amount of resources (lowest)

	Phones	Oil		
South Korea	16	8	=	32
Iraq	4	12	=	224





Comparative Advantage - ACDC Econ

# **Limitations of Comparative and Absolute Advantage**

# Limitations of Comparative Advantage

## Problems or issues with comparative advantage:

- Only 2 goods and 2 countries (simplified and unrealistic)
- Assumption of full employment
- Assumption of perfect information
- Assumption that technology is fixed
- No calculation of the cost of transportation between countries



# Practice Question



# Paper 1

- a. Explain how the theory of comparative advantage can result in two countries improving economic well-being through international trade.

[10]



# Mark Scheme

3. (a) Explain how the theory of comparative advantage can result in two countries improving economic well-being through international trade.

[10]

*Answers may include:*

- Definition: comparative advantage, economic well-being and/or international trade.
- Explanation: of theory of comparative advantage with countries producing at a lower opportunity cost that creates greater social surplus with lower prices for imports and greater choice for consumers.
- Diagram: PPC diagrams illustrating comparative advantage or import/export diagrams for international trade..

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