

# Tutorial Letter 201/2/2014

## International Trade ECS3702

Semester module

Department of Economics

**IMPORTANT INFORMATION:**

This tutorial letter contains solutions to Assignment  
01 for Semester 2

BAR CODE

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Dear Student

## 1. INTRODUCTION

To date you should have received the following study material for ECS3702:

- Study guide
- Tutorial Letter 101/2013 (Introductory tutorial letter and assignments)
- Tutorial Letter 301/2013 (General information to all students of Economics)

This tutorial letter contains the following information:

- Answers to Assignment 01

Please read this tutorial letter carefully, together with Tutorial Letter 101 and the other study material that you have received. You will find answers to many of your questions if you do this.

## 2. ANSWERS TO ASSIGNMENT 01

Make sure that you **understand** where and why you made mistakes in your assignment. Refer to the relevant pages in the study guide (SG) or the prescribed textbook (TB). We provide an explanation if the answer is not self-evident from the prescribed text.

You had to answer 20 multiple-choice questions for this assignment, PLUS 10 student-profile questions. The questions appeared on pages 32 to 38 of Tutorial Letter 101.

### THE ANSWERS TO THE QUESTIONS OF ASSIGNMENT 01 ARE:

[1]	2	[6]	1	[11]	4	[16]	2
[2]	1	[7]	3	[12]	2	[17]	3
[3]	1	[8]	3	[13]	2	[18]	1
[4]	1	[9]	1	[14]	1	[19]	3
[5]	2	[10]	1	[15]	2	[20]	4

**QUESTION 1**

**The correct alternative is 2.**

The primary reason why countries take part in international trade is due to differences in their factor endowments.

**QUESTION 2**

**The correct alternative is 1.**

**QUESTION 3**

**The correct alternative is 1.**

One of the gains from trade is the opportunity to consume more than what is domestically produced. International trade enables consumption beyond the levels of domestic production.

**QUESTION 4**

**The correct alternative is 1.**

See page 58 section 3.3 of the TB

**QUESTION 5**

**The correct alternative is 2.**

Increasing opportunity costs result in a production frontier that is concave from the origin. See page 56 of the TB.

**QUESTION 6**

**The correct alternative is 1.**

The PPC shows all possible combinations of 2 goods that can be produced if all resources are used efficiently. All points on the PPC represent attainable combinations.

**QUESTION 7**

**The correct alternative is 3.**

The classical theories assume complete specialization.

**QUESTION 8**

**The correct alternative is 3.**

**QUESTION 9**

**The correct alternative is 1.**

The labour theory of value suggests that the value of a commodity depends exclusively on the amount of labour that goes into producing it. Thus it assumes that labour is the only factor of production. This assumption is limiting as in reality, labour is not the only factor of production.

**QUESTION 10**

**The correct alternative is 1.**

According to the theory of comparative advantage if nation A has a comparative advantage over nation B in the production of good X, then nation B will have a comparative advantage in the production of good Y.

**QUESTION 11**

**The correct alternative is 4.**

See page 58 of the TB.

**QUESTION 12**

**The correct alternative is 2.**

See page 104 of the TB.

**QUESTION 13**

**The correct alternative is 2.**

According to the H-O theory, a country will produce and export the commodity that uses its abundant and cheap factor of production intensively. A labour abundant country will therefore produce labour intensive commodities.

**QUESTION 14**

**The correct alternative is 1.**

See explanation in 13 above.

**QUESTION 15**

**The correct alternative is 2.**

The theory of comparative advantage assumes labour is the only factor of production while the FPT assumes that labour and capital are both utilised in the production process.

**QUESTION 16**

**The correct alternative is 2.**

When countries open up to trade and trade according to their comparative advantage, they increase the production of the commodity that utilizes the abundant and cheap factor, therefore the owners of this factor of production will benefit from trade.

**QUESTION 17**

**The correct alternative is 3.**

See explanation in 16 above.

**QUESTION 18**

**The correct alternative is 1.**

The premise of the FPT is that comparative advantage arises due to differences in factor endowments between countries.

**QUESTION 19**

**The alternative is 3.**

Factor abundance can be determined in physical terms (total capital/total labour ratio of the country). Therefore the TK/TL ratio for South Africa is 0.5 and for Namibia is 0.33, therefore since the ratio is higher for South Africa than Namibia, South Africa is said to be capital abundant. Cars are capital intensive; South Africa will therefore produce and export cars.

**QUESTION 20**

**The correct alternative is 4.**

See page 155 of the TB.

### 3. ASESMENT

As indicated in Tutorial Letter 101, your semester (year) mark will be based on your assignment marks. The first assignment will contribute 25%, the second assignment will contribute 25% to your semester mark and the third assignment will contribute 50%. Your final mark will be calculated using the following weights:

Semester (year) mark:	20%
Final examination mark:	80%
Total:	100%

#### 4. COPY OF THE MAY 2013 EXAMINATION PAPER

##### SECTION A AFDELING A

This section is compulsory for all students. All students must answer question 1.  
Hierdie afdeling is verpligtend vir alle studente. Alle studente moet vraag 1 beantwoord.

##### QUESTION 1 VRAAG 1

- (a) Explain the general characteristics of mercantilism. To what extent do nations today practice mercantilism? (10)

Mercantilism was developed by writers in Europe between 1500 and 1800. According to the mercantilists, trade is a **zero sum game** where the gains of the winners were offset by the losses of the losers. Since not all nations could have trade surpluses at the same time, it meant one nation gained at the expense of the other nation. Trade was based on **self-interest**. They believed that in order to **become rich and powerful** a nation must **export more than it imported**, by so doing accumulating precious metal or bullions. **Governments** had to therefore ensure that **exports were stimulated and imports restricted** using **tariffs and other trade barriers**. The excess of exports over imports led to an inflow of precious metals such as gold and silver/bullion. They did not consider the **inflationary impact** of having a trade surplus. They also did not take into account the **welfare implications of having a trade surplus**. Having a balance of payment surplus weakens a country's competitiveness.

Verduidelik die algemene eienskappe van merkantilisme. Tot welke mate be-oefen lande vandag merkantilisme? (10)

- (b) Explain the theory of comparative advantage. *Assumptions and criticisms of the theory must be clearly stated.* (10)

**David Ricardo** argued that **mutually beneficial trade was still possible** between two trading partners even if one had an absolute advantage in the production of both commodities. According to Ricardo, **what was important is the degree of the advantage. I.e. the opportunity costs**. A nation would **produce and export the commodity of its lowest opportunity cost**. For trade to occur the **domestic terms of trade must fall within the international terms of trade**.

**Assumptions and criticisms can be found in the class notes on myUnisa.**

Verduidelik die teorie van vergelykende voordeel. Aannames van en kritiek teen die teorie moet duidelik aangetoon word. (10)

- (c) Criticisms of the factor proportions theory led to new trade theories being developed. Name and describe **any one** of the alternative theories of trade. (5)

You need to discuss any **of intra industry trade, technological gap model, product life cycle model** and **economies of scale and international trade**.

Kritiek teen die faktorverhoudingsteorie het aanleiding gegee tot die ontwikkeling van nuwe handelsteorieë. Noem en beskryf **enige een** van die alternatiewe handelsteorieë. (5)

**[25]**

**SECTION B**  
**AFDELING B**

Answer any *three* questions of your choice from this section.  
Beantwoord enige *drie* vrae van u keuse uit hierdie afdeling.

**QUESTION 2**  
**VRAAG 2**

(a) Define and explain the following terms

- (i) Effective rate of protection. (5)
- (ii) Nominal tariff. (5)

Definieer en verduidelik die volgende begrippe:

- (i) Effektiewe koers van beskerming. (5)
- (ii) Nominale tarief. (5)

- The effective rate of protection is the percentage increase in domestic value added per unit of output made possible by the tariff structure. The rate of protection is calculated on domestic value added. The effective rate of protection is important to domestic producers because it indicates how much protection is actually provided to the domestic processing of the import competing commodity. If a nation imposes a tariff on imported clothes but imports wool duty free, then the effective rate of protection will be higher than the nominal tariff.
- Nominal tariff is the tariff rate imposed on the final commodity. Nominal tariff is calculated on the value of the final commodity. The nominal tariff is important to consumers because it indicates by how much the price of the final commodity will increase as a result of the tariff.

(b) Assume South Africa produces shoes, and R80 of leather is used in the production of each pair of shoes. Assume also that the free trade price of leather shoes is R100 and a 10% nominal tariff is imposed on each pair of shoes.

- (i) How much is the domestic value added? *Show how you obtained your answer.* (5)
- (ii) How much is the effective tariff rate? *Show how you obtained your answer.* (5)
- (iii) Between the producers and consumers who is better off in this situation? Explain. (5)

Neem aan dat Suid-Afrika skoene produseer en dat R80 se leer gebruik word in die produksie van elke paar skoene. Neem ook aan dat die vrye-handelsprys van leerskoene R100 is en dat 'n nominale tarief van 10% gehef word op elke paar skoene.

- (i) Wat is die waarde plaaslik toegevoeg? *Toon aan hoe u by die antwoord uitkom.* (5)
- (ii) Wat is die effektiewe tariefkoers? *Toon aan hoe u by die antwoord uitkom.* (5)
- (iii) Wat betref die produsente en die verbruikers, wie is die beste af in hierdie situasie? Verduidelik. (5)
- [25]**

Price of shoes = R100

Price of shoes plus tariff = R110

Price of wool = R80.

**Therefore domestic value added = R20 (100-80)**

EFFECTIVE RATE OF PROTECTION

**ERP =  $10 - (0.8 * 0.1) / 1 - 0.8 = 0.02 / 0.2 = 0.1$  or 10%**

**The nominal tariff rate is 10% (10/100) and the effective tariff rate is 50% (10/20), therefore since the effective tariff rate is greater than the nominal tariff rate, the producers are better off.**

### QUESTION 3

#### VRAAG 3

Use your knowledge of the classical trade theories to evaluate the following statement. “The principle of absolute advantage asserts that mutually beneficial trade can occur even if one nation is absolutely more efficient in the production of all goods”. *Assumptions and criticisms of theories discussed must be included.* [25]

Gebruik u kennis van die klassieke handelsteorieë om die volgende stelling te evalueer: “Die beginsel van absolute voordeel stel dit dat onderlinge voordelige handel kan plaasvind al is een land absoluut meer produktief in die produksie van alle produkte.” *Aannames van en kritiek teen die teorieë moet ingesluit word.* [25]

**Adam Smith** developed the theory of absolute advantage. Smith posited that mutually beneficial trade between two nations is possible only if each nation had an absolute advantage in the production of 1 of the commodities. A nation has an absolute advantage in the production of commodity X if it can produce it more efficiently than its trading partner. By trading according to absolute advantage, complete specialization occurs. Trade based on absolute advantage ensures resources are utilised more efficiently. There is also increased output of both commodities in both countries as a result of specialization. Mutually beneficial trade will not occur if one nation has an absolute advantage in the production of both commodities. The theory explains only a small part of international trade as it explains trade only between developed and developing countries. /it fails to explain trade between developed countries.

**David Ricardo** argued that mutually beneficial trade was still possible between two trading partners even if one had an absolute advantage in the production of both commodities. According to Ricardo, what was important is the degree of the advantage. I.e. the opportunity costs. A nation would produce and export the commodity of its lowest opportunity cost. For trade to occur the domestic terms of trade must fall within the international terms of trade.

- The theory is founded upon the following ASSUMPTIONS
- Producers and consumers display rational behaviour.
- It's a 2 commodity, 2 nation model.
- There is full employment
- Labour is the only factor of production
- Each country has a fixed endowment of resources
- Perfect competition exists
- Factors of production are mobile between the two commodities and within the country, but not between countries
- There are no barriers to trade
- Production shows constant returns to scale
- There are no transport costs
- The level of technology is fixed for both countries, but may differ between them.

The theories assume labour is the only factor of production. This is not so as there are other factors of production such as capital, land. The assumption of perfect competition is unrealistic. Market structures are characterised by imperfections. The labour theory of value is oversimplified. Theory assumes that trade leads to complete specialisation, however specialisation is always incomplete. Adam Smith's theory can be criticised for not being able to explain trade of one country has an absolute advantage in the production of both commodities.

#### QUESTION 4

##### VRAAG 4

(a) Evaluate **any three** of the main arguments for trade protection. (15)

Evalueer **enige drie** van die vernaamste argumente ten gunste van handelsbeskerming. (15)

##### Infant Industry

- A nation may have a potential comparative advantage in a commodity, but because of a lack of know-how and the initial small level of output, the industry will not be able to set up, or if already set up, cannot compete with established forms. An industry should be protected temporarily during its infancy against competition from more established and more efficient foreign firms. The protection should continue until the industry acquires enough economies of scale to compete effectively with foreign industries. However the protection should be temporary. The protection should not be indefinite; it should be removed once the industry has grown. For the argument to be valid, the return from the grown up industry must be sufficiently high enough to offset the higher prices paid by domestic consumers of the community during the infancy period. This argument can be abused however. Some industries may remain in the infancy stage for ever. Also, it may be difficult to identify which industry or potential industry qualifies for this treatment.

##### Optimum tariff

- The optimum tariff is the tariff rate that maximises the difference between the gain from improved terms of trade and the loss from reduced volume of trade. This argument applies only to large countries. Only a large country can improve its terms of trade by imposing a tariff. The optimum tariff for a small country is always zero. When a large country imposes an import tariff, it forces the exporting country to lower its exporting price in order to continue exporting the product. This therefore raises the terms of trade of the large (importing) country and lowers that of the exporting country

##### Strategic trade policy

- This refers to governments protecting some large oligopolistic industries in order to increase their global market share at the expense of foreign competitors. The aim of such a policy is to increase the global share of the domestic firms at the expense of the foreign firms. By encouraging high tech industries, a nation can reap the external economies of scale that result from such high tech industries. Strategic trade policy needs a large capital outlay at the beginning. As output expands, the marginal costs decrease. An example is the aircraft industry. The policy however lacks adequate information. It brings about productivity loss as resources move from efficient industries to protected industries that may be less efficient.

### Scientific tariff

- Is the rate that equalises wage rates across nations. It is implemented so as to offset the competitive advantage of low wages in foreign nations. The policy makes no allowance for productivity differences between nations. It is therefore not as scientific as it can be.
- The tariff assumes that labour is the only factor in production costs.

Also see the protection of domestic labor against cheap foreign labour, reducing domestic unemployment and cure deficit in nation's balance of payment arguments (Page 260 of the textbook).

(b) Name and describe **any two** of the main forms of non-tariff barriers. (10)

Noem en beskryf **enige twee** van die vernaamste vorme van nietariefbeperkings. (10)

[25]

### Import Quota

- Are the most important non-tariff barriers. Import quotas are absolute limits on permissible imports. For import quotas to be effective, the free market demand for the imports must be above the quota. Import quotas are used to protect the domestic industry. Import quotas have been used by developing nations to stimulate import substitution of manufactured products and for balance of payment purposes. Governments distribute import licenses to importers, enabling them to import up to a prescribed amount. Quotas restrict the volume of imports, therefore raising domestic price of imported commodity. Quotas thus result in a decline in the imported commodity forcing consumer to consume less desirable domestic substitutes. Quotas raise local production of the substitute product. Revenue does not accrue to the government but to license holders. Import quotas require administrative apparatus which can be cumbersome. Import quotas displace market mechanisms.

### Export subsidy

- Payment by government to a firm for each unit of product shipped abroad. Export subsidies lead to deadweight loss from distortions in ranking by comparative advantage. Low ranking products are subsidised ahead of higher ranking products. If the exporting nation is large, the increase in exports reduces world prices therefore causing its terms of trade to deteriorate.

### Voluntary export restraint

- VER's are bilateral agreements between two governments, where the exporting country limits its exports of a certain commodity to the importing country. Import competing industries normally pressure governments to initiate such agreements. Since CER's are agreed on in advance they do not pose a retaliation threat. A VER agreement is implemented by governments or the exporters themselves. VER's tend to discriminate between the sources of supply and as such violate the WTO's MNF principle. VER's restrict supply and thus raise the import prices in the importing country. VER's are used to save domestic jobs as they raise import prices. VER's are considered to be the most harmful trade barriers to nation welfare

### International commodity agreements

- ICA's are designed to stabilize world price of the commodity or to dispose of surpluses. ICA's take the form of (a) export restriction schemes which involves control of the amount sold internationally with the use of quotas, (b) buffer stocks, which aims at keeping prices within a given range and (c) multilateral contracts, which specifies maximum price producing countries can sell certain quantities and the minimum prices importing countries can buy a given quantity of the commodity.

### International cartels

- The restrictions and regulation of markets by business organisations of the same industries in different countries or groups of governments is known as international cartels. A cartel agreement is limited to suppliers and excludes consuming countries. An example of a cartel is OPEC. Cartels restrict output; misallocate resources and lead to higher prices than would have existed under competitive situations. Cartels are harmful to the international economy.

## QUESTION 5

### VRAAG 5

- (a) Explain the fundamental principles on which the World Trade Organization (WTO) is based on. (10)
- Verduidelik die fundamentele beginsels waarop die Wêreldhandelsorganisaie (WHO) gebaseer is. (10)

- **Unconditional most favoured nation:** treating all trading partners alike, extending tariff reduction agreements to all partners. **Reciprocity:** we will treat your country's firms the same way you treat ours **Fast track voting system:** relates to trade promotion. **General prohibition of export subsidies . Mutual recognition:** EU members recognise the product standards applied by other member countries. **National treatment:** countries treat foreign firms operating within its borders in the same way it treats its own firms. It is a **Principle of non-discrimination**

- (b) With regards to the regional approach to free trade, explain free trade areas and economic unions, stating examples of each. (10)

Met verwysing na die streeksbenadering tot vrye handel, verduidelik vryhandelsgebiede en ekonomiese unies. Noem ook 'n voorbeeld van elk. (10)

- **Free trade areas (FTAs)** are similar to PTAs, but trade barriers between the member countries are removed completely. As with a PTA, each member country retains its own tariffs and other trade barriers with non-member countries. A recent example is the **North American Free Trade Agreement (NAFTA)** between the United States, Canada, and Mexico which took effect in 1994. A local example is the Southern African Development Community (**SADC**) which intends to reduce tariffs and to become eventually a free trade area.

- An **economic union** is the tightest (or most advanced) form of economic integration. Besides free trade and mobility of the factors of production, the member countries harmonise or even unify monetary and fiscal policies. As noted above, the EU achieved this status in 2002 with the adoption of a common currency, the euro, managed by a single central bank.

(c) Formation of custom unions results in both static and dynamic benefits. Explain the dynamic benefits of joining a customs union. (5)

Die vorming van 'n doeane-unie het beide statiese en dinamiese voordele tot gevolg. Verduidelik die dinamiese voordele van die aansluiting by 'n doeane-unie. (5)

**[25]**

- A CU expands the size of the market, economies of scale; It increases competition in the union; Favourable growth effect stimulates imports from non-members, partly offsetting static trade diversion; Investment (both domestic and foreign) is stimulated by the larger market. **See page 296 of the textbook for detailed discussion.**

## QUESTION 6

### VRAAG 6

Illustrate graphically and explain fully the welfare effects of international capital flows on the investing and host countries. [25]

Illustreer en verduidelik met behulp van 'n figuur die welvaartseffekte van internasionale kapitaalbewegings op die investerende en op die gasheerland. [25]

**See section 12.4A on page 360 of the textbook for the diagram and corresponding explanation.**

## 5. COMMUNICATION WITH LECTURERS

The lecturers for this module are:

- Ms K Amusa – 012 433 4642
- Mr M Marais – 012 433 4633

Appointments with the above lecturers should be made in advance. If you arrive without an appointment, the lecturers might not be able to see you immediately.

While we are happy to help students if they do not understand some of the economic principles, we do expect final-year students to try and solve problems by themselves.

Please do not contact your lecturers with administrative queries. Contact the relevant department (as listed in the brochure *My studies @ Unisa*).

**Please note:** Unisa's telephone lines are very busy during examination time (May and October). There is no guarantee that you will be able to get through to your lecturers in the last days before the examination. You should therefore go through your work **in good time** and **if** you have problems, contact us well before the examination.

## 6. CONCLUDING REMARKS

We hope that you are enjoying this module. Best wishes with your studies.

**Ms K Amusa**