

Tutorial Letter 203/2/2014

International Trade

ECS3702

Semester module

Department of Economics

IMPORTANT INFORMATION:

This tutorial letter contains solutions to Assignment 03 semester 1 and information on the October/November 2014 examination.

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)
- Tutorial letter 201 with solutions to assignment 01
- Tutorial letter 202 with solutions to assignment 02

This tutorial letter contains the following information:

- format of the October/November 2014 examination
- prescribed reading for the examination
- feedback on Assignment 03
- a copy of the May 2013 examination paper

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. EXAMINATION

The examination paper consists of two sections. Section A is **compulsory**. There will be only one question (question 1) in this section which will count 25 marks. **ALL** students must answer this question. Section B has four questions of 25 marks each and you will have to choose any three to answer. The format of the paper will be similar in style to the October 2013 examination paper (see section 6 for a copy of this paper).

Please ensure that you prepare well for the final examination by concentrating on the prescribed material as outlined in your study guide and Tutorial Letter 101.

3. PRESCRIBED MATERIAL FOR THE EXAMINATION

You will be examined on all the prescribed chapters outlined in Tutorial Letter 101 and the study guide. Therefore, ensure that you are familiar with the module content, including the relevant diagrams.

4. FEEDBACK ON ASSIGNMENT 03

Please note: The following are **NOT** model answers. They are only a guide on how you should answer the questions. Also note that your study guide is aimed at guiding you through the prescribed book and you are expected to study the relevant sections in the prescribed book as well as the study units in the study guide. In other words, you must buy the prescribed book. The relevant sections in the prescribed book are clearly indicated in each study unit of the study guide.

Read the questions carefully and make sure that you do what is asked. Even if you write many pages but go off on a tangent and do not address the topic of the question, you will not earn marks. Therefore, make sure that your answer does in fact reflect what you are asked to do.

Question 1

Critically evaluate the Heckscher-Ohlin theory of international trade.

This question is an open question and you can decide to either answer with the aid of correctly drawn or explained diagrams or by way of a comprehensive explanation. If you choose the former, then you need to correctly draw the diagrams on page 114 of the textbook and provide the corresponding explanation. The assumptions must also be listed and criticisms of the theory discussed.

The H-O theorem suggests that a nation will export the commodity whose production requires the intensive use of the nation's relatively abundant and cheap factor and import the commodity whose production requires the intensive use of the nation's relatively scarce and expensive factor.

The H-O theorem extends the theory of comparative advantage by explaining the source of comparative advantage. Countries have comparative advantage in the production of a commodity as a result of different factor endowments in the different countries. According to the H-O theorem, international trade is due to different factor endowments. The H-O theorem is presented in 2 theorems, the H-O theorem and the factor proportions theorem. The H-O theorem states that a nation will export the commodity whose production requires the intensive use of its relatively abundant and cheap factor and import the commodity whose production requires the intensive use of its relatively scarce and expensive factor. International trade, according to the H-O theory can be explained by factor intensity and factor abundance. Given two commodities, X and Y, and 2 factors of production, labour and capital, commodity Y is capital intensive if the K/L ratio used in the production of Y is greater than that used in the production of X. Therefore, Labour abundant nations will export labour intensive commodities and import capital intensive commodities, while capital abundant nations will export capital intensive commodities and import labour intensive commodities. Factor abundance can be explained in terms of *physical abundance*, whereby if the total capital to total labour ratio in nation one is larger than in nation 2, then nation 1 is said to be capital intensive. Looking at *factor prices*, nation 1 will be capital abundant if the r/w ratio in nation 1 is smaller than the r/w ratio in nation 2.

H-O theorem is based on a number of assumptions

- There are two countries, two commodities and two factors of production.
- Technology is the same in both countries.
- Both commodities in both commodities have constant returns to scale.
- The two commodities have different factors intensities.
- Taste and preferences are the same in both countries
- Perfect competition exists in both countries, commodities and factor markets
- Factors are mobile within each country but not between
- There are no transport costs
- There are no restrictions to trade
- There is incomplete specialisation in production in both nations
- All resources are fully employed
- International trade is balanced between the two nations.

Criticism of the factor proportions theory

Leontief paradox. Explains the situation where Leontief examined the trade patterns of the United States and noticed that though the US was a capital abundant nation, it imported capital intensive commodities and exported labour intensive commodities. These findings contradicted the H-O theorem. Demand reversals(explain further). Factor intensity reversals (explain further). It does not explain intra industry trade/trade between developed countries. It is based on simplified assumptions that may not hold in practice.

Question 2

Discuss the motives of foreign direct investment, the costs to both the home and host countries as well as the benefits to the host and home countries.

The following are points that need to be explained in a well thought out manner. WRITING IN POINT FORM AS BELOW IS NOT ALLOWED IN THE EXAMINATION AND YOU WILL BE PENALISED FOR DOING SO.

Motives for direct foreign investment

- (i) Profit expectations
 - -Investment funds flow to where profits are expected to be the highest.
- (ii) Cost considerations
 - -lower labour costs
 - -cheaper access to production inputs
 - -lower tariffs
 - (iii)Marketing considerations
 - To raise revenue
 - Increase familiarity with the foreign market
 - To be close to the market.

Other motives:

- To minimise risks
- To conquer the global market
- To take advantage of the growing markets abroad

- To take advantage of external economies of scale
- Large corporations have product knowledge or managerial skills that could easily and profitably be used abroad and over which they want to retain direct control
- To enter oligopolistic markets so as to share in the profits
- To control and adapt to the environment in which it operates
- To influence policies of the local government
- MNC's can finance large projects because of their access to international capital markets
- To take advantage of government subsidies
- To buy foreign firms so as to avoid future competition
- Because only MNC's can obtain the necessary financing to enter the market
- They have access to international capital markets, so they can finance large projects

Advantages and disadvantages of MNC's to host country

- (i) Positive effects among others:
 - International capital transfer from source country;
 - Technological transfer;
 - Increase in investment and innovation;
 - increase in capital investment;
 - Host country can access international capital markets;
 - Increase in managerial skills.
- (ii) Negative effects of FDI on host country.
 - Transfer pricing
 - Exploitation of cheap labour
 - DFI leads to capital repatriation
 - DFI replaces host country investment.
 - Use capital intensive production techniques in labour abundant developing countries
 - Create dualistic economies
 - Make host country technologically dependent
- (iii) Overall the host country benefits from foreign investment

Advantages and disadvantage of MNC's activities to home country

Loss of revenue for the government

Loss of capital

DFI increases labour productivity in the host country at the expense of the home country

Economic activity is diverting away from the home country

Reduces home country exports

Stimulates growth in the host country but not at home

Effects of FDI on source country are mostly negative

5. ASESMENT

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

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

6. 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)

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)

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)

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)

(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]

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]

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)

(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]

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)

(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)

- (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 van die aansluit by 'n doeane-unie. (5)

[25]

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]**

7. 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.

8 CONCLUDING REMARKS

We hope that you enjoyed this module. Best wishes as you prepare for the examination.

Ms K Amusa