

Tutorial letter 201/1/2013

International Trade ECS3702

Semester 1

Department of Economics

IMPORTANT INFORMATION:

This tutorial letter contains solutions to the semester assignments 1, 2 and 3 and information on the May-June Examination.

BAR CODE

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

Study guide:

Study guide for ECS3702

Tutorial letters:

- 101/2013 - Introductory tutorial letter and assignments (ECS3702)
- 301/2013 - General information to all students of economics (ECSALLR)

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Dear Student

This tutorial letter contains the following information:

- Format of the May 2013 Examination
- Prescribed Reading for the Examination
- Solutions to Assignment 01
- Solutions to Assignment 02
- Feedback on Assignment 03
- A copy of the October 2012 Examination Paper

Please read this tutorial letter carefully, together with the Tutorial Letter 101 and other study material that you have received so far. Many of your questions will be answered by doing this.

Wishing you all the best with your studies.

1. FORMAT OF THE EXAMINATION

The examination paper consists of two (2) sections. Section A is **compulsory**. There only one question (question 1) in this section, worth 25 marks. **ALL** Students must answer this question. In section B, there are five questions, of which you must answer any three (3) of your choice, each counting 25 marks. The format is similar to the October 2012 paper, a copy of which appears in this tutorial letter - see section 6. Please ensure that you are well prepared for the final examination by concentrating on the prescribed material, as outlined in your study guide and Tutorial Letter 101.

Some of the key topics that are prescribed for this module are outlined in the following section, for your ease of reference. Please familiarize yourself with these topics.

2. PRESCRIBED READING FOR THE EXAMINATION

1. Why Nations Trade

1.1 Mercantilists

1.2 Classical Theory of Trade

- 1.2.1 Absolute Advantage (Adam Smith)
- 1.2.2 Comparative Advantage (David Ricardo)
- 1.2.3 The Labour Theory of Value
- 1.2.4 Assumptions of the classical Theory
- 1.2.5 Criticisms of the Classical Theory
- 1.2.6 Gains from trade

2. Tariffs

- 2.1 Nominal tariff
- 2.2 Effective rate of protection
- 2.3 Calculation of the nominal tariff rate
- 2.4 Calculation of value added
- 2.5 Calculation of the effective rate of protection

3. Arguments for protection

- 3.1 Infant industry argument
- 3.2 Optimum tariff argument
- 3.3 Scientific tariff argument
- 3.4 Strategic trade policy argument

4. Non-tariff Barriers of Trade

- 4.1 Import Quota
- 4.2 Voluntary Export Restraints
- 4.3 Export Subsidies
- 4.4 International cartels
- 4.5 Anti dumping import duties

5. World trade organization (WTO)

- 5.1 Principles of the WTO

6. Forms (Levels) of Economic Integration

- 6.1 Preferential Trade Arrangements
- 6.2 Free Trade Area
- 6.3 Customs Union (CU)
- 6.4 Common Market
- 6.5 Economic Union

7. Customs Union

- 7.1 Trade creating customs union
- 7.2 Trade diverting customs union
- 7.3 Illustration of a trade creating customs union
- 7.4 Dynamic benefits of a customs union

8. Foreign Direct Investment (FDI), Multinational Corporations and International Capital flows.

- 8.1 Graphical illustration and explanation of the welfare effects of international capital flows to host and investing nations

3. ANSWERS TO ASSIGNMENTS

3.1 Answers to Compulsory Assignment 01

Make sure that you *understand* where and why you made any mistakes. You are referred to the relevant pages in the study guide (SG) or the prescribed textbook (TB). An explanation is provided if the answer is not self-evident from the relevant prescribed text.

You had to answer 20 multiple-choice questions for this assignment – including 10 student-profile related questions. The questions appeared on pages 19-23 of Tutorial Letter 101. (SG stands for Study Guide; TB for Prescribed Textbook).

THE SOLUTION TO ASSIGNMENT 1 IS:

[1]	2	[6]	1
[2]	3	[7]	1
[3]	3	[8]	3
[4]	2	[9]	3
[5]	1	[10]	1

QUESTION 1

The correct alternative is [2]

Countries trade because their resource endowment does not allow them to be able to produce all the goods that they consume. They therefore trade to import what they cannot produce domestically and to export what they can produce domestically.

QUESTION 2

The correct alternative is [3]

One of the main tenets of mercantilism is that government had to discourage imports as much as possible and promote exports in order to for the nation to be rich and powerful.

QUESTION 3**The correct alternative is [3]**

Under the labour theory of value, the value or price of a commodity depends on the amount of labor going into the production of the commodity. See page 43 of the TB.

QUESTION 4**The correct alternative is [2]**

The direction of trade according to David Ricardo is due to countries trading according to their comparative advantage. See pages 37-38 of the TB.

QUESTION 5**The correct alternative is [1]**

It takes South Africa 5 hours to produce a ton of sugar, while it takes Botswana 6 hours to produce the same ton of cars. Therefore in the production of sugar, South Africa has an absolute advantage. It takes South Africa 10 hours to produce a ton of pencils, while it takes Botswana 6 hours to produce the same ton of pencils. Therefore, Botswana is more efficient in the production pencils than South Africa. See pages35-37 of the TB

QUESTION 6**The correct alternative is [1]**

The classical theories of absolute and comparative advantage all suggest that if each country trades according to their commodity of absolute or comparative advantage, then they will focus completely on the production of that commodity (their export commodity). Therefore there will be complete specialization.

QUESTION 7

The correct alternative is [2]

Calculation of the opportunity cost in producing **good A** in:

South Africa:

$$\begin{array}{ccc} 3A=5B & \longrightarrow & 5AB=3A? \\ 1A=? & \longrightarrow & \longrightarrow & \text{Therefore: } 5AB/3A=? \\ & & & 1A=1.67B \end{array}$$

Tanzania:

$$\begin{array}{ccc} 6A=6B & \longrightarrow & 6AB=6A? \\ 1A=? & \longrightarrow & \longrightarrow & \text{Therefore: } 6AB/6A=? \\ & & & \mathbf{1A=1B} \end{array}$$

Calculating the opportunity cost of producing **good B** in:

South Africa:

$$\begin{array}{ccc} 5B=3A & \longrightarrow & 3AB=5B? \\ 1B=? & \longrightarrow & \longrightarrow & \text{Therefore: } 3AB/5B=? \\ & & & \mathbf{1B=0.6A} \end{array}$$

Tanzania:

$$\begin{array}{ccc} 6B=6A & \longrightarrow & 6AB=6B? \\ 1B=? & \longrightarrow & \longrightarrow & \text{Therefore: } 6AB/6B=? \\ & & & 1B=1A \end{array}$$

QUESTION 8

The correct alternative is [3]

The H-O model builds on the classical models by explaining the source or reason for comparative advantage. The model isolates differences in factor endowments/ resources between countries as the reason for comparative advantage. According to the H-O theorem, 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. See page 130 of the TB

QUESTION 9

The correct alternative is [3]

QUESTION 10**The correct alternative is [1]**

As the countries start to trade, in the capital abundant nation, the relative demand for capital rises while the demand for labour falls, therefore the w/r ratio falls. In the labour abundant country the relative demand for labour rises while that of capital falls, therefore the w/r ratio rises

Answers to Assignment 2

The correct alternatives are:

[1] 2

[2] 4

[3] 2

[4] 3

[5] 3

[6] 2

[7] 3

[8] 1

[9] 3

[10] 1

QUESTION 1

The correct alternative is [2]

Intra industry trade explains trade in differentiated products. See case study 6-2 page 175 of the TB for an example.

QUESTION 2

The correct alternative is [3]

See explanation on page 185 of the TB

QUESTION 3

The correct alternative is [4]

By opening up to trade, a country experiences increased investment, economies of scale and increased competition. See discussion of dynamic benefits of customs union, page 334 of the TB.

QUESTION 4

The correct alternative is [2]

Infant industry arguments protect infant industries and enable them to acquire economies of scale and to develop to the point where they can compete against foreign companies or firms. See explanation on page 293 of the TB.

QUESTION 5**The correct alternative is [3]**

A large country is defined as one whose imports are large enough to affect the world prices of the imported commodity. Because the country is large enough, the imposition of a tariff will result in the large country and the exporting country sharing the price increase, therefore the domestic prices of the imported good for the large country rises, but not by the full amount of the tariff.

QUESTION 6**The correct alternative is [2]**

Export subsidies are direct payments to the nation's exporters to stimulate the nation's exports.

QUESTION 7**The correct alternative is [3]**

A customs union removes all tariff and or barriers to trade amongst all members and in addition it harmonizes trade policies such as setting of common tariff rates against the rest of the world. See page 328 of the TB for discussion on the different degrees of economic integration.

QUESTION 8**The correct alternative is [1]**

Trade creation occurs when some domestic production of a member state is replaced by lower imports from another member state. See page 329 of the TB.

QUESTION 9**The correct alternative is [3]**

R30 is the price in nation A when there is no trade. With free trade nation 1 can choose to import from either nation b or nation c. since the free trade price of nation C is lower, nation A will import from nation C at R10. At that price nation A consumes 700 and produces 100, therefore 600 units of Q is imported from nation C

QUESTION 10

The correct alternative is [1]

With the formation of a customs union between nation A and B, A will now be able to consume 600 units of Q, produce 200 units and therefore is importing 400 units of Q from nation B.

4. FEEDBACK ON ASSIGNMENT 03

Note: The following are **NOT** model answers. They are a guide as to how you should answer the questions. Also note that your study guide is a guide to the textbook and you are expected to study the relevant sections in the textbook as well as those that are in the study guide. In other words, you must acquire a copy of the textbook. The relevant sections in the textbook are clearly indicated in each study unit of the study guide.

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

Question 1a

What were the Mercantilists views on trade? How did they relate to current ideology of protectionism?

As with any answer, you should firstly define your topic. You should explain who the mercantilists were. You SHOULD discuss what their beliefs or ideologies were. In addition, you should discuss briefly, what the criticisms of their ideas are. (See TB: 32-35).

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. There is a resurgence of neo Mercantilisms today, with nations plagued by high unemployment seeking to restrict imports in an effort to stimulate domestic production and employment.

Question 1b

Critically evaluate Adam Smith's theory of absolute advantage, outlining the assumptions necessary for the theory to hold in its purest form. What are the criticisms of this theory?

This question has three parts to it. The first part asks that the student evaluate Adam Smith's theory of absolute advantage. You should firstly define your topic. What does absolute advantage mean? A two country example will also suffice to illustrate the concept. According to the theory, what is the advantage of trading according to absolute advantage (see **TB**: 35-36). The second part requires the assumptions of the theory. Since the question is not specific (i.e., discuss the assumptions) then a correct listing of

ALL the assumptions will suffice. The last part requires a discussion of the criticisms of the theory. The criticisms, though not explicitly stated by the classical theorists stem from the assumptions made and can also be found in the **TB**: page 37 as well as the **class notes**.

Adam Smith and David Ricardo developed the theory of absolute and comparative advantage respectively. 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. There is also increased output as a result of specialization. Mutually beneficial trade will not occur if one nation has an absolute advantage in the production of both commodities.

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 theory has been criticised for the fact that it assumes 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 2

Critically discuss the Heckscher-Ohlin theory of international trade.

Please note that the Heckscher-Ohlin theory is also known as the factor proportions theory. It is called the Heckscher-Ohlin theory because it was developed by two Swedish economists, namely Eli Heckscher and Bertil Ohlin, in 1933.

Before discussing the Heckscher-Ohlin theory (study unit 4 of the SG), you must *list the assumptions* of the theory. ***In fact you should list the assumptions of any theory that you have to discuss. Please list but do not discuss the assumptions unless you have been specifically asked to do so. Remember that you have only 30 minutes to answer each question in the exam, and irrespective of how long your essay is you can only get a maximum of 25 marks for each question.*** After listing the assumptions, you need to clearly and succinctly explain the Heckscher-Ohlin theory. As presented in your study material, the Heckscher-Ohlin (factor proportions theory) rests on two premises: i) Commodities differ in their factor requirements; and ii) Countries differ in their factor endowments. Issues that you should explain here are relative factor endowments, relative factor intensities, as well as the pattern of trade and gains from trade.

According to the Heckscher-Ohlin theory, a country has a comparative advantage in the production of a commodity that uses its abundant factor of production intensively. Thus, a country should export the commodity that uses its relatively abundant factor of production intensively, and import the commodity that uses its relatively scarce factor of production.

Once you have explained the model, you should also briefly list its limitations (i.e. the criticisms).

NB: Please do not include the discussion on the factor price equalisation theorem here, as this is not necessary.

Here is an example of one of the ways to answer a question on the H-O theory:

What must be addressed if a question asks you to “discuss the factor proportion theory”?

[25 marks]

This question obviously requires a lot from you. It is after all worth 25 marks. There are essential things that you will need to address in your essay. Note that it must be in essay format (**not in point form as listed below**) and must be readable, easy to understand and correct.

Below are some essentials you need to touch on in your essay. It includes a discussion of the basis of the theory, the assumptions of the theory as well as the criticisms of the theory.

Note that this is not a model answer but should help you organise your thoughts if you are answering a question like this. This question did not ask for the use of diagrams.

- *This is the factors proportions theory. 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 (elaborate)*

- *Factor intensity reversals(elaborate)*
- *It does not explain intra industry trade/trade between developed countries.*
- *It is based on simplified assumptions that may not hold in practice.*

Question 3

Using a well labeled diagram, explain the partial equilibrium, effects of a tariff on a small Country.

For the correct diagram see TB: 242-243. THE DIAGRAM SHOULD BE CORRECTLY LABELLED. And the correct explanation/ interpretation of the diagram must be provided.

In this question, you are expected to discuss the general effects of a tariff, as well as the redistribution effects. The general effects of a tariff include, among others, an increase in the domestic price of the importable commodity, an increase in the domestic production of the tariff-distorted commodity, a decrease in the domestic consumption and a decrease in the amount of the commodity imported. Also, when a tariff is imposed, the government collects tariff revenue, which is determined by the tariff rate and the amount of the commodity imported. You need to explain these effects briefly and concisely. The redistribution effects, on the other hand, relate to the redistribution of income induced by a tariff. When a tariff is imposed some economic agents will lose while others will gain. Specifically, the domestic consumers in the importing country will lose part of their consumers' surplus due to an increase in price. Part of the consumers' surplus that has been lost by consumers will benefit the producer, whose producers' surplus will increase, while another part will benefit the government in the form of government revenue. However, there is a small portion of the consumers' surplus that has been lost to consumers but will not benefit either producers or government. The part of the consumers' surplus that does not benefit any of the economic agents is called the 'deadweight loss'.

5. THE ASESMENT SYSTEM

As indicated in the Tutorial Letter 101, your semester (year) mark is based on your assignment marks. The first assignment contributes 40%, while the second contributes 60% to your semester mark. The final grade is, however, computed using the following weights.

Semester (Year) Mark	10%
Final Exam Mark	90%
Total	100%

6. COPY OF THE OCTOBER 2012 EXAM PAPER

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ECS302E
10/11 2012**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**

Briefly define / explain the following

- | | |
|---|-----|
| (a) Community indifference curve | (5) |
| (b) Demand Reversal | (5) |
| (c) Tariffs | (5) |
| (d) Most favoured nation principle | (5) |
| (e) Multinational Corporation's (MNC's) | (5) |

Verduidelik/definieer die volgende kortliks

- | | |
|------------------------------------|-----|
| (a) Gemeenskapsonsydigheidskrommes | (5) |
| (b) Vraagomkering | (5) |
| (c) Tariewe | (5) |
| (d) Die gunstelinglandbeginsel | (5) |
| (e) Multinasionale maatskappye | (5) |

[25]

**[TURN OVER]
[BLAAI OM]**

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) Briefly explain why increasing opportunity costs in production arise (5)
Verduidelik kortliks waarom daar toenemende geleentheidskoste in produksie ontstaan (5)
- (b) Briefly explain why the production possibility frontiers of different countries have different shapes (5)
Verduidelik kortliks waarom die produksiemoontlikheidsgrens van verskillende lande verskillende vorms het (5)
- (c) Explain with the aid of a well drawn diagram, the gains from trade (exchange and specialisation) when increasing costs are present (15)
Verduidelik met behulp van 'n deeglik getekende figuur die winste uit handel (ruil en spesialisasie) wanneer toenemende geleentheidskoste teenwoordig is (15)
- [25]

QUESTION 3
VRAAG 3

With the aid of correctly drawn diagrams, **fully** evaluate the following statement "a capital abundant country will export capital intensive goods, while a labour abundant country will export labour intensive goods" NB state and explain any assumptions you make in order to answer the question and explain the criticisms of the model [25]

Evalueer die volgende stelling **deeglik** met behulp van 'n korrek getekende figuur "n Kapitaalryke land sal kapitaalintensiewe kommoditeite uitvoer terwyl 'n arbeidryke land arbeidsintensiewe kommoditeite sal uitvoer" NB Noem en verduidelik enige aannames wat u maak in die beantwoording van die vraag en verduidelik die kritiek teen die model [25]

[TURN OVER]
[BLAAI OM]

QUESTION 4
VRAAG 4

- (a) State and explain any five (5) assumptions upon which the factor proportions theory is based (10)

Noem en verduidelik enige vyf (5) aannames waarop die faktorverhoudingsteorie berus (10)

- (b) Using the specific factors model, explain the following statement "International trade will have an ambiguous effect on the nation's mobile factor, benefit the immobile factors specific to the nation's export sector and harm the immobile factors specific to the nation's import competing sector or commodity. **Assumptions should be clearly stated. Do not use a diagram** (15)

Deur gebruik te maak van die spesifieke faktormodel, evalueer die volgende stelling "Internasionale handel sal 'n twyfelagtige uitwerking op die land se mobiele produksiefaktor hê. Dit sal die immobiele produksiefaktore wat eie is aan die land se uitvoersector bevoordeel en die immobiele produksiefaktore wat eie is aan die land se invoermededingende sektor of kommoditeit benadeel. **Aannames moet duidelik genoem word. U moet nie 'n figuur gebruik nie.** (15)

[25]

QUESTION 5
VRAAG 5

- (a) State and explain any five (5) assumptions upon which the factor proportions theory is based (10)

Noem en verduidelik enige vyf (5) aannames waarop die faktorverhoudingsteorie berus (10)

- (b) Evaluate the following statement "International trade will bring about equalization in the relative and absolute returns to homogenous factors of production across nations (15)

Evalueer die volgende stelling "Internasionale handel sal gelykmaking teweegbring in die relatiewe en die absolute opbrengs van homogene produksiefaktore regoor alle lande." (15)

[25]

QUESTION 6
VRAAG 6

Using correctly drawn and labelled diagrams, compare and contrast the welfare effects of a tariff to the welfare effects of a quota (25)

Vergelyk en kontrasteer die welvaartsgevolge van 'n tarief met die van 'n kwota met behulp van korrek getekende en benoemde figure (25)

[TURN OVER]
[BLAAI OM]

QUESTION 7
VRAAG 7

- (a) Explain the following Trade creation and Trade diversion (5)
Verduidelik die volgende Handelskepping en handelsafwendings (5)
- (b) Using a correctly drawn diagram, explain the welfare effects of a trade creating customs union (15)
Verduidelik die welvaartsgevolge van 'n handelskeppende doeane-unie deur gebruik te maak van 'n korrek getekende figuur (15)
- (c) Discuss the dynamic benefits from joining a customs union (5)
Bespreek die dinamiese voordele van die aansluiting by 'n doeane-unie (5)

[25]**[TURN OVER]**
[BLAAI OM]

7. COMMUNICATION WITH LECTURERS

The following lecturers are involved with this module.

Miss K Amusa (012) 433-4642
Mr M Marais (012) 433-4633

Appointments with the above lecturers should be made in advance. Should you arrive without having made an appointment, you should be prepared to find that the lecturers might not be able to see you immediately.

Whilst we are happy to help you if you do not understand some economic principles, we do expect final year students to make some effort to try to solve problems themselves.

Please do not contact your lecturers with administrative queries. Contact the relevant department as listed in *The Unisa Services and Procedures* manual.

NB The telephone lines at Unisa are very busy during exam 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 exam. You must, therefore, go through your work *in good time* and *if* you encounter problems, make contact with us well before the exam time.

Best wishes with your studies.

Ms K Amusa

Tel: (012) 433 4642