

# 8. International Economics

EE 212

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## Outline

- Introduction to international trade
- Balance of Payments
- Market for foreign exchange
- The effect of exchange rate on economy

- International trade with the rest of the world
  - dealing with open economy
  - its theory is the extension of individual's exchange
  - Reason for trade
    - 1 The production cost of the same commodity in each country is not equal
    - 2 Comparative advantages
  - without international trade, no foreign-made product
  - trade  $\Rightarrow$  enlarge market size  $\Rightarrow$  room for division of labour  $\Rightarrow$  specialization (increase productivity)  $\Rightarrow$  more outputs with the same inputs

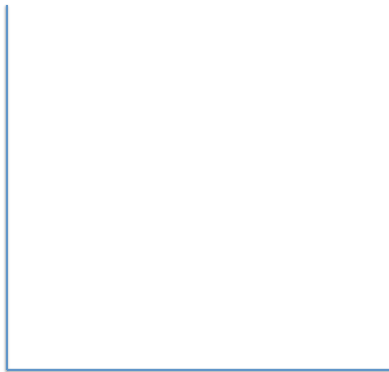
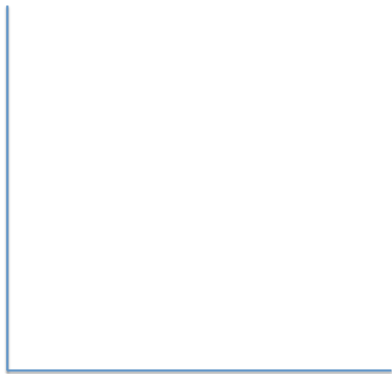
- We examine a special case. We assume the world to consist of two products; meat and potatoes.
- There are two producers: A Farmer and A Rancher
- Each producer has a production possibility frontier: How much of each good can they produce in an 8-hour day.
- The key to understanding the motivation for trade is defining the difference between absolute advantage and comparative advantage. The latter forms the basis for trade.
- The objective of trade is to improve the standard of living for both producers (consumers).

- Production Possibility Frontier: 2 Producers- 40 hours of labor each yields

	Amount produced in 8 hours		Minutes needed to make 1 kg of:	
	Meat	Potatoes	Meat	Potatoes
Farmer	.....kg.	.....kg.	20 hr./kg	10 hr./kg.
Rancher	.....kg.	..... kg.	1 hr./kg	8 hr./kg.

- It seems that rancher is more efficient because rancher use less time to produce both goods
- The rancher has a definite absolute advantage in meat and potato production.

- Draw production possibility frontier



- Suppose both divide their time equally for these 2 production; 20 hours for meat and 20 hours for potatoes

	Meat	Potatoes
Farmer	1 kg.	2 kg.
Rancher	20 kg.	2.5 kg.

- Without trade, for each individual, if they want to produce and consume more of one goods; they must produce and consume less of the other goods
- Show the production of the farmer and the rancher in PPC graph on the previous page
- How can the two improve their total [consumption] via trade?

- Consider the Opportunity Costs:

	Meat in terms of potatoes given up	Potatoes in terms of meat given up
Farmer	2	$\frac{1}{2}$
Rancher	$\frac{1}{8}$	8

- So the rancher can produce 1 kg. of meat at a lower opportunity cost
- The farmer can produce 1 kg of potatoes at a lower opportunity cost
- For the rancher – potatoes are more expensive relative to meat
- For the Farmer – meat is more expensive relative to potatoes

- How can the two improve their total [consumption] via trade?
- The Rancher's Offer to Farmer: Spend all 40 hours producing potatoes and I'll trade 3 kg of meat for 1 kg of your potatoes.
- So the farmer spends 40 hours producing ..... kg. potatoes
  - With the offer the farmer will exchange 1 kg of potatoes with 3 kg of meat
  - The farmer will have ..... kg of potatoes and ..... kg of meat.
  - The farmer will be better off because the farmer can consume more of both goods which might not be possible without trade
  - Show the consumption of the farmer on PPC graph
- The rancher will allocate more time on meat production and less time on rice production by 4 hours
  - The rancher will produce ..... kg of meat and ..... kg of potatoes
  - Then, the rancher will exchange 3 kg of meat with 1 kg of potatoes
  - The rancher will have ..... kg of potatoes and ..... kg of meat.
  - The Rancher will be better off because the farmer can consume more of both goods which might not be possible without trade
  - Show the consumption of the farmer on PPC graph

- The rancher has absolute advantage over the farmer in meat and potatoes production.
- However, the opportunity cost of producing potatoes of the rancher is greater than that of the farmer.
- Therefore, the farmer has a comparative advantage over the rancher in potatoes production.
- When one party has a comparative advantage over the other party, there is a benefit from trade.
- If the rancher had a comparative advantage over the farmer in producing both goods, there would be no benefit from trade.