Econ 110: Introduction to Economic Theory

26th Class **4/4/11**

Friday I will hand out a review sheet for next week's test. Recall the test is next Thur. evening, same format as last time, covers the material that wasn't on the last test up through last Friday's lecture (and everything as reflected on problem sets 3 and 4).

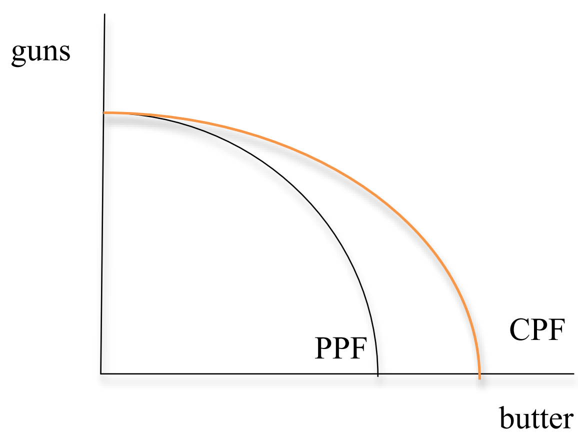
discuss options a little bit for those who want to take more courses in economics

Today we'll start with our 3-lecture project of developing a model of the open economy, i.e. one where there can be trade of goods and services as well as capital flows in and out of the country

so we will finally add back in the fourth element of AD : AD = C + I + G + NX

But let's start back with why we engage in trade at all

remember back to the PPF – production possibility frontier
in a closed economy, the production possibility frontier is equal to the consumption possibility frontier (CPF)
engaging in trade with other economies is a way to push out our consumption possibility frontier beyond our production possibility frontier



It is an exact analogy to trade between two individuals; more specialization possible
can test this idea of comparative advantage by looking at trade patterns

should see things flowing in one direction only, and at least some countries not producing some things at all

but what things make international trade different from domestic trade?
--transportation costs exist in either case, and international trade need not be over longer distances than domestic trade (think of Connecticut trade with Canada vs. trade with California)
--may require buying currency of the other country in order to complete the transaction
    --this adds an additional cost to international trade which may prevent some trades from occurring
    --also means that countries can intervene in the market for foreign currency in order to affect the demand for their own goods, but more on that later
--countries may impose tariffs and/or quotas on imported goods
--countries may also put restrictions on what can be exported
--other differences?

another difference is that factor markets may or may not operate across country borders
--physical capital can be hard to transport (e.g. buildings)
--increasingly there is free flow of financial capital, but countries may put on capital flow regulations
--labor restrictions (i.e., immgration and also emigration restrictions) are common
--land can't move at all—specific factors of production may be specific to particular countries! [natural wonders of the world for example]
    --note this means that some countries may have a "natural" comparative advantage at producing specific products—does this mean that some countries wouldn't produce anything? [brainstorm] Note trade theory doesn't guarantee that all countries are equally well off, just that countries are better off than if they don't trade at all (assuming it is noncompulsory trade)

so countries have both a tradeable goods and a nontradeable goods sector because of transportation costs and fixity of some factors
what are some examples of nontradeables? hot food; various services

Also note many of the things that make international trade different from domestic trade are at the behest of national governments rather than being intrinsic to international trade things that reduce transportation costs and reduction of governmental barriers to trade (i.e., reductions in protectionism) will tend to increase the volume of trade

How much trade is there? Let's look at some figures on total volume of trade, what types of things get traded a lot: http://en.wikipedia.org/wiki/International_trade

note that in the model we have developed in this course, trade is efficient and thus should always be encouraged on that ground
but there are also arguments against that view? (germ control, natl security, etc)
The World Trade Organization is one of the groups in the world that encourages trade; http://www.wto.org/

let's look at what they are working on right now
http://www.wto.org/english/news_e/news11_e/tnc_dg_infstat_29mar11_e.htm

let's look at their recent study
http://www.wto.org/english/news_e/news10_e/igo_04nov10_e.htm