

Trade in the Global Economy

2

Multiple Choice

1	D	6	B	11	B	16	B
2	B	7	B	12	B	17	D
3	A*	8	B	13	A	18	A
4	D	9	B	14	B	19	B
5	B*	10	D	15	D	20	A

*Note: In the diagram, the world price should read \$4, not \$6

Short Answers

Question 1

- (a) Opportunity cost of 1 million litres of wine in France = Wheat / Wine
 $= 50 / 80$
 $= 0.625$ thousand tonnes of wheat
- (b) The opportunity cost of producing wheat in France is 1.6 (80/50). The opportunity cost of producing wheat in Germany is 1.17 (35/30). So Germany has a comparative advantage in wheat.
- (c) Comparative advantage refers to the situation where economies have the lowest opportunity cost in producing one particular good or service, so should export that product to maximise the living standard for their own economy and that of their trading partners. In contrast, absolute advantage is concerned with which economy can produce the largest possible volume of a particular good, given their available resources.
- (d) Firstly, protectionist policies can be imposed to protect infant industries from foreign competition. Protection is useful in the short term to help infant industries achieve economies of scale and compete on a global level. Secondly, protection prevents foreign producers from dumping products on the domestic market, where foreign firms export goods to a country at a price lower than the selling price in their country of origin.
- (e) The two main benefits of free trade are a greater variety of products available in an economy, and at a cheaper price. More imported products will be available at a lower price than locally made products, benefiting local consumers as well as businesses that use imports as an input into production. The overall effect is higher living standards as a result of lower prices, increased production and increased consumer choice. However, in the short run inefficient import-competing firms will be forced to reduce or cease production in the face of global competition, increasing structural unemployment. A second disadvantage is that newer industries may find it more difficult to gain economies of scale without protection, and cannot establish themselves so that they can compete with the rest of the world.

Question 2

- (a) A multilateral trade agreement is a preferential trade agreement made between three or more countries, usually within a region, to reduce trade barriers in order to increase trade flows.
- (b) The World Trade Organisation (WTO) promotes multilateral free trade, providing a forum for the negotiation of global trade agreements. An example is the Doha Round, which aims to reduce protection in agriculture and other areas of global trade. Second, the WTO has a role in enforcing existing trade agreements, so that countries abide by the commitments they have made to reduce protection. If an economy refuses to comply with a WTO decision, it may face trade sanctions from WTO members.
- (c) Trade agreements allow an economy to gain greater access to goods and services that they cannot produce themselves, or in sufficient quantities to satisfy domestic demand. Consumers thus have a greater choice of goods and services, which are now available at a lower price. Trade agreements also provide domestic producers with better access to overseas export markets. This allows countries to reallocate resources towards those industries which are relatively more efficient, and thus trade according to their comparative advantage. This will lead to higher export revenue and improved living standards overall.
- (d) There is ongoing contention about whether regional trade agreements act as 'stepping stones' or 'stumbling blocks' to creating a situation of global free trade. On one hand, regional trade agreements have in some instances led to the creation of trading blocs, such as the European Union which imposes discriminatory trading policies against non-members. This creates a barrier towards pursuing global free trade, as the benefits for members within the trading bloc reduce the incentive to reduce the imposed tariff or subsidy protections against the rest of the world. On the other hand, regional trading agreements require economies to reduce the artificial barriers against foreign imports from certain economies, thus will encourage them to eventually reduce the level of protection against all imported goods. This view is promoted as the key benefit of pursuing multilateral trade liberalisation, as identified in the stimulus. In addition, aiming to achieve a regional trading agreement is often associated with targets for lower tariff or subsidy protection. An example is the APEC forum and the pursuit of the Bogor Goals for 2020 (stimulus).

Question 3

- (a) A tariff is a tax imposed on goods that may be imported into Australia, whilst a quota is a restriction on the amounts or values of the particular import.
- (b) Government revenue = size of the tariff x quantity of imports
= \$3 x (200-100)
= \$3 x 100
= \$300
- (c) A government might protect local industries through use of a subsidy. A subsidy is a cash payment to local producers. It artificially boosts the competitiveness of local producers and allows them to increase their supply. Secondly, a government might impose an import quota, which is a limit on the quantity of imports. By limiting the quantity of imports, the price of imports increases and local producers can increase their market share. Thirdly, a government could make certain industries subject to local content rules. These require that a certain proportion of a product must be locally made.
- (d) Protectionist policies generally have short term benefits like higher domestic production and job creation, but long term costs such as inflation, lower levels of productivity, exports and higher unemployment. In the short term, protectionist policies can allow 'infant industries' to expand their scale and reduce their production costs so that they can compete with overseas producers. However, unless this protection is temporary there is no incentive for the industry to reach a level of efficiency where it would be competitive without protection. In the long run, protectionist policies are likely to reduce living standards in an economy, as they tend to distort the allocation of resources away from efficient areas towards areas of less efficient production. In the long run, this is likely to lead to higher levels of unemployment and lower growth rates.