

### **Quick Review of International Trade Theory**

- Countries have a comparative (not absolute) advantage, due to different levels of technology, productivity, factor proportions, scale, et cetera.
- Gains from trade are mutually beneficial, but division of gains depends on many things.
- Competitive markets are most efficient, but gains from trade exist even when markets are not perfect, e.g., monopolies, monopolistic competition, externalities.
- Gains from trade exists even when we drop the full-employment assumptions.
- Balanced trade condition:  $P_x(Q_x - C_x) = P_y(C_y - Q_y)$

**Consider the neoclassical 2-2-2 model of trade.**

### **Quick Review of Commercial Policy**

- Protectionism benefits scarce factors, and industries which compete with imports, but it harms abundant factors, the exporting sectors, those who buy importable goods, and (usually) overall efficiency.
- When externalities are present, protectionism may have positive effects, but it is usually a second-best policy.
- Countries large enough to affect their terms of trade may benefit from protectionism, but by less than their trading partners are harmed.

### Labor and Capital Flows in the Basic Trade Model

- Trade in goods is a perfect substitute for trade in factors, at least when factors are equally productive. Trade in factors changes the PPF.
- Capital flows are usually done through transfers of savings.
- These transfers change the balanced trade condition:
 
$$P_x(Q_x - C_x) - P_y(C_y - Q_y) + F = 0$$
- Where  $F$  = inward flows of foreign savings.
- If this borrowing must be repaid in future, this will reverse the balance of trade.

### Putting Exchange Rates in the Neoclassical Model

- We know relative prices:
  - ♦  $P_x/P_y = P_x^* / P_y^*$
- We must find nominal prices:
  - ♦  $M V = P Q = P_x Q_x + P_y Q_y (+ P_z Q_z + \dots)$
  - ♦  $Q$  is found on the PPF, and  $M V$  must be given.
- If there are no tariffs or transaction costs, we can assume the Law of One Price:
  - ♦  $P_x = E P_x^*$
  - ♦  $P_y = E P_y^*$
- Purchasing Power Parity:
  - ♦  $P = E P^*$
- If trade is *not* perfect, then there is still some  $E$  which solves the trade balance equation:
  - ♦  $P_x(Q_x - C_x) - (E P_y^*)(C_y - Q_y) + F = 0$