DP IB Economics: SL

Your notes

4.1 Benefits of International Trade

Contents

4.1.1 The Advantages of Free Trade

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The Benefits of International Trade

- International trade refers to the **exchange of goods and services** between countries
- International trade involves the exchange of goods/service through **exports** and **imports**
- **International trade** is 'free' when there is no government intervention (quotas, taxes etc.) to reduce or limit trade

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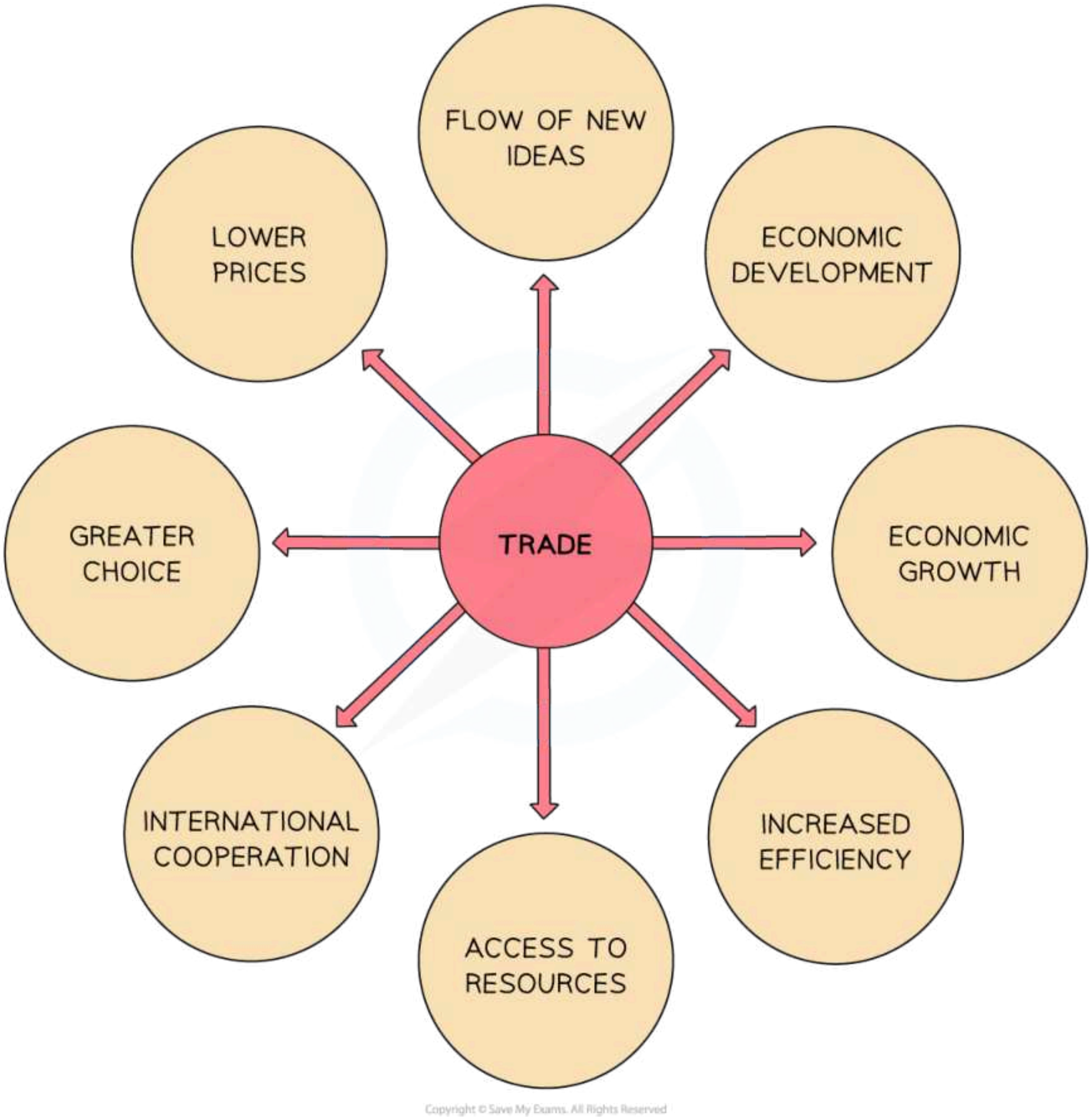

The benefits of free trade

- **Greater choice:** with access to a wider variety of goods/services, the standard of living improves
- **Lower prices:** with international competition prices fall giving households the ability to buy more
- **International cooperation:** required for trade helps countries to build better relationships which leads to lower levels of hostilities

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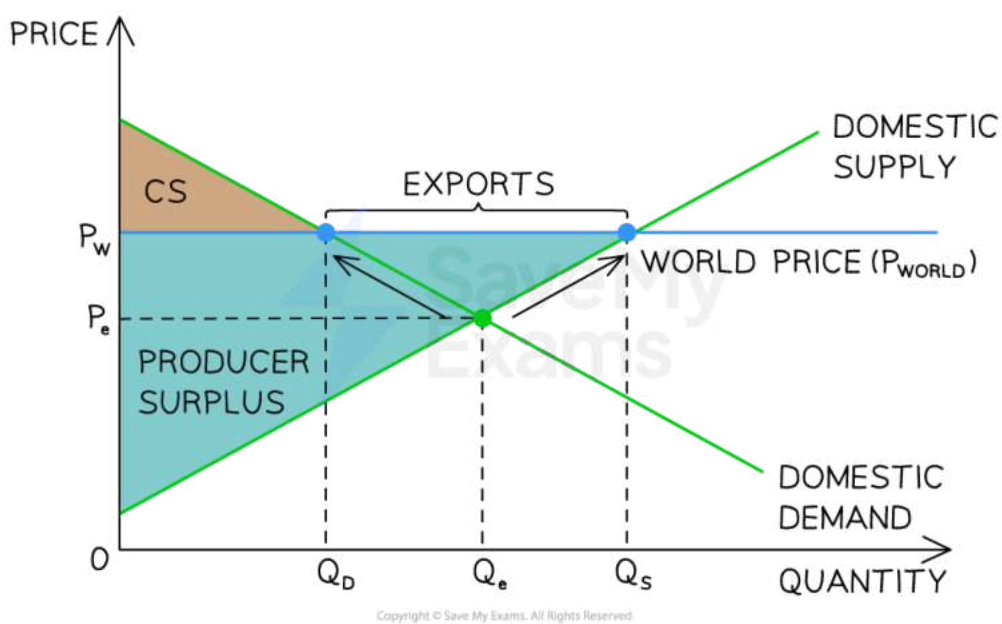
- **Flow of new ideas:** innovative ideas and technology can be shared between countries
- **Access to resources:** output can increase and costs of production can fall with increased access to raw materials
- **Increased efficiency:** international competition allows the most efficient firms to emerge and this improves the use of global resources
- **Economic growth:** exports are a key component of the gross domestic product of many countries and an increase in exports can lead to economic growth
- **Economic development:** Increased output leads to lower levels of unemployment which leads to higher incomes and a higher standard of living

The Benefits of Free Trade When World Price is Above Domestic Price

- The **benefits of free trade** can be seen for a country where the world price for a good/service is above the domestic price thus allowing for **exports**



When the world price (W_P) is above the domestic equilibrium price (P_E), a country's firms are able to export the excess supply

Diagram Analysis

- The **domestic equilibrium** in the market for rice in Vietnam is at P_eQ_e

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- The world price of rice is higher at P_w
- Vietnamese rice producers are **incentivised by the higher prices** to produce a higher level of output and domestic supply increases from Q_e to Q_s
- Vietnamese consumers now have to pay the world price for rice (Pw) and the domestic demand contracts from Q_e to Q_d
- The **excess domestic supply** (Q_s - Q_d) is now **available for export**

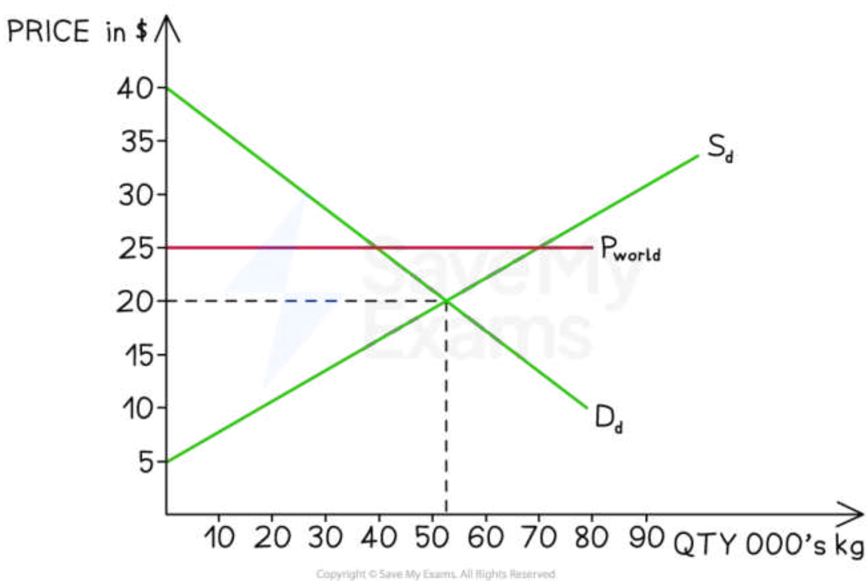
Worked Example

The Ukraine is one of the world's largest grain producers and due to their **comparative advantage**, their domestic price is below the world price.

From the diagram below

a) Calculate the quantity of exports [2]

b) Calculate the export revenue received [2]



Answer:

a) Calculate the quantity of exports

Step 1: Determine Ukraine's excess supply to be exported

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- Domestic prices will rise to the world price. At this price the quantity demanded (Q_d) is 40,000 kg's and the quantity supplied is 70,000 kg's **[1 mark]**
- The quantity of exports = 70,000 - 40,000 = 30,000 kg's **[1 mark]**

b) Calculate the export revenue received

Step 1: Substitute figures into the sales revenue equation

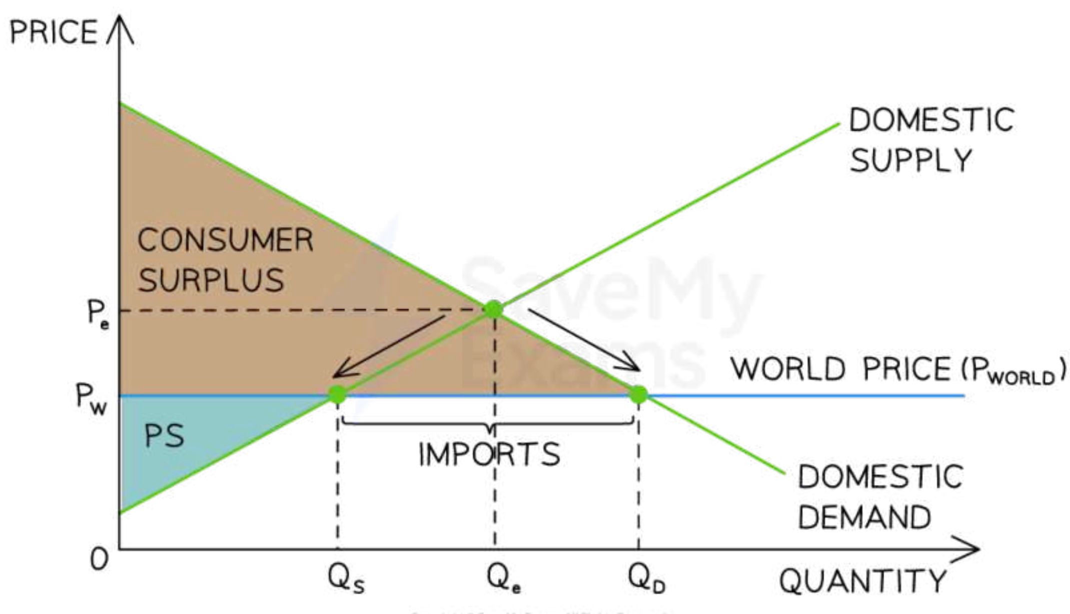
$$\text{Export sales revenue} = \text{price x quantity}$$

$$\text{Export sales revenue} = \$\,25 \text{ x } 30{,}000$$ [2 marks]

$$\text{Export sales revenue} = \$\,750{,}000$$

The Benefits of Free Trade When World Price is Below Domestic Price

- The **benefits of free trade** can be seen for a country where the world price for a good/service is below the domestic price thus allowing for **imports**



When the world price (Pw) is below the domestic equilibrium price (Pe), households and firms are incentivised to increase their imports

Diagram Analysis

- The **domestic equilibrium** in the market for bananas in Sri Lanka is at P_eQ_e
- The world price of bananas is lower at P_w
- Some of Sri Lanka's firms cannot compete with the **lower prices** and domestic supply contracts from Q_e to Q_s
- Sri Lanka consumers benefit from the lower world price (Pw) and the domestic demand extends from Q_e to Q_d
- The **excess domestic demand** (Q_d- Q_s) is now **met through imports**

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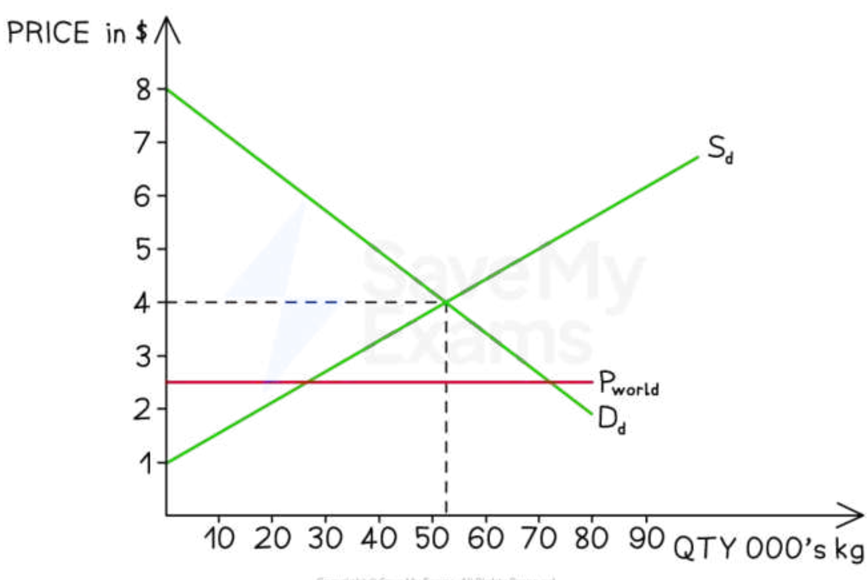
Worked Example

Sri Lanka consumers enjoy their bananas. Many bananas are grown locally, however their domestic price is higher than the world price creating an incentive to import bananas. Many bananas are imported from India.

From the diagram below

a) Calculate the quantity of imports [2]

b) Calculate the import expenditure [2]



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Answers:

a) Calculate the quantity of imports

Step 1: Determine Sri Lanka's excess demand to be imported

- Domestic prices will fall to the world price of $2.50. At this price the quantity supplied (Q_s) is 25,000 kg's and the quantity demanded (Q_d) is 73,000 kg's **[1 mark]**
- The quantity of imports = 73,000 - 25,000 = 48,000 kg's **[1 mark]**

b) Calculate the import expenditure

Step 1: Calculate consumer expenditure on imports

$$\text{Consumer import expenditure} = \text{price x quantity}$$

$$\text{Consumer import expenditure} = \$2.50 \text{ x } 48{,}000$$ [2 marks]

$$\text{Consumer import expenditure} = \$120{,}000$$