International Trade Cheatsheet

A concise reference guide to the key concepts, theories, and policies governing international trade, covering comparative advantage, trade barriers, exchange rates, and trade agreements.

Foundations of International Trade

Core Principles

Absolute Advantage: The ability to produce a good or service more efficiently than another country.

Comparative Advantage: The ability to produce a good or service at a lower opportunity cost than another country. This is the basis for trade.

Opportunity Cost: What is forgone when choosing one alternative over another. Crucial for determining comparative advantage.

Specialization: Countries should specialize in producing goods and services for which they have a comparative advantage.

Gains from Trade: Countries benefit from trade by consuming beyond their own production possibilities.

Theories of Trade

Mercantilism	Advocates trade surpluses to accumulate national wealth (gold reserves). Largely discredited today.
Adam Smith	Argued for free trade based on absolute advantage, promoting efficiency and wealth creation.
David Ricardo	Developed the theory of comparative advantage, demonstrating that trade can be mutually beneficial even if one country is more efficient in producing everything.
Heckscher-Ohlin Model	Countries export goods that use their abundant factors of production intensively (e.g., labor, capital).

Trade and Welfare

Consumer Surplus: The difference between what consumers are willing to pay and what they actually pay.

Producer Surplus: The difference between what producers receive and their cost of production.

Total Welfare: Sum of consumer and producer surplus. Trade generally increases total welfare, but can create winners and losers within a country.

Trade Barriers and Policies

Types of Trade Barriers

Tariffs	Taxes on imported goods. Increase the price of imports, protecting domestic producers but harming consumers.
Quotas	Quantitative limits on the amount of a good that can be imported. Similar effects to tariffs, but can lead to larger welfare losses.
Subsidies	Government payments to domestic producers. Lower production costs, making them more competitive, but can distort global markets.
Non-Tariff Barriers (NTBs)	Regulations, standards, and other policies that restrict trade without explicit tariffs or quotas (e.g., sanitary regulations, labeling requirements).

Arguments for Trade Restrictions

Infant Industry Argument: Protecting new industries until they are mature enough to compete internationally.

National Security Argument: Protecting industries vital for national defense.

Job Protection Argument: Shielding domestic jobs from foreign competition.

Unfair Competition Argument: Counteracting subsidies or other unfair practices by foreign firms.

Effects of Tariffs

Price Effect	Tariffs increase the domestic price of imported goods.
Quantity Effect	Tariffs reduce the quantity of imported goods.
Revenue Effect	Tariffs generate revenue for the government.
Welfare Effect	Tariffs create deadweight losses, reducing overall welfare.

Exchange Rates and the Balance of Payments

Exchange Rate Systems

Fixed Exchange Rate: The exchange rate is set and maintained by the government.

Floating Exchange Rate: The exchange rate is determined by market forces of supply and demand.

Managed Float: The exchange rate is primarily determined by market forces, but the government intervenes occasionally.

Balance of Payments

Current Account	Measures the flow of goods, services, income, and unilateral transfers.
Capital Account	Records the flow of investments in assets.
Financial Account	Transactions that involve the purchase or sale of assets, including foreign direct investment (FDI).
Official Reserve Account	A component of the balance of payments that reflects changes in a country's official reserves of foreign currency.

Factors Affecting Exchange Rates

Relative Inflation Rates: Higher inflation in a country typically leads to currency depreciation.

Relative Interest Rates: Higher interest rates attract foreign investment, increasing currency demand and appreciation.

Economic Growth: Stronger economic growth can lead to currency appreciation.

Government Policies: Interventions in the foreign exchange market can influence exchange rates.

Market Psychology: Expectations and speculation can drive short-term exchange rate movements.

Trade Agreements and Organizations

Types of Trade Agreements

Preferential Trade Agreement (PTA): Reduces trade barriers among participating countries.

Free Trade Area (FTA): Eliminates tariffs among member countries.

Customs Union: FTA plus a common external tariff policy.

Common Market: Customs union plus free movement of labor and capital.

Economic Union: Common market plus harmonization of economic policies.

Key Trade Organizations

World Trade Organization (WTO)	Deals with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible.
International Monetary Fund (IMF)	Promotes international monetary cooperation and provides policy advice and temporary financial assistance to countries to help them build and maintain strong economies.
World Bank	Provides loans and grants to governments of poorer countries for the purpose of pursuing capital projects.

Impact of Trade Agreements

Trade Creation: Increased trade due to reduced trade barriers within the agreement, leading to greater efficiency.

Trade Diversion: Trade shifts from a more efficient non-member country to a less efficient member country due to the trade agreement.

Economic Growth: Trade agreements can stimulate economic growth through increased trade and investment.