Chapter 1
Introduction to International Trade Theory and Policy

1.1 International Economics as a Distinct Subject

While several specialistic fields of economics have been developed as distinct branches of general economic theory only in relatively recent times, the presence of a specific treatment of the theory of international economic transactions is an old and consolidated tradition in the economic literature. Various reasons can be advanced to explain the need for this specific treatment, but the main ones are the following.

The first is that factors of production are generally less mobile between countries than within a single country. Traditionally, this observation has been taken as a starting point for the development of a theory of international trade based on the extreme assumption of perfect national mobility and perfect international immobility of the factors of production, accompanied by the assumption of perfect mobility (both within and between countries) of the commodities produced, exception being made for possible restrictive measures on the part of governments.

The second is the fact that the mere presence of different countries as distinct political entities each with its own frontiers gives rise to a series of problems which do not occur in general economics, such as the levying of duties and other impediments to trade, the existence of different national currencies whose relative prices (the exchange rates) possibly vary through time, etc.

The References (Bhagwati et al. 1998; Caves et al. 2006; Feenstra and Taylor 2008; Jones and Neary 1984; Krugman et al. 2011; Salvatore 2010; Södersten and Reed 1994; Woodland 1982) at the end of this chapter are a list of recent and less recent textbooks where the nature of international economics is further elucidated.

The specialistic nature of international economics—a discipline of increasing importance given the increasing openness of the single national economic systems—does *not* mean that its methods and tools of analysis are different from those of general economic theory: on the contrary, international economics makes ample use of the methods and tools of microeconomics and macroeconomics, as we shall see presently.

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As in any other discipline, also in international economics we can distinguish a *theoretical* and a *descriptive* part. The former is further divided into the *theory of international trade* and *international monetary economics*. All these distinctions are of a logical and pedagogical nature, but of course both the descriptive and the theoretical part, both the trade and the monetary branch, are necessary for an understanding of the international economic relations in the real world.

The descriptive part, as the name clearly shows, is concerned with the description of international economic transactions just as they happen and of the institutional context in which they take place: flows of goods and financial assets, international agreements, international organizations like the World Trade Organization and the European Union, and so forth.

The theoretical part tries to go beyond the phenomena to seek general principles and logical frameworks which can serve as a guide to the understanding of actual events (so as, possibly, to influence them through policy interventions). Like any economic theory, it uses for this purpose abstractions and models, often expressed in mathematical form. The theoretical part can be further divided, as we said above, into trade and monetary theory each containing aspects of both *positive* and *normative* economics; although these aspects are strictly intertwined in our discipline, they are usually presented separately for didactic convenience.

A few words are now in order on the distinction between international trade theory and international monetary theory.

The *theory of international trade* (which has an essentially microeconomic nature) deals with the causes, the structure and the volume of international trade (that is, which goods are exported, which are imported, and why, by each country, and what is their amount); with the gains from international trade and how these gains are distributed; with the determination of the relative prices of goods in the world economy; with international specialization; with the effects of tariffs, quotas and other impediments to trade; with the effects of international trade on the domestic structure of production and consumption; with the effects of domestic economic growth on international trade and vice versa; and so on. The distinctive feature of the theory of international trade is the assumption that trade takes place in the form of *barter* (or that money, if present, is only a veil having no influence on the underlying real variables but serving only as a reference unit, the *numéraire*). A by-no-means secondary consequence of this assumption is that the international accounts of any country vis-à-vis all the others always balance: that is, no balance-of-payments problem exists.

This part of international economics was once also called the *pure* theory of international trade, where the adjective "pure" was meant to distinguish it from *monetary* international economics.

International monetary theory (which is essentially of a macroeconomic nature) deals with the problems deriving from balance-of-payments disequilibria in a monetary economy, and in particular with the automatic adjustment mechanisms and the adjustment policies of the balance of payments; with the relationships between the balance of payments and other macroeconomic variables; with the various exchange-rate regimes; with the problems of international liquidity and other problems of the international monetary system; etc.

In this book we shall treat the theory of international trade. A companion volume treats international monetary theory, thus following the standard practice of international textbooks and courses.

One last word: in this work we shall be concerned mainly with the theoretical part (both positive and normative) of international economics, even if references to the real world will not be lacking. Thanks to the advances in econometrics and computer power, practically all theories of international trade have been subjected to a great number of empirical tests. As it would not be possible to consider all these tests, it was necessary to make occasionally arbitrary choices, though we feel that the most important empirical studies have been treated. In any case, where no treatment is given, we have referred the reader to the relevant empirical literature.

1.2 The Theory and Policy of International Trade: An Overview

The foundations of international trade theory are contained in three main models aimed at explaining the determinants of international trade and specialization:

1. The classical (Torrens-Ricardo) theory, according to which these determinants are to be found in technological differences between countries;
2. The Heckscher-Ohlin theory, which stresses the differences in factor endowments between different countries;
3. The neoclassical theory (which has had a longer gestation: traces can be found in J.S. Mill; A. Marshall takes it up again in depth, and numerous modern writers bring it to a high level of formal sophistication), according to which these determinants are to be found simultaneously in the differences between technologies, factor endowments, and tastes of different countries. The last element accounts for the possible presence of international trade, even if technologies and factor endowments were completely identical between countries.

From the chronological point of view, model (2) post-dates model (1), while model (3), as we said, has had a longer gestation and so has been developing in parallel to the others.

To avoid misunderstandings it must be stressed that the Heckscher-Ohlin theory is also neoclassical (in the sense in which the neoclassical vision is different from the classical one), as it accepts all the logical premises of, and follows the, neoclassical methodology. As a matter of fact the Heckscher-Ohlin model can be considered as a particular case of the neoclassical one in which internationally identical production functions and tastes are assumed. This loss in degree of generality is, according to some authors, the price that has to be paid if one wishes to obtain definite conclusions about the structure of the international trade of a country.

These models are treated in detail in Part II.

Part III is devoted to the *new explanations* of international trade. These are the theories which drop either one or both of the two fundamental assumptions of the traditional theory (perfect competition and product homogeneity), and analyse international trade in a context of imperfect competition and/or product differentiation.

Part IV deals with the problems of commercial policy, including the debate between free trade and protectionism. The *new protectionism*, whereby protection is based on non-tariff instruments and comes about through administrative procedures or lobbying activities, is examined in depth. *Strategic trade policy*, which assumes the presence of interaction between the firms involved in international trade (when the action taken by any one firm may have significant effects on other firms) will also be examined in this part.

Part V deals with the relations between *international trade and growth*, first in a comparative-static and then in a dynamic context. We shall examine both the traditional view and the new models based on the interaction between *endogenous growth* and the new trade theories.

Part VI treats a topic strictly related to international trade, namely *globalization*, examined both in its relation to the *new economic geography* and in its relation to wage inequality between nations.

1.3 Small and Large Open Economies

We shall use both *one-country* and *two-country* models. With the expression *one-country* or *small-country* model (also called SOE, *small open economy*) we refer to a model in which the rest of the world is taken as exogenous, in the sense that what happens in the country under consideration (call it country 1) is assumed to have a negligible influence (since this country is small relative to the rest of the world) on the rest-of-the-world variables (in particular, the terms of trade). This means that these variables can be taken as *exogenous* in the model.

With the expression *two-country* or *large country* model we refer to a model in which the effect on the rest-of-the-world's variables of country 1's actions cannot be neglected, so that the rest of the world has to be explicitly included in the analysis (as country 2). It follows that, through the channels of exports and imports of goods and services, and capital movements, the economic events taking place in a country have repercussions on the other country, and vice versa.

Two-country models may seen more realistic, as in the real world inter-country repercussions do take place. However, in such models the various countries making up the rest of the world are assumedly aggregated into a single whole (country 2), which is not necessarily more realistic. In fact, if the world is made up of n interdependent countries which interact more and more with one another (*globalization* is the fashionable word for this increasing interdependence and interaction), dealing with it as if it were a two-country world is not necessarily better than using the SOE assumption as a first approximation. These problems can be overcome by the construction of n-country models, which will be examined in the relevant Appendixes, given their degree of mathematical difficulty.

References

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Practically all international economics textbooks contain a treatment to show why it exists as a distinct subject and to illustrate its subdivisions. We therefore mention only a few; others might have served equally well. Ample references concerning the various theories will be given in the following chapters.

Throughout this book, the end-of-chapter references will be indicated only by name(s), date, title. Complete information as to publisher, place of publication, etc., is contained in the Bibliography at the end of this volume.