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CFA – Level II

Microeconomics

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Micro session structure

1) Trading with the World
   - Ricardian Model,
   - Comparative advantage,
   - Trade restrictions: the reasons.

2) Regulation in a globalized economy
   - Why regulation?;
   - Benefits and negative side effects of regulation;
   - Deregulation effects.

International Trade

- David Ricardo, an English economist in the early 19th century put forward the case for benefits of international trade.

- Opponents of free trade would argue that it would hurt the country's economy.

- Ricardo showed that when two countries engaged in trade, it could benefit both.

International Trade

- Ricardo gave the example of England and Portugal trading cloth and wine.
- Suppose labor units required are:

	Cloth	Wine
England	4	8
Portugal	2	1

- From the table it can be seen that Portugal has an absolute advantage in the production of both cloth and wine.

International Trade

- Can Portugal then benefit from trade with England?

- Yes, answered Ricardo. Because England has a **comparative advantage** in producing textiles.

- Compare opportunity costs.

International Trade

- Can they both benefit from trade?
- Once again the answer is YES!

- Take the following **example**:

1) England moves 1 unit of labor from production of wine to cloth => wine down 0.125 units, cloth up 0.25 units.
2) Portugal moves ¼ unit of labor from production of cloth to wine => wine up 0.25 units, cloth down 0.125 units.

- Net impact for both countries: wine up 0.125 units, cloth up 0.125 units.

International Trade

- So by moving England towards specializing in the production of cloth, and Portugal towards production of wine, the countries are able to expand the combined production of both goods.

- Trade then is possible that shares the increase such that the amount of both goods for both countries increases.

International Trade

- Even though Portugal had an absolute advantage in production of cloth, it is beneficial for it to trade with England and produce less cloth.

- How much resources will England move to production of cloth and Portugal to production of wine as they move from autarky to free trade?

- In the real world production functions are not likely to be linear as in this example due to law of diminishing returns, etc. This combined with the preferences of consumers will determine the shift in resources.

International Trade

- For **producers**: exports push out the demand schedule for their goods, enabling them to obtain higher prices. On the other hand, imports do hurt producers.

- For **consumers**: imports push out the supply schedule lowering prices. If tariffs or import quotas are imposed then consumers lose this benefit.

International Trade

- Comparative advantage explains the international trade that takes place in the world.

- Countries restrict international trade by imposing tariffs, quotas and voluntary export restraints.

International Trade

- Why impose restrictions?
  - **Weak arguments**: protection is necessary for national security; protect infant industries, prevent dumping.

  - Trade is restricted because tariffs raise government revenue and because protection brings a small loss to a large number of people and a large gain per person to a small number of people.

Regulation

- Rationales for Government Regulation of Business

- Economic regulation is typically intended to control the prices that regulated firms are allowed to charge.

- **3 types of government regulation** of business:
  - i) **natural monopolies**: take the form of *cost-of-service* regulation that seeks to achieve average cost pricing or rate-of-return regulation aiming to attain a competitive, zero-economic-profit rate of return.

  - ii) **regulation of otherwise competitive industries** is typically designed to address perceived market failures.

  - iii) **Social regulation**: designed to encompass a broad set of objectives concerning issues such as quality of products, product safety and conditions under which employees work.

Regulation drawbacks
- Alternative Theories of Regulator behavior

- It is difficult to regulate the price per constant-quality unit because it is difficult to measure all dimensions of quality.

- The **capture theory**: regulators end up by sharing the same vision of the firms to be regulated.

- **Share the gains, share the pains theory**: predicts that a regulator takes into account the preferences of legislators and consumers as well as the regulated firms.

Deregulation effects

- **Short-run effects**: typically include failures of high-cost producers, some cutbacks in products or services to some consumers, unemployment.
- **Long-run benefits**: profits fall toward competitive levels; price drop closer to marginal costs.

- **Deregulation** hopes that long-term social benefits outweigh short-term adjustment costs.