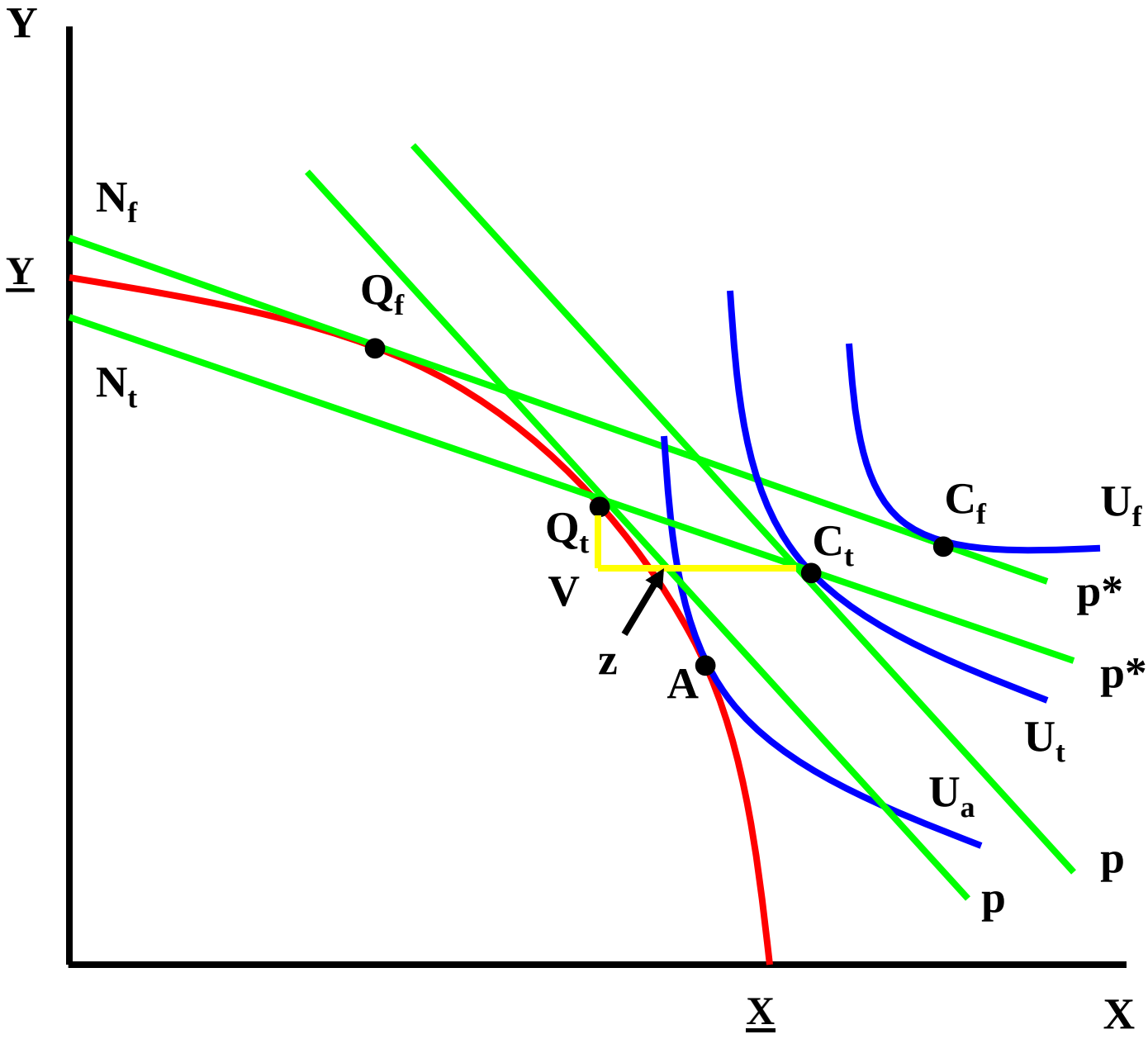
EFFECTS OF TRADE DISTORTIONS

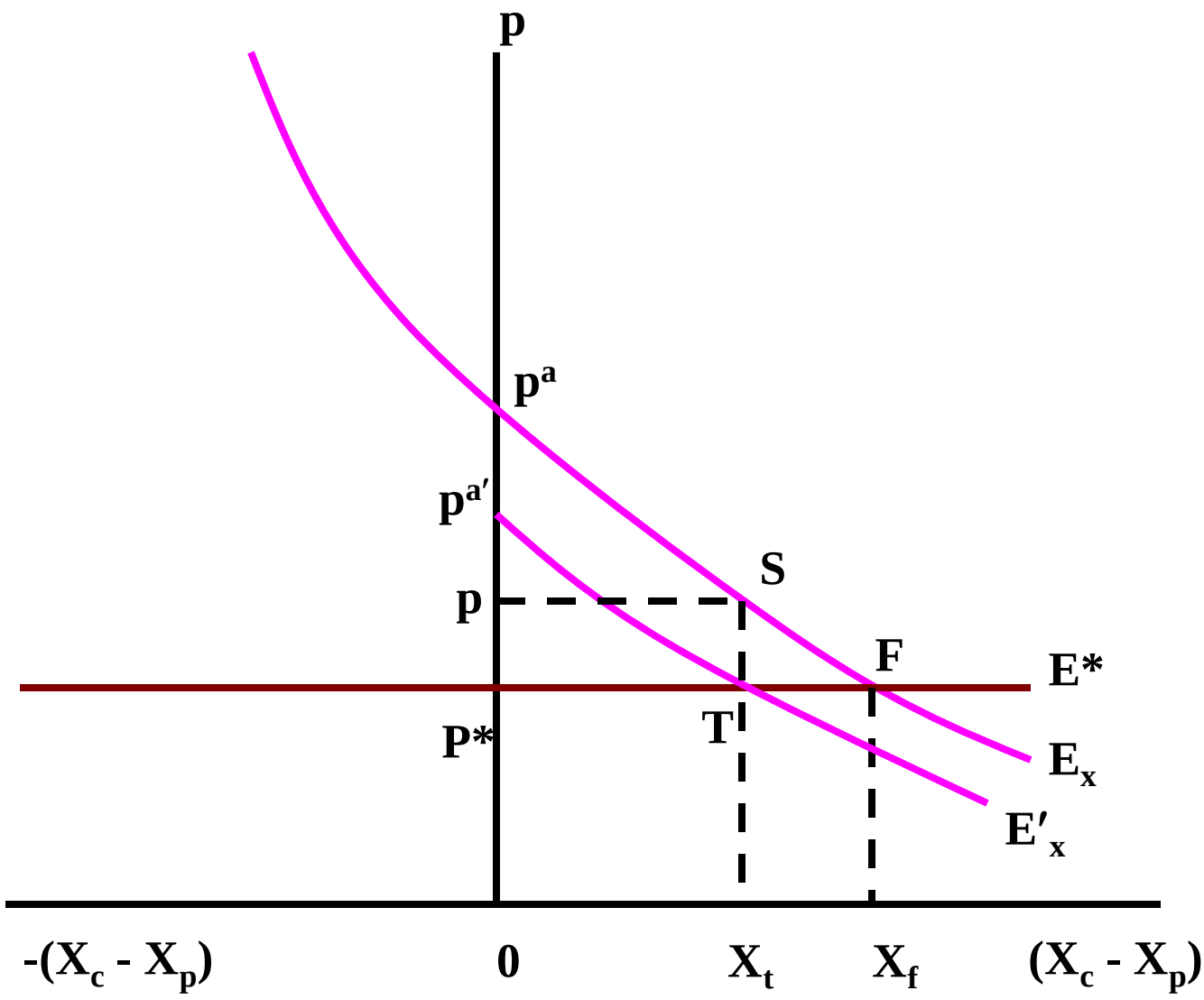
FIGURE 1: IMPORT TARIFF IN A SMALL ECONOMY



$$MRS = MRT = p = p^*(1+t) > p^* \qquad (1)$$

$$p_x^*(X_c - X_p) + p_y^*(Y_c - Y_p) = 0 \qquad (2)$$

FIGURE 2: EXCESS DEMAND AND IMPORT TARIFFS



Tariff revenue = pp* TS

FIGURE 3: IMPORT QUOTA IN A SMALL ECONOMY

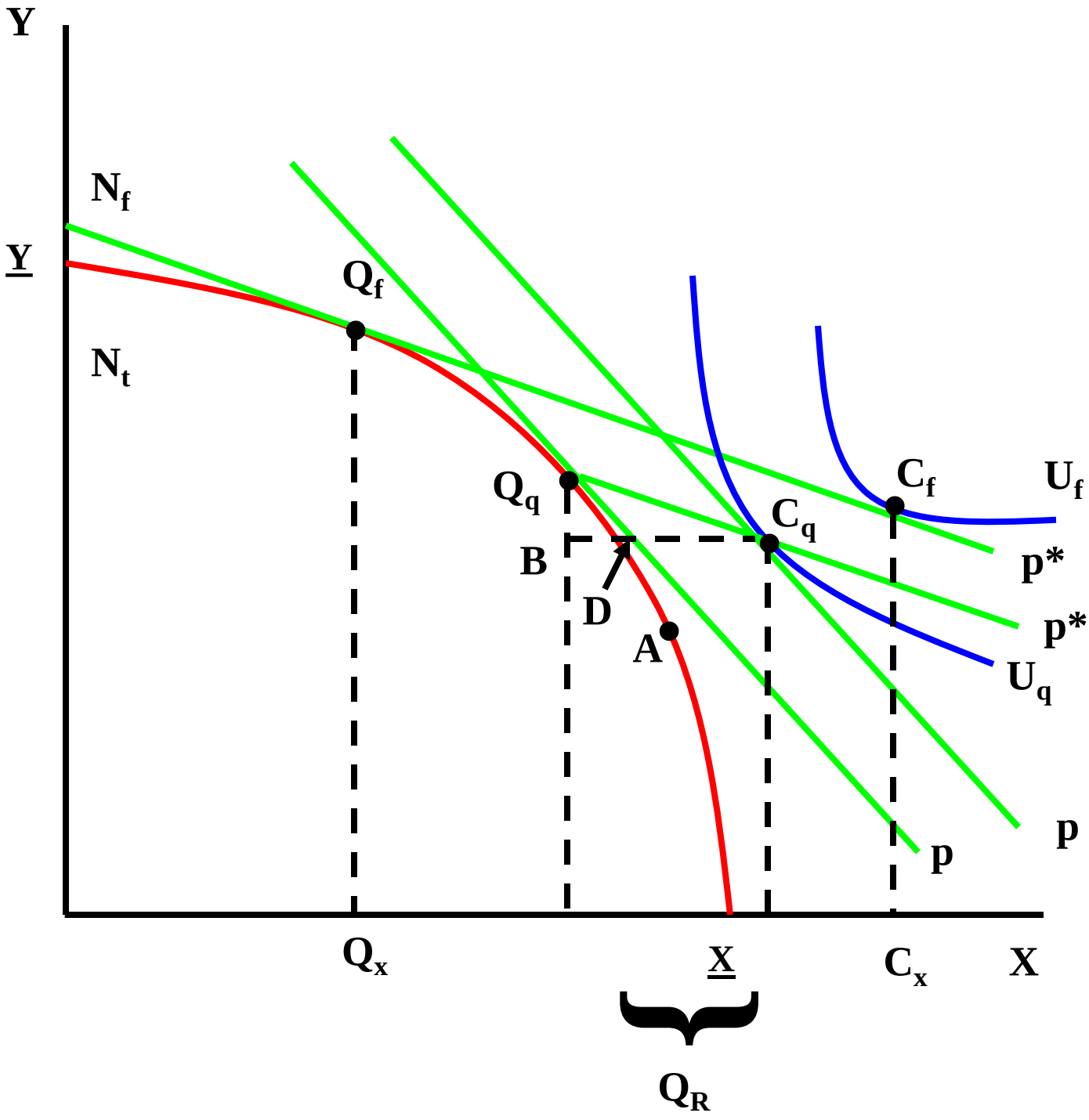
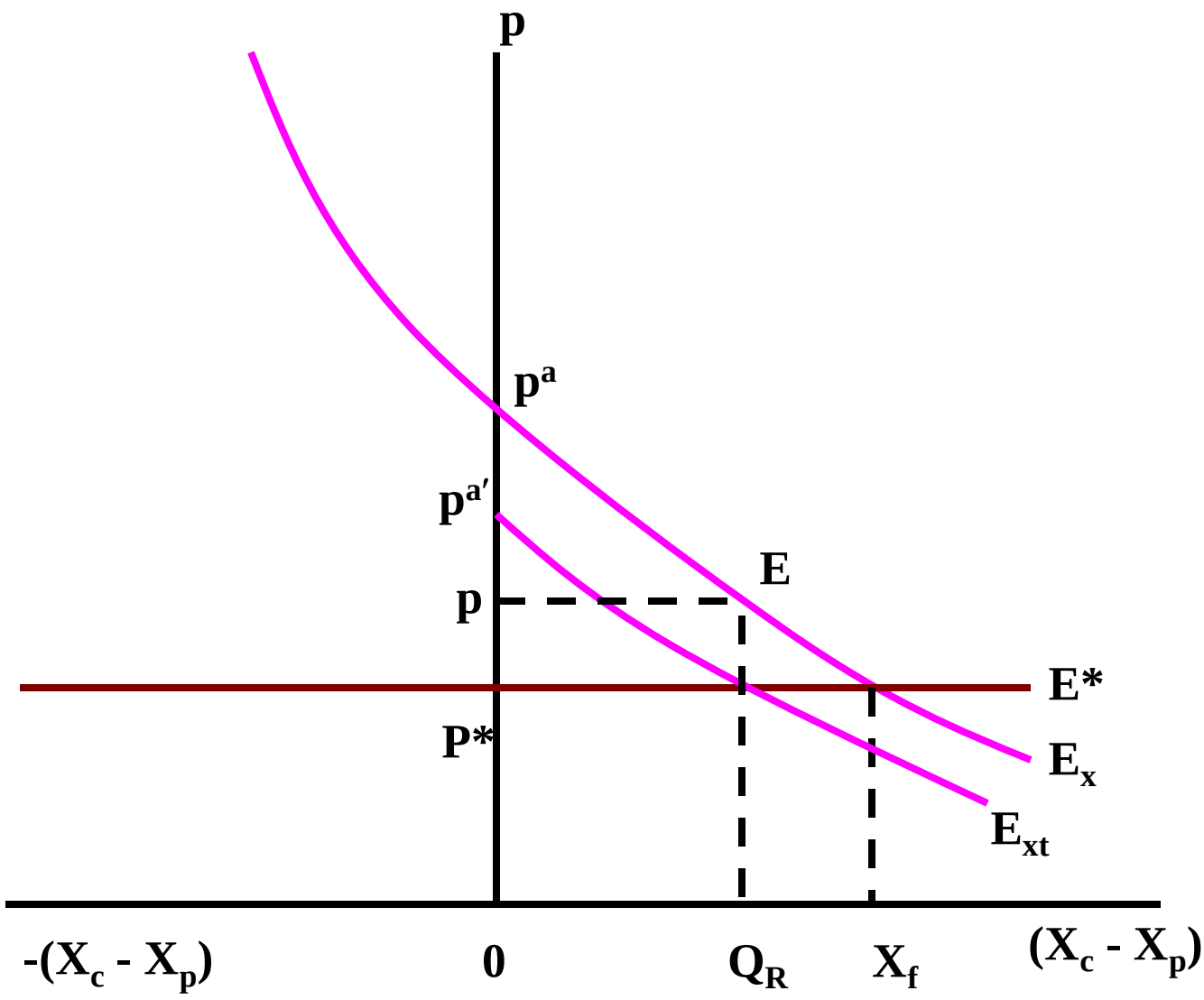


FIGURE 4: EXCESS DEMAND QUOTAS vs. TARIFFS



- **If a country is large, it can influence its *terms of trade*, i.e., the price of its exports falls as it exports more, and the price of its imports rise as it imports more**

- **It may be optimal for a large country to exploit its market power in order to alter its terms of trade by imposing tariffs on its exports and imports (see figure 5)**

- **An export tariff has two effects: it reduces supply of export good to world market, raising the world price, but at same time domestic supply increases, lowering the domestic price**

- **The import tariff also has two effects: it increases supply of import good on world market, lowering the world price, but at same time domestic supply is reduced, raising the domestic price**

- **However this worsens the terms of trade for other country, i.e., their export price falls and their import price rises, so they will retaliate with their own tariffs, resulting in a "trade war"**

FIGURE 5: OPTIMAL TARIFFS AND MARKET POWER

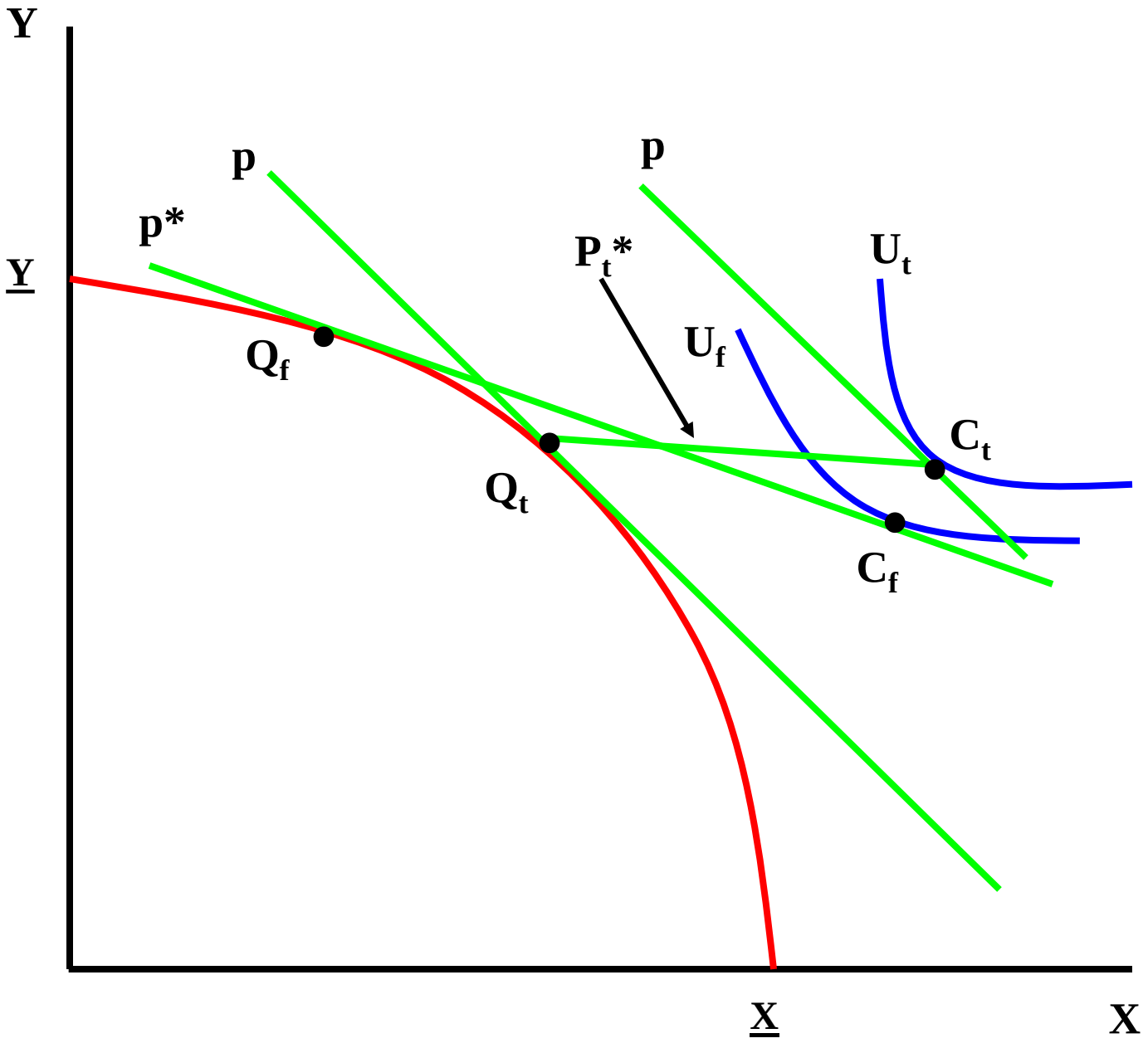


FIGURE 6: LOSSES FROM DISTORTIONS