AAT Level 1 — Economics

Chapter 6

International Trade & Foreign Exchange Market

6.1 International Trade

International Trade (Foreign Trade) refers to the exchange of goods and services between countries. It can be studied as Export Trade and Import Trade.

6.1.1 Advantages of International Trade

- Acceleration of economic growth
- Growth in international economic cooperation
- Ability to obtain foreign technology from developed countries
- Ability to find a market to sell surplus production
- Efficient and effective use of resources
- Ability to buy goods that cannot be produced domestically
- Ability to consume high quality products at a lower price
- Inflow of foreign loans, grants and foreign investments

6.1.2 Major Concepts in International Trade

- Absolute Advantage Theory
- Comparative Advantage Theory

6.1.2.1 Absolute Advantage Theory (Adam Smith)

A country has an Absolute Advantage in producing a good when it is MORE EFFICIENT than any other country in producing it — i.e., it can produce more output using the same input, or the same output using fewer inputs (lower cost).

Example (Output per 1 unit of labour):

Country	Material	Rice
Sri Lanka	8	5
China	4	7

- Sri Lanka has the Absolute Advantage in Material (8 > 4)
- China has the Absolute Advantage in Rice (7 > 5)

Alternative method — using input (labour) needed per unit of output: a country needing FEWER labour units to produce a good has the absolute advantage in that good.

6.1.2.2 Comparative Advantage Theory (David Ricardo)

Introduced to overcome the limitation of the Absolute Advantage Theory — even a country without an absolute advantage can still benefit from trade.

A country has a Comparative Advantage if it can produce a good at a LOWER OPPORTUNITY COST than another country.

Assumptions of Comparative Advantage Theory:

- Perfect mobility of resources
- Constant returns to scale
- No externalities in production and consumption
- Zero transport cost

Worked Example:

Country	Wheat (kg)	Materials (Meters)
USA	6	3
Canada	11	2

USA has the absolute advantage in BOTH goods — so opportunity cost must be compared:

Country	Opp. Cost of 1 unit Wheat(in units of Materials)	Opp. Cost of 1 unit Materials(in units of Wheat)
USA	3/6 = 0.5	6/3 = 2
Canada	2/1 = 2	1/2 = 0.5

- USA has the LOWEST opportunity cost in Wheat (0.5 < 2) → USA has Comparative Advantage in Wheat
- Canada has the LOWEST opportunity cost in Materials (0.5 < 2) → Canada has Comparative Advantage in Materials
- Result: USA specializes in Wheat, Canada specializes in Materials, and both trade

Sources of Comparative Advantage

- Change in the composition of resources
- Quality aspect
- Changes in preference
- Economies of scale
- Divisions in production (specialization)
- Changes in technology
- Public policies
- Inflation
- Location of industry

6.1.3 Advantages of International Trade (Detailed)

- Greater variety of goods available for consumption (beyond the Production Possibility Curve)
- Efficient allocation and better utilization of resources
- Promotes efficiency in production to remain competitive
- More employment generated in transport, banking, insurance, etc.
- Transfer of technology and knowledge
- Non-economic gains — political, social and cultural benefits

6.1.4 Disadvantages of International Trade

- Inflow of unwanted/unsuitable goods
- Over-specialization may have adverse impact
- Heavy dependence on other countries
- Domestic industries exposed to foreign competition & “dumping” → possible unemployment

6.2 Tariff and Non-Tariff Barriers on Free Trade

6.2.1 Protectionism

Protectionism involves any attempt by a country to impose restrictions on open trade in goods and services. It can be done in two ways:

- Tariffs — a tax/duty that raises the price of imported goods, causing a contraction in domestic demand for imports and expansion in domestic supply
- Non-tariff methods

Non-Tariff (Other) Methods:

- Quotas — physical limitation on the quantity of imports allowed
- Subsidies — grants/payments to domestic producers to lower prices & encourage local consumption
- Voluntary limits on exports
- Foreign exchange controls — limiting the foreign currency available to importers
- Setting limits/standards in administration and technology
- Economic embargoes — an official ban on trade with a country or commodity

6.2.2 Arguments FOR Protectionism

- Correct a Balance of Payments deficit
- Infant Industry protection — allows new domestic industries to grow and become competitive
- National security importance
- Protect employment — avoid job losses from cheaper imports
- Increase utilization of domestic resources
- Protect Key/Strategic Industries (e.g., iron, steel, agriculture, scientific instruments)
- Diversification of industry — avoid over-dependence on one or few industries

6.2.3 Arguments AGAINST Protectionism

- Market distortion and loss of economic efficiency
- Higher prices for consumers; protects inefficient domestic producers
- Reduction in market access for producers
- Export subsidies depress world prices and harm developing exporters
- Extra costs for exporters — tariffs act like a tax on exports
- Adverse effects on poverty — tariffs hit lower-income groups hardest
- Risk of retaliation and trade wars

6.3 The Terms of Trade

Terms of Trade is the rate at which one country's products are exchanged for those of other countries.

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Terms of Trade = (Index of Export
Prices / Index of Import Prices) ×
100
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- Improvement (favourable trend): export prices rise relative to import prices → more imports for the same exports
- Deterioration (unfavourable trend): export prices fall relative to import prices

Note: A rise in export prices due to higher demand is good for the country. But a rise in export prices due to inflation may reduce demand and lower export revenue — the cause of the price change matters.

6.4 Balance of Payment (BOP)

The Balance of Payment is a record of all economic transactions between residents of a country and the rest of the world, over a period (usually a year). Money coming IN is a credit item; money going OUT is a debit item.

6.4.1 Types of Transactions Recorded in BOP

- Balance of trade in goods
- Balance of trade in services
- Net primary income (interest, profits, dividends, migrant remittances)
- Net secondary income (contributions to world organisations, aid, etc.)
- Sale/transfer of patents, copyrights, franchises, leases, goodwill
- Transfer of ownership of assets
- Foreign direct investments
- Portfolio flows
- Balance of banking flows

6.4.2 Balance of Payment Accounts

- Current Account — trade in goods, services, investment income, current transfers
- Capital Account
- Financial Account

6.4.2.1 Current Account

Records all transactions relating to exports/imports of goods and services and unilateral transfers. Has THREE main components:

- Export & Import of Goods (Visible Trade / Merchandise) — imports = debit, exports = credit. Balance = Balance of Trade
- Export & Import of Services (Invisible Trade) — e.g., shipping, banking, insurance. Payments = debit, receipts = credit
- Primary & Secondary Income — Primary: interest, rent, profits, migrant remittances. Secondary: unilateral/unrequited transfers (gifts, donations) — receipts = credit, payments = debit

6.4.2.2 Capital Account

Records transactions between residents and the rest of the world that change the assets or liabilities of residents/government — mainly acquisition of non-produced, non-financial assets.

Non-produced financial assets include:

- Permits, lease agreements, trade marks
- Purchase/sale of goodwill, franchise, patents, copyrights
- Government grants

Borrowing from overseas increases foreign currency stock but increases external liabilities. Buying property overseas increases external assets but reduces foreign currency stock.

6.4.2.3 Financial Account

Concerns investments by residents abroad and by non-residents in Sri Lanka. Foreign investment IN Sri Lanka = credit; Sri Lankan investment ABROAD = debit.

The Financial Account includes:

- Foreign Direct Investment (FDI)
- Portfolio investment
- Financial derivatives
- Long-term & short-term government loans
- Receipts of privatization
- Private long-term & short-term loans/liabilities
- Foreign reserve assets
- Assets of commercial banks

6.4.3 Format of Balance of Payment (Example, Rs. million)

Item	Credit	Debit
Exports	1,000	—
Imports	—	1,300
Non-Monetary Gold Receipts	150	—
Non-Monetary Gold Payments	—	200
Services — Receipts	800	—
Services — Payments	—	600
Balance of Trade & Services A/C	—	(150)
Primary Income — Receipts	800	—
Primary Income — Payments	—	1,000
Balance of Primary Account	—	(200)
Workers' Remittances Receipts	1,800	—
Workers' Remittances Payments	—	800
Government Transfer Receipts	400	—
Balance of Secondary Income A/C	1,400	—
Balance of Current Account	1,050	—

Item	Credit	Debit
Capital Receipts	600	—
Capital Payments	—	300

Balance of Capital Account	300	—
Balance of Current & Capital A/C	1,350	—

Item	Credit	Debit
Direct Investments — Assets	150	—
Direct Investments — Liabilities	—	100
Portfolio Investments — Assets	200	—
Portfolio Investments — Liabilities	—	150
Other Investments — Assets	150	—
Other Investments — Liabilities	—	50
Reserve Assets (net)	250	—
Balance of Financial Account	450	—

Overall Balance, Monetary Movement & Deficits

- Overall Balance = adjusted Current + Capital + Financial Account balances (plus valuation adjustments / errors & omissions). Always tallies due to double-entry.
- A deficit = decrease in foreign assets; a surplus = increase in foreign assets
- Monetary Movements — how a BOP deficit or surplus is financed. That is done through moving foreign exchange reserves.
- Deficits are settled through official foreign assets or loans (e.g., from IMF); surpluses are added to official foreign reserves

6.5 Expansion of Businesses through International Trade

International trade lets domestic businesses expand into foreign markets, increasing competitiveness and opportunities for new businesses. However, domestic infant industries may struggle to compete with foreign markets, causing adverse impacts. A country should assess its strengths, weaknesses, opportunities, and threats (SWOT) before entering international markets.

6.6 Foreign Exchange Market and its Determinants

An exchange rate is the price of one currency in terms of another currency. It can be expressed in two ways:

- Direct Quoting — price of 1 unit of FOREIGN currency in terms of domestic currency
- Indirect Quoting — price of 1 unit of DOMESTIC currency in terms of foreign currency

Example (Direct Quote): 1 USD = Rs. 180.91 | 1 GBP = Rs. 236.35 | 1 INR = Rs. 2.55 | 1 EUR = Rs. 201.17

Example (Indirect Quote): 1 LKR = 0.0055 USD | 1 LKR = 0.0042 GBP | 1 LKR = 0.39 INR | 1 LKR = 0.0050 EUR

The Foreign Exchange (FOREX/FX) Market is a global, decentralized, over-the-counter market for trading currencies — the largest market in the world.

Demand for Sri Lankan Rupees comes from:

- Foreigners wishing to buy Sri Lankan goods & services
- Foreign-based Sri Lankan firms sending profits home
- Foreign banks paying interest on money held by SL residents
- Foreign firms paying dividends on shares held by SL residents
- Sri Lankans working abroad sending money home
- Foreign firms/individuals investing, saving, or lending in Sri Lanka

Supply of Sri Lankan Rupees comes from:

- Individuals wishing to buy foreign goods & services
- Multinational companies based in SL sending profits home
- SL banks paying interest to foreign account holders
- SL firms paying dividends to foreign shareholders
- Foreigners working in SL sending money home

6.6.1 Determination of the Foreign Exchange Rate

The exchange rate is determined where the Demand for Dollars curve intersects the Supply of Dollars curve (similar to ordinary market equilibrium).

Dollars are DEMANDED for:

- Importing goods from foreign countries
- Travelling abroad
- Repayment of loans & payment of interest
- Transfer payments to foreign countries
- Making investments abroad

Dollars are SUPPLIED based on:

- Income earned from exports of goods & services
- Primary income earned
- Secondary income earned
- Speculation

6.7 The Effect of Foreign Exchange on Businesses

6.7.1 Types of Foreign Exchange Rates

Type	Description
Fixed Exchange Rate	Value fixed against another currency and maintained by government. Creates certainty; does not respond to market demand & supply changes.
Flexible / Floating Exchange Rate	Determined entirely by market forces — supply and demand. Changes according to FOREX market movements.
Managed Exchange Rate	Government intervenes in the market to influence or set the rate for a period.

6.8 Depreciation and Appreciation of Exchange Rate

- Depreciation — a REDUCTION in the value of a currency against other currencies (due to demand & supply)
- Appreciation — an INCREASE in the value of a currency against other currencies (due to demand & supply)

6.8.1 Economic Effects of Currency Depreciation

- Imports become MORE expensive
- Increase in import expenditure
- Domestic inflation rises if production relies on imported inputs
- Increase in foreign loan settlements and interest payments
- Exports become CHEAPER → increased export demand
- Improvement in current account (more exports, fewer imports)
- Increased tourism revenue → favourable services account balance
- Demand shifts toward locally produced goods (imports become relatively costlier)

6.8.2 How to Reduce the Impact of Currency Depreciation

Example — US Dollar in Sri Lankan Rupees:

- Nov 2018: 1 USD = Rs. 173
- Jan 2019: 1 USD = Rs. 180 (Depreciation — more rupees needed per dollar)

Effects of depreciation: exports become cheaper; imports become more expensive.

Measures to reduce the impact of currency depreciation:

- Increase the competitiveness of exports
- Take necessary measures to reduce import expenditure
- Reduce external imbalances using domestic resources (similar to reducing internal imbalances)
- Allow monetary policy to operate freely without intervention