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International Trade & Foreign Exchange Market

AAT Level I

ECN - Economics

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Chapter 06

International Trade

- It can be defined as the trade that takes place of the countries across the domestic boundary.
- It includes the aggregate exports & imports mainly in terms of goods & services and factor based services
- International trade is based on principle of international division of labour.
- It arises because a country specializes in the production of certain goods & services and the surplus will be supplied to the international market.

The theory of international trade

1. Absolute advantage theory

- This was introduced by the well-known economist Adam smith.
- He believed that the country will only voluntarily engaged in international trade in such great way to make it effective.

Assumptions

1. Two countries are engaged in international trade
2. Only two goods are produced by each country
3. Both countries have same level capacity of resources.
4. The country which has the highest productivity level or the lowest production cost will be absolutely advantage for that particular good.

Example:

There are two countries USA and Canada which can produce wheat flour and clothes and their production per unit of input factor is given below.

Good / Country	Wheat Flour	Clothes
USA	220	105
Canada	45	130

Solution

- According to the above table with the given set of input USA can produce 220 units of wheat flour or 105 units of clothes but Canada can produce 45 units of wheat flour or 130 units of clothes.

- Therefore USA is absolutely advantage for the production of Wheat flour & Canada absolutely advantage for the production of the clothes
- Ultimately USA exports wheat flour to Canada and imports clothes form Canada and vice versa.

Example:

There are two countries Japan and Srilanka which can produce tea and automobiles and their production per unit of input factor is given below.

Good / Country	Tea	Automobile
Japan	20	65
Srilanka	48	6

Solution:

- According to the above table with the given set of input Japan can produce 20 units of Tea or 65 units of automobile but Srilanka can produce 48 units of Tea or 06 units of automobile.
- Therefore Japan is absolutely advantage for automobile & Srilanka is absolutely advantage for tea
- Ultimately japan exports automobile to Srilanka & imports tea from Srilanka & vice versa.

2. Comparative advantage theory

    - This theory was developed by David Ricardo a British economist was stated the principal of comparative advantage.
    - It means how it can be beneficial for two countries to trade if one has a lower of relative cast foe such good production.

Assumptions

1. Two countries are involved in international trade.
2. Two good are produced by each country.
3. Both countries have same level capacity of resources.
4. The country which has the lowest opportunity cost is comparatively advantages for such goods.

Example 1:

There are two countries USA and Canada which can produce wheat flour and clothes and their production per unit of input factor is given below.

Good / Country	Wheat Flour	Clothes
USA	6	3
Canada	1	2

Solution:

- According to the comparative advantage theory based on the above table with the given set of inputs USA can produce 6 units of wheat flour or 3 units of clothes.
- But Canada can produce 1 unit of wheat flour or 2 units of clothes.
- In accordance with the opportunity cost USA is comparatively advantage for wheat flour and Canada for clothes
- Therefore USA exports wheat flour to Canada and imports clothes from Canada and vice versa.

Advantages of international trade

1. Able to obtain consumption possibility curve outside from production possibility curve.
2. Able to consume the goods from other country which they cannot produce.
3. Improvement in employment opportunity and growth in trade & service sector.
4. Receiving foreign investment & foreign grants.
5. Able to consume international standard good in fair price.
6. Enhance strong political, social & cultural relationship among countries
7. Enables government income from tariffs.
8. Acceleration of economic growth

Disadvantages of international trade

1. Exploitation of resources
2. Import of harmful goods (alcohol, whitening creams)
3. Cultural Damages.
4. Local industries are getting damages
5. Technological errors lead to fraudulent activities
6. High dependency
7. Greater amount of imports leads to negative BOP

Protectionism

- All type of activities which are used to control incoming foreign goods & services freely to the domestic market is known as “Protectionism”

- If there are strict rules & regulations to control the foreign trade, it will affect multi traded activities, therefore these controls should be minimized.

- There are two types of following activities used in the protectionism.
  - ❖ Tariffs, Tax activities
  - ❖ Non-tariffs, Non-tax activities

1. <u>Tariffs, Tax activities</u>

   - ❖ Imposing tariffs on imports
   - ❖ Imposing tariffs on exports

2. <u>Non-Tariffs, Tax activities</u>

   - ❖ Control on exchange rate
   - ❖ Issuing on exchange imports E.g.: ISO
   - ❖ Dumping
   - ❖ Issuing certificates for imports & exports
   - ❖ Trade agreements
   - ❖ Issue standards for production
   - ❖ Quote
   - ❖ Economical unions / regional unions – NAFTA , SAFTA
   - ❖ Providing subsidies to encourage domestic producer E.g.: Tax free, tax holidays

Terms of Trade

- It measures the number of foreign products that can be imported by exporting one unit of domestic product. Therefore terms of trade depends on relative price of countries export to import.
- It can be defined as the ratio of the price a country receives for the product it exports to the price it pay for the products it imports.

$$\text{Terms of trade} = \frac{\text{Index of exports prices}}{\text{Index of exports prices}} \times 100$$

Balance of payments

It is the record of all economic transitions between the residents at a country and rest of world in a particular period of time

These transaction are made by individuals, firms and government bodies.

Types of transactions recorded in balance of payment

1. Trade of goods
2. Trade of services
3. Net primary income
4. Net secondary income
5. Sale of patents, copyrights, franchises, leases and transferable contracts and goodwill
6. Transfer of ownership of resources
7. Foreign direct investments
8. Portfolio flows
9. Balance of banking flows

Balance of Payment (BOP)

<u>Total Current Account</u>

a) Trade A/C
b) Service A/C
c) Primary Income A/C
d) Secondary Income A/C

<u>Capital and Finance Account</u>

a) Capital /C
b) Finance A/C

01. <u>Current A/C</u>

A. <u>Trade A/C or Goods A/C or Commodity A/C or Trade Balance.</u>

It is the balanced of visible or tangible good export & imports what one country made with other countries in the world

Trade Balance = Commodity Exports – Commodity Import

In Srilanka commodity export income is lower than commodity import expenditure, therefore it creates deficit trade balance and problems of payment.

B. <u>Service A/C</u>

It is the balance of invisible or intangible non-factor service export and import what one country made with other countries in the world.

Service Balance = Service Exports – Service Imports

In Srilanka following activities are included in service A/C

1. Transportation
2. Tourism
3. Communication
4. Computer & IT Service
5. Construction
6. Insurance
7. Other services (education, medicine etc.)
8. Government expenditure (foreign transportation)

C. Primary Income A/C

It is the balance of foreign factory income receipt minus foreign factory income payment what one country made with the other countries in the world.

Primary Income A/C = Foreign factor income receipt – foreign factor income payment

D. Secondary income A/C

The government of the foreign countries or international organization sending not specified donations to Srilankan government as current transfers receipt

AND

Srilankan government sending not specified donations to other foreign governments as current transfer payments.

The importance of secondary income A/C

It supports to decrease the deficit balance of current A/C, since secondary income A/C continuously provides excess balance in the BOP of Srilanka.

Total Current
A/C Balance = Trade account balance + Service account balance +Primary income account balance + Secondary Income account balance

1. Capital A/C

Non – produced non-monetary assets are included in capital account and monetary assets are included in financial account.

The non-produced and non-monetary assets between residents and non-residents are included in capital account as credit and debit.

Examples for non-produced monetary assets are given below:

- License
- Lease agreements
- Brand names
- Buying and selling of goodwill
- Selling a Land to an embassy
- Donations from governments and institutions of foreign countries
- Patents
- Royalties

2. <u>Finance A/C</u>

The last sub account of the balance of payments schedule is the financial account.

The financial account is reported the transactions related to monetary assets and liabilities that take place between residents and non-residents.

It has the following components.

1. Direct investment
2. Asset listed investments
3. Other investments and debts
4. Reserve asset
5. Short term and long term government loans
6. Receipts of privatizations

❖ Overall Balance = Current A/C + Capital A/C + Finance A/C + Errors and Omissions

Foreign exchange market and foreign exchange rate

Foreign exchange market

This is the market in which the countries legally exchange currency.

<u>The reasons why currencies are traded:</u>

Demand for srilanka rupees come from

1. Foreigners willing to buy srilankan goods
2. Foreign based srilankan firms sending back profit to srilanka

3. Foreign banks paying interest on money held by srilankan residents
4. Foreign banks paying dividend on shares held by srilankan residents
5. Srilankan working abroad sending back to their relatives

Supply of srilankan rupees come from

1. individuals willing to buy foreign goods
2. multinational companies based in srilankan sending profit home
3. srilankan banks paying interest on money held by foreign people
4. srilankan banks paying dividend on shares held by foreign people
5. foreigners working in srilanka sending home to their relatives

Foreign exchange rate

The rate at which one country's currency is exchanged with another country's currency

The foreign exchange rate can be measured in the two following methods.

1. Direct method – 1USD = 200 LKR
2. Indirect method – 1 LKR = 0.02USD

Nominal exchange rate

The rate at which one country's currency is exchanged with another country's currency

This is the formal authorized exchanged rate

It is the nominal and not adjusted for inflation among the countries

Real exchange rate

This is the rate which is adjusted for the inflation rates of two countries according to their general price level changes.

$$\textbf{Real exchange rate} = \textbf{Nominal exchange rate} \times \frac{\textbf{Domestic price level}}{\textbf{Foreign price level}}$$

The methods to determine foreign exchange rate

1. <u>Floating exchange rate</u>

It is the model that determines that value of the currency by the foreign exchange market through the supply and demand for the particular currency related to another currency

Here exchange rate will be floating according to the changes in the foreign currency demand and supply

Because of this it's known as equilibrium exchange rate.

2. <u>Fixed exchange rate</u>

It is the exchange rate that is determined by the monetary officers based on the main foreign currency unit or by the gold value and maintaining until it is changing.

This was used in Srilanka until 1977.

3. <u>Managed floating exchange rate</u>

This rate is determined by the monetary officers who decide the foreign exchange rate for its domestic currency and allow them to fluctuate within the given limit

Meanwhile if the exchange rate tends to exceed from the given range limit then the monetary officers intervene in the market

This is the rate currently in use