International Trade

Mr. Murugiah Greshan

JMC Jayasekera Management Centre (Pvt) Ltd
Pioneers in Professional Education
65/2A, Chittampalam Gardiner Mawatha, Colombo 02 | T: +94 112 430451 | E: info@jmc.lk | F: +94 115 377917

Why International Trade?

Countries cannot live in isolation. A country requires a market for its goods. Markets are available locally as well as internationally. Selling of a country's goods and services to other countries is known as “exports" and buying goods and services from other countries is known as “imports". Countries mutually share their resources, technical know-how and undertake trade in order to sell their surplus products. Therefore, the world economy is inter-dependent and economic progress of a nation would depend upon its relationship with other countries.

Countries maintain trade relations with each other. The exchange of goods and services between countries is known as international trade. There are numerous reasons that countries engage in international trade.

Some countries are lacking in critical raw materials, such as oil or wood. In order to overcome the problems that countries face due to the lack of resources, countries must engage in international trade to obtain the resources necessary to produce the goods and services desired by their citizens.

Each country has its own specialties that are based on its economy and the skills of its citizens. It is generally accepted in economics that there are two main production techniques according to the use of factors for the production, namely capital intensive and labor intensive.

- Capital-intensive products, such as cars and trucks, heavy construction equipment, and industrial machinery, are produced by nations that have a highly developed industrial base. Japan is an example of a highly developed industrial nation that produces larger quantities of high-quality cars for export around the world. Another reason Japan has adapted to producing capital-intensive products is that it is an island nation; there is little land available for land-intensive product production.

- Labor-intensive commodities, such as clothing, shoes, or other consumer goods, are produced in countries that have relatively low labor costs and relatively modern production facilities. China, Indonesia, and the Philippines are examples of countries that produce many labor-intensive products.

However, the distribution of resources, technology and specific products across counties change over time, and thus the goods and services that nation produces and exports will change. The United States, for example, was the dominant world manufacturer from the end of World War II until the early 1970s. But, beginning in the 1970s, other countries started to produce finished products more cheaply and efficiently than the United States. As a result of that U.S. manufacturing output and export experienced significant drop. However, rapid growth in computer technology began to provide a major export for the United States. Practically speaking, the United States has been slowly transformed from a manufacturing - based economy into a new information Age-based economy that relies on exporting cutting-edge technology.

JMC vLearning "your virtual learning partner"

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

1 Basic concepts of International Trade

1.1 Absolute Advantage

Adam Smith stated that all the countries can get benefits from international trade. He pointed out that productivity and the level of production are increased due to the division of labor and specialization, and as a result the production will also be increased. He further highlighted that two countries that engage in trade can gain a higher production and consumption levels simultaneously.

The idea presented by Adam Smith as the basis of international trade is known as the "absolute advantage". Absolute advantage is defined as the ability of a country to produce a good or service at a lower cost per unit than the cost at which any other country produces that good or service. A country has an absolute advantage over another in producing a good, if it can produce that good using fewer resources than another country.

For example, suppose the outputs that two countries can obtain from two products by using a similar quantity of a given input are given in the following table.

Country	Clothes (meters)	Wheat flour (Kgs)
USA	50	10
Canada	10	40

According to the above using a given level of labor, USA can produce 50 meters of clothes or 10 kilograms of wheat flour, while Canada can produce 10 meters of clothes or 40 kilograms of wheat flour. Then USA has an absolute advantage in producing clothes and Canada has an absolute advantage in producing wheat flour. USA can get more wheat flour with its labor by specializing in clothes and trading the clothes for Canada wheat flour, while Canada can benefit by trading wheat flour for clothes.

2. Comparative Advantage

David Ricardo, a British economist pointed out that even if one country has the absolute advantage in producing all the goods, all the countries can get the benefits from international trade by using the concept call comparative advantage. The principle of comparative advantage explains how it can be beneficial for two countries to trade if one has lower relative cost of producing some good.

Comparative advantage is a situation in which a country can produce a good at a lower opportunity cost than that of another country. This is an important concept in understanding specialization, through which all countries actually benefits from

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

Country	The opportunity cost of producing 1 kilogram of wheat flour	The opportunity cost of producing 1 meter of clothes
USA	0.5 meters of clothes	2.0 kilograms of wheat flour
Canada	2.0 meters of clothes	0.5 kilograms of wheat flour

Exchanging the products they make best, even if each is capable of supplying all its own needs.

Accordingly, what matters is not the absolute cost of production but the opportunity cost, which measures how much production of one good, is reduced to produce one more unit of the other good. Comparative advantage is a key economic concept in the study of free trade.

Suppose for example that USA is more efficient in producing both wheat flour and clothes than Canada. The daily production per one labor unit for the respective goods is given in the following table.

Country	Wheat flour (Kgs)	Clothes (meters)
USA	6	3
Canada	1	2

As per above table, USA has the absolute advantage in producing both products. Since Canada does not have absolute advantage in producing any product, one can argue that Canada cannot obtain any benefits from international trade by using specialization. But, that is not correct.

Even if there is no absolute advantage, any country can get the benefit from specialization, if there is comparative advantage. In order to identify whether a country has comparative advantage in producing a certain product, it is necessary to calculate the opportunity cost of producing respective products. Opportunity cost measures that number of units that should be sacrificed from one product, in order to produce one unit from the other product.

$$\text{The opportunity cost of producing 1 kilogram of wheat flour} = \frac{\text{No of meters sacrificed from clothes}}{\text{No of kilograms produced from wheat flour}}$$

$$\text{The opportunity cost of producing 1 meter of clothes} = \frac{\text{No of kilograms sacrificed from wheat flour}}{\text{No of meters produced from clothes}}$$

Accordingly, the opportunity cost of producing the above products for the two countries is given in the following table.

As per the above table, USA has the comparative advantage in producing wheat flour since the opportunity cost of producing that product is lower for USA than that for Canada. On

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

the other hand Canada has the comparative advantage in producing clothes since the opportunity cost of producing that product is lower for Canada than that for USA.

1.3 Terms of Trade

The advantages of international trade to a country can be basically determined by using "Terms of Trade". It measures the number of foreign products that can be imported by exporting a unit of domestic product. Therefore terms of trade depends on the relative prices of a country's export to import. An improvement in a nation's terms of trade (the increase of the ratio) is good for that country in the sense that it has to pay less for the products it imports, which means that it has to give up fewer exports for the imports it receives.

In the simplified case of two countries and two commodities, terms of trade is defined as the ratio of the price a country receives for the product it exports to the price it pays for the product it imports. In this simple case the imports of one country are the exports of the other country.

For example, if a country exports a product with a value of 50 dollars in exchange for a imported product which worth 100 dollars, that country's terms of trade are 50/100 = 0.5. The terms of trade for the other country must be reciprocal (100/50 = 2). When this number is falling, the country is said to have "deteriorating terms of trade". If multiplied by 100, these calculations can be expressed as a percentage.

However, since the international trade of country involves a large number of countries and products, export and import prices indexes are used to calculate the terms of trade.

$$\text{Terms of trade} = \frac{\text{Index of Export Prices}}{\text{Index of Import Prices}} \times 100$$

1.4 Balance of Payment

Balance of Payment (BOP) statement is record of all transactions made between particular country and all other countries during a specified period of time. BOP compares the difference of the amount of exports and imports, including all financial exports and imports. A negative balance of payments indicates that more money is flowing out of the country than coming in and vice versa.

In economic terms, a balance of payments surplus means a nation has more funds from trade and investments coming in than it pays out to other countries. As a result of that there will be an appreciation in the value of its national currency versus currencies of other nation. On the other hand, a deficit in the balance of payments has the opposite effect: an excess of imports over exports, a dependence on foreign inventors, and depreciation of local currency.

Balance of Payment Identity

The Balance of Payment is the sum of the Current Account and the Capital Account (also referred to as the Financial Account). The Balance of Payment identity states that:

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

Current Account + Capital Account = Change in official Reserve Account

A country will have a negative balance of payments (a net decrease in official reserves) if the net of the current account and the capital account is a deficit. Similarly, there will be a positive balance of payments (a net increase in official reserves) if the net of the current and the capital account results in a surplus. The basic principle behind the identity is that a country can only consume more than it produces (a current account deficit) if it borrows from abroad (a capital account surplus, where 'borrowing includes all forms of investment from abroad).

Current Account

The current account is the sum of net sales from trade in goods and services, net factor income from abroad, and net unilateral transfer from abroad. Accordingly, current account includes four sub accounts.

- Trade account
- Services account
- Income account
- Current transfers

Positive net sales to abroad correspond to a current account surplus; negative net sales to abroad correspond to a current account deficit. Because exports generate positive net sales, and because the trade balance is typically the largest component of the current account, a current account surplus is usually associated with positive net exports. Domestic currency depreciation makes domestic goods relatively cheaper, increasing exports relative to imports. A decrease in domestic GDP reduces domestic demand for foreign goods lowering imports without affecting exports. An increase in foreign GDP increases foreign demand for domestic goods, increasing exports without affecting imports.

Current account =

- Trade Balance
  - Net Exports (Exports – Imports) of Merchandise (tangible goods)
- Services account Balance

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

- Net Exports (Exports – Imports) of services (such as legal and consulting services)

- + Net Factor Income From Abroad (such as interest and dividends)
- + Net unilateral Transfers from Abroad (such as foreign aid, grants, gifts, etc.)

Capital (Financial) Account

The capital account (also known as the financial account) is one the second part of the BOP. While the current account shows a country's net income, the capital account reflects net change in ownership of national assets.

capital account = Change in foreign ownership of domestic assets
= Change in domestic ownership of foreign assets

If the increase in foreign ownership of domestic assets is greater than the increase in domestic ownership of foreign assets in a given year, then the domestic country has a capital account surplus. On the other hand, if the increase in domestic ownership of foreign assets is higher than the increase in foreign ownership of domestic assets, then the domestic country has a capital account deficit.

The accounting entries in the capital account record the purchase and sale of domestic and foreign assets. These assets are divided into categories such as Foreign Direct Investment (FDI), Portfolio Investment (which includes trade in stocks and bonds), and Other Investment (which includes transactions in currency and bank deposits).

Capital account = Foreign Direct Investment + Portfolio Investment + Other Investment

Official reserves

The official reserves account records the current stock of reserve assets (and also referred to as foreign exchange reserves) available to a country and it is controlled by the Country's monetary authority (generally the Central Bank) for financing of international payment imbalances, foreign exchange intervention and other uses. Official Reserves include official gold reserves, foreign exchange reserves, and IMF Special Drawing Rights (SDRs), all denominated in foreign currency. Change in the official reveres in a given year is equal to the differences between the capital account and current account of that year.

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

Question

Explain the meaning of comparative advantage

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

ANSWER

The ability of a country to produce a product at a lower opportunity cost than another country is known as comparative advantage. The theory of comparative advantage suggests that countries will tend to specialize in the production of those commodities in which they have greatest comparative advantage. Any surplus after home requirements have been met will be used to trade with other countries.

2. Tariff and Non-tariff barriers to trade

2.1 Protectionism

While international trade has helped to influence on the growth of the world economy throughout history, almost all countries take steps to control imports from other countries. This is known as "protectionism".

Accordingly, protectionism is the economic policy of protecting domestic industries against foreign competition. Countries use tariff as well as non-tariff barriers to international trade such as tariffs on imported goods, restrictive quotas, and a variety of restrictive government regulations designed to discourage imports, and anti-dumping laws. These measures are implemented in an attempt to protect domestic industries in a particular country from foreign competition.

Government-levied tariff which is the main measure used for protectionism, raise the price of imported goods, making them less attractive to consumers than cheaper domestic products. Import quotas, which limit the quantities of goods that can be imported, are another protectionist device.

2.2 Advantages of Protectionism

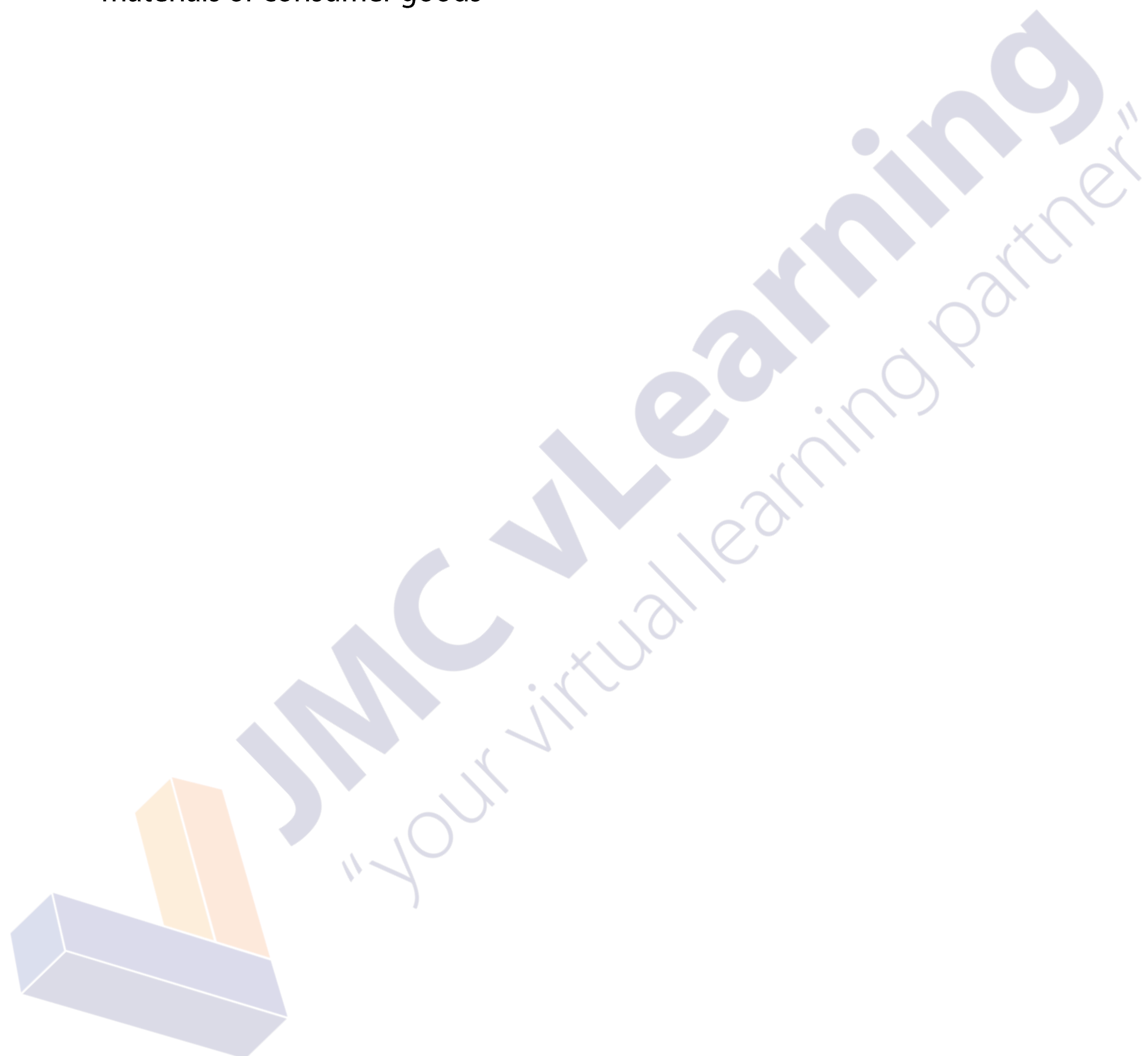
- Protects domestic producers from extra competition foreign countries
- Helps new business (infant industries) of the economy to develop before they face competition
- Helps protect an economy's jobs
- Prevents foreign countries 'dumping' lots of cheap imports into the economy
- Prevents imports of harmful goods
- Reducing imports improves the balance of payment position

2.3 Disadvantages of Protectionism

- Prevents countries enjoying the full benefits of international specialization and trade
- Invites retaliation from foreign governments. If an economy puts up trade barriers then other countries are likely to retaliate.
- Protects inefficient home industries from foreign competition and as a result, consumers pay more for inferior products

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

- Protectionism keeps the firms of an economy away from genuine competition. They may become lazy and inefficient
- Free trade forces local firms to produce quality goods and services as they face much foreign competition
- Free trade encourages firms to export and import. This should encourage a greater choice for consumers and a higher standard of living
- Trade barriers increase the cost of trading. For example, a tariff would mean that firms and consumers of the economy may have to pay more for imports of raw materials or consumer goods



© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

Question

What is an 'import Tariff'? An 'Import Quota'? What are some other forms of import restrictions?

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

ANSWER

An import tariff is a tax on imports. This may be imposed to raise revenues (on commodities not produced in an economy) or for protection. An import quota is a restriction imposed by the government on the quantity of a good that may be imported.
There are other restrictions on imports such as health regulations, safety and pollution standards, labeling and packaging standards etc. These are often disguised methods of protection.

3. Exchange rate and its impact on business

The rate at which one currency can be exchanged for another currency is known as the exchange rate. Accordingly, exchange rate is the price of one country's currency expressed in another country's currency. The exchange rate (also known as the foreign- exchange rate, forex rate or FX rate) between two currencies specifies how much one currency is worth in terms of the other.
Exchange rate may be fixed or flexible. An exchange rate is fixed when two countries agree to maintain a fixed rate through the use of monetary policy. An exchange rate is flexible, or "floating," when countries agree to allow international market forces to determine the rate through supply and demand. The rate will fluctuate with a country's exports and imports. Most countries currently use flexible exchange rates that fluctuate within relatively fixed limits.
The spot exchange rate refers to the current exchange rate. The forward exchange rate refers to an exchange rate that is quoted and traded today but for delivery and payment on a specific future date.

3.1 Floating Exchange Rate

Floating exchange rate system is the model that determines the value of a currency by the foreign-exchange market through supply and demand for that particular currency relative to other currencies.
Floating exchange rate system is further categorized into two systems called "clean float" and "dirty float". Clean Float is the system without official (central bank) intervention, except to maintain market stability, and its exchange rate is mostly determined by market forces. On the other hand, Dirty Float involves a varying amount of official interventions to overcome adverse fluctuations and to keep a country's currency within a desired level.

3.2 Fixed Exchange Rate

According to this system, the government or central bank ties the official exchange rate to another country's currency. The purpose of a fixed exchange rate system is to maintain a country's currency value within a very narrow band. Sometimes this is also known as pegged exchange rate.
Accordingly, a currency's value is matched to the value of another single currency or to a basket of other currencies, or to another measure of value, such as gold.

JMC vLearning "your virtual learning partner"

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

Many economists think that in most circumstances, floating exchange rates are preferable to fixed exchange rates because floating rates are responsive to the foreign exchange market. In addition, fixed exchange rate system does not allow governments to use domestic monetary policy independently to achieve internal stability. However, in certain situations, fixed exchange rates may be preferable for their greater stability.

4. Expansion of businesses through international trade

Expansion of businesses to overseas markets certainly has benefits and costs, and especially it may not be easy for small businesses and new companies. But it is possible for small businesses and large corporations to get the benefits of expanding operations internationally and there are varying reasons companies choose to engage in international trade.
However, it is very important for a company to study the overseas market very thoroughly before making a decision and that includes measuring and comparing the risks and benefits. In most countries of the world, international trade represents a significant percentage of gross domestic production.

4.1 Advantage of international trade

- Increase production. Free trade permits countries to specialize in the production of those commodities in which they have a comparative advantage. With specialization, countries are able to take advantage of efficiencies generated from economies of scale and increased output.
- A country may import things which it cannot produce. International trade enables a country to consume things which either cannot be produced within its borders or production may cost very high. Therefore it becomes cost cheaper to import from other countries through foreign trade.
- Maximum utilization of resources. International trade helps a country to utilize its resources to the maximum limit. If a country does not take up imports and exports then some of its resources may not be utilized. Thus it helps to eliminate the wastage of resources.
- Benefit to consumers. Imports and exports of different countries provide opportunities to the consumer to buy and consume those goods which cannot be produced in their own country. Therefore they get diversity in choices.
- Reduces trade fluctuations. By making the size of the market large, with large supplies and extensive demand, international trade reduces trade fluctuations. The prices of goods tend to remain more stable.
- Utilization of surplus production. International trade enables different countries to sell their surplus products to other countries and earn foreign exchange.
- Promotes International relationships. International trade fosters peace, goodwill and mutual understanding among nations. Economic interdependence of countries often leads to close cultural relationship and thus avoid war between them.

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd

4.2 Disadvantage of international trade

- Import of harmful goods. Foreign trade may lead to import harmful goods like cigarettes, drugs etc. which may affect the health of the residents of the country.
- It may exhaust resources. International trade leads to intensive cultivation of land. Thus it has the operations of law of diminishing returns in agricultural countries.
- Over specialization. Over specialization may be very risky for a country.
- A country might depend for its food mainly on foreign countries. In times of war there is a serious danger of not having essential food items for such countries.
- One country may gain at the expensive of another.
- Foreign trade may lead to problems among countries which compete with each other in finding new markets and sources of raw material for their industries.

JMC vLearning
"your virtual learning partner"

© 2020 JMC Jayasekera Management Centre (Pvt) Ltd