Industrial Economics and Foreign Trade

Module 5

International Trade

International trade or foreign trade means trade between countries. In other words, it is the exchange of goods or services between two or more countries. The branch of economics which deal with foreign trade is International Economics.

Advantages and disadvantages of foreign trade

1. **Optimal use of natural resources:**

2. Availability of all types of goods:

3. Specialisation:

4. Advantages of large-scale production:

5. Stability in prices:

6: Establishment of new industries:

7. Increase in efficiency:

8. Development of the means of transport and communication:

9. International co-operation and understanding:

10. Discouragement to Monopolies:

11. Better Employment Opportunities:

Disadvantages

1. **A threat to domestic industries**:

2. Economic dependence:

3. Misuse of natural resources :

4. Import of harmful goods:.

6. **Evil Effects of Dumping:**

7 **Against national Defence:**

Theories of International Trade

Absolute Advantage Theory

According to Adam Smith the basis of international trade is absolute cost advantage. Suppose there are two commodities and two countries which produce these two commodities. The countries will specialise and produce that commodity upon which they have an absolute advantage. They will export this commodity to the other country.

The absolute advantage theory can be explained with the help of an example.

	USA	UK
Number of Units of wheat per unit of labour	10	5
Number units of cloth per unit of Labour	3	8

Comparative Advantage Theory

Comparative cost advantage theory was developed by David Ricardo in 1857. According to Ricardo, even in the case of a country for which there is no absolute advantage for both the commodities, it can gain from international trade. In this situation, the country should specialise in the production and export of the commodity in which its absolute disadvantage is smaller and import the commodity in which its absolute disadvantage is greater.

The Ricardian theory is based on the following assumptions.

1. There are only two countries and two commodities
2. There are no barriers in international trade
3. There is no transport cost
4. Labour is the only component of cost of production

Ricardo in his two commodity, two country model taken cloth and wine as commodities and England and Portugal as two countries.

Country	No. of units of labour Per unit of cloth	No. of units of labour per unit of wine	Exchange ratio
England	100	120	1 wine = 1.2 cloth
Portugal	90	80	1 wine = 0.88 cloth

The Heckscher-Ohlin Theorem or Factor Endowment Theory

The factor endowment theory was originally developed by Eli Heckscher in 1919. Later in 1935 it was refined by his student Bertil Ohlin. Hence the theory is popularly known as Heckscher-Ohlin Theorem. It is a two-country two-commodity model.

The Heckscher-Ohlin theorem tried to explain the causes of comparative cost differences that exist internationally. According to the theorem, the differences in comparative advantage among nations is mainly due to the differences in relative factor abondance or factor endowments.

Heckscher-Ohlin theorem can be stated as follows. A country will produce and export that commodity whose production requires the intensive use of the nation's relatively abundant and cheap factor and import the commodity whose production requires the intense use of relatively scarce and expensive factor.

In the Heckscher-Ohlin theorem factors of production are considered as abundant or scarce in relative terms and not in absolute terms.

Country A	Supply of labour	= 50
	Supply of capital	= 40
	Capital- labour ratio	= 0.8
Country B	Supply of labour	= 16
	Supply of capital	= 20
	Capital-labour ratio	= 1.25

Factor Price Equalisation Theorem

Factor price equalisation theorem is a corollary of Heckscher-Ohlin theorem. It was proved by Paul Samuelson and hence it is called Heckscher-Ohlin-Samuelson theorem.

The theorem state that free international trade will equalise factor prices between countries relatively and absolutely and this serve as a substitute for international factor mobility.

Effects of International Trade

According to Heckscher-Ohlin theorem, international trade has the following effects.

1. Equalisation of factor prices:

2. Equalisation of Commodity prices:

Balance of Payments

Balance of payments is a systematic record of all economic transactions of a nation with the rest of the world for a specific period of time. Usually, time period is taken as one year.

It is obvious that during a period of time millions of transactions take place between one nation and with the rest of the world. Therefore, all these transactions cannot appear individually in the balance of payment statement. As a summary statement, balance of payments aggregates all these transactions under different heads.

Balance of Trade and Balance of Payments

Balance of trade includes only those transactions which are involved in the exporting and importing of visible items (goods). It does not include invisible items such as various kinds of services (shipping, banking, insurance), payment of interest and dividend etc. On the other hand, balance of payments includes both visible and invisible item.

Components of Balance of Payments

Usually, international transactions are classified under the following heads:

1. Current Account 2. Capital Account 3. Unilateral payments Account 4. Official Reserve Account

Current Account

Current account consists of two major items i) merchandise (visible) exports and imports ii) invisible exports and imports.

Capital Account

The capital account includes short term and long-term capital transactions. Capital inflows are coming as credit entries and capital outflows as debit entries.

The following are the two major items coming under capital account.

1.Loans and borrowings – It includes all types of loans from both the private and public sectors located in foreign countries.

2. Investments – These are funds invested in the corporate stocks by non-residents.

Unilateral Transfers Account

Unilateral Transfer means the one-way transfer of an item from one person to another.

The official reserve account

. It is the foreign currency and securities held by the government, usually by its central bank, and is used to balance the payments from year to year.

Balance of Payments Disequilibrium – Deficit

Economic Factors

The following are the important economic factors which lead to balance of payment disequilibrium.

i) **Development disequilibrium**:

ii) **Cyclical Disequilibrium:**

iii) **Secular Disequilibrium:**

Political Factors

Social factors

Correction of Disequilibrium or Deficit

1. **Automatic Correction:**
2. **2. Deliberate Measures:** The three deliberate measures are a) Monetary measures b) trade measures and c) Miscellaneous measures

Monetary measures The important monetary measures are

i) Monetary contraction or expansion:

ii) Devaluation:

iii) Exchange control:

Trade Measures

i) Export promotion:

ii) Import control:

Miscellaneous Measures

Devaluation

Devaluation means a deliberate reduction of the value of the domestic currency in terms of foreign currencies. A country which faces a serious problem of deficit in the balance of payments may resort to devaluation. This will stimulate their export and discourage import.

Limitations of Devaluation

1.The success of devaluation depends on reactions of other countries. If they retaliate by devaluing their currencies, devaluation will not be successful.

2. If prices in the domestic country increases at the same rate or at a higher rate of devaluation, it will not will not increase export or decrease import.

3. The success of devaluation also depends on the elasticities of demand for export and import.

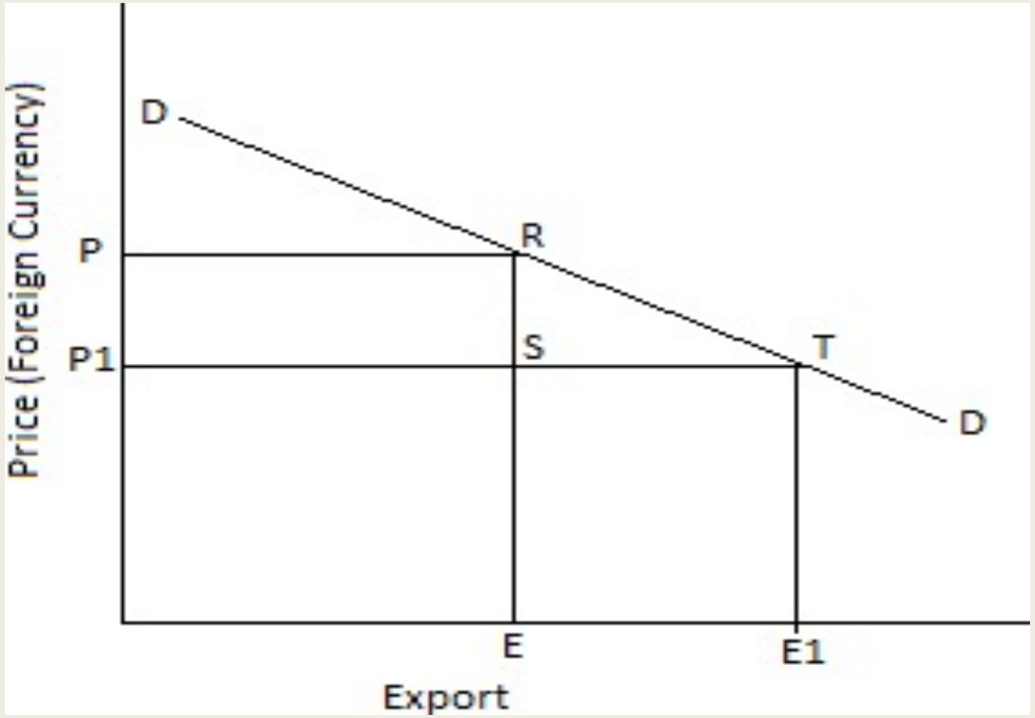
4.In spite of an increase in the demand for a country's export due to devaluation, the extent of increase in exports depends on the exportable surplus or the quantity available for export.

Devaluation and Elasticities of Demand for Exports and Imports

The success of devaluation depends on the elasticities of demand for exports and imports.

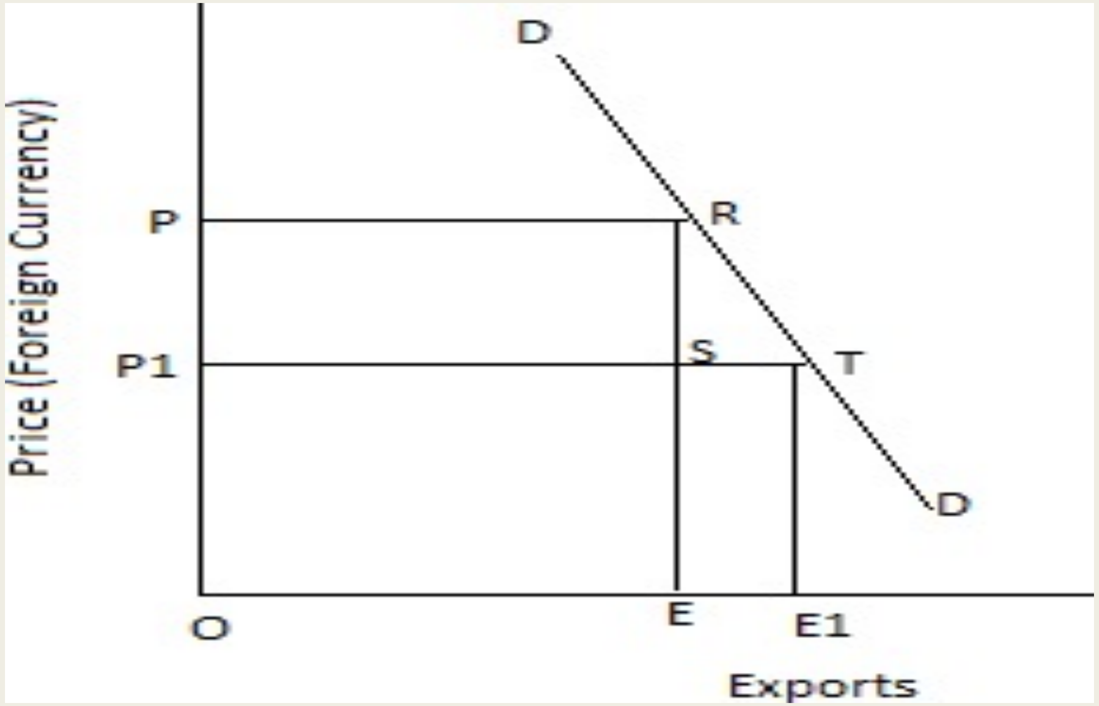
Devaluation and Exports

1. **More elastic demand:** When demand for exports is more elastic, a fall in price of exports in terms of foreign currency increases the export earnings and there will be a favourable effect on balance of payments.



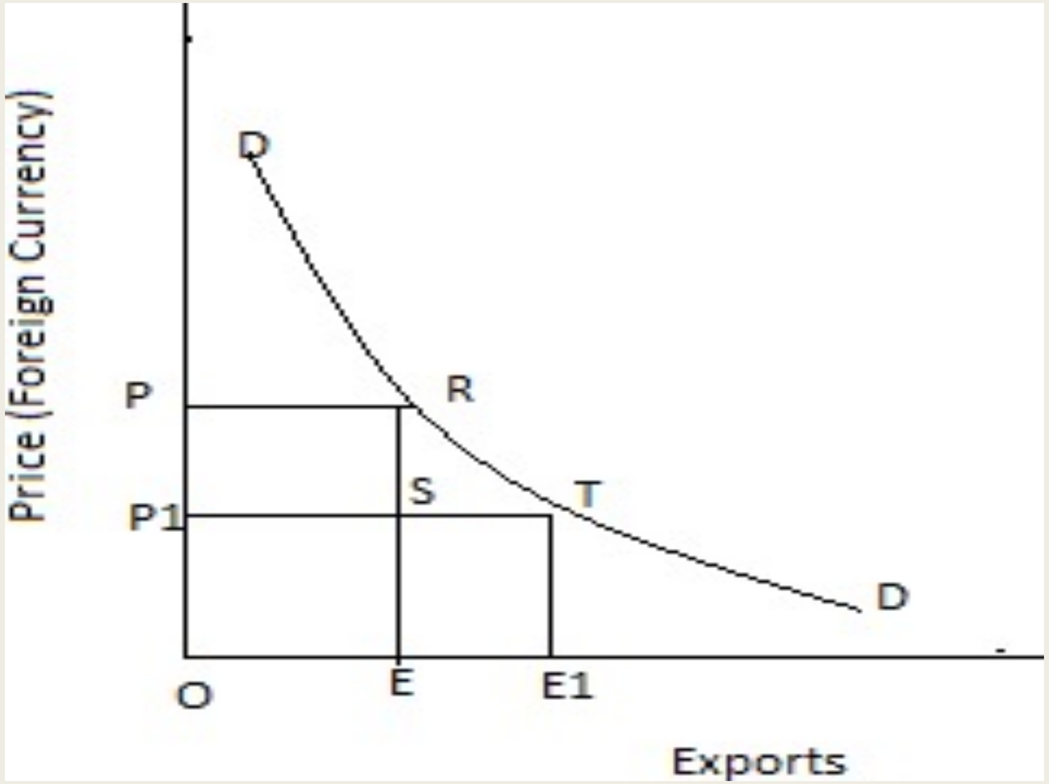
Less Elastic Demand

When price elasticity of demand is less than one, there will be a decrease in export earnings due to devaluation.



Unit elastic demand

When Demand for exports is unit elastic, devaluation will have no effect on the export earnings



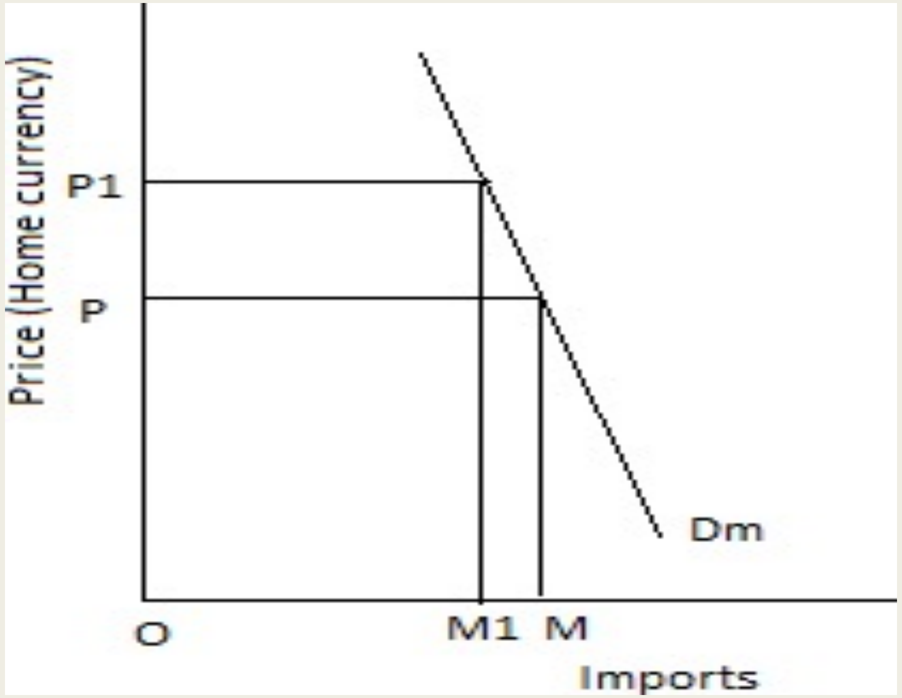
Devaluation and Imports

Devaluation increases the price of the imports in terms of home currency

Zero elasticity

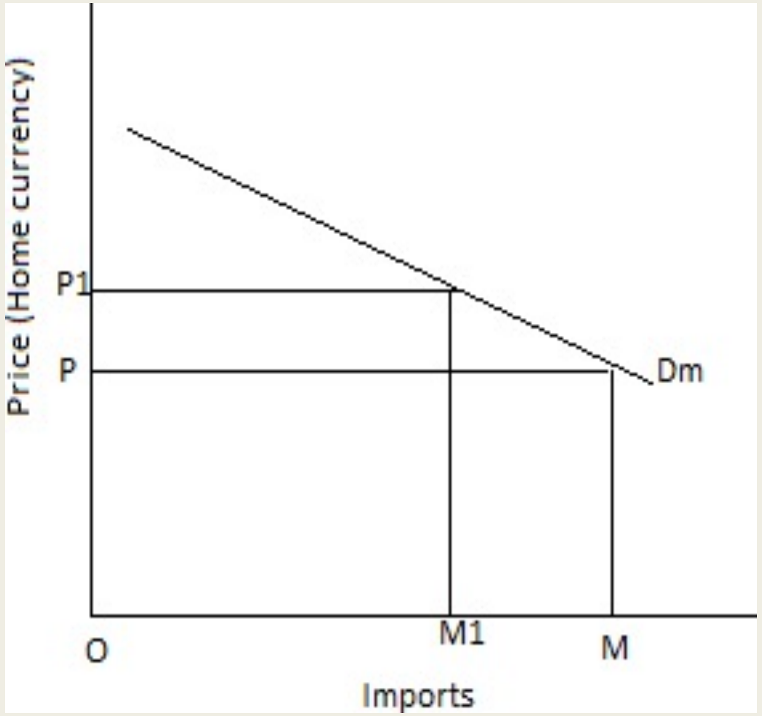
Less elastic demand

When the value of elasticity of demand is greater than zero but less than one, there will be a decline in imports due to an increase in the price of imports. But it will not be substantial



More elastic demand

When demand for imports is more elastic, an increase in price causes a substantial decrease in the volume of imports and hence it has larger impact on import bill as well as balance of payments.



Marshall-Lerner Condition

The Marshall-Lerner condition states that devaluation will improve the balance of payments of a country if the sum of elasticities of demand for a country' exports and its demand for imports is greater than one. In other words

$ex + em > 1$ where ex is the elasticity of export and em is the elasticity of import.

- If $ex + em > 1$, devaluation will improve current balance of payments position
- If $ex + em < 1$, Devaluation will deteriorate balance of payments
- If $ex + em = 1$, devaluation will have no effect on balance of payments

Devaluation – the J-curve effect

The J-curve shows the time path of trade flows after devaluation. It says that, devaluation will lead to an initial deterioration of the trade balance and this will be followed by a subsequent improvement.

Free Trade Versus Protection

Free trade is a trade policy that does not restrict imports or exports. In other words, it refers to the trade that is free from all artificial barriers to trade like, tariffs, quota restrictions, exchange control etc. In the case of free trade the free market idea is applied to international trade. Protection on the other hand is the policy of protecting domestic industries against foreign competition by means of tariffs, subsidies, import quotas etc. It affects mainly the imports of a country.

Arguments for Free Trade

The following are the important arguments in favour of free trade

1. **Better utilisation of resources:**
2. **Division of labour and specialisation:**

3. Efficiency:

4. Dampen monopoly practices

5. Wide variety of goods:

6. Avoid corruption and red-tapism:

7. Economic growth:

Arguments Against Free Trade

1. **Threat to domestic industries**:

2. Harmful commodities:

3. The Unfair-Competition Argument:

4. Job outsourcing leads to unemployment:

5. Degradation of environment

6. Poor Working Conditions:

Arguments in Favour of Protection

1. **Infant industry argument:**

2. Strategic and Key industry argument: **3. National Defence:**

4. Diversification **5. Improving balance of payments:**

6. Anti-Dumping: **7. Employment argument:** **8. Keeping money at Home**

Arguments Against Protection

1.Protection is against the interest of the consumers as it increases the price of the imported products. Further, consumers are denied the opportunity for enjoying variety goods.

2. It discourages competition and hence compromises efficiency.

3. It encourages the growth of domestic monopolies because of the weakening of foreign competition.

4. Protection discourages innovations and cost reduction.

5. It leads to uneconomic utilisation of world's resources.

6.Protection may lead to trade wars and international conflicts among trading nations. When one country takes protective measures, others may retaliate.

Trade Barriers

Trade barriers refer to the government policies and measures which restrict the free flow of goods between the countries. Broadly, trade barriers are divided into two groups. They are tariff barriers and non-tariff barriers.

Tariff Barriers

Tariff barriers are duties or taxes imposed by the government of a country on its imports or exports.

On the basis of origin and destination of goods, tariffs can be classified in to the following three categories.

i) Export duties: ii) Import duties: iii) Transit duty:

Based on the purpose they serve, tariffs can be classified as

i) Revenue tariff: ii) Protective tariff: iii) Countervailing and Anti-Dumping tariffs:

Effects of Tariff

The following are the effects of tariff on the economy.

i) Protective effect:.

ii) Revenue effect:

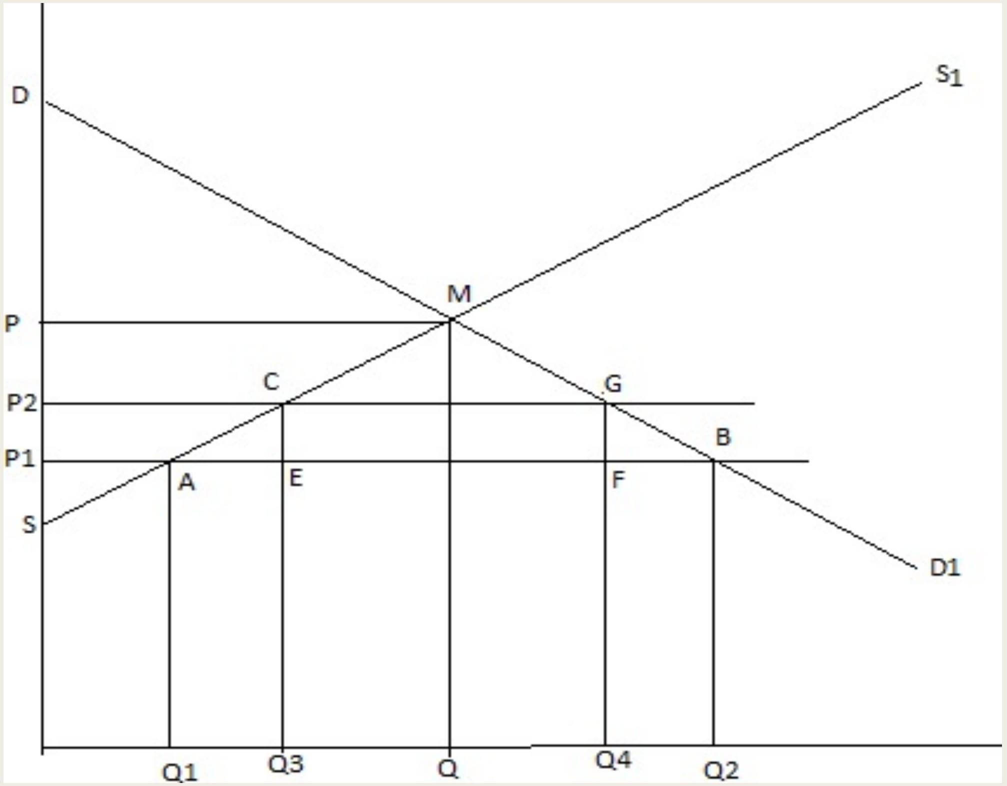
iii) Income and employment:

iv) Balance of payments effect:

v) Consumption effect:

vi) Competitive effect:

vii) Redistribution effect:



Non-Tariff Barriers (NTBs)

1.Voluntary Export Restraints: A voluntary export restraint (VER) is a trade restriction on the quantity of a good that an exporting country is allowed to export to another country.

2. Administered Protection: Administered protection encompasses a wide range of bureaucratic government actions. The important measures under administered protection include

a) **Safeguards:** A safeguard is a temporary import restriction that a country is allowed to impose on a product if imports of that product are increasing

b) **b) Health and product standards:** The developed countries fix certain health and product standards which hinder the exports of developing countries because of added cost or technical requirements.

c) Customs Procedures: Customs procedures of many countries act as a trade barrier

d) Licensing: Many countries use licensing as a measure to restrict trade, especially imports.

e)Monetary controls: Monetary controls are also employed to regulate imports. For example, RBI in 1990s took several measures which include a 25 percent interest rate surcharge on bank credit for imports.

f) Environmental protection laws: Many countries framed environment protection laws to restrict imports.

g)Foreign Exchange Regulations: In some countries, the State monopolise foreign exchange and hesitate to release foreign exchange for imports.

Quantitative Restrictions or Quotas

A quota represents a ceiling or limit on the volume of exports or imports. The following are the important types of import quotas.

1.The tariff or custom quota: Under this system, import of a commodity up to a specified quantity is allowed to be imported duty-free or at a special low rate of duty. But imports in excess of this fixed limit are charged a higher rate of duty. The tariff quota thus combines the features of a tariff with those of quota.

2.The Unilateral Quota: Under this system, a country places an absolute limit on the import of a commodity during a given period. It is imposed without prior negotiation with foreign governments.

3.The Bilateral Quota: Under this system, quotas are set through negotiation between the importing country and the exporting country.

4.The Mixing Quota: It is a type of regulation which requires producers to utilise a certain proportion of domestic raw materials along with imported parts to produce finished goods domestically. It thus sets limits on the proportion of foreign-made raw materials to be imported and used in domestic production.

5.Import Licensing: Under this, prospective importers are required to obtain a licence from the proper authorities for importing any quantity within the specified quotas.

Effects of quotas

The following are the important economic effects of quotas

1. **Price effect:**

2. Consumption effect:

3. Balance of payments effect:

4. Protective effects:

5. Revenue effect:

6. Redistributive effect: