INTERNATIONAL TRADE

Definition: It is the exchange of goods and services between one country and another. International Trade can be in goods, termed visibles or in services, termed invisibles e.g. trade in services such as tourism, shipping and insurance.

Reasons for the Development of International Trade

a. Some goods **cannot be produced** by the country at all. The country may simply not possess the raw materials that it requires; thus it has to buy them from other countries. The same would apply to many foodstuffs, where a different climate prevents their cultivation.

b. Some goods cannot be produced as **efficiently** as elsewhere. In many cases, a country could produce a particular good, but it would be much less efficient at it than another country.

c. It may be better for the country to give up the production of a good (and import it instead) in order to specialize in something else. This is in line with the **principle of comparative advantage.**

d. In a free market economy, a consumer is free to choose which goods to buy. A foreign good may be more to his or her liking. This is in line with the **principle of competitive forces** and the exercise **of choice.**

e. Shortages: At a time of high domestic demand for a particular good, production may not meet this demand. In such a situation, imports tend to be bought to overcome the shortage.

Gains From International Trade

The gains from International trade are to make the participating countries better of than they would have otherwise been. This will be the result of a number of advantages which a country can derive from international trade, namely:

The vent-for-“surplus” product

Many countries have products which are surplus to their own requirements and it is only by exporting these that they have value at all. Thus, the plantations of coffee in Kenya are only of value because of the existence of international trade. Without it, the coffee would mainly be unused and remain unpicked.

Many of the primary products that are exported would be of no use to the country. Without trade, the land and the labour used for their production would be idle. Trade therefore gives the country the opportunity to sell these products and to make use of the available land and labour.

Importation of what cannot be produced

A country has to import what it cannot produce. Certain countries like Japan and Britain could not manufacture goods without the importation of most of the raw materials. There is thus necessity for international trade in respect of these essential materials.

Specialization according to absolute advantage

International trade allows a country to specialize in the production of commodities where it more efficient than other countries. For instance, if we take a situation in which each country in a simple two country model has an absolute advantage in producing either fruits or beef but is able to produce the other commodity only if required (for simplicity we assume constant returns to scale and full utilization of resources).

Specialization according to comparative advantage

Even if one country can produce the two goods more efficiently at a lower comparative cost than the other country, there could be gains to be made from International Trade. This possibility is explained by the theory of comparative advantage.

Competition

Trade stimulates competition. If foreign goods are coming into a country, this puts home producers on their toes and will force them to become more efficient.

Introduction of new ideas

International trade can introduce new ideas into a participating country; it can stimulate entrepreneurship and generate social change. This is especially the case in developing countries where the development of expert industries can lead to the emergence of a commercial class desirous of change and opposed to any practice that hold back economic advancement.
Technological advances can also be introduced into a country as companies start to base their production in overseas countries.

Widening of choice to the consumer

It is undoubtedly a great benefit to be able to buy a wide range of goods that would not otherwise be available. International trade offers to the consumer a wider choice. This greater availability of goods may indeed prove to be of economic advantage. For in a country, producers may only be prepared to take risks and invest their time and money in a business if they can spend the resultant income on consumer goods. These may be imported, especially if the country lacks consumer goods industries – as in may developing countries. Thus, these imports of consumer goods provide the incentive for productive effort within the country.

Creation and maintenance of employmen

Once a pattern of international trade has developed, and countries specialize in the production of certain goods for export, it follows not only has that trade created employment in those sectors, but that the maintenance of that trade is necessary to preserve that employment. In the modern world with its high degree of interdependence, a vast number of jobs depend upon international trade.

Restrictions on International Trade

Despite the arguments of the “classical” theory of free trade, the twentieth century has seen the gradual movement away from free trade, with governments increasingly imposing restrictions on trade and capital flows. All have adopted, to varying extents, various forms of restrictions to protect some of their industries or agriculture.

Reasons for Protection

Cheap Labour

It is often argued that the economy must be protected from imports which are produced with cheap, or „sweated", labour. Some people argue that buying foreign imports from low wage countries amounts not only to unfair competition, but continues to encourage the exploitation of cheap labour in those countries as well as undermining the standard of living of those in high wage economies.

Infant Industry Argument

Advocates of this maintain that if an industry is just developing, with a good chance of success once it is established and reaping economies of sale, then is it necessary to protect it from competition temporarily until it reaches levels of producdton and cost which allow it to compete with established industries elsewhere, until it can "stand on its own feet". The argument is most commonly used to justify the high level of protection that surrounds the manufacturing industry in developing countries, as they attempt to replace foreign goods with those made in their own country ("import substitution").

Structural Unemployment

The decline of the highly localized industry due to international trade causes great problems of regional (structural) unemployment. If it would take a long time to re-locate the labour to other jobs, then this can put the government, under considerable political and humanitarian pressure, to restrict the imports that are causing the industry to decline.

Dumping

If goods are sold on a foreign market below their cost of production this is referred to as dumping. This may be undertaken either by a foreign monopolist, using high profits at home to subsidize exports for political or strategic reasons. Countries in which such products are "dumped" feel justified in protecting themselves. This is because dumping could result in the elimination of the home industry, and the country then becomes dependent on foreign goods which are not as cheap as they had appeared.

Balance of Payments

Perhaps the most immediate reason for bringing in protection is a balance of payment deficit. If a country had a persistent deficit in its balance of payments, it is unlikely to be able to finance these deficits from its limited reserves. If therefore becomes necessary for it adopt some form of restriction on imports (**e.g. tariffs, quotas, foreign exchange restrictions**) or some means of boosting its exports (**e.g. export subsidies**).

Danger of over-specialising

A country may feel that in its long-term interests it should not be too specialized.

A country may not wish to abandon production of certain key commodities even though the foreign product is more competitive, because it is then too dependent on imports of that good. In the future, its price or supplies may diminish. It is for this reason that countries wish to remain largely self-sufficient in food.

An exporting country may not wish to become overspecialized in a particular product. Such over specialization may make sense now, but in the future, demand may fall and the country will suffer disproportionally. It is for this reason that many developing countries choose not to rely solely on their comparative advantage; they wish to diversify into other goods as an: insurance policy".

Strategic Reasons

For political or strategic reasons, a country may not wish to be dependent upon imports and so may protect a home industry even if it is inefficient. Many countries maintain industries for strategic reasons. The steel industry, energy industries, shipping, agriculture and others have used this strategic defence argument.

Bargaining

Even when a country can see no economic benefit in protection, it may find it useful to have tariffs and restrictions bargaining gambits in negotiating better terms with other nations.

Ways of Restricting International Trade

The most common means of restricting international trade is through import restrictions. The main forms are:

Tariffs

This is a tax on each unit imported. The effect of the tax is to raise the price of imported varieties of a product in relation to the domestically produced, so that the consumers are discouraged from buying foreign goods by means of the price mechanism. Such a tax may be **ad valorem**, representing a certain percentage of the import price, or **specific** that is, an absolute charge on the physical amount imported as, for example, five shillings a ton.

Quotas

The most direct way of offering protection is by limiting the physical quantity of a good which may be imported. This can be done by giving only a limited number of import licenses and fixing a quota on the total amount which may be brought in during the period. The quota may be imposed in terms of physical quantities or in terms of the value of foreign currency, so that a maximum of so many “shillings-worth” may be imported.

Foreign exchange restriction

Exchange controls work much the same way as physical controls. Foreign exchange is not made available for all desired imports. It can be severely restricted to whatever the government decides it wants to see imported. Alternatively, the exchange rate may be fixed in such a way as to “overprice” foreign currency (compared to what would have been the free market price), so that importers have to pay more for foreign currency (in terms of domestic currency). This makes all imports dearer and thus gives protection “across the board” to all domestic production for the home market.

Procurement policies by government

The government itself, together with state corporations, is an important purchaser of goods; in its “procurement” policies, therefore, it can either buy goods from the cheapest source, whether domestic or foreign, or it can give preference to domestic producers. This could amount to a substantial advantage, or protection.

Other restrictions

Governments can devise health or safety requirements that effectively discriminate against the foreign good. Also where the country has state import agencies they can choose not to import as much as their citizens would require. The government can also introduce cumbersome administrative procedures that make it almost impossible to import.

Arguments against protectionism

Most of the arguments for protectionism may be met with counter arguments, but underlying the economic arguments as opposed to the social, moral, political, strategic, etc, is the free trade argument.

Free trade argument

This, in brief, maintains that free trade allows all countries to specialize in producing commodities in which they have a comparative advantage. They can then produce and consume more of all commodities than would be available if specialization had not taken place. By implication, any quotas, tariffs, other forms of import control and/or export subsidies all interfere with the overall advantages from free trade and so make less efficient use of world resources than would otherwise be the case.

Reduced output argument

It has been said that import controls will protect jobs initially, but not in the longer run. If we in the home country limit imports, then other countries will have less of our currency with which to buy our exports.

This will lead to a decline in sales and a loss of jobs in export industries. The overall effect is likely to be a redistribution of jobs from those industries in which the country has a comparative advantage to those in which it has a comparative disadvantage. The net result will be that total employment is unchanged but total output is reduced.

The infant industries seldom grow up

The infant industry argument is sometimes met with the claim that infant industries seldom admit to growing up and cling to their protection when they are fully grown up. Most economists, however, appear to accept the infant industry argument as a valid case for protection provided it is temporary.

Gains from comparative advantage

The argument for protection against low wage foreign labour is partly a moral argument which is outside the scope of positive economics, but even the economic part of the argument that it will drag down the living standards of high wage economies can be shown to be invalid. It is true as noted above that the payment of low wages will allow a country to export their goods cheaply and so possibly undercut those of high wage countries. However, it must be noted that countries importing these cheap goods gain by virtue of their low cost in terms of the goods required to be exported in return. This again is another use of the comparative advantage argument.

No Validity in economics

The other arguments such as the need to avoid over dependence on particular industries and the defence argument are really strategic arguments which are valid in their own terms and for which economic science is largely irrelevant.

Retaliation

Advocates of free trade also believe that if one country imposes import restrictions, then those countries adversely affected will impose retaliatory restrictions on its exports, so it will not end up any better off. This could lead to a "beggar-my-neighbour" tariff war, which no one can benefit from, and which contracts the volume of world trade on which every country"s international prosperity depends.

Inflation

If key foreign goods are not free to enter the country (or cost more), this will raise their prices and worsen the rate of inflation in the country.

Inefficiency

It is argued that if home industries are sheltered from foreign competition there is no guarantee that they will become more efficient and be able to compete in world markets.

Economic integration

It refers to the merging to various degrees of the economies and economic policies of two or more countries in a given region.

1. **Free Trade Area:**

Exist when a number of countries agree to abolish tariffs, quotas and any other physical barriers to trade between them, while retaining the right to impose unilaterally their own level of customs duty, etc, on trade with the rest of the world.

2. **Customs Market**

Exists where a number of countries decide to permit free trade among themselves without tariff or other trade barriers, while establishing a common external tariff against imports from the rest of the world.

3. **Common Market**

Exists when the countries, in addition to forming a custom union, decide to permit factors of production full mobility between them, so that citizens of one country are free to take up employment in the other, and capitalist are free to invest and to move their capital from one country to another.

4. **Economic union**

Is where the countries set up joint economic institutions, involving a degree of supranational economic decision-making.

5. **Common Monetary System**

Is where countries share a common currency, or ensure that each national currency can be exchanged freely at a fixed rate of exchange, and agree to keep any separate monetary policies roughly in line, to make this possible.

Benefits of integration

The formation of an economic integration could be beneficial in the light of the following aspects:

1 Enlarged market size: Regional economic blocks provide larger markets than individual countries. Such increase in size of the market permits economies of scale, resulting in lower production costs and expansion of output. In fact, member countries are better placed to bargaining for better terms of trade with non-member countries.

2 Industrialization: the size of the domestic market of one member country may not be sufficiently large to justify the setting up of an industry, whereas the market provided by many countries (regional market) is much more likely to be an incentive for establishment of new manufacturing industries, thus what economists consider as potentially derived industrial development.

3 Infrastructural facilities: Jointly financed infrastructural facilities such as in the field of transport (e.g. railway systems, ports and habours, and airlines. The East African Co-operation (EAC), for instance, would reduce costs by setting up one Development Bank to serve all the three countries rather than each country maintaining its own.

4 Specialisation: Each member country concentrates on production of those goods which it can produce more efficiently. Surpluses are exchanged and resources utilisation is increased - comparative advantage

4 Increased employment opportunities and subsequent reduction in income inequalities: Free mobility of labour leads to people moving from areas where incomes are low to areas of high labour incomes. This becomes even more beneficial if such incomes are invested back in respective countries. Furthermore, firms will have to pay highly in order to retain factor services (economic rent), thereby enhancing productivity.

5 Improvement of balance of payments (BOP): increased market implies more exports than before and given fairly low priced imports (from member countries) relative to imports from non-member countries, balance of payments position is most likely to improve. Foreign exchange savings also arise from this situation i.e. hard currencies such as the US dollar will only be required to import what cannot be produced from within the region.

6 Competitive business environment: Absence of trade barriers allows for free flow of goods and services which develops an upward pressure on competition and the driving force for relatively lower prices for higher quality products. This helps reduce or even eliminate monopoly practices, since firms can only acquire and maintain a market base by producing as efficiently as possible. Overall, there is increased variety of goods and services their consumption of which enhances living standards/development.

7 Indigenisation of economies: Regional governments play their part by creating the right incentives for the growth of the private sector which is the prime-mover of economic activities in liberalized situations. The private sector participation should not be limited to business activities but should extend to the formation of regional professional and business associations in order to advise on the influence future co-operation policies (e.g. the East African Business Council.) This creates more awareness among potential investors to take advantage of investment opportunities available within the region to create wealth. This way, over-reliance on private foreign investments and other forms of capital inflows (such as conditional Aid from IMF and World Banks) tends to be reduced.

The African continent regional integrations have not gone far in realizing the intended objectives due to:

Minimal or lack of practical commitment hence the low implementation of policies and agreements. Policy-induced factors such as inward looking policies of individual countries could result in the protection of less or uncompetitive domestic producers against imports irrespective of resources, and stringent trade and payments controls instituted to deal with the persistent balance of payments problems have adversely affected the volume of trade among African countries.

* Indispensable high capital import content: Most African countries are not in a position to sufficiently produce capital goods and other inputs for the production of goods hence continued vulnerability to foreign influence and dominance. This is traced to widespread poverty and minimal technical progress.

* Neo-colonialism and dependence mentality: The psychological influence arising from massive and persuasive advertising by the developed world has largely role-modelled the consumption pattern (tastes and preferences) of the African People. Preference has been given to products which do not originate from within the region. This then forces regional member countries to import such products in order to meet their domestic demand.

* Trade-diversion: countries previously importing cheap goods from outside the region switch to importing the same goods from other member countries. This is brought about by the removal of tariffs and other trade restrictions on the movement of goods between member states, while the tariffs on goods from outside remain. Depending on price/cost difference(s) such expenditure –switching may increase production cost accompanied by negative welfare implications.

* Government loss of tax revenue: Removal of tariffs (import duties) leads to reduced tax revenue to the government. With free trade, in countries where import duties constituted a high proportion of tax revenue; the government‟s spending programmes will be distorted.

* Unequal distribution of trade benefits/gains: Although all countries gain to a certain extent, one member country may benefit more than the others. This often arises due to high subsidization of production so that one country may succeed in attracting a more than proportionate share of new industrial development. In particular, incomes and employment opportunities will increase more than proportionately due to the multiplier effect.

* Product similarity and duplication: Because of product similarity (especially primary products), regional member countries have not lived to substantial benefits as would be required; what one country produces is equally produced by others so that the overall relative market share remains distinctively small.

* Widespread internal conflicts and general political instabilities: the most immediate result of such an atmosphere is suspicion and increase of protectionist strategies which no doubt hinders the free movement of goods and people. This then negates the intention of an economic integration. Owing to the current political and economic reforms sweeping across the economies of the developing would, it"s quite evident that much cannot be done without any form of collective effort. Economic integration aspect(s) could receive the seriousness deserved now or in the immediate future. In fact, some which had collapsed or remained insensitive are getting revived e.g. the East African Co-operation.

The disadvantages of economic integration

i. The "trade-diversion" effect has already been mentioned. Countries previously importing cheap goods from outside the free trade area switch to importing the same goods from other member countries. This is brought about by the removal of tariffs on goods moving between member states, while the tariffs on goods from outside remain. The result is a less efficient use of resources. Further more, the goods produced in the other member states are often of inferior quality to those formerly imported from outside.

ii. Government suffer a loss of tax revenue from the setting up of a free trade area. Before a lot of tax revenue was received from import duties on goods brought into the country from overseas. If goods are imported from other member states when the free trade area is up, import duties are no longer payable and tax revenue, the effect on a government"s spending programme will be substantial.

iii. The benefits arising from a free trade area may be unequally distributed. Even though all countries gain to a certain extent, one may benefit more than the others. If one country succeeds in attracting a more than proportionate share of new industrial development, it will enjoy more than proportionate economic benefits. In particular, incomes and employment opportunities will increase more than proportionately because of the multiplier effect.

INTERNATIONAL FINANCIAL INSTITUTIONS

In July 1944, a conference took place at Bretton Woods in New Hampshire to try to establish the pattern of post-war international monetary transactions. The aim was to try to achieve free convertibility, improve international liquidity and avoid the economic nationalism which had characterized the inter war period.

The result was that two institutions were established: in 1946, the International Bank for Reconstruction and Development (IBRD); and in 1947 the International Monetary Fund.

The International Monetary Fund

The International Monetary Fund is a kind of an embryo World Central Bank. Its objectives are:

i. To work towards the full convertibility of currencies by encouraging the growth of world trade.

ii. To stabilize exchange rates between currencies.

iii. To give short-term assistance to countries having balance of payments problems.

To achieve these objectives, the following conditions would have to be fulfilled: -

i. Countries should not impose restrictions in their trade with each other. This should encourage the growth of world trade and lead to full convertibility of currencies.

ii. Countries should adopt the **peg system** of exchange rates, in which each country quotes the exchange rate of its currency in gold and thus the exchange rates between currencies can be determined. The quoted exchanged rate is allowed to fluctuate to within 1% up and down, and the country can devalue or revalue its currency by up to 10%. This was meant to stabilize exchange rates between currencies.

iii. Each member state of the I.M.F should contribute to a fund to enable the I.M.F to give short-term assistance to countries having balance of payments problems. The quota contribution of the member state depends on the size of its G.D.P and its share of world trade. The member state contributed 25% of its quota in gold or convertible currency and the remaining 75% in its own currency.

iv. A member state in balance of payments problems can borrow from the I.M.F on a short-term basis. 25% of the country"s quota contribution is automatically available to it as stand-by credits. Beyond this the country can borrow on terms dictated by the I. M. F. the country borrows by purchasing gold or convertible currency using it own currency. The country"s borrowing facility expires when the I.M.F. holds the country"s currency twice the value of its quota contribution. In paying back to the I.M.F. the country will repurchase back its currency using gold or convertible currency until the I.M.F holds 75% of the country"s quota contribution in the country"s currency.

v. The I.M.F. reserves the right to dictate to the country borrowing from it how to govern its economy.

To what extent has the IMF achieved its objectives?

The objective of achieving full convertibility of currencies has not been achieved. In the first place countries impose restrictions in their trade with each other, and this has not helped the growth of world trade. Secondly, the export capabilities of different countries are different and it is difficult for all currencies to be convertible in particular the range of exports for developing countries very limited and so is the demand for them. This makes their currencies weak and unconvertible.

The objective of stabilizing exchange rates has not been achieved. This is because outside the stated limits the adjustable peg system of exchange rates has the same limitations as the gold standard in that it is deflationary and can put strains on the country"s foreign exchange reserves in times of a trade deficit and it is inflationary in times of a trade surplus.

While the IMF does give short-term assistance to member states in balance of payments problems, it is strictly on a short-term basis and it does not go to the root cause of the deficit. A more useful form of assistance would be one that would go into projects that would increase the productive potential of the country, making it less dependent on imports and increasing its export potential. Such assistance would have to be on long-term basis, but this is not within the objectives of the I.M.F., which gives assistance to finance a prevailing deficit.