Module – 5

International Trade

International Trade

International trade is the exchange of goods and services between countries.

Trading globally gives consumers and countries the opportunity to be exposed to goods and services not available in their own countries or more expensive domestically. International trade is an exchange involving a good or service conducted between at least two different countries. The exchanges can be imports or exports. An import refers to a good or service brought into the domestic country. An export refers to a good or service sold to a foreign country.

Advantages and Disadvantages of International Trade

Advantages of International Trade:

(i) Optimal use of natural resources:

International trade helps each country to make optimum use of its natural resources. Each country can concentrate on production of those goods for which its resources are best suited.

(ii) Availability of all types of goods:

It enables a country to obtain goods which it cannot produce or which it is not producing due to higher costs, by importing from other countries at lower costs.

(iii) Specialisation:

Foreign trade leads to specialisation and encourages production of different goods in different countries. Goods can be produced at a comparatively low cost due to advantages of division of labour.

(iv) Advantages of large-scale production:

Due to international trade, goods are produced not only for home consumption but for export to other countries also. Nations of the world can dispose of goods which they have in surplus in the international markets. This leads to production at large scale and the advantages of large scale production can be obtained by all the countries of the world.

(v) Stability in prices:

International trade irons out wild fluctuations in prices. It equalizes the prices of goods throughout the world (ignoring cost of transportation, etc.)

(vi) Exchange of technical know-how and establishment of new industries:

Underdeveloped countries can establish and develop new industries with the machinery, equipment and technical know-how imported from developed countries. This helps in the development of these countries and the economy of the world at large.

(vii) Increase in efficiency:

Due to international competition, the producers in a country attempt to produce better quality goods and at the minimum possible cost. This increases the efficiency and benefits to the consumers all over the world.

(viii) Development of the means of transport and communication:

International trade requires the best means of transport and communication. For the advantages of international trade, development in the means of transport and communication is also made possible.

(ix) International co-operation and understanding:

The people of different countries come in contact with each other. Commercial intercourse amongst nations of the world encourages exchange of ideas and culture. It creates cooperation, understanding, and cordial relations amongst various nations.

(x) Ability to face natural calamities:

Natural calamities such as drought, floods, famine, earthquake etc., affect the production of a country adversely. Deficiency in the supply of goods at the time of such natural calamities can be met by imports from other countries.

Disadvantages of International Trade:

(i) Impediment in the Development of Home Industries:

International trade has an adverse effect on the development of home industries. It poses a threat to the survival of infant industries at home. Due to foreign competition and unrestricted imports, the upcoming industries in the country may collapse.

(ii) Economic Dependence:

The underdeveloped countries have to depend upon the developed ones for their economic development. Such reliance often leads to economic exploitation. For instance, most of the underdeveloped countries in Africa and Asia have been exploited by European countries.

(iii) Political Dependence:

International trade often encourages subjugation and slavery. It impairs economic independence which endangers political dependence. For example, the Britishers came to India as traders and ultimately ruled over India for a very long time.

(iv) Mis-utilisation of Natural Resources:

Excessive exports may exhaust the natural resources of a country in a shorter span of time than it would have been otherwise. This will cause economic downfall of the country in the long run.

(v) Import of Harmful Goods:

Import of spurious drugs, luxury articles, etc. adversely affects the economy and well-being of the people.

(vi) Storage of Goods:

Sometimes the essential commodities required in a country and in short supply are also exported to earn foreign exchange. This results in shortage of these goods at home and causes inflation. For example, India has been exporting sugar to earn foreign trade exchange; hence the exalting prices of sugar in the country.

(vii) Danger to International Peace:

International trade gives an opportunity to foreign agents to settle down in the country which ultimately endangers its internal peace.

(viii) World Wars:

International trade breeds rivalries amongst nations due to competition in the foreign markets. This may eventually lead to wars and disturb world peace.

(ix) Hardships in times of War:

International trade promotes lopsided development of a country as only those goods which have comparative cost advantage are produced in a country. During wars or when good relations do not prevail between nations, many hardships may follow.

Theories of International Trade

Absolute Advantage Theory

The concept of absolute advantage was developed by Adam Smith in The Wealth of Nations to show how countries can gain by specializing in producing and exporting the goods that they produce more efficiently than other countries, and importing goods other countries produce more efficiently.

Adam Smith's Theory of Absolute Advantage

The trade theory that first indicated importance of specialization in production and division of labor is based on the idea of theory of absolute advantage which is developed first by Adam Smith in his famous book The Wealth of Nations published in 1776. Later on David Ricardo in his book titled On the Principles of Political Economy published in 1819 extended it to incorporate theory of comparative advantage and showed that it is the basis why nations need to trade and why trade is mutually beneficial to countries.

Statement of Theory

Countries should specialize in producing the goods and services in which they have absolute advantage and engage in free trade with other countries to sell their goods. A country's resources would therefore be utilized in the best possible way—in the production of goods and services in which the country has a productivity advantage compared with other countries—and national wealth would be maximized.

To illustrate the idea of absolute advantage (AA) consider the following table which gives the labor hours required to produce one unit of C and W in our hypothetical countries A and B.

	A	B
Cheese	2	10
Wine	8	4

Country A has AA in production of C as it takes fewer hours to produce a unit of C in A than in Country B. Since it takes less hours in Country B to produce W, Country B has an AA in production of W. Adam Smith's theory: Countries should specialize in the production of goods in which they have an AA. So Country A will be better of it specializes in the production of C and Country B will be better off if it specializes in W. So they don't need to produce both goods at home.

Comparative advantage Theory: David Ricardo

The law of comparative advantage is popularly attributed to English political economist David Ricardo and his book “On the Principles of Political Economy and Taxation” written in 1817.

The principle of comparative costs is based on the differences in production costs of similar commodities in different countries. Production costs differ in countries because of geographical division of labour and specialisation in production. Each country specialises in the production of that commodity in which its comparative cost of production is the least. Therefore, when a country enters into trade with some other country, it will export those commodities in which its comparative production costs are less, and will import those commodities in which its comparative production costs are high. This is basis of international trade, according to Ricardo.

Ricardo’s Theorem:

Ricardo stated a theorem that, other things being equal, a country tends to specialize in and export those commodities in the production of which it has maximum comparative cost advantage or minimum comparative disadvantage. Similarly, the country’s imports will be of goods having relatively less comparative cost advantage or greater disadvantage.

According to Ricardo even in the case of a country for which there is no absolute advantage for both the commodities, it can still gain from the international trade. In this situation, the country should specialize in the production and export of the commodity in which its absolute disadvantage is smaller and import the commodity in which the its absolute disadvantage is greater.

The Heckscher – Ohlin Theorem (H-O) or Factor Endowment Theory

The theory was originally developed y Eli Heckscher in 1919. Later in 1935 it was refined by Bertil Ohlin. Hence it is known as Heckscher – Ohlin Theorem.

Heckscher – Ohlin Theorem states that a country will produce and export that commodity whose production requires the intensive use of nation’s relatively abundant and cheap factor and import the commodity whose production requires the intense use of relatively scare and expensive factor. In other words, relatively labor abundant country will export the relatively labor-intensive commodity and import the relatively capital – intensive commodity.

Balance of Payments (BoP)

The balance of payments (BOP), also known as the balance of international payments, is a statement of all transactions made between entities in one country and the rest of the world over a defined period, such as a quarter or a year. It summarizes all transactions that a country's individuals, companies, and government bodies complete with individuals, companies, and government bodies outside the country.

The balance of payments summarises the economic transactions of an economy with the rest of the world. These transactions include exports and imports of goods, services and financial assets, along with transfer payments (like foreign aid).

The Components of the Balance of Payments

There are three components of balance of payment viz current account, capital account, and financial account (The official reserve account). The total of the current account must balance with the total of capital and financial accounts in ideal situations.

Current Account

The current account is used to monitor the inflow and outflow of goods and services between countries. This account covers all the receipts and payments made with respect to raw materials and manufactured goods.

It also includes receipts from engineering, tourism, transportation, business services, stocks, and royalties from patents and copyrights. When all the goods and services are combined, together they make up to a country’s Balance Of Trade (BOT).

Capital Account

All capital transactions between the countries are monitored through the capital account. Capital transactions include the purchase and sale of assets (non-financial) like land and properties.

The capital account also includes the flow of taxes, purchase and sale of fixed assets etc by migrants moving out/into a different country.

The deficit or surplus in the current account is managed through the finance from the capital account and vice versa. There are 3 major elements of a capital account:

- Loans and borrowings – It includes all types of loans from both the private and public sectors located in foreign countries.
- Investments – These are funds invested in the corporate stocks by non-residents.
- Foreign exchange reserves – Foreign exchange reserves held by the central bank of a country to monitor and control the exchange rate does impact the capital account.

The Official Reserve Account

The flow of funds from and to foreign countries through various investments in real estates, business ventures, foreign direct investments etc is monitored through the financial account.

Balance of Payments Deficit

Disequilibrium in the balance of payment means its condition of Surplus or deficit.

A Surplus in the BOP occurs when Total Receipts exceeds Total Payments. Thus,

BOP = CREDIT > DEBIT

A Deficit in the BOP occurs when Total Payments exceeds Total Receipts. Thus,

BOP = CREDIT < DEBIT

Causes of Disequilibrium/ Deficit in The Bop

- Cyclical fluctuations
- Short fall in the exports
- Economic Development
- Rapid increase in population
- Structural Changes
- Natural Calamites
- International Capital Movements

Measures To Correct Disequilibrium in the BOP

a) Monetary Policy

The monetary policy is concerned with money supply and credit in the economy. The Central Bank may expand or contract the money supply in the economy through appropriate measures which will affect the prices.

b) Fiscal Policy

Fiscal policy is government's policy on income and expenditure. Government incurs development and non - development expenditure,. It gets income through taxation and non - tax sources. Depending upon the situation governments expenditure may be increased or decreased.

c) <u>Exchange Rate Depreciation</u>

By reducing the value of the domestic currency, government can correct the disequilibrium in the BoP in the economy. Exchange rate depreciation reduces the value of home currency in relation to foreign currency. As a result, import becomes costlier and export become cheaper. It also leads to inflationary trends in the country

d) <u>Devaluation</u>

devaluation is lowering the exchange value of the official currency. When a country devalues its currency, exports becomes cheaper and imports become expensive which causes a reduction in the BOP deficit.

e) <u>Export Promotion</u>

To control export promotions the country may adopt measures to stimulate exports like:

- Export duties may be reduced to boost exports.
- Cash assistance, subsidies can be given to exporters to increase exports.
- Goods meant for exports can be exempted from all types of taxes.

f) <u>Import Substitutes</u>

Steps may be taken to encourage the production of import substitutes. This will save foreign exchange in the short run by replacing the use of imports by these import substitutes.

<u>Devaluation</u>

The reduction of a currency´s value in relation to other currencies. Devaluation is a downward adjustment to a country’s value of money relative to a foreign currency or standard. Devaluation occurs when a country intentionally reduces the value of its currency relative to one or more foreign countries. Devaluation occurs when a government wishes to increase its balance of trade (exports minus imports) by decreasing the relative value of its currency.

Trade policy

Trade policy can be defined as goals, rules, standards, and regulations that are involved in the trade between countries. The major 2 policies that the countries follow with respect to international trade are

1. Free Trade
2. Protectionism

Free Trade

Free trade means free and unfettered trade between countries, unhindered by steep tariffs, and where goods can pass over borders unmolested by any restrictions. Free trade agreements are contracts between countries to allow access to their markets.

Advantages of Free Trade

1. **Increased economic growth**: Free trade will increase the production scale and division of labour which lead to economic growth.
2. **More dynamic business climate**: Without free trade agreements, countries often protected their domestic industries and businesses. This protection often made them stagnant and non-competitive on the global market. With the protection removed, they became motivated to become true global competitors.
3. **Foreign direct investment**: Investors will flock to the country. This adds capital to expand local industries and boost domestic businesses.
4. **Technology transfer**: Local companies also receive access to the latest technologies from their multinational partners.
5. **Expertise**: Global companies have more expertise than domestic companies to develop local resources.
6. **More choice of goods**: Free trade is good for consumers. It reduces prices by eliminating tariffs and increasing competition.
7. **Improves Quality**: Greater competition is also likely to improve quality and choice.

Disadvantages of Free Trade

1. **Threat to domestic industries**: Many emerging markets are traditional economies that rely on farming for most employment. These small family farms can't compete with subsidized agri-businesses in developed countries. As a result, they lose their farms and must look for work in the cities. This aggravates unemployment, crime, and poverty.
2. **Poor working conditions**: Multinational companies may outsource jobs to emerging market countries without adequate labor protections.

3. **Degradation of natural resources**: Emerging market countries often don't have many environmental protections.
4. **Destruction of native cultures**: As development moves into isolated areas, indigenous cultures can be destroyed.

Protectionism

Trade protectionism is a policy stance that some countries adopt to protect their domestic industries from foreign competition. The policy may work in the short run to bolster domestic production and business, but in the long run, trade protectionism can make a country and its industries less competitive in international trade.

Trade protectionism is a measured and purposeful policy by a nation to control imports while promoting exports. It is done in an effort to promote the economy of the nation above all other economies.

Advantages of Protectionism

1. **Infant Industry Argument**: If a country is trying to grow strong in a new industry, tariffs will protect it from foreign competitors. That gives the new industry's companies time to develop their competitive advantages.
2. **Protect the Consumer**: One of the more recent phenomenon surrounding protectionism has been the development of protecting the consumer.
3. **National Security**: It is argued that should a nation become reliant on international imports, it also becomes defensively weak.
4. **More growth opportunities**: Protectionism provides local industries with growth opportunities until they can compete against more experienced firms in the international market
5. **Lower imports**: Protectionist policies help reduce import levels and allow the country to increase its trade balance.
6. **More jobs**: Higher employment rates result when domestic firms boost their workforce
7. **Higher GDP**: Protectionist policies tend to boost the economy's GDP due to a rise in domestic production

Disadvantages of Protectionism

1. **Limited choices for consumers**: Consumers have access to fewer goods in the market as a result of limitations on foreign goods.
2. **Increase in prices (due to lack of competition):** Consumers will need to pay more without seeing any significant improvement in the product.
3. **Economic isolation**: It often leads to political and cultural isolation, which, in turn, leads to even more economic isolation.
4. **Stagnation of technological advancements**: As domestic producers don't need to worry about foreign competition, they have no incentive to innovate or spend resources on research and development (R&D) of new products.
5. **Less Choice:** By restricting international competition, there are fewer goods coming into the country. This means less choice for the average consumer.
6. **Economic Loss:** Protectionist policies impose an additional cost and loss on all parties. First of all, domestic consumers must pay a higher price for goods. At the same time, importers face a decline in demand, so international jobs are lost.

Tariff and Non-Tariff Barriers.

Tariff barriers are the tax or duty imposed on the goods which are traded to/from abroad. On the contrary, non-tariff barriers are the obstacles to international trade, other than tariffs. These are administrative measures implemented by the country's government to discourage goods brought in from foreign countries and promote domestically produced items.

Tariff Barriers

When two countries trade in the goods, a certain amount is charged as a fee by the country, in which goods are entered, so as to provide revenue to the government as well as raise the price of foreign goods, so that the domestic companies can easily compete with the foreign items. This fee is in the form of tax or duty, which is called a tariff barrier.

The amount of tax or duty charged as tariff is added to the cost of the import, which makes the foreign goods more expensive, whose price is ultimately borne by the consumer of the products. The tariff is paid to the customs authority of the country in which goods are sent. It includes:

- Export Duties
- Import Duties
- Transit Duties

- Specific Duties
- Ad-valorem Duties etc.,

Non-Tariff Barriers

Non-tariff barriers refer to non-tax measures used by the country's government to restrict imports from foreign countries. It covers those restrictions which lead to prohibition, formalities or conditions, making the import of goods difficult and decrease market opportunities for foreign items.

It can be in the form of laws, policies, practices, conditions, requirements, etc., which are specified by the government to restrict import. Hence it encompasses popular trade-distorting practices such as:

- Import quotas
- VERs, i.e. Voluntary Export Restraints
- Import licensing
- Technical and administrative regulations
- Price control
- Foreign exchange regulations etc.

Differences between Tariff and Non-Tariff Barriers

1. Tariff Barriers implies the tax or duty levied by the country's government on the import of goods from a foreign country so as to restrict imports, to a certain extent. On the contrary, non-tariff trade barriers are the policies and regulations, which are implemented by the country, with the aim of protecting and supporting domestic industries.

2. World Trade Organization (WTO) permitted the levy of tariff barriers to its member nations but at a reasonable rate only. Conversely, World Trade Organization (WTO) has put an end to the imposition of Import Quotas and Voluntary Export Restraints, i.e. non-tariff barriers.

3. Tariff barriers are simple to understand and levy, whereas non-tariff barriers are difficult to understand and involve more official.

4. Tariff barriers can take the form of taxes and duties, while non-tariff barriers are in the form of regulations, conditions, requirements, formalities, etc.

5. The imposition of tariff barriers results in the increase in government revenue. On the other hand, enactment of non-tariff barriers does not adds to government revenue.

6. Tariff barriers levied by the government increases the cost of the imported item. As against, non-tariff barriers include quantity restrictions, which affects the volume, as well as it also sometimes affects the price of the imported goods.

7. In the case of tariff barriers, as the government levies import duty, monopolistic groups can be controlled. In contrast, when non-tariff barriers are imposed monopolistic organization charges high prices through low output.

8. When tariff barriers are levied, the importers cannot make more profits, as the tax imposed will already make the product expensive, and to compete in the country's market, they need to keep the prices competitive. On the contrary, when non-tariff barriers are imposed, importers can make good profits, as it is a non-tax measure, which does not increase the price.