Module – 5
International Trade

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International Trade

- International trade is the exchange of goods and services between countries.
- International trade is an exchange involving a good or service conducted between at least two different countries.

Advantages of International Trade

- Optimal use of natural resources
- Availability of all types of goods
- Advantages of large-scale production
- Stability in prices
- Exchange of technical know-how and establishment of new industries
- Development of the means of transport and communication
- Ability to face natural calamities
- International co-operation and understanding

Disadvantages of International Trade

- Impediment in the Development of Home Industries
- Economic Dependence
- Political Dependence
- Import of Harmful Goods
- Storage of Goods

Theories of International Trade

Adam Smith’s Theory of Absolute Advantage

- ~~The concept of absolute advantage was developed by Adam Smith in The Wealth of~~ Nations

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

Absolute advantage: It refers to the ability to produce a certain good or service at lower cost (i.e., more efficiently) than another party.

Comparative advantage Theory: David Ricardo

- 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 its absolute disadvantage is greater.

- Comparative advantage is **an economy's ability to produce a particular good or service at a lower opportunity cost than its trading partners**.
- The theory of comparative advantage introduces opportunity cost as a factor for analysis in choosing between different options for production
- It is the loss of other alternatives when one alternative is chosen.
- For example, **if a country is skilled at making both cheese and chocolate, they may determine how much labor goes into producing each good**. If it takes one hour of labor to produce 10 units of cheese and one of labor to produce 20 units of chocolate, then this country has a comparative advantage in making chocolate.

	WHEAT	POTATOES
CHINA	**100** 1 Wheat = 2 Potatoes	**200** 1 Potato = 0.5 Wheat
INDIA	**80** 1 Wheat = 1.25 Potatoes	**100** 1 Potato = 0.8 Wheat

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 scarce 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 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 balance of payments of a country is a systematic record of all economic transactions between the residents of a country and the rest of the world.

Components

- There are **three components of balance of payment** viz current account, capital account, and financial account (The official reserve account)

Current Account

- The **current account** is used to monitor the inflow and outflow of goods and services between countries

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 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

- A 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
- Natural Calamites
- International Capital Movements

Measures To Correct Disequilibrium in the BOP

- Monetary Policy
- Fiscal Policy
- Devaluation
- Export Promotion
- Import Substitutes

Devaluation

- 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 (Free trade means free and unfettered trade between countries)

2. Protectionism (Purposeful policy by a nation to control imports while promoting exports.)

Advantages of Free Trade

- Increased economic growth
- More dynamic business climate
- Improves Quality
- Technology transfer
- Expertise
- More choice of goods
- Foreign direct investment

Disadvantages of Free Trade

- Threat to domestic industries
- Destruction of native cultures
- Degradation of natural resources
- Poor working conditions

Advantages of Protectionism

- Infant Industry Argument
- Protect the Consumer
- National Security
- Higher GDP
- Lower imports
- More jobs
- More growth opportunities

Disadvantages of Protectionism

- Economic Loss
- Increase in prices (due to lack of competition)
- Economic isolation
- Stagnation of technological advancements
- Less Choice
- Limited choices for consumers

Tariff and Non-Tariff Barriers

Tariff

- 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

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