KTU STUDY MATERIALS

INDUSTRIAL ECONOMICS AND FOREIGN TRADE

HUT 300

Module 5

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.

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 the its absolute disadvantage is greater.

The Heckscher – Ohlin Theorem 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 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).

- 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 Disequilibr 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.