MODULE-5

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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. Wastage of resources is avoided.

(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) Specialization: Foreign trade leads to specialization and encourages production of different goods in different countries. Goods can be produced at a comparatively low cost due to advantages of division of labor.

(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.

Disadvantages of International Trade:
Though foreign trade has many advantages, its dangers or disadvantages should not be ignored.
(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-utilization 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.

● Absolute and comparative advantage theory

Theory of Absolute Cost Advantage:

According to absolute advantage theory, a country has an absolute advantage over another country in producing a good if that country can produce that good comparatively with less resources.

2 Labours	INDIA	USA
Commodity A	10 unit	5 unit
Commodity B	5 unit	10 unit

The theory states if India is having absolute advantage in the production of that commodity A, it should involve all its resources to produce that commodity. Similarly if the USA is having absolute advantage in the production of commodity B, it should involve its resources to produce that commodity. India has absolute advantage in the production of commodity A therefore it will export commodity A to USA and India will import commodity B from USA

Assumptions

1. There are only two countries
2. There are only two commodities
3. Taste and preference of both countries are same
4. Labor is homogeneous
5. There is a perfect competition in the market
6. Labor is considered as only factor of production
7. There is free trade between both countries
8. All factors of production are fully employed

Advantage and benefits of Absolute advantage

- Increase in quantity of both product
- Increase in standard of living in both countries
- Increase in production efficiency
- Maximization of global output and increase in productivity of labor
- Increase in global efficiency and effectiveness

Criticism

- Involvement of more than two countries
- Involvement of more than two products
- Same efficiency of labor are not possible
- Technology is not same or constant
- Supply of labor is not same

Comparative Advantage Theory

The challenge to the absolute advantage theory was that some countries may be better at producing both goods and, therefore, have an advantage in many areas. In contrast, another country may not have any useful absolute advantages. To answer this challenge, David Ricardo, an English economist, introduced the theory of comparative advantage in 1817. Ricardo reasoned that even if Country A had the absolute advantage in the production of both products, specialization and trade could still occur between two countries. Comparative advantage occurs when a country cannot produce a product more efficiently than the other country; however, it can produce that product better and more efficiently than it does other goods. The difference between these two theories is subtle. Comparative advantage focuses on the relative productivity differences, whereas absolute advantage looks at the absolute productivity.

Let's look at a simplified hypothetical example to illustrate the subtle difference between these principles. Miranda is a Wall Street lawyer who charges $500 per hour for her legal services. It turns out that Miranda can also type faster than the administrative assistants in her office, who are paid $40 per hour. Even though Miranda clearly has the absolute advantage in both skill sets, should she do both jobs? No. For every hour Miranda decides to type instead of do legal work, she would be giving up $460 in income. Her productivity and income will be highest if she specializes in the higher-paid legal services and hires the most qualified administrative assistant, who can type fast, although a little slower than Miranda. By having both Miranda and her assistant concentrate on their respective tasks, their overall productivity as a team is higher. This is a comparative advantage. A person or a country will specialize in doing what they do relatively better. In reality, the world economy is more complex and consists of more than two countries and products. Barriers to trade may exist, and goods must be transported, stored, and distributed. However, this simplistic example demonstrates the basis of the comparative advantage theory

Heckscher – Ohlin theory (Factor Proportions Theory)

The theories of Smith and Ricardo didn't help countries determine which products would give a country an advantage. Both theories assumed that free and open markets would lead countries and producers to determine which goods they could produce more efficiently.

In the early 1900s, two Swedish economists, Eli Heckscher and Bertil Ohlin, focused their attention on how a country could gain comparative advantage by producing products that utilized factors that were in abundance in the country. Their theory is based on a country's production factors—land, labor, and capital, which provide the funds for investment in plants and equipment. They determined that the cost of any factor or resource was a function of supply and demand. Factors that were in great supply relative to demand would be cheaper; factors in great demand relative to supply would be more expensive.

Their theory, also called the factor proportions theory, stated that countries would produce and export goods that required resources or factors that were in great supply and, therefore, cheaper production factors. In contrast, countries would import goods that required resources that were in short supply, but higher demand.

For example, China and India are home to cheap, large pools of labor. Hence these countries have become the optimal locations for labor-intensive industries like textiles and garments.

Balance of payments (BOP) - components

Meaning: BOP is an accounting statement that provides records of all economic transactions between residents of a country and the rest of the world during a particular period of time.

1. Accounting statement
2. Economic transactions

Accounting statements consists of

a. Debit side: all outflows are recorded in debit side
b. Credit sie : all inflows are recorded in credit side

Economic transactions includes (components of BOP)

I. Current account transactions
II. Capital account transactions

Components of current account	Components of capital account (concerned with assets & liabilities)
i. Visible trade items	i. Borrowing and lendings
ii. Invisible trade items	ii investments
iii. Unilateral transfers	iii. Foreign exchange reserves
iv. Income receipts & payments	

Components of Current account

Sl. no	Items	Details
1.	Visible trade items	It includes all types of physical goods that can be seen, touched, felt & measured - Import of goods: debit side - Export of goods: credit side
2.	Invisible trade items	It includes all types of services that can not be seen, touched, felt & measured Eg. import and exports of services (insurance, banking, education) - Import of services: debit side - Export of services: credit side
3.	Unilateral transfers	It includes gifts, personal remittance, and donations. or we can say one way transactions i.e. nothing in return - Transfer payment- Debit side - Transfer receipt- credit side
4.	Income receipts and payments to and from abroad	It includes investment incomes and payments in the form of Rent, profit, interest It is generated through capital account transactions - Income payments: Debit - Income received: Credit

<u>Components of Capital account</u>

Sl. No	Items	Details

	Borrowing and Lending from and to abroad	All transactions concerned with borrowing from abroad and lending to abroad are taken into consideration. Receipts of loan and Repayments of loan by foreigners- Credit side Lending to abroad and Repayment of loan to abroad- Debit side
2.	Investments to and from abroad	All transactions of investment in shares, real estate etc in between resident and foreigners are taken into consideration. Investments from abroad-Credit side Investment to abroad-Debit side
3.	Change in foreign exchange reserves (FER)	FER are the financial assets (money, bonds, securities) of the government held by the central bank. Withdrawal from these assets-credit sides Additions to these assets-debit sides

Balance of payments deficit and devaluation

DISEQUILIBRIUM IN THE BALANCE OF PAYMENTS

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 BOP deficit or Disequilibrium

- Cyclical fluctuations
- Short fall in the exports
- Economic Development
- Rapid increase in population
- Structural Changes

- Natural Calamities
- International Capital Movements

Measures To Correct Disequilibrium in the BOP

Devaluation

Devaluation refers to deliberate attempts made by monetary authorities to bring down the value of home currency against foreign currency.

While **depreciation** is a spontaneous fall due to interactions of market forces, devaluation is an official act enforced by the monetary authority. Generally the international monetary fund advocates the policy of devaluation as a corrective measure of disequilibrium for the countries facing adverse balance of payment position.

When India's balance of payment worsened in 1991, the IMF suggested devaluation. Accordingly, the value of Indian currency has been reduced by 18 to 20% in terms of various currencies. The 1991 devaluation brought the desired effect. The very next year the import declined while exports picked up. When devaluation is effected, the value of home currency goes down against foreign currency, Let us suppose the exchange rate remains $1 = Rs. 10 before devaluation. Let us suppose, devaluation takes place which reduces the value of home currency and now the exchange rate becomes $1 = Rs. 20. After such a change our goods become cheap in foreign markets. This is because, after devaluation, dollars are exchanged for more Indian currencies which push up the demand for exports. At the same time, imports become costlier as Indians have to pay more currencies to obtain one dollar. Thus demand for imports is reduced. Generally devaluation is resorted to where there is a serious adverse balance of payment problem.

Limitations of Devaluation :-

1. Devaluation is successful only when other countries do not retaliate the same. If both the countries go for the same, the effect is nil.

2. Devaluation is successful only when the demand for exports and imports is elastic. In case it is inelastic, it may make the situation worse.

3. Devaluation, though helps correct disequilibrium, is considered to be a weakness for the country.

4. Devaluation may bring inflation in the following conditions :-

i. Devaluation brings the imports down, When imports are reduced, the domestic supply of such goods must be increased to the same extent. If not, scarcity of such goods unleash inflationary trends.

ii. A growing country like India is capital thirsty. Due to non availability of capital goods in India, we have no option but to continue imports at higher costs. This will force the industries depending upon capital goods to push up their prices.

iii. When demand for our exports rises, more and more goods produced in a country would go for exports and thus creating a shortage of such goods at the domestic level. This results in rising prices and inflation.

iv. Devaluation may not be effective if the deficit arises due to cyclical or structural changes.

Trade policy – Free trade versus protection

International trade that takes place without barriers such as tariffs,quota,foreign exchange control is called free trade.

Free trade refers to a situation of international trade with no restrictions. Free trade implies absence of government interference.

Under free trade, the government cannot impose any duty on imports and exports. Government may levy duty on goods under free trade to augment revenues.

Advantages of Specialization:

Firstly, free trade secures all the advantages of international division of labor. Each country will specialize in the production of those goods in which it has a comparative advantage over its trading partners. This will lead to an optimum and efficient utilization of resources and, hence, economy in production.

ii. All-Round Prosperity:

Secondly, because of unrestricted trade, global output increases since specialization, efficiency, etc., make production large scale. Free trade enables countries to obtain goods at a cheaper price. This leads to a rise in the standard of living of people of the world.

iii. Competitive Spirit:

Thirdly, free trade keeps the spirit of competition in the economy. As there exists the possibility of intense foreign competition under free trade, domestic producers do not want to lose their grounds. Competition enhances efficiency. Moreover, it tends to prevent domestic monopolies and free the consumers from exploitation.

iv. Accessibility of Domestically Produced Goods and Services:

Fourthly, free trade enables each country to get commodities which it cannot produce at all or can only produce inefficiently. Commodities and raw materials unavailable domestically can be procured through free movement even at a low price.

v. Greater International Cooperation:

Fifthly, free trade safeguards against discrimination. Under free trade, there- is no scope for cornering raw materials or commodities by any country. Free trade can thus promote international peace and stability through economic and political cooperation.

Arguments against Free Trade:

i. Advantageous not for LDCs:

Firstly, free trade may be advantageous to the advanced countries but not to the backward economies. Free trade has brought enough misery to the poor, less developed countries, if past experience is any guide. India was a classic example of colonial dependence on the UK's imperialistic power prior to 1947. Free trade principles have brought colonial imperialism in its wake.

ii. Destruction of Home Industries/Products:

Secondly, it may ruin domestic industries. Because of free trade, imported goods become available at a cheaper price. Thus, an unfair and cut-throat competition develops between domestic and foreign industries. In the process, domestic industries are wiped out. Indian handicrafts industries suffered tremendously during the British regime.

iii. Inefficiency becomes Perpetual:

Free trade cannot bring all-round development of industries. Comparative cost principle states that a country specializes in the production of a few commodities. On the other hand, inefficient industries remain neglected. Thus, under free trade, an all-round development is ruled out.

iv. Danger of Overdependence:

Fourthly, free trade brings in the danger of dependence. A country may face economic depression if its international trading partner suffers from it.

The Great Depression that arose in 1929-30 in the US economy swept all over the world and all countries suffered badly even if their economies were not caught in the grip of the then Depression. Such overdependence following free trade also becomes catastrophic during war.

v. Penetration of Harmful Foreign Goods:

Finally, a country may have to change its consumption habits. Because of free trade, even harmful commodities (drugs, etc.,) enter the domestic market. To prevent such, restrictions on trade are required to be imposed.

Protectionism

Protectionism is the practice of following protectionist trade policies. A protectionist trade policy allows the government of a country to promote domestic producers, and thereby boost the domestic production of goods and services by imposing tariffs or otherwise limiting foreign goods and services in the marketplace.

Arguments in favor of protectionism

Infant industry argument: It is argued that the government should go in for protectionist measures to protect infant industries, or else they will not get an opportunity to survive due to international trade.

Efforts of a developing country to diversify: Developing countries need to protect industries in which they want to diversify.

Protection of employment: Protecting domestic industries also means protecting domestic employment.

Source of government revenue: Tariffs form a good source of revenue for governments.

Strategic arguments: it means use of a tariff to protect military capability. The idea is, to consume the goods of our country to promote the national industry and so, in the case of war we don't have to buy the products in a foreign country and our industries have the capacity to produce all the goods that our country needs. We want tariffs to reduce the "dependence" on international resources.

Means to **overcome a balance of payments disequilibrium**: High imports as compared to exports might lead to severe balance of payments issues. Government might resort to protectionist measures such as tariffs and quotas to restrict imports and thereby control the balance of payment disequilibrium.

Anti-dumping: Dumping is when manufacturers export a product to another country at a price either below the price charged in its home market. This harms the domestic industry and employment. The importing country might resort to protectionist measures such as tariffs to control dumping of these goods.

Arguments against Protectionism

misallocation of resources: It leads to global misallocation of resources, as it supports inefficient producers and in certain cases (tariffs and quotas) consumer surplus is scarified.

the danger of retaliation and "trade wars": Continuous protectionist measures by a country might lead to retaliation from other countries and they might also put protectionist measures on imports.

the potential for corruption: Putting administrative controls might also lead to corruption.

increased costs of production due to lack of competition: Constant protection to the domestic producers and lack of competition propagates inefficiency and lack of initiative to control cost.

higher prices for domestic consumers: As we can see due to tariffs and quotas domestic consumers end up paying more.

Increased costs of imported factors of production: Imported goods become expensive which might also lead to imported inflation.

reduced export competitiveness: Continuous protection to domestic industries (such as subsidies) might make them inefficient in terms of cost and technology. In the long run they might become uncompetitive in the exports market.

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.

Non-Tariff Barriers

1. **Direct Price Influences**

   Subsidies

- Subsidies are the direct payments made by the government to domestic producers. It can take the form of cash payments, low interest loans, government participation in ownership, tax incentives, etc.
- Subsidies help in lowering down the cost of production of domestic goods as a result of which the prices also come down. It helps domestic producers to capture export markets by making their products cheaper in international markets

2. **Quantity Controls**

   Quotas

- It refers to the direct restriction on the quantity of goods that can be imported into a country during any period of time.
- In other words quotas limit the quantity of imports of any particular commodity coming into a country during a certain period of time. This is normally done through giving of import licenses to the importers. For example, the United States has a quota on cheese imports; India has a quota on import of gold.

   Voluntary Export Restraints (VERs)

- VERs are bilateral agreements instituted to restrain the rapid growth of exports of specific goods. Essentially, the government of country X asks the government of country Y to reduce its companies' exports to country X voluntarily to help the importing country X to protect its domestic industry

3. **Local Content Requirement**

- A local content requirement is a requirement that some fraction of the product must be produced locally or in the domestic market. The requirement can either be expressed in physical terms (60% of the parts of the product) or in value terms (60% of the value of the product). Thus, it ensures that if any company wants a contract from the government agency, it must ensure that at least a certain portion of the product must be produced or procured locally.

- g: Domestic content Requirement under Jawaharlal Nehru National Solar Mission (JNNSM)

4. **Legislation**

- Under this form of trade policy the government makes its purchases from domestic producers only.
- This legislation forbids the government departments to make use of imported goods. However, the government may at times permit the use of imported products only if the price is below that of the domestic producer.
- The economic effect of local content requirement and buy local legislation is same as that of quota. It limits foreign competition thereby benefiting the domestic producers. The restrictions on imports raise the price of goods for the consumers.

Labeling and Testing Standards

- Some countries require that goods entering into their boundaries must meet certain requirements in terms of packaging, labeling and testing standards. Such countries allow sale of only those goods which satisfy these standards.

Sanitary and Phytosanitary (SPS)

- These measures are taken to protect against risks linked to food safety, animal health and plant protection or to prevent or limit damage within the territory of a country from the entry, establishment and spread of pests from a foreign country.

Specific Permission Requirements:

- This measure requires that potential importers or exporters secure permission from governmental authorities. This involves the issuing of import or export licences which may be costly and time consuming.

Counter trade

- The exchange of goods with goods between countries is referred to as countertrade. This practice is common in the aerospace and defense industries whereby the importer country may not have enough foreign currency to pay for imports.

5. **Administrative Barriers to Trade**

- Administrative barriers to trade are a special category of non-tariff barriers and their main sources are administrative regulations and procedures that have a restrictive effect on international trade.
- Delays may be made with respect to issue of licences, customs valuation, and clearance of consignment of goods and so on.

Tariff Barriers

Tariff barriers- custom duties which make imported goods costlier than domestically manufactured goods.

Anti-dumping & CounterVailing Duty (CVD):

- Dumping in economics is a type of predatory pricing talked about particularly in the international commerce space. Dumping is said to happen when manufacturers or marketers export a product to another nation at a price that is lesser than the home country price or lesser than the production cost.
- This is done with the intention of enhancing the market share in a foreign market or to remove competition. Government imposes Anti-dumping duty to nullify
- Countervailing duties (CVDs) are trade import tariffs imposed to nullify the adverse effects of subsidies. They are imposed only under World Trade Organization rules and are also called anti-subsidy duties.
- Anti-dumping duties are levied on goods that are imported at a substantially low price whereas countervailing duties are levied on subsidized products in the originating or exporting country.

MODEL QUESTIONS

1. What are the major components of balance of payments?
2. What is devaluation?
3. a) What are the advantages of disadvantages of foreign trade?
   b) Explain the comparative cost advantage.
4. a) What are the arguments in favor protection?
   b) Examine the tariff and non-tariff barriers to international trade.

1. Suppose a foreign country imposes a tariff on Indian goods. How does it affect India's exports?
2. What is free trade?