chapter 7

OBJECTIVES

At the end of this chapter, students should be able to:
â€¢ define international trade and types of international trade;
â€¢ differentiate between domestic trade and international trade;
â€¢ mention the reasons for international trade;
â€¢ explain the advantages and disadvantages of international trade;
â€¢ highlight the factors influencing terms of trade and the instruments of foreign trade protection.

7.1 Introduction

There are differences in natural endowment among countries. Some countries are more endowed with fertile soil, good climatic conditions, large quantities of mineral deposits, chemicals, potential human resources, etc. This uneven distribution of resources among countries or geographical regions tends to lead to some degrees of specialisation in production. Therefore, it becomes imperative that countries exchange commodities among themselves to curb the problem of self-insufficiency and this leads to international or foreign trade.

This chapter shall examine the definition and types of international trade, differences between international and domestic trade, the advantages and disadvantages of international trade and factors that influence terms of trade.

7.2 Meaning of International Trade

International trade, which is also called foreign trade or external trade, is the exchange of goods and services between two or more countries. It involves the trade activities of people, firms and governments across international boundaries.

7.3 Types of International Trade

There are two types of international trade and they are as follows:

(a) Bilateral international trade: This is the exchange of goods and services between only two countries. This occurs when a country is balancing its payments and receipts with every other country individually and separately from others, e.g., trade between Nigeria and Ghana.

(b) Multilateral international trade: This is the exchange of goods and services among many countries. This type of trade takes place when countries are perfectly free to trade with one another and international division of labour is allowed to operate at optimum.

7.4 Differences between Domestic and International Trade

Domestic trade is the form of trade that is carried out internally and involves free flow of goods and services within a country. It is the trade conducted within the home of people who are the producers and buyers themselves. While international trade is the trade across the boundary of a particular country. Here, the trade is foreign or external, involving different nationalities and the use of different currencies and languages. Below is a clear distinction between the two trades.

Table 7.1 Differences between Domestic and International Trade

Domestic Trade	International Trade
Currency: The same currency is used.	It involves the use of different currencies.
Distance: The distance covered is relatively small and the transport system is fast, less expensive and less risky.	It involves long distance and the means of transport is more expensive. Further, it has a higher level of risk.

Commercial policy: Movement of goods and services is free and unrestricted because it is controlled by one government.	There are restrictions on the movement of goods and services since various governments are involved in the trade.
Competition: There is protection of manufacturers from foreign competition by the imposition of duties and import quotas.	Manufacturers usually face competition from producers of other international markets
Language: This is usually not a barrier because local language or dialect may be used.	Different countries have different languages and it is most of the time a barrier to trade. This may lead to employment of interpreters or specialists to read labels or instructions.

7.5 Reasons for International Trade

The reasons why countries are involved in international trade is based on the benefits that they derive from it. The following are some of the benefits derived from international trade:

(a) Securing commodities and services that a country could not have produced for themselves.

(b) Concentrating on activities in which they seem most efficient and their exchange of commodities with those countries that have already become specialists.

(c) Due to specialisation, productivity is increased and greater skills acquired, thus leading to greater resources development.

7.6 Theory of Comparative Cost

The law of comparative cost advantage states that the world output will be increased if a country specialises in the production of those commodities or services for which the comparative cost is lowest and for which that country can produce the commodity cheaper than other countries. The law of

comparative cost advantage provides a mode on which foreign trade is based. But it relies on certain principles based on which it has the following assumptions:
(a) Two countries and only two commodities are involved.
(b) Labour is the only factor of production, while wages are considered to be constant.
(c) There is perfect competition, assuming that marginal cost equals marginal revenue.
(d) Both countries have fully developed the resources chosen, such that further development of one could lead to a reduction in the other.
(e) There is perfect mobility of resources within each country so that production could be shifted from one of the commodities to the other without problem.
(f) There exists a balance of trade between the two countries.

7.7 Limitations of the Theory of Comparative Cost

The theory of comparative cost advantage has its shortcomings arising from the assumptions we have made so far, and they include the following:
(a) The theory assumes that only two countries are involved but this is not true in the real world of international trade. Sometimes, the countries involved are more than two.
(b) Cost of transportation does not seem to be ideal because there is the tendency not to take into account the large transportation costs involved in trade. Instead of this, emphasis is laid on gain.
(c) The assumption of absence of currency is also unrealistic because currency restrictions and unrealistic monetary policy can affect the smooth running of international trade.
(d) Government interference is also a very important factor that limits or promotes foreign trade. It can neutralize other factors.
(e) The assumption of free mobility of factors of production is also not realistic. Factors of production are not easily transferable from one country to another or even from one industry to another.

7.8 Advantages of International Trade

(a) Variety of goods and services: External trade helps a country purchase goods and services that, under normal circumstances, would not be available in that country.
(b) Specialisation: This enables each country to specialize in the production of goods for which the countryâ€™s resources are most suitable.
(c) Efficiency: It gives countries access to large international markets. This helps industries attain greater productivity by selling both at home and abroad.
(d) Increased standard of living: Producers, because of extended markets, develop modern techniques of production and improve the quality of their products, which in turn increases the standard of living.
(e) Interdependence: International trade makes countries depend on one another for the supply of goods and services which they do not have and

demand for the ones they have.

(f) Economic development: International trade provides foreign technical assistance needed for the execution of development plans, mostly in less developed countries.

(g) Optimum use of resources: The theory of comparative cost advantage ensures the production of goods, where there is cost advantage, therefore engaging the countriesâ€™ resources optimally and avoiding wastages.

7.9 Disadvantages of International Trade

(a) Low demand for home-made goods: In less-developed countries, international trade encourages the flow of goods from developed countries. This in turn leads to lack of demand for locally made goods, especially for countries that do not apply protective measures.

(b) Unhealthy specialisation: The major principle of foreign trade is specialization, which involves opportunity costs. Countries specialize in the production of goods for which they have comparative cost advantage and forego the production of other goods that might be of more importance to them. Most less developed countries remain as producers of primary commodities, while industrialised
countries continue to remain as manufacturers.

(c) Discourages infant industries: Most of the infant industries may not be able to compete favourably with imported goods that serve as substitutes for their goods. These imported goods are, most of the times, cheaper and of a higher quality than those of the infant industries.

(d) Importation of dangerous products: International trade enhances the bringing in of dangerous and negative products from one country to another. Such products include firearms, alcohol, hard drugs, pornographic materials, etc.

7.10 Commodity Terms of Trade

The terms of trade show the rate at which a countryâ€™s exports are exchanged for imports.

A countryâ€™s commodity terms of trade show the ratio between her imports and exports.

This means that the comparison between the commodities involved in international trade will depend upon the prices of the exports and imports.

To measure the terms of trade, the formula is stated as follows:

Commodity terms of trade =

$$\frac{\text{Index of Export Prices}}{\text{Index of Import Prices}} \times \frac{100}{1}$$

$$\text{or TOT} = \frac{P_X}{P_M}$$

where TOT = commodity terms of trade

P_X = index of export prices

P_M = index of import prices

Favourable terms of trade: The terms are favourable if the average price of exports is higher than the average price of imports. This means that such a country receives much money from her exports than she pays for her imports. In calculation, the index terms of trade will exceed 100. The advantage is an increase in the real national income, leading to better standard of living.

Unfavourable terms of trade: The terms of trade become unfavourable if the average import price is higher than the average export price. Thus, such a country receives less money from her exports compared with what she pays for her imports. In calculation, the index terms of trade will be less than 100. This will lead to a reduction of the real national income and a decline in the standard of living.

7.11 Factors Influencing Terms of Trade

(a) Forces of demand and supply: If the demand for a countryâ€™s exports is high and the demand for her imports is low, the country will likely have favourable terms of trade and vice versa.

(b) Nature of production: Countries whose main export items are primary products are more likely to have unfavourable terms of trade, while those who export manufactured products are more likely to have favourable terms of trade.

(c) Availability of substitutes: If the demand for a countryâ€™s exports has no close substitutes, such a country will probably favourable terms of trade. On the contrary, importers may switch on to other countries that are producing similar goods. By this process, the affected country may, at the end, experience unfavourable terms of trade.

(d) External economic policies: Sometimes, external economic policies pursued by a government can affect that countryâ€™s terms of trade, e.g., effects of import tariffs, devaluation, monetary and fiscal policies, etc.

7.12 Foreign Trade Protection

Countries make use of commercial policies to protect themselves from the adverse effects of international trade. These commercial policies refer to all the actions of the government of a particular country designed to affect that countryâ€™s trade relations with other countries of the world.

Objectives and Instruments of Foreign Trade Protection

Main instruments of commercial policies include direct control, tariffs, quota, custom duties, exchange control relations, subsidies, etc. Each instrument has a specific objective to achieve within a given period of application.

(a) Prohibition of imports: This refers to the prohibition of import of certain items or commodities from a particular country by law or device. Such a measure is used to either protect the domestic industries or guard the economy.

(b) Restriction of imports: Sometimes, instead of prohibition, the law may require importers to obtain licenses for importation of certain items or goods only. At other times, government may appoint agents or corporations to

engage in trade on her behalf.
(c) Quotas: This system refers to the fixing of limits on the maximum quantity of commodities that a country can import from another country within a given period. Here, licenses have to be obtained to help control the quota allocation based on permission to supply goods.
(d) Custom duties: Tariffs are usually imposed on imported commodities as a protective measure, for revenue yielding purpose or retaliation against other countries.
(e) Exchange control system: The purchase and sale of foreign exchange in most cases is restricted or controlled by the government. By such restrictions, government requires importers to obtain foreign currency through application from central bank or any other institution designed to implement government policy on foreign exchange control.

7.13 General Objectives of Trade Protection

(a) Protection and encouragement of infant industries: This is achieved by restricting or controlling importation of goods by using import duties.
(b) Revenue generation from taxes: Government generates revenue through import and export duties.
(c) Improvement on the balance of payments: This depends on the nature of disequilibrium in the balance of payments. Increase in tariffs for imported products will discourage importation to help balance the accounts and vice versa.
(d) Stimulation of capital inflow: This can be achieved from foreign investors who want to invest in the country. They also look out for the measures adopted by the government of the country they want to invest in.
(e) Avoidance of dumping: Dumping refers to the selling of commodities in foreign countries at prices below the normal value. The objective mostly is to help the growth of infant industries and prevent the balance of payments disequilibrium.
(f) Self-reliance: Each country nowadays struggles to be self-reliant or self-sufficient in order to safeguard national interest. They, therefore, try to restrict importation of certain items and produce them for their local consumption.

7.14 Balance of Trade

Balance of trade is the relationship between the value in totality of a countryâ€™s visible imports and the value in totality of its visible exports within a given period of time. This implies the relationship between the value of goods that a country sold out and the value of goods the same country bought from outside countries within a period of one year.
A country is said to have a balance of trade when the value of the goods sold out to other countries is equal to the value of goods the country bought from other countries.
This means that payment for visible imports is equal to receipts from visible exports. The balance of trade becomes negative or unfavourable when the value paid for its imports is greater than the value received from its visible

exports. On the other hand, when the total value received from its exports is greater than the total value for its imports, the country can be said to have a favourable or positive balance of trade.

Summary

â€¢ **International trade or external trade:** This is the exchange of goods and services between two or more countries.
â€¢ **Bilateral international trade:** This is the exchange of goods and services between only two countries.
â€¢ **Multilateral international trade:** This is the exchange of goods and services among many countries.
â€¢ **Domestic trade:** This is the form of trade carried out internally and that involves a free flow of goods and services within a country. It is the trade conducted within the home of people who are producers and buyers themselves. While international trade is the trade across the boundary of a particular country.
â€¢ **The law of comparative cost advantage:** This states that the world output will be increased if a country specialises in the production of those commodities or services for which the comparative cost is lowest and for which that country can produce the commodity cheaper than other countries.
â€¢ **Advantages of international trade**
Variety of goods and services are derived, specialisation in production is easy, efficiency in production, increased standard of living, interdependence in goods and services, economic development and optimum use of resources
â€¢ **Disadvantages of international trade**
Low demand for home-made goods, unhealthy specialisation in production, discourages infant industries and importation of harmful products into the economy
â€¢ **Terms of trade:** It shows the rate at which a countryâ€™s exports exchange for imports.
â€¢ **Commodity terms of trade:** It shows the ratio between a countryâ€™s imports and exports. The terms of trade become favourable if the average price of exports is higher than the average price of imports. The terms of trade become unfavourable if the average import price is higher than the average export price.
â€¢ **Factors influencing terms of trade**
Forces of demand and supply, nature of production, availability of substitutes and external economic policies.
â€¢ **Instruments of foreign trade protection**
Prohibition of imports, restrictions of imports, introduction of quotas, custom duties and exchange control system.
â€¢ **Objectives of trade protection**
Protection of infant industries, revenue generation, improving of balance of payments, stimulation of capital flow, avoidance of dumping and self-reliance.
â€¢ **Balance of trade:** It is the relationship between the value in totality of a countryâ€™s visible imports and the value in totality of its visible exports within a given period of time.

Class Activities
1. The teacher should ask students to list out Nigeriaâ€™s major exports and imports. The class should agree or disagree on the list of export commodities.
2. The teacher should ask students to discuss the differences between domestic trade and international trade. They should also, however, note their similarities.

Revision Questions
Objective Questions
1. Trade among nations is desirable because it:
(a) Enables people in a country to know those in other countries
(b) Makes it possible for people in a country to enjoy the goods and services produced in other countries
(c) Enables residents of a country to understand the language of residents in other countries
(d) Makes it possible for a country to have the currencies of other countries **(SSCE 2008)**
2. Balance of payments surplus implies that the value of a countryâ€™s:
(a) Exports exceeds its imports
(b) Imports exceeds its exports
(c) Exports is equal to imports
(d) Terms of trade is constant **(SSCE 2008)**
3. Terms of trade may be defined as the
(a) Trade between one country and another
(b) Relationship between countryâ€™s receipt from others and payment to others
(c) Rate at which a countryâ€™s exports exchange for imports
(d) Difference between the value of exports and imports **(SSCE 2009)**
4. The terms of trade is described as unfavourable when:
(a) The price of imports rises relative to that of exports
(b) The price of exports rises relative to that of imports
(c) The net income from abroad does not change
(d) The value of exports exceeds that of imports **(SSCE 2009)**
5. Dumping means the selling of goods in a foreign market at a price that is:
(a) Below the home market price
(b) Above the home market price
(c) Equal to the home market price
(d) Able to clear the home market price **(SSCE 2010)**
Essay Questions
1. Explain each of the following terms:
(a) Export promotion
(b) Depreciation
(c) Terms of trade
(d) Balance of trade **(SSCE 2004)**
2. In what ways is foreign trade different from domestic trade?

3. Distinguish between absolute advantage and comparative advantage and use the latter to illustrate the basis for international trade.
4. (a) Explain the term â€˜balance of payments deficitâ€™.
(b) What four measures can be taken to reduce the â€˜balance of payments deficitâ€™ of a country? **(SSCE 2005)**

Glossary

International trade: This is also called foreign trade or external trade, and it is the exchange of goods and services between two or more countries.
Commodity terms of trade: The terms of trade show the rate at which a countryâ€™s exports exchange for its imports.
Favourable terms of trade: The terms are favourable if the average price of exports is higher than the average price of imports.