International Trade

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AS Economics

International Trade and its Significance

- Commercial exchange of goods and services that takes place between two and more sovereign countries is known as International Trade.
- Since as international community we are faced with basic economic problem of scarcity, we definitely need to make the best possible use of available world resources to maximize living standards across the globe.

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International Trade and its Significance

- Since international trade is mutually beneficial for participating economies; open economies generally experience higher economic growth and development as compared to closed economies.

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Important Definitions

- Open Economies: Economies that are open to international trade and make limited use of protectionist polices (economic instruments that restrict free international trade)
- Closed Economies: Economies that are NOT open to international trade and hence make substantial use of protectionist policies.

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Important Definitions

- **Balance of Payments**: An official document that records all international transactions of an economy with the rest of the world.
- **Productivity:** The ratio of output to input for any production process, business or economy (Output / Inputs).
- **Factor Endowments**: The quantity and quality of resources available to an economy.

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Why economies should promote International Trade?

- Though the slogan "Be Pakistani Buy Pakistani" might sound very appealing and logical but it has no economic justification.
- Though preferring Pakistani products over foreign products would result in higher domestic demand and hence national income but it will be even higher if our country engages in international trade.

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Why economies should promote International Trade?

- Since economies have unique factor endowments (factors of production) that favor production of certain type of goods/services; economies' specialization in those products will make them earn higher export revenue and benefit from consumption of cheaper foreign products for which their factor endowments are not very suitable.

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Examples of Economies' Specialization Patterns

- Pakistan being large country with huge amount of agricultural land can produce variety of agricultural products at lower costs and hence will benefit from exporting these products as opposed to specializing in manufactured goods which other countries of the world are more efficient in producing.

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Examples of Economies' Specialization Patterns

- A major proportion of total world production of manufactured goods like cell phones, cars etc is taking place in economies that have low costs for producing such products like China, India, Brazil, Russia.

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Theories explaining pattern of International Trade

- What theories explain which countries will export / import which products?

Example: What economic justification supports Pakistan's specialization in production of agricultural goods? Similarly why a lot of foreign companies are locating their production plants in China, India, Brazil etc?

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Absolute and Comparative Advantage

- Absolute Advantage: When a country can produce larger quantity of certain good it is said to have Absolute Advantage in production of that good.

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- Comparative Advantage: When a country can produce certain good at lower opportunity cost as compared to another country it is said to have Comparative Advantage in production of that good.

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Absolute and Comparative Advantage

- Economies will have comparative advantage in production of goods/services for which their factor endowments are more suitable. For instance Pakistan can be said to have Comparative Advantage in production of primary goods. Similarly Japan has Comparative Advantage in production of consumer goods etc.

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Assumptions of Absolute and Comparative Advantage Models

1. 2 countries with fixed resources are trading between themselves

2. Each of these two countries are producing the same 2 products like clothing and cheese etc.

3. The production possibility frontiers are linear meaning countries opportunity cost of producing one good in terms of other good is constant.

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Assumptions of Absolute and Comparative Advantage Models

4. There are no transportation costs of moving the goods from one country to another. Or these costs are low to be negligible.

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Assumptions of Absolute and Comparative Advantage Models

5. There are no trade restrictions
   - countries do not use protectionist policies to restrict international trade.

6. No currency is being used for trade and economies rely on barter system for exchange of goods.

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When is international trade beneficial for countries involved in it?

- Whenever the exchange rate of goods is between the domestic opportunity cost ratios of trading countries, trade will be economically beneficial for both countries.
- We will verify this in upcoming examples.

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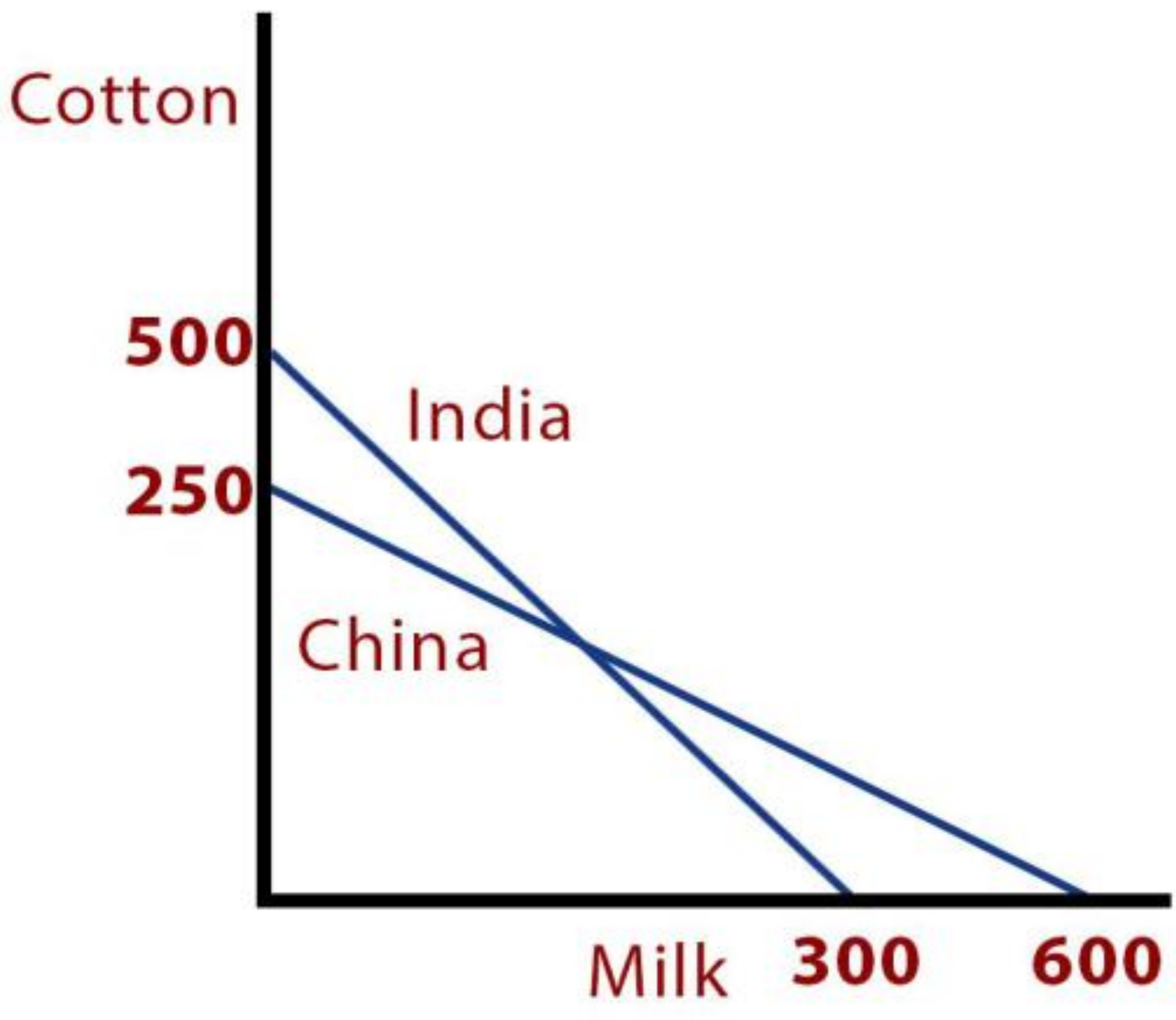
Absolute Advantage



Absolute Advantage

- if it allocates all of its resources towards production of Cotton India can produce larger quantity of Cotton as compared to China hence India has Absolute Advantage in the production of Cotton.

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- Similarly because China can produce larger quantity of Milk if it allocates all of its resources towards production of Milk hence China has Absolute Advantage in production of Milk.

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Absolute Advantage – Analysis

- Each country should specialize in the product in which it has Absolute Advantage.
- The surplus output produced should be exported to the other country to get the other product not produced by your country.
- Like in the previous example India should specialize in Cotton and China should specialize in Milk, export the surplus and get the other product from the other country.

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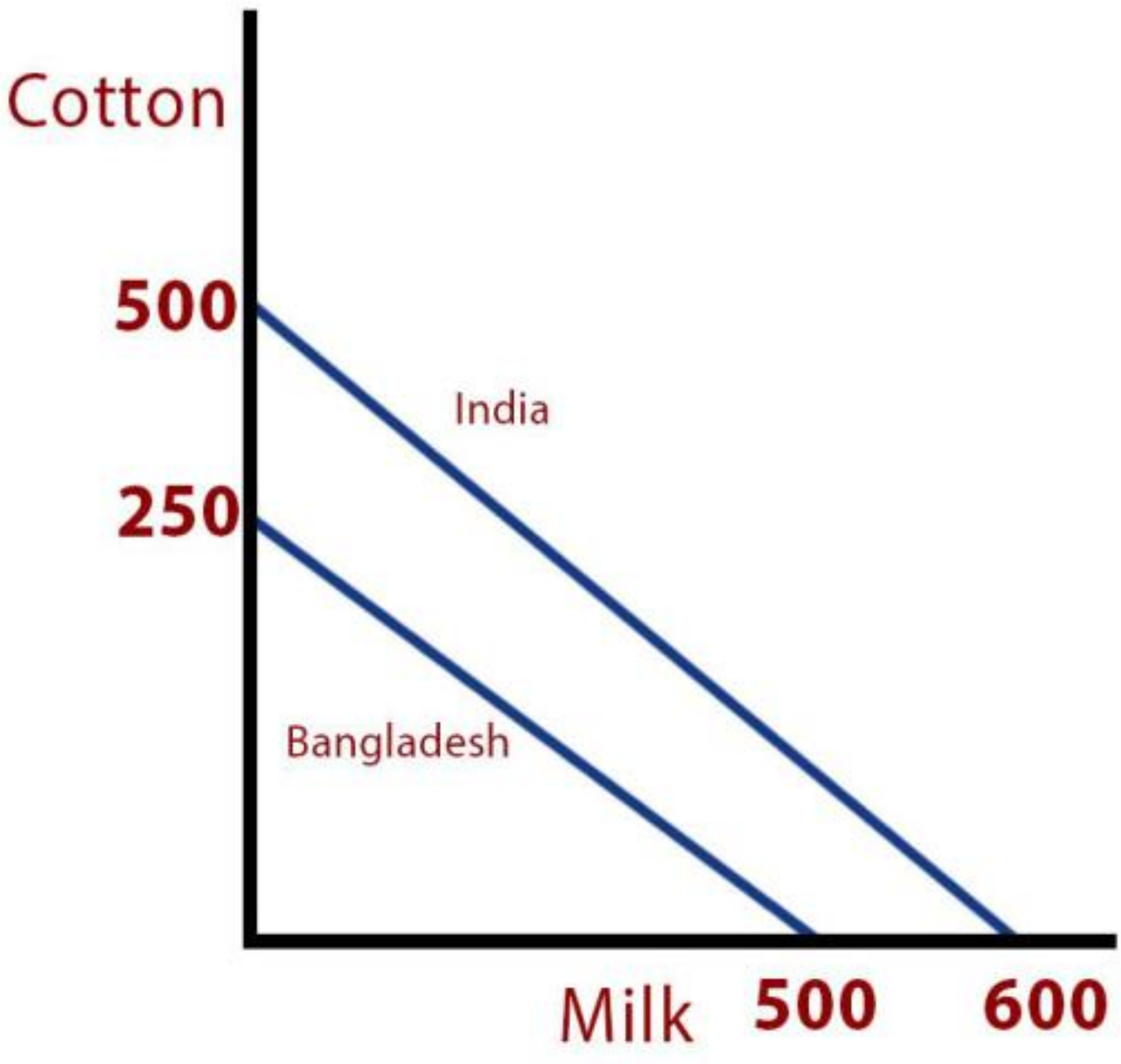
Absolute Advantage – Limitation



Absolute Advantage – Limitation

- As can be seen from the diagram in the previous slide, India has Absolute Advantage in the production of both Cotton and Milk.

- In this case, Absolute Advantage fails to explain which product should each country specialize in. Hence for such cases we need to rely on Comparative Advantage.

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Absolute Advantage – Analysis

Comparative Advantage – Calculation of Opportunity Cost Ratio

Step 1

	Cotton	Milk
India	500	600
Bangladesh	250	500

Step 2

	Cotton	Milk
India	500/500	600/500
Bangladesh	250/250	500/250

Step 3

	Cotton	Milk
India	1	1.2
Bangladesh	1	2

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Comparative Advantage – Calculation of Opportunity Cost Ratio

- As can seen from the calculation in the previous slide, to produce 1 unit of Cotton India needs to give up 1.2 units of Milk.
- On the other hand, to produce 1 unit of Cotton Bangladesh needs to give up 2 units of Milk.

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Comparative Advantage – Calculation of Opportunity Cost Ratio

- Since India's opportunity cost to produce Cotton is less than Bangladesh hence as per the Comparative Advantage analysis India should specialize in the production of Cotton and Bangladesh will then obviously specialize in the other product which is Milk.

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Absolute versus Comparative Advantage

- Where Absolute Advantage is based upon competitive advantages – ability of an economy to produce larger quantities of certain goods; Comparative Advantage is based upon economies' opportunity cost of production.

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Absolute versus Comparative Advantage

- Absolute Advantage refers to the idea that economies should specialize in goods that they can produce in larger quantities. On the other hand Comparative Advantage refers to the idea that economies should specialize in goods for which they have lower opportunity cost.

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Types of Protectionist Tools / Trade Barriers

- Tariffs: An indirect tax imposed on imported goods / services. Just like any indirect tax, it can either be of specific amount imposed on each unit of product or it can be Ad Valorem meaning a percentage of selling price is charged as tax.

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Types of Protectionist Tools / Trade Barriers

- Governments make imported goods expensive by artificially increasing their prices through taxation. This encourages any country's citizens to buy locally manufactured goods that would now become relatively

  cheaper compared to
imported products.

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Types of Protectionist Tools

- Quotas: The maximum quantity of any good / service that can be imported in any economy. This is a restriction on the quantity of the good that can be imported in any economy. Only producers or consumers who have the Quota rights can import that product.

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Types of Protectionist Tools

- Exchange Control: The limit of local currency that can be exchanged for foreign currency by any citizen of any economy. Lesser the foreign exchange possessed by individuals and businesses, lesser will be their imports.

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Types of Protectionist Tools

- Export Subsidies: Subsidies provided by government to local exporters. Other protectionist tools that we have looked at make foreign products less competitive in domestic markets by either increasing their prices or by limiting their quantity, export subsidies on the other hand make local products more competitive by reducing their price.

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Types of Protectionist Tools

- Unlike other protectionist tools like tariffs that increase government revenue through taxes, export subsidies require government expenditure and so can be quite costly of a policy to operate.

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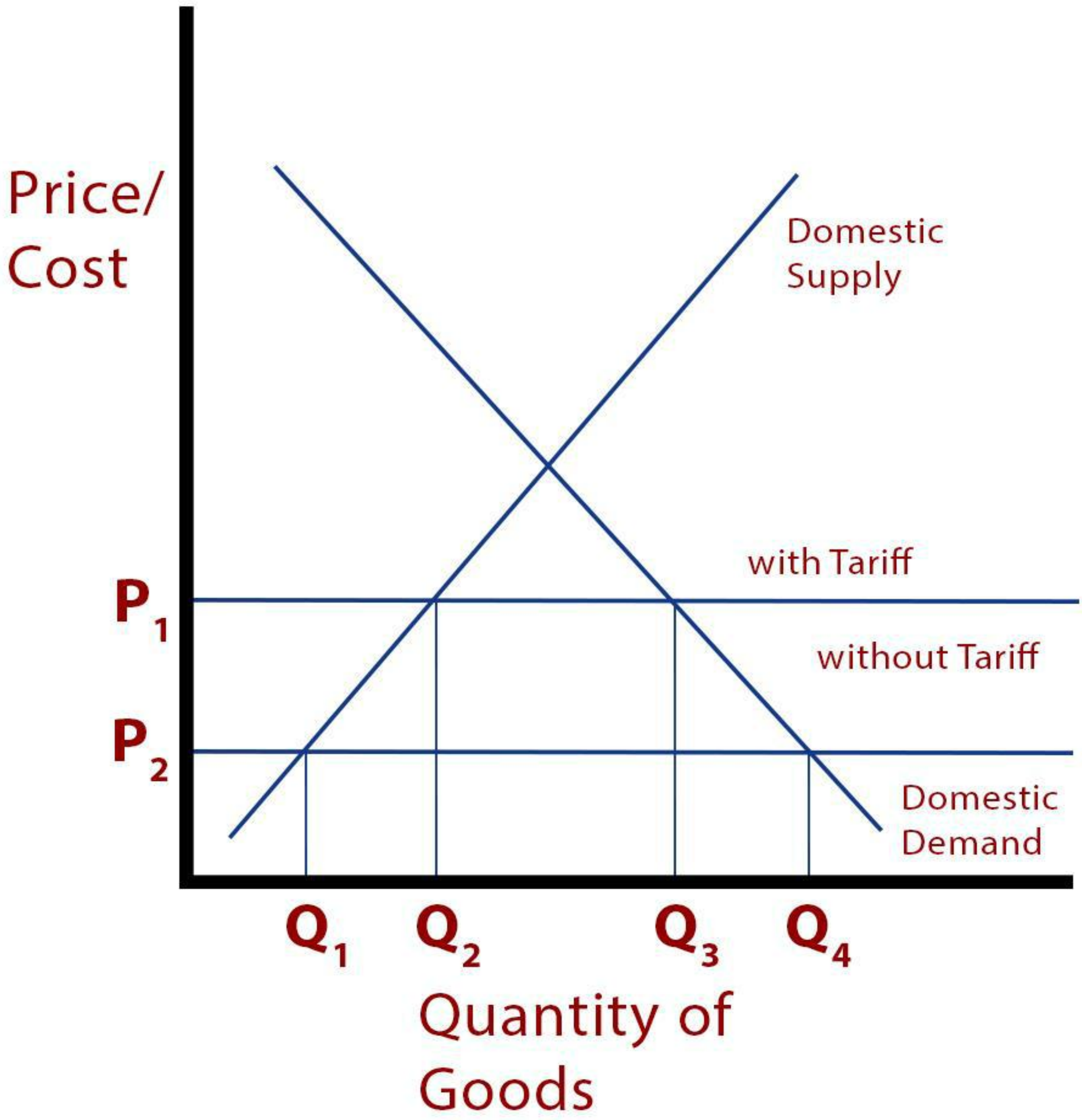
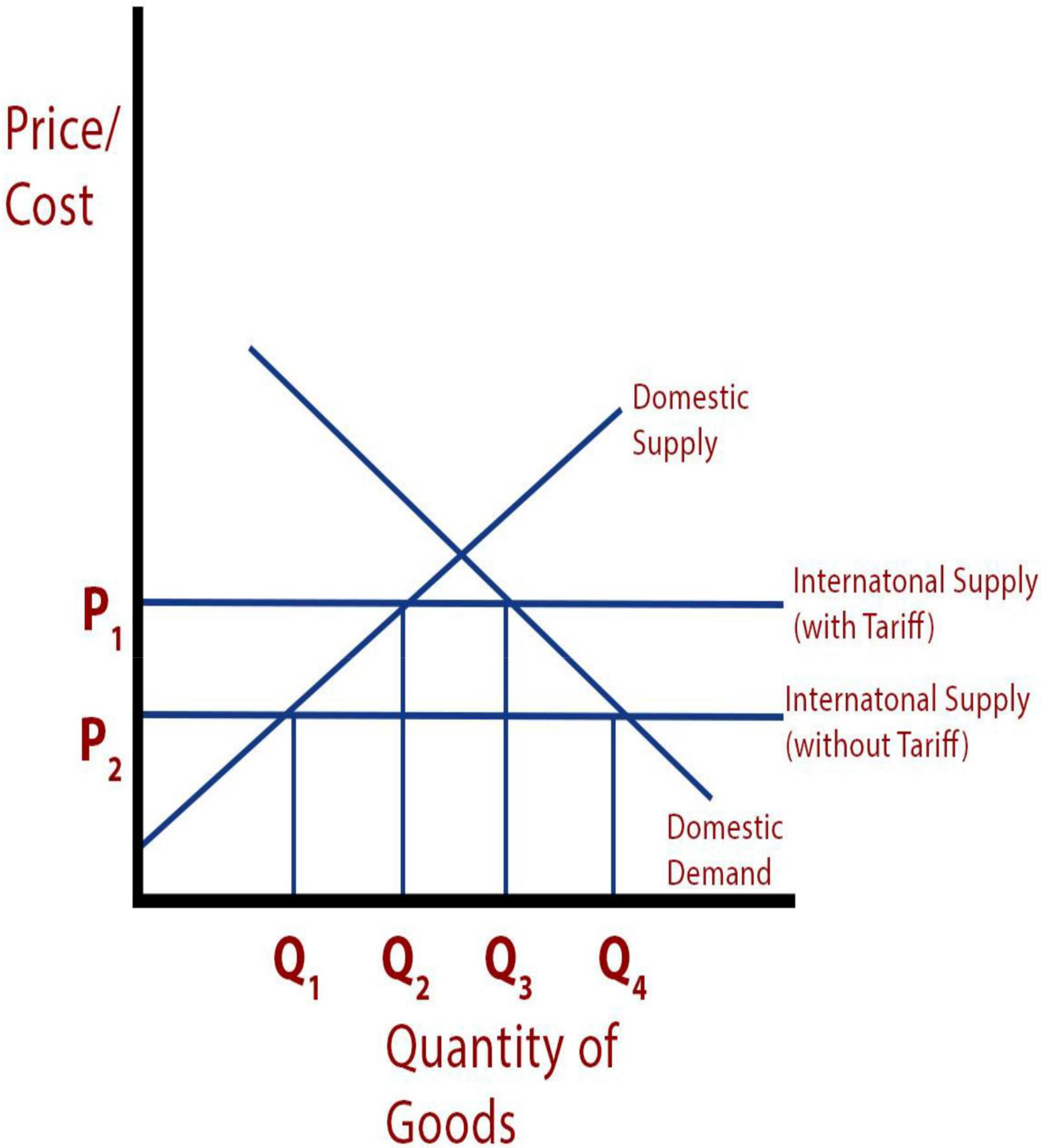
Tariffs



Price/
Cost
Domestic
Supply
with Tariff
without Tariff
Domestic
Demand
P1
P2
Q1
Q2
Q3
Q4
Quantity of
Goods

Tariffs



Price/
Cost
Domestic
Supply
Internatonal Supply
(with Tariff)
Internatonal Supply
(without Tariff)
Domestic
Demand
P1
P2
Q1
Q2
Q3
Q4
Quantity of
Goods

Tariffs

- Initially without tariff the quantity of imports was Q4 minus Q1.
- Later after tariff when the international supply curve shifted upwards the quantity of imports reduced to Q3 minus Q2

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Arguments in Favor of Free Trade

- Consumers can buy cheap imported products: If imported goods are cheap and / or are of higher quality then consumers living standards will be higher by consuming these imported products.

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Arguments in Favor of Free Trade

- More competition for local businesses: in absence of competition from foreign businesses in terms of threat of better quality imported goods capturing a bigger chunk of local market the local businesses will feel the pressure to improve the quality of their products and to offer more affordable prices to consumers.

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Arguments in Favor of Free Trade

- It is more economically efficient for any country to specialize in production of products in which it has Absolute or Comparative Advantage and import the other products at relatively cheaper prices.

- Other countries will not retaliate against your trade policies by imposing protectionist policies on your exports.

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Arguments in Favor of Protectionism

- Though economics strongly advocates for free trade however sometimes it might not be very beneficial for economies and therefore they might choose to restrict free trade using protectionist policies.
- Some major arguments in favor of protectionism are mentioned in following slides.

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Arguments in Favor of Protectionism

- To correct Balance of Payments (BOP) Deficit: Balance of Payments deficit refers to a situation when a country's import expenditure is greater than its export revenue. And if country's BOP deficits persists for long time periods then it is more severe of an economic problem that can be addressed to some extent by restricting imports using protectionist policies.

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Arguments in Favor of Protectionism

- To prevent exploitation of labor in developing countries: There has been instances when multinational companies have been found guilty of exploiting labor in developing countries by giving them less then minimum wage and less than safe working environments.

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Arguments in Favor of Protectionism

- Some people argue that cheaper imported goods indicate labor exploitation and so advocate for restricting goods from countries which are found to be exploiting labor including cases of child labor.

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Arguments in Favor of Protectionism

- However not in every case lower prices of imported goods are indicative of exploitation and instead in some cases it might be because of exporting countries Absolute or Comparative Advantage.

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Arguments in Favor of Protectionism

- To avoid Dumping: Dumping is when exporting country is charging lower price in foreign countries than their home country or are selling the good at less than its cost of production. This business strategy is intended to destroy the local competition and form a monopoly in the long term

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Arguments in Favor of Protectionism

- Developed economies often **restrict imports** from developing economies accusing them of dumping practices.
- This **illicit competitive practice is dangerous** for local market that can cause small local firms to exit the industry and therefore can result in lower national income for the economy.

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Arguments in Favor of Protectionism

- To safeguard Infant Industries: protecting newly established industries is an economic priority for countries for these industries are expected to contribute to the country's GDP in the future and a source of government revenue in the form of taxes.
- These newly established industries – infant industries – in their inception years do not have the potential to effectively compete with larger well established foreign rivals and therefore require protection.

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Arguments in Favor of Protectionism

- However infant industries should not be protected forever because it will eliminate the pressure for local businesses that arise from foreign firms to become more competitive.

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Economic Integration

- Greater economic integration – more free trade among countries – has substantially benefitted the world economy through more productive use of world's resources and has also massively contributed to the process of globalization.

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Economic Integration

- Economic Integration: is referred to as greater economic interdependence of world economy which arises from increased international trade. In simple words since countries do not produce everything that their citizens need for consumption they need to reply on other countries to import these products.

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Regional Trading Blocs

- Regional Trade Bloc is when 2 or more countries agree to form some sort of free trade agreement among member countries.
- Though regional trading blocs are not as beneficial as absolutely free trade but these trading blocs are definitely better than closed economies that do not engage in free trade.
- Depending upon the economic characteristics of trading blocs, they are classified into different categories.

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Free Trade Area

- **Free Trade Area:** This type of economic integration promotes free trade among member countries and does not impose any restrictions on member countries about their trade agreements with non-member countries as we will see is not the case in Custom Union.

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Free Trade Area

- Removal of trade barriers is slow and systematic process and is either equally applied to all products or to certain type and categories of products.
- North American Free Trade Agreement (NAFTA) is a Free Trade Area that exists between U.S, Mexico and Canada.

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Custom Union

- Customs Union: Apart from free trade arrangement between member countries, this type of trading bloc also applies common external tariff to non-member states.
- This common external tariff discourages potential trading relationships that could have been developed between member and non-member states.

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Custom Union

- European Union (EU) is an example of Custom Union for any import from outside European Union is subject to tariffs.

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Economic Union

- Economic Union: Apart from free trade among member countries and having common external tariff this type of trading bloc also has common currency for its member countries. European Union is an example of Economic Union since the member countries also use the same currency – Euro.

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Economic Union

- Economic Union is the tightest form of economic integration that not only discourages trade with non-member countries but it also promotes greater economic integration through common currency and similar economic policies.

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Economic effects of Trading Blocs

Trade Creation: When trade moves from less efficient to more efficient producers within the member states.

For instance if Germany is more efficient, meaning good value for money, in car manufacturing as compared to other European countries then due to formation of European Union countries will import cars from Germany rather than to make themselves.

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Economic effectcts of Trading Blocs

Trade Diversion: When trade diverts from more efficient non-member countries to less efficient member countries.

For instance if Japanese cars are more efficient but because Japanese products are subject to common external tariff as Japan is not part of European Union then instead of European countries importing from Japan will buy German cars which will be economically inefficient.

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Terms of Trade

- Terms of Trade or TOT as it is sometimes referred is a quantitative measure of countries' competitive advantage concerning their international trade position.
- As mentioned earlier, economies want to increase their Balance of Payments surplus which means export revenue exceeding import expenditure. This economic objective is better achieved when economies' export prices are rising at a faster rate compared to their import prices.

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Terms of Trade

- In literal sense, Terms of Trade is ratio of economy's index of export prices and index of import prices.

TOT = Index of Export Prices / Index of Import Prices

The base year value of TOT is 100. So any increase in value represents improvement in the country's terms of trade and any decrease represents deterioration of country's terms of trade.

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Interpreting the value of Terms of Trade

- Any increase in TOT represents rise in country's export prices faster than the increase in import prices.

- Similarly any decrease in TOT represents import prices rising at a faster rate compared to export prices.

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Factors affecting improvement in Terms of Trade

1. Exchange Rate appreciation
2. Economic Growth
3. Tariff
4. Reciprocal Demand

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Significance of Improving Terms of Trade

- Countries experiencing improving Terms of Trade have higher likelihood of earning Surplus on their Balance of Payments. This is because improved TOT allow economies to sustain their given import expenditure with lesser quantity of exports for now they will receive higher prices for their exports.

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Significance of Improving Terms of Trade

- Countries TOT improve when the prices of their primary exports increase/rise at a faster rate than the increase in their import prices. For instance Pakistan will experience improvement in its TOT when prices of primary commodities like wheat, rice pulses, fruits will rise more than the price hike experienced by imported goods like machinery, electronics etc.

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