What is International Trade?

Trade that takes place between countries is defined as international trade.

Justification of International Trade

1. Human needs are ever increasing and no country has enough resources to produce ***everything on its own*** and therefore they need to rely on other countries to provide them with products that they cannot produce.
2. ***Different countries have different factor endowments*** (the type of resources that a country has): therefore each country is suited for producing certain types of products. Therefore economically it is better for every country to specialize in products that it can produce cheaply and then exchange it for other products for which it does not has the expertise to produce.

Benefits of International Trade

1. When countries specialize in certain products, they produce larger quantities of those goods and therefore they benefit from economies of scale (lower average cost as output increases).
2. Secondly, ***specializing in products for which a country's factors of production*** are more suited allows for more efficient use of resources. For instance, if Pakistan tries producing manufactured goods then it will take us a couple of years before we can be as efficient as countries which have more capital and trained labor whereas on the other hand if we specialize in agricultural products we can produce more with fewer resources.
3. Allows countries to ***earn foreign exchange*** which could be used to pay off country's international debt or buy (import) other products which it cannot produce on its own.
4. Local consumers have more choice like having the choice to choose between locally manufactured phone/cars or imported.
5. ***More competition in the market for local firms***

Models of International Trade

These <u>models explain why countries specialize in products in which they specialize.</u>

1. ***Absolute Advantage:*** a country should specialize in products which it can produce in larger quantities or lower per unit cost.

2. ***Comparative Advantage:*** says that a country should specialize in products which it can produce with lower opportunity cost.

Assumptions of Absolute and Comparative Advantage

1. Only 2 countries who are trading among themselves
2. There are only 2 products which these countries produce
3. There is no currency involved and these countries are using barter system to exchange goods and services
4. That the transportation cost is negligible (very low or non-existent)
5. Factors of production are mobile between the production of the 2 products

Opportunity cost: is the benefit of the next best alternative forgone.

Pakistan	China	India	Bangladesh
$10	$13	$12	$9

Pakistan	***China***	***India***	***Bangladesh***	***Nepal***	***Bhutan***
Agricultural Goods - $50 billion	Cars - $76 billion	Phone - $65 billion	Clothes - $55 billion	Fruits - $56 billion	Tourism - $34 billion
Fruits - $35 billion	Laptops - $56 billion	Consumer electronics - $45 billion	Processed Food - $47 billion	Tourism - $ 49 billion	Electronic gadgets - $32 billion

Economics models are always a simplified version of reality and therefore assumptions help to exclude unnecessary complexities of real life.

Assumptions of Absolute and Comparative Advantage Models

1. There are only 2 countries which are trading among themselves.
2. There are only products that these countries produce.

3. The opportunity cost of producing these 2 products is always fixed.
4. The factors of production of each country are fixed during a certain time.
5. There is no use of currency for international trade and countries use a barter system for exchange of goods and services.

Absolute Advantage: is when a country can produce something at lower cost or in larger quantities it is said to have absolute advantage over the other country.

	Wheat	Cotton
Pak	1 = 2	
China	1 = 3	

Trade Barriers: are economic / financial / legal instruments that discourages or provides one group an unfair advantage over another is defined as a trade barrier.

AD = C + I + G + X - M

1. ***Tariff:*** refer to sales tax imposed on imported goods.
2. ***Embargoes:*** are extreme forms of trade restriction when few countries completely ban trade with another country.
3. ***Red Tape / Unnecessary paperwork:*** when a country makes legal documentation needed for international trade more complicated or strict just to discourage trade
4. ***Quotas:*** restriction on the quantity of the product that could be imported in the country
5. ***Product Standards:*** when countries set high product quality standards and then import products from only selective countries. For instance, European Union does not import any food items from Asia stating that they don't meet their quality / hygiene standards.
6. ***Customs / Duties:*** these are additional taxes imposed on imported goods.
7. ***Export Subsidies:*** are when a country provides subsidies to its local producers to artificially make their products more competitive in relation to other countries exporting the same product.
8. ***Voluntary Export Restraints:*** when a country has a surplus of a product (more production that what the local population can consume) but it decides to not export that or to create an artificial shortage to bid up product price and therefore to make profit in the future is known as voluntary export restraint.

Imported Inflation: it is when due to weaker exchange rate that the cost of importing necessary raw materials increase.

Dumping: as per World Trade Organization (WTO) dumping is defined as when a country exports a product in another country at lower than its cost of production or even lower than the price it charges in its home country.

Dumping is the only justification accepted by the WTO for countries using trade barriers.

Trading Blocs

It is when 2 or more countries sign an agreement removing trade barriers to encourage international trade among themselves.

Following are the 3 most common types of Trading Blocs

1. ***Free Trade Agreement:*** the agreement through which countries remove all or most of trade barriers with the other countries that they are signing the agreement with.

Free Trade agreement does not restrict a country from signing a similar trade agreement with any other non-member country. NAFTA (North American Free Trade Agreement)

2. ***Custom Union:*** is when member countries sign free trade agreement (just as explained above) but in addition to this they also have to impose a common external tariff (a fixed rate of tariff on all products being imported from non-member countries) on non-member countries.
   In this case you are encouraging trade with member countries but are also discouraging trade with non-member countries.
3. ***Economic Union:*** it is when you sign a free trade agreement with member countries, impose a common external tariff on non-member countries, remove restrictions on movement of labor and capital within the memberl and use the same currency with one central bank.

There are 2 major consequences of Trading Blocs namely Trade Creation and Trade Diversion.

Trade Creation: is the positive effect of a trading bloc in which after the free trade agreement the *trade moves from higher cost member country to lower cost member country.*

Trade Diversion: is the negative effect of trading bloc in which the *trade moves from a lower cost non-member country to a higher cost member country.*

Pak signed a custom union with other Asian countries
Japan is not part of it. However, Japan can produce cars at the lowest possible cost.

(b) Discuss how well comparative advantage explains the pattern of international trade. [12]

Define Comparative Advantage
Make a graph -

When a country can produce something with lower opp cost that is the product in which it has comparative advantage.

Pakistan can produce agricultural products with lower opp costs since our resources are not very well suited for production of manufacturing and services.

On the other hand, developed countries like UK, US can produce services at lower opp cost since their resources are not well suited for production of agricultural therefore these countries will not give up much on agricultural products if they focus on services.

However,

1. In real world international trade is based on couple of more factors rather than just comparative advantage
- Political ties (free trade agreement)
- Exchange rate
- Closeness towards other country
- Price and quality of the good

Rule: since the 2 countries in absolute and comparative advantage model are relying on barter and not using currency for buying goods and services, therefore the rate of exchange needs to be determined to know how much a unit of a product would cost a country in terms of another product.

This rate of exchange of goods is always between the domestic opportunity cost ratios.

(a) Compare the aims and features of a free trade area with those of an economic union. [8]

(b) Discuss whether an improvement in a country's terms of trade always works to its benefit. [12]

a) Define free trade areas and define economic union

Free trade area is an agreement between 2 or more countries through which they remove all trade barriers and decide to trade freely among themselves.

Economic union

Trading Bloc

1. Free trade agreement: no trade barriers
2. Custom Union: no trade barriers + common external tariff for non-member countries
3. Economic Union: no trade barriers + common external tariff for non-member countries + same currency + free movement of labor and capital between member countries

b) ***Terms of Trade*** = Index of Export Prices / Index of Import Prices

ToT captures a country's trade competitiveness by the fact that how fast its export prices are rising in relation to its import prices.

With improvement of TOT with the same quantity of exports a country would be able to finance more imports.

Your exchange rate is appreciating: yes and no