

WEEK 12: INTERNATIONAL TRADE

International trade arises simply because countries differ in their demand for goods and in their ability to produce them. On the demand side, a country may be able to produce a particular good but not in the quantity it requires. On the supply side, resources are not evenly distributed throughout the world. One country may have an abundance of land while another may have a skilled labour force. Capital, oil, mineral deposits, cheap unskilled labour and a tropical climate are other factors possessed by different countries in varying amounts. There are two concepts under international trade. In order to distinguish between these two concepts, we **assume**:

1. **There are only two countries**
2. **There are only two products**
3. **No transportation charges**
4. **No government intervention**
5. **Factors of production are mobile**

Two concepts:

- a. **Absolute advantage**
- b. **Comparative advantage**

Absolute Advantage

“A country (region, individual) has an absolute advantage in the production of a good if it can produce that good with fewer resources (less land, labour and capital) than other countries (or regions or individuals)”

For example: Country Y can produce cars more cheaply than country X but country X can produce wheat more cheaply than country Y. In these circumstances, country Y is said to have absolute advantage in cars and country X an absolute advantage in wheat.

	Wheat	Cars
Country X	20	5
Country Y	10	10
World Total	30	15

By Specialisation

	Wheat	Cars
Country X	40	-
Country Y	-	20
World Total	40	30

Both countries can produce more output when country X specializes in producing wheat while country Y specializes in producing cars.

Comparative Advantage

A country has a comparative advantage in the good that it can produce relatively cheaply i.e. at lower opportunity cost than its trading partner.

In comparative advantage, the country that has advantages to produce both products should produce both the products, but more of the product which has more advantages.

The principle of comparative advantage can be shown by an arithmetical example. It is now assumed that country X is more efficient in the production of both lorries and wheat. If each country devotes half of its resources to each industry, the assumed production totals are as shown below:

	Wheat	Lorries
Country X	200	20
Country Y	150	10
World Total	350	30

In country X, opportunity cost for producing 1 lorry is 10 tonnes of wheat, while, in country Y, opportunity cost for producing 1 lorry is 15 tonnes of wheat. Therefore, country X has a comparative advantage in the production of lorry. Country Y has a comparative advantage in producing wheat because the cost of wheat is cheaper in country Y.

By Specialisation

	Wheat	Lorries
Country X	-	40
Country Y	300	-
World Total	300	40

But the total world output of wheat decreases after specialisation than before specialisation. This is seen from the notes mentioned above. Therefore, country X should produce 80% of lorries and 20% of wheat. This will result in the following figures:

	Wheat	Lorries
Country X	120	32
Country Y	300	-
World Total	420	32

Advantages of international trade**1. More varieties of goods and services**

International trade enables the people of a country to enjoy a greater variety of commodities. For some countries, international trade may even be a matter of survival because they do not have the required factors of production and technology to produce all the basic needs. These countries need to import good stuff and their essential materials for their economic well being.

2. A wider market

International trade opens up the world as a potential market for the products of a country. A wider market means greater demand, and thus more production for the country. The increase in aggregate demand will raise the level of income and employment in the economy.

3. An increase in efficiency in production (specialisation and large scale of production)

When countries concentrate on the production of goods in which they are best suited to produce, they will be much better off. This is because they will become more efficient and be able to produce more and better goods with the same amount of resources. Large scale of production is encouraged which, in turn, will lead to a greater use of sophisticated machinery and equipment. The end result is an increase in productivity.

4. **Economies of scale**
Economies of scale can be obtained through large-scale production. Unit cost of production will fall. With greater output and increased foreign sales, ceteris paribus, the national income of a country can be expected to be larger.
5. **Economic development**
Countries which lack essential raw materials can acquire them through imports. This encourages industrial development and leads to efficient utilisation of scarce economic resources.
6. **Economic allocation of world resources**
Economic resources are scarce and some are exhaustible. International trade and specialisation allow each country to produce the goods and services that it is best suited to produce, and to trade these for the goods and services that it is not able to produce, or can only produce at high cost. International specialisation and trade, therefore, will lead to the most efficient allocation of world resources and provide participants with higher standards of living.
7. **Beneficial political links**
8. **Opportunity to create new product**

Disadvantages of international trade

1. **Unfair / greater competition**
International trade exposes home industries to foreign competition, and it has been argued that foreign competition keeps the home producers on their toes. But more often, unfair competition persists, and this gives rise to the infant industry and the employment argument for protection.
2. **Exhaustion of raw materials**
An exhaustion of irreplaceable materials and minerals of a country may result from international trade. For example, it has been argued that free trade which resulted in the export of agricultural commodities from America has led to the exhaustion of the soil. Similarly, natural resources such as coal, iron ore, manganese and petroleum are exhaustible materials. The depletion of natural resources will seriously affect the economy of the exporting country. This accounts for the 'conservation of natural resources' argument for production.
3. **Over dependence on other countries**
International trade makes a country dependent upon other countries. For example, if a country specializes in certain selected commodities, its economic well-being depends upon the fluctuations in world demand for its products. Furthermore, in

times of war when goods cannot move freely, the economic life of the country may even be paralysed.

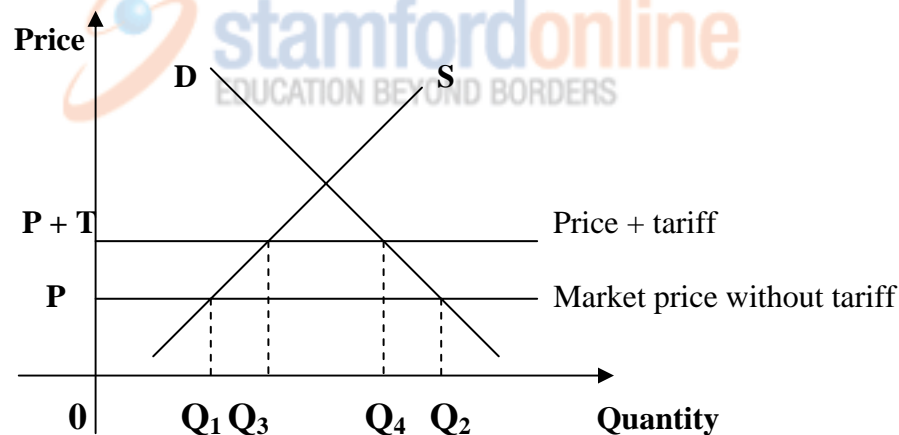
4. **Import inflation**
5. **Dumping of goods**
6. **Balance of payment**
7. **Undesirable political links**

PROTECTIONISM

In practice, many barriers to free trade exist because governments wish to protect industries against foreign competition. Protection can be applied in several ways:

1. Tariffs or Customs Duties / Excise

Tariffs or custom duties are taxes on imported goods. The effect of tariffs is to raise the price paid for the imported goods by domestic consumers, while leaving the price paid to foreign producers the same, or even lower. The difference goes to the government.



In the figure above, market price of the good is P , domestic suppliers are willing to supply at Q_1 but consumers are willing to buy at Q_2 , the difference between Q_2 and Q_1 is then the amount of imports.

An import tariff will raise the price of good ($P + T$). The domestic suppliers need not raise their prices. At the higher price, consumers demand at Q_4 . If the domestic producers were to raise their prices to $P + T$ then they would expand their output to Q_3 . Imports would fall from $(Q_2 - Q_1)$ to $(Q_3 - Q_4)$.

The end result of imposing the tariff is as follows:

- a. Domestic consumers buy fewer goods
- b. Domestic suppliers supply more to the market
- c. Foreign suppliers supply less to the market
- d. The government earns some tax revenue

In such cases, import duties benefit the domestic producers and government but they harm the consumer.

The price elasticity of demand and supply functions may be important in determining by how much a tariff will reduce imports. If demand and supply are price inelastic, a tariff will have a fairly small effect on import volumes.

2. **Import Quotas**

Import quotas are restrictions on the quantity of a product that is allowed to be imported into the country. The quota has a similar effect on consumer welfare to that of import tariffs, but the overall effects are more complicated:

- a. both domestic and foreign suppliers enjoy a higher prices
- b. domestic producers supply more
- c. there are fewer imports
- d. consumers buy less and pay at higher price
- e. the government collect no revenue

3. **Embargoes**

An embargo on import from one particular country is a total ban i.e. effectively a zero quota.

4. **Hidden export subsidies and import restriction**

- a. For export
Export credit guarantees (i.e. government-backed insurance against bad debts for overseas sales), financial help
- b. For imports
Complex import regulations and documentations, or special safety standards demanded from imported goods. etc.

5. **Devalue its foreign exchange rates so that the overseas customers feel that the prices for the imported goods are cheap.**

Learning Outcomes:

Students should be able to:

- Define international trade, comparative and absolute advantages.
- State the advantages and disadvantages of international trade.

Main Reference

Case, K. E., & Fair, R. C. (2007). *Principles of Economics* (8th ed.). Prentice Hall, Chapter 33.

Other Reference

Sloman, J. (1993). *Economics* (3rd ed.). Prentice Hall.

Review Questions

1. Distinguish between comparative and absolute advantages.
2. What are the advantages and disadvantages of international trade? Explain your answers.
3. Describe the various methods used by governments to protect their local industries.

