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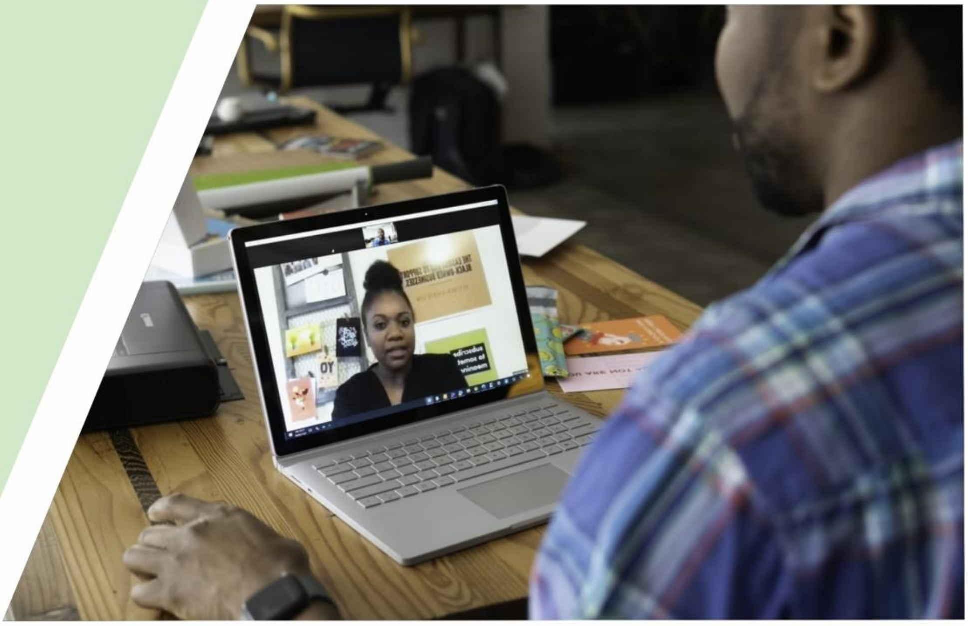

Global Economic Environment

Module 1

BUS 840 Global Economic Environment Module 1

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Module 1

Unit 1 International Trade

1.0 Introduction

International trade means the exchange of capital, goods, and services across international borders or territories. In most countries, such trade represents a significant share of gross domestic product (GDP). While international trade has been present throughout much of history, its economic, social, and political importance has been on the rise in recent times.

Industrialisation, advanced transportation, globalisation, multinational corporations, and outsourcing are all having a major impact on the international trade system. Increasing international trade is crucial to the continuance of globalisation. Without international trade, nations would be limited to the goods and services produced within their own borders.

International trade is, in principle, not different from domestic trade as the motivation and the behaviour of parties involved in a trade do not change fundamentally regardless of whether trade is across a border or not. The main difference is that international trade is typically more costly than domestic trade. The reason is that a border typically imposes additional costs such as tariffs, time costs due to border delays and costs associated with country differences such as language, the legal system or culture.

Another difference between domestic and international trade is that factors of production such as capital and labour are typically more mobile within a country than across countries. Thus, international trade is mostly restricted to trade in goods and services, and only to a lesser extent to trade in capital, labour or other factors of production. Trade in goods and services can serve as a substitute for trade in factors of production.

Instead of importing a factor of production, a country can import goods that make intensive use of that factor of production and thus embody it. An example is the import of labour-intensive goods by the United States from China. Instead of importing Chinese labour, the United States imports goods that were produced with Chinese labour. A report in 2010 suggested that international trade was increased when a country hosted a network of immigrants, but the trade effect was weakened when the immigrants became assimilated into their new country. International trade is also a branch of economics, which, together with international finance, forms the larger branch of international economics.

In this unit, we shall be discussing the various models of international trade and ranking countries by total international trade (goods and services). We shall also rank top traded commodities in international trade.

2.0 Objectives

At the end of this unit, you should be able to:

- explain the meaning and scope of international trade

- discuss the models of international trade
- list the largest countries by total international trade of goods and services.

3.0 Main Content

3.1 Models of International Trade

The following are noted models of international trade:

Adam Smith's model
Adam Smith opines that trade taking place on the basis of countries exercising absolute advantage over one another.

Ricardian model
The law of comparative advantage was first proposed by David Ricardo.
The Ricardian model focuses on comparative advantage, which arises due to differences in technology or natural resources. The Ricardian model does not directly consider factor endowments, such as the relative amounts of labour and capital within a country.

The Ricardian model makes the following assumptions:
- labour is the only primary input to production
- the relative ratios of labour at which the production of one good can be traded off for another differ between countries and governments.

Heckscher-Ohlin model
In the early 1900s, a theory of international trade was developed by two Swedish economists, Eli Heckscher and Bertil Ohlin. This theory has subsequently been known as the Heckscher-Ohlin model (H-O model). The results of the H-O model are that countries will produce and export goods that require resources (factors) which are relatively abundant and import goods that require resources which are in relative short supply.
In the Heckscher-Ohlin model, the pattern of international trade is determined by differences in factor endowments. It predicts that countries will export those goods that make intensive use of locally abundant factors and will import goods that make intensive use of factors that are locally scarce. Empirical problems with the H-O model, such as the Leontief paradox, were noted in empirical tests by Wassily Leontief who found that the United States tended to export labour-intensive goods despite having an abundance of capital.

The H-O model makes the following core assumptions:
- labour and capital flow freely between sectors
- the amount of labour and capital in two countries differ (difference in endowments)
- technology is the same among countries (a long-term assumption)
- tastes are the same.

Reality and Applicability of the Heckscher-Ohlin Model
In 1953, Wassily Leontief published a study in which he tested the validity of the Heckscher-Ohlin theory. The study showed that "the U.S. was more abundant in capital compared to other countries. Being more abundant in capital, U.S. would be expected to export capital-intensive goods and import labour-intensive ones". Nonetheless Leontief found out that the

U.S's exports were less capital intensive than its imports. This is what is referred to as Leontief's paradox.

After the appearance of Leontief's paradox, many researchers tried to save the Heckscher-Ohlin theory, either by new methods of measurement, or by new interpretations. Leamer emphasised that Leontief did not interpret H-O theory properly and claimed that with a right interpretation, the paradox would not occur. Brecher and Choudri found that, if Leamer was right, the American workers' consumption per head should be lower than the workers' world average consumption. Many textbook writers, including Krugman and Obstfeld and Bowen, Hollander and Viane, are negative about the validity of H-O model. After examining the long history of empirical research, Bowen, Hollander and Viane concluded: "Recent tests of the factor abundance theory [H-O theory and its developed form into many-commodity and many-factor case] that directly examine the H-O-V equations also indicate the rejection of the theory" .

In the specific factors model, labour mobility among industries is possible while capital is assumed to be immobile in the short run. Thus, this model can be interpreted as a short-run version of the Heckscher-Ohlin model. The "specific factors" name refers to the assumption that in the short run, specific factors of production such as physical capital are not easily transferable between industries. The theory suggests that if there is an increase in the price of a good, the owners of the factor of production specific to that good will profit in real terms.

Additionally, owners of opposing specific factors of production (i.e., labour and capital) are likely to have opposing agendas when lobbying for controls over immigration of labour. Conversely, both owners of capital and labour profit in real terms from an increase in the capital endowment. This model is ideal for understanding income distribution but awkward for discussing the pattern of trade.

New trade theory

New Trade Theory tries to explain empirical elements of trade which the comparative advantage-based models above have difficulty with. These include the fact that most trade is between countries with similar factor endowment and productivity levels, and the large amount of multinational production (i.e. foreign direct investment) that exists. New trade theories are often based on assumptions such as monopolistic competition and increasing returns to scale. One result of these theories is the home-market effect, which asserts that, if an industry tends to cluster in one location because of returns to scale and if that industry faces high transportation costs, the industry will be located in the country with most of its demand, in order to minimise cost.

Although new trade theory can explain the growing trend of trade volumes of intermediate goods, Krugman's explanation depends too much on the strict assumption that all firms are symmetrical, meaning that they all have the same production coefficients. Shiozawa, based on much more general model, succeeded in giving a new explanation on why the traded volume increases for intermediate goods when the transport cost decreases.

Gravity model

The Gravity model of trade presents a more empirical analysis of trading patterns. The gravity model, in its basic form, predicts trade based on the distance between countries and the interaction of the countries' economic sizes. The model mimics the Newtonian law of gravity which also considers distance and physical size between two objects. The model has been proven to be empirically strong through econometric analysis.

Ricardian theory of international trade (modern development)
The Ricardian theory of comparative advantage became a basic constituent of neoclassical trade theory. Any undergraduate course in trade theory includes a presentation of Ricardo's example of a two-commodity, two-country model. A common representation of this model is made using an Edgeworth Box.

This model has been expanded to many-country and many-commodity cases. Major general results were obtained by McKenzie and Jones, including his famous formula. It is a theorem about the possible trade pattern for N-country N-commodity cases.

Contemporary theories
Ricardo's idea was even expanded to the case of continuum of goods by Dornbusch, Fischer, and Samuelson. This formulation is employed for example by Matsuyama and others. These theories use a special property that is applicable only for the two-country case.

Neo-Ricardian trade theory
Inspired by Piero Sraffa, a new strand of trade theory emerged and was named neo-Ricardian trade theory. The main contributors include Ian Steedman and Stanley Metcalfe. They have criticised neoclassical international trade theory, namely the Heckscher-Ohlin model on the basis that the notion of capital as primary factor has no method of measuring it before the determination of profit rate (thus trapped in a logical vicious circle). This was a second round of the Cambridge capital controversy, this time in the field of international trade.

The merit of neo-Ricardian trade theory is that input goods are explicitly included. This is in accordance with Sraffa's idea that any commodity is a product made by means of commodities. The limitation of their theory is that the analysis is restricted to small-country cases.

Traded Intermediate Goods
Ricardian trade theory ordinarily assumes that the labour is the unique input. This is a great deficiency as trade theory, for intermediate goods occupy the major part of the world international trade. Yeats found out that 30% of world trade in manufacturing involves intermediate inputs. Bardhan and Jafee found that intermediate inputs occupy 37 to 38% of U.S. imports for the years 1992 and 1997, whereas the percentage of intra-firm trade grew from 43% in 1992 to 52% in 1997.

McKenzie and Jones emphasized the necessity to expand the Ricardian theory to the cases of traded inputs. In a famous comment McKenzie (1954, p. 179) pointed that: "A moment's consideration will convince one that Lancashire would be unlikely to produce cotton cloth if the cotton had to be grown in England." Paul Samuelson coined a term *Sraffa bonus* to name the gains from trade of inputs.

Ricardo-Sraffa trade theory
John Chipman observed in his survey that McKenzie stumbled upon the questions of intermediate products and discovered that "introduction of trade in intermediate product necessitates a fundamental alteration in classical analysis". It took many years until Y. Shiozawa succeeded in removing this deficiency. The Ricardian trade theory was now

constructed in a form to include intermediate input trade for the most general case of many countries and many goods. This new theory is called Ricardo-Sraffa trade theory.

Based on an idea of Takahiro Fujimoto, who is a specialist in automobile industry and a philosopher of the international competitiveness, Fujimoto and Shiozawa developed a discussion in which how the factories of the same multi-national firms compete between them across borders. International *intra-firm competition* reflects a really new aspect of international competition in the age of so-called **global competition**.

International Production Fragmentation Trade Theory
Fragmentation and International Trade Theory widens the scope for "application of Ricardian comparative advantage". In his chapter entitled *Li & Fung, Ltd.: An agent of global production* (2001), Cheng used Li & Fong Ltd as a case study in the international production fragmentation trade theory through which producers in different countries are allocated a specialised slice or segment of the value chain of the global production. Allocations are determined based on "technical feasibility" and the ability to keep the lowest final price possible for each product. An example of fragmentation theory in international trade is Li & Fung's garment sector network with yarn purchased in South Korea, woven and dyed in Taiwan, the fabric cut in Bangladesh, pieces assembled in Thailand and the final product sold in the U. S. and Europe to major brands. In 1995, Li & Fung Ltd purchased Inchcape Buying Services, an established British trading company and widely expanded production in Asia. Li & Fung supplies dozens of major retailers, including Wal-Mart Stores, Inc., branded as Wal-Mart.

3.2 Largest Countries by Total International Trade

Table 1 presents the largest countries by total international trade of goods and services.

Table 1.1: Largest Countries by Total International Trade of Goods

Rank	Country	International Trade of Goods (Billions of USD)	Date of information
-	World	36,534.0	2012 est.
-	European Union	4,468.6	2012 est.
1	United States	3,882.4	2012 est.
2	China	3,866.9	2012 est.
3	Germany	2,575.7	2012 est.
4	Japan	1,684.4	2012 est.
5	Netherlands	1,247.4	2012 est.
6	France	1,243.9	2012 est.
7	United Kingdom	1,149.4	2012 est.

8	South Korea	1,067.5	2012 est.
9	Italy	986.9	2012 est.
10	Hong Kong	947.9	2012 est.
11	Canada	917.3	2012 est.
12	Belgium	882.0	2012 est.
13	Russia	864.7	2012 est.
14	Singapore	788.1	2012 est.
15	India	779.4	2012 est.
16	Mexico	751.4	2012 est.
17	Spain	624.9	2012 est.
18	Taiwan	571.8	2012 est.
19	Saudi Arabia	529.8	2012 est.
20	Australia	518.2	2012 est.

Rank	Country	International Trade of Services (Billions of USD)	Date of information
-	World	8,452.6	2012 est.
-	European Union	1,465.8	2012 est.
1	United States	1,019.7	2012 est.
2	Germany	539.7	2012 est.
3	China	471.0	2012 est.
4	United Kingdom	453.9	2012 est.
5	France	379.2	2012 est.
6	Japan	313.4	2012 est.
7	India	272.8	2012 est.
8	Singapore	250.1	2012 est.
9	Spain	229.3	2012 est.
10	South Korea	214.2	2012 est.

Table 1.2: Top Traded Commodities (Exports)

Rank	**Commodity**	**Value in US$('000)**	**Date of information**
1	Mineral fuels, oils, distillation products, etc.	$2,183,079,941	2012
2	Electrical, electronic equipment	$1,833,534,414	2012
3	Machinery, nuclear reactors, boilers, etc.	$1,763,371,813	2012
4	Vehicles other than railway, tramway	$1,076,830,856	2012
5	Plastics and articles thereof	$470,226,676	2012

Rank	Commodity	Value in US$('000)	Date of information
6	Optical, photo, technical, medical, etc. apparatus	$465,101,524	2012
7	Pharmaceutical products	$443,596,577	2012
8	Iron and steel	$379,113,147	2012
9	Organic chemicals	$377,462,088	2012
10	Pearls, precious stones, metals, coins, etc.	$348,155,369	2012

Source: International Trade Centre.

4.0 Conclusion

Models of international trade help in appreciating the basis of international trade. It is also helpful in understanding how and why a country should engage in international trade and what goods and services it should be exporting and importing. Ranking of countries on the basis of total international traded goods and services will help nations in determining their relative positions and articulating appropriate trade policies if they are to climb on the ladder.

5.0 Summary

This unit served as an introduction to international trade and has introduced you into models of international trade and ranking of countries on the basis of total international trade of goods and services. It also ranked the top traded commodities in international trade.

6.0 Self-Assessment Exercise

1. Name the first three countries on the basis of international trade of goods and of services.
2. Explain the central argument in fragmentation theory in international trade.

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Unit 2 Strategic Aspects of International Trade

1.0 Introduction

Economics deals with the proper allocation and efficient use of scarce resources. International economics is also concerned with allocation of economic resources among countries. Such allocation is done in the world markets by means of international trade. Under the concept of free trade, the best products are produced and sold in a free competitive market. Such benefits of production efficiency like better quality and lower price are available to all peoples of the world.

One fundamental principle in international trade is that one should buy goods and services from a country which has the lowest price, and sell the goods and services to a country which has the highest price. This is good for the buyers and for the sellers. Equally, with free trade, the less developed countries have the opportunities to accelerate the pace of their economic development. They can import machines and adapt foreign technology. They can send their scholars and technocrats to more progressive countries to gain more knowledge and skills which are relevant to the particular needs of their developing economies.

In the final analysis, no country in the world can be economically independent without a decline in its economic growth. Even the richest countries buy raw materials for their industries from the poorest countries. If every country produces only for its own needs, then production and consumption of goods would be limited. Clearly, such situation hampers economic progress. Furthermore, the standard of living of the people all over the world would have no chance to improve. Because of international trade, people with money can acquire goods and services which are not available in their own countries. Hence, satisfaction of consumers can be maximised.

In this unit, we shall be discussing free trade, advantages and disadvantages of globalisation, advantages and disadvantages of international trade and trade barriers.

2.0 Objectives

At the end of this unit, you should be able to:

- discuss the importance of international trade
- describe free trade
- discuss the ad vantages and disadvantages of globalisation from an economic view
- explain the advantages and disadvantages of international trade
- discuss trade barriers.

3.0 Main Content

3.1 Free Trade

Free trade is a policy by which a government does not discriminate against imports or interfere with exports by applying tariffs (to imports) or subsidies (to exports) or quotas.

According to the law of comparative advantage, the policy permits trading partners' mutual gains from trade of goods and services.

Under a free trade policy, prices emerge from the equilibration of supply and demand, and are the sole determinant of resource allocation. 'Free' trade differs from other forms of trade policy where the allocation of goods and services among trading countries are determined by price strategies that may differ from those that would emerge under deregulation. These governed prices are the result of government intervention in the market through price adjustments or supply restrictions, including protectionist policies. Such government interventions can increase as well as decrease the cost of goods and services to both consumers and producers. Since the mid-20th century, nations have increasingly reduced tariff barriers and currency restrictions on international trade. Other barriers, however, that may be equally effective in hindering trade include import quotas, taxes, and diverse means of subsidising domestic industries. Interventions include subsidies, taxes and tariffs, non-tariff barriers, such as regulatory legislation and import quotas, and even inter-government managed trade agreements such as the North American Free Trade Agreement (NAFTA) and Central America Free Trade Agreement (CAFTA) (contrary to their formal titles) and any governmental market intervention resulting in artificial prices.

3.1.1 Features of Free Trade

Free trade implies the following features:

- trade of goods without taxes (including tariffs) or other trade barriers (e.g., quotas on imports or subsidies for producers)
- trade in services without taxes or other trade barriers
- the absence of "trade-distorting" policies (such as taxes, subsidies, regulations, or laws) that give some firms, households, or factors of production an advantage over others
- free access to markets
- free access to market information
- inability of firms to distort markets through government-imposed monopoly or oligopoly power.

3.2 The Advantages of Globalisation (An Economic View)

The economic benefits that greater openness to international trade brings are:

- Faster growth: economies that have in the past been open to foreign direct investments have developed at a much quicker pace than those economies closed to such investment e.g. communist Russia.
- Cheaper imports: this is down to the simple fact that if we reduce the barriers imposed on imports (e.g. tariffs, quota, etc.) then the imports will fall in price.
- New technologies: by having an open economy, new technology can be brought in as it happens rather than trying to develop it internally.
- Spur of foreign competition: foreign competition will encourage domestic producers to increase efficiency. Carbaugh (1998) states that global competitiveness is a bit like golf, you get better by playing against people who are better than you.
- Increase consumer income: multinationals will bring up average wage levels because if the multinationals were not there the domestic companies would pay less.
- Increased investment opportunities: with globalisation, companies can move capital to any country that offers the most attractive investment opportunity. This prevents capital being trapped in domestic economies earning poor returns.

3.2.1 Disadvantages of Globalisation

The negative drivers of globalisation included culture which is a major hold back of globalisation. An example of how culture can negatively affect globalisation can be seen in the French film industry. The French are very protective of this part of their culture and provide huge grants to help its development. As well as government barriers, market barriers and cultural barriers still exist.

Also a negative aspect to a countries development is war e.g. tourism in Israel fell by 40 per cent due to the latest violence. Corporate strategy can also be a negative driver of globalisation as corporation may try to locate in one particular area.

Another negative driver of globalisation is "local focus" or "localisation" as it is termed in Richard Douthwaite's book "Short Circuit". Douthwaite (1996) believes that globalisation can and should be reversed. He also believes that localisation is the way to do this. He defines localisation as "not meaning everything being produced locally but it means a better a balance between local, regional, national and international markets and thus brings less control to multinational corporations". Another step to reverse globalisation would be for governments to curb the power of multinational by negotiating new trade and treaties that would remove the subsidies powering globalisation and give local production a chance.

Douthwaite also states that the global economy is itself nothing less than a system of structural exploitation that creates hidden slaves on the other side of the world and also that the North should allow the South to produce for itself and not just for the North. So it can be seen that Douthwaite is very opposed to globalisation especially that part of it exploited by multinational corporations.

Further arguments put forward against globalisation by Mr. Lawton include that it actually destroys jobs in wealthy advanced countries. This is due to the lower costs of wages in developing countries. Multinationals will move to areas of lower wage levels at the drop of a hat e.g. Fruit of the Loom. Also, this ability to relocate has meant that wage levels of unskilled workers in developed countries have actually fallen relatively speaking. This is due to the fact that one now needs skill and knowledge in developed economies to survive. Also there is the loss of sovereignty that globalisation brings. Many anti-globalisation believers state that nations are losing their identity and selling their soul.

Then there are environmental factors of globalisation as described earlier. These are becoming more and more controversial. Technology, though usually viewed as a positive aspect of globalisation, also has some negative points. Jeffry Sachs (2000) argues that technology is now what divides the world. Sachs states that 15 per cent of the world's population account for nearly all the world's technological advances. This has to be a concern if developing economies are ever going to catch up. Many countries, almost 30 per cent of the world's population, are technologically excluded (this means not only that they do not innovate but also that they cannot adopt new technologies). In recent years, some countries such as Taiwan, South Korea and Israel, have become top rank innovators and with this their economies have flourished. This would indicate that perhaps the best way to tackle world poverty is to provide aid through education and technology.

3.3 Advantages and Disadvantages of International Trade

3.3.1 Advantages of International Trade

Various advantages are available for the countries entering into trade relations on an international scale such as:

A country may import things which it cannot produce: International trade enables a country to consume things which either cannot be produced within its borders or production may cost very high. Therefore it becomes cost cheaper to import from other countries through foreign trade.

Maximum utilisation of resources: International trade helps a country to utilise its resources to the maximum limit. If a country does not take up imports and exports then its resources remain unexplored. Thus, it helps to eliminate the wastage of resources.

Benefit to consumer: Imports and exports of different countries provide opportunities to the consumer to buy and consume those goods which cannot be produced in their own country. They therefore get diversity in choices.

Reduces trade fluctuations: By making the size of the market large with large supplies and extensive demand, international trade reduces trade fluctuations. The prices of goods tend to remain more stable.

Utilisation of surplus produce: International trade enables different countries to sell their surplus products to other countries and earn foreign exchange.

Fosters peace: International trade fosters peace, goodwill and mutual understanding among nations. Economic interdependence of countries often leads to close cultural relationship and thus avoid war between them.

3.3.2 Disadvantages of International Trade

International trade does not always amount to blessings. It has certain drawbacks also such as:

Import of harmful goods: Foreign trade may lead to import of harmful goods like cigarettes, drugs etc. This may ruin the health of the residents of the country. E.g. the people of China suffered greatly through opium imports.

It may exhaust resources: International trade leads to intensive cultivation of land. Thus, it has the operations of law of diminishing returns in agricultural countries. It also makes a nation poor by giving too much burden over the resources.

Over Specialisation: Over specialisation may be disastrous for a country. A substitute may appear and ruin the economic lives of millions.

Danger of starvation: A country might depend for her food mainly on foreign countries. In times of war there is a serious danger of starvation for such countries.
One country may gain at the expensive of another: One of the serious drawbacks of foreign trade is that one country may gain at the expense of other due to certain accidental

advantages. The industrial revolution in Great Britain ruined Indian handicrafts during the 19th century.

It may lead to war: Foreign trade may lead to war different countries compete with each other in finding out new markets and sources of raw material for their industries and frequently come into clash. This was one of the causes of the First and Second World War.

3.4 Trade Barrier

Trade barriers are government-induced restrictions on international trade.

Most trade barriers work on the same principle: the imposition of some sort of cost on trade that raises the price of the traded products. If two or more nations repeatedly use trade barriers against each other, a trade war results.

Economists generally agree that trade barriers are detrimental and decrease overall economic efficiency, this can be explained by the theory of comparative advantage. In theory, free trade involves the removal of all such barriers, except perhaps those considered necessary for health or national security. In practice, however, even those countries promoting free trade heavily subsidise certain industries, such as agriculture and steel.

Trade barriers are often criticised for the effect they have on the developing world. Because rich-country players call most of the shots and set trade policies, goods such as crops that developing countries are best at producing still face high barriers. Trade barriers such as taxes on food imports or subsidies for farmers in developed economies lead to overproduction and dumping on world markets, thus lowering prices and hurting poor-country farmers. Tariffs also tend to be anti-poor, with low rates for raw commodities and high rates for labour-intensive processed goods. The *Commitment to Development Index* measures the effect that rich country trade policies actually have on the developing world.

Another negative aspect of trade barriers is that it would cause a limited choice of products and would therefore force customers to pay higher prices and accept inferior quality.

3.4.1 Examples of Free Trade Areas

- North American Free Trade Agreement (NAFTA)
- South Asia Free Trade Agreement (SAFTA)
- European Free Trade Association
- European Union (EU)
- Union of South American Nations
- New West Partnership (An internal free-trade zone in Canada between Alberta, British Columbia, and Saskatchewan)
- Gulf Cooperation Council Common Market.

3.4.2 The Basics of Tariffs and Trade Barriers

International trade increases the number of goods that domestic consumers can choose from, decreases the cost of those goods through increased competition, and allows domestic industries to ship their products abroad. While all of these seem beneficial, free trade isn't widely accepted as completely beneficial to all parties. This article will examine why this is the case, and look at how countries react to the variety of factors that attempt to influence trade

3.4.2.1 What Is a Tariff?

In simplest terms, a tariff is a tax. It adds to the cost of imported goods and is one of several trade policies that a country can enact.

3.4.2.2 Why Are Tariffs and Trade Barriers Used?

Tariffs are often created to protect infant industries and developing economies, but are also used by more advanced economies with developed industries. Here are five of the top reasons tariffs are used:

Protecting Domestic Employment

The levying of tariffs is often highly politicised. The possibility of increased competition from imported goods can threaten domestic industries. These domestic companies may fire workers or shift production abroad to cut costs, which means higher unemployment and a less happy electorate. The unemployment argument often shifts to domestic industries complaining about cheap foreign labour, and how poor working conditions and lack of regulation allow foreign companies to produce goods more cheaply. In economics, however, countries will continue to produce goods until they no longer have a comparative advantage (not to be confused with an absolute advantage).

Protecting Consumers

A government may levy a tariff on products that it feels could endanger its population. For example, South Korea may place a tariff on imported beef from the United States if it thinks that the goods could be tainted with disease.

Infant Industries

The use of tariffs to protect infant industries can be seen by the Import Substitution Industrialisation (ISI) strategy employed by many developing nations. The government of a developing economy will levy tariffs on imported goods in industries in which it wants to foster growth. This increases the prices of imported goods and creates a domestic market for domestically produced goods, while protecting those industries from being forced out by more competitive pricing. It decreases unemployment and allows developing countries to shift from agricultural products to finished goods.

Criticisms of this sort of protectionist strategy revolve around the cost of subsidising the development of infant industries. If an industry develops without competition, it could wind up producing lower quality goods, and the subsidies required to keep the state-backed industry afloat could sap economic growth.

National Security

Barriers are also employed by developed countries to protect certain industries that are deemed strategically important, such as those supporting national security. Defense industries are often viewed as vital to state interests, and often enjoy significant levels of protection. For example, while both Western Europe and the United States are industrialised, both are very protective of defense-oriented companies.

Retaliation

Countries may also set tariffs as a retaliation technique if they think that a trading partner has not played by the rules. For example, if France believes that the United States has allowed its wine producers to call its domestically produced sparkling wines "Champagne" (a name specific to the Champagne region of France) for too long, it may levy a tariff on imported meat from the United States. If the United States agrees to crack down on the improper labeling, France is likely to stop its retaliation. Retaliation can also be employed if a trading partner goes against the government's foreign policy objectives.

3.4.3 Types of Tariffs and Trade Barriers

There are several types of tariffs and barriers that a government can employ:

- Specific Tariffs
- Ad Valorem Tariffs
- Licenses
- Import Quotas
- Voluntary Export Restraints
- Local Content Requirements
- Specific Tariffs.

A fixed fee levied on one unit of an imported good is referred to as a specific tariff. This tariff can vary according to the type of good imported. For example, a country could levy a $15 tariff on each pair of shoes imported, but levy a $300 tariff on each computer imported.

Ad Valorem Tariffs

The phrase ad valorem is Latin for "according to value", and this type of tariff is levied on a good based on a percentage of that good's value. An example of an ad valorem tariff would be a 15 per cent tariff levied by Japan on U.S. automobiles. The 15 per cent is a price increase on the value of the automobile, so a $10,000 vehicle now costs $11,500 to Japanese consumers. This price increase protects domestic producers from being undercut, but also keeps prices artificially high for Japanese car shoppers.
Non-tariff barriers to trade include:

Licenses

A license is granted to a business by the government, and allows the business to import a certain type of good into the country. For example, there could be a restriction on imported cheese, and licenses would be granted to certain companies allowing them to act as importers. This creates a restriction on competition, and increases prices faced by consumers.

Import Quotas

An import quota is a restriction placed on the amount of a particular good that can be imported. This sort of barrier is often associated with the issuance of licenses. For example, a country may place a quota on the volume of imported citrus fruit that is allowed.

Voluntary Export Restraints (VER)

This type of trade barrier is "voluntary" in that it is created by the exporting country rather than the importing one. A voluntary export restraint is usually levied at the behest of the importing country, and could be accompanied by a reciprocal VER. For example, Brazil could place a VER on the exportation of sugar to Canada, based on a request by Canada. Canada could then place a VER on the exportation of coal to Brazil. This increases the price of both coal and sugar, but protects the domestic industries.

Local Content Requirement

Instead of placing a quota on the number of goods that can be imported, the government can require that a certain percentage of a good be made domestically. The restriction can be a percentage of the good itself, or a percentage of the value of the good. For example, a restriction on the import of computers might say that 25 per cent of the pieces used to make the computer are made domestically, or can say that 15 per cent of the value of the good must come from domestically produced components.

In the final section we will examine who benefits from tariffs and how they affect the price of goods.

3.4.3.1 Who Benefits?

The benefits of tariffs are uneven. Because a tariff is a tax, the government will see increased revenue as imports enter the domestic market. Domestic industries also benefit from a reduction in competition, since import prices are artificially inflated. Unfortunately for consumers, both individual consumers and businesses, higher import prices mean higher prices for goods. If the price of steel is inflated due to tariffs, individual consumers pay more for products using steel, and businesses pay more for steel that they use to make goods. In short, tariffs and trade barriers tend to be pro-producer and anti-consumer. The effect of tariffs and trade barriers on businesses, consumers and the government shifts over time. In the short run, higher prices for goods can reduce consumption by individual consumers and by businesses. During this period, businesses will profit and the government will see an increase in revenue from duties. In the long term, businesses may see a decline in efficiency due to a lack of competition, and may also see a reduction in profits due to the emergence of substitutes for their products. For the government, the long-term effect of subsidies is an increase in the demand for public services, since increased prices, especially in foodstuffs, leaves less disposable income.

3.4.3.2 How Do Tariffs Affect Prices?

Tariffs increase the prices of imported goods. Because of this, domestic producers are not forced to reduce their prices from increased competition, and domestic consumers are left paying higher prices as a result. Tariffs also reduce efficiencies by allowing companies that would not exist in a more competitive market to remain open.

3.4.3.3 Tariffs and Modern Trade

The role tariffs play in international trade has declined in modern times. One of the primary reasons for the decline is the introduction of international organisations designed to improve free trade, such as the World Trade Organisation (WTO). Such organisations make it more difficult for a country to levy tariffs and taxes on imported goods, and can reduce the likelihood of retaliatory taxes. Because of this, countries have shifted to non-tariff barriers, such as quotas and export restraints. Organisations like the WTO attempt to reduce production and consumption distortions created by tariffs. These distortions are the result of domestic producers making goods due to inflated prices, and consumers purchasing fewer goods because prices have increased.

Since the 1930s, many developed countries have reduced tariffs and trade barriers, which has improved global integration and brought about globalisation. Multilateral agreements between governments increase the likelihood of tariff reduction, while enforcement on binding agreements reduces uncertainty.

3.5 The Bottom Line

Free trade benefits consumers through increased choice and reduced prices, but because the global economy brings with it uncertainty, many governments impose tariffs and other trade barriers to protect industry. There is a delicate balance between the pursuit of efficiencies and the government's need to ensure low unemployment.

4.0 Conclusion

International trade is important to both rich and poor countries, importing and exporting countries, domestic and foreign businesses. The concept of free trade explains the best circumstances under which international trade can be practiced to best serve the interest of all participants. In a free trade environment, the full advantages and disadvantages of globalisation and international trade will be magnified. But international trade is not always free. We therefore had to discuss the various barriers that nations can use in managing international trading relations to serve their identified trading interests.

5.0 Summary

This unit built on the meaning and scope of international trade and models of international trade discussed in Unit 1. It specifically explained the importance of international trade, free trade concept, advantages and disadvantages of globalisation, advantages and disadvantages of international trade and the concept of trade barriers.

6.0 Self-Assessment Exercise

1. List and discuss the several types of tariffs and barriers that a government can employ.
2. Who benefits from tariffs?

3. How do tariffs affect prices?

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Unit 3 International Trade and International Business

1.0 Introduction

In this unit, we shall examine comprehensively, the World Trade Organisation. Forces like technological breakthroughs, economic growth, market evolution, shifts in customer tastes, social changes and political events can expand or shrink business space and world trade. Vast amounts of new track space created today change perspectives. This unoccupied territory represents a land of opportunity for the technological and strategic innovators who can see or create it faster than their competitors do. The opportunities are great, but so are the competition and the chance of failure. Today's growth era produces huge discontinuities, creates new industries and destroys old ones, and accelerates global economic growth in the process. Expectations are rising everywhere; human creativity is flowing in every field. Emerging economies are industrialising and everyone is joining the digital revolution of boundless information and seamless electronic commerce. The World Trade Organisation (WTO) is an international body dealing with rules relating to international business operations. The organisation is responsible for global agreements, negotiations and ensures regulations and rule made by all is obeyed by all. It is also responsible for keeping various trade policies/rules within agreed limits and bounds. It came into existence on 1st January 1995 as a result of the Uruguay Round of Trade Negotiations URTN. It aims at:

- facilitating trade among countries by creating conditions for competition that are fair and equitable.
- encouraging entering into negotiations for the reduction of tariffs and the removal of other barriers to trade.
- applying a common set of rules to trade in goods and services.

This body is responsible for overseeing the multilateral trading system which has gradually evolved over the last 60 years (Otokity, 2006).

2.0 Objectives

At the end of this unit, you should be able to:

- define and explain international trade
- discuss the basic concepts and reasons for international trade
- explain the various forms of international trade
- examine the issues surrounding the establishment of World Trade Organisation (WTO).

3.0 Main Content

3.1 Comparison between International Trade and International Business

International trade is a business transaction between the nationals of two different countries. For example, a Nigerian businessman can import a consignment of a product from a British producer. He needs not to know anything about the business environment of Britain. But opening an international business is more involving. The operator must study and understand the international business environment such as culture, a legal, economic factor which prevails in the environment he would want to locate his business.

3.2 Prevailing Problems of International Trade

Engaging in international trade is a sophisticated activity. It requires great corporate, personal and business skill, experience and knowledge. International trade is being influenced by the following problems:

a. Cultural differences: Deep cultural differences like social expectations, manners and methods of doing business can be persistent problems to a country who is about to enter into a bilateral or multilateral agreement.
b. Currency problem: Trading between sovereign nation creates financial complications because currencies are not of equal value and the rate of exchange between currencies are not fixed.
c. Legal protection: countries often limit International trade by legal means. Examples include tariff, quota and embargo. This protective tariffs and quotas are to encourage the growth of domestic industries and to protect them from price competition from foreign companies.
d. Foreign political climates: these are often unpredictable. For example, terrorism and foreign tax structures may be favoured to business.
e. Foreign business climates and methods may create ethical problems. For instance, bribery is more widely accepted in Nigeria than in the United States.

3.3 Forms of International Trade

There are a number of ways in which nations can participate in international trade.

3.3.1 Direct Exporting

This form of international trade involves soliciting orders from foreign countries for goods and services that are made in a country and then shipped abroad. For example, without International trade, the market for the Nigerian crude oil, columbite, cocoa, rubber, etc. would have been limited to domestic economy. Export of goods and services act as foreign exchange earners to the domestic economy. Foreign exchange availability is essential requirement for the survival of any national income.

3.3.2 Foreign Licensing

This is another important form of trade that exists between two or more countries. It involves a country soliciting another country to produce and sell her product to them in a fee and after due procedural arrangement have been made which binds the elements of such countries contract. This is generally used for goods with established brand names.

Self-Assessment Exercise

What do you understand by the term international trade? And name the two major forms you know.

3.4 WTO and the Establishment of General Agreement on Tariff and Trade

The World Trade Organisation provides a forum for continuing negotiation to liberalise the trade in goods and services through the removal of barriers and the development of rules in new trade-related subject areas. The World Trade Organisation agreements have a common dispute settlement mechanism through which members enforce their right and settle the differences that arise between them in the course of implementation.

The multilateral trading system of WTO can broadly be defined as the body of international rules by which countries are required to abide in their trade relations with one another. The basic aim of these rules is to encourage countries to pursue open and liberal policies. These rules are continually evolving. The existing rules are being clarified and elaborated to meet the changing conditions of world trade. At the same time rules covering new subjects are being added to deal with problems and issues that are being encountered.

A tariff is an indirect taxes imposed upon imports. They can either be specific (fixed amount per good) or ad valorem (a % of the value). Tariff imposition arises due to reasons such as:

- to reduce imports and protect domestic firms from foreign competition
- to reduce imports in order to reduce balance of payment deficits.

The virtual developing country is a case study of Zambia. There are a series of field trips available looking at different issues connected with economic development. This tour is the trade tour, and this unit shall also look at the imposition of tariffs as a form of protection and the welfare loss that result.

If the government of a country imposes a tariff on the imports from another country they raise the world price by the amount of the tariff they impose. The WTO concept is the outcome of the first major effort to adopt rules to govern international trade relations which was made by countries in the years immediately after the Second World War. These efforts resulted in the adoption in 1948 of the General known as; consequently the GATT rules which basically applicable to international trade in goods was for years was modified to include new provisions particularly to deal with the trade problems of developing countries.

3.4.1 The Mechanism of World Trade Organisation

Nowadays, trade is increasingly global in scope. There are several reasons for this. One significant reason is technological, because of improved transportation and communication opportunities today, trade is now more political. Thus, consumers and businesses now have access to the very best products from many different countries.

Increasingly rapid technology life cycles also increase the competition among countries as to who can produce the newest in technology. In part to accumulate these realities, counties in the last several decades have taken increasing steps to promote global trade through agreements such as the General Treaty on Trade and Tariff GATT, and organisations such as the World Trade Organisation (WTO), North American Free Trade agreement (NAFTA), and the European Union (EU).

Similarly, the WTO system as it has emerged from the Uruguay round consisting of the following substantive agreements:

(i) General Agreement on Trade in Services (GATS)
(ii) Multilateral Agreement on Tariffs and Trade (GATT 1995) and all its associate agreements.
(iii) Agreement on Trade–Related aspects of Intellectual Property Rights (TRIPS).

3.4.2 Legal Instrument at Uruguay Round

The legal instrument embodying the results of the Uruguay round of multilateral trade negotiations were adopted in Marrakech on 15th April, 1994. The complete set covers the legal texts, the ministerial decisions and the Marrakech declaration, the signatory countries, as well as the individual agreements, the schedule of specific commitments on services, the tariff schedule for trade in goods, and the pluri-lateral agreements schedule in the original language only. The World Trade Organisation (WTO) deals with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible.

The trade in goods involve agreement on implementation of article VII of GATT 1994 (Customs valuation), agreement on Reshipment Inspection (RSI) and others.

3.4.3 The Benefits and Usefulness of World Trade Organisation

a. Member countries are obliged to ensure that their (User) national registration; regulations and procedures are in full conformity with the provisions of these agreements.
b. The system helps promote peace.
c. Disputes are handled constructively.
d. Rules make life easier for all.
e. Freer trade cuts the costs of living.
f. It provides more choice of products and qualities.
g. Trade raises incomes.
h. Trade stimulates economic growth.
i. The basic principles make life more efficient.
j. Government are shielded.

The World Trade Organisation (WTO) deals with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictable and freely as possible.

3.4.4 The Dynamic Nature of GATT Members to World Trade Organisation

It is of greater important to examine any change in attitude of GATT membership and how GATT rules applied to issues. Such issues do not posit whether a certain policy is environmentally correct or not. They suggest that the United States policy could be made compatible with GATT rules if members agreed on amendments or reached a decision to waive the rules especially for any issue that could spring up.

Many developing countries discarded import substitution, policies and are now pursuing export-oriented policies, under which they seek to promote economic growth by exporting more and more of their products. Another issue is related to the pace at which the world economy is globalising through international trade and the flow of foreign direct investment. Similarly, this process of globalising which has increases the dependence of countries on international trade is further accelerated by the shift in economic and trade policies noticeable in most countries. The collapse of communism has led to the gradual adoption of market-oriented policies in most countries where production and international trade had been state controlled. These countries, which in the past traded primarily among them, are increasingly trading on a worldwide basis (Otokity S. 2006).

In addition, the framework of rights and obligations which the WTO system has created therefore plays a crucial role in the development of trade in the fast globalising world's economy. The ability of governments and business enterprises to benefit from the system depends greatly on their knowledge and understanding of the rules of the system.

3.4.5 Major Features of World Trade Organisation Agreement

The World Trade Organisation (WTO) was established in 1st January, 1995 and represents the culmination of an eight-year process of trade organisation known as the Uruguay Round. 135 countries now belonging to the WTO and more will continue to join. The WTO is based in Geneva and is administered by a secretariat which also facilitates ongoing trade negotiations, and oversees trade dispute resolutions.
Another important feature is that WTO is an international that effectively creates a ceiling- but no floor for environmental regulation.

WTO agreement is made up of detailed procedural code for environmental law making and regulatory initiatives that would be difficult for even the wealthiest nations' meet.

Other features of WTO include:

- The objectives and principles of multilateral agreements on trade goods.
- Biding of tariffs
- Most favoured nation treatment (MFN)

National treatment rule: prohibits countries from discriminating among goods originating in different countries. The national treatment rule prohibits them from discriminating between imported products and domestically produced like goods, both in the matter of the levy of internal taxes and in the application of internal taxes.

3.4.6 Settlement of World Trade Organisation Dispute

Suppose a trade dispute arises because a country has taken action on trade (for example imposed a tax or restricted imports) under an environmental agreement outside the WTO and another country objects. Should the dispute be handled under the WTO or under the GATT agreement? The trade and environmental committee says that if a dispute arises over a trade action taken under an environmental agreement, and if both sides to the dispute have signed that agreement, then they should try to use the environmental agreement to settle the dispute. But if one side in the dispute has not signed the environmental agreement, then the WTO would provide the only possible forum for settling the dispute. Preferences for handling dispute under the environmental agreements do not mean environmental issues would be ignored in WTO disputes. The WTO agreements allow panels examining a dispute to seek expert advice on environmental issues.

3.4.7 The Control on World Trade Organisation by Government of Importing Countries

The governments seek to limit the level of imports through a quota. Examples of quotas were found in the textile industry under the terms of the multi-fiber agreement which expired in January 2005 and which led, in 2005 to a trade dispute between the European and China over the issue textile imports.

Quotas introduce a physical limit of the volume (number of units imported) or value (value of imports) permitted.
Countries can make it difficult for firms to import by imposing restrictions and being deliberately bureaucratic. These trade barriers range from stringent safety and specification checks to extensive holdups in the customs arrangements. A good example is the quality standards imposed by the European on imports of dairy products.

Preferential government procurement policies and state aid: Free trade can be limited by preferential behaviour by the government when allocating major spending projects that favours domestic rather than overseas suppliers. These procurement policies run against the principle of free trade within the European Union single market.

The use of financial aid from the state can also distort the free trade of goods and services of WTO nations, for example use of subsidies to a domestic cola or steel industry, or the widely criticised use of export refunds.

Control against dumping and anti-dumping: Anti dumping is designed to allow countries to take action against dumped imports that cause or threaten to cause material injury to the domestic industry. Goods are said to be dumped when they are sold for export at less than their normal value.

The agreement on safeguards permits importing countries to restrict imports of a product for a temporary period by either increasing tariffs or imposing quantitative restrictions. Such safeguard actions can be resorted to only when it has been established through properly conducted investments that a sudden increase in imports. (Both are absolute and relative to domestic production).

3.4.8 The General Agreement on Tariff and Trade (GATT)

This treaty was created following the conclusion of World War II. The General Agreement on Tariffs and Trade (GATT) was implemented to further regulate world trade to aid in the economic recovery following the War. GATT's main objective was to reduce the barriers of international trade through the reduction of tariffs, quotas and subsidies. GATT was formed in 1947 and signed into international law on January 1, 1948. GATT remained one of the focal features of international trade agreements until it was replaced by the creation of the World Trade Organisation on January 1, 1995. The foundation of GATT was laid by the proposal of the International Trade Organisation in 1945; however the ITO was never completed.

National treatment is a concept of international law that declares if a state provides certain right and privileges to its own citizens; it also should provide equivalent rights and privileges to foreigners.

WTO is an international organisation dealing with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably, and freely as possible.

3.4.9 World Trade Organisation Membership from Year 2000 to Date

The WTO General Agreement on Trade in Services (GATS) commits member's governments to undertake negotiations on specific issues and to enter into successive rounds of negotiations to progressively liberalise trade among member nations. The member nations of WTO are: Argentina, Bulgaria, Czech Republic, Hungary, India, Kenya, Mauritius, Nigeria, Pakistan, Slovenia, Lanka, Turkey, Thailand etc.

Self-Assessment Exercise
Distinguish between WTO and national treatments

4.0 Conclusion

In this unit, you have learnt about the meaning of international trade, the brief historical development of international trade, the reasons countries are engaged in international trade. The unit has also introduced you to the role of international trade in a countries economy, the prevailing problems affecting international trade and how it is differentiated from international business.

You have also been exposed to the establishment and formation of the WTO and GATTs, the dynamic nature of the world trade governing body, the essential features of WTO, the functions and the Uruguay Round concepts. This unit has also introduced you to government control on importation and WTO membership.

5.0 Summary

The goal of the WTO is to deregulate international trade. To accomplish this (and with one important exception), WTO rules seek to limit the capacity of governments to regulate international trade or otherwise "interfere" with the activities of large corporations.

During the early 90s, similar developments were also taking place in Europe and elsewhere, and the environmental implications of the Uruguay round trade negotiations began to emerge as important issues.

The importance of the environment analysis of the free trade and investment agenda lies in both its accessibility and its universal appeal.

6.0 Self-Assessment Exercise

1. Critically distinguish between a country **absolute advantage** and **factor endowment**.
2. Critically discuss the major instrument of the 1945 Uruguay Round.

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Unit 4 Terms of Trade and Theories of International Trade

1.0 Introduction

The buying and selling of goods and services across national border is known as international trade.

International trade is the backbone of our modern commercial world, as producers in various nations try to profit from an expanded market rather than be limited to selling within their own borders. There are many reasons that trade across the national borders occurs, including lower production costs in one region versus another, specialised industries, lack or surplus of national resources and consumer tastes.

International trade is a complex business system that operates independent of fixed spatial or geographical boundaries. It is concerned mostly with information and technology transfer, international trade in goods (e.g. gas, petroleum product, raw materials, cement, columbite etc.), international trade of flow of labour and money/capital. The fundamental fact upon which international trade rests is that goods and services are much more mobile internationally than the resources used in their production. Each country will tend to export those goods and services for which its resources base is most suited. The reasons for international trade is that it allows a country to specialise in the goods and services that it can produce at a relatively low cost and export those goods in return for import which domestic production is relatively costly. As a consequence, international trade enables a country and the world to consume and produce more than would be possible without trade.

No matter the proximity of one country to another, once there are differences in government currency and cultural values, any form of trade dealing at this level are international.

Any theory of international or foreign trade must explain reasons for trade and gains for trade or why international trade takes place for the same reasons for which inter-local, interstate or interregional trade (trade between districts or regions within a country) takes place.

Trade takes place because by trading, both parties gain and the gain consist of the advantages resulting from the division of labour.

There were lots of evolutionary theories of international trade in the past centuries. Some of which were; era of mercantilism, feudal society, era of classical trade theory.

Owing to the dynamism and the shifting which focus from the country to the firm, from costs of production to the market as a whole and from the perfect the imperfect, this course shall examine critically and extensively the theory of:

- the theory of comparative advantage
- the rent for surplus theory the theory of factor proportion and
- the competitive advantage of nations.

2.0 Objectives

At the end of this unit, you should be able to:

- discuss terms of trade and its features
- examine the techniques and economic effects of international trade restrictions
- examine the theories of international trade.

3.0 Main Content

3.1 Terms of Trade

Terms of trade are a quantitative measure of the rate at which a country's export exchanges for its imports. It is a measure of the purchasing power of its exports expressed in its imports or, alternatively, the price of its imports expressed in terms of its exports.

The terms of trade is said to be favourable if for some given imports a country pays with smaller exports, or if for some given exports, it gets more imports. Though, the gains from international trade brings about increase in output, except of course Portugal is able to trade some cloth for wine, workers in Portugal will not get much work done, the same applies to England.

Without trade, workers in England will not get much done. But how much cloth must England give in exchange for Portuguese wine is a question that is very much decided by countries terms of trade. In other words, terms of trade is basically expressed as a relationship between unit prices of a country's export to a unit price of the country's import. In the case of England and Portugal; terms of trade is how much of wine and vice versa.

3.1.1 Essential Features of Terms of Trade

An average: It should be carefully noted that when a country is trading in more than one item a measure of its terms of trade represents an average with prices of individual items of trade scattered around. This is because the measure is derived with the help of price index numbers, which are themselves average of scattered values.

A derivative: Being a derivative of price index numbers, a measure of terms of trade is bound to suffer from all the limitations which are inherent in the compilation of price index numbers. E.g. choice of base period, the choice of weights, the method of averaging, and so on.

3.1.2 Measures of Terms of Trade

Change in a country's terms of trade has some direct and indirect effects on; economic gains from trade, economic growth and potential, and its social welfare. If we take into consideration these "spill-over" effects, several alternative concepts of terms of trade come up for consideration. Hence there exists a plethora of measures of terms of trade going by different names.

Commodity terms of trade (TTC)

This is the most popular measure and it is also known as Net Barter Terms of trade or the unit value index. It is the ratio of the price index number of exports to the price index of imports of the country concerned.

Symbolically, this ratio may be written as: TTC 7(Px/Pm) 100

Where:

TTC = commodity terms of trade

Px = price index of exports

Pm = price index of imports.

TTC is limited by the choice of base years, weight and average. Gross barter terms of trade. This is a measure introduced by F.W. Taussig. It is uses relative change in a country's volume of exports and imports as against the comparative changes in their prices.

This is given as:

TTg = (Qm/Qx) x 100

TTg = Gross barter terms of trade Qm = Quantity index of imports
Qx = Quantity index of exports.

The major limitation of this measure is the problems of compilation, no credit sales, unilateral transfer etc.

3.2 Balance of Trade

This is the difference between visible imports and visible exports. Its visible imports are greater than visible exports; balance of payments is said to be unfavourable. Where visible exports are greater than visible imports, there is a favourable balance of trade. On the other hand, where visible exports is equal to visible imports, there is a balanced of trade.

3.3 The Negative Effects of International Trade

For centuries, economic and policy makers assumed that every country gained from its international trade. Their discussion focused on issues relating to the source, the mechanism, the firms and the extent of these gains.

Doubts however, began to emerge after the Second World War when issues relating to economic development and welfare began to gain ground.

Analysts found that while developed countries gained from international trade this was not necessarily the case with poor countries, rather, they could positively suffer on account of foreign trade. Such long term ill- effects may include:

- inability of a developing country to pursue sustainable development.
- exhaustion of non-renewable productive resources
- environmental degradation and pollution.

3.3.1 Immiserising Growth

The concept immiserising growth refers to the situation where an increase in a country's export commodity leads to such deterioration in its terms of trade that there is a net decline in its export earnings and social welfare.

For immiserising growth to occur, the following conditions must hold:

1. The country's growth should be characterised by a more than proportionate increase in the production of its export commodity.
2. The supply of its exports commodity should be price inelastic so that it is willing to export more even when price declines.
3. The share of its export commodity in the total supply in international market should be large enough to depress its international prices.

3.3.2 The Dutch Disease

The Dutch disease is an economic loss which a country suffers on account of an increase in its factor endowment or a natural windfall (like the discovery of huge oil resources or deposit of a mineral).

The concept describes a situation where industrial country starts exploiting a natural product which it was previously importing. In the process, its exchange rate appreciate so much that its competitiveness in traditional industries weakness and even results in its de-industrialisation to some extent. Netherlands developed its natural gas fields from the North Sea and gave birth to this term. Other countries that have suffered from the Dutch disease are the United Kingdom, Norway, Australia and Mexico.

Self-Assessment Exercise
Distinguish between government legislation and government commercial policy as non-tariff barriers to nations engaged in international trade.

3.4 Theories of International Trade

These are also known as the basis of international trade.

3.4.1 The Theory of Absolute Advantage

The classical economists, Adam Smith said that the basis of international trade falls along the division of absolute advantage, which may be defined as the good, or services in which a country is more efficient or can produce more than the other country or can produce the same amount with other country using fewer resources.

This theory was proposed in 1776, by Adam Smith. He also states that trade between two countries will take place if each of the two countries can produce one commodity at an absolute lower cost of production than the other country.

Example, Nigeria can produce one unit of cocoa with 10 labour hours and one unit of textile material (for instance, lace) with 20 labour hours while Australia can produce one unit of cocoa with 20 labour hours and one unit of lace textile material with 10 labour hours.

Note that from the above given example, it would be to their mutual advantage. If Nigeria produces only cocoa and Australia produced only lace textile material with the former exporting her surplus cocoa to Australia while Austria exporting her surplus production of lace textile material to Nigeria. This shows that there is absolute difference in terms of cost since each country can produce one commodity (Nigeria cocoa and Austria lace textile material) at an absolute lower cost than the other country.

3.4.2 The Theory of Comparative Advantage

This theory was first stated by Adam Smith and later developed by David Richardo and John Stuart Mill.

According to Adam Smith, "it is the maximum of every prudent master of a family never to attempt to make at home what it will cost him more to make than to buy".

If Nigeria and Togo for instance, are two countries of the world, Nigeria produces cassava better than Togo and Togo is better at producing fish. Nigeria should specialise in the production of cassava, while Togo concentrates its resources; on the production of fish. They can trade their products. But even if Nigeria is better than Togo in the production of both cassava and fish, while Togo is at a disadvantage, both countries can still benefit by each one specialising in the production of the goods where it has the greater comparative cost advantage or the least comparative cost advantage.

Richardo took the application of the law to trade between two countries and conclude that both countries will benefit if each of them concentrates on producing the commodity where it can perform more efficiently and exchange the product with the one it can produce less efficiently.

3.4.3 The Rent for Surplus Theory

This theory has its origin with the classical economists just like the theory of comparative cost advantage; it was first propounded by Adam smith. According to him, a country carries out that surplus part of the produce of their land and labour for which there is no demand; it gives a value of these surplus by exchange them for something else, which may satisfy a part of their wants, and increase their enjoyment. The important aspect of the rent for surplus theory includes:

- International trade does not necessarily reallocated factors of production but enables the output of the surplus resources to be used to meet foreign demand.
- The population density of a country largely determines its export potential since the total volume of production is based on available labour so also is internal consumption level as well as what will be the surplus to be exported.
- The surplus productive capacity of resources enables farmers to produce export crops without necessarily compromising the production of food crops which enter into the domestic market.

3.4.4 The Theory of Factor Proportions

This theory is also known as Hecksher – Ohlin theory. The theory was based on a more modern concept of production, one that raised capital to the same level of importance as labour. Heckscher –Ohlin theory states that the differences in the relative prices of commodities in the two isolated regions (this is the basic cause of international trade) depend upon the conditions of the demand and the supply of the commodities in the two regions.

This theory is based on four basic assumptions which are:

a. The theory assumes two (2) countries, two (2) products and two (2) factors of production hence, the so-called 2x2x2 assumption.
b. The markets for the inputs and the outputs are perfectly competitive. That is, the factors of production, labour and capital were exchanged in markets that paid them only what they were worth, hence, perfect competition ensured between the two countries involved, with no one having market power over the other.
c. Third assumption says increase in the production of a product can experience diminishing returns. This means that, as a country increasingly specialised in the production of one of the two outputs, it eventually would require more and more inputs per unit of output.
d. Lastly, assuming both countries make use of identical technologies, each production was produced in the same way in both countries. This meant that, the only way in which a god production can be produced more cheaply in one country than the other is when the factors of production used (Labour and capital) are cheaper.

3.4.5 Competitive Advantage of Nations

Michael Porter of Harvard Business School developed this theory which attempts to explain why particular nations achieve international success in particular industries.

Porter states that "National Prosperity is created, not inherited. It does not grow out of a country's natural endowments, its labour pools, its interest rates, or its currency's values, as classical economics insists." A nation's competitiveness depends on the capacity of its industry to innovate and upgrade. Porter points out the importance of country factors which he categorised into four major component. They are:

- Factor conditions
- Demand conditions
- Related and supporting industries
- Firm strategy, structure and rivalry.

The above mentioned four (4) components constitute what nations and firms must strive to create and sustain through a highly localised process" to ensure their success. It is also illustrated in the diagram below:

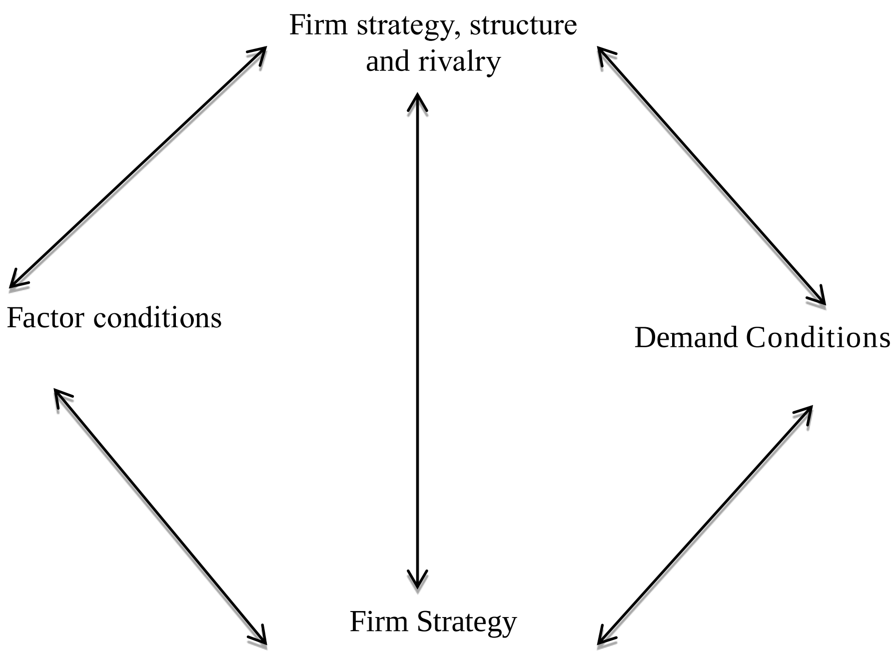

Fig. 1.1: Determinant of National Competitiveness
Source: M.E. Porter Adapted.

Self-Assessment Exercise
Highlight the major theories of international trade you know.

4.0 Conclusion

This unit is indeed self explanatory. You could see how broad and complex international trade is. You have learnt about the in-depth explanation of the term international trade, the major components of international trade, the terms of trade and balance of trade concept. You have also learnt about the techniques and economic effects of international trade restrictions and the common ill effects of trade.

What a journey. Can you see how international trade covers a wide spectrum knowledge that is derived from economics and other fields of study, beside you have learnt about why international trade is necessary.

5.0 Summary

International trade is quite wide. It involves not only merchandising, importing or export but trade in services, licensing and franchising as well as foreign investments.

While the theory of comparative cost advantage explains the principles of international division of labour, the rent for surplus theory, on the other hand, seeks to explain the principles of international trade in terms of both domestic and foreign demands.

It therefore infers that a country will not export its produce merely on the basis of comparative cost advantage if the volume produced cannot meet domestic demand. The point at which a country's product enters into international trade is determined at the time when it can produce a surplus.

6.0 Self-Assessment Exercise

1. Discuss succinctly, the three key components of international trade.
2. Carefully discuss the rent for surplus theory of international trade.

7.0 References/Further Reading

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