WJEC (Wales) Economics A-level

Trade Development

Topic 1: Global Economics

1.1 International trade

Notes

International trade

This is the exchange of goods and services across international borders.

The distinction between absolute and comparative advantage

A country has **absolute advantage** in the production of a good or service if it can produce it using fewer resources and at a lower cost than another country.

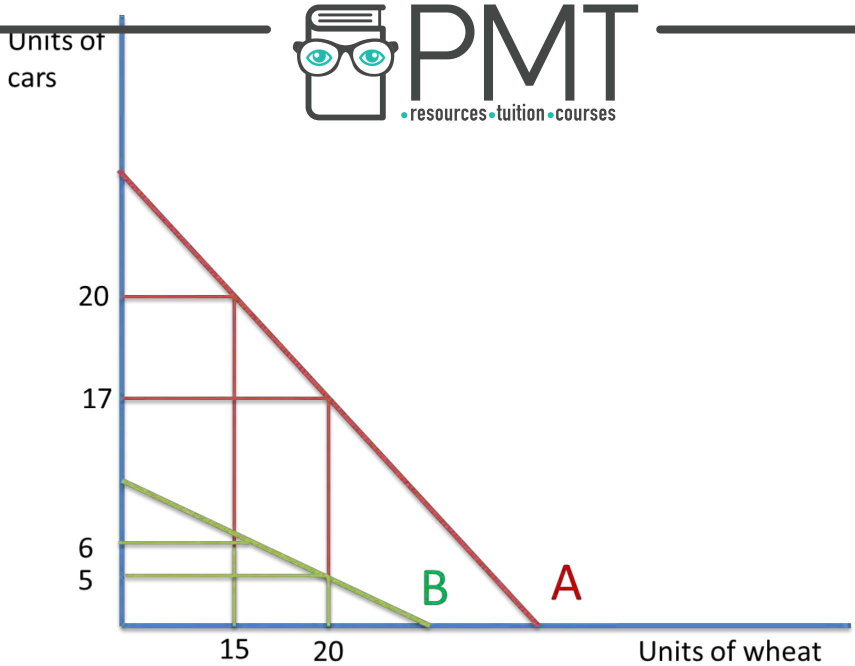
Comparative advantage occurs when a country can produce a good or service at a lower opportunity cost than another country. This means they have to give up producing less of another good than another country, using the same resources.

Opportunity cost ratios to illustrate the gains from trade derived from absolute and comparative advantage

Countries can specialise where they have comparative advantage. This increases economic welfare. By specialising and exploiting their comparative advantage, countries can increase world output.

Country A can produce 30 units of wine and 10 units of wheat with their resources, and country B can produce 32 units of wine and 20 units of wheat. It can be seen that country B has an absolute advantage in producing both products (it can produce more of both with the same resources). The greatest difference between the productions is with wheat, so country B should produce wheat and country A should produce wine.

The opportunity cost of production is reflected in the gradient of the PPF. If more of one good is produced, less of the other good can be produced.



From the diagram, it can be seen that to increase production of wheat by 5 units, A has to give up 3 units of cars (20 to 17). However, B only gives up 1 unit of cars (6 to 5). Therefore, B has a lower opportunity cost of producing wheat, so B should produce wheat. For each unit of wheat, the opportunity cost ratio for A is 3/5, whilst for B it is 1/5.

The measurement of the terms of trade

The terms of trade measures the volume of imports an economy can receive per unit of exports. It is calculated by the index price of exports over the index price of imports.

Terms of trade above 100 are improving, whilst those below 100 are worsening.

An example calculation is:

- The index price of exports increases by 15%. The index price of imports increases by 20%. The terms of trade are (115/120) x 100 = 95.83. This means that the terms of trade has reduced, so the economy gets fewer imports per unit of exports.

The determinants of the terms of trade, including Heckscher-Ohlin theory

The Heckscher-Ohlin model (H-O model) suggests that countries produce and export goods which need abundant resources, and import goods which need resources in short supply.

Essentially, the different factor endowments in each country determine what a country imports or exports. The model assumes that labour and capital is able to flow freely between sectors, that the quantity of labour and capital in each country varies, that in the long run technology is the same among countries and that tastes are the same.

How the pattern of global trade has changed over time

Since WW2, global trade has increased significantly. The increasing number of trading blocs, the rise of emerging markets such as China and India and greater participation from previously communist nations has led to a change in the pattern of trade.

Trading blocs have led to trade creation between members, since there is free trade within the bloc. However, trade has been diverted from outside the bloc, since protectionist barriers are often imposed on countries who are not members.

The deindustrialisation of countries such as the UK has meant the manufacturing sector has declined. This means that production of manufactured goods has shifted to other countries, such as China, whilst the UK now focuses more on services.

This has led to the industrialisation of China and India. Their share of world trade has and the volume of manufactured goods that they export has increased.

The collapse of communism has meant that more countries are participating in world trade.

For a long time, China has been running a trade surplus with the US. Since 2006, the US trade deficit has narrowed with China, and China has reduced their trade surplus, too. China has planned this change from export-led growth to growth fuelled by domestic consumption.

Evaluate comparative advantage as an explanation of global trade patterns

The theory of comparative advantages assumes a perfectly competitive market. In reality, this is likely to be different, which results in the full benefit of specialisation not happening. Specialising fully could also lead to structural unemployment, since workers might not gain the transferable skills they need to change between sectors, or they are simply unable to change.

Comparative advantage does not consider the exchange rate when considering the cost of production for both countries. Therefore, if the price of one good increase, it is more worthwhile producing that good, even if the country has a comparative advantage in the other good.

Countries can develop an advantage in the production of a good, such as Vietnam in the production of coffee. It is the largest coffee supplier to the UK and, over the last 30 years, it has become one of the world's largest coffee producers. During this period, Vietnam's market share increased from 1% to 20%.

Moreover, comparative advantage is derived from a simple model with two countries; the global trade market is significantly more complex than this.

It can be argued that comparative advantage is no longer a relevant concept. Countries do not only produce a handful of goods and services, like the theory suggests. Rather, a wide variety of goods and services are produced, and there is very little specialisation. This is helped by the advancement of technology. However, comparative advantage has helped construct the pattern of world trade, even if it has evolved over time.

Advantages and disadvantages of international trade

Advantages:

- Greater world output, so there is a gain in economic welfare.
- There could potentially be higher quality, since production focusses on what people and businesses are best at.
- A greater variety of goods and services could be produced.
- Lower average costs, since the market becomes more competitive.
- There is an increased supply of goods to choose from.
- There is an outward shift in the PPF curve.
- More opportunities for economies of scale

Disadvantages:

- Less developed countries might use up their non-renewable resources too quickly, so they might run out.
- Countries could become over-dependent on the export of one commodity, such as wheat. If there are poor weather conditions, or the price falls, then the economy would suffer.
- There could be more structural unemployment, since production moves abroad.
- Some countries might become stuck in the production of one good or service, so they cannot develop further.

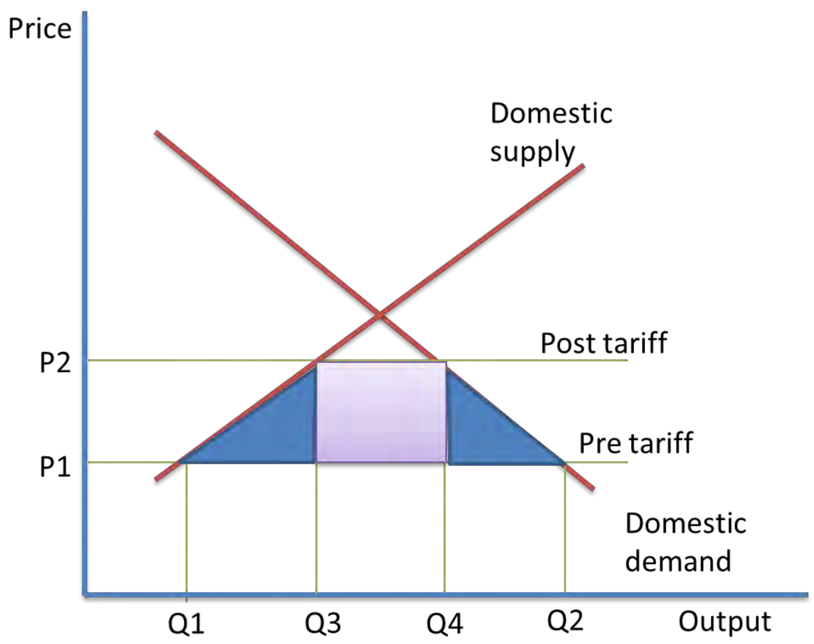
Protectionism

Protectionism is the act of guarding a country's industries from foreign competition.

Methods of protectionism and their impact

Tariffs

Tariffs are taxes on imports to a country. It could lead to retaliation, so exports might decrease. The impact of tariffs is that the quantity demanded of domestic goods increases, whilst the quantity demanded of imports decreases.



The tariff diagram illustrates the effects of imposing a tariff. The original quantity of imports is Q2 – Q1, and the new quantity of imports is Q4 – Q3.

The purple shaded rectangle shows the revenue the government gains from imposing the tariff. This could help finance government expenditure.

The two blue triangles show the area of deadweight loss of welfare, as a result of the tariff.

Quotas

A quota limits the quantity of a foreign produced good that is sold on the domestic market. It sets a physical limit on a specific good imported in a set amount of time. It leads to a rise in the price of the good for domestic consumers, so they become worse off.

- **Export subsidies**

This is a form of government intervention to encourage goods to be exported rather than sold on the domestic market. The government might use direct payments, tax relief, or provide cheap access to credit.

- **Embargoes**

This is the complete ban on trade with a particular country. It is usually politically motivated.

- **Excessive administrative burdens ('red tape')**

Excessive administration increases the cost of trading, and hence discourages imports. It makes it difficult to trade with countries imposing red tape, and is particularly harmful for developing countries which are unable to access these markets.

It is harder to notice this type of protectionism, which is why it is favoured among some countries.

Benefits of protectionism

- If a country employed several protectionist measures, then a trade deficit would reduce. This is because they will be importing less due to tariffs and quotas on imports.
- Infant industries might need protecting. These are industries which are relatively new and receive support. Protectionism is usually short term until the industry develops, at which point the industry can trade freely.
- Protectionism could be used to correct market failure. It can deal with demerit goods and protect society from them.
- Governments might employ protectionist measures to improve the current account deficit.

- Governments might want to protect domestic jobs.

Costs of protectionism

- Protectionism could distort the market and lead to a loss of allocative efficiency. It prevents industries from competing in a competitive market and there is a loss of consumer welfare. Consumers face higher prices and less variety. By not competing in a competitive market, firms have little or no incentive to lower their costs of production.

- It imposes an extra cost on exporters, which could lower output and damage the economy.

- Tariffs are regressive and are most damaging to those on low and fixed incomes.

- There is a risk of retaliation from other countries, so countries might become hostile.

- Protectionism could lead to government failure.

Characteristics of globalisation:

Globalisation is the ever increasing integration of the world's local, regional and national economies into a single, international market.

It involves the free trade of goods and services, the free movement of capital and labour and the free interchange of technology and intellectual capital.

With the spread of globalisation came more trade between nations and more transfers of capital including FDI (foreign direct investment). Moreover, brands developed globally and labour has been divided between several countries. There is more migration and more countries participate in global trade, such as China and India, as well as higher levels of investment. Additionally, countries have become more **interdependent,** so the performance of their own country depends on the performance of other countries. This could be seen in 2008 and 2009, when the effects of the global credit crunch spread across the globe.

Factors contributing to globalisation in the last 50 years

Trade in goods:

- Developing countries have acquired the capital and knowledge to manufacture goods. The efficient forms of transport make it easier and cheaper to transfer goods across international borders. Some developing countries have the cost advantage of cheaper labour, so MNCs move their production abroad. This causes developed countries to trade with these developing countries, so they can access the same manufactured goods.

Trade in services:

- For example, the trade of tourism, call centre services, and software production (particularly from India) has increased from developing countries to developed countries.

Trade liberalisation:

- The growing strength and influence of organisations such as the World Trade Organisation (WTO), which advocates free trade, has contributed to the decline in trade barriers.

Multinational Corporations (MNCs):

- MNCs are organisations which own or control the production of goods and services in multiple countries. They have used marketing to become global, and by growing, they have been able to take advantage of economies of scale, such as risk-bearing economies of scale. The spread of technological knowledge and economies of scale has resulted in lower costs of production.

International financial flows:

- For example, the flow of capital and FDI across international borders has increased. China and Malaysia have financed their growth with capital flows. Also, the foreign ownership of firms has increased. There has been more investment in factories abroad.
- The removal of capital controls has facilitated this increase.

Communications and IT:

- The spread of IT has resulted in it becoming easier and cheaper to communicate, which has led to the world being more interconnected. There are better transport links and the transfer of information has been made easier. This is sometimes referred to as the 'death of distance'.

Containerisation:

- This has resulted in it becoming cheaper to ship goods across the world. This causes prices to fall, which helps make the market more competitive. Containerisation means that goods are distributed in standard sized containers, so it is easier to load and cheaper to distribute using rail and sea transport. This helps to meet world demand. Cargo can be moved twenty times as fast as before, economies of scale can be exploited and less labour is required.
- However, it is mainly MNCs which have been able to exploit this, and it could result in some structural unemployment.
- This video provides a good background to containerisation https://www.youtube.com/watch?v=Gn7IoT_WSRA

Impacts of globalisation and global companies on:

Individual countries

There could be trade imbalances between countries. For example, the US runs a large current account deficit with China, who has a large current account surplus.

There could be imbalances and inequalities in consumers' and countries' accesses to health, education and markets.

Within individual countries, there could be income and wealth inequalities if the benefits and costs of globalisation are not evenly spread. This is evident in China, where the population in the rural and urban areas have vastly different levels of income and living standards.

Culture could spread across the globe. Some might say this has weakened culture and that there has been a loss of cultural diversity due to global brands. However, others will argue that the spread of culture has been positive and helped to improve their quality of life.

Governments

Some governments might lose their sovereignty due to the increase in international treaties. Individual states would find it hard to resist the force of them, and if countries become members of organisations, they will have to abide by their rules.

Producers and consumers

Consumers and producers can earn the benefits of specialisation and economies of scale as firms become larger.

Firms operate in a more competitive environment, which encourages them to lower their average costs and become more efficient.

Producers can also make their average costs lower by switching production to places with cheaper labour. The spread of technology has resulted in firms being able to employ the most advanced machines and production methods.

Globalisation leads to a general increase in world GDP, which increases consumer living standards and helps lift people out of absolute poverty. However, it is hard to calculate the proportion of growth which was due to globalisation.

This rise in average consumer incomes could offset some of the lower costs of production for firms. This is especially due to increased demand from China, which has contributed to the increase in price of commodities, and therefore pushed up the price of raw materials.

Some consumers gain more from globalisation than others. Globally, there are fewer people in extreme poverty, but this has not been the case in Sub-Saharan Africa. There could be increased inequality. Oxfam research in 2015 suggested that 1% of the world own more than the rest of the world (more information here http://www.bbc.co.uk/news/business-30875633).

Consumers could take advantage of a wider range of goods and services because of the increased availability of goods and services. However, some services might become homogenised, such as hotels.

- **Workers**

Workers can take advantage of job opportunities across the globe, rather than just in their home country.

However, there could be structural unemployment. For example, in the UK after the collapse of the ship building and mining industries, there was a lot of structural unemployment. This is because it was more efficient for manufacturing to occur abroad, so production shifted to lower labour cost nations.

However, it could be argued that countries would have had the change from agriculture to manufacturing to services anyway, and globalisation simply sped it up.

When production shifts to lower labour cost countries, the creation of jobs could be seen as either beneficial or harmful. On one hand, MNCs could be exploiting their labour and providing poor working conditions in, for example, sweatshops. On the other hand, working in a sweatshop might provide a higher, more stable income than any alternatives, such as agriculture.

- **The environment**

Although industrialisation and increased consumer living standards might lead to more pollution through increased production and increased car use, consumers might show more concern towards the environment as their average incomes increase.

Some of the negative impacts on the environment could include deforestation, water scarcity and land degradation.

The UK's major export sectors

- The UK trades mainly with the EU, and they export a lot to the US. Recently, the UK has increased the volumes of imports from China.
- The main UK exports are manufactured goods, services, chemicals; food, beverages, tobacco

The internal and external consequences of economic integration

- **Trade creation and trade diversion**

With more trading blocs, trade has been created between members, but diverted from elsewhere. Trade creation occurs when a country consumes more imports from a low cost producer, and fewer from a high cost producer. Trade diversion occurs when trade shifts to a less efficient producer. Usually, a country might stop importing from a cheaper producer outside a trading bloc to a more expensive one inside the trading bloc. Moreover, protectionist barriers are often imposed on countries who are not members, so trade is diverted from producers outside the bloc to producers within the trading bloc. The UK trades mainly with the EU, at the expense of former trade links in the Commonwealth.

- **Reduced transaction costs**

Since there are no barriers to trade or no border controls, it is cheaper and simpler to trade.

- **Economies of scale**

Firms can take advantage of a larger potential market in which to trade. For example, the EU has 500 million people to sell to. By specialising, firms and countries can exploit their comparative advantages, and the gains of efficiency and advanced technology can be reaped.

- **Enhanced competition**

Since firms operate in a more competitive market, they become more efficient and there is a better allocation of resources. There could be the long run benefits of dynamic efficiency too, although these benefits are not always spread evenly across each member.

- **Migration**

By being a member of a Customs Union, the supply of labour is increased, which could help fill labour shortages. However, this might mean some countries lose their best workers.

This summary by the BBC summarises the main costs and benefits of EU membership for the UK:

http://www.bbc.co.uk/news/uk-politics-20448450

The role of the WTO in policing trade agreements and negotiations

The WTO promotes world trade through reducing trade barriers and policing existing agreements. It also settles trade disputes, by acting as the judge, and organises trade negotiations.

Every member of the WTO must follow the rules. Those who break the rules face trade sanctions. In addition to trade in goods, the WTO covers the trade in services and intellectual property rights.

As of 2015, there are 161 member states in the WTO.

The progress made and difficulties faced by the WTO, such as agricultural disputes and trade agreements

Trading blocs might distort world trade or adversely affect those who do not belong to them. There could be an inefficient allocation of resources as a result of policies such as the EU CAP.

Conflicts between blocs could lead to a rise in protectionism. A common external tariff contradicts the WTO's principles, since although there is free trade between members, protectionist barriers are imposed on those who are not members.

Some countries might argue that the WTO is too powerful, or that it ignores the problems of developing countries. This could be since developed countries do not trade completely freely with developing countries, which limits their ability to grow.

Setting up a customs union or a free trade area could be seen to violate the WTO's principle of having all trading partners treated equally. This is especially if a common external tariff is applied. However, they can complement the trading system and the WTO strives to ensure that non-members can trade freely and easily with the members of a trade bloc.