International Trade

An **open economy** is one that engages in international trade (imports and exports) whereas a **closed economy** does not.

Reasons for International Trade

- **Greater choice of commodities / higher standard of living**
  - Trade allows us benefit from a greater variety of goods and services, than would be available without trade. We lack some essential raw materials for production and thus must import these. Trade increases our standard of living.
- **More competitive prices of goods and services**
  - Trade results in greater competition on the market which should lead to more competitive prices for consumers.
- **Strengthens home economy / boosts employment / investment opportunities**
  - Employment will be created in those industries which are expanding due to the benefits of trade. A healthy trading economy generates confidence in the economy and investment is thus encouraged. GDP is boosted and an incentive to grow may develop.
- **Companies benefit from economies of large scale production**
  - With trade, specialisation will take place. Companies will increase production and may benefit from economies of scale. Domestic firms may become more competitive and more efficient

The Laws of International Trade

- The Law of Absolute Advantage
  - Each country should specialize in the production of goods that it has absolute advantage in producing (can produce more efficiently than other countries) and trade for its other requirements

  - Specialisation
    - Where one country is more efficient than another in the production of a particular commodity, it should produce that commodity, as this will be to the benefit of the country itself and overall world output

Example

Before Trade:

Country	**Commodities**	
	Computers	**Beer**
France	**800**	**700**
Spain	**600**	**900**
Total Output	**1400**	**1600**

France has absolute advantage in producing computers (800>600)

` Spain has absolute advantage in producing beer (900>700)

After Specialisation:

Country	**Commodities**	
	Computers	**Beer**
France	**1600 (800x2)**	
Spain		**1800 (900x2)**
Total Output	**1600**	**1800**

France specialises in producing computers and doubles its production to 1600, as all those who used to make beer now switch to making computers.

Spain specialises in producing computers and doubles its production to1800, as all those who used to make computers now switch to making beer.

The world is better off as global production of computers has increased by 200 units and global production of beer has increased by 200 units, after specialization.

- **The Law of Compartive Advantage**
  - Each country should specialise in the production of goods that it is **relatively more efficient** at producing (can produce more efficiently than other countries) and trade for its other requirements

Example

Before Trade:

Country	**Commodities (Output per worker per hour)**	
	Food	**Machinery**
Country X	5 Tonnes	10 units
Country Y	20 Tonnes	30 units
Total Output	**25 Tonnes**	**40 units**

Country Y has absolute advantage (is more efficient) at producing both goods.
However Country Y is relatively more efficient (comparative advantage) when producing food

- It produces food at a ratio of 4:1 (20/5) versus Country X and machinery at a ratio 3:1 (30/10)
- Country Y should specialise in producing Food and trade for machinery

After Specialisation:

Country	**Commodities (Output per worker per hour)**	
	Food	**Machinery**
Country X		20 units (10 x 2)
Country Y	40 Tonnes (20 x 2)	
Total Output	**40 Tonnes**	**20 units**

Country X specialises in producing machinery and doubles its production to 20 machines, as all those who used to make food now switch to making machinery.

Country Y specialises in producing food and doubles its production to 40 tonnes of food, as all those who used to make machinery now switch to making food.

Option 1
Assuming there are only two countries in the world, as the 60% increase in food production (15/25) is greater than the 50% decrease in Machinery production (20/40) the world is using its resources more efficiently and is better off.

Option 2
So long as Country X **gets** at least ½ Tonne (5/10) of Food for each machine it exports, it will benefit from trade
So long as Country Y **gets** at least 1.5 machines (30/20), for each tonne of food it exports, it will benefit from trade

Option 3
For each tonne of Food Country X imports, provided it **gives** Country Y less than 2 machines (10/5), it will benefit from trade
For each machine Country Y imports, provided it **gives** Country X less than 2/3 tonnes of food (20/30), it will benefit from trade

- **Terms of Trade**
  - **Definition:** The amount of imports that can be purchased with a unit of export OR The ratio between the average price of exports and the average price of imports
  - **In the above example:**
    - 1 Tonne of food is worth 2 machines (10/5) to Country X and 1.5 Machines (30/20) to Country Y
    - 1 Machine is worth ½ Tonne of Food (5/10) to Country X and 2/3 Tonne of Food (20/30) to Country Y
    - Terms of Trade:
      - 1 Tonne of food is worth between 1.5 and 2 machines
      - 1 Machine is worth between ½ and 2/3 tonnes of food

- **Assumptions underlying the Law of Comparative Advantage**
  - **Transport costs do not exist**
    - The LOCA assumes that transport costs do not exist. However, for an island nation like Ireland, transport costs can be a major cost factor and can act as a major barrier to trade. A firm's cost-efficiencies may be eliminated by the transport costs involved.
  - **The law of diminishing marginal returns (LDMR) does not apply**
    - The LOCA assumes that the LDMR does not apply/assumes constant returns to scale. But this law does apply. Each extra person employed will not continue to produce the same amount as the original person. A point will eventually be reached when an extra person employed will produce less additional output.
  - **Free trade takes place**
    - The LOCA assumes that free tree takes place. While this may be true within the EU, free trade is often limited where countries impose barriers to trade for economic, social or cultural, moral reasons.

- **The complete mobility of labour/factors of production exist**
  - We have assumed that the person who becomes unemployed in each country as a result of specialisation occurring can switch to an alternative job and that there are no barriers to mobility. This is not always the case as there are barriers to the complete mobility of labour.
- **Alternative employment is available**
  - It is assumed that people who become unemployed in one sector arising from specialisation can find alternative employment. This may not be the case. Consider countries during a recession the availability of employment is very difficult/ huge adjustment costs in the transition.
- **An equal distribution of benefits occurs**
  - When we calculate the terms of trade we assume that both countries benefit from trade. Consider a developing country – sometimes the terms of trade may not be to its advantage. It may receive very low export prices and have to pay high import prices. Hence, their bargaining position is weak and they may not benefit from trade to the extent that developed more powerful counties do.

- **<u>Sources of Comparative Advantage for Ireland</u>**
  - **Climate**
    - Our climate is suitable for the production of crops like potatoes, grazing for livestock.
  - **Raw Materials**
    - For example Moss Peat, blanket bogs provide the raw material which is scarce in other countries.
  - **Educated and skilled workforce**
    - Companies locate here without incurring exorbitant training costs. the workforce has developed specific skills in production/services over a period of time e.g. ICT, food production, pharmaceutical companies
  - **Low rate of CPT**
    - This means that the costs of operation may be more competitive in Ireland than in other countries.

<u>Specialisation and Competitiveness</u>

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- **Factors that affect the competitiveness of Irish Firms**
  - **Irish inflation rates v. that of competitors**
    - If the level of inflation is lower in Ireland than in the firm's export markets then the firm's goods have a price advantage.
  - **Value of the Euro v. that of other currencies**
    - If the value of the euro rises against that of other currencies then the price of that firm's exports will rise. In the recent past the euro fell against both the dollar and sterling making exports to these countries cheaper / imports from these countries dearer.
  - **Transport costs**
    - As Ireland is an island nation transport costs can be significant when exporting goods from Ireland and must be included into the final price .Transport costs are rising: toll charges; fuel prices. The rise in world oil prices has meant that Irish producers face a rising transport bill.
  - **Labour Market – Costs**
    - If labour costs in Ireland rise above that in export markets, then these additional costs must be borne by the final consumer and this increases the price of the exports. Industry representatives have stated that Ireland must limit wage increases so as to maintain international competitiveness / lower wages rates in the public sector. The introduction of the minimum wage rate has increased labour costs
  - **Government policies which affect a firm's cost structure**
    - Any actions by the government or EU imposing further requirements on industry which have cost implications for firms will have the effect of making exports less competitive. Examples include increasing rates of VAT, additional regulations in the market.
  - **Costs of production**
    - Many firms have expressed concern about the cost of utilities i.e. waste disposal; water provision. These cost increases force prices up and this makes exports less competitive. With rising oil prices energy costs rise leading to reduced competitiveness.

- **Importance/benefit of specialization**
  - **Greater efficiency in the allocation of scarce resources.**
    - When countries specialise in producing goods in which they have a comparative advantage, they maximise their combined output and allocate their resources more efficiently.
  - **Greater inter-dependence.**
    - A country which specializes is no longer self-sufficient and hence must trade for the remainder of its requirements.
  - **Increased wealth, raising aggregate demand.**
    - When specialisation occurs individual countries gain thus increasing wealth and allowing it greater opportunities for engaging in trade / consumers will demand increased choice /variety of commodities.
  - **Lower costs and prices.**
    - Specialisation improves efficiency resulting in lower costs and prices. With lower prices for commodities consumers will increase their demand and this leads to more trade.
  - **Division of labour.**

  - When labour specialises skills may improve. Labour therefore becomes more mobile thus allowing for greater trade in labour.
- **Economies of scale.**
  - Greater economies of scale may be available when producing a product for a world market that would not be available when producing for a more limited domestic market.

Importance of International Trade for Ireland

- **Greater standard of living / increased wealth**
  - Trade increases wealth / GNP and this allows the purchase of a greater quantity of goods and services.
- **Greater choice of commodities / Commodities we are unable to produce.**
  - Trade allows us benefit from a greater variety of goods and services, than would be available without trade. We lack some essential raw materials for production and thus must import these.
- **More competitive prices of goods and services.**
  - Trade results in greater competition on the market which should lead to more competitive prices for consumers.
- **Employment / Investment opportunities.**
  - Efficient production means that employment in these industries is more secure. Employment will be created in those industries which are expanding due to the benefits of trade. A healthy trading economy generates confidence in the economy and investment is thus encouraged.
- **Companies benefit from economies of large scale production**
  - With trade specialisation will take place. Companies will increase production and may benefit from economies of scale. These savings may be passed onto consumers in the form of lower prices and/or greater innovation.
- **Allows for the sale of surplus/ excess domestic output.**
  - If a company is competitive then it has the opportunity to sell that output which it doesn't/can't sell domestically on the international market. The Irish domestic market is small.
- **More efficient use of scarce world resources.**
  - By specialising in production countries maximise their combined outputs and thus resources are allocated more efficiently, resulting in less wastage.

Free Trade verses Protectionism

Free Trade: When there are no barriers to the movement of good and services between nations

Protectionism: Where a country takes measures to restrict imports entering the country.

- **<u>Arguments in Favour of Restricting Free Trade</u>**
  - **Protect indigenous firms / infant industries.**
    - Infant industries may have a difficulty competing with established industries in other countries. By protecting a newly established **company it may mature into a strong company worldwide.**
  - **Protect domestic employment.**
    - Foreign competition may result in job losses. By limiting imports jobs may be protected.
  - **Prevent 'dumping'.**
    - Barriers will stop other firms from 'dumping' and so stop their ability to undermine domestic firms, which may result in their closure.
  - **Prevent imports from 'cheap labour' economies.**
    - Companies cannot compete with those countries who gain their comparative advantage by paying their workers low wages. Competition from these countries may be considered unfair.
  - **Protect a declining industry for a period of time.**
    - In the past some industries have been protected so that their decline can be gradual thus allowing workers retrain and allowing time for sourcing replacement industries.
  - **Protect industries/firms susceptible to foreign competition.**
    - Within the EU, agriculture and fishing are seen as important industries. For this reason the EU seeks to protect these industries from external competition.
  - **Safeguard National Security.**
    - In the past Ireland imposed strict regulations governing the importation of agricultural commodities so as to protect the country from foot and mouth disease.
  - **Safeguard the production of strategic goods.**
    - Countries may wish to ensure that the production of certain commodities, which it deems essential to the operation of the economy, are safeguarded from competition to provide continuity of supply.

- **<u>Methods of Restricting Free Trade (Protectionism)</u>**
  - **Tarrifs**
    - A tariff is a tax on imports. It makes the import more expensive so that consumers are encouraged to purchase home produced goods instead
  - **Quotas**
    - A limit placed on the number of goods allowed to enter the country. Again, this helps to encourage the purchase of domestically produced goods. Depending on the nature of the good, it can encourage profiteering by the importer.
  - **Embargoes**
    - A complete ban on the importing of a good, or importing goods from a particular jurisdiction.
  - **Administrative barriers**

        - Where countries place some much “red tape” on the importing of goods that importers do not bother with the inconvenience.
    - **Subsidies to exporters.**
        - Where the government intervenes to reduce the cost of production for domestically produced goods so that the indigenous firm can compete with foreign imports.

<u>Trade Agreements and Trading Blocs</u>

- **Trading Bloc**
    - An agreement between states, regions, or countries, to reduce barriers to **trade** between the participating regions.
        - **EU:** Within the EU there is free movement of good and services. Member states cannot place tariffs on good and services purchased from other EU states
        - **NAFTA** (North American Free Trade Agreement): A trading bloc involving Canada, USA and Mexico
- **World Trade Organisation**
    - WTO was setup in 1995 and now consists of 153 countries. The main objective of the WTO is the promotion of trade among its members based on the principle of non-discrimintation. It holds negotiations between countries and works towards the removal of trade barriers.
        - Objective of the WTO
            - To promote World Trade in a manner that benefits every country;
            - To ensure that developing countries secure a better balance in the sharing of the advantages resulting from the expansion of international trade corresponding to their developmental needs
            - To demolish all hurdles to an open world trading system and usher in international economic renaissance because the world trade is an effective instrument to foster economic growth;
            - To enhance competitiveness among all trading partners so as to benefit consumers and help in global integration;
            - To increase the level of production and productivity with a view to ensuring level of employment in the world;
            - To expand and utilize world resources to the best;
            - To improve the level of living for the global population and speed up economic development of the member nations.

Balance of Trade and Balance of Payments

Balance of Trade

- The difference between visible exports and visible imports
    - Visible goods are goods that are tangible
    - Generally, countries seek to have more exports than imports. i.e. a trade surplus

Balance of Invisible Trade

- The difference between invisible exports and invisible imports

    - Invisible exports are services we sell to other countries
        - Eg Ryanair selling a ticket to a foreign person
        - Or tourists staying in Irish Hotels
        - Foreign person buying insurance from an Irish company

    - Invisible imports are services we buy from other countries
        - Irish person buying a flight from British Airways
        - Irish tourists holidaying in Spain
        - Irish people attending a Coldplay gig in Dublin

Balance of Payments on Current Account

- The difference between total exports (visible and invisible) and total imports (visible and invisible) plus Net Factor Income
    - Net Factor income is made of up the inflow and outflow of dividends, interest and repatriation of profits into and out of Ireland.
        - In Ireland this figure is traditionally negative due to the significant number of MNCs and non-nationals living in Ireland versus the number of Irish people and companies based abroad.

Balance of Payments on Capital Account

- The record of capital receipts and capital payments for a country. The inflow and outflow of items of non-recurring expenditure
    - Examples of capital receipts are:
        - An EU grant or the
        - Sale of patents and copyrights by Irish companies.
        - Investments by foreign companies/individuals in Ireland.
        - Borrowings / grants from foreign sources.
    - Examples of outflows would be:
        - The purchase of foreign assets by domestic individuals or companies.
        - Investments by Irish companies / individuals in foreign companies.
        - Grants / loans to foreign recipients.

- **How foreign firms in Ireland affect the Balance of Payments**
    - These foreign firms may bring with them staff / expertise from their home country. Part of the salaries earned may be returned home (invisible imports).
    - Once they establish a plant they will require capital goods and raw materials. Some of these may need to be imported (visible imports).

    - Some foreign firms produce their commodities for export (visible exports).
    - Profitable foreign firms may decide to repatriate their profits (invisible import).
    - **Effect on the Balance of Payments – Capital Account.**
        - When the foreign firms first come to Ireland they bring with them additional capital investment. This is a long term capital inflow into Ireland.

- **Consequences of a Deficit on the Balance of Payments (Opposite is true for a surplus)**
    - **Income leakage from the economy.**
        - As imports are a leakage from the circular flow of income the multiplier is reduced in size and so national income falls.
    - **Reduction in our external reserves**.
        - If our external reserves are used to finance this deficit then we reduce our ability to make international payments.
    - **Increased foreign borrowing**
        - If borrowing is used to finance this deficit our national debt will increase placing a greater burden on taxpayers.
    - **Job losses**
        - If imports are bought in preference to domestically produced goods it may result in job losses in those domestic industries forced to rationalise.

- **Dealing with a Deficit on the Balance of Payments**
    - **Imports can be restricted**
    - **Control Inflation**
    - **Encourage Exports**
    - **Import Substitution**

- **How Foreign Firms operating in Ireland impact on the Balance of Payments on Current Account**
    - **Salaries / wages returned to home country**
        - These companies may bring staff / expertise from their home country. Part of the salaries earned may be returned to the home country thereby leaving Ireland.
    - **Imported raw materials / capital goods**
        - These companies will require capital goods and raw materials. Some of these may need to be imported. These are physical imports and will appear in the Current Section. **3.**
    - **Exported finished products**
        - Some foreign companies produce their commodities mainly for export. These are considered physical exports and appear in the Current Section.
    - **Repatriated profits**
        - Once profitable these companies may decide to repatriate their profits. These are considered an invisible import.