

4

International trade Core

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On completion of this core section you should know:

- the principles of absolute and comparative advantage and their real-world limitations
- other explanations/determinants of trade flows
- the arguments put forward for free trade and why protectionist measures are applied to limit international trade
- what types of protection are used in international trade and what are their likely effects
- what is meant by *economic integration* and the main characteristics of free trade areas, customs unions and economic unions
- what is meant by the *terms of trade* and how it can be estimated
- the main components of the balance of payments of an economy.

The global economy of the twenty-first century

International trade is the lifeblood of virtually all modern developed and developing economies. As such, it involves the buying and selling of goods and services across national frontiers. At a personal level this is clearly seen through the many imported items that can be found in supermarkets and other retail stores. Products such as Coca-Cola, Fujifilm, Apple iPods, Nike trainers and Nescafé coffee are brands that are available throughout the world.

Increasingly, through international trade, economies have become more and more economically dependent upon each other. For example, the well-being of the US economy affects the well-being of many other economies in Central and South America, Europe, Asia and Africa. This was obvious with the onset of recession in 2008. This dependency can be seen by looking at the respective contributions of **exports** and **imports** to a country's Gross Domestic Product (GDP) (see Chapter 5). For Pakistan, in 2005, these were approximately 15% and 23% respectively. In other economies, this percentage was much greater.

Trade provides an important link between developed and developing economies. From a very general standpoint, the developed economies provide a range of consumer goods, capital equipment and financial services in exchange for raw materials,

certain types of agricultural products and, increasingly, for a range of manufactured goods from the developing economies. Also included in international trade are the ever-increasing global receipts from international tourism. These are of very substantial importance, both domestically and as a source of foreign exchange, for many developing economies in the Caribbean, East Africa and Asia.

On the surface, it may seem best if we 'buy local'. After all, this promotes sales of home-produced goods and restricts the drain on foreign currency reserves caused by the need to pay for imports. But if all countries followed this strategy, there would be very little international trade except for certain essentials that could not be produced in the home market. As we shall see in this chapter, this state of affairs is very wasteful and the world economy as a whole would be poorer as a consequence.

Trade permits countries to specialise in products and commodities which they can produce relatively efficiently. There are many reasons for this specialisation and include the availability of particular factors of production. Economies which have naturally occurring resources, such as oil or copper, can exploit these and trade them on the world market. Alternatively, the climate or soils of a country may make it a good source of certain types of food product or a good destination for international tourists. Other economies may have

a highly skilled workforce or have unit labour costs below that of others so enabling them to produce clothing, electronics or vehicles at competitive prices. These examples are a very clear link to the factors of production identified in Chapter 1.

From an accounting standpoint, the **balance of payments** in an economy is a financial record of all such international transactions. In principle, receipts from exports of goods and services can be used to pay for imports which cannot be produced as efficiently or which cannot be produced at all. The nature of the global economy though is that this is not as simple an exchange process as it might seem. Some economies, such as Germany, Japan and China, have traditionally had export surpluses. In contrast, others, such as the UK, the US and many developing economies, have spent more on imports than exports. Although by definition the world economy's trade flows balance, for individual countries this may not happen. If the imbalance is other than marginal, corrective action has to take place (see Chapter 7).

SELF-ASSESSMENT TASK 4.1



Think about the main types of goods:

- imported into your country
- exported by your country.

Make a list of these and see if you can come up with a simple explanation as to why this is so. Mention the factors of production in your explanation.

The principles of international trade

The economic logic which has underpinned the development of international trade has its origins over 200 years ago in the writings of classical economists who firmly advocated what we now refer to as **multilateral trade**. Their principles of absolute and, particularly, of comparative advantage have modern relevance in the objectives of the World Trade Organization (WTO), which exists to promote freer trade amongst all of its member countries.

The simple economic principles involved are summarised below. These show that trade will take

place when countries have a clear-cut or **absolute advantage** over other countries in what they produce. If we look at the UK's position, for example:

- India has a clear-cut advantage over the UK in the production of tea.
- The Windward Islands can produce bananas, which the UK cannot produce.
- France has an obvious advantage in producing wine for export to the UK.

A list like this can be quite extensive; we could also compile a similar list of items for the trade of any economy.

What is obvious is that, under certain circumstances, trade can also be beneficial where a country may not have such clear-cut advantage. Provided it has a relative or **comparative advantage** in the production of a particular good over another country, trade can produce gains for both partners.

Summary of the principles of absolute and comparative advantage

The following assumptions are made:

- There are just two countries involved in trade (say, France and India).
- Each can produce just two products (say, cloth and cheese).
- Productivity differs between them, so varying quantities of each are produced.
- Production costs and opportunity costs are constant for each product.

The production possibilities are shown in Figure 4.1.

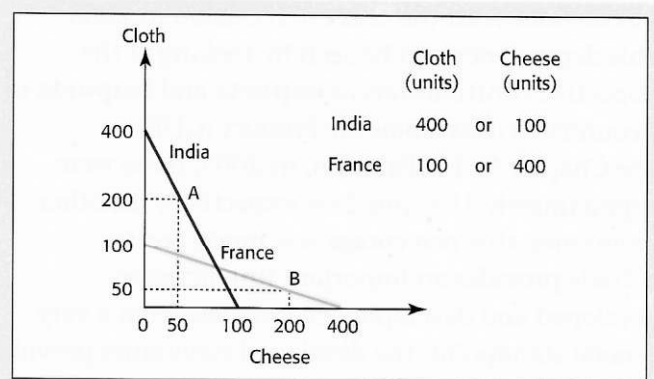


Figure 4.1 Production possibilities – absolute advantage

If each country was self-sufficient and devoted half of its resources to each product, then the situation would be as shown at points A and B on these production possibility frontiers.

India is clearly better at cloth production; France is better at producing cheese. India is said to have an absolute advantage in cloth, France in cheese. If, however, they subsequently specialised, concentrating on those products where they had absolute advantage, each country would actually be better off as a result of trade taking place (see Table 4.1).

	Before trade (half of all resources to each industry)		After trade (all resources to chosen industry)	
	Cloth (units)	Cheese (units)	Cloth (units)	Cheese (units)
India	200	50	400	0
France	50	200	0	400
Total world production	250	250	400	400

Table 4.1 The gains from trade under absolute advantage

India could now import 200 units of cheese from France, an overall gain of 150 units, without losing any cloth production. France can similarly benefit from buying cloth from India.

The above situation, sometimes called reciprocal absolute advantage, means that one country is better at producing one product, the other is superior in the production of the other. This rather obvious situation can be developed a stage further through the principle of comparative advantage – this states that trade between two countries should still take place and be mutually beneficial provided the domestic opportunity costs of production differ.

Going back to our earlier example, let us assume that India has a clear-cut advantage over France in the production of both cloth and cheese (somewhat unlikely, but remember this is no more than a simple model!). Factor endowments, including more advanced machinery, good pasture land and a more productive workforce, could provide this advantage. On the surface, there may seem little point in the two countries trading because India has the edge in producing both cloth and cheese. This is shown in Figure 4.2.

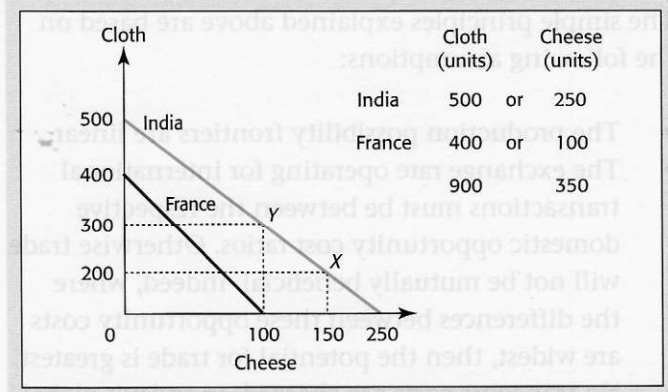


Figure 4.2 Production possibilities with one country having absolute advantage in both products

If India decided not to trade at all, opting for self-sufficiency, each time it wanted more cloth, say, it would have to divert resources from cheese production. This trade-off, applying the concept of opportunity cost, can be shown by a movement on the production possibility frontier from X to Y. As India gained 100 units of cloth, it had to sacrifice 50 units of cheese production – the opportunity cost being that each unit of cloth gained resulted in a loss of half a unit of cheese. A reverse movement would produce a gain of one unit of cheese for every two units of cloth sacrificed. In the case of France, to gain an extra unit of cheese, there would be an opportunity cost of four units of cloth whereas each additional unit of cloth produced would result in a loss of a quarter of a unit of cheese.

The outcome of this principle is that countries should specialise in those goods in which they have the greatest relative efficiency over their trading partners. In other words, they should produce those products where there is least comparative cost. So, using the data above, India should concentrate on producing cheese, France on cloth. If this were to happen, and all resources were re-allocated in this way, total production would increase. This is shown in Table 4.2.

	Cloth (units)	Cheese (units)	Total production has increased by 50 units
India	0	500	
France	800	0	
	800	500	

Table 4.2 The gains from trade under comparative advantage

The simple principles explained above are based on the following assumptions:

- The production possibility frontiers are linear.
- The exchange rate operating for international transactions must be between the respective domestic opportunity cost ratios. Otherwise trade will not be mutually beneficial. Indeed, where the differences between these opportunity costs are widest, then the potential for trade is greatest.
- No transport costs are charged. In today's global economy, this is very unrealistic, but it does reinforce the point made immediately above: There will be a gain from trade if the production benefit is greater than the transport costs.
- The two-country, two-product assumption is again a long way from reality in the twenty-first century. Countries might specialise in narrowly defined product areas, for example, high-quality woollen cloth, not cloth in general, and there are many potential trading partners in the global economy.
- Production costs are most unlikely to be constant. As countries specialise, for example, then they are likely to benefit from economies of scale as specialisation proceeds. They may also experience diseconomies of scale if specialisation goes too far.
- There are no restrictions on free trade between those countries which possess absolute and comparative advantage. This is clearly a very unrealistic assumption that has to be made.

Notwithstanding these assumptions, there are clear gains from international trade as the principles of absolute and comparative advantage indicate. These principles are, of course, extendable to any number of countries and any number of products – the more of each, the greater the total gains from trade, as long as the principle of comparative advantage is followed.

Multilateral trade free from restrictions is therefore beneficial for the overall well-being of the world economy. It ensures that goods are produced in those countries that are the most efficient producers, minimising the waste of scarce resources. Conversely, it is clear that restrictions on trade will reduce the gains that free trade can produce. In the interests of economic efficiency tariff barriers and any other

measures which protect the free movement of goods are to be frowned upon.

Other explanations and determinants of trade flows

The principles of absolute and comparative advantage clearly have their weaknesses when it comes to explaining the reasons underpinning international trade. Alternative theories have been put forward including the following:

- **Competitive advantage** This theory focuses on the actual cost of production and how in reality, firms are continuously striving to reduce their unit costs. This is evidenced in the way that multinational companies are continuously seeking to move production to low-cost economies in order to gain competitive advantage. A typical example is the way in which VW has progressively moved its car production from Germany to lower-cost countries such as Czech Republic, Brazil and Mexico where labour costs are much cheaper.
- **Factor endowment** To some extent this is taken into account in the principles of absolute and comparative advantage. This model of trade stresses the importance of the quantity and quality of the factors of production. Some countries possess natural resources such as oil, natural gas, gold and diamonds. These resources obviously affect what they can produce. Over time, an increase in the quantity and quality of labour and capital could provide the overriding reasoning for an economy's pattern of trade.
- **Government policy** A government may decide that it does not wish to over-specialise and that its best strategy is to diversify production so that it has a range of products available in the event of any dislocation or interruption of supplies. This is clearly a strategic decision which over-rides the underlying assumptions of the principles of absolute and comparative advantage.

Types of protection and their effects

Since free trade leads to a rise in world economic welfare, why should any country adopt policies



The letters below were published in the *Daily Telegraph* on 3 March 2006 in response to an article on the relative merits of cane and beet sugar. Read them and then answer the questions that follow.

Cost of cane and benefits of beet

Sir – As Europe’s main cane sugar refiner (Rose Prince: ‘Buying sugar is as much a moral choice as a hazard to our waistlines’, *Weekend*, 25 February), Tate & Lyle acts as the most important bridge to Europe for African, Caribbean, and Pacific least developed countries.

This access is independent of EU market demand, but commands an EU price, giving suppliers between £250 million and £300 million more for their sugar than would otherwise be the case. Last year this meant that 300 000 direct employees in some of the world’s poorer economies benefited from additional income for their raw sugar, compared with what they would have received by selling in the world market, competing with producers such as Brazil, Australia and Thailand. These funds are vital to sustaining their economies and employment.

Robert Gibber
Tate & Lyle
London EC3

Sir – Rose Prince indulged in the nation’s favourite pastime – farmer bashing. Yes, beet pulp from refining is used for animal feed, but what is wrong with that? It ensures there is no waste and it is not a ‘foul smelling mass’, just innocuous, sweet smelling shreds.

Beet farming does not have a ‘corrosive effect’ on the soil; it has its place in the crop rotation and uses no more pesticides than other crops. Subsidies help with the higher cost of European production. Most cane sugar is grown on farms in the Caribbean and South America, subsidised by very low wages, long working hours and a disregard for health and safety conditions, not just by small farmers seeking fair trade.

Beet sugar is produced, refined and consumed in this country, so demands no unnecessary food miles – something Rose Prince has applauded in previous articles.

Helen Bletcher
Appleby, Lincs



UK’s first bioethanol facility, Wissington, Norfolk

a Using information from the Tate & Lyle letter, explain the effects of the increased export earnings that are paid to sugar cane farmers.

b Comment upon the arguments put forward for producing sugar beet in the UK.

which prevent free trade? Sometimes policies are adopted which distort market forces in order to give a competitive advantage to the domestic industry of an economy. Such policies are called **protectionist** policies because they provide some degree of protection from foreign competition. We discuss below various methods of protecting domestic industry in this way.

Tariffs

A **tariff** is a tax on imports. It can be either specific, that is so much per unit, or ad valorem, which is a percentage of the price. Like all indirect taxes, tariffs have the impact of reducing the supply and raising the equilibrium price of the import. This gives a competitive advantage to home-produced goods and services, which become more attractive to consumers, resulting in a fall in imports.

Consider the situation in Figure 4.3. If this country did not engage in world trade, consumers would pay price P and consume quantity Q . This would be determined by the domestic supply and demand for the product. If the economy engaged in international trade, then consumers would benefit from international specialisation. World supply is shown as Supply (world). Under these circumstances prices would fall to P_1 . Consumption of the product would rise from Q to Q_4 . At this price, however, only Q_1 would be supplied by the domestic producers. This means that domestic production has fallen from Q to Q_1 . Lower-cost overseas producers have free

access to the market, which has benefited consumers, but domestic producers have suffered, leading to a fall in employment in the industry. The imposition of a tariff, like all indirect taxes, would shift the supply curve upwards. This would increase the price to domestic consumers from P_1 to P_2 . Production by domestic producers would increase from Q_1 to Q_2 . Some jobs in the domestic economy would be saved.

Clearly, tariffs distort market forces and prevent consumers from benefiting from all the advantages of international specialisation and trade.

Quotas

A **quota** is a restriction on the maximum quantity of imports. Its effect is to reduce the supply of imports on the domestic market. This will lead to a higher equilibrium price than would occur in a free market. As with tariffs the impact is to prevent the domestic consumer from benefiting from all the advantages of international trade. One difference is that whereas the government gains revenue as a result of tariffs, with quotas the increased price paid by consumers results in the foreign firm which supplied the imports earning higher profits. The other effect of a quota is to restrict the import bill of the country which imposes the quota. An alternative might be for the government to sell licences to foreign firms to allow them to sell some allocation of the quota on the domestic market. The prospect of raised profits would ensure a market for the import licences.

Exchange control

One way of preventing excessive spending on imports is to set legal limits on the dealings in foreign currency that a country's citizens and businesses can make. If importers are limited in their access to foreign currency, they cannot pay for sufficient imports to meet the existing domestic demand. Imports will fall to a level below that which will occur in a free market. Again the consumer would suffer. All member states of the European Union abandoned exchange controls in 1993. This is not the case with all developing economies. In 1998, for example, the Malaysian government introduced temporary exchange controls to protect its exchange rate during the Asian financial crisis. Other developing economies use exchange controls to reduce their external debt.

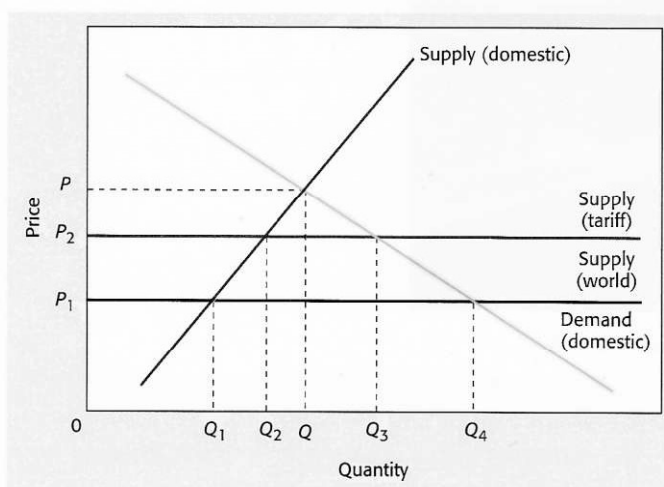


Figure 4.3 The effects of a tariff

Export subsidies

We have defined 'protectionism' in terms of any policy that distorts market forces to give competitive advantage to domestic industry. Sometimes, this is achieved through direct subsidies on exports. The impact of an export subsidy is to increase the supply of an industry's exports on the world market, which will have the effect of reducing prices below those determined in a free market. Foreign consumers will enjoy an increase in their economic welfare as the price of the good falls. Those employed in the domestic market might also benefit as production increases to match demand for the lower-priced goods. They might enjoy higher wages and their jobs might be more secure but only as long as the subsidy lasts. Those who lose out are the taxpayers who have to pay for the subsidy. In addition, as firms divert output to the overseas market, the supply of goods may fall in the domestic market, leading to rising prices and reduced welfare for domestic consumers.

The methods of protectionism described so far are all quite clear and obvious ways in which domestic industries can be given a competitive advantage over foreign industry in order to reduce imports and/or boost exports. Because these methods so obviously distort international market forces in pursuit of the more narrow national interest, they are all generally forbidden, except under very limiting circumstances, under the terms of international trading agreements such as the former General Agreement on Tariffs and Trade (GATT).

Protectionist policies are sometimes called expenditure switching policies because their aim is clearly to switch expenditure, both domestic and foreign, to the output of goods and services of the domestic economy (see Chapter 7).

An assessment of the arguments in favour of protectionism

International specialisation and free trade are justified because they lead to an optimal allocation of resources on a world scale and to a rise in the economic welfare of consumers. Any arguments advanced in justification of protectionist policies can only be assessed if the impact on world resource allocation and consumer welfare is also considered.

It is often argued that protectionism is justified for the reasons discussed below.

To safeguard employment in the home economy

An examination of the UK's trade accounts over the last few years will reveal the extent to which imports of manufactured goods have increased. The import penetration ratio is the proportion of the domestic sales of a product which is taken up by imports. For example, in 1968 the import penetration ratio in textiles was 16%. This means that out of every £100 spent on textiles in Britain, £16 was spent on imported textiles. By 2007 the figure had risen to 73%. In the category radio, television and communications equipment, the import penetration ratio was as high as 98% in 2007. As import penetration rises, domestic firms come under increasing pressure to maintain sales. The less successful will have to lay off workers and some may close down completely. This can result in considerable structural unemployment and can lead to calls for some degree of protection from imports.

Very often interest groups, such as trade unions, will call for tariffs when faced with a flood of cheap imports from abroad. There is no real economic justification in favour of import controls to protect jobs. These measures can only be justified on social grounds. To maximise economic welfare, labour should be considered as a resource that must be swiftly allocated and reallocated to its best use. This process can be aided by any measures to improve the occupational and geographical mobility of labour. Looked at in this way 'a flood of cheap imports' should be welcomed as a benefit to the consumer rather than seen as a threat to jobs.

To correct balance of payments disequilibria

Typical policies include raising income taxes and interest rates to prevent consumers purchasing imports. These policies are sometimes known as expenditure dampening policies. In addition to preventing imports, such policies also reduce consumer spending on the output of domestic industry, so the side effect is a rise in unemployment. This results in a call for these policies as an alternative way of protecting the balance of payments and the exchange rate. These policies will be analysed in detail in Chapter 7.

To prevent the exploitation of labour in developing economies

Very often when cheap goods are imported into a market there are claims that the goods are cheap because labour in the exporting countries is paid a very low wage. It is further claimed that labour, sometimes child labour, is exploited by unscrupulous business owners. This results in a call for import controls on moral grounds. There are often also calls for import controls on the grounds that firms in the importing country cannot compete with the cheap imports because they have to pay higher wages. This argument in favour of import controls is often combined with the argument that they are required in order to protect jobs.

Such arguments in favour of import controls have no economic justification whatsoever. If labour is cheap in an economy this is a reflection of that economy's factor endowment. A large supply of unskilled labour will lead to low wages and usually low priced products. The principle of comparative advantage states that this will lead to increased economic welfare as those economies with cheap labour specialise in those products in which they have the lowest comparative costs. This will be those products which are highly labour intensive. It should be noted that there may well be moral arguments to justify protectionism in this case, but it should also be considered that any measures which reduce imports from such countries are likely to make the problem of low wages worse. This is because any fall in demand for imports from such economies will reduce the demand for labour further and make wage rates fall even lower.

To prevent dumping

Dumping describes the process of selling goods in an overseas market at a price below the cost of production. This is a form of price discrimination because consumers in the home market will pay a higher price than those in the overseas market. The purpose of dumping might be to destroy existing competition in the overseas market or to prevent new firms in the overseas market from becoming established. Dumping can be achieved through export subsidies provided by the home government

or through ensuring that consumers in the home market pay a sufficiently high price to more than cover total costs. Alternatively, firms might be prepared to suffer losses in the short term if this allows them to destroy competition and create a monopoly, increasing excess profits in the long term.

Clearly, if dumping leads to anti-competitive behaviour in the long run and prevents the realisation of comparative advantage, then import controls on products dumped in a market can be justified. It should be noted, however, that firms which face competition through cheap imports will often claim that goods are being dumped, when in reality the low prices of such goods are merely a reflection of the greater efficiency of the exporting firm. Whether a good is truly being dumped on a market needs careful investigation before import controls can be justified. This argument is particularly controversial in the case of clothing products from China being dumped in EU markets.

To safeguard infant industries

As shifts in comparative advantage occur, conditions for setting up industries in particular economies can become favourable. Establishing a fledgling or **sunrise industry** can be quite difficult in the early years especially if a new firm faces competition from a long-established overseas company. The **infant industry argument** is that a firm with only a small part of the market will not be able to benefit from all potential economies of scale and will be unable to compete in the market. It will be in the interests of established firms to try to drive the new firm out of business and they might cut prices fiercely to retain their market. If the infant industry does have the potential to develop into an efficient producer in line with comparative advantage, then import controls may well be justified in this case. It should be noted, however, that many industries call for protection in their fledgling state but they then develop a vested interest in maintaining this protection once they have become established. Interest groups develop to lobby politicians to prevent import controls from being removed.

Read the feature below and then answer the questions that follow.

After seven years of talking, the future of free trade faces a sticky end over bananas

World trade talks that began with bold promises seven years ago to open up markets and help poor countries are in danger of collapse this week – and nothing illustrates why more effectively than the banana.

On the eve of the summit in Geneva, negotiations have failed to reach agreement over imports of fruit into Europe. Latin American countries want a better deal for their exports, while African and Caribbean producers are vowing to oppose them.

The banana dispute is one part of a giant jigsaw of about 30 outstanding issues that make up the Doha Round of talks so fiendishly complex. As negotiators from 152 countries gather for a make or break week, they know that failure risks plunging the world into a bout of protectionism. This would leave future deals to be struck piecemeal, and could also lock developing countries into poverty for decades.

Impoverished Latin American nations such as Costa Rica and Honduras are desperate for lower EU tariffs so that they can sell their bananas. However, poor Caribbean states such as Jamaica and St Lucia could see their economies suffer to the point of ruin from the resulting loss of exports. As members of the ACP group of countries, they have had preferential access into EU markets.



Banana production in Jamaica

The World Bank is keen for the talks to succeed. It has estimated that a deal could generate US\$287 billion extra trade by 2015, helping to lift some developing countries out of poverty.

France, Portugal and Spain are resisting any move to make concessions as they believe it would hurt their former colonies. The Latin American bloc is unsatisfied and is pushing for bigger changes.

Source: Charter, D. The Times, 21 July 2008 (adapted)

- 1 Explain what might happen if world trade in commodities such as bananas was completely free of restrictions.
- 2 Discuss whether there are any economic reasons why the EU is seemingly reluctant to reduce restrictions on trade with developing economies.

From theory to reality: trade and globalisation

Over the last 30 years or so, international trade in the world economy has grown more quickly than GDP

growth. This trend is expected to persist, as the various economies of the world become more dependent upon each other through **globalisation**. Markets across the world are becoming more integrated, with

developed and developing economies becoming much more economically dependent upon each other. For developing economies, trade is the main way in which they can realise the benefits of globalisation.

Consistent with the simple economic principles referred to earlier:

- Consumers in developing countries have an increasing variety of products to choose from as multinational corporations, such as Nestlé, Kelloggs, Sony, Microsoft, Coca-Cola, Toyota and so on, import goods into these countries and companies such as DHL, Schenker, Maersk and China Shipping provide the logistical support for this to take place cheaply and efficiently.
- Imports provide additional competition especially for domestic producers of food and drink products. It also exposes them to the best practices of such corporations.
- In turn, exports enlarge the markets for the products of developing countries, benefiting producers and their employees.
- Trade gives firms in developing countries access to improved capital inputs, such as machine tools, so improving their own productivity.
- There has been a substantial re-allocation of resources in the world economy. This can be seen through the ongoing shift in manufacturing activity from industrial countries to developing economies. International tourism growth has also benefited many developing economies.

The World Trade Organization (WTO), set up in 1995, has sought to create an environment in the world economy conducive to unrestricted multilateral trade. The most sensitive task it has faced to date has been to reduce trade barriers on international trade in agricultural products. These products provide genuine opportunities for many developing economies to trade in world markets. Unfortunately, some of the wealthy countries (the USA especially) have blocked moves to reduce tariffs and quotas on such trade, fearing competition from lower-priced imports. Notwithstanding, more developing countries have joined the WTO, recognising its importance in promoting their interests in the continued liberalisation of world trade.

Economic integration

Despite the work of the WTO, the structure of international trade in the twenty-first century is such that the benefits are being realised, not so much on a global scale, but through the increasing role of 'regional' trading blocs. Much of world trade takes place within these blocs, although the WTO continues to press for greater exchange between the blocs and developing countries.

There are four main organisations. These are:

- European Union (EU) – 27 member states in Western, Central and Eastern Europe (see Figure 4.4)
- North American Free Trade Agreement (NAFTA) – this includes the USA, Canada and Mexico
- The Association of Southeast Asian Nations (ASEAN) – 10 members including Singapore, Malaysia, Indonesia and Thailand
- Union of South American Nations (UNASUR) – formed in 2009, with the amalgamation of MERCOSUR and the Andean Community it has 12 members.

Table 4.3 shows their relative strength in 2007. As this shows, the EU is by far the most important overall.

	Total exports	Total imports
EU	5320	5574
NAFTA	1853	2684
ASEAN	864	774
MERCOSUR	224	184
Andean Community	76	70

Table 4.3 Merchandise trade of selected regional trade agreements in 2007 (US\$ bn)

Source: World Trade Organization, 2009

The process by which these trading blocs have been established is referred to as **economic integration**. It refers to deliberate ways in which national economies agree to merge their economic affairs into a single economic organisation. Consequently, there is a 'blurring' of their boundaries as their economies become more closely linked to each other.

Table 4.4 (page 170) shows the three main forms of organisation, which are described below:

- **Free trade area** The loosest form of organisation involving the systematic removal



From six to 27

1958
Belgium
France
Germany
Italy
Luxembourg
Netherlands

1973
Denmark
Ireland
UK

1981
Greece

1986
Portugal
Spain

1995
Austria
Finland
Sweden

2004
Cyprus
Czech Republic
Estonia
Hungary
Latvia
Lithuania
Malta
Poland
Slovakia
Slovenia

2008
Bulgaria
Romania

European Economic Community
1958-1985

European Community
1986-1994

European Union
1995-date

Figure 4.4 *The New Europe*

of trade restrictions between members. In practice, this may be for just a selected range of commodity types, such as manufactured goods. The sensitive nature of trade in agricultural goods has meant that these have often been either excluded or partially excluded. A free trade area is the typical form of organisation, the EU excepted.

- **Customs union** The crucial feature is that members agree to erect a common external tariff on trade with non-members. This tariff may be on all trade or, as is the case with the EU, mainly on imported goods which member

states are able to adequately produce themselves. Agriculture has always been a very sensitive issue in the EU, with policy being to protect the interest of EU member states very clearly. Consequently, developing countries are highly critical of this policy, despite preferential access for the agricultural products of some developing countries.

- **Economic union** This involves the removal of restrictions on the movement of factors of production (labour, capital and enterprise) between members. In the case of the EU, it has also meant the development of various common

Type of organisation	Characteristics	Comments
Free trade area	Removal of tariffs and quotas on internal trade	Members are free to determine their own external trade policy towards non-members. NAFTA, ASEAN and UNASUR are still at this stage
Customs union	As above but with the agreement of a common external tariff on trade with non-members	Results in some trade being deflected from outside the union to within. Applied to the EC before moves to EMU
Economic union	As above but with more harmonisation and centralisation of economic policies	EU has moved beyond this with single currency and European Central Bank single interest rate

Table 4.4 *Main forms of economic integration*

policies in areas such as agriculture, transport, regional and social affairs. There has also been the deliberate harmonisation of other aspects of economic affairs in order to ensure a highly competitive environment. Controversially for most member states, the EU is now progressing towards an objective of Economic and Monetary Union (EMU), with a single currency (the euro), a single exchange rate and centralised economic policies.

Within the context of this section, the most important issue is whether these regional trading blocs actually enhance, or detract from, global economic welfare. This is a very difficult question to answer. Economists do though point to two main effects:

- **Trade creation** – consistent with absolute and comparative advantage, trade is generated between members over and above what might otherwise have happened. Greater specialisation occurs and less-efficient producers lose markets as imports from within the group replace their production. Resources are therefore more efficiently allocated. All of the organisations referred to in Table 4.4 aim to gain these benefits.
- **Trade diversion** – more difficult to explain and only occurs when external trade restrictions are imposed. Trade from outside the group is replaced by trade from within; this is not consistent with an efficient allocation of

resources as the prices paid for such goods will be higher than if purchased on the open world market.

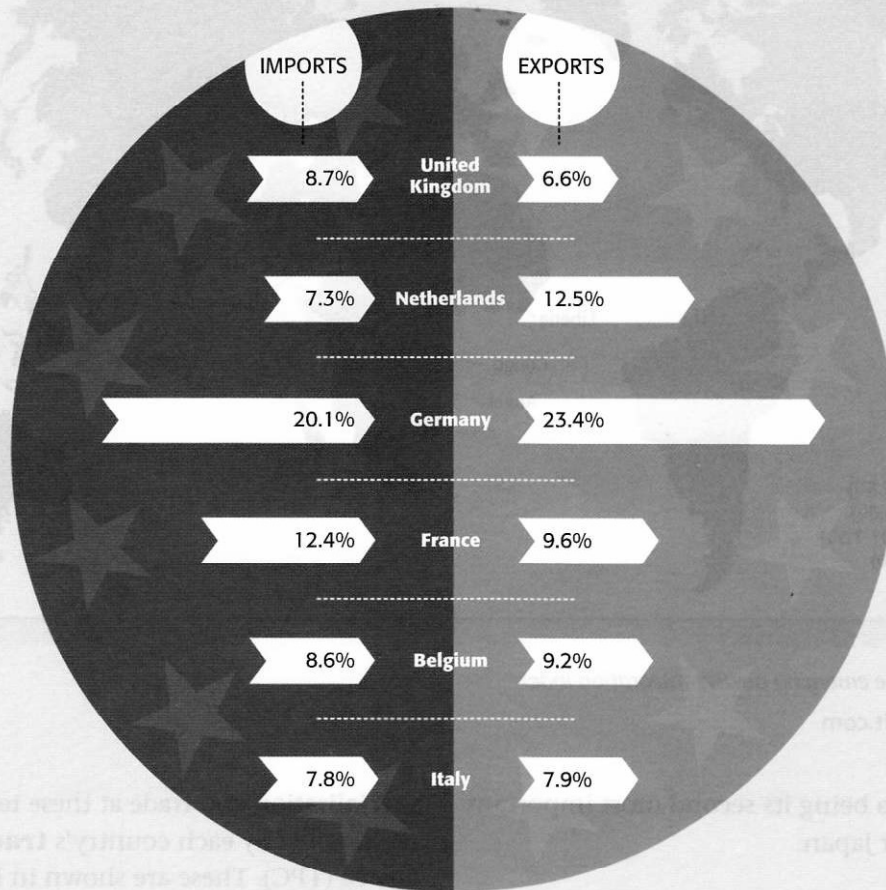
Figure 4.5 shows an analysis of intra-EU imports and exports of goods for selected member states. In particular, it indicates how, through increasing economic integration, trade creation has taken place, bringing the economies much closer to each other. In some respects, the UK remains the ‘odd European out’, with a lower percentage of exports than imports compared to its main trading partners.

In the case of the UK’s membership of the EU, former Commonwealth countries especially have had a decreasing share of imports to the UK. This is crude evidence of trade diversion. For many poor countries in Africa and Asia, this diversion has had a particularly negative impact on their economies through reduced employment and a destabilising of their balance of payments. This aspect of international trade globalisation has most certainly not enhanced their economic well-being.

A more recent feature of globalisation has been the extent of economic integration into the world economy of the BRIC (Brazil, Russia, India and China) group of emerging economies. Figure 4.6 (page 172) shows an index of the economic relationships that these countries have with 170 others. The emerging powers integration index measures a country’s trade with the BRIC economies as a percentage of total trade and GDP. It also incorporates foreign direct investment and labour

GERMANY WINS AGAIN

Biggest importers and exporters within EU27 zone (intra-EU27 trade 2008, % share of total)



Biggest importers and exporters with rest of the world (extra-EU27 trade 2008, % share of total)

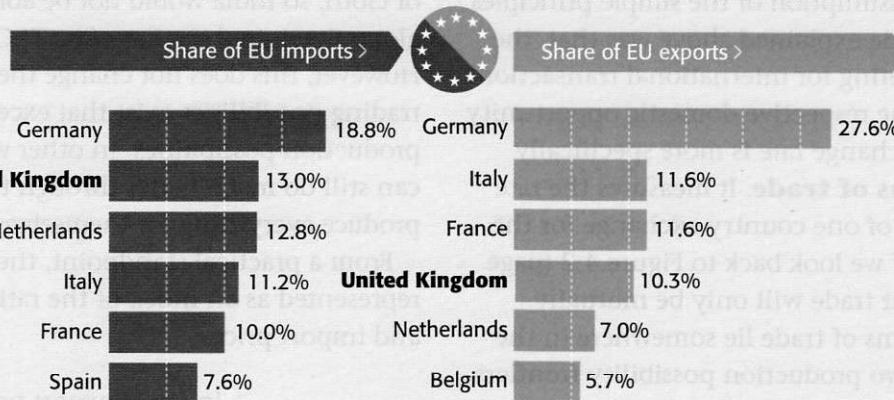


Figure 4.5 Biggest importers and exporters within the EU27 zone

Source: Daily Telegraph, 18 September 2009

migration flows. Four levels of integration have been identified. The figure identifies the ten countries that are most integrated with the BRIC'S economies. In general, the BRIC'S group

are most established with regional neighbours, in countries with mineral deposits and in politically unstable or repressive states. Of the developed economies, Australia is most integrated with BRIC'S,

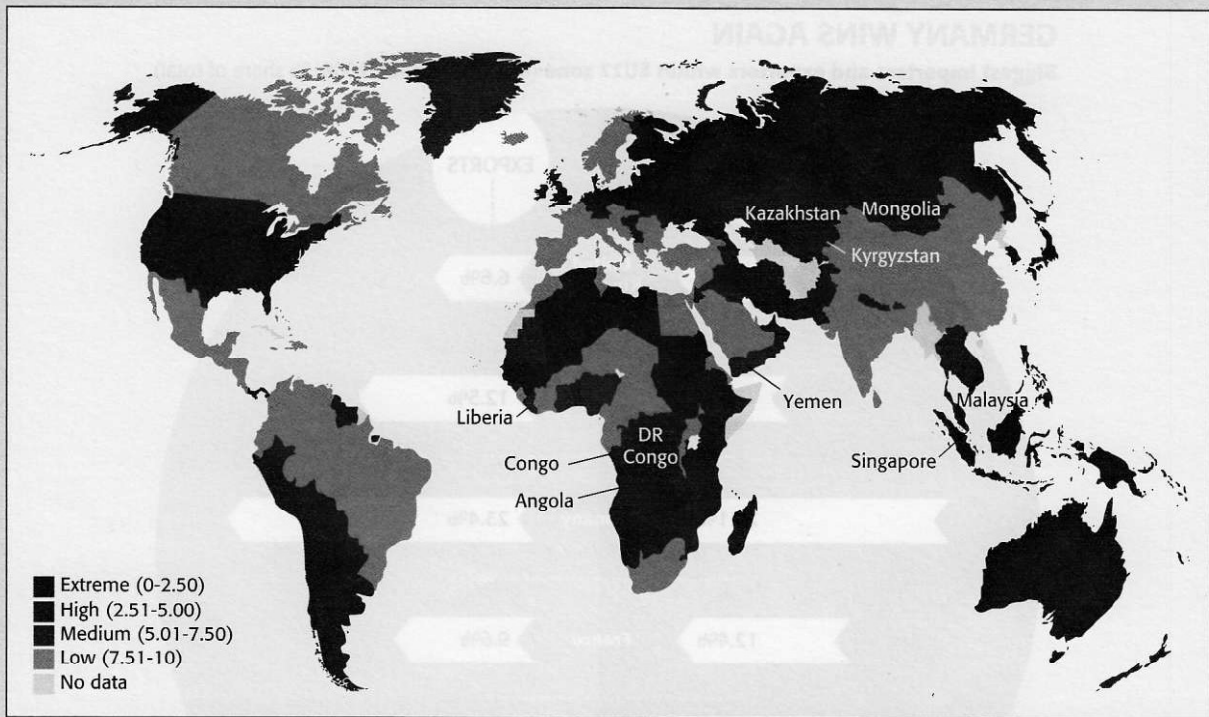


Figure 4.6 Map of the emerging powers integration index

Source: www.maplecroft.com

mainly due to China being its second most important trading partner after Japan.

The terms of trade

A very important assumption of the simple principles of international trade explained above was that 'the exchange rate operating for international transactions must be between the respective domestic opportunity cost ratios'. This exchange rate is more specifically known as the **terms of trade**. It measures the rate at which the goods of one country exchange for the goods of another. If we look back to Figure 4.2 (page 161), we can see that trade will only be mutually beneficial if the terms of trade lie somewhere in the area between the two production possibility frontiers.

Let us assume that the terms of trade are three units of cloth for one unit of cheese. With these terms, India could buy 750 units of cloth if it specialised in cheese production and sold it all to France. In turn France could buy 266.7 (800/3) units of cheese if it specialised in cloth and sold it all to India. If this were to happen, then each country would be consuming outside of its production possibility curve (PPC). The consumption combinations possible through

specialisation and trade at these terms of trade are represented by each country's **trading possibility curve** (TPC). These are shown in Figure 4.7. The problem is that France can only produce 400 units of cloth, so India would not be able to consume along the dotted section of its TPC (see Figure 4.7b). However, this does not change the conclusion that trading possibilities exist that exceed domestic production possibilities. In other words, countries can still do much better through trade than trying to produce everything for themselves.

From a practical standpoint, the terms of trade are represented as an index of the ratio of export prices and import prices:

$$\text{terms of trade index} = \frac{\text{index of export prices}}{\text{index of import prices}} \times 100$$

The ratio is calculated from the average prices of the many thousands of goods traded in world markets. In turn, these prices are weighted by the relative importance of each good traded. It is therefore a very complex calculation to work out for any type of economy.

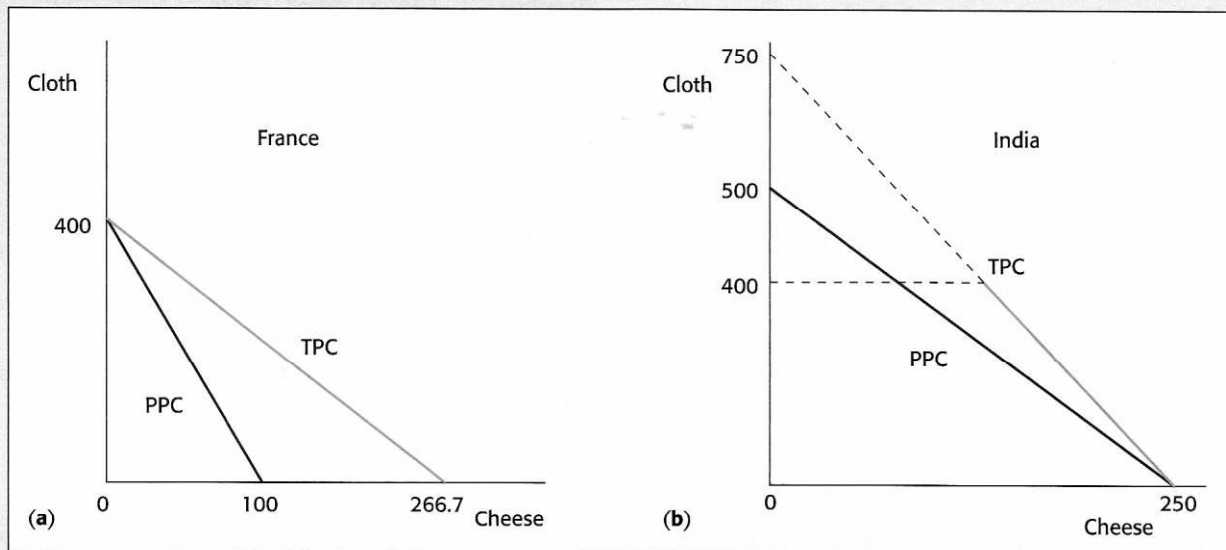


Figure 4.7 The trading possibility curve and the benefits of trade

Official statistics show the terms of trade as a single index in relation to a given base year. For example, if year 0 has a base year index of 100, then if in year 1 the terms of trade index is 102.4, this means that on average a country is receiving relatively better prices for its exports than it is having to pay other countries for its imports. So, in this case, the terms of trade have improved.

In contrast, if in year 1 the terms of trade index is 98.4, this means that on average a country is having to pay a relatively higher price for its imports than it is receiving for its exports. In this case, the terms of trade have deteriorated.

Relatively minor changes on a year-by-year basis have only limited economic significance. On a longer-term basis though, the time trend in the terms of trade can have a very marked impact on an economy. In general, the reality of the global trade market is as follows:

- The terms of trade for most developing economies were deteriorating up to around 2000. This means that year by year they had to export more and more goods (especially primary agricultural products) to support a given volume of imports. Since then, commodity prices have been volatile, reaching a peak in 2008. This is clearly shown in Figure 4.8.

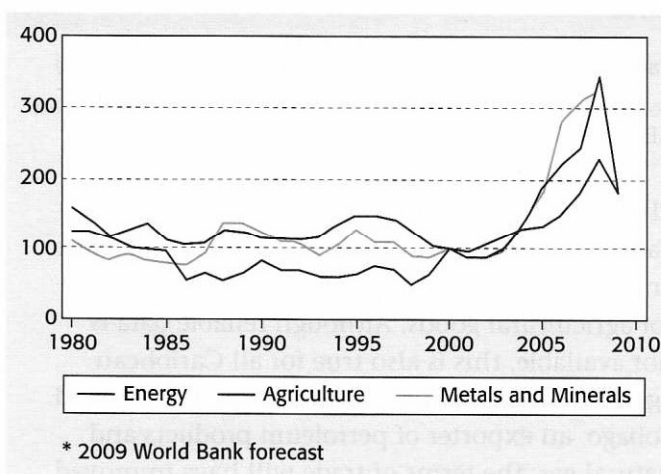


Figure 4.8 Commodity price indices* (2000 = 100)

Source: *Global Commodity Markets*, World Bank, 2009

- Fuel-exporting developing economies have been in a much stronger position, although in recent years, there has been considerable volatility in their terms of trade as the world price of crude oil has fluctuated widely. This hardly makes for sensible long-term economic planning.
- The terms of trade for most developed economies have shown longer-term improvement. This means that they have continued to receive increased real prices, especially for their exports of manufactured consumer goods.

Table 4.5 shows the terms of trade indexes for selected countries in Latin America from 1995 to 2004. For Chile, there was a large favourable increase in its terms of trade from 2003 to 2004 due to an increase in the world prices of copper and copper ores, the country's principal exports. In the case of Argentina, fuel exports account for the recent improvement in its terms of trade.

Country	1995	2000	2001	2002	2003	2004
Argentina	96.0	100	99.3	98.7	107.2	109.2
Brazil	107.6	100	99.6	98.4	97.0	97.9
Chile	102.1	100	93.3	97.2	102.8	124.9
Costa Rica	103.1	100	98.4	96.9	95.5	91.9
Ecuador	72.7	100	84.6	86.8	89.8	91.5
Mexico	83.1	100	97.4	97.9	98.8	101.6
Latin America area	89.7	100	96.3	96.6	98.7	104.0

Table 4.5 Terms of trade index, 1995–2004 (2000 = 100)

Source: Annual statistics of Latin America and the Caribbean, CEPAL, 2005

Elsewhere, and for other countries not shown in Table 4.5, the terms of trade have deteriorated due entirely to the fall in typical commodity prices for agricultural goods. Although reliable data is not available, this is also true for all Caribbean agricultural exporting countries. For Trinidad and Tobago, an exporter of petroleum products and natural gas, the terms of trade will have improved due to large price increases since 2003. The same is true for Barbados with respect to its exports of aluminium. Some benefit from rising commodity prices will have been lost through the increased prices for manufactured imports. A crude indication of these price trends is shown in Table 4.6 for selected typical Caribbean export products.

The balance of payments

It is important that governments have an accurate record of all the transactions that take place between residents of their country and all other countries in

Product	1995	2000	2001	2002	2003	2004
Bananas	104.7	100	138.8	125.5	89.4	125.1
Sugar	162.4	100	105.6	84.2	86.7	87.6
Coffee	154.3	100	70.4	63.6	65.6	82.0
Aluminium	116.6	100	93.2	87.1	92.4	110.7
Crude oil	61.1	100	77.3	85.9	102.5	127.9
Natural gas	40.0	100	91.8	77.9	127.2	136.8

Table 4.6 Price indexes for export commodities, 1995–2004 (2000 = 100)

Source: Annual Statistics of Latin America and the Caribbean, CEPAL, 2005

the rest of the world. These transactions are recorded in the balance of payments. In practice, this record is a very complex financial statement – though there is an internationally agreed method for its presentation. This is recommended by the International Monetary Fund (IMF) and permits economists to make international comparisons. The basics of this method are outlined below.

The balance of payments consists of the **current account**, the **capital account** and the **financial account**. We can use the UK as a typical example to explain the various components of the accounts.

It should be noted that the balance of payments accounts are simply a record of flows of money between residents of the UK and non-residents. Following basic accounting principles this means that every credit (+) entry is matched by a debit (–) entry. For example, if a UK resident exports goods abroad, this is recorded as a credit entry (+) in the accounts. We also have to record how foreign residents paid for these exports. Perhaps the foreign resident had a bank account in the UK and used this to pay the exporter. This would be shown in the accounts as a debit entry as a decrease in UK liabilities abroad (–). This means that the foreign resident has less of a claim on a UK bank account. The important point is that we have accounted for the spending and recorded both sides of the transaction. Since every credit item is matched by a debit item in the accounts, it follows that in an accounting sense, the balance of payments must

always balance. In practice, however, we cannot have fully accurate information. As a result, a section of the accounts is entitled 'Net errors and omissions' to allow for discrepancies in the calculations.

The current account

The current account consists of:

- trade in goods
- trade in services
- income
- current transfers.

Trade in goods

The goods account covers items that can be touched, weighed or counted as they are traded. For this reason, they are sometimes known as visibles. For example, the import of cars from Germany is a debit item in the current account of the UK, whereas the export of cashmere sweaters to Japan is a credit item. The difference between visible exports and imports is referred to as the **balance of trade**.

Trade in services

The services account covers exports and imports of services. For example, if a UK resident purchases an airline ticket from a foreign airline, this has the same impact as the import of a good and is recorded as a debit item. However, if a merchant bank in the City of London raises a loan for a foreign firm, the fee charged by the bank is equivalent to an export and will be recorded as a credit item. The difference in trade in such items is known as the *invisible balance*.

Income

The income account is made up of income from investments abroad. This covers any earnings from foreign investment and financial assets and liabilities. For example, any dividends paid on foreign shares held by UK residents are recorded as credits, whereas interest paid to foreign holders of deposits in UK financial institutions is recorded as a debit item.

Current transfers

Current transfers are made up of central government transfers, e.g. payments and receipts from the EU, and other transfers by private individuals such as gifts of cash. The latter includes payments that are sent home by migrant workers.

Capital account

The capital account records transactions which involve the transfer of ownership of fixed assets and the acquisition or disposal of non-financial assets. An example of the former might be a government investment grant to undertake a large construction project, such as a water purification plant abroad. An example of the latter might be land purchased or sold by a foreign embassy.

Financial account

The financial account was formerly known as the capital account. This section of the accounts records the forms of investment overseas by UK residents and the inward flow of investment funds from foreign residents. It is this flow which gives rise to flows of investment income in the current account.

Net errors and omissions is a balancing item.

Balance of payments examples

Table 4.7 (page 176) shows a summary of the balance of payments current accounts for selected countries in 2007. (For ease of comparison all of the data are shown in US\$.) It shows some interesting contrasts such as:

- The UK has traditionally experienced a deficit in its annual trade in goods and services. This is particularly the case for trade in goods; the positive invisible balance has helped to reduce this deficit.
- The USA has a massive deficit on trade in goods and services; in contrast, both Germany and Japan have substantial surpluses.
- Most developing economies invariably have a deficit in their trade in goods and services; China and Malaysia though have substantial export earnings from manufactured goods.

	Exports	Imports	Current account balance
<i>Developed economies</i>			
Germany	1326.5	1059.4	+150.7
Japan	712.8	621.0	+210.5
Spain	242.0	373.6	-145.3
UK	435.6	617.2	-115.2
USA	1163.2	2017.0	-738.6
<i>Developing economies</i>			
China	1218.0	955.8	+249.9
India	145.2	216.7	-9.4
Malaysia	176.2	146.9	+28.9
Pakistan	17.4	32.6	-8.3
South Africa	69.8	91.0	-20.6

Table 4.7 Balance of payments current accounts for selected countries in 2007 (US\$000 m)

Source: World Development Report, 2009

Looking at the balance of payments over time is in many respects more relevant to the economist than the information for just one year, as given in Tables 4.7 and 4.8 (see Self-assessment task 4.5). In this way, medium- and longer-term trends can be identified and analysed and appropriate policies put in place to deal with any problems that are identified. These policies will be analysed in Chapter 7.

SELF-ASSESSMENT TASK 4.4

Obtain an outline of the balance of payments account for your own economy. Summarise this in terms of the main headings used above and write a few sentences on what the data show.

SELF-ASSESSMENT TASK 4.5

Read the feature below and then answer the questions that follow.

Trade surplus narrows as export growth slows

China's politically sensitive trade surplus grew less than expected last month as Beijing's efforts to slow exports took hold and surging oil prices bloated import costs. Still, the trade gap for 2007 surged to a record US\$262 billion, a sign that pressure to accelerate Yuan appreciation is unlikely to ease any time soon.

China's thirst for commodity imports of foodstuffs and oil products saw imports rise by 26%; export growth was 22%. Beijing is trying to engineer a slowdown in exports to reduce trade tensions with the United States, which continues to accuse China of deliberately depressing the

value of the Yuan to help its own manufacturers. The EU has taken the same stand as the US.



Chinese exports en route to the EU

China already has the world's biggest foreign exchange reserves at a reported US\$1.52 trillion.

Table 4.8 shows the balance of trade for 2007 between China and its ten largest trading partners.

	Exports to	Imports from	Balance
European Union	245.2	111.0	+134.2
United States	232.7	69.4	+163.3
Hong Kong	184.4	12.8	+171.6
Japan	102.1	134.0	-31.9
ASEAN group	94.2	108.4	-14.2
South Korea	56.1	103.8	-47.7
Russia	28.5	19.7	+8.8
India	24.0	14.6	+9.4
Taiwan	23.5	101.0	-77.5
Australia	18.0	25.9	-7.9

Table 4.8 *Top 10 trading partners (US\$ bn)*

Source: South China Morning Post, 12 January 2008

- 1 Table 4.8 shows that China has a balance of trade surplus with five countries and a balance of trade deficit with five countries. Discuss the extent to which this state of affairs can be explained by the principles of absolute and comparative advantage.
- 2 Explain how an appreciation of the yuan against the euro and the US\$ is likely to affect the balance of trade between China and these trading partners.

SPECIMEN EXAM QUESTIONS

The following questions have been set in a recent CIE examination paper.

- 1 a How might opportunity cost help to explain the pattern of international trade. [8]
- b Discuss whether the formation of regional trading groups such as ASEAN and NAFTA is desirable. [12]

[20 marks]

(October/November 2008)

SUMMARY

In this core section it has been shown that:

- International trade is an essential and beneficial feature of the global economy of the twenty-first century.
- The principles of absolute and comparative advantage can be used to show the benefits of free trade.
- Tariffs, quotas, exchange control and export subsidies distort the benefits of multilateral trade for the world economy; in certain circumstances, protection may be relevant especially for developing economies.
- Increasingly, economic integration can bring benefits to the members of such organisations.
- The terms of trade index measures the rate at which the goods of one country exchange for those of another.
- The balance of payments is an important financial record of the international trading transactions of a country.