

International Trade

Dr Amir Ullah Khan

- Video Link- <https://www.youtube.com/watch?v=HfN8BnRJryQ>

Why do nations trade?

- The main reasons international trade takes place are differences in technology, differences in resource endowments, differences in demand, the presence of economies of scale, and the presence of government policies.
- International trade not only results in increased efficiency, but it also allows countries to participate in a global economy, encouraging the opportunity for foreign direct investment (FDI).

Free Trade vs. Protectionism

- **Free Trade:** when government put in place policies that allow producers from overseas nations to freely sell their goods in our country (promote trade).
- **Protectionism:** when government put in place policies to stop overseas producers freely selling goods in our country (restrict trade).

Arguments for Protectionism

Protects domestic
jobs

Protects infant
industries

Protects national
security

Maintenance of
health, safety and
environmental
standards

Evolution of Trade Theories

- **Mercantilism**
- **Absolute advantage (Classical)**
- **Comparative advantage**
- **Factor Proportions Trade**
- **International Product Cycle**
- **New Trade Theory**
- **National competitive advantage**



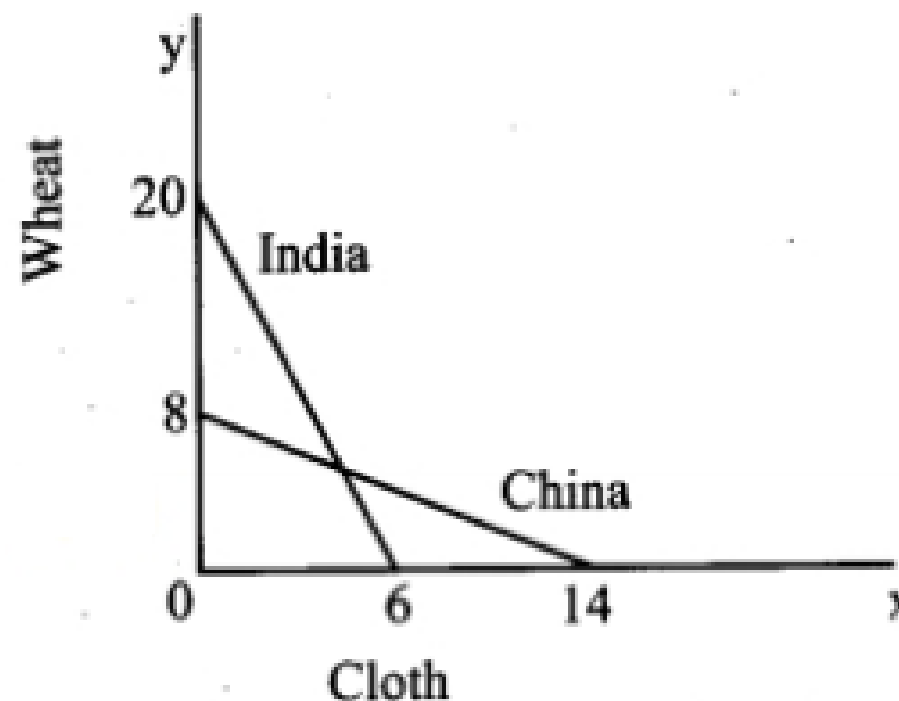
Theory of Absolute Cost Advantage

- Adam Smith argued that all nations can be benefitted when there is free trade and specialisation in terms of their absolute cost advantage.
- Trade between two countries would be mutually beneficial when one country produces a commodity at an absolute cost advantage over the other country which in turn produces another commodity at an absolute cost advantage over the first country.
- Assumptions- 2 countries, 2 commodities, Labour is the only factor of production and labour units are homogenous, there is no transportation cost.

Numerical Illustration

1. India has an absolute advantage in the production of wheat over China and China has an absolute advantage in the production of cloth over India.
2. Therefore, India should specialize in the production of wheat and import cloth from China.
3. China should specialize in the production of cloth and import wheat from India.
4. This kind of trade would be mutually beneficial to both India and China.

Country	India	China
	(Output per unit of labour)	
Wheat	20	8
Cloth	6	14



Examples of Nations With an Absolute Advantage

- A clear example of a nation with an absolute advantage is **Saudi Arabia**. The ease with which it can reach its oil supplies, which greatly reduces the cost of extraction, is its absolute advantage over other nations.
- Other examples include **Colombia** and its climate, ideally suited to growing coffee.
- **Zambia** possesses some of the world's richest copper mines and has absolute advantage within the same.
- For Saudi Arabia to try and grow coffee and Colombia to drill for oil would be an extremely costly and unproductive undertaking.

Theory of Comparative Cost Advantage

- The concept of comparative advantage was developed in the early 1800s by the economist David Ricardo.
- The theory attributed the cause and benefits of international trade to the differences in the relative opportunity costs (costs in terms of other goods given up) of producing the same commodities among countries.

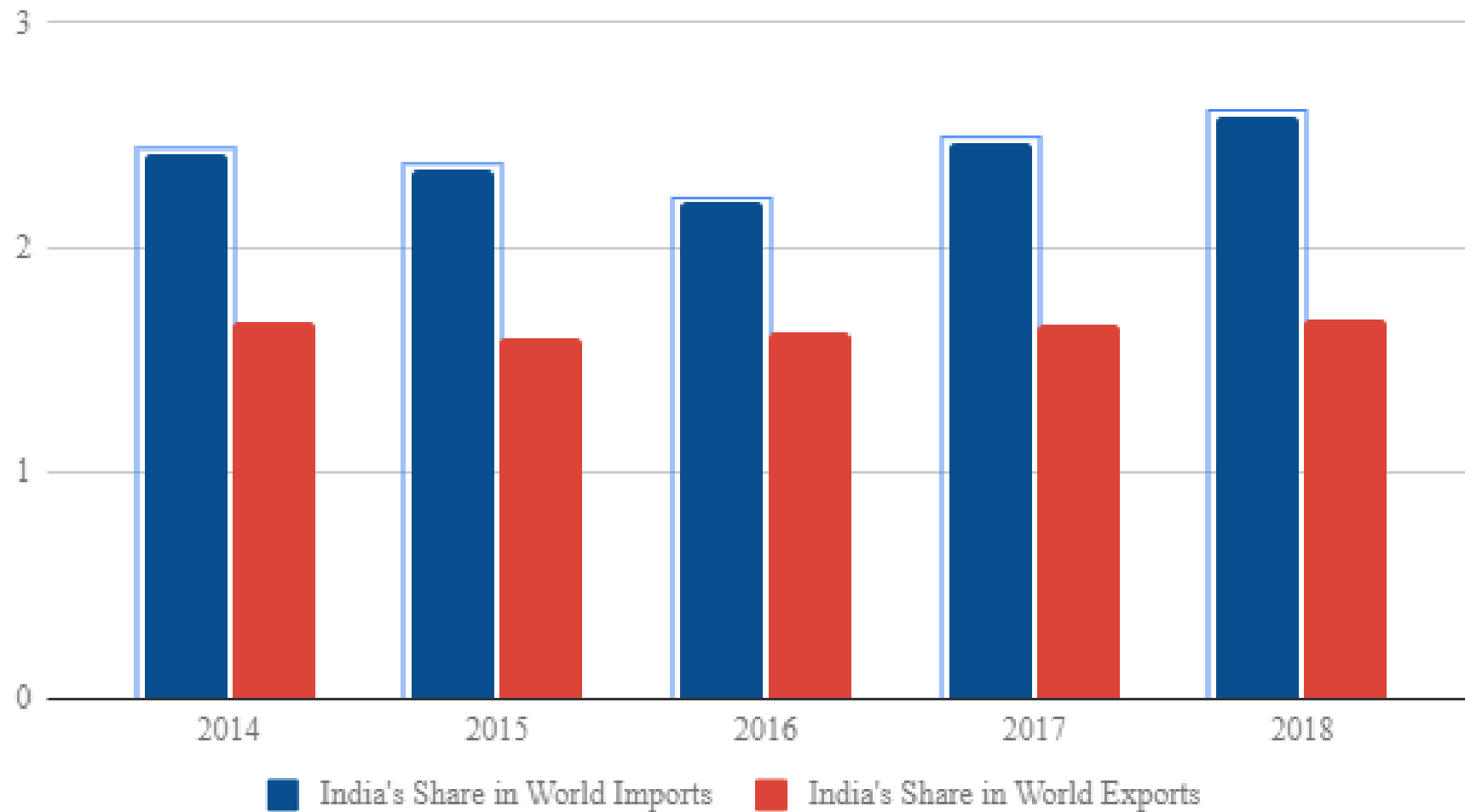
	England		Portugal	
Cost of Production	Cloth	Wine	Cloth	Wine
	100 Labor Hours	120 Labor Hours	90 Labor Hours	80 Labor Hours
Comparative Cost	1 Cloth Unit = 5/6 Wine (Comparative Advantage) 1 Wine Unit = 1.2 Cloth		1 Cloth Unit = 1.125 Wine 1 Wine Unit = 8/9 Cloth (Comparative Advantage)	
Total Production Before Trade	Assuming there's 220 Labor Hours England can produce one unit of cloth and one unit of wine		Assuming there's 170 Labor Hours Portugal can produce one unit of cloth and one unit of wine	
Trade	England gives Portugal one unit of cloth		Portugal gives England one unit of wine	
Total Production After Trade	Assuming there's 220 labor hours for cloth production only England can produce 2.2 units of cloth England after trade will have 1.2 units of cloth and 1 unit of wine		Assuming there's 170 labor hours for wine production only Portugal can produce 2.125 units of wine Portugal after trade will have 1 unit of cloth and 1.125 units of wine	
Trade Gain	0.2 Units of Cloth		0.125 Units of Wine	

Source: Constructed by the authors

Countries with Comparative Advantage

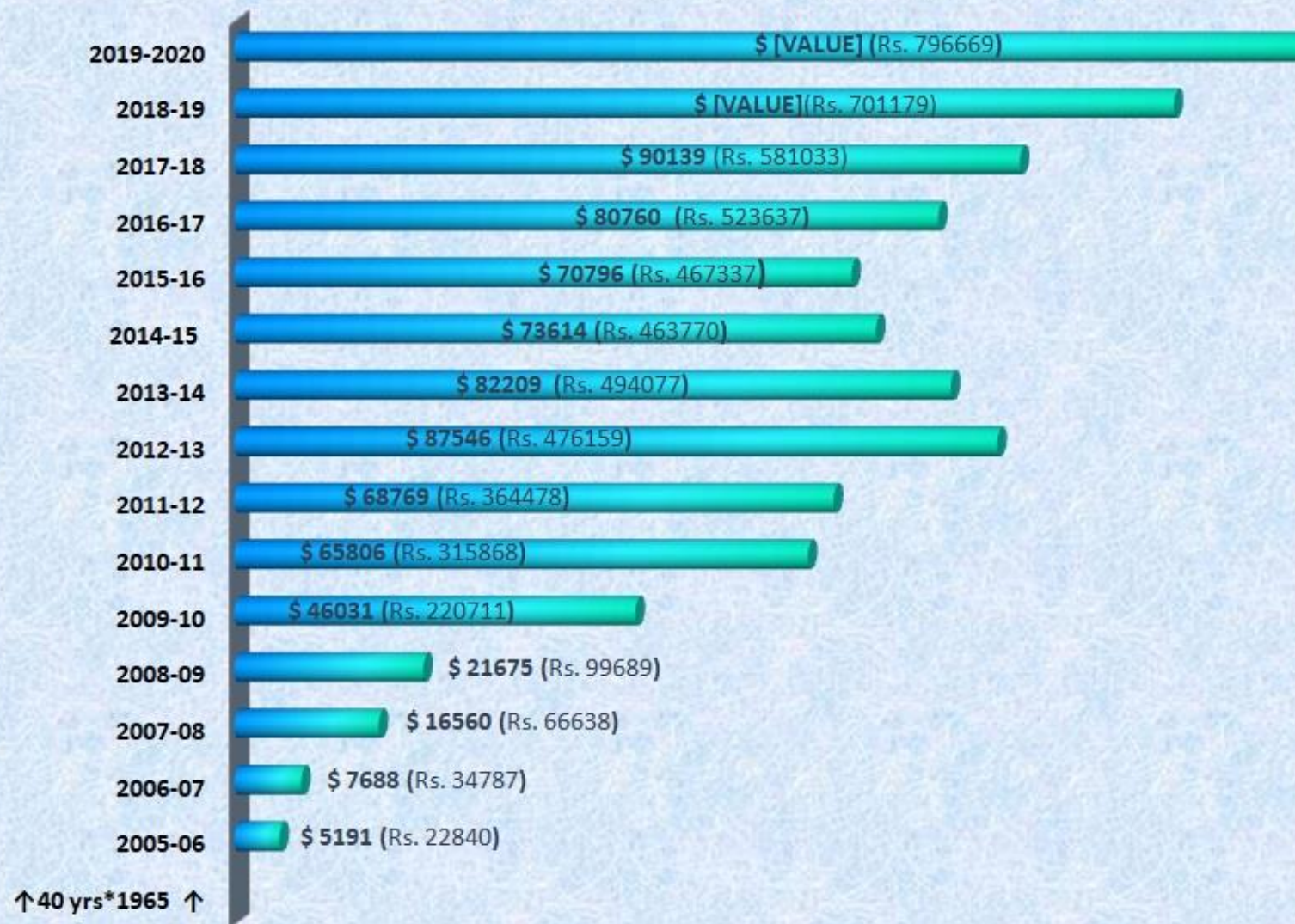
- Oil-producing nations have a comparative advantage in chemicals. Their locally-produced oil provides a cheap source of material for the chemicals when compared to countries without it. **Saudi Arabia, Kuwait, and Mexico** are competitive with U.S. chemical production firms. Their chemicals are inexpensive, making their opportunity cost low
- Another example is **India's call centers**. U.S. companies buy this service because it is cheaper than locating the call center in America
- **America** has comparative advantages due to its vast landmass bordered by two oceans. It also has lots of fresh water, arable land, and available oil. U.S. businesses benefit from cheap natural resources and protection from a land invasion

India's share in world exports/imports

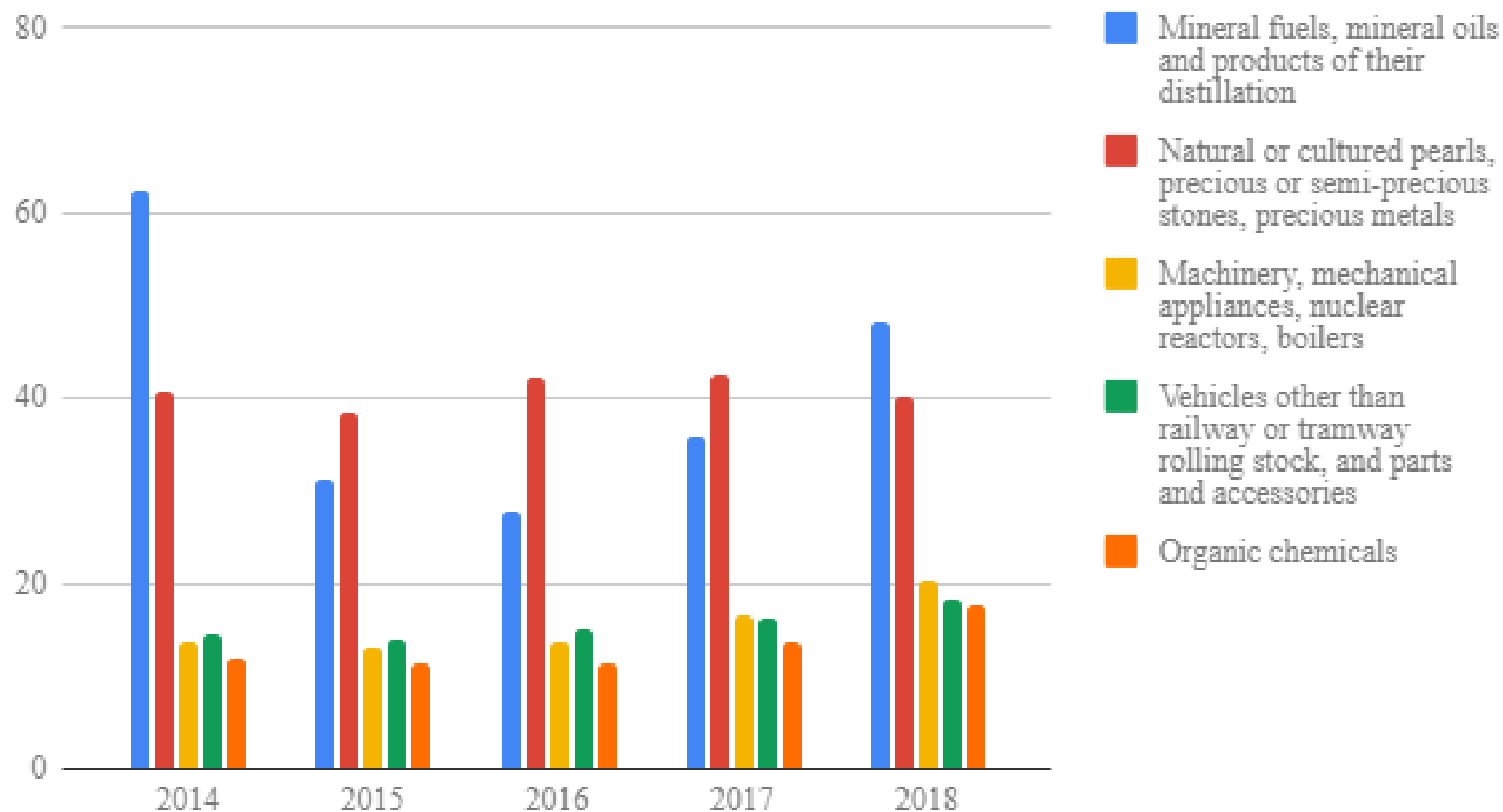


Source: WITS and ITC Trade Map

Exports from SEZs in INDIA (US \$ Million converted into Rs. in Crores)



India's top 5 Exported Products



India's Foreign Trade Policy

- India's Foreign Trade Policy (FTP) provides the basic framework of policy and strategy for promoting exports and trade. It is periodically reviewed to adapt to the changing domestic and international scenario.
- It is also responsible for multilateral and bilateral commercial relations, special economic zones (SEZs), state trading, export promotion and trade facilitation, and development and regulation of certain export-oriented industries and commodities.

Features of Foreign Trade Policy (FTP)

- **Goods**- Earlier there were 5 different schemes (Focus Product Scheme, Market Linked Focus Product Scheme, Focus Market Scheme, Agri. Infrastructure Incentive Scrip, VKGUY) for rewarding merchandise exports with different kinds of duty scrips with varying conditions attached to their use, now has been merged to a single MEIS scheme.
- **Services** - The *Served From India Scheme* has been replaced with the *Service Exports from India Scheme (SEIS)*. SEIS is stated to apply to 'Service Providers located in India' instead of 'Indian Service Providers'
- **Special Economic Zones (SEZ)**-The policy outlines extended incentives for Special Economic Zones in India
- **Export Houses**- The nomenclature of Export House, Star Export House, Trading House, Star Trading House, Premier Trading House certificate has been simplified and changed to One, Two, Three, Four- and Five-Star Export House.

India's Foreign Trade Policy 2015-20

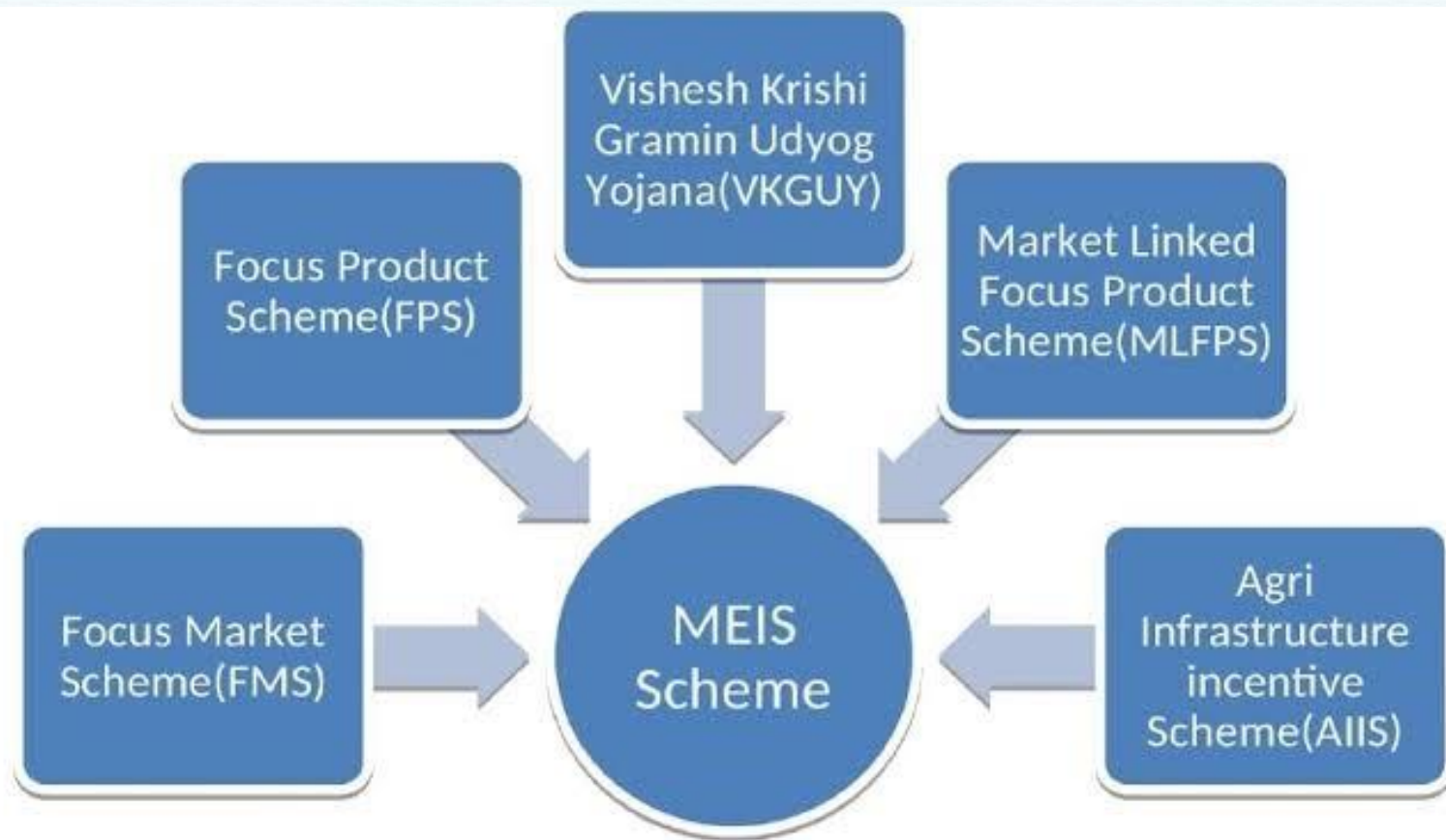
Key Highlights: FTP 2015-20

- Paperless processing of various DGFT licenses and applications.
- Introduction of MEIS and SEIS incentive Scheme, scrips are transferable under MEIS & SEIS Scheme – If exporter has no need they can sell in open market.
- It reduced export obligation from 90% to 75% for capital goods sourced from local manufacturers under the EPCG Scheme.
- It allows status holders to self-certify their manufactured goods as originating from India.
- The policy acknowledged 108 Micro Small and Medium Enterprises as a robust approach for export promotion

Drawbacks: FTP 2015-20

- There is a strong belief in India that free trade agreements (FTAs) haven't worked for it.
- Export Incentive schemes which were violating the WTO norms.
- Subsidy driven policies not much focus on skill development, and technological up-gradation,

Merchandise Exports from India Scheme (MEIS)



*All the earlier schemes of FTP 2009-14 merge into single
MEIS scheme under FTP 2015-20*

The World Trade Organisation (WTO)

A Brief History

WTO was Established in 1995.

- It Replaced GATT which was established in 1944.
- The GATT was established along with the Bretton Woods Twins of IMF and the World Bank.

The Agenda of the WTO

- To help global economy recover from the WW2.
- To support global development by promoting Free Trade and Free Market.
- To champion the cause of free trade by allowing seamless movement of goods and services across inter-national boundaries.

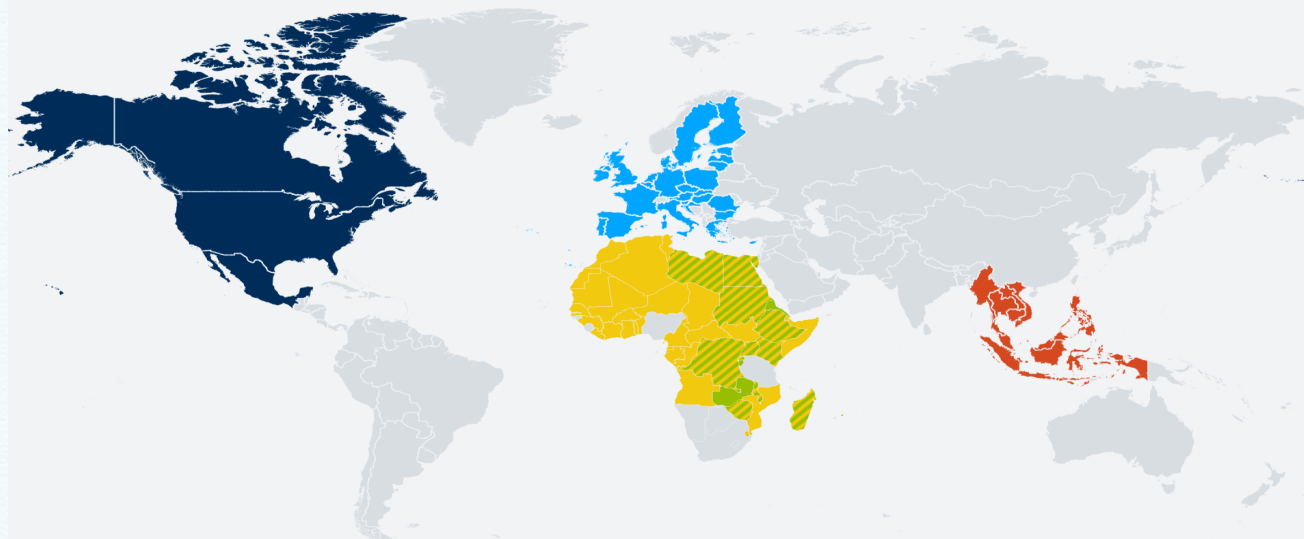
Member Countries

- GATT was signed in Geneva initially by 23 countries.
- The membership increased in the coming years and by the time Uruguay Round (1986) was concluded at Marrakesh (1995) there were 123 Members.
- Marrakesh Round (1995) led to creation of the WTO.

Free Trade Agreements (FTA)

- A free trade agreement is a pact between two or more nations to reduce barriers to imports and exports among them. Under a free trade policy, goods and services can be bought and sold across international borders with little or no government tariffs, quotas, subsidies, or prohibitions to inhibit their exchange.
- The concept of free trade is the opposite of trade protectionism or economic isolationism.
- Governments with free-trade policies or agreements in place do not necessarily abandon all control of imports and exports or eliminate all protectionist policies. In modern international trade, few free trade agreements (FTAs) result in completely free trade.

The world's major free trade associations



- North American Free Trade Agreement (NAFTA)
- EU (Also has CETA-agreement with Canada)
- African Continental Free Trade Area (AfCFTA)
- Common Market of Eastern and Southern Africa (COMESA)
- Association of Southeast Asian Nations Free Trade Area (AFTA)

Source: NAFTA; EU; AfCFTA; COMESA; AFTA | July 2018 ©DW

Discussion Questions

- How is trade affected in case of a war?
- Is economic cooperation and trade between the world's largest economies developing or is this cooperation diminishing due to the current trade wars?
- What do you think about the barriers to international trade?

Readings

- A. Dixit and V. Norman, “Gains from trade without lump-sum compensation,” JIE 1986, 111-122
- Deardorff, “The general validity of the law of comparative advantage,” JPE 1980, 941-957
- E. Helpman, “The factor content of foreign trade,” EJ 1984, 84-94.