

International Trade

Lecture I. World Trade: An Overview
Chapter 1 & 2

Erkan Yalcin

Flinders Business

What Is International Economics About?

- International economics is about how nations interact through trade of goods and services, flows of money, and investment.
- International economics is an old subject, but continues to grow in importance.
- Nations are now more closely linked than ever before.
 - International trade has roughly tripled in importance compared to the economy as a whole in the past 50 years.
 - Both imports and exports fell substantially in 2009 due to the recession.

What Is International Economics About? Cont'd

- Compared to the United States, other countries are even more tied to international trade.
 - Their imports and exports as a share of GDP are substantially higher.
 - The United States, due to its size and diversity of resources, relies less on international trade than almost any other country.

Gains from Trade

- Gains from trade is probably the most important insight in international economics.
- Countries selling goods and services to each other almost always generates mutual benefits.
- When a buyer and a seller engage in a voluntary transaction, both can be made better off.

Gains from Trade Cont'd

- How could a country that is the most (least) efficient producer of everything gain from trade?
 - Countries use finite resources to produce what most productive at (compared to their other production choices).
 - They then trade those products for what they want to consume.
 - Countries can specialise in production, while consuming many goods and services through trade.

Gains from Trade Cont'd

- Trade benefits countries by allowing them to export goods made with relatively abundant resources and imports goods made with relatively scarce resources.
- When countries specialise, they may be more efficient due to larger-scale production.
- Countries may also gain by trading current resources for future resources (international borrowing and lending) and due to international migration.

Gains from Trade Cont'd

- Trade is predicted to benefit countries as a whole in several ways, but trade may harm particular groups within a country.
 - International trade can harm the owners of resources that are used relatively intensively in industries that compete with imports.
 - Trade may therefore affect the distribution of income within a country.

Patterns of Trade

- The pattern of trade describes who sells what to whom.
- Differences in climate and resources explain why Brazil exports coffee and Saudi Arabia exports oil.
- Some countries export certain products that can stem from differences in:
 - Labor productivity;
 - Relative supplies of capital, labor and land and their use in the production of different goods and services.
- That is why Japan exports automobiles, while the U.S. exports aircrafts.

Effects of Government Policies on Trade

- Policy makers affect the amount of trade through:
 - Tariffs: a tax on imports or exports;
 - Quotas: a quantity restriction on imports or exports;
 - Export Subsidies: a payment to producers that export;
 - Through other regulations (ex., product specifications) that exclude foreign products from the market, but still allow domestic products.

Effects of Government Policies on Trade Cont'd

- The costs and benefits of these policies:
 - When a government restricts trade, there will be costs if foreign governments respond likewise;
 - Trade policies are often chosen to cater to special interest groups, rather than to maximise national welfare;
 - Governments tend to adopt tariffs, then negotiate them down in exchange for reduction in trade barriers of other countries.

Balance of Payments

- Governments measure the value of exports and imports, as well as the value of financial assets that flow into and out of their countries.
 - Trade deficits, where countries import more than they export in value, may be offset by net inflows of financial assets.
- The balance of payments, measures the balance of funds that central banks use for official international payments.
- All three values are measured in the government's national income accounts.

Exchange Rate Determination

- Exchange rates are an important financial issue for most governments.
- Exchange rates measure how much domestic currency can be exchanged for foreign currency and thus affect how much:
 - Goods denominated in foreign currency (imports) cost in the domestic country;
 - Goods denominated in domestic currency (exports) cost in foreign markets.
- Some exchange rates change continually (float) while others are fixed for periods of time.

International Policy Coordination

- In an integrated economy, one country's economic policies usually affect other countries as well, leading to the need for some degree of policy coordination.
 - Depends on type of exchange rate regime.
- Capital markets, where money is exchanged for promises to pay in the future, have special concerns in an international setting.
 - Currency fluctuations can alter the value paid;
 - Countries, especially developing ones, might default on debt.

The International Capital Market

- Capital markets are arrangements by which individuals and firms exchange money now for promises to pay in the future.
- International capital markets cope with special regulations that countries impose on foreign investments.
- This topic has outlined a useful framework for business analysis using financial statements.
 - Special risks of currency fluctuations and national default;
 - Sometimes offer opportunities to evade regulations placed on domestic markets.

Who Trades with Whom

- More than 30% of world output is sold across national borders.
 - World trade in goods and services exceeded \$21 trillion in 2015.
- The 5 largest trading partners with the U.S. in 2015 were China, Canada, Mexico, Japan, and Germany.
- The largest 15 trading partners with the U.S. accounted for 75% of the value of U.S. trade in 2015.

Size Matters: The Gravity Model

- 3 of the top 10 trading partners with the U.S. in 2012 were also the 3 largest European economies: Germany, the United Kingdom, and France.
- The United States trade more with these European countries than with others, because:
 - These countries have the largest gross domestic product (GDP), the value of goods and services produced in an economy, in Europe.
 - Each European country's share of U.S. trade with Europe is roughly equal to its share of European GDP.

Size Matters: The Gravity Model Cont'd

- The size of an economy is directly related to the volume of imports and exports.
 - Larger economies produce more goods and services, so they have more to sell in the export market.
 - Larger economies generate more income from the goods and services sold, so they are able to buy more imports.
- Trade between any two countries is larger, the larger is either country.

Size Matters: The Gravity Model Cont'd

- The gravity model assumes that size and distance are important for trade in the following way:

$$T_{ij} = \frac{A \times Y_i \times Y_j}{D_{ij}}$$

- Larger economies produce more goods and services, so they have more to sell in the export market. A is a constant term;
- Larger economies generate more income from the goods and services sold, so they are able to buy more imports. T_{ij} is the value of trade between country i and country j ;
- Y_i and Y_j are countries i 's and j 's GDPs;
- D_{ij} is the distance between country i and country j .

Size Matters: The Gravity Model Cont'd

- More generally:

$$T_{ij} = \frac{A \times Y_i^a \times Y_j^b}{D_{ij}^c}$$

- $a, b, c \neq 1$.
- The Gravity Model fits the data on U.S. trade with European countries well but not perfectly.
 - The Netherlands, Belgium and Ireland trade much more with the United States than predicted by a gravity model.

Impediments to Trade: Distance, Barriers, and Borders

- *Distance* between markets influences transportation costs and therefore the cost of imports and exports.
- Close *cultural* ties, such as a common language, usually lead to strong economic ties.
- *Geography*, such as, ocean harbours and a lack of mountain barriers make transportation and trade easier.
- *Multinational corporations* spread across different nations achieving import and export of many goods between their divisions.
- Crossing *borders* involves formalities that take time, often different currencies need to be exchanged, and perhaps monetary costs like tariffs reduce trade.

Impediments to Trade: Distance, Barriers, and Borders Cont'd

- The Gravity Model predicts that a 1% increase in the *distance* between countries is associated with a decrease in the volume of trade of 0.7% to 1%.
- Borders increase the cost and time needed to trade.
- Trade agreements between countries are intended to reduce the formalities and tariffs increasing trade.
- Even with a free trade agreement between the U.S. and Canada, which use a common language, the border between these countries still seems to be associated with a reduction in trade.

The Changing Pattern of World Trade

- The negative effect of distance on trade according to the gravity models is significant, but has grown smaller over time due to modern transportation and communication.
- Political factors, such as wars, can change trade patterns much more than innovations in transportation and communication.
- Vertical disintegration of production has contributed to the rise in the value of world trade through extensive cross-shipping of components.

What Do We Trade?

- Most (about 57%) of the volume of trade today is in manufactured products such as automobiles, computers, and clothing.
 - Services such as shipping, insurance, legal fees, and spending by tourists account for about 24% of the volume of trade.
 - Mineral products (ex., petroleum, coal, copper) remain an important part of world trade at 12%.
 - Agricultural products are a relatively small part of trade at 8%.
- More than 90% of the exports of China consist of manufactured goods.

Service Outsourcing

- Service outsourcing (or offshoring) occurs when a firm that provides services moves its operations to a foreign location.
- Service outsourcing can occur for services that can be transmitted electronically.
- Service outsourcing is currently not a significant part of trade.