International Trade

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Why trade among nations?

- Why not practice self-sufficiency?
- Mercantilists (17th & 18th C.): if you can export more than you import, that
  - Creates jobs in your country and
  - Gives you gold reserves to pay mercenaries
- Free-traders (late 18th & 19th C.):
  - Because trade is mutually beneficial:
    - Creates larger markets, which means more division of labor—more specialization—therefore more production, and higher real incomes.
    - David Ricardo: theory of comparative advantage
Comparative advantage

Best understood using a numerical example:

- 2 countries: England and Portugal
- 2 goods: wine and cloth
- Portugal takes fewer man-hours to produce both:

<table>
<thead>
<tr>
<th>Labor Required Per Unit of Product</th>
<th>Portugal</th>
<th>England</th>
</tr>
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<tbody>
<tr>
<td>100 yards (1 roll) cloth</td>
<td>3</td>
<td>10</td>
</tr>
<tr>
<td>Barrel wine</td>
<td>1</td>
<td>5</td>
</tr>
</tbody>
</table>

- Opportunity cost of cloth in Portugal is 3 barrels wine
- Opportunity cost of cloth in England is 2 barrels wine
Prices will probably be somewhere between two extremes: say, 2.5 rolls of cloth per barrel of wine.

- At these prices, both countries still better off with trade than without.

Key point: England has a *comparative advantage* in cloth.

- Even though Portugal has the *absolute advantage* in both goods.
- *Relative* price of cloth (in wine) is less in England.
Balance of Trade is a measure of the relative prices of imports and exports. It is calculated by taking the index of export prices and dividing it by index of import prices.

The balance of trade is favourable when the value of export goods increases. It is unfavourable when import exceeds the value of exports.
1. When countries trade money flows into and out of each country
2. The accounts that record a nation’s international financial transactions are called its balance of payments (BP)
3. Records all financial transactions between a country and the rest of the world over a year
4. The BP is maintained on a double-entry bookkeeping system
Balance of Payments

The difference between receipts and payments

**BP Receipts**
- costs of goods exported.
- money spent by foreign tourists.
- transportation.
- payments of dividends and interest from FDI abroad.
- new foreign investments

**BP Payments**
- costs of goods imported.
- spending by tourists abroad
- new overseas investments.
- cost of foreign aid.
The Balance of Payments includes three accounts:

1. current account
2. the capital account
3. the official reserves account
Balance of Payments

Current Account
1. Visible Trade
   A. Exports
   (-) B. Imports
2. Invisible
   A) Services
   B) Sea and air transport
   C) Financial services
   D) Interests, profit, dividend

Current Balance Position

= Visible Balance
(Balance of Trade)

= Invisible Balance
Balance of Payments

Capital Account
1. Investment overseas
2. Investment by foreigners
3. Net foreign currency transactions
4. Official reserves

Net Capital Balance
An exchange rate is the amount of currency that one needs in order to buy one unit of another currency, or the amount of currency that one receive when selling one unit of another currency.
Exchange Rates... Contd.

- Exchange rates are volatile
  - If the exchange rate floats, the value of the rate fluctuates daily.
  - When the exchange rate is fixed or pegged, it does not fluctuate daily, but can change dramatically if the peg is broken.

- Exchange Rates Today
  - Despite much effort, exchange rates have proven to be very difficult to predict or control.
  - Historically, almost all nations have sought to exert control over their exchange rates - but often with limited success.

- Exchange rate fluctuations can have substantial impact on the real economy.
  - The Asian crisis had a substantial impact on the domestic economies of the countries that were affected.
  - In the case of Indonesia, it also had an impact on the political environment, resulting in the resignation of Indonesia’s President Suharto.
Gold Standard as an Exchange Rate System

- The Gold Standard
  - Value of currency is fixed in terms of gold. The gold standard was popular before the WW1.
  - Now only of historical interest.
- The official gold price was fixed (“mint parity”), with free convertibility between domestic money and gold. US adopted standard in 1879 and defined the US$ as 23.22 fine grains of gold, or US$ 20.67/ounce of gold.
- All national currency is backed by gold, and growth in money supply is linked to gold reserves.
- As each separate currency was convertible into gold at a fixed price, the exchange rate between the two currencies was automatically fixed.
- There is no fluctuation in the exchange rate unless either country changes the local price of gold.

Mint parity theory explains the determination of exchange rate between the two countries which are a gold standard.
Gold Standard as an Exchange Rate System

Full Gold Standard or Gold Currency Standard

- The standard monetary units of a country are full bodied gold coins. They are declared by law as a certain amount of gold of specified weight and fineness. Prior to 1934, dollar was valued at 23.22 pure gold grains in the U.S.A. The British Sovereign pound contained 123.27 grains of gold before World War 1. Franc contained 4.97 grains of gold.

- People are allowed to get the bullion converted in unlimited quantity into standard gold coins with or without charge. Similarly, there is no restriction imposed on the melting of gold coins into bullion. Free coinage is thus an important characteristic of this standard.

- People are at liberty to do as they wish with their gold. They can import, export or hoard gold. Thus unlimited purchase or sale of gold is allowed in the country in order to maintain the market value of metal with the face value of the coins.
Gold Standard as an Exchange Rate System

- **Gold Bullion Standards**
  - The first modern international monetary system was the gold standard. Operating during the late 19th and early 20th cents, the gold standard provided for the free circulation between nations of gold coins of standard specification. Under the system, gold was the only standard of value.
  - The advantages of the system lay in its stabilizing influence. A nation that exported more than it imported would receive gold in payment of the balance; such an influx of gold raised prices, and thus lowered the value of the domestic currency. Higher prices resulted in decreasing the demand for exports, an outflow of gold to pay for the now relatively cheap imports, and a return to the original price level (see balance of trade and balance of payments).
Currency Devaluation

- Reduction in the exchange value of a country's monetary unit in terms of gold, silver, or foreign currency.

CURRENCY DEVALUATION TAKES PLACE WHEN ONE COUNTRY'S CURRENCY IS REDUCED IN VALUE IN COMPARISON TO OTHER CURRENCIES. AFTER CURRENCY DEVALUATION, MORE OF THE DEVALUED CURRENCY IS REQUIRED IN ORDER TO PURCHASE THE SAME AMOUNT OF OTHER CURRENCIES. A FICTIONAL EXAMPLE: IF LAST YEAR, ONE U.S. DOLLAR PURCHASED 10 MEXICAN PESOS, THEN THIS YEAR, ONE U.S. DOLLAR CAN ONLY PURCHASE FIVE MEXICAN PESOS, THE U.S. DOLLAR HAS UNDERGONE A CURRENCY DEVALUATION.

- Motives of devaluation. It stimulates exports of commodities. It restricts import demand for goods and services. It helps in creating a favorable balance of payments.
THE END

Thank You!