INTERNATIONAL TRADE AND FINANCE

INTRODUCTION TO INTERNATIONAL TRADE

International Trade vs. Interregional Trade:

There are two main basic differences between domestic and international trade:

1. Tariffs / Quotas:

Tariffs or quotas are imposed on multilateral trade relations (international trade) while no such restrictions are found in domestic trade.

2. Foreign Exchange:

Different countries involved in international trade, have their own currencies which create a new issue of international finances, known as foreign exchange. Therefore, economic protections and diversity of domestic currencies are main issues of international trade.

Basis of International Trade:

A particular country feels it profitable, feasible and useful to take part in international trade on the basis of the following reasons:

1. Different Productions:

All countries do not produce all the goods but consume everything which is produced anywhere in the world. Some countries, naturally and climatically, produce wheat, tea, coffee and bananas while other countries can produce sugar cane, citrus fruits and maple. Both the categories of countries mutually be benefited through International trade.

2. Decreasing Costs:

Increasing returns or diminishing costs of large scale production is the other reason of international trade relations among different countries. Many countries can use modern and sophisticated processes of production due to which, through economies of large scale product, average costs decrease. In other words some countries can specialise them for the production of some commodities while other cannot. Every country specialises in some fields of production while other fields are left unattended. Every country sells those goods for which it enjoys specialisation and purchases from others which are specialised for these goods.

3. Different Tastes:

Every country has different preferences due to differences in tastes. Even in the identical production conditions in different countries, they may involve in international trade relations because of different taste for goods and services.

Definition:

International trade refers to “the trade relations established among different countries through imports and exports on international accounts”.

THEORIES OF INTERNATIONAL TRADE

The classical theory of International Trade responds the question that why in trade relations among different countries should be established? There are two versions of classical theory:

1. Theory of Absolute Advantage:

Absolute advantage Idea was developed by Adam Smith who was of the opinion that a tailor does not make his shoes but exchanges a suit for it, and so both tailor and cobbler gain by trading, similarly, a country would gain by having its trade relation with other countries. Smith argues that if one country has absolute advantage in one line of production over the other and the other country may have absolute advantage in the other line of production over the first. In this manner, both the countries would gain by trading.

2. Theory of Comparative Advantage:

David Ricardo agreed completely with the idea propounded by Adam Smith that international trade would be mutual benefits of if one country has absolute advantage over the other in one line of production, and the other has absolute advantage over the first country in the other line of production, but Ricardo added a new idea and argued that even a country, having absolute advantage for both the lines of production, will be cultivating trade benefits if it specialises itself only for one of the two production lines which it can produce comparatively at lower cost of production. Comparative advantage principle will be workable only when the extent of absolute advantage is different in both the goods in question. In other words, compartment advantage should be greater in respect of one commodity than in that of the other it means nothing but the comparative difference in the cost.

GENERAL AGREEMENT ON TARIFFS AND TRADE (GATT):

At the end of Second World War, various financial problems raised their heads on the international forum. To smooth out these problems, international Institutions were proposed in conference held in 1944 and Bretton Woods. First of these institutions were was IBRD and the second was IMF. It was also realised that, to deal with the problems of post-war period and excessive protectionism, there would be a need of an international organisation. In response of this thought, a trade conference, represented by 23 countries, was held in Geneva in 1947 in which a multinational trade agreement, called general agreement on tariffs and trade (GATT) was signed. After the failure of Havana trade plan, GATT has emerged as most important source of mild restrictions on trade relationship.

The preamble of the agreement aims at curtailing and making the barriers on trade so that contracting countries could be benefited by the trade and fair trade relations. In Part 1 of the agreement, each signatory was required to give all other signatories any advantage favour, privilege or immunity that it

had already accorded to one most favoured nation. In Part 2 of the agreement, there are provisions intended to make sure that the advantage from tariff reductions cannot be reduced in other ways like quantitative import controls. Part 3 of the agreement deals with the problems of the enforcement.

As a result of efforts of GATT, tariffs have been reduced considerably although the objective is an entire elimination. GATT has not been successful in reducing import quota systems in particularly the countries which import on the plea of balance of payments. GATT operates by holding periodic conferences.

Briefly speaking, it can be said that GATT has performed mainly to two functions:

1. It has elaborated a code that has properly conducted commerce between its members.

2. Its general headquarters have served a meeting place where international tariff negotiations have taken place.

INTERNATIONAL TRADE AND DEVELOPING COUNTRIES

In maintaining international trade relations, no country can be selective to establish its trade exclusively with the similar developing countries only. Obviously, international trade relations are established with developing and developed countries.

Industrially advanced countries, through trade, can help less developed countries in their growth in various ways.

1. Expansion in Trade:

The developed countries, by lowering international trade barriers, can help the developing countries to crease their GNPs by ways of expanding their volume of trade. It is true that the developing countries need foreign markets to sell their abundant raw materials. But the problem is that not only they require raw materials market but fundamentally they also require capital goods and technical assistance to produce something to export.

Despite this advantage, closed tie of trade between the developed and the developing nations confirms the old quip, "When Uncle Sam gets his feet wet, the rest of the world gets pneumonia." If a recession takes place in the developed areas disastrous consequences for prices are put on the raw materials over the export earnings of the developing countries. Therefore, stability and growth in industrially developed countries is of crucial importance for the developing countries.

2. Foreign Aid:

Nobody can deny the significance of capital accumulation for achieving economic growth. Foreign public and private capital can supplement the efforts of developing countries regarding savings and investments. Foreign capital (AID) can help generally in breaking through the vicious circle of poverty in the less developed nations.

Unfortunately, developing countries lack infrastructural facilities and so they are unable to attract foreign capital to invest. To tear this roadblock down, foreign aid can serve the purpose. Foreign public aid is provided direct and indirectly. Direct aid is provided to the developing economics through a variety of programmes but participating in international institutional designed to stimulate economic development. This aid may be in terms of loans and grants. But sometimes this aid is provided on political and military rather than economic grounds.

Indirect foreign aid is provided to the less developed countries by the World Bank group.

3. Private Capital Flows:

Underdeveloped countries have also received substantial flows of foreign private capital largely from corporations and commercial banks of the developed countries.

CONCEPT OF BALANCE OF PAYMENTS

Exports to and imports from other countries create money rights and obligations in a country against the trading countries which lead to the concept of balance of payments. A country's exports create a demand for its currency and supply of foreign currencies. The imports of a country create a demand for foreign currencies and a supply of it down currency.

Balance of payments of a country consists on current account and capital account balances. Current account balance is a nation's export of goods and services less its imports of goods and services plus it is not invested incomes and net transfers. On the contrary, the capital account balance is a country's capital inflows less its capital outflows.

A balance of payments deficit occurs when the sum of advances on current and capital accounts is negative, a balance of payments surplus arises when the sum of the balances on current and capital account is positive.

Bilateral receipts from and payments to other countries in terms of foreign currencies involve the problems of rate of foreign exchange.

EXCHANGE RATE

Rate of exchange refers to the rate at which one currency can be exchanged for another. When two countries are on the gold standard, the exchange rate will vary only between very low and very high rates.

Exchange Rate and Adjustments:

Imbalances in the balance of payments, deficits or surpluses, need adjustments sometimes on internal and other times on external grounds. Adjustments depend on the system used for this purpose. Adjustments are made using one of the two polar options, namely, 'floating' and 'fixed/pegged' exchange rates. Under the floating exchange rate system, rate of exchange between the two currencies is determined by free forces of demand supply. In the fixed system, government's intervention or any

other mechanism is used to determine the rate of exchange of setting the influences of demand and supply forces.

Source: Saeed Ahmed Siddiqui