



ASSIGNMENT

BY

AYEBATARI CHRISTIANA BOMOIPRI

ID: UB75630BEC84810

COURSE

INTERNATIONAL ECONOMICS

TABLE OF CONTENT

Introduction

- What International Economics is all about?
- The Gains from Trade

The Pattern of Trade

An Overview on World Trade

- How much Trade?
- International Economics:

Trade and Money

- Who Trades with Whom?

Does Size Matter in International Trade?

- Size Matters: The Gravity Model

I • The Logic of the Gravity Model

- Impediments to Trade:

Distance, Barriers and Borders

Pattern of World Trade

- The Changing Pattern of World Trade
- Has the World Gotten Smaller?
- What do we Trade?

: The Classical and Neo-classical Trade Theory

- Smith's Theory of Absolute Advantage
- Ricardo's Theory of Comparative Advantage
- The Theory of Factor Endowments (H.O.S. Theory):

The Terms of Trade

- Definition and Illustration of Terms of Trade
- Effect of Supply and Demand on Terms of Trade

- Gains from Trade:

International Factor Movements

- Key issues in International Factor Movement
 - International Labour Mobility
 - International Capital Mobility:

Tariff Policy

- The Meaning and Nature of Tariffs
- Economic Effects of a Tariff
- Economic Argument for Tariff Protection
- Non-economic Reasons for Tariff

Other Instruments of Trade Policy

- The Need for other Trade Policy
- Import Quota
- Exchange Controls
- Embargoes

Trade Policies in Developing Countries

- Economic and Social Characteristics of Developing Countries
- Trade and Commercial Policies in Developing Countries
- Strategies for Stabilizing Exports and Prices

Regional and Economic Integration

- The Need for Economic Integration
- Levels of Economic Integration
- The European Economic Community (EEC) and the Economic Community of West African States (ECOWAS)

Introduction to International Trade

One could say or argue that the study of international trade and finance is where the discipline/field of economics as we know it began.

Historians of economic thought often describe or portray the essay “Of the Balance of Trade” by Scottish Philosopher David Hume as the first real exposition of an economic model. Hume published his essay in 1758, almost 20 years before his friend Adam Smith published the “An Inquiry into the Nature and Causes of the Wealth of Nations” in 1776.

Since then, the study of International Economics has been so important to countries/nations all over the world because the world is a global village and countries/economies are linked to one another through trade, money and capital flows, migration of people, investments in each other economy etc.

What is International Economics About?

International Economics employs the same basic method of analysis as other fields of economics, because the motives and behavior of individuals are the same in international trade as they are in domestic trade.

For instance, a cloth shop in Benin City that sells linen materials from Kano and London; the sequence of events that brought those linen materials to the shop is not very different;

- i. they both include factors of production (Land, Labour, Capital) to produce goods and services,
- ii. they both include transportation cost,
- iii. prices of the goods and services are determined locally the same way it is determined internationally, (market forces) Despite these similarities between international trade and domestic trade,

international trade/economics involves new and different concerns:

- i. It involves two or more sovereign nations/countries
 - ii. It involves tariffs and other forms of trade controls
 - iii. It involves the use of multiple currencies for its transaction
- Subject Matter of International Economics This consists of issues raised by special problems of economic interaction between sovereign states.

Throughout the study of International Economics, seven themes recur namely:

- i. The gains from trade
- ii. The pattern of trade
- iii. Protectionism
- iv. The Balance of Payments
- v. Exchange Rate Determination
- vi. International Policy Coordination
- vii. The International Capital Market

The Gains from Trade The following benefits can be derived when countries sell goods and services to each other.

These include:

- i. It allows nations to export goods whose production process makes relatively heavy use of resources that are locally abundant and import goods whose production process makes heavy use of resources that are locally scarce
- ii. It allows countries to specialize in producing narrower ranges of goods, giving them greater efficiencies of large-scale production
- iii. It promotes international migration of factors, international borrowing and lending of money
- iv. It allows international exchange of risky assets such as stocks and bonds and as such benefit all countries by allowing each country to diversify its wealth and reduce the variability of its income Despite these gains from international trade, still, it is quite probable that it might hurt particular groups within nations – In other words, it will have strong effect on the distribution of income.

This can occur in two ways namely:

- i. international trade can adversely affect the owners of resources that are “specific” to industries that compete for imports, that is, cannot find alternative employment in other industries
- ii. It can also alter the distribution of income between broad groups such as workers and owners of capital There is a common misconception that trade is harmful if there are large disparities between countries in terms of productivity or wages; for instance, businesses in less technologically countries like Nigeria and other third world countries often worry that opening their economies to international trade will lead to disaster

because their domestic industries won't be able to compete with their foreign counterpart.

Whereas on the other hand, people in technologically advanced countries like United States of America, England, Japan, Germany, France etc. where workers earn high wages/salaries often get scared that trading will less technologically advanced, low wages countries will drag their standard of living down.

The Pattern of Trade A major preoccupation of international economists is to explain the pattern of international trade; that is who sells what to whom? Some aspects of the pattern of trade are easy to understand e.g., Climate and resources clearly explain why Brazil exports coffee and Saudi Arabia exports crude oil.

However much of the pattern of trade is more complex and difficult to understand e.g., why does Japan export automobiles while the United States of America export aircraft?

In the 19th Century, English Economist, David Ricardo offered explanation to trade pattern in terms of international differences in labour productivity.

However, in the 20th Century, alternative explanations were also proposed; one of the most influential, but still controversial links trade pattern to an interaction between the relative supplies of factors of production (capital, labour and land) on one side and the relative use of these factors in the production of different goods on the other How Much Trade If there are gains from trade, the key question then is how much trade should be allowed?

Since the emergence of modern nation states in the 16th century, governments are worried about the impact of international competition on the prosperity of their domestic industries.

Due to this, government have introduced several protectionism instruments such as quota, embargo, tariffs etc. and export subsidies to shield their domestic industries from international competition.

The single most consistent mission of international economics has been to analyze the effects of these protectionist policies and usually not always criticize it and show the advantages of freer trade.

Since World War II, advanced democracies led by the United States of America have pursued a broad policy of removing barriers to international trade; this policy shows that free trade is not only a tool for prosperity but also to promote world peace.

In the first half of the 1990s, several major free trade agreements were negotiated; the most notable was North America Free Trade Agreement (NAFTA) between United

States of America, Canada and Mexico approved in 1993 and the so-called Uruguay Round Agreement establishing the World Trade Organization in 1994.

Since then, however, several international political movements opposing free trade and globalization has gained many adherents. In 1999, this movement gained notoriety when a mix of traditional protectionists disrupted a major international trade meeting in Seattle, United States of America

International Economics:

Trade and Money International Economics can be divided into two broad subfields namely:

i. International Trade – This focuses primarily on the real transactions in the international economy i.e., on those transactions that involve physical movement of goods or tangible commitment of economic resources.

Example is the dispute between U.S.A and Europe over Europe's subsidized exports of agricultural Product

ii. International Money – This focuses on the monetary side of the international economy i.e. on financial transactions such as foreign purchase of Nigerian Naira.

Example is the dispute whether the foreign exchange value of the Naira should be allowed to float freely or stabilized by the CBN's monetary action in the real world, there is no simple dividing line between international trade and international money, because most international trade involves monetary transactions

An Overview on World Trade Here we will examine why countries sell much of what they produce to other countries and they purchase much of what they consume from other countries.

We will also examine the benefits and costs of international trade and the motivations for and effects of government policies that restrict or encourage trade.

Who Trades with Whom?

Why do countries trade more with some countries than others? For example, why does Nigeria trade more with the United States of America than Niger? Size Matters: The Gravity Model Three top Nigeria's trading partners are China, United States of America and India.

Why does Nigeria trade more heavily with these countries than others? The answer is that these countries have large economies i.e., in terms of their Gross Domestic Product (GDP). There is a strong relationship between the size of a country's economy (Gross Domestic Product) and the volume of its imports and its exports.

Looking at world trade as a whole, economists have found an equation that predicts the volume of trade between any two countries fairly accurately.

The equation is shown below: $T_{ij} = A \times Y_i \times Y_j / D_{ij}$ (Gravity Model)

Where

A = constant term

T_{ij} = value of trade between country i and country j

Y_i = country i's Gross Domestic Product

Y_j = country j's Gross Domestic Product

D_{ij} = is the distance between the two countries.

That is the value of trade between any two countries is proportional, other things equal, to the product of the two countries' Gross Domestic Products and diminishes with the distance between the two countries.

The reason for the name is the analogy of Newton's law of gravity: which states that the gravitational attraction between any two objects is proportional to the product of their masses and diminishes with distance.

The logic of the Gravity Model Why does the gravity model work? Broadly speaking, large economies tend to spend large on imports, because they have large incomes.

They also tend to attract large shares of other countries' spending because they produce a wide range of products.

Thus, the trade between any two economies is larger, the larger is either economy.

To understand the statement above, let us look at a country's GDP (which is the value of the goods and services it sells), by definition, equals the spending of goods and services it produces.

Thus, a country's share of world GDP equals the share of total world spending on its products, e.g., in 2007, the United States of America share of world's GDP was 25% meaning that in 2007, out of the spending made in the world, 25% was on goods and services produced in the United States of America Illustration of the Gravity Model – Let's assume every country in the world spends their income in the same proportion, let's say 25% each.

In real world, this is not true because citizens of advanced countries like United States of America tend to spend higher fraction of their income on their products than citizens

of less advanced countries like Nigeria. Let us create an imaginary world where we have 4 countries (W, X, Y, Z). W & X are large economies which get 40% of the world's spending and Y & Z are small economies which get 10% of the world's spending.

Suppose the world's spending is \$10trillion; W & X will have a GDP of \$4trillion, while Y & Z will have a GDP of \$1trillion.

Thus, if W spends 40% of its GDP on other country's exports, X will get \$1.6trillion, while Y & Z will get \$0.4trillion; while if Y spends 10% of its GDP on other country's exports, W & X will get \$0.4trillion, while Z will get \$0.1trillion.

One of the principal uses of the Gravity Model is that it helps to identify Anomalies in trade. Indeed, when trade between two countries is either too much or too less than a gravity model predicts, economists search for explanation Impediment to Trade:

Distance, Barriers and Borders Distance - One of the reason why countries trade more with one another than others is distance; e.g. Canada whose economy is roughly almost the same size as Spain's trades as much with the U.S. as all of Europe does (Note, Spain is part of Europe) because it is closer to the U.S Barriers - Another factor that makes countries trade with one another is absence of barriers to trade; if barriers to trade are removed, trade becomes freer e.g. Canada, Mexico and U.S are members of NAFTA, which ensures that most goods shipped among these countries are not subject tariffs and other barriers of trade. Border - Trade occurs more within the same region in a country (i.e., the same national border) than between different regions of different countries; e.g., Borno State is closer to Niger than it is closer to Lagos State.

But trade occurs more between Borno and Lagos States than between Borno and Niger.

This shows that national border has a negative effect on trade between nations.

The Changing Pattern of World Trade The direction and composition of world trade is quite different today from what it was a generation ago and even more different from it was a century ago Has the World gotten Smaller? From popular economic discussion, we often encounter statements that modern transportation and communication (technology) have abolished distance and that the world has become a smaller place.

For example, jets and internet has made trade easy for people who are thousands of miles away.

In addition, it is important to note that before modern transportation and communication, telephone, railways, steamship and telegraph aided trade and this came to an end in 1914.

Despite technology, political forces and will can outweigh the effects of technology and depress world trade e.g., the two world wars (1914-1918; 1939-1945), the great depression of the 1930s and the widespread protectionism of trade in the 20th Century.

What do we Trade? When countries trade, what do they trade? For the world as a whole, the main answer is that trade on manufactured goods such as computers, automobiles etc. to each other.

Though trade in minerals mostly crude oil still remains an important aspect of world trade; while Agricultural products such as wheat, cocoa etc. also play a key role and are widely expected to become more important in the future A look at world exports in 2005 shows that Manufactures took the lion share with 59.32%, followed by Services with 19.59%, mining with 14.18% and Agriculture with 6.91%. Service exports include transportation fee charged by airlines and shipping companies, insurance fees received from foreigners and spending by tourist.

There is a new type of service trade made by modern telecommunication e.g., oversea call and help centers to assist in providing information (800) There is also a changing pattern in trade within developing countries and between developing countries and developed countries.

For example, between 1910 and 2002, the level of exports and imports for U.S and U.K shows a rise in Manufactures for these periods More recently, there has been transformation in the exports of Manufactures in third world or developing countries.

During the 1970s, they were mainly exporters of primary products. Since then, however, they have moved rapidly to exports of manufactured goods e.g., China which have the largest developing economy and a rapidly growing force in world trade has 90% of its exports as manufactured goods.

The Classical and Neoclassical Trade Theory Presently, opinions vary amongst economists regarding the contributions of the classical economists to economics as a special discipline.

The universal belief, however, is that the classical economists has left us with a rich and useful legacy.

Three broad questions were asked to define the framework in which the classical economists explained the implications of foreign trade.

These are:

1. What is the basis of trade and what good does a country export and import?
2. On what terms are the traded goods being exchanged?
3. If disturbances occur in trade pattern, what forces bring about adjustment and how will they do it? The answers to these three questions evolved several hundred years ago.

They incorporated the intellectual efforts of such economists as Adam Smith, David Ricardo, John Stuart Mill and many others.

The collective body of thought that was formed by these scholars later came to known as a general theory of international trade.

Modern economists, however, have found it necessary to treat the various aspects of international trade separately, and to distinguish between pure trade theory and the monetary (balance of payments) theory.

The pure trade theory has to do with the more fundamental questions that concern the basis for, and gains so be derived from foreign trade.

An example of the pure trade theory includes Smith's theory of Absolute Advantage and Ricardo's theory of Comparative Advantage.

Smith's Theory of Absolute Advantage

By absolute advantage, we mean the ability of a country to produce a specific good with fewer resources than other countries (Meier, 1988).

To illustrate this, we look at the example in which Nigeria and South Africa are both producing crude oil and diamond.

we see that using the amount of labour, Nigeria can produce more units of crude oil than South Africa. In the production of crude oil, Nigeria has an absolute advantage over South Africa. Specifically, Nigeria uses fewer resources to produce more unit of crude oil.

Similarly, South Africa has an absolute advantage over Nigeria in the production of diamonds because she uses fewer unit of labour to produce more units of diamonds.

Thus, it follows that if two countries trade with each other, Nigeria will benefit by specializing in crude oil production.

She will then export her surplus crude oil to finance diamonds imports from South Africa.

South Africa will benefit by specializing in diamond production and exporting her excess diamond to finance crude oil imports from Nigeria.

From this analysis, we have seen that, as a result of international division of labour, a country can consume a commodity that she cannot produce.

Ricardo's Theory of Comparative Advantage

The theory states that a country will gain from trade if she specializes in the production of a specific commodity in which she uses a lower opportunity cost than her trading partner.

That is, a country should specialize in the production of those commodities which makes the most efficient use of its scarce resources (for which the opportunity cost is the lowest). In illustrating the meaning of comparative advantage, Ricardo used a simple example of two countries, two commodities and one factor of production (labour), 2 x 2 x 1 model as shown below

The Neoclassical Trade Theory

Some classical economists recognized that some of their assumptions served to favor free trade.

For example, Mill as well as Ricardo admitted that the assumption about international mobility of labour and capital was unrealistic.

But since this assumption was indispensable to the classical case, Mill hit upon a compromise.

For the purpose of analysis, he defined international trade as the exchange of goods by areas among which productive resources cannot be moved easily.

This definition still underlines the modern trade theory.

A serious defect of the classical analysis is found in two other assumptions namely:

1. Labour was considered as the only factor of production
2. The value of goods is derived from their labour content These assumptions were an integral part of the labour theory of value, which as we have seen, played a major role in the classical economics.

The Theory of Factor Endowments Samuelson joined Heckscher and Ohlin to discredit the classical theory of trade.

Their new approach to trade is often known as the H.O.S. (i.e., Heckscher, Ohlin and Samuelson) model.

The starting point of this model is the very opposite of the Ricardian model.

The H.O.S. model recognizes that countries are endowed with many factors, but in different proportions.

Thus, as long as there are international differences in relative factor endowments, this alone seeks to explain differences in comparative cost and the basis for international specialization.

Since they assume equal factor qualities and production function among countries, each country would produce with the same technique of production, if confronted with identical factor ratios.

Even with the wrong assumption that all these variables are identical in every country, there is still a source of trade as long as the relative factor endowments differ among the countries.

It is important to note that relative factor abundance accounts for comparative advantage.

A country will export commodities that use intensively in their production, its relatively abundant factor.

If we consider the quantities of two factors, labour (L) and capital (K), and the ratio of (L/K) in country A is greater than the ratio of (L/K) in country B, A is abundant in L, and B in K. One important point to note here is that the relatively abundant factor will also have the relatively low factor price.

Wages will be relatively low in A and the return of K will be low in B.

Here, the underlying relatively abundant factor will therefore have a relatively low marginal cost and, in turn, a relatively low money price.

The labour abundant country will be able to sell in the world markets, labor-intensive commodities at low price, whereas the capital-abundant country will export capital-intensive commodities.

Therefore, the minimum difference between countries is sufficient condition to explain the pattern of trade and national difference in relative factor endowments (Meier, 1988)

Reference

- Gandolfo, G. (2004): Elements of International Economics. Springer Science and Business Media
- Gbosi, A. N. (2011): International Trade; Theory and Practice. Amethyst and Colleagues Publishers, Port Harcourt
- Gbosi, A. N. (2005): Contemporary Issues in International Trade and Development Finance. Sodek Associates, Port Harcourt.
- Jhingan, M. (2000): Money, Banking and International Trade. Vrinda Publications Ltd, Delhi
- Krugman, P. & Obstfeld, M. (2009): International Economics: Theory and Policy. Pearson International Edition, 8th Edition.
- Pugel, T. (2004): International Economics: McGraw Hill Series
- Ricardo, D. (1963): The Principles of Political Economy and Taxation. Homewood IL: Irwin, 1963. The Basic Source for the Ricardian Model
- Roy, M. & Roy, S. S. (2016): International Trade and International Finance: Exploration of Contemporary Issues. Springer, India
- Salvatore, D. (2009): International Economics: 10th Edition. Wiley Publishers
- Samuelson, P. (1948): International Trade and Equalization of Factor Prices. Economic Journal 58 pp 163-184