Chapter 5
International trade

International trade consists of buying and selling of exports and imports between countries.

Why do we trade?

The reason countries do not produce all their own goods to satisfy the needs and wants of their population is because different countries have different natural, human and capital resources and employ different ways of combining these resources. These factor differences encourage countries to specialise in those goods and services in which they are most efficient. They are then able to trade any surpluses they produce for other goods and services produced by other countries in which they are efficient. For example, Saudi Arabia exports oil whilst China exports electrical goods. Revenues from the exporting of electrical goods by China can be used to buy imported oil from Saudi Arabia.

The increased efficiency in the use of resources also means some countries can produce goods at a relatively cheaper cost than other countries. This may be because of the availability of natural resources, the skills or cost of the workforce or the quantity of the physical capital in the economy. Product differentiation can also lead to international trade. Many traded goods are similar but not identical, e.g. cars. However, the differences mean that some consumers in one country will want to buy a product made in another country, even if domestically produced products are available at a similar price. International trade allows consumers a much wider choice in the products they buy.

Key factors behind expansion of trade

- **Consumer expectations** – People now see what consumers in other countries have and want it for themselves. This is particularly the case in developing nations where wage levels are increasing
- Efforts of the **World Trade Organisation** to remove barriers to trade
- **Technological changes** such as the Internet and satellite communication systems
- **The falling costs of transporting goods** and the increased use of containerisation
- **Cross-border deregulation** – Trading blocs create an international trading community making trading across borders easier, e.g. European Union (EU) and the North American Free Trade Agreement (NAFTA)

Free trade

Free trade means international trade conducted without the existence of barriers to trade, such as tariffs and quotas.

Free trade area	Single market
A free trade area is one where there are no tariffs or taxes or quotas on goods and/or services from one country entering another. The members of a free trade area do not have a common external tariff on goods entering the area.	A single market is like a free trade area in that there are no tariffs, quotas or taxes on trade but also where there is free movement of goods, services, capital and people, and a common external tariff on goods entering the single market.

International free trade encourages specialisation by countries and the trading of surpluses. It increases wealth and adds to world GDP. A large proportion of the goods and services that we use on a daily basis are available because countries are able to trade with each other more freely than ever before. The advantages of the expansion of free trade are numerous:

- Allows economies of scale to occur, reducing costs and increasing productive efficiency
- Increases choice for consumers
- Increases competition, improving quality and reducing prices
- Increases chances of transfer of technology and other skills, helping with development
- Trading with other countries increases political stability
- Encourages innovation – lack of free trade often leads to domestic markets being dominated by a few businesses who avoid competition themselves. Competition provides a powerful incentive to innovate
- Leads to dilution of monopoly power in domestic markets and reduces potential for exploiting customers

For developing countries, international trade also:

- Brings employment and higher real wages
- Encourages inward investment and the move to manufacturing employment from agriculture. This, in turn, leads to up-skilling of the workforce and the growth of local supplier businesses

Protectionism

Protectionism is an economic policy of restraining trade between countries through the imposition of barriers to trade, such as tariffs or quotas.

In spite of all the advantages that free trade between nations offers, some countries actively pursue a policy of protectionism for a variety of reasons.

Reasons why protectionism exists
To **protect domestic industries**. Industries just starting up (infant industries) may face much higher costs than foreign competitors. A new low-volume domestic producer will find it impossible to compete on price against an established foreign high-volume producer. Only by protecting the new industry as it grows and develops can it compete in the future.
However, industries protected by trade barriers lack the competitive pressure to become efficient. Specific subsidies, training grants and tax concessions are likely to be better ways of creating new industries.
To **protect domestic employment**. Preventing those imports which consumers are likely to purchase can create, or at least, preserve jobs.
However, consumers are likely to have less choice and pay higher prices. *Foreign countries could retaliate by imposing trade restrictions on exports.*
To **prevent dumping**. This is the practice of selling goods at less than cost price by foreign producers in another country's domestic market. A foreign producer may deliberately price at a loss to drive domestic producers out of business. Once they have achieved this it can raise prices and enjoy monopoly profits.
However, preventing dumping stops consumers from being able to gain from buying cheaper foreign goods.

Protectionism can also occur because a country may wish to preserve a way of life, such as preventing depopulation of remote rural areas heavily dependent upon a particular agricultural product. In addition, many developing countries depend crucially upon one cash crop for their economic wellbeing. These commodities are subject to large fluctuations in price on world markets. Falls in price can give rise to large falls in living standards in these economies.

Methods of protectionism

- **Tariffs**

  These are a tax on imported goods and are sometimes referred to as customs duties. They can be used by a government to raise revenue to finance expenditure. However, most often they are used in a deliberate attempt to restrict imports. By imposing a tax on a good, it is likely that the final price to the consumer will rise. A rise in the price of the good will lead to a fall in demand and the volume of imports will fall. A tariff should therefore help domestic producers as some consumers will switch consumption from the more expensive imported goods to domestically produced substitutes.

- **Quotas**

  A quota is a physical limit on the quantity of a good imported. This will increase the share of the market available for domestic producers. It will also raise the price of the protected product.

- **Voluntary export restraint (VER)**

  This is a type of quota put in place by exporters. VERs are often created because the exporting countries would prefer to impose their own restrictions rather than risk sustaining worse terms from tariffs or quotas.

- **Non-competitive purchasing by governments**

  This involves a government only buying from domestic producers, even if this means paying higher prices.

- **Embargos**

  This involves complete or partial prohibition of commerce and trade with a particular country in order to isolate it.

International business

When businesses are considering moving into overseas markets, there are number of possible advantages. These include:

- **Higher earnings** – margins in overseas markets may exceed those found at home.
- **Spreading of risks** – this especially related to fluctuations in demand in the home market caused by the business cycle.
- **New potential markets** – Saturation of home market may have occurred. A business may have the finance to expand, but be unable to do so because of competition, or because of lack of new customers in the domestic existing market.
- **Cashing in on the brand** – new markets mean greater return on investment in expansion of a brand identity.
- **Benefits of economies of scale** – producing larger production runs helps to cut costs.

Problems in dealing with international markets

Successful exporting and trading with overseas countries depends upon an understanding that people all over the world have different needs, priorities, incomes and tastes. Businesses must acknowledge that most products will have to be adapted in some way to suit local cultures, currencies and buying habits.

Cultural differences can have a significant impact on how goods are sold in different markets. Marketing history is littered with examples of businesses who have ignored cultural differences at their cost. Examples include the Ford Fiesta, which was to be launched with the name Ford Caprino (goats' poo in Italian) and the leading Scandinavian soft drink Pschitt, which failed in the UK (the name has a silent p).

There are also a number of other factors external to the business that must also be considered when considering expanding internationally. These include:

- ***Exchange rate factors***. Fluctuations can cause lost orders or pressure on pricing and therefore profits.
- ***Different technological and health and safety standards***. These can create extra costs and prevent access to markets.
- **Administrative difficulties** such as customs paperwork.
- **Distribution problems**. Who is going to wholesale or retail the goods?

All of these factors mean that businesses must be aware of the increased risk that occurs when trading abroad.

The table below summarises potential differences between home and overseas markets:

Factors	Home Market	Overseas Market
Economic	No currency factors Secure economic environment	Fluctuations of currency value, affecting pricing and profitability Costs of currency transactions Potentially highly uncertain environment, with demand patterns changing quickly
Cultural	No language problems Known social structure Purchasing habits understood	Language barriers, costs of translation Different social structure Unknown purchasing habits
Technological	Familiar standards	Different standards Product adaptation required
Legal	Known laws and regulations	Different regulation Lack of rule of law Political requirements High levels of bureaucracy
Demographic	Size and structure of population known	Lack of understanding of population
Marketing and Competition	Distribution channels established Known brand Activities of competition understood	Need to establish distribution channels High spending required to establish brand Unknown competition Need to adapt pricing strategies

Discussion themes
Explain the reasons for international trade.
Free trade versus protectionism. Choose one and make a case for your choice.
International trade will always be beneficial to a business. Discuss.
The importance of international trade to the UK https://www.gov.uk/government/organisations/department-for-international-trade