# 15 Revision – Reasons for trade, economic integration and terms of trade

## The gains from international trade

- Lower prices
- Greater choice
- Access to resources that the country does not possess
- Economies of scale
- Increased competition

## Absolute and comparative advantage

A country is said to have an **absolute advantage** in the production of a good if it can produce it using fewer resources than another country. In this case, it is obvious that Australia has an absolute advantage in the production of lamb and China has an absolute advantage in the production of cloth. Australia should specialize in producing lamb and China in producing cloth. This is known as a **reciprocal absolute advantage**.

| Country | Kilos of lamb | Metres of cloth |
|---|---|---|
| Australia | 6 | 1 |
| China | 4 | 3 |
| Total without trade | 10 | 4 |

A country is said to have a comparative advantage in the production of a good if it can produce the good at a lower opportunity cost than another country. In simpler words, country A has to give up fewer units of other goods to produce the good in question than does country B.

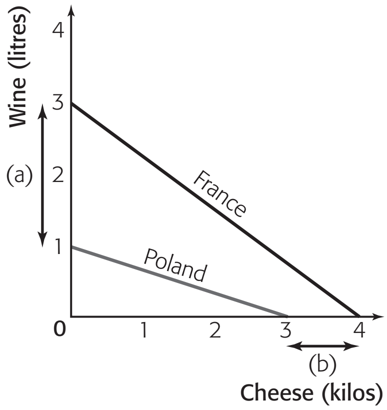
| Country | Litres of wine | Opportunity cost of 1 litre of wine | Kilos of cheese | Opportunity cost of 1 kilo of cheese |
|---|---|---|---|---|
| France | 3 | 4/3 kilos of cheese | 4 | 3/4 litre of wine |
| Poland | 1 | 3 kilos of cheese | 3 | 1/3 litre of wine |

France has an absolute advantage in the production of both goods. However, in terms of comparative advantage, France has a comparative advantage in the production of wine and Poland has a comparative advantage in the production of cheese.

This is because France only has to give up 4/3 kilos of cheese to produce a litre of wine, whereas Poland has to give up 3 kilos, but Poland only has to give up 1/3 litre of wine to produce a kilo of cheese, whereas France has to give up 3/4 litre of wine.

The theory of comparative advantage thus tells us that France should specialize in the production of wine and Poland should specialize in the production of cheese. France will then consume the wine that it wants and use any extra wine to exchange for cheese. In the same way, Poland will consume the cheese that it wants and use any extra cheese to exchange for wine.

The same can be shown on a diagram using production possibilities curves.




When a country has an absolute advantage in producing both goods, as France has here, and the scale of the axes is the same, the comparative advantage for the better producer is in the good where the distance between the production possibilities is greatest, shown by (a) in the diagram, and the comparative advantage for the less-efficient producer is in the good where the distance between the production possibilities is least, shown by (b) in the diagram. Thus, as we know, France has the comparative advantage in producing wine and Poland has the comparative advantage in producing cheese. If two countries face the same opportunity cost, then there is no point in trade taking place.

To a large extent, comparative advantage is based on a country's factor endowments. A country that is 'endowed' with a large amount of arable land may develop a comparative advantage in agricultural products. A country with abundant unskilled labour can develop its comparative advantage in the production of labour-intensive low-skilled manufactured goods. A country with abundant well-educated labour may have a comparative advantage in the output of financial services. A country with beautiful beaches and a favourable climate may develop its comparative advantage in the output of tourist services, illustrating that climate can actually be a factor of production! The abundance of a particular factor will make the price of this factor relatively lower than the price of other factors, thereby allowing the opportunity cost of the goods or services using that factor to be lower than it would be in other countries.

## Economic Integration

A **trading bloc** is groups of countries that join together in some form of agreement in order to increase trade between themselves and/or to gain economic benefits from co-operation on some level. The stages of economic integration are:

1. A **preferential trading area (PTA)** is a trading bloc that gives preferential access to certain products from certain countries.
2. A **free trade area** is an agreement made between countries, where the countries agree to trade freely amongst themselves, but are able to trade with countries outside of the free trade area in whatever way they wish, e.g. NAFTA.

3. A **customs union** is an agreement made between countries, where the countries agree to trade freely amongst themselves, and they also agree to adopt common external barriers against any country attempting to import into the customs union e.g. EU.
4. A **common market** is a customs union with common policies on product regulation, and free movement of goods, services, capital and labour, e.g. EU.
5. An **economic and monetary union** is a common market with a common currency, e.g. the Eurozone.
6. **Complete economic integration** This would be the final stage of economic integration, at which point the individual countries involved would have no control of economic policy, full monetary union, and complete harmonisation of fiscal policy.

## Terms of trade (TOT)

The TOT is an index that shows the value of a country's average export prices relative to their average import prices. It is calculated by using a simple equation:

$$\textbf{TOT} = \frac{\textbf{Weighted index of average export prices}}{\textbf{Weighted index of average import prices}} \times \textbf{100}$$

If the value of TOT increases, then we say that there has been an improvement. If it decreases, we say that there has been a deterioration. If the TOT improves, then a given quantity of exports will buy a larger quantity of imports than before.

### Short-run causes of changes in the TOT are changes in

- conditions of demand and supply
- relative inflation rates
- exchange rates.

### Long-run causes of changes in TOT are

- income changes
- long-run improvements in productivity within a country.

**How good is an improvement in TOT?** It depends where it comes from. If it is from an increase in the demand for a country's exports, then it is always a good thing and more will be demanded at a higher price. If it is from higher export prices caused by domestic inflation, then it will depend upon the elasticity of demand for exports. For most products, demand is elastic on the foreign trade markets, because they are very competitive. Thus, if export prices rise through inflation, there would be a relatively large fall in demand and thus a fall in total export revenue. Only essential products with inelastic demand, such as oil, would go against this.

Many developing countries, but certainly not all, are heavily dependent upon the exports of one or two commodities for their export revenue. There has been a long-term downward trend in commodity prices for many years. There are a number of reasons for this

- improvements in the technology of their production
- discovery of synthetic replacements
- income inelastic demand for commodities from developed countries
- protectionist policies in developed countries
- miniaturization of products, so less requirement for commodities to make and package the goods.

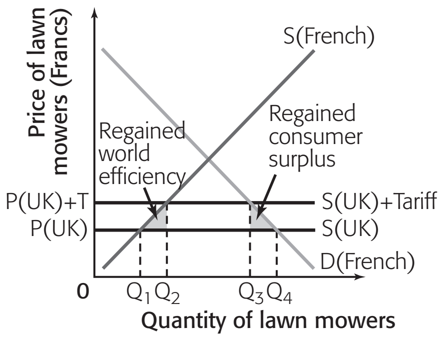
The deterioration in the TOT for developing countries that depend on commodities has several harmful consequences.

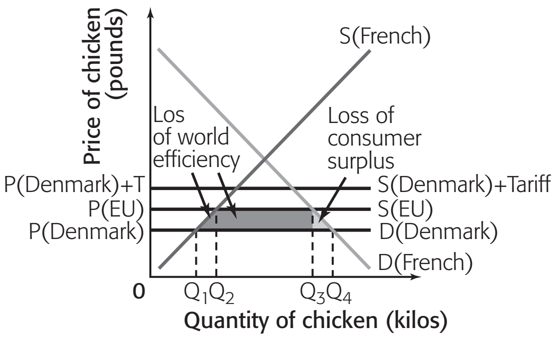
- Developing countries have to sell more and more exports in order to buy the same amount of imports. This is bad enough, but in order to do this, the developing countries then increase supply and this tends to push commodity prices down even more. We have a vicious circle.
- Many developing countries have high levels of indebtedness. Falling export prices and thus export revenue makes it harder to service their debt. Indeed, in extreme cases, this leads to countries having to increase their borrowing, thus increasing their levels of indebtedness. Another vicious circle. This vicious circle links to the previous one. In order to pay back their debts, many countries have had to increase their output of the commodities in which they have a comparative advantage. This increases the supply and drives the prices down.
- In order to increase the supply of commodities and gain more export revenue, some developing countries have overused their resources, resulting in negative externalities such as land degradation, desertification, soil erosion and massive deforestation. This is clearly not sustainable in the long run.

## Trade creation and trade diversion

### Trade creation

Trade creation occurs when the entry of a country into a customs union leads to the production of a good or service transferring from a high-cost producer to a low-cost producer. It is thus, obviously, an advantage of greater economic integration.




### Trade diversion

Trade diversion occurs when the entry of a country into a customs union leads to the production of a good or service transferring from a low-cost producer to a high-cost producer. It is thus, obviously, a disadvantage of greater economic integration. This represents a misallocation of the world's resources and represents a disadvantage of economic integration.