



Subject : Business Economics – Macro Economics

- *Globalization and International Trade*
- *Protectionism*

Globalization

What is Globalisation?

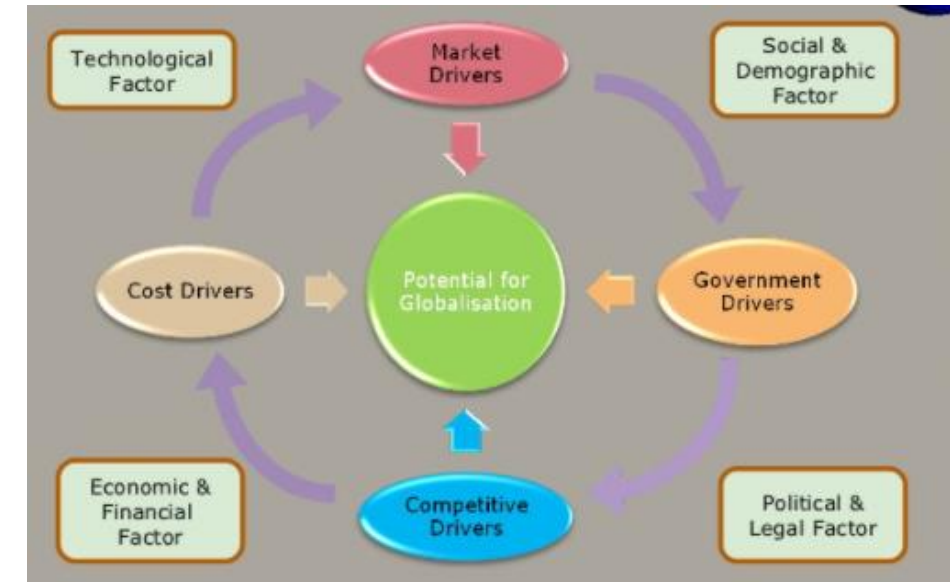
- Globalisation is the process of developing increasing political, cultural, financial and economic ties between people, companies and other institutions all around the world.
- In essence, globalization is about the world becoming increasingly interconnected. Countries today are more connected than ever before, due to factors such as air travel, containerized sea shipping, international trade agreements and legal treaties, and the Internet. In the world of business, globalization is associated with trends such as outsourcing, free trade, and international supply chains.



Drivers of Globalization

The wave of globalization is driven majorly by five different drivers. They are

- **Technological drivers** – Technology shaped and set the foundation for modern globalization. Innovations in the transportation technology revolutionized the industry. For instance, the rapid growth of the Internet is the latest technological driver that created global e-business and e-commerce.
- **Political drivers** – Liberalized trading rules and deregulated markets lead to lowered tariffs and allowed foreign direct investments in almost all over the world. The institution of GATT 1947 and the WTO 1995 as well as the ongoing opening and privatization in Eastern Europe are only some examples of latest developments.



Drivers of Globalization

- **Market drivers** – As domestic markets become more and more saturated, the opportunities for growth are limited and global expanding is a way most organizations choose to overcome this situation. Common customer needs and the opportunity to use global marketing channels and transfer marketing to some extent are also incentives to choose internationalization.
- **Cost drivers** – Sourcing efficiency and costs vary from country to country and global firms can take advantage of this fact. Other cost drivers to globalization are the opportunity to build global scale economies and the high product development costs nowadays.
- **Competitive drivers** – With the global market, global inter-firm competition increases and organizations are forced to “play” international. Strong interdependences among countries and high two-way trades and FDI actions also support this driver.

Globalization – The Good and The Bad

Positive Impacts

- Gives Access to a Larger Market
- Provides Cheaper Goods for Consumers
- Globalization lets Countries do what They do Best
- Leads to Better Economies
- Promotes World Peace and Unity
- Better Quality and Variety
- Innovation

Negative Impacts

- Causes Environmental Damage
- Causes Fluctuation of Prices
- Job Insecurity

International Trade

Without international trade we would all be much poorer.

There would be some items that we would simply have to go without. Then there would be other items like wine and spacecraft that we could produce only very inefficiently.

International trade has the potential to benefit all participating countries.

Free trade – international trade with no government intervention imposing restrictions of any kind on imports or exports. Totally free trade, however, may bring problems to countries or to groups of people within those countries.

A step on the road to freer trade is for countries to enter free trade agreements with just a limited number of other countries/

Try to think!!



What do you think can be
the potential benefits of
International trade??

Specialisation as the basis for trade

Why do countries trade with each other, and what do they gain from it?

Rather than people trying to be self-sufficient and do everything for themselves, it makes sense to specialise.

Firms specialise in producing certain goods. This allows them to gain economies of scale and to exploit their entrepreneurial and management skills and the skills of their labour force.

Countries also specialise. They produce more than they need of certain goods. What is not consumed domestically is exported.

Specialize in what??



But which goods should a country specialise in? What should it export and what should it import?

Absolute Advantage

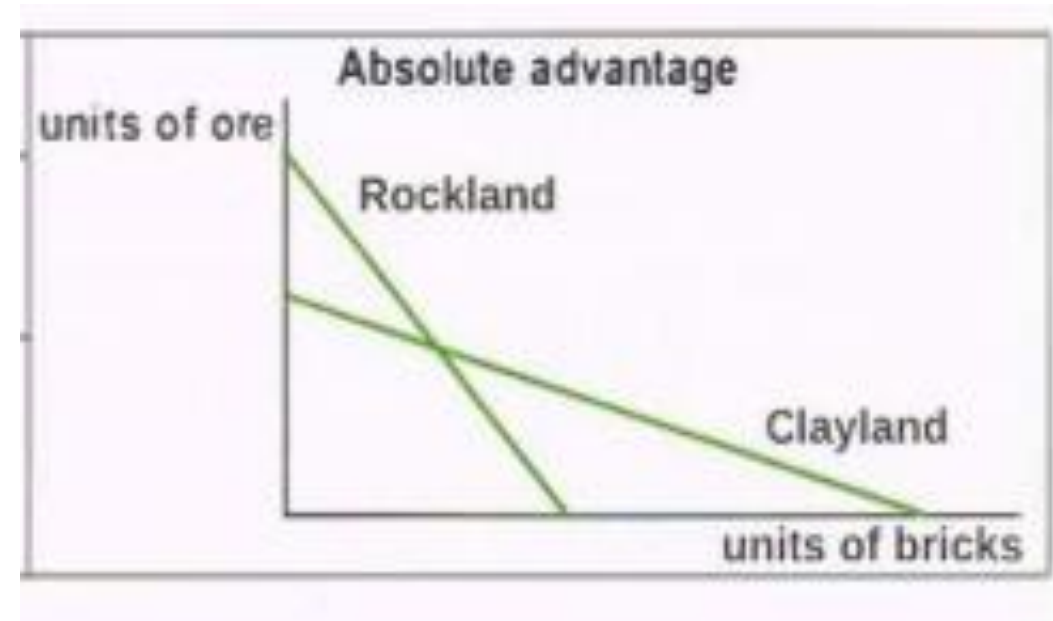
- **Absolute advantage**

When one country can produce a good with less resources than another country, it is said to have an absolute advantage in that good.

The PPC diagram shows Rockland with an absolute advantage in production of ore and

Clayland in production of bricks. Rockland should specialize in production and export of ore and Clayland in production and export of bricks. bricks.

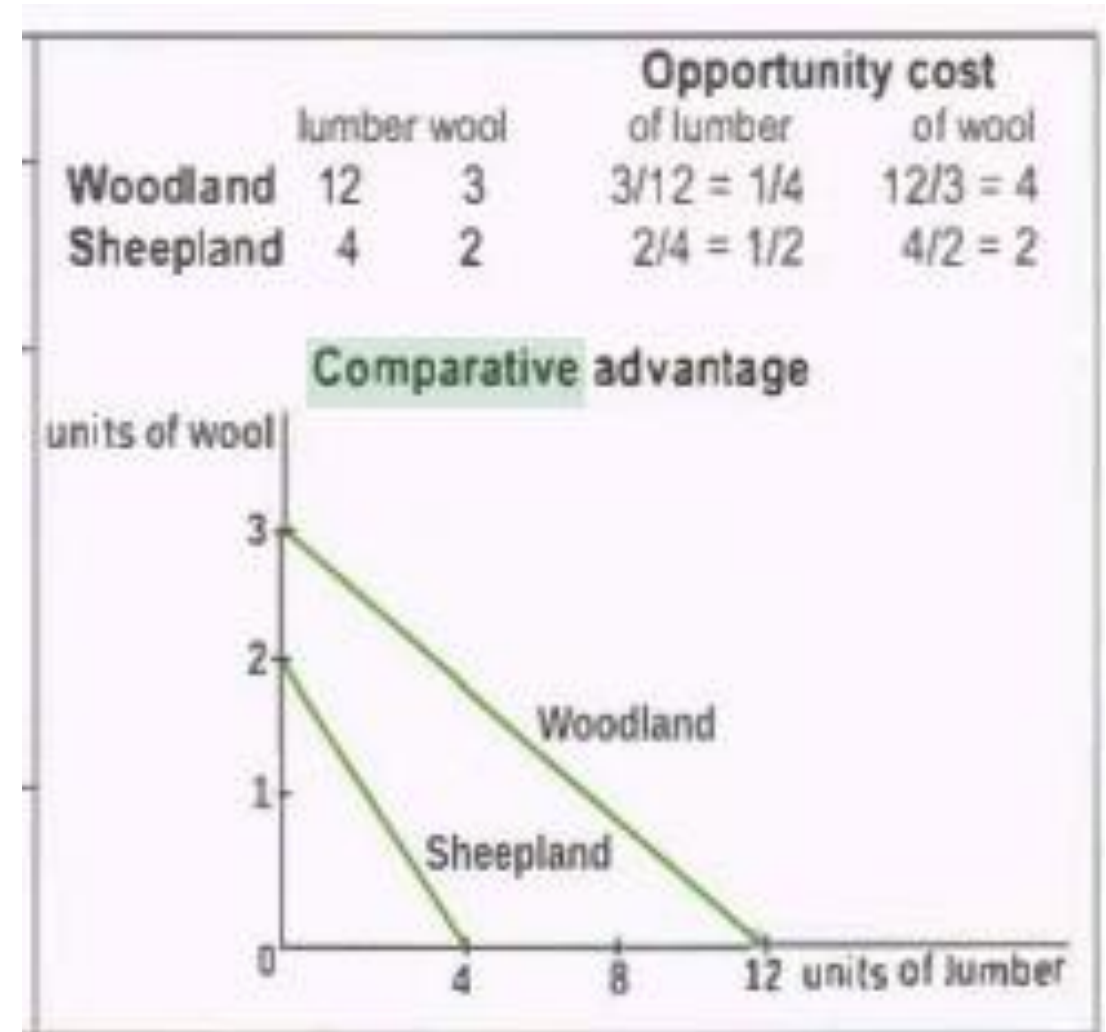
As a result, both countries will enjoy greater production and consumption due to increase in allocative efficiency



Comparative Advantage

- Comparative advantage

A country has a comparative advantage over another in the production of a good if it can produce it at a lower opportunity cost: i.e. if it has to forgo less of other goods in order to produce it.



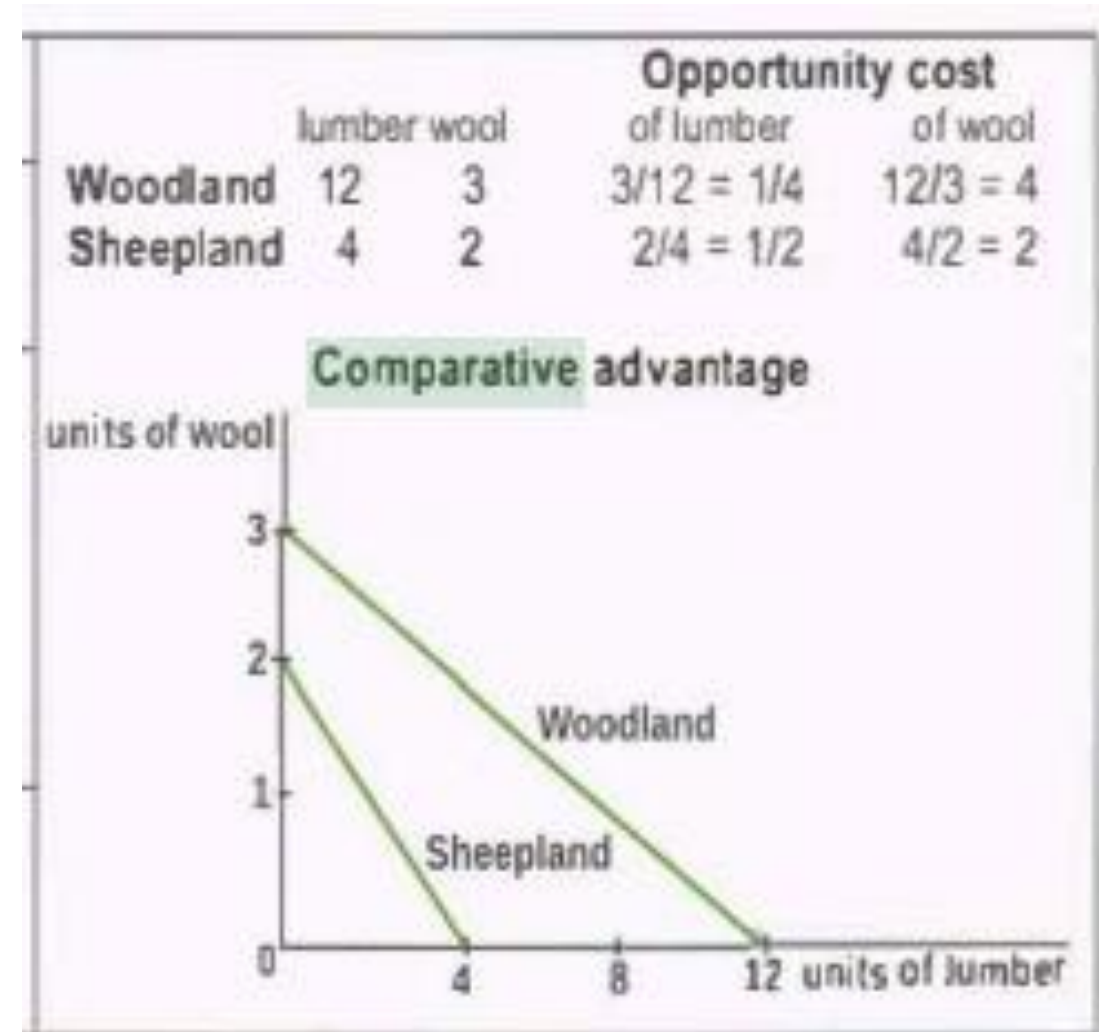
Comparative Advantage

- Comparative advantage**

The table shows production possibilities of Woodland and Sheepland producing lumber and wool, plotted as PPCs in the diagram.

Although Woodland has an absolute advantage in production of both lumber and wool, the countries can still benefit from trade because they have different opportunity costs (different PPC slope).

Countries should specialize in production and export of the good with the lower opportunity cost: Woodland in lumber and Sheepland in wool. Both countries will enjoy greater production and consumption due to increase in allocative efficiency.



Comparative Advantage

Countries have different endowments of factors of production. They differ in population density, labour skills, climate, raw materials, capital equipment, etc.

Thus the ability to supply goods differs between countries.

What this means is that the relative cost of producing goods varies from country to country.

For example, one country may be able to produce one fridge for the same cost as 6 tonnes of wheat or 3 MP4 players, whereas another country may be able to produce one fridge for the same cost as only 3 tonnes of wheat but 4 MP4 players. It is these differences in relative costs that form the basis of trade.

The law of comparative advantage

If countries are to gain from trade, they should export those goods in which they have a comparative advantage and import those goods in which they have a comparative disadvantage.

From this we can state a law of comparative advantage.

The law of comparative advantage.

Provided opportunity costs of various goods differ in two countries, both of them can gain from mutual trade if they specialise in producing (and exporting) those goods that have relatively low opportunity costs compared with the other country

OPPORTUNITY COST: Sacrifice of one good/ gain of other good

The terms of trade

- What price will our exports fetch abroad? What will we have to pay for imports?
The answer to these questions is given by the terms of trade.
- In the real world where countries have many exports and imports, the terms of trade are given by: $\frac{\text{Average price of exports}}{\text{Average price of imports}}$

expressed as an index, where price changes are measured against a base year in which the terms of trade are assumed to be 100.

- If the terms of trade rise (export prices rising relative to import prices), they are said to have 'improved', since fewer exports now have to be sold to purchase any given quantity of imports.
- Changes in the terms of trade are caused by changes in the demand for and supply of imports and exports, and by changes in the exchange rate.

Reasons why terms of trade may improve



Specialisation in higher value exports



World real income levels change in favour of this country's exports



Exchange rate appreciates causing import prices to fall



Fall in the world price of imported technology



Trade deal which lowers import tariffs or increases import quotas

Reasons why terms of trade may deteriorate



Increase in countries producing same good which decrease the world price of exports



Technological advances which reduces the cost of production (and, therefore, the price) of exports



World income levels change to the detriment of this country's exports



A depreciation of the exchange rate which increases the prices of a country's imports



Imposition of tariffs which increases the price of imports such as essential raw materials

Terms of trade and Comparative Advantage

Assuming there are two goods, x and m, trade can be advantageous to a country as long as the terms of trade P_x/P_m are different from the opportunity cost ratios of the two goods, given by MC_x/MC_m . For example, **if the terms of trade were greater than the opportunity cost ratio**

($P_x/P_m > MC_x/MC_m$), it would benefit the country to produce more x for export in return for imports of m, since

the relative value of producing x (P_x/P_m) is greater than the relative cost (MC_x/MC_m).

With increasing opportunity costs, however, increasing specialisation in x will lead to MC_x rising (and MC_m falling), until $P_x/P_m = MC_x/MC_m$. At this point, there can be no more gain from further specialisation and trade: the maximum gain has been achieved and comparative cost advantages have been exhausted.

Sum

Suppose there are just two countries, A and B, and the only factor of production is labour. In Country A it takes 10 hours to produce one unit of Good X and 2.5 hours to produce one unit of Good Y. In Country B it takes 15 hours to produce one unit of Good X and 7.5 hours to produce one unit of Good Y.

- (i) State which country has a comparative advantage in the production of Good X. [1]
- (ii) State which country has an absolute advantage in the production of Good X. [1]
- (iii) State whether international trade will take place between the two countries if the terms of trade were one unit of Good Y for one unit of Good X. [1] [Total 3]

Solution

- (i) The opportunity cost of Good X for Country A is 4 units of Good Y and the opportunity cost of Good X for Country B is 2 units of Good Y. So, Country B has the comparative advantage in the production of Good X. [1]
- (ii) Country A takes fewer hours of labour to produce Good X than Country B and so enjoys an absolute advantage. [1]
- (iii) The opportunity cost of Good Y for Country A is $\frac{1}{4}X$. Consequently, Country A will be willing to trade Good Y for Good X only if it receives more than $\frac{1}{4}X$ for each Y it exports. In other words, Country A will need to receive more than 1X for every 4Y it trades. Equivalently, it will be willing to give up fewer than 4Y for each X it receives.

Likewise, the opportunity cost of Good X for Country B is 2Y and so Country B will be willing to trade Good X for Good Y only if it receives more than 2Y for each X it exports.

So, the terms of trade at which both countries will gain from trade lie within the range 1X for fewer than 4Y and 1X for more than 2Y.

As the proposed terms of trade is 1X for 1Y, which lies outside of this range, no trade will take place. [1]

Increasing opportunity costs

- In practice, countries are likely to experience increasing opportunity costs. The reason for this is that, as **a country increasingly specialises in one good, it has to use resources that are less and less suited to its production and which were more suited to other goods. Thus ever-increasing amounts of the other goods have to be sacrificed.**
- For example, as a country specialises more and more in grain production, it has to use land that is less and less suited to growing grain.
- These increasing costs as a country becomes more and more specialised lead to the disappearance of its comparative cost advantage. When this happens, there will be no point in further specialisation.

Limits to Trade

- The increasing costs as a country becomes more and more specialised lead to the disappearance of its comparative cost advantage. Thus **increasing opportunity costs** limit the amount of a country's specialisation and hence the amount of its trade.
- **Transport costs** may outweigh any comparative advantage. A country may be able to produce bricks more cheaply than other countries, but their weight may make them too expensive to export.
- It may be the factors of production, rather than the goods, that move from country to country. Thus developed countries, rather than exporting finished goods to LDCs, may invest capital in LDCs to enable manufactures to be produced there. Also, labour may migrate from low-wage to high-wage countries.
- Governments may restrict trade.

Influence of elasticities

In general, a country's gains from trade will be greater the less elastic its own domestic demand and supply of tradable goods are, and the more elastic the demand and supply of other countries.

The less elastic the domestic demand and supply, the bigger will be the effect of trade on prices faced by that country.

Reasons for gains from trade

- **Decreasing costs** – Even if there are no initial comparative cost differences between two countries, it will still benefit both to specialise in industries where economies of scale can be gained, and then to trade. Several countries, by specialising in just one or two models each, can gain the full economies of scale and hence a comparative advantage in their particular model(s). Then, through trade, consumers can gain from having a wider range from which to choose. The decreasing cost reason for trade is particularly relevant for small countries where the domestic market is not large enough to support large-scale industries.
- **Trade as an ‘engine of growth’** – In a growing world economy, the demand for a country’s exports is likely to grow, especially when these exports have a high income elasticity of demand. This provides a stimulus to growth in the exporting country.

Reasons for gains from trade

- **Differences in demand** – Even with no comparative cost differences and no potential economies of scale, trade can benefit both countries if demand conditions differ. If people in country A like beef more than lamb, and people in country B like lamb more than beef, then rather than A using resources better suited for lamb to produce beef and B using resources better suited for producing beef to produce lamb, it will benefit both to produce beef and lamb and to export the one they like less in return for the one they like more.
- **Increased competition** – If a country trades, the competition from imports may stimulate greater efficiency at home. This extra competition may prevent domestic monopolies/oligopolies from charging high prices. It may stimulate greater research and development and the more rapid adoption of new technology, thereby increasing the economy's longer-term growth rate. It may lead to a greater variety of products being made available to consumers.
- **Non-economic advantages** – There may be political, social and cultural advantages to be gained by fostering trading links between countries.

The competitive advantage of nations

The theory of comparative advantage shows how countries can gain from trade, but why do countries have a comparative advantage in some goods rather than others?

One explanation is that it depends on the resources that countries have. Thus countries should specialise in goods which make intensive use of their abundant resources.

But this still does not give enough detail as to why countries specialise in the precise range of products that they do.

Also, why do countries both export and import the *same* products? Ex: Why do many countries produce and export cars, but also import many cars?

There are four key determinants of why nations are highly competitive in certain products but less so in others.

Reasons for competitive advantage

- **Available resources.** These include 'given' resources, such as raw materials, population and climate, but also specialised resources that have been developed by humans, such as the skills of the labour force, the amount and type of capital, etc. These specialised resources vary in detail from one country to another and give them a competitive advantage in very specific products. Once an industry has started to develop, this may attract further research and development, capital investment and training, all of which are very specific to that industry. This then further builds the country's competitive advantage in that industry.
- **Demand conditions in the home market.** The more discerning customers are within the country, the more this will drive the development of each firm's products and the more competitive the firm will then become in international markets. The demand for IT solutions within the USA drove the development of the software industry and gave companies such as Microsoft, Intel and Google an international advantage.

Reasons for competitive advantage

- **Strategy, structure and rivalry of firms.** Competition between firms is not just in terms of price. Competitive rivalry extends to all aspects of business strategy, from product design, to marketing, to internal organisation, to production efficiency, to logistics. The very particular competitive conditions within each industry can have a profound effect on the development of firms within that industry and determine whether or not they gain an international competitive advantage. Strategic investments and rivalry gave Japanese electronic companies an international competitive advantage.
- **Related and supporting industries.** Firms are more likely to be successful internationally if there are well-developed supporting industries within the home economy. These may be industries providing specialist equipment or specialist consultancy, or they may simply be other parts of the main value chain, from suppliers of inputs to distributors of the firms' output. The more efficient this value chain, the greater the competitive advantage of firms within the industry.

Protectionism – Trade Protection

- Trade protection = government intervention in international trade involving the imposition of trade barriers intended to limit the quantity of imports and protect the domestic economy from foreign competition
- Most countries have not pursued a policy of totally free trade. Their politicians know that trade involves costs as well as benefits. In this section, we will attempt to identify what these costs are, and whether they are genuine reasons for restricting trade.
- Although countries may sometimes contemplate having completely free trade, they usually limit their trade. However, they certainly do not ban it altogether.

Methods for Restricting Trade

- **Tariffs (customs duties).** These are taxes on imports and are usually **ad valorem tariffs**: i.e. a percentage of the price of the import. Tariffs that are used to restrict imports are most effective if demand is elastic. Tariffs can also be used as a means of raising revenue, but in this case they are more effective if demand is inelastic. They can in addition be used to raise the price of imported goods to prevent 'unfair' competition for domestic producers.

Methods for Restricting Trade

- **Quotas.** These are limits imposed on the quantity of a good that can be imported. Quotas can be imposed by the government, or negotiated with other countries which agree 'voluntarily' to restrict the amount of exports to the first country.

Methods for Restricting Trade

- **Exchange controls.** These include limits on how much foreign exchange can be made available to importers or to citizens travelling abroad, or for investment. Alternatively, they may take the form of charges for the purchase of foreign currencies.
- **Import licensing.** The imposition of exchange controls or quotas often involves requiring importers to obtain licences.
- **Embargoes.** These are total government bans on certain imports (e.g. drugs) or exports to certain countries (e.g. to enemies during war).

Methods for Restricting Trade

- **Administrative barriers.** Regulations may be designed to exclude imports: examples include customs delays and excessive paperwork.
- **Procurement policies.** This is where governments favour domestic producers when purchasing equipment (e.g. defence equipment).
- **Dumping.** Alternatively, governments may favour domestic producers by subsidising their exports in a process known as dumping. The goods are 'dumped' at artificially low prices in the foreign market.

Arguments in favour of restricting trade

Economic arguments having some general validity

- **The infant industry argument.** Some industries in a country may be in their infancy, but have a potential comparative advantage. Such industries are too small yet to have gained economies of scale; their workers are inexperienced; they lack back-up facilities etc. They may have only limited access to finance for expansion. Without protection, these **infant industries** will not survive competition from abroad. Protection from foreign competition, however, will allow them to expand and become more efficient. Once they have achieved a comparative advantage, the protection can then be removed to enable them to compete internationally.

Arguments in favour of restricting trade

- **To reduce reliance on goods with little dynamic potential.** Many developing countries have traditionally exported primaries: foodstuffs and raw materials. The world demand for these, however, is fairly income inelastic, and thus grows relatively slowly. In such cases, free trade is not an engine of growth. Instead, if it encourages countries' economies to become locked into a pattern of primary production, it may prevent them from expanding in sectors like manufacturing that have a higher income elasticity of demand.
- **To prevent the establishment of a foreign-based monopoly.** Competition from abroad, especially when it involves dumping or predatory pricing, could drive domestic producers out of business. The foreign company, now having a monopoly of the market, could charge high prices with a resulting misallocation of resources.
- **To prevent the importation of harmful goods.** A country may want to ban or severely curtail the importation of things such as drugs, pornographic literature and live animals.

Strategic trade theory

- Governments should adopt a 'strategic' approach to trade
- **Strategic trade theory** The theory that protecting/ supporting certain industries can enable them to compete more effectively with large monopolistic rivals abroad.
- The effect of the protection is to increase long-run competition and may enable the protected firms to exploit a comparative advantage that they could not have done otherwise

Arguments in favour of restricting trade

- **To spread the risks of fluctuating markets.** A highly specialised economy – Zambia with copper, Cuba with sugar – is highly susceptible to world market fluctuations. Greater diversity and greater self-sufficiency can reduce these risks.
- **To prevent dumping and other unfair trade practices.** A country may engage in dumping by subsidising its exports. The result is that prices may no longer reflect comparative costs. Thus the world would benefit from tariffs being imposed to counteract such practices.
- **To reduce the influence of trade on consumer tastes.** It is a mistake to assume that fixed consumer tastes dictate the pattern of production through trade. Multinational companies through their advertising and other forms of sales promotion may influence consumer tastes. Thus some restriction on trade may be justified in order to reduce this ‘producer sovereignty’.
- **To take account of externalities.**

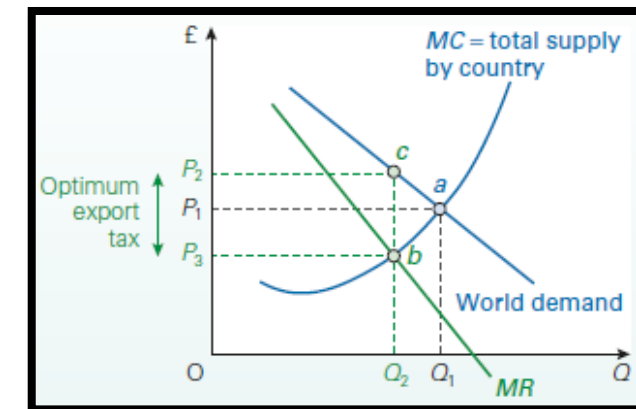
Arguments in favour of restricting trade

Economic arguments having some validity for specific groups or countries

- **The exploitation of market power.** If a country, or a group of countries, has market power in the supply of exports (e.g. South Africa with diamonds, OPEC with oil) or market power in the demand for imports (e.g. the USA or other large, wealthy countries), it can exploit this power by intervening in trade.

Consider the case of a country, or a group of countries acting as a cartel, which has monopoly power in the sale of a particular export: But let us assume that there are many individual producers that are therefore price takers and are thus not in a position to exploit the country's overall market power.

These price-taking firms will collectively produce at point *a* where $P = MC$. Market equilibrium is at a trade price of P_1 and an output of Q_1 .



Arguments in favour of restricting trade

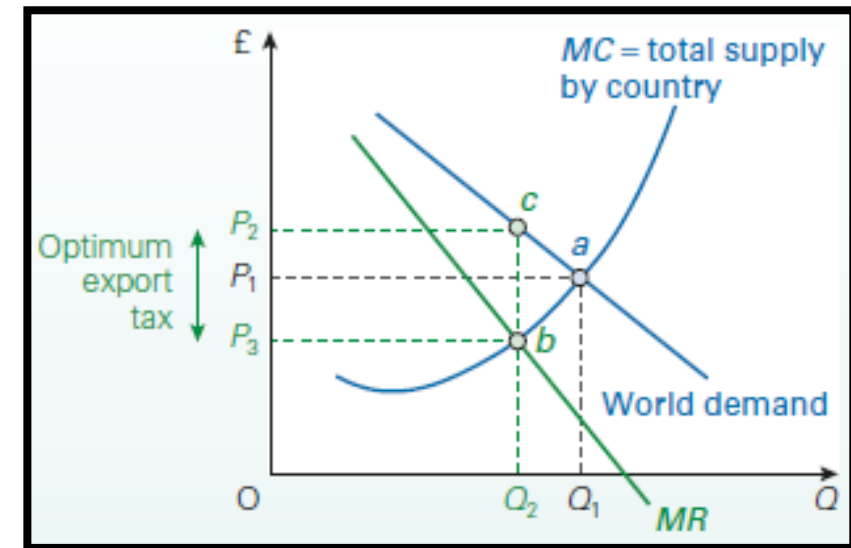
The country's profit, however, would be maximised at point b where $MC = MR$, with output at the lower level of Q_2 .

By imposing an export tax of $P_2 - P_3$, therefore, the country can maximise its gain from this export. Producers will receive P_3 and will therefore supply Q_2 . Market price will be P_2 .

Thus optimum tariff is $P_3 - P_2$.

Optimum tariff – A tariff that reduces the level of imports to the point where marginal social cost equals marginal social benefit

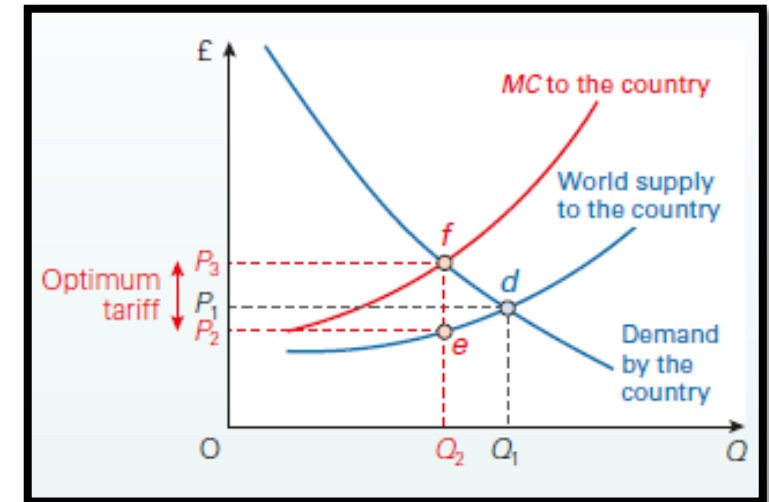
Diagrams shows optimum tariff for a country with a monopoly supply of an export >



Arguments in favour of restricting trade

Now let us take the case of a country that has *monopoly* power in the demand for an import. This is illustrated in the diagram below.

- Without intervention, equilibrium will be at point d where demand equals supply. Q_1 would be purchased at a price of P_1 .
- But the marginal cost of imports curve will be above the supply curve because, given the country's size, the purchase of additional imports would drive up their price. This means that the cost of additional imports would be the new higher price (given by the supply curve) plus the rise in expenditure on the imports that would previously have been purchased at a lower price.
- The country will maximise its gain from trade at point f by importing Q_2 , where demand equals marginal cost. Consumption can be reduced to Q_2 if the government imposes a tariff of $P_3 - P_2$.
- This is known as the **optimum tariff**. The country now only pays P_2 to importers. Consumers have to pay P_3 (i.e. P_2 plus the tariff)



Arguments in favour of restricting trade

'Non-economic' arguments

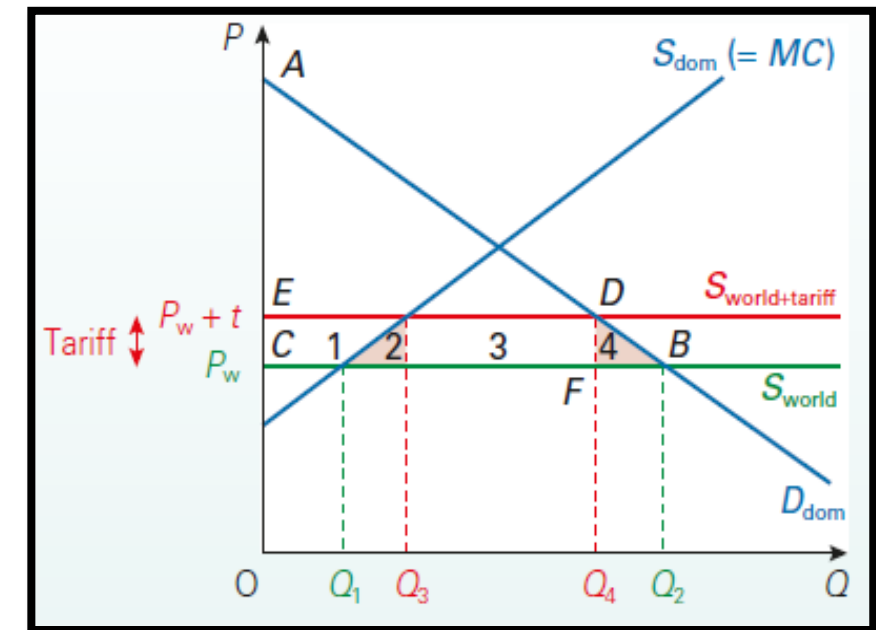
- A country may be prepared to forgo the direct economic advantages of free trade – consumption at a lower opportunity cost – in order to achieve objectives that are often described as 'non-economic':
- It may wish to maintain a degree of self-sufficiency in case trade is cut off in times of war.
- It may decide not to trade with certain countries with which it disagrees politically.
- It may wish to preserve traditional ways of life. Rural communities or communities based on old traditional industries may be destroyed by foreign competition.
- It may prefer to retain as diverse a society as possible, rather than one too narrowly based on certain industries.

Problems with protection

Tariffs and other forms of protection impose a cost on society. This is illustrated in Figure below. What are the costs of this tariff to the country?

- Consumers are having to pay a higher price, and hence consumer surplus falls from ABC to ADE . The cost to consumers is lost.
- The difference between MC and S_{world} (area 2) is the efficiency loss on the production side.
- Area 4 represents the loss of consumer surplus by the reduction in consumption from Q_2 to Q_4 .
- Apart from these direct costs to the consumer, there are several other problems with protection. Some are direct effects of the protection; others follow from the reactions of other nations.

The government should ideally weigh up such costs against any benefits that are gained from protection.



Problems with protection

- **Protection as ‘second best’.** Many of the arguments for protection amount merely to arguments for some type of government intervention in the economy. Protection, however, may not be the best way of dealing with the problem, since protection may have undesirable side effects. There may be a more direct form of intervention that has no side effects.

In such a case, protection will be no more than a second best solution.

For example, using tariffs to protect old, inefficient industries from foreign competition may help prevent unemployment in those parts of the economy, but the consumer will suffer from higher prices. A better solution would be to subsidise retraining and investment in those areas of the country in new, efficient industries – industries with a comparative advantage. In this way, unemployment is avoided, but the consumer does not suffer.

Problems with protection

- **World multiplier effects.** If the UK imposes tariffs or other restrictions, imports will be reduced. But these imports are other countries' exports. A reduction in their exports will reduce the level of injections into the 'rest-of-the-world' economy, and thus lead to a multiplied fall in rest-of-the world income. Which in turn will lead to a reduction in demand for UK exports. This, therefore, tends to undo the benefits of the tariffs.
- **Retaliation.** – The increased use of tariffs and other restrictions can lead to a trade war: each country cutting back on imports from other countries. In the end, everyone loses.
- **Protection may allow firms to remain inefficient.** By removing or reducing foreign competition, protection may reduce firms' incentive to reduce costs. Protection should not be excessive and should be removed as soon as possible.

The World Trade Organization

- Why do you think was there a need to set up an organization such as the WTO?
- How does the WTO help countries even today?

The World Trade Organization

- After the Second World War there was a general desire to reduce trade restrictions, so that all countries could gain the maximum benefits from trade. There was no desire to return to the beggar-my-neighbour policies of the 1930s.
- In 1947, 23 countries got together and signed the General Agreement on Tariffs and Trade (GATT). By 2017, there were 164 members of its successor organisation, the World Trade Organization (WTO), which was formed in 1995.
- The aims of GATT, and now the WTO, have been to liberalise trade.

WTO rules

The WTO requires its members to operate according to various rules. These include the following:

- **Non-discrimination.** Under the 'most favoured nations clause', any trade concession that a country makes to one member must be granted to all signatories. The only exception is with free trade areas and customs unions (such as the EU).
- **Reciprocity.** Any nation benefiting from a tariff reduction made by another country must reciprocate by making similar tariff reductions itself.
- The **general prohibition of quotas.**
- **Fair competition.** If unfair barriers are erected against a particular country, the WTO can sanction retaliatory action by that country. The country is not allowed, however, to take such action without permission.
- **Binding tariffs.** Countries cannot raise existing tariffs without negotiating with their trading partners.