Arguments in favour of the free trade concept

Discuss the two primary ways in which international business occurs and critically examine the advantages and disadvantages of specialisation and international trade. What arguments would you put forward in favour of the concept of free trade?

International Business is a vast subject and different authors have different ways to describe it, therefore there is no particular definition that has consensus of researchers which defines the subject area. According to Robock and Simmonds (1989, 3) International business is a field of management training that deals with the special features of business activates that cross national boundaries in comparison to Daniels and Radebugah (1989, 6) defining it as " all business transactions involving two or more countries." This provides a clear view that international business is a wide subject which includes a number of different views of readers when it comes to analysis. (Vaghefi et al., 1991)

Primarily there are two ways in which international Business occurs defined as International trade and Equities. Both the above mentioned ways include a number of different theories which will be discussed in this essay.

International Trade: International trade is the export and imports of goods and services in transactions between countries. It includes a number of different theories such as mercantilism, the theory of absolute and comparative advantage, Heckscher Ohlin Model, the new trade theory and Free trade. (Mmieh, 2010)

Equities:

The equities side of international business embrace the concepts of Visible and Invisible trade which affects the balance of payment (BOP) of the economy. Visible trade will be defined as the trade of goods, whereas the invisible trade is the inflow and outflow of services. This could include the foreign direct investments (FDI) and Portfolio investments in different countries.(Mmieh, 2010)

Globalization:

Globalization can be defined as a process through which economies become more interdependent. Globalization has resulted in reducing the barriers which restrict international trade, the consequence of reduction in barriers has motivated countries to specialize and gain from trading with other countries (Crystal, K., Lipsey, R. (1997).

Mercantilism:

Mercantilism is an old economic thought in which countries preferred to export more than imports. The main objective in this theory was to receive gold from the countries that run deficit (Daniels, J. Radebaugh, L. & Sullivan, D, 2009).

According to Adam Smith, a biased system that enriched country by promoting exports and restricting imports was specified a term “ mercantile system”

As in the mid-sixteenth century gold represented wealth therefore the main aim of the countries was to maintain the gold reserves in order to increase wealth. According to Ricardo and Adam Smith mercantilism was viewed as a zero-sum game which means if one country gains from trade the other will lose from it. Hill, C. W. L (2008)

International Trade Theories

Countries get involved in international trade as there is a difference between technologies, factor endowments and tastes and pattern. With international trade achieving economies of scale could be achieved and market distortions can be avoided.

Without trade each individual will have to be self sufficient and cater his own needs and desires. If this occurs today the world would have been a world of exceptionally low living standards. People specialize in activities they are good at and trade them with others in order to fulfill their other needs. Therefore trade and specialization are closely linked. For example: a doctor would be good at treating his patients where as he will be a bad butcher (lipsey, 1989). Similar principles apply when we talk about regions and countries. It is not possible for countries to cater all their demands therefore it is better to specialize in production of goods in which they have a natural or an acquired advantage. This would result in trade which will increase the living standards of the country and a large verity of choice available after trade for the product which they cannot produce.

Absolute Advantage

Some countries have advantages over the others in producing certain products more efficiently due to land, labour and technology. Adam Smith suggested that the country should specialize in production of one product they are more efficient in and have an absolute advantage over the other and trade for the goods they do not specialize in. The main idea was that if a country can buy some good on a lower cost from another country they should not produce that particular good. The table and the diagram below explain absolute advantage further.

Table 1: Gains from specialization with absolute advantage (adapted from Lipsey, 1989

The amount of wheat and Cloth that can be produced with one unit of resource in the US and the UK

Country

Wheat(bushels)

Cloth(yards)

USA

10

6

UK

5

10

Total

15

16

After specialization

USA

20

UK

20

Extra units after trade

5

4

It could be concluded from the above table that USA has an absolute advantage in production of wheat where as UK has an absolute advantage in production of cloth.

Comparative advantage

After the absolute advantage theory given by Adam Smith, David Ricardo took the study further and argued that it would be more beneficial if countries could produces goods in which they are more efficient and buy goods it could produce less efficiently. This would also include buying goods from other country which it can produce more efficiently itself. A simple example would explain what comparative advantage is.

Table 2: Gains from specialization with comparative advantage (adapted from Lipsey, 1989)

The amount of wheat and Cloth that can be produced with one unit of resource in the US and the UK and the ratios

Country	Wheat	Cloth
USA	100	60
UK	5	10
Ratios	20: 1	6: 1

The ratios derived show that USA has an absolute advantage is production of both wheat and cloth but it has a comparative advantage in production of wheat where it is 20 times more efficient than UK as compared to the 6 times efficiency in production of cloth.

It is argued that comparative advantage is more important for trade to occur. Without comparative advantage, given absolute advantage exists will lead to no gains from trade. The table below shows:

Table 3: Absence of gains from trade (adapted from Lipsey, 1989)

The amount of wheat and Cloth that can be produced with one unit of resource in the US and the UK and the ratios

Country	Wheat	Cloth
USA	100	60
UK	10	6
Ratios	10: 1	

10: 1

No trade will take place as the ratios show the opportunity cost of producing one product and forgoing the other. The opportunity cost of producing Wheat or cotton is 10: 1for both USA and UK. Therefore there are no gains from trade in such situation.

Heckscher- Ohlin

The factor endowment theory of comparative advantage was given by Heckscher Ohlin. According to them, the difference in price of production between two countries for a similar product exists due to factor endowment differences. For example a country which has a small population with plentiful fertile land will find land cheap and labour expensive. Such nation would prefer land intensive products like agricultural products. Further research argued that theory has considerable power to explain comparative advantage but suggested that the one natural factor, Climate shall also be considered. A simple example could be cotton and wool as they depend on climate. A country with dry weather could produce more than any other country with damp weather. Another argument is that the comparative advantage exists but they are acquired not natural. This argument suggested that comparative advantage can be acquired through technical training and education (Chrystal et al., 2004).

Leontief Paradox

The theory of paradox given by Leontief Wassily was a contradiction to the Heckscher- Ohlin model. The paradox argued that countries should which have abundant capital should export more capital intensive products and import labour intensive. The study proved that US being the relatively abundant in capital still had capital intensive imports were more than its exports. (Hill, 2005)

New Trade theory

It was introduced in 1970s keeping in mind the economies of scale concept, which means decreasing the unit cost by increasing output. The new trade theory explained that the due to economies of scale consumers can enjoy a variety of goods and reduce the average cost. It also emphasized on the first mover advantage which is the aptitude to capture economies of scale before another firm enters that particular market. The best example could be given from the aero space industry where Airbus launched A380 aircraft costing $14Billion to develop. In order to breakeven Airbus is expected to sell 250 A380 carriers whereas, selling 350 would earn them high profits. The current research shows that the demand for A380s over 20 years will be around 400-600 carriers therefore Airbus can earn large amounts of profits if they are able to sell above mentioned number of A380 carriers.(Daniels et al., 2009)

Advantages and disadvantages of International Trade & specialization

Countries get involved in international trade as there is a difference between technologies, factor endowments and tastes and pattern. With international trade achieving economies of scale could be achieved and market distortions can be avoided. Even though the argument by different writers and researchers sustain that countries gain from trade and specialization but there are also a number of disadvantages linked to it.

Specializing in producing one product and would lead to Economies of scale. This means that the firm would enjoy the lowering cost as the output rises. It could be in terms of Marginal, risk bearing and financially. The large scale production means that the machines could be used in a better way, where the dividing labour according to skills will also be possible. Specialization and trade allows small countries like Switzerland and Belgium to achieve economies of scale by producing large quantities of few products whereas, it could not have been possible given the small domestic markets in such countries. This also helps them to keep good relation with the other countries of the world they trade with.

Specialization would lead to better quality products. The product in the country specializes in the workers would become more efficient and will have better understanding of how the process can be performed in a better way which reduces costs. This concept is known as learning by doing. The argument here is that higher the production the higher will be the social cost i. e. negative externalities such as pollution.

Specialization and trade also encourage exports and imports therefore the large scale production of specialized good and exports lead to lower rate of unemployment and imports increased variety of products available therefore the standard of living may also improve. This would even have a positive impact on the balance of payment of the country.

International trade and specialization escorts towards efficient use of resources natural resources but it is argued that these resources can get exhausted due to the extensive use. The consumer can be benefited by the variety of goods and stable and low prices. The government might intervene at some point in order to save the local firms that are involved in similar businesses. It might impose some trade restrictions like tariffs or quotas to restrict trade of certain products. These restrictions lead to an increase in price of imported products and even increase government revenues. Such an action can be responded by a retaliation affect by the exporting country.

International trade can also attract foreign investment as the terms between countries involved in trade will be good. Such investment would bring in more technology and employment that will benefit the workers and the other firms in the market. Foreign investors may train their employees according to the new techniques and may support firm who provide raw materials to them. There can be a few flaws due to the culture differences and may lead to some organizational politics and communication problems.

Free Trade

Increase this world production and trade can be seen due to countries specializing in products they have a comparative advantage. It has been argued that countries gain from trade but at the same time trade can exhaust their natural resources and can exploit the labour and local firms. In order to safeguard their interest government tend to take precautionary measures to restrict trade which is known as protectionism. Free trade is when government does not intervene or take any measures to restrict trade. (Lipsey, 2004)

Arguments of free trade:

There are some arguments which favours free trade where as some economists disagree with this concept. Economists argue that free trade always benefits all countries. According to research the answer is No. Restricting trade can prove to be more beneficial for certain countries. Trade restrictions can lead to improvement in terms of trade and a favorable shift can be seen on the Balance of Payment position.

An argument is if government is trying to restrict free trade to protect the infant industries, these industries may never confess to be mature enough. This argument is immoral as every firm would want to grow and achieve economies of scale. A reduction in cost of production is what the firms' main motive will be hence as a result the resources can be freed for other purpose (chrystal et al., 2004).

Some studies also argue that both partners cannot gain mutually from trade. They suggest that one country will be gaining at the expense of the other partner. This argument is wrong given principles the theory of comparative advantage. It tells us that the both countries can get benefited as the ratios of opportunity cost are different. Therefore specialization and trade will enable them to produce and consumer more.(chrystal et al., 2004)

Keeping the money at home is another argument. Some economists also suggest that importing will lead to outflow of local currency. Buying good from other countries mean that local currency will have to be given to buy the currency of the country that is exporting form the international market.

Restricting trade will be important to maintain high living standards as the low wage foreign labour exists. For example importing products from low wage countries with a low living standard will drive the UK products out of the market and the UK living standard will be hauled down to its poor partners standard. The argument in such a case is that how can rich countries loose by trading to a poor country even though the goods are priced cheaply but that would not affect the rich country. To make this argument more clear and irrelevant the gains from trade depends on comparative advantage not absolute as discussed earlier. Even in the long run trade cannot damage a country by causing it to import without exporting.(Chrystal et al, 2004)

Another argument is exports raise living standards while imports lower them so it is better to restrict trade. It is true that exports increase employment and production and has a positive impact on national income and standard of living while importing reduce it. But standard of living is depending on the consumption of goods and services. Trading is important as exports open doors for import and there is more variety of good available for consumers which will increase their standard of living. Exporting also reduces unemployment as the production is high. If trade is restricted the countries might retaliate by reducing imports which can have a negative impact on the local industry and increase unemployment further. (sloman, 2000)

Conclusion

International trade and specialization support the concept of free trade as it is highly beneficial for countries to trade. However, critics argue that globalization will lead the world to be homogenous and future problems will arise such as causing the developed countries to lose the competitiveness of its labour market through off shoring and lower manufacturing costs. Nevertheless, free trade will allow countries to improve standard living conditions, consumers to have higher incomes, and businesses to gain a global market share.