

Why do countries trade with each other

[Economics](#), [Trade](#)



Why do countries trade with each other? Show, using examples, why this may be to do with principle of comparative advantage. Introduction In 1776 Adam Smith stated, " If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage. " This sentence shows basic principle on which the world trade is based. Countries buy and sell goods abroad to achieve the best possible cost-effectiveness.

Long-distance trade dates back to the ancient times and today it is the heart of the world economy. It is a crucial factor in economic growth of every state. Source of prosperity and development in industrialized world. Statistically speaking, countries with high per capita values of export and import tend to have relatively rich and prosperous societies. International trade is a necessity deriving from the diversity of international community. Countries have different weather, natural resources, population, educational level of workforce, infrastructure.

All these things make cost of producing particular commodities different in each country. And that difference causes international trade to be reasonable. In my essay I'll try to justify why countries trade with each other by pointing out and explaining particular aspects of foreign trade. Natural Resources and Factor of Endowment The most obvious and visible cause for international trade is a difference in location of natural resources and factor of endowment. Factor of endowment is amount of labor, land, money and entrepreneurship that could be exploited for manufacturing within a country.

Every country is unique, therefore they have different economic potentials. Some countries naturally have more natural resources, higher population, bigger territory than the others. Uneven location of resources causes limited possibilities of production within countries. For example France has basically no oil resources on its own yet it is the world 13th biggest consumer (CIA, 2010). That means that it has to import almost all it requires. They are importing it from countries that have oil surplus that they can exchange. Population is also a crucial factor.

More populated nations are more likely to produce huge surplus of commodities that they can subsequently sell. Like China which huge industry sector produce number of goods big enough to sell all over the world. In order to cultivate the land, grow particular plants, practice animal husbandry very specific climate and soil fertility is needed. For instance citrus fruits can develop only in climates with a cool winter. Relatively few countries can claim to have weather like this, yet we can buy oranges and limes all over the world.

These examples show that some countries do not have physical possibility to produce certain goods and have to import them. This is especially noticeable in industrialized western societies which historically have very big demand on tropical goods such as spices, fabrics, fruits etc. Specialization Heckscher-Ohlin theory indicates that countries specializes in the production of goods that it is adopted to produce. It directly derives from differences in factor of endowment I described before.

Countries have different production capacity some are rich in capital and poor in labour power, others have a lot of people but not much capital, some

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have a lot of raw materials, another have skilled man power. Principle of specialization is closely related to the division of labour. Whole country adopts a role of producer of certain good when the others do the same with different goods. Of course it is just a simplification because some commodities like for instance cars are produced in many different countries. One country can be specialized in production of many different goods.

But in general every country produce a certain range of products in high volume. That give them the opportunity to invest as much capital and labour as it is possible to develop the production and conduct research. That helps achieving higher efficiency of production and exploit economy of scale. Economy of scale is basically decreasing average cost of production per unit by expanding scale of output. By specialization economy is capable to produce high surplus and sell it abroad afterwards. Since when costs of production decreases, supply increases.

To visualize the point I'll present and theoretical example. Country " A" is very capital-abundant but is poor in labour and country " B" is poor in capital, but has a lot of labour force. Country " A" country can form capital-intensive industries that will have great efficiency thanks to scale of the production. It will produce surplus and then exchange it with country " B" which specialized itself in labour-intensive industries. By that means, production of both capital and labour intensive goods will be higher and of better quality. Great real world example is Dutch agriculture.

Holland is a medium populated country with only 61st place in the world in terms of population (CIA, 2012). Yet its agriculture which employs only 2% of the population provides large surpluses for the food-processing industry and <https://assignbuster.com/why-do-countries-trade-with-each-other/>

exports. After United states and France it is world third largest exporter of foodstuffs. That is thanks to huge investments in new technologies and mechanized agriculture. Comparative Advantage Both reasons for trading that I described in previous paragraphs boil down to one absolute cause for world trade to occur, comparative advantage.

Country has a comparative advantage when it has an ability to produce particular good at lower marginal and opportunity cost. Because of limited production capacity no country is able to produce every needed product. To produce particular good or service, economy sometimes has to give up on producing others. That means that a country has to specialize on producing goods that is has comparative advantage on. For instance let's assume that Poland can produce both cars and grow carrots at relatively low cost but at the same time Ukraine can grow carrots with a bit higher cost than Poland, but can't produce cars.

That means that Poland has absolute advantage on both goods but opportunity cost of producing a car in Poland is significantly higher than in Ukraine. By investing work force and capital in cultivation of carrots Poland misses an opportunity to produce more cars which can bring higher revenue to the polish economy. In that way Ukraine has a comparative advantage on production of carrots because Ukrainian economy do not lose opportunity to produce anything, by investing in carrot agricultural production. This example explains why it is sometime worthwhile for countries to export goods that they are capable of producing.

This can lead everyone to producing only those goods that one can produce most efficiently. Good example of comparative advantage in contemporary <https://assignbuster.com/why-do-countries-trade-with-each-other/>

world is the fact that in the last few years India became a major supplier of phone answering services for USA. Even though obviously Americans have better skill in English language and are able to provide this service independently, relatively high skilled American labour force is needed in other efforts. Opportunity cost of having that service provided by Americans is to apparently too high. That's why it is transferred to India. Conclusion

Conclusion that derives from previous points is that world trade is inevitable and necessary means in contemporary world. Factor of Endowments paragraph clearly states that countries are endowed with resources extremely unevenly. 81% of Petroleum reserves which is currently one of the most desired and needed commodities is localized in only 12 countries(OPEC, 2011). Concerning that most of the world countries do not have oil resources big enough to satisfy domestic demand, they have to import it. This is not only oil supply problem, many goods are able to be produced, mined etc. only in certain areas.

This is in my opinion the most visible and crucial reason why countries trade. Secondly over the years people understood that specialization and intensification of production can bring huge profit. Economy of scale make per unit production cheaper but involve bigger effort. That's why it is easier to focus on big production of only some range of goods why importing others. And of course comparative advantage principle which in mathematical way, shows how by division of production between countries and a proper assessment of opportunity cost every country can trade with one another with profit.

These three examples of reasons why do countries trade should explain concept of international trade clearly enough and show its benefits and inevitability in contemporary world. Bibliography Smith, A, An Inquiry into the Nature and Causes of the Wealth of Nations, (1776) Sokoloff, Engerman, History Lessons: Institutions, Factors Endowments, and Paths of Development in the New World, The Journal of Economic Perspectives, Available from: <http://www.jstor.org/stable/2646928?seq=8> [Accessed 29th October 2012]

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