The exchange of goods and equity between nations economics essay

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The process of exchanging goods and services (commercial transactions) between nations can be established in two major ways, these are: International Trade (Trading) and International Equity (Equity).

International Trade

As its name implies, international trade is the exchange of products, services, and money across national borders, essentially trade between countries. When consumers in the U. S. purchase Nigerian made fabrics, Lebanese-grown fruits, Chinese-made toys and electronics, and Japanese-manufactured automobiles, they experience the end result of international trade (Husted & Melvin, 2004). International trade has been maintained since the dawn of time and trading goods were transported on the backs of tradesmen across tribal boundaries in the early times. Imagine a country were limited to what we can produce locally. Without the goods and services available from other countries, we would be living in a world confined to

what we are given. This is against the principle of growth of humankind. A country would consider trading internationally in an effort to give their GDP a big boost very quickly.

As the process of international trade grew, a lot of theories where put in place to explain how international trade comes to light. The first theory on International Trade was called Mercantilism.

Mercantilism

The Mercantilism theory emerged in England in the mid-sixteenth century with principles that gold and silver were the currency of trade. The aim to mercantilism was for the country to maintain trade surplus by exporting more than it imports (Hill, 2008). Mercantilist believed in producing more at home and having enough to give out in exchange for wealth rather than producing less and having to buy from other countries which will mean the outflow of its own wealth. It was proposed therefore, that exports should be increased using such things like state subsidies promote export while importation of goods and services is decreased by increasing tariffs and quotas (Piggott & Cook, 2006).

China can be used as an example of a nation that practiced Mercantilism. China's quick rise to economic power has been built upon export led growth. China takes raw material from other countries, and using its cheap labour to convert them into high quantity products and then exporting them to foreign countries, which as lead to its exports growing much faster than its imports. China can be called a mercantilist nation (Hill, 2008). The down side to the

mercantilism theory was the zero sum gain which allows only one country to gain, while the other losses in any trade.

Adam smith was the first to address this problem and in doing so he disagreed with the mercantilist view of international trade. Adam Smith then formulated a theory that lead to the views of specialization and division of labour being applied to international trade. He called this theory Absolute Advantage.

Absolute Advantage

According to Adam Smith countries differ in the ability to produce goods and services efficiently, this means that Nigeria will be able to produce petrol more efficiently because of the availability of crude-oil in its country than England will be able to produce petrol. In theory all parties will gain if it specializes in the product it produces more efficiently and trades it with goods and services another country produces more efficiently. Thus both countries follow the theory of absolute advantage and both gain in International trade (Hill, 2008).

This allows Nigeria to trade its petrol which it efficiently produces with cocoa which Malaysia efficiently produces. Both countries will be able to enjoy goods and services produced by each other which increase’s specialization and allow a higher standard of living (Piggott & Cook, 2006). Smith also explained that the greater resources achieved would be allocated efficiently by the market. Any interference in this process would reduce these gains, thereby leading to the zero sum gain (Mercantilism) allowing only one country to gain in trading.

Thus, as a result of specialization and trade, output of both petrol and cocoa would be increased and consumers in both countries will be able to consume more. This makes trade a positive sum gain rather than the mercantilist zero sum gain (Hill, 2008). Some flaws in the theory of absolute advantage lead to the theory of Comparative Advantage which was established by David Ricardo

COMPARATIVE ADVANTAGE

David Ricardo elaborated on Adam Smith's theory by examining what would happen if one country has absolute advantage in the production of all goods and services which flaws Adam smith's theory, which says there's no benefit in trade if a country has absolute advantage on all goods (Hill, 2008). According to David Ricardo a country has a Comparative Advantage in a commodity when it has a higher degree of superiority in its production, and it has a Comparative Disadvantage in a commodity when its degree of superiority is lower (Piggott& Cook, 2006), encouraging countries to specialize in producing goods it efficiently produces and imports goods (International Trading) it produces less efficiently.

For example in a situation where Nigeria efficiently produces both petrol and cocoa, this means it has an absolute advantage in producing both petrol and cocoa. If Nigeria can produce 20 barrels of petrol and 40 cocoa with its given amount of resources and Norway produces 10 barrels of petrol and 50 cocoa with the same amount of resources, the cost of production for petrol and cocoa will be 0. 5 and 2 respectively while 0. 2 and 5 will the cost of producing petrol and cocoa in Norway respectively. Therefore, Nigeria can afford to produce petrol at a cheaper cost while Norway can produce cocoa

at a cheaper cost, even though the can both produce both commodities, they choose to specialize in the area were the cost of production is lower (Piggott & Cook, 2006). If both countries specialize in the production of goods where the resources can be use more efficiently, they will be able to trade each good they specialize in for the other with cost of production (Chu-shore, 2010). This system however is based on trading by barter. This changes when we bring money into it because world trade is determined not by differences in cost of labour but by differences in money prices (what each country's currency is valued at).

The theory of Comparative advantage emphasizes the fact that production is greater with unrestricted free trade than it is with restricted trade. Suggesting that consumers in both countries can consume more if there are no restriction to trade. Comparing to the theory of absolute advantage, Ricardo's theory of comparative advantage suggests that trade is a positive sum game in which all countries that trade with each other realize economic gain (Hill, 2008).

Hechscher-Ohlin Theory

Ricardo's theory explains that Comparative advantage arises from differences in productivity. Therefore whether Nigeria is more efficient in the production of petrol than Norway depends on how productively it uses its resources (Hill, 2008). Eli Heckscher (1919) and Bertil Ohlin (1933) laid the groundwork for substantial developments in the theory of international trade by focusing on the relationships between the composition of countries' factor endowments and commodity trade patterns as well as the consequences of free trade for the functional distribution of income within countries. From the

outset general equilibrium forms of analysis were utilized in these developments, which gradually came to be the pure theory of international trade (Fontage, 2004).

The Heckscher-Ohlin Theorem states that countries export those commodities that make relatively intensive use of those productive factors found locally in relative abundance, while importing goods that make use of intensive use of factors that are locally scarce (Hill, 2008). The twin concepts of relative factor intensity and relative factor abundance are most easily defined in the small dimensional context in which the basic theory is usually developed. Two countries engage in free trade with each producing the same pair of commodities in a purely competitive setting, supported by constant returns to scale technology that is shared by both countries. Each commodity is produced separately with inputs of two factors of production that, in each country are supplied perfectly (Krugman, 2003). For example, countries such as Argentina, Australia and Canada which has surplus land should export land-intensity goods while countries like India, china and Taiwan should produce and export more labour intensive goods, because of their availability of low labour cost.

The Heckscher- Ohlin theorem concludes that countries should specialize in goods that use intensively the factors of production that they have in abundance. The theorem basically says that trade is determined by relative amounts of factors of production, which determines the cost of trade (Piggott & Cook, 2006). Other modern theories such as Leontif Paradox, Product life-cycle theory, and Porters diamond model came about to improve upon the Heckscher- Ohlin Theory.

Trade is a vital part of all economies and also for companies. Different theories have explained why trade occurs between different countries and in which good and services they specialize in. Explaining international trade we have seen that with the exception of the Mercantilist theory which promotes the zero sum gain, absolute advantage encourages the specialization of goods produced more efficiently, while the Comparative advantage theory tells us that through the use of opportunity cost, a country gains comparative advantage but specializing in commodity with less production cost and the Heckscher-Ohlin Theorem tells us that factors endowment matter (Hill, 2008).

2. International Equity

International Equity can be broken down into two major parts. These parts are: Foreign Direct Investment and Foreign Portfolio Investment (Goldstein & Razin, 2005).

Foreign Direct Investment –

International Trade and Foreign Direct Investment can be describes as ways of obtaining market positions. A foreign market can be serviced either by investing and producing domestically and then exporting or by investing, producing and selling directly into that market (Piggott & Cook, 2006). For example coca-cola has it goods produced and sold in most countries rather than having to export because of its large consumptions in these countries. International trade and Foreign direct Investment are sometimes competing and sometimes complementary ways of servicing a foreign market (Julius, 1993).

It is difficult to provide a comprehensive definition of FDI. Some Authors and academic articles define it in terms of its international characteristics and contrast with portfolio investment. Nevertheless, Foreign Direct Investment occurs when firms invest directly in facilities to produce or market a product in a foreign country (Hill, 2008). Most definitions, however, seem to have two elements which are: FDI involves two countries (multinational), the other element is the issue of ownership and control. This distinguishes FDI from portfolio investment. Foreign portfolio Investment is a simple transfer of financial capital, equity or loan, from one country to another while FDI involves the ownership and control of production activities abroad (Piggott & Cook, 2006). FDI can simple be explained as the acquisition, establishment or increase in production facilities by a firm in a foreign country. This definition covers three elements of FDI. Greenfield investment, Mergers & Acquisition, and Reinvestment. FDI is basically approached in 3 ways, which is known as the Paradigm of ownership, location and internalization (Piggott & Cook, 2006).

While discussing FDI, it is important to explain the difference between Flow of FDI: This refers to the amount of FDI undertaking over a given period of time while the Stock of FDI refers to the total accumulated value of foreign owned assets at a given time (Hill, 2008).

International Trade and Specialization

The determinants of international trade have been of interest since the eighteenth century when Smith (1776) laid a foundation captured by the statement, “ Trade makes possible the gains from specialization.” This observation became the foundation of classical and modern trade theories.

The three theories reviewed are comparative advantage, new trade theory, and national competitive advantage. All begin with the idea that international trade is the result of specialization. Ricardo (1817) made the next significant contribution by stating the law of comparative advantage; that is, countries tend to export those goods which have the lowest relative costs. However, while Ricardo and later Mill (1848) presented a powerful and rational argument for free trade and effectively showed that trade was the result of differences in a country's production functions (Ellis & Pecotich, 2002).

In addition to favorable knowledge accumulation, there is a significant set of factors that could and should be taken into the analysis of economic growth. Where there is specialization there must also be trade, and, overtime, where there is trade there will also emerge the specialized roles and market structures needed to handle trade efficiently. These specialized roles and market structures, identified as marketing systems, together with institutions and technology constitute the three essential sets of factors needed for growth to occur (Layton, 2009)