Case Studies on

International Trade and Exchange Rates

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OVERVIEW

An understanding of international trade and exchange rates is necessary due to the effects of globalisation. This phenomenon has necessitated the apprehension of financial management procedures of a business organisation complex, as it encompasses integration across countries as well as markets.

When a firm operates only in the domestic market, both for procuring inputs as well as selling its outputs, it needs to deal only in the domestic currency. As companies expand globally, they come into contact with diverse cultures and societies. Different nations have different currencies. In such a situation, the question that becomes imperative is which country's currency should trade payments be settled in. Should there be a uniform international currency? The question of exchange rates between different currencies also arises. The determination of exchange rates can have a profound effect on the sales and profit figures of a company. Thus, the study of international trade and exchange rates is essential.

The first question that arises about international trade is: why does international trade take place? There are several theories to explain this and some of the major theories are:

- Theory of Absolute Advantage
- Theory of Comparative Advantage
- Heckscher-Ohlin Model
- Imitation Gap Theory
- International Product Life Cycle Theory.

Theory of Absolute Advantage – Adam Smith proposed this theory in 1776. According to this theory, any country is more efficient in producing a certain kind of goods than other countries. This provides an incentive for various countries to engage in trade as they can benefit from their respective specialisations and consequently increase productivity. This theory has been criticised as it has practical limitations.

Theory of Comparative Advantage – According to this theory, two countries can engage in mutual trade, even if one country possesses an absolute advantage in producing all commodities. This theory takes into account the concept of opportunity cost and states that, one country has a greater opportunity cost of manufacturing one kind of goods while the other country has a greater opportunity cost of manufacturing another type of goods; even if the first country has an absolute advantage in manufacturing both kinds of goods, they can still engage in trade. This theory too has practical limitations due to inherent assumptions.

Heckscher-Ohlin Model – Whereas the previous two theories are based on the premise of differences existing between two nations, in the relative efficiencies of manufacturing goods, this theory assumes similar levels of efficiency but classifies goods into two kinds: labour intensive and capital intensive. A labour rich country produces labour intensive goods, while a capital rich country produces capital intensive goods. The two countries can engage in mutual trade of these goods and reap the benefits of international trade. This theory is also hamstrung by practical limitations.

Imitation-gap Theory – This theory states that international trade can take place between two countries having similar features (factor endowments) and consumer tastes. Trade arises between two countries as a result of gap between invention or innovation of products and their imitation in these countries. There are two lags in this theory: Demand lag and Imitation lag. Demand lag is the time gap between the introduction of a new product in one country and the point when consumers in another country start demanding that product. Imitation lag is the time gap between the introduction of a new product in one country and the point when manufacturers in another country start producing that good. Trade occurs between the two countries when demand lag is shorter than imitation lag.

International Product Life Cycle Theory – This theory takes into consideration two important factors not considered by the other theories:

a) New products are developed as a result of technological innovations

b) Trade patterns are determined by the market structure and the phase in a new product's life.

According to this theory, capital rich nations have more scope for innovation because R&D requires more capital and these countries have a stable patent protection regime and, the people of these countries have higher incomes allowing them to try out newer products.

In the early stages of a product, it is produced and exported by the country that introduced innovation. In the second stage, the production may shift to another country, where factors of production are more economical. In the third and final stage, production shifts completely to the lesser-developed countries and the originally exporting country becomes an importer.

Trade Barriers

Despite the obvious benefits of international trade, national governments feel inclined to impose trade barriers in order to discourage imports. Trade barriers are of two kinds: Tariff and Non-tariff.

Tariff – It is a tax levied on goods traded internationally and is known as duty. Duties levied on imported goods are called Import duties, while duties levied on exported goods are called Export duties. The former are more extensively used than the latter.

Non-tariff – Non-tariff barriers include all rules, regulations, and bureaucratic delays that help keep foreign goods out of the domestic markets. Examples are Quotas, Embargos, Voluntary Export Restraints, Subsidies to local goods, Technical barriers, Procurement policies, Exchange controls, etc.

Trade barriers are in place in different countries not only due to a general misunderstanding regarding the benefits of international trade but also to protect various interest groups in these countries.

Balance of Payments

A country's international transactions are recorded in the balance-of-payments accounts. A country's balance of payments has three components: the current account, the financial account and the capital account.

A detailed break-up of the various accounts is given below:

1) **Current Account:** It measures a country's net exports (that is, the difference between exports and imports) of goods and services and net international income receipts.

   a) **Trade Balance (or Balance on Goods and Services):** It represents the difference between exports and imports of goods and services.

      i. Merchandise Trade Balance (or Balance on Goods): It equals exports minus imports of goods.

      ii. Services Balance: Includes net receipts from items such as transportation, travel expenditure, and legal assistance.

   b) **Income balance:**

      i. Net Investment Income: it is the difference between income receipts on assets of a country owned abroad and income payments on foreign-owned assets in that country. It includes international interest and dividend payments and earnings of domestically owned firms operating abroad

      ii. Net international compensation to employees.

   c) **Net Unilateral Transfers:** It is the difference between gifts (that is, payments that do not correspond to purchases of any good, service, or asset) received from the rest of the world by a country and gifts made by that country to foreign countries.

2) **Financial Account:** The difference between sales of assets to foreigners and purchases of assets held abroad.

   a) **Assets owned by a country consist of:**

      i. Official reserve assets such as special drawing rights (SDRs), foreign currencies, reserve position in the IMF

      ii. government assets, other than official reserve assets

      iii. private assets, such as direct investment and foreign securities.

   b) **Foreign owned assets consist of:**

      i. Foreign official assets in the country such as government securities of the home country

      ii. Other foreign assets such as currency of the home country.

3) **Capital Account:** It records non-financial transfers in wealth. For example, if a person migrates to another country, his assets abroad become a part of the net asset position of the country to which he has migrated, as a plus. If this country forgives debt to another country, it enters as a minus in the capital account.

The following relations are important:

a) Trade Balance = Merchandise Trade Balance + Services Balance

b) Current Account Balance = Trade Balance + Income Balance + Net Unilateral Transfers

c) Current Account Balance = – (Financial Account Balance + Capital Account Balance).

Exchange Rates

Exchange rates can be defined as the value of one currency in terms of another. There are different ways in which the exchange rates can be determined.

1) **Fixed Exchange Rate System:** Under this fixed (or pegged) system, the governments or the central banks of the respective countries decide the rate of exchange of currency. The pegging is done to some common commodity or to some common currency.

2) **Floating Exchange Rate System:** Under this system, the exchange rates between currencies are variable and determined by the demand and supply of the currencies in the international market. This, in turn, depends on the flow of money between the countries, which may result either due to international trade or due to purely financial flows.

3) **Free Float:** The exchange rate is said to be freely floating, when its movements are totally determined by the market. There is no governmental or official intervention.

In reality, complete free float systems are not allowed to exist due to some practical inconsistencies, since the value of a currency may fluctuate erratically and adversely affect trade and commerce. Thus, governments of various countries intervene in the currency markets through their central banks by systems such as: Managed float, Crawling Peg and, until recently, the Bretton Woods System. The Bretton Woods System was abandoned as it was not found suitable by many countries and most countries switched over to either a pegged system or a free float system, while some countries remain in a transitory system.

Trade Blocks

An important phenomenon that developed as international trade grew was the tendency amongst like-minded nations (having similar political ideologies) or nations located within certain geographical regions, to form close trading ties called blocks. These blocks differ in respect to the degree of economic cooperation between the member countries and can be classified as follows:

- **Free Trade Area:** In a Free Trade Area, there are no barriers of trade amongst the member countries. At the same time, each member country is also free to decide trading policies towards non-member countries.
- **Customs Union:** Under this system, in addition to the absence of internal trade barriers amongst the member nations, the external trade barriers for non-members are also common.
- **Common Market:** A common market allows the free flow of goods among member nations and also factors of production (labour and capital) and services.
- **Economic Union:** In this kind of an arrangement, member nations give up some of their economic freedom in order to have a uniform fiscal policy and currency system across their national boundaries. Such unions have their economic decisions taken largely by a common central bank. Even the policies on agriculture, industry, research, welfare, regional development, competition, etc. are similar across member nations.

The concepts that have been discussed above have been exemplified in the case studies that have been incorporated in this book. All these cases have been arranged in the following table, which will give the reader an initial understanding of what each of these cases strives to highlight.

Sl.No.	Name of the Case Study	Core Theoretical Concept
1.	Transfer Pricing	Tax Avoidance by Shifting Profits to Low Tax Countries
2.	Cancun Revisited	Issues Affecting World Trade
3.	NAFTA – Achievements and Challenges	Effects of a Trade Block
4.	Mexican Experiences with NAFTA	Effects of a Trade Block
5.	Bangladesh and the MultiFibre Agreement	Effect of Globalisation on Developing Nations
6.	US Trade Deficits	Balance of Payments
7.	European Trade with China	Bilateral Trade
8.	China's FDI Outflows	Foreign Direct Investment
9.	China's FDIs in Asia	Foreign Direct Investment
10.	Currency Boards and Countries' Experiences	Link Between International Trade and Exchange Rate Determination
11.	Currency Pegging	Exchange Rate System
12.	Yuan: To Peg or Not to Peg?	Exchange Rate System

Contd...

13.	Dollarisation and Countries' Experiences	Exchange Rate System
14.	America's Dollar Policy: Weak Dollar vs Strong Dollar	Relationship Between Exchange Rate and Other Economic Variables
15.	US Dollar vs the Yen	Currency Policy and Globalisation
16.	US Dollar vs the Yuan	Currency Policy and Globalisation
17.	Euro vs The US Dollar	Currency Policy and Globalisation
18.	The Appreciating Canadian Dollar: The Implications for Canadian Economy	Exchange Rate and Economy
19.	The 1994 Devaluation of Mexican Peso and After	Exchange Rate and Economy

The case studies, *Transfer Pricing*, *Cancun Revisited*, *NAFTA – Achievements and Challenges*, *Mexican Experiences with NAFTA*, *Bangladesh and the MultiFibre Agreement*, *US Trade Deficits*, *European Trade with China*, *China's FDI Outflows*, and *China's FDIs in Asia* focus on the various aspects of International Trade like issues related to world trade, regional trade blocks, bilateral trade and foreign direct investment. The case study, *Currency Boards and Countries' Experiences*, provides a link between international trade and Exchange Rate Determination mechanism. The case studies, *Currency Pegging*, *Yuan: To Peg or Not to Peg?*, *Dollarisation and Countries' Experiences*, *America's Dollar Policy: Weak Dollar vs Strong Dollar*, *US Dollar vs the Yen*, *US Dollar vs the Yuan*, *Euro vs The US Dollar*, *The Appreciating Canadian Dollar: The Implications for Canadian Economy*, and *The 1994 Devaluation Mexican Peso and After* deal with the various aspects of exchange rate and its relation to global issues and national economy.

The case studies presented in this book thus help the readers to realise the practical implications of theoretical concepts regarding international trade and the way they influence relations among different nations.