

Economic Environment and Business Strategy
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International Trade Environment

Hello, everyone. Welcome to this session on international trade. International trade has long been at the heart of economic thought. This thinking laid the foundation for understanding why countries trade and how everyone can gain from engaging in international trade. Trade allows nations to specialize, exchange goods and services, and achieve outcomes that would not be possible in isolation. In this session, we will begin with Adam Smith's theory of absolute advantage, which illustrates how differences in efficiency create the scope for specialization and international trade. We will then move on to David Ricardo's comparative advantage theorem, a powerful insight that trade can be beneficial even when one country is more efficient at producing everything.

From there, we will examine trade barriers and policy interventions in international trade, with a primary focus on subsidies, dumping, and embargoes, which significantly shape the global trading system. Finally, we will connect these theories and policies to the broader economic environment and business strategy, exploring how trade patterns influence competitiveness, job creation, industrial growth, and even environmental sustainability. By the end of this session, I am confident you will understand that international trade is not only about economics across borders but also a key determinant of business opportunities, policy choices, and global independence. So let me begin by defining what is meant by international trade.

International trade is the voluntary exchange of goods and services between countries. Typically, this exchange occurs primarily through the free market mechanism, in which buyers and sellers engage in market transactions freely and willingly. When trade is voluntary, and there are no barriers, both parties benefit and are better off after the trade than they were before. That is what we will see in this section. Let me begin with one of the oldest theories in international trade: the theory of absolute advantage.

This is known as the gains from trade under the theory of absolute advantage. It was proposed by Adam Smith, often called the father of economics, in his influential book, *The Wealth of Nations*. According to his theory, countries can gain from trade by specializing in the goods and services they produce more efficiently. To illustrate this theory, let us examine the case of trade between two countries: Portugal and England. Assume there is only one factor of production: labor.

The labor requirement is per unit of output. The output here is one unit of wine. So here is one unit of wine and one unit of cloth. According to this table, to produce one unit of wine and one unit of cloth, Portugal requires 80 hours of labor to produce one barrel of wine. Producing one yard of cloth requires 120 hours of labor.

Let us now move to England. In England, it takes 120 hours of labor to produce one barrel of wine and 80 hours of labor to produce one unit of cloth. From this table, you can see that Portugal has a comparative advantage in the production of wine because it requires only 80 hours of labor to produce one unit of wine, whereas it requires 120 hours of labor to produce one unit of cloth.

At the same time, producing one unit of wine in England requires 120 hours of labor. That means it's expensive here, but it requires only 80 hours of labor to produce one unit of coal. So, what is the main implication of this? The main implication is that since Portugal has an absolute advantage in wine production, it can specialize in this area; similarly, since England has an absolute advantage in cloth production, it should also specialize in this area. So, instead of producing both goods, suppose in this case that Portugal shouldn't produce both wine and cloth. Instead, it should only produce wine for domestic consumption; it should export wine to England.

England should specialize in cloth production. After meeting domestic consumption, it should export to Portugal. Simply put, this theorem states that countries should specialize in areas where they have an absolute advantage. After meeting domestic requirements, they can sell the surplus and exchange it with foreign countries, importing goods and services where they do not have an absolute advantage. So, by trading, both countries can consume more than they could in isolation. As you can clearly see from this calculation, it is better for Portugal to specialize in wine production and import cloth from Portugal, rather than specializing in cloth.

Another theorem proposed by David Ricardo holds that even if a country is more efficient at producing all goods than its trading partner, both can still gain from trade. This is known as comparative advantage. Assume that one country has an absolute advantage in producing both goods compared to the other country. It may still have a comparative advantage in producing one good if it can produce that good at a lower opportunity cost relative to the other good than its trading partner. In this case, the gains from trade arise because countries specialize in the goods in which they hold a comparative advantage.

Let us take an illustrative example. I am showing you the same product, wine and cloth, and the countries are also the same, Portugal and England. The only difference here is that now you look at Portugal. Portugal requires 80 units of labor to produce wine and 90

hours of labor to produce cloth. As you can see, Portugal has an absolute advantage in wine production and economic growth.

That means it requires 80 hours of labor to produce one barrel of wine and 90 hours of labor to produce one yard of cloth. But look at England. In England, producing wine requires 120 hours of labor, compared with Portugal's 80 hours. Similarly, producing cloth requires 100 hours of labor, which is greater than the 90 hours required in Portugal. As you can see here, Portugal has an absolute advantage in both goods.

Regarding England, it has an absolute disadvantage in producing both goods. The difference is clear here. But the key point is this: if Portugal is more efficient in both goods, does it still benefit from trading with England? You can see here why they would. You can just look at this table; you can see why Portugal should specialize in either? Because wine can be produced cheaply compared to England, and cloth can also be produced cheaply compared to England, then why should it specialize and engage in trade? But the answer lies in comparative advantage. Portugal should specialize where its relative efficiency is greatest. Instead of producing both wine and cloth, David Ricardo argued, with a proper illustrative calculation, that Portugal should specialize in the good in which it has a comparative advantage.

Forget, it's not just about absolute advantage. In addition to absolute advantage, there is comparative advantage; it should specialize. Similarly, England also specializes in those productions where it has a comparative advantage. We know that England has an absolute disadvantage in the production of both, but it will have an absolute disadvantage in both. But out of these, where the absolute disadvantage is less in the production of either wine or cloth, it should specialize and engage in trade accordingly.

Let us go further. In autarky, the price ratio shows that there is no trade. Suppose in Portugal, without free trade, there is no trade between Portugal and England. Then the price ratio is as follows: one unit of wine requires 80 units of labor, and cloth requires 90 units of labor. So, between wine and cloth, one unit of wine is worth less than one unit of cloth. Because the price is mainly based on labor requirements, one unit of wine is equal to 0.89 units of cloth; that is, under the scenario of no trade between these two countries. And if we look at England, without trade, one unit of wine is equivalent to 1.2 units of cloth. To produce one unit of wine, it requires 120 hours of labor. At the same time, producing cloth requires only 100 units of labor. So, the price ratio is that one unit of wine is equal to 1.2 units of cloth. Therefore, purely based on labor requirements, we do not consider any capital requirements or other input requirements.

Here you can see that Portugal has a comparative advantage in wine production because one unit of wine is equivalent to 0.89 units of cloth in Portugal. And look at England: one unit of wine is equivalent to 1.2 units of cloth. So, if they specialize—suppose Portugal

specializes in the production of wine and England specializes in the production of cloth—both countries will benefit because England also has a comparative advantage in the production of cloth. So, when Portugal has a comparative advantage in wine.

You can look at this figure. Therefore, you can see that the opportunity cost shows that both countries have a comparative advantage in the production of each of these products. That means Portugal should specialize in wine, and England should specialize in clothing production. To understand this and the concept of comparative advantage, we must examine all four labor requirements simultaneously. When examining the four labor requirements, you will encounter the concept of opportunity cost, which refers to the amount of one product you must give up to obtain another or to produce it.

By examining this ratio, you can see the opportunity cost. It will become clearer as we move forward. So, look at the opportunity cost here. The opportunity cost for Portugal is evident in the fact that one unit of wine is equivalent to 0.89 units of cloth. For cloth, one unit is equal to 1.125 units of wine. That means it has a lower opportunity cost for wine in terms of cloth. Looking at this, you can see that about England. This is the opportunity cost: the lower opportunity cost of cloth in terms of wine. In this case, it would be more beneficial for Portugal to specialize in wine production and export it to England, while England should focus on producing cloth and exporting it to Portugal.

If each country specializes in the good for which it has a lower opportunity cost and trades for the good for which it has a higher opportunity cost, both countries can gain from trade. This is the main argument. To summarize this example, England requires only 100 hours to produce one yard of cloth and 120 hours to produce one barrel of wine. However, Portugal can produce wine in under 80 hours. The key point is that Portugal can produce wine in fewer than 80 hours, compared with the 80 hours it takes to produce cloth.

Assuming the price of cloth divided by the price of wine equals one by one in trade is a simplifying assumption and a rather bold one; it may not accurately reflect the actual price ratio in the real world. Assume that one wine is equal to one cloth; then the price of wine divided by the price of cloth is equal to one by one in trade. It is better for Portugal to produce wine and for England to produce cloth, and for them to exchange with each other. This is a more illustrative example or a simplified illustration of the point we just discussed. Clearly, you can see here that England can produce one barrel of wine in 120 hours.

That means producing wine directly. Or England can use 100 hours to produce a yard of cloth, which it can sell for one barrel of wine. Ricardo called this indirect wine production. Therefore, it seems better to produce wine indirectly. Instead of producing wine directly in England, it is better to import wine from Portugal and export cloth to

Portugal. Therefore, by producing cloth and engaging in trade, England saves 20 hours for each unit of wine.

These 20 hours can be used to produce more cloth, either for personal use or for trade. So, by using this simple illustrative example, what does it show? When countries engage in trade, both can gain, even if one has a comparative disadvantage in producing all goods and services. To make it beneficial, consider the opportunity cost and identify areas where it is low. Engage in those goods and services, and then explore international trade opportunities. Additionally, there are several more theorems.

One is called the Heckscher-Ohlin theorem. The Heckscher-Ohlin theorem holds that countries should specialize in producing goods and services where they have a comparative advantage, based on their resource endowments. That means a capital-abundant country will export capital-intensive goods and import labor-intensive goods. Similarly, a labor-abundant country, or one with a labor surplus, can export labor-intensive goods and import capital-intensive goods. If that is the case, both countries can benefit. So let me now list some of the advantages of international trade.

One is called to lower costs and increase efficiency. The example discussed in the comparative advantage theorem, as well as the Heckscher-Ohlin theorem, shows that countries with lower opportunity costs and higher efficiency should specialize in those areas and benefit from international trade. Additionally, countries can access resources and inputs. For instance, importing raw materials, components, and technologies from other countries can give businesses access to resources and inputs that may be unavailable or more expensive domestically.

For instance, you know that India is experiencing a shortage of petroleum products. So, that resource is in short supply in India. India can import it from abroad. And where we have a comparative advantage, for example, in textile production, software, and computer hardware production, we can take advantage of exporting. Similarly, this will increase market opportunities.

It also helps with economies of scale. Economies of scale refer to lower opportunity costs. If a country specializes in producing specific goods and services, producing at a large scale can reduce the marginal cost of production, and it can benefit mainly due to economies of scale. When economies of scale exist, the marginal cost of production declines, profits increase, and there is also an exchange of knowledge and technology. Furthermore, it enhances consumer choices, allowing consumers from both countries to benefit through participation in international trade. Through access to a wider variety of goods and services, often at competitive prices, this leads to improved living standards and a higher quality of life.

Having discussed this, let us now proceed to the trade barriers that exist between countries. In this case, let us make a distinction between free trade and trade barriers. Free trade means that countries can trade with one another without restrictions. There are no barriers. That means nothing hinders or gets in the way of two nations trading with each other.

That means there are no tariffs and no quotas. Therefore, countries that can produce goods and services cheaply can specialize in these areas and export them to other countries where they are available at a higher cost. So that means free trade. Free trade clearly means that, apart from transportation costs between countries, there shouldn't be any other costs or trade barriers.

However, sometimes countries complain about trade. They argue that too much trade causes workers to lose their jobs and home industries to collapse. Therefore, if a foreign country can produce goods and services at a very low cost, it exports all its goods and services to, for example, India. That means we will be getting everything cheaply, but at the same time, it causes domestic industries to collapse because importing from abroad means that domestic firms will also collapse, resulting in job losses domestically.

People will lose jobs. The GDP will decline. Government revenue and tax revenue are expected to decline. Therefore, countries sometimes attempt to restrict trade by creating trade barriers. This is often referred to as protectionism. Protectionism is the practice of protecting domestic industries, the interests of domestic producers, and the interests of domestic workers, often through government intervention. That means imposing trade barriers, which are often referred to as trade hindrances.

One of the trade barriers is called a tariff. There are mainly two types of trade barriers. One is called a tariff; the other is referred to as a quota. A tariff is a tax levied on goods imported from abroad, also known as an import duty. It raises the price of the imported product domestically. As a result, foreign products become more expensive in the domestic market, making people more likely to purchase domestic products.

The European Union removes tariffs. However, some countries do not impose tariffs on each other. For example, within the EU, there are no tariffs between member nations, but tariffs are imposed on non-members. Similarly, NAFTA allows free trade between Mexico, Canada, and the United States, but it imposes tariffs on other countries. When a tariff is imposed, exporters must pay it, which raises the price of the product when it is sold in the foreign market.

As a result, it will be difficult for them to sell. Therefore, the theoretical expectation is that tariffs will reduce trade in the goods on which the tariff is imposed, leading to a decline in overall trade. Another form of trade barrier is a quota. A quota is a restriction on the maximum quantity of goods that can be imported. For example, at some point,

India imposed a textile quota. This meant protecting the domestic textile industry by limiting imports of textiles from specific countries within a specified period.

Similarly, agricultural quotas are mainly there to safeguard the interests of farmers by restricting imports of products such as rice, wheat, and sugar. Similarly, India had steel quotas to control the volume of imported steel and support domestic steel producers. Let me point out some of them, as you have seen that there are two types of trade barriers. One is a tariff, which is a tax or price intervention. A quota is mainly on the quantity of goods and services that can be imported.

The reason the quarter has some advantage, mainly in certain contexts, is that tariffs won't work. For example, in the quarter, when demand is price inelastic, and the product being imported from abroad is perfectly price inelastic, doubling the tariff or continuously increasing it will have no impact. Even though the price is very high, we still import that. In such cases, tariffs will not be effective. In this case, the government will state that this is the maximum number of units of this product, which is referred to as a quota; a quantity restriction is in place.

The second advantage is the certainty of restrictions and immediate protection for the domestic industry. It also helps maintain domestic price stability. Because import volumes are fixed under quotas, domestic producers are less exposed to sudden surges of foreign goods. Therefore, tariffs can still allow substantial inflows if foreign firms lower their prices.

Another form of trade barrier is a trade embargo. A trade embargo is the strictest form of trade barrier. It is typically imposed for political reasons to hurt the target country's economy. Suppose the country on the other side is an enemy country; then, instead of tariffs and quotas, we go with a trade embargo. That means the strictest form is a complete ban on trade between countries, primarily to undermine their political leadership. So, unlike tariffs or quotas, an embargo usually means a complete ban on trade.

Recently, following the removal of Article 370A, a trade embargo was imposed between India and Pakistan. The idea is that there should be a complete ban on trade. Then, suppose that, to overcome challenges, a domestic country's government provides export subsidies to exporters so that their cost of production declines, allowing them to sell products in foreign countries at a lower price. The effect is that consumers benefit from lower prices, while foreign producers lose due to reduced global prices, and taxpayers in the exporting country bear the cost of the subsidy.

Then there are related issues, such as dumping. Dumping is the practice of selling goods abroad at unfairly low prices. For example, if you sell a product in India for 100 rupees, the same product is sold abroad for 50 rupees. That is dumping, but the WTO has certain

restrictions on it. Countries cannot sell goods and services in foreign markets at prices lower than the domestic price. As I mentioned, if we sell a product in India for 100 rupees, the same product cannot be sold in the US or UK for 50 rupees.

That is called anti-dumping. Anti-dumping refers to policies designed to protect domestic producers from such practices, as the government has used export subsidies. So, suppose we want to capture foreign markets; the government can provide a substantial amount of export subsidies, allowing them to sell the product in the foreign market at a very low price. That is nothing but dumping. However, the producers in the other country will be severely harmed.

To avoid that, several anti-dumping measures exist. Mainly in the WTO clause, it is clearly stated that countries shouldn't engage in dumping. Therefore, there are several arguments in favor of restricting trade, including those against free trade. One is called the job argument because it protects trade and destroys domestic jobs; if more goods and services are imported from abroad, that means we are exporting jobs abroad, right? That means the domestic industries and domestic firms will shut down. That means trade destroys domestic jobs. The national security argument is also highlighted, especially in the case of critical goods and services, including defense.

Another key argument is the infant industry argument. It holds that, primarily in low- and middle-income countries, new industries and firms may require temporary protection to develop. That means, just as an infant in the infancy stage needs support, these firms need protection from foreign competitors during their early stages of development. We cannot ask the infant to walk immediately. Similarly, for the industry's firms, when they are in the early stages of their development, they need protection from foreign competitors. In that case, there is a restriction on international trade; however, the challenge is that it is difficult to implement in practice.

Temporary protection often becomes permanent, and some industries continue to grow without it. It is also referred to as environmental protection, as exemplified by the EU's carbon border adjustment mechanism. The mechanism imposes taxes on imports based on carbon emissions to ensure fair pricing and reduce pollution. I have listed some of the costs of trade barriers here. In this session, we discussed what is meant by international trade and how it is influenced by the basic theorems of absolute advantage and comparative advantage. We said that trade enables specialization, efficiency, and mutual gain. It also provides a basis for comparative advantage, explaining why all countries benefit even with unequal efficiencies. We also discussed various trade policies and trade restrictions, including tariffs, subsidies, and embargoes, and how they will impact global competitiveness.

Overall, international trade affects jobs, industries, and national security. It is also crucial to understand the dynamics of international trade and the interrelationships among countries. These are important considerations for businesses and firms when designing strategies and competing effectively in their operations. Thank you for watching this session. See you in the next one. Thank you.