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ECONOMICS NOTES
TOPIC 4: INTERNATIONAL TRADE
GRADE: 12
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TOPIC 4: INTERNATIONAL TRADE

International trade involves importing and exporting goods and services across countries.

REASONS FOR INTERNATIONAL TRADE (possible essay)

- There are two main reasons for international trade namely, demand reasons and supply reasons.

Demand reasons

- **Size of population**

- An increase in population creates a need for more goods and services.
- Local suppliers may not be able to satisfy the needs and wants for the growing population.
- As a result, members of the population can import some of the goods and services from other countries.

- **Income levels**

- An increase in people's income often increases the demand for goods and services.
- This can also result in the demand for goods and services, some of which may not be produced locally.
- This means such goods should be imported to satisfy such demand

- **Change in the wealth of the population**

- An increase in wealth of the population leads to greater demand for goods and services.
- People who have access to more money can spend more on luxury goods.
- Countries that cannot supply these luxury goods often import them.

- **Preferences and taste**

- Tastes and preferences differ from person to person.
- People need a variety of goods and services.
- If some goods and services are not available in their home country, international trade will develop as such goods will be imported.

- **The difference in consumption patterns**

- Consumption patterns differ from country to country.
- People in well-developed countries have a higher demand for luxury goods some of which they can easily buy even from other countries.
- Poor people in all countries have a high demand for basic goods and services, and those not available locally can also be imported.

Supply reasons

- **Natural resources**

- Natural resources are not evenly distributed across the earth.
- They vary from country to country and can only be exploited in places where there are such resources.
- Each country has its own unique mix of natural resources that makes it possible for them to produce certain goods and services more efficiently and at a relatively lower price.

- If a country without a particular natural resource needs that resource it has to import the resource from the country that has it e.g. South Africa export its minerals but has to import oil because it has no oil wells.
- **Climatic conditions**
 - Countries have different climates and certain crops can only grow in certain climatic conditions.
 - Some countries cannot grow agricultural products that they need, as a result, those countries have to import these products from countries that can grow them abundantly. For example, Brazil is one of the big producers of coffee due to its tropical climate, South Africans are importers of coffee.
- **Labour resources**
 - The quality, quantity, and cost of labour also differ between countries.
 - Some countries have highly skilled labour with high productivity rates.
 - This enables them to produce goods and services at a lower price than they are produced in other countries.
 - Certain individuals have greater ability and aptitude for certain tasks.
 - It is a worldwide phenomenon that some countries have developed a skill and aptitude for the production of certain commodities, for example, The Swiss are known for watch-making.
- **Capital**
 - In some countries capital is more easily available than in others.
 - Developed countries usually enjoy an advantage over underdeveloped countries.
 - Due to a lack of capital some countries cannot produce all the goods they require.
 - In many developing countries there is a lack of physical infrastructure and this hampers local production of goods and services.
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- **Specialisation**
 - Some countries specialise in the production of certain goods and services.
 - By specialising in the production of certain goods and services, a country is able to take advantage of economies of scale and therefore produce the goods at a comparatively cheaper unit cost, for example, Japan has specialised in the production of certain electronic goods and they sell such goods at a much lower price than they can be produced in other countries.
 - This often results in mass production because of division of labour automation and mechanisation.
 - Cost differences occur because goods and services can be produced at lower costs in one country than another because of the theory of comparative advantage.
- **Technological resources**
 - Some countries have access to technological resources that enable them to produce certain goods and services at a low unit cost.
 - Improved production processes, the availability of equipment and machinery, and other technological factors all influence the supply of goods and services and thereby contribute to cost differences between countries.
 - E.g. Japan has been producing more of electronic products because they have good technology for such production.

EFFECTS OF INTERNATIONAL TRADE

- **Specialisation**

- International trade enables countries to specialise in producing goods and services in which they have comparative advantage.
- Specialisation allow a country to produce for the local and export market.
- The revenue earned from such exports is used to pay for imports.

- **Mass production / increase in production**

- Firms produce goods and services in larger quantities in order to satisfy local and international demand.
- Mass production has an advantage of reducing production costs, therefore leading to high profits.

- **Efficiency**

- International trade increases competition among producers.
- For firms to compete successfully they have to be efficient by eliminating (removing) wastage of resources.
- This efficiency can lead to lower costs of production.
- Therefore, consumers can benefit by paying lower prices.

- **Greater variety of goods and services**

- Consumers have access to goods and services produced in other countries.
- This allows consumers to choose products that suit their taste better.

BALANCE OF PAYMENTS

- Balance of Payment is a country's systematic record of transactions with the rest of the world over a specific period.
- It consists of **THREE** main accounts/components namely: **current account**, **financial account** and the **capital transfer account**.

There are 3 components of the BOP (see the 2021 examination guideline)

1. CURRENT ACCOUNT

Merchandise exports
 + Net gold exports
 + Services receipts
 + Income receipts
 (-) Merchandise imports
 (-) Payment for services
 (-) Income payments
 Current transfers (net receipts)
 Balance on Current Account
 Memo item: trade balance

2. CAPITAL TRANSFER ACCOUNT

NET LENDING TO (+) OR BORROWING FROM (-) REST OF THE WORLD

3. FINANCIAL ACCOUNT

Net direct investment
 Net portfolio investment
 Net financial derivatives
 Net other investments
 Reserve assets

Balance on financial account

Memo item: balance on financial account excluding reserve assets

Unrecorded transactions

Memo item: Balance on financial account excluding reserve assets including unrecorded transactions

1. CURRENT ACCOUNT

- It is a component that records transaction related to production, income and expenditure.
- **Merchandise (goods) exports and merchandise (goods) imports:** record transaction on all visible goods (raw materials and intermediate goods, final goods) that South Africa export and import.
- **Net gold export:** shows the record of the income earned from the exportation of gold. While gold is a physical good it is recorded separately because of the **high** amount of

money that it earns as an individual product; and South Africa relies heavily on it as an earner of income.

- **Services:** record money **earned** or **spend** on services such as insurance, transportation, recreational, professional.
- **Income:** Income earned by South African citizens from non- citizens and vice versa (non -South African citizens earning income from South African).
- It consists of two components which are **compensation of employees** e.g. salaries and wages and **investment income** e.g. dividends and profits.
- **Current transfer (net):** Items transferred from residents to non-residents (and vice-versa) without any counter-performance required e.g. gifts/donations.

– CURRENT ACCOUNT

	2019	2020
Merchandise exports	1 235 964	1 286 047
Net Gold exports	67191	108 299
Service receipt	212 721	121 073
Income receipt	116 781	122 120
(Less) merchandise imports	1 263 824	1 109 459
(Less) service payments	226 494	160 422
(Less) income payment	259 944	216 319
Current transfers (net)	-35 561	43 135
Balance on current account	-153 166	194474
Memo item: trade balance	39 331	?

- A negative balance on the current account indicates a **deficit** in the account. This means the money outflow (capital outflow) was higher than the money (capital) inflow.
- A positive balance indicates a **surplus** which means money inflows was higher than money outflows.

1.1 Trade account

- It is part of the current account that reflects the transactions involving exports and imports of goods (merchandise) only.
- This means only **merchandise exports**; **net gold exports** and **merchandise imports** are part of trade account.
- The trade balance is obtained by subtracting merchandise imports from the sum total of merchandise export and net gold exports.

TRADE ACCOUNT	2019	2020
Merchandise exports	1 235 964	?
Net gold exports	67 191	?
(Less) merchandise imports	1 263 824	?
Trade balance	39 331	?

- A surplus balance indicates that South Africa exported more physical goods than it imported.

2. CAPITAL TRANSFER ACCOUNT

- It contains small amounts that move between countries as a result of the transfer of fixed assets and also grants of money from a foreign charity and money that migrants move.
- For example, when a foreign foundation gives a grant for HIV research, it is a transfer receipt (inflow). When a South African emigrates to Australia, the money she/he takes out of the country is a transfer payment (outflow).

3. FINANCIAL ACCOUNT

The financial account consists of the following **sub-accounts**:

3.1. Direct investments

- An investment in fixed property in a foreign country or the acquisition of a significant share (10 %+) in a business in a foreign country.
- In cases where an individual acquires more than 50% of the business the aim of the investment is to take control of such a business.
- The investments into South Africa by foreigners represents **incurrence of liability** by South Africa. However, it (liability) is recorded as a credit (+) because money enters the country (it is a money inflow)
- Investment by South Africans in foreign countries e.g. buying of 10% or more of shares in a company in foreign country represents **acquisition of asset**.
- However, it (asset) is recorded as a debit (-) because money leaves the country for that investment to take place (it is a money outflow).
- The difference between the assets and liabilities represents **Net direct investments**.

3.2. Portfolio investment.

- The purchase of financial assets such as **equity security assets** e.g. minority shares on a stock market of another country. The percentage of such share is very small and the aim is just to make more money (unlike in the case of direct investment where the aim of buying shares is to get control of the business). Portfolio investments are regarded as “**hot money**” because they can be quickly converted into cash.
- People can also invest in **debt security assets** such government bond. Government bond involve government borrowing money from people over a period of time.
- The investor then earn interest which will periodically be paid into his/her account while the principal amount invested is still with the borrower (government). At the end of the term the government will pay back the initial amount invested to the investor (buy back the bond).
- These assets are recorded as debits when south Africans invest in other countries while they are recorded as credit when other countries citizens invest in South Africa i.e. incurrence of **liabilities** represents **money inflow** and acquisition of financial **assets** represents **money out flow**.
- **Financial derivatives**
 - An investment made in a specific asset with a fixed future value that is paid out on a specific date.
- **Other investment**
 - Transactions that do not fall under direct, portfolio and financial derivatives, are classified as other investments e.g. short term loans
- **Reserve assets**
 - Financial capital held by the monetary authorities such as the central bank to finance the trading disequilibrium.
 - Reserve assets includes foreign currency that is held by the SARB.

FINANCIAL ACCOUNT	2014	2015
Net direct investments (inflows (+) , outflows (-) [1]	-20 607	?
(Net incurrence of) liabilities	62 627	22 065
(Net acquisition of financial) assets	-83 234	-73 282
Net portfolio investments [2]	49 132	69 568
(Net incurrence of) liabilities	73 386	?
<i>Equity securities</i>	26 826	89 824
<i>Debt securities</i>	46 560	16 189
(Net acquisition of) assets	-24 254	?
<i>Equity securities</i>	-14 721	-17768
<i>Debt security</i>	- 9 533	-18677
Net financial derivatives [3]	16 409	?
(Net incurrence of) liabilities	211 251	325 738
(Net acquisition of) assets	-194 842	-320 856
Net other investments [4]	121 821	?
(Net incurrence of) liabilities	148 133	72 273
(Net acquisition of) assets	- 26 312	- 46 769
Reserve assets (decrease (-) increase (+) [5]	-16 602	9071
BALANCE ON FINANCIAL ACCOUNT (1 +2+ 3+ 4+ 5)	150153	160 242
Memo item: Balance on financial account excluding reserve assets (1 +2 +3 +4)	166 755	?
Un recorded transactions	51 298	22 709
Memo item: Balance on financial account excluding reserve assets including unrecorded transactions (1 +2 +3 +4 +6)	218 053	?

UNIT 3: FOREIGN EXCHANGE MARKETS

Foreign exchange

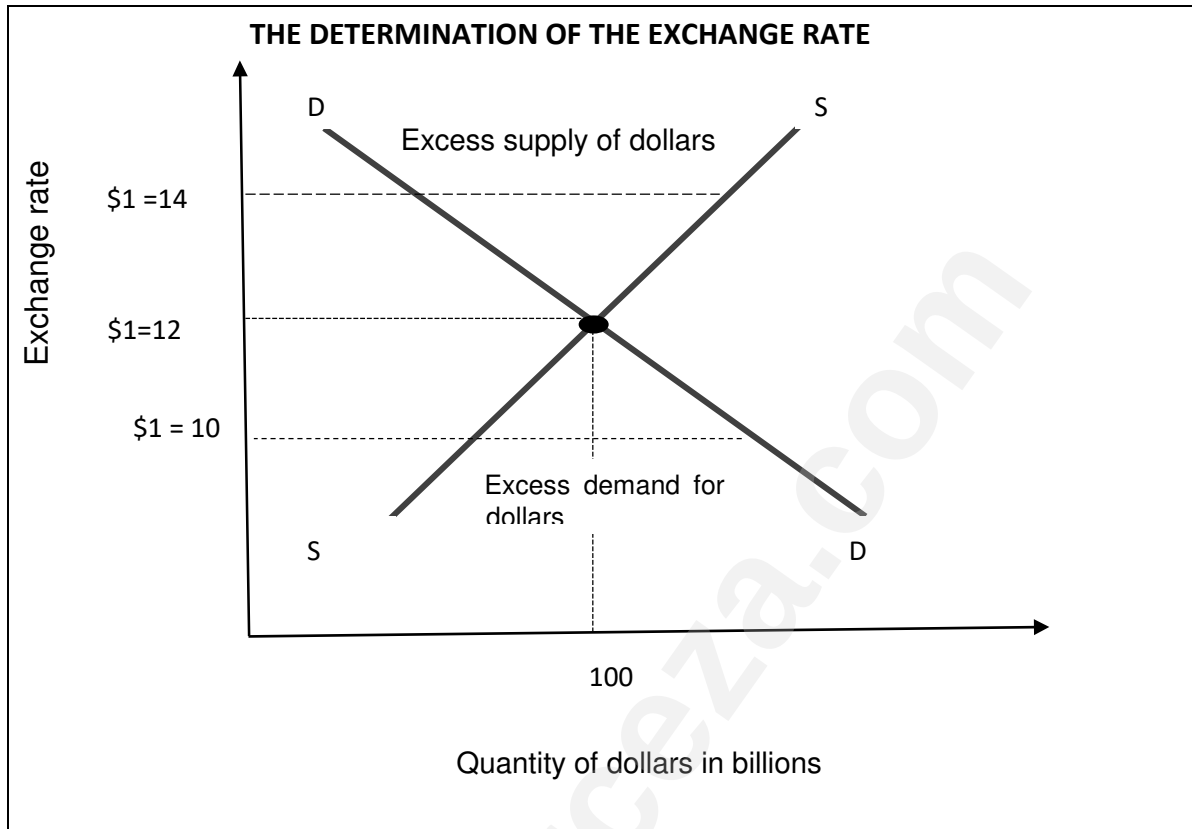
- Foreign exchange market is the market in which currencies are bought and sold.
- Foreign exchange is the process of changing one currency by another country's currency.
- Exchange rate is the price of a country's currency in terms of another country's currency
- Exchange rate can be quoted as the domestic price of one unit of a foreign currency e.g. $\$1 = R14.00$ (direct quote).
- It can also be quoted as the foreign price of the domestic currency e.g. $R1 = 0.07$ (indirect quote).

NATURE OF DEMAND AND SUPPLY OF CURRENCIES

- The market forces of demand and supply determines the value of a currency.
- The higher the price of a currency the lower the demand tend to be but, the higher the price of a currency the higher the supply tend to be. This shows that the law of demand and the law of supply also appl with currency trading.

Reasons for the demand of foreign exchange by South Africa

- Payments for imports.
- Payment for services received from foreign countries.
- Payment of interest and dividends on foreign capital invested in South Africa.
- Repayments of overseas loans.
- Transferring capital to foreign countries.
- South African spending money in foreign countries e.g. tourism
- **Reasons for the supply of foreign exchange by South Africa / (South Africa supplying its currency to foreign countries)**
 - Receiving earnings for goods exported
 - Receiving earnings for services rendered to foreign countries
 - Receiving interest and dividends on capital invested in foreign countries.
 - Repayment by foreign countries on loans made in South Africa.
 - Investments made by foreign countries
 - Foreign tourists' spending money in South Africa.



- The exchange rate is determined by the market forces of demand and supply.
- The interaction of demand and supply sets the equilibrium exchange rate at \$1 = R12
- At any exchange rate above the market equilibrium exchange rate e.g. \$1 = R14 there will be excess supply of dollars.
- At an exchange rate below the market exchange rate e.g. (\$1 = R10) there will be excess demand for dollars.

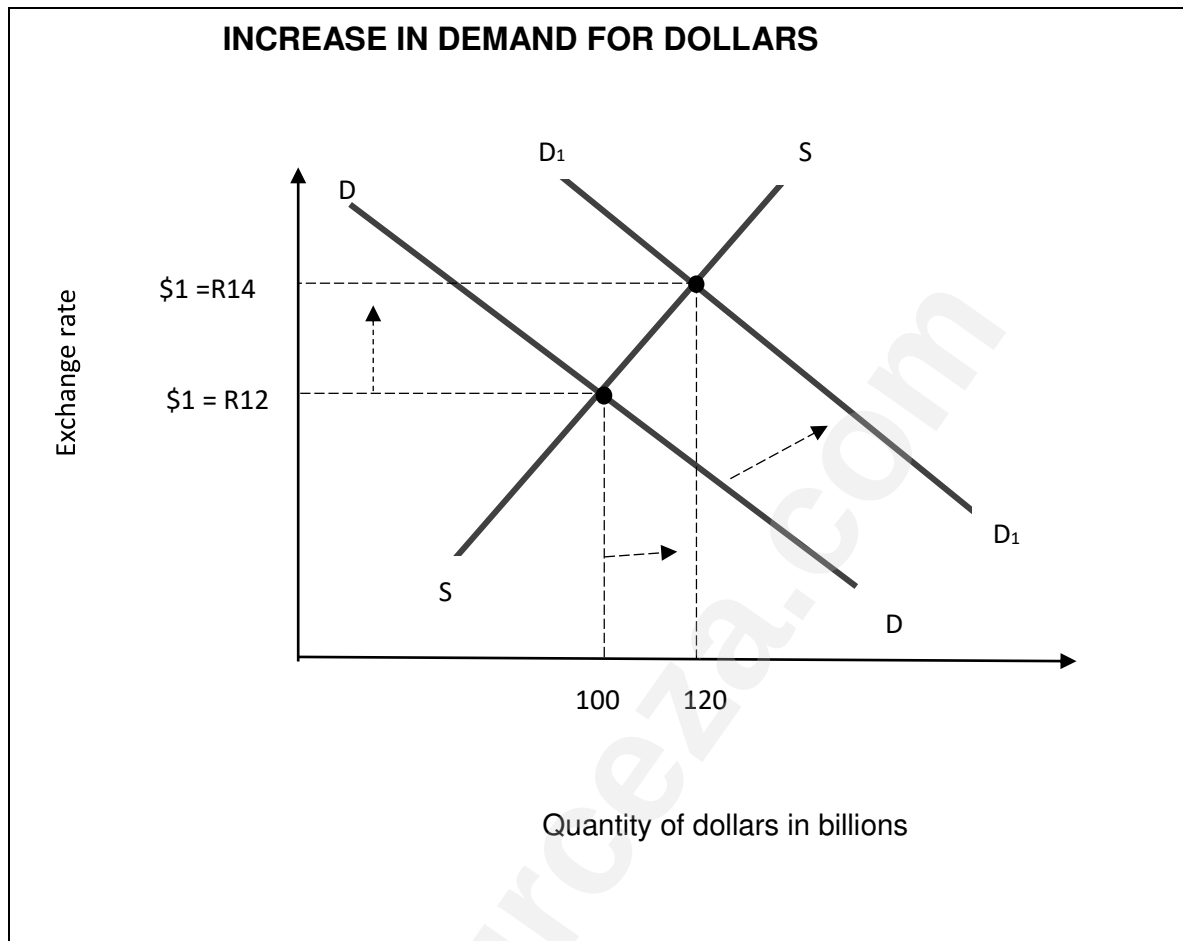
APPRECIATION AND DEPRECIATION OF A CURRENCY

Appreciation: is the increase in the value of a currency because of market forces.

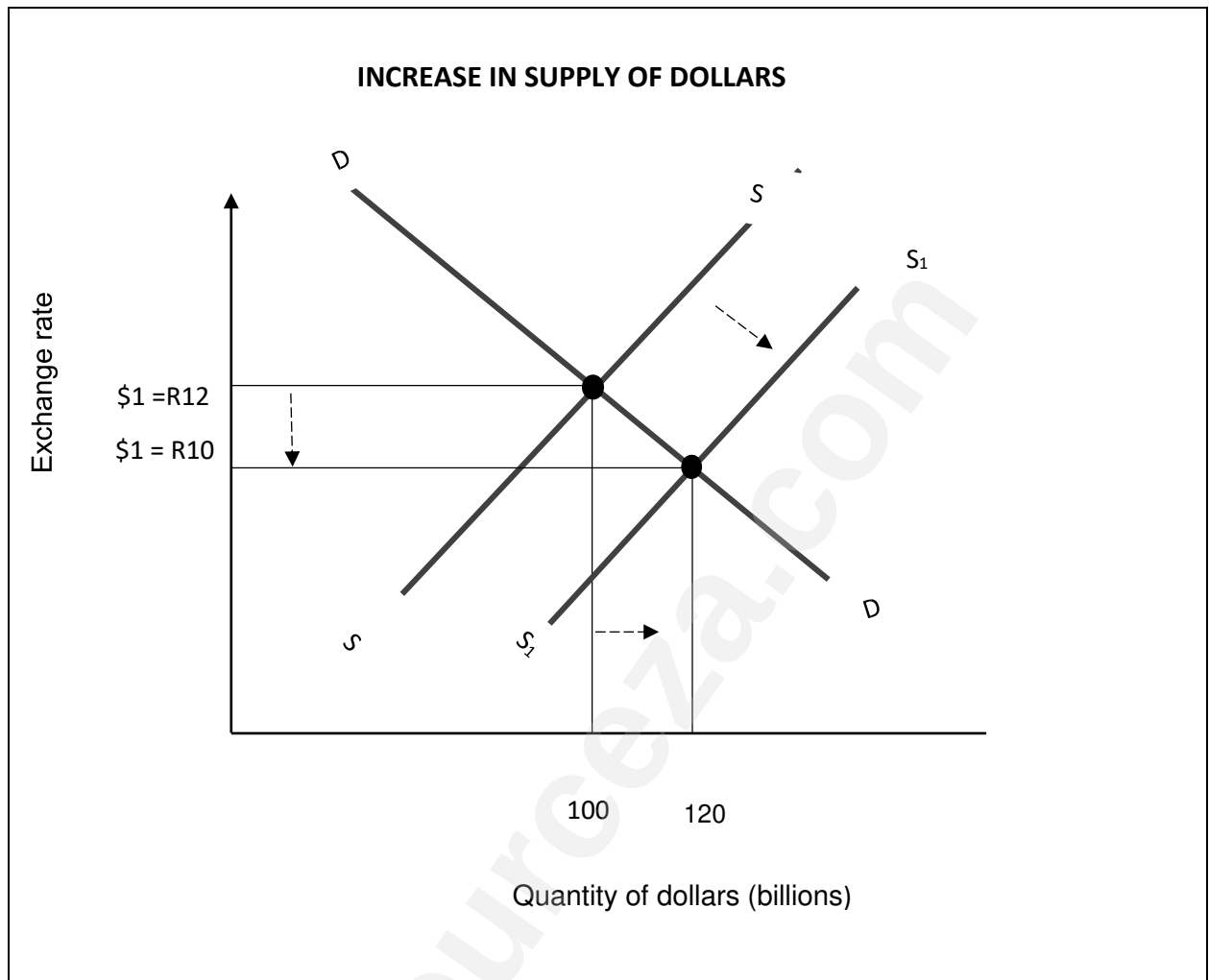
- If the dollar appreciates against the rand, it means South Africans need more rands than before to buy one dollar.

Depreciation: is the decrease in the value of a currency due to market forces of demand and supply.

- If the dollar depreciates against the rand, it means South Africans will need fewer rands than before to buy one dollar



- An increase in the demand for dollars causes the demand curve to shift to D_1D_1 and a new equilibrium exchange rate of $\$1 = R14$ is reached.
- This means the dollar appreciated (increased in value) while the rand has depreciated (decreased in value). South Africans need to pay R2 more for a dollar while Americans receive R2 more for their dollar than before.



- An increase in supply of dollars will result in the supply curve shifting to S_1S_1 .
- The new equilibrium exchange rate of $\$1 = R10$ is reached. At this point the dollar has depreciated and the rand has appreciated.
- Depreciation of the dollar means that the amount needed to buy a dollar has decreased by R2.
- The equilibrium quantity of dollars traded increases from 100 to 120 billion.

EXCHANGE RATE SYSTEM

There are **three types of exchange rates** namely:

- **Free floating exchange rate system**

- The value of the currency is determined purely by the forces of the market, which are the demand and supply of the currency
- South Africa uses the free-floating exchange rate system which means the reserve bank does not intervene to influence the value of the currency.

- **Managed floating exchange rate system**

- The value of the currency is determined by the market forces of demand and supply up to a certain limit that is set by the central bank.
- If the currency depreciates too much, the central banks of those countries often intervene by buying their own currencies in the foreign exchange market. This help to increase the demand for the currency and therefore the currency will appreciate.
- If the local currency appreciates too much, the central banks often sell their currency on the foreign exchange market, therefore increasing the supply of the currency and therefore reducing its value (depreciation).
- Majority of countries use this exchange rate system as very few countries have free floating or fixed exchange rates.

- **Fixed exchange rate system**

- The value of the currency is fixed or pegged to another country's currency usually the US dollar.
- This is often to avoid uncertainties with regard to exchange rates.
- If the government decide the amount of its currency that will be equal to one dollar.
- The government of these countries can increase the value of its currency when it sees fit and this is called **revaluation**.
- When the government feel that their currency is too strong it can decide to decrease its value, and this is called **devaluation**.

TERMS OF TRADE

- Another important indicator of how a country is performing in international trade is an index called terms of trade.
- Terms of trade is the ratio of index export prices to index import prices.
- This shows whether the country can afford to pay for its imported goods with the amount of money earned from its exports over the same period. Every country aims for index of export prices to be more than index of import prices.

- **Formula** = $\frac{\text{index of export prices}}{\text{Index of imports prices}} \times 100$

Year	Index of exports	Index of imports	Terms of trade
2005	100	100	$100 \div 100 \times 100 = 100 (1)$
2010	105	101	$105 \div 101 \times 100 = 104$
*year x	95	102	$95 \div 102 \times 100 = 93$

*year x is used for example purposes only to show a situation where export prices are lower than import prices.

- In the above example in 2005, the terms of trade indicate that the country 's earnings from exports were exactly the same as what it paid for its imports (no improvement, no deterioration/ **no** decline in welfare)
- In 2010, the country's situation improved, because it earned more money from its exports than what it paid for its imports (improvement in welfare)
- In year X, the terms of trade indicate a decrease in welfare as the amount of money earned from exports was less than the amount paid for exports (decline in welfare/ decrease in standard of living)

CORRECTION OF BALANCE OF PAYMENT DISEQUILIBRIUM

The following measures can be used to correct **the deficit** on the balance of payment.

• Interest rates

- Domestic demand can be changed by increasing the interest rates payable on credit.
- If interest rates are increased, spending including on imports can decrease.
- Foreign savers often try to take advantage by increasing their investment in the country with the higher interest rate. This will result in money inflow, therefore reducing the deficit on the BoP.

• Borrowing and lending

- Countries with surpluses often lend money to countries with deficits.
- Countries with deficits often borrow from countries with surpluses.
- In the event of fundamental disequilibrium, member countries may borrow from the IMF
- Borrowing is nevertheless not a long-term solution for a fundamental balance of payments disequilibrium.
- Fundamental disequilibrium is when the disequilibrium especially the deficit is persistent and long-term with no indication of it ending.

• Change in demand

- Change in demand is either domestic or foreign
- An increase in domestic demand cause imports to increase and this has a negative effect on the balance of the Balance of Payments.

- A decrease in domestic demand can reduce even the demand on imports. This can reduce the deficit on the Balance of Payment.
- **Export promotion**
 - Export promotion is applied to encourage the production of goods that can be exported,
 - Exports result in money inflow, and this can reduce the deficit on the Balance of payment.
- **Import substitution**
 - Government pays incentives to produce goods domestically rather than to import them.
 - This can result in less money flowing out of the country, therefore reducing the deficit on BoP.
- **Change in exchange rates**
 - The three systems of controlling exchange rates have different effects:
 - **Free-floating exchange rates.** They work automatically. If imports increase, the demand for foreign exchange increases. The currency depreciates as a result of the working of market forces. Depreciation makes imports more expensive in the depreciating country and exports cheaper in the foreign country. Imports decrease and exports increase, and the currency appreciates.
 - **Managed floating exchange rate.** Central banks use their reserves to effect depreciations and appreciations. Over the long term, currencies have to find their equilibrium levels.