



Why Countries Trade

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IF there is a point on which most economists agree, it is that trade among nations makes the world better off. Yet international trade can be one of the most contentious of political issues, both domestically and between governments.

When a firm or an individual buys a good or a service produced more cheaply abroad, living standards in both countries rise. There are other good reasons consumers and firms buy abroad—the product may better fit their needs than similar domestic offerings or it may not be available domestically. Foreign producers also benefit by making more sales than by selling solely at home and by earning foreign exchange that can be used to purchase foreign-made products.

Still, even if societies as a whole gain when countries trade, not every individual or company is better off. When a firm buys a foreign product because it is cheaper, it benefits—but the (more costly) home producer loses a sale. However, the buyer usually gains more than the domestic seller loses. Generally, the world is better off when countries import products that are produced more efficiently and cheaply abroad. The exception is if the foreign costs of production do not include social costs, such as pollution.

But those who feel they are adversely affected by foreign competition have long opposed international trade. Soon after economists such as Adam Smith and David Ricardo established the economic basis for free trade, British historian Thomas B. Macaulay was observing the practical problems governments face in deciding whether to embrace the concept: “Free trade, one of the greatest blessings which a government can confer on a people, is in almost every country unpopular.”

Two centuries later trade debates still resonate.

Why countries trade

Ricardo observed that trade was driven by *comparative* rather than *absolute* costs (of producing a good). One country may be more productive than others in all goods, in the sense that it can produce any good using fewer inputs (such as capital and labor) than other countries require to produce the same good. Ricardo’s insight was that such a country would still benefit from trading according to its *comparative advantage*—exporting products for which its absolute advantage was greatest and importing those for which its absolute advantage was comparatively less.

Though a country may be twice as productive as its trading partners in making clothing, if it is three times as productive in making steel or building airplanes it will benefit from making and exporting these products and importing clothes. Its partner will gain by exporting clothes—where it has a comparative but not absolute advantage—in exchange for these other products (see box). The notion of comparative advantage also extends beyond physical goods to trade in services—such as writing computer code or providing financial products.

Because of comparative advantage, trade raises the living standards of both countries. Douglas Irwin (2009) calls comparative advantage “good news” for economic development. “Even if a developing country lacks an absolute advantage in any field, it will always have a comparative advantage in the production of some goods” and will trade profitably with advanced economies.

Differences in comparative advantage may arise for several reasons. In the early 20th century, Swedish economists Eli Heckscher and Bertil Ohlin identified the role of labor and capital, so-called factor endowments, as a determinant

Comparative advantage

Even a country that is more efficient (has absolute advantage) in everything it makes would benefit from trade. Consider an example:

Country A: One hour of labor can produce either three kilograms of steel or two shirts. Country B: One hour of labor can produce either one kilogram of steel or one shirt.

Country A is more efficient in both products. Now suppose Country B offers to sell Country A two shirts in exchange for 2.5 kilograms of steel.

To produce these additional two shirts, Country B diverts two hours of work from producing (two kilograms) steel. Country A diverts one hour of work from producing (two) shirts. It uses that hour of work to instead produce three additional kilograms of steel.

Overall, the same number of shirts is produced: Country A produces two fewer shirts, but Country B produces two additional shirts. However, more steel is now produced than before: Country A produces three additional kilograms of steel, while Country B reduces its steel output by two kilograms. The extra kilogram of steel is a measure of the gains from trade.

of advantage. The Heckscher-Ohlin proposition maintains that countries tend to export goods whose production makes intensive use of relatively abundant factors of production. Countries rich in capital—such as factories and machinery—export capital-intensive products, while those rich in labor export labor-intensive products. Economists today think that although factor endowments matter, there are also other important influences on trade patterns (Baldwin, 2008).

Recent research shows that when trade opens up, it is followed by adjustment not only *across* industries, but *within* them as well. Increased competition from foreign firms puts pressure on profits, forcing less-efficient firms to contract, making room for more efficient firms. Expansion and new entry introduce better technologies and new product varieties. Likely most important, trade enables greater selection across different types of goods (say refrigerators). This explains the prevalence of intra-industry trade (for example, countries that export household refrigerators may import industrial coolers), which the factor endowment approach does not encompass.

There are clear efficiency benefits from trade that result in *more* products—not only more of the same products, but greater product variety. For example, the United States imports four times as many varieties (say different types of cars) as it did in the 1970s, while the number of countries supplying each good has doubled. An even greater benefit may be the more efficient investment spending that results from firms' access to a wider variety and quality of intermediate and capital inputs (think optical lenses rather than cars).

Economic models used to assess the impact of trade typically neglect technology transfer and pro-competitive forces such as the expansion of product varieties. This is because these influences are difficult to model, and results that do incorporate them are subject to greater uncertainty. Where this has been done, however, researchers have concluded that the benefits of trade reforms—such as reducing tariffs and other nontariff barriers to trade—are much larger than suggested by conventional models.

Why trade reform is difficult

Trade contributes to global efficiency. When a country opens up to trade, capital and labor shift toward industries in which they are used more efficiently. Societies derive a higher level of economic welfare. But these effects are only part of the story.

Trade also brings dislocation to firms and industries that cannot cut it. Such firms often lobby against trade. So do their workers. They often seek barriers such as import taxes (called tariffs) and quotas to raise the price or limit the availability of imports. Processors may try to restrict exports of raw materials to artificially depress the price of their own inputs. By contrast, the benefits of trade are diffuse, and its beneficiaries often do not recognize how trade benefits them.

Trade policies

Reforms since World War II have substantially reduced government-imposed trade barriers. But policies to protect

domestic industries vary. Tariffs are much higher in certain sectors (such as agriculture and clothing manufacturing) and among certain country groups (such as less-developed countries). Many countries have substantial barriers to trade in services in areas such as transportation, communications, and the financial sector; others have policies that welcome foreign competition.

Moreover, trade barriers affect some countries more than others. Often hardest hit are less-developed countries whose exports are primarily low-skilled, labor-intensive products that industrialized countries often protect. The United States, for example, is reported to collect about 15 cents in tariff revenue for each \$1 worth of imports from Bangladesh (Elliott, 2009), compared with 1 cent for each \$1 worth of imports from some major western European countries—even though imports of a particular product from Bangladesh face the same or a lower tariff than a similarly classified product imported from western Europe. World Bank economists calculated that exporters from low-income countries face barriers on average 50 percent higher than those of major industrialized countries (Kee, Nicita, and Olarreaga, 2006).

Members of the World Trade Organization, which referees international trade, are engaged in a complex effort to reduce and level out government-imposed obstacles to trade in a round of negotiations begun in Doha, Qatar, in 2001. The talks cover a wide range of issues, many of them politically sensitive, including elimination of remaining farm export subsidies, limiting domestic farm subsidies, and sharply cutting advanced economies' tariffs on farm and industrial products. Doha also seeks to address other crucial issues such as barriers to trade and investment in services, trade rules in areas such as fishery subsidies and antidumping, and customs and trade facilitation.

If successful, the Doha Round could yield hundreds of billions of dollars in annual global benefits. But some groups have sought to delay and to dilute the deal. A focus on the greater good, together with ways to help the relatively few that may be adversely affected, can help deliver a fairer and economically more sensible trading system. ■

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