CHAPTER 4
TRADE

WHAT IT'S ALL ABOUT

- Why trade is beneficial for the global economy
- Why countries specialise in what they produce
- How the trade balance is made up of exports and imports
- How currencies can affect trade
- What the current account is
- Why governments use tariffs and quotas

WHAT IS INTERNATIONAL TRADE?

Walk into any supermarket in any country today and you will see an array of produce from around the world. There might be bananas from the Dominican Republic, green beans from Kenya or mangoes from India.

The same is true when you look on the roads. There will be cars from Germany, the United States and Japan to name a few. In fact, you will see the fruits of international trade in every part of daily life as modern technology and transport means more goods are being shipped around the world than ever before. There are toys made in China, shirts made in India, flat screen TVs in Korea and so on.

Trade, or the buying and selling of goods & services, is one of the foundation stones of all economies. Early societies may have relied on barter – the simple exchange of one good or service for another. Later, commodities like gold and silver were used as a form of payment and now, of course, we use money.

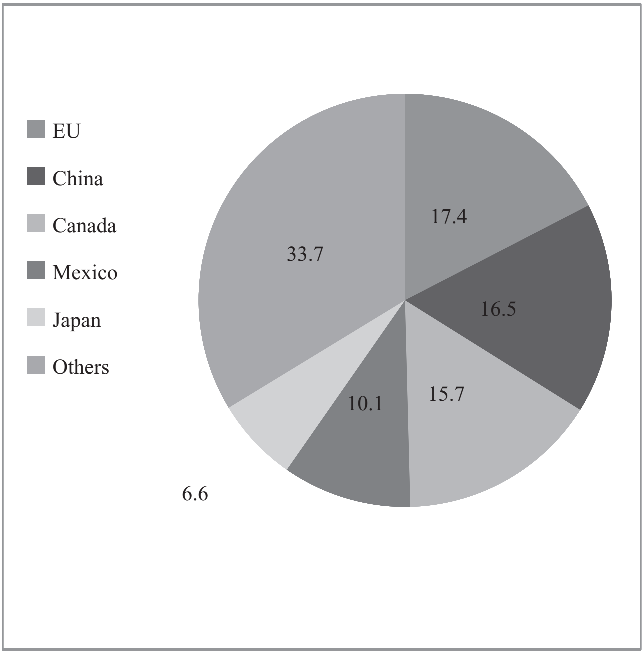
International trade is just the buying and selling of goods & services across national borders. It has also been going on for thousands of years. There is evidence of international trade routes going as far back as 3000 BC. The early Greeks would bring back spices from India. The Roman Empire created safe transportation routes so people could trade without fear of piracy.

So how is international trade different from trade within national borders? Perhaps the biggest difference is also its greatest advantage. It offers greater choice and provides a bigger market. If trade were restricted to just one country, then people would be limited to selling their goods in their home market. Think of the rush for Western companies to establish themselves in China. They are counting on being able to get a foothold selling into a market of more than 1 billion people. International trade also offers the chance to buy a bigger range of products. For example, people in France can now drink wine made in Spain, or Germany, or even New Zealand.

Another big difference is that international trade can be subject to greater regulation because it involves different countries. Each country regulates the flow of people, goods and money that passes across its borders. Within one country, it is usually relatively easy to move about or transport goods. But moving across borders is typically subject to immigration controls or customs.

In fact, some countries may throw up barriers to trade such as tariffs and quotas. The first is a tax on imported goods. The second is a limit on how much of a particular product can be brought into a country. Such measures are often referred to as examples of protectionism because countries introduce them to protect their own domestic industries or jobs.

Where the US gets its imports from



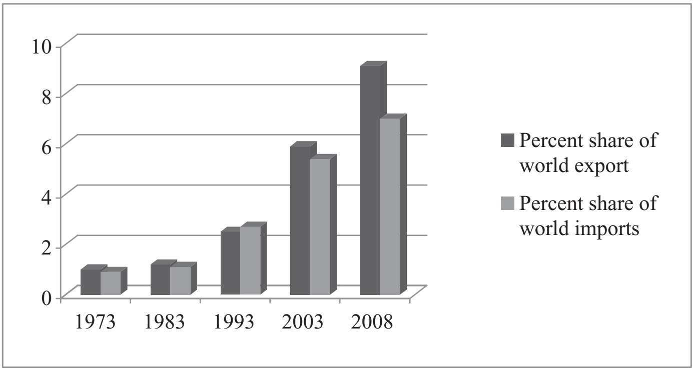
Of course, the other big difference between international and domestic trade is payment. Different countries or trading blocs tend to have their own currencies. People in the UK will have to exchange their pounds for euros if they want to buy wine from France. How many euros you get for one pound depends on the exchange rate set in foreign exchange markets. This relative price is also the result of trade flows between countries. For example, if people in the UK kept increasing the amount of wine they buy from France, they would then also need more euros. They would buy these with pounds, which would tend to push up the value of the euro against the pound.

International trade, of course, offers a much bigger marketplace but there are other reasons why countries trade with each other. The first is that different countries have different natural resources. Some countries may have very fertile farmland or have huge supplies of copper or gold. The Gulf states in the Middle East, for example, have oil. This is a very valuable commodity and many countries import their oil from these countries, making the oil exporters very rich in the process.

A second relates to difference in preferences. Even if countries had access to the same natural resources, they might trade with each other because they liked different things. For example, suppose the UK and France produce around the same amount of beer and wine. But the British like beer more and the French prefer wine. The British could sell their wine to the French and buy beer. Both sides would gain as a result.

One of the most important reasons for international trade, however, is the difference in costs. For example, salaries in China are much lower than they are in western countries. It is therefore much cheaper to manufacture goods in China which can then be sold at a lower price. That is why so much more manufacturing is now done

China's rising share of world trade



in countries like China or India and the goods they make exported to parts of the world where labour costs are higher.

Trade is also one of the surest ways out of poverty for many developing countries. This might be through the export of things like fruit and vegetables. Or it could be through manufactured goods utilising the cheaper labour that usually exists in those countries. Increased trade between countries is also likely to bind them together and reduce the likelihood of conflict.

While most economists preach the virtues of free international trade, some governments and special interest groups want to curtail trade if they feel it is costing jobs or hurting industries in their home countries. For example, India used to put very high duties on imported

WHO SAID IT

"No two countries that both had McDonald's had fought a war against each other since each got its McDonald's."
– Thomas Friedman

cars until the 1990s so that its consumers would buy cheaper domestically-made cars instead. In recent years, US politicians have been worried that cheap labour in China is driving production there and leading to the closure of factories in America.

COMPARATIVE ADVANTAGE

The English economist David Ricardo came up with perhaps the most persuasive argument about the benefits of international trade back in the 1800s. His principle of comparative advantage states that a country will benefit from producing and exporting any goods which it can make at a lower relative cost than other countries. Similarly, the country will stand to gain from importing a good that it makes relatively more expensively than other countries. What's more a country can gain from importing even if it can make those goods cheaper than anyone else.

The important concept here is what economists call opportunity cost. The opportunity cost of a good is the quantity of other goods that have to be sacrificed to produce another unit of that good. So according to the principle of comparative advantage, countries will gain when they export goods that have a lower opportunity cost than other countries.

Think of it like this. Imagine for simplicity's sake, there are only two countries – Country A and Country B. There are also only two types of goods – TVs and DVD players. It takes 30 hours of labour in Country A to make one TV and five hours to make a DVD player. In Country B, it takes 60 hours of labour to make one TV and six hours to make a DVD player.

On the face of it, Country A can make TVs and DVD players at less cost in terms of hours worked than Country B. That is what economists call absolute advantage and you would think there is no reason for Country A to trade.

But now think of it in terms of opportunity cost. Country A has to give up 6 DVD players for every TV it makes as that is the number it can make in the same time it makes a TV. But Country B has to sacrifice making 10 DVD players to make one TV.

So the opportunity cost of making a TV in Country A is 6 DVD players while the opportunity cost of making a TV in Country B is 10 DVD players. That shows that Country A has what economists call a comparative advantage in making TVs over Country B because it make them at a relatively lower cost.

Similarly, Country B has a comparative advantage in making DVD players because its opportunity cost for making one DVD player is 1/10 of a TV while the opportunity cost for Country A of making one DVD player is 1/6 of a TV.

So according to the principle of comparative advantage, Country A should specialise in making TVs and Country B should specialise in making DVD players. For example, if Country A makes 10 TVs, it has to give up 60 DVD players. But to make 60 DVD players, Country B only has to give up 6 TVs. So if both countries specialize, there

The principle of comparative advantage

	Hours needed to produce 1 unit	**Opportunity cost**
Country A		
TVs	30	6 DVD players
DVD player	5	1/6 of a TV
Country B		
TVs	60	10 DVD players
DVD players	6	1/10 of a TV

WHO YOU NEED TO KNOW

David Ricardo

David Ricardo's ideas have had a huge impact on economic thinking. The third of 17 children, Ricardo came from a Jewish family of Portuguese origin. He was born in London and followed his father to become a successful stockbroker. He amassed a huge personal fortune, in part by betting against a French victory at the Battle of Waterloo by investing in British securities.

Ricardo later became a member of parliament and started publishing papers on economics that still exert a massive influence on thinking to this day. He is perhaps best known for his theory of comparative advantage first advanced in his book *Principles of Political Economy*. According to the theory, even if one country could produce every good more efficiently than another country, it could still benefit by specialising in what it is best at producing. Ricardo's arguments are still used as a defence of free trade.

He also gave birth to the term Ricardian Equivalence – the theory that tax cuts today may have no effect on the economy now, because people will assume that they will have to pay for them in the future.

Ricardo also wrote widely on rent, wages and profits. For example, he stated that as real wages increase, real profits decrease because the revenue from the sale of manufactured goods is split between profits and wages.

can be extra TVs with no loss of DVD players. These are the gains of international trade.

It was in this way that Ricardo proved that all countries stood to gain from international trade even if one country had an absolute advantage in producing every good.

While Ricardo's model assumed that it was technological differences between countries that led to one having a comparative advantage over another, Swedish economists Eli Heckscher and Bertil Ohlin put forward a theory based on what economists call the factors of production of a country. These are the resources a country has available to make things, such as the amount of capital, labour or land. The Hecksher-Ohlin model, first developed in the 1930s, says that countries will export products that use their abundant factors of production and import those products that depend on scarce resources.

For example, India has a much bigger and cheaper workforce than the UK. The UK, however, has much more capital or machinery per worker so the relative cost of capital is cheaper. According to the Hecksher-Ohlin model then, it would make sense for the UK to specialise in making goods that were capital-intensive or required a lot of machinery. India, on the other hand, would be better off exporting goods which were much more labour-intensive as that's what it has in greater supply.

Of course, the world is not as simple as the two-country, two product models we've been looking at. Still, the principles can be extended to many countries. Just think of Country A as one country and Country B as the rest of the world. The concept can also be applied to many goods which are then arranged according to the comparative advantage of each.

There are, however, some more wrinkles as the theory of comparative advantage relies on assuming that there is a perfect market. In reality, prices and wages can take a lot of time to adjust. The model also takes no account of the business cycle – the notion that economies go up and down over a period of time. Nor does the model account for the effect on different people or sectors in the economy.

For example, a country might benefit overall from trade if it imports toys from another country where they are cheaply made. But that could still put the people who make toys in the first country out of business and they might not necessarily be able to transfer their skills to another industry. Still, the theory of comparative advantage to this day provides a useful benchmark for thinking about the benefits of international trade.

THE BALANCE OF PAYMENTS

Most modern economies are classed as open economies because they are open to international trade. One way of looking at how open they really are is to consider the total amount a country spends on imports as a proportion of its total spending (this of course took a knock during the financial crisis).

This brings us on to how economists keep track of what is going on with international trade. There are a variety of different items that together make up what is known as the balance of payments. First of all, you will hear about the trade balance. The trade balance is the value of exports minus imports. Statisticians tot up the value of all a country's exports and subtract that from the total value of imports. So if a country exports more than it imports, the trade balance will be positive. That is known as a trade surplus. The reverse of this is a trade deficit when the value of imports exceeds that of exports.

Economists also like to distinguish between the goods & services trade balance. The goods trade balance is relatively straightforward. It measures exports and imports of merchandise – this could include raw materials like oil or manufactured goods like toys and cars. The goods or merchandise items are also sometimes called visibles because you can see them – they are visible.

This differentiates them from the invisibles balance, which is made up mostly of trade in services. This consists of things like banking or insurance or even hairdressing and can, particularly in the modern world, form a very important part of international trade. For example, the UK has for several years run a goods trade deficit because it tends to import more goods than it exports. This is probably a consequence of a long-run decline in the importance of manufacturing. But it has tended to run a surplus on the services trade balance because of its banks and other financial services firms selling their services abroad.

In addition to the goods & services balance, the balance of payments also includes transfer payments. These are cash transactions which do not form payments for goods or services. Foreign aid to another country would be categorised as this. Another example is the payments European Union countries make to the running of the economic bloc's budget.

Then there is investment income which measures the earnings received on foreign investments less the earnings paid to foreigners on their investments in the home country. Together these four items (goods, services, income and transfers) make up what economists call the current account of the balance of payments. If the current account is in surplus, it means that a country's income exceeds its spending. If the current account is in deficit, then spending exceeds income.

The final piece of the balance of payments is the capital account. This is where economists record all international financial transactions. For example, if a UK company were to buy a French company, it would show up in the capital account. Japanese investors buying UK government bonds or company stocks would also be recorded in the capital account.

The sum of the capital and current accounts is called the balance of payments and technically should come to zero. Think of a current account surplus like a country's savings as it is the amount by which its international income exceeds its expenditure. A deficit, on the other hand, means there is a shortfall of cash. That money has to be either borrowed or paid for by the sale of assets. Either way, that should show up in the capital account which measures financial transactions.

Suppose the US has a current account deficit of $100 billion, perhaps because it is spending more on buying imports than it is on exporting. To plug the gap, it can either borrow that money or sell assets. Either of these will be recorded as a credit on the capital account because it brings money into the country.

That is why the current and capital account must sum to zero. Of course, in practice, they may not actually add up as such because of recording errors. The residual balance is often called a statistical discrepancy or balancing item.

You can see from the chart below how the balance of payments is made up. Adding together the goods & services balance together with transfer payments and investment income gives you the current account. The balancing item then makes sure the sum of the current account and the capital account comes to zero.

The balance of payments

	Trade in goods balance	-20
plus	Trade in services balance	4
plus	Transfer payments	2
plus	Investment income	6
equals	CURRENT ACCOUNT	-8
equals	CAPITAL ACCOUNT	5
plus	Balancing item	3
	BALANCE OF PAYMENTS	0

Financial markets tend to focus on both the goods trade balance numbers and the wider current account numbers because they can have a significant effect on exchange rates. Both can also be very politically sensitive. While the balance records a country's accounts with the rest of the world, the breakdown of the data released by statistics offices will often also show the position with individual countries. So, for example, we might want to look at the US-China bilateral trade balance, or the UK's trade balance with countries just in the European Union.

CURRENCIES AND TRADE

No discussion of trade would be complete without talking about currencies. Foreign exchange rates strongly affect, and are strongly affected by, a country's trading patterns. Payment in different currencies is a defining feature of most international trade outside of currency blocs like the euro zone where all countries use the same currency – in this case, the euro.

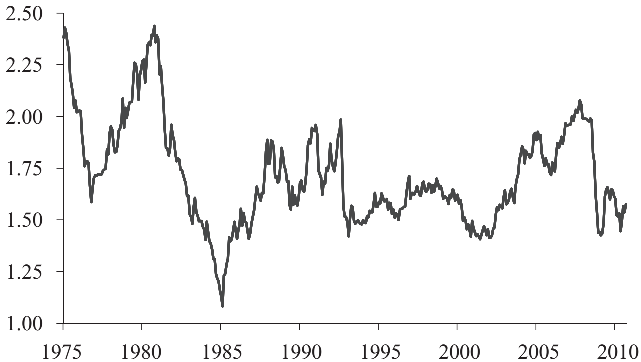
The foreign exchange rate is the price of one currency against another currency. Suppose there's a UK company importing wine from France. It needs to know how many euros it will get for its pounds and the French company needs to know how many pounds it will get for its euros.

Now suppose the exchange rate starts off with one pound buying 1.50 euros and a bottle of French wine costs 5 euros. It will cost the UK company £3.33. Suppose the pound goes up in value – it appreciates. It now buys 1.75 euros. This means that the UK company will be able to get the same bottle of wine for £2.85. The bottle of wine has become cheaper for the UK company. It can get more wine for the same money, thereby pushing up international demand for French wine. Now suppose instead the pound goes down in value, or depreciates, to 1.25 euros. That makes the bottle of wine more expensive (£4) and will thus lower international demand for French wine.

You can see from the above example that the exchange rate can have a real effect on demand for traded goods. When the value of a country's currency goes up, it makes imported goods cheaper, increasing demand for them. But if the currency goes down, then imports became more expensive eventually and so less desirable. Similarly, a country will see demand for its exports go up when its currency weakens and vice versa.

So a fall in a country's exchange rate should push the surplus higher or deficit lower because it cuts imports and raises exports. A rise in the exchange rate, on the other hand, should raise the deficit or lower the surplus because it raises imports and cuts exports.

Sterling's exchange rate with the US dollar since 1975



GOING BACK TO BALANCE

Most advanced economies like the UK and US have what economists call floating exchange rates. That means their value is set by supply and demand without government intervention. Some countries, however, opt for what is known as a fixed exchange rate. Under a fixed exchange regime, the government or the central bank is committed to maintaining a particular rate or range for its currency against another currency.

It will thus buy and sell its currency to try to preserve that rate. So if people were selling its currency so much that its value would fall below the fixed rate, then the central bank would step in and buy as much of the currency needed so it stayed at the fixed rate.

Of course, there are times when it might not be feasible for the government to maintain a fixed exchange rate despite its intervention. In September, 1992, Britain was a member of the European Exchange Rate Mechanism (ERM) – the system of fixed exchange rates that preceded the launch of the euro in 1999. That meant the pound's value was fixed to other currencies in the ERM. But traders in foreign exchange markets kept selling the pound because they were not convinced the fixed exchange rate would stick, forcing its value down. The Bank of England spent billions trying to defend the value of the pound but in the end the government had to admit defeat and pull out of the ERM.

Finally, some countries may also adopt what is known as a dirty or managed float of their currency. In this regime, the government or the central bank may regularly intervene in the foreign exchange markets, perhaps to stop its currency rising too much and hurting the prospects of its exporters, but there is no set rate.

We saw earlier how the value of the exchange rate can affect the trade balance or the current account. But the trade balance and current account can also have significant effects on the exchange rate.

Imagine there are only two countries – the US and Japan. Both countries have their own exchange rates – the dollar and the yen. Now suppose the US is running a trade deficit so its imports from Japan exceed its exports to Japan. US companies need to sell more dollars to get yen than Japanese companies need dollars to pay for their imports of American goods. This means there is an excess supply of dollars and an excess demand for yen. As we have seen a number of times already, the price of everything is determined by supply and demand. So it should come as no surprise that the value of the dollar should fall against the yen.

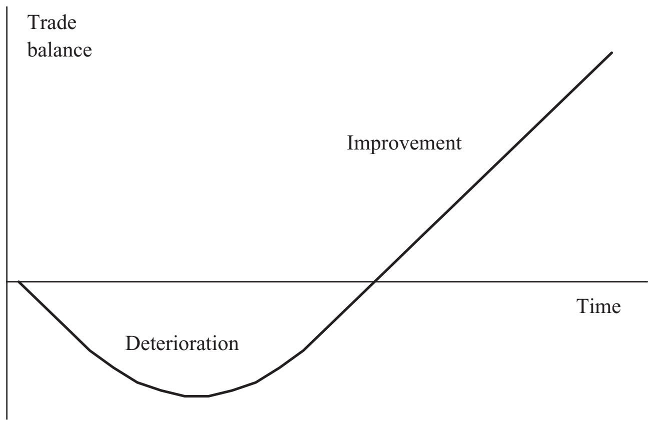
In brief: if a country runs a current account deficit, its currency should depreciate or fall in value because it implies there is an excess of its currency available as money leaving the country is outstripping that coming in. Similarly, if a country is running a surplus, its currency should appreciate or rise in value.

In economic theory, in a world of floating exchange rates, this should ultimately restore deficits and surpluses to balance. To see this let's return to our example of the US and Japan. The fall in the value of the dollar will make imports from Japan more expensive. The US will therefore cut the amount it imports. At the same time, its exports to Japan will have become cheaper. Japan should increase the amount of US exports it buys. This will reduce the trade deficit until it comes into balance.

In reality, however, life is much more complicated. Firms may take a long time to adjust the amount of goods they buy or sell because of changes in the exchange rate. In fact, it is possible that if a currency depreciates, the trade balance will initially fall. This is because the immediate effect of the currency depreciating is to make imports more expensive and exports will sell for less foreign currency while their volumes initially remain the same.

Economists call this effect the J-curve (the graph below) as the trade balance initially dips when the currency falls but then starts rising as firms adjust the amount of imports and exports being bought and sold.

The effects of a currency change: The J curve



Firms may also try and offset their exposure to fluctuating currencies by hedging. This involves taking a position in one market to protect against losses in another. Firms may, for instance, lock in an exchange rate for a transaction to occur in the future – this is known as a forward contract.

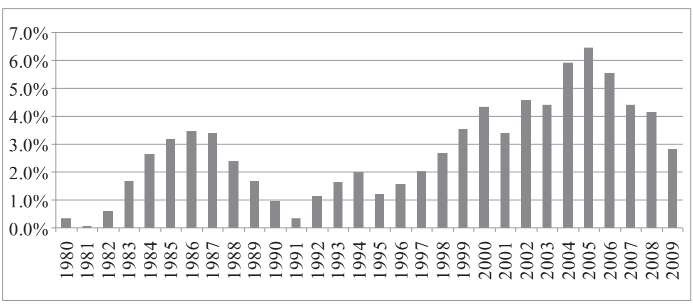
Moreover, the value of the currencies in the modern world is set in the global foreign exchange market where a few trillion dollars are traded every working day. Traders operating in giant financial institutions can buy and sell securities from around the world at the touch of a button.

Given this, changes in the value of the exchange rate tend to be driven much more by financial transactions. Suppose a US bank wants to buy stock in Japanese companies. It will need yen to do this and so will sell dollars in exchange. The effect will be to lower the dollar versus the yen.

Nowadays, freely moving capital around the world means that countries can run current account deficits indefinitely as long as the gaps are being financed by a surplus on the capital account.

The United States is a good example of this. It has been running a current account deficit for a long time as its imports vastly exceed its exports. In one respect, it is living beyond its means. Now you might expect this situation would result in there being an excess supply of dollars available on the market, which would then push the US currency down.

The US current account deficit as a percentage of GDP



But remember the financial account is the mirror image of the current account. People outside the US, most notably China, are using their surplus money to buy US Treasuries, essentially IOUs from the US government. Current account surplus countries like China therefore are financing the US current account deficit.

PURCHASING POWER PARITY

Exchange rates may be set by supply and demand but how do we know what a fair value is for any currency? Economists like to use a concept called purchasing power parity (PPP) to assess the relative value of currencies. This looks at the buying power of a currency so if an item cost £10 in the UK and $20 in the US, a fair exchange rate should be $2 to the pound, according to PPP theory, which, of course, looks not just at one pair of prices but lots of them.

In reality, however, the prices of the same good can vary wildly across different countries depending on its supply, the demand for it, the cost of production, consumer incomes, etc. Prices can even vary significantly between regions in the same country or even city. For example, the price of a meal out will tend to be much higher in London than in the north of England as restaurateurs have to make up for things like higher rents and labour costs.

To get round this, the Economist magazine reports the Big Mac index. This looks at the cost of a McDonald's hamburger across the world to come up with an assessment of a fair value for the currency on the assumption that the Big Mac is a generic good that is available internationally.

So if a Big Mac cost $3 in the US and £2 in the UK, then the exchange rate can be determined as £1 equals $1.50. However, even this approach has limitations because while McDonald's' hamburgers are considered a cheap fast food in most Western countries, they are more of a luxury item in some developing countries. For example, in India, McDonald's' restaurants are usually only found in upmarket shopping areas and its clientele tends to be affluent young people.

THE ASIAN CRISIS

We saw earlier that a country can run a current account or trade deficit for a while as long as foreign investors are willing to finance that deficit by lending it money. That does mean, however, that countries can become reliant on that funding. The US therefore needs China to keep buying its government bonds. If China stopped buying US securities, the result could be a drop in the value of the dollar.

The Asian financial crisis in 1997 is a lesson of what happens when capital flows dry up. Thailand then became a victim of what economists refer to as a balance of payments or currency crisis.

All through the early 1990s, Asian economies like Thailand, Korea and Indonesia had been doing spectacularly well and growing strongly. But they had also been running big current account deficits while unofficially fixing their currencies to the dollar. Through that time they witnessed strong capital inflows as they looked abroad to finance expansion.

As their exchange rates were fixed to the dollar, the Asian economies were able to benefit from the weakness of the US currency in the early 1990s. That meant they were weaker against the Japanese yen, the main trading currency of the region and thus able to boost their share of exports. But when the trend in the dollar changed in 1995, they found their currencies appreciating against the yen, cutting their share of trade at a time when their current account deficits were already running high.

Capital flows began to fall as higher interest rates in the US started attracting more money there. The Thai currency, which was fixed to the dollar, was under particular downward pressure from speculators. The authorities then had to raise interest rates themselves to stop money flowing out of the economy. This damaged the economy further and increased bankruptcies until the authorities could no longer maintain the fixed exchange rate to the dollar in July 1997.

The result was an instant fall in the value of the currency. That meant the foreign debt they had was even more costly in terms of the domestic currency, triggering more defaults and bankruptcies. The crisis then spread to other Asian countries, leading to a number of currencies losing as much as half their value.

The International Monetary Fund (IMF) established bailout packages for the stricken countries but demanded tough conditions such as higher interest rates to restore confidence in the domestic currency. These measures were regarded as controversial as some economists argued they exacerbated the recessions in those countries.

PROTECTIONISM

The Asian crisis led to many people criticising speculators in financial markets. Blame was laid at the door of so-called 'hot money' that flowed freely from one capital market to another. Some people argued that greater controls should be put in place to prevent such volatile flows.

True or not, recessions or crises often lead to calls for protectionism in trade policy. While economists may argue that trade and open markets are beneficial to the world economy as a whole, it may well be the case that not everyone gains. For example, Americans may benefit from cheaper clothes made in China but factory workers who used to make those clothes in the US may lose their jobs.

Governments, therefore, often put in place restrictions to protect particular industries or groups. The most common of these is a tariff or import duty. By imposing a tax on certain imported goods, governments can make them more expensive in the hope that it will cut demand for the import and shift it to the domestically-produced good.

WHO YOU NEED TO KNOW

Paul Krugman

University of Princeton professor Paul Krugman grew up in New York and studied at the University of Yale before getting his PhD from the Massachusetts Institute of Technology in 1977. He has taught there as well as the London School of Economics, Stanford and the University of California at Berkeley.

The author of 20 books, Krugman also writes a regular column in the *New York Times* on current economic and political issues. His blog is also very widely read, making him one of the best-known modern-day economists.

Krugman won the Nobel Prize in 2008 for his contribution to international trade theory. He argued that Ricardo's theory of comparative advantage, where each country specialises in producing the item that it can make relatively cheaper, did not fully capture the reasons for production in international trade. He argued that brand preferences also played a part and that countries would produce those things which afforded them economies of scale – that is mass production became cheaper for them.

During the 1997 Asian crisis, Krugman advocated currency controls as a way to mitigate the crisis. Only Malaysia followed that course and its government has credited the policy with helping it through the crisis. Krugman was also a stern critic of former US president George W. Bush. His best-selling book, *The Great Unravelling*, argued that the large deficits of the Bush administration in the early 2000s were unsustainable and would eventually generate a major economic crisis.

For example, India imposes a duty of above 100% on imported wine and spirits. That means if a bottle of whisky normally cost the equivalent of £10, duty would add at least another £10. This makes imported spirits in India very expensive compared with domestically-produced liquor. Consumers therefore are likely to choose the Indian-made spirits over imports, protecting domestic jobs and firms.

Arguments made in favour of tariffs often include that they are needed to protect particular ways of life or craftsmanship; that they nurture fledgling industries; and that they ensure scarce resources in poor countries are not frittered away on luxury items. However, if every country tried to protect their domestic industry, there would be less international trade and the world economy would be the loser.

WHO SAID IT

"The philosophy of protectionism is a philosophy of war."
– Ludwig von Mises

Quotas are another form of protectionist trade policy. In this case, there is a limit, or quota, put on the amount of a good that can be imported. This also has the effect of raising the domestic price of the imported good because its supply has been restricted. For example, the European Union has ceilings on poultry imports.

Another example of how imports may be restricted is the existence of non-tariff barriers. These may be things like delays clearing imports through customs which make them less attractive. The government may ask for goods to meet particular specifications that foreign producers may be less aware of or unable to match.

Governments may also try and support their exporters through subsidies. These are grants or other government assistance to domestic firms who are competing with foreign firms. This has the effect of lowering the price the domestic firm can charge so as to make it more competitive against foreign firms. The European Union's Common Agricultural Policy is an example of such a subsidy.

Exchange rate management may be another way that governments can boost their exports or cut down on imports. For example, China has a fixed exchange rate to the dollar. Many US politicians have argued that the Chinese have unfairly benefited by keeping the rate of their currency lower than it should be, thereby boosting Chinese exports.

So what stops governments from always using tariffs, quotas or subsidies to help their own economies? In fact, there was a school of thought known as Mercantilism which flourished in Europe from the 16th to the 18th centuries that believes that governments should restrict imports and encourage exports. Well, if everyone put up barriers to trade, there would be no trade left. Trade wars would make the global economy a poorer place.

GLOBAL TRADE DEALS

This is where the World Trade Organisation (WTO) comes in. It officially came into being in 1995 when it replaced the General Agreement on Tariffs and Trade (GATT) which had been set up after World War Two. Its purpose is to create the rules for the multilateral trading system through a system of agreements that are signed up to by the majority of the world's economies. It has more than 150 member countries and covers 97% of world trade.

Since 2001, the WTO has been trying to clinch a global trade deal called the Doha Round after the Qatari city where the initial meeting took place. The avowed purpose is to spread the benefits of globalisation to poorer countries and break down trade barriers. The debate has been very contentious, however, with developed and developing countries finding it difficult to establish common ground on a variety of issues such as agricultural subsidies in the rich world.

Global imbalances are another issue which policymakers have been unable to come up with a satisfactory solution to. By this they mean that certain countries like the US have big current account deficits which are then matched by equally large current account surpluses in countries like China.

Many economists say this is a situation that can't go on indefinitely and makes the world more susceptible to crises as it is overly reliant on the US consumer. So far, however, there has been little progress in tackling the imbalances which have become a feature of the world economy for more than a decade.

Despite these concerns, international trade continues to improve the lives of billions of people on the planet by increasing the overall wealth in the global economy. For many countries, it remains the only route out of poverty and the remarkable advance of economies like India and China shows just how powerful a force it can be.

WHAT YOU NEED TO READ

- The World Trade Organisation has a comprehensive website discussing its aims and has articles on live issues in international trade: *www.wto.org/*.
- For a scathing criticism of the policy failures of organisations like the International Monetary Fund and their role in the Asian crisis, read *Globalization and Its Discontents* by former World Bank chief economist Joseph Stiglitz, WW Norton and Co, 1996.
- Nobel Prize-winning economist Paul Krugman has a provocative blog where he regularly discusses international trade and other economic policy issues: *www.krugman.blogs.nytimes.com/*.
- Economist David Ricardo's original 1817 work *On the Principles of Political Economy and Taxation* is still an incredibly elegant exposition of his trade and other economic theories. Prometheus Books, 1996.
- For an interesting take on the emergence of China as the big economic superpower, try *China Inc* by Ted C. Fishman, Simon and Schuster, 2005.

IF YOU ONLY REMEMBER ONE THING

International trade is the buying and selling of goods between different countries. The trade balance is the difference between exports and imports. A country can run a current account deficit as long as other countries are willing to finance that deficit.