Why Nations Trade

by Adam Gonnelli

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Summary

International trade occurs because there are things that are produced in a particular country that people in other countries desire to purchase. Trade provides people with a greater collection of goods and services to choose from, often at lower costs that at home. There are two principle reasons why nations trade: comparative advantage and economies of scale. In this selection, Adam Gonnelli discusses the concepts of comparative advantage and economies of scale, what causes them, and their impact on international trade patterns.

International trade occurs because there are things that are produced in a particular country that individuals, businesses and governments in other countries want to buy. Trade provides people with a greater selection of goods and services to choose from, often at lower costs than at home. But what makes trade profitable and productive for both trading partners?

In order to become wealthier, countries want to use their resources—labor, land and capital—as efficiently as possible. However, there are large differences in the quantity, quality and cost of different countries' resources. Some countries have natural advantages, such as abundant minerals or a climate suited to agriculture. Others have a well-trained workforce or highly developed infrastructure, like good roads, advanced telecommunications systems and reliable electric utilities, that help the production and distribution of goods and services.

BENEFITS OF SPECIALIZATION

Instead of trying to produce everything by themselves, which would be inefficient, countries often concentrate on producing those things that they can produce best, and then trade for other goods and services. By doing so, both the country and the world become wealthier.

Through specialization and trade, the supply of goods increases; more supply tends to bring prices down, making the goods more affordable. In addition, trade provides a wider variety of goods to consumers: salmon from Scandinavia, bananas from South America and cameras from South Korea, to name just a few of the many thousands of products that trade makes available. If countries did not engage in trade and instead limited their consumption to what they produced at home, consumers would not live nearly as well.

Today, most industrialized nations could produce almost any product they chose. For instance, the United States could conceivably devote all of its resources to the production of tropical fruits. The United States could compensate for an unsuitable climate in certain areas by clearing and fertilizing land, building hothouses, developing new irrigation techniques and retraining workers—no tropical fruit would ever need to be imported and there would plenty left over to export.

However, this does not make good economic sense. Much of the labor, land and capital that would have to be directed toward the tropical fruit industry could be used more efficiently in other industries. Countries achieve greater total wealth by devoting more resources to their most productive industries.

LAW OF COMPARATIVE ADVANTAGE

But what happens when everything a country produces can be produced more efficiently somewhere else? Does this mean that there is no possibility for profitable trade with other countries?

The answer is no. According to the Law of Comparative Advantage a country can profit from international trade even when everything it produces can be produced more efficiently by other countries. A country maximizes its wealth by putting its resources into its most competitive industries, regardless of whether other countries are more competitive in those industries.

Suppose Cottonland produced

both cloth and furniture better than Woodland:

	Cotton-land	Wood-land
Bales of cloth per day	10	2
Pieces of furniture per day	5	3

Cottonland has an absolute advantage—it is more efficient—in the production of both products. However, to achieve greater wealth, each country should specialize in producing that item in which it has a **comparative advantage**, or greatest advantage among the products it produces. Cottonland should continue to make cloth and trade for Woodland's furniture. Woodland should concentrate on producing furniture and trade for cloth. If resources are channeled into the most productive enterprises in each country, there will be more products to trade.

Let's look at it in terms of opportunity cost, or the cost of *not* transferring resources. Cottonland is twice as efficient at producing cloth as furniture, so each time it produces a piece of furniture, it could have produced two bales of cloth instead. In contrast, Woodland is one-and-a-half times as efficient at producing furniture as cloth (three pieces and two bales each day). Each time Woodland produces a piece of furniture, it misses out on the production of only two-thirds of a bale of cloth. Since its missed opportunity for production is less than Cottonland's, it makes sense for Woodland to make the furniture.

BENEFITS OF DIVERSITY

While it makes good economic sense to put resources into the most productive industries, no country wants to rely on only one product. Specialization in the production of one, or too few, goods makes a country more vulnerable to changes in the world economy, such as recessions, new trade laws and treaties, and new technologies. If a country relies heavily on producing a single product and demand for that product suddenly drops because another country produces a less expensive alternative, or if trade is restricted, the economy could be devastated. For example, several Middle Eastern countries rely on oil for more than 90 percent of their exports; to a large extent the economic fortunes of these countries rise and fall with the oil market.

In addition, the degree to which countries specialize is influenced by that country's **terms of trade**. A country's terms of trade reflect the relative prices of a country's imports and exports. In general, it is most advantageous to a country to have declining import prices compared with the prices of its exports. Exchange rates and productivity differences affect the terms of trade more than any other factors.

By developing a diverse economy, a country can make sure that even if some industries are suffering, other, more prosperous industries will keep the economy relatively healthy. Larger, more developed economies, like those of the United States, Japan, Germany and Great Britain, have many internationally competitive industries. Among many other fields, the United States is competitive in finance, entertainment, aerospace, industrial equipment, pharmaceuticals and communications.

COMPETITIVENESS

Competitiveness is a broad term used to describe the relative productivity of companies and industries. If one company can produce better products at lower prices than another, it is said to be more competitive. If, overall, the steel mills of Germany are more efficient and productive than the steel mills of France or Belgium, it would be said that the German steel industry is more competitive than the French and Belgian steel industries. Governments are always concerned about the competitiveness of their countries' different industries, since it is difficult for uncompetitive industries to survive.

In the long run, competitiveness depends on a country's natural resources, its stock of machinery and equipment, and the skill of its workers in creating goods and services that people want to buy.

Natural resources are already there and must be used efficiently, but a country's infrastructure and its workers' skills have to be built up over time. The ability of a society to use natural resources wisely, develop new technologies, improve the skills and efficiency of its workforce, and invest in its infrastructure are key factors in trying to remain competitive.

ECONOMIES OF SCALE

The Law of Comparative Advantage says that a country can become more competitive by putting its resources, through investment in training and production facilities, into its most efficient industries. Using its resources in this manner may enable a country to achieve economies of scale—increasing its output in a particular industry so that its costs per unit decrease. Lower-cost goods become more competitive in international markets.

Having access to international markets may help countries to achieve economies of scale in different industries. For example, it would not be profitable for a small country to produce expensive, sophisticated weapons systems unless it could spread the enormous research and development costs over many units. To do this, it may need to export. If nations know that they have access to foreign markets and can export, it is possible to increase the scale of their manufacturing operations far beyond what they need for their own use, and as a result the nations become more efficient and competitive.

Of course, in reality, the factors affecting a country's trade competitiveness are more complicated. Greater specialization improves competitiveness, but sometimes resources are difficult to transfer from one industry to another. An insurance agent cannot be moved to an architectural company without retraining, and it would cost a great deal of money to turn a car factory into a shoe factory.

To further complicate matters, governments often attempt to restrict or encourage international trade to achieve domestic economic goals, such as increasing employment in certain industries, developing new sources of wealth, or maintaining economic independence.

Reading Questions

1. What are the advantages of specialization and trade?
2. Describe the law of comparative advantage.
3. What factors underlie an industry's competitiveness?
4. How do economies of scale affect a country's competitiveness?
5. Putting the principle of comparative advantage into operation involves problems. Discuss.
6. Give examples of industries that benefit from economies of scale.