Trade

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Learning Outcomes

In this chapter we will:

1. investigate and analyse patterns in Irish trade in terms of quantity and types of goods and services over a period of time; assess the benefits and costs of trade on the Irish economy
2. describe the main components/the basic composition of Ireland's balance of payments account
3. discuss the factors that determine a country's competitiveness
4. explain the principle of comparative advantage and its role in determining competitiveness
5. discuss the arguments in favour of international trade, trade protection and the fair trade movement
6. discuss the determinants of exchange rates; analyse the effects of changes in exchange rates on the Irish economy
7. examine the role and effectiveness of trade agreements and global institutions in the operation and management of international trade

Some Basic Concepts

Visible imports: purchase of physical goods from abroad/foreign countries, for example, Irish firms buying Spanish oranges.

Visible exports: sale of physical goods to foreign countries, like selling Irish beef to China.

Invisible imports: purchase of intangible (untouchable) services from abroad/foreign countries, e.g., Irish people going on holidays to Malaga.

Invisible exports: the sale of intangible (untouchable) services from abroad/foreign countries, e.g., Americans coming to Dublin for U2 concert.

IMPORTANT FORMULA 1:
Balance of Payments = visible exports − visible imports

If visible exports > visible imports, the Irish economy is running a trade/BOP SURPLUS.
If visible exports < visible imports, the Irish economy is running a trade/BOP DEFICIT.

IMPORTANT FORMULA 2:
Balance of Trade = total exports − total imports (total = visible and invisible trade)

Composition of Ireland's Balance of Payments

The Irish balance of payments, in line with international standards used by the CSO, is divided into three main accounts:

$$\text{BOP Account} = \text{Current Account} + \text{Capital Account} + \text{Financial Account}$$

Current Account

Records the flow of goods, services, income, and current (day-to-day) transfers between residents of Ireland and the rest of the world.

Capital Account

Records capital (irregular) transfers and transactions involving non-produced, non-financial assets.

Financial Account

Records transactions in foreign financial assets and liabilities, categorised by the type of investment. These types of investments are Direct, Portfolio and Other. The financial account also includes reserve assets. These are foreign currency claims, gold, special drawing rights (SDRs), and the reserve position in the IMF held by the national monetary authority (the Central Bank of Ireland) for policy purposes

Impacts of Balance of Payments on Economic Activity

As discussed earlier, BOP surplus occurs when visible imports < visible exports. This has a number of impacts on our economy, including:

1. Injection into circular flow of income – value of imports < value of exports so the multiplier effect (MPM) is amplified.
2. Increase in external reserves (treasury bills, bonds, bank deposits, banknotes, etc. held in foreign currency) – greater ability to make international payments as the state can use the trade surplus to pay creditors.
3. Creation of jobs – export-led jobs lead to an increase in Irish employment if Irish exports are chosen over domestic produce of foreign countries due to lower price, higher quality or both.

BOP deficit has the opposite impacts, i.e., leakage from circular flow, fall in external reserves, job losses.

Benefits of foreign trade for the Irish economy

Benefits of importing:

1. Choice for consumers: suppliers divide markets into niche sectors. You want to go on holidays. You can have a staycation, opt for a safari tour, a ski resort or a sun holiday in Lanzarote – this expansive choice has been made possible by easy access to foreign goods and services.
2. Lower/competitive prices: by introducing foreign competition into domestic markets, there is an onus on all firms to offer lower prices to attract/keep customers.
3. Access to raw materials for domestic producers: open markets allow Irish businesses to source oil, minerals and labour.

Benefits of exporting:

1. Injection into Irish economy: when foreigners buy Irish produce, foreign money is transferred to the hands of locals and domestic producers, contributing to Irish wealth and economic growth.
2. It creates jobs: a domestic firms expand into international markets, a larger workforce is required, firms hire more.
3. Export-led growth: with domestic recession, sales in foreign markets can help to grow the economy externally.

Challenges of foreign trade for the Irish economy

Challenges of Trade for Ireland as a small open economy:

1. Skills mismatches: rapid innovation/automation can lead to graduates being trained for jobs which are no longer needed.
2. Rising overheads: cost of Irish labour, transport and utilities is increasing – MNC's may relocate to lower-cost countries.
3. Over-exposure to foreign markets: Ireland is very liable to economic slowdown in trading partners (like a US recession) or structural shocks like Brexit.

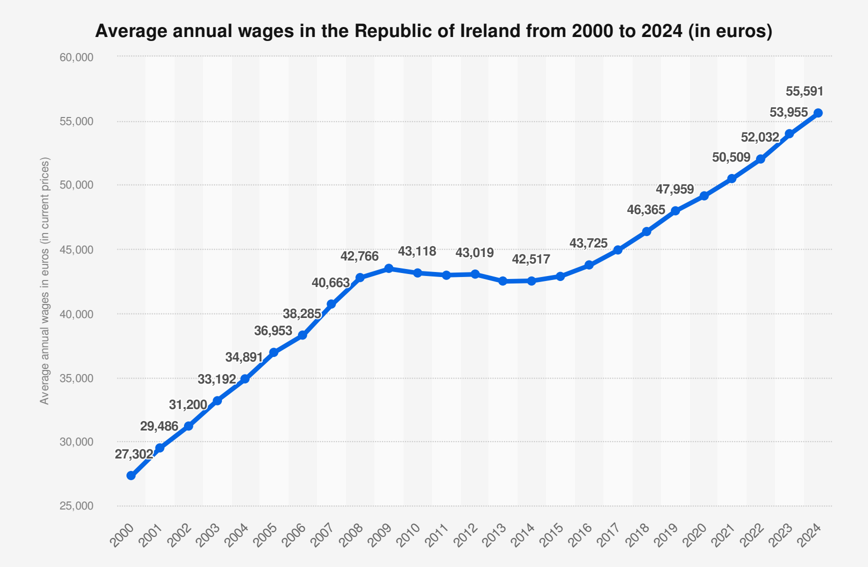
Factors influencing Ireland's international competitiveness

1. Value of the euro against non-euro currencies: if the value of the euro rises against foreign currencies, Irish exports become relatively more expensive in those non-euro markets.
2. Domestic inflation vs inflation in export markets: if the Irish rate of inflation is lower than that of foreign markets, Irish exports have a price advantage – however if Irish inflation grows faster than that if export partners, Ireland could be priced out of international markets.
3. Cost of transport: as Ireland is an island nation, transport costs can be significant when exporting goods, and these must be included in the final price. Transport costs are rising: toll charges, fuel prices, etc. Falling world oil prices mean that Irish producers face lower transport bills.
4. Cost of Irish labour: if labour costs in Ireland rise above those in export markets, then these additional costs must be borne by the final consumer, and this increases the price of the exports. Industry representatives have stated that Ireland must limit wage increases so as to maintain international competitiveness/restrict wages increases in the public sector.

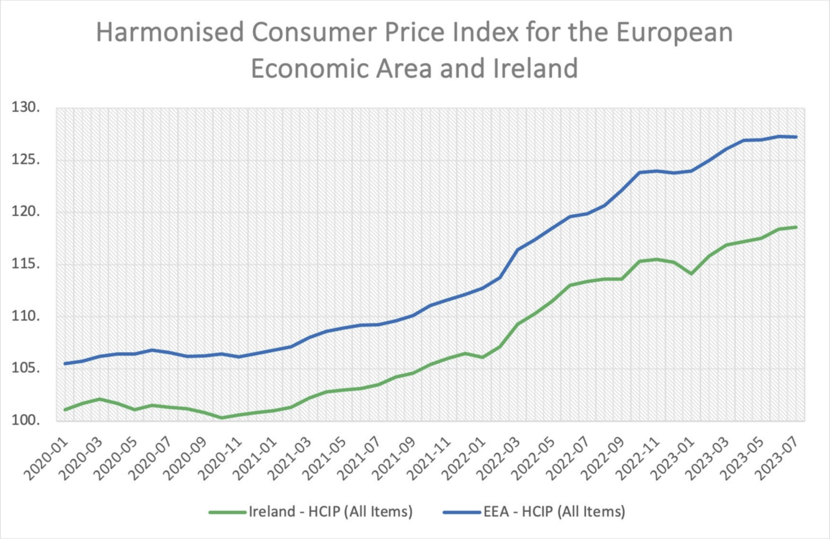
On the next few slides I've attached some visuals to help you assess Ireland's international competitiveness over time. Use this as an opportunity to test your critical thinking and analytical skills – identify any trends, research whats causing each trend. Then, discuss the implications of each trend you identify on Irelands international competitiveness.

Irish Private Sector Wages

Irish Wages (Cost of Labour) – Data from Statista



Irish vs EU Inflation



Comparative Advantage

Definition (learn it off)

The Law of Comparative Advantage states, assuming free trade exists, a country should specialise in the production of those goods and services at which it is relatively most efficient and trade the remainder.

What are the limitations of this theory?

- It assumes free trade always exists: while this may be true for trade blocs like EU and NAFTA, some countries like North Korea and Trump in US impose protectionist measures.
- Ignores Law of Diminishing Marginal Returns: LOCA assumes constant returns to scale, but as discussed in the Costs chapter, this normally isn't the case.
- Assumes perfect mobility of the factors of production: LOCA expects unemployed workers find new employment immediately, yet workers may have to retrain before being able to work again.

The Sources of Comparative Advantage in the Irish economy:

Climate: our mixed climate (rain, sun, temperate) is ideal for livestock grazing, crop production but also no too hot for data centres (Irish weather is unique so it's a good source of comparative advantage).
Skilled workforce: Ireland's highly-educated, well-trained labour market means that companies don't have to carry out costly training programmes.
Availability of Raw Materials: arable/pastoral land is plentiful in Ireland yet quite scarce in other countries. This makes it an excellent source of comparative advantage.

Protectionism

So far, we have been discussing free trade but what exactly does 'free trade' mean?

Free trade is the international exchange of goods and services where there is no barriers to the movement of those goods and services.

Protectionism, however, seeks to construct barriers to this free movement of goods and services across international borders – the Brexit Referendum and the election of Donald Trump recently signal the growing popularity of protectionist measures.

For what reasons are protectionist measures imposed?

- Raise exchequer revenue through import tariffs: the government can fund public services by collecting tariffs. This can help ease a burden on public finances.
- Protect infant industry: new firms may not have resources or wealth to compete with massive multinational companies and so some argue they must be protected.
- Prevent dumping: dumping occurs when goods are sold cheaper in foreign markets than in domestic markets. Protectionism prevents the dumping of surplus production at prices domestic firms can't compete with.

Protectionism

Imagine you are in the Irish Government. There are too many imports coming into the country. What protectionist measures can the state impose to limit imports?

1. Tariffs – a tax on the price of imported goods, e.g., 25% US tariff on Chinese steel imports.
2. Quota – a physical limit on the amount of a particular good can be imported.
3. Embargo – an outright ban on import of good(s) or outright ban of all imports form a particular country, for example, US' infamous embargo on Cuban cigars.
4. Health & safety regulations – the government could force foreign producers to adhere to very high safety standards, driving up business costs.
5. Administrative barriers – imposing excessive paperwork and bureaucracy could force importers out of the market as trade becomes too expensive and time-consuming.

The Fair Trade Movement

Fair trade is a trading partnership based on dialogue, respect and transparency which seeks greater equity in international trade. The economic benefits of fair trade include:

- The organisation of supplier-based co-operatives to improve the position of small local suppliers on the supply chain – this helps those suppliers to negotiate better prices for their produce.
- The fair trade premium offers an additional source of income to suppliers which supports: co-operatives, better farming methods and investment in high-yield crop production.
- The fair trade movement has improved access to agricultural services (like organic training) which incentivises farmers to farm better and sell more.

The Exchange Rate

Definition: An exchange rate is the price of one currency in terms of another currency.

Factors influencing exchange rates:

Interest rates: if a region raises interest rates (ie higher return on money), demand for that region's currency increases. This flow of money to avail of higher interest rates is called 'hot money'. Conversely, if interest rates are reduced in one area relative to others, funds may leave to earn better interest elsewhere. This is termed 'capital flight'.

The level of money supply: an increase in money supply may create greater demand for imports, so money flows out of the country causing the currency to weaken.

Role of speculators: if currency is expected to fall/rise in value, speculators can place bets by selling or buying the currency to make a quick profit. If these bets are sufficiently large, they can put pressure on the value of the currency. The 1992 Sterling crisis is a great example of this. A hedge fund owned by a Hungarian businessman named George Soros placed a large bet that the Bank of England (the body responsible for monetary policy in the UK) would have to devalue its currency. His trades, along with those of other currency speculators, caused the price of the Pound Sterling to collapse and forced the UK to leave the ERM, which was a sort of monetary union among European countries before the Euro was a thing. If you're interested learning more, theres a documentary called 'Black Wednesday' which you can find on YouTube.

Black Wednesday Documentary

Click the image below to watch the documentary on YT.

Purchasing Power Parity

Definition: Theory of Purchasing Power Parity states that in a free market, the exchange rate of two currencies is in equilibrium when their domestic purchasing powers are equivalent at that rate of exchange.

Limitations of this theory:

- Assumes free trade exists: PPP ignores the real-world barriers and frictions of international trade. Factors such as tariffs, taxes, shipping fees, and import restrictions create barriers to trade that prevent the equalisation of prices for identical goods across countries.
- Some goods and services cannot be traded across borders: PPP theory primarily focuses on internationally traded goods. However, many goods and services like real estate, haircuts, and local transportation are not traded across borders, allowing for persistent price differences that are not corrected by international arbitrage.
- Market Imperfections and Competition: The theory assumes perfectly competitive and efficient markets where prices adjust quickly. In reality, market power (monopolies or cartels) and slow price adjustments can lead to deviations from PPP.

Devaluation

Definition: Devaluation is a decrease in the price of one currency relative to the price of another.

Reasons for Devaluing a Currency

Improve Export Competitiveness: Lowering the currency's value makes domestic goods cheaper for foreign buyers. When the exchange rate drops, the same amount of foreign currency can buy more units of the domestic currency. This effectively slashes the price of exports on the global market, boosting demand and stimulating economic growth.

Reduce Trade Deficits: Devaluation aims to balance trade by increasing exports and discouraging expensive imports. As foreign products become more expensive for domestic consumers, they shift spending to local alternatives. Simultaneously, the boost in export volume helps close the gap between what a country sells abroad and what it buys.

Lower Sovereign Debt Burdens: A weaker currency can reduce the real cost of servicing government-issued debt. If a government has large amounts of domestic-currency-denominated debt with fixed interest payments, devaluing makes those payments worth less in real terms over time, making the debt easier to manage.

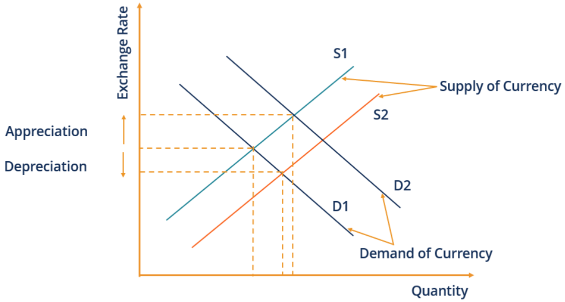
Devaluation

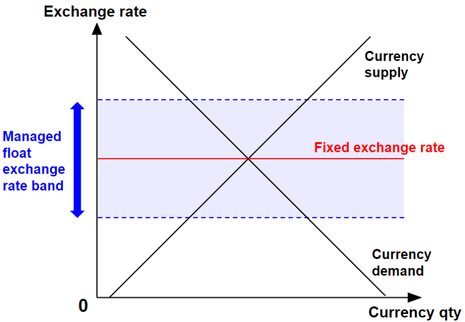
1990s Case Studies: Ireland and the UK

UK (Black Wednesday): Britain was forced to leave the ERM on September 16, 1992, after failing to maintain the pound's value above its required limit. Speculators like George Soros bet billions against the pound, believing its fixed rate was too high for the struggling UK economy. Despite hiking interest rates to 15% and spending billions in reserves, the government conceded defeat and devalued the pound.

Ireland (1993): Following the UK's exit, the Irish pound (punt) came under extreme pressure because Britain was Ireland's largest trading partner. The punt became artificially strong against sterling, damaging Irish export competitiveness. After months of trying to defend the currency with interest rates as high as 16%, Irish gov't devalued the punt by 10% in January 1993 to restore its competitive position.

Types of Exchange Rate





Dynamics of floating (left) and fixed (right) exchange rates

Floating exchange rate: currencies change in value where the equilibrium exchange rate is set by the forces of supply and demand.The value of most major global currencies like USD, Yen and Euro are determined by supply of and demand for the currency.

Fixed (pegged) exchange rate: value of currencies is agreed upon and each country exchanges the currency at that rate. For example, the value of Danish Krone is pegged to the Euro.

Global Trade Institutions

World Trade Organisation (WTO):

- Provides forum/platform to negotiate trade agreements, removing barriers to international trade.
- Aims, through these efforts, to encourage economic growth/development for members.
- Monitors trade agreements and holds its members to account.
- Settles disputes that arise from misinterpretations of trade rules to ensure level playing field for all.

The World Bank:

- Issues long-term capital to developing countries if they agree to strict monetary policies.
- Offers low-cost loans and grant-aid to fund healthcare and education development.
- Provides policy advice, research, analysis and technical assistance.

OECD:

- Promotes policies which help to boost social/economic wellbeing globally.
- Platform for national governments to co-ordinate and solve common problems.
- Sets international standards regarding tax, chemical safety and agriculture.