International Finance

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Theory of Comparative Advantages

Balance of Payments

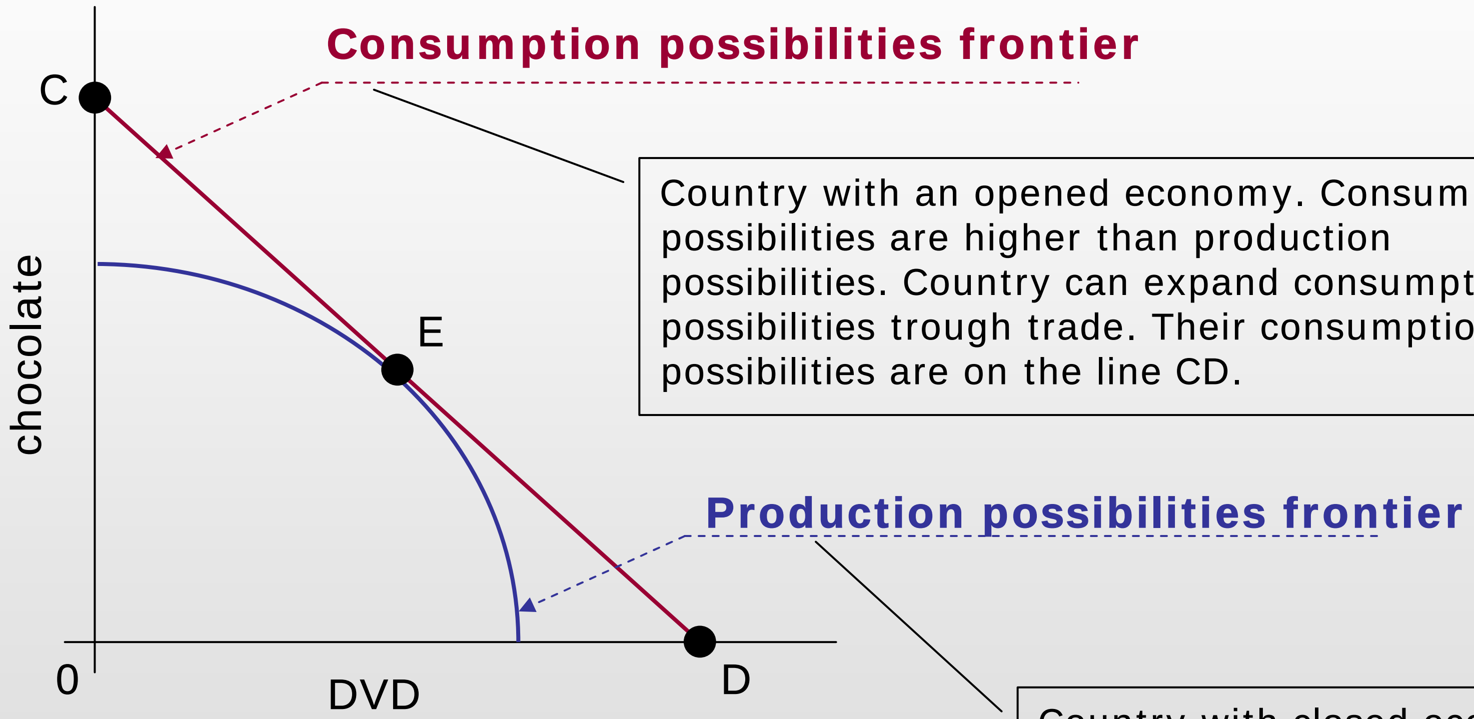
Theory of Comparative Advantages - introduction 1/6

- International trade – foreign currency
- Why countries should enter into international trade?
- What does it mean „open economy“?
- ratio of country’s export and import to GDP

Theory of Comparative Advantages – introduction

Production and consumption possibilities frontier

2/6



Country with an opened economy. Consumption possibilities are higher than production possibilities. Country can expand consumption possibilities trough trade. Their consumption possibilities are on the line CD.

Country with closed economy. Consumption possibilities are identical to production possibilities.

Theory of Comparative Advantages - introduction 3/6

small market → effective production → export → income from export is used for import:

- domestic market is enlarged by foreign goods and services,
- customers have better choice,
- competition pressures domestic producers to better and cheaper production.

- Advantages: better company's efficiency,
  better position for customers on the market
- Disadvantages: increasing competition of foreign companies causes bankruptcies of domestic companies (increasing unemployment of some regions of the country)

Theory of Comparative Advantages - introduction 4/6

International trade means better opportunities
for productively using of world manufacturing factors.

International trade and specialization increases
productivity and living standards.

Theory of Comparative Advantages - introduction 5/6

Reasons of international trade:

1. <u>diversity in the conditions of production among regions</u>
2. <u>decreasing costs of production</u>
3. <u>differences of tastes</u>

Theory of Comparative Advantages - introduction 6/6

THEORY OF **ABSOLUTE** ADVANTAGE

THEORY OF **COMPARATIVE** ADVANTAGE

Theory of Absolute Advantage 1/3

Adam Smith (1776)

example of two countries and two goods

"Country has an absolute advantage in a product
if it is more efficient than any other nation
in the production of that good."

Theory of Absolute Advantage 2/3

<u>Example:</u>

Absolute advantage (AA) – outputs produced by one worker per a time

	Country A	Country B
Commodity X	**6 kg**	3 kg
Commodity Y	2 l	**4 l**

AA – absolute advantage

Theory of Absolute Advantage

Interpretation:

Country A has absolute lower costs of work by commodity X, because one worker per a time produces more (6 kg) of that commodity and one worker per a time in country B produces less (only 3 kg) of that commodity.

Country B has absolute lower costs of work by commodity Y, because one worker per a time produces more (4 l) of that commodity and one worker per a time in country A produces less (only 2 l) of that commodity.

Theory of Comparative Advantage

What about the situation, when one country has an absolute advantage in production of both goods?

The answer on this question has a principle in **comparative advantage**.

This principle is based on the relative differences in costs of work per one commodity.

Theory of Comparative Advantage

David Ricardo (1817)

statement: „one country has an absolute advantage in production of both goods"

- Country with **lesser absolute advantages** and with **higher opportunity costs** in production of both goods, will specializes on production and export of that good, which **absolute disadvantage (AD) is lower**
  (it means country has a comparative advantage).
- Country with **lower opportunity costs** in production of both goods, will specializes on production that good, which **absolute advantage (AA) is higher.**

Theory of Comparative Advantage

Example:

Comparative advantage (CA) – outputs produced by one worker per a time

	(**AA**)	(**AD**)	Ratio AA **:** AD
	Country A	Country B	
Commodity X	**6 kg**	3 kg	**2** **:** 1
Commodity Y	7 l	**5 l**	**1,4** **:** 1

AA – absolute advantage

AD – absolute disadvantage

Theory of Comparative Advantage

Interpretation:

Country A (has an absolute advantage in production of both goods) has a comparative advantage in production of commodity X, because ratio of AA : AD is higher than in production of commodity Y. (**2 >** 1,4)

Country B (has an absolute disadvantage in production of both goods) has a comparative advantage in production of commodity Y, because ratio of AA : AD is lower than in production of commodity X. (**1,4 <** 2)

Theory of Comparative Advantage

in conclusion:

The principle of Comparative Advantage consists in that country can trade even if it is absolutely efficient (or more inefficient) than other countries in the production of every good.

Theory of Comparative Advantages - conclusion

Comparative advantage the ability to produce a good at a lower opportunity cost (other goods forgone) than others could do.

Absolute advantage the ability to produce a good with fewer resources than other producers.

Example:

Country **C (USA)** has 5 times higher productivity of labor in production of **PC** than country **D (Japan)** and in production of **TV** country C has productivity of labor higher only by 25 % than country D.

(Country C, which is better in production of both goods, is not “better identically”.)

It means that country C has comparative advantages in production of PC and country D in production of TV.

Example:

Alternative outputs from one-year input of labor of 1 worker

	(**AA**)	(**AD**)	Ratio AA **:** AD
	C (USA)	D (Japan)	
PC	**50**	10	**5**
TV	50	**40**	**1,25**

AA – absolute advantage
AD – absolute disadvantage

Example:

Suppose that **Japan (D)** moves 2 000 years of labor from production of PC to the production of TV. Because production of 1 worker per year is 10 PCs, this movement means decrease of PC's production by 20 000 PCs (10 PC x 2 000 years of work).

At the other side, production of TV increases by 80 000 TVs.

(2 000 years of work x 40 TV).

Suppose also, that **USA (C)** moves 1 000 years of labor from production of TV to the production of PC. It means that production of TV decreases by 50 000 TVs (50 TV x 1 000 years of work), and at the other side the production of PC increases by 50 000 PCs.

Example:

Outcome: Because of specialization we can produce with the same amount of inputs by 30 000 PCs more and by 30 000 TVs more products.

Advantages of specialization

	C (USA)	D (Japan)	Total
PC	+ 50 000	- 20 000	+ 30 000
TV	- 50 000	+ 80 000	+ 30 000

Because of specialization prosperity of every country is increasing, thereby total prosperity of the world is increasing too.

Balance of Payments

- Each country records the details of trade in its **balance of payments accounts**
- BP is the **statistical record** that summarizes transactions between residents and nonresidents during the period.

  PB is presented in the form of **double-entry bookkeeping**.
- The BP contains **subaccounts** that categorize the major types of international economic interactions. The two primary subaccount are:
  - **the current account** (the „real“ side of PB)
  - **the capital and financial account** (the „financial“ side of PB)

Balance of Payments

Important <u>credits (+)</u> are:

- merchandise exports,
- interest and dividends on investments abroad,
- investment by foreigners in the home country,
- foreign travel in home country.

Important <u>debits (-)</u> are:

- merchandise imports,
- tourist expenditures abroad,
- shipping services,
- investment abroad.

Balance of Payments

- the **debit items (-)** give rise to the **demand (D)** for foreign exchange,
- the **credits items (+)** give rise to the **supply (S)** of foreign exchange,
- the rate of exchange is determined by demand and supply

Balance of Payments

- Suppose that U.S. company **imports** 100 000 USD worth of bicycles from England company.
- There will exist a 100 000 USD **credit recorded by England company** that offsets a 100 000 USD **debit at U.S. company's bank account.**
- This will lead to a rise in the **supply of dollars** and the **demand for British pounds.**

Balance of Payments

Current account – records the monetary value of imports and exports of goods and services, adjusted for international incomes and transfers.

Capital account – records the monetary value of capital inflows from other countries (foreign investment in the domestic country), and outflows to other countries (investment abroad). (With adjustment for government transactions)

THE BALANCE OF TRADE

The monetary value of exported goods minus the monetary value of imported goods.

Balance of Payments

THE CURRENT ACCOUNT

A country **exports** goods and services when it sells them to another country. A country **imports** goods and services when it purchases them from another country. The current account measures the values of

1. **exports of goods and services**, along with income received from abroad.
2. **imports of goods and services**, along with income payments made abroad.
3. **net transfers**, including gifts and foreign aid.

Balance of Payments

THE CAPITAL AND FINANCIAL ACCOUNT

Two types of investments counted in the capital account:

1. **direct investments** (investments in foreign properties such as office buildings, golf courses, manufacturing plants)
2. **financial investment** (are purchases of stocks and bonds)

Current Account	
Exports of goods	$719
Imports of goods	–$1,146
(Balance of trade = –$427)	
Exports of services	$279
Imports of services	–$210
(Balance of services = $69)	
Net income adjustment	$14
Adjustment for net transfers	–$49
Balance on current account	***–$393***
Capital and financial account	
Net capital account transactions	$1
Foreign investment in the U.S.	$752
U.S. investment in other countries	–$371
Balance on capital and financial account	***$382***
Statistical discrepancy	$11

The U.S. Balance of Payments

(BP items and their 2001 values in billions of dollars.)

Balance of Payments

Balance of Payments accounts

- The current account
- The capital and financial account
- Statistical discrepancy
- Official reserved account

Balance of payments identity states that:

Current Account + Capital Account + Financial Account +
+ Statistical discrepancy = Change in Official Reserve Account

Thank you for your attention!