International Trade: Why It Matters, Advantages, Disadvantages

What's it: International trade refers to trade of goods and services across countries. It consists of exports and imports. Export means you sell domestic goods and services to consumers abroad. Conversely, imports are when you buy goods and services from abroad.

Why is international trade important

International trade benefits all countries involved. Domestic production cannot fulfill all needs and wants, whether consumers or businesses.

You may need some items that are only available overseas. Say, you want an iPhone. However, since Apple does not have production facilities in your country, you will need to buy them from abroad. When you do, you are getting into international trade.

And, in macroeconomics, international trade is useful for:

- **Encouraging economic growth.** Exports and imports are components of gross domestic product, a reliable measure of economic growth. Exports stimulate GDP to rise. Conversely, imports reduce GDP.
- **Providing a better standard of living.** You get a more varied and cheaper product, which is not produced domestically. The more products available in the global market, the more consumers can meet their needs and wants.
- **Encouraging businesses to be more competitive.** International trade increases competitive pressure, especially for those involved in exports and imports. They not only have to compete with domestic players but also players abroad. And to win the competition, they must increase their competitiveness.

Of course, such benefits are only more significant when the trade is fair.

However, trade is not always fair. It may be because:

- Protection of national interests, such as protection of domestic businesses and economies
- Anti-competitive behavior such as dumping

Such issues then raise various types of trade barriers.

And to reduce barriers, various free trade agreements continue to emerge. One of the points of the deal is to reduce import tariffs.

The emergence of international organizations such as the World Trade Organization (WTO) has also attempted to reduce international trade barriers. The organization creates global rules and standards which are then adopted by member countries.

The entry of foreign direct investment

International trade benefits for increased efficiency but also enables countries to participate in the global economy. This encourages opportunities for foreign direct investment.

Foreign direct investment is vital for increasing the production capacity of an economy. It is also a means for the transfer of knowledge, expertise, and technology.

Contagion effect

International trade gives rise to what we call the global economy. Here, the economies between countries are linked to each other through international trade. Trade interconnection makes a country's market not only influenced by domestic supply-demand but also global.

A worsening of the economy in one country can affect the economy of its partner countries. For example, a slowdown in China's economic growth reduces demand for various metal commodities. This causes the economy in trading partner countries like Indonesia to also slow down.

Likewise, economic shocks occurring in the United States can spread through international trade. When experiencing a recession, consumers in the United States will reduce their demand for goods from abroad. And for partner countries, their exports will decline.

Since exports are a share of gross domestic product, a decline in exports also results in lower GDP growth. That might eventually send partner economies into recession, following the United States.

International trade basis

There are actually two fundamental theories that explain international trade: comparative advantage and absolute advantage. But, in this article, I'll focus on comparative advantage.

In 1817, David Ricardo introduced comparative advantage, which explains the need for trade between countries.

A comparative advantage exists if a country has a superior margin in producing goods or services. In other words, the country bears lower marginal costs of production.

Countries should specialize in products with lower opportunity costs than other countries. This is done by using the most abundant production factors intensively. By doing so, they will bear lower marginal production costs.

If each country specializes, the total output can be increased. Also, the specialization will lead to allocative efficiency and better welfare.

Free trade or protectionism

International trade has many benefits. How the benefits are obtained, economists are divided into two views: free trade versus protectionism.

Free trade emphasizes trade without restrictions. Supply and demand, operating on a global scale, will ensure efficient production.

Market forces will direct international trade to its most significant benefit. The interaction of supply and demand globally allows the market to operate efficiently. Trade protection will only lead to inefficient markets.

Conversely, proponents of **protectionism** argue that international trade regulation is necessary. It ensures that markets function properly and that competition does fairly. After all, international trade may be of the most significant benefit to some countries but not others.

Unfair competitive practices, such as dumping, can hamper the benefits of international trade. Therefore, regulations or policies are needed. Also, these regulations are to protect consumers and the environment from trading in dangerous goods.

The form of protection can take various forms, including import tariffs, subsidies, and quotas. Also, environmental requirements or national standards are a form of protection.

International trade advantages

- Increasingly abundant and varied supply. Products do not only come from domestic, but also from abroad. Finally, consumers have more options to satisfy their needs and wants. That, in turn, led to improved welfare and living standards.
- **Lower price.** A larger supply exerts downward pressure on prices. If the price of domestic products is high, consumers can switch to cheaper imported products.
- **Broader market access.** Companies can export their products abroad. Such expansion of market access is essential, especially if the domestic market enters a mature or declining stage. In particular, for capital-intensive firms, greater market access enables them to increase profits from economies of scale.
- **Better selling price.** Trade allows companies to access foreign markets with high purchasing power, for which people are willing to pay higher prices. That, of course, increased their profits.
- **Increased productivity and innovation.** International trade opens up new competition for domestic companies. They not only compete with domestic rivals but also from imported goods. To stay competitive, they need to be more innovative and productive.
- **More efficient allocation of resources.** Countries should focus on efficient industries. For the rest, they can import them from abroad.
- **Production specialization.** Producers will produce the most efficient and competitive goods and services in the international market. If all countries did, it would deliver cheaper goods, which increases well-being.
- **Reducing monopoly power.** International trade increases foreign competition, for example, through the entry of imported goods. That, in turn, reduces domestic companies' monopoly power and forces them to keep trying to be more efficient.
- **Higher and sustainable economic growth.** International trade encourages higher real GDP due to a more efficient allocation of

resources, learning curves, an abundance of knowledge, and increased productivity.

International trade disadvantages

International trade also carries risks.

- **Domestic industry bankruptcy.** Because they are less efficient, some companies are unable to compete with imported products. That forced them to close down the operation.
- **Higher unemployment rate.** The closure of domestic industries reduces the demand for labour. That ultimately results in lower income for those who are unemployed.
- **Exchange rate risk.** International trade involves currency for payment. Hence, it raises an exchange rate risk unless using the same currency. The increase in exports pushed the domestic currency to depreciate. Meanwhile, the increase in imports caused the domestic currency to depreciate.
- **Imported inflation.** It occurs when the price of imported goods affects the price level in the domestic economy. It may be the result of exchange rate depreciation or price increases (inflation) in partner countries.
- **Contagion effects.** Shocks in one country can spread to partner countries through export and import transmission. If a partner country experiences an economic recession, the demand for domestic goods falls. As a result, exports fell and reduced the rate of domestic economic growth.

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