

# International Trade and Exchange Rates

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Countries trade because they benefit from specialisation. No country is equally efficient at producing everything, so it makes sense to produce what you do best and trade for the rest. This section explains why trade happens, how it is measured, and what happens when currencies exchange hands.

### Why Countries Trade: Absolute and Comparative Advantage

#### Absolute Advantage

A country has an **absolute advantage** in producing a good if it can produce more of that good using the same quantity of resources as another country.

If Jamaica can produce 10 tonnes of sugar per hectare and Canada can produce only 2 tonnes per hectare, Jamaica has an absolute advantage in sugar production.

#### Comparative Advantage

A country has a **comparative advantage** in producing a good if it can produce it at a lower **opportunity cost** than another country — even if it has no absolute advantage in it.

Comparative advantage is the deeper justification for trade. Even if one country is better at producing everything, both countries still gain by specialising in what they produce at the lowest opportunity cost.

**Example**

Suppose Jamaica and the USA each have 100 units of resource and can produce either bananas or computers:

| Country | Bananas per 100 units | Computers per 100 units |
|---------|-----------------------|-------------------------|
| Jamaica | 80                    | 20                      |
| USA     | 60                    | 60                      |

USA has an absolute advantage in computers (60 vs 20) and is competitive in bananas (60 vs 80 — Jamaica still has the absolute advantage in bananas).

**Opportunity costs:**

- Jamaica: producing 1 computer costs 4 bananas ( $80 \div 20$ ); producing 1 banana costs 0.25 computers.
- USA: producing 1 computer costs 1 banana ( $60 \div 60$ ); producing 1 banana costs 1 computer.

Jamaica can produce bananas at a lower opportunity cost (0.25 computers) than the USA (1 computer). The USA can produce computers at a lower opportunity cost (1 banana) than Jamaica (4 bananas).

**Conclusion:** Jamaica should specialise in bananas; the USA in computers. Both countries gain from trade even though the USA is more productive in computers overall.

**Gains from Trade**

When countries specialise according to comparative advantage and trade, total world output rises. Each trading partner can consume more than it could produce alone. The gains from trade come from:

- Greater total output due to specialisation
- Economies of scale as production is concentrated
- Wider variety of goods available to consumers
- Technology transfer and innovation driven by competition

**Terms of Trade**

The **terms of trade** is the ratio of export prices to import prices:

$$\text{Terms of trade} = \frac{\text{Index of export prices}}{\text{Index of import prices}} \times 100$$

If the terms of trade index rises, a country can buy more imports for the same quantity of exports — the terms of trade have improved. A fall means fewer imports per unit of exports — a deterioration.

## Factors Influencing International Trade

- Comparative advantage and production costs
- Exchange rates (a depreciated currency makes exports cheaper and imports dearer)
- Trade barriers (tariffs, quotas, regulations)
- Quality and non-price competitiveness
- Bilateral and multilateral trade agreements
- Size of domestic markets
- Preferences and cultural factors

## Balance of Payments

The **balance of payments** is a systematic record of all economic transactions between residents of one country and the rest of the world over a given period (usually a year). It is structured as three accounts.

### Current Account

Records flows of goods, services, income, and current transfers:

| Item                        | Credit examples                              | Debit examples   |
|-----------------------------|--|--|
| Balance of trade (visibles) | Exports of goods                             | Imports of goods   |
| Services (invisibles)       | Tourism receipts, financial services exports | Tourism spending abroad, insurance payments to foreign firms |
| Income                      | Profit and dividends received from abroad    | Profit and dividends sent abroad                             |
| Current transfers           | Remittances received                         | Remittances sent abroad                                      |

The **balance of trade** is the difference between the value of exported goods and imported goods. A trade surplus occurs when exports exceed imports; a trade deficit when imports exceed exports.

### Capital Account

Records transfers of financial assets and liabilities:

- Foreign direct investment (FDI): when a foreign firm builds or buys a production facility in a country.

- Foreign portfolio investment: purchase of stocks, bonds, or other financial assets.
- Short-term capital flows: movements of money seeking higher interest rates or safer assets.
- Changes in official reserves (Net International Reserves, NIR).

## Official Financing Account

Records transactions in official reserves — gold and foreign currency holdings of the central bank — used to finance any overall deficit or absorb a surplus.

## Equilibrium and Disequilibrium

The balance of payments must always **balance in an accounting sense** — every debit has a corresponding credit. However, there can be **disequilibrium** in specific accounts.

A **balance of payments deficit** means the country is spending more in international transactions than it is receiving — requiring it to draw down reserves or borrow from abroad.

A **balance of payments surplus** means the country is earning more than it spends — reserves accumulate.

## Consequences and Remedies

| Problem     | Consequences  | Remedies   |
|-------------|---|--|
| BOP deficit | Loss of foreign reserves; currency depreciates; rising debt             | Depreciate currency to boost exports, cut imports; raise interest rates; reduce government spending; import controls |
| BOP surplus | Reserves accumulate; trading partners may retaliate; domestic inflation | Allow currency to appreciate; stimulate domestic consumption of imports  |

## Exchange Rates

An **exchange rate** is the price of one country's currency expressed in terms of another.

### Exchange Rate Regimes

**Fixed (pegged) exchange rate:** The government or central bank sets and maintains the exchange rate at a specific level, intervening in the foreign exchange market by buying or selling its own currency as needed.

Advantages: certainty for traders and investors; disciplines government against inflationary policies.

Disadvantages: requires large foreign exchange reserves; may not reflect economic fundamentals.

**Floating (flexible) exchange rate:** The exchange rate is determined entirely by the forces of supply and demand for the currency in the foreign exchange market, without government intervention.

Advantages: self-correcting — a deficit causes the currency to depreciate, automatically improving competitiveness.

Disadvantages: volatility creates uncertainty for businesses engaged in international trade.

**Managed float (dirty float):** The exchange rate is primarily market-determined, but the central bank intervenes periodically to smooth excessive fluctuations or keep the rate within a desired range.

## Appreciation, Depreciation, Revaluation, and Devaluation

| Term         | Meaning  | Regime        |
|--------------|--|---------------|
| Appreciation | Currency rises in value due to market forces           | Floating rate |
| Depreciation | Currency falls in value due to market forces           | Floating rate |
| Revaluation  | Government deliberately raises the fixed exchange rate | Fixed rate    |
| Devaluation  | Government deliberately lowers the fixed exchange rate | Fixed rate    |

## Effects of Exchange Rate Changes

A **depreciation** (currency becomes cheaper):

- Exports cheaper for foreign buyers 'export demand rises
- Imports more expensive for domestic buyers 'import demand falls
- Net effect: current account deficit tends to improve (subject to the Marshall-Lerner condition)
- Inflation risk: import prices rise, feeding through into domestic costs

An **appreciation** (currency becomes more expensive):

- Exports more expensive 'export demand falls

- Imports cheaper 'import demand rises
- Current account may worsen

## Protectionism: Trade Barriers

Governments sometimes restrict trade to protect domestic industries, employment, or strategic sectors.

| Barrier             | Description   | Effect  |
|---------------------|---|---|
| Tariff              | Tax on imports, raising their price                                     | Reduces import demand; raises government revenue; protects domestic producers |
| Quota               | Quantitative limit on the volume of imports                             | Directly limits import quantity; raises domestic price                        |
| Embargo             | Complete ban on imports (or exports) from a specific country            | Stops trade entirely  |
| Exchange controls   | Restrict the amount of foreign currency available for imports           | Limits import spending  |
| Subsidies           | Government payments to domestic producers                               | Allow domestic producers to compete on price without raising quality          |
| Non-tariff barriers | Technical standards, labelling requirements, complex customs procedures | Raise the cost and difficulty of exporting to a market                        |

**Common External Tariff (CET):** A tariff rate applied uniformly by all members of a customs union (such as CARICOM) on imports from non-member countries.

## Arguments for Protectionism

- **Infant industry** — new industries in developing countries need time to reach economies of scale before facing global competition.
- **National security** — certain strategic industries (food, defence) should not depend on foreign supply.
- **Preventing dumping** — foreign firms may sell below cost to capture market share.
- **Retaliation** — protecting domestic industries in response to a trading partner's trade barriers.

## The World Trade Organisation (WTO)

The **WTO** is an international body that oversees the rules of global trade, mediates trade disputes between members, and pushes for progressive trade liberalisation — the reduction of tariffs and other barriers.

Its core principles: non-discrimination (most favoured nation treatment), transparency, and reciprocity in trade concessions.

### Exam Tip

The comparative advantage calculation appears frequently in Paper 02. Always: (1) identify who produces what at a lower opportunity cost, (2) state which country specialises in which good, and (3) explain how both countries gain from trade. Stating "Country A is better" is not enough — you must compare opportunity costs.