



ITF — Certificate Course in International Trade Finance

Complete Book | Table of Contents | 51 chapters + 10 sections

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CH-1

International Trade - Meaning and Definitions

Topic 1 — Basic Principle and Theories of International Trade

- **Basic principle** — A country should **import** products it **cannot produce cheaply at home**.
- **Export rule** — It should **export** the products it **produces cheaply at home**.
- **Theories** — Four theories explain why and what countries trade.
- **Cause** — International trade arises from differences in **resources, costs and efficiency**.
- **Basis** — Its basis is **specialisation and division of labour at country level**.

International trade differs from domestic trade through	Gains from trade
Multiple currencies and exchange-rate risk	Static gains: specialisation and efficient resource allocation
Customs duties and tariffs	Dynamic gains: technological progress, learning and economic growth
Different regulatory frameworks and laws	

- **Modern relevance** — Trade theory now covers **services, digital trade and technology flows**; the factor-endowment idea now includes **human capital and knowledge assets**.
- **Key exam areas** — Comparative advantage (most fundamental), H-O assumptions, the Leontief Paradox, the terms-of-trade formula (numerical) and trade creation vs trade diversion.
- **See** — Ch 2 (p. 5) for the summary table of the four trade theories and the other theories of trade.

Remember this

- Static gain = **specialisation**; dynamic gain = **technology, learning, growth**.

Topic 2 — Theory of Absolute Advantage

- **Also called** — The theory is known as **Smith's theoretical contribution**.
- **Core idea** — It highlights the benefits of **specialisation and trade**.
- **Condition** — Each trading party should produce its exports at the **lowest absolute cost**.

Example: Country A produces **wheat** more cheaply than Country B, and Country B produces **petroleum** more cheaply than Country A. Both meet the condition of producing at the lowest absolute cost, so trading wheat for petroleum is a **win-win** for both.

Smith's own summary

"If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it from them with some part of the produce of our own industry, employed in a way in which we have some advantage."

The theory assumes that **each country specialises in one commodity** in which it holds the absolute advantage. It cannot explain trade when one country is more efficient in both goods.

Topic 3 — Theory of Comparative Advantage

- **Condition** — A country can specialise and trade if it produces a good at a **lower relative cost (opportunity cost)** than the other country.
- Compare the **opportunity cost of the same good** between countries.

- Specialise in the good with the **lower opportunity cost** than the other country, not merely the good with the smallest numerical cost across unlike products.

Opportunity cost of good X, where Q is the output of each good from one labour hour in that country:

$$OC_X = \frac{Q_Y}{Q_X} \text{ units of Y per unit of X}$$

Production per labour hour	India	England
Shirt (S)	5	3
Cotton (C)	10	9
OC of 1 Shirt	10 / 5 = 2 C	9 / 3 = 3 C
OC of 1 Cotton	5 / 10 = 0.5 S	3 / 9 = 0.33 S
Specialise in	Shirts (2 C < 3 C)	Cotton (0.33 S < 0.5 S)

Example: India produces more of **both** goods per hour (absolute advantage in both), yet trade still pays. India's OC of a shirt is 10/5 = 2 cotton against England's 9/3 = 3 cotton, so India makes shirts. England's OC of cotton is 3/9 = 0.33 shirt against India's 5/10 = 0.5 shirt, so England makes cotton.

Remember this

- The two opportunity costs of a country are **reciprocals** (2 C and 0.5 S); the country with the lower OC in one good always has the higher OC in the other.
- **See** — Ch 2 (p. 5) for Ricardo's assumptions, the labour-hours method and the terms-of-trade band.

Topic 4 — Heckscher-Ohlin Theory

- **Also called** — It is the **Modern Theory of International Trade**.
- **Export pattern** — A country tends to **export the commodity that uses relatively more of the factor of production that is relatively most abundant** in that country.
- **Use** — It helps evaluate the **trend of trade** between two nations based on factors of production.

Assumption	What it means
Identical production function	The quantum of factors differs across countries, but technology (production function) is the same
Different factor intensities	Different products need factors in different relative proportions (e.g., labour-intensive vs capital-intensive)
Different factor endowments	Countries hold different endowments of land, labour and capital

Example: A labour-abundant country tends to export labour-intensive goods such as garments; a capital-abundant country tends to export capital-intensive goods such as machinery.

- **See** — Ch 2 (p. 5) for the capital-labour ratio test of factor abundance and the Ricardo vs Heckscher-Ohlin comparison.

Topic 5 — Factor-Price Equalisation Theory

Under the model's **restrictive assumptions**, trade in goods alone can **equalise factor prices** (wages, returns on capital) across countries. It does **not require workers or capital to move** internationally.

- **See** — Ch 2 (p. 5) for the assumptions, the India-Germany wage example and why equalisation may fail in practice.

Topic 6 — Limits of International Trade Theory

- Theories rest on **assumptions that may not prevail** in the real world.
- **Barriers to free trade exist** in the real world, unlike the basis assumed by comparative advantage.

- The theories may **not be sufficient to explain which types of exports** from which country could be developed to compete in international markets.
- See** — Ch 2 (p. 5) for the real-world challenges and limits to comparative advantage.

Topic 7 — World Trade Organization

- Origin** — The **WTO** is the successor of the **General Agreement on Tariffs and Trade (GATT)**.
- How created** — It came out of a series of trade rounds held under GATT.
- Established** — It was set up in **1995**.
- Trade agreements are **negotiated and signed in the WTO** and then **implemented by nations through their Parliaments**.
- See** — Ch 3 (p. 8) for WTO membership, headquarters, functions, agreements and the Doha Development Agenda areas.

Topic 8 — Regional Trade Blocks and Preferential Trade Arrangements

Trade blocks are groups of countries that have established **Preferential Trade Arrangements (PTAs)** among members. They help **liberalise trade** between member countries.

Form of PTA	Internal barriers	Barriers against non-members	Example
Free Trade Area (FTA)	Reduced / eliminated among members	Each member keeps its own tariffs	USMCA (replaced NAFTA from 1 July 2020); ASEAN arrangements
Customs Union (CU)	Eliminated among members	Identical (common) external barriers	European Union (EU)

Potential negative effects of regional trade agreements

- Trade diversion** and trade distortions.
- Discriminatory** in nature, which can undermine the **multilateral system**.
- May stifle technological development, networked and joint manufacturing, and **restrict third-country sourcing**.
- Increased **administrative complications at customs**.
- Emergence of different **Preferential Rules of Origin (RoO)**, raising business costs. RoO are the rules that check whether goods **qualify for preferential treatment**.

Solutions

- Cumulation of origin**: inputs from partner countries are counted as originating, easing compliance.
- Harmonisation and simplification** of preferential rules of origin.
- See** — Ch 3 (p. 8) for the full integration ladder (PTA to common market) and the advantages and disadvantages of trade blocs.

Topic 9 — Trade and Cooperation Groups

The list below mixes **trade arrangements and cooperation forums**. It is **not** a list of equivalent free-trade areas or customs unions; each arrangement must be assessed under its **own agreement and date**.

Group	Full form / nature
ASEAN	Association of South East Asian Nations
APEC	Asia-Pacific Economic Cooperation
EAEC	East Asia Economic Caucus
Commonwealth	British Commonwealth of Nations
EU	European Union (customs union)

Group	Full form / nature
USMCA	United States-Mexico-Canada Agreement; replaced NAFTA from July 2020
CIS	Commonwealth of Independent States
COMESA	Common Market for Eastern and Southern Africa
SAARC	South Asian Association for Regional Cooperation
MERCOSUR	Tariff (customs) union of South American countries
G-15	Group of Fifteen developing countries
G-7	Economic power group of major advanced economies
G-77	Coalition of developing countries
D-8	Group of Developing Eight countries
IORA	Indian Ocean Rim Association; a cooperation forum

Topic 10 — International Chamber of Commerce

- Founded** — The **ICC** was founded in **1919**.
- Aims** — It promotes (a) **trade and investment**, (b) **open markets** for goods and services and (c) the **free flow of capital**.

Practical services to business	Importance of ICC for banks
Keeps in touch with members through conferences	ICC Banking Commission develops widely used contractual rules and guidance for international trade
Established the ICC International Court of Arbitration	Guidance to bankers through publications and market intelligence
Other practical services to meet the changing needs of business	Issues the Uniform Customs and Practice for Documentary Credits - UCP 600
	Promotes co-operation between nations
	World Chambers Federation (WCF) , formerly IBCC , administers the ATA Carnet system for temporary duty-free imports
	Set up the Institute of (World) Business Law , (Counterfeiting) Intelligence Bureau , International Maritime Bureau and Financial Investigation Bureau

Remember this

- ICC rules for banks: **UCP 600** (documentary credits); ATA Carnet via **WCF** (ex-IBCC).
- See** — Ch 4 (p. 12) for ICC's headquarters, network, rules, dispute-resolution services and ICC India.

ITF | Module 1 | CH-1 | MCQs

Q1. Country A makes wheat more cheaply than Country B, while B makes petroleum more cheaply than A. Trade between them is best explained by: [Ref: Topic 2, p. 3]

- (a) Absolute advantage (b) Factor-price equalisation
(c) Customs union theory (d) Heckscher-Ohlin theory

Q2. India produces 5 shirts or 10 units of cotton per labour hour. India's opportunity cost of one shirt is: [Ref: Topic 3, p. 3]

- (a) 2 units of cotton (b) 0.5 unit of cotton
(c) 5 units of cotton (d) 10 units of cotton

Q3. England produces 3 shirts or 9 units of cotton per labour hour. England's opportunity cost of one unit of cotton is: [Ref: Topic 3, p. 3]

- (a) 3 shirts (b) 0.33 shirt (c) 0.5 shirt (d) 2 shirts



Q4. Country X produces 4 units of wine or 8 units of cloth per hour; Country Y produces 2 wine or 6 cloth per hour. Under comparative advantage: [Ref: Topic 3, p. 3]

- (a) X should specialise in cloth and Y in wine
- (b) Y should produce both goods
- (c) X should specialise in wine and Y in cloth
- (d) No gainful trade is possible since X is better at both

Q5. Brazil makes 6 coffee or 12 sugar per hour; Kenya makes 4 coffee or 4 sugar per hour. Which statement is correct? [Ref: Topic 3, p. 3]

- (a) Brazil's OC of coffee is 1 sugar
- (b) Kenya should specialise in sugar
- (c) Brazil should specialise in coffee
- (d) Kenya's OC of coffee is 1 sugar, lower than Brazil's 2 sugar

Q6. A country rich in labour but short of capital will, under the Heckscher-Ohlin theory, tend to export: [Ref: Topic 4, p. 3]

- (a) Labour-intensive goods
- (b) Capital-intensive goods
- (c) Goods using its scarce factor
- (d) Only primary commodities

Q7. Which is NOT an assumption of the Heckscher-Ohlin theory? [Ref: Topic 4, p. 3]

- (a) Countries have different factor endowments
- (b) Countries have different production technologies
- (c) Products use factors in different relative proportions
- (d) Countries have identical production functions

Q8. Under the factor-price equalisation model, equal factor prices can result from: [Ref: Topic 5, p. 3]

- (a) Free international movement of labour and capital
- (b) Common external tariffs
- (c) Trade in goods alone, under restrictive assumptions
- (d) Harmonised rules of origin

Q9. Which is a recognised limit of international trade theory? [Ref: Topic 6, p. 3]

- (a) Barriers to free trade exist in the real world, unlike the theory's basis
- (b) It explains exactly which exports each country can develop
- (c) It guarantees social development through free trade
- (d) It assumes trade barriers are high

Q10. WTO trade agreements become effective in a member country when they are: [Ref: Topic 7, p. 4]

- (a) Ratified by the WTO General Council alone
- (b) Implemented by the nation through its Parliament
- (c) Approved by the ICC Banking Commission
- (d) Registered with GATT

Q11. Members of a group remove trade barriers among themselves and also adopt identical barriers against non-members. This is a: [Ref: Topic 8, p. 4]

- (a) Free trade area
- (b) Cooperation forum
- (c) Customs union
- (d) Preferential rule of origin

Q12. An exporter finds that its goods meet the rules of origin of one FTA but not another, raising compliance cost. The suggested remedy is: [Ref: Topic 8, p. 4]

- (a) Higher common external tariffs
- (b) Exit from the multilateral system
- (c) Restricting third-country sourcing
- (d) Cumulation of origin and harmonised rules of origin

Q13. Which agreement replaced NAFTA? [Ref: Topic 9, p. 4]

- (a) MERCOSUR
- (b) USMCA
- (c) COMESA
- (d) APEC

Q14. A bank's trade finance desk handling documentary credits applies rules issued by: [Ref: Topic 10, p. 4]

- (a) WTO
- (b) World Bank
- (c) ICC (UCP 600)
- (d) IORA

Q15. An exhibitor wants to take equipment abroad temporarily without paying import duty. The ATA Carnet system is administered by: [Ref: Topic 10, p. 4]

- (a) ICC International Court of Arbitration
- (b) International Maritime Bureau
- (c) WTO Secretariat
- (d) World Chambers Federation (formerly IBCC)

Answer key

Q	Ans	Q	Ans	Q	Ans	Q	Ans	Q	Ans
1	a	4	c	7	b	10	b	13	b
2	a	5	d	8	c	11	c	14	c
3	b	6	a	9	a	12	d	15	d

CH-2

Theories of International Trade

Topic 1 — International Trade: Why Countries Trade

International trade, also called **cross-border trade**, is the **exchange of goods and services between nations**. It arises because **no country is self-sufficient** in all resources and products.

Why countries trade	Benefits of trade
Acquire goods/services they cannot produce , or can import more cheaply	Boosts GDP and economic growth
Export surplus produce where there is demand abroad	Optimal allocation of resources
Specialise in sectors of strength or cost advantage	Earns foreign exchange revenue
	Access to global technologies and products
	Promotes employment , especially in export-focused sectors

Topic 2 — Theory of Absolute Advantage

- **Given by** — The theory was given by **Adam Smith**.
- **Absolute advantage** — A country produces a good using **fewer resources**, i.e., at a **lower absolute cost**, than another country.
- **Policy** — Each country should **specialise in what it produces best** and trade for the rest.

Country	Product	Production cost	Trade outcome
India	Textiles	Low	Exports textiles to Germany
Germany	Machinery	Low	Exports machinery to India

Both countries gain because each buys from the other what it would make at a higher cost at home. The test compares the **cost of the same good** across countries in absolute terms.

Topic 3 — Theory of Comparative Advantage: Assumptions

- **Origin** — **David Ricardo** proposed it to refine Smith's ideas.
- **Key result** — Even a country **more efficient in producing all goods** still benefits from trade.
- **Basis** — Trade rests on **opportunity cost**, not absolute efficiency.