1 International Business and International Trade

INTRODUCTION

The primary emphasis in this book is on the techniques of international finance, but in this chapter the opportunity is taken to discuss, in broad terms, the motives and strategy of companies seeking to increase their value through the international exploitation of their relative strengths.

Quite deliberately no distinction is made between international business based on trade and international business based on direct investment outside the home country. In our view such a distinction ignores the degree to which trade and investment strategies intertwine, and in terms of interests, it is difficult to argue that any company choosing to exploit its relative strengths through international trade rather than international investment is not just as concerned about the same issues of political, economic and exchange risk, as one primarily engaged in direct investment. Indeed, in modern conditions, international trade and international investment are almost invariably associated. A car manufacturer who simply offloaded his products on to the quayside would find that pure international trade had its drawbacks. ¹

INTERNATIONAL TRADE AND INTERNATIONAL BUSINESS

The economic basis for international trade is relatively uncontroversial. Trade exists to exploit international differences in relative prices whether these differences arise from dissimilarities in tastes or from unevenness in the distribution of productive resources. In the face of relative price differences ² international exchange can benefit both countries participating in the exchange process and also the agencies that initiate and support the trade.

The factors influencing the process of international exchange, or
international trade, can be illustrated quite simply. Suppose that we take as an example the trade in textiles between countries A and B.

Now the willingness of textile manufacturers in A to supply textiles domestically depends on the price that they can obtain. At a low price only the most efficient could survive while at a high price new entrants will rapidly swell capacity in the industry. The relationship between the price of textiles and the quantity of textiles supplied by the textile industry in A is summarised by the supply schedule $S_A$ (Figure 1.1). Similarly, the line $D_A$ shows the relationship between demand for textiles in A, and the level of possible prices for textiles. If country A has no external trade it follows that there is only a single price, $P_A^1$, at which the quantity of textiles offered by producers is exactly equal to the quantities demanded by consumers.

Suppose we now add a second country B, which also manufactures and consumes textiles, at a point in time at which no textiles are traded between A and B. If one unit of the currency of A buys 100 units of the currency of B we can show the supply and demand position in both A and B side by side, using appropriate scales. Comparing the position in A with that in B, it is obvious that supply costs in country A are far lower than in country B, and also that consumers in country B are willing to buy textiles at well above the going rate in A.

Suppose that someone then notices the price difference between the two countries and starts to buy textiles in country A at $P_A$, whilst selling in B at $P_B$. Initially he can make an attractive margin, but as the scale of operations increases the trader will gradually find that in order to increase the volume of supplies he can buy in A he has to put up the price he pays there, while to sell the increased volume in B the price he charges has to drop. In the process his margin drops but provided it is still adequate to cover tariff and transport costs it is worth making the transaction.

Eventually, however, the trader will find that in expanding trade, the price he has to pay in A, plus tariffs and transport costs, exactly equals the price he can obtain in B. It does not pay to expand trade further. This leaves the countries in the position shown in the second part of Figure 1.1, where the price of textiles in A has risen to $P_A^2$, while in B it has fallen to $P_B$, a level that is greater than $P_A^2$ by exactly the cost of transport and tariffs. At this point the trader will have no further incentive to expand, and a new equilibrium will be established in which supply of textiles in A will have expanded under the influence of improved prices to $Q_{A_5}$, where it exceeds demand $Q_{A_1}$ by the amount exported. In turn, lowered prices in B have reduced domestic supply and stimulated demand. The shortfall