UNIT 5

TRADE AND FINANCE

Introduction to Trade

Trade is the process of buying, selling, or exchanging goods and services. It is divided into two main categories:

1. **Domestic Trade**: This is the exchange of goods and services within a single country or territory. It involves:
    - **Retail Trade**: Selling goods directly to consumers.
    - **Wholesale Trade**: Selling goods in bulk to retailers or other businesses.

    Importance of Domestic Trade:

    - **Economic Growth**: Enhances the standard of living and creates jobs.
    - **Investment:** Encourages investment and development within the country.
    - **Stability**: Reduces dependence on foreign sources and mitigates impacts of international conflicts.

    Advantages:

    - Lower transaction and transportation costs.
    - Keeps money within the country for future economic growth.

    Limitations:

    - Limited product selection and capacity to meet demand.
2. **International Trade**: This involves the exchange of goods and services between countries. It allows nations to:
    - **Utilize Specialization**: Focus on producing goods more efficiently.
    - **Access Varied Products**: Obtain goods that are not available or are expensive to produce domestically.
    - **Improve Efficiency**: Foreign competition can boost domestic efficiency.

    Benefits:

    - Increases the variety of goods available.

   - Enhances technological exchange and cultural ties.
   - Promotes better resource use globally.

Theories of International Trade

1. **Absolute Advantage (Adam Smith)**:
   - **Concept**: A country has an absolute advantage if it can produce a good more efficiently than another country.
   - **Example**: Ethiopia produces coffee more efficiently than it produces cloth, while China produces cloth more efficiently than it produces coffee. Thus, both countries benefit by specializing and trading.
2. **Comparative Advantage (David Ricardo)**:
   - **Concept**: Even if one country is less efficient in producing all goods compared to another country, trade can still be beneficial if each country specializes in producing the goods it makes relatively more efficiently.
   - **Implication**: Specialization and trade lead to more efficient global production and increased overall economic welfare.

Key Terms

- **Import**: Goods brought into a country from abroad.
- **Export**: Goods sent from a country to be sold in another country.
- **Trade Balance**: The difference between the value of exports and imports.
- **Tariffs**: Taxes imposed on imports.
- **Non-tariff Measures**: Regulations other than tariffs that countries use to control the amount of trade.

Limitations of the Theory of Absolute Advantage

1. Simplistic Assumptions:

- **Labor as the Only Factor:** The theory assumes labor is the only factor of production. However, production involves various factors such as capital and technology, which vary between countries.
- **Homogeneous Labor:** It also assumes labor is homogeneous within each country, but in reality, labor varies in skill and productivity.

2. Limited Scope of Trade Explanation:

- **Developed vs. Developing Countries:** Absolute advantage explains trade mainly between countries with different levels of development. It doesn't

fully account for trade between developed nations where both countries may have absolute advantages in different sectors.
- **Both Goods Production:** It doesn't address scenarios where one country has an absolute advantage in producing both goods.

3. Introduction of Comparative Advantage:

- **David Ricardo's Contribution:** To address these gaps, David Ricardo introduced the principle of comparative advantage, which considers opportunity costs and allows for beneficial trade even if one country has an absolute advantage in all goods.

David Ricardo's Principle of Comparative Advantage

1. Ricardo's Model Assumptions:

- **Two Countries, Two Goods:** The model involves two countries and two goods with labor as the sole production factor.
- **Homogeneous Goods and Labor:** Goods are identical across countries; labor is identical within but not across countries.
- **Fixed Technology and Full Employment:** Technology and labor are constant; there is full employment and perfect competition.
- **No Trade Barriers:** Assumes no government obstacles and zero transportation costs.

2. Comparative Advantage Concept:

- **Opportunity Cost:** Ricardo introduced opportunity cost—the value of what must be forgone to produce an additional unit of a good.
- **Specialization:** Even if one country is more efficient in producing both goods, trade can still be beneficial. Countries should specialize in goods where they have the lowest opportunity cost and trade for the rest.

3. Numerical Example:

- **Ethiopia vs. Germany:** For instance, if Ethiopia and Germany produce automobiles and wine, and Germany is more efficient in both, Ethiopia still has a comparative advantage in wine if it sacrifices fewer automobiles to produce wine compared to Germany.

Criticisms of Ricardo's Theory

1. Labor Theory of Value: Ricardo's theory assumes labor as the only input, which is unrealistic as other factors like capital are also crucial. **2. Constant Returns to**

Scale: The theory assumes constant production costs, which may not hold true in real-world scenarios.

Summary

The theory of absolute advantage, while foundational, has limitations due to its simplifying assumptions and scope. David Ricardo's principle of comparative advantage addresses these by focusing on opportunity costs and showing that trade can be mutually beneficial even if one country holds an absolute advantage in all goods.

Fixed and Floating Exchange Rate Systems

Fixed Exchange Rate Systems

- **Definition:** In a fixed exchange rate system, the value of a country's currency is set relative to another currency. This rate is determined by the government or central bank and is maintained through intervention in the foreign exchange market.
- **Mechanism:** The central bank buys or sells foreign currency to keep the exchange rate stable. They must hold reserves of foreign currency to manage this stability.
- **Advantages:**
  - **Stability:** Keeps the currency value stable, reducing uncertainty in international trade.
  - **Predictability:** Helps exporters and importers by providing a stable environment for international transactions.
  - **Inflation Control:** Can help keep inflation low by maintaining a stable exchange rate.
- **Adjustments:**
  - **Devaluation:** When the fixed rate is lowered, making the local currency cheaper. This typically boosts exports and reduces imports.
  - **Revaluation:** When the fixed rate is raised, making the local currency more expensive. This typically reduces exports and increases imports.

Floating Exchange Rate Systems

- **Definition:** In a floating exchange rate system, the value of a currency is determined by the foreign exchange market based on supply and demand.
- **Mechanism:** The exchange rate fluctuates based on market forces. Governments or central banks might intervene occasionally to influence

the currency's value, but the rate is mostly determined by market dynamics.

- **Advantages:**
  - **Market-Driven:** Exchange rates adjust naturally based on economic conditions, which can help balance trade deficits or surpluses.
  - **Flexibility:** Allows for automatic adjustment of the currency value based on market conditions.
- **Adjustments:**
  - **Appreciation:** When the value of the currency increases relative to others, meaning it can buy more of other currencies. This can occur due to strong economic performance.
  - **Depreciation:** When the value of the currency decreases relative to others, meaning it buys less of other currencies. This can occur due to economic instability or other factors.

Regional Integration and Globalization

Regional Integration

- **Definition:** Regional integration is when countries work together to achieve common goals, such as economic growth or stability. It involves agreements to reduce trade barriers and enhance cooperation.
- **Types:**
  - **Free Trade Area:** Removes trade barriers between member countries but allows them to set their own trade policies with non-members (e.g., NAFTA).
  - **Customs Union:** Removes trade barriers between member countries and adopts a common trade policy towards non-members.
  - **Common Market:** Allows for free movement of goods, services, labor, and capital among member countries (e.g., COMESA).
  - **Economic Union:** Combines the features of a common market with a unified economic policy (e.g., the EU).
- **Advantages:**
  - **Trade Benefits:** Reduces trade costs and increases access to markets.
  - **Employment:** Can create jobs through market expansion and investment.
  - **Political Cooperation:** Strengthens relationships and promotes stability among member countries.
- **Disadvantages:**
  - **Trade Diversion:** Might lead to less efficient trade if it shifts from efficient non-member countries to less efficient member countries.
  - **Employment:** Can lead to job losses if firms relocate to countries with lower costs.

    - **Sovereignty:** Member countries may lose some control over their own trade and economic policies.

Globalization

- **Definition:** Globalization refers to the increasing interconnectedness of the world through trade, technology, and cultural exchange.
- **Benefits:**
    - **Market Access:** Provides new markets for products and services.
    - **Technology:** Facilitates the transfer of technology and innovation.
    - **Standards of Living:** Can lead to improved living standards through economic growth and competition.
- **Downsides:**
    - **Cultural Impact:** Can lead to loss of cultural identity.
    - **Exploitation:** May lead to exploitation of workers, especially in developing countries.

By understanding these concepts, students can better grasp how global economics operates and how different exchange rate systems and regional integrations impact international trade and economic stability.