

Trade

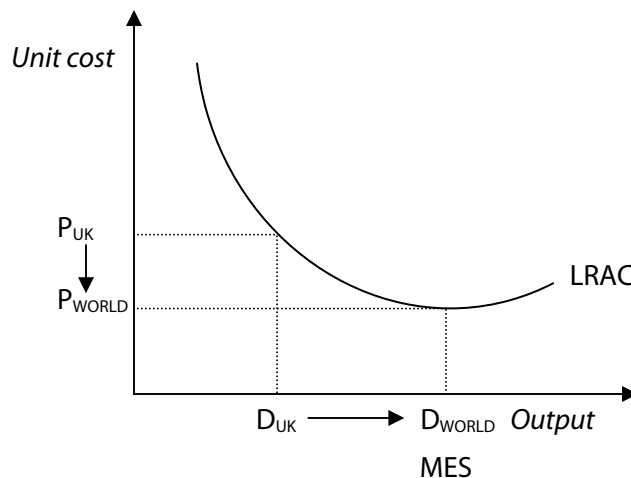
What types of trade take place between economies?

Inter-industry trade: Where different economies specialise in producing different goods and services then trade, e.g. France makes bread and the UK meat.

Intra-industry trade: Where one economy is both an exporter and an importer of the same good or service. For example, the UK exports cars and unrefined oil but imports different models of cars and refined oil.

Why does trade take place?

- Different countries have different availability of resources (factor endowments), for example India has excess labour whereas the UK has a shortage. Economies with large resources can specialise, for example agriculture for an economy with lots of land.
- Access to different levels of technology allows easier production of some goods and services.
- Differentiated products are offered by different economies so goods are imported to increase consumer choice for different types of apples and cars.
- To exploit economies of scale to create lower unit costs. Very large companies may choose a variety of smaller factories around the world instead of one large factory so as not to exceed their MES (minimum efficient scale – output at which the unit cost is lowest).



Trading allows UK companies to increase demand from D_{UK} to D_{WORLD} and so decrease their unit cost from P_{UK} to P_{WORLD} .

What are the gains of free trade?

(See Anderton p. 263 and study guide p. 67)

Free trade is the international exchange of goods and services without barriers such as quotas and tariffs.

- *Specialisation:* Economies specialise in producing what they are best at.
- *Economies of scale:* As above, allow an extension in the LRAC curve which causes a fall in unit costs.

- *Choice*: Consumers can choose from differentiated products produced in different economies.
- *Innovation*: Increased competition (from suppliers in other economies) leads to pressure to innovate and increase efficiency.

Under free trade, Adam Smith said that economies should specialise according to absolute advantage. What is this?

(See Anderton p.88)

Absolute advantage is when a country can produce a good more cheaply in absolute terms than another country. That is, what a country can produce given its factor endowment. If an economy is said to have an absolute advantage this means that it can produce more than another economy or produce the same output at a lower absolute cost.

In reality one economy may be better at producing many goods than another economy – the economy may have an absolute advantage in the production of all goods. Trade can still be worthwhile if one economy has a comparative advantage. A comparative advantage is the opportunity cost of producing that item, the production of another good or service forgone. If one economy can produce good A by sacrificing the production of good B, yet another economy can only produce good A by sacrificing the production of two good B's the first economy is said to have a comparative advantage over the second.

The terms of trade and price ratio (the ratio of export prices to import prices) will determine whether trade is beneficial. However whilst specialisation brings rewards of increased productivity for all involved the benefits, the extra production, may appear predominantly or exclusively in a single economy or a minority of economies involved in the trade. As long as no economy is worse off through trading it is still likely though that trade will take place.