UNIT 9

INTERNATIONAL TRADE AND BALANCE OF PAYMENTS

Unit Objectives

After completing this unit, you will be able to:

- realize the concept of balance of payments and identify the parts of balance of payments;
- understand the restriction on trade and modes of payments; and
- exemplify the impact of foreign trade on the economy.

Main Contents

INTRODUCTION

Just as an individual produces only that commodity which he/she can produce with the greatest skill and efficiency, similarly a nation produces only those commodities which it can produce with great efficiency and minimum cost. On the other hand, just as an individual cannot produce all commodities he/she wishes to consume, similarly, a nation cannot produce all of the commodities which its nationals wish to consume. Each country has to depend on others for the supply of commodities which it cannot produce. This gives rise to international trade, i.e., *the exchange of goods and services among different countries*. Naturally, this exchange of goods and services involves payments by one country to another. A concept broadly related to such payments is known as *balance of payments*. In the present unit we discuss some important aspects of international trade and balance of payments — features, causes, benefits, procedures, etc.

9.1 INTERNATIONAL TRADE

At the end of this section, you will be able to:

- define the concept of international trade;
- analyze absolute advantage and comparative advantage;
- explain import and export;
- distinguish the difference between trade surplus deficit and balance;
- identify and define the basic restrictions on trade; and
- identify and explain mode of payment in international trade.

Key Terms and Concepts

- Import
- Export
- Trade surplus
- International trade
- Absolute advantage
- Comparative advantage
- Volume of trade
- Value of trade
- Tariff restrictions
- Import quota

Startup Activity

What do you mean by international trade? Discuss its advantages, with examples.

No country in the world is completely self-sufficient, i.e., no country produces all the goods and services that it requires. Due to differences in the availability of natural resources and other inputs required for production, some countries specialise in production of some goods which they produce more cheaply than other countries. The other countries may likewise produce some other goods relatively cheaply. Hence, countries specialise in the production of those goods for which they are best suited. They produce more of such goods than their own requirements and exchange their surplus production for those goods from other countries that they need but either cannot produce at all or can produce only at a relatively high cost. This sort of international specialisation gives rise to the exchange of goods (purchase and sale) across geographical boundaries of countries. This is called international trade or foreign trade. We may say *international trade refers to the exchange of goods and services among different countries of the world*.

The above paragraph makes it clear that nations trade with each other because of their specialisation in the production of certain goods. But what are the factors that determine this specialisation?

Factors Determining International Trade

Some of the factors which are responsible for international specialisation, and hence international trade, are identified as follows:

- ***Unequal Distribution of Natural Resources:*** *Natural resources are not equally distributed over the world. These resources are in the form of agricultural land, mineral deposits, forests, seas, rivers, climatic conditions, etc. For example, Ethiopia is rich in natural resources. On the other hand Japan is deficient in natural resources. A land-abundant country may specialise in the production of agricultural products, minerals, timber, fish, etc.*
- ***Unequal Distribution of Population:*** *Population is the source of labour supply. Labour-scarce countries prefer to import labour-intensive products from labour-abundant countries.*
- ***Unequal Distribution of Capital:*** *Capital is probably the most important factor of production in the sense that, in the absence of capital, all other resources may remain inactive. Capital means man-made machines,*

equipment, etc. A country that is rich in capital exports capital-intensive goods. Japan, the USA, Germany, the UK, France, etc., are capital-rich countries and thus export machines and equipment.

- ***Level of Technological Development:*** *Technology is another important aspect of production. Countries using sophisticated technology specialize in technology-based goods like computers, telecommunication equipment, airplanes, etc. Those countries that do not have advanced technology have no option but to import technology-based goods from technology-rich countries.*
- ***Increasing Returns to Scale:*** *The countries which are in a position to produce goods on large scales enjoy significant reductions in per-unit costs as they produce more. This gives these countries a competitive advantage over their rivals in the export market and helps them to specialize in these particular goods.*
- ***Difference in Demand:*** *Demand is largely a function of income levels and taste patterns. In high-income countries, demand is high, and so is price. In low-income countries, demand is low, and so is price. Naturally, a high-price country would like to import from low-price countries. The producers in low-price countries would like to export to higher-price countries and increase their profit. Similarly, goods move to the countries where people have tastes for them because producers can get high prices for their goods from the people of these countries.*

Advantages of International Trade

International trade is an economic phenomenon of vital importance and has always played an important role in the economic life of nations throughout world history. We identify below some of the major advantages of international trade.

- ***Variety of Goods:*** *International trade enables a country to consume a larger variety of goods than would be available otherwise to its population.*
- ***Availability of Raw Material and Specialised Goods:*** *A country is able to acquire those commodities through international trade which it cannot produce at home. For example, raw material and mineral resources are not available in all countries. Raw materials which are not available within a country can be imported through international trade. Similarly, many commodities can be grown only under particular climatic conditions or in certain soils. Most of the countries of the world, therefore, depend upon international trade to obtain of these commodities.*

- ***Specialization and Division of Labour:*** *International trade enables different countries of the world to exploit the advantages of division of labour and specialization.*
- ***Increase in Efficiency through Widening of Market:*** *International trade is a means by which efficiency in the economy increases. International trade widens the extent of the market. Consequently, every country attempts to produce goods in large quantities. This induces production on large scales, and thereby generates economies of scale.*
- ***Cheaper Goods:*** *International trade lowers the prices of goods and services all over the world, due to lower costs of production.*
- ***Competition:*** *International trade encourages countries to compete with each other. Competitiveness stimulates productivity. It also reduces monopolistic exploitation of consumers.*
- ***Optimum Allocation of Resources:*** *International trade leads to optimum allocation of resources. Under a system of free trade, a country can sell its products in those markets where it can get the best price for its products, and it can buy its requirements from the cheapest source of supply.*
- ***Vent for Surplus Production:*** *International trade enables every country to dispose of its surplus production. As a result, a country is able to avoid the possibility of deflationary pressure which may arise because of unsold stocks of goods.*
- ***Possibility of Economic Development:*** *International trade can be an important vehicle for promoting economic development. Developing countries are able to initiate economic development by importing machinery and technical know-how from developed countries.*

Basis of International Trade

What is the basis of international trade? Or why do different countries trade with one another?

We have two different explanatory principles or theories.

i Adam Smith's Theory of Absolute Cost Difference

ii David Ricardo's Theory of Comparative Cost

Theory of Absolute Cost Difference (Adam Smith)

This theory is also known as the *theory of absolute advantage*. According to this theory, the fundamental basis of international trade is the difference in absolute cost. An absolute cost difference arises when one country can produce a commodity at a lower cost compared to another country, and the other country can produce some other commodity at a lower cost compared to the first country. Thus, an absolute cost difference arises when each of the two countries can produce some commodities at an absolutely lower production cost than the other.

This may be because each country possesses a special kind of soil, climatic conditions, human resources and technology. Consequently, a country tends to specialize in producing that particular commodity which it can produce at an absolutely lower cost and exports it to other countries. Similarly, it imports the other commodity, which it produces at a higher cost. To put it differently, if one country has an absolute advantage (in cost of production) in the production of one commodity and another country has an absolute advantage in the production of another commodity, each country should specialise in the production of that commodity for which it enjoys the absolute advantage and import the commodity for which it has the absolute disadvantage.

The theory of absolute cost difference (or absolute advantage) can be illustrated through a simple two-country two-commodity hypothetical example as given in Table 9.1.

Table 9.1: Absolute Cost Difference (Production of One Labourer in One Day)

Country	Coffee	Wheat
India	4	8
Ethiopia	8	4

It is clear from Table 9.1 that labourer can produce 4 units of coffee and 8 units of wheat in India, whereas in Ethiopia 1 labourer can produce 8 units of coffee and 4 units of wheat. Wheat can be produced more cheaply in India and coffee more cheaply in Ethiopia. India has an absolute advantage in producing wheat and an absolute disadvantage in producing coffee. In the same way, Ethiopia has an absolute advantage in producing coffee and an absolute disadvantage in producing wheat. Hence, India would specialise in the production of wheat and export it in exchange for coffee from Ethiopia. On the other hand, Ethiopia would produce and export coffee to India in exchange for wheat.

II Theory of Comparative Cost (David Ricardo)

This theory is also known as *theory of comparative advantage*. Now consider a situation in which one country can produce both commodities at a lower cost than the other country. In this case, the first country has an absolute advantage in the production of both of the commodities, and the other has an absolute disadvantage in the production of both commodities. Trade in such a situation is better explained with the use of the theory of comparative advantage.

A *comparative difference in costs* means that one country can produce both goods at an absolutely lower cost than a second country can, but the first country's cost for the production of one of those goods is comparatively lower than its cost of producing the other good. The second country produces both goods at an absolutely higher cost than the first country does, but it has less of a comparative disadvantage in the production of one good than in the production of the other good.

According to the theory of comparative cost, *a country tends to specialise in the production of those goods for which it has lower comparative costs.* To put it differently, *a country tends to specialize in the production of those goods for which it has greater comparative advantages.* Thus, a country would produce and export the product for which its advantage is more, or in which it has a comparative advantage, and import the commodity in which its advantage is less, or in which it has comparative disadvantage.

The theory of comparative cost (or comparative advantage) can be illustrated through the simple hypothetical example in Table 9.2.

Table 9.2: Comparative Cost Difference (Production of One Labourer in One Day)

Country	Coffee	Wheat
India	20	8
Ethiopia	8	4

It is clear from — Table 9.2 that India can produce both coffee and wheat at a cheaper cost — i.e., it is more efficient than Ethiopia in the production of both goods, but India's efficiency in the production of coffee is two and a half times more than that of Ethiopia, while in the production of wheat it is twice as much. Cost being reciprocal to efficiency, the per-unit cost of the production of coffee in India is two and a half times less than that of Ethiopia, while the cost per unit of wheat in India is half that of Ethiopia.

Thus, relative productivity ratios for wheat and coffee in India are:

Relative Productivity Ratios for Coffee

$$= \frac{\text{In India 20 Units of Coffee}}{\text{In Ethiopia 8 Units of Coffee}} = \frac{20}{8} = 2.5$$

Relative Productivity Ratio for Wheat

$$= \frac{\text{In India 8 Units of Wheat}}{\text{In Ethiopia 4 Units of Wheat}} = \frac{8}{4} = 2$$

Thus, it will be to the advantage of India to specialize in the production of coffee, in which it enjoys greater relative efficiency or greater comparative advantage over the other country.

Likewise, it can also be proved that Ethiopia has a comparative advantage (or less of a comparative disadvantage) in the production of wheat. Thus according to this example India should produce and export coffee, and Ethiopia should produce and export wheat.

Concepts, Components and Impacts of Foreign Trade

As we know, foreign trade refers to the exchange of goods and services among different countries of the world. It has two components, namely, *exports* and *imports*.

The goods and services that enter into a country in the form of purchases from other countries are called *imports*. On the other hand, goods and services that leave the country's frontiers as sales by that country (or as purchases by other countries) are called *exports*. The value of exports (i.e., money value of all goods exported) plus the value of imports (i.e., money value of all goods imported) during a given year is called the *value of trade*. On the other hand, the physical quantities of goods exported plus those imported in a year, is called the *volume of trade*. Based upon comparisons between the imports and exports of a country, we have three different cases for the foreign trade of a country.

- *When the value of exports is more than that of imports, the country is said to have a trade surplus or favourable (or positive) foreign trade.*
- *When imports are more than exports, the country is said to have a trade deficit, i.e., unfavourable (or negative) foreign trade.*
- *When the value of exports equals the value of imports, we call it a trade balance.*

Trade Restrictions

As a measure towards protection of domestic industries of a country, sometimes restrictions are imposed on foreign trade, particularly on imports. These restrictions are broadly of two types.

- ***Tariff Restrictions:*** *Tariff restrictions are in the form of taxes on the import of goods, called custom duty or import duty. Such taxes raise the price of imported goods in the domestic market. These high prices of imported goods are expected to reduce their demand in the domestic market and thus to act to restrict imports.*
  - *Tariff increases government revenue.*
- ***Quantitative Restriction (Import Quota):*** *These restrictions take the shape of fixing the maximum quantity of goods that is permitted to be imported. Thus, the government may determine the total import quota of goods, i.e., the total amount of goods that can be imported, and can allot this quota to various importers. Nothing beyond the quota is allowed to be imported. This naturally limits the quantity of imports.*

Mode of Payments in Foreign Trade

Every country exports and imports goods as a normal part of its economic activity. A country receives payment for goods that it sells to foreign countries. The payments for such goods by the foreign purchasers are made in their own country's currency (foreign currency) and hence the exporting country receives *foreign exchange* (foreign currency) for goods that it exports. Similarly, for whatever a country imports from foreign countries, it has to make payment for these purchased goods in a foreign currency acceptable to the foreign sellers because the local currency might not have any value in the sellers' country. Thus, imports lead to payments in foreign currency, and exports of goods give rise to receipts of foreign currency to a country. The difference between the amount of foreign currency received on account of export of goods and the payment made for import of goods is called *balance of trade*. The balance of trade may be expressed in terms of foreign currency such as US dollars or in terms of domestic currency (Birr in the case of Ethiopia).

Impact of Foreign Trade on an Economy

We have already discussed in the advantages of international trade (or foreign trade), which gives us an idea of the impact of foreign trade on an economy. It may be re-emphasised here that international trade has a very significant role to play in the economic growth of nations. The following points indicate how foreign trade acts as an engine of growth for an economy.

- *Since international trade results in increasing output and income of nations, it obviously leads to economic growth. Thus, through trade, the world economy can achieve a more efficient allocation of resources and a higher level of well-being of its people.*
- *The developing countries can take advantage of the superior technology of advanced countries. It is possible only when the former import capital goods from the latter.*
- *When developing countries establish trade relations with advanced countries, the former are not only able to procure advanced technology but the latest technical know-how and managerial skills, which are extremely important for growth.*

Thus, if each nation specializes according to its resource endowments and enters into trade with other nations, the world economy and the economy of each of these trading partners can achieve greater output and income and can maintain a higher level of economic growth.

Impact of Foreign Trade on GDP

As we know from the previous unit,

GDP = C + Ig + G + (X – M),

Where C = Consumption expenditure by households,

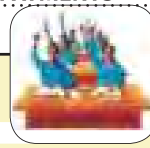
Ig = Gross Investment expenditure by firms,

G = Government expenditure on goods and services and

X – M = Exports – Imports = Net exports

Since net exports (X – M) is a component of GDP, foreign trade balance impacts GDP. There are three possible situations.

- ***When exports are more than imports (X > M):*** *i.e., the country has a trade surplus — GDP rises.*
- ***When imports are more than exports (X < M):*** *i.e., the country has a trade deficit — GDP falls.*
- ***When exports and imports are equal (X = M):*** *i.e., the country has a trade balance — GDP is not affected by foreign trade.*



Activity 9.1

1 Find out about the major exports and imports of Ethiopia and make a list of the export items and import items.

2 Collect available information from the internet and other sources to prepare a brief report on Ethiopia's major trading partners.

3 With your friends, discuss the major cause of Ethiopia's balance of trade deficit.

4 Examine the role played by international trade in the economic growth of nations.

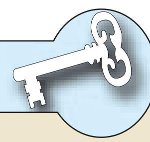
5 What do you mean by comparative difference in cost of production?

9.2 BALANCE OF PAYMENTS

At the end of this section, you will be able to:

- define balance of payments;
- define and identify the components of current account;
- define trade balance and show how trade balance is computed;
- define net services;
- define current account balance;
- identify the components of current account balance;
- compute and interpret change in countries — assets held abroad; and
- compute and interpret change in foreign assets held in a country.

Key Terms and Concepts



- Trade balance
- Net service
- Current account
- Capital account
- Direct investment
- Portfolio investment
- Private transactions
- Official transactions

Startup Activity

Ethiopia imports commodities much more than its exports. How do you think we can measure such a gap?

Meaning of Balance of Payments

The principal tool for the analysis of the monetary aspects of international trade is the balance of international payments statement. This statement, also simply known as the *balance of payments (BOP), is a systematic record of all international economic transactions, visible and invisible, of a country during a given period, usually a year.* In other words, the statement is a device for recording all the economic transactions within a given period between the residents of a country and the residents of other countries.

All payments and receipts of foreign exchange arising from such transactions are listed in the *balance of payments accounts*. It is, thus, a complete statement of a country's payments and receipts of foreign exchange in the given period of one year. Note that the trade of merchandise (goods) is only one of the many items on account of which a country makes payment or receives it. There are many other items, such as shipping and insurance services, interest and dividends, tourist traffic, etc., which give rise to payments or receipts of foreign exchange. They too are recorded, along with many others, to make a complete statement of accounts of how much foreign currency a country has to pay and how much of it is to receive in a given year.

Balance of payments accounts are prepared using the double-entry system of accounting, in which the sum of all debits equals the sum of all credits, and the accounts are always in balance. If a transaction earns foreign currency for the country, it is called a *credit* and is recorded using a *plus sign*. On the other hand, if a transaction refers to a spending of foreign currency by the country, it is called a *debit* and is recorded in BOP accounts using a *minus sign*.

In other words, all receipts of foreign currency are credit items, whereas all payments of foreign currency are debit items. If the total of the debit items and the total of the credit items are equal in value, the country's international payments are balanced. If the credit items are larger, so that there is a net balance due to it, the country is said to have a *favourable balance*. If the debit items are larger, so that there is a net balance due to foreigners, the country is said to have an *unfavourable balance*. Although, the terms "favourable" and "unfavourable" are misleading, they have the sanction of long usage.

Components (or Elements) of BOP

The balance of payment account is divided into two parts:

i Current account

ii Capital account

Current Account

The *current account* records inflows and outflows of foreign currency resulting from flows of goods, flows of services and unrequited (or unilateral) transfers. Accordingly, a current account has three parts — trade balance, net services, and net transfers.

- ***Trade Balance:*** *The difference between the export and import of goods is called the trade balance. The export and import of goods is also called visible trade, since goods are visible items.*
- ***Net Services:*** *The difference between the export and import of services is called net services. There are many services that are made use of in international trade, for example shipping, insurance and banking services. Ships have to be hired for transporting goods from one country to another. The merchandise carried by the ships has to be insured for any loss and damage in transit. Banking services are used to facilitate receipts from and payments to foreign dealers. When foreign ships (for example, ships from a company in the USA) are hired by a country to bring in goods imported from the USA, then, in addition to the payment for the import of goods, payment has to be made to the US shipping company in foreign currency. Conversely, if foreign countries use the services of, say, Ethiopian insurance companies and banks, Ethiopia will receive foreign currency from such countries on account of these services. Nowadays, tourism and travel among countries has also become an important item on balance of payments. When foreign tourists come to Ethiopia, they bring foreign currency in with them and convert it into our currency to spend it in our domestic market. The country thus receives foreign currency. Similarly, when Ethiopian tourists go abroad, they have to convert Ethiopian currency into foreign currency to spend it abroad. This involves an outflow or payment of foreign exchange.*

We may conclude that the difference between the inflow and outflow of foreign currency as a result of the export and import of services, such as banking, insurance, transport, tourism, etc., constitutes what we call net services. Note that the export and import of services is called invisible trade.

- ***Net Transfers:*** *Transactions such as gifts, remittances, donations, etc., are unrequited or unilateral receipts and payments, because residents of a country receive them 'for free'. Nothing has to be paid in return, either at present or in the future, for such receipts. The difference between the receipts and payments of such transfers is known as net transfers.*

The sum total of the above mentioned three components-trade balance, net services, and net transfers-is called *balance of payments on current account* or simply *current account balance* (CAB).

Remark: *If total receipts on the current account of balance of payments are more than the total payments, there is said to be a surplus in the current account. But if payments exceed receipts, the current account is said to be in deficit. The deficit in the current account of balance of payments means that the country has, during the year, spent more than what it earned in the form of foreign exchange. But how can a country spend more than what it has earned? It can do so only by borrowing from others, or finding some other avenues to get foreign exchange. These borrowings, loans, investments, etc., form the capital account of balance of payments.*

II *Capital Account*

The capital account of BOP records all such transactions between residents of a country and the rest of the world which cause a change in the assets or liability status of residents of a country or its government. It represents the international flow of loans and investments that change the country's foreign assets and liabilities. A capital account is made up of two major parts: the *country's assets held abroad* (which are recorded as a negative entry) and the *assets held by foreigners in the country* (recorded as a positive entry). The sum total of these two components gives the *balance of payments on capital account* or simply the *capital account balance*.

Various forms of capital account transactions are as given below:

- ***Private Transactions:*** *These are transactions which affect the assets and liabilities of individuals, businesses, and other non-government entities.*
- ***Official Transactions:*** *These include transactions affecting the assets and liabilities of the government and its agencies.*
- ***Direct Investment:*** *It means purchasing an asset and, at the same time, acquiring control of it. For example, the acquisition of a firm in one country by a firm in an other country or the purchase of a house by individuals abroad.*
- ***Portfolio Investment:*** *It is the acquisition of an asset that does not give the purchaser control over the asset. Examples are the purchase of shares in a foreign country or the purchase of bonds issued by a foreign government.*

Remark: *Many times there are some omissions from and errors in balance of payment accounts. Such an omission or error is known as a statistical discrepancy. Statistical discrepancies are normally included in the capital account so as to make the net capital account balance equal to and opposite of the net balance on the current account.*

Balance of Payments: Complete Account

By adding the balance on the capital account and the balance on the current account, we get the *complete balance of the payments account*. When receipts and payments are equal, the balance of payments is said to be *in balance*. If the total BOP receipts are more than the payments, the *excess* goes to a third account, the Foreign Exchange Reserves. And when payments exceed receipts, there is a *depletion of foreign exchange reserves*.

Activity 9.2

1 Given below is a table that shows Ethiopia's account balance, as a percent of GDP, between 2003/04 and 2007/2008. Study the table and make your observations about the trends in exports, imports, trade balance, etc.

Table 9.3: Ethiopian Current Account (as percent of GDP) 2003/04 – 2007/08

Item	2003/04	2004/05	2005/06	2006/07	2007/08
Trade balance	–19.8	–22.6	–23.7	–20.2	–20.1
Exports of goods (f.o.b.)	6	6.9	6.6	6.1	5.5
Imports of goods (c.i.f.)	25.7	29.5	30.3	26.2	25.6
Net services	3.08	2.25	0.98	0.82	0.47
Factor income	–0.63	–0.29	–0.01	0.15	0.13
Current transfers	13.3	14.4	13.8	14.8	13.9
Current Account Balance (including official transfers)	–4.0	–6.3	–8.9	–4.4	–5.6

Source: *NBE*

2 The following table shows Ethiopia's BOP accounts from the year 1999/2000 to 2004/05. Study the table and identify the major trends in

a Current account
b Capital account
c Overall balance

Table 9.4: Ethiopia's Balance of Payment (in millions of USD) 1999/2000 – 2004/2005

Description	1999/2000	2000/01	2001/02	2002/03	2003/04	2004/05
Exports	222.4	279.6	453.6	410.2	604.4	600
Imports	1051.8	914.6	1063	1412.9	1403.1	1450.5
Trade balance	–829.4	–635.1	–609.4	–1002.7	–798.7	–850.5
Net services	–23.1	10.9	60.8	95.1	99.6	88.7
Private transfers	247.9	246.9	311.2	313.4	251.8	334.1
Current account balance	–604.6	–377.2	–237.4	–594.2	–448.7	–427.8
Capital account	–128	236.3	8.6	–11.3	–54.9	174.8
Errors and omissions	233.5	23.6	–37.1	124.7	–116.9	–145.9
Overall balance	–98.9	167.7	161.6	–89.1	–386.7	–107.5

Source: *NBE*

9.3 FOREIGN EXCHANGE RATES

At the end of this section, you will be able to:

- assess the impact of foreign trade on the economy;
- classify exchange rates;
- define fixed exchange rate and identify the types of fixed exchange rates;
- define the revaluation and devaluation of fixed exchange rates;
- explain what floating exchange is; and
- distinguish the differences between appreciation and depreciation floating exchange rate.

Key Terms and Concepts

- Foreign exchange
- Revaluation
- Devaluation
- Appreciation
- Deppreciation

Startup Activity

Discuss the impacts of foreign exchange rate on the balance of payments of a country.

Every country has its own currency which is used as a medium of exchange within the national borders of that country (and not outside the country). For instance, the currency of Ethiopia is the Birr, of America it is the US dollar, that of the UK is the British pound, that of Japan is the Yen, etc. There is no problem of payment if transactions (sales and purchases) are made within the national border of a country. For instance, if a seller in Addis Ababa sells goods to a buyer in Dire Dawa, he/she is paid in birr. There is no problem because both use the same currency.

But if a seller sells goods to a buyer in England, the problem of foreign currency occurs because the seller wants to receive payment in birr, whereas the buyer wants to pay in pounds. Payments across national borders give rise to a new situation that of international payments. Currency which is used for making international payments is called *Foreign Exchange*. Thus *foreign exchange refers to all currencies other than the domestic currency of a given country*. For instance, for Ethiopia, all currencies other than birr are foreign exchange, and similarly for America, all currencies other than its US dollar are foreign exchange. Now this problem arises: at what rate should currencies of two countries be exchanged? We discuss this in the following paragraphs.

Foreign Exchange Rate and its Types

Foreign Exchange Rate

The price of one currency in terms of another is known as their foreign exchange rate. It is the rate at which one unit of a foreign currency is exchanged for domestic currency. Since there is symmetry between two currencies, their exchange rate can be quoted in two ways, i.e., foreign currency expressed in terms of domestic currency or domestic currency expressed in terms of foreign currency.

There are various concepts of *exchange rate system*. Its two broad types are *Fixed Exchange Rate* and *Floating Exchange Rate*. In between these two extreme rates, there are some hybrid systems like Crawling Peg, Managed Floating, Adjustable Peg, etc.

Fixed Exchange Rate

The fixed exchange rate is the rate which is officially fixed (or pegged) in terms of gold or any other currency by the government and adjusted only infrequently. Only a very small deviation from this fixed value is possible. In this system, foreign central banks stand ready to buy and sell their currencies at a fixed price. In case there is disequilibrium in the balance of payments, causing excess demand or excess supply of foreign exchange, the central bank of the country has to buy or sell the quantities of foreign exchange required to eliminate the excess demand or supply.

Remark: *The value of a currency fixed in terms of another currency or in terms of gold is known as the parity value of the currency.*

Floating Exchange Rate

The floating exchange rate is the rate which is determined by forces of supply and demand in the foreign exchange market. There is no (official) government intervention. Here the value of a currency is to be left completely free to be determined by market forces of demand and supply of foreign exchange. Under this system, the central banks, without intervention, allow the exchange rate to adjust so as to equate the demand and supply for foreign currency. The foreign exchange market is busy at all times with changes in the exchange rate. Just like the market price of a commodity, the exchange rate of a currency is determined by demand and supply of foreign exchange in a freely fluctuating exchange market.

Changes in the Value of a Currency

The value of a currency in terms of foreign currency may increase or decrease under these two systems of exchange rate, i.e., fixed and floating. Under the fixed exchange rate system, these changes take place as a result of a policy decision by the monetary authority (government) of the country, whereas under the floating exchange rate system, these changes are the result of changes in the demand and supply of the currency in the free exchange market.

Under a fixed exchange regime, *when a country raises the value of its currency in terms of foreign currency, it is called revaluation*. On the other hand, *when a country brings down the value of its currency in terms of foreign currency it is called devaluation*. For example, in 1983 E.C., the Ethiopian transitional government devalued the exchange rate of birr from birr 2.07 per US dollar to birr 5 per US dollar. Thus, because of devaluation, more birr were required to buy one US dollar, i.e., the value of birr in terms of dollar went down.

Under the floating exchange rate system, *an increase in the value of a currency in terms of foreign currency is called appreciation*. On the other hand, *a fall in the value of a currency in terms of foreign currency is called depreciation*.

Remarks:

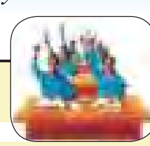
- *Under the floating exchange system, the exchange value of a currency frequently appreciates or depreciates, depending upon the change in the demand for and supply of the currency in the free exchange market.*
- *Managed Floating: Managed floating is a hybrid of the fixed and floating exchange rate systems. It is characterised by some intervention in the exchange rate movements by the government of the country when a particular situation requires it. Currently, the exchange rate of the birr is determined by the managed floating exchange rate system.*
- *The US dollar, British pound, French franc, and Japanese yen are considered to be strong or hard currencies because, worldwide, people have faith in their general acceptance as money. The Ethiopian birr and currencies of other developing countries are called soft currencies since their exchange value is weak.*

Impacts of Foreign Exchange Rate on BOP

The *balance of payments account* of a country largely indicates the monetary aspect of its foreign trade, i.e., exports and imports. Also exports earn foreign currency for a country, whereas imports imply the spending of foreign currency by the country. Naturally, *a change in the value of the currency of the country, in terms of foreign currency, has an impact on its balance of payments*. An increase in the value of the currency of a country makes its imports cheaper and its exports costlier (for foreign countries). In such a situation, imports increase and exports decrease, thus leading to a trade deficit, i.e., an unfavourable balance of payments. On the other hand, a decrease in the value of the currency of a country in terms of foreign currency, makes its imports costlier (for the local buyers) and exports cheaper (for the foreign buyers). In this situation, imports decrease and exports increase, thus leading to a trade surplus or favourable balance of payments.

Thus, for example, under a fixed exchange rate system

- *if countries face a deficit in trade balance, they devalue their currency.*
- *if countries have a surplus in their trade balance, they revalue their currency.*



Activity 9.3

Make a search of sources, such as the internet and others, to gather information and then prepare a brief report on changes in the exchange rates of the Ethiopian birr during recent times.

UNIT REVIEW

UNIT SUMMARY

- *International trade* refers to the exchange of goods and services among different countries of the world.
- *Factors determining international trade:*
  - *Unequal distribution of natural resources,*
  - *unequal distribution of population,*
  - *unequal distribution of capital,*
  - *Level of technological development,*
  - *Increasing returns to scale,*
  - *Difference in demand.*
- *Advantages of international trade:*
  - *Variety of goods,*
  - *Availability of raw material and specialized goods,*
  - *Specialization and division of labour,*
  - *Increase in efficiency through widening of market,*
  - *Cheaper goods,*
  - *Competition,*
  - *Optimum allocation of resources,*
  - *Vent for surplus production,*
  - *Possibility of economic development.*
- *Theory of absolute advantage:* if one country has an absolute advantage (in cost of production) in the production of one commodity, and another country has an absolute advantage in the production of another commodity, each country should specialise in the production of that commodity for which it enjoys absolute advantage and import the commodity for which it has absolute disadvantage.
- *Theory of comparative advantage:* a country tends to specialise in the production of those goods in which it has comparative advantages.
- When exports are more than imports, a country is said to have a trade surplus.
- When imports are more than exports, a country is said to have a trade deficit.

- When the value of exports equals value of imports, we call it a trade balance.
- *Tariff restrictions* and *import quota* are two broad types of trade restriction.
- *Balance of payments* (BOP), is a systematic record of all international economic transactions, visible and invisible, of a country during a given period, usually a year.
- *Current account* and *capital account* are two main components of BOP.
- *Current account* records inflows and outflows of foreign currency that result from flows of goods, flows of services and unrequited (or unilateral) transfers.
- The *capital account* of BOP records all such transactions between the residents of a country and the rest of the world which cause a change in the assets or liability status of the citizens of a country or of its government.
- *Foreign exchange* refers to all currencies other than the domestic currency of a given country.
- The price of one currency in terms of another is known as the *foreign exchange rate*.
- *Fixed exchange rate* is the rate which is officially fixed (or pegged) in terms of gold or any other currency by the government and adjusted only infrequently.
  - *When a country raises the value of its currency in terms of foreign currency, it is called revaluation.*
  - *When a country brings down the value of its currency in terms of foreign currency it is called devaluation.*
- *Floating exchange rate* is the rate which is determined by forces of supply and demand in the foreign exchange market.
  - *An increase in the value of a currency in terms of foreign currency is called appreciation.*
  - *A fall in the value of a currency in terms of foreign currency is called depreciation.*
- *Managed floating* is a hybrid of the fixed and floating exchange rate systems.
- Currently, the exchange rate of Birr is determined by the managed floating exchange rate system.
- A change in the value of the currency of a country in terms of foreign currency impacts its balance of payments.

REVIEW EXERCISE FOR UNIT 9

I ***Write detailed answers to the following questions and instructions.***

1 What do you mean by *international trade*? Discuss its advantages. Provide examples.

2 Describe the major factors determining international specialisation in the production of goods.

3 Discuss the theory of *absolute advantage* as a basis of international trade. Provide a suitable example.

4 What do you mean by *comparative difference in cost of production*? Explain the theory of comparative advantage. As part of your explanation, provide examples.

5 Discuss the meaning of *trade balance*, *trade deficit*, and *trade surplus* in the context of foreign trade.

6 Discuss the ways and measures used by a country to restrict imports.

7 Examine the role played by international trade in the economic growth of nations.

8 Explain how foreign trade affects the GDP of a country.

9 What do you mean by *balance of payments*? Discuss its major components.

10 What do you mean by *foreign exchange rate*? Describe how it is determined under the fixed exchange rate and floating exchange rate systems.

11 Describe the meaning of the concepts of *revaluation* and *devaluation*, as used under the fixed exchange rate system.

12 Discuss the impacts of foreign exchange rate on the balance of payments of a country.

II ***Distinguish between the following:***

13 Appreciation and revaluation

14 Depreciation and devaluation

15 Fixed exchange rate and floating exchange rate

16 Balance of trade and balance of payments

III *Label each of the following as 'True' or 'False':*

17 International trade narrows the extent of the market.

18 A country imports the commodity for which it has an absolute disadvantage.

19 A country tends to specialise in the production of those goods for which it has comparative advantages.

20 The goods and services that enter into a country in the form of purchases from other countries are called *exports*.

21 When imports are more than exports, the country is said to have a *trade surplus*.

22 Trade restrictions are a measure to protect domestic industries of a country.

23 The birr is considered to be a soft currency.

24 The Japanese yen is considered to be a strong currency.

25 Export and import of material goods is *invisible trade*.

26 An increase in the value of a currency in terms of foreign currency is called *appreciation*.

IV *Match the following:*

27	International trade	A	Trade surplus
28	X > M	B	Currencies other than domestic currency
29	M > X	C	Revaluation
30	Foreign exchange	D	Depreciation
31	Rise in value of currency	E	Engine of economic growth
32	Fall in value of currency	F	Trade deficit

V *For each of the following, four choices are given, but only one is correct. Choose the correct one.*

33 Equality between exports and imports implies:

A trade deficit
B trade surplus
C trade balance
D none of these

34 International trade increases:

A consumption of goods and services
B efficiency of an economy
C specialization of labour
D all of these

35 The sum total of the money value of exports and imports is known as:

A volume of trade
B value of trade
C total trade
D none of these

36 Which of the following is a soft currency?

A Indian rupee
B US dollar
C British pound
D French franc

37 An increase in the international value of the currency of a country:

A makes its imports costlier
B makes its imports cheaper
C makes its exports cheaper
D none of these

VI *Write very short answers to the following questions and instructions:*

38 List two factors that determine international trade.

39 Name the two theories that explain the basis of international trade.

40 Name two export items of Ethiopia.

41 How does a surplus of imports over exports of a country affect its GDP?

42 Name the three components of a current account.

43 Name the two elements of BOP.

44 What types of transaction are recorded with a minus sign in BOP accounts?

45 Name an element of a current account which is treated as invisible trade.

46 Given that trade balance = Birr (–) 400 million, and the value of exports = Birr 300 million, find the value of imports.

47 What are the two major parts of a capital account?

48 If the exchange rate of birr in terms of the US dollar falls, what will be the impact on Ethiopia's imports?

49 What do you mean by *statistical discrepancy*?

50 What do you mean by *parity value of a currency*?

51 Which items are included in the visible trade of a current account?

52 What do you mean by *net services*?