

Abstract

Uncertainty and Insurance in the Pure Theory of International Trade

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Almost two centuries ago Adam Smith maintained that international trade is riskier than domestic trade. Even though such an observation makes the subject of international economics under uncertainty an old issue, it is the fruitfulness of the theory of risk-bearing which brings the old issue back to life.

The expected utility maximization criterion combined with the relatively new Arrow-Pratt measure of risk-aversion have given the trade theorists a new insight into the impact of risk and uncertainty in the pattern of production, trade, and consumption of an open economy.

A two-stage analysis is used to investigate these patterns. In the first stage, resource allocation decisions are made before the uncertainty is resolved, while trading and consumption decisions are made after the actual values of the random variables are known.

The first part of our inquiry concerns the introduction of technological uncertainty in a Ricardian model of international trade, when the consumers of the country are assumed to be risk-averse. To lessen impact of risk and uncertainty, we assume the existence of an international insurance market. The major result of this examination is that, with or without an international insurance market, uncertainty generate trade.

The second part of this analysis uses a two-factor model and is concerned with the impact of technological and price uncertainty on the factors remunerations and the economy's levels of production.

We show that the factor rewards depend not only on the assumptions about the form of the production function, perfect competition, and many other standard assumptions, but that they depend, also, on the consumer's attitudes toward risk.

Our probe continues to consider the impact of the existence of an insurance market on factor price. Furthermore, the differences in factor prices when the insurance company is a "national" rather than an "international" agency is discussed. The "national" company is defined as a company owned and operated by a part of the country's citizens. Thus the exposition is one of risk-sharing versus risk-transferring. In the case of the "national" insurance company, the results obtained are the same as in the case of the non-existence of any insurance.