

## INTERNATIONAL TRADE

### I. TRADE FACTS

- a. A TRADE DEFICIT occurs when imports exceed exports. In 2007, the U.S. trade deficit was \$816BB
- b. A TRADE SURPLUS occurs when exports exceed imports.
- c. Canada is the U.S.'s most important trading partner qualitatively.
- d. The U.S. has a sizeable trade deficit with China. \$257BB in 2007
- e. The U.S. dependence on foreign oil is reflected in its trade with members of OPEC
- f. The U.S. leads the world in the combined volume of exports and imports, as measured by dollars. Currently, the U.S. provides about 9% of the world's exports.
- g. Exports of goods and services account for about 10% of total U.S. output.
- h. China has become a major international trader, with an estimated \$1.2TT of exports in 2007.
- i. International trade and finance are often at the center of economic policy.

### II. COMPARATIVE ADVANTAGE AND SPECIALIZATION

- a. Given the presence of any OPEN ECONOMY- one that includes the international sector- the U.S. produces MORE of certain goods (exports) and FEWER of other goods (imports) than it would otherwise.
- b. Does the shifting of resource make economic sense and do they enhance U.S. output and the U.S. standard of living? YES! Specialization and international trade increase the

- productivity of a nation's resources and allow for greater output than otherwise be possible.
- c. Greater specialization leads to greater output and income.
  - d. **COMPARATIVE ADVANTAGE:**
    - PRODUCTION POSSIBILITIES ANALYSIS**
      - i. **ASSUMPTIONS AND COMPARATIVE COSTS:** Review the example in detail in the book on page 444.
        - 1. Simplicity in Table 18.1 and 18.2 show that the U.S. has an **ABSOLUTE ADVANTAGE** in producing both avacados and soybeans.
        - 2. Due to the absolute advantage, the **LABOR PRODUCTIVITY** (output per worker), in the U.S. exceeds Mexico in producing both products
        - 3. However, gains in specialization and trade can increase both countries' output and income via **COMPARATIVE ADVANTAGE** – a lower relative or comparative opportunity cost than that of another person, producer or country.
        - 4. **A COUNTRY HAS A COMPARATIVE ADVANTAGE IN SOME PRODUCT WHEN IT CAN PRODUCE THAT PRODUCT AT A LOWER OPPORTUNITY COST THAN CAN A POTENTIAL TRADING PARTNER.**
        - 5. Review the comparative advantages in table 18.3 on page 445.

- ii. TERMS OF TRADE: Review the discussion on page 445
  - 1. The U.S. would specialize in soybeans ONLY if it could obtain MORE than 3 tons of avocados for 1 ton of soybeans (It could make 3 tons itself).
- iii. GAINS FROM SPECIALIZATION AND TRADE
  - 1. Specialization based on comparative advantage improves global resource allocation. If the same inputs of world resources and technology result in a larger global output.
  - 2. Review table 18.4 on page 446 to see then net gains in the avocado and soybean example.
- iv. TRADE WITH INCREASING COSTS
  - 1. This discussion was simplified by only dealing with two products. Multiproducts and multinational analysis will yield the same conclusions.
  - 2. As the U.S. expands production of soybeans, the cost of soybean production will rise.
  - 3. At some point, the differing domestic cost ratios that underlie comparative advantage will disappear and further specialization will become uneconomical.
  - 4. The primary effect of increasing opportunity costs is less-than-complete specialization. This is the

reason that domestically made goods can eventually compete with foreign goods.

### III. THE FOREIGN EXCHANGE MARKET

- a. In international markets, sellers set their prices in their home domestic currencies, but buyers often possess different currencies.
  - i. A FOREIGN EXCHANGE MARKET is a market in which various national currencies are exchanged for one another, serving the need to transact in the international markets.
  - ii. The equilibrium prices in the foreign exchange markets are called EXCHANGE RATES. It is the rate at which currency of one nation can be exchanged for the currency of another nation.
  - iii. The market price or exchange rate of a nation's currency links all domestic prices with all foreign prices
- b. EXCHANGE RATES
  - i. Review figure 18.1 on page 450
  - ii. The DEMAND-FOR-POUNDS CURVE in figure 18.1 is downward sloping because all British goods and services will be cheaper to the U.S. if pounds become less expensive to the U.S.. At lower dollar prices for pounds, the U.S. can obtain more pounds for each dollar and therefore buy more British goods and services per dollar.
  - iii. The SUPPLY-OF-POUNDS CURVE in figure 18.1 slopes upward because the British will purchase more U.S. goods

- when the dollar price of pounds rises ( or the pound price of dollars falls).
- iv. The intersection of the supply and demand curve will determine the dollar price of pounds. In figure 18.1 that price (exchange rate) is \$2 for one pound.
- c. DEPRECIATION AND APPRECIATION
- i. In figure 18.1, when the price of pounds RISES, from one pound for \$2 to one pound for \$3, the dollar has DEPRECIATED in value versus the pound; DEPRECIATION means that more units of that currency (dollar) are needed to buy a single unit of some other currency (pound).
  - ii. If the dollar price of pounds FALL from one pound for \$2 to one pound for \$1, the dollar has APPRECIATED relative to the pound. APPRECIATION means that it takes fewer units of the currency (dollar) to buy a single unit of some other currency (pound).
  - iii. WHEN THE DOLLAR DEPRECIATES (DOLLAR PRICE OF FOREIGN CURRENCIES RISE), U.S. EXPORTS RISE AND IMPORTS DECREASE. WHEN THE DOLLAR APPRECIATES (DOLLAR PRICE OF FOREIGN CURRENCY FALLS), U.S. EXPORTS DECREASE AND IMPORTS INCREASE.
- d. DETERMINANTS OF EXCHANGE RATES:  
The factors that contribute to changes in exchange rates

- i. If the demand for a nation's currency INCREASES, that currency will APPRECIATE; if the demand DECLINES, that currency will DEPRECIATE
  - 1. If the supply for a nation's currency INCREASES, that currency will DEPRECIATE; if the supply DECLINES, that currency will APPRECIATE.
  - 2. If a nation's currency APPRECIATES, some other nation's currency DEPRICIATES.
- ii. TASTES: Any change in consumer tastes or preferences for products of a foreign country may alter the demand for that nation's currency and change its exchange rate.
- iii. RELATIVE INCOME: A nation's currency is likely to depreciate if its growth of national income is greater than that of other countries.
- iv. RELATIVE PRICE LEVELS: Changes in the relative price levels of two nations may change the demand for and supply of currencies and alter the exchange rate of the two nations. If the price level of the U.S. rises compared to Britain, U.S. consumer will demand British low priced goods and increase demand for pounds.
- v. RELATIVE INTEREST RATES: If relative interest rates rise compared to other countries, other countries will want to loan money to the U.S. and demand

U.S. dollars. The dollar will appreciate compared to other currencies.

- vi. **CHANGES IN RELATIVE EXPECTED RETURNS ON STOCKS, REAL ESTATE, AND PRODUCTION FACILITIES:** If it is advantageous to invest in a foreign country, we will be demanding their currency and will cause their currency to appreciate and the U.S. dollar to depreciate.
- vii. **SPECULATION:** Speculation of future movements in currency exchanges will exacerbate the appreciation or depreciation of that currency.

#### IV. GOVERNMENT AND TRADE

- a. **TRADE PROTECTIONS AND SUBSIDIES:** Excise taxes on imported goods are called **TARIFFS**. A **PROTECTIVE TARIFF** is designed to shield domestic producers from foreign competition. The put foreign producers at a competitive disadvantage in selling domestic markets.
  - i. **IMPORT QUOTAS** – limits on the quantities or total value of specific goods that may be imported. More effective than tariffs.
  - ii. **NONTARIFF BARRIERS (NTBs)** – include onerous licensing requirements, or excessive bureaucratic hurdles, or delays in clearing customs.
  - iii. **VOLUNTARY EXPORT RESTRICTION (VER)** – trader barrier where foreign firms “voluntarily” limit the amount of their exports to a particular country. Much like an import quota.

iv. EXPORT SUBSIDIES – government gives domestic firm a subsidy which lowers the cost and allows the firm to charge lower export cost.

b. ECONOMIC IMPACT ON TARIFFS

i. DIRECT EFFECTS: Higher prices reduce quantity demanded; a tariff prompts consumers to buy fewer of the imported goods, and reallocate their expenditures to less desired substitute goods.

1. Higher import prices increase the quantity supplied of domestic goods which allows domestic producers to increase output.
2. Foreign producers are hurt by tariffs.
3. Government gains revenue from tariffs. Transfer of income from consumers to government; no net change in nation's economic well-being.

ii. INDIRECT EFFECTS:

1. Hurt domestic producers that use imported goods as input for production of goods.
2. Reduce competition in the protected industries.
3. Expand inefficient industries that do not have a comparative advantage.
4. Tariffs cause resources to be shifted in the WRONG direction.

iii. NET COSTS OF TARIFFS:

1. Raises the price of the product in three ways:

- a. Price of imported product goes up.
  - b. Higher price of imported goods causes some consumers to shift their purchases to higher-priced domestically produced goods
  - c. Prices of domestically made goods rise due to no overseas competition
2. The gains that U.S. trade barriers produce for protected industries and their workers come at the expense of much greater losses for the entire economy. The result is **ECONOMIC INEFFICIENCY, REDUCED CONSUMPTION AND LOWER STANDARDS OF LIVING.**

iv. **SO WHY GOVERNMENT TRADE PROTECTIONS?**

- 1. **MISUNDERSTANDING THE GAINS FROM TRADE:** Suggests that exports are “good” and imports are “bad.” Reduce domestic jobs and domestic sales.
- 2. **POLITICAL CONSIDERATIONS:** A relatively few producers and unions cry **PROTECTIONISM** and politicians respond.

V. **THREE ARGUMENTS FOR PROTECTION :** infant industries and military self-sufficiency are logical arguments

- a. **INCREASED DOMESTIC EMPLOYMENT ARGUMENT**

- i. Arguing to save American jobs when U.S. enters a recession and experience cyclical unemployment.
  - ii. While imports may eliminate some jobs it creates others.
  - iii. To the extent that one country is able to expand its economy through an excess of exports over imports, the resulting excess of imports over exports worsens another economy's unemployment problem.
  - iv. Trade barrier war: SMOOT-HAWLEY ACT OF 1930 – reduce imports and stimulate U.S. production- cause for the Great Depression.
- b. CHEAP FOREIGN LABOR ARGUMENT: U.S. must shield domestic firms and workers from ruinous competition of countries where wages are low.
  - i. Logic of this argument suggests it is not mutually beneficial for rich and poor persons to trade with one another. However, gains from trade are from comparative advantage, not absolute advantage.
  - ii. This argument is that the U.S. should not trade with lower wage countries.
- c. PROTECTION-AGAINST-DUMPING ARGUMENT
  - i. DUMPING – the sale of products in a foreign country at prices either below costs or below prices charged at home.
  - ii. Because it is an unfair practice, most nations prohibit it.
  - iii. U.S. would add on anti-dumping duties to products.

- iv. Often what appears to be dumping is actually comparative advantage at work.

## VI. TRADE ADJUSTMENT ASSISTANCE

- a. A nation's comparative advantage is never fixed. Shifts in patterns of comparative advantage and removal of trade protection can hurt specific groups of workers.
- b. The TRADE ADJUSTMENT ACT OF 2002 has introduced cash assistance, education and training benefits, health care subsidies and wage subsidies to workers displaced by imports or plant relocations.
- c. Helps create the political support for reduction of trade barriers and export subsidies.
- d. Review Offshoring on page 459.

## VII. MULTILATERAL TRADE AGREEMENTS AND FREE-TRADE ZONES

- a. Due to overall trade benefits, nations have worked to lower tariffs worldwide.
- b. GENERAL AGREEMENT ON TARIFFS AND TRADE (GATT) – 1947; based on principles of equal, nondiscriminatory trade treatment for all 23 member nations and reduction of tariffs and quotas.
- c. WORLD TRADE ORGANIZATION (WTO) – GATT's successor; provides for further reductions in trade barriers; DOHA ROUND latest, uncompleted sequence of trade negotiations by WTO participants, 2008.
- d. EUROPEAN UNION – trade bloc of European countries- 27 nations; TRADE BLOC- group of countries having common identity, economic interests, and trade rules; 15 use the EURO as their currency.

- e. NAFTA – established a free-trade zone for Canada, U.S. and Mexico; 1993; fear of massive U.S. job losses never materialized; not all aspects of trade blocs are positive – reduces members’ trading with non-bloc countries; world loses benefit from truly open trade.

## VIII. U.S. TRADE DEFICITS

- a. Review figure 18.2; the U.S. has incurred large and persistent trade deficits over the past years.

### b. CAUSES OF TRADE DEFICITS

- i. U.S. has grown more rapidly than the economies of several of its major trading partners. Has enabled U.S. to buy more imported goods.
- ii. Large trade deficits have emerged with China; \$257 BB in 2007
- iii. A declining U.S. saving rate has contributed; part of this added consumption spending is on imported goods.

### c. IMPLICATIONS OF U.S. TRADE DEFICITS

#### i. INCREASED CONSUMER

CONSUMPTION - Consumers benefit because the U.S. is receiving more goods and services as imports from abroad than it is sending as exports.

#### ii. INCREASED U.S. INDEBTEDNESS-

When U.S. exports are insufficient to finance U.S. imports, the U.S. increases both its debt to people abroad and the value of foreign claims against assets in the U.S.

1. If the U.S. wants to regain ownership of the domestic assets, at

some point in the future exports need to be greater than imports.

2. Increases in production capacity and real GDP enhance the economy's ability to serve foreign debt and buy back real capital, if that is desired.
3. **DOWNWARD PRESSURE ON THE DOLLAR** – large U.S. trade deficit depreciates the dollar;