



Everyone's Smart University

Introduction to Economics

Chapter11

INTERNATIONAL TRADE



U.S. Trade Patterns

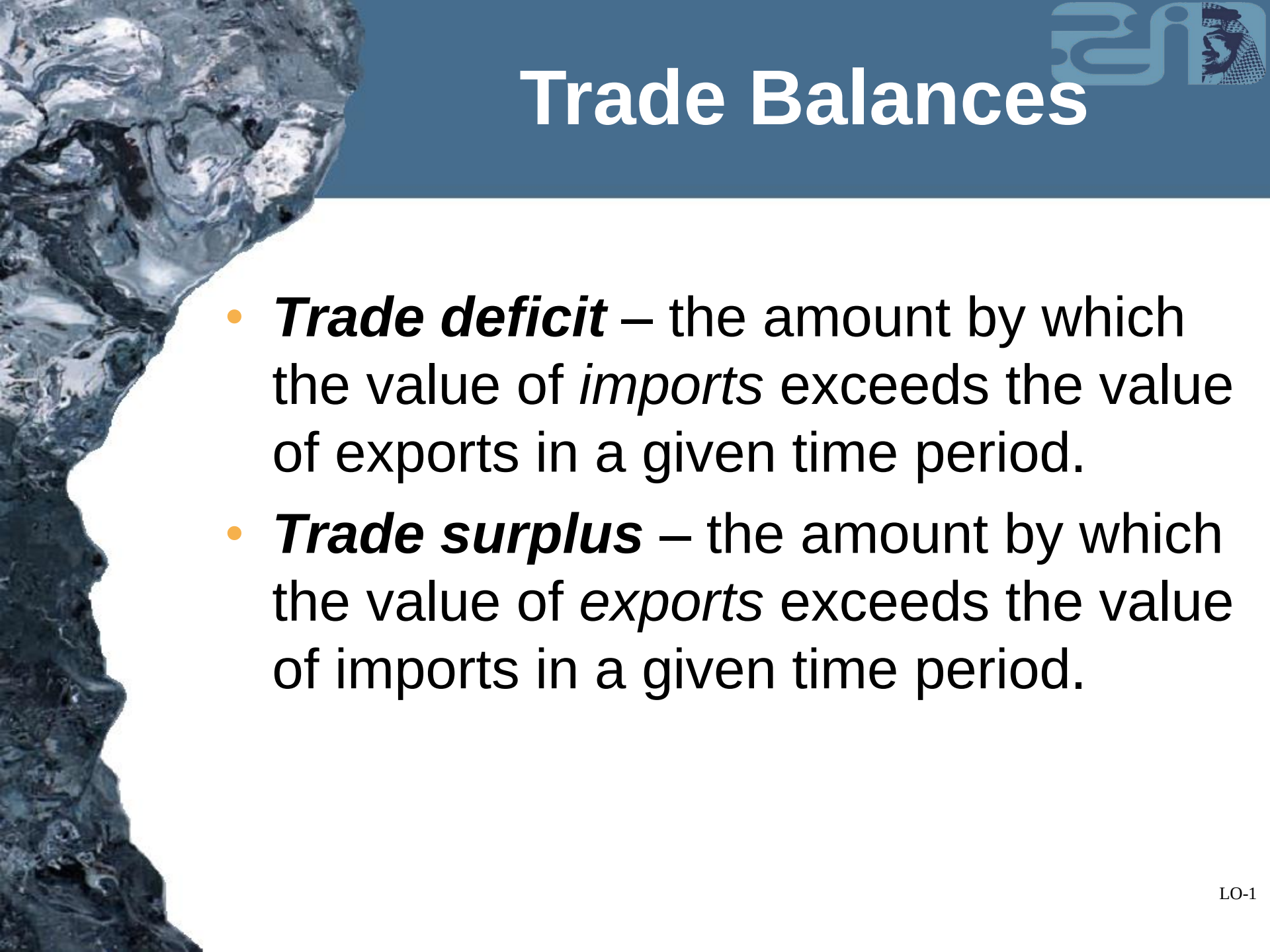
- Imports and Exports:
 - ***Imports***—goods and services purchased from foreign sources.
 - ***Exports***—goods and services sold to foreign buyers.



Trade Balances

- Imports and exports are seldom equal.
 - The ***trade balance*** is the difference between exports and imports:

$$\textit{Trade balance} = \textit{exports} - \textit{imports}$$



Trade Balances

- ***Trade deficit*** – the amount by which the value of *imports* exceeds the value of exports in a given time period.
- ***Trade surplus*** – the amount by which the value of *exports* exceeds the value of imports in a given time period.

Table 11.2

Country	Trade Balance (in billions of dollars)
Top deficit countries	
China	-227
Mexico	-48
Japan	-45
Germany	-28
Ireland	-21
Top surplus countries	
Hong Kong	+18
Netherlands	+16
Australia	+12
United Arab Emirates	+11
Singapore	+7.7



Trade Balances

- The U.S. typically has a merchandise deficit, a services surplus, and an overall *trade deficit*.
- Any imbalance in America's trade must be offset by reverse imbalances elsewhere.

Table 11.1

Product Category	(In billions of dollars)		
	Exports	Imports	Surplus (Deficit)
Merchandise	\$1,039	\$1,575	\$(536)
Services	<u>525</u>	<u>381</u>	<u>144</u>
Total trade	\$1,564	\$1,956	\$(392)



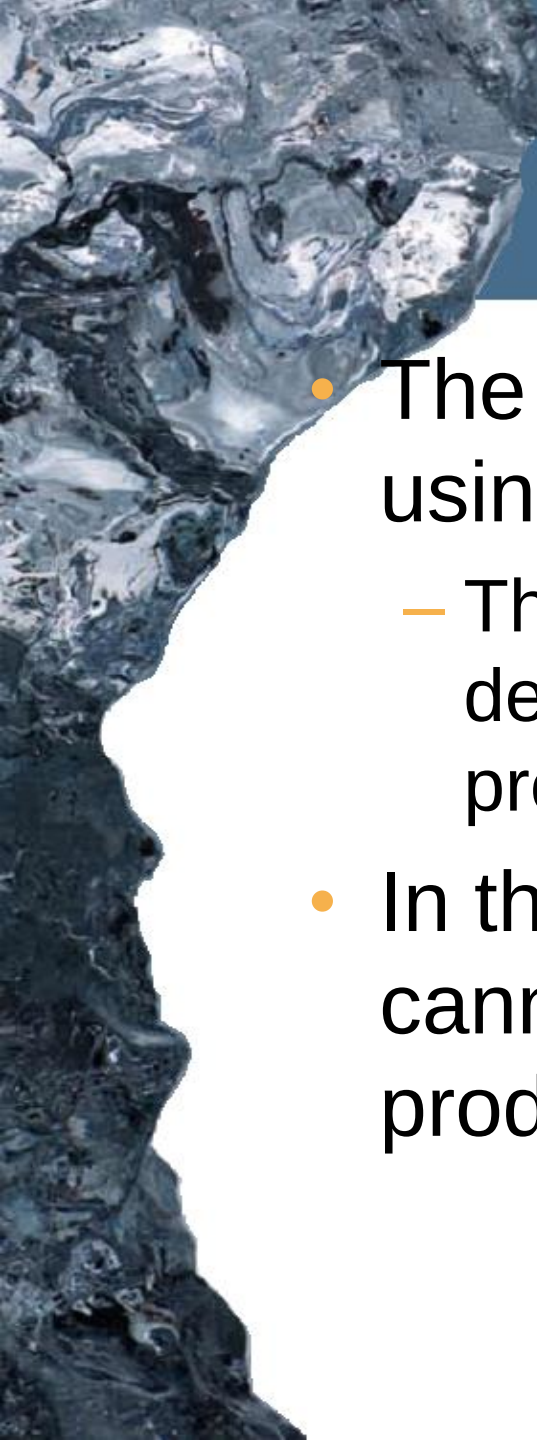
Trade Balances

- One result of the 2008-09 recession was a decrease in the U.S. trade position as consumers bought fewer imports.
- The 2009 trade deficit dropped to \$392 billion from \$712 billion in 2007.



Motivation to Trade

- Specialization increases total output.
- The gain from trade will be increased world output and thus a higher standard of living in both countries.
- Consumers gain more choice and the potential for lower prices.



Production and Consumption without Trade

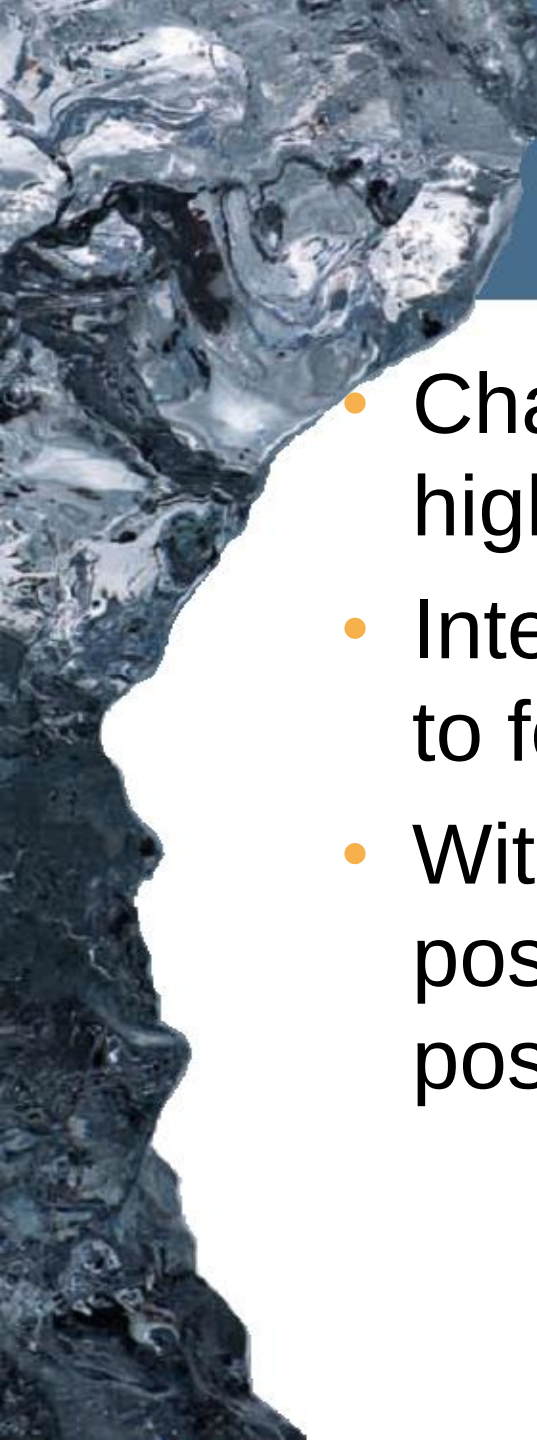


- The gains from trade may be illustrated using a production possibilities curve:
 - The ***production possibilities curve*** defines the limits to what a country can produce.
- In the absence of trade, a country cannot consume more than it produces.

Consumption Possibilities

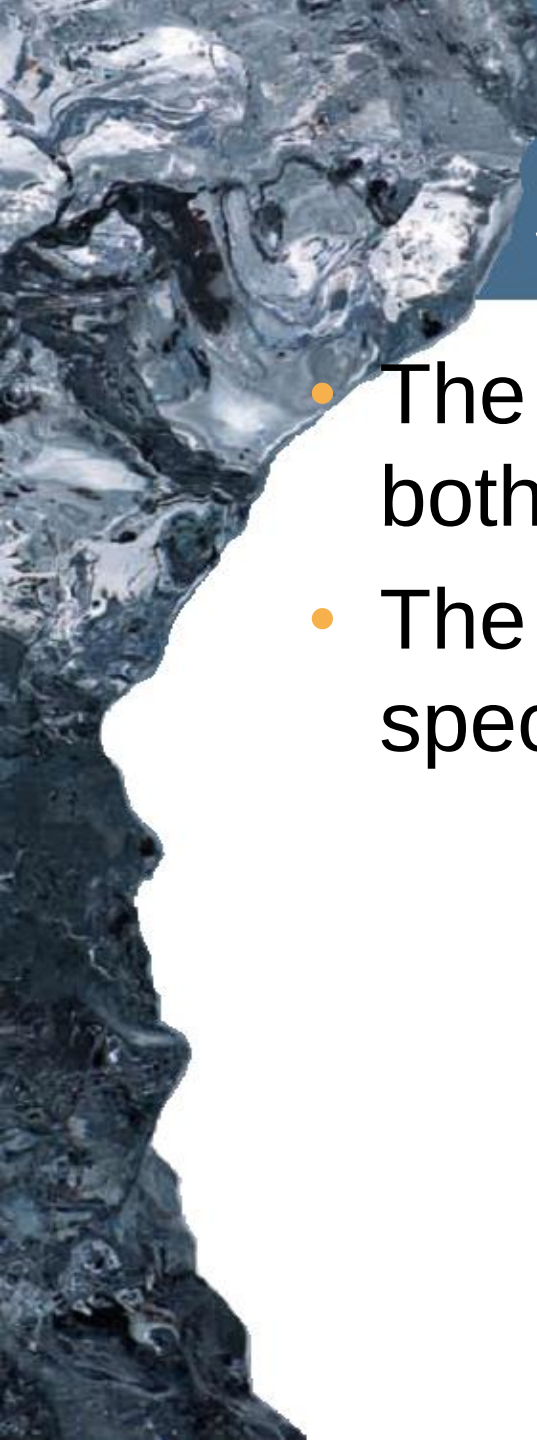


- Without trade, a country's consumption possibilities equals its production possibilities:
 - ***Consumption possibilities***—the alternative combinations of goods and services that a country could consume in a given time period.



Production and Consumption with Trade

- Changing the mix of output results in a higher level of total output.
- International trade allows each country to focus on what it does best.
- With trade, a country's consumption possibilities *exceed* its production possibilities.



Trade Increases Specialization and Output



- The increase in the combined output of both countries is the gain from trading.
- The gains from trade are due to specialization in production.



Comparative Advantage

- ***Comparative advantage***—the ability of a country to produce a specific good at a lower opportunity cost than its trading partners:
 - ***Opportunity cost***—the most desired goods or services that are forgone in order to obtain something else.



Comparative Advantage

- A country should specialize in what it is *relatively* efficient at producing, that is, goods for which it has the lowest opportunity cost.

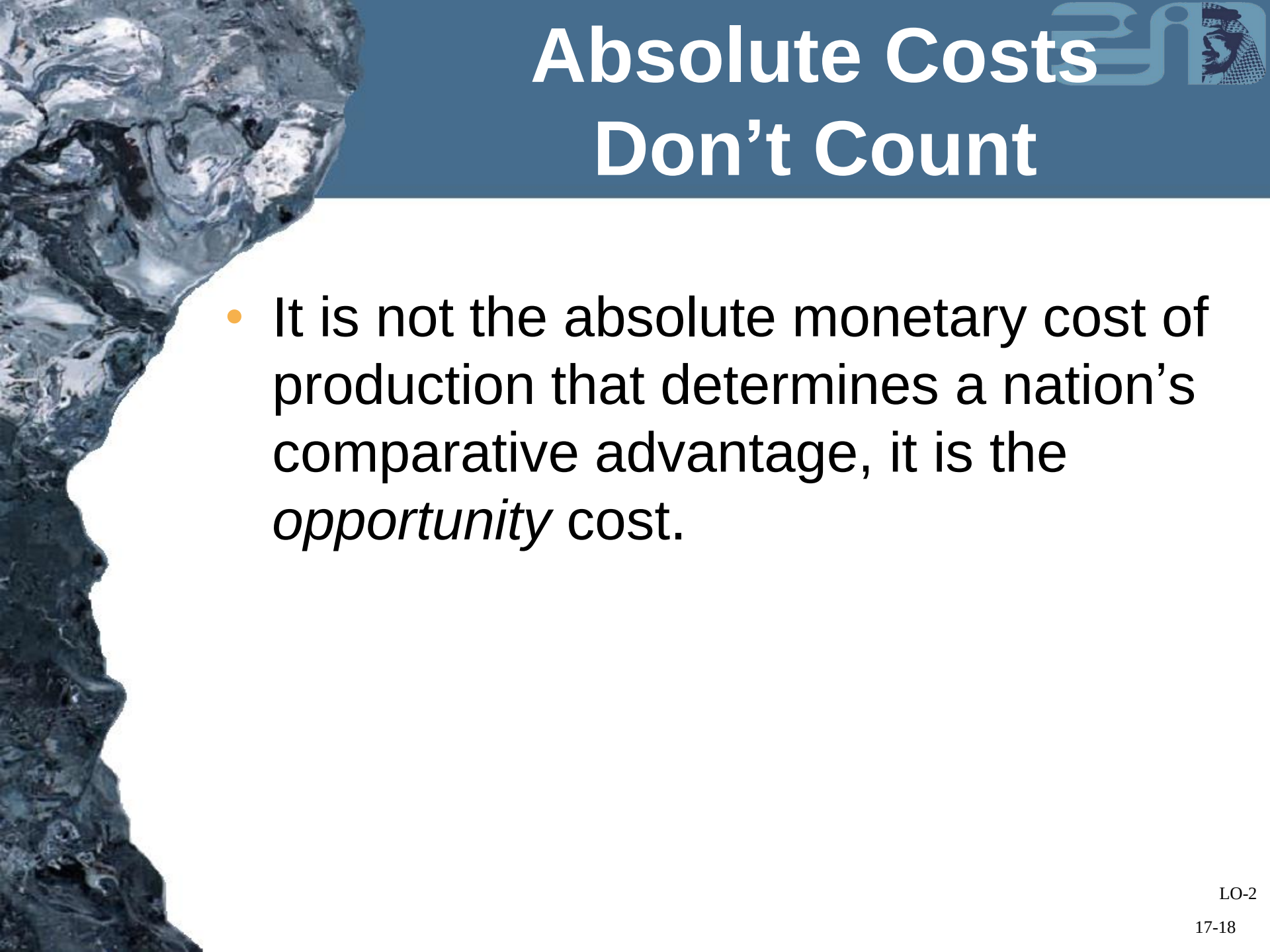


Comparative Advantage

- Comparative advantage refers to the relative (opportunity) costs of producing particular goods.
- Comparative World output, and thus the potential gains from trade, will be maximized when each country pursues its comparative advantage.

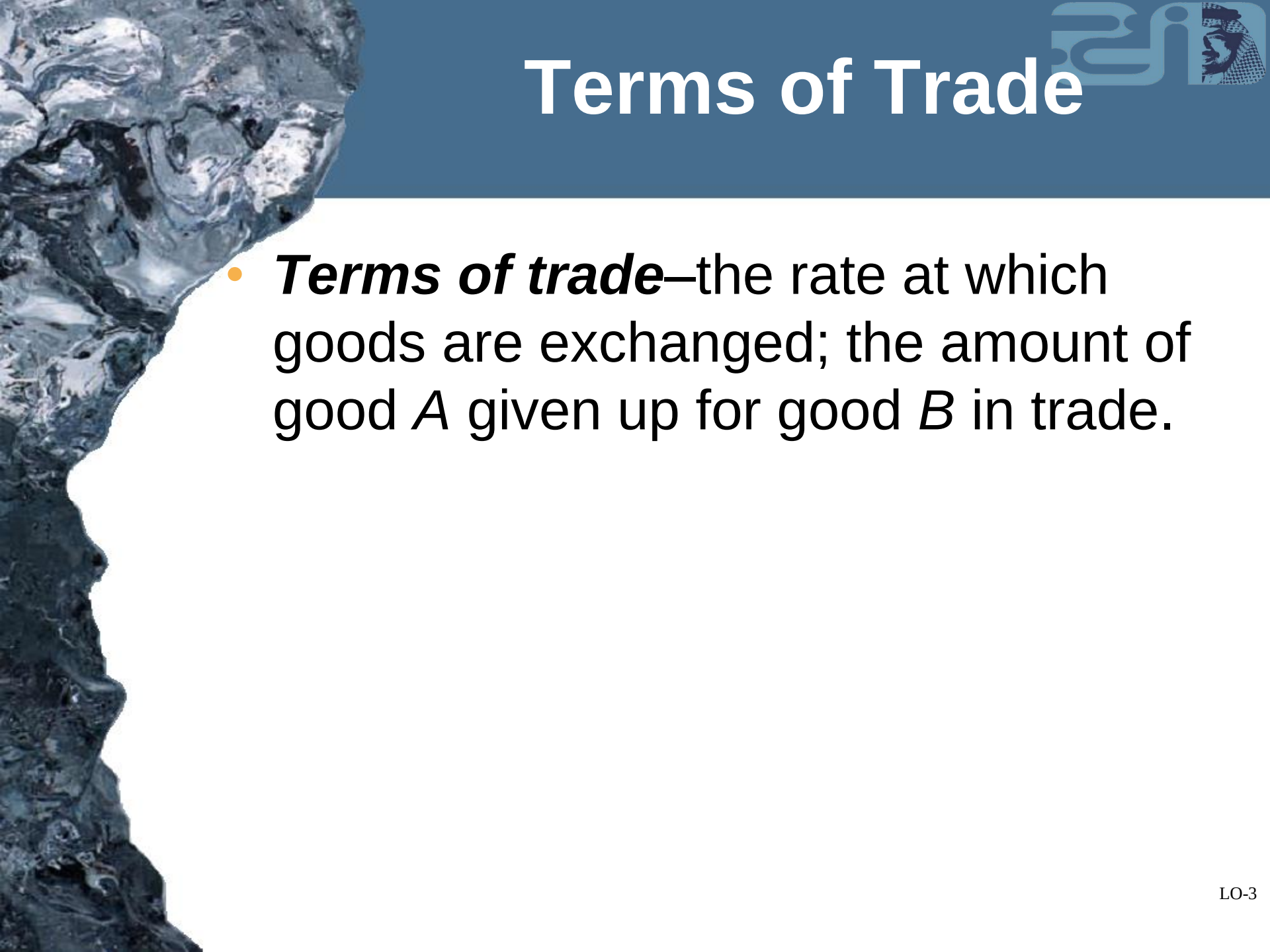
Absolute Costs Don't Count

- ***Absolute advantage***—the ability of a country to produce a specific good with fewer resources (per unit of output) than other countries.



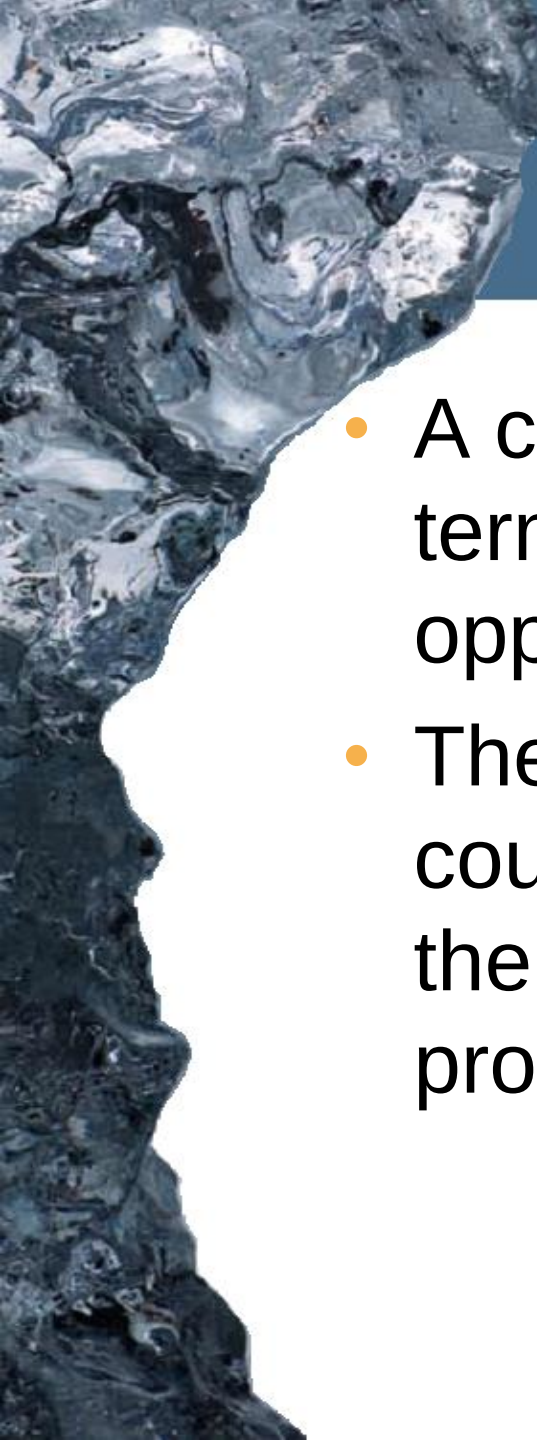
Absolute Costs Don't Count

- It is not the absolute monetary cost of production that determines a nation's comparative advantage, it is the *opportunity* cost.



Terms of Trade

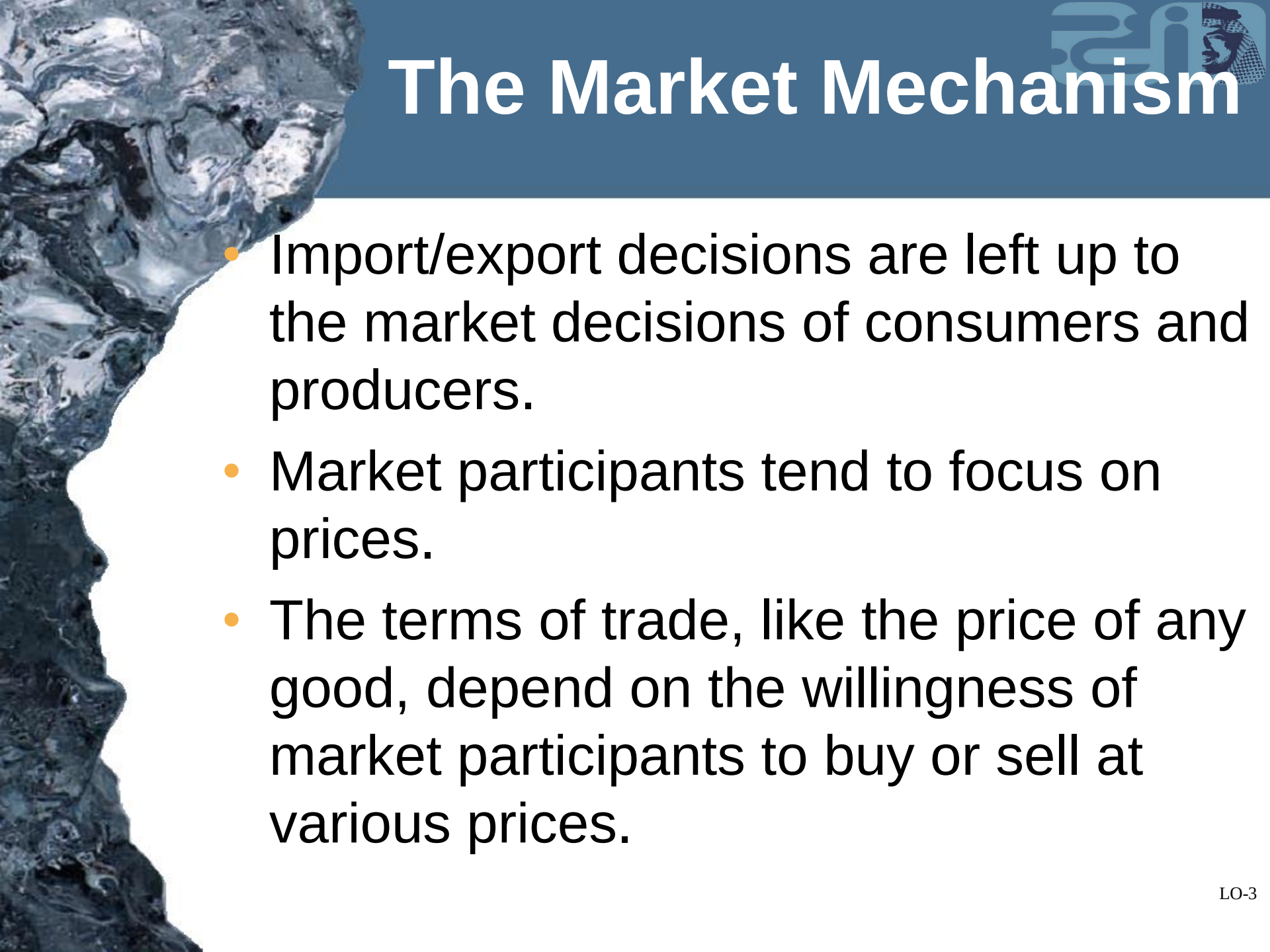
- ***Terms of trade***—the rate at which goods are exchanged; the amount of good *A* given up for good *B* in trade.



Limits to the Terms of Trade



- A country will not trade unless the terms of trade are superior to domestic opportunity costs.
- The terms of trade between any two countries will lie somewhere between their respective opportunity costs in production.



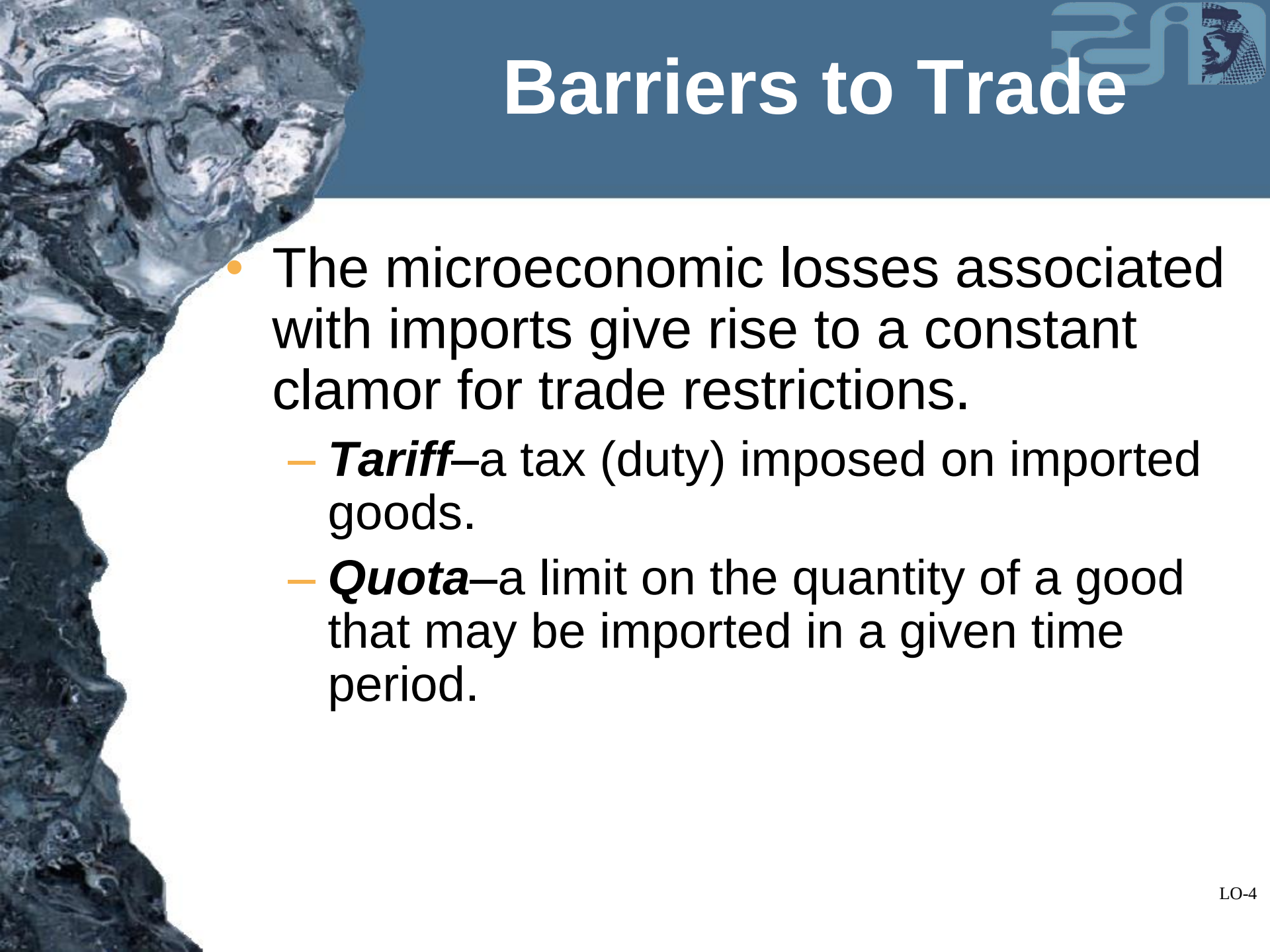
The Market Mechanism

- Import/export decisions are left up to the market decisions of consumers and producers.
- Market participants tend to focus on prices.
- The terms of trade, like the price of any good, depend on the willingness of market participants to buy or sell at various prices.



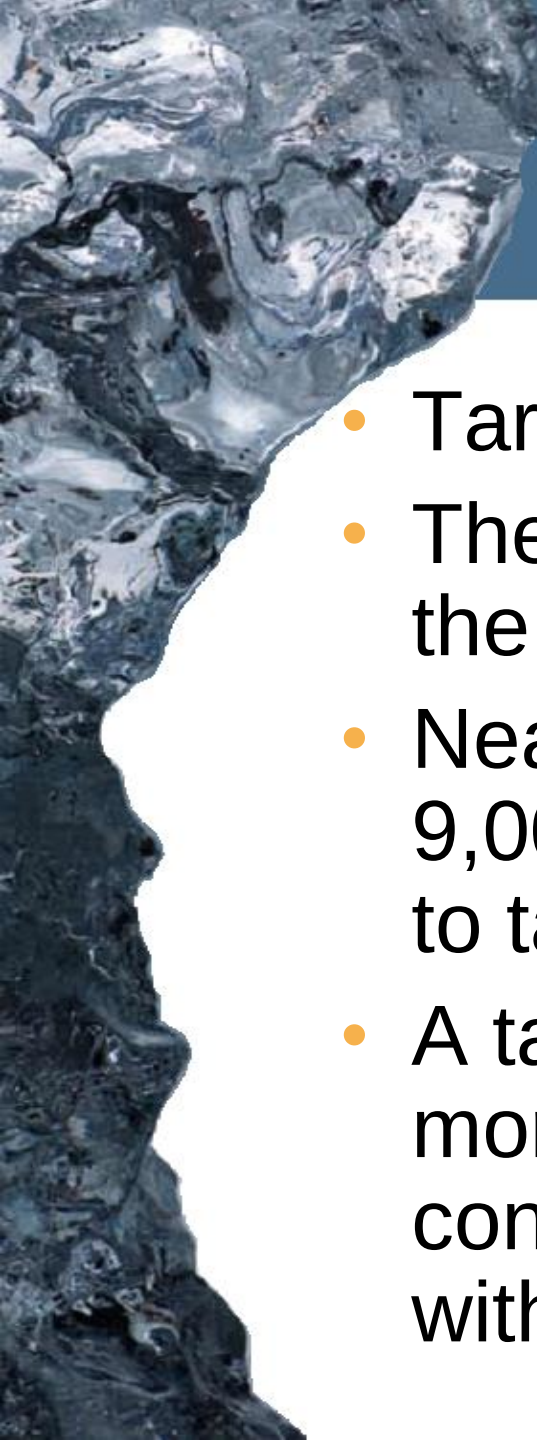
Protectionist Pressures

- Although the potential gains from world trade are impressive, not everyone supports free trade.
- The Office of the United States Trade Representative shares trade policies issued by the U.S. (www.ustr.gov).



Barriers to Trade

- The microeconomic losses associated with imports give rise to a constant clamor for trade restrictions.
 - ***Tariff***—a tax (duty) imposed on imported goods.
 - ***Quota***—a limit on the quantity of a good that may be imported in a given time period.



Tariffs

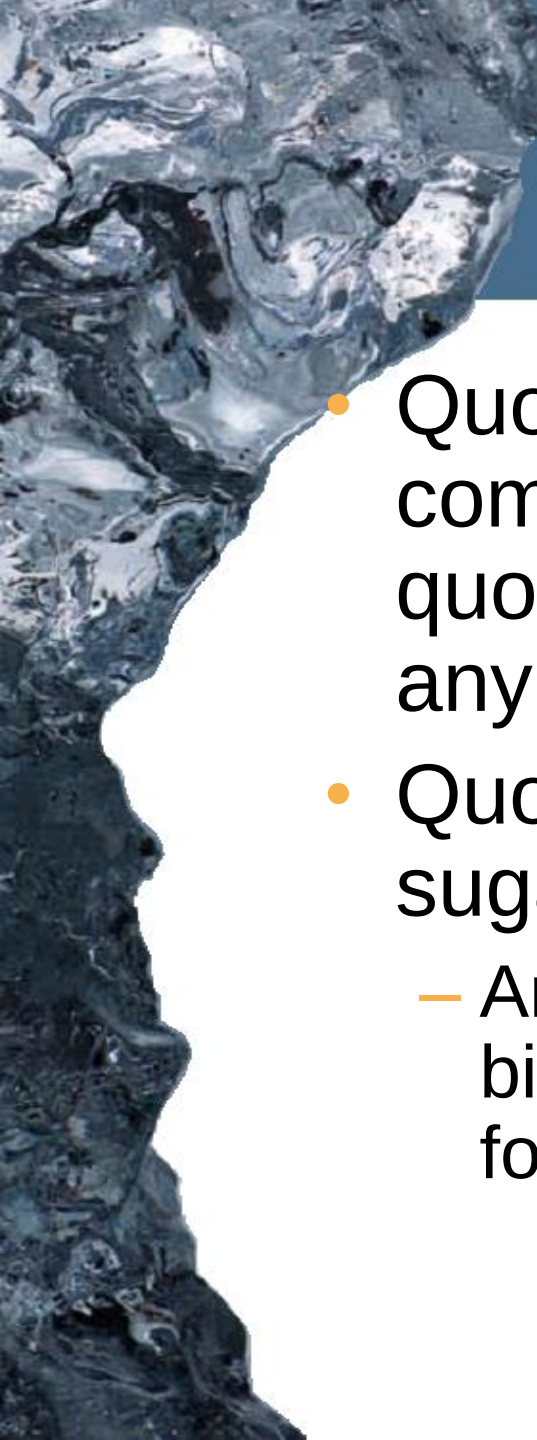


- Tariffs are also called customs duties.
- They raise domestic prices and reduce the quantity sold.
- Nearly 50% of all U.S. imports—over 9,000 different products—are subject to tariffs.
- A tariff on imported goods makes them more expensive to domestic consumers, and thus less competitive with domestically-produced goods.



Quotas

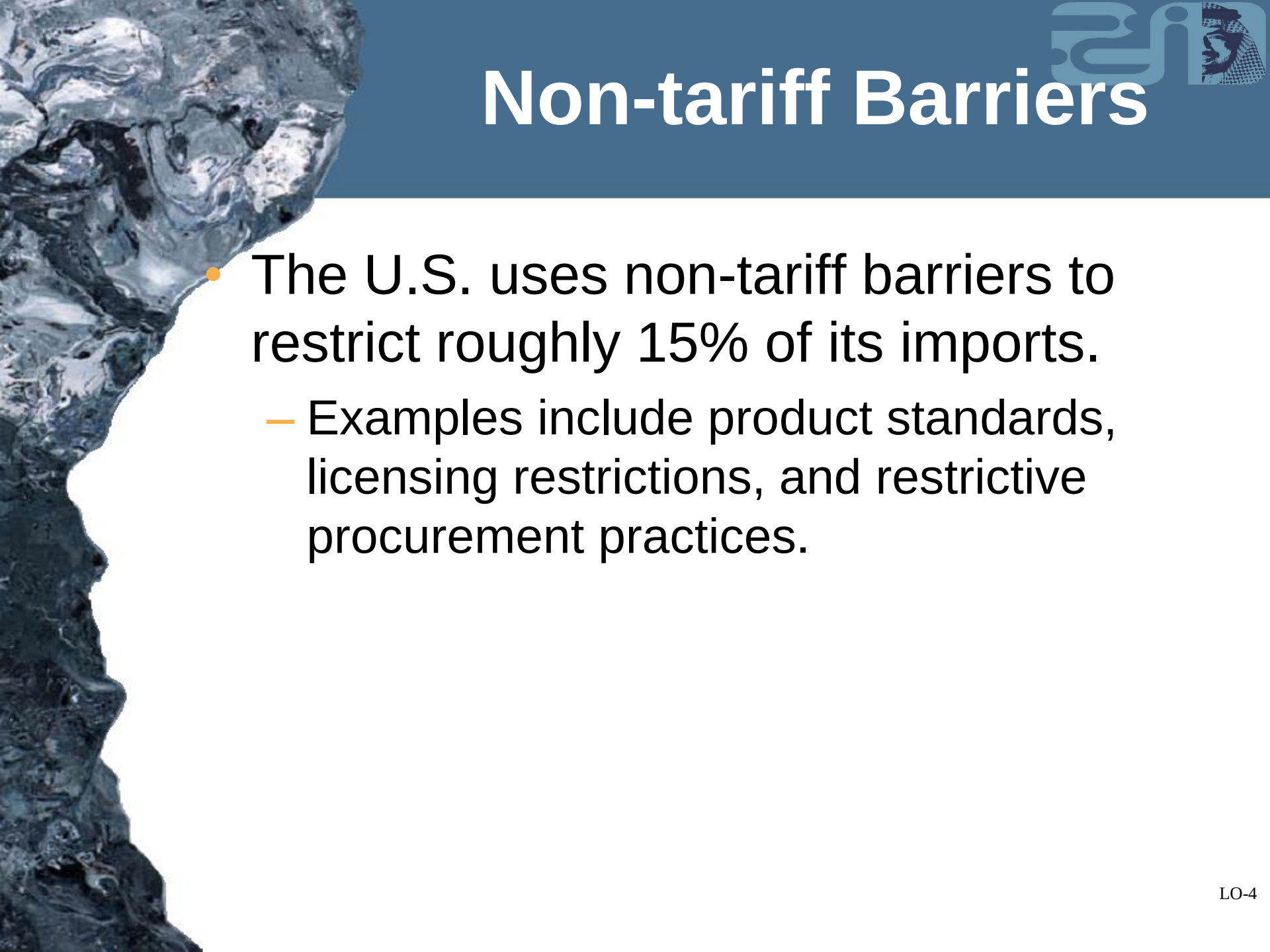
- Quotas, like all trade barriers, reduce world efficiency and invite retaliatory action.
- Quotas put an absolute limit on imported sales and give domestic producers the opportunity to raise market prices.



Quotas

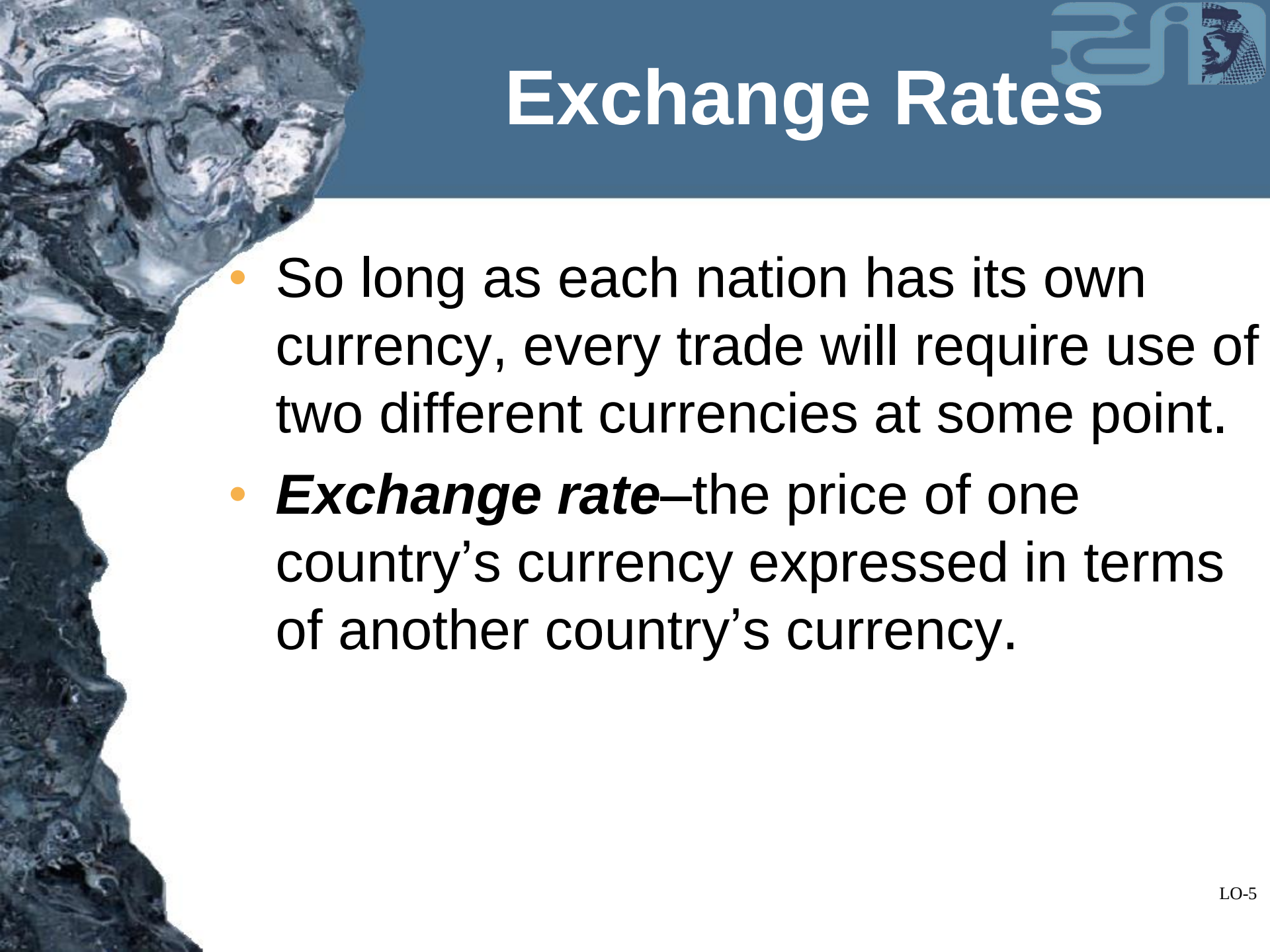


- Quotas are a much greater threat to competition than tariffs, because quotas preclude additional imports at any price.
- Quotas have long been maintained on sugar coming into the U.S.
 - American consumers have paid about \$2 billion per year in the form of higher prices for candy, sodas, and sugar.



Non-tariff Barriers

- The U.S. uses non-tariff barriers to restrict roughly 15% of its imports.
 - Examples include product standards, licensing restrictions, and restrictive procurement practices.



Exchange Rates

- So long as each nation has its own currency, every trade will require use of two different currencies at some point.
- ***Exchange rate***—the price of one country's currency expressed in terms of another country's currency.

Global Pricing

- Import prices depend on:

$$\text{Dollar price of imported good} = \text{Foreign price of good} \times \text{Dollar price of foreign currency}$$

Appreciation/ Depreciation



- Whenever exchange rates change, so does the global price of all imports and exports.
- ***Currency appreciation***—an *increase* in the value of one currency relative to another.
- ***Currency depreciation***—a *decrease* in the value of one currency relative to another.

Appreciation/ Depreciation

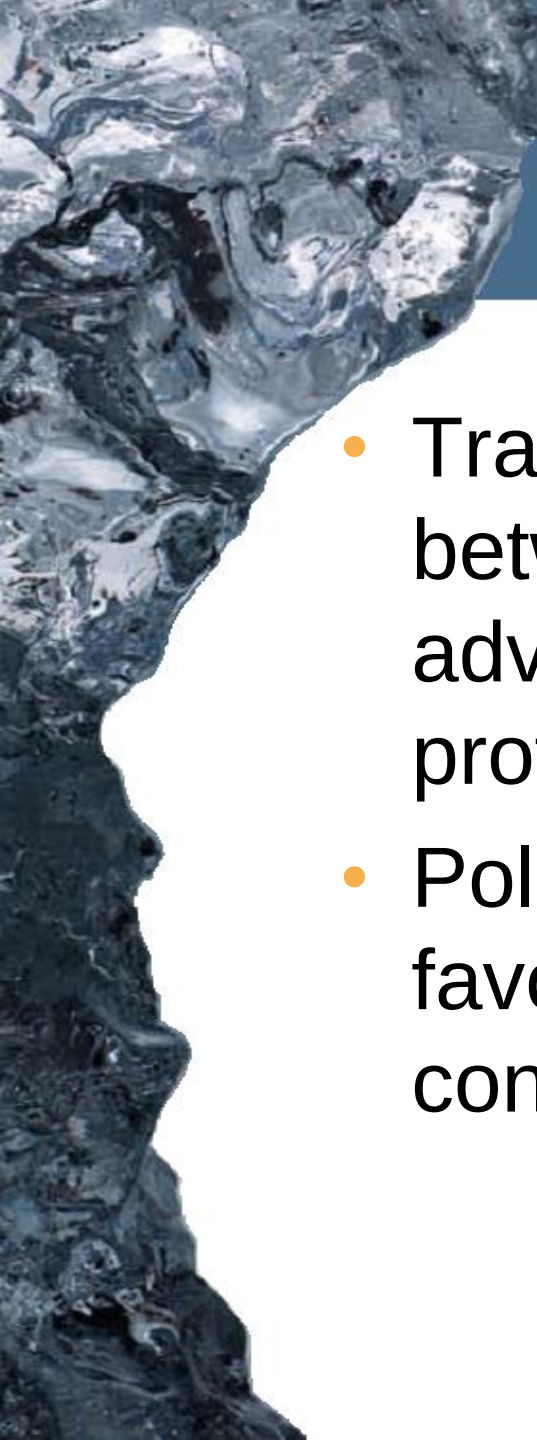


- If the value of a nation's currency declines:
 - Its exports become cheaper.
 - Its imports become more expensive.



Foreign Exchange Markets

- Exchange rates change when *either* the supply or the demand for a currency shifts.



Policing World Trade

- Trade policy is a continuing conflict between the benefits of comparative advantage and pleadings of protectionists.
- Politically, the battle over trade policy favors protectionist interests over consumer interests.



GATT



- In 1947 the General Agreement on Tariffs and Trade (GATT) was signed by 23 of the world's largest trading partners, committing these nations to:
 - Pursue free-trade policies.
 - Extend equal access (***most favored nation status***) to domestic markets for all GATT members.

GATT



- Tariff rates in developed countries averaged 40 percent when GATT was first signed.
- The first seven GATT rounds pushed tariff rates down to an average of 6.3 percent, and the 1986-94 Uruguay Round lowered them further, to 3.9 percent.

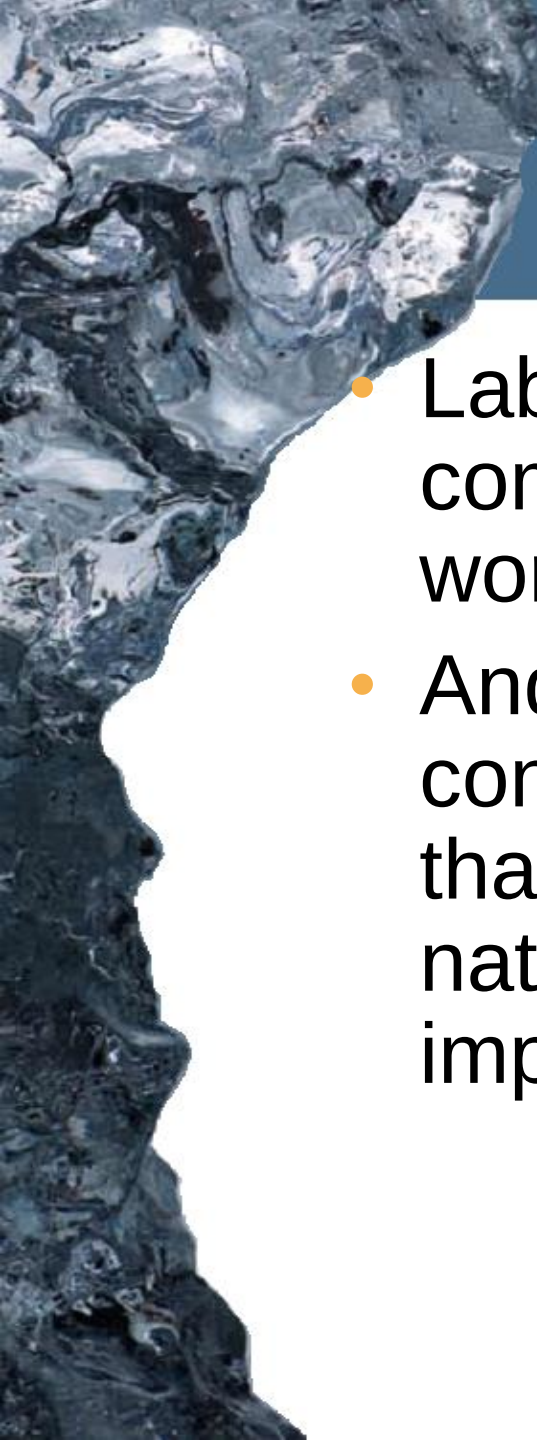
- The World Trade Organization (WTO) was created to replace GATT.
- In effect, the WTO is now the world's trade police force.
- The WTO is empowered to:
 - Cite nations that violate trade agreements.
 - Impose remedial action when violations persist.



WTO Protests



- Some believe freer trade is a mixed blessing.
- Environmentalists:
 - Question the very desirability of continued economic growth.
 - Worry about the depletion of resources, congestion and pollution, and the social friction that growth often promotes.



WTO Protests



- Labor organizations worry that global competition will depress wages and working conditions.
- And many third-world nations are concerned about playing by trade rules that always seem to benefit rich nations (e.g., copyright protection, import protection).

- End Chapter 11