ECONOMICS UNIT FIVE REVIEW

International Economics

WHY NATIONS TRADE

- Comparative Advantage
- Uneven distribution of resources

THE WORLD ECONOMY

- Each nation sells some of its products to other nations and then buys things from other nations that it can't easily produce
  - This activity is called **trade**
  - Goods and services that are sold to other nations are called **exports**
  - Goods and services that are bought from other nations are called **imports**

THE WORLD ECONOMY

- Specialization and trade increase the amount and variety of goods available to all nations!
- The benefit that comes from specialization depends on the concepts of **comparative advantage** and **absolute advantage**

TRADE EFFICIENCY

- Absolute Advantage: one country can produce a product at lower cost or with higher labor productivity given their available resources
- Comparative Advantage: One country can produce at a *lower opportunity cost* than another country given their available resources.

ABSOLUTE ADVANTAGE

- If a country can make a larger quantity of a good than another country, then it is said to have an absolute advantage in that good
- However, absolute advantage does not mean that a country *should* produce that certain product
  - They may produce it at the expense of producing other useful goods
  - In this case, the opportunity cost of *not* producing the other good may be too much for the country to give up!
  - This is why comparative advantage is important!

COMPARATIVE ADVANTAGE

- Sometimes we import things that we could make ourselves – why would we do that?
- The reason is that sometimes its *cheaper* in opportunity costs to import a good rather than produce it!
  - That is the concept of *comparative advantage* in a nutshell!
  - If one country can make a product relatively more efficiently (lower opportunity cost) than another country, then it is said to have a comparative advantage in that good

HOW TO CALCULATE COMPARATIVE ADVANTAGE

- Remember this formula (*write this down!*)

We Give Up = Your Opportunity Cost

If We Make

Comparative Advantage

	Shoes		Wheat	
China	400	.25 wheat	100	4 shoes
U.S.A	1000	.5 wheat	500	2 shoes

Opportunity Cost in red

BALANCING TRADE

- A nation's **balance of trade** is the difference between the value of its imports and the value of its exports in a given year

+ EXPORTS
- IMPORTS

BALANCE OF TRADE

BALANCE OF TRADE

- Trade Surplus – the value of a nation’s exports exceeds the value of what they import

Imports < Exports

- Trade Deficit – the value of a nation’s exports are less than the value of what they import

Imports > Exports

BALANCE OF PAYMENTS

- Any transaction that brings money into a nation is a **credit** and any transaction that takes money out is a **debit**
- The difference between the total amount of money coming into a nation and the total amount leaving is called its **balance of payments**

IN AN IDEAL WORLD

- Just as in a family budget, the amount of money going out should not be greater than the amount of money coming in
  - Otherwise, the nation will incur a debt
  - So, ideally, a nation's balance of payments should be zero or a positive number
- In recent decades, the US has suffered from a negative balance of payments because of our trade deficit

  (which includes the cost of imported oil, foreign aid, and military investment abroad)

INTERNATIONAL TRADE BENEFITS EVERYONE

- When countries interact with other countries, each country gains a higher standard of living.
- A high degree of **economic interdependence** exists in the world
  - No country is able to get everything it needs within its own borders.
- We live in a time in which most countries are moving toward **open economies**:
  - High degrees of free trade with few trade barriers such as quotas and tariffs.

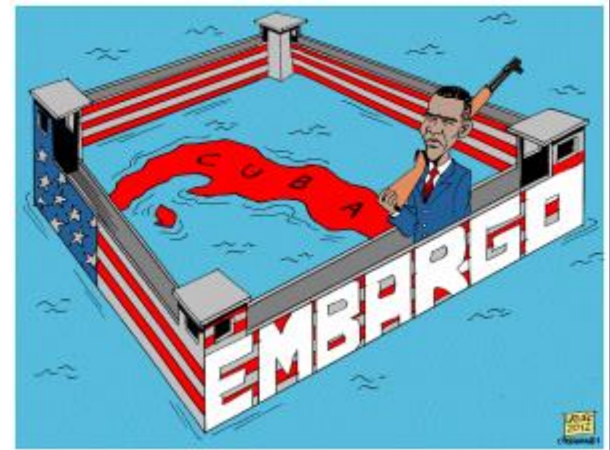
PROTECTIONISM

- When a government enacts a policy that attempts to limit imports, it is practicing **protectionism**
  - Protectionism aims to "protect" domestic (i.e. home country) industries by limiting competition with foreign producers
  - It lessens the variety of goods for consumers, but may keep domestic workers employed!
- The opposite of protectionism is **free trade**, or open trade between nations without barriers to imports

TYPES OF TRADE BARRIERS

- Tariff: a tax imposed on certain imports
  - These make imports more expensive to buy and earn revenue for the government
- Quota: a limit on the number of certain products that can be imported
- Standards: rules about the quality of imports
  - If the product doesn't meet the standards, then it isn't imported
- Subsidies: direct financial aid to certain domestic industries
  - These lower the production costs for businesses

EMBARGOS



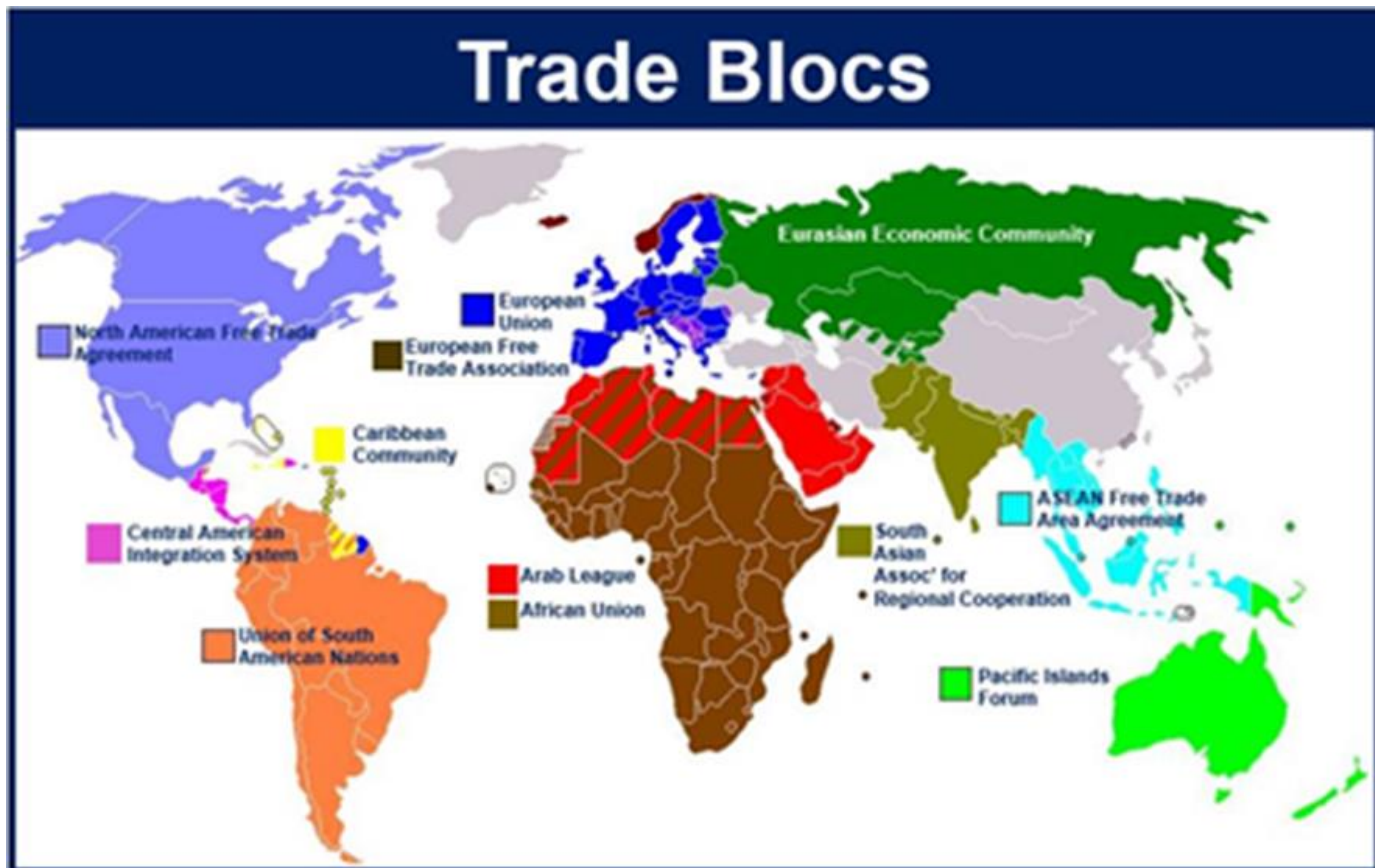
- The most severe trade barrier is an **embargo**, or a total ban on one or more products from a particular nation
  - Embargos are often motivated by political rather than economic factors because they put pressure on governments to change their actions

ARGUMENTS FOR/AGAINST FREE TRADE

- Most economists argue that free trade:
  - Improves economic efficiency
  - Offers consumers of all nations a wide variety of goods
  - Offers consumers the lowest possible prices
- However, those who favor trade barriers argue that:
  - It protects national security
  - It protects "infant industries" in the nation
  - It protects domestic jobs

TRADING BLOCS

- **Trade blocs** are groups of nations that work together through trade agreements



IMPORTANT TRADE AGREEMENTS

- **Trade Agreements** are documents that outline the conditions under which trade will take place between nations.
  - General Agreement on Tariffs and Trade (GATT)
  - NAFTA: The North American Free Trade Agreement.
  - CAFTA: The Central American Free Trade Agreement.
  - ASEAN: Association of Southeast Asian Nations
  - EU: European Union
- US is member of World Trade Organization (WTO)
  - Organization that seeks to reduce protectionism around the world.

THE EU

- The European Economic Community (EEC) was established in 1957 to create a "common market" in Europe
- In 1993, this association was strengthened with the creation of the **European Union** – 27 nations with a shared currency, the Euro
- Today, the EU is the largest free association of trading nations in the world

FOREIGN TRADE

- When international trade occurs, one nation must exchange money, or **<u>currency</u>**, for another nation's goods
- The problem is: not every nation uses the same currency!
  - So, before a transaction takes place, the purchasing nation must <u>*exchange*</u> their currency for the currency of the producing nation!
  - This exchange is governed by **<u>foreign exchange rates</u>** – or the <u>value</u> of one nation's currency in terms of another nation's currency

EXCHANGE RATES

- Exchange rates are "floating", e.g., they change based on the relative Supply and Demand for a currency.
  - The value of the dollar compared to the value of other currencies is determined by supply and demand.
  - Demand for U.S. dollars is synonymous with demand for U.S. products.
    - High demand for American products will drive the value of the dollar up compared to other currencies.

An Example

$c = a \times b$

a = money you have

b = exchange rate

c = money after exchange

Example:

a = $1,500 (USD); b = 0.7618

1,500 × 0.7618

= 1,142.70 EUR

wikiHow to Calculate Exchange Rate

FOR EXAMPLE…

- Let's imagine that you import a Japanese computer that costs $1,000
- The American company must exchange $1,000 for Yen – but, how many?
  - Figure it out by looking at the table:
  - Then, set up the multiplication:

$1,000 x 113.94 = 113,940 Yen

	Value of $1 US (in foreign curr.)	Value of foreign currency (in US $)
Canadian $	0.97	1.03
Euro	0.70	1.42
Japanese Yen	113.94	0.008
Mexican Peso	10.84	0.09

APPRECIATION AND DEPRECIATION

- Exchange rates change over time
- When a currency is **strong** in terms of another, that means it is worth more
  - So, if the US $ is *strong*, American tourists can buy more abroad and US businesses can import more foreign goods for lower cost
  - If the currency gains value, it has **appreciated**
- When currencies lose their value, they have **depreciated** in terms of another currency

WEAK DOLLAR

- What is a 'weak' dollar?
  - The value of the dollar falls compared to other currencies
  - More U.S. dollars are needed to purchase foreign currencies
  - The value of the dollar is depreciating
- Who is helped by a weak dollar?
  - **U.S. Producers** – because they're competing with higher priced imported goods & services
  - **Foreign Consumers** – because they can buy U.S. goods & services at a lower price
  - **U.S. Exporters** – because American goods & services become less expensive for foreign consumers
- Who is hurt by a weak dollar?
  - **U.S. consumers** – because the cost of foreign goods & services is more expensive
  - **U.S. investors** in foreign companies because it costs more
  - **Foreign exporters** – because their goods & services are more expensive

STRONG DOLLAR

- What is a strong dollar?
  - The value of the dollar rises compared to other currencies
  - More foreign currency is needed to purchase a U.S. dollar
  - The value of the dollar is appreciating.
- Who is helped by a strong dollar?
  - **U.S. consumers** because the prices of foreign goods & services are less expensive
  - **U.S. investors** in foreign companies because the prices of foreign securities are lower
  - **U.S. importers** because they can sell foreign goods & services at a lower price
- Who is hurt by a strong dollar?
  - **U.S. producers** because they are competing against lower priced foreign goods & services
  - **Foreign consumers** because U.S. goods & services are more expensive
  - **U.S. exporters** because U.S. goods & services are more expensive

EFFECTS OF CHANGING RATES

- *When the dollar is strong, or appreciates:*
  - Imports increase and are <u>cheaper</u> for consumers to buy ☺
  - Travel <u>abroad</u> is cheaper for American tourists ☺
  - US <u>exports</u> decline ☹
  - The US trade <u>deficit</u> increases ☹
- *When the dollar is weak, or depreciates:*
  - US exports <u>increase</u> and the prices of exports go up ☺
  - Travel abroad is <u>more</u> expensive for American tourists ☹
  - The US trade balance <u>improves</u> ☺
  - <u>Foreign</u> investment in US businesses increases ☺

- So, there are pros and cons of both conditions!