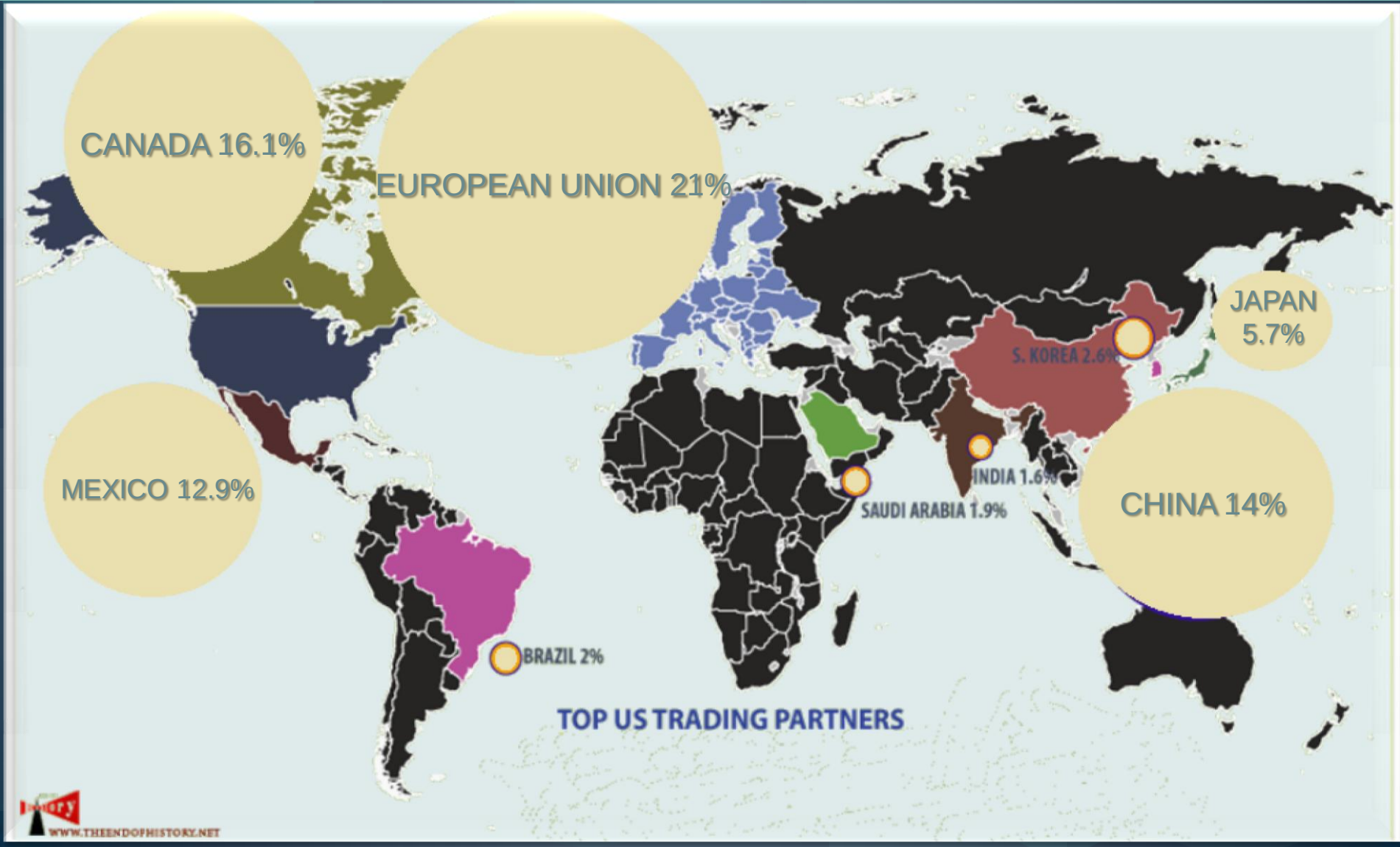
Test Yourself: International Trade and Finance

The industrialized countries need the economic recovery of the Third World, need these billions of human beings, potential buyers of our products. This is not only a generous attitude, it is a self-serving one.
-Francois Mitterrand

Why do countries trade?

Trade allows counties to consume goods and services exceeding their production possibilities curve.

Graphic: US Trading Partners, 2012



Why should countries specialize?

Total world output increases, and therefore, the potential for greater total world consumption increases when countries specialize.

If countries specialize, in what should they specialize?

If countries specialize, they should produce those goods and services in which they have a comparative advantage.

What is comparative advantage?

Comparative advantage is the ability of a country to produce a good at a lower *opportunity cost* than another country.

This is not the same as absolute advantage, which is the ability of a country to produce a good using fewer resources than another country.

What is specialization?

When countries specialize, they produce those goods and services in which they have a comparative advantage.

When countries specialize, total world output increases and the potential for greater total world consumption increases.

Chart: US Production and Consumption

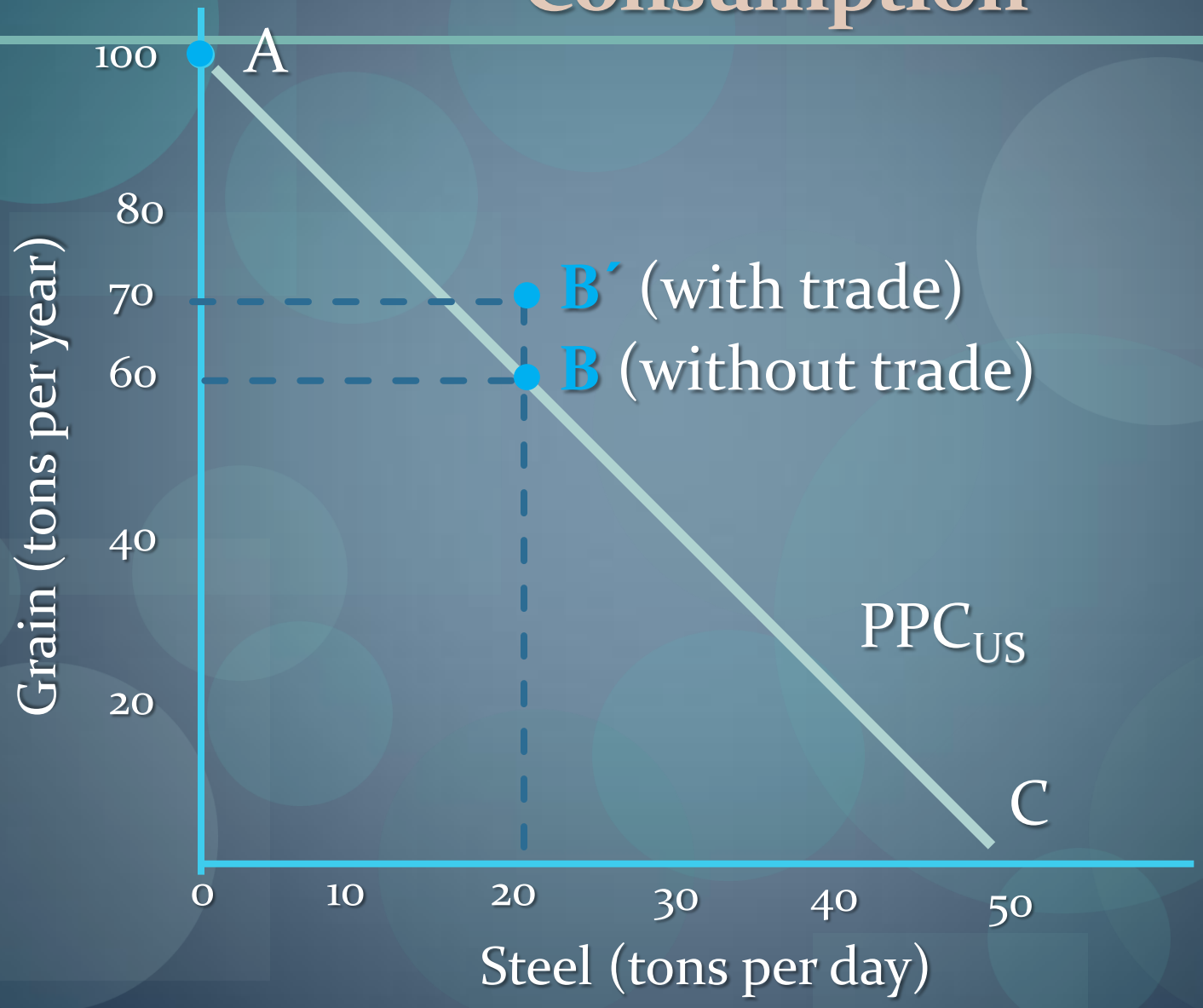
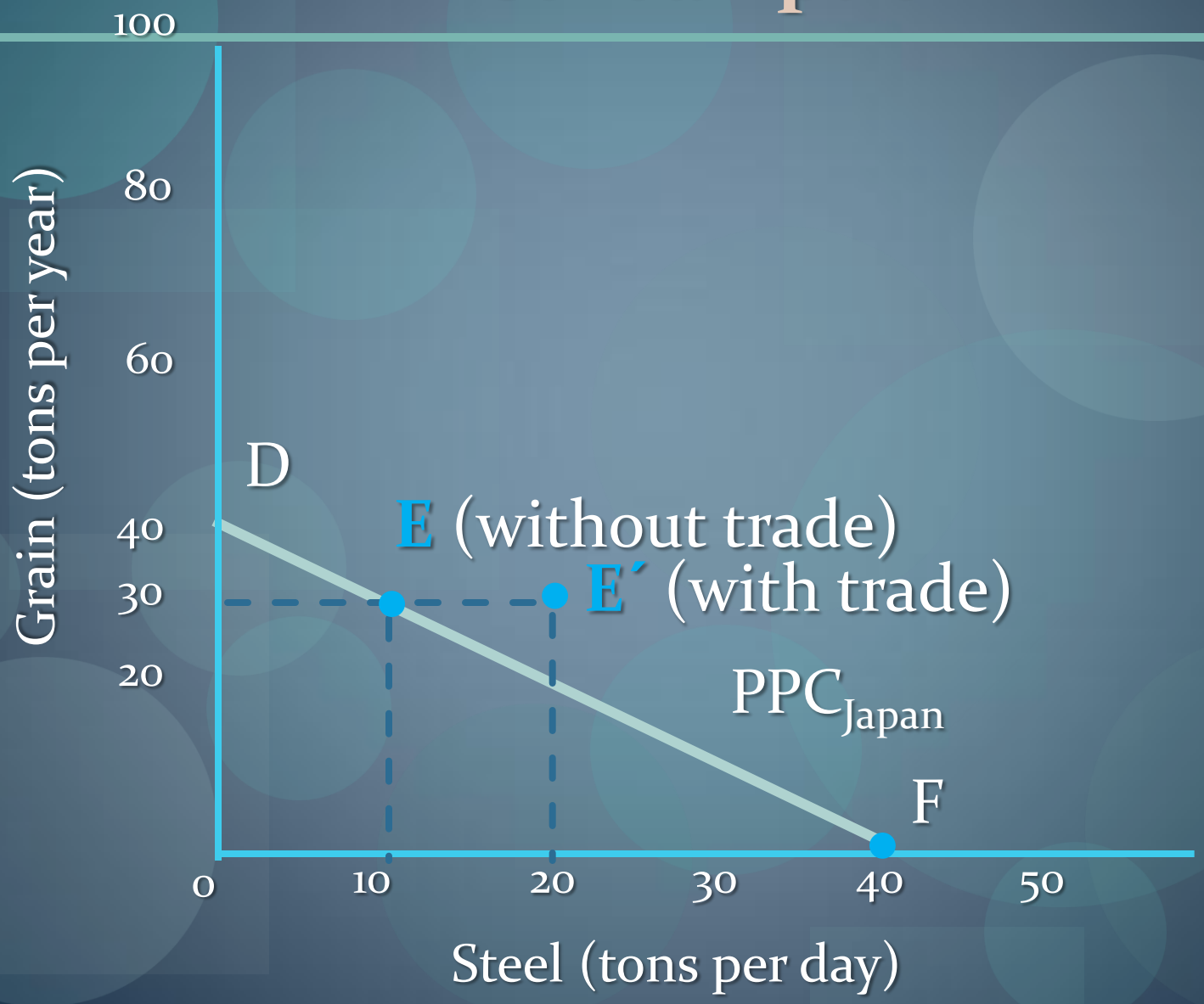


Chart: Japanese Production and Consumption



What is free trade?

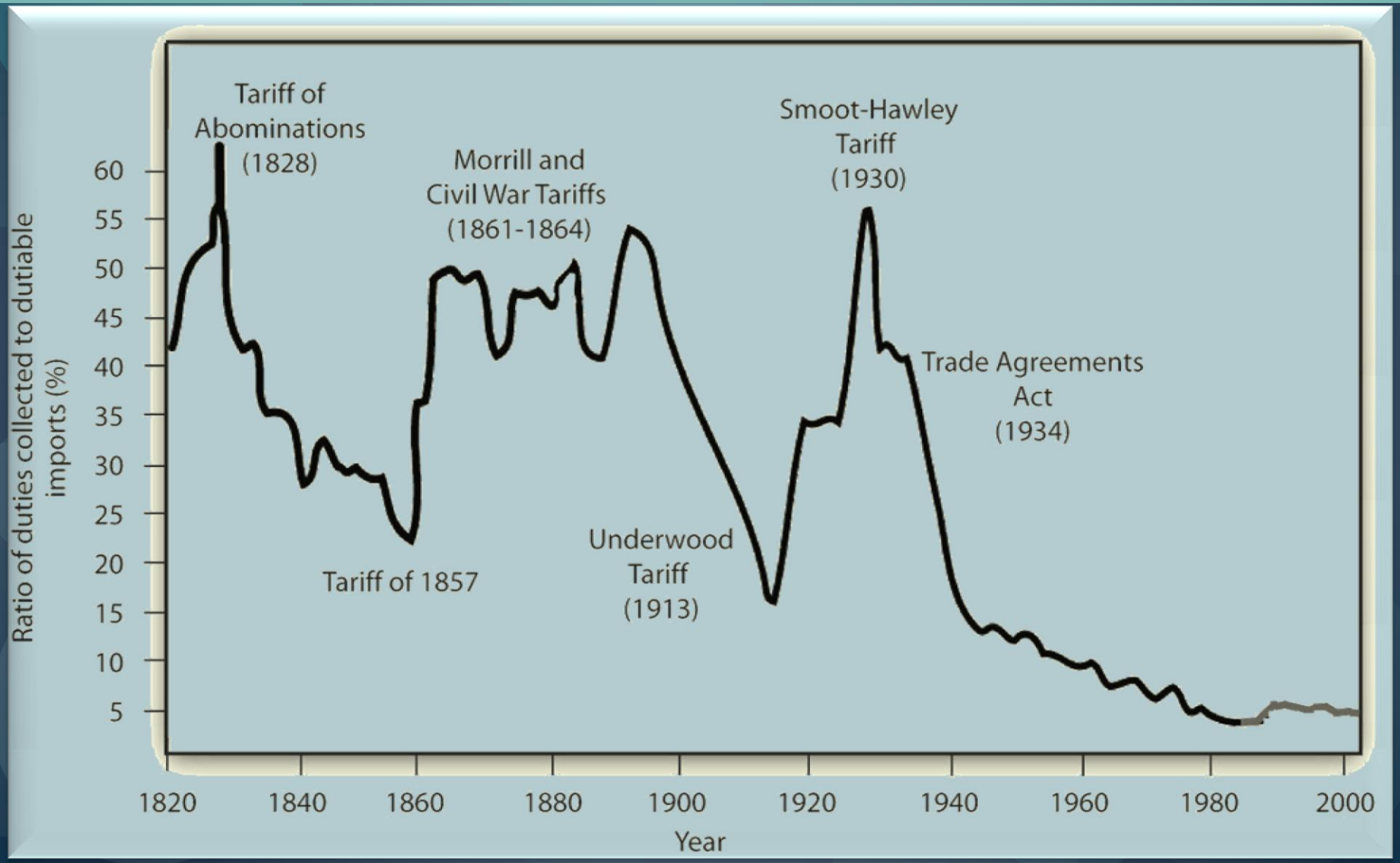
Free trade refers to the flow of goods between countries without restrictions or special taxes.

What is protectionism?

Protectionism is the government's use of embargoes, tariffs, quotas and other restrictions to protect domestic producers from foreign competition.

- embargo – a law that bars trade with another country
- tariff – a tax on imports
- quota – a limit on the quantity of a good that may be imported in a given time period

Chart: US Tariff Rates, 1820-2005



US Tariff Rates, 1820-2005

US Tariff Rates, 1820–2005 (on the previous slide) shows average tariff rates on dutiable imports in the US since 1820. The high tariffs of the early 19th century were typically justified as being necessary to allow US firms to gain a competitive foothold in the world economy. As domestic industries became established, tariff rates fell. Subsequent increases in tariffs were a response in part to internal crises: the Civil War and the Great Depression. Tariff rates have fallen dramatically since 1930.

What are the arguments for protectionism?

Arguments for Protectionism

- infant industry
- national security
- domestic employment
- cheap foreign labor
- free trade agreements

What is a free trade agreement?

Nations negotiate free trade agreements to reduce trade barriers.

The North America Free Trade Agreement (NAFTA) is a 1993 free trade agreement between the US, Canada and Mexico.

What is the balance of trade?

The balance of trade is the value of a nation's merchandise imports subtracted from its merchandise exports.

Chart: US Balance of Trade, 1980-2010

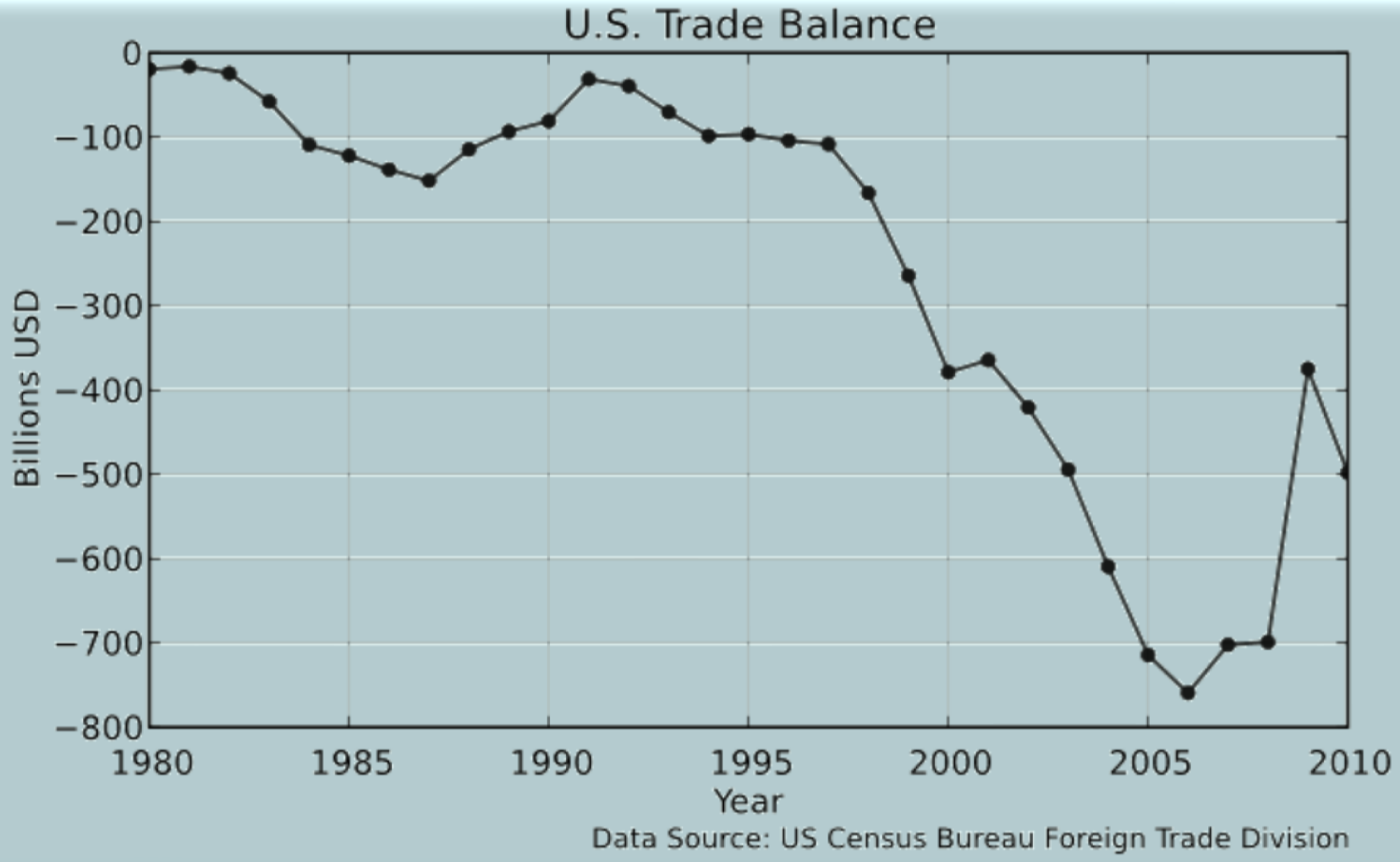
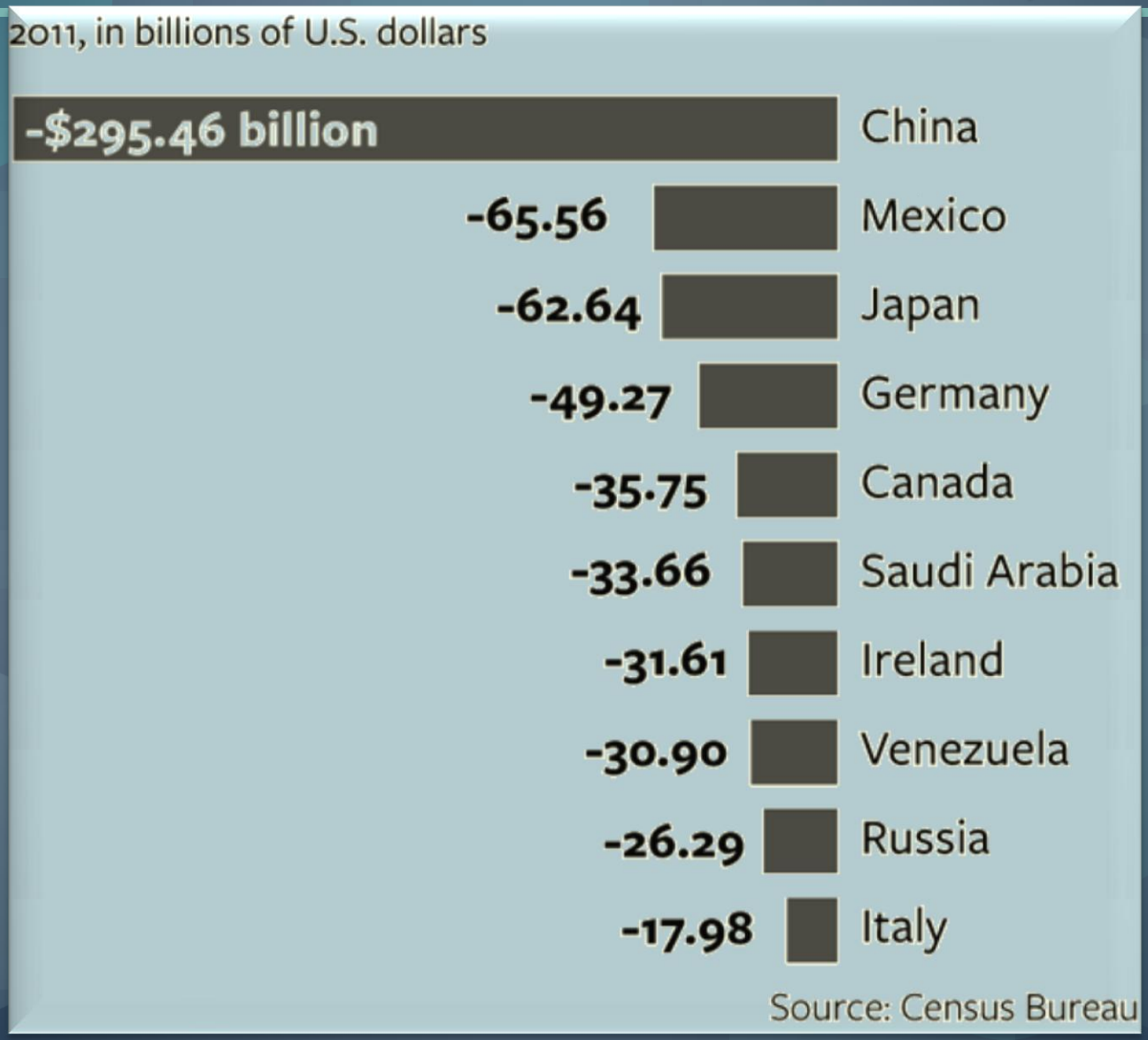


Chart: Top Countries with which the US Has A Trade Deficit, 2011



What is a balance of payments?

A balance of payments is a bookkeeping record of international transactions between countries during a given period of time.

A balance of payments always equals zero … the current account deficit should equal the capital account surplus.

Example: Balance of Payments

U.S. BALANCE OF PAYMENTS (HYPOTHETICAL)			
Current Account			
Goods exports	$30		
Goods imports	–$50		
Balance on goods (merchandise)		*–$20*	
Service exports	$18		
Service imports	–$12		
Balance on services		*$6*	
Balance on goods and service		*–$14*	Note: This negative balance indicates a trade deficit in goods and services.
Net investment income	–$5		
Net transfers	–$7		
Balance on current account		*–$26*	
Capital (or Financial) Account			
Inflow of foreign assets to U.S.	$35		
Outflow of U.S. assets abroad	–$20		
Balance on capital account		*$15*	
Official Reserves Account			
Official reserves		*$11*	
		$0	

What is a current account?

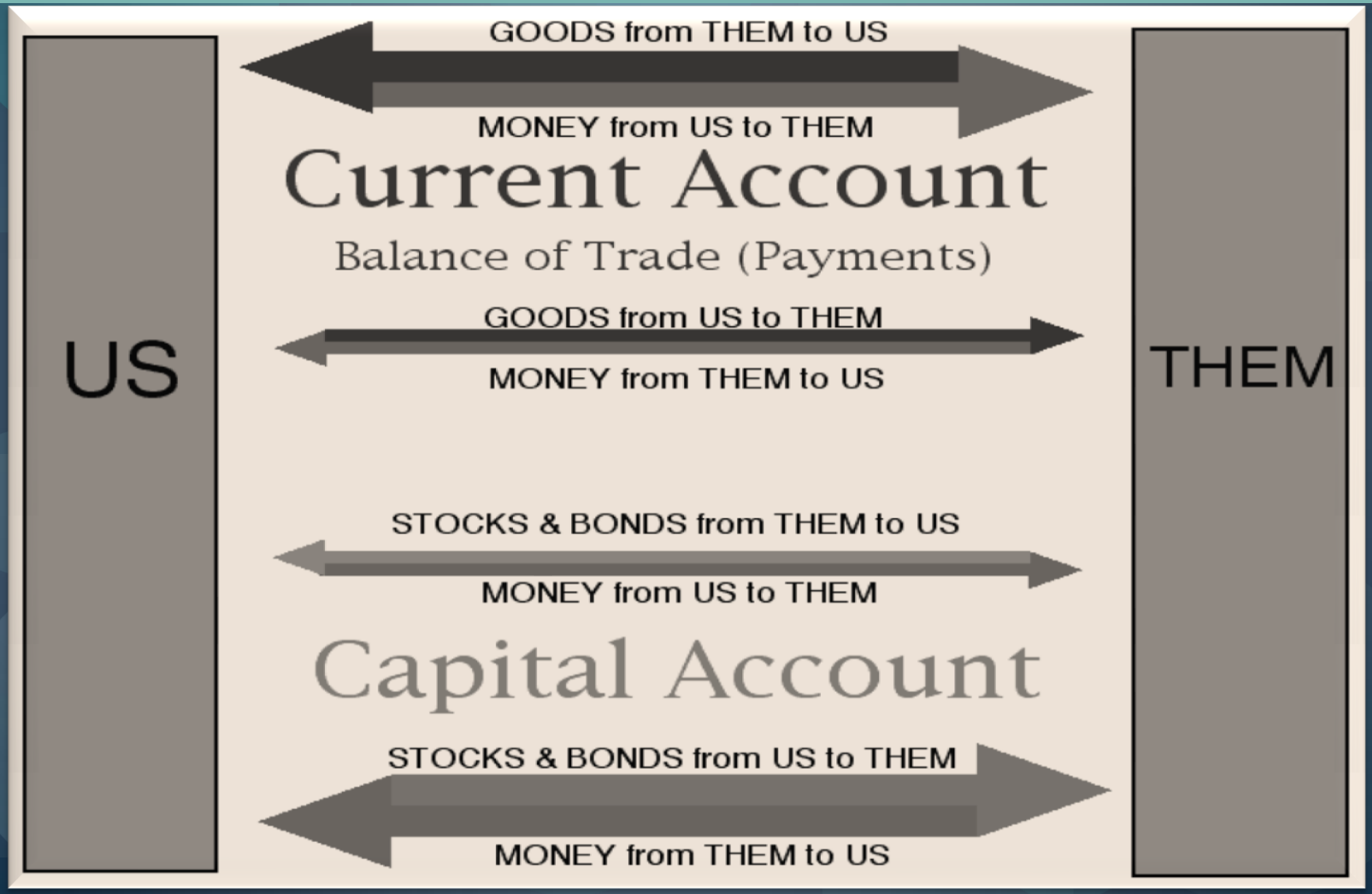
A current account is the first section of a balance of payments, which includes trade in currently produced goods and services.

A current account deficit is financed by a capital account surplus.

What is a capital account?

A capital account is the second section of a balance of payments and records payment flows of financial capital.

Comparing Current and Capital Accounts



Example: Current Account and Capital Account

	Credits	Debits
Current Account		
Exports	$ 1,418.64	
Imports		$ -1,809.18
Unilateral Transfers	$ 10.24	$ -64.39
Balance on current account		$ -444.69
Capital Account		
Direct Investment	$ 287.68	$ -152.44
Portfolio Investment	$ 474.39	$ -124.94
Other Investment	$ 262.64	$ -303.27
Balance on capital account	$ 444.26	
Statistical Discrepancies	$ 0.73	
Overall Balance	$ 0.30	
Official reserve account		$ -0.30

In 2000, the U.S. imported more than it exported, thus running a current account deficit of $444.69 billion.

During the same year, the U.S. attracted net investment of $444.26 billion—clearly the rest of the world found the U.S. to be a good place to invest.

In the real world, there is a statistical discrepancy.

What is an exchange rate?

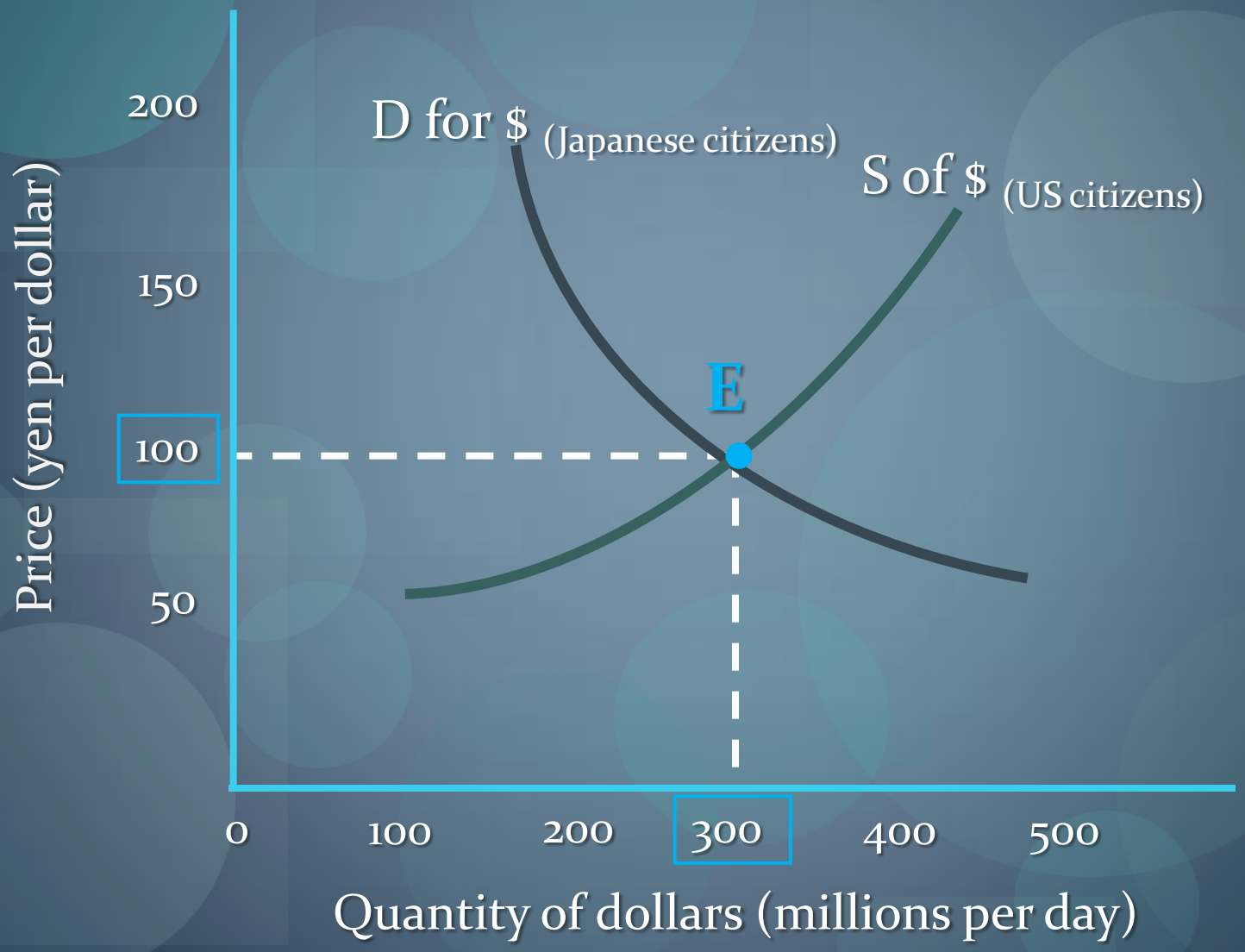
An exchange rate is the amount of one nation's currency that equals one unit of another nation's currency.

For example, if $1.81 is exchangeable for £1 (British pound), the exchange rate is:

1 / 1.81 = .552 pounds per dollar

The supply and demand for foreign currency determine the exchange rate.

Chart: Supply and Demand for Dollars



What happens when a currency depreciates?

When the price of the currency falls in relation to another currency it is said to have depreciated (lost value).

When a country's currency depreciates, its goods and services cost foreign consumers less and it pays more for foreign goods and services.

What happens when a currency appreciates?

When the price of a currency rises in relation to another currency, it is said to have appreciated (gained) in value.

When a country's currency appreciates, its goods and services cost foreign consumers more and it pays less for foreign goods and services.

What can cause a currency to change value?

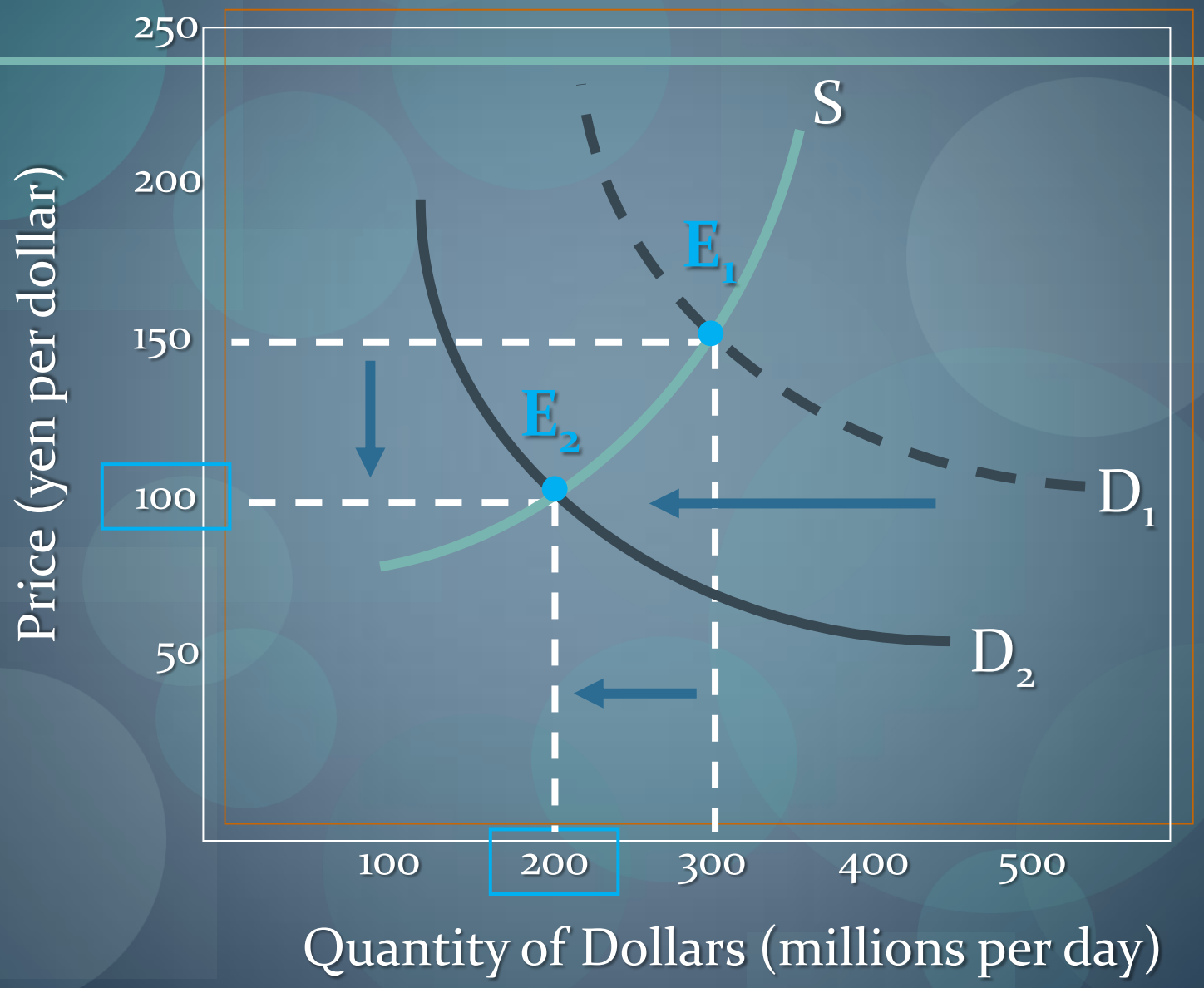
A currency's value changes if the demand and/or supply of the currency in the international market changes.

What can cause a change in the demand for a currency?

There can be a change in the demand for a currency if there is a change in any of the following.

- tastes and preferences
- relative price levels
- relative interest rates

Chart: Decrease in Demand



Graphic: Decrease in Demand

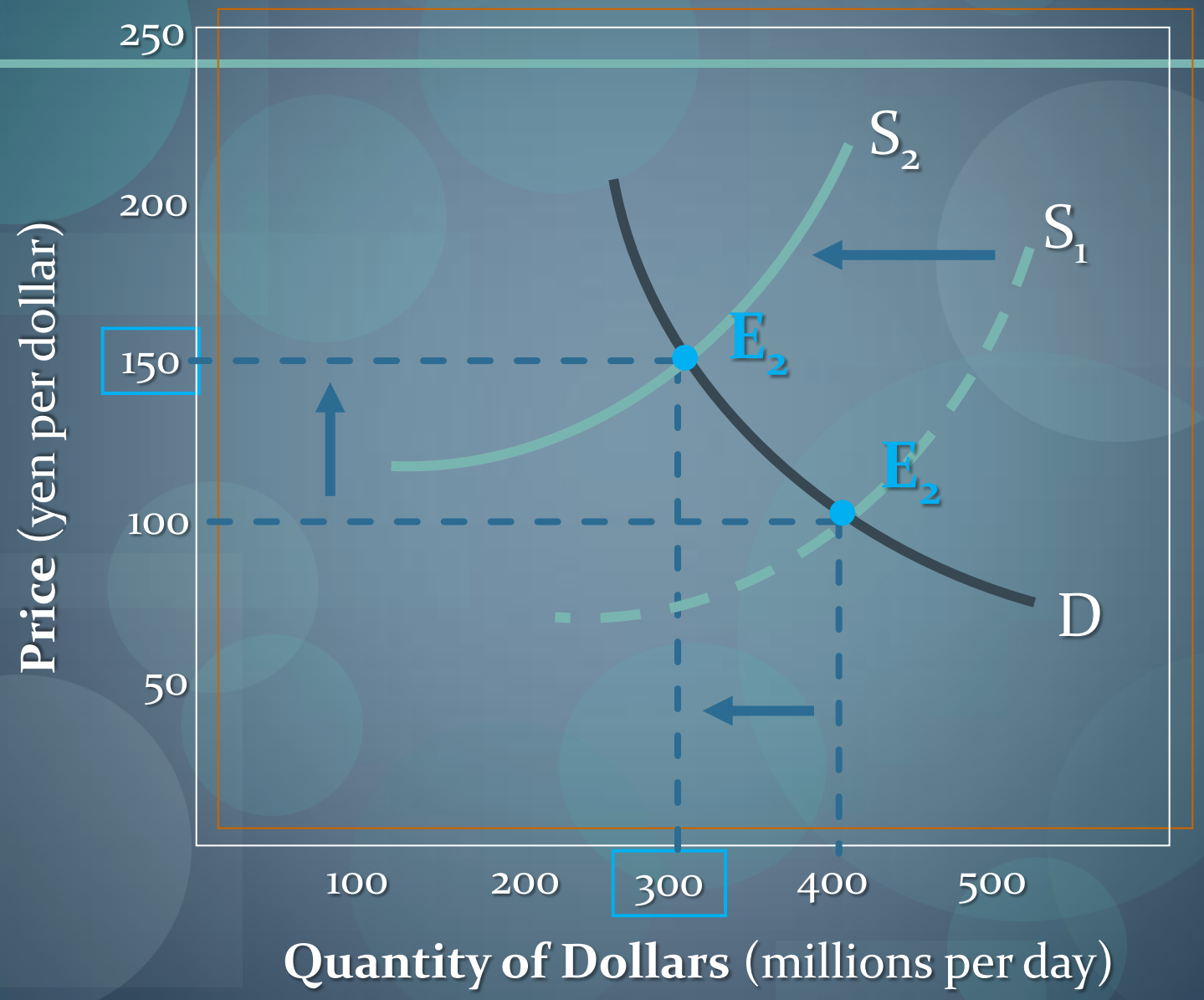
US exports less popular → decrease in the demand for dollars → value of the dollar falls (depreciates)

What can cause a change in the supply of a currency?

There can be a change in the supply of a currency if there is a change in any of the following.

- relative incomes
- relative price levels
- relative interest rates

Chart: Decrease in Supply



Graphic: Decrease in Supply

Japanese imports less popular → decrease in the supply of dollars → value of the dollar rises (appreciates)

Changes in Demand and/or Supply

- The demand and/or supply of a currency can change in the international market.
- Demand can change if there is a change in:
  - tastes and preferences
  - relative price levels
  - relative interest rates
- Supply can change if there is a change in:
  - relative incomes
  - relative price levels
  - relative interest rates

What happens when demand and/or supply in the currency market changes?

When demand and/or supply changes, the currency affected seeks a new equilibrium and the currency's value changes.

Graphic: Impact of Relative Price Changes on Exchange Rates

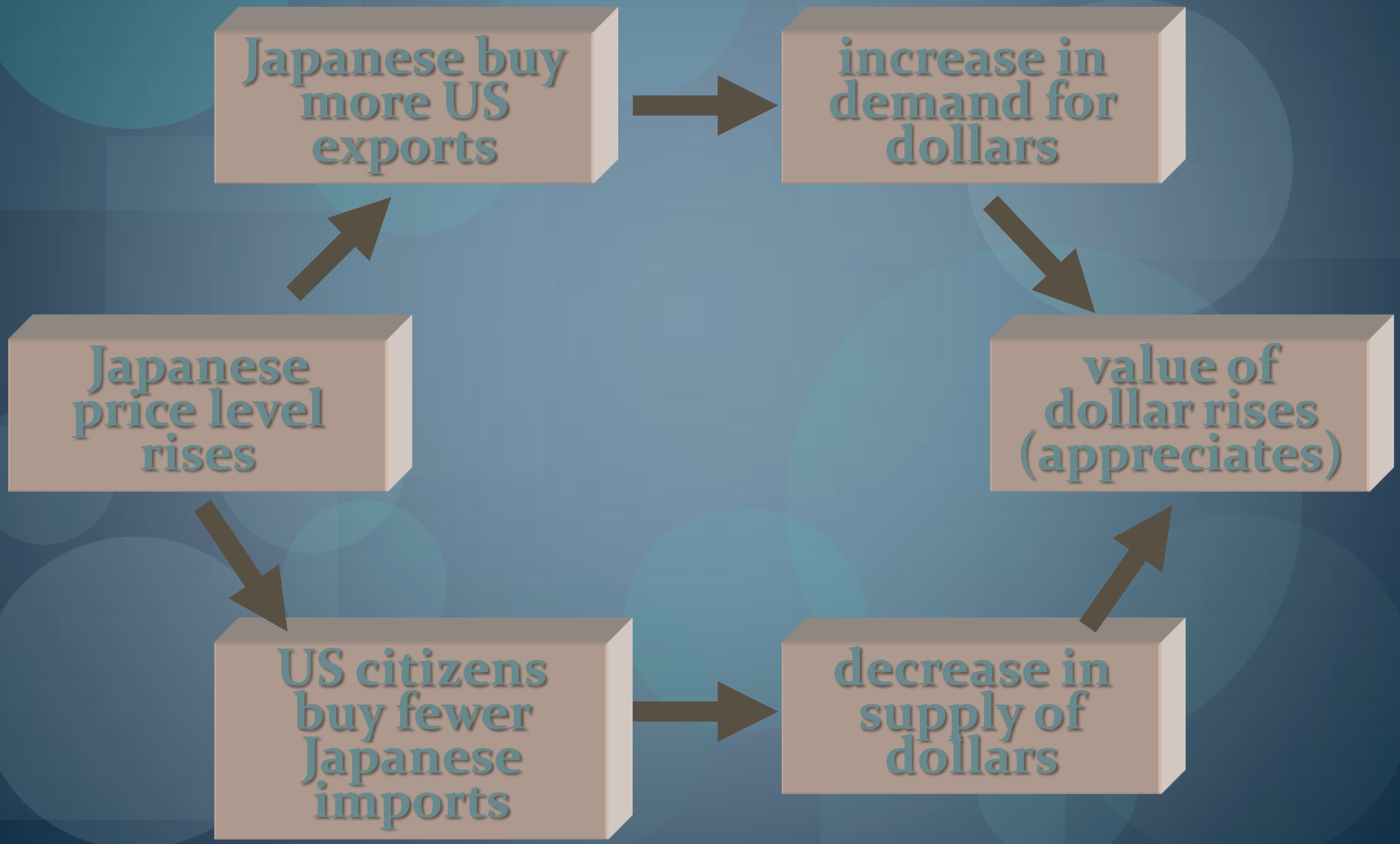
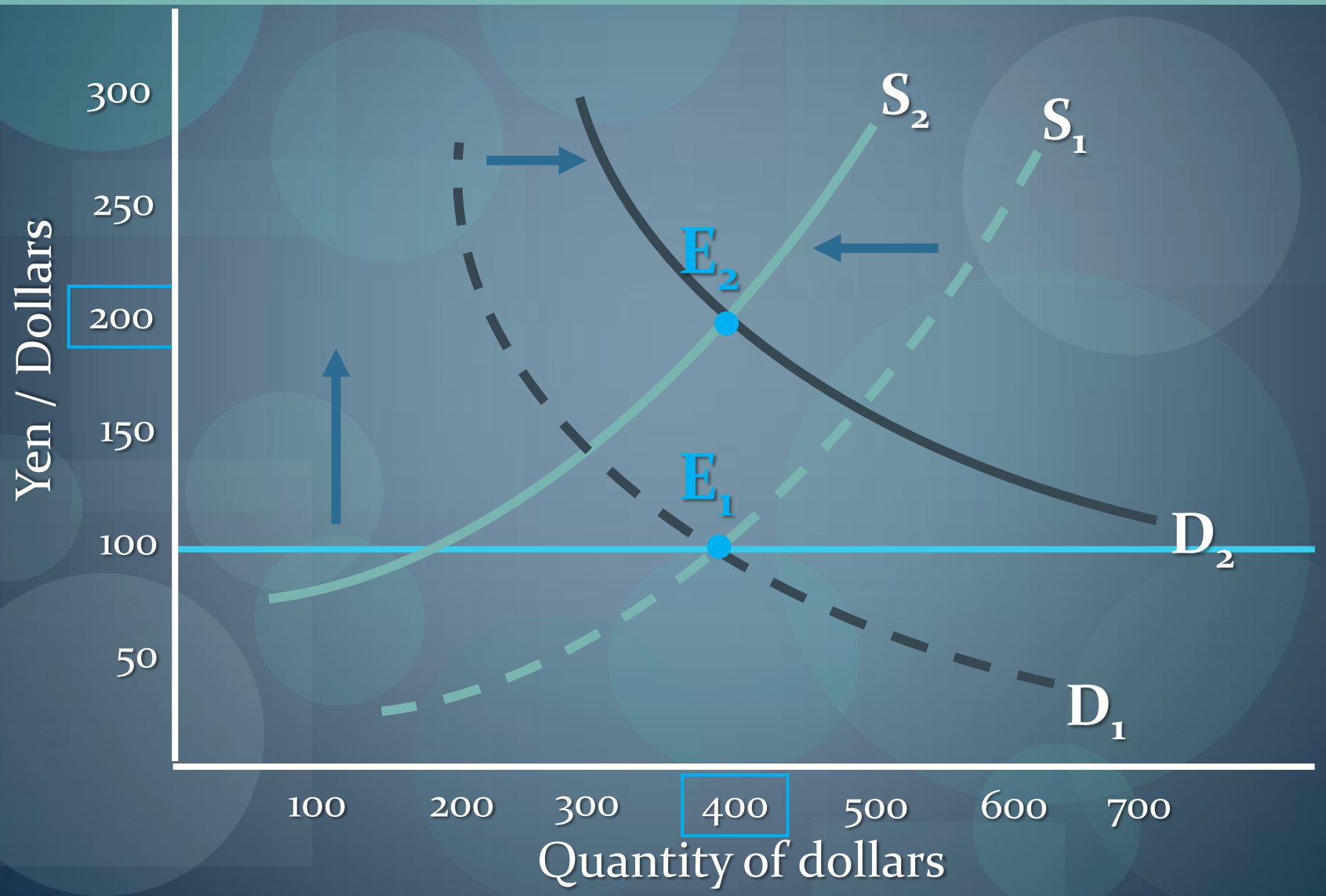


Chart: The Effects of a Shift in Supply on Market Equilibrium




TRADE
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