Unit 8
The Global Economy

Concept Review:
Trade Makes People Better Off

- None of us is equally skilled at doing everything
- It makes more sense to concentrate on what we do best and trade with others for what they do best
- End up with more and better choices than by trying to do everything for ourselves

Concept Review: Absolute Advantage

- One group (individual/business/state/country) can produce a given item <u>cheaper</u> and/or <u>better</u> than another group
- Example: Apples & Oranges
  - Due to climate, Virginia can produce apples much better (and more cheaply) than Florida.
  - Likewise, Florida can produce oranges much better (and more cheaply) than Virginia.
  - Each state could produce the other fruit, but it would be much more costly (need for greenhouses, artificial lighting, etc., to simulate the climate needed for the other fruit).
  - Virginia has an absolute advantage over Florida in producing apples.
  - Florida has an absolute advantage over Virginia in producing oranges.
  - Virginia grows apples for use & to sell to Florida
  - Florida grows oranges for use & to sell to Virginia

Concept Review: Comparative Advantage

- The ability to perform a task at a lower ***opportunity cost*** than someone else is able to perform that task

Example

	Factory A	Factory B
Computers	9,000	6,000
Cell Phones	36,000	12,000

Opportunity Costs

Factory A

- Opportunity cost for producing 9,000 computers is 36,000 cell phones
  - Opportunity cost for producing 1 computer is 4 cell phones
- Opportunity cost for producing 36,000 cell phones is 9,000 computers
  - Opportunity cost for producing 1 cell phone is ¼ computer

Factory B

- Opportunity cost for producing 6,000 computers is 12,000 cell phones
  - Opportunity cost for producing 1 computer is 2 cell phones
- Opportunity cost for producing 12,000 cell phones is 6,000 computers
  - Opportunity cost is for producing 1 cell phone is ½ computer

- Factory A has lower opportunity cost to produce cell phones (¼ computer compared to Factory B's ½ computer)
  - Factory A has a ***comparative advantage*** over Factory B in producing cell phones
- Factory B has a lower opportunity cost to produce computers (2 cell phones compared to Factory A's 4 cell phones)
  - Factory B has a ***comparative advantage*** over Factory A in producing computers
- Conclusions:
  - Factory A should focus on producing cell phones
  - Factory B should focus on producing computers

What Causes Comparative Advantages?

- ***Differences in <u>Climate</u>***
  - Countries may be able to produce certain crops better than other countries due to their climate being better suited for those crops
  - Examples:
    - Tropical countries produce bananas, mangos, and coffee
    - Countries with temperate climate produce grains like wheat and corn
  - Seasonal variations between the Northern & Southern Hemisphere can also play a part
    - US & northern hemisphere countries purchase fruits and vegetables from southern hemisphere countries when it is winter in the northern hemisphere (and is the summer growing season in the southern hemisphere)

- ***Differences in Factors of Production***
  - Countries with an abundance of a particular factor of production (land, labor, capital) may have a comparative advantage in the production of goods or services derived from that resource
  - Examples:
    - Canada has extensive forestland, giving it a comparative advantage in producing timber
    - China has a huge population, giving it a comparative advantage in the production of goods that require large amounts of low-cost labor, like clothing
    - The US has a relatively high-skilled labor force, giving it a comparative advantage in producing machinery & equipment, aircraft & parts, automobiles & parts, etc.

- ***Differences in Technology***
  - Countries that have developed a high level of technology also enjoy a comparative advantage in producing high-value goods
  - Examples:
    - US software and pharmaceutical industries have a higher level of technology than many others, giving it a comparative advantage in those industries
    - Japan’s advances in engineering and production have given it a comparative advantage over many other countries in auto production

Differentiated Products Promote Global Trade

- Global trade not solely a matter of absolute or comparative advantage
- Products produced by different firms (and in different countries) are not always identical
  - ***Differentiated products*** – products that essentially the same, but are distinguished from each other by variations in style, materials, and taste
- Products will have varying levels of quality
  - Provides consumers worldwide a larger variety of a given product at different prices based on the level of quality

Functions of Money

- Medium of Exchange
  - Widely and readily accepted in exchange for goods & services
    - Eliminates the need for barter (coincidence of wants)
    - As long as someone is willing to accept the money in exchange for the item, whatever is being used can serve as money (currency, coins, other items)
- Measure of Value
  - Allows society to place measurable values on items

- Store of Value
  - A dollar will always be a dollar
  - You can save money to buy things in the future
  - Does not work well in this function if there is inflation

Most Nations Have Their Own Form of Money

- There is not (yet) a <u>global</u> currency used by every nation
- Each nation has its <u>own</u> currency (coins and paper money)
  - Examples:
    - US = US Dollar ($)
    - Japan = Yen (¥)
    - Hong Kong = Hong Kong Dollar ($)
    - China = Yuan Renminbi (¥)
- Some nations have agreed to use a common currency for trade
  - Example:
    - European Union = Euro (€)

Nations Want to Deal in Their Own Currency

- Each nation uses its <u>own</u> currency as its medium of exchange, measure of value, and store of value
  - Prices of goods & services in that country are stated in its own currency
    - Those businesses expect to be paid in that currency
  - Wages are set and paid in its currency
- Those nations expect to be <u>paid</u> for their exports in their own currency
  - The importer must <u>exchange</u> his/her currency for the currency of the country from which they are buying
  - Importer is <u>buying</u> that nation's currency with his/her own nation's currency

Exchange Rate

- The rate at which one currency is exchanged for another
- Example:
  - \$1 = €0.7690
    - You will receive €0.7690 for every \$1 you exchange
    - You will receive \$1.30 for every €1 you exchange (1 divided by 0.7690)

Fixed or Floating Exchange Rate

- ***Fixed (also called pegged) Exchange Rate***
  - One country ties (or pegs) its currency to another currency
  - That country will only exchange its currency for the set rate of the other currency
    - Example: Mexico might fix the exchange rate of its Peso to the US Dollar at 10 pesos per dollar
    - The exchange rate of the peso to other currencies will now be based on what the exchange rate of the dollar currently is

- ***Floating Exchange Rate***
  - Exchange rate of a country's currency to any other country's currency will go up and down based on the supply and demand of that currency
    - Exchange rates determined by the currency market
    - Supply & demand of the currency from another country is determined by the exports & imports between the two countries; the exchange is needed for each country to pay for its imports

Devaluation

- ***Devaluation*** = a situation where one currency is losing purchasing power relative to another currency
  - Example: if the exchange rate for the dollar goes down from €0.7690 to €0.7500 ($1.33 for each euro)
    - It will now cost you more dollars to purchase a euro than before
    - Anything you are buying that you must pay euros for will be more expensive to you
    - Example: a Mercedes Benz that would have cost $87,775 (€ 67,499) at the old exchange rate now costs $89,775 at the new exchange rate

- Devaluation of one country’s currency relative to another country makes imports more expensive from that other country
  - Usually results in fewer imports into that country
- Devaluation of one country’s currency relative to another country makes exports less expensive to that country
  - Usually results in more exports out of that country
  - Some economists argue that this can help a country whose economy is not performing well
    - Cheaper exports can boost Gross National Product(GDP + Net Exports)
    - Devalued currency makes it easier for government to pay off debt it owes to other countries

Trade

- ***Exports*** = goods and services a country <u>sells</u> <u>to</u> other countries
- ***Imports*** = goods and services a country <u>buys</u> <u>from</u> other countries
- ***Balance of Trade*** = the <u>difference</u> between exports and imports between two countries
  - Also referred to as the ***Balance of Payments***
  - Calculated as:

Exports – Imports

- ***Trade Surplus***= imports are less than exports
  - Exports are greater than imports
  - Who benefits
    - Businesses that export
      - More of their goods and services are being demanded
      - Often results in higher profits for owners
    - Workers in industries that export
      - More demand for their labor
      - Often results in lower unemployment and/or higher wages for workers in those industries
  - Who might be harmed
    - Consumers
      - The additional money coming into the economy could result in inflation as that money is chasing relatively few goods & services
      - If wages are not rising at the same pace as inflation, this could hurt the standard of living for those consumers
  - There are tradeoffs between the benefits (domestic producers) and costs (inflation & possible impact on standard of living) of having a trade surplus

- ***Trade Deficit*** = imports are greater than exports
  - Exports are less than imports
  - Who benefits
    - Consumers
      - The imports tend to be less expensive than identical items produced domestically
      - Consumers can afford to buy more
      - Overall standard of living goes up
  - Who might be harmed
    - Domestic businesses that compete with the goods & services being imported
      - Less of their goods & services may be demanded (unless products are sufficiently differentiated to justify a higher price)
      - May result in lower profits for owners
    - Workers in industries that compete with goods & services being imported
      - Less demand for their labor
      - May result in higher unemployment and/or lower wages for workers in those industries
  - There are tradeoffs between the benefits (higher overall standard of living) and costs (challenges for domestic producers) of having a trade deficit

Strong vs. Weak Dollar

- ***"Strong dollar"*** – refers to when the U.S. dollar is <u>increasing</u> in value relative to another currency
  - Dollar can buy <u>more</u> of that other currency
  - <u>Imports</u> from that other country become cheaper for the U.S.
  - <u>Exports</u> to that country become more expensive for that country

- Effects of “strong” dollar:
  - Imports go <u>up</u>
    - Benefits individuals (especially those with lower incomes who rely on purchasing cheap imports for day-to-day living) in the economy because they can purchase more inexpensive imports to improve their standard of living
  - Exports go <u>down</u>
    - Can negatively impact GDP due to lower production of products that compete with the imports and reduced exports
  - Investment flows <u>into</u> the U.S. from the other country
    - Investments made by investors from the other country, when converted back into their currency, will make more due to the each dollar buying a larger amount of their currency

- ***"Weak dollar"*** – refers to when the U.S. dollar is decreasing in value relative to another currency
  - Dollar can buy less of that other currency
  - Imports from that other country become more expensive for the U.S.
  - Exports to that country become cheaper for that other country

- Effects if a “weak” dollar:
  - Imports go <u>down</u>
    - Can hurt individuals (especially those with lower incomes who rely on purchasing cheap imports for day-to-day living) as the price of imports goes up
  - Exports go <u>up</u>
    - Helps the economy overall as GDP grows due to increases in purchases of domestic products and increases in exports
  - Investment flows <u>out of</u> the U.S. to the other country
    - Investments in the other country that pay off will, when converted back into U.S. dollars, will make more because each unit of their currency will buy a larger amount of dollars

- “Strong” and “weak” do not necessarily mean “good” and “bad”
  - Each has its positives & negatives
    - Some aspects of the economy benefit from either
    - Some are possibly harmed by either
    - “Good” or “bad” will be a matter of perspective

Trade Barriers

- ***Free Trade*** = unrestricted movement of goods and services between countries
- ***Trade Barriers*** = restrictions to trade between countries
  - Known as ***protectionism***
  - Normally done to shield domestic markets from foreign competition

Types of Trade Barriers

- ***Protective Tariffs***
  - A tax on imported goods
    - The importer must pay the tariff
    - The price of the tariff is passed on to the consumer in the form of higher prices
    - Ex: the U.S. imposes a 4% tariff on felt-tip pens
  - Used to:
    - Raise tax revenue
    - Protect domestic competition from cheaper foreign goods

- Who benefits
  - Specific domestic producers (those whose products compete with the imports)
    - Tariff pushes prices of imported goods <u>up</u>
    - Don’t have to worry about lowering prices to <u>compete</u> with cheaper imports
- Who is harmed
  - Consumers
    - Have to pay <u>higher</u> prices for products than if there were free trade
- Other consequences
  - Trade war
    - Other countries may <u>retaliate</u> and impose tariffs on your country’s exports
    - Can slow or even <u>halt</u> trade between the two countries, hurting both in the process

- ***Import Quotas***
  - Limits the quantity of a good that can be imported during a specified period of time
    - Once the quota of the import is reached, no further imports of the good are allowed
  - Used to protect domestic industries
    - Do not raise any revenue for the government
  - Who benefits
    - Specific domestic industries
      - They don't have to worry about an unlimited amount of cheaper foreign goods being imported
  - Who is harmed
    - Consumers
      - They end up having to pay higher prices for domestic goods once all the cheaper foreign imports are purchased

- ***Trade Embargoes***
  - Imposes a <u>ban</u> on trade with a country or group of countries
    - No imports from or exports to that country are allowed
  - Usually done for <u>political</u> reasons
    - Intent is to put economic pressure on the country to change its political policies
  - Example: the U.S. has a trade embargo on Iran, Cuba, & North Korea

- ***Voluntary Export Restraints (VER)***
  - A country voluntarily <u>limits</u> the quantity of a good that can be exported to a specific country during a specific time period
    - Actually is a self-imposed export quota
  - Normally done at the insistence of the importing country
    - Importing country often threatens harsher & more restrictive tariffs & quotas if the exporting country doesn't voluntarily restrict itself
  - Example: the Japanese in the 1980s imposed a VER on automobile exports to the U.S. when the U.S. threatened to impose more severe restrictions on Japanese auto imports

The Debate over Trade Restrictions: The Jobs Argument

- Argument for:
  - Allowing cheap imports into a country destroys jobs
    - Domestic companies must cut costs, lay off workers, or even go out of business
  - Highly paid workers in the U.S. can't compete with low-wage workers in poorer countries
    - Only way to protect American jobs is to make cheap imports more expensive and/or less available so goods produced by American workers are demanded

- Argument against:
  - Tariffs & quotas cost <u>more</u> jobs than they save
    - Higher prices on raw materials (like steel) drive <u>up</u> the cost of inputs for those using those materials
    - Prices on all goods using those materials go up, resulting in <u>lower</u> demand, hurting those domestic industries
  - Workers in US can <u>compete</u> with lower-wage workers in foreign countries
    - Lower wages in foreign countries are usually <u>less</u> productive
    - Jobs will go where productivity (output per unit input) is <u>highest</u>
  - Consumers pay <u>more</u> for items whose price is higher than what the market would normally dictate
    - Hurts overall standard of living because consumers can buy <u>fewer</u> items overall if prices are kept high

The Debate over Trade Restrictions: The National Security Argument

- Argument for:
  - Certain industries are vital for national security
    - Don't want to rely on certain items critical for the U.S. from countries who might become enemies
  - Tariffs & quotas will allow domestic industries deemed vital for national security to stay in business
    - Businesses providing products for national defense
    - Critical raw materials like oil, steel, & basic foods (wheat, corn, etc.)

- Argument against:
  - Some industries might be critical, so trade barriers might be justified when the country's security is at stake
  - Most calls for trade barriers using this argument come from the industries themselves, not the military or intelligence communities
    - Industries facing stiff foreign competition have a selfish interest in proclaiming their importance to the country's security

The Debate over Trade Restrictions: The Infant Industry Argument

- Argument for:
  - Newly formed industry in a country needs time to become competitive
  - Trade barriers are needed to protect them until they become strong enough to “stand on their own”
- Argument against:
  - Assumption is that industry will actually become competitive & is therefore worth protecting
  - New firms must be willing to accept start-up losses if they believe they can become profitable in the long run

The Debate over Trade Restrictions: The Unfair Competition Argument

- Argument for:
  - Some countries "cheat" by providing <u>subsidies</u> to their industries to help them compete with foreign firms
    - Those industries can afford to sell more <u>cheaply</u> since the subsidy is covering their losses
  - Trade barriers are justified to <u>protect</u> domestic industries from subsidized foreign imports
    - Trade barrier can drive the cost back <u>up</u> to what it would be if that foreign industry was not receiving a subsidy from their government

- Some countries “dump” their products on foreign markets
  - Sell in foreign markets for less than it costs to make the product
  - Hope to drive domestic producers out of market and raise price back up
  - Trade barriers can offset the practice of “dumping”

- Argument against:
  - Benefits to consumers of cheaper imports outweigh costs to domestic producers
  - It is nearly impossible to detect “dumping”
    - Difficult to determine foreign firm’s costs
    - What may appear to be “dumping” may actually be comparative advantage at work

The Debate over Trade Restrictions: The Protection as Bargaining Chip Argument

- Argument for:
  - Trade restrictions can be used as a bargaining tool in trade negotiations
    - Threats of trade restrictions will persuade other country to remove or reduce its trade barriers
- Argument against:
  - Strategy can backfire
  - If other country doesn’t give in, you must either carry out the threats or back down
    - Either option leaves country worse off

The Debate over Trade Restrictions: The Environmental & Labor Standards Argument

- Argument for:
  - Countries with lax environmental or labor laws have an economic advantage over countries that must comply with stricter laws
    - They don't have to spend the money on worker and environmental protection
  - To make trade fair, countries with stricter laws should impose tariffs against countries that do not uphold these standards

- Argument against:
  - Countries with lax standards are often poorer countries with few resources to devote to worker and environmental protection
  - As they develop their economies, in part through global trade, they will be able to pay more attention to labor & environmental standards
    - Restricting trade would slow the pace at which they could make improvements

Trade Agreements

- Agreements between two or more countries to reduce trade barriers
  - Goal: export more products
  - Increased trade benefits all involved
- Some involve just a few countries
  - Example: the North American Free Trade Agreement (NAFTA) involves just the U.S., Canada, & Mexico

- Some involve a large number of countries
  - Example: the World Trade Organization (WTO) involves 153 countries
- All countries involved in the agreement agree to abide by the trade rules established in the agreement
  - Countries involved in the agreement meet periodically to discuss & negotiate trade agreements to improve trade among member countries