UNIT 5

International and Global Economics

Why It's Important

As you read this unit, learn how the study of economics helps answer the following questions:

- **Why do imported goods sometimes cost more than domestically produced goods?**
- **Why did capitalism triumph over communism?**
- **How do population growth rates on the other side of the world affect you?**

International trade—both the importing and exporting of goods—is essential to the U.S. economy.

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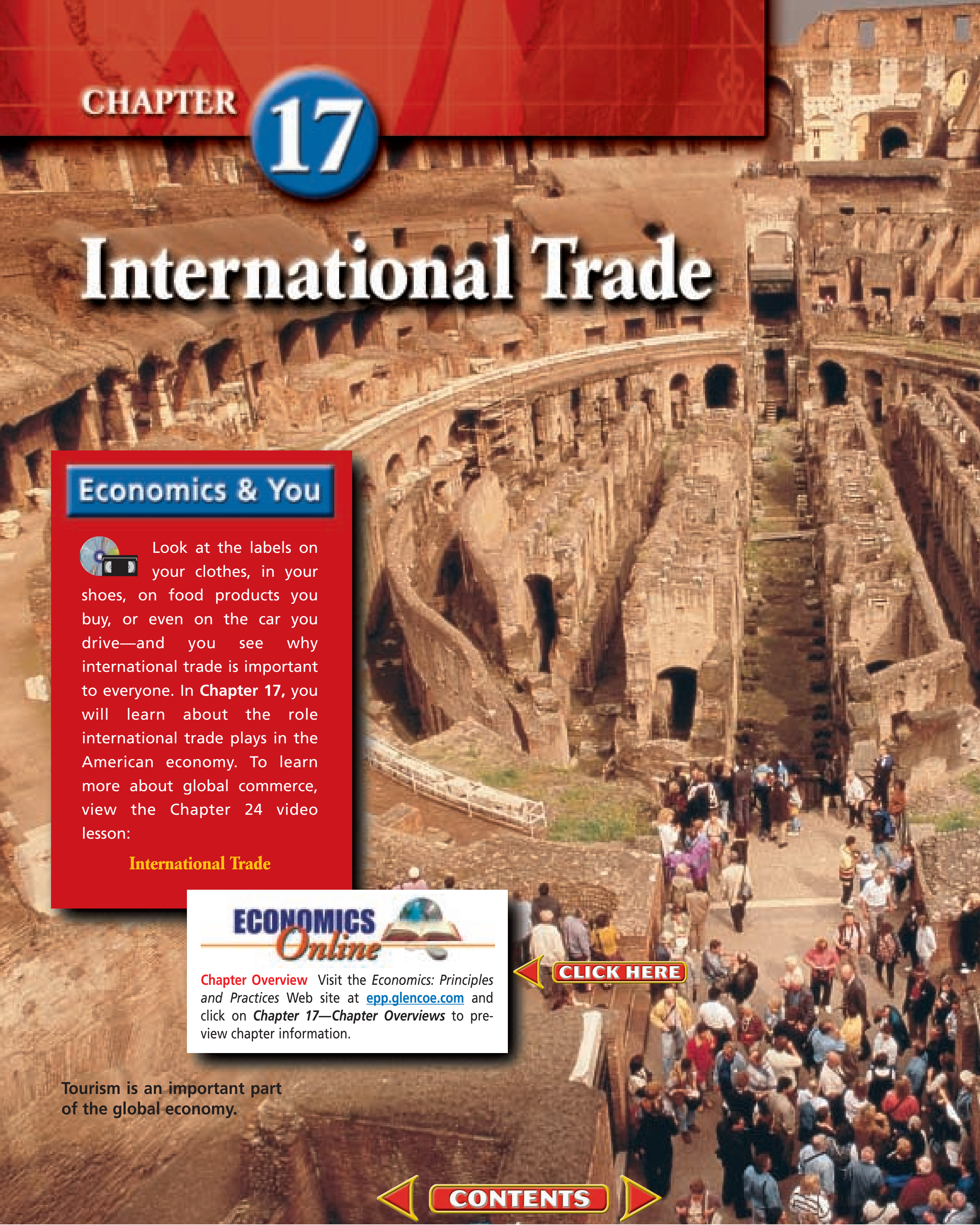
CHAPTER 17

International Trade



Economics & You

Look at the labels on your clothes, in your shoes, on food products you buy, or even on the car you drive—and you see why international trade is important to everyone. In **Chapter 17,** you will learn about the role international trade plays in the American economy. To learn more about global commerce, view the Chapter 24 video lesson:

International Trade

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Tourism is an important part of the global economy.

SECTION 1

Absolute and Comparative Advantage

Study Guide

Main Idea
Nations trade according to the theory of comparative advantage.

Reading Strategy
Graphic Organizer As you read the section, complete graphic organizers similar to the ones below by defining each term and providing an example of each.

Absolute advantage	Comparative advantage
Definition	Definition
Example	Example

Key Terms
exports, imports, absolute advantage, comparative advantage

Objectives
After studying this section, you will be able to:
1. **Explain** the importance of international trade in today's economy.
2. **Describe** the basis for international trade.
3. **Explain** why total world output increases when countries specialize to engage in trade.

Applying Economic Concepts
Comparative Advantage When you do the chores around the house, you are probably better at some than others. Read to find out how the concept of comparative advantage helps everyone become more productive.

Cover Story

Study: U.S. Still Biggest Arms Provider


U.S. warship at sea

WASHINGTON—Worldwide demand is slumping, but that hasn't kept the USA out of the arms business, a congressional study finds. In 1998, the USA led in new arms deals, with $7.1 billion—up from $5.7 billion the year before. Germany ranked second, with $5.5 billion in new sales, and France third, with $3 billion. The value of all new arms sales worldwide was $23 billion, up from $21.4 billion the year before. However, the report said that the trend in terms of arms sales has generally been downward, particularly among developing nations, which are the biggest buyers of weapons.

—*USA Today*, August 6, 1999

The key to trade—whether among people, states, or countries—is specialization. Some people specialize in cutting hair. Others specialize in fixing computers. These people exchange their services for money, which they then use to buy the specialized goods and services they need from others.

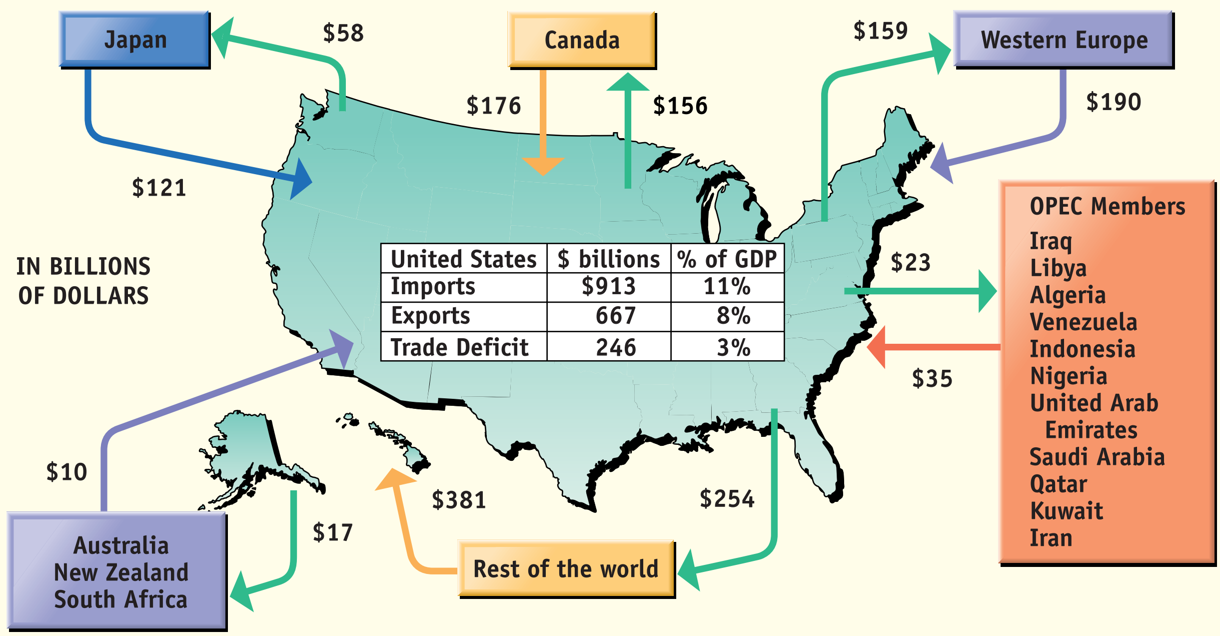
Different regions of a country specialize in certain economic activities in much the same way. New York, for example, is a center of the U.S. financial industry, and Detroit specializes in automobiles. The Midwest and High Plains areas are known for wheat farming. Texas is recognized for oil and cattle, while Florida and California are famous for citrus fruit. All of these states trade with one another so that people in one area can consume the goods and services that workers in other areas offer.

If you want to find out what a country specializes in, look at its **exports**—the goods and services that it produces and then sells to other nations.

ECONOMICS AT A GLANCE

Figure 17.1

United States Merchandise Trade by Area



United States	$ billions	% of GDP
Imports	$913	11%
Exports	667	8%
Trade Deficit	246	3%

Source: *Economic Report of the President,* 1999

Using Charts The United States exports merchandise (goods) all over the world. The biggest trade imbalance is with Japan, followed by Western Europe and by OPEC members. **Which single area of the world trades the most with the United States?**

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The U.S. and International Trade

International trade is important to all nations, even a country as large as the United States. Most of the products exchanged are goods, although services, such as insurance and banking, are being bought and sold in increasing numbers.

In 1999, **imports**—goods and services that one country buys from other countries—amounted to about $1,150 billion. This number corresponds to nearly $4,200 for every person in the country, and it has grown steadily over the years.

Figure 17.1 shows the merchandise trade patterns for the United States and the rest of the world. As large as these numbers are, they would be even bigger if we counted the value of services in addition to the merchandise, or goods, shown in the figure. The sheer volume of trade between nations of such different geographic, political, and religious characteristics is proof that trade is beneficial.

In fact, nations trade for the same reasons that individuals do—they trade because they believe that the products they receive are worth more than the products they give up.

Without international trade, many products would not be available on the world market. Bananas, for example, would not leave Honduras, nor would coffee beans leave Colombia or Brazil. Some people may think of international trade as a way to obtain exotic products and fancy consumer goods, but trade is much more than that. Many imports are necessities, such as crude oil, clothing, and shoes. In the United States, many minerals, metals, and raw materials that are not available must be imported.

The Basis for Trade

In many cases, it may be cheaper for a country to import a product than to manufacture it. This becomes clear when we examine the difference between absolute and comparative advantage.

Absolute Advantage

A country has an **absolute advantage** when it is able to produce more of a given product than another country can. Consider, for example, the hypothetical case of two countries—Alpha and Beta—which are the same size in terms of area, population, and capital stock. Only their climate and soil fertilities differ. In each country, only two crops can be grown—coffee and cashew nuts.

Figure 17.2 shows the production possibilities frontiers for Alpha and Beta. Note that if both countries devote all of their efforts to producing coffee, Alpha could produce 40 million pounds and Beta six million—giving Alpha an absolute advantage in the coffee production. However, if both countries devote all their efforts to the production of cashew nuts, Alpha could produce eight million pounds and Beta six million. Alpha, then, also has an absolute advantage in the production of cashew nuts because it can produce more than Beta.

For years, people thought that absolute advantage was the basis for trade because it enabled a country to produce enough of a good to consume domestically while leaving some for export. However, the concept of absolute advantage did not explain how a country with a large output like Alpha could trade with a country having a smaller output like Beta—and yet have both countries benefit from the exchange.

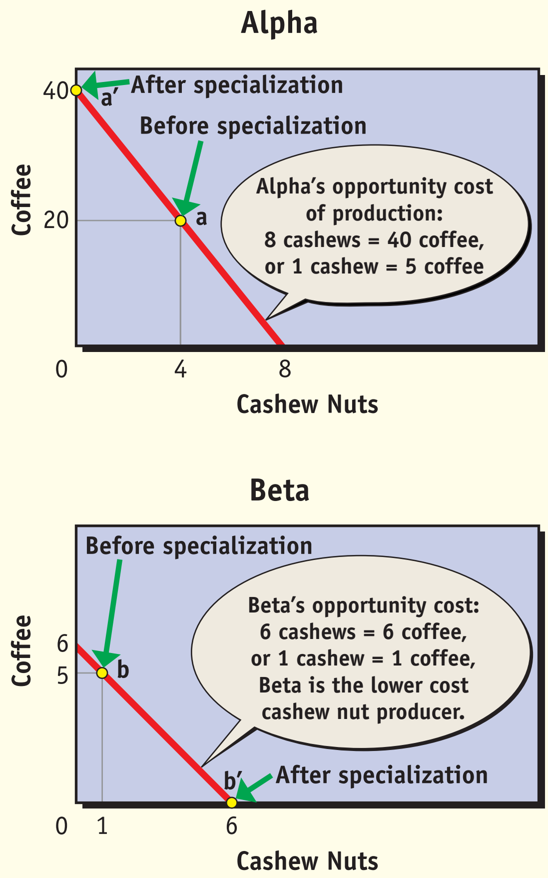
Comparative Advantage

Even when one country enjoys an absolute advantage in the production of all goods—as in the case of Alpha above—trade between it and another

ECONOMICS AT A GLANCE

Figure 17.2

The Gains From Trade



Total Output Before Specializing						Total Output After Specializing					
	Alpha		Beta				Alpha		Beta		
Coffee	20	+	5	=	**25**	Coffee	40	+	0	=	**40**
Cashews	4	+	1	=	**5**	Cashews	0	+	6	=	**6**

(Coffee and nuts measured in pounds)

Using Graphs If Alpha and Beta each specializes in the product it can produce relatively more efficiently, total output for both countries goes up. After specialization, each country would trade its surplus production with its neighbor. **Does Alpha or Beta have a comparative advantage in the production of coffee?**

country is still beneficial. This happens whenever a country has a **comparative advantage**—the ability to produce a product *relatively* more efficiently, or at a lower opportunity cost.

To illustrate, because Alpha can produce either 40 pounds of coffee or 8 pounds of cashew nuts, the opportunity cost of producing 1 pound of cashew nuts is 5 pounds of coffee (40 pounds of coffee divided by 8). At the same time, Beta's opportunity cost of producing 1 pound of cashew nuts is 1 pound of coffee (6 pounds of coffee divided by 6). Clearly, Beta is the lower-cost producer of cashew nuts because its opportunity cost of producing 1 pound of nuts is 1 pound of coffee—whereas Alpha would have to give up 5 pounds of coffee to produce the same amount of cashews.

If Beta has a comparative advantage in producing cashews, then Alpha must have a comparative advantage in coffee production. Indeed, if we try to find each country's opportunity cost of producing coffee, we would find that Alpha's opportunity cost of producing 1 pound of coffee is $^1/_5$ of a pound of cashews (8 pounds of cashews divided by 40). Using the same computations, Beta's opportunity cost is 1 pound of cashews (6 pounds of cashews divided by 6). Alpha, then, has a comparative advantage in coffee production, because its opportunity cost of production is lower than Beta's.

The Gains From Trade

The concept of comparative advantage is based on the assumption that everyone will be better off producing the products they produce relatively best. This applies to individuals, companies, states, and regions as well as to nations. The final result is that specialization and trade increases total world output, just as in the case of Alpha and Beta.

This explains the nature of trade between the United States and a country such as Colombia. The United States has excellent supplies of iron and coal. It also has the capital and the labor that are needed to produce tractors and farm machinery efficiently. Colombia, in contrast, does not have as much capital or skilled labor. It does, however, have the land, labor, and climate to produce coffee efficiently. Because the United States has a comparative advantage in the production of farm machinery, it will trade these products for Colombian coffee. Because Colombia has a comparative advantage in the production of coffee, it will export coffee and import farm equipment.

For similar reasons, a country like Saudi Arabia produces more crude oil than it can consume—enabling it to export the surplus. The United States, in turn, produces more military aircraft than it consumes—allowing it to sell aircraft to Saudi Arabia in exchange for oil.

Section 1 Assessment

Checking for Understanding

1. **Main Idea** What does the theory of comparative advantage offer as a guideline to countries?
2. **Key Terms** Define exports, imports, absolute advantage, comparative advantage.
3. **Explain** why international trade is important in today's economy.
4. **Compare** the concepts of absolute advantage and comparative advantage.
5. **Explain** why total world output increases as countries specialize to engage in trade.

Applying Economic Concepts

6. **Comparative Advantage** If you were to open a business with two of your best friends, how would you divide the work to be done? Would your decisions regarding who does what reflect comparative advantage? Explain.

Critical Thinking

7. **Making Generalizations** Do you know of a product for which your state has a comparative advantage? Explain how this might affect trade with another state.

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Profiles in Economics

Marketing Savvy: Bill Gates

(1955–)

One unavoidable fact about Bill Gates, cofounder of Microsoft, is that with a net worth of billions of dollars, he is one of the richest men in the world.

Gates is matter-of-fact about the reason for his wealth. "Our success," he says, "is based on only one thing: good products. It's not very complicated." To his many critics, however, the story is not so simple.

A TEENAGE WIZARD

While in high school, Gates designed a class scheduling program so that he could take courses with the prettiest girls in his school. He also started Traf-O-Data, a computer traffic analysis company.

At age 19, Gates dropped out of Harvard University to pursue his interest in computers. He and his friend Paul Allen developed a condensed operating-system language, which they licensed to a computer manufacturer. Based on this success, Gates and Allen established Microsoft Corporation in 1975.

INTO THE BIG LEAGUES

In 1980 computer industry giant IBM asked Gates to develop an operating system for its new personal computer. Gates bought an operating system from a small company, revamped it, and licensed it to IBM. The system was called MS-DOS, for Microsoft Disk Operating System. The key fact is that Gates licensed MS-DOS to IBM–he didn't sell it to them. Because he retained ownership of MS-DOS, he was able to market it to other companies. In 1981 IBM unveiled its PC, setting off the personal computer boom. MS-DOS became the dominant operating system in the market, and propelled Gates to wealth.

When Microsoft went public in 1986, Gates, who owned 45 percent of the company, became a millionaire several hundred times over.

CONTROVERSIAL SUCCESS

By 1993 Microsoft operating systems ran nearly 90 percent of the world's PCs. Much of Gates's success came from his unique combination of technological expertise and an understanding of the computer needs of the average user. But not everyone attributes Gates's success to know-how and marketing. Many view Gates's Microsoft as an industry bully, forcing would-be competitors out of the market. In fact, the Justice Department and many states have pursued antitrust legislation against Microsoft.

Examining the Profile

1. **Predicting Consequences** How might the Microsoft story have been different if Gates had sold MS-DOS to IBM rather than licensing it?
2. **For Further Research** Report the current status of the lawsuits against Microsoft.

Barriers to International Trade

Study Guide

Main Idea
Tariffs and quotas are two restrictions on international trade.

Reading Strategy
Graphic Organizer As you read the section, complete a graphic organizer similar to the one below by describing the differences between a tariff and a quota.

Tariff/Quota → Differences

Key Terms
tariff, quota, protective tariff, revenue tariff, dumping, protectionists, free traders, infant industries argument, balance of payments, most favored nation clause, World Trade Organization (WTO), North American Free Trade Agreement (NAFTA)

Objectives
After studying this section, you will be able to:
1. **Explain** how international trade can be restricted to protect special interests.
2. **Cite** the main argument used in support of protection.
3. **Relate** the history of the free trade movement.

Applying Economic Concepts
Quotas Do you think the prices of some goods are too high? Read to find out how international trade can help keep some prices low.

Cover Story

US Gets Go-Ahead for European Sanctions


French delicacies subject to U.S. duties

The World Trade Organization yesterday authorized the US to impose trade sanctions on European Union goods in retaliation for the EU's ban on hormone-treated beef.

From July 29, the US will impose punitive 100 percent duties on imports from the EU, including delicacies such as foie gras, truffles, and Roquefort cheese as well as beef, pork, canned tomatoes and mustard.

US officials said last week the sanctions, worth a total of $116.8 [million] would target goods from France, Germany, Italy and Denmark as these were the countries most influential in preserving the 10-year-old beef hormone ban.

—The Financial Times, July 27, 1999

Although international trade can bring many benefits, some people object to it because it can displace selected industries and groups of workers in the United States. The European ban on American hormone-treated beef discussed in the cover story is just one example of attempts to restrict trade.

Restricting International Trade

Historically, trade has been restricted in two major ways. One is through a **tariff**—a tax placed on imports to increase their price in the domestic market. The other is with a **quota**—a limit placed on the quantities of a product that can be imported.

Tariffs

Governments levy two kinds of tariffs—protective and revenue. A **protective tariff** is a tariff high enough to protect less-efficient domestic industries. Suppose, for example, that it costs $1 to produce a mechanical pencil in the United States. The exact

STANDARD & POOR'S INFOBYTE

The Trade Balance This term refers to the difference between exports and imports. In the United States, we continue to import more than we export and are therefore experiencing a trade deficit. Because international trade is significant to GDP forecasts, this Department of Commerce statistic is important. The standard release time is around the 22nd of each month.

same product, however, can be imported for 35 cents from another country. If a tariff of 95 cents is placed on each imported pencil, the cost climbs to $1.30—more than the cost of the American-made one. The result is that a domestic industry is protected from being undersold by a foreign one.

The **revenue tariff** is a tariff high enough to generate revenue for the government without actually prohibiting imports. If the tariff on imported mechanical pencils were 40 cents, the price of the imports would be 75 cents, or 25 cents less than the American-made ones. As long as the two products are identical, people would prefer the imported one because it was less expensive—so the tariff would raise revenue rather than protect domestic producers from foreign competition.

Traditionally, tariffs were used more for revenues than for protection. Before the Civil War, tariffs were the chief source of revenue for the federal government. From the Civil War to 1913, tariffs provided about one-half of the government's total revenue. In 1913 the federal income tax was passed, which gave the government a new and more lucrative source of revenue. Modern tariffs—also called customs duties—only account for a small portion of total government revenue, as shown in **Figure 9.4** on page 232.

Quotas

Foreign goods sometimes cost so little that even a high tariff on them may not protect the domestic market. In such cases, the government can use a quota to keep foreign goods out of the country. Quotas can even be set as low as zero to keep a product from ever entering the country. More typically, quotas are used to reduce the total supply of a product to keep prices high for domestic producers.

In 1981, for example, domestic automobile producers faced intense competition from lower-priced Japanese automobiles. Rather than lower their own prices, domestic manufacturers wanted President Ronald Reagan to establish import quotas on Japanese cars. The Reagan administration told the Japanese to voluntarily restrict auto exports, and they reluctantly agreed. As a result, Americans had fewer cars from which to choose, and the prices of all cars were higher than they would otherwise have been.

During the Bush administration, "voluntary" import quotas were imposed on steel. The quotas protected jobs in the domestic steel industry, but at the cost of higher steel prices for the rest of the

Protectionism

Jobs These citizens are protesting the loss of manufacturing jobs in the face of competition from other countries. ***What is the purpose of a protective tariff?***

country. A trade crisis emerged in mid-1997 when charges of **dumping,** or selling products abroad at less than it cost to produce them at home, were levied against Japan and Russia.

Other Barriers

Tariffs and quotas are not the only barriers to trade. Many imported foods are subject to health inspections far more rigorous than those given to domestic foods. For years this tactic was used to keep beef grown in Argentina out of the United States. Another tactic is to require a license to import. If the government is slow to grant the license, or if the license fees are too high, international trade is restricted.

The United States is not the only country to use health issues to restrict trade. Many Europeans are reluctant to consume corn, wheat, and other crops that have been genetically altered for superior yield, taste, and disease resistance. A more sensitive case is that of American beef raised on artificial hormones, a product that Europeans refuse to import. While most Americans feel that their food is safe, Europeans are not so sure. After all, they point out, an experiment by U.S. scientists demonstrated that Monarch butterflies died when they ate the pollen from genetically altered corn plants.

Nationalism and culture often play a role in these debates, with Europeans frequently claiming that they prefer regional and traditional foods to genetically altered ones. While these may or may not be legitimate arguments, they do restrict trade between nations.

Did you know?

A Safety Net To minimize the price changes caused by the Arab oil embargoes of the 1970s, the United States in 1977 created the Strategic Petroleum Reserve, to store millions of barrels of oil. The reserve can be used as an emergency supply of oil in case of a complete oil embargo. The reserve holds enough oil to provide a normal level of petroleum use in the United States for 60 days.

Arguments for Protection

Freer international trade has been a subject of debate for many years. Some people, known as **protectionists,** favor trade barriers that protect domestic industries. Others, known as **free traders,** favor fewer or even no trade restrictions. The debate between the two groups usually centers on the five arguments for protection discussed below.

National Defense

The first argument for trade barriers centers on national defense. Protectionists argue that without trade barriers, a country could become so specialized that it would end up becoming too dependent on other countries.

During wartime, protectionists argue, a country might not be able to get critical supplies such as oil and weapons. As a result, even some smaller countries such as Israel and South Africa have developed large armaments industries for such crises. They want to be sure they will have a domestic supply if hostilities break out or other countries impose economic boycotts.

Free traders admit that national security is a compelling argument for trade barriers. They believe, however, that the advantages of having a reliable source of domestic supply must be weighed against the disadvantages that the supply will be smaller and possibly less efficient than it would be with free trade. The political problem of deciding which industries are critical to national defense and which are not must also be considered. At one time, the steel, auto, ceramic, and electronics industries all have argued that they are critical to national defense and so should receive protection.

Promoting Infant Industries

The **infant industries argument**—the belief that new or emerging industries should be protected from foreign competition—is also used to justify trade barriers. Protectionists claim that these industries need to gain strength and experience before they can compete against developed industries in other countries. Trade barriers would give them the time they need to develop. If infant industries compete against foreign industries too soon, they argue, they might fail.

Many people are willing to accept the infant industries argument, but only if protection will eventually be removed so that the industry is forced to compete on its own. The problem is that industries used to having some protection are normally unwilling to give it up—making for difficult political decisions later on.

To illustrate, some Latin American countries have used tariffs to protect their own infant automobile industries, with tariffs as high as several hundred percent. In some cases, the tariff raised the price of used American-made cars to more than double the cost of new ones in the United States. In spite of this protection, no country in Latin America has been able to produce a competitive product on its own. To make matters worse, governments have come to rely on the revenue supplied by tariffs, so prices for automobiles remain high for their citizens.

International Trade

Expansion With the great expansion of trade, many U.S. companies set up operations in other countries. Protectionists favor trade barriers that protect domestic industries. ***What is the assumption behind the infant industries argument?***

Protecting Domestic Jobs

A third argument—and one used most often—is that tariffs and quotas protect domestic jobs from cheap foreign labor. Workers in the shoe industry, for example, have protested the import of lower-cost Italian, Spanish, and Brazilian shoes. Garment workers have opposed the import of lower-cost Korean, Chinese, and Indian clothing. Steelworkers have blocked foreign-made cars from company parking lots to show their displeasure with the foreign-made steel used in producing the cars.

In the short run, protectionist measures provide temporary protection for domestic jobs. This is especially attractive to people who want to work in the communities where they grew up. In the long run, however, industries that find it hard to compete today will find it even harder to compete in the future unless they change the way they are doing things. As a result, most free traders believe that it is best not to interfere, and thereby keep pressure on threatened industries to modernize and improve.

When inefficient industries are protected, the economy produces less and the standard of living goes down. Because of unnecessarily high prices, people buy less of everything, including those goods produced by protected industries. If prices get too high, substitute products will be found and protected jobs will still be lost. Free traders argue that the profit-and-loss system is one of the major features of the American economy. Profits reward the efficient and hard working, while losses eliminate the inefficient and weak.

Keeping the Money at Home

Another argument for trade barriers claims that limiting imports will keep American money in the United States instead of allowing it to go abroad. Free traders, however, point out that the American dollars that go abroad generally come back again.

THE GLOBAL ECONOMY

The Art of Communication

With the globalization of business, it is necessary to understand and to adjust to the communication style of other cultures.

Only in the Germanic countries will the people be as eager to get down to business as in the United States of America. Almost anywhere else in the world, but especially in Asian and Latin countries, it's important to first get to know the person with whom you're dealing to build a bond of trust. Three f's of business in Asian cultures are family, friends and favors. If you're not part of an extended Asian family or if you don't have close Asian chums from your school days, find the time to develop a friendship with a well-connected intermediary [agent]. Relationships, once formed, are long lasting bonds of loyalty that must be respected. . . .

Space is one of those seemingly inconsequential aspects of human interaction that can have major consequences elsewhere. The American personal bubble of space is much greater than that of an Arab or a Russian, but smaller than that of a Briton. Infringing upon another's personal space or inadvertently backing away when someone enters your bubble can send unintended negative messages. Touching someone—a hand on the forearm, an arm around the shoulder, or a pat on the back—is one of the easiest ways to violate personal space.

—*Etiquette International*

Critical Thinking

1. **Analyzing Information** What does the writer mean by "space"? Explain the concept in your own words.
2. **Summarizing Information** What does it mean to say that "the American bubble of space is much greater than that of an Arab or Russian"?
3. **Drawing Conclusions** Why is it important to understand the values of another culture when doing business?

The Japanese, for example, use the dollars they receive for their automobiles to buy American cotton, soybeans, and airplanes. These purchases benefit American workers in those industries.

The same is true of the dollars used to buy oil from the Middle East. The money comes back to the United States when oil-wealthy foreigners buy American-made oil technology. Keeping the money home also hurts those American industries that depend on exports for their jobs.

Helping the Balance of Payments

Another argument involves the **balance of payments**—the difference between the money a country pays out to, and receives from, other nations when it engages in international trade. Protectionists argue that restrictions on imports help the balance of payments by restricting the amount of imports.

What protectionists overlook, however, is that the dollars return to the United States to stimulate employment in other industries. As a result, most economists do not believe that interfering with free trade can be justified on the grounds of helping the balance of payments.

The Free Trade Movement

The use of trade barriers to protect domestic industries and jobs works only if other countries do not retaliate with their own trade barriers. If they do, all countries suffer because they have neither the benefits of efficient production nor access to less costly products and raw materials from other nations.

Tariffs During the Great Depression

In 1930 the United States passed the Smoot-Hawley Tariff, one of the most restrictive tariffs in history. It set import duties so high that the price of many imported goods rose nearly 70 percent. When other countries did the same, international trade nearly came to a halt.

Before long, most countries realized that high tariffs hurt more than they helped. As a result, in 1934 the United States passed the Reciprocal Trade Agreements Act, which allowed it to reduce tariffs up to 50 percent if other countries agreed to do the same. The act also contained a **most favored nation clause**—a provision allowing a country to receive the same tariff reduction that the United States negotiates with a third country.

Suppose, for example, that the United States and China have a trade agreement with a most favored nation clause. If the United States then negotiates a tariff reduction with a third country, the reduction would also apply to China. This clause is very important to China, because its goods will then sell at an even lower price in the American market.

The World Trade Organization

In 1947, 23 countries signed the General Agreement on Tariffs and Trade (GATT). The GATT extended tariff concessions and worked to do away with import quotas. Later, the Trade Expansion Act of 1962 gave the president of the United States the power to negotiate further tariff reductions. As a result of this legislation, more than 100 countries had agreed to reduce the average level of tariffs by the early 1990s.

More recently, the GATT was replaced by the **World Trade Organization (WTO)**—an international agency that administers previous GATT trade agreements, settles trade disputes between governments, organizes trade negotiations, and provides technical assistance and training for developing countries. As you read in the cover story, the WTO agreed that Europe was discriminating against the United States by banning hormone-treated beef. While the WTO normally opposes retaliatory measures, it approved the U.S. measures because the European Union ignored earlier WTO demands to drop American beef restrictions.

Because so many countries have been willing to reduce tariffs and quotas under GATT and the WTO, international trade is flourishing. Tariffs that once nearly doubled the price of many goods now increase prices by a small percentage, while other tariffs have been dropped altogether. As a result,

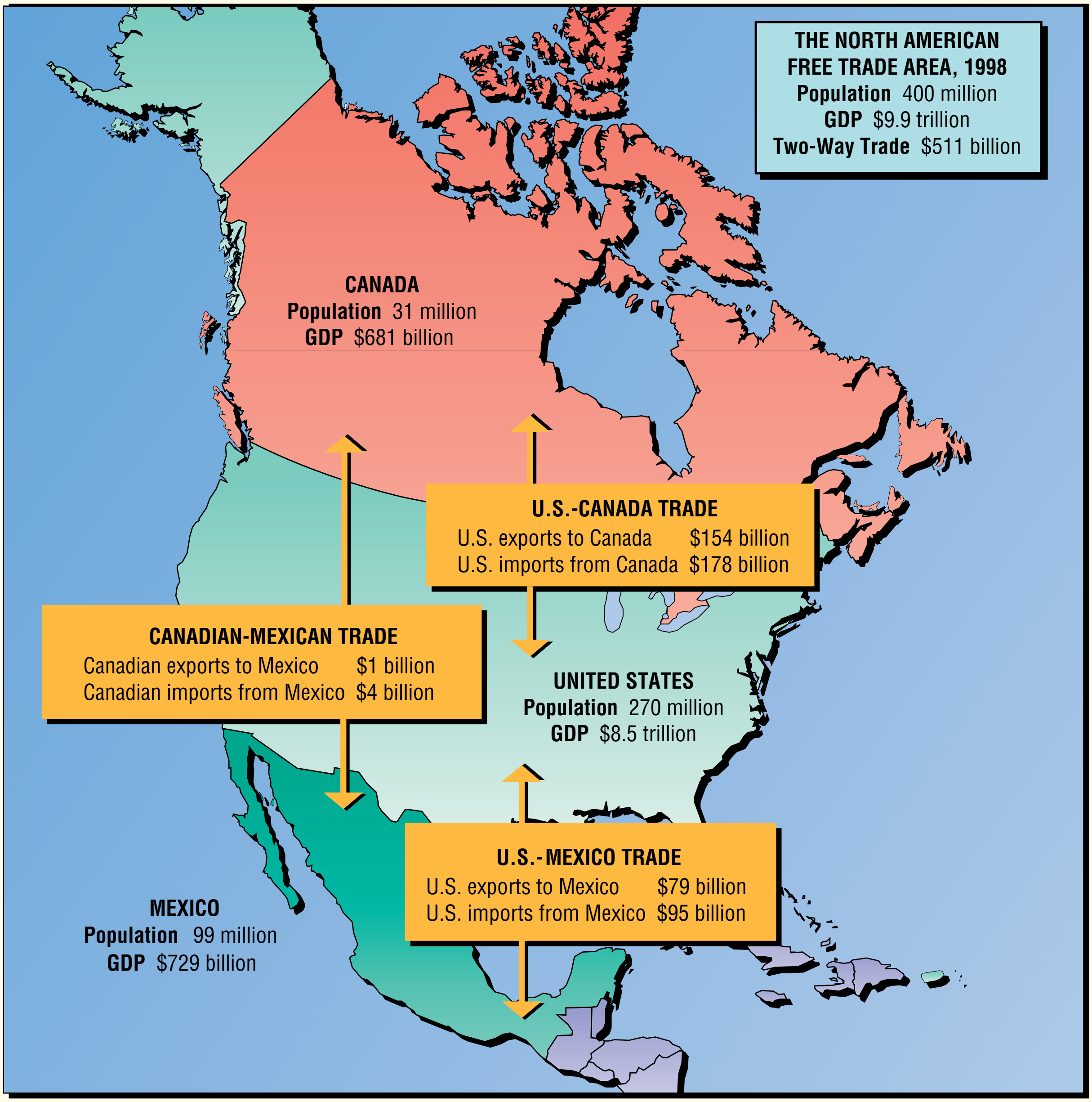
Trade

Protectionism vs. Free Trade Free traders argue that reducing tariffs and quotas allows consumers to choose from a variety of both domestic and foreign products. ***What arguments do protectionists use in support of trade restrictions?***

ECONOMICS AT A GLANCE

Figure 17.3

The North American Free Trade Agreement



Source: *CIA Fact Book*

Using Maps The North American Free Trade Agreement (NAFTA) makes up the second largest free-trade area in the world, after the European Union. After NAFTA was implemented, trade between the three nations began to grow by 10 to 15 percent annually. **Do imports or exports comprise the larger portion of Mexico's trade with Canada and the United States?**

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CONTENTS

stores are able to offer a wide variety of industrial and consumer goods from all over the world.

NAFTA

The **North American Free Trade Agreement (NAFTA)** is an agreement to liberalize free trade by reducing tariffs among three major trading partners: Canada, Mexico, and the United States. It was proposed by the Bush administration and concluded by the Clinton administration in 1993.

Before NAFTA, United States goods entering Mexico faced an average tariff of 10 percent. At the same time, approximately half of the goods entering the United States from Mexico were duty-free, while the other half faced an average tax of only 4 percent. Exceptions did exist, however. A 32 percent tariff on brooms imported from Mexico protected approximately 3,000 broom makers in southern Illinois.

Free trade is good in general, but it is not painless. NAFTA was controversial specifically because some workers would be displaced when trade barriers were lowered. Opponents predicted that some high-paid American jobs would be lost to Mexico—including those held by broom makers who will find their protective tariff reduced to zero over a 15-year period. Proponents predicted that trade among all three nations would increase dramatically, stimulating growth and bringing a wider variety of lower-cost goods to everyone, protectionists and free traders alike.

The case for freer trade is a classic case of cost-benefit analysis. Some of the costs and benefits identified during the NAFTA debate actually occurred, but not to the extent originally predicted. Trade among the three countries has grown dramatically since NAFTA was created. In the end, freer trade allowed the NAFTA partners to capitalize on their comparative advantages for everyone's benefit.

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Section 2 Assessment

Checking for Understanding

1. **Main Idea** Explain why protectionists favor tariffs and quotas.
2. **Key Terms** Define tariff, quota, protective tariff, revenue tariff, dumping, protectionists, free traders, infant industries argument, balance of payments, most favored nation clause, World Trade Organization (WTO), North American Free Trade Agreement (NAFTA).
3. **Describe** three barriers to international trade.
4. **List** five arguments that are commonly used to support the protectionist argument.
5. **Identify** two attempts to facilitate the growth of international trade.

Applying Economic Concepts

6. **Quotas** Explain how a quota on a good or service produced in your community can protect the jobs in a particular industry. Then explain how the same quota might be harmful to consumers.

Critical Thinking

7. **Drawing Conclusions** If you were a member of Congress approached by a delegation of autoworkers seeking additional tariff or quota protection, how would you respond? Defend your response.
8. **Analyzing Information** Explain the infant industries argument.

Practice and assess key social studies skills with the *Glencoe Skillbuilder Interactive Workbook, Level 2.*

CONTENTS

BusinessWeek

JULY 27, 1998

Newsclip

The North American Free Trade Agreement (NAFTA), is a free trade pact. The trading area includes Canada, the United States, and Mexico. NAFTA has created one of the world's most productive economic blocs, rivaled only by the European Union and by Japan.

NAFTA and Change in Mexico

For the first time, Mexico this year overtook China as the No. 1 supplier of clothing and textiles to the U.S. . . .

Spurred by the North American Free Trade Agreement (NAFTA), the surge in apparel exports has touched off an investment boom. Not only are manufacturers expanding their low-wage plants, but they are building high-tech operations to spin fibers and weave fabrics. . . .

To encourage the growth of the industry, Mexico is trumpeting both its proximity to the U.S. and the benefits of NAFTA to potential investors. . . . Although Mexican garment workers start at about $6 a day—double their Chinese counterparts—manufacturers save on the three- to four-week shipping time from the Far East. Mexican garments are trucked to the U.S. border in two to three days—a crucial difference in the time-sensitive garment business. And NAFTA has eliminated U.S. import quotas on garments made from fabric produced in North America. . . .

Clothing factory, Aguascalientes, Mexico

Meanwhile, several U.S. producers are building new mills in Mexico rather than expand at home. Guilford Mills, Inc., a Greensboro (N.C.) manufacturer, is spending $100 million on a knitting, dyeing, and finishing plant in the Gulf Coast port of Altamira. . . .

As the foreign-owned companies rev up their export machines in Mexico, savvy local producers are making sure they win, too. Denim producer Compañía Industrial de Parras expects to boost its exports to $146 million this year, up 13 times since the start of NAFTA in 1994. It all signals a new era for the Mexican industry—and shows how NAFTA is reshaping North America's economy.

Examining the Newsclip

1. **Analyzing Information** What are manufacturers doing as a result of the increase in apparel exports?
2. **Understanding Cause and Effect** How has NAFTA helped the growth of the garment industry in Mexico?

SECTION 3

Financing and Trade Deficits

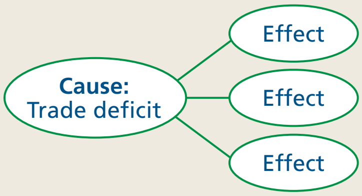
Study Guide

Main Idea

A long-lasting trade deficit affects the value of a nation's currency and the price and volume of its exports and imports.

Reading Strategy

Graphic Organizer As you read the section, complete a graphic organizer similar to the one below by describing the effects of a long-lasting trade deficit.



Key Terms

foreign exchange, foreign exchange rate, fixed exchange rate, flexible exchange rate, trade deficit, trade surplus, trade-weighted value of the dollar

Objectives

After studying this section, you will be able to:

1. **Explain** how foreign currency is used in trade.
2. **Describe** the problem of a trade deficit and the main solution to the problem.

Applying Economic Concepts

Foreign Exchange Do you have any souvenir foreign currency such as pesos, pounds, or yen? Read to find out how this foreign exchange is used to finance international trade.

Cover Story

Quaking Before the Fed

Boeing 747 flies over Kowloon peninsula

No place has more to fear from every twitch of U.S. monetary policy than Hong Kong. Its currency is rigidly pegged to the U.S. dollar, and when U.S. interest rates go up, Hong Kong's must follow. With the economy in its worst recession in half a century, Hong Kong can ill afford higher rates, although the Federal Reserve is now leaning in that direction. . . .

[In Hong Kong, the] grinding process of deflation continues. Property prices are down about 50% from their mid-1997 peak . . . the government expects consumer prices to fall 2.5% for all of 1999 . . . real interest rates [are] more than 8% . . . the benchmark Hang Seng stock index is . . . 26% below its August 1997, peak, and higher interest rates could knock [the current modest] recovery off track.

—*Business Week*, June 21, 1999

Trade between nations is similar to exchange between individuals. The major difference is that each country has its own monetary system, which makes the exchange more complicated. The value of some currencies, like the Hong Kong dollar in the cover story, is tied to the value of the U.S. dollar in the hope of simplifying international trade.

Financing International Trade

Scenarios like the following occur every day across the globe. A clothing firm in the United States wants to import business suits from a company in Great Britain. Because the British firm pays its bills in a currency called "pound sterling," it wants to receive payment in sterling. Therefore, the American firm must exchange its dollars for British pounds.

Foreign Exchange

In the field of international finance, **foreign exchange**—foreign currencies used to facilitate international trade—are bought and sold in the foreign exchange market. This market includes banks that help secure foreign currencies for importers, as well as banks that accept foreign currencies from exporters.

Suppose that one pound sterling, £1, is equal to $1.62. If the business suits are valued at £1,000 in London, the American importer can go to an American bank and buy a £1,000 check for $1,620 plus a small service charge. The American firm then pays the British merchant, and the suits are imported.

American exporters sometimes accept foreign currency or checks written on foreign banks for their goods. They deposit the payments in their own banks, which helps the American banking system build a supply of foreign currency. This currency then can be sold to American firms that want to import goods from other countries. As a result, both the importer and the exporter end up with the currency they need.

The **foreign exchange rate** is the price of one country's currency in terms of another country's currency. The rate can be quoted in terms of the United States dollar equivalent, as in $1.61 = £1, or in terms of foreign currency per United States dollar, as in £0.6194 = $1. The rate is reported both ways, as shown in the foreign currency listings in **Figure 17.4.**

ECONOMICS AT A GLANCE **Figure 17.4**

Foreign Exchange Rates

Exchange Rates
Thursday, August 10

Country	U.S. $ equiv.	Currency per U.S. $
Argentina (Peso)	1.0010	0.9990
Australia (Dollar)	0.6518	1.5342
Britain (Pound)	1.6145	0.6194
Canada (Dollar)	0.6680	1.4970
Chile (Peso)	0.001952	512.25
China (Renminbi)	0.1208	8.2771
Czech. Rep. (Koruna)		
Commercial rate	0.02956	33.825
Finland (Markka)	0.1801	5.5511
France (Franc)	0.1633	6.1241
Germany (Mark)	0.5476	1.8260
Israel (Shekel)	0.2372	4.2166
Japan (Yen)	0.008705	114.87
Mexico (Peso)		
Floating rate	0.1051	9.5190
Russia (Ruble)	0.04073	24.550
South Korea (Won)	0.000834	1199
Taiwan (Dollar)	0.03114	32.109

Reading the Financial Page Exchange rates are set according to the demand and supply of different types of money. **About how many Japanese yen equal one U.S. dollar?**

Fixed Exchange Rates

Today, two major kinds of exchange rates exist—fixed and flexible. For most of the 1900s, the world depended on **fixed exchange rates**—a system under which the price of one currency is fixed in terms of another so that the rate does not change.

Fixed exchange rates were popular when the world was on a gold standard. Gold served as the common denominator that allowed comparisons of currencies, and it also kept exchange rates in line. For example, suppose that a country allowed its money supply to grow too fast and that some of the money was spent on imports. Under a gold standard, the countries receiving the currency had the right to demand that it be converted into gold. Because no country wanted to lose its gold, each country worked to keep its money supply from growing too fast.

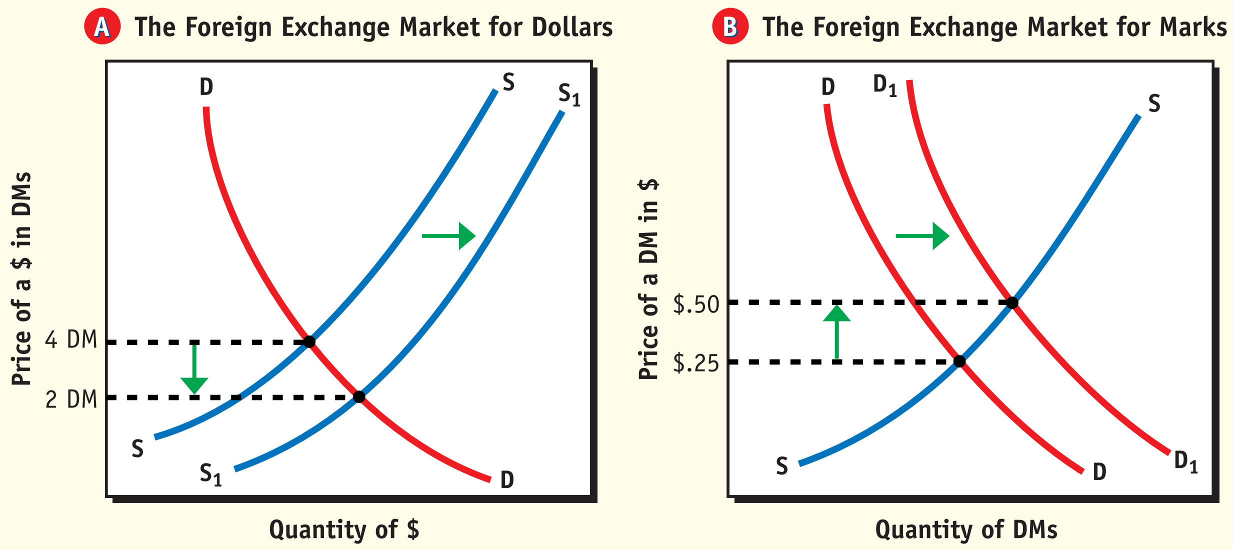
CYBERNOMICS SPOTLIGHT

Economic Espionage

Economic espionage is on the increase as trade grows between countries. Economic espionage is the stealing of technology secrets. In order to be competitive, many countries are tempted to steal the secrets of another to avoid paying the high costs of research and development. Fax machines, cellular phones, and the Internet make it easier than ever to commit economic espionage.

ECONOMICS AT A GLANCE Figure 17.5

Flexible Exchange Rates



Using Graphs The value of foreign exchange, like the value of most other products, is determined by supply and demand. **When investors sell one currency to buy another, what happens to the value of the currency that is sold?**

This practice worked until the early 1960s when the United States developed a huge appetite for imports. During that time, it bought large quantities of foreign goods with dollars. At first, foreign countries willingly held dollars because they were acceptable as an international currency, so only a portion of these dollars came back when other countries bought American exports.

As dollars began to pile up in the rest of the world, many countries wondered if the United States could honor its promise that the dollar was "as good as gold." Eventually France and several other countries started redeeming their dollars, which drained U.S. gold reserves. As a result, President Richard Nixon announced that the United States would no longer redeem foreign-held dollars for gold in 1971. This action saved the gold stock, but it also angered many foreign governments that were planning to cash their American dollars into gold.

Flexible Exchange Rates

When the United States stopped redeeming foreign-held dollars for gold, the world monetary system went to a floating or flexible rate system. Under flexible exchange rates, also known as floating exchange rates, the forces of supply and demand establish the value of one country's currency in terms of another country's currency.

Figure 17.5 shows how flexible exchange rates work. In 1971, for example, the price of the dollar was four German marks (DM) as shown in **Panel A.** Alternatively, we could say that the price of one DM was $0.25 as shown in **Panel B.**

Suppose now that an American car dealer wanted to purchase Volkswagens that could be bought for 12,000 DMs in Germany. To obtain a single car, the American importer would have to sell $3,000 in the foreign exchange market to obtain the 12,000 DMs needed to buy the

Volkswagen. This would simultaneously increase the supply of dollars shown in **Panel A** and the demand for DM in **Panel B.** Eventually the continuing American demand for foreign products would push the value of the dollar down to 2 DM, and its reciprocal, the price of the DM, up to $0.50.

When the dollar reaches 2 DMs, the price of the Volkswagen is much less competitive. This is because the importer now has to pay $6,000 to obtain the 12,000 DMs needed to purchase the car. Excessive imports thus cause the value of the dollar to decline, making imports cost more.

This may be bad news for U.S. importers, but it is good news for exporters. A German firm that bought American soybeans at $6 a bushel before 1971, for example, would have paid 24 DMs for each bushel. After the value of the dollar fell, it had to pay only 12 DMs for each bushel. As a result, soybeans were cheaper, and more could be sold abroad.

The system of flexible exchange rates has worked relatively well. More importantly, the switch to flexible rates did not interrupt the growth in international trade as many people had feared. More countries trade with one another today than ever before.

Trade Deficits and Surpluses

A country has a **trade deficit** whenever the value of the products it imports exceeds the value of the products it exports. It has a **trade surplus** whenever the value of its exports exceeds the value of its imports. Each is dependent on the international value of its currency.

The International Value of the Dollar

Ever since floating rates became standard in 1971, the Federal Reserve System has kept a statistic that measures the international value of the dollar. Called the **trade-weighted value of the dollar,** it is an index showing the strength of the dollar against a group of foreign currencies. When the index falls, the dollar is weak in relation to other currencies. When the index rises, the dollar is strong.

When the dollar reached strong levels in 1985, foreign goods became less expensive, and American exports became more costly for the rest of the world. As a result, imports rose, exports fell, and the United States suffered record trade deficits in 1986 and 1987. The value of the dollar remained relatively stable throughout the early 1990s, and then rose late in the decade when the rest of the world, especially countries in Asia, experienced an economic downturn. The stronger dollar led to another record trade deficit in late 1999.

The Effect of a Trade Deficit

A persistent trade imbalance tends to reduce the value of a country's currency on foreign exchange markets. The devalued currency then causes a chain reaction that affects income and employment in that country's industries.

To illustrate, the large deficit in the United States balance of payments in the mid-1980s and late 1990s flooded the foreign exchange markets with dollars. An increase in the supply of dollars, as illustrated by the supply and demand curves in **Figure 17.5,** causes the dollar to lose some of its

Careers

Sociologist

Sociologists study the development, interaction, and behavior of organized groups as well as various social, religious, and business organizations.

The Work

Sociologists may work for the government, universities and colleges, and in private business. Duties include gathering firsthand information from people. They prepare reports to be used in comparative studies of similar programs in other communities. Sociologists derive conclusions about the effectiveness of programs that can lead to formulating policy.

Qualifications

Sociologists must be skilled in research and analysis and possess the ability to communicate ideas clearly. A master's degree in sociology is a requirement.

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value. The weaker dollar causes unemployment to rise in import industries as imports become more expensive, and it causes unemployment to go down in export industries as their goods become more competitive.

Eventually the dollar will get strong again as foreigners sell their currency in order to buy dollars—thereby reversing the patterns of unemployment. As the dollar gets stronger, export industries will have a more difficult time and import industries will begin to recover. The economy may adjust slowly to changes in the value of the dollar, but the adjustments do take place.

As a result, the shift in employment between import and export industries is one of the biggest problems with a trade deficit. In the automobile industry, for example, Japanese cars once undercut the price of cars being produced in Detroit, causing severe unemployment for both domestic autoworkers and domestic car dealerships. As the Japanese yen rose against the dollar in the early 1990s, however, the price of Japanese cars increased, making domestic automobiles more attractive and restoring some of the employment in that industry.

Under flexible exchange rates, trade deficits tend to automatically correct themselves through the price system. A strong currency generally leads to a deficit in the balance of payments and a subsequent decline in the value of the currency. A weak currency tends to cause trade surpluses, which eventually pull up the value of the currency. As a result, the United States and many other countries no longer design economic policies just to improve their trade position.

The Global Economy

Value of Currency Exchange When the value of the dollar goes up, American exports go down and imports rise. ***What causes the value of the dollar to fluctuate?***

Section 3 Assessment

Checking for Understanding

1. **Main Idea** What is the relationship between the international value of the dollar and foreign trade?
2. **Key Terms** Define foreign exchange, foreign exchange rate, fixed exchange rate, flexible exchange rate, trade deficit, trade surplus, trade-weighted value of the dollar.
3. **Describe** how foreign exchange is used in trade.
4. **Explain** how trade deficits correct themselves under flexible exchange rates.

Applying Economic Concepts

5. **Foreign Exchange** How does a weak American dollar affect you as a consumer? How does a strong dollar affect you?

Critical Thinking

6. **Making Generalizations** How do exchange rates influence international trade?
7. **Making Comparisons** Explain the difference between a fixed exchange rate and a flexible exchange rate.

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CRITICAL THINKING Skill

Drawing Inferences and Conclusions

To *infer* means to evaluate information and arrive at a conclusion. When you make inferences, you "read between the lines," or draw conclusions that are not stated directly in the text. You must use the available facts *and* your own knowledge and experience to form a judgment or opinion about the material.

International flags, airport display

Learning the Skill

Use the following steps to help draw inferences and make conclusions:

- Read carefully for stated facts and ideas.
- Summarize the information and list the important facts.
- Apply related information that you may already know to make inferences.
- Use your knowledge and insight to develop some conclusions about these facts.

Practicing the Skill

Read the passage below, then answer the questions that follow.

From its beginnings until the mid-1860s, the United States encouraged trade with other nations, protecting only a few industries from foreign competition. We encouraged the world to buy American agricultural products and traded for manufactured goods. Beginning in the 1860s, Northern industrial interests in control of the government passed high protective tariffs to prevent foreign competition from threatening our young industries. With some fluctuations, these tariffs remained high until the 1930s, when President Franklin Roosevelt tried to increase trade by lowering tariffs and encouraging our trading partners to do the same.

When World War II ended, the United States knew it would be necessary to help Europe rebuild its economy. The government did this through the Marshall Plan, which provided the resources needed to reconstruct European economies. Along with other nations, the United States set up a World Bank for Reconstruction and Development from which all nations could borrow. The United States also led the development of the International Monetary Fund, so that nations could borrow foreign currencies in short-term loans in order to trade. Finally, the United States helped organize the General Agreement on Tariffs and Trade (GATT). Under this agreement, nations meet regularly to discuss mutual tariff policies.

1. What events does the writer describe?
2. What facts are presented?
3. What can you infer about the effects of the Marshall Plan on relations between the United States and Europe today?
4. What conclusion can you make about U.S. trade policy?

Application Activity

Study the statistics in Figure 17.1 on page 468. From the data, what can you infer about U.S. trade with Canada? Why does this relationship exist?

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Chapter 17 Summary

Section 1

Absolute and Comparative Advantage (pages 467–470)

- The United States is extensively involved in international trade, with the average American spending more than $4,200 per year for **imports** in the form of goods and services.
- **Absolute advantage** means that a country can produce more of a good than another country can.
- The basis for trade today is **comparative advantage.** If people and countries specialize in the things they produce relatively more efficiently, and if they engage in trade to secure the things they do not produce, then total world output will increase.

Section 2

Barriers to International Trade

(pages 472–479)

- Barriers to trade include **tariffs, quotas,** licensing, health certifications, and voluntary quotas, all of which have been used to restrict the free flow of products.
- **Protectionists** support trade barriers on the grounds of national defense, **infant industries,** protecting domestic jobs, keeping the money at home, and helping the **balance of payments.**
- **Free traders** believe that all of these arguments are flawed, with the possible exception of the infant industries argument.
- High tariffs were one of the causes of the Great Depression, although the world has moved toward freer trade since then.
- The **most favored nation clause** is important to many countries because it gives them the same tariff reductions that the United States negotiates with other trading nations.
- The GATT was established in 1947 and has evolved into the **World Trade Organization (WTO),** which administers GATT agreements, promotes freer trade, and helps settle disputes between governments.

- The **North American Free Trade Agreement (NAFTA)** will eventually remove all trade barriers among Canada, Mexico, and the United States.

Section 3

Financing and Trade Deficits

(pages 481–485)

- **Foreign exchange** is the lifeblood of international trade; its value is determined in foreign exchange markets where currencies are bought and sold.
- Most countries use a system of **floating** or **flexible exchange rates,** meaning that supply and demand determine the currency's value.
- Some smaller countries also use a system of **fixed exchange rates,** which ties the value of their currency to a major currency like the U.S. dollar.
- The large **trade deficits** in the United States in the mid-1980s were partially caused by a strong dollar, resulting in unemployment in the export industries; the country would have had a **trade surplus** if the value of its exports had exceeded the value of its imports.
- Because deficits tend to be self-correcting, most nations no longer design economic policies just to improve the balance of payments.

Chapter 17 Assessment and Activities

ECONOMICS Online

Self-Check Quiz Visit the *Economics: Principles and Practices* Web site at epp.glencoe.com and click on ***Chapter 17—Self-Check Quizzes*** to prepare for the chapter test.

CLICK HERE

Identifying Key Terms

For each of the pairs of terms below, write a sentence or short paragraph showing how the two are related.

1. **absolute advantage**
   comparative advantage
2. **balance of payments**
   trade deficit
3. **balance of payments**
   flexible exchange rates
4. **trade deficit**
   trade surplus
5. **foreign exchange**
   flexible exchange rates
6. **protectionist**
   infant industries
7. **protective tariff**
   revenue tariff
8. **tariff**
   quota
9. **trade deficit**
   trade-weighted value of the dollar

Reviewing the Facts

Section 1 (pages 467–470)

1. **Describe** the extent of United States involvement in world trade.
2. **Describe** a case in which the United States might have an absolute advantage over another country in the production of a good.
3. **Explain** how comparative advantage can make trade between countries of different sizes possible.

Section 2 (pages 472–479)

4. **Name** three barriers to international trade.
5. **Describe** five protectionist arguments.
6. **Describe** the role of the WTO in the free trade movement.

Section 3 (pages 481–485)

7. **Differentiate** between fixed and flexible exchange rates.
8. **Explain** how deficits can be self-correcting when currency values are flexible.

Thinking Critically

1. **Drawing Conclusions** Do you favor protection as a national trade policy? Why or why not?
2. **Making Comparisons** What is the difference between a protective tariff and a revenue tariff? Use a graphic organizer similar to the one below to help you organize your answer.

Tariffs	
Protective	Revenue

3. **Analyzing Information** Some people feel the United States should return to a system of fixed exchange rates. Defend or oppose this view. Cite examples to support your position.
4. **Understanding Cause and Effect** Does the protection of inefficient industries hurt an economy? Why or why not?
5. **Making Comparisons** How might the issue of protectionism differ for a worker and a consumer? Use examples to support your argument.

Chapter 17 Assessment and Activities

Applying Economic Concepts

1. **Comparative Advantage** Think of a project you recently completed with a friend. How could you have completed the project more efficiently, applying the principle of comparative advantage? Explain.
2. **Quotas** You have just started a business manufacturing toothbrushes. Would you favor a quota on imported toothbrushes? Why or why not?
3. **Foreign Exchange** Explain how doubling the $400 tax-free limit on goods brought in from abroad by American citizens would affect the balance of payments.
4. **Interdependence** How does the lack of certain raw materials force nations to become interdependent?

Math Practice

Suppose you are planning a trip to Russia and plan to bring $500 in spending money. If the exchange rates in **Figure 17.4** prevail at the time of your departure, how many rubles would you have after you exchanged your dollars for rubles? If you spent 5,000 rubles while you were there, and if you converted the rest of the rubles back to dollars when you came home, how many dollars would you have?

Thinking Like an Economist

Assume that the country is running a large trade deficit. What predictions would you make about future changes in the value of the dollar in the foreign exchange markets. Would these developments be a matter of concern?

Technology Skill

Using E-Mail During the course of one day, make a note of at least 10 manufactured items you handle, such as your clothing and the cafeteria trays used in your school. Find out where each item is produced, and make a log of the items, noting whether each is domestic or foreign made.

Next, write a persuasive argument explaining your opinion on international trade. In writing a persuasive argument, it is important to state the issue clearly and to give your position on it.

Use the evidence you gathered in your log notes to support your position and to refute any opposing position. Use other sources to identify evidence that will help you establish your claim. Conclude your argument by restating your position and summing up the evidence.

Finally, e-mail your argument to the editor of a newspaper or magazine. One day soon, you may see your argument in print!

Building Skills

Drawing Inferences and Conclusions Read the following passage about U.S. trade with other nations. Use the stated facts and your own knowledge to answer the questions that follow.

In the early 1980s, American producers found it increasingly difficult to sell their products to other countries. At least part of this problem was the result of the high value of the dollar. To buy American products, foreign nations must trade their currency for dollars. When the dollar's value is too high, foreign nations receive fewer dollars in exchange for their money. Beginning in the mid-1980s, the value of the dollar declined in relation to foreign currencies. That was like putting American products on sale to foreign buyers. U.S. exports increased sharply.

1. What is the main topic of the passage?
2. What facts are presented?
3. From this passage, what can you infer about fluctuations in U.S. trade?
4. What fact(s) or observations helped you make this inference?

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