Why Nations Trade

- How does resource distribution affect trade?
- What are the differences between absolute and comparative advantage?
- What are the major imports and exports of the United States?
- How does trade affect employment?
Resource Distribution and Trade

- Each country of the world possesses different types and quantities of land, labor, and capital resources.
- By specializing in the production of certain goods and services, nations can use their resources more efficiently.
- Specialization and trade can benefit all nations.
The law of comparative advantage states that nations are better off when they produce goods and services for which they have a comparative advantage in supplying.

Absolute and Comparative Advantage

- A person or nation has an **absolute advantage** when it can produce a particular good at a lower cost than another person or nation.

- **Comparative advantage** is the ability of one person or nation to produce a good at a lower opportunity cost than that of another person or nation.
In this example, both Kate and Carlos benefit from specialization.

<table>
<thead>
<tr>
<th>Benefits from Specialization and Trade for Carl and Kate</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Carl</strong></td>
</tr>
<tr>
<td>Specialization</td>
</tr>
<tr>
<td>Carl specializes, switching 2 hours from T-shirt production to birdhouse production.</td>
</tr>
</tbody>
</table>
The United States is the world’s largest exporter.

The United States is also the world’s largest importer.

The United States’ main trading partners are Canada, Mexico and Japan.
Trade and Employment

- Workers who lose their jobs due to specialization face three options:
  - **Unemployment**: Inability to adapt and find a new job
  - **Relocation**: Moving to where current skills meet current jobs
  - **Retraining**: Gaining new human capital to meet the demands of specialized labor markets

As nations begin to specialize in certain goods, dramatic changes in the nation’s employment patterns also occur.
Section 1 Assessment

1. Trade benefits both wealthy and poor countries because
   (a) self-sufficiency is too costly.
   (b) both wealthy and poor countries increase their wealth if they specialize.
   (c) both wealthy and poor countries lack human resources.
   (d) without trade neither wealthy nor poor countries could increase their wealth.

2. What is the law of comparative advantage?
   (a) a country is better off producing goods for which they have a comparative advantage in supplying
   (b) a country that supplies things for others has a comparative advantage in trade
   (c) a country has a comparative advantage if it produces goods for export
   (d) a country’s greatest advantage is in the import of goods that it cannot produce

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Trade Barriers and Agreements

• What are trade barriers?
• What are the effects of trade barriers?
• What is protectionism?
• What organizations promote international cooperation on matters of trade?
What Are Trade Barriers?

A trade barrier is a means of preventing a foreign product or service from freely entering a nation’s territory.

- **Import Quotas**
  - An import quota is a limit on the amount of a good that can be imported.

- **Voluntary Export Restraints**
  - A voluntary export restraint (VER) is a self-imposed limitation on the number of products shipped to a certain country.

- **Tariffs**
  - A tariff is a tax on imported goods, such as a customs duty.

- **Other Barriers to Trade**
  - Other barriers to trade include high government licensing fees and costly product standards.
The Effects of Trade Restrictions

Increased Prices for Foreign Goods

- Tariffs and other trade barriers increase the cost of imported products, making domestic products more competitive.

- Although manufacturers of many products may benefit from trade barriers, consumers can lose out.

Trade Wars

- When one country restricts imports, its trading partner may impose its own retaliatory restrictions.
Protectionism is the use of trade barriers to protect a nation’s industries from foreign competition.

- **Protecting Jobs**
  - Protectionism shelters workers in industries that would be hurt by specialization and trade.

- **Protecting Infant Industries**
  - Protectionist policies protect new industries in the early stages of development.

- **Safeguarding National Security**
  - Certain industries may require protection from foreign competition because their products are essential to the defense of the United States.
International Cooperation

- Recent trends have been toward lowering trade barriers and increasing trade through international trade agreements.

- In 1948, the General Agreement on Tariffs and Trade (GATT) was established to reduce tariffs and expand world trade.

- In 1995, the **World Trade Organization (WTO)** was founded to ensure compliance with GATT, to negotiate new trade agreements, and to resolve trade disputes.
Many nations have formed regional trade organizations. These trade organizations establish **free-trade zones**, or regions where a group of countries has agreed to reduce trade barriers among themselves.
1. Protectionism does not
   (a) protect immigrant labor.
   (b) protect domestic jobs.
   (c) protect infant industries.
   (d) safeguard national security.

2. Members of regional trade organizations generally work together to
   (a) abolish free-trade zones.
   (b) limit commerce between member states.
   (c) establish centrally planned economies.
   (d) eliminate trade barriers.
Section 2 Assessment

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Measuring Trade

- How do exchange rates affect international markets?
- How do exchange rate systems vary?
- What is a balance of trade?
- What is the United States trade deficit?
The value of a foreign nation’s currency in relation to your own currency is called the **exchange rate**.

- An increase in the value of a currency is called **appreciation**.
- A decrease in the value of a currency is called **depreciation**.
- Multinational firms convert currencies on the foreign exchange market, a network of about 2,000 banks and other financial institutions.
The following table shows an example of exchange rates.

### Foreign Exchange Rates

<table>
<thead>
<tr>
<th></th>
<th>U.S. $</th>
<th>Aust $</th>
<th>U.K. £</th>
<th>Canadian $</th>
<th>¥en</th>
<th>Euro</th>
<th>Mexican NP</th>
<th>Chinese renminbi</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S. $</td>
<td>1</td>
<td>0.6489</td>
<td>1.599</td>
<td>0.6764</td>
<td>0.01</td>
<td>1.051</td>
<td>0.11</td>
<td>0.12</td>
</tr>
<tr>
<td>Australian $</td>
<td>1.541</td>
<td>1</td>
<td>2.465</td>
<td>1.042</td>
<td>0.01</td>
<td>1.62</td>
<td>0.17</td>
<td>0.19</td>
</tr>
<tr>
<td>U.K. £</td>
<td>0.6252</td>
<td>0.4057</td>
<td>1</td>
<td>0.4229</td>
<td>0.01</td>
<td>0.657</td>
<td>0.07</td>
<td>0.08</td>
</tr>
<tr>
<td>Canadian $</td>
<td>1.478</td>
<td>0.9593</td>
<td>2.365</td>
<td>1</td>
<td>0.01293</td>
<td>1.554</td>
<td>0.16</td>
<td>0.18</td>
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<tr>
<td>¥en</td>
<td>114.3</td>
<td>74.19</td>
<td>182.9</td>
<td>77.34</td>
<td>1</td>
<td>120.2</td>
<td>12.24</td>
<td>13.81</td>
</tr>
<tr>
<td>Euro</td>
<td>0.9516</td>
<td>0.6175</td>
<td>1.522</td>
<td>0.6436</td>
<td>0.01</td>
<td>1</td>
<td>0.1</td>
<td>0.11</td>
</tr>
<tr>
<td>Mexican nuevo peso</td>
<td>9.33</td>
<td>6.06</td>
<td>6.3</td>
<td>6.3</td>
<td>0.08</td>
<td>9.81</td>
<td>1</td>
<td>1.13</td>
</tr>
<tr>
<td>Chinese renminbi</td>
<td>8.28</td>
<td>5.37</td>
<td>13.25</td>
<td>5.6</td>
<td>0.07</td>
<td>8.7</td>
<td>9.8</td>
<td>1</td>
</tr>
</tbody>
</table>
Types of Exchange Rate Systems

Fixed Exchange-Rate Systems

• A currency system in which governments try to keep the values of their currencies constant against one another is called a fixed exchange-rate system.

Flexible Exchange-Rate Systems

• Flexible exchange-rate systems allow the exchange rate to be determined by supply and demand.
The relationship between a nation’s imports and its exports is called its balance of trade.

- When a nation exports more than it imports, it has a trade surplus.
- When a nation imports more than it exports, it creates a trade deficit.
The United States Trade Deficit

• The Trade Deficit
  – The United States has run a trade deficit since the early 1970s.

• Why the Trade Deficit?
  – Imports of foreign oil as well as Americans’ enjoyment of imported goods account in part for the large American trade deficit.

• Reducing the Trade Deficit
  – Quotas and other trade barriers can be used to raise prices of foreign-made goods and urge consumers to buy domestic goods.
Section 3 Assessment

1. When a nation imports more than it exports, economists say it has a
   (a) trade insufficiency.
   (b) trade deficit.
   (c) balance of payments.
   (d) trade surplus.

2. When an economist says that a currency has become stronger, he or she means that
   (a) it will buy less foreign goods.
   (b) it can be exchanged for more of a foreign currency.
   (c) services, unlike goods, can be exported freely.
   (d) there are very few things that the currency cannot buy in a foreign market.

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