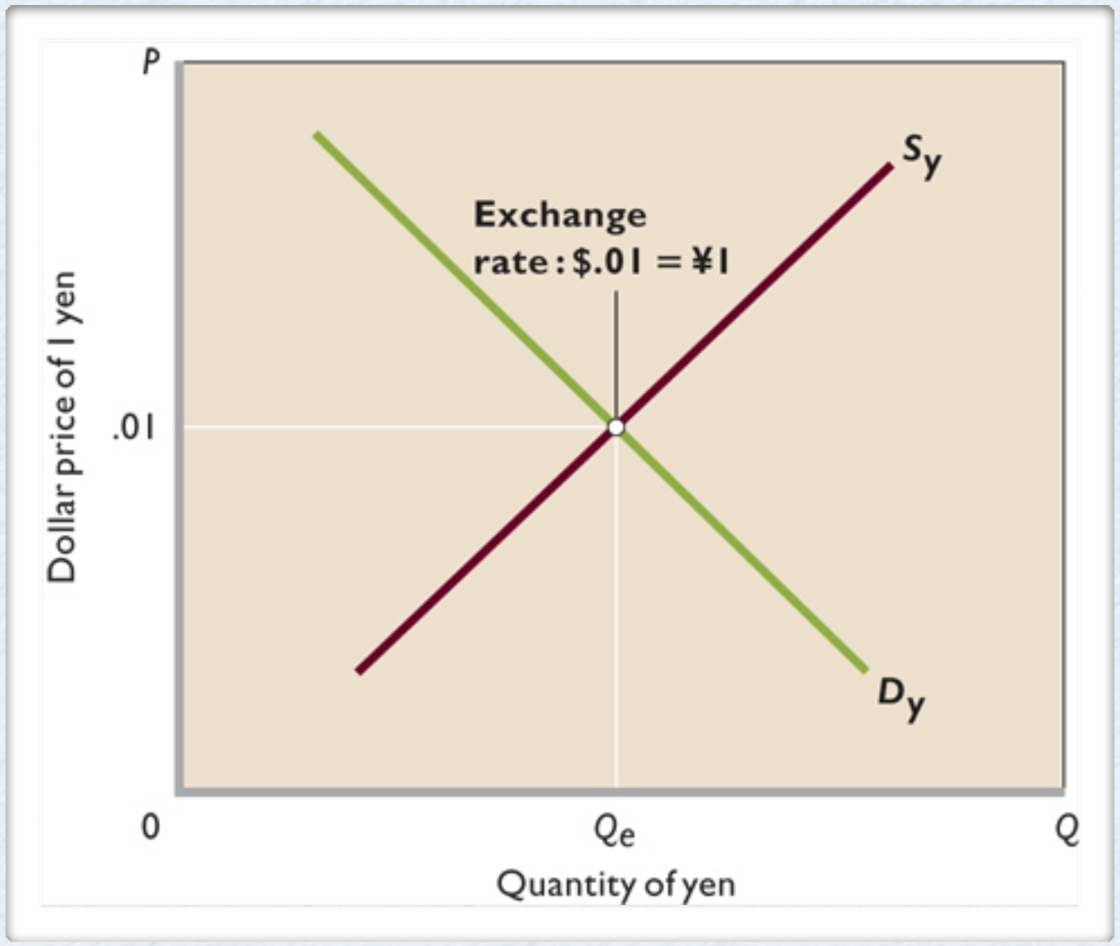
CHAPTER 21

The Economic Bases for Trade

- **Distribution of resources varies among nations:**
  - Labor - intensive goods
  - Land - intensive goods
  - Capital - intensive goods
- However, the distribution of resources and technology among nations is not forever fixed.
- This above gives bases for trade among nations

Foreign Exchange Market

- **The foreign exchange market** establishes the different exchange rates through market supply and demand

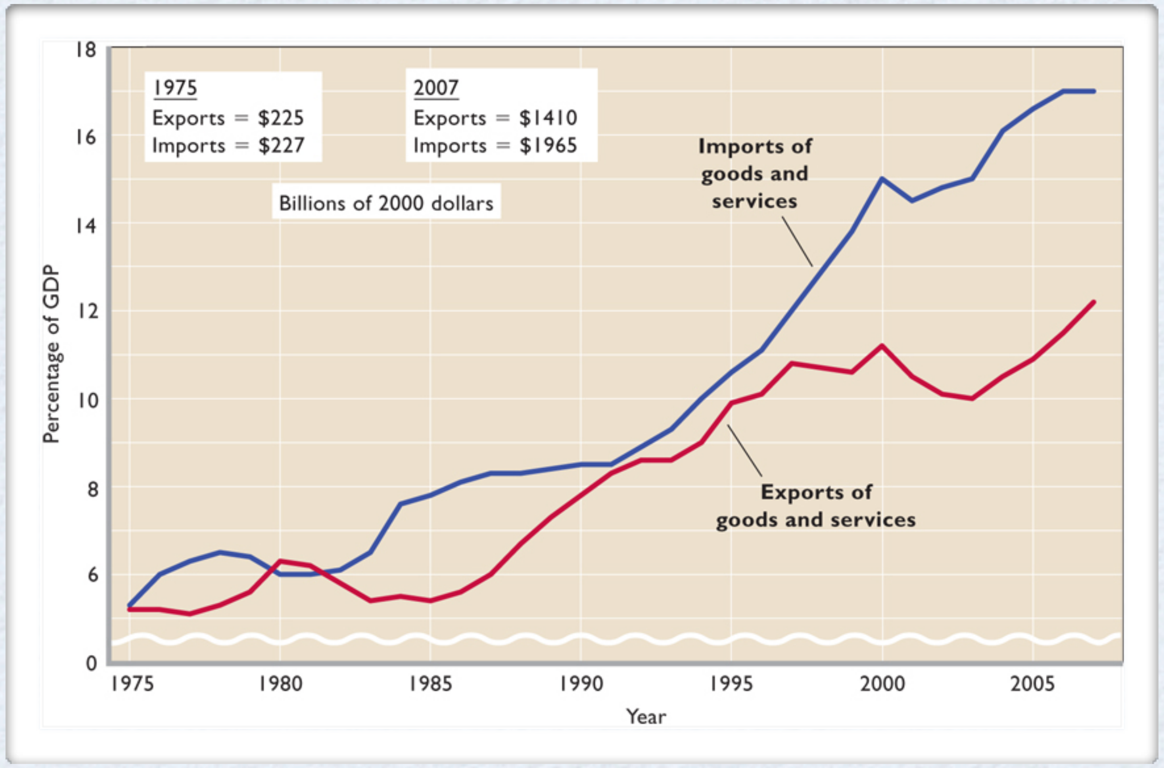


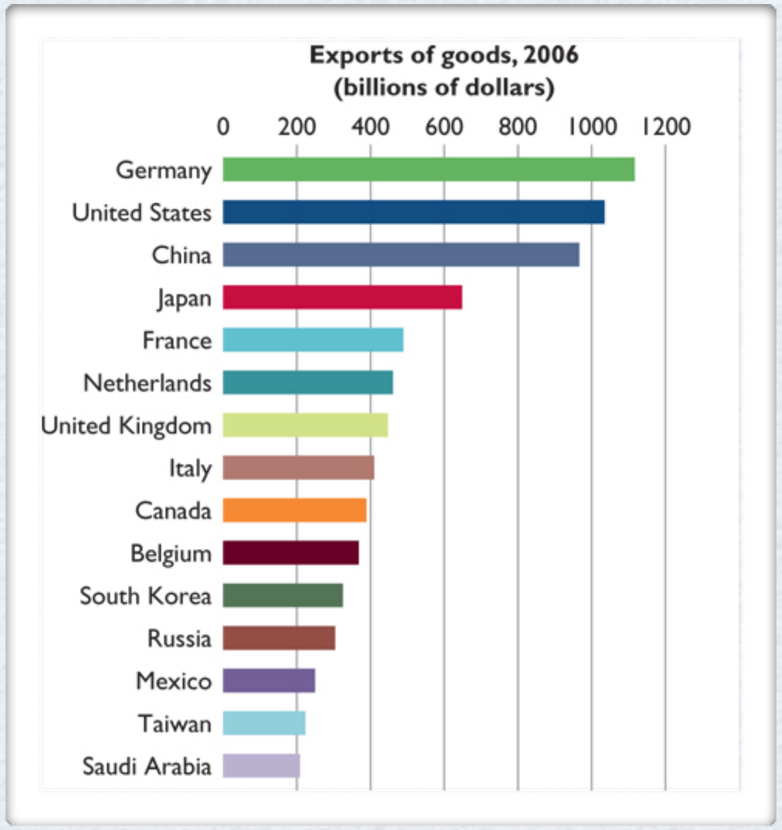
$1 Will Buy
39.17 Indian rupees
.51 British pound
1.01 Canadian dollars
10.94 Mexican pesos
1.12 Swiss francs
.68 European euro
109.87 Japanese yen
937.38 South Korean won
6.42 Swedish kronors

The $ price of ¥ increases = **$ depreciates**
The $ price of ¥ decreases = **$ appreciates**

Specialization and Comparative Advantage

- **David Ricardo - 1800s - British economist - Comparative advantage**
- **Comparative advantage - specialization will allow for greater efficiency -** a nation has a comparative advantage in some product when it can produce that product at a lower domestic opportunity cost than can a potential trading partner
- Specialization based on comparative advantage improves global resource allocation. The same total inputs of world resources and technology results in a larger global output.



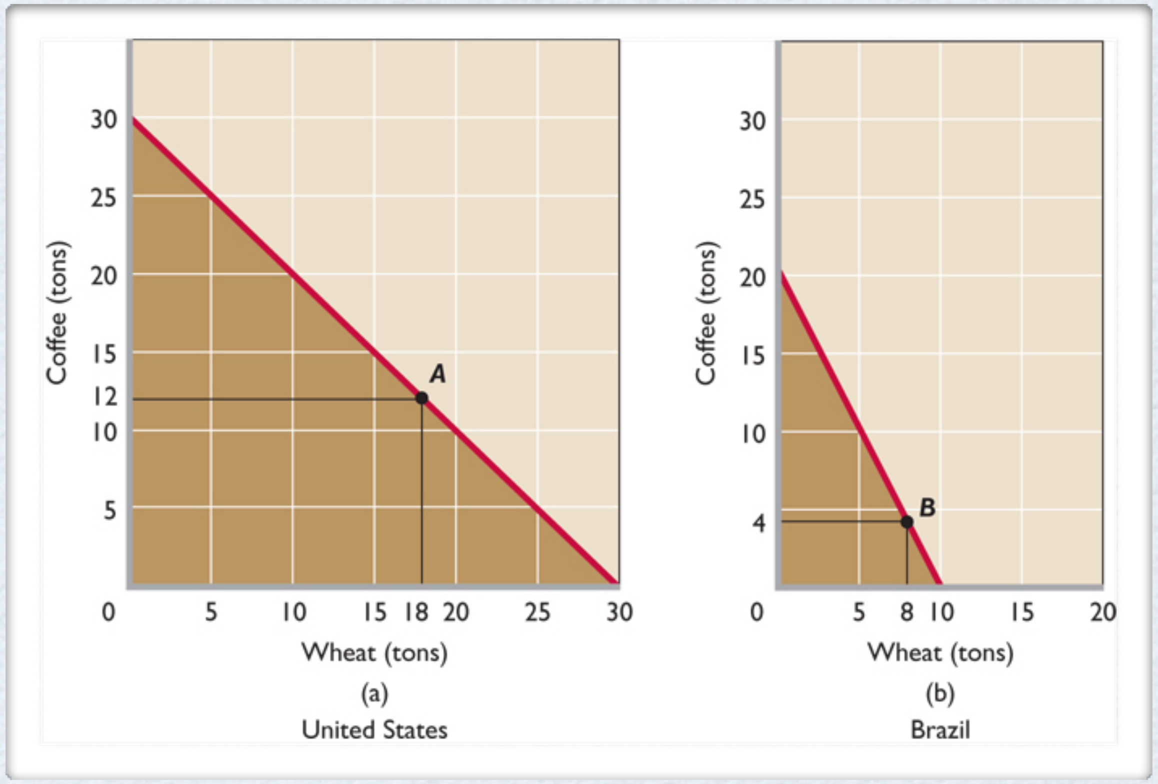


Comparative Advantage: Graphical Analysis

- **Assumptions:**
  - Two nations - Brazil and USA
  - Two goods - coffee and wheat
  - Constant costs - curves are straight lines
  - Different costs - different slopes of curves tell that there are different opportunity costs of producing wheat and coffee
  - US has absolute advantage in both, coffee and wheat (output per worker the US prevails)

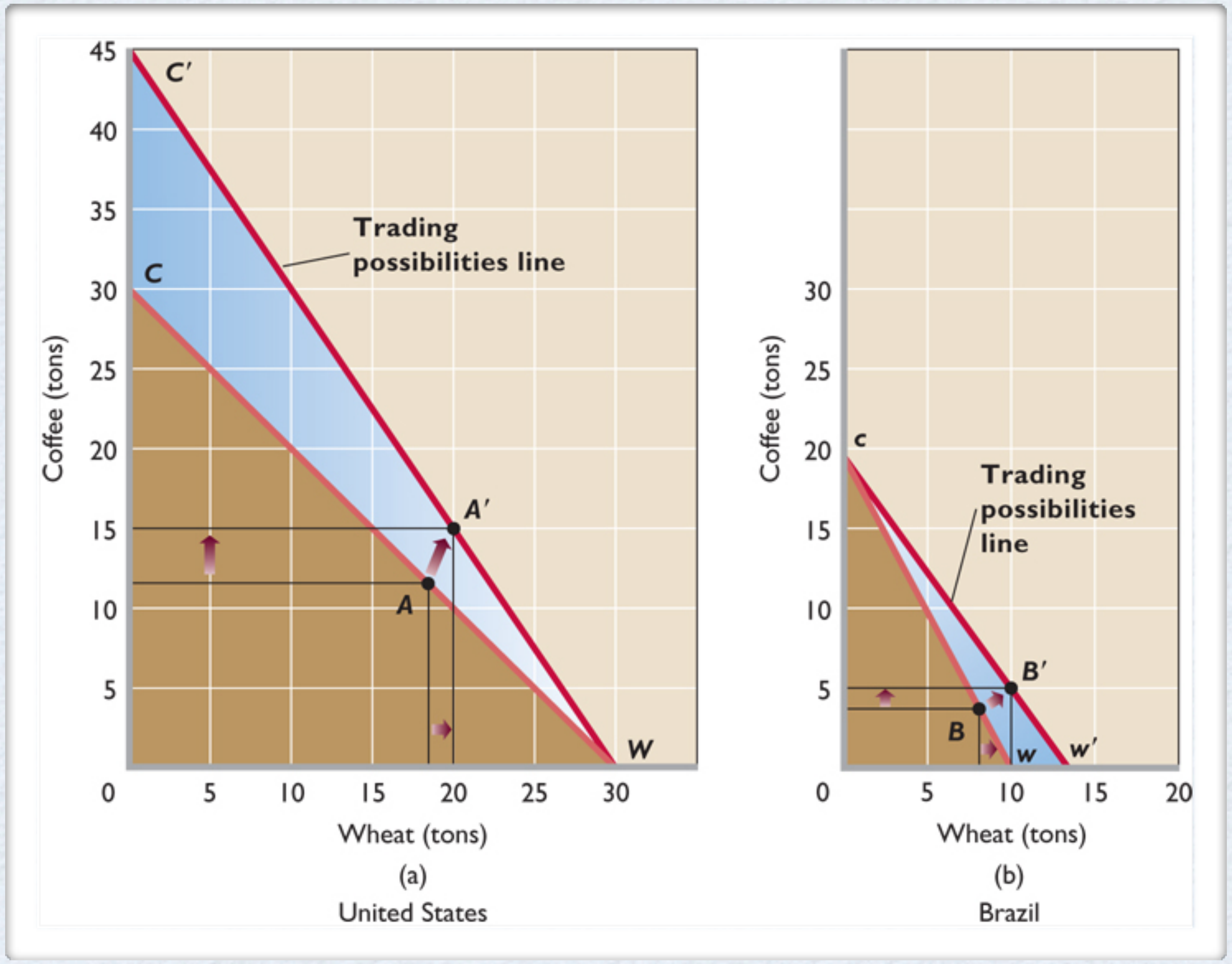
Comparative Advantage: Graphical Analysis

- US - 30 tons of coffee / 30 tons of wheat
- Brazil - 20 tons of coffee / 10 tons of wheat
- US opportunity cost ratio is: **1C = 1W**
- Brazil opportunity cost ratio is: **2C = 1W**
- **Comparative advantage** - total output will be greatest when each good is produced by the nation that has the lowest domestic opportunity cost for that good.
- US has to give up 1W to produce 1C
- Brazil has to give up 1/2W to produce 1C
- **The US should specialize in wheat and Brazil should specialize in coffee**
- **Terms of Trade** - Brazil 1.25C : 1W, US 1.75C : 1W Settlement will be in the middle (S & D).



Comparative Advantage: Graphical Analysis

- **Gains from Trade** - Final terms of trade - 1.5C : 1W
- US coffee = 1.5C = 45
- Brazil wheat = 1.5C : 1W = 20C : XW ➠ 20C / 1.5C = XW ➠ 13.333W



Trade Barriers

- **Revenue tariff** - usually applied to a product that is not produced domestically. Rates on revenue tariffs are modest. Their purpose is to provide the Federal government with revenue.
- **Protective tariff** - is designed to shield domestic producers from foreign competition
- **Import quota** - specifies the maximum number of a commodity that may be imported in any period.
- **Non-tariff barrier** - licensing, standards regarding quality and safety, red tape
- **Voluntary export restriction** - foreign firms “voluntarily” limit the amount of their exports to a particular country

Government and Trade

- **General Agreements on trade and Tariff (GATT)** - 1947 - 23 nations
  1. Equal treatment for all members
  2. Reduction of tariffs by multilateral negotiations
  3. Elimination of import quotas
- **World Trade Organization (WTO)**
  - Successor of GATT - 140 member nations
  - Trend toward liberalized trade
- **European Union (EU)** - trade block - a group of countries having common identity, economic interests and trade rules
- **The Euro** - EU common currency (€)
- **North American Free Trade Agreement (NAFTA)** - 1993

Most globalized economies