

Lecture 10: International Markets

I. Why trade with other countries?

Same reasons people trade with each other - because it's beneficial to do so.

But two specific reasons when looking at international trade

1. *Absolute Advantage*: Consider countries A and B. A can make brooms better and cheaper than B can make brooms, whereas B can pump oil better and cheaper than A can pump oil. So A trades brooms to B for oil.
2. *Comparative Advantage*: A can *both* make brooms and pump oil better than can B. However, between broom making and pumping oil, A does brooms the best. So here it still makes sense for A to concentrate on making brooms and trade brooms to B for oil.

Example in class: Your favorite professional athlete, who is in excellent condition, likely doesn't mow the lawn at his/her home, even though he or she could do it better than anyone else. But the athlete hires someone to mow the lawn because the time the athlete would use for lawn mowing could be better spent practicing, considering investments, etc. This is again the idea of opportunity cost.

II. Tradeoffs in foreign trade

1. When trade with a foreign country does occur, and domestic consumers switch from purchasing from domestic companies to purchasing from foreign companies, domestic investors and workers in those domestic companies lose.
2. Presumably domestic consumers save money by buying from foreign companies. So one approach is to tax away *some* of those benefits, or gains, and use the proceeds to compensate or assist the domestic workers who lose.

Example: As a result of being able to purchase lower priced foreign made clothing, it's estimated US consumers are saving \$20 billion annually (that is, they are spending \$20 billion *less* on clothes than they would have if they couldn't purchase foreign made clothing. If they paid a 5% special tax on these purchases, they would still be left with a gain of \$10 billion annually, but the other \$10 billion could be spent assisting the displaced textile and apparel workers. So this is a "win-win".

3. Issue of whether foreign workers are paid much less than US workers, and whether this makes it impossible for US workers to compete.

- a) Are foreign workers "unfairly" paid less? Answer: Must put their pay in context of their country's cost of living. For example, pay of \$1 per day in some foreign country might be enough for a reasonable standard of living, since prices there are much lower than in the U.S.
- b) Can higher paid U.S. workers compete with lower paid foreign workers? Answer: Yes, if the productivity (output per hour) of US workers is sufficiently higher. What matter is {worker output per hr./wage per hr.}

Example: US wage: \$20 per hour
 US productivity: 100 computer chips per hour
 Labor cost per chip: 5 chips per \$1 or \$0.20 per watch

Foreign wage: \$1 per hour
 Foreign productivity: 4 computer chips per hour
 Labor cost per chip: 4 chips per \$1 or \$0.25 per watch

Conclusion: US worker is actually cheaper

III. Trade Terminology (from the perspective of the U.S.)

- Exports: sales of goods and services from the U.S. to other countries
 Imports: purchases of goods and services from other countries by the U.S.

- Current Account Balance*: trade in products and services

Trade Deficit: US buys more products and services from foreign countries than it sells to foreign countries

Trade Surplus: US sells more products and services to foreign countries than it buys from foreign countries

- Capital Account Balance*: comparison of investment flows

Capital Deficit: US invests more in foreign countries than foreign countries invest in the US

Capital Surplus: Foreign countries invest more in the US than US invests in foreign countries

- Interesting fact: The balance on the current account will equal the balance on the capital account, but of opposite sign.

That is, if there is a trade deficit, there will be a capital surplus of the same size. Or, if there is a trade surplus, there will be a capital deficit of the same size.

What's going on: If US has a trade deficit, foreigners are accumulating US dollars, and those dollars are used to purchase US investments (assets).

Or, if US has a trade surplus, US is accumulating foreign monies, and those monies are used to purchase foreign investments (assets). Notice the impact on US jobs: If, for example, the US has a trade deficit, US jobs are lost from US consumers buying from foreign companies. But, a trade deficit means a capital surplus, which means foreigners are investing in the US, and this in turn creates other jobs.

5. Exchange rate: is a price between the currencies of two countries. Usually expressed in terms of how many units of a foreign currency are obtained for one US dollar

Example: Exchange rate of "2" for the British pound means 1 US dollar trades for 2 British pounds.

Like any price, an exchange rate can fluctuate.
In general:

The US dollar becomes "stronger" (meaning get more units of a foreign currency for one US dollar) when the US inflation rate drops and/or US *real* interest rates rise (real interest rate = observed interest rate minus inflation rate).

Conversely, the US dollar becomes "weaker" (meaning get fewer units of a foreign currency for one US dollar) when the US inflation rate rises or US and/or US *real* interest rates fall.

Is a "strong" dollar good and a "weak" dollar bad?

No, there are "pluses" and "minuses" of each.

A *strengthening dollar* makes imports cheaper (including travel to foreign countries), so US consumers gain, but it also makes US exports more expensive in foreign countries, so US exporters lose.

A *weakening dollar* makes imports more expensive, so US consumers lose, But it makes US exports less expensive in foreign countries, so US exporters gain.

6. Purchasing power parity: The idea that the exchange rate between two currencies will end up at a level where people can purchase the same product in the two countries at the same price.

Example: A Big Mac costs \$2 in the U.S. If it costs 4 pounds in the UK, then the exchange rate should settle at:

$$1 \text{ US dollar} = 2 \text{ British pounds}$$

7. Restrictions on trade and trade pacts

tariff: a tax on imports

quotas: a limitation on the quantity of an imported product and service

trade pact: a treaty specifying the terms of trade between countries; e.g., NAFTA, GATT, CAFTA