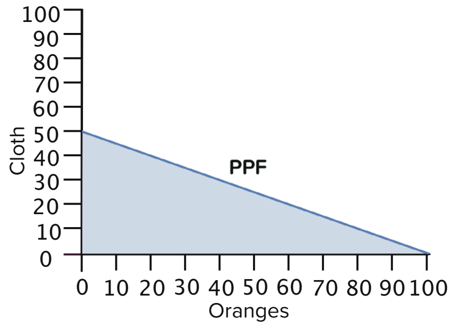
INTERNATIONAL TRADE

Trade Between Countries

Production possibilities frontier (PPF): A graph depicting an economy's maximum possible output combinations, given fixed resources.

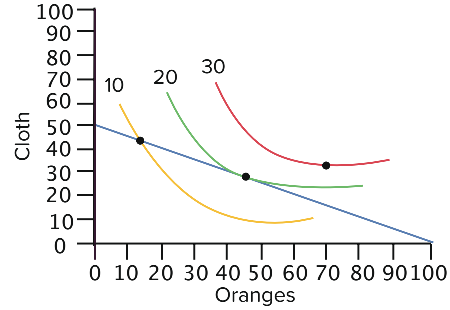
- If a point is either on or below the PPF, then it is a possible production combination.
- The slope of the PPF represents the opportunity cost for each good.



Utility measures satisfaction from consuming a good. High utility implies high satisfaction.

Indifference curve: A curve that represents all combinations of goods that yield the same utility—the higher the curve, the higher the utility.

- The intersection of the PPF and the highest indifference curve yields the best production combination.



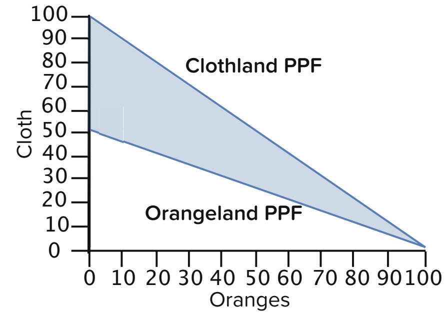
Comparative advantage: Producing a good at a lower opportunity cost than another producer.

International specialization: When countries focus on producing goods that give them comparative advantage.

Terms of trade: The ratio at which a country can trade its exports for imports.

- Terms of trade must be in between the slopes of the countries' PPFs.

Gains from trade: The increase of utility due to trade.



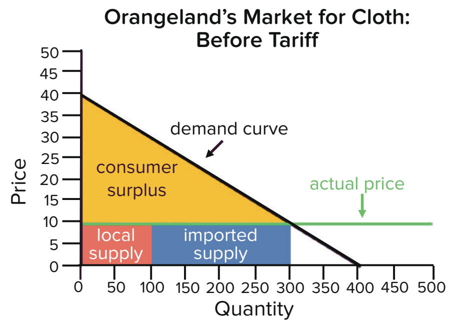
Trade Restrictions

Tariff: A tax on imports; tariffs often increase international prices.

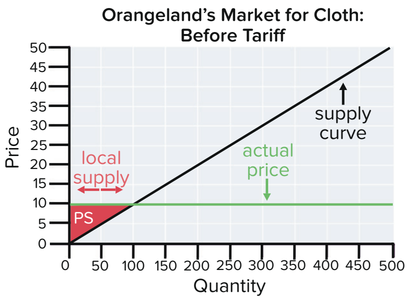
Consumer surplus (CS): The difference between the price consumers are willing to pay and the price they actually pay. Also known as consumer welfare.

- To calculate consumer surplus, find the area of the triangle between the demand curve and the actual price.

Quota: A limit on the quantity of imports.



Producer surplus (PS): The difference between the price at which producers are willing to sell their product and the actual price.



World trade organization (WTO): An international organization that works to promote free trade and creates trade rules.

The WTO is a **multilateral agreement**, or an agreement among many nations, to reduce tariffs and quotas.

The WTO works to create **common markets**, or groups of countries with minimal trade restrictions.

Openness in Goods and Financial Markets

Goods market: A market in which people buy and sell goods and services.

Financial market: A market in which people buy and sell financial assets.

Openness: A consumer's ability to choose between domestic and foreign products.

- A country's openness can be measured by calculating the trades of goods and services as a percentage of GDP.

Openness formula:

$$\frac{(\text{exports} + \text{imports})}{\text{GDP}} \times 100$$

Trade balance: The total value of exports minus the total value of imports.

Trade surplus: Occurs when trade balance is positive, or when a country exports more than it imports.

Trade deficit: Occurs when trade balance is negative, or when a country imports more than it exports.

Trade balance may also be called **net exports**.

Net capital flow (NCF): The net flow of funds a country invests abroad.

- A positive net capital flow means that a country invests more outside of itself than the world invests in it.

Balance of payments (BOP): A set of accounts that summarize a country's international transactions.

Current account: Mainly composed of the trade balance.

Capital account: Summarizes the financial market, or NCF.

Labor in International Markets

Labor productivity: The quantity of goods and services that can be produced by one worker.

Capital: The factories, machinery, and equipment used for production.

Labor standards: Regulations directly affecting workers, such as health, safety, and minimum wages.

Labor union: An organization of employees that have a legal right to bargain with employers about wages and working conditions.

Collective bargaining: The process of negotiation between employers and union representatives.

Brain drain: The emigration of highly skilled workers.

Economic Development

Economic development: The improvement of economic well-being and quality of life.

Per capita GDP measures economic well-being.

- By increasing labor productivity and technology, a country can produce more, leading to a larger per capita GDP.

Technology: The process used to produce goods and services.

Calculating per capita GDP:

$$\text{per capita GDP} = \frac{\text{total GDP}}{\text{total population}}$$

Exchange Rates

International Monetary Fund (IMF): An international organization that provides foreign currency loans to central banks, overseeing the international monetary system.

Purchasing power parity (PPP): That the equivalent amount of any given currency should be able to buy the same quantity of goods in all countries.

Trade restrictions, varying quality of goods between countries, goods and services that aren't tradable, and other aspects of international trade can hinder PPP.

Nominal exchange rate: The rate used for foreign currency trading, or the value of currency in terms of another currency.

Remember: PPP theory states that rates adjust to equalize the purchasing powers of different currencies.

Real exchange rate formula:

$$\text{Nominal exchange rate} \times \frac{\text{Domestic price level}}{\text{Foreign price level}}$$

Real exchange rate: The price of domestic goods in terms of foreign goods; used to compare the price of goods between countries.

Fixed exchange rate system: Exchange rates remain constant for long periods of time.

Bretton Woods Agreement: The value of the US dollar was set at a constant price per ounce of gold, and the values of member nations' currencies were fixed in terms of the US dollar.

Pegging: When a nation commits to setting a fixed exchange rate against either a commodity or foreign currency.

Floating exchange rate system: Supply and demand determine a currency's value.

- An *increase in demand* for a currency will increase its value, and an *increase in supply* will decrease the currency's value.
- Countries peg their currency to other floating currencies, as opposed to fixed currencies.

Changes in supply and demand cause fluctuations in a currency's value.