



UNIT  
**5**

# The Global Economy

## CHAPTER 16

International Trade

## CHAPTER 17

Developing Countries

## CHAPTER 18

Global Economic Challenges

This Japanese-owned ▶  
Honda manufacturing  
plant in Marysville, Ohio,  
reflects increasingly global  
markets and production.



# HONDA

VEHICLES ASSEMBLED IN NORTH AMERICA!





CHAPTER  
**16**

# International Trade

## Why It Matters

You and a classmate are planning to open a lawn-service business. You will each contribute \$200 toward the purchase of a mower, gas can, trimmer, and other materials for the business. Now it is time to get organized. Work with a classmate and make a list of the different "jobs" associated with your lawn-service business. What criteria will you use to divide up these jobs? Why? Read Chapter 16 to find out how nations make decisions about what to produce and trade with other nations.

### The BIG Idea

Trade and specialization lead to economic growth for individuals, regions, and nations.

International trade allows us to purchase items produced in any country, such as the items from Africa and the Caribbean in a store in Syracuse, New York.



**Economics ONLINE Chapter Overview** Visit the *Economics: Principles and Practices* Web site at [glencoe.com](http://glencoe.com) and click on *Chapter 16—Chapter Overviews* to preview chapter information.



SECTION

1

# Absolute and Comparative Advantage

## GUIDE TO READING

### Section Preview

In this section, you will learn that comparative advantage is the basis for international trade.

### Content Vocabulary

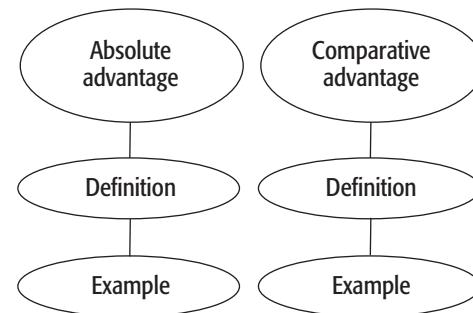
- exports (p. 442)
- imports (p. 442)
- absolute advantage (p. 443)
- production possibilities frontier (p. 444)
- comparative advantage (p. 444)
- opportunity cost (p. 444)

### Academic Vocabulary

- volume (p. 443)
- enabled (p. 444)

### Reading Strategy

**Defining** As you read the section, complete graphic organizers similar to the ones below by defining each term and providing an example of each.



## ISSUES IN THE NEWS

—BusinessWeek

### Russia: Shoppers Gone Wild

It's midday on Saturday, and the Mega-1 mall in southern Moscow is packed. Shoppers have come to stock up on groceries at the mall's French-owned Auchan hypermarket, buy furniture at Swedish retailer IKEA, and browse dozens of boutiques selling everything from Yves Rocher cosmetics to Calvin Klein underwear. Although crammed with expensive Western merchandise, Mega has been a hit since it opened its doors in December, 2002. Last year it was the world's most frequented shopping center, with 52 million visitors.

Down the road at the Rolf car dealership, Oxana Starostina is filling in registration forms for her new Mitsubishi Lancer, purchased with \$20,000 in cash. She and her husband, Maxim, saved the money from their small construction supply business.

... [F]or many multinationals from the U.S., Europe, and Asia, the consumer boom, not oil and gas, is the investment story to watch. ■



Nations trade for the same reasons that individuals do—because they believe that the products they receive are worth more than the products they give up. International trade is partially responsible for the incredible variety of goods and services both we and the shoppers in the news story consume.

For example, we purchase clothing made in China, oil from the Middle East, bananas from Honduras, and coffee beans from Colombia and Brazil. We consume a service when we vacation in the Caribbean or in Europe. The shoppers in Moscow are doing the same thing: enjoying the goods produced in France, Sweden, and Japan.



**exports** the goods and services that a nation sells to other nations

**imports** the goods and services that a nation buys from other nations

## Why Nations Trade

**MAIN Idea** Trade allows nations to specialize in some products and then trade them for goods and services that are more expensive to produce.

**Economics and You** When you were young, did you ever trade toys, cards, or candy with your friends? Read on to learn about international trade.

Some trade takes place because countries lack goods at home. **Figure 16.1** shows some essential raw materials used in the United States that come from abroad.

### Specialization

A more important reason for trade—whether among people, states, or countries—is specialization. When people specialize, they produce the things they do best and exchange those products for the things that other people do best.

States also specialize. For example, New York is a financial center for stocks and bonds, while automobiles are a major industry in Michigan. Texas is known for oil and cattle, while Florida and California are famous for citrus fruit. Countries specialize in different goods and services in much the same way.

If you want to find out what a country specializes in, look at its **exports**—the goods and services that it produces and sells to other nations. If you want to see what a country would like to have but does not produce as efficiently, look at its **imports**—the goods and services that one country buys from other countries.

### Extent of Trade

International trade is important to all nations, even a country as large as the United States. Most of the products that

**Figure 16.1 ► American Dependence on Trade**

Raw Material	Imports as a Percent of Consumption	Primary Foreign Sources	Use of Raw Materials
Industrial diamonds	100	South Africa, Australia, Democratic Republic of the Congo, Botswana	Industrial cutting tools, oil well drills
Bauxite	100	Jamaica, Guinea, Brazil, Guyana	Anything made of aluminum
Columbium	100	Brazil, Canada, Thailand	Rocket structures and heat radiation shields
Mica (sheet)	100	India, Belgium, France	Electrical insulation, ceramics
Strontium	100	Mexico, Spain	Flares, fireworks
Tin	88	Peru, China, Bolivia, Indonesia	Cans and containers, electrical components
Tantalum	80	Thailand, Germany, Brazil	Surgical instruments, missile parts
Barite	79	China, India	Filler for gas and oil well drilling fluids, paint, plastics
Cobalt	76	Democratic Republic of the Congo, Zambia, Canada	High-temperature jet fighter engines
Chromium	72	South Africa, Zimbabwe, Turkey	Chrome, ball bearings, trim on appliances and cars

**Sources:** *Statistical Abstract of the United States*; U.S. Geological Survey

- ▶ International trade is the primary means by which nations, including the United States, obtain many essential materials.

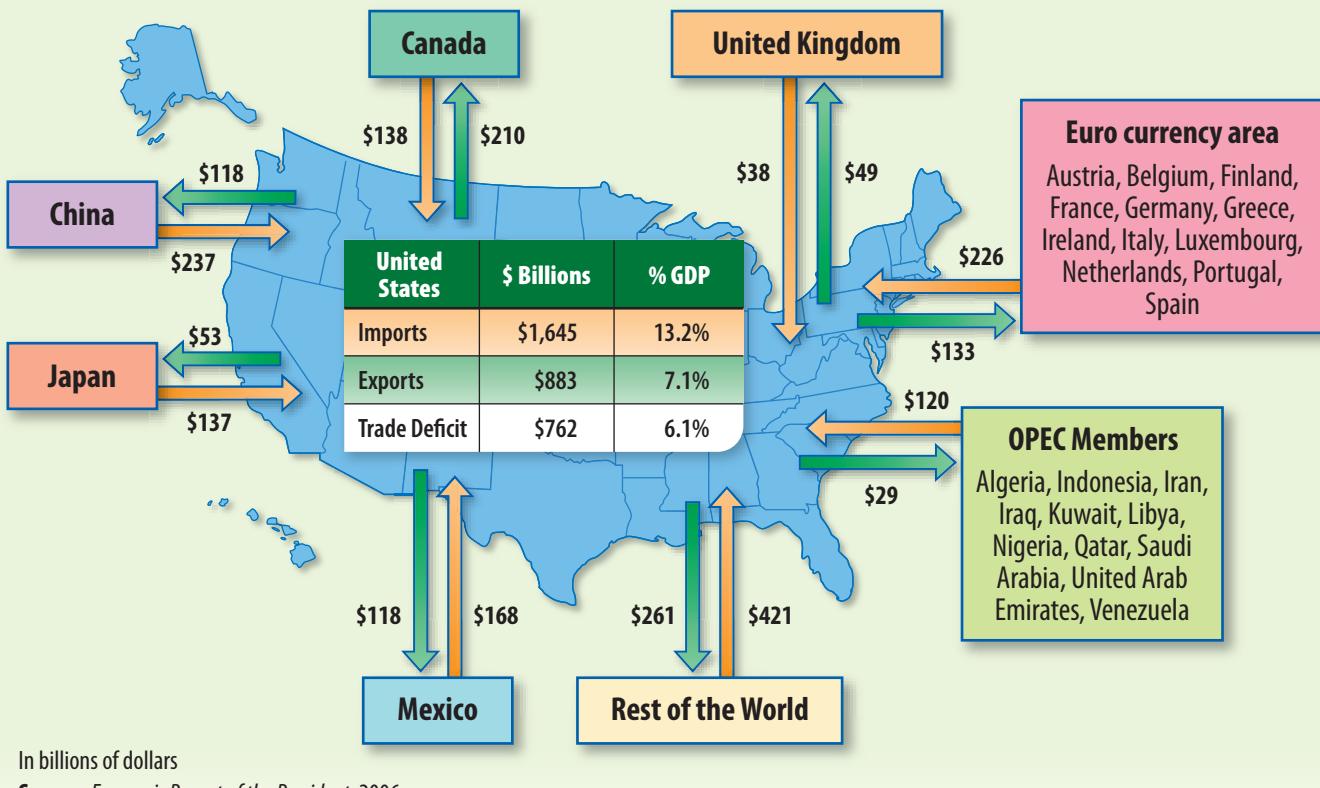
**Economic Analysis** *How does the lack of certain raw materials force nations to become more interdependent?*



## Figure 16.2 ▶ U.S. Merchandise Trade by Area

► The United States exports merchandise (goods) all over the world. The biggest trade imbalance is with China, followed by the OPEC members.

**Economic Analysis** Which single area of the world trades the most with the United States?



countries exchange are goods. However, trade in services such as banking and insurance is increasing.

**Figure 16.2** shows the patterns of merchandise trade for the United States with the rest of the world. The import of goods alone amounts to \$1,645 billion, or about \$5,500 per person. The numbers in the figure would be even larger if we included the value of services.

In the end, international trade is much more than a way to obtain exotic products. The sheer **volume** of trade between nations with such different geographic, political, and religious characteristics is proof that trade is beneficial.

**✓ Reading Check Explaining** Why is specialization a good idea in trade?

## The Basis for Trade

**MAIN Idea** Trade works best when countries focus on those products they can produce best.

**Economics and You** Have you ever bought anything, such as clothing or a meal, that you could have made yourself? Read on to learn how this action relates to international trade.

**absolute advantage**  
country's ability to produce more of a given product than another country can produce

It may be cheaper for a country to import a product than to manufacture it. The difference between absolute and comparative advantage makes this clear.

### Absolute Advantage

A country has an **absolute advantage** when it can produce more of a product than another country. For example, assume



## Figure 16.3 ▶ The Gains From Trade

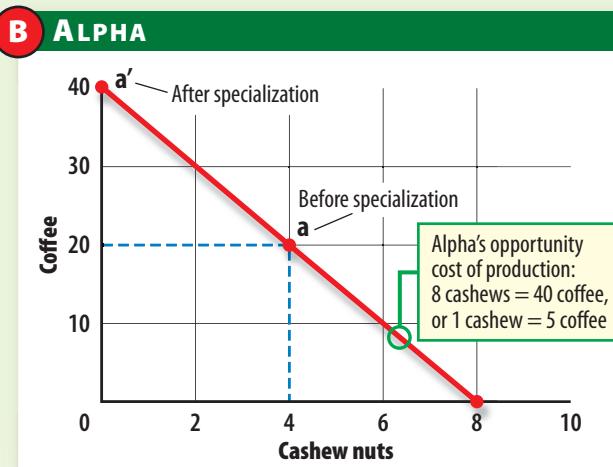
### Graphs In Motion

See StudentWorks™ Plus  
or [glencoe.com](http://glencoe.com).

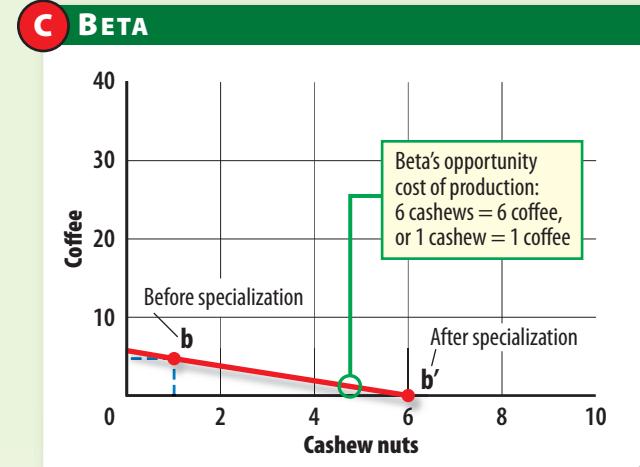
A Total Output Before Specializing		Total Output After Specializing	
Alpha	Beta	Alpha	Beta
Coffee 20 + 5 = 25		Coffee 40 + 0 = 40	
Cashews 4 + 1 = 5		Cashews 0 + 6 = 6	

- 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.

**Economic Analysis** Does Alpha or Beta have a comparative advantage in the production of coffee?



(Coffee and nuts measured in pounds)



**production possibilities frontier** diagram showing the maximum combinations of goods and/or services an economy can produce when all resources are fully employed (also see page 21)

**comparative advantage** country's ability to produce a given product relatively more efficiently than another country by doing it at a lower opportunity cost

**opportunity cost** cost of the next-best alternative use of money, time, or resources when making a choice (also see page 20)

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.

In **Figure 16.3** you see an illustration of 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. If both countries concentrate on producing 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 two countries could benefit from an exchange in which a country with a large output like Alpha traded with a country with a smaller output like Beta.

### 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 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). 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 see 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 specializing in the products they produce best. This applies to individuals, companies, states, and regions as well as to nations.

If we look at the final result of trade between Alpha and Beta, we can see that specialization and trade increased the total world output. Without trade, both countries together produced 25 coffee and 5 cashews. After trade, total world output grew to 40 coffee and 6 cashews.

This explains why countries such as the United States and Colombia trade. The United States has the necessary resources to produce farm equipment efficiently, while Colombia has the resources to produce coffee efficiently. Because each country has a comparative advantage in a product the other country wants, trade will be beneficial to both.

**Reading Check Summarizing** Why is it beneficial for a country to trade with another when it has comparative advantage?



### Student Web Activity

Visit the *Economics: Principles and Practices* Web site at [glencoe.com](http://glencoe.com) and click on Chapter 16—*Student Web Activities* for an activity on international trade agreements.



**Skills Handbook**  
See page R43 to learn about Comparing and Contrasting.

### SECTION

# 1

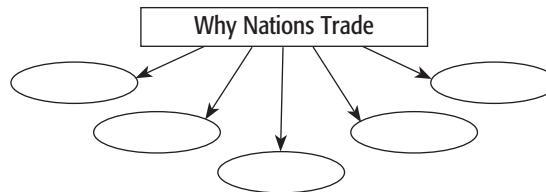
## Review

### Vocabulary

- 1. Explain** the significance of exports, imports, absolute advantage, and comparative advantage.

### Main Ideas

- 2. Listing** Use a graphic organizer like the one below to list the reasons that nations trade with one another.



- 3. Describing** How do specialization and trade benefit both trading partners?

- 4. Explaining** Why does total world output increase as countries specialize to engage in trade?

### Critical Thinking

- 5. The BIG Idea** What does the theory of comparative advantage suggest that countries should do?  
**6. Contrasting** How do comparative advantage and absolute advantage differ? Use examples to support your comparison.  
**7. Predicting** Suppose a nation has a great deal of human capital but few natural resources. In what kinds of products might the nation specialize?  
**8. Analyzing Visuals** Look at Figure 16.3 on page 444. What would happen to total output if Alpha preferred growing cashew nuts and Beta specialized in coffee?

### Applying Economics

- 9. Comparative Advantage** Do you know of a product for which your state has a comparative advantage? Explain how this might affect trade with another state.



# CASE STUDY

## Virgin Group

### Unlimited Advantage

The theory of comparative advantage has led many companies to narrow their product lines. Richard Branson, founder of Virgin Group, did just the opposite. He decided to expand into a wide range of products in an even wider geographic area. Rather than building one large corporation with many divisions, though, Branson decided to create many individual companies united under the Virgin brand. The result: companies located on most continents, selling everything from train rides and low-cost flights to music, mobile phones, and luxury vacations.



### Virgin's Success

1968	Company begins
1970	Start of mail order record sales
1971	Opens first record shop
1973	Virgin record label launched
1984	Virgin Atlantic Airways opens
1987	Virgin Records America founded
1991	Virgin Publishing Company founded
1993	Virgin Radio begins
1999	Virgin Mobile launched
2000	Virgin Cars Produced
2002	Virgin Credit Card established

Source: [www.virgin.com](http://www.virgin.com)

### Finding Niche Markets

Virgin traces its origins back to 1968, when Branson published the first issue of Student Magazine for his university. Shortly after, he expanded into mail-order record sales and record shops. He also launched his own record label, signing such artists as Phil Collins and Boy George.

For over a decade, Branson limited his business ventures to

those related to music. During the 1980s, Branson decided to begin his expansion into other products and worldwide markets. His business plan was to find markets that are either underserved or lack competition. First steps included Virgin Atlantic Air Cargo and a luxury hotel in Spain.

### Success Story

Today, Virgin Group has about 200 companies on most continents. Some provide their everyday customers with affordable vacations. Others cater to a more exclusive crowd, such as a luxury game resort in Africa and a motorcycle limousine service that can skirt London traffic jams. His latest venture will take vacationers into space. Branson's formula for success is apparently working. In 2005 the Virgin Group reported revenues of about \$8 billion.

### Analyzing the Impact

- Recalling** How does the organization of Virgin Group differ from that of most other corporations?
- Drawing Conclusions** How did Branson's business plan allow him to use comparative advantage?



SECTION

## 2

# Barriers to International Trade

## GUIDE TO READING

### Section Preview

In this section, you will learn that nations use tariffs and quotas to protect special interests, while the free trade movement tries to eliminate trade barriers.

### Content Vocabulary

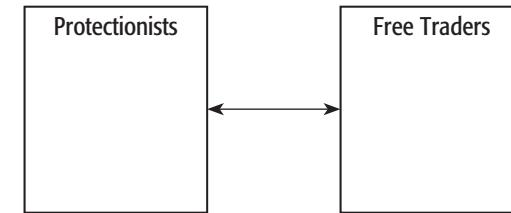
- tariff (p. 448)
- quota (p. 448)
- protective tariff (p. 448)
- revenue tariff (p. 448)
- protectionists (p. 450)
- free traders (p. 450)
- infant industries argument (p. 450)
- balance of payments (p. 452)
- most favored nation clause (p. 453)
- World Trade Organization (WTO) (p. 453)
- North American Free Trade Agreement (NAFTA) (p. 454)

### Academic Vocabulary

- imposed (p. 448)
- justify (p. 450)

### Reading Strategy

**Describing** As you read the section, complete a graphic organizer similar to the one below by describing the arguments of protectionists and free traders.



## ISSUES IN THE NEWS

—www.usinfo.state.gov

### China Economic Ties Under Scrutiny

U.S. Commerce Secretary Carlos Gutierrez warns that the United States might be forced to reassess its economic relationship with China if Beijing fails to address economic frictions between the two countries quickly and effectively. . . . He said that China maintains a range of non-tariff barriers that, in combination with other policies, prevent the United States from achieving balanced trade with that country. . . .

He said that “with a stroke of a pen” China could open critical closed sectors to competition from abroad. “Progress would greatly strengthen those of us who oppose protectionist policies,” Gutierrez said. But if the Chinese government refuses or fails to act quickly, the U.S. Congress might “go down a path that none of us want,” that is “build protectionist barriers around the U.S. market,” he said. ■



**W**hile free markets and international trade can bring many benefits, some people still object, because trade can displace selected industries and groups of workers. When these people object to trade, they look for ways to prevent it, or to at least slow the rate of growth.

Because of the wealth that a market economy can generate, China has decided to join the community of nations committed to markets and trade. China is still new at this, however, and as you read in the news story, it is trying to protect some sectors of the economy while opening up to trade.



**tariff** tax placed on an imported product

**quota** limit on the amount of a good that is allowed into a country

**protective tariff** tax on an imported product designed to protect less-efficient domestic producers

**revenue tariff** tax placed on imported goods to raise revenue

## Restricting International Trade

**MAIN Idea** Tariffs and quotas are the main ways to restrict international trade.

**Economics and You** Have you noticed where your clothes, electronics, or home appliances are made? Read on to find out about ways to restrict imports of such goods.

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** In 2002 a temporary tariff on steel imports protected the jobs of steelworkers such as this one. **What is the name of this kind of tariff?**



The result of the tariff is that a domestic industry is protected from being undersold by a foreign one.

The **revenue tariff** is a tariff that is 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, consumers would prefer the imported one because it is 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. After the federal income tax became law in 1913, the government had a new and more lucrative source of revenue. Since then tariffs—also called customs duties—have accounted for only a small portion of total government revenue, as shown in Figure 9.3 on page 239.

In practice, a tariff achieves a little bit of both goals—it gives some protection and it raises some revenue. In 2002, for

example, the Bush administration imposed a 30 percent temporary tariff on foreign steel imports to protect the domestic steel industry. The tariff raised some revenue and preserved some jobs during an election year, but it also raised the price of domestic steel by 20 to 30 percent—and hence the cost of goods to U.S. consumers.

## Quotas

Foreign goods sometimes cost so little that even a high tariff on them might 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 imports. Rather than lower their own prices, domestic manufacturers wanted President Ronald Reagan to establish import quotas on Japanese cars. The Reagan administration agreed. As a result, Americans had fewer cars from which to choose, and the prices of all cars were higher than they otherwise would have been.

More recently, the threat of a quota has been used as a way to persuade other nations to change their trade policies. For example, the United States became concerned when the low prices China charged for its exports of textiles created problems for the domestic textile industry. In order to make China raise prices, in 2005 the government threatened China with quotas on these textiles. While it may seem odd to have the U.S. government pursue policies that would raise the cost of products to American citizens, the real purpose of a quota is to protect domestic industries and the jobs in those industries.

## Other Barriers

Tariffs and quotas are not the only barriers to trade. Many imported foods are subject to health inspections that are far more rigorous than those given to domestic foods. For years this tactic was used to keep beef from Argentina out of the United States. Another method 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. Other nations also use health issues to restrict trade. Several European countries, for example, refuse to import genetically altered crops grown in the United States.

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

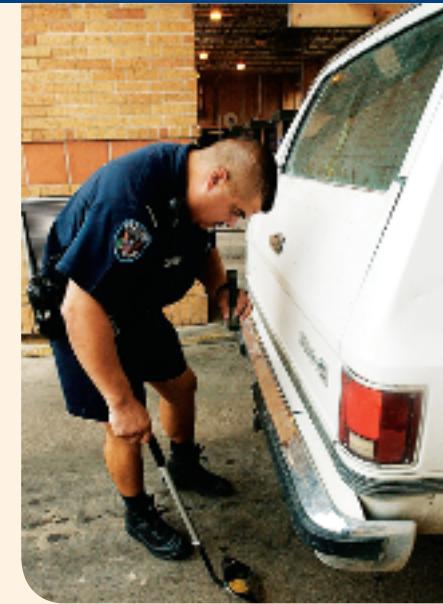
✓**Reading Check** **Comparing** How do tariffs and quotas differ?

## CAREERS

### Customs Inspector

#### The Work

- \* Inspect cargo, baggage, and articles worn or carried by people, vessels, vehicles, trains, and aircraft entering or leaving the United States
- \* Examine, count, measure, weigh, gauge, and sample commercial and noncommercial cargoes entering and leaving the United States
- \* Seize prohibited or smuggled articles and intercept contraband
- \* Apprehend, search, detain, and arrest violators of U.S. laws



#### Qualifications

- \* Must be a U.S. citizen between 21 and 36 years of age when hired
- \* Possess a valid driver's license and pass a civil service exam
- \* Must pass a background investigation, meet certain health requirements, and undergo a drug screening test
- \* Bachelor's degree and one year of related work experience

#### Earnings

- \* Starting annual salary: \$35,100

#### Job Growth Outlook

- \* Average

Source: *Occupational Outlook Handbook, 2006–2007 Edition*



## protectionist

person who wants to protect domestic producers against foreign competition with tariffs, quotas, and other trade barriers

**free trader** person who favors fewer or even no trade restrictions

## infant industries argument

argument that new and emerging industries should be protected from foreign competition until they are strong enough to compete

# Arguments for Protection

**MAIN Idea** Protectionists disagree with free traders over the best way to protect a country's independence, industries, and workers.

**Economics and You** What might you be willing to do to ensure the well-being of your family? Read on to learn why protectionists want to limit international trade.

Freer international trade has been a subject of debate for many years. **Protectionists** are people who favor trade barriers to protect domestic industries. Other people, known as **free traders**, prefer fewer or even no trade restrictions. The debate between the two groups usually centers on the six arguments for protection discussed below.

## Aiding 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, some smaller countries such as Israel and South Africa have developed large armaments industries to prepare for such crises. They want to be sure they will have a domestic supply should hostilities break out or other countries impose economic sanctions such as 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, automobile, ceramic, and electronics industries all have argued that they are critical to national defense and so should receive some protection.

## Promoting Infant Industries

The **infant industries argument**—that new or emerging industries should be protected from foreign competition—is also used to **justify** trade barriers. Protectionists claim that some industries need to gain

## Protecting Industries

While Harley-Davidson was not a new industry at the time, trade protection in the 1980s helped it to retool and become a worldwide competitor. **Why do protectionists believe that new industries need protection?**





strength and experience before they can compete against established industries in other countries. Trade barriers, they argue, would give them the time they need to develop.

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 that become accustomed to having protection are often 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 globally competitive automobile 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.

## Protecting Domestic Jobs

A third argument—and the 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. Some steelworkers have even blocked foreign-made cars of coworkers from company parking lots to show their displeasure with the foreign-made steel components in 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 difficult to compete today will find it even more difficult

© Mike Baldwin / Comicon

*Baldwin*



**Outsourcing** Protectionists fear that U.S. jobs might move to other countries and Americans will become unemployed. **Why do free traders disagree with this reasoning?**

to compete in the future unless they change the way they operate. As a result, most free traders believe that it is best not to interfere, thereby keeping the 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 artificially high prices, people buy less of everything, including those goods produced by the protected industries. If the prices of protected products get too high, people look for substitute products, and the jobs that were supposed to be protected will still be lost. Free traders argue that the profit-and-loss system is one of the major features of the American economy and should be allowed to work. Profits reward the efficient and hard working, while losses eliminate the inefficient and weak.



## Limiting Imports

With fewer imports, domestic companies can sell more of their products. **What happens when imports are limited?**



Tom Prisk/Cartoonstock

*"I move we go on record for fewer imports here and more imports there!"*

**balance of payments**  
difference between money paid to, and received from, other nations in trade

## 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 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 at home also hurts those American industries that depend on exports for their jobs.

## Helping the Balance of Payments

Another argument in the free trade debate 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 reduce trade deficits and thus help the balance of payments.

Protectionists overlook the dollars that 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.

## National Pride

A final argument for protection is national pride. France, for example, is proud of its wines and cheeses and protects those industries for nationalistic reasons. In the 1980s, the United States gave temporary protection to Harley-Davidson, an American icon. Whether this is a good idea depends on how long the protection lasts. If it is permanent, then the government is simply protecting inefficient producers.

**Reading Check** **Synthesizing** Do you agree with the protectionists' arguments or those of the free traders? Why?



# The Free Trade Movement

**MAIN Idea** Because tariffs hurt more than they helped during the Great Depression, the United States has found ways to reduce trade restrictions.

**Economics and You** You learned about the Great Depression in your history courses. Read on to find out how tariffs during that time have affected international trade today.

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 Act, one of the most restrictive tariffs in history. It set import duties so high that the prices 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 gives to any 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

such as Canada, 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.

**most favored nation clause**  
trade law allowing another country to enjoy the same tariff reductions the United States negotiates with any third country

**World Trade Organization (WTO)**  
international agency that administers trade agreements, settles trade disputes between governments, organizes trade negotiations, and provides technical assistance and training for developing countries

## World Trade Organization

Regular meetings of the WTO assist in smoothing out or eliminating trade disagreements.

### Why do countries enter trade agreements?





**North American Free Trade Agreement (NAFTA)**  
agreement signed in 1993 to reduce tariffs and increase trade among the United States, Canada, and Mexico

As a result, 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 a bipartisan agreement proposed by President George Bush and concluded by the Clinton administration in 1993.

Before NAFTA, U.S. goods entering Mexico faced tariffs averaging 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 taxes averaging only 4 percent. NAFTA terms outlined a phase-out of tariffs among the three countries over a 15-year period.

Free trade is beneficial 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-paying American jobs would be lost to Mexico. Proponents predicted that trade among all three nations would increase dramatically, stimulating growth and bringing a wider variety of lower-cost goods to everyone.

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 steadily since NAFTA was created. In the end, freer trade has allowed the NAFTA partners to capitalize on their comparative advantages for everyone's benefit.

✓ **Reading Check Recalling** How did the WTO help international trade?

### SECTION

## 2

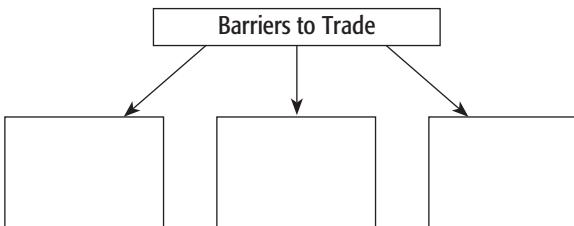
## Review

### Vocabulary

- Explain** the significance of tariff, quota, protective tariff, revenue tariff, protectionists, free traders, infant industries argument, balance of payments, most favored nation clause, World Trade Organization (WTO), and North American Free Trade Agreement (NAFTA).

### Main Ideas

- Describing** Use a graphic organizer like the one below to describe three barriers to international trade.



- Listing** What six arguments are commonly used to support the protectionists' views on trade?
- Describing** What happened to tariffs during the Great Depression?

### Critical Thinking

- The BIG Idea** How do the views of protectionists and free traders differ?
- Drawing Conclusions** If you, as a member of Congress, were approached by a delegation of autoworkers seeking additional tariff or quota protection, how would you respond? Defend your response.
- Synthesizing** How would a high tariff on sugar affect U.S. sugar producers, manufacturers of products containing sugar, consumers, workers in the sugar industry, and workers in other related businesses?
- Analyzing Visuals** Look at the cartoon on page 452. Explain the meaning of "fewer imports here and more imports there" as it relates to the balance of payments.

### Applying Economics

- Quotas and Tariffs** Suppose you were in charge of trade policy for the United States. Would you recommend that we increase or decrease trade barriers on athletic shoes? Explain your answer.



# BusinessWeek NEWSCLIP

Barriers to international trade include tariffs, quotas, and . . . censorship? Before Yahoo!, Google, and other U.S. tech companies enter the Chinese search engine market, they must censor themselves. With more than 110 million Chinese using the Internet, censoring online content is evidently worth the profits generated.

## The Great Firewall of China

It's no secret that Western Internet companies have to hew to the party line if they want to do business in China. Google, Yahoo!, and scores of other outfits, both domestic and foreign, have made concessions to China's censors. . . .

Getting a phone call from the government is one part of the picture. What few Westerners know is the size and scope of China's censorship machine and the process by which multinationals, however reluctantly, censor themselves. Few also know that China's censors have kept up with changing technologies, from cell phone text messaging to blogs.

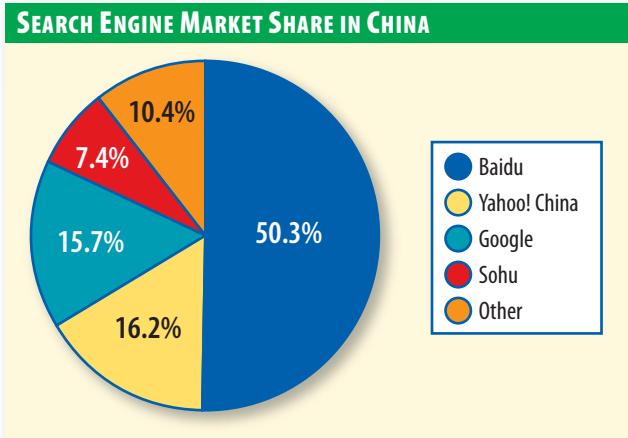
How do the Chinese do it? Beijing has a vast infrastructure of technology to keep an eye on any potential online dissent. It also applies lots of human eyeballs to monitoring. The agencies that watch over the Net employ more than 30,000 people to prowl Web sites, blogs, and chat rooms on the lookout for offensive content as well as scammers. In the U.S., by contrast, the entire CIA employs an estimated 16,000 people.



Companies, both foreign and domestic, also abet the government's efforts. Virtually all Net outfits on the mainland are given a confidential list of hundreds of banned terms they have to watch for. . . .

The restrictions have led many companies to make both subtle and substantial changes to their operations. . . . IDG Venture Technology Investment . . . has invested in a Chinese company that operates online bulletin boards on real estate, entertainment, technology, autos, and more. But "we don't touch politics at all," says Quan Zhou, managing director of the group's Chinese arm. . . . Not that such policies deter investors.

—Reprinted from *BusinessWeek*



### Examining the Newsclip

- 1. Summarizing** How does China censor Internet traffic?
- 2. Making Connections** Why is censorship a form of trade barrier?



## SECTION

## 3

# Foreign Exchange and Trade Deficits

## GUIDE TO READING

### Section Preview

In this section, you will learn that a long-lasting trade deficit affects the value of a nation's currency as well as the value and volume of its exports and imports.

### Content Vocabulary

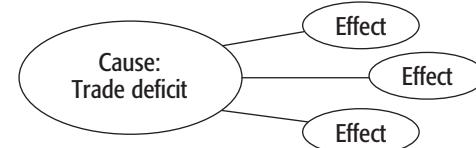
- foreign exchange (p. 457)
- foreign exchange rate (p. 457)
- fixed exchange rates (p. 457)
- flexible exchange rates (p. 458)
- floating exchange rates (p. 458)
- trade deficit (p. 460)
- trade surplus (p. 460)
- trade-weighted value of the dollar (p. 460)

### Academic Vocabulary

- secure (p. 457)
- persistent (p. 460)

### Reading Strategy

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



## ISSUES IN THE NEWS

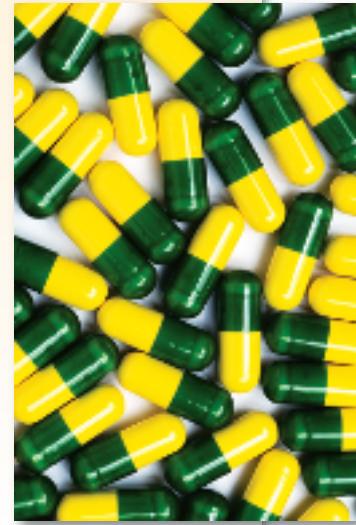
—BusinessWeek

### A Ray of Hope for the Trade Gap

In recent years the U.S. trade deficit has been the No. 1 blight on an otherwise robust economy. Its persistent widening has fueled trade tensions around the world, outsourcing worries among workers, and protectionist sentiment in Washington. Is there a chance for improvement in the trade gap anytime soon?

Well, don't look for outright shrinkage, but the emerging strength in exports is the best sign yet that the rate of deterioration is slowing and that the deficit may even level off later this year.

. . . Overseas demand is picking up as economies from Japan to Europe shake off the blahs of recent years. . . . The other big plus in the export outlook is the dollar's renewed decline, which will give U.S. goods an extra bit of competitiveness in many global markets. ■



**Skills Handbook**  
See page R38 to learn about **Distinguishing Fact From Opinion**.

The decline in the value of the American dollar, as you read in the news story above, helped exports by making goods made in the United States cheaper for the rest of the world to buy.

It turns out that this is simply a matter of supply and demand. Whenever people in other countries sell their American dollars, the worldwide supply of dollars increases,

and the value of the dollar declines. If people in other countries decide to buy more American dollars, then the decrease in supply of dollars on world markets drives up the value of the dollar.

As a result, the value of the dollar, euro, yen, and most other international currencies tends to fluctuate daily with changes in supply and demand.



# Financing International Trade

**MAIN Idea** International trade relies on the ability to exchange foreign currencies.

**Economics and You** Have you ever seen a coin or bill from another country? Read on to learn how the exchange rates for currencies are determined.

Scenarios like the following occur every day around 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 the British currency, called “pound sterling,” it also wants to receive all of its payments in pound sterling. Therefore, the American firm must sell its American dollars to buy British pounds.

## Foreign Exchange

In the field of international finance, **foreign exchange**—different 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, or £1, is equal to \$1.89. If the business suits are valued at £1,000 in London, the American importer can go to a U.S. bank and buy a £1,000 check for \$1,890 plus a small service charge. The American firm then pays the British merchant in pounds, and the suits are shipped.

American exporters sometimes accept foreign currency or checks written on foreign banks in exchange for their goods. They deposit the payments in their own banks, which helps the U.S. banking system build a supply of foreign currency. This currency can then 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  $\$1.89 = £1$ , or in terms of foreign currency units per United States dollar, as in  $£0.5291 = \$1$ . The rate is reported both ways, as shown in the foreign currency listings in **Figure 16.4**.

**foreign exchange**  
various currencies  
used to conduct  
international trade

**foreign exchange**  
**rate** price of one  
country’s currency in  
terms of another  
country’s currency

**fixed exchange**  
**rate** system under  
which the values of  
currencies are fixed in  
relation to one another

## Fixed Exchange Rates

Today, two major kinds of exchange rates exist—fixed and flexible. For most of the 1900s, the world depended on the use of **fixed exchange rates**—a system under

**Figure 16.4 ▶ Foreign Exchange Rates**

Exchange Rates, May 12, 2006		
Country	U.S. \$ Equivalent	Currency per U.S. \$
Australia (dollar)	0.7728	1.2940
Brazil (real)	0.4686	2.1340
Britain (pound)	1.8900	0.5291
Canada (dollar)	0.9021	1.1085
China (yuan)	0.1249	8.0056
Denmark (krone)	0.1729	5.7841
EU (euro)	1.2888	0.7759
Hong Kong (dollar)	0.1290	7.7532
India (rupee)	0.0223	44.8900
Japan (yen)	0.0091	110.4900
Malaysia (ringgit)	0.2791	3.5825
Mexico (peso)	0.0905	11.0525
South Africa (rand)	0.1603	6.2375
South Korea (won)	0.0011	932.7662
Sri Lanka (rupee)	0.0097	102.6500
Sweden (krona)	0.1377	7.2632
Switzerland (franc)	0.8319	1.2020
Thailand (bhat)	0.0264	37.900

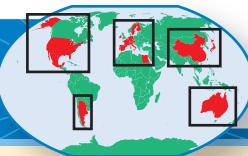
**Source:** finance.yahoo.com

- ▶ Exchange rates change constantly according to the supply and demand for different national currencies.

**Economic Analysis** *About how many Japanese yen equal one U.S. dollar?*



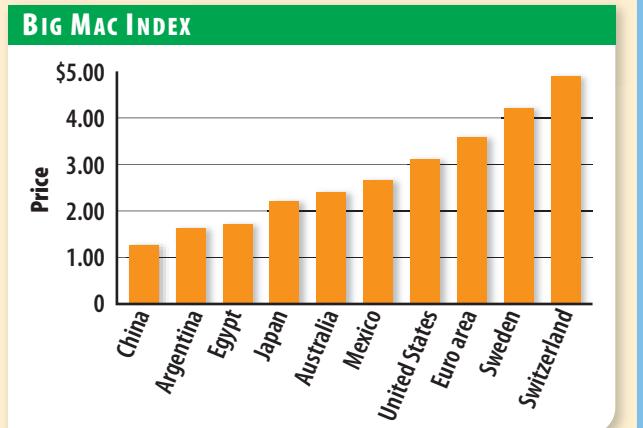
# The Global Economy & YOU



## The Big Mac Index

Exchange rates should adjust to even out the cost of a market basket of goods and services, wherever it is bought around the world. For example, if you use Canadian dollars to buy a sandwich at a Tim Horton's restaurant in Canada, it should cost the same as if you bought the same sandwich using U.S. dollars at a Tim Horton's in the United States.

One way to see whether a currency is devalued or overvalued against the U.S. dollar is to use the "Big Mac Index" developed by *The Economist* magazine. Economists compare the price of a Big Mac hamburger in the United States to what it costs in another country's local currency. Converting the foreign price to U.S. dollars shows whether the price of a Big Mac is undervalued or overvalued against the U.S. dollar. The cheapest burger in the chart here is in China,



Source: *The Economist*, using McDonald's price data

where it costs \$1.30, compared with an average American price of \$3.15. This implies that China's currency, the yuan, is 59 percent undervalued.

**flexible exchange rates or floating exchange rates**  
system that relies on supply and demand to determine the value of one currency in terms of another

which the price of one currency is fixed in terms of another currency 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 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.

This practice worked until the early 1960s when the United States developed a huge appetite for imports. During that time, American consumers bought large quantities of foreign goods with dollars. At first, foreign countries willingly held U.S. dollars because the dollars were acceptable throughout the world as an international currency. This meant that 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 several countries started redeeming their dollars, which drained U.S. gold reserves. As a result, President Richard Nixon announced in 1971 that the United States would no longer redeem foreign-held dollars for gold. This action saved the gold stock, but it also angered many foreign governments that had been planning on cashing their American dollars into gold.

### Flexible Exchange Rates

As soon as the United States stopped redeeming foreign-held dollars for gold, the world monetary system shifted 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 16.5** shows how flexible exchange rates work. For example, in 2006 the price of the dollar was 8 yuan, as shown in **Panel A**. Alternatively, we could say that the price of one yuan was \$0.125 as shown in **Panel B**, because the two numbers are reciprocals of each other.

Suppose now that an American importer wanted to purchase sandals that could be bought for 40 yuan in China. The American importer would have to sell \$5 in the foreign exchange market to obtain the 40 yuan needed to buy the sandals. If this continued over a long period of time, the increased supply of dollars shown in Panel A would drive the price of the dollar down to 6 yuan. The dollar is now cheaper because one dollar costs only 6 yuan rather than 8. At the same time, the increased demand for yuan, shown in Panel B, would raise the price of a single yuan to \$0.167 from \$0.125. The yuan is now more expensive because it costs more in terms of U.S. currency.

When the yuan reaches \$0.167, the price of a pair of sandals is less competitive. This is because the importer now has to pay \$6.68 (or 40 times \$0.167) to obtain enough

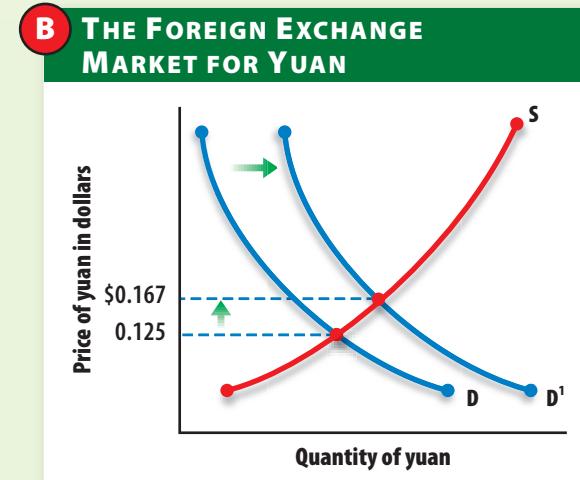
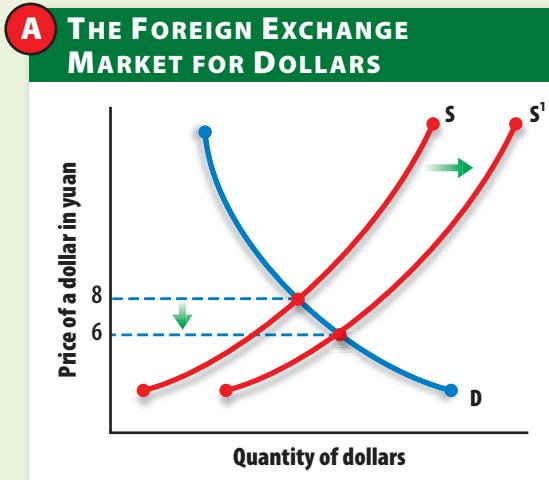
yuan to purchase a pair of sandals. Excessive imports thus can cause the value of the dollar to decline, making imports cost more.

This is bad news for U.S. firms that import products from China, but it is good news for exporters. A Chinese firm that bought American soybeans at \$6 a bushel before the fall in the dollar, for example, would have paid 48 yuan (or  $\$6/0.125$ ) per bushel. Afterward, it had to pay only 36 yuan (or  $\$6/0.167$ ) per bushel. Soybeans became cheaper, and U.S. farmers could sell more abroad. Whenever the dollar falls, exports tend to go up and imports down. If the dollar rises, the reverse will occur.

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. China is not yet on a system of flexible rates, but it is selling so many products abroad that the yuan is under intense pressure to revalue upward, thus becoming more expensive as in the example above.

**Reading Check Summarizing** How do U.S. banks build a supply of foreign currency?

## Figure 16.5 ► Flexible Exchange Rates



- The value of foreign exchange is determined by supply and demand.

**Economic Analysis** When investors sell one currency to buy another, what happens to the value of the currency that is sold?

**Graphs In Motion**

See StudentWorks™ Plus or [glencoe.com](http://glencoe.com).



## Figure 16.6 ▶ International Value of the Dollar

- The forces of supply and demand help set the international value of the dollar. Because the United States now imports more than it exports, the international value of the dollar has fallen.

**Economic Analysis** *What happens to the cost of imports when the dollar falls?*



Source: Federal Reserve System

**trade deficit**  
balance of payments outcome when spending on imports exceeds revenues received from exports

**trade surplus**  
balance of payments outcome when revenues received from exports exceed spending on imports

**trade-weighted value of the dollar** index showing strength of the U.S. dollar against a group of major foreign currencies

## Trade Deficits and Surpluses

**MAIN Idea** The strength of the dollar affects trade and therefore trade deficits and surpluses.

**Economics and You** Have you ever bought an imported product because it was cheaper than the domestic alternative? Read on to find out how the changing value of the dollar affects the cost of goods.

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.

## International Value of the Dollar

Since the dollar started to float in 1971, the Fed has kept a statistic that measures the strength of the dollar. **Figure 16.6** shows the **trade-weighted value of the dollar**, an

index displaying the strength of the dollar against a group of major 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 is strong, as it was in 1985 and 2002, foreign goods become less costly and American exports become more costly for the rest of the world. As a result, imports rise, exports fall, and trade deficits result. With more dollars going abroad, the value of the dollar then goes down.

## Effect of a Trade Deficit

A **persistent** trade imbalance can cause a chain reaction that affects income and employment. To illustrate, the large U.S. trade deficit in 2005 and 2006 flooded the foreign exchange markets with dollars. The increase in the supply of dollars on world markets caused the dollar to lose some of its value, making imports more expensive for Americans and exports less expensive for foreigners.



The recent trade imbalance provided some relief to the U.S. automobile industry. A weaker dollar drives up the price of Japanese-built cars relative to American-built ones. As a result, imported automobiles become less attractive to American buyers. If the dollar continues to weaken, other domestic industries will be affected in a similar manner.

When the value of the dollar gets low enough, the process will reverse. Foreigners will sell their currency so that they can buy more American products. This will drive the value of the dollar up, making it more difficult for American export industries and easier for import industries.

### A Strong vs. a Weak Dollar

Changes in the international supply and demand for dollars cause the value of the dollar to change daily. What is best—a strong dollar or a weak dollar?

The answer is: neither. Under flexible exchange rates, trade deficits tend to correct themselves automatically through the price system. A strong currency generally

## DID YOU KNOW?

**Duty-Free** When Americans return from traveling abroad, they have to fill out a customs declaration form that lists the dollar value of goods they purchased during their trips. Travelers can bring home items ranging in value from \$200 to \$800 duty-free. For anything over that amount, customs officials will charge a duty, or tax on imports. The original purpose of this customs law was to help the balance of payments by making it more difficult for Americans to shop abroad—which shows up as an “import” in the balance of payments accounts.

leads to a deficit in the balance of goods and services and a subsequent decline in the value of the currency. A weak currency tends to cause a trade surplus, which eventually pulls up the value of the currency.

Because one sector of the economy is hurt while another is helped, there is no net gain in having either a strong or a weak dollar. As a result, the United States and many other countries no longer design economic policies just to improve the strength of their currency on international markets.

**Reading Check Describing** Why did the value of the dollar fall in 2005 and 2006?

### SECTION

## 3

### Review

#### Vocabulary

- 1. Explain** the significance of foreign exchange, foreign exchange rate, fixed exchange rates, flexible exchange rates, floating exchange rates, trade deficit, trade surplus, and trade-weighted value of the dollar.

#### Main Ideas

- 2. Identifying** What are the factors involved in determining exchange rates?
- 3. Describing** Use a graphic organizer like the one below to describe what is meant by a strong or weak dollar, and how each affects the prices of imports and exports.

	Description	Effect on imports	Effect on exports
Strong dollar			
Weak dollar			

#### Critical Thinking

- 4. The BIG Idea** What is the relationship between foreign trade and the international value of the dollar?
- 5. Making Generalizations** What would happen if the United States lost its comparative advantage in producing soybeans?
- 6. Analyzing Visuals** Use the information from Figure 16.4 on page 457 to compare the price of a pair of \$100 tennis shoes in the United States with the same brand sold (a) in South Korea at 11,000 ₩ (won) and (b) in France for 100€ (euros).

#### Applying Economics

- 7. Exchange Rates** You are planning to travel to Canada in the next week and have just learned that the Canadian dollar has weakened. Is this good news or bad news? Explain your answer.



# Profiles in Economics



*Jerry Yang, along with his partner David Filo, built a search engine in a trailer at Stanford University to help with their research—and to have some fun. Soon “people from all over the world were using this database that we created.”*

## Jerry Yang (1968– )

- cofounder of the Internet Web portal Yahoo!
- became a billionaire three years after starting the company
- ranked on *Forbes*'s list of the world's richest people

### **Yahoo! . . . and Having Fun**

When 10-year-old Jerry Yang immigrated to the United States from Taiwan, getting an advanced degree was a distant dream. But in 1994, he found himself working on his Ph.D. at Stanford University. Along with his friend David Filo, he began searching sites on the Internet, partly to do research for their doctoral theses . . . and partly to find information about their fantasy basketball leagues.

Frustrated by the chaos of information on the Web, the two students began to organize sites into subject-based categories. Soon the online traffic flocking to “Jerry’s Guide to the World Wide Web” caught the attention of venture capitalists, who provided funds for the start-up company in 1995. Yang and Filo renamed their site Yahoo!, short for “Yet Another Hierarchical Officious Oracle,” and called themselves “Chief Yahoos.”

### **The Face of Business**

Yang has become the public face and business mind of Yahoo!, but he does not direct the day-to-day operations of the company. Instead, he helps develop business strategy and future business direction. Constant travel brings him to all parts of the world, where he can see firsthand how people use his search engine. This helps him with ideas for growing and expanding Yahoo!.

Yang wants to stay on the cutting edge of Web development, and he wants “to continue to get audience.” He knows his site is a hub for online groups worldwide. One way he plans to expand his audience is by tapping into these user groups to find out what they want. Yang also does not hesitate to move away from the Web and develop information delivery on cell phones and other tools.

Despite all this success, Yang has not quite given up on his educational dream. Even today, the Yahoo media relations site lists him as “currently on a leave of absence from Stanford’s electrical engineering Ph.D. program.”

### **Examining the Profile**

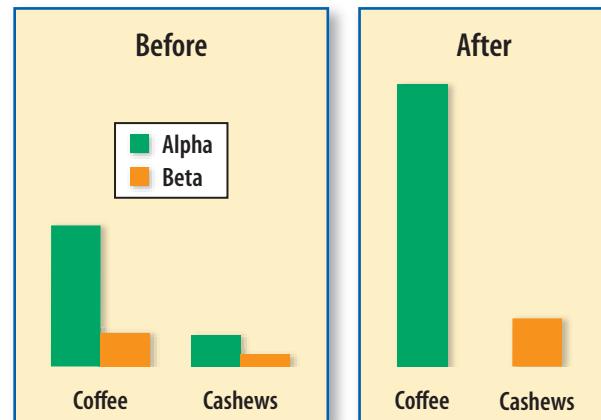
1. **Summarizing** Why did Yang begin organizing Internet sites?
2. **Analyzing** How does Yang hope to stay ahead of the competition?



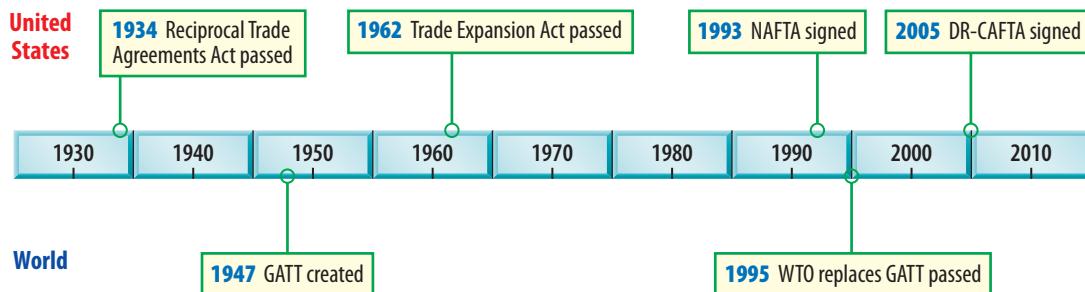
Study anywhere, anytime!

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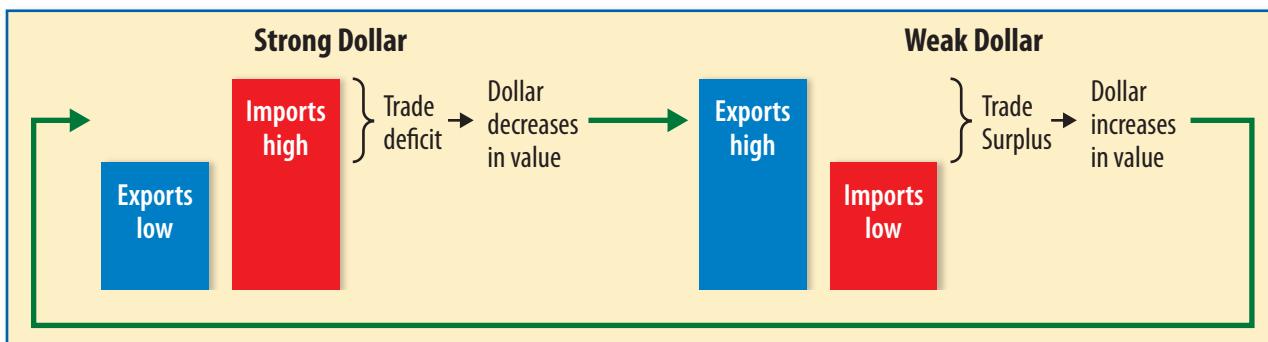
- Absolute and Comparative Advantage** A country has absolute advantage when it can produce more of a product than can another country. It has comparative advantage when it can produce a product at a lower opportunity cost than another country. When countries focus on those products for which they have comparative advantage, world production increases.



- Free Trade Movement** After strict tariffs severely limited world trade during the early years of the Great Depression, the United States and other countries worked to open trade.



- Trade Deficits and Surpluses** The strength of the dollar affects the balance of trade of the United States.



# Assessment & Activities

## Review Content Vocabulary

Write crossword puzzle clues for the terms below. All clues should relate to the content of this chapter and should differ from the definitions in the textbook. Create a puzzle grid as an additional challenge.

1. absolute advantage
2. balance of payments
3. comparative advantage
4. foreign exchange rate
5. exports
6. trade surplus
7. imports
8. protectionism
9. quota
10. tariff
11. trade deficit
12. flexible exchange rate

## Review Academic Vocabulary

Match each term below with its synonym.

- a. enable
- b. imposed
- c. justify
- d. persistent
- e. secure
- f. volume
  
13. capacity, amount, quantity
14. facilitate, permit, make possible
15. forced, established, ordered
16. defend, excuse, rationalize
17. gain, acquire, access
18. tenacious, enduring, constant

## Review the Main Ideas

### Section 1 (pages 441–445)

19. **Identify** the basic assumption supporting the theory of comparative advantage.
20. **Explain** how comparative advantage helps nations acquire goods, services, and the resources they otherwise lack.
21. **Explain** why international trade is important in today's economy.

### Section 2 (pages 447–454)

22. **Describe** the different types of tariffs.
23. **Explain** how tariffs and quotas protect American jobs.
24. **Describe** two attempts to facilitate the growth of international trade by using a graphic organizer like the one below.

Agreement or Organization	Description	Encourages trade by...

### Section 3 (pages 456–461)

25. **Describe** how the value of the dollar is established using a flexible exchange rate.
26. **Describe** the meaning and effect of a trade deficit.
27. **Identify** the reason why the United States switched to a flexible exchange-rate system in the early 1970s.

## Critical Thinking

28. **The BIG Idea** Why is a nation with abundant resources better off trading than being self-sufficient?
29. **Synthesizing** How does comparative advantage make trade between countries of different sizes possible?
30. **Drawing Conclusions** Do you favor protectionism as a national trade policy? Why or why not?

- 31. Making Inferences** How might the issue of protectionism differ for a worker and a consumer? Use examples to support your argument.
- 32. Analyzing Information** Some people think the United States should return to a system of fixed exchange rates. Defend or oppose this view. Cite examples to support your position.
- 33. Drawing Conclusions** How do trade deficits correct themselves under a system of flexible exchange rates?
- 34. Synthesizing Information** Why do you need to know the exchange rate when you plan a trip to a foreign country?

## Math Practice

- 35. Imagine** that you are traveling through South America and staying in budget hotels. Based on the average room rates and exchange rates in the table below, establish the room rates in dollars for each country.

Country	Cost of room in foreign currency	Currency per U.S. \$	Cost of room in U.S. \$
Argentina (peso)	70	0.3247	
Bolivia (boliviano)	96	0.1251	
Brazil (real)	71	0.4561	
Chile (peso)	80	0.001853	
Paraguay (guarani)	41,100	0.0001826	
Peru (neuvo sol)	49	0.3086	
Uruguay (new peso)	299	0.04185	
Venezuela (bolivar)	35,000	0.0003818	

## Thinking Like an Economist

- 36.** Assume that the United States is running a large trade deficit. What predictions would you make about future changes in the value of the dollar in foreign exchange markets? Would these developments be a matter of concern? Explain your answer.

## Writing About Economics

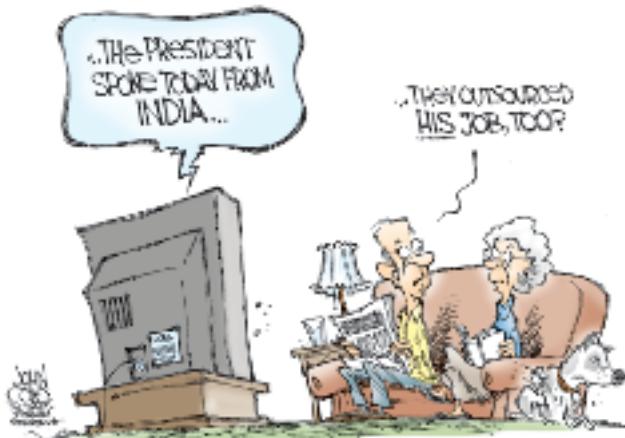
- 37. Persuasive Writing** During the course of one day, make a list of at least 10 manufactured items that you handle, such as your clothing and the cafeteria trays used in your school. Find out where each item is produced, and make a log of the items, noting whether each is domestic- or foreign-made. Based on your log and the information in this chapter, write a persuasive essay supporting or opposing international trade.

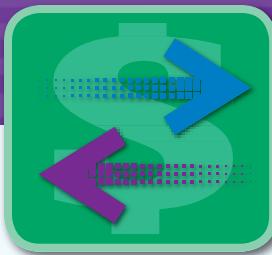
## Applying Economic Concepts

- 38. Foreign Exchange** How does a weak U.S. dollar affect you as a consumer? How does a strong dollar affect you? Explain.
- 39. Comparative Advantage** Think of a project you recently completed with a friend. Apply the principle of comparative advantage to the way you and your friend worked. How could you have completed the project more efficiently? Explain.

## Interpreting Cartoons

- 40. Critical Thinking** What aspect of foreign trade does the cartoonist illustrate in this cartoon? Do you think the cartoon is effective? Explain.





# DEBATES IN ECONOMICS

## Will CAFTA Be Beneficial to the U.S.?

**A**s you learned in Chapter 1, the United States has a remarkable degree of economic interdependence with other nations. On August 2, 2005, President George W. Bush expanded this interdependence by signing into law DR-CAFTA—the Dominican Republic-Central America Free Trade Agreement. This agreement among the United States and Costa Rica, the Dominican Republic, El Salvador, Guatemala, Honduras, and Nicaragua takes effect as soon as all countries involved ratify it. Still, it was hotly debated. Some believe the agreement, sometimes called CAFTA, will help the U.S. economy. Others fear it will be harmful.

Who is right? As you read the selections, ask yourself: Will DR-CAFTA help or harm the U.S. economy?

### PRO CAFTA: A WIN-WIN CASE

The economic case for CAFTA is compelling. First, the level playing field created by the pact would benefit U.S. consumers and businesses. Currently about 80% of Central American products enter the U.S. duty-free. CAFTA would provide some balance with reciprocal treatment for U.S. goods and agricultural exports, and all tariffs on U.S. goods would be eliminated over time. CAFTA would also require increased transparency in corporate governance, legal systems, and due process in the region, strengthening the local economies. For U.S. business, the newly expanded access to the region would benefit companies in financial services, telecommunications, entertainment, and computer services. CAFTA, moreover, would create jobs in Central America and make the

region's economies more competitive with Asian nations.

. . . There are foreign policy reasons to favor the CAFTA accord. Since the 1970s, CAFTA nations have moved toward market economies and democracy, becoming commercial and political allies of the U.S. CAFTA's boost to economic growth and incomes in Central America would further bolster support for free markets and democratic institutions.

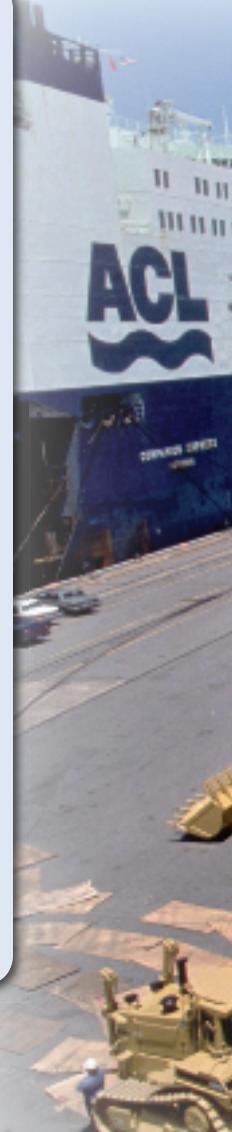
*—Glenn Hubbard, Dean of the Columbia University Business School*

#### CAFTA-DR eliminates these tariffs:

- El Salvador's 30% auto tariff
- Guatemala's 23% tariff on certain footwear
- Plastics and cosmetics tariff of up to 15%
- Air conditioning and refrigeration equipment tariffs of up to 15%
- Building products and home construction accessories, including fixtures, sinks, and doors, 15% tariffs

Current Tariffs on Central America and Dominican Republic Imports from the U.S.	
Motor vehicles/parts	11.0%
Wood products	10.0%
Textile/apparel/leather products	10.0%
Chemicals/petroleum/coal/rubber	5.0%
Ferrous metals	6.3%
Other metals/metal products	3.5%
Transport equipment	3.5%
Electronic equipment	1.4%
Other machinery/equipment	4.0%
Other manufactures	7.1%

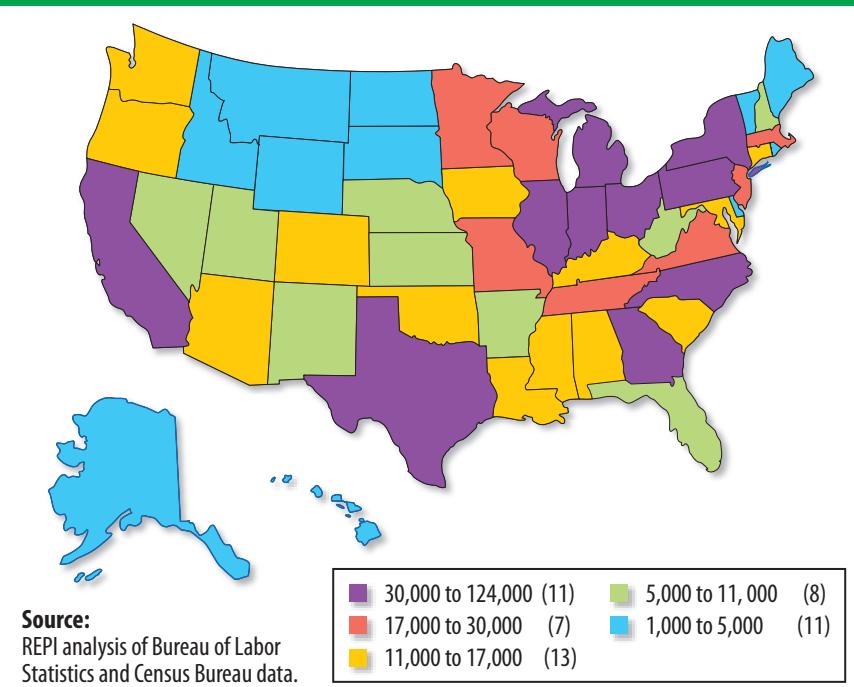
Source: [www.export.gov](http://www.export.gov)





## CON CAFTA COULD LEAD TO FURTHER U.S. JOB DISPLACEMENT

### NAFTA COSTS JOBS IN EVERY STATE



No protections were contained in [NAFTA] to maintain labor or environmental standards. As a result, NAFTA tilted the economic playing field in favor of investors and against workers and the environment, causing a hemispheric “race to the bottom” in wages and environmental quality.

... These experiences raise serious questions about the likely economic impact of the . . . DR-CAFTA agreement on the economies of the United States, and equally important, its neighbors in the Dominican Republic and Central America.

*—Robert E. Scott, Director of International Programs, Economic Policy Institute, and David Ratner, research assistant at the Economic Policy Institute*



### Analyzing the Issue

- 1. Identifying** What arguments does Hubbard make in support of DR-CAFTA?
- 2. Summarizing** Why do Scott and Ratner believe DR-CAFTA will not benefit either the United States or Central America?
- 3. Deciding** Which opinion do you believe is correct? Explain your reasoning.