Trade Policy

1. Why economists like free trade.
2. Comparative advantage.
3. Distributional issues.
4. Trade deficits.
3. Exchange rates.

Why Economists Like Trade

Mutually beneficial trade increases surplus without causing direct harm to anyone else.

Trade restrictions reduce surplus by limiting trade and “forcing” people to choose “second choice” trading partners.

Comparative Advantage

Sometimes it makes sense for Party A to buy a product from Party B, even though Party A can make it at lower cost. This happens when Party B has a *comparative* advantage in making that product.

Comparative Advantage (2)

Example: Suppose, in the U.S., the cost of producing wheat or corn is $1 per bushel. In Canada, suppose the cost of producing a bushel of wheat is $2 but the cost of producing a bushel of corn is $10. For simplicity, also assume that these are the only two countries in the world.

Then it can make sense for the U.S. to buy wheat from Canada, while the U.S. focuses on producing corn. If Canada gives the U.S. three bushels of wheat in exchange for one bushel of corn, then Canada saves $10−$6=$4 in production costs, while the U.S. saves $3−$1=$2 in production costs. Both countries benefit when the U.S. specializes in the crop that is hard for Canada to produce. We say that Canada has a comparative advantage in wheat production, even though its costs are higher.

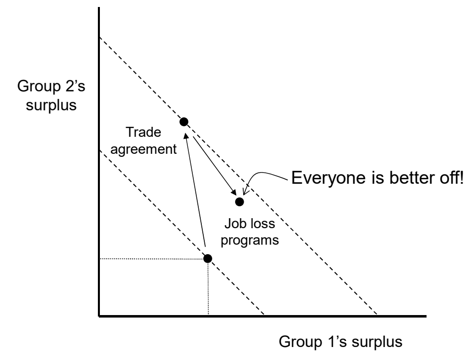
Distributional Issues

Changes in the aggregate pattern of trade can change equilibrium prices.

Changes in equilibrium prices have distributional effects, transferring income from some groups to other groups.

=> Even if increased trade increases the economy's overall wealth, typically some groups benefit more than others, and price changes imply that some groups may even be harmed.

Compensating the Losers



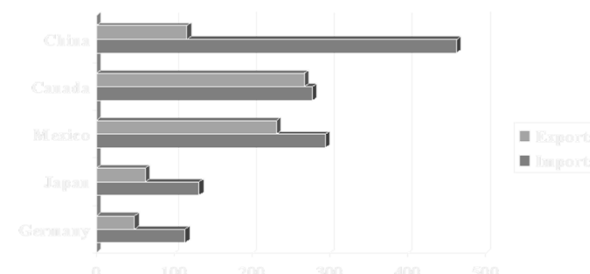
Trade Deficits

The trade deficit is the dollar amount by which imports exceed exports.

The U.S. currently imports about 50% more than it exports, and the resulting trade deficit is almost 3% of the U.S. gross domestic product.

The U.S. runs a small trade surplus in *services*. The deficit is in *merchandise*.

U.S. Trade Partners (2016)



Current Account

The current account measures the net inflow or outflow of dollars from the U.S., excluding purchases or sales of assets.

The current account is affected by:

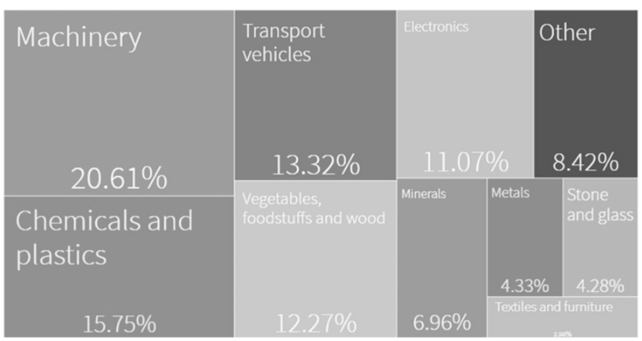
- Trade deficit or surplus.
- Returns to capital owned abroad.
- Gifts to relatives or others abroad.
- Foreign aid by governments, or charities.

Effects of a Current Account Deficit

A deficit in the current account implies that dollars build up overseas. Those dollars either:

1) Stay overseas as dollar reserves;
   or
2) Return to the U.S. through purchases of U.S. assets.

U.S. Exports (2016)



Exchange Rates

Most exchange rates (e.g. dollar/euro) are set in competitive (worldwide) markets.

Exchange rates are influenced by:

- Demand for currency to support trade.
- Demand for currencies that hold value.
- Relative demand for different countries' products. (Excess demand lifts the country's currency.)