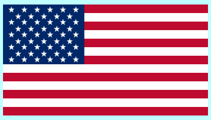
Unit 5

International Trade

NAFTA

NORTH AMERICAN FREE TRADE AGREEMENT



-In a typical year, about 15 percent of the world's output is traded in international markets.

-Of course, the importance of the international sector varies enormously from country to country.

-Some nations are almost closed economies (no interactions with other economies), with foreign trade equaling only a very small proportion (perhaps 5 percent) of total output.

-In Canada's open economy, exports were about 38 percent of GDP, while imports of goods and services were about 34 percent of GDP.

-In the United States, by contrast, exports were only 10 percent of GDP, while imports were 14 percent of GDP.

-The volume of international trade has increased substantially in Canada over the last 50 years; exports and imports have gone from about 20 percent of GDP to almost 40 percent.

-Most of this change has taken place since the early 1990's.

Canada's Trading Partners

-In early history, Canadian international trade was largely directed to Europe and Great Britain in particular. Now Canada trades with many different countries.

-The single most important Canadian trading partner is the United States, accounting for an enormous 83 percent of our exports and 70 percent of our imports.

Trade

-Why would anyone (or country) want to buy something rather than make it at home?

-In other words, why are people not self-sufficient? Adam Smith, father of modern day Economics, had an answer for this:

> *It is the maxim of every prudent master of a family, never to make at home what it will cost him more to make than to buy.*

-This, in essence, is the main argument for trade: why make something yourself if you can buy it cheaper elsewhere?

Specialization is the cornerstone of trade. Big advantages can be gained from specialization. From an individual's point of view, each of us is better suited to one thing than to another. Rather than try to grow all of our own food, make our own clothes, build our own cars, it makes more sense to specialize in our chosen occupation and with the proceeds obtain things that other people can make better and cheaper.

The Principle of Comparative Advantage

-Ricardo's theory of international trade centers on the concept of comparative advantage. A person, a region, or a country can gain by specializing in the production of the good in which they have the comparative advantage.

-That is, if they can produce a good or service at a lower opportunity cost than others, we say that they have a comparative advantage in the production of that good or service.

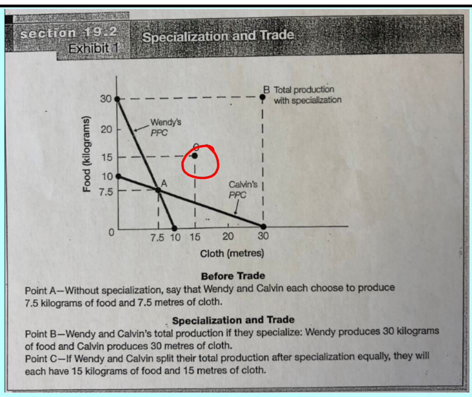
-In other words, a country or a region should specialize in producing and selling those items that it can produce at a lower opportunity cost than other regions.

Absolute Advantage

-Absolute advantage refers to the ability of a country to produce a good more efficiently than other countries. In other words, a country that has an absolute advantage can produce a good with lower marginal cost (fewer materials, cheaper materials, in less time, with fewer workers, with cheaper workers, etc.)

-Absolute advantage differs from comparative advantage, which refers to the ability of a country to produce specific goods at a lower opportunity cost.

-A country with an absolute advantage can sell the good for less than a country that does not have the absolute advantage. For example, the Canadian economy, which is rich in low cost land, has an absolute advantage in agricultural production relative to some other countries. China and other Asian economies export low-cost manufactured goods, which take advantage of their much lower unit labor costs.



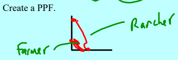
Practice Questions

A farmer can produce 1kg of meat or 1kg of potatoes in an hour. A rancher can produce 8kg of meat or 2kg of potatoes also in an hour.

1. Create a table.

	meat	potatoes
Farmer	1kg	1kg
Rancher	8kg	2kg

2. Create a PPF.



3. What is the opportunity cost for the rancher and the farmer for one kg of meat and one kg of potatoes? (always go other over to calculate)

Opportunity cost table

	meat	potatoes
Farmer	$1/1 = 1$	$1/1 = 1$
Rancher	$2/8 = .25$	$8/2 = 4$

According to the PPF, we can see the farmer can use all of his resources to make 1kg of potatoes or 1kg of meat. Therefor, when he chooses to make 1kg of meat he must give up 1kg of potatoes (and vice versa)

The rancher's PPF shows that he can make 8kg of meat or 2kg of potatoes. Therefor, when he chooses to make 1kg of meat he must give up 1/4 of potatoes. When he chooses to make 1kg of potatoes he must give up 4kg of meat.

4. Who has the comparative advantage in the production of meat? potatoes? (lower opportunity cost)

CA of meat = Rancher
CA of potatoes = Farmer

5. Who has the absolute advantage?

Rancher for both products.

6. Are there potential gains from trade between the farmer and the rancher?

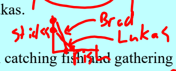
Yes. The rancher should trade meat to the farmer for potatoes.

Lukas can gather 25 sticks or catch 3 fish per hour. His friend Brad can gather 30 sticks or catch 2 fish per hour.

1. Create a table.

	Sticks	Fish
Lukas	25	3
Brad	30	2

2. Create a PPF for both Brad and Lukas.



3. Who has the absolute advantage in catching fish and gathering sticks?

AA sticks → Brad, AA fish → Lukas

4. Who has the comparative advantage in gathering sticks and catching fish? (lower opportunity cost)

Opportunity cost table

	Sticks	Fish
Lukas	$3/25 = 0.12$	$25/3 = 8.3$
Brad	$2/30 = 0.07$	$30/2 = 15$

use least cost

CA sticks → Brad, CA fish → Lukas

5. If trade were to take place between the two people briefly describe what this would look like.

Canada and the US can produce lumber and oil. Canada can make 40 tonnes of lumber or 2 million barrels of oil. The US can make 10 tonne of lumber or 3 million barrels of oil.

1. Create a table. CAN 40 2
   US 10 3
2. Create a PPF for Canada and US.
3. Who has the absolute advantage in oil? lumber?
4. Who has the comparative advantage in oil? lumber?
5. Who will trade with who?

AA and CA Worksheet

-Complete for Monday

Summative In Class Assignment

Barriers to Trade:
Tariffs, Import Quotas and Subsidies

For as long as nations and international trade have existed, people have debated whether a country is better of with free international trade or with protection from foreign competition. The debate continues, but for most economists, a verdict has been delivered. Free trade promotes prosperity for all; protection is inefficient. Free trade (when done well) has the following advantages:

1. Lower prices
2. Higher incomes
3. A greater variety of products
4. Increased competition

Despite this, protection still occurs.

Tariffs:
The first barrier to trade is a tariff, which is a tax on imported goods. Tariffs are usually relatively small revenue producers that slow the expansion of trade. They bring about higher prices and revenues to domestic producers, and lower sales and revenues to foreign producers.

Tariffs lead to:

1. A smaller total quantity sold
2. A higher price for domestic consumers'
3. Greater sales at higher prices for domestic producers
4. Lower sales of foreign products

While domestic producers do gain more sales and higher earnings, consumers lose much more. Despite this there are arguments for tariffs.

1. Temporary trade restrictions help infant industries grow.

Rationale: This argument states that it is necessary to protect a new industry to enable it to grow into a mature industry that can compete in world markets. (Example: Swiss Watches)

Why this argument doesn't work:
-Loan this companies the money to grow more quickly (more efficient)
-Tariffs stay in place for too long

2. Tariffs can reduce unemployment.

Rationale: When we buy shoes from Brazil or shirts from Taiwan, Canadian workers in these industries lose their jobs. With no earnings and poor prospects, these workers become a drain on welfare and spend less, causing a ripple effect of further job losses.

Why this argument doesn't work: Free trade does cost some jobs, but it also creates other jobs.
- Jobs created in other parts of the world
- Canadian workers go to expanding export industries
- Jobs are created for those people selling imports etc.

Bottom line is that free trade brings about global rationalization of labour and allocates labour resources to their highest-valued activities.

3. Tariffs are necessary for National Security reasons.

Rationale: Tariffs are a means of preventing a nation from becoming too dependent on foreign suppliers of goods vital to national security.

Why this argument doesn't work: High tariffs will cause an economy to deplete domestic resources. Any of the resources which are non-renewable will be depleted, and this means we will be more reliant on foreign resources in the future.

Import Quotas:

An import quota is a legal limit on the imported quantity of a good that is produced abroad and can be sold in domestic markets. Import quotas directly restrict imports, leading to reductions in trade and thus preventing nations from fully realizing their comparative advantage.

Example: Suppose that the Japanese have been sending 50,000 cars annually to Canada but now are told that, because of quota restrictions, they can only send 30, 000 cars. The Japanese companies would likely raise the prices on these 30, 000 cars above what the 50, 000 original buyers would have paid for them.

Subsidies:

-Working in the opposite direction, governments sometimes try to encourage exports by subsidizing producers.

-With a subsidy, revenue is given to producers for each exported unit of output. This stimulates exports.

-While not a barrier to trade like tariffs and quotas, objections can be raised that subsidies distort trade patterns and lead to inefficiencies. With subsidies, producers will exports goods not because their costs are lower than that of a foreign competitor, but because their costs have been artificially reduced by government action, transferring income from taxpayers to the exporter. Gains from trade in terms of world output are reduced from such subsidies.

<u>Reading on trade</u>

1. According to the article, how does the Trump administration want to bring back "American jobs"?

2. What would the effects of this be on the Indiana (and American) economy?

International Trade
Formative Assignment

Assessment on Monday