Chapter 24 Lesson 1

Why and How Nations Trade

Why do people trade?

Trade Between Nations

Individual nations do not always have the necessary resources to make the products their people need and want. To solve this problem of scarcity, nations trade with one another. They trade food, manufactured goods, services, and even raw materials. Nations import, or bring into the country, goods produced in other nations. They export, or sell to other nations, goods they produce.

The main reason countries trade is because of comparative advantage. Comparative advantage is the ability to produce something at a lower opportunity cost than another country can. (Give example.)

Country A could produce 1 bicycle or 10 units of bread while Country B can produce 1 bicycle or 15 units of bread. Country A thus has a lower opportunity cost, it has a comparative advantage in making bicycles.

A country’s factors of production – natural resources, labor, capital, and entrepreneurs – often determine its comparative advantage. China’s large population gives it a large labor force, many of the workers are unskilled who earn low wages, China has a comparative advantage in manufacturing goods that need a lot of labor to produce. Nations with large areas of farm and ranch land – like Brazil and the US – have a comparative advantage in farm exports.

Some less advanced economies specialize in a single export. These are known as single-resource economies. Reliance on a single resource can be risky if there are changes in the marketplace. Diversified economies are better able to respond to market changes.

Managing Trade

Because many customers want low prices, many of the nation’s stores line shelves with products from nations with low labor costs. China can produce goods more cheaply than the US, consumers benefit when they buy these less costly goods. When they do, however, they take business away from domestic companies, or companies operating in the US. This can hurt those companies, leading them to cut production and lay off their workers.

Trade Barriers

Countries that are hurt in this way often resort to protectionism, the use of tactics that make imported goods more expensive than domesticated goods. Governments try to protect home industries in 3 ways: tariffs, import quotas, or subsidies.

Tariff: a tax on imports. The goal is to make the price of imported goods higher than the price of those goods produced at home.

Quota: an import quota limits the amount of a particular good that enters the country.

Subsidies: a payment or other benefit given by the government to help a domestic producer.

Free Trade Agreements

Almost all economists agree that the total cost of trade barriers is higher than their benefits. Most countries try to reduce trade barriers leading to a policy known as free trade. In 1994, the US, Canada and Mexico joined together to create a free trade zone (largest in the world). North American Free Trade Agreement (NAFTA). The 3 countries agreed to remove most trade barriers. Since then trade has tripled bringing lower prices and greater variety of goods to consumers. However, many companies hurt by these imports lost sales and had to close factories resulting in thousands of jobs being lost. The benefits of free trade encouraged 27 countries in Europe to form the largest economy in the world, the European Union (EU). The EU is to integrate or combine the economies of its members. It creates a free trade zone where goods and services and workers can travel freely across national borders. Most EU nations even share a common currency the Euro.

The AU promotes this idea among nations in Africa and the APEC does the same in Asia.

The World Trade Organization

1995 founding of a group of 153 member nations the World Trade Organization (WTO). The WTO oversees trade agreements and tries to settle disputes among its member nations. One goal is to help countries that are trying to build their economies. Some critics say the WTO actually hurts poor countries charging that its policies favor big corporations and hurt workers, the environment, and poor countries.

Balance of Trade

The difference between the value of a nation’s imports and the value of its exports is the balance of trade. That balance can be negative or positive.

Positive Balance of Trade

If a country’s exports is 100 billion and its imports are 70 billion it is said to have a positive balance of trade of 30 billion. This is known as a trade surplus. A country that has a long period of a trade surplus will see the value of its currency increase as well.

Negative Balance of Trade

When a nation imports more than it exports, it has a negative balance of trade. A country exports 70 billion and imports 100 billion it has a trade deficit of 30 billion. Two results of a long term trade deficit are low demand for domestic goods slows production for goods at home leading to job losses. The currency tends to fall.

Role of Currency and Exchange Rates

Each country likes to use its own currency to trade, for example in Japan they like to use the yen. The value of one currency in terms of another currency is its exchange rate.

For example, the US wants to import goods from Japan and Japan wants to be paid in yen. As a result the US must sell dollars and buy yen making more dollars available in the markets. The higher the supply of dollars the less the dollar is worth. This is not always a bad thing it usually helps exports by making goods less expensive.