International Trade and the Economy

Federal Reserve Bank of Dallas

Grade Levels: 9,10,11,12

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Description:
Full color booklet which discusses the basics of international trade.

This document may be printed.
Today, no country can long remain isolated from the rest of the world.

international (in′-te

Our businesses, our technology, our standard of living and all other

relating to or affected by

complicated flows of products, services, money, equipment and technology. It

nations or national

skills are combined; people in every country can benefit from trading with

reaching beyond national

providing new and better jobs, and encouraging innovations in equipment

trade (trad′) n. 1: an exchange

standard of living as well as the living standards of people in other countries

for another. 2: the buying

and open markets become increasingly clear.

selling or bartering
r-nashéenéĺ) adj. 1: facets of our economy are tied to the economies of other countries by acting two or more lities. 2: known or other countries. By reducing prices on the goods and services we buy, tional boundaries. and materials, trade provides an excellent means of improving our change of one thing As the world becomes one giant marketplace, the benefits of trade siness of buying and goods and services.
Why Trade?

As consumers, all of us have an interest in trading with other countries. We often are unaware of trade’s influence on product prices and the quality and availability of the goods we buy, but we all benefit from the greater abundance and variety of products and the lower prices that trading with others makes possible.

Without trade, countries become isolated. The quality of their goods and services lags behind that of countries that do trade. We see evidence of this in Eastern European countries that restricted access to their markets for much of the 20th century.
The international flows of trade are bafflingly complex. Materials for an item as uncomplicated as a pencil come from many countries: the wood from Canada, the graphite from Brazil or Argentina, the rubber eraser from Vietnam, Malaysia or Singapore, and the bauxite used to produce aluminum for the eraser casing comes from Jamaica. Finally, the United States processes the aluminum casing, and workers from Mexico put the pencil together. The result — all of these countries have benefited from producing the simple pencil.
Every time we walk into a store, restaurant, theater or any other place of business to buy something, we trade — whether the goods we are acquiring were produced across the street or across the Rio Grande. Essentially, then, international trade does not differ from trade with other people in the United States. The key to understanding trade is to remember why it takes place. The reason people trade, regardless of where they live, is because they believe they will be better off by trading. When we consider the alternative — each of us producing everything for ourselves — trade simply makes more sense.

The process of importing and exporting creates a greater variety of goods and services because it permits countries to specialize in what they do best. By specializing in the goods it can produce the most efficiently, a country can increase production. By distributing those goods to firms and individuals throughout the world, businesses have the opportunity to make more sales and profits. Profits can translate into increased wages for the work force and additional investment in plants and equipment. The process also provides consumers with more goods at lower prices.

International trade is the system by which countries exchange goods and services.

**Absolute and Comparative Advantage**

The benefits of trade can be explained using the economic principles of absolute and comparative advantage. For example, suppose a lawyer is a better lawyer and a better typist than a legal assistant, because it takes the lawyer less time to prepare briefs or to type letters than it does the assistant. In economic language, the lawyer has an “absolute advantage” both in preparing legal briefs and in typing letters. If we stopped here, we might be inclined to say that the lawyer should produce both, because the lawyer is better at both.
But the beauty of trade is that it is beneficial even when one person or, more generally, one country has an absolute advantage in producing almost everything. That's because the gains from trade depend on a concept that economists call "comparative advantage."

The goods and services that a country buys from other countries are called imports, and goods and services that are sold to other countries are called exports.

According to comparative advantage, the lawyer should specialize in his or her strongest skill, probably the law, and the legal assistant should specialize (in this case) in what he or she does relatively best, probably typing letters. If they specialize, they actually will produce more than if each of them had tried to do both tasks alone. Specializing in what they do best and then trading their product for the other things they need will make both parties better off.

The Benefits of Trade

To benefit from international trade, countries must specialize, just as the lawyer and the legal assistant did. Why? Because countries also have only a finite quantity of resources; producing more of one implies taking resources away from the production of another. Every country's unique combination of scarce natural resources, labor and capital determines what goods and services its people can produce most efficiently.

Through trade, countries exchange goods they produce most efficiently for goods other countries produce most efficiently. The more consumers there are in the market, the greater the ability of each country to specialize in what it does best. It is important to note that both the lawyer and the legal assistant would benefit from specialization and trade. Likewise, free trade is a win–win situation for all countries that participate.
In a world where the old is constantly giving way to the new, where the efficient and productive are always replacing the less efficient and less productive, yesterday’s jobs have to make room for tomorrow’s. The invention of the automobile, for example, eliminated many blacksmith jobs but replaced them with higher skilled, better paying work. Just as technological progress makes the country richer, so does free trade.
road construction

gas stations

oil drilling

cab drivers

mechanics

drive thru
GATT — The Worldwide Effort to Open Trade

Before World War II, the benefits of free trade were not well known around the world. Especially during the 1930s, countries extensively used tariffs — taxes on imports — to protect domestic industries from foreign competition. The most well-known and damaging such measure in the United States was the Smoot–Hawley tariff of 1930, which raised tariffs on almost a thousand goods coming into the United States. This practice caused other countries to retaliate with high tariffs on U.S. exports, creating a situation that nearly halted world trade. In fact, many economists regard this tariff as a major contributor to the severity of the worldwide depression of the 1930s.

After World War II, the United States and other countries began to understand the harmful effects of protectionist tariffs, and negotiations to reduce them took place in Switzerland in 1947. The outcome of these negotiations was the General Agreement on Tariffs and Trade (GATT), which provides a framework for less government interference in international trade. Since World War II, the trade policies of the United States and more than a hundred other countries have been conducted under the umbrella of this agreement. The result has been worldwide growth in the amount of trade between nations and a higher standard of living in those countries that have opened their markets to trade.
Protectionism and Free Trade

Because international trade benefits all countries, one might expect everyone to be in favor of free trade, permitting goods and services to flow without restrictions. But although the case for free trade is strong, there are people who want to erect barriers against the free flow of products and services. These barriers constitute what is called protectionism.

Protectionists argue that opening our borders to trade with other countries will cause people in the United States to lose their jobs. However, while it is true that some jobs will be lost due to foreign competition, it is also true that free trade creates new jobs. The outcome is greater specialization, more efficiency, more production and better jobs.

An example may best illustrate how this works. Suppose the United States imposed high tariffs on imported steel to protect the U.S. steel industry from foreign competition. By limiting competition and raising steel prices, policymakers have preserved profits and saved thousands of jobs in the U.S. steel industry. This is usually where the protectionist argument stops.

Unfortunately, the damage from protectionism is only beginning. Higher prices in the steel industry means U.S. businesses that use steel to produce their goods (tractors and automobiles, for example) will see their costs increase. Some of these costs will be passed on to consumers in the form of higher prices; some of these costs will result in lower profits and job losses. Additionally, when people have to pay more for a lawnmower because steel prices went up, then they have less money to spend on the other things they want to buy — perhaps clothing, food or entertainment. Industries and consumers with no relationship to the steel industry will suffer. The bottom line: protecting special interests to save jobs actually costs jobs and lowers the living standard of all consumers.
The law of comparative advantage says that a country can become more competitive by putting its resources, through investment in training and production facilities, into its most efficient industries. Using its resources in this manner may enable a country to achieve economies of scale — increasing its output in a particular industry so that its costs per unit decrease. Goods that are lower in cost become more competitive in international markets.
A similar argument for protectionism focuses on protecting the nation’s workers from the competition of cheaper foreign labor in low-wage countries. This argument is shortsighted. Workers may command higher wages than workers in another country. But better management and technology, a better system of roads, bridges and communications, and the capability of workers to produce more than another country’s workers for each hour they work may allow a nation to produce a product less expensively and more efficiently, even with higher wages.

Again, an example will make this clear. Suppose the U.S. computer industry has to pay workers $10 per hour to assemble computers, but the Mexican computer industry only has to pay workers $2 per hour. On the surface, it appears that U.S. computer manufacturers should move to Mexico to take advantage of the cheaper labor. But what if U.S. technology is so good that U.S. computer producers can build 45 computers per hour, while Mexican computer workers only can produce five computers per hour? (This example may sound extreme, but it is really quite realistic.) Without even looking at the added benefits of a more advanced transportation, communications and management structure, it is obvious the U.S. computer manufacturer is better off in the United States. It is interesting to note that while some workers in this country argue that they cannot compete with the low wages in other countries, protectionists in low-wage countries argue that they cannot compete with the highly productive industries in the United States.

In the long run, free trade creates new jobs, promotes economic growth, provides a greater variety of goods and services, and lowers consumer prices. By specializing in the goods it can produce most efficiently, a country can increase production. By selling those goods to firms and individuals across the world,
businesses have the opportunity to make more sales and profits. Profits can translate into increased wages for the labor force and additional investment in the economy. The process also provides consumers with more goods at lower prices.

All of this sounds good, but does trading with poorer countries that have lax environmental laws endanger Earth’s fragile environment? Actually, research on the relationship between pollution and economic growth shows that the opposite can be true. When a country can barely feed its people, the priority for environmental cleanliness most likely is quite low. As very poor countries begin to grow, pollution initially could get worse. But as they continue to grow and accumulate wealth, they will have both more resources and a greater resolve to keep the environment clean. Because trade increases economic growth, it gives these countries the resources they need to fight pollution.

Just as the invention of the airplane temporarily displaced some railroad workers and the invention of the computer temporarily displaced some office workers, opening our borders to international trade may cause some job losses in the short run. But because the benefits of free trade are greater than the costs, we can divert some of the resulting wealth into educating and retraining our workers to meet the demands of a changing world. The United States has a comparative advantage in producing goods and services that require an educated, highly skilled work force. Specializing in what we do best and encouraging other countries to do the same will result in more and better jobs in the future. Protecting industries from market competition will dampen our potential, just as it did in Eastern Europe. Preserving our commitment to free enterprise in general and, more specifically, to free international trade will ensure that our living standards will continue to be among the highest in the world.
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