

Chapter 14

THE GLOBAL ECONOMY AND POLICY

Essentials of Economics in Context (Goodwin, et al.), 1st edition

Chapter Overview

This chapter presents different perspectives on the important subject of international trade. It begins by presenting the classical economic contributions to economic theory of Adam Smith and David Ricardo. It shows the reasoning behind why free markets promote specialization and, in turn, efficiency and comparative advantage.

The chapter then discusses other important advantages of trade, but also equally important disadvantages. These illustrate that trade is a much more complex topic than may appear just from looking at the logic of the comparative advantage model. Next, the idea of protectionism—or restrictions on trade—is introduced, with examples such as tariffs and quotas. We look at some reasons why countries sometimes pursue protectionist policies, and also briefly discuss some of today’s trade institutions like the World Trade Organization, the European Union, and the North American Free Trade Agreement. The chapter then discusses some political economy considerations that influence the “fairness” of free trade or protectionism.

The final section of this chapter will take you through the basics of the macroeconomic model with open economy by adding imports and exports to the circular flow diagram. You will learn about international financial system, including discussion on exchange rate systems and balance of payments.

Objectives

After reading and reviewing this chapter, you should be able to:

1. Describe how specialization, productivity, and trade are related.
2. Explain the law of comparative advantage.
3. List the advantages and disadvantages of free trade.
4. Understand the major policy tools countries have used to manage the degree of “openness” of their economies.
5. Explain why countries sometimes follow protectionist policies.
6. Discuss how trade and protectionism relates to issues of fairness.
7. Explain the macroeconomic impact of imports and exports using the circular flow model.
8. Understand basic principles of international finance.

Key Terms

free trade	trade surplus
absolute advantage	purchasing power parity (PPP)
opportunity cost	exchange rate
comparative advantage	purchasing power parity adjustments
labor-intensive production	currency depreciation
capital-intensive production	currency appreciation
factor price equalization	real exchange rate
race to the bottom	foreign exchange
exporting pollution	flexible (floating) exchange rate
protectionism	system
import substitution	capital flight
infant industry	fixed exchange rate system
tariffs	Bretton Woods system
trade quota	devaluation
trade-related subsidy	revaluation
dumping	balance of payments (BOP) account
administrative obstacles	current account (in the BOP account)
World Trade Organization (WTO)	trade account (part of current account)
globalization	capital account (in the BOP account)
trade deficit	official reserve account

Active Review

Fill in the Blank

1. According to Adam Smith, free trade led to specialization, which in turn increased _____.
2. Comparative advantage refers to a country's ability to produce some good or service at a lower _____ than other countries.
3. A productive method that employs a high ratio of labor to capital is known as _____ production.
4. A _____ refers to when countries compete with each other by providing low-cost business environment.
5. Tariffs and quotas are both examples of _____ policies.
6. A government policy undertaken to reduce reliance on inputs and encourage development of domestic industry can be referred to as a/an _____ policy.

7. The practice of selling products at prices below production costs is known as _____.
8. Suppose the U.S. government puts a tax on the imports of steel produced abroad. Such taxes charged on imports or exports are called _____.
9. Countries sometimes set up _____ within their borders, where foreign-owned manufacturers can operate free of many taxes, tariffs, and regulations.
10. The exchange rate between two currencies, when adjusted for inflation in each country, is known as the _____.
11. The notion that, under certain idealized conditions, the exchange rate between the currencies of two countries should be such that the purchasing power of currencies is equalized is called _____.
12. The national account that tracks inflows and outflows arising from international trade, earnings, transfers, and transactions in assets is called the _____.
13. The account that tracks flows arising from international transactions in assets is called the _____.
14. Under a fixed exchange system, if a government lowers the value at which it fixes its exchange rate, the currency will undergo a _____.

True or False

15. Suppose Costa Rica and Panama both produce two goods: bananas and beans. According to the principle of comparative advantage, if Costa Rica produces both bananas and beans less efficiently than Panama, it should simply buy both goods from Panama.
16. Relying excessively on other countries for petroleum imports increases vulnerability to free trade.
17. Lock-in is one of the key strategies followed by countries to achieve prosperity.
18. Exporting pollution is when all countries increase their pollution levels in order to gain a competitive advantage over trading partners.
19. Both quotas and tariffs provide a monetary revenue benefit to the government that has imposed them.
20. When a currency becomes less valuable in a flexible (floating) exchange rate system the correct term to use is “devaluation.”

21. When foreigners buy U.S. bonds or invest in a U.S. business, these are capital outflows in the balance of payments account.
22. The fixed exchange rate system of Bretton Woods broke apart in 1972, when the U.S. dollar came under too much selling pressure.

Short Answer

23. Explain Adam Smith's reasoning for why free trade would lead to economic prosperity.
24. List and describe at least three disadvantages of free trade.
25. List three policy tools to regulate trade in goods and services.
26. Identify and describe each of the three leakages and the three injections in the open economy version of the circular flow model.
27. Explain the difference between "depreciation" and "devaluation."
28. Explain what is meant by purchasing power parity (PPP), and purchasing power parity (PPP) adjustments.

29. Explain what happens to the value of the currency when there's an increase (or decrease) in the supply (or demand) of the currency in a foreign exchange market with flexible exchange rates.

30. Explain what is meant by the balance of payments account, the current account (in the BOP account), and the capital account (in the BOP account).

Problems

1. Suppose that by devoting all its resources to coffee production, Ethiopia can produce 6 tons of coffee, while if it devotes all its resources to peanut production, it can produce 2 tons of peanuts. Senegal can produce 2 tons of coffee if it devotes all its resources there, or 4 tons of peanuts if it grows only peanuts.
 - a. Draw the PPFs for Ethiopia and Senegal. (Put the quantity of coffee on the vertical axes.)
 - b. Which country is the more efficient producer of coffee? Explain how you got your answer.

c. Suppose that Ethiopia would like to consume 4 tons of coffee and 1 ton of peanuts, while Senegal would like to consume 2 tons of coffee and 3 tons of peanuts. Could either country consume their desired consumption bundle, without trade? Show on your graphs above.

d. If the countries trade, could they each get their desired consumption bundle? If so, how?

2. Identify whether each of the following represents an *inflow* or an *outflow* from either the *current account* or the *financial account*:

a. A Mexican banker purchases a United States government bond.

b. A U.S. corporation invests in a Chinese facility.

c. A U.S. corporation collects profits earned in Mexico and sends the money back to United States.

d. An exporter in the U.S. receives payment for goods shipped to France.

e. The U.S. government pays interest to bondholders in China

3. Exchange rates

- a. Suppose under a flexible exchange system, there is a drop in the demand for the U.S. dollar, as investors find higher returns in countries that use the Euro. Use a graph of the foreign exchange market, with the price of dollars expressed as “Euros per dollar” to illustrate the impact on the value of the dollar.

- b. Suppose that under a fixed (or managed) exchange system, China strives to keep the value of its Yuan artificially low. Illustrate with a graph of the foreign exchange market, how China’s Central Bank can do this.

Self Test

1. According to Adam Smith, productivity gains could be brought about through...
 - a. factor-price equalization.
 - b. labor-intensive production.
 - c. diversification.
 - d. market expansion.
 - e. protectionism.

2. David Ricardo is most well-recognized for his...
 - a. advocacy of the GATT and the WTO.
 - b. theory of comparative advantage.
 - c. theory of absolute advantage.
 - d. development of capital-intensive modes of production.
 - e. Slavonic approaches to trade.

3. According to the principle of comparative advantage:

- a. Each country should specialize in the good it can produce most efficiently compared with its trading partner.
- b. Buyers should compare goods before signing a contract.
- c. Wealthier countries have significant advantages compared to poorer countries.
- d. Each country should produce at least some quantity of every important consumer good.
- e. Some countries should act strictly as consumers and not as producers.

Use the table below, showing the maximum quantities of two items that two countries could produce if they each specialized entirely in one good or the other, to answer Questions 4-7.

<u>Country</u>	<u>Industry</u>	
	Wheat	Copper
United States	5 bushels	7 tons
Zambia	1 bushel	2 tons

4. The opportunity cost of a bushel of wheat in the United States is...

- a) 7/5 ton of copper.
- b) 7 tons of copper.
- c) 5.7 tons of copper.
- d) 7/5 bushels of wheat.
- e) 5/7 tons of copper.

5. The opportunity cost of a bushel of wheat in Zambia is...

- a) ½ ton of copper.
- b) ½ ton of wheat.
- c) 2 bushels of wheat.
- d) 2 tons of copper.
- e) None of the above.

6. Which country has the comparative advantage in producing copper?

- a) The United States
- b) Zambia
- c) both
- d) neither
- e) you can't tell from the information given

7. If it follows the principle of comparative advantage, which item should the United States specialize in producing?
- a) wheat
 - b) copper
 - c) both
 - d) neither
 - e) you can't tell from the information given
8. According to the infant industry argument:
- a. Government should sometimes protect domestic firms from foreign competition until they can compete on their own.
 - b. Tariffs may be justified to protect an industry until it becomes more competitive.
 - c. Quotas are never justified in an international trade situation.
 - d. Both a and b
 - e. Both b and c
9. Which of the following is a disadvantage of import substitution policies?
- a. Decreased likelihood of lock-in
 - b. Loss of potential gains from trade in the short run
 - c. Loss of infant industry advantages
 - d. Loss of long run comparative advantage
 - e. Diversification of production
10. In theory, free trade enables countries to...
- a. consume at points within their production possibilities frontiers.
 - b. consume at points on their production possibilities frontiers.
 - c. consume at points beyond their production possibilities frontiers.
 - d. shift their production possibilities frontiers outward.
 - e. Trade has nothing to do with production possibilities.
11. Which of the following is *not* among the listed advantages of free trade?
- a. Efficiency
 - b. Fairness
 - c. Incentive for hard work
 - d. Non-coerciveness
 - e. Promotes common interests

12. The World Trade Organization...

- a. provides emergency assistance to countries in financial crisis.
- b. issues project-specific loans to developing countries.
- c. rules on trade disputes between countries.
- d. (b) and (c)
- e. None of the above are true.

13. Economists say that a process that is highly automated is...

- a. capital intensive.
- b. labor intensive.
- c. labor scarce.
- d. capital abundant.
- e. None of the above are true.

14. The theory of factor-price equalization states that...

- a. for both trading partners to benefit, factor prices should be equalized.
- b. free trade tends to equalize returns on productive factors across countries.
- c. returns on all of a country's productive factors should be the same in the long run.
- d. specialization inhibits the equalization of factor price.
- e. None of the above are true.

15. Which of the following is *not* one of the policy tools to regulate trade in goods and services?

- a. Import quotas
- b. Tariffs
- c. Licensing requirements on imports
- d. Capital controls
- e. Trade-related subsidies

16. Suppose Hereland puts a quota on imports of oranges from Thereland. Which of the following groups is most likely to reap financial benefits from the imposition of the quota?

- a. Hereland's orange producers
- b. Hereland's government
- c. Thereland's government
- d. Hereland's consumers
- e. None of the above

17. The circular flow model in this chapter frames aggregate demand as:
- a. $\text{Aggregate Demand} = \text{Consumption} + \text{Intended Investment} + \text{Taxes} + \text{Exports}$
 - b. $\text{Aggregate Demand} = \text{Consumption} + \text{Actual Investment} + \text{Government Spending} + \text{Exports} - \text{Imports}$
 - c. $\text{Aggregate Demand} = \text{Consumption} + \text{Actual Investment} + \text{Government Spending} - \text{Taxes} + \text{Exports}$
 - d. $\text{Aggregate Demand} = \text{Consumption} + \text{Intended Investment} + \text{Government Spending} + \text{Net Exports}$
 - e. None of these accurately describes aggregate expenditure.
18. Suppose that the exchange rate between U.S. dollars and currency in France, the euro, is 1.25 dollars per euro. If purchasing parity holds, how much would we expect a bottle of perfume that costs €100 in France to sell for in the United States?
- a. 80 dollars
 - b. 100 dollars
 - c. 120 dollars
 - d. 125 dollars
 - e. 150 dollars
19. Suppose that the exchange rate between U.S. dollars and currency in Mexico, the peso, is 0.10 dollars per peso. If purchasing parity holds, how much would we expect a scooter that costs \$10,000 in the United States to sell for in Mexico?
- a. 1,000 pesos
 - b. 10,000 pesos
 - c. 20,000 pesos
 - d. 50,000 pesos
 - e. 100,000 pesos
20. Suppose the Chinese demand for United States government bonds decreases due to concerns about political battles in Washington D.C. What would we expect to happen in the foreign exchange market, holding all other factors constant?
- a. The dollar will depreciate and more dollars will be traded.
 - b. The dollar will depreciate and fewer dollars will be traded.
 - c. The dollar will appreciate and more dollars will be traded.
 - d. The dollar will appreciate and fewer dollars will be traded.
 - e. The dollar could appreciate or depreciate, but fewer dollars will be traded.

21. Assume a foreign exchange market with a flexible exchange system. Suppose the demand for a country's currency decreases. This results in a _____ in its currency.

- a. depreciation
- b. appreciation
- c. devaluation
- d. revaluation
- e. The value of the currency will remain unchanged.

22. If the value of a country's currency falls, what is the effect on exports and imports, assuming all else remains unchanged?

- a. Exports will fall, and imports will rise.
- b. Exports and imports will both fall.
- c. Exports will rise, and imports will fall.
- d. Exports and imports will both rise.
- e. Exports and imports will remain unchanged.

23. How would payments from the sale of fighter jets to Saudi Arabia be registered in the U.S. balance of payments?

- a. As an inflow in the current account.
- b. As an outflow in the current account.
- c. As an inflow in the capital account.
- d. As an outflow in the capital account.
- e. None of the above.

24. Suppose a Kuwaiti company invests in a U.S. bank. How would this transaction be registered in the balance of payments?

- a. As an inflow in the current account.
- b. As an outflow in the current account.
- c. As an inflow in the capital account.
- d. As an outflow in the capital account.
- e. None of the above.

Answers to Active Review Questions

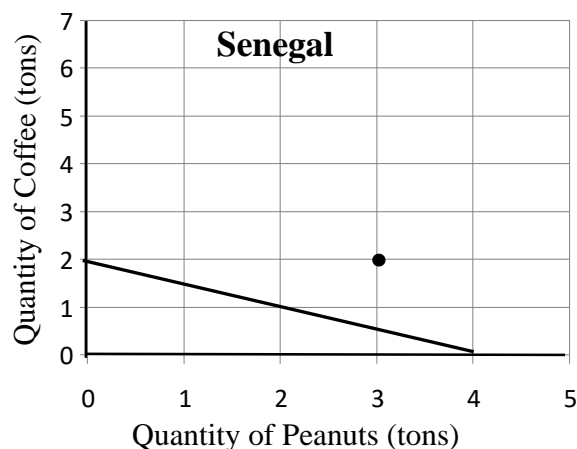
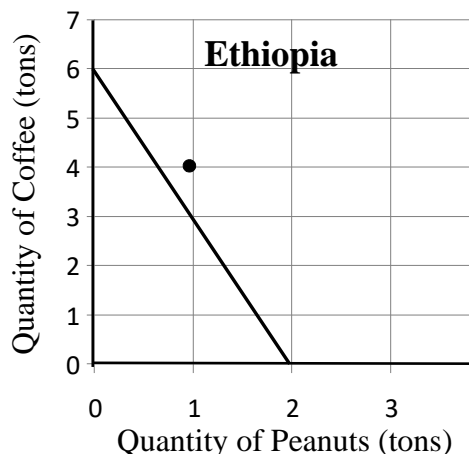
1. productivity or efficiency
2. opportunity cost
3. labor intensive
4. race to the bottom
5. protectionist
6. import substitution
7. dumping
8. tariffs
9. foreign trade zones
10. real exchange rate
11. purchasing power parity (PPP)
12. balance of payments (BOP) account
13. capital account (in the BOP account)
14. devaluation
15. False.
16. True.
17. False.
18. False.
19. False. Only tariffs provide a monetary revenue benefit to the government.
20. False. “Depreciation” is the correct term.
21. False. They are capital inflows.
22. True.
23. Smith believed that free trade increased the extent of the market, which would increase gains to specialization, which would motivate a greater degree of specialization, leading to greater economic productivity and, in the long run, greater national prosperity.
24. Vulnerability, lock-in, coercion and power differentials, tension between government and corporate interests, race to the bottom, inequality, and commodification of fundamental social needs are among potential disadvantages of free trade.
25. Three policy tools to regulate trade are: a trade quota, a tariff, or a trade- related subsidy.
26. The leakages in the open economy circular flow model include savings, taxes, and imports. The injections in the open economy version of this model include intended investment, government spending, and exports.
27. “Depreciation” refers to the reduction in a currency’s value in a flexible exchange rate system, while “devaluation” refers to a reduction in a currency’s value in a fixed exchange rate system.
28. Purchasing power parity is the theory that exchange rates should reflect the difference in purchasing power among countries, under certain idealized conditions (such as the free trade of currencies and goods, and the absence of transportation costs). However, in reality these conditions often do not exist. Thus purchasing power parity (PPP) adjustments are made to take account of differences in the cost of living between countries.
29. If the supply of the currency increases, the value of the currency will fall. If the demand of the currency increases, the value of the currency will rise. (And vice versa for the decrease.)

30. The balance of payment account tracks the inflows and outflows arising from international trade, earnings, transfers, and transactions in assets. It's divided into two subsections: the current account and the capital account. The current account tracks the inflows and outflows from trade in goods and services, as well as earnings and transfers. The capital account tracks inflows and outflows from transactions in assets.

Answers to Problems

1.

a.



b. Ethiopia is the more efficient producer of coffee. Ethiopia can produce 1 ton of coffee at an opportunity cost of only 1/3 ton of peanuts, while the opportunity cost of a ton of coffee in Senegal is 2 tons of peanuts.

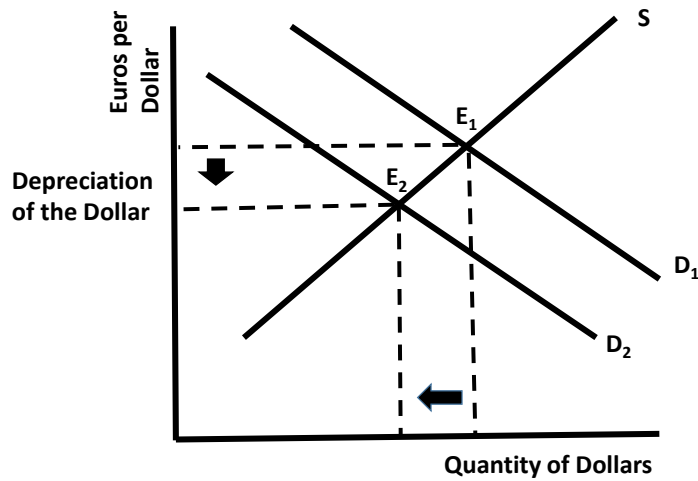
c. No. (See the points marked on the graphs above—they are outside the PPFs.)

d. Yes. If Ethiopia produces 6 tons of coffee and sells 2 tons to Senegal in exchange for 1 ton of peanuts, while Senegal produces only peanuts (keeping 3 tons, and using the fourth to buy 2 tons of coffee from Ethiopia), both countries will get their desired consumption bundle.

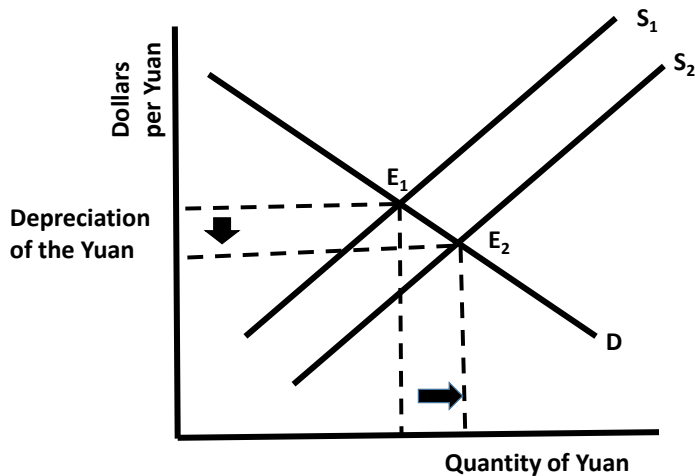
2.

- | | | |
|--------------------|-------------------|----------------------------------|
| a. Inflow, abroad" | financial account | This is "borrowing from |
| b. Outflow, | financial account | This is "FDI abroad" |
| c. Inflow, | current account | This is "income receipts" |
| d. Inflow, goods" | current account | This is "payments for exports of |
| e. Outflow, | current account | This is "income payments" |

3. a. A drop in demand for the U.S. dollar results in a depreciation in the value of the dollar.



b. The Chinese Central Bank can increase the supply of the Yuan to keep its value low.



Answers to Self Test Questions

- | | |
|-------|-------|
| 1. D | 13. A |
| 2. B | 14. B |
| 3. A | 15. D |
| 4. A | 16. A |
| 5. D | 17. D |
| 6. B | 18. D |
| 7. A | 19. E |
| 8. D | 20. B |
| 9. B | 21. A |
| 10. C | 22. C |
| 11. B | 23. A |
| 12. C | 24. C |