CHAPTER 6

The United States in the Global Economy

The United States is linked to the global economy in many ways. As you will learn in the first section of Chapter 6, there are four types of ***economic flows*** among nations.

The second section explains ***why international trade is important*** to the United States. In *relative* terms, other nations have exports and imports that are a larger percentage of their GDPs because they often have a small domestic market and a limited resource base. By contrast, the exports and imports of the United States account for a smaller percentage of its GDP because it has a larger domestic market and a more abundant resource base. In *absolute* terms, however, the United States is the world's largest trading nation. Most of the trade is with other industrially advanced nations such as Canada, Japan, and Germany. This volume of trade has grown over the years with expansion of the global economy, the rise of multinational corporations, and the emergence of new trading nations.

In the third section, you learn about the principle of ***comparative advantage,*** which is the basis for all trade between individuals, regions, and nations. A nation, for example, will specialize in the production of a product for which it has a lower domestic opportunity cost and trade to obtain those products for which its domestic opportunity cost is higher. Thus, specialization and trade increase productivity within a nation and increase a nation's output and standard of living.

Trading in a global economy requires a ***foreign exchange market*** in which national currencies are exchanged, as you discover in the fourth section. This market is competitive, so the principles of supply and demand that you read about in Chapter 3 apply to it. Changes in supply and demand for currency will affect the price of a national currency. When the U.S. dollar price of another currency has increased, the value of the U.S. dollar has *depreciated* relative to the other currency. Conversely, when the U.S. dollar price of another currency has decreased, the value of the U.S. dollar has *appreciated* in value relative to the other currency.

Government can affect international trade in many ways, as you learn in the fifth section. Governments can impose protective tariffs, import quotas, and nontariff barriers, or they can foster exports through subsidies. The reasons for the interventions are difficult to explain given the strong economic rationale for free trade based on the principle of comparative advantage. Nevertheless, public misunderstanding of the gains from trade, or political considerations designed to protect domestic industries, often lead to government policies that create trade barriers and distort the free flow of products between nations, thus increasing costs for society.

The sixth section discusses ***multilateral agreements*** among nations and the creation of ***free-trade zones*** that have been designed to reduce trade barriers and increase world trade. In the United States, the process of gradual tariff reduction began with the Reciprocal Trade Agreements Act of 1934. Since 1947, worldwide multilateral negotiations to reduce trade barriers have been conducted through the General Agreement on Tariffs and Trade (GATT). The Uruguay round of GATT negotiations established the World Trade Organization (WTO) as GATT's successor. The other major development has been the formation of free-trade zones. The European Union (originally the Common Market) is a trading bloc of 15 western European nations. In 1993, the North American Free Trade Agreement (NAFTA) created a free-trade zone covering the United States, Canada, and Mexico. These trade blocs have the potential to create more trade frictions or lead to freer worldwide trade.

The final section of the chapter explores the issue of the effects of ***increased competition in the global economy.*** Global competition has certainly changed production practices and employment in U.S. industry. Many U.S. firms have adapted to the changes in the global economy by increasing productivity to reduce costs, improve product quality, and expand export markets. Some firms have failed. Consumers have benefited from lower prices and a wider variety of goods.

■ CHECKLIST

When you have studied this chapter you should be able to

☐ Identify the four main categories of economic flows linking nations.
☐ Explain the importance of international trade to the U.S. economy in terms of volume, dependence, trade patterns, and financial linkages.
☐ Describe several factors that have facilitated the rapid growth of international trade since World War II.
☐ Identify the key participating nations in international trade.
☐ Explain the basic principle of comparative advantage based on an individual example.
☐ Compute the comparative costs of production from production possibilities data when you are given an example with cost data for two countries.

☐ Determine which of two countries has a comparative advantage in an example.
☐ Indicate the range in which the terms of trade will be found in an example.
☐ Show the gains from specialization and trade in an example.
☐ Define the main characteristics of the foreign exchange market.
☐ Demonstrate how supply and demand analysis applies to the foreign exchange market.
☐ Distinguish between the appreciation and depreciation of a currency.
☐ Identify four means by which governments interfere with free trade.
☐ Discuss two reasons why governments intervene in international trade.
☐ Give estimates of the cost to society from trade restrictions.
☐ List the major features of the Reciprocal Trade Agreements Act and the General Agreement on Tariffs and Trade (GATT).
☐ Identify the major provisions of the Uruguay round of GATT negotiations.
☐ Describe the World Trade Organization (WTO).
☐ Describe the history, goals, and results from the European Union (EU).
☐ Explain what the euro is and expectations for it.
☐ Explain the features and significance of the North American Free Trade Agreement (NAFTA).
☐ Discuss the effects on increased competition in the global economy on U.S. firms, workers, and consumers.

■ CHAPTER OUTLINE

1. Four main categories of ***economic flows*** link nations: goods and services flows, capital and labor flows, information and technology flows, and financial flows.

2. ***Trade is important*** and thus warrants special attention.

a. Although the relative importance of international trade to the United States is less than it is for other nations, it is still vital.

(1) Exports and imports are about 12–14% of GDP, and the United States is the largest trading nation in the world.

(2) The U.S. economy depends on international trade for vital raw materials and a variety of finished products.

(3) There are some patterns in U.S. trade: most are with industrially advanced nations, with Canada being the largest trade partner; overall imports exceed exports, but the deficits are greatest with Japan, China and OPEC countries.

(4) International trade must be financed, and, in the case of the United States, large trade deficits have required the selling of business ownership (securities) to companies in other nations.

b. Factors facilitating trade since World War II include improvements in transportation and communications technology, and a general decline in tariffs.

c. The major participants in international trade are the United States, Japan, and the nations of western Europe. Newer participants include many Asian economies—Hong Kong (now part of China), Singapore, South Korea, Taiwan, Malaysia, and Indonesia. China has also emerged as a major trading nation in this region. The collapse of communism in the former Soviet Union and the nations of Eastern Europe significantly changed trade patterns in that region, opened these nations to market forces, and increased international trade.

3. International trade policies have changed over the years with the development of ***multilateral agreements*** and ***free-trade*** zones.

a. United States trade policy has been significantly affected by the *Reciprocal Trade Agreements Act* of 1934. Until 1934, the United States steadily increased tariff rates to protect private interest groups, but since the passage of the 1934 act, tariff rates have been substantially reduced. This act gave the President the authority to negotiate with foreign nations and included *most-favored-nation (MFN) status* clauses.

b. The *General Agreement on Tariffs and Trade* (GATT) began in 1947. GATT provided equal treatment of all member nations and sought to reduce tariffs and eliminate import quotas by multilateral negotiations. The Uruguay round of GATT negotiations started in 1986 and was completed in 1993. The major provisions, which will be phased in through 2005, reduce tariffs on products, cut restrictive rules applying to services, phase out quotas on textiles and apparel, and decrease subsidies for agriculture.

c. The *World Trade Organization* (WTO) was the successor to GATT. It oversees trade agreements and provides a forum for trade negotiations. The WTO works to expand trade and reduce protectionism, but the outcomes can be controversial.

d. The *European Union* (EU) is an example of a regional free-trade zone or trade bloc among 15 western European nations. It abolished tariffs among member nations and developed common policies on various economic issues, such as the tariffs on goods to and from nonmember nations. The EU has produced freer trade and increased economies of scale for production in its member nations, but such a trading bloc creates trade frictions with nonmember nations like the United States. Many of the 15 EU nations share a common currency–the *euro.*

e. In 1993, *The North American Free Trade Agreement* (NAFTA) created a free-trade zone covering the United States, Mexico, and Canada. Critics of this agreement fear job losses and the potential for abuse by other nations using Mexico as a base for production. Defenders cite the mutual advantages from freer trade and the fact that increased worldwide investment in Mexico will stimulate growth in that nation and trade with the United States.

4. Increased international trade has resulted in more ***global competition.*** Most U.S. firms have been able to meet the competitive challenge by lowering production

costs, improving products, or using new technology. Some firms and industries have had difficulty remaining competitive and continue to lose market share and employment. Overall, increased trade has produced substantial benefits for U.S. consumers (lower prices and more products) and enabled the nation to make more efficient use of its scarce resources.

HINTS AND TIPS

1. Comparative advantage is directly related to the opportunity cost concept and production possibilities you learned about in Chapter 2.

a. A nation has a comparative advantage in the production of a product when it can produce the product at a lower domestic opportunity cost than can a trading partner. A nation will specialize in the production of a product for which it is the low (opportunity) cost producer.

b. When production possibilities schedules for two nations that trade two products have a constant cost ratio, you can reduce the complicated production possibilities schedules to a 2 × 2 table. Put the two products in the two columns and the two nations in the two rows of the matrix. In each cell of the matrix put the *maximum* of each product that can be produced by that row's nation. Then for each nation, divide the maximum of one product into the maximum amount of the other product to get the domestic opportunity cost of one product in terms of the other.

c. This last point can be illustrated with an example from problem 2 in this study guide chapter. Lilliput can produce a *maximum* of 40 pounds of apples or 20 pounds of bananas. Brobdingnag can produce a *maximum* of 75 pounds of apples or 25 pounds of bananas. The 2 × 2 matrix would look like this:

	Apples	Bananas
Lilliput	40	20
Brobdingnag	75	25

For Lilliput, the domestic opportunity cost of producing 1 pound of apples is .5 pound of bananas. In Brobdingnag, the domestic opportunity cost of producing 1 pound of apples is .33 pound of bananas. Brobdingnag is the lower (opportunity) cost producer of apples and will specialize in the production of that product. Lilliput is the lower (opportunity) cost producer of bananas, because producing 1 pound of bananas requires giving up 2 pounds of apples, whereas in Brobdingnag producing 1 pound of bananas requires giving up 3 pounds of apples.

2. Foreign exchange rates often confuse students because they can be expressed in two ways: the U.S. dollar price of a unit of foreign currency ($1.56 for 1 British pound), or the amount of foreign currency that can be purchased by one U.S. dollar ($1 can purchase .64 British pound). If you know the exchange rate in one way, you can easily calculate it the other way. Using the information from the first way, dividing $1.56 into 1 British pound gives you the British pound price for 1 U.S. dollar (1/1.56 = .64 of a British pound). Using information from the second way, dividing .64 of a British pound into 1 U.S. dollar gives you the dollar price of a British pound (1/.64 = 1.56). Both ways may be used, although one way may be used more often than the other. Rates for British pounds or Canadian dollars are usually expressed the first way, in terms of U.S. dollars. Rates for the Swiss franc, Japanese yen, or German mark are expressed the second way, per U.S. dollar.

■ IMPORTANT TERMS

multinational corporations
comparative advantage
terms of trade
foreign exchange market
exchange rates
depreciation
appreciation
protective tariffs
import quotas
nontariff barriers
export subsidies
Smoot-Hawley Tariff Act
Reciprocal Trade Agreements Act
most-favored-nation clauses
General Agreement on Tariffs and Trade (GATT)
World Trade Organization (WTO)
European Union (EU)
trade bloc
euro
North American Free Trade (NAFTA)