Chapter 37: International Trade

Now that we have completed our examination of the United States domestic economy, we turn to the ultimate "big picture" of macroeconomics: international trade. But in doing so, we return to the concepts with which we began our study of economics: factors of production, comparative advantage, and production possibilities. Chapter 37 introduces the reasons for international trade and the controversy between free traders and protectionists who seek limits on trade.

Why do nations trade? The easy answer is that nations possess different natural resources and build their industries based on their available resources. Nations develop land-intensive, labor-intensive, or capital-intensive industries—or a combination of such industries—based on their best available resources. They then trade for those products they cannot profitably produce themselves. But the better answer is that nations specialize in those goods for which they hold a comparative advantage.

Absolute advantage refers to a nation's ability to produce more than another nation, but comparative advantage focuses on a nation's ability to produce relatively more efficiently than another nation, as measured by a lower opportunity cost. If nations specialize in producing the goods for which they have the comparative advantage and trade, both nations gain from the trade. The terms of trade then determine the parameters for the price of the product being traded. This relationship can be illustrated in production possibilities curves or determined mathematically. It is critical to be able to determine comparative advantage using both methods.

Using a supply and demand model for a closed economy, compared to an economy open to trade, we can see that domestic prices quickly adjust to world prices in an open economy. If the world price is higher than the domestic price, domestic firms will have an incentive to export products, reducing the domestic supply and increasing domestic prices. If the world price is lower than the domestic price, consumers have an incentive to import products, reducing the domestic demand and lowering domestic prices.

The benefits of international trade include a wider variety of products, greater output, greater efficiency in production, and a higher standard of living. The increased competition with foreign firms helps to deter monopolies and holds prices down in the marketplace. International connections help to promote peaceful solutions to political problems, rather than war.

While consumers and the nation may benefit from trade, less efficient domestic firms and their employees are hurt by the drop in domestic demand. Protectionists argue that trade barriers must be used to limit trade. Tariffs, quotas, non-tariff barriers, voluntary export restraints, and export subsidies can all be used to protect domestic industries from foreign competition. The direct effects of these trade barriers include reduced consumption of goods, increased domestic consumption, a reduction in sales for foreign firms, and increased tariff revenue for the government. Indirect effects include a reduction in exports because of the reduced incomes of foreigners, the resulting cuts in output and employment in U.S. export industries, and a reduction in the efficiency of production. Repeated studies of trade barriers have demonstrated that the increased costs to consumers are greater than the gains for domestic industries and the government.

But protectionists argue that trade barriers are important for other reasons beyond protection of American industries and jobs. Protectionists argue that we must remain self-sufficient and protect industries vital to national defense. Free traders agree in principle, but argue such a policy is subject to significant abuse. Protectionists argue that economies must be diversified to maintain economic stability, but free traders note that this argument is irrelevant for an economy as diversified as the United States. Protectionists argue that "infant industries" must be shielded with temporary tariffs from the pressures of international competition until they are mature enough to fully compete with foreign firms. Free traders contend that direct subsidies would more effectively promote the growth of new firms, and that so many new firms emerge each year that directed, temporary tariffs would be impossible to impose. Protectionists also argue what widespread tariffs must be used to prevent dumping of imports below cost. Free traders counter that such low-cost goods may be the result of a strong comparative advantage, rather than dumping, and punishments can be narrowly targeted at those guilty of dumping. While protectionists argue that trade barriers protect jobs, free traders argue that trade also creates jobs in more efficient industries; further, retaliatory trade barriers can lead to trade wars. Finally, protectionists argue that trade will reduce U.S. wages, as firms are forced to compete with low-cost foreign labor. Free traders contend that U.S. wages will remain higher than wages in most countries because of the higher productivity of U.S. workers.

Material from Chapter 37 is likely to appear in a few multiple-choice questions on both the AP Microeconomics and AP Macroeconomics Exams. Questions concerning comparative trade, specialization, terms of trade, gains from trade, supply and demand analysis, and trade barriers can be expected in the multiple-choice and free-response portions of both exams. It is important to be able to calculate the opportunity costs of production for the countries involved in trade, determine the absolute and comparative advantage, calculate the range of the terms of trade, and determine whether both countries would gain if the product is set at a particular price. It is also important to recognize the arguments on each side of the trade issue.