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STUDY GUIDE Chapter 17, Section 1

For use with textbook pages 467–470

CT 2.3

ABSOLUTE AND COMPARATIVE ADVANTAGE

KEY TERMS

exports The goods and services produced by a country and sold to other countries *(page 467)*

imports The goods and services that one country buys from other countries *(page 468)*

absolute advantage The ability of one country to produce a given product more efficiently than another country *(page 469)*

comparative advantage The ability of one country to produce a product relatively more efficiently, or at a lower opportunity cost, than another country *(page 470)*

DRAWING FROM EXPERIENCE

Where were your shoes made? Your shirt and jeans? If your family has a car, do you know where it was made?

This section focuses on the role that international trade plays in the U.S. economy.

ORGANIZING YOUR THOUGHTS

Use the table below to help you take notes as you read the summaries that follow. Think about how the United States benefits from international trade.

The United States and International Trade	
What kinds of products are usually exchanged?	
Why do nations trade with one another?	
Why is international trade important?	

READ TO LEARN

Introduction *(page 467)*

Specialization, or concentrating on one kind of good or service, is the key to trade. This is true in a neighborhood or around the world. A specialist may supply a service, such as fixing TVs, or a product, such as wheat. The specialist is paid for his or her services. He or she then uses the money to buy goods and services from those who specialize in other things. Within a single country, different regions specialize in certain economic activities. The Midwest of the United States, for instance, is known for farm products. Some cities specialize in banking services. A country's specialties are shown by its ***exports.*** Those are the goods and services it produces and sells abroad.

1. How are specialization and trade related?

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The U.S. and International Trade *(page 468)*

International trade—trade among different countries—once involved mainly goods. Today trade also includes services such as insurance and banking. The amount of ***imports***—goods bought from other countries—that Americans buy has increased greatly.

International trade has benefits. Trade links countries that are very different in politics, geography, and religion. Trade makes regional products, such as coffee, available all over the world. Trade also brings essential raw materials, such as minerals and oil, to countries that lack them.

2. Why are imports of raw materials such as oil and metals important to a country?

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The Basis for Trade *(page 469)*

If a country can make more of a specific product than another country, it has an ***absolute advantage*** in trade. For example, Country A and Country B can both grow coffee and cashew nuts. Country A can produce 40 million pounds of coffee, and Country B can produce six million pounds. Country A can produce eight million pounds of cashews, while Country B can produce six million pounds. This means that Country A has an absolute advantage over B in the production of both coffee and cashews.

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In contrast, one country can have a ***comparative advantage*** over another in trade. That is, it can make a certain product with a lower opportunity cost. (Remember that the opportunity cost is basically what someone gives up in order to do something else.) For instance, suppose that workers in Country A can make either 40 million pounds of coffee or eight million pounds of cashews. The opportunity cost of one million pounds of cashews is five million pounds of coffee. This is calculated by dividing 40 by eight. In Country B, however, the opportunity cost of one million pounds of cashews is only one million pounds of coffee (6 ÷ 6). Since Country B's opportunity cost for producing cashews is less than Country A's, Country B has a comparative advantage over Country A in producing cashews.

3. What is the difference between absolute advantage and comparative advantage?

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The Gains from Trade *(page 470)*

To trade successfully, a country needs to specialize. It must produce more of the good for which it has a comparative advantage. Then it trades its extra production for extra goods made by its trading partner. For example, the United States has iron, coal, industries, and skilled labor. It can produce farm machinery efficiently. Colombia has few industries, but it has the resources to produce coffee. Each country has a comparative advantage for a certain product. That makes trade benefit both countries.

4. Use the idea of comparative advantage to explain why the United States sells farm machinery to Colombia while Colombia exports coffee to the United States.

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STUDY GUIDE Chapter 17, Section 2

For use with textbook pages 472–479

BARRIERS TO INTERNATIONAL TRADE

KEY TERMS

tariff A tax placed on imports to increase their price in the domestic market *(page 472)*

quota A limit placed on the quantities of a product that can be imported *(page 472)*

protective tariff A tariff high enough to protect less efficient domestic industries from foreign competitors *(page 472)*

revenue tariff A tariff high enough to generate revenue for the government without actually prohibiting imports *(page 473)*

dumping Selling products abroad less than it costs to produce them at home *(page 474)*

protectionists Those in favor of trade barriers to protect home industries *(page 474)*

free traders Those who favor few or even no trade restrictions *(page 474)*

infant industries argument The belief that new or emerging industries should be protected from foreign competition *(page 474)*

balance of payments The difference between the money a country pays to, and receives from, other nations when it engages in international trade *(page 476)*

most favored nation clause A provision allowing a country to receive the same tariff reduction that the United States negotiates with a third country *(page 477)*

World Trade Organization (WTO) An international agency that administers previous GATT (General Agreement on Tariffs and Trade) agreements, settles trade disputes between governments, organizes trade negotiations, and provides technical assistance and training for developing countries *(page 477)*

North American Free Trade Agreement (NAFTA) An agreement to liberalize free trade by reducing tariffs between three major trading partners: Canada, Mexico, and the United States *(page 479)*

DRAWING FROM EXPERIENCE

Do you enjoy shopping in big stores? How would you feel if there were only one or two brands of the product you were looking for?

In the last section, you read about the role of international trade in the American economy. This section focuses on barriers that interrupt or interfere with trade.

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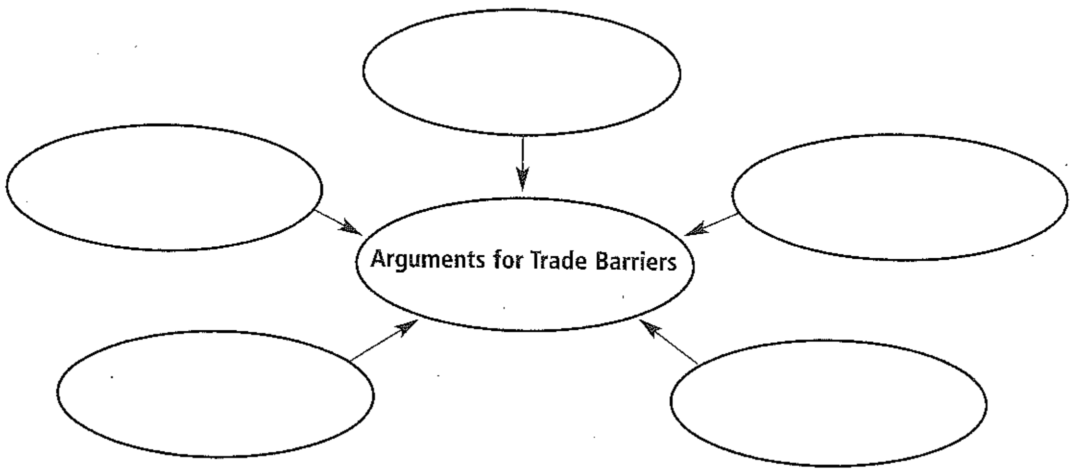
ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read the summaries that follow. Think about arguments for and against limiting trade.



READ TO LEARN

Restricting International Trade (*page 472*)

Some people are afraid that international trade can hurt American workers and industries. People in other countries have the same fears. For that reason, countries sometimes try to limit the amount of imports. A ***tariff*** is a tax on imports, which increases the price of the imported product. A ***quota*** limits the quantity of a certain product that can be imported. That may also increase its price.

A ***protective tariff*** is a tariff that is very high. Its purpose is to protect industries in the home country that are not as successful as similar industries in foreign countries. Protective tariffs make imported products more expensive than the same products made at home. Such a tariff protects the home industry.

Revenue tariffs were once an important source of income for the government. They were kept low so as not to discourage trade. Today tariffs are only a minor source of revenue.

Quotas are used to limit imports of a product that might, because its price is low, compete with a similar product made within the country. The smaller supply of the imported product raises its price. Sometimes quotas are set at zero, which prevents any imports. Foreign manufacturers may agree to "voluntary" limits on their imports to avoid having official quotas established.

In some cases, countries try to get rid of products by exporting them to other countries and then selling them for less than it cost to make them at home. This practice is called ***dumping.***

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STUDY GUIDE (continued) Chapter 17, Section 2

The United States and other countries can use health issues to restrict trade. They limit or stop most imports of food and other agricultural products. Imported foods may have to pass stricter inspections. Some nations want to restrict foods that contain hormones or have been genetically changed.

1. How do protective tariffs and quotas affect prices?

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Arguments for Protection (page 474)

Trade and trade barriers are political issues. On one side are ***protectionists.*** They want barriers that will protect home industries or farmers. On the other side are ***free traders.*** They want few or no restrictions on imports.

Protectionists and free traders disagree on the following issues:

A. ***National security*** Protectionists say that trade can make a country too dependent on imports, such as imported oil. War or other crises could cut off the supply of necessary resources. On the other hand, free traders argue that if a country tries to depend only on itself, it may have a smaller supply of those resources.

B. ***Infant industries argument*** New or developing industries may not be able to compete with established foreign companies. Protectionists say that trade barriers give new industries time to develop. However, as free traders point out, once industries are used to being protected, they will fight the removal of trade barriers. Also, governments may find it hard to give up the revenue from high protective tariffs.

C. ***Domestic jobs*** Protecting workers' jobs is the most popular argument for trade barriers. Labor costs are often lower in countries outside the United States. Tariffs can help protect American workers. Free-traders, however, believe that outside pressures force industries to find new technologies and become more efficient. They also say that it is not a good idea to protect industries that are not productive. Those industries reduce overall output, which sends prices up.

D. ***Flow of money*** Some protectionists argue that limiting imports keeps dollars within the United States. Free traders, though, say that the dollars spent in foreign countries can be used later by foreigners to buy American goods. That brings dollars back to the United States. It also creates jobs in American export industries.

E. ***Balance of payments*** This measure weighs the money spent abroad against the money received from other nations in international trade. Trade barriers can limit the money paid out. On the other hand, many trade dollars do come back to the United States. Trade can also create American jobs.

2. What are the arguments for and against using tariffs to protect "infant" industries?

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STUDY GUIDE (continued) Chapter 17, Section 2

The Free Trade Movement *(page 476)*

If one country sets high tariffs, other countries react by setting their own tariffs. As a result, international trade can slow down or stop. One example was the United States' Smoot-Hawley Tariff of 1930. It was a high import tariff and seriously hurt worldwide trade. Countries then looked for new approaches. Most worked toward lowering trade barriers.

A ***reciprocal trade agreement*** is an agreement that works both ways and helps everyone who enters the agreement. Under a 1934 law, the United States can make reciprocal trade agreements with other countries. In these agreements, both the United States and the other countries reduce tariffs. The ***most favored nation clause*** of this law lets certain countries share in tariff reductions given a third country. In other words, if the United States reduces a tariff for one country, it can also reduce the tariff for all other countries that are considered to be most favored nations.

Several steps have been taken to help lower trade barriers. ***GATT (General Agreement on Trade and Tariffs)*** was an international agreement made in 1947. With later laws, it aimed toward lowering tariffs worldwide. The ***World Trade Organization (WTO),*** an international agency, replaced GATT. It oversees trade agreements and tries to settle trade disagreements. It also works to develop trade in countries whose economies are just beginning to grow.

NAFTA (North American Free Trade Agreement) is a regional agreement that was passed in 1993. It aimed at lowering trade barriers between Canada, Mexico, and the United States. NAFTA has caused disagreements among many economists, politicians, and workers. NAFTA may make some American workers lose jobs. On the other hand, the agreement was expected to help economic growth. It would bring new jobs and lower-cost goods in all three countries. Since it took effect, NAFTA has increased trade between the United States, Canada, and Mexico.

3. What is NAFTA? What is its goal?

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