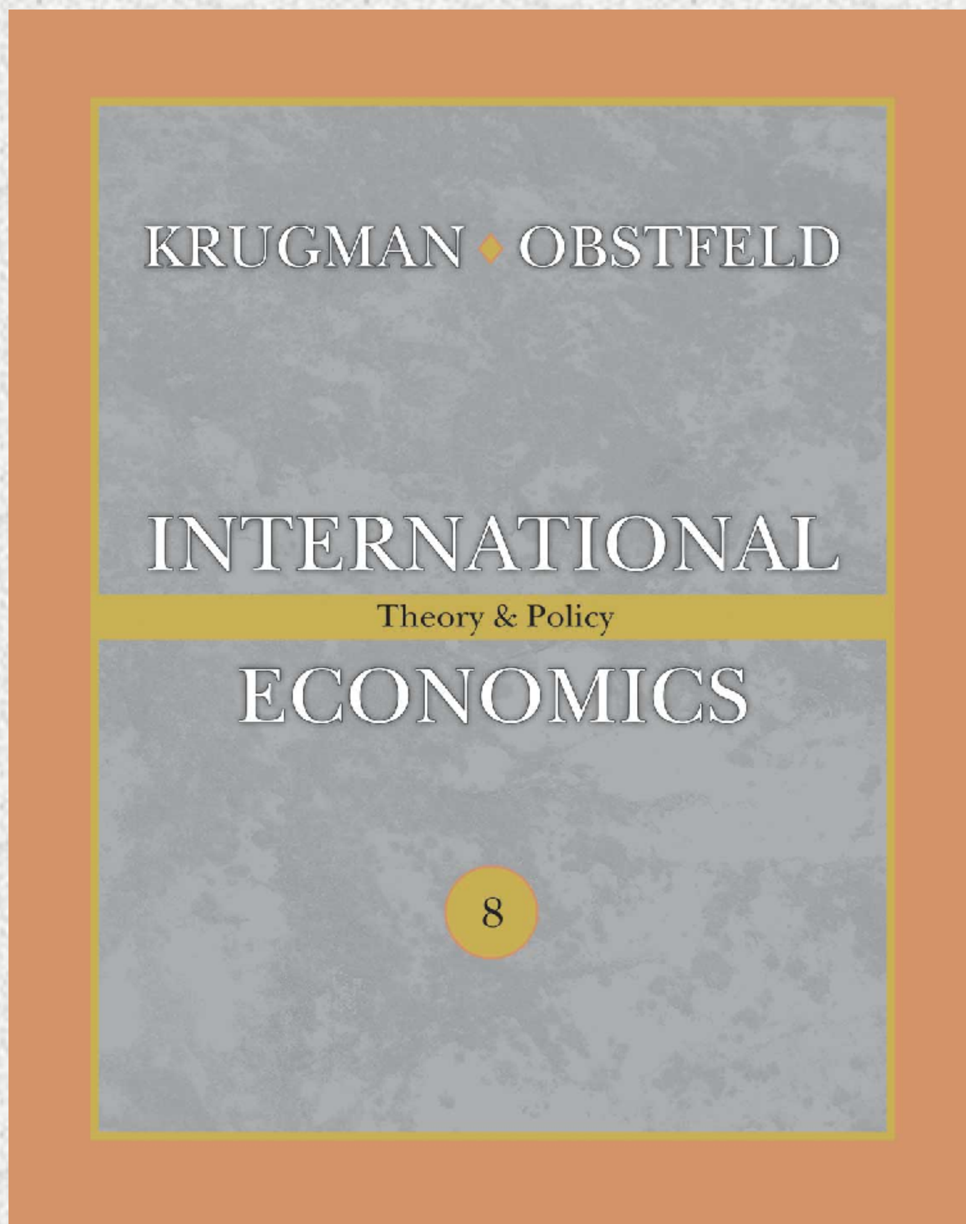

Chapter 1

Introduction

Slides prepared by Thomas Bishop

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PEARSON
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- What is international economics about?
- Gains from trade
- Explaining patterns of trade
- The effects of government policies on trade
- International finance topics
- International trade versus international finance

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What Is International Economics About?

- International economics is about how nations interact through trade of goods and services, through flows of money and through investment.
- International economics is an old subject, but it continues to grow in importance as countries become tied to the international economy.
- Nations are more closely linked through trade in goods and services, through flows of money, and through investment than ever before.

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What Is International Economics About? (cont.)

- International trade as a fraction of the national economy has tripled for the U.S. in the past 40 years.
- Compared to the U.S., other countries are even more tied to international trade.

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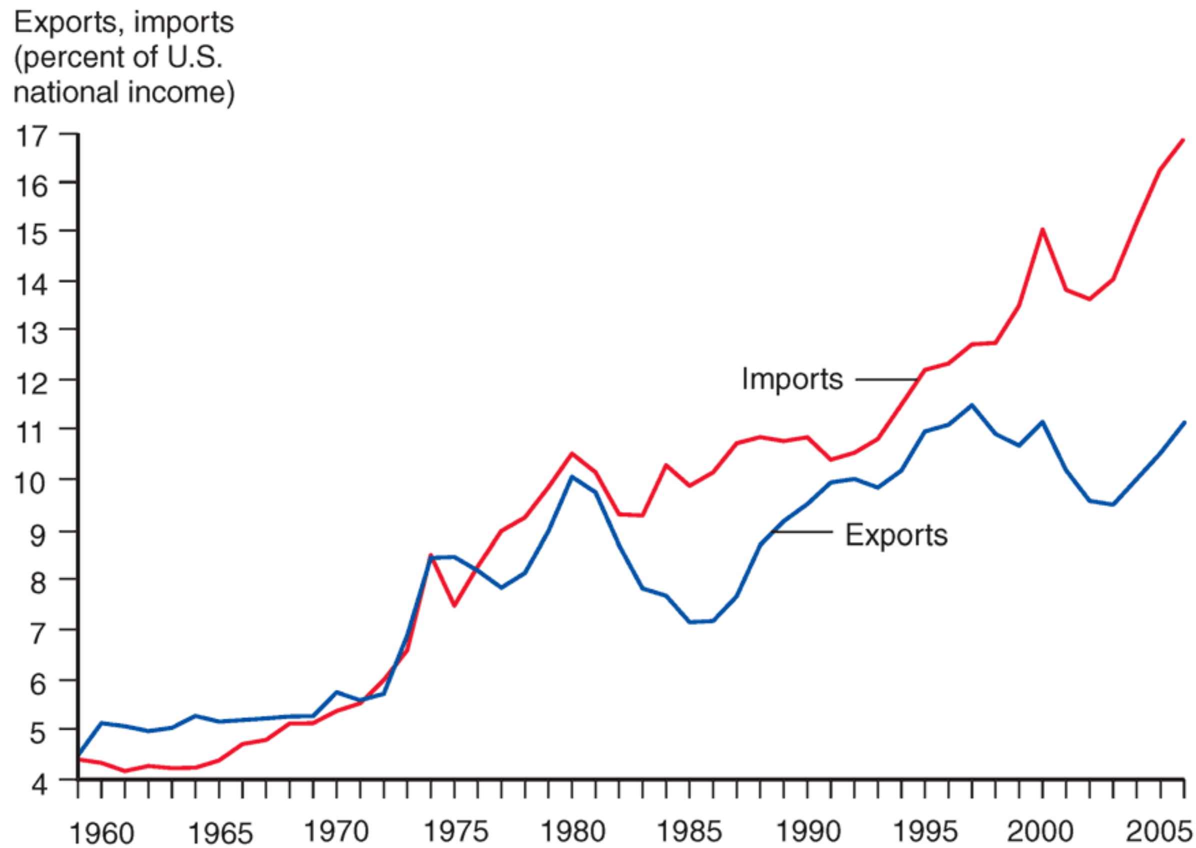
Fig. 1-1: Exports and Imports as a Percentage of U.S. National Income



Source: U.S. Bureau of Economic Analysis

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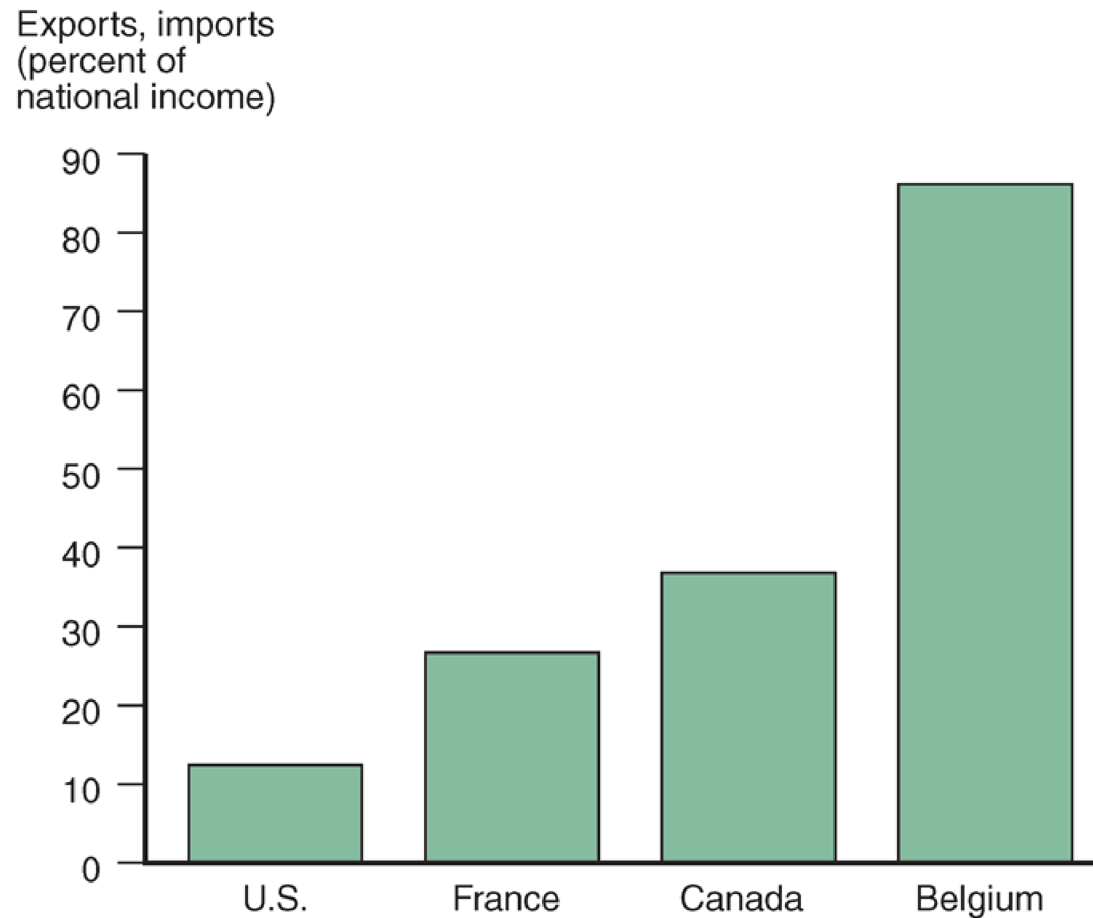
Fig. 1-2: Exports and Imports as Percentage of National Income in 2005



Source: Organization for Economic Cooperation and Development

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Gains from Trade

- Several ideas underlie the gains from trade
  1. When a buyer and a seller engage in a voluntary transaction, both receive something that they want and both can be made better off.
     - Norwegian consumers could buy oranges through international trade that they otherwise would have a difficult time producing.
     - The producer of the oranges receives income that it can use to buy the things that it desires.

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Gains from Trade (cont.)

2. How could a country that is the most (least) efficient producer of everything gain from trade?
   - With a finite amount of resources, countries can use those resources to produce what they are most productive at (compared to their other production choices), then trade those products for goods and services that they want to consume.
   - Countries can specialize in production, while consuming many goods and services through trade.

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Gains from Trade (cont.)

3. Trade is predicted to benefit a country by making it more efficient when it exports goods which use abundant resources and imports goods which use scarce resources.
4. When countries specialize, they may also be more efficient due to large scale production.
5. Countries may also gain by trading current resources for future resources (lending and borrowing).

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Gains from Trade (cont.)

- Trade is predicted to benefit *countries as a whole* in several ways, but trade may harm *particular groups within a country*.
  - ♦ International trade can adversely affect the owners of resources that are used intensively in industries that compete with imports.
  - ♦ Trade may therefore have effects on the distribution of income within a country.
  - ♦ Conflicts about trade should occur between groups within countries rather than between countries.

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Patterns of Trade

- Differences in *climate and resources* can explain why Brazil exports coffee and Australia exports iron ore.
- But why does Japan export automobiles, while the U.S. exports aircraft?
- Differences in *labor productivity* may explain why some countries export certain products.
- How *relative supplies of capital, labor and land* are used in the production of different goods and services may also explain why some countries export certain products.

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The Effects of Government Policies on Trade

- Policy makers affect the amount of trade through
  - *tariffs*: a tax on imports or exports,
  - *quotas:* a quantity restriction on imports or exports,
  - *export subsidies*: a payment to producers that export,
  - or through other regulations (ex., product specifications) that exclude foreign products from the market, but still allow domestic products.
- What are the costs and benefits of these policies?

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- Economists design models that try to measure the effects of different trade policies.
- If a government must restrict trade, which policy should it use?
- If a government must restrict trade, *how much* should it restrict trade?
- If a government restricts trade, what are the costs if foreign governments respond likewise?

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International Finance Topics

- Governments measure the value of exports and imports, as well as the value of financial assets that flow into and out of their countries.
- Related to these two measures is the measure of *official settlements balance*, or the balance of payments: the balance of funds that central banks use for official international payments.
- All three values are measured in the government's *national income accounts*.

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International Finance Topics (cont.)

- Besides financial asset flows and the official settlements balance, *exchange rates* are also an important financial issue for most governments.
  - Exchange rates measure how much domestic currency can be exchanged for foreign currency.
  - They also affect how much goods that are denominated in foreign currency (imports) cost.
  - And they affect how much goods denominated in domestic currency (exports) cost in foreign markets.

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International Trade Versus International Finance

- International trade focuses on transactions of goods and services across nations.
  - ♦ These transactions usually involve a physical movement of goods or a commitment of tangible resources like labor services.
- International finance focuses on financial or monetary transactions across nations.
  - ♦ For example, purchases of U.S. dollars or financial assets by Europeans.

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- International trade topics
  - International trade theory (chapters 2–7)
  - International trade policy (chapters 8–11)
- International finance topics
  - Exchange rates and open economy macroeconomics (chapters 12–17)
  - International macroeconomic policy (chapters 18–22)

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