Content Domain IV: International Economics

**A LOOK AT CONTENT DOMA IN IV**

Test questions in this content domain will measure your understanding of the international economy. Your answers to the questions will help show how well you can perform on the following topics:

- Advantages of international trade
- Issues concerning international trade
- Exchange rates

A good way to think of Content Domain IV is “macro-macroeconomics.” While microeconomics covers the interaction of a single market and macroeconomics views the larger national picture, international economics views an even larger picture: how the various national economies interact to form a world economy.

The growth of massive multinational corporations is one sign that the world’s economy is becoming more interconnected each year. Take a trip to a local grocery store to see this phenomenon. You could find fruit and vegetables from Australia, Asia, and South America sitting next to peaches and tomatoes that may have been grown mere miles away from your home. As national economies become more interconnected, international economic issues such as trade agreements and trade barriers become more important. Content Domain IV covers some of the key topics involving the world economy today.

**Spotlight on the Topics**

★ Advantages of international trade ★

International trade allows a country to concentrate on what it does best and trade for what it can’t or doesn’t produce. In effect, trade allows a country to specialize in certain goods, which leads to more efficient production. An example of this can be found by considering the relationship between Brazil’s sugar industry and the United States’ auto-making industry. The climate and environment of Brazil make growing sugar cane relatively easy. It would be much harder to grow sugar cane in Detroit, for example, which would require large greenhouses, huge sunlamps, and a labor force skilled in the growth of this tropical plant. It is much easier for Detroit (and by extension the United States) to specialize in manufacturing automobiles and then trade for sugar from Brazil. In fact, when each country specializes in what it does best, each country has more to trade. In other words, as both countries take advantages of their strengths, both countries increase their overall economic well-being.
The terms economists use to describe a country’s economic strengths in relation to another country are absolute advantage and comparative advantage.

When a country has an absolute advantage over another country, it simply means that the country can produce more of a good than another country. For example, Brazil has an absolute advantage over the United States in the production of sugar, while the United States has an absolute advantage over Brazil in the production of cars.

While large countries will probably have an absolute advantage in production over smaller countries, when any two countries are producing two goods (like cars and sugar), one country will always have a comparative advantage over the other in the production of one of the two goods. Put another way, given two countries that can both produce sugar and cars, one country should specialize in producing cars and one country should specialize in producing sugar so that they can trade.

At first this might seem silly. After all, what if a country is better at producing both sugar and cars? Imagine that the United States isn’t trading sugar and cars with a country as large as Brazil. Instead, suppose that the United States is trading with a very small country like Costa Rica. Unlike Brazil, Costa Rica cannot produce as much sugar as the United States, nor can it produce as many cars as the United States. In fact, the United States has an absolute advantage over Costa Rica in the production of both cars and sugar. Does this mean that they cannot benefit from trade? The answer is no. They can still benefit from trading with one another because each country has a comparative advantage over the other. In essence, this means that one country is more efficient at producing a good than the other. While Costa Rica might not be able to produce as much sugar as the United States, it does not cost very much to produce the small amount that it can grow. After all, Costa Rica doesn’t need greenhouses and expensive equipment to grow sugar cane. So, while the United States could produce more sugar than Costa Rica, it should put more effort into producing cars because the costs are so high to produce sugar in the United States. If Costa Rica and the United States trade, the United States should produce cars (because it has a comparative advantage in the production of cars) and Costa Rica should produce sugar (because it has a comparative advantage in the production of sugar). While the United States could produce more of both, it is more efficient to specialize in the production of cars and trade those extra cars for sugar.

When countries trade with one another, two terms—balance of trade and balance of payments—are often used to summarize the activity. A balance of trade records the values of all goods and services exported from a country minus the value of all goods and services imported from outside the country. This is often referred to as the "trade surplus" (if exports exceed imports) or the "trade deficit."

The balance of payments covers all the economic transactions of a country; this includes the trade balance, but it also includes other items such as the transfer of capital goods and changes in a country's official reserves.
Issues concerning economic trade

The previous example illustrates the benefits of international trade. In economic terms, there are clear advantages to both countries. Sometimes, however, policymakers make decisions that are not always based on economic principles. For instance, sometimes a nation’s leader might feel that a particular industry is important for national security. Since a war might disrupt trade, a country that is dependent on others for certain goods might be left unprepared. Therefore, a country might try to encourage certain industries to remain functional, even though it might be more efficient to trade for that particular good rather than produce it. This is known as protectionism because it protects a country’s industries from foreign competition.

If a nation engages in protectionist policies, it usually does so by finding ways to reduce the amount of a foreign good that enters the country. This can be accomplished any number of ways, but the following items explain the more common barriers to trade.

Barriers to Trade

1) Tariff—A tariff is a tax on an imported good. This increases the price of that good, thereby decreasing the quantity demanded. A tariff might help a domestic producer stay in business, even though an imported good would (without the tax) be cheaper for domestic consumers.

2) Quota—A quota is similar to a tariff, but instead of taxing the import, a quota limits the amount of a good that is allowed into the country. That way, while a foreign good may be cheaper, domestic consumers can only buy so much of it before they have to buy comparable domestic goods instead.

3) Embargo—An embargo on a particular good is like a quota set at zero; a government completely prohibits the import of that item. While there are embargoes on particular goods and services, governments also place trade embargoes on nations that they disagree with, politically or otherwise. These embargoes prohibit trade in goods or services with businesses from the embargoed nation.

4) Standards—Governments employ standards to ensure the safety of imported goods and to make sure that these goods comply with local laws. For example, the use of lead in paint is prohibited in the United States due to the toxic effects associated with ingestion of this lead-based paint. However, other nations have no such law or prohibition. Therefore, the U.S. government has various agencies to ensure that imported goods adhere to the national standard that prohibits use of lead in paint. To comply with this standard, foreign firms may have to incur higher production costs in order to use paint with no lead.

5) Subsidy—With a subsidy, the government makes payments to a local supplier to reduce the production costs of the supplier. Lowered production costs should allow the local supplier to charge less for his or her goods and services, thereby making the local
supplier more competitive in comparison to foreign firms offering the same good or service.

While barriers to trade can help a sector of a nation’s economy, there are costs associated with them. In almost all cases, placing trade barriers increases price, and this increased cost is paid for by a country’s buyers, its citizens. So while a tariff on pineapples will make a nation’s pineapple growers happy, this tariff will result in higher pineapple prices for all of that nation’s citizens. In addition, over time, keeping trade barriers in place can actually harm a national economy, making it inefficient and unresponsive to long-term economic changes. Consider, for instance, a nation with a booming banking sector and a high tariff on imported pineapples. With this tariff intact, many people will stay in the pineapple business simply because the price is being kept above its free-market price. However, if there was no tariff on imported pineapples, some pineapple growers would find themselves unable to compete and be forced out of that business. This would be painful in the short term, but if they switched businesses and became Pineapple Savings and Loan (a new bank in the booming sector of the economy), they could find themselves better off as bankers in the long run than they would have been by staying pineapple farmers.

Without trade barriers, unprotected businesses are forced to remain challenged by all foreign competitors. Although this can occasionally be painful for individual businesses, in the long run a nation’s economy remains healthier because the increased competition fosters innovation and efficiency.

Since barriers to trade increase prices, many nations often try to reduce these barriers with their economic partners. In theory, this will lead to lower prices for buyers (citizens) within the trading nations, as well as firms that are more competitive on the international market (because of increased competition). The North American Free Trade Agreement, NAFTA, is one such trading block; its goal is to eliminate barriers to trade—most notably tariffs—between Canada, Mexico, and the United States. Another such trading block, the European Union (EU), is fashioned with the similar goal of reducing barriers to trade between its member nations, which should then reduce prices throughout the trading block while making firms more competitive. Whether NAFTA or the EU has actually improved the economies of their nation-state members is the subject of a good deal of debate.
★ Exchange rates ★

Tariffs, quotas, and other trade agreements are international trade issues that entire countries must address. For individuals, the exchange rate is one of the most important international trade issues. The exchange rate measures the price of one nation’s currency in terms of another nation’s currency.

Consider the case of two grocery stores: Americo-store and Groceria Mexicana. Americo-store is in Brownsville, Texas, while Groceria Mexicana is right across the border in Matamoros, Mexico. Suppose a bank on the U.S. side of the border—perhaps the Apple Saving and Loan bank—published the following exchange rate table.

<table>
<thead>
<tr>
<th>British pound</th>
<th>One U.S. dollar</th>
<th>in U.S. dollars</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>0.49</td>
<td>2.06</td>
</tr>
<tr>
<td>Danish krone</td>
<td>5.17</td>
<td>0.19</td>
</tr>
<tr>
<td>Euro</td>
<td>0.69</td>
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</tr>
<tr>
<td>Japanese yen</td>
<td>114.69</td>
<td>0.0087</td>
</tr>
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<td>Mexican peso</td>
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</tr>
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<td>Thai baht</td>
<td>31.7</td>
<td>0.03</td>
</tr>
</tbody>
</table>

This shows that the exchange rate between the U.S. dollar and the Mexican peso is 1:10.71, meaning one U.S. dollar translates to 10.71 Mexican pesos. The second column, “in U.S. dollars,” shows how much would be needed to purchase one Mexican peso. This rate is 1:0.093, meaning 9 American cents—or 9 and 3/10 American cents, to be precise—translates to one Mexican peso.

Exchange rates move up and down to reflect the value of one country’s currency in comparison to another. If there is a great demand for U.S. products, people need more U.S. dollars to purchase these goods. This drives the demand for U.S. dollars up, causing the dollar to appreciate, or strengthen. At the same time, the peso has depreciated, or weakened, relative to the dollar. Suppose the following exchange rate is published one year after the previous one (see next page):
The new exchange rate is 1:15.02, meaning the value of an American dollar now translates to 15.02 Mexican pesos. This leads to the big question: Which grocery store benefits from the new exchange rate?

If you answered Groceria Mexicana, you would be correct. The appreciated dollar makes U.S. goods more expensive relative to their Mexican counterparts. The dollar can purchase more, but it also raises the price of U.S. goods. Some U.S. customers might take advantage of the stronger dollar and cross the border to shop at Groceria Mexicana, since their dollars are now worth 15.02 pesos instead of 10.71. Similarly, anyone converting pesos to dollars needs to pay 15.02 pesos for one dollar (rather than 10.71). In this case, when a person is converting dollars to pesos, his or her purchasing power has increased due to the new exchange rate. When a person is converting pesos to dollars, however, the stronger dollar lowers his or her purchasing power. Overall, business at Groceria Mexicana would increase while the America-store’s business would decline as some customers cross the border to take advantage of their strengthened currency.

A question for this standard might look like this:

**Over the course of one year, the Japanese yen depreciates relative to the British pound. Who would benefit MOST from this occurrence?**

A  British consumers of British goods  
B  British consumers of Japanese goods  
C  Japanese consumers of Japanese goods  
D  Japanese consumers of British goods

The yen has depreciated, meaning that one British pound now purchases more yen than it did previously. This would help British consumers of Japanese goods, since they now have additional purchasing power in Japanese markets due to the stronger pound. The answer is choice B.
Sample Questions for Content Domain IV

This section contains sample questions for you to try to answer. After you have completed all the questions, check your answers in the “Answers to the Content Domain IV Sample Questions” section that follows. The section will also explain why the other answer choices are incorrect.

1. A tariff placed on foreign steel imports represents
   A. a barrier to trade
   B. a balance of payment deficit
   C. a subsidy to domestic producers
   D. an increase in domestic production

2. Those in favor of protectionist trade policies would MOST likely
   A. support a reduction in tariffs
   B. call for fewer import restrictions
   C. cite the need to preserve domestic industries
   D. believe that restrictions harm consumers

3. In the country of Balmoria, it takes 9 hours of labor to harvest a bushel of wheat and 6 hours of labor to build a wooden bookcase. In the nearby country of Dashmund, it takes 8 hours of labor to harvest a bushel of wheat and 7 hours to build a wooden bookcase. In terms of labor on these identical goods, which statement describes the situation accurately?
   A. Dashmund has an absolute advantage in both wheat and bookcases.
   B. Balmoria has an absolute advantage in both wheat and bookcases.
   C. Dashmund has a comparative advantage in wheat harvesting.
   D. Balmoria has a comparative advantage in wheat harvesting.

4. Use this exchange rate table to answer the question.

<table>
<thead>
<tr>
<th>U.S. Dollar, end of Year 1</th>
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Which monetary amount is the closest equivalent to having two U.S. dollars?

A. 64 Thai baht
B. 57 Japanese yen
C. 0.7 Euro
D. 0.25 British pound
1. Answer: A  
Standard: Issues concerning international trade
Tariffs are taxes on imports. They often have the effect of helping domestic industries, so they might boost domestic production. First and foremost, though, they are a barrier to trade, since the added tax makes trading with that country less profitable. The answer is choice A.

2. Answer: C  
Standard: Issues concerning international trade
Tariffs can help protect domestic industries by discouraging trade with other nations. Domestic workers who could be unemployed by lower-costing imports are now able to retain employment, and “infant” industries are protected. Therefore, choice C is the answer. However, the domestic consumers will face higher prices because of the tariff, and the tariff would also patch over the fact that their domestic business is unable to compete in a world market.

3. Answer: C  
Standard: Advantages of international trade
To answer this question, take each good and compare the labor required to produce it in both countries. For a bushel of wheat, Dashmund requires 8 hours of labor to Balmoria’s 9, so Dashmund has the absolute advantage there. This means choice B is incorrect. For bookcases, Dashmund requires 7 hours of labor to Balmoria’s 6, so Balmoria has the absolute advantage when it comes to bookcases. This eliminates choice A as an answer, leaving only choices C and D. Since Dashmund’s 8 hours of labor for wheat harvesting is lower than Balmoria’s 9 hours, Dashmund has the comparative advantage. Choice C is the answer.

4. Answer: A  
Standard: Exchange rates
The first column shows how much one U.S. dollar is worth in the various currencies. Looking down the column, you can see one U.S. dollar is worth about 32 Thai baht, meaning two dollars would be twice as much, or 64 baht.