Name ______________________ Date ________________ Class ______________________

STUDY GUIDE Chapter 18, Section 1

For use with textbook pages 473–477

THE BENEFITS OF WORLD TRADE

KEY TERMS

imports Goods bought from other countries for domestic use *(page 473)*

exports Goods sold to other countries *(page 474)*

absolute advantage Ability of one country, using the same quantity of resources as another country, to produce a particular product more efficiently *(page 475)*

specialization Concept that a nation should produce and export a limited assortment of goods for which it is particularly suited in order to remain profitable *(page 475)*

comparative advantage Ability of a country to produce a product at a lower opportunity cost than another country *(page 476)*

DRAWING FROM EXPERIENCE

What is the name brand on the computer you use at school? Do you think that all the parts in that computer were made in the United States? Is it possible that a computer made by an American company like IBM contains parts made in other nations?

This section explains international trade and the value of exports and imports. It also explains the factors that determine what goods a nation produces.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read through the summaries that follow. Think about the television in your household and where it might have been manufactured.

Absolute Advantage	Comparative Advantage
Definition: Example:	Definition: Example:

READ TO LEARN

■ **Benefits of Trade** *(page 474)*

Imports make up about 14 percent of the United States' GDP, or Gross Domestic Product. Fourteen percent might not seem like much. However, life in the United States would be very different without ***imports,*** or goods bought from other countries. Specifically, there would be no coffee, pepper, or chocolate in the United States because these items are imported from other countries.

Exports are goods sold to other countries. More than 40 percent of the engineering and scientific instruments manufactured in the United States are sold to consumers in other countries. Nearly half of all the wheat produced in the United States is sold to consumers in other countries.

Some products that appear to be made in the United States might contain parts made in other countries. For instance, Minute Maid and Tropicana orange juices are made from concentrate that comes from the United States, Mexico, or Brazil. So, even though Minute Maid packages orange juice in the United States, they might use resources that are imports from other countries.

Nations differ in the factors of production they have available for use. The factors of production in any nation are natural resources, labor, capital, and entrepreneurship. The United States has a highly skilled labor force and large amounts of capital. This is why the United States is well suited for producing scientific instruments. Another country that does not have the same highly skilled labor force and large amounts of capital, will not be well suited for producing scientific instruments.

1. What factors of production must a nation have to be well suited for producing scientific instruments?

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▣ Absolute vs. Comparative *(page 475)*

The relative cost of production helps determine what a nation will import and export. Also, all nations must make choices about how they use their scarce resources, or resources that are limited in supply such as natural resources, time, and money.

Brazil's tropical climate is ideal for growing bananas. Suppose France uses the same amount of labor, land, and capital as does Brazil to grow bananas. France will never produce as many bananas as does Brazil because France does not have a tropical climate. This means that Brazil has an absolute advantage over France in the production of bananas. ***Absolute advantage*** is when one nation can produce a particular product more efficiently than another nation, even though both countries use the same amount of resources.

Some nations are well suited for producing and making a profit on certain goods. This is called ***specialization.*** For instance, Japan's specialization is consumer electronics, such as CD players and televisions. Many countries import consumer electronics from Japan.

One nation can have a comparative advantage over another nation in producing a particular good. ***Comparative advantage*** is the ability of one nation to produce a product at a ***lower opportunity cost*** than another country. In this instance, a ***lower opportunity cost*** means that the trade-offs involved in producing a particular good are well worth the profit made from selling the good. For example, the United States has a comparative advantage over many countries in the production of scientific instruments. Other nations might produce scientific instruments, but the United States can produce these goods at a lower opportunity cost than most other nations.

The purpose of international trade is to obtain imports. We export goods in order to obtain funds. With these funds we import goods that we can not produce efficiently ourselves. In other words, in international trade *exports pay for imports*.

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

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STUDY GUIDE Chapter 18, Section 2

For use with textbook pages 479–484

FINANCIAL WORLD TRADE

KEY TERMS

exchange rate The price of one nation's currency in terms of another nation's currency *(page 479)*

foreign exchange markets Markets dealing in buying and selling foreign currency for businesses that want to import goods from other countries *(page 480)*

fixed rate of exchange System under which a national government sets the value of its currency in relation to a single standard *(page 480)*

International Monetary Fund (IMF) Agency whose member governments once were obligated to keep their foreign exchange rates more or less fixed; today it offers monetary advice and provides loans to developing nations *(page 481)*

devaluation Lowering a currency's value in relation to other currencies by government order *(page 481)*

flexible exchange rates Arrangement in which the forces of supply and demand are allowed to set the price of various currencies *(page 482)*

depreciation Fall in the price of a currency through the action of supply and demand *(page 482)*

balance of trade Difference between the value of a nation's exports and its imports *(page 483)*

DRAWING FROM EXPERIENCE

Have you ever thought about how businesses purchase goods from foreign countries? How does a business in the United States use U.S. dollars to purchase goods from Japan where the medium of exchange is the yen?

This section focuses on exchange rates, or how the price of one nation's currency is expressed in terms of the price of another nation's currency. It also explains how exchange rates affect international trade.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read through the summaries that follow. Think about how exchange rate systems have changed to benefit businesses and global trade.

Foreign Exchange Markets

the past (before 1970) → **International Monetary Fund**

the present (after 1970) → **supply and demand**

Fixed Exchange Rates	**Flexible Exchange Rates**
definition:	definition:

READ TO LEARN

Introduction *(page 479)*

In the United States, the dollar is our medium of exchange. Remember that a *medium of exchange* is something a seller will accept in exchange for a good or service. In order for nations to be involved in international trade, there must be an established ***exchange rate,*** a price for one nation's currency in terms of another nation's currency. Also, there must exist a way in which individuals, nations, or businesses exchange one type of currency for another. In order to do this, businesses must be able to convert one currency to another easily. ***Foreign exchange markets*** deal in buying and selling foreign currency for businesses that want to import goods from other countries. Foreign exchange markets daily list the price of one nation's currency in comparison to another nation's currency.

1. What do foreign exchange markets do?

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Fixed Exchange Rates *(page 480)*

From 1945 to the early 1970s, a fixed rate of exchange was used to trade currency. A ***fixed rate of exchange*** means that a national government sets the value of its currency in relation to a single standard such as gold. For example, the value of the United States dollar had to be determined by the amount of gold the United States held in reserve. Before 1970, member governments of the ***International Monetary Fund (IMF)*** had to keep their foreign exchange rates more or less fixed. IMF member governments had to set the value of their currency by a single standard that each government held in reserve.

One of the benefits of a fixed rate of exchange was that it allowed importers and exporters to know exactly how much currency they could purchase with their nation's money. A fixed exchange rate also allowed central banks to affect the level of imports and exports in their country by devaluing their country's currency. A ***devaluation*** occurs when the value of one country's currency is lowered in relation to other nations' currencies by government order. If Japan devalues its yen by one-half, then the cost of Japanese goods to consumers in the United States will decrease.

The system of fixed exchange rates became impractical. In a global economy, the economic climate changes constantly. Suppose the United States experiences high inflation and Japan does not. As a result, United States products become too expensive for Japanese consumers to buy. At the same time, Japanese products become very affordable for Americans to buy. The result is that United States imports large quantities of goods from Japan, but exports very little to Japan. Since exports pay for imports, the United States is not exporting enough goods to pay for the amount of goods it imports from Japan.

2. Why were fixed exchange rates impractical?

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Flexible Exchange Rates (page 482)

In 1971, President Richard Nixon announced the end of fixed American exchange rates. After that announcement, many nations followed the United States by switching to a flexible exchange rate. Under a system of ***flexible exchange rates,*** supply and demand determine the value of one nation's currency against another. With flexible exchange rates, a nation's currency can change, or go up and down, a little each day. Suppose the amount of American dollars wanted by Japanese exporters is more than the quantity of dollars supplied by Americans buying Japanese goods. Then the American dollar will become more expensive in relation to the Japanese yen. In other words, it will take more yen to equal one dollar. This follows the basic law of supply and demand. When the demand is high and the supply is low, then the price goes up.

Suppose the opposite is true, that the quantity of dollars American importers supply is more than the quantity demanded by Japanese exporters. Then the American dollar will become cheaper in relation to the Japanese yen. Fewer yen will equal one dollar. In this case, when the American dollar becomes cheaper in relation to the Japanese yen, we call it depreciation. ***Depreciation*** of a country's currency occurs when the price of that currency falls as a result of supply and demand.

3. What is a flexible exchange rate?

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Balance of Trade (page 483)

Balance of trade is the difference between the value of a nation's exports and its imports. When a nation's currency depreciates, or becomes "weak," that nation will probably export more goods. This happens because those goods become cheaper for other nations to buy. If on a given day the American dollar depreciates against the Japanese yen, then the Japanese can purchase more American-made goods for their money. At the same time, America will import fewer goods from Japan because its depreciated dollar will have less purchasing power in Japan. This example is called a positive balance of trade, when the value of exports exceeds the value of imports.

If the opposite is true, it is called a negative balance of trade, or a *trade deficit.* This occurs when the value of a nation's imports is greater than the value of its exports. A trade deficit usually brings with it a negative *balance of payments,* which occurs when a nation spends more money abroad than it receives from other countries. A trade deficit is not necessarily a bad thing. For instance, if the value of United States exports is high, that means foreigners are investing in the U.S. economy. When foreigners invest money in the U.S. economy, it benefits the U.S. by creating jobs and supporting industries in the U.S.

4. What is the benefit of a trade deficit?

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STUDY GUIDE Chapter 18, Section 3

For use with textbook pages 486–489

RESTRICTIONS ON WORLD TRADE

KEY TERMS

tariff Tax placed on an imported product *(page 486)*

revenue tariff Tax on imports used primarily to raise income without restricting imports *(page 487)*

protective tariff Tax on imports used to raise the cost of imported goods and thereby protect domestic producers *(page 487)*

import quota Restriction imposed on the value of or on the number of units of a particular good that can be brought into the country *(page 487)*

embargo Complete restriction on the import or export of a particular good *(page 487)*

protectionists People who argue for trade restrictions to protect domestic industries *(page 487)*

General Agreement on Tariffs and Trade Trade agreement under which countries met periodically to negotiate tariff reductions that were mutually advantageous to all members *(page 488)*

World Trade Organization World's largest trade agreement among more than 140 nations *(page 488)*

North American Free Trade Agreement Trade agreement designed to reduce tariff barriers among Mexico, Canada, and the United States *(page 489)*

European Union Organization of European nations whose goal is to encourage economic integration as a single market by eliminating restrictions on trade and using a common currency. *(page 489)*

DRAWING FROM EXPERIENCE

Do you remember learning about the Boston Tea Party in American history class? Do you remember why the colonists thought the tax on tea imposed by England was unfair?

This section explains restrictions that governments impose on imports. It explains why these restrictions are sometimes necessary. Also, it outlines several international trade agreements signed during the 1900s.

ORGANIZING YOUR THOUGHTS

Use the diagram below to help you take notes as you read through the summaries that follow. Think about the pros and cons of free trade and import restrictions.

Ways to Restrict Imports
1.
2.
3.

Trade Agreements
1.
2.
3.
4.

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STUDY GUIDE (continued) Chapter 18, Section 3

READ TO LEARN

■ Three Ways to Restrict Imports *(page 486)*

There are three major ways to restrict imports. The first is ***tariffs,*** or taxes on imports. Some governments apply ***revenue tariffs*** to imports. Revenue tariffs raise a government's income without restricting the amount or type of imports. Until the early 1900s, the United States government obtained most of its revenue, or income, from revenue tariffs. Some governments apply ***protective tariffs*** to imports. A ***protective tariff*** raises the cost of imported goods in order to protect domestic producers. For instance, a government might apply a protective tariff to imported cars if that country is trying to establish its own car manufacturing industry. Making imported cars more expensive will help encourage the population to purchase domestic-made cars. Tariffs are not used as much today as they have been in the past.

The second major way to restrict imports is to enact a quota system. An ***import quota*** usually restricts the amount of a product being imported into a country. The United States has placed quotas on imports of sugar, shoes, shirts, and cloth.

The third major way to restrict imports is by imposing embargoes. An ***embargo*** is a complete restriction on imports or exports. Most embargoes are enacted for political reasons. For example, in 1980 President Jimmy Carter ordered an embargo on all grain exports to the Soviet Union. He did this because the Soviet Union had invaded Afghanistan. Some embargoes are enacted on a particular good. For example, in the 1990s there were embargoes on the importation of yellowfin tuna from certain countries that did not meet "safe dolphin" fishing requirements.

1. What is the difference between a revenue tariff and a protective tariff?

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■ Arguments Against Free Trade *(page 487)*

Whether or not free trade is good or bad is a matter of intense public debate. People who argue against free trade and *for* trade restrictions such as tariffs and quotas are called ***protectionists.*** Protectionists use three main arguments to support their opinion. Protectionists argue that in order to ensure job security for domestic workers, a nation must restrict imports. This way, American manufacturers will not have to compete with lower-priced goods from other countries. For example, in the 1980s, imported steel became much less expensive than steel manufactured in American steel mills. Because there were no restrictions or tariffs on imported steel, most businesses purchased imported steel. As a result, American steel mills lost business and had to lay off many workers. Protectionists also argue that the nation's economic security is dependent upon certain industries. Protectionists further argue that a new, or infant, industry needs to be protected from foreign competition until that industry can compete in the world market.

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2. What are three main arguments used by protectionists?

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Arguments For Free Trade *(page 488)*

There are three main arguments in support of free trade. People who believe in free trade argue that foreign competition encourages United States firms to improve their products. The second argument in support of free trade is that many American workers produce goods that are exported. If other countries restrict their imports, then that hurts the American exporters. If the United States restricts imports, other nations might retaliate and restrict their imports. The third argument in support of free trade is that specialization benefits consumers. When countries specialize in producing certain goods, those goods are usually available to other countries at a lower price.

3. What are the three main arguments in support of free trade?

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Trade Agreements *(page 488)*

Trade agreements enacted in the last half of the 20th century reflect a global trend toward fewer trade restrictions. The ***General Agreement on Tariffs and Trade (GATT)*** is an agreement that was signed after World War II. Under GATT, countries agreed to negotiate tariff reductions that would benefit all member nations.

The ***World Trade Organization (WTO)*** was formed in 1994 when the nations belonging to GATT signed a new treaty. The goal of the WTO is a 40 percent reduction in tariffs by 2005. This is the most far-reaching global trade agreement in history.

Smaller regional trade agreements also have been signed. For instance, the United States reached an agreement with Canada and Mexico called the ***North American Free Trade Agreement (NAFTA).*** Since this treaty was approved, trade has increased among the three nations. The most important regional trade agreement today is the ***European Union (EU).*** As of 2000, 15 European countries made up the EU. Starting in 2004, 10 more countries planned to join. One of the goals of the EU is to enact a common currency among its member nations. The EU also has helped eliminate trade restrictions among its member nations.

4. What is the global trend in trade agreements today?

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