



Understanding Economics

2nd edition

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Chapter 16

Foreign Trade

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Chapter Objectives

In this chapter, you will:

- learn about Canada's foreign trade, trade relationships, and trading patterns
- analyze the case for trade, based on absolute and comparative advantage
- examine the impact of trade protection and the arguments for and against it
- Learn about Canada's trade policies from its beginnings as a country of recent international trade arrangements

The Importance of Trade (a)

- Canada has shown a heavy reliance on trade, with exports representing 41% of its GDP.
 - When compared with other countries, Canada's exports are a higher proportion of GDP than is average for the world's countries, including Japan and the US.
 - Some small industrialized countries, such as Belgium, have a higher reliance on foreign trade than does Canada.

The Importance of Trade (b)

Figure 16.1, Page 402

(exports as a percentage of GDP, 1999)

	Percent
Belgium	73
Canada	41
Switzerland	40
United Kingdom	29
Germany	27
France	27
China	22
United States	12
Japan	11
World average	22

Canada's Trade Patterns (a)

- Canada's primary trading partner is the US which buys over four-fifths of Canadian merchandise exports and provides about three-quarters of Canadian merchandise imports

Canada's Merchandise Trade by Region (2000)

Figure 16.2, Page 402

	Merchandise Exports		Merchandise Imports	
	(\$ millions)			
United States	359 630	(86%)	267 578	(74%)
European Union (E)	21 007	(5%)	33 572	(9%)
Japan	9 920	(2%)	11 718	(3%)
Other OECD countries	8 159	(2%)	18 925	(5%)
All others	18 941	(5%)	31 371	(9%)
Total	417 657	(100%)	363 164	(100%)

Canada's Trade Patterns (b)

- Canada's merchandise exports are about equally divided between natural resources (both raw and processed) and manufactured goods
- Canada's merchandise imports of manufactured goods are more than double its merchandise imports of natural resources (both raw and processed)

Canada's Merchandise Trade by Type of Product (2000)

Figure 16.3, Page 403

	Merchandise Exports		Merchandise Imports	
	(\$ billions)			
Consumer Goods	14 669	(3%)	40 080	(11%)
Automobile Products	96 297	(23%)	77 404	(21%)
Machines and Equipment	105 575	(25%)	122 740	(34%)
Industrial Goods	64 612	(15%)	70 461	(19%)
Forest Goods	41 381	(10%)	3 064	(1%)
Energy Products	52 538	(13%)	17 753	(5%)
Agriculture and Fish Products	27 577	(7%)	18 568	(5%)
Other	15 010	(4%)	3 039	(4%)

Canada's Trade Patterns (c)

- The impact of Canada's service sector on trade is not fully reflected in the stated figures for service exports and imports

What is Traded

- Three main factors determine what products a country exports and imports
 - resources
 - market size
 - climate

The Case for Trade

- International trade brings three main economic gains
 - product variety
 - competition
 - specialization

Absolute and Comparative Advantage

- Specialization can be based either on absolute advantage or comparative advantage
 - absolute advantage is exhibited by a producer who can supply a certain quantity of an item more efficiently than can other producers
 - comparative advantage is exhibited by a producer who can supply a certain item with a lower opportunity cost than can other producers

Gains from Trade Based on Absolute Advantage

Figure 16.4, Page 406

	Time Spent Building Furniture	Time Spent Preparing a Will	Time Saved through Specialization
Lawyer	20 hours	2 hours	$20 - 2 = 18$ hours
Carpenter	5 hours	10 hours	$10 - 5 = 5$ hours

Gains from Trade Based on Comparative Advantage

Figure 16.5, Page 406

	Hypothetical Output Per Worker		Opportunity Cost	
	Paper	Computers	of 1 tonne of paper	of 1 computer
Canada	12 tonnes	12 computers	1 computer	1.0 tonnes paper
Mexico	3 tonnes	9 computers	3 computers	0.33 tonnes paper

Total Gains from Specialization

Figure 16.6, Page 407

	Before Trade		After Trade	
	Paper	Computers	Paper	Computers
Canada	60 tonnes	60 computers	120 tonnes	0 computers
Mexico	30 tonnes	90 computers	0 tonnes	180 computers
	90 tonnes	150 computers	120 tonnes	180 computers

The Terms of Trade

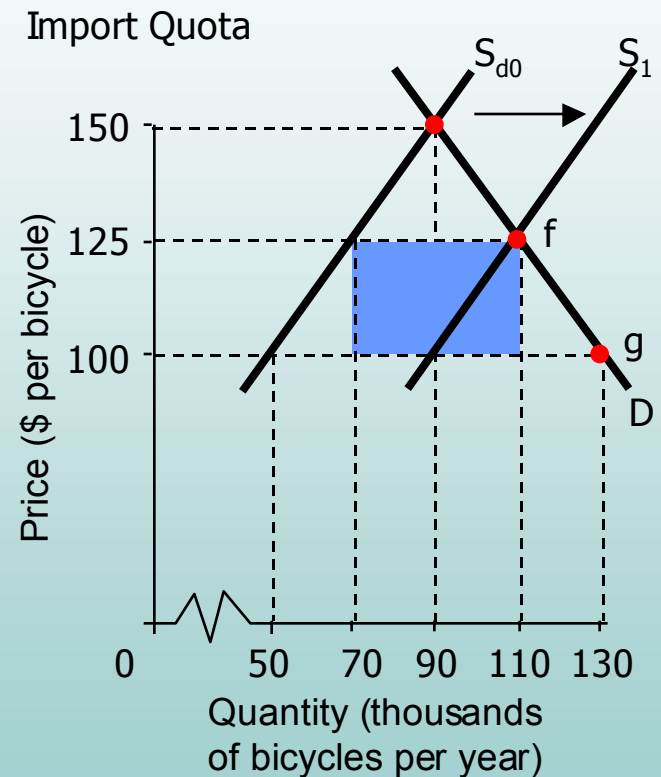
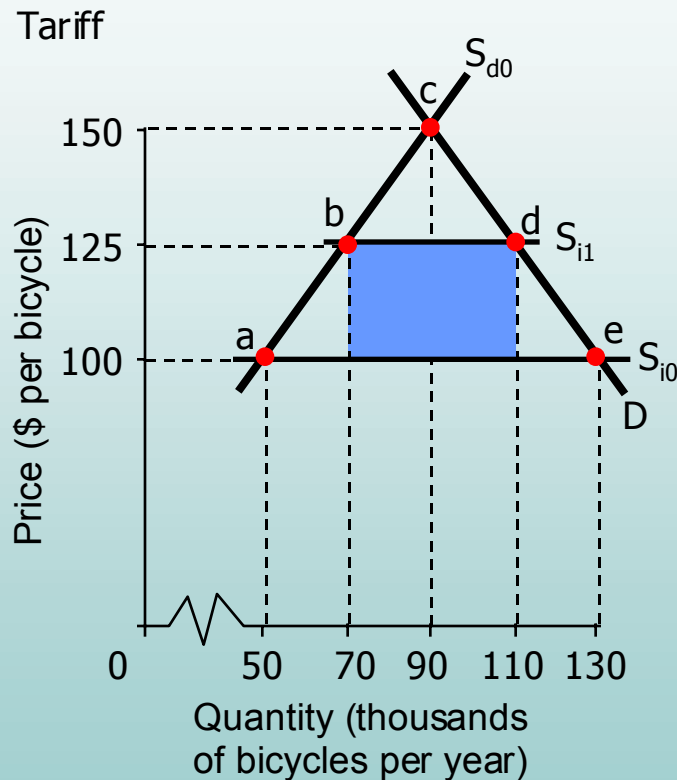
- The terms of trade represent the international price of one product in terms of another
- The limits of the terms of trade for a pair of products traded between two countries are determined by the cost ratios of the products in each country

The Impact of Trade Protection (a)

- In a perfectly competitive market
 - a tariff (which is an excise tax on imported goods) decreases consumption and foreign imports while it increases domestic production and government revenues
 - an import quota (which is a non-tariff barrier) has the same effect as a tariff except that the increase in government revenues is replaced by a increase in the price of foreign imports

The Impact of Import Barriers

Figure 16.7, Page 410



The Case for Trade Protection

- Seven arguments are used to support trade protection
 - domestic employment
 - infant industries
 - terms of trade
 - environment and safety standards
 - cheap foreign labour
 - national security
 - cultural sovereignty

Past Canadian Trade Policies (a)

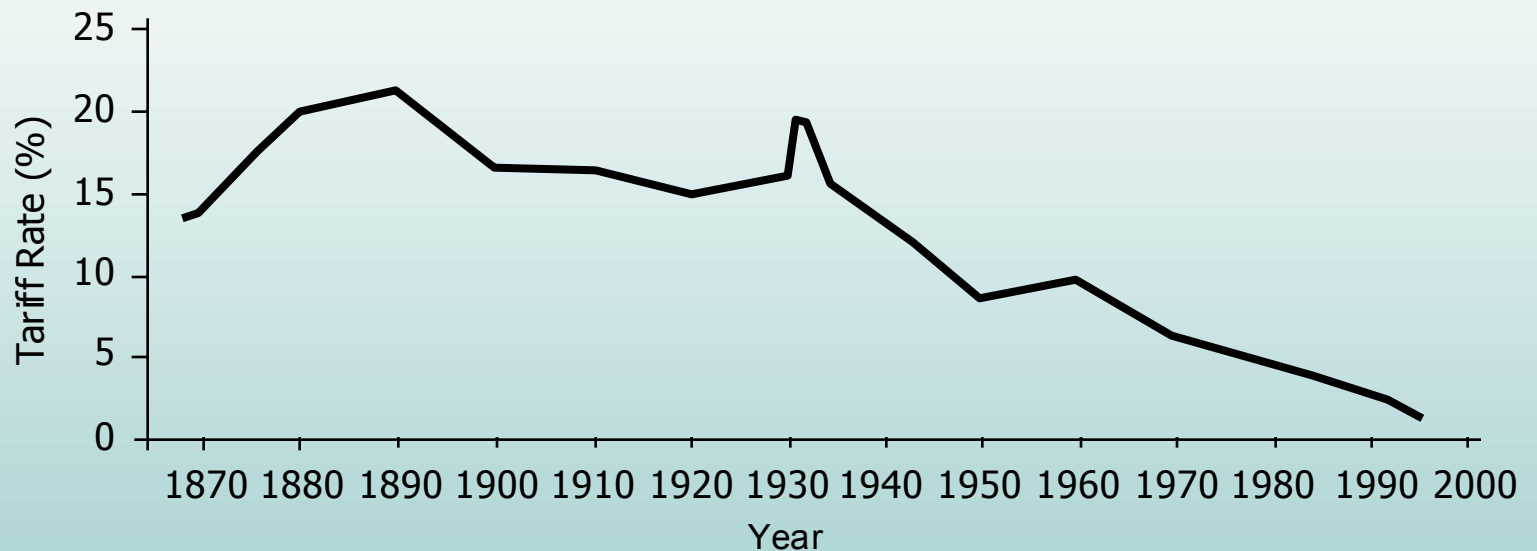
- Canadian trade policy has undergone several significant shifts
 - the Reciprocity Treaty (1854) established favourable trade between British North American and the US
 - the National Policy (1879) initiated wide-ranging Canadian tariffs on manufactured goods to stimulate a domestic manufacturing sector

Past Canadian Trade Policies (b)

- the Great Depression sparked an international round of protectionism in which Canada participated
- the General Agreement on Trade and Tariffs (GATT) and its replacement the World Trade Organization (WTO) represent multilateral initiatives to reduce trade protection among member countries including Canada

Average Tariff Rates in Canada

Figure 16.8, Page 416



Recent Trade Blocs (a)

- A trading bloc (which is a relatively small number of countries involved in a trade agreement) can take three forms
 - a free trade area is an area in which trade is tariff-free although member countries are able to impose separate trade barriers on outside countries (e.g. NAFTA)
 - a customs union is a group of countries with common trade barriers with outside countries as well as a free trade area (e.g. Mercosur)

Recent Trade Blocs (b)

- a common market is a customs union that allows for the free movement of labour and capital among member countries (e.g. the EU)

The Auto Pact

- The Auto Pact (1965)
 - is an example of a free trade area in one class of products
 - eliminated tariffs on both sides of the Canada-US border as long as the “Big Three” auto companies met North American content and Canadian value-added rules
 - has been successfully challenged in the WTO by Japan and the European Union

The Free Trade Agreement (a)

- The Free Trade Agreement (FTA) signed by Canada and the US in 1988
 - has eliminated tariffs on virtually all products
 - includes services
 - reduces governments' ability to screen foreign direct investment
 - has introduced a new North American content rule for autos
 - has created a continental energy market

The Free Trade Agreement (b)

- excludes cultural industries
- has been accompanied by a significant increase in trade between the two countries

The North American Free Trade Agreement

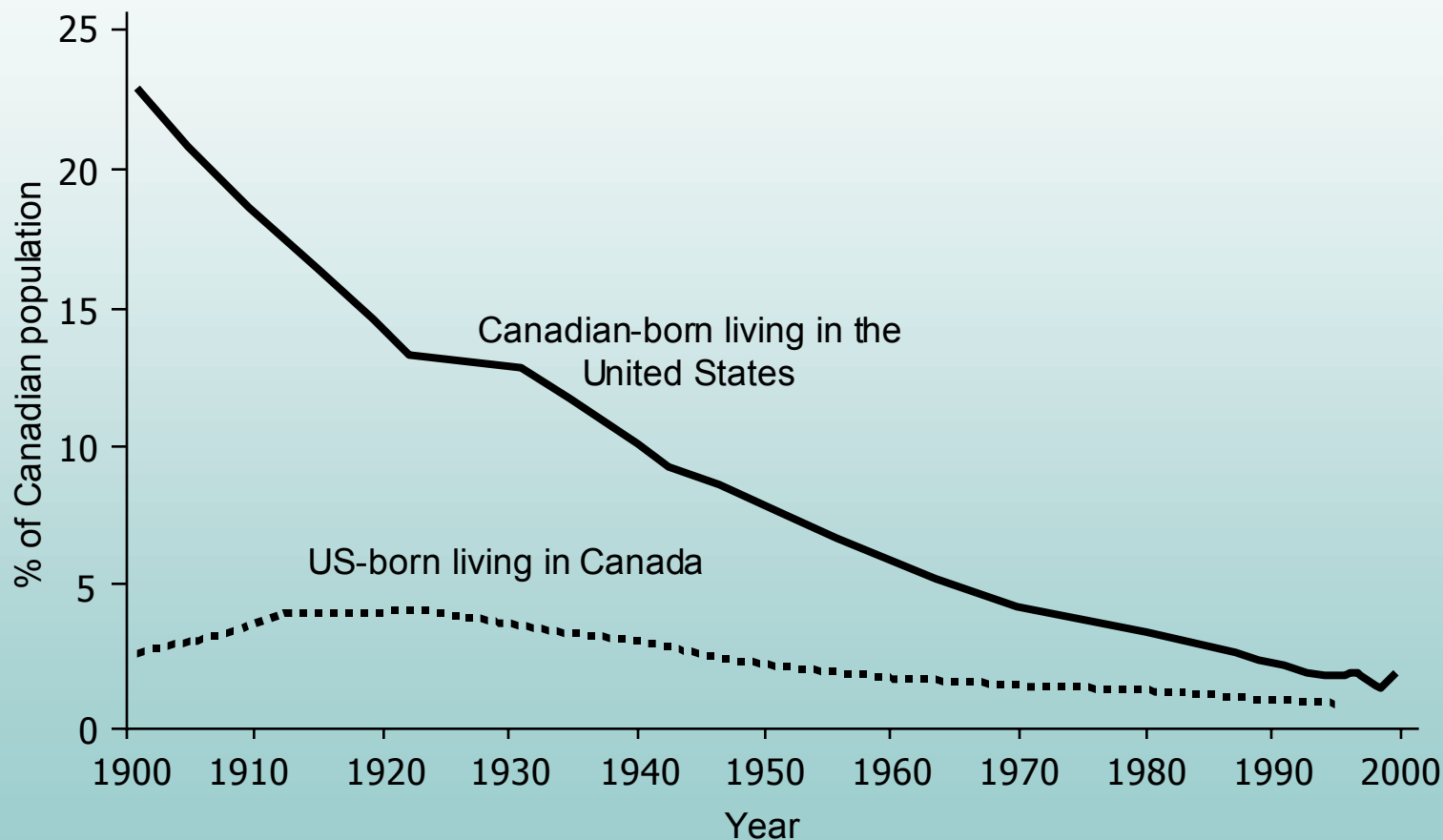
- The North American Free Trade Agreement (NAFTA) signed by Canada as well as the US and Mexico in 1993
 - extends most of the provisions of the FTA to include Mexico
 - includes side agreements concerning labour and environmental standards
 - has so far had little effect on Canada given Canada's relatively minor trade with Mexico

Globalization: Myths, Facts, and Consequences (a)

- According to Canadian economist John Helliwell, national borders still have an extensive effect on trade patterns and flows of financial capital
- These border effects are also very large for movements of people. In fact the number of Canadians moving to the US is much lower than in previous decades.

Canadian-Born Living in the United States and US-Born Living in Canada, 1990-2000

Figure A, Page 426



Globalization: Myths, Facts, and Consequences (b)

- Helliwell suggests that, while the 'body drain' to the US is not as significant as it once was, there is evidence to show that the 'brain drain' is a problem.
- Helliwell argues that growing inequality in the distribution of incomes is primarily due to domestic causes rather than globalization.

Globalization: Myths, Facts, and Consequences (c)

- Helliwell suggests that Canadian economic welfare compares well with other nations, and in particular the US
 - satisfaction with our health care system is relatively high by international standards
 - Canada has been relatively successful at educating its workforce, though there are some problems in the area of knowledge production
 - Canada has high levels of social capital

Globalization: Myths, Facts, and Consequences (d)

- Helliwell concludes that small countries such as Canada can stand up quite well in the face of today's globalizing trends.



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Chapter 16 **The End**

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