

# Chapter 8

## The Export-Import Sector

The American economy is, by far, the largest and most productive in the world. Consequently, we are the world's largest importer and exporter of goods and services. Yet foreign trade is less important to the U.S. economy than it is to those of nearly all other industrial nations. But, in spite of the relatively small percentage of U.S. GDP accounted for through foreign trade, we have become thoroughly integrated into the global economy.

So far we've looked at the three main sectors of GDP—C (consumption), I (investment), and G (government spending). Now let's consider  $X_n$  (net exports).  $X_n = \text{exports} - \text{imports}$ .

### CHAPTER OBJECTIVES

*In this chapter we'll cover:*

- The basis for international trade.
- U.S. imports and exports.
- A summing up:  $C + I + G + X_n$ .
- The world's leading trading nations.
- World trade agreements and free-trade zones.

---

### The Basis for International Trade

If you follow baseball, then you're familiar with trades. Let's say that the Houston Astros have five righthand hitting outfielders and trade one of them to the Philadelphia Phillies. In exchange the Phillies send the Astros one of their four lefthanded relief pitchers. Baseball folk would say that that was a trade that helped both teams. Of course, why else would they trade?

We're going to look at trading, first between individuals, and then between nations. There are a lot of people who like to putter around the house, doing their own repairs.

So how would you feel about doing a really *big* job, like building a 12' × 20' deck in your backyard? If you're really good with tools, it might take you 60 hours from start to finish.

Let's say you're a very successful attorney, who earns \$300 an hour. Now you could hire a construction person or a carpenter to do the deck for you at \$20 an hour. And to make things interesting, let's say that this person will also need 60 hours to complete the deck. Question: Should you hire him or her or build the deck yourself?

I'm sure that, unless you would rather do carpentry than anything else in the world, you would hire this person to build your deck. The labor will cost you \$1,200. You could make \$1,200 in just four hours by practicing law.

By the way, can you figure out the opportunity cost of building the deck yourself? It would be \$18,000 (60 hours × \$300). So you would save yourself \$16,800 (the \$18,000 that you earned – the \$1,200 you paid the deckbuilder). If this sounds at all familiar, it may be because we talked about this in the section on specialization and exchange in Chapter 4.

Back in 1776 Adam Smith made *this* observation:

It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy. The taylor does not attempt to make his own shoes, but buys them of the shoemaker. The shoemaker does not attempt to make his own clothes, but employs a taylor. The farmer attempts to make neither the one nor the other, but employs those different artificers....

What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom. If a foreign country can supply us with a commodity cheaper than we can make it, better buy it of them with some part of the produce of our own industry, employed in a way in which we have some advantage.<sup>1</sup>

Just as individuals can gain by specialization and trade, so too can nations. The basis for international trade is that a nation can import a particular good or service at a lower cost than if it were produced domestically. We will put off the technical analysis of this trade until the next-to-last chapter, when we will discuss absolute and comparative advantage.

## U.S. Exports and Imports

From the earliest days of our nation's history, we engaged in trade. As colonies of England in the 17th and 18th centuries, Americans were expected to provide her with raw materials and to buy England's manufactured goods. Indeed, we were largely prohibited from competing with her own manufacturers.

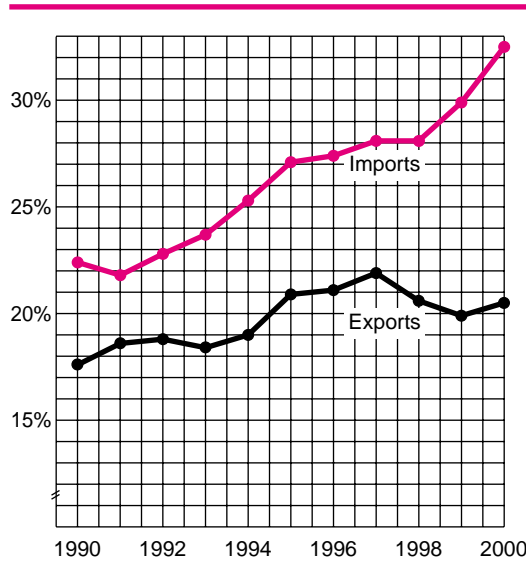
However, after independence, we became increasingly self-sufficient. As we noted back in Chapter 1, we were not only self-sufficient agriculturally, but by the time of the Civil War we had built a powerful manufacturing base in the North.

Our self-sufficiency in food production and our huge manufacturing base were important factors in helping us win World Wars I and II.<sup>2</sup> America was called "the arsenal of democracy" because of the vast quantity of armaments we sent our allies, especially Great Britain and the Soviet Union during the Second World War. This self-sufficiency continued until well into the 1970s, when our relatively small export-import sector began to grow significantly.

Figure 1 shows how dependent we have become on the global economy. During the 1990s, our merchandise imports and exports have sharply increased as a percentage of

<sup>1</sup>Adam Smith, *The Wealth of Nations* (New York: Modern Library, 1937), p. 424. (Originally published in 1776.)

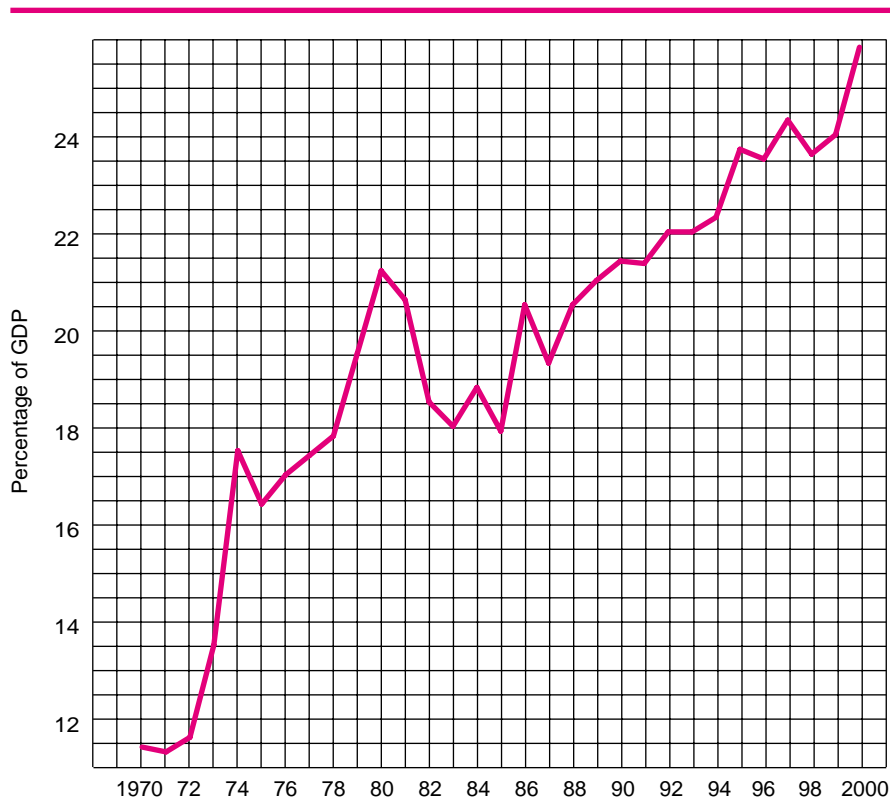
<sup>2</sup>During World Wars I and II our imports and exports combined soared to more than 20 percent of GDP. But for most of the first 60 years of the 20th century, this percentage was virtually always below 5 percent. As late as 1970 our combined imports and exports were just 11 percent of GDP (see Figure 2).



**Figure 1**  
Merchandise Imports and Exports as Percentage of Goods Produced in the United States, 1990–2000

Since 1990 our imports and exports as a percentage of goods produced in the United States has grown substantially. About one-fifth of all the goods produced here are shipped abroad, while our imports are equal to about one-third of the goods we produce in the United States.

Sources: *Economic Report of the President, 2001*; *Survey of Current Business*, February 2001.



**Figure 2**  
Sum of U.S. Imports and Exports as Percentage of GDP, 1970–2000

Between 1970 and 2000 the foreign trade sector more than doubled as a percentage of GDP.

Sources: *Economic Report of the President, 2001*; *Survey of Current Business*, March, 2001.

goods produced by our economy. Until the mid-1970s, our imports and exports were each less than 10 percent of our domestic goods output.

Figure 1 provides a somewhat misleading picture of our dependence on foreign trade because it focuses just on goods rather than on goods and services. Today Americans spend about 58 cents out of every dollar on services (see Figure 7 of Chapter 5). A more accurate gauge of the importance of foreign trade to the American economy would be the sum of our imports and exports as a percentage of GDP. This is shown in Figure 2.

As you can see from Figure 2, our foreign trade sector has more than doubled over the last 30 years. Before 1966 the sum of U.S. imports and exports never reached 10 percent of GDP. The big jump in 1973–74 was due mainly to a quadrupling of oil prices, something we'll talk more about in Chapter 10. Another long-term factor was Americans' increasing appetite for Japanese cars and consumer electronics from Japan and other countries in Southeast Asia.

We're going to be using a couple of new terms: positive balance of trade and negative balance of trade. *We run a positive balance of trade when we export more than we import.* You can easily figure out, then, what a negative balance of trade is. *We run a negative balance of trade when we import more than we export.* As we'll soon see, in recent years the United States has been running huge and growing negative trade balances. We have been buying a lot more goods and services from foreigners than they have been buying from us. Sometimes we refer to a negative trade balance as a trade deficit.

### Figure 3

U.S. Balance of Trade in Goods, Services, and Overall Balance, 1970–2000 (in billions of dollars)

Since the late 1980s we have been running a large and growing balance on services. Our balance on goods, which has been negative since the mid-1970s, has grown steadily worse since 1991 and now totals  $-\$459$  billion.

Source: *Economic Report of the President*, 1985; *Survey of Current Business*, February 2001.



What do we import and what do we export? We import and export both goods and services. The goods we import include cars, VCRs, TVs, computer chips, cameras, wine, oil, toys, clothing, and steel. Among the goods we export are cotton, wood, wheat, cars, tractors, and airplanes.

We import and export services such as hotel stays, restaurant meals, and car rentals for tourists, movies, TV programming, compact disks, computer software, banking, insurance, legal, and accounting services. In recent years we have been running a large and growing positive balance of trade in services. In 2000 we exported \$89 billion more in services to foreigners than we imported from them.

When foreign tourists fly to the United States on U.S.-owned airlines and spend billions of dollars on hotels, meals, and local transportation, they are contributing to our positive balance of trade in services. That spending is added to our export of services. So the next time you see Japanese tourists snapping pictures of one of our national monuments, walk up to them and thank them. They might even ask you to pose with them.

Our balance of trade in goods is a completely different story. From the outbreak of World War I until 1970 we maintained a positive trade balance in merchandise. By the late 1970s we were beginning to run substantial deficits. In 1984 the trade deficit broke the \$100 billion mark, broke the \$200 billion mark in 1997, and reached \$370 billion in 2000.

Figure 3 shows us three things: our trade balance in goods (or merchandise); (2) our trade balance in services; and (3) our overall trade balance, the sum of the balance in goods and services. Since the mid-1970s, we've been running trade deficits in merchandise and trade surpluses in services. But as you can see, the deficits in goods have far outweighed the surpluses in services, leaving us with large and growing overall trade deficits.

Does it really matter that we're running these huge trade deficits? After all, isn't the American economy so big and prosperous that we can afford to keep buying hundreds of billions of dollars more of goods and services from foreigners than we are selling to them? Virtually all economists agree that we cannot keep running these trade deficits indefinitely. In the last two chapters of the book, we'll talk about why we've been running these huge deficits and why we can't run them indefinitely.

Moving right along, we come to our two top five lists. Table 1 presents our five leading exports. Our number-one export in 2000 was computers, followed by airplanes and parts, and ADP (automatic data processing) equipment (see box, "Our Number-One Export").

One of the services we provide to foreigners is education. There are more than 500,000 foreign college students in the United States spending over \$13 billion, 75 percent of which is funded by overseas sources. Higher education now ranks as America's fifth-largest service sector export. China supplies us with more than 10 percent of these students, followed by Japan and Korea. What are they studying? About 21 percent are management and business majors, 15 percent are studying engineering, and 10 percent are studying math and computer sciences. At the Polytechnic University of New York, one of the nation's leading engineering schools, the Russian students often complain that they cannot understand the English spoken by their Chinese professors.

**TABLE 1** The Top Five U.S. Exports of Goods, 1999

	Value (in \$ billions)
1 Electrical machinery	\$75
2 Airplanes and parts	48
3 ADP equipment, office machinery	41
4 Agricultural commodities	37
5 Power-generative equipment	31

Source: U.S. Statistical Abstract, 2000

## *Our Number-One Export*

What's our number-one export? Computers, right? Wrong! I know that's what I've got in Table 1. If you're asked to name our number-one export on an exam, write "computers." But that's really the wrong answer.

Our number-one export is U.S. currency—mainly 20-dollar bills and 100-dollar bills. Maybe you're thinking Russian mafia or international narcotics peddlers, but tens of billions of U.S. dollars are spent abroad by American tourists, and most of those dollars then circulate as currency in those or other countries. When you travel abroad, your dollars will often be accepted at stores, in hotels, and by cab drivers. But just imagine some poor tourist attempting to pay for something in the United States in pounds, marks, francs, or yen.

Since we import some \$370 billion more in goods and services than we export, how do we make up the difference? Partially by paying foreigners in dollars.

Many of those dollars are recycled back to the United States in the form of investment—mainly in U.S. government and corporate bonds, corporate stock, in real estate, and in the building of factories. But there may be more than one trillion dollars in U.S. currency circulating in foreign countries. As long as foreigners are willing to accept tens of billions of dollars every year, there's no problem. But what happens if they stop accepting those dollars? At the end of the book, I promise to tell you what would happen.

OK, is U.S. currency *really* our leading export? No. We *pay* for about two-thirds of our exports with U.S. dollars. The reason so many dollars end up in foreign countries is because we have been running larger and larger trade deficits (see Figure 3). In recent years we have shipped hundreds of billions of dollars abroad. *Think* about it. It's certainly a lot cheaper to print up dollars than it is to produce goods and services.

What is our leading import? As you'll see by glancing at Table 2, it is motor vehicles, followed by electrical machinery, clothing, and crude oil. The price of oil tripled between late 1999 and the spring of 2000, so that factor was responsible for catapulting oil into the number-four spot.

Table 3 summarizes our balance of trade in 2000. As you'll notice, we imported more goods than we exported. And we exported more services than we imported. But our positive balance of trade in services (+\$89 billion) was far outweighed by our negative balance of trade in goods (−\$459 billion). That left us with a balance of trade in goods in services,  $X_n$  of −\$370 billion.

Why have we been running such huge trade deficits? We'll answer that question in the last two chapters of this book.<sup>3</sup>

Why did our trade deficit shoot up in the late 1990s?

## A Summing Up: $C + I + G + X_n$

Subtract imports from exports to get net exports.

$$X_n = \text{Exports} - \text{Imports}$$

The last three chapters examined the three main components of GDP: C, or consumption; I, or investment; and G, or government spending. One more variable goes into GDP; net exports, or  $X_n$ . *Net exports = Exports − Imports*. If we subtract all the money the United States spends on foreign goods and services from what foreigners spend on U.S. goods and services, we get net exports. This number represents the difference between what we sell to foreigners and what they sell to us.

Until recently many economists more or less ignored this last item in the GDP equation. The figure for net exports, while positive, was usually less than 1 percent of GDP. More significantly, since the turn of the century net exports was a positive figure every year until 1971.

For the first seven decades of the 20th century, we sold more to foreigners every single year than they sold to us. But in the early 1970s our balance of trade turned negative,

<sup>3</sup>The next-to-last chapter, "International Trade," and the last chapter, "International Finance," introduce more technical terms which will be used to analyze the reasons for our rapidly climbing trade deficit.

**TABLE 2** The Top U.S. Imports of Goods 1999

	Value (in \$ billions)
1 Motor vehicles	\$146
2 Electrical machinery	89
3 Clothing	56
4 Crude oil	51
5 Televisions, VCRs	51

Source: U.S. Statistical Abstract, 2000

**TABLE 3** U.S. Balance of Trade, 2000 (in billions of dollars)

Exports of goods	\$791	Imports of goods	\$1249
Exports of services	\$308	Imports of services	\$220
Exports of goods and services	\$1099	Imports of goods and services	\$1469

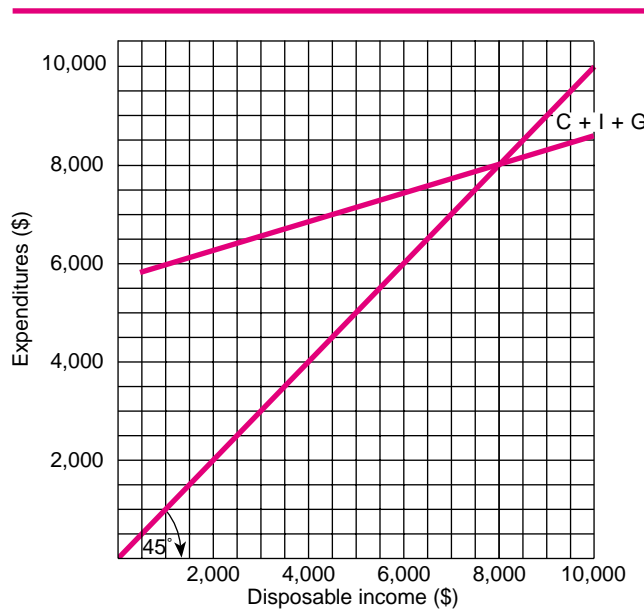
$$X_n = -\$370$$

Source: Survey of Current Business, March 2001

with net exports reaching  $-\$370$  billion in 2000. Why did net exports turn negative in the early 1970s, and what accounts for the fluctuations in the negative trade balance since then? You'll find out when you reach the next-to-last chapter, "International Trade."

Now we're going to graph the  $C + I + G + X_n$  line. We'll take as our starting point the graph of the  $C + I + G$  line, shown in Figure 5. Now keep in mind that  $X_n$  has been negative since the early 1970s and will probably continue to be negative for at least the rest of this decade.

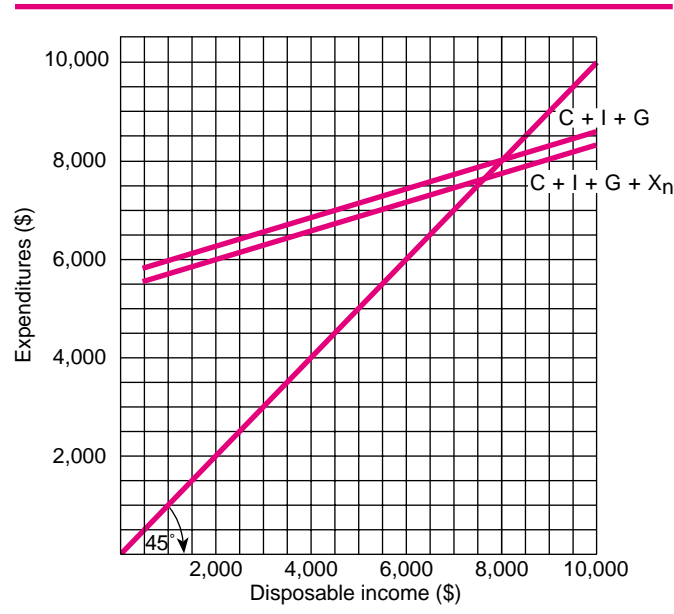
Draw a  $C + I + G + X_n$  line in Figure 4. You might as well make it parallel to the  $C + I + G$  line. Are you done? OK, let's see what your line looks like. I hope it looks a lot like *my* line in Figure 5. It doesn't have to be as close to the  $C + I + G$



**Figure 4**  
Measuring GDP

**Figure 5**

Measuring GDP (solution)



Why is the  $C + I + G + X_n$  line drawn below the  $C + I + G$  line?

line, and it doesn't have to be exactly parallel, but your  $C + I + G + X_n$  line should lie *below* the  $C + I + G$  line.

Why do we draw the  $C + I + G + X_n$  line *below* the  $C + I + G$  line? Because  $X_n$  is a negative number, so the sum of  $C + I + G + X_n$  is *less* than the sum of  $C + I + G$ .

Let's suppose that we somehow eliminated our trade deficit. How much, then, would  $X_n$  be?  $X_n$  would be 0. Now, if  $X_n$  were 0 instead of  $-370$ , then our GDP, or total output of goods and services, would be \$370 billion higher. That would mean we would be producing over \$1,300 worth more goods and services for each person living in the United States. So one may conclude that running a huge trade deficit represents producing a lot less output than would be produced if there were no deficit.<sup>4</sup>

This graph completes an odyssey we began back in Chapter 5 when we graphed the  $C$  line, and continued with the  $C + I$  line in Chapter 6, and the  $C + I + G$  line in Chapter 7. I'll give you a chance to catch your breath in this chapter and the next, but in Chapter 11 the graph of the  $C + I + G + X_n$  line returns.

## The World's Leading Trading Nations

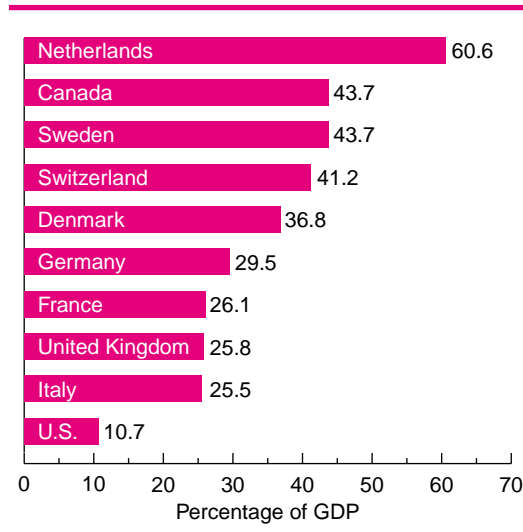
Who is the world's leading trading nation? For most of the 18th and 19th centuries it was undoubtedly England, although for some of that time the Dutch certainly gave the English a run for their money. In Figure 6 it appears that the Netherlands (a.k.a. Holland) were now the world's leading trading nation, with Canada a distant second.

But now look at Figure 7. The United States exports more than any other nation. Indeed, the Netherlands didn't even make the top ten list. So, while trade is more important to the Dutch economy than to ours, we are the world's leading exporter. OK, given the data in Figure 7, who is the world's leading trading nation?

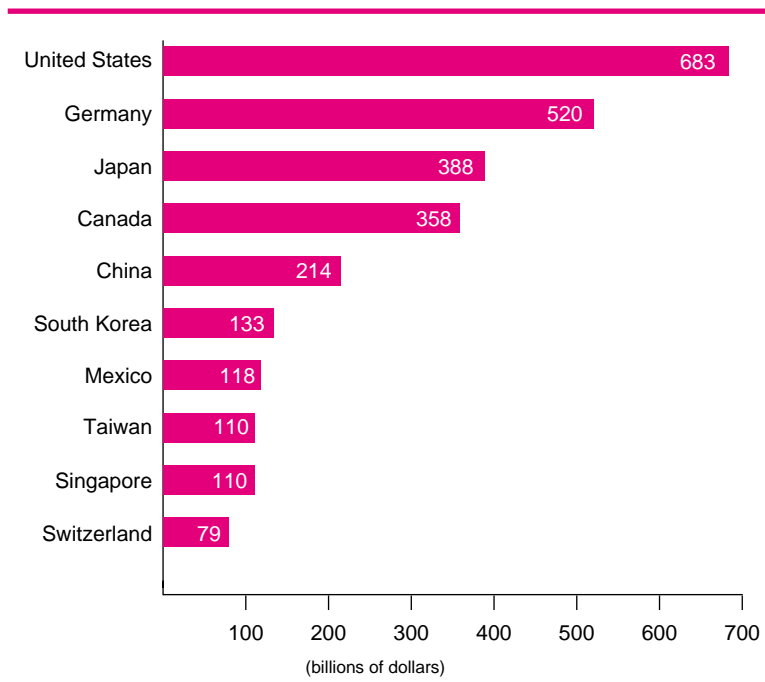
We are! In terms of world trade, we export more than any other nation. So, even though trade is less important to our economy than to those of the Netherlands, Canada, and several other nations, we are the world's leading trading nation because we export more than anyone else.

We also import more than anyone else. As you know, we have a very large negative balance of trade. In fact our negative balance of trade is much larger than that of any other nation.

<sup>4</sup>This is, of course, an oversimplification, mainly because it assumes we are operating below full employment.



**Figure 6**  
Exports of Goods and Services as a Percentage of GDP, Selected Countries, 1999



**Figure 7**  
The World's Top Ten Merchandise Exporting Nations, 1999

The United States, Germany, and Japan are the world's largest exporters.

Source: World Trade Organization.



Source: World Trade Organization

Which nation is the world's largest exporter? It's the United States. And which nation has the world's largest negative net exports? Also the United States. Can you explain how we can be the world's leading exporter and have the largest negative net exports? I'd like you to think about that and then read the box titled "How Can We Be the World's Leading Exporter and Have the Largest Negative Net Exports?"

## How can we be the world's leading exporter and have the largest negative net exports?

**Y**ou can see from the data in Figure 7 that we are the world's leading exporter. But we also lead the world in negative net exports. How can we be the world's leading exporter and have the largest negative net exports?

Answer: We also happen to be the world's largest im-

porter. In fact our imports are so much larger than our exports that we have the largest negative net exports. In the year 2000 we bought \$370 billion more goods and services from foreigners than they bought from us. We bought \$1,469 billion, and they bought just \$1,099 billion.

## World Trade Agreements and Free Trade Zones

Since the end of World War II in 1945 there has been an accelerating movement toward free trade. The formation of the European Common Market, renamed the European Union, and of NAFTA (the North American Free Trade Agreement), have placed most of the industrial world within two virtual free trade zones. In addition, the General Agreement on Trade and Tariffs (GATT), now the World Trade Organization, has reduced trade barriers worldwide.

### *Free Trade Zones*

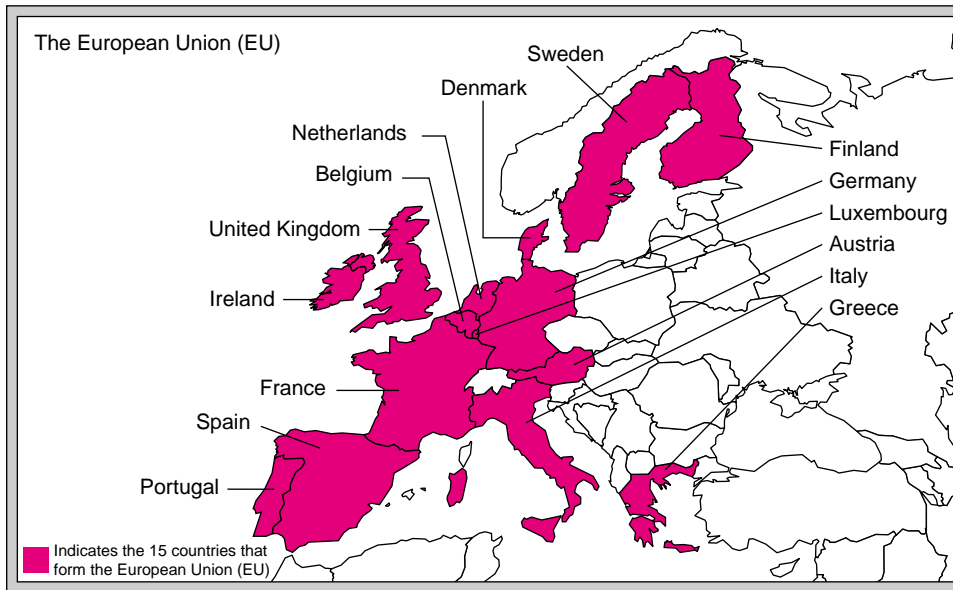
**NAFTA** The North American Free Trade Agreement, which was ratified by Congress in 1993, created a free-trade area including Canada, the United States, and Mexico, a market fast approaching 400 million consumers. Here is how the agreement is described in the 1994 *Economic Report of the President*:

In addition to dismantling trade barriers in industrial goods, NAFTA includes agreements on services, investment, intellectual property rights, agriculture, and strengthening of trade rules. There are also side agreements on labor adjustment provisions, protection of the environment, and import surges.<sup>5</sup>

How well has the agreement worked so far? Has a flood of cheap Mexican goods resulted in “the sound of jobs being sucked out of the United States”? Hardly. Despite the precipitous fall of the peso against the dollar and other currencies in late 1994, our trade with Mexico was up about 20 percent, and we continued to run a very small trade surplus.

In early 1995, however, the full effects of the peso's fall turned our small trade surplus with Mexico into an annual deficit of more than \$15 billion. The effect of NAFTA on jobs is more difficult to discern. Clearly the threat of moving operations to Mexico, where hourly wages and fringe benefits average about \$1.50 an hour, has had a depressing effect on American factory wages. But there is little evidence that the agreement has cost more than 200,000 jobs, which is less than 2 one-thousandths of our total employment. Keep in mind, too, that since the advent of NAFTA in 1993 our unemployment rate fell from just under 7% to just over 4% in 2000.

Mexico is becoming a manufacturing export platform. Currently 62 percent of all U.S. exports to Mexico are eventually re-exported back to the United States—up from 40 percent before NAFTA. Mexican autoworkers performing sophisticated, highly

**Figure 8**

Countries of the European Union



productive manufacturing work that used to be done in America do it at one-eighth the U.S. wage.

Currently the United States absorbs 87 percent of Mexico's exports. This figure should fall substantially during the next decade, especially after the trade deal negotiated between Mexico and the European Union, which will abolish most tariffs between them by 2007. Volkswagen, which makes the New Beetle solely in Mexico, currently pays a seven-percent duty when it ships to Europe, but under the new pact, these cars will be shipped to Europe duty-free.<sup>6</sup>

NAFTA was an extension of an earlier trade agreement with Canada, our most important trading partner, with whom we have been running a \$10 billion to \$15 billion trade deficit in recent years. Under the agreement, duties on most goods will be phased out within the next few years.

Canada remains our most important trading partner, and we, theirs. We import more from Canada than any other country, and we export more to Canada than any other country. Because of our mutual interdependence—and because of the integration of our economies—it would be unthinkable for either country to erect trade barriers to keep out imports from the other.

Canada is our most important trading partner.

**The European Union (EU)** Although this free trade association of 15 nations (see Figure 8) can trace its origins back to the 1950s, it wasn't until 1992 that a truly common market was formed. Freight was now able to move anywhere within the EU without checkpoint delays and paperwork. So-called "quality" codes such as German beer-purity regulations and Belgian chocolate-content restrictions were ended. Workers from any EU country could work in any other member country.

With a population and GDP comparable to those of the United States, the EU is already an economic powerhouse. In 1999, 11 EU countries formed the European Monetary Union, which established the euro as a common currency. The euro initially existed along with each country's own currency. In 2002 new euro coins and paper money will begin replacing the old national currencies. This common currency is expected to make trade among participating member nations much easier to conduct. A

<sup>6</sup>See Geri Smith, "Mexico Pulls Off Another Trade Coup," *BusinessWeek*, February 7, 2000, p. 56.

German tourist buying a meal in a Parisian restaurant will no longer have to convert her marks into francs, and a Dutch businessman buying Italian wine will no longer have to convert his guilders into lira.

How much will the euro increase trade among the 11 member nations? According to a study by Andrew K. Rose of the National Bureau of Economic Research (a private research company based in New York), nations with the same currency trade three times as much with one another as they would with different currencies.<sup>7</sup>

The introduction of the Euro went very smoothly, and it has eased trade and commerce among its 11 members. However, two major problems persist. First, Great Britain has so far refused to join, preferring to continue using its own currency for internal and international transactions.<sup>8</sup> And second, almost immediately after being introduced, the euro dropped steadily in value for a year. Initially it was set at \$ 1.17; that is, you could exchange \$ 1.17 for one euro. But within a year the euro had fallen below \$ .90 and then traded for most of the year 2000 at between \$ .85 and \$ .95. We'll be covering the euro much more thoroughly in the last chapter of this book.

### Exchange rate

A more general topic we'll be covering in that chapter is exchange rates. *An exchange rate is the price of one unit of a country's currency expressed in terms of another's.* We've already expressed exchange rates of euros and dollars. In a couple of pages we'll mention the exchange rate between U.S. dollars and Japanese yen. If you can get 90 yen for a dollar one day and 91 yen for a dollar the next, we would say that the dollar went up in value relative to the yen because you're getting more yen for your dollar. Similarly, we would say that the yen fell in value relative to the dollar because you would need to exchange more yen for one dollar.

**Mercosur** Much less well known than NAFTA and the EU, this free trade zone includes Argentina, Brazil, Paraguay, and Uruguay and associate members Bolivia and Chile. It is the fourth largest integrated market after NAFTA, the EU, and Japan. Mercosur is an acronym for Mercado Común del Sur, or Common market of the South. Formed in 1991, it has succeeded in eliminating all internal tariffs while imposing a common external tariff on goods imported from countries outside the union. However, some trade restrictions—especially between Brazil and Argentina—still persist.

## *World Trade Agreements*

**GATT** The General Agreement on Trade and Tariffs was drafted in 1947 and has since been signed by more than 135 nations. GATT is a uniform system of rules for the conduct of international trade. Its latest version, which was ratified by Congress in 1994, was the culmination of years of negotiations. It will reduce tariffs worldwide by an average of 40 percent, lower other barriers to trade such as quotas on certain products, and provide patent protection for American software, pharmaceuticals, and other industries.

Will GATT hurt our trade balance, unleash a flood of cheap foreign imports, and result in the loss of millions of American jobs? Although some industries will be affected adversely, the positive appears to outweigh the negative. First of all, on the average, foreign countries have more trade restrictions and tariffs on U.S. goods than we have on theirs, so GATT should help us much more than it hurts us. For the first time intellectual property rights like patents, trademarks, and copyrights will be protected. GATT will also open markets for service industries such as accounting, advertising, computer services, and engineering—fields in which Americans excel.

Finally, GATT brings agriculture under international trade rules for the first time. Many countries heavily subsidize their farmers (in 1999 the United States spent \$22 billion in

<sup>7</sup>See *BusinessWeek*, March 27, 2000, p. 30.

<sup>8</sup>In September of 2000, the people of Denmark voted against joining the European Monetary Union.

### *The WTO, the IMF, and the World Bank*

What do the WTO and the IMF stand for, and what do they do? And what is the World Bank? You don't have a clue? Don't worry—you are not alone.

The WTO stands for the World Trade Organization, which was set up to encourage world trade by bringing down existing trade barriers. In the next section we'll see how it operates.

The International Monetary Fund (IMF), an organization of more than 150 nations, was set up in 1944 as a lender of last resort to discourage member nations from devaluing their currency. For example, the IMF

would lend dollars to Japan if the Japanese yen were falling relative to the dollar. Let's say that 100 yen were trading for one dollar and the yen fell to 105 for one dollar, and then to 110 for one dollar. The IMF would lend reserves to Japan to stabilize the yen.

The World Bank, also created in 1944, makes long-term, low-interest loans to developing countries, mainly to build highways, bridges, dams, power generators, and water supply systems. In addition, it acts as a guarantor of repayment to encourage some private lending.

crop subsidies), but European subsidies dwarf those paid to American farmers. Clinton's Council of Economic Advisors noted that, "Since the United States has a strong underlying comparative advantage in agriculture, the mutual reduction in trade barriers and subsidization will be to the distinct advantage of U.S. producers."<sup>9</sup> Proportionately, the Europeans will have to reduce their subsidies a lot more than we'll have to, making American crop exports even more competitive.

**WTO** The World Trade Organization was set up in 1995 as a successor to GATT. It is based on three major principles: (1) liberalization of trade; (2) nondiscrimination—the most-favored-nation principle; and (3) no unfair encouragement of exports. Let's consider each principle in detail.

Trade barriers, which were reduced under GATT, should continue to be reduced. Incidentally, barriers have been falling *within* free-trade zones such as NAFTA and the European Union.

Under the most favored nation principle, members of the WTO must offer all other members the same trade concessions as any member country. Which is a lot like when the teacher says that if you bring candy to class, you must bring some for *everyone*.

Finally, no unfair encouragement of exports encompasses export subsidies, which are considered a form of unfair competition. American and European governments have long subsidized their farmers, who, in turn, have exported much of their crops. Boeing, and the European consortium, Airbus, have also received substantial export subsidies from the governments.

The WTO has a Dispute Settlement Body to handle trade disagreements among member nations. Many of the disputes involve the charge of the dumping of products below cost. Although many politicians in the United States have very reluctantly accepted the jurisdiction of the WTO, we have won almost all the more than two dozen cases in which we have been the complaining party.

At present, China is the largest economic power not yet a member of the WTO. Negotiations have begun over its conditions for entry. As a nation with some of the highest trade barriers in the world, China will have to agree to provide much greater access to its market before it will gain admission.

The United States has long championed free trade. Presidents Ronald Reagan, George Bush, and Bill Clinton were strong proponents of lowering trade barriers and helped make free trade a mainstream political issue. We'll come back to this issue in the next to the last chapter of this book.

<sup>9</sup>*Economic Report of the President*, 1995, p. 208.

**The Seattle Protest** When the WTO held a meeting in Seattle in late 1999 to formulate further trade agreements, tens of thousands of protesters descended on the city. Not only did they manage to disrupt the conference, but they wreaked so much havoc that the governor of Washington state was forced to call in the National Guard to restore order. Only a minority of the protesters were at all unruly, and prominent among them were labor union members, environmentalists, and human rights advocates.

*BusinessWeek* outlined the reasons for the protests:

Environmentalists argue that elitist trade and economic bodies make undemocratic decisions that undermine national sovereignty on environmental regulation. Unions charge that unfettered trade allows unfair competition from countries that lack labor standards. Human rights and student groups say the IMF and the World Bank prop up regimes that condone sweatshops and pursue policies that bail out foreign lenders at the expense of local economies.<sup>10</sup>

In early 2000 there were protests in Washington and Prague targeting the WTO, the IMF, and the World Bank. Although there is little chance these institutions will be very much affected by the protests, they could well be an indication of spreading concern about the consequences of globalization.

Many Americans, as well as citizens of other leading industrial nations, have strong reservations about ceding their national sovereignty to international organizations, especially the WTO. Much of their concern centers on the possible loss of jobs and the reduction of wages in their countries if their workers were forced to compete with low-wage workers in the world's poorer countries, most of whom earn just one or two dollars a day. Is it fair to make American factories, which uphold relatively high environmental standards, compete with Third World factories that are not similarly burdened? If the United States and other industrial countries are subject to the rules and regulations of the WTO, their own governments would be unable to prevent a flood of cheap imports. In sum, the debate is not about "free trade," but about "fair trade."<sup>11</sup>

## Questions for Further Thought and Discussion

1. Explain how and why trade barriers have come down in recent decades.
2. Do you think we should have joined NAFTA? Try to argue this question from both sides.
3. List the reasons why our trade deficit has grown so quickly since the mid-1990s. What we can do to help bring it down?
4. Identify the goods and services that you purchase that are imported. How would your lifestyle change if these imports were unavailable?
5. How would your life change if the United States were no longer the world's leading exporter?
6. Explain how international trade (exports and imports) affects a nation's output, employment, and income.

<sup>10</sup>*BusinessWeek*, April 24, 2000, p. 40.

<sup>11</sup>In a *BusinessWeek*/Harris poll conducted in April, 2000, 1,024 people were asked these questions:

Which of the following best describes your views about foreign trade? Do you consider yourself to be someone who believes in free trade or trade without any restrictions, someone who believes in fair trade or trade with some standards for labor and the environment, or someone who is protectionist, meaning that there should be rules to protect U.S. markets and workers from imports?

Here is how they answered:

Free trader . . . . .	10%	Fair trader . . . . .	51%	Protectionist . . . . .	37%
Don't know . . . . .	3%	Refused . . . . .	0%		

(*BusinessWeek*, April 24, 2000, p. 44.).

# Workbook for Chapter 8

Name \_\_\_\_\_ Date \_\_\_\_\_

## Multiple-Choice Questions

Circle the letter that corresponds to the best answer.

1. Today world trade is regulated by \_\_\_\_\_.
  - a) NAFTA
  - b) GATT
  - c) WTO
  - d) E.U.
2. During the last ten years our trade balance in merchandise was \_\_\_\_\_, and our trade balance in services was \_\_\_\_\_.
  - a) positive, positive
  - b) negative, negative
  - c) negative, positive
  - d) positive, negative
3. Which is the most accurate statement?
  - a) Our trade deficit has narrowed since 1995.
  - b) We export more merchandise than services (in terms of dollars).
  - c) The largest service purchase that foreigners make from the United States is educational services.
  - d) In recent years foreigners have generally refused to accept U.S. dollars in payment for their goods and services.
4. Since the early 1990s our trade deficit has \_\_\_\_\_.
  - a) fallen substantially
  - b) fallen slightly
  - c) risen slightly
  - d) risen substantially
5. In the 20th century our balance of trade was positive until the \_\_\_\_\_.
  - a) 1950s
  - b) 1960s
  - c) 1970s
  - d) 1980s
  - e) 1990s
6. Statement I: The European Union was formed as a trading counterweight to NAFTA.  
Statement II: Since the formation of NAFTA, the United States has lost millions of jobs to Mexico.
  - a) Statement I is true, and statement II is false.
  - b) Statement II is true, and statement I is false.
  - c) Both statements are true.
  - d) Both statements are false.
7. The basis for international trade is that \_\_\_\_\_.
  - a) a nation can import a particular good or service at a lower cost than if it were produced domestically.
  - b) we stand to gain if we can sell more to other nations than they buy from us.
  - c) there are winners and losers.
  - d) it pays to trade, provided we remain independent by producing all our necessities.
8. Adam Smith believed that \_\_\_\_\_.
  - a) people should never buy anything if they can make it themselves.
  - b) what makes sense in the conduct of a private family's economic endeavors also makes sense in those of a nation.
  - c) trading with other nations promotes full employment.
  - d) A nation will gain if its citizens trade among themselves, but it will probably lose if it trades with other nations.
9.  $GDP = C + I + G + X_n$ . If  $X_n$  were not included, our GDP would be \_\_\_\_\_.
  - a) higher
  - b) about the same
  - c) lower
10. The most-favored nation clause of the WTO agreement stipulates that \_\_\_\_\_.
  - a) no member nation may impose a tariff on the goods of any other member nation.
  - b) all member nations must offer all other member countries the same trade concessions as any member country.
  - c) each member may designate another member as a favored nation, providing that nation with trade concessions.
  - d) all member nations must sell their goods to other member nations at cost.

11. Statement I: The United States has a much larger population and GDP than the European Union. Statement II: The European Union has attained a higher degree of economic integration than NAFTA.
- Statement I is true, and statement II is false.
  - Statement II is true, and statement I is false.
  - Both statements are true.
  - Both statements are false.
12. Statement I: Our trade deficit, although still high, is lower than it was five years ago. Statement II: We both export and import computers and semiconductors.
- Statement I is true, and statement II is false.
  - Statement II is true, and statement I is false.
  - Both statements are true.
  - Both statements are false.
13. Most economists and people in the business community supported \_\_\_\_\_.
- both NAFTA and GATT.
  - neither NAFTA nor GATT.
  - NAFTA but not GATT.
  - GATT but not NAFTA.
14. Which statement is true?
- $X_n$  has always been positive.
  - $X_n$  has always been negative.
  - $X_n$  had been positive from the turn of the century until the 1970s.
  - $X_n$  had been negative from the turn of the century until the 1970s.
  - None of these statements is true.
15. Statement I. Since the late 1990s, our negative balance of trade has become much larger. Statement II. The United States has the world's largest negative balance of trade.
- Statement I is true, and statement II is false.
  - Statement II is true, and statement I is false.
  - Both statements are true.
  - Both statements are false.
16. The world largest exporter is \_\_\_\_\_.
- the United States
  - Japan
  - Germany
  - the United Kingdom
  - China
17. Since the passage of NAFTA our trade deficit with Mexico has gone \_\_\_\_\_ and our trade deficit with Canada has gone \_\_\_\_\_.
- up, up
  - down, down
  - up, down
  - down, up
18. Statement I. The United States has a much less self-sufficient economy than those of countries in Western Europe. Statement II. Mexico sends the United States more than 80 percent of its exports.
- Statement I is true, and statement II is false.
  - Statement II is true, and statement I is false.
  - Both statements are true.
  - Both statements are false.
19. Mexico has recently signed a trade pact with \_\_\_\_\_.
- Japan
  - China
  - the European Union
  - Brazil and Argentina
20. Each of the following is a characteristic of the European Union EXCEPT that \_\_\_\_\_.
- workers from any EU country could seek work in any other member country
  - the euro replaced the domestic currencies (for example, francs, marks, lira) in 1999
  - its population and GDP are comparable to those of the United States
  - freight is able to move anywhere within the EU without checkpoint delays and paperwork
21. The trading bloc that has eliminated all internal tariffs is \_\_\_\_\_.
- the European Union
  - NAFTA
  - Mercosur
  - the World Trade Organization
22. Which one of these statements best describes the complaints of the protesters at the 1999 WTO meeting in Seattle.
- They opposed military aid to Third World dictatorships.
  - They opposed trade with poor countries because of the exploitative nature of that trade.
  - They opposed free trade with nations whose people worked under sweatshop conditions and opposed ceding national sovereignty to an international group.
  - They opposed strict environmental standards, which they felt would increase our cost of living.

23. Most Americans would describe themselves as being in favor of \_\_\_\_\_.
- a) free trade      c) trade protection  
b) fair trade      d) no foreign trade
24. Which statement would best describe the situation of the American economy?
- a) We are more dependent on foreign trade than most other nations.  
b) We are much more dependent on foreign trade than we were 30 years ago.  
c) We are much less dependent on foreign trade than we were 30 years ago.  
d) We are virtually self-sufficient.
25. Which statement is false?
- a) During World War I and World War II, the sum of our imports and exports as a percent of GDP rose sharply.  
b) Foreign trade in goods is much more important to the American economy than foreign trade in services.  
c) Because the American economy is much larger than any other economy, we can continue running larger and larger trade deficits for as long as we like.  
d) We pay for a large chunk of our trade deficit with U.S. dollars.
4. In the year 2000 we ran a trade deficit of \$ \_\_\_\_\_ billion.
5. Our leading merchandise export is \_\_\_\_\_, and our leading merchandise import is \_\_\_\_\_.
6. Of all the goods consumed in the United States, about \_\_\_\_\_ percent were imported.
7. The most prominent nation not yet a member of the World Trade organization is \_\_\_\_\_.
8. Our two leading exports are \_\_\_\_\_ and \_\_\_\_\_; our two leading imports are \_\_\_\_\_ and \_\_\_\_\_.
9. Our most important trading partner is \_\_\_\_\_.
10. We run a trade deficit in \_\_\_\_\_ and a trade surplus in \_\_\_\_\_.
11. As a percentage of GDP the sum of our imports and exports is more than \_\_\_\_\_ times as high today as it was 30 years ago.
12. The only trading bloc that has eliminated all its internal tariffs is \_\_\_\_\_.
13. What was the main concern of the labor union members who were protesting against the WTO in Seattle in 1999?
14. Foreign trade was relatively unimportant to our economy until around the year \_\_\_\_\_.

### Fill-In Questions

1. The world's leading exporting nation is \_\_\_\_\_; the nation with the largest trade deficit is \_\_\_\_\_.
2.  $X_n =$  \_\_\_\_\_ - \_\_\_\_\_.
3. The three members of NAFTA are \_\_\_\_\_, \_\_\_\_\_, and \_\_\_\_\_.