# From the Fed: Why Trade?

The establishment of free trade agreements can be a critical and progressive step toward greater economic integration and continues to become more valuable in an increasingly global world.

Dan Kildee

# Specialization and Trade

- Trade
  - occurs when parties expect to gain
  - among individuals or organizations within a nation or in different nations
- Specialization
  - Producers specialize in what they can produce at the *lowest cost*.
  - Necessitates trade.
  - Production and (total) consumption increase.

# Absolute Advantage

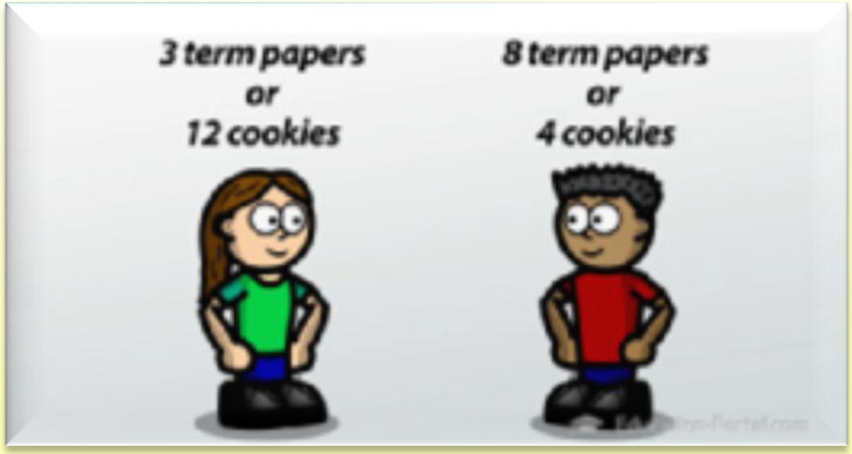
"The natural advantages which one nation has over another in producing particular commodities are sometimes so great that it is acknowledged by all the world to be in vain to struggle with them."

Adam Smith in *Wealth of Nations*

Book IV, Chapter 2

# Comparative Advantage

- David Ricardo showed that nations could benefit from trade even without an absolute advantage.
- **Comparative advantage** refers to a nation's ability to produce a good at a lower *opportunity cost* than another nation.



# Opportunity Costs

- An economic way of thinking…
  - Costs are not monetary.
  - The cost of getting something is really the value of the next best alternative that is not chosen (opportunity cost).
- Think about the choices you make.
  - Nap or workout on Sunday afternoon?
  - Beach or mountains or city for vacation?

# Differing Opportunity Costs

- Investments in technology
- Relative supply of key inputs
  - Land (natural resources)
  - Labor (both skilled and unskilled)
  - Capital
- Government services and regulations

# Comparative Advantage – A Hypothetical Example

The US can make baseballs cheaper than Haiti (absolute advantage) but that doesn't matter.

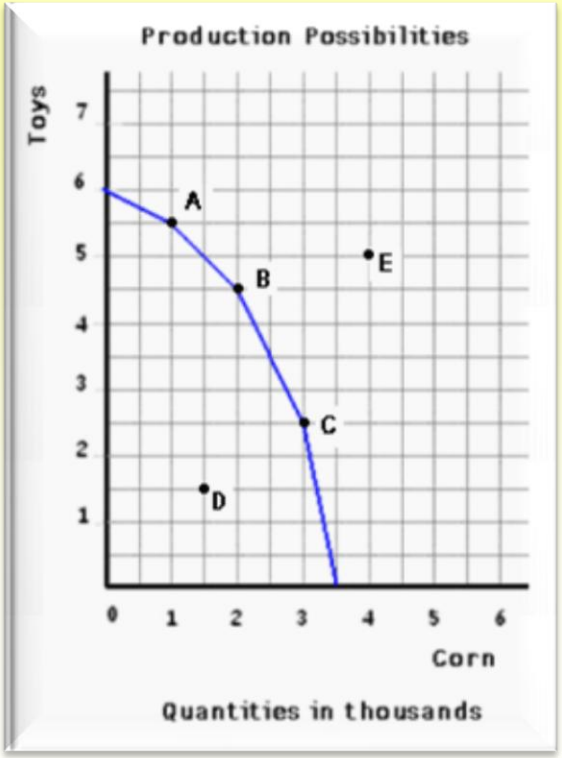
Haiti has almost no opportunity cost if it makes baseballs because it has few other alternatives.

The US would have to give up making tech in order to make baseballs and so would have a high opportunity cost.

As a result, the US makes tech and Haiti makes baseballs even though the US could make them financially cheaper.

Remember: Comparative advantage refers to a nation's ability to produce a good at a lower *opportunity cost* than another nation.

# Resources




One note regarding the previous slide:

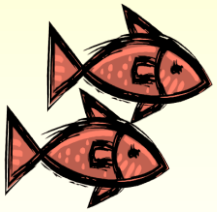
Why – you may be asking – can the US not make baseballs <u>and</u> tech?

Don't forget that every economy, rich or poor, has **limited resources** (land, labor, capital).

The **production possibilities curve** demonstrates that an economy cannot increase production of one good without decreasing production of another.

The US <u>can</u> make both ... and the world will have lots of cheap baseballs and not much tech.

# Imagine Two Islands…



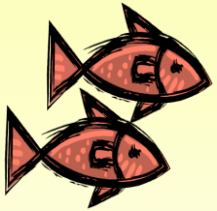
- Both produce fish and coconuts.
  - Fishing requires boats (capital) and labor.
  - Coconut harvesting requires trees (land) and labor.

- Different amounts of resources
  - One island has many trees and few boats.
  - The other island has many boats but few trees.

# Coconut Island

- **Resources** – lots of coconut trees and only a few boats
- **Coconut Industry** – thriving coconut harvests with lots of competition
- **Fishing Industry** – very little fishing and almost no competition
- **Food supply** – abundant coconuts and scarce fish
- **Consumers** – cheap coconuts and expensive fish

# Fish Island

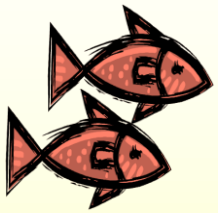


- **Resources** – lots of boats and only a few trees
- **Coconut Industry** – small harvests and no competition
- **Fishing Industry** – abundant catches and intense competition
- **Food supply** – abundant fish and scarce coconuts
- **Consumers** – cheap fish and expensive coconuts

# Graphic: New Connections

# The Impact of Trade

- Who cares about the price of coconuts?
  - people who eat coconuts
  - people who own trees (land)
  - people who climb trees (labor)
- Who cares about the price of fish?



  - people who eat fish
  - people who own boats (capital)
  - people who sail and fish (labor)

# The Impact of Trade

- As the price of coconuts falls, land owners and labor in that industry are harmed. As the price of fish rises, boat owners and crew benefit.
- Conversely, as the price of coconuts rises, land owners and labor in that industry benefit. As the price of fish falls, boat owners and crew are harmed.

# Graphic: Who Could Object?

Domestic Price > World Price

Nation imports cheaper products. → Domestic supply rises. → Domestic price falls.

Domestic *consumers* benefit.

Domestic *producers* are harmed.

# Graphic: Who Could Object?

Domestic Price < World Price

Nation exports its cheaper product. → Domestic supply drops. → Domestic price rises.

Domestic *producers* benefit.

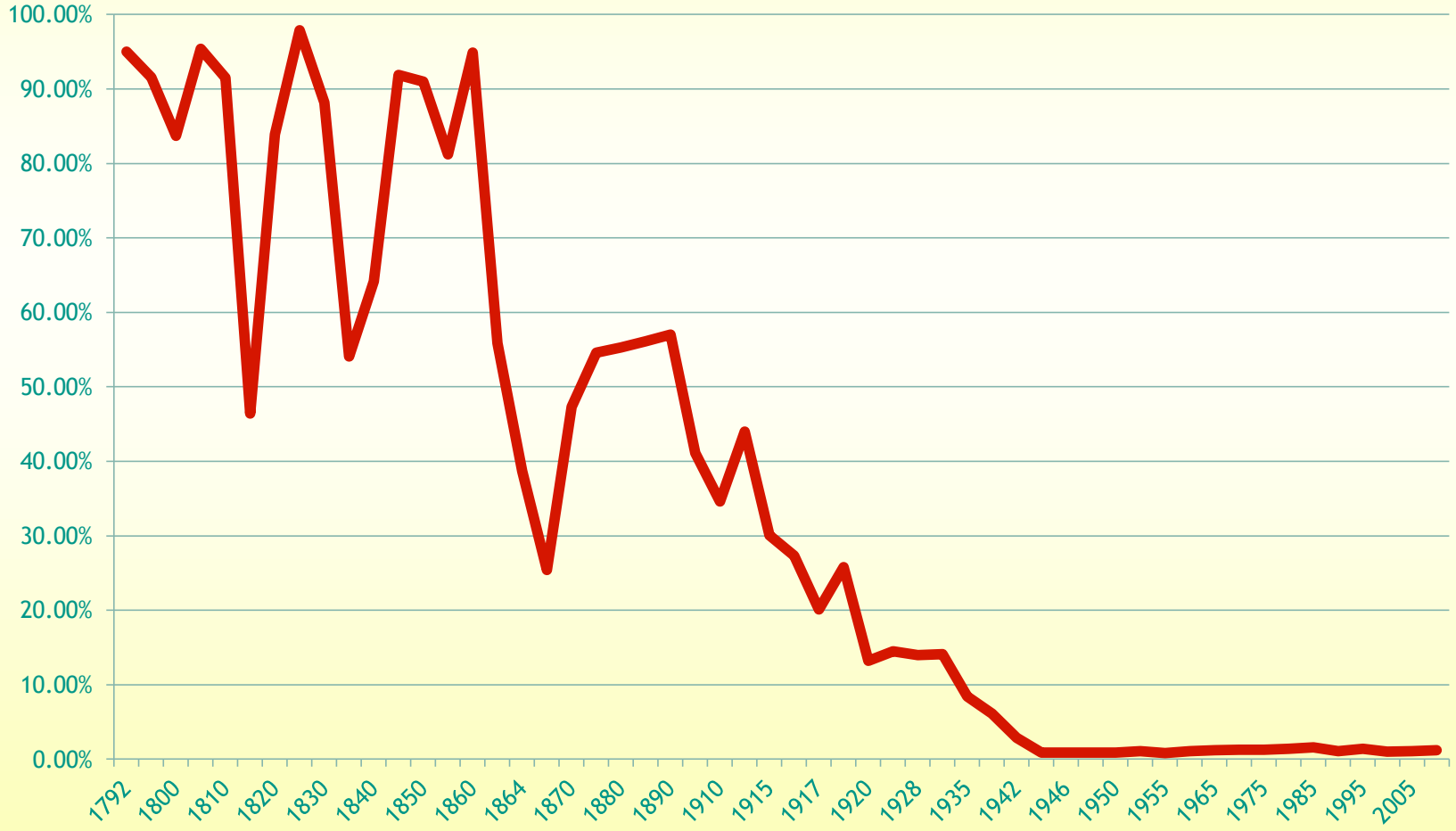
Domestic *consumers* are harmed.

# Barriers to Trade

# I. Tariffs

- taxes on imported foreign goods or services
- reasons
  - raise tax revenues
  - reduce consumption of the imported good or service
- effects
  - Price of import rises due to tariff.
  - Cheaper (by comparison) domestic goods become more attractive.

# Chart: Tariffs: Percent of US Federal Budget Revenue from Tariffs



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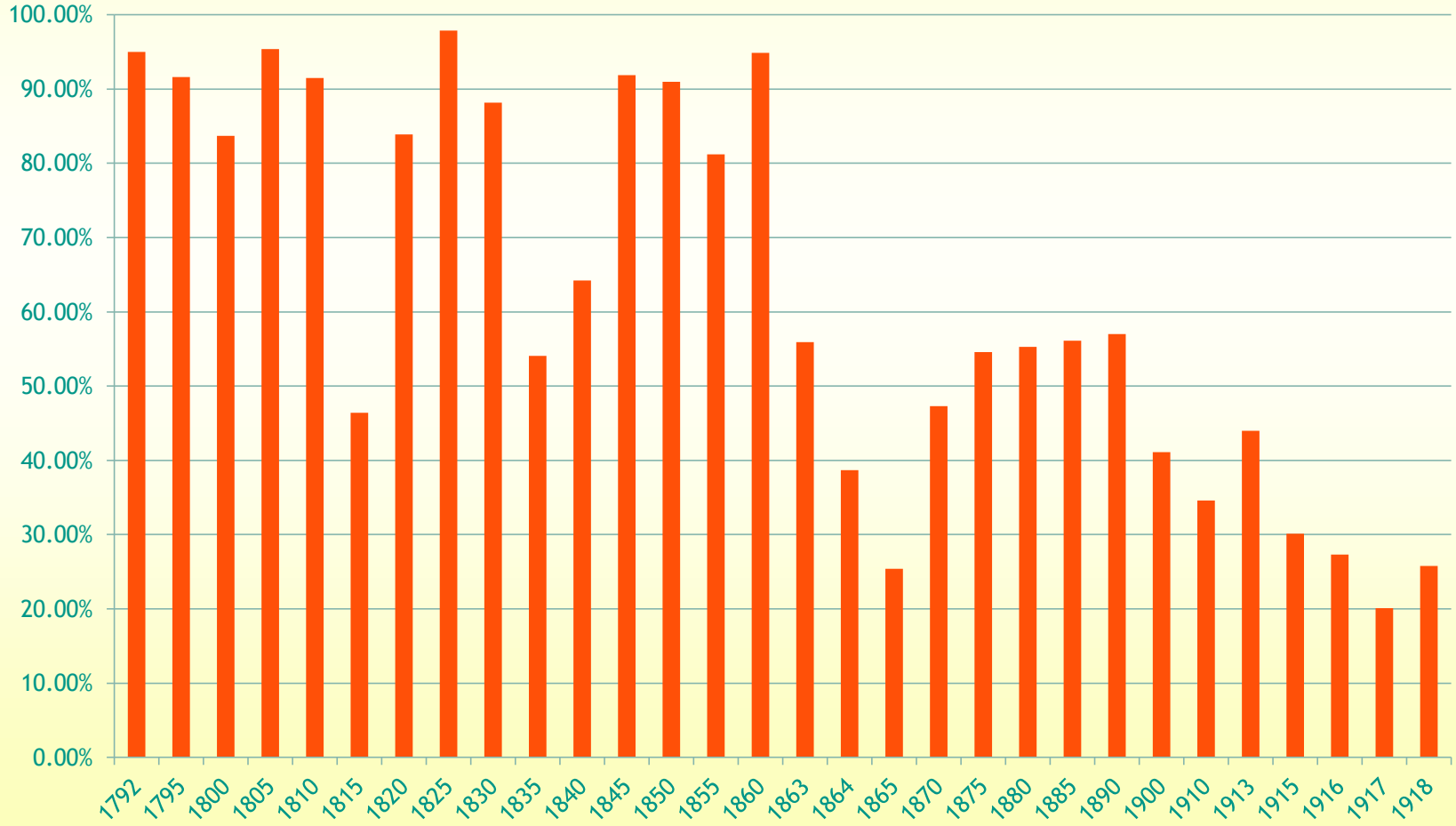
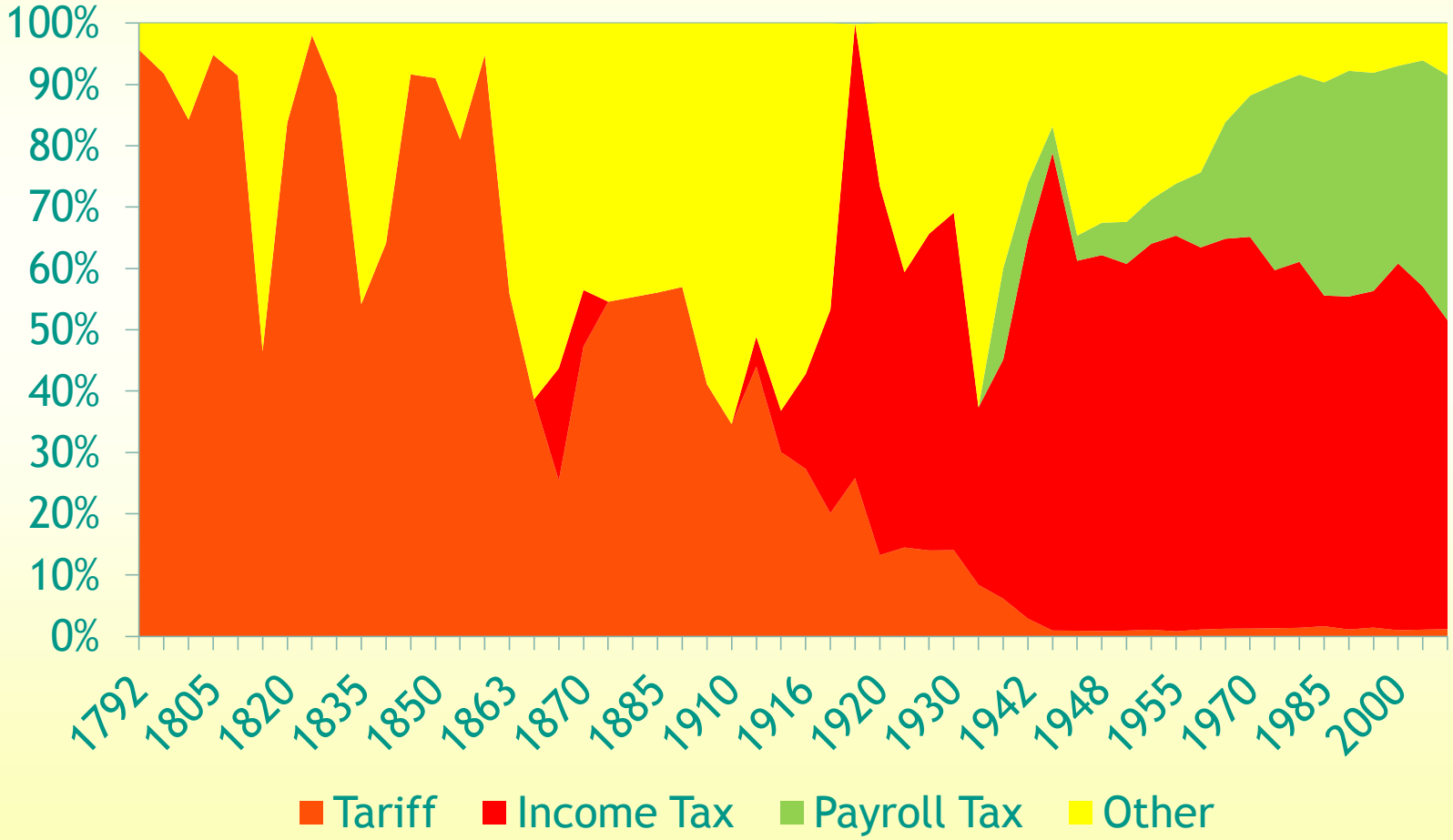


# Chart: Tariffs: Types of US Federal Revenue

## (as a percent of total receipts)



# Tariffs: Alexander Hamilton

- Hamilton proposed extensive tariffs to provide revenue and to protect American manufacturers.
- The idea of tariffs is rooted in mercantilism, an economic theory that trade generates wealth and is stimulated by the accumulation of profitable balances, which a government should encourage by means of protectionism.
- Three tariff acts
  - 1789 – "It is necessary for the support of government, for the discharge of the debts of the US and for the encouragement and protection of manufactures, that duties be laid on goods, wares and merchandise."
  - 1790 – slightly increased the rate imposed by the 1789 act
  - 1792 – increased again the rate imposed by the previous acts

# Tariffs: Andrew Jackson

- The Tariff Act of 1828 was a tariff designed to protect industry in the northern US. It was called the Tariff of Abominations by the South because of the effects it had on the Southern economy.
- Nullification Crisis (1832) – SC declared the federal tariffs of 1828 and 1832 unconstitutional and therefore null and void within the sovereign boundaries of South Carolina.

# Tariffs: Progressive Ideal

- The federal government replaced tariffs with the income tax.
- 1913 was a watershed year.
  - The Underwood Tariff Act lowered tariffs.
  - The federal income tax was created.

# Tariffs: Ongoing

- Fordney-McCumber Tariff Act (1922) raised American tariffs on many imported goods in order to protect factories and farms.
- Smoot-Hawley Act (1933) raised US tariffs to historically high levels. The original intention was to increase the protection afforded domestic farmers against foreign agricultural imports but it soon became a means to raise tariffs in all sectors of the economy.

# II. Quotas

- limit the amount of an imported good allowed into the country
- **Voluntary Export Restrictions (VERs)** are similar to quotas but are voluntary rather than legally imposed.
- reasons
  - protect domestic industry or market, perhaps during infancy
  - politically beneficial and/or politically popular
- effects
  - decrease in availability of foreign product and so decrease in supply
  - price of domestic product increases

# III. Export Subsidies

- government financial assistance to a firm or industry that allows that firm or industry to sell its product at a reduced price
- reasons
  - protect domestic industry or market, perhaps during infancy
  - politically beneficial and/or politically popular
- effects
  - lower prices for consumers (domestic and foreign)
  - lower profits for foreign producers not receiving subsidies
  - domestic taxpayers pay the subsidy through their taxes and thus are not actually benefitting from a lower price (although they may not realize it)
  - higher profits for domestic producers (via subsidies) than if they charged a market price

# IV. Product Standards

- a type of hidden trade barrier that prohibits the import of foreign products that don't meet certain government- or industry-defined standards
- types of standards
  - product safety
  - content
  - packaging
- reasons
  - genuine concern about domestic consumer safety
  - politically beneficial and/or politically popular
- effects (see effects of quotas above)


The End