CPA BEC - STUDY UNIT 7
International Trade:
Core Concepts

A. Advantages of International Trade

1. Under the concept of **comparative advantage**, total world output will be maximized when each nation specializes in the products in which it has the **lower opportunity costs**, that is, a comparative advantage. When nations specialize in what they produce most efficiently and then exchange with others, more is produced and consumed than if each nation tries to be self-sufficient. Comparative advantage compares costs within a single country.
   a. **Absolute advantage** compares the costs of inputs between countries. Thus, a given country might have an absolute advantage with respect to every product compared with a specific other country. A nation will export goods for which it has a comparative advantage and import goods for which it has a comparative disadvantage.

B. Trade Barriers

1. Even though individuals (as a whole) are best off under **free trade**, governments often block or restrict the importation of certain products, encourage exports, or even restrict exports. **Protectionism** is the opposite of free trade. Protectionists argue that reducing foreign imports protects jobs and businesses and benefits the entire economy.
   a. Typical **trade barriers** are tariffs, import quotas, domestic content rules, exchange controls, export subsidies, and special tax benefits to exporters. The economic effect of trade barriers on free trade is to shift workers from relatively efficient export industries into less efficient protected industries. Real wage rates will decline as a result, as will total world output.

C. Foreign Currency Rates and Markets

1. For international trade to occur, the two currencies involved must be easily converted. The **exchange rate** is the price of one country's currency in terms of another country's currency. Currency appreciates (depreciates) when it can buy more (fewer) units of another currency. In other words, depreciation in country A's currency is an appreciation of the currency of country B.
   a. A **managed float** is the current method of exchange rate determination. Supply and demand forces primarily guide exchange rates, but governments or central banks may intervene to maintain fairly stable exchange rates. The use of floating rates allows governments to make the necessary adjustments to eliminate balance-of-payments deficits or surpluses.
   b. **Demand for currencies** comes from international trade in goods and services, investor global trading, and international corporate activity. **Supply of currencies** comes from reversing these transactions.
   c. **Long-term exchange rates** are dictated by the purchasing-power parity theorem.
   d. **Medium-term exchange rates** are dictated by the economic activity in a country.
   e. **Short-term exchange rates** are dictated by **interest rates**. Big corporations and banks invest their large reserves of cash where the real interest rate is highest.

2. **Interaction in foreign currency markets.** The **spot rate** is the exchange rate paid for immediate delivery of a currency. The **forward exchange rate** is the future price of the currency. If the forward rate in foreign currency units per dollar is greater than the spot rate, the dollar is selling at a premium. If the spot rate in foreign currency units per dollar is greater than the forward rate, the dollar is selling at a discount. Thus, a firm may **hedge** its exchange rate risk by purchasing or selling forward exchange contracts.

D. Balance of Payments

1. The **balance of payments** is an economic measure that includes all international payments made by one nation to another, including those for imports, exports, investments, unilateral transfers, and capital movements. The principal accounts are the current account and the capital account.
   a. The **current account** records [1] exports (credits) and imports (debits) of goods, [2] exports (credits) and imports (debits) of services, [3] interest and dividends received on investments abroad (credits) and interest and dividends paid on foreign investments in the U.S. (debits), [4] net unilateral transfers, and [5] the balance on the current account.
   b. The **capital account** records capital flows resulting from the purchase and sale of fixed or financial assets. The balance-of-payments deficit or surplus is the net of the current and capital account balances.