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ECON 201—Montgomery College

LECTURE 27: GLOBALIZATION & BALANCE OF PAYMENTS

I. A trading game
   a. Trade increases aggregate utility.
   b. *The Fundamental Theorem of Exchange*—voluntary trade with complete information is always mutually beneficial.
      i. Note this is not the same thing as equally beneficial.
      ii. Trade also encourages peace and understanding.
   c. Mistakes surely happen but either the harm is small (a movie wasn't all that good) or people make special effort to ensure they don't make a mistake (research a new car, inspect a house, consult a critic).

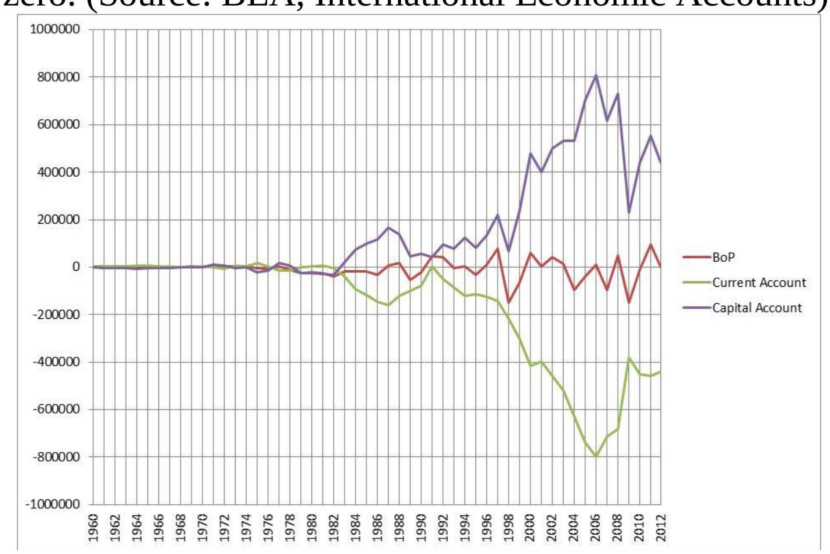
II. Barriers to Efficient Trade
   a. *Globalization*—the process of countries being open to more foreign trade and investment.
   b. We recognize trade is a wonderful; not only does it increase production but it also is good for the individuals who participate in it.
   c. But the foreign producers who benefit have little political voice; the domestic producers who are harmed by trade have much more political pull.
   d. Thus governments are prone to trade barriers (not an exhaustive list):
      i. A *tariff* is a tax on imports. By making imports more expensive, governments help shield domestic production from competition.
      ii. An *import quota* caps how much (either in quantity or in value) can be imported into a country over a specific period of time.
      iii. *Regulatory barriers* are regulations or bureaucratic rules which make it more difficult to import. For example, Japan has strict inspection requirements on imported food. Supposedly this is to prevent the introduction of harmful insects but it is particularly strong.
      iv. An *export subsidy* is a subsidy for domestic production which, in turn, makes it cheaper on the world market. The United States heavily subsidizes its food (much to the anger of developing nations).

III. The trade deficit

a. Exports – Imports = NX (or the balance of trade).
b. The “deficit” is when imports > exports, or when NX is negative.
c. People are very concerned that the US’s NX is negative, seeing it as a sign of a weak economy. There are several things wrong with this view.
    i. Trade deficits occur within countries.
    ii. People are buying things they want—utility is increasing.
    iii. The trade deficit is only part of the equation. This last point warrants further exploration.

IV. Balance of Payments (BoP)

a. All trade activity is captured in this equation: NX + CA = 0.
    i. Where CA is the capital account, or the net flow of investment. Note that sometimes NX is called the current account, as in the flow of goods that *currently* exist, while the capital account speaks to the money used to create *capital*, the investment.
    ii. Note your book splits CA into a narrower version of capital account (debt forgiveness) and financial account (sale of financial assets).
b. But does it balance in practice? It does indeed! Note how one account is almost the perfect mirror of the other and the BoP always hovers around zero. (Source: BEA, International Economic Accounts).



c. In a trade, the domestic country gave up their currency for goods and services. Abroad, this currency can have three different uses:
    i. Import from the domestic country (NX increases).
    ii. Invest in the domestic country (CA increases).
    iii. Circulating it outside the domestic country.

d. The only reason people would accept currency that's worthless in their country is because they think they can use in the country it is worth something.
    i. Circulating it outside the domestic country is rare.
e. The trade deficit is not, *repeat not*, debt. It is merely an arbitrary distinction between the flow of goods and the flow of investment.
f. This harkens back to the distinction between increasing GDP and increasing wealth. A fall in NX reduces GDP but it doesn't necessary mean people are poorer.