**Exchange Rates:**

* When trade is free—unimpeded by government-instituted barriers—patterns of trade and trade flows result from the independent decisions of thousands of importers and exporters and millions of private households and firms.
* To understand these patterns we must learn about exchange rates.
* An *\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_* is the ratio at which two currencies are traded, or the price of one currency in terms of another.
* For any pair of countries, there is a range of exchange rates that can lead automatically to both countries realizing the gains from specialization and comparative advantage.

**Trade and Exchange Rates in a Two-Country/Two-Good World:**

* Exchange rates determine the terms of trade.
* *The option of buying at home or importing will depend on the exchange rate.*

**Exchange Rates and Comparative Advantage:**

* If exchange rates end up in the right ranges, the free market will drive each country to shift resources into those sectors in which it enjoys a comparative advantage.
* Only those products in which a country has a comparative advantage will be competitive in world markets.

**The Sources of Comparative Advantage:**

* *\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_* refer to the quantity and quality of labor, land, and natural resources of a country.
* *Factor endowments* seem to explain a significant portion of actual world trade patterns.

**The Heckscher-Ohlin Theorem:**

* The *Heckscher-Ohlin theorem* is a theory that explains the existence of a country’s comparative advantage by its factor endowments.
* According to the theorem, a country has a comparative advantage in the production of a product if that country is relatively well endowed with inputs used intensively in the production of that product.

**Other Explanations for Observed Trade Flows:**

* *Product \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_*is a natural response to diverse preferences within an economy, and across economies.
* Some economists also distinguish between gains from *acquired comparative advantage* and gains from *natural comparative advantages*.
* *Economies of scale* may be available when producing for a world market that would not be available when producing for a limited domestic market.

**Trade Barriers: Tariffs, Export Subsidies, and Quotas:**

* *Protection* is the practice of shielding a sector of the economy from foreign competition.
* A *tariff* is a tax on imports.
* A *\_\_\_\_\_\_\_\_\_\_\_\_\_\_* is a limit on the quantity of imports.
* *Export subsidies* are government payments made to domestic firms to encourage exports.
* *Dumping* refers to a firm or industry that sells products on the world market at prices below the cost of production.

**U.S. Trade Policies and GATT:**

* The *Smoot-Hawley tariff* was the U.S. tariff law of the 1930s, which set the highest tariff in U.S. history (60 percent). It set off an international trade war and caused the decline in trade that is often considered a cause of the worldwide depression of the 1930s.
* The *General Agreement on Tariffs and Trade (\_\_\_\_\_\_\_\_\_\_)* is an international agreement signed by the United States and 22 other countries in 1947 to promote the liberalization of foreign trade.

**Economic Integration:**

* *Economic integration* occurs when two or more nations join to form a free-trade zone.
* The *European Union (EU)* and *the North American Free-Trade Agreement \_\_\_\_\_\_\_\_\_\_*are examples of economic integration.
* The *European Union (EU)* is the European trading bloc composed of Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the United Kingdom.
* The *U.S.-Canadian Free-Trade Agreement* is an agreement in which the United States and Canada agreed to eliminate all barriers to trade between the two countries by 1988.
* *The North American Free-Trade Agreement (NAFTA)* is an agreement signed by the United States, Mexico, and Canada in which the three countries agreed to establish all of North America as a \_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_ zone.

**The Case for Free Trade:**

* The case for free trade is based on the theory of comparative advantage. When countries specialize and trade based on comparative advantage, consumers pay less and consume more, and resources are used more efficiently.
* When tariffs and quotas are imposed, some of the gains from trade are lost.

**The Gains from Trade:**

* When world price is $2, domestic quantity demanded rises, and quantity supplied falls. U.S. supply drops and resources are transferred to other sectors.

**The Losses from the Imposition of a Tariff:**

* The loss of efficiency from a $1 tariff:
  1. Consumers must pay a higher price for goods that could be produced at a lower cost.
  2. Marginal producers are drawn into textiles and away from other goods, resulting in inefficient domestic production.

**The Case for Protection:**

* Protection saves jobs
* Some countries engage in unfair trade practices
* Cheap foreign labor makes competition unfair
* Protection safeguards national security
* Protection discourages dependency
* Protection safeguards infant industries
* An *\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_\_* is a young industry that may need temporary protection from competition from the established industries of other countries to develop an acquired comparative advantage.