Eco 10350 Principles of Macro

Lecture 6

International Trade

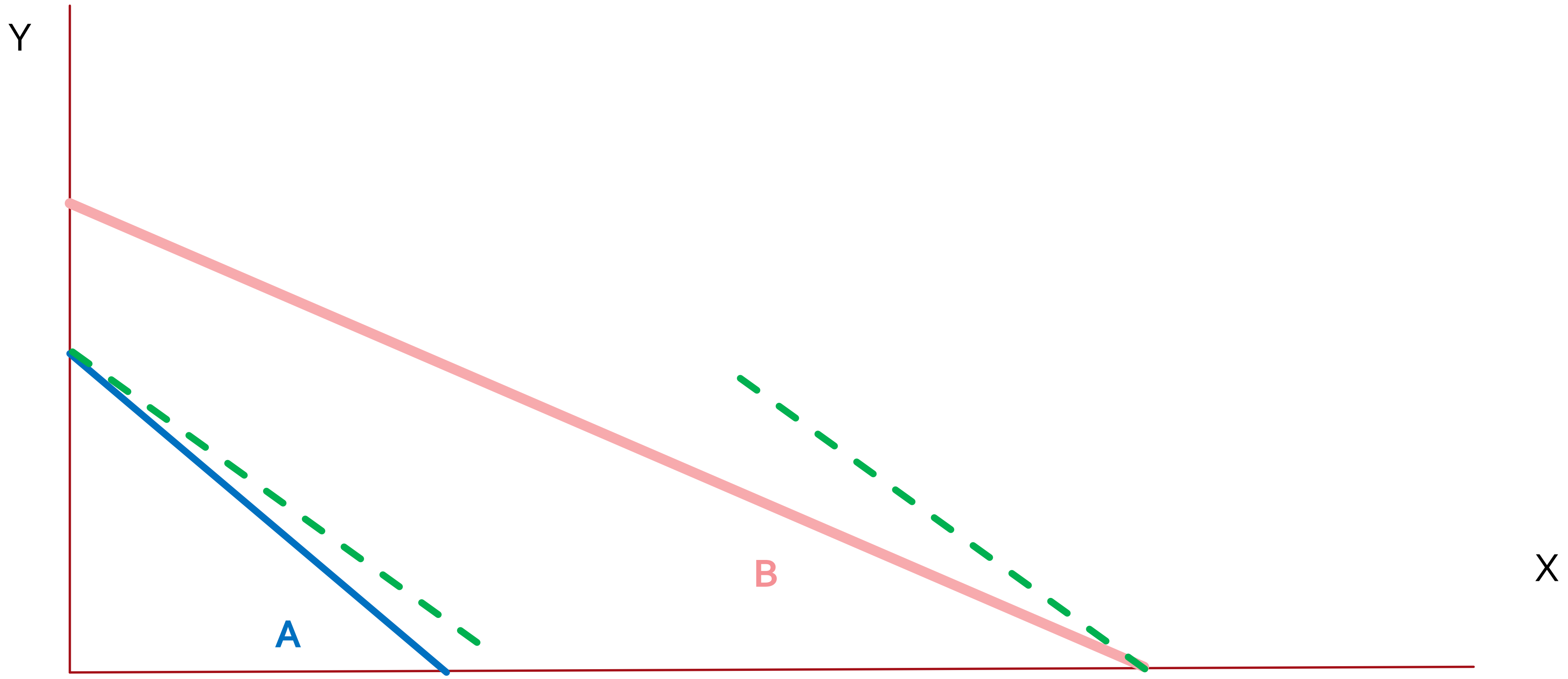
- Throughout world history, trade has made people better off
- Adam Smith, first economist, made this point repeatedly
- Distinguish absolute advantage from comparative advantage:
  - Two countries, A&B, can produce combinations of 2 goods, X&Y:

Country A:	10X, 0Y	0X, 10Y
Country B:	30X, 0Y	0X, 15Y

  - Does B want to trade? Should they go it alone since they're better at everything?
  - Go back to the PPFs! (Remember Production Possibility Frontiers? Of course you do!)

Elon Musk is great at Twitter and great at running Tesla … should he be doing both though? Would he be better off hiring someone to make snarky comments on Twitter and concentrating on cars?

Comparative Advantage



Trade Measures

- Exports and Imports include goods and services
- But sometimes look at "merchandise trade balance" of just goods
- Total (X – M) includes goods and services, the trade balance
- Current Account Balance is trade balance plus flows of money
- Flows of money categorized as income receipts and payments plus unilateral transfers

Balance of Flows

- If a person exports more than they import, what do they get?
- If a country exports more than it imports, what does it get?
- Financial Claims
- Balance of Current Account is exactly the Balance of Payments (but opposite signs)
- Imports of stuff are paid for with flows of finance; exports of stuff are paid for with flows of finance
- Investment income from abroad to US happens because in past there was an investment of funds, & vice versa

Supply & Demand of Financial Capital

- Investments in future production, I, can be financed from various sources
- I competes with government since government must fund deficit, (G – T)
- This demand for financial capital is met with a supply from:
- S, the savings of households and firms
- (M – X) the financial flows from foreigners
- $S + (M - X) = I + (G - T)$
- In US, the terms in parentheses are usually positive but other countries could be different balance
- $S + M + T = I + X + G$ is same equation

Causation…

- Causation between Current Account deficit/surplus and Balance of Payments surplus/deficit ????
- Trade surplus means financial surplus (savings invested abroad) too; trade deficit means financial deficit (savings invested domestically)
- A country with lots of investment projects offering a high return, with low domestic savings and small government net surplus, will need to run Current Account deficit
- Rewrite equation so $(M - X) = (I - S) - (T - G)$

Positive or Negative Trade Balance?

- Some countries have positive net exports, (X – M), while others are negative
- US has deficit; Germany, Japan, & China have surplus
- Recall from comparative advantage argument that trade makes both sides better off
- One argument sees deficit as good – we're getting actual stuff in return for pieces of paper!
- Other side sees trade surplus as demonstrating advantage
- Generally a modest sized deficit/surplus is not a worry
- For US, most financial flows are in USD but other countries might denominate in foreign currency
- Sometimes distinguish financial flows as "hot money" vs longterm investments
- Level of trade vs balance of trade