

29

TRADE WITH MONEY

OVERVIEW

1. The foreign exchange rate is the number of dollars it takes to buy a foreign currency. The exchange rate will be one factor in determining the price of foreign goods in the United States. If many dollars are required to buy a pound, then British goods will be more expensive here than if it takes fewer dollars to buy a pound.
2. The exchange rate is determined in a market. The foreign exchange market involves all those who want to buy pounds and all those who want to sell pounds. The demand for pounds together with the supply of pounds will determine the number of dollars needed to buy a pound.
3. The international accounts consist of three parts. The current account measures the value of what is sold to other countries minus what is imported from other countries. The capital account measures the flow of money from one country to another for the purpose of buying financial assets. The official settlements account includes the movement of cash from one country to another or the movement of credit from one central bank to another. The official settlements account also records the changes in a government's reserves of foreign exchange.
4. All foreign transactions go through the foreign exchange market, and the value of the inflow of pounds equals the value of the outflow of dollars. Since every foreign transaction fits into one of the international accounts, all three accounts together show a zero net balance. A balance of payments deficit means that the current account plus the capital account is a negative number. A balance of payments surplus means that the sum of the current account and the capital account is positive. A balance of trade deficit means that we import more than we export. A balance of trade surplus means that we export more than we import.
5. The gains from free trade may be offset by other considerations. When free trade occurs, foreign goods may replace the same good produced here and our workers are unemployed. They may be able to find employment in some other industry, but the relocation will take time. Barriers to trade may be erected to protect an industry that is just getting started or to protect an industry important to national defense. Barriers to trade may be desired if a foreign industry is replacing ours because the foreign industry is subsidized by the foreign government. In that case, our firms without subsidies may not be able to compete.
6. Two common forms of barriers to trade are tariffs and import quotas. A tariff is a tax on the imported good while a quota is a restriction on the amount that can be imported.

MATCHING

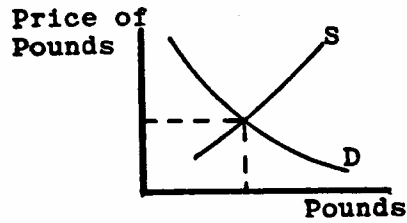
- | | | | | |
|-------|----|------------------------------|----|---|
| _____ | 1. | exchange rate | a. | exports minus imports |
| _____ | 2. | foreign exchange market | b. | movements of cash from one country to another or movements of credit from one central bank to another |
| _____ | 3. | current account | c. | taxes on imports |
| _____ | 4. | capital account | d. | a restriction on the amount of a good that can be imported |
| _____ | 5. | official settlements account | e. | the price of one currency in terms of another currency |
| _____ | 6. | balance of payments | f. | the flow of money from one country to another for the purpose of buying financial assets |
| _____ | 7. | tariffs | g. | sum of the current account and the capital account |
| _____ | 8. | quotas | h. | the market where currencies are traded |

TRUE-FALSE

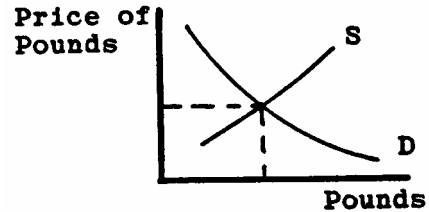
- _____ 1. An increase in the demand for pounds by citizens of the US will cause the price of pounds to rise.
- _____ 2. A tariff on goods produced in Britain will cause the price of those goods in the US to be lower.
- _____ 3. A quota will not make the price of the good rise or fall.
- _____ 4. If the balance of trade is negative, the balance of payments must also be negative.
- _____ 5. If there is not a balance of payments in a floating exchange rate system, then forces will automatically bring the balance of payments to equilibrium.

PROBLEMS

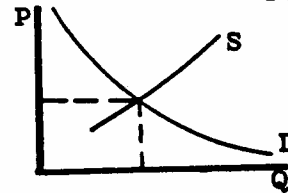
1. a. Use the graph to show Price of the impact on the exchange rate of an increase in the supply of pounds.



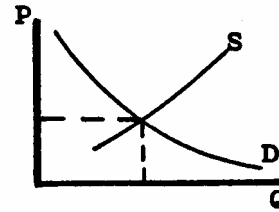
- b. Use the graph to show the impact of a decrease in the demand for pounds.



2. a. If a quota is placed on the sale of an imported good, show the impact on the price and quantity of the imported good.



- b. If a tariff is placed on the sale of an imported good, show the impact on the price and quantity of the imported good.



IN THE NEWS

1. Even though the Constitution prohibits states from erecting barriers to trade, there are barriers to trade among states. States require that certain professionals be licensed, including dentists, doctors, beauticians, and pharmacists. Anyone wishing to practice these professions must pass an examination to obtain a state license.
 - a. In what way are these laws barriers to trade?

 - b. Why do states enact laws that require state licenses?

 - c. Who gains by these laws? Who loses?

2. The U.S. steel industry is now protected from foreign trade. Foreign steel imports are restricted to a percentage of the total steel market. American steel is about 10 percent more expensive than foreign steel. This is partly due to the lower production cost in foreign countries and partly due to the strong dollar. Opponents of protection argue that high wages and insufficient technology are responsible for the troubles of U.S. steelmakers, not imports.¹

a. Why should steel be protected?

b. Who loses? Who gains?

3. American firms with international business frequently send American employees to live abroad and sell their products. These individuals have their salaries paid in dollars. When the dollar is strong, the Americans living abroad benefit. It now takes about \$1.70 to buy a British pound which used to cost \$2. The American's income increases because of the favorable change in the exchange rate. But the bad news is that because it takes fewer dollars to buy a pound, it takes more pounds to buy a dollar and the cost of American goods in Great Britain has gone up. This makes selling those goods harder.²

a. Is a strong dollar good for U.S. trade?

b. What benefits do Americans living or traveling abroad gain from a strong dollar?

4. In the summer of 1985, the Israeli government did not want its citizens going abroad because they took Israel's foreign currency with them. The travel tax on citizens leaving the country was doubled to \$300 an individual. The main purpose of the tax was to discourage travel, but the revenue generating prospects have not been overlooked.³

a. How is the travel tax like a tariff?

b. What impact does the tax have on travel?

¹ Adapted from "U.S. Consumer Is Seen as Big Loser In New Restraints on Imported Steel," *The Wall Street Journal*, Jan. 7, 1985.

² Adapted from "American in Britain is Caught Between Dollar Pain, Pleasure," *The Blade*, Toledo, Ohio, March 17, 1985.

³ Adapted from "Doubled Travel Tax 'Is No Barrel of Joy,'" *The Blade*, Toledo, Ohio, June 2, 1985.

PRACTICE TEST

Circle the correct answer.

1. The price of one currency in terms of another is:
 - a. the currency rate.
 - b. the money rate.
 - c. the exchange rate.
 - d. the trade rate.

2. If the number of dollars required to buy a pound goes up, you would expect:
 - a. U.S. imports from Great Britain to rise.
 - b. U.S. imports from Great Britain to fall.
 - c. U.S. imports from Great Britain to stay the same.
 - d. the number of Japanese cars imported into the U.S. to rise.

3. A purchase of a foreign good by a U.S. citizen would be recorded in:
 - a. the current account.
 - b. the capital account.
 - c. the official settlements account.
 - d. all of the above.

4. If the value of what we export is greater than the value of what we import, we have:
 - a. a balance of payments deficit.
 - b. a balance of payments surplus.
 - c. a balance of trade deficit.
 - d. a balance of trade surplus.

5. A quota:
 - a. is a reduction in the amount of a good that can be imported.
 - b. is a barrier to trade.
 - c. tends to raise the price of the imported good. that is restricted.
 - d. all of the above.

ANSWERS

Matching

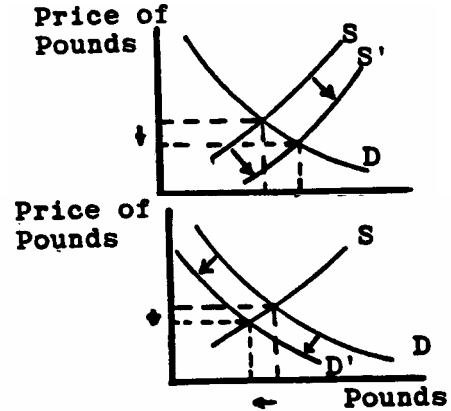
1. e
2. h
3. a
4. f
5. b
6. g
7. c
8. d

True-False

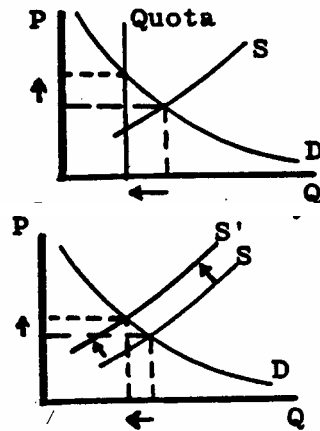
1. T
2. F
3. F
4. F
5. T

Problems

1. a. An increase in the supply of pounds will cause the exchange rate to fall.
- b. A decrease in the demand for pounds will cause the exchange rate to fall.



- c. A quota will cause the price of the imported good to rise and the quantity of the good to fall.
- d. A tariff will cause the supply of the good to decrease, the price to rise, and the quantity to fall.



In the News

1. a. The barrier to trade is that states do not freely allow professionals from other states to practice.
- b. States believe that in licensing these professionals, they protect public welfare.
- c. The professionals already licensed gain from the laws. If licenses are required to practice a profession in a state, the supply of practitioners is reduced. That allows the

- professionals in the state to charge higher prices for their work than they could if there were free entry into the profession. The consumers lose to the extent that they have to pay higher prices than they would pay if there were no barrier to entry.
2. a. Reasons given for the protection of steel are its importance to our national defense, the difficulties of reallocating workers in the industry, and the fact that the industry competes with foreign firms given government subsidies.
b. The losers are the consumers who have to pay higher prices because of the more expensive steel. The gainers are the steel companies who are allowed to prosper with reduced threat of foreign competition.
 3. a. A strong U.S. dollar is not good for trade in the sense that it makes U.S. goods more expensive abroad. That higher cost makes the goods harder to sell.
b. Tourists or Americans living abroad are helped by the strong dollar because their dollars are used to buy foreign goods. A strong dollar means that one dollar buys a larger amount of the foreign currency which makes foreign goods less expensive. Going abroad becomes a bargain.
 4. a. A tariff is a tax that has the impact of raising the price of a good and reducing the quantity of the good. This tax is like a tariff in that it raises the cost of travel out of Israel and therefore reduces the amount of such travel.
b. The quantity of travel out of Israel is reduced.

Practice Test

1.c., 2.b., 3.a., 4.d., 5.d.