DISCUSSION QUESTIONS

1. Assume you are going to take a trip to Paris. You buy euros at your local bank or at the airport. Then you start spending them once you are in Paris. Every time you buy something there, you explicitly or implicitly translate the euro price into dollars. Often, you might say to yourself, "How do Parisians afford such high prices?" What is wrong with this line of reasoning? (*Hint*: In what currency do Parisians earn their income?)
2. Why don't the local prices of restaurant meals, haircuts, and gardening services affect a country's exchange rate?
3. If the same amount of materials and the same methods are used to produce Big Macs in over 120 countries, why are the prices of Big Macs not all the same, expressed in dollars?
4. Is there anything that a Big Mac preparer in a developing country can do to earn a higher real wage rate?
5. Why does McDonalds provide a six hundred-page manual to the company's franchises in every country? (*Hint*: What are the ways that any franchisor can monitor quality of its franchisees?)
6. In a wealthy country, wages are not only high in the traded-goods and services sector, but they are also high in the non-traded goods and services sector. Why? (*Hint*: Are there two separate labor markets or just one?)

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CHAPTER 30

Globalization and the Wealth of America

The past twenty-five years have been a time of great change for international trade and **globalization.** The North American Free Trade Agreement (NAFTA), for example, substantially reduced the **trade barriers** among citizens of Canada, the United States, and Mexico. On a global scale, the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) was ratified by 117 nations, including the United States. Under the terms of this agreement, GATT was replaced by the **World Trade Organization (WTO),** whose membership now numbers over 150, and **tariffs** were cut worldwide. Agricultural **subsidies** were reduced, patent protections were extended, and the WTO established a set of arbitration boards to settle international disputes over trade issues.

Many economists believe that both NAFTA and the agreements reached during the Uruguay Round were victories not only for free trade and globalization but also for the citizens of the participating nations. Nevertheless, many noneconomists, particularly politicians, opposed these agreements, so it is important that we understand what is beneficial about NAFTA, the Uruguay Round, and free trade in general.

GAINS FROM TRADE

Voluntary trade creates new wealth. In voluntary trade, both parties in an exchange gain. They give up something of lesser value in return for something of greater value. In this sense, exchanges are always unequal. But it is this unequal nature of exchange that is the source of the increased **productivity** and higher wealth that occurs whenever trade takes place. When we engage in exchange, what we give up is worth less than what we get—for if this were not true, we would not have traded. And what is true for us is also true for our trading partner, meaning that both partners end up better off.

Free trade encourages individuals to use their abilities in the most productive manner possible and to exchange the fruits of their efforts. The **gains from trade** lie in one of the most fundamental ideas in economics: A nation gains from doing what it can do best *relative to other nations*, that is, by specializing in endeavors in which it has a **comparative advantage.** Trade encourages individuals and nations to discover ways to specialize so that they can become more productive and enjoy higher incomes. Increased productivity and the subsequent increase in economic growth are exactly what the signatories of the Uruguay Round and NAFTA sought—and are obtaining—by reducing trade barriers.

Globalization and the Opposition to It

Globalization differs from free trade chiefly in the degree of integration across nations. For example, although there is free trade in wine, the wines produced in Australia, California, and France are each created wholly within the geopolitical borders indicated by their labels. Moreover, each remains a distinct economic entity, in that significant relative price changes between, say, French and California wines are observed. In contrast, the market for automobiles has become truly "global." If you purchase a "Japanese" automobile in the United States, assembly of the vehicle may have taken place in Japan, the United States, or even Mexico, and the components of the car may have come from a half-dozen or more different nations. And if you call for customer support for your car, the person answering the phone may be at a call center located in any of a variety of English-speaking nations. Globalization thus means that trade between nations becomes as seamless as trade between states, provinces, or cities within a given nation.

Despite the enormous gains from exchange, globalization is routinely opposed by some people. Many excuses are offered for this opposition, but they all basically come down to one issue: When our borders are fully open to trade with other nations, some individuals and businesses in our nation face more competition. As you saw in Chapter 19, most firms and workers hate competition, and who can blame them? After all, if a firm can keep the competition out, **profits** are sure to rise. And if workers can prevent competition from other sources, they can enjoy higher wages and greater selection among jobs. So the real source of most opposition to globalization is that the opponents to trade dislike the competition that comes with it. There is nothing immoral or unethical about this—but there is nothing altruistic or noble about it, either. It is self-interest, pure and simple.

One aspect of globalization that looms large in the minds of its opponents is the unremitting competitive vigilance that it requires. When world markets are completely integrated, one's competitors may emerge at any time from any place—often from corners of the world that one may least expect. And because competitors may only need to create a Web site to get started and can have their products delivered the next day by air freight, that competition can emerge devastatingly quickly. Thus, when operating in a global economy, firms and their employees must contend with a level of uncertainty that is simply not present when trade patterns are less integrated. Note that this highly competitive atmosphere ultimately benefits all of us, but that doesn't make it any less unnerving for those who must endure its pressures, day after day. Competition is tough, and global competition is toughest of all.

Beggar-Thy-Neighbor

Because of this, opposition to globalization is nothing new. One of the most famous examples of such opposition led to passage of the Smoot–Hawley Tariff of 1930. This major federal statute was a classic example of **protectionism**—an effort to protect a subset of American producers at the expense of consumers and other producers. It included tariff schedules for more than twenty thousand products, raising taxes on affected imports by an average of 52 percent.

The Smoot–Hawley Tariff encouraged beggar-thy-neighbor policies by the rest of the world. Such policies represent an attempt to improve (a portion of) one's domestic economy at the expense of foreign countries' economies. In this case, tariffs were imposed to discourage **imports** so that domestic import-competing industries would benefit. The beggar-thy-neighbor policy at the heart of Smoot–Hawley was soon adopted by the United Kingdom, France, the Netherlands, and Switzerland. The result was a halt to globalization and a massive reduction in international trade that almost certainly worsened the worldwide depression of the 1930s.

Opponents of globalization sometimes claim that beggar-thy-neighbor policies benefit the United States by protecting import-competing industries. In general, this claim is not correct. It is true that some Americans benefit from such policies, but two large groups of Americans lose. First, there are the purchasers of imports and import-competing goods. They suffer from higher prices and reduced selection of goods and suppliers caused by tariffs and import **quotas.** Second, the decline in imports caused by protectionism also causes a decline in **exports,** thereby harming firms and employees in these industries. This follows directly from one of the most fundamental propositions in international trade: *In the long run, imports are paid for by exports.* This proposition simply states that when one country buys goods and services from the rest of the world (imports), the rest of the world eventually wants goods from that country (exports) in exchange. Given this fundamental proposition, a corollary becomes obvious: *Any restriction on imports leads to a reduction in exports.* Thus, any business for import-competing industries gained as a result of tariffs or quotas means at least as much business lost for exporting industries.

DUMPING

Opponents of globalization raise a variety of objections in their efforts to restrict international trade. For example, it is sometimes said that foreign companies engage in dumping, that is, selling their goods in America below cost. The first question to ask is: Below *whose* cost? Clearly, if the foreign firm is selling in America, it must be offering the good for sale at a price that is at or below the cost of buying from American firms or else it could not induce American consumers to buy it. But the ability of individuals or firms to get goods at lower cost is one of the *benefits* of free trade, not one of its negatives.

What about claims that import sales are taking place at prices below the foreign company's costs? This amounts to arguing that the owners of the foreign company are voluntarily giving some of their wealth to us, namely, the difference between their costs and the lower price they charge us. It is possible, though unlikely, that they might wish to do this as a way of getting us to try a product that we would not otherwise purchase. But if so, why would we want to refuse this gift? As a nation, we are richer if we accept it. Moreover, it is a gift that will be offered for only a short while, for there is no point in selling below one's cost unless one hopes soon to raise price profitably above cost!

LABOR AND ENVIRONMENTAL STANDARDS

Another argument sometimes raised against globalization is that the goods are produced abroad using unfair labor practices (such as the use of child labor) or using production processes that do not meet American environmental standards. Such charges are sometimes correct. But we must remember two things. First, although we may find the use of child labor (or perhaps sixty-hour work weeks with no overtime pay) objectionable, such practices were once common in the United States. They used to be prevalent in America for the same reason they are now practiced

abroad. The people involved were (or are) too poor to do otherwise. Some families in developing nations cannot survive unless all members of the family contribute. As unfortunate as this is, if we insist on imposing our attitudes—shaped in part by our great wealth—on peoples whose wealth is far lower than ours, we run the risk of making them worse off even as we think we are helping them.

Similar considerations apply to environmental standards. It is well established that individuals' and nations' willingness to pay for environmental quality is very much shaped by their wealth. Environmental quality is a **luxury good.** That is, people who are rich (such as Americans) want to consume much more of it per capita than people who are poor. Insisting that other nations meet environmental standards that we find acceptable is much like insisting that they wear the clothes we wear, use the modes of transportation we prefer, and consume the foods we like.[1] The few people who manage to comply will indeed be living in the style to which we are accustomed, but most people will simply be impoverished by the attempt.

Our point is not that foreign labor or environmental standards are, or should be, irrelevant to Americans. Our point is that achieving high standards of either is costly, and trade restrictions are unlikely to be the most efficient or most effective way to achieve them. Just as important, labor standards and environmental standards are all too often raised as smoke screens to hide the real motive—keeping the competition out.

THE POLITICAL ECONOMY OF TRADE BARRIERS

If it is true that globalization is beneficial and that restrictions on trade are generally harmful, we must surely raise the question, how does legislation such as the Smoot–Hawley Tariff (or any other such restriction) ever get passed? As Mark Twain noted many years ago, the reason the free traders win the arguments and the protectionists win the votes is simple. Foreign competition often clearly affects a narrow and specific import-competing industry such as textiles, shoes, or automobiles, and thus trade restrictions benefit a narrow, well-defined group of economic agents. For example, restrictions on imports of Japanese automobiles in the 1980s chiefly benefited the Big Three automakers in this country—General Motors, Ford, and Chrysler. Similarly, long-standing quotas on

1 There is one important exception to this argument. In the case of foreign air or water pollution generated near enough to our borders (for example, with Mexico or Canada) to cause harm to Americans, good public policy presumably dictates that we seek to treat such pollution as though it were being generated inside our borders.

the imports of sugar benefit a handful of large American sugar producers. And when tariffs of up to 30 percent were slapped on many steel imports in 2002, an even smaller number of American steelmakers and their employees benefited. Because of the concentrated benefits that accrue when Congress votes in favor of trade restrictions, sufficient lobbying and campaign funds can be raised in those industries to convince members of Congress to impose those restrictions.

The eventual reduction in exports that must follow is normally spread in small doses throughout all export industries. Thus, no specific group of workers, managers, or shareholders in export industries will feel that it should contribute money to convince Congress to reduce barriers to globalization. Furthermore, although consumers of imports and import-competing goods lose due to trade restrictions, they too are typically a diffuse group of individuals, none of whom will be individually affected much because of any single import restriction. It is the simultaneous existence of concentrated benefits and diffuse costs that led to Mark Twain's conclusion that the protectionists would often win the votes. (Concentrated benefits and dispersed costs are at the heart of Chapters 21, 23, and 27 in explaining some U.S. domestic policies.)

Of course, the protectionists don't win all the votes—after all, roughly one-sixth of the U.S. economy is based on international trade. Despite the opposition to globalization that comes from many quarters, its benefits to the economy as a whole are so great that it is unthinkable that we might do away with international trade altogether. Thus, when we think about developments, such as NAFTA and the WTO, it is clear that both economic theory and empirical evidence indicate that Americans are better off because of globalization.

DISCUSSION QUESTIONS

1. During the late 1980s and early 1990s, American automobile manufacturers greatly increased the quality of the cars they produced relative to the quality of the cars produced in other nations. What effect do you think this had on American imports of Japanese cars, Japanese imports of American cars, and American exports of goods and services other than automobiles?
2. Over the past twenty-five years, some Japanese automakers have opened plants in the United States so that they could produce (and sell) "Japanese" cars here. What effect do you think this had on American imports of Japanese cars, Japanese imports of American cars, and American exports of goods and services other than automobiles?

3. For a number of years, Japanese carmakers voluntarily limited the number of cars they exported to the United States. What effect do you think this had on Japanese imports of American cars and on American exports of goods and services other than automobiles?
4. Until recently, American cars exported to Japan had driver controls on the left side (as in the United States), even though Japanese cars sold in Japan have driver controls on the *right* side, because the Japanese (like the British) drive on the left side of the road. Suppose the Japanese tried to sell their cars in the United States with the driver controls on the right side. What impact would this likely have on their sales in this country? Do you think the unwillingness of American carmakers to put the driver controls on the correct side for exports to Japan had any effect on their sales of cars in that country?
5. The U.S. government subsidizes the export of U.S.-manufactured commercial aircraft. What effect do you think this policy has on American imports of foreign goods and American exports of products other than commercial aircraft? Explain.
6. Who bears the costs and enjoys the benefits of the subsidies mentioned in the previous question?