

# **Basic Economics**

## **A Citizen's guide to the Economy**

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**The International Economy**

**PART VI:  
The International Economy**

**International Trade**

Before NAFTA was passed, Congressman David Bonior of Michigan warned: “If the agreement with Mexico receives congressional approval, Michigan’s auto industry will eventually vanish.” But what actually happened was that employment in the automobile industry increased by more than 100,000 jobs over the next six years.

What happens when a given country, in isolation, becomes more prosperous? It tends to buy more because it has more to buy with. And what happens when it buys more? There are more jobs created making the additional goods and services that are now in greater demand.

Make that two countries and the principle remains the same. There is no fixed number of jobs that the two countries must fight over. If they both become more prosperous, they are both likely to create more jobs. The only question is whether international trade tends to make both countries more prosperous.

What it comes down to is the fact that the only reason international trade takes place in the first place is because both parties expect to benefit. If it is not a win/win, then don't trade.

### **The Basis for International Trade**

The reasons why countries gain from international trade are usually grouped together by economists under three labels: Absolute Advantage, Comparative Advantage, and Economics of Scale.

#### **Absolute Advantage**

It is much cheaper to grow bananas in the tropics than in places where greenhouses and other artificial means of maintaining warmth would be necessary. In tropical countries, nature provides free the warmth that people have to provide by costly means in cooler climates.

This is just one example of what economists call “absolute advantage”—one country, for any of a number of reasons, can produce some things cheaper than another. These reasons may be due to climate, geography, or the mixture of skills in their respective populations.

#### **Comparative Advantage**

Let's suppose that one country is so efficient that it is capable of producing anything more cheaply than another country. Should the two countries trade?

Yes.

Why?

Because even in an extreme case, where one country can produce anything more cheaply than another country, it may do so to varying degrees. For example, it may be twice as efficient at producing chairs but ten times as efficient at producing television sets. In this case, the total number of chairs and television sets produced in the two countries combined would be greater if one country produced all the chairs and the other produced all the television sets. Then they could trade with one another and each end up with more chairs and more television sets than if they each produced both products for themselves.

As economists would say, country A has an “absolute advantage” in producing both products but, country B has a “comparative advantage” in producing chairs while A has a “comparative advantage” in producing television sets.

Let’s look at this on a small, human scale. Imagine that you are an eye surgeon and that you paid your way through college by washing cars. Now that you have a car of your own, should you wash it yourself or should you hire someone else to wash it—even if your previous experience allows you to do the job more efficiently than the person you hire?

-- Even though you have an “absolute advantage” in both activities, your comparative advantage in treating eye diseases is far greater.

The surgeon has only 24 hours in the day, like everyone else. Time that he is spending doing one thing cannot be spent doing something else. The same is true of countries.

Although country A may be capable, in the abstract, of producing anything more cheaply than country B, it cannot in reality produce everything more cheaply because the time it spends producing one thing comes at the expense of the time that could have been spent producing other things.

While Country A can produce either product more efficiently, the time it spends producing chairs would pay off much bigger in producing television sets, some of which it can trade for chairs from Country B, ending up with more of both products than if it produced both for itself.

Assume for the sake of argument that the United States can produce 75 shirts per man-hour, while Canada produces only 30 and that the United States produces 25 shoes per man-hour, while Canada produces only 20.

	American	American	Canadian	Canadian
Products	Man-Hours	Output	Man-Hours	Output
Shirts	300	22,500	300	9,000
Shoes	200	5,000	200	4,000

With both countries producing both products, their combined output would come to a grand total of 31,500 shirts and 9,000 shoes from a grand total of 1,000 man-hours of work.

If they engage in international trade, with each country specializing in producing the product in which it has a comparative advantage, the table below illustrates the output under these conditions and with the same individual productivity as before:

	American	American	Canadian	Canadian
Products	Man-Hours	Output	Man-Hours	Output
Shirts	500	37,500	0	0
Shoes	0	0	500	10,000

Even though output per man-hour remains the same in each country as before, now their combined total of 1,000 man-hours produces 37,500 shirts and 10,000 shoes, instead of 31,500 shirts and 9,000 shoes as before. By utilizing their comparative advantages, the two countries can produce 6,000 more shirts and 1,000 more shoes than before, with no more resources than before and with no technological change.

It has been more than a century since Great Britain produced enough food to feed itself. Britons have been producing those things in which it has been a comparative advantage, such as manufacturing, shipping, and financial services—and using the proceeds to buy food from other countries.

British consumers end up better fed and with more manufactured goods than if the country grew enough of its own food to feed itself. Furthermore, it would cost the British too much industry to put enough efforts into agriculture to become self-sufficient in food.

### **Economies of Scale**

Sometimes a particular product requires such huge investment in machinery and in developing a skilled labor force that the resulting output can be sold at a low enough price to be competitive only when some enormous amount of output is produced, because of what economists call “economies of scale.”

If General Motors produced only a hundred Chevrolets, the cost per car would be astronomical, since all the expensive machinery and all the engineering research and development that went into creating the automobile would have to be recovered from the sale of just 100 vehicles.

It has been estimated that the minimum output of automobiles needed to achieve an efficient cost per car is somewhere between 200,00 to 400,000 automobiles per year.

Producing in such huge quantities is not a serious problem in a country of the size and wealth of the United States. But, in a country with a much smaller population—Australia, for example—there is no way to sell enough cars within the

country to be able to develop and produce automobiles from scratch to sell at prices that would compete with automobiles produced in much larger quantities overseas.

If you take small countries like South Korea and Taiwan, they have to depend on international trade to be able to produce on a scale far exceeding what can be sold domestically.

International trade is necessary for many countries to achieve economies of scale that will enable them to sell at competitive prices. For some products requiring huge investments in machinery and research, only a very few large and prosperous countries could reach the levels of output needed to repay all these costs from domestic sales alone.

International trade creates greater efficiency by allowing more economies of scale, as well as by taking advantage of each country's absolute or comparative advantages.

**Labor is one of innumerable scarce resources that have alternative uses. The computer software industry in the United States could not have expanded so much and so successfully if all American computer engineers were tied down with the production of machines that could have been just as easily produced in some other country. Since the same American labor cannot be in two places at one time, it can move to where its comparative advantage is greatest only if the country "loses jobs" where it has no comparative advantage.**

But if Americans in general were losing higher-paid jobs and being forced to take lower-paid jobs, how then could the American standard of living have continued to rise, as all data show? In reality, when the shifting of low-skill jobs to other countries enables an American company to become more profitable, it can then afford to hire American labor for higher-skilled jobs. It is not a zero-sum game when there are more total resources available after the shift.

When the number of jobs in the American steel industry was cut from 340,000 to 125,000 during the decade of the 1980's, it had a devastating impact and was big economic and political news. It also led to a variety of laws and regulations designed to reduce the amount of steel imported into the country to compete with domestically produced steel. Of course, this reduction in supply led to higher steel prices within the United States and therefore higher costs for all American industries producing objects made of steel, ranging from automobiles to oil.

It has been estimated that the gain in domestic American steel production due to import restrictions led to a net loss in the production of domestic American steel products as a whole. In other words, American industry as a whole was worse off, on net balance, as a result of the import restrictions. While such steel import restrictions made no sense economically, it made sense politically to those in Washington responsible for creating these restrictions.

In many cases, laws are passed by Congress restricting international trade for the benefit of some concentrated and vocal constituency, even though these restrictions may cause far more losses of jobs nationwide.

Then you have imports of things in which other countries have a comparative advantage, that create losses of profits and jobs in the corresponding domestic industry.

Despite offsetting economic gains that typically far outweigh the losses, politically it is almost inevitable that there will be loud calls for government protection from foreign competition through various restrictions against imports.

### **The High-Wage Fallacy**

In a prosperous country such as the United States, a fallacy that sounds very plausible is that American goods cannot compete with goods produced by low-wage workers in poorer countries. Both history and economics refute it. High-wage countries have been exporting to low-wage countries for centuries.

The key flaw in the high-wage argument is that it confuses wage rates with labor costs—and labor costs with total costs.

When workers in a prosperous country receive twice the wage rate as workers in a poorer country and produce three times the output per man-hour, then it is the high-wage country that has the lower labor costs. It is cheaper to get a given amount of work done in the more prosperous country simply because it takes less labor, even though individual workers are paid more. The higher-paid workers may be more efficiently organized and managed, or have far more or better machinery to work with.

A prosperous country usually has a greater abundance of capital and, because of supply and demand, capital tends to be cheaper than in poorer countries where capital is scarcer and earns a correspondingly higher rate of return.

That “giant sucking sound” we were forewarned about fearing that American jobs would go to Mexico in the wake of the North American Free Trade Agreement of 1993 turned out to be completely wrong. The number of American jobs increased and the unemployment rate in the United States fell to record lows. This did not come at the expense of Mexico, however. Both countries gained for the same reasons that countries have gained from international trade for centuries—absolute advantage and comparative advantage.

Just as free trade provides economic benefits to all countries simultaneously, so trade restrictions reduce the efficiency of all countries simultaneously, lowering standards of living, without producing the increased employment that was hoped for.

A protective tariff for other import restrictions may provide immediate relief to a particular industry and thus gain the financial and political support of corporations and

labor unions in that industry. But, like many political benefits, it comes at the expense of others who may not be as organized as visible, or as vocal.

### **International Transfers of Wealth**

The great Supreme Court Justice Oliver Wendell Holmes said: “Think things, not words.” Nowhere is that more important than when discussing international trade, where there are so many misleading and emotional words used to describe and confuse things that are not difficult to understand in themselves. The terminology used to describe an export surplus as a “favorable” balance of trade goes back for centuries.

As early as 1776, Adam Smith’s classic *The Wealth of Nations* argued that the real wealth of a nation consists of its goods and services, not its supply of gold.

If the goods and services available to the American people are greater as a result of international trade, then Americans are wealthier, not poorer, regardless of whether there is a “deficit” or a “surplus” in the international balance of trade.

**If Americans buy more Chinese goods than the Chinese buy American goods, then China gets American dollars to cover the difference. Since China is not just going to collect these dollars as souvenirs, it usually turns around and invests them in the American economy. In most cases, the money never leaves the United States. The Chinese simply buy investment goods—Rockefeller Center, for example—rather than consumer goods. American dollars are worthless to the Chinese if they do not spend them on something. In growth terms, international trade has to balance, in order to make any economic sense. But it so happens that the conventions of international accounting count imports and exports in the “balance of trade,” but not things which don’t move at all, like Rockefeller Center.**

What do the makers of Hondas and Toyotas do with all that American money? One of the things they do is build factories in the United States, employing thousands of American workers to manufacture their cars closer to their customers, so that Honda and Toyota do not have to pay the cost of shipping cars across the Pacific Ocean. Their American employees have been paid sufficiently high wages that they have repeatedly voted against joining labor unions in secret ballot elections.

What alarms people are the words and the accounting rules that produce numbers to fit those words. A country’s total output consists of both goods and services—houses and haircuts, sausage and surgery—but the international trade balance consists only of physical goods that move. The American economy produces more services than goods, so it is not surprising that we import more goods than we export—and export more services than we import.

American know-how and American technology are used by other countries around the world and these countries of course pay us for these services. For example, most of the

computers in the world run on operating systems created by Microsoft. But their payments to Microsoft and other American companies for their services are not counted in the international balance of trade, since trade includes only goods. Yet the American “balance of trade” is reported in the media as if this partial picture were the whole picture and the emotionally explosive world “deficit” sets off alarm.

When you count all the money and resources moving in and out of a country for all sorts of reasons, then you are talking about the international “balance of payments”—regardless of whether payments were made for goods or services.

According to the accounting rules, when people in other countries invest in the United States, that makes us a “debtor” to those people, because we owe them the money that they put here.

Foreigners invested \$12 billion in American businesses in 1980 and this rose over the years until they were investing more than \$200 billion annually by 1998. Looked at in terms of things, there is nothing wrong with this. It creates more jobs for American workers and creates more goods for American consumers. Looked at in terms of words, however, this is a growing debt to foreigners. Contrary to popular fears that Japan was buying up America, the largest share of foreign direct investment in the United States in 1998 was Great Britain’s 19 percent, compared to Japan’s 16 percent. Britain was also the largest recipient of American direct investment abroad, receiving 18 percent of such investments, with Canada being next at 11 percent.

The more prosperous and secure the American economy is, the more foreigners are likely to want to send their money here and the higher our annual balance of payment “deficits” and accumulated international “debt” rises. Hence it is not at all surprising that the long prosperity of the U.S. economy in the 1990’s was accompanied by record levels of international deficits and debts. The United States was where the action was and this was where many foreigners wanted their money to be, in order to get in on the action.

The late, distinguished economist Herbert Stein and a fellow economist co-author put it best: “If all transactions are accounted for, there can be no deficit in the balance of payments.” Money does not disappear into thin air, nor do foreign recipients of American dollars let the money sit idle—and they know that the best place to put American dollars is in the United States. However, because accounting conventions count some kinds of cash flows, but not others, there can be “deficits” and “surpluses.” When flows of foreign investments into the United States are not counted, then the United States can have a deficit and run up “debts”—according to accounting conventions.

Every time you deposit a hundred dollars in a bank, that bank goes a hundred dollars deeper in debt, because it is still your money and they owe it to you.

Some people might become alarmed if they were told that the bank in which they keep their life's savings was going deeper and deeper into debt every year. But such worries would be completely uncalled for, since the bank's growing debt means only that many other people are also depositing money in that same bank.

For most of its history, the United States has been a debtor nation—and has likewise had the highest standard of living in the world. One of the things that helped develop the American economy and changed the United States from a small agriculture nation to an industrial giant was an inflow of capital from Western Europe in general and from Great Britain in particular. These vast resources enabled the United States to build canals, factories and transcontinental railroads to tie the country together economically.

Obviously, foreign investors would never have sent their money here unless they expected to get it back with interest and dividends. Equally obvious, American entrepreneurs would never have agreed to pay this interest and these dividends to them unless they expected these investments to produce big enough returns to cover these payments and still leave a profit for the American enterprises.

Only as a result of lending money to European governments during the First World War did the United States become a creditor nation. Since then we have been both, at one time or another.

Neither the domestic economy nor the international economy is a zero-sum game, where some must lose what others win. Everyone can win when investments create a growing economy.

The massive infusion of foreign capital contributed to making the United States the leading industrial nation by 1913, when it produced more than one-third of all the manufactured goods in the world.

In these poorer countries, when exports will not cover the costs of imports and there is no high-tech know-how to export, the government must borrow money from some other country or from some international agency, in order to cover the difference. These are genuine debts and causes for genuine concern.

Through it all, the American standard of living has remained the highest in the world, unaffected by whether it was a creditor or a debtor nation.

In the late twentieth century, there were so many emigrants working in so many countries abroad, and sending money home, that their remittances exceeded all the foreign aid from all the government agencies in the world combined. Most of Pakistan's international trade deficit was covered by remittances from Pakistanis working abroad and Jordan received more money from Jordanians living overseas than it did from all its exports.

## **Imperialism**

Genuine plunder of one nation or people by another has been all too common throughout human history.

During the era before the First World War, when Germany had colonies in Africa, only 4 of its 22 enterprises with cocoa plantations there paid dividends, as did only 8 of 58 rubber plantations and only 3 out of 49 diamond mining companies.

At the height of the British Empire in the early twentieth century, the British invested more in the United States than in all of Asia and Africa put together. Quite simply, there was more wealth to be made from rich countries than from poor countries. For similar reasons, throughout most of the twentieth century the United States invested more in Canada than in Asia and Africa put together. Only the rise of prosperous Asian industrial nations in the latter part of the twentieth century attracted more American investors in that part of the world.

Perhaps the strongest evidence against the economic significance of colonies in the modern world is that Germany and Japan lost all their colonies and conquered lands as a result of their defeat in the Second World War—and both countries reached unprecedented levels of prosperity thereafter.

Wealthy individuals in poor countries often invest in richer countries, where their money is safer from political upheavals and confiscations.

What we call “foreign aid” are transfers of wealth from foreign governmental organizations to the governments of poorer countries. The term “aid” assumes a priori that such transfers will in fact aid the poorer countries’ economies to develop.

Because it is a transfer of wealth to governments, as distinguished from investments in the private sector, foreign aid has encouraged many countries to set up government run enterprises that have failed.

The vast sums of money dispensed by foreign aid agencies such as the International Monetary Fund and the World Bank give the officials of these agencies enormous influence on the governments of poorer countries -- regardless of the success or failure of the programs they suggest or impose as preconditions for receiving the money.

Sometimes a richer country takes over a whole poorer society and heavily subsidizes it, as the United States did in Micronesia. So much American aid poured in that many Micronesians abandoned economic activities on which they had supported themselves before, such as fishing and farming. If and when the Americans decide to end such aid, it is not at all certain that the skills and experience that Micronesians once had will remain sufficiently widespread to allow them to become self-sufficient again.

One of the leading development economists of his time, Professor Peter Bauer of the London School of Economics, has argued that, on the whole, “official aid is more likely to retard development than to promote it.”

## **The International Monetary System**

Wealth may be transferred from country to country in the form of goods and services, but by far the greatest transfers are made in the form of money. Just as a stable monetary unit facilitates economic activity within a country, so international economic activity is facilitated when there are stable relationships between one country's currency and another's. It is not simply a question of the ease or difficulty of translating dollars in yen, francs or yuans. It is a far more important question of knowing whether an investment made in the United States, Japan, China or France today will be repaid a decade or more from now in money of the same value – whether measured in purchasing power or in the currency originally invested.

Various attempts at stabilizing international currencies against one another have followed the disappearance of the gold standard. Some nations have made their currencies equivalent to a fixed number of dollars, for example. Various European nations have created their own international currency, the Euro and the yen has been another stable currency widely accepted in international financial transactions.

With the spread of electronic transfers of money, reactions to any national currency's change in reliability can be virtually instantaneous. Any government that is tempted toward inflation knows that money can flee from their economy literally in a moment. The discipline this imposes is different from that one imposed by a gold standard, but whether it is equally effective will only be known when future economic pressures put the international monetary system to a real test.

## **An Overview**

Most American's lives are not likely to be changed in any obvious and fundamental way by international trade or international financial activities. While there are many imported products in the American economy, these are typically products that Americans also make today or have made in the past and could make in the future, if there were no international trade.

There are, however, some important consequences of international economic events that may not be obvious. As already noted, the severe tariff restrictions put in place early in the Great Depression of the 1930's have been regarded by many economists as needlessly worsening and extending the worldwide depression. The last thing needed when the national income is going down is a policy that makes it go down faster, by denying consumers the benefits of being able to buy what they want at the lowest price available.

Just as trade restrictions such as the Hawley-Smoot tariffs of the 1930s damaged the already ailing economy of the Great Depression, the North American Free Trade Agreement of 1993 helped enhance the prosperity of the 1990s, creating more jobs and reducing unemployment to record low levels, despite the cries of protectionists that

NAFTA would lead to a massive flight of jobs from America to low-wage countries elsewhere.

Whatever the complications of international economic activities, the fundamental fact in international markets is the same as that in domestic markets: Exchanges continue to take place only to the extent that both parties benefit. Opponents of free trade try to depict it as harmful and to appeal to a sense of “us” against “them” as if other countries are in some way making Americans worse off by selling them things that they want to buy.

Sometimes this approach is buttressed by claims that this or that foreign country is being “unfair” in its restrictions on imports from the United States. But, the sad fact is that all countries impose “unfair” restrictions on imports, usually in response to some internal special interests.

International trade is not a favor we bestow on other nations, despite laws about giving or withholding “most favored nation” treatment to this or that country in its trade with the United States. International trade is not a contest, despite talk about who “wins” or “loses” in this trade. Anybody who loses stops trading. The real losses occur when the public allows this kind of rhetoric to lead them astray from the basic fundamentals of economics.

If investments with a given degree of risk are paying off at a higher rate in Taiwan than in Sweden, then American or British or German capital will flow to Taiwan and not to Sweden, thereby raising the level of productivity in the world as a whole and raising standards of living internationally. Money and the resources it represents become, as it were, citizens of the world.

While comparative advantages and free trade allow all nations to share in the world prosperity promoted by free movements of resources, not all industries in all nations prosper. Those sectors of particular economies that are unable to match the competition in efficiency stand to lose money and jobs, and may even be threatened with bankruptcy. Seldom will they go quietly.