CHAPTER 1

International Markets

Chapter Preview

This chapter introduces some fundamental concepts:

- *International markets*, supply and demand from different countries
- *Excess supply* and *excess demand*, the international market model
- *Comparative advantage*, the foundation of international trade
- *Balance of trade*, net receipts from trade in goods

INTRODUCTION

The most important tools of economics are market supply and demand. A market is any place or mechanism in which goods and services are traded. Markets determine prices both in nominal currency terms and relative to one another. Markets include the corner convenience store, the stock market, the market for brain surgeons, the foreign exchange market, a neighborhood lemonade stand, the international market for steel. In market transactions, money changes hands between buyer and seller at an agreed price.

An international transaction arises when the buyer and seller are in different countries. International markets involve economic agents in different countries. Two currencies are typically involved in an international transaction. The buyer's currency and the seller's currency must be exchanged.

Another fact that distinguishes international economics is that governments can easily tax transactions with tariffs or limit transactions with quotas or nontariff barriers. International economics is also characterized by the lack of labor mobility between countries. Workers can move within a country with relative ease, but international migration is more difficult and typically restricted by law. Investment is also inhibited across national boundaries.

Comparative advantage is one of the cornerstones of economics. Comparative advantage, a relative advantage in production efficiency, is the fundamental cause of international trade. The principle of comparative advantage rests on the important idea of opportunity costs. The opportunity cost of an action is the value of its next best alternative. When a country turns its resources to producing a particular good or service, it gives up producing alternatives. Productive resources are limited and it is important to employ them efficiently.

The balance of trade regularly makes headlines, but what it estimates and why it is important are rarely clear. The balance of trade is a country's export revenue minus import expenditure on manufactured goods during a given time period. Trade deficits occur if import expenditure is greater than export revenue.

A. INTERNATIONAL MARKETS

Everyone is involved in international markets every day. Almost everything we buy has some foreign element or component. Virtually every job provides something to exports and uses some imports. International markets provide a beginning toward understanding the policy issues of international economics. This section presents the picture of an international market.

Domestic Demand

The law of demand states that as the price of a good rises, the quantity demanded falls. Examples of the law of demand are everywhere. If a clothing retailer wants to clear the shelves, prices are lowered. Car dealers offer discounts and rebates when inventories are too high. Fast food restaurants introduce specials with low prices to increase their sales.

Figure 1.1 shows a domestic market demand curve *D* for new rugs. This demand curve represents the quantity of a particular quality of rug that would be demanded at various prices by domestic consumers. If the price of a rug is \$15, 100 units are demanded per month. Demand curves show the quantity consumers would buy at various prices.

Demand curves slope downward for two reasons:

- *substitution effect* — a higher price induces consumers to look for substitutes

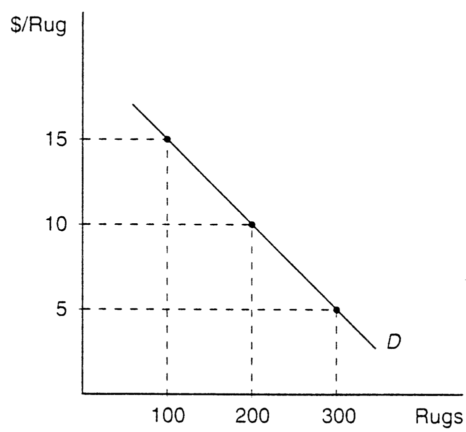

Figure 1.1
The Domestic Demand (*D*) for Rugs
The quantity demanded is inversely related to price. When price goes up, the quantity demanded falls. When price goes down, the quantity demanded rises.