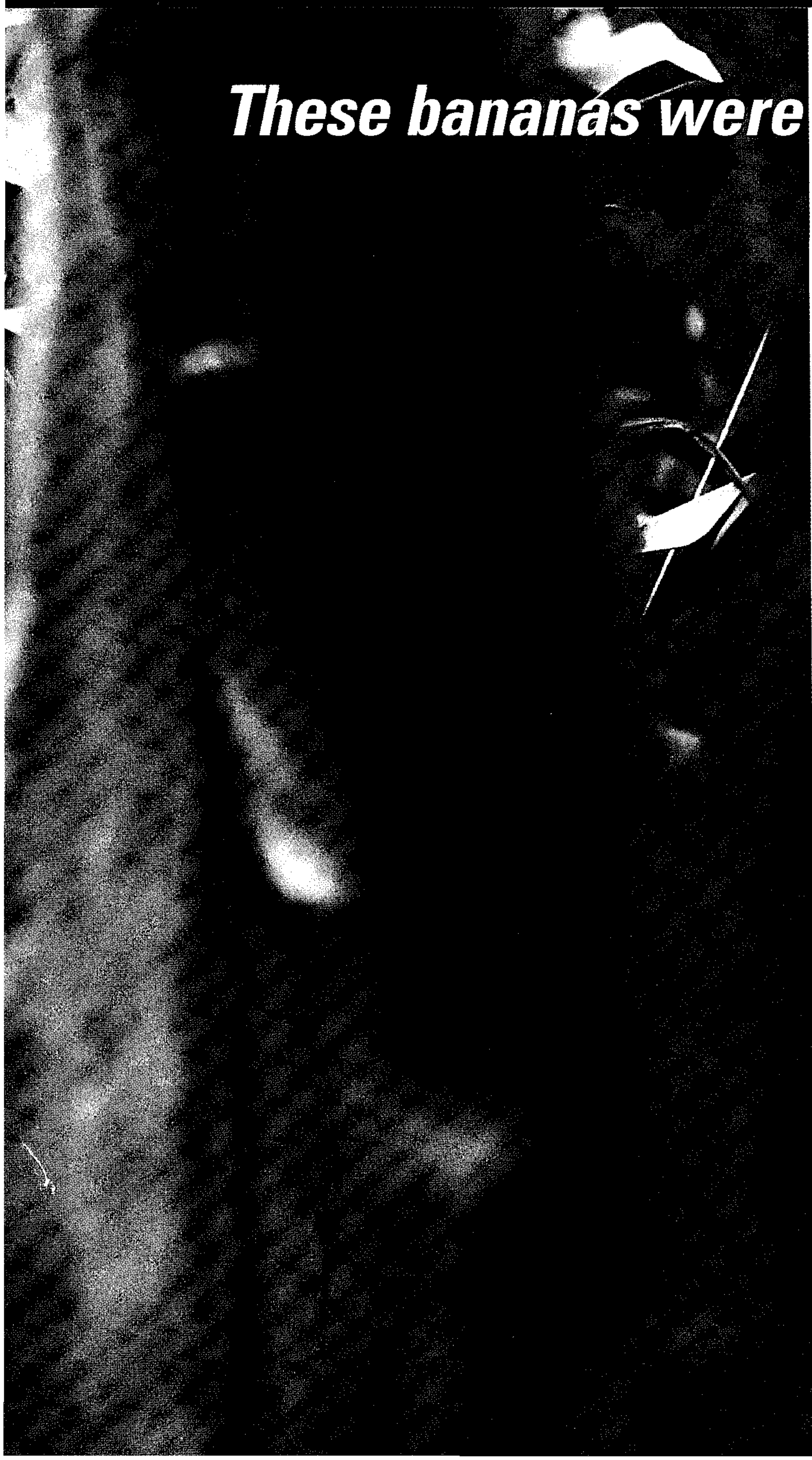
Chapters in This Unit

17. *International Trade*

18. *Economic Development and Transition*



These bananas were grown in Costa Rica.

Your shoes were made in Indonesia and your backpack in China. While many people take the global economy for granted, when you step back to consider the entire flow of goods, services, and money around the world, the result is mind-boggling.

- Who made your shirt, and how much were they paid for their labor?
- Which goods does the United States export, and which goods are imported?
- How does international trade affect the economy of the United States?

In this unit you'll read about why nations trade and actions nations take to restrict or increase trade. Finally, you'll look at why standards of living vary greatly from country to country and the impact of the global economy on everyone's future.

Focus Activity

Choose five items you own, and identify where they were made. Compare your list of items and countries with that of a classmate.

Chapter 17 International Trade

In today's global economy, many products that Americans use every day were produced in other countries. We drive Japanese cars, wear clothes from China, and sit on furniture from Canada. These products come by trucks and trains or arrive at United States ports aboard huge freighters like the one you see here.

Economics Journal

Check the labels on clothing, appliances, electronics, and other items that you use every day. Then make a list of the items and the countries in which they were made. What does your list suggest about the importance of international trade?

Keep It Current

Items marked with this logo are periodically updated on the Internet. Keep up-to-date with what's in the news. To get current information on international trade go to **www.phschool.com**

Section 1

Why Nations Trade

Preview

Objectives

After studying this section you will be able to:

1. **Analyze** the locations of resources and evaluate the significance of these locations.
2. **Explain** the concepts of absolute and comparative advantage and apply the concept of comparative advantage to explain why and how countries trade.
3. **Analyze** the impact of U.S. imports and exports on the United States and its trading partners.
4. **Describe** the effects of trade on employment.

Section Focus

International trade is based on resources that one country needs and another can provide. Each country in the world possesses different resources. By specializing in the production of certain goods and services, nations can use their resources more efficiently. Specialization and trade can benefit all nations.

Key Terms

absolute advantage
comparative advantage
law of comparative advantage
export
import

Have you logged on to a computer today? Ridden in a car or bus? Bought a new sweatshirt or jacket? Chances are these items all have one thing in common. They—or some of their components—were likely made outside the United States.

We know that the United States produces many products, such as jeans, machinery, and some types of computers. We don't, however, produce most of the world's video game systems or VCRs. Why? The answer lies with resources and their distribution. The unequal distribution of resources prevents countries from producing everything their citizens need and want. This is also why we trade.

Resource Distribution

As you read in Chapter 1, the resources that are used to make goods and services are called the factors of production. They include natural resources (land), human resources (labor), and capital resources.

Natural Resources

As you have read, natural resources include those materials found in nature that people use to make goods and provide services. Natural resources include arable land (land that can be farmed), mineral deposits, oil and gas deposits, water, and raw materials like timber.

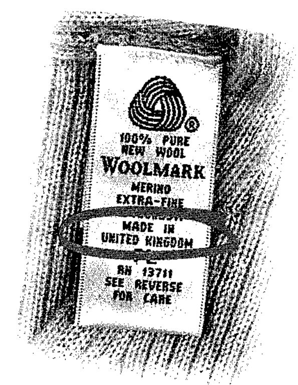
It is easy to see why a region with fertile soil, such as the central United States, is likely to have an economy based on agriculture. Similarly, you can predict that a region with large oil and natural gas reserves—such as Southwest Asia—is likely to have an economy based on income from the sale of these resources.

Natural resources, as well as climate and location, help determine what goods and services an economy produces. They are not, however, the only influences.

Human Capital

You learned in Chapter 1 that human capital is the knowledge and skills gained by a worker through education and experience. Every job requires some human capital. To be a surgeon you must learn about anatomy and acquire surgical skills. To be a taxi driver, you must know the layout of the city streets.

How do you measure the amount of human capital available in a country? One measure is the literacy rate, or percentage



▲ **Many items of clothing are traded internationally.**

Figure 17.1 **Resource Distribution**

	India	Peru	United Kingdom	United States
Total area (sq km)	3,287,590	1,285,220	244,820	9,629,091
Arable land (sq km)	1,664,986	38,400	60,398	1,740,202
Natural resources	Coal, iron ore, manganese, mica, bauxite, titanium ore, chromite, natural gas, diamonds, petroleum, limestone, arable land	Copper, silver, gold, petroleum, timber, fish, iron ore, coal, phosphate, potash, hydropower	Coal, petroleum, natural gas, tin, limestone, iron ore, salt, clay, chalk, gypsum, lead, silica, arable land	Coal, copper, lead, phosphates, molybdenum, uranium, bauxite, gold, iron, mercury, nickel, potash, silver, tungsten, zinc petroleum, natural gas, timber
Population	1.030 billion	27,483,864	59,647,790	278,058,881
Labor force	441 million	9 million	30 million	143 million
Literacy rate	52%	88.7%	99%	97%
Telephones*	27 per 1,000 people	55 per 1,000 people	585 per 1,000 people	697 per 1,000 people
Airports	337	233	489	14,720

*non-cellular
Sources: *CIA World Factbook*, 2001; WorldBank

BUILDING KEY CONCEPTS

These countries each possess different natural, human, and physical resources.
Specialization How do a nation's resources determine what that nation produces?

of people over 15 who can read and write. A country with a high literacy rate is likely to have an educated, skilled work force.

Physical Capital

Physical capital includes objects made by men and women that are used to produce goods and services. Examples include factories, machinery, and computers. Physical capital also includes the public infrastructure, such as roads and bridges, that allows raw materials and finished goods to be manufactured and transported.

Economic Activity Patterns

Five major economic activities are producing, exchanging, consuming, saving, and investing. Patterns of production, distribution, and use develop as the economic activities become concentrated in urban, industrial, or agricultural areas. Geographic and human factors also influence patterns of economic activity. Ski resorts develop in the mountains, farming in the valleys, and mining where there are ore deposits. Saving and investment also follow patterns, becoming concentrated in areas of potential growth.

Unequal Resource Distribution

Each country in the world possesses different types and quantities of land, labor, and capital resources. Some of these resources are determined by nature. Others are not. A nation's culture and history affect its human and physical resources. For example, if a nation has experienced prolonged civil wars, it may not have been able to develop its resources fully.

The table in Figure 17.1 provides data on different types of resources in selected countries. You can see that the availability of resources differs greatly from country to country. For example, the United Kingdom has over twice as many airports as Peru despite its smaller land area, suggesting that the United Kingdom has more physical capital than Peru. Economists can confirm this fact with additional data. As you might expect, because countries differ in resources, they also differ in their capacities to produce different goods and services.

The Need for Trade

Specialization occurs when producers—either individuals or nations—decide to produce only certain goods and services, rather than producing all the goods and services they need. Specialization is determined by a nation's natural resources and by its human and physical capital. For example, the world's wheat is grown in regions with a cool climate. In the United States, we grow wheat, soybeans, and other crops for which we have appropriate soil and climate conditions. We cannot, however, produce diamonds or coffee.

When nations specialize in producing only certain goods, they obtain the goods they don't or can't produce through trade. For example, Costa Rica specializes in producing coffee and exports a large quantity of coffee beans. The country then uses the money it earns from coffee exports to buy products that it does not produce.

What about a nation that enjoys an abundance of resources, including a rich natural environment, a well-educated work force, and the latest technologies? It can, in theory, produce almost all that it needs by itself, without trade. If you were in charge of such a country, would you engage in large-scale trading? Or, would you decide to rely mostly on your country's own resources and be largely self-sufficient? Although self-sufficiency may sound appealing, it actually is better for countries to specialize in some products and trade for others.

Absolute and Comparative Advantage

Trading relationships benefit countries with abundant resources as well as countries with few resources. To see why, you need to look at two related concepts—absolute advantage and comparative advantage.

Absolute Advantage

A person or nation has an **absolute advantage** when it can produce more of a given product using a given amount of resources. A simple example can illustrate this idea.

Suppose that two of your friends, Carl and Kate, want to make some extra money. They decide to print designs on T-shirts and make birdhouses.

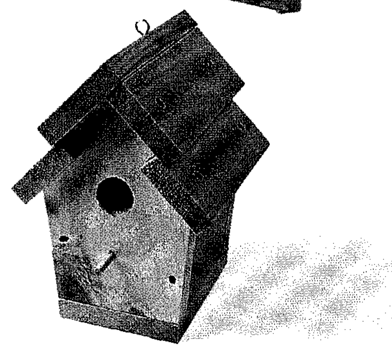
Figure 17.2 **Productivity per Hour**

	T-shirts per hour	Birdhouses per hour
Kate	6	2
Carl	1	1

BUILDING KEY CONCEPTS

Kate has an absolute advantage in producing both T-shirts and birdhouses.

Specialization In which good should each person specialize?



As shown in Figure 17.2, Kate can either print six T-shirts or make two birdhouses per hour. Carl can print one T-shirt or make one birdhouse per hour. In other words, Kate is more productive than Carl in making both T-shirts and birdhouses. In economic terms, Kate has an absolute advantage over Carl in producing both goods.

Suppose that each person is initially self-sufficient. Both Kate and Carl produce their own T-shirts and their own birdhouses. Because Kate enjoys an absolute advantage in both goods, should she remain self-sufficient? Or would Kate be better off if she specialized in either T-shirts or birdhouses? What should Carl produce—T-shirts, birdhouses, or both?

Countries have to face the same sorts of questions as individuals. Should a wealthy country with many resources be self-sufficient, or should it specialize in a few products and trade for the goods it doesn't produce? How does a poorer nation decide what to produce? The answer to these questions lies with the concept of comparative advantage.

Comparative Advantage

Early in the nineteenth century, British political economist David Ricardo argued that the key to determining which country should produce which goods is opportunity cost. Remember that the opportunity cost is what you give up in order to produce a certain product. The nation that has the lower opportunity cost in producing a

absolute advantage *the ability to produce more of a given product using a given amount of resources*

Figure 17.3 **Opportunity Costs for Kate and Carl**

	Opportunity cost of a T-shirt	Opportunity cost of a birdhouse
Kate	$\frac{1}{3}$ birdhouse	3 T-shirts
Carl	1 birdhouse	1 T-shirt

BUILDING KEY CONCEPTS

Kate gives up three T-shirts for each birdhouse she produces. Carl gives up only one T-shirt for each birdhouse he produces.
Opportunity Costs What are Kate and Carl's opportunity costs for T-shirts and birdhouses?

certain good has a comparative advantage in producing that good. A country has a **comparative advantage** in the product that it can produce most efficiently given all the products it could choose to produce. It is the nation with the comparative advantage—not necessarily the absolute advantage—that should specialize in producing that good.

According to the **law of comparative advantage,** a nation is better off when it produces goods and services for which it has a comparative advantage. Each nation can then use the money it earns selling those goods to buy other goods that it cannot produce as efficiently. We can use the example of Kate and Carl to illustrate the benefits from trade that is based on comparative advantage.

comparative advantage *the ability to produce a product most efficiently given all the other products that could be produced*

law of comparative advantage *the idea that a nation is better off when it produces goods and services for which it has a comparative advantage*

The Importance of Opportunity Cost

To determine comparative advantage in the example involving Kate and Carl, you need to look at the opportunity costs of producing T-shirts and birdhouses.

- *Kate's opportunity costs* In an hour, Kate can make either six T-shirts or two birdhouses. She therefore sacrifices three T-shirts for every birdhouse she produces. In other words, the opportunity cost of a birdhouse is the three T-shirts she could have produced instead. Conversely, the opportunity cost of a T-shirt is one third of a birdhouse.
- *Carl's opportunity costs* Carl sacrifices only one T-shirt for every birdhouse. His opportunity cost for a birdhouse is the one T-shirt that he could have produced instead.

As you have read, each person should produce the good for which he or she has a comparative advantage—that is, a lower opportunity cost than another person. Carl's opportunity cost for producing a birdhouse (one T-shirt) is lower than Kate's (three T-shirts), so it is sensible for Carl to produce birdhouses. Kate's opportunity cost for producing a T-shirt (one third of a birdhouse) is lower than Carl's (one birdhouse), so Kate should produce T-shirts.

Why is it sensible for Carl to specialize in birdhouses? Although Kate has an absolute advantage in making birdhouses, Carl has a comparative advantage in birdhouses because he has a lower opportunity cost. Remember that in order to make a birdhouse, Kate has to give up three T-shirts. In order to make a birdhouse, Carl has to give up only one T-shirt.

Benefits for Trading Partners

As you might remember from trading baseball cards or small toys when you were younger, trade usually involves bargaining. Each side tries to make the best deal it can. In a modern economy, we don't exchange goods directly—we use money. The main principle, however, remains the same: both sides agree on a price that benefits both.

When Kate wants a birdhouse, she can either produce it herself or produce some shirts and trade some of them for a birdhouse made by Carl. Suppose Kate and Carl agree to trade two T-shirts for one birdhouse. In this case, Kate will be better off producing T-shirts and trading for a birdhouse. That's because in the time she could have taken to produce her own birdhouse, Kate can produce three T-shirts. Once she pays Carl two T-shirts to get a birdhouse, she will still have one T-shirt left over. In other words, trade makes her better off by one T-shirt. (See Figure 17.4.)

When Carl wants two more T-shirts, he can either make them himself, or make some birdhouses and trade some of them for shirts made by Kate. If Kate and Carl agree to trade one birdhouse for two T-shirts, Carl will be better off producing birdhouses and trading for shirts. In the time he could have taken to produce two T-shirts for himself, he can produce two birdhouses. Once he pays one birdhouse to Kate to get two T-shirts, he will still have one birdhouse left over. Trade makes him better off by one birdhouse.

Kate and Carl both benefit from trade. Each person specializes in the production of the good for which he or she has a comparative advantage, and then trades for the other good. The same is true with nations—both sides benefit from trade.

Comparative Advantage and International Trade

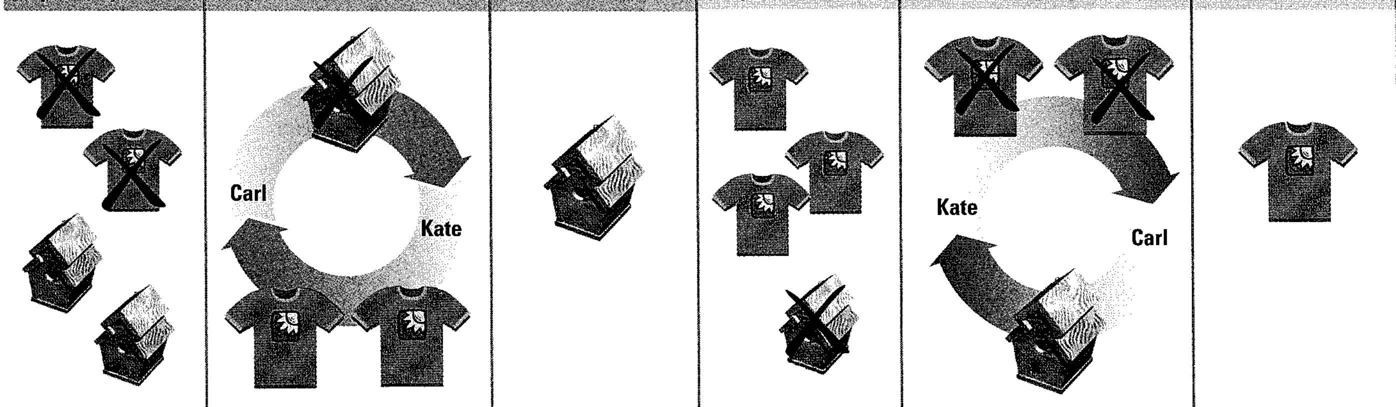
The lessons from this example of trade between two individuals apply to trade between nations. According to Ricardo, the nation that has the lower opportunity cost in producing a certain good has a comparative advantage in producing that good. Remember that comparative advantage is the ability of one nation to produce a good at a lower opportunity cost than that of another nation. It is the nation with the comparative advantage—not necessarily the absolute advantage—that should specialize in producing that good.

Suppose 2 countries, Country A and Country B, produce bananas and sugar. If Country A must sacrifice 2 tons of sugar in order to produce a ton of bananas, the opportunity cost of a ton of bananas is 2 tons of sugar. If the opportunity cost of a ton of bananas in Country B is 3 tons of sugar, Country A has a comparative advantage in producing bananas. That's because Country A's opportunity cost (2 tons of sugar) is lower than Country B's (3 tons of sugar). If Country A specializes in producing bananas, it could use the money earned from selling bananas to buy other goods and services.

The United States and Trade

The United States enjoys a comparative advantage in producing many goods and services. What, then, is its position as an

Figure 17.4 **Benefits From Specialization and Trade for Carl and Kate**

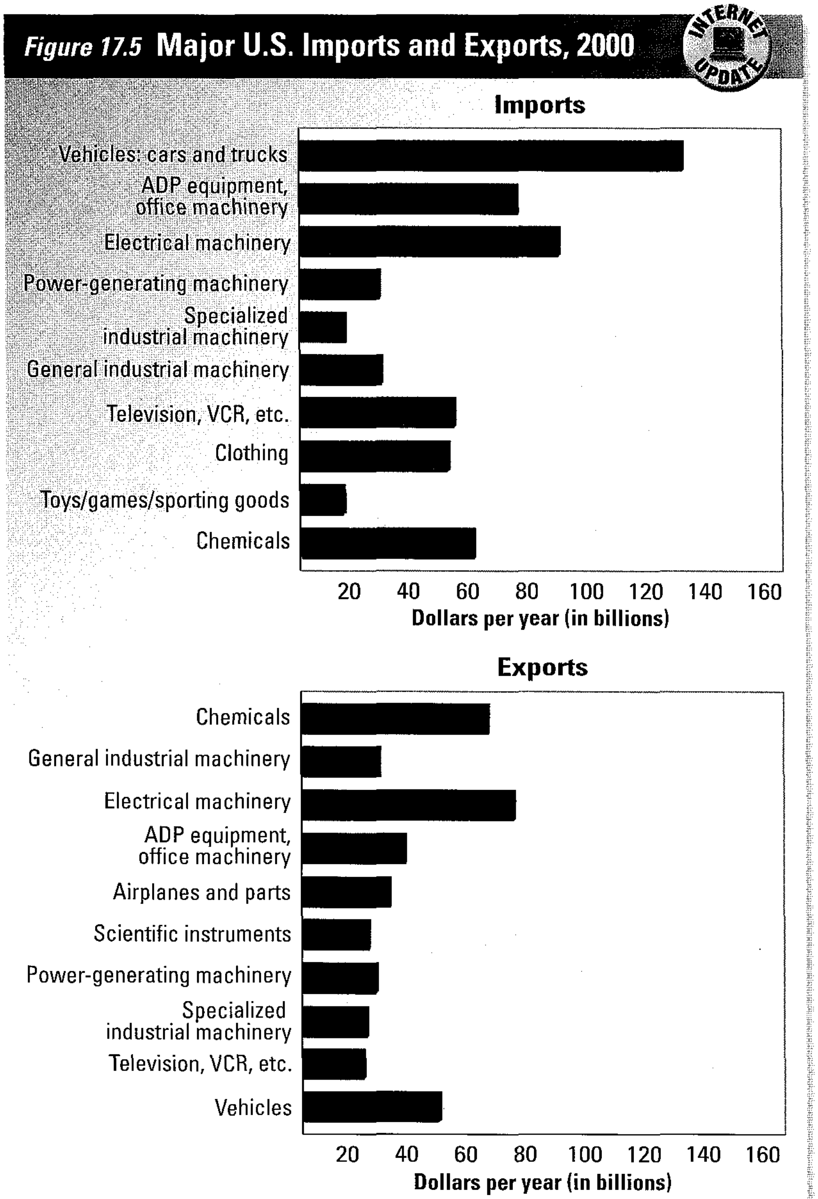


Carl			Kate		
Specialization	**Trade**	**Net Effect**	**Specialization**	**Trade**	**Net Effect**
Carl specializes, switching 2 hours from T-shirt production to birdhouse production.	Carl trades 1 birdhouse for 2 T-shirts.	Net effect is same number of T-shirts and 1 more birdhouse.	Kate specializes, switching one half-hour from birdhouse production to T-shirt production.	Kate trades 2 T-shirts for 1 birdhouse.	Net effect is the same number of birdhouses and 1 more T-shirt.

BUILDING KEY CONCEPTS

Kate and Carl both benefit from specialization and trade.
Trade What is the net effect of trade for Kate and Carl? Why are they both better off trading?

Figure 17.5 Major U.S. Imports and Exports, 2000



Source: U.S. Census Bureau

BUILDING KEY CONCEPTS

The United States is both the world's largest importer and its largest exporter. **Trade Judging from these graphs, does the United States export more than it imports or import more than it exports? Explain your answer.**

export *a good that is sent to another country for sale*

import *a good that is brought in from another country for sale*

importer and exporter on the world market? In the language of international trade, an **export** is a good sent to another country for sale. An **import** is a good brought in from another country for sale.

As you can see from the map on page 545 of the Databank, the main U.S. trading partners are Canada, Mexico, Japan, and China. Trade with China has grown tremendously in recent years.

The United States as an Exporter

The United States is the world's leading exporter, followed by Germany and Japan. One reason for the success of the United States as an exporter is the wide range of its exports, from telecommunications equipment to soybeans. Another reason is that the United States has a commanding lead in manufacturing such products as computer software, medical equipment, and other advanced technology.

The United States is also in a good position to benefit from increased trade in services. Goods make up the bulk of international trade, but services are also traded on the world market. These include education, information services, computer and data processing, financial services, and medical care. Exports of services have grown rapidly over the last decade. The United States is the world's top exporter of services, so it stands to gain significantly from this trend.

The United States as an Importer

Besides being the world's largest exporter, the United States is also the world's top importer, and by a significant amount. The United States imports nearly $900 billion in goods and services, or 16.1 percent of the world's total. That amount exceeds total imports for Germany and Japan combined, the world's largest importers after the United States.

The Effects of Trade on Employment

Trade allows nations to specialize in producing a limited number of goods while consuming a greater variety of goods. However, specialization can also dramatically change a nation's employment patterns.

Specialization and Employment

To help you better understand the effects of international trade on employment, think back to the example of Kate and Carl. As you have read, Kate can make six T-shirts or two birdhouses by herself in an hour.

Suppose she hires Ari to help her build birdhouses. She later realizes that she should specialize only in T-shirts since that is where her comparative advantage lies. She no longer needs Ari to help her. Unfortunately, Ari's only skill is making birdhouses.

Ari now faces three possibilities: unemployment, retraining, or relocating to a part of the country where his skills are in demand. Ari may be able to find a training program and learn to make T-shirts or another product. He might even find himself better off than he was making birdhouses.

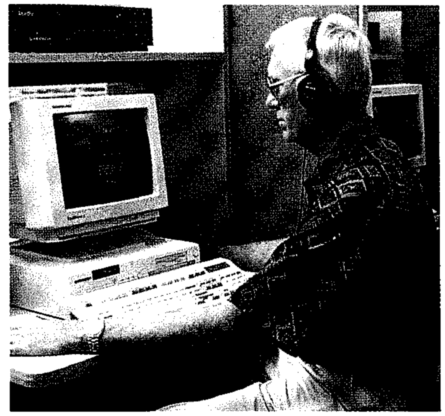
If Ari relocates, he may or may not be better off. How well he does depends on housing prices, the quality of his new neighborhood, the impact on his family, and a variety of other factors.

Government assistance is often available to help retrain laid-off workers for new jobs or to help them relocate to fit shifts in employment patterns. However, especially in the case of older workers or workers with families, retraining or relocation is not an easy (or sometimes not a possible) option. Some workers may become unemployed or be forced to take lower-paying jobs.

Specialization and Employment in the United States

In the United States, significant changes in employment patterns have occurred in the past two decades as a result of specialization and international trade. For example, during the 1970s, specialization, new technologies like robotics, and high productivity gave Japan a comparative advantage in producing automobiles. As a result, Japanese cars became less expensive than many comparable American-made cars. As more consumers bought Japanese cars, many American workers lost jobs in automobile-producing centers such as Detroit.

Many other shifts in employment have also taken place in the United States in recent decades as a result of world trade and other factors. The overall result has been a shift in population from the manufacturing states of the Midwest to the Sunbelt states of the South and Southwest.



▲ **Workers who lose their jobs can often learn new skills.**

Section 1 Assessment

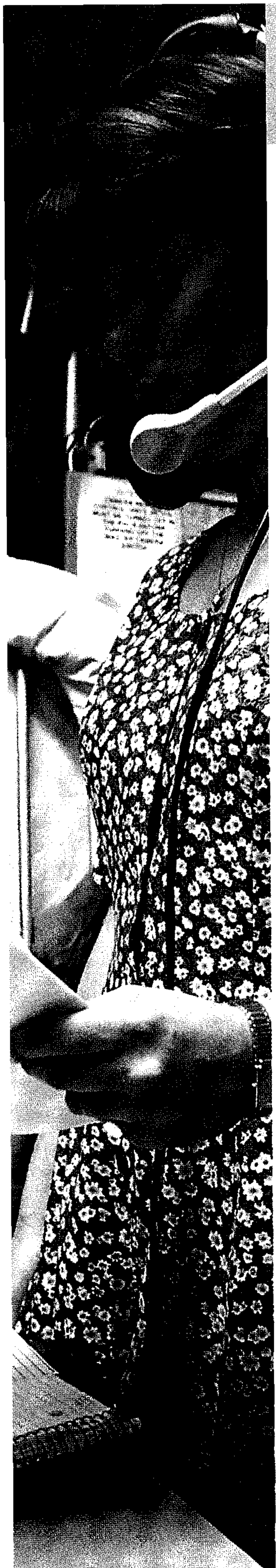
Key Terms and Main Ideas

1. How do nations obtain goods and services for which they lack adequate resources?
2. Susan grows coffee in a North Dakota greenhouse under sunlamps. Growing coffee this way takes a lot of effort and money. She also grows sunflowers, which are easy to grow in the dry climate in which she lives. In which crop does she probably have a **comparative advantage?**
3. Why is a nation with abundant resources better off trading than being self-sufficient?
4. Specialization and trade can result in shifting employment patterns. **(a)** What possibilities are available to people who lose their jobs due to changes in employment patterns? **(b)** What are the advantages and disadvantages of each possibility?

Applying Economic Concepts

5. ***Critical Thinking*** Suppose a nation has a great deal of human capital but few natural resources. In what kinds of products might it specialize?
6. ***Try This*** Make a Productivity Table for yourself and a friend using the table on page 443 as a model. Choose your own goods and estimate production times. Then decide where you and your friend have a comparative advantage.
7. ***Using the Databank*** Turn to the map showing United States trading partners on page 545. Considering geographical location and resources, give reasons to explain why the countries shown are major U.S. trading partners.

Take It to the NET Compare the resources available in the United States to those of two other countries. Use the links provided in the Social Studies area at the following Web site for help in completing this activity. **www.phschool.com**



Creating a Multimedia Presentation

Multimedia presentations communicate information in a variety of forms, both audio and visual. The preproduction, or planning, stage of a presentation requires a considerable amount of work if the production stage and final product are to go well. During the preproduction stage, the producer drafts an outline and script, decides what media to use and where, arranges interviews or photography sessions, selects images, and chooses music.

Suppose that you have been assigned to produce a multimedia presentation on how the global economy affects the lives of people in your region. Use the following steps and a copy of the preproduction topic analysis sheet below to prepare your presentation.

1. **Plan your content.** Select a topic for your presentation. (a) What possible topics might you focus on? (b) How could you break up your presentation into different segments? (c) How do these segments connect with one another?

PREPRODUCTION TOPIC ANALYSIS SHEET

Assignment: The impact of the global economy on the local community

Possible topics:
1. ____________________
2. ____________________
3. ____________________

My choice: ____________________
Sources for topic information: ____________________
Intended audience: ____________________
Information to be presented: ____________________
____

Segment description and sequence:
1. ____________________
2. ____________________
3. ____________________

Mood: ____________________
Type of narration: ____________________
Graphics/illustrations, interviews, music
Segment #1 ____________________
Segment #2 ____________________
Segment #3 ____________________

2. **Plan a script.** You must decide whether to use a running commentary by a single narrator, comments by several interviewees, or a combination. (a) What are the advantages and disadvantages of using a single narrator? (b) Which script style do you feel would be most appropriate for a presentation on the local impact of the global economy, and why?

3. **Make a list of images, interviews, and music.** The images you choose will help viewers visualize your message. (a) What images would fit the content and mood of each segment? (b) Which people could you interview? (c) What pieces or types of music would best enhance the mood of your presentation?

Additional Practice

Suppose that you are planning a multimedia presentation on some aspect of life at your school. Prepare a preproduction chart like the one shown here for your presentation.

Section 2 Preview

Trade Barriers and Agreements

Objectives

After studying this section you will be able to:

1. **Define** various types of trade barriers.
2. **Compare** the effects of free trade and trade barriers on economic activities.
3. **Understand** arguments in favor of protectionism.
4. **Evaluate** the benefits and costs of participation in international trade agreements.
5. **Explain** the role of multinationals in the global market.

Section Focus

The free exchange of goods can be restricted by barriers to trade, such as tariffs, quotas, and voluntary export restraints. International trade agreements and organizations work to reduce trade barriers.

Key Terms

trade barrier
import quota
voluntary export restraint (VER)
customs duty
tariff
trade war
protectionism
infant industry
international free trade agreement
World Trade Organization (WTO)
European Union (EU)
euro
free-trade zone
NAFTA

So far, our discussion of trade has assumed that international trade is not subject to government regulations. Many people, however, argue that governments should regulate trade in order to protect certain industries and jobs from foreign competition.

Trade Barriers

Most countries have some form of trade barriers that hinder free trade. A **trade barrier,** or trade restriction, is a means of preventing a foreign product or service from freely entering a nation's territory. Trade barriers take three common forms: import quotas, voluntary export restraints, and tariffs.

Import Quotas

An **import quota** is a limit on the amount of a good that can be imported. For example, the United States limits the annual amount of raw (unprocessed) cotton coming into the country from other nations. Quotas limit India and Pakistan to 908,764 kilograms of cotton, China to 621,780 kilograms, and Egypt and Sudan to 355,532 kilograms. The United States will accept no more than these amounts of cotton from these countries. Other nations that produce cotton must also observe quotas of various amounts.

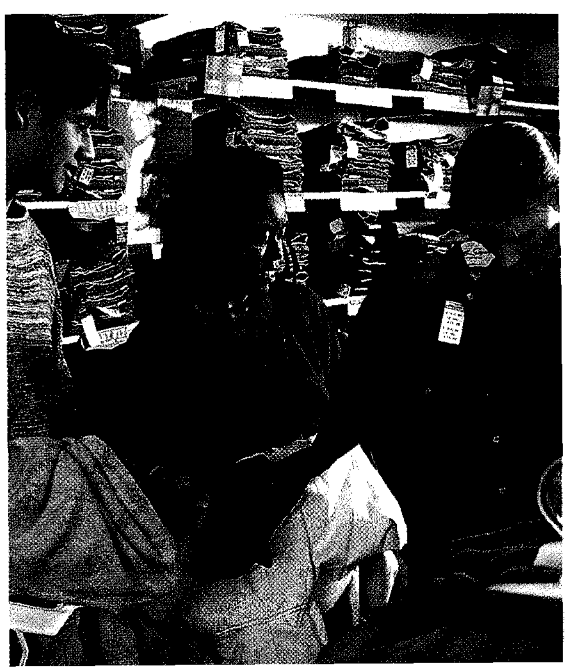
Voluntary Export Restraints

An import quota is a law. A **voluntary export restraint (VER)** is a self-imposed limitation on the number of products that are shipped to a particular country. Under a voluntary export restraint, a country voluntarily decreases its exports in an attempt to

trade barrier *a means of preventing a foreign product or service from freely entering a nation's territory*

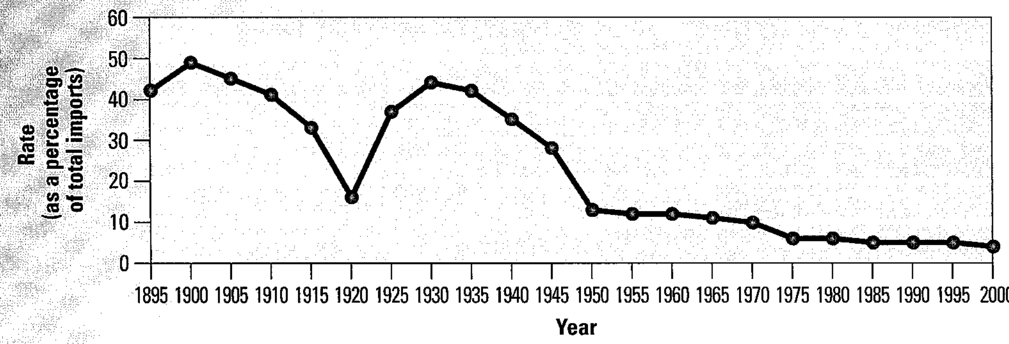
import quota *a limit on the amount of a good that can be imported*

voluntary export restraint (VER) *a self-imposed limitation on the number of products shipped to a particular country*

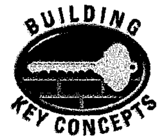


◀ **The cotton used to make much of the clothing Americans wear is subject to import quotas.**

Figure 17.6 **Average Tariff Rates, 1895–2000**



Sources: *Historical Statistics of the United States: Colonial Times to 1970; Statistical Abstract of the United States; Trade Policy Review of the United States*



Tariffs work to safeguard American products from foreign competition.
Trade What has been the overall trend in the use of tariffs as trade barriers?

customs duty *a tax on certain items purchased abroad*

tariff *a tax on imported goods*

reduce the chances that the importing country will set up trade barriers.

Tariffs

If you have traveled to a foreign country, you might have had to pay a tax called a **customs duty** on certain items you purchased abroad. You might also have seen "duty free" stores at international borders and airports selling luxury items like perfume and chocolate. Countries have agreed that items purchased in these shops will be free of customs duty.

Customs duty is one kind of **tariff,** or tax on imported goods. As you read in Chapter 14, both individuals and businesses have to pay tariffs. For example, the United States collects tariffs on steel, foreign-made cars, and many other products that are brought into the country. As you can see from Figure 17.6, however, tariffs have become far less important sources of government revenue than they were in the late 1800s and early 1900s.

Other Barriers to Trade

Governments sometimes use less formal methods to limit imports. For example, sometimes a government will require foreign companies to obtain a license to sell goods in that country. High licensing fees or slow licensing processes act as informal trade barriers.

Health and safety regulations and requirements are often used by governments as subtle trade barriers. For example, suppose a nation treats the fruit it grows with an insecticide that is widely accepted in its own country. Another nation that wants to discourage imports of this product might ban any fruit treated with that insecticide. The importing nation hopes that it will be too troublesome for potential sellers to meet this condition. In this way, imports will be sharply reduced or eliminated.

Effects of Trade Barriers

Trade barriers have a number of effects, some negative and some positive. Simply put, trade barriers limit supply. You will recall that the United States limits cotton imports through import quotas. These quotas ensure that the United States manufacturers of jeans and other cotton clothing will probably not be able to meet their needs for cotton with imported cotton alone. Instead, clothing manufacturers will have to buy some cotton grown in the

United States to make up their shortfall. In this way, American cotton growers benefit from quotas on cotton.

Increased Prices for Foreign Goods

Although producers of many products may benefit from trade barriers, consumers can lose out. That's because trade barriers result in higher prices. For example, suppose the market price of an imported car is $20,000. The United States wants to use a tariff to restrict the number of imported cars coming into the country. The United States government thus places a 10 percent tariff on all foreign-auto imports. With this tariff, the price of the $20,000 imported car now rises to $22,000.

As a result of this price increase, American car makers can compete more easily in the market. American manufacturers and workers therefore benefit through increased sales. On the other hand, consumers must now pay higher prices for foreign-made cars. In addition, American manufacturers lose the economic incentive to become more efficient and produce their cars less expensively.

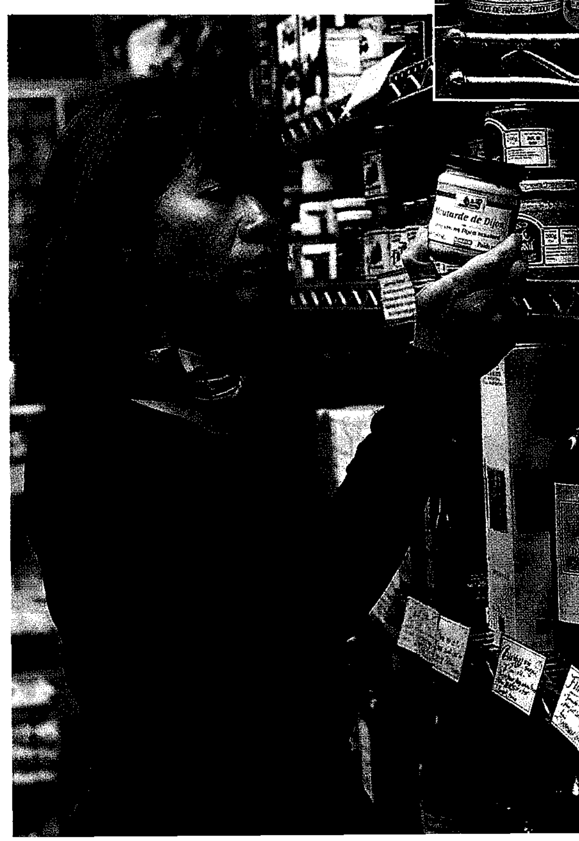
Trade Wars

Escalating economic conflict is another possible outcome of trade barriers. When one country restricts imports, its trading partner may impose its own restrictions against the first country. Such a cycle of increasing trade restrictions is known as a **trade war.**

Trade wars often lead to a substantial decrease in trade for both countries. As you read in Section 1, trade benefits both trading partners. Conversely, a decrease in trade hurts both trading partners. The following list describes a few of the many tariffs that have led to trade wars and that have negatively affected the United States economy.

- *Smoot-Hawley Tariff of 1930* When the United States increased its average tariff on all products to 50 percent, its trading partners retaliated with higher tariffs. The trade war that resulted decreased international trade and deepened the worldwide depression of the 1930s.
- *Chicken Tariff of 1963* The European Economic Community (or EEC, the trade organization that preceded the European Union) imposed a large tariff on frozen chickens from the United States. This tariff cut American chicken exports in half. The United States retaliated by increasing its tariffs on expensive brandies from France, potato starch from Holland, and light trucks from Germany.
- *Pasta Tariff of 1985* The United States imposed tariffs on pasta from the European Economic Community. The EEC retaliated by increasing tariffs on lemons and walnuts from the United States.
- *Beef War of 1999* The United States imposed tariffs on European clothing and specific foods, including certain cheeses, meats, and mustards, in response to a European ban on hormone-treated beef from the United States. This "Beef War" continued an ongoing trade dispute between the United States and Europe over Europe's refusal to import Caribbean bananas. (See the Global Connections on the next page.)

trade war *a cycle of increasing trade restrictions*



◀ Trade wars in the late 1990s resulted in increased prices for some imported foods such as this mustard from France.

protectionism *the use of trade barriers to protect a nation's industries from foreign competition*

infant industry *a new industry*

Arguments for Protectionism

Why does a country impose trade barriers? There are three main arguments that support **protectionism**, the use of trade barriers to protect industries from foreign competition. These include protecting workers' jobs, protecting infant industries, and safeguarding national security.

Protecting Jobs

One argument for protectionism is that it shelters workers in industries that would be hurt by foreign competition. For example, suppose that nations in East Asia have a comparative advantage in producing textiles. If the United States reduced existing tariffs on textile imports, domestic manufacturers may not be able to compete with East Asian imports. They would have to close their factories and lay off workers.

In an ideal world, the laid-off workers would take new jobs in other industries. In practice, however, as you read in Section 1, retraining and relocation can be difficult. Many workers do not have the skills to work in other industries, and obtaining such skills takes time and money.

In addition, industry and political leaders often do not want to shut down existing industries and lose jobs in their home regions. For example, the textile industry is heavily concentrated in the southeastern United States. Politicians and industry leaders from the Southeast might try to keep textile tariffs in place to prevent loss of jobs and business.

Protecting Infant Industries

Suppose you are learning a new skill, such as playing ping-pong. At first you find it difficult to hit the ball, but as you play more your skills improve. This process is called "learning by doing."

Similarly, new industries need time and practice to become efficient producers. Tariffs and other protectionist policies are often defended on the grounds that they protect new industries in the early stages of their development. A new industry is often called an **infant industry.**

A tariff shields a young industry from the competition of its more mature rivals. After the infant industry grows up—that is, acquires the ability to produce goods efficiently and at a competitive price—the tariff can be eliminated because the industry is able to compete.

Two main difficulties arise with protecting infant industries, however. First, a protected infant industry lacks the incentive to become more efficient and competitive. Second, once an industry is given tariff protection, it is difficult to take the protection away. In other words, the infant may never "grow up."

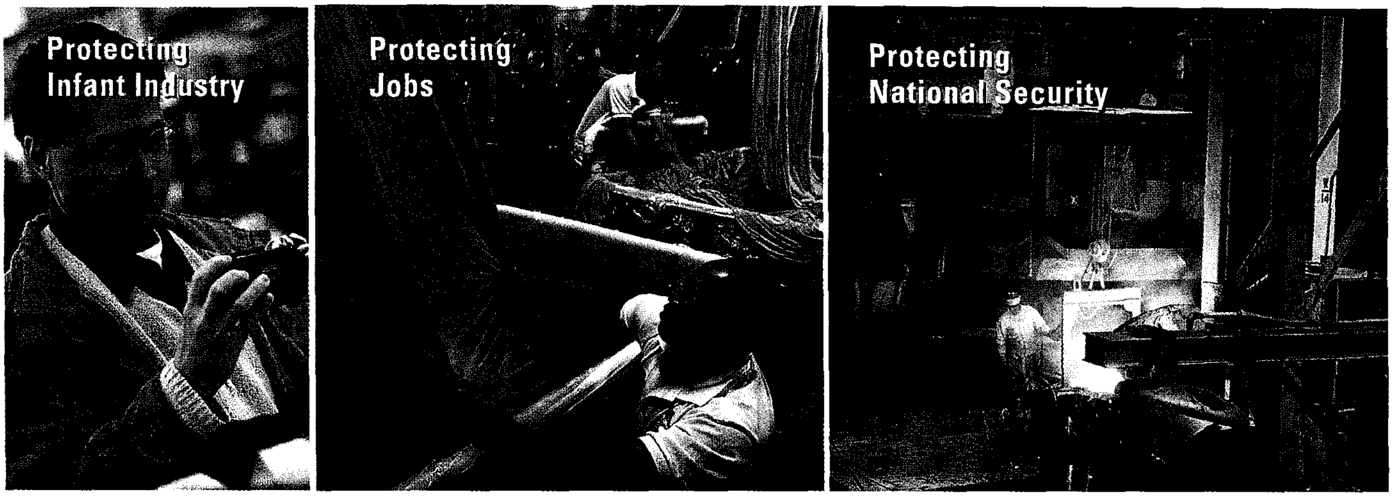
Safeguarding National Security

Certain industries may require protection from foreign competition because their products are essential to defending the United States. In the event of a war, the United States would need steel and other products from heavy industries. It would also need industries that provide energy and advanced technologies. For this reason, the government wants to ensure that these industries remain active in the United States.

Even supporters of free trade agree that some industries need to be protected—or at least receive government financial help—so

Global Connections

The Banana Wars Throughout much of the 1990s, the European Union and the United States were at war—a trade war, that is—and the conflict was over bananas. At the heart of the conflict was a European Union policy that favored banana imports from former European colonies in Africa and the Pacific. Much of the world's banana crop, however, is grown in Latin America and the Caribbean. To aid growers in its own hemisphere, the United States placed tariffs on a variety of items—including gourmet cheese, handbags, and cashmere clothing—imported from EU nations. These tariffs charged European exporters a fee equal to 100 percent of the good's value when it entered the United States. By the late 1990s, the trade war over bananas showed no signs of slowing, and in fact became part of a larger trade war over beef exports in 1999. **Who are the winners and losers in a trade war?**



Protectionists argue in favor of trade barriers based on protecting infant industries, jobs, and national security.
Competition How does protectionism reduce foreign competition?

that the United States will not have to depend on other nations during a crisis. Free trade supporters argue, however, that certain industries claim trade protection when in fact their products are not essential to national security at all.

International Cooperation and Agreements

Recent trends favor lowering trade barriers and increasing free trade. Many people argue that free trade is the best way to pursue comparative advantage, raise general living standards, and further international peace.

To increase free trade, a number of international free trade agreements have developed. An **international free trade agreement** results from cooperation between at least two countries to reduce trade barriers and tariffs and to trade with each other.

The Reciprocal Trade Agreement Act

The history of today's free trade movement goes back to the 1930s when the United States began to promote international trade, which had been dwindling, partly as a result of the Smoot-Hawley tariff. The Reciprocal Trade Agreements Act of 1934 gave the president the power to reduce tariffs by as much as 50 percent.

The Act also allowed Congress to grant most-favored-nation (MFN) status to U.S. trading partners. Today, MFN status is called normal trade relations status, or NTR. A country with NTR status pays the same tariffs as those paid by all NTR partners. Therefore, if the United States lowers the tariff on imported rice from 25 percent to 15 percent for one NTR nation, all other NTR nations automatically receive the reduction. (Non-NTR nations may still be taxed at the higher rate, however.)

The World Trade Organization

In 1948, GATT, the General Agreement on Tariffs and Trade, was established to reduce tariffs and expand world trade. The **World Trade Organization (WTO)** was founded in 1995 to ensure compliance with GATT, to negotiate new trade agreements, and to resolve trade disputes. Various conferences, or rounds, of tariff negotiations have advanced the goals of GATT and the WTO. For example, the Uruguay round of negotiations, completed in 1994, decreased average global tariffs by about a third. From 1930 to 1995, the average tariff in the United States dropped from about 59 percent to about 5 percent.

international free trade agreement
agreement that results from cooperation between at least two countries to reduce trade barriers and tariffs and to trade with each other

World Trade Organization (WTO)
a worldwide organization whose goal is freer global trade and lower tariffs

European Union (EU) *a regional trade organization made up of European nations*

euro *a single currency that replaces individual currencies among members of the European Union*

free-trade zone *a region where a group of countries agrees to reduce or eliminate trade barriers*

NAFTA *agreement that will eliminate all tariffs and other trade barriers between Canada, Mexico, and the United States*

The World Trade Organization also acts as a referee, enforcing the rules agreed upon by the member countries. For example, when the banana and beef wars erupted between the United States and the European Union, the case was brought before the WTO. The WTO found in favor of the United States and allowed the United States tariffs to remain in effect.

The European Union

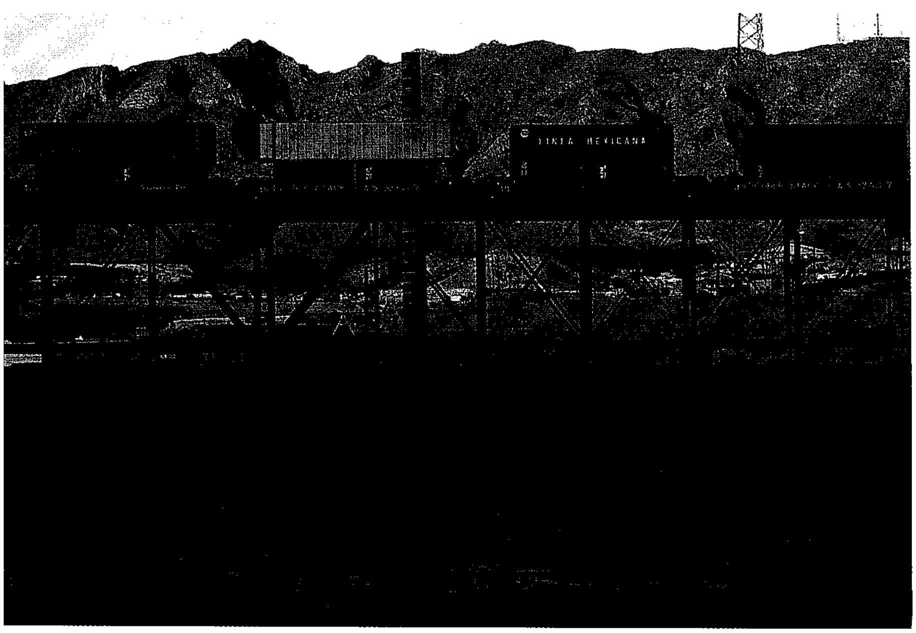
In recent years, many countries have formed customs unions—agreements that abolish tariffs and trade restrictions among union members, and that adopt uniform tariffs for nonmember countries. The most successful example currently is the **European Union (EU).**

The European Union as we know it today developed slowly over time. In 1957, six western European nations set up the Common Market to coordinate economic and trade policies. In the years that followed, additional European nations joined the Common Market. In 1986, member nations agreed to eliminate tariffs on one another's exports. They thereby created a single market, called the European Economic Community (EEC).

FAST FACT

Europe and the United States account for 55 percent of world trade, 60 percent of trade in services, and 80 percent of world wealth.

▼ **NAFTA has resulted in increased trade across the Rio Grande.**



In 1993, the European Economic Community nations formed the European Union (EU). The EU has a parliament and a council in which all member nations are represented. It also has its own flag, its own anthem, and celebrates Europe Day on May 9. In early 2002, eleven member nations replaced their individual currencies with a single currency called the **euro.**

NAFTA

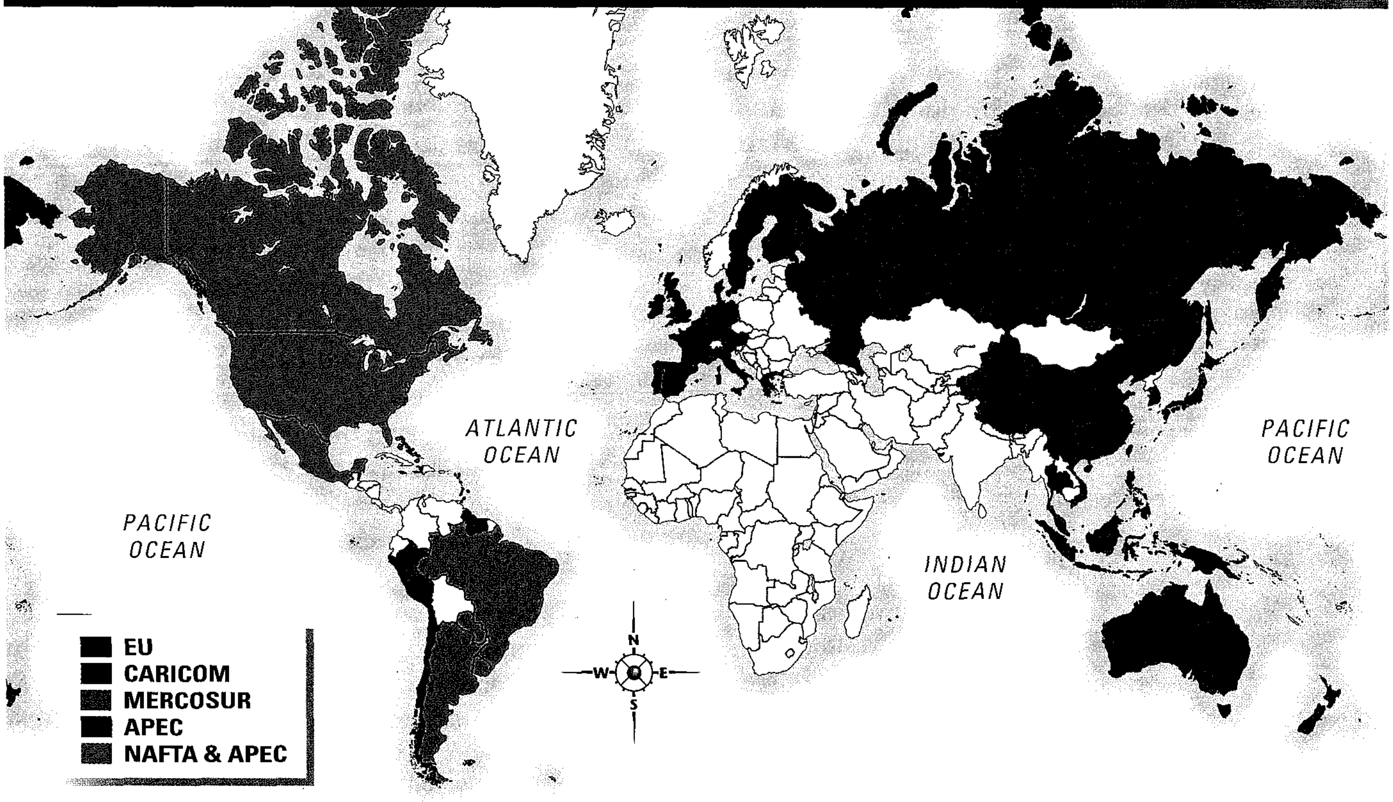
In other parts of the world, countries have developed **free-trade zones,** or regions where a group of countries agrees to reduce or eliminate trade barriers. **NAFTA** (the North American Free Trade Agreement) will eliminate all tariffs and other trade barriers between Canada, Mexico, and the United States by 2009. The resulting free-trade zone is the largest in the world.

NAFTA provisions include the following:

1. Tariffs on all farm products and on some 10,000 other goods are to be eliminated over 15 years.
2. Automobile tariffs are to be phased out over 10 years.
3. Special judges have authority to resolve trade disputes.
4. The agreement cannot be used to override national and state environmental, health, or safety laws.
5. Trucks are to have free access across borders and throughout the three member countries.

Before the agreement was signed, the NAFTA measure aroused a great deal of controversy in the United States. NAFTA opponents worried that American factories would relocate to Mexico, where wages were lower and government regulations, such as environmental controls, were less strict. The result would be a loss of jobs in the United States. Supporters of NAFTA claimed that the measure would instead create more jobs in the United States as a result of increased exports to Mexico and Canada.

Figure 17.7 **Major Trade Organization Members**



BUILDING KEY CONCEPTS

Many countries are members of major regional trade organizations.
Trade What is the purpose of these organizations?

The United States Senate ratified NAFTA on January 1, 1994, after a bruising Congressional battle. In 1997, the government's first study of NAFTA revealed that while some jobs had been created, an almost equal number had been eliminated. On the other hand, trade between the United States, Canada, and Mexico had increased significantly. From 1993 to 1997, United States exports to Mexico increased from $41 million to $71 million. Imports from Mexico to the United States more than doubled, from $40 million to $86 million. To the north, United States exports to Canada during that time increased by one third, from $100 million to $152 million. Imports also increased by about one third from $111 million to $168 million. Today, the United States government is working to expand the NAFTA agreement to include other countries in the Western Hemisphere.

Other Regional Trade Agreements

Throughout the world, many countries have entered into other regional trade agreements. In fact, about 100 regional trading organizations operate in the world today. The largest of these organizations include the following.

- *APEC* The Asia-Pacific Economic Cooperation includes countries that lie along the Pacific Rim, including the United States, Mexico, and Canada. These nations have signed a nonbinding agreement to reduce trade barriers among their nations.
- *MERCOSUR* The Southern Common Market is similar to the European Union

THE WALL STREET JOURNAL.
CLASSROOM EDITION

In the News *As this excerpt from an article in* The Wall Street Journal Classroom Edition *shows, multinational trade alliances are becoming increasingly commonplace.*

"More and more, national boundaries, cultural variations and accidents of geography such as the Atlantic Ocean aren't stopping business leaders who see a chance to expand their reach as trade barriers fall, communication becomes cheap and consumer tastes for everything from cola to cellular phones converge."

in its goals. Its members are Brazil, Argentina, Paraguay, and Uruguay.

- *CARICOM* The Caribbean Community and Common Market includes countries from South America and the Caribbean.

The Role of Multinationals

Multinational corporations (MNCs) also contribute to international trade. As you read in Chapter 8, a multinational is a large corporation that sells goods and services throughout the world. For example, an automobile company might design its cars in the United States. The same company might import parts from Asia and assemble its cars in Canada and Mexico. As a result, although you might purchase the automobile from a company based in the United States, it is not a purely domestic product.

Many goods besides cars are produced globally. Some brands of athletic shoes are designed in the United States but are produced in East Asia. Some personal computers are designed in the United States and assembled abroad with parts and components from the United States.

The decision to build production facilities in a foreign country benefits both the multinational corporation and the host nation. By locating abroad, the corporation avoids some shipping fees and tariffs. It may also benefit from cheaper labor in much of Asia and Latin America. The host nation benefits by gaining jobs and tax revenue on the corporation's income, profits, and property.

On the other hand, host nations worry about the effect of multinationals on their countries. Multinationals in a small country with a less developed economy could gain excessive political power. In addition, host nations are concerned that multinationals could replace the host country's domestic industries and exploit their workers. In order to address these concerns, nations have instituted rules that require multinationals to export a certain percentage of their products. Host nations hope that such requirements will help protect their domestic industries.

Section 2 Assessment

Key Terms and Main Ideas

1. Describe the similarities and differences among the following barriers to free trade: **import quotas, voluntary export restraints (VERs),** and **tariffs.**
2. Explain the effects of **trade barriers** on manufacturers, workers, and consumers.
3. What are the advantages and disadvantages of protecting an **infant industry?**
4. Describe the three arguments in favor of **protectionism.**
5. Choose one of the trade organizations or agreements described in the section and explain its purpose.

Applying Economic Concepts

6. ***You Decide*** Suppose that you were in charge of trade policy in the United States. Would you recommend that the United States increase or decrease trade barriers on video game systems? Explain your answer.
7. ***Problem Solving*** Suppose that a company called NewMovies, Inc., located in Country X, has decided to produce and distribute movies. NewMovies, Inc., would like the government of Country X to impose a tariff on foreign-made movies. Why?
8. ***Critical Thinking*** What are the advantages of international trade agreements? What might be some disadvantages?

Take It to the NET Several international trade agreements have been mentioned in this section, but many more exist. Describe two additional agreements. Use the links provided in the Social Studies area at the following Web site for help in completing this activity. **www.phschool.com**

ECONOMIC

Profile

Economist

Entrepreneur

Carla Anderson Hills (b. 1934)

Although a strong believer in free trade, U.S. Trade Representative Carla Anderson Hills was not afraid to use tariffs and quotas as tools to pry open foreign markets. Her approach to eliminating overseas barriers to American trade earned her the nickname "the Velvet Crowbar."

An Advocate for Free Trade

"The case for free trade does not easily fit on a bumper sticker," Carla Anderson Hills observes. Free trade, she says, results in a stronger economy with more innovation and technological development.

As U.S. Trade Representative from 1989 to 1993, Hills was charged with carrying out U.S. trade policy. She earned a reputation as a tough advocate for U.S. rights in world trade. "With less than 5 percent of the world's population, we produce more than 20 percent of the world's output," Hills asserts. "We need access to foreign markets to sell the goods we produce."

From Law to International Trade

After graduating from Stanford University, Hills earned a law degree from Yale in 1958. She joined her husband and three other attorneys to found their own law firm in 1962. In 1974, she left California to work in the Justice Department.

In 1975, President Gerald Ford named Hills Secretary of Housing and Urban Development. After Jimmy Carter became president, Hills returned to the private practice of law, where she remained until President George Bush appointed her U.S. Trade Representative in 1989. Today her firm, Hills & Company, provides advice on trade to U.S. businesses.

The Velvet Crowbar

Hills described her negotiating approach as "a handshake wherever possible [and] a crowbar where necessary." To open the Japanese market to U.S. electronic and wood products, Hills threatened U.S. retaliation against Japanese goods. She said, "I'll never say I'm satisfied until their market is as open to our entrepreneurs as ours is to theirs."

In 1992, Hills threatened to pull the United States out of global trade talks unless the European Union agreed to cut government subsidies to its farmers. When France resisted, she slapped a 200 percent tariff on French wine and farm products.

In general, however, Hills opposes this kind of trade protection. She labels it "the worst possible policy option to deal with jobs thought to be lost to foreign competition, because in the long run it will cost more jobs by making our companies less competitive."

CHECK FOR UNDERSTANDING

1. Source Reading Explain the reasoning in the following Hills statement: "It is in our interest to persuade our trading partners to lower their barriers. That is particularly true with respect to nations of Asia and Latin America, the two fastest-growing regions in the world."

2. Critical Thinking As U.S. trade representative, why would Hills have opposed European governments who provided subsidies to European farmers?

3. Decision Making Some opponents of free trade contend that it costs American workers jobs. If you were the U.S. Trade Representative, would you try to protect American companies from foreign competition?

Section 3

Preview

Measuring Trade

Objectives

After studying this section you will be able to:

1. **Analyze** how changes in exchange rates of world currencies affect international trade.
2. **Describe** the effect of various exchange rate systems.
3. **Analyze** the effects of changes in exchange rates on the balance of trade.

Section Focus

International trade is complicated by the fact that different nations have different currencies. Countries pay for imports in their own currencies and receive foreign currency for exports. If a nation imports more than it exports, or vice versa, a trade imbalance is created.

Key Terms

exchange rate
appreciation
depreciation
foreign exchange market
fixed exchange-rate system
flexible exchange-rate system
trade surplus
trade deficit
balance of trade

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exchange rate *the value of a foreign nation's currency in terms of the home nation's currency*

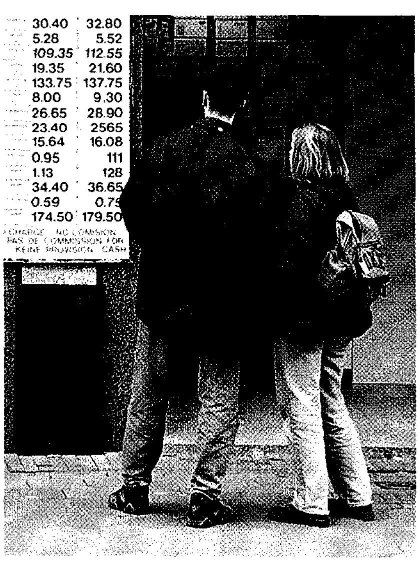
Have you ever traveled to a foreign country? If so, you may have been unable to purchase goods in that country using U.S. dollars. Similarly, tourists buying goods in the United States need to exchange their home country's money for U.S. dollars. In order for foreign visitors to buy something in another country, they usually must obtain that country's currency before making any purchases.

Exchange Rates

International trade takes place whenever a good or service is produced in one country and sold in another. Trade between countries is more complex than buying and selling within the same country because of the world's many currencies and their changing values.

Foreign Exchange

If you want to buy a newspaper in Beijing, you will need to change your American dollars for Chinese renminbi. If a Mexican visitor to New York wants to buy lunch, she must change her pesos to dollars.



▼ Tourists can exchange their currency for that of the country they are visiting at currency exchange outlets or centers.

Changing money from one currency to another is not a simple matter of exchanging, say, one peso for one American dollar. A dollar might be worth 9 pesos—or 115 Japanese yen, or 8 Chinese renminbi.

The value of a foreign nation's currency in relation to your own currency is called the foreign exchange rate, or simply the ***exchange rate.*** The exchange rate enables you to convert prices in one currency to prices in another currency.

Reading an Exchange Rate Table

Exchange rates are listed on the Internet and in many major newspapers. Figure 17.8 shows a table of sample exchange rates. If you read down the first column, for example, you will see that one U.S. dollar can be exchanged for about one-and-a-half (1.478) Canadian dollars, for a bit less than one euro (0.9516), and so forth.

It is important to realize that these rates are what one U.S. dollar is worth on one particular day. Exchange rates go up and down daily.

Determing the Rate of Exchange

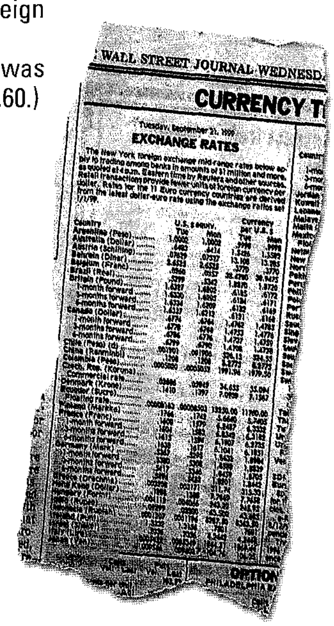
The following example will help you calculate exchange rates. Suppose your family is planning a trip to Mexico this summer and wants to determine the cost of staying in a

Figure 17.8 Foreign Exchange Rates

	U.S. $	Aust $	U.K. £	Canadian $	¥en	Euro	Mexican NP	Chinese renminbi
U.S. $	1	0.6489	1.599	0.6764	0.01	1.051	0.11	0.12
Australian $	1.541	1	2.465	1.042	0.01	1.62	0.17	0.19
U.K. £	0.6252	0.4057	1	0.4229	0.01	0.657	0.07	0.08
Canadian $	1.478	0.9593	2.365	1	0.01293	1.554	0.16	0.18
¥en	114.3	74.19	182.9	77.34	1	120.2	12.24	13.81
Euro	0.9516	0.6175	1.522	0.6436	0.01	1	0.1	0.11
Mexican nuevo peso	9.33	6.06	14.94	6.3	0.08	9.81	1	1.13
Chinese renminbi	8.28	5.37	13.25	5.6	0.07	8.7	9.8	1

BUILDING KEY CONCEPTS

Read down the first column of the chart to find what one U.S. dollar was worth in foreign currencies on this particular day. (Example: One U.S. dollar was worth 0.6252 British pounds.) Read across the top row to find out how much a selected foreign currency was worth in U.S. dollars. (Example: One British pound cost 1.599 U.S. dollars or about $1.60.) **Money How much were 8.28 Chinese renminbi worth in U.S. dollars?**



hotel. If a hotel room in Mexico costs 400 pesos per night and the exchange rate is 8.0 pesos per dollar, a hotel room will cost $50:

$$\frac{400 \text{ pesos}}{8.0 \text{ pesos per dollar}} = \$50.00$$

If your family decides to go to Mexico the following fall, however, the exchange rate will probably have changed. If by fall, the exchange rate is 8.5 pesos per dollar, the hotel room will cost only about $47 a night (assuming that the hotel still charges 400 pesos per night):

$$\frac{400 \text{ pesos}}{8.5 \text{ pesos per dollar}} = \$47.05$$

By fall, the exchange rate might, however, be only 7.5 pesos per dollar. In that case, your family would need to spend more money on your visit. The hotel room would now cost about $53 per night:

$$\frac{400 \text{ pesos}}{7.5 \text{ pesos per dollar}} = \$53.33$$

Strong and Weak Currencies

You have probably heard newscasters talk about a "strong" or "weak" dollar or a currency like the Japanese yen "rising" or "falling." What do these terms mean, and are they good news or bad news for the United States economy?

An increase in the value of a currency is called **appreciation.** When a currency appreciates, it becomes "stronger." If the exchange rate between the dollar and the yen increases from 100 yen per dollar to 110 yen per dollar, one dollar will purchase more yen. Since the dollar has increased in value, we say that the dollar has appreciated against the yen. This appreciation means that people in Japan will have to spend more yen to purchase a dollar's worth of goods from the United States.

When a nation's currency appreciates, that nation's products become more expensive in other countries. For example, a strong dollar makes American goods and services more expensive for Japanese consumers. Japan will therefore probably import fewer products from the United States. That means that total United States exports to Japan will likely decline.

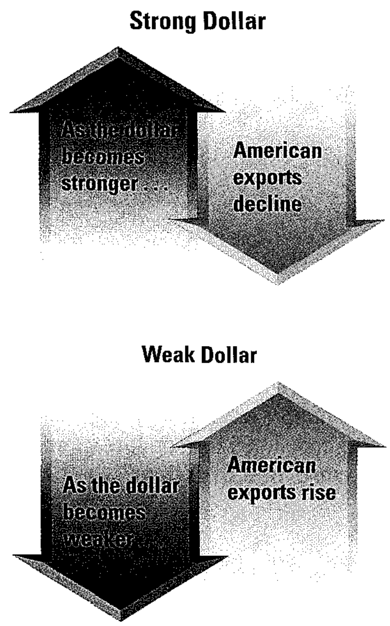
On the other hand, a strong dollar means that foreign products will be less expensive for consumers in the United States. A strong dollar is therefore likely to lead consumers in the United States to purchase imported goods.

A decrease in the value of a currency is called **depreciation.** You might also hear depreciation referred to as "weakening." If the dollar exchange rate fell to 90 yen per

appreciation *an increase in the value of a currency*

depreciation *a decrease in the value of a currency*

Figure 17.9 Effects of a Strong or Weak Dollar on Exports



BUILDING KEY CONCEPTS A strong dollar leads to a decrease in exports. A weak dollar leads to an increase in exports. **Trade What is the effect of a strong or weak dollar on imports?**

foreign exchange market *the banks and other financial institutions that facilitate the buying and selling of foreign currencies*

dollar, you would get fewer yen for each dollar. In other words, the dollar has depreciated against the yen.

When a nation's currency depreciates, its products become cheaper to other nations. A depreciated, or weak, dollar means that foreign consumers will be able to better afford products made in the United States. As you can see from Figure 17.9, exports are likely to increase as a result of a weakened dollar. At the same time, other nations' products become more expensive for consumers in the United States, so imports are likely to decrease.

The Foreign Exchange Market

When a company in the United States sells computers in Japan, that company is paid in yen. It must, however, pay its United States workers in dollars. The company must therefore exchange its yen for dollars in order to pay its workers. This exchange takes place on the foreign exchange market. Because each nation uses a different currency, international trade would not be possible without this market.

The **foreign exchange market** consists of about 2,000 banks and other financial institutions that facilitate the buying and selling of foreign currencies. These banks are located in various financial centers around the world, including New York, London, Paris, Singapore, Tokyo, and many other cities. Wherever they are located, the banks that make up the foreign exchange market maintain close links to one another through telephones and computers. This technology allows for the instantaneous transmission of market information and rapid financial transactions.

Exchange Rate Systems

As you read in Chapter 10, currencies varied in value from state to state in early America. In the United States today, of course, it doesn't matter whether you are in California, New York, or Texas—all prices are in dollars, and all dollars have the same value. No one asks whether your dollars came from San Francisco or Miami. Within the United States, a dollar is just a dollar.

Think how much more complicated it would be to do business if each state still had different currencies. To buy goods from a mail-order company in Indiana, for instance, you would have to find out the exchange rate between your local dollar and the Indiana dollar. Any large business in the United States would be overwhelmed by its efforts to keep track of all the exchange rates among the states. The economy would become less efficient as individuals and businesses spent time dealing with exchange rates.

You can understand from the above example how complex transactions would become if states had different exchange rates. The same ideas also apply to exchange rates among nations.

Fixed Exchange-Rate Systems

Wouldn't it be easier if all countries either used the same currency or fixed their exchange rates against one another? Then no one would have to worry about shifts in exchange rates. A currency system in which governments try to keep the values of their currencies constant against one another is called a **fixed exchange-rate system.**

fixed exchange-rate system *a currency system in which governments try to keep the values of their currencies constant against one another*

In a typical fixed exchange-rate system, one country with a stable currency is at the center. Other countries fix, or "peg," their exchange rates to the currency of this central country.

Normally, the fixed exchange-rate is not just a single value, but is kept within a certain prespecified range (for example, plus or minus 2 percent). If the exchange rate moves outside of this range, governments usually step in—or intervene—to help maintain the rate.

How do governments intervene to maintain an exchange rate? Like the price of any product or service, the exchange rate relies on supply and demand. To preserve its exchange rate, a government may buy or sell foreign currency in order to affect a currency's supply and demand. It will follow this course of action until the exchange rate is back within the prespecified limits.

The Bretton Woods Conference

In 1944, as World War II was drawing to a close, representatives from 44 countries met in Bretton Woods, New Hampshire. Their purpose was to make financial arrangements for the postwar world after the expected defeat of Germany and Japan.

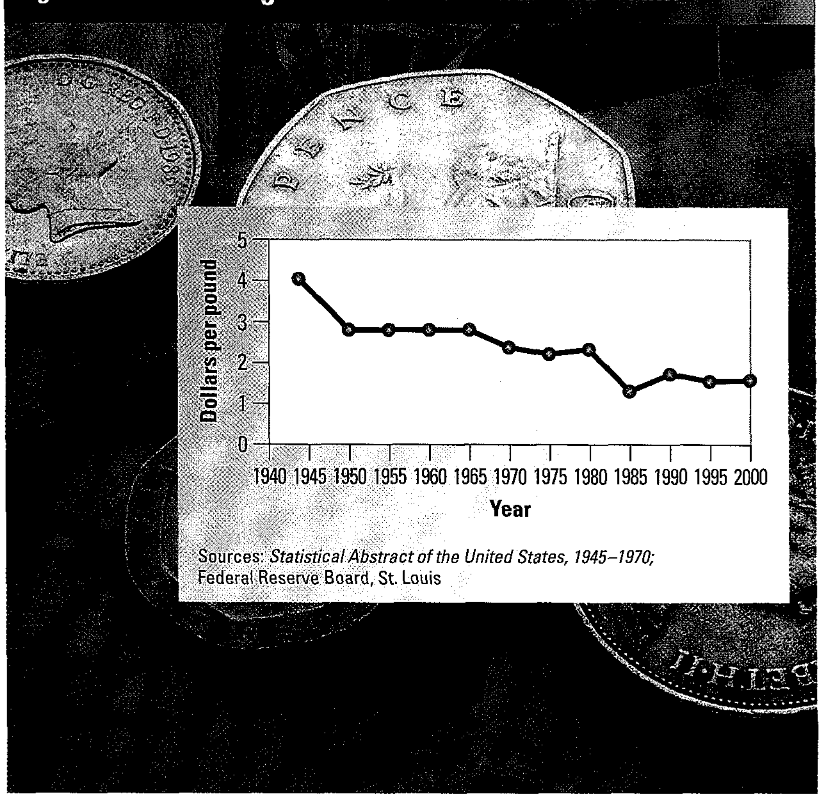
The Bretton Woods conference resulted in the creation of a fixed exchange-rate system for the Untied States and much of western Europe. Because the United States was the strongest economic power with the most stable currency, the U.S. dollar was at the center of the new system. Beginning in 1945, the conference participants agreed to fix their currencies to the U.S. dollar.

The Bretton Woods conference also established the International Monetary Fund (IMF) to make the new system work. Today this organization promotes international monetary cooperation, currency stabilization, and international trade. You will read more about the International Monetary Fund in Chapter 18.

Flexible Exchange-Rate Systems

Although fixed exchange-rate systems make it easier to trade, they require countries to maintain similar economic policies, including similar inflation and interest rates. By the late 1960s, changes were continually occurring in the international trading system, and worldwide trade was growing rapidly. At the same time, the war in Vietnam was causing inflation in the United States. These factors made it increasingly difficult for many countries to rely on a fixed exchange-rate system.

Figure 17.10 **Exchange Rates of the Dollar and Pound**



BUILDING KEY CONCEPTS

The United States and Britain shifted from a fixed rate to a flexible exchange-rate system in the early 1970s.
Money How did this shift affect exchange rates between the dollar and the pound?

FAST FACT

In general, the United States has a negative trade balance. While the United States may experience an overall trade deficit, however, trade with any one particular country may run a surplus. For example, in 2001, the United States had trade surpluses with The Netherlands, Hong Kong, Belgium, and Australia, as well as with Brazil, Argentina, and Egypt.

flexible exchange-rate system *a currency system that allows the exchange rate to be determined by supply and demand*

trade surplus *the result of a nation exporting more than it imports*

trade deficit *the result of a nation importing more than it exports*

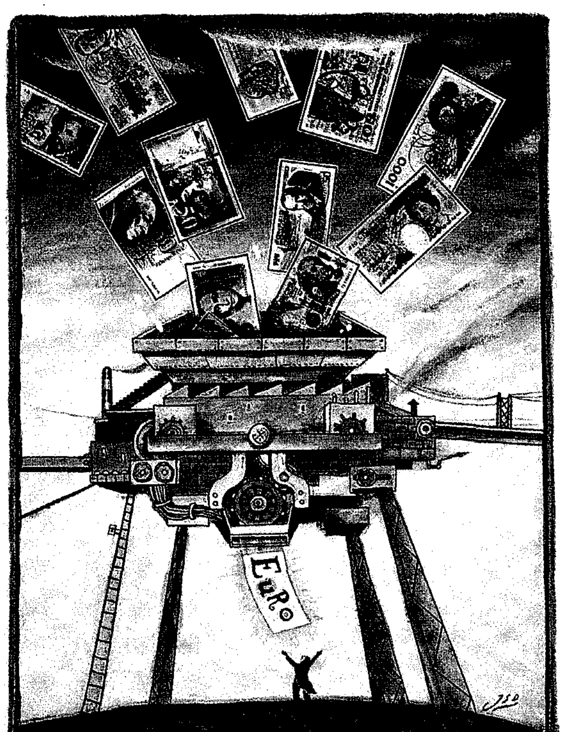
balance of trade *the relationship between a nation's imports and its exports*

In 1971, the West German and Dutch governments abandoned the fixed exchange-rate system. By 1973, many countries, including the United States, had adopted a system based on flexible, or floating, exchange rates.

In contrast to the fixed rate system, the **flexible exchange-rate system** allows the exchange rate to be determined by supply and demand. With a flexible exchange-rate system, exchange rates need not fall into any prespecified range.

Today, the countries of the world use a mixture of fixed and flexible exchange rates. Most major currencies, however—including the U.S. dollar and the Japanese yen—use the flexible exchange-rate system. This system accounts for the day-to-day changes in currency values that you read about earlier in this section.

When the flexible exchange-rate system was first adopted, some economists worried that changes in the exchange rate might interrupt the flow of international trade. In fact, the flexible exchange-rate system has worked reasonably well since the breakdown of the Bretton Woods fixed-rate system. World trade has grown at a rapid rate, and more nations trade today than ever before.



▲ **Most members of the European Union have phased out their individual currencies in favor of a single currency, the euro.**

The Euro

Although the flexible exchange-rate system works well, some countries whose economies are closely tied together want the advantages of fixed exchange rates. One way to enjoy the advantages but avoid some of the difficulties of fixed exchange rates is to abolish individual currencies and establish a single currency.

This is just what most of the European Union countries have done. The EU has established a new currency, which twelve EU member nations have adopted. As you read in Section 2, this single currency is called the euro. Use of this common currency requires participating countries to coordinate their economic policies, but it also simplifies trade.

The Balance of Trade

When a nation exports more than it imports, it has a **trade surplus.** When a nation imports more than it exports, it creates a **trade deficit.** The relationship between a nation's imports and its exports is called its **balance of trade.**

When a large difference between a nation's imports and exports arises, it is said to have a trade imbalance. A nation that exports more goods than it imports has a positive trade balance. A nation that imports more than it exports has a negative trade balance.

Understanding the Balance of Trade

Nations seek to maintain a balance of trade with values of imports equal to values of exports. By balancing trade, a nation can protect the value of its currency on the international market. If a trade imbalance continues, with one country importing more than it is exporting, the value of its currency falls. For example, in the 1980s the United States imported considerably more than it exported, and the foreign exchange market was glutted with dollars. As the value of the dollar fell, the prices of imports increased and consumers paid more for the goods.

A trade imbalance can be corrected by limiting imports or increasing the number and/or quality of exports. Both of these actions affect trading partners, of course, who may retaliate by raising tariffs. Maintaining a balance of trade thus requires international cooperation and fair trade.

The United States Trade Deficit

Although the United States sells many goods abroad (supercomputers, movies, and CDs, for example), in general it buys more goods from abroad than it sells (cars, clothing, and VCRs, for example). The result is that the United States is running a large trade deficit, and has been for several decades.

The United States trade deficit has existed since the early 1970s. At that time, the Organization of Petroleum Exporting Countries (OPEC) dramatically raised the price of oil. The United States had to increase the money spent on foreign oil, thus increasing the money spent on imports. The total cost of imports to the United States then exceeded the income from exports, and a trade deficit developed. (See the United States Trading Partners map on page 545 of the Databank for the names and locations of the countries that belong to OPEC.)

As you can see from Figure 17.11, the United States suffered record trade deficits in 1986 and 1987, reaching over $150 billion in 1987. In the early 1990s, the trade deficit began to fall. By the late 1990s, however, the deficit had skyrocketed to record levels, largely as a result of increasing oil prices.

The United States trade deficit totaled over $375 billion in 2000, with the largest amounts owed to China, Japan, Canada, Germany, Mexico, Taiwan, and oil exporting countries, such as Malaysia and Venezuela. Imported petroleum accounted for almost 25 percent of the deficit.

Reducing the Trade Deficit

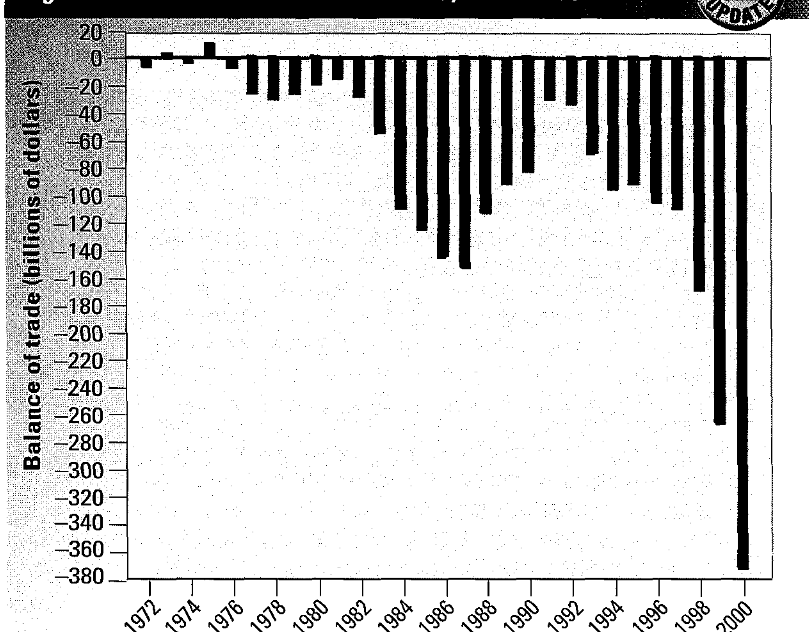
You have read that trade deficit occurs when United States businesses and consumers purchase more goods and services from foreign producers than foreigners buy from the United States during the same time period. This means that Americans are spending more than they produce.

For the United States to run a trade deficit, other countries must be willing to finance the deficits by lending to the United States or buying American assets. When Americans are buying more goods abroad than they sell, extra dollars end up in the hands of foreigners. The foreigners can then use these dollars to purchase American assets. As a result of America's persistent trade deficits, people from other

THE WALL STREET JOURNAL.
CLASSROOM EDITION

In the News *As this excerpt from an article in* The Wall Street Journal Classroom Edition *shows, the growing United States trade deficit is not all bad.*
"The deepening trade deficit is generating the usual complaints about lost U.S. jobs and foreign companies' allegedly predatory tactics. On the other side, most economists say the deficit is just symptomatic of a strong economy and helps hold down inflation."

Figure 17.11 **U.S. Balance of Trade, 1972–2000**



Source: U.S. Department of Commerce

BUILDING KEY CONCEPTS

The United States has had a significant trade deficit since the mid-1970s.
Trade Describe the U.S. balance of trade in the 1990s.

Figure 17.12 Leading Exporters and Importers, 2000

Exporters	$ Billions	% Change 1999–2000	Importers	$ Billions	% Change 1999–2000
United States	781.1	11	United States	1257.6	19
Germany	551.5	1	Germany	502.8	6
Japan	479.2	14	Japan	379.5	22
France	298.1	-1	United Kingdom	337.0	5
United Kingdom	284.1	6	France	305.4	4
Canada	276.6	16	Canada	244.8	11
China	249.3	28	Italy	236.5	7
Italy	237.8	1	China	225.1	36
Netherlands	212.5	6	Hong Kong, China	214.2	19
Hong Kong, China	202.4	16	Netherlands	198.0	4

Note: Billions are in U.S. dollars
Source: World Trade Organization

BUILDING KEY CONCEPTS

Many of the countries listed on this chart are becoming world trade powerhouses.
Trade Which countries are growing both as importers and exporters?

countries now own a bigger piece of the American economy. They have used the surplus dollars that they received from sales of products to Americans to purchase American land, stocks, bonds, and other assets.

Some economists worry that foreign investment might not always be available to support the trade deficit. Federal Reserve Chairman Alan Greenspan has commented that "we do not know how long net imports and U.S. external debt can rise before foreign investors become reluctant to continue to add to their portfolios of claims against the United States." The U.S. Trade Deficit Review Commission reported in 2000 that "Maintaining large and growing trade deficits is neither desirable nor likely to be sustainable for the extended future."

To reduce the trade deficit, individuals and companies could purchase fewer foreign goods or they could sell more domestic products abroad. Nationally, the country could cut back spending by adjusting its monetary or fiscal policy. Or it could appreciate the exchange rate in order to make its own goods more expensive on the world market and make other countries' goods correspondingly less expensive. All of these approaches would result in fewer surplus dollars ending up in the hands of foreigners.

Section 3 Assessment

Key Terms and Main Ideas

1. Explain why you need to know the **exchange rate** when you travel to a foreign country.
2. Explain what is meant by a strong or a weak dollar. How do a strong or a weak dollar affect prices of imports and exports?
3. What is the difference between a **fixed exchange-rate system** and a **flexible exchange-rate system?** Why did the United States shift to a flexible exchange-rate system in the early 1970s?
4. What is a **trade deficit?** How would you describe the current **balance of trade** in the United States?

Applying Economic Concepts

5. ***Critical Thinking*** Assume you have just heard that the Canadian dollar has weakened. Is this good news or bad news for travelers from the United States visiting Canada? Explain your answer.
6. ***Math Practice*** Suppose you are planning to take a train between the Chinese cities of Beijing and Xian. A ticket costs 480 renminbi. Use the exchange rate table in Figure 17.8 to calculate how much money in U.S. dollars the ticket will cost.
7. ***Try This*** You have been invited to a local high school to explain one of the following topics: **(a)** Understanding exchange rates or **(b)** The United States balance of trade. Choose one of the above topics and prepare notes for a brief presentation.

Take It to the NET Find out how much your dollar can buy of a similar good (for example, a can of soda or a cup of coffee) in three different countries. Use the links provided in the Social Studies area at the following Web site for help in completing this activity. **www.phschool.com**

NAFTA: Is Free Trade a Good Idea?

In the 1980s and early 1990s, debate raged over the North American Free Trade Agreement (NAFTA). The goal of this agreement was to eliminate all trade restrictions among Mexico, Canada, and the United States. It included provisions for more than 9,000 products and services.

▲ NAFTA has given Mexico's electronics assembly industry a boost.

Pro-NAFTA Arguments Supporters of NAFTA argued it would benefit the economies of all three nations. They believed NAFTA would increase trade and promote healthy competition. They also argued that employment in some U.S. industries would increase, as the elimination of tariffs made American goods less expensive in Mexico and Canada.

Anti-NAFTA Arguments NAFTA critics argued that without tariffs, items produced in Mexico would be cheaper than American-made goods, resulting in widespread unemployment among American industrial workers. The authors of NAFTA anticipated this possibility and reduced its effects by slowly phasing out tariffs and by providing compensation to many workers who lost jobs because of NAFTA.

Consequences NAFTA went into effect January 1, 1994. By 1999, it was clear that NAFTA had a generally positive impact on the economies of all three trading partners. American exports of farm products, technology, and textiles to Mexico increased over pre-NAFTA levels. Canada's trade with the United States increased by 80 percent, while its trade with Mexico doubled. And although the United States did lose thousands of jobs because of increased imports, the growth in exports to Canada and Mexico resulted in thousands of newly created jobs.

Major Provisions of NAFTA

Automobile manufacturing
- 20% Mexican tariff on U.S. cars eliminated in 1999

Agriculture
- 57% of all Canadian, U.S., and Mexican tariffs on farm products eliminated immediately
- Remaining tariffs phased out over 15 years

Clothing and Textiles
- Canadian and U.S. tariffs phased out over 10 years
- Mexican tariffs eliminated immediately

Trucking
- Mexican, Canadian, and U.S. truck drivers allowed to drive and deliver goods anywhere in North America

Banking
- U.S. banks and brokerage firms to have unlimited access to doing business in Mexico

Applying Economic Ideas

1. How has NAFTA benefited the economies of all three nations that signed it?
2. The table shows some of the major provisions of NAFTA. Which of these provisions benefit the United States? Which have a negative impact? Explain.

Chapter 17 Assessment

Chapter Summary

A summary of major ideas in Chapter 17 appears below. See also the **Guide to the Essentials of Economics**, which provides additional review and test practice of key concepts in Chapter 17.

Section 1 Why Nations Trade (pp. 441–447)

Because resources are distributed unevenly throughout the world, nations specialize in producing certain goods and services, then trade to acquire the goods and services that they cannot produce. Nations, like individuals, specialize in producing goods and services based on the **law of comparative advantage:** that is, nations should specialize in producing the goods for which they have the lowest opportunity cost. As a result of specialization, both sides in the trading relationship benefit from trade.

Section 2 Trade Barriers and Agreements (pp. 449–456)

Import quotas, voluntary export restraints (VERs), and **tariffs** are three types of **trade barriers.** Their overall effect is to raise prices and protect domestic industries from foreign competition. People who favor **protectionism** argue that these measures are necessary to protect the jobs of domestic workers, shelter **infant industries,** and safeguard national security. Current trends, however, generally favor international cooperation, regional trade agreements, and an overall reduction in trade barriers.

Section 3 Measuring Trade (pp. 458–464)

After World War II, the United States and many of its trading partners used a **fixed exchange-rate system** in which exchange rates were fixed relative to the U.S. dollar. Today, most countries use a **flexible exchange-rate system** in which exchange rates shift according to market forces. As exchange rates change, currencies weaken and strengthen relative to other currencies. The difference between a nation's imports and exports is called the **balance of trade.** When a country imports more than it exports, it has a **trade deficit.** The United States has generally had a large trade deficit since the 1970s.

Key Terms

Complete each sentence by choosing the correct answer from the list of terms below. You will not use all of the terms.

comparative advantage	**imports**
appreciation	**infant industry**
exchange rate	**protectionism**
exports	**tariff**
free-trade zone	**trade surplus**
	depreciation

1. The ____ determines how much a foreign currency is worth in a certain nation.
2. Nations may choose to impose a ____, or tax, on imports from other countries.
3. A ____ occurs when one nation exports more goods than it imports.
4. Economists use the term ____ to refer to one nation's currency rising in value in comparison to another country's currency.
5. Goods shipped abroad for sale are ____.
6. A country has a ____ when it has the lowest opportunity cost of producing a good.
7. A young business that is shielded from foreign competition is called a(n) ____.

Using Graphic Organizers

8. On a separate sheet of paper, copy the web map below to help you organize information about trade organizations. Complete the web map by writing examples of trade organizations. Include a brief description of each organization in the blank circles.

Reviewing Main Ideas

9. How do specialization and trade benefit both trading partners?
10. Explain the concept of a flexible exchange-rate system.
11. List and describe three arguments in favor of trade barriers.
12. Why does the United States stand to benefit from increased trade in services?

Critical Thinking

13. **Analyzing Information** Suppose the United States loses its comparative advantage in producing computers. How would this loss affect employment in the United States?
14. **Drawing Conclusions** Suppose you have heard that the U.S. dollar is strong on world markets. (a) What does this news mean for imports and exports? (b) How will it affect American tourists in other countries?
15. **Recognizing Cause and Effect** Assume the United States has established a tariff on clocks. Why would the United States establish this tariff, and what are two possible effects of its enactment?

Problem-Solving Activity

16. Divide your class into small groups, each group representing a country. Have each country answer the following questions: What goods and services will you produce? With which other countries will you trade? Will tariffs and import quotas exist? Discuss the implications of your choices for the other countries in your class.

Economics Journal

Organizing Ideas Review your Economics Journal entry for Chapter 17. Then answer the following questions: Which countries do the items represent? Do the countries you have listed have any similarities, such as where they are located? What generalizations about the comparative advantages of these countries or regions can you make?

Skills for Life

Creating a Multimedia Presentation Review the steps shown on page 448; then use the chart below to help you plan your presentation. You have been asked to create a multimedia presentation on NAFTA.

17. Review the discussion of NAFTA on pages 454–455 and in the Chapter 17 Case Study on page 465. What aspects of NAFTA should you learn more about?
18. Into what segments will you divide your presentation?
19. What types of sources might you use for your presentation?
20. What sort of audio-visual aids could you use?

PREPRODUCTION TOPIC ANALYSIS SHEET

Assignment: North American Free Trade Agreement

Aspects of NAFTA to consider: ____________
1. ____________
2. ____________

My choice: ____________

Segment description and sequence:
1. ____________
2. ____________
3. ____________

Sources of information: ____________

____

Audio-Visual Aids: ____________

____

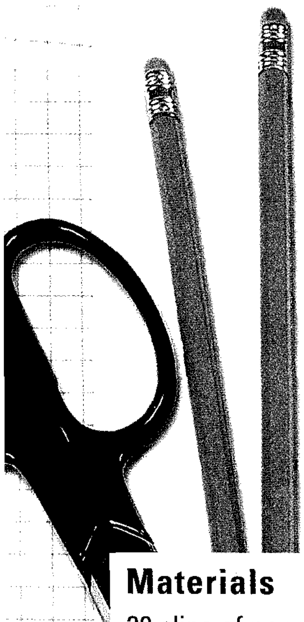
____

Take It to the NET

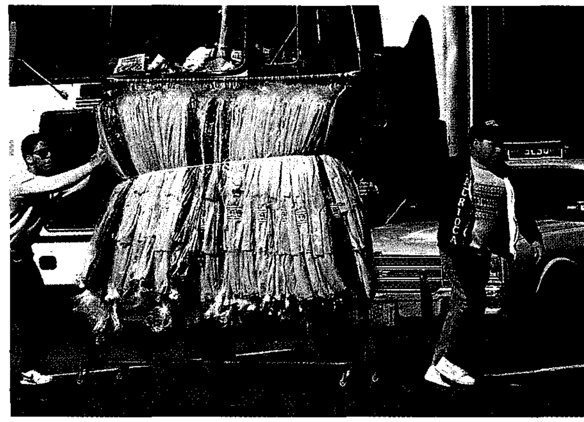
Chapter 17 Self-Test As a final review activity, take the Chapter 17 Self-Test in the Social Studies area at the Web site listed below, and receive immediate feedback on your answers. The test consists of 20 multiple-choice questions designed to test your understanding of the chapter content.
www.phschool.com

Economics Simulation

Protectionist Policies



The laws of supply and demand apply in international trade as well as in the domestic market. Consumers and producers negotiate to find a price they can agree on. In international trade, though, there is often another player—government. Governments may put certain kinds of restrictions on particular goods in order to protect industries and workers at home. In this simulation, you will explore some effects that protectionist policies have on trade.



▲ How might protectionist policies affect the cost of these foreign-produced coats?

Materials

20 slips of paper (one color)

10 slips of paper (contrasting color)

10 slips of paper (third color)

2 small boxes

notebook paper

Preparing the Simulation

In this simulation, you will role-play foreign and domestic producers who are competing to sell wool coats. Labor costs and other factors make domestic coat manufacturing more expensive. Certain government policies try to make up for this to protect domestic manufacturing. You will discover how different kinds of protectionist policies affect the workings of supply and demand.

Step 1: Your class will be divided into two equal groups: Consumers and Producers.

Step 2: The Consumers group will prepare 20 slips of colored paper that represent the prices a Consumer is willing to pay for a coat. Number these slips from $15 to $110 by fives ($15, $20, $25, and so on). Put these slips into a box.

Step 3: Meanwhile, the Producers group will prepare two sets of ten slips each (each set in a different color). These slips will represent the costs to produce a coat. One color will designate Foreign Producers. Number the Foreign Producers' slips from $10 to $50 by tens ($10, $20, etc.). The other color will designate Domestic Producers. Number the Domestic Producers' slips from $60 to $100 by tens ($60, $70, etc.). Each amount will be used twice—two $60 slips, two $70 slips, and so on. Put all the Producer slips into a second box.

Step 4: Each member of the Consumer group will draw a slip from the Consumer box. This is the maximum price you are willing to pay for a coat. Each member of the Producer group should draw a slip from the Producer box. The color indicates whether you are a Foreign or a Domestic Producer, and the amount represents your cost to make a coat.

Conducting the Simulation

There will be three trading periods. Your goal in each trading period is to make the best deal you can—to buy below your maximum price if you are a Consumer, and to sell for more than your cost if you are a Producer.

If you are a Consumer, your score is your savings—the difference between the maximum price you were willing to pay and the price you actually paid for a coat. For example, if the price on your slip is $50, and you succeed in buying a coat for only $30, your score is $20. If you are a Producer, your score is your profit—the difference between your cost to produce the coat and the price at which you can sell it.

You do not have to buy or sell a coat in any trading period, but if you do not, your score for that round will be $0. Your teacher will keep a record of all the transactions. You should also keep a record of your own scores. The final score is the sum of all savings (Consumers) or profits (Producers).

Trading Period 1

Producers and Consumers will meet in a trading area and try to make deals. Each person can buy or sell one coat in each trading period. When you reach an agreement, report the price and your own score to the teacher. The trading period will end when no more pairs of Producers and Consumers can make a deal. Your teacher will list the prices at which coats were sold and their origins (domestic or foreign) in this trading period.

Trading Period 2

Now you will see the results of one kind of protectionist policy. The government has imposed a tariff—an import tax—of $30 on each imported coat. If you are a Foreign Producer, add $30 to your cost amount. Then trade as before. Record your transaction with your teacher.

Trading Period 3

Another government policy changes the market. Politicians from textile-manufacturing states have succeeded in banning imports of wool coats. As a result, the Foreign Producers cannot take part in this trading period. Consumers must try to buy coats from the remaining Domestic Producers. Record your transaction with your teacher.

Transactions Chart

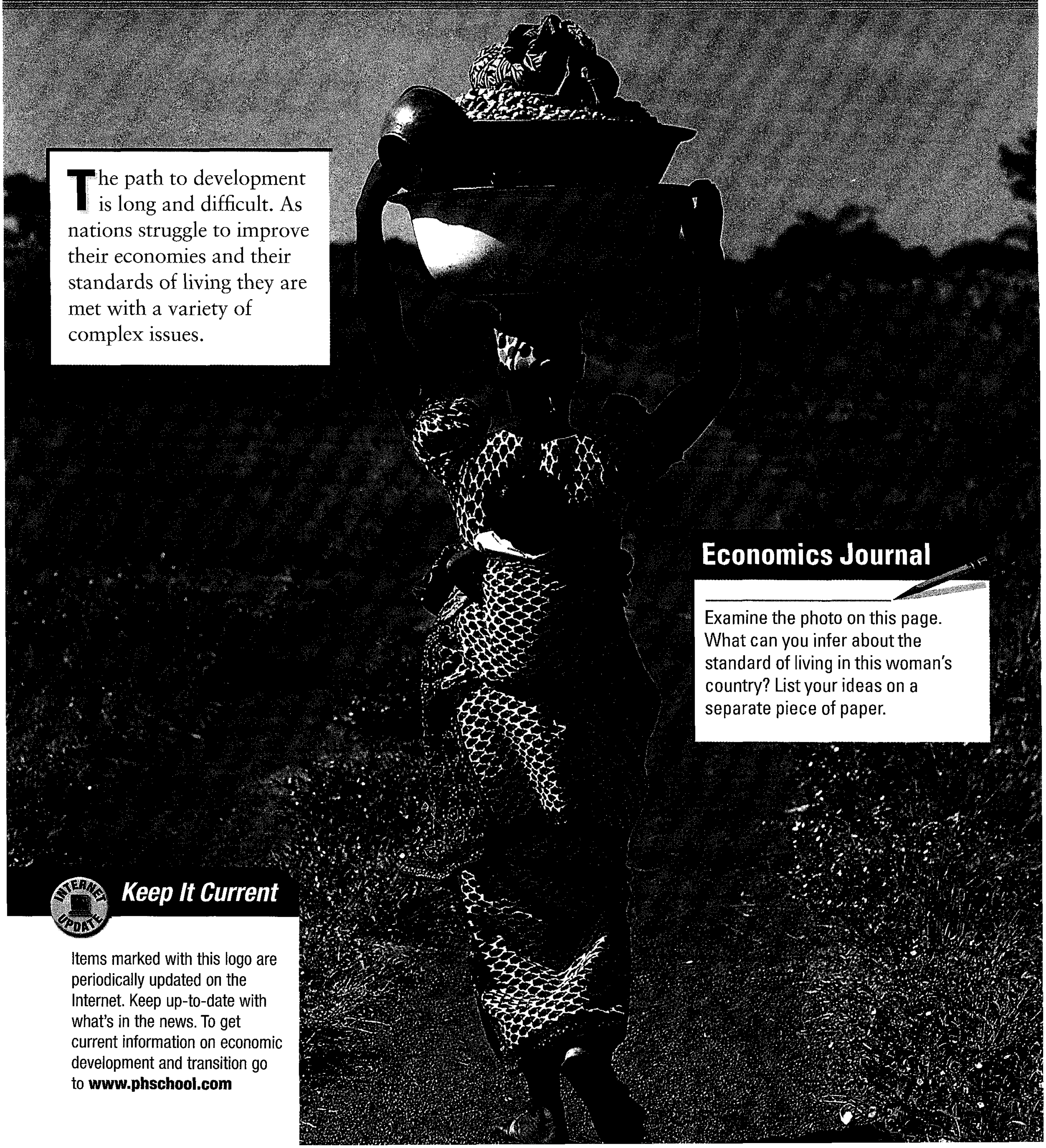
	Trading Period 1	Trading Period 2	Trading Period 3
Number of deals made			
Number of Consumers unable to buy			
Number of Producers unable to sell			
Average price for a wool coat			
Lowest price			
Highest price			

Simulation Analysis

Use a sheet of notebook paper to create a transaction chart like the one on this page. As a class, complete the transaction chart using information that you reported to your teacher. Discuss the following questions as a group.

1. In which trading period were the largest number of coats sold?
2. In Trading Period 2, what were the effects of the tariff on the Foreign Producers? On Consumers? How did the tariff affect Domestic Producers?
3. What happened to coat prices when imports from Foreign Producers were banned in Trading Period 3? Why?
4. **Drawing Conclusions** In the real world, what would domestic coat producers probably do if imported coats were banned? Why?

Chapter 18 Economic Development and Transition



The path to development is long and difficult. As nations struggle to improve their economies and their standards of living they are met with a variety of complex issues.

Economics Journal

Examine the photo on this page. What can you infer about the standard of living in this woman's country? List your ideas on a separate piece of paper.

Keep It Current

INTERNET UPDATE

Items marked with this logo are periodically updated on the Internet. Keep up-to-date with what's in the news. To get current information on economic development and transition go to **www.phschool.com**

Section 1

Levels of Development

Preview

Objectives

After studying this section you will be able to:

1. **Understand** what is meant by developed nations and less developed countries.
2. **Identify** the tools used to measure levels of development.
3. **Describe** the characteristics of developed nations and less developed countries.
4. **Understand** how levels of development are ranked.

Section Focus

Nations throughout the world exhibit varying levels of economic well-being. Many tools are used to measure a nation's level of development.

Key Terms

development
developed nation
less developed country
per capita gross domestic product (per capita GDP)
industrialization
subsistence agriculture
literacy rate
life expectancy
infant mortality rate
infrastructure
newly industrialized country (NIC)

Three billion people—half the world's population—live in extreme poverty. The United Nations estimates that 1 billion people live on less than $1 a day. Concern over these startling statistics has led to close examination of the world's economies.

Social scientists measure the economic well-being of a nation in terms of its level of development. **Development** is the process by which a nation improves the economic, political, and social well-being of its people.

Developed Nations and Less Developed Countries

Some nations enjoy a high standard of living. Wealthy nations, such as the United States, Canada, the nations of Western Europe, Australia, New Zealand, and Japan, are called developed nations. **Developed nations** are those nations with a higher average level of material well-being. Most nations, however, have low levels of material well-being. These are the **less developed countries** (LDCs). LDCs include the world's poorest countries, such as Bangladesh, Nepal, Albania, and the nations of Central and Southern Africa. They also include nations such as Mexico, Poland, Saudi Arabia, and the former republics of the Soviet Union. The countries in this second group of nations are not the world's poorest, but they have yet to achieve the high standard of living of the world's developed nations.

It is important to remember that development refers to a nation's material well-being. It is not a judgment of the worth of a nation or its people. The level of development does not indicate cultural superiority or inferiority. Rather, the level of development indicates how well a nation is able to feed, clothe, and shelter its people. It indicates how healthy people are, how well they are educated, and how productive they are.

Measuring Development

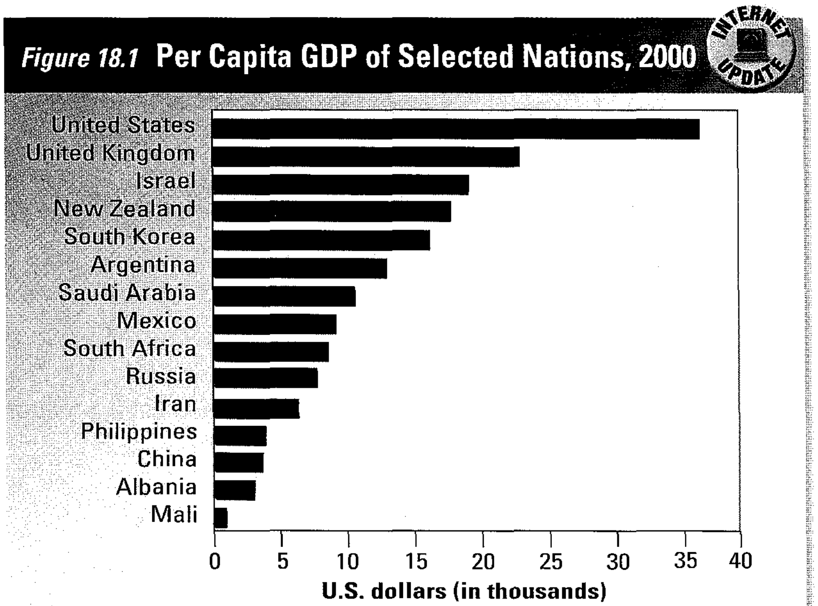
Life expectancy, diet, access to health care, literacy, energy consumption, and many other factors are used to measure development. As you will read below, the primary measure of a country's development, however, is per capita gross domestic product (GDP).

development *the process by which a nation improves the economic, political, and social well-being of its people*

developed nation *nation with a higher average level of material well-being*

less developed country *nation with a low level of material well-being*

Figure 18.1 **Per Capita GDP of Selected Nations, 2000**



Source: *CIA World Factbook*, 2001

BUILDING KEY CONCEPTS

Per capita GDP varies greatly among nations.
Standard of Living Which nation on this graph do you think has the highest standard of living. The lowest?

Per Capita GDP

As you read in Chapter 12, gross domestic product, or GDP, is the total market value of all the final goods and services produced within an economy in a given year. It is used to measure the economic activity of a nation. GDP measures the value of production and also provides a measure of income for an economy. **Per capita gross domestic product (per capita GDP)** is a nation's GDP divided by its total population.

Development experts use per capita GDP figures because GDP alone is not adequate to compare the living standards within nations. For example, Australia and India have similar GDPs, around $390 billion for Australia and around $380 billion for India. Yet, Australia enjoys a high standard of living, while India is very poor. What accounts for this difference? The answer is population size.

Australia's $390 billion is shared by fewer than 20 million people. India's $380 billion is shared by about 1 billion people. This is why economists use per capita GDP to compare levels of development. Australia's per capita GDP is around $20,650. India's per capita GDP is around $370. (See Figure 18.2.)

per capita gross domestic product (per capita GDP) *a nation's gross domestic product (GDP) divided by its total population*

industrialization *the extensive organization of an economy for the purpose of manufacture*

subsistence agriculture *level of farming in which a person raises only enough food to feed his or her family*

These per capita figures indicate that the average Australian can more easily meet basic needs than the average Indian. The average Australian also has income left over to spend on nonessentials or to save.

Using per capita GDP to measure a nation's economic health has its limitations, however. Per capita GDP does not take into account a country's distribution of income. Within every nation, some people are wealthier than most, while others are poorer than most. In many less developed countries, the gap between rich and poor is especially wide. In some LDCs, a small, wealthy elite controls much of the wealth while most of the nation's population remains poor.

Energy Consumption

Energy consumption is another way to measure development. The amounts of fossil fuel, hydroelectricity, and nuclear energy a nation uses depends on its level of industrialization. **Industrialization** is the extensive organization of an economy for the purpose of manufacture. Industrial processes generally require large amounts of energy. For this reason, low levels of energy use tend to indicate low levels of industrial activity. High levels of energy use tend to indicate high levels of industrial activity. Because most of the developed nations of the world are highly industrialized, they are sometimes referred to as "industrialized nations."

Nations that have low levels of per capita energy consumption tend to have little industry. Most of the people in such nations are farmers working with simple tools and few machines. This is true of many LDCs, where large portions of the population engage in **subsistence agriculture.** That is, they are able to raise only enough food to feed their families.

Labor Force

What does it mean for the economy if a nation has low industrialization? It means that most of the labor force is devoted to agriculture. If most of the people are working simply to raise food for themselves, few are available to work in industry. As a result, there is little opportunity for workers to specialize. (Recall from Chapter 2 that specialization makes economies more efficient.) If individuals—or nations—are unable to produce specialized goods to sell, they are unable to generate cash income.

Consumer Goods

The quantity of consumer goods a nation produces per capita can also indicate its level of development. A large number of consumer goods in an economy means that people have enough money to meet their basic needs and still have some money left over for nonessential goods. Social scientists look to the number of large consumer goods per person to measure development. They count, for example, how many people have televisions, automobiles, refrigerators, washing machines, or telephones.

Literacy

Usually, the more a country's people attend school, the higher its level of development. This makes sense because the greater the number of people that can read and write, the more productive a population can be at both industrial and agricultural jobs.

A country's **literacy rate** is the proportion of the population over age 15 that can read and write. A well-educated nation has a high literacy rate. A low literacy rate indicates a poorly educated nation.

Life Expectancy

Life expectancy is the average expected life span of an individual. It indicates how well an economic system supports life and fends off death. A population that is well nourished and housed, as well as protected from disease, will have a long life expectancy. A population that has a poor diet and shelter and that is exposed to poor sanitation and disease will have a shorter life expectancy.

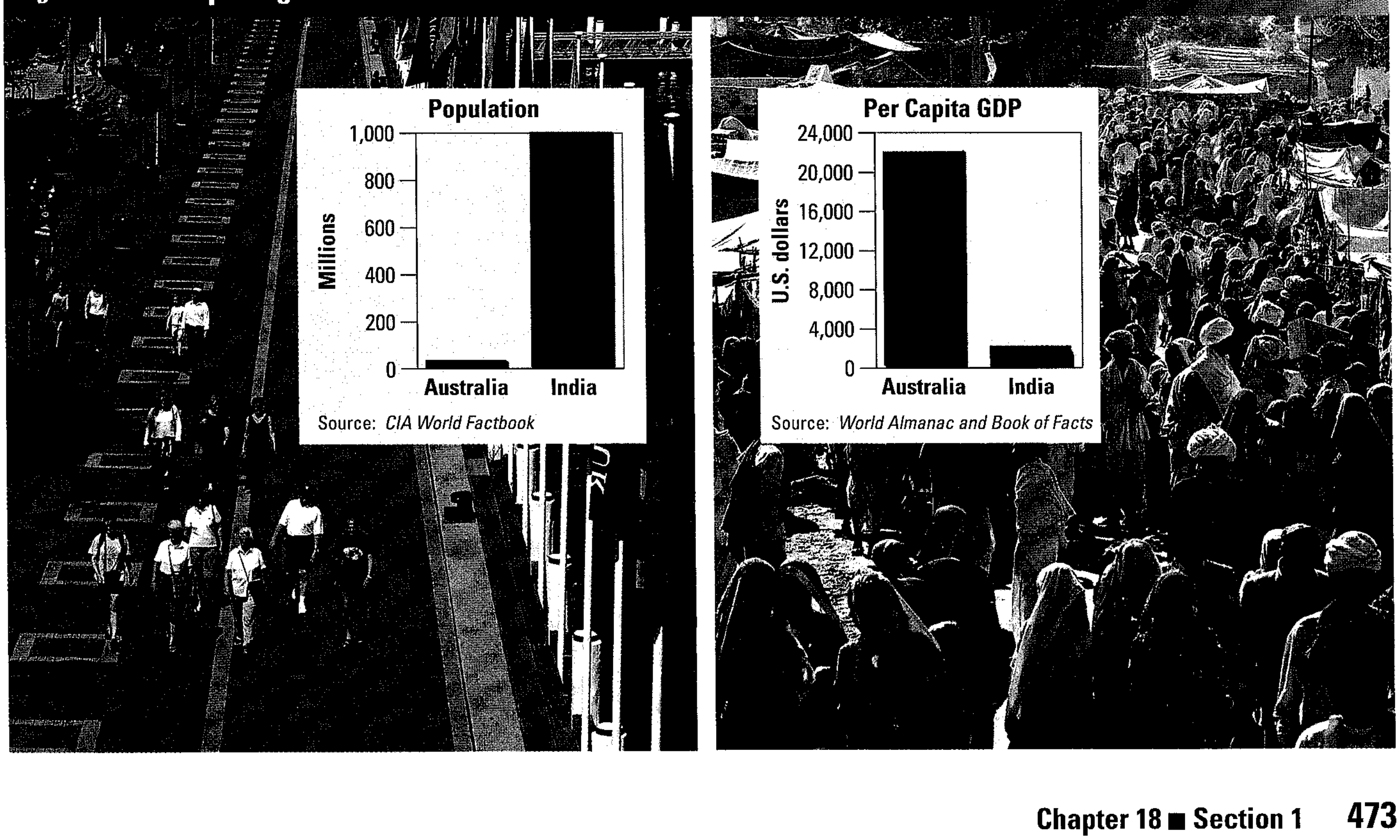
literacy rate *the proportion of the population over age 15 that can read and write*

life expectancy *the average expected life span of an individual*

BUILDING KEY CONCEPTS

Australia (left) and India (right) have very different standards of living.
Gross Domestic Product What do the photos below tell you about the population levels of Australia and India? How do their population levels affect the measurement of per capita GDP?

Figure 18.2 **Comparing Australia and India**



▶ **In the developed world, the infant mortality rate is 8; in the less developed world, it is 62.**

infant mortality rate *the number of deaths that occur in the first year of life per 1,000 live births*

infrastructure *the services and facilities necessary for an economy to function*

Infant Mortality Rate

Another measure of development related to nutrition and health care is a country's infant mortality rate. A country's **infant mortality rate** indicates the number of deaths that occur in the first year of life per 1,000 live births. For example, the United States has an infant mortality rate of 6.4. This means that out of every 1,000 infants born alive in a given year, 6.4 of them die before they reach their first birthdays. Like most measures of development, infant mortality rate is an average. Not all regions of a country or sectors of a population have the same infant mortality rates.

Characteristics of Developed Nations

Developed nations have high per capita GDPs, and a majority of their populations are neither very rich nor very poor. Developed nations enjoy a higher degree of economic and political freedom than do less developed countries. They also have a high degree of consumer spending. For example, in the United States, the average household has at least two television sets.

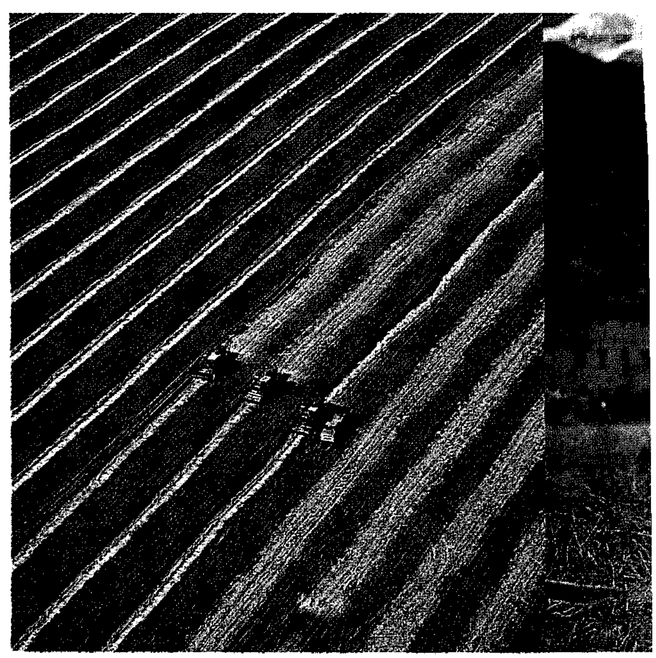
In most developed nations, agricultural output is high, but relatively few people work on farms. Use of advanced irrigation techniques, fertilizers, pesticides, seed varieties, and heavy machinery makes farmers very productive. In the United States a single farmer can feed 80 people. Compare this to many LDCs, where a single farmer can support only his or her own family.

Since only a small portion of the labor force is needed in agriculture in a developed nation, most of the labor force is available to work in industry and services. High per capita energy use in developed nations reflects a high level of industrialization. Widespread use of technology increases the productivity of the work force.

The populations of developed nations are generally very healthy. Infant mortality rates are low, while life expectancy is high. People in developed nations tend to be well educated, and literacy rates are high.

Developed nations have been urbanized for many generations. That is, most of their populations live in cities and towns and have done so for many years. A solid infrastructure has grown along with these cities and towns. **Infrastructure** is the services and facilities necessary for an economy to function. Transportation and communication systems, roads, power plants, schools, and banks are all part of a nation's infrastructure, which determines that nation's capacity to produce.

▶ **Technology plays a huge role in agricultural productivity.**



Characteristics of Less Developed Countries

Less developed countries have low per capita GDPs. Low per capita energy consumption signals their low level of industrialization. Many in the labor force work on their own farms and grow only enough food to feed themselves and their families. Unemployment rates are high, often around 20 percent. In addition, much of the labor force is underemployed. That is, some people have work, but not enough. They cannot support themselves or their families because they work less than eight hours a day.

Even if an LDC could produce consumer goods, most of the population would be unable to buy them. Subsistence-level agriculture does not provide a family with an income. It is so labor-intensive that farmers have no time for other work, even if they could find it.

The impoverished economy of an LDC has trouble educating the populace. Resources for schools are limited. In addition, children in subsistence-level economies are often needed to work on the family farm, limiting the amount of time they can spend in school.

Literacy rates in LDCs are very low. In Cambodia, for example, only 35 percent of the people over 15 years old can read and write. Compare this figure with the United States, where the literacy rate is nearly 100 percent.

In the world's poorest countries, housing is of poor quality. Diet is, too. Along with limited access to health care, these factors lead to high infant mortality rates and short life expectancy.

There are additional characteristics common to most LDCs. In the next section, you will read about some of the difficult issues challenging less developed countries.

Global Connections

Global Development and the Environment In 1997, the Kyoto Protocol was signed by 159 nations in an effort to reduce greenhouse gas emissions. Less developed countries, such as Brazil, China, India, and Mexico, voiced concern over who would pay for these measures, and whether they would hamper economic growth. In further discussions in 1998, the participants recognized that less developed countries may not have the capacity to handle increased environmental standards while trying to develop their economies. **Do you think less developed countries should be held to the same standards as developed nations?**

Levels of Development

Economic development commonly occurs in the following stages.

- *Primitive equilibrium* Economy has no formal economic organization or monetary system. It exists in equilibrium based on tradition.
- *Transition* Cultural traditions begin to crumble and people adopt new living patterns.
- *Takeoff* New industries grow and profits are reinvested.
- *Semidevelopment* Economy expands significantly and enters the international market.
- *Highly developed* Basic human needs are met easily. Economy is focused on consumer goods and public services.

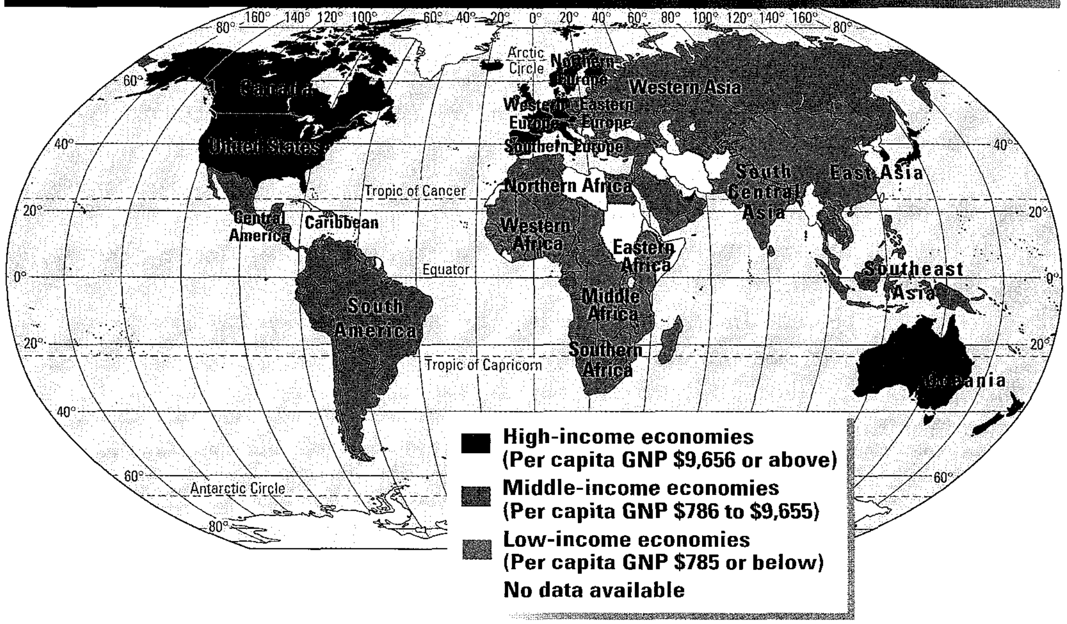
Some of the more successful of the developing countries are referred to as **newly industrialized countries (NICs).** NICs are less

newly industrialized country (NIC) *less developed country that has shown significant improvement in the measures of development*

Building Key Concepts

Although income is only one measure of development, it gives a good indication of a nation's standard of living.
Income Can you see a pattern in the locations of developed nations and less developed countries?

Figure 18.3 **Levels of Development**



developed countries that have shown significant improvement in development. Newly industrialized countries include Mexico, Brazil, Malaysia, Thailand, Singapore, Hong Kong, South Korea, and Taiwan. The most successful of these—Singapore, Hong Kong, South Korea, and Taiwan—are known collectively as "the four Asian tigers." These countries now have incomes comparable to those of some developed nations.

The World Bank is an international organization devoted to assisting development. It uses per capita gross national product (GNP) to categorize nations as *high income, middle income,* and *low income.* High-income economies are the developed nations. Middle- and low-income economies are the less developed countries. See the map in Figure 18.3 for the distribution of these nations.

Section 1 Assessment

Key Terms and Main Ideas

1. What is **development?**
2. Why are **developed nations** sometimes referred to as industrialized nations?
3. Why is **per capita GDP** a better measure of development than GDP?
4. What role does **infrastructure** play in a nation's development?
5. List and describe three characteristics of **developed nations** and three characteristics of **less developed countries.**

Applying Economic Concepts

6. ***Decision Making*** Create a list of three factors used to measure a nation's development. If you were in charge of an LDC, how would you attempt to obtain higher levels of development in those three areas?
7. ***Using the Databank*** Turn to the charts showing the health expenditures as a percent of GDP on page 547. **(a)** Which countries spend the least percentage of GDP on health care? **(b)** How do those countries' figures compare to the amount spent in the United States?

Take It to the NET

Find out more about three countries considered to be among the least developed countries in the world. How many telephones are there per 1,000 people? What is the adult literacy rate? What percentage of the population has access to safe drinking water? Use the links provided in the Social Studies area at the following Web site for help in completing this activity.
www.phschool.com

Economist

Entrepreneur

ECONOMIC *Profile*

W. Arthur Lewis (1915–1991)

W. Arthur Lewis rose from working as a file clerk to become a world authority on economic development. Through his economic models, Lewis hoped to bring nations in Africa, Asia, and Latin America into the global marketplace and to help poor farm workers escape from poverty.

A Man of Ideas

William Arthur Lewis grew up on the island of St. Lucia, a poor British colony in the Caribbean. Leaving school at age 14, he went to work as a clerk in a government office. A few years later, he applied for a scholarship to go to college in Great Britain. He enrolled as a business student at the London School of Economics, and received a Ph.D. in 1940.

Lewis taught economics in Britain until 1958. In 1963, he accepted a position at Princeton University, where he became well respected for stressing ideas over numbers.

A Theory of Economic Development

Lewis focused his research and teaching on developing nations. In 1954, Lewis identified a "dual economy" in poor nations—a small, profitable "capitalist" sector dominated by a large, inefficient "traditional" agricultural sector. In 1955, he expanded his ideas into a book, *The Theory of Economic Growth.*

Lewis drew the path of economic development as an upside-down U. Countries grow rich by moving excess farm workers to factory jobs. On the left of the U were poor countries like Bangladesh, where growth was slow because too many people worked in the countryside. On the right were rich countries like the United States, with large manufacturing sectors and efficient farms. Growth in these wealthier countries was also slow, Lewis argued, because "the gains from diverting labour out of agriculture are almost all exploited." At the top, with the fastest-growing economies, were countries like South Korea, where the labor shifted from agriculture helped fuel manufacturing.

Lewis concluded that poor countries should move workers from farm to factory. This idea provided a model for many developing nations.

International Economic Advisor

Lewis put his ideas into practice as advisor to Ghana and as president of the Caribbean Development Bank. Britain's Queen Elizabeth II knighted him in 1963, and in 1979, Lewis was awarded a Nobel Prize in economics.

Because Lewis supported foreign investment in developing countries, critics once attacked his work as justifying capitalist exploitation. The collapse of socialism in most developing nations in the 1980s and early 1990s helped redeem his work.

CHECK FOR UNDERSTANDING

1. **Source Reading** Explain what Lewis meant when he said that economic growth in developed nations is slow because "the gains from diverting labour out of agriculture are almost all exploited."
2. **Critical Thinking** Why might Lewis's ideas have encouraged developing countries' governments to limit economic freedoms?
3. **Learn More** Research economic growth in an African or Asian nation and describe how closely it has followed Lewis's model for development.

Section 2

Issues in Development

Preview

Objectives

After studying this section you will be able to:

1. **Identify** the causes and effects of rapid population growth.
2. **Describe** the effects of the unequal distribution of the factors of production.
3. **Understand** the importance of human capital to development.
4. **Analyze** how political factors and debt are obstacles to development.

Section Focus

Less developed countries face a variety of complex issues. These include rapid population growth, a lack of natural resources, inadequate quantities of physical and human capital, political instability and government corruption, and debt.

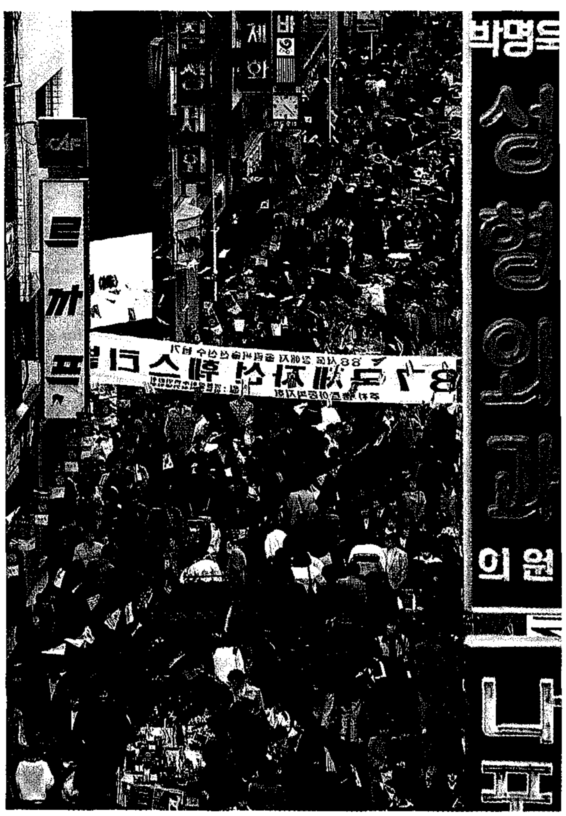
Key Terms

population growth rate
natural rate of population increase
arable
malnutrition

population growth rate *the increase in a country's population in a given year, expressed as a percentage of the population figure at the start of the year*

natural rate of population increase *the difference between the birth rate and the death rate*

If you were an official in the government of a less developed country, you'd quickly discover that there are no easy solutions for ending decades of underdevelopment. The fortunate discovery of oil, diamonds, or some other valuable natural resource could certainly help. Natural resources, however, are but one factor in development.



►**Rapid population growth has created new challenges for South Korea, particularly in its capital, Seoul.**

Rapid Population Growth

One of the most pressing issues in development is the rapid population growth experienced by many less developed countries. Some economists point out that a population's quality of life depends on economic productivity, not on population density. Very dense populations can have rising living standards where free markets foster growth. Nevertheless, the already poor economies of many LDCs have trouble meeting the needs of rapidly growing populations.

Causes of Rapid Population Growth

The **population growth rate** is the increase in a country's population in a given year. It is expressed as a percentage of the population figure at the start of the year. The population growth rate takes into account the number of births, deaths, and the number of people migrating to or from a country.

When analyzing population growth in less developed countries, development experts often focus on the **natural rate of population increase.** This is the difference between the birth rate and the death rate.

Many LDCs are experiencing an increase in life expectancy. This is good news for individuals and families. However, while life expectancy has increased, birth rates have not decreased, at least not significantly.

What this means is that births are far outpacing deaths, leading to rapid population growth.

The age structure of LDCs also contributes to rapid population growth. In many LDCs, a high proportion of the population is of childbearing age. In developed nations, the largest segment of the population is older. Populations in developed nations therefore increase at a much slower rate. Figure 18.5 compares the age structure of low-income economies and high-income economies.

Consequences of Rapid Population Growth

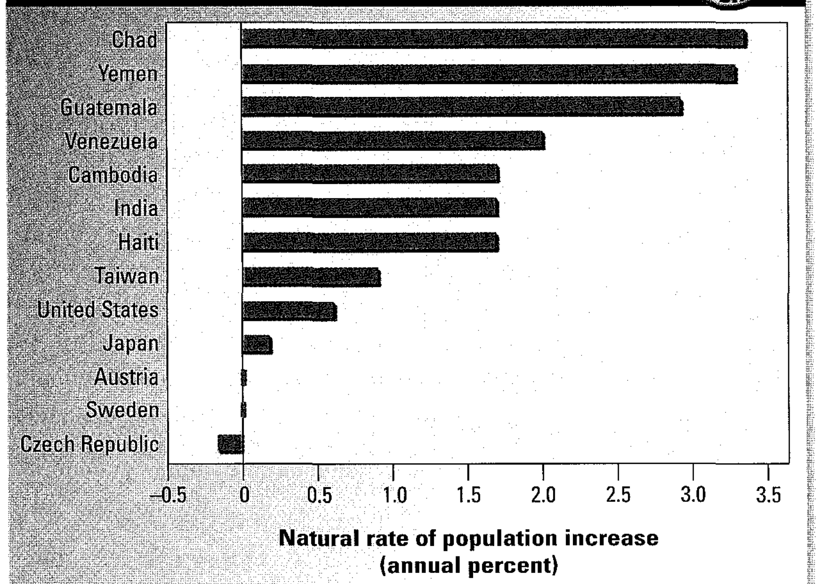
The average population growth rate of the less developed countries is estimated to be around 1.7 percent. This may sound low to you, but at this rate the population of LDCs will double from their 1990 figure of 4.1 billion to over 8 billion by the year 2031. Compare this to the growth rate of developed nations, which is 0.5 percent. Their population won't double until 2129.

To stay at its current level of development, a country that doubles its population must also double employment opportunities, health facilities, teachers and schoolrooms, agricultural production, and industrial output. To increase its level of development, an economy must do even more. With all the obstacles less developed countries face, achieving this level of growth is a daunting task.

On the other hand, some economists argue that population growth creates larger markets; prompts improved transportation and communication to these markets, reducing the likelihood of famine; encourages economies of scale; stimulates diversified production; enlarges the pool of human ingenuity and creativity; and provides more workers to support retirees. Their research shows that per capita income rises about 35 years after the population expands.

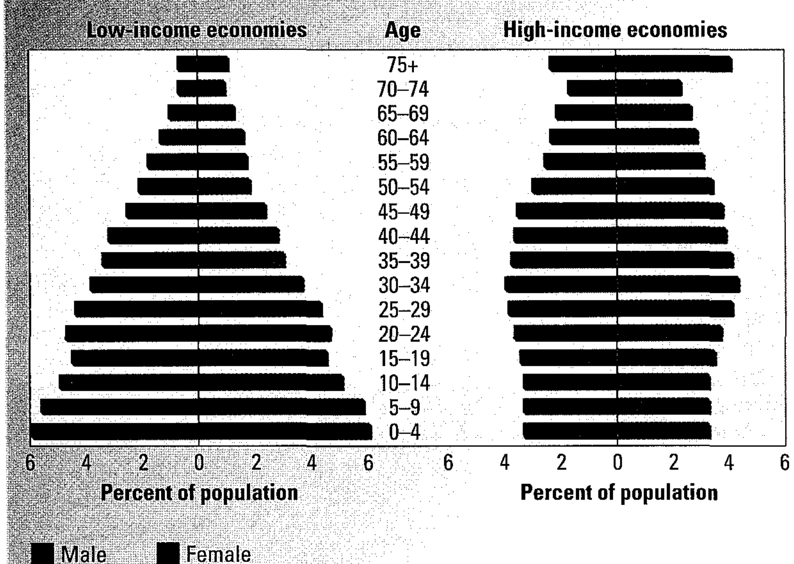
Population growth is only one factor in development. There are additional factors that affect development, as described below. All these factors interact with each other, making both the causes of and solutions to underdevelopment difficult to identify.

Figure 18.4 **Population Growth Rates of Selected Nations, 2001**

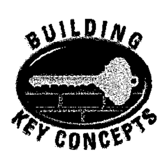


Source: Population Reference Bureau

Figure 18.5 **Age Structures**



Source: World Bank



Rapid population growth results in a large proportion of the population being young and dependent. If the largest segment of the population is too young to work, then production does not increase along with the population.

Standard of Living What is Chad's natural rate of population increase? Describe the shapes of the age structure graphs for low-income and high-income economies. Which shape would you expect Chad's age structure to have? Why?

arable *suitable for producing crops*

Factors of Production

In parts of Africa, Asia, and Latin America, physical geography makes development more difficult. Natural resources are not spread evenly across the globe. Only about 10 percent of Earth's land is **arable,** or suitable for producing crops. Some land is more fertile than other land. Some climates are better for agriculture than others. Key mineral resources, too, are unevenly distributed across the globe. Harsh climates, uncertain rainfall, and lack of good farmland or mineral resources have contributed to the problems of some LDCs.

Sometimes the problem isn't the absence of resources. Rather, it is that the means to utilize resources are lacking in less developed countries.

Technology may help LDCs develop the resources they do have. Technology, however, is costly to develop and requires much capital. As you will read below, the formation of capital is another important issue in development.

Physical Capital

The lack of economic productivity typical of LDCs is due in part to a lack of physical capital. Physical capital, you will recall, is any human-made resource that is used to create goods and services. Without capital, industry cannot grow. Agricultural output remains low.

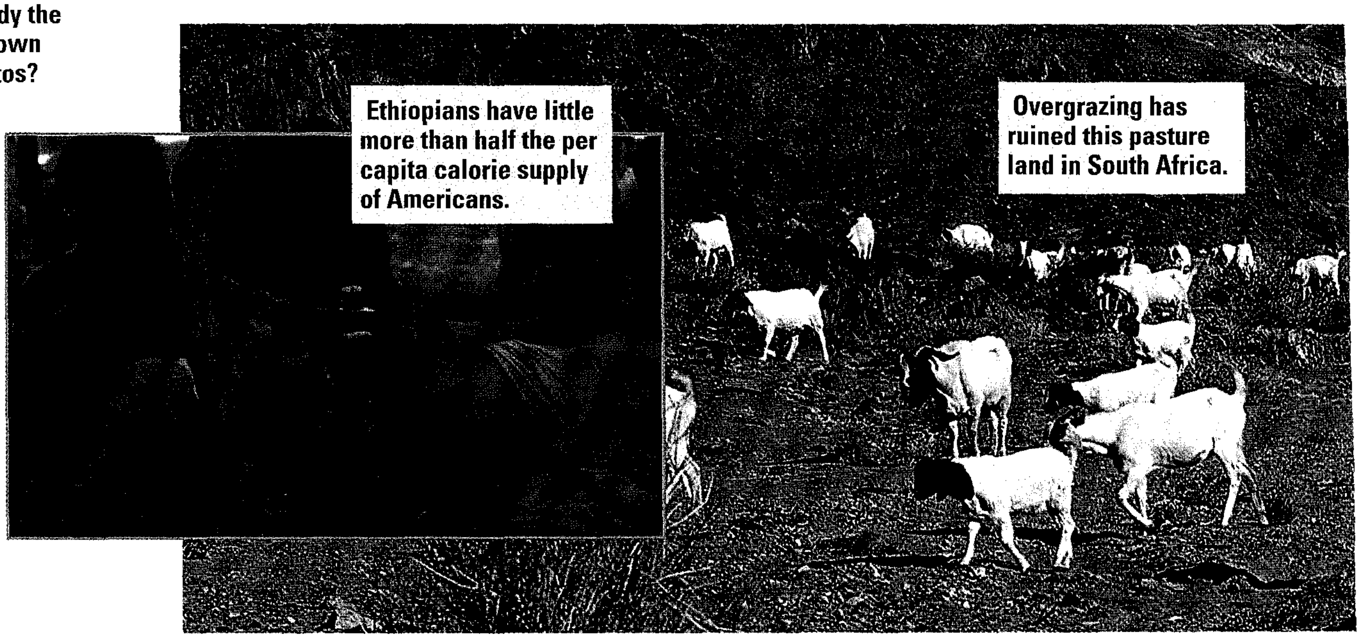
What's more, the resulting subsistence-level agriculture does not give individuals or households the opportunity to save. Neither does the presence of a large dependent segment of a population. A large proportion of dependents means a large number of people who don't produce and who must be supported by others. No savings means no money for purchasing capital.

Some countries turn to foreign investment to boost capital. However, as you will read below, that won't happen unless LDCs invest in human capital.

Human Capital

Human capital is the skills and knowledge gained by a worker through education and experience. Health and nutrition, as well as education and training, are important to the development of human potential. Human capital is crucial to the functioning of an economy. It is the people who develop and utilize technology, who work in agriculture, industry, and services. It is the people who manage businesses and government. When a country doesn't invest in human capital, the supply of skilled workers, industry leaders, entrepreneurs,

▼ How might increased physical and human capital help to remedy the problems shown in these photos?



Ethiopians have little more than half the per capita calorie supply of Americans.

Overgrazing has ruined this pasture land in South Africa.

government leaders, doctors, and other professionals is limited. As a result, foreign investors become discouraged because investment is profitable only if there is a skilled work force to use it.

Health and Nutrition

Proper food and nutrition are necessary not only for survival, but also for physical and mental growth and development. An individual's performance and productivity depend on the benefits of good nutrition.

Inadequate nutrition is called **malnutrition.** The populations of many less developed countries suffer chronic malnutrition. Malnourished mothers may give birth to infants with low birth weight, brain damage, and birth defects. Malnutrition in children slows or delays their physical and mental development. In adults, it can cause lethargy, heart disease, diabetes, and other health problems.

Education and Training

To be able to use technology and move beyond mere subsistence, a nation must have an educated work force. Education and training let people develop new skills and adapt to new technologies and processes. It also helps them develop new and better ways of doing things.

Many less developed countries have low literacy rates. Access to education and participation in education are limited. Adult literacy in many countries is below 40 percent. Only three out of four children in LDCs who begin primary school are still in school four years later. Throughout the world, many children are needed at home to work on the family farm, and have no time to go to school.

Improvements in literacy rates in many countries are held back by the gender gap in education. In highly developed nations, the literacy rates for men and women are nearly identical. In many LDCs, however, women's literacy lags behind that of men. The greatest difference in literacy rates between men and women exists in regions that have poor social and economic conditions for women. Some of the factors that discourage families from investing in the education of girls are the following:

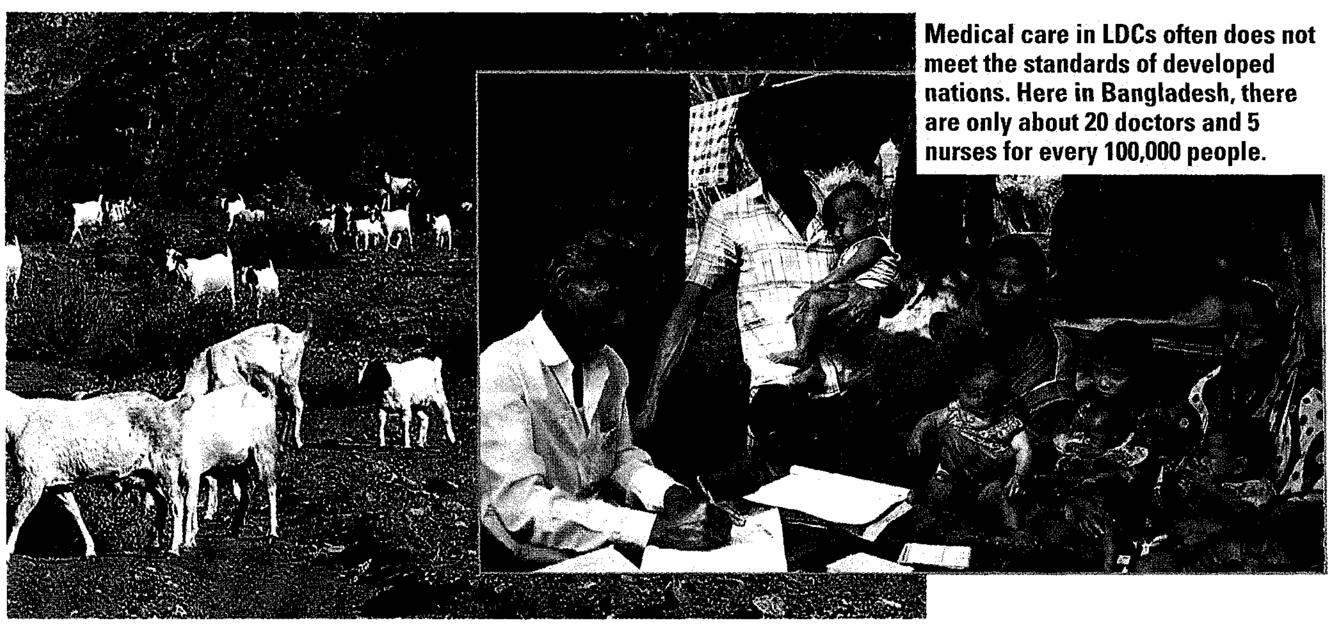
- early child-bearing age
- limited job opportunities for women
- lower wages for women
- cultural factors that devalue women

THE WALL STREET JOURNAL.
CLASSROOM EDITION

In the News *As this excerpt from a* Wall Street Journal Classroom Edition *article shows, increased trade with the United States is helping Mexico increase its human capital.*

"Once-sleepy towns are turning into cities, with malls and multiplexes reminiscent of the U.S. Sunbelt. And laborers, who once sought a better life across the border, are now settling in the arid north of Mexico to work in factories that have become critical to the global production plans of U.S. firms."

malnutrition
inadequate nutrition



Medical care in LDCs often does not meet the standards of developed nations. Here in Bangladesh, there are only about 20 doctors and 5 nurses for every 100,000 people.

Figure 18.6 Education and Literacy

	School enrollment rate (percentage enrolled)		Literacy rate (percentage literate)	
Country	**Female**	**Male**	**Female**	**Male**
United States	99	91	97	97
Peru	79	81	83	94.5
Indonesia	61	68	78	89.6
Nigeria	41	49	47.3	67.3
Yemen	29	72	26	53
Chad	20	42	34.7	62.1
Niger	12	20	6.6	20.9

Sources: United Nations Development Program, *CIA World Factbook*, 2001

These Saudi Arabian women (right) are participating in a university course. Since 1960, public education has been opened to Saudi women—if they have permission from their families. **Standard of Living Examine the table. What patterns do you see in the school enrollment and literacy rates of males and females?**

"Brain Drain"

Wealthy people in LDCs have the most access to education. Yet, many of the best-educated citizens leave to live and work in developed nations. The scientists, engineers, teachers, and entrepreneurs of LDCs are often attracted to the enormous opportunities developed nations can offer. This loss of educated citizens to the developed world is called "brain drain."

Political Factors

Political factors have limited and even reduced the development of many poor nations. These factors include dependence on former colonial powers, experiments with central planning, and corrupt and unstable governments.

From Colonial Dependency to Central Planning

Many LDCs are former colonies of European powers. As colonies, they had to supply their rulers with agricultural products and raw materials. In turn, they were forced to rely on their colonizers for manufactured goods. This relationship prevented the development of industry within the colonies.

After achieving independence following World War II, many of these new nations turned to central planning, rather than free enterprise, in an effort to modernize their economies quickly. They made some gains in the 1950s and 1960s. In the long run, however, central planning hindered economic growth. As you will read in Section 4, many LDCs are now making the transition to free enterprise.

Government Corruption

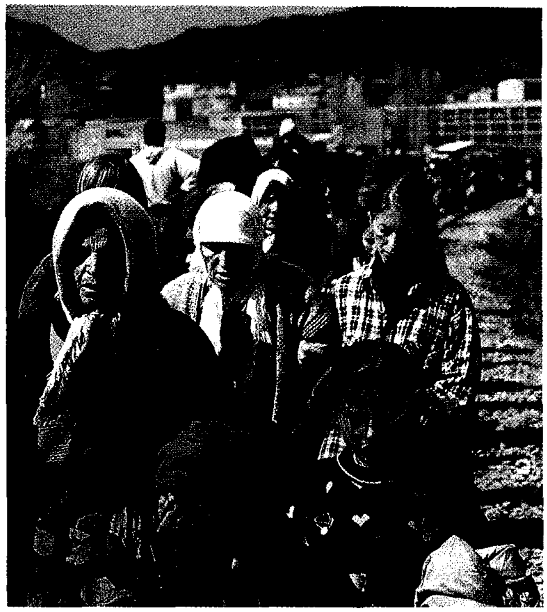
Corruption in the governments of many LDCs also holds back development. Leaders often make political decisions and laws to benefit themselves and their friends, not the country at large. Economic policies often benefit only the urban minority, which has greater political influence.

For example, Mobutu Sese Seko, the president of Zaire (now the Democratic Republic of Congo) from 1965 to 1997, ran a government noted for its corruption and mismanagement. Mobutu Sese Seko used his position to accumulate one of the largest personal fortunes in the world. As he plundered the nation's treasury and natural resources, Zaire's infrastructure crumbled for lack of funding. Today, the country is one of the poorest in the world, with a per capita GDP of only $98.

Political Instability

Civil wars and social unrest plague many less developed countries. El Salvador, Lebanon, Cambodia, and Rwanda, for example, suffered years of civil unrest.

In these countries, war has killed millions of people and created millions of refugees. Military leaders spend huge sums of money on weapons and warfare instead of on education, housing, health care, or other investments in development.



◀ **Civil unrest in the former Yugoslavia produced scores of refugees, like these ethnic Albanians forced from Kosovo in the late 1990s. It also reduced opportunities for development in the region.**

Debt

In the 1970s and 1980s, many less developed countries acquired loans from foreign governments and private banks to finance development. Events in the world economy, however, have hindered repayment of these loans.

In 1973, a political crisis in the Middle East prompted the oil-producing nations of the Organization of Petroleum Exporting Countries (OPEC) to reduce oil exports, and then to raise prices. The price of crude oil rose from \$8 a barrel to \$35 a barrel. Many LDCs, like most of the world, depend heavily on oil from OPEC. Many had to borrow yet more money to import oil. Increased debt made repayment of loans difficult, if not impossible, for many LDCs.

Between 1980 and 1985, the value of the U.S. dollar appreciated, or increased in value against other currencies, on the world market. Since most of their loans were based on U.S. dollars, LDCs, as a result, had further difficulty in repayment.

Between 1970 and 1984, the combined debt of LDCs increased by 1,000 percent to \$700 billion. Today it exceeds \$1.5 trillion. In some countries, the foreign debt is greater than the annual gross domestic product. In the next section, you will read about the ways debt repayment is being handled.

Section 2 Assessment

Key Terms and Main Ideas

1. What is **population growth rate?**
2. How does **arable** land play an important role in a nation's development?
3. How does a lack of physical capital hinder development?
4. What is the connection between human capital and foreign investment?
5. How does **malnutrition** affect human capital?
6. Why are many less developed countries carrying a large burden of debt?

Applying Economic Concepts

7. ***Math Practice*** The United States has a population of about 281 million and a population growth rate of about 0.97 percent. By how many people do you expect the nation's population to increase over the next year?
8. ***Critical Thinking*** How does the formation of physical capital relate to resource development?
9. ***Decision Making*** As leader of a less developed country, what measures could you undertake to limit "brain drain"?

Take It to the NET

The natural environment is an important resource, both in developed nations and less developed countries. Research current environmental issues facing less developed countries and summarize your findings in one paragraph. Use the links provided in the Social Studies area at the following Web site for help in completing this activity. **www.phschool.com**

Skills for LIFE

Using the Writing Process

Good writers generally follow three steps in the writing process: prewriting, writing, and revising. During the prewriting stage, the writer decides what to write about and gathers information. In the writing stage, the writer decides the purpose of the writing, the audience, and the best form for the work. The writer then prepares a first draft. During the revising stage, the writer reviews the draft for sense, style, and errors, and shapes the work into its final form. Use the following steps to learn more about the writing process.

1. **Prewriting: Develop ideas for writing and organize your information.** Decide upon a general topic, and then brainstorm several possible areas to explore within the topic. Research these subtopics in the library or on the Internet, and list what you have found under each topic. Organize your research findings into a chart like the one below. Use the chart to answer the following questions. (**a**) What has this student chosen to research for his essay? (**b**) Why do you think he chose these three countries? (**c**) What is a likely title for his essay?

Comparison of Three Economies

United States' economy	Sweden's economy	China's economy
market-based economy with low level of government control	mixed economy with moderate level of government control	centrally planned economy with high level of government control
mostly white-collar work force	mostly white-collar work force	mostly blue-collar work force, strong in agriculture and manufacturing
imports much more than it exports	exports and imports balanced	exports much more than it imports
relatively low taxes	high taxes	relatively low taxes

2. **Writing: Identify who will read the work and what the purpose is, and write a first draft.** (**a**) Who are the likely readers of this essay? (**b**) How should this affect the tone and style of the writing? (**c**) Would the writer be likely to use an eyewitness approach, an analytical approach, or a biographical approach? Why? (**d**) Write a topic sentence for the first draft of this essay.

3. **Revising: Review your writing to see whether it makes sense.** Ask one of your classmates to read your topic sentence and make suggestions for improving it. (**a**) What changes were suggested? (**b**) Rewrite your sentence based on any useful suggestions your classmate gave you.

Additional Practice

What problems do you foresee with using a chart to organize ideas? Can you think of an alternative way to organize your research findings?

Section 3

Financing Development

Preview

Objectives

After studying this section you will be able to:

1. **Understand** the role investment plays in development.
2. **Identify** the purposes of foreign aid.
3. **Describe** the functions of various international economic institutions.

Section Focus

Less developed countries can obtain capital for economic development through investment, loans, and grants. Economic policy advice and technical help are also valuable aids to development.

Key Terms

internal financing
foreign investment
foreign direct investment (FDI)
foreign portfolio investment
World Bank
United Nations Development Program (UNDP)
International Monetary Fund (IMF)
debt rescheduling
stabilization program

Building an infrastructure, providing education and health care, and creating technology and industry all require large sums of money. Less developed countries often turn to wealthier nations for the money they need to develop their economies. Businesses, individuals, foreign governments, banks, and development organizations all contribute to the financing of international development.

Investment

As you read in Section 2, the creation of capital is crucial to development. But where does the money for purchasing capital come from? A country can use two methods to finance its economic development. It can either use internal financing or external investment. **Internal financing** is derived from the savings of the country's citizens. A developing country can also look to the developed world for investment funds. External investment originates from other countries and is called **foreign investment.**

Internal Financing

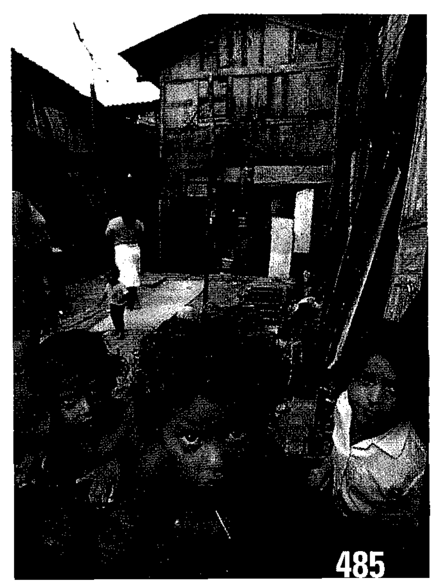
Recall from Chapter 11 the role that personal savings and investment play in capital formation. Savers deposit money in banks. Banks, in turn, lend money to firms. Firms invest in physical and human capital so they can expand. They create new products and provide new jobs. Job growth enables individuals to improve their standard of living. The economy as a whole grows.

In many less developed countries, large segments of the population do not have enough money to save. Many do not even have enough to meet their basic needs. The wealthy elite, with plenty of money to save and invest, often keep their money in foreign banks. They also often invest in foreign companies. This is because overseas savings and investments are often

internal financing *financing derived from the savings of a country's citizens*

foreign investment *investment originating from other countries*

▼ In Brazil, as in most LDCs, the country's large poor population (right) has no money to save, while the tiny elite population (left) chooses to invest its money overseas.



▲ **LDCs often have dual economies: domestic production consisting largely of subsistence agriculture and local markets, and export production in foreign-owned multinational corporations, such as the garment factory show here. Do you think MNCs help or hurt less developed countries? Explain your reasoning.**

more secure. As a result, there is often little internal financing. Most LDCs must, therefore, turn to foreign investment to finance development.

Foreign Direct Investment

There are two types of foreign investment: foreign direct investment and foreign portfolio investment. **Foreign direct investment (FDI)** is the establishment of an enterprise by a foreigner. For example, a foreign company can build a factory in an LDC, merge with an existing firm in an LDC, take over a firm in an LDC, or enter into a partnership with a firm in an LDC. Foreign direct investment often takes the form of a multinational corporation (MNC) establishing production facilities in an LDC. As you recall from previous chapters, a multinational corporation is a large corporation that produces and sells goods and services throughout the world.

foreign direct investment (FDI) *the establishment of an enterprise by a foreigner*

foreign portfolio investment *the entry of funds into a country when foreigners make purchases in the country's stock and bond markets*

MNCs are often attracted to less developed countries in their search for profit. An MNC might locate in a less developed country to take advantage of the natural resources available and the large and cheap labor force. It may also wish to introduce its products to the country.

Some economists feel that MNCs have a positive effect on LDCs. The presence of an MNC can introduce technology, provide jobs, train the labor force, and provide the opportunity for related services and industries to develop.

Other economists argue that MNCs do little to aid less developed countries. These economists argue that most of the money earned by MNCs is not reinvested in the LDC. It goes to the foreign owners of the corporation. On the other hand, if the money were reinvested in the host LDC, critics of MNCs argue, foreign control of the economy would increase.

Supporters of MNCs point to the job opportunities these large corporations provide. But, others argue, most of the industries introduced by MNCs are capital-intensive. That is, they are highly mechanized, providing few jobs relative to the massive size of the labor pool in less developed countries.

Finally, many are concerned about the potential for unethical behavior on the part of MNCs. MNCs are attracted to the labor force of LDCs because wages in LDCs are very low compared to wages in industrialized nations. It can be argued that the cost of living in LDCs is also relatively quite low, justifying the low wages. However, critics charge MNCs with underpaying workers and using the justification that a poorly paying job is better than no job at all. In addition, in many countries, companies do not have to provide the same high standard of working conditions or environmental protection required in industrialized nations.

Foreign Portfolio Investment

Foreign portfolio investment is the entry of funds into a country when foreigners make purchases in the country's stock and bond markets. For example, an investor in the United States buys shares in a mutual fund. The mutual fund buys shares in a foreign company. That company then takes the money gained by the sale and uses it to build another plant or to pay for research and development. In other words, the funds lead indirectly to increases in production.

Foreign Aid

In Section 2, you read about development loans given to LDCs by foreign governments. Sometimes, foreign governments give, rather than loan, money and other forms of aid for development. Many developed nations provide aid to less developed countries for building schools, sanitation systems, roads, and other infrastructure. Such assistance can be motivated by humanitarian concern for the welfare of fellow human beings.

However, there are also military, political, economic, and cultural reasons for one country to extend aid to another. For example, in the early 1940s, the United States gave nearly $50 billion in food, weapons, ammunition, and other supplies to its allies in World War II. Government officials believed that this aid would help win the war. More recently, the United States has supplied large amounts of military aid to nations such as Israel, Egypt, and Taiwan.

In the years following World War II, political and economic concerns motivated American foreign aid policies. American officials noted that the Soviet Union had extended its power by establishing more Communist governments with centrally planned economies around the world. Such actions threatened both democracy and free market economic systems. Containment, or prevention of such expansion, became the cornerstone of American foreign policy.

In 1947, Secretary of State George C. Marshall unveiled a plan to help restore the war-torn countries of Europe so that they might create stable democracies and achieve economic recovery. Congress approved the plan in 1948. Over the next four years, the United States sent $13 billion in grants and loans to Western Europe. The region's economies soon recovered, and the United States gained new markets for American goods.

During the 1990s, the same logic that motivated foreign aid under the Marshall Plan prompted many countries to work together to fund the redevelopment of the war-torn Balkan nations. Figure 18.7 shows the top five recipients of aid from the United States.

International Economic Institutions

Several international institutions promote development. Among the most prominent are the World Bank, the United Nations Development Program, and the International Monetary Fund.

World Bank

The largest provider of development assistance is the **World Bank,** founded in 1940. The World Bank raises money on the financial markets and accepts contributions from the wealthier member nations.

The World Bank offers loans, advice, and other resources to more than 100 LDCs. The World Bank also coordinates with other organizations to promote development throughout the world.

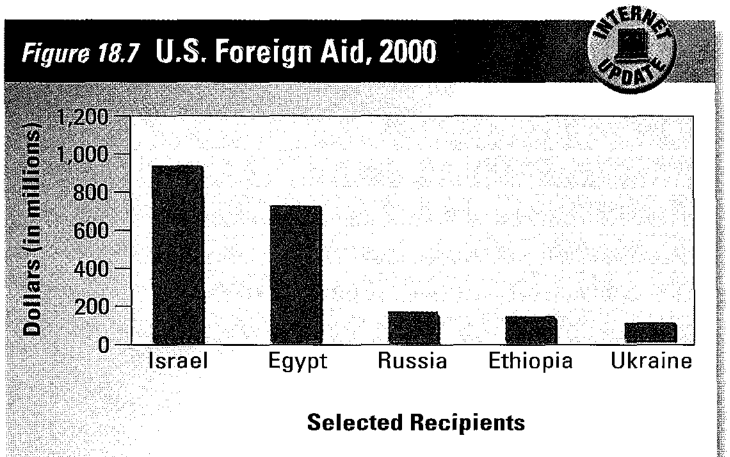
United Nations Development Program

The **United Nations Development Program (UNDP)** is dedicated to the elimination of poverty through development. The UNDP

World Bank *the largest provider of development assistance*

United Nations Development Program (UNDP) *United Nations program dedicated to elimination of poverty through development*

Figure 18.7 **U.S. Foreign Aid, 2000**

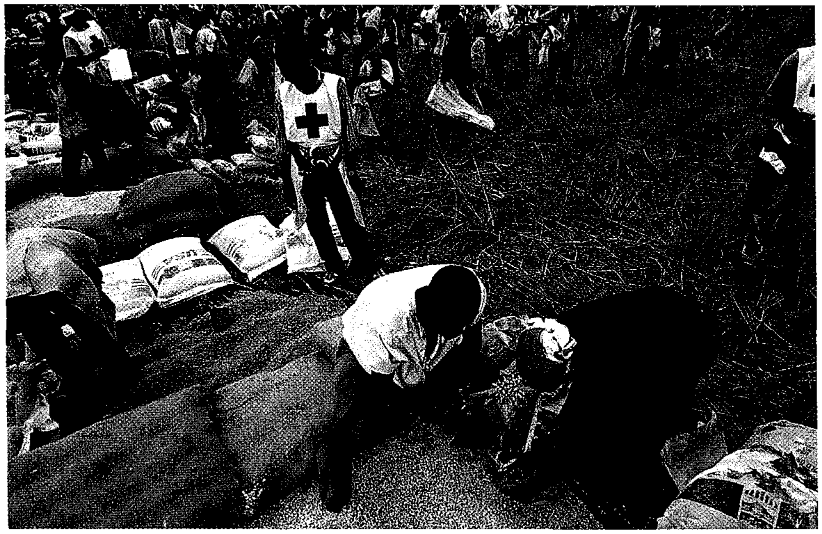


Source: *United States Agency for International Development*

BUILDING KEY CONCEPTS

Military, political, and humanitarian concerns motivate the United States to extend aid to certain nations.

Government Why might it be in the interest of the United States to provide aid to Russia?



▲ **Some international institutions, like the Red Cross and the World Food Program, support development by providing disaster relief. Here, workers delivered food aid to victims of Rwanda's ethnic turmoil in the mid-1990s.**

International Monetary Fund (IMF) *organization formed to stabilize international exchange rates and facilitate development*

debt rescheduling *lengthening the time of debt repayment and forgiving, or dismissing, part of the loan*

stabilization program *an agreement between a debtor nation and the IMF in which the nation agrees to revise its economic policy*

is one of the world's largest sources of grant funding for economic and social development. It devotes 90 percent of its resources to 66 low-income nations, where 90 percent of the world's poorest people live. The UNDP is funded by the voluntary contributions of United Nations member states and agencies.

International Monetary Fund

The **International Monetary Fund (IMF)** was originally developed to stabilize international exchange rates. Since its establishment in 1946, the IMF has expanded its role to facilitate development. The IMF primarily offers policy advice and technical assistance to LDCs. It also intervenes when LDCs need help in financing their international transactions.

The International Monetary Fund is often viewed as a last resort for struggling LDCs. If a less developed country has trouble repaying a debt, it may ask its lenders to reschedule the debt. **Debt rescheduling** involves lengthening the time of debt repayment and forgiving, or dismissing, part of the loan. In return, the debtor nation is expected to accept a stabilization program from the International Monetary Fund.

A ***stabilization program*** is an agreement between a debtor nation and the IMF. In the agreement, the nation agrees to change its economic policies to provide incentives for higher export earnings and to lower imports. By increasing exports, an LDC can earn more foreign money that can be used to pay off its debt.

Stabilization programs are sometimes controversial because they can have a negative impact on the poor in the short term. They often require the lifting of wage and price controls, causing wages to go down while prices go up. They may also include cuts in government spending on health and education services. Stabilization programs may also decrease domestic consumption of goods in order to increase exports.

Section 3 Assessment

Key Terms and Main Ideas

1. How do **internal financing** and **foreign investment** differ?
2. What is **foreign direct investment?**
3. What is **foreign portfolio investment?**
4. What are some of the ways international economic institutions help less developed countries?
5. What roles do **stabilization programs** play in **debt rescheduling?**

Applying Economic Concepts

6. ***Decision Making*** Your corporation is thinking about opening a factory in a less developed country. What economic factors will you consider? What ethical factors will you consider? What political factors might be important to consider?
7. ***Try This*** Suppose that you are the president of a less developed country. Write a speech to persuade the wealthy elite of your country to invest at home.

Take It to the NET Volunteerism and philanthropy also play a role in aiding less developed countries. Outline one potential activity that you or your class could participate in to aid development. Use the links provided in the Social Studies area at the following Web site for help in completing this activity. **www.phschool.com**

Section 4

Transitions to Free Enterprise

Preview

Objectives

After studying this section you will be able to:

1. **Identify** some important steps in moving from a centrally planned economy toward a free market economy.
2. **Describe** the political and economic changes that have taken place in Russia in recent decades.
3. **Describe** the actions that China's communist government has taken to introduce free market reforms into China.

Section Focus

Making the transition from a command economy to a market economy is a difficult process. The shift requires tremendous changes on the part of the government and workers.

Key Terms

privatization
work ethic
glasnost
perestroika
light industry
special economic zones

As you read in Section 2, many less developed countries have discovered that a centrally planned economy limits development. For this reason, many communist nations are reshaping their economies. Some, like the former Soviet Union, are dismantling their centrally planned economic systems entirely and replacing them with market-based systems. Others, like China, are modifying their centrally planned economies to incorporate some free market practices.

The transition to free markets and capitalism is a huge adjustment for an economy and a nation. As you will read below, Russia has had to adjust to rapid changes in the economy and political system. China, on the other hand, is slowly introducing market reforms within its existing communist system.

Moving Toward a Market Economy

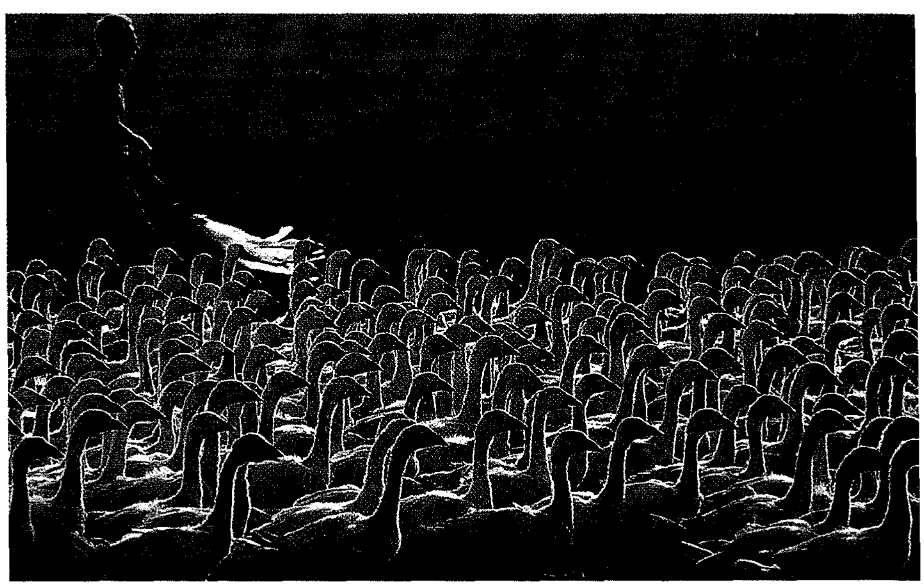
One of the key elements of a centrally planned economy is that the government, not individuals, owns and controls the factors of production. The government answers the three key economic questions of what to produce, how to produce it, and how to distribute goods and services. In contrast, in a market-based economy, the factors of production are owned by individuals. Individual buyers and sellers answer the three economic questions. One of the first steps, then, in moving from a centrally planned economy to a market economy is privatization.

Privatization

Privatization is the sale or transfer of government-owned businesses to individuals. Private ownership gives individuals, rather than the government, the right to

privatization *the sale or transfer of state-owned businesses to individuals*

▼ Hungary slowly began privatizing its economy in the 1960s. Instead of raising his flock on a collective, today this goose farmer raises geese at his own expense. He then sells the meat and feathers to a cooperative, keeping all the profits.



make decisions about what to produce and how much to produce.

There are several ways in which a government can privatize a state-owned business. First, it can simply sell the business to one owner. Another option is to sell shares in the business to interested individuals. A third method is to give every citizen a voucher or certificate that can be used to purchase shares in the businesses when they are privatized.

Simple as this may sound, privatization is a complicated process. One difficulty in privatizing is that only the profitable production facilities will continue to operate. No one will want to buy unprofitable facilities, so many people will lose their jobs. Other job opportunities will eventually appear as successful operations are expanded. However, there may be a period when total employment drops. Some people oppose privatization because it means the end of secure, lifelong government jobs with little or no competition. In a free market, jobs are not guaranteed.

Another difficulty is that there may be only one or two firms in a certain market. Even after firms are privatized, there will be little competition with so few privatized firms.

Protecting Property Rights

Even when it gives up its role as the owner and decision maker, the government still plays a vital role in ensuring the success of a new market-based economy. Legal systems under central planning do not include laws guaranteeing private property rights. A free market cannot function without such rights. As a result, the government must create new sets of laws that ensure a person's right to own and transfer property.

If property rights are uncertain, entrepreneurs will not be willing to make large

Figure 18.8 **Communist and Noncommunist Nations**

BUILDING KEY CONCEPTS

Beginning in the late 1980s, communism in Eastern Europe began to collapse. Countries such as East Germany, Poland, Hungary, and Czechoslovakia made profound changes in their governments and their economies.

Economic Systems Roughly what percentage of the world remains communist?

investments and take risks because there will be no guarantee they will benefit from successful projects. Entrepreneurs need law and order to prevent criminals from stealing the profits from legitimate enterprises. They also need a legal system that prevents the government from unduly interfering with their everyday business activities.

It will take time to develop the legal culture necessary to support a market-based economy. To have a successful market-based economy, the government must establish property rights, enforce laws, and provide a framework of regulation. Western market economies have developed the roles of government gradually over many decades. Economies making the transition to free markets need to develop these roles more rapidly.

More New Roles for Government

During privatization, government must be prepared to deal with the unrest that might develop from rising unemployment. A government could, for example, institute unemployment insurance.

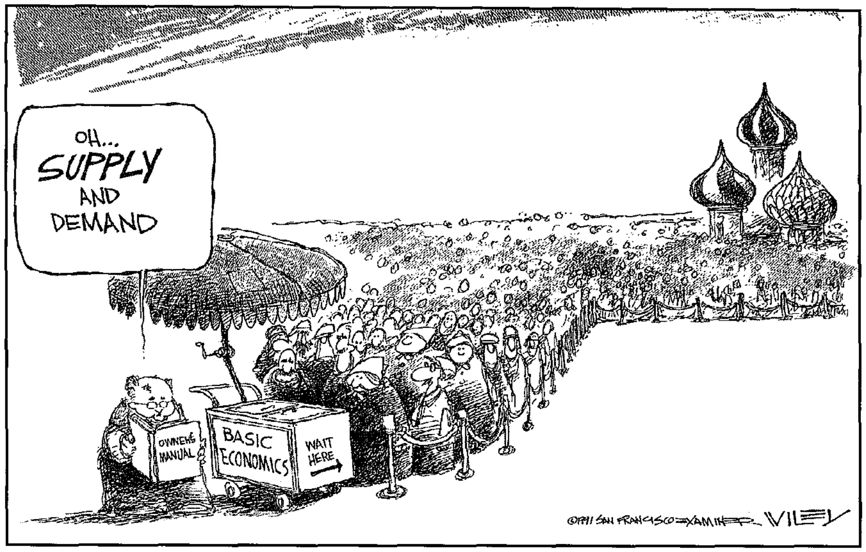
The government can also play a role in helping workers make the transition from a centrally planned economy to a market economy. Workers in transition often need to learn a new **work ethic**, or system of values that gives central importance to work. In a free market, incentives, not quotas, influence people's labor.

Transition in Russia

Russia was once the dominant republic of the Soviet Union and the world's most powerful communist nation. In the latter part of the twentieth century, the lagging Soviet economy prompted economic and social reform. Change came quickly to Russia, as economic freedom led to the desire for political freedom.

Communism in Russia

As you read in Chapter 2, the Soviet Union arose out of a pair of revolutions in Russia in 1917, followed by three years of civil war in which the Communists, led by Vladimir Lenin, won control of the government. Under the repressive control of the Communist party, central planning was introduced during the 1920s.



▲ Entrepreneurs in the former Soviet Union had a lot to learn about free market systems.

The Soviet government reorganized farmland into state farms and collective farms. State farm workers received wages, similar to factory workers. On the collectives, workers shared any surpluses that remained after the required quantity of products was sold and expenses were paid. Few incentives existed to encourage farmers to work hard. As a result, agricultural output remained low.

Soviet policy also emphasized the development of heavy industry. By 1940, the Soviet Union was the second-largest producer of iron and steel in Europe. The growth of heavy industry, however, came at a great opportunity cost. With so much land, labor, and capital being devoted to heavy industry, little was left over to produce consumer goods. Everyday items such as soap and shoes were in short supply.

Glasnost and Perestroika

In the late 1980s, a new leader, Mikhail Gorbachev, began a series of radical political and economic reforms. Because Gorbachev believed that economic prosperity could not happen without political freedom, he introduced ***glasnost***. A policy of "openness," *glasnost* encouraged Soviet citizens to say what they wished without fear of government persecution.

work ethic *system of values that gives central importance to work*

glasnost *a policy of political "openness" introduced into the Soviet Union in the late 1980s*

FAST FACT

Corruption and unfair market conditions have hampered Russia's development. ***Foreign direct investment*** *in Russia equals only about 1 percent of its GDP.*

Gorbachev's economic reform was a plan for economic restructuring, called ***perestroika.*** *Perestroika* called for a gradual change from a centrally planned system to free enterprise. Gorbachev's main desire was to incorporate the use of markets and incentives into the existing structure of communism.

perestroika *Soviet leader Gorbachev's plan for economic restructuring*

Under *perestroika,* the government began to allow factory managers, rather than central planners, to decide what goods to produce and how much to charge for them. It converted several factories from the production of military goods to the production of consumer goods. Many factories set goals to improve the quality of goods produced. For the first time in decades, people were allowed to start their own businesses.

Farmers were granted long-term leases on land. By making farmers their own bosses, Gorbachev hoped to increase food production.

With little experience in democracy and free enterprise, however, the transition to a market economy proved difficult. Economic reform produced some initial hardships. People lost secure government jobs, benefits, and pensions. Many people, especially the elderly, were hurt financially. Other Russians, however, quickly began to make the new system work for them, starting their own businesses. Many prospered.

Collapse of Communism

Enjoying the newfound freedoms of *glasnost* and *perestroika,* many people called for a complete end to communism and the domination of the central government. In 1991, Russians voted in their first democratic election. They chose Boris Yeltsin as president of the Russian Republic. A few months later, some officials and army officers tried unsuccessfully to restore old-style communism. The attempt backfired. One by one, the Soviet republics declared themselves independent nations. At the end of the year, Gorbachev resigned as leader, announcing the end of the Soviet Union.

Transition to the Free Market

Yeltsin came to power by promising rapid progress towards a market-based economy. Under Yeltsin's administration, there were improvements in the economy. But many hardships continued. Prices of goods in the Soviet Union were kept artificially low by the government. In 1992, Yeltsin lifted price controls. Now that prices were controlled not by the government, but by the workings of supply and demand, prices tripled.

The distribution of wealth tended to be concentrated in the urban centers such as Moscow. The uneven distribution of income led many to call for additional change. It also led to extensive corruption within the economy, including widespread organized crime.

Billions of dollars in financial aid flooded into the country from the World Bank, the International Monetary Fund, and through independent donations. However, due to mismanagement and corruption, the funds were not used efficiently.

Russia and the former Soviet republics have great potential, however. Together they comprise a market about the size of the United States, Mexico, and Canada combined, and three quarters the size of the European Union.

▼ In 1991, Communist hard-liners failed in their efforts to overthrow the democratically elected government of Boris Yeltsin. Yeltsin supporters blocked the Soviet army from the parliament building during the coup.

Transition in China

In the first half of the twentieth century, China struggled with civil war. In 1949, the supporters of communism, led by Mao Zedong, defeated the anticommunist nationalists. The Nationalist party retreated to what is now Taiwan. The communists took power in China's capital city, Beijing. Since then, China developed its own version of communism.

The Great Leap Forward

In 1958, Mao introduced an ambitious development plan called the Great Leap Forward. The Great Leap Forward was intended to turn China into a world economic power in the shortest time possible. All of the country's land was taken over by the central government. The people were organized into self-sufficient settlements called People's Communes.

These communes, sometimes with as many as 25,000 people, contained both farms and industries. Life in a People's Commune resembled life in the military. Communist party officials made all the decisions about what goods were made and who received them. The people's task was simply to work in the fields or factories. They received the same rewards no matter how much or how little they produced.

The Great Leap Forward was a huge disaster. Without incentives for workers, production fell. In the ensuing famine, about 20 million people starved to death under this development plan.

The Cultural Revolution

In the 1960s, Mao instituted a Cultural Revolution. His intention was for China to further embrace communism by destroying all traces of the past. Mao organized an army of radical young men and women, called the Red Guards, to carry out his policy. The Red Guards persecuted people in their attempt to eradicate what Mao called "the Four Olds": old ideology, old thought, old habits, and old customs. Mao succeeded only in further damaging the Chinese economy.

▲ **During China's Cultural Revolution, Mao's sayings were collected and distributed in what became known as Mao's "little red book."**

Transition to the Free Market

Mao died in 1976. He was succeeded by Deng Xiaoping. Deng introduced a new approach that not only shifted more power to local government, but also used the tools of the free market to improve productivity.

Deng began a program of economic reform called the Four Modernizations. The goals of the program were to improve agriculture, industry, science and technology, and defense as quickly as possible. Deng was not afraid to use free enterprise as a means of accomplishing these goals.

Deng replaced the People's Communes with the contract responsibility system. Under this arrangement, the government rented land to individual farm families. Each family then decided for themselves what to produce. The families contracted with the government to provide a certain amount of crops at a set price. Once the contract was fulfilled, they were free to sell any extra crops at markets for whatever prices they could get.

Under this system, farmers had the incentive to grow more crops. Farmers increased their production by about 8 percent. In the first eight years of the program, their incomes tripled.

Industry

As in the Soviet Union, when the communists came to power in China they had used most of the nation's resources to increase

THE WALL STREET JOURNAL.
CLASSROOM EDITION

In the News *As this excerpt from a* Wall Street Journal Classroom Edition *article shows, China is making strides in eliminating poverty.*

"The World Bank says poverty in parts of Asia is in a remarkable decline. . . . China is still home to more than three-fourths of the region's poor—269 million in 1995 by the World Bank's estimates—but this number is less than half of what it was two decades before."

heavy industry. By the time Deng came to power, however, Chinese technology was outdated.

Deng had two goals for industry. First, he wanted people to spend more money on consumer goods. Therefore he changed the focus on production to **light industry,** or the production of small consumer goods such as clothing, appliances, and bicycles. He also wanted factories to increase production. To accomplish this, Deng gave more decision-making power to factory managers. He started a system of rewards for managers and workers who found ways to make factories more productive.

light industry *the production of small consumer goods*

special economic zones *designated regions in China where foreign investment is encouraged, businesses can make most of their own investment and production decisions, and foreign companies are allowed to operate*

Economic Zones

In addition, Deng set up four **special economic zones** along China's east coast. In these zones, local governments are allowed to offer tax incentives to foreign investors. Businesses are allowed to make most of their own investment and production decisions. Foreign companies are allowed to operate in these zones. Deng located these first four zones near Hong Kong and Taiwan. He hoped to attract foreign investment, companies, and technology from these economic giants. The zones have proved so successful that China now has hundreds of these special economic zones.

Most of China's rapid economic growth has taken place in the special economic zones of the coastal cities. The interior regions lag far behind. The population has also shifted dramatically. About 120 million people have left the interior villages to seek their fortunes in the booming cities. Rapid urban growth has resulted in an increase in crime that the weak and sometimes corrupt police force has trouble handling.

Despite these negative effects, the economy has benefited. Since the start of Deng's reforms, China's economy has quadrupled in size. The question now at hand is whether or not China's political leaders will be able to maintain their Communist regime in the face of pressures for cultural freedom brought about by economic freedom. China's leadership continues to come under criticism for its violations of human rights and political repression.

Section 4 Assessment

Key Terms and Main Ideas

1. Identify three factors necessary for the transition to free enterprise.
2. Why is **privatization** necessary to create a free market economy?
3. What is ***glasnost?***
4. What is ***perestroika?***
5. Why was the Great Leap Forward such a disaster for China?
6. How does **light industry** differ from heavy industry?
7. What role do **special economic zones** play in China's transition to free enterprise?

Applying Economic Concepts

8. ***Critical Thinking*** What is the main difference between transition in Russia and transition in China?
9. ***Problem Solving*** How could China expand its economic success to the interior?

Take It to the NET

Photocopy a map of China that includes cities, provinces, and major waterways. On your map, use stars to indicate special economic zones. Why do you think these particular locations were chosen? Write a brief caption describing the location of these zones. Use the links provided in the Social Studies area at the following Web site for help in completing this activity. **www.phschool.com**

The World Bank and Economic Assistance

As World War II drew to a close, much of Europe lay in ruins, and the World Bank was created to help finance the reconstruction. Within a few years, the World Bank changed its mission from helping rebuild war-torn areas to helping developing nations achieve stable economic growth.

▲ The World Bank helps finance highway construction in developing nations such as Colombia.

Function The primary function of the World Bank is to make loans to countries unable to borrow from other sources. Its loans are used for many purposes: to improve health care, to build transportation networks, and to promote economic reforms. The Bank makes about $20 billion in new loans each year.

The World Bank raises most of its money in financial markets by issuing bonds. In addition, it receives contributions from its member nations, including industrialized nations such as the United States and Japan. Even some developing nations, once borrowers from the World Bank themselves, make contributions.

Controversy Despite its worthwhile goals, the World Bank has sometimes been a source of controversy. Some critics have argued that the United States would be better off using its money to help less fortunate American citizens. Others have criticized the Bank for not holding developing nations fully accountable for effectively carrying out projects it has funded.

Accomplishments Still, the World Bank can boast of many significant accomplishments. It has helped many developing countries improve roads, hospitals, schools, and water supplies. In addition, by strengthening the economies of less developed countries, the World Bank has helped build new markets for American goods, which in turn benefits the economy of the United States.

Per Capita Earnings in Selected Countries

GDP per Capita Earnings	Countries	
High income (more than $10,000)	Australia Great Britain	Japan United States
Moderate income ($5,000–10,000)	Israel New Zealand	Singapore Spain
Low income ($1,500–5,000)	Algeria Greece	Malaysia Russia
Poor income ($500–1,500)	Colombia Honduras	Nigeria Philippines
Extremely poor income (less than $500)	China Haiti	India Pakistan

Source: The World Bank

Applying Economic Ideas

1. How does the World Bank work to improve conditions in developing nations?
2. The table shows how the World Bank classifies selected countries according to per capita Gross Domestic Product. What factors might have led to some countries being poor for so long?

Chapter 18 Assessment

Chapter Summary

A summary of major ideas in Chapter 18 appears below. See also the **Guide to the Essentials of Economics,** which provides additional review and test practice of key concepts in Chapter 18.

Section 1 Levels of Development (pp. 471–476)

Nations throughout the world exhibit varying levels of economic success. The most prosperous are called **developed nations.** Nations with relatively low standards of living are called **less developed countries. Per capita gross domestic product** is the primary measure of development.

Section 2 Issues in Development (pp. 478–483)

Less developed countries face a wide range of issues. A high **population growth rate,** lack of natural resources, inadequate human and physical capital, political instability and corruption, and foreign debt often inhibit development.

Section 3 Financing Development (pp. 485–488)

Less developed countries turn to many sources to finance their development, including **internal financing, foreign investment,** and foreign aid and loans. Help also comes in the form of policy advice and technical assistance.

Section 4 Transitions to Free Enterprise (pp. 489–494)

Some communist and former communist nations, such as China and Russia, are making transitions to free enterprise in order to boost their lagging economies. The move to free enterprise requires **privatization** of industry and changes in the legal system.

Key Terms

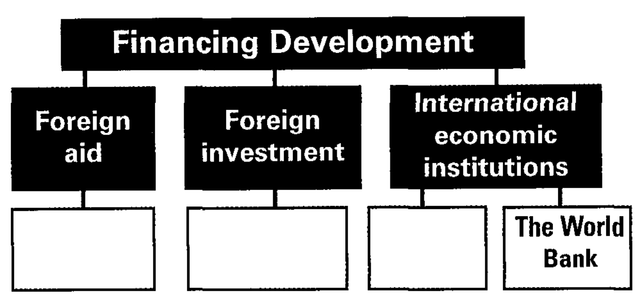
Complete each sentence by choosing the correct answer from the list of terms below. You will not use all of the terms.

malnutrition	**light industry**
infrastructure	**work ethic**
industrialization	**foreign direct investment**
literacy rate	**life expectancy**
internal financing	
debt rescheduling	

1. Measuring a nation's ____ provides data on how many people in that country can read or write.
2. ____ may cause disease in adults, and may cause infants to be born with brain damage or birth defects.
3. The production of small consumer goods is referred to as ____.
4. ____ is the establishment of an enterprise in a country by a foreigner.
5. The services and facilities necessary for an economy to function are called ____.
6. A country undergoing ____ is allowed more time to pay off its loans and have a portion of its loans forgiven.
7. ____ is the extensive organization of an economy for the purpose of manufacture.
8. Economists use the term ____ to describe investment derived from the savings of a country's citizens.

Using Graphic Organizers

9. On a separate sheet of paper, copy the tree map below. Chart financing options for less developed countries by filling in each box with an example and description of a financing option.



Reviewing Main Ideas

10. List and describe three characteristics of less developed countries.
11. Which development status (developed, less developed, or newly industrialized) does each of the following characteristics describe? **(a)** low per capita GDP **(b)** many consumer goods available **(c)** shows significant improvement in the measures of economic performance **(d)** high infant mortality rate **(e)** high life expectancy
12. What issues arise when less developed countries adopt a stabilization program?
13. How did *glasnost* and *perestroika* factor in Russia's transition to a free market economy?
14. What role do special economic zones play in China's transition to a free market economy?

Critical Thinking

15. **Drawing Conclusions** In measuring development, what relationship exists between the activities of the labor force and energy consumption?
16. **Making Comparisons** Which do you believe is more important for a nation's development—physical capital or human capital? Why?
17. **Recognizing Cause and Effect** Describe four consequences faced by nations experiencing rapid population growth.

Problem-Solving Activity

18. Compare and contrast the transitions to free market economies in China and Russia. Describe three unique aspects of each country's transition. Which country do you believe will be most successful in the long run?

Economics Journal

Essay Writing Review your comments on the chapter opener photo. What comments can you add, based on your reading of the chapter? Write a brief essay to accompany the photo. Then, check an encyclopedia or other resource for information on Ghana, the country shown. Revise your essay as needed.

Skills for Life

Utilizing the Writing Process Review the steps shown on page 484; then complete the following activity based on the information below.

19. Study the chart below. **(a)** Who is involved in each of these organizations? **(b)** How could these organizations be compared?
20. You have been assigned the task of writing an essay comparing these three organizations.
(a) What is a possible title for your essay?
(b) Compose a topic sentence for your essay.
21. Exchange your topic sentence with a classmate. Analyze each other's topic sentences; then revise your sentence based on your classmate's input.
22. Use the information in the chart below to write a rough draft of an essay. Ask your classmate to read your draft and comment on it.

Global Economic Organizations

	World Trade Organization	G-8 Countries	International Monetary Fund
Membership characteristics	Entrance granted by vote of existing member countries	Top eight industrialized nations	Finances supported by members
Function	Establishes agreements on lowering or abolishing tariffs on a global level	Summit meetings allow members to discuss international issues	Provides monetary services and loans in attempts to stabilize global trade
Countries involved	141 as of 2001	United States, Japan, France, Germany, Italy, Great Britain, Russia, Canada	183 as of 2001

Take It to the NET

Chapter 18 Self-Test As a final review activity, take the Chapter 18 Self-Test in the Social Studies area at the Web site listed below, and receive immediate feedback on your answers. The test consists of 20 multiple-choice questions designed to test your understanding of the chapter content.
www.phschool.com

THE WALL STREET JOURNAL.

CLASSROOM EDITION

DEBATING CURRENT ISSUES: *A Strong Dollar*

In the mid-1990s, the U.S. government encouraged the dollar's rise in value compared with the Japanese yen and German mark while trying to keep inflation low and interest rates steady. The goal was to encourage stable economic growth for the United States.

In supporting this policy, Treasury Secretary Robert Rubin and Federal Reserve Chairman Alan Greenspan also in some ways were selecting winners and losers in the U.S. economy. That is the conclusion of the following excerpts from *The Wall Street Journal Classroom Edition* article "Winners and Losers" by Michael M. Phillips, Staff Reporter of *The Wall Street Journal.*

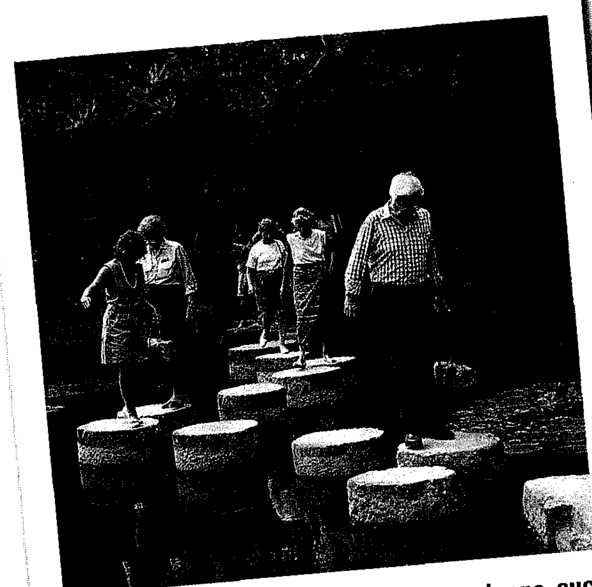
YES *Should the U.S. Government Support a Strong Dollar?*

IN MINNETONKA, MINNESOTA, executives at Insignia Systems Inc. cheered every time the dollar gained further against the yen in 1997. The company expected to turn its first profit in several years, mainly because the rising greenback had cut the cost of Japanese-made sign-printing machines that Insignia imports and resells to U.S. retailers. Insignia Systems estimated that the dollar's earlier tumble, which bottomed out at 80.63 yen in April 1995, cost the company $2 million a year.

Some companies that use imported products also benefited from the currency realignment in 1997. Rohr Inc., a San Diego aircraft-component manufacturer, realized some savings on the MD-11 engine pylons it buys in Japan. And since Boeing Co. reported that the rising dollar hadn't hurt jet sales, Rohr was shielded from the dollar's downside as well. "There's tremendous demand out there for new aircraft," said Laurence Chapman, Rohr's chief financial officer.

Some companies benefited on the interest-rate side of the economic equation, since economists believe that a stronger dollar can help check both inflation and the Fed's urge to raise interest rates.

U.S. consumers also could find lower prices for imported Japanese and European goods, although there is typically some delay before discounts appear on the shelves.



A strong dollar encourages many Americans, such as these tourists in Japan, to visit other nations where their vacation budgets will stretch further.

NO Should the U.S. Government Support a Strong Dollar?

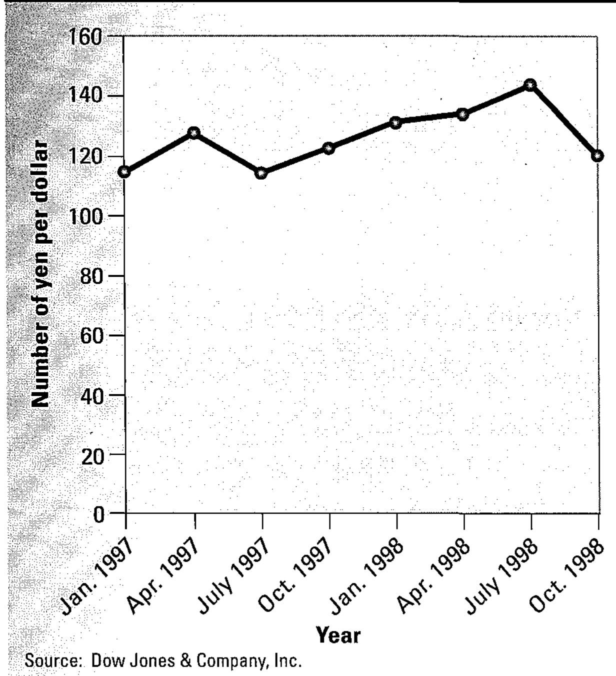
THE PAINS AND PROFITS of the strong dollar policy aren't evenly distributed. The negative impact goes beyond the usual complainers—U.S. auto makers have been most vocal about the rising dollar. On the pain side, there also are small commodities exporters, huge manufacturers, even service providers whose clients or competition are overseas. As the dollar climbs, these companies face the choice of cutting export prices and accepting lower profits, or passing along the price increase and losing customers.

AlliedSignal Inc., a Morristown, N.J., multinational company, ended up losing a customer in 1997, in this case a $13 million contract to supply air-bag modules to Japan's Suzuki Motor Corp. "We had a huge cost disadvantage because of the strong dollar against the yen," said Mark Greenberg, vice president for external communications.

Economists say the impact of the surge in the dollar isn't always clear right away. The industries that feel it most quickly are often those competing head-to-head with Europeans or Japanese to sell goods that are roughly indistinguishable. In 1997, Feedcom Enterprises Inc. of Seattle earned 90 percent of its revenue exporting livestock-feed hay to Japan. Weakness in the yen, however, gave North Korean and Australian hay a price edge, and during one period, Freedom's sales were down 15 percent. "It's a very price-sensitive commodity," said Ed Bitanga, Feedcom's head of international sales.

Another exchange-rate-sensitive industry is tourism, since one palm-edged beach can quickly substitute for another if prices change. In the spring of 1997, the Hawaii Visitors and Convention Bureau revised downward by 120,000 its estimate of how many Japanese would visit that year. The reason? The slow economy and the falling yen made it too expensive for many Japanese to travel to the United States.

Strength of the U.S. Dollar Compared to the Japanese Yen

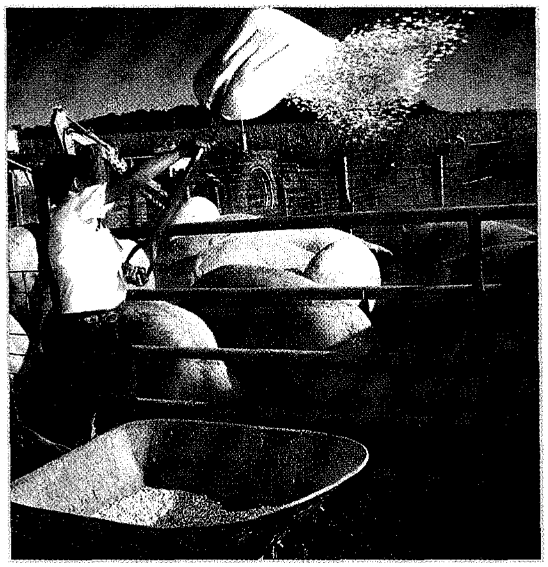


This chart shows the monthly average number of yen to one U.S. dollar. The more yen to the dollar, the weaker the yen and the stronger the dollar.

DEBATING THE ISSUE

1. What impact does the rising value of the dollar have on the cost of Japanese equipment that Insignia Systems imports and sells in the United States?
2. How did the strong dollar cause AlliedSignal to lose a contract?
3. **Critical Thinking** How can a stronger dollar help keep inflation in check?
4. **Reading Graphs** Did the dollar get weaker or stronger between April 1997 and July 1997? Did it get weaker or stronger between October 1997 and July 1998?

Take It to the Net Visit **www.phschool.com** for additional resources relating to this debate.

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