PUTTING PIECES TOGETHER

IER

WHAT IS INTERNATIONAL ECONOMICS ABOUT?

- International economics is about how nations interact through trade of goods and services, through flows of money and through investment.

INCOME GROUPS BY GDP PER CAPITA, 2009 (COUNTRIES):

- **low income**, **$995 or less;**
- **lower middle income**, **$995 – $3,945;**
- **upper middle income**, **$3,946 – $12,195;**
- **high income**, **$12,196 or more.** 25

2009 GDP PER CAPITA (PPP)

Country	2009 GDP per capita, $
Afghanistan	800
Burkina Faso	1200
Uzbekistan	2600
India	2800
Indonesia	3570
China	6000
Ukraine	6900
World average	10000
Mexico	14200
Russia	15800
United States	47000

CAUSES OF DIFFERENCES IN ECONOMIC GROWTH OF COUNTRIES

- Quantity and quality of resource endowments, particularly human capital
- Investment in plant and equipment
- Political and socioeconomic environment that is stable and conducive to competition

CHARACTERISTICS OF WORLD TRADE

- Value and growth of world merchandise trade
- Geographic patterns
- Commodity composition
- Largest exporters and importers

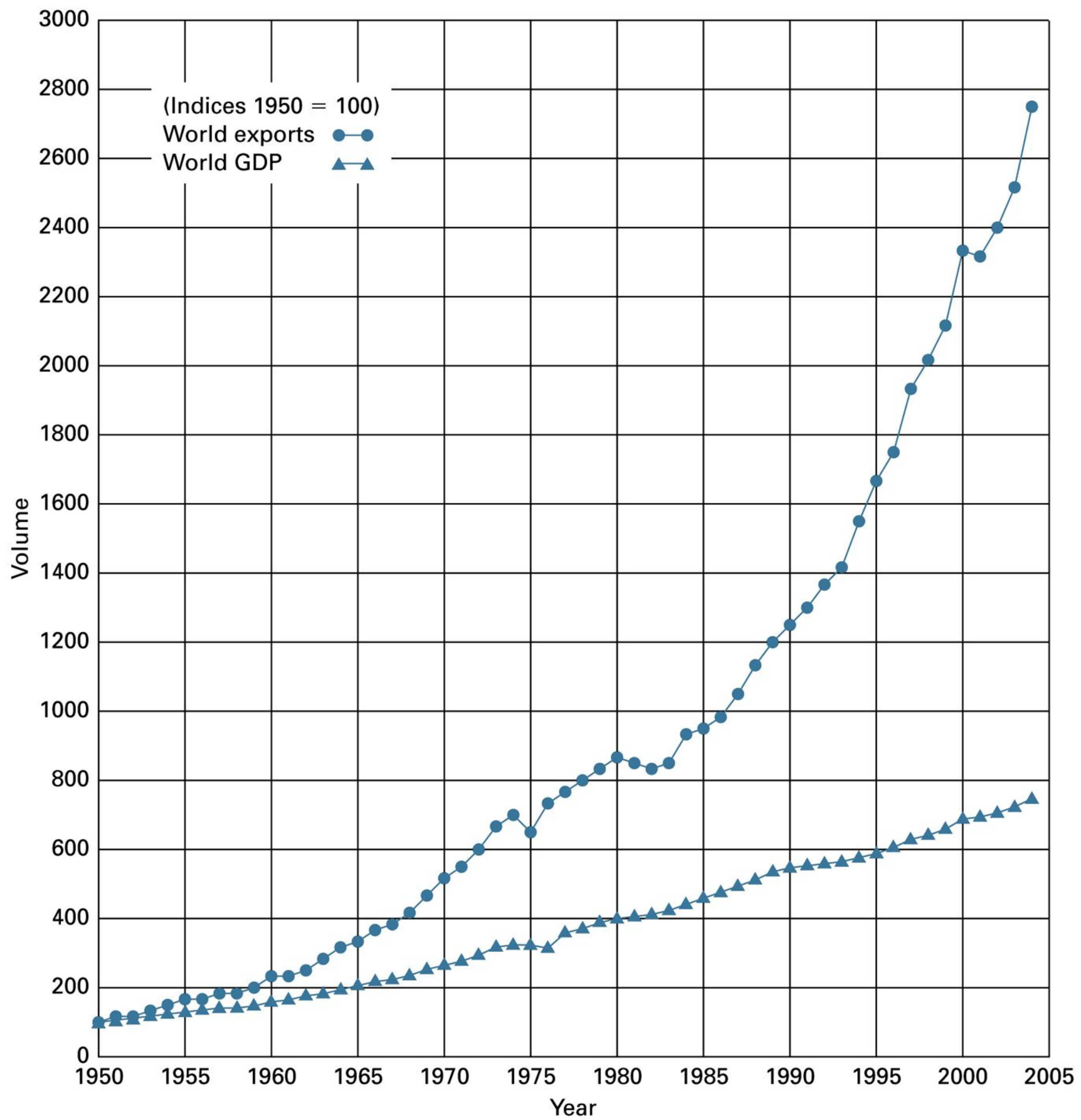
GROWTH OF WORLD EXPORTS

What has caused the explosion of world trade?

- Reduction in trade barriers
- Advances in transportation, communication and technology
- Proliferation of trade agreements

GROWTH OF WORLD EXPORTS

FIGURE 1.1 World Exports and Output in Real Terms, 1950–2004



SOURCE: WTO *International Trade Statistics 2005*, Table A1.

MERCANTILISM: MID–16TH CENTURY

- A nation's wealth depends on accumulated treasure
- Gold and silver are the currency of trade.
- Theory says you should have a trade surplus.
  - Maximize exports through subsidies.
  - Minimize imports through tariffs and quotas.
- "Zero-sum game"?

DAVID HUME – 1752

- Increased exports leads to inflation and

  higher prices.
- Increased imports lead to lower prices.
- Result: Country A sells less because of high prices and Country B sells more because of lower prices.
- In the long run, no one can keep a trade surplus.

THEORY OF ABSOLUTE ADVANTAGE

- Adam Smith: *Wealth of Nations* (1776).
- Capability of one country to produce more of a product with the same amount of input than another country.
- Produce only goods where you are <u>most</u> efficient, trade for those where you are not efficient. ***The concept of specialization is introduced***
  - Trade between countries is, therefore, beneficial.
- Assumes there is an *absolute advantage* balance among nations.

THEORY OF COMPARATIVE ADVANTAGE

David Ricardo: *Principles of Political Economy* (1817).

- Extends free trade argument
- Efficiency of resource utilization leads to more productivity.
- Should import even if country is more efficient in the product's production than country from which it is buying.
  - Look to see how much more efficient. If only comparatively efficient, than import.

- Makes better use of resources
- Trade is a positive-sum game.

HECKSCHER (1919)-OLIN (1933) THEORY

- Export goods that intensively use factor endowments which are locally abundant.
  - import goods made from locally scarce factors.
- Patterns of trade are determined by differences in factor endowments – not productivity.
- Remember, focus on relative advantage, not absolute advantage.

PRODUCT LIFE CYCLE THEORY

- **Raymond Vernon, 1966**

Article in the *Quarterly Journal of Economics*

- **Focus on the product, not its factor proportions**

The New Product

- Flexible production
- Innovator Monopoly
- Concentration

The Maturing Product

- Intl market & competition
- More standardized production

The Standardized Product

- Low-margin cost-based production
- Highly competitive

THE NEW TRADE THEORY

- Began to be recognized in the 1970s.
- Deals with the returns on specialization where substantial economies of scale are present.
  - Specialization increases output, ability to enhance economies of scale increase.

PORTER'S DIAMOND DETERMINANTS OF NATIONAL COMPETITIVE ADVANTAGE

Firm Strategy, Structure and Rivalry

Factor Endowments

Demand Conditions

Related and Supporting Industries

DEFINITION OF TRADE BARRIERS

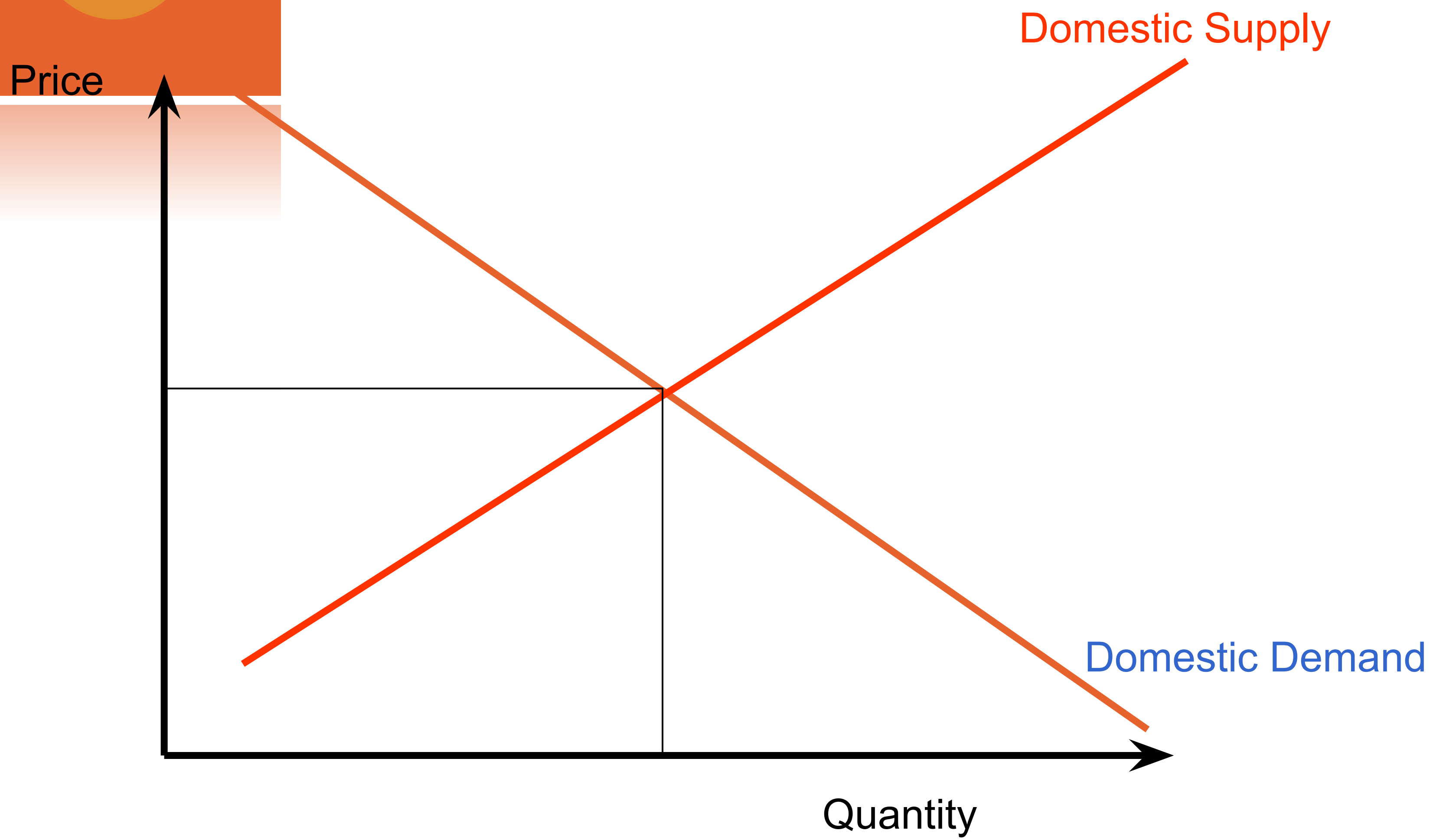
- Government laws, policies, or practices that either:
  - Protect domestic products from competition
  - Artificially stimulate exports of particular domestic products

PROTECTION: INSTRUMENTS OF PUBLIC POLICY

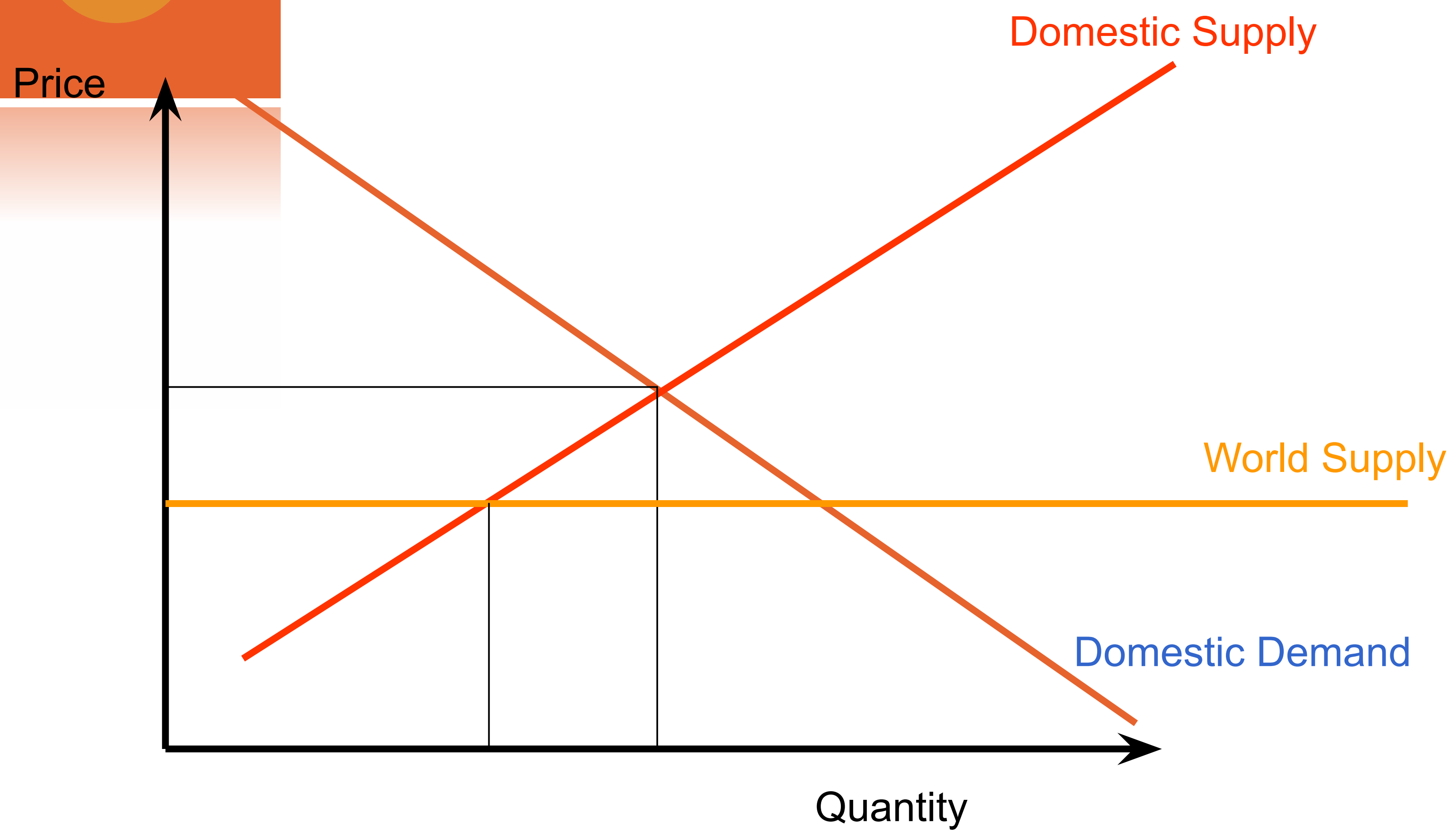
- Tariff (Taxes)
- Quotas (quantity restrictions)
- Non-tariff barriers (Product standards, voluntary restraints).

EFFECT OF TARIFF ON VALUE

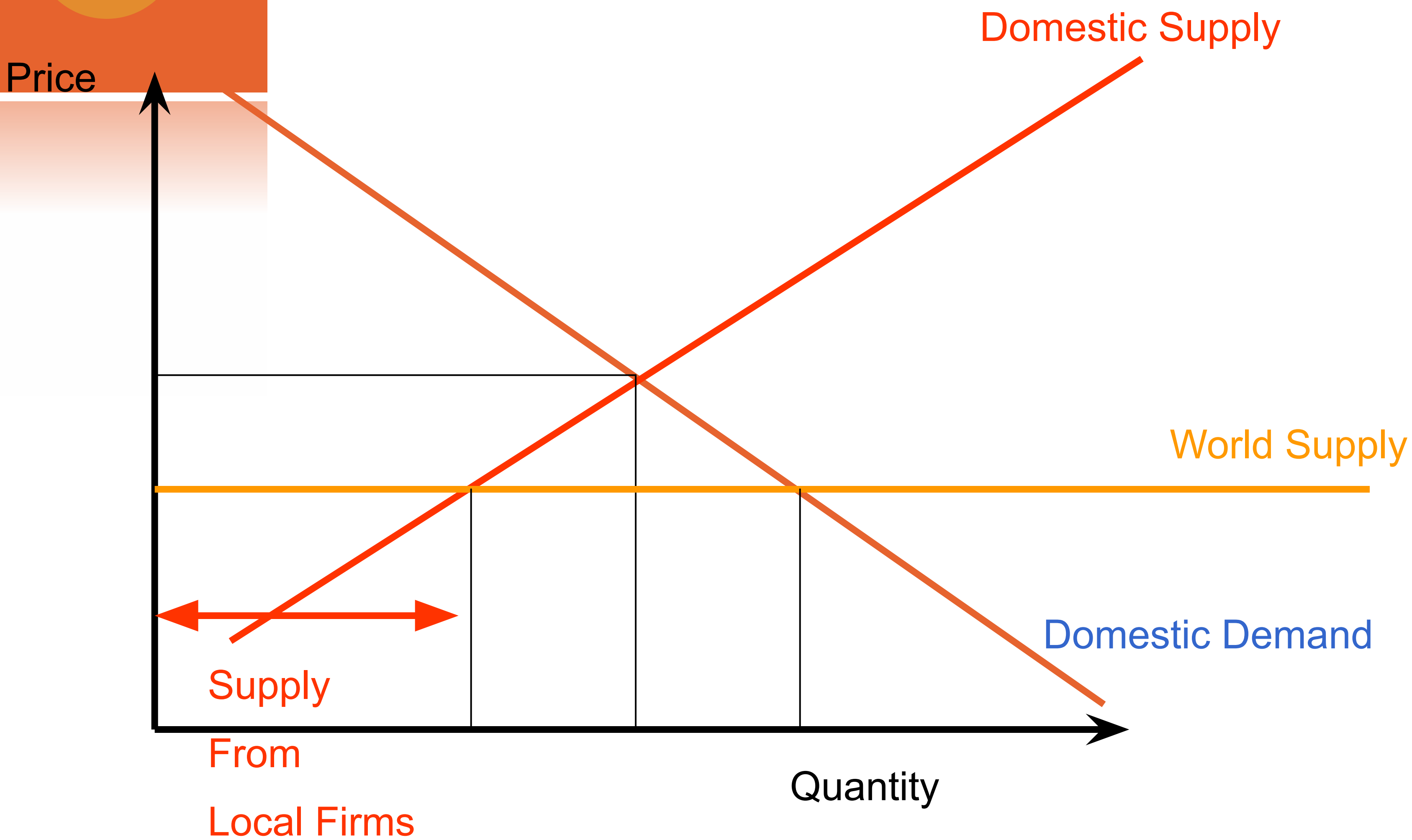
Domestic Equilibrium Price and Quantity (No trade)



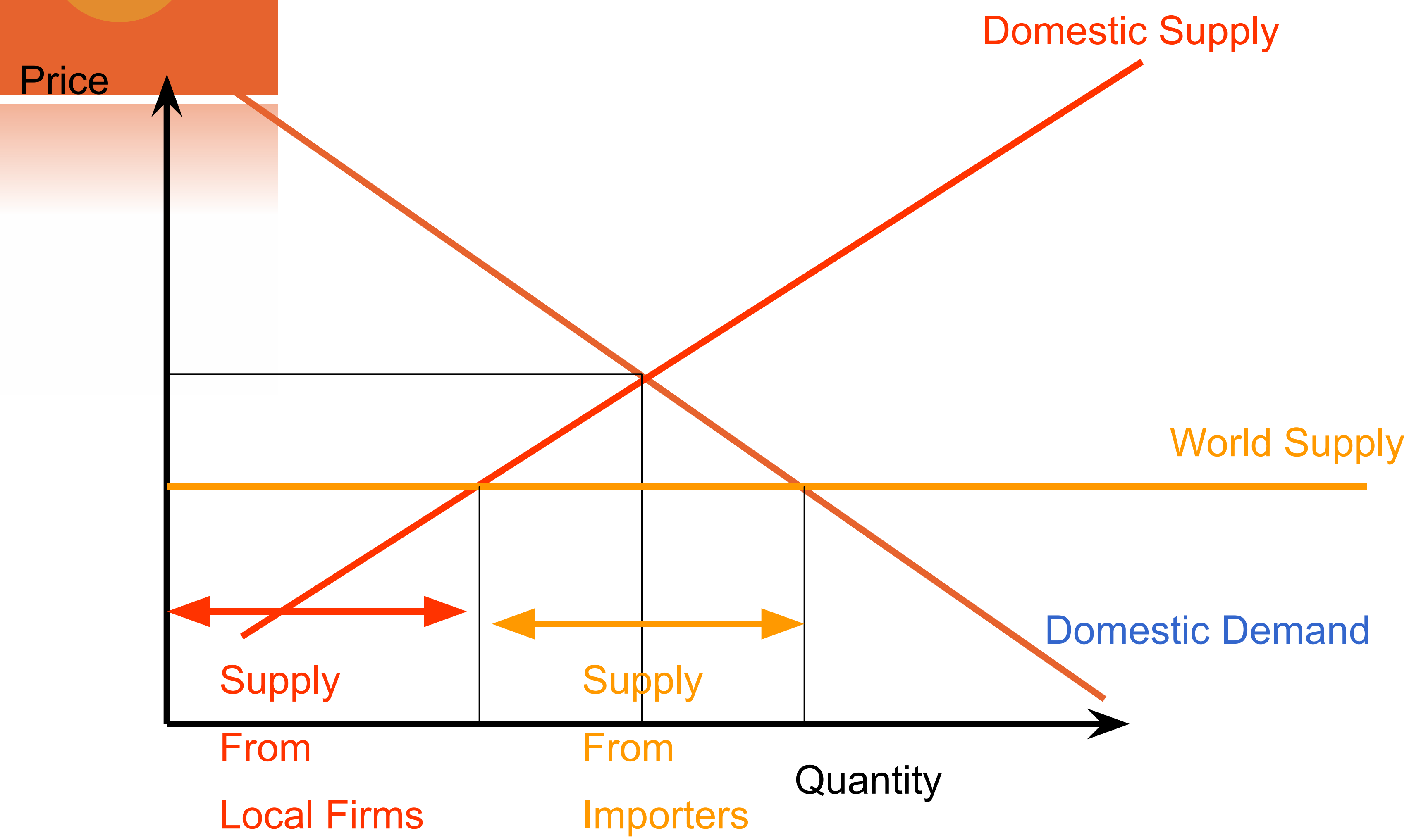
Once Imports are allowed there is infinite supply at the world price.



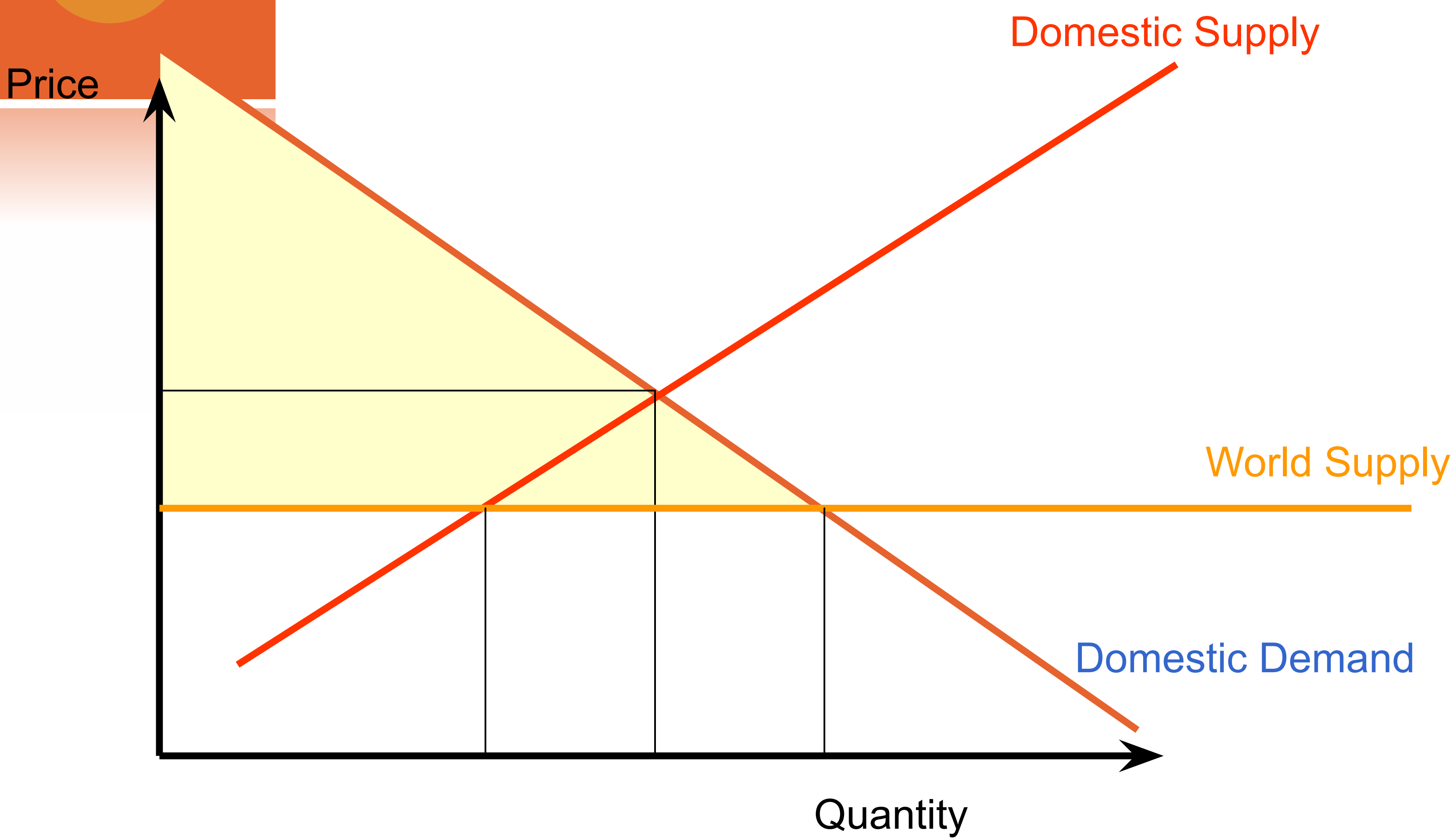
Efficient domestic producers continue to produce.



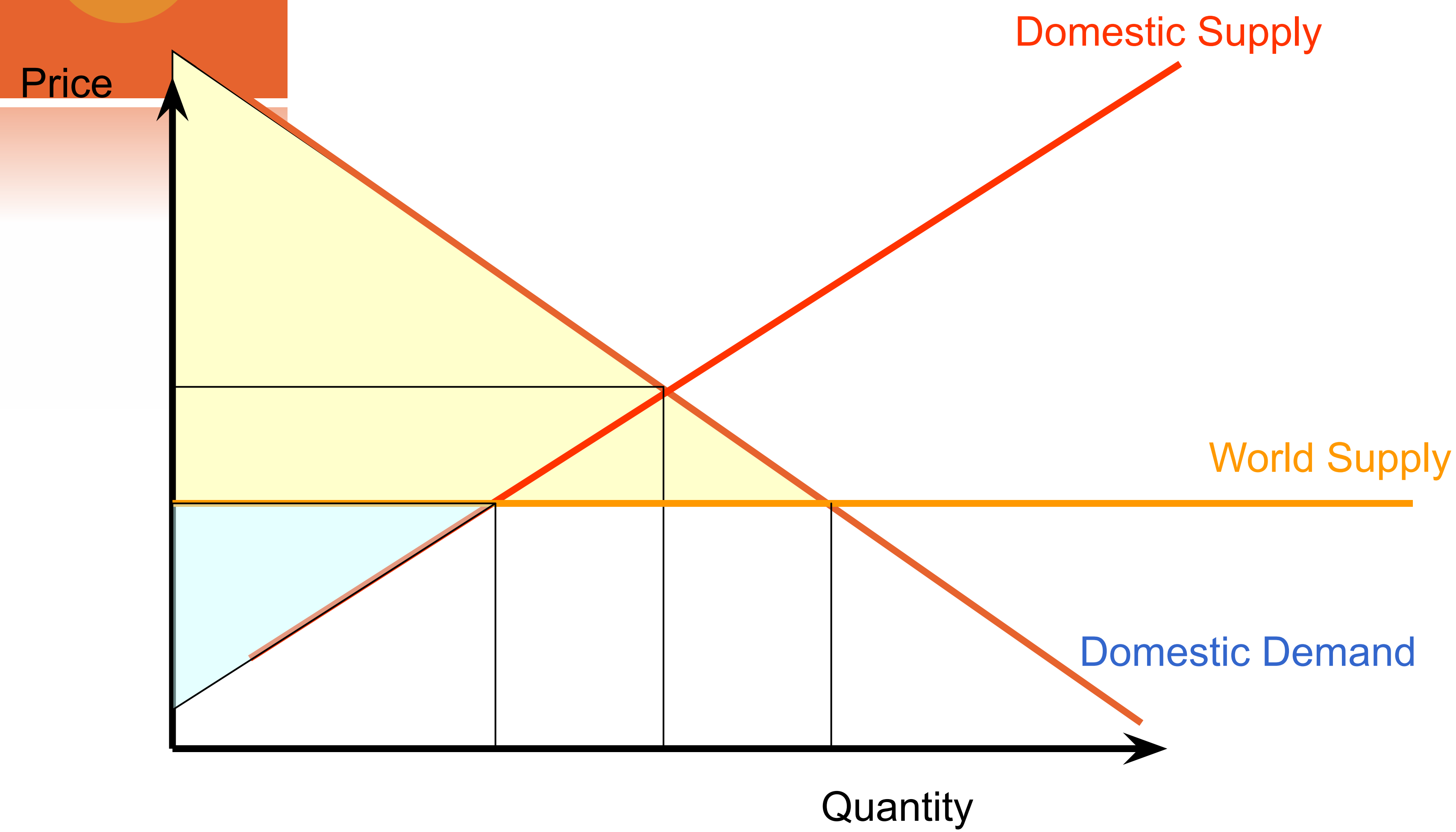
But there is an increase in supply from importers.



Consumers' value with trade:

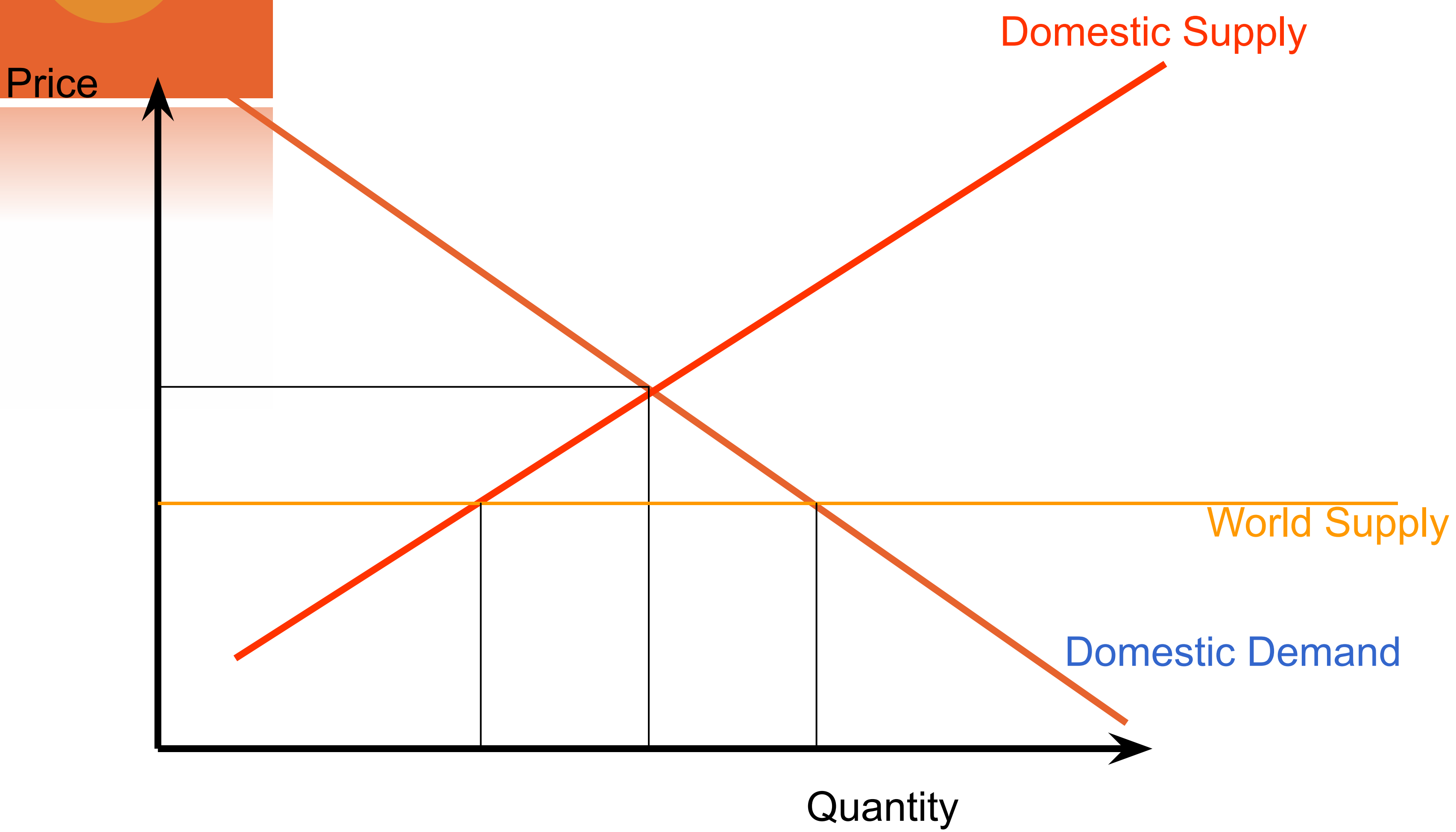


Local Producers' value:

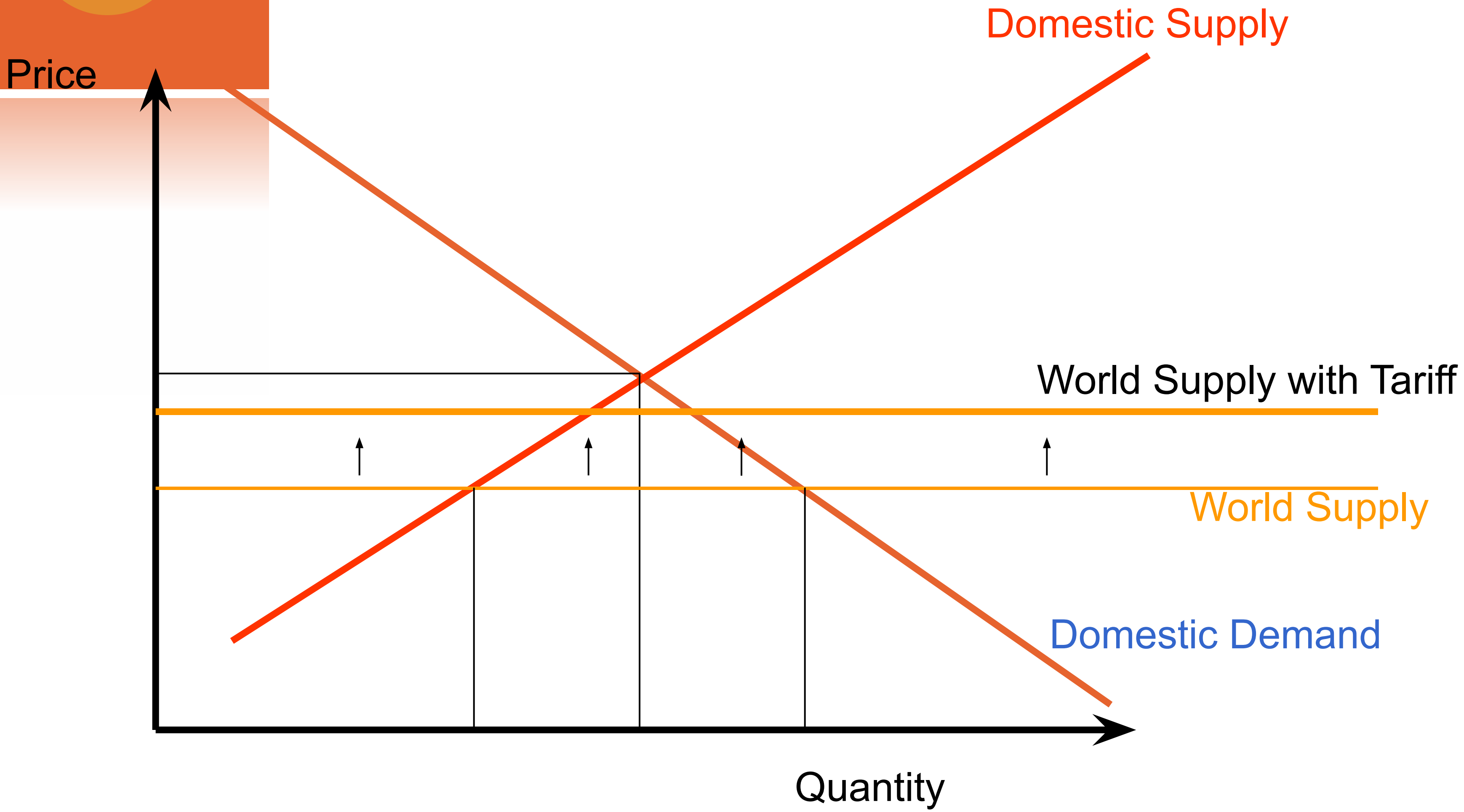


THE GOVERNMENT IMPOSES A TAX/TARIFF

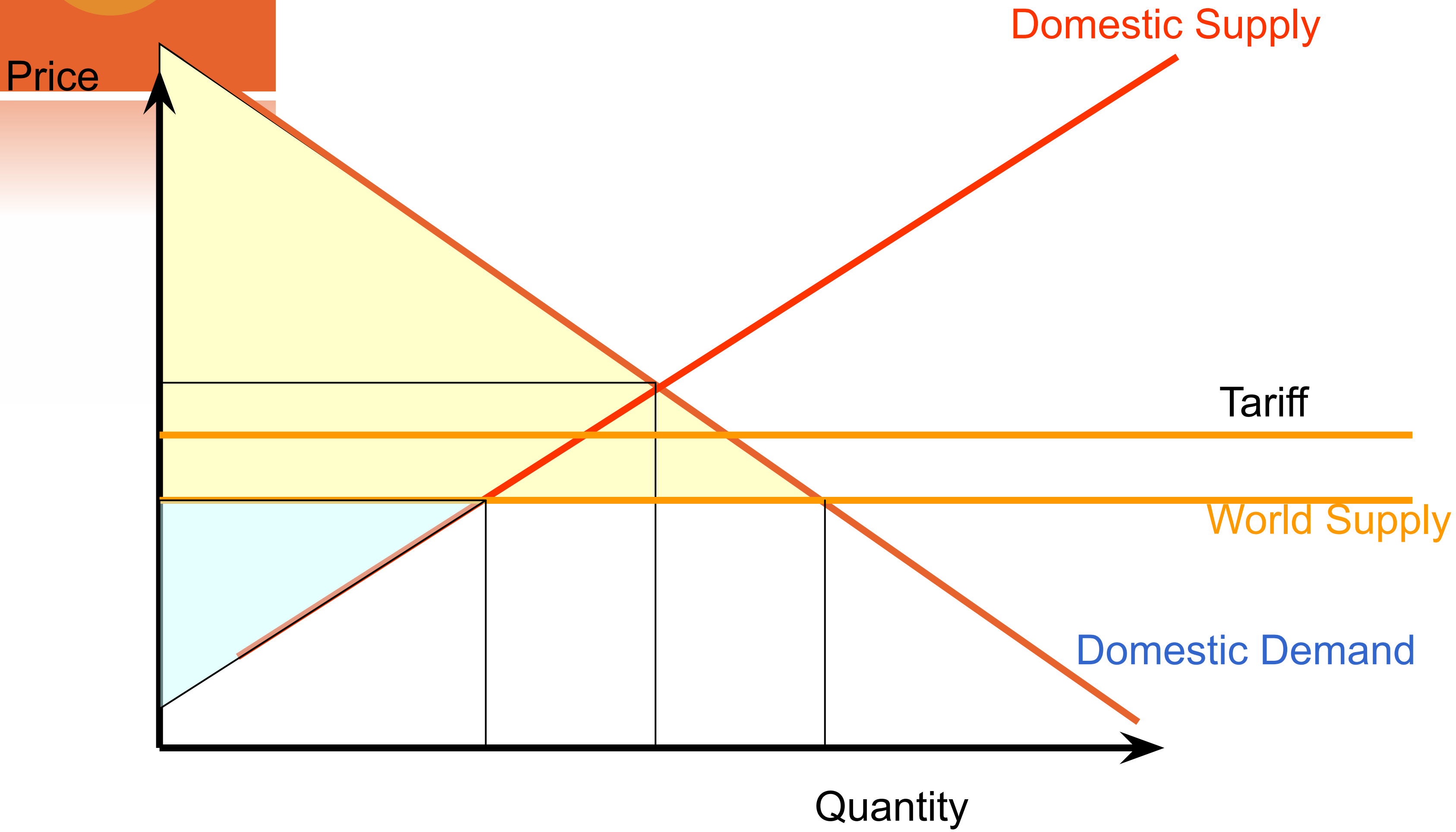
LOCAL PRODUCERS' VALUE:



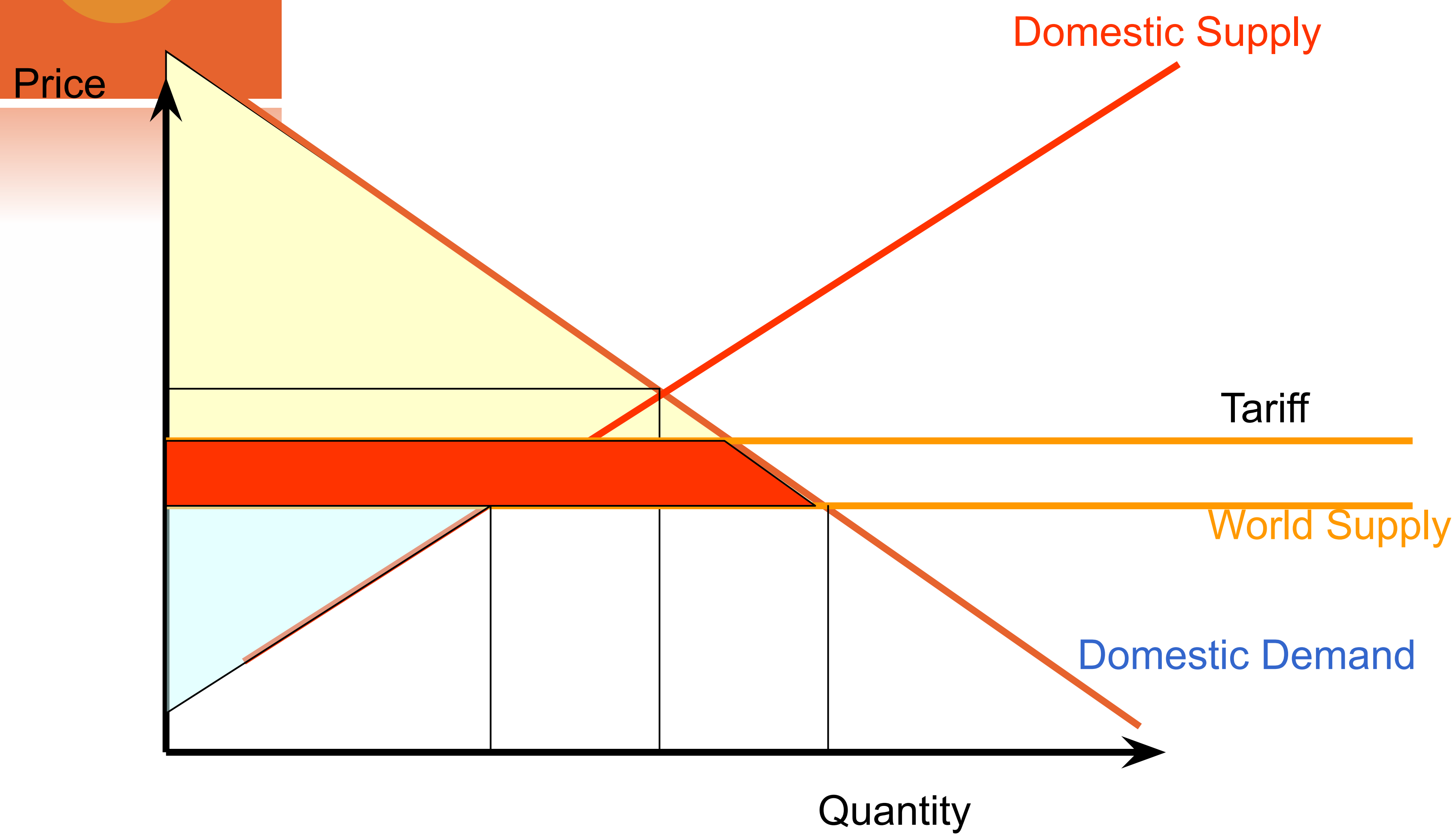
LOCAL PRODUCERS' VALUE:



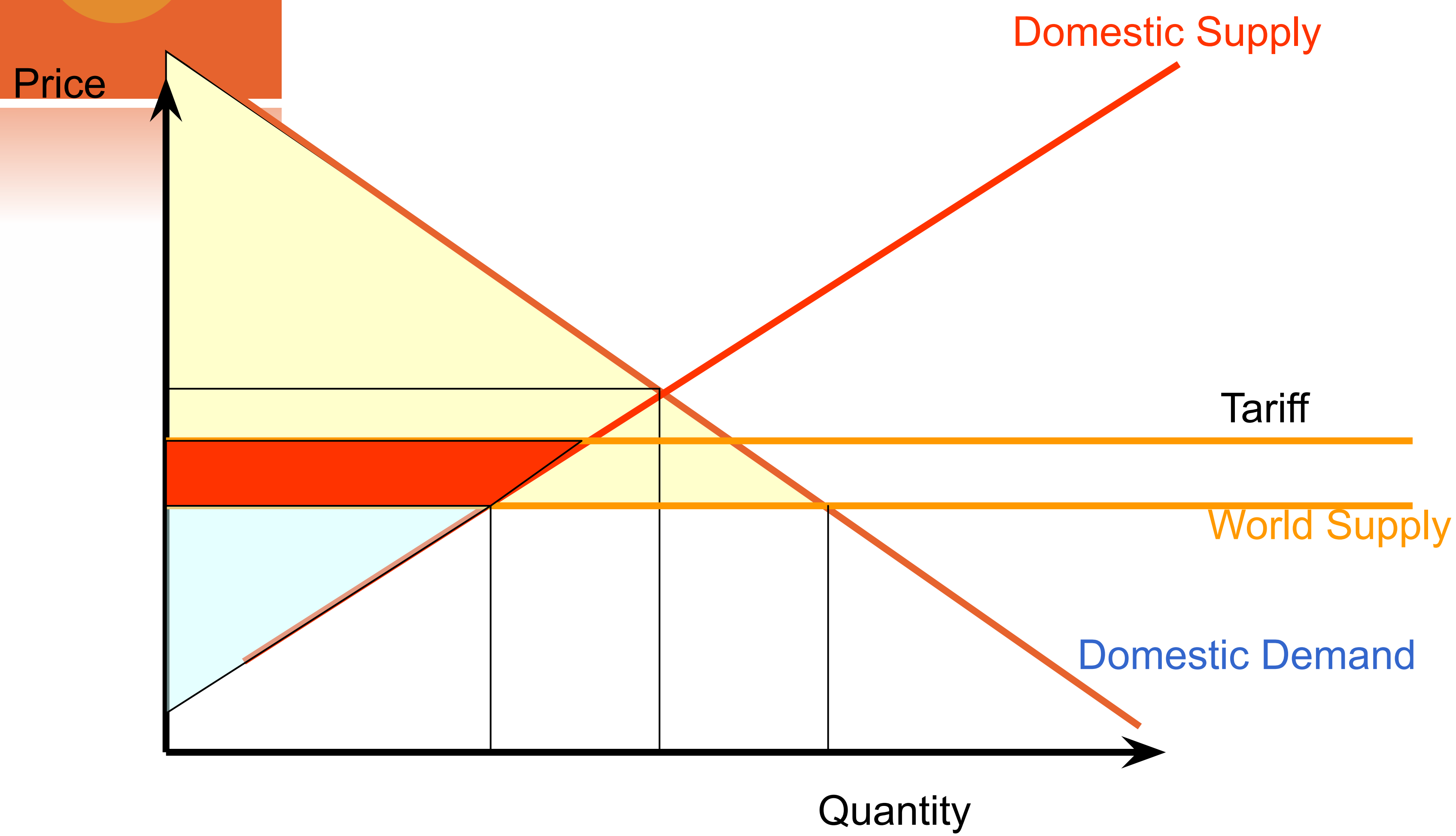
WHO GAINS WHO LOSES?



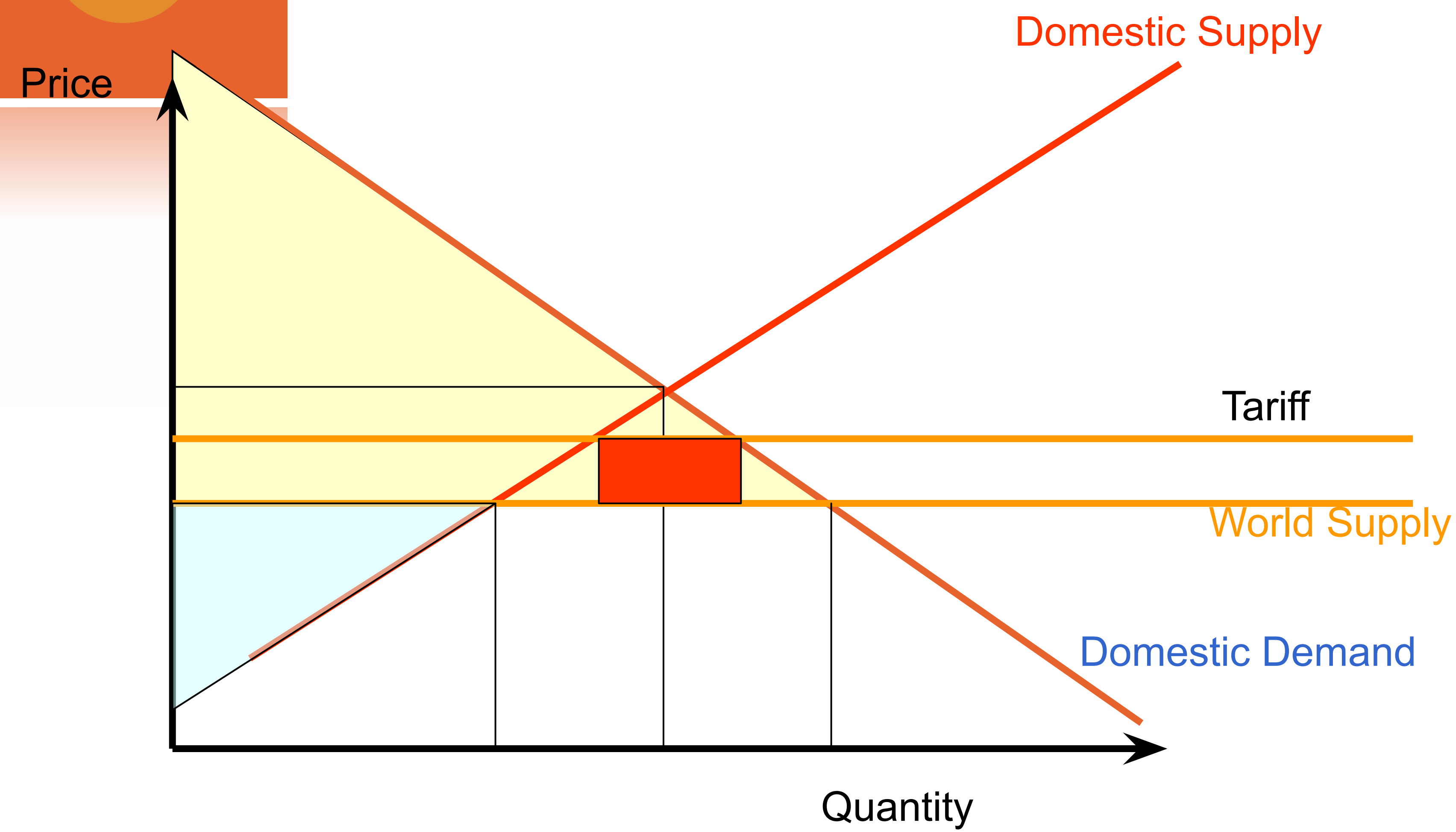
CONSUMERS LOSE THIS



PRODUCERS GAIN THIS



GOVERNMENT GAINS THIS MUCH TAX



TRADE POLICIES IN DEVELOPING COUNTRIES

- ***Import-Substituting Industrialization***

It states that developing countries have a *potential* comparative advantage in manufacturing and they can realize that potential through an initial period of protection.

- ***Dual Economy***

1. Countries with highly dualistic economies also seem to have a great deal of urban unemployment.
2. An increase in the number of manufacturing jobs will lead to a rural-urban migration so large that urban unemployment actually rises.

- ***Export-Oriented Industrialization: The East Asian Miracle***
  - The World Bank's definition of HPAEs contains three groups of countries, whose "miracle" began at different times :
    - Japan (after World War II)
    - The four "tigers": Hong Kong, Taiwan, South Korea, and Singapore (in the 1960s)
    - Malaysia, Thailand, Indonesia, and China (in the late 1970s and the 1980s)

GLOBALISATION

- **Definition:**
  - An economic phenomenon?
  - A social phenomenon?
  - A cultural phenomenon?
- The movement towards the expansion of economic and social ties between countries through the spread of corporate institutions and the capitalist philosophy that leads to the shrinking of the world in economic terms.

INTEGRATION OF ECONOMIES

Stock Markets are now accessible from anywhere in the world!

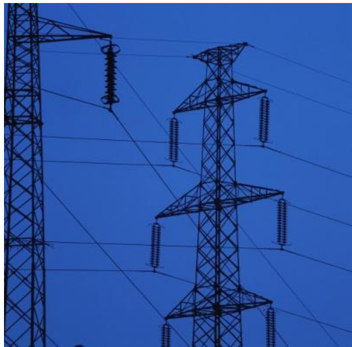
Copyright: edrod, stock.xchng

- The increasing reliance of economies on each other
- The opportunities to be able to buy and sell in any country in the world
- The opportunities for labour and capital to locate anywhere in the world
- The growth of global markets in finance

INTEGRATION OF ECONOMIES

Made possible by:

- Technology
- Communication networks
- Internet access
- Growth of economic cooperation – trading blocs (EU, NAFTA, etc.)
- Collapse of ‘communism’
- Movement to free trade



CORPORATE EXPANSION

Controlling supplies may be one reason for global expansion.

Characteristics:

- Expanding revenue
- Lowering costs
- Sourcing raw materials
- Controlling key supplies
- Control of processing
- Global economies of scale

- Movement of goods and services is one form of international integration.
- Another form of integration is international movements of factors of production (factor movements).
- Factor movements include:
  - Transfer of capital via international borrowing and lending
  - International linkages involved in the formation of multinational corporations
  - Labor migration

THERE ARE TWO MAIN TYPES OF FOREIGN INVESTMENTS:

Portfolio investments (bonds, stocks)

Direct investments (real investments in factories, capital goods, land, and inventories)

- **The basic motives are:**
  - **To earn higher returns abroad.**
  - **To reduce risks to account for *the* two-way capital flows.**

REASONS FOR EXISTENCE OF MNCS

- To achieve the competitive advantage of a global network of production and distribution.
- MNCs can better protect and exploit their monopoly power, adapt their products to local conditions and tastes, and ensure consistent product quality.
- The competitive advantage of MNCs also comes from economies of scale in production, financing, R&D, and the gathering of market information.
- The large output of MNCs allows them to carry division of labor and specialization in production much further than smaller national firms.

MOTIVES FOR INTERNATIONAL LABOR MIGRATION

- **Migration takes place for: Economic Reasons and non-economic Reasons.**

Economics Reasons: prospect of earning higher **real wages and income abroad.**

Non-economic Reasons: greater educational and job opportunities for children.

- **Costs:**

1) Expenditures for transportation and the loss of wages;
2) Separation from relatives, friends, and familiar surroundings;
3) Need to learn new customs and often a new language;
4) Risks involved in finding a job, housing, and so on in a new land.

THE BALANCE OF PAYMENTS

- **A record of international transactions between a country and the rest of the world for a given period of time**
- Trade in goods
- Trade in services
- Income flows

= Current Account

- Transfer of funds and sale of assets and liabilities

= Capital Account

- Record of Payments to & Receipts from Foreign Entities
  - Double-entry bookkeeping system.
    - Every transaction has two entries – a credit (+) and a debit (–)!
      - Payment = Debit (–)
      - Receipt = Credit (+)
  - Multiple Accounts
    - Current Account (CA) and Capital/Financial Account (KA)
  - Is a summary (net) record of flows, not stocks

BALANCE OF PAYMENTS EQUATION

$$CA + K \equiv 0$$

CA is the ***current account*** (mostly trade)

K is a ***capital and financial account*** (investment and other payments)

STATISTICAL DISCREPANCY

- CA + KA + Stat. Dis. = 0
- Why Statistical Discrepancy?
  - Sampling Error
    - financial, services trades data inaccuracies
  - Unrecorded interest/dividends
    - Global BOP Deficit correlated with interest rates.
  - Timing Discrepancies
  - Black Markets

EXCHANGE RATES AND INTERNATIONAL TRANSACTIONS

- Two types of changes in exchange rates:
  - <u>Depreciation of home country's currency</u>
    - A rise in the home currency prices of a foreign currency
    - It makes home goods cheaper for foreigners and foreign goods more expensive for domestic residents.
  - **<u>Appreciation of home country's currency</u>**
    - A fall in the home price of a foreign currency
    - It makes home goods more expensive for foreigners and foreign goods cheaper for domestic residents.

EXCHANGE RATES AND INTERNATIONAL TRANSACTIONS

- Exchange Rates and Relative Prices
  - Import and export demands are influenced by relative prices.
  - Appreciation of a country's currency:
    - Raises the relative price of its exports
    - Lowers the relative price of its imports
  - Depreciation of a country's currency:
    - Lowers the relative price of its exports
    - Raises the relative price of its imports

EXCHANGE RATES AND INTERNATIONAL TRANSACTIONS

- Spot Rates and Forward Rates
  - **Spot exchange rates**
    - Apply to exchange currencies "on the spot"
  - **Forward exchange rates**
    - Apply to exchange currencies on some future date at a prenegotiated exchange rate
  - Forward and spot exchange rates, while not necessarily equal, do move closely together.

EXCHANGE RATES AND INTERNATIONAL TRANSACTIONS

- Foreign Exchange Swaps
  - Spot sales of a currency combined with a forward repurchase of the currency.
  - They make up a significant proportion of all foreign exchange trading.

EXCHANGE RATES AND INTERNATIONAL TRANSACTIONS

- Futures and Options
  - Futures contract
    - The buyer buys a promise that a specified amount of foreign currency will be delivered on a specified date in the future.
  - Foreign exchange option
    - The owner has the right to buy or sell a specified amount of foreign currency at a specified price at any time up to a specified expiration date.

EQUILIBRIUM IN THE FOREIGN EXCHANGE MARKET

- How Changes in the Current Exchange Rate Affect Expected Returns
  - Depreciation of a country's currency today lowers the expected domestic currency return on foreign currency deposits.
  - Appreciation of the domestic currency today raises the domestic currency return expected of foreign currency deposits.

INTEREST RATES, EXPECTATIONS, AND EQUILIBRIUM

- The Effect of Changing Expectations on the Current Exchange Rate
  - A rise in the expected future exchange rate causes a rise in the current exchange rate.
  - A fall in the expected future exchange rate causes a fall in the current exchange rate.

INTERNATIONAL MONETARY SYSTEM

- **GOLD STANDARD PERIOD** (1876–1914), exchange rates determined as ratio of nations' own valuation of gold.
- Economic uncertainty and government obligations changed nations' willingness to pay more or less for gold reserves. F(x) rates changed accordingly.

THE YEARS 1914–1944.

- The War interrupted the free movement of gold.
- During the Wars and the inter-war years, The Years 1914–1944.
- currencies fluctuated widely in terms of gold and one another.
- Many countries attempted to return to the Gold Standard, without success
- The banking crises of Austria in 1931 led most countries to abandon the Gold Standard once again.
- Except for the dollar, many currencies lost their convertibilities into other currencies.
- The volume of world trade decline significantly, as a share

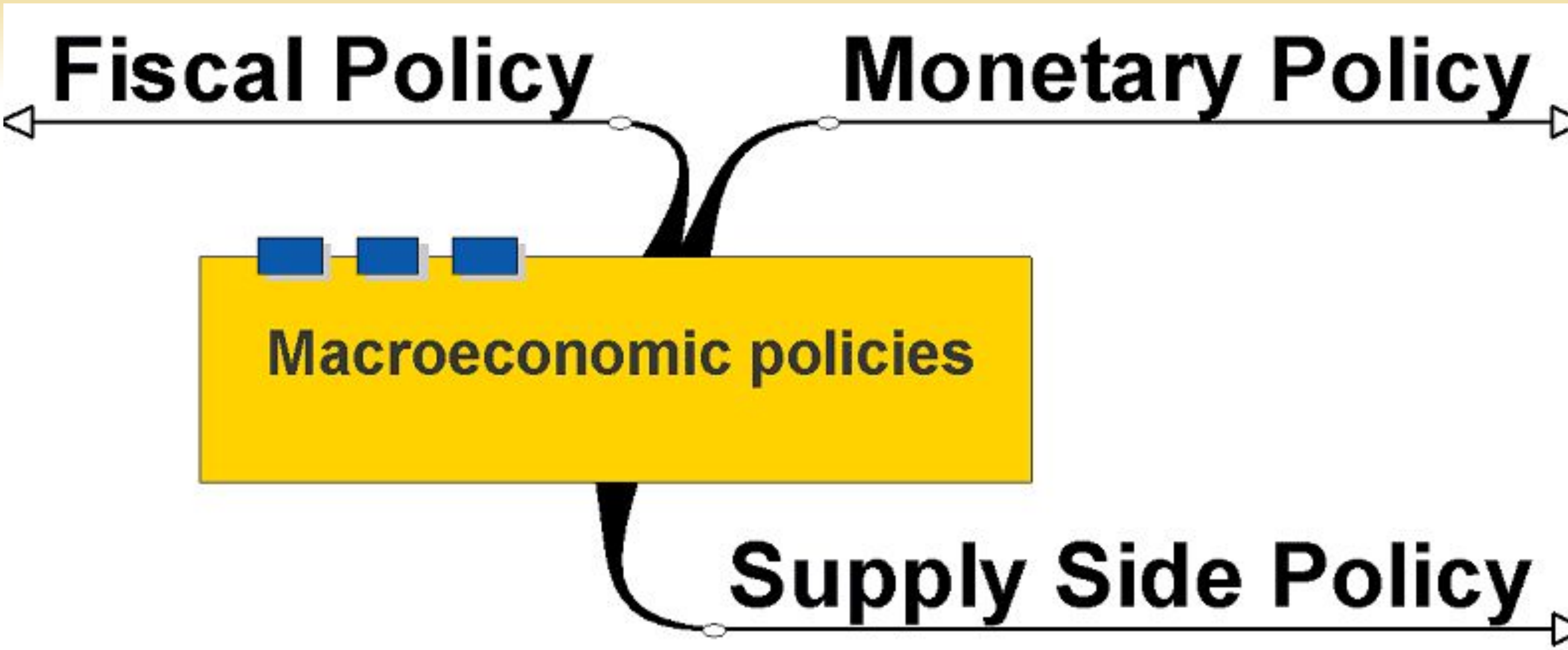
FIXED EXCHANGE SYSTEM: 1945–1973.

- Countries fixed the values of their currencies in terms of gold or a currency tied to gold.
- Only the dollar was convertible into gold (at $35/ounce).
- After the War, the US had accumulated 20,205 metric tons of gold (about 650 million ounces) or 2/3 of world's reserves (today, the US has 8,200 metric tons with the EURO area holding 11,000 mt).
- Countries set their exchange rates against the dollar.
- Countries agreed to maintain their currency values within 1% of par, by buying or selling of foreign exchange or gold.
- Countries agreed to have currency convertibility for current account transactions, but could impose capital controls.
- Devaluation was not to be used as competitive trade policy, though a devaluation of up to 10% did not required IMF approval.
- The BW Conference also led to the creation of the International Monetary Fund (IMF) and the World Bank.

MULTIPLE CURRENCY ARRANGEMENTS FROM 1973 TO PRESENT.

- Countries have opted for different currency systems, blessed by the IMF in the Jamaica Conference of 1976 (under "firm surveillance", floating rates were accepted if consistent with "market" forces).
- The only way to cope with international FX instability is to have greater economic policy coordination among the G-7 countries: A stable international monetary system has yet to emerge.
- A number of currency events and crises have occurred since then that produced significant volatility in exchange rates

MACROECONOMIC POLICIES



MONETARY POLICY

- Attempts to influence the level of economic activity (the amount of buying and selling in the economy) through changes to the amount of money in circulation and the price of money – short-term interest rates.
- Interest rates the key area of Monetary Policy

SUPPLY SIDE POLICY

- Intention is to shift the aggregate supply curve to the right, increasing the long term productive capacity of the economy
- Tend to be long-term policies
- Arguments about how effective they are – e.g. lowering taxes increases incentives, reducing welfare dependency increases the urge to find work

SUPPLY SIDE POLICIES

- Policies aim to influence productivity and efficiency
  of the economy
- Key feature – open up markets and de-regulate to improve efficiency in the working of markets and the allocation of resources

FISCAL POLICY

- Influencing the level of economic activity though manipulation
  of government income and expenditure
- Associated with Keynesian Demand Management Policies
- Now seen in wider terms:

GOVERNMENT INCOME

- Tax Revenue
- Sale of Government Services – e.g. prescriptions, passports, etc.
- Borrowing (PSNCR)