The Political Economy of International Trade, Finance, & Regional Integration

Classical Trade Theory & Comparative Advantage

Neoclassical & Subsequent Economic Thought

Trade and Finance

An International Monetary Regime

Regional Economic Integration & Global Commerce
Understanding Trade

- International trade amounts to a sixth of the total economic activity in the world.
- Scholars of international political economy (IPE) study the politics of international political activities.
  - Most focus is on the industrialized regions of the world.
  - Global South is receiving growing attention.
  - States are the most important actors in IPE, but not as important as in international security.
  - Actors in IPE tend to act in their own interests.
  - Collective goods problem is important throughout IPE.
David Ricardo's ideas on comparative advantage provide a good first glance at international trade. According to Ricardo, countries will produce and export to other countries those products that they can produce relatively more efficiently than can their trading partners. If there were no differences between countries, then there would be no trade.

The Hecksher-Ohlin theorem, along the lines of comparative advantage, states that different countries have different factor endowments, such as land, labor, and capital. As a result, they will likely export those goods or services in which their combination of these factors gives them a comparative advantage. In other words, a state rich in labor will export something different than a state rich in capital.
A common objection to classical trade theory is that it ignores terms of trade. Terms of trade is the ratio of export prices of one country to those of another, which tells us in effect the amount of revenue from a country's export sales to the other that can be used to pay for imports from the other. In other words, a country in the South exporting raw materials would have to export quite a bit of it in order to turn around and import the product which has been created from those exported raw materials in a northern state.
Trade and Payment Balances

Balance of trade = Exports – Imports
\[ b = X - M \]

China’s Growing Trade Surplus

Balance of payments = Current Account + Capital Account + Transfers + Reserves = 0
\[ B = I + II + III + IV \]
Applying Classical Theory

- Barter – exchange of goods without using money
- Commodities – any article that is bought or sold; agricultural products, metals, and raw materials; traded in bulk in commodities exchanges.
- Opportunity Costs – the cost of not pursuing some alternative course of action when a decision is made to do one thing.

Production Possibilities

Any agreement, such as at point A, yields certain benefits to each actor (dotted lines). Joint benefits are maximized at line MP, but the distribution of those benefits, as between points B and C (both of which are better than A for both actors), is a matter for bargaining. Liberalism is more concerned with joint benefits, mercantilism more with the relative distribution.
Neoclassical & Subsequent Economic Thought

- Neoclassical thought refers to late nineteenth and early twentieth century developments in economic theory.
- Instead of seeing the value of a good as determined by the labor put into it, neoclassical thought sees it as based upon supply and demand.
- Classical thought focuses more on macroeconomics (or the economy as a whole) while neoclassical thought looks at microeconomics (or the interaction of buyers and sellers).
Some economists say that Ricardo's explication of comparative advantage is not the only reason states trade.

Other economists point to the concept of economies of scale.

The idea that goods and services can be produced cheaper if they are done so in large quantities.

As a result, it may be beneficial to produce large quantities of certain products cheaply, and trade them for other products.
The Impact of Technological Innovation on Free-trade

- A free and efficient market requires a fairly large number of buyers looking for the same item and a large number of sellers supplying it.

- Also requires that participants have fairly complete information about the other participants and transactions in the market. Technology speeds up the flow of information and of transactions, affecting:
  - Supply & Demand
  - Access to capital
  - Market prices
  - Mergers & acquisitions
Trade and Finance

- Classical trade theory assumes the neutrality of money, but reality is far from this ideal.
- Today, each state’s currency can be exchanged for a different state’s currency according to an exchange rate.
- Exchange rates are important because they affect almost every international economic transaction – trade, investment, tourism, and so forth.
- In the real world, we must deal with exchange rates, or the price of one currency in terms of another.
  - For example, it may take 2000 Italian lira to purchase one U.S. dollar. Tomorrow, if I can purchase 2100 lira for a dollar, then the U.S. dollar has appreciated in relation to the lira. If I can only purchase 1900 lira, then the dollar has depreciated in relation to the lira.
Trade and Finance

- These variations in exchange rates can have a massive impact on import and export prices.
- Currency policies directly affect trade issues, but are not governed by the WTO regime.
- Most exchange rates are expressed in terms of the world’s most important currencies: U.S. dollar, the Japanese yen, and the EU’s euro.
  - Thus the rate for exchanging Danish kroner for Brazilian reals depends on the value of each, relative to these world currencies.
  - Exchange rates that most affect the world economy are those within the G7 states – U.S. dollars, euros, yen, British pounds, and Canadian dollars.
  - China has held its currency at a fixed rate to the U.S. dollar in recent years.
Trade and Finance

- Changes in the value over time are meaningful.
  - Value of euro rises (or falls) relative to the dollar, because euros are considered more (or less) valuable than before, the euro is said to be strong (weak).

- Convertible versus non-convertible currencies (Hard vs. Soft currencies)
  - In the absence of a convertible currency, the holder of such money has no guarantee to being able to trade for another currency.
    - Ex: foreign Soviet Union
    - Inflated currencies/hyperinflation
International Currency Exchange

- Hard currency
  - Money that can be readily converted to leading world currencies (which now have relatively low inflation)
  - States maintain reserves of hard currency

- Types of Exchange systems
  - Fixed exchange rates
  - Floating exchange rates
  - Managed float system
  - Government intervention in the currency market
    - Coordinated multinational intervention
    - Argentina
    - China
Why Currencies Rise or Fall

- In the short term, exchange rates depend on speculation about the future value of currencies.
- In the long term, the value tends to rise and fall relative to others because of changes in the long-term supply and demand for the currency.
  - Strong currency vs. weak currency
- Overvalued currency
- Devaluation
An International Monetary Regime

- International monetary regimes are financial rules, regulations, and institutions agreed on by states to facilitate international trade and commerce.
- There is a long history to international monetary regimes.
- Today, these can be seen in institutions such as the International Monetary Fund (IMF).
- The focus of the IMF is on the finance of trade—assisting member countries to manage their payments and obligations to each other.
- Oftentimes, decisions made by states affect others outside of the state in positive or negative ways.
- These are referred to as externalities.
Central Banks

- In most industrialized countries, politicians know they cannot trust themselves with day-to-day decisions about printing money.
- To enforce self-discipline and enhance public trust in the value of money, these decisions are turned over to a central bank.
  - Limit the amount of money printed and not allowing high inflation.
  - In the U.S., the central bank is called the Federal Reserve.
- Sets the discount rate: the interest rate the government charges when it loans money to private banks.
The World Bank and the IMF

- As in security affairs, the main international institutions were created near the end of WWII
  - The Bretton Woods system (1944)
    - Established the International Bank for Reconstruction and Development (World Bank)
The World Bank and the IMF

- International Monetary Fund (IMF)
  - Coordinates international currency exchange, the balance of international payments, and national accounts

- World Bank and IMF are the pillars of the international financial system.
  - Special Drawing Right (SDR)
    - Used to replace gold as a world standard; new world currency
    - Cannot buy goods – only currencies
    - Owned by states (central banks), not by individuals or companies
The IMF

- The IMF maintains a system of national accounts statistics to keep track of the overall monetary position of each state.
  - State’s balance of payments is like the financial statement of a company. It summarizes all the flows of money in and out of the country.
    - Current account
    - Capital flows
    - Changes in foreign exchange rates
The World Trade Organization

- WTO is a global, multilateral IGO that promotes, monitors, and adjudicates international trade.
  - Central to the overall expectations and practices of states with regard to international trade.
  - Successor organization to GATT (1947)
  - In 2007, WTO had 150 countries (all of the major countries, with the exception of Russia) in membership.
  - Most countries likely to become members
  - Condition of membership – liberalization of the trading practices of would-be members
The World Trade Organization

- Reciprocity
  - Most favored nation (MFN) concept: trade restrictions imposed by a WTO member on its MFN trading partner must be applied EQUALLY to all WTO members
  - Exception: Generalized System of Preferences (GSP)
    - Trade concessions to third world states to help economic development
- Benefits to belonging to WTO outweigh the costs.
Most international trade is governed by more specific international political agreements.

There are generally two types:

- Bilateral trade agreements
  - Reciprocal arrangements to lower barriers to trade between two states

- Regional free-trade areas
  - Groups of neighboring states agree to remove the entire structure of trade barriers and adopt a common tariff toward states that are not members of the agreement (customs union).
  - If they coordinate other policies such as monetary exchange, the customs union becomes a common market.

NAFTA
Protectionism

- When states try to manipulate international trade to strengthen one or more domestic industries and shelter them from world markets
  - Protection of domestic industries from international competition
  - Infant industry protection considered a relatively legitimate reason for (temporary) protectionism
  - Protection of industry vital to national security
  - Defense effort to ward off predatory practices by foreign companies or states
Protectionism

☐ Means to discourage imports
  ■ Tariff or duties
    ☐ Tax imposed on certain types of imported goods as they enter a country
  ■ Nontariff barriers
    ☐ Quota
  ■ Subsidies to a domestic industry, which allow it to lower its prices without losing money
    ☐ Tax breaks
  ■ Restrictions and regulations
  ■ Economic nationalism

☐ Protectionism can have both positive and negative effects on an economy
Trade Regimes

Two contradictory trends are at work in global trading patterns today:

- One trend is toward integration of the industrial regions with each other in a truly global market.

- The second trend is the emerging potential division of the industrialized West into three competing trade blocs, each internally integrated but not very open to the other two blocs.
Regional Economic Integration & Global Commerce

- Functionalists look at how international organizations rise up out of the need to accomplish some task, such as postal service. Neofunctionalists focus on the political processes orchestrated by politically connected specialists or elites.

- Trade has been influenced by economic integration among nations. The European Union (EU) has been the most successful case of economic integration to date. Even in the EU, however, there are tensions between those who desire increasing economic, social, and even political integration and those who are in favor of lower levels of integration but the inclusion of additional countries within the EU.
Glossary List:

- Balance of payments
  - surplus
  - deficits
- Comparative advantage
- Commodity
- Economies of scale
- Exchange rate
  - Hard currency
  - Soft currency
  - Fixed, Float, Managed float
  - Liquidity
- Hecksher-Ohlin theorem
- Macro economics
- Micro economics
- Opportunity costs
- Fiscal policy
- Monetary policy
- Protectionism
- Terms of trade
  - exports
  - imports
Review – How much do you understand?

1. According to the idea of comparative advantage, what will occur if there are no differences in efficiency of production and domestic supply can meet demand?
   
   A. Specialization will occur anyway.
   
   B. No trade will occur at all.
   
   C. Limited trade will take place.
   
   D. Only select countries will trade with one another.
Review– How much do you understand?

2. The theorem that states that since states have different amounts of land, labor, and capital, they will export those goods and services in which the combination of these factors gives them a comparative advantage is known as the

A. Ricardo theorem.
B. comparative advantage.
C. Hecksher-Ohlin theorem.
D. Theory of Factor Endowments.
Review– How much do you understand?

3. The concept of terms of trade refers to

A. certain allowances that are made by one country to another in order to grant them some sort of preference.

B. the status which trading partners grant one another, for example, most favored nation status.

C. the ratio of export prices of one country to those of another.

D. the level of tariffs or taxes imposed by one country on another's imports.
Review– How much do you understand?

4. Economies of scale refer to
   A. the ratio of one state's economy to another.
   B. economies that span continents or even the globe—such as the European Union or a global economy.
   C. efficiencies that come from larger quantities or mass production resulting in lower costs.
   D. economies based on the production of capital goods.
Review– How much do you understand?

5. If 1 U.S. dollar could purchase 7 French francs last week, but can only purchase 6.5 today, then

A. the franc has depreciated in relation to the dollar.
B. the dollar has appreciated in relation to the franc.
C. the dollar has depreciated in relation to the franc.
D. the exchange rate has not technically changed.
Review– How much do you understand?

6. The fact that the postal exchange led in the nineteenth century to the formation of the Universal Postal Union is an example of

A. Functionalism.
B. Neofunctionalism.
C. Neoclassicism.
D. Classicism.
7. Which of the following provides the best example of regional economic integration?

A. Latin America
B. Europe
C. Africa
D. Asia
Review– How much do you understand?

8. Subtracting a state's imports from its exports gives you
   A. unilateral transfers.
   B. official reserves.
   C. balance of payments.
   D. balance of trade.