

International Political Economy

Spring 2020 (Block III)

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Leiden
The Netherlands

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International Trade: The Good, the Bad, and the Ugly

- ▶ While we listen to the Danish National Symphony Orchestra performing "*The Good, the Bad and the Ugly*"
- ▶ Discuss with the classmates next to you for 5 minutes:
 - First introduce yourself!
 - What types of questions do you expect you learn to answer in this class?
 - How do you define International Political Economy?
 - Is international trade good or bad?
 - What are the advantages and disadvantages of international trade?

International Trade: The Good, the Bad, and the Ugly



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International Political Economy: Definition

Definition of economics

Economics is the study of the production, distribution, and consumption of scarce resources.

Distribution of resources

Definition of politics

Competition between rival interest groups or individuals for power and leadership.

Distribution of power to formulate and implement policies as well as to control over monopoly of violence

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International Political Economy: Definition

Definition of IPE

International political economy (IPE) studies how politics shape developments in the **global economy** and how the **global economy** shapes politics.

global economy: the flows of production, distribution, and consumption across national borders.

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Winners & Losers

- ▶ Trade policies affect the political and economic distributions
 - The state makes decisions that have heterogeneous consequences across society.
 - Some benefit, some lose out. (i.e. taxation, trade policy, social programs, just about everything)
 - Sometimes general welfare is increased, sometimes small groups win at the expense of general welfare.
- ▶ Economists (main stream) claim that international trade improve *Pareto efficiency/optimality*, but this does not mean everyone would be better off!
- ▶ Part of this course is about how international trade affects Pareto optimality and distribution of power and resources

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The consequences of global economy

Flow of resources and productions:

- ▶ Trade (goods and services)
- ▶ Capital (finance, currency)
- ▶ Immigration (people, labor)

Political consequences:

- ▶ Affecting the quality of democratic institutions
- ▶ Environment (pollutants)
- ▶ Violent conflicts (terrorism, civil conflict, peace)
- ▶ add more...?

Avocado, Trade War, and Gang Violence

Read the story [here](#).



Source: Daily Mail

Studying IPE

IPE is an interdisciplinary topic, so to study it, we need to learn:

- ▶ about the economic interests of the businesses and workers who produce and consume traded goods
- ▶ about the political processes of trading countries
- ▶ about international and regional laws and institutions, such as WTO and NAFTA, that govern these trades
- ▶ What about ideas? Ideologies? *-isms*? They do matter, but not to an extent that we ignore incentives and institutions to discuss IPE questions only using *-isms*. We come back to this later!

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What types of questions can we answer by IPE?

- ▶ **The global trade regime & trade agreements:** What the EU and Brexit meant for you!
- ▶ What power do corporations have over our lives and politics?
- ▶ Why do countries have different currencies? Does it impact our life?
- ▶ What is a dollar worth and why does it matter? What is money anyway?
- ▶ Is a trade deficit *really* bad?
- ▶ How does economic and financial globalization impact your life and (future) business?

A note on Social Science

- ▶ What does the science part in "Social science" and "political science" mean?
 - Karl Popper's and Lakatos's Philosophy of science
- ▶ While we take a specific political economy approach in our classroom, the approach may lead us astray in some cases.
- ▶ Social science is hard (harder than rocket science) (Just to mention that I'm an engineer 😊)
- ▶ You should always question what the book says and what your professors say. We will practice in this class how to ask *good* question, so feel free ask questions. Practice makes perfect: Watch David Beckham's free kicks in the game against Greece

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Syllabus

Course materials:

- ▶ Text Book: International Political Economy (6th ed) by Thomas Oatley.
Kindle and e-book edition available
- ▶ Supplemental readings & media on BlackBoard

Syllabus (2)

Grading:

- ▶ Everything is the final exam
- ▶ The final exam is:
 - 50% multiple choice
 - 50% short answer
- ▶ What is on the final exam ...
 - Everything (book & lectures)
 - But be strategic.
 - I will put what I think is important on the final exam.
 - So, coming to class will give you the best indication of what I think is important.

Lectures Will Not Be Recorded

- ▶ Lecturing is a strategic interaction and not a one way conversation.
- ▶ You need to practice ingesting information and taking notes when information is delivered.
- ▶ Additionally, the value of a college degree does not solely lie in your ability to prove you learned information (most of which you are likely to forget).
- ▶ Lastly, it isn't clear that online classes have the same educational impact as viewing a lecture in person.

In class anonymous polls!



<https://forms.gle/LnEXSueSmwBMD5Cb8>

Approaches to IPE

The old schools ...

- ▶ Mercantilist School (mercantilist)
- ▶ Liberal School (liberalism)
- ▶ Marxist School (Marxism)

Though I enjoy reading about “-isms”, we don’t do “-isms”

- ▶ A single paradigm can’t explain physics
- ▶ A single paradigm certainly can’t explain the global economy and political order

Instead, a modern approach studies focuses on

- ▶ How do actor’s interest as well as institutions shape the choices, and
- ▶ their *welfare consequences* and *distributional consequences*:
Watch Bernie Sanders talking about these two! the US vs. North Korea!

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Mercantilism

- ▶ Similar to IR's Realism focuses on the state, rather than sub-national interests.
- ▶ *Three central propositions:*
 - Wealth \iff National power (tightly connected)
 - Trade provided one way for countries to acquire wealth from abroad. But, trade is good as long as the trade balance is positive: (Export > Import)
 - Some types of economic activity are more valuable than others: Manufactured goods are superior
- ▶ Implication: Economy is a matter of national security, and too important to let the market's "invisible hand" allocates the resources and benefits.
- ▶ Question: China economy is growing, does it make a threat to the US?

└ Session 1: What is International Political Economy?

 └ Traditional Schools of International Political Economy

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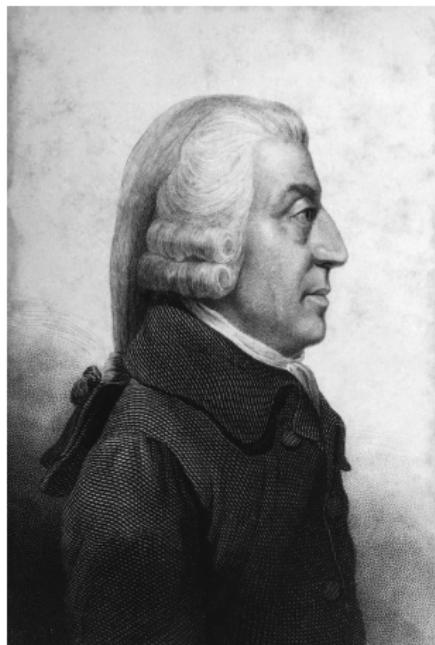
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Liberalism



Adam Smith (1723-1790) "It is not from the benevolence of the butcher, the brewer, or the baker that we expect our dinner, but from their regard to their own self-interest. We address ourselves not to their humanity but to their self-love, and never talk to them of our own necessities, but of their advantages." *The wealth of nations*: Vol. 1

Liberalism (2)

Three central propositions, while criticize mercantilism:

- ▶ The purpose of economic activity was to enrich individuals, not to enhance the state's power
- ▶ Countries gain from trade, either export>import or export<import
- ▶ Producing manufactured goods is not superior to other productions. The value is in producing what is "relatively" low cost products in home and trading them with what is "relatively" high cost.

Implication: Government, even in its best state, is but a necessary evil; in its worst state, an intolerable one (Thomas Paine 1737-1809).

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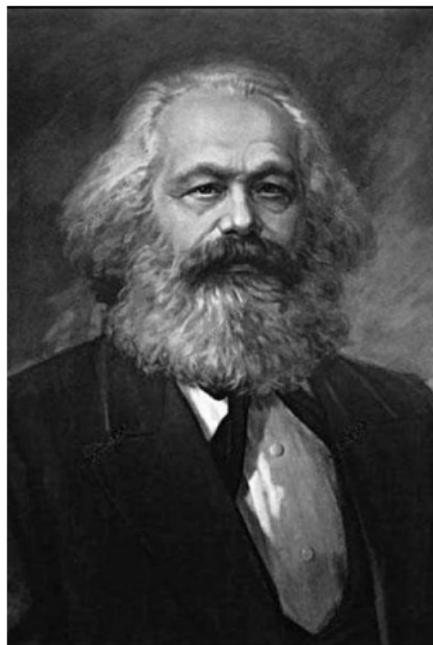
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Marxism



Karl Marx (1818-1883) “Capitalist production, therefore, develops technology, and the combining together of various processes into a social whole, only by sapping the original sources of all wealth - the soil and the labourer.”

└ Session 1: What is International Political Economy?

 └ Traditional Schools of International Political Economy

Marxism (2)

- ▶ According to Marx, capitalism is characterized by two central conditions:
 - the private ownership of the means of production (or capital)
 - wage labor
- ▶ Marx argued (assumed) that the value of manufactured goods was determined by the amount of labor used to produce them: capital is dead labor!
- ▶ Predicting: proletariat revolution: “Workers of the world unite; you have nothing to lose but your chains.” *The Communist Manifesto* (1848)

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Marxism (3)

- Dynamics would interact to drive this revolution:
 - Competition ⇒ Accumulation of capital ⇒ Concentration of capital in a small group of elites
 - Concentration of capital ⇒ Efficiency of capital ↓ ⇒ Capitalists decrease labor share to survive the competitions ⇒ economic inequality ↑
- These socio-economic conditions ⇒ Overthrow of the capitalist system, and replace it with socialism.
- Of course, there is a an intermediate stage: the dictatorship of the proletariat. See Friedrich von Hayek's book *The Road to Serfdom* (1944)
- The state exists to protect capital (not labor)
- Internationally: exploitation of the South by the North

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Summary of these three Approaches

- ▶ Each offers a way to view the politics and the world economy
 - The important actors
 - The relationship between them
 - And each proposes distinct economic policy
- ▶ Each is limited because of their rigid frameworks dependence on questionable assumptions
 - And normative views on how the world “should” work, not how the world work!

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A Modern Approach

- ▶ Interest (preferences) and institutions
- ▶ The interaction between societal interests and the political institutions that funnels them to policy.
- ▶ We use assumptions about interests and institutions to build a model that helps us explain an outcome.

Interests (Preferences)

- ▶ What drives your (political and economic) behavior?
 - Material/Monetary: What increases your welfare?
 - Political/Power: What will keep me in political office?
- ▶ We evaluate a certain policy based on our interests
- ▶ Material interests (in IPE) are assumed to largely shaped by endowments:
 - Skill level & Factor of production: Land, Labor (skilled & unskilled), Capital
 - Industry: what kind of industries employs you (Sector): Ex. Import competing, export-oriented
 - "Tell me where you work and I'll tell you your political preferences"
- ▶ The interests that matter differ depending on the question we are trying to answer
- ▶ Sometime interests are hard to identify, so we have to make assumptions and simplify

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Example: Interests of (most) College Students

In regards to government economic policy:

- ▶ Plentiful student aid (pro handouts)
- ▶ Lower interest rates (inflation is fine, but who hates this a lot?)
- ▶ Hopefully, you'll hold skilled labor upon graduation and you'd like to sell that labor to the rest of the world (Pro-Free Trade)

Do Ideas Matter?

- ▶ Probably: But it's harder to theorize or quantify
- ▶ Do people act against their own interests because of ideas
 - Certainly ... watch
 - But most of the time people are rational, even harder than interests
- ▶ Did FDR adopt Keynesian economics because he read a book or because it was politically favorable?
- ▶ Did Communism rise because it was an attractive idea or because the political circumstances brought it to the forefront?
- ▶ Difficult questions to answer

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Institutions

What is an institution?

- ▶ A set of rules that governs behavior
- ▶ Both enforced or unenforced
 - Driving on the right side of the road
 - QWERTY Keyboard
 - US Constitution
 - Markets

Want to learn more, I suggest Daron Acemoglu's research.
Here is a link to one of his lectures on 'Understanding
Institutions': <https://economics.mit.edu/files/1353>

Political Institutions

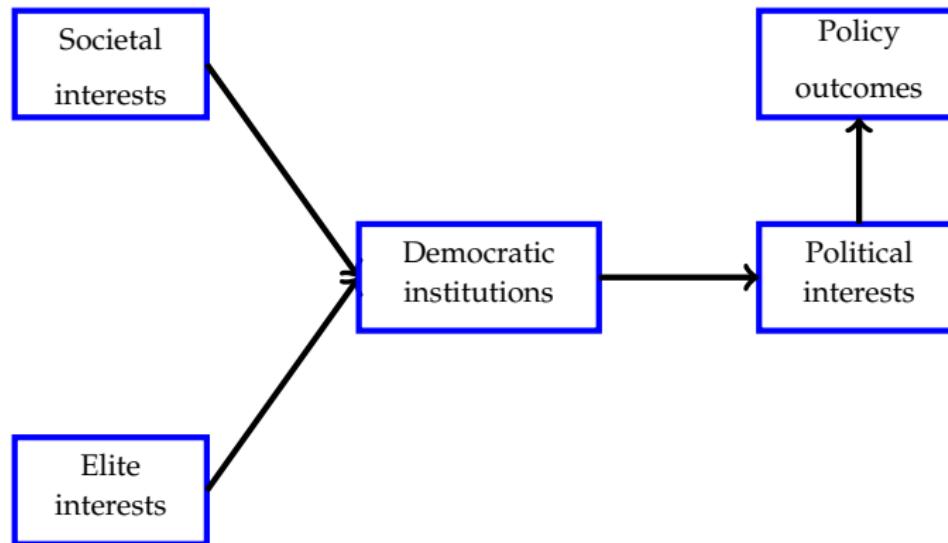
► Domestic:

- Democracy, Dictatorship, Anocracies
- Presidential, Parliamentary
- Parties

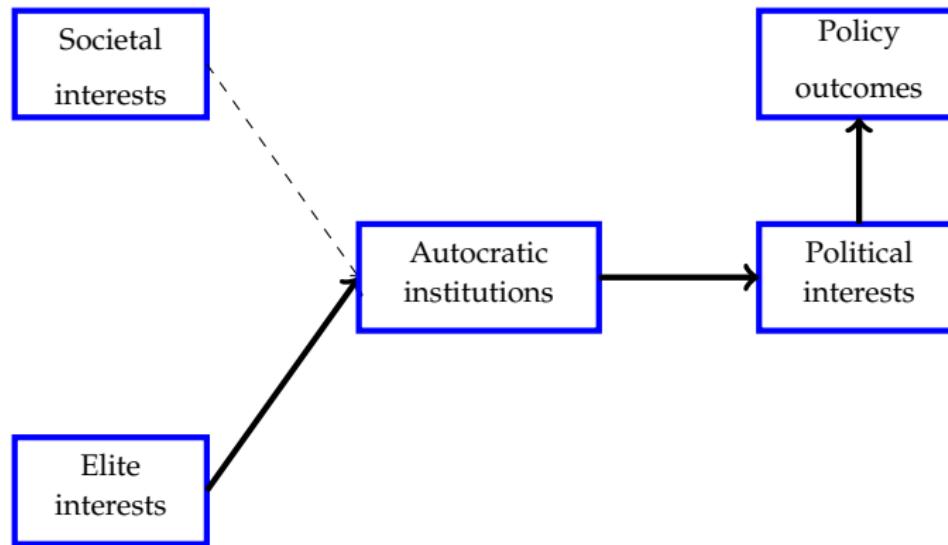
► International

- UN
- ICC
- World Trade Organization
- NATO
- NAFTA → USCMA

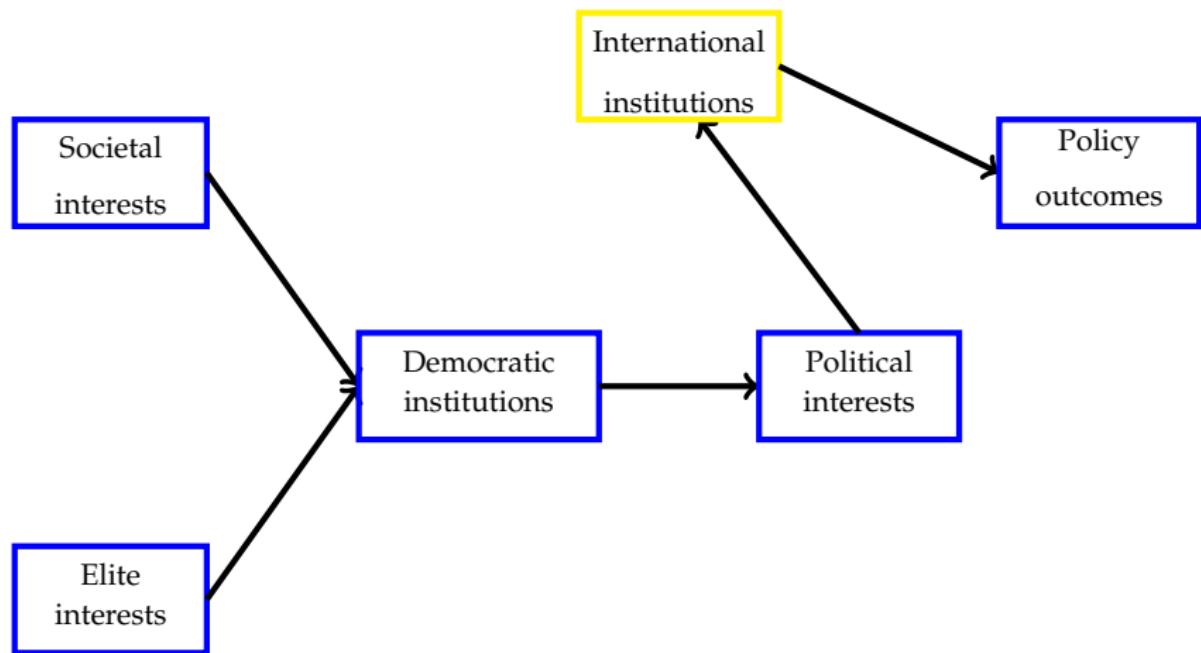
Interests & Institutions in Democracies



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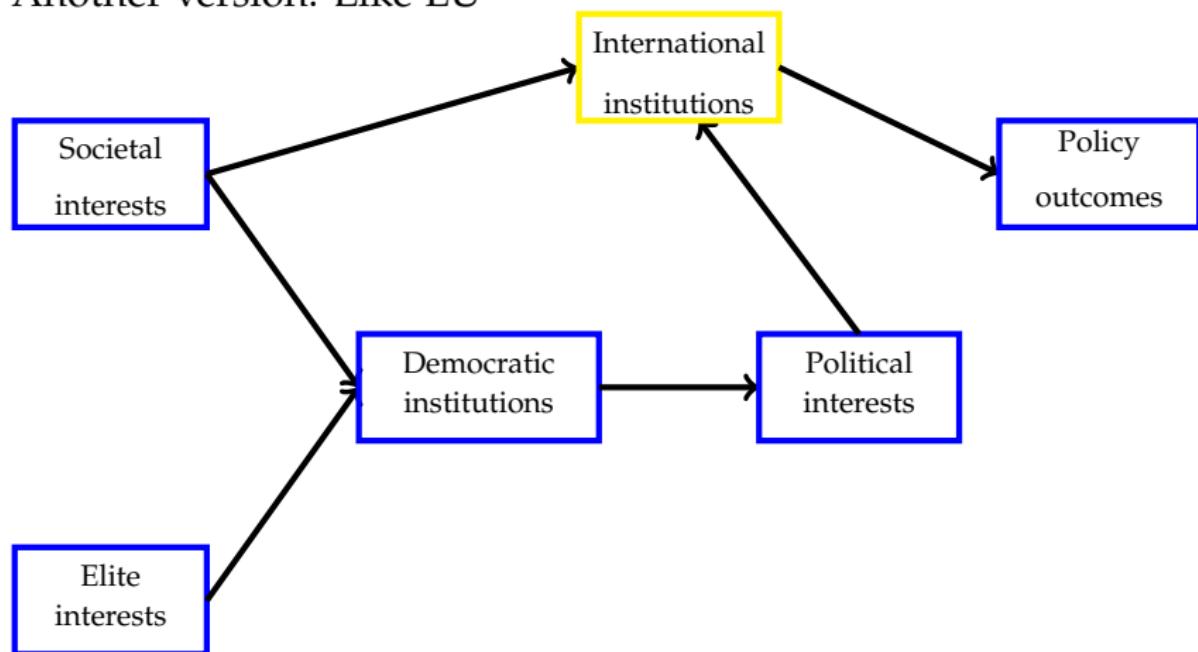


Interests & Institutions in Democracies adding Int' Institutions



Interests & Institutions in Democracies adding Int' Institutions (2)

Another version: Like EU



Summary of approaches

	Mercantilism	Liberalism	Marxism	Interests & Institutions
Most important actor	The state	Individuals	Capitalist class	Winners & losers
Role of the state	Intervene to allocate resources	Property rights	Protect/sustain the capitalist system	Survive in office (politicians)
Image of the IPE	Conflict – between states over trade	Harmony	Exploitation of labor	Mix of conflict & cooperation
Proper objective	Enhance national power	Enhance aggregate social welfare	Promote equal income distribution	Politically constrained efficiency

Interests & Institutions

- ▶ Has own assumptions: But they are flexible
- ▶ Provides a framework to accommodate a variety of research questions that isn't limited to an *-ism*'s strict framework
- ▶ Often ignores some potentially important variables: Culture, the power of ideas and norms

Poll!



International trade

Class 2: International Trade Theories I

- ▶ Trade is an important political economic phenomenon;
 - Reason 1: Trade is an increasingly important part of the world economy.

Thinking inside the box

World merchandise trade

2012 prices*, \$trn



Sources: World Trade Organisation; US Bureau of Labour Statistics;
Daniel Bernhofen et al; *The Economist*

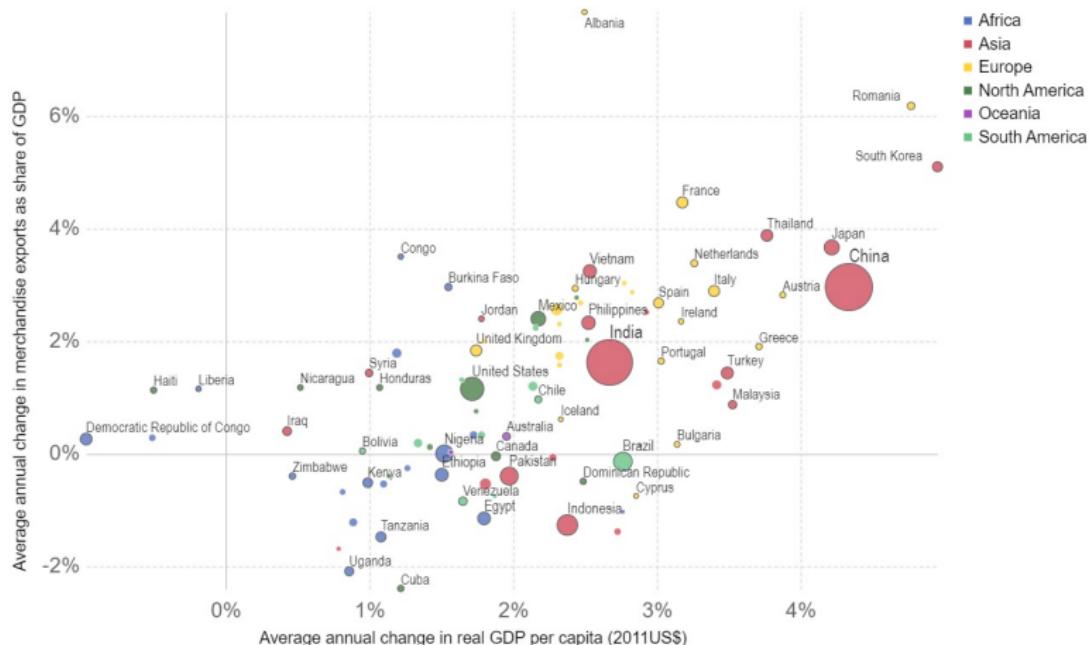
International trade

Class 2: International Trade Theories I

- ▶ Trade is an important political economic phenomenon;
 - Reason 1: Trade is an increasingly important part of the world economy.
 - Reason 2: Trade seems closely linked with economic growth

Growth of income and trade, 1945 to 2014

Average annual change in real GDP per capita vs Average annual change in export volumes.



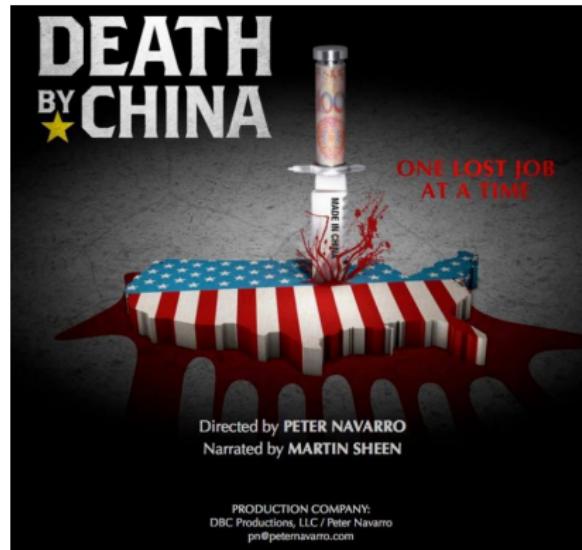
Source: CEPII imports - Two Centuries of Bilateral Trade and Gravity Data: 1827-2014 (2016), Maddison Project Database (2018)

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International trade

Class 2: International Trade Theories I

- ▶ Trade is an important political economic phenomenon;
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 - How do nations trade?
 - Who benefits from trade?
 - Despite gains from trade, why is there resistance? How can we understand this resistance?



Trailer
Full movie

When you are watching this movie, have a critical view about it. Try to understand whether the arguments make sense or not.

International trade

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 - How do nations trade?
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 - Despite gains from trade, why is there resistance? How can we understand this resistance?
- ▶ The efforts to answer these questions go back to about 170 years ago, when David Ricardo developed his *Comparative Advantage* model of Trade.
- ▶ To understand the nexuses of trade and politics, it is beneficial to learn about the theories of international trade, especially that they sometime have contradictory implications.

Gravity model

- ▶ Gravity model is a popular statistical model for explaining international trade
- ▶ Developed by Jan Tinbergen (1903-1994)
- ▶ Tinbergen was a physicist and economist; he was among the first economist to use econometrics models to explain economics (macroeconomics) processes.
- ▶ Tinbergen's gravity model is inspired by Newton's gravity model
- ▶ It was a purely empirical and intuitive model, but later economists provided rigorous theories to support it.

Gravity in physics



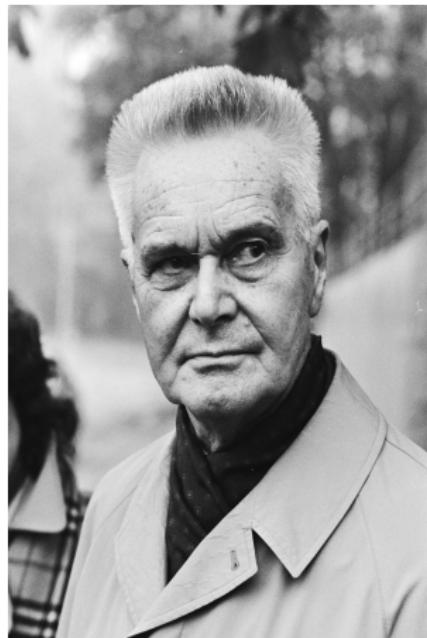
$$F_{ij} = G \frac{M_i \times M_j}{r_{ij}^2}$$

- F_{ij} : Force between two objects
- M_i and M_j are the size of masses
- r_{ij} : distance between the masses
- G : Gravity

This famous physics equation inspired Tinbergen to use it for explaining the trade between two countries. This was one of the reasons that he won the first economics Nobel prize.

Intuitive gravity for trade

- Tinbergen and other economists came up with a gravity model of trade



$$X_{ij} = C \frac{Y_i \times Y_j}{t_{ij}^2}$$

- X_{ij} : exports (or trade) from i to j
- Y_i and Y_j : the economic size of two country (i.e. GDP)
- t_{ij} : trade costs between two countries: distance, tariffs,...

Intuitive gravity model of trade

$$X_{ij} = C \frac{Y_i \times Y_j}{t_{ij}^2}$$

- ▶ Larger countries trade more than smaller ones
- ▶ Trade costs between two trade partners reduce trade between them.
- ▶ Proxies for trade costs:
 - Distance
 - Adjacency
 - Common language
 - Colonial links
 - Common currency
 - Island, landlocked
 - Institutions, infrastructures, migration flows,...
 - Bilateral tariff barriers

An example

Consider three below countries, and discuss the patterns of trade among them using the *Trade Gravity* model:

- ▶ Netherlands: GDP=826.2 billion USD (2017)
- ▶ Indonesia: GDP=1.016 trillion USD
- ▶ Germany: GDP=3.677 trillion USD (2017)

Why is it so popular?

- ▶ Intuitively appealing
- ▶ Fits with some important stylized facts
- ▶ Easily to use real data to explain trade flows with respect to policy factors.
- ▶ Estimation using the simplest econometrics model
- ▶ Despite its popularity, the classic version of gravity model lacks solid theoretical foundations.
- ▶ Remember that we want to build our arguments around interests, institutions, and their interactions!
- ▶ Also, it does not explain why the Netherlands is a major flower exporter and Germany is a major car exporter. Which country exports what and why?

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Why is trade beneficial?

Adam Smith's Division of Labor:

- ▶ Specialization increases productivity
- ▶ exchange allows the benefits of specialization to be realized
- ▶ the gains of exchanges apply to both individuals and to nations

"It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy. The tailor does not attempt to make his own shoes, but buys them of the shoemaker. [...] All of them find it for their interest to employ their whole industry in a way in which they have some advantage over their neighbours, and to purchase with a part of its produce, or what is the same thing, with the price of a part of it, whatever else they have occasion for." Adam Smith (1973: 424), *Wealth of Nation*.

David Ricardo (1772-1823)



- ▶ Third of seventeen children.
- ▶ Eloped at the age of 21.
- ▶ Became rich by purposefully misleading the public about the outcome of the Battle of Waterloo and buying British securities at a steep discount.
- ▶ Died from an ear infection at 51.

Ricardo model of trade

- ▶ Ricardo extended Smith's arguments to inter-state trade.
- ▶ The Ricardian model uses the concepts of opportunity cost and comparative advantage.
- ▶ The opportunity cost: the loss of other alternatives when one alternative is chosen.
- ▶ Example: The opportunity cost of studying IPE over the weekend is missing the joy of watching Ajax game with friends!
- ▶ The opportunity cost of producing something measures the cost of not being able to produce something else.
- ▶ The opportunity cost of producing Tulip for the Netherlands is the cost of not being able to produce cars
- ▶ How does the Netherlands decide to produce Tulip but not car?
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Comparative advantage

The core argument in David Ricardo's trade theory is comparative advantage, and the below quote clarify this concept very well:

"A famous and wealthy impresario of stage and screen in the 1940s, Billy Rose was also a world-class typist and stenographer with many awards to his credit. He would thus have encountered enormous difficulty in hiring a secretary who could work nearly as he himself could. Still, he hired secretaries because even though he was the world's best at the job, he could still earn much more in a hour manipulating his stage and screen empire than he could in typing."

W.B. Brown and J.S. Hogendorn (1994: 28): International Economics: Theory and Content

Ricardo model: assumptions

- ▶ Two countries
- ▶ Two goods
- ▶ One factor of production
- ▶ Country-specific production technology

Example

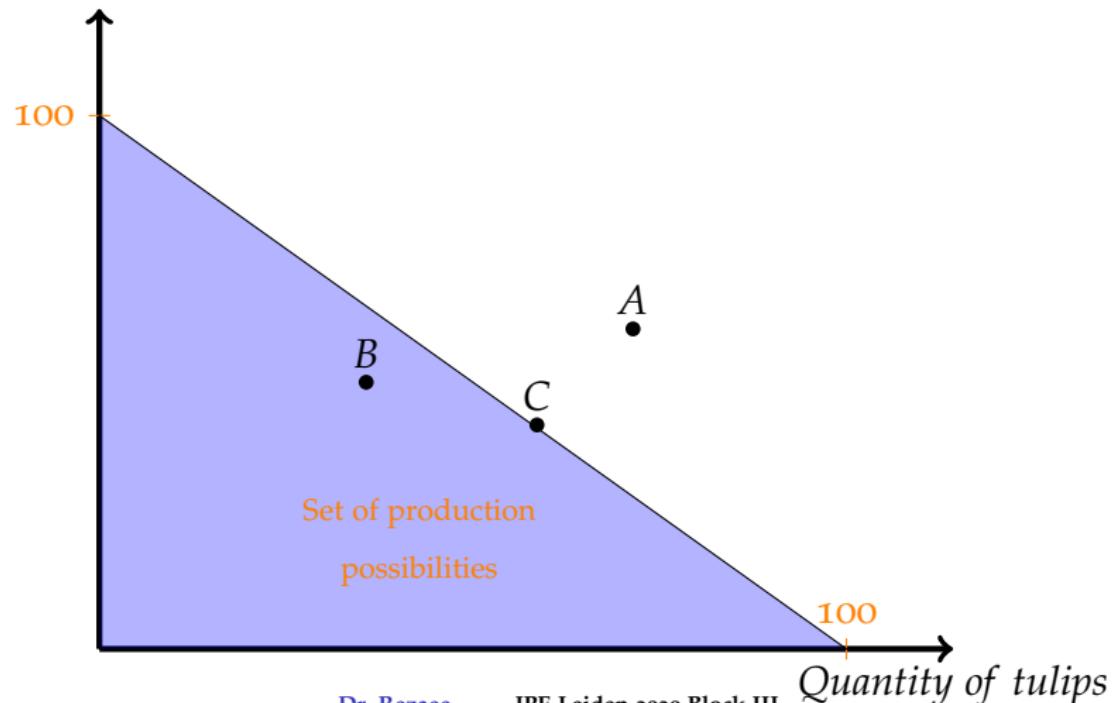
- ▶ Two countries: Netherlands and Germany
- ▶ Two goods: Tulip and sausage
- ▶ One factor of production: Labor
 - Germany: 100 people.
 - Netherlands: 50 people
- ▶ Country-specific production technology:
- ▶ Germany: Each worker can produce 1 tulip or 1 sausage.
- ▶ Netherlands: Each worker can produce 2 tulips or 1 sausage.

The production possibility frontier

- ▶ Consider the Netherlands in autarky. (“Autarky” means in the absence of trade).
- ▶ We first characterize the **production possibilities** of the Netherlands:
 - The **set of production possibilities** of the Netherlands is all the different combinations of tulip and sausage that the Netherlands can produce.
 - The **production possibility frontier** (PPF) is the most sausage the Netherlands can produce for each number of tulips produced.

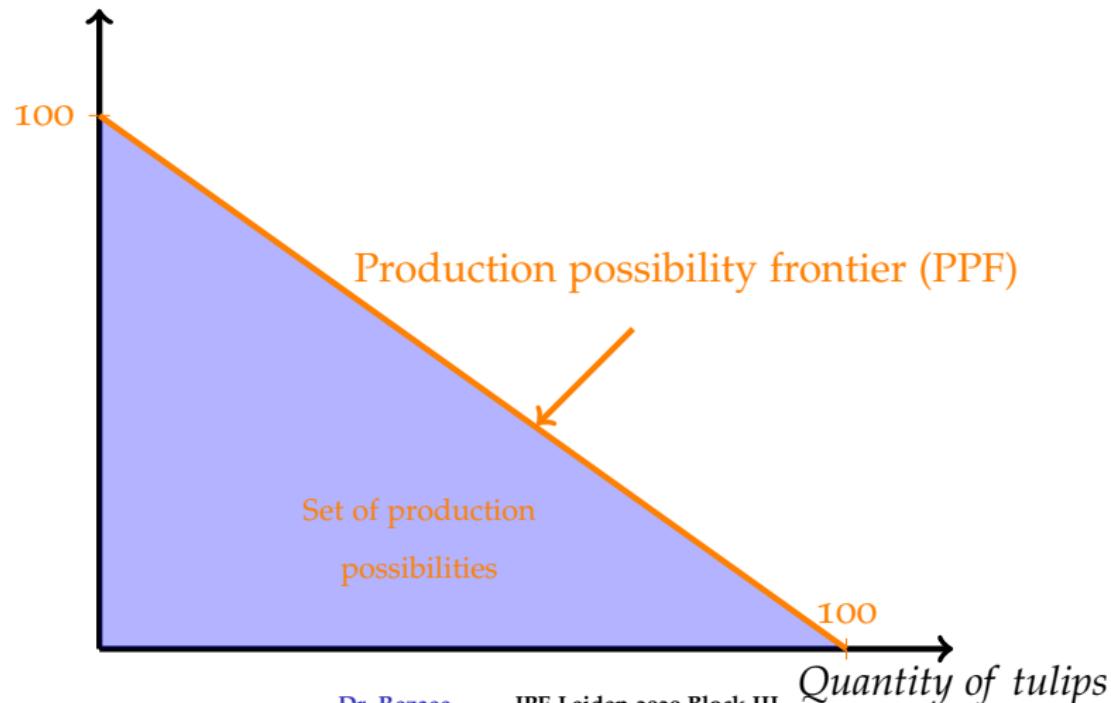
PPF for the Example (Germany)

Quantity of sausages



PPF for the Example (Germany)

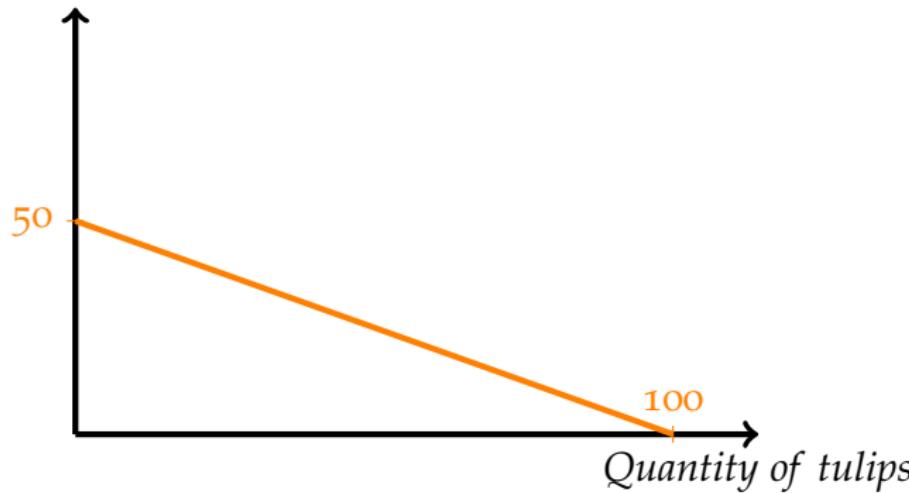
Quantity of sausages



PPF for the Example (Netherlands)

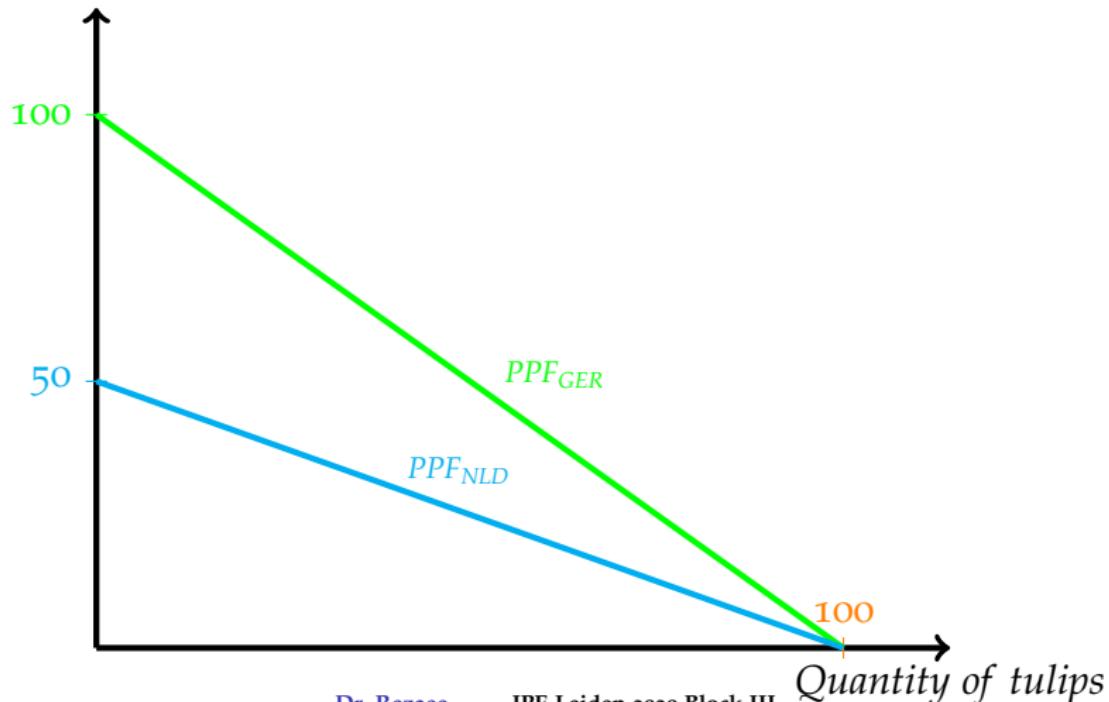
[Class question:] Draw the production possibility frontier for the Netherlands?

Quantity of sausages



PPF for the Example (Germany & Netherlands)

Quantity of sausages



What Germany and Netherlands produce?

- ▶ Under autarky:
 - Germany can produce 100 sausages, 100 tulips, or any combinations on its PPF (red line).
 - Netherlands can produce 50 sausages, 100 tulips, or any combinations on its PPF (blue line).
- ▶ However, if we allow trade, according to Ricardo, Germany produces 100 sausages and Netherlands produce 100 Tulips, so there would be more goods (sausage and tulips) available in the market.
- ▶ Germany has absolute advantage in producing neither tulips nor sausages, but it is better for the aggregate supply of the world economy, and so the people in the world, Germany produces sausages and Netherlands produces tulips.
- ▶ Don't forget our world here has only two countries: Germany and Netherlands. You can use inductive reasoning to extend this finding for a world with many countries.

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Calculating comparative advantage

- We can look at the slope of PPFs to find the comparative advantage of countries:
- If $\alpha_{Sausage}^{NLD}$: Sausage produced per labor unit in Netherlands and $CA_{Sausage/Tulip}^{NLD}$ is comparative advantage of NLD in producing Tulip vs. Sausage, then:
- $CA_{Sausage/Tulip}^{NLD} = \frac{\alpha_{Sausage}^{NLD}}{\alpha_{Tulip}^{NLD}} = \frac{1}{2}$
- $CA_{Sausage/Tulip}^{GER} = \frac{\alpha_{Sausage}^{GER}}{\alpha_{Tulip}^{GER}} = \frac{1}{1}$
- Since $CA_{Sausage/Tulip}^{NLD} < CA_{Sausage/Tulip}^{GER}$, Germany has comparative advantage in producing sausages.

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[Class question:] Calculate the comparative advantage of Netherlands and Germany in producing tulip, and explain why Netherlands has a comparative advantage in producing tulips?

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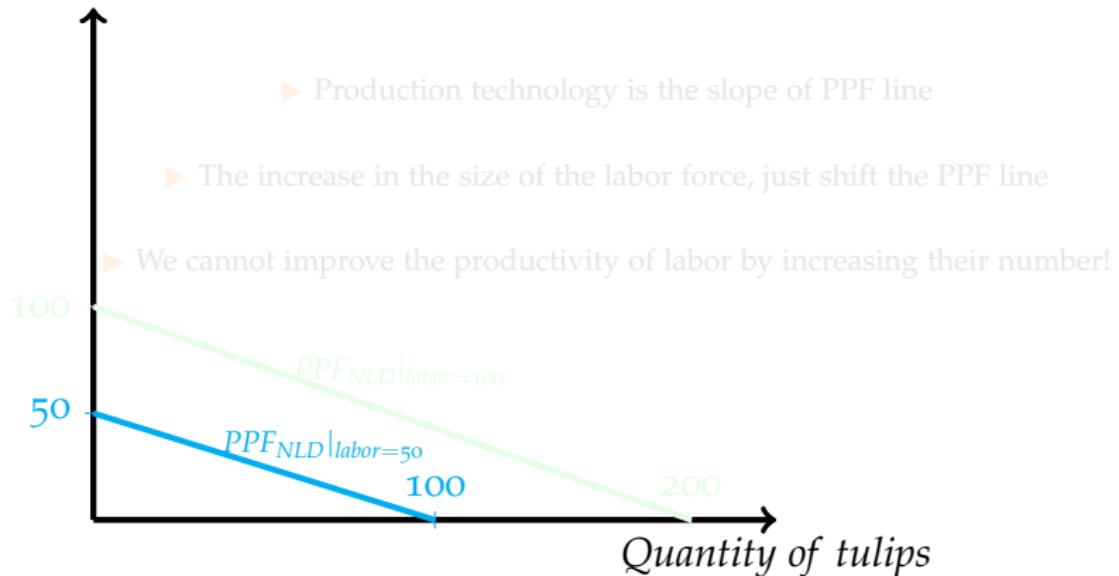
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The role of production factor size in Ricardo's model?

- ▶ An interesting implication of Ricardo's model is that the size of production factor does not affect the pattern of trade between two countries.
- ▶ That is, even if we increase the size of labor in the Netherlands in our example, still the suggested trade pattern would be the same as 50 labor in the Netherlands and 100 labor in Germany:
- ▶ It is better the Netherlands produces Tulip and Germany produces Sausage.
- ▶ Why? Let's plot the PPF for the Netherlands under the new assumption, i.e. 100 labor

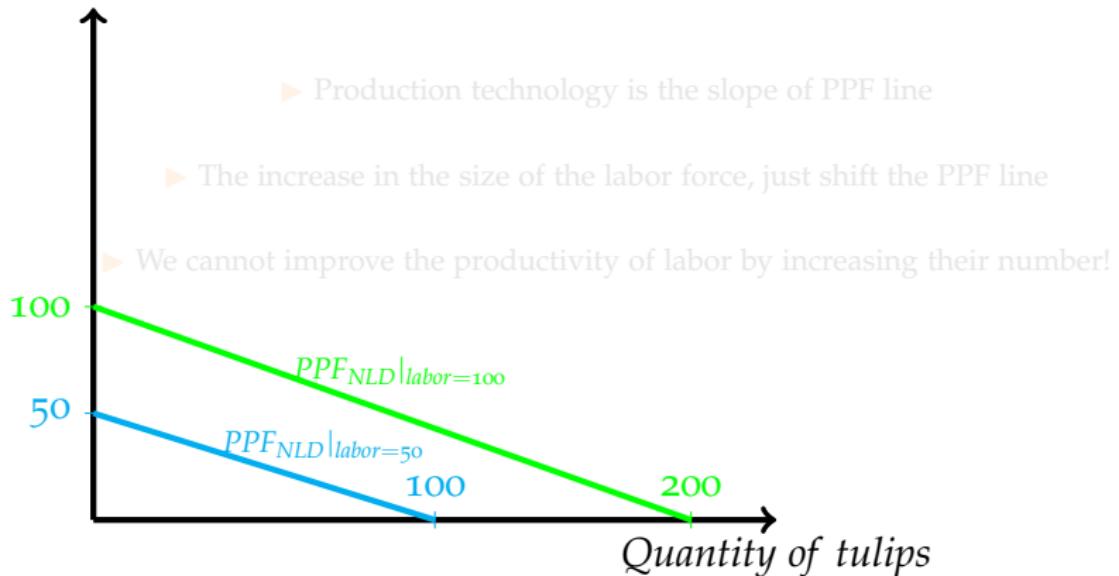
The Production Possibility Frontier of the Netherlands for 100 units of labor

Quantity of sausages



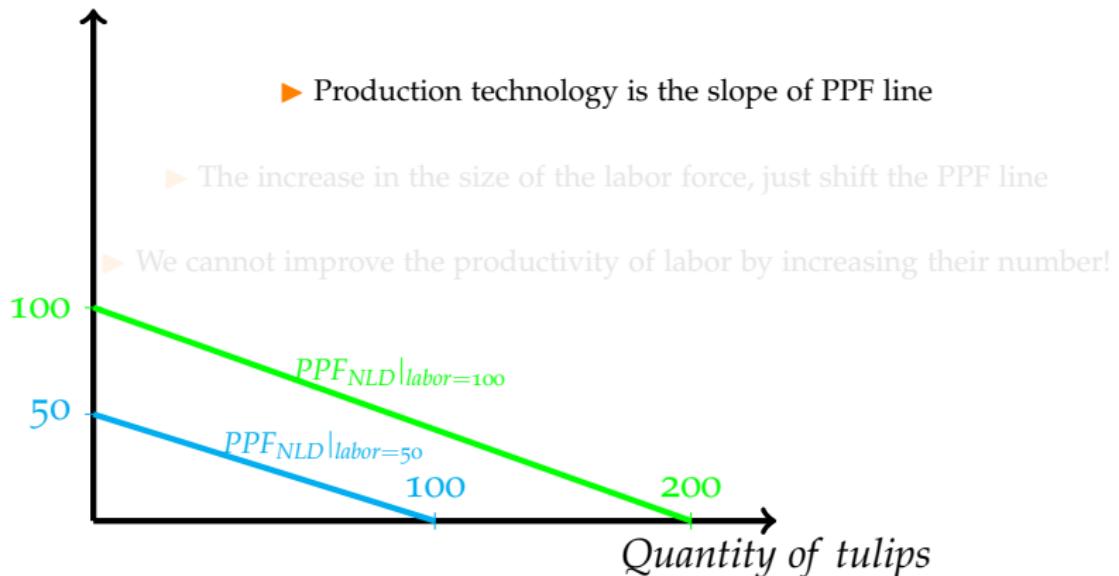
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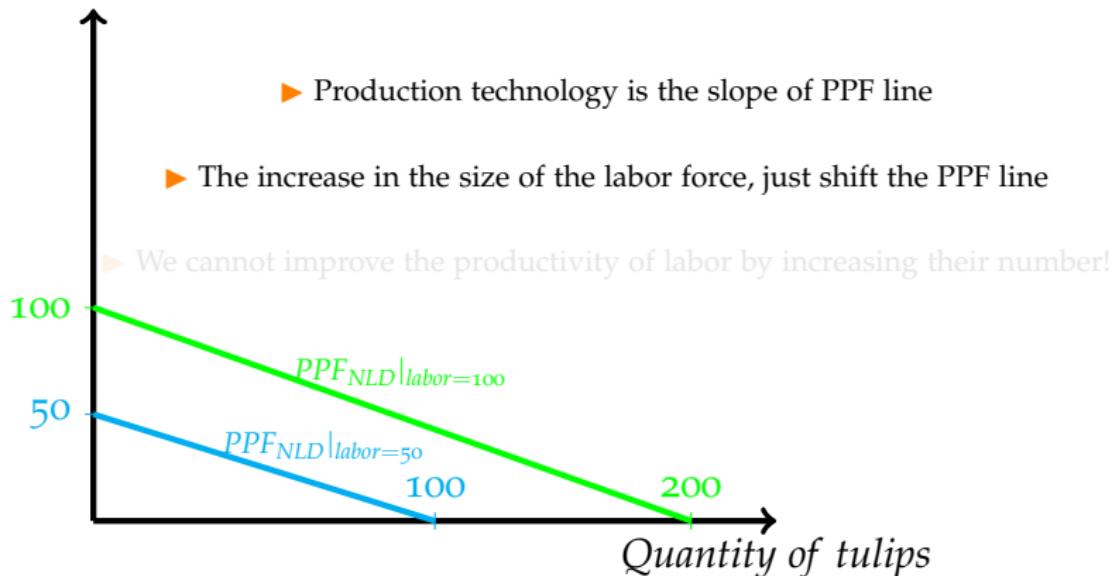
The Production Possibility Frontier of the Netherlands for 100 units of labor

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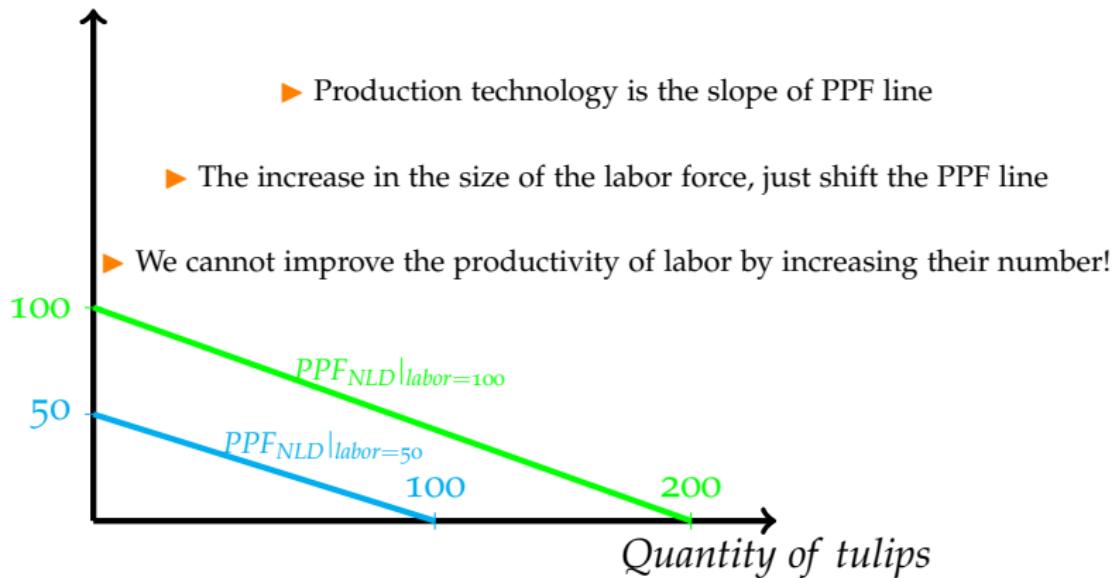
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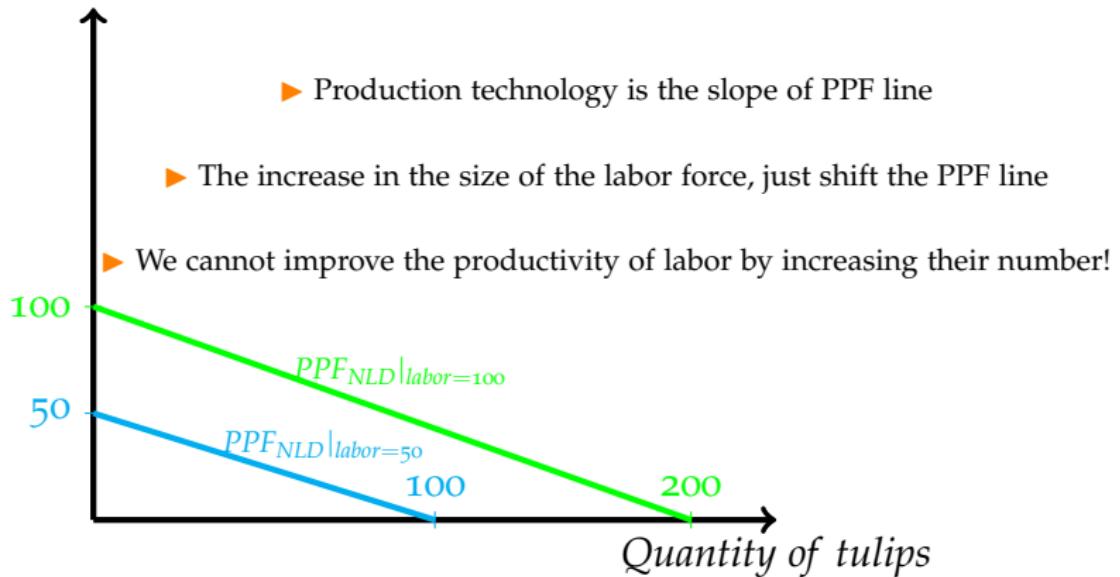
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Another example

If the size of labor(production factor) does not matter in Ricardo model, let's solve the below problem.

# of workers to produce:	Beer	Prosciutto
Netherlands	10	12
Italy	9	8

- Italy requires less labor to produce both goods.
- If two countries decide to trade, which produce what according to Ricardo's theory?
- Trade benefits both countries! How?

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► $CA_{\frac{Beer}{Prosciutto}}^{ITA} = \frac{\text{The number of Beer a unit of labor in Italy produces}}{\text{The number of Prosciutto a unit of labor in Italy produces}} = \frac{\frac{1}{9}}{\frac{1}{8}} = \frac{8}{9} = .89$

► $CA_{\frac{Beer}{Prosciutto}}^{NLD} > CA_{\frac{Beer}{Prosciutto}}^{ITA}$, so according to Ricardo's model, the Netherlands should produce beer and Italy should produce Prosciutto.

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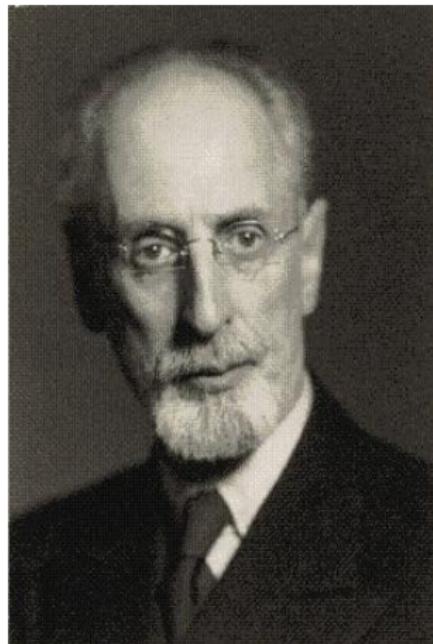
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Class 3: International Trade Theories II

Reviewing last session...

- ▶ Gravity model/equation
- ▶ Ricardo's trade theory
- ▶ What are the differences between these two models?

Eli Heckscher



- ▶ Eli Heckscher (1879-1952)
- ▶ Swedish economist
- ▶ By his death, he had published 1148 books and articles: ~ 16 for every year he was alive!

Bertil Ohlin



- ▶ Bertil Ohlin (1899-1979)
- ▶ Swedish economist
- ▶ His advisor was Eli Heckscher.
- ▶ Won the Nobel Prize in 1977.

Why the Heckscher-Ohlin (H-O) theory?

- ▶ In the Ricardian model, countries could gain from trade because they have different productivities/ production technologies.
- ▶ The basic idea of the H-O theory is that countries vary in their endowments, and this affects their trade patterns.
- ▶ Even if the production technologies are the same, differences in endowments will result in countries using different factor proportions in the production of goods.

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Summary of the H-O model

- ▶ What is the H-O model prediction of **trade patterns**?
- ▶ A country exports goods that are intensive in its relatively abundant factor and imports goods that are intensive in its relatively scarce factor.
- ▶ Review: Ricardo's model predicts that ...
 - a country exports goods in which has *comparative advantage* and imports goods in which does not have *comparative advantage*.
- ▶ Therefore, Ricardo links the patterns of trade to differences in technologies, and the H-O links the patterns of trade to differences in the endowment of production factors (labor, capital, energy, land, ...)

Summary of the H-O model

- ▶ What is the H-O model prediction of **trade patterns**?
- ▶ A country **exports** goods that are intensive in its **relatively abundant factor** and **imports** goods that are intensive in its **relatively scarce factor**.
- ▶ **Review:** Ricardo's model predicts that ...
 - a country exports goods in which has *comparative advantage* and imports goods in which does not have *comparative advantage*.
- ▶ Therefore, Ricardo links the patterns of trade to differences in technologies, and the H-O links the patterns of trade to differences in the endowment of production factors (labor, capital, energy, land, ...)

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Model setup/assumptions

- ▶ Two countries: Germany and Netherlands
- ▶ Two goods: Tulip and car
- ▶ Two production factors: Capital and land (fertile)

The H-O model predictions

► K : Capital and T : Land

- $\frac{K_{GER}}{T_{GER}} > \frac{K_{NLD}}{T_{NLD}}$: Between Germany and Netherlands, Germany is a **capital abundant country**.
- This makes the Netherlands a **land abundant country**, why?
- $\frac{K_{GER}}{T_{GER}} > \frac{K_{NLD}}{T_{NLD}} \iff \frac{T_{GER}}{K_{GER}} < \frac{T_{NLD}}{K_{NLD}}$
- Also, we can make a similar analysis for the goods:
- If $\frac{K_{Car}}{T_{Car}} > \frac{K_{Tulip}}{T_{Tulip}}$, then we say car is a **capital intensive good**.
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A numerical example of the H-O model

Before answering the question, explain to the classmate next to you why you think the option you picked is the correct answer!



<https://forms.gle/7aePtZRW4FdbrJXD6>

The H-O model predictions (2)

- ▶ Therefore, a labor abundant country exports labor intensive goods, and imports capital intensive goods; a capital abundant country exports capital intensive goods, and imports labor intensive goods.
- ▶ In this example, Germany exports cars and imports tulips, and the Netherlands exports tulips and imports cars.

Economies of Scale, Monopolistic Competition, and Intra-Industry Trade

Do the predictions of Gravity, Ricardo, and H-O about the patterns of trade patterns consistent with your daily observations? Discuss!

- ▶ Why do we find Japanese car in the US and American cars in Japan?
- ▶ Why do we find Dutch cheese in France and French cheese in the Netherlands?
- ▶ The new theory of trade, also known as Krugman model and Monopolistic Competition model, adds firms and their decision-making to modeling and explaining trade patterns.
- ▶ It is built on a price theory developed by Dixit-Stiglitz
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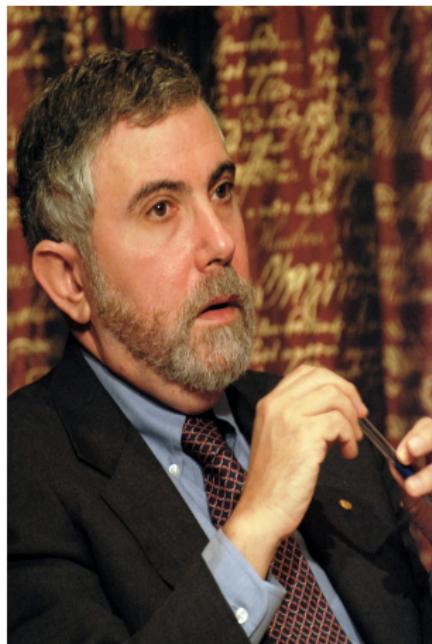
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Joseph E. Stiglitz



- ▶ Has been a professor at Princeton, Yale, MIT (while getting his PhD!), Stanford, and Columbia
- ▶ Won Nobel Prize in 2001
- ▶ (Unsubstantiated) rumor: clause in his employment contract at Yale that he couldn't live in his office

Paul R. Krugman



- ▶ Neo-Keynesian economist, pro-government policy and monetary stimulation, especially during recession periods! ("In the long run we are all dead" Keynes)
- ▶ Watch: Keynes vs. Hayek - Round 1!
- ▶ Watch: Keynes vs. Hayek - Round 2!
- ▶ He won the Nobel Prize in 2008, due in large part to the model you'll see today.

“New” Trade Theory

- ▶ Pioneered by Krugman in late 1970s and meant to supplant the “standard” trade model we have considered thus far.
- ▶ Based on a simple mathematical structure developed by Dixit and Stiglitz.
- ▶ The basic idea is best summarized by Krugman (1980):
“For some time now there has been considerable skepticism about the ability of comparative cost theory to explain the actual pattern of international trade. Neither the extensive trade among the industrial countries, nor the prevalence in this trade of two-way exchanges of differentiated products, make much sense in terms of standard theory. As a result, many people have concluded that a new framework for analyzing trade is needed.”

[Class question: why are the highlighted phrases inconsistent with what we have seen so far?]

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[Class question: why are the highlighted phrases inconsistent with what we have seen so far?]

Building blocks of “new” trade theory

- ▶ Economies of scale
- ▶ Product differentiation
- ▶ Imperfect competition

Building blocks of “new” trade theory

► Economies of scale

- The average cost of producing each unit declines as firms produce more: $C(q) = F + c \times q \Rightarrow \frac{C(q)}{q} = \frac{F}{q} + c \Rightarrow q \uparrow \rightarrow \frac{C(q)}{q} \downarrow$
- Opening up to trade increases the market that a firm can sell to, allowing it to capitalize on the economies of scale

► Product differentiation

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► Product differentiation

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Building blocks of “new” trade theory

- ▶ Economies of scale
- ▶ Product differentiation
 - Up until now, the trade theories we discussed were silent about the concept of a firm; countries only traded two products.
 - In reality, **firms produce** different products (and **consumers get utility** from consuming many different products).
- ▶ Imperfect competition

Building blocks of “new” trade theory

- ▶ Economies of scale
- ▶ Product differentiation
- ▶ Imperfect competition
 - If firms produce different products, then they are price setters (unlike perfect competition where they are price takers).
 - Example: The heterogeneity across car brands and their customers allow the car companies segment the market/customers based on their tastes, needs, and financial power.
 - BMW, Tesla, and Ford Mustang target different groups of customers, and this differentiation allows them set different prices. They all compete, but it is not a perfect competition, as they do not produce the same car.
 - This is also known as "monopolistic competition"
 - Do you know any other imperfect competition markets?

The predictions of the “new” trade theory

- ▶ A country might not have comparative advantage in producing a good, but if it can differentiate its goods from the goods in the market and find a taste for it, then it can export its goods!
Example: Japanese whisky!
- ▶ Firms export to decrease the average cost of production!
- ▶ Firms sell more ⇒ their income increases ⇒ the profits for any firm also increases
- ▶ More firms enter the market ⇒ decreases the price, also increases variations in products
- ▶ Hence, it is less costly for consumers to get the same amount of welfare! Also, they have access to more types of goods.
- ▶ Customers gain from trade!

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Implications of the “new” trade theory

- ▶ Firms with higher productivity, more innovation, and better marketing (the science of understanding consumer preferences/tastes, and their manipulation) win, and export is part of their strategy.
- ▶ The survival of the firms that cannot compete at the global level is in danger, and they should leave their local market, as they cannot compete with multi-national global corporations!
Starbucks, McDonald's, Burger King, KFC, ...
- ▶ Multi-national giant corporations are killing local businesses?!
So, trade can be harmful to some small business-owners in the importer countries!

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Implications of the “new” trade theory (2)

“Trade has the potential to allow the U.S. economy to expand output in areas where it is more productive and to enable higher-productivity firms to expand” - Chapter 10, 2010 Economic Report of the President

[Class question: In order to achieve these gains, what must happen in the short-run?]

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[**Class question:** In order to achieve these gains, what must happen in the short-run?]

Implications of the “new” trade theory (3)

“While the act of specializing should lift living standards over time, it requires shifting resources from one sector to another, and so can generate short-run dislocations. As a result, it is essential to strengthen both targeted and more general policies that seek to ensure all can benefit from increases in trade.” - Chapter 10, 2010 Economic Report of the President (later on)

- ▶ This adjustment toward export-friendly businesses also hurts less-productive and smaller/local/without expansion strategy businesses! This makes the owner of these businesses and their employees upset in exporter countries!

Summary of the “new” trade theory

- ▶ “New” trade theory has created a revolution (of sorts) in the study of international trade.
- ▶ Focuses on the market power of individual firms rather than comparative advantage.
- ▶ Emphasizes new gains from trade based on competition amongst firms.

Conclusion of International Trade Theories

- ▶ We didn't cover all trade theories, but covered the most important ones!
- ▶ Based on each of these theories, the societies gain from trade in total.
- ▶ However, there are winners and losers from the outcomes of these trade policies.
- ▶ In long-term, these trade models predict a higher welfare for everyone!
- ▶ However, even if we assume everyone can adjust and re-allocate resources according to the trade patterns, there would be an adjustment period that can ruin some people's life!
- ▶ Example: the US encourages focus on the high-tech jobs, but how does a Ford motor blue-collar with a high-school degree who worked all his/her life in the auto-industry can get a job in a high-tech company?
- ▶ This can explain the popularity of "Make America Great Again", and the "bringing their jobs back" slogans among some

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The New York Times

Trump's Push to Bring Back Jobs to U.S. Shows Limited Results



The nonprofit Reshoring Initiative found fewer than 30,000 jobs that companies said they would relocate to the United States because of President Trump's tariffs. Anna Moneymaker/The New York Times

By Jim Tankersley

Aug 13, 2019



WASHINGTON — From tax cuts to relaxed regulations to tariffs, each of President Trump's economic initiatives is based on a promise: to set off a wave of investment and bring back jobs that the president says the United States has lost to foreign countries.

"We have the greatest companies anywhere in the world," Mr. Trump said at the White House recently. "They're all coming back

Class question

Which economic forces do you think are more important in the real world: comparative advantage (Ricardo), endowment abundant (Heckscher–Ohlin), or competition amongst firms (Krugman)?

Next steps

Now that we learned about

- ▶ the most important trade theories,
- ▶ why countries trade,
- ▶ who gains, and who loses

The next step is learning and discussing the political-economic implications of trade and global economy across different actors and institutions.

The questions of this session

Class 4: : International Trade Cooperation

Today's questions:

- ▶ If free trade can increase the total welfare, why is it the exception rather than the rule?
- ▶ Why do we leave all this money lying on the floor?
- ▶ How did some couturiers reach free-trade agreement but not others?

The questions of this session

Class 4: : International Trade Cooperation

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Coordination Simulation: Setup

- ▶ Use the papers that I shared with you.
- ▶ At each turn, you and your “collaborator” will play one card...
- ▶ Your “earnings” are determined by the card you play and by the card your “collaborator” plays
- ▶ You **CANNOT** communicate with the other student while playing your card!
- ▶ Your goal is to get the highest number of points.
- ▶ **KEEP TRACK OF YOUR POINTS ON A SHEET OF PAPER** for each round!

Coordination Simulation: Outcomes

		Partner plays	
		Red	Blue
You play	Red	2	5
	Blue	-1	3

Points are determined by the following:

- If you play a **red** card:
 - You get 2-points if your partner plays **red**
 - You get 5-points if your partner plays **blue**
- If you play a **blue** card:
 - You get 3-points if your partner also plays **blue**
 - You get (-1) points if your partner plays **red**

Coordination Game

Partner plays

		Red	Blue
You play	Red	(2, 2)	(5, -1)
	Blue	(-1, 5)	(3, 3)

- ▶ What is the solution of this game?
- ▶ John Forbes Nash Jr. suggested a solution for these types of games.
- ▶ The definition of *Nash Equilibrium* is:
a stable state of a system involving the interaction of different participants, in which **no participant can gain by a unilateral change of strategy** if the strategies of the others remain unchanged.
- ▶ To understand the intuition behind *Nash Equilibrium*, [Watch!](#)

John Forbes Nash Jr. (1928-2015)



- ▶ Nash's adviser wrote a letter of recommendation for Nash's entrance to Princeton stating, "He is a mathematical genius."
- ▶ Hollywood movie *A Beautiful Mind* is about his life
- ▶ The scene showing how Nash came up with the idea of Nash Equilibrium explains the idea of Nash Equilibrium very well, but it is not completely what later Nash formulated as an equilibrium!

Coordination Game

Partner plays

		Red*	Blue
You play	Red	(2, 2)	(5, -1)
	Blue	(-1, 5)	(3, 3)

Coordination Game

Partner plays

		Red	Blue*
You play	Red	(2, 2)	(5, -1)
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Coordination Game

Partner plays

		Red	Blue
You play	Red*	(2, 2)	(5, -1)
	Blue	(-1, 5)	(3, 3)

Coordination Game

		Partner plays	
		Red	Blue
You play	Red	(2, 2)	(5, -1)
	Blue*	(-1, 5)	(3, 3)

- ▶ Playing Red by both player is a Nash Equilibrium, although both players can get better off if they play Blue. The fear of deviation by the other player impede the realization of a better outcome from this game.
- ▶ Here, both players maximize their utility, as Adam Smith suggested, but the society, which here includes these two, does not get the maximum benefits.

Extending coordination game argument to international trade.

- ▶ It takes 2 to trade, few govt's liberalize unilaterally. Why?
 - Because, if you open and another state does not, comparative advantage might not be realized and one state maybe worse off.
 - Depending on the gain given by the size of the tariff, some states maybe better off imposing a tariff.
 - Or, at least politicians can be better off! Why?
 - While trade is jointly beneficial sometimes, it is more beneficial to exploit others open markets while you keep your market closed.
 - Gov'ts often want to protect important (non-competitive) industries
 - Sometime states can disagree over the distribution of trade's benefits and want to make sure they're not getting the worst deal ever signed, ever!
- ▶ States bargain over opening borders. Bargaining causes cooperation problems:
 - Hard to remove barriers unilaterally
 - Hard to monitor compliance

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EU and China bargaining game to protect or liberalize

		EU	
		Liberalize	Protect
China	Liberalize	(L, L)	(L, P)
	Protect	(P, L)	(P, P)

Preferences of countries over their and the other countries' trade policies:

- China: $P, L > L, L > P, P > L, P$
- EU: $L, P > L, L > P, P > P, L$

Types of Trade Protection

- ▶ Tariffs
 - A tax on imported goods
- ▶ Quotas
 - A limit on the amount of goods that can be imported by a nation or globally
- ▶ Non-Tariff Barriers (Everything else):
 - Industry subsidies
 - Industry insurance programs
 - Laws to protect regional products
 - Industry lobbies and law makers can get very creative

Example of Laws to protect regional products: Prosciutto



- ▶ Only cured pork leg cured in Parma can be officially called “Prosciutto” in the European Union.

Bargaining Over Trade

- ▶ While free trade is beneficial, states can be better off by using economic and even military power to create an advantage for themselves
 - Usually by allowing for exports and limiting imports through adopting protectionist policies.
- ▶ A state's bargaining power then plays a role in trade agreements
 - Not all interested in providing a public good, since a rational actor (state) wants to maximize its benefits.
- ▶ Essentially, states use bargaining power to give themselves a better deal
 - So they can export more and protect domestic markets
 - Example: EU agricultural markets are heavily protected, yet we can sell our manufactured goods almost anywhere.
 - States that have a strong interest in EU markets may accept more demands from the EU than states that gain less from the EU markets.

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So why is not free trade a reality?

- ▶ What prevents bargaining
 - Incomplete/Private Information
 - Ability to commit to the agreement
 - Indivisible goods
 - Outside options (increases bargaining power)
- ▶ These obstacles Can lead to a failure to agree on opening of borders to trade

What does facilitate trade?

Several Factors can aid cooperation:

- ▶ Small number of states
- ▶ Information (monitor compliance)
- ▶ Repeated interaction
 - Ability to punish defectors
- ▶ Linkage of policies
 - Tie compliance to other issues like security
- ▶ **International institutions** (WTO or RTAs) can help with this...

International institutions

- ▶ Provide mechanisms to aid cooperation and coordination including trade cooperation
 - Set standards of behavior
 - Monitor and enforce compliance
 - Reduce transaction costs
- ▶ Often based upon the principle of reciprocity (iteration)
 - Concessions granted by one state are matched by others
- ▶ Can take many forms
 - Global Orgs (WTO)
 - Regional Orgs (NAFTA, CARICOM, MECOSUR)
- ▶ We see more regional groups today
 - cooperation is easier with fewer actors

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The GATT/WTO

- ▶ After WWII, The GATT is created
 - with other Bretton Woods institutions (IMF, World Bank)
 - General Agreement on Tariffs and Trade
 - 23 members by 1948
 - Lasts until 1994, when the WTO takes over
- ▶ The World Trade Organization (WTO) is small!
 - Budget: \$197 million (World Bank: \$2,577 million)
 - 640 staff members

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WTO

- ▶ World Trade Organization, updated the General Agreement on Tariffs and Trade (GATT).
 - Both successful in reducing barriers to trade
 - Still, can't agree on trade on agricultural and other goods protected by strong interest groups in western world.
- ▶ All members have an equal vote, unlike the UN security council!
 - But, still negotiations dominated by largest states! Why?
- ▶ WTO encourages cooperation by collecting information about trade policies and monitoring compliance.
- ▶ Also ties individual trade relationships to a state's overall trading network

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Summary of how WTO facilitates trade

- ▶ Provides a forum for negotiation
- ▶ Administers trade agreements
- ▶ Provides a dispute settlement mechanism

Three elements of WTO

- ▶ Established common principles and rules
- ▶ Intergovernmental bargaining process
- ▶ Dispute settlement mechanism

Three elements of WTO: Established common principles and rules

- ▶ Market liberalism

- ▶ Nondiscrimination

- Most Favored Nation (MFN): all countries are treated as the closest trading partner. Although its name implies favoritism toward another nation, it denotes the equal treatment of all countries
 - Exceptions: RTAs, Developing countries can get an exception
- Prohibits non-tariff barriers
 - Subsidies, regulation and other policies that give domestic firms an unfair advantage.

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Three elements of WTO: Established common principles and rules (2)

- ▶ Article I
- ▶ General Most-Favored Nation Treatment
 - 1. *With respect to customs duties and charges of any kind imposed on or in connection with importation or exportation or imposed on the international transfer of payments for imports or exports, and with respect to the method of levying such duties and charges, and with respect to all rules and formalities in connection with importation and exportation, and with respect to all matters referred to in paragraphs 2 and 4 of Article III,* any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties.*

Three elements of WTO: Established common principles and rules (3)

- ▶ Article III*
- ▶ National Treatment on Internal Taxation and Regulation
 - 1. *The contracting parties recognize that internal taxes and other internal charges, and laws, regulations and requirements affecting the internal sale, offering for sale, purchase, transportation, distribution or use of products, and internal quantitative regulations requiring the mixture, processing or use of products in specified amounts or proportions, should not be applied to imported or domestic products so as to afford protection to domestic production.*

Three elements of WTO: Established common principles and rules (4)

- ▶ Article III*
 - ▶ National Treatment on Internal Taxation and Regulation
 - 2. *The products of the territory of any contracting party imported into the territory of any other contracting party shall not be subject, directly or indirectly, to internal taxes or other internal charges of any kind in excess of those applied, directly or indirectly, to like domestic products. Moreover, no contracting party shall otherwise apply internal taxes or other internal charges to imported or domestic products in a manner contrary to the principles set forth in paragraph 1.*

Three elements of WTO: Established common principles and rules (5)

► MFN exceptions

- Regional trade arrangements
 - Free-Trade Area (e.g., NAFTA)
 - or Customs Union (e.g., EU)
- Generalized System of Preferences (from 1960s):
 - Developed countries can apply lower tariffs for developing countries than for their peers

Three elements of WTO: Intergovernmental bargaining process

- ▶ Bargain over the composition of new agreements
 - Who wins and loses, and over what
- ▶ Tariffs, dumping, intellectual property right, ...
- ▶ WTO rounds of bargaining
 - The latest (Doha) is stalled over agricultural subsidies
 - Conflict between developed and developing world
- ▶ Bali Package (December 2013)
 - States agreed on first new rules since WTO's inception
 - Focused on aiding development and giving special privileges to developing state

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Three elements of WTO: Intergovernmental bargaining process (2)

Rounds of Bargaining

- ▶ 1947 Geneva
- ▶ 1949 Annecy
- ▶ 1951 Torquay
- ▶ 1956 Geneva
- ▶ 1960-61 Dillon Round
- ▶ 1964-67 Kennedy Round
- ▶ 1973-79 Tokyo Round
- ▶ 1986-93 Uruguay Round (led to WTO creation)
- ▶ 2002-??? The Doha Round

Three elements of WTO: Intergovernmental bargaining process (3)

The latest round (Doha) has stalled mostly

- ▶ Agriculture
 - Developed states (US, EU) heavily protect their agricultural industries
 - Yet, this is where many developing states hold a comparative advantage
 - Many see this as unfair as developing states must open goods to products that developed states have a comparative advantage in, but developing states can not access developed markets for their agricultural goods.
- ▶ Services & Intellectual Property
 - Rich countries want more protection for trade in services and protection for intellectual property
- ▶ This has been going on for some time but the domestic interests in both camps has prevented an agreement

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Three elements of WTO: Dispute settlement mechanism

- ▶ A standard upon which to adjudicate and punish violations of WTO agreements
- ▶ Allows for legal reciprocity of victim states
 - Other firms or sectors can see new restrictions
 - Can be good for violators (a scapegoat)

Why States like the WTO

- ▶ The WTO lets you lose
 - This is an easy way to shift blame away from politicians onto the WTO
 - Lets politicians avoid scorn of special interest lobbies
 - Ties a country's hands
- ▶ States can get creative with retaliation
 - US steel tariffs, EU orange tariffs

Costa Rican Underwear: A Tale of WTO Compliance

- ▶ In 1995, Costa Rica sued the US through the World Trade Organization because of an import restriction.
- ▶ Why did the US comply?
 - Costa Rica is tiny and has no army!
 - Who cares if they don't like our policy?
- ▶ Short-term incentives to disobey rules can be outweighed by the long-term benefits provided by an institution.

WTO flexibility

Why has the GATT/WTO lasted despite anarchy?

- ▶ Ties a state's individual trade relationships to its trade with WTO members
 - Failure to comply with a WTO agreement risks the legitimacy of the WTO, which is beneficial in other interactions
- ▶ The WTO makes exceptions. If it requires too much, states may defect from cooperation
- ▶ Under anarchy, an institution must suit the interests of its members
- ▶ Yet, the need for many actors agree has stalled the widening of the WTO's scope

Does the WTO work?

- ▶ Did it increase trade?
 - Maybe! The jury is still out.
 - WTO members do engage in more int'l trade
 - It is unclear if states that joined would have liberalized unilaterally and traded just as much
- ▶ States bring few cases to the WTO
 - Still it might act as a deterrent to imposing trade barriers

WTO take away

- ▶ Cooperation is hard because of the anarchy of the int'l system
- ▶ The WTO aids trade cooperation by providing a forum for bargaining, monitoring behavior and an enforcement mechanism through institutional reciprocity
- ▶ WTO progress has been stalled because of diverse interests

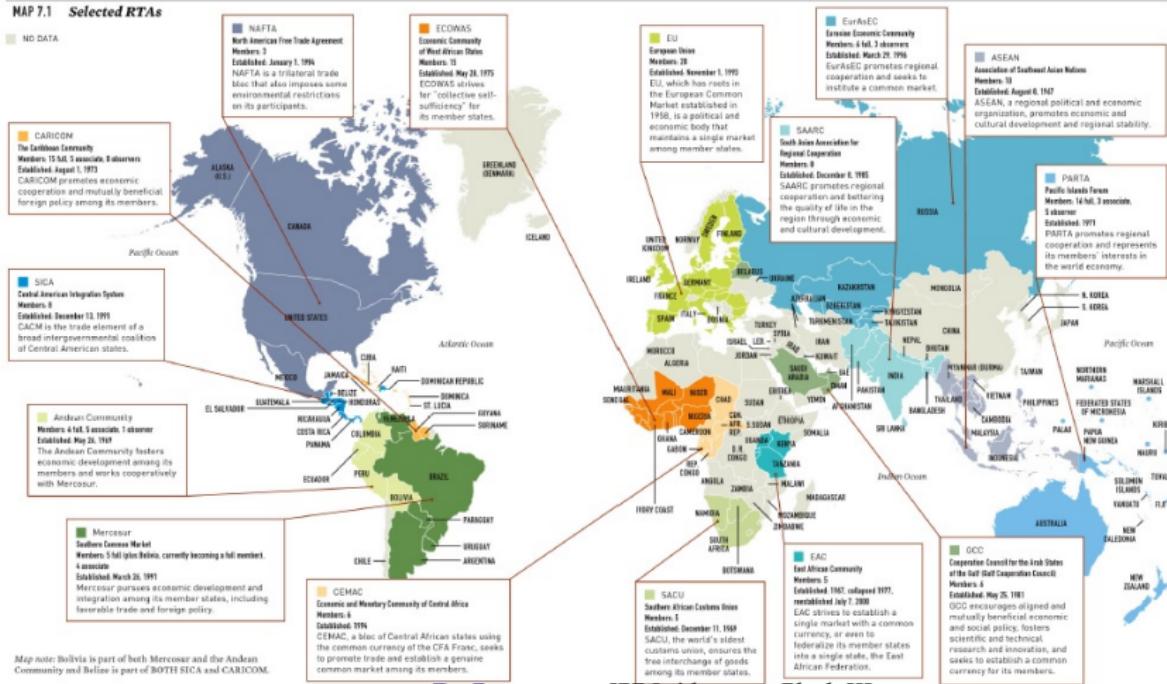
Regional Trade Agreements

- ▶ Global bodies are limited and require cooperation of many members.
- ▶ States may seek regional trade agreements with more important trade partners instead.
- ▶ Most trade is concentrated with a few partners.
- ▶ In the past two decades we have seen an explosion of regional trade agreements.

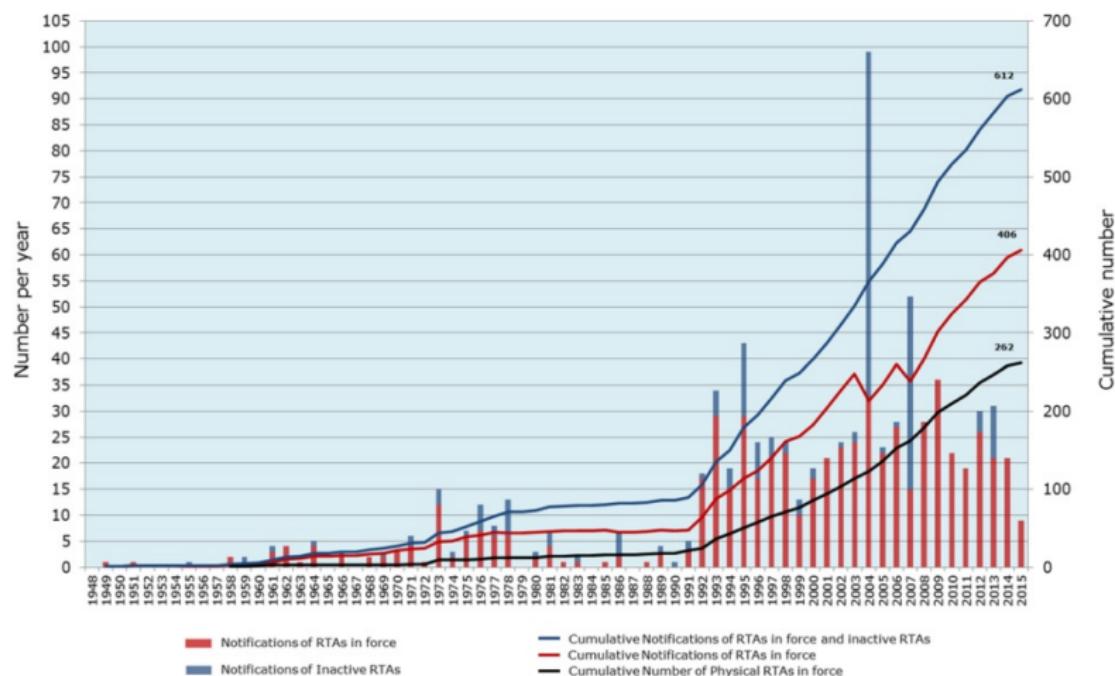
Regional Trade Agreements(2)

- ▶ Two main types of RTAs
 - Free Trade Area (NAFTA, TPP)
 - Eliminate tariffs among members
 - Separate trade policies with non-members
 - Most RTA are Free trade agreements
 - Customs Unions (EU)
 - Eliminate tariffs among members
 - Common trade policy with non-members
- ▶ Can be as few as two members (bilateral)
- ▶ Easier to implement because they require fewer members
 - Remember the more actors, the harder cooperation.
 - Powerful states can shop around for the best deal
 - Makes it easier to ease into free-trade policy.
 - More acceptable than joining the WTO for many domestic interests

RTAs across the world



Evolution of Regional Trade Agreement in the World, 1948-2015



Note: Notifications of RTAs: goods, services & accessions to an RTA are counted separately. Physical RTAs: goods, services & accessions to an RTA are counted together.
Source: WTO Secretariat.

Are RTA's a Problem?

- ▶ Why might RTAs be a problem for global trade?
- ▶ They prevent full realization of comparative advantage
- ▶ Favors states with a strong bargaining position
- ▶ Biases trade rules in favor of states with large markets (The US!)
 - States can exercise “outside options”

Why the move toward RTAs?

What global forces are driving a preference for RTAs over expansion of the WTO?

- ▶ Free trade is a public good!
- ▶ Thus it suffers from the collective action problem in enforcement.
- ▶ How do we get everyone to play by the rules?

Public Goods

- ▶ Socially desirable products defined by two qualities
 - Nonexcludable
 - Nonrival
 - Examples: National defense, Clean air and water, Public radio, Roads and Bridges, Common currency, FREE TRADE!
- ▶ Achieving public goods is hindered by collective action problems/ free-riding
- ▶ Contrast to Private Goods

Collective Action Problems

- ▶ Public goods are great, why can't we have more?
- ▶ Individuals have an incentive to consume goods and not contribute (Free Rider Problem)
 - Prevalent in all aspects of social life.
 - Group projects in class
 - As groups size increases, incentive to free ride grow
- ▶ Despite free rider problem we still find cooperation. Why?

In-class group project example: A good grade is a public good!

- ▶ 10 students in a group
 - Effort of each counts for 10% of the final grade
 - Grade each student gets if they don't participate (90%)
 - Do you participate or free ride?
- ▶ 3 students in a group
 - Effort of each counts for 33% of the final grade
 - Grade each student gets if they don't participate (66%)
 - Do you participate or free ride?

Hegemonic Stability Theory

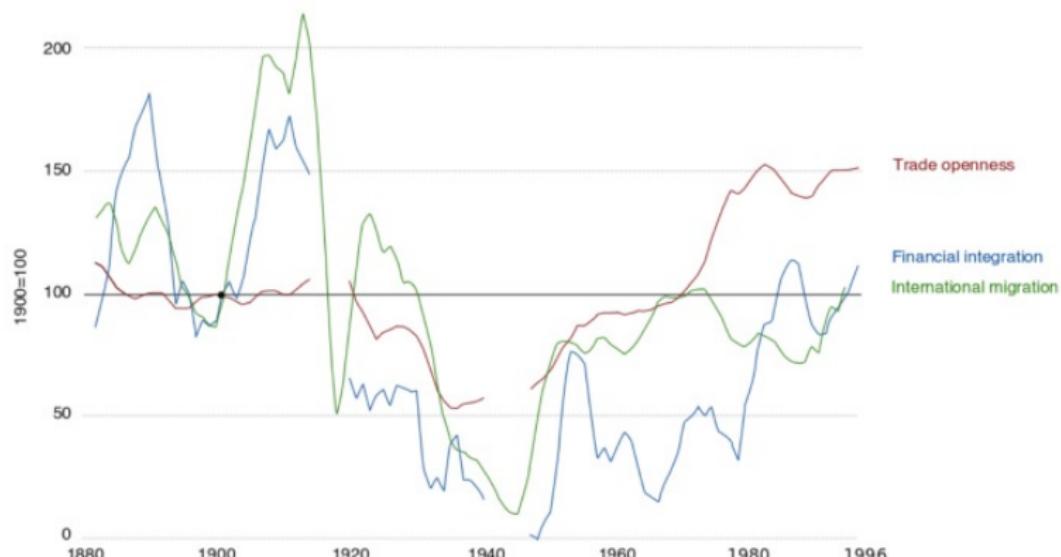
- ▶ Idea that one dominant actor can shoulder the burden of enforcement for all
- ▶ In our most recent case it is the United States (Previously the UK).
 - We benefit tremendously from trade liberalization (especially after WWII)
 - We were willing to incur the costs of mobilizing and monitoring enforcement of the rules
 - We were willing to pay the costs if others cheated.
- ▶ Now the US power has declined, perhaps no one state is willing to provide the public good of trade liberalization
 - COLLECTIVE ACTION PROBLEM!

Hegemonic Stability Theory

- ▶ Can we test this theory?
- ▶ How could we test it?

Migration, financial integration and trade openness, World, 1880-1996

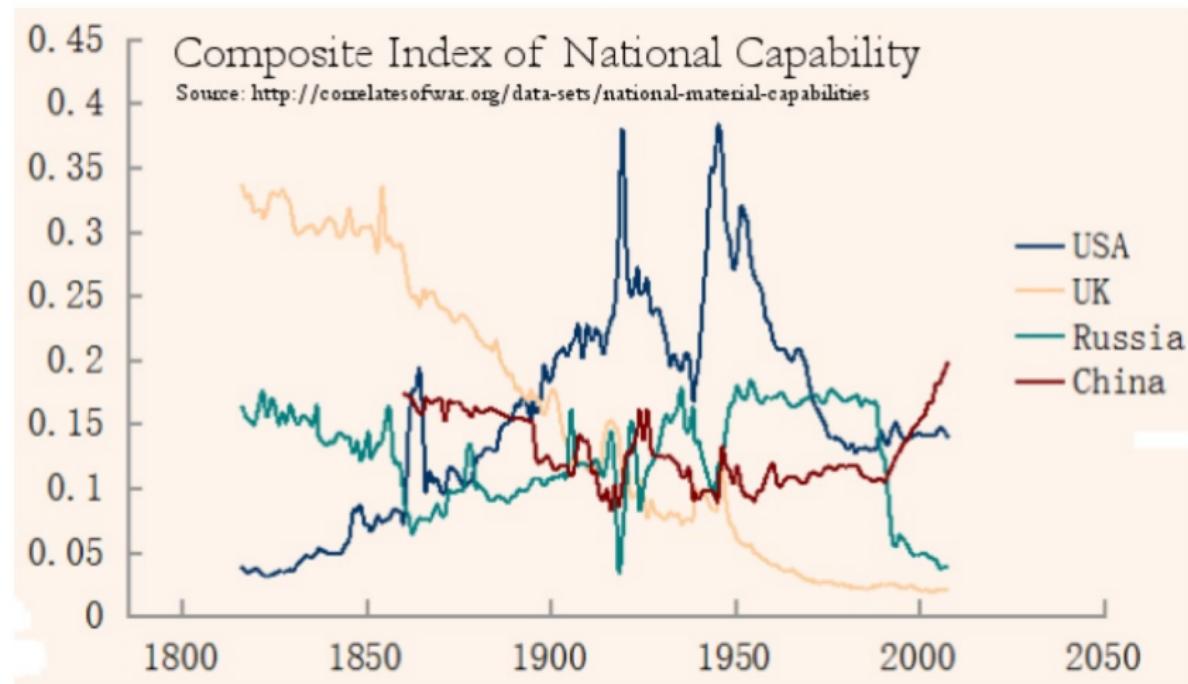
This chart shows the evolution of three indicators measuring integration in commodity, labor, and capital markets over the long run. All indicators are indexed, so that 1900 =100.



Note: Commodity market integration is measured by computing the ratio of goods exports to GDP. Labor market integration is measured by dividing the migratory turnover by population. Financial integration is measured using Feldstein-Horioka estimators of current account disconnectedness.

Source: Broadberry and O'Rourke (2010), The Cambridge Economic History of Modern Europe: Volume 2, 1870 to the Present. Cambridge University Press.

This is a visualization from OurWorldinData.org, where you find data and research on how the world is changing. Licensed under CC-BY-SA by the authors Esteban Ortiz-Ospina and Diana Beltekian.



The questions of the next two sessions

Class 5: A Society-Centered Approach to Trade Politics

- ▶ What does determine the specific trade objectives that governments pursue
 - when bargaining within the WTO, when negotiating regional trade arrangements,
 - or when making unilateral trade-policy decisions?
- ▶ We take up this question in this chapter and the next by examining two approaches to trade politics rooted in domestic politics:
 - A society-centered approach (class 5)
 - A state-centered approach (class 6)

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How to study the society-centered approach

- ▶ The society-centered approach emphasizes the **interplay between organized interests and political institutions.**
- ▶ The approach is based on the recognition that **trade has distributional consequences.**
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Our today plan

- ▶ Trade Policy Preferences
 - Factor Incomes and Class Conflict (factor based)
 - Sector Incomes and Industry Conflict (sector/industry based)
- ▶ Organizing Interests: The Collective Action Problem and Trade Policy Demands
- ▶ Political Institutions and the Supply of Trade Policy

Trade Policy Preferences: Trade's Distributional Consequences

- ▶ Sorry! Not everyone benefits from trade . . .
 - At least in the short-run
 - Free trade produces winners and losers
- ▶ Economics theories of trade help to determine who wins and who loses

Setup of a model/an example

- ▶ There are only two countries in the world: the United States and China.
- ▶ Both countries produce two goods: shirts and computers.
- ▶ Each country uses two factors of production, labor and capital, to produce both goods.
- ▶ Shirt production relies heavily on labor and less heavily on capital, whereas computer production requires a lot of capital and little labor.
- ▶ The United States is endowed with a lot of capital and little labor, whereas China is endowed with a lot of labor and little capital.

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Factor Incomes and Class Conflict: Trade pattern

[Class discussion] According to provided information in the previous slide, who wins and who loses from a free trade policy?

- ▶ According to available data, we can apply the Heckscher-Ohlin theory here:
 - America as the capital abundant country produces computers
 - China as the labor abundant country produces shirts

Factor Incomes and Class Conflict: Winners and losers

- ▶ the US import shirts from China ⇒ demand for American-made shirts falls ↓ ⇒ American shirt production falls ↓:
 - apparel firms liquidate the capital they had invested in shirt factories
 - they lay off their employees
- ▶ At the same time,
 - American computer firms are expanding production in response to the growing Chinese demand for American computers.
 - As American computer production expands, computer firms demand more capital and labor, and they begin to employ capital and labor released by the shirt industry.
- ▶ All seems good? For consumers YES! Cheaper and more shirts and computer for both China and the US! What do you think?
- ▶ However, this is called a partial equilibrium analysis, as we are ignoring what happened in other markets!
- ▶ We need to look at labor and capital markets as well (General equilibrium).

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- ▶ However, this is called a partial equilibrium analysis, as we are ignoring what happened in other markets!
- ▶ We need to look at labor and capital markets as well (General equilibrium).

Factor Incomes and Class Conflict: Winners and losers

- ▶ the US import shirts from China ⇒ demand for American-made shirts falls ↓ ⇒ American shirt production falls ↓:
 - apparel firms liquidate the capital they had invested in shirt factories
 - they lay off their employees
- ▶ At the same time,
 - American computer firms are expanding production in response to the growing Chinese demand for American computers.
 - As American computer production expands, computer firms demand more capital and labor, and they begin to employ capital and labor released by the shirt industry.
- ▶ All seems good? For consumers YES! Cheaper and more shirts and computer for both China and the US! What do you think?
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Factor Incomes and Class Conflict: Winners and losers (2)

- ▶ The trade of shirts and computers between the US and China changes the equilibrium of production factors (labor and capital) markets.
- ▶ So, there is an imbalance between the factors being released and those being demanded after free trade between the US and China.
- ▶ The shirts industry relative to the computer industry is labor-intensive and vice-versa!
- ▶ Therefore, there would be an excessive of demand for capital and an excessive of supply for labor in the US. This increases the price/value/return of capital, and decreases the price/value/return of labor.
- ▶ What about China?
- ▶ Similarly, China experiences an increase of labor price/value/return and a decrease of capital price/value/return.

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Factor Incomes and Class Conflict: Winners and losers (3)

- ▶ Trade between the United States and China has thus caused changes in the incomes earned by workers and capitalists in both countries.
- ▶ Abundant American capital and abundant Chinese labor both gained from trade.
- ▶ Scarce American labor and scarce Chinese capital both lost.
- ▶ If we do not interrupt the free trade, the capital and labor values change in both countries, until equalize: In the US, capital value raises, labor value declines; and in China, capital value decreases and labor values increases!
- ▶ The tendency for trade to cause factor prices to converge is known as **factor-price equalization** (or the **Stolper-Samuelson Theorem**).

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Factor Incomes and Class Conflict and Marxism predictions?!

- ▶ Here, the economic predictions of Marxism are to some extent consistent with the predictions of factor-based models! There would be a class conflict between workers and capitalists in capital-abundant countries (global north);
- ▶ However, the labor will be better off in labor-abundant countries (global south).

Sector Incomes and Industry Conflict: Winners and losers

- ▶ In the previous analysis, we made an implicit assumption about the factors! **Can you tell what is this assumption?**
- ▶ We assume **factor mobility**: the ease with which labor and capital can move from one industry to another.
- ▶ The factor model assumes that factors are highly mobile; labor and capital can move easily from one industry to another.
- ▶ The sector model assumes that factors are **not easily moved** from one industry to another. Instead, factors are tied, or specific, to the sector in which they are currently employed.
- ▶ When factors are immobile, trade affects the incomes of all factors employed in a given industry in the same way.
- ▶ In our China-US example, workers and business owners in the apparel sector thus both suffer from trade; and workers and business owners in computer industry win from trade.

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- ▶ Labor and capital employed in industries that rely intensively on society's abundant factor (that is, the country's comparatively advantaged industries) both gain from trade.
- ▶ Factor-intensive industries are called export-oriented industries, and the not-factor-intensive industries are called import oriented.
- ▶ In our China-US example, computer and shirts industries are respectively export-oriented and imported-oriented industries.

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Summary of factor-based and industry-based models

Two Models of Interest-Group Competition over Trade Policy

	The Factor Model	The Sector Model
The principal actors	Factors of production or classes	Industries or sectors
How mobile are factors of production?	Perfectly mobile across sectors of the economy	Immobile across sectors of the economy
Who wins and who loses from international trade?	<i>Winner:</i> abundant factor—capital in the advanced industrialized countries <i>Loser:</i> scarce factor—labor in the advanced industrialized countries	<i>Winner:</i> labor and capital employed in export-oriented industries <i>Loser:</i> labor and capital employed in import-competing sectors
Central dimension of competition over trade policy	Protectionist labor versus liberalizing capital	Protectionist import-competing industries versus liberalizing export-oriented industries

Organizing Interests: The Collective Action Problem and Trade Policy Demands

- ▶ Collective action problem
 - The larger the group, the harder it is to organize (lobby the government)
 - Larger the group, the greater incentive to defect (or free ride)
 - The smaller the group, the benefits are concentrated and there is less of an incentive to free ride
- ▶ The winners of trade (consumers) are often much larger than the losers
- ▶ The losers, because of their size, have a greater ability to organize and change policy
- ▶ The logic of collective action helps us understand why governments rarely liberalize trade unilaterally, but have been willing to do so through negotiated agreements.

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Institutional Effects

- ▶ Review: The modern approach to IPE discusses the interactions of interests and institutions.
- ▶ We covered the interests part (demand for the trade policy), now is the institution turn (supply of the trade policy).

Political institutions:

- Democracy vs. Autocracy
- Majoritarian vs. Proportional Representation
- Military vs. Party Dictatorships
- Veto players

Electoral Systems

- ▶ We focus on the democracies, as non-democracies weakly represent and weigh in citizens' views.
- ▶ Majoritarian systems
 - Small districts dominated by fewer industries
 - Sector based organization
 - More protectionism
- ▶ Proportional representation (PR)
 - Represent national constituency. Appeal to broad rather than narrow interests.
 - Organization around factors.
 - Less protectionism

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Veto Players

- ▶ Some political systems might make change (or a new trade deal) more difficult to achieve.
- ▶ More veto players ⇒ Less change
- ▶ Veto player: any domestic actor that can “veto” a policy
- ▶ Opposition party in Congress, Courts, Multiple parties in parliament, Cabinet ministers, Bureaucrats.
- ▶ Veto players also make it more difficult to defect from a trade agreement!

Embedded Liberalism

- ▶ Would we expect those with the most liberalized internal markets to also have the most liberalized external markets?
- ▶ No, those countries that engage in more in free trade tend to have larger welfare states ...
- ▶ The welfare state is used to protect or “buy off” the “losers” of globalization so they don’t strongly oppose liberalization
- ▶ It is no surprise that the U.S. and U.K. are seeing backlashes to globalization while states with more generous welfare states are not.

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Societal Interests Takeaway

- ▶ Trade causes winners and losers domestically
- ▶ Despite overall welfare gains of trade
- ▶ Salient short term costs for some domestic actors
- ▶ Two approaches to identify the winners and losers
 - Factor model
 - Sector model
- ▶ Domestic institutions shape societal interests into policy

Today's plan

Class 6: A State-Centered Approach to Trade Politics

- ▶ What does determine the specific trade objectives that governments pursue
- ▶ We take up this question in this chapter and the next by examining two approaches to trade politics rooted in domestic politics:
 - A society-centered approach (class 5: previous session)
 - A state-centered approach (class 6)

Today's Questions

- ▶ What does the state want?
- ▶ How does the state get what it wants?
- ▶ Why does the state intervene in the market?

An Interesting Story

- ▶ Watch: The Little Plane War!



Key Assumptions

1. The State centered approach assumes that the “State” acts to maximize national welfare.
 - ▶ We know this is not always “true”, but it may shed light on some outcomes.
 - ▶ In previous session, the state only entered our analysis when we wanted to aggregate the preferences of winners and losers of trade policies.
 - ▶ In this session, the state intervenes in the economy by formulating and enforcing economic policies.

Key Assumptions

1. The State centered approach assumes that the “State” acts to maximize national welfare.
2. Protectionism can be “good” sometimes
 - ▶ In contrast with the neo-classical approach.

Key Assumptions

1. The State centered approach assumes that the “State” acts to maximize national welfare: benevolent government!
2. Protectionism can be “good” sometimes
3. Governments act independently of interest groups
 - Again, not always true. We come back to this at the end of this session.

What Does the State Want?

- ▶ To improve overall welfare
- ▶ To increase its relative power

Industrial Policy

- ▶ The policies that governments have adopted to manage trade according to its interests are called **industrial policy**.
- ▶ **Industrial policy** can be defined as the use of a broad assortment of instruments, including **tax policy, subsidies** (including the provision of state credit and finance), **traditional protectionism**, and **government procurement practices**, in order to channel resources away from some industries and direct them toward those industries that the state wishes to promote.

Why does the state intervene in trade?

- ▶ To protect infant industries
- ▶ Oligopolistic market structures
- ▶ Strategic interests

Does not this all make a country economically worse off?

Infant Industry Protection

- ▶ Sometimes a state faces barriers to exploiting its comparative advantage and making use of its abundant factors.
- ▶ “new” industries might not be competitive at first but have potential in the long run
 - Comparative advantages are DYNAMIC
 - Why is this the case?

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Infant Industry Protection (2)

- ▶ Economies of Scale
- ▶ Economies of Experience

Economies of Scale

- ▶ Simply: production becomes more efficient and profitable as the number of units produced grows (to a point). Why?
- ▶ Economies of Scale from the Krugman Trade model: The average cost of producing each unit declines as firms produce more: $C(q) = F + c \times q \Rightarrow \frac{C(q)}{q} = \frac{F}{q} + c \Rightarrow q \uparrow \rightarrow \frac{C(q)}{q} \downarrow$
- ▶ Example:
 - Suppose an industry requires an initial investment (fixed cost) of \$1000
 - With 100 customers, the Average Fixed Cost is \$10
 - With 200 customers, the Average Fixed Cost becomes \$5
 - This results in a lower average total cost

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 - Until a firm is big enough to produce efficiently, it might need protection, subsidies to help maintain business until it reaches that point
 - Protection might improve welfare if infant firms can be protected until they get to this point.

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- ▶ Efficient production requires specific skills that can only be acquired through protection of the industry
- ▶ Experience in:
 - Management
 - Skilled workers
 - Network of suppliers
- ▶ Implication:
 - Firms need to get their hands dirty or “learn on the job” before they can compete globally. As such, they need to be protected initially.

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Infant Industry Protection: Examples



- ▶ Used by many “late developing” states to “catch up” to the west.
- ▶ Can lead to welfare gains.
- ▶ Example:
 - South Korea: KIA and Samsung
- ▶ Or it can go badly and distort the market.

Infant Industry: Who decides?

- ▶ Which industry do you choose? Who makes this decision?
 - Technocrats?
 - Interest groups?
- ▶ Critics argue that the market best decides who wins and loses.
States are poor at making this choice.

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Strategic Trade Theory

- ▶ Simply: Governments support industries to minimize foreign competition and thus gain from oligopolistic markets.
- ▶ Oligopoly:
 - An oligopoly is a market structure in which a few firms dominate. When a market is shared between a few firms, it is said to be highly concentrated.
 - Examples? Aircraft industry; Mobile industry; Computer Operation System; Car industry
 - Not perfect competition
 - Higher prices (profits) b/c of less competition
- ▶ Less competition means higher RENTS
 - RENTS: profits in excess of what a natural market would provide

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Oligopolistic market without protection

Suppose an industry where market-demand supports only one firm (high tech – e.g., aircraft)

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US firm	Produce	(-5, -5)	(100, 0)
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Strategic Trade Theory: First mover advantage

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 - Economies of scale and experience
- ▶ States with the industry first can shutout competitors
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- ▶ The state benefits from higher incomes
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Strategic Trade Theory: implications

- ▶ Governments can potentially capture, or own the major shares, of these industries if they provide subsidies.
- ▶ They alter the investment decisions of firms in other states.
- ▶ Comparative advantage does not hold.
- ▶ Factor endowments have less bearing on who trades and what is traded.
- ▶ Sometimes protection can increase national welfare.

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State Strength

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- ▶ Centralized vs. decentralized decision making
- ▶ Industrial policy has benefited states with strong leaders
 - Japan, Singapore, Thailand, Indonesia, S. Korea, CHINA!
 - “Asian Tigers”
 - Now they are more democratic. Economic growth took place under heavy handed leaders

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 - “Asian Tigers”
 - Now they are more democratic. Economic growth took place under heavy handed leaders

State Strength (2)

► Institutions matter

- Insulation from interest groups and voters can be good for economic development
- It can also be reallllly bad!

► Infant industry protection is harder to pull off where there are many “veto players”

- i.e. individuals who can ‘veto’ a bill or policy (US Congress, Courts)

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Example of Multiple Choice Questions in the Exam

Which two core elements stand at the base of the WTO?

- A. Political liberalism and nondiscrimination
- B. Market liberalism and nondiscrimination
- C. Market conservatism and dispute settlement
- D. Intergovernmental bargaining and dispute settlement

Poll!



Click here: <https://forms.gle/zExwK9JQVTTM3Z7PA>

Example Short Answer

Some politicians in Brazil believe that the government should support the aircraft company in this country by providing subsidies and investing in this industry. Assume that you are one of these politicians, how do you defend this trade policy?

Let's review last week with a couple of sample questions

1. Which one is **not** a reason for state intervention in trade?
 - A. To protect infant industries
 - B. To benefit oligopolistic market structures
 - C. To improve the distribution of economic benefits
 - D. To protect strategic interests
2. Which one is correct about the role of the state in trade?
 - A. Authoritarian states perform poorly in implementing industrial policies due to their centralized power.
 - B. Industrial policy limits state interventions in trade.
 - C. Veto players in government facilitate transitions to and from infant industry policies.
 - D. Centralized power improves the success chance of industrial policies.

Frame Title



Click here: <https://forms.gle/iuHRWShQae4TbVfU8>

Today's plan

Class 7: Multinational Corporations (MNCs)

A couple questions we will try to answer today?

- ▶ Why do MNCs exist? Why not just outsource?
- ▶ Despite theoretical expectations, why does most FDI flow between developed countries?
- ▶ What influence do MNC have over sovereign states?
- ▶ Why are there no large international institutions to regulate FDI & MNCs?
 - No IMF, WB, ...

What is an MNC?

► Multinational Corporation:

- An MNC is more than just a firm that engages in international activities.
- Many firms that engage heavily in international activities are not MNCs.
- A single corporate structure that controls & manages production establishments in at least 2 countries

► Emerged during the late 19th century

- Maybe before (Dutch & British East India Companies)

► Initially UK companies dominated

- 1st US MNC in 1867
- US overtook UK in 1920s as largest source of FDI
- Since 1960s US dominance has diminished

► Other regions, namely Europe, Japan and other companies, have gathered steam

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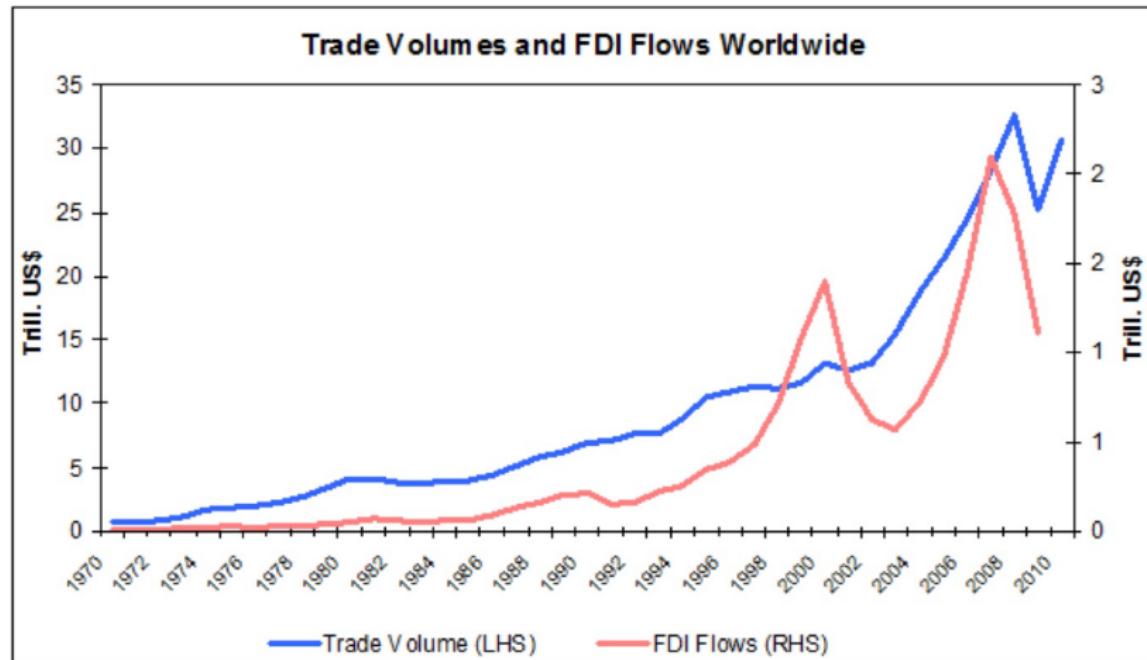
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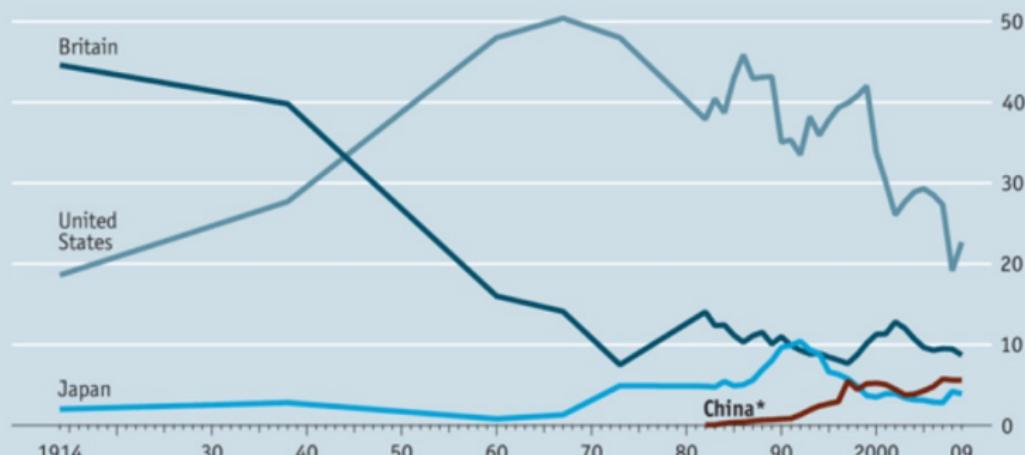
FDI Flows Across Time



FDI Flows Across Time

Stock of outward foreign direct investment

% of world total



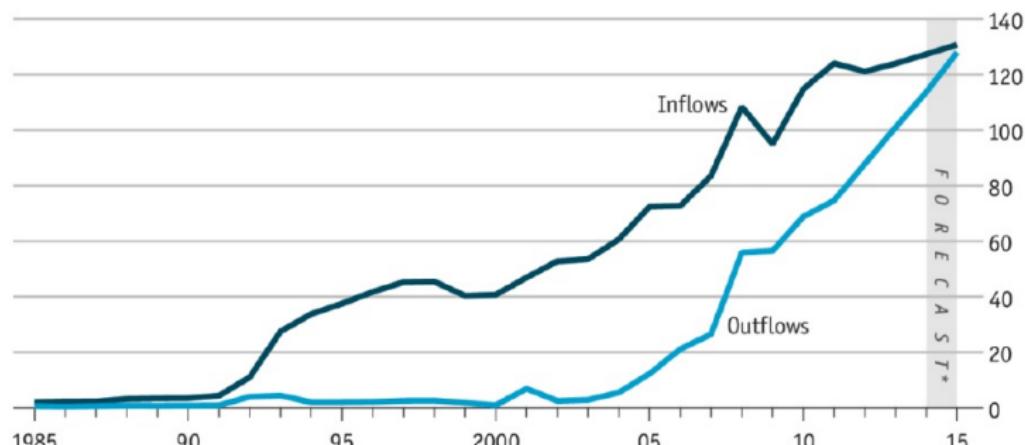
Sources: UNCTAD; "Multinational Enterprises and the Global Economy" by J.H.Dunning

*Including Hong Kong and Macau

China's FDI Flows Across Time

China's foreign direct investment

\$bn



Source: UNCTAD

Economist.com/graphicdetail

*Based on 2008-13 average annual growth rates

Two categories of foreign investment

- ▶ Portfolio investment
- ▶ Direct investment

Two categories of foreign investment

► Portfolio investment

- Investors have claim on some income, but do not manage the investment (less than a controlling percentage)
- Investors only interested in the rate of return
- Ex: Loans, Stocks, Bonds (Highly mobile, can be sold instantaneously)
- Sovereign lending is most prominent (Lending directly to a country's government)
- We'll explore this in greater detail in a few weeks

Two categories of foreign investment

- ▶ Portfolio investment
- ▶ Direct investment (FDI: Foreign direct investment)
 - Investment by a company that owns and controls facilities that are located in another country
 - Ex. Shell Oil Refinery in Nigeria
 - Ex. Nissan factory in US
 - Highly immobile, requires a fixed-investment

Two categories of foreign investment

- ▶ Portfolio investment
- ▶ Direct investment (FDI: Foreign direct investment)
- ▶ When discussing MNCs, we are primarily concerned with FDI (direct investment)

Why invest abroad?

- ▶ Why not just hire a foreign company?
 - Like Apple does to build its products (Foxconn)
- ▶ Two factors and their interactions shapes the firm's decision about MNCs:
 - Locational Advantages
 - Market Imperfections

Locational Advantages

- ▶ A firm will internationalize its activities when it believes that it can profit by doing so.
- ▶ Historically, locational advantages have been based on one of three specific country characteristics:
 - Large reserve of natural resources
 - Access a large local market
 - market-oriented investments
 - “jump over” trade-barriers!
 - Enhance efficiency

Locational Advantages

- ▶ A firm will internationalize its activities when it believes that it can profit by doing so.
- ▶ Historically, locational advantages have been based on one of three specific country characteristics:
 - Large reserve of natural resources
 - Access a large local market
 - lower cost of the factors of production
 - match the factor intensity of a production stage to the factor abundance of particular countries (**Who can use what discussed in previous sessions to explain this?**)
 - Go where you get the most for your money
 - Design the Honda Accord in capital-abundant Japan,
Assemble the car in labor-abundant Mexico
 - Enhance efficiency

Market Imperfections: intangible asset

- ▶ How much is the Coca Cola formula worth? How about the inner workings of IOSX ? Or the details of management at a firm like Kia?
- ▶ **Intangible asset:** The value is derived from knowledge or from a set of skills/routines possessed by a firm's workforce
- ▶ Paradox of information: The value of the information for the purchaser is not known until she has the information... but then she has acquired it without cost.
- ▶ Essentially, a firm has proprietary knowledge (the secret sauce) that its unwilling to share with other firms.
- ▶ As a result, it opens factories itself rather than sharing this information with trading partners.

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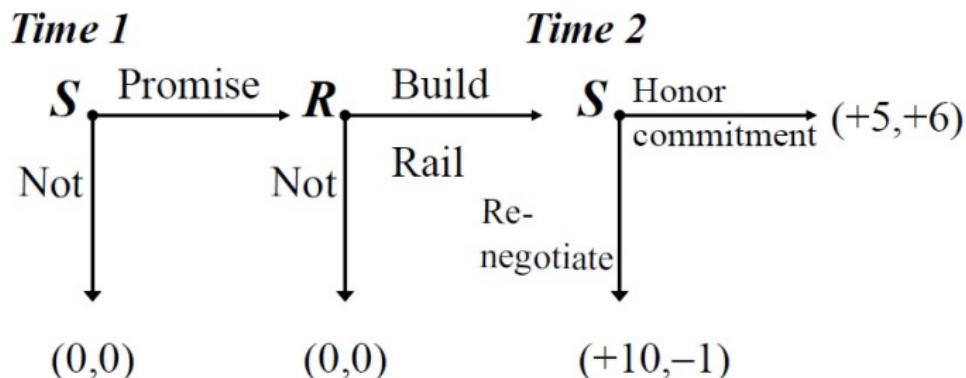
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Market Imperfections: specific asset

- ▶ A **specific asset** is an investment that is dedicated to a particular long-term economic relationship.
- ▶ Difficult to enforce long-term contracts
- ▶ One party in the long-term relationship can take advantage of the specific nature of the asset to extract a larger share of the value from the transaction

Example: Ship owner & Railroad builder



Time-Inconsistent Preference

- ▶ This is called a time-inconsistent preference problem
- ▶ What you want today is not what you'll want tomorrow
- ▶ You need to find a way to lock in your current preferences

Horizontal Integration vs. Vertical Integration

- ▶ **Horizontal integration** occurs when a firm creates multiple production facilities, each of which produces the same good or goods.
- ▶ **Vertical integration** refers to instances in which firms internalize their transactions for intermediate goods. An intermediate good is an output of one production process that serves as an input into another production process.
- ▶ Horizontal integration eliminates the problem arising from Intangible asset
- ▶ Vertical integration eliminates the problem arising from specific assets

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Where and When MNCs

- ▶ MNCs are a “predictable” response to the economic environment in which firms operate
- ▶ Locational advantages tell us if MNCs are profitable
- ▶ Imperfections tell us that whether a firm will internalize the production

TABLE 8.4

Market Imperfections, Locational Advantages, and Multinational Corporations (MNCs)

		Market Imperfection	
		Intangible Assets	Specific Assets
	Yes	Horizontally integrated	Vertically integrated
		MNC	MNC
Locational Advantages	Market based		Natural resource based; Cost based
	No	Horizontally integrated domestic firm	Vertically integrated domestic firm

Why Attract FDI?

- ▶ The Economic Benefits of FDI inflows.
- ▶ The Economic Costs of FDI inflows.

Why Attract FDI?

- ▶ The Economic Benefits of FDI inflows:
 - 1. Transfer savings (capital) between states.
Aids economic growth
 - 2. Technological and managerial experience.
First world tech that can be learned from.
 - 3. Integration into global markets.
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 - 2. Can drive local firms out of business
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 - 4. MNC objectives might clash with domestic economic objectives

Why Attract FDI?

- ▶ The Economic Benefits of FDI inflows.
- ▶ The Economic Costs of FDI inflows:
 - 1. Can potentially reduce domestic capital
 - Sometimes they borrow domestic capital and “crowd out” investment to other firm
 - Charge affiliates with licensing fees royalties for technology
 - Require affiliates to purchase inputs abroad from MNC
 - 2. Can drive local firms out of business
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Why Attract FDI?

- ▶ The Economic Benefits of FDI inflows.
- ▶ The Economic Costs of FDI inflows:
 - 1. Can potentially reduce domestic capital
 - 2. Can drive local firms out of business
 - More competitive (better tech and management) than local firms.
 - Like the Starbucks effect
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But, what about the political effects?

THE POLITICS OF MULTINATIONAL CORPORATIONS

What do MNCs care about?

- ▶ Do they represent the interests of their home state?
- ▶ Do they represent the interest of the state they have investments in?
- ▶ Are they concerned with shareholder's profits?

Accountability

- ▶ Who holds governments accountable?
 - Depend on institutions
 - But generally, the folks who keep a leader in power.
 - In democracies: the voters
 - In non-democracies: the elites
- ▶ Who holds MNCs accountable
 - Stockholders
- ▶ Keep this in mind ...

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MNCs in the developing world

- ▶ After independence from colonialism, many states wanted to establish political & economic autonomy from former powers
 - Through nationalization or expropriation
- ▶ They took control of existing foreign investments and managed the terms of new investments
- ▶ Why give control back to foreign interests?
- ▶ The economic benefits are attractive

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How Do States Try to Manage FDI and MNCs to Their Advantage

- ▶ Prohibited ownership of: utilities, extractive industries, and other important industries.
- ▶ Required some local ownership
- ▶ Imposed performance requirements

Countries vary in how they regulated FDIs ⇒ competition between potential hosts of FDIs

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How is the FDI flow pattern?

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- ▶ FDI to developing world is concentrated, largely, in most populous and wealthy countries
- ▶ FDI has increased to developing world in past 30 years, but still a small %

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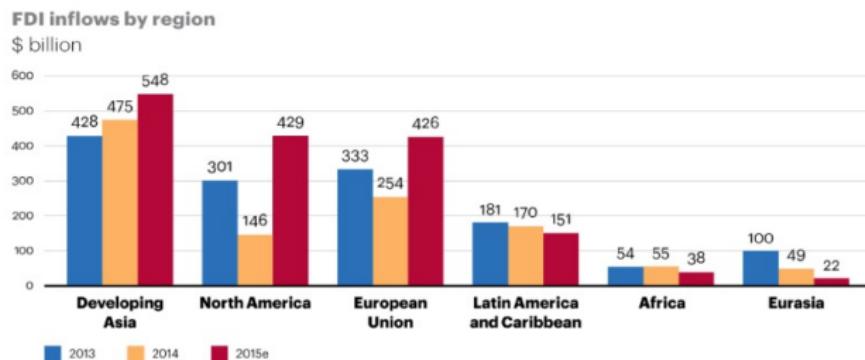
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Where does FDI go?

Figure 4

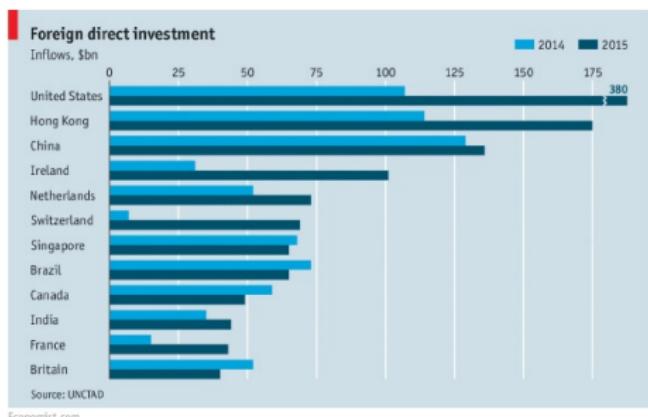
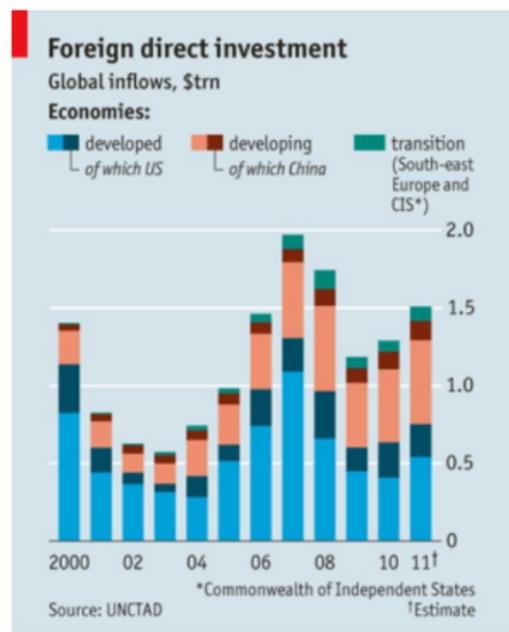
Asia, North America, and Europe dominate as destinations for global FDI flows



Note: These regional groupings are the only ones for which UNCTAD provides data in their 2015 estimate release.

Sources: UN Conference on Trade and Development; A.T. Kearney analysis

Where does FDI go?



Bargaining for FDI

- ▶ The state wants the economic benefits
- ▶ The MNC wants a profit maximizing environment and limited risk
- ▶ State fears:
 - Loss of economic policy control, other negative externalities
- ▶ MNCs fear:
 - Burdensome regulation
 - Expropriation of investments
 - Which are fixed and difficult to remove, i.e immobile
 - The fixed investment can become a hostage
- ▶ Obsolescing bargain
 - Over time bargaining power shifts towards the governments (b/c investments grow)
- ▶ These fears (the time inconsistency problem) make attracting FDI difficult for states
- ▶ How can governments tie their hands?

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Democracy and FDI

- ▶ Some states are better at tying MNCs hands
- ▶ Generally, democracies attract more FDI because the costs of expropriation are greater
- ▶ Expropriation buys them little in terms of \$\$ to provide to a larger group of supporters
 - Those \$\$ buy a lot more support where the individuals needed to remain in power is smaller
- ▶ Plus, FDI has widespread benefits
 - Leaders will be punished (with poor economic growth) if they deter investment with expropriation.
- ▶ Democracies have more “veto players” that can constraint policy choices

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The “Race to the Bottom”

- ▶ States want to attract FDI and thus offer incentives to firms
- ▶ Firms go where ever taxes are lowest, risk is lowest and regulation is least burdensome.
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Bangladesh Factory Collapse (April 2013)



from
2013 **The
Guardian**

Bangladesh Factory Collapse

- ▶ Are MNCs responsible for a lack of regulation and poor working conditions?
- ▶ Does poor regulation attract FDI? (race to the bottom) Or can it make things better? (climb to the top)
- ▶ What would incentivize foreign firms to adopt better standards?

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The “Climb to the Top”

- ▶ Firms not only want lower taxes and regulation
- ▶ They also want public goods!
 - Infrastructure, educated work force
 - These are usually paid for with taxes
- ▶ Democracy (remember?) and public good investment may attract FDI
- ▶ FDI then helps states grow and provides incentives for “better” political regimes and public good investments

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Examples of short answer questions (1)

Define each of the following terms in 2-3 sentences:

- ▶ Heckscher-Ohlin (factor endowment) model
- ▶ Most-Favored Nation Status
- ▶ Portfolio investment
- ▶ Economies of scale
- ▶ Non-Tariff barrier

Examples of short answer questions (2)

Usually a choice of 3 of 5 or 2 of 3.

- ▶ Despite theoretical expectations based in economics, foreign direct investment (FDI) tends to flow between wealthy capital abundant countries. Based on the textbook and lecture, why doesn't more FDI flow to the capital scarce developing world?
- ▶ Historically, locational advantages have been based on three specific country characteristics, what are these characteristics? Explain briefly.
- ▶ Explain the difference between a customs union and a free trade area. Next, provide a real world example of each.

Today's plan

Class 8: The International Monetary System

A couple questions we will try to answer and topics to discuss today:

- ▶ What is Money (and an exchange rate regime) Good For?
- ▶ Basics of Monetary Exchange
- ▶ International Monetary Exchange
- ▶ Balance of Payments Adjustment

What is money?

- ▶ This is a deep question. Think about it for a minute.

What is money?

The functions of money:

- ▶ A medium of exchange
- ▶ Store of value
- ▶ Unit of account

The functions of money

- ▶ A medium of exchange
 - Money evolved to resolve the “double coincidence of wants problem”
 - Individuals accept a common good with certain characteristics that becomes the common medium of exchange
 - Those characteristics are:
 - High value to bulk ratio
 - Divisible
 - Durable
 - Uniform in quality
- ▶ Store of value
- ▶ Unit of account

Different types monies over time



The functions of money

- ▶ A medium of exchange
- ▶ Store of value
 - Money allows individuals to convert perishable goods into more durable goods
 - This allows
 - Storing value between transactions
 - Saving by collecting cash
- ▶ Unit of account

The functions of money

- ▶ A medium of exchange
- ▶ Store of value
- ▶ Unit of account
 - Money provides a standard relationship between various goods in the economy

Non-standard Unit	Standard Unit
1 Blazer = 2 pairs of clogs	Blazer = €100
2 Blazers = 2 boxes of herring	1 pairs of clogs = €50
4 pairs of clogs = 2 boxes of herring	1 box herring= €100

Using a standard unit simplifies accounting and transactions

► Money is a **public good**:

- It benefits everyone!
- its creation and maintenance also suffers from the collective action problem
- (both internationally and domestically)

Monetary Exchange: The Basics

- ▶ Money can take many forms:
 - Today most countries use “paper” currency, which is made of cotton and/or linen
 - For most of history, in most places, markets came to rely on specie—minted, precious metal coins
- ▶ With all these different forms of money, how do transactions take place?
- ▶ We can organize money systems according to the various values of the money ...
- ▶ And, the **sole purpose** of the international monetary system is to facilitate international economic exchange: International transactions are possible only with an inexpensive means of exchanging one national currency for another.

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Monetary Exchange: The Basics

The Values of Money:

- ▶ Intrinsic Value: market value of the currency's constituent material when used for non-monetary purposes
 - e.g. The value of copper, gold or silver in a coin
- ▶ Exchange Value: market value of the currency when used as currency in trade
 - e.g. using gold coin to buy jewelry made of gold
- ▶ Extrinsic/Nominal Value: "Official" value and/or units
 - e.g. "1 shilling" "1 dollar"
 - Not the market value. A stated value

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Money Is Dependent On Faith & Expectations

- ▶ The value of money is dependent on **expectations**.
 - Your belief and others belief the government won't devalue the currency.
 - Or faith in others to continue valuing the currency or basis of currency (like gold)
- ▶ This is especially true today, since we use government issued that has low intrinsic value.
- ▶ We need a system to translate the expectations about the money used by each country.
- ▶ Because, when it's easy to determine the value of goods in two different countries, it's easier to engage in trade and investment.
- ▶ And, trade and investment are good for everyone!!! Do you agree? disagree?

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The importance of International Monetary Exchange today

- ▶ For most of modern history, Gold and Silver backed paper currencies and served as the common medium of exchange between economies
 - Each country's currency was worth a fixed amount of gold or silver (specie)
 - This made it easy to determine value of goods relative to each other domestically and internationally
 - Still, it required cooperation to manage the conversions
- ▶ Today, most states have a floating currency system where the value of currency is determined by the market ...
 - The dollar serves as the primary unit of account and store of value
 - Although it faces some competition from the Euro (not so much anymore) and the Renminbi (if you trust the Chinese Government)

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The Economics of the International Monetary System

To understand international monetary system, we need first to learn about three economic concepts:

- ▶ exchange rates and exchange-rate systems
- ▶ balance of payments
- ▶ balance-of-payments adjustment

Exchange rates and exchange-rate systems

Exchange rate regime:

- ▶ A set of rules governing how much national currencies can appreciate and depreciate in the foreign exchange market, the market in which the world's currencies are traded
- ▶ The relationship between a country's currency and a foreign/international currency/commodity
- ▶ Imbalances between the supply of and the demand for currencies in the foreign exchange market cause exchange rates to change

Exchange Rate Regimes

- ▶ Fixed
- ▶ Floating
- ▶ Fixed-but-Adjustable
- ▶ Managed Float

Exchange Rate Regimes

- ▶ Fixed:
Government allows for only very small changes. The government maintains this fixed price by buying & selling currencies in the foreign exchange market.
- ▶ Floating
- ▶ Fixed-but-Adjustable
- ▶ Managed Float

Exchange Rate Regimes

- ▶ Fixed
- ▶ Floating:
Governments do not intervene. There are no limits on how much XR can move up or down (USD, EURO)
- ▶ Fixed-but-Adjustable
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Exchange Rate Regimes

- ▶ Fixed
- ▶ Floating
- ▶ Fixed-but-Adjustable:
Governments intervene under a set of well defined circumstances (ex. Bretton Woods for non-US countries). Sometimes called a **crawling peg**.
- ▶ Managed Float

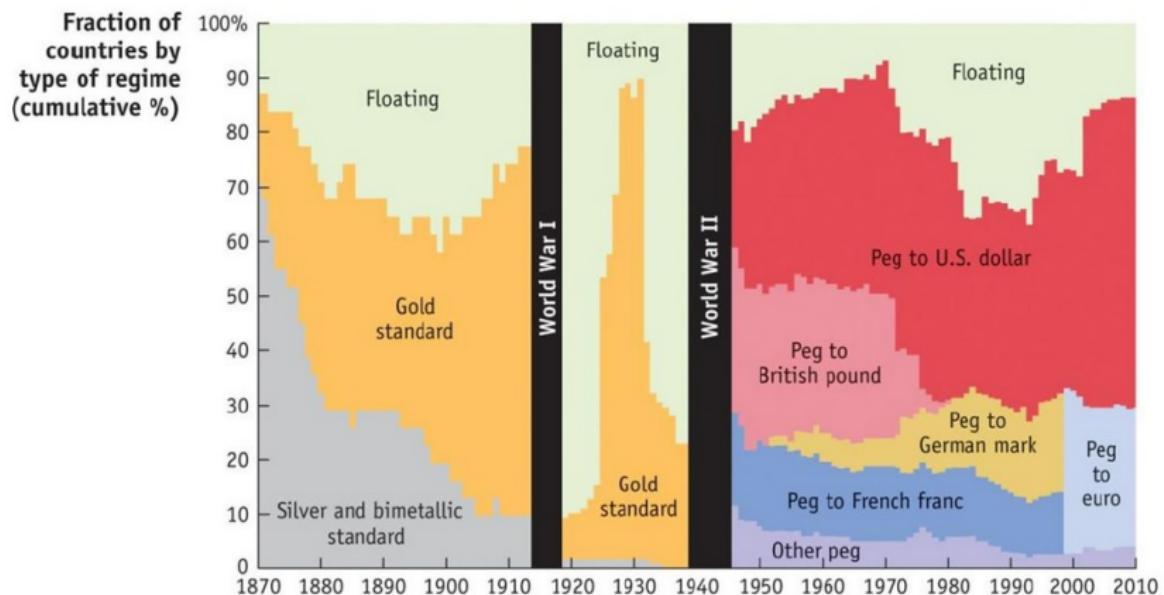
Exchange Rate Regimes

- ▶ Fixed
- ▶ Floating
- ▶ Fixed-but-Adjustable
- ▶ Managed Float:
Governments intervene but there are no clear rules. Most governments do this today. Sometimes called a **flexible float**.



Fixed versus Floating Exchange Rate Regimes

Exchange Rates Regimes of the World, 1870-2010



Balance of Payments

- ▶ Balance of Payments=Current Account+Capital Account
- ▶ Current Account: Records all current (non-financial) transactions between home country and rest of the world
 - Imports & exports of goods & services, royalties, fees, interest payments, profits, remittances, foreign aid grants
- ▶ Capital Account: Records all financial flows between the home country and the rest of the world
 - FDI, portfolio investment, & other investments
- ▶ Current & Capital Accounts are the mirror image of each other (in theory)
- ▶ But, when they don't match up a government has an imbalance of payments and needs to fix/adjust it!

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Balance-of-Payments Adjustment



How much a pack of American produced Tobasco (\$29.9) cost in the Netherlands?

- $p_{tobasco}^{NLD} = p_{tobasco}^{USA} \times \frac{\epsilon^{USD}}{\epsilon^{EURO}} = \$29.9 \times .91 = 27.21 Euro$
- $\frac{\epsilon^{USD}}{\epsilon^{EURO}}$ is the exchange rate of USD to Euro.
- The price of a foreign produced good/service is dependent on the exchange rate between the foreign and home country.

Balance-of-Payments(BOP) Adjustment

The exchange rate regime determines, in part, how balance in the BoP is maintained:

- ▶ In Floating exchange rate (XR) regimes:
 - BoP adjustment occurs through **exchange rate movements**.
- ▶ In Fixed XR regimes:
 - BoP adjustment occurs through **changes in domestic prices**.

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 - Deficit countries ($BoP < 0$) see an excess of demand for foreign currency: $XR^{foreign} \uparrow$ (domestic currency depreciates)
 - This makes foreign goods relatively more expensive and domestic goods relatively cheaper
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- ▶ To summarize, in Floating exchange rate (XR) regimes:
- ▶ Balance is restored as:
 - deficit countries see imports go ↓ & exports go ↑
 - surplus countries see imports go ↑ & exports go ↓
- ▶ Prices of domestic goods & services remain pretty stable.
- ▶ Important Benefit: The Government is free to pursue domestic policy goals (employment and inflation) using monetary policy.
 - See Quantitative Easing: Increasing the money supply to make loans cheaper hoping employers will invest in new production
 - We'll come back to this later!

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BOP Adjustment under floating exchange regime: An example

US has Disproportionate Demand for Euro \Rightarrow Excessive Demand in US for Euro \Rightarrow Appreciation of Euro vis-à-vis USD \Rightarrow Higher Relative Price of European Goods & Investments in US \Rightarrow demand of European Goods \downarrow & Investments in US $\uparrow \Rightarrow$ Contraction of BoP Surplus

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BOP Adjustment under floating exchange regime: An example

Europe has Disproportionate supply of USD \Rightarrow Excessive supply in Europe for USD \Rightarrow Depreciation of USD vis-à-vis Euro \Rightarrow Higher Relative Price of American Goods & Investments in Europe \Rightarrow
Higher demand of American Goods \downarrow & Investments in Europe $\uparrow \Rightarrow$
Contraction of BoP deficit

Balance-of-Payments(BOP) Adjustment

Adjusting the BoP under fixed exchange rate :

- ▶ The government maintains a fixed XR by using monetary policy.
- ▶ Governments buy/sell each other's currency (thus changing the money supply and prices in each country) that they store in reserve
- ▶ Via these policies, governments change interest rates, also changing domestic prices.

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Balance-of-Payments(BOP) Adjustment (2)

Adjusting the BoP under fixed exchange rate :

- ▶ In deficit countries ($BOP < 0$), the government enters the exchange currency market to prevent the increase in exchange rate. To do so:
 - ▶ The government sells foreign currency in the domestic market
⇒ it collects domestic money ⇒ demand for domestic money ↑ interest rates ↑
 - ▶ In surplus countries ($BOP > 0$), the government enters the exchange currency market to prevent the decrease in exchange rate. To do so:
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Capital control

- ▶ The government also can impose capital controls or change commercial policy that limit financial transactions with other countries.
- ▶ If you cannot supply foreign currency to satisfy the excessive demand for it, you can ban its trade within the borders! This policy often doesn't work specially in long-term: leads to an informal market, and there would be multiple exchange rate! Then those who have access to government rate currency sell them in informal market to make money!

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BOP adjustement under fixed exchange regime

Adjusting the BoP under fixed XR:

- ▶ The adjustment occurs through prices changes
 - Not through changes in the value of currencies
 - The value of the currency has to remain fixed!
- ▶ Deficit countries see a reduction in the money supply
 - So prices fall
- ▶ Surplus countries see an increase in the money supply
 - So prices rise
- ▶ The price of goods RISE and FALL (Why?)

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 - So prices fall
- ▶ Surplus countries see an increase in the money supply
 - So prices rise
- ▶ The price of goods RISE and FALL (Why?)

BOP adjustement under fixed exchange regime

Adjusting the BoP under fixed XR:

- ▶ The adjustment occurs through prices changes
 - Not through changes in the value of currencies
 - The value of the currency has to remain fixed!
- ▶ Deficit countries see a reduction in the money supply
 - So prices fall
- ▶ Surplus countries see an increase in the money supply
 - So prices rise
- ▶ The price of goods RISE and FALL (Why?)

Fisher effect

There is an inverse correlation between interest rates and the rate of inflation.

BOP Adjustment: Summary

Fixed vs. Floating: Each has different consequences
(winners/losers)

► Fixed:

- Makes trade very easy because prices **across** countries are stable
- However, prices **within** countries are unstable

► Floating:

- Prices **across** countries are unstable, making trading relations subject to changing prices
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IMPORTANT:

The politics of monetary policy largely center around these differences

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Why control over monetary policy is important?

- ▶ Monetary policy control is useful for controlling domestic business cycles (inflation and unemployment)
 - When unemployment is high, governments can lower interest rates to increase investment (and hopefully jobs)
 - When inflation is high, governments can increase interest rates to decrease the supply of money domestically.
- ▶ The choice of a exchange rate(XR) regime determines a state's monetary policy autonomy:
 - Fixed XR:
 - Provides greater certainty for int'l trade & investment
 - With the cost of monetary policy control
 - Floating XR:
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What to know well

- ▶ A common or transferable currency is a public good Types of XR regimes
- ▶ XR regimes determine how states adjust balance of payments and influences price levels at the domestic and international level
- ▶ Adjusting BoP under fixed XR: monetary policy raises/lowers the money supply to deal with surplus/deficit (domestic price, including the price of money, i.e. interest rate, changes!)
- ▶ Adjusting BoP under floating XR: XR appreciates/depreciates to deal with surplus/deficit

Examples of multiple choice questions

Which one of below statements is **not** correct about the balance of payment?

- A. The balance of payment is the sum of current account and capital account
- B. The balance of payment in float exchange regime countries is adjusted without government intervention.
- C. Countries with current account deficit definitely experience the excess demand of foreign currency.
- D. Balance of payment summarizes the governments financial and non-financial transactions of a country with other foreign countries.

Examples of multiple choice questions

Which one of below statements is correct about the exchange rate regime, monetary policy of governments, and the goods market?

- ▶ Countries with a fixed exchange regime often do not experience fluctuations in their domestic goods market.
- ▶ Countries with a fixed exchange regime increase money supply in response to a deficit of balance of payment.
- ▶ Countries with a float exchange regime decrease interest rate in response to an excess of balance of payment.
- ▶ Countries with a fixed exchange regime decrease interest rate in response to an excess of balance of payment.

“SOCIETY CENTERED” APPROACH TO MONETARY POLITICS

What are your monetary preferences?

Should the Netherlands have ...

- ▶ A fixed or floating exchange rate?
- ▶ A strong or weak currency (relative to major trading partners)?

Society Centered Approach

- ▶ Domestic politics, interest groups and politicians, shapes monetary policy
- ▶ Interests and Institutions ...

Different types of institutional settings:

1. Electoral Models
2. Partisan Models
3. Sectoral Models

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Different types of institutional settings:

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Electoral Models

- ▶ XR policy is determined by a politician's need to stay in office (remember political survival theory).
- ▶ Politicians have two major ways to influence the state of the economy:
 - Fiscal policy (taxes & spending)
 - Monetary policy (adjust interest rates, if available: When is it available?) Generally developed and advanced developing countries do not allow politicians decide about the monetary policy!
- ▶ Monetary policy is determined by a leader's desire to control their own fate.

Electoral Models(2)

- ▶ Regime Type:
 - Democracies are more sensitive to the state of the domestic economy...
 - Therefore, monetary policy autonomy is more important (but not irrelevant in non-democracies).
- ▶ Institutional heterogeneity
 - Electoral rules in different democracies (or non-democracies) might alter these incentives.
 - Again, veto players!

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Electoral Models: Institutions and Credibility

- ▶ Fixed XR requires a commitment to uphold the peg ...
- ▶ Democracies might not be the best at upholding commitments'... Why?
 - ▶ Elections!
 - Politicians often have incentives to focus on the next election, not long term commitments.
 - Nordhaus's (1975): Political business cycles!
 - We'll explore this more later!

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William Dawbney Nordhaus (1941-)



- ▶ Sterling Professor of Economics at Yale University
- ▶ Best known for his work in economic modeling and climate change
- ▶ Won the 2018 Economics Nobel prize for integrating climate change into long-run macroeconomic analysis.

Partisan Models

XR policy is determined by the ruling party's ideology/interests

- ▶ Left-wing parties are “pro-employment”
 - Tend to represent labor organization
- ▶ Right-wing parties are “anti-inflation”
 - Tend to represent business interests

There is a trade-off between inflation and employment.

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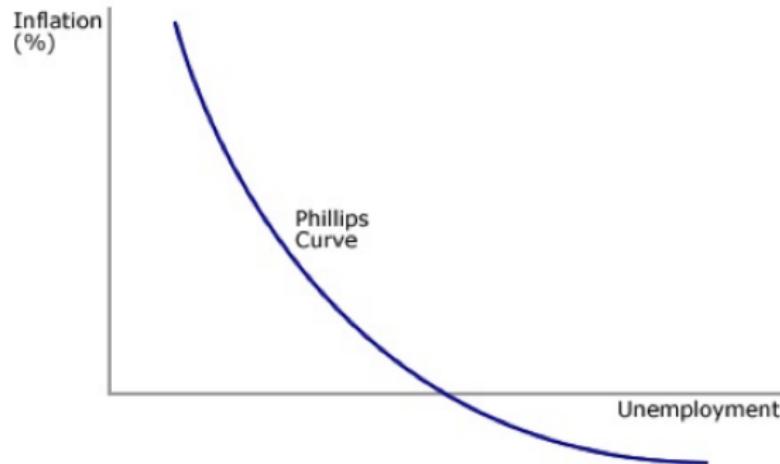
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The Phillips Curve

This tells us that there is a trade off between inflation and unemployment



Prediction of partisan model

- ▶ A fixed exchange regime ties the hand of policy makers to expand the economy, decrease the unemployment/increase inflation, using monetary policy ⇒
- ▶ Leftist governments are less likely to maintain a fixed exchange rate than rightist governments.

Connection with Electoral Model:

- ▶ Voters choose left-wing parties during recessions & right wing parties under inflation

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Summary of Partisan model

- ▶ Left – labor-oriented – parties versus Right – business-oriented – parties
- ▶ This sounds familiar!
- ▶ What other models are based on labor and business (capital owners) interests?
- ▶ Also, also having weak or strong currency matters, too.
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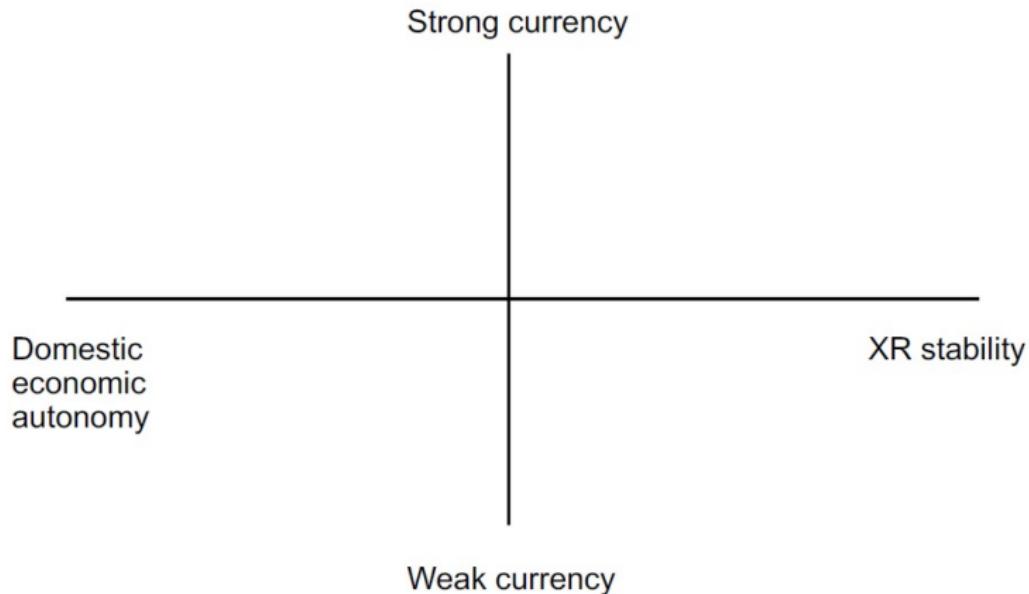
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Sector Model

Interest groups have different preferences towards the trade-off:

- ▶ Some prefer XR stability
- ▶ Others like monetary policy autonomy

The “sector” of employment determines preferences.

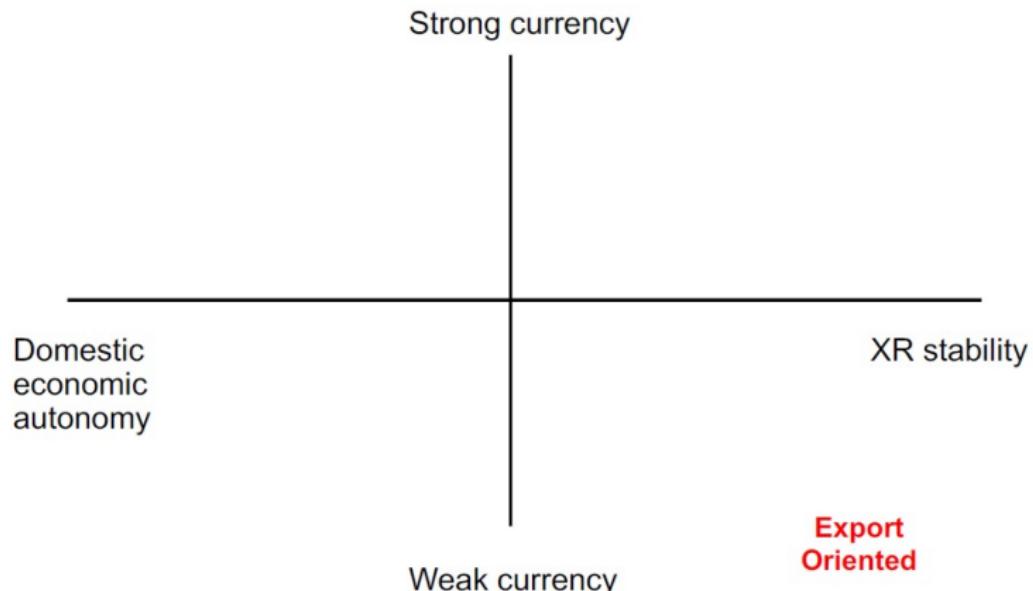


Four interest groups

1. Export-oriented producers
2. Import-competing producers
3. Nontraded-goods producers
4. Financial services industry

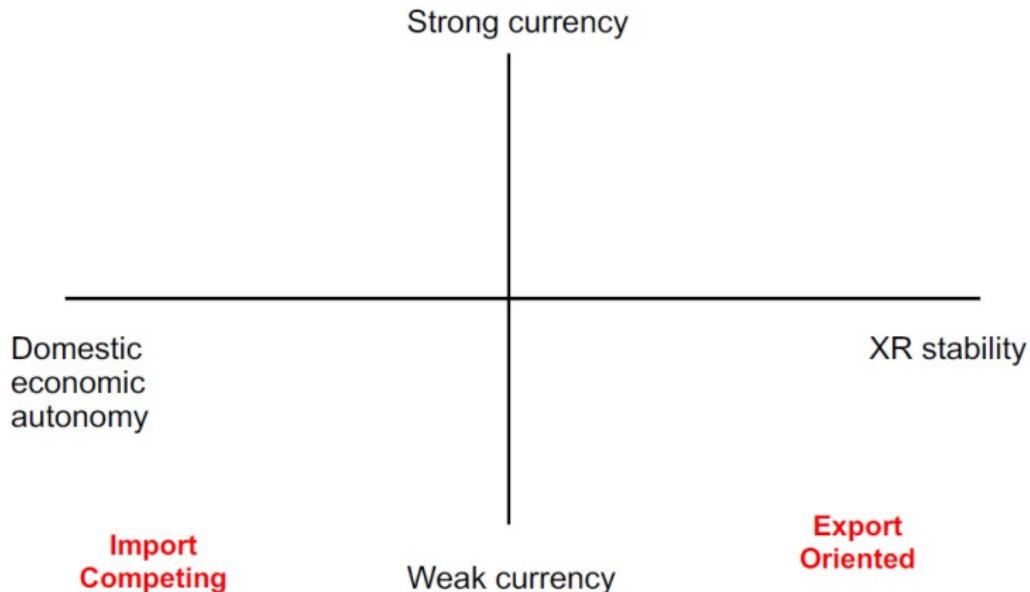
Four interest groups

1. Export-oriented producers
 - ▶ Fixed XR: stability for international transactions
 - ▶ Weak XR: lowers price of domestic products abroad
2. Import-competing producers
3. Nontraded-goods producers
4. Financial services industry.



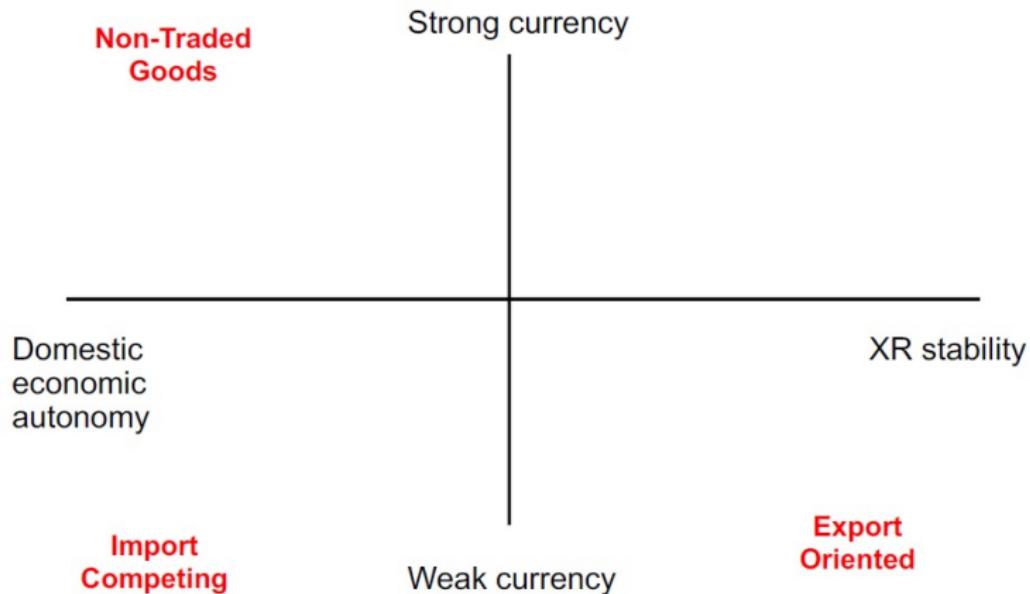
Four interest groups

1. Export-oriented producers
2. Import-competing producers
 - ▶ Floating XR: prefer monetary policy to address recessions/inflation
 - ▶ Weak XR: keeps imports high, they are more competitive
3. Nontraded-goods producers
4. Financial services industry.



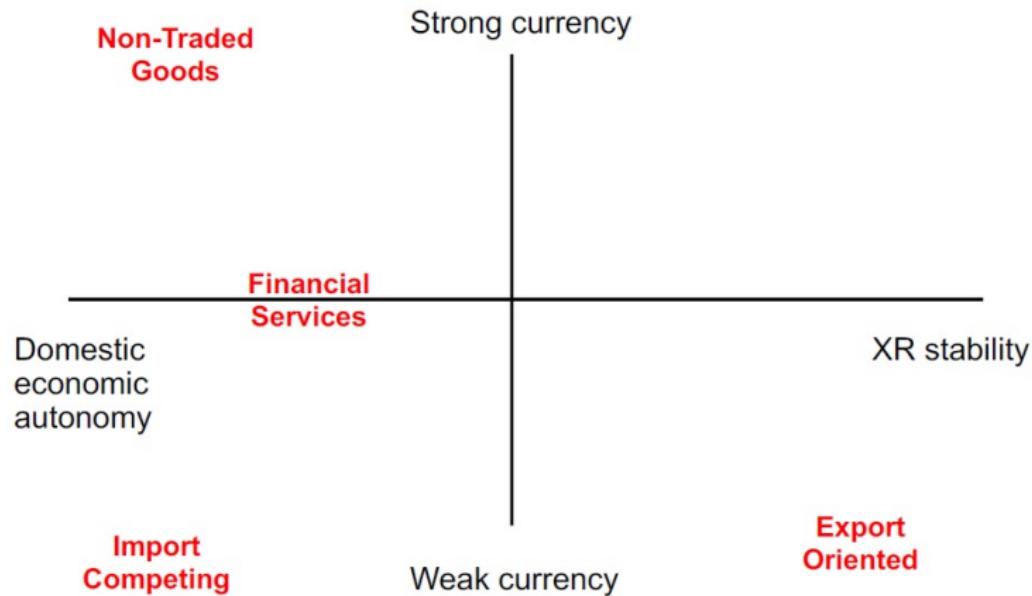
Four interest groups

1. Export-oriented producers
2. Import-competing producers
3. Nontraded-goods producers
 - ▶ Floating XR: prefers monetary policy to address recession/inflation
 - ▶ Strong XR: consumes more goods, travel more, pay for tuition, ...
4. Financial services industry.



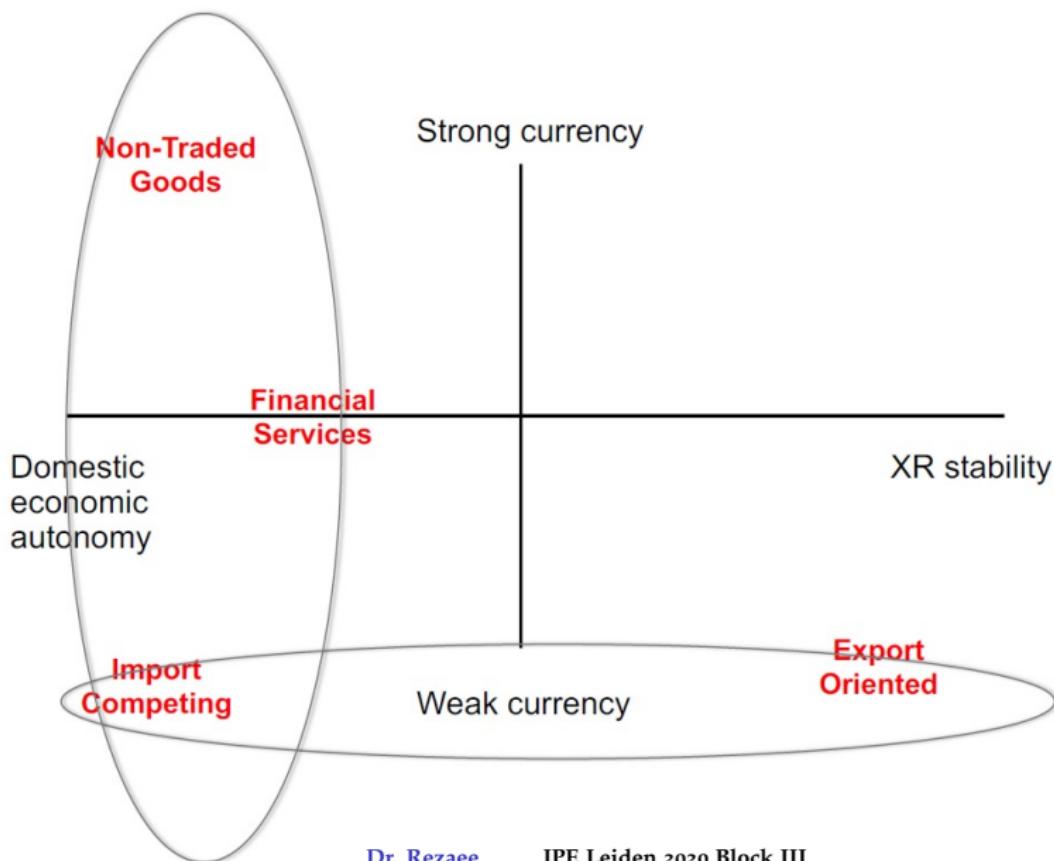
Four interest groups

1. Export-oriented producers
2. Import-competing producers
3. Nontraded-goods producers
4. Financial services industry.
 - ▶ XR stability for int'l transactions
 - ▶ But XR volatility can be profitable
 - Currency trade
 - ▶ Monetary policy autonomy maintains stable domestic banking system
 - ▶ WEAK preferences for floating XR
 - ▶ No preference for strength of currency
 - Buy foreign assets when XR is strong, repatriate investments when XR is weak.
 - Win/win



Allies and adversaries

- ▶ XR stability
 - Non-tradeable and import competing want flexibility
 - Also financial services...
 - Export oriented wants stability
- ▶ XR strength:
 - Export oriented and import-competing want a weak currency
 - Non-tradeables want strong currency



Criticism of each model?

► Electoral Model

- Limited in explanation. Tells us only why a government might abandon a fixed XR.
- Some governments don't abandon fixed XRs according to its predictions

Criticism of each model?

► Partisan Model

- Monetary policy preferences isn't always neatly distributed across parties. Other issues matter.
- Leftists sometimes pursue contradictory measures, rightists are sometimes expansionary
- Can't explain situations where monetary policy is separated from politics (Federal Reserve)

Criticism of each model?

► Sector Model

- Overestimates importance of fixed XR to export interests
 - They have ability to purchase insurance
- Weak currency also increases production costs, eliminating some gains to traded-goods sector
 - They also use imported imports, which rise in cost as a currency weakens
- Can't tell us much about which sectors will prevail in political competition.

Sample short answer questions

Briefly explain below concepts:

- ▶ Phillips curve
- ▶ Floating exchange rate regime
- ▶ Fixed exchange rate regime
- ▶ Political business cycle
- ▶ Balance of payment
- ▶ Balance of payment deficit

Session 11: Economic Statecraft and Sanctions

- ▶ What are sanctions and typologies of economic coercion?
- ▶ Are sanctions ever successful?
- ▶ What impact do sanctions have?
- ▶ What are the limits of economic coercion.



9:01 AM - 2 Nov 2018



Donald J. Trump



As I have stated strongly before, and just to reiterate, if Turkey does anything that I, in my great and unmatched wisdom, consider to be off limits, I will totally destroy and obliterate the Economy of Turkey (I've done before!). They must, with Europe and others, watch over...

♡ 60.3K 3:38 PM - Oct 7, 2019



⌚ 73.6K people are talking about this



Donald J. Trump



The Iran sanctions have officially been cast. These are the most biting sanctions ever imposed, and in November they ratchet up to yet another level. Anyone doing business with Iran will NOT be doing business with the United States. I am asking for WORLD PEACE, nothing less!

10:31 AM - Aug 7, 2018

⌚ 19,076 ⏱ 23,889 ♡ 81,796



Donald J. Trump



.....Honduras, Guatemala and El Salvador are doing nothing for the United States but taking our money. Word is that a new Caravan is forming in Honduras and they are doing nothing about it. We will be cutting off all aid to these 3 countries - taking advantage of U.S. for years!

7:06 AM · Dec 28, 2018 · Twitter for iPhone

35K Retweets 156.3K Likes



Economic Coercion

- ▶ Refers to the use of a state's economic power, rather than military power, as a tool of foreign policy
- ▶ Goal: force another state to change policies or behavior

FIVE forms of Economic Sanctions:

1. Trade Sanctions (most common)
 - ▶ Export sanctions OR import sanctions
 - ▶ Public, Slower, Market Incentives to undermine, long lasting
2. Aid (more on this in a later lecture)
 - ▶ positive OR negative
 - ▶ Good for signaling, positive sanctions
3. Finance
 - ▶ Lending and investment restrictions
 - ▶ positive OR negative
 - ▶ Can be informal, limited market circumvention
4. Currency (Monetary)
 - ▶ Destabilize the value of country's currency
 - ▶ Fast, can be secret, effect may fade over time
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 - ▶ Seizure of a country's (or individual's) assets
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Further distinction

- ▶ Unilateral – One state impose sanctions
- ▶ Multilateral – Many states impose sanctions – the more the better as there are few alternative markets.

Suez Crisis 1956-57



"I must not bully"

- ▶ Egypt's Nassar Nationalized the Suez Canal in 29 October 1956 (UK control since 1888)
A crucial route for the transport of oil from the middle east to Europe & US
- ▶ UK, France, & Israel retaliated and took over the canal
- ▶ The US (not initially consulted), trying to avoid Soviet intervention & an international crisis pressured UK & co. to relinquish control to Egypt

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- ▶ **Export Sanctions:** Saudi Arabia imposed oil embargo on UK and NATO members refused to sell oil to UK to make up difference
- ▶ **Monetary Sanctions (threat):** US President Eisenhower threatened to sell US reserves of British pounds, creating an over supply and devaluing the currency, if the British did not back off

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Suez Crisis 1956-57



"I must not bully"

- ▶ After the threat of monetary sanctions, the UK, France, & Israel withdrew and left the canal to Egypt.

Sanctions usually require (inter)dependence

- ▶ Existing ties or dependence on another country is (often) necessary for sanctions to be useful.
- ▶ The US & EU give aid to many countries and have large consumer markets that are a magnet for imports.
- ▶ Many countries are dependent on the US' and EU's aid and market.

US sanction against Iran



Donald J. Trump



@realDonaldTrump



The Iran sanctions have officially been cast. These are the most biting sanctions ever imposed, and in November they ratchet up to yet another level. Anyone doing business with Iran will NOT be doing business with the United States. I am asking for WORLD PEACE, nothing less!

10:31 AM - Aug 7, 2018

19,076

23,889

81,796

US sanction against Iran



Domestic Economic Cost

- ▶ With interdependence comes mutual costs.
- ▶ Sanctions hurt the target state but also hurt the sending state
 - ▶ Lost trade, lost investment
 - ▶ These winners & losers are sometimes politically important constituents.
 - ▶ Sanctions can be costly signals if they impose a significant cost on the sender.
 - ▶ The more it hurts the more resolved the sender is.

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How economic sanctions work in theory?

► In democracies:

- Sanctions increase economic pressures on citizens, and either the incumbent government changes its policies, or will be replaced by a government that changes the policies to remove the sanctions

► In autocracies:

- Sanctions increase economic pressures on citizens, and they organize protests to put pressure on the state. Either the government changes its policies, or will be overthrown by the protestors

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Do Sanctions Work? How Could We Find Out?

Sanctions do not work?

- ▶ Many in the policy community believe sanctions are ineffective
 - Are they right or just bad at statistical thinking?
- ▶ Haubauer, Schott & Elliot (1990, 2009) Economic Sanctions Reconsidered
 - Collected data on each imposition of sanctions and stated goals
 - Found that 34% of sanctions have been effective at achieving goals
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- ▶ Think strategically about the process of using sanctions to get what you want.
- ▶ What would you do first?
- ▶ When are we most likely to see sanctions imposed?

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Monetary Threat by US during Suez Crisis was never imposed! The threat was sufficient

Why do we see impositions then?

► Miscalculation by the target :

- Target thought costs of sanctions for target < the cost of policy change.
- Imposed sanctions can eventually work if the cost > cost of policy change (Hovi et al (2007) "When do Imposed Economic Sanctions Work" World Politics)

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 - Expressing preference
 - “making an example” (a wider audience)
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The Costs of Sanctions

- ▶ The costs of sanction often fall on average citizens.
 - This is often intentional as senders hope the people will overthrow or put pressure on the regime.
 - UN Sanctions on Iraq 1990s
 - Food prices increase 25 times over in 5 years (Hoskins 1997)
 - 100k - 227k deaths (many young children) 1991-1998 (Garfield 1999)
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Examples of Targeted Sanctions

- ▶ North Korea – Goods consumed by elites (fancy cars, watches, wine, shellfish) are banned from being exported to the country. In addition to goods used to make Nukes
- ▶ Magnitsky Act (2012) - US law passed to punish 18 Russians associated with the death of whistleblower Sergei Magnitsky. Now extended to other Human Rights abusers.
 - US govt allowed to freeze assets and ban travel to US of specific individuals deemed a threat to human rights
 - Russia even tries to *meet* with presidential candidates to try and get this overturned.
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Limits of Economic Coercion

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 - Farrell & Newman (2019) “Weaponized Interdependence” International Security
 - Trump’s abuse of US economic leverage may backfire.
- ▶ Some problems are so fundamental to a regime’s survival that economic power is not sufficient
 - North Korean Nuclear Weapons
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Rally round the flag

- ▶ It is assumed that economic sanctions increase the oppositions against the incumbent regime, but economic sanctions can increase support for the regime, too. How?
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Trump sanctions against Iran

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Iran's Exchange Rate

Iran's currency has hit record lows recently

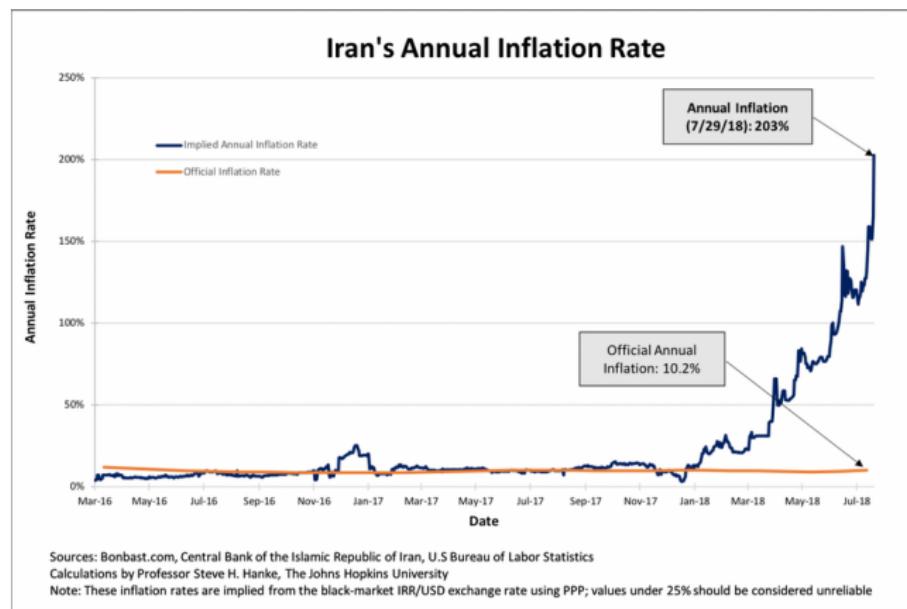
Number of Iranian rials to one US dollar at unofficial market rate



Source: Bonbast.com

BBC

Iran's Inflation Rate



Trump sanctions against Iran (2)

- ▶ These sanctions had adverse effects on Iran's economy. However, they didn't reach their goals. Why?
- ▶ One reason can be that Trump sanctions have decreased the opposition against the state in Iran within the network of resistance.
- ▶ NOTE: It didn't necessarily turn the oppositions to the supporters, but what if it decreased the opposition?!

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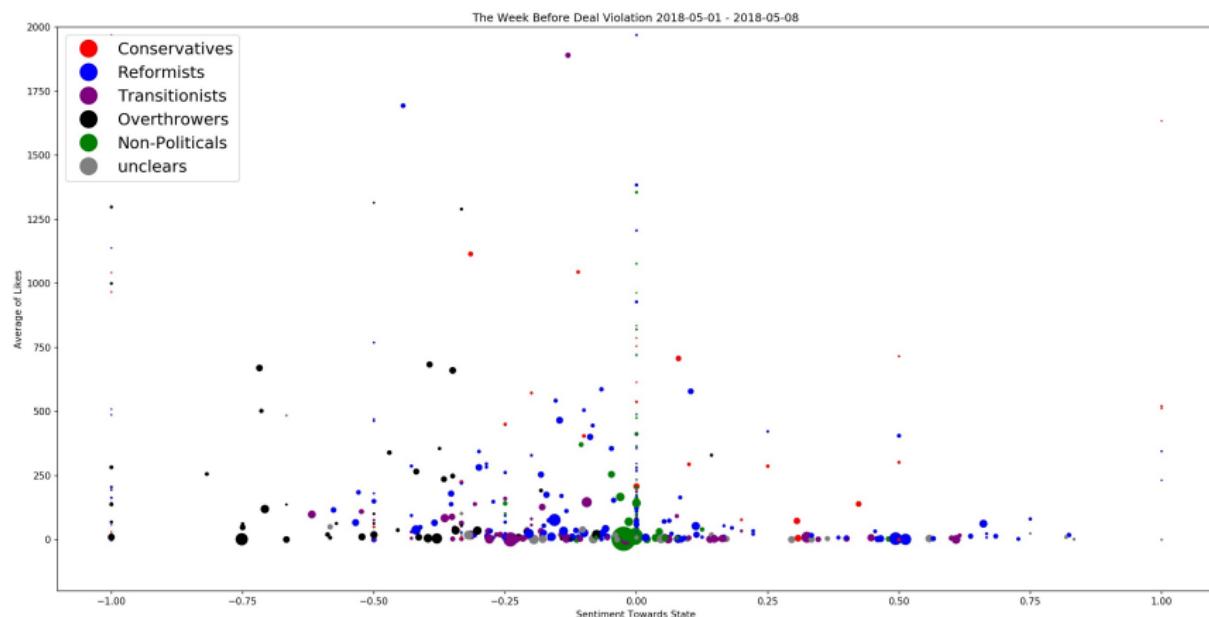
Trump sanctions against Iran (3)

- ▶ Here, there is a methodological challenge?
- ▶ In democratic regimes, you can measure support for the government by conducting surveys. However, it doesn't sound a good idea to ask a non-democratic regime about its leaders' popularity! Why?!
- ▶ However, in a project, my colleagues and I used Tweets of Iranian influences to measure change in the attitude toward the state!
- ▶ We used machine learning to analyze 3 million tweets from about 1000 Iranian Twitter influencers (politicians, journalists, celebrities, ...).

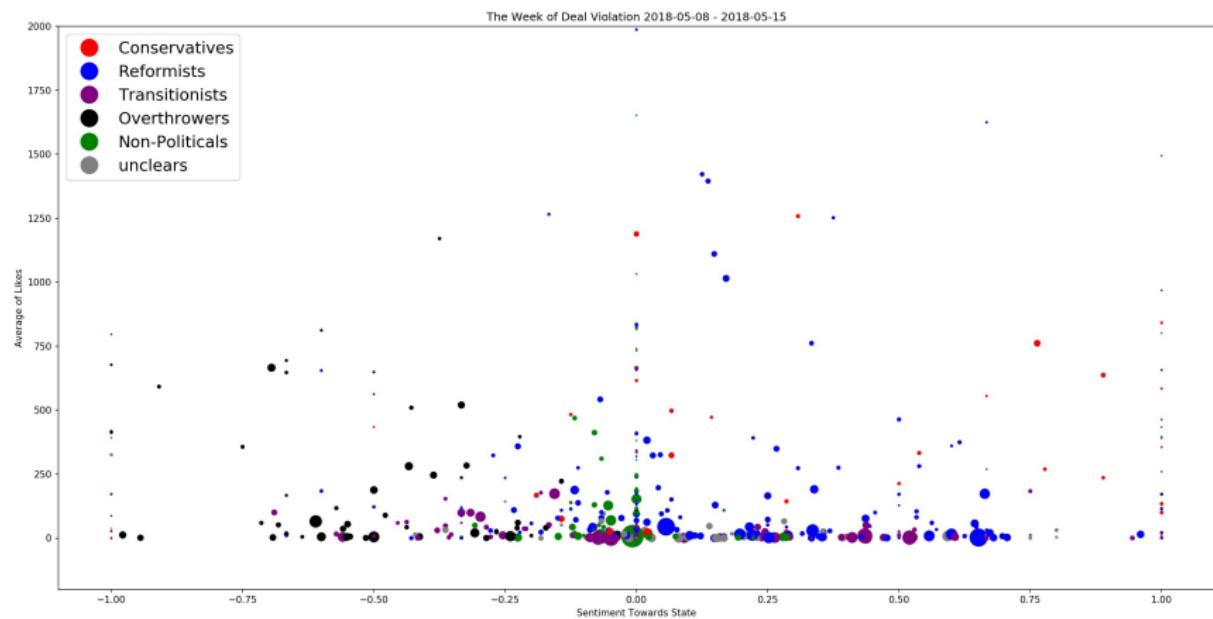
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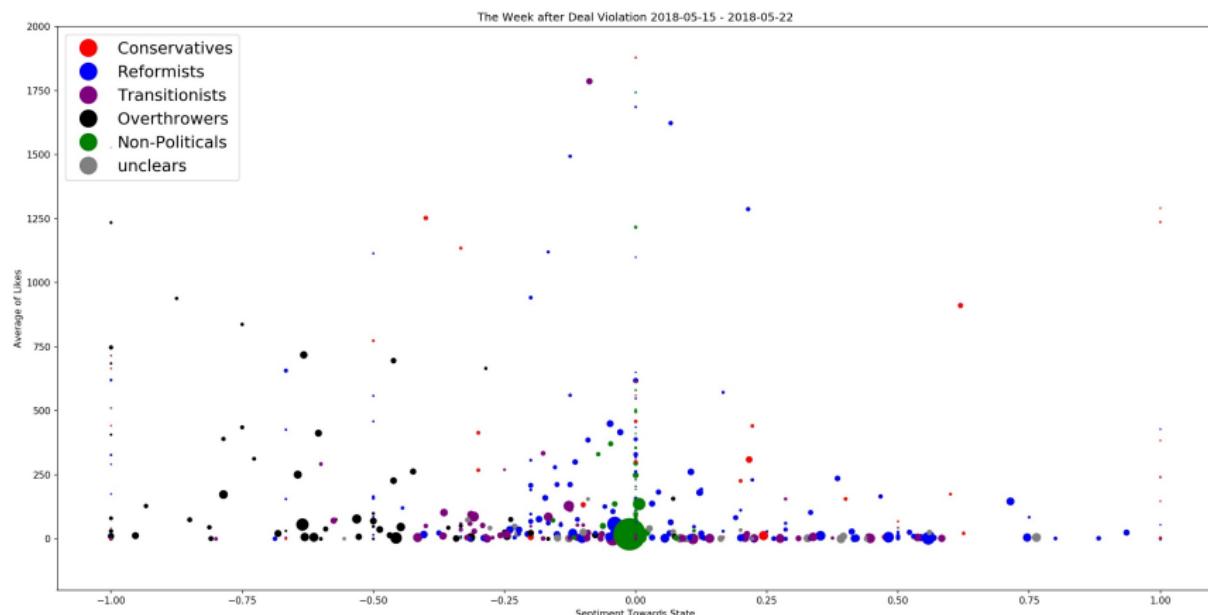
The attitude of Iranian elites toward the Iranian government: the week before sanctions



The attitude of Iranian elites toward the Iranian government: the sanctions week



The attitude of Iranian elites toward the Iranian government: the week after sanctions



Summary of economic sanctions

- ▶ Economic and financial interdependence can be used to put pressure on a country to change its policies
- ▶ The threat of economic sanctions vs. the imposition of economic sanctions
- ▶ If the imposition of economic sanctions perceived to be effective, it will lead to change of policy at the threat stage!
- ▶ Comprehensive Economic sanctions often lead to heavy humanitarian costs/issues.
- ▶ Comprehensive vs. targeted sanctions.
- ▶ Generally, economic sanctions are not effective in changing authoritarian regimes' policy! Why?
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International Finance, Debt Crises & “The Great Recession”

Movie suggestion for the weekend!

The movie is about the 2008 Financial crisis and available on Netflix! [Watch!](#)



Potential Explanations for the Crisis

- ▶ It was the financial industry's fault
- ▶ Emerging market savings glut (excessive supply)
- ▶ Debt-driven consumption boom

Each has a degree of truth but which was the major factor?

Blame it on the banks!

Most common arguments:

- ▶ Growing complexity of the US financial system.
 - New model of securitization
 - Mortgaged back securities
 - Collateralized debt obligations
- ▶ Inability of regulators to keep up.
- ▶ Banks had short term incentives for long term loans.
- ▶ Failure of Credit Rating Agencies to properly assess risk.
- ▶ Fraud on the part of Mortgage brokers

Blame it on the banks!

Add on top of that:

- ▶ Deregulation of financial industry:
 - Financial Services Modernization Act of 1999
 - Removed separation of commercial and investment banking (Glass-Steagall Act of 1933).
- ▶ Banks become too big to fail and can take down the entire economy
- ▶ Essentially:
 - Banks could now use savings to play in the stock market and invest in securities
 - Which, included these new fangled debt securities.

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A Failure of Markets and Regulators?

"The captains of finance and the public stewards of our financial system ignored warnings and failed to question, understand, and manage evolving risks ... Theirs was a big miss, not a stumble"

(Financial Crisis Inquiry Commission 2011 : xvii).

A Failure of Markets and Regulators?

"Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity, myself included, are in a state of shocked disbelief" -Alan Greenspan 2008

Watch!

A GLOBAL AND HISTORICAL PERSPECTIVE

- ▶ Is the US financial crisis unique?
- ▶ Does it share anything in common with previous crises?
 - 1980's Latin American debt crisis
 - 1997-98 Asian crisis
 - Mexican 1994 crisis
 - Russian, Brazilian, Turkish and Argentinian crises (late 90s)
 - Germany 1930's
 - US 1890s.

WHAT'S REALLY BEHIND THE CRISIS?

- ▶ Remember imbalances...

SIMILAR SITUATION TODAY

- ▶ US twin deficits: fiscal & current account
- ▶ Japan, Europe, China, current account surpluses ⇒ Finance the American deficit
 - US absorbs about 6% of the world's savings
- ▶ US international investment position:
 - Foreign-owned assets in US in 2007: \$17.8 trillion
 - US residents' foreign assets in 2007: \$15.4 trillion
 - International investment position: -\$2.4 trillion

HOME PRICES AND CURRENT ACCOUNT BALANCE

