

International Economics: Introduction

- Michael Kevane
- Department of Economics
- Santa Clara University
- Spring 2004

Importance of trade

- Trade (exports and imports of goods and services, and the receipt and payment of earnings on foreign investment) has increased 25-fold since 1970 and nearly 120 percent since 1990. In 2000, the value of U.S. trade reached a record \$3.4 trillion.
- www.ustr.gov/new/legaldoc1.PDF

Figure 1-1 Exports and Imports as a Percentage of U.S. National Income

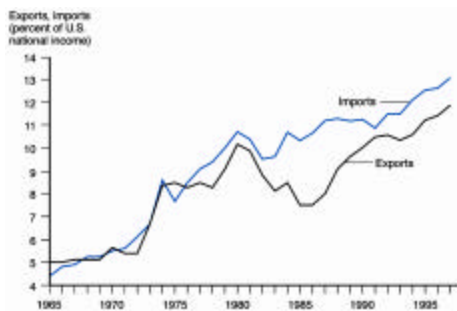
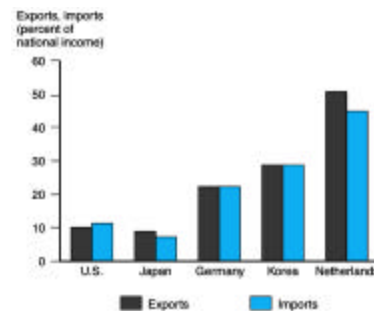


Figure 1-2 Exports and Imports as Percentages of National Income in 1994



Effects of trade barriers

- In addition to lowering national income overall, trade protection shifts income from consumers to producers. The consumers costs of trade protection therefore generally exceed the loss to national income.
- In 1994, Gary Hufbauer and Kimberly Elliott estimated that consumer costs of tariffs and quantitative restrictions in effect in the United States in 1990 was \$70 billion, or 1% of GDP. This figure would have represented about \$1,100 for the average household of four persons in 1999.

Effects of trade barriers

- According to a 1999 U.S. ITC study, if all significant, quantifiable U.S. tariff and non tariff restraints were eliminated in 1996, U.S. economic welfare (real income) would have been as much as \$14.9 billion higher (\$12.4 billion from the significant restraints and \$2.5 billion from all other tariffs). This is a per capita level of \$56.
 - The economic welfare gains to be achieved from a total opening of textile and apparel imports, at \$10.4 billion, accounts for more than 3/4ths of the forgone economic welfare estimated by the ITC.
 - Other major sectors include: Maritime (the Jones Act) for \$1.3 billion; Sugar for \$986 million; Footwear for \$501 million; and Dairy for \$152 million.

Effects of sugar quotas

- According to Public Voice, the sugar program acts like a regressive tax on consumers, adding approximately \$1.17 billion a year to the cost of boxed and bagged sugar and processed foods at the retail level.
- A 1993 report by the General Accounting Office estimated the sugar program to cost U.S. consumers \$1.4 billion annually.
- <http://www.sugar-reform.org/jtc.html>

The Benefits of Liberalization of International Trade

- Uruguay Round: Had pre- Uruguay Round tariff rates been applied to 1999 U.S. imports, duty collections would have been an estimated \$21.4 billion higher. The Uruguay Round tariff cuts were thus similar to a \$310 tax cut for an average household of four.
- NAFTA/CFTA (U.S.-Canada Free Trade Agreement): Had NAFTA/CFTA tariff rates been applied to 1999 U.S. imports, duty collections would have an estimated \$ 14.2 billion higher. The NAFTA/CFTA tariff cuts were thus similar to a \$210 tax cut for an average household of four

• Source: IMF website

The Benefits of Trade Liberalization

- Estimated gains from \$250 to \$680 bil. annually from eliminating all trade barriers to merchandise
- two-thirds of these gains would accrue to industrial countries
- amount to developing countries would still be more than twice the level of aid they currently receive.
- developing countries would gain more from global trade liberalization as a percentage of their GDP than industrial countries

• Source: IMF website

Benefits of Liberalization of Trade

- David Dollar and Aart Kraay at the World Bank
 - compare developing countries that participate more in globalization (accounting for 50% of developing world population) with other developing countries and the high-income countries.
 - from the 1970s to the 1980s to the 1990s, growth rates accelerated for the globalizing developing countries while they decelerated for high-income countries and non-globalizing developing countries.
 - In the 1990s, per capita incomes grew 5.1% for globalizing developing countries, by 1.9% for high-income countries, but declined by 1.1 percent for non-globalizing developing countries.
 - The successful globalizing LDCs were found to have cut their tariffs three times more (by 34 percentage points) than was the case for non-globalizing LDCs (cut by 11 percentage points) between the mid-1980 and late 1990s.
 - The trade share of GDP doubled for the globalizers

The Need for Further Liberalization of International Trade

- Global trade protection remains - esp. in agriculture and labor-intensive industry - where developing countries have comparative advantage
- Average tariff protection in agriculture is about nine times higher than in manufacturing
- Industrial countries continue protection in agriculture by:
 - tariff peaks (tariffs above 15 percent)
 - tariff escalation (tariffs that increase with the level of processing)
 - restrictive tariff quotas (limits on the amount that can be imported at a lower tariff rate)
- agricultural subsidies in industrial countries undermine developing countries' agricultural sectors and exports by depressing world prices.

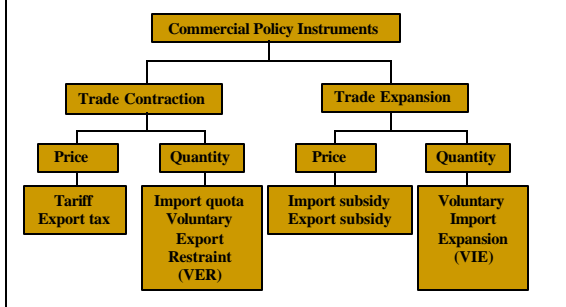
• Source: IMF website

The Need for Further Liberalization of International Trade

- In industrial countries, protection of manufacturing is generally low, excepting labor-intensive products produced by developing countries.
 - the US has an average import tariff of only 5 %, but has tariff peaks on almost 300 individual products- primarily textiles and clothing, which account for 90% of the \$1 billion annual US imports from the poorest countries
- Many developing countries themselves have high tariffs.
 - On average, their tariffs on industrial products are three to four times higher than those of industrial countries
 - Tariffs on agriculture are even higher (18 percent) than those on industrial products.

• Source: IMF website

Classification of Commercial Policy Instruments



Tariffs can be classified as:

- **Specific tariffs**
 - Taxes that are levied as a fixed charge for each unit of goods imported
 - Example: A specific tariff of \$10 on each imported bicycle with an international price of \$100 means that customs officials collect the fixed sum of \$10.
- **Ad valorem tariffs**
 - Taxes that are levied as a fraction of the value of the imported goods
 - Example: A 20% ad valorem tariff on bicycles generates a \$20 payment on each \$100 imported bicycle.

- A compound duty (tariff) is a combination of an ad valorem and a specific tariff.
- Modern governments usually prefer to protect domestic industries through a variety of nontariff barriers, such as:
 - **Import quotas**
 - Limit the quantity of imports
 - **Export restraints**
 - Limit the quantity of exports

Voluntary Export Restraints

- A **voluntary export restraint (VER)** is an export quota administered by the exporting country.
 - It is also known as a voluntary restraint agreement (VRA).
- VERs are imposed at the request of the importer and are agreed to by the exporter to forestall other trade restrictions.

Voluntary Export Restraints

- A VER is exactly like an import quota where the licenses are assigned to foreign governments and is therefore very costly to the importing country.
- A VER is always more costly to the importing country than a tariff that limits imports by the same amount.
 - The tariff equivalent revenue becomes rents earned by foreigners under the VER.
 - Example: About 2/3 of the cost to consumers of the three major U.S. voluntary restraints in textiles and apparel, steel, and automobiles is accounted for by the rents earned by foreigners.
- A VER produces a loss for the importing country.

Other Instruments of Trade Policy (non-tariff barriers to trade)

- **Local content requirements**
- **Export credit subsidies**
 - A form of a subsidized loan to the buyer of exports.
 - They have the same effect as regular export subsidies.
- **National procurement**
 - Purchases by the government (or public firms) can be directed towards domestic goods, even if they are more expensive than imports.
- **Red-tape barriers**
 - Sometimes governments place substantial barriers based on health, safety and customs procedures.

Antidumping And Countervailing Duties

- **Dumping: goods exported to another country at a price below the fair price**
 - industry that is harmed can petition for anti-dumping duties to be placed on imports
- **Countervailing duty is used as a retaliatory tool if a trading partner provides production and export subsidies**

The big questions in international trade

- **What is the best policy: open to trade or closed?**
 - intuition suggests openness is the right policy
 - experience of China and India
 - but other changes could be responsible for improvements
- **What should international rules be like?**
 - Are bad rules better than no rule?
 - Is free trade is really about international commercial agreements that are written by corporate lobbyists for their benefit?
 - Should the power of WTO be curtailed?

If trade so good how come not more?

- **Political economy**
 - steel, textiles, sugar
- **Is trade bad for environment?**
 - lots of other things bad/worse?
 - Amazon
 - Soviet Union
 - sometimes trade improves environment
 - lots of countries protect big, polluting industries, esp. agriculture

- **The Doha Round**

- **General tariff and NTB reduction**
- **Reduction in developed country agricultural support programs**
- **TRIPS- intellectual property in pharmaceuticals**
- **“Singapore issues”**
 - protection of Foreign Direct Investment
 - competition policy
 - government procurement

The Balance of Payments Accounts

- A country's balance of payments accounts keep track of both its payments to and its receipts from foreigners.
- Every international transaction automatically enters the balance of payments twice: once as a credit (+) and once as a debit (-).

The Balance of Payments Accounts

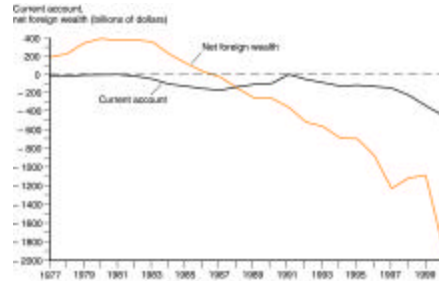
- **Three types of international transactions are recorded in the balance of payments:**
 - Exports or imports of goods or services (current account)
 - Purchases or sales of financial assets (financial account)
 - Transfers of wealth between countries
 - They are recorded in the capital account.

- **The Current Account and Foreign Indebtedness**

- **Current account (CA) balance**

- The difference between exports of goods and services and imports of goods and services ($CA = EX - IM$)
- A country has a CA surplus when its $CA > 0$.
- A country has a CA deficit when its $CA < 0$.
- CA measures the size and direction of international borrowing.
 - A country's current account balance equals the change in its net foreign wealth.

Figure 12-2: The U.S. Current Account and Net Foreign Wealth Position, 1977-2000



A string of current account deficits in the 1980s reduced America's net foreign wealth until, by the decade's end, the country had accumulated a substantial net foreign debt.
 Source: U.S. Government Printing Office, Economic Indicators, March 1998, April 2001.

Exchange rates

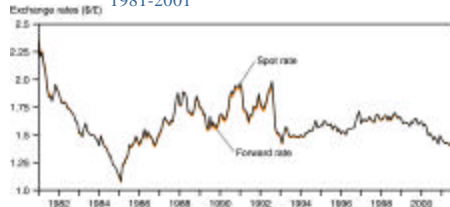
- Exchange rates are important because they enable us to translate different countries' prices into comparable terms.
- Exchange rates are determined in the same way as other asset prices.
- The general goal of this section will be to show:
 - How exchange rates are determined
 - The role of exchange rates in international trade

CURRENCY TRADING			
EXCHANGE RATES		U.S. \$ PER	U.S. \$ PER
Country	Rate	100 Yen	100 Yen
Argentina	100	100	100
Australia	1.00	1.00	1.00
Brazil	1.00	1.00	1.00
Canada	1.00	1.00	1.00
France	1.00	1.00	1.00
Germany	1.00	1.00	1.00
Italy	1.00	1.00	1.00
Japan	1.00	1.00	1.00
UK	1.00	1.00	1.00
Spain	1.00	1.00	1.00
South Africa	1.00	1.00	1.00
Sweden	1.00	1.00	1.00
Switzerland	1.00	1.00	1.00
Taiwan	1.00	1.00	1.00
Thailand	1.00	1.00	1.00
US Dollar	1.00	1.00	1.00
West Germany	1.00	1.00	1.00
Yen	1.00	1.00	1.00

Source: The Wall Street Journal, October 25, 2001. Republished by permission of Dow Jones, Inc., via Copyright Clearance Center, Inc. ©2001 Dow Jones and Company, Inc. All rights reserved worldwide.

Exchange Rates and International Transactions

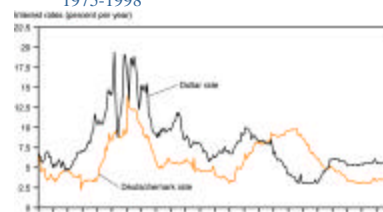
Figure 13-1: Dollar/Pound Spot and Forward Exchange Rates, 1981-2001



Spot and forward exchange rates tend to move in a highly correlated fashion.
 Source: Ocasio. Rate shows 90-day forward exchange rates and spot exchange rates, at end of month.

The Demand for Foreign Currency Assets

Figure 13-2: Interest Rates on Dollar and Deutschmark Deposits, 1975-1998



Since dollar and DM interest rates are not measured in comparable terms, they can move quite differently over time.
 Source: Claxton. Three-month interest rates are shown.

- **Interest Parity: The Basic Equilibrium Condition**

– The foreign exchange market is in equilibrium when deposits of all currencies offer the same expected rate of return.

– **Interest parity condition**

- The expected returns on deposits of any two currencies are equal when measured in the same currency.
- It implies that potential holders of foreign currency deposits view them all as equally desirable assets.
- The expected rates of return are equal when:

$$R_{\$} = R_{\text{€}} + (E_{\$/\text{€}}^e - E_{\$/\text{€}}) / E_{\$/\text{€}}$$

Interventions in foreign exchange markets

- Fix the exchange rate
- Capital controls
- Purchase and sell currency and assets

Key problems in international finance

- Do currencies of developed countries become vulnerable to misalignments, bubbles, excessive speculation?
- A number of financial crises have occurred during the last 20 years. What are the causes of these crises and how can these crises be prevented?
- The role of the IMF and the World Bank as crisis-solvers has been attacked severely. Why? Should the IMF be reformed?