

Transparencies for PS 240

International Politics

Political Economy Segment

Terms

autarky: national economic self reliance.

balance of payments: the result of economic transactions that takes into account outflows and inflows of money.

balance of trade: the value of exports relative to the value of imports.

capital account: the part of the balance of payments that records international borrowing, lending, investment, and other transactions.

current account: records the net flow of current transactions, including goods, services, and interest payments, between countries.

capital: any physical productive resource, usually meant to include physical capital, human capital, and financial capital.

comparative advantage: a unit has a comparative advantage in production of a good or service if it can produce it at a lower opportunity cost than other units.

devaluation: steps taken by a central bank that reduce the value of a national currency relative to other currencies for the primary goal of increasing the prices of imported goods while decreasing the prices of exported goods.

foreign direct investment: investment in a country made by a foreign firm or state.

embargo: a government prohibition on particular types of economic activity with a specific country.

exchange rate: two systems of exchange rates are fixed and floating. A system of fixed exchange rates (for instance the Gold Standard of 1871-1914 and the Bretton Woods system from 1945-1973) provides that currencies are valued at fixed rates against one another. This makes economies more stable on the surface, but it also creates pressures if a currency's value fails or is prevented from adjusting to the internal economic forces in an economy. A system of floating exchange rates is one in which the value of a currency relative to other currencies is determined by market forces, although it may be regulated by central banks or international organizations.

free trade liberalism: the idea that open and unrestricted trade will allow every country to pursue its comparative advantage in such a way that aggregate welfare is increased through maximizing the efficiency of productive forces.

The Gross Domestic Product (GDP) is a measure of economic activity that the United States economy adopted in 1991. GDP is defined as the total market value of goods and services produced by workers and capital (labor and property) within the United States borders during a given period, conventionally calculated on an annual basis.

Gross National Product (GNP) equals the market value of goods and services produced by labor and property supplied by U.S. residents, regardless of where they are located.

monetary policy: is a policy designed to influence the value of currency.

protectionism: economic policies designed to shield domestic industries and producers from foreign competition.

public goods: (see collective goods)

quota: a volume limit on importable goods.

tariff: a fee on imported goods designed to raise the cost of those goods and thereby discourage domestic consumers from preferring these goods to domestically produced ones.

Mercantilism and Liberalism

"Mercantilism" is used to describe the situation that prevailed between 1400-1799:

- a) many states, each with a presumption of absolute sovereignty
- b) intense competition among states each pursuing its absolute advantage in trade
- c) states guided by the premise that wealth and power are a consequence of the possession of precious metals in zero-sum exchanges
- d) states seek to influence the configuration of power for the purpose of maintaining a favorable balance of trade to accumulate these metals.

The "liberal international economic order" or "free trade system" refers to the period between 1812-1914:

- a) many states, each with a presumption of political sovereignty
- b) a competition for spheres of influence
- c) states guided by the premise that aggregate welfare is best served by each state pursuing its comparative advantage in positive-sum exchanges
- d) one state (or bloc of states) seeks to maintain the configuration of power

The free trade argument holds that what consumers of an imported good gain from open trade is greater in value than what the import competing domestic producers lose.

A Demonstration of the Advantages of Trade (Portugal and England)

- 1) Assume both countries produce only cloth and wine and do not trade
- 2) Assume that using all of their resources, both England and Portugal can produce 50 units of each product
- 3) Assume that England has an absolute advantage in cloth production (because of England's climate--flax grows better in England)
- 4) Assume that Portugal has an absolute advantage in wine production (because of climate--grapes grow better in Portugal)

NO TRADE

	Production		trade		consumption	
	cloth	wine	cloth	wine	cloth	wine
England	50	50	0	0	50	50
Portugal	50	50	0	0	50	50

SPECIALIZATION AND TRADE

	Production		trade		consumption	
	cloth	wine	cloth	wine	cloth	wine
England	120	0	-60	+60	60	60
Portugal	0	120	+60	-60	60	60

Ricardo showed that the gains from trade still accrue to both sides even when a country has no absolute advantage whatsoever.

Neo-mercantilism

Neo-mercantilism is a trade policy whereby a state seeks to maintain a balance-of-trade surplus and to promote domestic production and employment by reducing imports, stimulating domestic production, and promoting exports.

Instruments of neo-mercantilism include:

- 1) Development of infrastructure: more efficient transportation facilities assist exporting firms;
- 2) General assistance to industries, support for research and development, subsidies, and the provision of financing for firms.
- 3) Tariffs (taxes on imports)
- 4) Non-tariff trade barriers (quotas; "orderly marketing agreements"; health standards; bottlenecks at borders such those caused by impractical inspection requirements or an inadequate number of inspectors; maintenance of an undervalued currency.

Economic Nationalism

Economic nationalism refers to economic policies that a state follows that have the effect of improving its position at the expense of its neighbors' positions. These economic policies include trade policies, monetary policies, fiscal policies, investment policies, and others. A vivid example of economic nationalism is provided by the case of interwar Europe. Between 1919 and 1939, each of the countries of Western Europe was faced with a series of domestic problems that each assumed could only be solved by foreign policies which improved their positions relative to that of their neighbors' positions. The ensuing proliferation of tariffs, trade barriers, currency exchange controls, competitive devaluations and, in general, beggar thy neighbor policies led to economic disaster. A direct line may be traced from this cycle of economic conflict to political conflict and, ultimately, to violent conflict. The dynamics of this type of situation are well understood; the competitive search for unilateral economic advantage through the use of tariffs, trade barriers and other mechanisms designed to produce a foreign trade surplus produces a form of "economic nationalism."

Mercantilism

Mercantilism refers to the situation that prevailed in the international economy between 1400-1799. It was a system characterized by many states. The states were involved in intense competition and guided by the view that wealth and power were associated with the possession of precious metals. The states engaged in commercial relations for the purpose of maintaining a favorable balance of trade to accumulate these metals. Political leaders were committed to the idea that the acquisition and retention of bullion was a source of wealth for the state. Bullion could be obtained by maintaining trade surpluses with other countries, by plundering, and through exploitative relationships with colonies.

The mercantilist world was a trading world best characterized as a zero-sum game. The presuppositions of the mercantilists were that wealth is essential to power, that power is essential to get more wealth, and that sometimes wealth is more important than power, but only if it can be used to acquire more power. The mercantilist argument gained credence through the successes of some European countries. For instance, the French foreign minister Jean Baptiste Colbert (1619-1683) used subsidies and tariff protection to encourage industry, while simultaneously building a large navy in support of commerce and colonization. For many years Britain followed a mercantilist policy. The British Navigation Act of 1651 forbade importation of many goods unless carried in British ships. Britain established an elaborate system of taxes and prohibitions on imports.

Economic Liberalism also known as Free Trade Liberalism

The mercantilist argument was challenged by the development of the "free trade" doctrine. England was reluctant to give up position of the mercantilist position. Adam Smith (1723-1790) was an economist who noted that "economics is not zero-sum game" that everybody can be better off when the rules of exchange are open. In a domestic economy, exchange situations were typically analyzed in terms of a) employers and suppliers of goods (firms) and b) consumers and suppliers of labor (households). Smith applied these concepts to trade among and between nations.

Smith noted that this applied to states just as it applied to households. He provided the classic statement of liberalism in *Inquiry into the Nature and Causes of Wealth of Nations* (first published in 1776). Smith argued that nations were like households. Self-sufficiency in households obviously is not the best situation since some households have natural advantages. Thus the tailor buys shoes from the shoemaker, he doesn't make them himself. Extending the logic to nation-states, Smith argued that countries benefited from free trade.

Comparative Advantage

When a country had a natural advantage, it was clear that it should trade. But what if it had no natural advantages? What if a country were backward? What should it do? Defer trade and hope that it will eventually catch up with other countries? This theoretical question was addressed by the British Economist David Ricardo in his articulation of the "law of comparative advantage." David Ricardo (1772-1823) published *Principles of Political Economy and Taxation* in the early 19th century. It was designed to convince his fellow Englishmen that both countries could benefit from international trade. Ricardo introduced two definitions that were particularly important: 1) absolute advantage: idea that one country can produce more of something per unit of inputs than can other countries because of factor endowments; 2) comparative advantage: when a country can produce a good at a lower relative cost than other countries.

Neo-Mercantilism

Neo-mercantilism is a trade policy whereby a state seeks to maintain a balance of trade surplus and to promote domestic production and employment by reducing imports, stimulating domestic production, and promoting exports.

Instruments of neo-mercantilism include:

- Development of infrastructure: more efficient transportation facilities assist exporting firms;
- General assistance to industries, support for research and development, subsidies, and the provision of financing for firms.
- Tariffs (taxes on imports)
- Non-tariff trade barriers (quotas; "orderly marketing agreements"; health standards; bottlenecks at borders such those caused by impractical inspection requirements or an inadequate number of inspectors; maintenance of an undervalued currency. Many newly industrializing countries, or "NICs" as they are sometimes called, keep the price of their currency low to make their goods inexpensive abroad and make foreign goods expensive at home.

Strategies for a Solving a Balance of Payments Problem

Two direct actions: 1) Reduce outflow
 2) Increase inflow

How to Reduce OUTFLOW?

- * raise tariffs, or barriers
- * cut back foreign aid
- * increase restrictions on foreign investment abroad by one's citizens
- * reduce overseas military
- * limit foreign travel of citizens

There are problems:

if you raise tariffs

why give foreign assistance and have bases? if you stop ?

makes the banks mad,, not only that, why are people investing abroad, to make a profit, where does that profit show up,

How to Promote INFLOW?

- * export expansion
- * tax benefits for foreign investment
- * tourist industry
- * foreign aid

Balance of Payments

A Country's Accounting Ledger

<u>Credits</u>	<u>Debits</u>
Trade exports to partner	Trade imports from partner
Foreign investment from partner	Foreign investment in partner countries
Profits Repatriated from foreign investment	Losses from foreign investment
Foreign aid received	Foreign aid given
Income from foreign military bases	Military expenses for bases in other countries
Income from tourists' spending in partner	Tourists' spending in partner country

Balance of payments: the result of economic transactions that takes into account outflows and inflows of money.

Balance of trade: the value of exports relative to the value of imports.