МІНІСТЕРСТВО ОСВІТИ І НАУКИ УКРАЇНИ
ЧЕРКАСЬКИЙ НАЦІОНАЛЬНИЙ УНІВЕРСИТЕТ
ІМЕНІ БОГДАНА ХМЕЛЬНИЦЬКОГО

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МІЖНАРОДНА ЕКОНОМІКА:
курс лекцій англійською мовою

Для підготовки студентів першого (бакалаврського) рівня вищої освіти
спеціальностей: 051, 072, 075, 292
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Курс лекцій знайомить із сутністю сучасної міжнародної економіки та проявом основних форм МЕВ, які уособлюють функціонування світового ринку товарів (послуг) і капіталу, розгортання міжнародних процесів трудової міграції, організацію і регулювання світового валютного ринку, посилення глобальних інтеграційних процесів тощо. Також лекційний курс сприяє формуванню важливої компетентності – здатності спілкуватися іноземною мовою з фахових економічних питань.

Рекомендовано для всіх зацікавлених осіб, передусім науковців, викладачів вищих навчальних закладів і студентів економічних та інших спеціальностей.

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ВСТУП

Мета навчального курсу: набуття знань про сутність міжнародної економіки та закономірності її формування і розвитку; оволодіння методами аналізу політико-правового, економічного, соціально-культурного середовища та інфраструктури міжнародних економічних відносин; надання знань про міжнародну торгівлю, міжнародний рух капіталу, міжнародну трудову міграцію, світову валютну систему, процеси міжнародної економічної інтеграції, а також національні та міждержавні особливості регулювання МЕВ; набуття вмінь використовувати отримані знання у практичній зовнішньоекономічній діяльності країни.

Предмет дисципліни: основні закономірності виникнення і розвитку сучасних міжнародних економічних відносин (МЕВ), їх основні форми та суб'єкти; місце та роль країни в сучасній глобальній економічній системі.

Компетентності та очікувані результати навчання: дисципліна "Міжнародна економіка" забезпечує формування низки інтегральних, загальних та фахових компетентностей відповідно до стандарту вищої освіти за спеціальностями 051 (Економіка), 072 (Фінанси, банківська справа та страхування), 075 (Маркетинг), 292 (Міжнародні економічні відносини) галузей знань 05 (Соціальні та поведінкові науки), 07 (Управління та адміністрування), 29 (Міжнародні відносини).

Згідно із стандартом вищої освіти за вказаними спеціальностями дисципліна сприяє досягненню відповідних результатів навчання. Одним з ключових результатів є вміння в різних формах вільно спілкуватися з професійних питань державною та іноземними мовами, фахово використовуючи економічну термінологію.

LECTURE 1

International Economics: basic characteristics and the structure

Thematic Content of the Lecture:

1. Introduction to International Economics

2. International Economics in the system of economic science

3. The subject and the structure of International Economics

1. Introduction to International Economics

Nations are not like regions or families. They are sovereign, meaning that no central court can enforce its will on them with a global police force. Being sovereign, nations can put all sorts of barriers between their residents and the outside world. A region or family must deal with the political reality that others within the same nation can outvote it and can therefore coerce it or tax it. A family or region has to compromise with others who have political voice. A nation feels less pressure to compromise and often ignores the interests of foreigners. A nation uses policy tools that are seldom available to a region and never available to a family. A nation can have its own currency, its own barriers to trading with foreigners, its own government taxing and spending, and its own laws of citizenship and residence.

International economics is growing in importance as a field of study because of the rapid integration of international markets. Increasingly, businesses, consumers, and governments realize that their lives are affected not only by what goes on in their own town, state, or country but also by what is happening around the world. Consumers can walk into their local shops today and buy goods and services from all over the world. Local businesses must compete with these foreign products. However, many of these same businesses also have new opportunities to expand their markets by selling to a multitude of consumers in other countries. The advance of telecommunications is also rapidly reducing the cost of providing services internationally, while the Internet will assuredly change the nature of many products and services as it expands markets even further.

As long as different countries exist, international economics will be a body of analysis distinct from the rest of economics. The special nature of international economics makes it fascinating and sometimes difficult.

2. International Economics in the system of economic science

Discipline "**International Economics**" belongs to the number of basic economic disciplines. It's not only based on the market economy theory, but also develops it. International Economics (IE) is a connecting link between such university courses as

Economics (Political Economics), Microeconomics, Macroeconomics and specific economic disciplines, such as Marketing, Management, Finances, Accounting and Audit, Money and Credit, Banking etc.

Initially "IE" in the system economic science occupied a peripheral place and was based on the principles of separate parts of Micro- and Macroeconomics, which contained the analysis of definite international economic relations in the sphere of foreign trade, international flows of production factors, financial and monetary system that causes those flows.

Establishment, development and functioning of the world economic relations as a special, integral and organic system influenced the separation of "International economics" into the independent discipline. Formation of this system was caused by evolution of international division of labor, the internationalization process of the world economies, the integration of countries groups into regional economic complexes (unions) with interstate and suprastate regulation of the socioeconomic processes, production transnationalization, functioning of the international monetary and financial sphere as an independent phenomenon, which is not connected directly with the external trade and the international factor flows.

The **economic openness** in relations between every country and the world community in whole is the defining feature of the "IE" existence as an independent academic discipline. The current state of international economic relations allows to define ***two levels of openness***:

1. the level of countries involvement not only into the international goods and production factors turnover, but also into the international production and investment activities;

2. the cooperation level between national economies and the world economy in whole in terms of financial markets globalization.

On the first level, the "openness" means the development of three main channels, which not only connect the national economic systems, but also determine the form and degree of countries' involvement into the international flows of goods, capital and labor.

The export ratio (export quota) and the import ratio (import quota) in gross domestic product (GDP) can be the indicators of openness on the first level.

$$\mathbf{Eq} = \frac{E}{GDP} x\, 100,$$

where:

- Eq – export quota;
- E – export volume.

$$\mathbf{Iq} = \frac{I}{GDP} x\, 100$$

where:

- Iq – import quota;

- I – import volume.

Export and import combinations of quotas inform about relation scales between separate national economies and the world economy in whole.

The migration intensity, which is defined as a ratio of migrants' number to the population size, can also be the openness indicator of the first level. In this case coefficients of emigration (Ce), immigration (Ci) and migration turnover (Ct) must be calculated.

$$\mathbf{Ce} = \frac{Me}{P} x\, 1000;$$

$$\mathbf{Ci} = \frac{Mi}{P} x\, 1000;$$

$$\mathbf{Ct} = \frac{Me + Mi}{P} x\, 1000$$

where:

- P – average annual population size;
- Me – number of emigrants;
- Mi – number of immigrants.

The migration coefficients are usually defined in per mille (‰).

The difference between the amount of immigrants and emigrants (Mi – Me) forms the migration balance of the country, which can be positive or negative.

Involvement of the country into the international capital flows is also a factor of the economic openness. The role of foreign capital (such as FDI) in national economy is determined by its share in total amount of capital investment in a country (including investment of residents).

A share of foreign investment (FDI and FPI) in GDP can be another indicator:

$$\mathbf{FI} = \frac{FDI + FPI}{GDP} x\, 100$$

where:

- FI – foreign investment;
- FDI – foreign direct investment;
- FPI – foreign portfolio investment.

Economic openness **on the second level** is mainly determined by the existence of international monetary system, which is realized due to the functioning of international financial market. The efficiency of monitoring and regulation within either national or the world economy is the main indicator of market economy performance as the international economy.

3. The subject and the structure of International Economics

International economics is one of three main parts of modern economics. The other two are:

- Microeconomics;
- Macroeconomics.

The components of modern economics are correlated. This reflects the integral approach to functioning and developing of the market economy. But the subject of Micro- and Macroeconomics is substantially limited by borders of national economies. Microeconomics examines market behavior of individual consumer and company, whereas Macroeconomics – functioning of national economy as a whole and also its leading components.

As opposed to Micro- and Macroeconomics, IE is to wide extent a theory which is mainly applied to the analysis of interstate economic relations as an integral phenomenon. That's why international economic relations and foreign economic influence on national economies are regarded as paramount phenomena in IE.

Increasing openness level in countries, harmonization and correlation of their economies, internationalization and integration of international economic relations, which are realized under globalization conditions, compose an individual subject for analysis in IE. Thus, ***the subject matter*** of international economics consists of different issues raised by economic interaction between sovereign states. These issues are usually related to the pattern of trade, international migration of labor force, the balance of payments, the international capital market, international policy coordination etc.

International economics uses the same ***fundamental methods*** of analysis as other branches of economics, because the motives and behavior of individuals are the same on international level as they are in domestic transactions. At the same time international economics involves new and different concerns, because international trade and investment, for instance, occur between independent nations.

International economics (according to ***its functions***) consists of:

- International Microeconomics;
- International Macroeconomics.

Separate countries in the **International Microeconomics** are regarded as the primary elements, as well as households or companies in traditional Microeconomics. International microeconomics as a part of IE examines the international flows of goods and production factors. In other words it studies market behavior of a certain commodity and its basic characteristics. It's a well-known definition of the international economics part, which has been lectured for a long time at universities and colleges in the USA and Western Europe.

In contrast to the international microeconomics, the general definition of the **International Macroeconomics** theory does not exist yet. The subject of this part of IE is still controversial and contradictory, that sometimes makes it diverse. The selection of the basic components of research in international macroeconomics focuses on their practical significance and usefulness in solving specific problems of open economies functioning and the development of the world economy as a whole.

Therefore, the international macroeconomics significantly expands a subject of the analysis of IE theory, provides it out at the level of interaction between open national economies the world economy as a whole. This expansion is based on the existence of the international monetary system not only as the mechanism that serves the goods and production factors flows, but also as an independent system of the international economics. Therefore, the leading position in international macroeconomics primarily belongs to:

- the research of the modern international monetary system phenomenon;
- the analysis of the problem, which concerns the exchange rate and the mechanism of its formation, the status of the balance of payments, that determines the place of national economies in the international economic relations;
- the exploration of the international financial markets and the concrete financial instruments (e.g. currency exchange rates).

Regulation of the world economic relations by international economic and financial organizations – another subject for international macroeconomics.

Thus, the international macroeconomics is a part of the IE, which develops the macroeconomic theory under conditions of open economy, studies the features of interaction of national economies and the world economy as a whole, their specific functions and regulation in the context of globalization.

The International Microeconomics and the International Macroeconomics are the interrelated parts of the International Economics which, in turn, is a component of the modern economic theory. As such, IE examines the processes and phenomena of the economic life of the society, which has an international character and even supranational (global) character.

The "International Economics" as a science is a separate discipline and its subject deals with the relations that are formed between individuals in the sphere of international trade (goods and services), international production factor flows (capital, labor, technology), international monetary and financial system as well as interstate mechanisms of those relations monitoring and regulation.

LECTURE 2

The Dimensions of the World Economy

Thematic Content of the Lecture:

1. International division of labour as the basis of the world economic system
2. The subsystems of the world economy
3. Multidimensionality of the world economy

1. International division of labour as the basis of the world economic system

The modern world economy as an integral economic system began to form on the basis of the world market on the turn of XIX-XX centuries. Now we can talk about the world economy as a global economic system that is based on international division of labour, internationalization and integration of production and exchange, and which operates on the principles of market economy.

The integrity of a present-day world economy evolved gradually. It was formed due to the evolution of the international division of labour, the process of internationalization of the countries' economic life, the integration of groups of countries into regional economic unions, development of the socioeconomic processes interstate regulation, transnationalization of production, etc.

The international division of labour. The history of the world economy begins with the international division of labour (IDL). It is associated with the exchange of activities and products between nation states. That is IDL – is a spatial division of labour which occurs when the process of production is no longer confined to national economies. The international division of labour exists in *two basic forms*:

- international specialization;
- international production cooperation.

International specialization. It is a method of production whereby a country focuses on the production of a limited scope of goods to gain a greater degree of efficiency. Many countries, for example, specialize in producing the goods and services that are native to their part of the world, and they trade for other goods and services. This specialization is, therefore, the basis of global trade, as few countries have enough production capacity to be completely self-sustaining.

International production cooperation. It is defined as joint actions with supply chain partners in the manufacturing of products based on the principles of cost and revenue sharing to achieve operational efficiency. Such cooperation is the result of the specialization of national industries, which interact in the international division of labour. The international production cooperation is meant to include the country in the international division of labour within the so-called horizontal or vertical models of the production process.

The global division of labour. In contrast to the IDL, this division of labour is not between the group of countries, but within transnational corporations (TNCs). Global division of labour (GDL) is an extraterritorial nature. It cannot be represented on a territorial basis and in the forms of public-private division of labour. GDL is a technological division of labour in the production on the basis of a single division (that is internal to multinational corporations) in the form of transnational cooperation and specialization of production.

Thus, forms of GDL are *intra-corporate specialization* and *intra-corporate production cooperation*.

Intra-corporate specialization is carried out not in the context of national economies but inside the TNC which does not recognize national boundaries and considers the world as a global economic space.

Intra-corporate cooperation is characterized by cooperation of TNCs in the field of research development, cooperation of industrial companies with so-called

"technological parks", the implementation of joint programs and joint ventures. Due to such economic relations partner TNCs produce goods (services) that tend to occupy a niche market and become the main suppliers of niche products that meet the world's total demand.

The activities of TNCs as the organizational form of global economic division of labour provide regular circulation on a planetary scale of goods, services, financial and natural resources, knowledge, technology and management experience. Through participation in the GDL the national economy has direct access to the world market of goods and capital, new technologies and modern management.

2. The subsystems of the world economy

The essential subsystems of the world economy today include *technological, economic, legal and sociocultural spaces*.

Economic subsystem. It is a common economic space of free movement of goods and services, capital and labour, information across the borders of nation-states and the free exchange of national currencies.

Economic subsystem is formed as the development and implementation of common standards for international trade, production, investment and monetary relations between states. The common economic space also provides specific rules and standards for international management.

Nowadays economic subsystem is totally based on socially-oriented market economy and worldwide activities of TNCs, transnational banks, international and supranational economic institutions.

Technological subsystem. It is a set of requirements imposed by the technological revolution and which provide competitiveness in the global market. These technology requirements can be reduced to basic parameters:

- computer technology;
- research intensity;
- resource-saving, waste-free and environmentally friendly type of technology;
- biotech (technology based on natural resources and processes exploitation).

These parameters provide maintaining world-class efficiency, productivity, quality and novelty of products, implementation of the principles of modern management. The implementation of these requirements is virtually impossible and ineffective under separate national technology spaces.

Legal subsystem. It is a set of general rules of business law and the norms of business behaviour. Such rules and norms form a single legal framework, for example, the creation of rules for international patent law. The trend of further convergence of legal systems of different countries, that takes place today, lays the foundation for global legal space.

Sociocultural subsystem. It is formed much more slowly in comparison with other subsystems. The process of formation of the unique social and cultural environment provides:

- one approach to social policy in all countries;
- formation of new thinking – breaking the old way of thinking in relation to various sociocultural events and processes;
- developing common standards of business conduct and ethics in management;
- achieving a high general standards of living and reducing disparities between developed and developing countries;
- peaceful solutions of national and international issues.

3. Multidimensionality of the world economy

Each of the subsystems of the world economy (technological, economic, legal and sociocultural) is unique. They have their own logic of development, its own structure, but they function as elements of the whole organism – a common supranational economic space. The imbalance in the operation of any of the mentioned subsystems influences the state of the whole world economic system. This fact creates the essence of ***multidimensionality*** of the world economy.

Besides, the system of the world economy, based on four subsystems, has *two main dimensions*:

- the world economy as a collection of national economies;
- the world economy as a supranational economic space constituted mainly by global TNCs.

Each of the dimensions by itself does not show the entire range of the relationships within the world economic system. Each dimension captures a certain aspect of the economic life of the world community, a specific facet of its nature.

Analysis of the world economy as an integral system makes it possible to determine the place of ***international economic relations*** in the world economic system. This will be discussed in the next lectures.

LECTURE 3

Theories of International Trade

Thematic Content of the Lecture:

1. The reasons for international trade in goods and services
2. International trade theory of Mercantilism
3. Classical theories of Absolute and Comparative Advantages
4. Heckscher-Ohlin theory (theorem)

1. The reasons for international trade in goods and services

Nations (or firms in different nations) trade with each other because they benefit from it. Other motives may be involved, of course, but the basic motivation for international trade is that of the benefit, or gain, to the participants. The gain from international trade (IT), like the gain from all trade, arises because specialization enables resources to be allocated to their most productive uses in each trading nation. Everyone recognizes that it would be foolish for a town or a province to try to be self-sufficient, but we often fail to recognize that the benefits of specialization and the division of labor also exist in international trade. The political boundaries that divide geographic areas into nations do not change the fundamental nature of trade, nor do they remove the benefits it confers on the trading partners.

Despite fundamental motivation for international trade (to gain benefit from it) nowadays we can single out ***five more specific reasons*** why trade takes place between countries.

Reason for IT #1: *Differences in Technology*

Advantageous trade can occur between countries if the countries differ in their technological abilities to produce goods and services. Technology refers to the techniques used to turn resources (labor, capital, land) into outputs (goods and services).

Reason for IT #2: *Differences in Resource Endowments*

Advantageous trade can occur between countries if the countries differ in their endowments of resources. Resource endowments refer to the skills and abilities of a country's workforce, the natural resources available within its borders (minerals, farmland, etc.), and the sophistication of its capital stock (machinery, infrastructure, communications systems).

Reason for IT #3: *Differences in Demand*

Advantageous trade can occur between countries if demands or preferences differ between countries. Individuals in different countries may have different preferences or demands for various products. For example, the Chinese are likely to demand more rice than Americans, even if consumers face the same price. Canadians may demand more beer, the Dutch more wooden shoes, and the Japanese more fish than Americans would, even if they all faced the same prices.

Reason for IT #4: *Existence of Economies of Scale in Production*

The existence of economies of scale in production is sufficient to generate advantageous trade between two countries. Economies of scale refer to a production

process in which production costs fall as the scale of production rises. This feature of production is also known as ***"increasing returns to scale"***.

Reason for IT #5: *Existence of Government Policies*

Government tax and subsidy programs alter the prices charged for goods and services. These changes can be sufficient to generate advantages in production of certain products. In these circumstances, advantageous trade may arise solely due to differences in government policies across countries.

The history of IE knows ***various theories (models)***, representatives of which tried to explain why IT does occur between countries. However, these models of international trade rarely include all five reasons for trade simultaneously. The reason is that such a model is too complicated to work with. Economists simplify the world by choosing a model that generally contains just one reason. This does not mean that economists believe that one reason, or one model, is sufficient to explain all outcomes. Instead, one must try to understand the world by looking at what a collection of different models tells us about the same phenomenon.

For example, the ***Ricardian model of trade***, which incorporates differences in technologies between countries (*reason #1*), concludes that everyone benefits from trade, whereas the ***Heckscher-Ohlin model***, which incorporates endowment differences (*reason #2*), concludes that there will be winners and losers from trade. Change the basis for trade and you may change the outcomes from trade.

In the real world, trade takes place because of a combination of all these different reasons. Each single model provides only a glimpse of some of the effects that might arise. Consequently, we should expect that a combination of the different outcomes that are presented in different models is the true characterization of the real world. Unfortunately, because of this, understanding the complexities of the real world is still more of an art than a science.

2. International trade theory of Mercantilism

From the historical point of view all trade theories can be divided into preclassical, classical and modern schools. Mercantilism represents the ***preclassical version***. Adam Smith and David Ricardo are associated with ***the classical theories*** of IT. All ***modern versions*** begin with a trade model suggested by two Swedish economists Eli Heckscher and Bertil Ohlin.

Mercantilism was the preclassical philosophy that guided European thinking about international trade in the several centuries before Adam Smith published his "Wealth of Nations" in 1776. Mercantilists viewed international trade as a source of major benefits to a nation. Merchants engaged in trade, especially those selling exports, were good – hence the name ***mercantilism***. But mercantilists also maintained that

government regulation of trade was necessary to provide the largest national benefits. Trade merchants would serve their own interests and not the national interest, in the absence of government guidance.

A central belief of mercantilism was that national well-being or wealth was based on national holdings of ***gold and silver (specie or bullion)***. Given this view of national wealth, exports were viewed as good and imports (except for raw materials not produced at home) were seen as bad. If a country sells (exports) more to foreign buyers than the foreigners sell to the country (the country's imports), then the foreigners have to pay for the excess of their purchases by shipping gold and silver to the country. The gain in gold and silver increases the country's well-being, according to the mercantilist belief. Imports are undesirable because they reduce the country's ability to accumulate these precious metals. Imports were also feared because they might not be available to the country in time of war.

In addition, gold and silver accruing to the national rulers could be especially valuable in helping to maintain a large military for the country. Based on mercantilist thinking, governments **(1)** imposed an array of taxes and prohibitions designed to limit imports and **(2)** subsidized and encouraged exports.

Because of its peculiar emphasis on gold and silver, mercantilism viewed trade as a **zero-sum activity** – one country's gains come at the expense of some other countries, since a surplus in international trade for one country must be a deficit for some other(s). The focus on promoting exports and limiting imports also provided major benefits for domestic producer interests (in both exporting and import-competing industries).

Adam Smith and economists after him pointed out that the mercantilists' push for more exports and fewer imports turns social priorities upside down. Here are the ***key points that refute mercantilist thinking***:

• National well-being is based on the ability to consume products (and other "goods" such as leisure and a clean environment) now and in the future. Imports are part of the expanding national consumption that a nation seeks, not an evil to be suppressed.

• The importance of national production and exports is only indirect: they provide the income to buy products to consume. Exports are not desirable on their own; rather, exports are useful because they pay for imports.

• Trade freely transacted between countries generally leads to gains for all countries – trade is a positive-sum activity. In addition, even the goal of acquiring gold and silver can be self-defeating if this acquisition expands the domestic money supply and leads to domestic inflation of product prices – an argument first expounded by David Hume even before Smith did his writing.

Although the propositions of the mercantilists have been refuted, and countries no longer focus on piling up gold and silver, mercantilist thinking is very much alive today. It now has a sharp focus on employment. Neo-mercantilists believe that exports are good because they create jobs in the country. Imports are bad because they take jobs from the country and give them to foreigners. Neo-mercantilists continue to depict trade as a zero-sum activity. There is no recognition that trade can bring gains to all countries (including mutual gains in employment as prosperity rises throughout the world). Mercantilist thinking, though misguided, still pervades discussions of international trade in countries all over the world. Besides, if one tries to listen to trade political arguments today, most politicians (no matter which country they belong to) tend to be real mercantilists.

3. Classical theories of Absolute and Comparative Advantages

In the late 18th and early l9th centuries, first Adam Smith and then David Ricardo explored the basis for international trade as part of their efforts to make a case for free trade. Their writings were responses to the doctrine of mercantilism prevailing at the time. Their classic theories swayed policymakers for a whole century, even though today we view them as only special cases of a more basic, and more powerful, theory of trade.

The Scottish economist **Adam Smith** developed ***the Trade Theory of Absolute Advantages*** in 1776 through his legendary book *"An Enquiry into the Nature and Causes of Wealth of Nations"*. He developed the theory as an attack against the then prevailing mercantilist view of restrictive trade with the slogan *"free trade"*. Smith's argument was that the wealth of nations depends upon the goods and services available to their citizens, rather than the gold reserves held by the nation. Maximizing this availability depends primarily on fuller utilization of resources and then, on the ability:

• to obtain goods and services from where they are produced most cheaply (because of "natural" or "acquired" advantages), and…

• to pay for them by production of the goods and services produced most cheaply in the country.

Human skill up gradation, division of labour and specialization and the economies of scale are the sources of acquired advantage for cheaper production. Natural advantages may emerge out of natural factors.

As the name indicates this theory proposes that a country should engage in the production and exchange of those commodities where it has an *absolute advantage*. Such a country produces greater output of a good or service than other countries using the same amount of resources.

Absolute advantage is defined as the ability to produce more of a good or service than competitors, using the same amount of resources. Smith stated that tariffs and quotas should not restrict international trade; it should be allowed to flow according to market forces. Contrary to mercantilism Smith argued that a country should concentrate on production of goods in which it holds an absolute advantage. No country would then need to produce all the goods it consumed. The theory of absolute advantage destroys the mercantilist idea that international trade is a zero-sum game. According to the absolute advantage theory, international trade is a *positive-sum game*, because there are gains for both countries to an exchange.

Theory of Absolute Advantages possesses a ***number of assumptions***. They are:

- there are two countries and two goods;
- one country has absolute advantage in one commodity and the second country has advantage in another commodity;
- technology is assumed to be constant;
- labour is the only factor of production;
- labour is homogeneous, that means each unit of labour produces the same level of output;
- value of a good is measured in terms of its labour content;
- there is no technological improvement;
- labour is perfectly mobile within the country but perfectly immobile between the countries. It means that workers are free to move between industries within the nation but migration to other countries is impossible;
- a system of barter prevails;
- zero transportation cost.

Based on these assumptions the theory can be explained with the following example. Suppose there are two countries **A** and **B** that are producing two goods: ***cell phones*** and ***potato chips*** (*see Table 1*). The numbers are costs of producing one unit of a good, i.e. in country A it takes a worker 2 hours to produce a cell phone while it takes a worker 8 hours to do the same in country B.

Table 1

Country	**Cell phones**	**Potato chips**
A	2	6
B	8	4

It is easy to see where the absolute advantages are in the example.

In country A, workers take two hours to produce a cell phone while it takes eight hours in country B. In country B, on the other hand, it takes four hours for a worker to make a tonne of potato chips, which takes six hours in country A. Adam Smith therefore argued that both countries would benefit from trade if country A *specialized* in producing cell phones and country B specialized in producing potato chips. The difference to the mercantilist argument is therefore that even if country B specializes in producing a relatively simple good – potato chips – they still benefit from international trade. Hence, for countries to grow rich they would have to open up for international trade and international competition. However, he also acknowledged that producers of potato chips in country A would try to lobby for protection and limitations on imports of chips from country B, and producers of cell phones in country B would try to lobby for limitations on imports of cell phones from country A.

David Ricardo clearly showed, in his ***Principles of Political Economy (1817)***, that absolute advantages are not a necessary condition for two nations to gain from trade with each other. Instead, trade will benefit both nations provided only that their relative costs, that is, the ratios of their real costs in terms of labor inputs, are different for two or more commodities.

In short, Ricardo's approach demonstrated ***the principle of comparative advantage***: a country will export the goods and services that it can produce at a low opportunity cost (relative price) and import the goods and services that it would otherwise produce at a high opportunity cost (relative price). *The relative price* – the ratio of one product price to another product price within a country.

The key word in Ricardian model of IT is "comparative", meaning "relative" and "not necessarily absolute". Even if one country is absolutely more productive at producing everything and the other country is absolutely less productive, they both can gain by trading with each other as long as their relative (dis)advantages in making different goods are different. Each country can benefit from trade by exporting products in which it has the greatest relative advantage (or least relative disadvantage) and importing products in which it has the least relative advantage (or the greatest relative disadvantage).

Making a small change in Smith's example mentioned above the difference between two models gets obvious in *Table 2.*

Table 2

Country	**Cell phones**	**Potato chips**
A	2	4
B	8	10

Now, country A has an absolute advantage in producing both products. A worker takes two hours to produce a cell phone compared to four hours in country B, and eight hours to produce a tonne of potato chips compared to ten hours in country B. The puzzle was that according to the theory of absolute advantages, country A should specialize in both products. That would leave country B with no means to pay for imports from country A, which in turn would stop all trade between the two countries. However, Ricardo saw the possibility of arbitrage – that it would pay for a trader to buy a product in one country, sell it in the other country, use his profits to buy a product in that country and bring it home to his own country where he could sell what he bought in the other country with a profit.

Theory of Comparative Advantages also possesses a number of assumptions that are almost the same as in Smith's model. However, in this theory there are several assumptions that limit the real world application. The assumption that countries are driven only by the maximization of production and consumption and not by issues out of concern for workers or consumers is a mistake.

4. Heckscher-Ohlin theory (theorem)

In the early 20th century, Swedish economists **Eli Heckscher** and **Bertil Ohlin** identified the role of labor and capital, so-called factor endowments, as a determinant of advantage. In 1979 Ohlin was awarded Nobel Prize jointly with James Meade for his work in international trade theory. The Heckscher-Ohlin proposition maintains that countries tend to export goods whose production uses intensively the factor of production that is relatively abundant in the country.

Countries well endowed with capital (such as factories and machinery) should export capital-intensive products, while those well endowed with labor should export labor-intensive products. According to outstanding economists, trade arises due to the differences in the relative prices of different goods in different countries. The difference in commodity price is due to the difference in factor prices (i.e. costs). Factor prices differ because endowments (i.e. capital and labour) differ in countries. Hence, it occurs because different countries have different factor endowments.

The Heckscher-Ohlin theorem states that countries which are rich in labour will export labour-intensive goods and countries that are rich in capital will export capital-intensive goods.

Heckscher-Ohlin theory explains the modern approach to international trade on the basis of ***the following assumptions***:

- there are two countries involved;
- each country has two production factors (labour and capital);
- each country produces two goods (labour-intensive and capital-intensive);
- there exists perfect competition in both commodity and factor markets;
- all production functions are homogeneous of the first degree, i.e. production function is subjected to constant returns to scale;
- factors of production are freely mobile within a country but immobile between countries;
- two countries differ in production factors supply;
- each commodity differs in factor intensity;
- there is full employment of resources in both countries and demand is identical in both countries;
- international trade is free, i.e. there are no trade restrictions in the form of tariffs or non-tariff barriers;
- there are no transportation costs.

Given these assumption, theorem contends that a country export goods which use relatively a greater proportion of its abundant and cheap factor. While the same country imports goods whose production requires the intensive use of the nation's relatively scarce and expensive factor.

LECTURE 4

Characteristic Features of Modern International Trade

Thematic Content of the Lecture:
1.The nature of international trade
2. The geographic and commodity structure of international trade
3. The main characteristic features of international trade
4. The importance of international trade in the modern world

1. The nature of international trade

Today international trade is one of the major driving forces of economic development. It appears as a sphere of international economic relations and is formed

by merchandise trade, trade in services and products of intellectual labor of all countries in the world. Today, it accounts about 80% of all international operations.

A single country takes part in international trade in the form of foreign trade, i.e. it is the trade between the country and other ones, which ***consists of two opposing flows of goods*** and services: **export** and **import**.

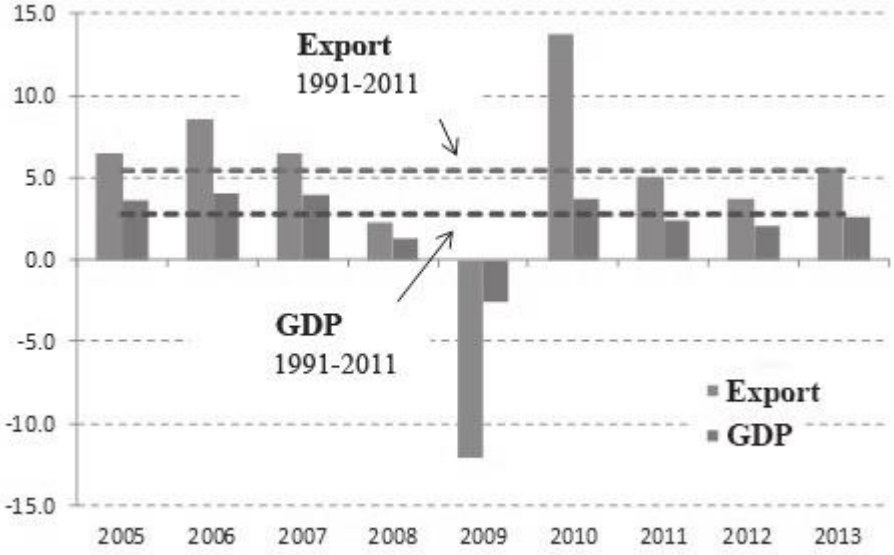
International trade is trading between residents of different countries, which may be individuals and legal persons, firms, TNC, non-profit organizations, etc. It provides the voluntary exchange of goods, services, products of intellectual labor between the parties of a trade agreement. Since this exchange is voluntary, both parties of the agreement must be confident that they will get benefit from this exchange, otherwise the agreement will not be signed.

International trade is a characteristic feature of the existence of the global market, which is the realm of commodity-money relations between the two countries and is based on the international division of labor and other factors of production. The product, which is located on the world market in the phase of the exchange, performs the function of information as reported on the mean values of aggregate demand and supply. Therefore, countries have the opportunity to evaluate and adapt the parameters of their products and production (for instance, how much and for whom to produce) to the demands of the global market.

International **trade of goods** was historically the first and until the certain period of time, the main sphere of international economic relations. Only at the end of the 20th century, different forms of financial operations became dominant in the international economic system. But international trade is still very important, which is proved by the growth of international trade volumes. According to the WTO experts, international trade volume increased by 7.6% in 2006, 15.2% in 2007, 15.4% in 2008. Such rapid development of international trade, is mainly connected with strengthening of international relations liberalization process, increase of demand on manufactured goods, percentage of which composes 70% in total volume of international export. However, in 2009 international trade volume reduced to 13.1% due to the world financial crisis. In 2010, the decline in world trade has stopped: the increase was 13.8%, in 2011 and 2012 – respectively 5.0% and 3.7%.

International trade today, as before, remains an important growth driver for international economics. International trade flows are well ahead of the growth of world gross domestic product (figure 1).

Figure 1. **Growth rate of volumes of world trade and world GDP, 2005-2013**



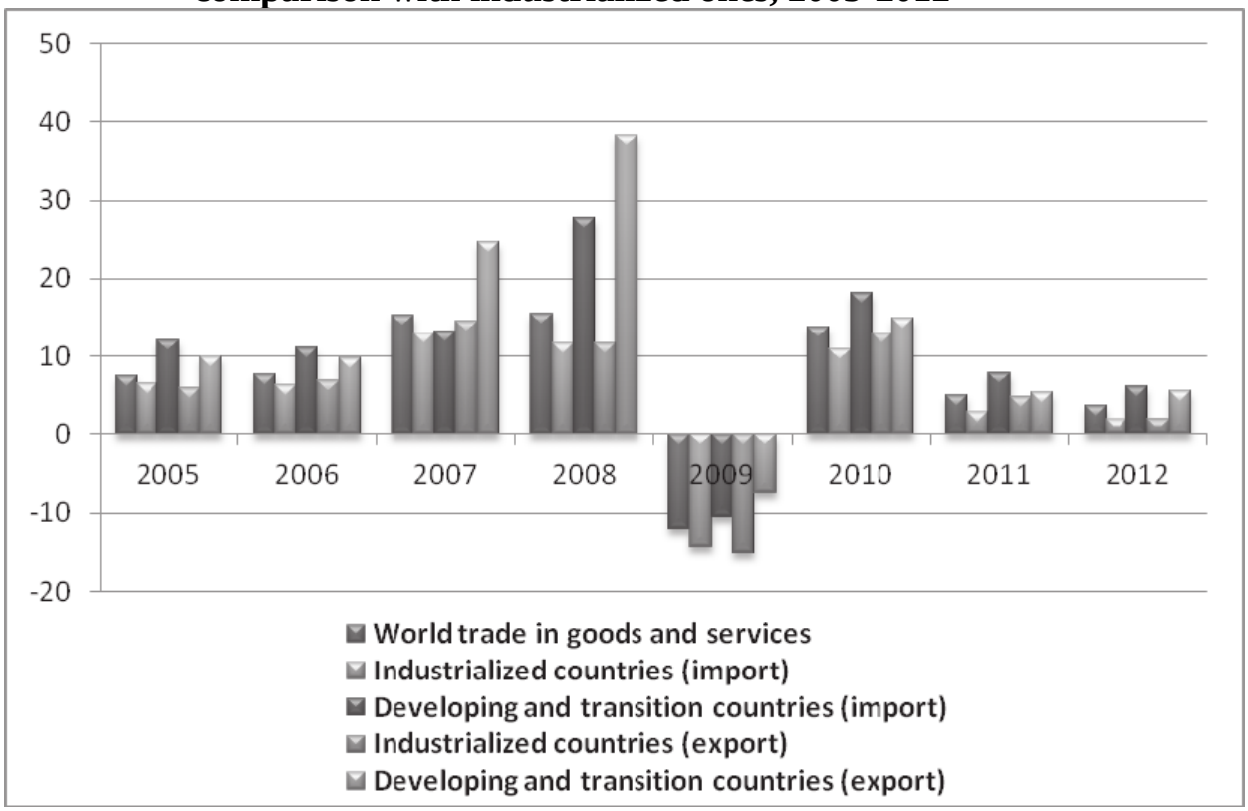
This is the result of the deepening of the international division of labor, the formation and development of new types of division of labor, which lie at the heart of international economic integration and intracompany exchange. In this regard, it is important to note that in the EU (the most economically integrated group of countries) trade goes ahead of production *by 3 times*.

Rapid growth of international trade has a favorable effect on the economy of developing countries by stimulating their exports (table 1, figure 2).

Table 1. **The dynamics of development of the world trade in goods and services**

Data	Growth %							
	2005	2006	2007	2008	2009	2010	2011	2012
World trade of goods and services	7,4	7,6	15,2	15,4	-12,0	13,8	5,0	3,7
Import								
Industrialized countries	6,5	6,3	12,9	11,7	- 14,4	10,9	2,8	1,9
Developing and transition countries	12,0	11,0	13,2	27,7	- 10,5	18,1	7,9	6,2
Export								
Industrialized countries	5,9	6,8	14,6	11,7	- 15,1	13,0	4,7	2,0
Developing and transition countries	9,9	9,7	24,6	38,2	- 7,5	14,9	5,4	5,6

Figure 2. **Economic growth in developing and transition countries in comparison with industrialized ones, 2005-2012**



2. The geographic and commodity structure of international trade

Geographic and commodity structure is an important feature of international trade and presents a structure in terms of geographic distribution and commodity filling.

Geographic structure of international trade means the distribution of trade flows between separate countries and their groups, created according to territorial or organizational criterion.

Territorial geographic structure generalizes information about international trade scale of countries belonging to the same part of world or extended country group (developed countries, developing countries, countries in transition). *Organizational geographic structure* generalizes data concerning international trade between both countries belonging to international trade and political unions and countries, which are separated in definite groups by the chosen criterion (oil-exporting countries, debtor countries etc.).

Geographic structure of international trade was formed under the influence of world economic division of labor and scientific and technical revolution development (table 2).

Table 2. **Geographic structure of the world commodity trade by separate regions in 2012**

Export volume		Region	Import volume	
billion dollars	%		billion dollars	%
18401,0	100,0	World	18601,0	100,0
2371,4	12,9	North America	3192,0	17,2
749,6	4,1	Latin America	754,7	4,1
6384,8	34,7	Europe	6530,5	35,1
5803,3	31,5	EU	5937,6	31,9
805,3	4,3	CIS	569,1	3,1
529,3	2,9	Russian Federation	335,5	1,8
630,0	3,4	Africa	610,2	3,3
1349,0	7,3	Middle East	739,6	4,0
6110,6	33,2	Asia	6205,1	33,4
798,6	4,3	Japan	885,8	4,8
2048,7	11,1	China	1818,4	9,8
294,2	1,6	India	489,7	2,6

Commodity structure of international trade is formed under the influence of competitive advantages, which are available for the national economy. A country has competitive advantages only if prices on export commodities (or domestic prices) are lower than the world ones. Difference in prices occurs due to different production costs, which are depended on ***two factor groups***.

The first factor group is formed by natural competitive advantages. Among them are natural-geographical factors: climate, availability of mineral fossils, soil fertility etc.

The second factor group (the socioeconomic one) is formed by gained competitive advantages. These factors define scientific-technical and economical level of country development, its production apparatus, scale and sequence of production, production and social infrastructure, scale of research activities. All this defines competitive advantages, which were gained in the development process of the national economy.

There is a typical tendency in goods trade: the growth of specific weight of the trade in manufactures (about ¾ of the world export cost volume) and reduction of raw materials and provision unit weight (about ¼).

The commodity structure by regions is presented below (table 3).

Table 3. **The structure of the world commodity export by major product categories by regions, 2012**

Region	Agriculture products		Fuels		Manufactures		Total	
	Billion dollars	%	Billion dollars	%		Billion dollars	%	Billion dollars
Europe	657,3	10,3	623,8	9,8	Europe	657,3	10,3	623,8
Asia	383,6	6,3	492,2	8,1	Asia	383,6	6,3	492,2
North America	257,6	10,9	305,3	12,9	North America	257,6	10,9	305,3
South and Central America	205,2	27,4	198,5	26,5	South and Central America	205,2	27,4	198,5
Commonwealth of independent states (CIS)	65,9	8,2	503,3	62,5	Commonwealth of independent states (CIS)	65,9	8,2	503,3
Africa	57,4	9,1	349,4	55,5	Africa	57,4	9,1	349,4
Middle East	29,8	2,2	911,2	67,5	Middle East	29,8	2,2	911,2
World	1656,8	9,0	3383,7	18,4	World	1656,8	9,0	3383,7

The data in *table 3* shows the relationship between the level of economic development and the structure of foreign trade. So, speaking about the countries of **Western Europe (EU), North America and Asia**, related to the industrial and newly industrializing countries, they posses predominantly competitive advantage in the export dominated by manufactures. Both **Middle East and Africa**, being countries with rich natural resources, have high proportion of the fuel industry products in their export. **The CIS countries** make extensive use of their natural competitive advantages, and therefore in the commodity structure, which is different from the world average, there is a high proportion of production extractive industries and, relatively, the low one of manufactures.

3. The main characteristic features of international trade

International trade, as a special sphere of international economics, has its own specific features, which distinguish it from intra-national trade: government regulation of the international trade; independent national economic policy; social and cultural differences of countries, financial and commercial risks.

Government regulation of the international trade. Every country is functioning within its own legal framework. The government of the country controls and takes an active part in foreign trade relations and monetary relations, connected with trade operations. Such interference and the control differ significantly from the degree and the nature of those measures, which are applied to domestic trade. Government of every sovereign country, due to its own trade and fiscal policy, creates its own system of export and import licensing, import and export quotas, duties, embargo, export subsidies, its own tax legislation etc. Government rules on monetary regulations and the delegated legislation, concerning standards of quality, security,

public health, hygiene, patents, trademarks, packing of goods and information content, which is mentioned on packing. All that can be regarded as international trade barriers.

Independent national economic policy. National economic policy can permit free flow of goods and services between countries, regulate or prohibit it. All this influences significantly the international trade.

To support the balance of international payments, a country must harmonize its economy with the world one, i.e. pursue a policy, which would provide the competitiveness of prices and costs in comparison with other countries and which wouldn't allow a discrepancy between domestic law and international regulation. That could lead to a conflict situation in the sphere of foreign trade.

Social and cultural differences between countries. Countries which take part in international trade have different traditions, languages, priorities and culture. Although such differences do not influence significantly on international trade, they complicate relations between governments and add a lot of new elements in activity of international enterprises. Lack of knowledge of exporting or importing in a country leads to uncertainty and distrust between sellers and customers.

Financial and commercial risks. International trade takes place between countries with different exchange systems, which create certain rules of currency exchange. Due to the exchange rate instability, there is a currency risk. Currency risk in international trade means risk of currency loss due to a sudden shift in exchange rates between signing an international contract and its carrying out.

During international trade realization, it's necessary to spend some time on goods transportation, that's why an exporter runs the credit risk and feels discomfort, connected with time and distance, which are needed for the transportation abroad and payment receiving. The time gap between the order to a foreign supplier and goods receiving, as a rule, is often connected with the duration of the period of transportation and the need to prepare the appropriate documentation for it.

The goods preparation and their delivery abroad require additional financing, for which an exporter has to apply to a bank. In this case, the exporter needs a credit for a much longer time than he needed in case of selling goods domestically. The exporter must carry out his own commitments in compliance with term and conditions of a credit deal. However, a risk of a bad debt can appear.

Commercial risks, connected with possibilities of non-receipt of profits or a loss occurrence during trade operations realization, can appear in such cases:

- importer's insolvency at the moment of payment for goods;
- importer's refusal of commodity payment;
- change in prices for goods after contract conclusion;
- decline in demand for goods;
- impossibility of money transfer to the exporter's country in connection with currency limitations in a customer's (importer's) country or a lack of currency; or refusal of an importer's country government for the transfer of a certain currency because of any other reasons.

4. The importance of international trade in the modern world

The importance of international trade within the world economic system is caused by crucial factors and practicability of international exchange of goods and services.

There are some factors predetermining the necessity of international trade. They are:

1. Emergence of the world market.
2. Unevenness of development of individual industries in different countries. Products of the most developed industries, which can't be realized at the internal market, are sold abroad. In other words, both the sales requirements at foreign markets and the need in receiving certain goods from outside, appear.
3. Tendency to unlimited expansion of the production. Since the capacity of domestic market is limited by insolvent demand of population, production is overgrowing the limits of domestic market and businessmen of every country are struggling for foreign markets.
4. Tendency to get higher income in connection with the usage of low-paid labour force and raw materials from developing countries.
5. International trade is especially important, because there is no country in the world, which can exist without foreign trade. They are all depended on international trade, but their level of dependency is different. It is determined by the volume of foreign trade turnover (export + import) to GDP. According to this indicator, all countries can be divided into 3 groups: high dependent (45-93%), medium dependent (14-44%) and low dependent (2,7-13%).

International trade is rational, when it provides some benefits, which can be received *on three levels*: **national level (macro)**, **the level of domestic international firm (micro)** and also **on customer's one (personal)**.

Due to taking part in the international trade, countries gain:

- the opportunity to export those goods, production of which takes more national resources, which country has in relatively large numbers;
- the opportunity to import those goods, which can't be produced in their country because of the lack of needed resources;
- economies of scale effect in production, specialized on more narrow set of goods.

There are two points of view on benefits from international trade for domestic international firms. The first point of view concerns the export opportunities, the second one – the import ones.

From the **export activity point of view**, enterprises obtain benefits at the expense of:

- using excess capacity, which is hold by companies, but are not desirable by domestic demand;
- getting greater profits. Because of the difference between the foreign trade competitiveness environment and the national one, the exporter can sell goods abroad with higher income;
- considerable volumes of foreign sales which makes national producers less dependent on domestic economic conditions;

- reduction of production costs connected with fixed costs covered by the expense of bigger volume of outputs; effectiveness rising due to experience gained during manufacture of large batch of products; bulk purchases of materials and their transportation by large batches;
- distribution of risk. Producer (exporter) can reduce the fluctuations of demand in its own country by organizing the production distribution on foreign markets;
- knowledge and best practices received by firms in the functioning process on foreign markets.

From the **import activity point of view**, domestic enterprises obtain benefits at the expense of:

- avoiding limits of the domestic market by reducing production costs or by upgrading quality of production;
- getting cheap high-quality materials, components, technologies to be used in their production process;
- using excess capacity of trade distribution network;
- possibilities of operative risks distribution. Due to expanding the suppliers range, the company will be less depended on a singular supplier.

In their turn, consumers obtain benefits from cheaper prices, increased quantity/quality and diversification of goods. All that leads to a higher standard of well-being.

LECTURE 5

International Trade Policy

Thematic Content of the Lecture:

1. Free trade: arguments for and against
2. Tariff as a basic instrument of protecting trade policy
3. Non-tariff instruments of trade policy

1. Free trade: arguments for and against

Previous two lectures have answered the question, ***"Why do nations trade?"*** by describing the causes and effects of international trade and the functioning of a trading world economy. While this question is interesting in itself, its answer is even more interesting if it also helps answer another question: ***"What should a nation's trade policy be?"***. For example, should the United States use a tariff or an import quota to protect its automobile industry against competition from Japan and South Korea? Who will benefit and who will lose from an import quota? Will the benefits outweigh the costs?

Thus, this lecture examines the policies that governments adopt toward international trade, policies that involve a number of different actions. These actions usually include taxes on some international transactions, subsidies for other transactions, legal limits on the value or volume of particular imports, and many other measures. In other words, it provides a framework for understanding the most important instruments of trade policy.

Free trade may be defined as a government policy which does not discriminate against imports or interfere with trade by applying tariffs (to imports) or subsidies (to exports). In other words, it is the unrestricted purchase and sale of goods and services between countries without the imposition of constraints such as tariffs, duties and quotas. Free trade enables nations to focus on their core competitive advantages, thereby maximizing economic output and fostering income growth for their citizens. The idea that free trade promotes welfare is one of the most fundamental doctrines in modern economics dating back at least to Adam Smith and David Ricardo. So, here are some ***arguments in favour of*** the free trade regime.

1. The theory of comparative advantage

This explains that by specializing and trading goods in which countries have a lower opportunity cost or greater comparative advantage, there can be an increase in economic welfare for all countries. Free trade enables countries to specialize in those goods where they have a comparative advantage. Free trade in lines of comparative advantage is expected to mutually benefit the countries engaged in free trade.

2. Trade as a vent for surplus

Trade is identified as a vent for surplus output of an economy. The dictum is related to Adam Smith who identified the importance of division of labour. Smith also argued that the division of labour is limited by the size of the market. Hence division of labour is expected to raise the domestic production. A deficiency (lack) in aggregate demand may reduce the domestic prices. Here trade can act as a vent for surplus production brought forth through technology and division of labour. Free trade is expected to smoothen this process.

3. Reducing tariff barriers leads to trade creation

Trade creation occurs when consumption switches from high cost producers to low cost producers. Reducing the tariff barriers with an objective to bring about free trade in an economy may help countries to increase their trade.

4. Economies of scale

If countries can specialize in certain goods they can benefit from economies of scale and lower average costs. Economies of scale refer to the capacity of firms to change their output more than proportionately to changes in their costs. This is

especially true in industries with high fixed costs or that require high levels of investment. The benefits of economies of scale will ultimately lead to lower prices for consumers. Lowering of trade restrictions enhances this outcome.

5. Increased Competition

With more trade domestic firms will face more competition from abroad. As a result of this there will be more incentives to cut costs and increase efficiency. It may prevent domestic monopolies from charging too high prices.

6. Trade is an engine of growth

World trade has increased by an average of 7% since the 1945 per year, causing this to be one of the big contributors to economic growth.

7. Make use of surplus raw materials

Middle Eastern counties such as Qatar are very rich in reserves of oil but without trade there would be not much benefit in having so much oil. Japan on the other hand has very few raw material without trade it would be very poor.

8. Tariffs encourage inefficiency

If an economy protects its domestic industry by increasing tariffs industries may not have any incentives to cut costs. Trade liberalization is often justified in terms of the efficient market outcome and efficient price fixation through a competitive price fixing mechanism.

Despite all these "arguments for" few countries today are approaching completely free trade. The city of *Hong Kong*, which is legally part of China but maintains a separate economic policy, may be the only modern economy with no tariffs or import quotas. All other countries choose from a spectrum of free trade regimes with various degrees of liberalization. Therefore, we can say their governments practice to some extent **trade policy of protectionism** advocating ***arguments against*** free trade:

1. The infant industry argument

Governments are sometimes urged to support the development of infant industries, protecting home industries in their early stages, usually through subsidies or tariffs. Subsidies may be indirect, for instance, when import duties are imposed or some prohibition against the import of a raw or finished material is imposed. If developing countries have industries that are relatively new then without restrictions in free trade policy these industries would struggle against international competition. However, if they invested in the industry then in the future they may be able to gain comparative advantage.

2. The senile (old) industry argument

If industries are declining and inefficient they may require large investment to make them efficient again. Protection for these industries would act as an incentive for firms to invest and reinvent themselves. However, protectionism could also be an instrument for protecting inefficient firms.

3. Revenue increase for the government

Import taxes and tariffs can be used to raise money for the government (budget) which, by using it, can somewhat improve a socioeconomic situation in the country.

4. Assistance to the balance of payments

Reducing imports can help the current account. However, in the long run this is likely to lead to retaliation from trade partners.

5. Cultural identity

This is not really an economic argument but more political and cultural. Many countries wish to protect their nations from what they consider as an Americanization or commercialization of their homes.

6. Protection against dumping

The EU sells lots of its food surplus from the *Common Agricultural Policy (CAP)* at very low prices on the world market. This causes huge problems for the world farmers because they face a big fall in their market prices.

7. Environmental argument

It is argued that free trade can harm the environment because developing countries may use up natural reserves of raw materials to produce exportable commodities. Also countries with strict pollution controls may find consumers import the goods from other countries where legislation is lax and pollution allowed.

2. Tariff as a basic instrument of protecting trade policy

Restrictions on international movement of goods and services can be divided into *tariff barriers* and *non-tariff barriers*. A **tariff** is a tax levied when a good is imported. The main effect of a tariff is to raise the price of the imported product. It helps domestic producers of similar products to sell them at higher prices. The money received from the tariff is collected by the domestic government. An import tariff is a tax on import commodities and an export tariff is a tax on export commodities.

Tariffs can be *ad valorem*, *specific* or *compound*. An ***ad valorem tariff*** is levied as a fixed percentage of the value of the traded commodity. For example, if the U.S.

government decides to levy a 10% ad valorem tax on the $500 worth bicycle that the USA imports from Nigeria, that means the importer will have to pay $50 tax for each bicycle that he imports from the African country. A ***specific tariff*** is levied as a fixed sum per physical unit of the traded commodity. For instance, if it equals $25 then the customs officials have to collect $25 for each bicycle that is imported from Nigeria irrespective of its price. A ***compound tariff*** is the combination of the ad valorem and specific taxes. A compound tax of $75 on the bicycle imported to the USA will lead the customs officials to collect $25 as a specific part of the compound tariff and $50 (i.e. 10% if each $500 worth bicycle) as the ad valorem part of the compound tax.

Besides these classifications tariffs can be classified as *protective* and *revenue* tariffs. ***Protective tariffs*** are levied with the only purpose to make foreign goods more expensive to protect domestic industries from competition. In the early 19th century, for example, the United Kingdom used tariffs (the famous Corn Laws) to protect its agriculture from import competition. In the late 19th century, both Germany and the USA protected their new industrial sectors by imposing tariffs on imports of manufactured goods.

Revenue tariffs are put in place to raise money for the government. For instance, the U.S. government previously raised most of its revenue from tariffs. It all depends on the intention of the government that implements the tariff.

Not only the government but also consumers and producers can face some costs and benefits of a tariff. A tariff raises the price of a good in the importing country and lowers it in the exporting country. As a result of these price changes, consumers lose in the importing country and gain in the exporting country. Producers gain in the importing country and lose in the exporting country.

Despite the fact that tariffs are *the oldest form of trade policy* their importance has declined in modern times because modern governments usually prefer to protect domestic industries through a variety of non-tariff barriers, such as import quotas (limitations on the quantity of imports) and export restraints (limitations on the quantity of exports – usually imposed by the exporting country at the importing country's request). Nonetheless, an understanding of the effects of a tariff remains vital for understanding other trade policies.

3. Non-tariff instruments of trade policy

Tariffs are the simplest trade policies, but in the modern world, most government intervention in international trade takes other non-tariff forms, such as import quotas, export subsidies, voluntary export restraints, local content requirements, bureaucratic delays at customs, technical barriers to trade, sanitary and phytosanitary measures, rules of origin, etc. Fortunately, once we have understood tariffs, it is not too difficult to understand these other instruments of trade policy.

Import quotas

An import quota is a direct restriction on the quantity of some good that may be imported. The restriction is usually enforced by issuing licenses to some group of

individuals or firms. For example, the United States has a quota on imports of foreign cheese. The only firms allowed to import cheese are certain trading companies, each of which is allocated the right to import a maximum number of pounds of cheese each year; the size of each firm's quota is based on the amount of cheese it imported in the past.

It is important to avoid having the misconception that import quotas somehow limit imports without raising domestic prices. The truth is that *an import quota always raises the domestic price of the imported good*. When imports are limited, the immediate result is that at the initial price, the demand for the good exceeds domestic supply plus imports. This causes the price to be bid up until the market clears. In the end, an import quota will raise domestic prices by the same amount as a tariff that limits imports to the same level (except in the case of domestic monopoly, in which the quota raises prices more than this).

The difference between a quota and a tariff is that with a quota, the government receives no revenue. When a quota instead of a tariff is used to restrict imports, the sum of money that would have appeared with a tariff as government revenue is collected by whoever receives the import licenses. License holders are thus able to buy imports and resell them at a higher price in the domestic market. The profits received by the holders of import licenses are known as ***quota rents***. In assessing the costs and benefits of an import quota, it is crucial to determine who gets the rents. When the rights to sell in the domestic market are assigned to governments of exporting countries, as is often the case, the transfer of rents abroad makes the costs of a quota substantially higher than the equivalent tariff.

Export subsidies

An export subsidy is a payment to a firm or individual that ships a good abroad. Like a tariff, an export subsidy can be either specific (a fixed sum per unit) or ad valorem (a proportion of the value exported). When the government offers an export subsidy, national producers will export the good up to the point at which the domestic price exceeds the foreign price by the amount of the subsidy.

Voluntary export restraints

A variant of the import quota is the voluntary export restraint (VER), also known as a voluntary restraint agreement (VRA). A VER is a quota on trade imposed from the exporting country's side instead of the importer's. The most famous example is the limitation on auto exports to the United States enforced by Japan after 1981.

Voluntary export restraints are generally imposed at the request of the importer and are agreed to by the exporter to avoid (forestall) other trade restrictions. From an economic point of view a voluntary export restraint 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 difference is that what would have been revenue

under a tariff becomes rents earned by foreigners under the VER, so that the VER clearly produces a loss for the importing country.

Local content requirements

A local content requirement is a regulation that requires some specified fraction of a final good to be produced domestically. In some cases this fraction is specified in physical units, like the U.S. oil import quota in the 1960s. In other cases the requirement is stated in value terms, by requiring that some minimum share of the price of a good represent domestic value added. Local content laws have been widely used by developing countries trying to shift their manufacturing base from assembly back into intermediate goods.

From the point of view of the domestic producers of parts, a local content regulation provides protection in the same way an import quota does. From the point of view of the firms that must buy locally, however, the effects are somewhat different. Local content does not place a strict limit on imports. Instead, it allows firms to import more, provided that they also buy more domestically.

The important point is that a local content requirement does not produce either government revenue or quota rents. Instead, the difference between the prices of imports and domestic goods in effect gets averaged in the final price and is passed on to consumers.

The effects of the major instruments of trade policy are usefully summarized below (table 1).

Table 1. **Effects of major trade policy instruments**

	Tariff	**Export Subsidy**	**Import Quota**	**Voluntary Export Restraint**
Producer surplus	Increases	Increases	Increases	Increases
Consumer surplus	Falls	Falls	Falls	Falls
Government revenue	Increases	Falls (government spending rises)	No change (rents to license holders)	No change (rents to foreigners)
Overall national welfare	Ambiguous (falls for small countries)	Falls	Ambiguous (falls for small countries)	Falls

The table compares the effect of four major kinds of trade policy on the welfare of consumers. It is clearly seen that all four trade policies *benefit producers and hurt consumers*. The effects of the policies on economic welfare are at best ambiguous; two

of the policies definitely hurt the nation as a whole, while tariffs and import quotas are potentially beneficial only for large countries that can drive down world prices.

There are many other ways in which governments influence trade. We list some of them briefly.

Export credit subsidies. This is like an export subsidy except that it takes the form of a subsidized loan to the buyer. The United States, for instance, like most other countries, has a government institution, the Export-Import Bank, that is devoted to providing at least slightly subsidized loans to aid exports.

National procurement. Purchases by the government or strongly regulated firms can be directed toward domestically produced goods even when these goods are more expensive than imports. The classic example is the European telecommunications industry. The nations of the European Union in principle have free trade with each other. The main purchasers of telecommunications equipment, however, are phone companies – and in Europe, these companies have until recently all been government-owned. These government-owned telephone companies buy from domestic suppliers even when the suppliers charge higher prices than suppliers in other countries. The result is that there is very little trade in telecommunications equipment within Europe.

Red-tape barriers. Sometimes a government wants to restrict imports without doing so formally. Fortunately or unfortunately, it is easy to twist normal health, safety, and customs procedures in order to place substantial obstacles in the way of trade. The classic example is the French decree in 1982 that all Japanese videocassette recorders had to pass through the tiny customs house at Poitiers – effectively limiting the actual imports to a handful.

Dumping. It is international price discrimination. Price discrimination is usually practiced by a monopolist and refers to charging different prices to same commodity for different people. A firm may charge higher price for domestic consumers and a lower price for foreign consumers. This may be considered as a trade barrier.

Dumping can be of *different types*:

- ***Persistent dumping.*** It is a continuous tendency of a domestic monopolist to maximize total profits by selling the commodity at a higher price in the domestic market than foreign markets.
- ***Predatory dumping.*** It is a “temporary sale” of a commodity at a lower price abroad in order to drive foreign producers out of business.
- ***Sporadic dumping.*** It is an occasional sale of a commodity at a lower price abroad than domestically in order to unload an unforeseen and temporary surplus of the commodity without having to reduce domestic prices.

Trade restrictions to counteract first of all predatory dumping are justified and allowed to protect domestic industries from unfair competition from abroad. These restrictions usually take the form of antidumping duties (taxes) to offset price differentials.

LECTURE 6

International Capital Market

Thematic Content of the Lecture:

1. The essence and historical overview of international capital market
2. The structure of the international capital market
3. Main assets in the international capital market
4. Foreign direct investments (FDI) versus portfolio investments

1. The essence and historical overview of international capital market

If some imaginary financier named *Casper van Damme* had gone to sleep in the 1960s and awakened after 50 years, he would have been shocked by changes in both the nature and the scale of international financial activity. In the early 1960s, for example, most banking business was purely domestic, involving the currency and customers of the bank's home country.

Five decades later, many banks were deriving a large share of their profits from international activities. To his surprise, Casper would have found that he could locate branches of *Citibank in Kyiv (Ukraine)*, and branches of *Britain's National Westminster Bank in Lagos (Nigeria)*. He would also have discovered that it had long since become routine for a branch of an American bank located in London to accept a deposit denominated in Japanese yen from a Swedish corporation, or to lend Swiss francs to a Dutch manufacturer. Finally, he would have noticed much greater participation by nonbank financial institutions in international markets, and a huge expansion in the volume of international transactions.

The market in which residents of different countries trade assets is called the **international capital market** (ICM). The international capital market is not really a single market; it is instead a group of closely interconnected national or regional markets in which asset exchanges. International currency trades take place in the foreign exchange market, which is an important part of the international capital market. The main actors in the international capital market are the same as those in the foreign exchange market: *commercial banks, large corporations, nonbank financial institutions, central banks and other government agencies*. And, like the foreign exchange market, the international capital market's activities take place in a network of ***world financial centers*** linked by sophisticated communications systems. The assets traded in the international capital market, however, include different countries' stocks and bonds in addition to bank deposits denominated in their currencies.

When we compare international capital flows today to a century ago, there are two points to keep in mind. *First,* savings and investment are highly correlated. That is, countries with high savings tend to have high rates of investment, and low savings is correlated with low investment. If there were a single world market in which capital flowed freely and easily, this would not necessarily be the case. Capital would flow

from countries with abundant savings and capital to countries with low savings and capital, where it would find its highest returns.

Second, a variety of technological improvements increased capital flows in the 1800s, as they are doing today. Transoceanic cables and radio telephony greatly facilitated the development of ICM, but capital flows also increased in the late 1800s because there were new investment opportunities such as national railroad networks and other infrastructure, both at home and abroad.

If we compare the size of capital flows today to the previous era of globalization, flows today are much larger but mainly because economies are larger. Relative to the size of economies, the differences are not great and may even favor the 1870 to 1913 period, depending on what is measured. Great Britain, for instance, routinely invested 9% of its GDP abroad in the decades before 1913, and France, Germany, and the Netherlands were as high at times. For significant periods, Canada, Australia, and Argentina borrowed amounts that exceeded 10% of their GDP, a level of borrowing that sends up danger signals in the world economy today. In other words, it is hard to make the argument that national economies have a historically unprecedented level of international capital flows today.

While the relative quantity of capital flows today may not be that much different for many countries, there are some important qualitative differences. *First*, there are many more financial instruments available now than there were a century ago. These range from relatively mundane (ordinary) stocks and bonds to relatively exotic instruments such as derivatives, currency swaps, and others. By contrast, at the turn of the twentieth century there were many fewer companies listed on the world's stock exchanges and most international financial transactions involved the buying and selling of bonds.

A *second* difference today is the role of foreign exchange transactions. In 1900, countries had fixed exchange rates and firms in international trade or finance had less day-to-day risk from a sudden change in the value of a foreign currency. Many firms today spend significant resources to protect themselves from sudden shifts in currency values. Consequently, buying and selling assets denominated in foreign currencies is the largest component of international capital movements. For example, according to the *Bank for International Settlements* in Geneva (Switzerland) daily foreign exchange transactions in 2010 were equal to $3.98 trillion. In 1973, at the end of the last era of fixed exchange rates, they were $15 billion.

The *third* major difference in capital flows is that the costs of foreign financial transactions have fallen significantly. Economists refer to the costs of obtaining market information, negotiating an agreement, and enforcing the agreement as ***transaction costs***. They are an important part of any business's costs, whether it is a purely domestic enterprise or a company involved in foreign markets. Due to sheer distance, as well as differences in culture, laws, and languages, transaction costs are often higher in international markets than in domestic ones. Today's lower transaction costs for foreign investment mean that it is less expensive to move capital across international boundaries.

The volatile movement of financial capital across international boundaries is often mistakenly regarded as a new feature of the international economy. However, speculative excesses and overinvestment, followed by capital flight and bankruptcies, have occurred long ago, going back at least to the 1600s and probably earlier. U.S. and world history show a number of such cases. Thus, financial crises are not a new phenomenon, nor have we learned how to avoid them – a fact driven home by the recent subprime mortgage crisis.

2. The structure of the international capital market

As we noted above, the main actors in the international capital market include commercial banks, corporations, nonbank financial institutions (such as insurance companies, money market funds, hedge funds, and pension funds), central banks, and other government agencies.

1. Commercial banks. Commercial banks are at the center of the international capital market, not only because they run the international payments mechanism but also because of the broad range of financial activities they undertake. Bank liabilities consist chiefly of deposits of various maturities, as well as short-term borrowing from other financial institutions, while their assets consist largely of loans (to corporations and governments), deposits at other banks (interbank deposits), and bonds. Multinational banks are also heavily involved in other types of asset transaction. For example, banks may underwrite issues of corporate stocks and bonds by agreeing, for a fee, to find buyers for those securities at a guaranteed price. One of the key facts about international banking is that banks are often free to pursue activities abroad that they would not be allowed to pursue in their home countries. This type of regulatory asymmetry has spurred the growth of international banking over the past 50 years.

2. Corporations. Corporations – particularly those with multinational operations such as *Apple, Google, Microsoft, IBM, Coca-Cola, Toyota* and *Nike* – routinely finance their investments by drawing on foreign sources of funds. To obtain these funds, corporations may sell shares of stock, which give owners an equity claim to the corporation's assets, or they may use debt finance. Debt finance often takes the form of borrowing from and through international banks or other institutional lenders; when longer-term borrowing is desired, firms may sell corporate debt instruments in the international capital market.

Corporations frequently denominate their bonds in the currency of the financial center in which the bonds are being offered for sale. Increasingly, however, corporations have been pursuing novel denomination strategies that make their bonds attractive to a wider spectrum of potential buyers.

3. Nonbank financial institutions. Nonbank institutions such as insurance companies, pension funds, mutual funds, and hedge funds have become important players in the international capital market as they have moved into foreign assets to diversify their portfolios. Of particular importance are investment banks such as *the Lazard Group*, which are not banks at all but specialize in underwriting sales of stocks and bonds by corporations and (in some cases) governments. In 1933 U.S. commercial

banks, for instance, were barred from investment banking activity within the United States (and from most other domestic transactions involving corporate stocks and bonds), although the U.S. government eased these barriers in 1999. But U.S. commercial banks have long been allowed to participate in investment banking activities overseas, and such banks as *Citigroup* and *J.P. Morgan Chase* have competed vigorously with the more specialized investment banks.

4. Central banks and other government agencies. Central banks are routinely involved in the international financial markets through foreign exchange intervention. In addition, other government agencies frequently borrow abroad. Developing-country governments and state-owned enterprises have borrowed substantially from foreign commercial banks.

On any measure, the scale of transactions in the international capital market has grown much more quickly than world GDP since the early 1970s. One major factor in this development is that, starting with the industrial world, countries have progressively dismantled barriers to private capital flows across their borders.

3. Main assets in the international capital market

Among the many assets traded in the international capital market are bonds and deposits denominated in different currencies, shares of stock, and more complicated financial instruments (derivatives) such as currency options. A purchase of foreign real estate and the direct acquisition of a factory in another country are other ways of diversifying capital abroad.

In thinking about asset trades, it is frequently useful to make a distinction between **debt instruments** and **equity instruments**. ***Bonds*** and ***bank deposits*** are debt instruments, since they specify that the issuer of the instrument must repay a fixed value (the sum of principal plus interest) regardless of economic circumstances. In contrast, ***a share of stock*** is an equity instrument: it is a claim to a firm's profits, rather than to a fixed payment, and its payoff will vary according to circumstances. By choosing how to divide their portfolios between debt and equity instruments, individuals and nations can arrange to stay close to desired consumption and investment levels despite the different eventualities that could occur.

The dividing line between debt and equity is not a neat one in practice. Even if an instrument's money payout is the same in different states of the world, its real payout in a particular state will depend on national price levels and exchange rates. In addition, the payments that a given instrument promises to make may not occur in cases of bankruptcy, government seizure of foreign-owned assets, and so on. Assets like low-grade corporate bonds, which superficially appear to be debt, may in reality be like equity in offering payoffs that depend on the doubtful financial fortunes of the issuer. The same has turned out to be true of the debt of many developing countries.

Speaking about **derivatives** one should admit that they are financial contracts which gain or lose values with the movement of the price of a commodity or a financial asset. Commodities and financial futures contracts are examples of derivatives. Derivatives do not involve the direct ownership of an asset or the existence of a

liability, and therefore do not typically appear on a balance sheet, but nevertheless do create the opportunity for speculative gains or losses. Many domestic financial derivatives have become quite controversial, due to large losses being suffered on such contracts by hedge funds (*Long Term Capital Management*), nonfinancial corporations (*Procter & Gamble*), and even local governments (*Orange County, California*) in recent years. Our concern, however, is only with some international derivatives, such as foreign exchange forwards, futures, and options.

Foreign exchange forwards allow the purchase or sale of foreign exchange today for delivery and payment at a fixed date in the future. Contracts typically have maturities of 30, 60, or 90 days. If, for example, a US importer is committed to pay euro 500,000 for German exports in 90 days, a forward purchase of euro is a convenient way to avoid the possibility that the currency may appreciate over that time, which would impose higher dollar costs on the importer.

A futures market for foreign currencies exists as the International Monetary Market (IMM) in Chicago where trading is carried on just as it would be for commodities such as copper or wheat. It is used both to hedge risks arising from relatively small trade transactions and to provide a vehicle for speculation.

The forward market is similar to the futures market for commodities, where it is possible to buy or sell for future delivery at a price determined now. There are, however, small differences between the two types of arrangements. All futures contracts close on the same day of the month, whereas forward contracts close a fixed number of days after they are signed, which can be any day of the month. Futures contracts are relatively liquid, in that they can be resold in commodity exchanges before maturity, whereas forward contracts usually have to be held to maturity. Although forward contracts are traded by banks in large transactions, futures are traded in commodity exchanges such as *the Chicago Board of Trade* in smaller transactions and with sizable brokerage commissions.

The forward (futures) exchange market has ***two separate, but related, roles*** in ICM. First, it is a way of hedging risks arising from typical credit terms on export/import business or currency depreciation. Second, forward (futures) contracts can be used to take on risk rather than to avoid it. If speculators believe that a currency will depreciate during the next 90 days to a level below the existing forward exchange rate, a forward sale of that currency is a convenient way to gamble on that outcome without investing large sums of money.

Futures or forward contracts obligate the holder to complete the transaction at maturity, unless it is sold in the meantime or offset by a contract in the opposite direction. A 90-day forward purchase of sterling, for example, could be canceled after 30 days through a sale of 60-day sterling. Otherwise the contract goes to maturity, whether or not the outcome is favorable. An **option contract**, in contrast, provides the opportunity to purchase or sell a fixed amount of a currency or a common stock during a fixed period of time at a guaranteed price (called the *strike price*), but the holder of the option has the alternative of not completing the purchase or sale.

Foreign exchange options are a useful means of covering possible exchange exposure from a transaction that may not occur. If, for example, a US firm were in the

midst of negotiating a contract to purchase a British firm for £1 million sterling, it might want to lock in its US dollar price but not be bound to take delivery of the sterling if the negotiations were to fail. Besides, purchasing option contracts is a means of speculating on the future of the spot exchange rate with a limited risk of loss.

The contracts described above are the most commonly used international derivatives, but there are many others (for example, ***swaps***). The variety and complexity of both domestic and international derivatives are limited only by the imagination of the officers of commercial and investment banks who are selling them in exchange for handsome fees. Derivatives were originally seen as a way of offsetting risks from previous financial exposures, but have increasingly become ways of *speculating*. Many investors have become involved in such derivatives without fully understanding the risks, and have absorbed large financial losses when markets turned against them.

4. Foreign direct investments (FDI) versus portfolio investments

The movement of private assets via ICM is broken into two basic components. The first component is **foreign direct investments (FDI)**. FDI in the financial account includes tangible items such as real estate, factories, warehouses, transportation facilities, and other physical (real) assets. The latter can also be called ***greenfield investments*** (a form of foreign investments where a parent company builds its operations in a foreign country from the ground up). The second component is **foreign portfolio investments** since they represent paper assets such as stocks, bonds, loans etc.

The similarity between FDI and foreign portfolio investment is that they both give their holders a claim on the future output of the foreign economy. However, the differences between them are present as well. To realise them let's look at the following example.

The U.S. corporation Apple pays cash to acquire all of the equity shares of a German company that makes computer software. Another U.S. investor named Google pays cash to buy 10 000 shares (0,1% of all outstanding equity shares) of a similar German company that also makes software.

Both of these share purchases are international flows of financial capital from the United States to Germany. But only one is foreign direct investment. *The key difference* between the two investments is the degree to which each investor can control or influence the management of the company. In foreign direct investment the investor has, or could have, an effective voice in the management of the foreign company. Thus, ***FDI*** are the flow of funding provided by an investor or a lender (usually a firm) to establish or acquire a foreign company or to expand or finance an existing foreign company that the investor owns and controls. Apple's acquisition of the first German company is FDI.

In contrast, Google does not expect to have any influence on the day-to-day management of the second German company. Rather, Google is seeking financial returns by adding the 10 000 shares to his investment portfolio. Generally, the term ***international portfolio investment*** is used for all foreign securities investments that do not involve management control (that is, all that are not direct investments).

Both foreign direct investments and international portfolio investments are important ways in which financial capital moves between countries. During 2010-

2012, the global flows of FDI and the global flows of international portfolio investment each averaged close to $1,7 trillion per year.

In many cases, including the acquisition of the German company by Apple (described above), we can easily tell whether an investment is or is not FDI. In other cases, the investor acquires or owns part of the equity of the foreign company but not all of it. How much ownership is enough to give the investor the ability to affect the management of the foreign firm? There is no clear-cut answer to this, but it is certainly at most half, and probably less than this. Someone who owns even, say, 20% of a firm can have some ability to influence the management of the firm.

The agreed international standard is ***10% ownership***. That is, foreign direct investment is any flow of lending to, or purchases of ownership in, a foreign firm in which the investor (usually a firm) has or gains ownership of 10% or more of the foreign firm. Note, that direct investment consists of any investment (either greenfield or in paper assets) as long as the investing firm owns or acquires over 10% of the foreign firm.

The differences between two main types of foreign investments are also in their time horizons, and this can have dramatic effects on the host country, where assets are located. FDI usually involve a longer time horizon because they are difficult to liquidate quickly and therefore represent a long-term position in the host country. Portfolio investments in stocks and bonds tend to be more short term. While many investors may decide to hold their foreign securities through all the ups and downs, stocks and bonds by their nature are much more liquid than real estate or factories. It is common, therefore, for portfolio investors to have a shorter time horizon and to move quickly if they expect a downturn (crisis).

Shifts in expectations can lead to a sudden cessation of inflows followed by large and destabilizing outflows of financial capital. Economist *Guillermo Calvo* has labeled this a ***sudden stop***. Sudden stops have been involved in most of the financial crises of the last thirty years.

High liquidity is the key reason why investors choose international portfolio investments. Why would a firm choose to operate an affiliate in a foreign location, in other words – what is the reason for FDI?

The answer depends, in part, on the production activities that the foreign affiliate carries out. These activities fall into two main categories: (1) The affiliate replicates the production process (that the parent firm undertakes in its domestic facilities) elsewhere in the world; and (2) the production chain is broken up, and parts of the production processes are transferred to the affiliate location. Investing in affiliates that do the first type of activities is categorized as ***horizontal FDI***. Investing in affiliates that do the second type of activities is categorized as ***vertical FDI***.

Vertical FDI is mainly driven by *production cost differences* between countries (for those parts of the production process that can be performed in another location). What drives those cost differences between countries? This is just the outcome of the theory of comparative advantage that we discussed earlier. For example, Intel (the world's largest computer chip manufacturer) has broken up the production of chips into wafer fabrication, assembly, and testing. Wafer fabrication and the associated research

and development are very skill-intensive, so Intel still performs most of those activities in the United States, as well as in Ireland and Israel (where skilled labor is still relatively abundant). On the other hand, chip assembly and testing are labor-intensive, and Intel has moved those production processes to countries where labor is relatively abundant, such as Malaysia, the Philippines, and, more recently, Costa Rica and China. This type of vertical FDI is one of the fastest-growing types of FDI, and is behind the large increase in FDI inflows to developing countries.

In contrast to vertical FDI, horizontal FDI is dominated by flows between developed countries; that is, both the multinational parent and the affiliates are located in developed countries. The main reason for this type of FDI is *to locate production near a firm's large customer bases*. Hence, trade and transport costs play a much more important role than production cost differences for these FDI decisions. Consider the example of Toyota, which is the world's largest motor vehicle producer (at least, one of them). At the start of the 1980s, Toyota produced almost all of its cars and trucks in Japan and exported them throughout the world, but mostly to North America and Europe. High trade costs to those markets (in large part due to trade restrictions) and rising demand levels there induced Toyota to slowly expand its production overseas. By 2009, Toyota produced over half of its vehicles in assembly plants abroad. Toyota has replicated the production process for its most popular car model, the Corolla, in assembly plants in Japan, Canada, the United States, the United Kingdom, and Turkey. This is horizontal FDI in action.

LECTURE 7

Foreign Market Entry and International Production

Thematic Content of the Lecture:

1. The types of foreign market entry
2. The choice of foreign market entry mode
3. Motivations for international production

1. The types of foreign market entry

As we now know, ***international trade*** and ***foreign direct investment (FDI)*** are two of the main types of international economic activity. In other words, they are two generic parts of a menu of ways in which a firm in one country can interact with the world economy. This menu of options concerns the process of foreign market entry. Foreign market entry takes a close look at a firm's decision-making process with regard to how it is going to supply a foreign market, for instance, with goods and services. There are *three broad categories of such entry*:

- exporting;
- contractual;
- investment.

Let's consider a purely domestic, home-country firm. The entire sales of this firm are within its home-country base. At some point, it might begin to considering selling its output in foreign markets. How might it do this? One possible way of entering foreign markets is via exporting. This might seem to be a simple decision, but only at the first glance. The extra costs of exporting to foreign markets can confine exporting activity to a relatively small set of firms. For example, they estimate that just 4percent of firms based in the United States engage in exports. Even within the tradable industries of the United States, only 15 percent of firms export. So the decision to export is not as casual as we might first assume.

Exporting. How can the home-country firm begin its exporting activity? There are *two basic approaches*. If the firm has little experience with and knowledge of international trade, it might first enter foreign markets in an ***indirect exporting mode***. Here it relies on another firm known as a sales agent or trading company to complete the export transaction. This indirect mode of exporting can give the firm some experience with foreign market entry even if it is indirect experience. Alternatively, given this experience, it can begin to make a commitment to a ***direct exporting mode***. In this case, the firm undertakes the export transaction itself rather than relying on another specialized firm. In this case, the firm takes on the research, marketing, finance, and logistics requirements of the trade transaction. Despite these extra costs, there might be offsetting advantage in being able to develop and manage its own foreign market entry strategy.

Contractual. For a number of reasons, it is possible that our firm might grow dissatisfied with the exporting mode and begin to wish to actually produce abroad. *For example*, *Honda in Vietnam* (*students info*). The firm might be motivated by the perceived need to engage in some final product finishing, service, or sales to address local demand conditions in an export market. Or it might simply need to engage in some trade-related services itself in that country. However, lack of experience in global production might make it wary of carrying out production itself in the foreign market. This would lead the firm to the *contractual modes* of foreign market entry. The key characteristic of contractual entry modes is that they are not about ownership.

We can distinguish among at least *three types of contractual foreign market entry*. These are:

- *licensing*;
- *franchising*;
- *subcontracting*.

In the ***licensing case***, the home-country firm sells a license to a foreign firm to allow it to use the home-country firm's production process. This could include use of logos, trademarks, designs, and branding. In return, the foreign firm would pay royalties to the home-country firm for the license rights. In some cases, technology features prominently in decisions with regard to licensing. This is because, given the nature of the firm, the resulting licensing agreement is largely about licensed technology. This puts the firm in the realm of what is known as technology licensing agreements on which a great deal of research has taken place. The key issue with

technology licensing agreements is that here is always a danger that the home-country firm could lose aspects of the licensed technology to the foreign firm.

In the ***franchising type*** of contractual foreign market entry, the home-country firm licenses a foreign firm to allow it to use the home-country firm's production process in the foreign country but exerts more control over production and marketing to ensure consistency across foreign markets. The home-country firm also provides assistance to the foreign firm to ensure this consistency. Franchising arrangements are more common in service and retail firms than in manufacturing, and we are usually most familiar with this type of mode through international hotel and fast food chains.

The third type of contractual foreign market entry is ***subcontracting***, but it is also known as foreign outsourcing and contract manufacturing. Here the home-country firm contracts with a foreign firm to produce a product to certain specifications (materials, processes, and quality). This form of international production, while not new, has become increasingly important over time. Indeed, it is so significant in some sectors (e.g., clothing and electronics), that there are now contract manufacturing organizations (CMOs) that have evolved to facilitate the activity.

Investment. Contracting is not the only way to produce abroad. The home-country firm can also engage in foreign direct investment (FDI). There are *three modes of FDI* to consider. These are:

- joint venture (JV);
- mergers and acquisitions (M&As);
- greenfield investment.

In a ***JV***, the home-country firm establishes a separate firm in the foreign country that is jointly owned with a foreign-country firm. Sometimes a JV is required by a foreign host country, whereas in other instances, a home-country firm will enter into a JV willingly in order to tap into local assets of the foreign partner. These local assets might include local market knowledge, existing production facilities, and knowledge of the local regulatory environment. *A classic case of a JV and its issues is "Beijing Jeep"* (*students info*).

The second way of engaging in FDI is through ***M&As***. Here the home-country firm buys part (merger) or all (acquisition) of the shares of an already existing production facility in the foreign country. As has been pointed out by many observers, M&A activity is the most prominent type of investment mode for foreign market entry. That is, M&As are the most common means of FDI. For example, the M&A vehicle *"offers the attraction of an already functioning business compared with the more difficult, and possibly more risky, method of starting a firm from scratch in an unfamiliar environment"*.

The third means of engaging in FDI is through ***greenfield investment***, or starting a subsidiary from scratch. Here the home-country firm establishes a brand-new production facility in the foreign country that it fully owns. This is clearly the investment option that requires the most commitment on part of the home-country firm but one that offers this firm the most control over the foreign-based production facility.

In the case of Honda in Vietnam, it hoped to move from a direct exporting mode of foreign market entry to a greenfield investment mode with a wholly owned factory.

However, the Vietnamese government prevented Honda from pursuing this strategy and required that it enter the market as a JV with a Vietnamese firm. As a result, Honda Vietnam is only 70 percent owned by Honda. The Vietnam Engine and Agricultural Machinery Corporation (VEAM) owns the remaining 30 percent. This JV was established in 1997 outside of Hanoi producing the Super Dream motorcycle. It began producing the Future motorcycle in 1999 and the Wave Alpha motorcycle in 2001. In 2008 Honda Vietnam opened a second factory as well.

2. The choice of foreign market entry mode

As we already know, exporting, contractual, and investment are three categories of foreign market entry mode (pattern). But what prompts a firm to choose one category over another?

From a purely economic point of view, we can begin with the observation that a firm will chose the entry mode that will provide it with the greatest risk-adjusted or expected return on the entry investment. Although this statement in itself is accurate, it is not entirely helpful because it does not specify the types or magnitudes of risks involved nor how returns would differ among the mode choices. Consequently, we need to take a slightly more applied approach, and there are a few of these we can consider.

The first approach to foreign market entry can be called the **sequential approach**. The focus in the sequential approach is on the home-country firm's learning process. The foreign market and the entry process itself are largely unknown to the purely domestic home-country firm. This firm develops its understanding of the environment and process by slowly moving down in a sequential or evolutionary process from indirect exporting to greenfield FDI. This approach makes some sense and captures some important features of the firm's decision-makingprocess: learning is indeed important. Its limitation is that not all firms abide by it! Instead, they sometimes jump into foreign environments farther down rather than moving sequentially.

Why might that be so? An answer can be found in a second approach to foreign market entry that can be called the **firm-specific asset approach**. The term firm-specific assets refers to tangible (real) and intangible resources that the firm owns and that contribute to its competitiveness over time. It might be a patent on particular technology, or it might be a corporate product brand. It could even be some aspect of corporate culture that allows a firm to be more productive. Whatever the asset's form, its presence is the result of the firm incurring costs to acquire it, and it provides the firm with value in enhancing its competitiveness.

It is worth noting that, among all the different types of firm-specific assets that can exist, ***knowledge capital*** can play a particularly important role. Of course some knowledge is also embedded in individuals rather than firms in the form of human capital, but a lot of knowledge is also embedded in firms themselves in the form of knowledge capital or intellectual capital. Indeed, one of the well-known models of FDI behavior is known as the *knowledge capital model*. The presence of knowledge capital as an important firm-specific asset leads to the issue of ***dissemination risk***.

Dissemination risk refers to the possibility of a foreign firm obtaining knowledge capital of the home-country firm and exploiting it for its own commercial advantage. This risk is especially prevalent (widely spread) in the licensing mode of entry.

Given the possibility of dissemination risk for knowledge-intensive firms, FDI can be a favored means of entry. However, it also requires a greater degree of resource commitment on the part of the home-country firms.

Suppose a firm's most important concern was the degree of control over the production and marketing process. This would draw the firm toward an investment mode of foreign market entry based on a subsidiary obtained either through M&A or greenfield investment. Alternatively, if a firm were concerned only with limiting resource commitment to low levels, it would consider either trade or contractual modes of foreign market entry. Finally, if a firm were solely concerned with maintaining a low degree of dissemination risk, then either trade or investment via a subsidiary would be the preferred mode of entry. In most instances, firms have more than one primary concern, so the entry strategy is less than clear-cut.

3. Motivations for international production

Now that we have a sense of the means by which firms engage in international production, the next step is to say something about the ***motivations*** for these activities.

Two central motivations that have emerged from international business research are *resource seeking* and *market seeking*. We consider each in turn.

A primary motivation for international production is **resource seeking**. Here, the home-country firm is trying to gain access to certain resources in a foreign country. The resources involved could be natural resources such as minerals or timber, as well as human resources such as inexpensive or specially trained labor. Despite the continued relevance of resource-seeking as a motivation for international production, the gradual shift over time away from resource seeking international production is one of the most important aspects of the history of TNCs. In the current era, therefore, use of a simple mental model in which TNCs locate production solely based on wage considerations is incomplete. *For example, the province of Ontario, Canada, has been a destination of a great deal of foreign investment, and this province has wage rates and benefits packages that exceed even those of the United States.*

A second, growing reason for international production is **market seeking**. A number of considerations can be active here. ***First***, international production might be necessary to adopt and tailor products to local needs. ***Second***, international production might be required to effectively deliver a product, as is the case for many financial services. ***Third***, international production might be required for a firm supplying intermediate products to another firm opening up operations in a foreign country. *For example, Japanese auto parts firms often follow Japanese auto companies to Europe and the United States*. ***Finally***, firms may simply locate where they expect demand to grow in the future. This certainly has been the case in China where, despite losses, many foreign firms maintain at least small operations. Why? A deputy chairman of a

Malaysian conglomerate once stated: *"You cannot not be there"*. The reason for this statement was the anticipated growth of the market.

Along with the two central motivations for international production of resource seeking and market seeking, there are ***two subsidiary motivations***. One of these is **efficiency seeking**. The concern here *"is to rationalize the structure of established resource-based or market-seeking investment in such a way that the investing company can gain from the common governance of geographically dispersed activities"*. These efficiencies may stem (arise) from economies of scale, economies of scope, etc. The efficiency-seeking motivation is most important for large, mature TNCs with a great deal of international experience.

The next subsidiary motivation is **strategic asset seeking**. This motivation can be quite important for M&As in the current era but can also be difficult to comprehend. Strategic asset-seeking behavior tends to be part of the strategic game among competitors in oligopolistic sectors.

To take one example, some time ago the U.S.-based TNC Kodak established a film sales affiliate in Japan called Nagase. The purpose of Nagase was not limited to the market-seeking motivation. A further motivation was to attack the profit sanctuary of the Japanese film company Fujifilm. As alleged by a Kodak executive, "While Fuji competes with Kodak on a global basis, it makes virtually all of its profits in Japan, using those proceeds to finance low-price sales outside Japan".

Well, for Kodak, Nagase was a strategic asset.

LECTURE 8

International Labor Mobility

Thematic Content of the Lecture:

1. Present-day international labor migration
2. The determinants of international labor migration
3. The effects of international labor migration
4. The modern international centers of labor migration

1. Present-day international labor migration

In the previous lectures we saw how goods (services) and capital can be mobile. Now it's time to focus on labor which can also be mobile internationally by means of emigration or immigration.

International migration is the movement of people from one country (***the sending country***) to another country (***the receiving country***) in which they plan to reside for some noticeable period of time, usually, more than a year. International migration has played an enormous role in the past expansion of receiving countries. Indeed, most of the populations of the Western Hemisphere and of Australia and New Zealand consist of descendants of those who immigrated in the past several centuries. In addition, since

1960 the fastest-growing migration has been from developing countries to industrialized (developed) countries.

Currently in the world there are more than 214 million of international migrants. International migration of the population has played an increasingly significant role in the development of societies and has become a global process that covered almost all the continents and countries, as well as various social strata. The total number of international migrants increases continuously.

More than half of migrants come from developing countries and countries with economies in transition. From these countries over the past decade, industrialized nations have taken nearly 24 million migrants, in other words, the annual inflow of migrants is an average of 2.3 million people, of whom 1.4 million went to the North America and 800 thousand – to Europe.

International labor mobility is one of the objective bases for creating an integrated international system. At the same time, the problem of free migration is the most dangerous for governments, both politically and in the social aspect. Ethnic and religious superstition and direct economic threat to the interests of particular groups who are afraid of competition from immigrants make this problem too spicy. For politicians, the issue of migration is a *"hot potato that it is better not to take out of the fire"*. Therefore, during the migration policy implementation is very important to know the nature and general economic and social implications.

The international migration consists of two basic interdependent processes: emigration and immigration. **Emigration** is a departure of a labor force from one country to another, **immigration** is the entrance of the labor force to the receiving country. Also as a part of international flows of people one can distinguish **remigration** which is the return of the labor to the country of origin.

The main forms of migration include:

- **permanent migration**. This form of migration prevailed over others before World War I and is characterized by the fact that lots of people were left their countries for the permanent residence in the USA, Canada, Australia etc.;
- **temporary migration** providing the migrant's homecoming on the expiration of certain term. In this connection it is necessary to notice that modern labor migration has got rotational character;
- **illegal migration** which is rather favorable to businessmen of the receiving country as supplies an original reserve of cheap labor necessary for them.

There are other types of international migration with different degrees of relevance to the issue of international production. To take one possible categorization some scholars distinguish among *nine different types* of international migration. Let's briefly consider each of them here:

Permanent high-skilled migration involves permanent residence and is sometimes granted in countries such as Australia, New Zealand, Canada, the United States, and the European Union. It is granted to high-skilled migrants often at the urging of hiring corporations such as the multinational enterprises (MNEs/TNCs). Leading source countries include China and India.

Temporary high-skilled migration is similar in motivation to permanent high-skilled migration but can be more politically detrmined in some cases where there is political resistance to granting permanent residence.

Temporary low-skilled migration is more important in volume than temporary high-skilled migration. Temporary low-skilled migration includes migrant workers in the areas of manual labour, construction, domestic service, and nursing.

Family migration allows permanent residence to the families of those who have already gained this residence. It is considered that family migration is among the largest channels of migration and represents a disproportionate share of flows from low- and middle-income countries to high-income countries.

Coethnic and national priority migration exists in some countries and involves granting permanent residence based on ethnic background, religious affiliation, and national origin. The most famous and controversial is Israel's *"Law of Return"*.

Asylum seekers are granted certain rights by the 1951 Geneva Convention addressing persons with well-founded fears of persecution.

Refugees are those who flee to neighboring countries to escape war, famine (hunger), or environmental catastrophes. International organizations estimate that there were about 25 million refugees in the world in 2017.

Undocumented migration involves both voluntary and nonvoluntary (trafficked) illegal migrants. In some regions (e.g., North America and part of Africa) these flows can be quite significant. The International Organization for Migration (IOM) estimates that there are about 25 million undocumented migrants.

Visa-free migration relates to common markets that involve the free movement of both labor and capital. The European Union is a prime example of visa-free migration, but this arrangement also exists between Australia and New Zealand, for example.

All of these nine types of migration are important from political, human rights, and public policy perspectives, but not all of them are relevant to international production.

Differently organized and directed international flows of labor force, which cross national borders, create the international labor market functioning in interrelation with the markets of capital, goods and services.

2. The determinants of international labor migration

Economists have long studied migration, as have sociologists, demographers, political scientists, and other social scientists. Each discipline brings its own tools of analysis and contributes another piece to our understanding of the determinants and effects of migration. Sociologists and anthropologists, for example, have helped to clarify that the decision to migrate is often a family decision or, in some cases, a community decision to send one of its members abroad. Political scientists have helped to clarify how migration policies are set and enforced, or not enforced, as the case may be. The economic view of migration tends to understand it in terms of the individual migrant and the underlying incentives to migrate. In this view, *economic incentives*

play a major role by determining the factors that cause migrants to leave and the factors that attract them to a particular destination.

Economists refer to **supply-push factors** as the forces inside a country that cause people to think about leaving. Push factors include recessions, long-run structural changes that cause job dislocations, wars, natural disasters, and anything else that makes life difficult at home. Examples of structural changes include the recent transformations of Eastern European economies, Latin American economic reforms, and industrial development in many parts of the globe. In the near future, we can expect large migrations from changing agricultural patterns and the inundation (flood) of coastal areas as a result of climate change.

Demand-pull factors are the forces that pull migrants to a particular country. Key factors include the cost of reaching a particular destination, the probability of finding a job, and the wage that will be earned. The wage gap between developed countries and developing countries explains a large share of the flow of migrants, but other factors are important as well. The business cycle in the receiving country, its migration policies, and the overall set of opportunities encountered by foreign workers are all important demand-pull factors.

A third factor determining migration is the existence of **social networks**. Migrants do not scatter randomly around a desirable destination, but instead congregate in certain places. This is partly due to job opportunities, but it also reflects the fact that migration is hard and expensive and the presence of family or community members makes it a little easier. The supply of information about the new locale is better if there are already migrants who can report home on conditions, and who can help newcomers become established with a place to live, a job, and familiar faces to ward off (avoid) loneliness.

3. The effects of international labor migration

Redistribution of the world's labor force proves that ***the sending country*** loses economic well-being because of emigration. Employers (and consumers of the products produced by these firms) lose more than the domestic workers gain. Knowing that means that the sending countries should try to restrict somehow emigration. But first at all let's look at some important costs and benefits of emigration for the sending country

First, let's look at the effects on **the government budget**. The sending-country government loses the future tax payments that the emigrants would have made. At the same time, those who emigrate no longer require government goods, services, and public assistance, so government spending also goes down. However, some public-expenditure items are true *"public goods"* in the economic sense that one person's enjoyment does not increase if there are fewer other users. That is, to provide the same level of benefits to the people who do not emigrate, the government has to continue spending the same amount of money. Examples of true public goods include national defense and flood-control levees.

Because some government spending is for true public goods, the loss of future tax contributions is likely to be larger than the reduction in future government spending as people migrate from the sending country. The likelihood of a net fiscal drain from emigration is raised by the life-cycle pattern of migration. People tend to migrate in early adulthood. This means that emigrants are concentrated in the age group that has just received some public schooling funded by the government, yet the migrants will not be around to pay taxes on their adult earnings. For this age group, the net loss to the sending country is likely to be largest for highly skilled emigrants – *the brain drain*. They have received substantial education at public expense, and they would pay substantial taxes on their above-average earnings if they stayed. For example, in some small developing countries, including Guyana, Haiti, Jamaica, Senegal, Mozambique, and Trinidad and Tobago, over half of the college-educated people have emigrated.

There is also a monetary benefit to the sending country that is not captured in the examination of the labor market effects of migration. Those who emigrate often send **voluntary remittances** back to relatives and friends in their home country. Globally, emigrants send home at least $400 billion in remittances per year. Remittances add over 20% to the national incomes of such countries as Haiti, Lesotho, Moldova, Nepal, and Tajikistan. Sending countries that do not receive much in the way of remittances probably lose well-being, but those that receive substantial remittances probably gain well-being.

What could the sending country do to try *to restrict emigration or its negative effects*? It could simply block departures. However, this would probably require severe restrictions on any foreign travel, with all of the losses that such travel restrictions would impose on the businesses and people of the country. A more defensible policy would be a tax on emigrants that is roughly equal to the net contributions the country has made to them through public schooling and the like. An alternative policy approach is to encourage return after the emigrant has been gone for a while, by appealing to national pride, offering good employment, and so forth. Taiwan and South Korea, for instance, have encouraged the return of their scientists and engineers to work in their rapidly developing high-tech industries.

On the other side we can argue that ***the receiving country*** gains economic well-being because of immigration, even if we ignore the gains to the migrants themselves. Employers (and consumers of the products produced by these firms) gain more than the native workers lose. But again let's examine some costs and benefits this time – of immigration for the receiving country.

The effects here are symmetrical to those noted for the sending country. Immigrants **pay taxes** in their new country, and they use government goods and services. Some of the government goods and services are pure public goods, so we begin with a presumption that the tax payments are larger than the extra government spending required to serve the immigrants. However, there is a concern in many receiving countries that immigrants use government social services disproportionately. This suspicion was the basis for a 1996 U.S. law that made even legal immigrants ineligible for some forms of public assistance.

The true fiscal effects of immigrants are hard to measure. However, there is consensus that immigrants generally were major net taxpayers, not a fiscal drain. There is also consensus that the fiscal effects of an immigrant depend on the skill level of the immigrant. More-educated, more-skilled immigrants have higher earnings, pay larger taxes, and are less likely to use public assistance. For the United States, for example, since 1970, the fiscal balance is shifting toward immigrants being a fiscal burden because the average skill level of immigrants is declining relative to that of natives. Still, any net positive or net negative effect on the government budget from current immigration into the United States is probably small.

Other possible effects of immigration include **knowledge benefits**. People carry knowledge with them, and much of that knowledge has economic value, be it tricks of the trade, food recipes, artistic talent, farming practices, or advanced technology. American examples include migrants *Andrew Carnegie*, *Albert Einstein*, and many virtuosi of classical music. Often only part of the economic benefits of this knowledge accrues to the migrants and those to whom the migrants sell their services. Part often spills over to others, especially others in the same country. Migration may thus transfer external benefits of knowledge from the sending to the receiving country.

At the same time immigration provokes **congestion costs**. Immigration, like any other source of population growth, may bring external costs associated with crowding: extra noise, conflict, and crime. If so, then this is a partial offset to the gains of the receiving country.

It's also necessary to remember about **social friction (tension)**. Immigrants are often greeted with bigotry (intolerance) and harassment – even from native groups that would benefit from the immigration. Long-lasting restrictions on the freedom to migrate, such as American discrimination against Asian immigrants beginning in the late 19th century, the sweeping restrictions during the "red scare" of the early 1920s in the United States, and Britain's revocation (cancellation) of many Commonwealth passport privileges since the 1960s, have been motivated largely by simple dislike for the immigrating nationalities.

In theory, as we know, if the endowment of a particular factor increases, then the relative abundance of the factor and, potentially, its comparative advantage also changes. In practice, labor inflows are often used to produce services that are not traded. For example, two countries with large percentages of foreigners in their population are Qatar (86,5% of residents are immigrants) and the United Arab Emirates (70,0% of residents are immigrants). A large share of the foreign workers in those countries are Filipinos, Palestinians, and other migrants who work as domestics, providing cleaning, cooking, day care, and other services that cannot be traded.

These migrants do not have a direct impact on the host country's comparative advantage since the labor is not used to produce tradable goods (although they free up citizens to work in the export sector). However, many migrant workers are also engineers and business specialists who provide technical expertise to the oil and gas industry. Without some high-skilled migrant labor, it is possible that production in these oil- and gas-producing countries would be much more limited.

Most international migration is from developing to developed countries. For example, in the 1980s and 1990s, civil wars in Central America produced large outflows of Salvadorian and Guatemalan immigrants to the United States, many of whom settled in California where some found employment in apparel manufacturing. California's apparel sector added over 40,000 jobs between 1983 and 1997 (a growth of almost 50%), largely based on the availability of low-wage, unskilled immigrant workers. Given that apparel is a declining sector in the United States, immigrant labor appears to have postponed the decline of the industry in California for about a decade. Other U.S. examples of where immigration influences comparative advantage include certain agricultural crops that depend on abundant supplies of immigrant labor and the tourism industry. In these cases, increases in the supply of unskilled labor shifted production towards industries that intensely use that factor of production. Taking into account everything mentioned above, we can single out **production benefits** of labor migration for the receiving countries.

Finally, international labor mobility ***on the global*** level can lead to:

- increasing of the world's output as a whole;
- a convergence of real wage rates. Real wages rise in the sending countries and fall in the receiving ones;
- substantial costs and benefits for different groups of people. For example, landowners in the receiving countries benefit from the larger labor supply, but landowners in the countries of emigration suffer from its decline.

4. The modern international centers of labor migration

The international labor migration in modern conditions has got a character of the global process. Migration captures the majority of the countries of the world. The quantity of the countries involved in the international migratory process, has essentially increased, first of all at the expense of Central and Eastern Europe, as well as CIS. According to the experts' forecast, the quantity of migrants which are accepted by the developed countries, will remain at high level in the nearest decades.

In the second decade of 21st century countries leading in emigration were Mexico, India, China, Russia, Ukraine and, in turn, countries leading in immigration were the USA, Russia, Germany, Saudi Arabia and Canada.

As the major centers of gravity of foreign workers, which define modern directions of the international labor migration, can be identified as: *North and South America, Western Europe (EU), South-East and Western Asia*. The largest centers of migrants attraction are **the USA and Canada** (their readiness to accept foreigners is estimated about 1,1 million and more than 200 thousand people per year correspondingly).

The European Union is another place of destination where the aggregate number of the people captured by migration during the post-war period is estimated in 30 million people. It is a common fact that during last 20 years over 1 million people annually move, looking for a job, from one European country to another, i.e. take part

in the intercontinental exchange of labor. For modern European migrations such directions are characteristic:

- from less developed countries of Southern and Eastern Europe (Greece, Spain, Turkey, Poland, Hungary, Ukraine, etc.) to the advanced countries of Western and Northern Europe (France, Great Britain, Germany, Sweden, etc.);
- from the countries of North Africa, India, Pakistan to the West European labor market;
- labor movements from one advanced country to another.

Number of the foreigners living today in the EU countries reaches 17-21million people, 12-14 million people of whom (about 4% of the population of EU) arrived from the countries which are not members of the Union. Among them 29% of migrants are citizens of Turkey and former Yugoslavia, 20,7% – citizens of the African countries, 7% – Americas, 13,6 % – Asia, 7,8 % – the countries of Central and Eastern Europe.

Among the EU countries which have accepted the majority of foreigners the first places occupy: Germany (over 7 million people); France (about 5 million people) and Great Britain (about 3 million people). The main countries of emigration to Germany are Turkey, the countries of the former Yugoslavia, Italy, Greece and Poland; to France – Algeria, Morocco and Portugal; to Great Britain – India.

The important centre of labor force gravity is **Australia** and **New Zealand**. The area of **Persian Gulf (Middle East)** became a new concentration place of international groups of labor, where in 1975 the aggregate number of foreign population in 6 countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates) was 2 million people, and at the beginning of the 21st century – 4 million people or about 40% of all population. The majority of the Arabian emigrants arrives from Palestine, Egypt, Iraq, Syria, Jordan.

In **Africa** the centers of gravity are the countries of Southern and Central Africa. The aggregate number of migrants in all countries of Africa reaches 6 million people.

Besides during the last 2 or 3 decades the new centers of gravity of foreign workers appeared. These include, in the first place, **newly industrialized countries** of Asian-Pacific region. And in Latin America they are Argentina and Brazil.

LECTURE 9

International Technology Transfer

Thematic Content of the Lecture:

1. The essence and forms of international technology transfer
2. Characteristic features of international technology transfer
3. The role of licenses in international technology transfer

1. The essence and forms of international technology transfer

The international **technological exchange/technology transfer (ITT)** is the complex of economic relations between different countries concerning the transfer of scientific and technological achievements – technologies.

The scientific and technical knowledge can be bought and sold in the world market, which is the result of scientific research, engineering and experience of their commercial exploitation, as well as engineering services for the use of scientific, technical/technological and managerial developments. **Technologies** are the objects of intellectual property, possessing both scientific and commercial values.

As commodities technologies include the following:

- a ***patent*** is a certificate, which is issued by the proper government agency to an inventor and certifies its monopoly for the use of the invention;
- a ***license*** is an agreement involving the transfer of rights from one party (*"the licensor"*) to the other (*"the licensee"*). These rights commonly control the use (for copying, manufacture, sale etc.) of intellectual property products (a patent, copyright material, confidential know-how etc.);
- a ***copyright*** is an exclusive right of an author of a literary, audio or video product for display and reproduction of his/her work;
- a ***trademark*** is a symbol (a picture, graphics, combination of letters, etc.) of a particular company which is used to personalize the product manufacturer and which cannot be used by other organizations without the official permission of the owner;
- ***non-divulged information (know-how)***, which is secret and kept in secret, has commercial value and is provided to the government and non-governmental organizations in order to manufacture certain products;
- a ***variety of technical, design, commercial and marketing documentation***.

These products of intellectual property belong to so-called *commercial forms* of international technology transfer, i.e. they are traded in the world technological market. However, it should be noted that there are also *non-commercial forms* of international technological exchange:

- technical, scientific and professional journals, patent publications, periodicals and other specialized literature;
- database and databanks;
- international exhibitions, fairs, symposia, conferences;
- exchange of delegations;
- migration of scientists and specialists;
- training of scientists and specialists in companies, universities and organizations;
- education of undergraduate and graduate students;
- activities of international organizations in the field of science and technology.

2. Characteristic features of international technology transfer

Today ITT can be characterized by certain ***specific features***:

1. **The development of the world market of high technologies**. The generally accepted classification of high technologies for exports and imports of products, containing new and leading technology, is the classification developed in the USA, which is used by international organizations for statistical comparisons of different countries. The classification system allows to explore the trade in products of high technology in 10 main technological sectors: biotechnology; human life science technology; optoelectronics; computers and telecommunications; electronics; computerized production; new materials; aerospace technology; armament (weapon); nuclear technology.

2. **The monopoly of large firms in technology markets**. Research and development are concentrated in the largest firms of the developed countries, since only they have sufficient financial means for expensive research. Transnational corporations (TNC) actively attract for research and development (R&D) their foreign subsidiaries, thus radically increasing the expenses for scientific research in the total amount of the expenses.

3. **Technology policy of TNCs**. In recent years there have been changes in the trends of R&D of TNCs. Research moves to the industries that determine success in the production and marketing activities:

- enhancement of traditional kinds of products to meet the requirements of the world market concerning the indicators of inmaterial intensity, energy efficiency, security, reliability, etc.;
- creation of innovative products, market research, where you can expect high returns;
- improvement of the existing technology and creation of a new one.

Besides, as main actors in the world technological market TNCs apply *new approaches* to the transfer of scientific and technological achievements:

- sale of licenses at the initial stages of the life cycle of products in order to cover the expenses for R&D by incomes from realization of their results;
- establishment of exclusively high prices for the patented products and limitation of the production and output of a new product by license buyers;
- agreement undertaking between TNCs to obtain exclusive rights to the patents for the most important inventions. The use of patents to control technique development or to hamper this development;
- deprivation of TNCs subsidiaries the autonomy in the choice of equipment and technology. They should be guided by the general licensing policy within the TNCs;
- TNCs transmission of licenses in non-commercial terms to their subsidiaries and affiliates;
- the establishment of strategic alliances between TNCs from different countries to solve jointly the scientific and technological problems.

4. **Relationships between TNCs and developing countries**. TNCs try to create a structure of international division of labor, which would provide economic and technical dependency of the developing countries. For example, in these countries, TNCs very often create enterprises that produce components which at the end must be directed to the parent companies to produce final goods. Transferring the technology for manufacturing intermediate products to the countries with cheap labor force TNCs reduce the cost of the final goods.

TNCs often move to the developing countries the production of goods the lifecycle of which expired and the profit from sales of which gradually decreases. Subsidiaries receive these goods at low prices and then sell them through their marketing network under TNC trademark, getting a higher profit.

A technology, which is transferred to the developing countries, is generally ill-adapted to their possibilities, because it takes into account the level of development and the structure of the industry in the developed countries. In general, developing countries account for about 10% of international technological exchange due to the small capacity of their technological markets.

5. **Participation in ITT of "venture" firms** (small and mid-sized firms employing up to 1000 people). The advantage of these firms in the market of technologies is a narrow specialization. Producing a limited product line, these firms have access to highly specialized global markets; they do not bear additional expenses for market research, advertising; they pay more attention to the direct solving of scientific and technical problems. However, such limited specialization in some cases can be very risky.

6. **Development of international technical assistance**. This assistance is provided by the developed countries to the developing countries (countries with economies in transition) in the field of the transfer of technical knowledge, experience, technologies, technology-intensive products, personnel trainings.

The main buyers in the world technological market are the following: foreign subsidiaries of TNCs and other independent firms. Speaking about independent firms they usually buy technology of the industries where the expenses for R&D are small (metallurgy, metal processing, textile and clothing industry).

Results of intellectual activities are sold in the world market mainly due to international licensing agreements as well as *contracts for engineering services* (*individual report*).

3. The role of licenses in international technology transfer

International license trade is the main economic mechanism of international technological exchange and currently has become widespread. The growth of international license trade is due to ***a number of factors*** that encourage firms to sell and buy licenses in the world market:

- commercial interest in the technology transfer;
- increased competition in the world market;
- acceleration of new products placing in the market;
- gain of access to additional resources;

- penetration and winning of difficult markets in the countries with high tariff and non-tariff barriers;
- profits from the sale of licenses for the products that do not meet the new strategic priorities;
- countries with limited resources of scientific and technological development, participating in international technological exchange, have an opportunity to take a stable position in the world market without additional costs;
- licenses help to create advertising of domestic products and increase demand in other countries, as well as explore foreign markets;
- political and legal motivations.

International license relationships are mostly between the developed countries. The proportion of the developed countries is almost 98% in the total revenues from international license trade.

In general, the turnover of license trade is about 30 billion dollars per year. However, the significance of this market is defined by the fact that the prices of products, manufactured in different countries with the help of foreign licenses, are estimated in 330-400 billion dollars annually. The leading position in the market of licenses belongs to the USA (65% of income of the developed countries from license export).

The objects of licenses are as follows:

- a patented invention or technological process;
- technological knowledge and experience;
- know-how, i.e. technical knowledge, practical experience of technical, productive, managerial, financial and other nature which has commercial value and can be successfully applied in production process and professional practice (such experience is never provided with patent protection);
- copyright;
- industrial designs (new art and design solutions, which define external appearance of the product);
- trademark.

Licensing agreements are typically concluded for 5-10 years.

LECTURE 10

Exchange Rate and Foreign Exchange Market

Thematic Content of the Lecture:

1. Exchange rates and international transactions

2. Characteristics of the foreign exchange market and its main actors

3. Spot and forward rates, instruments in the foreign exchange market

1. Exchange rates and international transactions

In the first years of the millennium, Americans flocked to Paris to enjoy French cuisine while shopping for designer clothing and other specialties. When measured in terms of dollars, prices in France were so much lower than they had been a few years before that a shopper's savings could offset (cover) the cost of an airplane ticket from New York or Chicago. Five years later, however, the prices of French goods again looked high to Americans. What economic forces made the dollar prices of French goods swing so widely? One major factor was a sharp fall in the dollar price of France's currency after 1998, followed by an equally sharp rise starting in 2002.

The price of one currency in terms of another is called an **exchange rate**. At 5 P.M. London time on April 3, 2018, you would have needed 1,2270 dollars to buy one unit of the European currency, the euro, so the dollar's exchange rate against the euro was $1,2270 per euro.

Because of their strong influence on the current account and other macroeconomic variables, exchange rates are among the most important prices in an open economy. First of all, exchange rates play a central role in international trade because they allow us to compare the prices of goods and services produced in different countries. A consumer deciding which of two American cars to buy must compare their dollar prices, for example, (for a Lincoln Continental) or (for a Ford Taurus). But how is the same consumer to compare either of these prices with the 2,500,000 Japanese yen it costs to buy a Nissan from Japan? To make this comparison, he or she must know the **relative price** of dollars and yen.

The relative prices of currencies are reported daily in newspapers' financial sections or official financial web-sites (in the Internet). An exchange rate *can be quoted in two ways*:

- as the price of the foreign currency in terms of dollars (for example, $0,01194 per 1 yen);
- as the price of dollars in terms of the foreign currency (for example, 83,77 yen per 1 dollar).

The first of these exchange rate quotations (dollars per foreign currency unit) is said to be in ***direct (or "American") terms***, the second (foreign currency units per dollar) in ***indirect (or "European") terms***.

Households and firms use exchange rates to translate foreign prices into domestic currency terms. Once the money prices of domestic goods and imports have been expressed in terms of the same currency, households and firms can compute the relative prices that affect international trade flows.

If we know the exchange rate between two countries' currencies, we can compute the price of one country's exports in terms of the other country's money. For example, how many dollars would it cost to buy an *Edinburgh Woolen Mill* sweater costing 50 British pounds (£50)? The answer is found by multiplying the price of the sweater in pounds, 50, by the price of a pound in terms of dollars – the dollar's exchange rate against the pound. At an exchange rate of $1,50 per pound (expressed in American terms), the dollar price of the sweater is:

(1.50$/£) * (£50) = $75.

A change in the dollar/pound exchange rate would alter the sweater's dollar price. At an exchange rate of $1.25 per pound, the sweater would cost only:

(1.25 $/£) * (£50) = $62,50.

At an exchange rate of $1,75 per pound, the sweater's dollar price would be higher, equal to:

(1.75 $/£) * (£50) = $87,50.

Changes in exchange rates are described as *depreciations* or *appreciations*. A **depreciation** (decreasing of the price) of the pound against the dollar is a fall in the dollar price of pounds, for example, a change in the exchange rate from $1,50 per pound to $1,25 per pound. The preceding example shows that *all else equal, a depreciation of a country's currency makes its goods cheaper for foreigners*. A rise in the pound's price in terms of dollars – for example, from $1,50 per pound to $1,75 per pound – is an **appreciation** (increasing of the price) of the pound against the dollar. *All else equal, an appreciation of a country's currency makes its goods more expensive for foreigners.*

As you can see, descriptions of exchange rate changes as depreciations or appreciations can be bewildering, because when one currency depreciates against another, the second currency must simultaneously appreciate against the first. If we remember that a depreciation of the dollar against the pound is at the same time an appreciation of the pound against the dollar, we reach the following conclusion:

When a country's currency depreciates, foreigners find that its exports are cheaper and domestic residents find that imports from abroad are more expensive. An appreciation has opposite effects – foreigners pay more for the country's products and domestic consumers pay less for foreign products.

2. Characteristics of the foreign exchange market and its main actors

Just as other prices in the economy are determined by the interaction of buyers and sellers, exchange rates are determined by the interaction of the households, firms, and financial institutions that buy and sell foreign currencies to make international payments. The market in which international currency trades take place is called the **foreign exchange market**.

Foreign exchange trading takes place in many financial centers, with the largest volumes of trade occurring in such major cities as London (the largest market), New York, Tokyo, Frankfurt and Singapore. The worldwide volume of foreign exchange trading is enormous, and it has ballooned in recent years. In April 1989, the average

total value of global foreign exchange trading was close to $600 billion per day. Twenty-one years later, *in April 2010*, the daily global value of foreign exchange trading had jumped to around $4,0 trillion. A total of $1,85 trillion was traded daily in Britain, $904 billion in the United States, and $312 billion in Japan.

Telephone, fax, and Internet links among the major foreign exchange trading centers make each a part of a single world market on which the sun never sets. Economic news released at any time of the day is immediately transmitted around the world and may set off numerous activities by market participants. Even after trading in New York has finished, New York-based banks and corporations with affiliates in other time zones can remain active in the market. Foreign exchange traders may deal from their homes when a late-night communication alerts them to important developments in a financial center on another continent.

The integration of financial centers implies that there can be no significant difference between the dollar/euro exchange rate quoted in New York at 9 A.M. and the dollar/euro exchange rate quoted in London at the same time (which corresponds to 2 P.M. London time). If the euro were selling for $1,1 in New York and $1,2 in London, profits could be made through **arbitrage**, the process of buying a currency cheap and selling it dear. At the prices listed above, a trader could, for instance, purchase €1 million in New York for $1,1 million and immediately sell the euros in London for $1.2 million, making a pure profit of $100,000. If all traders tried to cash in on the opportunity, however, their demand for euros in New York would drive up the dollar price of euros there, and their supply of euros in London would drive down the dollar price of euros there. Very quickly, the difference between the New York and London exchange rates would disappear. Since foreign exchange traders carefully watch their computer screens for arbitrage opportunities, the few that arise are small and very short-lived.

While a foreign exchange transaction can match any two currencies, most transactions (roughly 85%) are exchanges of foreign currencies for U.S. dollars. This is true even when a bank's goal is to sell one nondollar currency and buy another! A bank wishing to sell *Swiss francs* and buy *Israeli shekels*, for example, will usually sell its francs for dollars and then use the dollars to buy shekels. While this procedure may appear roundabout, it is actually cheaper for the bank than the alternative of trying to find a holder of shekels who wishes to buy Swiss francs. The advantage of trading through the dollar is a result of the United States' importance in the world economy. Because the volume of international transactions involving dollars is so great, it is not hard to find parties willing to trade dollars against Swiss francs or shekels. In contrast, relatively few transactions require direct exchanges of Swiss francs for shekels.

Because of its pivotal role in so many foreign exchange deals, the U.S. dollar is sometimes called a **vehicle currency** (key currency). A vehicle currency is one that is widely used to denominate international contracts made by parties who do not reside in the country that issues the vehicle currency. It has been suggested that the euro, which was introduced at the start of 1999, will evolve into a vehicle currency on a par with the dollar. By April 2010, about 39% of foreign exchange trades were against euros – less than half the share of the dollar. Japan's yen is the third most important

currency, with a market share of 19%. The pound sterling, once second only to the dollar as a key international currency, has declined greatly in importance.

The *major participants* in the foreign exchange market are commercial banks, corporations that engage in international trade, nonbank financial institutions such as asset-management firms and insurance companies, and central banks. Individuals may also participate in the foreign exchange market – for example, the tourist who buys foreign currency at a hotel's front desk – but such cash transactions are obviously an insignificant fraction of total foreign exchange trading.

Let's now describe the major actors in the market and their roles.

1. Commercial banks. Commercial banks are at the center of the foreign exchange market because almost every sizable international transaction involves the debiting and crediting of accounts at commercial banks in various financial centers. Thus, the vast majority of foreign exchange transactions involve the exchange of bank deposits denominated in different currencies.

Banks routinely enter the foreign exchange market to meet the needs of their customers – primarily corporations. In addition, a bank will also quote to other banks exchange rates at which it is willing to buy currencies from them and sell currencies to them. Foreign currency trading among banks – called *interbank trading* – accounts for much of the activity in the foreign exchange market.

Because their international operations are so extensive, large commercial banks are well suited to bring buyers and sellers of currencies together. A multinational corporation wishing to convert $100,000 into Swedish kronor might find it difficult and costly to locate other corporations wishing to sell the right amount of kronor. By serving many customers simultaneously through a single large purchase of kronor, a bank can economize on these search costs.

2. Corporations. Corporations with operations in several countries frequently make or receive payments in currencies other than that of the country in which they are headquartered. To pay workers at a plant in Mexico, for example, IBM may need Mexican pesos. If IBM has only dollars earned by selling computers in the United States, it can acquire the pesos it needs by buying them with its dollars in the foreign exchange market.

3. Nonbank financial institutions. Over the years, deregulation of financial markets in the United States, Japan, and other countries has encouraged nonbank financial institutions such as *mutual funds* (investment funds) to offer their customers a broader range of services, many of them indistinguishable from those offered by banks. Among these have been services involving foreign exchange transactions. Institutional investors such as *pension funds* often trade foreign currencies. So do *insurance companies*. *Hedge funds*, which cater to very wealthy individuals and are not bound by the government regulations that limit mutual funds' trading strategies, also trade actively in the foreign exchange market.

4. Central banks. While the volume of central bank transactions in the foreign exchange market is typically not large, the impact of these transactions may be great. The reason for this impact is that participants in the foreign exchange market watch central bank actions closely for clues about future macroeconomic policies that may

affect exchange rates. Government agencies other than central banks may also trade in the foreign exchange market, but central banks are the most regular official participants.

3. Spot and forward rates, instruments in the foreign exchange market

The foreign exchange transactions we have been discussing above usually take place on the spot, i.e. two parties agree to an exchange of bank deposits and execute the deal immediately. Exchange rates governing such "*on-the-spot*" trading are called **spot exchange rates**, and the deal is called a spot transaction.

Foreign exchange deals sometimes specify a future transaction date – one that may be 30 days, 90 days, 180 days, or even several years away. The exchange rates quoted in such transactions are called **forward exchange rates**. In a 30-day forward transaction, for example, two parties may commit themselves on April 1 to a future exchange of £100,000 for $155,000 on May 1. The 30-day forward exchange rate is therefore $1.55 per pound, and it is generally different from the spot rate and from the forward rates applied to different future dates.

When you agree to sell pounds for dollars on a future date at a forward rate agreed on today, you have "*sold pounds forward*" and "*bought dollars forward*". The future date on which the currencies are actually exchanged is called ***the value date***. Forward and spot exchange rates, while not necessarily equal, in fact, do move closely together.

Described two types of rates are closely connected with *financial instruments* traded in the foreign exchange market.

For instance, when you buy a **futures contract**, you buy a promise that a specified amount of foreign currency will be delivered on a specified date in the future. A **forward contract** between you and some other private party is an alternative way to ensure that you receive the same amount of foreign currency on the date in question. But while you have no choice about fulfilling your end of a forward deal, you can sell your futures contract on an organized futures exchange, realizing a profit or loss right away. Such a sale might appear advantageous, for example, if your views about the future spot exchange rate were to change.

A **foreign exchange swap** is a spot sale of a currency combined with a forward repurchase of that currency. For example, suppose the *Toyota* auto company has just received $1 million from American sales and knows it will have to pay those dollars to a California supplier in three months. Toyota's asset-management department would meanwhile like to invest the $1 million in euro bonds. A three-month swap of dollars into euros may result in lower brokers' fees than the two separate transactions of selling dollars for spot euros and selling the euros for dollars on the forward market. Swaps make up a significant proportion of all foreign exchange trading.

A **foreign exchange option** gives its owner the right to buy or sell a specified amount of foreign currency at a specified price at any time up to a specified expiration date. The other party to the deal, the option's seller, is required to sell or buy the foreign currency at the discretion (demand) of the option's owner, who is under no obligation to exercise his right.

Imagine that you are uncertain about when in the next month a foreign currency payment will arrive. To avoid the risk of a loss, you may wish to buy a *put option* giving you the right to sell the foreign currency at a known exchange rate at any time during the month. If instead you expect to make a payment abroad sometime in the month, a *call option*, which gives you the right to buy foreign currency to make the payment at a known price, might be attractive. Options can be written on many underlying assets (including foreign exchange futures), and, like futures, they are freely bought and sold. Forwards, swaps, futures, and options are all examples of **financial derivatives**.

LECTURE 11

The Balance of Payments Accounts

Thematic Content of the Lecture:
1. The notion and structure of the balance of payments
2. Official reserve transactions, net errors and omissions
3. The nature of the balance of payments' paired transactions
4. Equilibrium and disequilibrium in the balance of payments

1. The notion and structure of the balance of payments

The balance of payments (BoP) is a summary of all economic transactions of the residents of a nation with the residents of the rest of the world during a particular period of time – usually a calendar year. In other words, a country's balance of payments accounts keep track of both its payments to and its receipts from foreigners. Any transaction resulting in a receipt from foreigners is entered in the balance of payments accounts as a **credit**. Any transaction resulting in a payment to foreigners is entered as a **debit**. *Three types of international transactions* are recorded in the balance of payments:

1. Transactions that arise from the export or import of goods or services and therefore enter directly into ***the current account***. When a French consumer imports American blue jeans, for example, the transaction enters the U.S. balance of payments accounts as a credit on the current account.

The balance of payments accounts divide exports and imports into three categories. The first is *goods* trade, that is, exports or imports of merchandise. The second category, *services*, includes items such as payments for legal assistance, tourists' expenditures, and shipping fees. The final category, *income,* is made up mostly of international interest and dividend payments and the earnings of domestically owned firms operating abroad. If you own a share of a German firm's stock and receive a dividend payment of $5, that payment shows up in the accounts as a U.S. investment

income receipt of $5. Wages that workers earn abroad can also enter the income account.

2. Transactions that arise from the purchase or sale of financial assets. An asset is any one of the forms in which wealth can be held, such as money, stocks, factories, or government debt. The ***financial account*** of the balance of payments records all international purchases or sales of financial assets. When an American company buys a French factory, the transaction enters the U.S. balance of payments as a debit in the financial account. It enters as a debit because the transaction requires a payment from the United States to foreigners. Correspondingly, a U.S. sale of assets to foreigners enters the U.S. financial account as a credit. The difference between a country's purchases and sales of foreign assets is called its *financial account balance*, or its *net financial flows*.

3. Certain other activities resulting in transfers of wealth between countries are recorded in the ***capital account***. These international asset movements – which are generally very small for such countries as the United States – differ from those recorded in the financial account. For the most part they result from nonmarket activities or represent the acquisition or disposal of nonproduced, nonfinancial, and possibly intangible assets (such as *copyrights* and *trademarks*). For example, if the U.S. government forgives $1 billion in debt owed to it by the government of Pakistan, U.S. wealth declines by $1 billion and a $1 billion debit is recorded in the U.S. capital account.

The balance of payments played an important historical role as a measure of disequilibrium in international payments, and for many countries it still plays this role. A negative balance of payments (*a deficit*) may signal a crisis, for it means that a country is running down its international reserve assets or incurring debts to foreign monetary authorities.

Therefore, the main purpose of the balance of payments is to inform the government about the international economic position of the nation and to help in formulating its trade, investment and fiscal policies. The governments also use the BoP accounts for the purpose of formulating trade and other commercial relations with other countries. Other economic agents like banks, firms and individuals may also depend upon the balance of payments accounts for various reasons.

2. Official reserve transactions, net errors and omissions

Although there are many types of financial account transactions, one type is important enough to merit separate discussion. This type of transaction is the purchase or sale of official reserve assets by central banks.

An economy's central bank is the institution responsible for managing the supply of money. In the United States, for instance, the central bank is the *Federal Reserve System*. **Official international reserves** are foreign assets held by central banks as a cushion against national economic misfortune. At one time, official reserves consisted largely of gold, but today, central banks' reserves include substantial foreign financial assets, particularly U.S. dollar assets such as *Treasury bills*.

Central banks often buy or sell international reserves in private asset markets to affect macroeconomic conditions in their economies. Official transactions of this type are called ***official foreign exchange intervention***. One reason why foreign exchange intervention can alter macroeconomic conditions is that it is a way for the central bank to inject money into the economy or withdraw it from circulation.

When a central bank purchases or sells a foreign asset, the transaction appears in its country's financial account just as if the same transaction had been carried out by a private citizen. A transaction in which the central bank of Japan (*the Bank of Japan*) acquires dollar assets might occur as follows: a U.S. auto dealer imports a Nissan sedan from Japan and pays the auto company with a check for $20,000. Nissan does not want to invest the money in dollar assets, but it so happens that the Bank of Japan is willing to give Nissan Japanese money in exchange for the $20,000 check. The Bank of Japan's international reserves rise by $20,000 as a result of the deal. Because the Bank of Japan's dollar reserves are part of total Japanese assets held in the United States, the latter rise by $20,000. This transaction therefore results in a $20,000 credit in the U.S. financial account, the other side of the $20,000 debit in the U.S. current account due to the import of the car.

The BoP accounts are completed by the entering some other minor items that can be identified but do not fall comfortably into one of the standard categories. Thus, appears **errors and omissions** account, which reflects transactions that have not been recorded for various reasons and cannot be entered under a standard procedure. Balance of payments is constructed as an accounting identity with each transaction theoretically recorded twice: the sum of total debits and credits should in theory always be equal. That means that if a debit entry is made to record an outflow of value, a corresponding credit entry is to be made in some other part of the balance of payments. However, one or another transaction can take more than one year. As a result, a discrepancy may arise and the BoP may not be balanced.

3. The nature of the balance of payments' paired transactions

To avoid any complexities with the balance of payments accounts understanding one should keep in mind the following simple rule of double-entry bookkeeping: *every international transaction automatically enters the balance of payments twice, once as a credit and once as a debit*. This principle of balance of payments accounting holds true because every transaction has two sides: if you buy something from a foreigner, you must pay him in some way, and the foreigner must then somehow spend or store your payment.

Two examples below will show how the principle of double-entry bookkeeping operates in practice.

First, imagine you buy an ink-jet fax machine from the Italian company *Olivetti* and pay for your purchase with a $1,000 check. Your payment to buy a good (the fax machine) from a foreign resident enters the U.S. current account as a debit. But where is the offsetting balance of payments credit? Olivetti's U.S. salesperson must do

something with your check – let's say he deposits it in Olivetti's account at Citibank in New York. In this case, Olivetti has purchased, and Citibank has sold, a U.S. asset – a bank deposit worth $1,000 – and the transaction shows up as a $1,000 credit in the U.S. financial account. The transaction creates the following two offsetting bookkeeping entries in the U.S. balance of payments:

	Credit	Debit
Fax machine purchase (*Current account*, U.S. good import) **Sale of bank deposit by Citibank** (*Financial account*, U.S. asset sale)	$1,000	$1,000

Second, let's consider how the U.S. balance of payments accounts are affected when U.S. banks forgive (that is, announce that they will simply forget about) $5,000 in debt owed to them by the government of Nigeria. In this case, the United States makes a $5,000 capital transfer to Nigeria, which appears as a $5,000 debit entry in the capital account. The associated credit is in the financial account, in the form of a $5,000 reduction in U.S. assets held abroad (a negative "acquisition" of foreign assets, and therefore a balance of payments credit):

	Credit	Debit
U.S. banks' debt forgiveness (*Capital account*, U.S. transfer payment) **Reduction in banks' claims on Nigeria** (*Financial account*, U.S. asset sale)	$5,000	$5,000

These examples show that many circumstances can affect the way a transaction generates its offsetting balance of payments entry. We can never predict with certainty where the flip side of a particular transaction will show up, but we can be sure that it will show up somewhere.

4. Equilibrium and disequilibrium in the balance of payments

Balance of payments should always be in equilibrium. Disequilibrium in the BoP of a country appears either as a *surplus* or as a *deficit*. A **surplus in the balance of payments** implies receipts from the rest of the world exceed payments made to rest of the world. A **deficit in the balance of payments** occurs as the payments made to foreigners exceed receipts from the rest of the world. When a BoP is in equilibrium any positive transaction (credit) in its current account is exactly offset by a negative transaction (debit) on its capital account and vice versa. In an accounting sense, the BoP always balances.

There are different points of view when it goes about the primary cause of imbalances in the BoP. Conventionally, it is believed that the factors with regard to the *current account* are the primary causes of disequilibrium. They include the appreciation or a depreciation of exchange rate, the government's fiscal deficit, business competitiveness, and private behavior such as the willingness of consumers to take debt to finance extra consumption. However, an alternative view, as argued by *Ben Bernanke*, the chairman of the Federal Reserve System in 2005, is that the primary driver of balance of payments deficit is the *capital account*. He maintained that the cause of the BoP disequilibrium in the USA is a global savings glut (abundance) which caused moving of investors to the "surplus" countries, over the available investment opportunities, which resulted in excess consumption and asset price inflation.

Persistent disequilibrium in the balance of payments, particularly a deficit in it, is undesirable because it:

- weakens the country's economic position at the international level;
- affects the progress of the economy adversely (negatively).

Hence, such imbalances must be cured by taking appropriate measures. There are many of them to correct disequilibrium in the balance of payments. They are, for example: deflation, depreciation, devaluation, exchange control, tariffs, quotas, etc.

Deflation is the classical medicine for correcting the deficit in the balance of payments. Deflation refers to the monetary policy of reducing the quantity of money in circulation in order to reduce the prices and the money income of the people. This is done by the central bank of the country through raising the interest rate and by other methods that can reduce the volume of credits in the economy which will lead to a fall in prices and money income of the people. Thus, deflationary policy restores equilibrium to the BoP **(a)** by encouraging exports through reduction in their prices and **(b)** by discouraging imports through the reduction in incomes at home. Moreover, a higher interest rate in the domestic market will attract foreign funds which can be used for correcting disequilibrium.

Depreciation (appreciation) of the exchange rate is another method of correcting disequilibrium in the balance of payments. Deprecation means a fall in the rate of exchange of one currency (home currency) in terms of another (foreign currency). A currency will depreciate when its supply in the foreign exchange market is large in relation to its demand. In other words, a currency is said to depreciate if its value falls in terms of foreign currencies, i.e., if more domestic currency is required to buy a unit of a foreign currency. An appreciation, on the other hand, is the increase in the value of domestic currency relative to the foreign currency. Depreciation helps a country to achieve a favorable balance of payments by limiting imports and stimulating exports.

Devaluation refers to the official reduction of the external value of a currency. The difference between devaluation and depreciation is that while devaluation means the lowering of external value of a currency by the government, depreciation means an automatic fall in the external value of the currency by the market forces; the former is arbitrary and the latter is the result of market mechanism.

Thus, devaluation serves only as an alternative method to depreciation. Both the methods imply the same thing, i.e., decrease in the value of a national currency in terms of foreign currencies.

Exchange control is the most widely used method for correcting disequilibrium in the balance of payments. Exchange control refers to the control over the use of foreign exchange by the central bank. Under this method, all the exporters are directed by the central bank to surrender their foreign exchange earnings. Foreign exchange is then rationed (spread) among the licensed importers. Only essential imports are permitted. Exchange control is the most direct method of restricting a country's imports. The major drawback of this method is that it deals with the deficit only, and not its causes. In short, exchange control does not provide a permanent solution for a chronic disequilibrium.

Tariffs are duties (taxes) imposed on imports. When tariffs are imposed, the prices of imports would increase to the extent of tariff. The increased prices will reduced the demand for imported goods and at the same time induce domestic producers to produce more of import substitutes. Non-essential imports can be drastically reduced by imposing a very high tariff rates, thus somehow correcting disequilibrium in the balance of payments.

Under the **quota system** the government may fix and permit the maximum quantity or value of a commodity to be imported during a given period. By restricting imports through the quota system the deficit is reduced and the balance of payments position is improved.

LECTURE 12

Regional Integration of Countries

Thematic Content of the Lecture:

1. Trade blocs as alternative forms of regional liberalization
2. Main gains and losses from a trade bloc
3. Regional trade blocs in names and figures
4. Postwar regional integration in Europe and the EU experience

1. Trade blocs as alternative forms of regional liberalization

A nondiscriminatory trade (liberalization of export/import) is a major goal of the GATT/WTO system, but it is far from universal. Nowadays, most countries, despite participating in World Trade Organization, have different levels of protection, maintaining the lowest level for partners in trade blocs or friends, and less favorable conditions for others.

A **trade bloc** is a type of intergovernmental agreement, often part of a regional intergovernmental organization, where barriers to trade (tariffs and others) are reduced or eliminated among the participating states.

Regional trading blocs can be categorized at different levels according to how extensive the integration of national economies becomes. The first and easiest to negotiate is a **free-trade area**, under which tariffs and other barriers to trade among the members are removed (sometimes only for manufactured goods, owing to differing agricultural support programs). To the extent that each country retains its own antidumping procedures, national restrictions can still influence trade among members. Also, each country maintains its own tariff schedule and other commercial policies with regard to goods coming from nonmember countries. Most trade blocs operating today are free-trade areas. One example is the *North American Free Trade Area (NAFTA)*, which formally began at the start of 1994.

The next stage of economic (trade) integration of countries is a **customs union**. It is a free-trade area in which members remove barriers to trade among themselves as well as set unified external tariffs and other barriers to imports coming from nonmembers. The *Southern Common Market (MERCOSUR)*, formed by Argentina, Brazil, Paraguay, and Uruguay in 1991, is actually a customs union.

A **common market**, the next step in regional integration, is a customs union that allows the free mobility of capital and labor among the member countries.

A final step is a full **economic union**, in which member countries unify all their economic policies, including monetary and fiscal policies as well as policies toward trade and factor migration. Belgium and Luxembourg have had such a union since 1921. The EU is considered to be the economic union also.

Preferential trading and other economic activities are not a new concept. Colonial empires, such as those that existed in the nineteenth and early twentieth centuries, can be viewed as discriminatory trading blocs, because the colonial power frequently maintained a highly favorable situation for itself selling in the colonies and for the colonies selling in its markets. One reason for creating such empires was to guarantee export markets and sources of imports that could not be produced at home. Such an example may cause us to question who gains from such trade blocs: just some members, all members, or the world as a whole? We will try to find the answer below…

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2. Main gains and losses from a trade bloc

The creation of a regional bloc or other form of discriminatory trading arrangement would appear to be a movement toward free trade and therefore toward greater economic efficiency. Because some barriers to trade are being eliminated and others are being left in place, the average tariff level for the world declines. This appearance of liberalization and of greater efficiency can be deceiving, however. Some regional blocs do increase efficiency, but others can represent a movement away from the allocation of resources that would occur under free trade and can therefore reduce world efficiency. The fact that the tariff cutting is discriminatory creates this

possibility. Thus, there is no general rule to establish whether discriminatory trade blocs increase or decrease efficiency; instead, each must be evaluated separately.

In the general case, analysis of preferential trade agreements points out two main effects: *trade creation* and *trade diversion*.

Trade creation. This is the beneficial effect of a discriminatory trading arrangement. For the case of constant costs of production in two countries, we observe it when a member country was not previously importing the product and was instead consuming local goods that were produced inefficiently. As a result of the creation of the trading bloc, the product is imported from more efficient firms in another member country. Inefficient local production is displaced by more efficient output in another member country.

Trade diversion. This is the undesirable or efficiency-reducing effect of such a bloc. It occurs when a member country was previously importing a product from a country that does not become a member of the bloc. When the discriminatory tariff-cutting occurs, other members have an advantage over nonmembers; as a result, a member country takes export sales away from a nonmember. Discriminatory tariff cuts mean that the more efficient nonmember country loses sales to less efficient producers in a member country, thus reducing world efficiency. Trade is diverted from low-cost to higher-cost sources.

Hence, we can say that in general the gains from a regional trade bloc are tied to trade creation, and the losses are tied to trade diversion. The net effect on well-being, the trade creation gain minus the trade-diversion loss, could be positive or negative.

Researches have identified several other possible sources of gains from forming a trade bloc of countries. Several gains arise because *the trade bloc creates a larger market* (bloc-wide rather than only national) in which firms can sell their products with few or no trade barriers. It is easiest to see the possibility for these gains if we think of an extreme case in which the countries that form the bloc all had such high trade barriers before the bloc was formed that they traded little with each other or with the rest of the world. In this setting, there are *four possible sources* of additional gains from forming the trade bloc.

An increase in competition can reduce prices. Before the bloc, firms in each country may have monopoly power in their separate national market, so prices are high in each national market. When the national markets are joined in the trade bloc, firms from the partner countries must compete with each other. The extra competition reduces monopoly power and reduces prices. Therefore, the inefficiency of monopoly pricing is reduced.

An increase in competition can lower costs of production. If a firm has monopoly power and substantial protection from foreign competition, there is little pressure on it to minimize costs or implement new technologies. When the national markets are joined in the trade bloc, the extra competition forces firms to pay more attention to reducing costs and improving technology.

Firms can lower costs by expanding their scale of production. Before the bloc is formed, the size of a firm is largely limited by the size of its own national market. If scale economies are substantial, the firm may not be large enough to exploit all of the

scale economies. When the markets are joined in the trade bloc, each firm now has a larger market to serve. Some firms expand their size to take advantage of additional scale economies. (Other firms that cannot gain the scale economies fast enough may be driven out of business by these larger lower-cost firms. This is good for the trade bloc as whole, but some member countries may feel harmed if it is their firms that disappear.)

Consumers gain access to a larger number of varieties or models of a product. Before the bloc is formed, consumers in the country are mostly limited to the versions of the product produced by domestic firms. When the markets are joined in the trade bloc, consumers can buy additional imported versions of the product produced by firms in the partner countries.

A final possible source of gains is the possibility that forming the trade bloc ***increases opportunities for business investments***. Multinational firms (TNCs) often seek foreign production locations based on the size of the market that can be served by their affiliates. By expanding the market that can be served inside the external trade barriers, a trade bloc can attract more foreign direct investment into the member countries. Global firms often bring better technologies, management practices, and marketing capabilities. If these "intangibles" diffuse to/influence local firms (positive externalities), then the country gains an extra benefit from the direct investment by foreign firms. More broadly, by increasing the rate of return to business investments as the trade bloc opens new profit opportunities, the formation of the bloc can increase real investment and can therefore expand the overall production capacity of the partner countries.

However, not all of these effects occur for every product or member country when a trade bloc is formed, but they do occur for some products and some members. They provide gains from being a member of a trade bloc that are in addition to the basic gains from trade creation.

3. Regional trade blocs in names and figures

In 2014 about half (50%) of world trade occurred within functioning trade blocs, including:

- the 28 countries of the EU;
- the 4 remaining countries of the European Free Trade Area (EFTA);
- the preferential trade agreements that the EU has with 59 other countries (including the 4 EFTA countries);
- the 3 countries of NAFTA;
- the trade agreements that Mexico has with the EU, EFTA, Chile, Costa Rica, Colombia, El Salvador, Guatemala, Honduras, Israel, Japan, Nicaragua, Peru, and Uruguay, in addition to its membership in NAFTA;
- the 7 countries of the Central American Free Trade Area (CAFTA-DR);
- the free-trade areas that the USA has with Australia, Bahrain, Chile, Colombia, Israel, Jordan, Korea, Morocco, Oman, Panama, Peru, and Singapore, in addition to its memberships in NAFTA and CAFTA-DR;

- the 5 countries of MERCOSUR (with a sixth country, Bolivia, in the process of acceding to full membership) and its trade association agreements with Chile, Colombia, Ecuador, Guyana, Peru, and Suriname;
- the trade agreements that Turkey has with the EU, EFTA, and 16 other countries.

As of second decade of 21st century, there were almost 250 preferential trade agreements in force in the world, and over half of them had begun operating since 2000. Only four WTO members (Congo, Djibouti, Mauritania, and Mongolia) were not members of some trade bloc.

4. Postwar regional integration in Europe and the EU experience

European political and economic cooperation over the past 50 years demonstrates remarkable progress in achieving deeper economic integration and in expanding to include more countries. In fact, Europe has been the locus (place) of the longest and deepest regional integration in the world. The chronology of postwar regional integration in Europe is presented below.

1950-1952: Following the *Schuman Plan*, "the six" (Belgium, France, West Germany, Italy the Netherlands, and Luxembourg) set up the ***European Coal and Steel Community***. Meanwhile, Benelux is formed by Belgium, the Netherlands, and Luxembourg. Both formations provide instructive early examples of integration.

1957-1958: The six sign the *Treaty of Rome* setting up the ***European Economic Community*** (EEC, or "Common Market"). Import duties among them are dismantled and their external barriers are unified in stages between the end of 1958 and mid-1968. Trade preferences are given to a host of developing countries, most of them former colonies of EEC members.

1960: The *Stockholm Convention* creates the ***European Free Trade Area*** (EFTA) among seven nations: Austria, Denmark, Norway, Portugal, Sweden, Switzerland, and the United Kingdom. Barriers among these nations are removed in stages, 1960-1966. Finland joins EFTA as an associate member in 1961. Iceland becomes a member in 1970, Finland becomes a full member in 1986, and Lichtenstein becomes a member in 1991.

1967: The ***European Community*** (EC) is formed by the merger of the EEC, the ***European Atomic Energy Commission***, and the ***European Coal and Steel Community***.

1972–1973: Denmark, Ireland, and the United Kingdom join the EC, converting the six into nine. Denmark and the United Kingdom leave EFTA. The United Kingdom agrees to abandon many of its Commonwealth trade preferences. Also, *Ode to Joy* from Beethoven's Ninth Symphony is chosen as the EC's anthem.

1973–1977: Trade barriers are removed in stages, both among the nine EC members and between them and the remaining EFTA nations. Meanwhile, the EC reaches trade preference agreements with most nonmember Mediterranean countries along the lines of earlier agreements with Greece (1961), Turkey (1964), Spain (1970), and Malta (1970).

1979: European Monetary System begins to operate based on the ***European Currency Unit***. The *European Parliament* is first elected by direct popular vote.

1981: Greece joins the EC as its 10th member.

1986: The admission of Portugal and Spain brings the number of members in the EC to 12.

1986-1987: Member governments approve and enact the *Single European Act*, calling for a fully unified market by 1992.

1989-1990: The collapse of the East German government brings a sudden expansion of Germany and therefore of the EC. East Germans are given generous entitlements to the social programs of Germany and the EC.

1991-1995: Ten countries from Central and Eastern Europe establish free-trade agreements with the EC. All become EU members in 2004 and 2007.

End of 1992: The Single European Act takes effect, integrating labor and capital markets throughout the EC.

1993: The *Maastricht Treaty* is approved, making the EC into the **European Union** (EU), which calls for unification of foreign policy, for cooperation in fighting crime, and for monetary union.

1994: The ***European Economic Area*** is formed, bringing the EFTA countries (except Switzerland) into the EU's Single European Market.

1995: Following votes with majority approval in each country, Austria, Sweden, and Finland join the EU, bringing the number to 15. As it had done in 1972, Norway rejects membership in its 1994 vote.

1996: The EU forms a customs union with Turkey.

1999: Eleven EU countries establish the ***euro*** as a common currency, initially existing along with each country's own currency. Greece becomes the 12th member of the euro area in 2001.

2002: The euro replaces the national currencies of the 12 countries.

2004: Ten countries (Estonia, Lithuania, Latvia, Poland, Czech Republic, Slovakia, Hungary, Slovenia, Malta, and Cyprus) join the EU, bringing the total number to 25.

2007: Romania and Bulgaria join the EU, bringing the total number to 27. Slovenia joins the euro area.

2008: Cyprus and Malta join the euro area.

2009: Slovakia joins the euro area.

2011: Estonia joins the euro area.

2013: Croatia joins the EU, bringing the total number to 28.

2014: Latvia joins the euro area, bringing the total number of EU countries using the euro as their currency to 18.

2016: After the nationwide referendum – the beginning of the United Kingdom's withdrawal from the European Union ("***Brexit***"). The UK is due to leave the EU on 29 March 2019.

2017: The **Ukraine-European Union Association Agreement** comes into force, establishing a *Deep and Comprehensive Free Trade Area* between the parties.

As we can see, the EU successfully grew over time from 6 members in 1952 to 28 in 2013. The outlook for further expansion is less clear, especially considering so-called Brexit. The other countries of the Balkans (Serbia, Montenegro, Bosnia, Macedonia, and Albania) want to join, but it probably will be years before they qualify. Possible entry of such countries as *Ukraine*, Moldova, and Georgia (Eastern European countries that were part of the Soviet Union) is more distant. Turkey is eager to join, but the EU continues to be skeptical of Turkey's willingness to make the necessary political and economic policy changes, and it is concerned about its own ability to gainfully integrate such a large and poor country.

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