

Issue Three: International Economics

The Search for Prosperity

Our world today is in an age of economic globalization, one where countries' economies are becoming increasingly interdependent. The levels of trade and money transfers between countries are growing. Developed countries depend on developing countries for the supply of raw materials and the manufacture of labor-intensive goods. Developing nations depend on developed countries for investment, loans, modern technology, and markets for their goods. These increased exchanges can be very beneficial, and many countries have made tremendous economic progress over the past decades because of them. However, increased economic interdependence can also be very risky.

With the advent of computer trading, billions of dollars in capital can be moved through countries' financial markets through the click of a mouse. We are currently experienced a global recession that began in one sector of one economy and spread to many sectors and many countries economies. It happened because the complexity of the global financial markets got ahead of the regulations and transparency rules that governments and international organizations create to make sure there are safe and fair rules governing all financial transactions. For the first time in decades, the two engines of global integration-trade and capital flows-are simultaneously moving in reverse.

INTERNATIONAL ECONOMICS: INTERNATIONAL TRADE

Trade is one of the principal ways that nations are connected to each other. The worldwide reduction in trade barriers is a key feature of globalization. The World Trade Organization (WTO) was created to set rules for the conduct of international trade. Regions around the world are establishing their own trade agreements to increase economic cooperation among member states. And within states, governments are reforming their economies to try and become more competitive in the global marketplace.

Increased trade has created many opportunities for countries that manufacture goods for export. For example, the promotion of exports is a major reason for the prosperity that East Asian economies enjoyed during the 1980s and to the present. Countries gain from trade because it is a way for them to produce more and enlarge their economies.

The effects of trade are not equally beneficial to all. Some countries feel political pressure to restrict trade when some of their industries fear that they might lose in the marketplace if they face competition. Also, some countries fear that they might never be able to develop their industries if their markets are open to foreign competition through trade. Thus, the great challenge of international negotiation is how to reduce trade barriers at the global level despite political or other reasons for not doing so at home.

QUESTIONS FOR NEGOTIATION

Guiding Question

1. What international policies are needed to promote world trade?

Related Questions

2. What rules should the international community develop on trade, and how would those rules be enforced?
3. How should the debate over "free trade" vs. "fair trade" be resolved?
4. How can the world ensure that developing countries benefit from any global agreements on trade?
5. Under what conditions, if any, should countries be allowed to protect certain industries from foreign competition?

ESSENTIAL BACKGROUND KNOWLEDGE

A country's wealth (or income) depends on the goods and services that it is able to produce. Its ability to produce goods and services in turn depends on its endowments. Endowments, or factors of production, are things which determine how much a country can produce. They include labor (the work done by the people in a country), technology (which can make labor more productive), land (including natural resources) and capital (property or money from which future income can be gained), which can be used to invest in the economy. Different countries have different levels of endowments.

Reasons for Trading

Although countries have different endowments and different levels of wealth, no single country is totally self-sufficient. That is, no country is able to provide all of the things that its people need and want by itself. The lack of self-sufficiency means that countries have to look to the outside world for some of their needs, and this is a primary reason why nations trade.

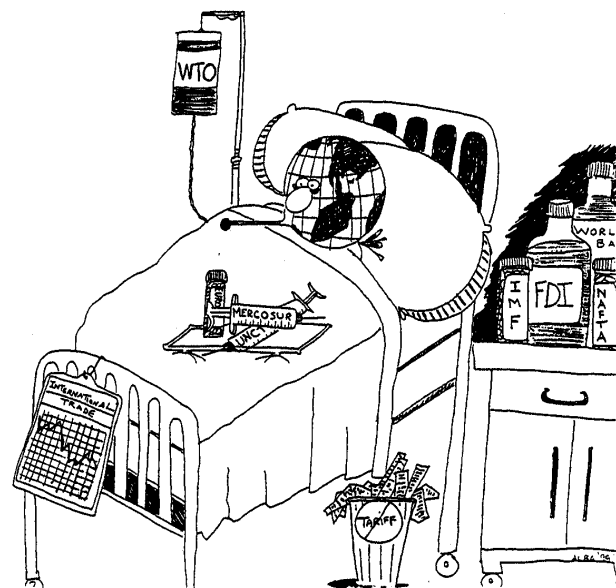
Another reason for trade, and the main reason why economists argue in favor of free trade, is that countries can make gains from trade. If countries specialize in producing those goods that they can produce more easily and efficiently (or those in which they have a comparative advantage), then they stand to benefit from having more goods between them if they trade their produced goods freely with each other. Also, specialization can help countries achieve economies of scale in production. What economies of scale means is that if a country focuses on producing only a few goods, then it could concentrate its efforts better, and become more efficient in production. It could produce even more of those goods with the same endowments than it would have been able to produce before. Greater production would allow the country to increase its income by exporting some of its products to be sold overseas. The country could also use some of its income to buy imports (goods brought in from other countries) to meet its other needs.

Trade Practice

In reality, trade policy often does not strictly follow trade theory in that countries do not practice totally free trade with each other. The reason is that although a country as a whole might benefit from free trade, not everyone within the country gains equally from trade, and some people or economic interests may actually be hurt by it.

Competition through Trade Helps Some, Hurts Others

In reality, countries produce many goods. Their industries use comparative advantage to produce goods for export, but they also have industries that produce goods for the domestic market. If the same type of product is also imported, the presence of two or more of the same types of goods in a country's market leads to competition for consumers. With market competition, if there are two goods of similar quality, consumers usually choose the good that has the lower price. If the cheaper product is the imported one, then the domestic company loses customers. If the company loses enough customers, it will have to either lower its prices, or go out of business. If it cannot lower its prices and is forced out of business, then the people who work for it would be out of a job. Job losses of this kind are of great concern to most governments.



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WTO Page
<http://www.wto.org/>

AmosWEB Economics Reference
<http://www.amosweb.com/>

About.com's Economics Page
<http://economics.about.com/money/economics/>

Economic Education Web
<http://ecedweb.unomaha.edu/teach.htm>

United Nations Conference on Trade and Development (UNCTAD)
<http://www.unctad.org>

Protectionism and Trade Barriers

In part because of a fear of losing jobs due to foreign competition, and in part because of a desire by every country to promote its own industries, governments often view increases in exports as benefits, and increases in imports as losses. This leads them to put up trade barriers to protect their industries from foreign competition. Trade barriers are things a government does to make it more difficult to sell imports within a country. Examples of trade barriers include tariffs and import quotas, which are limits on the amount of a good that can be imported. Another form of protectionism is export subsidy, where governments pay money to companies in their country that export, making it easier for them to produce and sell goods overseas at lower prices.

International Negotiations

Most countries realize that if all countries followed protectionist policies, then everyone would lose, as the levels of trade would drop worldwide. This is why they engage in a process of international negotiation as a way of reducing trade barriers. Countries can enter into regional agreements, like the North American Free Trade Agreement (NAFTA), Mercosur and the European Union (EU), which aim at reducing trade barriers among the countries that are part of a particular trading bloc. Or they can enter into global agreements, which are aimed at reducing

trade barriers for the entire world. The World Trade Organization (WTO) is an organization established in 1995 through international negotiation. The WTO aims to set the rules for the conduct of international trade and to settle trade disputes between member states. It is the successor to the General Agreement on Tariffs and Trade (GATT).

WTO and Policy Issues

The WTO provides the legal and diplomatic framework within which countries can advance their trade relations through collective debate, negotiation and dispute settlement. The work of the WTO is undertaken by representatives of all its member governments, but its roots lie in everyday business and economic activities. Each country forms its own negotiating positions on trade policy, usually with input from its own business, agriculture, labor, and other interest groups concerned with international trade. The specific positions any country takes depend, of course, on its own economic and political circumstances. Then delegates from each country come together within the WTO to try and negotiate large agreements that become the basis of the world's trading system. The WTO tries to make decisions by consensus, so that all of its members can feel their interests have been considered. But where consensus is not possible, then decisions in the WTO can be made by voting on a "one country, one vote" basis. WTO votes usually require substantial majorities (two-thirds or three-fourths, depending on

the issue) in order to pass. Through its negotiation, monitoring, and dispute settlement processes, the WTO aims to provide consistent and non-discriminatory rules for the conduct of international trade.

The WTO has been successful in reducing trade barriers, which was its first agenda item when it was created in 1995. However, when the talks were mostly about tariffs, they involved the way countries treated imports at their borders. The last several years have seen a shift in emphasis to services and issues that involved countries' domestic laws. Thus, there is much less agreement between countries on how a new set of trading rules will affect their industries' ability to compete internationally.

Developed countries worry that developing countries have an unfair advantage because they have fewer regulations for their industries, especially on labor and environmental standards. Some developed countries argue in favor of "fair trade," where countries would be required to have very similar regulations so that industries could compete on a "level playing field." Developing countries, who receive some exemptions in the WTO, say that they are not wealthy enough to afford the same types of regulations as developed countries.

Developed and developing countries have been at an impasse over the past seven years over the issue of agriculture. Developed countries subsidize their farmers, which is against WTO rules. Developing countries argue that this protection for farmers is costing them billions of dollars in missed trade opportunities. With WTO talks stalled, more regional free trade zones are being created. The problem with this is that small non-aligned countries will miss out on free trade advantages.

Both types of countries are eager to make sure that their industries are successful because these industries are important for their economies. Developed countries want stronger protection of intellectual property rights. Some developing countries feel that they must protect their industrial base from competition, at least initially, in order to allow them to grow.

INTERNATIONAL ECONOMICS: INTERNATIONAL FINANCE

All countries need financial capital, or money, to keep their economies going. Countries need to raise capital so that they can make investments in important areas like education, infrastructure, agriculture, and industry. There are a number of ways of raising capital, including domestic saving, international borrowing, foreign aid and foreign investment.

The increased integration of the world economy has made foreign investment the most important source of funding for developing countries. This is because far more money can flow into an economy through foreign direct investment (FDI) and foreign investments in local stock markets than from any loans a government might receive. However, for the poorest of the developing countries, international loans and foreign aid are still very important sources of financing.

Increased international capital flows can be harmful as well as beneficial. International investors can pull their money out of a country very rapidly causing a financial crisis that leaves the economy on the brink of collapse. This type of situation can be especially devastating for countries that are heavily dependent on foreign investment, as we saw in the 1990s in Mexico, East Asia, Russia, and Brazil.

In 2008-09, we are seeing a new problem with financial markets. Instead of capital flight from developing economies, we are experiencing a problem that began in one sector of a developed economy (the US housing market). It has caused a liquidity problem, so that not enough cash is available to fund different types of projects in many countries.

Up to now, the world has responded to financial crises in developed countries by coming to the aid of the affected countries after their economies have begun to collapse. The usual mode of response is to provide a package of loans through the International Monetary Fund (IMF). However, to qualify for an IMF loan, a country usually has to commit to cutting state spending and a privatization program. Such measures will regain foreign investors' confidence and thus help stabilize the country's financial markets. But such austerity measures can increase unemployment and citizen unrest, as social benefits are slashed and inefficient businesses are closed.

In the current financial crisis, IMF loans will be available to developing countries. Developed countries are making adjustments internally to stabilize their financial markets. These methods include increasing the liquidity of the financial markets and providing extra government funding through stimulus plans.

ESSENTIAL BACKGROUND KNOWLEDGE

Countries use their endowments to produce goods and services that can be sold to provide income. Endowments, or factors of production, are things which determine how much a country can produce. They include labor (the work done by the people in a country), technology (which can make labor more productive), land (including natural resources) and capital (property or money from which future income can be gained), which can be used to invest in the economy. (In addition, a country's institutions are also sometimes considered part of its endowments.) Different countries have different levels of endowments. The more endowments a country has, the wealthier it is likely to be.

The Need for Capital

Different countries have different levels of endowments, based on their size, location and history. Endowments can be improved upon, but to do so requires investment, and this creates the need for countries to raise capital.

Ways to Raise Capital

There are five ways to raise capital:

- borrowing
- foreign direct investment
- financial markets
- foreign aid
- domestic savings

Borrowing

Borrowing and foreign aid used to be the principal ways that developing countries in particular raised investment capital for their economies. Countries would borrow from other countries, from international organizations (like the IMF and World Bank), or from commercial banks. However,

high levels of borrowing combined with high interest rates and difficult conditions of repayment created a heavy debt burden for many developing countries, and some are still struggling to repay loans. Options to deal with debt burden include debt forgiveness, debt re-scheduling, lower interest rates, and increased levels of aid. (In theory, increased aid would strengthen the developing countries' economies, thus making them better able to pay back their loans.)

Debt forgiveness in particular has become a more important issue. Criticism of the international finance system is growing, as is concern that crushing debt is stifling economic growth in developing countries. This has led to increased pressure on developed countries and the IMF to forgive more of the external debt of the Third World. There are two kinds of debt forgiveness. The first is bilateral, in which a single creditor nation forgives all or part of the debt owed directly to it by a debtor country. Forgiving debt that is owed to multilateral organizations such as the IMF is more compli-

QUESTIONS FOR NEGOTIATION

Guiding Question

1. How can the international financial system be made to work better for all countries?

Related Questions

2. How can countries stabilize the impact of capital flows and still enjoy the benefits of capital flows?
3. What should be done to ease the effects of debt? What should creditors do? What should debtors do?
4. What role should governments, organizations (like the IMF and World Bank), and commercial banks play in the debate about the flow of capital?
5. What role should governments play in controlling foreign direct investment flows?
6. Under what conditions should debt relief be linked to other issues such as human rights or the environment?

cated. The money debtor countries repay on existing loans is used to fund new loans and grants, and simply forgiving all the debt it is owed would leave no funds to aid other countries with less external debt.

There is also concern that forgiving debt before underlying economic problems are addressed would simply plunge the countries back into debt in a few years. The IMF has responded to criticism by creating the Heavily Indebted Poor Countries (HIPC) Initiative to target debt forgiveness to the countries most in need.

Foreign Direct Investment

Foreign direct investment (FDI) is when foreign companies, usually multinational corporations, invest money in a domestic economy to build factories, buy real estate, or other tangible goods. It is an important way to increase investment in the economy without worrying about the burdens associated with debt. Many countries in the world place restrictions on the types of industries that foreign companies can invest in. Also, many countries place restrictions on how much ownership of a domestic company a foreign investor can have. Countries sometimes adopt these policies because they do not want foreigners to have too much control over their economies. Other concerns with FDI include ensuring that the foreign investor makes use of and helps to develop the skills level of the do-

mestic country's citizens. Ensuring that people working for foreign-owned businesses are not exploited is another concern.

Financial Markets

Financial markets, including stock markets and bond markets, are organized ways of exchanging ownership of the goods, services and resources that make up an economy. Countries can raise the level of capital in their economies by allowing their stocks and bonds to be traded internationally. Financial markets are well established in developed countries, and they are becoming one of the most crucial ways of raising capital in developing countries. They allow international investors to own assets in a country and to have a stake in the economy's progress without being directly in control of those assets. However, financial markets also allow international investors to trade their assets and withdraw their money whenever they want.

Investors are attracted to the financial markets of developing countries because they see a greater profit potential. If those countries' economies grow rapidly and their industries prosper, then their financial markets go up, and investors benefit. However, if a country's economy performs badly and its industries suffer, then its financial markets go down, and investors lose.

The fear of the downside risk is a major reason why developing countries' have fewer investors than developed countries. Fluctuations in their financial markets, both up and down, tend to be greater. Typically, more money flows into the more stable and mature stock markets of developed countries, and the potential for large swings up or down are diminished. In the current financial crisis, the outflows of money from stock markets have been dramatic. But the outflows from stock markets in developing countries still tend to be higher than from the more mature markets of the developed countries.

Because capital can flow into and out of a country's money markets very easily, this way of raising capital can be a double-edged sword. If, for example, investors lose confidence in the strength of one country's economy, they can withdraw money. If money is withdrawn, then the economy may suf-

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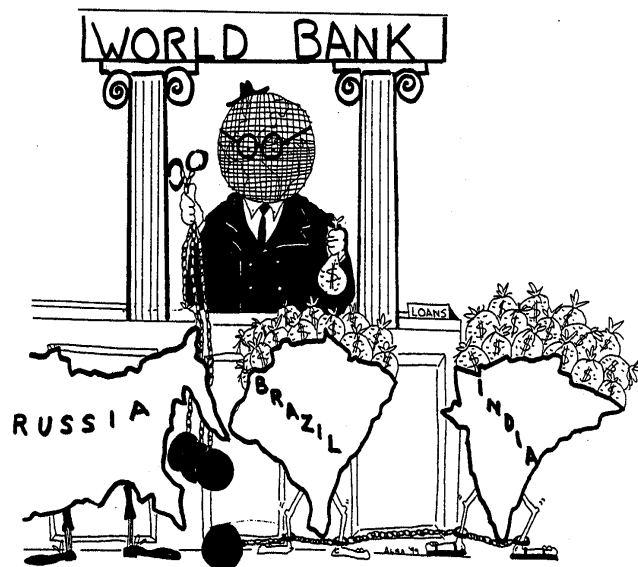
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fer. If the withdrawal is abrupt, the economy will lose an important source of investment and economic crisis may occur.

Foreign Aid

Foreign aid is money that one country gives to another country without any expectation that the money will be repaid. However, the money usually is given with conditions on how it will be used. For example, aid can be given for health care, education, or military purposes. For several reasons, foreign aid is not given as frequently today as it was 20 or 30 years ago: 1) it is no longer considered a very effective policy; 2) the receiving governments do not always use the money for the requested purposes; and 3) it has fallen out of favor with the domestic populations of the countries providing aid. In addition, some countries require foreign aid to be used in a way that benefits domestic companies. For example, if a country gives aid to modernize the phone system of a community, it may be required to purchase equipment from a domestic company of the aiding country.

Savings

The most basic way a country can raise capital for investment is through its own savings. National savings can be raised either through government savings programs or through private savings in banks. If individuals and families throughout a country increase the amount of money they save, then the

country as a whole can generate more capital for investment. These investments can help it become economically stronger and more independent.

The Flow of Capital Across Borders

Except for self-generated savings, the ways of raising capital described above are all examples of capital flows. Increased international capital flows can benefit or harm countries. They can benefit countries because of increased opportunities for economic growth. They can harm them because of the fear of capital flight. Capital flight is when people start to withdraw their money from a country in large amounts all at the same time. It is like a run on a bank, for example. Recent historical examples that illustrate both the good and bad aspects of increased capital flows on a regional basis are the Mexican financial crisis in 1994 and the Asian financial crisis in 1997. In both cases, the countries benefited for many years when international capital was flowing into their economies, and they depended on this capital to help them grow. However, international investors suddenly became worried about the economic health of these countries and quickly withdrew their money in large amounts, which seriously hurt their economies. To understand why international investors withdrew their money in large amounts from these countries requires a brief discussion of currencies and exchange rates.

Exchange Rates and Finance

A currency is the type of money that is used in a particular country. For example, the dollar is the currency used in the United States, and the yen is the currency used in Japan. An exchange rate is the value of one currency in terms of another. For example, the yen-dollar exchange rate might be 140 yen for one dollar, which is the same as 0.00714 dollars per yen.

Exchange rates can change. A country's currency goes up in value, or appreciates, when more money is invested in that country. Conversely, a country's currency depreciates, or goes down in value, as more money is taken out of the country. These changes are important for international investment. Investors will be afraid to put their money into a country if they believe the currency is going to go down in value because that means that they will lose money on their investment.

Some countries try to calm the fears of investors by keeping a fixed exchange rate, where the government promises not to allow the value of the currency to change. However, if a country has a weak economy, then a fixed exchange rate will be very hard to maintain, and this will make international investors more nervous. In the cases of Mexico and the Asian countries, international investors were worried that the economies of these countries were not strong enough to maintain their fixed exchange rates. And when the governments of these countries admitted that they could no longer keep their fixed exchange rates and that they would have to devalue their currencies, investors rapidly withdrew their money.

Dollar Peg and Dollarization

To lessen the threat of currency devaluation, a developing country can link its money to a foreign currency known for its stability, such as (until recently) the US dollar. There are two methods of creating such a linkage. The first is a dollar peg, in which a country fixes or “pegs” the value of its currency to the US dollar, usually on a one-to-one ratio. This will calm nervous investors, spur foreign direct investment and trade, and dampen rising inflation, since a country cannot just print money. But if the value of the dollar rises, or the country's economy is experiencing difficulties, then it may be forced to devalue its currency, which will negate any benefits of dollar pegging. This is what happened during the Mexican and Asian financial crises. Several countries, including Mexico, Brazil and Argentina had to abandon their dollar peg system. To make a dollar peg system even more stable, a currency board system can establish a direct link between the country's currency and US dollars held in

reserve. This is what Argentina had done until its recent financial crises. For every Argentinean peso issued by the central bank, they had to have a US dollar in reserve to match it.

The final linkage is dollarization, in which a country phases out its own currency and adopts the US dollar in its place. Panama, Ecuador, and El Salvador have dollarized. This rather drastic step eliminates devaluation as a possibility, but it also has a downside. If the value of the dollar rises, the dollarized countries' exports become more expensive and thus less desired. This reduces the country's access to foreign currency and makes foreign debt harder to repay.

Conversely, if the dollar falls, this makes imports from other countries more expensive. Dollarization also causes the country to lose some of its cultural identity and the ability to use homegrown exchange rates and monetary policies to dampen domestic crises. For the US, the concern is that during difficult financial times, or when US monetary policy is considered inappropriate or inconvenient, there is the risk that US policies will create resentment. Or it could encourage policy makers to deflect blame for their countries' problems on the US. As a result, the US does not officially encourage dollarization.

The increase in the number of countries using a dollar linkage plan demonstrates the importance countries place on demonstrating a stable economic environment. As the Mexican and Asian crises have shown, capital can move very quickly in a closely connected world. The challenge of international finance is to find a way to manage the flow of capital so that countries can benefit from it instead of being negatively impacted.