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International Economics

I. Introduction

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I. Introduction

1. Course Overview
2. Division of Labour and the Law of Association
3. Money and Currencies
4. The Balance of Payments
5. Interventionism

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1. Course Overview

Objectives

- Basic understanding of the theory of international economics
- Insight into the modern institutions of the international economy

Method

- International economics the same as "standard" economics
- Basic method and insights the same (methodological individualism)
- Overview of historical development in order to understand present institutions

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Textbooks

- Pugel, *International Economics* 17th edition
- Caves, Frankel, Jones, *World Trade and Payments* 10th edition

Downloads available online:

https://www.wifa.uni-leipzig.de/institut-fuer-wirtschaftspolitik/studium-1/sommer-2023/international-economics

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Course Outline

1. Introduction

Part I: International Trade

2. World Trade: an Overview
3. Mercantilism, Smith, and Ricardo
4. Growth and the Political Economy of Free Trade
5. Interventionism: The Instruments of Trade Policy
6. Globalization, Economic Development, and the Environment

Part II: International Finance

7. Balance of Payments
8. Currency Markets and Exchange Rates
9. Exchange Rates and International Finance
10. Currency Regimes
11. International Lending, Inflation, and Financial Crises
12. The Open Economy

Part III: European Integration and International Sanctions

13. European Economic and Monetary Integration
14. The Economics of International Sanctions
15. TBA, Q&A

Why Trade at All?

A Few Questions

- Isn't self-sufficiency (autarky) better?
- Doesn't trade generate conflict?
- Don't rich countries exploit poor countries?

Short answer: no!

- If these statements were correct about international trade…
- they would also be correct for individual persons and interpersonal exchange

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2. Division of Labour

People cooperate freely

- Difference in utility → exchange
- Because people realize that they gain from it:

Division of labour leads to greater productivity

- The law of comparative advantage or the Ricardian Law of Association
- (After David Ricardo, credited with first stating the principle)

The Foundations of Economic Life

Experience teaches man that cooperative action is more efficient and productive than isolated action of self-sufficient individuals. The natural conditions determining man's life and effort are such that the division of labor increases output per unit of labor expended.

- Ludwig von Mises

The Case of Absolute Advantage

Factors leading to ongoing exchange

- Innate inequality of men
- Unequal distribution of resources over the earth
- Unequal distribution of manmade factors of production
- Differences in acquired skills

Case of absolute advantage

- Consider following example: person *A* can produce 6 *p* or 4 *q*
  Person *B* can, in same unit of time, produce only 2 *p* but 8 *q*
- If they work in isolation, total production will be 4 *p* + 6 *q*
- If they divide and trade, total production will be 6 *p* + 8 *q*

Comparative Advantage

Benefits of trade under *absolute advantage* are self-evident

- When each person specialize where he is the most productive, total physical output increases
- Clearly leads to increased wealth for all

What happens when some people are overall less productive?

- In this case, the output of at least some goods must diminish if people specialize and trade – right?
- The law of *comparative advantage* shows that here too exchange leads to greater total productivity

Comparative Advantage: Example

Two persons, *A* and *B*: *A* is more productive in all fields

- For one unit of *p*, *A* needs 3 hours, *B* needs 5 hours of labour
- For one unit of *q*, *A* needs 2 hours, *B* needs 4 hours of labour

They now produce for 120 hours

- In isolation: total product is 32 *p* and 45 *q*
- When they specialize: total product is 24 *p* and 60 *q*

Can we say this is a higher output? Yes!

- For *A*, the rate of substitution of *p* is 3/2 *q*
- For *B*, the rate of substitution of *p* is 5/4 *q*
- This means that 24 *p* + 60 *q* is more than 32 *p* + 45 *q*

Comparative Advantage: Price is Key

The *price* to each participant to exchange is key

- The *price* is what a person gives up in exchange
- We can conceive of individual action as an exchange – *autistic exchange*
- Hence, when *A* is working in autarky, the price of 1 *p* is 3/2 *q*
- And for *B*, the price of 1 *p* is 5/4 *q*
- (*p* prices of *q* are the inverse, 2/3 and 4/5 respectively)
- If *A* buys *p* from *B* instead of producing, he can pay a lower price – between 3/2 and 5/4 *q*
- If *B* buys *q* from *A*, he too will pay less – between 4/5 and 2/3

Comparative Advantage and Prices

Price Determination in Exchange

- Somewhere between the autistic prices

Necessary Conditions for Exchange

- *A* considers *p* and *B q* valuable
- *A* and *B* recognizes the higher productivity of work under division of labour

Limits to Specialization

- If *A* wants more *p* than *B* can produce, he will start producing some himself
- *B* can never benefit from reducing his specialization

Gains Reinforced by Dynamic Effects

Reinforcing developments follow naturally from trade:

- People acquire specialized skills
- People may lose skills in other areas
- Savings are invested in specific capital goods
- This increases productivity and may in fact turn a comparative advantage into an absolute advantage

These developments are not necessary to reap the gains from trade. The law of comparative advantage always holds

Universal Benefits from Division of Labour

Therefore it is manifest that the division of labor brings advantages to all who take part in it. Collaboration of the more talented, more able, and more industrious with the less talented, less able, and less industrious results in benefit for both. The gains derived from the division of labor are always mutual.

- Ludwig von Mises

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3. Money and Currencies

Money in the international economy

- functions in the same way as in the national economy
- Money is always valued for its purchasing power

Demand for money

- Exchange demand: the supply of goods and services
- Reservation demand: the fund of money individuals want to hold

The total demand for money and determines the value of money and/or the amount of money in a given area

Interlocal Exchange Rates

Changes in demand → changes in value of money

- An increase (decrease) in production in one area constitutes an increase (decrease) in exchange demand.
  - Money will flow in (out)
- An increase (decrease) in the quantity of money people desire to hold constitutes an increase (decrease) in the reservation demand in a given area.
  - Money will flow in (out)

Changes in supply of money

- Money is less valuable close to where it is produced
- Relatively more valuable farther away

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Different Moneys

More Currencies Circulating Side-by-side

- Gold and silver historically
- Local and foreign currencies in some countries

Exchange Rates between Currencies

- Will tend toward the purchasing power ratio between the moneys
- If 1 euro buys the same as 1 dollar, the exchange rate will be 1:1
- If 1 ounce of gold buys 15 times the quantities of goods an ounce of silver buys, the exchange rate will be 1:15

Actual exchange rates also have a speculative component

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4. The Balance of Payments

- The balance of payments is a crucial tool
  - for understanding international economic relations
- Only relevant in a monetary economy
  - Meaningless in the absence of monetary exchange
- We can make a BoP for any individual person
- So let's do it!

Individual Balance of Payments

A person's income is all the money he receives

- Income from selling goods and services (labour)
- From interest payments, repayment of loans
- Borrowing
- Gifts

A person's expenditure is all the money he spends

- Expenditure on goods and services
- Payment of interest on loans, repayment of loans
- Lending
- Gifts he gives

The Cash Balance

- In order for the BoP to balance, we need one final item: additions and subtractions from the cash balance
- Additions to the cash balance is an expenditure
- Subtractions from the cash balance is income

Individual Balance of Payments

March 2023			
Income		*Expenditures*	
Wages	1,500 €	Rent	500 €
Sale of car	3,000 €	Food	300 €
Gift from uncle	500 €	Furniture	800 €
		Investment	2,500 €
		Addition to cash balance	900 €
Total	5,000 €		5,000 €

Current Account and Capital Account

The current account records flows of income

- The purchase and sale of goods and services, the trade balance
- Payment and receipt of interest

The capital account records flows of savings and capital

- If a person buys financial assets – stocks, obligations, and so on – he is exporting capital
- If a person is selling financial assets or taking out loans he is importing capital
- Exchanges of fixed assets – land – also belong on the capital account

The Importance of the Balance of Payments

The BoP and an individual's place in the economy

- Is he a worker, a capitalist
- Is he a net saver, an investor or living off of borrowed funds etc.

There is no reason to worry about an "unfavourable" BoP

- Favourable simply means that a person is spending less than his income and adding to his cash balance
- Unfavourable means that he is spending more than his income and drawing down his cash balance
- The size of the cash balance is not passive or a residual – it's an integral result from the individual's decisions

Aggregate Balances of Payments

Aggregate BoPs for larger groups

- Simply add individual BoPs and net out internal transactions
- The larger the group or country, the less informative the BoP is – that of Leipzig is more informative than that of Saxony, which in turn tells us more than the German BoP
- BoPs of smaller nations tells us more than BoPs of larger nations – A global BoP would tell us nothing

A change or disequilibrium in a BoP is always monetary in nature

- From the side of supply or demand (exchange or reservation)

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5. Interventionism

- The analysis of government regulation of economic activity
- Trade policy
- International monetary affairs and regulations

Instruments of Trade Policy

Instruments

- Tariffs
- Product quotas
- Quality controls and other barriers to trade

Specific Effects

- Some effects are specific to the international sphere
- Generally reduces the amount and scope of international trade

General Effects

- Higher taxes lead to lower productivity
- Regulations impede entrepreneurship
- Quotas cause shortages, misallocation of goods

International Monetary Regulations

International monetary and financial regulations look complex, but they can be understood in simple terms:

- A fixed exchange rate means imposing price controls on one money in terms of other currencies
- Capital controls mean limiting exchanges of capital between one country and the rest of the world – usually in an attempt to prevent "capital flight", i.e., selling domestic assets and investing the capital abroad

International sanctions are essentially attempts by one country (or group of countries) from preventing some or all transactions between one country and the rest of the world

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Conclusion

- This is the core of international economics – the rest is just a matter of application to special circumstances
- Written exam: date TBD
- One trial exam

References

- Pugel, *International Economics* chap. 1
- Mises, *Human Action*, pp. 157-64 (for law of comparative advantage)
- Rothbard, *Man, Economy, and State*, pp. 198-206 (for individual balances of payments)