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# International Economics

## I. Introduction

Leipzig University | April 7, 2025

Dr. Kristoffer J. M. Hansen | Institute for Economic Policy



# I. Introduction

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



# 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



### Dr. Kristoffer J. M. Hansen

- Office: Room I 240
- Email: [mousten\\_hansen@wifa.uni-leipzig.de](mailto:mousten_hansen@wifa.uni-leipzig.de)
- Phone: 0341 97-33566
- Office hours: by appointment

### Textbooks

- Pugel, *International Economics* 17<sup>th</sup> edition
- Caves, Frankel, Jones, *World Trade and Payments* 10<sup>th</sup> edition
- More readings given in the lectures

### Downloads available online:

<https://www.wifa.uni-leipzig.de/institut-fuer-wirtschaftspolitik/studium/sommer-2023/international-economics-2>

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## 1. Introduction

### **Part I: International Trade**

## 2. Trade Theory: Smith and Ricardo

## 3. An Overview of Trade and Mercantilism

## 4. Development 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

### **Part III: International Sanctions**

## 12. The Economics of International Sanctions



# Schedule

	Datum	Von	Bis	Raum	Lehrende
1	Mo, 7. Apr. 2025	15:15	16:45	Seminarraum 5 - I127 I1.004	Dr. Kristoffer Mousten Hansen
2	Mo, 14. Apr. 2025	15:15	16:45	Seminarraum 5 - I127 I1.004	Dr. Kristoffer Mousten Hansen
3	Mo, 28. Apr. 2025	15:15	16:45	Seminarraum 5 - I127 I1.004	Dr. Kristoffer Mousten Hansen
4	Mo, 5. Mai 2025	15:15	16:45	Seminarraum 5 - I127 I1.004	Dr. Kristoffer Mousten Hansen
5	Mo, 12. Mai 2025	15:15	16:45	Seminarraum 5 - I127 I1.004	Dr. Kristoffer Mousten Hansen
6	Di, 20. Mai 2025	13:15	14:45	Seminarraum 5 - I127 I1.004	Dr. Kristoffer Mousten Hansen
7	Mo, 26. Mai 2025	15:15	16:45	Seminarraum 5 - I127 I1.004	Dr. Kristoffer Mousten Hansen
8	Mo, 2. Jun. 2025	15:15	16:45	Seminarraum 5 - I127 I1.004	Dr. Kristoffer Mousten Hansen
9	Mo, 16. Jun. 2025	15:15	16:45	Seminarraum 5 - I127 I1.004	Dr. Kristoffer Mousten Hansen
10	Mo, 23. Jun. 2025	15:15	16:45	Seminarraum 5 - I127 I1.004	Dr. Kristoffer Mousten Hansen
11	Mo, 30. Jun. 2025	15:15	16:45	Seminarraum 5 - I127 I1.004	Dr. Kristoffer Mousten Hansen
12	Mo, 7. Jul. 2025	15:15	16:45	Seminarraum 5 - I127 I1.004	Dr. Kristoffer Mousten Hansen



# Why Trade at All?

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## 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
- War and conflict would be better than peace



## 2. Division of Labour

### People cooperate freely

- Because people realize that they gain from it
- Difference in utility  $\rightarrow$  exchange

### The Law of Comparative Advantage

- or the Ricardian Law of Association
- **Division of labour leads to greater productivity**
- (After David Ricardo, credited with first stating the principle)





# The Foundations of Economic Life

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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

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## 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, during the same 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

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**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

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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  $60 q$

Is this a higher output? Yes!

- For  $A$ , the rate of substitution (or price) 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

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The *price* to each participant to exchange is key

- The *price* is what a person gives up in exchange

## Autistic Exchange

- We can conceive of individual action as an exchange
- 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)

## Interpersonal Exchange

- If  $A$  buys  $p$  from  $B$ , 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  $2/3 p$



## 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

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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

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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





### 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 determines the value of money and/or the amount of money in a given area



## **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, since supply is greater
- Relatively more valuable farther away



## 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**



## 4. The Balance of Payments

- 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

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**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

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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

April 2025			
<i>Income</i>		<i>Expenditures</i>	
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 €
<b>Total</b>	<b>5,000 €</b>		<b>5,000 €</b>



# Current Account and Capital Account

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## **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, bonds – 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

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## **The BoP and an individual's place in the economy**

- We can see whether he 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
- Currency questions complicate this simple truth



# Aggregate Balances of Payments

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## 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**

- 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

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International monetary and financial regulations appear 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) at preventing some or all transactions between one country and the rest of the world



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)