

International Economic Relations

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ABSTRACT

The International Economic Relations field focuses on the consequences of the economic interaction among countries. These interactions include trade in goods, services, assets, ideas, and macroeconomic spillover effects, as well as the effects of rules, regulations and policies like tariffs, trade quotas, controls on the international flow of capital and the exchange rate regime. There are important consequences of these interactions including unemployment and inflation, the rise or fall of particular industries, and the outcomes for different categories of workers. These affect national welfare, economic stability, inequality and political movements, which in turn affect economic policymaking. The coursework in this field prepares students through the teaching of economic theory, political theory, statistics and various types of empirical analyses.

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International economics is concerned with the effects upon economic activity from international differences in productive resources and consumer preferences and the international institutions that affect them. It seeks to explain the patterns and consequences of transactions and interactions between the inhabitants of different countries, including trade, investment and transaction.^[1]

- **International trade** studies goods and services flows across international boundaries from supply-and-demand factors, economic integration, international factor movements, and policy variables such as tariff rates and trade quotas.^[2]
- **International finance** studies the flow of capital across international financial markets, and the effects of these movements on exchange rates.^[3]
- **International monetary economics** and international **macroeconomics** study flows of money across countries and the resulting effects on their economies as a whole.^[4]
- **International political economy**, a sub-category of **international relations**, studies issues and impacts from for example international conflicts, international negotiations, and international sanctions; national security and economic nationalism; and international agreements and observance.

The economic theory of **international trade** differs from the remainder of economic theory mainly because of the comparatively limited international mobility of the capital and labour.^[6] In that respect, it would appear to differ in degree rather than in principle from the trade between remote regions in one country. Thus the methodology of international trade economics differs little from that of the remainder of economics. However, the direction of academic

research on the subject has been influenced by the fact that governments have often sought to impose restrictions upon international trade, and the motive for the development of trade theory has often been a wish to determine the consequences of such restrictions.

The branch of trade theory which is conventionally categorized as "classical" consists mainly of the application of deductive logic, originating with Ricardo's Theory of *Comparative Advantage* and developing into a range of theorems that depend for their practical value upon the realism of their postulates. "Modern" trade analysis, on the other hand, depends mainly upon *empirical analysis*.

Classical theory

The theory of *comparative advantage* provides a logical explanation of international trade as the rational consequence of the comparative advantages that arise from inter-regional differences - regardless of how those differences arise. Since its exposition by David Ricardo^[7] the techniques of neo-classical economics have been applied to it to model the patterns of trade that would result from various postulated sources of comparative advantage. However, extremely restrictive (and often unrealistic) assumptions have had to be adopted in order to make the problem amenable to theoretical analysis.

The best-known of the resulting models, the Heckscher-Ohlin theorem (H-O)^[8] depends upon the assumptions of no international differences of technology, productivity, or consumer preferences; no obstacles to pure competition or free trade and no scale economies. On those assumptions, it derives a model of the trade patterns that would arise solely from international differences in the relative abundance of labour and capital (referred to as factor endowments). The resulting theorem states that, on those assumptions, a country with a relative abundance of capital would export capital-intensive products and import labour-intensive products. The theorem proved to be of very limited predictive value, as was demonstrated by what came to be known as the "Leontief Paradox" (the discovery that, despite its capital-rich factor endowment, America was exporting labour-intensive products and importing capital-intensive products^[9]) Nevertheless, the theoretical techniques (and many of the assumptions) used in deriving the H-O model were subsequently used to derive further theorems.

The Stolper-Samuelson theorem, which is often described as a corollary of the H-O theorem, was an early example. In its most general form it states that if the price of a good rises (falls) then the price of the factor used intensively in that industry will also rise (fall) while the price of the other factor will fall (rise). In the international trade context for which it was devised it means that trade lowers the real wage of the scarce factor of production, and protection from trade raises it.

Another corollary of the H–O theorem is Samuelson's factor price equalisation theorem which states that as trade between countries tends to equalise their product prices, it tends also to equalise the prices paid to their factors of production.^[11] Those theories have sometimes been taken to mean that trade between an industrialised country and a developing country would lower the wages of the unskilled in the industrialised country. (But, as noted below, that conclusion depends upon the unlikely assumption that productivity is the same in the two countries). Large numbers of learned papers have been produced in attempts to elaborate on the H–O and Stolper–Samuelson theorems, and while many of them are considered to provide valuable insights, they have seldom proved to be directly applicable to the task of explaining trade patterns.^[12]

Modern analysis

Modern trade analysis moves away from the restrictive assumptions of the H–O theorem and explores the effects upon trade of a range of factors, including technology and scale economies. It makes extensive use of econometrics to identify from the available statistics, the contribution of particular factors among the many different factors that affect trade. The contributions of differences of technology have been evaluated in several such studies. The temporary advantage arising from a country's development of a new technology is seen as contributory factor in one study.^[13]

Other researchers have found research and development expenditure, patents issued, and the availability of skilled labor, to be indicators of the technological leadership that enables some countries to produce a flow of such technological innovations^[14] and have found that technology leaders tend to export hi-tech products to others and receive imports of more standard products from them. Another econometric study also established a correlation between country size and the share of exports made up of goods in the production of which there are scale economies.^[15] The study further suggested that internationally traded goods fall into three categories, each with a different type of comparative advantage:

- goods that are produced by the extraction and routine processing of available natural resources—such as coal, oil and wheat, for which developing countries often have an advantage compared with other types of production—which might be referred to as "Ricardo goods";
- low-technology goods, such as textiles and steel, that tend to migrate to countries with appropriate factor endowments—which might be referred to as "Heckscher-Ohlin goods"; and,
- high-technology goods and high scale-economy goods, such as computers and aeroplanes, for which the comparative advantage arises from the availability of R&D resources and specific skills and the proximity to large sophisticated markets.

There is a strong presumption that any exchange that is freely undertaken will benefit both parties, but that does not exclude the possibility that it may be harmful to others. However (on assumptions that included constant returns and competitive conditions) Paul Samuelson has proved that it will always be possible for the gainers from international trade to compensate the losers.^[16] Moreover, in that proof, Samuelson did not take account of the gains to others

resulting from wider consumer choice, from the international specialisation of productive activities - and consequent economies of scale, and from the transmission of the benefits of technological innovation. An OECD study has suggested that there are further dynamic gains resulting from better resource allocation, deepening specialisation, increasing returns to R&D, and technology spillover. The authors found the evidence concerning growth rates to be mixed, but that there is strong evidence that a 1 per cent increase in openness to trade increases the level of GDP per capita by between 0.9 per cent and 2.0 per cent.^[17] They suggested that much of the gain arises from the growth of the most productive firms at the expense of the less productive. Those findings and others^[18] have contributed to a broad consensus among economists that trade confers very substantial net benefits, and that government restrictions upon trade are generally damaging.

Factor price equalisation

Nevertheless, there have been widespread misgivings about the effects of international trade upon wage earners in developed countries. Samuelson's factor price equalisation theorem indicates that, if productivity were the same in both countries, the effect of trade would be to bring about equality in wage rates. As noted above, that theorem is sometimes taken to mean that trade between an industrialised country and a developing country would lower the wages of the unskilled in the industrialised country. However, it is unreasonable to assume that productivity would be the same in a low-wage developing country as in a high-wage developed country. A 1999 study has found international differences in wage rates to be approximately matched by corresponding differences in productivity.^[19] (Such discrepancies that remained were probably the result of over-valuation or under-valuation of exchange rates, or of inflexibilities in labour markets.) It has been argued that, although there may sometimes be short-term pressures on wage rates in the developed countries, competition between employers in developing countries can be expected eventually to bring wages into line with their employees' *marginal products*. Any remaining international wage differences would then be the result of productivity differences, so that there would be no difference between unit labour costs in developing and developed countries, and no downward pressure on wages in the developed countries.^[20]

Terms of trade

There has also been concern that international trade could operate against the interests of developing countries. Influential studies published in 1950 by the Argentine economist Raul Prebisch^[21] and the British economist Hans Singer^[22] suggested that there is a tendency for the prices of agricultural products to fall relative to the prices of manufactured goods; turning the *terms of trade* against the developing countries and producing an unintended transfer of wealth from them to the developed countries.

Their findings have been confirmed by a number of subsequent studies, although it has been suggested that the effect may be due to *quality bias* in the index numbers used or to the possession of *market power* by manufacturers.^[23] The Prebisch/Singer findings remain controversial, but they were used at the time—and have been used subsequently—to suggest that the developing countries should erect barriers against manufactured imports in order to nurture their own "infant industries" and so reduce their need to

export agricultural products. The arguments for and against such a policy are similar to those concerning the *protection* of infant industries in general.

Infant industries

The term "infant industry" is used to denote a new industry which has prospects of gaining comparative advantage in the long-term, but which would be unable to survive in the face of competition from imported goods. This situation can occur when time is needed either to achieve potential *economies of scale*, or to acquire potential *learning curve* economies. Successful identification of such a situation, followed by the temporary imposition of a barrier against imports can, in principle, produce substantial benefits to the country that applies it—a policy known as "import substitution industrialization". Whether such policies succeed depends upon the governments' skills in picking winners, with reasonable expectations of both successes and failures. It has been claimed that South Korea's automobile industry owes its existence to initial protection against imports,^[24] but a study of infant industry protection in Turkey reveals the

absence of any association between productivity gains and degree of protection, such as might be expected of a successful import substitution policy.

Another study provides descriptive evidence suggesting that attempts at import substitution industrialisation since the 1970s have usually failed, but the empirical evidence on the question has been contradictory and inconclusive. It has been argued that the case against import substitution industrialisation is not that it is bound to fail, but that subsidies and tax incentives do the job better. It has also been pointed out that, in any case, trade restrictions could not be expected to correct the domestic market imperfections that often hamper the development of infant industries.

Literature

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