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INTERNATIONAL ECONOMICS

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for the same course
for full-time students of economic specialties

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The textbook outlines the basic concepts of the discipline “International Econo-mics” in accordance with the standard curriculum of the course.
The textbook can be recommended for students of economic specialties.

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Contents

Introduction 4
Theme 1. Course subject. International Economics:
Structure and Trends development 5
Theme 2. Theory of International Trade 10
Theme 3. National and international regulation of Trade.......................... 17
Theme 4. The international movement of capital 21
Theme 5. The international flow of labor force.. 26
Theme 6. The international economic commercial integration 31
Theme 7. Balance of payments 37
Theme 8. World exchange rate system and exchange rates....................... 41
Theme 9. The government's macro policies and open economy 48

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Introduction

The study guide is an attempt summary of the International Economics course. The need to study the course is caused by the role of international economic relations in the development of the country and the increasing globalization of the world economy. The course focuses in teaching students the bases of international economy.

Structurally, the course includes three sections. The first part of the course discusses the theoretical and methodological foundations of the formation of international relations. The basic theoretical approaches to the analysis of international trade and methods of its regulation are described.

The second part is devoted to the analysis of microeconomic mechanism of World Economy and International Economic Relations System: the functioning of international trade relations and the international movement of factors of production.

The third part presents the researches of the macroeconomic enforcement mechanism of World Economy and International Economic Relations: the functioning of modern monetary and financial structures. The fourth part discusses basic questions of macroeconomic policy in an open system of international economic relations.

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Theme 1. Course subject. International Economics: Structure and Trends development

1. The subject of the course "International Economics". The concept of the world economy and its total characteristics

Concept of International Economics. Initially "International Economics" in the economics system occupied a peripheral place and based on the principles of separate parts of Micro- and Macroeconomics. 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. The "International Economics" is a separate discipline and its subject consists of the relations, which are formed between entities in the spheres of international trade (goods and service), international factor flows (capital, labor, technology), in the international monetary and financial sphere. In other words, international economics is a field concerned with economic interactions of countries and effect of international monetary and financial sphere.

The scope of international economics is wide as it includes various concepts, such as globalization, gains from trade, pattern of trade, balance of payments. Apart from this, international economics describes production, trade, and investment between countries. Generally, the economic activities between nations differ from activities within nations. For example, the factors of production are less mobile between countries due to various restrictions imposed by governments. Thus, it is important to study the international economics as a special field of economics.

International economics is dividing into two parts, namely, International Microeconomics and International Macroeconomics. International Microeconomics is a part of International Economics that examines the international flows of goods and production factors and its basic characteristics. 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. 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.

✓ The analysis of the international financial markets and the concrete financial instruments trade (e.g. currency, credit, securities).

Subjects of the world economy:

✓ The states with their economic complexes.

✓ Transnational corporations.

✓ The international organizations and institutes.

✓ Firms of all sectors the economy, which have left for national borders.

2. Stages of formation, subsystems and the structure of world economy. Main centers

Stages of formation of world economy. The world economy develops of the national-state economy, which are among themselves in the constant and mutual economic Communications.

The initial stage. The first phase of development of the world economy due to the appearance of the first elements of the world economy – world trade, origin, formation and development of the world commodity market. The historical framework of this process: XVI century – first half of XIX century. The second – this phase is associated with the monopolization of production, a sharp increase in the export of capital abroad, territorial and economic division of the world (the second half of XIX century – the first half of the XX century). The third stage is due to several factors. Due to the deregulation of the global economy after the economic crisis of the 30's. (Great Depression) and the Second World War, from the middle of the XX century. It became clear that the world economy could not function stably without any common to all countries of the mechanisms of coordination and management. At the micro level, firms have become more actively create vertical control circuit of the reproduction process, and gradually grew into an international corporation. At the macro level, a system of economic and financial organizations that monitor and regulate the world economic development: International Monetary Fund (IMF), World Bank, International Bank for Reconstruction and Development (IBRD) United Nations, World Trade Organization. The fourth stage. In the 50-ies. XX century destroyed the colonial system linking the economy of the colonies and colonial powers. At the turn of the 90s, there was a collapse of the system of "real socialism". The transition of the former colonies and the socialist countries to the market economy has made these countries more open. Thus, in the second half of the XX century the global economy has moved to a new, higher than the world economy.

The development of the world economy in modern times is significantly affected by the technological revolution (including internet deve-

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lopment), which has forced the reconsideration of methods and, in fact, a mechanism organization and regulation of production, trade, currency and monetary sphere.

The classification of countries. For analytical purposes, **the statistical annex the World Economic Situation and Prospects (WESP)** classifies all countries of the world into one of three broad categories: **developed economies, economies in transition and developing economies. Developed economies** – European Union, New EU member States, Other countries and major developed economies – (G7). **Economies in transition** – South-Eastern Europe, Commonwealth of Independent States and Georgia. **Developing economies** by region.

The World Bank′s Classification of Countries by Income. Economies by per capita GNI (High-income, Upper middle income, Lower middle income, Low-income). In 1971, **UN the General Assembly** identified a group of **Least Developed Countries**. The current list includes 49 countries.

The UNDP′s country classification system builds around the Human Development Index (HDI). The HDI is a composite index of three indices measuring countries' achievements in longevity, education, and income.

3. Nature and modern trends in international division of labor and its types. International specialization and cooperation

International division of labor. The specialization of particular countries in distinct branches of production, whether this be in certain products, or in selected parts of the production process.

The international division of labor (IDL) develops in two directions:

✓ Vertical division of labor – when various manufacturers form one-linear technological chain and carry out a number of consecutive industrial operations in which course the product of each previous stage is not complete product and becomes an object of the labor for each subsequent stage.

✓ Horizontal division of labor assumes manufacturing by separate manufacturers of components from, which then gathers technically or technologically complex product.

Both horizontal and vertical IDL break up already at the international have three levels:

1. The general (between large groups of branches).
2. Private (disintegration of large groups of branches on less aggressive branches).
3. Individual (intrasectoral division).

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The international production cooperation is the result of the specialization of national industries, which interact in the international division of labor.

Marketability index – an indicator, which also characterizes a measure of participation of a national economy in IDL: $t = e + \frac{i}{p}100\,\%$. Where: e – export to a current of year; i – export to a current of year; p – annual gross national product.

4. The open economy: essence, indicators, factors. Globalization of the world economy, the consequences of contradiction

• **The open economy.** An open economy is a type of economy in which people are free to sell goods and services to other countries. They also have the opportunity to buy goods and do business in the international community. The current state of international economic relations allows defining two **levels of openness**:

1. The level of countries involvement not only into the international goods and into 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. Economic openness on the second level mainly determined by independence standard of international monetary system, which realized over the functioning of international financial market. The efficiency of monitoring and regulation within either national economy or the world one in whole is the main indicator of market economy performance as the international economy.

• **The open economy: indicators**

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.

$$Eq = \frac{E}{GDP}100,\;\; Iq = \frac{I}{GDP}100,\;\; \text{Impex} = \frac{I+E}{GDP}100.$$

Where: Eq – export quota; Iq – import quota; E – export volume.

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Export and import combinations of quotas inform about relation scales between separate national economies and the world economy in whole. The Openness Index (Impex). The interpretation of the Openness Index is the higher the index the larger the influence of trade on domestic activities, and the stronger that country's economy.

The migration intensity, which 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 calculate:

$$Ce = \frac{Me}{P}1000;\ Ci = \frac{Mi}{P}1000;\ Ct = \frac{Me + Mi}{P}1000.$$

Where: *P* – average annual population size; *Me* – number of emigrants; *Mi* – number of immigrants.

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

Globalization of the world economy. The term “globalization” appeared the first time in 1985. There is no single standard definition of globalization. Globalization can define as a process of growth and intensification of relations between countries, which leads to high dependence and the solution of common problems.

The process of globalization in the world economy is a natural result of the internationalization of production and capital. Phenomenon (the phenomenon), globalization can be seen from two sides. **At the macro level**, globalization refers to the total commitment of individual countries and regions in economic activity outside their borders. Signs of such aspirations: the liberalization, the removal of trade and investment barriers, the creation of free zones, etc. **At the micro level**, under globalization meant the expansion of the company beyond the domestic market. In contrast to the inter-ethnic and multi-national orientation of entrepreneurship, globalization means a unified approach to the development of the world market.

The globalization of production under the influence of scientific and technological revolution creates a situation where virtually no country is not practical to have “their” production. The individual national economies integrate into the world economy, trying to find their niche in it.

By the end of the 90-s the globalization of the world economy has acquired a number of new features:

First, the liberalization of foreign economic relations and international payments covered a number of new countries of the former “socialist camp.”

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Second, actively tendency to unification and standardization. It is increasingly common to all applicable standards of the technology, the environment, the financial institutions, accounting and statistical reporting. The standards apply to education and culture.

Third, international economic organizations are adopting uniform criteria macroeconomic policy is the unification of requirements for tax policy to the policy in the field of employment, etc.

The formation of the global world economy – an important sign that the former world economy based on self-sufficiency and sustainability of the national cultures of specific economic systems, is coming to end. There is a new form of organization and structure of the world economy.

However, it should be noted that globalization – a process that is not yet acquired a global character. About half of the population in developing countries live in a closed economy. In parallel, there are two worlds: international and self-sufficient economy, one of which (the self-sufficient economy) is reducing in size and importance in the world.

Theme 2. Theory of International Trade

1. Classical theories. The modern version of international trade

The three phases of the trade theories are pre classical, classical and modern schools. Mercantilism represents the pre classical version. Adam Smith, David Ricardo and John Stuart Mill are associated with the classical theory. The modern versions classical theories are linked with two Swedish economists Eli Heckscher and Bertil Ohlin.

- **The pre classical school. Mercantilism**

The trade theory that states that nations should accumulate financial wealth, usually in the form of gold, by encouraging exports and discouraging imports called mercantilism. Mainly Great Britain, France, the Netherlands, Portugal and Spain used mercantilism during the 1500s to the late 1700s. They simply focused on the accumulation of gold. Mercantilism proposed that a country should try to export more than its imports, in order to receive gold. For this, they advocated strict controls on trade in the form of tariffs and quotas. Mercantilist countries practiced the zero-sum game, which meant that world wealth was limited and that countries could increase their share only at the expense of other countries. This protectionist policy decelerated the long-term growth.

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Features:

✓ Restrictive trade aiming at the acceleration of exports and reduction of imports.

✓ Strict focus on the wealth accumulation than welfare promotion.

✓ No simultaneous gains or sharing of gains among countries is possible. One country can benefit only at the cost of other countries.

✓ Adoption of trade protectionism.

Neo mercantilism is the modern version of mercantilist practices, through the formation of local trading blocks and promotion of trade with imposition of tariffs and quotas.

• **The trade theory of absolute advantage: Adam Smith**

The Scottish economist Adam Smith developed the trade theory of absolute advantage in 1776 through his legendary book "An Inquiry into the Nature and Causes of Wealth of Nations".

He developed the theory as an attack against the mercantilist view of restrictive trade with the slogan 'free trade'. Smith's argument was that the wealth of nations depends upon goods and services available to their citizens, rather than the gold reserves held by the nation. This theory proposes that a country should engage in the production and exchange of those commodities where it has an absolute advantage.

Absolute advantage define as the ability to produce more of a good or service than competitors, using the same amount of resources. 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.

Assumptions:

✓ There are two countries and two commodities.

✓ One country has absolute advantage in one commodity and the second country has advantage in another commodity.

✓ Technology is assumed being unchangeable. There is no technological improvement.

✓ Labor is the only factor of production and labor is homogeneous, that means each unit of labor produces same level of output.

✓ Value of a commodity measured in terms of its labor content.

✓ Labor 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.

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An example (Table 1).

Suppose there are two countries – India and Cuba producing tea and sugar. When hiring a worker for one hour, India can produce 10 kg of tea or 5 kg of sugar. Same if a Cuban worker employed he is capable of producing 10 kilograms of sugar or 5 kilograms of tea.

Table 1

Output per hour, kg

Country	Sugar	Tea
India	5	10
Cuba	10	5

From the table it is clear that by spending an hour's labor India is capable of producing twofold of tea than Cuba similarly in the case of sugar Cuba is able to generate double the production in India. In short, Cuba has absolute advantage in sugar and India in tea. In this situation by concentrating on the respective absolute advantageous areas, both nations can benefit. Since there is perfect factor mobility within a country, India can channelize (send) laborers into tea sector and Cuba into sugar industry. If India transfer one labor from sugar to tea sector production may fall by 5 kilograms but can produce 10 more kilograms of tea. By exchanging this one unit effort India is capable of purchasing 10 kilograms of sugar from Cuba. Therefore, it is beneficial for India. If India goes for domestic exchange, due to the increased cost it will not benefit India. The same is true for Cuba in the case of sugar.

There is a potential problem with absolute advantage. If there is one country, that does not have an absolute advantage in the production of any product, will there still be benefit to trade, and will trade even occur?

The theory of comparative advantage offers an answer to this question.

The theory of comparative advantage: David Ricardo.

Ricardo changes only one premise of Smith's exploration, leaving the rest unchanged – one country has absolute advantage in both commodities and the second country has in another commodity.

An example (Table 2).

Table 2

Output per hour, kg

Country	Sugar	Tea
India	10	10
Burma	4	5

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In this example, Indian laborers are capable of producing both wheat and tea in absolute advantage. Burma is disadvantageous in both cases. However, there is a possibility for trade. In India, we can exchange wheat for tea in the ratio of one to one, and in Burma, one to 1.25 Burma has fewer disadvantages in tea than wheat. Therefore, it is its comparative advantage. This is because its advantage in wheat is comparatively greater than its advantage in tea. In this situation, India can concentrate on wheat and Burma on tea and both can benefit from trade.

Milley's theory of reciprocal demand is also important for understanding the classical theory of international trade. Mill argued, acquisition of imports from abroad is the purpose of trade while exports are just means of payment for imports. In order to import some useful commodities from abroad exports of a country should have a real demand in the other countries. Therefore, a country should produce both for itself and for consumers in the other countries. Otherwise, if the country does not export goods and services, it will not be able to import any goods at all. The value, then, in any country, of a foreign commodity, depend upon the quantity of home produce which must be given to the foreign country in exchange for it.

The Heskscher-Ohlin model. 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.

According to B. Ohlin, 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 labor) differ in countries. Hence, trade occurs because different countries have different factor endowments. The Heckscher Ohlin theorem states that countries, which are rich in labor will export labor-intensive goods and countries, which are rich in capital will export capital-intensive goods.

The Heckscher-Ohlin theorem had further development in the factor-price equalization theorem (the Heckscher-Ohlin-Samuelson theorem). It answers the following question: "If the relative price of labor-intensive goods changes, how will the relative price of the labor change in a labor abundant country, which produces these goods, as well as, if the relative price of capital abundant goods changes, how will the price of capital change in a capital abundant country?" The essence of the factor-price equalization theorem is as follows: international trade leads to the equalization of absolute and relative prices for the goods, and this, in its turn, leads to the equalization of relative and absolute prices for homogeneous factors of production, whereby there produced these goods in partner-countries.

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W. Leontief paradox. Nevertheless, in the analysis of trade flows in the "triangle" of the United States – Western Europe – Japan, the Heckscher-Ohlin theorem faces difficulties and contradictions. The American Nobel Laureate Wassily Leontief applied the Heckscher-Ohlin theorem to the analysis of foreign trade of the United States, and he showed that the terms of the theory do not keep in practice. Since the United States was a capital abundant country with relatively high wages, according to the theory, it should export capital-intensive goods, and import labor-intensive ones. However, in reality, they exported more labor-intensive goods, and capital intensity of American imports exceeded exports by 30 %. W. Leontief explains this paradox by division of labor into skilled and unskilled. The United States exported the goods, whose production in other countries was impossible or inefficient due to the lower labor skill. W. Leontief created the model of "labor skill", according to which, instead of the three factors (capital, land, labor) the production includes four factors: skilled labor, unskilled labor, capital and land.

2. New theories of international trade

Modern or Firm-Based Trade Theories. In contrast to classical, country-based trade theories, the category of modern, firm-based theories emerged after World War II. The firm-based theories evolved with the growth of the multinational company (MNC). The country-based theories could not adequately address the expansion of either MNCs or intraindustry trade, which refers to trade between two countries of goods produced in the same industry. For example, Japan exports Toyota vehicles to Germany and imports Mercedes-Benz automobiles from Germany.

Unlike the country-based theories, firm-based theories incorporate other product and service factors, including brand and customer loyalty, technology, and quality, into the understanding of trade flows.

The main alternative theories usually include the product life-cycle theory; the country similarity theory, the theory of strategic competitive advantage, Porter's National Competitive Advantage Theory.

The product life-cycle theory. The product life-cycle theory created by Raymond Vernon in 1966. A product consistently passes four stages of life cycle:

1. The stage of appearance of a new product on the market shows the low sales. The costs of implementation of this product make the profits low too.

2. The stage of growth is characterized by growth of profits and sales growth.

3. In the stage of maturity, the development of competition and market saturation stabilize the sales and profits.

4. In the stage of decay, the products become obsolete, the sales and profits fall off.

R. Vernon argues that the role of technology and research is important in building trade relations between countries. Industrialized countries have much more technological and scientific capabilities to develop a new product. In countries such as the United States, companies may have comparative advantages in science and technology, which will lead them to a competitive advantage in the new products development. To stretch the stage of growth of their product life – cycle, these firms most probably will export the goods developed by themselves.

The product cycle-theory characterizes the dynamic aspect of comparative advantages, assuming that during its life cycle a product consistently changes its suppliers in the world market.

The country similarity theory developed by a Swedish economist Stefan Linder in 1961, where he takes as a basis the volume of exchange of similar goods between countries with a comparable level of development, without regard to the Heckscher-Ohlin theorem. A new approach found on the following principles:

✓ The conditions of production depend on the conditions of demand. Efficiency of production is as high as demand.

✓ The conditions of domestic production depend mainly on the domestic demand. It is the domestic representative demand that is the basis of production and is necessary, but not a sufficient condition to export the goods.

✓ The foreign market is just a continuation of the internal one, and the international exchange is only the continuation of the interregional one.

There is a conclusion, that international trade in manufactured goods will be more intensive between the countries with the similar income levels, in comparison with product turnover between the countries with different income levels.

The theory of strategic competitive advantage. In the 80s researchers P. Krugman and K. Lancaster developed new theoretical principles to describe patterns of international trade.

According to this theory, companies seek to obtain sustainable competitive advantages, which can used to provide access to international mar-

kets. In particular, according to the research by Krugman, at the disposal of companies participating in the competition in the international market, there are several ways to obtain a sustainable competitive advantage by using techniques such as:

– R&D investment;

– obtaining savings out of scale or diversification of activities;

– using of the opportunities provided by the experience curve;

– Possession of the right to intellectual property.

The company, which has intellectual property rights (with rights to the trademark and trade name, and holds patents and copyrights on various inventions), in many cases gains significant advantages over their competitors. According to this theory, trade flows in the international market are forming depend on the companies' investments in R&D. Also according to the theory of strategic competitive advantage of P. Krugman and C. Lancaster, it is necessary to use the potential of patent law in the field of R&D in developing a strategy for entering the international market.

Porter's National Competitive Advantage Theory. In the continuing evolution of international trade theories, Michael Porter of Harvard Business School developed a new model to explain national competitive advantage in 1990.

Porter′s theory stated that a nation's competitiveness in an industry depends on the capacity of the industry to innovate and upgrade. His theory focused on explaining why some nations are more competitive in certain industries. To explain his theory, Porter identified **four determinants** that he linked together. The combination of determinants forms **the diamond of national advantage**. The four determinants are:

1. Factor Conditions. The nation's position in factors of production, such as skilled labor or infrastructure, necessary to compete in a given industry.

2. Demand Conditions. The nature of home-market demand for the industry's product or service.

3. Related and Supporting Industries. The presence or absence in the nation of supplier industries and other related industries that are internationally competitive.

4. Firm Strategy, Structure, and Rivalry. National circumstances and context create strong tendencies in how companies created, organized, and managed, as well as what the nature of domestic rivalry will be.

The components of Porter's diamond create an environment in which companies born and learn to compete.

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In addition to the four determinants of the diamond, Porter also noted that government and chance play a part in the national competitiveness of industries. Governments can by their actions and policies, increase the competitiveness of firms and occasionally entire industries.

Which Trade Theory Is Dominant Today?

In practice, governments and companies use a combination of these theories to both interpret trends and develop strategy. Just as these theories have evolved over the past five hundred years, they will continue to change and adapt as new factors impact international trade.

Theme 3. National and international regulation of Trade

1. The Main Types of Trade Policy

Regulation of international trade supposes purposeful influence of the state on trade relations with other countries. **The main goals of foreign trade policy** are:

– the volume change of exports and imports;
– changes in the structure of foreign trade;
– providing the country with the necessary resources;
– the change in the ratio of export and import prices.

There are three **main approaches to the regulation** of international trade:

✓ **A system of unilateral measures**, in which the instruments of state control used by the government unilaterally and not coordinated with the trading partner.

✓ **The undertaking of bilateral agreements**, in which trade policy measures agreed between trading partners.

✓ **The undertaking of multilateral agreements.** Trade policy is coordinated and regulated by the participating countries (the General Agreement on Tariffs and Trade, which is included in the system of the WTO agreements, agreements on trade of EU member states).

The basic line of government control of international trade is the application of two different types of foreign trade policy in combination: liberalization (free trade policy) and protectionism.

The **free trade policy** is understood as minimal state intervention in foreign trade, which develops on the basis of market forces of supply and demand. The **protectionism** is a government policy that protects the domestic market from foreign competition by using tariff and non-tariff trade policy instruments.

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These two types of trade policy characterize the measure of state intervention into international trade.

In actual practice, a combination of these types of policies is used. There are arguments both in defense of protectionism and against it.

The main arguments for restrictions on foreign trade are: necessity of defense providing; increase of domestic employment; diversification for the sake of stability; protection of infant industries; protection from dumping; cheap foreign labor force.

However, the removal of foreign competition reduces the interest of domestic producers in the implementation of scientific and technological progress, improving the efficiency of production.

An effective trade policy is to find a balance between two trends: free trade and protectionism. Each policy has its advantages and disadvantages, depending on the circumstances, time and place of its application.

The instruments of state regulation of international trade include the following:

✓ **The tariff methods** that regulate mostly the imports and protect domestic producers from foreign competition. They make foreign products less competitive than domestic ones.

✓ **The nontariff methods**, regulating both imports and exports. The nontariff methods help to bring out more domestic products on the world market, making them more competitive.

2. Methods for international trade regulation

Tariff Methods. Customs tariff is the main and oldest instrument of foreign trade policy. **This is a systematic set of rates of customs duties**, imposed on goods and other things, imported to the customs territory of a country or exported from this territory. That immediately raises the price of imported goods. They become less competitive when compared to local goods. Tariff methods of foreign trade protection are always associated with extra expenditures of consumers.

The customs tariff performs the following functions:

– **a fiscal function**, when they are used to generate, mobilize, accumulate financial resources of the state;

– **a protectionist function**, when they are introduced to reduce or eliminate the imports, thereby protecting domestic producers from foreign competition;

– **a balance function**, when they are introduced to prevent from undesired exports of the goods, the domestic prices of which are lower than the world ones.

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This method works best for countries with lots of imports, such as the United States. An import tariff does not only protect the market from foreign competition, but is also a means to improve the terms of trade with the surrounding world.

Non-tariff Barriers. Non-tariff methods are widely used in trade policy as they are not regulated by international agreements unlike tariffs.

A quota is the most common form of non-tariff barriers. A quota is a quantitative measure of the export or import restricting of the goods by a certain number or amount for a certain period time. Quotas are usually used to regulate the imports of agricultural products. The most common import quotas. Their introduction allows achieve equilibrium in the trade balance, to regulate supply and demand within the country, as an adequate measure in response to discriminatory trade policies of other countries.

Licensing. Quotas are imposing by government authorities through the issuance of licenses. **A license** is a permission, granted by public authorities for export or import of goods in the assigned amount for a certain period. A license is issued by the state through the special authorized agencies.

Voluntary export restraints (VERs) is a quantitative restriction of exports, based on the commitment of one of the trading partners to limit (or not to expand) the volume of exports, adopted within the intergovernmental agreement on quota imposing on product exports. The reason of a VERs implementation is usually the statements of national producers that the importation of some product causes the losses in production and disorganization of the local market.

The hidden trade restrictions. The essential role of non-tariff methods of trade policy focuses on the hidden methods of trade restrictions. They allow countries to restrict exports or imports unilaterally. They are technical barriers, internal taxes and charges, public procurement, local content requirement.

Technical barriers are national standards of quality, economic requirements, medical restraints, packing and marking of goods, requirements to implement the complicated customs formalities, laws of consumer protection etc.

Local content requirement. This method of the hidden trade policy involves the legal establishment of a share of the final product, which should be produced by local (national) manufacturers, in case of selling this product in the domestic market.

Internal taxes and charges. State and local governments may impose various direct (value added tax, excise taxes, etc.) and indirect (charges for customs clearance, registration, port charges, etc.) taxes on the

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imported goods with a view to enhance their internal prices and decline competitiveness in the domestic market.

Public procurement. The policy within the government procurement is that the public authorities and enterprises must buy certain goods only from national firms, even if these goods are more expensive than the imported ones.

3. The World Trade Organization (WTO)

The World Trade Organization is a global membership group that **promotes and manages free trade**. It does this in three ways. **First**, it administers existing multilateral trade agreements. Every member receives Most Favored Nation Trading Status. That means they automatically receive lowered tariffs for their exports. **Second**, it settles trade disputes. Most conflicts occur when one member accuses another of dumping. That is when it exports goods at a lower price than it costs to produce it. The WTO staff investigates, and if a violation has occurred, the WTO will levy sanctions. **Third**, it manages ongoing negotiations for new trade agreements.

A multilateral treaty of 23 countries established the WTO's predecessor, the **General Agreement on Tariffs and Trade (GATT), in 1947** after World War II.

The GATT consists of a set of promises, or commitments, that countries make to each other regarding their own trade policies. **The goal of the GATT** is to make trade freer (i.e., to promote trade liberalization), and thus the promises countries make must involve reductions in trade barriers.

Seven rounds of negotiations occurred under GATT. The GATT trade rounds concentrated on further reducing tariffs, a GATT anti-dumping Agreement and on trade barriers that do not take the form of tariffs. Most importantly, the agreements are reaching by consensus. A round finishes only when every negotiating country is satisfied with the promises it and all of its negotiating partners are making.

The eighth GATT round – known as **the Uruguay Round** – launched in September 1986, in Punta del Este, Uruguay. The Final Act concluding the Uruguay Round and officially establishing the WTO regime been signed **15 April 1994**, during the ministerial meeting at Marrakesh, Morocco, and hence is known as the Marrakesh Agreement.

The WTO establishes a framework for trade policies. That is, it is concerned with setting the rules of the trade policy games. The WTO does not make trade rules. The only makers of rules are national governments.

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In this sense, then, the WTO does not govern anybody. The WTO agreements include thousands of promises for every country, that all intend to reduce barriers to trade relative to what the barriers were before the Uruguay Round. Besides monitoring each member country's trade policies, which the WTO fulfills by conducting periodic trade policy reviews of the member countries, the WTO club also created to deal with disputes.

The goal of the WTO is the same goal as its predecessor, the General Agreement on Tariffs and Trade (GATT): namely, to promote trade liberalization and thereby to foster growth and economic development.

The WTO launched the current round of negotiations, the Doha Development Round, at the fourth ministerial conference in Doha, Qatar in November 2001. The initial agenda comprised both further trade liberalization and new rule making, underpinned by commitments to strengthen substantial assistance to developing countries. Progress stalled over differences between developed nations and the major developing countries on issues such as industrial tariffs and non-tariff barriers to trade particularly against and between the EU and the US over their maintenance of agricultural subsidies–seen to operate effectively as trade barriers.

As of July 2012, there were various negotiation groups in the WTO system for the current stalemated agricultural trade negotiation.

Theme 4. The international movement of capital

1. The essence and forms of international capital flow. Direct investments. Portfolio investments

International movement of capital is well-developed component of the international movement of factors of production. **International capital migration** is not a physical movement of production means, but a financial transaction: loans, purchase and sale of securities, the investment. International Capital Flows (Financial flows) means **the inflow and outflow of capital from one nation to another nation**.

Government and Private Capital. The government capital refers to the lending and borrowing from foreign countries by the government of a given country. On the opposite, the lending made by the private individuals and institutions to the foreigners and borrowing by them from abroad signify the private capital.

Short-Term and Long-Term Capital. Short-term international capital movements consist of such credit instruments that have a maturity of less than one year. The short-term capital movements can take place

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through currency, demand deposits, bills of exchange, commercial papers and time deposits up to a maturity of one year. The long-term capital movements take place through credit instruments having a maturity of more than one year. Long-term capital movements occur through the purchase or sale of long-term securities or bonds.

Direct and Portfolio Capital. The essence of foreign direct investment is that the ownership, control and management of business are vested the foreign investors. In case of portfolio investment, the foreign investors have only the ownership of capital. The control and management rests with the capital-importing country.

The capital flows depend on:

- **Bank Rate:** If these rates rise higher than the corresponding rates in the foreign countries, the home country will be able to attract short-term and long-term capital flows from abroad and vice versa.
- **Foreign Capital Policy:** If a restriction regime for foreign capital introduces, the inflow of foreign capital will decline. On the contrary, liberal policy in this regard can cause a significant inflow of capital from foreign countries.
- **Economic and Political Conditions:** Investors are attracted by a developed economic infrastructure, including means of transport and communications, power, market structures and financial institutions, as well as political stability.

What is the place of foreign direct investment within international capital movements? **Foreign direct investment (FDI)** has a special place among the forms of international capital movements. This is due to the following two main reasons:

✓ Foreign direct investment is a **real investment**, which, unlike portfolio investment, is not purely financial assets denominated in the national currency. This is an investment in business, land and other means of production.

✓ Foreign direct investment, unlike portfolio investment, usually provides a managerial control over the object of the invested capital.

However, foreign direct investment is composed primarily of fixed assets and is highly illiquid and hard to sell during crises. FDI is also more influencing by long-term profitability expectations associated with a country's fundamentals, rather than speculative factors and differences in interest rates.

2. The international movement of loan capital. Basic forms of international lending. The nature of external debt of the country and its restructuring

International lending and borrowing is the movement of loan

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capital over national borders between the subjects of international economic relations, connected with granting of currency and commodity resources on the terms of repayment, urgency and payment of interest.

The importance of the international loan and it is that it induces a reallocation of capital between countries in accordance with the needs and capabilities of the more profitable its use. Each country is an importer and exporter of capital. Creditors and borrowers are banks, firms, public institutions, and governments, international and regional monetary and financial organizations. Development of international crediting today is largely determining by the activities of TNCs and its role's enhancement in the evolution of international economic relation.

Basic forms of international lending. They can be the following:

– long-term (over 5–7 years):

– short-term (up to 1 year).

The movement of short-term loan capital has the following forms: a) commercial and bank credit; b) current accounts in foreign banks. **Commercial (corporate) credit** is widely using in foreign trade and given by an exporter of one country to an importer of another country in the form of a payment delay. In the commercial credit, a loan operation is combining with the sale of goods, and the movement of loan capital is combining with the movement of commodity capital. **Bank short-term crediting** is the provision of funds in the monetary form on the security of goods, commodity documents and bills.

The main form of international long-term crediting is **international loans**. Depending on who is the creditor, international loans divide on:

✓ **Private loans** are providing by major commercial banks in the world from their resources.

✓ **Governmental loans** are giving by government crediting institutions. A country assumes all the costs connected with the loan, it relieves expenditures in case of non-payment of debt.

✓ **Loans of international organizations** are giving mainly by the International Monetary Fund; the structures of the World Bank; the International Bank for Reconstruction and Development; regional development banks and other credit and financial institutions.

3. The nature of external debt of the country and its restructuring

External debt is the amount of financial obligations of a country owed to foreign creditors for unpaid foreign loans and interests.

Long-term debt obligations of a country include the following:

✓ The external public (official) debt, which is the amount of obligations of central and local state bodies to external creditors for unpaid loans and interest.

✓ The state-guaranteed debt, i.e. an obligation of private firms,

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banks, companies, where the guarantor of payment is the country.

✓ Private non-guaranteed debt, i.e. a debt of private borrowers that is not guaranteed by a country. External debt service payments are usually making in a foreign currency.

Debt restructuring is a rescheduling of debt obligations, which have an expired payment term. Debt restructuring is using to alleviate the debt burden of the least developed countries and countries with economies in transition. **The measures of debt restructuring include** transfer payments, reduction of the amount of debt or its full cancellation, conversion of debt into national assets of a debtor-countries and recapitalization. The mechanism of recapitalization involves exchanging debts for obligations of debtors, or providing them with new target loans to pay off former debts.

Analyzing the results of the multilateral programs of overcoming the international debt crisis of the developing countries, the World Bank came to the following conclusion: external financing can play a positive role only when it complements and reinforces a healthy domestic economic policy. Debt restructuring requires an economic policy, endorsed by the IMF, from a debtor-country.

4. The role of transnational corporations of international movement of capital. The definition of TNCs. A characteristic feature of TNCs

International corporations have become key actors in today's global economy, playing a role that is difficult to overestimate the system of international economic relations.

The definition of transnational corporations. TNC has been technically defined by United Nations Commission on Transnational Corporations and Investment as **"enterprises which own or control production or service facilities outside the country in which they are based."** Transnational companies (TNC) are much more complex firms. They invest in foreign operations, have a central corporate facility but give decision-making, R&D and marketing powers to each individual foreign market. Most of them relate to the oil industry, information consulting, pharmaceutical industry, etc. Examples are Shell, Accenture, Deloitte, Glaxo-Smith Klein, and Roche.

A multinational corporation (MNC) is usually a large corporation incorporated in one country, which produces or sells goods or services in various countries. Multinational companies (MNC) have investment in other countries, but **do not have coordinated product offerings in each country**.

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The two main characteristics of MNCs are their large size and the fact that their worldwide activities are centrally controlling by the parent companies.

Well-known MNC's are mostly consumer goods manufacturers and quick-service restaurants like Unilever, Proctor & Gamble, Mc Donald's and Seven-Eleven.

The role of international companies. The first MNCs and TNC act as modernizers of the world economy. This is reflecting in the continuous promotion of new technologies and the introduction of innovations around the world. **Second**, such corporations promote efficiency and growth of the world economy. **The third**, positive role is economic integration. MNCs promote regional agreements and alliances.

The negative side of international companies. The negative impacts are *seeing* in exploitation of local employees, doing harm to the environment, not paying taxes, robbing the natural resources of the host country. Moreover, small economies lose their abilities and chances to be competitive.

Even if there are some positive effects seen in the economy, the government of any developing country should be able to regulate its economy so that this country could benefit from it.

5. International Macroeconomic Institutions

International financial institutions (IFI) are organizations that created by national governments from different nations. The World Bank, the International Monetary Fund (IMF) and other are all international financial institutions. Some institutions, such as the World Bank, provide lending services to nations around the world, and others focus on working with governments and humanitarian organizations within one particular area. International financial institutions attempt to foster economic development and improve economic relations between nations.

The World Bank founded in 1944 with the intention of reducing poverty around the world. In the after math of World War II, the World Bank, with funding from nations including the United States and the United Kingdom, began to write loans to war ravaged nations. Since its inception, the World Bank has shifted its attention to tackling poverty by providing loans to developing nations. The United States is the primary international power behind the bank and nominates the president of the bank, who has always been a United States citizen since the organization's inception.

The IMF founded in 1944, and its original purpose was to establish an international monetary exchange rate system. Some nations are not part

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of the IMF, and its policies and directives only have a direct impact on member nations. The IMF attempts to stabilize global financial markets by encouraging member nations to work closely together and to implement laws that encourage economic development and international trade. IMF member nations can borrow money from the fund, and during recessionary periods, some nations heavily rely on these loans to combat the danger of economic collapse.

The International Bank for Reconstruction and Development (IBRD) established at the Bretton Woods Conference in 1944 and became operational in 1946. The IBRD had the original mission of financing the reconstruction efforts of war-torn European nations following World War II, with goals shared by the later Marshall Plan. Following the reconstruction of Europe, the Bank's mandate has transitioned to eradicating poverty around the world. While the IBRD historically prioritized funding infrastructure projects, since the 1990s, the Bank has directed less lending to infrastructure projects in favor of other development projects such as fighting climate change, eradicating poverty and ensuring good governance.

The African Development Bank (ADB) is an organization that founded in 1964 in order to facilitate the economic development of African nations. National governments can obtain low cost loans from the ADB to finance projects such as the implementation of new communication systems, improved sanitation, and roads. Although it founded as an African entity, the bank now allows non-African nations to join. The United States, China, and Japan are among the non-African member states that have a role in the ADB.

Among the most politically powerful international financial institutions is the **European Investment Bank (EIB)**. The EIB created by members of the European Union (EU) in 1958. Member nations can obtain loans from the EIB, but its primary objective is to provide economic support for the EU's political objectives. Within Europe, the bank primarily focuses on fostering cohesion between member nations, but outside Europe, the bank helps to encourage economic reform and energy conservation.

Theme 5. The international flow of labor force

1. Concept, types and causes of international labor migration

International labor migration covers the whole world: both the development part and the underdeveloped periphery. The total number of international migrants increases continuously. International labor migration

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is one of the objective bases of becoming 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. **International labor migration is the mobility of labor from one country to another for a period more than one year.**

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

The main **forms of migration**:

– **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 for ever;

– **time 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;

– the **illegal migration**, which rather favorable to businessmen of the country of immigration and makes an original reserve of cheap labor necessary for them.

International migration flows form in accordance with many factors, most of important of which are socio-economic (migration caused by search of a new work place, education, marriage). Also exist demographic, political, religious, ethnical reasons that make someone to leave his native country.

So, the international labor migration, first of all, is the form of movement concerning surplus population from one centre of accumulation of the capital to another. It is the economic nature of labor migration.

However in the international labor migration not only the unemployed, but also a part of the working population are involved. In this case, **the driving motive of migration** is the search of more favorable working conditions. The labor moves from the countries with a low standard of living and salaries to the countries with higher ones. So, **an objective basis of labor migration is national distinctions in the level of wages.** Most common reasons nowadays are low level of wage, high level of unemployment and insufficient education.

2. The directions of movement of workers. Centers of gravity of the workforce. Modern tendencies

Scientific approach to the analysis of global labour market requires separation of the main centres of concentration of foreign labour based on

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criteria such as scale, intensity, geographic orientation and structure of migrant workers.

Among **the most important of these centres** are North and South American region, the Western European market, Southeast and West Asia, African segment of resettlement movements. In the last period more than 20 million people crosses national borders annually.

At the beginning of the XXI century, the annual influx averaged 2.3 million people, of which 1.4 million people went to North America, and 0.8 million people – to Europe. The largest centers of attraction for migrants are the United States and Canada.

In The Western Europe last 20 years over 1 million people annually moves, looking for a job, from one European country to another, i.e. take part in a intercontinental interstate 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, etc.) to the advanced countries of Western and Northern Europe (France, England, 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. Emigration in the countries of the European Union has increased. Number of the foreigners living today in the EU countries reaches 17–21 million 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: 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.

The important centre of gravity of labor is Australia. The area of Persian Gulf became new point of concentration of international groups of labor, where in the beginning of the 21st century aggregate number of nonlocal population in 6 countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates) – 4 million people, or about 40 % of all population. The most part of the Arabian emigrants arrives from Palestine, Egypt, Iraq, Syria, Jordan.

On the African continent 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.

Along with Western Europe, for last two decades **the new centers of gravity of foreign workers**. These include, in the first place, “the new industrial countries” of Asian-Pacific region. And in Latin America they are Argentina, Venezuela, Brazil.

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As regards **the structure of migrating labor**, there are following main regularities. Structure of labor, which migrates to industrially developed countries and between the developed countries, is characterized by two moments. **The first** one: the necessity of a high share of the highly skilled and scientific personnel for development of new directions of scientific and technical progress. Industrially developed countries stimulate such moving of labor with the right of reception of the status of the constant resident. **The second** one: there is a considerable share of labor for branches with physically heavy, low qualification and unattractive kinds of work.

Migration of labor between developing countries is mainly migration between new industrial countries and OPEC member countries, on the one hand, to other developing countries, on the other hand. The basic structure of migrants from these countries is semi-skilled labor. Rather small flow of skilled labor goes from the developed countries to developing ones.

3. The consequences of the movement of labor. The effects of migration on host countries workforce for the exporting countries. Modern tendencies

Social and economic impacts occur with respect to both countries of emigration and immigration. Among the countries main consumers of foreign labour should are the United States, Germany, Belgium, Switzerland, Canada, France, England, Japan, South Africa, Israel, Malaysia, Kuwait, Saudi Arabia, South Korea, Venezuela and others.

The positive effects of mass labour immigration into these countries include:

– softening of the labour market by filling certain specific niches in it;

– savings in manpower training, attracting foreign manufacturing experience;

– pressure on wages in the country and its general lowering.

Regarding negative effects, they lie in braking education and qualification of personnel in those areas and sectors of production, which are dominated by foreign labour, problems of social and psychological adaptation of immigrants, the outflow of currency abroad and others.

For exporting countries, among which the most active are Mexico, Greece, Italy, Turkey, the countries of the Maghreb, Central and Eastern Europe, Central Africa, the Caribbean, Sri Lanka, Pakistan, India and others, **positive results of emigration** is partial solution to the problem of unemployment, improvement of professional skills of immigrants, a substantial foreign exchange earnings in the form of remittances, which are

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the source of investment into the national economy. of remittances, which are the source of investment into the national economy. On the other part, these countries sustain **essential losses from labor export**: a) reduction of tax revenues because of reduction of number of taxpayers; b) the constant migration cased an outflow of the qualified, initiative workers.

Modern tendencies. In the immigration flows to these countries dominate immigrants from Asia, Latin America, Africa and the Caribbean.

Qualitative changes in international migration include a significant increase in the proportion of migrant skilled workers.

At the present stage of development has increased significantly the illegal labor migration, which has become a global problem.

One of the characteristics of the present stage of international labor migration has become more and more active government intervention in that process.

4. Forms and methods of regulating international exchange of labour, which is used in modern practice

Migration policy of each state is a set of special measures, legislation and bilateral and multilateral agreements on the basis of which regulation is managed. At each historical period migration policy had either emigration or immigration character, but currently second one dominates. Almost all developed countries prefer to implement immigration policy and to impose tougher measures of controlling undocumented migration.

The subjects of control and regulation are social, age and skill composition of migrants, the level of exit and entry of foreign workers. Functions of interstate and intrastate distribution of labour, establishing the scope and structure of migration flows are performed by national Ministries of Labour, Interior and Foreign Affairs, as well as specially created national and international bodies.

Many importing countries adhere to a selective method of regulation which consists in encouraging entry into its territory of certain categories of workers who seems to be the most preferable for it, but prevents the immigration of others. These categories may include workers who agree to work for a lower price than local, qualified ones or from fields industries that the country plans to develop. It is possible to restrict the entry by presenting certain requirements for qualification of personnel, their state of health, age and education.

Many states have a policy of quantitative quotas, which means establishment of a ceiling that is the maximum number of immigrants. There is also economic regulation, which involves the imposition of

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financial restrictions or temporal regulation. The governments by their own choose type of regulation, and what restrictions to apply, basing primarily on the interests of employees of the national labor market, however, they must not forget to respect international law.

It is necessary to note the role and functions of regional and supranational regulatory institutions. Among them a leading position occupied by the International Labour Organization (ILO) and the International Organization for Migration (IOM). It consists of agreements between the countries themselves, the laws on the status of migrants and other regulatory documents. There is also a system of ongoing monitoring after the migration (SOPEMI), which was founded by OECD.

The main function of these institutions is to protect the socio-economic and legal rights of migrant workers, to prevent discrimination in their national, religious and ethnic basis and in rewarding, to promote employment and social adaptation of immigrants, providing them with training, coordination of efforts of various states aimed to restrict illegal immigration and others.

Theme 6. The international economic commercial integration

1. Definition of international economic integration

In the common meaning, **international economic integration is a process of a merge of national economies**. Yet, this merge does not mean to add economic potentials, but creation new economic organism with different characteristics.

Conditions of the international economic integration. The most important condition is a real, or at least potential (possible to achieve while realizing) complementarity of economic structures of countries heading for the economic integration. **Complementarity can have inter branch or inside branch character.** An example of inter branch complementarity can be a traditional, international work division. Its bases are differences in recourses of production factors, coming from differences in raw materials, geographical situation and climate conditions. While, the base of inside complementarity, are differences in effectiveness of production factors. **Inter branch complementarity is not a necessary and enough condition, to the progress of international economic integration.** In case of developed countries, a necessary condition of the progress of international

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economic integration is existing **inside branch complementarity**, understood in dynamic way.

The second necessary condition for the process of integration is existing of a right technical infrastructure, allowing countries to make trade sales. **The third**, important equally, although not always necessary condition, is pro integrative economic politics of countries.

Targets of the economic integration process. The main economic target are:

✓ Progress of economic effectiveness, and in a consequence, economic development, which a synthetic factor is an increase of the national product and income. While, to the more analytical targets, we can count.

✓ Modernization of economy, by leading structural changes in production zone, progress of specialization and cooperation in production.

✓ Free flow of goods, services, labor force and production factors, easy access to outside production factors, that means natural sources and technical knowledge.

✓ Free access to foreign markets, reaching profitable prices in import and export.

✓ To reduce costs of technical progress and its higher dynamics.

Models of diversity integration. Among ideas of diversity integration, a special attention, need four conceptions: the model of many speeds, the model of changeable geometry, the model of individual options and the mode center-peripheries.

Forms of economic integration. Processes of economic integration are characterize by stages. By B. Ballasa considered as classical one, there are five stages of integration process: a free trade zone, customs union, common market, economic and monetary union and a total integration. Each of mentioned stage is characterize by specific charts. The main characteristics of each stage present in Table 3.

After creation the **free trade zone**, commercial sales between member countries become more liberal. It means that goods, made by member countries, are cheaper by abolished customs in the grouping market. While, towards the third countries, each country uses its own, most often different customs and commercial politics.

An essence of **the customs union** is a full liberalization of mutual trade sales, acceleration a common outside customs tariff and unification of commercial politics, towards other countries. It means that customs politics of this grouping is focusing on liberalization of trade between

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member countries and discrimination goods from other countries, at the same time.

Table 3

Institutional forms of regional integrative groupings

Stages of integration	Liberalization of trade between member countries	Common outside customs tariff	Free flow of production factors	Harmonization of economic politics	Unification of economic politics
Free trade zone	*	–	–	–	–
Customs Union	*	*			
Common market	*	*	*	*	*
Economic and monetary union	*	*	*	*	*
Full integration	*	*	*	*	*

The following stage, of the integration process, by B. Balassa, is **the common market**. It joins elements characteristic for the customs union – liberalization of the internal trade, a uniform outside customs tariffs and the common economic politics towards the third countries, with a free flow between member countries, and factors of production (labor and capital). In frames of the common market happens leading, such called rule of four freedoms, containing the free flow of goods, services, capital and people.

The monetary union contains all elements, characteristic to the common market, and additionally characterizes by the common capital market (including financial one) of integrating countries.

For the right functioning of the monetary union, some conditions are necessary. They are:

– liberalization of the capital sales and providing a freedom of financial service (integration of the capital market means a full freedom of the capital flow, portfolio, productive one) and an income from lending and productive capital);

– elimination of differences in fluctuation of exchange rate or setting a common currency;

– creation an over national center of issuing banks, leading the common monetary politics;

– effective coordination of the economic politics of member countries, to eliminate essential differences in stage of the economic cycle.

The full union determinates a total unification of joining economies, and leading a common politics in many important branches, for example: social safety, income taxes, macroeconomic politics and stabilization politics.

2. Regional integration groupings

In the 20th century, there was a strong dynamics of integration processes, in the singular regions of the world. A structure of the modern world economy is very complex. It comes from growing number of subjects. In the last century, a new subject of the world economy appeared – integration grouping. The Table 4 shows the main integration groups, their main and actual composition and legal form.

Table 4

Regional integration groupings

Integration groupings	Primary composition and the year of founding	Actual composition	Institutional organization form
UE – European Union	1951 Belgium, France, Germany, Holland, Luxemburg, Italy	Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Greece, Spain, Holland, Ireland, Lithuania, Luxemburg, Latvia, Malta, Germany, Poland, Portugal, Croatia, Romania, Slovakia, Slovenia, Sweden, Hungary, Italy	Economic and Monetary Union (not all countries belong to it)
NAFTA – North American Free Trade Association	1992 USA, Canada, Mexico	USA, Canada, Mexico	Free Trade Zone
MERCOSUR – Common Market of The South. Customs Union	1991 Argentina	Argentina, Brazil, Paraguay, Uruguay	Customs Union
SACU – Southern African Customs Union	1969 Botswana, Lesotho, Republic of Southern Africa, Suazi	Bostvana, Lesotho, Namibia, Republic of Southern Africa, Suazi	Customs Union

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Integration groupings	Primary composition and the year of founding	Actual composition	Institutional organization form
COMESA – Common Market for Eastern and Southern Africa	1994 Angola, Burundi, Dzibuti, Egypt, Erytrea, Ethiopia, Comory, Congo, Kenia, Madagascar, Malavi, Mauritius, Namibia, Ruanda, Seszele, Suazi, Sudan, Uganda, Zambia, Zimbabwe	–	Free Trade Zone
ASEAN – Association of South – East Asian Nations	1967 Philippians, Indonesia, Malaysia, Singapore, Thailand	Brunei, Darussalam, Philippians, Indonesia, Cambodia, Laos, Malaysia, Myanmar	Free Trade Zone

Majority of organizations stay at beginning stages of the free trade zone or the customs union. They also have ambitious integration projects, but for now, do not feel like getting rid of their independence. At the same time, a new phenomenon appears which did not meet before.

The target of integration groupings is not only liquidation of economic barriers, to increase trade, but also cooperation with scientific, technical and financial character. It is, such called **new regionalization**, which an essence is widening of integration areas, besides building economic groupings, also to ecology, culture or social matters. Regionalization, which somehow is a synonym of different integration forms, takes a form less or more close and institutionalized relations, is characterized by inter weaving economic, commercial, technical and financial cooperation. A new stage of integration is often determined as, an open regionalism, what means, that its target is not a creation of close commercial blocks, but only increase of the free trade area. International regional cooperation treats as a factor to strengthen of democratic and political stabilization, and to ensure economic progress and life improvement.

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The Arguments for Regional Economic Integration

Free trade and movement of goods, services, capital, and factors of production allow for the most efficient use of resources. That is positive sum game, as all countries can benefit.

Regional economic integration is an attempt to go beyond the limitations of WTO. While it is hard for 100 countries to agree on something, (e.g. the United Nations) it is much more likely that only a few countries with close proximity and common interests will be able to agree to even fewer restrictions on the flows between their countries.

The political case for integration has two main points: (1) by linking countries together, making them more dependent on each other, and forming a structure where they regularly have to interact, the likelihood of violent conflict and war will decrease; (2) by linking countries together, they have greater influence and are politically much stronger in dealing with other nations.

In the case of the EU, both a desire to decrease the likelihood of another world war and an interest in being strong enough to stand up to the US and USSR were factors in its creation.

There are two main impediments to integration:

1. There are always painful adjustments, and groups that are likely to be directly hurt by integration will lobby hard to prevent losses.

2. Concerns about loss of sovereignty and control over domestic interests.

For example, Canada is worried about the dominance of its southern neighbor. The case on NAFTA and the US Textile Industry shows that although the effects of NAFTA have hurt employment in the US textile industry, the overall effect has actually been positive. The reason: clothing prices have fallen, exports have increased, and sales to apparel factories have surged. Those factors more than compensate for the loss of jobs.

The Arguments against Regional Economic Integration

Many groups within the country do not accept arguments for integration, especially those that may suffer, or those whose sovereignty may be reduced. Thus, it is not surprising that most attempts to achieve integration are progressing slowly and indecisively.

Whether regional integration is in the economic interests of the participants depends upon the extent of **trade creation** as opposed to **trade diversion**. **Trade creation** occurs when low cost producers within the free trade area replace high cost domestic producers. **Trade diversion** occurs

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when higher cost suppliers within the free trade area replace lower cost external suppliers.

A regional free trade agreement will only make the world better off if the amount of trade it creates exceeds the amount it diverts.

Theme 7. Balance of payments

1. Balance of Payments Accounts: Structure, Classification

The balance of payments is one of the most important concepts of the international economics. Its study provides a generalized estimator of the economic situation of the country, the effectiveness of its international economic relations.

The Balance of Payment is an organized account of all economic transactions between a country (say India) and the rest of the world, carried out in a particular period. In other words, a country archives all the inflows and outflows of funds in a statement referred to as BOP.

A payment from a foreign country, it is a **credit transaction** while payment to a foreign country is a **debit transaction**. **The principal items shown on the credit side (+) are exports** of goods and services, unrequited (or transfer) receipts in the form of gifts, grants etc. from foreigners, borrowings from abroad, investments by foreigners in the country and official sale of reserve assets including gold to foreign countries and international agencies. **The principal items on the debit side (–) include imports** of goods and services, transfer (or unrequited) payments to foreigners as gifts, grants, etc., lending to foreign countries, investments by residents to foreign countries and official purchase of reserve assets or gold from foreign countries and international agencies.

The balance of payments account of a country represented in Table 5.

Table 5

The Balance of Payment

Credits (+) **(Receipts)**	**Debits (–)** **(Payments)**
I. Current Account	
Export a) Goods b) Services c) Transfer Payments	Imports a) Goods b) Services c) Transfer Payments

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End of table 5

Credits (+) (Receipts)	Debits (–) (Payments)
II. Capital Account	
a) Borrowings from Foreign Countries b) Direct Investments by Foreign Countries	a) Lending to Foreign Countries b) Direct Investments in Foreign Countries
III. Official Settlements Account	
Increase in Foreign Official Holdings	Increase in Official of Gold and Foreign Currencies
IV. Errors and Omission	

Current Account. The current account consists of trade in services, dividends, unilateral receipts, investment income, etc. When debits are more than credits deficit occurs. Current account surplus will take place when credits are higher than debits. Current account balance is extremely important. It exhibits a country′s earning and payments in foreign currency. A surplus balance improves the country′s financial position.

Capital Account. The Capital account includes all the short-term and long-term transactions between a country and the world. Direct and portfolio investments reflect in the capital account. External assistance and commercial borrowing are net repayment. Direct investment identifies the money, which moves across national boundaries with the intention of investing in a business. Portfolio investment moves across national boundaries with the intention of purchasing shares and bonds **Errors and Omission**. According to double entry book – keeping concept for every credit, there exists a matching debit and thus, there must be a balance in BOP as well. In reality, BOP may not balance. After registering various types of international financial flows, a statistical discrepancy, called errors and omissions, also record. The statistical discrepancy occurs due to complications associated with collecting balance of payments data. You can find different sources of data, which occasionally differ in their approach.

Foreign Exchange Reserves. The Official reserves means the reserves of gold and foreign exchange kept by the National Bank of country. It may be for exemple in form of dollar, pound and Special Drawing Rights (SDRs). If the total balance is excessive, the official reserve account is increased.

2. Equilibrium and Disequilibrium in Balance of Payments

Balance of payments always balances means that the algebraic sum of the net credit and debit balances of current account, capital account and official settlements account must equal zero.

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Balance of payments is written as: $B = R_f – P_f$. Where B represents balance of payments, R_f – receipts from foreigners, P_f – payments made to foreigners.

When $B = R_f – P_f = 0$, the balance of payments is in equilibrium.

When $R_f – P_f > 0$, it implies receipts from foreigners exceed payments made to foreigners and there is **surplus in the balance of payments**. On the other hand, when $R_f P_f < 0$ or $R_f < P_f$ there is **deficit in the balance** of payments as the payments made to foreigners exceed receipts from foreigners.

If net foreign lending and investment abroad take, a flexible exchange rate creates an excess of exports over imports. The domestic currency depreciates in terms of other currencies. The exports become cheaper relatively to imports. It can show in equation form: $X + B = M + I_f$.

Where X represents exports, M imports, I_f foreign investment, B foreign borrowing or $X – M = I – B$ or $(X – M) – (I_f – B) = 0$.

The equation shows the balance of payments in equilibrium. Any positive balance in its current account exactly offsets by negative balance on its capital account and vice versa. In the accounting sense, the balance of payments always balances. This can show with the help of the following equation:

$$C + S + T = C + I + G + (X – M)$$

or $Y = C + I + G + (X – M)$ $[Y = C + S + T]$, where C represents consumption expenditure, S domestic saving, T tax receipts, I investment expenditures, G government expenditures, X exports of goods and services, and M imports of goods and services. In the above equation.

$C + S + T$ is national income (Y), and $C + l + G = A$, where **A is called 'absorption'**.

In the accounting sense, total domestic expenditures $(C + I + G)$ must equal current income $(C + S + T)$ that is $A = Y$. Moreover, domestic saving (S_d) must equal domestic investment (I_d). Similarly, an export surplus on current account ($X > M$) must be offset by an excess of domestic savings over investment ($S_d > I_d$). Thus, the balance of payments always balances in the accounting sense, according to the basic principle of accounting.

In the accounting system, the inflow and outflow of a transaction are record on the credit and debit sides respectively. Therefore, credit and debit sides always balance. If there is a deficit in the current account, it is offset by a matching surplus in the capital account by borrowings from

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abroad or/and withdrawing out of its gold and foreign exchange reserves, and vice versa. Thus, the balance of payments always balances in this sense also.

Balance of Payments Adjustments

The short-term and small Balance of Payments deficits do not call for immediate corrective actions. A country facing constant large deficits in balance of payments have to adopt corrective measures, such as changes in its internal economic policies for wiping out the deficits, or at least to bring it in a manageable size. It should be borne in mind that policy-mix in this regard may vary from country to country and from time to time depending on the prevailing economic conditions.

Measures used to correct Deficits in Balance of Payments

Indirect measures to correct adverse Balance of Payments: under free trade system, the deficits in balance of payments arise either due to greater aggregate domestic demand for goods and services than the total domestic supply of goods and services or domestic prices are significantly higher than the foreign prices. Thus, **the deficit may be removed** either **by increasing domestic production** at an internationally comparable cost of production or **by reducing excess demand or by using the two methods simultaneously**. It may be very difficult to increase the output in the short-run, especially when a country is close to full-employment or when there are other limiting factors to its industrial growth. **Therefore, the only way to reduce deficit is to reduce the demand for foreign goods.**

Income and Expenditure Policies: the two policy tools to change disposable income are monetary and fiscal policies. Monetary policy operates on the demand for and supply of money while fiscal policy operates on the disposable income of the people.

Exchange Depreciation and Devaluation. Reducing excess demand through price measures involves changing relative prices of imports and exports. Relative prices of imports and exports can to change through exchange depreciation and devaluation. Exchange depreciation refers to fall in the value of home currency in terms of foreign currency.

Devaluation and exchange depreciation change the relative prices of imports and exports. Import prices increase and export prices decrease, though not necessarily in the proportion of devaluation. As a result, of change in relative prices of exports and imports, the demand for imports decreases in the country, which devalues its currency and foreign demand for its goods increases provided foreign demand for imports is price elastic. Thus, if devaluation or exchange depreciation is effective, imports will

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decrease and exports will increase. Country's payments for imports would decrease and export earnings would increase. This ultimately decreases the deficits in the balance of payments in due course of time.

Theme 8. World exchange rate system and exchange rates

1. The Evolution of the international financial system

The world monetary system is a functional form of organization of international currency relations, which is a combination of methods, tools and bodies (institutions) that allows making cash payments within the global economy.

The evolution of the world monetary system defines by the development and the needs of both national and global economy, changes in the world economy and the periodic emergence of currency crises as well. The development of the global monetary system had a few stages, which took relatively long historical periods. There is the difference between world monetary systems. The essence of the difference depends on a reserve asset, which provided the balance-of-payments equilibrium (in different periods it was gold, the dollar, which was convertible into gold at a fixed rate, a currency fulfilling the function of international means of payment).

There have been four phases/stages in the evolution of the international monetary system:

– Gold Standard (1875–1914);

– Inter-war period (1915–1944);

– Bretton Woods system (1945–1972);

– Present International Monetary system (1972–present).

Gold Standard. The gold standard is a monetary system in which each country fixed the value of its currency in terms of gold. The exchange rate is determined accordingly. Let us say – 1 ounce of gold = 20 pounds (fixed by the UK) and 1 ounce of gold = 10 dollars (fixed by the US). Hence, the dollar-pound exchange rate will be 20 pounds = 10 dollars or 1 pound = 0.5 dollars. The Gold standard created a **fixed exchange rate** system. There is a free convertibility between gold and national currencies. Also all national currencies had to be providing by gold. Therefore, the countries had to keep enough gold reserves to issue currency. The gold standard created a **stable exchange rate system that was conducive to international trade**.

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Inter-war period. After the outbreak of World War II in 1914, countries abandoned the gold standard. Countries began to depreciate their currencies to be able to export more. It was a period of fluctuating exchange rates and competitive devaluation.

Bretton Woods's system. In the early 1940s, the United States and the United Kingdom began discussions to rebuild the world economy after the destruction of two world wars. Their goal was to create a fixed exchange rate system without the gold standard. The new international monetary system created in 1944 at a conference organized by the United Nations in Bretton Woods in New Hampshire (USA). The Bretton-woods created a dollar-based fixed exchange rate system. In the Bretton-woods system, only the US fixed the value of its currency to gold. The initial peg was 35 dollars = 1 ounce of gold. All currencies were pegged to the dollar. Fluctuations in exchange rates allowed within plus or minus 1 percent. Countries have the right to depreciate their currencies in the event of an emergency. It had similar features with the gold standard. However, there were some differences. Only the USA guaranteed the exchange of its currency for gold. Other currencies did not have to maintain gold convertibility. In addition, this convertibility was limited. Only governments (not anyone who demanded it) could convert their US dollars into gold.

Present International Monetary system. The Bretton Woods system collapsed in 1971. The United States had to stop the convertibility to gold due to high inflation and trade deficit in the economy. Inflation led to an increase in the price of gold. Hence, the US could not maintain the fixed value of 35 dollars to 1 ounce of gold. In 1973, the world moved to flexible exchange rate system. In 1976, the countries met in Jamaica to formalize the new system. **The main characteristics of the Jamaican currency system:**

1. The system is polycentric, i.e. based not on one but on several key currencies.
2. Cancelled mint parity gold.
3. The main means of international payments has become a freely convertible currency and SDR and reserve position in the IMF.
4. There are no limits of currency fluctuations.
5. The Central Bank countries are not obliged to intervene in currency markets to maintain the fixed parity of its currency. However, they carry out foreign exchange intervention to stabilize exchange rates.
6. The country chooses an exchange rate regime.
7. The IMF oversees the policies of the countries in the area of exchange rates: the member countries of the IMF must avoid free of currency

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manipulation designed to prevent active restructuring of the balance of payments or to obtain unilateral advantage over other countries-members of IMF.

2. The Essence of Currency and Exchange Rates

The term "currency" in the broad sense is any product that is able to act as a medium of exchange in international payments. Depending on the belonging (status), currencies are divided into national, foreign and international (regional) ones. **National currency** is the statutory means of payment of the country. The national currency is the basis of the national monetary system. **Foreign currency** is the currency notes of foreign countries, credit and payment instruments, denominated in foreign currency units and used in international payments. **International (regional) currency** is an international or regional monetary unit of account, means of payment and reserves. For example, **the SDR** (Special Drawing Right) is an international means of payment, which by the IMF uses for noncash international payments through the records in special accounts, and the payment unit of the IMF. The Euro is a regional international payment unit of the EU's countries. Under **the reserve** currency, realize the foreign currency, in which the central banks of other countries accumulate and store reserves for international payments on foreign trade transaction and foreign investment.

The exchange rate is the ratio in which currencies are exchanged. "The currency exchange rate" is: 1) the number of units of one currency required to purchase a unit of another currency; 2) the market price of one currency denominated in another currency; 3) the aggregate price of currencies, interconnected by a tripartite arbitration. Determination of the exchange rate is called the quotation. There are two methods of the foreign currency quotation to the national one: direct and indirect. With direct quotation the rate of one unit of foreign currency is dominated in the national currency (1 USD = = 5.0 UAH). With **indirect quotation** the rate of one unit of national currency is denominated in the foreign currency (1 UAH = 0.20 USD).

The Calculating Types of Exchange Rates. The nominal exchange rate. This is the rate between two currencies, that is, the relative price of two currencies. For example, **the nominal exchange rate** of the dollar to the pound sterling equals 2.00 USD / 1 GBP. It is used in the foreign exchange contracts and is the simplest and the most basic definition of the exchange rate. However, it is not very suitable for long-term forecasting, because the cost of foreign and national currencies are changing at a

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time with the change in the overall price level in the country. **The real exchange rate.** This is the nominal exchange rate adjusted for relative level of prices in home country and in that country, to whose currency the local currency is quoted. The real exchange rate is a comparison of purchasing power of the two currencies. For its calculation, the following formula is used:

$$S_r = S_n \frac{P_f}{P_h}.$$

Where S_r – the real exchange rate; S_n – the nominal exchange rate; P_f – the price index of a foreign country; P_h – the price index of home country.

The real exchange rate is the ratio of the consumer goods basket abroad, transferred from a foreign currency into the national one with help of the nominal exchange rate (the nominal exchange rate multiplied by the price index of a foreign country) and the prices of the consumer goods basket of the same goods in home country. The index of real exchange rate shows its change adjusted for inflation rate in both countries. If the rate of inflation in home country is higher than foreign one, then the real exchange rate will be higher than nominal one.

The Forecast of the Exchange Rate. Forecasts on tendencies of the exchange rate changes built on the basis PPP, which links the price in the national currency with exchange rates. There are theories of **absolute and relative purchasing power parity**. In theory of **the absolute purchasing power parity** states that the exchange rate between the currencies of the two countries is the ratio of price levels in these countries:

$$\frac{R_d}{f} = \frac{P_d}{P_f}.$$

Where $\frac{R_d}{f}$ – the exchange rate; P_d – the domestic price level (the price of the customer goods basket in their country); P_f – the price level abroad (the price of customer goods basket in a foreign country).

The theory of relative purchasing power parity (RPPP) states that the exchange rate between the currencies of the two countries is in proportion to the relative change in price levels in these countries, i.e. the inflation is taken into account

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$$R_{d/f}^{1} = R_{d/f}^{0}\frac{P_d^1/P_d^0}{P_f^1/P_f^0}.$$

Where $R_{d/f}^{1}$ and $R_{d/f}^{0}$ – exchange rate in the current and the base year; P_d^0 and P_d^1 – the level of domestic prices in the base and the current year; P_f^0 and P_f^1 – the price level abroad in the base and in the current year.

3. Exchange Rate Regimes. Fixed versus Floating Exchange Rates

There are such major exchange rate regimes in the international practice: fixed, floating (flexible) and pegged.

The fixed exchange rate regime is a system in which the exchange rate is fixed, and its changes under the influence of fluctuations in supply and demand eliminated by government stabilization measures. The classic form of fixed rate is the currency system of the "gold standard", when each country sets the gold content of its currency. Exchange rates in this case fix ratio of the gold content of currencies. **The advantages of fixed exchange** rates should include the fact that when the rate is stable, it: provides companies with a sound basis for planning and price formation; limits domestic monetary policy; has positive impact on the underdeveloped financial markets and financial instruments. **Disadvantages of fixed exchange** rates are as follows:

✓ If they are not trustable, they can succumb to speculative activities.

✓ There is no reliable way to determine whether the chosen rate optimal and stable.

✓ The fixed rate provides the readiness of the central bank to carry out the currency intervention in order to support it.

The system of fixed exchange rate can only solve short-term problems associated primarily with high inflation and instability of the national currency. In countries with market economy and a high level of income, as a rule, there are **market (floating) exchange rates**. **Flexible or freely floating exchange** rates mean the regime, whereby exchange rates determines by the untrammeled play of supply and demand. The currencies market balances by means of the price, i.e. rate mechanism. **Advantage of market exchange rates** is that:

✓ The advantage of market exchange rates is that fluctuations in the demand for foreign currency and its supply are automatically adjusted.

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✓ The black marketers have no possibility to make a profit at the expense of the central bank.

✓ The central bank does not need to carry out currency interventions.

The disadvantages are there is a risk that the exchange rate will be on the unreasonable by economic forecasts level for a long time; the uncertainty about the future exchange rate may create problems for the company in the field of planning and price forming.

Choice of Exchange Rate System. Fixed versus Floating Exchange Rate. Which exchange rate system is the best? The answer depends upon the objectives of the monetary authorities in a country. There are three possible objectives:

– maintain stable exchange rates;

– allow mobility of capital;

– have control over monetary policy.

With a floating exchange rate, the last two objectives can be attain but there will be exchange rate volatility. With a fixed exchange rate, the first two objectives can be attain but there will be no control over the monetary policy.

4. Foreign Exchange Markets

Forex Market is a decentralized global market where all the world's currencies are traded against each other, and traders make a profit or loss from the currencies' value changes. Forex Market is known as Foreign Exchange Market, or Currency Trading Market. It has no physical location and operates 24 hours a day from 5 p.m.

The trade that takes place in Foreign exchange market involves simultaneously the buying of one currency and the selling of another. This is because the value of one currency is relative to the other currency and is determined by their comparison. From a retail trader's perspective Forex trading is the speculation on the value of one currency relative to another.

Foreign exchange market is composed of different participants, also called **Forex market players**, who trade on the market for quite various reasons. This means that participating in Forex market transactions does not take place simply for speculative purpose. Each of the participants plays its own role in the market providing the latter is wholeness and stability.

The main players of the Forex market are:

- Governments and Central Banks.
- Commercial banks and companies.
- Hedge funds.

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- Brokerage companies.
- Investors.
- Retail Forex traders.
- Speculators.

The Forex is largest and the most liquid financial market in the world. This global market has two tiers. **The first is the interbank market.** It is where the biggest banks exchange currencies with each other. Even though it only has a few members, the trades are enormous. As a result, it dictates currency values. **The second tier is the over-the-counter market (OTC).** That is where companies and individuals trade. OTC has become very popular since there are now many companies that offer online trading platforms. The biggest geographic OTC trading center is in the United Kingdom. London dominates the market. A currency's quoted price is usually London's market price. As of April 2019, U.K. is forex trading amounted to 43,1 % of total global trading. This makes London the most important forex trading center in the world.

Foreign exchange trading is a contract between two parties. **There are three types of trades. The spot market** is for the currency price at the time of the trade. **The forward market** is an agreement to exchange currencies at an agreed-upon price on a future date. **A swap trade** involves both. Dealers buy a currency at today's price on the spot market and sell the same amount in the forward market. This way, they have just limited their risk in the future. No matter how much the currency falls, they will not lose more than the forward price.

The interbank market includes the three trades mentioned above. Banks also engage in **the SWIFT market**. It allows them to transfer foreign exchange to each other. SWIFT stands for Society for World-Wide Interbank Financial Telecommunications.

Retail Market. The Chicago Mercantile Exchange was the first to offer currency trading. It launched the International Monetary Market in 1971. Other trading platforms include OANDA, Forex Capital Markets LLC, and Forex.com. The retail market has more traders than the Interbank Market but the total dollar amount traded is less. The retail market does not influence exchange rates as much.

Central banks don not regularly trade currencies in foreign exchange markets but they have a significant influence. Central banks hold billions in foreign exchange reserves.

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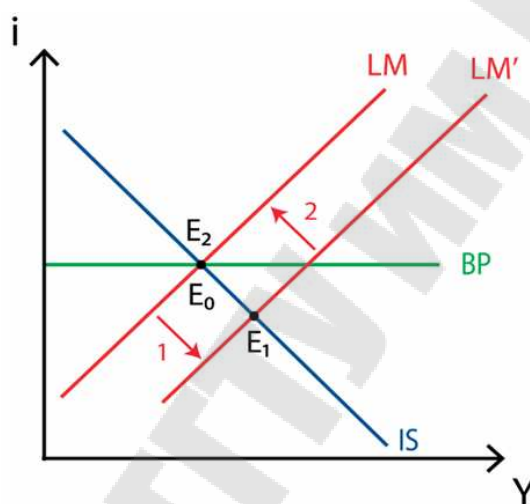
Theme 9. The government's macro policies and open economy

1. Perfect capital mobility and the government's macro policies
Fixed exchange rate. An expansionary monetary policy will shift the LM curve to LM', which makes the equilibrium go from point E_0 to E_1. However, since we are below the BP curve, we know the economy has a balance of payments deficit. Since exchange rates are fixed, government intervention is required: the government will purchase domestic currency and sell foreign currency, which will drop the money supply and therefore shift the LM' curve to its original position (which makes the equilibrium go to E_2). Monetary policy has therefore no effect under these circumstances (Graph 1).



Graph 1

An expansionary fiscal policy will shift the IS curve to IS', moving the equilibrium form point E_0 to point E_1. Since the economy has now a balance of payments surplus, and because the exchange rate is fixed, government will intervene in the exact opposite way: they'll purchase foreign currency and sell domestic currency. This will increase the money supply, shifting the LM curve to the right. The final equilibrium is reached at point E_2 where, at the same interest rate, production has increased greatly: fiscal policy works perfectly under these circumstances (Graph 2).

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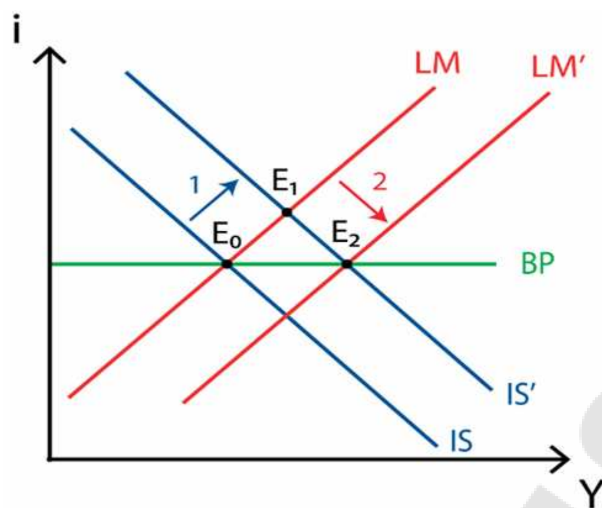
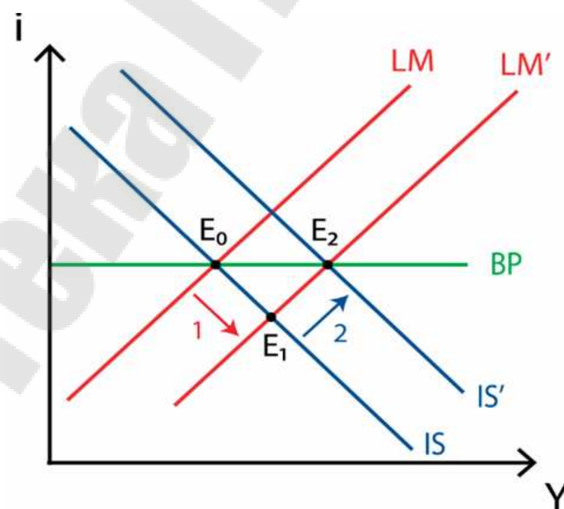


Graph 2

Flexible exchange rate. An expansionary monetary policy will shift the LM curve to LM', which makes the equilibrium go from point E_0 to E_1. However, since now exchange rates are flexible, we have a different situation: the balance of payments deficit will depreciate the domestic currency. This will increase net exports (since foreigners can now buy more of our products with the same amount of money), which will shift the IS curve to the right (to IS'). The final equilibrium is reached at point E_2 where, at the same interest rate, production has increased greatly: monetary policy works perfectly under these circumstances (Graph 3).



Graph 3

An expansionary fiscal policy will shift the IS curve to IS', moving the equilibrium from point E_0 to point E_1. The economy will therefore have

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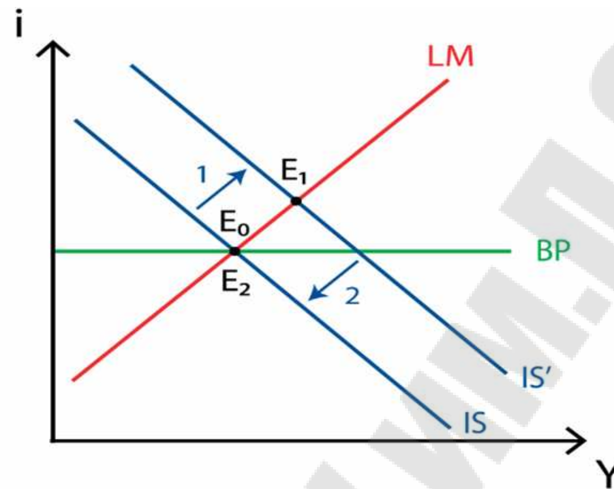
a balance of payments surplus, which in this case of flexible exchange rate will appreciate the domestic currency. This will decrease net exports, since we are able to import more goods and services with less money, while foreigners will import less of our products because of our appreciated domestic currency. This drop in net exports will shift the IS' curve back to its original position. Since now the final equilibrium E_2 corresponds to the initial equilibrium, we know fiscal policy is no good in this case (Graph 4).



Graph 4

2. Imperfect capital mobility and the government's macro policies

Fixed exchange rate. Here we have the exact same situation as before: an expansionary monetary policy will shift the LM curve to LM', which makes the equilibrium go from point E_0 to E_1. However, since we are below the BP curve, we know the economy has a balance of payments deficit. Since exchange rates are fixed, the government will purchase domestic currency and sell foreign currency, which will drop the money supply and therefore shift the LM' curve to its original position (which makes the equilibrium go to E_2). Monetary policy has again no effect, no matter how great or small capital mobility is (Graph 5).

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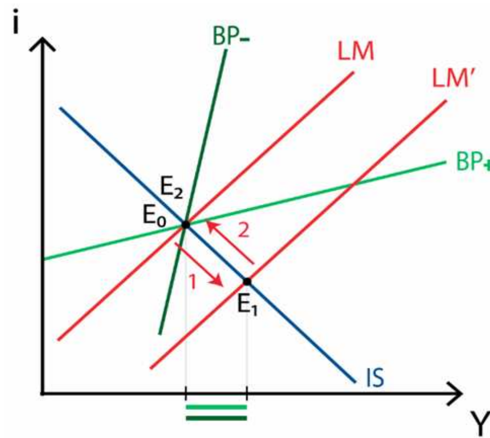
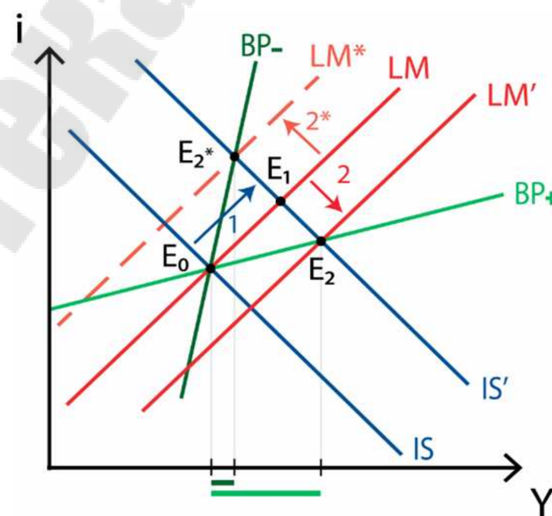


Graph 5

An expansionary fiscal policy will shift the IS curve to IS', moving the equilibrium from point E_0 to point E_1. Now, depending on capital mobility, we'll either have a balance of payments surplus (high capital mobility, BP+ curve) or a balance of payments deficit (small capital mobility, BP– curve). Since exchange rates are fixed, government will need to intervene: its acquisitions and disposals of both domestic and foreign currency will shift the LM curve to either LM' or to LM* (you can review what happens above: a balance of payments surplus is the same scenario as in a fiscal policy with perfect capital mobility and fixed exchange rates, while the balance of payments deficit corresponds to the monetary policy scenario). Under these circumstances, fiscal policy is completely efficient. It's actually the more efficient the higher capital mobility is (Graph 6).



Graph 6

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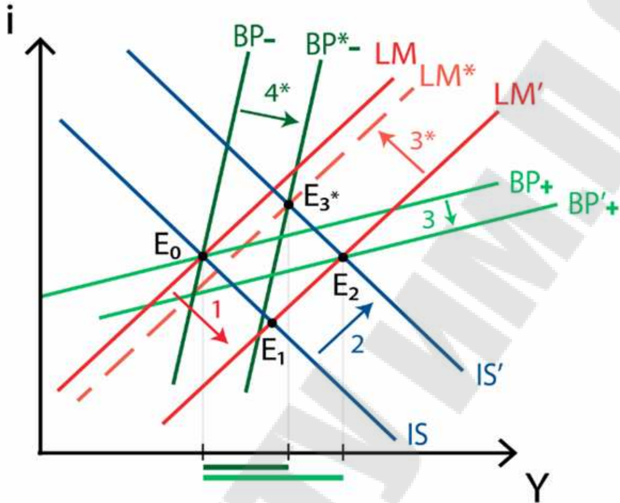
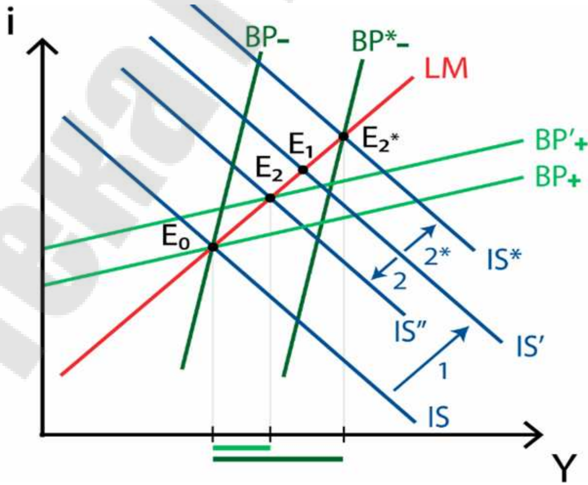
Flexible exchange rate. An expansionary monetary policy will shift the LM curve to LM', which makes the equilibrium go from point E_0 to E_1. However, since now exchange rates are flexible, the balance of payments deficit will depreciate the domestic currency. This will increase net exports, shifting the IS curve to IS'. Also, since domestic assets are less expensive, the BP curve will shift to the right (to either BP'+ or BP'–). Therefore, with high capital mobility, final equilibrium will be at point E_2. Monetary policy works well under these assumptions. It's actually the more efficient the higher capital mobility is (Graph 7).



Graph 9



Graph 8

An expansionary fiscal policy will shift the IS curve to IS', moving the equilibrium from point E_0 to point E_1. Now, depending on capital mobility, we'll either have a balance of payments surplus (high capital

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mobility, BP+ curve) or a balance of payments deficit (small capital mobility, BP– curve). In the case of a balance of payments surplus, and considering flexible exchange rates, there will be an appreciation of the domestic currency. This will decrease net exports, which will shift the IS′ curve to the left. Also, since domestic assets are more expensive, the BP+ curve will shift to the left. The final equilibrium will therefore be at point E_2. If there is a balance of payments deficit (the case for the BP– curve), the result will be the same one as in the monetary policy case (being E_2* the final equilibrium). In this scenario, fiscal policy will be more efficient the smaller capital mobility is (Graph 8).

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