

## **The Global Economy**

International Trade & Finance

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For the Center for Political Education

## **Agenda: August 13<sup>th</sup>, 2007**

### Introduction, Guidelines & Goals

Review from last class

Goals of today's class

International Trade

International Finance

The China Example: Putting it all together

### *Series Goals & Guidelines*

## **Introduction to Political Economy and Radical Economics**

### Goals

- \* Better understand the theories, mechanisms, and related critiques of the U.S. economy,
- \* Better articulate a critique of neo-classical economics, both from within the economics framework and outside of it,
- \* Better understand the interconnections between different components of the economy and how those components work to maintain the status quo.

### *Series Goals & Guidelines*

## **Guidelines for Participation**

- Step Up, Step Back
- Don't interrupt, please raise your hands
- W.A.I.T. (Why Am I Talking???)--thanks to S.O.U.L. for this
- Feel free to ask questions during appropriate times, but please consider whether a question is tangential and can be brought up at a different time or after the class
- Remember our shared interests
- Respect the facilitators, respect the presenter and the other participants
- Speak for yourself!
- Turn technology to off or to vibrate

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## Last Week We Talked About...

- The Domestic Macroeconomy
  - Unemployment and Inflation
  - Accumulation and Investment
  - Stock Market
  - Bonds & Investment
  - The Federal Reserve

*Review from Last Class*

## What are Government Bonds?

- Essentially, a loan to the government with a fixed interest rate.
- What is an interest rate?
  - It's the amount you charge a lender to borrow your money. Usually, a percentage of the amount you borrow.
- Who makes these loans?
  - Anyone (Big institutional, individuals, other governments)
- Remember, Bonds are another way to raise money (instead of stocks)

*Review from Last Class*

## The Federal Reserve

- Founded in DC in 1913 to regulate national banks and govern money supply
- The Fed can set the interest rate on short-term government bonds.
- Fed "tries" to balance inflation and unemployment using the interest rate
  - Fed lowers the interest rate in order to raise employment, but this increases inflation
  - Fed increases the interest rate in order to lower inflation, but this increases unemployment
- In reality, the Fed is more committed to low inflation than low unemployment because inflation hurts capitalists/investors more than it hurts workers/debtors.

## Example: The Roaring 1990s

- The 1990s were “the fabulous decade”
- High employment, high wages for *some* people, not much inflation.
- Early 1990s, Greenspan makes the call that the economy can grow (employment increase) much more than previously thought without raising inflation.
- Fed keeps interest rates low during 1990s
- He was right.
- Otherwise, the Fed may have increased interest rates too early, choking off the boom.

## Example: Last week's NYTimes Reading

### Article Summary

The economy is growing and investment was increasing  
But wages aren't growing  
So there is no threat of inflation  
The Fed does not have to increase the interest rate.

This is a current example of the employment (wages) vs. inflation tradeoff.

## Summary: US Macroeconomy

- 1) There is an inverse relationship between inflation and unemployment
  - Lower unemployment → Higher Wages → Higher Prices → Higher Inflation
  - Higher unemployment → Lower Wages → Lower Prices → Lower Inflation
- 2) Fed buys and sells bonds in order to affect the interest rate, which affects investment and employment
  - Fed Buying bonds → Lowers Interest Rate → Cheaper to borrow money → Increases Investment → Increases Employment
  - Fed Selling Bonds → Raises Interest Rate → More expensive to borrow money → Decreases Investment → Decreases Employment

## Making International Connections...

These concepts of managing inflation, interest rates, and unemployment will also be useful when understanding international economics.

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The China Example: Putting it all together

*Goals of Today's Class*

## Understanding International Economics

- Today we will try to cover 1 thing only: International Economics and the role of the U.S. on the international stage
- By the end of the class you should be able to understand neoclassical international trade theory, some major concepts in international finance, and the Mexican Peso crisis.

*Goals of Today's Class*

## Why is important to study international trade and finance?

- These are the economic mechanisms that facilitate U.S. imperialism and allow global finance/Wall Street to keep poor countries poor
  - For example, Structural Adjustment Programs rely on and are justified by the concepts that we will talk about today
  - Explains why imports to the U.S. are so cheap
- International political tensions and conflict exist because of these finance and trade concepts.
- Others?

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## In this section...

- The Basics on Trade
- Free Trade
  - Comparative Advantage
- Small Group Exercise

## Basics of Trade

- International trade is simply the buying and selling of goods and services between countries.
- Basic rationale: If you have access to a large international market, you can focus on producing whatever it is you produce best.
- Allows for an extensive “International Division of Labor.”
- For information, visit the CIA or the IMF.  
<https://www.cia.gov/library/publications/the-world-factbook/>

## What is Free Trade ideology?

Free Trade ideology advocates for eliminating all barriers to the international exchange of goods and services. Why? Goes back to how they think any intervention on markets are negative.

Barriers may include tariffs and quotas

Tariff: A tax on the good being imported

Quota: A limitation on the amount of good that can be imported

Most neoclassical economists are militantly advocating free-trade agreements. Under this theory, they believe the markets everyone can best get what they want/need through international markets. While there are some Team B economists who oppose free trade, they are few and far between!

## The Centrality of Comparative Advantage

- Comparative Advantage is the theoretical backbone of Free Trade ideology and is critical to understanding international trade theory.
- Comparative Advantage is the *only* economics principle behind the ideology of free trade.
- Definition: The economic activity that a country does that is the most valuable on international markets. This theory states that a country should stick to that activity, rather than focus on other economic activities.
  - E.g. Botswana should keep mining diamonds and gold, sell them, and import manufactured goods.
- International Trade allows countries to maximize their revenue by specializing in their comparative advantage.

## Arguments for why free trade will eventually reduce poverty

Proponents of Free Trade argue:

- Free trade will let Third World countries specialize in export agriculture/low-end manufacturing, and rich countries specialize in high-end manufactured goods and services.
  - For example, Japan makes and exports electronics and cars, Ghana grows and exports cacao/chocolate
- According to this theory, poor countries will eventually get more money from selling their stuff abroad and get cheaper stuff, and eventually become richer.

## The more sophisticated defense of trade

- Okay, so trade has all these winners and losers and all these market imperfections.
- But we should have free trade and fix the market imperfections using other tools
- And we should compensate the losers with retraining, generous benefits, etc.
- Problem: Politically Naïve!!

## What are the Criticisms of Comparative Advantage & Free Trade Theory?

- 1) Advantage is historically determined (e.g. colonialism) (ex: Caribbean and Sugarcane)
- 2) There may be other positive benefits that can result by not sticking to your comparative advantage  
EX: Chavez reducing reliance on imported food
- 3) Patterns of trade ensure poor countries will stay relatively poor.
- 4) Doesn't account for the fact that there will still be winners (elites) and losers (masses) inside a country from the opening of trade.  
EX: landlords vs. small farmers; US Capitalists vs. US Workers
- 5) Most trade is between rich countries that have larger markets

## In effect, Free Trade hurts poor countries and keep them poor

- Any gains that you might gain are temporary, but it does not lead to structural change and consistent economic growth
- Reinforces historic patterns of economic disparity and unequal development within and between countries
- Relies on the false assumption that markets are perfect (see class 1)
- Essentially, class on a global level with nuances.
- **No** country has gotten developed by pursuing unrestricted free trade
  - Free Trade proponents always use Hong Kong as an example but it is unclear that free trade alone is responsible for HK's economic growth.

## What did Marx have to say about Free Trade?

- “The 1848 speech on free trade in England”
- Really brilliant, little known speech.
- Points out a lot of the above criticisms.
- Suggests that the left’s position on free-trade should be developed in the context of the time, place, and conditions. Free trade can be progressive in the right institutional/political framework...
- e.g. strong left makes free trade between Venezuela and Cuba and Bolivia ok....

• <http://www.marxists.org/archive/marx/works/1848/free-trade/index.htm>

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## In this section...

### Components of International Finance

- Exchange Rates
- Case Study: 1995 Mexican Peso Crisis  
We’ll use this case for the rest of the class to understand various international finance concepts such as balance of payments, foreign reserves, capital controls, and structural adjustment programs.
- IMF & Structural Adjustment Programs
- Case Study: China & the U.S. (if we have time)

## What is the Exchange Rate?

- The conversion rate of a foreign currency in domestic currency
- Example: The exchange rate between dollars and pesos is 1:4
- This means
  - \$1 = 4 pesos
  - 1 peso = \$.25.

## The multiple money world



We live in a world with international trade and investment. If you want to buy or invest in a different country, you need to convert your currency into that country's currency.

The way exchange rates are set is related to the supply and demand of the currency of countries. Let's discuss an example....

## It's important to understand currency is like any other market

- When a lot of people want to buy or invest in a particular country (India) then, there is an increased demand of that country's currency (Rupees).
- If a lot of Americans want to invest in Bangalore by buying stocks in Indian software companies, then there will be an increased demand for Rupees.
- Whenever you have an increased demand for a commodity (Rupee), the price of that commodity (Rupee) will go up.
- That means it will be more expensive for Americans (or anyone else) to buy Rupees.

## Why and how do exchange rates change?

**The exchange rate gets set in foreign exchange markets**

**The exchange rate of a country changes when that country's...**

- Exports are booming or falling
- Domestic economy is booming or falling
- Foreign investors want to invest or divest

## Did exchange rates always move around?

- No.
- Before 1973, all exchange rates were fixed.
- Fixed exchange rates means the government uses its foreign reserves and monetary policy to maintain the exchange rate at a fixed level.
- The need to finance the Vietnam War is what prompts the U.S. to abandon fixed exchange rates.

## How to make money as a currency speculator

Say exchange rate is 1 dollar = 3 pesos.

- A) Borrow 100\$, promising to pay back 110\$ tomorrow
- B) I convert 100\$ to 300 pesos.
- C) Hope for the exchange rate to move down to 1 dollar = 2 pesos
- D) Convert back 300 pesos to 150 dollars
- Yay! I just made 40\$.

## What happened in Mexico in 1995?

- Peso exchange rate changes very quickly in 1995.
- It went from 3 pesos per dollar to 9 pesos per dollar.
- Why do you think this happened?

## Historical context

- In the 80's and early 90's, Mexico was the darling of the IMF and had attracted significant foreign investment
- In 1994, Zapatistas burst onto the scene
- Some investors (foreign & Mexican elite) get spooked by the political "instability."
  - The strength of the Zapatista movement
  - The assassination of a PRI party (the ruling party) politician
- Classic case of Herd Behavior and Capital flight. Investors scramble to get the hell out of Mexico...

## How did the Peso get Devalued?

For the sake of easier numbers, say that the peso exchange rate before 1995 is 1:10 or \$.10 (each \$1 = 10 pesos)

Because foreign investors and the Mexican elite want to divest, they act to get rid of pesos.

Because it deregulated the movement of money across the border, NAFTA facilitated the capital flight of the Mexican elite. They put their money in New York City banks.

Because the demand for pesos decreased, the price of buying pesos also decreased.

This caused the peso to be worth less. Other ways of saying this:

The peso was devalued

The exchange rate fell from the Mexican perspective

The exchange rate rose from the U.S. perspective.

## What happened to trade when the exchange rate changed?

- Mexican exporters can now export more, because Mexican goods are cheaper to Americans. (e.g. cheap t-shirts)
- Mexican importers can now import less from the U.S., because American goods are more expensive to Mexicans. (e.g. corn)
  - Tangent: Why does Mexico import corn anyway?

## Small Group Exercise

So all that is economically speaking.

What does this mean for real everyday people?

Report back 3 things you discussed

5-10 min

Discuss

## Additional effects of Peso Devaluation

- International debt contracts that were written under the old exchange rate became unsustainable--Defaults and Bankruptcies! (AKA Debt Overhang)
- The big effect is that Mexican companies and the government that owed U.S. debt couldn't pay it off
- Revenues were in pesos, but interest payments were in dollars.
- Threatened a lot of banks and businesses in Mexico.

## Could Mexico have done anything to stop the devaluation?

- The Mexican Central Bank (Mexico's Fed) could have raised interest rates. Why?
- Recall that a central bank could decrease domestic investment by increasing the interest rate on bonds. This could cause
  - Domestic investors to buy more bonds and invest less in stocks and companies
  - However, there are also foreign purchasers of government bonds, who will also buy more bonds
- Now the interest rate also changes the exchange rate...How?

## How are Interest rates and exchange rates related?

- Interest rate goes up → Increases foreign bond purchases because it's a good investment → To buy the bonds, people need your currency → Demand for your currency goes up → The exchange rate rises
- Interest rate goes down → Foreign investors want to sell their Mexican bonds because it becomes worse investment → When they sell their bonds, they get pesos which they want to convert to something else → The supply of your currency increases → The exchange rate falls

These effects are in addition to the domestic investment and employment effects.

## Recap: What options did Mexico have?

Three tough options:

- A) Raise interest rates to keep old exchange rate stable.
  - This will lower domestic investment and employment.
- B) Take the new exchange rate, which will lead to bankruptcies and unemployment.
- C) Borrow a pile of foreign currency from the IMF (or the US), and
  - pay off your international debt and bailout your businesses, to reduce the impact of B)
  - increase demand for your own currency, trying to keep the exchange rate up.
  - This is never a free lunch. (We will come back to this)

## Hold up. Were there more options?

If not for neo-liberal policies (e.g. NAFTA), Mexico would have had more and better options such as foreign reserves along with capital controls.

It's important to realize that neoliberal policies make these kinds of crises

- more likely because it allows herd behavior and quick money flight
  - and worse because it restricts the options countries have to respond.
- Neoliberalism makes the legacy of colonialism even worse!

## What are Foreign Reserves?

- Amount of foreign currency held by the central bank.
- For example, the US central bank (the Federal Reserve) holds some foreign bonds.
- China holds a HUGE amount of US bonds!
- Why is this useful? These provide a ready source of foreign currency if needed.

## What are Foreign Reserves? (2)

If Mexico would have been able to use their foreign reserves, they could have:

Increased the demand for the peso by flooding the market with non-Mexican currency being converted into Pesos.

For this to work, the Mexican government would have to be able to act faster than the private domestic and foreign investors.

## What are Capital Controls?

- Basically restrictions on investors' ability to take money out of any given country.
- But, it would allow the government to act faster than the investors.
- Capital controls give a country more time, allowing it to use its reserves more effectively.
- Means you don't have to suddenly jerk the interest rate up to keep the exchange rate stable. Instead you could use your foreign reserves first.

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## International Financial Institutions



World Bank

Long-term loans  
for big  
development/infrastructure  
projects



IMF

Short-term loans to  
ameliorate  
financial crises

World Bank loans make financial crisis more likely. This is because in order to repay the loan (that is in foreign currency), the lender will inevitably lower its exchange rate because it needs foreign currency.

## The IMF in brief

We'll focus on IMF because its more related to the case of the 1995 Mexican Peso crisis.

What does the IMF say they do?

They say their job is to manage balance of payment crises.

What do they actually do for countries?

They loan money during crises to help stabilize exchange rates

What does this do for the capitalist system?

- The conditions they attach to loans further integrate developing countries into the world market and make them more "attractive" to global investors
- Unclear whether the IMF fixes crises or makes more of them
- Simple Marxist analogy is IMF: Global Financial Capital :: Treasury Department : U.S. Domestic Capital. In other words, it's a tool of the capitalist class to bail-out or manage the inevitable crises capitalism produces.

## How does the IMF do it? Structural Adjustment Programs

Getting an IMF loan comes with a bunch of conditions  
AKA structural adjustment programs.

Theoretically, these conditions are supposed to prevent future rapid devaluations by keeping that country permanently attractive for investors.

Two of the major conditions countries must adopt are:

- a) raising the interest rate, privatizing public services, and reducing government debt to attract foreign capital
- b) promoting exports because it raises the demand for that country's currency (e.g. switching from food to cash crops)

## Criticizing the IMF on its own turf

- Raising the interest rate often doesn't work to bring back foreign capital because of no future taxes.
- Free trade further lowers the tax base.
- Nothing about raising taxes or investing in long-term growth strategies like health or education.
- Resulting pissed-off social movements also not good for attracting investment
- Good chunk of IMF policy was just free-market ideology.
- The rest of it was imperialism.

## Why the IMF riots?

- If you import food, the price of food goes way up.
- Lots of unemployment
- Public services cut massively because governments can't borrow anymore.

## **Example: The Chinese Dilemma**

- China is growing by exporting to the US
- Needs to a) keep a lid on domestic inflation to keep domestic investors investing.
- And b) keep the exchange rate low to keep exports to the US cheap.
- Thus, needs to both have high and low interest rates!

## **How does China manage?**

- Uses Foreign Reserves to keep exchange rates low while keeping domestic interest rates high.
- Chinese central bank buys lots of US bonds, keeping the demand for dollars high, and therefore keeping the exchange-rate for yuan low.
- This is the current situation.

## **What is foreign bond purchases financing?**

- First bought US stocks, now lending to US gov. This is pushing down US interest rates.
  - Also allowing US to borrow more, financing war in Iraq without taxation.
  - Twin deficits: budget deficit(internal) and trade deficit(external)
- Also allowing Americans to finance housing and remortgage houses to consume.

## **Now have all the pieces...**

- China stops lending to US, and the US interest rate rises to attract other lenders.
- This lowers US investment
- US exchange rate also rises and US imports from China fall
- Bad news!

## No Worries?

- US has the “exorbitant privilege” because all international trade and lending occurs in US dollar-denominated contracts.
- Less money comes in from abroad, means US has to pay less to foreign lenders.
- Maybe offsets loss in imports.
- This is one reason crisis less damaging in US than other countries.

## Will this happen?

- Don't know.
- Will the consequences be horrible? Don't know. Depends on speed of adjustment.
- Also, people worry too much about China, maybe.
- Does this have anything to do with left-wing politics?
  - A) Good to understand global finance
  - B) Part of the criticism of globalization

## What is the Balance of Payments?

- Just like a country's checkbook with the rest of the world.
- Domestic currency doesn't allow you to buy goods in another country .
- So, need to either invest that currency back in the country from which it came.
- Or buy stuff from that country with it.

## What is the Capital Account?

- This is the amount of foreign money that is coming in minus the amount leaving as investment.
- A big part of globalization has been “liberalizing” the capital account.
- This means that more foreign private investment can enter and leave.
- Increases the size of the capital account.
- This account can change very quickly.

## What is the Current Account?

- Amount of foreign money coming in and leaving due to trade
- Exports minus Imports
- Trade Deficit is when the Current Account is negative.
- You have a trade deficit when you are importing more than you are exporting.
- E.g. United States right now.
- This changes slowly.

## Example: Dutch Disease

- Netherlands discovers natural gas, sells a ton and promptly sees its manufacturing exports decline.
- What happened?
- Gas sales increased trade surplus, so dutch had lots of foreign currency, which they then converted into domestic currency, raising the exchange rate.
- This made their exports uncompetitive internationally.

## Dutch Disease continued

- Similar story can be told for the impact of foreign aid money in Global South.
- AID → US dollars being exchanged for domestic currency → exchange rate goes up → exports fall
- E.g. Exporting farmers go out of business thanks to “aid”.