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INTERNATIONAL ECONOMICS

Tutorial

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МИНИСТЕРСТВО ОБРАЗОВАНИЯ И НАУКИ РОССИЙСКОЙ ФЕДЕРАЦИИ

Федеральное государственное автономное образовательное учреждение высшего образования «Национальный исследовательский Нижегородский государственный университет им. Н.И. Лобачевского»

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МИРОВАЯ ЭКОНОМИКА

Учебно-методическое пособие

Рекомендовано методической комиссией института экономики и предпринимательства для иностранных студентов ННГУ, обучающихся по направлению подготовки 38.04.02 «Менеджмент»

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В настоящем пособии изложены учебно-методические материалы по курсу «Мировая экономика» для иностранных студентов, обучающихся в ННГУ по направлению подготовки 38.03.02 «Менеджмент» (магистр).

Учебно-методическое пособие может быть использовано студентами финансово-экономических специальностей, изучающим английский язык для профессиональных целей.

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CONTENT

International economics is a branch of economic thought that dates back to XIV century when the mercantilism, the first economic doctrine focusing on international economic relations, appeared. Since that time, the study of world economic processes became one of the most developed part of economic theory. Strictly speaking, this discipline focuses on a global system of national economies connected by different forms of international economic relations. As a part of economic theory, international economics uses the same analytical methods, because the motives and behavior of agents are the same in international economic relations as they are in domestic transactions. The major trend of the world economy is the globalization. It is creating many opportunities and risks to the nations and theirs economic agents across the globe. In economic terms, the globalization means a high interdependence among countries, an impossibility of an autonomous autarchic development, and international competitors for almost all business agents.

Unit 1. International trade and capital flows

Current international economic problems. Basic concepts and indicators. Patterns and trends in international trade and capital flows. Cost and benefits of international trade. Comparative advantage and the gains from trade. Hecksher-Ohlin model of international trade. Economies of scale and international trade. Technological gap and product cycle models of the international trade. National competitive advantage theory. Immiserizing growth. Import-substitution vs export-oriented industrialization.

The mobility of production factors. The notion and types of foreign capital movements. Motives for international portfolio and direct investments. Reasons for the existence of multinational corporations: OLI-paradigm. Problems created by multinational corporations in the home and host countries.

The global community needs to resolve a few acute international economic problems, although they may differ among organizations and scholars. A non-exhaustive list of them includes:

1. Global financial and economic instability. The world economy faces the periodical economic recessions in advanced countries and the reduction in economic growth in emerging markets. The United States have structural imbalances, Japan and Western Europe suffer from slow growth, the transition economies of Central and Eastern Europe face an insufficient restructuring [Salvatore, 2013].

2. Resource scarcity, climate change, environmental degradation. All these phenomena inhibit opportunity for the global sustainable development.

3. Deep poverty in many countries and global health crises. Millions of people all over the world starve each day. Theirs health needs remain unmet. This situation is unacceptable from an ethical point of view and leads to further global problems involving almost all advanced and less advanced countries.

4. Excessive fluctuations in exchange rates, interests, stock prices and structural imbalances regarding real and financial markets. These trends interfere the specialization, international trade, and investment.

5. Widening trade protectionism and trade wars in conditions of political controversy and economic stagnation. This problem is now intensified by the competitive challenges that national economies face from the outside world.

Now, let us focus on international trade. The *international trade* is the most traditional form of international business and a leading one among all other international activities. Thus, it serves as a rough estimation for cross-border investment and financial flows, technology transfer and its results, unilateral money transfer caused by migrants. There is a wide range of indicators providing information on the importance and development of country foreign trade activities in an international context. The indicators, which are collected and calculated on the annual basis, are

1. ***Exports of goods and services*** represent the monetary value (usually measured in current U.S. dollars) of all transactions involving a change of ownership from residents to nonresidents of general merchandise and services.

2. ***Imports of goods and services*** represent the monetary value (usually measured in current U.S. dollars) of all transactions involving a change of ownership from nonresidents to residents of general merchandise and services.

3. ***Foreign trade balance or net exports*** is the difference between exports and imports. It can be positive (surplus) or negative (deficit). A trade surplus leads to a net inflow of currency from foreign markets and creates a basis for further foreign investment. It is a measure of a country's production competitiveness. The situation is the opposite for a trade deficit. The advanced countries excluding Germany and Japan have a foreign trade deficit.

4. ***Export propensity*** is the ratio of exports to the gross domestic product (GDP) calculated on the same time basis.

5. ***Import ratio*** is the ratio of imports to the GDP.

6. ***Import penetration rate or Import dependency*** is the ratio of imports to the GDP adjusted for the foreign trade balance (difference between exports and imports). In other terms, it specifies the extent of dependency on importation in relation to domestic consumption.

7. ***Openness index or Foreign trade-to-GDP ratio or Globalization*** index is the ratio of country's sum of exports and imports to the country's GDP.

8. ***Terms of trade*** is indicate how the country's purchasing power of an export unit measured in terms of import units has changed on the base year. It is the relation between the export and import prices. The gains from the exports of same quantity of goods increase when the export prices rise or the import prices go down. The country's terms of trade are improved, and vice versa. It is calculated using index numbers and not absolute values. Some important modifications of this indicator are *income terms of trade* which is obtained by multiplying per volume of exports of a country and *single factoral terms of trade* calculated by multiplying terms of trade by an index of productivity changes in domestic export sectors (Jhingan, 2014). All these indicators

focus on dynamics of country's gains from international commerce.

There are some open research questions in the field of international trade regarding

1. Impact of intra-firm trade on international commerce (for example a tax optimization may determine and diverge prices and directions of flows of goods and services observed by the official statistics); the lateral scientific inquiries regard influence of trade networks, significance of offshore production decisions and results of multiproduct firms international strategy;

2. Existence of positive influence of international trade on country's GDP growth and employment, what are the gains form trade and how they are distributed between countries and economic agents;

3. Uncertainties on trade policy effects. There is a tendency to support and promote free trade policy, because of its positive influence on output, utilization of resources, factor incomes, consumption and other relative indicators. However, the opposite opinion suggests nonexistence of non-interventional or laissez-faire trade policy that justifies a protection of certain domestic industries from foreign competition. This debate is relevant for all developing countries adopting a liberalization policy under international bodies and developed countries requirements.

International trade is one of the most conceptualized and studied economic phenomenon. The first economic doctrine on international trade or more precisely on international trade policy was mercantilism that spanned from the 16th to the late 18th century. The goal of these policies was to build a wealthy state by obtaining a positive balance of trade that would bring gold into the country. The idea was that national strength could be maximized by limiting imports and maximizing exports through appropriate import and export tariffs. Among the measures suggested there were embargoes upon raw materials export, the same restrictions on imports of any good producing by a country, promotion of unavailable raw materials import and so on. So, the mercantilists believed that a nation could gain in international trade only at the expense of other nations. Under that logic, the international trade is a zero-sum game and needs to be regulated.

As D. Hume and A. Smith showed later, this type of trade policy cannot last forever. First, because the world development would stop if every country wanted to sell abroad and no one wanted to buy abroad. Second, after a period of such policy being applied, an accumulation of gold as an increase of money supply leads to inflation and to loss of price competitiveness against imported goods, if a country achieves an upper limit of production possibilities. Hence, the mercantilist policy is senseless and useless.

The continued pressure of growing capitalist business, initially in England and then in the rest of Europe, resulted in the implementation of laissez faire principles and trade based on *absolute advantag*e proposed in Adam Smith's book "Wealth of Nations" (1776). A country has an absolute advantage in producing a good if it is able to provide its lower absolute cost, i.e. use fewer resources (labor primarily) in its production than its partnering country. This consideration

coincides with the labor theory of value introduced by Adam Smith and supported later by David Ricardo.

Example 1. Absolute advantage (cost) principle illustration

Table 1.1
Labor cost per unit of good, working hours

	Russia	Belorussia
Potato	4	3
Grain	5	6

Table 1.2
Output per hour (productivity), units

	Russia	Belorussia
Potato	0,25	0,33
Grain	0,2	0,17

Table 1.1 indicates that Russia has a lower absolute labor cost in grain cultivation, while table 1.2 demonstrates its absolute advantage (higher productivity) for the good. Belorussia has a lower cost and higher productivity in potatoes production. The trade between countries will save about one working hour per unit for both goods. A. Smith considered the labor as unique production factor and labor cost in working hours can be easy transformed in monetary terms multiplying by hourly payment.

Because of model's assumption of two countries and two commodities there may be a situation when one of two countries has absolute advantage (lower absolute cost) in both goods. In that case, the international exchange will not have a place. Table 1.3 reports the situation when Belorussia has an absolute advantage in both grain and potato production and hence no interest to trade with Russia.

Table 1.3
Labor cost per unit of good, working hours

	Russia	Belorussia
Potato	4	3
Grain	5	4

Table 1.4
Relative prices

	Russia	Belorussia
Potato, units of grain for unit of potato	0,8	0,75
Grain, units of potato for unit of grain	1,25	1,33

D. Ricardo overcame this limitation proposing to use comparative and not absolute cost for goods. The comparative or relative cost of good X is the amount of good B that might otherwise have been produced with the same quantity of labor (together with other production factors). Transforming the information of table 1.3 into relative prices, we obtained table 1.4. Belorussia has a lower relative price for potatoes (0,75 unit of grain against 0,8 unit in Russia), while Russia has a relative advantage in grain cultivation.

A country has a comparative (relative) advantage in producing a good of its relative price (later nominated opportunity cost) is less than that of another trading country. Participating in the trade with Belorussia Russia gains additional 8 units of potato exchanging 100 units of grain for 133 units of potato at the foreign market and not for 125 units as at home. The same logic is valid for Belorussia that can obtain additional 5 units of grain exchanging 100 units of potato abroad and not at home.

Gottfried Haberler in 1936 explained the theory of comparative advantage by the opportunity cost theory and production possibility frontier. The concept of opportunity cost substituted the Ricardo's idea about comparative (relative) price. In the absence of trade, a nation's production possibility curve is also its consumption frontier. With trade, each nation can specialize in producing commodity of its comparative advantage (lower opportunity cost) and exchange part of its production with the other nation for the commodity of that country's advantage, i.e. of proper disadvantage.

Let's suppose that Russia possesses 2400 working hours as labor endowment, and Belorussia has 1200 working hours. For simplicity, the opportunity cost in both countries is constant (see Fig. 1.1). The Production Possibility Frontier of Russia passes from a combination of 480 units of grain (obtained by dividing 2400 hours of labor endowment of Russia by 5 working hours of grain's labor cost) corresponding and 0 units of potato to a combination of 0 units of grain and 600 units of potato (obtained in the same way). The Production Possibility Curve of Belorussia has extreme points corresponding to 300 units of grain and 0 units of potato, from one side, and 0 units of grain and 400 units of potato.
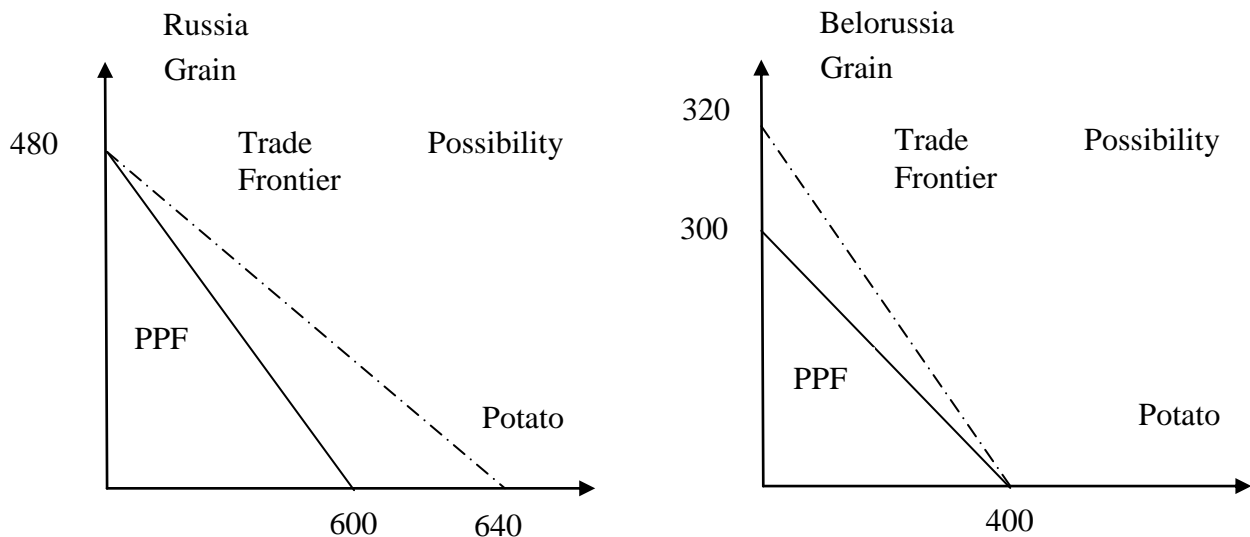

Fig.1.1. The Production and Trade (Consumption) Possibilities Frontiers of Russia and Belorussia

The historic signification of the Smith and Ricardo theories is the justification and promotion of free international trade and policy based on the good specialization and respective export of more efficient countries.

The next important development of international trade theory is the Heckscher-Ohlin theory (or model). This theory consisting of four fundamental propositions (theorems) focuses on the explanation of commodity trade patterns by the composition of countries' factor endowments and goods' factor intensity as well as the consequences of free trade for the functional distribution of income within trading countries.

The first contribution is the Heckscher-Ohlin theorem. It builds on two separate research works, Eli Heckscher's *The effect of foreign trade on the distribution of income* (1919) and Bertil

Ohlin's *Interregional and International Trade* (1933). The Heckscher–Ohlin Theorem developed by Ohlin states that countries export those goods that require for their production relatively intensive use of those productive factors possessed locally in relative abundance, and import the commodity intensive in its relatively scarce and expensive factor. Therefore, they determined the basis of both absolute and comparative advantages and therefore reasons for international trade.

The second idea, factor price equalization or Heckscher-Ohlin-Samuleson theorem arises from homonymous P. Samuelson's article *International Trade and the Equalisation of Factor Prices* (1948). According to this theorem that the relative and absolute prices or returns for two identical factors will be equalized across countries because of international trade.

The third proposition is the Stolper–Samuelson theorem published in a joint article *Protection and Real Wages* (1941). According to it, an increase in the relative price of a commodity will rise the return to that factor which is used most intensively in the production of the good, and conversely, to a fall in the return to the other factor. If some factors are specific, i.e. can only be used in some industries, that trade will have a controversial effect: it will benefit the immobile production factors that are specific to export commodities and influence negatively factors specific to the nation's import-competing goods.

To complete the list of Heckscher-Ohlin theory's propositions, the Rybczynski Theorem (1955) emphases the relationship between factor availability and commodity outputs. The Rybczynski theorem states: when only one of two production factors is increased there is a relative increase in the production of the good using intensively that factor. This leads to a corresponding decline in that good's relative price as well as a decline in the production of the good that uses the other factor more intensively. The reason of the process is that expanding production of the intensive good also requires some of the other factor. This amount of the other factor must be drawn from the other industry, so its output declines. The Rybczynski theorem explains a famous phenomenon of the 'Dutch disease', i.e. deindustrialization following discovery, extraction and further export of a natural resource.

The first empirical test of the Heckscher-Ohlin model was conducted by Wassily Leontief in 1954 and led to a paradox. He found that U.S. import substitutes (which he used for modelling factors structure of normally imported commodities) were about 30 percent more capital-intensive than U.S. exports. This result contradicts the Heckscher-Ohlin model's prediction based on the U.S. absolute leadership in capital endowment in the early postwar period.

Another major reason that international trade may take place is the existence of economies of scale in production. Economies of scale means that production at a larger scale can be realized at a lower cost. Although both trading partners have same level of productivity and mostly identical factor endowments, international trade exists. Each country produces the entire quantity of a certain commodity, one of the wide range, obtains lower costs comparing with the situation of production of less quantity for each variety. This phenomenon explains the existence of intra-industry international trade and trade between similarly gifted countries.

The Ricardo's and Hecksher-Ohlin theories are based on the unrealistic assumption that technology is the same in all trading countries. M.V. Posner in article *Technical Change and*

International Trade (1961) recognized the effect of temporary technological monopoly of an innovating firm on its export leadership. There are two types of delay in competition: imitation lag and demand lag. The revealed imitation gap has three components [Jhingan, 2014]: domestic reaction lag, foreign reactions lag, and learning period. The first two lags regard a delay in competitors' reactions to pursue the innovating leader. The learning time is time taken by producers to master the production techniques for the new product. The demand lag refers to foreign consumers' reaction. The gaps in competitors' efficiency maintain export positions of the first inventor.

R. Vernon developed M Pozner's ideas and proposed to reflect on the product cycle's influence on the international trade and investment in homonymous paper *International Investment and International Trade in the Product Cycle* (1966). He noticed that many new products were developed in capital-rich and R&D-intensive countries. He derived three-phase model including production, trade and investment.

At the first, *new product*, stage the production requires cheap financial resources, highly skilled labor, and exclusive technological capabilities, therefore the production is located in developed countries, the promotion and sales regard domestic clients, the international trade and investment do not exist. At the next, *maturing product* stage, the mass production and distribution require a decrease in prices and costs, the innovative firm starts overseas sales. At the *standardized product* stage, the technological gap is overcome and the competitive advantage of the initial producer disappears, and the manufacturing operations become less sophisticated and shifts abroad, so the international trade takes the opposite direction.

Michael Porter proposed the national competitive advantage (NCA) concept in his book *The Competitive Advantage of Nations* (1990). Evaluating the key success factors of leading manufacturers in different industries, M. Porter discovered their preferential localization within a single country in a contradiction with marketing demand-driven orientation. Porter proposed a diamond-shaped diagram to outline four key factors of country's competitiveness (see Fig. 1.2). The four determining elements of the model 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 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. The condition in the nation governing how companies are created, organized, and managed, as well as the nature of domestic rivalry.
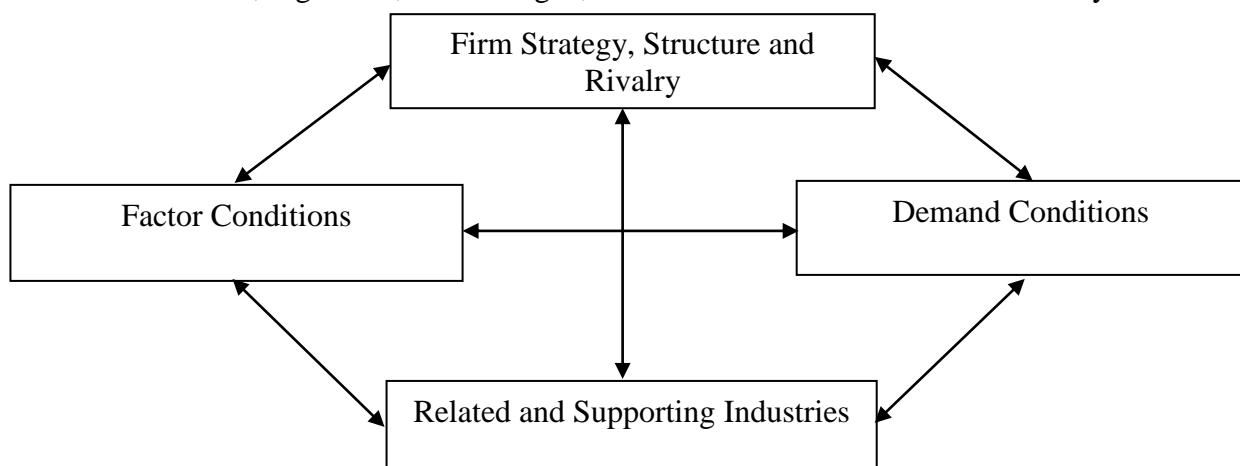
Fig. 1.2 Porter's Diamond of National Advantage

The resource endowments, technology and consumer tastes change over the time. It affects the comparative advantages of trading countries, the volume of trade and the welfare of each nation. First, the growth in capital and labor is considered. There are three situations in regard.

1. Labor and capital grow at the same rate (balanced growth). The nation's production possibility curve enlarges in all directions at the identical rate of factor endowment increase, the output per worker or productivity remains constant.

2. If labor grows faster than capital, the production possibility curve will shift more in the axes of labor, so the nation will be able to produce a greater quantity of labor-intensive commodity but the labor productivity will decrease.

3. If the capital grows faster than labor the opposite situation happens.

The extreme case of the growth in factor endowments is considered in the Rybczynski theorem when only one factor grows.

The technical progress decreases the amount of factors required to produce any given quantity of a commodity or a service and therefore push the production possibility curve outward increasing a nation's welfare. The influence of technological development on production and consumption and consequently on trade, however, can be protrade, anti-trade and neutral. Production is protrade if the growth in exportable goods is greater than the growth in importable goods. Consumption is protrade in the opposite case when the incentive of import occurs.

The Generalized System of Preferences, a fruit of the discussion within the Unite National Commission on Trade and Development in the 1960s partially is based on the protrade production and consumption concept. It is a system of preferential tariffs for developing countries when they exports to developed countries. Nevertheless, the relationship between trade and welfare is ambiguous. The growth in export without rising price leads to a deterioration of terms of trade. The positive effect of growth on nation's welfare caused by export may be eliminated by the terms-of trade deterioration. This situation is known as 'immisering growth'.

The next important form of international economic activity is the movement of so-called production factors. The *movement* or *migration* of capital, labor, and technology between countries is mainly caused by different factor endowments and intensities, and consequently, by respective prices. The production factor migration substitutes and accompanies flows of commodities and services. The standard model of factor movement considers two countries, donor and recipient, and three effects:

1) impact on GDP;

2) change in moving factor revenues;

3) change in other factor revenues.

The factor-exporting country or 'donor' manifests a decline in both the GDP and the remaining factor revenues, and a growth in the migrating factor revenue. The factor-importing country or receiver experiences the opposite dynamics; therefore, there is an increase in both the GDP and the revenues of non-migrating factors, and a decline in the revenues of imported factor. At the global level an increase in the world GDP occurs, it means that a factor migration lead to an optimal resource utilization.

Capital is absolutely mobile factor, because in a world there are few barriers to the movement of capital. The *international capital migration* consists of inflows and outflows of funds conditioned by the temporal utilization of capital abroad in a form of loans, stocks acquiring, intergovernmental credits or profit repatriation. The capital flows metaphorically represent a circulatory system of the global economy since they determines production (employment), consumption and general living conditions in any geographical community of reference. Following general laws of factor migration, capital moves from nations where capital is abundant and cheap to countries where capital is limited and expensive. Nevertheless, there is also an opposite flow from high return on capital countries to law return ones justified by risk diversification needs. However, if we consider risk-adjusted return the capital movements the capital flows follow the logic of pursuing a higher return on real investment. This phenomenon is typical only for monetary flows unlike labor migration and technology transfer.

The international movement of capital has several structural taxonomies

1) *functional division* based on sphere of activity and type of return includes foreign loans and international investment. *Foreign loans* regard fixed or floating income capital credit, with a low uncertainty and risk expectations. The income on foreign loans is the interest. Loans are typically released by banking sector as well as official public institutions as governments and international bodies. *International investments* do not guarantee directly return on capital. The investment income is profit or security risky return. Historically, investment is connected to the real sector, building new facilities or new assets abroad. The purchase of shares and bonds abroad involves also financial institutions;

2) classification based on *terms of investment* supposes existence of short-term (up to a year), mid-term (1-3 years) and long-term (over 3 years) capital flows;

3) classification on *source of capital* presumes division of capital flows into official and non-official ones.

The international investment flows as s part of capital flows include portfolio investment and direct investment. *Portfolio investment* is the international exchange of financial assets regarding purchases of stocks, bonds, bank accounts, etc. in another country, and then international portfolio of assets is formed.

Direct investment implies not only acquisition of foreign assets, but control of activity as well. What constitutes a controlling cannot be precisely determined. Clearly, anything above 50% ownership is a controlling interest, but according international standards an ownership recognized as direct investment with 10% control. The motives of portfolio and direct investment partially coincides (see Tab. 1.5)

Table 1.5.

Motives for international portfolio and direct investments

Common motives	
• Higher real income considerations; • Balance of payment effect; • Tax optimization both in source and host countries	
Distinct motives	
International portfolio investment	Foreign direct investment (FDI)
• Risk diversification; • Advantage of different interest rates	• Horizontal integration; • Vertical integration (downstream and upstream activities); • Business diversification

Foreign direct investment is realized mostly by multinational corporations (MNCs) or transnational corporations (TNCs). Strictly speaking, a TNC belongs to the capital of a single nation, while the owners of MNC represent few countries. In a general case, these two terms are used in parallel. The common trait of both types of companies is the possession of production facilities in more than nation, for this purpose the international commercial presence is not enough.

MNCs create and develop the competitive advantages that can be conceptualized as in OLI-model, also known as the eclectic paradigm, proposed by John H. Dunning [Dunning, 1980].

The OLI paradigm collects and arranges all revealed by 1980 motives of foreign direct investment into three pillars

1. *Ownership advantages* (trademark, production technique, entrepreneurial skills, returns to scale). Ownership specific advantages refer to the proper unique assets allowing to obtain an additional revenue alone or in combination.

2. *Location advantages* (logistically favorable geographical position, right to enter a foreign market, access to raw materials and low-cost labor, moderate regulation in tax, labor, custom, environmental law). Location advantages leads to an economy of production resources and a respective cost reduction.

3. *Internalization advantages* (advantages of well-controlled hierarchical structure of business). Firms earn from internal and not external organization of transactions. It is a business trend characteristic for 1970s, in the contemporary conditions of digital revolution, the strategies to outsource (and offshore) win.

The rapid growth and significant role of MNCs since WWII has raised important issues concerning their effect on the source and host countries as well as the world economy (see Tab. 1.6).

Table 1.6.

Pros and cos of MNC's operating

Areas Effects	Home country	Host country	World economy
Pros	Increase of jobs in administrative and financial service Better utilization of a	Increase of jobs, GDP, and tax revenues Access to new technology	Increase in the world output and welfare Achievement of economies of scale and

			diminishing of production costs and selling prices Establishment of minimum standards
Cos	Transfer pricing, tax optimization, and budget shortfall Loss of jobs in production Eventual erosion of technological knowledge of the home nation Difficult monitoring of financial flows	Rising dependency on foreign firms Eventual erosion of technological knowledge of the host nation Abusive exploitation of local resources	Profit at the expense of the consumer, destruction of product diversity across the globe; Difficult for small local business that usually generates more jobs Violation of Western-type labor standards, humiliation of human dignity

Unit 2. Trade and capital flows: restrictions and agreement

Types of tariffs. Effects of a tariff in a small nation. Tariff escalation and effective rate of protection. Nontariff trade barriers: nature and basic types. Quotas, voluntary export restraint, and licensing. Hidden nontariff measures: technical and ecological standards, trade-related investment measures, government spending and others. Financial nontariff measures: export subsidies, credits and insurance. Trading blocs, common markets, and economic unions. Capital restrictions.

International trade or commercial policy is a system of tariff and non-tariff restrictions altering volume, structure, and direction of international flows of goods and services. The intent of intervention in the foreign trade includes protection of the domestic market from foreign competition, support of national business abroad and the generation of tariff revenues.

Tariff or duty is a trade restriction in an indirect tax form whose value depends on three elements: (1) type of a good, (2) country of origin, (3) customs value. Tariff barriers are historic trade policy tool. Nowadays their role is diminished by the multiple tariff concession and reduction in the framework of the WTO and its predecessor, General Agreement on Tariffs and Trade (the GATT) rounds. Besides that, the WTO rules make almost impossible to levy tariffs on imported goods freely. Because of this, countries have shifted to non-tariff barriers. Therefore, tariffs are relatively low in developed countries; on the other hand, developing economies have high average tariffs in order to defend infant or labor-intensive industries appealing to the interests of future development, employment support and necessity to finance budget expenditures.

Non-tariff tool is any barrier to international trade flows of a kind differ commodity-based indirect tax. There are more than 100 types of them. The simplest classification of non-tariff barriers includes quantitative, hidden, and financial groups of non-tariff barriers.

According to intensity of tariff and non-tariff tools application, trade policy has three basic forms. The first one is *protectionism* that implies tariff restrictions comprising a relevant part of country's commerce and excessing 30% and a wide range of non-tariff restrictions covering a

significant part of trade. *Free trade policy* refers to minimal impact on export and import flows, it means that the trade-weighted tariff is below 5%, non-tariff measures are seldom used. Free trade policy is an ideal state of commercial policy, that is why it is promoted by advanced economies, but even they are far from its real implementation because their high salaries and therefor low price competitiveness in production of commodities except innovative ones.

The most part of countries accomplish a *restrained trade policy* based on targeting sectors, commodities to protect, and selecting countries to deal with. Typically, the regulation occurs in so-called 'sensitive industries' including agriculture, textiles, clothing, footwear, steel, and civil aircraft. Despite the prohibition of single country's discrimination by the WTO, regional trade blocs represent a clear case of major trade preferences toward a group countries and automatic discrimination of all remained ones.

There are several classifications of tariffs that a country or group of countries can employ.

1. According to the object or direction of international trade, there are import, export and transit duties. Import duties are most frequently used. Export duties are proscribed in some countries, usually the developing countries tax raw material export as natural resource rent appropriation in the public interest. Some countries introduce export tariffs when the world price for a certain commodity is too high and the export decimates its domestic consumption. Transit duties are rare and used as trade war tool

2. According to the way of taxation, the duties are divided into ad valorem, specific, and compound ones. The *ad valorem tariff* is expressed as a percentage of the value of the commodity customs value of the traded commodity. The import duty on silk yarn in the Russian Federation equals to 5% of customs value. The specific tariff is a fixed sum per unit. Import duty on almond in shell in the United States amounts to 7.7¢/kg. *Compound* tariff combines both a specific and an ad valorem components. The Russian import tariff on drawing tables now equals to 20%, but not less than 0.5 € per kg. At the end of transition period after the Russian Federation's WTO accession will be10 plus 0.06 € per kg.

3. According to the tariff column or country's of origin, the duties are divided into autonomous, conventional or most-favored nation (MFN) level and preferential. The *autonomous*, highest, level of tariff is for commodities originating from countries without a trade agreement with the country in consideration. The conventional tariff coincides with the WTO level of duty. The preferential duty is designed for trading bloc's partners or for the countries benefiting from the Generalized System of Preferences of the United Nations. The less developed countries enjoys zero-tariffs for the selected or complete nomenclature of commodities, the developing countries have normally 50 per cent discount for the MFN level. A country can skip every single item from the preferences of generalized system and diminish the discount rate. For example, historically Russia has a donor status in this system, but in front of economic difficulties, it excluded nonagricultural products from the preferences and diminished a discount until 25%.

4. Special duty types. They are varied. *Season tariffs* run few month a year or have a variable rate. *Countervailing duty* serves to offset the production or export subsidy in importing countries. *Anti-dumping* duty is a penalty imposed on abnormally low-priced imports, to

increase their price in the importing country in order to protect domestic industry from harmful competition. *Safeguard duties* are temporary taxes applied when increased imports occurs.

The influence of tariff *in a small country* is considered by the partial equilibrium analysis. The first situation refers to *an import tariff introduction* (see Fig.2.1). D is the demand and S is the supply of a commodity in a domestic market. This country is small, price-taker. Therefore, the supply of import S_M is a horizontal line. With the free trade at the price P_M, the consumers of this country want to buy Q_{D1} units of the good and the producers are able to sell Q_{S1} of the good.
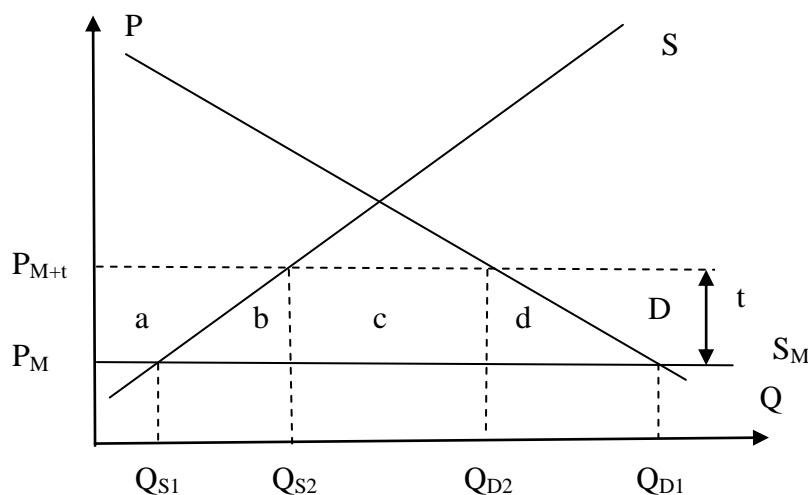

Fig. 2.1. The effects of an import tariff in a small nation

Hence, the import Q_{M1} is equal to the difference ($Q_{D1} - Q_{S1}$). If now a tariff of *t* currency units per unit of the good or t% per P_M is imposed on imports of the good, the price line shifts up to the position $P_{M+t,}$ the new price for the domestic market.

With this increase in price, producers increase the supply until Q_{S2} units, and consumers buy less, Q_{D2}. The imports declines to Q_{M2} equal to the difference ($Q_{D2} - Q_{S2}$). The government will obtain revenues from the duty calculated as T = ($P_{M+t} - P_M$) x ($Q_{D2} - Q_{S2}$).

Summarizing the effects of the import tariff:

Consumption: 1) decrease in domestic consumption ($Q_{D1} - Q_{D2}$); 2) negative change in consumer surplus (a+b+c+d);

Production: 1) increase in domestic production ($Q_{S2} - Q_{S1}$); 2) positive change in producer surplus (a);

International trade effect: decrease in units imported ($Q_{M2} - Q_{M1}$);

Government revenue: tax income (c);

Net welfare or *deadweight loss*: (b+d).

In essence, consumers in a case of an import tariff 'pay' (a+b+c+d) to producers (a) and to government (c). The amount (b+d) is not transferred to anybody.

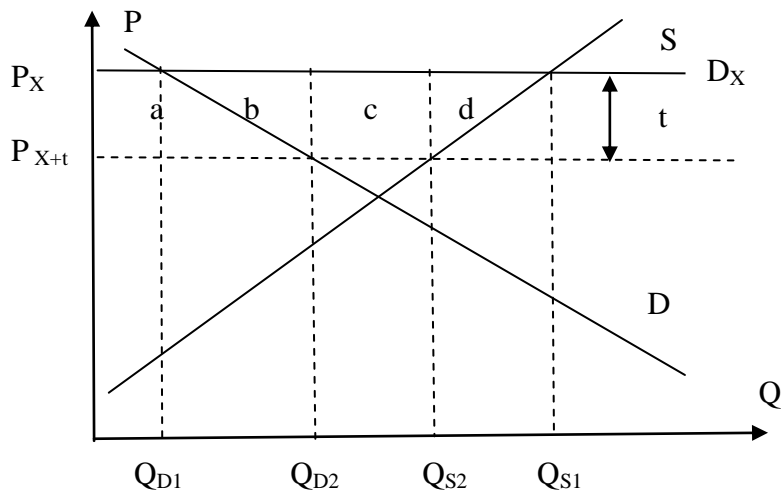The influence of an *export tariff in a small country* can be considered in the same manner (see Fig.2.2).

Fig. 2.2. The effects of an export tariff in a small nation

Since the country is small, the demand for exports D_X is a horizontal line. With the free trade at the price P_X, the consumers of this country are able to buy only Q_{D1} units of the good and the producers want to sell Q_{S1} of the good. Hence, the export Q_{X1} is equal to the difference $(Q_{S1} - Q_{D1})$. If now a tariff of *t* currency units per unit of the good or t% per P_X is imposed on exports of the good, the price line shifts down to the position $P_{X+t,}$ the new, lower, price for the domestic market. The price goes down because of impossibility to influence the export price by local producers forced to pay the tax from the price and therefore to collect less effective gross returns.

With the reduction of effective price, producers decrease the supply until Q_{S2} units, and consumers buy more, Q_{D2}. The exports declines to Q_{X2} equal to the difference $(Q_{D2} - Q_{S2})$. The government will obtain revenues from the duty calculated as $T = (P_X - P_{X+t}) \times (Q_{S2} - Q_{D2})$.

Summing up the effects of the export tariff in a small nation:

Consumption: 1) increase in domestic consumption $(Q_{D2} - Q_{D1})$; 2) positive change in consumer surplus (a);

Production: 1) decrease in domestic production $(Q_{S1} - Q_{S2})$; 2) negative change in producer surplus (a+b+c+d);

International trade effect: decrease in units exported $(Q_{X1} - Q_{X2})$;

Government revenue: tax income(c);

Net welfare or *deadweight loss*: (b+d).

Fundamentally, producers in a case of an import tariff 'pay' (a+b+c+d) to consumers (a) and to government (c). The net loss (b+d) is not assigned to anybody.

Not all countries are 'small nation' like. For example, eventual U.S., EU or China restrictions on imports could deteriorate the situation in exporting country, because the reduced U.S. demand would cause import prices to drop. As a result, the price increase to domestic consumers would be less than the size of tariff expressed in monetary units because the tariff would be added to the import price, which has fallen (see Fig.2.3). With the free trade at the price P_M, the consumers of this country want to buy Q_{D1} units of the good and the producers are able to sell Q_{S1} of the good. Hence, the import Q_{M1} is equal to the difference $(Q_{D1} - Q_{S1})$. If now a tariff *t* is imposed on imports of the good, the price for consumers shifts up to the position $P_{M+t,}$ the new price for the domestic

market. Meanwhile, the price for importers or foreign producers goes down until P_{EF} level effectively determined their total revenues.
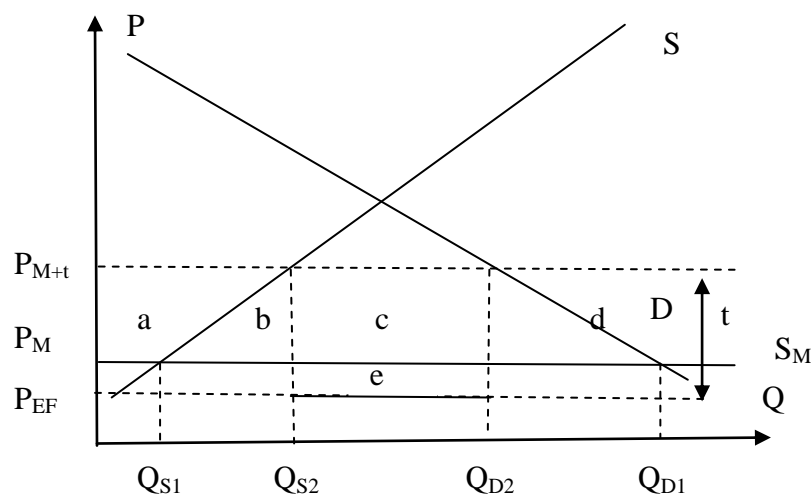

Fig. 2.3. The effects of an import tariff in a large nation

With this increase in price, producers increase the supply until Q_{S2} units, and consumers buy less, Q_{D2}. The imports declines to Q_{M2} equal to the difference $(Q_{D2} - Q_{S2})$. The government will obtain revenues from the duty calculated as $T = (P_{M+t} - P_{EF}) \times (Q_{D2} - Q_{S2})$.

Summarizing the effects of the import tariff:

Consumption: 1) decrease in domestic consumption $(Q_{D1} - Q_{D2})$; 2) negative change in consumer surplus (a+b+c+d);

Production: 1) increase in domestic production $(Q_{S1} - Q_{S2})$; 2) positive change in producer surplus (a);

International trade effect: decrease in units imported $(Q_{M2} - Q_{M1})$;

Government revenue: tax income (c+e);

Net welfare or *deadweight loss (gain):* the common effect depends on difference [e-(b+d)].

If area (e) exceeds area (b+d) then there is a gain to the nation introducing the tariff. The opposite situation leads to the net loss of the importing country. Therefore, a large country can benefit from import duty imposing. From the whole world prospective, a tariff always deteriorates efficient allocation of scarce resources.

The nominal tariff rate misestimates the degree of protection from foreign competition, because the tariff protection expressed in currency units falls on domestic value added which is less than the price of a commodity. Value added is the difference between selling price and cost of intermediate goods. The *effective rate of protection* (ERP) is calculated by the formula:

ERP = $(VA_1 - VA_0) / VA_0$

where: VA_1 – value added after taxation; VA_0 – value added before taxation.

The rate of effective protection in an industry may also be negative. It happens if the condition of tariff escalations is not satisfied. The WTO'S glossary defines *tariff escalation* as situation when import duties on raw materials are lesser than duties on semi-processed products, which are still less

than duties on finished products. The policy of tariff escalation allows to protect the processing industries without contradiction to the WTO's rules.

Although nontariff barrier varies significantly (see Tab. 2.1), their impact on trade flows is compatible with the results of tariffs imposing. They increase the cost of international operations and reduce export or imports. The influence of *import quota* – representing a limit on the quantity of imports allowed – is similar to an import tariff effect for a small nation (see Fig.2.4) as well as for a large nation.

Table 2.1

Nontariff barriers classification

Group of restrictions	Definition	Examples
Quantitative	Limitation on quantity or value of imports or exports allowed into a country	*Import and export quotas* *Embargo* (the total prohibition of imports or exports) *'Voluntary' exports restraints* *Import or export licenses*
Hidden	Domestic economic policy tools affecting international trade flows	*Health/technical/product/labor/environmental standards* *Tools of sanitary, phytosanitary and veterinary control* *Local content requirements (Trade-related investment measures – TRIMS)* *Government procurement* *Customs and administrative entry procedure, etc.*
Financial	Measures relating to or involving money	*Export subsidies, credits and risks compensation fees* *Border and other internal taxes or charges* *Undervalued currency policy* *Domestic subsidies* *Import deposits*

With the free trade at the price P_M, the consumers buy Q_{D1} units of the good and the producers sell Q_{S1} of the good. Hence, the import Q_{M1} is equal to the difference ($Q_{D1} - Q_{S1}$).
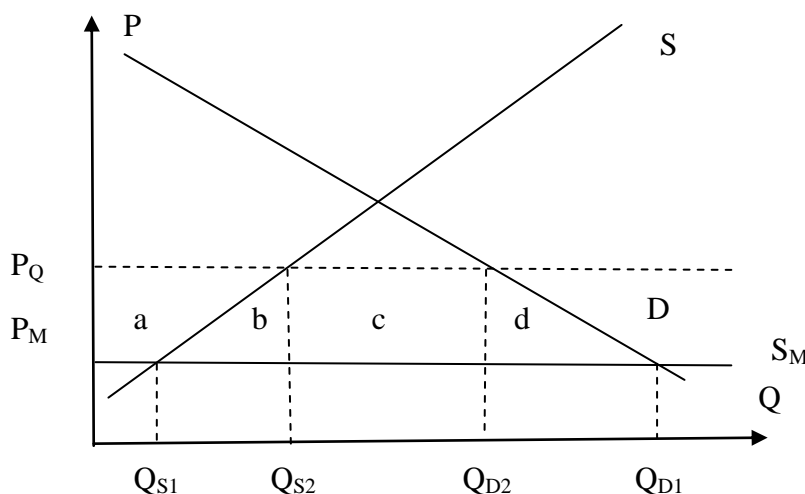

Fig. 2.4a. The effects of an import quota in a small nation

If a quota of *q* units is imposed on imports of the good, the price line shifts up to the position P_Q, the new price for the domestic market. With this increase in price, producers increase the supply

until Q_{S2} units, and consumers buy less, Q_{D2}. The imports declines to Q_{M2} equal to the difference $(Q_{D2} - Q_{S2})$. The government revenues from the quota (c) are in question now. If the government applies open auctions to sell rights to import quoting commodity, the import stakeholders will pay a right price that is equal to the difference $(P_Q - P_M)$. If the state use for import permissions approach 'take as you go', the above-mentioned difference will be the additional revenue of the successful importers'. This alternative represents the worst way to distribute the quotas form the nation's welfare.

The effects are:

Consumption: 1) decrease in domestic consumption $(Q_{D1} - Q_{D2})$; 2) negative change in consumer surplus (a+b+c+d);

Production: 1) increase in domestic production $(Q_{S1} - Q_{S2})$; 2) positive change in producer surplus (a);

International trade effect: decrease in units imported $(Q_{M2} - Q_{M1})$;

Government revenue: depends on efficiency of licensing;

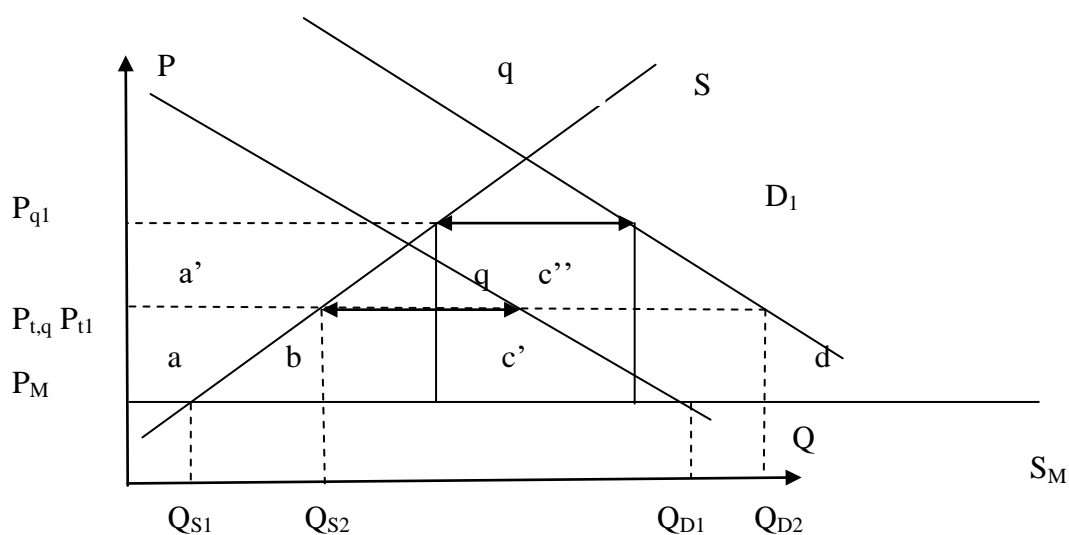*Net welfare* or *deadweight loss*: from (b+d) to (b+c+d).

Fig. 2.4b. The comparison between an import tariff and import quota in a small nation

Let us consider one of the hidden non-tariff barriers which is the requirement for localization also known as trade-related investment measures, i.g. TRIMs (see Fig. 2.5). Such measures like

almost non-tariff barriers are likely to be implemented by the developed countries typically for complex manufactured goods, for instance, aircrafts, ships, cars. The main principle of this barrier consists of implying a defined percentage of cost or value that should be originated by the importing country. The initial situation is always the same. With the free trade at the price P_M, the consumers buy Q_{D1} units of the good and the producers sell Q_{S1} of the good. Hence, the import Q_{M1} is equal to the difference $(Q_{D1} - Q_{S1})$.
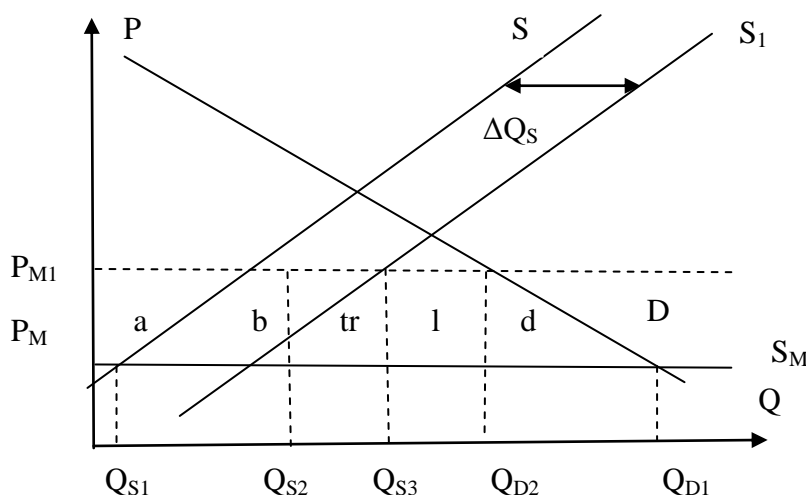

Fig. 2.5. The effects of an import quota in a small nation

If a coefficient of localization is imposed on an importing good, there are two effects to be generated. First, the price line shifts up to the position P_{M1}, the new price for the domestic market. Second, a part of the production of a good under consideration, ΔQ_S, is moved to the importing country. With this increase in price, the national producers increase the supply until Q_{S2} units, the local production is enlarged also by the new production facilities (ΔQ_S), therefore the whole domestic production becomes equal to Q_{S3}. The consumers buy less Q_{D2}, hence, the imports declines to Q_{M2} equal to the difference $(Q_{D2} - Q_{S3})$. The government receives nothing from this measure.

The effects are:

Consumption: 1) decrease in domestic consumption $(Q_{D1} - Q_{D2})$; 2) negative change in consumer surplus (a+b+c+d);

Production: 1) increase in domestic production $(Q_{S1} - Q_{S2})$; 2) positive change in producer surplus (a);

International trade effect: decrease in units imported $(Q_{M2} - Q_{M1})$;

Government revenue: absent;

Net welfare or *deadweight loss*: from (b+d+tr+l), where ***tr*** stands for the additional revenue of the foreign producers shifted the production to the country under consideration.

In conclusion, we consider the effects of two types of subsidies, the first type is given to the exporters of a certain good, while the second one is set for the producers competing with the import. The influence of an *export subsidy* is considered for a small nation in the same manner used beforehand (see Fig.2.6).

Since the country is small, the demand for exports D_X is a horizontal line. With the free trade at the price P_X, the consumers of this country are able to buy only Q_{D1} units of the good and the

producers want to sell Q_{S1} of the good. Hence, the export Q_{X1} is equal to the difference ($Q_{S1} - Q_{D1}$). If now a subsidy of *sub* currency units per unit of the good is associated to export of the good, the price line shifts up to the position P_{X+S}, the new, higher, price for the domestic market. The domestic price goes up because the local producers have now a new price of reference equal to P_{X+S}.
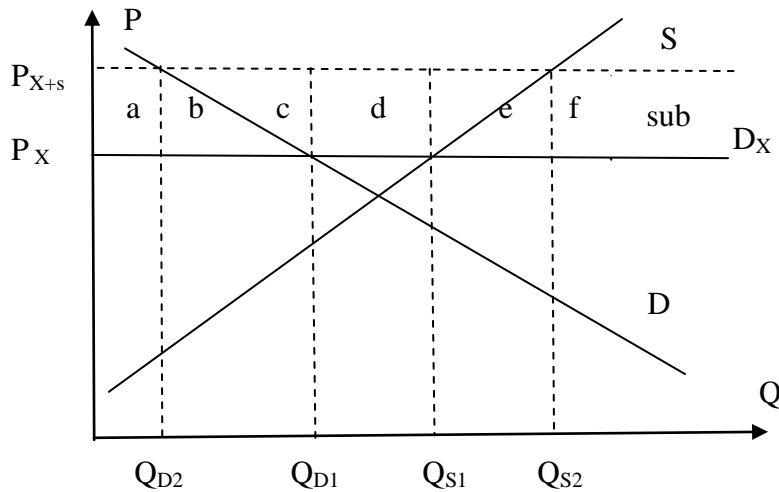

Fig. 2.6. The effects of an export subsidy in a small nation

With the augmentation of effective price, producers increase the supply until Q_{S2} units, and consumers buy less, Q_{D2}. The exports grow till Q_{X2} equal to the difference ($Q_{D2} - Q_{S2}$). The government will obtain spend a sum of money calculated as $T = (P_{X+S} - P_X) \times (Q_{S2} - Q_{D2})$.

Summing up the effects of the export subsidy in a small nation:

Consumption: 1) decrease in domestic consumption ($Q_{D2} - Q_{D1}$); 2) negative change in consumer surplus (a+b);

Production: 1) increase in domestic production ($Q_{S2} - Q_{S1}$); 2) positive change in producer surplus (a+b+c+d+e);

International trade effect: increase in units exported ($Q_{X2} - Q_{X1}$);

Government expenses: amount of subsidy (b+c+d+e+f);

Net welfare or *deadweight loss*: (b+f).

The last but not least is the case of subsidy to the local producers competing with the import (see Fig. 2.7). With the free trade at the price P_M, the consumers of this country want to buy Q_{D1} units of the good and the producers are able to sell Q_{S1} of the good.
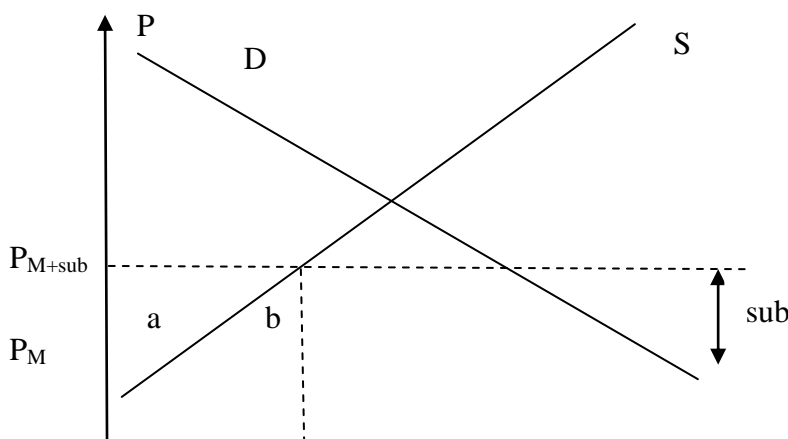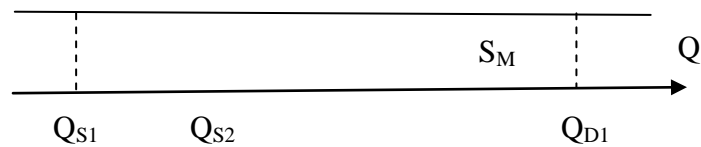
Fig. 2.7. The effects of as subsidy to the producers competing with the import

Hence, the import Q_{M1} is equal to the difference $(Q_{D1} - Q_{S1})$. If now a subsidy of *sub* currency units per unit is proposed to the producers competing with the import of the good, the effective price for the local producers will increase together the supply until Q_{S2} units, and consumers buy the same quantity of the good, Q_{D1}. The imports declines to Q_{M2} equal to the difference $(Q_{D1} - Q_{S2})$. The government will spend money in this case.

Summarizing the effects of the subsidy:

Consumption: zero-effect because the stability of the local price.

Production: 1) increase in domestic production $(Q_{S2} - Q_{S1})$; 2) positive change in the producer surplus (a);

International trade effect: decrease in units imported $(Q_{M2} - Q_{M1})$;

Government expenses: subsidy (a+b);

Net welfare or *deadweight loss*: (b).

In essence, in this case the negative effect of trade policy is minimal, if we take into consideration only small-nation's cases.

Despite negative effects of interventionist trade policy leading to net welfare loss, the justifications or *political economy arguments in favor of protectionism* are numerous. The typical arguments of policy makers in favor of protection trade policy are

1) support of employment;

2) increase of budget revenues;

3) security considerations;

4) absence of countries which do not protect proper markets absolutely.

Economists consider them as an aid to some special interest group that worsens welfare of nations and the world as a whole. The generally recognized plausible argument is the *infant industry* defense since the protection of such sectors can help to slide faster on the experience curve reaching economy of scale and may be sustainable comparative advantage. Another reasonable argument in favor of protectionism is the implementation of industrial and strategic trade policy. In a case of industries with significant internal and/or external economies of scale, a government contributes to comparative advantage development in an industry, while trading partners will support and specializes in other industries.

The existing *arguments in favor of free trade policy* are

1) optimal allocation of resources all over the world leading to an increase in global output;

2) possibility responsive restrictions leading to eventual trade disputes and wars;

3) reduction of poverty by decreasing the cost of living;

4) moral arguments, for example, that free trade prevents conflicts or that reciprocity in free trade policy is in interests of all producers and exporters.

Another important case of trade restrictions is represented by the regional trade agreements also known as the integration. Moreover, this case is a clear exception of the WTO's principle of non-discrimination of a country in the trade policy.

The *economic integration* is a process of liberalization where barriers to trade, investment and migration are reduced or eliminated, at the highest level of economic integration, nations agree to coordinate fiscal and monetary policy by adopting fixed exchange rates or a single currency as in the European Union, tax equalization, and budget principles unification.

The examples of regional economic integration spread worldwide are the European Union (EU), North American Free Trade Agreement (NAFTA), Southern Common Market (Mercosur), West African Economic and Monetary Union (UEMOA), Eurasian Customs Union.

The core *reason* of economic integration is the need of enterprises for more secure business expansion to a greater market. Hence, the interest groups promote an alleviation of trade barriers at the intergovernmental level.

Drivers of economic integration are numerous

1. *Geographic proximity of countries* distinguish trading blocs from other institutions of international public law.
2. *Same level of economic development of member states* is historic attribute of economic integration. Recently, there is an appearance of trade blocs both the high-income industrialized and developing countries participate to. For example, NAFTA or EU28 represent such 'North-South' regional agreements.
3. *Presence of common problems* pushes countries to adopt international coordination policy.
4. *'Domino effect'* process when each successive integration increases the pressure of non-member state to join the trading bloc.

There are several *stages* or *forms* in the process of economic integration varying from a very loose association of countries in a preferential trade to the complete economic integration, where the participating countries have a joint fiscal and monetary system. In increasing order of consolidation, the most common forms are preferential trade agreements, free trade areas, customs unions, common markets, and economic unions.

A *preferential trade agreement* provides lower duties on trade in a limited range of goods among participating countries than on trade with the rest of the world. This form or phase of integration is not welcome by the WTO, because does not suppose directly the full trade liberalization and represents a trade discrimination of nonmember states.

Free trade areas are based on the complete removal of all tariff and nontariff barriers on trade among countries. Each single member state, however, preserves its own trade policy toward third countries. Besides that, the liberalization within free trade zones does not comprise a whole range of goods and services. The EU's example demonstrates that the agricultural sector was outside of integration regulation until the common market phase. The NAFTA agreement is also underdeveloped excluding some service sectors from the provision of national treatment.

A *customs union* goes beyond a free trade area unifying customs territory and barriers to international trade for the third parties. Creation of customs union represents a challenge in a course of integration, and the number of them is significantly less the quantity of free trade areas. That is why, the unification of commercial policy toward outsiders requires indigenous efforts due to divergence of economic structure and respective interest of insiders. At this level, the trade liberalization is formally accomplished with the exclusion for the agriculture as in the EU, unique bloc concluded this phase of integration.

A *common market* deals with the production factors liberalization and allows the free movement of capital, labor, and technology among member states. Only the EU arrived until this phase of economic integration, Mercosur is a project yet which only pretends to realize this type of integration bloc.

An *economic and currency union* is designed to harmonize or even unify the monetary and fiscal policies of members. The creation of distinctive economic area equalizes the conditions of living and doing business in all participating countries. This is the most progressive form of integration. The evident example of economic union is the European one. D. Salvatore describes the U.S. as an example of complete economic and monetary union [Salvatore, 2013].

There are two static effects of forming a customs union called trade creation and trade diversion. The *trade creation* effect is considered by the partial equilibrium analysis. The situation refers to an *import tariff* abolition (see Fig. 2.8). D is the demand and S is the supply of a commodity in a domestic market. This country is small, price-taker. With the regulated trade at the price P_{M+t}, the consumers of this country want to buy Q_{D1} units of the good and the producers are able to sell Q_{S1} of the good. Hence, the import Q_{M1} is equal to the difference $(Q_{D1} - Q_{S1})$. If within the customs union a tariff t on imports is eliminated, the price line shifts down to the position P_M, the new price for the domestic market will coincide with the world one.
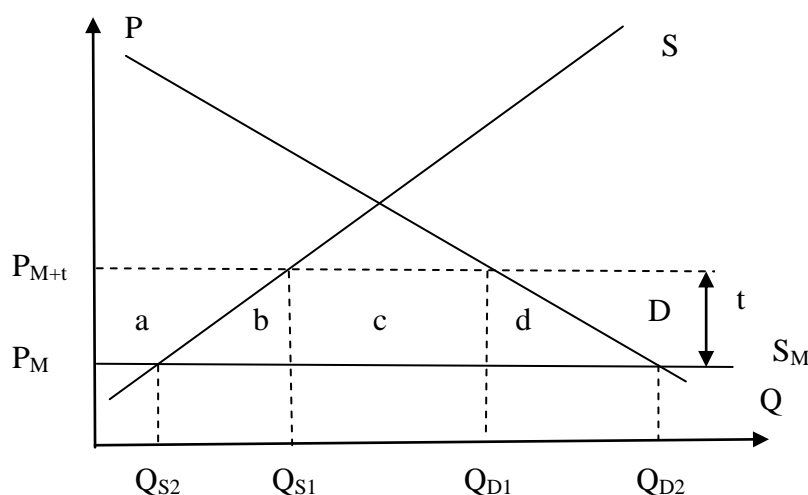

Fig. 2.8. A trade-creating customs union

With this decrease in price, producers diminish the supply until Q_{S2} units, and consumers buy more, Q_{D2}. The imports increase to Q_{M2} equal to the difference $(Q_{D2} - Q_{S2})$. The government losses revenues from the duty calculated as $T = (P_{M+t} - P_M) \times (Q_{D1} - Q_{S1})$.

Summarizing the effects of the customs union:

Consumption: 1) increase in domestic consumption ($Q_{D2} - Q_{D1}$); 2) positive change in consumer surplus (a+b+c+d);

Production: 1) decrease in domestic production ($Q_{S2} - Q_{S1}$); 2) negative change in producer surplus (a);

International trade effect: increase in units imported ($Q_{M2} - Q_{M1}$);

Government revenue: tax loss (c);

Net welfare gain: (b+d).

In essence, tariff revenues disappears, an amount of money is transferred from domestic producers to domestic consumers.

The *trade diversion* effect takes place if the most efficient producer of the imposed good is outside the customs union. Therefore, there are two foreign suppliers, the outsider with the import price P_M, and insider with the higher price $P_{M'}$. With the regulated trade at the price P_{M+t}, equal to sum (P_M+t) the consumers of this country want to buy Q_{D1} units of the good and the producers are able to sell Q_{S1} of the good. Hence, the import Q_{M1} is equal to the difference ($Q_{D1} - Q_{S1}$). If a creation of customs union occurs and the import tariff *t* is removed (see Fig. 2.9), the price line shifts down to the position $P_{M'}$, the new price for the domestic market will be equal to the price of less-efficient member state. Therefore, a part of domestic production in a nation that is a member of the customs union is replaced by lower-cost less-effective imports from member nation.
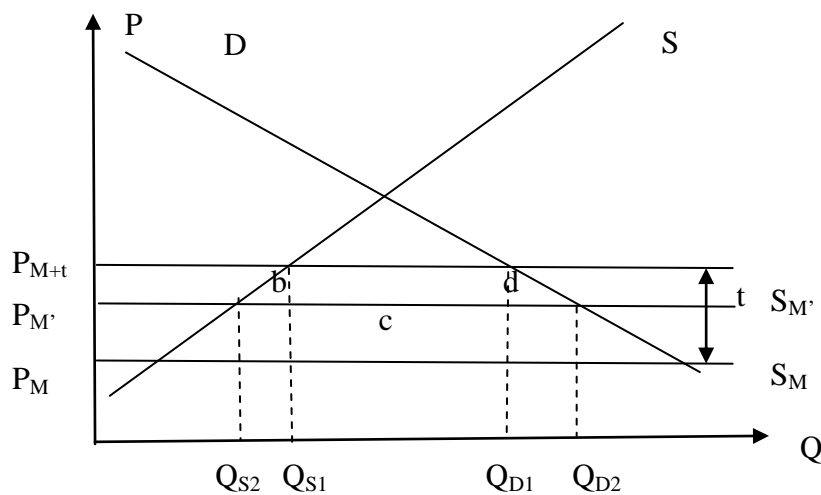

Fig. 2.9. A trade-diverting customs union

With this decrease in price, producers diminish the supply until Q_{S2} units, and consumers buy more, Q_{D2}. The imports increase to Q_{M2} equal to the difference ($Q_{D2} - Q_{S2}$). The government losses revenues from the duty calculated as $T = (P_{M+t} - P_M) \times (Q_{D1} - Q_{S1})$. The losses would be partially compensated by increasing consumer surplus due to price shifting from P_{M+t} to $P_{M'}$. The rectangle (c) is welfare loss from diversion.

The effects of the customs union with the most efficient producer outside:

Consumption: 1) increase in domestic consumption ($Q_{D2} - Q_{D1}$); 2) positive change in consumer surplus lesser than in a case of customs union with the efficient producer;

Production: 1) decrease in domestic production ($Q_{S2} - Q_{S1}$); 2) negative change in producer surplus;

International trade effect: increase in units imported ($Q_{M2} - Q_{M1}$);

Government revenue: tax loss;

Net welfare gain (loss): (b+d) – (c).

Essentially, tariff revenues disappears; an amount of money is transferred from domestic producers to domestic consumers. The impact on net welfare depends on difference [(b+d) – (c)]. If it is negative, the trade-diverting effect is stronger than the trade-creating effect, and the customs union in question has a lesser, but still negative impact not only on global welfare, but also on the welfare of a country importer in question.

Another static effect of economic integration is an extension of the *theory of the second best,* which declares that if all the conditions required to maximize welfare or reach Pareto optimum cannot be satisfied, trying to satisfy as many as possible does not necessarily or usually lead to the second-best position [Salvatore, 2013; Viner, 1950]. It means that a removal of trade barriers only among members of a certain trading bloc does not generate automatically the second best situation. It matches with the trade-diversion effect discussed earlier when formed customs union could increase as well as reduce the welfare of participating countries.

Besides the static welfare effects, the countries forming a trading bloc can get *important dynamic benefits* from economic integration which are increased competition, economies of scale, stimulus to investment, and better utilization of economic resources. The first two predispositions reduce prices on the enlarged domestic market of customs union, so the consumer surplus (welfare) enlarges. The amplification of common, 'single nation' like, domestic market attracts a greater investment in production facilities as well as in portfolio of various securities. A better utilization of resources that occurs within the common market triggers further integration steps connected to the labor and capital movement liberalization.

Table 2.2

Economic integration in various geographic regions

Integration bloc	Participants	Region	Level of economic integration	Characteristics
North American Free Trade Agreement (NAFTA)	Canada, Mexico, and the United States	North America	Free trade zone (planned) Preferential trade zone (achieved)	The largest in the world in terms of combined nominal as well as PPP GDP in the 2013
West African Economic and Monetary Union (UEMOA – Union économique et monétaire ouest-africaine)	Benin, Burkina Faso, Ivory Coast, Guinea-Bissau, Mali, Niger, Senegal, Togo	West Africa	Economic union (planned) Customs Union (achieved)	The furthest along the path toward integration of all the regional groupings in Africa. Presence of combined indirect taxation regulations, regional

				structural and sectoral policies

Integration bloc	Participants	Region	Level of economic integration	Characteristics
Eurasian Customs Union	Belarus, Kazakhstan, Russian Federation	Eurasia	Customs Union (achieved) Eurasian Economic Union (planned) Single market (planned)	Created from a disintegrated country and based upon another trading bloc the Commonwealth of Independent States (i.e. the former URSS)
Southern Common Market (Mercosur - Mercado Común del Sur)	Argentina, Brazil, Paraguay, Uruguay, Venezuela (full members); Chile, Bolivia, Colombia, Ecuador, Peru (associate partners); New Zealand, Mexico (observer countries)	South America (Southern Hemi-sphere)	Common market (planned) Customs union (achieved) Free movement of manpower (achieved)	Three-level membership
European Union (EU28)	Belgium, Bulgaria, Czech Republic, Denmark, Germany, Estonia, Ireland, Greece, Spain, France, Croatia, Italy, Cyprus, Latvia, Lithuania, Luxembourg, Hungary, Malta, Netherlands, Austria, Poland, Portugal, Romania, Slovenia, Slovakia, Finland, 3Sweden, United Kingdom	Western and Central Europe	Economic union	The most developed integration bloc with a combined population of over 500 million inhabitants

As the impact of the uncontrolled international financial flows may be quite dangerous for an economy, such movements may also be restricted or at least controlled, for instance, during the financial crisis or panic. Furthermore, as it was recognized earlier, the longer-term investments by foreign firms can not only benefit the receiving economic system, it is also possible that the domestic industry may be hurt because local firms that are unable to compete are forced to exit the market. In times of macroeconomic crisis, capital mobility can result in capital flight out of the country, especially in the segment of short-term assets.

The capital controls serve *two purposes*. First, they make it easier to maintain the undervalued exchange rate that help fostering the nation's export sector. Second, the capital controls defend

domestic financial market, banking and real estate sectors from external market forces.

These restrictions raised revenues by keeping capital in the domestic economy, facilitating the taxation of wealth, and producing interest income. Moreover, capital controls helped to maintain a low level of interest rates, reducing the government's borrowing costs on its liabilities.

Quantity restrictions on capital flows may include rules imposing upper limits or special authorization for new or existing borrowing from foreign creditors. Or there may be administrative controls on cross-border capital movements in which a government agency must approve transactions for certain types of assets. Effective implementation of capital restrictions usually is difficult to be introduced by law, because of the opposition of strong financial lobby and, therefore, may require nontrivial administration abilities, perdurability and costs.

There is also the risk that protecting the domestic financial markets by capital restrictions may give rise to negative market perceptions, which may, in turn, make it more costly and difficult for the country to access foreign funds.

Considerable administrative costs are incurred in continuously extending, amending, and monitoring compliance with the regulations. Although controls on inflows appeared to be effective in some countries, it was difficult to distinguish the impact of the controls from the impact of other policies, such as strengthening of prudential regulations, increased exchange rate flexibility, and adjustment of monetary policy.

Unit 3. Trade and financial organizations

Worldwide organizations. Economic organizations. International monetary fund. World bank group. London Club of private creditors. Paris Club of public lenders. World trade organization. The contribution of trade to development: UNCTAD and Generalized system of preferences.

Because of size and complexity of a global economy, there are two ways to structure it. The *first way* is to rank countries. There are many country classifications based upon a single criterion or a combination of them:

   a. Geographical position. Neighboring countries may have comparable resources pools, face same economic problems, and realize common, sometimes copied from each other, development patterns. Examples are Southeast Asian countries, Central and Eastern European countries, Latin American countries;

   b. GDP or GNI per capita. The World Bank proposed the classification. In a large extent, the average income of a country's citizens coincides with a country development. The same World Bank later transformed the ranking into the Human development report based upon homonym index. Countries by income are divide into low income, lower middle income, upper middle income, high income ones;

   c. Country economic size or potential. The criteria of the ranking are territory, population, GDP, access to natural resource, etc. A country with a larger economic potential is more self-sufficient, independent on the international stage than a smaller one. This may

serve as a foundation for economic growth and prosperity and affect decisions for foreign direct investment, for example;

d. Member of relevant formal or informal international bodies as the OECD, OPEC, G7, G20, BRICS and so on. The OECD membership means high level of country's development as well as its strong commitment to the free market system;

e. Human development index level. The same World Bank later transformed the ranking into the Human development report based upon homonym index. Countries by income are divide into very high, high, medium and low human development. The Human Development Index understands human well-being (ultimate policy goal) as individual capabilities to access to health, education, and goods.

The most relevant classifications are analytical groupings provided by the World Bank (the WB) and the International Monetary Fund (the IMF) on the basis economic and financial data submitted by member states. They are dichotomous and include industrial, developed countries or *the Global North*, on the one hand, and developing, less-developed, primary producing in less developed areas countries or *the Global South*, on the other hand. The intermediate categories are capital-surplus oil-exporting countries (1978, the WB), primary producing countries in developed areas (early 1970s the IMF), other high-income countries (1974, the IMF), other Europe, Australia, New Zealand, South Africa (late 1970, the IMF), countries in transition (1993-2004, the IMF) (Nielsen, 2011). These approaches recognize the existence of three 'worlds' in contrast to concepts whereby the global economy is a system of center and periphery. The intermediate group usually is characterized by a high level of one of three pylons of the Human development index. It can be a per capita income as in oil and gas exporting countries, education level typical for countries in transition, former socialist Central and Eastern European countries, etc. Whereas the Global North countries are postindustrial market economies, the nations of the Global South typically have a dualistic economy built upon market fundamentals accompanied by traditional beliefs and values affecting decision-making.

The *second approach* to the world economic system sees it as a combination of the various actors characteristic for any economic system: households, firms, State, financial institutions. The specific world economy establishments are international organizations, regional trading blocs, free economic zones and NGOs. According to philosophical dichotomy the 'subject–object', not all economic agents mentioned above are independent subjects of the world economy. For example, there is a commonplace idea that only countries with export to GDP ratio less than 30% are truly self-sufficient in relation to the rest of the world. The subjectivity of the most significant international organizations and quite developed trading blocs (economic and currency unions, firstly) ascends from part of proper sovereignty transmitted by entering member States. The private agents such as multinational corporations (MNCs) or big NGOs, the Roman Catholic Church, the Green Peace, for instance, can influence have sometimes a decisive impact on the governments economically and politically inferior to them.

Let us consider the subjects of international economy which are relevant for the global financial infrastructure.

The *international financial institutions* (IFIs) are subjects of international law, that have been established by more than one country. Their owners or shareholders are generally national governments. The most influential IFIs were established after World War II, in the logics of Keynesian economic policy, first to assist in the reconstruction of the developed countries with a further aim to provide mechanisms for international cooperation in the global financial system.

After the Great Depression in the 1930s, when the global production and world trade declined dramatically, it had become a prevalent opinion that the world economy was in need of organizations that would help international economic cooperation. In July 1944, during the United Nations Monetary and Financial Conference in Bretton Woods representatives of 45 governments agreed on a framework for international economic cooperation.

Two crucial multinational organizations emanated from this conference— the *World Bank*, which was founded during the conference, and the *International Monetary Fund* (IMF), which came into formal existence in December 1945.

The IMF was founded with the goal to stabilize exchange rates and assist the reconstruction of the world's international payment system, the World Bank was created to facilitate postwar reconstruction and development. A third institution, the *International Trade Organization* (ITO), was to be created to handle the trade side of international economic cooperation, joining the other two Bretton Woods institutions. Although the ITO charter was finally approved in Havana in March 1948, the opposition of the U.S. Congress removed this organization. Instead of the ITO, the group of 23 nations by the time the deal was signed on 30 October 1947 and the General Agreement on Tariffs and Trade (GATT) was born. As a consequence of the ITO death, the GATT became the only multilateral instrument governing international trade from 1948 until the World Trade Organization (WTO) was officially established in 1995.

The *IMF*, the leading financial organization, stands ready to lend foreign currencies to member countries to assist them during periods of significant external deficits. A pool of gold and currencies contributed by members provides the IMF with the resources required for these lending operations. The funds are lent only under strict conditions, and borrowing countries' macroeconomic policies are continually monitored. The IMF's main mandate is to facilitate the growth of international trade and promotes employment, economic growth, and poverty reduction. It also supports exchange rate stability and an open system of international payments. The IMF lends foreign exchange to members when needed, on a temporary basis and under adequate safeguards, to help them address balance of payments problems.

In this context, it has doubled member countries' access to fund resources and streamlined its lending approach to reduce the stigma of borrowing for countries in need of financial help.

The IMF comes to the rescue of the countries affected by the perpetual financial crisis with considerable loans, accompanied by policies designed to control domestic demand, which included fiscal austerity and tightened monetary reins.

The IMF has taken several steps to improve economic and financial surveillance, which is its

framework for providing advice to member countries on macroeconomic policies and warning member countries of risks and vulnerabilities in their economies. The IMF is devoting more resources to the analysis of global financial markets and their links with macroeconomic policy. It also offers training to country officials on how to manage their financial systems, monetary and exchange regimes, and capital markets.

The *World Bank's* main objective is to help developing countries fight poverty and enhance environmentally sound economic growth. For developing countries to grow and attract business, they have to [6]:

- Strengthen their governments and educate their government officials.
- Implement legal and judicial systems that encourage business. Protect individual and property rights and honor contracts.
- Develop financial systems robust enough to support endeavors ranging from microcredit to financing larger corporate ventures.
- Combat corruption.

Given these targets, the World Bank provides funds for a wide range of projects in developing countries worldwide along with financial and technical expertise aimed at helping those countries reduce poverty.

The World Bank's two closely affiliated entities—the International Bank for Reconstruction and Development (*IBRD*) and the International Development Association (*IDA*) — provide low- or no-interest loans and grants to countries that have unfavorable or no access to international credit markets. Unlike private financial institutions, neither the IBRD nor the IDA operates for profit. From an investment perspective, the World Bank helps to create the basic economic infrastructure that is essential for the creation of domestic financial markets and a well-functioning financial industry in developing countries. IBRD lending to developing countries is primarily financed by selling AAA-rated bonds in the world's financial markets. This capital consists of reserves built up over the years and money paid in from the Bank's 185 member country shareholders.

The IDA is the world's largest source of interest-free loans and grant assistance to the poorest countries. Its funds are replenished every three years by 40 donor countries. Additional funds are regenerated through repayments of loan principal on 35- to 40-year, no-interest loans, which are then available for relending.

Besides acting as a financier, the World Bank also provides analysis, advice, and information to its member countries to enable them to achieve the lasting economic and social improvements their people need. Another of the World Bank's core functions is to increase the capabilities of its partners, people in developing countries, and its own staff. It has set up links to a wide range of knowledge-sharing networks to address the vast need for information and dialogue about development.

There are two important informal group of financial officials, the London Club of private creditors and the Paris Club of public lenders that have a central place in the global financial infrastructure.

The London Club is an informal group of private creditors on the international stage. The

London Club is the organization responsible for rescheduling debt payments made by countries to commercial banks. The Paris Club is an informal group of financial officials from the world's biggest economies, which provides financial services such as debt restructuring, debt relief, and debt cancellation to indebted countries and their creditors. Debtors are often recommended by the International Monetary Fund after alternative solutions have failed. The Paris club is chaired by a senior official of the French Treasury.

The World Trade Organization (WTO) provides the legal and institutional foundation of the multinational trading system. It is the only international organization that regulates cross-border trade relationships among nations on a global scale. It was founded on 1 January 1995, replacing the General Agreement on Tariffs and Trade (GATT) that had come into existence in 1947. The GATT was the only multilateral body governing international trade from 1947 to 1995. It operated for almost half a century as a quasi-institutionalized, provisional system of multilateral treaties. Several rounds of negotiations took place under the GATT, of which the Tokyo round and the Uruguay round may have been the most far-reaching. The Tokyo round was the first major effort to address a wide range of nontariff trade barriers, whereas the Uruguay round focused on the extension of the world trading system into several new areas, particularly trade in services and intellectual property, but also to reform trade in agricultural products and textiles. The GATT and the General Agreement on Trade in Services (GATS) are the major agreements within the WTO's body of treaties that encompasses a total of about 60 agreements, annexes, decisions, and understandings. So far, under GATS, which came into force in January 1995, banks, insurance companies, telecommunication firms, tour operators, hotel chains, and transport companies that want to do business abroad can enjoy the same principles of free and fair trade that had previously applied only to international trade in goods. In November 2001, the most recent and still ongoing round of negotiations was launched by the WTO in Doha, Qatar. No agreement has been reached in Doha so far, however, despite intense negotiations at several ministerial conferences and at other sessions. The WTO's most important functions are the implementation, administration, and operation of individual agreements; acting as a platform for negotiations; and settling disputes. Moreover, the WTO has the mandate to review and propagate its members' trade policies and ensure the coherence and transparency of trade policies through surveillance in a global policy setting.

Finally, the WTO is in close cooperation with the other two Bretton Woods institutions, the IMF and the World Bank. From an investment perspective, it would be hard to conceive of today's global multinational corporations without the major institutional and regulatory base provided by the WTO's framework of global trade rules. Modern financial markets would look different without the large, multinational companies whose stocks and bonds have become key elements in investment portfolios. In the equity universe, for instance, investment considerations focusing on global sectors rather than national markets would make little sense without a critical mass of multinational firms competing with each other in a globally defined business environment.

UNCTAD, another organization dealing with international commerce, is the principal organ of the United Nations General Assembly dealing with trade, investment and development issues. The organization's goals are to increase development opportunities of developing countries and assist

them in their efforts to integrate into the world economy on an equitable basis.

The primary objective of UNCTAD is to formulate policies relating to all aspects of development including trade, aid, transport, finance and technology. The conference ordinarily meets once in four years; the permanent secretariat is in Geneva. One of the principal achievements of UNCTAD has been to conceive and implement the Generalised System of Preferences (GSP). The UNCTAD's aim is to promote exports of manufactured goods from developing countries, by implementing special tariff concessions to such exports. Since imports of such items from other developed countries are subject to the normal rates of duties, imports of the same items from developing countries would enjoy a competitive advantage.

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МИРОВАЯ ЭКОНОМИКА

Учебно-методическое пособие,