

# POLI 144: International Political Economy

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Summer Session I 2017

# What is IPE?

*International Political Economy* is a subfield of political science that attempts to explain international and global problems using interdisciplinary tools and theoretical perspectives.

Globalization has continued to erode barriers and make the world smaller. Yet, economists often assume away state interests and political scientists fail to look beyond the state. A complex world requires a complex approach.

## How can we study IPE?

“IPE seeks to advance knowledge of how political institutions, processes and actors influence economic interactions, and conversely, how economic institutions, processes, and actors affect political interactions.”

# Areas of IPE

The course will be divided into four sections:

- International Trade
- International Investment
- International Finance
- International Development

But why should we care?



But why should we care?



Economic policies affect domestic politics

But why should we care?



But why should we care?



Domestic politics affect economic policies

# Course learning objectives

By the end of the course, students should be able to:

- Use economic and political theories to identify the distributional consequences of economic policy and predict who wins and who loses
- Evaluate how political institutions aggregate interests and determine policy
- Synthesize competing explanations and develop unique arguments for the success or failure of global economic infrastructure

# Introductions

## Instructor Lauren Lee

- Ph.D. Candidate, Political Science
- Office: SSB 346
- Office Hours: Wednesday 12-1:50pm
- Email: llee@ucsd.edu

# Requirements

## Policy Memos (2 memos, 25% each)

- Memos are client based, problem driven recommendations
- Memo 1: due **July 12**
- Memo 2: due **July 31**
- Topic and directions will be distributed **1 week** prior
- Each memo will be followed by an in-class “think tank”

## Final Exam (40%)

- Cumulative final on **August 4**
- Short answer and essay questions

## Participation and Professionalism (10%)

- Attendance **and participation** are required
- Be prepared to work together!

# Expectations

## Supportive classroom environment

- Respect for all class members' contributions, opinions and ideas is required

## Academic integrity

- Students will do their own work
- Violators will receive a failing grade and be reported to the Academic Integrity Office

## Technology

- No electronic devices allowed in lecture
- Includes smartphones, tablets, and laptops

# Readings

- Textbook: Oatley, Thomas. 2011. *International Political Economy*. Fifth Edition. New York, NY: Longman Publishing Group.
- On TED:
  - Academic Articles (selected pages)
  - Popular press articles (links)
  - Planet Money Podcasts (links)
  - Youtube videos (links)



# What is trade?

## **International Trade**

International trade is the exchange of capital, goods and services across international borders

## **Trade Openness**

Trade openness is the *amount* of exchange, measured as the sum of exports and imports (% GDP)

## **Trade Protectionism**

Trade protectionism is the imposition of barriers to restrict exports. Trade can be protected through tariffs, quotas (quantitative restrictions), non-tariff barriers (regulations)

## **Gross Domestic Product**

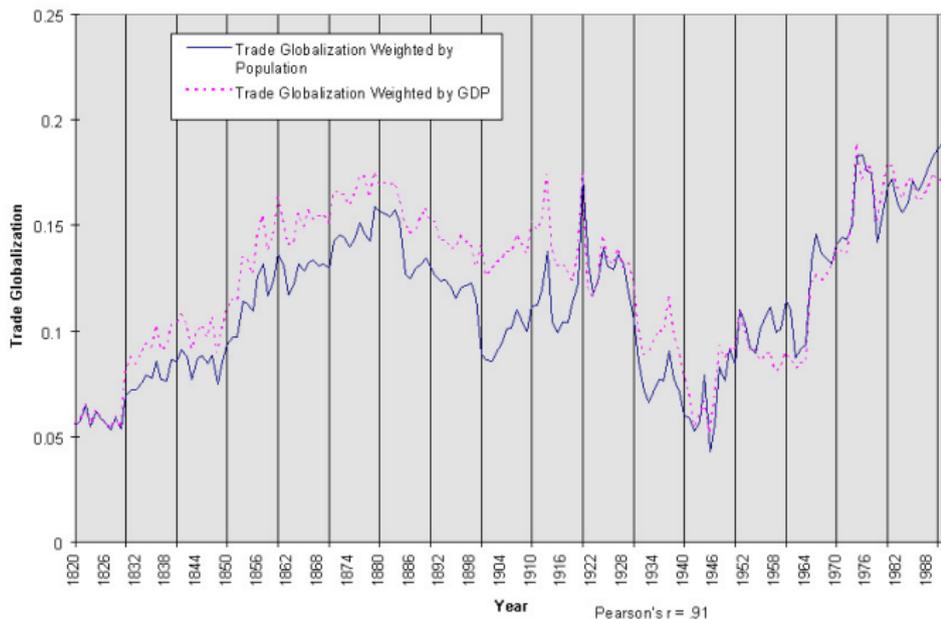
GDP is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It is used to measure the size of an economy.

# Trade in a historical perspective



# Trade in a historical perspective

Average Openness Trade Globalization Weighted by Population and GDP



## Discussion question

Free Trade is:

- Always good
- Always bad
- More bad than good
- More good than bad

## The answer: We don't agree

A random survey of the American Economic Association polled more than 100 Ph.D. economists. They found that:

**83% of economists agree** that the United States should **eliminate all remaining tariffs and barriers to trade** (CATO)

# The answer: We don't agree

<b>Survey of Economists on Trade</b>	<b>Strongly Agree/ Agree</b>	<b>Strongly Disagree/ Disagree</b>
Freer trade improves productive efficiency and offers consumers better choices, and in the long run these gains are much larger than any effects on employment.	<b>96%</b>	<b>0%</b>
On average, citizens of the U.S. have been better off with the North American Free Trade Agreement than they would have been if the trade rules for the U.S., Canada and Mexico prior to NAFTA had remained in place.	<b>98%</b>	<b>0%</b>
Trade with China makes most Americans better off because, among other advantages, they can buy goods that are made or assembled more cheaply in China.	<b>100%</b>	<b>0%</b>
Some Americans who work in the production of competing goods, such as clothing and furniture, are made worse off by trade with China.	<b>96%</b>	<b>0%</b>
The current trade barriers in the U.S. sugar industry raise the profits of sugar producers and make the typical U.S. consumer pay more for sugar and goods that use sugar as an input.	<b>98%</b>	<b>0%</b>

**Source:** University of Chicago's Booth School of Business.

 heritage.org

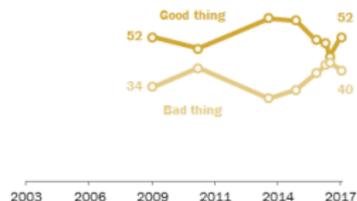
Figure: University of Chicago 2012

# The answer: We don't agree

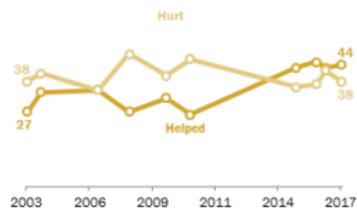
Yet American citizens are far less certain

## Support for free trade agreements recovers from 2016 campaign low

*% who say free trade agreements between the U.S. and other countries have been a \_\_\_ for the U.S.*



*% who say free trade agreements have definitely/probably \_\_\_ their financial situation*



Note: Don't know responses not shown.  
Source: Survey conducted April 5-11, 2017.

PEW RESEARCH CENTER

Figure: Pew Research Center, 2016

The answer: We don't agree

Why is free trade so popular among economists and so contentious among citizens?

International trade theory is helpful here!

## **Comparative Advantage**

Explains why free trade is welfare maximizing

## **Heckscher-Ohlin Theory**

Explains why countries have a comparative advantage in the products they do

## **Stolper-Samuelson and Ricardo-Viner Theories**

Explains why Americans are divided over free trade

# Some truisms

## **Absolute Advantage**

The capability to produce more of a given product using the same amount of resources as a competing entity

Why is absolute advantage less helpful? A superhuman or supercountry would be better at everything - but they still can't do it all!

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The capability to produce more of a given product using the same amount of resources as a competing entity

Why is absolute advantage less helpful? A superhuman or supercountry would be better at everything - but they still can't do it all!

## **Comparative Advantage**

The ability of a party to produce a particular good or service at a lower **opportunity cost** than another

All countries have a comparative advantage in something. No country has a comparative advantage in everything.

## Some assumptions

- There are only two goods
  - Shirts
  - Computers
- There are only two countries
  - The United States
  - China
- There is no trade between countries
- All resources are fully employed in the production of the two goods
- Greater consumption of the two goods is always better

# Production possibilities frontier

The US can produce **100** million computers, **300** million shirts or a combination of both

How can we represent this graphically?

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How can we represent this graphically? **The Production Possibilities Frontier**

- Shows the combination of goods that can be produced with full resource utilization
- Negative slope demonstrates that to produce more of one good, I have to forgo some of another
- Slope = opportunity cost, how much of the other good I have to forgo

# Production possibilities frontier

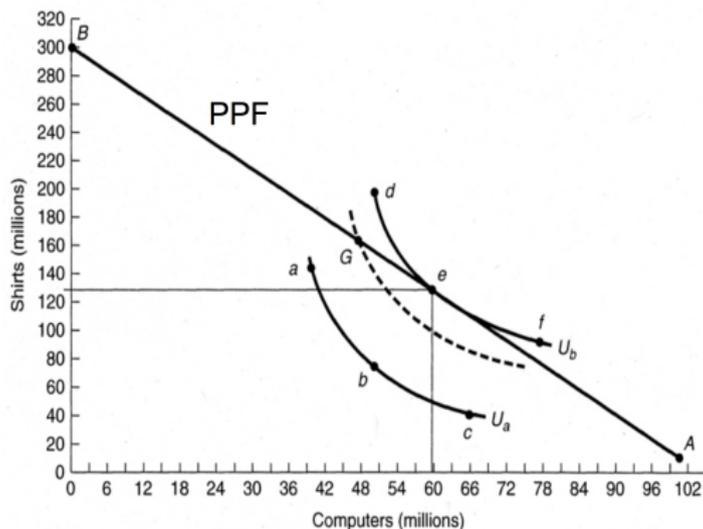


Figure 3.2 U.S. Production Possibility Frontier.

Each computer produced comes at an opportunity cost of 3 shirts  
( $300/100=3$ )

# Indifference curves

But how do we choose which combination of goods to produce?

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**Indifference curves**

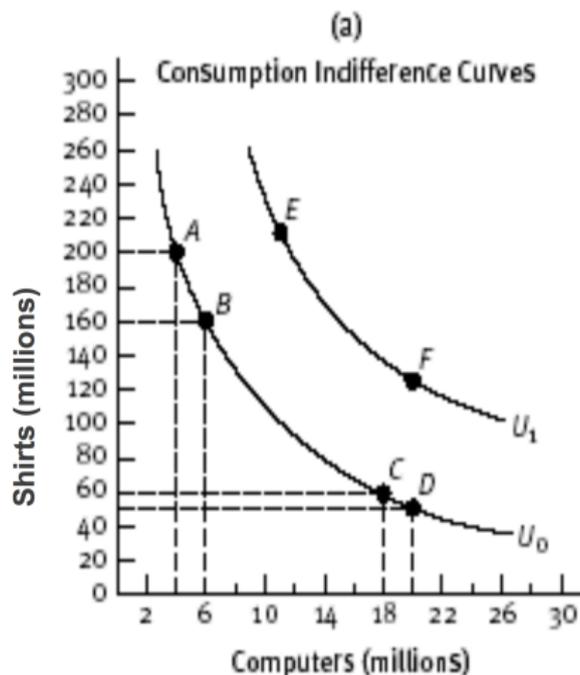
# Indifference curves

But how do we choose which combination of goods to produce?

## **Indifference curves**

- Shows different combinations of goods that leave people equally happy (I'm "indifferent" between them)
- People always prefer more to less and will choose the combination that maximizes their happiness
- This means people want to be at a curve farther from the origin
- All curves bend toward the origin to reflect diminishing marginal utility

# Indifference curves



$U_1$  gives me more utility than  $U_0$ , but I'm indifferent to being at points E or F

## In autarky

Together, the **production possibilities frontier** and **indifference curves** tell us the optimal production in autarky (no trade)

- Equilibrium occurs where the slope of the PPF equals the slope of the indifference curve
- Point of tangency with the farthest possible indifference curve
- Optimal = efficiently utilizes all resources and maximizes consumer happiness

# In autarky

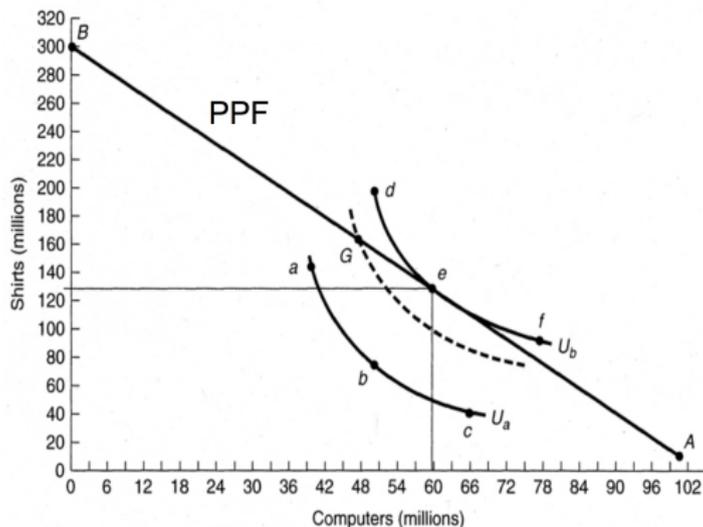


Figure 3.2 U.S. Production Possibility Frontier.

At point e, I maximize resources and utility. The US should produce 60 million computers and 120 million shirts

## But what about China?

China can produce **20** million computers, **400** million shirts or a combination of both

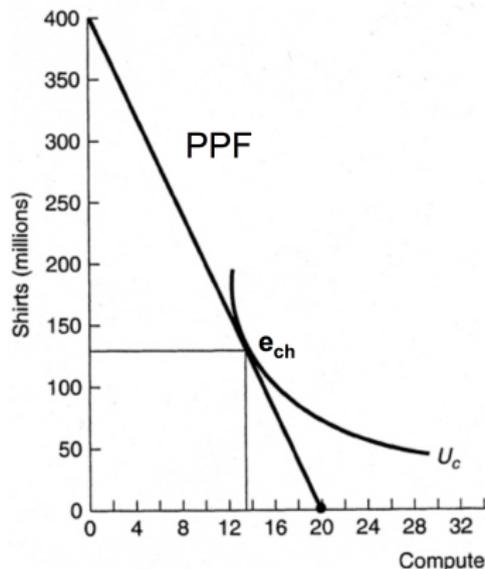
## But what about China?

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What does the PPF look like?

How do we determine optimal production in anarchy?

## But what about China?



Each computer produced comes at an opportunity cost of 20 shirts ( $400/20=20$ ). At point  $e$ , I maximize resources and utility. China should produce 13 million computers and 140 million shirts

## No trade

In autarky, maximum consumption is:

	Computers	Shirts
U.S.	60 mil	120 mil
China	13 mil	140 mil
Total	73 mil	260 mil

Can we do better with trade? What should each country trade?

# Comparative advantage

Remember...

- **Opportunity cost** is the amount of one good I have to forgo in order to produce a number
- **Comparative advantage** is the ability to produce a particular good at a lower opportunity cost than another
- So I should **specialize** in producing what I have a comparative advantage in and trade for the things I don't have a comparative advantage in.

# Opportunity cost

We must ask: Where is it *relatively* cheaper to produce computers?

	Computers
US	$300 \text{ shirts} / 100 \text{ computers} = 3 \text{ shirts}$
China	$400 \text{ shirts} / 20 \text{ computers} = 20 \text{ shirts}$

The U.S. should produce computers because each computer costs less shirts ( $3 < 20$ )

# Opportunity cost

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The U.S. should produce computers because each computer costs less shirts ( $3 < 20$ )

We must ask: Where is it *relatively* cheaper to produce shirts?

	Shirts
US	100 computers/300 shirts = 0.33 computers
China	20 computers/400 shirts = 0.05 computers

China should produce shirts because each shirt costs less computers ( $0.05 < 0.33$ )

\*Hint: Other goes over\*

## Putting it together

If both countries only produced the good that they are most efficient in, **total consumption increases**

Without trade, maximum consumption is:

	Computers	Shirts
U.S.	60 mil	120 mil
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Total	73 mil	260 mil

With specialization, maximum consumption is:

	Computers	Shirts
U.S.	100 mil	0 mil
China	0 mil	400 mil
Total	100 mil	400 mil

## Allowing for trade

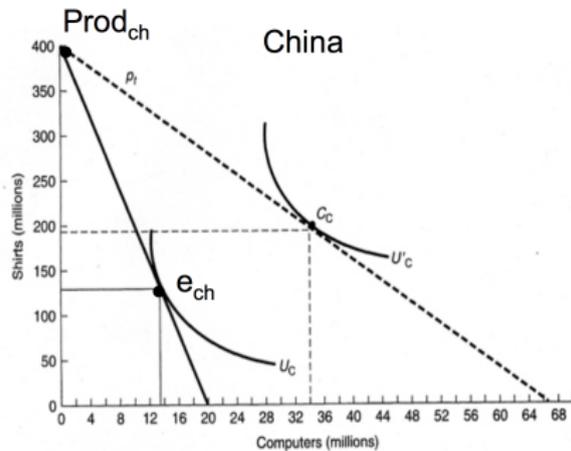
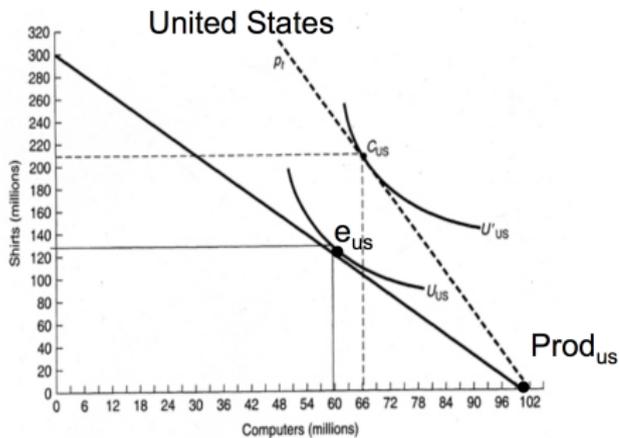
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## Allowing for trade

Specializing in your comparative advantage increases consumption, but what if I want some of both goods? **Trade!**

- Any rate of trade between both countries' opportunity costs will be welfare maximizing. In this case, any rate of trade between 3-20 shirts per computer.
- Assume a trade rate of 6 shirts per computer is set.
- This changes the US PPF. They can produce 100 mil computers, or trade them all for 600 mil shirts
- This changes the Chinese PPF. They can produce 400 mil shirts, or trade them all for 66.6 mil computers.
- This means we can achieve greater utility, as a society **we're all better off!**

# Allowing for trade



## Allowing for trade

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With specialization and trade, maximum consumption is:

	Computers	Shirts
U.S.	75 mil	150 mil (imports)
China	25 mil (imports)	250 mil
Total	100 mil	400 mil

## Discussion question

On paper, answer the following:

- What is comparative advantage?
- Why is it important?

# Class example

Each group represents a country

- Name your country

Remember our assumptions:

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**Ready, Set, Go**

## Now what do we do with the data?

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- ⑤ Determine what each country has a **comparative advantage** in
- ⑥ Determine a mutually beneficial range of trade, notice how **consumption** (PPF shifts out) and **utility** increase (higher curve).

# Discussion question

Revise your previous answer to the following questions:

- What is comparative advantage?
- Why is it important?

Why is free trade so popular among economists and so contentious among citizens?

**Comparative Advantage**

Explains why free trade is welfare maximizing

**Heckscher-Ohlin Theory**

Explains why countries have a comparative advantage in the products they do

**Stolper-Samuelson and Ricardo-Viner Theories**

Explains why Americans are divided over free trade

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# Heckscher-Ohlin Theorem

**The Heckscher-Ohlin Theorem** explains why countries have a comparative advantage in the goods they do

There are two major assumptions:

- Countries differ in their shares of **factors of production** (resources required to produce goods)
  - Land, labor and capital
  - The US has a lot of capital.

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Comparative advantage arises from differences in countries' factor endowments

# Heckscher-Ohlin Theorem

Where something is abundant, it is **cheap** vs. Where something is scarce, it is **expensive**

⇒ To produce most efficiently, a country should produce goods whose inputs are relatively **cheaper** to acquire

⇒ A country should produce and export goods that intensively use their abundant factor

# Heckscher-Ohlin Theorem

A country will export those goods whose production requires the intensive use of the factor of production that it has in abundance relative to the rest of the world.

## Discussion question

Choose any country in the world

- What is that country relatively abundant in? What is that country relatively scarce in?
- According to Heckscher-Ohlin what should that country export?
- According to Heckscher-Ohlin what should that country import?

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# Stolper-Samuelson Theorem and Ricardo-Viner Theorem

Why are citizens so divided on free trade?

- Raising and lowering tariffs redistributes income

# Stolper-Samuelson Theorem and Ricardo-Viner Theorem

Why are citizens so divided on free trade?

- Raising and lowering tariffs redistributes income

But which groups prefer protection? Which groups prefer liberalization?

- Predictions depend on factor mobility
- According to **Stolper-Samuelson**, if factors are **mobile** divisions will be along **factor** lines
- According to Ricardo-Viner, if factors are **immobile** divisions will be along **industry** lines

# Stolper-Samuelson Theorem

According to the the HO Theroem, the US is relatively abundant in capital and should therefore produce capital intensive goods, i.e. computers

The US **increases** production of computers for **export** and **decreases** production of shirts because they're cheaper to **import**

**How does this affect both industries if factors are allowed to flow between industries?**

# Stolper-Samuelson Theorem

## In the shirt industry

- American shirt firms produce fewer shirts
- Liquidate capital and lay off workers
- All of the capital can be absorbed by the computer industry
- But the computer industry doesn't need a lot of extra labor

## In the computer industry

- American computer firms produce more computers
- Employ a lot more capital and slightly more labor
- The computer industry cannot absorb all the excess labor from the shirt industry

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More capital is being demanded than is being released (**scarcity = expensive**) and less labor is being demanded than is being released (**abundance = cheap**)

# Stolper-Samuelson Theorem

Owners of capital see their incomes rise vs. Owners of labor see their incomes fall

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Can we make this theory more generalizable?

# Stolper-Samuelson Theorem

Owners of capital see their incomes rise vs. Owners of labor see their incomes fall

Can we make this theory more generalizable?

- Free trade benefits the factor of production that is relatively abundant and harms the factor of production that is locally scarce

## Discussion question

Go back to the country you chose earlier:

- According to Stolper-Samuelson, who should support free trade?
- According to Stolper-Samuelson, who should be against free trade?

# Ricardo-Viner Theorem

What if the capital and labor released by the shirt industry couldn't be absorbed by the computer industry? What if factors of production were **immobile**?

**The Ricardo-Viner Theorem:** Factors are specifically tied to the industry in which they are employed?

- Why might this be the case?

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More capital and labor in the computer industry are being demanded (**scarce=expensive**) and less capital and labor in the shirt industry are being demanded (**abundant=cheap**)

## Ricardo-Viner Theorem

Owners of labor **and** capital in the computer industry see their incomes rise vs. Owners of labor **and** capital in the shirt industry see their incomes fall

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Can we make this theory more generalizable?

- Labor and capital employed in industries that rely intensively on society's abundant factor both gain from trade. Labor and capital employed in industries that rely intensively on society's scarce factor both lose from trade. Export oriented sectors win, while import competing sectors lose.

## Discussion question

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# Comparison

	Factor Model	Sector Model
Actors	Factors/Classes	Industries/Sectors
Factor Mobility	Perfectly mobile	Immobile
Winners	Abundant factor	E-O sector
Losers	Scarce factor	I-C sector
Conflict	Labor vs. Capital	E-O vs. I-C sector

## Which theorem is more important?

Ricardo-Viner most likely applies...

- In industries where factors are relatively immobile (highly specialized)
- In a short run framework

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Stolper-Samuelson more likely applies...

- In industries where factors are relatively mobile (can easily be reconfigured)
- In a long run framework

But empirical evidence is mixed

- Labor groups like the AFL-CIO lobby against free trade while the Chamber of Commerce lobbies for free trade
- Steel workers and steel executives lobby together for protection
- The latest empirical work is based on firm heterogeneity and trade preferences. There may be intra-industry divisions about free trade.

Why is free trade so popular among economists and so contentious among citizens?

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### **Stolper-Samuelson and Ricardo-Viner Theories**

Explains why and how Americans are divided over free trade