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P382

INTERNATIONAL POLITICAL ECONOMY

http://www.stanford.edu/~wacziarg/p382.html

ANNOUNCEMENT

The Friday, April 23 class is cancelled and the corresponding class will take place on Wednesday April 21 at the usual time and location

COURSE CONTRACT

Overview

The objective of the course is to develop an understanding of the global environment of business, with a focus on applications such as the South-East Asian crisis, international trade negotiations and the role of international organizations. It is organized around two main themes: Firstly, it addresses the issue of trade integration, by covering recent findings in the analysis of trade flows and trade policy. Applications include strategic trade policy, international trade negotiations on intellectual property rights, and their impact on business. Secondly, it surveys the topic of current account dynamics, balance of payments crises and the appropriate policy response to such crises. Applications here include the European Monetary Union, the South-East Asia crisis and the role of the IMF and World Bank.

Readings

The main text for the course is Dominick Salvatore, International Economics, Sixth Edition, Prentice Hall, 1998. This text covers the conceptual background for most of the topics covered in the course. It has been adopted by a number of business schools for courses on globalization and is extremely up-to date. Every session will involve some readings from Salvatore, academic and press articles written by economists, as well as business cases when appropriate, and selected readings from other sources. These supplemental readings will be distributed in advance during the course of the quarter. A quick visit to the Website of the day is part of the required readings. Finally, keeping abreast of current events in the international arena, by reading the relevant sections of The Economist every week, is recommended.

Course requirements and grading

Students are expected to master the content of the readings, to make constructive contributions to class discussions, to make occasional presentations, and to perform adequately or better on midterm and final examinations. Grades will be assigned as a weighted average of three components—class participation (30%), a take-home midterm exam (30%), and a short written project (40%). My office hours will be Tuesday and Thursday mornings, 10:00-12:00 on a drop-in basis, or at other times by appointment. Please initiate appointments by email (wacziarg@gsb.stanford.edu).

The Short Paper

The written project will be the main assignment for the class. The paper should be short and written in the style of a business report. Specifically, it should be no more than 10 pages (double spaced), including tables/figures and references. You may work on papers jointly, in groups of no more than three. The maximum number of pages is then to be multiplied by the number of co-authors, and all co-authors will earn the same grade.

For the paper topic, you are expected to select one of the two halves of the course. If you elect to write a paper on the trade part, you will need to pick an instance of international trade dispute or negotiation among countries or trade blocks. For instance, you may want to cover the EU-US banana trade dispute, the Mexico-US negotiations on labor standards during the drafting of NAFTA, the EU-Japan automobile imports negotiation, or the more recent US-Asia steel dumping dispute. In addition to briefly exposing the facts of the case under study, you are expected to employ the analytical methods studied in class (strategic trade theory, comparative advantage, strategic trade policy) and show how they can further our understanding of the issue.

If you choose to write a paper on the international finance part, you will need to pick an episode of a balance of payments crisis and/or subsequent stabilization. For instance, you may elect to cover the 1992 attack on the Italian Lira, the 1995 Mexican crisis, or the more recent Thai or Brazilian currency collapses. Again, the idea is to analyze the causes and consequences of these events, and examine possible policy responses, in light of the tools of economic analysis introduced in class.

It is a good idea to pick a topic early, even if the corresponding background material is to be covered only later in class. To this end, you are all expected to come to office hours for a 15-20 minute chat on your paper, with a one-page project ready, before May 11. Attending office hours at least once during the course of the quarter counts towards the class participation grade.

COURSE OUTLINE

I. Introduction – The Determinants of Country Performance

1. MARCH 31— ASSESSING A COUNTRY'S ECONOMIC PERFORMANCE

If the US rate of growth had been on average equal to 0.75 percent a year since 1870, instead of the actual 1.75%, the level of US per capita GDP in 1990 would have been close to that of Mexico or Hungary. Economic growth is the single most powerful indicator of economic success. This session is devoted to understanding economic growth in the framework of a cross-section of countries, and how the growth performance of a country can be used to assess its business potential in terms of market size, aggregate risk and expected future returns on investment.

Readings: Mankiw (1994), Chapter 4, pp. 76-108.
Barro (1998), Chapter 1, pp. 1-36 and 42-47.

Website of the day: http://www.worldbank.org/html/prdmg/grthweb/growth_t.htm

2. APRIL 2 — OPENNESS AND GOVERNANCE

The degree of openness and the quality of governance are amongst some of the most important determinants of growth. Open countries seem to achieve higher rates of economic growth, because they have access to larger markets, are subject to more vigorous market competition, and are able to specialize according to the pattern of comparative advantage. Countries with stable governments, a high degree of property rights enforcement and a well-maintained rule of law also perform better. This session surveys the determinants of economic growth with special emphasis on these factors.

Readings: Barro (1998), Chapter 2.
Sachs and Warner (1995), pp. 1-64.
Optional: Alesina (1997), pp. 217-237.

Website of the day: http://www.transparency.de/

II. Trade Flows and Trade Policy

3. APRIL 6 — THE POWER OF COMPARATIVE ADVANTAGE

The aim of this session is to provide an understanding of the very basis of international trade: comparative advantage. We will consider the opportunities for mutually gainful trade arising from differences in technology across countries and sectors, the implications of this idea for predicting trade flows and designing trade policy. We will employ simple examples from North-South trade.

Readings: Salvatore Chapter 2, pp. 25-51.

Website of the day: http://www.intracen.org/

4. APRIL 9 — THE DETERMINANTS OF COMPARATIVE ADVANTAGE: HETEROGENEITY

Differences in technology, factor endowments and tastes are the source of all trade. Relative differences in technology drive trade based on comparative advantage. Differences in relative factor endowments – whether a country is more or less endowed with capital relative to labor – may also generate incentives to trade goods across borders. This session will examine the role of factor endowments in driving trade flows, and approach such questions as: is increased trade with China the source of increased wage inequality in the US ? Who stands to gain or lose from trade liberalization ?

Readings: Salvatore Chapter 5, pp. 110-138.

Website of the day: http://trading.wmw.com/

5. APRIL 13 —NON TRADED GOODS AND EXTERNAL SHOCKS

Many goods and services, such as haircuts and houses, are non-tradable across national borders. This has drastic effects on the way we should approach the economics of international trade. When goods are non-tradable, there is no natural tendency for their prices to be equalized internationally through arbitrage. This is a natural terrain to study structural adjustment and the case of the "Dutch disease"– the paradoxical but frequent phenomenon whereby an expansion of an economy's natural resource availability may bring about a drastic contraction of its traded goods sectors.

Readings: Sachs and Larrain, Chapter 21, pp. 657-672.
Krugman. "External Shocks and Domestic Policy Responses", pp. 54-79.

Website of the day: http://www.itd.org/

6. APRIL 16 — CLASSICAL TRADE POLICY

This session analyzes the effects of imposing tariffs and other forms of trade restrictions on the allocation of resources in the economy. We will examine what different kinds of restrictions are available to policy-makers, which are the best (or least harmful) means of intervening, and what incentives politicians face to adopt optimal trade policies.

Readings: Salvatore, Chapter 8, pp. 221-242, and Chapter 9, pp. 257-273.
Caves, Frankel and Jones, pp. 216-233.

Website of the day: http://www.unctad.org/en/techcop/tradpage.htm

7. APRIL 20 — TRADE UNDER IMPERFECT COMPETITION

In the late 70s and throughout the 80s, economists started analyzing international trade under imperfect market structures. Most markets are not characterized by perfect competition, but by some degree of market power. When this is the case, the analytical methods studied in sessions 3-6 break down, and understanding international trade implies understanding market structure. The goal of this session is to provide several examples of how market power, resulting from increasing returns to scale, can helps understand such phenomena as intra-industry trade and the agglomeration of industries.

Readings: Salvatore, Chapter 6.
HBS Note: New Theories of International Trade

Website of the day: http://ciber.bus.msu.edu/busres.htm

8. APRIL 21* — STRATEGIC TRADE POLICY ***NOTE SPECIAL DAY**

When there are only a few actors in a given international market, the resulting market power creates possibilities for countries to employ strategic trade policy to improve domestic competitiveness. For instance, the session case looks at the entry of Airbus onto the market for civilian airplanes. Given the fixed costs involved in starting a production line for commercial airliners, on its own Airbus could not have entered Boeing's monopoly market. But with the help of government subsidies, the entry of Airbus was facilitated and may have benefited Europe. We also discuss how some strategic policy arguments serve as excuses to politicians for adopting distortive trade policies.

Readings: Salvatore, Chapter 9, pp. 273-278.
Case: Airbus vs. Boeing, A, B.

Website of the day: http://www.ustr.gov/

9. APRIL 27 — MULTILATERALISM: INTERNATIONAL TRADE ORGANIZATIONS

After the Second World War, most countries in the world embarked on a project of multilateral trade liberalization, under the auspices of an informal organization known as the General Agreement on Tariffs and Trade (GATT). In 1995, the GATT became a full-fledged international organization – the WTO. This session surveys the rationale for multilateral trade liberalization and the history of its successes and failures. We focus on recent attempts to include the protection of intellectual property rights in the framework of multilateralism.

Readings: Salvatore, Chapter 9, pp. 278-288.
The Economist 1998 Survey of World Trade

Websites of the day: http://www.wipo.int/eng/main.htm
http://www.wto.org/

10. APRIL 30 — REGIONAL FREE TRADE ARRANGEMENTS: IS REGIONALISM BAD ?

Concurrently with the movement towards multilateral liberalization, regional trading blocs were formed in the past 50 years – around the Latin American, North American, European and Asia-Pacific regions. This sessions surveys the properties of regional integration from a conceptual and practical viewpoint. Conceptually, regional integration may not result in improvements in economic efficiency comparable to those of multilateral integration– as it creates trade *diversion* as opposed to uniform trade *creation*. From a practical viewpoint, however, regional arrangements may provide businesses with access to a large markets and be preferable to no liberalization at all.

Readings: Salvatore, Chapter 10.

Website of the day: http://www.nafta-sec-alena.org/

Assignment: Take-home midterm exam distributed at the end of class.

III. International Finance: Understanding Currency Crises

11. MAY 4 — THE CURRENT ACCOUNT

This session is entirely devoted to understanding balance of payments accounting. This is the source of much confusion amongst practitioners. Formally, the current account balance equals the difference between domestic savings and domestic investment. It also represents the net change in the foreign investment position of domestic residents vis-à-vis the rest of the world. It is also defined as exports net of imports plus interest income on net foreign assets. We will see how these various definitions relate. One cannot understand globalization without a firm grasp of balance of payments accounting.

Assignment: Take-home midterm due at the beginning of class.
Readings: Salvatore, Chapter 13, pp. 397-421.
Current Account Handout (to be distributed)
Helmers, "National Account Identities"

Website of the day: http://dsbb.imf.org/

12. MAY 7 — THE DETERMINATION OF EXCHANGE RATES

This session examines different theories of the determination of exchange rates. While economists have a relatively good grasp of the long-run determinants of exchange rates, our understanding of short-run fluctuations is relatively limited. The session covers concepts such as interest rate parity, purchasing power parity and exchange rate overshooting.

Readings: Salvatore, Chapter 15, pp. 465-497.
Optional: Salvatore, Chapter 14.
Website of the day: http://www.bis.org/

13. MAY 11 — UNDERSTANDING EXCHANGE RATE REGIMES

This session is devoted to understanding the economic properties of various exchange rate regimes. While we focus on contrasting fixed and flexible exchange rate regimes, we also discuss floating pegs, currency boards, and full monetary integration as alternative regimes. As an application we study the economics of European Monetary Union in depth.

Assignment: Last day to turn in the 1-page project for the course paper.
Readings: Salvatore Chapter 20,
The Economist Euro Briefs
"Exchange Rate Policy" by Dornbusch and Kuenzler
Application: European Monetary Integration
Website of the day: http://europa.eu.int/euro/

14. MAY 14 — DEVALUATIONS AND BALANCE OF PAYMENTS CRISES

Countries adopting a regime of fixed exchange rates sometimes need a one-time adjustment of their exchange rate when faced with external shocks or inappropriate internal policies. Typically, a developing country with a fixed exchange rate regime will tend to exhibit an overvalued real exchange rate and a concomitant current account deficit. If such is the case, the currency will end up being attacked by foreign holders, who will sell their assets denominated in this currency. The country may try to use foreign exchange reserves to purchase its own currency and try to avert the crisis, but when it runs out of reserves the crisis accelerates and forces a devaluation. This session will examine the mechanics of a typical balance of payments crisis. We will use the June 1991 Indian devaluation and the 1992 Pound Sterling devaluation as examples.

Readings: Salvatore, Chapter 16, pp. 509-522.
Balance of Payments Crisis handout (to be distributed)
Application: The 1991 Indian Devaluation and the 1992 Pound Sterling Devaluation (to be distributed)
Websites of the day: http://www.bankofengland.co.uk/index.htm
http://www.rbi.org.in/

15. MAY 18 — STABILIZATION POLICIES

Balance of payments crises require tough policy responses. In the aftermath of a currency collapse, governments are often required to trim public expenditure, toughen monetary policy to combat inflation, and improve domestic competitiveness to reestablish the current account balance. This package is often known as a *stabilization policy*, and is generally carried out under the guidance of the IMF. After the initial phase of stabilization, the country will typically need to implement deeper structural reforms, sometimes known as *structural adjustment*. This involves liberalizing trade and payments, restructuring manufacturing sectors, and privatizing state owned enterprises. The structural adjustment phase is typically conducted under the auspices of the World Bank.

Readings: Bruno, pp. 223-248
Readings on Brazil (to be distributed)
Optional: Sachs and Larrain, Chapter 23, pp. 726-760.
Application: The Brazilian Stabilization Program of November 1998

Website of the day: http://www.fazenda.gov.br/ingles/welc.html

16. MAY 21 — UNDERSTANDING THE ASIAN CRISIS

This session is devoted to understanding the causes of the recent East Asian crisis. We will focus on the micro-economic aspects of the crisis, which have to do with the type of economic system in place in many of the countries affected by the crisis (close bank-industry-government ties, poor corporate governance, etc.), as well as macroeconomic factors (foreign debt accumulation, government finances, etc.). This will lead naturally to discussing the strengths and weaknesses of the East Asian model, with the benefit of hindsight.

Readings: Sachs and Radelet (1998)
Corsetti, Pesenti and Roubini (1998) - Part 1
Website of the day: http://www.stern.nyu.edu/~nroubini/asia/AsiaHomepage.html

17. MAY 25 — RESPONSES TO AND LESSONS FROM THE ASIAN CRISIS

This session examines the policy responses to the Asian crisis, focusing both on internal policy responses (fiscal, monetary and structural policies) and external factors (IMF stabilization programs and bailouts). We also consider the lessons from the episode. The Asian crisis has had deep implications for policy and business. On the policy side, the realization that moral hazard problems will make bailouts increasingly expensive and ineffective requires a rethinking of the international monetary system and of the role of the IMF. Self-fulfilling currency runs and the resulting systemic risk can jeopardize an entire investment strategy, a fact that has greatly modified the attitude of global investors towards emerging markets.

Readings: Corsetti, Pesenti and Roubini (1998) - Part 2
Additional material to be distributed.
Website of the day: http://web.mit.edu/krugman/www/

18. MAY 28 — THE ROLE OF THE IMF AND THE INTERNATIONAL MONETARY SYSTEM

This session is devoted to understanding the history and evaluating the prospects of the international monetary system. In the past 100 years, the world has been through the Gold Standard, the Gold Exchange Standard and finally a system of largely floating exchange rates since the early 1970s. The advent of the Euro has led to new thinking on what an optimal international monetary system should look like, and we will examine the policy debates this has implied. As an application, we will focus on recent debates on the appropriate role of the IMF.

Assignment: Final versions of the papers due.
Readings: Salvatore Chapter 21, pp. 677-716.
Eichengreen, Chapters 1, 2 and 3, pp. 1-40.
Press articles: The IMF Debate (to be distributed)
Application: The debate on the role of the IMF.
Website of the day: http://www.imf.org/

19. JUNE 1 — PRESENTATION OF THE PAPERS

Three students (or groups in the case of collaborative projects) will be randomly chosen to present their paper in class. The presentations will last 30 minutes, with 20 minutes to present the paper and 10 minutes of discussion.

Readings

Alesina, Alberto (1997), The Political Economy of High and Low Growth, in Pleskovic, Boris; Stiglitz, Joseph E., eds. *Annual World Bank Conference on Development Economics, 1997*, Washington, D.C.: World Bank, 1998.

Barro, Robert (1997), *Determinants of Economic Growth*, Cambridge: MIT Press.

Bruno, Michael (1988), Opening Up: Liberalization with Stabilization, in Rudiger Dornbusch and Leslie Helmers, eds., *The Open Economy: Tools for Policymakers in Developing Countries*, Oxford: EDI series in Economic Development, Appendix B, pp. 375-391.

Caves, Richard, Jeffrey Frankel and Ronald Jones (1993), *World Trade and Payments: An Introduction*, New York: Harper Collins, Sixth Edition.

Corsetti, Giancarlo, Paolo Pesenti and Nouriel Roubini (1998), What Caused the Asian Currency and Financial Crisis ? Part I – Macroeconomic Overview, *NBER Working Paper* #6833, December.

Corsetti, Giancarlo, Paolo Pesenti and Nouriel Roubini (1998), What Caused the Asian Currency and Financial Crisis ? Part II – The Policy Debate, *NBER Working Paper* #6834, December.

Dornbusch, Rudiger and Luis Tellez Kuenzler (1993), Exchange Rate Policy: Options and Issues, in Rudiger Dornbusch, ed., *Policymaking in the Open Economy: Concepts and Case Studies in Economic Performance*, Oxford: EDI Series in Economic Development, Chapter 5, pp. 91-126

Eichengreen, Barry (1994), International Monetary Arrangements for the 21rst Century, Washington, DC: Brookings, pp.1–40.

Helmers, F. Leslie C. H. (1988), National Account Identities, in Rudiger Dornbusch and Leslie Helmers, eds., *The Open Economy: Tools for Policymakers in Developing Countries*, Oxford: EDI series in Economic Development, Appendix B, pp. 375-391.

Krugman, Paul (1988), External Shocks and Domestic Policy Responses, in Rudiger Dornbusch and Leslie Helmers, eds., *The Open Economy: Tools for Policymakers in Developing Countries*, Oxford: EDI series in Economic Development, Chapter 4, pp. 55-79

Mankiw N. Gregory (1994), *Macroeconomics*, Second Edition, New York: Worth Publishers.

Radelet, Steven and Jeffrey Sachs (1998), The Onset of the East Asian Crisis, *NBER Working Paper* #6680, August.

Sachs, Jeffrey and Andrew Warner (1995), Economic Reform and the Process of Global Integration, *Brookings Papers on Economic Activity*, vol. 0, no. 1, 1995, pp. 1-95.

Sachs, Jeffrey and Felipe Larrain (1993), *Macroeconomics in the Global Economy*, Englewood Cliffs (NJ): Prentice Hall, Chapter 21, pp. 657-688 and Chapter 23, pp.727-760.

The Economist Newspaper Ltd. (1998) *The Euro: Ready or not ?* 19 pages. Eight briefs from The Economist written by Robert Cottrell, Philippe Legrain, Pam Woodall, Mark Roberts, Zanny Minton-Beddoes, Richard Cookson and edited by John Peet.