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Study text

15th Chapter

Foreign-trade and Currency Policy

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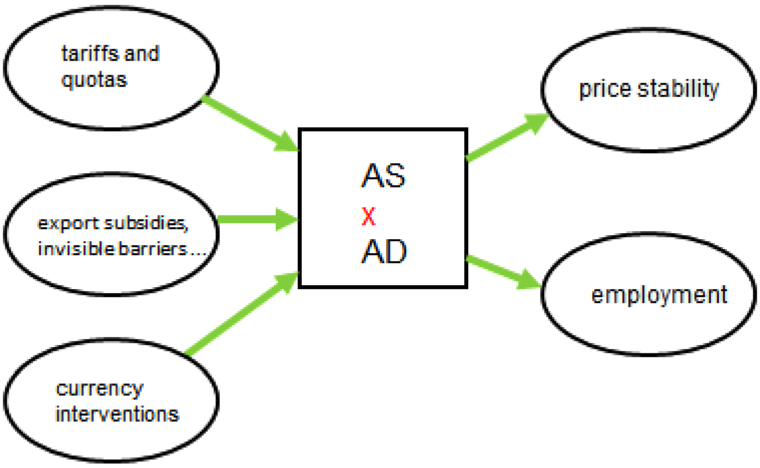
15 Foreign-trade and currency policy

In this chapter, the foreign trade policy will be defined including its objectives and instruments used to influence fundamental macroeconomic variables, and monetary policy will be defined that is used to influence the exchange rate and foreign trade consequently. Foreigh trade policy and monetary policy are part of macroeconomic policy. The basis of this policy is to regulate foreign trade, international capital flow and exchange rates. As we will see in the text, these regulations take place at the national, but also international level.

15.1 Objectives and instruments of foreign-trade and currency policy

The immediate goal of foreign trade and currency policy is balanced Balance of payments; its structure was described in detail in the previous chapter. External trade and monetary policy focuse on the regulation of import and export and international flow of capital to ensure the Balance of payments balanced (its current and capital account). Monitoring the immediate goal should be consistent with other economic policy goals. Figure 15.1 shows the transmission mechanism of the various instruments action of foreign trade and monetary policy on aggregate supply and demand and consequently on the basic macroeconomic variables. The final objectives of this policy are price stability and employment.

Fig. 15.1 The transmission mechanism of foreign trade policy instruments action on basic macroeconomic variables



There are two opposite approaches reflecting the character of foreign trade and monetary policy - free trade and protectionism. Liberalism in foreign trade (free trade) is one of the principles of classical liberalism, whose basic starting point is the freedom of the individual. Classical liberalism emphasized the division of labor at national and international level. Internationally, it is the application of the principle of comparative advantage. Liberalizing tendencies mean gradual elimination of all barriers to foreign trade.

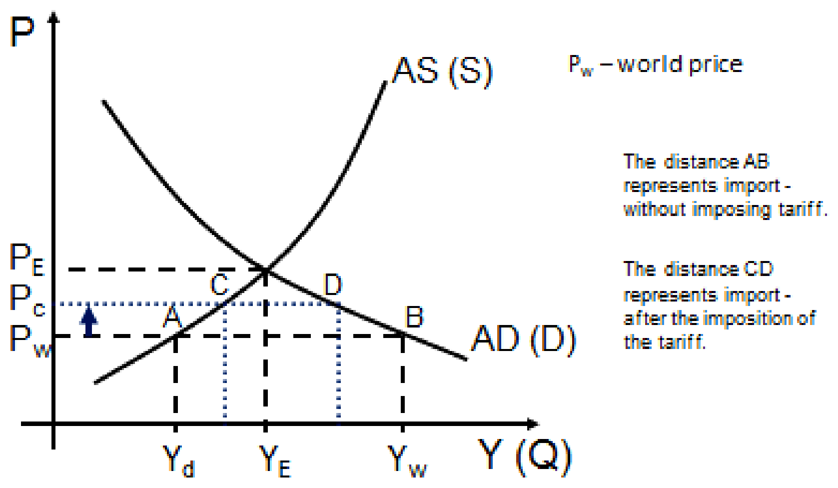
Protectionism means protecting of domestic producers against foreign competitors and their production. Tools of protectionism can be divided according to their character in the following way:

- ***indirect (market) instruments,*** including measures of monetary and fiscal policy, affecting balances of Balance of payments´ accounts and affecting aggregate macroeconomic variables; we can mention a change in interest rates or changes in tax system;
- ***direct (administrative, non-market) tools*** such as import quotas, tariffs, export subsidies, invisible barriers to imports, the licenses for import and export or embargo.

Tariff has the character of taxes. It is collected by the state and imposed on imported or exported production. Implemented or increased tariff reduces the total volume of imports. This effect is demonstrated in Fig. 15.2. Changes can be shown at the part or at the aggregate market. Letter D (AD) is demand (aggregate) for goods domestically and S (AS) is the (aggregate) the supply of goods at this market. If we do not consider the foreign trade, market equilibrium would be formed at the point of S (AS) and D (AD) intersection.

The intersection of S (AS) and D (AD) determines the equilibrium price of production (or price level) P_E. If the price at the world market (p_w) is lower than P_E, then the quantity demanded will be Y_w, but domestic manufacturers will produce only Y_d. The difference (Y_w – Y_d), or AB can be represented as an import. If a country imposes a tariff, the price (price level) of production will rise to P_c and imports will be limited to the distance CD. It is clear that tariffs increase prices and create better conditions for domestic producers and maintain jobs (employment) in the domestic economy. If the tariff results in the price P_E, this situation is called *prohibitive duty* – ecluding the import into economy.

Fig. 15.2 Effect of imposition of tarriff on imported quantities of production



Import quotas set the maximum amount or value of the type of good that can be imported into the country within the specified period. The quota may be zero and this means practically a ban on imports.

Export subsidies promote exports from the country. They may take the form of deductions from taxes that exporters would pay at domestic market, they may occur in the form of a fixed amount per unit or as a percentage of the value of exported goods.

Invisible barriers to imports include various norms, rules and obligations (technical, health, environmental) which imported products have to meet.

Licence authorizing the importation or exportation is the instrument used to regulate the flow of goods and generate additional state revenue.

Embargo is a ban on trade with a state or a commodity. It may be a ban on the export of certain strategic raw materials or products of the defense industry in any state. About it can be decided at both, national and international level.

Why do states resort to protectionism?

Thera are usually less-developed economies that resort to protectionism, because they would suffer from an influx of more competitive products from abroad. A common argument is to protect domestic producers, expand domestic production, increase domestic demand and maintain high employment. Other objectives are the fear of too narrow specialization of production and dependence on the external environment. A country can be interested in keeping the sector, which would otherwise have disappeared due to foreign competition. Another reason may be to create favorable conditions for the development of "juvenile" sector, this is known as "educational protectionism" (a part of German Historical School´s theory). It can also be a temporary protection of the economy that is in terms of undergoing structural changes. In addition to these economic and non-economic objectives there are military-political objectives, maintaining the industry with national tradition, and environmental goals.

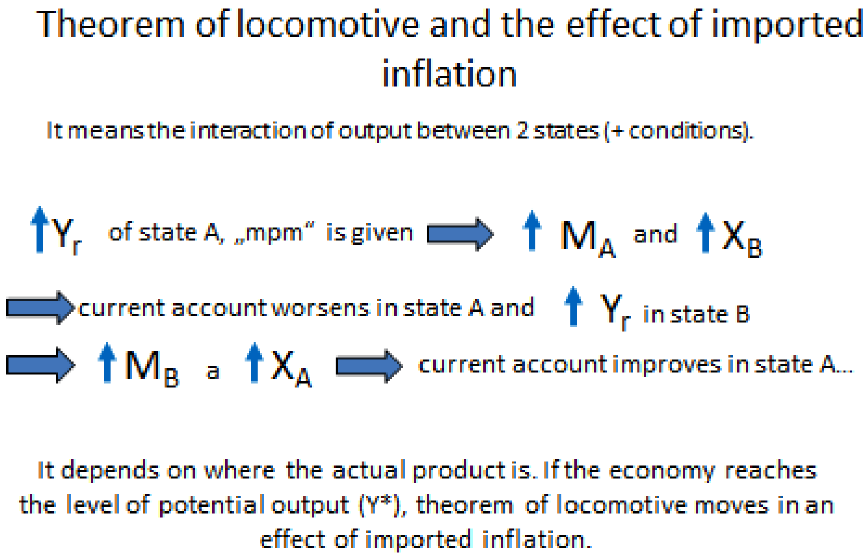
What are the consequences of protectionism?

Protected firms produce usually with higher costs reflected in higher price of domestic production compared to the world price. Consumers in such economy loose part of their consumer surplus, because otherwise they would buy similar goods at a lower price. Protectionism leads to lower world GDP, because of not applying the principle of comparative advantage. Protectionist measures lead to reduce the competitiveness of products, export decline and vice versa for the increase in unemployment. However, in some cases there is “legitimate” protectionism. Duties may be retaliatory – they can represent a response to the previous imposition of duties abroad and to a decline in foreign demand. Anti-dumping duties respond to dumping when foreign producers sell their produce at a lower price, without leading to cost reduction, in order to dispose of competition abroad.

A positive feature of the ***cancellation of protectionist measures*** is to increase the performance of the economy and the world economy as a whole. However, in addition to the benefits of trade and increase in consumer optionsm, the risk of the dependence on other economies arises. If the economy is more open and more dependent on abroad, it has greater risk.

The effects of developed international trade by eliminating barriers in international trade depend on where the product of a national economy is. Consider country A and country B that do not use their production capacity fully. Suppose that their Balances of payments are balanced and both countries have a given marginal propensity to import (*mpm*). If real product in country A is rising, then at constant *mpm* induced import (*mpm.Y*) will also increase. Import growth in country A will lead to growth in exports in country B. Balance of payment of the country becomes passive, but the Balance of payment of country B becomes active. Aggregate demand (export is a part of AD) in country B is rising and real product is rising. Growth in real output in country B will increase the volume of imported production in country B, and this will lead to increase in export in country A.

In this way both economies interact. This mechanism is known as ***theorem (effect) of locomotive***. Its acting is based on the assumption that countries have unused production capacity and their performance is below the potential output. If the economy operates at the level of potential output (in terms of full employment), the theorem of locomotive will pass to the ***effect of imported inflation,*** when the growth of exports, followed by aggregate demand, reflects in a higher price level.



In the case of export we can examine multiplier effects in the economy. Multiplier effect have been expressed in Chapter 4 within neokeynesianism theory of multiplier. *Multiplier of foreign trade* says how many times the ouput will increase, if export rises by one unit.

15.2 Currency policy – influencing the exchange rates

The currency policy means the regulation of exchange rates by the central bank (not the influencing of the money supply and interest rates in the domestic economy by the central bank). The currency policy represents interventions at foreign exchange markets when a central bank buys or sells foreign currencies for domestic currency. Method of implementation of these interventions depends on the mode of exchange rates and attitudes of a central bank to the exchange rate development. Moreover, exchange rate may be influenced by other factors, such as the setting of basic interest rates or a change in the tax burden on incomes from international financial assets.

If exchange rates are fixed (or fixed at the central level), their change is made by revaluation or devaluation. It takes place usually in response to the state currency reserves level, to the development of international trade flow of foreign capital and other economic variables. Devaluation leads to cheaper goods exported (to increase their competitiveness) and after exporters´s adjustment to export growth. But it leads to higher prices of imported goods and to reducing its volume. The overall effect, however, depends on other variables, such as price elasticity of demand of foreign entities for goods in the domestic economy, the price elasticity of demand of domestic entities for goods from abroad and the existence of substitutes in individual sectors. **After the devaluation**, net export (NT) is expected to increase, and aggregate demand (AD) and the product (Y) are expected to increase, too.

In the system of freely floating exchange rates (floating and managed floating), the central bank can influence the exchange rate by buying or selling foreign currencies. The exchange rate is formed under the changes in supply and demand for currency. Change in exchange rate here is referred to appreciation or depreciation. For example, if the Czech central bank buys the euro and sell the Czech crown, it will exert pressure on depreciation of the Czech crown and the appreciation of the euro. After **depreciation** of the Czech crown the competitiveness of Czech products abroad will increase (products will be cheaper) and Czech exporters will increase the value export after their adjustment to new conditions. Selling euros and appreciation of the Czech koruna will act in the opposite way (to decrease the export value).

Regulation of exchange rates may not only take place in the national economy, but it can be implemented in a coordinated manner at the international level, where the state is integrated into the international monetary system.

15.3 International coordination of economic activities

V realitě dochází k mezinárodní koordinaci ekonomických aktivit jednotlivých národních vlád, centrálních bank a dalších institucí. Tato koordinace ve světovém hospodářství je stejně důležitá jako koordinace jednotlivých politik na národní úrovni.

In reality, there is international coordination of economic activities of the national governments, central banks and other institutions. This coordination in the global economy is as important as the coordination of policies at the national level.

International coordination may involve mutual barriers removing and administration simplifying in foreign trade, fre flow of labor and capital, but also in the creation of a united monetary system, or united currency. As we shall see, there are more degrees of coordination.

An example of international coordination of trade policies is the *World Trade Organization (WTO)*. It establishes the rules for international trade and dealing with international trade disputes between its member states. It was established in 1995 as a successor to the *General Agreement on Tariffs and Trade (GATT)* that contained rules and procedures providing a framework for international trade and trade policy.

International Monetary Fund (IMF), founded in 1944, is an organization with the main objective of facilitating international monetary cooperation, promoting exchange rate stability and encouraging countries at the time of their difficulties.

An important institution is the *World Bank* (WB), also founded in 1944, and its 5 organizations. One of them is the *International Bank for Reconstruction and Development* (IBRD), focusing on lending to governments and private entities (mainly assistance to developing countries). In times of financial crises the roles of IMF and World Bank are rising.

Coordination of national economic activities (interventions) may have different degrees. If the economies of different countries link up and remove barriers for mutual trade, we can speak of ***international economic integration***. This is one of the manifestations of globalization. The aim of economic integration is to promote foreign trade and improve living standards of the population (based on the principle of comparative advantage).

There are *two basic approaches* and implementation of international economic integration:

- ***functionalist approach***, it is liberal and it highlights an important role of national markets (generally of markets), where producers, consumers and macroeconomic policies compete. The condition here is the removal of obstacles to the free flow of goods and services, labor and capital;

- ***institutional approach***, based on interventions of national and supranational authorities (setting norms and rules); this approach does not rely on regulating effects of markets.

Degrees of economic integration

According to the degree of interconnection between national economies and the extent of sovereignty of national regulatory institutions we distinguish five forms of international coordination of economic activities.

1. ***Free trade zone***, characterized by removing barriers in international trade - the abolition of customs duties, import quotas and other barriers. Feature of this first stage is that countries retain their own customs policy. For example we can mention these international organizations: ASEAN, NAFTA, EFTA.

2. ***Customs Union*** is characterized by the abolition of customs barriers in international trade and a united trade policy (united tariffs) against non-member countries. For example, we can mention Benelux in a certain era or the Southern African Customs Union (JACU). Customs Union and free trade zone constitute interstate integration with still preserving the sovereignty of the member states. Decisions are making at the international level and are based on the unanimous consent of all its members.

3. **The united market** is a high degree of economic integration. It is characterized by enlargement of the free flow of labor and capital. Its feature is the gradual transfer of national competence towards supranational bodies. Within the EU we talk about the united internal market (higher form) based on four economic freedoms: free flow of goods, services, people and capital. Customs and passport controls at the internal borders of the EU member were abolished and the Schengen area was created.

4. **Economic union** is characterized by the unification of economic policies, by common budget and redistribution of resources between member states in order to reduce disparities in living standards among states. Economic policy is coordinated through common or coordinated policies and cooperation in these areas, as in the European Union. The competence is shifting to supranational entities and decisions are usually based on the majority principle. It creates the conditions for economic and monetary union – that is roughly the same economic level and harmonized macroeconomic policies of member countries.

5. ***Full economic integration*** is the highest level. In addition to the common economic policy it is characterized by monetary union - a single currency and a common monetary policy. As example of the full economic integration we can mention the EU, its common currency euro and monetary policy of the ECB - European Central Bank. The very highest degree is a full economic and political integration (e.g. the unification of Germany in 1990).

15.4 The history of EU integration processes

In 1948 the Benelux was formed, it was Community of Belgium, Netherlands and Luxembourg. Later, it was transformed into an economic union.

In 1952 the European Coal and Steel Community (ECSC) was established, also known as Montan Union. The ECSC was founded on the basis of the Paris Agreement of 1951, in addition to the Benelux also involved France, Italy and Germany. It is considered as the basis of the European Union.

It was first proposed by French Foreign Minister Robert Schuman in 1950 as a way to prevent another war with Germany. Later ECSC incorporated into the European Community (EC).

In 1957, the Treaty of Rome was signed and *the European Economic Community* (EEC) and *the European Atomic Energy Community* (Euratom) were established. The founding countries were again France, Germany, Italy, Belgium, Netherlands and Luxembourg.

On the basis of the Merger Treaty of 1965 and, valid from 1967, the three Communities (ECSC, EEC and Euratom) merged together and acted as the European Community (EC). The European Community was later the first pillar of the European Union, which was established by the Maastricht Treaty of 1992. After the ratification of the Lisbon Treaty in 2007, ES disappeared and became the legal successor of the European Union. The Euratom Community is partially independent and continues to work.

As an alternative of the EC, the European Free Trade Association (EFTA EFTA - European Free Trade Association) was established in 1960. The United Kingdom was the leading country of the Association and other members were Denmark, Norway, Sweden, Austria, Switzerland and Portugal. Some states then passed to the EC. The current members of EFTA are Iceland, Liechtenstein, Norway and Switzerland, of which Iceland, Liechtenstein and Norway are members of EEC.

In 1973 there was a first extension of the then EC. Denmark, Ireland and the United Kingdom joined the EC. In 1981 Greece and in 1986 Portugal and Spain entered the EC. In 1995 Austria, Finland and Sweden became members.

The Maastricht Treaty of 1992 renamed the EEC to the European Community, and launched the European Union (EU), which should involve the three pillars including existing integration activities. The EU has also begun recently to cooperate in the common foreign and security policy and judicial matters. In 1999, the first cashless and then in 2002 cash a common currency was launched (formerly a unit of account ECU) and integration processes were completed.

In May 2004, 5th the EU expanded eastward. 10 countries - Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovakia and Slovenia entered the EU. The number of member countries in the EU rose to 25.

Further east extension is associated with the date 1st January, 2007 when Bulgaria and Romania entered the EU. Thus, the number of member countries in the EU rose to 27. In January 1st, 2013 Croatia joined the EU. In 2014, the EU had 28 members and approximately 500 million inhabitants.

Eighteen EU countries (Austria, Belgium, Finland, France, Ireland, Italy, Cyprus, Luxembourg, Malta, Netherlands, Portugal, Austria, Greece, Slovenia, Spain, Estonia, Latvia and Slovakia) are members of the euro area (2014) which means that on their territory the euro is the sole legitimate currency euro.

A necessary condition for adopting the euro is fulfillment of **the Maastricht (convergence) criteria:**

- average ***inflation rate*** of the country in the period of one year before examining the entry into the final stage may not exceed by more than 1.5% of the average inflation rate of the three countries with the lowest inflation rate;
- ***long-term nominal interest rate*** must not exceed by more than 2% of the average interest rate of three countries with the lowest inflation rate before the examining the country during the final stage;
- ***government (public) deficit*** must not exceed 3 % of GDP and government debt may not exceed 60 % of GDP at a time when the EU examines joining the country to the European Monetary Union (EMU) and this debt criterion can be considered to be met if the debt ratio is decreasing in the long term;

- ***exchange rate*** shall not exceed the margin of the European Monetary System (EMS) and at least two years before examining the possibility of entering into the final stage a member country must not devalue its currency relatively to the currencies of other EU member states.

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