

PSC 102: Intro to International Politics

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Money Left Lying on the Ground

Introduction

- Three goals for this lecture
 - Discuss potential **benefits of free trade**
 - Clarify relationship b/w **exchange rates** and trade
 - Discuss potential **benefits from free migration**

Overview

- $>90\%$ of economists agree \downarrow barriers to trade \uparrow welfare
- Removing all barriers in US could \uparrow GDP by \$1.5 tril per year
- Equivalent to \$15,000 per household
- If A trades $2\times$ as B , likely to experience 50% higher growth

A Simple Model

- Suppose we have two states, Rich Republic and Pooristan
 - $u_R = 0$ if $\mathcal{E} < 8$ and $u_R = \mathcal{L}$ if $\mathcal{E} \geq 8$
 - $u_P = 0$ if $\mathcal{E} < 4$ and $u_P = \mathcal{L}$ if $\mathcal{E} \geq 4$
 - Each month, R can produce 2 units of \mathcal{E} or 10 units of \mathcal{L}
 - Each month, P can produce 1 unit of \mathcal{E} or 2 units of \mathcal{L}
 - Annual production is simply sum of monthly outcomes

Analysis

- If R and P opt for **self-sufficiency**
 - Both meet their needs for \mathcal{E}
 - Takes each 4 months to do so
 - With remaining months, R produces **80** units of \mathcal{L}
 - With remaining months, P produces **16** units of \mathcal{L}

- A **better** way
 - R spends all its time producing \mathcal{L}
 - P spends all its time producing \mathcal{E}
 - 12 units of \mathcal{E} will be produced
 - 120 units of \mathcal{L} will be produced
 - That's a **surplus** of 24 units of \mathcal{L}

Discussion

- Self-sufficiency leaves money lying on the ground
 - Specialization ensures there is more to go around
 - No matter the bargaining protocol, no state made worse off
 - B/c some needs essential, barriers prevent specialization
- Importance of comparative advantage
 - Surplus maximized when opportunity costs minimized
 - P does not produce \mathcal{E} as fast as R
 - But world needs \mathcal{E} and R shouldn't produce it
 - Each unit of \mathcal{E} that R produces robs world of 5 units of \mathcal{L}
 - Each unit of \mathcal{E} that P produces robs world of 2 units of \mathcal{L}
 - Absolute advantages do not justify self-sufficiency

Dubious Benefits of Mercantilism

- Public, politicians often worry about **trade deficit**
- Work all day, never buy anything, maximize personal **surplus**
- Would that maximize your **happiness**?
- Imbalances can matter if relationship sufficiently **adversarial**
- But not **intrinsically** harmful

Terminology

Fixed exchange rate

When a currency's value is tied to that of another currency or a particular commodity, such as gold.

Floating exchange rate

When a currency's value is set by supply and demand.

Upsides to Fixed Exchange Rates

- Fixed exchange rates promote trade by limiting **uncertainty**
- Particularly true if major economies all have their currencies fixed to the same standard
- Period of British dominance characterized by **gold standard**, which meant most states effectively had a common currency
- States that shared gold standard traded roughly 30-60% more than other pairs of states
- From 1945 to 1973, Bretton Woods monetary system effectively treated gold-backed dollar as common currency

Downsides to Fixed Exchange Rates

- Fixed exchange rates deny states control over **monetary policy**
- Monetary policy affects rate of **inflation**
- Inflation creates **winners and losers**
- **Leaders** have interest in who wins and loses

Migration

- Barriers to **migration** are effectively barriers to **specialization**
- Greater implications for culture, politics, security than trade
- But potential benefits are much larger
- World GDP would **double** if barriers to migration removed
- **Trillions of dollars** are left lying on the ground
- And it's possible to reap most of the benefits w/ minimal costs