

Chapter 1

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Definitions

Gross Domestic Product (GDP)

The market value of all final goods and services produced in a year inside a nation (collected quarterly, then averaged); a measure of total production

Formulas

GDP (Expenditure Approach)

$$C + I + G + NX$$

Consumption + Investments + Government + Net Exports

Consumption = Households

Investments = Businesses

Government = Municipal, Federal, Provincial

Net Exports = Exports - Imports

WE reduce Imports because we're looking at gross DOMESTIC product

GDP (Income Approach)

Total National Income + Sales Tax + Depreciation + Net Foreign Factor Income

GDP (Value Added Approach)

Gross Value of Output - Value of Intermediate Consumption

Trade-to-GDP Ratio

$$(\text{Exports} + \text{Imports}) / \text{GDP}$$

Content

August 2007:

- Crisis erupted in the housing sector of the US
- Few people realized that the subprime mortgage crisis = demonstration of international economic integration and it would push the world economy to the brink of collapse
- Crisis grew through the remainder of 2007 and 2008 and all high-income economies were in deep distress
- Grew to be an epidemic -> banks and other financial firms collapsed, solvent firms stopped lending

stopped lending

- Scarcity of credit = businesses could not find financing for their day-to-day operations
- Consumers cut back spending, businesses cut back on new investment

End of 2008 there was a global economic recession (except China, India, and major oil producers)

Most Dramatic instance since Great Depression which led to severe economic recession around the world

International Integration of National Economies = controversial

- Brought many benefits to nations across the globe
 - Technological innovation
 - Less expensive products
 - Greater investment in regions where local capital is scarce
- Many costs as well
 - Made countries more vulnerable to economic problems that have become more easily transmitted from one place to another

Due to globalization, the major economies of the world are more integrated than ever, here's a brief history:

- Before 1866 -> it took a person in New York three weeks to complete a financial transaction in London
- 1866 -> it took a person in New York a day to complete a financial transaction in London
- 1870-1913 -> new technologies such as transatlantic cables, steam-powered ships, railroads, and many others led the way for dramatic economic growth between countries
 - 1914 -> it took a person in New York a minute to complete a financial transaction in London due to radio telephony
- 1950 -> reduction of trade barriers after WW2
- 1970 -> countries began encouraging financial integration by increasing the openness of their capital markets
- 1990 -> telecommunication revolution & advent of internet pushed economic integration to new levels as multinational firms developed international production networks and markets became ever more tightly linked

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4 Measures of the Degree of International Economic Integration

1. Trade Flows
2. Capital Flows
3. People Flows
4. Similarity of Prices in Separate Markets
 - a. Integrated economies have relatively small price differences mainly due to differences in transportation costs
 - b. Goods that can move freely from a low-cost to a high-cost region should experience price convergence as goods move from where they are plentiful and cheap to where they are relatively scarcer and more expensive

Growth of World Trade

Since the end of WWII, world trade has grown much faster than world output

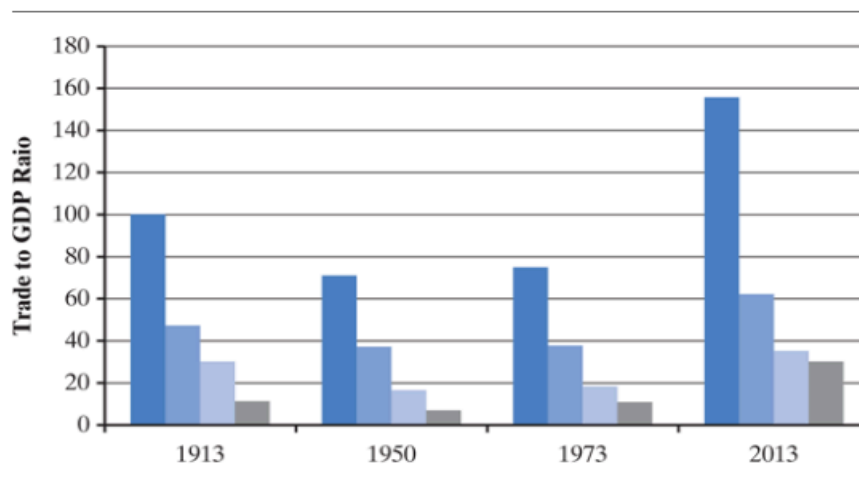
1950: Total World Exports (which always equals World Imports) = 5.5% of world GDP

2013: Total World Exports = 30% of world GDP, six times more important relative to the size of the world economy

Important measure of international trade in a nation's economy is the **Trade-to-GDP Ratio**

- Measures the relative importance of international trade in a nation's economy
- Ratio doesn't provide any direct information about a country's trade policies
- Countries with higher ratios do not necessarily have lower barriers to trade (but it could be a possibility)
- Large countries are less dependent on international trade because their firms can reach an optimal production size without having to sell to foreign markets
- Smaller countries tend to have higher ratios of trade-to-GDP

Figure 1.1 Trade-to-GDP Ratios for Four Countries, 1913–2013



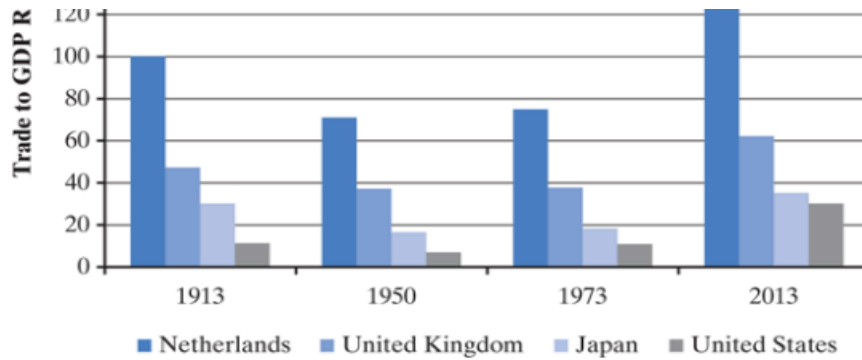


Figure 1.1

- Shows trade-to-GDP ratio for four countries between 1913-2013
- Smaller ratios for the US and Japan which have largest population
- Higher ratio for Netherlands which has the smallest population
- In general smaller countries trade more than larger ones
 - Smaller countries cannot efficiently produce a wide range of goods and must depend on trade to a greater extent
 - If Netherlands were to produce autos solely for its own market, it would lack economies of scale and could not produce at a competitive cost, whereas the US market can absorb a large share of US output
- Historical overview of international trade decline and return
 - Decline of trade between the onset of WWI and 1950 is clearly visible in each country
 - Subsequent increase after 1950 visible as well
- BUT obscures important changes in the composition of trade flows from early in the twentieth century to those at the end of the century
 - Before WWI most trade consisted of agricultural commodities and raw materials
 - Current trade is primarily manufactured consumer goods and producer goods (machinery and equipment)
 - Today's manufactures are more exposed to international competition than was the case in 1900
 - Much of the growth of world trade since 1950s has been accomplished by multinational corporations since 1950s has been accomplished by multinational corporations
 - Production site in multiple countries and inputs that pass back and forth between affiliates, multinational corporations have become dramatically more important
 - Trend has been supported and encouraged by the telecommunications revolution and transportation

telecommunications revolution and transportation improvements

- lowered the cost of coordinating operations physically separated by oceans and continents
- Possible to coordinate service operations such as accounting and data processing from a great distance
- Trade today is qualitatively different than in 1913
- Growth of the trade-to-GDP ratio since 1950 does not tell the whole story

Capital and Labor Mobility

- Another indicator of economic integration
- As national economies become more interdependent, labor and capital should move more easily across boundaries
- Labor is less mobile internationally in comparison to 1900
 - 1890: apprx. 14.5% of the US population was foreign born
 - 2010: apprx. 12.9% of the US population was foreign born
 - Why??
 - 1900 many nations had open door immigration policies and passport controls, immigration visas, and work permits were exceptions rather than rules
 - Movement of people was severely restricted by the two world wars and the great depression of the 1930s
 - In 1920s during the interwar period, US sharply restricted immigration with policies that lasted until the 60s when immigration laws once again encouraged foreigners to migrate to the US
- Hard to measure capital
 - Several ways to measure capital flows
 - Most basic distinction is between Capital flows:
 - flows of financial capital representing paper assets such as stocks, bonds, currencies, bank accounts
 - flows of capital representing physical assets such as real estate, factories and business; FDI- Foreign Direct Investment
 - Distinction is immaterial because both represent the shifts in wealth across national boundaries and both make one nation's savings available to another
- Two things to keep in mind while comparing international capital flows today to a century ago

