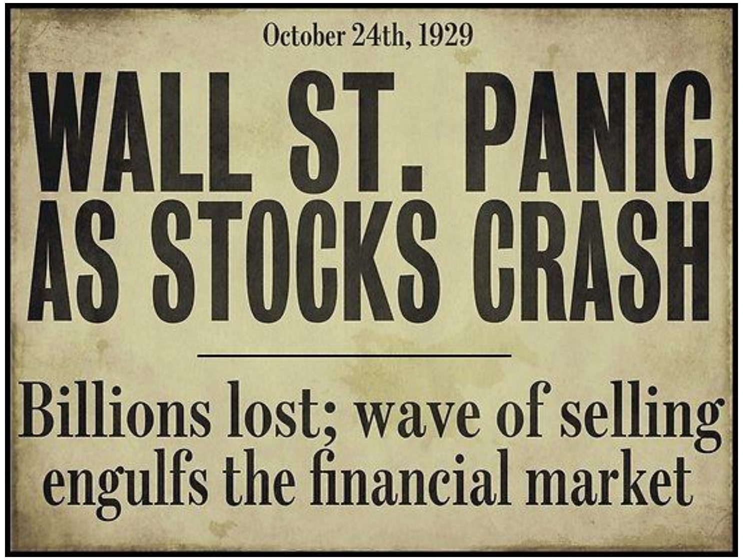
ITI 1202: Introduction to Global Politics

Unit 7: Globalization of Trade and Finance

Globalization of Trade



- Following World War II, the leading economic powers broadly agreed the purpose of improving trade cooperation.
- Leaders in many states perceived that rebuilding free trade was critical.
- The policy of isolationism, which had led the United States to shun the League of Nations and to stay out of World War II until the Pearl Harbor attack, has been discredited.

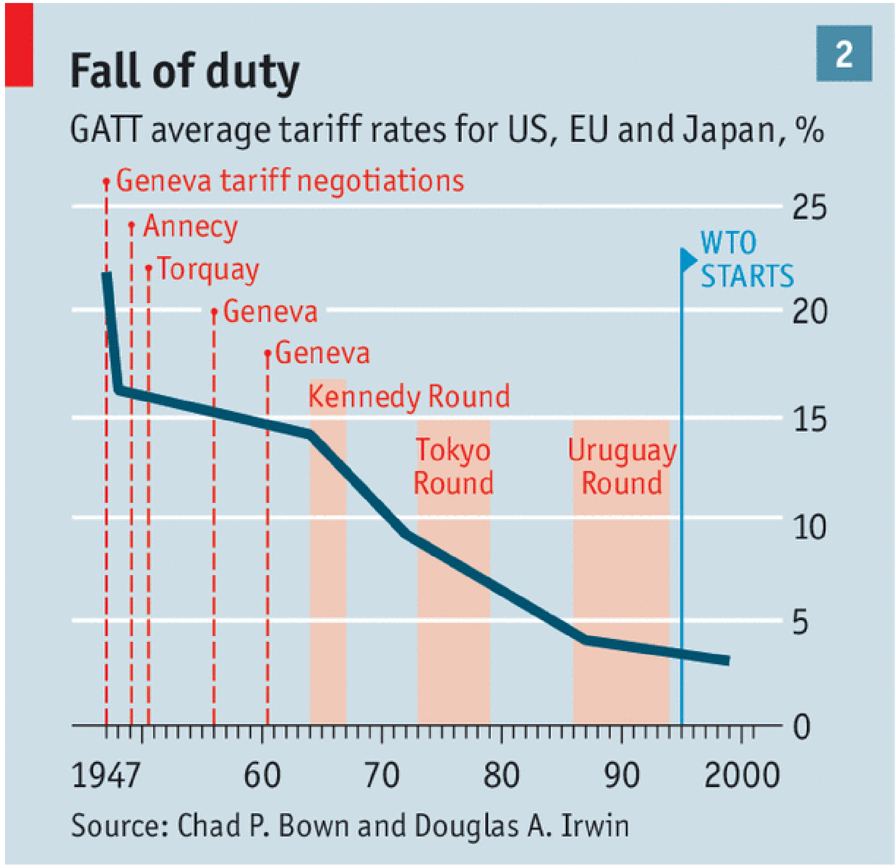
Globalization of Trade

- The United States and its allies met in 1944 to set up a new trading and financial system.
- The Bretton Woods system consisted of both trade and financial provisions, which were intended to promote free trade and increase wealth around the world.
- The main trade provision was known as the General Agreement on Tariffs and Trade (GATT). Initiated in 1946, the GATT lasted until 1995, when it was replaced by a stronger version embodied in the World Trade Organization (WTO).

Globalization of Trade

- The mechanism of the GATT – First, members agreed that they would use tariffs rather than other methods (such as quotas) as their primary means of protection.
- Second, they would work over time to slowly decrease the level of those tariffs. These reductions were carried out in nine "rounds" held over the succeeding decades.
- The GATT was based on the principle of nondiscrimination rather than the reciprocity. Nondiscrimination meant that a given state's tariff on a same for all GATT members.

Globalization of Trade



Economist.com

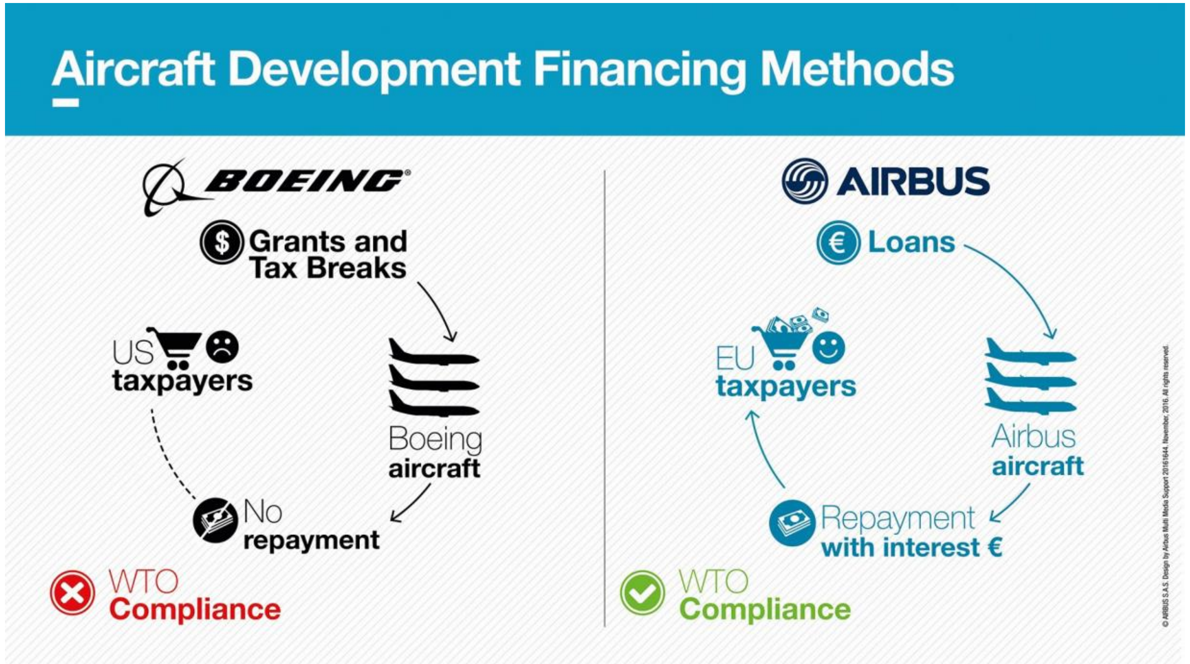
- However, GATT only covered certain classes of products. Agriculture products, services such as insurance, banking, and consulting was left out entirely.
- Moreover, state increasingly enacted "nontariff barriers" to trade. (Quotas, Voluntary export restraints (VERs), Domestic content laws, Health and environmental regulations)

Globalization of Trade

- To address the problems inherent in the GATT, 117 states signed a new agreement in 1994 founding the WTO.
- The main provisions of the GATT were incorporated into the WTO, and a General Agreement on Trade in Services (GATS) was added.
- The main change in moving to the WTO was the development of an enforcement mechanism that allows states to challenge each other's laws. If the laws are found to be barriers to trade that violate the agreement, then the WTO can assign penalties against the offending states.

Globalization of Trade

- These penalties consist of countertariffs that the injured state can enact to offset the damage.
- The WTO dispute settlement process is intended not simply to judge right and wrong, but to mediate conflict.



Globalization of Finance

- The international financial system has experienced two revolutions in recent decades. First, in 1971, the United States single-handedly ended the system of fixed exchange rates that had prevailed since 1946. Second, in the 1980s and 1990s, governments lifted limits on capital movements, paving the way for the massive international flows of capital today.
- In foreign exchange markets, nearly 2 trillion dollars' worth of currencies are traded every day. Thus, the amount of cross-border portfolio investment—investing by purchasing stocks rather than physical assets—has skyrocketed.

Globalization of Finance

- **The Monetary "Trilemma"**
- Predictable exchange rates. Fixed exchange rates facilitate free trade and investment by eliminating the risk that fluctuations in exchange rates will destroy anticipated profits. Stability and predictability are accomplished most precisely by fixing exchange.
- Free movement of capital. Free capital movement allows investors to invest where returns are greatest and provides poor economies access to much-needed foreign investment.

Globalization of Finance

- Autonomous monetary policy. Governments use monetary policy to respond to changes in their domestic economies (raising and lowering interest rates to regulate growth and inflation), without regard for policy choices in other countries or internal markets.
- **Evolution of the International Financial System**
- Since the late nineteenth century, three different international financial systems have existed, separated by two long intervening periods in which states struggled to create a new system after the previous one had collapsed.

Globalization of Finance

I. The Classical Gold Standard, 1870-1914

- Every major currency was valued in terms of a certain weight of gold. Because of this, the exchange rates were highly stable, which facilitated the steady increase in trade and international investment prior to World War I.
- The gold standard prioritized fixed exchange rates and the free flow of capital, at the expense of domestic monetary autonomy. The strength of this system was its stability and predictability, as well as the system's strong limits on inflation.

Globalization of Finance

II. The Interwar Era, 1914-1944

- The economic demands of World War I caused all the major countries to abandon the gold standard and instead to print large amounts currency to finance the war effort. Moreover, the war severely weakened Britain’s financial position.
- When Germany’s inability to pay debts associated with World War I threatened other countries’ financial systems, the United States, with its isolationism policy, refused to finance a new loan to avoid crisis.

Globalization of Finance

III. The Bretton Woods System, 1946-1971

- Following World War II, the United State embraced internationalism, aimed both at avoiding the mistakes that had led to World War and at heading off competition from the Soviet Union.
- As a result, the United States and its partners pursued the Bretton Woods system or "embedded liberalism," which opted for fixed exchange rates and domestic monetary autonomy at the expense of the free flow of capital across borders.

Globalization of Finance

- The Bretton Woods system key components:
  1. The price of the U.S. dollar was fixed to gold at $35 per ounce. But, the United States continued to issue more dollars in order to facilitate economic expansion.
  2. The prices of other currencies were fixed to the U.S. dollar. while other states had to adjust to changes in the world economy, the United States, as the standard setter, never had to adjust.
  3. All countries placed limits on the import and export of capital. Hence, imbalances in financial flows would occur primarily as a result of trade imbalances.

Globalization of Finance

- By the 1960s, the number of dollars held in foreign hands grew much faster than supply of gold backing them.
- In early 1970s, redemptions of dollars from abroad for U.S. gold increased as many states saw less reason to hold dollars as "payoff" for the U.S. role combating the Soviet Union and the Vietnam War.
- In 1971, U.S. President Richard Nixon announced that the United States would no longer redeem dollars for gold and that henceforth the dollar would be allowed to float against other currencies. Hence, the Bretton Woods era was over.

Globalization of Finance

IV. Post-Bretton Woods System, 1971-1980s

- The leaders of the biggest economies called the G-7 (the G-8 with Russia and by many others in the G-20) meets regularly to coordinate economic policies.
- It was a mixture of coordinated government interventions, unilateral government policies, and market forces. It included partly floating exchange rates, limits on capital movements, and a moderate degree of domestic policy autonomy. The governments sometimes intervened in markets (buying and selling currencies) to alter the price.

Globalization of Finance

V. Global Capital Mobility

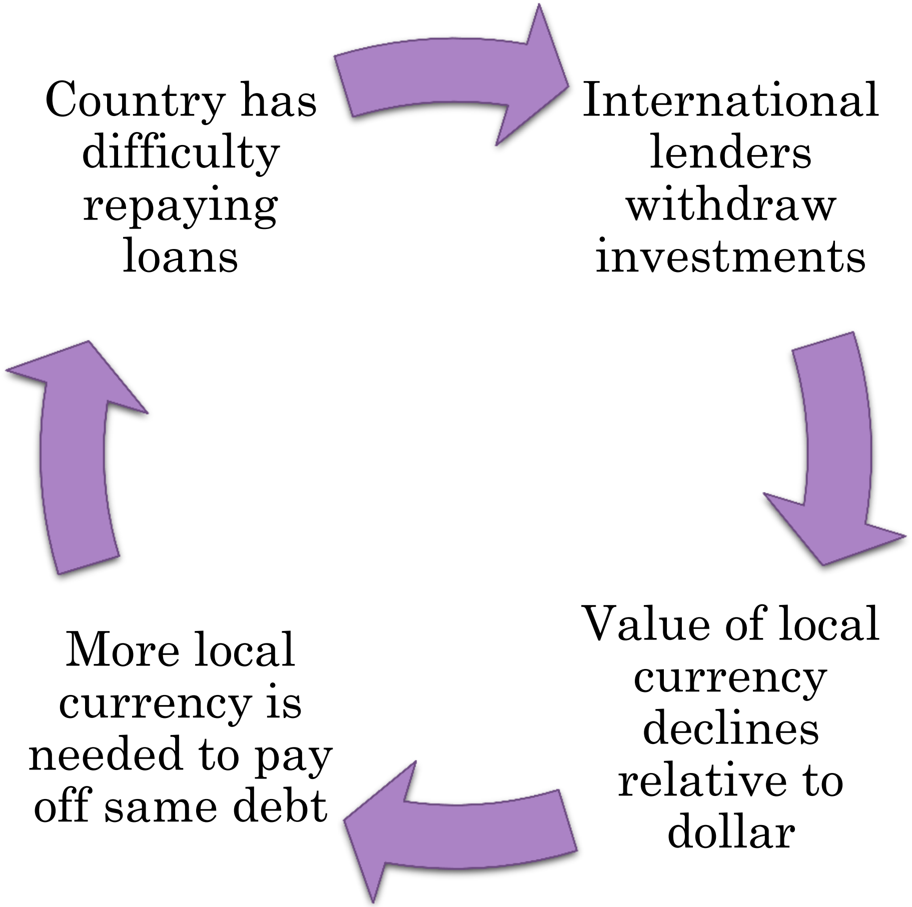
- In the 1980s and 1990s, an increasing number of states removed the restrictions on capital flows.
- First, in terms of interest group politics, actors who controlled a lot of capital (investment banks and corporations hoping to invest abroad) put pressure on governments to allow freer movement.
- Second, an ideology of liberalization: Thatcher government in Great Britain (1980-1990) and the Reagan administration in the United States (1981-1989).

Globalization of Finance

- Third, for countries that sought to bring in investment to promote economic development, allowing capital mobility provided access to massive amounts of international capital. Global investors were much more willing to invest in economies where they had the freedom to move money in and out at will.
- Opening up to global capital made it possible for developing states to bring much more money into their stock markets, providing investment that they badly needed and could not accumulate domestically.

Globalization of Finance

- Today, flows of capital around the world are now so large that not even the biggest governments can control them.
- Developing countries often do not have enough extra money in their economies to finance investment along with current consumption. So, they borrow internationally.



Globalization of Finance

- Debt crisis occurs when the debtor is no longer willing or able to make the schedule payment on its debts.
- On the other hand, a monetary crisis emerges when investors anticipate that the value of a particular currency is likely to fall.
- In the modern era with a great deal of cross-border stock investment and instant movement of capital, there may be a panic.

CREDIT RATINGS

LONG-TERM SOVEREIGN DEBT RATINGS

Ratings Agency

Country	Moody's	S&P	Fitch
U.S.A.	Aaa	AA+	AAA
Japan	Aa3	AA–	A+
Euro zone			
Finland	Aaa	AAA	AAA
Germany	Aaa	AAA	AAA
Luxembourg	Aaa	AAA	AAA
Netherlands	Aaa	AAA	AAA
Austria	Aaa	AA+	AAA
France	Aaa	AA+	AAA
Belgium	Aa3	AA	AA
Estonia	A1	AA-	A+
Slovakia	A2	A	A+
Slovenia	Baa2	A+	A-
Malta	A3	A-	A+
Italy	Baa2	BBB+	A-
Spain	Baa3	BBB-	BBB
Ireland	Ba1	BBB+	BBB+
Cyprus	B3	BB	BB+
Portugal	Ba3	BB	BB+
Greece	C	CCC	CCC

Investment Grade Ratings

- **Aaa/AAA** Minimal risk
- **Aa/AA** Very low
- **A/A** Low risk
- **Baa/BBB** Moderate risk
- **Ba/BB** Substantial risk
- **B/B** High risk
- **Caa/CCC** Very high
- **SD/RD** Selective Default Restricted Default

Sources: Moody's, Standard & Poor's, Fitch

REUTERS

Globalization of Finance

- Unmanagable panic sends the value of the currency crashing downward and the entire economy with it, as investors lose confidence in the ability of the market to right themselves.
- In the current system of capital mobility, it is not clear how the role of lender of last resort will be fulfilled (the US, the IMF, the EU, or China?)