David Youngberg

Econ 280—Bethany College

**Lecture 21: Exchange Rates and International Trade**

1. Floating Exchange Rate Regime
   1. In a floating exchange rate regime, market forces determine how rates are priced. Since there’s little to it beyond that, but since the market’s doing all the work, it seems like a good time to overview how various market forces change the rate.
      1. Because we will be focusing on changes in the short run, the analysis of E will be rooted in the demand for domestic assets. “E” is the foreign currency divided by the domestic currency (CF/CD).
      2. When E decreases, CD is *depreciating*. When E increases, CD is *appreciating*.
   2. PPP: As we discussed, the purchasing power parity influences the exchange rate. The more a currency can buy, the more the currency is worth. E increases as CD’s purchasing power increases (each CD can be exchanged for more CF).
   3. A change in the *relative* domestic interest rate causes appreciation (if the change is positive) or depreciation (if the change is negative).
   4. A change in the expected domestic price level causes appreciation (if the change is negative) or depreciation (if the change is positive).
   5. A change in the expected demand for imports in the country causes appreciation (if the change is negative) or depreciation (if the change is positive). The opposite is true for exports.
   6. A change in the expected domestic productivity causes appreciation (if the change is positive) or depreciation (if the change is negative).
2. Fixed Exchange Rate Regime
   1. A fixed rate first focuses on an “anchor currency” to be pegged to. China, for example, once kept their rate at about 8 yuan to the dollar.
   2. The domestic government (the central bank) holds foreign currency, drawing a distinction between the private sector capital account and the government’s capital account, often called the *official reserve transactions balance* (the government’s international reserves).
   3. It is with this reserve of foreign currency that fixed exchange rate regimes manipulate the market.
   4. Suppose China as a major manufacturer suddenly looks less appealing to the world at large, putting downward pressure on the yuan.
      1. At eight to the dollar, the yuan is currently *overvalued*.
      2. To defend the currency, the government buys yuan with their international reserves (causing them to shrink).
      3. In effect, the government simulates additional demand for a currency people are losing interest in.
   5. Now suppose China suddenly looks more appealing as an economy to the world at large, putting upward pressure on the yuan.
      1. At eight to the dollar, the yuan is currently *undervalued*.
      2. To defend the currency, the government sells yuan for additional international reserves (causing them to grow).
      3. In effect, the government simulates a lack of demand for a currency people are gaining interest in.
   6. Many governments have tried to fix the exchange rate in the past in the hopes it would create greater stability and thus possibilities for growth. But in practice, these regimes have a hard time lasting. If problems with the economy keep cropping up, the foreign reserves will drain away and a *devaluation* of the currency (fixing it to a lower level) must occur. (By contrast, the reverse—*revaluation*—happens but is rare.)
3. GATT
   1. Established in 1947, the goal of the General Agreement on Tariffs and Trade (GATT) is to reduce trade barriers between countries.
      1. At first, it didn’t do this in the “normal” way of removing legal barriers. Many tariffs at the time were specific dollar amounts that members allowed to fade with inflation.
      2. After that first reduction, GATT’s progress was slow and mostly just added new members. But after countries in Western Europe reduced barriers between each other in the 1960s, the U.S. led a charge to reduce world tariffs to keep America competitive. This process continued and now the average tariff rate in the U.S. is less than 10%.
   2. GATT is a treaty any country can sign on to with the aim to reduce barriers to trade across the world. The major way it does this is through its Most Favored Nation (MFN) clause. When a country is another’s MFN, then the lowest tariff for any product is extended to that country. All GATT countries are each other’s MFN.
   3. GATT is a treaty and for most of its history, it had no body to hear disputes. When one country would violate GATT, other members would effectively exclude that country from the agreement, raising trade barriers. A common example of this is a *retaliatory tariff*.
   4. Embedded in the GATT are exceptions to various products and countries (notably the agricultural sector and many developing nations). The GATT also allows countries to form smaller trade blocs, such as free trade zones. Despite the use of “General” in GATT’s name, it can be quite discriminatory.
4. World Trade Organization (WTO)
   1. Despite all the focus on the WTO, it’s actually quite young compared to the GATT. Founded during the Uruguay Round of talks (1986-1994), it is the institutional body of the GATT. It has 150 members.
   2. The main function of the WTO is to hear disputes. Is the tariff country A established in violation of the treaty (and thus allows for retaliatory tariffs) or is it legal? Is the quota country B put up illegal or a proportional response to A’s tariff?
      1. Not surprisingly, the results of these rulings are under constant criticism often by groups who feel the WTO isn’t putting enough weight on an issue (women’s welfare, the environment, working conditions, etc.)
      2. Companies have their hand in this WTO lobbying as well. The general removal or addition of restrictions, intellectual property, and goods where there are conflicting legal standards are common themes.
5. Dumping
   1. In theory, dumping is pricing below cost to force domestic companies out of business. In practice, the comparison comes between the importing price and the price in the importer’s home market.
   2. Antidumping laws attempt to correct this “unfairness.” A domestic company can accuse an importer of dumping and the case is brought before the Commerce Department. If found guilty (which usually happens), import duties follow to correct the “imbalance.”
   3. Commerce checks for “less than fair value,” or if the export price is less than the normal price. Normal price is found in one of three ways:
      1. Price importer charged in its home market.
      2. Price importer charged in a third country.
      3. Constructed value, where the commerce department tries to estimate a fair price based on production costs, administration costs, and a “normal” profit margin.
   4. Results vary widely based on the method used, with the constructed value often resulting in the high margins. Not surprisingly, the constructed value is increasingly relied on.
   5. Once ruled, the International Trade Commission determined if the competing industry is “materially injured”[[1]](#footnote-1) by the dumping. They do not rule on the harm to consumers or to other domestic industry. If material harm exists, AD tariffs follow as a matter of law.
6. Complications
   1. Firms engage in *price discrimination*—when a firm charges two different prices to two different groups even though costs are constant.
      1. Some groups of people are more sensitive to prices than others. For “elastic” demand curves, lowering price increases revenue. For “inelastic” demand curves, raising price increases revenue.
      2. Many firms *have to* price discriminate to survive, offering deals to the more sensitive and charging higher rates to the less sensitive. Some form of PD crops up in virtually all industries.
      3. Country populations can differ in elasticity, based on the conditions of the country. Americans, for example, often have many choices due to a strong competitive environment. This encourages companies to price lower than they might in another country.
   2. The Commerce Department weighs any *individual* price versus the *average* home market price the accused firm charges.
      1. Since prices change over time, this is tremendously deceptive. It becomes pretty easy to find a U.S. price that’s less than the average foreign price.
      2. Furthermore, whenever the U.S. price exceeds the average price foreign price, the Department ignores the instance. Dumping occurs even if 99/100 prices are higher and just one is lower.

1. Meaning “harm which is not inconsequential, immaterial, or unimportant.” [↑](#footnote-ref-1)