GEOPOLITICAL STRATEGY OF STATES IN TRADE SURPLUS

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Abstract

This paper highlights the role of a national state in the international financial system scenario. The case study herein reported details the creation of an "optimum currency area" (OCA), linked to a fixed currency exchange. A geopolitical strategy, able to give rise to 2 different state categories, is described. On one hand, there are numerous geographical areas in economic surplus, on the other there are some in economic deficit. The relationship of the countries, united in an OCA, defines a hierarchy linked to the economic value and production capacity created by each territory.

1. An Optimum Currency Area: a Geographical Enclosure for Global Economies

The political economy of a country is linked to the use of one's own currency. However, a state could renounce using this economic instrument, thus losing the ability both to make a national monetary policy and to establish advantages for the competitiveness of production in goods and services. The countries adhering to a monetary union i.e. an Optimum Currency Area (OCA) sign a political and financial agreement linked to the removal of power from the national banks. The members of a monetary union cannot modify the price of the respective currencies using the financial instrument of devaluation and revaluation. An OCA does not allow the national financial system to determine the amount of money required for public expenses within a state or it to modify the short-term interest rate, so that the political capacity of each member to modify the local economic trends is blocked. This financial and economic strategy is not able to increase the local competitiveness trends or to decrease the economic and social divergences.

This economic and geographical analysis, called OCA, was studied and reported by Robert Mundell (1961), McKinnon (1963) and Kenen (1969) emphasizing the costs and benefits of the monetary union linked to competitive advantages or disadvantages (Ishiyama, 1975; Tower, Willett, 1976; Mongelli, 2002).

The OCA strategy is linked to the rigidity of the exchange rate, imposing a common monetary policy to the countries in trade deficit economic policies, aimed at making macroeconomic convergences emphasizing economic and financial dynamics, based on mercantilist ideology (Bagnai, 2012). The choice of each state to adopt a common currency is linked to a complex rule system between technical and political laws. The

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political system is divided into two layers, e.g. there are the advantages raised by the monetary union for the middle-class creating more employment and social mobility and numerous economic advantages for the social élite.

The most important advantages linked to an OCA geographical area are: the decrease of costs both for financial transactions and the uncertainty of the financial exchange. However, the macroeconomic impact linked to the decrease of financial transactions costs is low, it is quantifiable in 0.4% of GDP (Emerson, 1990). There are fewer advantages for the territories as most of the financial transactions are linked to a large amount of money with a low impact of commissions. Indeed, the financial markets have created a system called *forward market* able to protect the financial operators against financial risks.

The OCA project is contradictory from a macroeconomic point of view, as there is no need for a monetary union in a group of states with a similar range of institutional levels, economic productive factors and economic policies producing balanced exchanges. In fact, their exchange rates have similar trends and the uncertainty of financial exchange is negligible. Some authors on macroeconomics have reported that alignment plays a pivotal role in the exchange trends of each country (Kim, Mao, 1995). The OCA system is useful to territories with inhomogeneous economic and financial systems, in order to avoid productive economies that decrease the economic divergences and the range of currency exchange. The exchange flexibility is a useful tool able to reduce the economic divergences connected to the economic productive factors amongst countries, as it is important to decrease the costs linked to the economic fundamentals within the economic shock cycles. However, renouncing monetary flexibility means imposing high cost levels in social and economic environments.

The OCA theory is connected to the concept of harm reduction by the adoption of a fixed monetary exchange i.e. all economic fundamentals of each country are analysed and emphasized to introduce the strategy linked to not damaging the respective economies. However, numerous policies have been made to compensate for the economic rigidity introduced by a fixed exchange i.e. mobility of productive factors[1], wage flexibility[2], industrial diversification[3] (Kenen, 1969), openness to foreign trade, the convergence of inflation levels towards a common value (Fleming, 1971) and tax integration. Moreover, one important goal is to make a two-layer system, i.e. a set of efficient rules and common political strategies (Kenen, 1969).

However, in Europe, there are no *best practices* so as to overcome the current economic and social crisis, i.e. the job mobility is discouraged by cultural and language barriers, different education systems and social security, as well as the segmentation of the job market. The mercantilist ideology evaluates exclusively positive strategies and the economic policies aimed at increasing the export flows, downloading the costs of economic adjustments to the countries in trade deficit[4]. The strategy linked to

[1] This strategy emphasizes the movement of the unemployed during the economic cycles of stagflation. This flow of people stems from countries in economic deficit, to States in economic surplus, where there it is easier to find employment.

[2] This job policy is connected to recovering territorial competiveness, thus decreasing the productive costs of goods and services.

[3] It is an industrial strategy linked to the economic dynamics of scale economies, which are useful in overcoming difficulties connected to a specific productive hub.

[4] Wage flexibility is linked to the reduction of *pro capita* income within the countries in trade deficit, e.g. one case study by PIIGS (Portugal, Ireland, Italy, Greece and Spain). The strategy linked to the

productive diversification is bad for the smaller economies as they have more difficulties in emerging in every productive sector and to take advantage of scale economies. Krugman (2015) reports on how the tax and monetary integrations in numerous states in a monetary union are connected by gathering some specific productive branches to create economic comparative advantages within each country. Moreover, the monetary union is not an efficient strategy for the cost distribution during economic shocks, as some productive branches are gathered by the scale cycle of economy and are the ones that are most affected by the economic crisis. The differences linked to trade volumes are linked to geopolitical tensions that have been ignored by governmental intuitions for the political project in the Eurozone.

2. Economic Adjustments within States in Trade Surplus

This case study, connected to the states in trade surplus, aims at clarifying some geopolitical strategies within an OCA. This paragraph gives a strategic example linked to states in economic surplus, hereafter know as S, all of which have a larger volume of export than import. Moreover, the goods, services and currency of an S are highly valued and exchanged, so as to link the financial market to the law of supply and demand. They suffice to both balance the trends of the national currency and link the increase of demand to exchange value. This analysis highlights how goods and currency of S are fundamental.

The financial market establishes the price of the exchange rate and evaluates it faster than the market connected to goods and services, enabling instant bargaining. The trend of financial increase is mainly linked to the exchange rate, which, in turn, increases the monetary value. Then, there is a revaluation of the assets of an S, which become more expensive for *foreigner traders* (i.e. those outside **the S**) as the currency value of an S increases to decrease the export trends of the S. However, the residents in an S have more spending power within foreign financial and economic markets, this means that they can increase their imports. The foreigner traders analysing the high trends of currency value consider the currency of an S a good investment and are willing to buy their bonds, i.e. stocks, bonds and government bonds. These financial flow movements from other countries to an S allow for the lending of money to residents within an S. The result of this financial chain is a rebalancing of the import and export trends of goods and capital flows, emphasising the increase of imports in both cases. This currency rebalance is linked to the creation of a larger market for people who live within an S, as monetary revaluation is connected to spending power aimed at increasing the import flows. Moreover, the currency demand of an S allows for inexpensive financing, i.e. the foreigner traders invest in an **S's** stocks by lending money to its residents, in an effort to obtain a capital gain from the difference between the initial and the last exchange rate linked to the future revaluation. This case study of financial flows discusses how money is invested in an **S**.

The monetary revaluation within a country in surplus trade makes raw materials cheaper, stimulates consumption and accelerates the foreign capital investments. However, the presence of a greater amount of money creates inflation connected to the

decreasing income of the middle and worker classes is implemented also within the countries in trade surplus, as the economic and social élite refuse to share the earnings made with the rest of society, aiming to keep production costs low. The strategy linked to keep the levels of the territorial competitiveness high creates external economic imbalances (De Grauwe, 2012).

goods and services in an **S** making them less convenient. Thus, the export trends decrease in an S, creating a financial rebalance linked to economic growth, which focuses on internal demand for goods within the **S**. The exchange flexibility makes an easier economic and financial adjustment between an **S** in trade surplus and the other countries in trade deficit.

3. The Geopolitical Strategy within the States in Trade Surplus

One of the main issues involved in OCA is the political relationship amongst the countries who decide to join the monetary union. Indeed, some states are known as "central," i.e. all countries that are in trade surplus, others are called "peripheral," i.e. all territories that are in trade deficit. The central regions have a strong financial and industrial base, whilst the peripheral regions are relatively backward. Frenkel's economic model (Frenkel, Rapetti, 2009) may be used to analyse the geopolitical strategy of the countries in trade surplus. This model is formulated to identify the economic and political steps so agreements linked to form a monetary union can be signed, i.e. the choice to adopt a fixed exchange, making new trade agreements within the OCA regions, aimed at the implementation of financial and economic integration within the monetary union. The central regions *suggest* the peripheral countries (in trade deficit) adopt *The Code of Liberalisation of Capital Movements* and a fixed exchange. Thus the central countries reach a double goal, i.e. they can lend money to the peripheral states (fig. 1) without running exchange risks, the peripheral regions always have the highest internal interest rates (fig. 2) with the aim of obtaining returns on the investment. This political scenario is a good strategy for the peripheral regions to obtain easily borrowed money linking to the second advantage of the central states i.e. to make an inflation economic cycle within the peripheral countries connected to a two-fold goal i.e. on the one hand the peripheral regions can increase the pro capita incomes through a easy access to credit aimed at buying the central countries' goods and on the other, the central states can make another market for their goods within the peripheral regions (fig. 3).

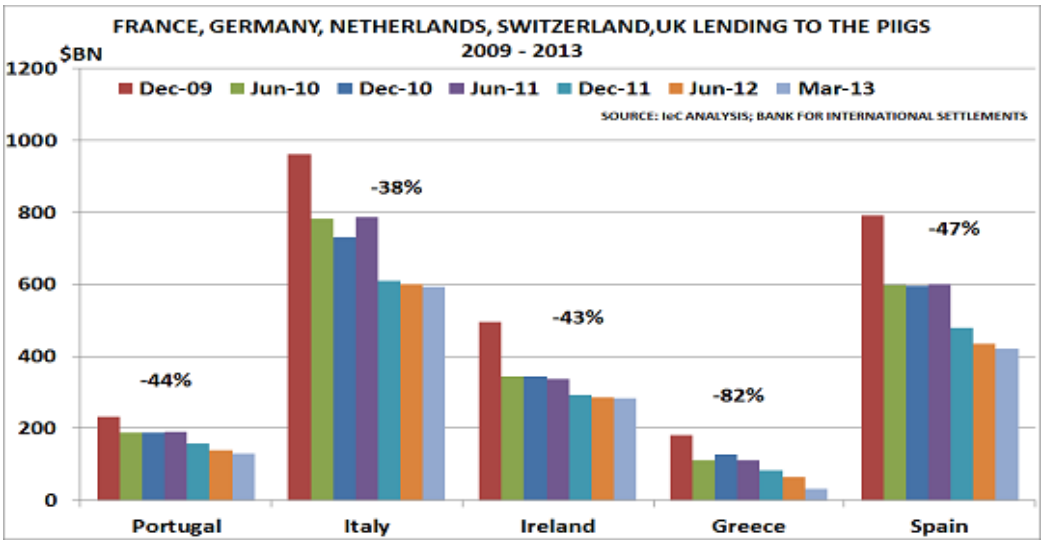

Figure 1

Source: https://www.icis.com/chemicals-and-the-economy/2013/10/the-eurozone-debt-crisis-is-no-nearer-solution.

However, the inflationary economic trend is linked to the economic growth within the peripheral regions, emphasising an improvement of public finances i.e. the relationship between public debt and GDP is stable or decreased depending on the increase of the private debt, i.e. the foreign capital is lent to families and entrepreneurs. The inflation trend is linked to an excess of easy credit, making foreign goods more competitive. Moreover, the deficit trade tends to expand, which then requires foreign capitals to finance the trade imbalance.

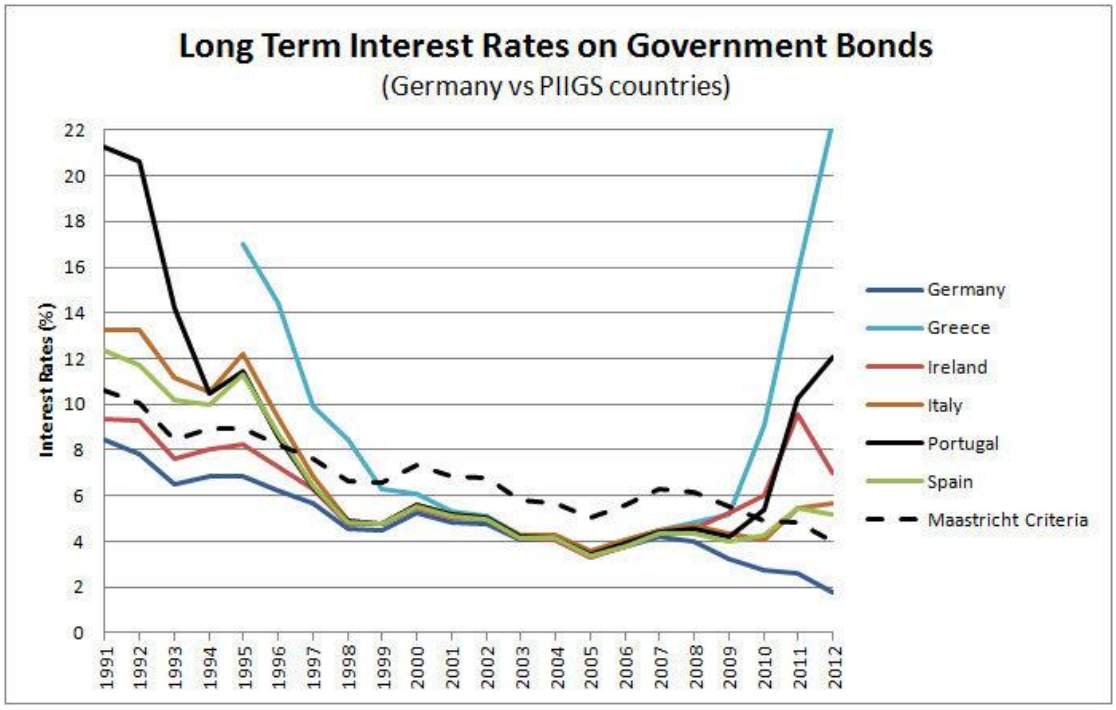

Figure 2
Source: Kuo R. (2012).

Capital flows lent by the central regions to the peripheral countries constitute debts that the states in trade deficit have to repay. The states in trade surplus then use a pretext, such as the outbreak of an economic recession to put in doubt the deficit countries' ability to repay the debts. Moreover, the central regions ask the peripheral countries for a higher interest rates than those previously agreed to cover the risk on the debts, making a process of acceleration to increase the spread so that the countries in deficit trade are pressed by the debt spiral. The debt cycle is linked to a social and political scenario of crisis e.g. Greece's economic and financial crisis, in 2009.

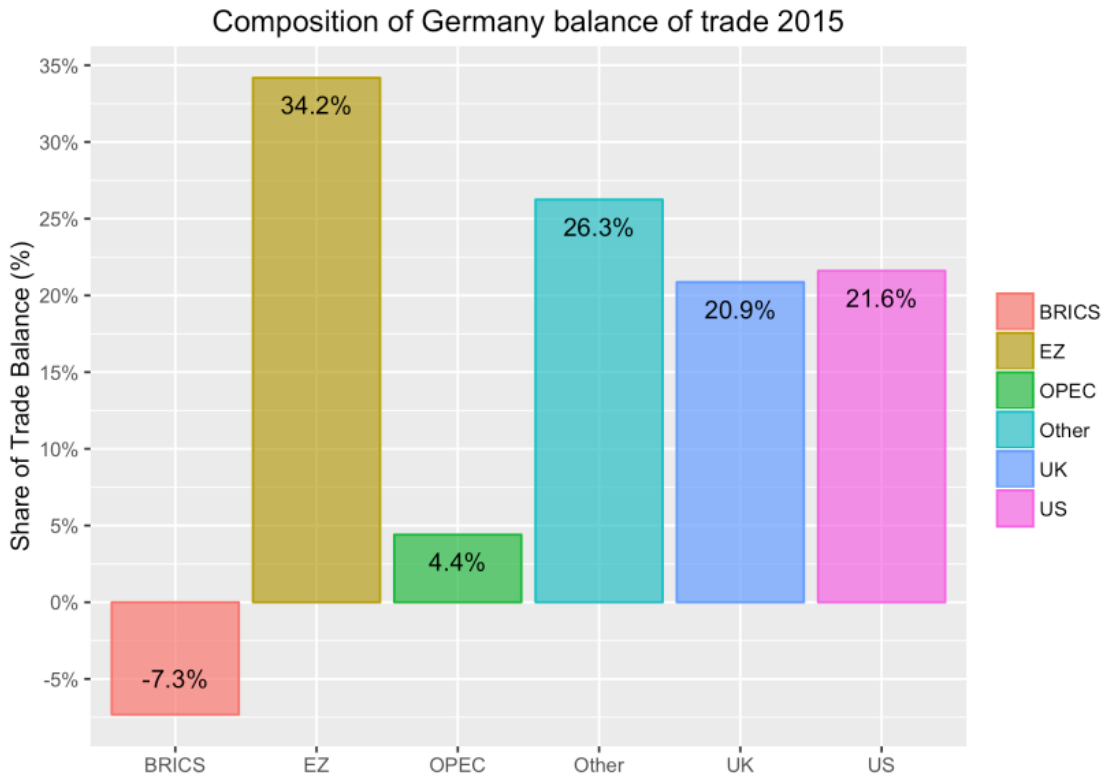

Figure 3: This graphic is connected to the trade trends of Germany, that is both a central region within the EU group and a state in trade surplus. The European area becomes a large internal German market.
Source: Eurostat.

The strategies of political destabilization are led by the financial markets as there is a speculative gain; during the inflation phase the central regions make high interests to create financial instability, linked to the national banks. The private debts of the national banks are repaid by *the state*, who, in turn increases taxes to cover them. It has been reported that public debts create financial and economic instability. Therefore, a financial analysis of the economic crisis must include a study of the national banks' debt level, which is connected to the loan the banks have made to families and companies. There are numerous ideological solutions that create obstacles for the making of public policies and facilitate the neoliberal policy for the free action of the financial market. Most economic interests are linked to the economic élite within the central regions i.e. the industrial classes earn through the sale of goods within the peripheral countries, creating political strategies against trade unions through external economic constraints. Indeed, the policies connected to wage deflation and increase in production are tools that enable the economic system to reach its profit goal (fig. 4; fig. 5) (Acocella, 2005).
However, only some economic élite benefit from the economic advantages within the countries in trade surplus, as the success is linked to the industrial system based on the export of goods and capitals. The exporter territories must decrease their internal consumption as they can become imports which, in turn, create economic advantages for the peripheral regions. Therefore, the citizens within the state in trade surplus do

not always benefit from the big profits made within the countries in trade surplus (Bagnai, 2012).

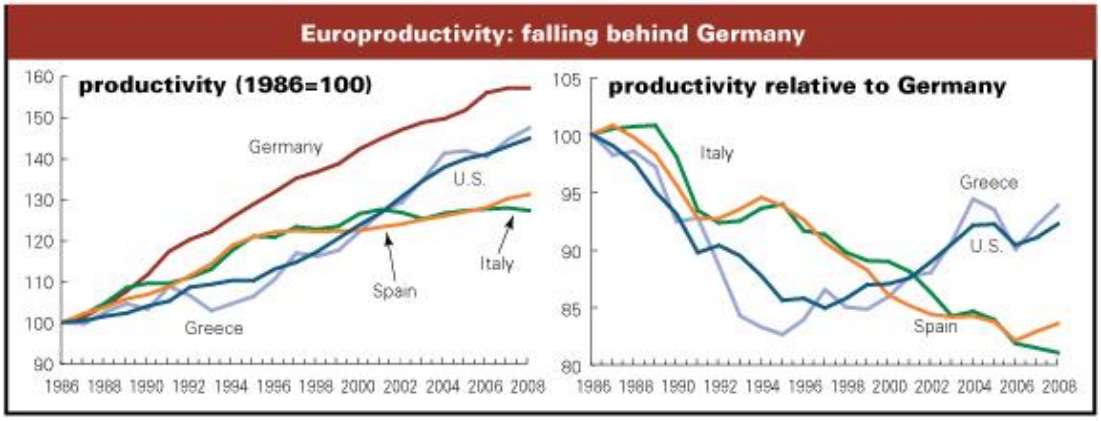

Figure 4
Source: Eurostat.

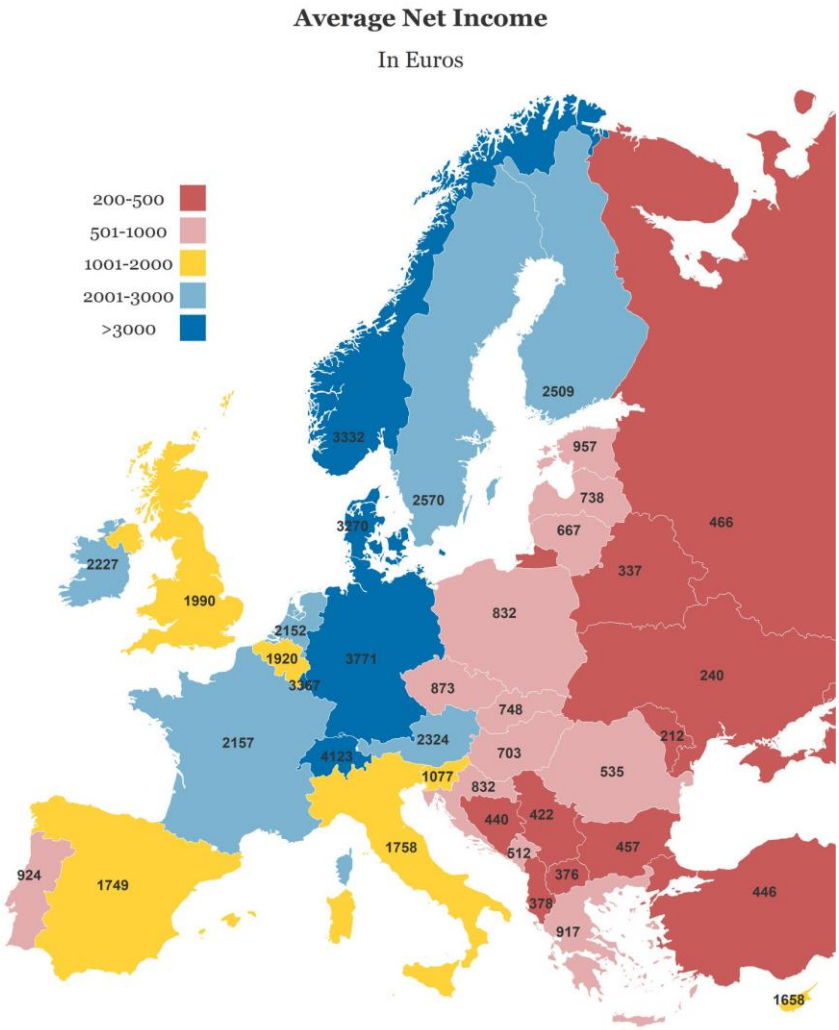

Figure 5
Source: Eurostat.

4. Conclusions

The modern economies are linked to endogenous cycles (Minsky, 1982), i.e. there is an expansive phase connected to both a good economic trend and the introduction of innovations and deregulation of the financial market; there numerous financial agents who take a progressively riskier financial position. There is also a debt step linked to the financial markets and another phase connected to the purchase of financial securities with a high risk level. However, whilst, on the one hand there is an economic and financial trend connected to an inflation trend, on the other there is a recessive cycle.

Frenkel (2009) adds two important links i.e. he emphasises the existence of a transnational level (centre/periphery) linked to the relationships between debts and credits; he also highlights an exogenous feature connected to an economic cycle linked to the changes in economic policies that adopt a fixed exchange rate and the liberalization of the financial markets. The economic and financial analysis always raises the contraposition between centre and periphery, i.e. the former are the United States of America or the Anglo-Saxon countries that are the international financial hubs; then there are all territories in the South of the world. Moreover, Frenkel analyses the economic cycle linked to *The Glorious Thirty* i.e. the period after the Second World War. During this period economic crisis were not so frequent or as large as todays. The change in the economic trends is linked to the choice to deregulate the financial markets promoted by Regan and Thatcher in the '80s concluding the previous period of financial control, called *Bretton Woods*. The Bretton Woods' agreements were linked to the government control of the interest rates and there were national markets that financed the public debt (Reinhart, Sbrancia, 2011). The features of the financial markets were: the local banks' dependence on the National Treasury that is involved in financing public expenditure. The other financial institutions, i.e. banks and pension funds, were linked to the direct or indirect state control. The cost of money was fixed by the state who established goals of maximum limits for interest rates. The capital movement were controlled as the capital flows would have fled to places with lower taxes and the capital inflows were controlled so as to maintain the property of national strategic assets. The national financial institutions were controlled by the governments so as to impose a portfolio constraint and the purchase of a share in the public debt. A limit, linked to the bank credit was imposed to eliminate the risk of a high debt level. The state was not highly indebted, that is its relationships between the GDP and public debt decreased as it did not use interest expenditure linked to the increase in the tax levels for the essential services and the redistribution of income from taxpayers to holders of debt securities.

It is a must to analyse the economic and financial system linked to the '80s when politics controlled finance, if we are to limit the movement of capitals, profits and interest rates. The world connected to the Bretton Woods' agreements was more stable, the national states used some economic and political instruments to change the dynamics linked to the economic and financial recessions.

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