
THE WORLD ECONOMY:

TRADE AND FINANCE

Second Edition

Beth V. Yarbrough

Robert M. Yarbrough

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both of Amherst College

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PREFACE

The success of the first edition of *The World Economy: Trade and Finance* underscores a widespread perception of increased importance of international economics for understanding events in the world. Students, economists, policy-makers, and citizens are more aware of international issues than ever before. Everyone agrees that the issues are crucial, but consensus on the nature of problems faced by policymakers and the precise character of appropriate remedies is elusive.

Despite the hectic pace of international events, where a single month like December 1989 can change the face of Eastern Europe, the tools of economic analysis still provide a great deal of insight into the ever-changing world economy. The goal of this second edition of *The World Economy* remains unchanged from that of the original: to develop the tools of international economic analysis clearly, consistently, and comprehensively and to establish the theoretical principles basic to the analysis of international economic problems.

By combining theory with current events and policy debates, this text emphasizes learning how to *use* international economics as a tool for understanding. If it achieves this goal, the student will be able to analyze all types of problems independently, not just those that dominated the headlines at the time of the book's writing. On the other hand, *The World Economy* does not glorify theory for its own sake. The rule we have endeavored to follow is: Any theory worth mentioning is worth teaching the student to use.

The integration of clear, concise theory with up-to-date examples and cases sets this book apart from its competitors. One example of this integration is a strong focus on the distributional consequences of policy throughout both the international trade and open-economy macroeconomics sections of the book. These consequences are the crux of international economic policy controversies, but most texts shortchange them with a flurry of tangency conditions. A second example is the extensive treatment of nontariff barriers to trade and the "new protectionism" provided in Chapter Eight; this is where the action is as the Uruguay Round of trade negotiations nears completion. Third, the debt problems facing developing countries are treated extensively from both micro (Chapter Ten) and macro (Chapter Twenty-One) perspectives, as well as being linked to other world events including macro and trade policies in the developed countries and capital flight.

Changes from the First Edition

Although the basic goals of the book remain unchanged, this revised edition incorporates a number of improvements. The most obvious is the introduction of a two-color format that substantially enhances the clarity of the figures and the book's overall appearance.

The book has been thoroughly updated and revised. This includes the text of each chapter as well as figures, tables, and cases. Existing cases have been expanded, and many new cases added to reflect current events and issues. Just a few of the many new cases include trade policy in the semiconductor industry, the effects of

maquiladora plants along the U.S.-Mexico border, and the statistical discrepancy in the world current account.

Some of the current events with new or substantially expanded coverage in this new edition are the Omnibus Trade Act of 1988, European Community preparation for 1992, the U.S.-Canada free-trade pact, changes in U.S. immigration laws, industry outsourcing, proposals for dealing with developing country debt, the debate over macroeconomic policy coordination, disagreement over the “correct” value for the dollar, and the increased use of markets in Eastern Europe and the Soviet Union. In terms of theory, this edition contains new or expanded treatment of the specific-factors model, intertemporal trade, the J-curve, the asset approach to exchange rates, the “twin” deficits, exchange rate expectations, distinctions between permanent and temporary macro policies, and exchange rate overshooting.

Unique Coverage of Open-Economy Macroeconomics

Our continuing goal in the open-economy macroeconomics portion of the text is to examine ongoing debates and controversies within the context of well-established models. This is reflected in our attention to the distinctions between real and nominal magnitudes and between temporary and permanent policies and the distinctions’ importance for economic policy-making in an international context. The first edition of *The World Economy* broke a major barrier by developing an aggregate real demand/aggregate real supply model under both fixed and flexible exchange rates (Chapter Eighteen). The reaction to the chapter from both students and instructors has been overwhelmingly positive.

Real-World Emphasis

The World Economy is self-contained in that it defines all necessary concepts; it does not rely on students’ memory of other courses. Numerous tables tie abstract concepts to their measurable counterparts. We believe that an international economics course should familiarize the student with the empirical reality of the world economy as well as with abstract models of it. This is reflected in more frequent use of real-world data than is typical in other texts. In addition, we frequently refer to common errors or misinterpretations in the popular press. Learning how to read the newspaper or listen to the evening news with a keen eye and ear is at least as important as learning how to read the scholarly literature.

Graphics

All graphs are fully integrated into the text and are accompanied by self-contained legends. We encourage students to practice active translation between graphs and legends. (*Can you cover the graph and draw your own given the legend? Can you cover the legend and write your own explanation of the graph?*) Once again, the emphasis is on learning to use the graphs as tools for understanding, not on memorization.

You may notice that *The World Economy* has more graphs than some other texts. This reflects our choice to avoid both illustrating multiple results in a single graph

and leaving the case of the second country to the reader. The number of graphs as well as their new two-color format should make the book's arguments easier to follow.

Useful, Clear Pedagogy

Major sections within each chapter are numbered for easy reference. At crucial points in an argument, the student is asked "why?" These queries encourage active reading, stopping the reader from passively moving through the argument without confronting its underlying logic; comments from our students indicate that the queries are successful in achieving their goal. Each chapter contains several cases, a summary, a "Looking Ahead" section that links the chapter to the next one, a list of key terms (boldfaced in the text), review questions and problems, and a list of supplementary readings. The cases provide real-world examples as well as extensive empirical information about the countries of the world economy. The revised and expanded end-of-chapter questions and problems review the major concepts from the chapter and relate those concepts to current policy debates. Unlike the bibliographies in many texts, the readings suggested here include short, up-to-date articles as well as classic treatises (we do not mean to discourage students from reading the classics!). Each reading is noted as appropriate for introductory, intermediate, or advanced students. We also include a list of source materials for international data (Appendix to Chapter One). It is our hope that this material will aid students in pursuing subjects of particular interest and in locating potential topics for term papers and projects.

Organization of the Book

As in the first edition, the text is organized in two parts. Part One (Chapters Two through Eleven) covers international microeconomics and Part Two (Chapters Twelve through Twenty-One), international macroeconomics. Basic theoretical development, examples, and cases are contained in the main body of each chapter. Extensions and other optional materials (for example, the derivation of a world production possibilities frontier, Edgeworth boxes, offer curves, and algebraic formulations) are covered in appendixes that can be assigned at the instructor's discretion.

Intended Audience

By presenting the fundamentals of international economics clearly but rigorously, the text becomes adaptable for a variety of courses. Our correspondence with users of the first edition indicates that the book has been used successfully in a number of different ways. Students with only a one-semester introductory economics course as background have no trouble mastering the material; in fact, we use the text extensively in classes at that level. All appendixes can be omitted without loss of continuity, and any supplementary reading can be chosen from articles denoted as appropriate for beginning students. For students who have completed courses in intermediate micro and macro, the appendixes can be added along with a wider

range of supplementary reading. The book can serve beginning graduate students with no specific background in international economics and provide a stepping-stone to more advanced texts and the professional literature. The book also appeals to students of political science, international relations, and international business by providing insight into economics' unique perspective on international issues.

Alternative Course Outlines

For full-year courses, the entire book can be covered along with a sizable sample of readings. The micro-macro ordering reflects our own teaching preferences but is easily reversible. In a one-semester course emphasizing microeconomic aspects of the world economy, we use Chapters One through Eleven, but it is possible to omit any combination of Chapters Five, Six, Ten, and Eleven to permit more extensive use of supplementary readings. In a one-semester course emphasizing macroeconomics, we cover Chapters Twelve through Twenty-One, but any combination of Chapters Sixteen, Seventeen, Nineteen, Twenty, and Twenty-One can be omitted. By limiting the scope of outside readings, a one-semester course can easily cover the essentials of both the micro and macro perspectives. We have taught such a course by concentrating on Chapters Two through Four, Seven through Nine, Twelve through Fifteen, and Eighteen. No doubt many other permutations are possible. For users of the first edition, the basic chapter structure remains unchanged.

Instructor's Manual

The *Instructor's Manual* that accompanies this book includes more information on alternative course structures. The *Instructor's Manual* also contains the following:

- Answers to the "Why?" questions running throughout the text
- Answers to the end-of-chapter problems and questions
- Advice on teaching the course

Acknowledgments

This new edition would have been impossible to produce without help from a number of individuals. For the successful metamorphosis of black-and-white manuscript into colorful book, we are grateful to the entire staff of The Dryden Press, especially Becky Ryan, Eric Elvekrog, Paula Dempsey, Karen Shaw, and Alan Wendt. We are fortunate to have benefited once again from Nancy Maybloom's patient copyediting.

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