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INTERNATIONAL ECONOMICS

• SECOND EDITION

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In recognition of their deep appreciation
for education and of their love and support,
we dedicate this book to our parents.

PREFACE

We have been teaching international economics since the late 1960s, mostly at the University of North Carolina at Chapel Hill, and have been very pleased with the strong student interest in the area over the years. This interest reflects the growing internationalization of economic activity and the recognition that no intelligent citizenry can focus only on its own country's economy when viewing and interpreting economic events. Especially in the United States, international economic events used to be confined to the business and financial sections of newspapers and newsmagazines, and seldom appeared in radio and television newscasts. Happily, this relative neglect has disappeared, particularly since the breakdown of the Bretton Woods system in 1971 and the occurrence of the first OPEC "oil shock" in 1973–74. Concerned individuals, including of course college students, now can hardly avoid a passing acquaintance with such newsworthy events as the acerbic attempts by a number of industrialized countries to induce Japan to increase its imports and thereby reduce its trade surpluses, the ongoing protectionist debates associated with the North American Free Trade Agreement and the Uruguay Round of trade negotiations, monetary union in Europe, the emergence of China as a major exporter and market, and the difficulties of the transition to market economies in the countries of Eastern Europe and the former Soviet Union.

Our motivation for writing the first edition of this book was that we were not satisfied with the clarity and the coverage of existing texts. We found that the level of analysis was often either too advanced (thereby posing difficulties for noneconomics majors) or too elementary (thereby failing to stimulate economics majors). In addition, the quality of treatment of the two main subdivisions of international economics—international trade theory and policy and international monetary theory and policy—was often inconsistent. A very good treatment of trade was matched with a weaker treatment of international monetary economics or vice-versa. Further, we felt that it would be helpful to bring out more fully the insights of the Classical economists, as well as the insights associated with several of the newer trade theories and contemporary policy approaches. In addition, we felt that more attention needed to be paid to both the trade and monetary problems of the developing countries and the problems of economic integration among nations. In short, we wanted to write a text that was comprehensive and uniformly clear and, most importantly, that could help students move beyond recognition and toward an understanding of current and future international events.

We have been very flattered by the favorable response to the first edition. In this second edition we have built upon the well-received features to develop a text that is even more attuned to our objectives. Because of the positive response to the coverage of international trade, no fundamental changes have been made in that material. However, there has been some reordering in the description and analysis of trade policy instruments, and an expanded treatment of the role of trade in economic development has been provided. The major changes in this second edition are a reorganization and a more thorough development of the international monetary material. Due to the growing

importance of international financial flows, we felt it important to devote more attention to the integration of the monetary and portfolio balance approaches into the overall framework of analysis. This was accomplished by considering the role of financial flows in influencing exchange rates earlier than in the first edition, and by consolidating the information on the traditional price (elasticities) and income approaches. As in the first edition, we continue to rely on the IS-LM-BP framework for analyzing macroeconomic policy, because we believe that the framework is effective in facilitating student understanding and since that material was very favorably received by users of the first edition. However, in this new edition we have incorporated key aspects of the monetary and portfolio approaches into the IS-LM-BP model, thus adding to the richness of the overall framework.

In addition, throughout the text, we have updated key information and have included features to make the book more student-friendly. Chapter introductions now include a “roadmap” to indicate more thoroughly the topics of the chapter and to motivate student interest, and more real-world questions have been added to end-of-chapter material. Further, effective case studies from the first edition have been retained and updated, and a number of new cases have been introduced. Despite these additions, the book is actually shorter this time around, since strenuous efforts have been made to delete out-dated and extraneous material.

As many instructors know, the rapidly expanding body of knowledge in international economics is making it increasingly difficult to cover both international trade and international monetary economics in a one-semester course. Consequently, growing numbers of colleges and universities are offering the subject in two semesters. In response to this trend, a major innovation is that this text is available not only in its entirety but also as two distinct parts (splits). Instructors in one-semester courses dealing with trade issues may wish to consider using the split, *International Economics: Trade Theory and Policy*, rather than the entire *International Economics* book. Similarly, for those teaching the monetary material by itself in a semester course, the split, *International Economics: Payments, Exchange Rates, and Macro Policy*, is available.

DESCRIPTION OF TEXT

Our book follows the traditional division of international economics into the trade and monetary sides of the subject. Although the primary audience for the book will be students in upper-level economics courses, we feel that the material can effectively reach a broad, diversified group of students—including those in political science, international studies, history, and business who may have fewer economics courses in their background. Having taught international economics ourselves in specific non-majors’ sections and Master’s of Business Administration sections as well as in the traditional economics department setting, we are confident that the material is accessible to both noneconomics and economics students. This broad audience will be assisted in its learning through the fact that we have included separate, extensive review chapters of microeconomic (Chapter 5) and macroeconomic (Chapters 23 and 24) tools.

International Economics presents international trade theory and policy first. For the trade section the numbering of the chapters is identical to that of the trade split, *International Economics: Trade Theory and Policy*. (The introductory material of Chapter 1 is identical in all three books.) Chapters 2–4 present the Classical model of trade, including a treatment of pre-Classical Mercantilism. A unique feature is the **devotion of an entire chapter to extensions of the Classical model** to include more than two commodities, more than two goods, money wages and prices, exchange rates, and

transportation costs. The analysis is brought forward through the modern Dornbusch-Fischer-Samuelson model. Chapter 5 then presents an **extensive review of microeconomic tools** used in international trade, and can be thought of as a “short course” in intermediate micro. Chapters 6–9 present the workhorse neoclassical and Heckscher-Ohlin trade theory, including an examination of the assumptions of the model. Chapter 6 focuses on the traditional production possibilities-indifference curve exposition. We are unabashed fans of the offer curve because of the nice general-equilibrium properties of the device and because of its usefulness in analyzing trade policy and in interpreting economic events, and Chapter 7 extensively develops this concept. Chapter 8 explores Heckscher-Ohlin in a theoretical context, and Chapter 9 is **unique in its sole focus on testing the Heckscher-Ohlin model** (including development of both the commodity approach and the factor content approach to testing).

Continuing with theory, Chapters 10–12 treat extensions of the traditional material. Chapter 10 **discusses various alternatives to Heckscher-Ohlin** as explanations for trade flows when assumptions such as international factor immobility, homogeneous products, constant returns to scale, and perfect competition are relaxed. An important focus here is upon imperfect competition and intraindustry trade. An appendix has been added in this edition to present the Rodney Falvey model that combines Heckscher-Ohlin and intraindustry trade. Chapter 11 explores the comparative statics of economic growth and the relative importance of trade. Chapter 12 examines causes and consequences of international factor movements, including both capital movements and labor flows.

Chapters 13–18 are devoted to trade policy. Chapter 13 is **exclusively devoted to presentation of the various instruments of trade policy**. A reorganized Chapter 14 then explores the welfare effects of the instruments, including discussion of the welfare effects in a “small country” as well as a “large country” setting. Chapters 15–16 subsequently work systematically through various arguments for protection. This **two-chapter treatment of the arguments for protection** (one for traditional arguments and one for newer approaches) is more extensive than in most competing texts. Chapter 17 reviews recent U.S. trade policy actions, and includes material on the successful conclusion of the Uruguay Round. Chapter 18—unlike the treatment in most texts—is **solely devoted to discussion of economic integration**. The chapter includes discussion of developments in Eastern Europe and the former Soviet Union and of the North American Free Trade Agreement, in addition to the standard theoretical analysis. The trade section concludes with Chapter 19, which provides an overview of how international trade influences growth and change in the developing countries. This material been brought forward into the trade section in this edition and has been expanded in coverage.

The international monetary material begins with Chapter 20, which introduces balance-of-payments accounting (Chapter 2 in the monetary split, *International Economics: Payments, Exchange Rates, and Macro Policy*). In contrast to most texts, **balance-of-payments accounting is discussed prior to the foreign exchange market**, which is considered in Chapter 21 (Chapter 3 in the monetary split). We think this sequence makes more sense than the reverse, since the demand and supply curves of foreign exchange reflect the debit and credit items, respectively, in the balance of payments. A differentiating feature of the presentation of the foreign exchange market is the **extensive development of various exchange rate measures**, e.g., nominal, real, and effective exchange rates. Chapter 22 (Chapter 4 in the monetary split) presents in considerable detail **the monetary and portfolio balance (or asset market) approaches to the balance of payments and to exchange rate determination**. This chapter concludes with an examination of the phenomenon of **exchange-rate overshooting**, which has appeared to characterize some exchange rate behavior in recent years. In Chapter 23 (Chapter 5 in

the monetary split), our attention turns to the more traditional price and income adjustment mechanisms. This material is a one-chapter consolidation of material that was dealt with in three different chapters in the first edition, and it includes a **review of basic macroeconomic analysis**.

Chapters 24–26 (Chapters 6–8 in the monetary split) are concerned with macroeconomic policy under different exchange-rate regimes. As noted earlier, we continue to **utilize the IS-LM-BP, Mundell-Fleming approach** in this edition, rather than to employ exclusively the asset-market approach. The value of the IS-LM-BP model is that it can embrace both the current and the capital accounts in an understandable and perhaps familiar framework for many undergraduates. This model is developed in Chapter 24 in a manner that does not require previous acquaintance with it, but does constitute review material for most students who have previously taken an intermediate macroeconomic theory course. The chapter concludes with an analysis of monetary and fiscal policy in a fixed-exchange-rate environment. These policies are then examined in a flexible-exchange-rate environment in Chapter 25, and the analysis is broadened to the **aggregate demand-aggregate supply framework** in Chapter 26.

The concluding chapters, Chapters 27 and 28 (Chapters 9 and 10 in the monetary split), focus on particular topics of global concern. Chapter 27 considers various issues related to the choice between fixed and flexible exchange rates, and the material has been thoroughly reorganized from the first edition. Chapter 28 then traces the historical development of the international monetary system from Bretton Woods onward, examines **proposals for reform such as target zone proposals**, and concludes with an overview of the external debt problems of developing countries.

Because of the length and comprehensiveness of the *International Economics* text, it is probably not wise to attempt to cover all of it in a one-semester course. For such a course, we recommend that material be selected from Chapters 1–3, 5–8, 10, 13–15, 20–25, and 28. If more emphasis on international trade is desired, additional material from Chapters 16–18 can be included. For more emphasis on international monetary economics, we suggest the addition of material from Chapters 26 and 27. For a two-semester course, the entire *International Economics* book can be covered (or the two splits). Whatever the course, occasional outside reading assignments from academic journals, current popular periodicals, and a readings book can further help to bring the material to life. The “References for Further Reading” section at the end of the book, which is organized by chapter, can hopefully give some guidance. If library resources are limited, the text contains summaries of some noteworthy contributions both in the main body and in case studies.

PEDAGOGICAL DEVICES

To assist the student in learning the material, we have included a variety of pedagogical devices. We like to think of course that the major device in this edition is again clear exposition. Although every author stresses clarity of exposition as a strong point, we are flattered that virtually all reviewers have praised this feature. Beyond this general feature, more specific devices are:

Boxes

Boxes that are analytical in nature (18 in total) further explore some difficult concepts or relationships for the interested student. We also have retained several biographical Boxes in this edition. These short sketches of well-known economists add a personal dimension to the work being studied. These biographies discuss not only the professional interests and concerns of the individuals but also some of their less well-known “human” characteristics.

Case Studies	There are 65 Case Studies contained in <i>International Economics</i> . These Case Studies serve to illuminate concepts and analyses under discussion, and they give the student an opportunity to see the relevance of the material to events going on in practice. The cases also provide a break from the sometimes heavy dose of theory which permeates this (and virtually any other) international economics text.
Concept Checks	These are short “stopping points” at various intervals within chapters (about two per chapter). The Concept Checks pose questions which are designed to see if basic points that have been made in the text have been grasped by the student.
End-of-Chapter Questions and Problems	These are standard fare in all texts. The questions and problems are broader and more comprehensive than the questions contained in the Concept Checks.
Lists of Key Terms	The major terms in each chapter are boldfaced in the chapters themselves and then are brought together at the end of the chapter in list form. A review of each list can serve as a quick review of the chapter.
References for Further Reading	These lists occur at the end of the book, organized by chapter. We have provided bibliographic sources that we have found useful in our own work as well as entries that are relatively accessible and provide further theoretical and empirical exploration opportunities for interested students.
Instructor’s Manual	This companion publication offers instructors assistance in preparing for and teaching the course. We have included suggestions for presenting the material as well as answers to the end-of-chapter questions and problems. In addition, sample examination questions are provided, including some of the hundreds of multiple-choice questions and problems that we have used for examining our own students.
Student Workbook	This edition also offers a companion student workbook as a guide for grasping the text’s material and for applying international economics concepts in practice. The workbook has been prepared by Steven L. Cobb of the University of North Texas. Professor Cobb is an insightful and dedicated teacher whom we both were lucky enough to have had as a graduate student in our courses at the University of North Carolina at Chapel Hill.

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Dennis R. Appleyard
Alfred J. Field, Jr.

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