

International Economic Problems



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James C. Ingram

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Preface

This preface is addressed to economists and other specialists; the book itself is addressed to students and laymen who want a compact statement of the major problems confronting the world economy. I hope that my professional colleagues will be patient with the simplifications and understanding about the omissions that must inevitably occur in a work of this kind.

Teachers of introductory courses in a variety of disciplines, notably economics, political science, and history, frequently complain that they find it difficult to obtain a reasonably comprehensive discussion of major international economic problems in convenient form. In college and university courses in the principles of economics, for example, textbooks typically include two or three chapters on international trade and finance, but these chapters are usually limited to general principles. To enable the student to see how these principles apply to contemporary problems, the instructor must assign a wide variety of additional material. All too often, limited time and library pressures cause the harried instructor to omit the extra assignments and leave the student with only the bare principles.

The purpose of this book is to supply a brief but authoritative account of three major topics in international economics: trade between advanced and underdeveloped countries, the international monetary mechanism, and the trend toward an integrated world economy. As an essential preliminary to the discussion of these topics, a brief statement of the principles of international trade and monetary organization is provided.

I am grateful to all the students, instructors, and other readers who have given me their suggestions and comments about the first two editions of this book. In this third edition, I have taken account

of these suggestions, as far as possible. I have also made substantial revisions in this edition, especially in chapters 4–7. The discussion of the European Common Market, formerly chapter 6, has been included as a section of the new chapter 7 on world economic integration. All statistical data and factual material have been brought up to date.

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Chapel Hill

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1 Introduction

For nearly half a century, the United States has occupied a position of leadership in world affairs. Along with this leadership, the United States has fallen heir to awesome international responsibilities, both political and economic. Americans are now presented with a daily diet of headlines concerned with international economic issues, and even our domestic issues have important effects on the outside world.

Modern developments in transportation and communication have greatly increased the degree of economic interdependence among nations. Although we may yearn for a simpler world, and indulge in rhetoric about achieving self-sufficiency in fuels or other products, technology and the tide of events are steadily pushing us toward interdependence. In the modern world, economic changes in one country are rapidly transmitted to other areas. Thus, a change in the United States wheat program can have profound effects on farmers in Australia and Argentina or upon consumers in Rome or Tokyo. Similarly, technological innovations in German or Japanese firms can influence prices in American markets and thus affect firms and workers in our towns and cities. Many economic policies which we may think of as purely domestic in nature actually have substantial impact upon the outside world.

The size and strength of the U.S. economy are so great that the nation is intimately involved in economic issues throughout the world. The United States alone accounts for over one-third of total industrial production in the free world. Even though our exports constitute only 6 percent of our gross national product, they constitute about 15 percent of total world exports. The enormous market of the United States absorbs a large part of the commodities that other countries want to sell. For example, American consumers buy over one-half of world coffee exports, and American industry purchases

about one-half of world exports of tin, rubber, and many other products. The United States has also made large investments in foreign countries; it is the major source of loans and grants to underdeveloped countries; and it plays an important role in world banking and finance. When the dollar is under pressure, as it has been in recent years, the stability of the entire world monetary system is placed in jeopardy.

Whether we like it or not, every action of the United States is of interest and concern to all other nations, and the United States is affected by actions taken by other nations. The informed citizen in such an interdependent world needs to have an understanding of the nature of economic problems confronting the world economy and, as a basis for that understanding, he needs a framework of analysis within which the problems may be studied.

In the following chapters we shall set forth some basic principles of international economics and use them to analyze and explain several important issues of international economic policy. "International economics" is not a separate and distinct field of study; it is just plain economics applied to the trade and financial relationships among nations. The concepts and techniques studied in the principles of economics clearly have their application to international economic problems.

The plan of this book is as follows. Chapters 2 and 4 contain an explanation of some basic principles of international trade and monetary organization. For many readers, these chapters, especially chapter 2, will be the most difficult part of the book. The readers should persevere, however, because mastery of these principles will give them a surer grasp of the problems to follow. Chapters 5–7 are devoted to three of the most important issues or problems in the world economy at the present time: (1) world payment problems, including the collapse of the postwar international monetary system based on the Bretton Woods agreement, and evolution of a new system in its place, (2) trade relations between advanced and underdeveloped countries, an aspect of the "revolution of rising expectations" in the poor countries of the world, and (3) the steady trend toward a more closely integrated world economy, a trend which is manifested in several ways. A fourth issue, the perennial tariff question, is discussed more briefly in chapter 3.

These issues are highly topical. They are intimately bound up with political and social aspects, but they can scarcely be understood without a firm grasp of the underlying economic principles. Although economic analysis does not yield clear and definite conclusions on the major policy questions involved in these issues, it provides useful insights and an understanding of the nature of the problems.

These issues are large and complex, and many books have been written about each of them. The purpose of this book is not to give an exhaustive account of any of them, but to provide an introductory account that will encourage the reader to pursue the matter in greater depth.

2 Why Nations Trade

Nations trade with each other because they benefit from it. Other motives may be involved, of course, but the basic economic motivation for international trade is that of *gain*. The gain from international trade, like the gain from all trade, exists because specialization increases productivity. We are familiar with the fruits of specialization and the division of labor in trade between regions of a single country, or between persons in a town, but we may not perceive that the same benefits exist in international trade. The political boundaries that divide geographic areas into nations do not change the fundamental nature of trade and the benefits it confers on the trading partners. Our task in this chapter is to establish and illustrate this basic truth.

I. Trade and Exchange between Persons

In the modern world, all of us depend upon other people to produce a large part of the goods and services we consume. A man may think of himself as independent and self-reliant, but he probably satisfies most of his material needs by selling his services or his own specialized output in the market, buying in exchange a variety of goods and services for his own use. We may be intrigued by Thoreau and Robinson Crusoe, but few of us are prepared to accept the standard of living that genuine self-sufficiency implies.

As a mental experiment, imagine that a single family (the Smiths) undertakes to become completely self-sufficient. Smith vows to have “no truck” with the rest of the economy, to sell no part of his produce and to buy nothing whatsoever—no fertilizer, gasoline, repair parts, tools, or anything. Suppose that Smith finds 160 acres of fertile,

well-watered land to homestead; allow him the enormous advantage of an initial stock of clothing, tools, equipment, household goods, and other supplies. A little reflection will probably convince us that no matter how skillful and industrious Smith and his family may be, they will be unable to produce, through their own efforts, the necessities of life (bread, meat, sugar, fruit, clothing, shoes, and light), not to mention such frills as medicine, television, lipstick, books, or carbonated beverages. Their initial stock of supplies will inexorably shrink, even though conserved and patched, and their standard of living will sink to a low level. At best, they will be able to eke out a hard, mean existence, and even that will be at the mercy of weather and disease. Yet Smith might, with exactly the same skill, energy, and resources, achieve a comfortable standard of living if he specialized in the production of a small number of products, selling these and buying other products for his family's use.

Suppose, for example, that wheat is one of Smith's principal crops. If he specializes in wheat, he can produce 8000 bushels per year. To supply the shoes that his family needs, Smith can sell 75 bushels of wheat for \$4 per bushel and buy 10 pairs of shoes at an average price of \$30 per pair (75 bushels @ \$4 = \$300 = 10 pairs of shoes @ \$30). If he tries to make the shoes himself, he must spend less time on his wheat crop, and it will fall by (for example) 600 bushels. The real cost of making shoes by hand is measured by the fall in wheat output. In this case what economists call the "opportunity cost" of 10 pairs of shoes is 600 bushels of wheat. Thus we can compare the cost of obtaining shoes in two different ways:

<i>Cost of 10 Pairs of Shoes</i>	
Through trade	75 bushels
Through direct production (opportunity cost)	600 bushels

If Smith devotes his efforts to wheat production, he can buy 10 pairs of shoes and still have 525 bushels of wheat (600 - 75) to use for other purchases. Alternatively, in the time that it takes him to make 10 pairs of shoes by hand, he could produce 600 bushels of wheat that he could exchange for 80 pairs of shoes.

This simple principle of opportunity-cost comparison applies to a great variety of choices at many levels: individuals, business firms, and nations. Should an expert engineer do his own drafting or hire a draftsman? Should a student spend 10 hours typing his own term paper or work 2 hours to earn the money to hire a typist? Should a shoe factory generate its own electricity or use the funds to expand its output of shoes? Should Scotland produce wine, even though "by means of glasses, hotbeds, and hotwalls, very good grapes can be raised in Scotland, and very good wine too can be made of them at

about thirty times the expense for which at least equally good can be brought from foreign countries."?"¹

Adam Smith dramatized the benefits of trade and the division of labor, for both individuals and nations, in the following passage.

It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy. The taylor does not attempt to make his own shoes, but buys them of the shoemaker. The shoemaker does not attempt to make his own clothes but employs a taylor. The farmer attempts to make neither the one nor the other, but employs those different artificers. All of them find it for their interest to employ their whole industry in a way in which they have some advantage over their neighbours, and to purchase with a part of its produce, or what is the same thing, with the price of a part of it, whatever else they have occasion for.²

II. Trade between Nations

Nations, like individuals, should specialize in the production of the goods that they can make with relatively greatest efficiency. Through such specialization and trade, they can each obtain a larger amount of consumable goods than they would have without trade.

Sometimes a nation cannot possibly produce a given product because it does not possess the necessary natural resources or climate. For example, the United States possesses no known deposits of tin ore, and we must import the tin that we need from other countries. Our soil and climate are not suitable for growing tea; thus, to keep our tea-drinkers happy, we import \$79 million (1974) worth of tea from India, Ceylon, and other tea producers. Much international trade is based on such unequal geographic distribution of minerals, soil types, and rainfall. The benefit of this trade is obvious to all, and its desirability is rarely questioned.

The more difficult cases concern those situations in which two countries can both produce the same commodities. Our problem is to show that the advantages of specialization and exchange are still present. (The alert reader may object, at this point, that the above distinction is not sharply drawn. Tea *could* be produced in the United States if we were willing to devote enough energy and resources to its cultivation. We could even "mine" tin from scrap heaps and junkyards, and thereby supply new tin for industrial use. The reader is correct; the difference is usually one of degree, although in popular usage we often speak as if it were absolute.)

1. Adam Smith, *The Wealth of Nations* (New York: The Modern Library, 1937), p. 425.

2. *Ibid.*, p. 424.

Consider a simple example to illustrate the basic principle. Suppose that Germany is producing only two commodities: wheat and steel. German resources are fully employed, and the conditions of production are such that if wheat output increases five tons, steel output drops five tons. That is, we assume that a given package of resources can produce five tons of wheat or five tons of steel.³ The opportunity cost of one ton of steel is one ton of wheat, and vice versa. To start with, assume that Germany has no foreign trade.

Now if the opportunity arises to trade with the rest of the world (ROW) at an exchange ratio different from her domestic ratio ($1S = 1W$), Germany can benefit from trade. For example, suppose that the exchange ratio between steel and wheat in ROW is $1S = 2W$, and suppose that Germany is so small in relation to ROW that German sales of steel have no effect on world prices. Comparing Germany's domestic ratio to the world exchange ratio, we can see that Germany has a *comparative* advantage in steel. That is, its cost of steel (measured in terms of wheat given up) is less than in the outside world. Note that we do not need to know whether German labor is efficient or inefficient compared to labor in other countries. Foreign producers may use 10 times as much labor (or one-tenth as much) as German producers, but all that matters to Germany is that it can obtain more wheat through trade than through direct production at home. It will pay Germany to shift resources out of wheat and into steel, using the increased steel output to buy wheat in ROW (we shall ignore transport costs for the time being). For every ton of wheat lost through curtailed production, Germany can obtain two tons through trade. Germany's gain from trade lies in its ability to obtain wheat at less cost in resources than it would cost at home. Some gain will exist as long as the exchange ratio in ROW *differs* from Germany's domestic ratio. That is, with a domestic ratio of $1S = 1W$, Germany will benefit as long as it can get anything more than one ton of wheat for one ton of steel.⁴ Only if the external exchange ratio is exactly equal to Germany's ratio ($1S = 1W$) will there be no opportunity for gainful trade.

3. The practical reader may be appalled at the suggestion that resources released from wheat production could be transferred to steel production. The example is illustrative, not fully realistic, but we should note that more substitutability in resource use exists than may appear at first sight. If Germany curtailed wheat production, resources used to make agricultural machinery, fertilizer, farm buildings, and the like, would be released for use in expanding the steel industry. Labor released from agriculture would move into towns and cities. Even if the farm laborers did not go directly into steel, they would release other workers, for instance, in service industries, for employment in steel.

4. If one ton of steel buys *less* than one ton of wheat in ROW, Germany will benefit by trading wheat for steel.

This example can be conveniently illustrated through use of the "production possibility curve." Suppose that if *all* Germany's resources were put into wheat-growing, its total output would be 100 million tons. Germany would then produce no steel. If resources capable of producing 10 million tons of steel were taken out of wheat growing, the output of wheat would drop by 10 million tons. (This follows from our assumption that a given package of resources can produce five tons of wheat or five tons of steel in Germany.) If all German resources were shifted to steel production, total output would be 100 million tons of steel and *no* wheat. We can now draw up a list (Table 2-1) of a number of alternative combinations of wheat

Table 2-1. Alternative Combinations of Wheat and Steel that Germany Can Produce

		(Millions of Tons)									
Wheat:	100	90	80	70	60	50	40	30	20	10	0
Steel:	0	10	20	30	40	50	60	70	80	90	100

and steel that Germany could produce. In this example we assume that opportunity costs remain constant; that is, every increase of 10 million tons of steel requires a reduction of 10 million tons of wheat, and vice versa. These facts can also be shown in a diagram (Figure 2-1). The figure contains the same information as Table 2-1. The straight line *AB* represents the "production possibility curve" for the German economy. Points along the line *AB* represent combinations of wheat and steel that Germany can produce at full employment. At *A*, it produces 100 wheat and no steel; at *B*, 100 steel and no wheat; at *P*, 60 wheat and 40 steel. That *AB* is a straight line indicates that opportunity cost remains constant ($1S = 1W$) as Germany shifts resources from one industry to the other. The *slope* of *AB* is equal to the domestic ratio of exchange. The line *AB*, therefore, represents the highest attainable outputs the German economy can produce at full employment. All points to the right of *AB* represent combinations of wheat and steel that are beyond the reach of German capacity. (What can you say about a point to the left of *AB*, such as *Q*?) In a market economy, consumers will decide at what point along *AB* the economy will actually operate. If they want more wheat and less steel, they will bid up the price of wheat, and businessmen will shift resources from steel to wheat. We shall assume that when Germany has no trade with the rest of the world, German consumers prefer the combination at point *P*. At *P*, German production (60W and 40S) equals German consumption.

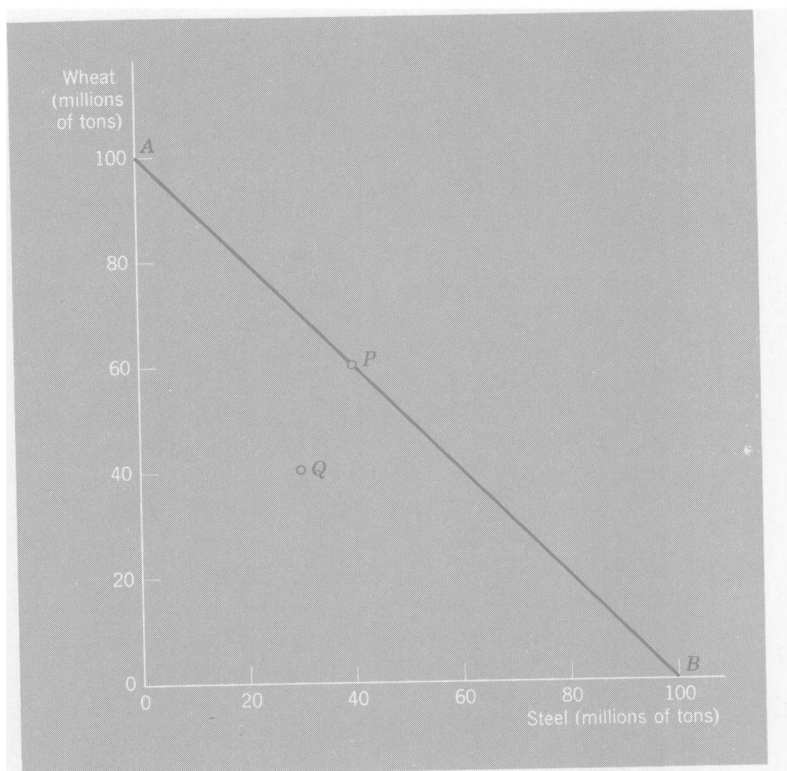


Figure 2-1. German production possibilities. The line AB shows how many tons of wheat that Germany can produce at each level of steel production. If Germany produces 40 steel, it can also produce 60 wheat; this combination is indicated by the point P . The slope of AB represents the rate at which steel can be transformed into wheat by a shift in resources from steel production to wheat production.

Production (Net National Product) = Consumption			
Wheat:	60 million tons	Wheat:	60 million tons
Steel:	40 million tons	Steel:	40 million tons

We can now show what happens when the opportunity arises to trade with ROW and exchange one ton of steel for two tons of wheat. In Figure 2-2 we add the trading-possibility line, CB , drawn with a slope equal to the exchange ratio in ROW ($1S = 2W$). The opening up of trade enlarges the range of choice available to German consumers. It makes possible the choice of some combinations of wheat and steel that formerly lay beyond their reach. All those combinations lying between AB and CB (in the elongated triangle ACB) are now available to German consumers. If Germany specializes in steel (produces at B), it can trade steel for wheat and move along the

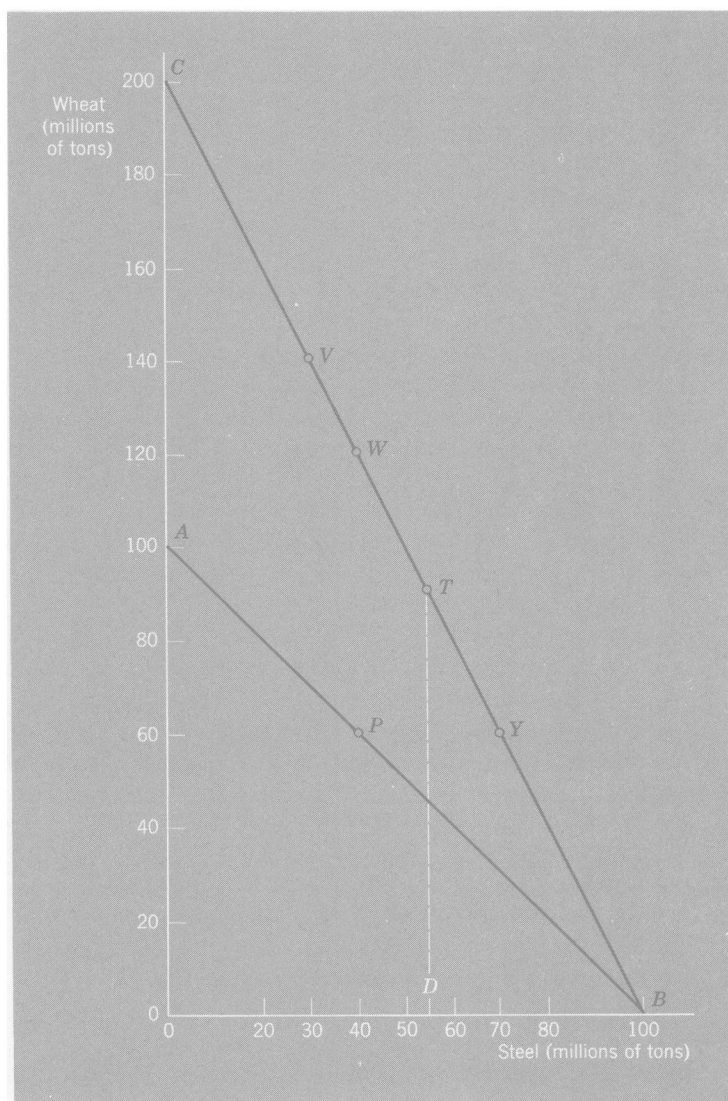


Figure 2.2 Trade between Germany and the rest of the world. Before trade, Germany produced 40 steel and 60 wheat, consuming all that it produced. Given the opportunity to trade one steel for two wheat (along the line BC), Germany produces OB (100) of steel, exporting DB (45) of it to buy DT (90) of wheat from ROW. Germany then consumes OD (55) of steel and DT (90) of wheat.

“trade possibility” line CB to whatever point its consumers prefer. For example, if their preference is for the point T , Germany can trade 45S for 90W and therefore obtain more of both commodities than it