INTERNATIONAL ECONOMICS AND INTERNATIONAL ECONOMIC POLICY: A Reader

Philip King

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Contents

III

Trade Policies and Developing Countries

IV

Economic Integration among Developed Countries

V

The Multinational Corporation and World Trade

VI

OPEC

VII

International Monetary Reform: is the Current System Working?

VIII

The IMF: Pro and Con

IX

Macro and Micro Adjustments after the Fall of the Dollar

X

The Debt Crisis: Diagnoses and Prescriptions

XI

Recent Developments in the Eurodollar Market

Acknowledgments

Preface

Not long ago, international trade and finance was considered an arcane subject which was confined to a tiny corner of the field of economics. Today, it is difficult to discuss any aspect of economic theory or policy, from macroeconomics to antitrust, without considering international markets. The reason for this trend is not hard to determine. The late eighties have been a time of great upheaval and uncertainty in the world economy. Even a casual observer of the events of the past few years cannot help but be struck by the significance of recent events such as the fall of the dollar, the debt crisis, the world stock market crash, and the enormous U.S. trade deficit. All of these events reflect the growing interdependence of the world economy as well as a breakdown of the clear guidelines established at Bretton Woods just after World War II.

The uncertainty surrounding international trade and international financial markets has brought about increasing interest in the subject from both inside and outside of academia. Economists have responded to the great demand for more analysis of the international economy with a steadily increasing supply of articles and books intended for people who do not necessarily have Ph.D.'s in the field.

This reader is designed to present a number of the most important of these articles between the covers of a single book. In putting together this reader I had several criteria in mind. First, each article had to be on a topic of key interest given the situation in today's international economy. Second, I searched for articles which were well written and interesting. I wanted articles with a clear theoretical framework and clear policy prescriptions spelled-out in terms which someone with a literacy in economics could understand. As it turned out, I found that the best articles were often those written by leaders in the field in such journals as: *Foreign Policy, Finance and Development* and *Foreign Affairs.* My third criterion was that all major sides of any particular debate be presented, preferably by their main proponents. Last of all, I wanted articles which discussed the institutions within which the policy debate occurs. (Too often in economics, academics discuss theories without relating them to the institutional framework within which they must be applied.)

These readings are designed to accompany an upper level undergraduate course or a masters/MBA level course in international economics, international business or international relations, though anyone with an interest in learning more about contemporary international economic issues should find all of these readings stimulating. I have collected these articles and presented them by topic, with a brief introduction to each section.

The increase in interest in international economics among college and MBA students in the last ten years has been phenomenal and I hope that this reader will satisfy their demands to go beyond the text book level analysis of international trade and finance and enter the real world of policy and decision making.

Philip King

I

Free Trade Versus Protectionism

For over forty years, much of the world's trade has been conducted under the rules of GATT, the General Agreement on Tariffs and Trade. GATT is an agreement under which participating countries agree to lower their trade barriers, in particular, their tariff barriers. When GATT was created, however, many loopholes in the agreement were left which allow countries which formally follow GATT to create substantial trade barriers. This section examines many of the types of trade barriers which exist in the world today. Many of these arrangements are referred to as nontariff barriers (NTB's) since they involve trade restrictions other than tariffs.

The first article below, "The cost of trade restraints" presents an analysis of one particular trade barrier: import quotas on Japanese automobiles sold in the United States. The article concludes that these quotas increased the price of automobiles substantially in the U.S.. In 1984, they estimate that the average price of a car was $600 higher than it would have been without the quotas; if one also examines the effect on quality, the authors conclude that the cost is over $1000 per car. The study also concludes that Japanese automobile producers have benefited from import quotas by several billion dollars.

The second article, "Voluntary Export Restraints," by Clemens Boonekamp, examines one of the most common import barriers Voluntary Export Restraints (VERs); Boonekamp argues that VERs represent a convenient loophole in GATT since they are essentially informal agreements between two countries. The article also points out that exporting countries may benefit from VER's since they collect the rents resulting from the higher prices. The selection by William Cline examines the history of the multifibre agreement, an agreement among many nations to restrict production of textiles by Asian and other textile exporting countries. Cline also examines the cost of these types of restraints.

Another important trade issue of the 80's was the enormous trade deficit run by the US and the corresponding trade surplus of Japan. The increasing awareness of Japan's economic power and its enormous trade surplus have lead to calls for protectionism in the US. There is growing concern that it is losing out as a major economic power and that the Japanese are ascending. Many have argued that Japan is not following the international rules of the game, formalized in GATT. Instead, the argument goes, the Japanese are running an essentially mercantilist policy, exporting as much as they can and importing as little as possible. Several bills proposed before the US Congress call for the retaliation against unfair trade by countries, like Japan, which run huge trade surpluses against the US.

Are the Japanese running a free trade policy or a protectionist policy? In terms of its formal barriers, the Japanese are no worse, possibly slightly better, than the US (except for agriculture which is mostly exempt from GATT). Many have argued that the most significant barriers to trade in Japan are implicit barriers which cannot be easily detected by economists. The fourth article, "Japan's intangible barriers to trade in manufactures" contends that while Japan has relatively few formal trade restrictions such as tariffs or quotas many of its other policies do in fact create significant trade barriers. The article focuses on three areas where substantial barriers occur: product standards, the distribution system, and favorable government procurement. The paper concludes that elimination of these barriers would increase Japan's imports by 7%, much of this being in the telecommunications industry, the computer industry, and industrial machinery.

The final selection, "Countertrade offsets, barter and buybacks," by Cohen and Zysman, points out that up to 25% of world trade is conducted under some form of modified barter arrangement as opposed to a market form of exchange. Cohen and Zysman describe the different type of arrangements and give examples.

1

The Cost of Trade Restraints. The Case of Japanese Automobile Exports to the United States

Charles Collyns and Steven Dunaway

In early 1981, the Japanese authorities imposed restraints on exports of automobiles to the United States in order to pre-empt more restrictive measures advocated by the U.S. automobile industry. Export restraints have been maintained since that time, although the quantitative limits were relaxed substantially in March 1985. Since the imposition of the restraints, the domestic share of sales has risen appreciably, reversing the previous downward trend. At the same time, new car prices have risen almost twice as rapidly as consumer prices in general. This paper assesses the degree to which developments in automobile sales and prices were affected by export quotas during the period 1981-84, when restraints were at their tightest. These estimates are used to assess the impact of the restraints on net revenues of the domestic automobile industry and foreign producers and to measure the costs to purchasers.

In theory, the restraints on Japanese automobile exports would be expected to affect prices, sales, and types of cars purchased in the United States. Under the export quotas, individual Japanese producers are constrained in the number of cars they can export to the United States. To maximize profits subject to this constraint, Japanese producers have an incentive to raise the prices they charge for given models. The action would reduce competitive pressures on U.S. producers and non-Japanese exporters and prompt them to raise their prices in turn, although probably by less than the increase in Japanese prices. Faced with higher prices on most models, U.S. purchasers may be expected to buy fewer new automobiles. Nevertheless, sales of domestic cars and imports of non-Japanese automobiles may increase as purchasers shift away from relatively more expensive Japanese cars.

In addition to these effects, the restraints on Japanese automobile exports may have had a significant impact on the average quality of cars purchased in the United States. To maximize the profits derived from each unit sale, Japanese producers are likely to shift the mix of cars exported to the United States toward larger or more luxurious models that can be sold at higher prices. Producers may also be expected to install more "optional" equipment in each unit. These actions would tend to raise the average quality of imported Japanese automobiles and to reduce the extent to which the quotas would curtail real expenditures on such cars.[1] The average transactions price of Japanese automobiles sold in the United States would tend to increase, reflecting the higher average quality of each unit. The average quality of domestic cars may also rise if Japanese automobiles are relatively closer substitutes for higher-quality rather than for lower-quality domestic automobiles.

The technique used in this paper to quantify the effects of the Japanese export restraints is to compare actual outcomes during the quota period with outcomes predicted by a small model of the U.S. automobile sector estimated over the period preceding the imposition of the restraints. The central assumption underlying this approach is that the Japanese export restraints were the dominant factor excluded from the model that affected the auto market during the quota period.

A major difference between the present study and other recent attempts to assess the impact of the Japanese export restraints[2] is that the model developed in this paper directly allows for the effects of the quotas on the average quality of automobiles purchased. The estimated effect of the the restraints on the average transactions price of new cars is divided between pure changes in price and changes in price associated with variations in the mix of automobiles being sold. The ability to distinguish between pure price effects and quality effects makes it possible to assess the welfare costs and income transfers resulting from the imposition of the export restraints.

RECENT DEVELOPMENTS IN THE U.S. AUTOMOBILE SECTOR

In the late 1970s, the U.S. automobile industry was faced with severe difficulties as sales dwindled and foreign imports took up an increasing share of the market. Japanese imports increased particularly rapidly, accounting for over 21 percent of total U.S. sales in 1980 compared with less that 10 percent five years earlier. Net income of U.S. producers shifted from a profit of $4.9 billion in 1978 to a loss of $4.2 billion in 1980, while production and employment were curtailed sharply. In June 1980, the industry filed a petition for import relief under the escape clause, on the grounds that both automobiles and trucks were being imported in such quantities as to damage the domestic industry. The U.S. International Trade Commission ruled that, while increased imports were a contributing factor, the "substantial" causes of the industry's difficulties were a general decline in the demand for automobiles and a switch by consumers toward more fuel-efficient vehicles. The Commission recommended that no restrictive action be taken.

Despite the Commission's decision, pressures for protection of the U.S. automobile industry remained intense and led to legislation being introduced in the Congress to restrict Japanese imports of passenger cars. In May 1981, the Japanese Government responded by announcing measures to restrain exports of automobiles to the United States for two years. These restraints limited Japanese exports to the United States to 1.68 million units in the year ended March 1982, about 8 percent below their 1980 level. Within this total, individual Japanese producers were allotted export quotas based on their market share prior to the imposition of the restraints. In the second year of the restraints, shipments were to be held at the first-year level, with a provision for an increase if there was a rise in domestic U.S. automobile sales; in the event, this increment did not materialize. Total sales in the United States continued to decline in 1981 and 1982, reflecting the general weakness of the U.S. economy and high interest rates. At the same time, the Japanese share of the U.S. market increased further, albeit at a much slower rate than in previous years.

In 1983 and 1984, demand for automobiles picked up sharply, reflecting a substantial decline in interest rates and the strengthening of economic activity in the United States. Domestic producers increased production in line with growing sales, and were able to achieve record profits after several years of weak earnings. The restraints on Japanese car exports were extended for third and fourth years; the ceiling was held fixed in the third year and raised 10 percent in the fourth year to 1.85 million units.[3] Sales of Japanese automobiles remained roughly unchanged in this period, and the market share of imports from Japan declined significantly, dropping to 18 1/4 percent in 1984.

In early 1985, the U.S. authorities judged that the domestic automobile industry had been able to adjust to import competition and announced that they would not ask Japan to extend the restraints. Nevertheless, the Japanese Government decided to extend the restraints for two additional years through March 1987. In this period, the ceiling was raised by 24 percent to 2.3 million units a year, while the export shares allotted to individual producers were reallocated to increase the shares of producers that previously had received relatively small shares. In early 1987, the export restraints were extended for a further year without an increase in the export ceiling.

The record levels of net income achieved in 1983 and 1984 by U.S. automakers were earned on sales volumes similar to those in 1980, when the automobile industry incurred unprecedented losses. In part, this turnaround reflected efforts made by the industry to control production and inventory costs. Capital spending by the industry was exceptionally high during 1979-81, although it dropped somewhat in 1982-84; much of this investment was directed toward raising labor productivity as well as improving product quality. In conjunction with this investment, employment was cut back sharply while increases in hourly compensation were moderated by union wage concessions in 1981-82. As a result of these measures, the rate of increase in unit labor costs fell substantially, and was well below that in the nonfarm business sector as a whole during 1981-84.

Despite improvements in the cost performance of the U.S. automobile sector, the gap between production costs in the United States and Japan did not appear to narrow significantly. Hourly compensation of automobile production workers in Japan (expressed in terms of U.S. dollars) rose at a somewhat slower rate than hourly compensation in the U.S. industry during 1981-84, although there is some evidence that productivity may have improved somewhat more rapidly in the United States than in Japan. The Japanese cost advantage in producing a subcompact model in 1984 was estimated to be $1,500-2,500, roughly the same as in 1980.[4]

A dramatic feature of the period 1981-84 was the rapid increase in automobile prices, which far exceeded the rate of consumer price inflation. The average transactions price of new passenger cars jumped by 17 1/2 percent in 1981 alone and increased by 49 percent during 1981-84 as a whole; the consumer price index for all items (CPI) rose by only