International economics

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Preface

Major changes in the international economy call for changes in the study of international economics. Such developments as the OPEC victory over the oil-importing countries, other fresh attempts at forming international cartels, the increased flexibility of exchange rates since 1971, and new complexities in the relationship of trade policy to international investment flows need to find their way into the textbooks. Ours is the delicate task of suggesting what new kinds of analysis these events require, while at the same time showing how they are often easier to understand when one uses analytical tools already at hand.

We have attempted to fit new events and new improvements in theory together in this thoroughgoing revision. The wave of cartels has earned a chapter of its own (Chapter 10). Experience with fluctuating exchange rates has yielded a rich empirical record and a mixed verdict, as we note in Parts Three and Four. Chapter 12 on the political economy of trade barriers unifies a slowly growing theory of why we have the trade barriers we do with a new literature testing such theories against the experience of the United States, Canada, and other countries. Refinements in the link between trade and income distribution, led by Ronald W. Jones' development of simple general-equilibrium models, have been carefully combined with the growing empirical literature on the same subject, much of it spawned by attempts to unlock the older Leontiev paradox, in Chapter 5. And some of the more durable advances resulting from the resurgence of the monetary approach to international payments adjustment have been worked into an extensive revision of Chapter 17.

The present edition should serve at least as wide a range of students as past editions. The level of difficulty can be tuned fairly finely by adjusting the amount of appendix material used. The style of the text chapters is designed to suit both readers with broad interests in international relations and readers seeking more specialized tools of analysis. The appendixes are aimed mainly at the latter group. Those seeking review exercises to firm up their command of the analytical tools can use the Questions for Review at the ends of the building-block chapters.

Thanks are again due to the hosts of students, colleagues, and teachers at other campuses who volunteered suggestions for improving on previous editions. Our thanks also to Lloyd G. Reynolds of Yale University for editorial assistance.

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The study of international economics

The subject matter of this book will always require a separate body of analysis, distinct from the rest of economics. The mere existence of sovereign nations introduces complications requiring that we make changes in our ordinary tools of economic analysis before we can apply them to international economics. These complications are what makes the study of international economics fascinating and sometimes difficult. Future events are certain to keep reminding us of the problems that are special to international economics. To see why, let us look at four events of the 1970s that have shaped the approach and subject matter of this book.

FOUR EVENTS

Floating the dollar

In a dramatic televised speech on August 15, 1971, President Nixon stunned both the nation and the world by announcing a new economic policy. On the domestic front he unveiled a freeze on wages and most prices, plus some tax changes, designed to check inflation overnight without adding to unemployment. On the international front he ended one era and began another with a few terse sentences announcing that the value of the U.S. dollar must be changed in terms of other nations' currencies and gold. He soon had his way on the international currency issue. Soon the exchange rates between the dollar and other currencies were drifting toward higher values for other currencies and lower values for the dollar. Suddenly international travelers, long accustomed to fixed exchange rates between dollars and other currencies, found that their dollars exchanged for fewer German marks, Japanese yen, and other currencies. The change also affected firms and individuals trading goods between countries. U.S. firms such as Boeing found it easier to sell their aircraft and other products abroad now that foreigners felt that they could afford more dollars and more U.S. goods priced in dollars. Foreign firms used to selling large amounts of goods to the United States felt a new kind of pressure. Volkswagen found that the same dollar prices for VWs in North America brought it fewer West German marks with which to pay West German workers and shareholders. It soon had to raise its car prices in dollars, losing some business to its U.S. and Canadian competitors.

The change brought a different kind of crisis headline to the newspapers. Before August 15, 1971, the system of keeping fixed rates of exchange between national currencies had been cracking, with increasingly frequent "balance-of-payments crises." Now the headlines began to shift, dropping the usual references to the balance of payments and replacing them with news of rising marks, falling dollars, and wavering pounds. Officials felt at least as much sense of crisis as before, and hurriedly arranged meetings to deal with the new system. Meeting at the Smithsonian Institution in Washington on December 18, 1971, the governments and central banks of major countries announced an agreement to make the dollar worth less in gold and a few major currencies, and to try to hold fixed the new exchange rates between certain European currencies and the dollar. Yet the float more or less continued, with further changes in the ability of each currency to buy others, despite the Smithsonian agreement and a second round of unsuccessful attempts to make rates more fixed in early 1973. By July 1973 the U.S. dollar had sunk in its ability to buy other currencies by about 26 percent relative to the exchange rates of three years earlier. The Swiss franc, West German mark, and Japanese yen had risen by about 40 percent in dollar value. The Canadian dollar had risen over the U.S. dollar by about 12 percent for a year, but had returned to its old U.S. dollar value by mid-1973. There was an early rise and then a prolonged fall in the dollar values of the British pound sterling, Italian lira, and French franc.

Whether the new system of fluctuating exchange rates was better or worse than the system it replaced is a very complex issue that will be pursued in Parts III and IV of this book. Yet it is clear that this issue is unique to the international sphere in economics. Exchange rates do not change between Kansas and Missouri, or between Alberta and British Columbia. The usual tools that economics applies to domestic issues have to be modified and extended if we are to make sense of what changes in exchange rates mean to ordinary people.

U.S. protectionism and the near miss of 1970–1973

In the early 1970s the Congress of the United States generated heated debate over another kind of policy move that is unique to the international side of economics: it debated bills proposing to clamp down on the import of foreign goods into the United States. The pressure to do so had been building for some time, as one U.S. manufacturing industry after another felt the competition of rising imports. The United States was importing larger and larger shares of its clothing, steel, automobiles, motorcycles, radios, TV sets, ships, and other products. A CBS documentary at the start of the 70s, entitled "Made in Japan," scared viewers by arguing that more and more of them would lose their jobs to foreign competition that was unpatriotically backed by U.S.-based multinational firms ("You can be sure if it's Westinghouse—it's made in Japan"). Even the Stars and Stripes were being imported from the Far East. The U.S. trade surplus dwindled, and in 1971 and 1972, for the first time since World War II, the United States imported a greater value of goods and services than it exported.

The rising fear of losing jobs and profits to import competition caused many congressmen to switch to favoring import restrictions, such as higher tariffs (import duties) and tougher quotas (quantitative limits on imports). A protectionist (import-cutting) bill was passed by the U.S. House of Representatives and by a Senate committee late in 1970, but it narrowly missed passage when a few senators favoring continued liberal policies toward imports were able to stall until the year-end adjournment of Congress. Had a vote been forced, the Senate might have passed the protectionist bill, putting pressure on an election-minded president to follow suit.

The pressure continued through 1973, largely because the largest organized labor group, the AFL–CIO, was vehemently determined to push for protection against imports. From late 1971 through mid-1973, Congress debated the historic Burke-Hartke Bill, which would have slashed imports into the United States and put new limits on the ability of U.S. firms to set up manufacturing subsidiaries abroad, in order to defend U.S. jobs. The bill ultimately failed to pass and even yielded to a moderately trade-liberalizing law at the very end of 1974. Yet the protectionist sentiment remains, calmed only marginally by a few presidential decisions to restrict imports on such goods as beef, sugar, and footwear. The issue of whether or not to try defending U.S. jobs by cutting imports also remains.

The issue of protection against imports requires a specifically international analysis. Within nations, such protection is illegal except in subtle and slight forms. California is not allowed to put up, say, a 50 percent tax on all goods and services imported into that state from the rest of the United States. The argument that doing so would protect the jobs of Californians against "unfair" Eastern competition would receive the retort that protecting California jobs in this way would destroy jobs in the companies elsewhere that counted on being able to sell to California. The interests of the rest of the nation cannot be ignored, and are explicitly defended against intranational trade barriers by the U.S. Constitution. Yet foreign interests can be more easily ignored, and any analysis of the likely effects of protectionist laws must explicitly distinguish between effects within the nation and effects of foreigners. Such analysis is offered in Parts I and II of this book.

The victory of OPEC

A chain of events in late 1973 revolutionized the world oil economy. In a few months' time, the 13 members of the Organization of Petroleum Exporting Countries (OPEC) effectively quadrupled the dollar price of crude oil, from $2.59 to $11.65 a barrel.[1] Oil-exporting countries became rich, though still "underdeveloped" in some cases, almost overnight. The industrial oil-consuming countries sank into their deepest depression since the 1930s. The "economic miracles" of superfast growth in oil-hungry Japan and Brazil came to a halt.

OPEC had already been building its collective strength earlier in the 1970s, after having little apparent power for the first decade after its formation in 1960. First in 1971 and again in 1972 OPEC had demanded and won both higher official oil prices and a greater share of oil profits and ownership at the expense of the major international oil companies. The rise in OPEC's power was greatly accelerated when the Arab-Israeli "Yom Kippur War" broke out in early October 1973. The war stiffened the resolve of the Arab oil-exporting countries, whose representatives were then in Vienna arguing over oil prices with the major private international oil companies. The Arab negotiat-

[1] OPEC was created by a treaty among five countries—Iran, Iraq, Kuwait, Saudi Arabia, and Venezuela—in Baghdad in September 1960. Since then the following countries have joined: Qatar, January 1961; Indonesia, June 1962; Libya, June 1962; Abu Dhabi, November 1967; Algeria, July 1969; Nigeria, July 1971; Ecuador, 1973; Gabon, associate member by 1973, full member in 1975.

ing team became excited at the early news of Arab military successes and began passing around newspaper photographs of huge U.S. shipments of arms to Israel. The team's new firmness matched that of the oil companies, and negotiations ceased. Then, at a historic meeting in Kuwait on October 16, six key Persian Gulf oil countries decided that henceforth oil prices would be set by each country without consulting the major oil companies.

Meanwhile, oil buyers were beginning to panic. The Arab boycott against selling oil to the United States or other countries suspected of being pro-Israeli added to already existing fears that oil would become very scarce. The fears soon fulfilled themselves. Iran tested the market by auctioning off crude oil in early December 1973. Several smaller oil companies bid $16–18 a barrel for oil that cost less than a dollar a barrel to produce and that had earlier sold for $5 or less. There were also reports that Libyan and Nigerian crude oil was fetching as much as $20 a barrel. With such solid evidence of buyer panic, OPEC imposed a price of $11.65 a barrel at its Teheran meeting of December 22–23, 1973. This price remained even after the Arab oil embargo was lifted in early 1974.

Thus unfolded the most successful artificial price hike of all time. Receiving $11.65 for each barrel, OPEC gained far more than John D. Rockefeller's Standard Oil Company or any other monopoly or cartel ever had. This judgment would stand even if OPEC were to break up tomorrow and start slashing its prices competitively.

The strengths and weaknesses of OPEC as a cartel relate to uniquely international developments. The Arab-Israeli conflict played an unquestionably important role in making the Arab majority in OPEC insist on a hard line. The persistent U.S. foreign policy of support for Israel was also decisive in causing the Saudi government to sever its friendship with the U.S. and use oil as a political weapon. The exporting countries, being sovereign nations, were also beyond the legal reach of their main consumers. Irate U.S. consumers could not threaten Venezuela or Saudi Arabia with government antitrust actions the way they could threaten domestic oil interests. On the other hand, the fact that no one government reigns over the oil exporters has made it more difficult for them to force one another to hold back production to keep oil prices up. Any country wanting to go its own way could reject the demands of the other OPEC members and sell as much oil as it wished, compromising the power of the cartel over buyers.

Thus any analysis of OPEC, like the analysis of exchange rates between currencies, must recognize the distinctly international dimensions of this outstanding cartel. The well-established economic literature on how cartels work and how they break down must be modified to deal with OPEC, since that literature concentrates almost exclusively on cartels among private firms within a country. Chapter 10 faces this issue.

Regulating the multinationals

In 1974 Canada set up a Foreign Investment Review Agency to ride herd on U.S. investments in Canadian firms wholly or predominantly owned by U.S. firms. The agency soon denied several U.S. firms the legal right to expand their ownership in new or existing Canadian enterprises. As a result of this new regulation of U.S. investments in Canada, several enterprises have not been set up and several others have remained in the hands of Canadian owners who probably would have sold them to U.S. companies if they had not been prevented from doing so by the agency. All indications are that this sort of regulation of foreign investments will remain part of Canadian policy indefinitely.

The creation of the Foreign Investment Review Agency was part of a prolonged cooling trend in Canada's attitude toward incoming U.S. investors. After welcoming U.S. investment inflows for a few decades, Canada took a steadily dimmer view of them from the early 1960s on. There was widespread concern over the large shares of Canadian firms owned and controlled from below the border. Specifically, there was concern that the U.S.-controlled firms would drain money from Canada when sending profits back to U.S. parent companies, and that the same firms might become a lobbying force that would subvert the Canadian government itself.

The spirit of skepticism about multinational firms has not been confined to Canada. Japan has traditionally put high hurdles in the way of U.S. and other foreign firms trying to set up subsidiaries producing in Japan. Recently Brazil, a country that had heretofore rolled out the red carpets for foreign investors, has also leaned hard on foreign-owned firms to sacrifice profits more heavily than domestic firms during the post-OPEC austerity program. In fact, multinational investments have also faced new resistence within the United States, the main investing country. Organized labor has called for limitations on the ability of U.S. firms to invest in subsidiaries abroad, on the argument that their foreign investments will tend to destroy U.S. jobs and replace them with foreign jobs producing the same goods. In addition, would-be U.S. investors have shown some new skittishness about foreign investments, which they now view as endangered by the threat of foreign expropriation and exchange-rate fluctuations.

It is in some ways remarkable that a profit-pursuing move could have so many enemies. Yet controlling investments in one company by a firm based in another has often been a focal point for friction. Both host countries and investing countries have viewed the international investors as virtually an alien group, with partial justification. There is indeed a long history of interference by the international firms in the affairs of both the investors' home country and the host country. Yet under what conditions does the international investment bring net gains to the rest of either country? To investigate this question is to draw national boundaries and take close looks at the political and economic effects on both sides of each boundary. That is what Canada has chosen to do, and that is what this book's special analysis of international investments undertakes to do, in Part V.

ECONOMICS AND THE NATION STATE

It should be clear from these four events that international economics has to be a separate branch of economics as long as nation-states are sovereign. For every country there is a whole set of national policies. And for each country, those policies will always be designed to serve some part of the national constituency. Nation-states almost never give the interests of foreigners the same weight as domestic interests. In most cases national politics is simply indifferent to the interests of foreigners. That is why the protectionists in the United States have seldom had to ask how their barriers to imports of, say, footwear, would affect the jobs and incomes of people making footwear in Italy or Taiwan. That is also why Canada could hammer out a policy of limiting U.S. investments in Canada without investigating the effects of doing so on U.S. firms or consumers. Although international economics does not need to confine its view to the interests of one country, it does have to analyze the different national interests separately, in order to be relevant to the national level of decision making.

DIFFERENT MONEYS

To many economists, and especially to the average person, the principal difference between domestic and international trade is that the latter involves the use of different moneys. A dollar is accepted in California and in Maine. But the Swiss franc, which is the coin of the realm in Basel, must be converted into French francs or West German deutsche marks before it can be used to buy goods in Strasbourg in France or Freiburg in West Germany, each but a few miles away.

With a little more sophistication, however, it is evident that the important fact is not the different moneys so much as the possibility of change in their relative value. When Switzerland, Belgium, and France belonged to the Latin Monetary Union and all three francs