



The International Economy

Sixth Edition

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PREFACE

Developments in the international economy and the theory of international economics during the past several years have made it essential that this revision be thoroughgoing. The task of revision has been made easier by teamwork. P. T. Ellsworth and J. Clark Leith continue as full collaborators in preparation of this edition.

The text continues to provide the reader with a balanced coverage of all important topics in international economics. The approach blends theory, history, institutions, and policy. The level of difficulty in the theoretical material assumes only that the reader has had two semesters of principles of economics. Some of the more complex material in the previous edition has been omitted, and some transferred to appendixes.

Starting from a general equilibrium model of prices and production, the factor proportions basis for international trade is developed, as in earlier editions, as the dominant but not unique basis for trade. These chapters have been rewritten with the aim of simplifying the explanation of difficult material without a loss of rigor. The revision of later chapters on trade theory has been thorough, including the introduction of considerable new material. The balance-of-payments chapters have been totally redone. The approach emphasizes the fundamental importance of the simultaneous determination of income, expenditure, and asset changes. A systematic general framework permits both Keynesian and monetary approaches to be considered and then integrated.

As in earlier editions, history is employed to complement theory by showing the changes in institutional environment conditioning the principles developed in the analytical portions of the text. These chapters provide illustrations of how abstract principles apply in an ever-

changing world. Recent changes in the international economy necessitated a thoroughgoing revision of the treatment of the evolution of the international monetary system to reflect the past decade.

We are indebted to numerous discussions of the issues to Leith's colleagues in international economics at Western Ontario and to Joseph D. Coppock and Ray Boddy in San Diego. In addition we would like to thank John Adams, University of Maryland; Dennis Appleyard, University of North Carolina—Chapel Hill; Lance Girton, University of Utah; and Lawrence H. Officer, Michigan State University, who reviewed the penultimate draft and provided valuable suggestions. A special note of thanks goes to Rubén Suarez and Brenda Gonzalez-Hermosillo, research assistants to Leith, and to Diane MacDonald and Judy Purves, who typed the manuscript.

Finally, on many occasions the patience of both the authors' wives and the Leith children was severely tried by our preoccupation with the manuscript. For their unfailing and cheerful support in our labors, we dedicate this edition to Frieda, Carole Ann, Jim, Deb, and Jonathan.

P. T. E.
J. C. L.

The International Economy

CONTENTS

Introduction 1

International Economics as a Distinct Field of Study 2

History as a Complement to Theory 3

The Changing Character of the International Economy 4

The Plan of This Book 4

Part 1 From Restriction Toward Freedom in Trade and Enterprise

1 Regulated Trade: Mercantilism 9

Social and Economic Characteristics of the Mercantilist Period 10

The Bases and Chief Elements of Mercantilist Thought 14

Mercantilism in Action: Concrete Policies 19

Selected References 26

2 The Transition to Economic Liberalism 27

The Influence of the Rising Capitalist Class 28

The Balance-of-Trade Doctrine Meets the Quantity Theory of
Money 32

Individualism in Political Thought 33

Adam Smith and the New Economics 34

The Industrial Revolution: Technical Aspects 37

The Industrial Revolution: Social and Economic Aspects 41

Selected References 45

3 The Classical Doctrine of Comparative Cost 46

Adam Smith 47

David Ricardo 48

John Stuart Mill	52
The Adequacy of Classical Theory	55
Selected References	56

Part 2 The Theory of International Trade: Bases of Specialization and Trade

4 The Basis for a Modern Trade Theory	59
Price Theory and Trade Theory	60
The Production Function and Isoquants	62
Production Frontiers and Cost Conditions	66
Consumption and Demand	70
General Equilibrium Before Trade	73
Equilibrium in a Small Open Economy	75
Gains from Trade	77
Selected References	79
5 Factor Endowments and International Trade	81
Everything the Same	81
Different Factor Endowments	82
Factor Price Equalization	86
The Factors of Production	89
Multiple Factors	92
Summary	94
Selected References	95
Appendix 1: Derivation of the Production Frontier	96
Appendix 2: Offer Curves	99
6 Modifications of the Basic Model	102
Many Goods	102
Costs of Transport	105
Income Distribution and the Short-Run Immobility of Capital	109
Summary	113
Selected References	114
7 Alternative Bases for Trade	115
Differences in Technology	116
Competition in the Modern World	117
Technological Change	120
The Product Cycle	123
Technological Change, Factor Proportions, and Perfect Competition	124
Summary	126
Selected References	127

8	Empirical Evaluation	129
	Factor Proportions	130
	Technology: Technological Change and R & D Expenditure	136
	The Product Cycle	137
	Product Differentiation	137
	Multivariate Tests	138
	Summary and Conclusions	140
	Selected References	142
	Appendix: Elasticity of Substitution	142
9	Trade Under Changing Conditions	144
	Growth and the Transformation Function	144
	Growth and Consumption Patterns	147
	Growth and the Offer Curve	149
	The Terms of Trade	150
	International Factor Movements	155
	Factor Mobility in the International Economy	157
	Summary	167
	Selected References	169

Part 3 Tariffs and Protection

10	The Tariff Issue	173
	Effects of a Tariff: Partial Equilibrium	173
	Alternative Instruments of Protection	180
	Effects of a Tariff: General Equilibrium	181
11	The Case for Protection	185
	Serious Arguments for Protection	185
	Special-Interest Arguments for Protection	199
	Selected References	204
12	Economic Integration	205
	The Customs Union	205
	Static Effects of a Customs Union	206
	Dynamic Aspects of Union	216
	Selected References	219
13	Trade Liberalization and Regional Integration	221
	Contrasting Trade Policies in History	221
	Cooperation to Restore a World Economy	222
	A Proposal for an International Trade Organization	223
	The General Agreement on Tariffs and Trade	224
	United States Tariff Policy Since 1934	226
	Economic Union in Europe	233
	Economic Union in Latin America	243
	Selected References	246

14 Developing Countries and the International System 247

- The Nature of Poverty in the Poor Countries 247
- Trade and Economic Development 249
- The New International Economic Order 251
- Selected References 257

Part 4 Internationalism and Its Rival

15 The Growth of an International Economy 261

- The Rise of Britain 263
- Western Europe Catches Up 270
- Economic Developments Overseas 272
- Trade Is Made Free 276
- An International Economy 279

16 The Revival of Nationalism 281

- The Challenge to Britain's Leadership 281
- Nationalism and Protectionism 288
- Imperialist Expansion, 1880–1913 291
- Selected References 297

Part 5 International Monetary Relations

17 Income, Expenditure, and the Balance of Payments 301

- The Basic Relationship: Income and Expenditure 302
- A Very Simple Model of National Expenditure, Income, and the Balance of Payments 304
- One Asset 307
- Conclusion 309
- Selected References 310

18 The Balance-of-Payments Accounts 311

- The Balance-of-Payments Accounts in the Basic Model 311
- The Balance-of-Payments Accounts of Nations 313
- Balance-of-Payments Accounting Conventions 314
- Donations 315
- Estimates Versus Accounts 316
- Measures of Balance 317

	The Balance of International Indebtedness	319
	Selected References	321
19	Foreign Exchange	322
	The New York Foreign Exchange Market	325
	Instruments of Foreign Exchange	326
	The Role of International Financial Centers	328
	Arbitrage	329
	The Foreign Exchange Market and the Balance of Payments	330
	Foreign Exchange Demand and Supply	331
	A Digression: The Foreign Exchange Market Diagram	333
	Selected References	336
20	Balance-of-Payments Adjustment	337
	Fixed Exchange Rates	338
	Flexible Exchange Rates	356
	A Summary Contrast Between Fixed and Flexible Exchange Rates	361
	The Choice Between the Keynesian and Monetary Approaches	363
	Selected References	364
21	International Capital Movements	365
	Fixed Exchange Rates	369
	Flexible Exchange Rates	373
	Conclusion	387
	Selected References	388
22	The IS—LM Model and Tradeable Bonds	390
	Derivation of the <i>IS—LM</i> Model: Nontradeable Bonds	391
	<i>IS—LM</i> with Perfectly Tradeable Bonds	398
	Conclusion	407
23	External and Internal Balance	409
	The <i>IS—LM</i> Model with a Foreign Balance Curve	409
	External Versus Internal Balance in the <i>IS—LM—FB</i> Model	412
	Activist Versus Passivist Adjustment to Internal and External Balance	
	Under Fixed Exchange Rates	417
	Selected References	419
	Appendix: Derivation of the <i>FB</i> Curve	419
24	Exchange Control	422
	Why Countries Choose Exchange Controls	423
	The Anatomy of Exchange Control Regulations	426
	Domestic Consequences of Exchange Control Regimes	428
	Consequences for the International System	430
	Conclusion	439
	Selected References	441

Part 6 The International Monetary System in the Twentieth Century

- 25 Structural Weakening of the World Economy 445**
The World Economy of 1913 445
Forces of Disintegration 446
A Weakened International Structure 447
The Burden of Structural Change 455
- 26 Forces of Disintegration 464**
The Great Depression of the 1930s 464
The Results of Exchange Depreciation 475
The World Economy Prior to World War II 476
Selected References 478
- 27 From Reconstruction to Payments Problems 479**
International Payment Difficulties 480
The European Recovery Program 482
Europe's Recovery 483
The U.S. Balance of Payments to 1968 485
Recovery in Germany and Japan 485
Selected References 487
- 28 Development of the Postwar International Monetary
System 489**
The Bretton Woods System 490
The Eurocurrency Market 496
Conclusion 502
Selected References 502
- 29 From Fixed to Floating Exchange Rates 503**
Fixed Rates 503
Floating Rates: 1973 Onward 509
Conclusion 523
Selected References 523
- 30 The IMF and the International Monetary System 525**
Organization and Functioning 526
The Need for Greater Liquidity and the SDR 533
Limiting Disequilibrating Capital Flows 538
Is the IMF Evenhanded? 541
Selected References 542
- Author Index 545**
- Subject Index 549**

Introduction

As a social science, economics focuses on one major aspect of social life: the activities related to maintaining life and to improving its condition. These activities encompass both consumption, whose pattern and composition determine the standard of living of an individual or of a group, and production, whose sole purpose is to provide the means for consumption.

In its analysis of these activities, economics has concerned itself with three major areas: the allocation of productive resources to the various branches of production, the degree of utilization (full or partial) of those resources, and the forces underlying their growth over time. In an unregulated economy, resources are allocated primarily through the operation of the price system. The task of studying this complex system falls to price theory, or microeconomics. Macroeconomics encompasses the analysis of the forces determining the level at which resources are employed, whereas growth theory, as its name implies, relates to problems of growth and development.

International economics is concerned with these same problems in their international setting. Thus the allocation of resources among several economies or nations, rather than within a single one, is studied. As far as unregulated economies are concerned, this means an examination of the way in which a number of distinct national price systems are interrelated. On the side of macroeconomics, the international transmission of the forces affecting the employment of resources must be analyzed. The same can be said of the problems of growth. In summary, international economics simply moves on from a study of the operation of a single economy to an analysis of the interrelation of two or more economies, and this with respect to their price systems, the forces affecting the level of employment, and the forces determining growth.

As any student of elementary economics knows, the prices of goods in a given economy are determined in the various markets for those goods by the interaction of the forces of demand and supply, stemming respectively from the needs and desires of consumers, on the one hand, and from the firms engaged in production, on the other. The prices of the factors used to produce these goods are similarly determined in the factor markets.

The principal way in which a number of economies are linked together into an international economy is through the extension of markets from the national to the international level. National prices are compared in these broader markets, with the business of supplying a particular commodity normally going to the cheapest supplier. Another link between economies is provided by movements of some of the factors of production. But commodities also move in trade within the boundaries of each nation. So do the movable factors of production: labor, capital, and enterprise. And as we just noted, the basic principles of microeconomics and macroeconomics form the theoretical foundation of international economics, as they do in the study of a national economy. Why, then, should the economic transactions between nations require a separate study?

INTERNATIONAL ECONOMICS AS A DISTINCT FIELD OF STUDY

Two reasons are generally advanced for distinguishing international economics as a special field. One is that such international movement of factors as occurs is, in general, far less free than movement within a single country. Thus factor prices can differ widely among nations. Wages need not be the same in Italy as in the United States, nor the return to capital the same in Britain, India, and Argentina. But within each country, the rewards of each factor tend strongly toward equality. Since payments to the productive factors are the ultimate costs of producing commodities, such national differences in factor prices suggest that international trade requires a different explanation from that of domestic trade.

Another reason for undertaking a separate study of international economics is that the economic activity we seek to analyze operates within a framework of laws and institutions that vary widely from country to country. That each country has its own money is of particular importance. Since the nationals of each country execute their transactions, whether domestic or foreign, in their own national money, this raises the problem of foreign exchange—of translating interna-

tional payments and receipts from one currency into another. A closely related problem is the ways and means of bringing international payments and receipts into balance.

The major task of international economics is to provide an understanding of the basis for trade among nations, and of how a nation's international payments can be brought into balance with its receipts. These aspects of our study are the theoretical core, which make it possible to perceive regularity and order in the multitude of transactions among 150 or so nations, involving thousands of commodities, a wide variety of financial instruments, and services ranging from insurance to the leasing of patents.

By its very nature, the theory of international trade and finance is abstract. Yet this theory, when put to use, must always be applied to a concrete situation, one that is shaped by the laws and institutions of the nation or nations involved. And such institutional differences can, through their effect on a nation's development, strongly influence the character of its economy and therewith the role it plays in the world economy.

HISTORY AS A COMPLEMENT TO THEORY

It is considerations such as the preceding that make it desirable to complement the analytical tools of theory with a study of relevant aspects of history.

Thus the near absence in most of Latin America until recently of a middle class accounts in large part for a slow rate of growth, whereas the existence of such a class in the United States and Canada was an important factor in their rapid progress in the last century and a half. This striking difference can be traced to the character of the settlers in the two regions and the institutions they brought with them. To North America came people mainly from the lower middle classes, who brought with them a tradition of individual striving, a questioning of authority, and a desire for economic improvement. In South America, on the other hand, the Spanish *conquistadores* who dominated the early settlements introduced feudal ideas and institutions and imposed the *hacienda* system on the native Indian population. A concentration of land ownership and wealth resulted, which made for a rigid social structure, a continued predominance of agriculture, and a slow and tardy appearance of modern industry.

But institutional differences alone do not account for differences in the structure and operation of national economics. Laws and institutions are not immutable, but undergo constant change. As they

change, they may greatly alter, not the operative economic principles themselves, but their impact on a society and hence upon the economic policies it adopts. Thus the gold standard, the international monetary system that tied national currencies together at fixed exchange rates, worked relatively well in the nineteenth century because the environment was favorable. But with increasing industrialization and urbanization, and with the changes in social attitudes that these developments caused, the deflationary bias of the gold standard condemned it as a satisfactory international monetary framework. In recent years, attention has therefore been directed toward alternative types of international arrangements.

THE CHANGING CHARACTER OF THE INTERNATIONAL ECONOMY

Looked at more broadly, the international economy—the system of trade relationships and the system of monetary arrangements that link nations with one another—has gone through at least four phases, each of considerable duration. The earliest phase, economic nationalism or mercantilism, was one of aggressive struggle, with each nation pitted against its rivals. Despite the seeming anarchy, international economic relations conformed to a unique kind of order, with trade regulated in great detail. Then, following deep-seated changes in methods of production and in the growth of social and economic classes, the nineteenth century witnessed a period of rapid growth under an international system based on freedom of trade. This phase endured down to 1914. Then the shocks of World War I, the Great Depression of the 1930s, and finally World War II brought the international economy near to disintegration. Fortunately, the lessons of that period led to rapid reconstruction and to a substantial degree of deliberate international cooperation. Whether, with the worldwide recession of 1982–1983 and the associated protectionist pressures, that phase is coming to an end, it is too soon to tell. In any event, changes of great moment appear to be upon us. These changes will be interesting to watch and, for those who can, exciting to help guide.

THE PLAN OF THIS BOOK

The preceding discussion gives some indication of the structure of this book. We start in Part 1 with an account of the beginnings of an international economic system in the preindustrial era, of the economic ideas that guided statesmen, and of the manner in which trade was conducted and regulated. There follows a chapter on the rise of liber-

alism in economic thought and of the social and economic consequences of the Industrial Revolution, two developments that were to shape events for well over a century. The third and final chapter of this section presents the theories on international trade of Adam Smith, David Ricardo, and John Stuart Mill, theories that were powerful weapons in the struggle to free trade from its mercantilist restrictions. Part 2 consists of six chapters that present, in a sequence running from the simple to the complex, the modern analysis of international trade. The trading equilibrium is set out and bases for trade are developed, followed by an empirical evaluation of the theories. We also take into account changing conditions—changes in technology and in supplies of productive factors, from sources that are either internal or external to the domestic economy.

Part 3 deals with the issues arising from the restriction of trade. In the first pair of chapters we undertake an analysis of the nature and effects of tariffs, and an evaluation of the case for protection. In a second pair of chapters we take up some international institutional arrangements that have been designed to free-up trade: economic integration among a group of countries, and multilateral tariff reductions. The final chapter of Part 3 considers the case put forward by developing countries for special treatment in the international economic system.

Part 4 picks up the historical narrative. It opens with a description of the development in the nineteenth century of a closely interwoven world trading system, with Britain at its center. The next chapter goes on to show the reemergence of expansive nationalism, which ended with World War I.

Part 5 moves from microeconomics to macroeconomics in eight chapters devoted to the monetary and financial relations among nations. The stage is set by establishing a simplified framework of real production, consumption, and trade. This provides a link between the pure theory of trade and the balance of payments. The simultaneity of the determination of income, expenditure, and asset changes is emphasized to assist the reader in understanding the fundamentals of the balance of international payments of a country. This system approach is taken from the very beginning to guard against treating balance-of-payments policy issues as the sum of unconnected parts.

To keep the analysis simple at this early stage, only one asset is assumed but is not identified specifically. Further, the complication of different currencies is left until a later chapter.

The accounting of the various elements of the balance of payments is added in the next chapter.

Complications are then added one at a time. Chapter 19 adds the first major complication: different currencies and the concept of exchange rates.