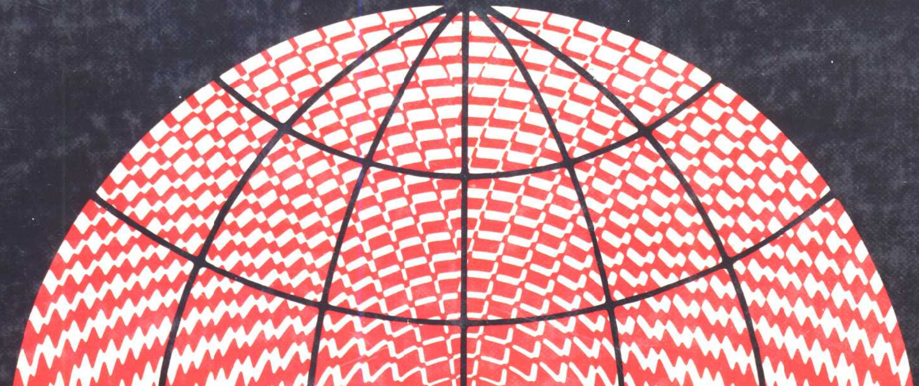

The International Economy

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 everchanging 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.

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J. C. L.

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CONTENTS

Part 6 The International Monetary System in the Twentieth Century

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 international 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 liberalism 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.