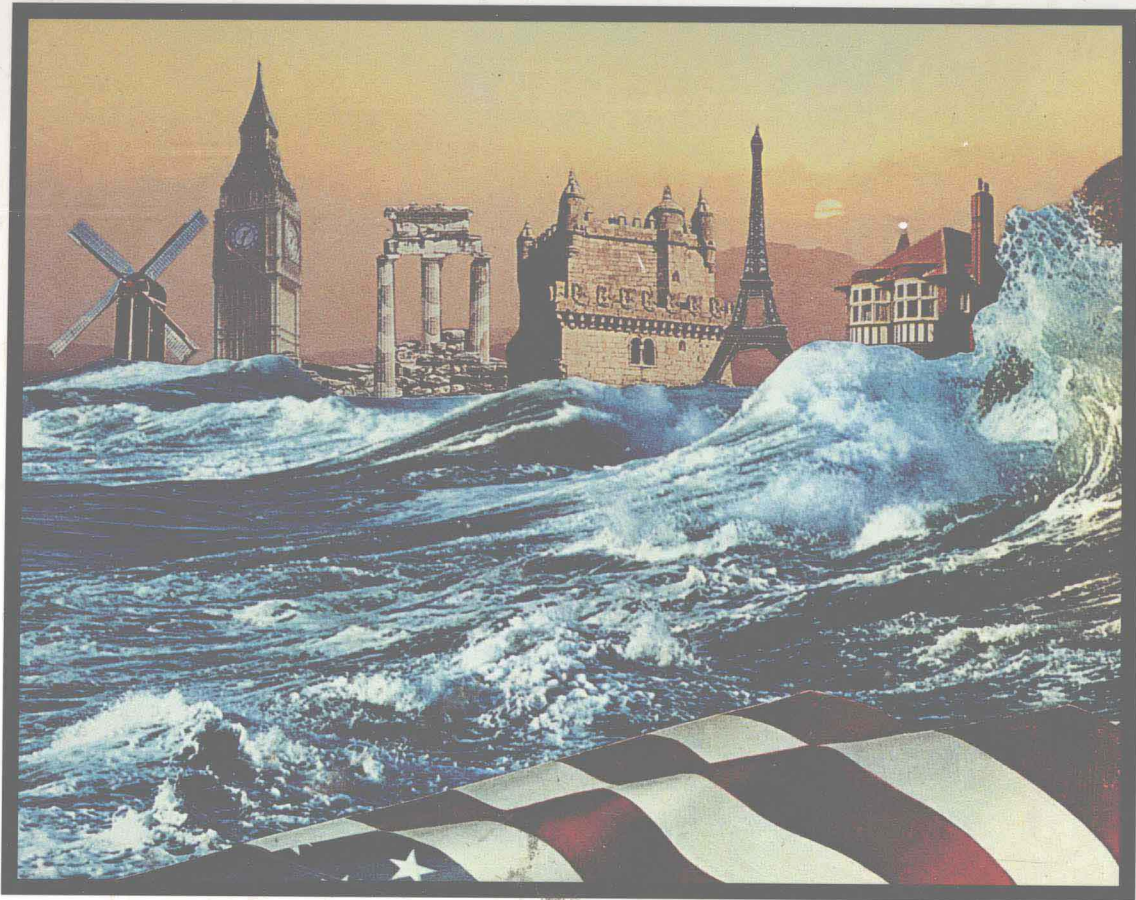


7th edition



INTERNATIONAL Economics

Robert J. Carbaugh

7th Edition

International Economics

Robert J. Carbaugh

Professor of Economics

Central Washington University



South-Western College Publishing

an International Thomson Publishing company I(T)P®

Cincinnati • Albany • Boston • Detroit • Johannesburg • London • Madrid • Melbourne • Mexico City
New York • Pacific Grove • San Francisco • Scottsdale • Singapore • Tokyo • Toronto

Team Director/Publisher: *Jack W. Calhoun*
Acquisitions Editor: *Keri Witman*
Development Editor: *Thomas S. Sigel*
Production Editor: *Peggy K. Buskey*
Marketing Manager: *Lisa L. Lysne*
Production House: *Pre-Press Company, Inc.*
Cover Design: *Jennifer Lynne Martin*
Cover Illustrator: © *Joan Hall/SIS*

Copyright © 2000
by South-Western College Publishing
Cincinnati, Ohio

All Rights Reserved

The text of this publication, or any part thereof,
may not be reproduced or transmitted in any form
or by any means, electronic or mechanical, includ-
ing photocopying, recording, storage in an informa-
tion retrieval system, or otherwise, without prior
written permission from the publisher.

International Economics, 7th edition
ISBN: 0-324-00108-8

2 3 4 5 6 7 8 D1 5 4 3 2 1 0 9
Printed in the United States of America

Library of Congress Cataloging-in-Publication Data
Carbaugh, Robert J.

International economics / Robert J. Carbaugh. —
7th ed.

p. cm.

Includes bibliographical references and index.

ISBN 0-324-00108-8 (hardcover)

1. International economic relations. I. Title.

HF1359.C37 1999

337—dc21

98-51511

CIP

ITP®

International Thomson Publishing

South-Western College Publishing is an ITP Company.
The ITP trademark is used under license.

7th Edition

International Economics

Preface

My belief is that the best way to motivate students to learn a subject is to demonstrate how it is used in practice. The first six editions of *International Economics* reflected this belief and were written to provide a serious presentation of international economic theory with an emphasis on current applications. Adopters of these editions strongly supported the integration of economic theory with current events.

The present edition has been revised with an eye toward improving this presentation and updating the applications as well as toward including the latest theoretical developments. Like its predecessors, this edition is intended for use in a one-quarter or one-semester course for students who have no more background than principles of economics. This book's strengths are its clarity and organization and its applications, which demonstrate the usefulness of theory to students. The revised and updated material in this edition emphasizes current applications of economic theory and incorporates recent theoretical and policy developments in international trade and finance. New or substantially revised topics in the seventh edition include:

- What the United States stood to lose from Asia's economic crisis—Ch. 1
- Globalization and the business cycle—Ch. 1
- Competition in the world steel industry—Ch. 1
- Where does U.S. comparative advantage lie?—Ch. 2
- The Heckscher–Ohlin theory and U.S.–China trade—Ch. 4
- Falling transportation costs foster trade boom—Ch. 4
- Contribution of international trade to wage inequality—Ch. 4
- U.S. steelmakers win even when they lose an unfair trade case—Ch. 7
- Fast track, workers' rights, and the environment—Ch. 7
- Are international labor standards needed to prevent social dumping?—Ch. 8
- Economic flu spreads throughout Asia—Ch. 8
- Do low wages attract foreign investment?—Ch. 10
- Is immigration good for California?—Ch. 10
- Has NAFTA been a success?—Ch. 9
- Do developed countries gain from trade liberalization with developing countries?—Ch. 9
- Differing sides of the EMU: Portugal and Sweden—Ch. 9
- Will the EMU be good for the United States?—Ch. 9
- Fears and facts about foreign direct investment—Ch. 10
- Should foreign-exchange transactions be taxed?—Ch. 12
- Adjusting to dollar fluctuations—Ch. 12
- Should speculators be regulated?—Ch. 12
- Time path of U.S. trade balance in response to dollar depreciation and appreciation—Ch. 15

- Growing imports help to hold prices down in the United States—Ch. 15
- Inflation works against the gains of devaluation—Ch. 15
- The pass-through effect and profit margins—Ch. 15
- Stabilizing currencies: currency boards versus central banks—Ch. 16
- Speculative attacks on the Swedish krona—Ch. 16
- Are fixed exchange rates good for developing countries? Lessons from Asia—Ch. 16
- A new world of currency contenders: the dollar and the euro—Ch. 16
- The United States attacks Japanese crisis by stabilizing yen—Ch. 17
- Should the IMF be abolished?—Ch. 18

Although instructors generally agree on the basic content of the international economics course, opinions vary widely about what arrangement of material is appropriate. This book is structured to provide considerable organizational flexibility. The topic of international trade relations is presented before international monetary relations, but the order can be reversed by instructors who choose to start with monetary theory. Instructors can begin with Chapters 11–18 and conclude with Chapters 2–10. Those who do not wish to cover all the material in the book can omit Chapters 7–10 and Chapters 16–18 without loss of continuity.

In this age of computing, no text package would be complete without web-based resources. For the first time, an international economics website is offered with the seventh edition. This site, <http://carbaugh.swcollege.com>, will contain many useful pedagogical enrichment features, including Netlink Exercises, which draw upon the expanded Netlinks feature at the end of each chapter. While the Netlinks direct the student to an appropriate international economics website to gather data and other relevant information, the Netlink Exercises allow students to access these websites to answer perti-

nent and practical questions that relate to international economics. As an added enrichment feature, a Virtual Scavenger Hunt engages and encourages students to search for international economics answers at various Internet websites.

New to this edition are comprehensive Power Point slides created by Steve Norton and Lynda Maillet of Okno Consulting Group, Ann Arbor, Michigan. These slides can be easily downloaded from the Carbaugh website. The slides offer professors flexibility in enhancing classroom lectures. Slides may be edited to meet individual needs. They also serve as a study tool for students.

In addition, students and instructors alike can address questions and provide commentary directly to the author with the Talk to the Author feature. Return often to <http://carbaugh.swcollege.com> to access pertinent updates by the author, reflecting developments in the global economy as situations emerge.

The most current economic-policy debates, written by John Kane from SUNY Oswego, can also be accessed through this website, as well as *Economic News Online*, a news summary service of important news-breaking reports. For other high-tech study tools, Visit the South-Western Economics Resource Center at <http://economics.swcollege.com>.

To assist instructors in the teaching of international economics, I have written an *Instructor's Manual* to accompany the seventh edition. It contains: (1) brief answers to end-of-chapter study questions, (2) multiple-choice questions and true-false questions for each chapter, and (3) suggestions for further readings.

To accompany the seventh edition of the *International Economics* text, Professor Jim Hanson of Willamette University has prepared a *Study Guide* for students. This guide reinforces key concepts by providing a review of the text's main topics and offering practice problems, true-false and multiple-choice questions, and short-answer questions.

Besides serving the educational needs of resident college students, the seventh edition of

International Economics addresses the needs of distant-learning students; it is the recommended text for the telecourse *Inside the Global Economy*, provided by the Annenberg/CPB Project. *Inside the Global Economy* includes 13 one-hour television programs that present an in-depth examination of the basic principles of international economics. Each program features two documentary case studies that illustrate the connection between economic theory and global trade, business, and finance in concrete, highly visual terms. The 26 case studies were produced in more than 20 countries. Besides the case studies, each program provides an introduction and analysis of the economic principles by the project's director of content, Dr. Nariman Behraves, senior vice-president and research director at DRI/McGraw-Hill. A distinguished group of international economists from Australia, Sweden, Venezuela, and the United States wraps up each program with an illuminating roundtable discussion of a major economic issue. To request a VHS preview cassette, phone 1-800-LEARNER or write Annenberg/CPB Collection, P.O. Box 2345, South Burlington, VT 05407-2345.

To accompany *Inside the Global Economy*, I have also prepared a reader, *Inside the Global Economy: A Case Study Reader and Review Guide*. A discount package is available for those courses using my textbook and reader.

I am pleased to acknowledge those who aided me in preparing the seventh edition. Helpful suggestions and often detailed reviews were provided by:

- Burton Abrams, University of Delaware
- Richard Adkisson, New Mexico State University
- Richard Anderson, Texas A&M—College Station
- John Charalambakis, Asbury College
- Daniel Falkowski, Canisius College
- Jim Hanson, Willamette University
- Mike Marks, Georgia College School of Business

- John Olienyk, Colorado State University
- Chuck Rambeck, St. John's University
- Ben Slay, Middlebury College (now at PlanEcon)
- Darwin Wassink, University of Wisconsin—Eau Claire
- Peter Wilamoski, Seattle University

I would like to thank Margaret Landman, of Bridgewater State University, for creating the NetLinks for this edition, as well as the Netlink Exercises and Virtual Scavenger Hunt. I would also like to thank my colleagues at Central Washington University—Don Cocheba, Ron Elkins, Wolfgang Franz, Koushik Ghosh, Jane Johnson, Richard Mack, Peter Saunders—for their advice and help while I was preparing the manuscript. I am also indebted to Barbara Hodges, who assisted in the manuscript's preparation.

It has been a pleasure to work with my editors, Thomas Sigel and Keri Witman. In particular, Tom provided many valuable suggestions and assistance in seeing this edition to its completion. Special thanks is given to Peggy Buskey who orchestrated the production of this book in conjunction with Jenna Schulman, project manager at Pre-Press Company, Inc. Also, Lisa Lysne did a wonderful job in advertising and marketing the seventh edition. Finally, I am grateful to my students, who commented on the revisions included in this new edition.

I would appreciate any comments, corrections, or suggestions that faculty or students wish to make, so that I can continue to improve this text in the years ahead. Please contact me! Thank you for permitting this text to evolve to the seventh edition.

Bob Carbaugh
 Department of Economics
 Central Washington University
 Ellensburg, Washington 98926
 Phone: (509) 963-3443
 Fax: (509) 963-1992
 E-mail: Carbaugh@CWU.Edu

Contents in Brief

Introduction 1

CHAPTER 1	<i>The International Economy</i>	3
-----------	----------------------------------	---

Part One International Trade Relations 23

CHAPTER 2	<i>Foundations of Modern Trade Theory</i>	25
CHAPTER 3	<i>International Equilibrium</i>	57
CHAPTER 4	<i>Trade Model Extensions and Applications</i>	73
CHAPTER 5	<i>Tariffs</i>	113
CHAPTER 6	<i>Nontariff Trade Barriers</i>	153
CHAPTER 7	<i>Trade Regulations and Industrial Policies</i>	189

CHAPTER 8	<i>Trade Policies for the Developing Nations</i>	234
CHAPTER 9	<i>Regional Trading Arrangements</i>	269
CHAPTER 10	<i>International Factor Movements and Multinational Enterprises</i>	310

Part Two
International Monetary Relations 347

CHAPTER 11	<i>The Balance of Payments</i>	349
CHAPTER 12	<i>Foreign Exchange</i>	366
CHAPTER 13	<i>Exchange-Rate Determination</i>	401
CHAPTER 14	<i>Balance-of-Payments Adjustments under Fixed Exchange Rates</i>	437
CHAPTER 15	<i>Exchange-Rate Adjustments and the Balance of Payments</i>	453
CHAPTER 16	<i>Exchange-Rate Systems</i>	477
CHAPTER 17	<i>Macroeconomic Policy in an Open Economy</i>	513
CHAPTER 18	<i>International Banking: Reserves, Debt, and Risk</i>	531

Contents

Introduction 1

CHAPTER 1

The International Economy 3

The United States as an Open Economy	4
WHAT THE UNITED STATES STOOD TO LOSE FROM ASIA'S ECONOMIC CRISIS	5
FOREIGN COMPETITION AND THE U.S. AUTO INDUSTRY	8
Consequences of Increased Openness	9
Globalization and the Business Cycle	10
What Makes a Company "American"?	11
EVEN THE BOEING 777 ISN'T ALL AMERICAN	12
International Competitiveness	13
<i>Firm (Industry) Competitiveness</i>	13

<i>A Nation's Competitiveness</i>	14
<i>Globalization and Competitiveness</i>	15
Is International Trade an Opportunity or a Threat to Workers?	17
COMPETITION IN THE WORLD STEEL INDUSTRY	18
The Plan of This Book	20
SUMMARY	20
STUDY QUESTIONS	21
NETLINKS	21

Part One *International Trade Relations 23*

CHAPTER 2

Foundations of Modern Trade Theory 25

Historical Development of Modern Trade Theory	25
<i>The Mercantilists</i>	25

<i>Why Nations Trade: Absolute Advantage</i>	26	<i>U.S. Manufacturing Productivity Trends</i>	40
<i>Why Nations Trade: Comparative Advantage</i>	27	Trade Restrictions	41
WHERE DOES U.S. COMPARATIVE ADVANTAGE LIE? 30		DO RISING HEALTH-CARE COSTS LEAD TO COMPETITIVE DISADVANTAGE?	42
<i>Comparative Advantage in Money Terms</i>	30	Trading under Increasing-Cost Conditions	43
Transformation Schedules	32	<i>Increasing Costs</i>	43
Trading under Constant-Cost Conditions	32	<i>Increasing-Cost Trading Case</i>	45
<i>Constant Costs</i>	33	<i>Partial Specialization</i>	47
<i>The Basis for Trade and Direction of Trade</i>	34	THE RACE IN RESEARCH AND DEVELOPMENT	48
<i>Production Gains from Specialization</i>	36	Comparative Advantage Extended to Many Products and Countries	49
<i>Consumption Gains from Trade</i>	36	<i>More Than Two Products</i>	49
<i>Distributing the Gains from Trade</i>	37	<i>More Than Two Countries</i>	50
<i>Complete Specialization</i>	38	Exit Barriers	50
Productivity and Comparative Advantage	38	Empirical Evidence on Comparative Advantage	51
<i>Changing Comparative Advantage</i>	39	SUMMARY	54
		STUDY QUESTIONS	55
		NETLINKS	56

CHAPTER 3

International Equilibrium 57

Indifference Curves	57	Economic Growth and the Terms of Trade	67
<i>Autarky Equilibrium</i>	59	Terms-of-Trade Estimates	68
A Restatement: Basis for Trade, Gains from Trade	59	SUMMARY	70
The Equilibrium Terms of Trade	62	STUDY QUESTIONS	71
<i>Theory of Reciprocal Demand</i>	62	NETLINKS	72
<i>Offer Curves and the Equilibrium Terms of Trade</i>	64		

CHAPTER 4

Trade Model Extensions and Applications 73

Factor-Endowment Theory	73	Specific Factors: Trade and the Distribution of Income in the Short Run	85
<i>Factor-Price Equalization</i>	75	Economies of Scale and Specialization	87
THE HECKSCHER-OHLIN THEORY: U.S.-CHINA TRADE	76	Theory of Overlapping Demands	90
<i>Trade and the Distribution of Income</i>	77	Intraindustry Trade	91
Does Trade Make the Poor Even Poorer?	78	Product Cycles	93
Are Actual Trade Patterns Explained by the Factor-Endowment Theory?	80	POCKET CALCULATORS AND THE INTERNATIONAL PRODUCT CYCLE	94

Dynamic Comparative Advantage: Industrial Policy	95
BOEING, AIRBUS, AND INDUSTRIAL POLICY	96
Environmental Regulatory Policies and International Competitiveness	99
Trade in Business Services	102
Transportation Costs	104
<i>Trade Effects</i>	104

FALLING TRANSPORTATION COSTS FOSTER TRADE BOOM	106
<i>Transportation Costs and the U.S. Steel Industry</i>	109
SUMMARY	110
STUDY QUESTIONS	110
NETLINKS	112

CHAPTER 5

Tariffs 113

The Tariff Concept	114
<i>Types of Tariffs</i>	115
<i>Effective Rate of Protection</i>	116
<i>Tariff Escalation</i>	118
Production Sharing and Offshore-Assembly Provision	119
Postponing Import Duties	121
<i>Bonded Warehouse</i>	121
<i>Foreign-Trade Zone</i>	121
Tariff Welfare Effects: Consumer Surplus and Producer Surplus	122
CALCULATING THE WELFARE EFFECTS OF A TARIFF	125
Tariff Welfare Effects: Small-Nation Model	125
Tariff Welfare Effects: Large-Nation Model	127
COSTS TO THE CONSUMER OF PRESERVING A PRODUCTION WORKER'S JOB	128
Tariff Examples	131
<i>Motorcycles</i>	132
<i>Japanese Luxury Cars</i>	133

Who Pays for Import Restrictions?	135
EFFECTS OF ELIMINATING IMPORT TARIFFS	136
How a Tariff Burdens Exporters	136
Arguments for Trade Restrictions	139
<i>Job Protection</i>	139
<i>Protection against Cheap Foreign Labor</i>	140
<i>Fairness in Trade: A Level Playing Field</i>	143
<i>Maintenance of the Domestic Standard of Living</i>	143
<i>Equalization of Production Costs</i>	144
<i>Infant-Industry Argument</i>	144
<i>Noneconomic Arguments</i>	145
The Political Economy of Protectionism	146
PETITION OF THE CANDLE MAKERS	149
SUMMARY	149
STUDY QUESTIONS	150
NETLINKS	152

CHAPTER 6

Nontariff Trade Barriers 153

Import Quota	153
<i>Trade and Welfare Effects</i>	155
<i>Sugar Import Quotas</i>	156
ALLOCATING QUOTA LICENSES	157

<i>Quotas versus Tariffs</i>	159
EFFECTS OF ELIMINATING NONTARIFF TRADE BARRIERS	161
Tariff-Rate Quota: A Two-Tier Tariff	162

Orderly Marketing Agreements	163
<i>Export Quota Effects</i>	164
CATERPILLAR OPPOSES STEEL QUOTAS	167
<i>Japanese Auto Restraint</i>	168
Domestic Content Requirements	168
Subsidies	171
<i>Domestic Subsidy</i>	171
HOW "FOREIGN" IS YOUR CAR?	172
<i>Export Subsidy</i>	173
Dumping	175
<i>Forms of Dumping</i>	176
<i>International Price Discrimination</i>	176
<i>Excess Capacity</i>	178

SMITH CORONA FINDS ANTIDUMPING VICTORIES ARE HOLLOW	179
<i>Antidumping Regulations</i>	179
<i>Washington Apples</i>	181
Other Nontariff Trade Barriers	181
<i>Government Procurement Policies</i>	181
<i>Social Regulations</i>	183
<i>Sea Transport and Freight Restrictions</i>	184
SUMMARY	185
STUDY QUESTIONS	185
NETLINKS	188

CHAPTER 7

Trade Regulations and Industrial Policies 189

The Smoot–Hawley Tariff Act	189
The Reciprocal Trade Agreements Act	191
The General Agreement on Tariffs and Trade and the World Trade Organization	192
<i>The Uruguay Round</i>	195
FAST TRACK, WORKERS' RIGHTS, AND THE ENVIRONMENT	196
<i>The World Trade Organization</i>	198
Trade Remedy Laws	199
<i>The Escape Clause</i>	199
<i>Countervailing Duties</i>	199
<i>Antidumping Duties</i>	202
<i>Section 301: Unfair Trading Practices</i>	202
U.S.–Japanese Automotive Trade Dispute	203
U.S. STEELMAKERS LOSE AN UNFAIR-TRADE CASE AND STILL WIN	204
World Trade Organization Turns Kodak Down	206
Remedies against Dumped and Subsidized Imports	207
Protection of Intellectual Property Rights	209

Trade Adjustment Assistance	211
Industrial Policies of the United States	212
<i>Export Promotion and Financing</i>	214
<i>Knowledge-Based Growth Policy</i>	215
Industrial Policies of Japan	216
Strategic Trade Policy	218
<i>Imperfect Competition and Government Subsidies</i>	218
<i>Welfare Effects of Strategic Trade Policy</i>	220
Economic Sanctions	223
HAS INDUSTRIAL POLICY HELPED JAPAN?	224
<i>Factors Influencing the Success of Sanctions</i>	224
<i>Iraqi Sanctions</i>	227
<i>Indian and Pakistani Sanctions</i>	228
TRADE IN INTERNATIONAL SERVICES	229
SUMMARY	231
STUDY QUESTIONS	232
NETLINKS	233

CHAPTER 8

Trade Policies for the Developing Nations 234

Developing-Nation Trade Characteristics	234	<i>Unstable Export Markets</i>	236
Trade Problems of the Developing Nations	235	<i>Worsening Terms of Trade</i>	237

Call for a New International Economic Order	239	<i>East Asian Economies</i>	255
ARE INTERNATIONAL LABOR STANDARDS NEEDED TO PREVENT SOCIAL DUMPING?	240	<i>East Asia's Growth Strategy</i>	257
Stabilizing Commodity Prices	242	<i>Flying-Geese Pattern of Growth</i>	258
<i>Production and Export Controls</i>	243	ECONOMIC FLU SPREADS THROUGHOUT EAST ASIA	259
<i>Buffer Stocks</i>	244	<i>Industrial Policies</i>	260
<i>Multilateral Contracts</i>	245	<i>Will the East Asian Miracle Continue?</i>	260
Commodity Agreement Experience	245	China as a High-Performing Economy	261
The OPEC Oil Cartel	246	<i>China's Most-Favored-Nation Trade Status</i>	263
<i>Maximizing Cartel Profits</i>	247	CHINA'S FAILURE TO PROTECT U.S. INTELLECTUAL PROPERTY	265
<i>OPEC as a Cartel</i>	249	<i>Barring Entry? China and the World Trade Organization</i>	266
Generalized System of Preferences	250	SUMMARY	267
Economic Growth Strategies: Import Substitution versus Export-Led Growth	251	STUDY QUESTIONS	267
<i>Import Substitution</i>	251	NETLINKS	268
IMPORT-SUBSTITUTION LAWS BACKFIRE ON BRAZIL	253		
<i>Export-Led Growth</i>	254		

CHAPTER 9

Regional Trading Arrangements 269

Types of Regional Trading Arrangements	270	DO DEVELOPED COUNTRIES GAIN FROM TRADE LIBERALIZATION WITH DEVELOPING COUNTRIES?	296
The Impetus for Regionalism	271	Free Trade Area of the Americas	298
Effects of a Regional Trading Arrangement	271	Asia-Pacific Economic Cooperation	300
<i>Static Effects</i>	271	Regional Integration versus Multilateralism	300
<i>Dynamic Effects</i>	274	The Transition Economies of Eastern Europe and the Former Soviet Union	301
European Union	274	<i>Financing Limitations</i>	302
<i>Pursuing Economic Integration</i>	276	<i>Industrial Cooperation</i>	303
<i>Economic and Monetary Union</i>	278	<i>The Council for Mutual Economic Assistance</i>	304
THE EMU PRESENTS DIFFERENT FACES TO PORTUGAL AND SWEDEN	281	<i>The Transition toward a Market-Oriented Economy</i>	305
<i>Agricultural Policy</i>	281	SUMMARY	307
<i>Government Procurement Policies</i>	285	STUDY QUESTIONS	308
U.S.–Canada Free Trade Agreement	287	NETLINKS	309
THE EUROPEAN MONETARY UNION WILL BE GOOD FOR THE UNITED STATES	288		
North American Free Trade Agreement (NAFTA)	291		
<i>Has NAFTA Been a Success?</i>	295		

CHAPTER 10

International Factor Movements and Multinational Enterprises 310

The Multinational Enterprise	311	<i>New United Motor Manufacturing</i>	329
Motives for Foreign Direct Investment	312	Multinational Enterprises as a Source of	
<i>Demand Factors</i>	312	Conflict	330
DO LOW WAGES ATTRACT FOREIGN		<i>Employment</i>	330
INVESTMENT?	314	BOEING WORKERS CONTEST TECHNOLOGY	
<i>Cost Factors</i>	315	TRANSFER TO CHINA	331
Supplying Products to Foreign Buyers: Whether		<i>Technology Transfer</i>	332
to Produce Domestically or Abroad	316	<i>National Sovereignty</i>	332
<i>Direct Exporting versus Foreign Direct</i>		<i>Balance of Payments</i>	333
<i>Investment/Licensing</i>	316	<i>Taxation</i>	334
<i>Foreign Direct Investment versus</i>		<i>Transfer Pricing</i>	334
<i>Licensing</i>	317	U.S. Production Sharing with Mexico	336
International Trade Theory and Multinational		International Labor Mobility: Migration	337
Enterprise	318	<i>Effects of Migration</i>	337
Is Foreign Direct Investment a Threat to the		IS IMMIGRATION GOOD FOR CALIFORNIA?	340
United States?	319	<i>Immigration as an Issue</i>	340
FEARS AND FACTS ABOUT FOREIGN DIRECT		<i>Immigration and the U.S. Labor</i>	
INVESTMENT	320	<i>Market</i>	342
Japanese Transplants in the U.S. Automobile		SUMMARY	344
Industry	322	STUDY QUESTIONS	345
International Joint Ventures	324	NETLINKS	346
<i>Welfare Effects</i>	327		

Part Two

International Monetary Relations 347

CHAPTER 11

The Balance of Payments 349

Double-Entry Accounting	349	The U.S. Balance of Payments	357
Balance-of-Payments Structure	350	Balance of International Indebtedness	360
INTERNATIONAL PAYMENTS PROCESS	351	The United States as a Debtor Nation	361
<i>Current Account</i>	352	VIEW CONCERNING U.S. INTERNATIONAL	
<i>Capital Account</i>	353	INDEBTEDNESS	362
<i>What Does a Current Account Surplus</i>		SUMMARY	364
<i>(Deficit) Mean?</i>	354	STUDY QUESTIONS	364
<i>Statistical Discrepancy: Errors and</i>		NETLINKS	365
<i>Omissions</i>	357		

CHAPTER 12

Foreign Exchange 366

Foreign-Exchange Market	367
Types of Foreign-Exchange Transactions	368
FOREIGN-CURRENCY TRADING	369
Interbank Trading	369
IS A STRONG DOLLAR ALWAYS GOOD AND A WEAK DOLLAR ALWAYS BAD?	372
Reading Foreign-Exchange Quotations	373
ADJUSTING TO DOLLAR FLUCTUATIONS	376
Forward and Futures Markets	376
Foreign-Currency Options	380
<i>Advantage of Foreign-Currency Options to Exporters</i>	381
<i>Understanding Option Quotations</i>	381
Exchange-Rate Determination	382
<i>Demand for Foreign Exchange</i>	382
<i>Supply of Foreign Exchange</i>	382
<i>Equilibrium Rate of Exchange</i>	383
Effective Exchange Rate: The Trade-Weighted Dollar	384
Arbitrage	384
The Forward Market	385
<i>The Forward Rate</i>	386
<i>Forward Market Functions</i>	387

EXCHANGE-RATE RISK: THE HAZARD OF INVESTING ABROAD	388
Interest Arbitrage	389
<i>Uncovered Interest Arbitrage</i>	389
<i>Covered Interest Arbitrage</i>	390
Foreign-Exchange Market Speculation	392
<i>Speculating in the Spot Market</i>	392
<i>Speculating in the Forward Market</i>	393
<i>Other Forms of Speculation</i>	394
Speculation and Exchange-Market Stability	394
<i>Stabilizing Speculation</i>	395
<i>Destabilizing Speculation</i>	395
<i>Should Speculators Be Shot?</i>	395
SHOULD FOREIGN-EXCHANGE TRANSACTIONS BE TAXED?	396
SUMMARY	398
STUDY QUESTIONS	398
NETLINKS	400

CHAPTER 13

Exchange-Rate Determination 401

Exchange-Rate Determination in a Free Market	401
Real Income and Exchange Rates	403
INTEREST RATES AND THE DOLLAR'S EXCHANGE VALUE	406
Real Interest Rates and Exchange Rates	407
Inflation Rates, Purchasing-Power Parity, and Exchange Rates	408
<i>Law of One Price</i>	409
<i>Relative Purchasing-Power Parity</i>	409
THE "BIG MAC" INDEX AND THE LAW OF ONE PRICE	410
Other Market Fundamentals and Their Effects on Exchange Rates	414

INFLATION RATES AND THE DOLLAR'S EXCHANGE VALUE	415
Market Expectations and Exchange Rates	415
Interaction of Exchange-Rate Determinants	418
The Monetary Approach to Exchange-Rate Determination	419
THE SLIDE OF THE DOLLAR	421
The Asset-Markets Approach to Exchange- Rate Determination	421
Exchange-Rate Overshooting	425
Forecasting Foreign-Exchange Rates	427
<i>Judgmental Forecasts</i>	428
<i>Technical Forecasts</i>	429

<i>Fundamental Analysis</i>	431
<i>Forecast Performance of Advisory Services</i>	432
SUMMARY	432
STUDY QUESTIONS	433

APPENDIX: FUNDAMENTAL FORECASTING:	
REGRESSION ANALYSIS	434
NETLINKS	436

CHAPTER 14

Balance-of-Payments Adjustments under Fixed Exchange Rates 437

Price Adjustments	438	<i>Implications of the Foreign-Trade Multiplier</i>	445
Gold Standard	438	<i>Foreign Repercussions</i>	447
Quantity Theory of Money	439	<i>Disadvantages of Automatic Adjustment Mechanisms</i>	447
Balance-of-Payments Adjustment	439	Monetary Adjustments	448
Interest-Rate Adjustments	440	<i>Payment Imbalances under Fixed Exchange Rates</i>	449
Capital Flows and the Balance of Payments	440	<i>Policy Implications</i>	450
Income Adjustments	442	SUMMARY	451
<i>Income Determination in a Closed Economy</i>	443	STUDY QUESTIONS	452
<i>Income Determination in an Open Economy</i>	444	NETLINKS	452

CHAPTER 15

Exchange-Rate Adjustments and the Balance of Payments 453

Effects of Exchange-Rate Changes on Costs and Prices	453	The Absorption Approach to Exchange-Rate Adjustment	471
Cost-Cutting Strategies of Japanese Manufacturers in Response to Yen Appreciation	457	THE PASS-THROUGH EFFECT AND PROFIT MARGINS	472
Requirements for a Successful Depreciation (Devaluation)	459	The Monetary Approach to Exchange-Rate Adjustment	474
The Elasticity Approach to Exchange-Rate Adjustment	459	SUMMARY	475
CHEAPER IMPORTS? NOT SO FAST	460	STUDY QUESTIONS	475
<i>Empirical Measurement: Import/Export Demand Elasticities</i>	464	NETLINKS	476
<i>Time Path of Depreciation (Devaluation)</i>	464		
INFLATION STEALS THE BENEFITS OF DEVALUATION	468		