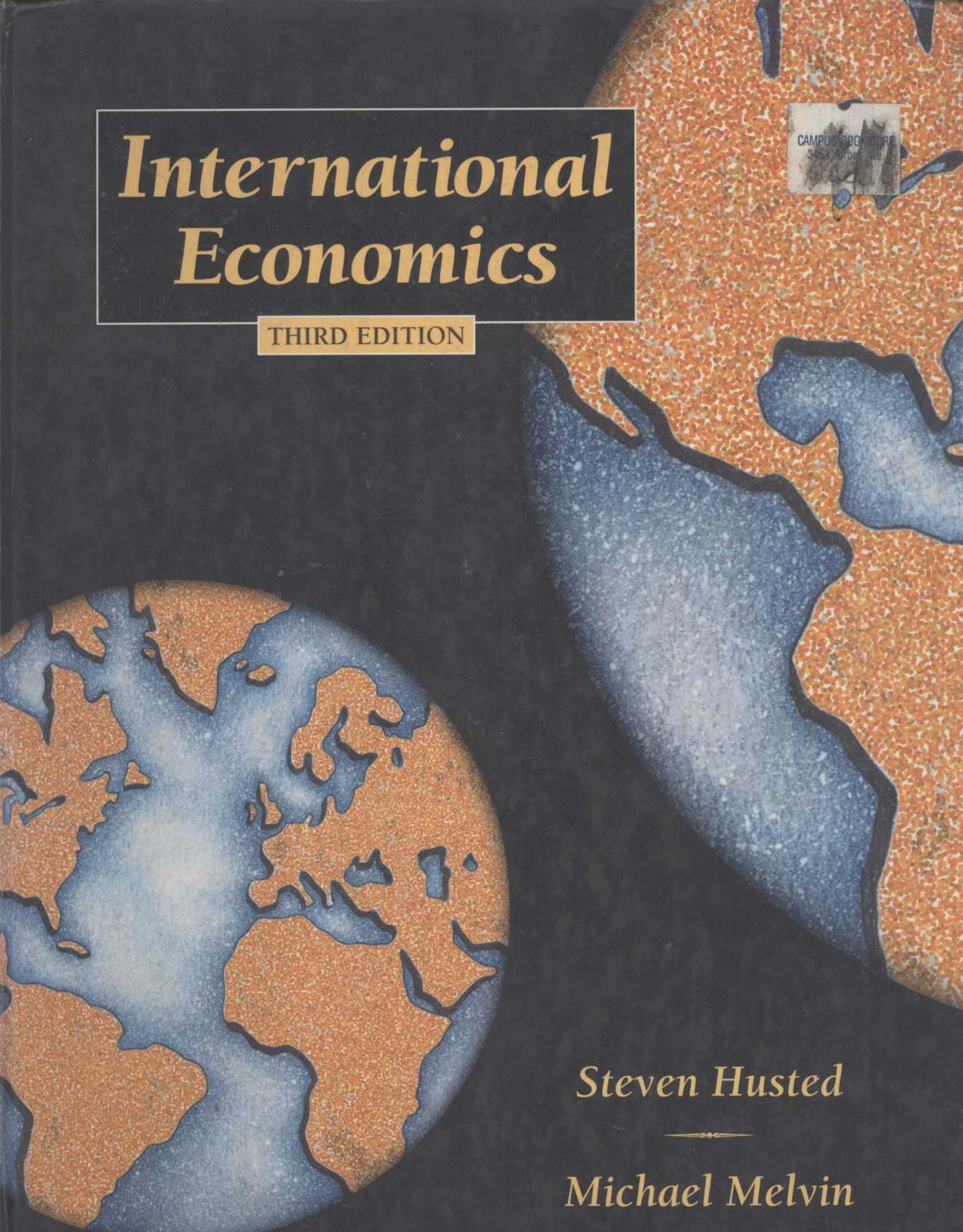
International Economics

THIRD EDITION



Steven Husted

Michael Melvin

International Economics

Third Edition

Steven Husted
University of Pittsburgh

Michael Melvin
Arizona State University

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Preface

The year 1994 will stand out for some time as a watershed in international economic relations. After 7 years of negotiations, the latest round of GATT talks, known as the Uruguay Round, was finally completed. This agreement should produce a major expansion of trade in both goods and services as trade barriers are lowered around the world. Moreover, it calls for the creation of a new international institution, the World Trade Organization (WTO), to administer existing trade agreements, to settle disputes between member countries, and to provide a forum for future trade negotiations. At about the same time, the United States, Canada, and Mexico approved the formation of the North American Free Trade Agreement (NAFTA), which will significantly lower barriers to trade among these countries, and the European Union (EU) began negotiations with several European countries to expand its membership to include virtually all of Western Europe.

The year 1994 also marks a number of changes in international financial arrangements. The foreign-exchange market continued to grow at record pace, with trading activity occurring around the clock and trading volume exceeding $1 trillion per day! Perhaps because the market grew so large, countries found it increasingly difficult to influence its behavior. The attempt by the EU to achieve fixed exchange rates among the member countries as the first step toward a monetary union was put on hold following a barrage of speculative attacks on the French franc and the Spanish peseta in late 1993.

As we have stated in previous editions of this book, our goal in writing this text is simple: We hope to provide the student with a guide to the study of international economics that is accessible, comprehensive, relevant, and up to date. Judging by the many favorable reviews we have received from students and professors who have used this book, we feel that we have been generally successful in accomplishing our goal. Our purpose remains unchanged. To that end, we have substantially revised this edition in order to cover all of the material discussed above as well as many other topics, such as trade and the environment, that have recently been the subject of substantial debate.

LEVEL OF PRESENTATION

We have sought to write a text that covers current developments in international economics but at the same time is accessible to students who may have had only one or two courses in the principles of economics. To that end, we have minimized mathematics and relegated more difficult extensions to appendixes. The book contains a wide range of helpful learning aids, including a marginal glossary that defines new concepts, boxed items and case studies that present "real-world" counterparts to the ideas being developed in the main text, and, in this edition, an expanded set of exercises at the end of each chapter. In addition to these exercises, a *Study Guide* has been prepared by John K. Hill. This guide offers a variety of problems and questions aimed at helping the student explore and learn the text material.

To give the student a better feel for the issues discussed in the text, we have incorporated an extensive amount of data from the real world. For instance, Chapter 1 is devoted almost entirely to describing national economies and the patterns and directions of international trade. Other tables appear throughout the book. To every extent possible, we have sought to provide the most up-to-date statistics currently available.

Chapter 2 is one of the more unusual chapters to be found in a textbook on international economics. Its purpose is to provide a review of basic general equilibrium analysis, and, in particular, to introduce students to the logic and method of economic model building. The chapter begins with a straightforward analysis of the general equilibrium of a closed economy, using simple production possibility frontier diagrams. It then proceeds to the first description of what it means for an economy to engage in international trade. The next two chapters of the text detail the classical and Heckscher-Ohlin models of trade, using production possibility frontiers as the chief analytical tool.

COVERAGE AND EMPHASIS

Strategic trade policy and protection of the environment as justifications for trade protection are discussed in Chapter 7. Chapter 8 provides considerable detail on U.S. trade policy, including three new trade policy case studies that deal with environmental issues, the enforcement of U.S. dumping laws, and recent trade dispute with Canada over beer. Also in this chapter is an extended discussion of the Uruguay Round agreement.

Chapter 9 is new to this edition. It is devoted entirely to the economics of regional trade agreements. The chapter begins with a standard discussion of the costs and benefits of such arrangements. It then turns to consider both NAFTA and the EU.

Unlike the case with many competing texts, the focus of the material in the international macroeconomics portion of this text is on flexible exchange rates. Chapter 12 provides an extensive introduction to foreign-exchange markets that goes well beyond the detail found in other textbooks. New for this edition is an expanded description of the 24-hour nature of the market, including local trading times in various market centers. Also discussed in greater detail are new estimates of the market shares and trading volumes in the various centers. Chapters 13 and 14 continue the focus on flexible exchange rates by considering long-run behavior (purchasing power parity) and short-run behavior (interest rate parity). Chapters 15 and 19 should be of special interest to business students. The first discusses foreign-exchange risk, foreign-exchange forecasting, and international capital flows. The latter provides a treatment of international lending, the offshore banking industry, the international debt problem, and country-risk analysis.

Chapters 16 and 17 are devoted to the theoretical analysis of the balance of payments and of exchange rate determination. Again, following developments in the real world, the primary focus is on various competing theories of exchange rate determination. Chapter 17, for instance, discusses the asset approach to exchange rate determination and includes material on exchange rate overshooting, currency substitution, and the role of "news" in currency markets. New for this edition is an expanded discussion in Chapter 16 of pricing-to-market behavior of various exporters following exchange rate changes. Chapter 18, which is devoted to alternative international monetary standards, has been substantially revised to include coverage of recent changes in the European Monetary System (EMS). Chapter 20 analyzes the advantages and disadvantages of international policy coordination and describes the 1985 Plaza Agreement.

ALTERNATIVE COURSE EMPHASES

The text is designed to provide sufficient flexibility to be used for a one-term survey of international economics or two separate terms devoted to a more comprehensive study of international trade and international finance. Realizing that individual instructors may have unique preferences regarding material to be presented, we offer the following suggestions:

- For a one-term overview of international economics: Chapters 1–4, 6–8, 11–14, and 18–19
- For a one-term course in international trade theory: Chapters 1–10
- For a one-term course in international finance: Chapters 11–20

We have prepared an *Instructor's Manual* to accompany the text. Beginning with this edition, we now include suggested answers to the end-of-chapter questions as part of this manual.

Acknowledgments

No textbook can be written without imposing on friends and colleagues for comments, criticism, and ideas. We owe considerable debts to a number of people: Jim Cassing, Ked Hogan, Douglas Irwin, Ali Kutan, and Jacquie Pomeroy. Special mention should go to Marie Connolly and Bettina Peiers, who read, edited, and proofread a considerable portion of the text, and to Lawrence Officer, whose ideas about content and level of presentation were utilized heavily in the first part of the text.

Throughout the writing of this text, we benefited from the comments of external readers. Help with this edition was provided by Addington Coppin, Panos Hatzipanayotou, Bang Nam Jeon, William E. Morgan, Douglas Nelson, Susan Pozo, and Allan H. Zeman. The preparation of earlier additions was aided by the thoughtful comments of Mohsen Bahmani-Oskooee, Lloyd B. Brown, Phillip J. Bryson, Steven Skeet Chang, Robert V. Cherneff, Satya P. Das, Zane Dennick-Ream, Susan

K. Jones, Joseph A. McKinney, Michael H. Moffett, Douglas Nelson, John Neral, Andreas Savvides, Garry Brooks Stone, Harold R. Williams, and Darrel Young. We were not always able to incorporate all of their excellent suggestions, but they have added greatly to the final product. The editorial staff at HarperCollins, including Jack Greenman, have made our task as pleasant as possible.

Finally, we owe a debt of gratitude to our families for supporting our efforts and to many former students in international economics classes who helped to shape our ideas regarding the appropriate methods and topics for both our classes and this text.

Steven Husted
Michael Melvin

Contents

4 THE HECKSCHER–OHLIN THEORY

5 TESTS OF TRADE MODELS: THE LEONTIEF PARADOX AND ITS AFTERMATH 119

6 TARIFFS 145

9 PREFERENTIAL TRADING ARRANGEMENTS 251

10 INTERNATIONAL TRADE AND ECONOMIC GROWTH 273

11 THE BALANCE OF PAYMENTS 305

1 An Introduction to International Economics

Topics to Be Covered

National Production
Magnitude of International Trade
Trading Partners
Patterns of Trade Flows

Key Words

Gross national product (GNP)
Gross domestic product (GDP)
Exports
Imports
Index of openness
Trade deficits
Trade surpluses

International economists study fascinating questions. Should the United States join the North American Free Trade Agreement (NAFTA)? Do foreigners engage in "unfair trading practices," and, if so, what should be done about such practices? Why does the United States have such a large trade deficit, and is this deficit harmful to the economy? What is the appropriate value of the dollar? In other words, international economists are concerned with a variety of real-world topics that appear in the evening news reports almost every day.

This book provides a comprehensive introduction to international economics. mistake We discuss all the of the issues just mentioned. We show you how economists go about investigating these issues. We provide you with a large amount of information on the extent and nature of international commercial transactions. Along the way we attempt to relate the many issues and concepts we encounter to real-world events. Finally, and most importantly, we attempt to provide you with a simple analytical tool kit that will allow you to study issues such as those mentioned in the preceding paragraph and to weigh future events as they occur.

Recall that when you took Principles of Economics, the course material was divided into two main parts: microeconomics and macroeconomics. In international economics, in general, and in this book, in particular, there is a similar division of material. The first ten chapters of this book deal with the theory of international trade (international microeconomics). Of central importance in these chapters is the international exchange of goods and services. Questions of particular interest include the following: Why do nations engage in international trade? What goods do nations trade? How does international trade affect the amount and distribution of jobs and the level of earnings in the economy? Should international trade be regulated by tariffs, quotas, or other barriers, and, if so, to what extent should the regulation occur? And how are countries affected by international flows of labor and capital? In addition to these questions, this part of the book discusses how trade policies are formulated in the United States and elsewhere and describes the various currently existing forms of trading arrangements between countries.

Chapters 11 through 20 are concerned with international finance (or international macroeconomics). The subject matter in these chapters tends to focus on the international exchange of financial assets. Issues that are studied include the balance of payments; the determination of exchange rates; the relationship between exchange rates, prices, and interest rates; international banking, debt, and risk; and the interaction of macroeconomic policies between various nations. Also discussed in these chapters are the evolution of the world's international monetary system and the role of international organizations, such as the International Monetary Fund, in today's international economy.

The purpose of economics is to develop an explanation for the patterns of commercial transactions that we observe in the real world. International economics focuses its analysis on the commercial interactions between the countries of the world. The goal of international economics is to fashion a theoretical framework that is sufficiently general to allow one to offer explanations of phenomena and to make predictions about the likely outcome of changes in the international environment. Thus, much of the discussion in this book is devoted to developing theories about economic behavior. But theorizing should not be done in a vacuum. It is important to know the facts before we begin. How important is international trade to the nations of the world? Which countries trade with which other countries? What goods do countries trade? The remainder of this chapter is devoted to presenting the factual answers to questions such as these.

CHARACTERISTICS OF NATIONAL ECONOMIES

There are over 170 countries in the world today. They come in all shapes and sizes. There are large countries with large populations (China, India) and large countries with small populations (Australia, Canada). There are small countries with large populations (Japan) and small countries with small populations (Fiji, Luxembourg). No matter what their size, however, there are certain characteristics that are common to all. In each, for instance, there is economic activity. Goods and services are produced, exchanged, and consumed.

The extent of economic activity in a country can be measured in many ways. The two most common measures are the **gross national product (GNP)** and the **gross domestic product (GDP)** of a country. Both GNP and GDP provide estimates of the total value of sales of new goods and services for a given country. And, because sales of goods and services constitute income to those selling these products, GNP and GDP can also be thought of as indicators of total national income. The difference between GNP and GDP has to do with who is producing the goods, and where. Gross domestic product refers to production within a country, no matter whether the factors of production (e.g., labor and capital) are domestic or foreign. Gross national product refers to production by domestic factors, no matter where they are located. Thus, wages earned by Canadians working in factories in the United States would count as part of U.S. GDP and would also be part of Canadian GNP. For most countries there are only very small differences between GNP and GDP. That there is any difference at all is because some factors of production (labor, capital, etc.) are internationally mobile. In Chapter 10 we discuss some of the economic implications of international factor mobility.

Gross national product (GNP)
The value of new goods and services produced by domestic factors of production.

Gross domestic product (GDP)
The value of new goods and services produced within a country.

A crude measure of the standard of living in a country is obtained by the ratio of that country's GDP (or GNP) to its population. This measure is known as the country's *income per capita,* or *per capita* GDP (GNP). In essence, it tells us how much each resident of a country would have if the value of a country's production were equally divided among all members of society. By this standard, some countries are low or middle income (even though some residents may be rich) while other countries are high income (even though some residents may be poor). In this book poorer countries are referred to as *developing countries*. Richer countries are identified as *developed* or *industrialized.*

All countries participate in international trade. That is, some goods and services produced within every country are sold to economic agents (individuals, firms,