WORLD TRADE AND PAYMENTS

AN INTRODUCTION

Seventh Edition

RICHARD E. CAVES | JEFFREY A. FRANKEL | RONALD W. JONES

Seventh Edition

World Trade and Payments
An Introduction

Richard E. Caves
Harvard University

Jeffrey A. Frankel
University of California, Berkeley

Ronald W. Jones
University of Rochester

HarperCollins*CollegePublishers*

Executive Editor: John Greenman
Developmental Editor: Barbara Conover
Project Editor: Elizabeth LaManna
Senior Designer: John Callahan
Text Designer: A Good Thing
Cover Designer: John Callahan
Art Studio: Electra Graphics, Inc.
Electronic Production Manager: Su Levine
Desktop Administrator: Laura Leever
Manufacturing Manager: Willie Lane
Electronic Page Makeup: Interactive Composition Corporation
Printer and Binder: RR Donnelley & Sons Company
Cover Printer: New England Book Components, Inc.

World Trade and Payments: An Introduction, Seventh Edition

Library of Congress Cataloging-in-Publication Data

Caves, Richard E.
World trade and payments: an introduction / Richard E. Caves, Jeffrey A. Frankel, Ronald W. Jones. — 7th ed.
p. cm.
Includes bibliographical references and index.
ISBN 0-673-52418-3
1. International trade. 2 Balance of payments. 3. Commercial policy.
I. Frankel, Jeffrey A. II. Jones, Ronald Winthrop, 1931-. III. Title.
HF1379.C38 1995
382—dc20 95-263
CIP

95 96 97 98 9 8 7 6 5 4 3 2 1

Preface

The seventh edition of *World Trade and Payments* arrives at a time of both triumph and tension in the world economy. The triumph lies in the sweep of an apparently effective market organization of economic activity across the trading nations of the world. Nobody expected a smooth transition for the centrally planned economies of the former Soviet Union and Eastern Europe, but the transition is making progress, bumps and all, and trade between these nations and the rest of the world (suppressed under central planning) is fast being restored. In 1992 the members of the European Union took a big step toward the elimination of remaining border restrictions and the economic unification of their national markets. The Union's membership has expanded to embrace most of Western Europe, and the Eastern European nations have begun knocking at the door. The less-developed countries have continued a decades-long trend toward reducing their restrictions on international commerce and, increasingly, have removed many other regulatory restraints that were apparently dysfunctional for their development. After a perilous journey of negotiation, the world's trading nations reached an agreement in the Uruguay Round to reduce restrictions on trade—not just conventional tariffs, but also nontariff barriers and deterrents to trade in services and foreign investment. The World Trade Organization provides a new governance structure to limit and resolve trade disputes. World capital markets grow increasingly integrated, providing new funding opportunities for borrowers and making it increasingly easy for lenders to diversify their risks internationally.

Yet beneath these triumphs there remain tensions of discontent with national and international economic performance. The United States remains fixated—inappropriately in the eyes of most economists—on its deficit in merchandise trade with Japan. Integrated international capital markets make it harder and harder for countries to implement policies to stabilize or manage their foreign exchange rates: cracks in the European Monetary System and the 1995 crisis of the Mexican peso provide dramatic examples. The Western European countries struggle with macroeconomic problems of high unemployment and central government deficits that clearly cannot be sustained without serious consequences. Despite appearances of prosperity and growth, wages and real personal incomes in some industrial countries rise slowly or even fall, generating disappointment and discontent.

The subject of international economics takes on the large task of explaining the economic mechanisms and the policy options behind all these complex developments. We claim no clairvoyance about how these issues will be resolved. We do, however, believe that students can be prepared to understand and interpret these structural changes and policy issues in the international economy along with others now unforeseen.

What's New in This Edition

Through this and previous editions of *World Trade and Payments* we have sought to combine clear exposition of the proven and long-lasting basic theories and analytical constructs of international trade and finance with applications that illustrate their uses. We have incorporated new theoretical developments as they have come on stream and adjusted the emphasis given to those—new or old—that seem particularly helpful to the student seeking to understand the currently high-profile issues. At the same time we have kept a place for analyses speaking to issues currently shaded from popular attention, but likely to burst forth in the future into the light of public discourse.

This general objective guides the changes that were made in this seventh edition. The basic treatment of theory has, in some parts, been completely rewritten. In particular, recent debates over regional economic integration and tariff reduction have emphasized the potential downside of freeing up trade—the possibility of causing unemployment or lowering the real incomes of some groups. This possibility is addressed very early in the book (Chapter 2), and unemployment as a possible outcome is considered in the treatment of Ricardian models. The conflict between overall gain and individual loss is stressed. As well, more emphasis is placed on growth possibilities and the crucial role that international trade can play as a country develops and raises living standards when facing competition from other countries. In Chapter 10 the treatment of multinational enterprise has been rewritten to focus more sharply on a few central issues.

Part III was extensively reorganized to provide a more integrated treatment of the theory and practice of international trade policy (trade controls and their liberalization). The analyses of trade controls in general equilibrium and partial equilibrium are now placed side by side in Chapter 11, while Chapter 12 addresses the political economy of protection, both as positive economics and as political behavior (the latter formerly was in Chapter 14). Chapter 14 focuses on the contrast between the industrial countries' cooperative efforts to liberalize trade and their individual efforts to control and restrict it. Chapter 15 analyzes the trade policy issues facing three groups of countries: those joining together in customs unions (European Union and NAFTA); the economies in transition to market organization in their domestic economies and international trade; and the fast-growing economies of Asia whose trade policies have been important to their economic successes.

Parts IV and V were completely rewritten in the fifth edition to reflect the importance of international macroeconomics and finance in the 1990s. They have undergone significant polishing. Relative to the sixth edition, Chapters 18 and 22 have each been split in half to enhance readability. Attention is given to many recent and prospective developments, including the liberalization of Japanese financial markets, portfolio investment in so-called emerging-market countries, hyperinflation in some Eastern European countries and economic shock therapy in others, the monetary unification of Germany, and the European Union's agreement on a European Economic and Monetary Union.

Pedagogy

Pedagogical features from previous editions of this book are retained and strengthened. Each chapter ends with a series of problems and discussion questions, as well as a list of suggestions for further reading. These readings represent either fundamental contributions or elaborations and applications that might prove useful to both student and instructor. The accompanying *Student Workbook* by Carsten Kowalczyk and Linda Tesar and updated by Eirik Evenhouse and Siobhan Reilly provides an extensive review of key concepts and contains numerous problem sets. We are pleased that David Bishop has prepared a new Instructor's Manual/Test Bank to accompany this edition.

Adapting the Course

World Trade and Payments is adaptable to various tracking styles. Some chapters are followed by one or more appendixes that explain specialized points or analytical constructions that some instructors might want to emphasize (but others want to avoid). Omitting any appendix will not lessen comprehension of the chapter. For instructors wanting a more advanced approach we have retained, at the back of the text, the mathematical supplements present in previous editions.

The book covers a conventional, full line of topics and, with some additional material, can serve as the basis for a full-year course at the undergraduate level or for separate semester (quarter) courses on the real and financial aspects of international trade. We have paid special attention, however, to the needs of one-semester courses. The chapters in Part I and Chapters 17, 18, and 24 and Section 20.2, provide the nucleus of a one-semester course that covers both the core of the real theory (with applications) and elements of open-economy macroeconomics and balance-of-payments adjustment. Many of the chapters outside this core are at least somewhat independent of one another, so that instructors can round out the course with selections from them (examples are Chapters 9, 10, and 15). A course in international macroeconomics might include Chapters 16 to 20 (Section 20.2) and 23 to 26, and then might emphasize Chapters 22 and 27 if the orientation is toward finance, or Chapter 21 and Section 20.3 if it is toward less-developed countries.

Acknowledgments

As authors of a textbook in its sixth revision, we have acquired a string of debts to colleagues, students, and various helpers that stretches the bounds of memory, let alone explicit acknowledgment. We confine ourselves to thanking those who helped with the seventh edition. Suggestions for revision were received from Patrick Asea, Robert Blecker, Robert Cook, Elzbieta Czarny, Eirik Evenhouse, Joanne Feeney, Peter Frexert, Henry Goldstein, Thomas C. Lowinger, Joseph A. McKinney, William Maloney, Nadeem Naqvi, Deborah Swenson, Ed Tower, and Rolf Weder. For clerical and related assistance we thank Lynn Enright, Ann Flack, and Alan Kackmeister, and for data Peter Hooper, Carmen Reinhart, and George Tavlas.

Richard E. Caves
Jeffrey A. Frankel
Ronald W. Jones

Contents

PART VI The Determination of Exchange Rates in International Asset Markets 615

to be devalued within the Exchange Rate Mechanism of the EMS. If the capital markets had been free, then franc interest rates would have risen in Paris and London equally, to compensate holders of franc assets for the anticipated loss in value. Instead, a shortage of investors willing to hold Eurofrancs caused the interest rate to be bid up offshore, while most Frenchmen—because they could not get their money out of the country fast enough—were stuck with the lower domestic rate. These episodes ended as soon as the question of devaluation was resolved, usually when the suspected EMS realignment actually took place and investors decided it was safe to hold French assets again for another year. This same pattern was evident in Italy.[16]

Liberalization became quite a popular trend in the 1980s. After 1986, France and Italy dismantled their capital controls. They were followed by Spain and Portugal, to meet a 1990 deadline for liberalization set by the European Community. Elsewhere in the world, Australia began the process of financial liberalization in the early 1980s and New Zealand followed suit.

Most other countries still retain serious barriers to international capital movements. Several South American countries, such as Chile, attempted international capital market liberalization in the 1970s. The experiments were largely unsuccessful, because of a wave of borrowing from abroad that turned out to be excessive.[17] Most of the various plans for economic reform in the republics of the former Soviet Union and Eastern Europe in the 1990s postpone to last the complete removal of restrictions on international capital flows. Nevertheless, financial liberalization around the world does seem to be the continuing trend. Many Latin American countries have removed capital controls in the 1990s.

Changes in Tax Laws

Tax reform can have important effects on international capital flows. Countries' income tax rates may have less of an effect on international investors' decisions concerning where to put their money than one would think, however. The mere fact that the citizens of one country are taxed at a higher rate than those of another does not necessarily create an incentive for capital flows, assuming that either group of citizens is taxed at the same rate on its foreign interest earnings as on its domestic earnings. However, high corporate taxes, as opposed to personal income taxes, will reduce the return to corporate equity for any investor. As part of a tax reform, for example, the government of Japan decided to reduce its corporate income tax in

[16] Francesco Giavazzi and Marco Pagano, "Capital Controls and the European Monetary System," *Capital Controls and Foreign Exchange Legislation,* Occasional Paper (Milano: Euromobiliare, 1985); and Charles Wyplosz, "Capital Flows Liberalization and the EMS: A French Perspective," *European Economy,* European Economic Community (June 1988).

[17] Carlos Diaz-Alejandro, "Goodbye Financial Repression; Hello Financial Crash," *Journal of Development Economics,* 19 (September/October 1985).