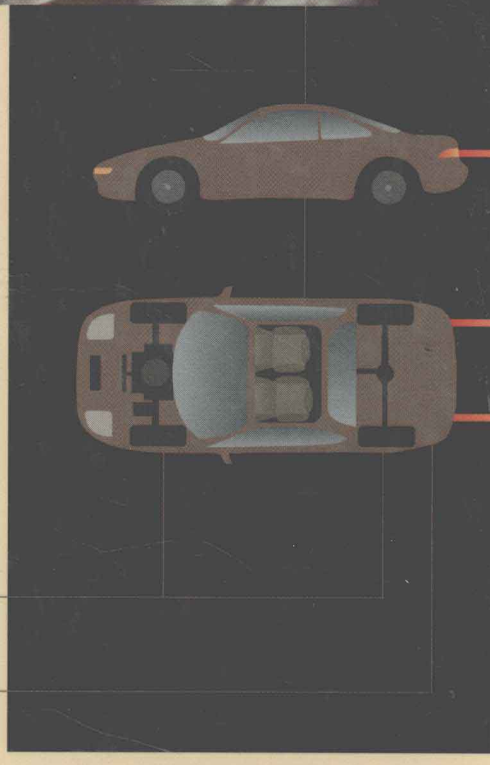
Robert J. Carbaugh



FIFTH EDITION

International Economics

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International Economics

SOUTH-WESTERN College Publishing
An International Thomson Publishing Company

ISBN 0-538-84427-2

1 2 3 4 5 6 MT 9 8 7 6 5 4

Printed in the United States of America

Acquisitions Editor: *Ken King*
Production Coordinator: *Robin Schuster*
Production: *Cecile Joyner*
Manuscript Editor: *Margaret C. Tropp*
Cover Design: *Stuart Patersen, Image House, Inc.*
Internal Design: *Terri Wright Design*
Internal Art: *Carl Brown*
Marketing Manager: *Denise Carlson*
Typesetting: T:H *Typecast, Inc.*

Library of Congress Cataloging-in-Publication Data

Carbaugh, Robert J., 1946–
International economics / Robert J. Carbaugh. —5th ed.
p. cm.
Includes bibliographical references and index.
ISBN 0-538-84427-2
1. International economic relations. I. Title.
HF 1359.C37 1994
337—dc20 94-13411
CIP

This book is printed on acid-free recycled paper.

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International Thomson Publishing
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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 four 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. This 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. Among the new, or substantially revised, topics in the fifth edition are the following:

- What is international competitiveness?
- Comparative advantage with money
- International competitiveness in the U.S. auto and steel industries
- Health care costs and comparative advantage
- Specific factors trade model
- Jet aircraft competition: Boeing and Airbus
- Sugar import quotas
- Minivan dumping
- Smith Corona's antidumping victories
- Trade remedy laws
- Industrial policies of the United States and other nations
- Strategic trade policy
- OPEC's incentive to cheat
- The North American Free Trade Agreement
- Government procurement policies of the European Community
- Direct exporting, foreign direct investment, and licensing
- Japanese automobile transplants
- Interest arbitrage
- Foreign exchange speculation
- Law of one price
- Exchange rate overshooting
- Exchange rates, costs, and prices
- European currency crisis of 1993
- Exchange rate stabilization and monetary policy
- International economic policy coordination
- International lending risk

The fifth edition contains a new chapter, Chapter 17, which discusses international economic policy and international policy coordination. A substantially revised Chapter 7 emphasizes the role of industrial policy for the United States and other nations.

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.

An *Instructor's Manual* accompanies the fifth edition. It contains (1) brief answers to end-of-chapter study questions, (2) multiple-choice questions for each chapter, and (3) suggestions for further readings. It is available both as a book and on disk.

To accompany this fifth edition, Professor Jim Hanson of Willamette University has prepared a student *Study Guide*. The guide provides a review of the text's main topics and provides practice problems, true-false and multiple-choice questions, and short-answer questions.

I am pleased to acknowledge those who aided me in preparing the fifth edition. Helpful suggestions and often detailed reviews were provided by Robin Klay, Hope College; Darwin Wassink, University of Wisconsin, Eau Claire; Terutomo Ozawa, Colorado State University; Jim Hanson, Willamette University; Farhad Rassekh, University of Hartford; Eleanor Craig, University of Delaware; Bun Song Lee, University of Nebraska, Omaha; Byron Brown, Southern Oregon State College; G. Rod Erfani, Transylvania University; Al Gutowsky, California State University, Sacramento. I would also like to thank Wolfgang Franz of Central Washington University for his 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 my editor Ken King, as well as Jason Moore, Peter Cochran, Margaret Tropp, Terri Wright, and Carl Brown. Special thanks and recognition are given to Cecile Joyner, who orchestrated the production of this text. 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 I can continue to improve this text in the years ahead. Thank you for permitting this text to evolve to a fifth edition!

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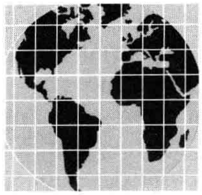
CHAPTER 1



The International Economy

KEY CONCEPTS AND TERMS

Benefits of international trade
Economic interdependence
Import penetration ratio
International competitiveness
Open economy

In today's world, no nation exists in economic isolation. All aspects of a nation's economy—its industries, service sectors, levels of income and employment, living standard—are linked to the economies of its trading partners. This linkage takes the form of international movements of goods and services, labor, business enterprise, investment funds, and technology. Indeed, national economic policies cannot be formulated without evaluating their probable impacts on the economies of other countries.

The high degree of **economic interdependence** among today's economies reflects the historical evolution of the world's economic and political order. At the end of World War II, the United States was economically and politically the most powerful nation in the world. It was sometimes stated that "when the United States sneezed, the economies of other nations caught a cold." But with the passage of time, the U.S. economy became increasingly integrated into the economic activities of foreign countries. The formation of the European Community (EC) during the 1950s, the rise in importance of the multinational corporation during the 1960s, and the market power in world oil markets enjoyed by the Organization of Petroleum Exporting Countries (OPEC) during the 1970s all resulted in the evolution of the world community into a complicated system based on a growing interdependence among nations.

In recent years, the character of global economic interdependence has become much more sophisticated. Rather than emphasizing only the economic issues of the industrial countries, world conferences are now recognizing and incorporating into their discussions the problems of the less developed nations. For resources such as energy and raw materials, the Western industrial nations rely on the less developed nations for a portion of their consumption requirements. However, this reliance varies among nations. For Europe and Japan, dependence on foreign energy and materials is much more striking than for the United States. On the other hand, the livelihood of the developing nations' economies greatly depends on the exports of the industrial nations.

Recognizing that world economic interdependence is complex and its effects uneven, the economic community has made efforts toward *international cooperation.* Conferences devoted to global economic issues have explored the avenues through which coöperation could be fostered between the industrial and the less developed nations. The efforts of the less developed nations to reap larger gains from international trade and to participate more fully in international institutions have been hastened recently by the impact of the global recession on manufacturers, industrial inflation, and the burdens of high-priced energy.

Interdependence among nations also applies in the case of *foreign debt.* Throughout the 1970s, the growth of middle-income developing nations (such as Brazil) was widely viewed as a great success story. Of particular importance was their success in increasing exports of manufactured goods. However, much of this success was due to the availability of loans from industrial nations. Based on overly optimistic expectations about export earnings and interest rates, these nations borrowed excessively to finance growth. Then, with the impact of world recession on export demand, high interest rates, and tumbling oil prices, countries such as Argentina and Mexico found they had to make annual payments of principal and interest that exceeded their total exports of goods and services. The reluctance of creditor nations to lend as much as in the past meant that debtor nations were pressed to cut imports or expand exports, in spite of a worldwide recession. It was recognized that failure to repay the debt could result in a serious disruption of the international financial system.

During the past decade, the world's market economies have become integrated as never before. Exports and imports as a share of national output have reached unprecedented levels for most industrial nations, while foreign investment and international lending have expanded more rapidly than world trade. This closer linkage of economies can be mutually advantageous for trading nations. It permits producers in each nation to take advantage of specialization and economies of large-scale production. A nation can consume a wider variety of products at a cost less than that which could be achieved in the absence of trade. Despite these advantages, demands have grown for protection against imports. For industrial nations, protectionist pressures have been strongest during periods of rising unemployment caused by economic recession. Moreover, developing nations often maintain that the so-called liberalized trading system called for by industrial nations works to the disadvantage of developing nations. Their reason: Industrial nations can control the terms (prices) at which international trade takes place.

Economic interdependence also has direct consequences for a student taking an introductory course in international economics. As consumers, we can be affected by changes in the international values of currencies. Should the Japanese yen or German mark appreciate against the U.S. dollar, it would cost us more to purchase Japanese television sets or German automobiles. As investors, we might prefer to purchase British securities if overseas interest rates rise above U.S. levels. As members of the labor force, we might want to know whether the president plans to protect U.S. workers producing steel or television sets from foreign competition.

In short, economic interdependence has become a complex issue in recent times, often resulting in strong and uneven impacts among nations and among sectors within a given nation. Business, labor, investors, and consumers all feel the repercussions of changing economic conditions or trade policies in other nations. Today's global economy requires cooperation on an international level to cope with the myriad issues and problems.

THE UNITED STATES AS AN OPEN ECONOMY

It is generally agreed that the U.S. economy has become increasingly integrated into the world economy in recent decades. Such integration involves a number of dimensions, including trade of goods and services, financial markets, the labor force, ownership of production facilities, and dependence on imported materials.

One type of dependence on the rest of the world concerns the damage that could be done to the U.S. economy—and possibly to national security—by loss of access to foreign supplies