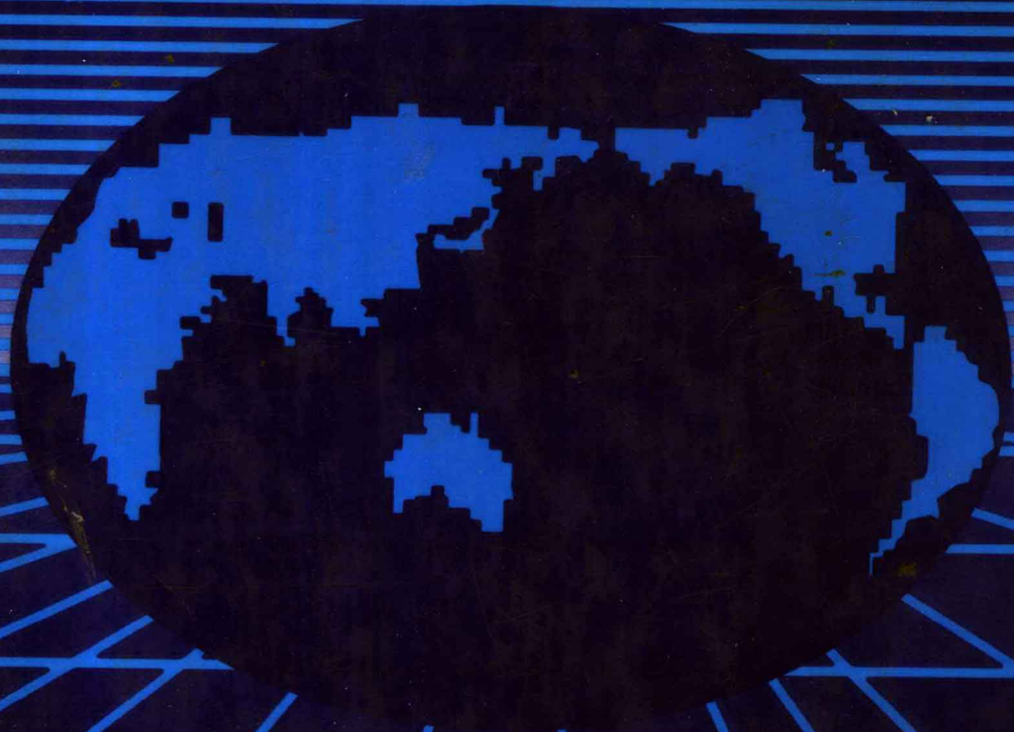

INTERNATIONAL ECONOMICS

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PREFACE

During the last two decades the world economy has undergone major structural changes, such as the introduction of flexible exchange rates, the rise and fall of OPEC, and the success of newly industrialized countries in penetrating the markets of developed economies with their manufactures. At the same time, international economists have been busy developing new approaches and refining older ideas in an attempt to provide better answers to such perennial questions as the merits of free trade relative to protection and the nature of the balance-of-payments adjustment mechanism. The 1990s promise to present formidable challenges to policymakers, ranging from the need to deal with the world debt crisis to the reform of the international monetary system.

Despite the plethora of textbooks, there is still a need for a book that would incorporate all these developments and provide a sensible balance among theory, institutions, and empirical evidence, so that students will be well prepared to face the future complexities of the world economy. I hope this gap is now filled by *International Economics*.

This book provides an up-to-date and balanced approach to world economic relations; integrates theory and empirical evidence; and presents in a logical, intuitive fashion the basic principles of our discipline at a level appropriate for undergraduate students whose only background is an introductory course in economics and a desire to learn.

COMPETITIVE ADVANTAGES

Perhaps the most important feature of this book is the inclusion of empirical applications which bring the theory closer to the real world. Examples include the free-trade agreement between Canada and the United States, countertrade, the trade deficit of the United States, and the policy mix of the first Reagan Administration.

The latest developments in the theory of international trade and finance, such as monopolistic competition and international trade, the efficiency of the foreign exchange market, exchange-rate overshooting, and target zones have been incorporated. Because of the widespread interest in the new monetary approach a whole chapter has been devoted to it. This chapter also proposes a new common-sense reconciliation between the monetary and traditional approaches to the balance of payments. The LDC debt is singled out as a major problem facing the world economy today. Because of its complexity and possible repercussions to the prosperity of developed and developing countries alike, the world debt crisis is studied in a separate chapter.

The text has been designed to be as "self-teaching" as possible. Difficult material (such as the derivation of the Marshall-Lerner condition, the optimal tariff rate, and the foreign-trade multipliers) has been relegated to brief appendixes at the end of the book. All appendixes are optional and can be omitted without interrupting the continuity of the book. They are, however, carefully keyed into the main text to allow easy integration for those who choose to use them.

ORGANIZATION

The book is divided into two parts. Part One (Chapters 2–10) deals with international trade. Part Two (Chapters 11–20) focuses on international finance. Ideally the book can serve the needs of a two-semester course, with international trade covered in the first semester and international finance covered in the second semester. However, the book is quite flexible and can be used in several different ways. For instance, a course in international finance could cover Part Two only (plus perhaps Chapter 2, depending on the tastes of the instructor), without prior knowledge of Part One. Similarly, a one-semester course in international economics could cover Chapters 2–4, 7, 11, 12, 14, 15, and 17–19.

For the benefit of the reader, each chapter concludes with a brief summary, problems, and a list of suggested additional readings. Some of the more difficult problems are marked by an asterisk.

OTHER IMPORTANT FEATURES

International Economics is in a sense the second edition of the *Principles of International Economics*, which was published in 1981. However, the revision was so extensive and the introduction of new material was so overwhelming that a new title was considered appropriate. Some instance are:

- The old chapters on opportunity cost, community indifference, and international equilibrium were combined into a single chapter.
- The chapter on the Hechscher-Ohlin model now contains in one place a simplified discussion of the four main propositions: the Hechscher-Ohlin theorem, the factor-price equalization theorem, the Stolper-Samuelson theorem, and the Rybczynski theorem.

- The old chapters on money and the balance of payments, and fiscal and monetay policy for internal and external balance were fused together to form Chapter 17.

All of these changes made room for the empirical applications, new theoretical developments, and the two new chapters on the world debt crisis and on the monetary approach. In my judgment, the result is a treatment of international economics that is systematic, intuitive, up-to-date, and relevant.

An *Instructor's Manual* is available to accompany this text. Each chapter in the manual begins with a brief summary of the contents of the corresponding textbook chapter; it provides a list of key concepts and terms for review; it gives answers to almost all problems that appear at the end of each chapter; and it finally concludes with a set of additional questions.

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My editors, Scott Stratford, Ira Roberts, Eileen Gualberto, Michael Morales and Cynthia Phelps, have been very understanding, cooperative, and supportive at all phases of the manuscript. My research assistants, Kwoh-Cheung Chan, Eungmin Kang, Jon Mansfield, Chairin Weerastavanee, and Zheng-Yu Zhu, have also been very helpful throughout the writing of this book. Amy Gaffney worked cheerfully and competently with the word processor. Ann I. Sprague and Marilyn H. King also helped. Above all, I wish to thank my wife and daughters (Lea, Marina, and Linda) for their understanding and encouragement during the time I spent preparing this text.

Miltiades Chacholiades

CONTENTS

PART TWO INTERNATIONAL FINANCE

CHAPTER **1**

INTRODUCTION

1-1 THE RELEVANCE OF INTERNATIONAL ECONOMICS

Until the early 1970s, the relationship between the United States and the world economy was asymmetrical. To most Americans, the U.S. economy appeared to be self-sufficient and closed. For instance, in the 1960s U.S. exports and imports were less than 5 percent of gross national product (GNP), and the U.S. economy was thought to be immune to economic events that occurred in faraway places, such as Frankfurt, Riyadh, Seoul, Taipei, and Tokyo. In contrast, foreign countries were greatly influenced by events that took place in the United States, because of the sheer size of its economy. For example, in 1986 the share of U.S. imports in total world imports was almost 19 percent. A U.S. recession spelled gloom for the rest of the world. According to a popular saying, when America sneezed, Japan and Europe used to catch cold.

But as the Greek philosopher Heraclitus noted a long time ago, nothing stays the same. America's exports and imports have grown substantially over the years. From 1970 to 1980 the share of both U.S. exports and imports in GNP doubled. This is shown in Figure 1-1. Of course, adjustment is never easy. With the opening up of the U.S. economy, many traditionally important industries (such as steel and autos) came under severe attack by foreign competition. As Toyotas flooded the U.S. market, producers in the United States faced a hard choice: to either trim their budgets or close their doors. Many workers lost their jobs, and louder and louder calls for "protection from ruinous foreign competition" were heard. As a result, the country that championed free trade in the world economy had second thoughts about the benefits of free trade and felt morally obligated to defend its honest workers from the influx of foreign products.

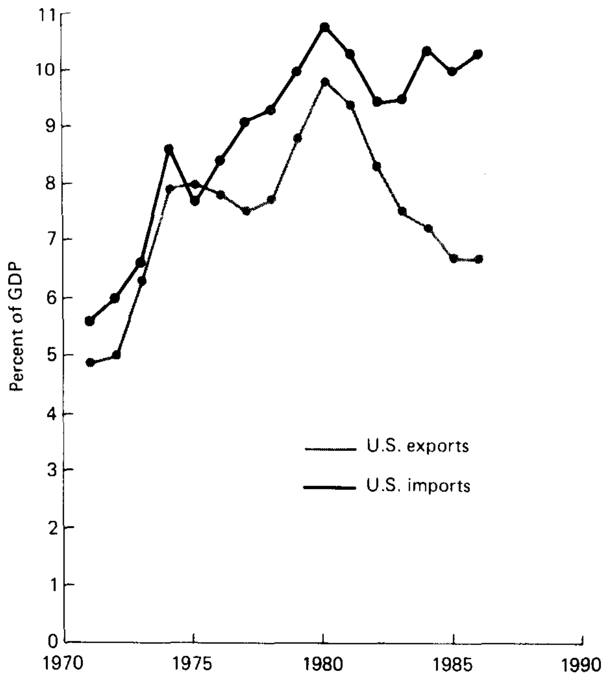

FIGURE 1-1 **U.S. exports and imports of goods and nonfactor services as percent of gross domestic product, 1971–1986.**

Is free trade a friend or a foe? Since the time of Adam Smith, economists have vigorously supported the idea of free trade. It is one of the prime objectives of this book to clarify this fundamental issue. We should bear in mind, however, that when things go sour, special-interest groups, politicians, and editorial writers arouse the patriotic feelings of the citizens, who are led to believe that buying a foreign product is a sacrilegious act. The stakes are high. There has never been a better time than now to study international economics.

Although international economics has become important to the United States only recently, other foreign countries have long been aware of the relevance of international trade to welfare, prosperity, and growth. Figure 1-2 shows the 1986 shares of exports and imports in gross domestic product (GDP) for a small sample of countries. All of these countries participate in world trade to a greater degree than the United States.

1-2 THE SCOPE OF INTERNATIONAL ECONOMICS

What is international economics about? International economics studies how a number of distinct economies interact with one another in the process of allocating scarce resources to satisfy human wants. Whereas general economic theory deals with the problems of a single closed economy, international econom-