Understanding International Economics

Theory and Practice

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To Karen

Preface

This book springs from repeatedly stimulating offerings of introductory international economics to undergraduates at the University of Wisconsin. My students in this course have always had a marked diversity of educational backgrounds: high-school training of variable quality; from one to four years of undergraduate experience; and majors that are as numerous in business, education, pre-law, political science, and history as in economics. The book reflects my (perhaps quixotic) attempt to educate and satisfy all.

Many excellent international economics texts are aimed primarily at students who have been exposed to intermediate microeconomics and macroeconomics. Only a few seem to be aimed at students who are less well-prepared or who would benefit from a more interpretative, less methodologically demanding course. And these latter texts go too far for my tastes toward jettisoning the unified analytical framework that is the strength of the logic called economics. The result is often a not fully satisfying potpourri of casual reflections on international economic policy, disparate glimpses at familiar economic models, and journalistic descriptions of international economic history and institutions. This book is not completely free of such shortcomings, but I have worked hard to develop a uniform approach and tone and to encourage students to think analytically about economic motivation, policy, and explanation—while still writing for students who cannot or choose not to master international economics at a comparatively abstract level.

AUDIENCE AND LEVEL

Students who have taken from twenty to thirty weeks of economics principles, covering both microeconomics and macroeconomics, should not feel strained approaching the central text. They are its primary audience. Students who have taken intermediate economic theory should be able to master the entire book, including those chapter supplements and footnotes that extend the central text in a more rigorous direction. I believe further that two students with the same economics preparation will comprehend the material comparably even when one is an economics major and one is not.

PURPOSE AND COVERAGE

The word *understanding* in the title conveys the book's principal purpose: to shed light on what is traditionally one of economics' most abstruse and arcane subdivisions, even to professionals. Some of its difficulty stems simply from subject matter. Much also stems from the lack of terminological clarity, from the frequency with which simple intuition and popular reporting is wrong, and from the occasional willingness of many private and governmental commentators to mislead out of self-interest or the pursuit of other goals. To encourage understanding of international economics, I have thus made a special effort to employ clear language, to explore apparent paradoxes at length, to explain in detail why some "received wisdom" is wrong, to highlight popular inaccuracies, and to reveal the economic incentives that underlie the statements and actions of the most prominent participants, including governments, in international exchange.

In this last endeavor, it helps greatly to emphasize income-distributional consequences of international economic transactions, in addition to their consequences for the nation as a whole. This dual emphasis sets the text apart from others, I believe, and characterizes both the macroeconomic part of the book (especially Chapter 3) and the microeconomic part (especially Chapters 10, 13, and 14).

Encouraging understanding has also prompted me to stress material that is relevant to modern policy and private decision-making; for example, a more complete treatment than is traditional of external-currency (Euro-) banking, multinational corporations, and the new international economic order. Less immediately relevant matters, by contrast, are addressed less completely than is typical; the historical working of the gold standard and empirical testing of international trade theories, for instance. The content of the last chapters of each part (Chapters 7 and 14) was chosen to be especially topical, and these chapters were written after the others to minimize their datedness.

My hope is that students who use this book will be more perceptive and incisive readers, critics, voters, and decision-makers. To that end, I have emphasized only a few familiar tools from the economist's toolbox rather than introducing a multiplicity of them. I have found that the latter approach diverts student attention toward mastering analytic techniques. Despite my self-imposed technical limitation, I have tried throughout to synthesize as well as summarize, drawing parallels among diverse themes when possible (the book contains numerous cross-references), and I have occasionally attempted to fill gaps in the existing literature or make subtle extensions to it. I hope that the result is a book that is more cohesive and coherent.

TECHNIQUES AND APPROACH

Most of the book's content is conveyed verbally, graphically, and by numerical example. There are almost no algebraic manipulations or demonstrations, and the number of *different* graphical and numerical approaches is minimized. The macroeconomic material on international finance relies principally on a supply-demand diagram of the foreign exchange market and on schematic diagrams that reveal exogeneity/endogeneity relationships and directional influences that come from IS-LM and "monetary approach" models. The microeconomic material on international trade relies principally on a two-country supply-demand diagram for a typical tradeable and on a two-country production-possibilities diagram. It is remarkable how far these simple tools can take us in understanding international economics.

There is no explicit textual dependence on Keynesian crosses, IS-LM diagrams, community indifference curves, offer curves, or Edgeworth-Bowley boxes. Extended footnotes, however, outline when and how these analytical constructs would provide an alternative way of understanding the text. Some footnotes also provide or point out analytically more advanced extensions, subtleties, and qualifications of the material in the text.[1] So do several of the chapter supplements.[2] Reliance on them enables this book to be used conveniently in courses with a more abstract orientation than I adopt at Wisconsin.

I have tried to fold liberal doses of data, real illustrations, and hypothetical examples into each chapter. Most come from recent economic history (post-1945). I have, by contrast, paid only slight attention to formal econometric work in international economics, feeling that its appreciation required skills beyond those of a large majority of readers.

The concerns of international economics often arouse heated controversy. I have made an effort to be fair to all well-taken conflicting viewpoints—without being bland. "Objective fairness" is, of course, unattainable. Fairness is subjective; my values and presuppositions shape my definition of *fair* (and my definition of *well-taken*). But the practical impossibility of objective treatment does not furnish me

[1] Examples are footnotes 1, 2, and 4 to Chapter 4, on the meaning of the *ceteris-paribus* approach; footnotes 3, 4, and 5 to Chapter 9, on the relationship of partial- to general-equilibrium diagrams; footnotes 16 to Chapter 9 and 1 to Chapter 12, on international economic transactions in a socialist system; and footnote 7 to Chapter 12 on factor-intensity reversals.

[2] Examples are Supplement 4A on price inelasticity of commodity demand and the foreign exchange market; Supplement 7A on Euro-currency banking; Supplement 9A on export taxes; and Supplement 11A on nontariff barriers and the terms of trade.

grounds for failing to move as close as I can to it. I apologize to the reader if the resulting discourse seems unduly indecisive. I think by contrast that we are altogether too quick to offer "the" answer as instructors and to insist on it as students.

ORGANIZATION

The macroeconomics of international finance precedes the microeconomics of international trade because I have always found students more receptive to the material presented in that sequence. Other instructors have no doubt found the opposite, and I have endeavored to oblige them. I believe that there would be very little awkwardness in a course which proceeded from the Introduction immediately to Part II and Chapter 8, continued through Chapter 14, and then turned to Part I.

Each chapter includes a summary. Some of them tie together and provide perspective on several chapters at once (the summaries to Chapters 4, 5, 9, and 11, for example). Each summary is followed by a list of key terms and key concepts for review. Suggestions for further reading will be found at the end of the book.

Most chapters contain from one to three chapter supplements—self-contained essays, almost mini-chapters. They furnish a second level of material to the text, in some cases providing additional detail, in others providing a more technically challenging treatment of similar material. I tried to avoid intrusiveness by placing supplements after chapters to which they relate most closely. I imagine that several of them could be shifted around. Flexibility is the principal aim of these supplements—flexibility in both content and length of the course.

LENGTH

The book contains more material than I cover in a typical fifteen-week (one-semester) course, in which I lecture two-and-a-half hours per week. Were I teaching a twenty-week (two-quarter) course, I would assign the entire text and most of the chapter supplements. Were I teaching a thirty-week (two-semester) course, I would assign the entire text (with supplements), along with outside readings (or an edited collection of them). Were I teaching a ten-week (one-quarter) course, I would rely on the central text alone, excluding almost all the chapter supplements.

TOPICAL HIGHLIGHTS

The following are highlights of both content and organization in addition to those already mentioned:

—The foreign exchange market (Chapter 1) is introduced before balance-of-payments concepts (Chapter 2) in order to reveal why the latter are important.

—A glossary and schema of equivalencies is provided for alternative terminology relating to international capital movements (Supplement 1B).

—An entire chapter (3) is devoted to the fundamental and normative reasons why exchange rates and the balance of payments matter to the man or woman on the street and therefore also to governments; I have observed a striking need for such a discussion—most people care only because everyone else does, but there are better reasons than that.

—The special yet volatile position of the United States and the dollar in international monetary affairs is examined in depth in Chapters 2, 3, 5, and 7.

—Whether the United States has benefitted from this special position, and if so, whether at the expense of the rest of the world, is addressed in Chapter 3 and Supplement 3B.

—Chapters 4, 5, and 6 are parallel, harmonized treatments of interaction between international and domestic macroeconomic variables, drawing from both traditional and "monetary" approaches to the interaction: first, the impact of exogenous changes in domestic on international variables is discussed; then the impact of exogenous changes in international on domestic; and finally the impact of exogenous changes in one country on others.

—Material that is as up-to-date as possible is provided on International Monetary Fund reform, the European Monetary System, and external-currency (Euro-) banking.

—A sharp distinction is drawn between "normative" trade theory (Chapters 8 through 11) and "positive" trade theory (Chapter 12, with both normative and positive aspects to Chapters 13 and 14).

—There is minimal recourse to perfect competition or other restrictive assumptions in order to convey how unassailable certain conclusions are (for example, that some trade is nationally preferable to none, discussed in Chapter 8).

—The economics of real government reluctance to trade freely is revealed sequentially in Chapters 8, 9, and 10: allowing some trade is clearly beneficial (Chapter 8); but allowing free trade is less clearly so (Chapter 9 examines distortions, second-best considerations, and the terms of trade); and allowing fre*er* trade is even less clearly so (Chapter 10 examines adjustment costs and income-distributional considerations).

—As much space is devoted to "modern" trade theories as to Heckscher-Ohlin, and each trade theory is introduced as a complement to the others, not as a competitor to them (Chapter 12).

—Considerable attention is paid to migration, the brain drain, and international trade in factors of production (Chapter 13).

—The treatment of multinational corporations (Chapter 13) is extensive, synthetic, and integrated with the rest of the book.

—An effort is made to explain the noneconomic motivation and objectives of the program for a new international economic order, as well as its economic aspects (Chapter 14).

ACKNOWLEDGEMENTS

Whatever credit my approach in this book receives is due in great part to my teachers and colleagues over the years, especially to Donald E. Kelly, H. Frank Carey High School, Franklin Square, New York; Robert M. Stern, University of Michigan; and Robert E. Baldwin, University of Wisconsin.

The content, organization, and style of the book has been improved immeasurably by a superb army of reviewers for Little, Brown. Noteworthy for their painstaking scrutiny of the entire manuscript are Richard E. Caves, Harvard University, and Judith Cox, University of Washington. The care with which they criticized and chided was much appreciated. They are not to be condemned for my stubborn reluctance to agree wholeheartedly. Other extremely helpful reviewers included: Thomas C. Anderson, Eastern Michigan University; Howard A. Bridgman, Southeastern Massachusetts University; Byron B. Brown, Southern Oregon State College; Dennis C. Duell, Wichita State University; H. Peter Gray, Rutgers University; Robert R. Johnson, Idaho State University; Gerald M. Lage, Oklahoma State University; Gilbert S. Suzawa, University of Rhode Island; Harold R. Williams, Kent State University; and Nancy Baggott, M. O. Clement, Arnold Collery, Richard Cooper, Alexander Garcia, Bernard Goodman, Kiyotoshi Iwanoto, Jerry Kingston, Steve Magee, Llewellyn M. Mullings, E. Wayne Nafziger, E. Dwight Phaup, Thomas Sears, Roger A. Sedjo, Donald Sternitzke, and B. H. Wilkins.

Not to be neglected are several generations of University of Wisconsin students, whose lively reaction to lectures and conscientious feedback shaped many parts of this book—the best parts, I trust.

This work was so long in the making that I think I exhausted even the extraordinarily patient Basil G. Dandison and Darrell R. Griffin, who both left the editor's position during its preparation. Gregory Franklin managed to hang on and to continue the praiseworthy Little, Brown tradition of long-suffering encouragement. The assistance of the publisher has been superb, and the Little, Brown staff, especially Al Hockwalt and Elizabeth Schaaf, deserve thanks.

Jean Arnold, Joneen Lee, and Kathy Monroe suffered my eccentricities with quiet acceptance while typing, pasting, drawing, and formatting with their usual grace. Jackie Forer, Jean Kennedy, Laurie Murphy, and Alice Wilcox shared their agony occasionally and should share their credit too.

Last but not in any way least, I want to thank my Christian brothers and sisters who upheld me continually in my labor, and especially Karen, Kris, and Laura for their love, patience, and support, to which I could return eagerly after each day of struggle over these pages.

Contents

Introduction

International economics is concerned with exchange that takes place across national boundaries—with nation-to-nation purchases and sales.

Wheat, whisky, breeding bulls, chicken, copper, cosmetics, steel products, machine tools, auto parts, scientific equipment, blueprints, production manuals, management services, motion pictures, air travel, deeds to property, mineral rights, stock certificates, bonds, and even bank deposits—these are just a few of the goods that are bought and sold internationally. The only unique feature of such transactions is that the buyer is a resident of one country, and the seller is a resident of another. Except for that feature, international economics would be the same as everyday, garden-variety economics, and there would be no need of special courses and textbooks. Because of that feature, international economics emphasizes what makes countries economically different from each other—differences in such things as resource endowments, size, tastes, technology, education, growth, inflation, reliance on markets, systems of taxation, immigration laws, and national moneys.

Most such differences among nations are due to politically determined boundaries and policies. That is why governments and government policies have such a prominent place in this subject and book. Without government, there is *no* distinctive international economics, and no one can understand private international exchange without understanding the government policies that shape, structure, and sometimes try to suppress it. International economics, more than most other fields in economics, is necessarily "political economy."

The subject is traditionally divided into two distinct parts. *International finance* deals with the political economy of multiple world moneys. *International trade* deals with the political economy of