International Trade & Finance

New Frontiers for Research

Essays in Honor of Peter B. Kenen

Edited by
Benjamin J. Cohen

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Introduction

Benjamin J. Cohen

Peter Kenen received his doctorate from Harvard University in 1958. Four decades later, on the occasion of his sixty-fifth birthday, a group of his former students and collaborators present this collection of essays in his honor. Our intention is to offer a selection of contemporary work in international trade and finance that will not only salute a great teacher and scholar but also help in defining an agenda for research in the late 1990s and beyond. The title of our collection deliberately echoes a seminal volume of cutting-edge scholarship edited by Kenen – and also published by Cambridge University Press – in 1975 (Kenen 1975). As Kenen's first Ph.D. student, the privilege fell to me to edit and introduce this tribute to his many contributions to the field.

We begin with a brief essay by Paul Krugman highlighting some of Peter Kenen's more important achievements over a lifetime of outstanding research and writing. Although still as active and innovative as ever, Kenen has already distinguished himself as one of this century's most notable, not to say prolific, international economists. His influence has been felt in the development of both the trade and monetary sides of the field; and he has contributed work in applied policy analysis and political economy as well as pure theory. As Krugman's survey amply demonstrates, Kenen's many accomplishments demonstrate a span of vision that is as creative as it is unusual.

Like the main body of Peter Kenen's work, the remainder of the volume is divided into three parts: international trade theory, international monetary theory, and applied policy analysis. Although diverse, the individual chapters – all written expressly for this *festschrift* – accurately reflect both the breadth and the underlying coherence of Kenen's varied intellectual interests.

Leading off Part I, on trade theory, is an essay by Patrick Conway offering a retrospective look at Kenen's early – and, to some extent, unjustly neglected – article on "Nature, Capital, and Trade" (Kenen 1965). In that paper, Kenen suggested that international trade theory might best be understood if the factor capital were viewed not as a direct input into production but rather as an activity that "improves" land and labor services – in effect, an ingenious extension of the standard 2 × 2 Heckscher–Ohlin (HO) model to incorporate a third factor, anticipating much subsequent development in the field. An effort to update that formulation within a general 3 × 3 (or $N \times M$) theoretical structure, Conway shows, only reinforces Kenen's conclusions that neither factor-price equalization nor identical technology is a necessary result of international trade. Kenen's formulation also provides a convincing explanation for the shortcomings of the traditional HO model in most recent empirical tests of trade patterns.

Next, Arvind Panagariya turns to the work of James Meade, who, as any of Kenen's former students can testify, was a major influence on Peter's own thinking about international trade and finance. Even before "Nature, Capital, and Trade," Panagariya notes, Meade had constructed a complete 3 × 3 model of trade in his 1955 monograph on *The Customs Union Issue* – in fact, the first welfare theoretic analysis of economic integration in a general-equilibrium setting. Much commented upon but poorly understood, the model is restated by Panagariya in more formal terms in order to underscore a number of critical implications, including the importance of both the level of tariffs in nonmember countries and the presence of flexibility in the terms of trade in evaluating the desirability of preferential trading arrangements. Meade's model also casts some doubt on the validity of the "natural trading partners" hypothesis that has been much touted in the literature lately.

In Chapter 4, Dani Rodrik explores the relationship between the openness of an economy and the size of its government sector. Available evidence for a large sample of countries, he finds, overwhelmingly demonstrates a positive correlation between foreign trade and the level of public spending (both expressed as a percentage of GDP). The explanation for this striking empirical regularity, he suggests, lies in the heightened exposure to external risk characteristic of more open economies. Government can play a "sheltering" or stabilizing role to help insulate society against the vagaries of the global marketplace, including in particular a high degree of variability in the terms of trade.

Part II, comprising four chapters on international monetary theory, starts with a pair of related essays on the effects of exchange-rate behavior on real economic activity, both inspired by Peter Kenen's pioneering work in the early 1980s (Kenen and Rodrik 1986). In Chapter 5, Reuven Glick and Clas Wihlborg focus on trade flows and challenge the conventional presumption of a negative relationship between currency flexibility and import–export volumes. The problem, they argue, is the ambiguous relationship between exchange-rate variability and risk exposure under different types of currency regimes. In fact, the total macroeconomic risk that traders face need not increase, and may even decrease, with the degree of flexibility of exchange rates. Employing an original measure of nominal currency flexibility that depends on foreign reserve changes as well as exchange-rate variability, the authors conclude that the evidence lends no support to the view that firms face more risk, and therefore may trade less, when currencies float.

Linda Goldberg, by contrast, focuses on investment activity, which in many economies does appear to be highly sensitive to movements of the real exchange rate. The real question, she suggests, is what determines the *strength* of the exchange-rate effect, which clearly varies from country to country. The answer, she argues, is related to structural differences in export and imported-input exposures and in the industrial organization of exporting sectors. Applying an innovative theoretical model to a sample of six Latin American economies, she shows that countries with more concentrated export activity also tend to have the greatest exposure to exchange-rate movements through their reliance on imported inputs. While revenues are greatly influenced by currency fluctuations, therefore, input cost exposures tend to mitigate some of the corresponding effects on firm profitability and investment activity.

Chapters 7 and 8 are also closely related to one another, this time by a common interest in the theory of optimum currency areas (OCAs), another branch of the literature that has benefited from Peter Kenen's pioneering insights (Kenen 1969). Tamim Bayoumi and Barry Eichengreen address the choices of exchange-rate regime by individual countries. Analysis of data from industrial economies demonstrates that such choices have been heavily influenced by the kinds of structural variables traditionally highlighted by OCA theory, such as bilateral trade patterns, country size, and asymmetric shocks. The impact of such variables has been especially evident since the end of the Bretton Woods era. But other country characteristics not obviously associated with OCA theory have at times also played a critical role, particularly during the 1960s, and even more important have been systemic considerations reflecting the structure of global and regional currency arrangements. The choice of exchange-rate regime, they argue, cannot be fully understood except in the context of a broader model explicitly recognizing the interdependence of such national policy decisions.

Benjamin Cohen considers the implications of rapidly growing cross-border currency use and competition for traditional OCA theory which, reflecting conventional political geography, tends to define monetary arrangements in strictly territorial terms: physically distinct and mutually exclusive enclaves that are the explicit product of collective state action. Cross-border currency competition, by contrast, which is driven largely by market forces, creates new currency spaces ("regions") that are functional rather than geographic in nature – bounded not by territorial frontiers but rather by the range of each money's effective use and authority. After outlining the welfare implications of currency regions, Cohen addresses the issues that their existence poses for the creation of a formal monetary union as traditionally defined in OCA theory. The degree of symmetry between a proposed currency area and preexisting currency regions significantly influences the net gains of monetary union for participating countries.

Part III, devoted to applied policy analysis, includes two chapters on industrial countries, two on developing economies, and one on problems of transition in the successor states of the former Soviet Union.

In Chapter 9, Marina Whitman compares and contrasts labor-market institutions and processes in Europe, North America, and Japan, stressing the extent to which all industrial countries now appear to rely increasingly on "external" rather than "internal" adjustments in response to cyclical fluctuations and changing economic signals. Even Japan, which has traditionally placed most emphasis on diversification and reallocation of labor *within* firms rather than through external labor markets, is becoming more tolerant of American-style layoffs and increased rates of labor turnover as commercial and financial conditions vary. Such a shift, Whitman suggests, is in fact a rational management response to recent structural transformations in the global economy, including the deregulation of capital markets, technological catch-up, and intensifying competition across national borders. But in an argument reinforcing Dani Rodrik's conjectures in Chapter 4, she also suggests that by shifting more of the costs of adjustment from firms to workers, this trend in labor markets is likely as well to heighten demands for protection or other actions by government to reduce or cushion the transitional costs of adjustment for workers – precisely the sort of "sheltering" role that Rodrik evokes to explain the larger size of the public sector in more open economies.

Kathryn Dominguez focuses on monetary-policy coordination among the main industrial economies, a topic frequently addressed by Peter Kenen in recent years (Kenen 1988, 1989, 1990). For over twenty years the United States, Germany, and Japan – the Group of 3 (G-3) – have repeatedly pledged to coordinate their policy responses to shared macroeconomic problems, often in formal public agreements. But have they meant what they said? In a detailed evaluation of available data dating back to 1975, Dominguez finds little evidence of systematic or sustained coordination by the G–3 governments. Ironically, the United States, often thought to be most guilty of unilateralism in its foreign economic behavior, is found to honor its international commitments more often than either Germany or Japan. The latter, on the other hand, are found to respond more to U.S. policy changes, whereas Washington is generally unaffected by policy changes in Germany or Japan.

In Chapter 11, Polly Allen returns to a subject that she and Peter Kenen first addressed nearly two decades ago: the determinants of equilibrium exchange rates (Allen and Kenen 1980). Using the recently developed NATREX (Natural Real Exchange Rate) model, which stresses the "fundamentals" of investment, saving, and long-run flows of capital in exchange-rate determination, Allen reexamines Mexico's currency crisis of 1994–5. A peso crisis, she notes, was inevitable at some point, given the unstable trajectories of falling saving and an appreciating real exchange rate that were allowed to develop after 1987. The NATREX model identifies problems in the underlying fundamentals that have been largely ignored in discussions of the Mexican crisis.

Nancy Marion, too, is concerned with exchange-rate management in developing countries, seeking in particular to account for the recurrent devaluation cycles – periods of growing currency misalignment punctuated by periodic downward revisions – that seem endemic in countries like Mexico. Data from a sample of 17 Latin American countries, she argues, suggest that the size and timing of devaluations are in fact heavily influenced by the costs of rate adjustment relative to the costs of sustained misalignment. And what determines the magnitude of these costs? In a manner parallel to that of Bayoumi and Eichengreen in Chapter 6, Marion explores the role of key structural variables highlighted by traditional OCA theory, on the assumption that the same factors thought to influence the choice of exchange-rate regime might play a role in determining the size and timing of devaluations as well. Analysis confirms the importance of country size as well as both commodity and geographic concentration in foreign trade. Openness, on the other hand, appears to have surprisingly little effect on decisions to devalue – perhaps, Marion speculates, because greater openness increases the cost of rate adjustment as well as the cost of a given misalignment.

Finally, in Chapter 13, Constantine Michalopoulos addresses some of the difficult payments problems that have confronted many formerly communist countries since the end of the Cold War – yet another of the many subjects to which Peter Kenen has turned his attention (Kenen 1991). Focusing specifically on the members of the Commonwealth of Independent States (the CIS, comprising all the republics of the former Soviet Union except the Baltic nations of Estonia, Latvia, and Lithuania), Michalopoulos reviews recent trends in trade and payments within the CIS and evaluates alternative policy solutions that were attempted or might have been considered to alleviate the financing difficulties that most CIS countries have experienced. The remedy for their payments problems, he argues, must be sought along two tracks: first, more effective stabilization measures, to enhance the prospect of convertibility in the region; and second, a strengthening of institutional arrangements to permit efficient settlements through correspondent bank accounts. A multilateral clearing arrangement, though once a potentially appealing option, would no longer be appropriate in these countries' changed economic circumstances. Increased external financing, on the other hand, remains essential, but only if conditioned on continued progress in stabilization and structural reform.

In keeping with the spirit of inquiry that we all imbibed from Peter Kenen as his students or collaborators, each of the essays in this volume concludes with suggestions for further research. In this way we hope that the impact of Kenen's outstanding intellect and imagination, which we have all felt so profoundly in our own work, will continue to manifest itself in international economic scholarship for years to come.

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CHAPTER 1

The practical theorist: Peter Kenen's contribution to international economics

Paul R. Krugman

Academic economists can achieve distinction in many ways. Some become innovative theorists, who re-imagine the world and give us a new language to discuss how it works. Some become sage advisers to the powerful, shaping policies and institutions by the force of their intellect. Some become servants to the profession – great teachers, or those invaluable academic statesmen who edit journals and guide centers of research. And a few masochistic economists even become academic administrators – a job somebody once described as being like trying to herd cats.

The extraordinary thing about Peter Kenen's career is that he has filled all these roles, and filled them all so very well. The theorist who wrote "Nature, Capital, and Trade" and "The Theory of Optimum Currency Areas" was also a key member of the famed Bellagio Group, which brought together policy-minded academics and intellectually inclined policymakers to discuss international monetary institutions with a depth and cogency that have never been matched. It goes without saying that Kenen's combination of analytical force and real-world acumen has made him one of the most influential teachers of his generation. But not content with these accomplishments, he has also directed the International Finance Section, which under his leadership has maintained to this day a unique role as a center for and publisher of policy-relevant research in international economics. And surely he deserves some academic version of the Purple Heart for not merely serving as provost of a university, but doing so at Columbia in 1969–70 – and emerging from that cauldron with his good humor intact.

A career so varied defies easy summary, especially given that in the midst of all his other activities Peter Kenen has somehow managed to write dozens of books and monographs and publish more than a hundred papers. Still, at the risk of being presumptuous I would suggest that there is a distinctive Kenen modus operandi that informs many of his writings – whether they were written for an academic or a policy audience.

To understand the quintessential Kenen contribution, one needs to realize that economists and policymakers, each in their separate ways, are inveterate oversimplifiers. Economists, of course, are always trying to reduce the complexity of the world to something they can model. This is an entirely appropriate goal. Sometimes, however, the pursuit of simplicity, which is necessary, leads modelers to confuse beauty with truth – to imagine that the simplest, most elegant model that seems to yield insight about a phenomenon must also be an adequate framework for discussing how that phenomenon actually works in practice. Often, alas, factors that the modeler regards as inessential details turn out to be crucial in reality. To take only one important example: the elegance of the two-good, two-factor trade model, its ability to illustrate in so compact a form so many principles of economic analysis, has seduced many theorists into believing that so beautiful a model must also be essentially true; yet the evidence is overwhelming that this model is too simple to provide even a first cut at understanding the realities of world trade.

Policymakers, in their own way, also seek more simplicity than the world really offers. They want strong, clear ideas, and are averse to hearing about awkward tradeoffs. (I am told that the European Commission's EMU study, *One Market, One Money*, was originally intended as a survey of the costs and benefits of monetary union. After looking at some early draft chapters, the higher-ups redefined it as a survey of the benefits.) Yet many policy issues – above all, the kinds of international monetary issues on which Peter Kenen has often worked – have no ideal resolution; they must be viewed as a matter of making the best compromise among competing objectives.

If there is a distinctive Kenen attribute, it is his ability to identify the crucial piece that is missing in an oversimplified discussion, whether among academics or among policymakers, and to supply that missing piece. It is always, of course, an easy shot to tell people that they have overlooked important complications. What takes real talent and insight is not merely to say that a discussion is oversimplified but to propose a useful way to correct it – to point out, for example, that the size of an optimum currency area depends crucially on the fiscal institutions that span regions (or fail to); that no matter how carefully worded, an international monetary agreement cannot produce a "rhinopotamous" that reconciles fundamentally opposed objectives. One suspects that Peter Kenen's uniquely broad experience has been crucial to his ability both to point out the missing pieces and to supply them – for example, that he is sensitive to institutional issues that other economists might miss because of his unusual experience in talking with people who really make policy, but that he is more conscious of the limits of institutional competence than many other international advisers because he is such a good analytical economist. Whatever the source of Kenen's ability to combine sharp-edged analysis with institutional realism, it is a very special talent indeed.

With these remarks as background, let me follow the outline of this book and highlight some (but by no means all!) of Peter Kenen's important contributions to the theory of international trade, international monetary theory, and the realities of international economic policy.

International trade theory

Peter Kenen began his career during the golden age of Heckscher–Ohlin trade theory – the era marked not only by the thorough analysis of the two-sector model but more generally by the development of techniques for thinking about general equilibrium in small-scale models. Two of Kenen's earliest papers, "On the Geometry of Welfare Economics" (1957) and "Distribution Demand, and Equilibrium in International Trade" (1959), were significant methodological contributions to that enterprise, offering analytical techniques for integrating the analysis of production with that of distribution.

More than a decade later, in his paper "Migration, the Terms of Trade, and Economic Welfare in the Source Country" (1971), Kenen returned to the two-factor model, making the point that assessing the effects of a shock depends crucially on taking into account the full general equilibrium consequences of that shock. The then-standard analysis of factor mobility found that emigration would lower the income of those who remained in the source country. Kenen pointed out that this analysis assumed a downward-sloping marginal product curve for labor, which was necessarily true only in the case of a closed economy. In an open economy facing given world prices, emigration would leave factor prices and hence the income of remaining residents unchanged. In an open economy facing a nonlinear offer curve, emigration might either improve or worsen the terms of trade (depending on the factor intensity of exports), producing first-order gains or losses rather than the second-order welfare effects asserted by the standard model. Finally, Kenen pointed out that it might be crucial to take into account the impact of the migrants on production and demand in the destination as well as in the source country, a point often forgotten to this day in analyses of factor mobility. All in all, the paper is an elegant application of classic trade