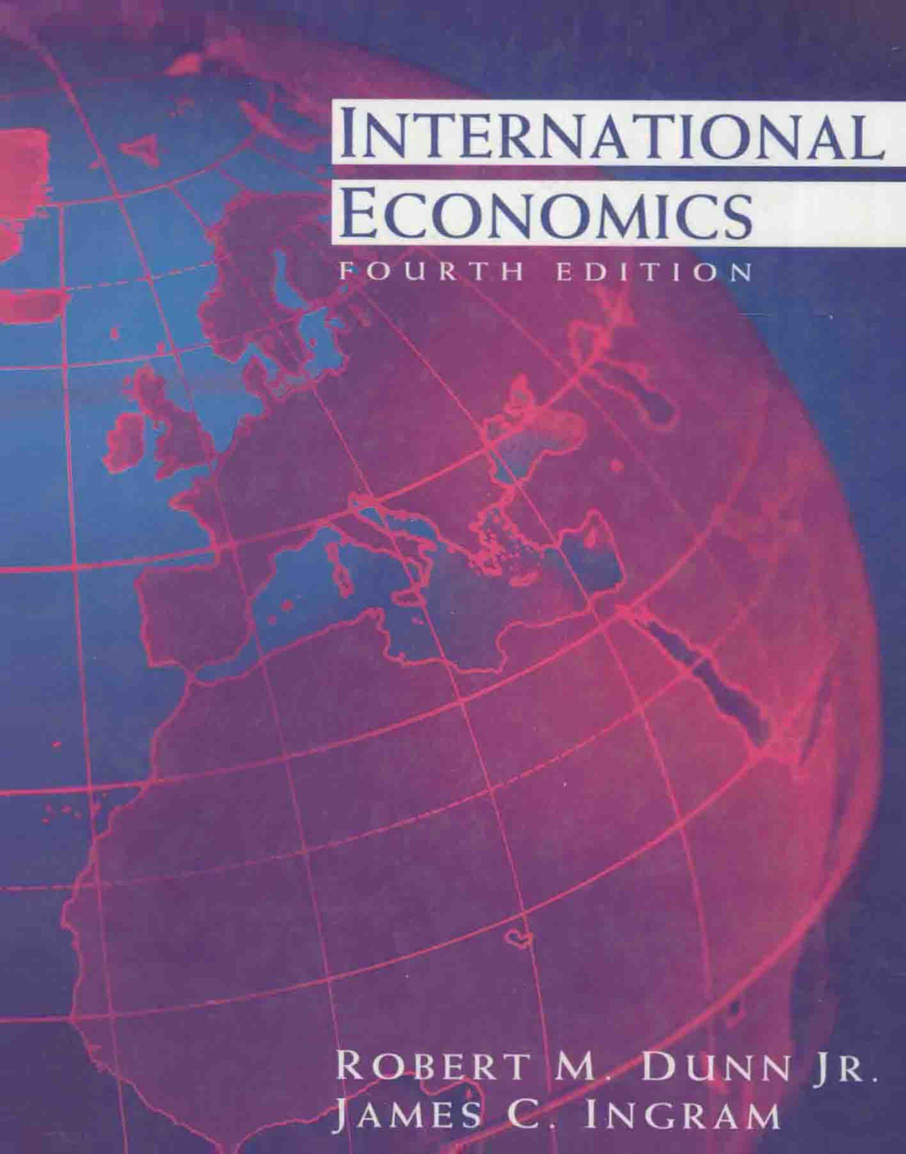

INTERNATIONAL ECONOMICS

FOURTH EDITION

ROBERT M. DUNN JR.
JAMES C. INGRAM

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PREFACE

This book is an introduction to international economics, intended for students who are taking their first course in the subject. The level of exposition requires, as a background, no more than a standard introductory course in the principles of economics. Those who have had both intermediate microeconomics and macroeconomics will find them helpful, but except for two or three of the Appendices, the book is accessible to readers whose prior exposure to economics is limited to that introductory course. Intermediate micro & macro tools are taught within the text whenever necessary.

The primary purpose of this book is to present a clear, straightforward account of the main topics in international economics. We have tried to keep the student's perspective constantly in mind and to make the explanations both intuitively appealing and logically convincing.

Reactions from users of the first three editions—both students and instructors—have been encouraging. However, the passage of time itself erodes the usefulness of a book in a field such as international economics, and we have therefore prepared this fourth edition.

This book covers the standard topics in international economics. Each of the two main parts, International Trade (Part I) and International Finance and Open Economy Macroeconomics (Part II), develops the theory first, and then applies it to particular policy issues and historical episodes. This approach reflects our belief that economic theory should be what Professor Hicks calls "a handmaiden to economic policy."

Wherever possible, we use economic theory to explain and interpret experience. That is why this book contains more discussion of actual historical episodes than most existing textbooks of international economics. The historical experience is used as the basis for showing how the analysis works. We have found that students generally appreciate this approach. However, some instructors may find that time does not permit a detailed discussion of some of these historical episodes. In that case, some extended discussions, as in Chapter 19, can be left for independent study, used as the basis for term papers, or simply omitted.

CHANGES IN THE FOURTH EDITION: TRADE

Throughout the book more examples from recent events are used in order to make the theory more realistic to students. A brief description of each graph is placed with its title in order to make the figures easier to understand; in too many cases the description of a graph in the text ends up on a different page, making it difficult for readers to understand the material; providing a brief description with each graph is intended to ease that problem. Chapters 3 and 4 have been extensively rewritten in order to make them more clear; some of the more difficult material in those chapters, including long numerical examples and Edgeworth box diagrams, have been placed in Appendices because many students found that they made an understanding of the basic points of the chapter excessively difficult. Much more attention has been given to models of imperfect competition and to economies of scale in Chapter 5. In addition a section on international aspects of environmental economics has been added to that chapter; it deals with the trade distorting effects of national pollution control laws, cross border pollution, and the tragedy of the commons as it applies to the oceans and the world's air mass. So-called 'green protectionism' is also discussed in Chapter 5, while Chapter 7 has been extended to provide more treatment of the industrial strategy argument for protectionism. The treatment of regional blocs in Chapter 8 has been extended to deal with recent changes in the European Union and the 1993 political battle over the ratification of the NAFTA agreement. The completion of the Uruguay round is given considerable attention in Chapter 9. Chapter 10, which deals with developing countries, has been completely rewritten with the goal of updating data and of stressing the growing diversity in the trade experience of these countries; the previous version of that chapter was excessively pessimistic and made these countries seem more homogeneous than they are. The discussion of multinational corporations in Chapter 11 has been restructured in order to remove coverage of issues that are now far less important than they were a few years ago. The Chapter 11 emphasis on immigration, which existed in the previous edition, is retained because of the growing political importance of this issue.

CHANGES IN THE COVERAGE OF INTERNATIONAL FINANCE

Since this half of the book was extensively restructured in the third edition, the changes in the fourth edition are less extensive than in the first part of the book. The discussion of exchange markets in Chapter 13 has been extended to make the discussion of forward rate determination, which many readers found to be difficult, clearer and to provide a more extensive discussion of foreign exchange options contracts. Foreign trade multipliers, which allow for reverberations, are added to Chapter 14, and the discussion of balance of payments adjustment with fixed exchange rates has been extended to include coverage of international policy coordination. The discussion of the absorption condition in Chapter 17 has been rewritten to include the necessary changes in a country's savings/investment relationship if the balance of trade is to improve. The arguments for so-called heterodox adjustment programs, which include temporary price and wage controls, are also covered in this chapter. The use of the IS/LM/BB graphs to illustrate the workings of macroeconomic policies in a regime of flexible exchange rates in Chapter 18 has been extended to introduce exchange rate expectations. Because this issue can become quite confusing, the subject is dealt with only through extended footnotes at the end of the discussion of each macroeconomic policy change. A brief discussion of international financial arrangements before 1880 has been added to Chapter 19; although Chapter 20, which deals with the international

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financial history of the 1945–1973 period, is largely unchanged, Chapter 21 has been extensively rewritten. The changes in the final chapter of the book include a discussion of the Basle Accord on capital adequacy for international banks, and of the 1992–93 difficulties of the European Monetary System, which leads into a more extensive discussion of optimum currency areas. A section has also been added on empirical tests of various models of exchange rate determination during the 1973–94 period. Throughout the book new references have replaced older ones so that readers can more easily find additional readings on topics which may interest them. The glossary at the end of the book has been updated by clarifying definitions which seemed unclear and by adding new items.

INSTRUCTORS' ALTERNATIVES FOR THE USE OF THIS EDITION

Those instructors using this book for a full-year course can cover the entire volume and assign supplementary material such as a book of readings. Those who choose to use this book for a one-semester (or one-quarter) course will probably want to eliminate some chapters. The core chapters are Chapters 2 through 8 and 12 through 18. For a one-term course in international trade, Chapters 1 through 11 provide a compact, self-contained unit. For a one-term course emphasizing international finance or open economy macroeconomics, Chapter 1 and Chapters 12 through 21 are the appropriate choice.

In writing this book, we have accumulated a number of obligations: to our students and colleagues at the University of North Carolina and George Washington University and to international economists too numerous to mention whose work is drawn on in writing a textbook such as this. We also gratefully acknowledge the economics editors and outside reviewers at John Wiley and Sons—for the second edition, Maurice B. Ballabon, Baruch College, CUNY; Elias Dinopoulas, University of California, Davis; Geoffrey A. Jehle, Vassar College; Marc Lieberman, Vassar College; Don Schilling, University of Missouri; and Parth Sen, University of Illinois at Urbana/Champaign; for the third edition, Robert W. Gillespie, University of Illinois at Urbana/Champaign; Henry Goldstein, University of Oregon; Gerald M. Lage, Oklahoma State University; Robert Murphy, Boston College; William Phillips, University of South Carolina at Columbia; and Henry Thompson, Auburn University; and for the fourth edition, Ron Schramm, Columbia University; John Carlson, Purdue University; Wayne Grove, College of William and Mary; Oded Galor, Brown University; Chong K. Yip, Georgia State University; Chi-Chur Chao, Oregon State University; Zeljian Suster, University of New Haven; Mark Shupack, Brown University; Paolo Pesenti, Princeton University; Francis Lees, St. John's University. Finally, we thank the users of the first two editions who have sent us their helpful comments and suggestions.

July, 1995

Robert M. Dunn, Jr.
Washington, D.C.
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ABOUT THE AUTHORS

Robert M. Dunn, Jr. is a Professor of Economics at George Washington University. He was previously an economist with the Division of International Finance at the Federal Reserve Board and a faculty member at Dartmouth College. He received his B.A. from Williams College and his M.A. and Ph.D. in economics from Stanford University. In addition to teaching at GWU, Professor Dunn lectures at the Foreign Service Institute of the Department of State and for the World Bank. He has been a consultant for the Brookings Institution and for the Stanford Research Institute.

Professor Dunn's research interests are primarily in the area of international finance. He has published articles in the *Journal of Political Economy*, the *Southern Economic Journal*, *Princeton Essays in International Finance*, and other journals. He is the author of *Canada's Experience with Fixed and Flexible Exchange Rates*, and *The U.S.-Canada Capital Market*. He has written over 30 columns for the *Washington Post*, which have appeared on the Op-Ed page, the Outlook Section, and the Business section, as well as four Op-Ed columns for the *New York Times*.

James C. Ingram, Professor of Economics Emeritus at the University of North Carolina at Chapel Hill, is a specialist in the field of international economics. He is the author of *Economic Change in Thailand* (2nd ed., 1971), *Regional Payments Mechanisms* (1962), *International Economic Problems* (3rd ed., 1978), and numerous articles on international trade and finance.

Professor Ingram has been a visiting scholar at the London School of Economics and at the Brookings Institution, and he was a visiting professor at Thammasat University (Bangkok) for two years. He was formerly president of the Southern Economic Association, managing editor of the *Southern Economic Journal*, and dean of the Graduate School at the University of North Carolina.

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PART **ONE**

INTERNATIONAL TRADE

CHAPTER 1

INTRODUCTION

A few decades ago international trade and finance were viewed in the United States as relatively minor areas within economics. Both macro- and microeconomics courses typically contained little or no reference to the role of international transactions, and relatively few students enrolled in international economics courses. The popular and financial press reflected a similar attitude; news stories concerning international business were seldom carried, and when they were they appeared at the end of the publication. The United States had a rather isolated economy, a fact that was reflected both in academic economics and in the world of business.

This situation has changed radically in the last few years. Enrollments in international economics courses (and in international affairs programs) in colleges and universities have risen sharply, and even domestic macro- and microeconomics courses make some reference to the role of international transactions. The business press carries many stories concerning international events and their impact on the U.S. economy. The United States is now a far more open or outward-oriented economy, and both academic and popular economics reflect that transformation.

A major reason for growing interest in international economics in the United States and in other industrialized countries can be found in Table 1-1. In three decades the share of foreign trade in the U.S. gross national product (GNP) rose by 127 percent. In all seven major industrialized countries, except Japan, there was a sizable increase in the share of foreign trade in GNP since 1960; for the group as a whole, the increase was from 28 to 42 percent of GNP.

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