FOURTH EDITION

INTERNATIONAL ECONOMICS

A Policy Approach

Mordechai E. Kreinin

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To my daughters:

Tamara
Elana
Miriam

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Preface

Although the way our economy functions became more familiar to a large segment of the American public after World War II, our knowledge of international economics remained limited for some time thereafter. In recent years, however, international economics has so frequently occupied the financial headlines that our attention has been forced beyond domestic concerns to those of the world market.

Through its four editions, this book has aimed to provide a simplified yet comprehensive analysis of international economic relations, with the fundamental objective of extracting maximum policy insight from a minimum number of theoretical constructs. Written for students with only one or two previous courses in the principles of economics, it is designed primarily as a basic text for a one- or two-term undergraduate sequence in international economics. Although the volume contains analytical tools, the material is arranged so that the theoretical sections may be omitted and the main text used also in policy-oriented noneconomics courses. Finally, the book is useful as supplementary reading for students of international relations and business administration, as well as for economics students in money and banking courses.

The method of presentation has remained unchanged through all editions. Each subject is expounded verbally before any use is made of analytical tools beyond simple supply and demand curves. Whenever technical terms and tools are needed, they are carefully explained. Although the focus is on policy, the necessary theoretical underpinnings are fully presented.

Some major events have occurred in the international economy since the Third Edition was published. They include, but are not limited to, the conclusion of the Tokyo Round of tariff negotiations; the establishment of the European Monetary System (EMS); a change in the currency composition of SDRs; realignment of the exchange rates of certain currencies, such as the Mexican peso; the U.S. policy of minimal intervention in the foreign exchange market; the proposed U.S. local content legislation in autos; establishment of the Common Fund of UNCTAD; and the 1981–82 oil glut. All these events are discussed in the Fourth Edition. In addition, all statistics, theoretical formulations, and other ongoing events have been brought up to date.

Part One has been extensively reorganized. A new Chapter 3 deals with market-determined exchange rates and the foreign exchange market, and a new Chapter

5 is devoted to national income determination in an open economy. The presentation of the statement of international transactions in Chapter 2 now reflects a freely floating dollar exchange rate (or nearly so), although it also discusses the alternatives of a fixed rate and a managed float. Chapter 4, dealing with the international currency system, contains almost all the institutional material that was previously scattered over several chapters. Old chapters 6 and 9 have been deleted, although much of their material appears elsewhere. Many examples are now drawn from the late 1970s and early 1980s.

Although Part Two has not been reorganized (except for reversing the order of chapters 14 and 15), it has been updated in all respects. Generally speaking, the order in which Parts One and Two can be studied is fully interchangeable. The sole exception is the short section in Chapter 11 entitled "The Limits to Sustainable Exchange Rates," which requires at least minimal familiarity with exchange rates. Instructors using Part Two before Part One can either omit this section or have students read the first section of Chapter 3 as a prerequisite. The appendixes have also been reorganized and some material deleted. The deletions include the detailed statement of international transactions and the analysis of the generalized stability conditions in the foreign exchange market.

The original arrangement that enabled uninitiated readers to skip over the technical sections without loss of continuity has been retained: Each technical section is set off by a short horizontal line at the beginning and the end, each paragraph within the section begins with an open square (□), and the complete section ends with a closed square (■).

The appendixes are intended for students interested in more complex theoretical and policy formulations. Additional readings are suggested in footnotes, while sources of relevant statistics are cited for various topics under discussion. A short bibliography at the end of the text lists books of readings, a selection of single-topic survey articles that have extensive bibliographies, and sources of international, regional, and national statistics.

My deep gratitude is due the many professors who took the trouble to write words of encouragement, suggestions, and constructive criticism of previous editions. Special thanks for their many helpful comments go to Professor Max Corden of the Australian National University, Gerald Meier of Stanford University, Robert Baldwin of the University of Wisconsin, Franklyn Holzman of Tufts University, Phillip Thomas of Kalamazoo College, and Lawrence Officer of Michigan State University. I also wish to renew my thanks to William J. Baumol of Princeton University, Robert W. Gillespie of the University of Illinois, the late Henry G. Johnson of the University of Chicago, and Norman N. Mintz of Columbia University for their valuable comments and advice during the preparation of the manuscript for the first edition.

Mordechai E. Kreinin

Contents

1 Foreign Trade in the American Economy

International economics deals with the flow of commodities, services, and capital across national boundaries. Trade in commodities refers to imports and exports of merchandise. Services involve such activities as shipping, travel, insurance, or tourist services performed by companies of one country for residents of another. And finally capital flows refers to setting up plants in foreign countries or to acquisition of bonds, stocks, and bank accounts in one country by residents of another country.

Because it involves flows across boundaries of sovereign states, the *conduct* of international transactions differs greatly from that of domestic trade. For example, governments may impose restrictions such as import duties or import quotas on international transactions but not on domestic transactions. Each government employs its own set of domestic monetary and fiscal policies. These are uniform within each country, but vary from one country to another, and consequently they affect the flow of international trade. Each country uses its own currency (such as the dollar in the U.S. and the pound sterling in the U.K.) to finance internal transactions; but international transactions require exchanging one currency for another.

These are but a few examples of why international economics is a separate field of study. Interest in this field expanded in recent years, partly as a result of the vast growth of international transactions. A case in point is the phenomenal and uninterrupted expansion of international merchandise trade. The value of world exports grew from $108 billion in 1958 to nearly $1 trillion in 1976, and to about $2 trillion in 1980 and in 1981.[1] Most rapid was the growth of trade in manufactured products (from $64 billion in 1960 to $1.1 trillion in 1980), followed by minerals and agricultural products. Particularly remarkable was the expansion of trade among the score of industrialized nations who are members of the Organization of Economic Cooperation and Development (OECD)—Western Europe, North America, Japan, and Australia. Intra-OECD trade amounts to nearly one-half of total world trade. Table 1-1 shows the network of total exports by

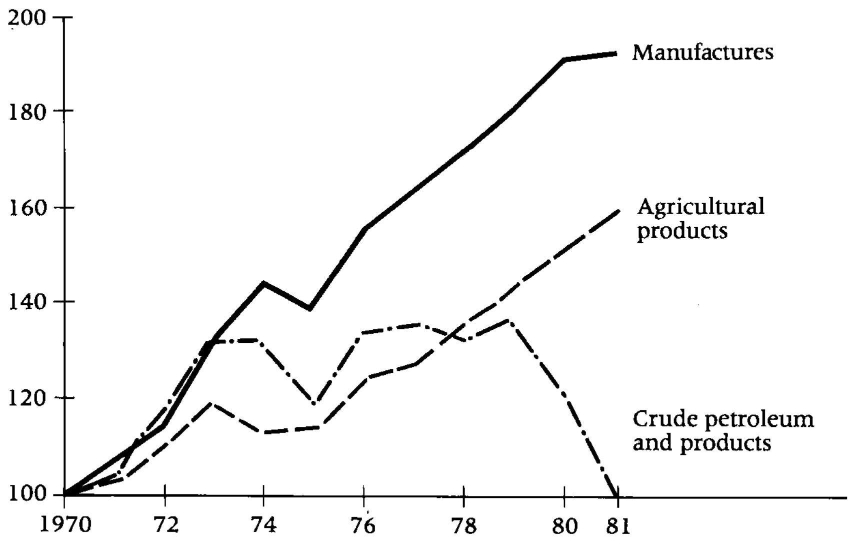
[1] All the figures in this paragraph are expressed in current dollars. Thus the increases in trade value over time are made up of price increases as well as expansions in the real volume of trade. The real volume of world trade grew at an annual rate of 7 percent between 1963 and 1973, and of 3.5 percent between 1973 and 1980.

Table 1-1
Network of Total Exports by Major Areas, 1981
($ Billions)

	Destination					
Origin	Industrial Countries	Oil Exporting Developing Countries	Other Developing Areas	Eastern Trading Area	Total* World	Export of Manufactures to World, 1981
Industrial Areas	804.00	117.00	192.00	57.00	1,203.00	881.00
Oil-Exporting Developing Countries	204.00	3.70	56.50	3.90	271.00	6.00
Other Developing Areas	163.00	19.30	61.80	18.40	268.00	108.50
Eastern Trading Area	56.50	9.50	28.00	92.50	187.00	99.00
Total World*	1,252.50	151.50	345.50	174.50	1,968.00	1,103.00

SOURCE: GATT, *International Trade*, 1981/82, Geneva, 1982, Table A-24, and GATT release, March 1982.
*Includes Australia, New Zealand, and South Africa, which are excluded from the individual areas.

Figure 1-1
Development of World Exports, 1970–81
(Volume indices, 1970 = 100)



SOURCE: GATT release No. 1313, March 30, 1982, p. 3.

major areas in 1981. The 6th column shows that most of the exports of manufactured products originate in the industrial countries, although the manufacturing exports of certain developing countries have grown rapidly in recent years.

Figure 1-1 depicts the expansion of the physical volume (value net, of price increases) of world trade in 1970–81. It is seen that exports of crude petroleum declined in 1980–81, while that of manufactures and agricultural products continued to expand.

As the analysis of international economic relations unfolds in subsequent chapters, the United States will be seen as a pivotal member in the world trading and financial community. Two features of its economy make this country ideally suited for such a central role: It is a giant among nations and a *relatively* "closed economy" at one and the same time. The first-named feature refers to the fact that the U.S. gross national product (GNP)[2] is 40 percent of the total of all industrial countries combined and that the United States is the leading importing and exporting nation. As a consequence, whatever occurs in the U.S. may have profound implications for the rest of the world. For example, a recession in the United States lowers our

[2]Total value of final goods and services produced during a one-year period. In 1980 U.S. GNP stood at $2,626 billion, and that of the world as a whole at $11,269 billion. Thus the U.S. accounts for nearly a quarter of worldwide GNP.

demand for imported materials and other goods and may thereby cause problems for the exporting countries for which we are such an important market. Thus American economic policies that affect our trade position are important not only to us but also to our trading partners.

On the other hand, the term "closed economy" refers to the fact that the United States is relatively independent of foreign trade; quantitatively, exports (or imports) occupy a relatively small proportion of total economic activity. Because of its size and the diversity of its resources, the American economy can satisfy consumer wants and national needs with a minimum of reliance on foreign trade. This is in contrast to other industrial economies in which foreign trade plays a significant, if not a dominant, role. Thus the U.S. gross national product in 1981 amounted to $2,938 billion. Exports of goods and services were $367 billion or 12.5 percent of GNP (see Table 1-2). By comparison, exports amount to about one-half of GNP in some small European countries and to nearly a third in the U.K. and Germany. *Comparatively* speaking, therefore, the United States is immune to disturbances originating abroad.

This should not be construed to mean that the American economy is completely independent of foreign trade in either a quantitative or qualitative sense. The quantitative importance of foreign trade cannot be judged solely on broad aggregative measures, because its impact is not spread evenly over all sectors of the economy. A substantial portion of GNP is made up of such items as construction activities and various services—many of which never enter international trade and are therefore termed *nontraded goods*—and is not directly affected by changes in trade policies. Most of the direct effects of such changes are concentrated in the commodity-producing sectors. Exports appear to be most important in the agricultural sector, while imports are most significant among mineral commodities.

But even these figures are too aggregative. Foreign trade among industrial nations is extremely specialized, and the manufacturing sector in particular contains variations that are not reflected in the sectoral average. In assessing the role of foreign trade in individual industries, it is customary to examine the ratio of exports to output and the ratio of imports to apparent consumption, where appar-

Table 1-2
Gross National Product of the United States, 1981 ($ Billions)

Personal Consumption Expenditures	$1,843	
Gross Private Domestic Investments	472	
Government Purchases of Goods and Services	597	
Net Exports of Goods and Services	26	
Exports:		$367
Imports:		341
Total GNP	$2,938	

SOURCE: *Federal Reserve Bulletin*, August 1982, p. 4.

ent consumption is measured as output plus imports minus exports. There are numerous industries in which one or the other of these ratios is very high, at times upward of 15 to 20 percent. Such industries are often termed, respectively, *export-* and *import-competing industries.* In the United States steel and motor vehicles are examples of import-competing industries with imported cars exceeding a quarter of U.S. consumption in recent years; whereas aircraft, chemicals, and machinery are examples of export industries. Thus, although most American manufacturing industries are relatively independent of foreign trade, there are a few industries in which foreign trade plays an important role.

Table 1-3(A) shows U.S. foreign trade by sectors and Table 1-3(B) shows U.S. foreign trade with major trading partners. In 1981 merchandise exports and imports amounted to $226 billion and $271 billion respectively. The United States is a net exporter of farm products, chemicals, machinery, and aircraft, and a net importer of fuels, iron and steel, motor vehicles, and certain consumer goods.

A second sense in which this country cannot be considered independent of foreign trade is qualitative. To say that imports of goods and services amount to 11.6 percent of the gross national product is to understate their importance in several respects. American imports contain important primary commodities that cannot be produced domestically but are crucial for numerous productive processes. Their absence would considerably curtail domestic production, lower consumer satisfaction, and interfere with our ability to meet national goals. Over 70 percent of U.S. agricultural imports are "complementary commodities"—commodities such as tropical products that cannot easily be grown in the United States. Likewise, the absence of imported fuel could have severe effects on the nation's output and/or environment. The same may apply in the future to shortages of other basic materials. Although most manufacturing imports compete directly with domestically produced substitutes, foreign trade increases economic welfare (Chapter 11), widens consumer choice through diversification of available products, and expands producers' horizons in marketing their products and investing their capital. Opening the economy to the fresh winds of foreign competition also adds to its viability by curbing domestic monopoly power and spurring technological progress. And foreign imports can also be used to curtail inflationary pressures at home. Countries often relax import restrictions to cope with domestic inflation by increasing supply. Moreover, the external payments position of the country, of which merchandise trade is the major component, influences aggregate output and income indirectly through its effects on government fiscal and monetary policies. Finally, American imports constitute an important source of dollar earnings for many underdeveloped countries whose stability is vital to the United States. Similar considerations can be articulated with respect to exports. Thus it would be misleading to suggest that the elimination or diminution of foreign trade would work no hardship on the American economy.

These are important qualifications, but they do not change the position of the United States *relative* to that of other countries. Comparatively speaking, this country is indeed a giant among nations and is also a closed economy. Whatever happens in the American economy has much more important repercussions abroad

Table 1-3
(A) U.S. Merchandise Trade by Sectors, 1981 ($ Billions)

Sector	Exports	Imports
Food	41.7	20.9
Raw materials	9.7	6.5
Minerals and ores	3.9	4.3
Fuels	10.2	84.3
Nonferrous metals	3.0	7.2
Primary Products (total)	68.5	123.2
Iron and steel	2.9	12.2
Chemicals	24.9	11.3
Semi-manufactures	7.4	11.6
Specialized machinery	28.2	12.4
Office and telecommunications equipment	14.5	10.9
Road motor vehicles	15.8	29.0
Other machinery and transportation equipment	43.2	19.1
Household appliances	3.2	9.9
Textiles	3.6	3.1
Clothing	1.3	8.1
Other consumer goods	7.0	15.4
Total Manufactures	152.0	143.0
Total Trade	225.8*	271.2

(B) U.S. Merchandise Trade with Major Trading Areas 1981 ($ Billions)

Trading Partner	Primary Products U.S. Exports	Primary Products U.S. Imports	Manufactures U.S. Exports	Manufactures U.S. Imports
Canada	6.0	17.4	30.1	26.5
Japan	12.2	0.8	9.1	38.9
Western Europe	21.5	14.8	39.2	37.8
Oil Exporters	4.2	51.3	16.4	0.3
Other Developing Countries	17.8	33.9	45.3	34.9

SOURCE: GATT, *International Trade, 1981/82*, Geneva, 1982.
*Includes "special category" exports not broken down by sector.