


# World Trade and Payments

## An Introduction



Fifth Edition



**Richard E. Caves**  
**Jeffrey A. Frankel**  
**Ronald W. Jones**

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# PREFACE

The biggest change in the fifth edition of *World Trade and Payments* is indicated on the title page: Jeffrey A. Frankel joins Richard E. Caves and Ronald W. Jones and revised the sections of the book that address monetary and financial phenomena (Parts Four and Five). While the research and teaching interests of both Caves and Jones focus on the real-variables side of international economics, Frankel brings attention to the monetary side as an author fully engaged in international finance and related aspects of macroeconomics.

Accordingly, Parts Four and Five of the book consist of entirely new chapters. They share the general orientation and strategy of previous editions: to supply an exposition of international economics that is serious in its theoretical underpinnings, yet is connected to current economic events. Traditional coverage of both Keynesian and monetary models and both fixed and flexible exchange rates is followed by such "frontier topics" as: hysteresis in import pricing, wage indexation, rational expectations, international macroeconomic policy coordination, credible pre-commitment of monetary policy, the asset-market approach to exchange rates, excess volatility, efficiency of the forward market and optimal portfolio diversification, speculative bubbles, and announcement effects. Analysis of these topics is now more rigorous than before; extensive references to empirical uses of theoretical concepts help students understand recent patterns of macroeconomic behavior and public policy. The material is presented in a sequence that students can readily comprehend. Part Four introduces the role of money in the international economy to permit nonzero balances of trade to persist. Then, with the basic open-economy macroeconomic models established, Part Five introduces international capital movements.

Parts One through Three of *World Trade and Payments* present updated coverage of topics that are familiar to users of previous editions. Chapters 2 through 9 cover the same general territory as 2 through 8 of the fourth edition. What was formerly a lengthy Chapter 7 on factor endowments and the Heckscher-Ohlin Model has been expanded into a two-chapter treatment (Chapters 7 and 8). Important topics such as product differentiation, intra-industry trade, and scale economics are now thoroughly integrated into the text rather than pushed off into the periphery.

The chapters on trade policy have undergone substantial change. In former editions, departures from pure competition were treated in their positive or behavioral context. This material has been completely rewritten and focused on policy issues in a new chapter (Chapter 14) that incorporates a full treatment of strategic trade policy and industrial policy in an international context. Chapter 15 on preferential trading arrangements has been strengthened to give due attention to "Europe in 1992" and the Canada-United States free-trade arrangement.

Throughout the text, we have continued to focus on applications and uses of theory. The debt crisis of developing countries is related to real long-term capital flows (its genesis) and short-term macroeconomic conditions (its continual development). Treatment of multinational companies and footloose activities is illustrated by the *maquiladoras* in Mexico. The dangers of overvalued exchange rates and overly expansionary demand policies are illustrated by the debt crisis of 1982. We hope that by showing examples such as these, students will gain some feeling for the emotional and controversial nature of international economic policy and the ostensible value of the welfare changes that it can bring about.

## **PEDAGOGY**

Pedagogical features of the book are consistent with previous editions. Each chapter ends with a series of problems and discussion questions, as well as a list of suggestions for further reading. These readings represent either fundamental contributions, or elaborations and applications that might prove useful to both student and instructor. New to this edition is a *Student Workbook* by Carsten Kowalczyk and Linda Tesar that provides extensive review of key concepts and contains numerous problem sets.

The book is adaptable to various tracking styles. Following each chapter, we present an appendix to explain specialized points or analytical constructions that some instructors may want to emphasize. Omitting the appendices, however, will not lessen comprehension of the chapters. For instructors who want a more advanced approach, we have retained the mathematical supplements presented at the back of previous editions; the supplements now include more material relating to open-economy macroeconomics.

The book covers a conventional full line of topics, and with some additional material can serve as the basis for a full-year course at the undergraduate level, or for separate semester courses on the real and financial aspects of international trade. We have paid specific attention, however, to the needs of one-semester courses. The chapters in Parts One and Four provide the nucleus of a one-semester course that covers both the core of the real theory (with applications) and elements of open-economy macroeconomics and balance-of-payments adjustment. Many of the chapters outside this core are at least somewhat independent of one another. Instructors can round out the course with selections from these chapters.



## **ACKNOWLEDGMENTS**

As authors of a textbook in its fourth revision, we have acquired a string of debts to colleagues, students, and various helpers that stretches the bounds of memory, let alone explicit acknowledgment. We confine ourselves to thanking those who supplied suggestions for changes in the fifth edition. Peter Warr and Alvin Marty supplied corrections to the fourth edition. Charles Bates, Paul Christopher, Sudipdo Dasgupta, Michael Devereux, Bruce Forster, Michael Gavin, Carsten Kowalczyk, Kala Krishna, Val Lambson, Stephen Marks, and Linda Tesar made numerous suggestions for improving the clarity of the new text. Charles Engel, Eric Fisher, Alberto Giovanni, Debra Glassman, Catharine B. Hill, Coleman Kendall, Dani Rodrick, and Tharman Shanmugaratnam supplied valuable suggestions on the new Chapters 16 to 24; Rudiger Dornbusch inspired much of the material in these chapters. Sharon Carboni provided prompt and efficient secretarial services.

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# INTRODUCTION

Unique among the concerns of economics, international trade has always carried a note of romance—the lure of the exotic, the hint of danger. Traders' dreams of bartering for the riches of the Orient spurred the European voyages of discovery that began in the fifteenth century. Today, supertankers move hundreds of thousands of tons of crude oil at a time from producing to consuming lands at strikingly low cost—except when breakups at sea pollute hundreds of miles of shoreline when a tanker breaks up at sea.

The romance of international commerce surges through its contact with public policy. British restrictions on colonial trade helped to fuel the American Revolution. After World War II the nations of Western Europe, sickened by the recurrent wars spawned by modern nationalism, sought permanent reconciliation and peace through a trade treaty that removed barriers to commerce through the European Community.

This book promotes an understanding of the economic causes and consequences of international exchange. Any branch of economics rests on theoretical concepts and models. The scholar's job is to bring systematic observation and explanation to the chaotic diversity of the world. The Census Bureau records data on about 14,000 classifications of commodities entering into the foreign trade of the United States—4,000 for exports and 10,000 for imports. Are 14,000 explanations for these trade flows truly necessary? Could one explanation possibly cover every bundle of merchandise? Our quest is for the simplest model, or the smallest family of models, capable of answering the important questions about trade patterns, and how public policy should deal with them.