

INTERNATIONAL ECONOMICS AND INTERNATIONAL ECONOMIC POLICY

A Reader

• Second Edition •



Philip King



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INTERNATIONAL ECONOMICS AND INTERNATIONAL ECONOMIC POLICY A Reader

• Second Edition •

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Preface

As I noted in the preface to the first edition, the eighties experienced an enormous outpouring of research in international economics. This trend has continued in the nineties at perhaps an even faster rate. To keep up, the second edition has been completely revised, retaining only two articles from before. Most of the articles from the first edition are still relevant today, but I thought a new edition was necessary for a number of reasons. First, many of the issues discussed in the earlier edition have now been incorporated into most textbook discussions (e.g., voluntary export restraints and strategic trade policy). Second, a number of new issues have cropped up in the past few years which are widely debated in the profession, but have yet to make their way into the textbooks. The debate about strategic trade policy has progressed from theory to policy, the main concern today is whether some sort of managed trade policy is preferable to *laissez faire*. As the 90s unwind it is also becoming increasingly clear that laws designed to regulate alleged dumping and other “unfair” trade practices are becoming an important vehicle for American protectionism. Several of the articles in this reader address the issue of dumping either directly or indirectly.

Perhaps the most notable change over the past few years has been the increasing attention paid to economic integration. The reasons for this attention are easy to understand. Despite the final completion of the Uruguay Round, there is concern that the multilateral trading system created by GATT will have less and less to say about how goods and services are traded. In its place, many economists believe that regional trading blocs such as the European Community and NAFTA, or bilateral trade agreements such as the MOSS agreement between Japan and the U.S. will gradually supplant GATT. The rise and (partial) demise of the European monetary system and the collapse of the Soviet Union have also created an outpouring of literature on a wide variety of topics in international finance, for example on target zones and optimal currency areas.

In choosing the articles that follow, my criteria are essentially the same as before. I have deliberately avoided the pro/con format because I think it limits the scope of the debate to one, or at most two issues, when in fact a range of opinions exist among economists. Also, despite the recurrent joke — if you lined all economists end to end they still couldn’t agree on anything—there is a surprising consensus on many important issues. Few economists oppose NAFTA, thus a pro/con debate on NAFTA would in fact distort the issue. There is also a general agreement among both conservative and liberal economists that there is no strong economic rationale (though there may be a political one) for a common European currency.

One other significant addition to the second edition is the inclusion of 69 discussion questions. In my own experience using readings in international economics and other classes, I've often found that students don't know what questions to ask; when they do, they often comprehend a great deal more of the material. The questions are placed at the end of each section, rather than at the end of each reading, in order to allow for questions which draw from more than one article from the section. I've also tried to begin with somewhat easier questions and move on to more difficult questions later. The questions have several goals: (1) to first get students to see what basic economic theory is being applied, (2) to force students to see how different assumptions and different models often lead to different empirical results and different policy conclusions, (3) to make students grapple clearly with the policy implications of each view, including the difficulties encountered in implementing economic policy, (4) to bring up points of view not mentioned in the articles. No reader can present every point of view; where I see some deficiency in the readings, I have tried to get students to critically assess these deficiencies. I hope that these questions will add significantly to the value of the readings.

In some ways this is a more difficult text than the first edition. I believe the change reflects an increasing availability of sophisticated policy discussions in international economics which are accessible to undergraduates and masters-level students. It also reflects a growing knowledge about international affairs among my students and an increasing desire to plunge more deeply into the material. In the first edition, a number of the articles I chose were from *Foreign Policy* or *Foreign Affairs*; in this edition, none are. Instead, the *Journal of Economic Perspectives* figures prominently.

A number of people have been extremely helpful in putting together this book, a substantial portion of which was done while I was on sabbatical in Prague. Scott Stratford, the economics editor at McGraw-Hill, has strongly supported both editions of this reader when other editors told me "Readers don't sell." Scott's assistant, Victoria Richardson has also been extremely helpful in putting this edition together and dealing with the many glitches that invariably come up. Rebeca Schiller did a great deal of the typing for this book. Thoreau Lovell, as always, was helpful with his time and with the BSS computer lab at San Francisco State. Many of my students provided useful feedback and served as guinea pigs in trying out articles for this reader. I also received a number of helpful comments from faculty who use my book which I have paid close attention to; I welcome further feedback for this edition.

Desktop publishing a book for production at 1200dpi is still difficult these days despite advances in technology; Murphy's law always seems to apply in putting a book together. Kevin Ready has been extremely helpful in formatting and desktop publishing this book, in remaining calm despite system crashes, bad Syquest cartridges, anxious editors, Federal Express packages that didn't arrive when they were supposed to, and various other glitches.

For the final steering of this book's course through the rough waters separating Prague, Boston, New York, London, and San Francisco, I am very grateful for the teamwork exhibited by the individuals who helped in assembling the book for publication. Their dedication to this project through the final logistical maelstrom has been very appreciated.

Finally, a special note of thanks to my father, who helped tie up several loose ends while I was on sabbatical in Prague.

Phil King

London

June 1, 1994

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Section I

Free Trade vs. Strategic Trade: Making the Case For and Against Selective Protectionism

It is hard to find an economist, or even a politician, who will categorically state that they are against free trade. The standard response is either unabashed support for free trade or a response similar to the following: "I'm basically in favor of free trade... but." It is the "but" part that this section is concerned with. For most of the post-war era, economists who argued for any type of protectionism were summarily dismissed by the profession. That has changed somewhat. Led by Paul Krugman, a new generation of economists have been willing to embrace the idea of protectionism, at least at an intellectual level, though many are wary of actually implementing protectionist policies.

The first article in this section, "How Costly Is Protectionism?," by Feenstra, provides a survey of the empirical evidence on the welfare losses from protectionism. Many of these studies attempt to actually measure the triangular deadweight losses that all students of international economics are familiar with. Most estimates of this loss indicate that current U.S. policy imposes a small loss on the U.S. economy or the world economy. The outcome of all of these studies depends critically on the assumptions employed, in particular the assumptions made about market structure and elasticity of demand. In all cases, Feenstra believes that these estimates should be taken as a lower bound since they do not include other costs, such as the appropriation of rents due to lobbying by domestic industries for protectionism. Finally, Feenstra is less enthusiastic than Krugman (see the Krugman article in Section 3) about the welfare implications of free trade zones.

The second article, "Is Free Trade Passé?," by Paul Krugman, has been widely circulated and most of the ideas in the article have now found their way into international economics textbooks. Krugman sets out some conditions which may be sufficient to justify selective protectionism. Both economies of scale and spillover effects from research and development play an important role in Krugman's models and other models of strategic trade policy. To demonstrate the importance of economies of scale, he presents a simple game in which Boeing and Airbus vie for a natural monopoly. Without any government subsidy, Boeing wins; with a small subsidy, Airbus is able to recoup much greater profits. None of these simple models, nor the more complex models that Krugman and

others have created are meant as an endorsement of protectionism. Krugman finally argues that, even though a theoretical case for strategic trade policy can easily be made, implementing such a policy is fraught with pitfalls. One must have confidence in the theoretical model being applied; one must be able to measure the effects of spillovers or positive externalities. Finally, one must have faith that the political process will reward worthy industries, rather than ones that are able to lobby effectively. In the end, Krugman is reluctant to endorse any specific protectionist policies.

Laura Tyson, currently President Clinton's chief economic advisor, is in a much better position to influence economic policy than most economists. Tyson calls herself a "cautious activist" and believes in "managed trade." In the third article, "From MOSS to Motorola and Cray: Managing Trade by Rules and Outcomes," taken from her book *Who's Bashing Whom: Trade Conflict in High-Technology Industries*, she presents a detailed study of the negotiations between the United States and Japan involving American companies, in particular, Motorola and Cray. According to Tyson, Motorola was systematically shut out of the cellular phone market in Japan, which continually changed its regulations to favor less efficient Japanese companies. With fairer regulations, Tyson argues, Motorola would have obtained a much larger share of the cellular telephone market. She contends that U.S. government interference, through such mechanisms as the MOSS agreement, has benefited American companies, allowing them to gain market share that they otherwise would not have. The final case study examines Cray supercomputers. Despite an overwhelmingly dominant market share in the U.S. and in Europe, Cray was unable to penetrate the Japanese supercomputer market until after the U.S. government intervened.

Tyson is careful to distinguish between rules and outcomes. She generally favors trade agreements that create rules which allow the most efficient competitor to win. However, she argues that, absent a truly level playing field, the United States should move toward results-oriented agreements which propose specific timetables and market shares for particular industries.

How Costly is Protectionism?

Robert C. Feenstra

When economists attempt to measure the gains from trade and costs of protection for industrial countries, the resulting estimates often look small. As Krugman recently wrote:

Just how expensive is protectionism? The answer is a little embarrassing, because standard estimates of the cost of protection are actually very low. America is a case in point. While much U.S. trade takes place with few obstacles, we have several major protectionist measures, restricting imports of autos, steel, and textiles in particular. The combined costs of these major restrictions to the U.S. economy, however, are usually estimated at less than three-quarters of 1 percent of U.S. national income. Most of this, furthermore, comes from the fact that the import restrictions, in effect, form foreign producers into cartels that charge higher prices to U.S. consumers. So most of the U.S. losses are matched by higher foreign profits. From the point of view of the world as a whole, the negative effects of U.S. import restrictions on efficiency are therefore much smaller—around one-quarter of 1 percent of U.S. GNP.

Are the efficiency costs of protection really so small? While the estimate cited by Krugman for the U.S. costs of its own protectionism is a plausible lower bound, I will argue that the rents arising from import quotas should not be thought of as simple, nondistortionary transfers to trading partners. On the contrary, the evidence is that U.S. quotas impose a loss on our trading partners, and that in some cases this loss is comparable in magnitude to the transfer of rents. This means that even when foreign firms earn quota rents through higher selling prices in the U.S., the foreign countries gain by less due to the efficiency losses, and in some cases do not gain at all. It follows that the world efficiency losses from U.S. protection are as large as the U.S. costs.

It is quite common to ignore the efficiency costs imposed on foreign countries through U.S. protection. This approach does not reflect the reality that U.S. protection, like that of other industrial countries, occurs at quite restrictive levels

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in a small number of industries, and also discriminates against particular supplying countries. The U.S. is not a "small" country in the large world market, and its highly selective pattern of protection generates substantial deadweight losses both at home and abroad.

This paper begins from a U.S. perspective, examining the costs to both the U.S. and other countries from U.S. protectionism. It then moves to a more global policy perspective. The emerging free trade areas in Europe, North America and Asia raise the prospect of gains from trade within each region, but also the possibility of global costs from protectionist actions across the regions. To quantify this, Krugman considers a world split onto three trading regions, where under a hypothetical trade war each region restricts trade with the other regions by one-half. Using a simple triangle calculation, he suggests that the global efficiency losses from this dramatic reduction in trade may be only 2.5 percent of world GNP.

This calculation does not reflect the highly selective pattern of current protection, however, where trade barriers are maintained against specific goods rather than uniformly. Under this form of protection, reducing trade across regions can mean eliminating trade in the varieties of certain goods imported from outside the region, while other internal varieties are still available. This approach is particularly relevant to differentiated manufactured goods such as cars, consumer electronics, footwear, textiles and apparel, and so on. When the *range* of product varieties is reduced in this manner, the global losses can easily be several times larger than Krugman's estimate.

From a policy perspective, our discussion emphasizes the importance of limiting the use of selective and discriminatory trade protection whenever possible. Of course, the General Agreement on Tariffs and Trade aims at this goal, but GATT may be undercut by the movement towards regional free trade areas. The most important determinant of trade protection in the years ahead is likely to be a choice between the GATT approach of multilateral negotiations to lower all trade barriers, and the more recent shift toward agreements which offer free trade within a region, but also risk discriminatory trade barriers against those outside the region.

COST OF U.S. IMPORT PROTECTION

Figure 1 illustrates the effect of an import quota on the U.S. market. Let S be the U.S. supply curve for a particular good, and let Q be the U.S. demand curve. Suppose that imports are initially available at the free trade price of P_0 , so that the quantity imported is $M_0 = Q_0 - S_0$. Then if the U.S. limits the amount imported to \bar{M} using a quota, the equilibrium price in the U.S. would rise to P_1 . Domestic producers would benefit, of course, and their rise in producer surplus is measured by the area A . In contrast, U.S. consumers would suffer from the increase in the price, and their drop in consumer surplus is measured by the entire area $A + B + C + D$.

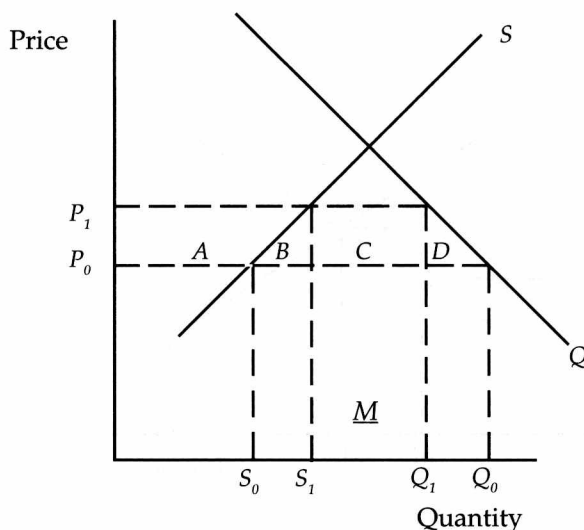


Figure 1
The Effect of an Import Quota on the U.S. Market

If the U.S. were a “small” country, so that its purchases had no effect on the international price P_0 , then the area C would be the “rents” associated with the quota \underline{M} . In nearly all the cases of U.S. import quotas we shall consider, the quotas are allocated to foreign exporters by their own governments. Under this system, it is the *foreign firms* that earn area C in Figure 1, so that the net U.S. loss from the quota is areas $B + C + D$. In contrast, the global efficiency loss is only $B + D$, since the quota rents C are a redistribution from the United States to the foreign firms.

However, if protectionist actions by the U.S. have some effect on the world prices, then the measurement of global losses is quite different. This is illustrated in Figure 2, where we incorporate the exporting countries. Let M be the U.S. excess demand curve for imports of the good in question (which is the horizontal difference between domestic demand Q and supply S) and let S^* be the excess supply curve from all foreign countries. Under free trade the equilibrium price and quantity of imports are again at P_0 and M_0 . With the quota limit of \underline{M} , the U.S. price rises to P_1 , as before. Foreign firms would have been willing to supply this amount at the reduced price P_2 , so that $(P_1 - P_2)$ is the “quota premium” they earn on each unit sold. Then the quota rents they earn are measured by $(P_1 - P_2)\underline{M}$ = area $C + E$ in Figure 2.

However, not all of the quota rent is a welfare improvement abroad. The drop in foreign producer surplus due to the reduced U.S. sales would be

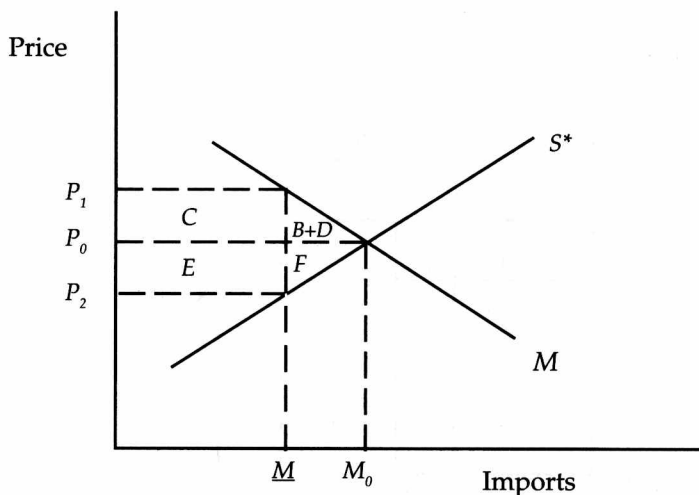


Figure 2
When U.S. Protectionism Affects World Prices

calculated as the area $E + F$, which represents the losses of those pushed out of the U.S. market as a result of the quota.¹ These losses must be counted against the rents that the foreign firms earn. The net change in the welfare of the supplying countries is therefore $(C + E) - (E + F) = C - F$. The area F represents the deadweight loss to the foreign countries. These countries are worse off due to the import restriction if this deadweight loss exceeds C , which will certainly occur if the quota \underline{M} is set at a very restrictive level. The efficiency losses to the world as a whole are measured by the areas $B + D + F$.

In summary, the costs of U.S. import protection in the United States can be measured as the sum of deadweight losses ($B + D$) and that part of the quota rents which represent the increase in U.S. prices (area C). The measurement of the *global* losses due to U.S. protectionism would need to subtract the quota rents from U.S. losses, and add the efficiency losses created in the countries supplying to the U.S. (area F). Table 1 offers estimates of these three categories: U.S. deadweight loss ($B + D$), quota rents (C or $C + E$), and foreign deadweight losses (F).

U.S. Deadweight Loss

The first column of Table 1 displays estimates of the deadweight loss to the U.S. economy from the major instances of import protection. Other cases of import protection include machine tools and meat, though the losses involved are much less than those in Table 1, and would not substantially affect the totals. The estimates shown are *annual* costs for years ranging between 1983 and 1987, and are centered around 1985. For each industry, imports are primarily restricted

Table 1
Annual Cost of U.S. Import Protection
(billion dollars, years around 1985)

	U.S. Deadweight Loss (B+D)	Quota Rents (C or C+E)	Foreign Dead- Weight Loss (F)
Automobiles	0.2-1.2	2.2-7.9	0-3
Dairy	1.4	0.25	0.02
Steel	0.1-0.3	0.7-2.0	0.1
Sugar	0.1	0.4-1.3	0.2
Textiles & Apparel	4.9-5.9	4.0-6.1	4-15.5
Average Tariffs	1.2-3.4	0	n.a.
Total*	7.9-12.3	7.3-17.3	4.3-18.8

* In dairy the quota rents are earned by U.S. importers, and so are not included in the total. n.a. — not available

by quotas, though small tariffs rates also apply.

The estimates in column one are obtained from two sources: partial equilibrium models estimating the deadweight loss triangles for U.S. consumers and producers; and computable general equilibrium models. Both of these methods rely on a wide range of literature for estimates of the demand elasticities, supply elasticities, and the value of the import quota. In some cases the value of the import quotas, or quota premium, is directly observed, while in other cases it is inferred from the reduction in trade and the supply and demand elasticities; some examples will be provided below. The range of estimates in Table 1 is intended to emphasize that the losses are subject to error from both the parameters used and the assumptions imposed.

A few details on each industry should be mentioned. The “voluntary” export restraint on Japanese auto imports was negotiated in 1981, and limited the U.S. sales of each Japanese company. These quotas were increased in 1987, and are still in place today. However, they are not currently binding for most companies, partly because many Japanese firms have established plants in the United States, and sales from these plants are not limited by the agreement.

The estimate of the deadweight loss in column one does not reflect this foreign investment, though we shall discuss later the effect of including it.

Dairy products subject to import restrictions include cheese, butter and powdered milk. These restrictions are used in conjunction with domestic support prices, and are intended to preserve income for U.S. farmers, as is the case with sugar. The deadweight loss of \$1.4 billion in dairy is primarily due to the restrictive quotas on cheese imports.

The U.S. steel industry has lobbied for various forms of protection during the