INTERNATIONAL ECONOMICS

second edition

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Preface to the Second Edition

The first edition of *International Economics* was published in Swedish in 1969. The American edition came out in 1970 and the British in 1971. An Italian translation was published in 1976.

The first edition of the book was well received and has been used in many countries. The purpose of the book was to present a reasonably rigorous, modern treatment of international economics which should still be accessible to undergraduate students and persons with a general interest in economics and international affairs. The emphasis was on theory, even though problems of economic policy were discussed throughout. The book tried to provide the reader with theoretical tools that could be applied to various kinds of problems, not just those that happened to be at the forefront of discussion just when the book was published.

This basic outline and approach has been kept in the second edition. However, as almost a decade has gone by since the first edition was originally published, the second edition has been thoroughly revised, both in order to take into account new theoretical developments and to bring the exposition up to date and take account of the changes in institutional settings and of new policy perspectives.

Parts I and II, on the pure theory of trade and on economic growth and trade, have been organized around the standard trade barter model. This is the area where standard theory is most firmly rooted. Hence the outline of the first edition has been kept. However, the exposition has been tightened, condensed and also simplified. More emphasis has been given to the testing of trade theories and a new chapter on alternative trade theories has been added to Part I to review alternative approaches to the Ricardo and Heckscher-Ohlin models. In Part II the empirical survey has been revised to take recent trends into account.

Part III now deals with trade policy. The chapters on institutions have been altered to keep pace with facts and changing perspectives on policy problems. Two new chapters have been added to strengthen the book's emphasis on the theory and policy of trade and development. One of the chapters is on import substitution versus export-push, and the other is on the quest for a new international economic order. The section on effective rates of protection has been changed to take care of new theoretical insights.

Part IV now comprises the balance of payments and problems of international economic monetary policy. In this area major theoretical advances have been made. This has led to the addition of a new chapter on the monetary approach to the balance of payments and to complete revisions of the chapters on fixed versus flexible exchange rates and on how to achieve external and internal balance.

Part V, on the international monetary system, has been completely rewritten as the institutional scene has completely changed following the breakdown of the Bretton Woods system and the introduction of floating exchange rates.

HOW TO USE THE BOOK

There is no one best way of organizing the subject of international economics. Some will prefer to start with macroeconomic aspects, others with micro-economic or pure-theory parts. Each part of this book has a logical structure, and it might prove difficult to break up a part, though it is unnecessary to study all the material in any one part before turning to the next. The sequence in which one chooses to cover the parts is to some extent a matter of taste and interest. For example, if one starts with pure theory, perhaps it would be logical to continue with the theory of growth and trade.

But whether one wishes to take Part III, on trade policy, next, or Part IV, on the balance of payments, is a matter of preference. The part on trade policy has been placed before the part on international monetary economics because the theoretical structure of the analysis underlying trade policy problems has more logical connections with the pure theory of trade. But it might also be argued that insights into balance-of-payments problems will enhance the understanding of problems of trade policy. I have instead chosen to concentrate the exposition in the first three parts of the book to problems connected with the 'real' side of the economy and to concentrate the analysis of monetary aspects of the international economy to Parts IV and V. However, the five parts are intended to be self-contained.

ONE-SEMESTER COURSES

Instructors who wish to use the book in one-semester courses on international economics may find it too voluminous. For one-semester courses I would suggest the following fifteen chapters: 1–4, 7, 8, 9, 14, 17–19 and 22–25. But other combinations are equally possible.

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BO SÖDERSTEN

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Introduction: international economics and economic theory

Today the national state is the dominant political entity. Most countries, from an economic point of view, are still intimately linked with others. A few - the United States, the Soviet Union, and China - could conceivably withdraw from the world economy without disastrous consequences to themselves. For other countries such an act would border on the unthinkable. It would bring about not only a drastic lowering of economic welfare but also a complete change of ways of life. For practical purposes, all countries must accept the fact that they are part of a world economy. No country can escape its role in the system of interdependent trading nations.

It is debatable whether the degree of interdependence among nations is increasing or not. It is true that world trade has grown exceptionally fast in the post-war years. The forces behind the internationalization process have been strong. Technical progress in transport and communication has played an important role. Increased returns to scale in production and high income elasticities for differentiated products have also had their impact. These and many other factors have favored international specialization and trade. The forces working for economic interdependence among nations seem irresistible.

At the same time, we should not forget that the nation-state is still in the 1970s the dominant entity. However, there are forces working against interdependence. The possibilities for the advanced industrial countries to control their own economies and isolate themselves from international repercussions are considerable. While it is true that the increase in oil prices in 1973 played havoc with the world economy and induced an international depression, many countries, notably Japan and some of the stronger Western European economies, have not been so greatly affected by international business cycle fluctuations as they were in the interwar period.

Labor markets, especially those in Western Europe, have been influenced by regional migration, but we have not witnessed any migrations on the scale of those which took place in the nineteenth century from Europe to the United States.

Many less developed countries have tried to establish a policy of self-reliance. They have tried to isolate themselves from international influences by a policy of import-substitution. When speaking about integration a word of caution should be inserted. The really important integration is between parts of the world economy. There is still, for instance, a very definite dividing line between the Soviet Union and the East European communist countries on the one hand, and the United States and the Western European capitalist countries on the other. What has been said so far really applies to parts of the world economy; the world economy as a whole is not and never was integrated in any qualified sense of the word.

It is therefore an open question if the degree of interdependence is increasing or not. There are undoubtedly many economists who would argue that the forces behind the internationalization process are strongest and that the national state will wither away. I am not convinced that this will be the case. The forces working for a national identity – perhaps a new type of identity, be it from dominating neighbours or a new type of changed social and political system – are also strong in many countries. Whether existing trends toward internationalization or new forms of nationalism will get the upper hand is impossible to say. This is primarily a political question.

To be able to reach an informed opinion about these matters, it is necessary to study international economics.

INTERNATIONAL ECONOMICS AS A SUBJECT

Even if most people agreed that international economic relations are of great importance for most countries, it does not necessarily follow that international economics should be studied as a subject independent of other branches of economics.

International economics is often referred to as 'applied economics', and there are certainly many policy problems and problems of an empirical nature within international economics that the use of economic theory can elucidate. But there are more deep-seated reasons why international economics has a long tradition as a subject in its own right.

Many theorems and insights central to economic theory have been developed by economists working within international economics. The theory of comparative advantage and the factor-price equalization theorem are examples. Both belong to the area usually called the *pure theory* of international trade. The pure theory of trade can be said to be part of price theory, the terms used in a broad sense. But price theory or microtheory *per se* seldom pursues the subject to such a degree that all the aspects of the theory which are of interest to a trade theorist are revealed in its full implications. Trade theory is a distinct part of modern economic theory with a rich body of theorems. These results are not part of general economic theory as it is commonly understood and taught.

Analogous conditions hold, though perhaps to a less degree, for the macroeconomic parts of international economic theory. Some of its results, for instance those about income determination in open economies, are quite straightforward applications of the corresponding parts of the theory for closed economies. But other parts, for instance exchange-rate theory, can hardly be obtained except from a study of the specific theory.

When it comes to the policy aspects of the subject, it is quite obvious that international economic relations give rise to problems not encountered in other fields of economics. The nation is not only a distinct political entity, it also has many important economic characteristics that set it apart from the larger integrated areas that make up the world economy: the mobility of the factors of production is much larger within the nation than among nations, there are tariffs and taxes on imported goods, different currencies give rise to specific problems, etc. All these lead to international economic policy problems that are different in nature from national policy problems.

There are, therefore, from both theoretical and policy points of view, good reasons why international economics is dealt with as a specific branch of economics. Modern economics is a large and diversified subject. A training in general economic theory is the best background for a study of international economics. But it can be regarded only as a background. To obtain a real understanding of the field, the student will have to study international economics directly.

Now we shall look at some characteristics of international economics and preview some of its problems and results.

COMPARATIVE ADVANTAGE AND PURE THEORY

One of the basic questions facing international trade theory is why trade takes place. The classical economists saw labor as the only factor of production and said that differing labor productivity among countries caused trade.

A closely linked question is: Why do countries gain by trading? The classical economists said that as long as cost conditions differ between two countries, at least one and probably both will gain by trading.

These questions and answers contain the essence of the theory of comparative advantage. The first can be said to state the positive side and the second the normative side. The normative aspect is perhaps the most interesting to the modern student. It demonstrates, on very weak assumptions, that trade will be beneficial to all countries involved in trade. It is important to understand the nature of this theory. It has often been attacked and is often misunderstood. It is still frequently argued that trade is detrimental to countries, today especially in connection with less developed countries. Right from the outset, therefore, we will enter disputed territory. Whatever the student's final opinion is, he will have to undertake a certain amount of theoretical work before he can reach an informed judgement.

One of the central assumptions of the classical economist was that factors of production were fully mobile within countries but not at all mobile between countries. Labor could move freely from New York to Arizona, but it could not cross the border into Mexico. This is an assumption that modern trade theorists have stuck to in elaborating the modern theory of trade. It might seem to be too strong. Some four million workers, for instance, have since 1945 moved north from Portugal, Spain, southern Italy, Greece and Turkey to France, West Germany and Switzerland. But the movements of labor have taken place primarily within somewhat integrated areas. The movement of workers from the United States to Europe, or from Eastern Europe to Western Europe, is still insignificant.

For many purposes the assumption that labor is immobile between countries is valid. Using this (and some other fairly stringent assumptions), modern trade theory has proved some quite startling theorems. One is that trade alone will lead to a complete equalization of factor prices. Even in the absence of factor movements, if only goods can be traded freely, wages will be equalized.

A study of modern trade theory will also help the student understand one of the basic principles of economics, that of *general equilibrium*. Trade theory is essentially a branch of general-equilibrium analysis. It is firmly embedded in the Walrasian tradition. From there stems the preoccupation with creating a theory that is self-contained, where all variables of importance enter and where all variables are interdependent. Such a theory will of necessity be of an abstract and simplified nature. It works with a few well-defined variables and relies on simplifying assumptions, some of which are of a drastic nature. Its strength lies in the fact that it creates a picture of the world which in important ways is complete.

At the heart of general-equilibrium theory are the notions of determinateness and completeness: the relations which describe an economy must form a complete whole where all the variables of the system can be determined. The viewpoint that all factors which make up an economy hang together and are dependent on one another has had a very strong place in economic theorizing. It might even be said to have been *the* distinctive feature of economics as a science. It had also had important policy implications as it has forced policy-makers to try to view the economy as a whole and not simply try to focus the attention on the effect of a parameter change on one or two obvious variables. The pure theory of trade offers the student an excellent illustration of one of the basic notions of economics as a science.

COMPARATIVE STATICS: THE QUESTION OF CHANGE

The pure theory of trade is fundamentally a static theory. It studies some aspects of trading economies in the setting of static equilibrium. It abstracts from one fundamental aspect, that of change.

The simplest way to study the effects of change is by the use of comparative statics. We take an economy in a given equilibrium and then introduce a change in some of the basic variables. This is done in Part II, which studies the effects of economic growth on international trade. The theory in Part II is based on the same type of model as is used in Part I for the pure theory of trade. It is the so-called 'two-by-two-by-two model', i.e. a model with two countries, using two factors of production, labor and capital, to produce two goods, one export commodity and one import commodity.

Growth of production and trade in the world economy was very rapid in the 1950s and 1960s. The more precise theory of growth and trade was also primarily developed during these two decades. From a methodological point of view, this type of theory is also interesting because it illustrates clearly how the static models used in Part I can be developed in a comparative-static way. It clearly demonstrates also some of the basic effects of economic growth on the variables in the trade model. One question it answers is the following. Let us assume that economic growth occurs in two trading economies. What will be the effects on the terms of trade (the ratio of export prices to import prices) and on national income? The answer will depend on which sectors growth occurs in and what the income elasticities are.

The effects of increases in factor endowments and technical progress are also studied. These effects can be handled clearly by the use of geometry. An understanding of this type of theory therefore does not involve very advanced or difficult methods. The effects of technical progress, for instance, are quite striking. An understanding of this kind of theory is essential also for a broad group of problems outside the field of international trade, so it seems appropriate to treat the theory of economic growth and trade rigorously and explicitly.

TRADE POLICY: IS TRADE GOOD OR BAD?

The book is based on the principle of decreasing abstraction. The most theoretical parts are in the beginning, especially in Parts I and II; then, as the exposition develops, it becomes more and more policy oriented – it assumes more of an 'applied' nature. This is because theory is needed to appreciate all the facets of a policy problem. It is logical to start with theory and then proceed to policy, though it perhaps seems that policy problems are sometimes 'easier' to deal with than theoretical questions.

Part III is devoted to problems of trade policy. It both demonstrates principles of trade policy, for example the effects of tariffs on trade, and analyzes the factual development of trade policy. One thing it shows is that free trade, in a world of sovereign states, is practically never the best policy. However, some trade is always better than no trade.

The trade problems of the developed countries and the less developed countries are seldom of the same kind. One of the trade problems confronting less developed countries is the stabilization of commodity prices. Together with the question of tariff preferences, this problem has dominated the few UNCTAD conferences held so far. These questions are also intimately linked with the strivings for a new economic world order.

The proposals for stabilization of commodity prices are of different kinds. The object of some is to stabilize terms of trade between less developed and industrial countries; others, less far-reaching, aim at stabilizing export prices or export proceeds. To understand the true nature of some of these plans, they should be considered against the models of growth and trade developed in Part II.

These models show explicitly the basic factors that determine the development of commodity prices in international trade. Therefore, they show clearly which factors have to be controlled if international prices are to be controlled. They give an example of how recent developments in trade theory can be used to elucidate long-standing policy problems.

Part III analyzes the real content of, and conflicts surrounding, the proposals for a new economic world order. It also treats another important feature of the present era: the development of regional trade groupings.

MACROECONOMIC ASPECTS: DIFFERENT CURRENCIES

One of the obvious differences between trade within a country and international trade is that the latter involves different currencies. If a New Yorker trades with a Californian, they both use the same currency, but trade between a New Yorker and a Canadian involves different currencies.