FOURTH EDITION

WORLD TRADE AND PAYMENTS

AN INTRODUCTION

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Preface

In this fourth edition we have retained the goal proclaimed in previous editions: to supply an exposition of international economics that is serious in its theoretical underpinnings and yet connected to current economic events. These events are not in short supply; nor are advances in some areas of international economic theory, particularly the macroeconomic and monetary area. The late comic Fred Allen ad-libbed, as a joke fell flat, "When we warmed up the audience before the show, we must have cremated them." The trick is to adapt a textbook to the pace of events and intellectual development without losing the student in the resulting turbulence.

The book's organization underwent some revision in this edition to help us incorporate new issues and concepts. The real-variables section now consists of four parts. Chapters 8–10 make up Part III and deal with international flows of factors of production and intermediate goods and with noncompetitive markets. We seek to provide a more extensive and better-integrated treatment than before of these issues lying outside the classical core of trade theory. More theoretical and empirical material than before is provided on international migration and long-run capital transfers. In a new Chapter 8, we address trade in nonfinal products and related issues of internationally "footloose" industries.

The balance of the real-variables section retains the organization of the third edition, although with many minor changes. Chapters 2–7 have been further simplified and some of them completely rewritten. Chapter 13 was extensively revised to focus on the rise of "managed trade" and the political economy of trade controls.

In the section dealing with monetary and financial issues, a good deal of revision was undertaken in order to tighten the organization and ingest more fully the financial-asset approach to the foreign-exchange rate. The theory of exchange-rate determination now directly follows the monetary model of macroeconomic adjustment (Chapters 17 and 18), and the analytical relationship between them is developed extensively. Institutional material on the foreign-exchange market is now combined with the analysis of other international financial-asset markets in Chapter 20. The third edition's chapter on inflation has been dropped, but some material on this subject in Chapter 17 illustrates the monetary mechanism of adjustment. Chapter 21 on internal and external balance was rewritten extensively to integrate it more fully with Keynesian concepts of open-economy adjustment used in earlier chapters.

Users of the book have urged more applications to current policy issues, and accordingly we have expanded the space devoted to empirical investigations of these issues and the behavior underlying them. We consider, for example, the rapid increase in offshore sourcing by United States manufacturers (Chapter 8), the problem raised by the heavy external debts of certain developing countries (Chapter 10), and the relation between the United States government deficit and the current-account balance (Chapter 19). We have continued our effort to make generous reference to recent research findings on how the intenational economy operates, to show the student that the concepts of international economics are actively useful and not just a made-up story.

We have also added a pedagogical feature to this edition. To help students learn, we have included problems and exercises following each chapter. The Suggestions for Further Reading, a pedagogical tool of previous editions, have been thoroughly updated.

We have stuck to the third edition's level of difficulty, restricting the text to material that requires only the background in micro and macro theory provided by the standard course on principles of economics. To make the book adaptable for instructors who wish a more advanced approach, we have retained the mathematical supplements presented at the back of previous editions and also expanded the appendixes at the ends of chapters. The appendixes typically offer geometrical constructions that some instructors favor but others wish to avoid. The conclusions reached in the appendixes always receive self-sufficient coverage in the text, though with less weighty or less general analytical underpinning.

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 careful attention, however, to the needs of one-semester courses. In particular, we view the chapters in Part I and the first four chapters of Part V as the nucleus of a one-semester course that is meant to cover both the core of the real theory (with applications) and elements of balance-of-payments adjustment. Many of the chapters outside this core are at least somewhat independent of one another, and so can be selected to round out the course, with an emphasis depending on what topics the instructor wishes to emphasize.

Authors whose textbook reaches its third revision 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 fourth edition—Robin Bade, Bradley Billings, Patrick Conway, Isaias Coelho, Robert Dohner, Jonathan Eaton, Dudley Johnson, and Jose Vinals.

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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 — and have been known to pollute hundreds of miles of shoreline when they break 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 of the recurrent wars spawned by modern nationalism, sought permanent reconciliation and peace through a trade treaty — removing barriers to commerce through the European Common Market.

In this book we try to provide 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 he observes. The Census Bureau records data on about 14,000 classifications of commodities entering into the foreign trade of the United States — about 4,000 for exports and 10,000 for imports. Do we need 14,000 explanations for these trade flows? Could we find one that would cover every bundle of merchandise? Our quest is for the simplest model, or the smallest family of models, capable of answering what seem to be the important questions about patterns of trade, and how public policy should deal with them.

The foreign commerce of nations is one of the oldest branches of economics, and has drawn the attention of some of the greatest economists. Indeed, many of the ideas you will meet in this book can boast of famous ancestors. We owe much of our understanding of money in international trade to the philosopher David Hume (Chapter 17). One of our principal models of international trade and production (Chapter 5) derives from David Ricardo, an English stockbroker with a powerful analytical mind. Yet much of present-day international economics is quite new. A most fruitful model relating trade to factors of production comes from two twentieth-century Swedish economists, Eli F. Heckscher and Bertil Ohlin (Chapter 7). And our understanding of how trade relates to employment, and how policy can deal properly with both, is in part a late fallout of the Keynesian Revolution of the late 1930's (Chapter 16).

1.1 The Subject of International Economics

International economics is somewhat curiously related to the other conventional branches of economics. Public finance, money and banking, or labor economics selects a neatly distinguished group of transactors or markets in the economy for special study. "But," you may ask, "doesn't international economics similarly deal with international markets?" It does, and these markets are capable of exact *legal* definition. Sovereign states are ubiquitous; therefore, we can always tell whether the two parties to a transaction are citizens of different countries.

But are international transactions economically unique and readily separated from transactions within nations? Does the Kansas wheat farmer know or care whether the bushel of wheat he sells will be exported? When you buy a handkerchief, do you inspect it closely for a label indicating manufacture abroad? International transactions are of a piece with domestic markets. Ultimately our explanation of international trade must be part of an explanation of each national market.

This intertwining of international and national markets runs through all of international economics. If India decides to train more physicians, the supply of physicians in Britain is apt to increase (through emigration). If the United States raises government spending to increase employment, employment in Canada is almost sure to increase. Hence you should not be surprised that international economics can easily (and usefully) be viewed as "international aspects of supply and demand," or "international aspects of money and finance," or "international aspects of taxation."

Nonetheless, there are good reasons for treating international trade and payments as a separate field of study. Here are two reasons that we think are most important:

1. The models we find useful for explaining international trade are simple, but strong and general. They not only explain patterns of international trade, but they also tell much about patterns of production, income distribution, etc., within countries.

2. The policy questions that arise in international exchange differ from those typically discussed within nation-states, and they require a special analytical apparatus. Yet we contend that the *principles* of policy-making should be the same at home and abroad. International economics can attack both the special questions of international economic policy and show how to couple foreign and domestic policies correctly.

What, indeed, is the simplest possible way to model the international economy? The central questions about international trade deal solely with *exchange* between traders in two national markets. We shall argue that the sparest and clearest explanation of trade between nations, and the gains nations derive from trade, requires only a description of the exchange of fixed endowments of goods. The simplification we make, by concentrating first on exchange, is to put aside the details of how goods are produced. We can then explain, for example, what happened in 1973 when the exporting nations quadrupled the price of oil. Having set the essentials, we then can expand the basic model of trade to explore details of how bundles of goods are produced.

Why should we employ separate models to explain international trade and domestic trade? The traditional answer has been that factors of production — labor and capital — in the long run move freely within the national economy, but their mobility between countries is sharply limited. We suppose that labor and capital move freely between New York and California, whenever workers or lenders feel that such a shift will improve their real incomes. If that assumption is correct, the goods traded between the two states, and the effect of that trade on their "native" factor endowments will be less interesting. (California has no natives.) On the other hand, if little movement of labor and capital takes place between, say, Mexico and France, the commodities they trade and their benefit from the exchange become both interesting and important.

The assumption that factors of production are perfectly mobile within countries and perfectly immobile between them is obviously not completely true. Think of the international migrations of the nineteenth century, the outflow of long-term capital from the United States in the last three decades — and the immobility of low-paid labor out of America's Appalachia or Italy's Mezzogiorno! However, probably no assumption used by economists is completely true. We start out by supposing that the assumption is true, but we then relax that assumption in two ways. We introduce a form of immobility in the domestic economy by assuming that one factor of production used by each industry is tied to that industry and cannot find employment elsewhere, no matter what happens to its wage. We also relax the assumption that factors are immobile between countries; after we learn how trade affects the incentive for factors to migrate internationally, we can show more easily what happens when some factors seize the opportunity.

We mentioned above a second reason for studying international economics separately: Special questions of policy arise in the international economy. Trade