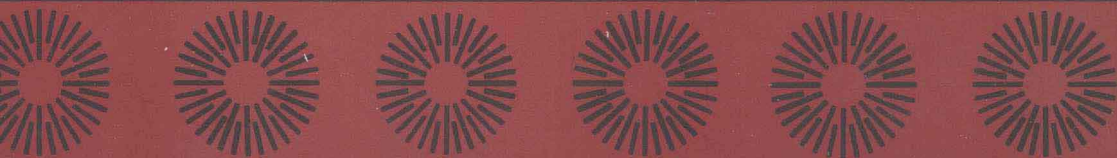


The International Economy: A Modern Approach

Ferdinand E. Banks



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Preface

This is a reference and textbook in international economics. It can be used as supplementary reading for a wide variety of courses in international economics and other disciplines. In addition to providing an up-to-date analysis of traditional topics in the field, it is designed to introduce the reader to issues that are ignored in most books in international economics but which, by common acclaim, have become more important than most of the material included in these books. I am referring, of course, to oil and nonfuel minerals. As far as I know, the only textbooks to treat these subjects in regard to the international economy are those by Rowe (1965) and Banks (1976b, 1977b); however, things are moving very rapidly where these matters are concerned, and I am sure that in the future, textbook writers who ignore these subjects risk offending their readers. I have also attempted to provide a concise but nontechnical discussion of some important facets of international monetary economics. The presentation of this topic, while placing certain demands on the concentration of the reader, is nonmathematical and involves none of the usual geometric devices of economic theory.

There are three principal targets of this book, of which the student is only one. I am also interested in reaching the person who has studied some economics but, as is quite common, has finished his or her studies without any real understanding of the subject because his or her teachers neglected the real world in favor of theory—and superfluous theory at that. Similarly, I am interested in providing a reference and textbook for the individual who has never had a formal course of studies in economics, but at the same time is conversant with the material presented on the business pages of his local newspaper and the topics covered in some of the more outstanding business and economic periodicals such as *Business Week*, *Fortune*, *The Wall Street Journal*, *The London Economist*, *Euromoney*, etc. Although in general I dislike giving away professional secrets, I feel it necessary to inform the reader that anyone with a serious interest in international economics should make an intensive effort to peruse some of these publications, even if he or she might not happen to agree with some of their editorial policies and even if it means spending less time with the interesting, elegant, intellectually challenging, but quite useless models that fill the so called scholarly journals. I can also suggest the readers of this book peruse chapter 9 to get some idea of the range of topics I attempt to treat.

I have also some apologies to tender the more impressionable readers of this book, of whom there may be several. It has been stated by a Swedish journalist that I do not like the “new economic world order.” The simple truth is that I did not approve of the previous version either—the one proposed by Adolf Hitler which had almost the same name. As I see things, the world economy is in for a bad spell that could last several decades unless a systematic and conscientious

effort is made to increase the efficiency with which most economic operations (to include academic training) are carried out. Whether the incompetent but overpaid phrase mongers who are now trying to market the “new world economic order” to the governments and taxpayers of the developed countries are eligible for a place in the ranks of this crusade is at best uncertain, although on the basis of the record, I personally would have to answer in the negative. Put more directly, the new world economic order is counterproductive, an obstruction to the design of a rational international order, and unlikely to benefit anyone except the officials of U.N. and aid organizations and their traveling circuses of advisors and consultants.

By the same token, although important politicians in highly developed democracies often find it difficult to retain the cloak of near infallibility with which they try to cover themselves during their election campaigns, especially when so much of their energy is diverted to wining and dining assorted dignitaries and VIPs, the initiatives taken in regard to energy by President Carter and his Energy Secretary, Dr. Schlesinger, are judged in this book as both wise and necessary, and will almost certainly be viewed in this light in the future, regardless of whether or not they are adopted by the U.S. Congress. Failure to produce adequate solutions for the “energy crisis” will not only have severe consequences for future generations but also jeopardize the standard of living of the present generation. Behind the statistics about rising unemployment and inflation and the decline of the U.S. dollar is nothing more than uncertainty about future energy prices and the configuration of future energy sources.

Now the time has come to thank a number of individuals for the help they have given me, either directly or indirectly, in the production of this book. Reviewers of my other books have pointed out the advantages and disadvantages of repetition as a pedagogical device; and I now have it clear in my own mind, at least, that many things worth saying are worth saying more than once—even in the same book. Considerable attention has also been paid my prose style, which sometimes appears to lack the restraint commonly associated with scientific usage. Here I can only quote the observation of Joseph Conrad: “Nothing lays itself open to the charge of exaggeration more than the language of naked truth.”

When I began this book, I was able to discuss a number of issues with Professor Jacques Royer and Paul Rayment of the Economic Commission for Europe at Geneva. I was also able to incorporate some ideas from Paul Rayment’s ongoing research and published material into my own work, although in a greatly diluted form. Let me say now that neither of these economists has any responsibility for what follows, given that they would disagree probably with certain portions of my analysis and certainly with a large part of its phrasing. The same thing holds true for John Cuddy (who is now with the Brandt Commission), Jay Colebrook, Christopher Rogers, and P.A. Della Valle of UNCTAD, and for that matter any of the very skillful economists and statisticians of

UNCTAD with whom I have talked or communicated with over the past year or so.

I would also like to thank Kraaft Holtz and the brilliant members of his research team at Eurofinance and Euroeconomics in Paris who provided many of the facts on which I based my humble theorizing. I am also indebted to Drs. Jan Herin and Per Wijkman of the University of Stockholm for being allowed to refer to their important work, and my colleague at Uppsala, Yngve Andersson, with whom I have discussed various aspects of international monetary theory. I also want to thank the publishers, Lexington Books, for taking into consideration the pressures under which I worked between the time I received the Reserve Bank of Australia's professorial fellowship for 1978 and my departure for the University of New South Wales; and finally the universities of Uppsala and Stockholm for blessings too numerous to name here.

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1

Introduction and Background

In his book *The Crash of '79*, Dr. Paul Erdman, an economist and banker turned successful novelist, has one of the financial superstars whose escapades he so enjoys recounting observe that the most important things in the world today are oil and money. Actually, this is not far from wrong. *The* most important thing still happens to be work (that is, physical and intellectual exertion), but oil and money rank high on the list, along with nonfuel minerals.

Under the circumstances, the justification for this book must be that it spends proportionally more time on these subjects than other books on the international economy. In fact, chapter 2 is a survey of the world petroleum economy and can be read independent of the rest of the book. On the other hand, I am not concerned with whether “comparative advantage” was the brain-child of David Ricardo or some obscure lieutenant colonel in the Royal Marines; and I presume the mature reader is not interested in such pretentious trivia as “immiserizing growth,” or perusing the work of economists who are—despite the revoltingly large amount of cash that has been squandered on research in this particularly sterile field. I can say, though, that readers interested in the pure theory of international trade should be aware that, at last, a number of superb books and surveys are available: Caves and Jones (1977) and I.W. Pearce (1969) at the elementary level, Akira Takayama (1972) at the intermediate level, and John Chipman (1965) and Murray Kemp (1969) at the advanced level.

This chapter opens with a fairly compressed review of trade and investment over the past few decades. Here I can say that I have made a considerable effort to keep unnecessary abstractions out of the exposition but since the study of economics cannot be reduced to the level of jaywalking or sunbathing, some concentration is occasionally required of the reader. I also use this chapter to introduce several topics that will be gone into in greater detail in chapters 2, 5, and 6: oil and money. Where the second topic is concerned, some readers might find it preferable to first read chapters 5 and 6 and then use the last section of this chapter as a summary of those materials. (Similarly, chapter 9 provides a résumé of the entire book.)

Some Aspects of Trade and Growth

During the 35 years from 1913 to 1948, world production increased at an average annual rate of 2 percent. The corresponding figure for the volume of world

trade was only 1 percent. Since 1948, production has grown at an average annual rate of 5 percent, with the rate of increase of trade being somewhat higher. These values describe the *trend* growth, but there has been a great deal of movement around this trend in the form of oscillations or cycles of varying length. The most important interruptions to growth came during the Great Depression, in particular during the period from 1930 to 1932, and in the immediate aftermath of World War II. But even if we examine cyclic activity as far back as 1870, we see that there were very few years in which there was an absolute fall in world output.

Particularly important was 1948 because at that time global industrial output regained its prewar high and the United States launched the accelerated program of foreign aid known as the Marshall Plan that succeeded in revitalizing the economies of Western Europe. In 1948 labor productivity in most of what had been industrial Europe, and Japan, was far under its prewar and wartime levels and greatly inferior to that of the United States. However, by taking advantage of hindsight, we immediately see that the lead of the United States in this sphere was not destined to be permanent, as many prominent and comparatively well-educated Americans were claiming at that time.

According to Abramovitz (1977), in 1913 the average labor productivity of the ten leading industrial countries other than the United States was about 60 percent of that prevailing in the United States in the same year. A precise explanation for this situation cannot be given, but it seems clear that considerable weight must be accorded the incentives offered by an open society in a huge, rich country with a modern political system. By 1950, however, probably half of this gap had disappeared, and American economic superiority apparently rested on such things as the size and adaptability of its stock of reproducible capital and the high quality of its labor force—things that were, in principle, available to other countries willing to take the trouble to acquire them. This is essentially what has happened over the last decade or so, although various descriptions of the changes in the structure of the world economy as Europe and Japan began to draw abreast of the United States fail to agree on certain important details.

Some economists claim that the United States now specializes in producing and exporting goods that are particularly rich in skill or “learning,” while on the whole Europe and Japan are oriented toward products whose manufacture requires large amounts of physical capital and relatively unskilled labor. Measurement and statistical problems here are in truth enormous, and many of us are not sure that the economists dealing with this problem have come up with the right answers. When we look at the rate of increase of output per head in countries such as Japan, Germany, Sweden, and Holland, it is difficult to avoid the conclusion that there is some factor other than machinery and labor hours which, prior to the oil price increases of 1973, was enabling them to overtake the United States—which is precisely what they were doing. Most likely this

factor was technical progress based on the rapidly increasing skill levels of various categories of employees, together with an increase in the aggregate level of motivation caused by raising the proportion of immigrants and women in the labor force.

It has also been argued that what the United States is now doing is trading new technologies for old. But it does not follow that the amount of brains and refurbished or reinvigorated human capital in new technologies exceeds, quantitatively or in any other sense, the amount of these factors incorporated in the commodities whose manufacture and trade are being increasingly dominated by Europe and Japan. Moreover, there is a new factor on the scene. This is technological change that can be moved rapidly from one part of the world to another, via transnational corporations, and which can be applied in situations characterized by labor costs that are much lower than in the traditional manufacturing centers. Unsophisticated but inexpensive labor, combined with highly sophisticated equipment and technical direction, is already in the process of cornering the cheap-assembly market, and may be capable of making similar progress with such things as steel making and shipbuilding. Under the circumstances, the future leaders of the international growth and trade derby may be those countries whose firms are in position to complement domestic operations with very large investments abroad, as is the case with many manufacturing organizations in the United States and Japan.

Investment

We continue by examining our topic from another angle—that of investment in machines and structures.

To get some idea of what capital investment can mean for a country, it might be instructive to examine some aspects of growth in one of the four great success stories of this century: Japan. (The others are East Germany, West Germany, and the U.S.S.R.) The first point that can be made here is that only a portion of the amazing performance witnessed in that country can be attributed to the unhampered functioning of the free market, the so-called invisible hand. Hardly had Japan moved out from under the tutelage of General Douglas MacArthur and his military government when the old cartel masters emerged from their semiretirement. At first they espoused the conventional kind of capitalism that emphasized private initiative and the glories of the consumer society; but when the time came to put the Japanese economy into high gear, they added a number of interesting refinements.

Huge mergers became the order of the day, sometimes with the good wishes of the concerned managements and stockholders, but just as often without, since the majority of these mergers were blessed in advance by the Ministry of Trade and Industry and/or one of Japan's major financial institutions. A typical

bank-inspired fusion resulted in three of Japan's major producers of special steels forming a new company, Daido Special Steel, which became not only one of the world's largest firms in this branch but also one of its most efficient. The logic behind this fusion was self-evident, but for the record was expressed by the head of another large steel firm in more or less the following terms: unchecked competition will only lead to Japanese companies destroying one another and opening Japanese markets to foreigners.

Adam Smith would undoubtedly have found this kind of philosophy deplorable, especially had he been unlucky enough to hear it emanating from the executive suite, but there can be no doubt about its therapeutic effect on the Japanese economy, and in particular what it meant for the incentive to invest. In general, economic policy functioned so as to keep the rate of growth of consumption below its "natural" rate and ensure that the right firms were well supplied with working capital. Firms carrying the designation "right" included those showing a solid record of success in production and marketing who were quick to import and exploit foreign technology and unhesitant about opening up new sources of raw materials. To get an idea of the situation in Japan as compared to that of some other industrial countries, the reader should examine figure 1-1, which shows gross investment as a percentage of gross national product.

If the reader is interested in some figures, the following are probably significant. Japan invested, on the average, about 33 percent of its gross national product in the years 1962-1973. Corresponding figures for other countries were France, 27 percent; West Germany, 26 percent; Canada, 22 percent; Italy, 21 percent; the United Kingdom, 20.5 percent; and the United States, 15 percent. As a reward for their diligence, the Japanese obtained in this period a total increase in gross national product that was more than twice that of France and West Germany, and about four times that of the United States. Put another way, productivity increased in Japan at an average annual rate of more than 10 percent, as opposed to 5.5 percent in Germany and only 3.25 percent in the United States.

Furthermore, according to Professor Dale Jorgenson of Harvard University and Mieko Nishimizu of Princeton, the level of technology as a whole in Japan overtook that of the United States in the beginning of the 1970s. At the heart of this astounding achievement was the extremely rapid rate of growth of capital referred to above, with the mechanics of the process functioning about as follows. As new equipment was put into use, it increased the share of output being produced by the most technologically advanced methods, which raised the income of employees working with this equipment as well as the profits of its owners, which in turn created a demand for other goods and services with a high skill content. In order to satisfy this demand, it was imperative that good ideas and technical improvements from every corner of the Japanese economy were, when relevant, immediately applied to the production of such things as steel,

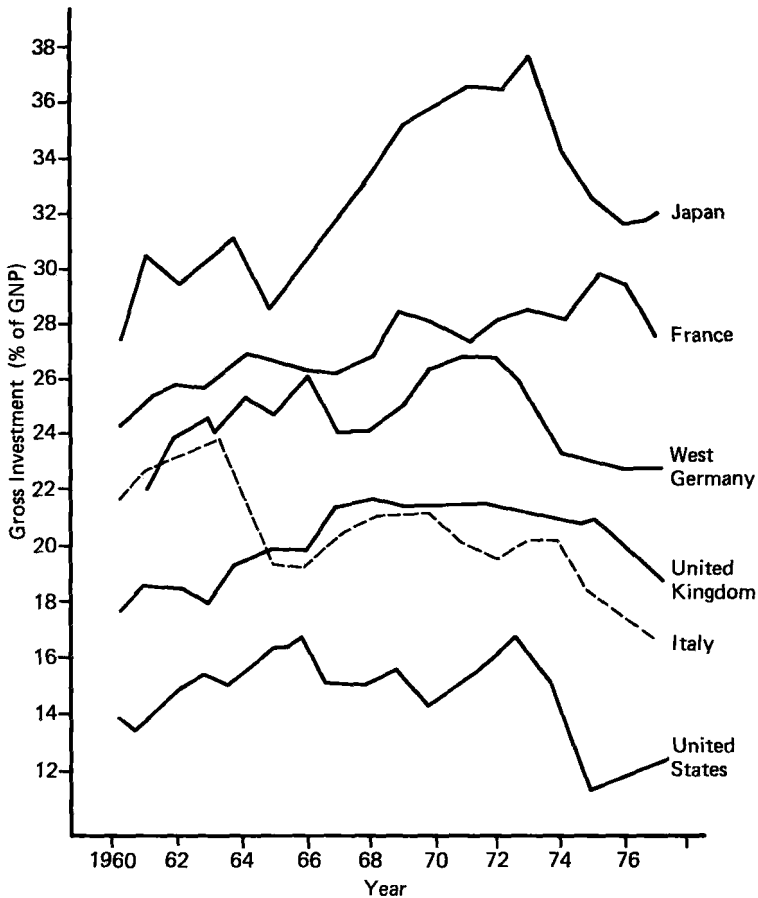


Figure 1-1. Gross Investment in Some Industrial Countries.

automobiles, and electronics. It was the assembling and organization of a very large number of small or marginal improvements that allowed these items to be manufactured with an efficiency that was completely out of line to the relatively small advantages held by the Japanese (until the early 1970s) in such things as the quantity and age disposition of capital goods and the quality of the Japanese educational system.

On the other hand, the United States did not do so badly in the growth sweepstakes, considering its modest level of investment over the postwar period. The thing to remember here is that the United States already had a big lead in most of the prerequisites for a satisfactory rate of growth: a large amount of capital per head, a highly trained labor force, an efficient labor market, and something that probably comes as a surprise to many television viewers of the

1960s and early 1970s—a very high degree of political stability in comparison to most of the other industrial powers. Eventually, however, much of the leverage emanating from these factors was undermined by the war in Vietnam, which distorted resource allocation by deflecting time, effort, and money from productive work into military projects of dubious virtue and profitability. Moreover, as is well known, this is a one-way street, since when the war ended, military spending continued to expand. For instance, the end of hostilities featured one of the most cost-ineffective measures ever introduced in the United States in peacetime: the volunteer army. This creature of perverted logic provides an important example in the explanation of why the United States has moved from a low-inflation to a medium-inflation country: invaluable capital is being siphoned into low-yield or even counterproductive outlets, and as a result productive capacity is no longer capable of expanding rapidly enough to keep up with the money demand generated by these economically—and sociologically—absurd schemes.

Energy, in the context of investment, will be touched on later in this chapter and in the next; but in such things as the decline in the rate of return on investment that business economists believe to be taking place in many industrial countries, the increase in energy prices that took place in 1973-1974 must be given its due. The average rate of return on physical investment in the United States seems to have fallen from about 13 percent in 1966 to approximately 9 percent in 1976, while the U.S. Commerce Department reports that profits, as a percentage of gross national product, fell from 9 percent in 1966 to 5 percent in 1977. As far as I am concerned, it is the increase in the cost of energy that explains much of this; and until most investors get some assurances that cost increases of this nature cannot happen again, they are going to react by keeping investment in industrial facilities at an unsatisfactory level.

We can close this part of our discussion by mentioning that in a climate of sliding profitability, investment tends to concentrate on sure things. When a firm's return on equity shows a persistent decrease, its ability to raise money in an emergency falls, and as a result a "safety first" attitude finds its way into boardrooms. What should be appreciated here is that behavior of this nature, which is perfectly sound for the individual company, can be catastrophic for the economy as a whole. One firm's increase in capital spending is another company's triumph—the company that receives the order—and might in turn lead to the latter increasing its spending on equipment and hiring more people. But as fewer firms expand plant and equipment, the economy becomes weaker, and the disaster that everyone is intent upon avoiding becomes a fact. In the United States the rate of growth of manufacturing capacity was only 3 percent a year from 1973 to 1976, as compared to an average rate of increase of slightly over 4 percent during the previous 24 years. A continuation of this trend can only mean trouble. It requires about a 4 percent growth rate in manufacturing capacity, on the average, to absorb the yearly increase in the labor force in the United States, and, according to Arthur Okun of the Brookings Institution, another 3 or 4 percent to reduce unemployment by a single percentage point.¹