GERALD M. MEIER

# INTERNATIONAL ECONOMICS

# THE THEORY OF POLICY

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GERALD M. MEIER

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# Preface

As economics books go, this one does not even look difficult. It is not intended to be. I simply want to set forth as directly and succinctly as possible some central normative principles of international economics.

Economists have long debated the issues of trade policy, balance of payments policy, and development policy — the three parts of this text. But in our time, economic models have become ever more complex, and technique is frequently practiced for its own sake. Students naturally become dismayed when they cannot discover the basic relationships because they are covered over by elaborate filigree. Unfortunately, students also often become too enmeshed in the curiosa and arcania of "high theory" to comprehend the wider questions that must absorb economists when they move from being model builders to policy-makers. I have tried therefore to write in a large way about the fundamental normative principles that underlie commercial policy, international payments policy, and international development policy. I hope that this return to the first principles of international economic policy will have more meaning for students than yet another book on theoretical refinements, or one that is empirical, institutional, or descriptive.

During the period of classical political economy in the eighteenth and nineteenth centuries, the English classical economists "shared a common interest in economic reform, which manifested itself, not so much in common support of specific measures though there was much of that — as in a commonly held belief that the application of certain methods of approach and analysis, the recently discovered science of Political Economy, offered superior hopes for what they would have called improve-

ment" (Lionel Robbins, *The Theory of Economic Policy in English Classical Political Economy,* 1952, p. 4). Today we must again become absorbed with these profound questions of "improvement." But we must now do so using modern analysis that is more rigorous, and yet not so technically complex that it has only a tenuous, if any, connection with our ultimate objective — the pursuit of more effective policies for social betterment.

Ever since Adam Smith's criticism of Mercantilism, successive generations have argued the merits of free trade versus protection. In Part I, therefore, the case for free trade, the conditions of optimal governmental interventions, and the different effects of various trade policies are appraised.

During the past half-century, problems of maintaining simultaneously domestic economic stability and balance in international payments have become ever more perplexing. Keynesian analysis has been extended to the open economy; monetary and fiscal policies have been related to the balance of payments; the search for international monetary order is still with us. These problems of international monetary economics are analyzed in Part II.

During the past three decades, there has been a concerted effort to accelerate the development of poor countries. The future of these countries depends in large part on the course of their trade and access to external resources. In Part III, the problems of national development are interpreted in an international context.

Our discussion will be mainly verbal: mathematics is absent, and the diagrams have been kept to a bare minimum. The more extensive geometrical expositions are reserved for optional Appendices that can be omitted with no loss of the central argument.

If I slight the mathematics and the geometry, I give more attention than is usual to the history of thought. Economics does not advance in the same way as do the natural sciences; the insights of an earlier-day economist might still be valuable. And, after all, international trade is the oldest branch of economics as a disciplined subject. The history of economic thought is too rich to be neglected. I have therefore tried to relate some thought of the past to policy dilemmas that did not appear just today. If these problems have continued to be perplexing for so long a time, they must surely be "real" problems worthy also of this generation's concern.

I have benefited from all the authors of international textbooks who have preceded me. Special thanks are due W.M. Corden, John Cuddington, James S. Hanson, Robert Stern and T.N. Srinivasan for their

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criticisms and perceptive suggestions on parts of the manuscript. Pamela Adler has steadily, but cheerfully transformed a mass of handwritten scrawls into a proper typescript. Paul Brophy kindly provided general research assistance. Above all, I am indebted to several generations of students who have helped me distill the essentials of this subject and have inspired whatever merit this book might have.

*Pedagogical Note:* This book is for a one-semester or a one-quarter undergraduate course in international economics in which policy-oriented theory is emphasized. Only an introductory economics course is a prerequisite. But even without such a course, a student could easily remove any initial deficiency by some elementary background reading as needed.

For students who wish supplementary readings, an annotated list is provided at the end of each chapter. These offer more detailed exposition, analysis of select topics, or more advanced theoretical treatment.

Empirical studies or policy materials can also readily supplement this book. To aid in this, I have prepared a trilogy on policy problems in international political economy that could be parallel reading with this text: *Problems of Trade Policy, Problems of a World Monetary Order*, and *Problems of Cooperation for Development*.

G. M. M.

*Stanford*
*April 1979*

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# Prologue: Toward an International Public Order

Now, more than ever, we need to try to understand what international economic policy is all about. The consequences of a greater degree of "internationalization" are upon us. But there is no authoritative international normative process to bring order to international economic affairs. The result is that each nation practices suboptimal policies, and nations compete among themselves in policy-making. We shall therefore try to clarify the principles of international economic action, in the hope that the quality of public decisions in the international economy might be improved both in the choice of objectives and the use of policy instruments.

## "Internationalization" of the Economic System

It is fashionable to characterize our age in terms of interdependence. This is not a new phenomenon: for centuries the world economy has become ever more integrated. In the past quarter-century, however, the pace of integration has accelerated. And the implications of interdependence have become more pronounced, as measured by the duration of international economic conflicts, the extent of the economic gains and losses to the parties affected, and the inadequacy of policy instruments to resolve the conflicts.

An outstanding feature of the internationalization of the economic system has been the increase in the flows of commodities, factors of

production, management, technology, and financial capital across national borders. Not only have the movements of these goods, services, and factors increased, but they have also become more responsive, or more **elastic**, to differences between domestic and foreign variables. The **stocks** of factors of foreign origin are now also much larger within a country. We refer to these three phenomena—flows, elasticity, and stocks—as the "**internationalization of markets.**"[1]

This internationalization process is reflected in statistics that indicate that during the last two decades, while world output has been growing about 4% per year, world trade has been growing about 8% and production by foreign subsidiaries has been growing by some 10%. Export and import shares of output have increased considerably in practically all industrial sectors. A growing percentage of world trade is becoming intra-industry trade (reflecting economies of scale and increased demand for differentiated products) and even intra-firm trade by transnational firms (reflecting decomposition of production activities around the world).

Another side of the internationalization process has been the internationalization of **institutions**. Beyond the nation state, a number of intergovernmental institutions have arisen—ranging from international organizations, such as the General Agreement on Tariffs and Trade (GATT), the World Bank, the International Monetary Fund (IMF), and the United Nations Conference on Trade and Development (UNCTAD), to regional groups, such as the European Economic Community (EEC), Latin American Free Trade Area (LAFTA), the Andean Group, Association of Southeast Asian Nations (ASEAN), or the Organization for Economic Cooperation and Development (OECD). Interest groups, such as labor unions, employer associations, and foundations, have also expanded across national borders. Above all, the population of multinational corporations has increased remarkably, and many more large firms operate an expanding number of foreign subsidiaries in a number of countries.

As a result of the internationalization of the economic system, we must incorporate other units of analysis than the nation state (or a variety of "actors," as the political scientist would say). We must also consider policy issues that are not delimited by national territorial boundaries. Important decision-making units are not only national governments, but also international organizations, regional organizations, transnational interest groups, and multinational corporations. These

[1]This process is elaborated by Assar Lindbeck in "The Changing Role of the National State," *Kyklos*, 28 (1975), 23–46.

nonterritorial participants in the transnational economy shape decisions and events that transcend national frontiers.

Each unit has a different decision domain, characterized by different objectives, responsibilities, constituencies, time concern, and power. And yet, they all interact within a transnational economy that is essentially decentralized. The operational domain of transnational economic transactions extends beyond the jurisdictional domain of independent nations. Each decision-making unit is actually part of a larger decision process. But there is no central decision unit in the system. The relationships and interactions among different decision-making units therefore demand more analysis and evaluation.

## International Economic Conflicts

To an economist, the internationalization of markets has the virtue of promoting efficiency, specialization, and competition. To the national policy-maker, however, internationalization has a negative side, heightening the sensitivity and increasing the vulnerability of the nation to external events and developments. International economics confronts national politics. If the objectives of two or more actors in the transnational economy become incompatible, international economic tensions and conflicts result. This is especially likely when there are changes in world production, and the distribution of the world product alters over time, with resultant benefits and detriments to different nations and to various groups within each nation.

The conflicts can be grouped into three general categories: (i) those that arise because a nation **seeks to acquire a larger share of the gains** from trade or foreign investment; (ii) those that arise when a country **tries to avoid being damaged or injured** by developments in another country; and (iii) those that arise because a country wants to **maintain its domestic autonomy in policy-making** when confronted with an international event.

More specifically, the major conflicts tend to be over the following issues:

i. **Markets:** The attempt of each nation to have greater access for its exports in the markets of other countries and to have ready access to imports of needed resources from the markets of other countries.
ii. **Terms of trade:** The attempt of each country to improve its terms of trade by raising export prices relative to import prices.

iii. **Terms of foreign investment:** The attempt by host governments to raise the benefit-cost ratio of foreign capital inflows.
iv. **Externalities:** The attempt to avoid the impact of detrimental spillovers or to capture more of the external benefits of a production activity.
v. **Adjustment costs to imports:** The attempt of each nation to minimize the "market disruption" or the "domestic injury" caused by greater imports.
vi. **Costs of balance of payments adjustment:** The attempt of each nation to minimize the cost of adjusting to a disequilibrium in its balance of payments by avoiding remedial policies or by trying to place some of the burden of adjustment on other countries.
vii. **Stabilization policies:** The attempt of each nation to exercise national economic autonomy in stabilizing its own economy, without subjecting its policies to external conditions.

Recognizing the stresses that are inherent in the internationalization process, we must ask by what means are the conflicts resolved or at least mitigated? There is no well-defined international normative process to keep pace with other features of the internationalization process. We therefore must search for a normative order that will accommodate conflicts, make "better" choices, and control change. Is it possible to establish more effective management of the internationalization process, so that there will be an economic order with less discord? Can nations improve the quality of their own policy-making, without injuring other nations? What rules, norms, or standards can be invoked to control the behavior of nations in the transnational economy?

The driving technological, economic, and political forces behind the internationalization process will not wane, but as internationalization proceeds, we shall have to seek policy solutions for future conflicts. The challenge is to improve these policy solutions. This is difficult because the outlines of decision-making processes in the world community remain vague, supranational institutions are few, and their power to pursue international public policy-making is limited. The internationalization of institutions has not kept pace with the internationalization of markets. International economics, in the sense of the internationalization of markets, will continue to be opposed by national politics, since governments desire to retain autonomy over economic policies. Nations will only too readily tend to compete among themselves in policy-making, which coordination of

Nobel Laureate JAN TINBERGEN, *Development Planning* (1967), 189–190

We are becoming increasingly conscious of the fact that the well-being of each separate country does not depend simply on the government of that country alone, but to a great extent on what happens in other countries. We also know that there are often conflicts of interest between different countries. If our aim is to promote the well-being of every nation as much as possible, then we must ask ourselves how we can best organise economic and social policy for the world as a whole. Even though it is not yet possible to establish a world government, we must force ourselves to be guided by the question, what would a world government do, if we are to see what the best policy is. We must make the interests of the world as a whole the basis of our own policy.

This immediately confronts us with the question as to which affairs can be left to the national authorities or to various other authorities at a lower level, and which affairs must be dealt with at a higher than national level. It has long been recognised that the supranational level is the only possible level for a number of means of economic policy. Yet, even though we have in certain cases accepted a higher authority than that of the national governments, we have certainly not yet reached the point where the two authorities are perfectly balanced. On the contrary, the world is still groaning under far too heavy a weight of traditional and emotional nationalism, which again and again plunges entire communities into disaster.

national policies remains an ideal. Nonetheless, if progress is to be made, it will necessarily depend first on understanding the basic principles of international economic policy.

## The Three Problem Areas

To analyze and evaluate international economic conduct, we shall find it useful to have a conceptual framework within which we might systematize what would otherwise appear as an incomprehensibly wide array of diverse topics. Fortunately, the current concerns of the subject, as well as its intellectual history, can be considered under three major problem areas that have long been—and give promise of continuing to be—of central importance in the study of international economic rela-

tions. We can subject each of these three problem areas, in turn, to three levels of analysis.

Although international economic relations are wide-ranging, most of the important policy issues fall into place within three major problem areas: (i) **trade and welfare,** (ii) **trade and stability,** and (iii) **trade and development.** Each of these problem areas lends itself to three types of analysis: (i) **theoretical,** (ii) **empirical,** and (iii) **normative.**

The problems of international resource allocation, the determinants of the pattern of world trade, the gains from trade, the relative merits of free trade and protection—all these problems relate to trade and welfare. The central issue is economic efficiency in the international economy, and this becomes, in large part, an application of international welfare economics.

The body of theory corresponding to this first problem area is that of classical and neoclassical trade theory. It begins with Adam Smith's refutation of mercantilist regulations (1776), proceeds to David Ricardo's celebrated exposition of the doctrine of comparative advantage (1817), and continues through John Stuart Mill, Alfred Marshall, and more modern economists, such as Jacob Viner and Gottfried Haberler.

This theory is labeled "pure" in the sense of being the non-monetary theory of international trade in equilibrium. In determining relative prices and real incomes in international trade, it concentrates on the "real" non-monetary forces of trade, such as factor supply, productivity, and technology, and establishes whether an equilibrium solution exists. In recent years, this theory has been extended and refined through the infusion of the more systematic elements of the "new welfare economics."

Some of the more prominent manifestations of this trade and welfare problem appear in the operation of the General Agreement on Tariffs and Trade (GATT), the European Economic Community (EEC), the United States' Trade Acts, and the proliferation of non-tariff distortions of trade. Policy problems in this area have become more complex as an earlier generation's concern with "freer trade" has had to accommodate to recent demands for 'fairer trade" and "orderly trade."

The second problem area—trade and stability—involves the interrelationships between *international trade and national income.* What are the relationships between internal balance and external balance? What are the causes of balance of payments disequilibrium? How may the disequilibrium be corrected? This branch of trade theory is usually termed the "monetary theory" of trade. It is now in an active state of revision and extension to incorporate problems of unemployment and inflation not

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