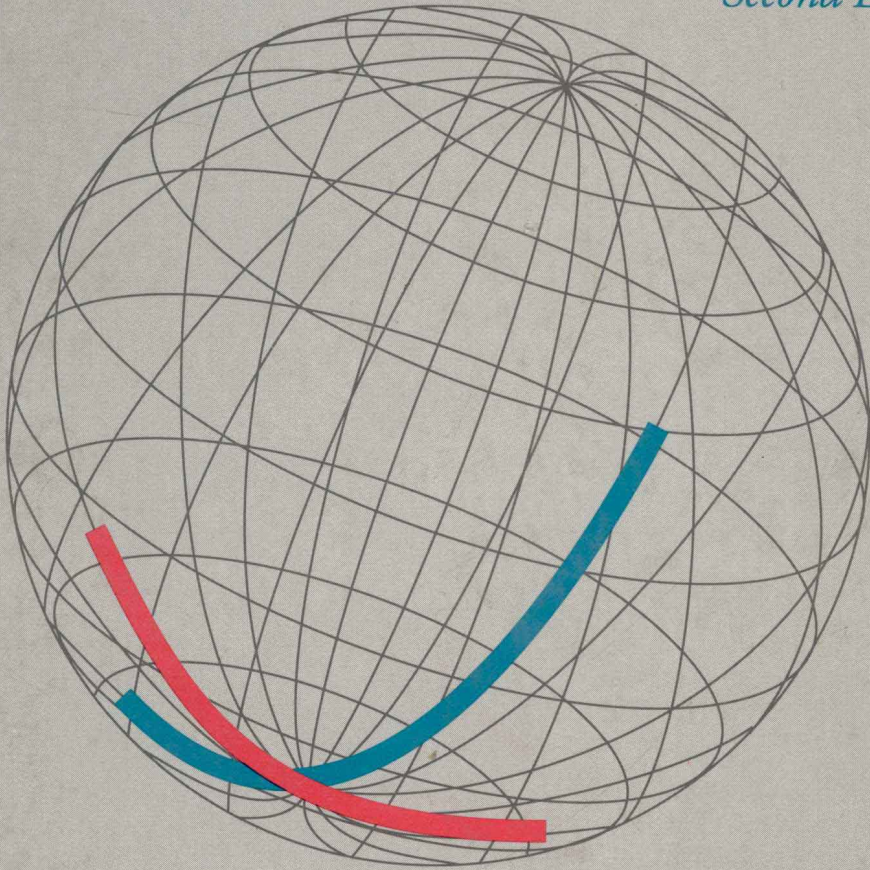


International Economics

Theory and Policy

Second Edition



Paul R. Krugman

Maurice Obstfeld

INTERNATIONAL ECONOMICS

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PREFACE

The years since 1970 have brought a steady sequence of upheavals in economic relations among countries. The fixed dollar exchange rates of the Bretton Woods system have been abandoned in favor of a managed float; a booming international capital market has not only forged new links among the world's financial centers but also raised new unease about global financial stability; newly industrializing developing countries have seized from developed countries an important share of the world market for manufactured exports; and most recently, macroeconomic imbalances, combined with structural shifts in trade patterns, have generated political pressures that gravely threaten the open international trading system built up so painstakingly after World War II. Even in the United States, which is more self-sufficient than nations with smaller economies, problems in international economic policy have assumed primacy and moved decisively to the newspapers' front pages.

Recent general developments in the world economy raise concerns that have pre-occupied international economists for more than two centuries, such as the nature of the international adjustment mechanism and the merits of free trade compared with protection. As always in international economics, however, the interplay of events and ideas has led to new modes of analysis. Three notable examples of recent progress are the asset-market approach to exchange rates; new theories of foreign trade based on increasing returns and market structure rather than the traditional foundation of comparative advantage; and the intertemporal analysis of international capital flows, which has been useful both in refining the concept of "external balance" and in examining the determinants of developing-country borrowing and default.

The idea of writing this book came out of our experience in teaching international economics to undergraduates and business students over the past fifteen years. We perceived two main challenges in teaching: The first was to communicate to students the exciting intellectual advances in this dynamic field. The second was to show how the development of international economic theory has traditionally been shaped by the need to understand the changing world economy and analyze actual problems in international economic policy.

We found that published textbooks did not adequately meet these challenges. Too often, international economics textbooks confront students with a bewildering array of special models and assumptions from which basic lessons are difficult to extract. Because many of these special models are outmoded, students are left puzzled about the real-world relevance of the analysis. As a result, current textbooks typically leave a gap between the somewhat antiquated material to be covered in class and the exciting issues that dominate current research and policy debates. This gap has widened dramatically as the importance of international economic problems—and enrollments in international economics courses—have grown.

This book is our attempt to provide an up-to-date and understandable analytical framework for illuminating current events and bringing the excitement of international economics into the classroom. In analyzing both the real and the monetary sides of the subject, our approach has been to build up, step by step, a simple, unified framework for communicating the grand traditional insights as well as the newest findings and approaches. To help the student grasp and retain the underlying logic of international economics, we motivate the theoretical development at each stage by pertinent data or policy questions.

THE PLACE OF THIS BOOK IN THE ECONOMICS CURRICULUM

Students assimilate international economics most readily when it is presented as a method of analysis vitally linked to events in the world economy, rather than as a body of abstract theorems about abstract models. Our goal has therefore been to stress concepts and their applications rather than theoretical formalism. Accordingly, the book does not presuppose an extensive background in economics. Students who have had a course in economic principles will find the book accessible, but students who have taken further courses in microeconomics or macroeconomics will find an abundant supply of new material. Specialized chapter appendices and mathematical postscripts have been included to challenge the most advanced students.

We follow the standard practice of dividing the book into two halves, devoted to trade and to monetary questions. Although the trade and monetary portions of international economics are often treated as unrelated subjects, even within one textbook, similar themes and methods recur in both subfields. One example is the idea of gains from trade, which is important in understanding the effects of free trade in assets as well as free trade in goods. International borrowing and lending provide another example. The process by which countries trade present for future consumption is best understood in terms of comparative advantage (which is why we introduce it in the book's first half), but the resulting insights deepen understanding of the external macroeconomic problems of developing and developed economies alike. We have made it a point to illuminate connections between the trade and monetary areas when they arise.

At the same time, we have made sure that the book's two halves are completely self-contained. Thus, a one-semester course on trade theory can be based on Chapters 2 through 11 and a one-semester course on international monetary economics can be based on Chapters 12 through 21. If you adopt the book for a full-year course covering both subjects, however, you will find a treatment that does not leave students wondering why the principles underlying their work on trade theory have been discarded over the winter break.

SOME DISTINCTIVE FEATURES OF *INTERNATIONAL ECONOMICS: THEORY AND POLICY*

This book covers the most important recent developments in international economics without shortchanging the enduring theoretical and historical insights that have traditionally formed the core of the subject. We have achieved this comprehensiveness

by stressing how recent theories have evolved from earlier findings in response to an evolving world economy. Both the real trade portion of the book (Chapters 2 through 11) and the monetary portion (Chapters 12 through 21) are divided into six chapters focused on theory, followed by four chapters applying the theory to major policy questions, past and current.

In Chapter 1 we describe in some detail how this book addresses the major themes of international economics. Here we emphasize several of the newer topics that previous authors failed to treat in a systematic way.

Asset-Market Approach to Exchange-Rate Determination

The modern foreign exchange market and the determination of exchange rates by national interest rates and expectations are at the center of our account of open-economy macroeconomics. The main ingredient of the macroeconomic model we develop is the interest parity relation (augmented later by risk premiums). Among the topics we address using the model are exchange-rate “overshooting”; behavior of real exchange rates; balance-of-payments crises under fixed exchange rates; and the causes and effects of central-bank intervention in the foreign exchange market.

Increasing Returns and Market Structure

After discussing the role of comparative advantage in promoting trade and gains from trade, we move to the frontier of recent research (in Chapter 6) by explaining how increasing returns and product differentiation affect trade and welfare. The models explored in this discussion capture significant aspects of reality, such as intra-industry trade and shifts in trade patterns due to dynamic scale economies. The models show, too, that mutually beneficial trade need not be based on comparative advantage.

Politics of Trade Policy and Industrial Policy

Starting in Chapter 3, we stress the effect of trade on income distribution as the key political factor behind restrictions on free trade. This emphasis makes it clear to students why the prescriptions of the standard welfare analysis of trade policy seldom prevail in practice. Chapter 11 is focused on the currently popular notion that governments should adopt “industrial policies” aimed at encouraging sectors of the economy seen as crucial. The chapter also includes a discussion of strategic trade policy based on simple ideas from game theory.

International Macroeconomic Policy Coordination

Our discussion of international monetary experience (Chapters 18 and 19) stresses the theme that different exchange-rate systems have led to different *policy coordination* problems for their members. Just as the competitive currency depreciations of the interwar years showed how beggar-thy-neighbor policies can be self-defeating, the current float challenges national policymakers to recognize their interdependence and formulate policies cooperatively. Chapter 19 presents a detailed discussion of this very topical problem in the current system.

The World Capital Market and Developing-Country Debt

A broad discussion of the world capital market is given in Chapter 20, which takes up the welfare implications of international portfolio diversification as well as recent problems of prudential supervision of offshore financial institutions. Chapter 21 is devoted to the specific macroeconomic problems of developing countries, emphasizing the debt problem. The chapter places in historical perspective the interactions among developing-country borrowers, money-center banks, and international financial institutions such as the International Monetary Fund. In addition, students will find a structured approach to a problem that is treated only vaguely in other textbooks despite its central position on the international financial scene since 1982.

International Factor Movements

In Chapter 7 we emphasize the potential substitutability of international trade and international movements of factors of production. A feature in the chapter is our analysis of international borrowing and lending as *intertemporal trade*, that is, the exchange of present consumption for future consumption. We draw on the results of this analysis in the book's second half to throw light on the macroeconomic implications of the current account.

NEW TO THE SECOND EDITION

For this second edition of *International Economics: Theory and Policy*, we have extensively redesigned several chapters. These changes respond both to users' suggestions and to some important developments on the theoretical and practical sides of international economics. The most far-reaching changes are in the following chapters:

Chapter 3 We now present a complete, step-by-step analysis of the specific-factors model with intersectorally mobile labor. This model leads to an examination of the income-distribution problems that may accompany the overall gains from trade. In Chapter 3 we also take a first look at how factor proportions affect trade patterns.

Chapter 6 The chapter now contains a fully worked-out model of intra-industry trade with monopolistic competition. A numerical example of how international trade leads to a larger, integrated market and gains from trade reinforces the insights from the theoretical model. In addition, this chapter now introduces students to the dynamics of shifting comparative advantage.

Chapter 15 The chapter features a simplified treatment of long-run nominal and real exchange rates. After introducing the idea of purchasing power parity (PPP), Chapter 15 builds on PPP to develop the monetary approach to exchange rates. It then sketches the major factors influencing real exchange rates in the long run, and shows how the monetary approach must be modified to account for shifts in those factors.

Chapter 21 Our treatment of developing-country debt has been updated to reflect the changing circumstances of troubled debtors, as well as evolving policy approaches

to the debt problem. The focus shifts from concerted lending to the issues reflected by the Brady Plan of 1989: debt overhangs, debt relief, and financial engineering. The analytical focus of the chapter is on a simple model of debt buybacks, debt-for-equity swaps, and forgiveness.

In addition to these structural changes, we have updated the book in other ways to maintain current relevance. Thus, we examine various aspects of Europe's drive for full economic integration by 1992 (in Chapters 9, 19, and 20); we document the upsurge of direct foreign investment into the United States in the late 1980s (in Chapter 7); we analyze the causes of the slow return to balance of the U.S. current account after 1985 (in Chapter 16); and we look at the foreign debts of the rapidly changing economies of Eastern Europe (in Chapter 21).

Another major improvement: This new edition is accompanied by a Study Guide that will help students get even more out of reading *International Economics: Theory and Policy*.

LEARNING FEATURES

This book incorporates a number of special learning features that will maintain students' interest in the presentation and help them master its lessons.

Case Studies

Theoretical discussions are often accompanied by case studies that perform the threefold role of reinforcing material covered earlier, illustrating its applicability in the real world, and providing important historical information.

Special Boxes

Less central topics that nonetheless offer particularly vivid illustrations of points made in the text are treated in boxes. Among these are the political backdrops of Ricardo's and Hume's theories (pp. 59 and 521); the story of the Bolivian hyperinflation (p. 370); the Soviet Union's exchange-rate troubles (p. 320); and China's growth into an exporter of manufactures (p. 247).

Captioned Diagrams

The roughly 200 diagrams are accompanied by descriptive captions that reinforce the discussion in the text and will help the student in reviewing the material.

Summary and Key Terms

Each chapter closes with a summary recapitulating the major points. Key terms or phrases appear in boldface type when they are introduced in the chapter and are listed at the end of each chapter. To further aid student review of the material, key terms are italicized when they appear in the chapter summary.

Problems

Each chapter is followed by problems intended to test and solidify students' comprehension. The problems range from routine computational drills to "big-picture" questions suitable for classroom discussion. In many problems we ask students to apply what they've learned to real-world data or policy questions.

Further Reading

For instructors who prefer to supplement the textbook with outside readings, and for students who wish to probe more deeply on their own, each chapter has an annotated bibliography which includes established classics as well as up-to-date examinations of recent issues.

STUDY GUIDE AND INSTRUCTOR'S MANUAL

This edition of *International Economics: Theory and Policy* is accompanied by a Study Guide written by Linda S. Goldberg of New York University and Michael W. Klein of Clark University. The Study Guide aids students by providing a review of central concepts from the text, further illustrative examples, and additional practice problems. An Instructor's Manual, also by Linda S. Goldberg and Michael W. Klein, includes chapter overviews, answers to the end-of-chapter problems, and suggestions for classroom presentation of the book's contents.

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