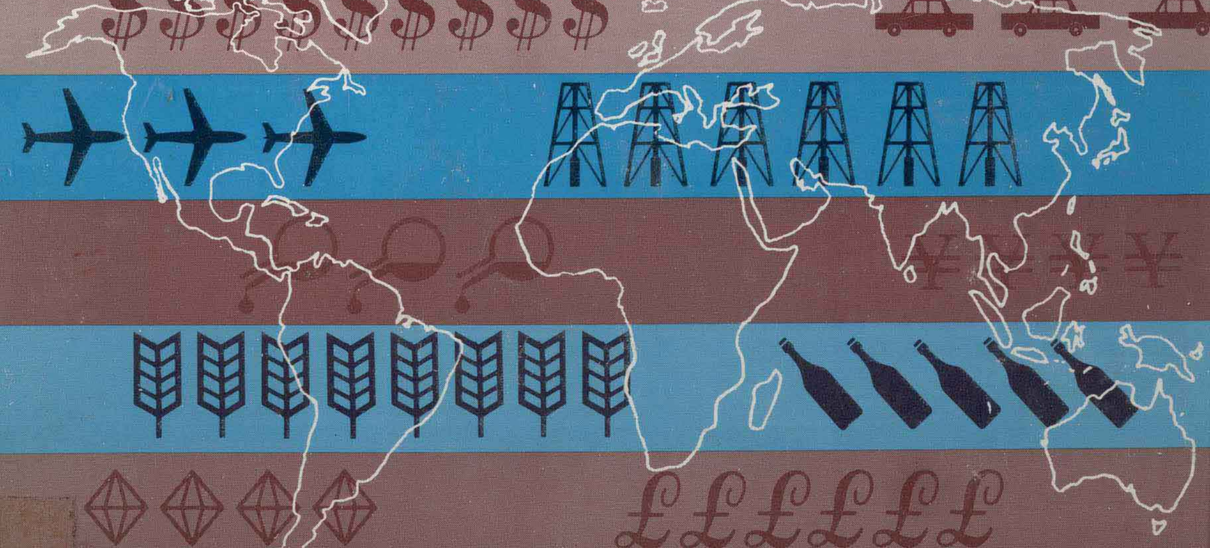
INTERNATIONAL ECONOMICS

THIRD EDITION

INGO WALTER
KAJ ARESKOUG



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PREFACE

Students often find international economics complex and difficult. But if it is presented well, they usually derive a great deal of satisfaction from it as it helps them to analyze past and present developments in the world economy and to interpret such developments on their own. The subject is a live one, full of current events and policy issues.

In this third edition, as in previous editions, we have continued to emphasize the orderly and logical presentation of the principles of international economic relations. The discussion concentrates on basic concepts and analytical techniques that can readily be applied to the global economic context. Institutional and historical detail is avoided, except where it is indispensable. And the reader is encouraged to relate what is happening in the real world to the reasons why it is happening, in accordance with the underlying theory.

Those familiar with previous editions will find a great many differences in this one. Part I on the theory of international trade has been extensively rewritten for greater clarity. Most of the diagrams have been revised and, while still in many cases relatively complex, are now far easier to follow. We focus on essential theoretical building blocks, for the benefit of readers who do not have much general economics background or those in need of review. *Advanced Material* sections elaborate on specific theoretical points for readers seeking greater depth. They can be omitted without loss of continuity. Each chapter ends with a list of important concepts, a set of questions, and additional readings related to the topics discussed.

Part II presents the theory and practice of international trade policy, beginning with an introduction to the political environment within which commercial policies are set and proceeding to a full discussion of different types of barriers to trade, the relevance of market structure, trade liberalization, and regional economic integration. Once again, the content of previous editions has been extensively restructured, updated, and rewritten for greater teaching effectiveness. Questions pertaining to economic development, for example, are integrated into the substantive chapters rather than being relegated to separate sections. The discussion concludes with an analysis of the economics of international factor movements and a new chapter on the multinational corporation.

Approximately the last half of the book is devoted to international monetary and financial problems. Here, our job has been even more demanding. Several important advances and revisions have occurred over the last decade in both theory and practice, including the broader acceptance of international monetarism, the general floating of exchange rates, the growth of the Euromarkets, and the recycling of petrodollars. We have given a great deal of attention to these developments.

We have also felt that the conventional textbook approach to international finance is unsatisfactory. It tends to concentrate on three or four major macrofinancial topics—balance-of-payments accounting and adjustment analysis, the foreign exchange markets, and the international monetary system—and to treat them as if they were relatively unconnected to one another, rather than as extensions or applications of common financial principles. It is symptomatic that the ordering of these topics varies sharply from text to text. We have therefore felt compelled to take some innovative steps to reorganize, integrate, and clarify the entire topic of international finance.

Our principal aim has been to reveal the common purposes, characteristics, and effects of *all* financial behavior. This can best be done at the microlevel, using the simple concepts of international lending, borrowing, and flows of funds or capital, as well as the more sophisticated notions of international liquidity, diversification, and portfolio management. The student can then be taught to appreciate the connections between financial decisions and decisions about consumption, investment, and production; they all involve the allocation of real resources. In short, we have tried to show the microfoundations of international finance—in our opinion, the missing link in other textbooks.

We have organized and developed the international finance sections of the book accordingly. In Part III, we first summarize the essential nature and purposes of private international financial transactions so as to provide a conceptual background and frame of reference for the discussions that follow. In so doing, we draw several instructive parallels between financial trade and commodity trade. We then proceed to a discussion of international financial markets, followed in Part IV by an analysis of balance-of-payments accounting and the private and public macroeconomic interdependencies among nations (usually called "adjustment theory and policy") and, finally, the supranational issues of monetary-financial cooperation (Part V). This topic-to-topic progression closely parallels the way we present international trade theory and policy in the first half of the book. We believe strongly that this somewhat novel approach will facilitate the reader's comprehension and absorption of seemingly difficult material. It should be especially helpful to students without prior exposure to the theory of finance.

This edition has been extensively reviewed by instructors of international economics at various universities. We are particularly indebted to Professors Holger L. Engberg, Robert G. Hawkins, Thomas A. Pugel, Richard M. Levich, and Clas Wihlborg at New York University; Norman Miller of the University of Pittsburgh; Thomas A. Wolf of Ohio State University; and E. Ray Canterbery of Florida State University. All contributed pedagogic and substantive insights, although they can hardly be held accountable for any

remaining deficiencies. No less important have been our undergraduate and M.B.A. students, who rarely hesitated to give us free advice. Marion Epps, Ligija Roze, and Mary Jaffee typed and retyped the manuscript. Rich Esposito of Wiley kept the heat on and in various ways facilitated completion of the manuscript. To all we owe sincere thanks.

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INTRODUCTION

In the beginning, studying a new subject is like a voyage into unfamiliar territory. Travelers do not really know its size, contours, or characteristics. They may need a guide who can prepare them for the experience to come by pointing out unique features and relating them to broader, more familiar phenomena. This is, in part, the function of an introduction to a text such as this. The student who is taking his or her first course in international economics ought to know what the subject is about, how it is related to other branches of economics, and what kinds of things distinguish it.

WHAT IS INTERNATIONAL ECONOMICS?

Like all economic subjects, international economics deals with the allocation of scarce resources to competing ends for the satisfaction of human wants. It puts this very basic economic problem in the context of international relations—relations among economic "actors" located in separate nations. It attempts to explain how international economic relations affect the allocation of resources, both within nations and among nations.

International economics has a private aspect and a governmental, public-policy aspect. And so the economic "actors" we will be concerned with include both firms—and, occasionally, other private institutions and individuals—and government agencies of various types. They also include official international organizations that have assumed certain supranational functions in the world economy.

International economics owes its existence as a more or less distinct academic field to a particular political institution—the nation-state. Without this institution, there would still be ample reason to study economic relations between different parts of the world. But that subject—perhaps called "global economics"—essentially would be just a geographic extension of the study of national economies; it could perhaps be characterized as *interregional* economics. In reality, *international* economic relations are generically quite distinct from interregional economic relations within any one nation, say between the American Northeast and the Sunbelt, or the north of Italy and the Mezzogiorno.

To be sure, both international and interregional economics share certain problems of distance and transportation. But the nation-state presents us with a much more important differentiating feature in the world economy. Each national government is politically sovereign, develops international economic relations on its own, and in many diverse ways injects itself into international relations among private parties. It initiates and administers economic policies, which sometimes—as in the case of trade and exchange-rate policy—directly aim at affecting international transactions. Other policies (such as pollution control and income taxation) may on the surface appear to be purely domestic, both in intent and in effects. But we will find that such policies, too, will usually have international economic consequences.

One traditional function of governments is the issue and regulation of money, often via a central bank that may or may not take direct instructions from the government itself. The world is divided into separate currency areas that mostly, but not entirely, coincide with national political boundaries. The creation and use of money, in turn, is closely connected with the structure and activities of national banking systems and national financial markets. National monies can be converted into one another in the *foreign exchange markets*, and many large firms can operate in foreign, as well as domestic, financial markets. Even so, economic relations between parties that use different types of currencies and rely on different financial markets will usually create special complications—problems that form an integral part of international economics.

Most economic transactions among private parties take the form of exchange, or trade. Firms buy certain goods and services and sell other goods or services in the marketplace, hoping to earn a profit in the process. This is the basis of *microeconomics*, as viewed from the perspective of the individual economic unit. *Macroeconomics* concerns itself, in part, with broad exchange relationships among entire sectors of the national economy and tries to determine how these relationships affect total national output, employment, and the price level. International economics contains major elements of both microeconomics and macroeconomics. International selling and buying—*exports* and *imports*—are the main topics of the theory of international trade. Such activities depend on conditions in the input and output markets of each firm, as shown in basic microeconomic analysis. At the same time, individual markets for goods or services will always be connected with one another—and this is where the macroeconomic aspects come into the picture.

In a dynamic economy, firms will grow or shut down, and new firms will be established. Workers may move from industry to industry, or from region to region. This occurs internationally as well as domestically. When a firm shifts part of its operations abroad, or when workers migrate to foreign countries in search of better jobs, we usually speak of *international factor movements*—the factors of production in these cases being capital and labor, perhaps combined with technology and entrepreneurship. International capital movements usually take place, not directly through shipments of capital goods, but indirectly through transfers of funds. International lending, borrowing, and transactions in securities can provide the means for an expansion of productive facilities in the receiving country. In such instances, international trade can acquire both a "real" and a financial dimension.

Sometimes there is no discernable link between financial transactions and the flow of physical goods or services. One can then regard financial activity as a separate form of economic behavior, with "inputs" and "outputs" consisting of different financial instruments (stocks, bonds, loans) and with analytical principles all its own. And so there is a special branch of international economics called the *theory of international capital movements* or, more broadly, *international financial theory*. Still, it helps to remember that most of the general rules that we shall develop about private economic behavior can be applied to both real and financial transactions. Lending and borrowing can be construed as trade in financial assets, internationally as well as domestically. Analogies of this sort can provide a useful shortcut to understanding.

At a private level, international economics thus draws on microeconomics, macroeconomics, money and banking, and financial economics. To a somewhat lesser extent, it embodies elements of the study of industrial organization, labor economics, and transport economics. When it addresses the special international problems of developing countries, it naturally enters the territory of development economics. And in studying the behavior of large contemporary firms with activities in many different countries, it incorporates much of the just-emerging theory of multinational enterprise.

At a governmental level, international economics naturally becomes an extension of the analysis of economic policy. We can divide economic policy into three chief segments: *money and credit policy*, usually executed by the central bank; *fiscal* (tax and expenditure) *policy*, in the hands of legislators and national administrators; and *regulatory policies* of many kinds, implemented by various specialized agencies under mandate from the authorities in power. Such a breakdown provides a useful perspective on international economic policy as well. Governments try to regulate exports and imports through various direct controls; this is the subject of *trade policy*, or *commercial policy*. They often impose controls and regulations on various types of international lending or borrowing, and on foreign-exchange market transactions; these matters come under the rubric of *international financial* (or monetary) *policy*.

But the most important and controversial international policy questions center on the effects of national monetary and fiscal measures on overall international economic-financial relations. How do such measures affect international trade and capital flows, and how might they have to be modified so as to take these effects into account? The fact is that all major trading nations must tailor their monetary and fiscal policies to both domestic and international circumstances. There is, for example, a significant amount of cooperation in the formulation and execution of monetary policies among the leading industrial countries, and elaborate efforts have been made to develop mutually acceptable exchange-rate policies and to set up intergovernmental credit facilities. These arrangements are part of what is loosely called the *international monetary system*. They clearly belong in the policy part of international financial analysis. Similarly, trade policies adopted by one country will clearly have an impact on others that buy from it or sell to it, and these, too, have to be coordinated if economic conflicts are to be avoided.

A SWEEP THROUGH HISTORY

International trade, in a strict sense, can be traced in history to the emergence of the true national state, with well-defined borders and a functioning central authority. In Europe, such states began to evolve during the sixteenth century, with France, England, Spain, and the Netherlands being the most prominent ones. By contrast, Germany and Italy did not really become national entities until the late nineteenth century. The United States, of course, assumed nationhood during the late eighteenth and early nineteenth centuries.

Trade that took place in earlier times was certainly important to the level and structure of economic activity at the time. But the development of the modern international economy really began with the period of rapid industrialization that more or less coincided with the emergence of national states. With the introduction of new manufactured products and specialized production techniques, and the need for raw materials to feed them, international commerce became increasingly crucial to producers and consumers alike.

The significance of international economic relationships in earlier times can be gauged by the government policies adopted during the so-called *mercantilist* era, which dates from about 1500 to the middle of the eighteenth century. The mercantilists felt that the accumulation of precious metals in national coffers was crucial to the welfare of the state, and that the prime function of international trade was to augment this particular form of wealth. Accordingly, their efforts were geared toward maximum export sales and minimum import purchases—that is, toward maximum trade "surpluses." These were to be settled through the importation of gold and other precious metals, which functioned as international money and were placed in the national treasury.

By necessity, international trade under the mercantilist system was subject to a great deal of government control. State trading monopolies were common, and there were administrative regulations on both exports and imports. Import taxes reduced purchases from abroad, or prevented the importation of certain goods completely. Concurrently, exports were subsidized.

Although mercantilist ideas, particularly the narrow concept of wealth, might seem irrational today, the accumulation of precious metals did in fact serve to stimulate, via exports, the growth of national economic activity. Also, there occurred an opening of many new trade routes and a state-fostered buildup of maritime industries—developments that created new opportunities for economic activity. The early phases of the mercantilist era were dominated by Spain and Portugal, which pioneered in exploring the Western Hemisphere, Africa, and Asia. But it was not long before the British and the Dutch began to expand their operations as well. Early exports by these nations included cloth, metalwares, ornaments, and gunpowder, whereas their imports comprised tobacco, spices, and other commodities often foreign to the European culture.

One institution that facilitated mercantilist policies was the *trading company*. Through this type of organization, merchants pooled their physical and financial resources and, under government charter, engaged in long-term and often risky trading ventures. The Dutch East India Company operated in parts of Asia and Africa, whereas the British East India Company concentrated on India, and the Hudson's Bay Company on North America. These trading companies established enclaves in their respective trading areas and thus became an important feature of the rapidly emerging colonial and imperial era. Simple manufactures were added to the list of imports as colonial production capabilities improved. Regions under colonial domination effectively supplemented the economy of the mother country, and of course aided in its acquisition of precious metals.

Eventually, the mercantilist era gave way to a more liberal conception of national and international economic activity. This coincided with a parallel transformation of political and religious thought, as well as with the rise to power of the bourgeois classes. But the strongest force for the liberalization of international economic transactions was probably the Industrial Revolution itself. By the late nineteenth century, in fact, international trade and capital movements among the then "advanced" countries were relatively unrestricted, and each of them benefited enormously from the existence of a stable, dependable international system of money and finance—the gold standard.

Despite the periodic ups and downs in economic activity that made themselves felt in international economic transactions, not until the onset of World War I was the relatively smooth operation of the international economy severely disrupted. Yet even the wartime emergency proved to be only a temporary setback. The period after World War I was marked by rapid recovery and a surge of economic activity throughout most of the Western world, despite the disastrous inflations in such countries as Austria and Germany. By 1928, the volume of international trade had expanded enormously, and the flow of people (migration) and capital (lending and investing) between nations had reached unprecedented levels.

The start of the Great Depression, in the early 1930s, was followed by a precipitous decline in international economic transactions, punctuated by the suspension of the international gold standard and mushrooming controls on trade. The demise of gold in international exchange, as well as the continuing problem of World War I reparations, intensified the recessionary forces in the world economy. A period of marked international economic disintegration and fragmentation followed. Each nation geared its policies more and more toward economic self-sufficiency, or *autarky*. This development by itself was not excessively painful for large nations such as the United States, but it had near-disastrous consequences for small countries that depended on foreign markets for a large portion of their product needs.

The rampant *economic* nationalism during the late 1930s coincided with the growth of virulent *political* nationalism that ultimately led to World War II. By contrast, the year 1946 marked the beginning of an international economic resurgence in the war-devastated nations of Europe and Japan in an atmosphere of economic cooperation. This led to a period of relatively continuous and rapid economic growth in these areas, supported by an expanding volume of international trade and by massive infusions of American financial aid. Major efforts were made to achieve a renewed liberalization of international trade and payments. The establishment of the International Monetary Fund (IMF), the International Bank for Reconstruction and Development (IBRD)—or World Bank—and the General Agreement on Tariffs and Trade (GATT) serve as prominent examples of these efforts. Still, the broad ideal of essentially free trade and free mobility of productive factors has never been fully attained.

The 1950s saw the rise of a number of regional economic blocs, of which the European Economic Community (EEC) is certainly the best known. To a degree, the emergence of *economic regionalism* underscores the failure to achieve trade and payments liberalization on a global scale. Although considerable progress was achieved during the 1960s and 1970s—particularly during the "Kennedy Round" and "Tokyo Round" of trade negotiations—economic regionalism seems here to stay. The EEC has helped to strengthen the relative economic and political power of Western Europe at the expense of the United States. Financially, this trend has manifested itself in a weakening in the official international status of the U.S. dollar, and in the rapid development of European money and capital markets, especially the so-called *Eurocurrency markets*.

Two additional recent changes in the organization of the world economy ought to be mentioned. The last few decades have seen an astonishing