# INTERNATIONAL ECONOMICS

JAMES C. INGRAM

# INTERNATIONAL ECONOMICS

**James C. Ingram**
University of North Carolina

**JOHN WILEY & SONS**
New York Chichester Brisbane Toronto Singapore

*Library of Congress Cataloging in Publication Data:*

Ingram, James C.
International economics.

Includes index.
I. International economic relations. I. Title.
HF1411.I392 1983 337 82-13651
ISBN 0-471-42789-6

Printed in the United States of America

10 9 8 7 6 5 4 3 2 1

# ABOUT THE AUTHOR

James C. Ingram is Professor of Economics at the University of North Carolina at Chapel Hill, a specialist in the field of international economics. He is the author of *Economic Change in Thailand* (2nd ed., 1971), *Regional Payments Mechanisms* (1962), and *International Economic Problems* (3rd ed., 1978); and numerous articles on international trade and finance.

Professor Ingram has been a visiting scholar at the London School of Economics and at The Brookings Institution, and he was a visiting professor at Thammasat University (Bangkok) for two years. He was formerly President of the Southern Economic Association, Managing Editor of the *Southern Economic Journal*, and Dean of the Graduate School at the University of North Carolina.

# PREFACE

This book is an introduction to international economics, intended for students who are taking their first course in the subject. The level of exposition requires, as a background, no more than a standard introductory course in the principles of economics. Those who have had intermediate microeconomics and macroeconomics will find them helpful, but, except for two or three of the optional sections (marked with an arrowhead ▶) the entire book is accessible to readers whose prior exposure to economics is limited to a first course in economic principles.

The justification for still another textbook in international economics, aisde from pecuniary motivations, is largely expositional. I have tried to keep the student's perspective constantly in mind, and to make the explanations both intuitively appealing and logically convincing. Where appropriate, numerical examples have been worked out to illustrate the analysis. I hope the effort has been successful, but readers will be the judge of that.

I am grateful to the members of several classes in international economics, over the years, who have given me their reactions to various portions of this book, along with suggestions for improvement.

The book is organized with monetary aspects first and, trade theory and policy second. However, this order can easily be reversed by instructors who prefer to begin with trade theory. The sequence can simply be changed to chapter 1, 11 to 19, 2 to 10.

For a full-year course, the entire book can be covered, plus some supplementary material. For a one-semester (or one-quarter) course, some chapters will need to be omitted. The core chapters are Chapters 2 to 7 and Chapters 11 to 15. Other chapters can be added to fit the needs of a particular course. For a one-term course in international monetary economics, Chapters 1 to 10 provide a compact, self-contained unit. For a one-term course emphasizing trade theory and commercial policy, Chapters 1 and Chapters 11 to 19 are the appropriate choice.

The optional sections contain material that is either more difficult or more detailed than the rest. In either case, these sections can be omitted without loss of continuity. I have chosen to leave them in the text instead of tucking them away in appendixes because I think some students will read and derive benefit from them, even if they are not assigned.

This book covers most of the standard topics in international economics.

In each of the two main parts, the theory is developed first, and it is then applied to particular policy issues and historical episodes. This approach reflects my belief that economic theory should be "a handmaiden to economic policy" (in Professor Hicks' phrase).

Wherever possible, economic theory is used to explain and interpret experience. That is why this book contains more discussion of actual historical episodes than most existing textbooks of international economics. The historical experience is used as the basis for showing how the analysis works. I have found that students generally appreciate this approach. However, some instructors may find that time does not permit a detailed discussion of some of these historical episodes. In that case, some extended discussions, as in Chapter 8, can be left for independent study, or used as the basis for term papers, or simply omitted.

While writing this book I accumulated a number of obligations: to my students in international economics over a period of several years; to my colleagues at the University of North Carolina, especially Dennis R. Appleyard and Thomas P. O'Toole; to international economists too numerous to mention whose work is drawn on in writing a textbook such as this; to Richard Esposito, economics editor at Wiley, and Tom Wolfe, Alan Deardorff, Polly Reynolds Allen, Gerald Lage, John Adams, and Shanti Tangri, whose comments have greatly improved the final product; and, finally, to Carol Hamilton for her expert assistance in converting manuscript into final copy.

James C. Ingram
Chapel Hill, North Carolina

# CONTENTS



The ▶ denotes sections of greater than average difficulty. These sections may be omitted without loss of continuity.

# CHAPTER 1

# INTRODUCTION

International economics exists as a special field of study because the world is divided into nation-states. Political boundaries tend to separate markets, which leads to price differences, and price differences are an incentive to trade, as we shall see. Each nation has its own national money, which gives rise to problems of exchange rates and the balancing of payments between nations. Political boundaries also inhibit the movement of labor and capital. People can move more freely within a country than between countries, a fact that plays a large role in the traditional theory of trade.

International economics is a field of study in which the basic principles of economics are used to analyze and interpret these economic exchanges between nations—all the transactions that cross the borders of the nation-states. These transactions include trade in goods and services, movements of labor and capital, and a variety of financial transactions in bonds, stocks, notes, deposits, and other financial assets.

Although international economics originates in the separation of national markets, the trend in recent decades has been toward the lessening of that separation, toward a more closely integrated world economy. Modern developments in transportation and communication have greatly increased the degree of economic interdependence among nations. The world has shrunk. Economic changes are now rapidly transmitted from one country to another. Thus, a change in the United States wheat program can have profound effects on farmers in Australia and Argentina, or on consumers in Rome and Tokyo. Similarly, technological innovations in German or Japanese firms can influence prices in American markets and, thus, affect firms and workers in our towns and cities. For major commodities, such as wheat, coffee, tin, and rubber, prices have long been largely determined in markets so interconnected that they can be thought of as world markets. But in recent decades international competition has also spread into national markets for a wide variety of manufactured goods, and prices in every country are influenced by prices elsewhere. Financial markets have also become more closely linked, and monetary and fiscal authorities in each nation must take account of reactions to their policies in international capital markets. These developments lead toward what may be called the "internationalization of markets." Although we may yearn for a simpler world, and indulge in rhetoric about achieving self-sufficiency in fuels or other products, technology and the tide of events are steadily pushing us toward a greater degree of interdependence.

One indication of the growing economic interdependence in the world is that the volume of world exports has risen more rapidly than the volume of world commodity output. From 1963 to 1979 the volume of world exports tripled, whereas the volume of output slightly more than doubled. See Table 1-1 for the comparative figures. Another related indication is that the ratio of imports to gross national product has increased in many countries in recent years. We show the data for a few selected countries in Table 1-2. Even in the United States, which used to be considered virtually self-sufficient, the share of imports in GNP has risen to 11 percent. In some small, highly open countries, this ratio is 50 percent or more. The United States' dependence on petroleum imports has attracted much attention in the last decade as a result of the sharp increases in oil prices. However, we also depend heavily on imports for many other products: raw materials and foods, such as tin, bauxite, coffee, and tea, and manufactured goods, such as television sets, shoes, cameras, and automobiles.

Another response to increased interdependence has been the emergence of many institutions and organizations whose purpose is to facilitate and oversee international economic relationships. These institutions include some with worldwide scope, such as the World Bank, the International Monetary Fund, the General Agreement on Tariffs and Trade, and the United Nations Conference on Trade and Development; and some regional organizations such as the European Economic Community, the Latin American Free Trade Association, and the Organization for Economic Cooperation and Develop-

**TABLE 1-1** Comparison of World Exports and Output, by Volume (1963 = 100)

| Year | Volume of World Exports | Volume of World Commodity Output |
|---|---|---|
| 1963 | 100 | 100 |
| 1973 | 231 | 180 |
| 1974 | 239 | 185 |
| 1975 | 232 | 183 |
| 1976 | 258 | 196 |
| 1977 | 269 | 205 |
| 1978 | 284 | 214 |
| 1979 | 300 | 223 |

*Source:* GATT, *International Trade*, 1979/80 (Geneva, 1980).

**TABLE 1-2** Imports as a Proportion of GNP: Selected Countries

| | 1951 | 1965 | 1980 |
|---|---|---|---|
| Canada | 0.23 | 0.20 | 0.28 |
| France | 0.18 | 0.12 | 0.24 |
| Germany | 0.14 | 0.19 | 0.29 |
| Italy | 0.13 | 0.14 | 0.27 |
| Japan | 0.11[a] | 0.10 | 0.16 |
| Mexico | 0.17 | 0.10 | 0.14[b] |
| Netherlands | 0.50 | 0.46 | 0.58 |
| Switzerland | 0.30 | 0.30 | 0.35 |
| United Kingdom | 0.29 | 0.19 | 0.26 |
| United States | 0.04 | 0.04 | 0.11 |

[a]1952 data.
[b]1979 data.

*Source:* International Monetary Fund, *International Financial Statistics*, 1979 Yearbook and July 1981 issues.

ment. We shall become acquainted with some of these organizations in subsequent chapters.

The real world of international relations is extremely complex. There are more than 150 nation-states, thousands of commodities, dozens of international institutions, and large numbers of business firms, banks, traders, and other participants in international markets. No one could possibly marshall all of the relevant facts and assimilate all this information. What is needed is a method of analysis, an apparatus of thought, that will enable this complex reality to be comprehended. That is exactly what international economics attempts to provide.

For the most part, international economics utilizes concepts, theories, and models drawn from general economics, both macro and micro. It deals with the same kinds of problems that are dealt with in general economics, but it treats them in an international setting. International economics is just plain economics applied to the trade and financial relationships among nations. The objective is to provide a framework, a systematic method of analysis, that will enable us to organize data and to explain and interpret the complexity of the real world.

Because of its origin in the national political boundaries, international economics must take account of political and social considerations. It is political economy. But the strength of economics lies in its analytical structure, its ability to construct simple models that enable one to understand the way things work without having to cope with all the details of a complex reality. That will be our emphasis in this book. When we describe certain historical episodes in subsequent chapters, we do so primarily to illustrate the method of analysis, to show how the system has worked, in practice.

International economics is commonly divided into two broad subdivisions: international monetary economics, and international trade theory and policy. These can be taken in either order, but in this book we shall begin with international monetary economics. We first examine (in Chapters 2 and 3) the mechanics of international payments and the meaning of the "balance of payments." Next, in Chapters 4 to 7 we analyze the process of adjustment in a nation's balance of payments under different monetary systems, and in Chapters 8 to 10 we review the international monetary experience in recent decades. This examination of the actual problems that have arisen in the past provides useful insights into the economic analysis of the adjustment process. The contemporary international monetary situation can scarcely be understood without some knowledge of the earlier episodes from which it has evolved.

The theory of international trade is the subject of Chapters 11 to 14. We state the classical theory (Smith, Ricardo, and Mill) in Chapter 11, the mainstream modern theory in Chapters 12 and 13, and briefly examine some new approaches in Chapter 14. These chapters depend heavily on microeconomics and make use of highly simplified models. For example, we examine trade in just two commodities instead of attempting to deal with the 14,000 commodity classifications listed by the Census Bureau. It is the principle that matters, and we abstract from the complexities of the real world in order to isolate and focus on a few basic principles.

Tariff theory and policy are dealt with in Chapters 15 and 16, and a brief survey of United States commercial policy is provided in Chapter 17. Finally, the special trade problems of the third world are described in Chapter 18, and the role of multinational corporations in Chapter 19.

Our focus throughout is on the predominantly market economies—those countries that rely primarily on market forces to organize and direct their economic activities. That includes most of the world outside the Soviet bloc. We do not examine international trade within the Soviet bloc, or the special problems involved in trade between centrally planned economies and predominantly market economies. These are interesting and important subjects, but they are outside the purview of this book.

## Selected References

### Useful Sources of Data on International Trade and Finance

General Agreement on Tariffs and Trade. *International Trade* (annual)
International Monetary Fund. *International Financial Statistics* (monthly); *Balance of Payments Yearbook* (annual)
Morgan Guaranty Trust Co. *World Financial Markets* (monthly)
United Nations. *Yearbook of International Trade Statistics* (annual)
U.S., *Economic Report of the President* (annual)
World Bank. *World Development Report* (annual)

**Useful Collections of Readings**

Adams, John, ed. *The Contemporary International Economy: A Reader.* New York: St. Martin's Press, 1979.

Balassa, Bela, ed. *Changing Patterns in Foreign Trade and Payments.* New York: Norton, 1978.

Baldwin, Robert E., and J. David Richardson, eds. *International Trade and Finance: Readings.* 2nd ed. Boston: Little, Brown, 1981.