# International Economics

## Fifth edition

Robert M. Dunn, Jr.

**GEORGE WASHINGTON UNIVERSITY** 

John H. Mutti

**GRINNELL COLLEGE, IOWA** 



LONDON & NEW YORK

### Contents

List of fi	gures	xiv
List of to		xvii
	ist of politics	
List of e:	chibits	xxi
Preface	,	xxiii
1	Introduction	1
	Learning objectives	1
	Why international economics is a separate field	8
	The organization of this volume	9
	Information about international economics	11
	Summary of key concepts	14
	Questions for study and review	14
	Suggested further reading	15
part o	ne INTERNATIONAL TRADE AND TRADE POLICY	17
2	Patterns of trade and the gains from trade: insights	
	from Classical theory	19
	Learning objectives	19
	Absolute advantage	20
	Comparative advantage	22
	Additional tools of analysis	24
	The concept of opportunity cost	25
	The production-possibility curve with constant opportunity cost	25
	Demand conditions and indifference curves	27
	International trade with constant costs	30
	International trade with increasing costs	36
	The pre-trade equilibrium	37
	The post-trade equilibrium	38
	The effect of trade	39
	The division of the gains from trade	40
	Comparative advantage with many goods	45
	Empirical verification in a world with many goods	· 47
	Summary of key concepts	48

#### CONTENTS

	Questions for study and review	49
	Suggested further reading	51
	Appendix: The role of money prices	51
	Notes	53
3	Trade between dissimilar countries: insights from the	
	factor proportions theory	55
	Learning objectives	55
	Factor proportions as a determinant of trade	56
	Formulating a model	57
	Implications of the factor proportions theory for the distribution	
	of income	64
	The distribution of income and factor price changes	64
	Income redistribution and the welfare economics of trade	69
	Fixed factors of production in the short run	71
	Trade: a substitute for factor movements	71
	Empirical verification in a world with many goods	73
	Modifying the basic assumptions	74
	Summary of key concepts	76
	Questions for study and review	77
	Suggested further reading	78
	Appendix: A more formal presentation of the Heckscher-Ohlin	
	Model with two countries, two commodities, and two factors	78
	The production function	78
	Derivation of the production-possibility curve	81
	Another application of the box diagram	84
	Notes	85
4	Trade between similar countries: implications of	
	decreasing costs and imperfect competition	87
	Learning objectives	87
	External economies of scale	89
	Decreasing opportunity cost	91
	The product cycle	95
	Preference similarities and intra-industry trade	98
	Economies of scale and monopolistic competition	101
	Trade with other forms of imperfect competition	106
	Cartels	109
	Dumping	111
	Further aspects of trade with imperfect competition	115
	Summary of key concepts	117
	Questions for study and review	117
	Suggested further reading	118
	Appendix: Derivation of a reaction curve	119
	Notes	120
5	The theory of protection: tariffs and other barriers	
	to trade	122
	Learning objectives	122

	CONTENTS	VII
	Administrative issues in imposing tariffs	123
	Tariffs in a partial equilibrium framework	124
	The small-country case	125
	Quotas and other nontariff trade barriers	128
	Quantitative restrictions on imports	130
	Production subsidies	137
	Tariffs in the large-country case	138
	General equilibrium analysis	140
	The small-country case	140
	The large-country case	141
	The effective rate of protection	144
	Export subsidies	148
	Export tariffs	151
	Summary of key concepts	152
	Questions for study and review	153
	Suggested further reading	154
	Notes	154
6	Arguments for protection and the political economy of	•
	trade policy	156
	Learning objectives	156
	Arguments for restricting imports	157
	Increasing output and employment	. 157
	Closing a trade deficit	159
	Pauper labor	159
	Heckscher-Ohlin and factor-price equalization	160
	The terms-of-trade argument	161
	The infant-industry argument	164
	Industrial strategy or strategic trade	166
	Secondary arguments for protectionism	172
	National defense	172
	Cultural or social values	173
	Protection to correct distortions in the domestic market	174
	Revenues	175
	The political economy of trade policy	176
	Summary of key concepts	178
	Questions for study and review	179
	Suggested further reading	179
	Notes	180
7	International mobility of labor and capital	182
/	Learning objectives	182
	Arbitrage in labor and capital markets	183
	Additional issues raised by labor mobility	188
	Multinational corporations	191
	The decision to become an MNC	192
	Effects of MNC operations on the home country	19.
	Effects of MNC operations on the hone country	19.
	Summary of key concepts	200
	Guilliary of key concepts	∠00

 viii

#### CONTENTS

	Questions for study and review	201
	Suggested further reading	202
	Notes	202
8	Regional blocs: discriminatory trade liberalization	204
	Learning objectives	204
	Alternative forms of regional liberalization	205
	Efficiency gains and losses: the general case	206
	Efficiency gains and losses with economies of scale	210
	Dynamic effects and other sources of gain	211
	The European Union	212
	Empirical assessments and interpretations	213
	Important challenges	216
	NAFTA	217
	Other regional groups	219
	Summary of key concepts	221
	Questions for study and review	222
	Suggested further reading	222
	Notes	222
9	Commercial policy: history and recent controversy	225
	Learning objectives	225
	British leadership in commercial policy	226
	A US initiative: the Reciprocal Trade Agreements program	228
	The shift to multilateralism under the GATT	229
	The Kennedy Round	231
	The Tokyo Round	233
	The Uruguay Round	235
	Intellectual property	241
	Expanding the World Trade Organization	243
	Summary of key concepts	244
	Questions for study and review	244
	Suggested further reading	245
	Notes	245
10	Trade and growth	247
	Learning objectives	247
	The effects of economic growth on trade	249
	Changes in factor supplies	249
	Neutral growth	249
	Biased production and growth	251
	Worsening terms of trade and immiserizing growth	254
	Trade policies in developing countries	257
	Primary-product exporters	259
	Deteriorating terms of trade	262
	Alternative trade policies for developing countries	264
	Import substitution	264
	Free-trade sones	266
	Export-led growth	266

	CONTENTS	ix
	Summary of law compones	269
	Summary of key concepts Questions for study and review	269
	Suggested further reading	270
	Notes /	270
11	Issues of international public economics	272
••	Learning objectives	272
	Environmental externalities	274
	Cross-border pollution	278
	Unilateral action and extraterritoriality	279
	The tragedy of the commons	281
	Taxation in an open economy	284
	Taxes on goods	285
	Taxes on factor income	287
	Portfolio capital	289
	Foreign direct investment	290
	International tax rules	292
	The distribution of income across nations	293
	Summary of key concepts	295
	Questions for study and review	296
	Suggested further reading	297
	Notes	297
part 1		200
	ECONOMY MACROECONOMICS	299
12	Balance-of-payments accounting	303
	Learning objectives	303
	Distinguishing debits and credits in the accounts	305
	Analogy to a family's cash-flow accounts	308
	Calculation of errors and omissions	309
	Organizing the accounts for a country with a fixed exchange rate	311
	The IMF International Financial Statistics accounts	315
	Balance-of-payments accounting with flexible exchange rates	315
	The international investment position table	320
	Trade account imbalances through stages of development	320
	Summary of key concepts	325
	Questions for study and review	326
	Suggested further readings	327
	Appendix: Intertemporal trade Notes	327 329
13	Markets for foreign exchange	331
	Learning objectives	331
	= :	332
	Supply and demand for foreign exchange Exchange market intervention regimes	332 334

#### CONTENTS

	The Bretton Woods arrangements	335
	Payments arrangements in developing countries	336
	Exchange market intervention with floating exchange rates	338
	Exchange market institutions	338
	Alternative definitions of exchange rates	341
	The nominal effective exchange rate	341
	The real effective exchange rate	343
	Alternative views of equilibrium nominal exchange rates	344
	Summary of key concepts	347
	Questions for study and review	347
	Suggested further reading	348
	Notes	348
14	International derivatives: foreign exchange	
	forwards, futures, and options	351
	Learning objectives	351
	Forward exchange markets	352
	Reasons for forward trading	353
	Factors determining forward rates: the interest parity	
	theory and the role of speculators	355
	Problems with this model	358
	Foreign exchange options	359
	Other international derivatives	364
	Summary of key concepts	365
	Questions for study and review	366
	Suggested further reading	367
	Notes	367
15	Alternative models of balance-of-payments or	
	exchange-rate determination	368
	Learning objectives	368
	Why the balance of payments (or the exchange rate) matters	370
	Alternative views of balance of payments (or exchange rate)	
	determination	374
	The nonmonetarist view of the trade balance	374
	The capital account	377
	The portfolio balance approach	378
	Combining models of the capital and current accounts	380
	Asset market approaches to the balance of payments and the	201
	exchange rate	381
	The monetarist model of the balance of payments	382
	Criticisms or limitations of the monetarist model	385
	Exchange rates and the balance of payments: theory versus reality	389
	Summary of key concepts  Overtions for study and society	390 301
	Questions for study and review Suggested further reading	391 391
	Notes	391
	TAULCO	コリノ

16	Payments adjustment with fixed exchange rates	394
	Learning objectives	394
	David Hume's specie flow mechanism	395
	Currency boards	396
	The Bretton Woods adjustment mechanism: fiscal and monetary	
	policies	406
	Critical flaws in the Bretton Woods adjustment process	409
	The policy assignment model: one last hope for fixed exchange rates	411
	Problems with the policy assignment model	412
	Macroeconomic policy coordination	414
	Summary of key concepts	416
	Questions for study and review	416
	Suggested further reading	417
	Notes	417
17	Balance-of-payments adjustment through exchange	
	rate changes	419
	Learning objectives	419
	A return to supply and demand	420
	Requirements for a successful devaluation	421
	The Marshall-Lerner condition: the desirability of high	
	elasticities of demand	422
	Macroeconomic requirements for a successful devaluation	429
	Effects of the exchange rate on the capital account	434
	Potentially undesirable side-effects of devaluations	435
	A brief consideration of revaluations	438
	The Meade cases again	439
	Summary of key concepts	440
	Questions for study and review	441
	Suggested further reading	441
	Notes	442
18	Open economy macroeconomics with fixed	
	exchange rates	444
	Learning objectives	444
	The Keynesian model in a closed economy	445
	Determination of the level of income	445
	The multiplier in a closed economy	449
	An open economy	451
	Determination of the level of income	451
	The multiplier in an open economy	455
	The international transmission of business cycles	457
	Foreign repercussions	458
	Some qualifications	459
	Capital flows, monetary policy, and fiscal policy	460
	Monetary policy	460
	Fiscal policy with fixed exchange rates	463
	Domestic macroeconomic impacts of foreign shocks	467
	Domestic impacts of monetary policy shifts abroad	468

xii CONTENTS

	Conclusion	469
	Summary of key concepts	469
	Questions for study and review	470
	Suggested further reading	470
	Notes	471
19	The theory of flexible exchange rates	472
	Learning objectives	472
	Clean versus managed floating exchange rates	474
	The stability of the exchange market	474
	Impacts of flexible exchange rates on international transactions	476
	Open economy macroeconomics with a floating exchange rate	476
	Business cycle transmission with flexible exchange rates	477
	Monetary policy with flexible exchange rates	478
	Fiscal policy with a flexible exchange rate	485
	The domestic impacts of foreign monetary and fiscal policy	400
	shifts with flexible exchange rates	489
	Monetary policy	489
	Foreign fiscal policy shifts with a floating exchange rate	490 491
	Mercantilism and flexible exchange rates	491
	Purchasing power parity and flexible exchange rates Summary of key concepts	494
	Questions for study and review	495
	Suggested further reading	495
	Notes	496
20	The international monetary system from 1880 to 1973	498
	Learning objectives	498
	The gold standard, 1880 to 1914	499
	The process of adjustment	502
	The interwar period: 1918 to 1939	503
	The Bretton Woods system: 1945 to 1973	507
	Essential elements of the Bretton Woods system	507
	The IMF system in operation: 1947 to 1971	512
	The dollar shortage, 1945 to 1958	. 513
	The dollar surplus: a basic dilemma	514
	Failure of adjustment	516
	Perimeter defenses and basic reforms	519
	The Eurocurrency market	523
	How the Eurodollar market works	524
	Why the Eurodollar market exists	526
	The effect of the Eurocurrency market on national monetary	
	autonomy	527
	Recycling oil payments	529
	Summary of key concepts	530
	Questions for study and review	531 531
	Suggested further reading Notes	532
	INDICS	J.) 2

CONTENTS			

xiii

21	Events in international monetary relations from 1973 to 1998 534				
	Learning objectives	534			
	A very brief history of the US float	535			
	Continuing questions about flexible exchange rates	538			
	Trying to explain exchange rate movements	542			
	Protectionism and flexible exchange rates	544			
	Alternatives to flexible exchange rates	544			
	The European Monetary Union	547			
	Early history	547			
	Recent developments	548			
	Changes in the role of the SDR	<b>55</b> 3			
	LDC debt crises: Latin America in the 1980s, Mexico in	``			
	1994–5, and Asia in the Late 1990s	553			
	Latin America	553			
	The Basle Accord	556			
	Mexico in 1994–5: a return of the debt crisis?	557			
	The Asian crisis of the late 1990s	560			
	Prospective issues in international economic policy in the decade				
	beginning in 2000	566			
	Summary of key concepts	568			
	Questions for study and review	569			
	Suggested further reading	569			
	Notes	570			
Glossary		573			
Index		588			