

DOMINICK SALVATORE

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DOMINICK SALVATORE

Fordham University

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To Lucille

This is the 12th edition of a text that has enjoyed a flattering market success, having been adopted by more than 700 colleges and universities throughout the United States, Canada, and other English-speaking countries. The text has also been translated into Chinese, French, Greek, Indonesian, Italian, Korean, Polish, Portuguese (Brazilian), Serbian, Spanish, Russian, and other languages. All of the features that have made the previous editions of this text, one of the leading texts of International Economics in the United States and around the world, have been retained in the 12th edition. However, the content has been thoroughly updated and expanded to include many new significant topics and important recent developments.

Significant International Developments

The main objective of this 12th edition is to present a comprehensive, up-to-date, and clear exposition of the theory and principles of international economics that are essential for understanding, evaluating, and suggesting solutions to the important international economic problems and issues facing the United States and the rest of the world today and that they are likely to face in the coming years. These are:

1. Slow growth and high unemployment in advanced economies after the “Great Recession”—the deepest financial and economic crisis since the Great Depression of 1929.
2. Increasing trade protectionism in the United States and in other advanced countries reduces the level of specialization and trade and raises the specter of trade wars that would be very detrimental to the welfare of all nations.
3. Excessive volatility and large and persistent misalignments of exchange rates discourage the international flow of trade and investments and could lead to international financial and monetary crises.
4. Deep structural imbalances in the United States, slow growth in Europe and Japan, and insufficient restructuring in the transition economies of Central and Eastern Europe reduce the volume of international trade and could lead to the collapse of the dollar.
5. The deep poverty in many developing countries and the widening international inequalities pose serious moral, political, and developmental problems for the United States and other advanced countries.
6. Resource scarcity, environmental degradation, and climate change put at risk continued growth in the United States and other advanced countries and sustainable development in developing countries.

These events significantly affect the well-being of the United States and the rest of the world but are, to a large extent, beyond U.S. or any individual country’s control.

New to the 12th Edition

Chapter 1 has been thoroughly revised and updated to reflect the dramatic economic and financial changes that have taken place in the world economy since the last edition of this text. Section 1.6 has been thoroughly revised to identify the major international economic

(trade and financial) problems facing the United States and the world today and so has the discussion in Chapter 21 (Section 21.6), which examines how they can be resolved.

The rapid globalization of the world economy is providing major benefits to most countries, but it is also presenting many challenges to poor countries that are unable to take advantage of globalization, as well as to the United States and other advanced countries, which face increasing competition from some emerging markets, especially China. These topics are discussed in several new sections and case studies in the trade and finance part of the text.

The dollar–euro exchange rate is much in the news these days as are the huge and unsustainable trade deficits of the United States. The relationship between U.S. trade deficits, trade protectionism, and misaligned exchange rates is examined, both theoretically and empirically, and in all of its ramifications, in several trade and finance sections and case studies in this new edition of the text.

Besides its effect on international trade and international competitiveness, the continuing globalization of the world economy and liberalization of international capital markets have further eroded governments' control over national economic and financial matters. Exchange rates exhibit great volatility and large misalignments, which interfere with the flow of international trade and investments and the comparative advantage of nations. At the same time, international macroeconomic policy coordination has not progressed sufficiently to deal adequately with the potential problems and challenges that increased interdependence in world financial markets created.

The 12th edition of the text also presents an in-depth analysis of the dangerous structural imbalances in the world economy and provides an evolution of the policy options available to deal with them. The major imbalances in the world economy today are the huge trade and budget (twin) deficits of the United States, the slow growth and high unemployment in Europe, the decade-long stagnation in Japan, the serious competitive challenge for both advanced and developing countries provided by the competition from China, the danger of financial and economic crises in advanced and emerging market economies, world poverty, resource scarcity, and environmental degradation. All of these topics are addressed in this edition of the text.

There are 126 case studies in the text. Many are new and the others have been thoroughly revised.

The extended annotated Selected Bibliography for each chapter (on the WEB) has been thoroughly updated and extended, and it represents a major resource for further study and research on various topics.

The INTERNET section for each chapter (also on the Web) has been updated and expanded and gives the most important Internet site addresses or links to data sources, information, and analyses for the topics presented in each chapter to show the student how to access and use the wealth of information available on the Internet.

The Companion Website for the text has also been thoroughly updated and expanded, and it presents for each chapter additional examples, cases, and theoretical points, as well as questions and problems that can be answered or solved using the Internet.

New, extended, and revised sections and case studies in the trade theory and policy parts of the text include benefits and challenges of globalization before and after the recent global financial crisis, the gravity model, the changing pattern of comparative advantage, variety gains from international trade, EU–U.S. trade disputes and protectionism, the pervasiveness of nontariff trade barriers, strategic trade and industrial policies, the emergence of new economic giants, job losses in high U.S. import-competing industries, international

trade and deindustrialization of the United States and other advanced countries, international trade and U.S. wage inequalities, benefits and costs of NAFTA, international trade and environmental sustainability, globalization and world poverty, trade and growth in developing countries, the collapse of the Doha Round and the several failed attempts to revive it, and the debate over U.S. immigration policy.

New sections and case studies in international finance include size, currency, and geographical distribution of the foreign exchange market; the carry trade; fundamental forces and “news” in exchange rate forecasting; the exploding U.S. trade deficit with China; the euro/dollar exchange rate defies forecasting; the Balassa–Samuelson effect in transition economies; structural imbalances and exchange rate misalignments; the effective exchange rate of the dollar and U.S. current account deficits; exchange rate pass-through to import prices; monetary policies across the Atlantic; EU’s inadequate restructuring and slow growth; petroleum prices and growth; inflation targeting and exchange rates; the global financial crisis and the Great Recession; slow recovery and growth after the Great Recession; the Eurozone crisis and the future of the euro; exchange rate arrangements of IMF members; and reforms of the international monetary system.

More international trade and finance data are included throughout the text.

Audience and Level

The text presents all of the principles and theories essential for a thorough understanding of international economics. It does so on an intuitive level in the text itself and more rigorously in the appendices at the end of most chapters. In addition, partial equilibrium analysis is presented before the more difficult general equilibrium analysis (which is optional). Thus, the book is designed for flexibility. It also overcomes the shortcomings of other international economics texts in which the level of analysis is either too complicated or too simplistic.

Organization of the Book

The book is organized into four parts. Part One (Chapters 2–7) deals with trade theory (i.e., the basis and the gains from trade). Part Two (Chapters 8–12) deals with trade policy (i.e., obstructions to the flow of trade). Part Three (Chapters 13–15) deals with the measurement of a nation’s balance of payments, foreign exchange markets, and exchange rate determination. Part Four (Chapters 16–21) examines open-economy macroeconomics or the macro relationships between the domestic economy and the rest of the world, as well as the operation of the present international monetary system.

In the typical one-semester undergraduate course in international economics, instructors may wish to cover the 14 core chapters (1–6, 8, 13–18, 21) as well as the few other sections in other chapters and exclude the appendices. Undergraduate courses in international trade could cover Chapters 1–12, 21 while in undergraduate courses in international finance could cover Chapters 1, 13–21. The many examples and real-world case studies presented also makes the text very suitable for international economics courses in business programs. In first-year graduate courses in international economics and business, instructors may want to cover the appendices also and assign readings from the extensive annotated bibliography at the end of each chapter (on the Web).

For the Student

- *The same example is utilized in all the chapters dealing with the same basic concept.* This feature is unique to this text. For example, the same graphical and numerical model is used in every chapter from Chapters 2 through 11 (the chapters that deal with trade theory and policy). This greatly reduces the real burden on the student who does not have to start afresh with a new example each time. It also shows more clearly the relationship among the different topics examined.
- *Actual numbers are used in the examples, and the graphs are presented on scales.* This makes the various concepts and theories presented more concrete, accessible, and pertinent to the student, and the graphs easier to read and understand.
- *There are 126 case studies (from 4 to 9 per chapter).* These real-world case studies are generally short and to the point and serve to reinforce understanding and highlight the most important topics presented in the chapter.
- *The sections of each chapter are numbered for easy reference.* Longer sections are broken into two or more numbered subsections. All of the graphs and diagrams are carefully explained in the text and then summarized briefly in the captions.
- *The judicious use of color and shading enhances the readability of the text and aids student understanding.*
- *Each chapter ends with the following teaching aids:*
 - **Summary**—A paragraph reviews each section of the text.
 - **Key Terms**—Lists the important terms introduced in boldface type in the chapter. A glossary of all these terms in is then provided at the end of the book.
 - **Questions for Review**—Fourteen questions (two or more for each for each section in the chapter).
 - **Problems**—Fourteen to fifteen problems are provided for each chapter. These ask the student to calculate a specific measure or explain a particular event. Brief answers to selected problems (those marked by an asterisk) are provided at www.wiley.com/college/salvatore for feedback.
 - **Appendices**—These develop in a more rigorous, but careful and clear fashion, material that is presented on an intuitive level in the chapter.
 - **Selected Bibliography**—The most important references are included along with specific notes indicating the topic they deal with (on the Web). A separate author's index is included at the end of the book.
 - **INTERNET**—There is a section at the end of each chapter that provides Internet site addresses or links to data sources, information, and analyses on the topics presented in each chapter to show the student how to access and use the wealth of information available on the Internet (on the Web).
- *Accompanying the text, there are also:*
 - **A Website**—This presents for each chapter additional examples, cases, and theoretical points and questions as well as problems that can be answered or solved using the Internet. The Website is continuously updated to reflect important new developments in the international economy as they unfold.

- An **Online Study Guide** prepared by Professor Arthur Raymond of Muhlenberg College is available for students. This provides extensive review of key concepts, numerous additional illustrative examples, and practice problems and exercise sets.
- A **Schaum Outline** on the *Theory and Problems of International Economics* (4th edition, 1996), prepared by the author, can be purchased at a very low price in most bookstores. This provides a problem-solving approach to the topics presented in the traditional way in this and other international economics texts.

For the Instructor

- An **Instructor's Manual** prepared by the author is available which includes chapter objectives and lecture suggestions, answers to the end-of-chapter problems, a set of 15–20 multiple-choice questions with answers, and additional problems and essays for each chapter.
- **PowerPoint Presentations** prepared by Professor Carol Stivender of the University of North Carolina, Charlotte, provides brief outline notes of the chapter and also contains all the figures and tables in the text. Available on the Instructor Companion Site.
- A **Test Bank**, prepared by Jeffrey Sarbaum of the University of North Carolina, Greensboro, contains at least 25 multiple-choice questions per chapter and is available on the Instructor Companion Site. A computerized version for easy test preparation is also available.

Acknowledgments

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Brief Contents

1	Introduction	1
PART 1 INTERNATIONAL TRADE THEORY		
2	The Law of Comparative Advantage	29
3	The Standard Theory of International Trade	53
4	Demand and Supply, Offer Curves, and the Terms of Trade	79
5	Factor Endowments and the Heckscher-Ohlin Theory	101
6	Economies of Scale, Imperfect Competition, and International Trade	141
7	Economic Growth and International Trade	169
PART 2 INTERNATIONAL TRADE POLICY		
8	Trade Restrictions: Tariffs	197
9	Nontariff Trade Barriers and the New Protectionism	227
10	Economic Integration: Customs Unions and Free Trade Areas	263
11	International Trade and Economic Development	287
12	International Resource Movements and Multinational Corporations	317
PART 3 THE BALANCE OF PAYMENTS, FOREIGN EXCHANGE MARKETS, AND EXCHANGE RATES		
13	Balance of Payments	345
14	Foreign Exchange Markets and Exchange Rates	365
15	Exchange Rate Determination	401
PART 4 OPEN-ECONOMY MACROECONOMICS AND THE INTERNATIONAL MONETARY SYSTEM		
16	The Price Adjustment Mechanism with Flexible and Fixed Exchange Rates	437
17	The Income Adjustment Mechanism and Synthesis of Automatic Adjustments	465
18	Open Economy Macroeconomics: Adjustment Policies	493
19	Prices and Output in an Open Economy: Aggregate Demand and Aggregate Supply	531
20	Flexible versus Fixed Exchange Rates, the European Monetary System, and Macroeconomic Policy Coordination	555
21	The International Monetary System: Past, Present, and Future	589
	Answers to Selected Problems	On Web
	Glossary of Key Terms	623
	Name Index	637
	Subject Index	641

1	INTRODUCTION	1
1.1	The Globalization of the World Economy	1
1.1A	We Live in a Global Economy	1
	CASE STUDY 1-1 The Dell PCs, iPhones, and iPads Sold in the United States are Anything but American!	2
1.1B	The Globalization Challenge	2
	CASE STUDY 1-2 What Is an “American” Car?	3
1.2	International Trade and the Nation’s Standard of Living	4
	CASE STUDY 1-3 Is India’s Globalization Harming the United States?	5
	CASE STUDY 1-4 Rising Importance of International Trade to the United States	7
1.3	The International Flow of Goods, Services, Labor, and Capital	8
1.3A	The International Flow of Goods and Services: The Gravity Model	8
1.3B	The International Flow of Labor and Capital	9
	CASE STUDY 1-5 The Gravity Model at Work	10
	CASE STUDY 1-6 Major Net Exporters and Importers of Capital	11
1.3C	Globalization Before and After the Global Financial Crisis	11
1.4	International Economic Theories and Policies	12
1.4A	Purpose of International Economic Theories and Policies	12
1.4B	The Subject Matter of International Economics	13
1.5	Current International Economic Problems and Challenges	14
1.6	Organization and Methodology of the Text	16
1.6A	Organization of the Text	16
1.6B	Methodology of the Text	17
	Summary	18
	Key Terms	19
	Questions For Review	19
	Problems	19
	Appendix	20
A1.1	Basic International Trade Data	20
A1.2	Sources of Additional International Data and Information	24
	Selected Bibliography (on Web)	
	INTERNet (on Web)	

Part 1 International Trade Theory

2 THE LAW OF COMPARATIVE ADVANTAGE 29

- 2.1 Introduction 29
- 2.2 The Mercantilists' Views on Trade 30
 - CASE STUDY 2-1 Munn's Mercantilistic Views on Trade 30
 - CASE STUDY 2-2 Mercantilism Is Alive and Well in the Twenty-First Century 31
- 2.3 Trade Based on Absolute Advantage: Adam Smith 32
 - 2.3A Absolute Advantage 32
 - 2.3B Illustration of Absolute Advantage 33
- 2.4 Trade Based on Comparative Advantage: David Ricardo 33
 - 2.4A The Law of Comparative Advantage 34
 - 2.4B The Gains from Trade 34
 - 2.4C The Case of No Comparative Advantage 36
 - 2.4D Comparative Advantage with Money 36
 - CASE STUDY 2-3 The Petition of the Candlemakers 38
- 2.5 Comparative Advantage and Opportunity Costs 38
 - 2.5A Comparative Advantage and the Labor Theory of Value 38
 - 2.5B The Opportunity Cost Theory 39
 - 2.5C The Production Possibility Frontier Under Constant Costs 39
 - 2.5D Opportunity Costs and Relative Commodity Prices 41
- 2.6 The Basis for and the Gains from Trade under Constant Costs 42
 - 2.6A Illustration of the Gains from Trade 42
 - 2.6B Relative Commodity Prices with Trade 43
- 2.7 Empirical Tests of the Ricardian Model 44
 - CASE STUDY 2-4 Other Empirical Tests of the Ricardian Model 46
- Summary 47
- Key Terms 48
- Questions for Review 48
- Problems 49
- Appendix 50
 - A2.1 Comparative Advantage with More Than Two Commodities 50
 - A2.2 Comparative Advantage with More Than Two Nations 52
- Selected Bibliography (on Web)
- INTERNet (on Web)

3 THE STANDARD THEORY OF INTERNATIONAL TRADE 53

- 3.1 Introduction 53
- 3.2 The Production Frontier with Increasing Costs 53

3.2A	Illustration of Increasing Costs	54
3.2B	The Marginal Rate of Transformation	55
3.2C	Reasons for Increasing Opportunity Costs and Different Production Frontiers	55
3.3	Community Indifference Curves	56
3.3A	Illustration of Community Indifference Curves	56
3.3B	The Marginal Rate of Substitution	57
3.3C	Some Difficulties with Community Indifference Curves	57
3.4	Equilibrium in Isolation	57
3.4A	Illustration of Equilibrium in Isolation	58
3.4B	Equilibrium-Relative Commodity Prices and Comparative Advantage	59
	CASE STUDY 3-1 The Comparative Advantage of the Largest Advanced and Emerging Economies	59
3.5	The Basis for and the Gains from Trade with Increasing Costs	60
3.5A	Illustrations of the Basis for and the Gains from Trade with Increasing Costs	60
3.5B	Equilibrium-Relative Commodity Prices with Trade	61
3.5C	Incomplete Specialization	62
3.5D	Small-Country Case with Increasing Costs	62
	CASE STUDY 3-2 Specialization and Export Concentration in Selected Countries	63
3.5E	The Gains from Exchange and from Specialization	63
	CASE STUDY 3-3 Job Losses in High U.S. Import-Competing Industries	64
	CASE STUDY 3-4 International Trade and Deindustrialization in the United States, the European Union, and Japan	65
3.6	Trade Based on Differences in Tastes	66
3.6A	Illustration of Trade Based on Differences in Tastes	67
	Summary	68
	Key Terms	69
	Questions for Review	69
	Problems	69
	Appendix	71
A3.1	Production Functions, Isoquants, Isocosts, and Equilibrium	71
A3.2	Production Theory with Two Nations, Two Commodities, and Two Factors	72
A3.3	Derivation of the Edgeworth Box Diagram and Production Frontiers	73
A3.4	Some Important Conclusions	76
	Selected Bibliography (on Web)	
	INTERNet (on Web)	

4 DEMAND AND SUPPLY, OFFER CURVES, AND THE TERMS OF TRADE 79

- 4.1 Introduction 79
- 4.2 The Equilibrium–Relative Commodity Price with Trade–Partial Equilibrium Analysis 79
 - CASE STUDY 4-1 Demand, Supply, and the International Price of Petroleum 81
 - CASE STUDY 4-2 The Index of Export to Import Prices for the United States 82
- 4.3 Offer Curves 82
 - 4.3A Origin and Definition of Offer Curves 82
 - 4.3B Derivation and Shape of the Offer Curve of Nation 1 83
 - 4.3C Derivation and Shape of the Offer Curve of Nation 2 84
- 4.4 The Equilibrium–Relative Commodity Price with Trade–General Equilibrium Analysis 85
- 4.5 Relationship Between General and Partial Equilibrium Analyses 86
- 4.6 The Terms of Trade 88
 - 4.6A Definition and Measurement of the Terms of Trade 88
 - 4.6B Illustration of the Terms of Trade 88
 - CASE STUDY 4-3 The Terms of Trade of the G-7 Countries 89
 - CASE STUDY 4-4 The Terms of Trade of Industrial and Developing Countries 89
 - 4.6C Usefulness of the Model 90
- Summary 90
- Key Terms 91
- Questions for Review 91
- Problems 92
- Appendix 92
 - A4.1 Derivation of a Trade Indifference Curve for Nation 1 93
 - A4.2 Derivation of Nation 1's Trade Indifference Map 94
 - A4.3 Formal Derivation of Nation 1's Offer Curve 95
 - A4.4 Outline of the Formal Derivation of Nation 2's Offer Curve 97
 - A4.5 General Equilibrium of Production, Consumption, and Trade 98
 - A4.6 Multiple and Unstable Equilibria 99
- Selected Bibliography (on Web)
- INTERNet (on Web)

5 FACTOR ENDOWMENTS AND THE HECKSCHER–OHLIN THEORY 101

- 5.1 Introduction 101
- 5.2 Assumptions of the Theory 102
 - 5.2A The Assumptions 102
 - 5.2B Meaning of the Assumptions 102

5.3	Factor Intensity, Factor Abundance, and the Shape of the Production Frontier	103
5.3A	Factor Intensity	104
5.3B	Factor Abundance	105
5.3C	Factor Abundance and the Shape of the Production Frontier	106
	CASE STUDY 5-1 Relative Resource Endowments of Various Countries	107
	CASE STUDY 5-2 Capital–Labor Ratios of Selected Countries	108
5.4	Factor Endowments and the Heckscher–Ohlin Theory	109
5.4A	The Heckscher–Ohlin Theorem	109
5.4B	General Equilibrium Framework of the Heckscher–Ohlin Theory	110
5.4C	Illustration of the Heckscher–Ohlin Theory	111
	CASE STUDY 5-3 Classification of Major Product Categories in Terms of Factor Intensity	112
	CASE STUDY 5-4 The Factor Intensity of Trade of Various Countries	113
5.5	Factor–Price Equalization and Income Distribution	114
5.5A	The Factor–Price Equalization Theorem	114
5.5B	Relative and Absolute Factor–Price Equalization	115
5.5C	Effect of Trade on the Distribution of Income	116
	CASE STUDY 5-5 Has International Trade Increased U.S. Wage Inequalities?	117
5.5D	The Specific–Factors Model	118
5.5E	Empirical Relevance	119
	CASE STUDY 5-6 Convergence of Real Wages among Advanced Countries	120
5.6	Empirical Tests of the Heckscher–Ohlin Model	121
5.6A	Empirical Results–The Leontief Paradox	121
	CASE STUDY 5-7 Capital and Labor Requirements in U.S. Trade	122
5.6B	Explanations of the Leontief Paradox and Other Empirical Tests of the H–O Model	123
	CASE STUDY 5-8 The H–O Model with Skills and Land	125
5.6C	Factor–Intensity Reversal	126
	Summary	127
	Key Terms	128
	Questions for Review	129
	Problems	129
	Appendix	130
A5.1	The Edgeworth Box Diagram for Nation 1 and Nation 2	131
A5.2	Relative Factor–Price Equalization	132
A5.3	Absolute Factor–Price Equalization	134
A5.4	Effect of Trade on the Short–Run Distribution of Income: The Specific–Factors Model	134
A5.5	Illustration of Factor–Intensity Reversal	136

A5.6 The Elasticity of Substitution and Factor–Intensity Reversal 138

A5.7 Empirical Tests of Factor–Intensity Reversal 139

Selected Bibliography (on Web)

INTERNet (on Web)

6 ECONOMIES OF SCALE, IMPERFECT COMPETITION, AND INTERNATIONAL TRADE

141

6.1 Introduction 141

6.2 The Heckscher–Ohlin Model and New Trade Theories 141

6.3 Economies of Scale and International Trade 143

CASE STUDY 6-1 The New International Economies of Scale 145

CASE STUDY 6-2 Job Loss Rates in U.S. Industries and Globalization 146

6.4 Imperfect Competition and International Trade 146

6.4A Trade Based on Product Differentiation 146

CASE STUDY 6-3 U.S. Intra-Industry Trade in Automotive Products 147

CASE STUDY 6-4 Variety Gains with International Trade 148

6.4B Relationship Between Intra-Industry and H–O Trade Models 149

6.4C Measuring Intra-Industry Trade 150

CASE STUDY 6-5 Growth of Intra-Industry Trade 150

CASE STUDY 6-6 Intra-Industry Trade Indexes for G–20 Countries 151

CASE STUDY 6-7 Index of Intra-Industry Trade of Some U.S. Industries, 2013 152

6.4D Formal Model of Intra-Industry Trade 153

6.4E Another Version of the Intra-Industry Trade Model 154

6.5 Trade Based on Dynamic Technological Differences 155

6.5A Technological Gap and Product Cycle Models 156

6.5B Illustration of the Product Cycle Model 157

CASE STUDY 6-8 The United States as the Most Competitive Economy 158

6.6 Costs of Transportation, Environmental Standards, and International Trade 159

6.6A Costs of Transportation and Nontraded Commodities 159

6.6B Costs of Transportation and the Location of Industry 161

6.6C Environmental Standards, Industry Location, and International Trade 161

CASE STUDY 6-9 Environmental Performance Index 162

Summary 163

Key Terms 164

Questions for Review 164

Problems 164

Appendix	165
A6.1 External Economies and the Pattern of Trade	165
A6.2 Dynamic External Economies and Specialization	167
Selected Bibliography (on Web)	
INTERNet (on Web)	

7 ECONOMIC GROWTH AND INTERNATIONAL TRADE 169

7.1	Introduction	169
7.2	Growth of Factors of Production	170
7.2A	Labor Growth and Capital Accumulation over Time	170
7.2B	The Rybczynski Theorem	171
7.3	Technical Progress	172
7.3A	Neutral, Labor-Saving, and Capital-Saving Technical Progress	173
7.3B	Technical Progress and the Nation's Production Frontier	173
	CASE STUDY 7-1 Growth in the Capital Stock per Worker of Selected Countries	175
7.4	Growth and Trade: The Small-Country Case	175
7.4A	The Effect of Growth on Trade	176
7.4B	Illustration of Factor Growth, Trade, and Welfare	176
7.4C	Technical Progress, Trade, and Welfare	178
	CASE STUDY 7-2 Growth in Output per Worker from Capital Deepening, Technological Change, and Improvements in Efficiency	179
7.5	Growth and Trade: The Large-Country Case	180
7.5A	Growth and the Nation's Terms of Trade and Welfare	180
7.5B	Immiserizing Growth	181
7.5C	Illustration of Beneficial Growth and Trade	182
	CASE STUDY 7-3 Growth and the Emergence of New Economic Giants	184
7.6	Growth, Change in Tastes, and Trade in Both Nations	185
7.6A	Growth and Trade in Both Nations	185
7.6B	Change in Tastes and Trade in Both Nations	186
	CASE STUDY 7-4 Growth, Trade, and Welfare in the Leading Industrial Countries	187
	Summary	187
	Key Terms	188
	Questions for Review	188
	Problems	189
	Appendix	190
A7.1	Formal Proof of the Rybczynski Theorem	190
A7.2	Growth with Factor Immobility	192
A7.3	Graphical Analysis of Hicksian Technical Progress	193

Selected Bibliography (on Web)

INTERNet (on Web)

Part 2 International Trade Policy

8 TRADE RESTRICTIONS: TARIFFS 197

8.1 Introduction 197

CASE STUDY 8-1 Average Tariff on Nonagricultural Products in Major Developed Countries 198

CASE STUDY 8-2 Average Tariffs on Nonagricultural Products in Some Major Developing Countries 199

8.2 Partial Equilibrium Analysis of a Tariff 199

8.2A Partial Equilibrium Effects of a Tariff 199

8.2B Effect of a Tariff on Consumer and Producer Surplus 200

8.2C Costs and Benefits of a Tariff 202

CASE STUDY 8-3 The Welfare Effect of Liberalizing Trade on Some U.S. Products 203

CASE STUDY 8-4 The Welfare Effect of Liberalizing Trade on Some EU Products 204

8.3 The Theory of Tariff Structure 205

8.3A The Rate of Effective Protection 205

8.3B Generalization and Evaluation of the Theory of Effective Protection 206

CASE STUDY 8-5 Structure of Tariffs on Industrial Products in the United States, the European Union, Japan, and Canada 207

CASE STUDY 8-6 Tariff Escalation in Developed and Developing Nations 208

8.4 General Equilibrium Analysis of a Tariff in a Small Country 208

8.4A General Equilibrium Effects of a Tariff in a Small Country 209

8.4B Illustration of the Effects of a Tariff in a Small Country 209

8.4C The Stolper-Samuelson Theorem 211

8.5 General Equilibrium Analysis of a Tariff in a Large Country 211

8.5A General Equilibrium Effects of a Tariff in a Large Country 212

8.5B Illustration of the Effects of a Tariff in a Large Country 212

8.6 The Optimum Tariff 213

8.6A The Meaning of the Concept of Optimum Tariff and Retaliation 213

8.6B Illustration of the Optimum Tariff and Retaliation 214

Summary 215

Key Terms 216

Questions for Review 216

Problems	217
Appendix	217
A8.1 Partial Equilibrium Effects of a Tariff in a Large Nation	218
A8.2 Derivation of the Formula for the Rate of Effective Protection	220
A8.3 The Stolper–Samuelson Theorem Graphically	221
A8.4 Exception to the Stolper–Samuelson Theorem–The Metzler Paradox	222
A8.5 Short-Run Effect of a Tariff on Factors' Income	224
A8.6 Measurement of the Optimum Tariff	225
Selected Bibliography (on Web)	
INTERNet (on Web)	

9 NONTARIFF TRADE BARRIERS AND THE NEW PROTECTIONISM 227

9.1 Introduction	227
9.2 Import Quotas	227
9.2A Effects of an Import Quota	228
CASE STUDY 9-1 The Economic Effects of the U.S. Quota on Sugar Imports	229
9.2B Comparison of an Import Quota to an Import Tariff	229
9.3 Other Nontariff Barriers and the New Protectionism	230
9.3A Voluntary Export Restraints	230
CASE STUDY 9-2 Voluntary Export Restraints (VERs) on Japanese Automobiles to the United States and Europe	231
9.3B Technical, Administrative, and Other Regulations	232
9.3C International Cartels	232
9.3D Dumping	233
CASE STUDY 9-3 Antidumping Investigations by G20 Members	235
9.3E Export Subsidies	235
CASE STUDY 9-4 Agricultural Subsidies in OECD Countries	236
CASE STUDY 9-5 Pervasiveness of Nontariff Barriers	237
9.3F Analysis of Export Subsidies	238
9.4 The Political Economy of Protectionism	239
9.4A Fallacious and Questionable Arguments for Protection	239
9.4B The Infant-Industry and Other Qualified Arguments for Protection	240
9.4C Who Gets Protected?	241
CASE STUDY 9-6 Benefits to the World Economy from Complete Trade Liberalization	242
9.5 Strategic Trade and Industrial Policies	243
9.5A Strategic Trade Policy	243
9.5B Strategic Trade and Industrial Policies with Game Theory	244
9.5C The U.S. Response to Foreign Industrial Targeting and Strategic Trade Policies	245

9.6	History of U.S. Commercial Policy	246
9.6A	The Trade Agreements Act of 1934	246
9.6B	The General Agreement on Tariffs and Trade (GATT)	247
9.6C	The 1962 Trade Expansion Act and the Kennedy Round	248
9.6D	The Trade Reform Act of 1974 and the Tokyo Round	249
9.6E	The 1984 and 1988 Trade Acts	249
9.7	The Uruguay Round, Outstanding Trade Problems, and the Doha Round	250
9.7A	The Uruguay Round	250
	CASE STUDY 9-7 Gains from the Uruguay Round	252
	CASE STUDY 9-8 The Multilateral Rounds of Trade Negotiations	253
9.7B	Outstanding Trade Problems and the Doha Round	254
	CASE STUDY 9-9 Benefits from a Likely Doha Scenario	255
	Summary	256
	Key Terms	257
	Questions for Review	257
	Problems	258
	Appendix	259
	A9.1 Centralized Cartels	259
	A9.2 International Price Discrimination	260
	A9.3 Tariffs, Subsidies, and Domestic Goals	261
	Selected Bibliography (on Web)	
	INTERNet (on Web)	

10 ECONOMIC INTEGRATION: CUSTOMS UNIONS AND FREE TRADE AREAS **263**

10.1	Introduction	263
10.2	Trade-Creating Customs Union	264
10.2A	Trade Creation	264
10.2B	Illustration of a Trade-Creating Customs Union	264
10.3	Trade-Diverting Customs Unions	265
10.3A	Trade Diversion	266
10.3B	Illustration of a Trade-Diverting Customs Union	266
10.4	The Theory of the Second Best and Other Static Welfare Effects of Customs Unions	267
10.4A	The Theory of the Second Best	267
10.4B	Conditions More Likely to Lead to Increased Welfare	268
10.4C	Other Static Welfare Effects of Customs Unions	268
10.5	Dynamic Benefits from Customs Unions	269
10.6	History of Attempts at Economic Integration	270
10.6A	The European Union	270

CASE STUDY 10-1 Economic Profile of the EU, NAFTA, and Japan	271
CASE STUDY 10-2 Gains from the Single EU Market	273
10.6B The European Free Trade Association	273
10.6C The North American and Other Free Trade Agreements	274
CASE STUDY 10-3 Mexico's Gains from NAFTA—Expectations and Outcome	275
10.6D Attempts at Economic Integration Among Developing Countries	276
CASE STUDY 10-4 Economic Profile of Mercosur	278
CASE STUDY 10-5 Changes in Trade Patterns with Economic Integration	279
10.6E Economic Integration in Central and Eastern Europe and in the Former Soviet Republics	280
Summary	281
Key Terms	282
Questions for Review	282
Problems	283
Appendix	283
A10.1 General Equilibrium Analysis of the Static Effects of a Trade-Diverting Customs Union	284
A10.2 Regional Trade Agreements Around the World	285
Selected Bibliography (on Web)	
INTERNet (on Web)	

11 INTERNATIONAL TRADE AND ECONOMIC DEVELOPMENT **287**

11.1 Introduction	287
11.2 The Importance of Trade to Development	288
11.2A Trade Theory and Economic Development	288
11.2B Trade as an Engine of Growth	289
11.2C The Contributions of Trade to Development	290
11.2D International Trade and Endogenous Growth Theory	291
CASE STUDY 11-1 The East Asian Miracle of Growth and Trade	292
11.3 The Terms of Trade and Economic Development	293
11.3A The Various Terms of Trade	293
11.3B Alleged Reasons for Deterioration in the Commodity Terms of Trade	294
11.3C Historical Movement in the Commodity and Income Terms of Trade	295
CASE STUDY 11-2 Change in Commodity Prices Over Time	297
11.4 Export Instability and Economic Development	298
11.4A Cause and Effects of Export Instability	298

- 11.4B Measurements of Export Instability and Its Effect on Development 299
- 11.4C International Commodity Agreements 300
- 11.5 Import Substitution versus Export Orientation 301
 - 11.5A Development Through Import Substitution versus Exports 301
 - 11.5B Experience with Import Substitution 302
 - CASE STUDY 11-3 The Growth of GDP of Rich Countries, Globalizers, and Nonglobalizers 303
 - 11.5C Trade Liberalization and Growth in Developing Countries 304
 - CASE STUDY 11-4 Manufactures in Total Exports of Selected Developing Countries 305
- 11.6 Current Problems Facing Developing Countries 305
 - 11.6A Poverty in Developing Countries 305
 - 11.6B The Foreign Debt Problem of Developing Countries 307
 - CASE STUDY 11-5 The Foreign Debt Burden of Developing Countries 307
 - 11.6C Trade Problems of Developing Countries 308
 - CASE STUDY 11-6 Globalization and World Poverty 309
- Summary 310
- Key Terms 310
- Questions for Review 311
- Problems 311
- Appendix 312
 - A11.1 Income Inequalities by Traditional and Purchasing-Power Parity (PPP) Measures 312
 - A11.2 The World by Income 313
- Selected Bibliography (on Web)
- INTERNet (on Web)

12 INTERNATIONAL RESOURCE MOVEMENTS AND MULTINATIONAL CORPORATIONS

317

- 12.1 Introduction 317
- 12.2 Some Data on International Capital Flows 318
- 12.3 Motives for International Capital Flows 320
 - 12.3A Motives for International Portfolio Investments 320
 - CASE STUDY 12-1 Fluctuations in Foreign Direct Investment Flows to the United States 320
 - 12.3B Motives for Direct Foreign Investments 322
 - CASE STUDY 12-2 The Stock of Foreign Direct Investments Around the World 323
- 12.4 Welfare Effects of International Capital Flows 324
 - 12.4A Effects on the Investing and Host Countries 324
 - 12.4B Other Effects on the Investing and Host Countries 326

12.5	Multinational Corporations	327
12.5A	Reasons for the Existence of Multinational Corporations	327
12.5B	Problems Created by Multinational Corporations in the Home Country	328
	CASE STUDY 12-3 The World's Largest Non-Petroleum, Industrial Corporations	328
	CASE STUDY 12-4 Employment of U.S. MNCs Abroad	329
12.5C	Problems Created by Multinational Corporations in the Host Country	331
12.6	Motives for and Welfare Effects of International Labor Migration	332
12.6A	Motives for International Labor Migration	332
12.6B	Welfare Effects of International Labor Migration	332
12.6C	Other Welfare Effects of International Labor Migration	333
	CASE STUDY 12-5 U.S. Immigration and Debate over Immigration Policy	335
	Summary	336
	Key Terms	337
	Questions for Review	337
	Problems	338
	Appendix	338
A12.1	The Transfer Problem	338
A12.2	International Trade, Financial and Aid Flows, and Migration	339
	Selected Bibliography (on Web)	
	INTERNet (on Web)	

Part 3 The Balance of Payments, Foreign Exchange Markets, and Exchange Rates

13 BALANCE OF PAYMENTS 345

13.1	Introduction	345
13.2	Balance of Payments Accounting	346
13.2A	Current Account and Capital Account	346
13.2B	Financial Account	347
13.2C	International Transactions with Double-Entry Bookkeeping	347
13.3	The International Transactions of the United States	348
	CASE STUDY 13-1 The Major Goods Exports and Imports of the United States	350
13.4	Accounting Balances and the U.S. Balance of Payments	351
13.5	The Postwar Balance of Payments of the United States	351
	CASE STUDY 13-2 The Exploding U.S. Trade Deficit with China	352
	CASE STUDY 13-3 The Major Trade Partners of the United States	353

13.6	The Importance of the Current Account	354
13.7	The International Investment Position of the United States	355
	CASE STUDY 13-4 The United States as a Debtor Nation	357
	Summary	358
	Key Terms	359
	Questions for Review	359
	Problems	360
	Appendix	360
A13.1	The IMF Method of Reporting International Transactions	360
	Selected Bibliography (on Web)	
	INTERNet (on Web)	

14 FOREIGN EXCHANGE MARKETS AND EXCHANGE RATES **365**

14.1	Introduction	365
14.2	Functions of the Foreign Exchange Markets	365
	CASE STUDY 14-1 The U.S. Dollar as the Dominant International Currency	367
	CASE STUDY 14-2 The Birth of a New Currency: The Euro	368
14.3	Foreign Exchange Rates	369
	14.3A Equilibrium Foreign Exchange Rates	369
	CASE STUDY 14-3 Foreign Exchange Quotations	371
	14.3B Arbitrage	372
	14.3C The Exchange Rate and the Balance of Payments	373
14.4	Spot and Forward Rates, Currency Swaps, Futures, and Options	375
	14.4A Spot and Forward Rates	375
	14.4B Foreign Exchange Swaps	376
	14.4C Foreign Exchange Futures and Options	377
	CASE STUDY 14-4 Size, Currency, and Geographical Distribution of the Foreign Exchange Market	378
14.5	Foreign Exchange Risks, Hedging, and Speculation	378
	14.5A Foreign Exchange Risks	378
	14.5B Hedging	381
	14.5C Speculation	382
14.6	Interest Arbitrage and the Efficiency of Foreign Exchange Markets	384
	14.6A Uncovered Interest Arbitrage	385
	CASE STUDY 14-5 Carry Trade	385
	14.6B Covered Interest Arbitrage	386
	14.6C Covered Interest Arbitrage Parity	387
	14.6D Covered Interest Arbitrage Margin	389
	14.6E Efficiency of Foreign Exchange Markets	390

14.7 Eurocurrency or Offshore Financial Markets	391
14.7A Description and Size of the Eurocurrency Market	391
CASE STUDY 14-6 Size and Growth of the Eurocurrency Market	392
14.7B Reasons for the Development and Growth of the Eurocurrency Market	392
14.7C Operation and Effects of Eurocurrency Market	393
14.7D Eurobond and Euronote Markets	394
Summary	395
Key Terms	396
Questions for Review	397
Problems	397
Appendix	398
A14.1 Derivation of the Formula for the Covered Interest Arbitrage Margin	398
Selected Bibliography (on Web)	
INTERNet (on Web)	

15 EXCHANGE RATE DETERMINATION **401**

15.1 Introduction	401
15.2 Purchasing-Power Parity Theory	402
15.2A Absolute Purchasing-Power Parity Theory	402
CASE STUDY 15-1 Absolute Purchasing Power Parity in the Real World	403
CASE STUDY 15-2 The Big Mac and the Law of One Price	403
15.2B Relative Purchasing-Power Parity Theory	404
15.2C Empirical Tests of the Purchasing-Power Parity Theory	405
CASE STUDY 15-3 Relative Purchasing-Power Parity in the Real World	406
15.3 Monetary Approach to the Balance of Payments and Exchange Rates	407
15.3A Monetary Approach under Fixed Exchange Rates	408
15.3B Monetary Approach under Flexible Exchange Rates	409
15.3C Monetary Approach to Exchange Rate Determination	411
15.3D Expectations, Interest Differentials, and Exchange Rates	412
CASE STUDY 15-4 Monetary Growth and Inflation	413
CASE STUDY 15-5 Nominal and Real Exchange Rates, and the Monetary Approach	414
CASE STUDY 15-6 Interest Differentials, Exchange Rates, and the Monetary Approach	415
15.4 Portfolio Balance Model and Exchange Rates	416
15.4A Portfolio Balance Model	416
15.4B Extended Portfolio Balance Model	418
15.4C Portfolio Adjustments and Exchange Rates	420

- 15.5 Exchange Rate Dynamics 421**
 - 15.5A Exchange Rate Overshooting 421
 - 15.5B Time Path to a New Equilibrium Exchange Rate 422
 - CASE STUDY 15-7** Exchange Rate Overshooting of the US Dollar 424
- 15.6 Empirical Tests of the Monetary and Portfolio Balance Models and Exchange Rate Forecasting* 425**
 - CASE STUDY 15-8** The Euro Exchange Rate Defies Forecasting 427
- Summary 428
- Key Terms 429
- Questions for Review 429
- Problems 429
- Appendix 431
- A15.1 Formal Monetary Approach Model 431**
- A15.2 Formal Portfolio Balance Model and Exchange Rates 432**
- Selected Bibliography (on Web)
- INTERNet (on Web)

Part 4 Open-Economy Macroeconomics and the International Monetary System

16 THE PRICE ADJUSTMENT MECHANISM WITH FLEXIBLE AND FIXED EXCHANGE RATES 437

- 16.1 Introduction 437**
- 16.2 Adjustment with Flexible Exchange Rates 438**
 - 16.2A Balance-of-Payments Adjustments with Exchange Rate Changes 438
 - 16.2B Derivation of the Demand Curve for Foreign Exchange 439
 - 16.2C Derivation of the Supply Curve for Foreign Exchange 440
- 16.3 Effect of Exchange Rate Changes on Domestic Prices and the Terms of Trade 441**
 - CASE STUDY 16-1** Currency Depreciation and Inflation in Developing Countries during the 1997–1998 East Asian Crisis 442
- 16.4 Stability of Foreign Exchange Markets 443**
 - 16.4A Stable and Unstable Foreign Exchange Markets 443
 - 16.4B The Marshall–Lerner Condition 445
- 16.5 Elasticities in the Real World 445**
 - 16.5A Elasticity Estimates 446
 - 16.5B The J-Curve Effect and Revised Elasticity Estimates 447
 - CASE STUDY 16-2** Estimated Price Elasticities in International Trade 448

- CASE STUDY 16-3** Other Estimated Price Elasticities in International Trade **449**
- CASE STUDY 16-4** Effective Exchange Rate of the Dollar and U.S. Current Account Balance **450**
- CASE STUDY 16-5** Dollar Depreciation and the U.S. Current Account Balance **451**
- CASE STUDY 16-6** Exchange Rates and Current Account Balances during the European Financial Crisis of the Early 1990s **452**
- 16.5C** Currency Pass-Through **452**
 - CASE STUDY 16-7** Exchange Rate Pass-Through to Import Prices in Industrial Countries **453**
- 16.6 Adjustment under the Gold Standard 454**
 - 16.6A** The Gold Standard **454**
 - 16.6B** The Price–Specie–Flow Mechanism **455**
- Summary 456**
- Key Terms 457**
- Questions for Review 457**
- Problems 457**
- Appendix 458**
- A16.1** The Effect of Exchange Rate Changes on Domestic Prices **458**
- A16.2** Derivation of the Marshall–Lerner Condition **459**
- A16.3** Derivation of the Gold Points and Gold Flows Under the Gold Standard **461**
- Selected Bibliography (on Web)**
- INTERNet (on Web)**

17 THE INCOME ADJUSTMENT MECHANISM AND SYNTHESIS OF AUTOMATIC ADJUSTMENTS **465**

- 17.1** Introduction **465**
- 17.2** Income Determination in a Closed Economy **466**
 - 17.2A** Determination of the Equilibrium National Income in a Closed Economy **466**
 - 17.2B** Multiplier in a Closed Economy **468**
- 17.3** Income Determination in a Small Open Economy **469**
 - 17.3A** Import Function **469**
 - 17.3B** Determination of the Equilibrium National Income in a Small Open Economy **470**
 - CASE STUDY 17-1** Income Elasticity of Imports **471**
 - 17.3C** Graphical Determination of the Equilibrium National Income **472**
 - CASE STUDY 17-2** Private Sector and Current Account Balances **472**
 - 17.3D** Foreign Trade Multiplier **474**
 - CASE STUDY 17-3** Growth in the United States and the World, and U.S. Current Account Deficits **476**

	CASE STUDY 17-4 Growth and Current Account Balance in Developing Economies	477
17.4	Foreign Repercussions	478
	CASE STUDY 17-5 Effect of the Asian Financial Crisis of the Late 1990s on OECD Countries	479
17.5	Absorption Approach	480
17.6	Monetary Adjustments and Synthesis of the Automatic Adjustments	482
	17.6A Monetary Adjustments	482
	17.6B Synthesis of Automatic Adjustments	482
	17.6C Disadvantages of Automatic Adjustments	483
	CASE STUDY 17-6 Interdependence in the World Economy	484
	Summary	485
	Key Terms	486
	Questions for Review	486
	Problems	487
	Appendix	488
A17.1	Derivation of Foreign Trade Multipliers with Foreign Repercussions	488
A17.2	The Transfer Problem Once Again	490
	Selected Bibliography (on Web)	
	INTERNet (on Web)	

18 OPEN ECONOMY MACROECONOMICS: ADJUSTMENT POLICIES 493

18.1	Introduction	493
	CASE STUDY 18-1 Government, Private-Sector, and Current Account Balances in the G-7 Countries	494
18.2	Internal and External Balance with Expenditure-Changing and Expenditure-Switching Policies	496
18.3	Equilibrium in the Goods Market, in the Money Market, and in the Balance of Payments	498
18.4	Fiscal and Monetary Policies for Internal and External Balance with Fixed Exchange Rates	500
	18.4A Fiscal and Monetary Policies from External Balance and Unemployment	500
	18.4B Fiscal and Monetary Policies from External Deficit and Unemployment	502
	18.4C Fiscal and Monetary Policies with Elastic Capital Flows	502
	CASE STUDY 18-2 Relationship Between U.S. Current Account and Budget Deficits	505
	18.4D Fiscal and Monetary Policies with Perfect Capital Mobility	506
	CASE STUDY 18-3 Effect of U.S. Fiscal Policy in the United States and Abroad	507
18.5	The IS-LM-BP Model with Flexible Exchange Rates	508
	18.5A The IS-LM-BP Model with Flexible Exchange Rates and Imperfect Capital Mobility	508

18.5B	The <i>IS-LM-BP</i> Model with Flexible Exchange Rates and Perfect Capital Mobility	509
	CASE STUDY 18-4 Effect of Monetary Policy in the United States and Other OECD Countries	511
18.6	Policy Mix and Price Changes	512
18.6A	Policy Mix and Internal and External Balance	512
18.6B	Evaluation of the Policy Mix with Price Changes	514
18.6C	Policy Mix in the Real World	515
	CASE STUDY 18-5 U.S. Monetary and Fiscal Policies during the Past Decade	517
	CASE STUDY 18-6 Deeper U.S. Recession without Strong Fiscal and Monetary Measures	518
18.7	Direct Controls	518
18.7A	Trade Controls	518
18.7B	Exchange Controls	519
	CASE STUDY 18-7 Direct Controls on International Transactions Around the World	520
18.7C	Other Direct Controls and International Cooperation	521
	Summary	521
	Key Terms	522
	Questions for Review	522
	Problems	523
	Appendix	524
A18.1	Derivation of the <i>IS</i> Curve	524
A18.2	Derivation of the <i>LM</i> Curve	526
A18.3	Derivation of the <i>BP</i> Curve	527
A18.4	Mathematical Summary	529
	Selected Bibliography (on Web)	
	INTERNet (on Web)	

19 PRICES AND OUTPUT IN AN OPEN ECONOMY: AGGREGATE DEMAND AND AGGREGATE SUPPLY **531**

19.1	Introduction	531
19.2	Aggregate Demand, Aggregate Supply, and Equilibrium in a Closed Economy	532
19.2A	Aggregate Demand in a Closed Economy	532
19.2B	Aggregate Supply in the Long Run and in the Short Run	533
19.2C	Short-Run and Long-Run Equilibrium in a Closed Economy	534
	CASE STUDY 19-1 Deviations of Short-Run Outputs from the Natural Level in the United States	536
19.3	Aggregate Demand in an Open Economy under Fixed and Flexible Exchange Rates	537

19.3A	Aggregate Demand in an Open Economy under Fixed Exchange Rates	537
19.3B	Aggregate Demand in an Open Economy under Flexible Exchange Rates	538
19.4	Effect of Economic Shocks and Macroeconomic Policies on Aggregate Demand in Open Economies with Flexible Prices	539
19.4A	Real-Sector Shocks and Aggregate Demand	540
19.4B	Monetary Shocks and Aggregate Demand	541
19.4C	Fiscal and Monetary Policies and Aggregate Demand in Open Economies	542
19.5	Effect of Fiscal and Monetary Policies in Open Economies with Flexible Prices	542
	CASE STUDY 19-2 Central Bank Independence and Inflation in Industrial Countries	545
	CASE STUDY 19-3 Inflation targeting—A New approach to Monetary Policy	546
19.6	Macroeconomic Policies to Stimulate Growth and Adjust to Supply Shocks	547
19.6A	Macroeconomic Policies for Growth	547
19.6B	Macroeconomic Policies to Adjust to Supply Shocks	548
	CASE STUDY 19-4 Petroleum Shocks and Stagflation in the United States	550
	CASE STUDY 19-5 Impact of an Increase in the Price of Petroleum	551
	CASE STUDY 19-6 Actual and Natural Unemployment Rates and Inflation in the United States	551
	Summary	552
	Key Terms	553
	Questions for Review	553
	Problems	554
	Selected Bibliography (on Web)	
	INTERNet (on Web)	

20 FLEXIBLE VERSUS FIXED EXCHANGE RATES, THE EUROPEAN MONETARY SYSTEM, AND MACROECONOMIC POLICY COORDINATION 555

20.1	Introduction	555
20.2	The Case for Flexible Exchange Rates	556
	20.2A Market Efficiency	556
	20.2B Policy Advantages	557
20.3	The Case for Fixed Exchange Rates	558
	20.3A Less Uncertainty	558
	20.3B Stabilizing Speculation	560
	20.3C Price Discipline	561

CASE STUDY 20-1 Macroeconomic Performance under Fixed and Flexible Exchange Rate Regimes	563
20.3D The Open-Economy Trilemma	564
20.4 Optimum Currency Areas, the European Monetary System, and the European Monetary Union	565
20.4A Optimum Currency Areas	565
20.4B European Monetary System (1979–1998)	566
CASE STUDY 20-2 The 1992–1993 Currency Crisis in the European Monetary System	567
20.4C Transition to Monetary Union	568
CASE STUDY 20-3 Maastricht Convergence Indicators	569
20.4D Creation of the Euro	569
CASE STUDY 20-4 Benefits and Costs of the Euro	571
20.4E The European Central Bank and the Common Monetary Policy	572
CASE STUDY 20-5 The Eurozone Crisis	573
20.5 Currency Boards Arrangements and Dollarization	574
20.5A Currency Board Arrangements	574
20.5B Dollarization	574
CASE STUDY 20-6 Argentina's Currency Board Arrangements and Crisis	575
20.6 Exchange Rate Bands, Adjustable Pegs, Crawling Pegs, and Managed Floating	576
20.6A Exchange Rate Bands	576
20.6B Adjustable Peg Systems	577
20.6C Crawling Pegs	577
20.6D Managed Floating	579
CASE STUDY 20-7 Exchange Rate Arrangements of IMF Members	580
20.7 International Macroeconomic Policy Coordination	581
Summary	583
Key Terms	584
Questions for Review	584
Problems	584
Appendix	585
A20.1 Exchange Rate Arrangements	585
Selected Bibliography (on Web)	
INTERNet (on Web)	

21 THE INTERNATIONAL MONETARY SYSTEM: PAST, PRESENT, AND FUTURE

589

21.1 Introduction	589
21.2 The Gold Standard and the Interwar Experience	590
21.2A The Gold Standard Period (1880–1914)	590

21.2B	The Interwar Experience	592
21.3	The Bretton Woods System	593
21.3A	The Gold-Exchange Standard (1947–1971)	593
21.3B	Borrowing from the International Monetary Fund	594
21.4	Operation and Evolution of the Bretton Woods System	595
21.4A	Operation of the Bretton Woods System	596
21.4B	Evolution of the Bretton Woods System	596
	CASE STUDY 21-1 Macroeconomic Performance under Different Exchange Rate Regimes	598
21.5	U.S. Balance-of-Payments Deficits and Collapse of the Bretton Woods System	599
21.5A	U.S. Balance-of-Payments Deficits	599
21.5B	Collapse of the Bretton Woods System	600
21.6	The International Monetary System: Present and Future	602
21.6A	Operation of the Present System	602
21.6B	Current IMF Operation	604
21.6C	Problems with Present Exchange Rate Arrangements	605
21.6D	Proposals for Reforming Present Exchange Rate Arrangements	607
21.6E	Financial Crises and the International Monetary System	609
	CASE STUDY 21-2 The Anatomy of a Currency Crisis: The Collapse of the Mexican Peso	610
	CASE STUDY 21-3 Chronology of Economic Crises in Emerging Markets	610
	CASE STUDY 21-4 The 2008–2009 Global Financial Crisis and Great Recession	613
21.6F	Other Current International Economic Problems	614
	CASE STUDY 21-5 Trade Imbalances of the Leading Advanced Nations	616
	Summary	618
	Key Terms	619
	Questions for Review	620
	Problems	620
	Appendix	621
A21.1	International Reserves: 1950–2014	621
	Selected Bibliography (on Web)	
	INTERNet (on Web)	

GLOSSARY OF KEY TERMS 623

NAME INDEX 637

SUBJECT INDEX 641

CASE STUDY 1-1	The Dell PCs, iPhones, and iPads Sold in the United States are Anything but American!	2
CASE STUDY 1-2	What Is an “American” Car?	3
CASE STUDY 1-3	Is India’s Globalization Harming the United States?	5
CASE STUDY 1-4	Rising Importance of International Trade to the United States	7
CASE STUDY 1-5	The Gravity Model at Work	10
CASE STUDY 1-6	Major Net Exporters and Importers of Capital	11
CASE STUDY 2-1	Munn’s Mercantilistic Views on Trade	30
CASE STUDY 2-2	Mercantilism Is Alive and Well in the Twenty-First Century	31
CASE STUDY 2-3	The Petition of the Candlemakers	38
CASE STUDY 2-4	Other Empirical Tests of the Ricardian Model	46
CASE STUDY 3-1	The Comparative Advantage of the Largest Advanced and Emerging Economies	59
CASE STUDY 3-2	Specialization and Export Concentration in Selected Countries	63
CASE STUDY 3-3	Job Losses in High U.S. Import-Competing Industries	64
CASE STUDY 3-4	International Trade and Deindustrialization in the United States, the European Union, and Japan	65
CASE STUDY 4-1	Demand, Supply, and the International Price of Petroleum	81
CASE STUDY 4-2	The Index of Export to Import Prices for the United States	82
CASE STUDY 4-3	The Terms of Trade of the G-7 Countries	89
CASE STUDY 4-4	The Terms of Trade of Industrial and Developing Countries	89
CASE STUDY 5-1	Relative Resource Endowments of Various Countries	107
CASE STUDY 5-2	Capital–Labor Ratios of Selected Countries	108
CASE STUDY 5-3	Classification of Major Product Categories in Terms of Factor Intensity	112
CASE STUDY 5-4	The Factor Intensity of Trade of Various Countries	113
CASE STUDY 5-5	Has International Trade Increased U.S. Wage Inequalities?	117
CASE STUDY 5-6	Convergence of Real Wages among Advanced Countries	120
CASE STUDY 5-7	Capital and Labor Requirements in U.S. Trade	122
CASE STUDY 5-8	The H–O Model with Skills and Land	125
CASE STUDY 6-1	The New International Economies of Scale	145
CASE STUDY 6-2	Job Loss Rates in U.S. Industries and Globalization	146
CASE STUDY 6-3	U.S. Intra-Industry Trade in Automotive Products	147
CASE STUDY 6-4	Variety Gains with International Trade	148
CASE STUDY 6-5	Growth of Intra-Industry Trade	150
CASE STUDY 6-6	Intra-Industry Trade Indexes for G-20 Countries	151
CASE STUDY 6-7	Index of Intra-Industry Trade of Some U.S. Industries, 2013	152

CASE STUDY 6-8	The United States as the Most Competitive Economy	158
CASE STUDY 6-9	Environmental Performance Index	162
CASE STUDY 7-1	Growth in the Capital Stock per Worker of Selected Countries	175
CASE STUDY 7-2	Growth in Output per Worker from Capital Deepening, Technological Change, and Improvements in Efficiency	179
CASE STUDY 7-3	Growth and the Emergence of New Economic Giants	184
CASE STUDY 7-4	Growth, Trade, and Welfare in the Leading Industrial Countries	187
CASE STUDY 8-1	Average Tariff on Nonagricultural Products in Major Developed Countries	198
CASE STUDY 8-2	Average Tariffs on Nonagricultural Products in Some Major Developing Countries	199
CASE STUDY 8-3	The Welfare Effect of Liberalizing Trade on Some U.S. Products	203
CASE STUDY 8-4	The Welfare Effect of Liberalizing Trade on Some EU Products	204
CASE STUDY 8-5	Structure of Tariffs on Industrial Products in the United States, the European Union, Japan, and Canada	207
CASE STUDY 8-6	Tariff Escalation in Developed and Developing Nations	208
CASE STUDY 9-1	The Economic Effects of the U.S. Quota on Sugar Imports	229
CASE STUDY 9-2	Voluntary Export Restraints (VERs) on Japanese Automobiles to the United States and Europe	231
CASE STUDY 9-3	Antidumping Investigations by G20 Members	235
CASE STUDY 9-4	Agricultural Subsidies in OECD Countries	236
CASE STUDY 9-5	Pervasiveness of Nontariff Barriers	237
CASE STUDY 9-6	Benefits to the World Economy from Complete Trade Liberalization	242
CASE STUDY 9-7	Gains from the Uruguay Round	252
CASE STUDY 9-8	The Multilateral Rounds of Trade Negotiations	253
CASE STUDY 9-9	Benefits from a Likely Doha Scenario	255
CASE STUDY 10-1	Economic Profile of the EU, NAFTA, and Japan	271
CASE STUDY 10-2	Gains from the Single EU Market	273
CASE STUDY 10-3	Mexico's Gains from NAFTA—Expectations and Outcome	275
CASE STUDY 10-4	Economic Profile of Mercosur	278
CASE STUDY 10-5	Changes in Trade Patterns with Economic Integration	279
CASE STUDY 11-1	The East Asian Miracle of Growth and Trade	292
CASE STUDY 11-2	Change in Commodity Prices Over Time	297
CASE STUDY 11-3	The Growth of GDP of Rich Countries, Globalizers, and Nonglobalizers	303
CASE STUDY 11-4	Manufactures in Total Exports of Selected Developing Countries	305
CASE STUDY 11-5	The Foreign Debt Burden of Developing Countries	307
CASE STUDY 11-6	Globalization and World Poverty	309

CASE STUDY 12-1	Fluctuations in Foreign Direct Investment Flows to the United States	320
CASE STUDY 12-2	The Stock of Foreign Direct Investments Around the World	323
CASE STUDY 12-3	The World's Largest Non-Petroleum, Industrial Corporations	328
CASE STUDY 12-4	Employment of U.S. MNCs Abroad	329
CASE STUDY 12-5	U.S. Immigration and Debate over Immigration Policy	335
CASE STUDY 13-1	The Major Goods Exports and Imports of the United States	350
CASE STUDY 13-2	The Exploding U.S. Trade Deficit with China	352
CASE STUDY 13-3	The Major Trade Partners of the United States	353
CASE STUDY 13-4	The United States as a Debtor Nation	357
CASE STUDY 14-1	The U.S. Dollar as the Dominant International Currency	367
CASE STUDY 14-2	The Birth of a New Currency: The Euro	368
CASE STUDY 14-3	Foreign Exchange Quotations	371
CASE STUDY 14-4	Size, Currency, and Geographical Distribution of the Foreign Exchange Market	378
CASE STUDY 14-5	Carry Trade	385
CASE STUDY 14-6	Size and Growth of Eurocurrency Market	392
CASE STUDY 15-1	Absolute Purchasing-Power Parity in the Real World	403
CASE STUDY 15-2	The Big Mac Index and the Law of One Price	403
CASE STUDY 15-3	Relative Purchasing-Power Parity in the Real World	406
CASE STUDY 15-4	Monetary Growth and Inflation	413
CASE STUDY 15-5	Nominal and Real Exchange Rates, and the Monetary Approach	414
CASE STUDY 15-6	Interest Differentials, Exchange Rates, and the Monetary Approach	415
CASE STUDY 15-7	Exchange Rate Overshooting of the U.S. Dollar	424
CASE STUDY 15-8	The Euro Exchange Rate Defies Forecasting	427
CASE STUDY 16-1	Currency Depreciation and Inflation in Developing Countries during the 1997-1998 East Asian Crisis	442
CASE STUDY 16-2	Estimated Price Elasticities in International Trade	448
CASE STUDY 16-3	Other Estimated Price Elasticities in International Trade	449
CASE STUDY 16-4	Effective Exchange Rate of the Dollar and U.S. Current Account Balance	450
CASE STUDY 16-5	Dollar Depreciation and the U.S. Current Account Balance	451
CASE STUDY 16-6	Exchange Rates and Current Account Balances during the European Financial Crisis of the Early 1990s	452
CASE STUDY 16-7	Exchange Rate Pass-Through to Import Prices in Industrial Countries	453
CASE STUDY 17-1	Income Elasticity of Imports	471
CASE STUDY 17-2	Private Sector and Current Account Balances	472
CASE STUDY 17-3	Growth in the United States and the World, and U.S. Current Account Deficits	476

CASE STUDY 17-4	Growth and Current Account Balance in Developing Economies	477
CASE STUDY 17-5	Effect of the Asian Financial Crisis of the Late 1990s on OECD Countries	479
CASE STUDY 17-6	Interdependence in the World Economy	484
CASE STUDY 18-1	Government, Private-Sector, and Current Account Balances in the G-7 Countries	494
CASE STUDY 18-2	Relationship Between U.S. Current Account and Budget Deficits	505
CASE STUDY 18-3	Effect of U.S. Fiscal Policy in the United States and Abroad	507
CASE STUDY 18-4	Effect of Monetary Policy in the United States and Other OECD Countries	511
CASE STUDY 18-5	U.S. Monetary and Fiscal Policies during the Past Decade	517
CASE STUDY 18-6	Deeper U.S. Recession without Strong Fiscal and Monetary Measures	518
CASE STUDY 18-7	Direct Controls on International Transactions Around the World	520
CASE STUDY 19-1	Deviations of Short-Run Outputs from the Natural Level in the United States	536
CASE STUDY 19-2	Central Bank Independence and Inflation in Industrial Countries	545
CASE STUDY 19-3	Inflation targeting—A New approach to Monetary Policy	546
CASE STUDY 19-4	Petroleum Shocks and Stagflation in the United States	550
CASE STUDY 19-5	Impact of an Increase in the Price of Petroleum	551
CASE STUDY 19-6	Actual and Natural Unemployment Rates and Inflation in the United States	551
CASE STUDY 20-1	Macroeconomic Performance under Fixed and Flexible Exchange Rate Regimes	563
CASE STUDY 20-2	The 1992–1993 Currency Crisis in the European Monetary System	567
CASE STUDY 20-3	Maastricht Convergence Indicators	569
CASE STUDY 20-4	Benefits and Costs of the Euro	571
CASE STUDY 20-5	The Eurozone Crisis	573
CASE STUDY 20-6	Argentina’s Currency Board Arrangements and Crisis	575
CASE STUDY 20-7	Exchange Rate Arrangements of IMF Members	580
CASE STUDY 21-1	Macroeconomic Performance under Different Exchange Rate Regimes	598
CASE STUDY 21-2	The Anatomy of a Currency Crisis: The Collapse of the Mexican Peso	610
CASE STUDY 21-3	Chronology of Economic Crises in Emerging Markets	610
CASE STUDY 21-4	The 2008–2009 Global Financial Crisis and Great Recession	613
CASE STUDY 21-5	Trade Imbalances of the Leading Advanced Nations	616

Introduction

LEARNING GOALS

After reading this chapter, you should be able to:

- Understand the meaning and importance of globalization
- Understand the relationship between international trade and the nation's standard of living
- Describe the subject matter (trade and monetary aspects) of international economics
- Identify the major international economic problems and challenges facing the United States and the world today

1.1 The Globalization of the World Economy

The world is rapidly globalizing and this is providing many opportunities and major challenges to the nations and people of the world. We begin our study of international economics with a brief overview of the globalization revolution taking place in the world today.

1.1A We Live in a Global Economy

We live in a globalized world. We can connect instantly with any corner of the world by cellular phone, i-Pad, e-mail, instant messaging, and teleconferencing, and we can travel anywhere incredibly fast. Tastes are converging (i.e., more and more people all over the world generally like the same things), and many goods we consume are either made abroad or have many imported parts and components. Many of the services we use are increasingly provided by foreigners as, for example, when a radiography taken in a New York hospital is evaluated across the world in Bangalore (India) and when H & R Block sends our tax returns abroad for processing. Even small companies that until a few decades ago faced only local or regional competition now must compete with firms from across the globe.

Although not as free as the flow of international trade in goods and services, millions of workers at all skill levels have migrated around the world, and thousands of jobs have moved from advanced countries to such emerging markets as India and China.

Finance has also globalized: We can invest in companies anywhere in the world and purchase financial instruments (stocks and bonds) from any company from almost anywhere in the world. Many pension funds are in fact invested abroad, and a financial crisis in one financial center quickly spreads across the world at the click of a mouse. We can exchange dollars for euros and most other currencies easily and quickly, but the rates at which we exchange our currency often change frequently and drastically. In short, tastes, production, competition, labor markets, and financial markets have become highly globalized, and this affects all of us deeply as consumers, workers, investors, and voters—yes, we live in a global economy (see Case Studies 1-1 and 1-2).

CASE STUDY 1-1 The Dell PCs, iPhones, and iPads Sold in the United States are Anything but American!

Headquartered in Round Rock, Texas, Dell coordinates a global production network in 34 countries in the Americas, Europe, and Asia. For most of the PCs sold in the United States, Dell performs only the final assembly domestically and relies on outside suppliers and contract manufacturers for components, peripherals, printed circuit board (PCB) assemblies, and sub-assemblies (box builds). The reason is that most parts and components are cheaper to produce in other parts of the world and are thus imported (see Table 1.1). Neither high-value components nor very low-value components (such as power supplies or keyboards) have to be made close to Dell's assembly plants. Only some midlevel components (such as motherboards and other PCB assemblies), which are too expensive to ship by air to meet volatility in demand, as well as to risk holding in inventory, are produced locally, but even that is not always the case.

More than 90 percent of all the parts and components going into HP's PCs are made outside the United States. The components of an Apple iPhone are almost entirely Asian: the screen is from Japan, the flash memory is from Korea—and it is assembled in China! Apple contributed the design and software, and it integrated the innovations of others. The iPad introduced by Apple is made from parts and components by Samsung and LG Display (Korean); Toshiba (Japanese); Broadcom (United States); Catcher Technologies, Wintek, Simplo Technology, and Novatek Microelectronics (Taiwan); and STMicroelectronics (Italy and France) and assembled in China. Less than 30 percent of the parts and components of the new Boeing 787 Dreamliner jet that went into service in 2011 are made in the United States. The outsourcing of various parts and components in the supply chain of modern production is referred to as *fragmentation*.

TABLE 1.1. Locations and Companies that Supply Specific Parts and Components for Dell's PCs

Part/Component	Location	Company
Monitors	Europe and Asia	Phillips, Nokia, Samsung, Sony, Acer
PCBs	Asia, Scotland, and Eastern Europe	SCI, Celestica
Drives	Asia, mainly Singapore	Seagate, Maxtor, Western Digital
Printers	Europe (Barcelona)	Acer
Box builds	Asia and Eastern Europe	Hon Hai/Foxteq
Chassis	Asia and Ireland	Hon Hai/Foxteq

Sources: J. Dedrick and K. L. Kraemer, "Dell Computer: Organization of a Global Production Network" and "Globalization of the Personal Computer Industry: Trends and Implications," *Working Paper*, Irvine, CA: Center for Research on Information Technology and Organizations (CRITO), University of California, Irvine, 2002; "The Laptop Trail," *The Wall Street Journal*, June 9, 2005, p. 31; "Rising in the East," *The Economist*, January 3, 2009, p. 47; <http://www.ipadforums.net/apple-ipad-news/514-rumor-alert-ipad-release-date-likely-friday-march-26th-2.html>; and "Dreamliner Production Gets Closer Monitoring," *The Wall Street Journal*, October 7, 2009, p. B1; "Boeing 787 Production Target on Track, Supplier Says," at <http://www.bloomberg.com/news/2013-07-19/boeing-787-production-target-on-track-supplier-says.html>; and M. P. Timmer *et al.*, "Fragmentation, Incomes and Jobs: An Analysis of European Competitiveness," *Economic Policy*, October 2013, pp. 613–661.

1.1B The Globalization Challenge

Globalization is a revolution which in terms of scope and significance is comparable to the Industrial Revolution, but whereas the Industrial Revolution took place over a century, today's global revolution is taking place under our very eyes in a decade or two. Globalization, of course, is not new. Roman coins circulated throughout the empire 2,000 years ago; Chinese currency was used in China even earlier. More recently, the world has experienced three periods of rapid globalization, 1870–1914, 1945–1980, and 1980 to the present.

CASE STUDY 1-2 What Is an “American” Car?

Strange as it may seem, the question of what is an American car may be difficult to answer. Should a Honda Accord produced in Ohio be considered American? What about a Chrysler minivan produced in Canada (especially now that Chrysler is owned by Fiat)? Is a Kentucky Toyota or Mazda that uses nearly 40 percent of imported Japanese parts American? Clearly, it is becoming more and more difficult to define what is American, and opinions differ widely.

For some, any vehicle assembled in North America (the United States, Canada, and Mexico) should be considered American because these vehicles use U.S.-made parts. But the United Auto Workers union views cars built in Canada and Mexico as taking away U.S. jobs. Some regard automobiles produced by Japanese-owned plants in the United States as American because they provide jobs for Americans. Others regard production by these Japanese “transplants” as foreign, because (1) the jobs they create were taken from the U.S. automakers, (2) they use nearly 40 percent imported Japanese parts, and (3) they remit profits to Japan. What if Japanese transplants increased their use of American parts to 75 percent or 90 percent? Was the Ford Probe, built for Ford by Mazda in Mazda’s Michigan plant, American?

It is difficult to decide exactly what is an American car—even after the American Automobile Labeling

Act of 1992, which requires all automobiles sold in the United States to indicate what percentage of the car’s parts are domestic or foreign. One could even ask if this question is relevant at all in a world growing more and more interdependent and globalized. In order to be competitive, automakers must purchase parts and components wherever they are cheaper and better made, and they must sell automobiles throughout the world to achieve economies of mass production. Ford designs its automobiles in six nations (the United States, the United Kingdom, Germany, Italy, Japan, and Australia), has production facilities in 30 locations (3 in North America, 3 in South America, 7 in Asia, and 17 in Europe), and employs more workers outside than in the United States. In fact, the automotive and many other industries are rapidly moving toward a handful of truly global, independent companies.

Sources: “Honda’s Nationality Proves Troublesome for Free-Trade Pact,” *The New York Times*, October 9, 1992, p. 1; “What Is a U.S. Car? Read the Label,” *The New York Times*, September 18, 1994, Section 3, p. 6; “Made in America? Not Exactly: Transplants Use Japanese Car Parts,” *The Wall Street Journal*, September 1, 1995, p. A3B; “And Then There Were Five,” *U.S. News & World Report*, March 4, 2000, p. 46; “What Is an American Car?” *The Wall Street Journal*, January 26, 2009, p. A5; and “One Ford for the Whole World,” *Businessweek*, May 15, 2009, pp. 58–59.

Globalization in 1870–1914 resulted from the Industrial Revolution in Europe and the opening up of new, resource-rich, but sparsely populated lands in North America (the United States and Canada), South America (Argentina, Chile, and Uruguay), Australia and New Zealand, and South Africa. These lands received millions of immigrants and vast amounts of foreign investments, principally from England, to open up new lands to food and raw material production. These so-called regions of recent settlement grew rapidly during this period by exporting increasing amounts of food and raw materials to Europe in exchange for manufactured goods. This period of modern globalization came to an end with the breakout of World War I in 1914.

The second period of rapid globalization started with the end of World War II in 1945 and extended to about 1980. It was characterized by the rapid increase of international trade as a result of the dismantling of the heavy trade protection that had been put in place during the Great Depression that started in the United States in 1929 and during World War II. What is different about the present globalization revolution (since 1980) is its speed, depth, and immediacy resulting from the tremendous improvements in telecommunications and transportation, massive international capital flows resulting from elimination of most restrictions on their flow across national boundaries, as well as by the participation of most

countries of the world. This is what makes today's globalization that much more pervasive and dramatic than earlier periods of globalization. The recent (2008–2009) global financial and economic crisis, the deepest of the postwar period, only slowed down the march of globalization temporarily.

As all revolutions, however, today's globalization brings many benefits and advantages but also has some disadvantages or harmful side effects. In fact, there is a great deal of disagreement as to the extent and type of advantages and disadvantages. Does getting cheaper and/or better products and service from abroad justify sacrificing domestic jobs? Why are some people in some countries very rich and obese while others dismally poor and starving?

Although labor migration generally leads to the more efficient utilization of labor, it also leads to job losses and lower wages for less-skilled labor in advanced nations and harms (i.e., it is a “brain drain” for) the nations of emigration. Similarly, financial globalization and unrestricted capital flows lead to the more efficient use of capital throughout the world, as well as provide opportunities for higher returns and risk diversification for individuals and corporations. But they also seem to lead to periodic international financial crises, such as the ones that started in Asia in 1997 and affected most other developing countries and the subprime housing mortgage crisis that started in the United States in 2007 and affected the entire world in 2008 and 2009. Finally, are we running out of resources such as petroleum, other minerals, and water? Is the world headed for a climate disaster?

These disadvantages and negative aspects of globalization have given rise to a rethinking of the age-old belief in free trade and to a strong [antiglobalization movement](#), which blames globalization for many human and environmental problems throughout the world, and for sacrificing human and environmental well-being to the corporate profits of multinationals. Globalization is being blamed for world poverty and child labor in poor countries, job losses and lower wages in rich countries, as well as environmental pollution and climate change throughout the world. Although there is some truth in these accusations, an in-depth economic analysis will show that often the primary cause of many of the serious problems facing the world today lies elsewhere (see Case Study 1-3).

Globalization has many social, political, legal, and ethical aspects, and so economists need to work closely with other social and physical scientists, as well as with the entire civil society to give globalization a more human face (i.e., have all nations and people share its benefits). Globalization is important because it increases efficiency in the production of material things; it is inevitable because we cannot hide or run away from it. But we would like globalization also to be sustainable and humanizing and, ultimately, “fair.” This requires a profound change in world governance. Such is the challenge facing humanity today and in this decade.

All these topics and many more are either directly or indirectly the subject matter of international economics that are covered in this text.

1.2 International Trade and the Nation's Standard of Living

The United States, stretching across a continent and rich in a variety of human and natural resources, can produce, relatively efficiently, most of the products it needs. Contrast this with the situation of small industrial countries, such as Switzerland or Austria, that have a few very specialized resources and produce and export a much smaller range of products and import all the rest. Even large industrial countries such as Japan, Germany, France, England, Italy, and Canada rely crucially on international trade. For developing nations, exports provide employment opportunities and earnings to pay for the many products that they cannot now produce at home and for the advanced technology that they need.

CASE STUDY 1-3 Is India's Globalization Harming the United States?

The outsourcing of low-skilled service industry jobs (such as answering customer inquiries) from advanced countries to low-wage countries, such as India, reduces costs and prices in advanced countries, and it does not create much concern. In recent years, however, many high-skill and high-pay jobs in such diverse fields as computing and aircraft engineering, investment banking, and pharmaceutical research have been transferred to India and other emerging markets, creating great concern in advanced nations, especially the United States. Table 1.2 shows the outsourcing of high-tech services and jobs to India by some U.S. multinationals in 2008.

Companies such as IBM, Citigroup, and Morgan Stanley point out that outsourcing high-skill and high-wage jobs to India (and other emerging markets,

especially China) where they can be done more cheaply keeps them internationally competitive, leads to lower prices for their products and services to American consumers, and is necessary for them to take advantage of fast-growing emerging markets. Transferring abroad many high-skill and high-paying jobs, as well as the crucial technologies on which they are based, however, inevitably causes great concern in the United States, not only for the loss of good U.S. jobs but also for the ability of the United States to remain the world's technological leader.

Because of this and rising labor and other costs in some emerging markets, especially China, some manufacturing is heading back to the United States and other advanced nations.

TABLE 1.2. Globalizing India

U.S. Company	Global Work Force	Work Force in India	Percentage in India	Outsourced Services
Accenture	146,000	27,000	18.5	By the end of 2008, the company has had more workers in India than in the United States
IBM	356,000	52,000	14.6	Independent development of software solutions for Indian and global clients
Citigroup	327,000	22,000	6.7	Analysis of U.S. stocks and evaluation of creditworthiness of U.S. companies

Sources: "India's Edge Goes Beyond Outsourcing," *The New York Times*, April 4, 2008, p. C1; "IBM to Cut U.S. Jobs, Expand in India," *The Wall Street Journal*, March 26, 2009, p. B1; "Outsourced Forever," *Forbes*, September 26, 2011, pp. 38–39; "Benefits of Outsourcing Comes under Scrutiny," *The Financial Times*, October 16, 2013, p. 1; and "Manufacturers Capitalize on Goods Made in the U.S.," *The Financial Times*, October 16, 2013, p. 2.

A rough measure of the economic relationship among nations, or their **interdependence**, is given by the ratio of their imports and exports of goods and services to their gross domestic product (GDP). The GDP refers to the total value of all goods and services produced in the nation in a year. Figure 1.1 shows that imports and exports as a percentage of GDP are much larger for smaller industrial and developing countries than they are for the United States. Thus, international trade is even more important to most other nations than it is to the United States.

Even though the United States relies to a relatively small extent on international trade, a great deal of its high standard of living depends on it. First of all, there are many commodities—coffee, bananas, cocoa, tea, scotch, cognac—that the country does not produce at all. In addition, the United States has no deposits of such minerals as tin, tungsten, and chromium, which are important to certain industrial processes, and it has only dwindling reserves of copper and many other minerals. Much more important *quantitatively* for the nation's standard of living are the many products that could be produced domestically but only at a higher cost than abroad. We will see later that these account for most of the *benefits or gains from trade*.

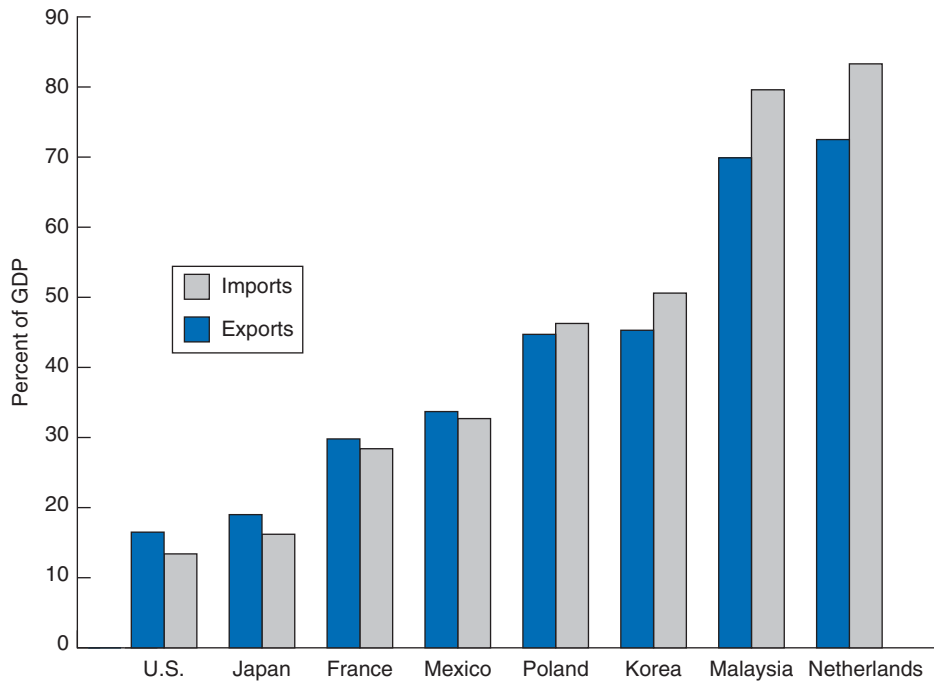


FIG. 1.1. Imports and Exports As a Percentage of GDP in Various Countries in 2014.

International trade (imports and exports) is even more important to most other smaller industrial and developing countries than it is to the United States.

Source: International Monetary Fund, *International Financial Statistics* (Washington, D.C.: IMF, July 2015).

Nevertheless, the United States could probably withdraw from world trade and still survive without too drastic a decline in its standard of living. The same cannot be said of such nations as Japan, Germany, England, or Italy—not to speak of Switzerland or Austria. Even Russia and China, which for political and military reasons have valued self-sufficiency very highly in the past, have now come to acknowledge their need to import high-technology products, foreign capital, and even grains, soybeans, and other agricultural commodities and at the same time be able to export large quantities of their goods and services in order to pay for all the imports they need.

In general, the economic interdependence among nations has been increasing over the years, as measured by the more rapid growth of world trade than world production (see Figure 1.2). This has certainly been the case for the United States during the past five decades (see Case Study 1-4). The only exception to world trade rising, and rising faster than world GDP, was in 2001 and 2009 because of the world recession. In 2012 and 2013, however, trade growth has been only slightly lower than world growth. The recent slower growth of world trade (see Figure 1.2) is believed to have resulted mostly from some reversal in fragmentation in world production. For example, the share of Chinese imports of parts and components in its merchandise exports decreased from its peak of 60 percent in the mid-1990s to about 35 percent in 2012.

But there are many other crucial ways in which nations are interdependent, so that economic events and policies in one nation significantly affect other nations (and vice versa). For example, if the United States stimulates its economy, part of the increased

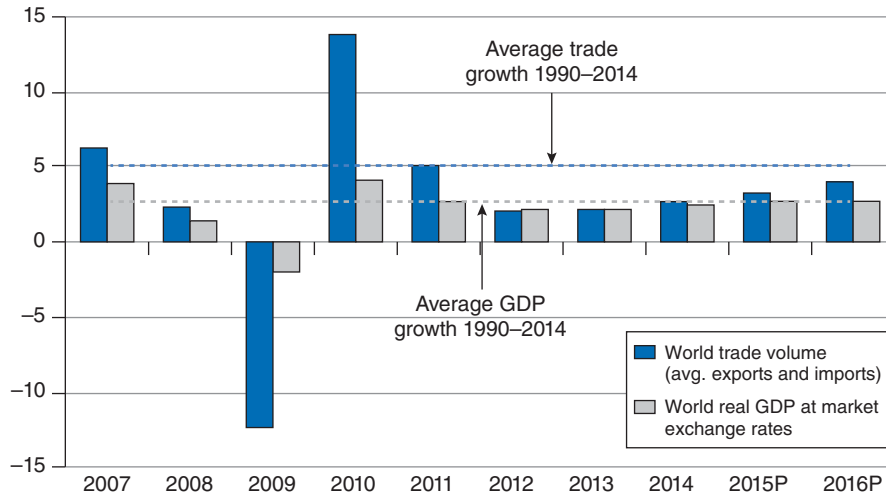


FIG. 1.2. Growth of World Trade and GDP, 2000–2014 (annual percentage changes).

International trade grew much faster than world production from 2000 to 2008 and 2010 to 2011.

Source: World Trade Organization, *World Trade Report*. Geneva: WTO, 2015, p. 18. See also C. Constantinescu, A. Mattoo, and M. Ruta, "The Global Trade Slowdown: Cyclical or Structural?" *IMF Working Paper WP/15/6*, January 2015.

demand for goods and services by its citizens spills into imports, which stimulate the economies of other nations that export those commodities. On the other hand, an increase in interest rates in the United States is likely to attract funds (capital) from abroad and increase the international value of the dollar. This stimulates U.S. imports and discourages U.S. exports, thus dampening economic activity in the United States and stimulating it abroad.

Finally, trade negotiations that reduce trade barriers across nations may lead to an increase in the exports of high-technology goods (such as computers) and thus to an increase in

CASE STUDY 1-4 Rising Importance of International Trade to the United States

After remaining at between 4 and 5 percent during most of the 1960s, imports and exports of goods and services as percentages of gross domestic product (GDP) rose sharply in the United States during the 1970s. Figure 1.3 shows that imports as a percentage of U.S. GDP increased from about 5 percent during the late 1960s to more than 10 percent of GDP in 1980 and to a high of nearly 18 percent in 2008 before falling below 14 percent in 2009 as a result of the U.S. recession. Exports increased from about 5 percent in the late 1960s to about 10 percent in 1980 and to a high of nearly 13 percent of GDP in 2008, but it fell to 11.4 percent of GDP in 2009 because of recession or slow growth abroad.

Afterward, both U.S. imports and exports rose as a percentage to GDP and were, respectively, 16.5 percent and 13.4 percent in 2014. The figure shows that international trade has become more important to the United States (i.e., the United States has become more interdependent with the world economy) during the past five decades. Figure 1.3 also shows that the share of imports in GDP exceeded the share of exports since 1976, and the excess widened sharply during the first half of the 1980s and then again from 1996 to 2006. This led to huge U.S. trade deficits and persistent demands for protection of domestic markets and jobs against foreign competition by American industry and labor.

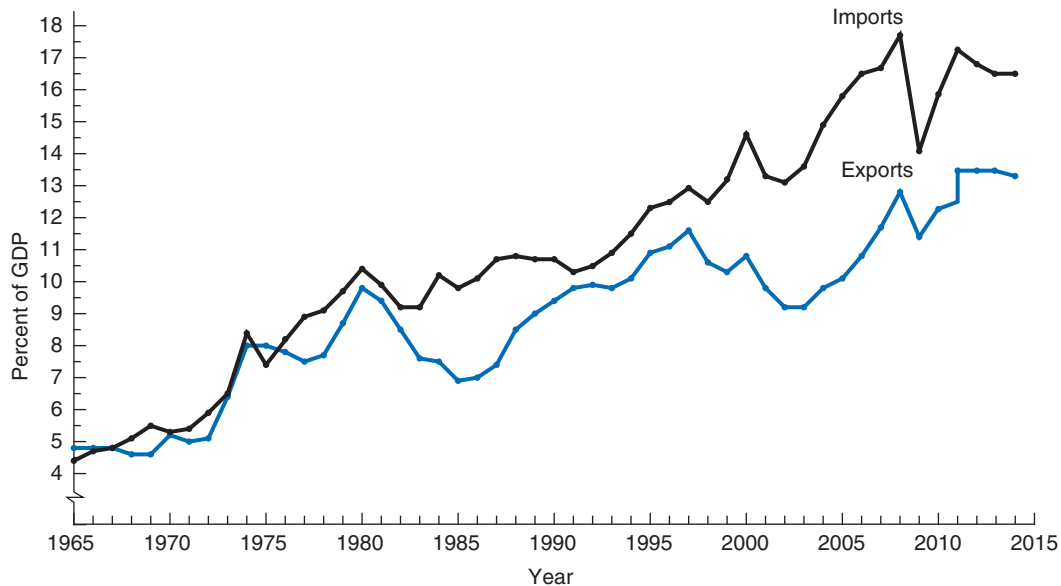


FIG. 1.3. Imports and Exports As a Percentage of U.S. GDP, 1965–2014.

The share of imports and exports in U.S. GDP increased sharply since the early 1970s. Thus, international trade has become increasingly important to the United States. During the first half of the 1980s, and again from 1996 to 2006, U.S. imports greatly exceeded U.S. exports, resulting in huge trade deficits for the United States.

Source: International Monetary Fund, *International Financial Statistics Yearbook* (Washington, D.C.: IMF, Various Issues).

employment and wages in those industries in the United States but also to an increase in imports of shoes and textiles, thereby reducing employment and wages in those sectors. Thus, we see how closely linked, or interdependent, nations are in today's world and how government policies aimed at solving purely domestic problems can have significant international repercussions.

1.3 The International Flow of Goods, Services, Labor, and Capital

Interdependence in the world economy is reflected in the flow of goods, services, labor, and capital across national boundaries.

1.3A The International Flow of Goods and Services: The Gravity Model

We have seen that international trade is of growing importance to the nation's well-being. But which are the major U.S. trade partners and why? In general, we would expect nations to trade more with larger nations (i.e., with nations with larger GDPs) than with smaller ones, with nations that are geographically closer than with nations that are more distant (for which transportation costs would be greater), with nations with more open economic systems than

with nations with less open systems, and with nations with similar language and cultural background than with nations that are more different.

In its simplest form, the **gravity model** postulates that (other things equal) the bilateral trade between two countries is proportional, or at least positively related, to the product of the two countries' GDPs, and to be smaller, the greater the distance between the two countries (just like in Newton's law of gravity in physics). That is, the larger (and the more equal in size) and the closer the two countries are, the larger the volume of trade between them is expected to be.

The gravity model can be expressed as follows:

$$T = C \cdot \frac{Y_1 \cdot Y_2}{D} \quad (1-1)$$

where

T = the value of the international trade between two countries (1 and 2)

C = a constant

Y = GDP

D = the distance between countries 1 and 2

Gravity Equation (1-1) reads as follows: T (the value of international trade between countries 1 and 2) is equal to C (a constant) times Y_1 (the GDP of country 1) times Y_2 (the GDP country 2), divided by D (the distance between countries 1 and 2). The constant, C , gives (scales) the magnitude of the relationship among the gravity terms (i.e., Y_1 and Y_2 and D). We expect the relationship to hold only approximately because there are other factors that affect trade between two countries besides the major ones specified by the model.

The value of trade between two countries tends to be greater than otherwise if the two countries have the same language, share a similar cultural background, and have unrestricted trade between them (as is the case between the United States and Canada that not only share the same language and a similar cultural background but also have, together with Mexico, a free trade agreement—NAFTA—discussed in Chapter 10). Indeed, deviations from the value of trade between two countries predicted by the gravity model are an indication and a measure of the extent to which the trade context between the two nations differs from the one most conducive to trade.

At the same time, the value of trade between the United States and Canada predicted by the model is not as large as that predicted by the model between any two adjacent states of the United States or provinces of Canada. Obviously, there are still other forces (i.e., remaining differences in culture and the existence of “buy national” preferences) at work that make trade between adjacent states and provinces of the same country greater than the international trade between even very similar countries (see Case Study 1-5).

1.3B The International Flow of Labor and Capital

Besides trade in goods and services, the international flow of people (migration) and capital across national boundaries is another measure or indicator of economic integration and globalization in the world economy.

Today, there are about 190 million people in the world who live in a country other than the one in which they were born—nearly 60 percent of them are in rich countries (about 36 million in Europe and 38 million in the United States). People migrate primarily for