Chapter 1

International Economics Is Different

# Overview

The introduction to the subject of international economics has three major purposes:

1. Show that international economics addresses important and interesting current events and issues.
2. Show why international economics is special.
3. Provide a broad overview of the book.

We begin with four controversies that show the importance of current issues addressed by international economics.

The first controversy began with innovation of hydraulic fracturing and horizontal drilling to extract natural gas from shale in the United States. U.S. production increased and U.S. prices decreased. The new production technology provides the United States with comparative advantage in natural gas (Chapters 3, 4, and 7 discuss comparative advantage). The United States was poised to become a major exporter of natural gas, but a 1938 law prohibits exports unless they are judged to be in the “public interest.” A group of U.S. chemical and other firms that use natural gas in their own production processes supported export limits so that the increased U.S. natural gas production results in general benefits rather than just profits to exporters. Should the U.S. government allow a large increase in U.S. natural gas exports? Is exporting in the national interest? Key themes from the course apply to this case. As discussed in Chapter 2, allowing exports will benefit some groups in the country (U.S. producers of natural gas and export distributors) and harm others (U.S. users and consumers of natural gas). If any environmental effects are small, then the economic analysis is clear. U.S. producers gain more than consumers lose, so exporting is in the national interest. What about environmental effects? The analysis of Chapter 13 applies. Production of natural gas using fracking can generate external costs. With negative externalities to domestic production, the country will tend to export too much, unless there is a government policy that forces producing firms to recognize and manage the spillover costs. As of late 2014, this case was still evolving, with the U.S. government moving slowly in providing export approvals.

The second controversy arises from international migration, especially the increasingly vehement complaints about immigrants in many of the major receiving countries. In these countries a rather large (10 percent or more) and rising percentage of the population is foreign-born, including many who are in their new countries illegally. Opponents accuse immigrants of causing general economic harm, imposing fiscal costs as immigrants use government services, and increasing crime. International economics is often about emotional issues like immigration, yet we do our best to use economic analysis to think objectively about actual economic effects. In a preview of the analysis of Chapter 15, we highlight two key conclusions about the effects of immigration on the receiving country. First, as with many issues in international economics, there are both winners and losers in the receiving country. Second, we can determine the net effect on the receiving country. As we often conclude when we examine freer international exchange, the net national effect of immigration is positive according to the basic economic model, in this case even if we ignore the gains to the immigrants themselves.

The third controversy is the exchange rate value of the Chinese yuan. From the mid-1990s to 2005, the Chinese government maintained a fixed exchange rate of the yuan to the U.S. dollar. As China’s trade surplus increased and the Chinese government continually had to enter the foreign exchange market to buy dollars and sell yuan to keep the exchange rate steady, the United States and the European Union increasingly complained about the fixed rate. In 2005 the Chinese government began to allow gradual increases in the exchange-rate value of the yuan. In mid-2008, in response to the worsening global crisis, the Chinese government reverted to a fixed exchange rate. Then, as the Chinese economy resumed its rapid growth and China’s government continued to amass international reserves through its intervention to defend the fixed exchange rate, foreign pressures reemerged. In mid-2010 China’s government again began to allow gradual appreciation of the yuan.

In the controversy over China’s exchange rate policy, we can see many of the issues that we will examine in Chapters 16-25 of the book, including the measurement and meaning of a country’s balance of payments (including its trade balance), government policies toward the foreign exchange market and how a government defends a fixed exchange rate against market pressure for the exchange rate value to change, foreign financial investments and the role of currency speculators, political pressures that can place limits on how long a country with a fixed exchange rate and a trade surplus can maintain the fixed rate value, and how exchange rates affect not only a country’s trade balance, but also its national macroeconomic performance (including production, employment, and inflation).

The fourth controversial development is the euro crisis. The euro was born in 1999, with the European Central Bank (ECB) overseeing the euro and conducting monetary policy for the euro area. The number of European Union countries using the euro went from 11 in 1999 to 16 in 2009. Generally, in its first decade the euro looked successful. The global financial and economic crisis that began in 2007 and intensified in 2008 caused a deep recession in the euro area countries, but recovery began in mid-2009.

Crises then hit a series of euro area countries, Greece in 2010 (beginning as a fiscal and sovereign debt crisis), Ireland later in 2010 (beginning as a banking crisis following a burst housing price bubble), and Portugal in 2011 (a credit boom and bust). Contagion spread these crises to adversely affect Spain and Italy in 2011 and 2012. As the euro crisis intensified, it threatened the continued existence of the euro itself. Because both the causes of the crisis and the possible solutions were and are controversial, the ECB reacted slowly, first with a mild form of quantitative easing through loans to banks in late 2011 and early 2012. The ECB moved more decisively with a commitment to “do whatever it takes” in July 2012, with the commitment formalized as the Outright Monetary Transactions program in September. The crisis subsided, though, as of late 2014, macroeconomic weakness lingers (and Greece is in depression).

We discuss the euro crisis throughout the second half of the book. Monetary union is an extreme form of fixed exchange rates. The euro crisis was three interrelated forms of crisis—government debt (fiscal), banking, and macroeconomic. The national use of fiscal policy within the euro area remains highly controversial. Is fiscal policy more a tool for improving national macroeconomic performance, or is it more a source of instability for individual countries and for the union as a whole?

These four controversies show that international economics addresses important current issues. They also can be used to show why international economics is special—why national boundaries matter in economics. The first reason that international economics is special is that some resources do not move freely between countries. Land is essentially immobile. There are substantial impediments to the movement of labor internationally, as we see in the analysis of international migration, because of the personal and economic costs to people of moving from one country to another, and because of restrictive government policies. Financial capital moves more freely, but there still seems to be a home bias to many people’s financial investments.

The second reason that international economics is special is that national government policies matter—in fact, they matter in two ways. One way is that national governments can adopt policies toward international transactions, as we see in the political decision to limit U.S. exports of natural gas. The other way is that national governments adopt different economic policies. These national policies usually are designed to serve national interests, but they often have international effects. We see the tension between national interests and international effects in the discussion of China’s exchange rate policy.

# Tips for teaching

One good way to begin the first class session is with a look at current events, even before the mechanics and requirements of the course are presented. The instructor might use the day’s newspaper (for instance, the *Financial Times* or *Wall Street Journal*) or the week’s magazine (for instance, the *Economist* or *Business Week*) to highlight a few stories related to the content of the course. We have found that this is good way to get the students’ attention and interest. Another good beginning would be to provide a discussion that updates one or more of the four controversies in Chapter 1. For example, the instructor could look at the most recent information on China’s trade balance and the exchange rate value of its yuan.

You may want to consider beginning other class sessions of the course (not only the first class session) with a look at one or two stories in that day’s newspaper. The stories should relate in some way to the material covered in the course, but they do not necessarily have to relate to the specific material covered in that day’s session. We have found that this look at current events reinforces the relevance of international economic analysis. It also encourages students to read a good newspaper or magazine and to keep up with current events. In addition, we can model critical reading, if we both summarize the article’s information and offer our own opinion or analysis (or ask the students for their opinions).

The instructor may also point out that there is a lot of information on international issues available on the Web. Figure A.1 in Appendix A provides a list of some important sites.

One issue in teaching is to get students to “take ownership” of the learning of the material. One good way to accomplish this is to get them to teach some of the material. In doing so they gain greater understanding as well as appreciation for the applicability of what sometimes sound like dry concepts and abstract issues. You may want to consider an assignment like the one that Pugel (and others at New York University) have been using successfully. It asks students working in groups to choose a topic based on current and recent events or developments and prepare and make a brief presentation to the rest of the class, during the second half of the course term. The accompanying pages under the heading “Sample Assignment” show a version of this assignment. It is good to get such an assignment set up early in the term, so that students have enough time to gather information and prepare the talk. One more thought—in evaluating each presentation, you may want to get the students in the audience involved by asking each to complete a brief evaluation form for each presentation.

# Sample assignment

NEW YORK UNIVERSITY

Stern School of Business

The Global Economy

Group Presentations

Each group will give a presentation to the class about one of the topics listed below. Your presentation is an opportunity to hone your research and presentation skills, to apply concepts from this course (and possibly from other courses), to attack a real issue, and to show off your creativity.

The formal presentation should last no longer than 15 minutes. In addition, after the presentation, you will have 5 minutes to take and answer questions from the class. I suggest you plan a talk that fills about 14 minutes to ensure that you finish within time. Going over the time limit for the presentation will result in a lower evaluation score for “style” and overall assessment.

For the oral part of the presentation, all group members must be involved in speaking. One aspect of the presentation is the ability to transition from one group member to the next as each in turn makes part of the presentation.

Evaluation will be based on three criteria:

* Informativeness: Information and data—how much did we learn from your presentation?
* Analysis and interpretation: Did you effectively use concepts and relationships from the course (and possibly from other courses) to analyze and/or interpret the information that you have? Were your conclusions sound? Did we gain novel insights into the topic?
* Style: Was your presentation logically structured, clear, and compelling? Were the slides effective? Did you keep within the time limit?

Above all, keep your classmates interested. If you use PowerPoint or similar slides, you should bring your presentation file to class on a USB memory stick.

**Presentation Topics**

Choose your topic from the list below. Topics will be allocated on a first-come, first-served basis.

Each topic comes with a set of questions. There is some scope to modify the questions, if you think it would lead to a more interesting presentation. Just ask me first.

After you know your topic, the group should search for information and start to plan the presentation. After you have an idea of what you will talk about, make an appointment to meet with me. You should come to speak with me at least once before giving your presentation**.** For many topics you can find much information on the Web. With Web research, it is up to you to verify that a source is credible and accurate.

Here are the suggested topics.

**International Outsourcing/Offshoring of Services**

Beginning in the 1990s, firms in the United States and other industrialized countries increasingly shifted service activities and jobs to developing countries, especially India. How large is this type of offshoring? How large could it be in the future? Why has it been controversial in the United States? Is it different from regular international trade? Should the U.S. government limit the ability of U.S. firms to send these jobs to other countries?

**Do African Countries Trade Too Little with Each Other?**

Countries that are closer to each other geographically tend to trade more with each other. Does this pattern hold as strongly across Africa as it does in other areas of the world? What do the data show? To the extent that African countries tend to trade less with each other than might otherwise be expected, how large is the “shortfall”? Why is there less international trade within Africa? Is the problem mostly a lack of free trade areas and similar bilateral and multilateral governmental agreements? Would African countries benefit from trading more with each other? What is the outlook for growing international trade within Africa during the next decade or so?

**The 2009 U.S. Safeguard Tariff on Tires from China**

In 2009 President Obama imposed an additional, temporary 35 percent tariff on imports of tires from China. Why did the U.S. government impose this tariff? What were the effects of the tariff? Did the tariff achieve the goals that President Obama was pursuing? Did the tariff increase U.S. national well-being? What alternative policy options did the U.S. government have? Would any of those have been better for the U.S. economy than imposing the tariff?

**ASEAN**

The member countries of ASEAN have committed to forming a true free trade area. What are the goals for this AFTA? How much progress has been made? Why has progress not been faster? Are there important issues that seem to thwart or limit the effort? What will happen over the next five years or so?

**CAFTA**

The United States, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua, and the Dominican Republic signed the Central American Free Trade Agreement in 2004. What are the key features of the agreement? Why did the various national governments push to reach the agreement? Why has the agreement been controversial in some of the member countries? What effects has CAFTA had in its first years?

**Cotton**

U.S. policies toward cotton have become globally controversial. What are these policies? What effects do they have on the global cotton market? Why have the policies become controversial? How has the WTO been involved in efforts to alter U.S. cotton policies? How have U.S. policies toward cotton changed in recent years? What is the outlook for the next several years?

**Russia and the WTO**

After years of negotiations, Russia joined the WTO in December 2011. What was the process for Russia to accede to membership? Why did it take so long for Russia to become a member? What were the major issues that had to be resolved? What have been, and what will be, the major effects of Russia becoming a WTO member?

**Locating a New Business Processing Center: India or Ghana?**

A major firm in the business processing industry is looking to expand its capacity for providing call center and data entry services for its clients. It is considering locating a new facility in India, where it already has other facilities, or in Ghana, a country in which it does not currently operate. What are the strengths and weaknesses of Ghana, relative to India, as a location for this facility? What could the company request from Ghana’s government if the company were to decide to locate the facility in Ghana? What would Ghana’s government agree to provide to the company? Overall, would you recommend that the company locate its new facility in India or in Ghana? Why?

**Ecuador**

Ecuador dollarized in 2000. Why did the Ecuadorian government choose this policy? In what ways does it seem to have helped the Ecuadorian economy? In what ways has it hurt or caused problems or costs? Do you think that it was a good or bad idea for Ecuador to dollarize?

**Sovereign Wealth Funds**

Some national governments use sovereign wealth funds to invest in a wide range of international financial assets. How large are these funds? What are their funding sources? Are they like other international investors? Should countries receiving their investments be concerned? How should sovereign wealth funds be regulated?

**Should Hong Kong Alter Its Fixed Exchange Rate Policy?**

The Hong Kong government has maintained a fixed exchange rate between the Hong Kong dollar and the U.S. dollar for three decades. What are the advantages and disadvantages for Hong Kong of having this exchange rate policy? If the Hong Kong government is now considering changing its policy, what are two most likely alternative exchange rate policies that the Hong Kong government could adopt in place of the current fixed value to the U.S. dollar? What are the advantages and disadvantages of each of these? What is the case for Hong Kong to continue to fix at the current value to the U.S. dollar? What is the case for Hong Kong to switch to the next best alternative policy (one of the two you have examined)? What do think will actually happen during the next five years or so?

**Internationalization of the RMB**

Until a few years ago the Chinese yuan (or renminbi) was not much used internationally. In what ways, and to what extent, is this changing? Why? What are the benefits and costs to China from greater international use of the yuan? Should China promote greater international use? What do you think will happen in the next five to ten years? When will the yuan become the equal of the U.S. dollar in international uses?

**Poland To Join the Euro Area?**

Poland could be the next country to adopt the euro and join the euro area. Does Poland qualify to join? What are the economic and political advantages to Poland of joining? What are the economic and political disadvantages of joining? Should Poland join the euro area in the next few years? Do you think that Poland actually will join the euro area in the next few years?

**Greece To Leave the Euro Area?**

Greece was the beginning of the euro crisis, and Greece’s economy has deteriorated since then. There has been much discussion of whether Greece should leave the euro area and stop using the euro. What has been the macroeconomic performance of Greece’s economy during the past decade or so? What are the economic advantages to Greece of leaving the euro area? What the economic disadvantages to Greece of leaving the euro area? Should Greece leave the euro area? Do you think that Greece actually will exit the euro area during the next several years?

**What Country is Ripe for a Speculative Attack on Its Currency?**

Identify a country that you think has a substantial probability of a speculative attack on the exchange rate value of its currency, sometime during the next several years. Why do think that a speculative attack may be imminent? If a speculative attack does not occur in the next several years, what do think will be most likely explanation for why the attack did not occur? What do you think is the probability that a speculative attack on this currency will occur during the next several years?