Chapter 1
The United States in a Global Economy

◼ Outline

**Introduction: International Economic Integration**

**Elements of International Economic Integration**

 The Growth of World Trade

Capital and Labor Mobility

 Features of Contemporary International Economic Relations

 Trade and Economic Growth

**Twelve Themes in International Economics**

 The Gains from Trade and New Trade Theory (Chapters 3, 4, and 5)

 Wages, Jobs, and Protection (Chapters 3, 6, 7, and 8)

 Trade Deficits (Chapters 9, 11, and 12)

 Regional Trade Agreements (Chapters 2, 13, and 14)

 The Resolution of Trade Conflicts (Chapters 2, 7, and 8)

 The Role of International Institutions (Chapters 2, 8, and 12)

 Exchange Rates and the Macroeconomy (Chapters 10 and 11)

 Financial Crises and the Global Contagion (Chapter 12)

 Capital Flows and the Debt of Developing Countries (Chapters 2, 9, and 12)

 Latin America and the World Economy (Chapter 15)

 Export-Led Growth in East Asia (Chapter 16)

 The Integration of the BRICs into the World Economy (Chapter 17)

◼ A Thumbnail Sketch of the Material Covered in Chapter 1

The goal of Chapter 1 is to examine international economic integration in historical perspective. Most features of globalization aren’t new, and international economic integration is described as re-emerging after a period of disruption during World War I, the Great Depression, and World War II. The chapter adds a brief discussion of new features in the current wave of globalization, including regional trade agreements and multilateral organizations. It also briefly discusses three types of evidence to support the idea of gains from trade: historical experiences of similar countries such as North and South Korea; economic theory; and large statistical comparisons of countries.

There are three aspects of international economic integration considered:

1. *The growth of world trade*. World trade has grown over the last sixty or seventy years but is roughly comparable in percentage terms to trade in 1900.

 Trade has become a larger share of national economies as measured by the:

Trade-to-GDP ratio  (Exports  Imports)/GDP

 This index does not tell us about a nation’s trade policies. Nations with higher figures for the index
of openness do not necessarily have lower trade barriers. Large economies are less dependent on international trade and often have lower measures of openness than small countries do.

 Figure 1.1 shows the openness index for six nations at different points in time. It shows the drop
in trade from 1913 to 1950 and its growth (even above 1913 levels) for most nations by 2000. A trend obscured in the overall trade data is that in 1890 most U.S. trade was in agricultural products and raw materials, while today it is mostly in manufactured goods. The relative importance of capital goods has increased dramatically.

2. *Capital and labor mobility*. Labor is much less mobile internationally now than it was in 1900.
For capital, it is somewhat more mobile. There is a difference between financial capital and physical capital. Foreign Direct Investment (FDI) is the flow of capital representing physical assets such as real estate, factories, and businesses. While capital flows to developing countries have increased in recent decades, the level of investment in any country is still correlated with its domestic level of savings, making national savings rates an important element in national economies.

 Capital flows today differ from earlier periods in three ways. More types of financial instruments exist today, and flows of financial capital are likely much greater. In 1900, the world operated on a fixed exchange rate standard, and much of today’s financial market transactions are aimed at protecting against exchange rate risk caused by floating exchange rates. Transactions costs associated with foreign capital flows have also fallen significantly. Volatility in international capital flows, while often a subject of intense attention today, is not new.

3. *Movement of prices in different markets*. The text does not develop this, but points out that in the
late 1800s wheat farmers, meat packers, and fruit growers all produced for a global market where international, rather than domestic, supply and demand determined prices. News reports today could easily demonstrate this for most commodities.

New issues in international trade and investment:

1. *Deeper integration*. Barriers to manufactured goods have fallen significantly as a result of a process that began at the end of WWII. As formal restrictions on imports have been reduced, domestic policies on issues such as the environment, labor, and fair market conditions have become the barriers to further increases in trade flows. Reducing trade barriers has been the focus of negotiations between nations. Eliminating the traditional barriers to trade, tariffs, and quotas is referred to as shallow integration because it just changes policies “at the border.” Eliminating domestic policy differences that create trade barriers is much more complicated and is referred to as deep integration.

2. *Regional trade agreements*. Since the 1960s, and increasingly after 1990, nations have formed preferential trade agreements with one or more other nations. The European Union, NAFTA, ASEAN, ASEAN+3, and a host of other agreements have provided privileged market access for member countries.

3. *Multilateral organizations*. While the number of preferential trade agreements has grown dramatically, it has occurred within an international economic environment that contains several
key international institutions: the WTO, IMF, and World Bank are each important and are the main institutions discussed in the text. Their roles are discussed more fully in Chapter 2.

Economists are in agreement that the benefits of trade outweigh the costs, although there is a great deal of disagreement over the form that trade agreements should take (and if preferential agreements are even desirable), the role that multilateral institutions should play, and the optimal trade policy for developing countries.

◼ What Students Should Know after Reading Chapter 1

Chapter 1 challenges the belief that the world has embarked on an entirely new and unprecedented era of globalization. In the long run, it seems clear that the period 1870 to 1914 was an earlier era with similar trends. Those years experienced rapid technological change, which came into widespread use in the form of railways, steamships, and telegraphs; they underwent business and financial sector innovation through rapid growth in the corporate form of business organization, the invention and spread of demand deposits, and the development of stock markets; trade policies were liberalized in many nations; and there were widespread protests against immigration and the global economy. In the United States, the protest movement was centered in populist movements that are reminiscent of the rhetoric of some politicians and commentators today.

This is not an argument about history repeating itself. Rather, it is an attempt to encourage students to think of the period from World War I to the end of World War II as an aberration in the last 150 years of world history. The long-run trend is toward integration, punctuated by protests and nationalistic movements that temporarily halt or reverse the trend. When students are asked what they think is new about today’s economy, they inevitably answer “technology.” E-mail, faxes, satellite systems, jet aircraft, and less visible forms such as container cargo transportation systems have each made significant contributions to increasing trade flows. It is useful to engage students in a discussion over the marginal impacts of these new technologies versus the marginal effects of steam-powered oceangoing vessels or transatlantic telegraphy. Telegraphy cut the time it took information to cross the ocean from around three weeks to relatively instantaneously, and reduced the time it took to buy a foreign bond from around three weeks to roughly one day.

It is useful for students to realize two points. First, much of what has happened over the last fifty years has been aimed at fixing something that was broken, not creating a new phenomenon. Second, the international institutions that deal with the global economy are new and were created because of a shared recognition that integration was important and helpful and needed to be encouraged. An important sub-theme of the text is the idea of deep versus shallow integration and the institutional process that nations go through to create deeper levels of integration.

The chapter also cover issues unique to today's economic climate. Important points include flexible exchange rates, regional trade agreements, and the changing mix of the types of goods nations produce. Domestic policies will be a key focus when trade barriers and capital flows are considered. Another important issue will be the developing role of international organizations in negotiating and enforcing changes in domestic policies.

◼ Assignment Ideas

1. I like to use the trade-to-GDP ratio to contrast the importance of trade to various nations and to drive home the fact that relative value matters. The United States is a huge participant in trade in dollar terms, but it is not as dependent on trade as many other countries. Some countries’ entire economies are dependent on international trade. I find students need some practice calculating and interpreting the trade-to-GDP ratio.

 The data below are from the World Trade Organization (exports and imports, http://www.wto.org/english/res\_e/statis\_e/trade\_data\_e.htm) and the International Monetary Fund (GDP, <http://www.imf.org/external/pubs/ft/weo/2012/02/weodata/index.aspx>). They are for 2011 and are in billions of current U.S. dollars.

|  |  |  |  |
| --- | --- | --- | --- |
| **Country** | **Exports** | **Imports** | **GDP** |
|  | Goods | Services | Goods | Services |  |
| Bahrain | 19.6 | 3.0 | 12.7 | 1.8 | 25.9 |
| Brazil | 256.0 | 36.7 | 236.9 | 73.1 | 2,492.9 |
| Cambodia | 6.9 | 2.2 | 9.3 | 1.4 | 12.9 |
| Chad | 4.6 | 0.2 | 2.4 | 1.9 | 9.3 |
| New Zealand | 37.7 | 9.9 | 37.1 | 10.8 | 158.9 |
| Nigeria | 116.0 | 2.3 | 55.0 | 22.5 | 244.0 |

2. For homework very early in the course, I sometimes assign each student a nation to study, with its trade-to-GDP ratio as one of the pieces of information to collect. I also ask them to find out its currency and its current exchange rate with the U.S. dollar, primary exports, imports, major trading partners, and the trade agreements in which it participates. The WTO’s Trade Profiles (http://stat.wto.org/Home/WSDBHome.aspx?Language=E) has much of this data and is a useful data source for students. For comparison with U.S. historical data, you might ask them to track the nation’s trade figures over time. While these are basic matters of record, I find it helps make what we are discussing more concrete.

3. The chapter also lends itself to students developing some factual knowledge about U.S. trade history. One possibility is to look at U.S. trade policy through various time periods. The U.S. had relatively high tariffs (greater than 40 percent on average) throughout the second half of the nineteenth century. In 1890, Congress passed the McKinley Tariff, followed in 1897 by the Dingley Tariff. Both tariffs raised rates further from their already high base. President Wilson tried to reduce tariffs but was thwarted by World War I. Rates in the 1920s fell, but the Tariff Act of 1930 (Smoot-Hawley Tariff) raised the rates back up to nearly 45 percent. In the midst of the Great Depression (1934), Roosevelt and his secretary of state, Dulles, persuaded Congress to pass the Reciprocal Trade Agreement Act. The act authorized Roosevelt to negotiate bilateral, reciprocal tariff reduction agreements. This piece of legislation marks an historic shift in U.S. tariff policy, away from protectionism and toward more openness.

◼ Answers to End-of-Chapter Questions

1. How can globalization and international economic integration be measured?

**Answer:** The chapter offers three ways to measure globalization and economic integration: (1) trade flows; (2) factor movements; and (3) convergence of prices (goods, factors, and assets).

2. In what sense is the U.S. economy more integrated with the world today than it was a century ago?
In what ways is it less integrated?

**Answer:** The WTO’s Trade Profile for the United States gives an average trade-to-GDP ratio of 28.3 for 2009-2011. That implies that the United States’ ratio is about 150 percent greater today than it was in 1913 ((28.3  11.2)/11.2  1.53).

At the same time, the composition of goods traded has changed from agricultural output to manufactured goods. This is consistent with the observation that world trade has been growing faster than world output, at least since 1950. Much of the growth in trade since then, however, simply brought us back to where we were before World War II.

In terms of labor flows, the United States is probably less integrated with the world economy than it was in 1890 or 1900. During that time we had an open door immigration policy (for all but Chinese citizens), and a larger share of our population was foreign born (14.5 in 1890 versus less than 8 percent in 1990 and 12 percent today).

Capital flows are more difficult to generalize since they can be measured several ways. While the absolute volume of capital flows has increased dramatically, as a share of world GDP it is probably no more than it was at the turn of the twentieth century, and it may even be less. The level of investment in nearly all countries is still highly correlated with domestic savings rates. What is different, however, is the ease with which capital can cross international boundaries (lower transaction costs) and the much greater variety of assets that are traded. The need to protect against exchange rate risk is a key component of today’s international financial markets and is a primary difference from the fixed exchange rate standard of the past. The incidence of financial crises has not increased and, as a metric of integration, it implies no increase in capital market integration.

The growth of regional trade agreements is also an indicator of increased integration.
A growing role for international institutions such as the IMF or World Bank may
also indicate an increase in international integration.

3. What does the trade-to-GDP ratio measure? Does a low value indicate that a country is closed to trade with the outside world?

**Answer:** The trade-to-GDP ratio is a measure of the relative importance of trade to a national economy. It is measured by the ratio of exports plus imports to GDP.

A relatively small ratio does not necessarily mean that an economy is intentionally closed to the outside world. Large countries like the United States have large domestic markets that enable firms to specialize and produce in volume in order to attain an optimal scale. Specialization and high volume in manufacturing is often associated with increased productivity, so firms in large markets can achieve the highest possible level of productivity without having to sell to foreign markets. Firms located in smaller countries have to trade their output across international boundaries if they want to have the same technology and the same level of productivity. Consequently, large countries tend to have lower trade-to-GDP ratios regardless of their trade policies.

4. Describe the pattern over the last century shown by the trade-to-GDP ratio for leading industrial economies.

**Answer:** The ratio fell between 1913 and 1950, but then began to rise relatively rapidly. The main causes of the pattern shown in Figure 1.1 are the two world wars and the Great Depression of the 1930s, and changes in trade policy accompanying that period. By 2000, the ratios were mostly higher than they were before World War I. Another pattern the chapter notes is that the ratio is smaller for the large population countries of Japan and the United States, and higher for The Netherlands, with its small population.

5. Trade and capital flows were described and measured in relative rather than absolute terms. Explain the difference. Which term seems more valid—*relative or absolute?* Why?

**Answer:** Absolute values are the dollar amounts of trade and capital flows. Relative values are the ratio of dollar values to GDP. Relative values are a better indicator of the importance of trade and capital flows since they are proportional to the size of national economies. Large economies like the United States may have large export and import values, but the importance of trade to the national economy is not nearly as great as it is for other economies. The United States is a large exporter and importer, but the national economy is so large that trade is much less important for the United States than it is for many smaller countries such as Canada, Belgium, or The Netherlands.

6. In relative terms, international capital flows may not be much greater today than they were
a hundred years ago, although they are certainly greater than they were fifty years ago. Qualitatively, however, capital flows are different today. Explain.

**Answer:** Major qualitative difference between late nineteenth and late twentieth century capital flows include the fact that there are many more types of financial instruments available now compared to a century ago. These instruments can be finely tailored to the income and risk preferences of investors. Secondly, a large share of the total flow of capital across borders is related to the need to protect against fluctuations in the value of currencies. This use of international capital markets was not as necessary when nations operated within fixed exchange rate systems. Third, the transaction costs of participating in international capital markets are much lower today than it was a century ago.

7. What are the new issues in international trade and investment? In what sense do they expose national economies to outside influences?

**Answer:** The new issues involve policy differences between nations that until recently were considered the exclusive responsibility of local or national governments. Examples include labor standards, environmental standards, competition or antitrust policies, and industrial support policies.

Negotiations between nations potentially give foreign interests a voice in setting domestic policy. The scope and the depth of the negotiations determine how great a voice foreigners will have. It is often the case, however, that negotiations either occur or are proposed because some aspect of domestic policy is perceived by foreigners as a barrier to trade, and they seek to alter the domestic policy that created it.

8. Describe the three kinds of evidence economists use to support the assertion that economies open to the world grow faster than economies that are closed.

**Answer:** These are: (1) casual empirical evidence of historical experience; (2) economic logic and deductive reasoning; and (3) evidence of statistical comparisons of countries.

(1) The historical evidence examines the experiences of countries that tried to isolate themselves from the rest of the world. First, not only did trade protection exacerbate the Depression of the 1930s, but it also led to the misery and tragedy of World War II. Second, an examination of countries such as former East and West Germany, North and South Korea, and other countries with the same historical, economic, and ethnic background that were divided by war, indicate that those who closed their economies from the rest of the world suffered in terms of prosperity and environmental degradation. East Asia experienced an economic takeoff when it decided to integrate with the rest of the world, while Latin America, which had the same economic background as East Asia but chose to remain partially closed, experienced mediocre growth.

(2) The logic of economic theory also suggests a strong causal relation between trade and faster economic growth. The following is a summary of this linkage:

 Following Adam Smith, David Ricardo proved that comparative advantage leads to trade and this in turn leads to the reallocation of resources and the improvement of the standard of living of any nation, large or small. Modern trade theory also makes the case for exports and open trade as the causes for economic expansion. Exports and open trade foster competition, innovation, and learning by doing and bring international best practices to the attention of domestic producers, spurring greater efficiency and export expansion. This helps domestic producers to realize economies of scale when they attempt to produce for the world market rather than for their own limited base of domestic consumers. Larger markets create incentives for firms to engage in research and development, and allow countries to import important production inputs and foreign capital by minimizing foreign exchange constraints. They facilitate the transfer of technology and managerial skills. It follows that open trade and exports increase the demand for the country’s output and therefore contribute strongly to positive economic growth.

(3) Even though the statistical evidence is not quite conclusive (mainly due to measuring trade policy), the evidence of statistical comparison of countries (cross-sectional time series) indicates that countries benefit from open trade.