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Bo Södersten

and

Geoffrey Reed

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Preface to the Third Edition

The first edition of *International Economics*, written by Bo Södersten, was published in Swedish in 1969, with the American and British editions following in 1970 and 1971. The second edition was published in 1980. This third edition has been extensively rewritten by Bo Södersten and Geoffrey Reed.

The first and second editions were well received, and used in many countries. Their aim was to present a reasonably rigorous treatment of international economics in a way that would be accessible both to undergraduate students and to others with a general interest in economics and international affairs. The emphasis was on theory, although problems of economic policy were discussed throughout. The intention was to provide the reader with theoretical tools that could be applied to various kinds of problems, not just those that happened to be topical when the book was published.

This intention has been maintained in the third edition. There have, however, been many new developments in both economic theory and the institutional setting since the second edition, and the new edition has been substantially revised to take account of these.

Part I is concerned with the pure theory of international trade. It starts with the classical and neo-classical models of inter-industry trade that have been the mainstay of trade theory since the early nineteenth century, and are still much in use today. Such theories are concerned with explaining the determinants of what was, for many years, the dominant pattern of trade, with each country exporting the output of some industries and importing the output of others. More recently it has become apparent that much trade, at least between developed countries, is intra-industry in nature: that is, countries simultaneously import and export the same type of good. A major feature of recent trade theory has been the development of models explaining this phenomenon, usually in terms of product differentiation and economies of scale, and a discussion of such theories is included in Part 1. The gains from international trade, and the adjustment problems faced when a country opens its market to foreign competition, are discussed in the context of both types of trade.

Part II deals with trade policy. The reduction since the Second World War in the 'old' forms of protection, notably tariffs and quotas, has been to some extent restraints, accompanied by the development of regional trading blocs that combine free trade among members while maintaining

barriers to trade with other countries. Part II examines the arguments for and against both the old and the new protectionism, including an account of the contribution made by the renewed interest in the political economy of protection, and the role of the General Agreement on Tariffs and trade in securing and maintaining trade liberalisation. It deals also with the question of the best trade strategies to be followed by developing countries, and with the influences of foreign investment and multi-national enterprises.

Part III concentrates on international macroeconomics, discussing both international monetary problems and the implementation of macroeconomic policy in an open economy. There have been major changes in the institutional setting in the last two decades, and it is arguable that further changes are inevitable. Such changes have provided the stimulus for both new economic theories and the revival of some others.

There has been a significant increase in empirical studies in all areas of international economics in recent years. This reflects the development of new theories, and the wish to test them against both each other and the older theories, and is made possible by the availability of more comprehensive and reliable data and the development of econometric and other quantitative techniques. Discussions of empirical analyses form an important part of the third edition.

The structure and contents of the third edition are in many ways similar to those of the second edition, and so the acknowledgements made there still apply. There is, however, much new material, and we are grateful to Kevin Dowd, David Greenaway, Robert Hine and Mervyn Lewis for their willingness to read earlier efforts.

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Introduction: International Economics and Economic Theory

Today the national state is the dominant political entity. Most countries, from an economic point of view, are still intimately linked with others. Two – the United States and China – could conceivably withdraw from the world economy without disastrous consequences to themselves. For other countries such an act would border on the unthinkable. It would bring about not only a drastic lowering of economic welfare but also a complete change of ways of life. For practical purposes, all countries must accept the fact that they are part of a world economy. No country can escape its role in the system of interdependent trading nations.

There now seems little doubt that the degree of interdependence among nations has increased markedly over the last two decades or more. World trade has grown exceptionally fast in the post-war years, both absolutely and relative to national incomes. The forces behind the internationalisation process have been strong. Technical progress in transport and communication has played an important role. Increased returns to scale in production and high income elasticities for differentiated products have also had their impact. These and many other factors have favoured international specialisation and trade, both in tangible goods and in services. The forces working for economic interdependence among nations seem irresistible.

Although the nation-state is still in the 1990s the dominant entity, the increasing interdependence between countries has meant the loss of some degree of sovereignty. Some countries have surrendered a good part of their sovereignty willingly, for example the members of the European Community (although even there we see fierce debate over the degree to which sovereignty should be ceded to a central institution). Others, while unwilling to surrender sovereignty, are nevertheless constrained in how they can exercise their autonomy. Even the United States must nowadays take account of the reactions of other countries when formulating its economic policies.

Although governments are generally aware of the losses that would be incurred if they were to isolate themselves completely from the world economy, they are still often tempted to adopt policies that reduce the degree of dependence. Governments in the advanced industrial countries

are often concerned to limit the impact on their own economies of changes in the rest of the world, whether these be 'shocks', such as the increase in oil prices in 1973, or 'structural changes', such as the threat to domestic industries of imports from newly industrialising countries. Many less developed countries have also tried to establish a policy of self-reliance. They have tried to isolate themselves from international influences by a policy of import-substitution. It may however be argued that those countries, whether developed or developing, that have grown most quickly in the last few decades have been those that have not attempted to isolate themselves from the world economy.

Whether the degree of interdependence will continue to increase or not, and if so on what lines, is a matter for debate. On the one hand we see increasing interdependence between groups of countries, either formally, as in the European Community or the North American Free Trade Area, or informally, as in the 'Pacific Rim' countries. On the other hand, there is evidence of increasing friction over economic matters, as between the United States, the European Community, and Japan. The 'free trade versus fair trade' debate is important here, providing an impetus towards unilateral action. Some observers have suggested that the world economy will move towards a system of economic blocs, within which there will be free trade, but between which there will not. The forces working for a national identity – perhaps a new type of identity, be it from dominating neighbours or a new type of changed social and political system – are also strong in many countries. Whether existing trends toward internationalisation or new forms of nationalism will get the upper hand is impossible to say. This is primarily a political question.

■ *International economics as a subject*

Even if most people are agreed that international economic relations are of great importance for most countries, it does not necessarily follow that international economics should be studied as a subject independent of other branches of economics.

There are certainly many policy problems and problems within international economics that the use of economic theory can elucidate. At the same time, it is becoming less tenable for economists to discuss the policy options open to a government as though the economy were closed from the rest of the world, so that much of 'domestic economics' is necessarily discussed in an international setting. However, there are more deep-seated reasons why international economics has a long tradition as a subject in its own right.

Many theorems and insights central to economic theory have been developed by economists working within international economics. The

theory of comparative advantage and the factor-price equalisation theorem are examples. Both belong to the area usually called the *pure theory* of international trade. The pure theory of trade can be said to be part of price theory, the terms used in a broad sense. But price theory or micro theory *per se* seldom pursues the subject to such a degree that all the aspects of the theory which are of interest to a trade theorist are revealed in its full implications. Trade theory is a distinct part of modern economic theory with a rich body of theorems.

Analogous conditions hold for the macroeconomic parts of international economic theory. Some of its results, for instance those about income determination in open economies, are quite straightforward applications of the corresponding parts of the theory for closed economies. But other parts, for instance exchange-rate theory, can hardly be obtained except from a study of the specific theory.

When it comes to the policy aspects of the subject, it is quite obvious that the policy problems faced by an open economy are quite different to those faced by the closed economy. While the assumption that an economy is closed may be tenable for some problems (such as whether to impose a tax on a non-traded good that makes up a minor part of national output), in most cases the discussion must recognise the openness of the economy. The nation is however not only a distinct political entity: it also has many important economic characteristics that set it apart from the larger integrated areas that make up the world economy: the mobility of the factors of production is much larger within the nation than among nations, there are tariffs and taxes on imported goods, different currencies give rise to specific problems, etc. All these lead to international economic policy problems that must be considered in the context of many countries rather than one country.

There are, therefore, from both theoretical and policy points of view, good reasons why international economics is dealt with as a specific branch of economics. Modern economics is a large and diversified subject. A training in general economic theory is the best background for a study of international economics. But it can only be regarded as a background. To obtain a real understanding of the field, the student will have to study international economics directly.

Now we shall now consider briefly five areas in which international economics has had something important to contribute to economics in general, and preview some of the problems and results.

■ *Comparative advantage and pure theory*

One of the basic questions facing international trade theory is: Why does trade take place? The classical economists saw labour as the only factor of

production and said that differing labour productivity among countries caused trade. More recent economists have seen the source of trade as being differences in countries' endowments of factors of production. The most recent development has been to explain trade flows in terms of imperfectly competitive markets, so-called intra-industry trade.

A closely linked question is: Why do countries gain by trading? The classical economists said that as long as cost conditions differ between countries, at least one and probably both will gain by trading. The modern theory of intra-industry trade tends to focus as much on the role played by consumers' tastes.

These questions, and their answers, contain the essence of the theory of comparative advantage. The first can be said to state the positive side and the second the normative side. The normative aspect is perhaps the most interesting to the modern student. It demonstrates, on very weak assumptions, that trade will be beneficial to all countries involved in trade. It is important to understand the nature of this theory. It has often been attacked and is often misunderstood. It is still frequently argued that trade is detrimental to countries, today especially in connection with less-developed countries (LDCs). Right from the outset, therefore, we will enter disputed territory. Whatever the student's final opinion is, he will have to undertake a certain amount of theoretical work before he can reach an informed judgement.

One of the central assumptions of the classical economist was that factors of production were fully mobile within countries but not at all mobile between countries. Labour could move freely from New York to Arizona, but it could not cross the border into Mexico. This is an assumption that modern trade theorists have stuck to in elaborating the modern theory of trade. It might seem to be too strong. Within Western Europe, for instance, there have been substantial movements of workers, largely north from Portugal, Spain, southern Italy, Greece and Turkey to France, Germany and Switzerland. But the movements of labour have taken place primarily between somewhat integrated areas. The movement of workers between the United States and Europe, for example, is still insignificant.

For many purposes the assumption that labour is immobile between countries is valid. Using this (and some other fairly stringent assumptions), modern trade theory has proved some startling theorems. One is that trade alone will lead to a complete equalisation of factor prices. Even in the absence of factor movements, if only goods can be traded freely, wages will be equalised.

A study of modern trade theory will also help the student understand one of the basic principles of economics, that of *general equilibrium*. Trade theory is essentially a branch of general-equilibrium analysis. It is firmly

embedded in the Walrasian tradition. From there stems the preoccupation with creating a theory that is self-contained, where all variables of importance enter and where all variables are interdependent. Such a theory will of necessity be of an abstract and simplified nature. It works with a few well-defined variables and relies on simplifying assumptions, some of which are of a drastic nature. Its strength lies in the fact that it creates a picture of the world which in important ways is complete.

At the heart of general-equilibrium theory are the notions of determinateness and completeness: the relations which describe an economy must form a complete whole where all the variables of the system can be determined. The viewpoint that all factors which make up an economy hang together and are dependent on one another has had a very strong place in economic theorising. It might even be said to have been *the* distinctive feature of economics as a science. It had also had important policy implications as it has forced policy-makers to try to view the economy as a whole and not simply try to focus the attention on the effect of a parameter change on one or two obvious variables. The pure theory of trade offers the student an excellent illustration of one of the basic notions of economics as a science.

■ *Comparative statics: the question of change*

The pure theory of trade is fundamentally a static theory. It studies some aspects of trading economies in the setting of static equilibrium. It abstracts from one fundamental aspect, that of change.

The simplest way to study the effects of change is by the use of comparative statics. We take an economy in a given equilibrium and then introduce a change in some of the basic variables. This is done, for example, in the study of the effects of economic growth on international trade. Growth of production and trade in the world economy has been very rapid in the post-war years. The more precise theory of growth and trade was also primarily developed during this period. From a methodological point of view, this type of theory is also interesting because it illustrates clearly how the static models of pure trade theory can be developed in a comparative-static way. It clearly demonstrates also some of the basic effects of economic growth on the variables in the trade model. One question it answers is the following. Let us assume that economic growth occurs in two trading economies. What will be the effects on the terms of trade (the ratio of export prices to import prices) and on national income? The answer will depend on which sectors growth occurs in and what the income elasticities are.

The effects of increases in factor endowments and technical progress are also studied. These effects can be handled clearly by the use of geometry.

An understanding of this type of theory therefore does not involve very advanced or difficult methods. The effects of technical progress, for instance, are quite striking. An understanding of this kind of theory is essential also for a broad group of problems outside the field of international trade, so it seems appropriate to treat the theory of economic growth and trade rigorously and explicitly.

■ *Trade policy: is trade good or bad?*

The book is based on the principle of decreasing abstraction. The most theoretical parts are in the beginning, especially in Part I; then, as the exposition develops, it becomes more and more policy oriented – it assumes more of an ‘applied’ nature. This is because theory is needed to appreciate all the facets of a policy problem. It is logical to start with theory and then proceed to policy, though it perhaps seems that policy problems are sometimes ‘easier’ to deal with than theoretical questions.

Part 2 is devoted to problems of trade policy. It both demonstrates principles of trade policy, for example the effects of tariffs on trade, and analyses the factual development of trade policy, and in particular the political dimension of the formulation of that policy. One thing Part 2 shows is that free trade, in a world of sovereign states, is usually the best policy except in the case of the few large countries, but that the political pressure to restrict trade may be difficult to resist. However, since some trade is always better than no trade, it is unlikely that trade will ever be eliminated.

The trade problems of the developed countries and the LDCs are seldom of the same kind. One of the trade problems confronting LDCs is the stabilisation of commodity prices. Together with the question of tariff preferences, this problem has dominated the UNCTAD conferences held so far. These questions are also intimately linked with the strivings for a new economic world order.

The proposals for stabilisation of commodity prices are of different kinds. The object of some is to stabilise terms of trade between LDCs and industrial countries; others, less far-reaching, aim at stabilising export prices or export proceeds. To understand the true nature of some of these plans, they must be considered against the models of growth and trade developed earlier. These models show explicitly the basic factors that determine the development of commodity prices in international trade. Therefore, they show clearly which factors have to be controlled if international prices are to be controlled. They give an example of how recent developments in trade theory can be used to elucidate long-standing policy problems.

■ *Macroeconomic aspects: different currencies*

One of the obvious differences between trade within a country and international trade is that the latter involves different currencies. If a New Yorker trades with a Californian, they both use the same currency, but trade between a New Yorker and a Canadian involves different currencies.

One essential complication in connection with foreign trade is that the relative values of currencies change. One year, £1 sterling could be worth \$2.00 US, the next, 1.50. This concerns the balance of payments between countries.

Disequilibria in the external balances of countries give rise to changes in exchange rates. The policy problems surrounding disequilibria in the balance of payments and changes in exchange rates are among the most pertinent ones in the world economy. If anything, they have become more important and attracted increasing attention as domestic capital markets have become increasingly integrated.

The first chapters in Part 3 are devoted to these macroeconomic aspects of international economics. The basic principles of foreign exchange markets are discussed and an explanation is given of how a country's balance of payments can be in disequilibrium and how it can be kept in equilibrium.

International monetary matters have been at the forefront of economic theory in recent years, and important reformulations of theory have taken place. They centre around what is commonly called the *monetary approach to the balance of payments*. This theory states (to put it somewhat bluntly) that in the long run the exchange rate will primarily be determined by changes in the money supply. An increase in the money supply will cause inflation. This in turn will cause a depreciation of the exchange rate. This is an illustration of 'the law of one price': if the price level increases, the value of the currency will fall proportionately.

■ *The international monetary system and international policy co-ordination*

The international monetary system underwent great changes in the 1970s. Up until 1971 the Bretton Woods system reigned, which meant that exchange rates were fixed. During the 1960s this system was put under greater and greater strain. Finally, it broke down. It has now been replaced by a system of floating 'exchange rates, but one within which some countries attempt to link their currency to those of other countries.

A system of floating rates does not, however, solve all balance-of-payments problems. Exchange-rate changes have been very large, and international capital flows of increasing importance. Some might argue that the problems posed for economies by the current problems may best be solved by the international co-ordination of macroeconomic policies, others that there should be a return to the pegged exchange rate system of Bretton Woods, yet others that international capital movements should once more be regulated. The closing chapters of Part 3 discuss these questions.