Brief Contents

| Preface v | |
|---|-------------------------------------|
| 1 Introduction | 1 |
| Part 1 International Trade Theory | |
| The Law of Comparative Advantage The Standard Theory of International Trade Demand and Supply, Offer Curves, and the Terms of Trade Factor Endowments and the Heckscher—Ohlin Theory Economies of Scale, Imperfect Competition, and International Trade Economic Growth and International Trade | 31 57 85 109 157 189 |
| Part 2 International Trade Policy | |
| 8 Trade Restrictions: Tariffs 9 Nontariff Trade Barriers and the New Protectionism 10 Economic Integration: Customs Unions and Free Trade Areas 11 International Trade and Economic Development 12 International Resource Movements and Multinational Corporations | 221 257 301 331 367 |
| Part 3 The Balance of Payments, Foreign Exchange Markets, and Exchange Rates | |
| Balance of Payments Foreign Exchange Markets and Exchange Rates Exchange Rate Determination | 397 423 463 |
| Part 4 Open-Economy Macroeconomics and the International Monetary System | |
| The Price Adjustment Mechanism with Flexible and Fixed Exchange Rates The Income Adjustment Mechanism and Synthesis of Automatic Adjustments Open-Economy Macroeconomics: Adjustment Policies Prices and Output in an Open Economy: Aggregate Demand and Aggregate Supply Flexible versus Fixed Exchange Rates, the European Monetary System, and | 507 541 573 617 |
| Macroeconomic Policy Coordination 21 The International Monetary System: Past, Present, and Future | 645 687 |
| Glossary of Key Terms 72 | |
| Name Index 7 | |
| Subject Index | 751 |

Contents

| 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 | |
| ■ Case Study 1-2 What Is an "American" Car? 3 | |
| 1.1B The Globalization Challenge 3 | |
| ■ Case Study 1-3 Is India's Globalization Harming the United States? 5 | |
| 1.2 International Trade and the Nation's Standard of Living 6 | |
| ■ Case Study 1-4 Rising Importance of International Trade to the United States 8 | |
| 1.3 The International Flow of Goods, Services, Labor, and Capital 9 | |
| 1.3A The International Flow of Goods and Services: The Gravity Model 9 | |
| 1.3B The International Flow of Labor and Capital 10 | |
| ■ Case Study 1-5 Major Net Exporters and Importers of Capital 11 | |
| 1.4 International Economic Theories and Policies 11 | |
| 1.4A Purpose of International Economic Theories and Policies 11 | |
| 1.4B The Subject Matter of International Economics 12 | |
| 1.5 Current International Economic Problems and Challenges 13 | |
| 1.6 Organization and Methodology of the Text 15 | |
| 1.6A Organization of the Text 15 | |
| 1.6B Methodology of the Text 16 | |
| Summary 17 | |
| A Look Ahead 18 | |
| Key Terms 18 | |
| Questions for Review 18 | |
| Problems 19 | |
| A1.1 Basic International Trade Data 20 | |
| A1.2 Sources of Additional International Data and Information 24 | |
| Selected Bibliography 26 | |
| INTERNet 28 | |

Part 1 International Trade Theory

| 2 | The Law of Comparative Advantage |
|---|--|
| | 2.1 Introduction 31 |
| | 2.2 The Mercantilists' Views on Trade 32 |
| | CASE STUDY 2-1 Munn's Mercantilistic Views on Trade 33 CASE STUDY 2-2 Mercantilism Is Alive and Well in the Twenty-first Century 33 |
| | 2.3 Trade Based on Absolute Advantage: Adam Smith 34 |
| | 2.3A Absolute Advantage 34 |
| | 2.3B Illustration of Absolute Advantage 35 |
| | 2.4 Trade Based on Comparative Advantage: David Ricardo 36 |
| | 2.4A The Law of Comparative Advantage 36 |
| | 2.4B The Gains from Trade 37 |
| | 2.4c The Case of No Comparative Advantage 39 |
| | 2.4D Comparative Advantage with Money 39 |
| | ■ Case Study 2-3 The Petition of the Candlemakers 41 |
| | 2.5 Comparative Advantage and Opportunity Costs 41 |
| | 2.5A Comparative Advantage and the Labor Theory of Value 41 |
| | 2.5B The Opportunity Cost Theory 42 |
| | 2.5c The Production Possibility Frontier under Constant Costs 42 |
| | 2.5D Opportunity Costs and Relative Commodity Prices 44 |
| | 2.6 The Basis for and the Gains from Trade under Constant Costs 45 |
| | 2.6A Illustration of the Gains from Trade 45 |
| | 2.6B Relative Commodity Prices with Trade 46 |
| | 2.7 Empirical Tests of the Ricardian Model 47 |
| | ■ Case Study 2-4 Relative Unit Labor Costs and Relative Exports—United States and Japan 49 |
| | Summary 50 |
| | A Look Ahead 51 |
| | Key Terms 51 |
| | Questions for Review 51 |
| | Problems 52 |
| | A2.1 Comparative Advantage with More Than Two Commodities 54 |
| | A2.2 Comparative Advantage with More Than Two Nations 55 |
| | Selected Bibliography 56 |
| | INTERNet 56 |

| The Standard Theory of Ir | nternational Trade 57 |
|---|--|
| 3.1 Introduction 57 | |
| 3.2 The Production Frontier | with Increasing Costs 58 |
| 3.2A Illustration of Increa | asing Costs 58 |
| 3.2B The Marginal Rate of | of Transformation 59 |
| 3.2C Reasons for Increasi Production Frontiers | ing Opportunity Costs and Different |
| 3.3 Community Indifference | Curves 60 |
| 3.3A Illustration of Comm | nunity Indifference Curves 60 |
| 3.3B The Marginal Rate of | of Substitution 61 |
| 3.3C Some Difficulties wi | ith Community Indifference Curves 61 |
| 3.4 Equilibrium in Isolation | 62 |
| 3.4A Illustration of Equili | brium in Isolation 62 |
| 3.4B Equilibrium-Relative | e Commodity Prices and Comparative Advantage 63 |
| ■ Case Study 3-1 | Comparative Advantage of the Largest Advanced and Emerging Economies 64 |
| 3.5 The Basis for and the Ga Increasing Costs 64 | ins from Trade with |
| | Basis for and the Gains from Trade with |
| 3.5B Equilibrium-Relative | e Commodity Prices with Trade 66 |
| 3.5c Incomplete Specializ | zation 67 |
| ■ Case Study 3-2 | Specialization and Export Concentration in Selected Countries 67 |
| 3.5D Small-Country Case | with Increasing Costs 69 |
| 3.5E The Gains from Exc | change and from Specialization 69 |
| ■ Case Study 3-3 | Job Losses in High U.S. Import-Competing Industries 70 |
| ■ Case Study 3-4 | International Trade and Deindustrialization in the United States, the European Union, and Japan 71 |
| 3.6 Trade Based on Difference | ces in Tastes 72 |
| 3.6A Illustration of Trade | Based on Differences in Tastes 72 |
| Summary 73 | |

A3.1 Production Functions, Isoquants, Isocosts, and Equilibrium 76
 A3.2 Production Theory with Two Nations, Two Commodities, and

Key Terms 74

Problems 75

Questions for Review 74

Two Factors 78

A4.6 Multiple and Unstable Equilibria

108

Selected Bibliography

INTERNet 108

| Factor Endowments and the Heckscher-Ohlin Theory | 109 |
|---|-------|
| 5.1 Introduction 109 | |
| 5.2 Assumptions of the Theory 110 | |
| 5.2A The Assumptions 110 | |
| 5.2B Meaning of the Assumptions 110 | |
| 5.3 Factor Intensity, Factor Abundance, and the Shape of the Production Frontier 112 | |
| 5.3A Factor Intensity 112 | |
| 5.3B Factor Abundance 114 | |
| 5.3c Factor Abundance and the Shape of the Production Frontier 115 | |
| ■ Case Study 5-1 Relative Resource Endowments of Various Countr 116 | ries |
| ■ Case Study 5-2 Capital—Labor Ratios of Selected Countries 117 | 7 |
| 5.4 Factor Endowments and the Heckscher-Ohlin Theory 118 | |
| 5.4A The Heckscher–Ohlin Theorem 118 | |
| 5.4B General Equilibrium Framework of the Heckscher–Ohlin Theory 11 | 9 |
| 5.4c Illustration of the Heckscher–Ohlin Theory 120 | |
| ■ Case Study 5-3 Classification of Major Product Categories in Ter Factor Intensity 122 | ms oj |
| ■ Case Study 5-4 <i>The Factor Intensity of Trade of Various Countrie</i> 122 | S |
| 5.5 Factor–Price Equalization and Income Distribution 123 | |
| 5.5A The Factor–Price Equalization Theorem 124 | |
| 5.5B Relative and Absolute Factor–Price Equalization 125 | |
| 5.5c Effect of Trade on the Distribution of Income 126 | |
| ■ Case Study 5-5 Has International Trade Increased U.S. Wage Inequalities? 127 | |
| 5.5D The Specific-Factors Model 128 | |
| 5.5E Empirical Relevance 129 | |
| ■ Case Study 5-6 Convergence of Real Wages among Industrial Countries 130 | |
| 5.6 Empirical Tests of the Heckscher–Ohlin Model 131 | |
| 5.6A Empirical Results—The Leontief Paradox 131 | |
| ■ Case Study 5-7 Capital and Labor Requirements in U.S. Trade | 132 |
| 5.6B Explanations of the Leontief Paradox and Other Empirical Tests of the H-O Model 133 | e |
| ■ Case Study 5-8 The H–O Model with Skills and Land 135 | |
| 5.6c Factor-Intensity Reversal 137 | |
| Summary 138 | |

A Look Ahead 139 Key Terms 139

| Questions for Review 139 |
|--|
| Problems 140 |
| A5.1 The Edgeworth Box Diagram for Nation 1 and Nation 2 142 |
| A5.2 Relative Factor–Price Equalization 142 |
| A5.3 Absolute Factor–Price Equalization 145 |
| A5.4 Effect of Trade on the Short-Run Distribution of Income: |
| The Specific-Factors Model 146 |
| A5.5 Illustration of Factor-Intensity Reversal 148 |
| A5.6 The Elasticity of Substitution and Factor-Intensity Reversal 150 |
| A5.7 Empirical Tests of Factor-Intensity Reversal 151 |
| Selected Bibliography 151 |
| INTERNet 155 |
| Economics of Scale Importest Competition, and International Trade 157 |
| Economies of Scale, Imperfect Competition, and International Trade 157 |
| 6.1 Introduction 157 |
| 6.2 The Heckscher–Ohlin Model and New Trade Theories 158 |
| 6.3 Economies of Scale and International Trade 159 |
| ■ Case Study 6-1 <i>The New International Economies of Scale</i> 161 |
| ■ Case Study 6-2 <i>Job Loss Rates in U.S. Industries and Globalization</i> 162 |
| 6.4 Imperfect Competition and International Trade 163 |
| 6.4A Trade Based on Product Differentiation 163 |
| ■ Case Study 6-3 U.S. Intra-Industry Trade in Automotive Products 163 |
| ■ Case Study 6-4 Variety Gains with International Trade 165 |
| 6.4B Measuring Intra-Industry Trade 167 |
| ■ Case Study 6-5 Growth of Intra-Industry Trade 167 |
| ■ Case Study 6-6 Intra-Industry Trade Indexes for G-20 Countries 168 |
| 6.4c Formal Model of Intra-Industry Trade 169 |
| 6.4D Another Version of the Intra-Industry Trade Model 170 |
| 6.5 Trade Based on Dynamic Technological Differences 172 |
| 6.5A Technological Gap and Product Cycle Models 172 |
| 6.5B Illustration of the Product Cycle Model 173 |
| ■ Case Study 6-7 The United States as the Most Competitive Economy |
| 175 6.6 Costs of Transportation Environmental Standards and International Trade 175 |
| 6.6 Costs of Transportation, Environmental Standards, and International Trade 175 |
| 6.6A Costs of Transportation and Nontraded Commodities 175 |
| 6.6B Costs of Transportation and the Location of Industry 177 |
| |
| |

| | 6.6C Environmental Standards, Industry Location, and International Trade 178 |
|---|---|
| | ■ Case Study 6-8 Environmental Performance Index 179 |
| | Summary 179 |
| | A Look Ahead 180 |
| | Key Terms 180 |
| | Questions for Review 181 |
| | Problems 181 |
| | A6.1 External Economies and the Pattern of Trade 182 |
| | A6.2 Dynamic External Economies and Specialization 184 |
| | Selected Bibliography 185 INTERNet 187 |
| | INTERNET 187 |
| 7 | Economic Growth and International Trade 189 |
| | 7.1 Introduction 189 |
| | 7.2 Growth of Factors of Production 190 |
| | 7.2A Labor Growth and Capital Accumulation over Time 190 |
| | 7.2B The Rybczynski Theorem 192 |
| | 7.3 Technical Progress 193 |
| | 7.3A Neutral, Labor-Saving, and Capital-Saving Technical Progress 193 |
| | 7.3B Technical Progress and the Nation's Production Frontier 194 |
| | ■ Case Study 7-1 Growth in the Capital Stock per Worker of Selected Countries 195 |
| | 7.4 Growth and Trade: The Small-Country Case 196 |
| | 7.4A The Effect of Growth on Trade 196 |
| | 7.4B Illustration of Factor Growth, Trade, and Welfare 197 |
| | 7.4C Technical Progress, Trade, and Welfare 199 |
| | ■ Case Study 7-2 Growth in Output per Worker from Capital Deepening, Technological Change, and Improvements in Efficiency 200 |
| | 7.5 Growth and Trade: The Large-Country Case 201 |
| | 7.5A Growth and the Nation's Terms of Trade and Welfare 201 |
| | 7.5B Immiserizing Growth 202 |
| | 7.5c Illustration of Beneficial Growth and Trade 203 |
| | ■ Case Study 7-3 Growth and the Emergence of New Economic Giants 205 |
| | 7.6 Growth, Change in Tastes, and Trade in Both Nations 206 |
| | 7.6A Growth and Trade in Both Nations 206 |
| | 7.6B Change in Tastes and Trade in Both Nations 208 |
| | ■ Case Study 7-4 Growth, Trade, and Welfare in the Leading Industrial Countries 208 |
| | |

| Summary 209 A Look Ahead 210 Key Terms 210 Questions for Review 211 Problems 211 A7.1 Formal Proof of the Rybczynski Theorem 212 A7.2 Growth with Factor Immobility 214 A7.3 Graphical Analysis of Hicksian Technical Progress 216 Selected Bibliography 217 INTERNet 218 Part 2 International Trade Policy |
|--|
| Fait 2 International Trade Policy |
| 8 Trade Restrictions: Tariffs 221 |
| 8.1 Introduction 221 |
| ■ Case Study 8-1 Average Tariff on Nonagricultural Products in Major Developed Countries 222 |
| ■ Case Study 8-2 Average Tariffs on Nonagricultural Products in Some Major Developing Countries 223 |
| 8.2 Partial Equilibrium Analysis of a Tariff 223 |
| 8.2A Partial Equilibrium Effects of a Tariff 224 |
| 8.2B Effect of a Tariff on Consumer and Producer Surplus 225 |
| 8.2c Costs and Benefits of a Tariff 226 |
| ■ Case Study 8-3 The Welfare Effect of Liberalizing Trade on Some U.S. Products 227 |
| ■ Case Study 8-4 The Welfare Effect of Liberalizing Trade on Some EU Products 228 |
| 8.3 The Theory of Tariff Structure 229 |
| 8.3A The Rate of Effective Protection 229 |
| 8.3B Generalization and Evaluation of the Theory of Effective Protection 231 |
| ■ Case Study 8-5 Rising Tariff Rates with Degree of Domestic Processing 232 |
| ■ Case Study 8-6 Structure of Tariffs on Industrial Products in the United States, the European Union, Japan, and Canada 232 |
| 8.4 General Equilibrium Analysis of a Tariff in a Small Country 234 |
| 8.4A General Equilibrium Effects of a Tariff in a Small Country 234 |
| 8.4B Illustration of the Effects of a Tariff in a Small Country 235 |
| 8.4C The Stolper–Samuelson Theorem 236 |
| 8.5 General Equilibrium Analysis of a Tariff in a Large Country 237 |

| 8.5A General Equilibrium Effects of a Tariff in a Large Country 23/ |
|---|
| 8.5B Illustration of the Effects of a Tariff in a Large Country 238 |
| 8.6 The Optimum Tariff 239 |
| 8.6A The Meaning of the Concept of Optimum Tariff and Retaliation 239 |
| 8.6B Illustration of the Optimum Tariff and Retaliation 240 |
| Summary 241 |
| A Look Ahead 242 |
| Key Terms 242 |
| Questions for Review 243 |
| Problems 243 |
| A8.1 Partial Equilibrium Effects of a Tariff in a Large Nation 244 |
| A8.2 Derivation of the Formula for the Rate of Effective Protection 247 |
| A8.3 The Stolper–Samuelson Theorem Graphically 248 |
| A8.4 Exception to the Stolper–Samuelson Theorem—The Metzler Paradox 250 |
| A8.5 Short-Run Effect of a Tariff on Factors' Income 251 |
| A8.6 Measurement of the Optimum Tariff 252 |
| Selected Bibliography 254 INTERNet 256 |
| INTERNET 250 |
| Nontariff Trade Barriers and the New Protectionism 257 |
| 9.1 Introduction 257 |
| 9.2 Import Quotas 258 |
| 9.2A Effects of an Import Quota 258 |
| ■ Case Study 9-1 The Economic Effects of the U.S. Quota on Sugar Imports 259 |
| 9.2B Comparison of an Import Quota to an Import Tariff 260 |
| 9.3 Other Nontariff Barriers and the New Protectionism 260 |
| 9.3A Voluntary Export Restraints 261 |
| ■ Case Study 9-2 Voluntary Export Restraints (VERs) on Japanese Automobiles to the United States and Europe 261 |
| 9.3B Technical, Administrative, and Other Regulations 262 |
| 9.3c International Cartels 263 |
| 9.3D Dumping 264 |
| 9.3E Export Subsidies 266 |
| ■ Case Study 9-3 Antidumping Investigations by G20 Members 266 |
| ■ CASE STUDY 9-4 Agricultural Subsidies in OECD Countries 267 |
| ■ Case Study 9-5 Pervasiveness of Nontariff Barriers 268 |
| 9.3F Analysis of Export Subsidies 269 |
| 9.4 The Political Economy of Protectionism 270 |
| |

| | 9.4A Fallacious and Questionable Arguments for Protection 270 |
|----|--|
| | 9.4B The Infant-Industry and Other Qualified Arguments for Protection 271 |
| | 9.4c Who Gets Protected? 272 |
| | ■ Case Study 9-6 Benefits to the World Economy from Complete Trade Liberalization 273 |
| | 9.5 Strategic Trade and Industrial Policies 274 |
| | 9.5A Strategic Trade Policy 274 |
| | 9.5B Strategic Trade and Industrial Policies with Game Theory 275 |
| | 9.5°C The U.S. Response to Foreign Industrial Targeting and Strategic Trade Policies 277 |
| | 9.6 History of U.S. Commercial Policy 278 |
| | 9.6A The Trade Agreements Act of 1934 278 |
| | 9.6B The General Agreement on Tariffs and Trade (GATT) 279 |
| | 9.6c The 1962 Trade Expansion Act and the Kennedy Round 280 |
| | 9.6D The Trade Reform Act of 1974 and the Tokyo Round 280 |
| | 9.6E The 1984 and 1988 Trade Acts 281 |
| | 9.7 The Uruguay Round, Outstanding Trade Problems, and the Doha Round 282 |
| | 9.7A The Uruguay Round 283 |
| | ■ Case Study 9-7 Gains from the Uruguay Round 285 |
| | ■ Case Study 9-8 The Multilateral Rounds of Trade Negotiations 286 |
| | 9.7B Outstanding Trade Problems and the Doha Round 286 |
| | ■ Case Study 9-9 Benefits from a Likely Doha Scenario 288 |
| | Summary 288 |
| | A Look Ahead 290 |
| | Key Terms 290 Questions for Review 290 |
| | Problems 291 |
| | A9.1 Centralized Cartels 292 |
| | A9.2 International Price Discrimination 293 |
| | A9.3 Tariffs, Subsidies, and Domestic Goals 294 |
| | Selected Bibliography 295 |
| | INTERNet 299 |
| 10 | Economic Integration: Customs Unions and Free Trade Areas 301 |
| | 10.1 Introduction 301 |
| | 10.2 Trade-Creating Customs Union 302 |
| | 10.2A Trade Creation 302 |
| | 10.2B Illustration of a Trade-Creating Customs Union 303 |
| | 10.3 Trade-Diverting Customs Unions 304 |
| | |

| | 10.3A Trade Diversion 304 |
|--------|---|
| | 10.3B Illustration of a Trade-Diverting Customs Union 304 |
| 10.4 | The Theory of the Second Best and Other Static Welfare Effects of |
| | Customs Unions 306 |
| | 10.4A The Theory of the Second Best 306 |
| | 10.4B Conditions More Likely to Lead to Increased Welfare 307 |
| | 10.4C Other Static Welfare Effects of Customs Unions 307 |
| 10.5 | Dynamic Benefits from Customs Unions 308 |
| 10.6 | History of Attempts at Economic Integration 309 |
| | 10.6A The European Union 309 |
| | ■ Case Study 10-1 Economic Profile of the EU, NAFTA, and Japan 310 |
| | ■ Case Study 10-2 Gains from the Single EU Market 311 |
| | 10.6B The European Free Trade Association 312 |
| | 10.6c The North American and Other Free Trade Agreements 313 |
| | ■ Case Study 10-3 Mexico's Gains from NAFTA—Expectations and Outcome 315 |
| | 10.6D Attempts at Economic Integration among Developing Countries 316 |
| | ■ Case Study 10-4 Economic Profile of Mercosur 317 |
| | 10.6E Economic Integration in Central and Eastern Europe and in the Former Soviet Republics 318 |
| | ■ Case Study 10-5 Changes in Trade Patterns with Economic Integration 319 |
| Summ | nary 321 |
| A Loc | ok Ahead 322 |
| Key T | Perms 322 |
| Questi | ions for Review 322 |
| Proble | ems 323 |
| A10.1 | General Equilibrium Analysis of the Static Effects of a Trade-Diverting Customs Union 324 |
| A10.2 | Regional Trade Agreements Around the World 325 |
| Select | ed Bibliography 327 |
| INTE | RNet 330 |
| Inte | rnational Trade and Economic Development 331 |
| 11.1 | Introduction 331 |
| 11.2 | The Importance of Trade to Development 332 |
| | 11.2A Trade Theory and Economic Development 332 |
| | 11.2B Trade as an Engine of Growth 333 |
| | 11.2c The Contributions of Trade to Development 335 |
| | r |

| 11.2D International Trade and Endogenous Growth Theory 336 |
|---|
| ■ Case Study 11-1 <i>The East Asian Miracle of Growth and Trade</i> 337 |
| 11.3 The Terms of Trade and Economic Development 338 |
| 11.3A The Various Terms of Trade 338 |
| 11.3B Alleged Reasons for Deterioration in the Commodity Terms of Trade 339 |
| 11.3C Historical Movement in the Commodity and Income Terms of Trade 340 ■ CASE STUDY 11-2 Change in Commodity Prices over Time 342 |
| 11.4 Export Instability and Economic Development 343 |
| 11.4A Cause and Effects of Export Instability 343 |
| 11.4B Measurements of Export Instability and Its Effect on Development 344 |
| 11.4C International Commodity Agreements 345 |
| 11.5 Import Substitution versus Export Orientation 346 |
| 11.5A Development through Import Substitution versus Exports 346 |
| 11.5B Experience with Import Substitution 348 |
| ■ Case Study 11-3 The Growth of GDP of Rich Countries, Globalizers, and Nonglobalizers 348 |
| 11.5c Trade Liberalization and Growth in Developing Countries 349 |
| ■ Case Study 11-4 Manufactures in Total Exports of Selected Developing Countries 350 |
| 11.6 Current Problems Facing Developing Countries 351 |
| 11.6A Poverty in Developing Countries 351 |
| 11.6B The Foreign Debt Problem of Developing Countries 353 |
| ■ Case Study 11-5 The Foreign Debt Burden of Developing Countries 353 |
| 11.6C Trade Problems of Developing Countries 354 |
| ■ Case Study 11-6 Globalization and World Poverty 355 |
| Summary 356 |
| A Look Ahead 357 |
| Key Terms 357 |
| Questions for Review 357 Problems 358 |
| |
| A11.1 Income Inequalities by Traditional and Purchasing-Power Parity (PPP) Measures 359 |
| Selected Bibliography 360 |
| INTERNet 365 |
| |

A12.1 The Transfer Problem 390

Selected Bibliography 391

INTERNet 393

| 12.1 Introduction 367 | | | |
|--|--|--|--|
| 2 Some Data on International Capital Flows 368 | | | |
| ■ Case Study 12-1 Fluctuations in Foreign Direct Investment Flows to the United States 370 | | | |
| .3 Motives for International Capital Flows 371 | | | |
| 12.3A Motives for International Portfolio Investments 371 | | | |
| 12.3B Motives for Direct Foreign Investments 373 | | | |
| 12.4 Welfare Effects of International Capital Flows 374 | | | |
| ■ Case Study 12-2 The Stock of Foreign Direct Investments Around the World 374 | | | |
| 12.4A Effects on the Investing and Host Countries 375 | | | |
| 12.4B Other Effects on the Investing and Host Countries 377 | | | |
| 2.5 Multinational Corporations 378 | | | |
| 12.5A Reasons for the Existence of Multinational Corporations 378 | | | |
| 12.5B Problems Created by Multinational Corporations in the Home Country 379 | | | |
| ■ Case Study 12-3 The World's Largest Nonpetroleum, Industrial Corporations 380 | | | |
| ■ Case Study 12-4 Employment of U.S. MNCs Abroad 381 | | | |
| 12.5°C Problems Created by Multinational Corporations in the Host Country 382 | | | |
| 12.6 Motives for and Welfare Effects of International Labor Migration 383 | | | |
| 12.6A Motives for International Labor Migration 383 | | | |
| 12.6B Welfare Effects of International Labor Migration 384 | | | |
| 12.6C Other Welfare Effects of International Labor Migration 385 | | | |
| ■ Case Study 12-5 U.S. Immigration and Debate over Immigration Policy 387 | | | |
| Summary 388 | | | |
| A Look Ahead 389 | | | |
| Key Terms 389 | | | |
| Questions for Review 389 | | | |
| Problems 390 | | | |

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

| 13 | Balance of Payments | 39 | | |
|--|--|----|--|--|
| | 13.1 Introduction 397 | | | |
| | 13.2 Balance-of-Payments Accounting Principles 398 | | | |
| | 13.2A Credits and Debits 398 | | | |
| | 13.2B Double-Entry Bookkeeping 399 | | | |
| | 13.3 The International Transactions of the United States 401 | | | |
| | ■ Case Study 13-1 The Major Goods Exports and Imports of the United States 403 | | | |
| | 13.4 Accounting Balances and the Balance of Payments 405 | | | |
| | 13.5 The Postwar Balance of Payments of the United States 407 | | | |
| | ■ Case Study 13-2 The Major Trade Partners of the United State 409 | S | | |
| | ■ Case Study 13-3 The U.S. Trade Deficit with Japan 410 | | | |
| | ■ Case Study 13-4 <i>The Exploding U.S. Trade Deficit with China</i> 411 | | | |
| | 13.6 The International Investment Position of the United States 412 | | | |
| | ■ Case Study 13-5 The United States as a Debtor Nation 414 | | | |
| | Summary 415 | | | |
| 1 | A Look Ahead 415 | | | |
| Key Terms 416 | | | | |
| | Questions for Review 416 | | | |
| | Problems 417 | | | |
| | A13.1 The IMF Method of Reporting International Transactions 418 Selected Bibliography 421 | | | |
| INTERNet 422 | | | | |
| 14 | Foreign Exchange Markets and Exchange Rates | 42 | | |
| | 14.1 Introduction 423 | | | |
| 14.2 Functions of the Foreign Exchange Markets 423 | | | | |
| | ■ Case Study 14-1 The U.S. Dollar as the Dominant International Currency 425 | ıl | | |
| | ■ Case Study 14-2 The Birth of a New Currency: The Euro 42' | 7 | | |
| | 14.3 Foreign Exchange Rates 427 | | | |
| | 14.3A Equilibrium Foreign Exchange Rates 427 | | | |
| | ■ CASE STUDY 14-3 Foreign Exchange Quotations 430 | | | |
| 14.3B Arbitrage 431 | | | | |
| | | | | |

| 14.3C The Exchange Rate and the Balance of Payments 432 | |
|--|-----|
| 14.4 Spot and Forward Rates, Currency Swaps, Futures, and Options 434 | |
| 14.4A Spot and Forward Rates 434 | |
| 14.4B Foreign Exchange Swaps 435 | |
| 14.4C Foreign Exchange Futures and Options 436 | |
| ■ Case Study 14-4 Size, Currency, and Geographic Distribution of the Foreign Exchange Market 437 | |
| 14.5 Foreign Exchange Risks, Hedging, and Speculation 438 | |
| 14.5A Foreign Exchange Risks 438 | |
| 14.5B Hedging 441 | |
| 14.5c Speculation 442 | |
| 14.6 Interest Arbitrage and the Efficiency of Foreign Exchange Markets 444 | |
| 14.6A Uncovered Interest Arbitrage 444 | |
| ■ Case Study 14-5 Carry Trade 445 | |
| 14.6B Covered Interest Arbitrage 446 | |
| 14.6C Covered Interest Arbitrage Parity 447 | |
| 14.6D Covered Interest Arbitrage Margin 449 | |
| 14.6E Efficiency of Foreign Exchange Markets 450 | |
| 14.7 Eurocurrency or Offshore Financial Markets 451 | |
| 14.7A Description and Size of the Eurocurrency Market 451 | |
| 14.7B Reasons for the Development and Growth of the | |
| Eurocurrency Market 452 | |
| ■ Case Study 14-6 Size and Growth of Eurocurrency Market 4 | 53 |
| 14.7c Operation and Effects of the Eurocurrency Market 454 | |
| 14.7D Eurobond and Euronote Markets 455 | |
| Summary 456 | |
| A Look Ahead 457 | |
| Key Terms 457 | |
| Questions for Review 457 | |
| Problems 458 | |
| A14.1 Derivation of the Formula for the Covered Interest Arbitrage Margin 459 | |
| Selected Bibliography 461 | |
| INTERNet 462 | |
| Exchange Rate Determination | 463 |
| 15.1 Introduction 463 | |

15.1 Introduction 463

15.2 Purchasing-Power Parity Theory 464

15

15.2A Absolute Purchasing-Power Parity Theory 464

| | ■ Case Study 15-1 Absolute Purchasing-Power Parity in the Real World 466 | | |
|---|---|--|--|
| | ■ Case Study 15-2 The Big Mac Index and the Law of One Price 467 | | |
| | ■ Case Study 15-3 Relative Purchasing-Power Parity in the Real World 469 | | |
| | 15.2c Empirical Tests of the Purchasing-Power Parity Theory 470 | | |
| 15.26 Empirical Tests of the Futerlashing-Fower Fairty Theory 476 15.3 Monetary Approach to the Balance of Payments and Exchange Rates | | | |
| 15.3 Monetary Approach to the Balance of Payments and Exchange Rates 4 15.3A Monetary Approach under Fixed Exchange Rates 471 | | | |
| 15.3B Monetary Approach under Flexible Exchange Rates 473 | | | |
| 15.3C Monetary Approach to Exchange Rate Determination 475 | | | |
| | ■ Case Study 15-4 Monetary Growth and Inflation 476 | | |
| | ■ Case Study 15-5 Nominal and Real Exchange Rates, and the Monetary Approach 477 | | |
| | 15.3D Expectations, Interest Differentials, and Exchange Rates 478 | | |
| | ■ Case Study 15-6 Interest Differentials, Exchange Rates, and the Monetary Approach 480 | | |
| 15.4 Portfolio Balance Model and Exchange Rates 480 | | | |
| 15.4A Portfolio Balance Model 481 | | | |
| | 15.4B Extended Portfolio Balance Model 482 | | |
| | 15.4c Portfolio Adjustments and Exchange Rates 484 | | |
| 15.5 | 15.5 Exchange Rate Dynamics 486 | | |
| | 15.5A Exchange Rate Overshooting 486 | | |
| | 15.5B Time Path to a New Equilibrium Exchange Rate 487 | | |
| 15.6 | 15.6 Empirical Tests of the Monetary and Portfolio Balance Models and Exchange Rate Forecasting 489 | | |
| | ■ Case Study 15-7 Exchange Rate Overshooting of the U.S. Dollar 490 | | |
| | ■ Case Study 15-8 <i>The Euro Exchange Rate Defies Forecasts</i> 491 | | |
| Summ | nary 493 | | |
| A Loc | ok Ahead 494 | | |
| Key Terms 494 | | | |
| Questions for Review 494 | | | |
| Problems 495 | | | |
| A15.1 Formal Monetary Approach Model 497 | | | |
| A15.2 Formal Portfolio Balance Model and Exchange Rates 498 | | | |
| Selected Bibliography 500 INTERNet 503 | | | |
| INTE | RNet 503 | | |
| | | | |

15.2B Relative Purchasing-Power Parity Theory 465

Part 4 Open-Economy Macroeconomics and the International Monetary System

| 16 | The Price Adjustment Mechanism with Flexible and Fixed Exchange Rates | | | |
|----|--|--|--|--|
| | 16.1 | Introduction 507 | | |
| | 16.2 | Adjustment with Flexible Exchange Rates 508 | | |
| | | 16.2A Balance-of-Payments Adjustments with Exchange Rate Changes 508 | | |
| | | 16.2B Derivation of the Demand Curve for Foreign Exchange 509 | | |
| | | 16.2c Derivation of the Supply Curve for Foreign Exchange 511 | | |
| | 16.3 Effect of Exchange Rate Changes on Domestic Prices and the Terms of Trade 512 | | | |
| | | ■ CASE STUDY 16-1 Currency Depreciation and Inflation in Developing Countries during the 1997–1998 East Asian Crisis 513 | | |
| | 16.4 | Stability of Foreign Exchange Markets 514 | | |
| | | 16.4A Stable and Unstable Foreign Exchange Markets 514 | | |
| | | 16.4B The Marshall–Lerner Condition 516 | | |
| | 16.5 | Elasticities in the Real World 517 | | |
| | | 16.5A Elasticity Estimates 517 | | |
| | | 16.5B The J-Curve Effect and Revised Elasticity Estimates 519 | | |
| | | ■ Case Study 16-2 Estimated Price Elasticities in International Trade 520 | | |
| | | ■ Case Study 16-3 Other Estimated Price Elasticities in International Trade 521 | | |
| | | ■ CASE STUDY 16-4 Effective Exchange Rate of the Dollar and U.S. Current Account Balance 521 | | |
| | | ■ Case Study 16-5 Dollar Depreciation and the U.S. Current Account Balance 523 | | |
| | | ■ CASE STUDY 16-6 Exchange Rates and Current Account Balances during the European Financial Crisis of the Early 1990s 524 | | |
| | | 16.5C Currency Pass-Through 524 | | |
| | | ■ Case Study 16-7 Exchange Rate Pass-Through to Import Prices in Industrial Countries 525 | | |
| | 16.6 | Adjustment under the Gold Standard 526 | | |
| | | 16.6A The Gold Standard 526 | | |
| | | 16.6B The Price-Specie-Flow Mechanism 527 | | |

17.6A Monetary Adjustments 559

17.6B Synthesis of Automatic Adjustments

17.6C Disadvantages of Automatic Adjustments

560

■ Case Study 17-6 Interdependence in the World Economy 561

| | Summ | mary 563 | | |
|----|---|--|--|--|
| | A Loc | ook Ahead 564 | | |
| | Кеу Т | Terms 564 | | |
| | Quest | ions for Review 565 | | |
| | Proble | ems 565 | | |
| | A17.1 | Derivation of Foreign Trade Multipliers with Foreign Repercussions 566 | | |
| | A17.2 The Transfer Problem Once Again 568 | | | |
| | Selected Bibliography 570 | | | |
| | INTERNet 572 | | | |
| 18 | 8 Open-Economy Macroeconomics: Adjustment Policies 57 | | | |
| | 18.1 | Introduction 573 | | |
| | | ■ Case Study 18-1 Government, Private-Sector, and Current Account Balances in the G-7 Countries 574 | | |
| | 18.2 Internal and External Balance with Expenditure-Changing and Expenditure-Switching Policies 576 | | | |
| | 18.3 Equilibrium in the Goods Market, in the Money Market, and in the Balance of Payments 578 | | | |
| | 18.4 | 8.4 Fiscal and Monetary Policies for Internal and External Balance with Fixed Exchange Rates 581 | | |
| | 18.4A Fiscal and Monetary Policies from External Balance and Unemployment 581 | | | |
| | | 18.4B Fiscal and Monetary Policies from External Deficit and Unemployment 583 | | |
| | | 18.4C Fiscal and Monetary Policies with Elastic Capital Flows 584 | | |
| | ■ CASE STUDY 18-2 Relationship between U.S. Current Account and Budget Deficits 585 | | | |
| | 18.4D Fiscal and Monetary Policies with Perfect Capital Mobility 586 | | | |
| | ■ Case Study 18-3 Effect of U.S. Fiscal Policy in the United States and Abroad 588 | | | |
| | 18.5 | The IS-LM-BP Model with Flexible Exchange Rates 589 | | |
| | 18.5A The <i>IS-LM-BP</i> Model with Flexible Exchange Rates and Imperfect Capital Mobility 589 | | | |
| | | 18.5B The <i>IS–LM–BP</i> Model with Flexible Exchange Rates and Perfect Capital Mobility 591 | | |
| | ■ Case Study 18-4 Effect of Monetary Policy in the United States and Other OECD Countries 592 | | | |
| | 18.6 | Policy Mix and Price Changes 594 | | |
| | | 18.6A Policy Mix and Internal and External Balance 594 | | |
| | | 18.6B Evaluation of the Policy Mix with Price Changes 596 | | |
| | | 18.6C Policy Mix in the Real World 597 | | |
| | | 18.6C Policy Mix in the Real World 597 | | |

■ CASE STUDY 18-5 U.S. Monetary and Fiscal Policies during the Past Decade 599 ■ Case Study 18-6 Deeper U.S. Recession without Strong Fiscal and Monetary Measures 600 18.7 Direct Controls 600 18.7A Trade Controls 601 18.7B Exchange Controls 18.7c Other Direct Controls and International Cooperation ■ Case Study 18-7 Direct Controls on International Transactions Around the World 603 Summary 604 A Look Ahead Key Terms 605 **Questions for Review** 605 Problems 606 A18.1 Derivation of the *IS* Curve 608 A18.2 Derivation of the *LM* Curve A18.3 Derivation of the *BP* Curve 611 A18.4 Mathematical Summary Selected Bibliography INTERNet 615 Prices and Output in an Open Economy: Aggregate Demand and Aggregate Supply 617 19.1 Introduction 617 19.2 Aggregate Demand, Aggregate Supply, and Equilibrium in a Closed Economy 19.2A Aggregate Demand in a Closed Economy 19.2B Aggregate Supply in the Long Run and in the Short Run 619 19.2c Short-Run and Long-Run Equilibrium in a Closed Economy 621 ■ Case Study 19-1 Deviations of Short-Run Outputs from the Natural Level in the United States 623 19.3 Aggregate Demand in an Open Economy under Fixed and Flexible Exchange Rates 623 19.3A Aggregate Demand in an Open Economy under Fixed **Exchange Rates** 624 19.3B Aggregate Demand in an Open Economy under Flexible **Exchange Rates** 625 19.4 Effect of Economic Shocks and Macroeconomic Policies on Aggregate Demand in Open Economies with Flexible Prices 626 19.4A Real-Sector Shocks and Aggregate Demand 627

| 19.4°C Fiscal and Monetary Policies and Aggregate Demand in Open Economies 629 | | | |
|---|---|--|--|
| 19.5 Effect of Fiscal and Monetary Policies in Open Economies with Flexible Prices 630 | | | |
| ■ Case Study 19-2 Central Bank Independence and Inflation in Industrial Countries 632 | | | |
| ■ Case Study 19-3 Inflation Targeting—A New Approach to Monetary Policy 633 | | | |
| 19.6 Macroeconomic Policies to Stimulate Growth and Adjust toSupply Shocks 634 | | | |
| 19.6A Macroeconomic Policies for Growth 634 | | | |
| 19.6B Macroeconomic Policies to Adjust to Supply Shocks 635 | | | |
| ■ CASE STUDY 19-4 Petroleum Shocks and Stagflation in the United States 637 | | | |
| ■ Case Study 19-5 Impact of an Increase in the Price of Petroleum 638 | | | |
| ■ CASE STUDY 19-6 Actual and Natural Unemployment Rates and Inflation in the United States 639 | | | |
| Summary 640 | | | |
| A Look Ahead 641 | | | |
| Key Terms 641 | | | |
| Questions for Review 641 | | | |
| Problems 642 | | | |
| Selected Bibliography 642 | | | |
| INTERNet 644 | | | |
| Flexible versus Fixed Exchange Rates, the European Monetary System, and Macroeconomic Policy Coordination 64. | 5 | | |
| 20.1 Introduction 645 | | | |
| 20.2 The Case for Flexible Exchange Rates 646 | | | |
| 20.2A Market Efficiency 647 | | | |
| 20.2B Policy Advantages 647 | | | |
| 20.2 The Cose for Fixed Evahence Potes 640 | | | |
| 20.3 The Case for Fixed Exchange Rates 649 | | | |
| 20.3A Less Uncertainty 649 | | | |
| | | | |
| 20.3A Less Uncertainty 649 | | | |
| 20.3A Less Uncertainty 649 20.3B Stabilizing Speculation 650 | | | |

20

19.4B Monetary Shocks and Aggregate Demand 628

| xxxvi | Contents | |
|-------|--|--|
| | | 20.4 Optimum Currency Areas, the European Monetary System, and the European Monetary Union 655 |
| | | 20.4A Optimum Currency Areas 656 |
| | | 20.4B European Monetary System (1979–1998) 657 |
| | | ■ Case Study 20-2 The 1992–1993 Currency Crisis in the European Monetary System 658 |
| | | 20.4C Transition to Monetary Union 658 |
| | | 20.4D Creation of the Euro 660 |
| | | ■ Case Study 20-3 Maastricht Convergence Indicators 660 |
| | | ■ Case Study 20-4 Benefits and Costs of the Euro 663 |
| | | 20.4E The European Central Bank and the Common Monetary Policy 663 |
| | | ■ Case Study 20-5 The Eurozone Crisis 664 |
| | | 20.5 Currency Boards Arrangements and Dollarization 665 |
| | | 20.5A Currency Board Arrangements 665 |
| | | 20.5B Dollarization 666 |
| | | ■ Case Study 20-6 Argentina's Currency Board Arrangements and Crisis 666 |
| | | 20.6 Exchange Rate Bands, Adjustable Pegs, Crawling Pegs, and Managed Floating 667 |
| | | 20.6A Exchange Rate Bands 667 |
| | | 20.6B Adjustable Peg Systems 668 |
| | | 20.6C Crawling Pegs 670 |
| | | 20.6D Managed Floating 670 |
| | ■ Case Study 20-7 Exchange Rate Arrangements of IMF Member 672 | |
| | 20.7 International Macroeconomic Policy Coordination 673 | |
| | Summary 675 | |
| | A Look Ahead 676 | |
| | | Key Terms 676 |
| | | Questions for Review 676 |
| | | Problems 677 |
| | | A20.1 Exchange Rate Arrangements 678 |
| | | Selected Bibliography 683 |
| | | INTERNet 686 |

The International Monetary System: Past, Present, and Future

- 21.1 Introduction 687
- 21.2 The Gold Standard and the Interwar Experience
 - 21.2A The Gold Standard Period (1880–1914) 689
 - 21.2B The Interwar Experience 690

| 21.3 | 21.3 The Bretton Woods System 691 | | | | |
|--|--|--|------|---|---|
| | 21.3A The Gold-Exchange Standard (1947–1971) 692 | | | | |
| | 21.3B Borrowing from the International | Monetary Fund 693 | | | |
| 21.4 | Woods System 694 | | | | |
| | 21.4A Operation of the Bretton Woods S | System 694 | | | |
| | 21.4B Evolution of the Bretton Woods S | ystem 695 | | | |
| | | omic Performance under Different Rate Regimes 697 | | | |
| 21.5 U.S. Balance-of-Payments Deficits and Collapse of the Bretton Woods System 698 | | Collapse of the Bretton | | | |
| | 21.5A U.S. Balance-of-Payments Deficits | s 698 | | | |
| | 21.5B Collapse of the Bretton Woods Sy | rstem 700 | | | |
| 21.6 | The International Monetary System: Pres | sent and Future 702 | | | |
| | 21.6A Operation of the Present System 702 | | | | |
| 21.6B Current IMF Operation 703 | | | | | |
| 21.6C Problems with Present Exchange Rate Arrangements 706 21.6D Proposals for Reforming Present Exchange Rate Arrangements 70 21.6E Financial Crises in Emerging Market Economies 709 | | | | | |
| | | | | ■ Case Study 21-2 The Anaton of the Mexic | ny of a Currency Crisis: The Collapse can Peso 709 |
| | | | | ■ Case Study 21-3 Chronology Markets: Fi | of Economic Crises in Emerging rom Asia to Argentina 710 |
| | · · · · · · · · · · · · · · · · · · · | ial Crisis in the United States and need Economies 713 | | | |
| 21.6F Other Current International Economic Problems 714 ■ CASE STUDY 21-5 Trade Imbalances of the Leading Industrial Nations 716 | | | | | |
| | | | Sumn | mary 718 | |
| • | Terms 720 | | | | |
| Quest Proble | tions for Review 720 ems 721 | | | | |
| A21.1 International Reserves: 1950–2011 722 | | | | | |
| Select | Selected Bibliography 724 | | | | |
| INTE | ERNet 728 | | | | |
| Glossary of I | Key Terme | 729 | | | |
| Name Index | • | 743 | | | |
| ame much | | 770 | | | |

751

Subject Index