GLOBAL EDITION

International Economics

EIGHTH EDITION

JAMES GERBER

International Economics

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For Monica and Elizabeth

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PREFACE

International Economics is designed for a one-semester course covering both the trade and finance components of international economics. The Eighth Edition continues the approach of the first seven editions by offering a principles-level introduction to core theories together with policy analysis and the institutional and historical contexts of international economic relations. My goal is to make economic reasoning about the international economy accessible to a diverse group of students, including both economics majors and nonmajors. My intention is to present the consensus of economic opinion, when one exists, and to describe the differences when one does not. In general, however, economists are more often in agreement than not.

What's New in the Eighth Edition

This Eighth Edition of *International Economics* preserves the organization and coverage of the Seventh Edition and adds several updates and enhancements. New to this edition:

- Five new case studies cover Mexico's participation in global value chains, the collapse of Thailand's currency in 1997–98, the North American automotive value chain, North American trade through the lens of the gravity model of trade, and the United Kingdom's exit from the European Union.
- The growth of protectionism is woven into the discussion of trade policies throughout the book.
- The gravity model of trade has a more complete presentation.
- Global value chains are introduced in the section on off-shoring.
- The national security argument for protection is discussed, along with the challenges it poses for the World Trade Organization.
- All tables and graphs have been updated.

Notable Content Changes

- **Chapter 1**'s minor revisions begin the discussion of the recently protectionist direction in U.S. trade policy. While it is uncertain if this is a permanent or temporary shift away from multilateral agreements and increasing openness, it is an expression of the concerns about globalization and international trade that are felt by many people around the world.

- **Chapter 2** changes reflect the discussion begun in Chapter 1 by adding an overview of the views of the opponents to regional trade agreements. Their concerns are presented in terms of jobs, industries, and communities.
- **Chapter 3** changes continue the discussion by highlighting and contrasting the views of trade economists with the objections of protectionist interests. The idea of gains from trade is emphasized and differentiated from the notion that every individual benefits from trade. The chapter points out the complexity and uncertainty of disentangling the trade effects from those caused by new communication, transportation, and information technologies.
- **Chapter 4** incorporates a discussion of the gravity model of trade. The gravity model is presented as the most accurate model for predicting trade flows between countries but is silent on the issue of the specific goods and services traded and on the determinants of comparative advantage. The section on outsourcing and off-shoring is rewritten to emphasize the role of global value chains (GVCs) and is followed up with a new case study on Mexico's participation in GVCs.
- **Chapter 5** has minor changes that refocus the case study on the WTO and industrial policies in order to ask whether WTO rules prohibit the use of industrial policies.
- **Chapters 6 and 7** on commercial policy describe the problems created when tariffs are applied to intermediate goods. They also discuss how the disconnect between wages and labor productivity reduces the bargaining power of workers and alters the labor argument for protection. Chapter 7 explains in more detail the problems associated with the national security argument for protection and has a new case study that addresses the WTO's rules for using national security as a reason for increased tariffs.
- **Chapter 8** adopts the position that labor and environmental standards have become a part of many new trade agreements and are here to stay. Since the efficacy of labor and environmental clauses in trade agreements is uncertain, alternatives to trade measures are still worth considering.
- **Chapter 9** retains most of the content from the previous edition. Given the current rhetoric about U.S. trade deficits, it is worth emphasizing the section that reviews the causes of current account deficits and the case study of the U.S. deficit.
- Changes to **Chapter 10** are mostly in its organization and a new case study. Fixed exchange rates, including the gold standard, are discussed directly after the section on flexible rates and before discussion of the real exchange rate. A new case study on the collapse of Thailand's currency in 1997–98 comes directly after the section on real rates.

- A very minor change to **Chapter 11** introduces the change in U.S. and European central bank policies that have enabled them to expand the types of assets they purchase.
- **Chapter 12** adds the concept of balance of payments crises to its list and introduces the concept of asymmetric information in the section on moral hazard and financial regulation. In addition, the case study on the Asian Crisis of 1997–98 is condensed.
- **Chapter 13** has major changes given the sudden redirection of U.S. trade policy. These changes emphasize the challenges to the United States stemming from the growth and development of the Chinese economy and the U.S. shift toward unilateral trade actions. The focus on the NAFTA model is retained since it is the basis for most subsequent U.S. trade agreements even as it is replaced by the United States-Mexico-Canada Agreement (USMCA). A new case study on the North American automotive value chain replaces the earlier study on Mexico's collective agriculture. The distinction between trade preference programs, trade initiatives, and bilateral or plurilateral trade agreements is clarified and strengthened, and a new case study uses the gravity model to discuss North American trade.
- **Chapter 14** takes into account the departure of the United Kingdom from the European Union with a new case study on the subject. It also improves the discussion of EU institutions. The final section adds a discussion of the challenge to the EU to find new institutional mechanisms for risk sharing across the region.
- All relevant economic data are made current and up to date for **Chapters 15 and 16**.
- **Chapter 17** highlights the advances of India and China and notes the growing conflict between China and high-income economies. It has added material on China's Made in China 2025 initiative and its Belt and Road Initiative. The problems for trade rules created by the extensive use of state-owned enterprises are highlighted, as are intellectual property enforcement and the forced transfer of technology.

Flexibility of Organization

A text requires a fixed topical sequence because it must order the chapters one after another. This is a potential problem for some instructors, as there is a wide variety of preferences for the order in which topics are taught. The Eighth Edition, like the previous editions, strives for flexibility in allowing instructors to find their own preferred sequence.

- **Part 1** includes two introductory chapters that are designed to build vocabulary, develop historical perspective, and provide background information about the different international organizations and the roles they play in the world economy. Some instructors prefer to delve into the theory chapters immediately, reserving this material for later in the course. There is no loss of continuity with this approach.

- **Part 2** presents the trade and commercial policy side of international economics. Part 2 can be taught before or after Part 3, which covers international finance. Part 2 includes six chapters that cover trade models (Chapters 3–5) and commercial policy (Chapters 6–8). A condensed treatment of this section could focus on the Ricardian model in Chapter 3 and the analysis of tariffs and quotas in Chapters 6 and 7. Chapter 8 on labor and environmental standards can stand on its own, although the preceding chapters deepen student understanding of the trade-offs.
- **Part 3** covers international finance. It begins with a discussion of the balance of payments that is followed by chapters on exchange rates, open economy macroeconomics, and financial crises. Chapter 11 on open economy macroeconomics is optional. It is intended for students and instructors who want a review of macroeconomics, including the concepts of fiscal and monetary policy, in a context that includes current accounts and exchange rates. If Chapter 11 is omitted, Chapter 12 (financial crises) remains accessible as long as students have an understanding of the basic concepts of fiscal and monetary policy. Chapter 12 relies most heavily on Chapters 9 (balance of payments) and 10 (exchange rates and exchange rate systems).
- **Part 4** presents five chapters, each focused on a geographic area. These chapters use theory presented in Chapters 3–12 in a similar fashion to the economics discussion that students find in the business press, congressional testimonies, speeches, and other sources intended for a broad civic audience. Where necessary, concepts such as the real rate of exchange are briefly reviewed. One or more of these chapters can be moved forward to fit the needs of a particular course.

Solving Teaching and Learning Challenges

Teaching and learning international economics has a number of inherent challenges. In a one-semester course, instructors must carefully choose the material they will cover and what they will omit. Meanwhile, students frequently experience international economics as overly theoretical and too abstract. These were two of the main concerns that led to the development of this text. In addition, the rapidly evolving international economy has led to the creation of global value chains, surprisingly frequent financial crises, intense debates about trade, trade agreements, and migration, as well as many other new issues. Moved by these trends and their impacts, many non-economics students with limited background have signed up for introductory courses in international economics. This is an ongoing opportunity for teaching international economics to a wider audience, but it also poses challenges for the traditional course.

A Solid Foundation for International Economics

While writing the text and selecting topics to cover and to omit, I constantly asked what students need to know. A one-semester course must leave out many topics. My goal is to provide a solid foundation for advancing student interests and skills for further study and, if this is to be their only course in international economics, for guiding them to a level of competency and understanding of the many international forces around us.

Case Studies

One of the first choices in writing this book was to include several case studies in each chapter that highlight and build on the core theories and ideas. This allows students the opportunity to see theories in action and provides instructors with concrete examples of how theories can be used to analyze the forces behind everyday events.

International Economic Institutions

The positioning of the introduction to international institutions in Chapter 2 enables students to understand the goals of those institutions and the constraints they face. This is particularly useful when they encounter those and other institutions in subsequent chapters. Throughout the text, there is more coverage of historical and institutional details than is typical. As with Chapter 2, this helps illuminate the relationships among economic theory, economic policy, and economic events.

Five World Regions

Another atypical component of the text is the final section, Part 4. It is organized into five chapters, each focused on a different geographic area of the world. Instructors may choose to skip some or all of this material without loss of continuity, although many find it useful for highlighting economic theory in a real-world setting. Students will also find it useful for seeing the deployment of theory as a tool for understanding the challenges, opportunities, and actions of different national economies.

Vocabulary Checks and Study Questions

Each chapter has a set of five to seven learning objectives that are stated at the beginning and individually repeated after the subchapter heading where the objective is covered. This helps the students to learn in an organized and structured way. And finally, the end-of-the-chapter vocabulary and study questions are designed for students to test their understanding.

Real-World Career Skills

Students who work with this text on international economics will gain numerous career-building benefits.

Knowledge Application and Analysis

Students are exposed to a large number of new concepts and relationships that they must appropriately apply. This requires them to recall the material, express it in their own words, and apply it to real-life situations. Application builds analytical skills, including the ability to break down concepts or ideas into component parts, and skills of synthesizing ideas to form new perspectives. Analysis also requires students to practice using their judgment to evaluate ideas and perspectives.

Critical Thinking

Critical thinking includes an understanding of the uses and limits of theory, but it also includes skills such as the ability to organize, synthesize, and analyze information. International economics is one of the subdisciplines of economics where the gap between expert opinion and the views of the general public is widest. Most of the propositions put forward by international economists are controversial with some groups or even the general public. Consequently, the ability to organize, synthesize, and analyze the arguments made and then to apply them to real-world conditions is an essential skill for mastering international economics.

Strengthened Numeracy

Numeracy is the ability to work with, interpret, and understand numbers. Those skills are directly covered in statistics and mathematical economics classes, but in order to strengthen their ability to work with data, most students need to experience numbers in their natural setting. The book offers many tables and graphs and a few equations that call for interpretation, analysis, and comparison. Students gain confidence and experience when they grapple with these types of real-world information.

Cultural Competency

The world is large, and there are many different ways that national economies exist in it. Throughout the text, there are examples drawn from a wide variety of countries. Part 4 delves more deeply into five specific world regions where students gain insight into the different ways countries solve the fundamental economic problem. These features widen student perspectives and prepare them for working in more diverse environments.

The Uses and Limits of Theories

Regardless of the career path a person takes, they need to understand the theories most relevant to their work because theories are usually the foundation for analysis and decision-making. All theories have limits, however, including the theories that form the field of international economics. It is important to know when conditions on the ground have exceeded the limits of theory. This text requires mastery of several theories, while the examination of specific conditions in countries and regions sometimes uncovers the limits of those theories. Throughout the text, the case studies, and examples drawn from actual historical conditions, help students practice applying theory and understanding their limits.

Supplementary Materials

For more information and resources, visit www.pearsonglobaleditions.com.

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PART

1

Introduction and Institutions

CHAPTER

1 An Introduction to the World Economy

Learning Objectives

After studying this chapter, students will be able to:

1.1 **Discuss historical measures of international economic integration with data on trade, capital flows, and migration.**

1.2 **Compute the trade-to-GDP ratio and explain its significance.**

1.3 **Describe three factors in the world economy today that are different from the economy at the end of the first wave of globalization.**

1.4 **List the three types of evidence that trade supports economic growth.**

1.5 **Describe the employment possibilities and occupations open to students of international economics.**

INTRODUCTION: INTERNATIONAL ECONOMIC INTEGRATION

In August 2007, a crisis erupted in the housing sector of the United States. At the time, few people realized that the subprime mortgage crisis would become a demonstration of international economic integration or that it would push the world economy to the brink of collapse. The crisis grew through the remainder of 2007 and into 2008, so that by the summer nearly all high-income economies were in deep distress. Contagion from the crisis spread like an epidemic as banks and other financial firms collapsed and solvent firms stopped lending. The scarcity of credit caused difficulties for businesses that could not find financing for their day-to-day operations, while, at the same time, consumers cut back on their spending and businesses cut back on new investment. By the end of 2008, economies around the world were in recession, with the notable exceptions of China, India, and the major oil producers.

In early 2020, another crisis, the deadly COVID-19 pandemic, caused national economies to suddenly shut down and severely disrupted the international flow of goods, services, and people. The effects are still developing as this text goes to print, but even though the pandemic has an entirely different origin than the financial crisis of 2007–09, both are examples of crises leading to severe economic recessions in many countries around the world. Both are extreme examples, but they are not unique. The Russian Crisis of 1998–99, the Asian Crisis of 1997–98, the Mexican Crisis of 1994–95, the Latin American Debt Crisis of 1982–89, and a number of others caused major damage to financial systems, businesses, and households, both in the places where they originated and in many other countries.

The international integration of national economies has brought many benefits to nations across the globe, including technological innovation, less expensive products, and greater investment in regions where local capital is scarce, to name a few. But it has also made countries vulnerable to economic problems that have become more easily transmitted from one place to another. Given that the benefits and costs of international economic integration are surrounded by controversy, it is worth clarifying what we mean by the term *international economic integration,* or *globalization in the economic sphere*. To help us understand these forces better, a historical perspective is also useful.

ELEMENTS OF INTERNATIONAL ECONOMIC INTEGRATION

LO 1.1 Discuss historical measures of international economic integration with data on trade, capital flows, and migration.

LO 1.2 Compute the trade-to-GDP ratio and explain its significance.

LO 1.3 Describe three factors in the world economy today that are different from the economy at the end of the first wave of globalization.

LO 1.4 List the three types of evidence that trade supports economic growth.

Most people would agree that the major economies of the world are more integrated than at any time in history. Given our instantaneous communications, modern transportation, and relatively open trading systems, most goods can move from one country to another without major obstacles and at relatively low cost. For example, most cars today are made in fifteen or more countries after you consider where each part is made, where the advertising originates, who does the accounting, and who transports the components and the final product. Nevertheless, the proposition that today's economies are more integrated than at any other time in history is not simple to demonstrate. It is clear that our current wave of economic integration began in the 1950s, with the reduction of trade barriers after World War II. In the 1970s, many countries began to encourage financial integration by increasing the openness of their capital markets. The advent of the Internet in the 1990s, along with the other elements of the telecommunications revolution, pushed economic integration to new levels as multinational firms developed international production networks and markets became ever more tightly linked.

Today's global economy is not the first instance of a dramatic growth in economic ties between nations, however, as there was another important period between approximately 1870 and 1913. New technologies such as transatlantic cables, steam-powered ships, railroads, and many others led the way, much as they do today. For example, when the first permanent transatlantic cable was completed in 1866, the time it took for a New York businessperson to complete a financial transaction in London fell from approximately three weeks to one day, and by 1914 it had fallen to one minute as radio telephony became possible.

We have mostly forgotten about this earlier period of economic integration, and that makes it easier to overestimate integration today. Instantaneous communications and rapid transportation, together with the easy availability of foreign products, often cause us to lose sight of the fact that most of what we buy and sell never makes it out of our local or national markets. We rarely pause to think that haircuts, restaurant meals, gardens, health care, education, utilities, and many other goods and services are partially or wholly domestic products. In the United States, for example, about 83.4 percent of goods and services are produced domestically, with imports (16.6 percent) making up the remainder of what we consume (2014). By comparison, in 1890 the United States made about 92 percent of its goods and services, a larger share than today but not radically different.

The question as to whether we are more economically integrated today or during some period in the past is not academic. Between the onset of World War I in 1914 and the end of World War II in 1945, the world economy suffered a series of human-made catastrophes that de-integrated national economies. Two world wars and a global depression caused most countries to close their borders to foreign goods, foreign capital, and foreign people. Since the end of World War II, many of the economic linkages between nations have served to repair the damage done during the first half of the twentieth century, but there is no reason to think that events might not cause a similar decoupling in the future.

Understanding international economic integration requires us to define what we mean by the term. Economists usually point to four criteria or measures for judging the degree of integration, which are trade flows, capital flows, people flows, and the similarity of prices in separate markets. The first three points are relatively self-explanatory, while the similarity of prices refers to the fact that integrated economies have price differences that are relatively small and are due mainly to differences in transportation costs. Goods that can move freely from a low-cost to a high-cost region should experience price convergence as goods move from where they are plentiful and cheap to where they are relatively scarcer and more expensive. All of these indicators—trade flows, factor (labor and capital) movements, and similarity of prices—are measures of the degree of international economic integration.

The Growth of World Trade

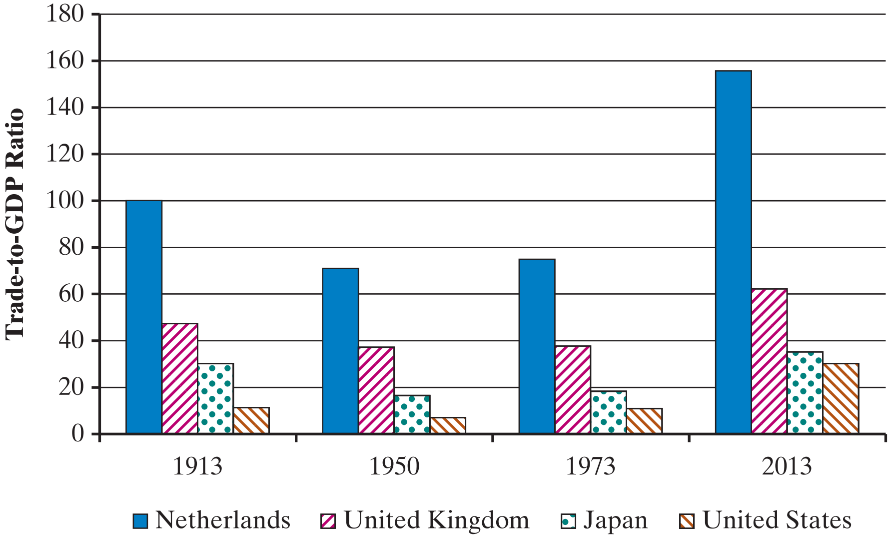
Since the end of World War II, world trade has grown much faster than world output. One way to show this is to estimate the ratio of exports by all countries to total production by all countries. In 1950, total world exports—which are the same as world imports—are estimated to have been 5.5 percent of world **gross domestic product (GDP)**, a measure of total production. Sixty-three years later, in 2013, they were approximately 30 percent of world GDP, nearly six times more important relative to the size of the world economy. One important measure of international trade in a nation's economy is the sum of exports plus imports divided by the GDP. Specifically, it is the value of all final goods and services produced inside a nation during some period, usually one year. The **trade-to-GDP ratio** is represented as follows:

$$\text{Trade to GDP ratio} = (\text{Exports} + \text{Imports}) \div \text{GDP}$$

The ratio does not tell us about a country's trade policies and countries with higher ratios do not necessarily have lower barriers to trade, although that is one possibility. In general, large countries are less dependent on international trade because their firms can reach an optimal production size without having to sell to foreign markets. Consequently, smaller countries tend to have higher ratios of trade to GDP.

Figure 1.1 shows the trade-to-GDP ratio for four countries between 1913 and 2013. The decline in trade between the onset of World War I and 1950 is clearly visible in each country, as is the subsequent increase after 1950. Another pattern shown in Figure 1.1 is the smaller ratios for the United States and Japan, which have the largest populations, and the much higher ratio for the Netherlands, which has the smallest population in the sample. In general, smaller countries trade more than larger ones since they cannot efficiently produce a wide range of goods and must depend on trade to a greater extent. For example, if the Netherlands were to produce autos solely for its own market, it would lack

FIGURE 1.1 **Trade-to-GDP Ratios for Four Countries, 1913–2013**



Data from Maddison, A. (1991). "Dynamic Forces in Capitalist Development" © 1991 Oxford University Press and The World Bank, *World Integrated Trade Solution*, © James Gerber.

economies of scale and could not produce at a competitive cost, whereas the U.S. market can absorb a large share of U.S. output. Hence, the trade-to-GDP ratio measures the relative importance of international trade in a nation's economy, but it does not provide any direct information about trade policy or trade barriers.

Figure 1.1 gives a historical overview of the decline and subsequent return of international trade after World War II, but it obscures important changes in the composition of trade flows from early in the twentieth century to those at the end of the century. Before World War I most trade consisted of agricultural commodities and raw materials, while current trade is primarily manufactured consumer goods and producer goods (machinery and equipment). Consequently, today's manufacturers are much more exposed to international competition than was the case in 1900. In addition, much of the growth of world trade since 1950 has been accomplished by multinational corporations. With production sites in multiple countries and inputs that pass back and forth between affiliates, multinational corporations have become dramatically important. This trend has been supported and encouraged by the telecommunications revolution and transportation improvements that have lowered the costs of coordinating operations physically separated by oceans and continents. And finally, it has also become possible to coordinate service operations such as accounting and data processing from a great distance. In sum, trade today is qualitatively different than in 1913, and the growth of the trade-to-GDP ratio since 1950 does not tell the whole story.

Capital and Labor Mobility

In addition to exports and imports, factor movements also are an indicator of economic integration. As national economies become more interdependent, labor and capital should move more easily across international boundaries. Labor, however, is less mobile internationally than it was in 1900. Consider, for example, that in 1890 approximately 14.5 percent of the U.S. population was foreign born, while in 2010, the figure was 12.9 percent. In 1900, many nations had open door immigration policies, and passport controls, immigration visas, and work permits were exceptions rather than rules. The movement of people was severely restricted by the two world wars and the Great Depression of the 1930s. In the 1920s, during the interwar period, the United States sharply restricted immigration with policies that lasted until the 1960s, when changes in immigration laws once again encouraged foreigners to migrate to the United States.

On the capital side, measurement is more difficult, since there are several ways to measure capital flows. The most basic distinction is between flows of financial capital representing paper assets such as stocks, bonds, currencies, bank accounts, and flows of capital representing physical assets such as real estate, factories, and businesses. The latter type of capital flow is called **foreign direct investment (FDI)**. To some extent, the distinction between the two types of capital flows is immaterial because both represent shifts in wealth across national boundaries and both make one nation's savings available to another.

When we compare international capital flows today to a century ago, there are two points to keep in mind. First, savings and investment are highly correlated. That is, countries with high savings tend to have high rates of investment, and low savings is correlated with low investment. If there were a single world market in which capital flowed freely and easily, this would not necessarily be the case. Capital would flow from countries with abundant savings and capital to countries with low savings and capital, where it would find its highest returns. Second, a variety of technological improvements increased capital flows in the 1800s, as they are doing today. Transoceanic cables and radio telephony have already been mentioned, but capital flows also increased in the late 1800s because there were new investment opportunities such as national railroad networks and other infrastructure, both at home and abroad.

If we compare the size of capital flows today to the previous era of globalization, flows today are much larger but mainly because economies are larger. Relative to the size of economies, the differences are not great and may even favor the 1870 to 1913 period, depending on what is measured. Great Britain routinely invested 9 percent of its GDP abroad in the decades before 1913, and France, Germany, and the Netherlands were as high at times. For significant periods, Canada, Australia, and Argentina borrowed amounts that exceeded 10 percent of their GDP, a level of borrowing that sends up danger signals in the world economy today. In other words, it is hard to make the argument that national economies have a historically unprecedented level of international capital flows today.

While the relative quantity of capital flows today may not be that much different for many countries, there are some important qualitative differences. First, there are many more financial instruments available now than there were a century ago. These range from relatively mundane stocks and bonds to relatively exotic instruments such as derivatives, currency swaps, and others. By contrast, at the turn of the twentieth century, there were many fewer companies listed on the world's stock exchanges, and most international financial transactions involved the buying and selling of bonds.

A second difference today is the role of foreign exchange transactions. In 1900, countries had fixed exchange rates and firms in international trade or finance had less day-to-day risk from a sudden change in the value of a foreign currency. Many firms today spend significant resources to protect themselves from sudden shifts in currency values. Consequently, buying and selling assets denominated in foreign currencies is the largest component of international capital movements. For example, according to the Bank for International Settlements in Geneva, Switzerland, *daily* foreign exchange transactions in 2013 were equal to \$5.3 *trillion*. In 1973, at the end of the last era of fixed exchange rates, they were \$15 billion.

The third major difference in capital flows is that the costs of foreign financial transactions have fallen significantly. Economists refer to the costs of obtaining market information, negotiating an agreement, and enforcing the agreement as **transaction costs**. They are an important part of any business's costs, whether it is a purely domestic enterprise or a company involved in foreign markets. Due to sheer distance, as well as differences in culture, laws, and languages, transaction costs are often higher in international markets than in domestic ones. Today's lower transaction costs for foreign investment mean that it is less expensive to move capital across international boundaries.

The volatile movement of financial capital across international boundaries is often mistakenly regarded as a new feature of the international economy. Speculative excesses and overinvestment, followed by capital flight and bankruptcies, have occurred throughout the modern era, going back at least to the 1600s and probably earlier. U.S. and world history show a number of such cases. Financial crises are not a new phenomenon, nor have we learned how to avoid them—a fact driven home by the recent subprime mortgage crisis.

Features of Contemporary International Economic Relations

While international economic integration has been rapid, it does not appear to be historically unprecedented. The trade-to-GDP ratio is about 50 percent higher in the U.S. economy than it was in 1890, and manufacturers and service providers are more exposed to international forces. Labor is less mobile than in 1900 due to passport controls and work permits, but capital is more mobile and encompasses a larger variety of financial forms. Prices in many U.S. and foreign markets tend to be similar, although there are still significant differences. In quantitative terms, the differences between today and 120 years ago may not be as great as many people imagine, but qualitatively, a number of additional features of the world economy separate the first decade of the twenty-first century from the first decade of the twentieth.

Deeper Integration High-income countries have low barriers to imports of manufactured goods. There are some exceptions (processed foodstuffs and apparel), but as a general rule import **tariffs** (taxes on imports) and other barriers such as **quotas** (quantitative restrictions on imports) are much less restrictive than they were in the middle of the twentieth century. As trade barriers came down during the second half of the twentieth century, three other trends began to intensify economic integration between countries. First, lower trade barriers exposed the fact that most countries have domestic policies that are obstacles to international trade. National regulations governing labor, environmental, and consumer safety standards; rules governing investment location and performance; rules defining fair and unfair competition; rules on government "buy-national" programs; and government support policies for specific industries—all have little impact on trade until formal trade barriers start to fall and trade volume increases. These policies were not implemented to protect domestic industries from foreign competition, and as long as tariffs were high and trade flows were limited, they did not matter much to trade relations. Once tariffs fell, however, many forms of domestic policies began to be viewed as barriers to increased trade. Economists sometimes refer to the reduction of tariffs and the elimination of quotas as **shallow integration** and negotiations over domestic policies that impact international trade as **deep integration**. Deep integration is much more contentious than shallow integration and much more difficult to accomplish since it involves domestic policy changes that align a country with rules that are created abroad or at least negotiated with foreign powers.

A second noticeable trend over the past few decades is that technologically complicated goods such as smartphones and automobiles are made of components produced in more than one country and, consequently, labels such as "Made in China" or "Made in the USA" are less and less meaningful. Low tariffs along with innovations in transportation and communication technologies have enabled firms to locate production of the different components of a sophisticated product in different countries. For example, the hardware for a 3G iPhone is produced in Germany, Korea, Japan, and the United States, and then it is assembled in China. The most valuable share of the hardware is made in Japan, but no one thinks of this device as a Japanese phone. In this case, as in many others, it is not accurate to say the product is made in one particular country since the parts come from all over and the product is the result of a multinational effort involving firms and workers from many different countries.

A third trend is the recent rise of organized movements opposed to international trade. In part, these movements are responding to the two trends cited in the previous paragraphs: deeper integration reduces national autonomy, and the movement of production processes abroad appears to threaten the well-being of national industries, communities, and families. Economic analysis that tries to separate the effects on economic security of international trade from those of changing technology is difficult and incomplete. Nevertheless, the growth of organized opposition to open trade is not the first such occurrence. During the first wave of globalization, populist movements arose in opposition to international integration and the rise of giant industrial firms. Ultimately, national governments were forced to devise ways to limit the power of industrial interests, and international integration was reversed by World War I. How the current trend of growing anti-international trade movements develops is anyone's guess.

Multilateral Organizations At the end of World War II, the United States, Great Britain, and their allies created a number of international organizations to maintain international economic and political stability. Although the architects of these organizations could not envision the challenges and issues they would confront over the next fifty years, the organizations were given significant flexibility, and they continue to play an important and growing role in managing the issues of shallow and deeper integration.

The International Monetary Fund (IMF), the World Bank, the General Agreement on Tariffs and Trade (GATT), the United Nations (UN), the World Trade Organization (the WTO began operation in 1995 but grew out of the GATT), and a host of smaller organizations have broad international participation. They serve as forums for discussing and establishing rules, as mediators of disputes, and as organizers of actions to resolve problems. All of these organizations are controversial and have come under increasing fire from critics who charge that they promote unsustainable economic policies or that they protect the interests of wealthy countries. Others argue that they are unnecessary foreign entanglements that severely limit the scope for national action. (Chapter 2 examines this issue in detail.) These organizations are attempts to create internationally acceptable rules for trade and commerce and to deal with potential disputes before they spill across international borders; they are an entirely new element in the international economy.

Regional Trade Agreements Agreements between groups of nations are not new. Free-trade agreements and other forms of preferential trade have existed throughout history. What is new is the significant increase in the number of **regional trade agreements (RTAs)** that have been signed in the past twenty years.

The formation of preferential trade agreements is controversial. Trade opponents dislike the provisions that expose more of the national economy to international competition, whereas some trade proponents dislike preferences that favor countries included in the agreement at the expense of countries outside the agreement. The North American Free Trade Agreement (NAFTA), the European Union (EU), the Mercado Común del Sur (MERCOSUR), and the Asia Pacific Economic Cooperation (APEC) are examples of RTAs, but more than 417 have been recorded by the World Trade Organization (2016).

Trade and Economic Growth

Many people are more than a little apprehensive about increased international economic integration. The list of potential problems is a long one. More trade may give consumers lower prices and greater choices, but it also means more competition for firms and workers. Capital flows make more funds available for investment purposes, but they also increase the risk of spreading financial crises internationally. Rising immigration means higher incomes for migrants and lower labor costs or a better pool of skills for firms, but it also means more competition in labor markets and, inevitably, greater social tensions. International organizations may help resolve disputes, but they may also reduce national sovereignty by putting pressure on countries to make operational changes. Free-trade agreements may increase trade flows, but again, that means more competition and more pressure on domestic workers and firms.

In general, economists remain firmly convinced that the benefits of trade outweigh the costs. There is disagreement over the best way to achieve different goals (for example, how to protect against the harmful effects of sudden flows of capital), but the general belief that openness to the world economy is a superior policy to closing off a country is quite strong. To support this stance, economists can point to the following kinds of evidence:

- Casual empirical evidence of historical experience
- Evidence based on economic models and deductive reasoning
- Evidence from statistical comparisons of countries

While none of these is conclusive by itself, together they provide solid support for the idea that open economies generally grow faster and prosper more than closed ones.

The historical evidence examines the experiences of countries that tried to isolate themselves from the world economy. There are the experiences of the 1930s, when most countries tried to protect themselves from world events by shutting out flows of goods, capital, and labor. This did not cause the Great Depression of the 1930s, but it did worsen it, and ultimately it led to the misery and tragedy of World War II. There are also the parallel experiences of countries that were divided by war, with one side becoming closed to the world economy, and the other side open. Germany (East versus West), Korea (North versus South), and China (mainland China before the 1980s versus Taiwan and Hong Kong) are the best examples.

Economic theory generally supports these examples by suggesting the causal mechanisms that lead from trade to faster growth. Generally, the benefits of increased innovation, competitive pressure to raise productivity levels, and access to new technologies and ideas that are fostered by trade are positive factors. On the consumer side, trade provides a greater variety of goods and offers them at lower prices.

The statistical evidence of the benefits of more open economies comes from comparisons of large samples of countries over different periods. While the statistical tests of the relationship between trade policy and economic growth suffer from their own technical shortcomings, the results consistently show that more open economies grow faster. These results cannot be viewed as absolutely conclusive, but together with trade theory and the casual empirical evidence drawn from historical experiences, the available statistical analysis provides additional support for the notion that trade is usually beneficial.

TWELVE THEMES IN INTERNATIONAL ECONOMICS

Each of the twelve themes discussed next are examined in the chapters that follow. These themes are overlapping and multidimensional and often go beyond pure economics. International economic analysis cannot claim the final word, but we hope it will provide you an analytically powerful and logically consistent approach for thinking about the issues raised by these themes.

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

Why is international trade desirable? We have briefly addressed this issue, and we will consider additional points as we continue. Given that economic analysis clearly demonstrates that the benefits of international trade outweigh the costs, it is not surprising that virtually all economists generally support open markets and increased trade. The benefits of international trade were first analyzed in the late 1700s and are perhaps the oldest and strongest finding in all of economics. More recently, economists have begun to analyze returns to scale within firms and industries. Under the label "New Trade Theory," economists have demonstrated a number of new sources of national welfare improvements due to international trade and added greater sophistication to our understanding of market structure and trade effects.

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

International trade raises national welfare, but it does not benefit every member of society. Workers in firms that cannot compete may be forced to find new jobs or take pay cuts. The fact that consumers pay less for the goods they buy or that exporters hire more workers may not help laid-off workers. Increased awareness of the international economy has heightened the fears of people who feel vulnerable to change. They are concerned that wages in high-income countries must fall in order to compete with workers in low-wage countries and that their jobs may be moved overseas. One of the key challenges for policymakers is to find the right mix of domestic policies so that the nation benefits from trade without creating a backlash from those individuals and industries that are hurt.

Trade Deficits (Chapters 9, 11, and 12)

In 1980, a comprehensive measure of trade accounts in the United States showed that there was a slight surplus. Every year since then, the United States has had a trade deficit, and the sum of the deficits since 2000 is more than $7.9 trillion (2001 through 2010). The United States was not the only country running deficits, but each year a country runs a deficit in its trade accounts, it must borrow from abroad, essentially selling a piece of its future output in order to obtain more goods and services today. As the United States and other countries borrowed, China, Germany, Japan, and oil producers like Saudi Arabia and Russia lent. These large imbalances in lending and borrowing played a key role in the financial crisis of 2007–2009 and the development of economic conflicts between the United States, China, and other nations.

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

Currently (2020) there are more than 303 regional trade agreements in force around the world, and over 150 more have been negotiated but are not yet active. There are agreements to reduce trade barriers on every continent that include some of the world's most important economies. For example, the European Union (EU) allows free movement of goods, services, capital, and people in its twenty-seven member countries and has similar agreements with several additional non-EU nations. Mexico, Chile, Canada, and, until recently, the United States are active in creating new agreements in the Americas, Asia, and Europe. The ten members of the Association of South East Asian Nations (ASEAN) have moved to create a free-trade zone, while individual countries have signed additional agreements. China has begun to build a set of extensive regional ties in Asia and beyond, and Japan has signed a trade agreement with the European

Union. The pros and cons of these and other agreements are an active area of economic analysis and will be considered in several chapters.

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

Commercial conflicts between nations cover a wide variety of issues and complaints. In one sense these conflicts are routine, as the WTO provides a formal dispute resolution procedure that has the assent of most of the world's nations. The WTO process does not cover all goods and services, however, nor does it say much about a large number of practices that some nations find objectionable. The ability of nations to resolve conflicts without resorting to protectionist measures is one key to maintaining a healthy international economic environment. Disputes can become acrimonious, so it is imperative that differences of opinion are not permitted to escalate into a wider disagreement. Trade wars are not real wars, but they are harmful nonetheless.

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

The organization with the greatest responsibility for resolving trade disagreements is the WTO. The WTO came into existence in 1995 and was an adaptation of the GATT, which was created shortly after World War II. Resolving trade disputes is only one of the new roles played by international organizations. Various organizations offer development support, technical economic advice, emergency loans in a crisis situation, and other services and assistance. These organizations perform services that were not offered before World War II (development support), or that were done by a single country (lending in a crisis)—usually the world's greatest military power. They exist today only through the mutual consent and cooperation of participating nations; without that cooperation, they would dissolve. Their abilities are limited, however. They cannot prevent crises, and they cannot make poor countries rich. They are also controversial and are viewed by some as tools of the United States or as a threat to national independence. They are very likely to grow in function, however, as many international problems cannot be solved by individual nations alone.

Exchange Rates and the Macroeconomy (Chapters 10 and 11)

Seventeen of the twenty-seven members of the EU have adopted the euro as a common currency, and several more are preparing to join them in spite of the euro crisis that began in 2011. Panama, El Salvador, and Ecuador use the U.S. dollar. Some members of the U.S. Congress and some economists think that China artificially manipulates its currency to gain commercial advantages, and China's leaders worry that the United States might let the dollar sink in value to depreciate its foreign debt. Exchange rate systems come in a variety of forms and link the domestic economy to the rest of the world. They can help protect a country against harmful developments outside its borders, but they can also magnify and transmit those developments to the domestic economy. Exchange rates play a key role in the international economy.

Financial Crises and Global Contagion (Chapter 12)

As international trade and investment barriers declined, and as new communications and transportation systems developed, increasing quantities of capital flowed across national borders. These flows were encouraged by financial innovation and a general spirit of deregulation that held sway in much of the world from the late 1970s forward. Capital flows brought many desirable things, such as investment, new technology, and higher consumption, but they also often outpaced our ability to monitor and supervise and were frequently at the root of financial crises, including the severe global crisis that began in 2007. Economists are engaged in a broad discussion today, aimed at finding techniques for reducing the macroeconomic and financial volatility caused by capital flows without hampering the new investment and lending that they provide.

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

In 1996, the World Bank and the IMF began a debt relief program for a group of forty-two countries labeled the *Highly Indebted Poor Countries (HIPC)*. Thirty-four of these countries are in Africa. At the same time, nongovernmental groups and celebrities, such as Bono, began to lobby successfully for a reduction in the debts of poor countries and for changes in the lending policies of rich countries. In many parts of the world, problems of extreme poverty are compounded by large foreign debts that are unlikely to be repaid and often require a constant supply of new loans to pay interest on the old ones. The search for workable solutions is complicated in the borrowing countries by economic shocks, corruption, and unsustainable economic policies. Common problems in the lending countries include unwise loans to corrupt dictators and loans for some expensive and unnecessary goods sold by rich countries.

Latin America and the World Economy (Chapter 15)

In Latin America, the 1980s are known as the *Lost Decade.* High levels of debt, deep recessions, and hyperinflation caused the region to lose a decade of growth and development. In response, many countries embarked on a profound shift in their economic policies. They opened markets, allowed increased foreign investment, signed trade agreements, and ended a long period of relative isolation from the world economy. These policy changes became known as the Washington Consensus and helped to bring an end to the Lost Decade, but few economists think the policies were successful. Growth remained relatively low in many places, financial crises continued to undermine economic gains, and traditional issues of economic fairness were largely ignored. Latin American countries have developed a wide variety of new policies and experiments as they try to reduce poverty, generate prosperity, and provide opportunity for all their citizens.

Export-Led Growth in East Asia (Chapter 16)

Throughout the late 1980s and into the 1990s, it was hard to ignore the East Asian "miracle." While some economists point out that it was not really a miracle—just a lot of hard work and sound economic policies—the growth rates of the "high-performance Asian economies" were unique in human history. Rates of growth of real GDP *per person* commonly reached 4 to 5 percent per year, with 6 to 8 percent not unusual. In 1997, an economic and financial crisis hit the region hard. Although there were lingering effects, by 2000 the economies of the region's developing countries were growing at more than 7 percent a year. One of the dominant traits of the countries in East Asia is the extent to which they are outward looking and dependent on the growth of their manufactured exports.

China and India in the World Economy (Chapter 17)

China and India are the two largest populations in the world. Together, they account for more than a third of humanity. Throughout much of the twentieth century, however, neither country had significant impact on the world economy. Change began in 1978, when China started its dramatic shift away from isolationism. India's transformation from a relatively closed economy toward greater openness began in 1991 and has proceeded at a slower pace. Nevertheless, its sheer population size coupled with the technical excellence of its scientists and engineers has turned it into a growing force in the world economy. Low wages, competitive firms, new technologies, and innovations in transportation and communication networks have increased the presence of both countries in the world economy and given rise to new tensions and new opportunities.

WHAT DO INTERNATIONAL ECONOMISTS DO?

LO 1.5 Describe the employment possibilities and occupations open to students of international economics.

International economics can be a stand-alone major or, more often, a specialty within the field of general economics. It is also frequently included within degree programs in diplomacy, international relations, international studies, and international business. Specialists in international economics have a wide range of opportunities to work at home and abroad, and in any field that requires an understanding of international finance, international trade, foreign relations, or conditions in foreign countries. This includes many of the subfields of finance, such as banking, insurance, and investing, as well as international organizations, think-tanks, governments, private companies including law firms that do business internationally, and education. Many international economists work as analysts in one capacity or another. For example, research analysts provide background on market and business conditions in foreign countries; policy analysts help governments, industries, and international organizations understand the influence of different policies on international trade and finance or the role of policies in promoting economic development. Other possibilities include positions as market or business analysts, international trade specialists, political risk specialists, and foreign aid specialists. International economics is also excellent training to work as a journalist in the fields of international business and international affairs, and the diplomatic corps of every nation employs international economists to help gather economic information about foreign economies and to report on conditions abroad.

There are a number of reasons why international economics prepares students for many possible career opportunities. First, it requires some knowledge of the world beyond one's own country and culture. Understanding the challenges and opportunities that other countries face is an important part of the training and an invaluable asset in any organization with interests that cross national boundaries. Second, the material is rigorously analytical and requires students to master and apply abstract models in real-world contexts. Mastery of the core ideas also means an understanding of the assumptions and limits of the models without tossing out the insights they provide. In this sense, the ideas developed in international economics provide a variety of ways to examine economic conditions while maintaining a high degree of realism regarding unique and special conditions. Third, students will become knowledgeable in the reading and interpreting of charts and tables. This is a skill that is much in demand because it helps individuals communicate clearly and succinctly and makes the organization where they work more effective.

Vocabulary

deep integration
foreign direct investment (FDI)
gross domestic product (GDP)
quotas
regional trade agreement (RTA)
shallow integration
tariffs
trade-to-GDP ratio
transaction costs

Review Questions

1.1 How can globalization and international economic integration be measured?

1.2 Considering the criteria used for judging the degree of integration, what can you tell about India? Is it more or less integrated than it was 20 years ago?

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

1.4 Describe the changes of trade-to-GDP ratio and the composition of trade for leading industrial economies between 1910 and 1950.

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

1.6 Factor movements are one of the indicators of economic integration. With more interdependent relations between countries, labor should move easily across international boundaries. However, it is less mobile internationally today than it was in 1900. Explain.

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

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

1.9 Name some job opportunities available to students of international economics. What are the industries that require this expertise?

CHAPTER

2 International Economic Institutions Since World War II

Learning Objectives

After studying this chapter, students will be able to:

2.1 **Classify the main types of international economic organizations with examples.**

2.2 **Identify economic circumstances in which the IMF, the World Bank, and the WTO are active.**

2.3 **Compare the different levels of integration found in regional trade agreements with examples.**

2.4 **Analyze the roles of international economic organizations.**

2.5 **Debate the pros and cons of international economic organizations.**

INTRODUCTION: INTERNATIONAL INSTITUTIONS AND ISSUES SINCE WORLD WAR II

LO 2.1 **Classify the main types of international economic organizations with examples.**

As World War II was drawing to a close, representatives from the United States, Great Britain, and other Allied nations met in the small New Hampshire town of Bretton Woods. The outcome of these meetings was a series of agreements that created an exchange rate system (which lasted until 1971); the International Bank for Reconstruction and Development (IBRD), also known as the **World Bank**; and the **International Monetary Fund (IMF)**. In 1946, two years after Bretton Woods, twenty-three nations including the United States and Great Britain began talks on reducing their trade barriers, leading to the **General Agreement on Tariffs and Trade (GATT)**, which began operation in 1948. This chapter focuses on these global economic institutions, their history, their role in the world economy, and controversies surrounding their activities.

International Institutions

International economic institutions are an important feature of the world economy. When social scientists try to explain the increasing integration of national economies after World War II, one of the key explanations must be the increased stability and reduced uncertainty that these institutions help to create. Nevertheless, as international economic integration has increased, these organizations have come under more scrutiny and received much criticism. Before we look at their impact and some of the criticisms levied at them, we should define what we mean by an *institution*.

When most people hear the word **institution**, they probably think of a formal organization. However, economists tend to define institutions more abstractly. For example, the "New Institutionalists," led by economist Douglas North, have argued that organizations are not institutions in themselves but are rather the rules that govern behavior—telling us what is permissible and what is not and acting as constraints that limit our actions.

Institutions can be formal or informal. A formal institution is a written set of rules that explicitly state what is and is not allowed. The rules may be embodied in a club, an association, or a legal system. An informal institution is a custom or tradition that tells people how to act in different situations but without legal enforcement. For example, informal institutions include the rules of socializing, gift exchange, table manners, e-mail etiquette, and so on. In this chapter, the term *institution* refers to both rules and organizations.

A Taxonomy of International Economic Institutions

International economic institutions come in many shapes and sizes. They can be lobbying groups for a particular commodity or an international producer's association, the joint management by several nations of a common resource, trade agreements or development funds for a select group of nations, or even global associations. Although this chapter's focus is on global economic institutions, it is useful to look at a taxonomy of international economic institutions, from the most limited and specific, to the most general. Table 2.1 shows five main types.

THE IMF, THE WORLD BANK, AND THE WTO

LO 2.2 **Identify economic circumstances in which the IMF, the World Bank, and the WTO are active.**

Three global organizations play a major role in international economic relations and are central to this book: the International Monetary Fund (IMF), the World Bank, and the **World Trade Organization (WTO)**. The IMF and the World Bank date from the end of World War II; the WTO began in 1995 and grew out of the GATT, which it deepens and broadens. Accordingly, it is useful to know the history and function of the GATT as well as the WTO.

The IMF and World Bank

During World War II, the United States, Great Britain, and several other nations held regular discussions about the shape of the postwar international economic order. They wanted to avoid the mistakes of the 1920s and 1930s, when a lack

TABLE 2.1 A Taxonomy of International Economic Institutions, with Examples

Type	Examples
Commodity- or industry-specific organizations: These range from trade associations, to international standards-setting bodies, to powerful cartels	■ Oil Producing and Exporting Countries (OPEC) ■ International Telecommunications Union (ITU)
Commissions and agencies for managing shared resources	■ International Boundary and Water Commission (IBWC) ■ Mekong River Commission
Development funds and banks	■ Asian Development Bank ■ Islamic Development Bank
International trade agreements involving a few nations (regional trade alliances or trade blocs)	■ North American Free Trade Agreement (NAFTA) ■ European Union
Global organizations for trade, development, and macroeconomic stability	■ International Monetary Fund (IMF) ■ World Bank ■ World Trade Organization (WTO)

of international cooperation led to the complete collapse of economic relations. The culmination of these talks was the **Bretton Woods conference** held in July 1944, in Bretton Woods, New Hampshire. The agreement was largely a result of negotiations between the United States and the United Kingdom and led directly to the creation of the IMF and the IBRD, which later became the World Bank.

The IMF began operation on December 27, 1945, with a membership of twenty-nine countries. Over time, it added new members and is currently at 188 countries. The IMF provides loans to its members under different programs for the short, medium, and long term. Each member is charged a fee, or quota, as the price of membership. The size of the quota varies with the size of the nation's economy and the importance of its currency in world trade and payments. Important decisions within the IMF are made by vote with the weight of each nation's vote proportional to its quota. This gives the high-income countries of the world a voting power that is disproportionate to their population. For example, the United States alone controls nearly 17 percent of the total votes, and the seven largest high-income industrial economies (Canada, Italy, France, Germany, Japan, the United Kingdom, and the United States) control almost 45 percent. Some votes on IMF policy require a "super majority" of 85 percent, giving the United States a veto power on those particular issues. In recent years, the asymmetry in quotas and votes has been under pressure from dynamic emerging economies that want more say in IMF policies and from advanced economies that want to increase quotas paid by other members.

The most visible role for the IMF is to intercede, by invitation, whenever a nation experiences a crisis in its international payments. For example, if a country imports more than it exports, then it may run out of foreign exchange reserves. **Foreign exchange reserves** are dollars, yen, pounds, euros, or another currency (or gold) that is accepted internationally. In addition, the IMF has its own currency, called an *SDR,* or *special drawing right.* SDRs are based on a country's quota and are a part of its international reserves. If a country lacks reserves, it cannot pay for its imports, nor can it pay the interest and principal it owes on its international borrowings. This is one scenario that warrants a call to the IMF. The IMF makes loans to its members, but it usually extracts a price above and beyond the interest it charges. The price is an agreement by the borrower to change its policies so that the problem cannot recur. If simple economic reforms such as a cut in the value of the currency or limits on the central bank's creation of credit are insufficient to solve the problem permanently, then the IMF usually requires a borrower to make fundamental changes in the relationship between government and markets in order to qualify for IMF funds. These requirements are known as **IMF conditionality**. For example, during the crisis of 1997–1998, the IMF was the main provider of funds and expertise to East Asia, again, with a great deal of controversy over the advice it gave and the conditions it imposed.

The IMF's resources for dealing with crises are limited. When the United States and other large economies experienced the crisis that began in 2007, IMF resources were far from adequate for addressing the issues. In 2009, the largest member countries voted to increase its resources to $750 billion, still far below the amount necessary to stem a crisis in the United States or in other large economies. In part, this reflects the institution's asymmetry, as high-income countries are generally unwilling to give the IMF either the funds or the power to allow it to intervene effectively in their economies.

The World Bank is the other major organization that emerged from the Bretton Woods conference. It has the same membership and a similar structure. Members buy shares that convey voting rights on policy proportional to the shares. The original purpose of the World Bank was to provide financing mechanisms for rebuilding Europe at the end of World War II; however, it was soon apparent that its capital reserves were inadequate to the task. In addition, the United States found it politically preferable to have more direct control over the reconstruction funds rather than routing them through an international organization. Hence, the job of reconstruction was directed toward the newly created Marshall Plan, and the World Bank moved toward assisting development in nonindustrial economies.

The GATT, the Uruguay Round, and the WTO

At the end of World War II, a third global economic organization, the International Trade Organization (ITO), was proposed. If it had been created, the ITO's job would have been to establish rules relating to world trade, business practices, and international investment. U.S. opposition killed the idea of the ITO, however, and no such organization was created until 1995. Nevertheless, in 1946, while they were still considering the idea of the ITO, twenty-three countries opened negotiations over tariff reductions. These negotiations led to about 45,000 tariff reductions affecting $10 billion, or one-fifth of world trade. In addition, a number of agreements were made on rules for trade, with the expectation that the rules would become a part of the ITO. Both the tariff reductions and the rules were implemented in 1948; when the possibility of an ITO died in 1950, the agreements on tariffs and trade rules remained in force as a separate agreement, known as the *General Agreement on Tariffs and Trade (GATT)*. The GATT has been very successful in bringing down trade barriers gradually. One indicator is that international trade has grown over the past fifty years from 5 percent of world gross domestic product (GDP) to over 31 percent in 2011.

The GATT functions through a series of **trade rounds** in which countries periodically negotiate a set of incremental tariff reductions. Gradually, through the Kennedy Round in the mid-1960s and the Tokyo Round of the 1970s, trade rules other than tariffs began to be addressed, including the problems of dumping (selling in a foreign market below cost or below a fair price), subsidies to industry, and nontariff barriers to trade.

The GATT intentionally ignored the extremely contentious sectors of agriculture, textiles, and apparel. In addition, trade in services was ignored because it was not important. The accumulation of unresolved issues in these sectors, however, along with the increased importance of nontariff trade barriers, led to the demand for a new, more extensive set of negotiations. These demands culminated in the **Uruguay Round** of trade negotiations that began in 1986. Among other outcomes, the Uruguay Round created the World Trade Organization (1995). As of 2020, there are 164 members and twenty-four additional governments with observer status.

The WTO continues trade talks and sector-specific discussions between comprehensive rounds of negotiations. For example, in 1997, sixty-nine countries signed an agreement to open their telecommunication sectors, and another seventy agreed to significant opening in their financial services sectors. In addition, every two years, trade ministers from the member countries meet to set the WTO's policy objectives. In 2001, trade ministers meeting in Doha, Qatar, agreed to launch a new round of trade negotiations emphasizing issues of developing countries. The **Doha Round** proposed a **Doha Development Agenda** to consider trade issues of importance to developing countries. The key issues are farm subsidies and agricultural protection and trade in services. These are highly sensitive issues, and the Doha Round has reached an impasse. In all likelihood it will be the first round of trade negotiations to fail since the start of the GATT in 1947. Nevertheless, WTO member governments continue to negotiate specific issues, and outside the WTO framework, small groups of countries continue a wide range of negotiations aimed at greater market access and lower trade barriers.

The foundation of all WTO and GATT agreements are the principles of **national treatment** and **nondiscrimination**. *National treatment* is the requirement that foreign goods are treated similarly to the same domestic goods once they enter a nation's markets. *Nondiscrimination* is embodied in the concept of **most-favored nation (MFN) status**. MFN requires all WTO members to treat each other as they treat their most-favored trading partner. In effect, this is a prohibition against discrimination. Somewhat contradictorily, MFN allows trade agreements such as the North American Free Trade Agreement (NAFTA) and the European Union (EU) even though every trade agreement causes countries to discriminate in favor of each other and implicitly against nonmembers. In theory, the WTO permits such agreements as long as they do not harm the overall level of international trade, and in practice, the WTO has never challenged the validity of a trade agreement between member countries.

CASE STUDY

The GATT Rounds

Agreements in the GATT forum to reduce trade barriers take place in rounds of negotiations. Counting the first round, there have been nine rounds of negotiations, with the Doha Round still in progress. Originally, the GATT was an international agreement and not an organization. The failure to create the International Trade Organization in 1950, however, resulted in the gradual conversion of the GATT into a de facto organization by 1960, with a permanent secretariat to manage it from Geneva. Table 2.2 lists the various rounds of negotiations.

The first five rounds were organized around product-by-product negotiations in which countries mutually cut their tariffs on specific products. Beginning with the Kennedy Round, negotiations were simplified as countries negotiated an across-the-board percentage reduction in all tariffs for a range of industrial products. One effect is that tariffs have never been uniform across countries. The goal has been to bring them all down but not to create the same tariff for all countries.

The Tokyo Round is notable because it was the first round to begin to establish rules regarding subsidies. Subsidies give an industry a competitive advantage, since the national government pays part of the cost of production, either through direct payment or indirectly through subsidized interest rates, artificially cheap access to foreign currency, or some other way. The Tokyo Round began the laborious process of creating rules in this area, one of the most important being the agreement to prohibit subsidies for exports of industrial goods (but not agricultural goods or textiles and apparel).

The subsidy issue of the Tokyo Round was carried forward into the Uruguay Round, where subsidies were defined in greater detail. The Uruguay Round accomplished many other things as well, not the least of which was the creation of the WTO as a formal organization to oversee and administer the GATT. Additional accomplishments are described in Chapter 7, which explores trade policy and trade barriers in more detail.

(continued)

TABLE 2.2 The GATT Rounds

Round	Year	Number of Participants
Geneva I	1947	23
Annecy	1949	13
Torquay	1951	38
Geneva II	1956	26
Dillon	1960–1961	26
Kennedy	1964–1967	62
Tokyo	1973–1979	102
Uruguay	1986–1993	105
Doha (WTO)	2001–	164

REGIONAL TRADE AGREEMENTS

LO 2.3 Compare the different levels of integration found in regional trade agreements with examples.

Regional trade agreements (RTAs) between two or more countries are another important institution in the world economy. Many of these have familiar names, such as NAFTA and the EU. Regional agreements can be classified into one of five categories, as shown in Table 2.3; however, they often combine elements from a couple of the categories.

TABLE 2.3 Five Types of Regional Trade Agreements

Type of Agreement	Characteristics
■ Partial trade agreement	■ Free trade in the outputs of one or a few industries
■ Free-trade area	■ Free trade in outputs (goods and services)
■ Customs union	■ Free trade in outputs plus a common external tariff
■ Common market	■ Custom union plus free movement of inputs (capital and labor)
■ Economic union	■ Common market plus substantial harmonization of economic policies, including a common currency

Five Types of Regional Trade Agreements

RTAs are bilateral (two countries) or plurilateral (several countries). The WTO is not an RTA because it is worldwide in scope and not just regional. In trade jargon it is called a *multilateral* agreement because it includes, potentially, all the countries of the world. Some plurilateral agreements are quite large, such as the EU, which has twenty-eight members, or the proposed free-trade area of the Pacific, called the Asia Pacific Economic Cooperation group, which has twenty-one.

CASE STUDY

Prominent Regional Trade Agreements

Each of the five levels of integration is an example of a different kind of regional trade agreement (RTA), or **trade bloc**. The question naturally arises as to how many agreements there are and whether they are beneficial or harmful for the world economy. The simple question of how many is difficult to answer precisely. Many of the agreements do not fit neatly into any of the five categories, so it is not clear they should be counted. That is, should all partial agreements be counted when they are not quite free-trade areas yet they have elements of free trade, customs unions, and even common markets? In addition, many of the agreements either exist on paper only (have no real effect) or have yet to be fully negotiated and/or implemented. Until there is substantial implementation, there is always the possibility that the agreement will collapse because opening an economy inevitably generates opposition from uncompetitive sectors.

Countries that have signed the GATT are obligated to notify the GATT secretariat when they form an RTA. According to the WTO, since the implementation of the GATT in 1948, it has been notified of nearly 700 RTAs. Many are no longer in force or have been superseded by newer agreements, but 303 RTAs were active in 2020. Most of the functioning agreements were started in the 1990s or 2000s.

The second question posited earlier—are agreements beneficial or harmful?—is even more difficult to answer. A 1995 study by the WTO concluded that in most cases "regional and multilateral integration initiatives are complements rather than alternatives."[1] Broadly speaking, the WTO sees these agreements as helping it to further reduce trade barriers. This view is not shared by all economists, however, as any regional agreement must favor the interests of its members over the interests of outsiders. In other words, there is an element of discrimination that goes against the WTO's fundamental principle of equal treatment (most-favored nation). Preferential treatment for members of the

(continued)

[1]© 1995 World Trade Organization

trade agreement causes most regional trade agreements to destroy some of the trade between their members and nonmembers. The WTO recognizes this problem but argues that as long as a regional agreement creates more new trade than it destroys, the net result is beneficial. In addition, the WTO sees the regional trade agreements as places where countries can try out new arrangements, some of which will be eventually incorporated into the larger, global agreement.

Nearly all WTO members belong to at least one RTA, and many countries belong to several. For example, Mexico is a member of NAFTA (Canada-Mexico-United States), but in 2000 it entered a free-trade agreement with the EU. It has also signed free trade and other agreements with other countries, including Chile, Japan, Israel, and Costa Rica, among others. Table 2.4 lists some of the RTAs currently in force. Among the best known are the EU, the EFTA, the NAFTA, MERCOSUR in South America, the ASEAN Free Trade Area in Southeast Asia, and COMESA in Eastern and Southern Africa. There are many more, however, ranging from tariff agreements on a subset of output, to common markets and economic unions. The dates in parentheses are the dates of implementation of the agreements.

TABLE 2.4 Prominent Regional Trade Blocs

Region/Trade Bloc	Objective
Africa	
COMESA—Common Market for Eastern and Southern Africa (1993)	Common market
ECOWAS—Economic Community of West African States (1975)	Common market
Asia	
AFTA—ASEAN Free Trade Arrangement (1992)	Free-trade area
APEC—Asia-Pacific Economic Cooperation (1989)	Free-trade area
Europe	
EFTA—European Free Trade Association (1960)	Free-trade area
EU—European Union (1957)	Economic union
Middle East	
ACM—Arab Common Market (1964)	Customs union
GCC—Gulf Cooperation Council (1981)	Common market
Western Hemisphere	
MERCOSUR—Southern Cone Common Market (1991)	Common market
NAFTA—North American Free Trade Area (1994)	Free-trade area

Sources: Data from Harmsen and Leidy, "Regional Trading Arrangements," in *International Trade Policies: The Uruguay Round and Beyond. Volume II: Background Papers*. Washington, DC: IMF, 1994. The WTO, "Regionalism." Geneva: The World Trade Organization, © James Gerber.

A **partial trade agreement** is the least comprehensive RTA. It occurs when two or more countries agree to drop trade barriers in one or a few economic sectors, such as steel, autos, or any other line of production. Partial trade agreements are used when countries are reluctant to open all sectors but they desire free trade for a limited set of goods.

As more goods are included in the partial trade agreement, it begins to look more like a **free-trade area**. One example is NAFTA, but there are many others, such as the European Free Trade Area (EFTA) and the U.S.-Israel Free Trade Agreement. In a free-trade area, nations trade goods and services across international boundaries without paying a tariff and without the limitations imposed by quotas, which are direct limits on imports. In reality, however, most free-trade areas such as NAFTA do not allow completely free trade. Nations usually reserve some restrictions for particularly sensitive items. For example, as part of its efforts to protect its culture, Canada limits the number of U.S. television programs that Canadian television stations may purchase. With a free-trade area, nations usually keep their own health, safety, and technical standards and may deny entry of imports if they do not meet national standards.

The next level of integration is called a **customs union**. A customs union is a free-trade area plus a **common external tariff** toward nonmembers. By 1968, the EU (then called the European Economic Community) had become a customs union, and in today's economy, MERCOSUR (Brazil, Argentina, Uruguay, Paraguay, and Venezuela) aspires to become one. As with free-trade areas, many items are usually left out of the agreement. In the European case, for example, each nation retained its own tariffs and quotas with respect to Japanese autos. Common markets are the next level beyond customs unions. A **common market** is a customs union plus an agreement to allow the free mobility of inputs, such as labor and capital. The clearest example is the EU in the 1990s. The three NAFTA countries have elements of a common market (without the common external tariff) because they allow capital to move freely around the region. NAFTA also grants relatively free movement to certain types of white-collar labor, such as architects, business consultants, and others.

The final level of economic integration is an **economic union**. An economic union is a common market with substantial coordination of macroeconomic policies, including a common currency, and harmonization of many standards and regulations. The clearest examples are the states of the United States or the provinces of Canada. The BENELUX Union of Belgium, the Netherlands, and Luxembourg is an example of separate nations that have formed a union, and the EU is in the process of becoming an economic union, with the euro as its common currency and, at some point, with a common defense policy, common citizenship rights, and a common fiscal policy.

Regional Trade Agreements and the WTO

When a WTO member signs an RTA, it is obligated to notify the WTO. Since 1948, nearly 700 agreements have been listed with the WTO, with a majority of the notifications having occurred since 1990. Not all of these notifications resulted in active trade agreements, but as of 2020, 303 separate agreements were actively in force.