The International Economy

This text is a rigorous introduction to international economics for upper-level undergraduates and above. The first half examines the causes and effects of international trade, how tariffs and other trade policies affect the gains from trade, and the ways in which governments try collectively to regulate those policies. It explains the roles of regional arrangements such as the European Union (EU) and North American Free Trade Agreement (NAFTA). The second half deals with monetary matters—the behavior of exchange rates, how trade and capital flows affect the functioning of monetary and fiscal policies, the causes and management of currency crises, and the new European monetary union (EMU).

This fourth edition retains the strategy and structure of the previous edition but has many new features. It assesses the outcome of the Uruguay Round of trade negotiations, the work of the new World Trade Organization (WTO), and the challenges posed by regional trade blocs. It surveys recent theoretical work on currency crises, examines recent crises in emerging-market countries and the role of the International Monetary Fund (IMF), and appraises innovations in exchange-rate arrangements, including the EMU and the use of currency boards. A problem set follows each chapter.

Peter B. Kenen has served as Walker Professor of Economics and International Finance since 1971 and was Director of the International Finance Section at Princeton University from 1971 through 1999. He previously taught at Columbia University from 1957 to 1971 and received its University Medal for Excellence in 1977. Professor Kenen is the author or editor of over a dozen books, including *Asset Markets, Exchange Rates, and Economic Integration* (1980, with P. R. Allen), *The International Monetary System* (1994, coedited with F. Pappadia and F. Saccomani), and *Economic and Monetary Union in Europe: Moving Beyond Maastricht* (1995), and is the honoree of the Festschrift *International Trade and Finance: New Frontiers for Research* (1997, edited by B. J. Cohen), all published by Cambridge University Press; he coedited the two-volume *Handbook of International Economics* (1984, with R. W. Jones). He has served as a consultant to the U.S. Treasury, the Council of Economic Advisers, the Federal Reserve Board, and the International Monetary Fund, has been a Visiting Fellow at the Center for Advanced Study in the Behavioral Sciences, the Royal Institute of International Affairs, and the Bank of England, and is a member of the Group of Thirty.

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who is almost always right

Contents

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Peter B. Kenen
Frontmatter
More information

Preface

The first edition of this book appeared in 1985. In grew out of an earlier book, *International Economics*, which was widely used but was sometimes criticized as being too difficult for elementary courses and too brief for intermediate courses. When I began to write this book, I planned to fill gaps in the earlier one but to keep it shorter than most other textbooks. Each chapter turned into three, however, as I filled more gaps and carried the analysis further.

The second edition of this book appeared in 1989 and differed greatly from the first. In the first edition, for example, two trade models featuring factor substitution appeared in a single chapter, and the analysis of trade and growth appeared in another chapter. In the second edition, each model appeared in a separate chapter, along with the analysis of trade and growth in the context of that model. Furthermore, I added a chapter on trade and trade policy under imperfect competition.

The third edition made several more changes, which were well recieved and are retained in this edition:

- The theory of trade policy is integrated with pure trade theory. The analysis of tariffs begins in Chapter 2, right after the analysis of the gains from trade, and the effects of tariffs are examined again in the context of models developed in subsequent chapters. The results are then summarized in Chapter 9, which examines the instruments and uses of trade policy.
- The caption beneath each diagram provides a detailed description of the processes at work. I have therefore been able to eliminate some of this material from the text and to focus the text more concisely on the basic economic issues.
- The algebraic notes that appeared previously in several chapters are consolidated into two self-contained appendixes. Appendix A deals with trade theory. Appendix B deals with monetary theory.
- Each chapter is followed by questions and problems designed to help students test their understanding of the methods and issues examined in the chapter. Answers

to the even-numbered questions and problems, including the relevant diagrams, are provided in Appendix C, at the end of the book.

Although this edition retains the basic structure of the third edition, it contains new features. Chapter 11, on the future of the trading system, assesses the achievements of the Uruguay Round, explains the role of the World Trade Organization, and examines the challenges posed by regional trade blocs. Chapter 17 uses the monetary model of the balance of payments to develop a first-generation model of currency crises based on the work of Paul Krugman, and Chapter 20, on the future of the monetary system, develops a second-generation model based on the work of Maurice Obstfeld. Furthermore, Chapter 19, on the evolution of the monetary system, discusses the currency crises of the 1990s, and Chapter 20 reviews innovations in exchange-rate arrangements, including currency boards, and describes the structure and functioning of the European monetary union.

Like most texts on international economics, this book aims at showing students how international transactions affect the domestic economy and the conduct of national economic policies. Unlike many other texts, it tries to introduce rigorously the analytic tools that economists use to examine these matters, and it stresses the assumptions used to devise those tools. Finally, it integrates empirical work with pure theory.

Although it is more rigorous than some other texts, it is designed mainly for undergraduates. Those who have taken intermediate courses in micro and macro theory (or are taking them concurrently) will not find it difficult. Those who have less preparation will have to work harder, but they will find that new concepts and tools are explained when they are introduced. Mathematical sophistication is not required. There is very little algebra in the text. I rely mainly on diagrams. (Equations are used extensively in the presentation of national-income analysis, but of the sort that most students encounter in the principles course.) Some of the diagrams are complicated, because trade problems are complicated; they typically involve two countries and goods, and sometimes involve two factors of production. But I have tried to lead the reader through each diagram carefully in the caption beneath it. I have also tried to follow the advice of my own students, who urged me not to introduce a diagram unless I use it more than once.

This book is designed for full-year courses on international economics but can also be used in separate one-semester courses on international trade and on international monetary economics. Those who want to use the book in a one-semester survey courses will have to omit some chapters, but I have tried to make that easy by the way in which I have organized the presentation. It is possible to omit Chapters 6, 7, and 8, on the general Heckscher-Ohlin model, imperfect competition, and factor movements. Subsequent chapters do not use any of the diagrams introduced in those chapters. It is likewise possible to omit Chapters 16, 17, and 18, on expectations and capital movements, the monetary model, and the portfolio-balance model.

I am grateful to students and colleagues at Princeton University who used previous editions of this book and made many helpful suggestions. I am also grateful to colleagues who read parts of this and earlier editions and helped me to improve them, especially to Polly Allen, Robert Baldwin, Alan Deardorff, Avinash Dixit, Gene Grossman, Anne Krueger, and Harvey Lapan. I thank Margaret Riccardi for editorial help, Corrinne Ho for preparing the diagrams, and Scott Parris of Cambridge University Press for strong support and sensible advice.