

# Chapter One

## International Economics Is Different

Nations are not like regions or families. They are sovereign, meaning that no central court can enforce its will on them with a global police force. Being sovereign, nations can put all sorts of barriers between their residents and the outside world. A region or family must deal with the political reality that others within the same nation can outvote it and can therefore coerce it or tax it. A family or region has to compromise with others who have political voice. A nation feels less pressure to compromise and often ignores the interests of foreigners. A nation uses policy tools that are seldom available to a region and never available to a family. A nation can have its own currency, its own barriers to trading with foreigners, its own government taxing and spending, and its own laws of citizenship and residence.

As long as countries exist, international economics will be a body of analysis distinct from the rest of economics. The special nature of international economics makes it fascinating and sometimes difficult. Let's look at four recent events that frame the scope of this book.

### FOUR EVENTS

#### Steel

In March 2002, President George W. Bush imposed taxes of up to 30 percent on many kinds of steel imported into the United States. Informed observers viewed this action as the most dramatic protectionist step taken by a U.S. president in many decades. Why would a Republican president who strongly advocates free trade put up such blocks to trade? What are the consequences?

International economics is different because we must follow at least two parallel strands of the story to answer these questions. One strand of the story is what's happening within the country—in this case the United States. The other strand is what's happening between countries that have an interest in the event.

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Let's look first at the story within the United States. The large integrated producers in the American steel industry have been in decline since the early 1960s. In 1998, following the Asian economic crisis, low-priced steel imports grew rapidly as foreign producers that had been selling to the crisis countries shifted their sales to the U.S. market. The Republican Bush won the 2000 election in part by making charges against the incumbent Democratic administration that it had ignored the pleas for help from steelworkers and steel firms.

In June 2001 President Bush took the unusual step of asking the U.S. International Trade Commission to investigate whether imports were causing serious injury to the American steel industry and, if so, what could be done about it. In December 2001 the commission reported that imports were hurting the industry and suggested that the government place either higher taxes on imports (such taxes are called *tariffs*) or new limits on the quantities of imports (called *quotas*). It was up to President Bush to decide what to do.

If we focus on the large integrated firms in the American steel industry, then we can see a case for compassion. Most of these firms had declared bankruptcy but continued to operate once relieved of servicing some of their debts. Employment in the industry was shrinking (though much of this decline was the result of technological innovation and rising productivity). The industry wanted tariffs of at least 40 percent on all steel imports, to give the firms time to improve their competitive position. A few days before President Bush announced his decision, thousands of steelworkers rallied in Washington in support of protection.

However, President Bush found himself in a dilemma of his own making. Steel producers and steelworkers were not the only groups in the United States that would be affected by his decision. Many U.S. firms buy and use steel to make their own products.

The administration and the steel producers tried to put a happy face on the tariffs that President Bush did impose. The administration hoped to reduce imports without hurting domestic steel users. U.S. trade representative Robert Zoelick said, "It's our belief that this will give the U.S. steel industry the opportunity to get back on its feet but without having any detrimental effect on the U.S. economy." Thomas Usher, chief executive of U.S. Steel Corporation, said that the tariffs "will only result in modest and reasonable price increases." If Zoelick and Usher had read this book, they would know better.

The firms that use steel—including producers of autos, appliances, heavy machinery, machine tools, and large buildings—knew better. They had formed groups like the Consuming Industries Trade Action Coalition and the Emergency Committee for American Trade to fight the impending tariffs. They argued that the tariffs would hurt hundreds of companies that employ far more than the 200,000 workers in the American steel industry.

When the tariffs were announced, the head of the Emergency Committee predicted, "A 30 percent tariff won't solve the integrated steel industry's problems, but it will force other American manufacturers to move steel-intensive production overseas, close U.S. plants, and outsource U.S. parts and components in order to compete."

And so it came to pass. In the months after the tariffs were imposed, prices of many kinds of steel rose by 20 to 30 percent. Even user companies that thought they were safe because they had long-term contracts with set prices were in for surprises. American steel firms broke these contracts and demanded higher prices. Steel imports declined by 30 percent. The country was paying a price to maintain the American steel industry. Gary Hufbauer, of the Institute for International Economics, estimated that the cost to U.S. consumers of maintaining one steelworker's job was over \$300,000 per year. It would be much cheaper to pay the worker to be idle.

Thus, one strand of the story is about domestic political battles that use international trade as the battleground. Most observers believe that President Bush made a calculated domestic political decision to help the steel firms and steelworkers. He hoped to gain votes in West Virginia, Pennsylvania, and Ohio for Republican candidates in the 2002 congressional elections. He hoped that voters elsewhere would not notice the price they were paying to provide this help. In Chapters 7–9 we will carefully examine the effects of tariffs and other forms of protection on different groups in a country. In addition, as we will see in Chapter 10, the Bush tariffs are not the only protection for American steel. Since the late 1960s the American steel industry has also been adept at gaining protection by using other laws that attack allegedly unfair practices by foreign exporters.

The other strand of the story brings in the other countries affected by the new U.S. tariffs. About one-third of the imports hit by the new tariffs were exports from the countries of the European Union (EU). The tariffs also hit exports from Japan, South Korea, China, and Taiwan. (The U.S. tariffs specifically exempted exports from Canada and Mexico, partners in the North American Free Trade Agreement, and many developing countries that were not major sources of steel.)

Foreign countries had two reactions. First, they acted to prevent “deflection” of exports that would have gone the United States. Second, they complained to the World Trade Organization (WTO) that the U.S. action violated the international rules to which the United States had agreed as a member of the WTO.

When the U.S. government imposed the new tariffs on steel imports, foreign producers that had been planning to export to the United States had to look elsewhere. Indeed, some deflection was literal, consisting of ships on the ocean that changed destination. A number of countries—including the EU, China, Mexico, Venezuela, and Malaysia—quickly raised import barriers of their own, to prevent a flood of steel imports into their markets. (The EU is not really a “country” but rather a regional entity created by agreement among its member countries. However, in matters of trade policy the EU functions like a country. We discuss the EU and other trade blocs in Chapter 11.) These countries did not want to risk harm to their steel producers, even if their consumers would benefit from the cheap steel imports. The danger is that all of this raising of import barriers could get out of hand, leading to a general trade war like the devastating one the world experienced in the early 1930s.

If the whole world were one country—a global nation—the rising barriers to the trade of steel would have been prevented or controlled quickly. If the laws of

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this global nation resembled those of the United States, the whole issue would have been left to the marketplace. Within a nation, it is usually illegal for one region to put a special tax on products produced in other regions of the country. So the United States could not have imposed the new tariff, and the other countries would not have responded with tariffs of their own.

The world has tried to set up a system of rules about international trade. The World Trade Organization oversees these rules and serves as a forum for settling trade disputes. After the U.S. government imposed the new steel tariffs, the second thing that foreign governments did was to complain to the WTO that the U.S. action violated the international rules. The U.S. government claimed that it imposed the new tariffs as a “safeguard,” a form of temporary protection against imports permitted under WTO rules when a surge of imports causes serious harm to an industry in the country. The U.S. government said that the tariffs would be temporary, ending in three years.

A number of other countries—including the European Union, Japan, South Korea, China, Brazil, Taiwan, Switzerland, Norway, and Thailand—complained to the WTO that the U.S. actions violated other aspects of the rules covering safeguards. These governments claimed that there was no recent sharp increase in steel imports into the United States. Any import surge had ended in 1998, and since then steel imports into the United States had declined by one-quarter. They also claimed that factors other than imports were the main cause of the decline of the big integrated steel producers in the United States. Production by U.S. mini-mills costs less than production by the big U.S. integrated firms. Minimills had been steadily gaining market share. The U.S. government disputed these complaints, stating that the import surge had not really reversed itself and that imports were a serious cause of injury.

If the WTO process runs its normal course, it will take perhaps two years for the organization to rule on whether the U.S. steel tariffs meet the WTO rules. Even if the U.S. tariffs are judged to be in violation of the rules, the dispute may not be resolved. If the U.S. government refuses to change its action or offer other compensation, the WTO can authorize retaliation by the injured countries. For instance, the European Union is claiming damage of about \$2 billion per year. The WTO could authorize the EU to impose 100 percent tariffs on this amount of imports from the United States.

This kind of fight between regions would not rage in the political arena for so long if the whole world were one country. The global nation’s supreme court would rule one way or the other, and the court’s ruling would be definitive. But actual nations are sovereign; they have their separate jurisdictions and separate policies. The WTO has only as much impact as the individual nations allow it to have. Tariffs and other trade barriers are part of what makes international economics so different.

### **Poor Workers in Poor Countries**

Many of the world’s people are very poor. These people work in the informal sector, scratching out an existence. Even those who have employment for pay

often receive wages that are very low in comparison to wages in the United States, Western Europe, and Japan—while working in conditions that are much worse. One way in which international economics is different is that it forces us to think about some very large differences between countries.

We all would like to have a world in which people are well off in their incomes and work conditions. During the past decade, some groups in the developed countries have staged protests and taken actions to try to help poor workers in poor countries. These groups, often called *nongovernmental organizations*, include nonprofit organizations like the Council on Economic Priorities and student groups at many of the leading universities in the United States.

One result of these protests and pressures was an agreement in the International Labor Organization that all countries should respect four core labor standards: freedom of association and the right to collective bargaining, no forced labor, no child labor, and no discrimination in respect of employment or occupation. Many countries are still far from achieving these four core standards. The International Labor Organization itself has no way to enforce these standards outside of disseminating information to bring pressure on countries that are major violators.

Many of us believe in these core standards as a matter of morals—these are human rights. This does not mean that international economics is not relevant or useful. Even for those who believe that improving the lot of poor workers in poor countries is essential, there is still the question of how to make it happen.

Let's focus on the issue of child labor (the other standards and issues have many similar features). It is estimated that, globally, about 125 million children under 15 years of age work full-time, and about the same number work part-time. In the poorest countries nearly half of children ages 5 to 14 work. How can we successfully reduce these numbers? Using economics, here are some things that we know or suspect.

Many activists blame globalization for widespread child labor, terrible working conditions, and mass poverty in the poor countries.<sup>1</sup> One claim is that rising international competition drives firms to pressure their governments for weaker regulations—a “race to the bottom.” While this is theoretically possible, there is little evidence that it is happening. More broadly, affiliates of foreign multinational firms and local firms that produce for export in developing countries generally pay better wages and have better working conditions than local firms producing for local sale in these countries. Workers in these countries generally seek jobs in these “globalized” firms. Also, multinational firms do little of their investing in countries with very poor respect for core labor standards (with the notable exception of coastal China). Poverty is most dire in Africa, rural India, and rural China. It is not a coincidence that these are the places in the world that globalization has almost not touched.

<sup>1</sup> Globalization is the process of intensifying the connections between national economies, through international trade, foreign direct investments by multinational firms, and international financial investments.

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In Seattle in 1999, the site of one of the largest protests about issues related to globalization, then-President Bill Clinton said the United States would support allowing countries to impose trade sanctions against countries that violate child labor and other core standards. Trade sanctions may make us feel better, but they probably won't accomplish our goal of helping children. If countries do not change their practices, and we reduce imports of products produced by child labor, we are likely to drive down the wages of child workers, making them poorer. Even if countries adopt laws against child labor, the laws probably will just drive these children into working in the informal part of the economy, with wages and working conditions worse than those they already endure.

Activist groups have put pressure on companies in the developed countries whose products are produced in poor countries using child labor. The pressure has been strongest in clothing, targeting companies like Levi Strauss, Nike, and Wal-Mart, as well as universities that sell items emblazoned with their logos. Again, boycotts and other such actions may make us feel better, but their effect is limited. Only about 5 percent of children work in production for export. Even if we reduce this number, the children are most likely to shift to other employment in which wages and conditions are worse.

We actually know the long-run solution to eliminating child labor: economic growth and rising incomes. When families are very poor, a child's income can be crucial to family survival. When average incomes per person rise to about \$5,000, child labor nearly disappears as an issue. Even U.S. history attests to this dynamic. Substantial child labor existed in the United States into the early 20th century. Indeed, U.S. respect for core labor standards is less than 100 years old. Better working conditions are a normal good. When we are very poor, we worry most about material survival. When our incomes rise, we use some of the rising income to "buy" better working conditions. Looked at this way, international trade is part of the solution. We know that countries that are more open to trade tend to grow faster.

However, we don't want just to wait for the long run to get here. What can be done now that has a good chance to speed up the process? If children are not working, what do we want them to do? The answer is clear—go to school. Poor families whose children are working know that their families would be better off in the future if their children received more education now, but they cannot invest for the future because their survival is at stake. Here is a problem that we could do something about. We need programs that pay very poor families to send their children to school. These programs exist and are successful. In Mexico and Brazil, poor families are paid to keep their children in school. In Bangladesh and Pakistan, children are shifted from work to school, the families are paid a monthly stipend, and adult family members are moved into work positions previously held by their children. The number of children who attend school through these programs is small, only a few tens of thousands, but it is a start. As we will see in Chapter 9, this policy approach is an application of what we will call the *specificity rule*.

## The Euro

In early 2002, the national moneys of 12 European countries disappeared. They were replaced by one new money, the *euro*. The idea of a common currency had seemed like a dream only 15 years earlier but has now become a reality. The countries using the euro as their “national” currency are 12 of the 15 members of the European Union. The exceptions as of mid-2002 are Britain, Denmark, and Sweden.

Adopting a single currency may seem like a natural choice. If the nations of the EU want to have a large unified economy like the United States, why shouldn't they have a unified currency like the United States? There are certainly advantages to having nations share a common currency. It's convenient—you don't have to change your money every time you cross a national border, any more than you need to change your money when you drive from Kansas to Missouri. It's less risky—you don't have to worry about the changing value of one local money relative to the local money in neighboring countries. There is evidence that having the same currency stimulates trade between countries, though there is debate about how large the trade increase is. So the basic question of this chapter is clearly raised by the euro: Why should international economics be any different from economic life within a country?

There are reasons why countries, including the three holdouts in the EU, are deeply reluctant to abandon their own national moneys in favor of an international money. Having your country's central bank control the national money supply gives it the ability to influence national prices, production, and jobs. Do you want your country to give up control of money to some international institution beyond your country's control? For most countries, the answer is no. They feel that it is important to maintain their national monetary sovereignty, basically because they feel they can manage their own economy better than an outside institution can.

In some countries the answer is actually “Yes, we do want to cede control over our money supply to some outside institution.” The 12 countries now using the euro made that decision. The European Central Bank now sets monetary policy for the “euro area.” For these 12 countries, adopting the euro is part of a much broader effort to create a true union of countries that have common policies for the economy and for other areas such as defense and foreign affairs. The decision to adopt the euro was largely political, but it will have major economic effects on these countries.

The idea of giving up monetary sovereignty is also popular in countries where disastrous national policies have ruined their own currencies by oversupplying them until price inflation made each unit of the national currency nearly worthless. As a last resort, a few countries have decided to shut down their own central banks and to replace their national currencies with some stable foreign currency. This process is called *dollarization*, although the U.S. dollar is not the only foreign currency that has been used. In 2000 Ecuador was in economic turmoil. By dollarizing, Ecuador's economy became noticeably more stable. Other countries

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have tried to gain this stability by tightly fixing the value of their currency to the dollar or to some other foreign currency. Argentina's experience with this approach is discussed in the next section of this chapter. We examine the basis for government policy toward the exchange rate in Chapter 24.

Use of the euro will probably grow during the next decade for two reasons. First, the three current holdout countries are likely to adopt the euro as the advantages of joining the monetary union become increasingly attractive. Second, the EU is likely to expand by adding new member countries. As of mid-2002 there were a dozen countries (Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Hungary, Slovenia, Romania, Bulgaria, Malta, and Cyprus) actively negotiating to join. There are tough issues that must be resolved before membership can be granted. A change in governance procedures for EU decision making is probably needed if the number of member countries goes to 25 or more. Financial aspects of membership, including the ability of new members to draw on the expensive and protectionist common agricultural policy, must be hashed out. Still, by 2010 it is likely that at least 25 countries will be members of the EU and will be using the euro as their "national" currency.

### **Argentina: From Darling to Delinquent**

In the late 1980s Argentina was in deep trouble. Its economy was a mess, with hyperinflation of over 2,000 percent per year for both 1989 and 1990. The international value of its currency was in free fall. Its government seemed capable of nothing but mismanagement.

Amazingly, a few years later Argentina had become one of the most attractive of the "emerging economies." It was a model of sensible economic policies, and its economy had become one of the best performing in the world. Then, in 1998 things started to go wrong. By late 2001 Argentina's economy was unraveling fast. Its political situation was in the throes of upheaval, too.

How did all this happen in such a short time? The answer is a tale with a hero who later became a villain, a story of how national government policies interact with global forces and foreign investors.

Argentina's hyperinflation in the late 1980s is not difficult to understand. The government was running a large budget deficit, and the central bank was running the printing presses overtime to shovel money to the government for its spending. With way too much money chasing the limited products available, product prices soared. Inflation exploded.

Enter Domingo Cavallo, an economist with a doctorate from Harvard. As Argentina's economy minister, he developed a plan, based on strict convertibility between the Argentinean peso and the U.S. dollar. He put in place a fixed exchange rate of 1 peso to \$1. This completely tied the hands of the central bank, which became merely a *currency board*, a government agency that stood ready to exchange pesos for dollars at the fixed rate. No more running of the peso printing press, unless people were willing to buy each peso by turning in a dollar. It took a few years for this shock treatment to have its full effect, but by 1994 inflation was

down to 4 percent. To Argentines weary of extraordinary inflation, Cavallo was the national hero.

Argentina's government adopted other policy changes to solidify its role as the darling of foreign investors. The government removed rules limiting international investment into and out of Argentina. It privatized a number of government-owned companies, with foreign investors buying large stakes in some of them. It accomplished some reduction in the fiscal budget deficit. Foreign investors saw all this and they liked it. Foreign capital flowed into Argentina. As a result of the near-zero inflation and the investment flowing in, Argentina's interest rates fell to surprisingly low levels. The economy took off. During 1991–1998 Argentina's production of goods and services (its real gross domestic product) grew at an average rate of nearly 6 percent per year. It began to look possible that Argentina would grow to regain the economic status that it had before World War II, when its income per person was equal to that of Canada, France, and Germany.

However, storm clouds began to appear, coming from over the national border. In 1997 the Asian crisis hit the global economy, with the "Asian miracle" countries—Thailand, Indonesia, South Korea, Malaysia, and the Philippines—becoming the pariahs of global finance. The Russian crisis followed in 1998. Foreign investors became nervous about emerging economies in general. They began to question whether countries with large foreign debts could continue to service the debts by paying interest and paying down the principal.

With the international liberalizations of the early 1990s, Argentina's businesses and people increasingly were buying more goods and services from foreigners than they were selling to them. This deficit on goods and services could be financed as long as foreigners continued to lend to Argentina. The fixed exchange rate actually encouraged Argentines to import and discouraged exports. In the early years of the fixed exchange rate, the high Argentinean inflation made it harder to export and attractive to import. Beginning in 1997, the Argentinean peso rode along with the U.S. dollar as the dollar rose in value against other currencies, especially the Brazilian currency. The results of these changes was a decline in the competitiveness of Argentina's products in comparison with the prices of products produced in other countries.

Beginning in 1997, a series of bad foreign shocks hit Argentina's economy. These shocks interacted with rigidities that remained in the Argentinean economy, the result of excessive regulation and government bureaucracy. In 1998, Argentina's economy went into a recession. As the economy slowed, the government budget deficit increased. Foreign investors began to seriously consider the possibilities of a devaluation of the peso and a default on government debt. Investment inflows dried up by 2001. Interest rates in Argentina rose, which only made the recession worse. Without borrowing from foreigners, Argentina could no longer buy more goods and services from foreigners than it was selling to them. Imports plummeted as incomes in Argentina declined with the recession.

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In late 2000 it looked like foreigners were coming to the rescue. In December the government announced that it had established a \$40 billion rescue package, including commitments of \$14 billion from the International Monetary Fund (IMF).

When things did not improve much, the government called on Domingo Cavallo to return as Argentina's economy minister. Unfortunately, Cavallo did not have another miracle up his sleeve. He did enact some policies to boost international competitiveness, including a broad scheme of subsidies to exports and taxes on imports. He had some success in reducing the fiscal budget deficit, but not enough. The Argentinean people began to fear for the soundness of the banking system. Depositors ran to the banks to get their money out. In December the IMF stopped making new loans to the Argentinean government under the rescue package because the government had not met the conditions set by the fund for improvements in government policies. In a final effort to save the system, including the fixed exchange rate, Cavallo ordered severe limits on the withdrawals from bank accounts. Angry protests spawned looting and rioting, with 23 deaths. Vilified by the people, Cavallo left the government. A few days later the country's president resigned. Argentina then had four new presidents in two weeks.

After all this the crisis became really serious. The government ended the fixed exchange rate in early 2002. The peso's value was then set by the market, and by May a peso was worth less than 30 U.S. cents. The government defaulted on its \$150 billion debt, including almost \$100 billion owed to foreigners. The terms of the debt were altered, and in the process investors took large losses. This was the largest default ever, anywhere.

The economy was in a shambles. The banking system was nearly nonfunctional. During 2002, production of goods and services declined by over 10 percent, the inflation rate rose to over 20 percent, and unemployment soared to over 25 percent.

What a series of events. What a complex set of relationships. Argentina's story shows how different international finance can be. In 1991 Argentina's government used international economic tools—the currency board and the fixed exchange rate—to conquer the national economic menace of high inflation. Argentina then thrived using funding from foreign investors. But shocks from abroad pushed the economy into a long-lasting recession. The views of the same foreign investors turned quite negative. A huge decline in the exchange-rate value of the peso accompanied a financial crisis. Foreign investors incurred huge losses, and the economy was in depression.

We will examine many of these issues in Parts III and IV of this book. For example, in Chapter 17 we explore foreign financial investment. In Chapters 19 and 24 we look at why a government would or would not choose a fixed exchange rate. We analyze the effects of international trade and investment on national production, unemployment, and inflation pressures in Chapters 21–23. And in Chapter 20 we take a close look at international financial crises.

Why is international finance so different from domestic finance? Why do financial firms keep studying something called country risk? International finance is different because, again, nations are independent sovereign states. The opportuni-

ties for profitable investments can be attractive when a sovereign government shifts toward market-friendly policies. But the risks can also be great, since a country can also get into trouble through its own bad policies or through bad luck that brings negative shocks from outside the country. The government of a country in trouble is often unwilling to pay off foreign creditors when its own people are hurting. When the debtor is a sovereign government, the foreign creditors cannot just take the delinquent borrower to court and seize some of its assets.

## ECONOMICS AND THE NATION-STATE

It should be clear from the four events described above that international economics is a special field of study because nations are sovereign. Each nation has its own government policies. For each nation, these policies are almost always designed to serve some group(s) inside that nation. Countries almost never care as much about the interests of foreigners as they do about national interests. Think of any recent debate about restricting cheap imports from other countries—say Asian imports into the United States. How loudly have Americans spoken out to defend the Asian jobs and incomes that would be lost if U.S. jobs and incomes are protected? Conversely, in China, where imports are also often blocked, how much outcry does one hear about how these import barriers are limiting jobs and incomes in the United States or Thailand?

The fact that nations have their sovereignty and their separate policies and their separate self-interests means that *nobody is in charge of the whole world economy*. The global economy has no global government, benevolent or otherwise. It is true that there are international organizations that try to manage aspects of the global economy, particularly the World Trade Organization, the International Monetary Fund, the United Nations, and the World Bank. But each country has the option to ignore or defy these global institutions if it really wants to.

Among the most important policies that each country can manipulate separately are monetary policy, fiscal policy, and policies toward the international movement of productive resources (people and financial capital).

### Different Moneys

To many economists, and especially regular people, the principal difference between domestic and international trade and investment is that international transactions often involve the use of different moneys. That is very different from transactions within a country. You cannot issue your own money, nor can your family, nor can the state of Ohio.

The existence of separate moneys means that the value of one money relative to another can change. We could imagine otherwise. If a U.S. dollar were worth exactly 10 Swedish kronor for 10 centuries, people would certainly come to think of a krona and a dime as the same money. But this does not happen. Since the 1970s the price ratios between the major currencies have been fluctuating by the minute. We must treat the dollar and the krona, for example as different moneys.

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Most countries have their own national money, but, as we saw with the euro, some countries share the same money. The supply of each kind of money is controlled by the monetary authority or central bank in charge of that money. Monetary policy affects not only the country using that money but also other countries, even if they use different moneys. Monetary policies affect the relative value of different moneys. Parts III and IV explore the special relationships between national moneys.

**Different Fiscal Policies**

For each sovereign country, its separate government has its own public spending, power to tax, and power to regulate. As a rule, differences in the spending, tax, and regulatory policies of different countries are more pronounced than differences between the policies of states, provinces, or prefectures in one country. In the international arena, differences in tax policies can cause large flows of funds and products that would not have existed without the tax discrepancies. Banks set up shop in the Bahamas, where their capital gains are less taxed and their books less scrutinized. Shipping firms register in Liberia or Panama, where registration costs little and where they are free from other countries' requirements to use higher-cost national maritime workers. Each country's array of import tariffs and export subsidies and duties are part of its separate fiscal policy. We examine the microeconomic effects of policies toward international trade in Part II, and the macroeconomic effects of different fiscal policies in Part IV.

**Factor Mobility**

In differentiating international from domestic economics, classical economists stressed the behavior of the factors of production. Labor, land, and capital were seen as mobile within a country, in the sense that these resources could be put to different productive uses within the country. For example, a country's land could be used to grow wheat or to raise dairy cattle or as the site for a factory. But, the classical economists believed, these resources were not mobile across national borders. Outside of war land does not move from one country to another. They also downplayed the ability of workers or capital to move from one country to another.

If true, this difference between intranational factor mobility and international factor immobility would have implications for many features of the global economy. For instance, the wages of French workers of a given training and skill would be more or less the same, regardless of which industry the workers happened to be part of. But this French wage level could be very different from the wage for comparable workers in Germany, Italy, Canada, or Australia. The same equality of return within a country, but differences internationally, was believed to be true for land and capital.

This distinction of the classical economists is partly valid today. Land is the least mobile factor internationally. Workers and capital do move internationally,

in response to opportunities for economic gain. Still, there appear to be differences of degree in mobility interregionally and internationally. People usually migrate within their own country more readily than they will emigrate abroad. This is true partly because identity of language, customs, and tradition is more likely to exist within a country than between countries. In addition, national governments impose greater limitations on international migration than they do on relocation within the country. Capital is also more mobile within than between countries. Even financial capital, which in many ways is free to move internationally, is subject to a “home bias” in which people prefer to invest within their own country. We examine international resource mobility in Chapter 14, and examine aspects of international financial investments in Part III.

## THE SCHEME OF THIS BOOK

We begin our exploration of international economics with international trade theory and policy. In Part I we look at why countries trade goods and services. In Part II we examine what government policies toward trade would bring benefits and to whom. These first two parts of the book might be called international microeconomics. The focus of Parts III and IV shifts to finance and macroeconomics. In Part III we enter the world of different moneys, exchange rates, foreign exchange markets, balance of payments, and international investors. Part IV surveys the effects of a national government’s choice of exchange rate policy on the country’s macroeconomic performance, especially unemployment and inflation. In a few places this organization creates some momentary inconvenience, as when we look at the exchange rate link between cutting imports and reducing exports in Part I before we have discussed exchange rates in depth. Yet there are gains in logic in proceeding from micro to macro, as in the way that the demand and supply analysis of trade in individual products sets the stage for the use of the same tools at a more aggregate level in the study of international finance.

