

# 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 out-vote 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

#### Outsourcing

International outsourcing leapt to prominence in 2003 and 2004, when we noticed that firms in the United States and other industrialized countries were shifting service activities and jobs to developing countries, especially India. For a typical firm international outsourcing (or, as it is sometimes more suitably called, offshoring) can reduce its cost of these service activities by about half.

Why this outsourcing has received so much attention is part of what makes international economics different. Firms are always attempting to lower the costs that they incur in their production activities. If this occurs within the country, it is just part of everyday business decisions, with outsourcing being the “buy” part of the make-or-buy problem—how a firm sources the various materials, components and services that it needs to carry out its overall production. But if it the outsourcing crosses national

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boundaries, it can become a controversial political issue. This is what has happened in the United States since 2003.

What's new here is that international competition from developing countries is directly affecting white-collar workers in service activities that had previously been largely insulated. The concern about these jobs in the United States was heightened because through mid-2004 total employment in the entire economy recovered slowly from the 2001 recession. (Interestingly, lost in much the discussion is the fact the United States overall is a large net *exporter* of business services [exports exceed imports]. U.S. firms actually gain much business though “inshoring” of work in such areas as computer, consulting, research, architectural, industrial engineering, and legal services.)

The start of the international outsourcing story is in India, which until 1991 had been following a policy aimed at self-sufficiency and government direction of the economy, with poor results. In 1991 the Indian government enacted a set of major liberalizations, including opening its economy to international trade and foreign companies. In the 1990s a number of U.S. and British companies quietly began to shift some back-office work like payroll processing to India, to take advantage of the availability of low-cost but educated workers who could speak English. Other firms, including Indian firms like Wipro and Infosys, noticed how successful this was, and began to expand the business further. At the same time the cost of voice and data transmission plummeted (a decline of more than 80 percent from 2000 to 2004), with a rapid increase in the bandwidth in place between India and the United States and Britain.

By 2005 this international outsourcing included a range of business services, including data entry, telephone call centers, and software development. Firms in the United States and Britain are the largest users of international outsourcing. In addition to India, the Philippines has also become an important provider, with China, Russia, and the countries of Central Europe also joining.

How large is this international outsourcing? It seems to be rather surprisingly small for all the attention that it has received, though it is growing rapidly. A reasonable estimate is that by 2005 perhaps 600,000 service jobs (in total, not per year) had been shifted from the United States to India and other developing countries, a number which is less than one percent of service sector jobs in the United States. Another way to gain perspective on this number is to compare it to the flow of job gains and losses in the U.S. economy. *Each year* about 30 *million* people lose or quit their jobs (and something more than 30 million new jobs are filled).

Which kinds of jobs have been affected, or might be affected in the future? The work that is being outsourced is generally work that is repetitive and routinized. In the United States outsourcing seems to be a driver behind the decline in the number of lower-paid and somewhat less-skilled positions such as data entry keyers, phone operators in call centers, and computer programmers. Even though there is some outsourcing of higher paid and more skilled positions in the computer services area, the number of U.S. workers in such positions as computer software engineers has increased since the late 1990s, and their wages continue to rise faster than the economy average.

More generally, there is a limited range of service jobs that can be outsourced, because positions that require substantial face-to-face contact with customers or in-depth local

knowledge cannot readily be outsourced. Essentially, the work that is most readily offshored is work that can flow internationally over wires. In total it appears that about 10 percent of service sector jobs are *potentially* affected by international outsourcing, and most likely the actual number that will be offshored will be much less than this.

So, we have a new form of international trade, and white-collar workers, especially those in the information technology sector, feel threatened. Another thing that is different about international economics is that national politicians have the power to enact laws and regulations that can limit international transactions. If the whole world were one country, the issue of outsourcing would be left to the marketplace. Within a country, it is usually impermissible for one region to restrict commerce with another region.

But the world is actually split into different countries, each with national policies. In the United States some politicians say that it was right and necessary to defend the jobs of American workers against the unfair outsourcing of those jobs to foreigners. If the product in question were a physical good, a possible defense would be obvious—some kind of a tax or other restriction on imports of the goods into the country. This is the approach that President Bush used in 2002 when he imposed tariffs (a form of taxes) of up to 30 percent on steel imports into the United States. (Facing growing objections from steel-using firms and a ruling that the U.S. actions violated the rules of the World Trade Organization, he rescinded the tariffs in late 2003.)

In the case of international outsourcing of service sector activities and jobs, it's less clear what the government could do, because the products are intangible. One possibility would be a prohibition on shifting such work out of the country, but that would be draconian and probably difficult to enforce. Another narrower possibility would be to tilt government procurement rules, something that politicians do control, against outsourcing. We have seen a series of proposals at the state and federal levels to withhold or terminate government contracts with private firms if they offshore any of the work, but nearly all of these proposals have failed to pass.

Overall, the U.S. economy is very likely to benefit from international outsourcing of services, because it allows Americans to replace high-cost domestic production with lower-cost foreign provision of these services. This is the essence of comparative advantage as a basis for international trade and the gains from trading.<sup>1</sup> We will explore these aspects of international economics in Part I of this book. At the same time, we can feel compassion for the workers who lose their jobs in the process. One useful thing that U.S. politicians could do is to extend *trade adjustment assistance* (discussed in more depth in Chapter 10) to service workers who lose their jobs because of international outsourcing.

Footnote 1

### Poor Workers in Poor Countries

Many of the world's people are very poor. Many 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

<sup>1</sup> Nobel Prize winner Paul Samuelson caused a stir when he pointed out in a 2004 article in the *Journal of Economic Perspectives* that it is possible for the United States to suffer a loss in well-being if the outsourcing that occurs leads to greater competition for U.S. exporters, so that the United States suffers a decline in its terms of trade. He did not offer any evidence that this was likely, but the general media implied that he just about said that it would happen. In Chapter 7 we examine why changes in the terms of trade are important to our understanding of economic growth.

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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 100 million children under 15 years of age work full-time, and at least that many work part-time. In the poorest countries nearly half of children ages 10 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>2</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 exception of China). Poverty is dire in Africa, and central Asia. It is not a coincidence that these are the places in the world that globalization has almost not touched.

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

<sup>2</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.

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 \$8,400, 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 now is at stake. Here is a problem that we can 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. These programs are successful in increasing schooling, and they are spreading to other countries. As we will see in Chapter 10, this policy approach is an application of what we will call the *specificity rule*.

## The European Union Expands

In recent years the European Union has attempted three kinds of major expansions:

- A monetary union, in which countries replace their national currencies with a supranational currency.
- Geographic expansion, with new members joining the Union.
- Adoption of a formal constitution, as a move toward greater political union.

The first two have succeeded, but the third has stalled, with the negative vote in France in May 2005. Let's focus on the first two expansions, the ones with direct importance to international economics.

### ***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 then 15 members of the European Union (all but Britain, Denmark, and Sweden).

Adopting a single currency may seem like a natural choice. If the nations of the European Union (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. 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, 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 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 have tried to gain this stability by tightly fixing the value of their currencies to the dollar or to some other foreign currency. Argentina's experience with this approach since the early 1990s at first looked like a great success, but later turned into economic crisis and depression.

So far the euro has been a success, though there are tensions at the edges. The shift away from separate national currencies has brought savings in transactions costs and made travel and trade easier. The shift has also eliminated the possibility of the kind of exchange rate crisis that had occasionally hit the previous system of fixed exchange rates among the national currencies. The largest benefit is probably the development

of wider European financial markets. Financial markets had previously been fragmented by the costs and risks of dealing in many different national currencies. The common currency removed these costs and risks, so that the financial markets integrated, deepened, expanded, and generally became more efficient. The improved allocation of financial capital should, over time, enhance European economic growth.

The tension comes, as we expected, because the common monetary policy is geared toward the average economic performance across all the member countries. Such policy is not necessarily right for each national economy individually. For instance, lower interest rates would have been better suited to address the recession and weak growth in Germany that began in late 2000 and continued through mid-decade.

### ***Geographic Expansion: From 15 to 25***

On May 1, 2004, ten countries—eight transition (that is, formerly communist) countries in Central Europe (Estonia, Latvia, Lithuania, Poland, Czech Republic, Slovakia, Hungary, and Slovenia), and two island countries (Cyprus and Malta)—joined the European Union. These new members add 25 percent to the total population of the EU (bringing the total to 455 million), but they are relatively poor countries, so they add only about 5 percent to the EU's total production and income.

The basic requirements to join the EU are that the country have a functioning democracy, a commitment to respecting human rights, a market economy, and the capacity and willingness to adopt and to implement EU rules and standards. These 10 countries had to work intensely to meet the latter set of requirements. EU standards cover 31 major areas, and the documents listing them are 80,000 pages long.

Why would a country agree to make changes to its national laws and regulations to conform to outside requirements? Each of these countries had to weigh the benefits and costs of joining. To a noticeable extent the countries welcomed making the changes. First, the changes entrenched democracy and market institutions. Second, the countries were able to make changes that resulted in national economic improvements, but that interest groups in the countries otherwise might have been able to block. Overall, the new members are forecasted to have net gains in economic well-being of 2–8 percent of their GDP, with a small gain for the other 15 EU countries.

An interesting question is when the two expansions will converge. Most of the new members want to adopt the euro, but it appears that gaining approval to replace their own national currencies with the euro will take years. Before each country can adopt the euro, the government must fix the exchange rate value of its currency to the euro and maintain the fixed rate for at least two years. It also must meet other requirements on the country's inflation rate, interest rates, government budget, and government debt.

In many ways May 1, 2004, the accession date of the 10 new members, was uneventful. Many changes had already been put in place during the previous decade. For instance, free trade agreements implemented in the 1990s had already eliminated tariffs on nonagricultural trade between EU countries and the then-aspiring countries. At accession the new members did adopt the common external tariffs of the EU. On average their tariffs against non-EU members declined from 9 percent to 4 percent. But the new members also adopted the Common Agricultural Policy, so their barriers against some agricultural imports (e.g., sugar and bananas) from outsiders increased substantially. At the broader level of the entire EU, there were concerns that governance

and decision-making in a group of 25 countries (rather than a group of 15 countries) would become much more complicated. Yet, at least through the first year, EU institutions continued to function smoothly.

Other European countries that are obvious candidates for membership have looked at the benefits and costs differently. Norway and Switzerland have close ties with the EU and agreements that align many policies, but they have decided not to be full EU members.

The geographic expansion of the EU is probably not over. Romania and Bulgaria are expected to accede in 2007 or 2008. Countries in the Balkans, including Croatia, Albania, Bosnia, Macedonia, and Serbia and Montenegro, are candidates further in the future. Turkey is eager to become a member, but the process has been long and very slow. EU member countries have doubts about Turkey's ability to meet governmental and human rights requirements. In addition, they have concerns about the ability to integrate into the EU such a poor country with such a large and growing population.

### **China Revalues Its Currency**

On July 21, 2005, the Chinese government announced and implemented a set of major changes in its policies toward the exchange-rate value of its currency, the yuan (also called the renminbi). It increased the value from 8.28 yuan per U.S. dollar to 8.11 yuan per dollar, a revaluation of 2.1 percent. (Yes, that does look odd, but the lower number means a higher value for the yuan. Welcome to the sometimes confusing world of foreign exchange. As stated, the numbers show a decrease in the value of a dollar, which is the same as an increase in the value of the yuan.) The Chinese government also said that it would henceforth manage the yuan exchange rate with reference to a set of other currencies, not just according to its dollar value, and that it would allow small variations around the daily target exchange rate value.

The fixed exchange rate to the U.S. dollar had served the Chinese economy well in the decade that it had been in place, and many in China did not want to change. In 1994 the Chinese government had switched from a system of having several different exchange rates, each applying to different kinds of international transactions, to an unofficial but unmistakable fixed rate to the U.S. dollar. In the conversion the Chinese government had lowered the average value of the yuan. Thereafter the exchange rate was fairly steady against the dollar, and was locked at about 8.28 from 1997 to 2005.

During the Asian crisis of 1997–1998, the U.S. government praised the Chinese government's fixed exchange rate as source of stability in an otherwise unstable region. But by 2003 the U.S. government began to complain that China's fixed rate policy was actually unacceptable currency manipulation. In 2004 the U.S. trade deficit (the amount by which imports exceeded exports) with China was \$160 billion, a substantial part of the total U.S. trade deficit of over \$600 billion with the entire world. These deficits were headed even higher in 2005, and the pressure from the U.S. government intensified. A bill introduced in the Congress proposed that a 27.5 percent tariff be placed on all imports from China, unless the Chinese government implemented a large increase in the exchange rate value of the yuan. This bill had substantial support and had a noticeable chance of passing. (Such a tariff would violate the commitments that United States had made as a member of the World Trade Organization, but that's a different story.)

The European Union also had a large trade deficit with China, and it was also placing pressure on China to revalue the yuan. The Chinese government resisted. It did not want to appear to be giving in to the foreign pressure, and it stated repeatedly that it alone would make any decisions about its exchange rate policy as it saw fit for the good of China's economy.

Can keeping the exchange rate steady be manipulation? What this must mean is that the exchange rate value should have changed but did not. What was the evidence? The bottom-line evidence was that, especially after 2001, the Chinese government continually had to go into the foreign exchange market to buy dollars and to sell yuan, to keep the market rate equal to the fixed-rate target. If it had not done so, the strong private demand for yuan would have led to a rise in the price (the exchange-rate value) of the yuan. (Equivalently, the large supply of dollars that were being sold to get yuan would have led to a decline in the value of dollar against the yuan.)

If there is a fixed exchange rate, the government must prevent private market pressures from changing the exchange rate value. In the process, the Chinese government was buying large amounts of dollars and investing these in financial assets. Its holdings of financial assets denominated in foreign currencies increased from about \$160 billion in 2001 to a staggering \$700 billion by mid-2005. About three-fourth of these were in dollar assets like U.S. government bonds. Although China was portrayed as the villain in the United States because of the U.S. trade deficit, China also appeared to be helping hold down long-term interest rates in the United States through the funds that it provided with its rapidly rising financial investments.

If you think that a change of 2.1 percent in the exchange-rate value of the yuan seems quite small compared to the size of trade deficit and Chinese purchases of dollars, you are correct. There are indications that the Chinese government initially intended to make a somewhat larger change (perhaps 5 percent), but internal concerns that this would hurt Chinese exporting firms led to a scaling back. Various estimates of the degree of undervaluation of the yuan have been offered by economists, and most were in the range of 15 percent to 40 percent. Even for the experts, there are some challenges in making this estimate.

First, while China had substantial trade surpluses with the United States and the European Union, it had trade deficits with many other countries, including South Korea, Thailand, Australia, Russia, Japan, and India. Overall China had a trade surplus, but it was not that large (although the surplus began to grow noticeably in 2004 and into 2005).

Second, China has a remarkably high household saving rate. For a typical developing country, its low saving rate usually leads to a trade deficit, but China is not typical. So there is some economic sense for China to have a trade surplus.

Third, as the official pressure built on the Chinese government to change the exchange rate, private speculators began to move "hot money" into the country in the hopes of profiting when the value of the yuan increased. A substantial part of the government's purchase of dollars has been buying this hot money, and the hot money flow will reverse once the speculators think that the play is done.

So this event, the yuan revaluation, is the beginning of a process. The Chinese government has introduced a degree of flexibility to the exchange rate value of the yuan. But it has also maintained a large degree of control. In the first several weeks after the

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announced change, very little more happened, with the exchange rate three weeks later having moved only a bit more to 8.10 yuan per U.S. dollar. The Chinese government continued to buy yuan and sell dollars to keep the rate nearly steady (at its new value). The government was also actively trying to discourage a new wave of inflow of hot money with statements that it did not intend to allow much additional change anytime soon. But such a small initial step and no further movement also made it much more likely that political pressures from the United States and the European Union would be likely to build again quickly.

In Parts III and IV of this book, we will examine in depth many of the issues raised in the description of this event. For example, in Chapter 18 we will explore foreign financial investments and the role of currency speculation. In Chapter 16 we will examine trade surpluses and trade deficits in the context of a country's balance of payments. In Chapters 22–24 we will examine how exchange rates affect not only a country's trade balance but also national production, unemployment, and inflation pressures. And in Chapters 20 and 25 we will look at why a country would or would not choose to have a fixed exchange rate.

## 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 the debate about international outsourcing. How loudly have Americans spoken out to defend the Indian and other jobs and incomes that would be lost if U.S. jobs and incomes are protected? Conversely, in India, where imports are also often impeded, 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 to 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.

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. Furthermore, 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

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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 15, 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.