

Instructor's Manual

An Introduction to International Economics:

New Perspectives on the World Economy

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Preface to the Instructor

An Introduction to International Economics introduces the student or professional reader to the basic concepts of international trade, international production, international finance, and international development. Its only prerequisite is an introductory-level understanding of *micro*-economics. The book draws upon principles-level concepts such as the circular flow diagram, the supply and demand model, the production possibilities frontier, and the value chain, each of which is developed using real-world examples. These basic concepts should be familiar to nearly all readers.

An Introduction to International Economics is designed primarily for a one-semester, introductory course in international economics but could also be used for a two-semester course that covers all of the chapters with supplementary readings. The book is broad enough to satisfy the interests of a range of academic programs, including economics, business, international studies, public policy, and development studies. Also, despite its introductory-level nature, *An Introduction to International Economics* covers some often-neglected, but important topics in international economics. These include intra-industry trade, intra-firm trade, foreign market entry, migration, and structural adjustment. The book also covers the major institutions of the world economy in an historical perspective. These include the World Trade Organization, the International Monetary Fund, and the World Bank, each of which is of some interest to almost all students.

This instructor's manual is designed to help you to teach a one- or two-semester course that introduces the student to the world economy using the above-described "windows on the world economy." In what follows, we take up each part of the book and each chapter within each of the four parts. We provide chapter objectives, teaching notes, and answers to the review questions.

In teaching a survey course of this kind, there will be a few places where you find yourself outside of your comfort zone. One source that might be helpful to you is *The Princeton Encyclopedia of the World Economy* (Princeton University Press, 2009), a 2-volume set that covers a vast array of topics in an accessible manner. The topical list of entries is divided up based on the four areas covered in this book (trade, production, finance and development) but also by: concepts and principles; models and theory;

institutions and agreements; analysis and tools; and sectors and special issues. Each entry contains an annotated list of references.

You will have your own approach to the class that reflects your interest, but a standard approach to chapter use by program can be found in the accompanying table, Suggested Chapter Use by Program.

The book's web-site is <http://iie.gmu.edu>. On this web-site you will find chapter updates and a place for instructors to share Power Point slides. Please contact Kenneth Reinert at kreinert@gmu.edu if you have any questions, comments, or ideas concerning the textbook or instructor's manual. Every effort will be made to address your reactions in subsequent editions and on the website.

Suggested Chapter Use by Program

| <i>Chapter</i> | <i>Economics</i> | <i>Business</i> | <i>International Studies</i> | <i>Development Studies</i> |
|---|------------------|-----------------|------------------------------|----------------------------|
| 1 Windows on the World Economy | X | X | X | X |
| <i>Part I International Trade</i> | | | | |
| 2 Absolute Advantage | X | X | X | X |
| 3 Comparative Advantage | X | X | X | X |
| 4 Intra-Industry Trade | X | X | | |
| 5 The Political Economy of Trade | X | X | X | X |
| 6 Trade Policy Analysis | X | X | X | X |
| 7 The World Trade Organization | X | | X | X |
| 8 Preferential Trade Agreements | X | X | X | X |
| <i>Part II International Production</i> | | | | |
| 9 Foreign Market Entry and International Production | | X | | |
| 10 Foreign Direct Investment and Intra-Firm Trade | | X | | |
| 11 Managing International Production | | X | | |
| 12 Migration and International Production | | | X | X |
| <i>Part III International Finance</i> | | | | |
| 13 Accounting Frameworks | X | X | X | X |
| 14 Exchange Rates and Purchasing Power Parity | X | X | X | X |
| 15 Flexible Exchange Rates | X | X | X | X |
| 16 Fixed Exchange Rates | X | X | X | X |
| 17 The International Monetary Fund | X | | X | X |
| 18 Crises and Responses | X | X | X | X |
| 19 Monetary Unions | X | | X | |
| <i>Part IV International Development</i> | | | | |
| 20 Development Concepts | X | | X | X |
| 21 Growth and Development | X | | X | X |
| 22 International Production and Development | | X | | X |
| 23 The World Bank | | | X | X |
| 24 Structural Change and Adjustment | | | | X |

CHAPTER 1

Windows on the World Economy

Chapter Objectives

Many students will come to your course with a general interest in “globalization” or “the world economy.” The purpose of Chapter 1 is to build on these interests and to communicate some empirical realities for the student to consider. The chapter also introduces the student to the “windows on the world economy” that frame the book as a whole: international trade, international production, international finance, and international development. As an instructor, you have your own interests, views, and important information concerning these topics. I invite you to view Chapter 1 as a *complement* to your own agenda and encourage you to bring your own cases, concerns, and anecdotes to the class session related to Chapter 1. Students will greatly appreciate this.

The chapter also begins to introduce the student to a set of concepts that are important to his or her understanding of international economics. These include international trade, trade in services, international production, foreign direct investment, multinational enterprises, international finance, balance of payments, and international development. Each of these will be developed in more detail in subsequent chapters, but an initial introduction to these concepts is helpful.

Finally, the chapter introduces the student to the analytical elements used in subsequent chapters. These include: countries, sectors, tasks, firms, factors of production, currencies and financial assets. They are used in different combinations in subsequent chapters.

Chapter Outline

- International Trade
- International Production
- International Finance
- International Development
- Connecting Windows
 - Box: ICT in the World Economy
- Analytical Elements

Conclusion

Teaching Notes

The chapter tries to arm you with some basic data related to globalization in the areas of trade, production, finance, and development. As new data become available, updates will be posted on the book's website (iie.gmu.edu). In my experience, the class session devoted to Chapter 1 will elicit a number of reactions from the students, including *both* comments *and* questions. This is a good time to foreshadow future topics and chapters on your syllabus: "That is an issue we will take up when we discuss...."

This is also an important time to orient students towards fundamental concepts in international economics. For example, many students cannot distinguish between international trade and foreign direct investment or between international trade (the exchange of merchandise and services) and international finance (the exchange of assets). It is probably a good idea not to over-estimate your students' understanding of these key concepts. It is not unusual, for example, for students to think that foreign direct investment is equivalent to international trade.

The chapter also stresses the utility of looking at the "windows on the world economy" as being inter-related. Your own personal take on this, illustrating one of the arrows in Figure 1.4 would be very helpful. While there are a few examples in the chapter, hearing about an additional example from you will be very important to the students. This is particularly important in the areas of technology, politics, culture and the environment and can be tailored to your program.¹

Finally, the *analytical elements* can be a useful tool to orient students to your course. Defining each of these carefully will be beneficial for many of them. For example, a careful definition of an *asset* is illuminating.

Comments on Review Exercises

1. Why are you interested in international economics? What is motivating you? How are your interests, major, or profession affected by the world economy?

For smaller classes, this can be used for classroom introductions and discussion.

2. What are the four windows on the world economy?

International trade, international finance, international production and international development. Draw your students' attention to Figure 1.4 throughout the course.

¹ Please note that the Goldin and Reinert book referenced and quoted in this chapter is now available in a new edition: I. Goldin and K.A. Reinert (2012) *Globalization for Development: Meeting New Challenges*, Oxford University Press.

3. What is the difference between trade in goods and trade in services?

Trade in goods involves tangible and storable items (things you can drop on your toe), while trade in service involves intangible and non-storable items (things you cannot drop on your toe). Note that Chapter 7 goes into specific categories of trade in services.

4. What is the difference between international trade and foreign direct investment?

International trade involves the cross-border exchange of goods and services, while FDI consists of the ownership (of over 10 percent) of a foreign firm. FDI can influence trade substantially, but is a separate process. This is a key distinction that is often lost on students.

5. What is the difference between international trade and international finance?

International trade involves the cross-border exchange of goods and services, while international finance involves the cross-border exchange of assets. The exchange of assets is the defining feature of international finance (and the capital account) as opposed to international trade (and the current account).

6. Identify one way in which the activities of international trade, finance, and production could *positively* contribute to international development. Identify one way in which these activities could *negatively* contribute to international development. How could you demonstrate that the activities have either a positive or negative impact on development?

This question is very open-ended, but important. It concerns three of the arrows in Figure 1.4. The question also gets to the issue of indicators and is worth classroom discussion. FDI that transfers technology could contribute to development. Primary product trade in the face of declining commodity prices could have a negative impact on development.

Part I

International Trade

CHAPTER 2

Absolute Advantage

Chapter Objectives

The purpose of this chapter is to start the student thinking about international trade within the comfort zone of the supply and demand model. It will help the student to visualize imports as an excess demand (shortage) at world prices and to visualize exports as an excess supply (surplus) at world prices. It will also help the student to visualize an adjustment of world prices to bring about equilibrium where the excess demand (imports) and excess supply (exports) for a particular good are equal. The student will understand the notion of the “gains from trade.” Changes in quantities supplied in the movement from autarky to trade are also an opportunity to give an initial sense of the political economy of trade. Throughout, there is an emphasis on trade arising from differences on the supply sides of the countries of the world.

Analytical elements for this chapter:

Countries, sectors and factors of production.

Chapter Outline

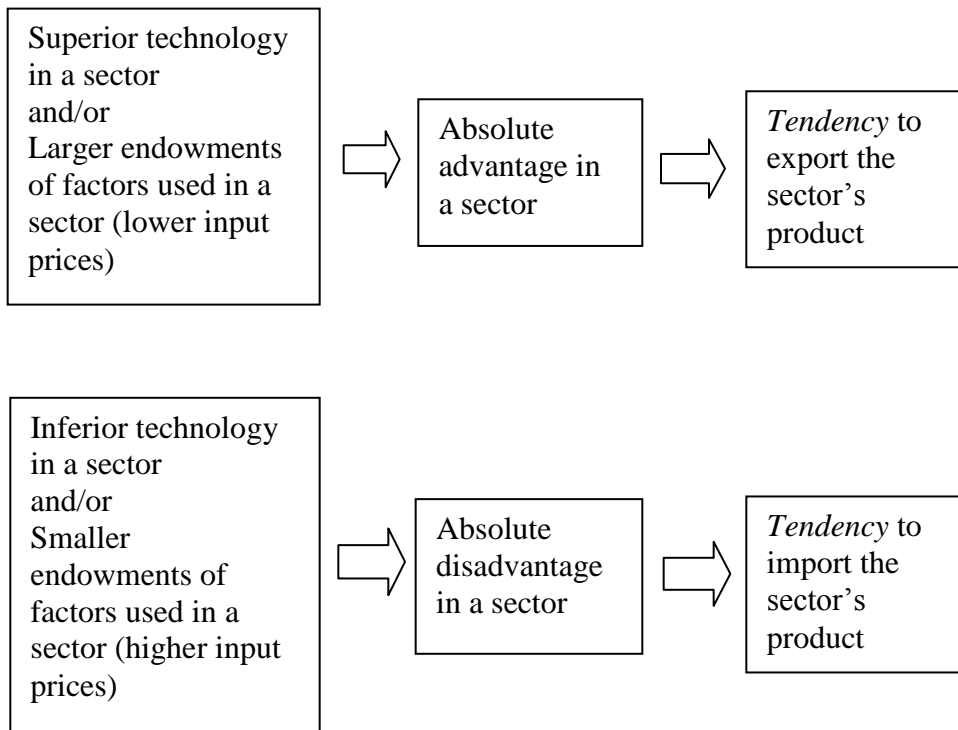
- Supply and Demand in a Domestic Market
- Absolute Advantage
- International Trade
 - Box: Japan’s Advantage in Industrial Robots
- Gains from Trade
 - Box: Rare Earth Elements
- Limitations
- Conclusion
- Appendix: Consumer and Producer Surplus

Teaching Notes

As stated above, the purpose of this chapter is to start the student thinking about international trade within the comfort zone of the supply and demand model. Two caveats are in order here, however. First, you should not assume that the students remember the

supply and demand model. A quick review of the model (movement along curves vs. shifts of the curves) is in order, and the students will be grateful to you if you take the time to do this. Second, it is important to emphasize to the students that the absolute advantage model of this chapter describes only a tendency. Actual trade patterns are determined by comparative advantage as discussed in Chapter 3. In doing this, you can draw the students' attention to the following figure:

Figure 2.5. A Schematic View of Absolute Advantage



That said, emphasize to the students that the absolute advantage model is used by trade policy analysts in anti-dumping and countervailing duty cases, particularly where the product category involved is narrow. They are learning something practical!

The absolute advantage model also helps the student to understand the gains from trade using consumer surplus and producer surplus. Again, do not assume the students remember these concepts. Take a few minutes to review the concepts, and the students will be appreciative. Be sure to emphasize that the gains from trade are *mutual*. Students are used to thinking in terms of zero-sum games, and the potential mutual benefits of trade might be new to them. That said, if you are teaching in a developments studies

program, mentioning how colonial trading relationships obviated mutual gains from trade might be important.

This chapter contains a box on “Japan’s Advantage in Industrial Robots.” For your classroom preparation, it would be helpful for you to prepare a “box” of your own on absolute advantage in an area in which you have some knowledge and interest. It would also be useful for you to prompt the students to think of their own examples. The chapter also contains a box on “Rare Earth Elements,” which have been very newsworthy. This example relates to “realist” trade policies discussed in Chapter 5.

To shift the students from a passive to an active mode, have them develop their own diagrams, like those of this chapter, for two countries and a good for which they have some knowledge. If you want to push them a bit further, have them consider an increase in supply in the exporting country and explain how this affects the equilibrium world price of the good.

Comments on Review Exercises

1. Use Figure 2.1 to consider the following changes: a fall in incomes due to a recession; an increased preference for rice consumption; an increase in input prices for rice production; and an improvement in rice production technology. Use diagrams to analyze the effects of these changes on equilibrium price and quantity.

The fall in income shifts the demand curve to the left; the increased preference for rice consumption shifts the demand curve to the right; the increase in input prices for rice production shifts the supply curve to the left; and the improvement in rice production technology shifts the supply curve to the right.

2. Create an example of an absolute advantage model by choosing two countries and a single product.
 - a. Draw a diagram describing *autarky* and a *pattern of absolute advantage* for your example.
 - b. Show the transition from autarky to trade in your diagram, label the trade flows, and demonstrate the *gains from trade*.
 - c. In a new diagram, and starting from a trading equilibrium, show what would happen to the world price if *income increased* by exactly the same, small amount in both countries.

This question can be done as an in-class exercise to shift the students from passive to active mode. In “c,” when income increases by exactly the same, small amount in both countries, exports in one country will fall, and imports in the other country will rise. This will cause global excess demand, so the world price needs to rise to bring the market back into equilibrium.

3. Can you recall from introductory microeconomics the nations of the price elasticity of demand and price elasticity of supply? If so, can you say what would happen to the gains from trade as supply *and* demand in Vietnam *and* Japan become more and more *inelastic*?

Inelasticity of the supply and demand curves tends to shrink the gains from trade triangles B and D in Figure 2.6.

CHAPTER 3

Comparative Advantage

Chapter Objectives

This chapter introduces the student to the concept of comparative advantage using the production possibilities frontier (PPF). The concept is introduced using production possibilities frontiers and the example of trade in rice and motorcycles between Vietnam and Japan. Later in the book (in Part II), the motorcycle example will be extended to foreign market entry via foreign direct investment. The chapter describes a chain of determination from supply-side characteristics, to a pattern of comparative advantage, to a pattern of trade and the gains from trade. Going through this chapter slowly is very important for your students and for your relationship to them. This chapter can be quite challenging to the average student, and they will need your help here. Don't assume that the students remember the PPF from their introductory microeconomics class. Even if they do, the use of relative prices in the chapter (covered in the appendix) will probably be new for them.

Analytical elements for this chapter:

Countries, sectors and factors of production.

Chapter Outline

- Autarky and Comparative Advantage
- International Trade
 - Box: Revealed Comparative Advantage
- Gains from Trade
 - Box: Comparative Advantage and the Environment
- Conclusion
- Appendix: The Production Possibilities Frontier

Teaching Notes

Introducing the student to comparative advantage is not easy. The concept is perhaps the most important thing they will take away from your course, but appreciating it requires a degree of comfort with production possibility frontiers. Most texts try to make PPFs more accessible to the student by linearizing them in a Ricardian model of technology-based comparative advantage, reintroducing PPFs later in concave form. This text works with concave PPFs throughout. However, the text eschews indifference curves, which many students will never have seen.

Begin easy, because this is one of the most challenging chapters of the textbook. Perhaps start with the box presented in the chapter that reads:

Differences in supply conditions among the countries of the world give rise to complementary patterns of comparative advantage. These patterns of comparative advantage, in turn, make possible complementary patterns of international trade.

Then, let the student know that, in order to understand supply conditions, she must understand PPFs, a concept they learned in introductory economics. Next, for most students, a visit to the appendix under your guidance is in order. It might seem like a waste of time to you, but they *will appreciate* your taking the time! A key concept to keep reinforcing is that the slope of a PPF gives the opportunity cost of the good on the *horizontal* axis. Relate this opportunity cost to the *relative* price of the good on the *horizontal* axis.

With the PPF in hand, you can begin to lead them through the body of the chapter using the Vietnam-Japan example or one of your own choosing. What you are communicating to the student is the following:

Supply-side characteristics

⇒ Pattern of comparative advantage

⇒ Pattern of trade

⇒ Gains from trade.

Note, if you feel you are losing your students, acknowledge that they might be out of their comfort zone in this particular chapter (some students will be). You can encourage them with comments like, “This is what Ph.D. trade theory students do, and you are doing it!”

In order to exclude the difficult topic of indifference curve, the text utilizes a demand diagonal line. Emphasize two things here: 1. the line is not the demand curve (it

has the symbol DD and not D and slopes up and not down) and 2. the line is not necessarily a 45 degree line.

The chapter includes boxes on revealed comparative advantage and on comparative advantage and the environment. Let your students know that government analysts use the revealed comparative advantage measure. If you have an interest in environmental issues, this would be a good place to reveal that interest. This issue is picked up again in Chapter 7 on the WTO. If you have any discomforts with the standard neoclassical “more is better” view of welfare, this would also be a good place to discuss that as well.

If you are not planning to cover Chapter 24 on Structural Change and Adjustment and would like to introduce your students to the Rybczynski Theorem at this point in your class, please see the appendix to Chapter 24.

Comments on Review Questions

1. What is the difference between *absolute* and *comparative* advantage?

Absolute advantage involves only one product and the comparison of only two autarky prices. Comparative advantage involves two products and, therefore, the comparison of four autarky prices in the form of relative prices. Comparative advantage is depicted using production possibilities frontiers, which allow for two goods, rather than supply and demand diagrams, which only allow for one good.

2. Create an example of a comparative advantage model by choosing two countries and two products.
 - a. Draw a diagram describing *autarky* and a *pattern of comparative advantage* for your example.
 - b. Show the transition from autarky to trade in your diagram, label the trade flows, and demonstrate the *gains from trade*.

This question can be done as an in-class exercise to shift the students from passive to active mode. In “b,” students can have a difficult time identifying the trade flows, and often can mistakenly measure them using the autarky point, which is no longer relevant under trade. Assistance might be necessary here.

3. Can you think of any patterns of comparative advantage and trade in the world economy that might have some significant environmental impacts? What are they?

Some primary commodity processes like mining and petroleum have significant environmental impacts. The latter is mentioned in a box in Chapter 22 on International Production and Development. Even advanced sectors such as computer products can have environmental impacts, and this is also mentioned in Chapter 22 in the case of Intel and the computer products cluster in Costa Rica.

CHAPTER 4

Intra-Industry Trade

Chapter Objectives

The purpose of this chapter is to introduce the student to the important difference between *inter*-industry trade and *intra*-industry trade, a topic neglected in many international economics textbooks. Motivate your students by letting them know that they are about to understand and *important* and *neglected* topic that most other students will not know about (even if you exaggerate a little). Also motivate them by letting them know that this is a topic considered to be important by “real” trade policy analysts (no exaggeration here). Students like to know they are getting something special.

The chapter makes an important distinction between horizontal *intra*-industry trade and vertical *intra*-industry trade. The latter is a link between trade and international production and foreshadows the discussion of global production networks in Part II of the book.

Analytical elements used in this chapter:

Countries, sectors, tasks, firms and factors.

Chapter Outline

Intra-Industry and *Inter*-Industry Trade
Global Patterns of *Intra*-Industry Trade
 Box: Intra-Industry Trade in East Asia
An Explanation of *Intra*-Industry Trade
 Box: Computer Products Trade
Conclusion
Appendix: The Grubel-Lloyd Index

Teaching Notes

If the student takes nothing from this chapter and your lecture other than Table 4.1, its main purpose will be served. These distinctions are central to applied trade policy analysis. For this reason, keep referring your students to this table.

Table 4.1 Types of Trade

| Type of Trade | Phrase | Meaning | Source |
|-----------------------------------|--------------------|--|---|
| <i>Inter</i> -industry | Either/or | <i>Either</i> imports <i>or</i> exports in a given sector of the economy | Comparative advantage |
| <i>Horizontal intra</i> -industry | Both/and/same | <i>Both</i> imports <i>and</i> exports in a given sector of the economy and at the <i>same</i> stage of processing | Product differentiation |
| <i>Vertical intra</i> -industry | Both/and/different | <i>Both</i> imports <i>and</i> exports in a given sector of the economy and at <i>different</i> stages of processing | Fragmentation (comparative advantage in some instances) |

This chapter uses an example of *intra*-industry trade in cheese. While this might appear to be silly at first, it is a useful example. The reason for this is that it is a highly *disaggregated* product category where, therefore, little *intra*-industry trade is thought to occur by standard trade theory. The disaggregation goes from food products to dairy products to cheese. It would be helpful to you and your students if you were to present another example in class with which you have some familiarity. If you can base this example on a personal story, they will like it even more.

The chapter also introduces the issue of the *smooth adjustment hypothesis* associated with *intra*-industry trade. This foreshadows the subject of the political economy of trade taken up in Chapter 5. This is worth mentioning to your students in your discussion.

If you are going to introduce your students to the Grubel-Lloyd index covered in the appendix, there is an easy way to make it clear to them. First have them consider a case in which both imports and exports are equal (say 10). Have them calculate the index, and they will see it has a value of 100, its maximum value indicating pure *intra*-industry trade. Then have them calculate the index with only imports or exports (again either being 10). They will see it has a value of 0, its minimum value indicating pure *inter*-industry trade.

Finally, Chapter 10 on Foreign Direct Investment and Intra-Firm Trade includes an appendix on the gravity model. If you wish to or if you don't plan to cover Chapter 10, you could introduce your student to gravity model at this point in the course.

Comments on Review Questions

1. In your own words, please explain the difference between *inter*-industry and *intra*-industry trade.

Answers here should be compared to Table 4.1, reproduced above.

2. How is the phenomenon of horizontal *intra*-industry trade related to product diversification?

Horizontal intra-industry trade takes place in differentiated products. If all products were the same, there would be no reason to both import and export them. Trade would revert to the inter-industry trade of the comparative advantage model. As quoted from van Marrewijk (2002) in a footnote in this chapter, "A satisfactory theoretical explanation (of intra-industry trade) should... be able to distinguish between goods and services which are close, but imperfect substitutes" (p. 183).

3. Create your own example of a *horizontal intra*-industry trade model by choosing a country and a product. Draw a diagram equivalent to Figure 4.3 describing *intra*-industry trade for your example. Next, draw a diagram equivalent to Figure 4.4 describing the gains from *intra*-industry trade.

This question can serve as a classroom exercise to shift the students from passive to active mode. Such a shift helps to reinforce the material.

4. Create you own example of *vertical intra*-industry trade and explain how it is related to fragmentation.

This question also can serve as a classroom exercise to shift the students from passive to active mode. Such a shift helps to reinforce the material. The key difference here is for the student to relate the example to different tasks or stages or processing. Make sure that they understand this.

5. Explain why the adjustment process stemming from *intra*-industry trade is easier for a country to accommodate than the adjustment process stemming from *inter*-industry trade.

Increases in inter-industry trade based on absolute or comparative advantage involve import sectors contracting and export sectors expanding. This, in turn, requires that productive resources, most notably workers, shift from contracting to expanding sectors in order to avoid unemployment. The adjustment process in

the case of intra-industry trade is very different. A given sector experiences increases in imports and exports simultaneously. Therefore, workers are less likely to need to shift between sectors.

CHAPTER 5

The Political Economy of Trade

Chapter Objectives

The main purpose of this chapter is to answer the question: If there are gains from trade, why do we observe opposition to trade? This leads to an investigation of the political economy of trade. The chapter begins broadly, identifying some main paradigms in Table 5.1. It then focuses on the distinction between the standard Heckscher-Ohlin analysis of this subject, with its associated Stolper-Samuelson theorem, and an alternative specific factors analysis. Rather than engaging in formal analysis, the chapter develops logical chains using flow charts. It also extends the Stolper-Samuelson theorem to the domain of North-South trade and wages. For advanced classes, there is an appendix with a simple, graphical treatment of endogenous protection.

This chapter follows directly from Chapter 3. As such, it is based on comparative advantage and *inter*-industry trade. As emphasized in Chapter 4, the politics of *intra*-industry trade tends to be less severe.

Analytical elements for this chapter:

Countries, sectors, firms and factors of production.

Chapter Outline

Approaches to the Political Economy of Trade
Comparative Advantage Revisited
Trade and Factors of Production
North-South Trade and Wages
 Box: Trade and Wages in Latin America
The Role of Specific Factors
 Box: US Steel Protection
Conclusion
Appendix: Endogenous Protection

Teaching Notes

Most students find this chapter to be of interest. It gives them an analytical handle on the politics of trade they hear so much about. Keep in mind that your students will have a wide range of opinion on these matters that are not entirely coincident with their political orientations. Anti-globalization students might agree with protectionist conservatives on trade policy. Emphasize that you are just providing them with a *framework* to inform their views. At the end of the day, their views are their own.

The purpose of the discussion related to Table 5.1 on the approaches to the political economy of trade is to allow for courses in varied programs. Pick and chose what you want to emphasize for your program. Most international economics programs emphasize only the factor-based and sector-based approaches, but international relations programs might require a wider view.

The key concepts of this chapter are summarized in the following box. You can keep referring to this box as you proceed through the chapter's material. You must make clear that the distinction between mobile factors of production and specific factors of production is one concerning the degree of *domestic* mobility. International mobility of capital is not addressed until Part II of the text. Also, make sure to emphasize that, while the distinction might seem mundane at first, it is key to understanding how the politics of trade manifests itself under different conditions.

Mobile factors of production: The Stolper-Samuelson theorem applies. The abundant factor of production (used intensively in the export sector) gains, while the scarce factor of production (used intensively in the import sector) loses.

Specific factors of production: The Stolper-Samuelson theorem does *not* apply. The factor of production specific to the export sector gains, while the factor of production specific to the import sector loses. The fate of mobile factors is uncertain.

Another box in the chapter introduces the reader to the case of US steel protection. This subject has a long history that you can make use of in class. It is also part of a dispute settlement case at the World Trade Organization that you can take up in Chapter 7. This is a good example to get into the nitty-gritty of labor unions, US presidential politics, technology (integrated- vs. mini-mills), and the export prospects of developing countries.

The chapter is cast in terms of trade between Japan and Vietnam. Developing your own example will both impress your students and give them an alternative to the text.

Do you have political scientists in your class? Find out. If so, let them know that their field makes substantial contributions to the material in this chapter. Direct them to the endogenous protection appendix. If you take up this subject in your class, feel free to develop your own small example with 5 to 10 individuals rather than 100 or just 5 as illustrated in the footnote.

Comments on Review Questions

1. Consider the trade between Germany and the Dominican Republic. Germany is a capital abundant country, and the Dominican Republic is a labor abundant country. There are two goods, a capital-intensive good chemicals and a labor-intensive good clothing.
 - a. Draw a comparative advantage diagram such as Figure 5.1 for trade between Germany and the Dominican Republic, labeling the trade flows along the axes of your diagrams.
 - b. Using the Stolper-Samuelson theorem, describe who will support and who will oppose trade in these two countries. Use a flow chart diagram like that of Figure 5.2 to help you in your description

This question makes a good classroom exercise to shift the students from a passive to an active mode. While the students might be nodding “yes” as you explain the comparative advantage and Stolper-Samuelson ideas, having them actually write down the PPF and flow chart diagrams is another matter entirely. As they work on this in class, circulate around the room helping them along. Alternatively, suggest that students take on this question outside of class in study groups.

2. In the early 1800s in England, a debate arose in Parliament over the Corn Laws, restriction on imports of grain into the country. David Ricardo, the father of the comparative advantage concept, favored the repeal of these import restrictions. Consider the two relevant political groups in England at that time: land owners and capital owners. Who do you think agreed with Ricardo? Why?

This question provides a little economic history relating to the father of comparative advantage. This question could be answered in terms of either the Stolper-Samuelson theorem or in terms of the specific factors model, the latter perhaps being the more accurate. Increased imports of grain lowers the rental rate on land, as Ricardo, a landowner himself, understood. It increases rental rates on physical capital.

3. Use daily papers to identify a political economy of trade issue. Can you also identify the factors or production involved in this issue? Are they mobile factors as in the Heckscher-Ohlin model, or are they specific factors? Alternatively, are there any elements of technology involved?

Here is where you can bring in recent news articles to help the discussion along. Preparing this sometime ahead will be important to ensure quality examples that are of interest to you.

CHAPTER 6

Trade Policy Analysis

Chapter Objectives

Chapters 2 and 3 of the text introduced students to the absolute and comparative advantage approaches to international trade, helping them to understand how market forces generate imports and exports of goods and services in the world economy. Chapter 5 introduced students to the ways in which increased trade can generate winners and losers in each country involved. In Chapter 6, the student is introduced to the market effects of government interventions in trade flows to meet demands for protectionism from losers. For the most part, the entire chapter is set out in a supply and demand framework rather than in terms of production possibilities frontiers. For this reason, the students should feel relatively comfortable with this chapter.

The most important understanding that your students can take from this chapter is the effect of a tariff. The contrast between a tariff and a quota is the next-most important objective of the chapter. Here, the important distinction is between a domestic-allocated quota and a foreign-allocated quota. Terms of trade effects are also described using the case of a tariff.

For continuity purposes, the chapter is set out in terms of Japan's rice protection. Other examples that you bring to class could be equally or even better suited to interesting discussions that can illuminate the complex of interests and effects surrounding any protection policy. For example, due to space constraints, the chapter does not take up anti-dumping policies, and many of these provide good examples for class analysis.

Some professional students involved in trade policy analysis need to be familiar with the imperfect substitutes model and with tariff rate quotas. If this is the case in your class, you can draw upon the appendix addressing this topic to meet these needs. Tariff rate quotas are covered in a second appendix.

Analytical elements used in this chapter:

Countries, sectors and factors of production.

Chapter Outline

Absolute Advantage Revisited
Trade Policy Measures
 Box: Used Automobile Protection in Latin America
A Tariff
Terms of Trade Effects
A Quota
Comparative Advantage Models
 Box: The Global Trade Analysis Project
Conclusion
Appendix: The Imperfect Substitutes Model
Appendix: A Tariff Rate Quota

Teaching Notes

While it might seem redundant, a brief review of the absolute advantage model is useful for the students who have spent a lot on attention of the comparative advantage model. Use Table 6.1 on non-tariff measures as a starting-point and add more detail where you can based on your own knowledge, perhaps in the area of anti-dumping, and use an example or two with which you are familiar.

The key diagram is Figure 6.2 analyzing the tariff. Here is a good place to review the concepts of *change in quantity demanded* and *change in quantity supplied*, mentioned in Chapter 2. The chapter conducts in analysis in terms of Japanese rice imports, but you can introduce another example instead. The terms of trade effects of a tariff can be initially difficult for students to understand. You might have to repeat a few times, “A Japan’s imports of rice decrease, there will be *excess supply* in the *world* market for rice.” Excess supply, of course, requires a fall in the world price.

The quota analysis assumes that there is *no* terms of trade effect. The key concept here is that of quota rents. You can ask you students, “Suppose you had the right to buy Z_{quota} of rice at P^W on the world market and to sell it at P_{quota} in Japan? How much would you earn?” This would be area C in Figure 6.4. The remaining question is: Where do these quota rents go? This is the domestic-allocated and foreign-allocated distinction made by trade economists.

The text summarizes this discussion with the following important box:

Tariff: unambiguous net welfare loss due to consumer surplus loss outweighing gains in producer surplus and government revenue.

Tariff with terms of trade effects: ambiguous net welfare effect due to terms of trade gain (fall in world price) potentially outweighing the efficiency loss.

Domestic-allocated quota: unambiguous net welfare loss due to consumer surplus loss outweighing gains in producer surplus and quota rents.

Foreign-allocated quota: unambiguous net welfare loss that exceeds that of the domestic-allocated quota case.

Turning your students' attention to this box as a study aid would be helpful.

Most international texts analyze trade policy in a general equilibrium, comparative advantage diagram using production possibilities frontiers. This is not easy for students of varied backgrounds to follow. For this reason, the text discusses the comparative advantage approach to trade policy analysis using examples but introduces the concept of applied general equilibrium modeling and the Purdue-based Global Trade Analysis Project (GTAP). You can find examples of AGE analysis on the GTAP web-site.

Comments on Review Questions

1. Consider Figure 6.2. For a given T , what would be the impact of an *increase in supply* (a shift of the supply curve to the right) on government revenue? What would be the impact of an *increase in demand* (a shift of the demand curve to the right)?

An increase in supply would reduce the amount of imports under the tariff, reduce the government's tariff revenue, and increase the amount of producer surplus generated by the tariff. An increase in demand would increase the amount of imports under the tariff, increase the government's tariff revenue, and increase the amount of consumer surplus lost due to the tariff.

2. In Figure 6.3, we introduced the terms of trade effects of Japan's tariff on imports of rice. The terms of trade effect (area E in the diagram) was positive for Japan. In a new diagram similar to Figure 6.1, show that these terms of trade effects adversely affect the welfare of Vietnam.

The fall in the world price of rice lowers Vietnam's exports and reduces its gains from trade triangle in the left-hand-side diagrams of Figure 6.1.

3. Consider our diagram of a quota in Figure 6.4. Suppose the government reduced the quota to below Z_{quota}^J . What would happen to the *quota premium*? Can you say with certainty what would happen to the total *quota rent*? What would this depend on?

The quota premium would increase, but the import volume falls. Whether the total quota rent increases or not depends on the price elasticities of demand and supply. The more inelastic are demand and supply, the more likely the total quota rent will increase.

4. Trade protection is often used to maintain employment in a sector. Given our analysis, what do you think of this approach to maintaining employment? Can you think of any other measures that might also maintain employment in a sector?

There is no single correct answer here. Production or employment subsidies are alternative policies that would maintain employment in a sector.

CHAPTER 7

The World Trade Organization

Chapter Objectives

The World Trade Organization has become a crucible for concerns about globalization. This is not entirely appropriate, but it is a fact. Chapter 7, along with Chapters 17 and 23, introduce your students to the three key institutions of the world economy: the WTO, the International Monetary Fund, and the World Bank. The main objective here is to historically inform the students about the actual roles of these institutions in “globalization” processes. These actual roles are distinct from the alleged roles that most students will have absorbed, and most students will have much to learn in this area. These chapters attempt to facilitate this process while maintaining a critical perspective.

For most students, the marginal gains of transmitting the material of this chapter are large. Some of the essential concepts to be transmitted are: nondiscrimination (including the sub-principles of most-favored nation and national treatment), binding, the WTO as “tripod” (GATT 1994, GATS, and TRIPs), WTO dispute settlement procedures, and trade-and-the-environment at the WTO. Any common, analytical ground you can open up between “free-trade” and “anti-globalization” in the discussion of the WTO will be very useful. Also, for students from powerful developed countries, notions of multilateralism versus unilateralism are particularly important.

One limitation to this chapter was that it went into press at the very beginning of 2011 and therefore missed much of the “final” year of the Doha Round. Therefore, you will need to update yourself on subsequent events. Please check the website (iie.gmu.edu) for any updates.

Analytical elements used in this chapter:

Countries and sectors.

Chapter Outline

The General Agreement on Tariffs and Trade
The World Trade Organization
Trade in Goods
Trade in Services
 Box: Telecommunication Services in the GATS
Intellectual Property
 Box: Access to Medicines
Dispute Settlement
 BOX: The “Bananarama” Dispute
The Environment
Doha Round
Conclusion
Appendix: WTO Membership and Multilateral Trade Negotiations

Teaching Notes

Students will appreciate this chapter and your lecture derived from it. They have a strong interest in this material. As always, take subjects step-by-step, bringing in your own examples where you can. For your own background, consult the Hoekman and Kostecki (2009) volume cited in the book, relying on the table of contents. Draw from the WTO web-site, which is quite user-friendly. You could even give the students a tour of this web-site in class. Since students can have strong feelings on some of the subjects of the chapter, you might need to play the two-handed economist: “On the one hand, some groups claim X. On the other hand, some groups claim Y. You will have to come to your own conclusions.”

If nothing else, your students should come away from the chapter/lecture with an understanding of nondiscrimination, described in Figure 7.1. Secondly, the students must have an appreciation of the WTO as covering the three elements of goods, services, and intellectual property. This is the notion of the WTO “tripod.”

The chapter is very compressed. Entire courses can be (and are) designed on the subject of the WTO and its legal intricacies. For this reason, it is possible to devote as many class sessions to this chapter as you wish. For example, a thorough treatment of just agricultural trade under the WTO can fill entire class session. Let your interests guide you here.

Students have strong opinions with regard to the access to medicines issue discussed in a box. This is one area where issues of intellectual property and development come together in a controversy. If you are so inclined, make good use of it!

Do you have budding lawyers in your classroom? They should know that trade law is a well-defined and growing field. Point them to the *Journal of International Economic Law* and the Matsushita, Schoenbaum and Mavroidis (2006) volume cited in

the text. Let your students know that this is one chapter where law and economic come together.

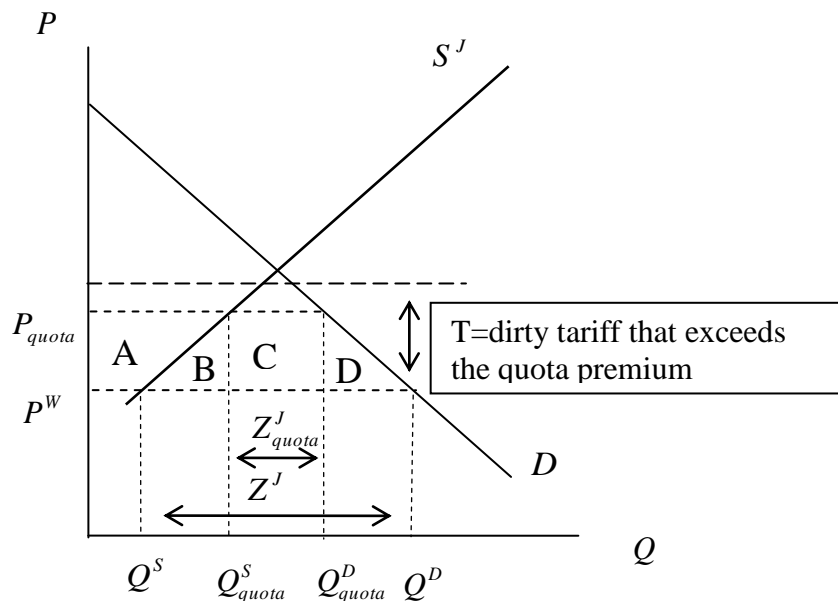
Comments on Review Questions

1. What is meant by *nondiscrimination* in international trade agreements? Be as specific as you can.

This question relates to Figure 7.1. The key insight is that nondiscrimination has two parts: one related to border measures (most-favored nation) and the other related to behind-the-border measures (national treatment).

2. One criticism of the Agreement on Agriculture is that it involves something known as *dirty tariffication*. Dirty tariffication involves quotas being converted into tariffs that are larger than the actual tariff equivalent of the original tariff. Draw a diagram like that of Figure 6.4, illustrating dirty tariffication.

Figure 6.4. A Quota on Japan's Rice Imports



3. The chapter mentioned the four modes by which trade in services can occur: cross-border trade; movement of consumers; foreign direct investment; and personnel movement. Try to give an example of each of these modes. The more specific the better.

Cross-border trade is a mode of supply that does not require the physical movement of producers or consumers. For example, Indian firms provide medical transcription services to US hospitals via satellite technology. Movement of consumers involves the consumer travelling to the country of the producer and is typical of the consumption of tourism services. Foreign direct investment is involved for services that require a commercial presence by producers in the country of the consumers and is typical of financial services. Finally, the temporary movement of natural persons involves a non-commercial presence by producers to supply consulting, construction, and instructional services.

4. The chapter also gave an example of the way that the “theft” of intellectual property in the case of pharmaceuticals suppresses trade in this product. Try to give another example of such trade suppression.

Video, DVD and CD pirating are examples with meaning to many students.

5. Can you think of any ways in which trade issues and environmental issues interact?

There is no single correct answer here, and this question would be good for class discussion. Trade in hazardous waste and its regulation by the Basel Convention is one example. Pesticide application in export agriculture is another.

CHAPTER 8

Preferential Trade Agreements

Chapter Objectives

This chapter on preferentialism follows Chapter 7 on multilateralism. The quote at the beginning of the chapter from the Canadian trade official, “When multilateralism falters, regionalism picks up the pace” sets out this tension in the world trading system. The purpose of this chapter is to put the preferential/regional channel of trade liberalization into some perspective for the student. Awkwardly, prominent trade economists have very different postures towards the role of PTAs in the world trading system. Try to use this to your advantage. Despite this lack of consensus, there are some key concepts that can be communicated to the students. These include types of PTAs, trade creation and trade diversion, and the tensions between regionalism and multilateralism.

Within space constraints, the chapter gives examples of PTAs. Your own interests can guide you on drawing from these examples and adding additional material.

Analytical elements for this chapter:

Countries, sectors and tasks.

Chapter Outline

Preferential Trade Agreements

Box: NAFTA Automobile ROOs

The Economic Effects of Preferential Trade Agreements

The European Union

The North American Free Trade Area

Box: NAFTA, Wages, and Industrial Pollution

Mercosur and the FTAA

ASEAN and AFTA

Regionalism and Multilateralism

Box: New or Open Regionalism

Conclusion

Appendix: Rules of Thumb for Evaluating PTAs

Teaching Notes

The first important task of the chapter is to allow the students to distinguish among types of PTAs. This is done in Tables 8.1 and 8.2. Table 8.1 takes the WTO classification approach (and includes some double-counting). Pay a visit to the WTO website to see if these data have been updated and check for updates at jie.gmu.edu. Table 8.2 is a more process-oriented view. Note that NAFTA, a “free trade area,” has one feature of a common market: liberalization of FDI among the three members. Mercosur (nominally a common market) does not actually reach the common market goal. These discrepancies can muddy the waters a bit for students.

It is important to make your students aware that, as stated in the text, WTO oversight is entirely absent in the case of PTAs. It is also important to sensitize your students to the role of ROOs in PTAs. To some real extent, the effects of FTAs (not CUs) are determined by ROOs. Of course, trade creation and trade diversion are central to the analysis of PTAs. Proceed slowly through Figures 8.1 and 8.2, using these as another opportunity to hone your students’ analytical skills.

Note that monetary aspects of the EU are taken up in Chapter 19. You might need to ask students who want to discuss the euro to be patient, saying something like “We need to first understand exchange rates before we can adequately take up the issue of monetary unions and the euro. Hang in there a bit longer! We *will* get to that topic.”

Comments on Review Questions

1. What distinguishes a customs union from a free trade area? What distinguishes a common market from a customs union?

A customs union, unlike a free trade area, has a common external trade policy (or common external tariff) adopted by member countries. A common market, unlike a customs union, allows for the free movement of labor and physical capital among member countries. There is a truth in advertising problem here. For example Mercosur is not a common market; it is a FTA attempting to be a customs union.

2. What is the difference between trade creation and trade diversion? Can you provide an example of each?

The box in the chapter sums this up:

Trade creation: switching of imports from a high-cost source to a low-cost source.

Trade diversion: switching of imports from a low-cost source to a high cost source.

If, as a result of NAFTA, the US imports clothing from Mexico rather than from the Dominican Republic where it is more expensively produced, then trade creation has occurred. If, as a result of NAFTA, the US imports clothing from Mexico rather than from the Dominican Republic where it is more cheaply produced, then trade diversion has occurred.

3. Do you support regionalism and PTAs as a legitimate trade policy option? Why or why not?

There is no single correct answer here. It depends on the quality of the students' arguments either for or against regionalism. This can be used for classroom discussion.

4. We mentioned above that the size of Brazil's tariff against El Salvador affects the amount of trade diversion that occurs in a PTA. Use a version of Figure 8.2 to demonstrate that the lower is T against El Salvador, the more likely it is that the PTA will improve welfare. Show that if the T on imports from El Salvador were eliminated, the PTA would unambiguously improve welfare.

If the tariff on imports from El Salvador were eliminated along with the tariff on imports from Argentina, Brazil would continue to import even larger amounts from El Salvador, causing even greater welfare gains for Brazil.

5. Pay a visit to the WTO's web site on regionalism. From www.wto.org, follow the link to "Trade Issues" and, from there, to "Regionalism." Spend some time perusing the WTO's materials on this issue.

You can give your students of tour of this in class if you wish.

Part II

International Production

CHAPTER 9

Foreign Market Entry and International Production

Chapter Objectives

This chapter, written primarily, but by no means exclusively for business students, has four purposes. First, it will help the student to visualize international trade as one of a number of alternative means of for foreign market entry. Second, it helps the students to begin to understand firms' considerations with regard to entry mode, most especially the concepts of firm-specific assets (including knowledge capital) and dissemination risk. Third, it introduces the student to the broad motivations for engaging in international production or FDI. Fourth, it provides the student with a (very) broad overview of the history of international production. The chapter sets the stage for the more detailed analysis of Chapter 10.

While much of the chapter appears to be elementary, you need to keep in mind that some students have a difficult time distinguishing international trade from FDI. The two are merged in their minds. Hopefully, the material of Chapter 1 was a good antidote to this tendency. If that was not the case, however, the present chapter is a second opportunity for the student to gain a clear picture of the trade-contracting-investment menu facing every international firm.

Analytical elements for this chapter:

Countries, sectors, tasks, firms and factors of production.

Chapter Outline

Foreign Market Entry

 BOX: Beijing Jeep

Motivations for International Production

Entry Mode Choice

The Rise of Multinational Enterprises and International Production

 Box: SAB and the Emergence of a South African MNE

Conclusion
Appendix: FDI and Comparative Advantage

Teaching Notes

If nothing else, the student should take from this chapter and your lecture Table 9.1 on foreign market entry. Don't rush over this table. Lead the students on a tour through it, with examples where you can supply them. This is your chance to give the students a clear picture of the trade-contracting-investment menu facing every international firm. The second priority is the notion of firm specific assets and Table 9.2 relating to dissemination risk. Here, you should ask the students to put themselves in the place of a corporate manager who must set a foreign market entry strategy. It is worth pointing out a few times during the semester/quarter that empirical analysis of FDI indicates that firm specific assets in the form of intellectual property (a particular kind of knowledge capital) is an important explanatory variable.

The chapter does contain two boxes with examples of international production. Without a doubt, any additional examples that you bring to class, and in particular examples that make it possible to discuss the motivations and strategies of firms' foreign market entry, will be greatly appreciated by your students.

Many discussions of "globalization" take it for granted that multinational enterprises view location decisions through the single lens of cheap labor. This is a very incomplete view that is not sufficient to understand the modern, global economy. Taking your students through the four motivations discussed in the text (resource seeking, market seeking, efficiency seeking, and strategic asset seeking) will help greatly in giving your students a more sophisticated understanding of the behavior of MNEs. If your class is small, you can break it up into groups to come up with examples of each, which they can briefly report to the entire class. Also, in distinguishing between "Fordism" and "Toytotism" or flexible manufacturing, it is useful to link the latter to the box on information and communication technology (ICT) discussed in Chapter 1.

It is worthwhile to introduce your student to UNCTAD's transnationality index (TNI) reported in Table 9.5. It is a useful measure and one that gives students a sense of the limits of the "globalized" firm concept. UNCTAD's *World Investment Report* website will be an important resource both for you and for your students. See: <http://www.unctad.org/wir/>.

Having completed Chapter 3 on comparative advantage, you can introduce your students to the appendix of this chapter, which relates the process of FDI to the production possibilities frontier diagrams of Chapter 3. This is a way to tie the international trade and international production parts of the book (and your course) together. There is a similar appendix to Chapter 12 on migration.

Comments on Review Exercises

1. Why should a firm move beyond trading relationships into international production? What is its motivation for doing so?

Exporting to the foreign market is not fully satisfactory in all cases of foreign market entry. For example, a firm might need to engage in some final product finishing, service, or sales to address local demand conditions in the foreign country. This could include after-sales services such as repair. Or it might simply need to engage in some trade-related services itself in that country.

2. Suppose a firm's competitiveness was based on its proprietary knowledge, perhaps in the form of a patent on a product or process. What can you say about its considerations with regard to foreign market entry?

A firm for which proprietary knowledge is important will be concerned with dissemination risk. Dissemination risk is lowest for the international trade mode of foreign market entry, as well as the subsidiary (not joint venture) form of FDI.

3. What key characteristics differentiate managerial capitalism or Fordism and Toyotism based on flexible manufacturing?

Managerial capitalism or Fordism emphasizes the role of economies of scale in the production line. It is associated with a shift of MNE activity from Europe to the United States. Flexible manufacturing or Toyotism emphasizes the role of flexibility based on information technology in the production line, namely computer-aided production that enables a rapid reconfiguration of production to suit changing consumer demands, for example.

4. For each of the four motivations for international production, please try to provide an example. The more specific your example, the better.

There are no "correct" answers here. This is a question that lends itself to classroom, group activity.

CHAPTER 10

Foreign Direct Investment and Intra-Firm Trade

Chapter Objectives

This chapter introduces students to a set of tools commonly used in corporate strategy as they are applied to the analysis of international production. The key concept here is the value chain and its generalization to global production networks (GPNs). Along the way, the concepts of firm-specific assets, firm-level economies, and internalization are considered. The chapter proceeds in a step-by-step fashion, aided by visual depictions of GPNs. The entire chapter is presented using the example of the semiconductor firm Intel, and this should help sustain student interest.

The analysis helps the student to appreciate, within the GPN framework, the phenomenon of intra-firm trade. This understanding is important. As stated in Chapter 1, approximately one third of world trade takes place *within* MNEs. The chapter allows students an understanding of how this important category of world trade arises.

The final objective of the chapter is to introduce the student to the OLI framework and its components of ownership or O advantages, location or L advantages, and internalization or I advantages. Note that for economics students, the work of trade economist James Markusen on MNEs is based on this framework, so the relevance here is not just to business students.

Analytical elements for this chapter:

Countries, sectors, tasks and firms.

Chapter Outline

Value Chains and Global Production Networks
Firm-Specific Assets and Internalization
 BOX: “Team Toyota” and “The Toyota Way” in Kentucky
Intra-Firm Trade
 BOX: FDI Flows in Asia
A Cost View of Internalization
Tying Things Together: The OLI Framework
Conclusion
Appendix: The Gravity Model

Teaching Notes

Since most of the chapter is set out in terms of GPNs, it is important to guide the student through them in a step-by-step fashion. Unless this concept is well understood, the remainder of the concepts will not flow well. You can use the example in the text or one of your own. The flow of the concepts is as follows:

Global production network (GPN)
 ⇒ Firm-specific assets
 ⇒ Firm-level economies
 ⇒ Internalization

One issue that comes up is how the intra-firm trade concept relates to the distinction between inter-industry trade and intra-industry trade made in Chapter 4. Indeed, this can be complicated for the student. Here you need to refer the students to Table 10.1, presented in the text and on the next page. The key distinction here is between an industry dimension and a firm dimension. Any example of trade will fit in one of the four cells defined by these dimensions in the table. Intra-firm trade can be inter-industry trade or intra-industry trade.

Table 10.1 Industry and Firm Dimensions of Trade

| | Firm Dimension: | |
|----------------------------|--|---|
| Industry Dimension: | <i>Inter-firm</i> | <i>Intra-firm</i> |
| <i>Inter-industry</i> | Trade that takes place between two different industries and two different firms. | Trade that takes place between two different industries and within a single firm. |
| <i>Intra-industry</i> | Type of trade that takes place within a single industry and between two different firms. | Trade that takes place within a single industry and within a single firm. |

If you wish to build on your students' understanding of cost concepts, then walk them through Figure 10.4 on a cost view of internalization. This has grounding in standard make-buy analysis in managerial economics and can tie things together for the more economic minded.

While the above analysis is in itself a lot for the student to take on, the chapter considers one more issue, summarizing the book's consideration of multinational enterprises. This is the well-known OLI framework. Again, a table is useful:

Table 10.2 The OLI Framework

| Symbol | Meaning | Contribution |
|---------------|---------------------------|--|
| O | Ownership advantage | Explains how a firm's tangible and intangible assets help it to overcome the extra costs of doing business internationally. Explains why a home country firm, rather than a foreign firm, produces in the foreign country. |
| L | Location advantage | Explains why a home-based MNE chooses to produce in a foreign country rather than in its home country. |
| I | Internalization advantage | Explains why a home-based MNE chooses FDI rather than licensing to achieve production in a foreign country. |

Any case of FDI must exhibit O, L, and I advantages. Otherwise, the firm would choose a non-investment mode (trade, contracting), discussed in Chapter 9, rather than the investment mode.

At the conclusion of your presentation of the material of this chapter, you should let your students know that they have absorbed some key concepts of international corporate strategy. It will be helpful for them to know that they have accomplished something important that is recognized by this important field. You might also tell your students that they have digested material that is not present in most international economics textbooks, to make them feel that they have done something “special.” A little motivation always helps!

Comments on Review Exercises

1. Choose any production process that might be of interest to you. Both merchandise and services are appropriate. As best you can, draw a value chain for this production process.

There is no single, correct answer here. This question can be a simple take-home assignment or can be expanded into a semester research assignment requiring detailed analysis of the value chain of a global firm.

2. Next, for this production process, choose two countries. Place the value chains for these two countries side by side in a GPN. Show how FDI by a firm based in the first country in the second country can be depicted for the cases of horizontal FDI, backward vertical FDI, and forward vertical FDI.

Again, there is no single correct answer here. The point is to have the student correctly differentiate among the three types of FDI.

3. Make a list of as many firm-specific assets you can think of, both tangible and intangible.

Once again, there is no single correct answer here. This question could be included in your classroom discussion at the appropriate time.

4. For each of ownership advantages, location advantages, and internalization advantages, state how it helps you to understand why firms engage in FDI rather than trade or contractual modes of foreign market entry.

Students' answers to this question should follow somewhat the contents of Table 10.2 above.

CHAPTER 11

Managing International Production

Chapter Objectives

This chapter introduces the student to a number of central issues in the management of international production, both contracting and FDI. It covers the organization of MNEs, joint ventures, the role of the home base in MNE operations and competitiveness (including the Porter diamond), spatial clusters and research and development. A touchstone concept is again the global production network (GPN) and its illustration in the case of Intel. Many economics professors are not used to these topics being present in an international economics text, but for the broad social and policy studies, they are indeed crucial. For business studies, they form a part of the “canon.” For development studies, spatial clusters are also important, underlying national and regional development strategies in many instances.

Analytical elements for this chapter:

Countries, sectors, tasks and firms.

Chapter Outline

Organizing the MNE

 BOX: The End of Corporate Imperialism?

Joint Ventures

The Home Base

Spatial Clusters

 BOX: The Surgical Instruments Cluster in Pakistan

Research and Development

 BOX: TRIPS and International Production

Conclusion

Teaching Notes

The key thing to communicate to your students in this chapter is that managing international production involves both intra-firm MNE design and inter-firm relationships. The former show up as the solid lines or boxes in GPN diagrams (e.g., Figure 11.1), while the latter show up as the dashed lines or boxes in these diagrams. With regard to the former, Table 11.1 is important, but not conclusive. If you want to pursue the heterarchy possibility in this Table further, Bartlett and Ghoshal (2002) is very helpful, is somewhat outdated. More current information on the intra-firm MNE design issue can be found in the encyclopedic Dunning and Lundan (2008).

With regard to inter-firm relationships, the framework of Gereffi, Humphrey and Sturgeon (2005) is very helpful. This links economic sociology to international business in a useful way. If you can bring in examples of one or two of these relationships, students will appreciate it. To better understand the relationship between “Toyotism” and intra-firm (particularly supplier) relationships, see Ruigrok and van Tulder (1995). This book links international political economy to international business.

Joint ventures compose an interesting but complicated realm. You should refer back to the Beijing Jeep example of Chapter 9, and try to bring a second example into class. The laptop PC industry is one area to look for these.

With regard to the home base, intra-firm MNE design issues arise again. Also relevant here is the Porter diamond. Here, you can inform the students that they are venturing into the realm of corporate strategy. The application of Michael Porter’s ideas to the Costa Rica Intel case is worth pursuing in class.

The next section takes up the contemporary phenomenon of clusters. It would be worth emphasizing to your students that the cluster phenomenon has been recognized as important by: corporate strategists, geographers, regional scientists, development studies scholars, economists, sociologists, and business entrepreneurs. The Pakistani surgical instruments cluster case demonstrates that there are development applications of this concept. The link here to issues of child labor might also be a worthwhile topic for classroom discussion.

Research and development is important. It links the field of science and technology to international business. The role of scientific and engineering talent in the FDI-migration choice is an excellent link from this chapter to the Chapter 12 on migration (in particular high-skilled migration). This is also an important point to spend a short while on the emerging roles of India and China in the world economy.

Comments on Review Exercises

1. Please try to provide specific examples of an *intra-firm design* issue and an *inter-firm relationship* issue, the latter in the context of an MNE and a supplier.

There is no correct answer here. Intra-firm design within the MNE refers to the issues represented in Table 11.1, as well as the role of the home base and the location of R&D. Inter-firm relationships concern relations with suppliers (upstream in the GPN) and with buyers (downstream in the GPN).

2. What is the difference between a *basic factor* of production and an *advanced factor* of production? What is the difference between a *generalized factor* of production and a *specialized factor* of production? Please try to give specific examples of these.

Basic factors are largely inherited, and their creation required very little sophisticated investment. An example would be unskilled labor. Advanced factors are more difficult to obtain and do require sophisticated investment. Fiber-optic cable networks and skilled labor are examples. Generalized factors serve a broad range of production processes, whereas specialized factors serve only a few. Sustained competitive advantage is often based on advanced, specialized factors.

3. Please use an internet search engine to identify a joint venture that is currently in operation. Can you gain some insight into the motivation for this JV?

There is no correct answer here, but this is an opportunity to bring examples into the class. This is also a potential topic for a short student briefing paper.

4. In our discussion of the surgical instrument cluster in Pakistan, we raised the issue of child labor. In your view, is this a cultural issue to which an international manager must be sensitive, or is it a violation of global norms that the manager should confront head on?

Again, this is a good classroom question, and room must be given for differing reactions on the part of students. You can mention the International Labor Organization's conventions (138 and 182) against child labor.

CHAPTER 12

Migration

Chapter Objectives

The purpose of this chapter is to introduce the student to the rudiments of international migration primarily from an economic perspective. The central issue is that of the *migration decision*, and the main tool here is basic supply and demand analysis. The supply and demand analysis is applied to both low-skilled and high-skilled migration. Migration policy is also discussed with a contrast made between bilateral and multilateral approaches. This chapter is the last of the four on international production but also has important links to the development section, particularly but not exclusively in the realm of remittances.

Analytical elements for this chapter:

Countries, firms and factors of production.

Chapter Outline

Types of Migration

The Migration Decision

High-Skilled Migration

Low-Skilled Migration

BOX: Migration Gone Wrong: The Morecambe Bay Cockle Tragedy

Remittances

Migration Policy

BOX: GATS Mode 4: The Temporary Movement of Natural Persons

Conclusion

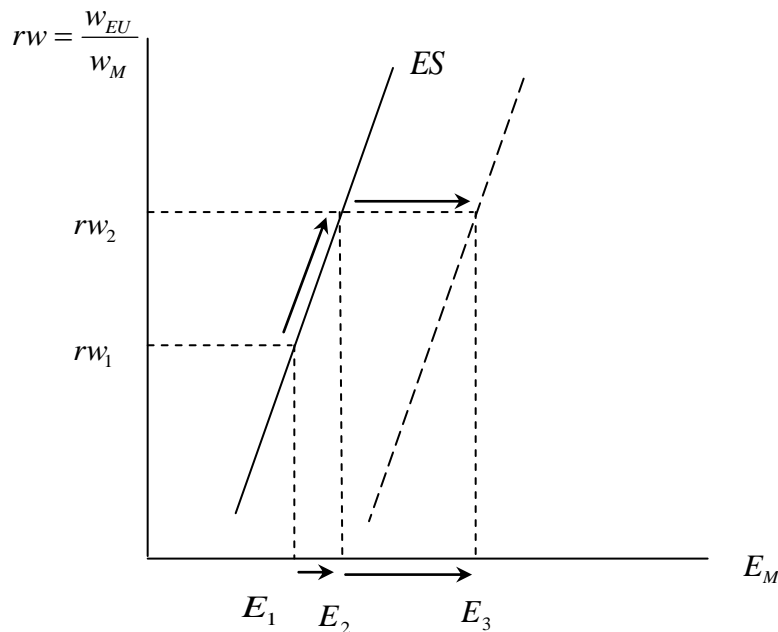
Appendix: Migration and Comparative Advantage

Teaching Notes

The chapter begins with a typology or categorization of types of migration. Obviously, this is not the only possible categorization, and you should feel free to use your own if you have a background in this area. In international relations oriented programs, it might make sense to spend more time on the non-economic types of migration at this point than in economics oriented programs. For the latter, moving quickly to the issue of the migration decision might make more sense.

The section of the chapter on the migration decision is the most important. Students will be familiar with supply and demand analysis from Chapter 2 or other courses but might not have seen it applied to this context. Don't rush through it. The most important point is to delineate the "move along" and "shift" factors in Figure 12.1. As you do this, remind the students of the "move along" vs. "shift" discussion in Chapter 2.

Figure 12.1 The Migration Decision



The next topics of high-skilled and low-skilled migration are usefully contrasted with each other. In principle, they are both valid dimensions of globalization, but they are given differential treatment both from other globalization dimensions and relative to each other. The case of high-skilled migration needs to be tied back to the discussion of R&D

in Chapter 11. The case of low-skilled migration can be more controversial for some students, particularly in its illegal form. Drawing on Pritchett (2006) might be helpful.

This chapter also provides a venue for dealing with the more negative aspects of globalization, namely human trafficking. You can use the box on the Morecambe Bay tragedy as a lead-in to this subject. This could also be an opportunity to discuss issues of human rights as they relate to globalization processes.

The discussion of remittances is important. This is a growing flow in the world economy with potentially large development implications. Stress that, for some countries and regions, remittance inflows can be larger than FDI inflows. If you want to link migration to development issues, you can consult Chapter 6 of the new edition of the book referenced in this chapter on *Globalization for Development*. See: I. Goldin and K. Reinert (2012) *Globalization for Development: Meeting New Challenges*, Oxford University Press.

There is the possibility that some parts of your classroom discussion with regard to migration policy will generate controversy. There are contemporary and strident policy conflicts on these issues. If these controversies arise, it might be helpful to contrast the issue of labor mobility with that of FDI and discuss the reasons why global policy communities have pursued what Pritchett (2006) referred to as “everything but labor globalization.”

If you covered the FDI and comparative advantage appendix to Chapter 9, then you will want to also cover the migration and comparative advantage appendix to this chapter. This is a way to tie the international trade and international production parts of the book (and your course) together.

Comments on Review Exercises

1. Do you know any migrants? To what extent and how does their experience fit into the discussion of this chapter? To what extent and how does it differ?

There is no correct answer here. It is worth noting, however, that in a historical sense, we are all migrants. This point is made in Goldin, Cameron and Balarajan (2011).

2. Can you identify reasons why the liberalization of the trade, FDI and finance components of economic globalization has proceeded much faster than for labor migration?

This reflects the rise of the nation state and the accompanying increase in border controls. It also reflects the identity characteristics of nation states. It is important for students to understand that, historically speaking, these restrictions on migration have been quite recent. In the globalization expansion of 1870 to 1914, migration was a significant component. This was the famed “Great Migration.”

3. We discussed the political economy of trade policy in Chapter 5. Can you identify any insights from that chapter that could be used in thinking about the political economy of migration policy?

Inflows of migration increase the labor supply and can put downward pressures on wages in specific labor categories. The opposite is true for outflows. Also, where trade leads to real income gains for labor (via Stolper-Samuelson effects in labor abundant countries), these income gains might help provide the resources for emigration, shifting the curve in Figure 12.1 to the right.

4. Can you identify any benefits for relaxing sovereignty in favor of multilateral policy coordination of migration?

The multilateral setting of migration policy would have the same standardization effects as those in trade (via the World Trade Organization), finance (via the International Monetary Fund), and development finance (via the World Bank). It can thereby improve upon piecemeal, disjointed policies set at the national level and reduce the injustices and abuses suffered by some migrants (e.g., via human trafficking).

Part III

International Finance

CHAPTER 13

Accounting Frameworks

Chapter Objectives

This chapter introduces students to open economy, macroeconomic accounts and to balance of payments accounts, both crucial to understanding the modern, world economy. An application of these accounts to global imbalances gives some sense of their usefulness. For development studies programs, an appendix covers social accounting matrices, an increasingly-common means of representing accounting information, and one that can be extended in a number of directions. For economics programs, a second appendix develops a simple, open-economy macroeconomic model illustrating the relationship between spending and the current account.

Analytical elements for this chapter:

Countries, currencies and financial assets.

Chapter Outline

- Open-Economy Accounts
- Balance of Payments Accounts
- Analyzing the Balance of Payments Accounts
- Global Imbalances
- Conclusion
- Appendix: Accounting Matrices
- Appendix: An Open-Economy Model

Teaching Notes

This chapter might not be on the top-10 list for your students. It is about accounting, and many students need some motivation to make them enthusiastic. Nevertheless, I have seen students have “aha!” moments in going through this material. They have heard of these concepts but might not have been taken through them in a user-friendly manner. One motivator is to have the students think of themselves as analysts in either the private

of public sector, with the job of making an assessment of the state of a particular national economy. Let them know that is nearly impossible to accomplish their task without an understanding of the material of this chapter. In the case of the circular flow diagram, it is worth mentioning that the open economy diagram lies beneath the macroeconomic accounts of any economy, as reported by the central government to the IMF, for example. These macroeconomic accounts have the same accounts listed in Figure 13.2: production, consumption, investment, government, and rest of the world. It is possible to show them this using the accounts of a country of your choice.

The key message of the open economy accounts section of the chapter is summarized in the fundamental accounting equations box below:

Fundamental Accounting Equations

$$\text{Domestic Investment} - \text{Domestic Savings} = \text{Foreign Savings} = \text{Trade Deficit}$$

$$\text{Domestic Savings} - \text{Domestic Investment} = \text{Foreign Investment} = \text{Trade Surplus}$$

If the student understands this box, he or she will have come a long way towards understanding open economies. If you can give them a feeling of having understood a “special key” to unlocking certain open-economy “mysteries,” then so much the better.

With regard to the balance of payments, the key insight is contained in the following material from the text:

- If the current and capital/financial accounts are both positive (negative), then official reserve transactions must be negative (positive).
- If the current and official reserve transaction accounts are both positive (negative), then the capital/financial account must be negative (positive).
- If the capital/financial and official reserve transaction accounts are both positive (negative), then the current account must be negative (positive).

Here again, the student can take a big stride towards increased understanding.

The material on global imbalances will be periodically updated at the book’s website. See: ie.gmu.edu to see if something has been posted.

Some instructors have used the material of the two appendices to delve into simple, open economy modeling. Try to judge if your students are prepared for this material. Perhaps international relations students won’t be, but economics students will be.

Comments on Review Exercises

1. In Figure 1.4 of Chapter 1, we emphasized connections among the four windows on the world economy: international trade, international production, international finance, and international development. Looking back on this chapter, please identify where in the open-economy accounts and balance of payments accounts connections appear among the first three of these windows: trade, production (FDI), and finance.

The key connection here is between trade, as it shows up in the current account, and the capital account which finances any trade deficit through direct investment (international production) and indirect investment (international finance).

2. Looking at the open-economy circular flow diagram of Figure 13.2, please explain how an increase in government expenditures, G , without any increase in tax revenues, T , would tend to impact the trade balance. You will need to use one of the fundamental equations to answer this question.

Increases in G without an increase in T would tend to lower S_G . This decline in domestic savings, for any given level of domestic investment, would need to be made up for by additional foreign savings. As foreign savings, S_F , increases, there would be an expansion of the trade deficit.

3. Repeat the exercise of Question 2 for an increase in household consumption, C , without any increase in income, Y .

In increase in C without any increase in Y would lower S_H . This decline in domestic savings, for any given level of domestic investment, would need to be made up for by additional foreign savings. As foreign savings, S_F , increases, there would be an expansion of the trade deficit.

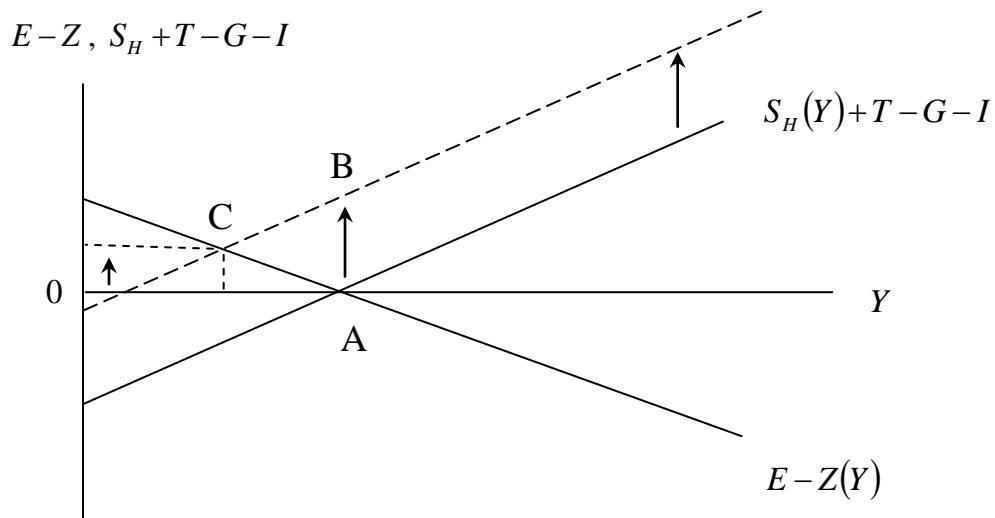
4. Consider the global imbalances issue discussed in this chapter. Given your understanding of the issue, try to suggest policies that might address it. You are just at the beginning of your exploration of international finance, but try to be as detailed as you can in your policy suggestions.

There is no one correct answer here, but the answers will break down between the United States and China. In the case of the United States, increases in domestic savings (both household and government) will have to be part of the picture. In the case of China, decreases in domestic savings (both household and government) will be necessary.

5. Using the open economy macroeconomic model of the appendix, graphically analyze an increase either tax revenues or the entire $S_H(Y)$ relationship. To do this use a diagram like that of Figures 13.5 and 13.6.

We begin at the same initial equilibrium below at point A. Suppose that, from this initial position, there is an increase in tax revenue. This shifts the $S_H(Y)+T-G-I$ curve upward by the amount of the increase in government spending or investment from point A to point B. At point B, however, the net of domestic savings over domestic investment is above the trade surplus (still at zero). The only way for the fundamental accounting equation to be restored is via a decrease in Y . As Y decreases, both S_H and Z decrease. The former decreases the net of domestic savings over domestic investment (a movement from B to C), while the latter reduces the trade surplus (a movement from A to C). The fundamental accounting equation and macroeconomic equilibrium are restored at point C, characterized by a trade surplus.

An Increase in Tax Revenue



CHAPTER 14

Exchange Rates and Purchasing Power Parity

Chapter Objectives

It is difficult for any student or professional to have a good understanding of the world economy without an appreciation of exchange rates. Many, but not all, of your students will have an intuitive understanding of nominal exchange rates from their international travel. Not so for real exchange rates, however, no less for purchasing power parity. This chapter will try to take them through this material in a step-by-step manner. We begin with the nominal exchange rate and its relationship to the value of the domestic currency through an inverse scale. We then move on to the real exchange rate as a modification of the nominal exchange rate using price levels. For students not familiar with price levels, there is an appendix that explains them intuitively. The purchasing power parity model of long-run exchange rate determination is presented, and is illustrated with *The Economist* Big Mac Index. Next, nominal exchange rates are related to trade flows, and this culminates in a graph relating the value of a home country currency to its trade deficit. This graph will be used in Chapters 15 and 16 in a simple model of exchange rate determination. Finally, the student is briefly introduced to hedging and foreign exchange derivatives. For more advanced students, there is also an appendix on the monetary approach to exchange rate determination.

Analytical elements for this chapter:

Countries, currencies and financial assets.

Chapter Outline

The Nominal Exchange Rate
The Real Exchange Rate
Purchasing Power Parity
 BOX: The Big Mac Index
Exchange Rates and Trade Flows
Hedging and Foreign Exchange Derivatives

Conclusion

Appendix: Price Levels and the PPP

Appendix: The Monetary Approach to Exchange Rate Determination

Teaching Notes

With regard to nominal vs. real exchange rates, the key differentiation you want students to be able to make is contained in the following box:

Nominal exchange rate: The rate at which two countries' *currencies* trade against each other.

Real exchange rate: The rate at which two countries' *goods* trade against each other.

This is a key insight, and if you have succeeded in conveying it, you have made some progress in your students' education in the world economy.

With regard to the PPP model, it is good to emphasize that this is a point of reference for analysts and market participants, albeit one that only applies in the long run. Again, the key insight is presented in a box:

PPP hypothesis: The nominal exchange rate will adjust so that the purchasing power of a currency will be the same in every country.

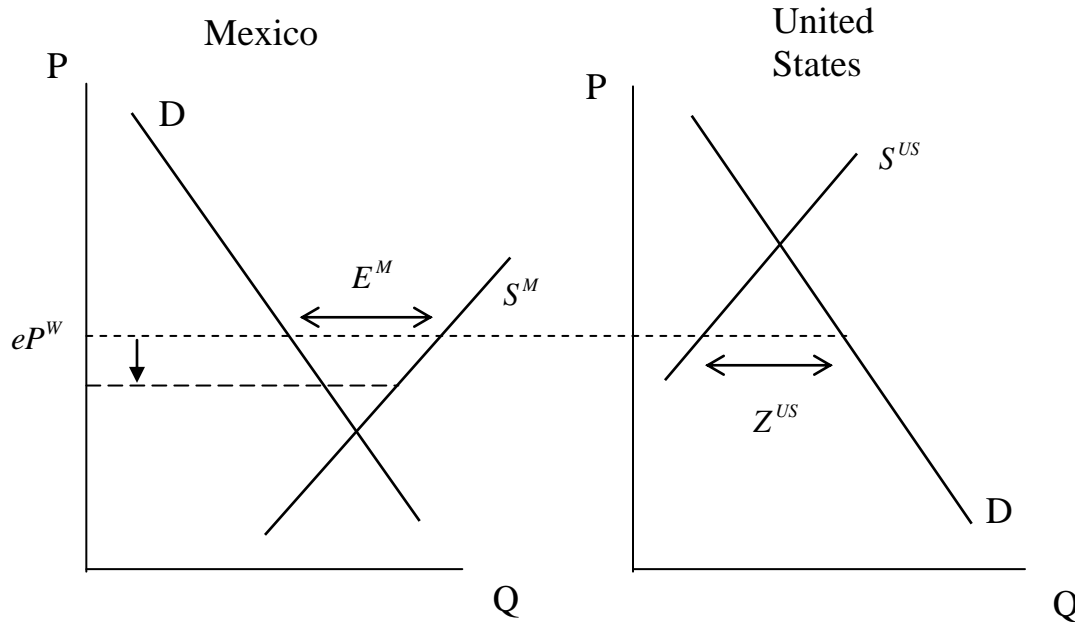
The Big Max index will be updated periodically on the website (ie.gmu.edu). Please check for this if you are interested.

For business programs, a case study on exchange rate exposure would be a helpful addition to the chapter's brief analysis of hedging and foreign exchange derivatives.

The next important relationship is given in Figure 14.4. This will become the supply curve of pesos in Chapters 15 and 16, so it is important that your students understand it. You can help them by considering movements up and down the curve, changes in the quantity supplied of pesos.

Comments on Review Exercises

1. Use supply and demand diagrams such as those we used in Chapter 2 to demonstrate why the relationships between the value of the peso and imports and exports illustrated in Figure 14.3 make sense. In doing so, keep in mind that $P^M = eP^W$.



As the value of the peso increases, e falls. To take Mexico's export side as an example, we see above that Mexico's exports would decline as e falls, contributing to the expanding trade deficit.

2. Explain the *intuition* of how each of the following changes affect the real exchange rate, re : a fall in P^M ; a fall in P^{US} ; and a fall in e . In each case, describe the impact of the change on the rate at which Mexican goods trade against US goods.

A fall in the price of Mexican goods implies that it takes fewer US goods to purchase Mexican goods. This means that the real value of the peso has fallen. A fall in the price of US goods implies that it takes more US goods to purchase Mexican goods. This means that the real value of the peso has risen. A fall in e implies that it takes fewer pesos to buy US dollars. This means that the real value of the peso has risen.

3. Use the PPP model of exchange rate determination to predict the impact on the nominal exchange rate of the following changes: a fall in P^M and a fall in P^{US} .

A fall in the price of Mexican goods will, in the long run, cause a fall in e or an increase in the value of the peso as the nominal exchange rate falls to equate the purchasing power of the peso in each country. Similarly, a fall in the price of US goods will, in the long run, cause a rise in the value of the peso.

4. As shown in Table 14.1, the spot nominal exchange rate for the Canadian dollar was 1.00 in April 2010. What happened to the value of the Canadian dollar during the previous year? What would have to be true of the forward rate for the Canadian dollar to be at a forward premium? A forward discount?

Between 2009 and 2010, the Canadian dollar increased in value from 1.21 per US dollar to 1.00 per US dollar. For the Canadian dollar to be at a forward premium, the 2010 forward rate would have had to be below 1.00. To be at a forward discount, the value would have had to be above 1.00.

CHAPTER 15

Flexible Exchange Rates

Chapter Objectives

Many international economics texts use supply and demand diagrams to depict exchange rate determination, and this is indeed taken up in this and the following chapter. However, these two chapters link the supply and demand analysis back to both the open-economy account of Chapter 12 and the assets-based approach to exchange rate determination as embodied in the interest rate parity condition. The goal is to communicate a realistic model of exchange rate determination within the comfort zone of supply and demand. A trade-based model precedes the asset-based model. Indeed, for students who are unable to absorb the assets-based considerations, a great distance can be covered with the trade-based model alone. For example, it is possible in a development studies class to show how capital inflows lead to an appreciation of the home country currency.

For more advanced students, there is an appendix linking exchange rate determination to monetary policies. This appendix can be used to extend this chapter into the monetary realm in a manner suitable for economics programs.

Analytical elements for this chapter:

Countries, currencies and financial assets.

Chapter Outline

A Trade-Based Model

BOX: Theory and Practice

An Assets-Based Model

Interest Rates, Expectations, and Exchange Rates

BOX: Covered vs. Uncovered Interest Rate Parity

Conclusion

Appendix: Monetary Policies and the Nominal Exchange Rate

Teaching Notes

At one level, the chapter is an exploration of the following relationship from Chapter 13:

$$S_F = (Z - E)$$

Foreign savings or capital/financial account surplus is examined here as a demand for pesos, while the trade or current account deficit is examined as a supply of pesos as in Chapter 14. The interaction of these two components of the balance of payments results in an equilibrium value of the peso or $1/e$. The trade-based model is one where the demand for pesos is perfectly inelastic, and this serves as an introduction to market-based determination of exchange rates. These considerations are summarized in the following box:

S_F (foreign savings) \Leftrightarrow demand for pesos (supply of dollars)

$Z - E$ (trade deficit) \Leftrightarrow supply of pesos (demand for dollars)

This framework is used to help the student distinguish between appreciation and depreciation in flexible exchange rate regimes.

The assets-based model intuitively leads the student to the interest rate parity condition:

Interest Rate Parity Condition

| | |
|--------------------------------------|----------------------|
| $r_M = r_{US} + \frac{(e^e - e)}{e}$ | Mexico/United States |
| $r_H = r_F + \frac{(e^e - e)}{e}$ | Home/Foreign |

As you introduce this concept, let the students know that they are learning one of the most central elements of international finance. This will encourage them.

To help your students understand how the interest rate parity condition translates into a downward-sloping demand for pesos in the assets based model, you must emphasize that *this demand curve is for a given e^e* . Changes in e or $1/e$ result in a movement along the demand curve, while changes in r_m , r_{US} , and e^e result in a shift of the demand curve.

Thus, the chapter can be explained in terms of movements along curves (adjustment to equilibrium value of the peso) and shifts of the demand curve (requiring a new adjustment from an old equilibrium value of the peso).

It will be worth your while to take this material *slowly* in class, presenting each step in the process carefully. You can pick up your pace of bit in Chapter 16 after the students have absorbed the framework developed here.

It is important to note that the analysis of capital inflows is important from both a development perspective (many developing countries have struggled to manage these inflows) and from a developing country perspective (the capital inflows into the United States helped to precipitate the recent sub-prime crisis).

More advanced students will benefit from the appendix on monetary policies. This places the exchange rate determination issue within a larger monetary context.

Comments on Review Exercises

1. As we will discuss in some detail in Chapter 19, in 1999, the European Union introduced a common currency known as the euro. Take the EU as your home country and the United States as your foreign country. In this case, $e = \text{euros}/\text{dollar}$. Set up the equivalent of Figure 15.5 to show the determination of e . Next, use three additional diagrams to show the impacts on e of the following changes: a fall in the euro interest rate; a fall in the dollar interest rate; and a fall in the expected value of the exchange rate (e^e). In each case, *explain the intuition of your result*.

A fall in the euro interest rate will shift the S_F curve to the left as investors reallocate their portfolios into dollar-denominated assets. This will reduce the value of the euro or increase e . A fall in the dollar interest rate will shift the S_F curve to the right as investors reallocate their portfolios into euro-denominated assets. This will increase the value of the euro or decrease e . A fall in the expected future value of the euro, will shift the S_F curve to the right. This is because it lessens the expected future depreciation of the euro, so investors reallocate their portfolios into euro-denominated assets. This will increase the value of the euro or decrease e .

2. In Chapter 14, we discussed the links between trade flows and the nominal exchange rate. All other things constant, what would an *increase* in a home country's interest rate tend to do to its exports, imports, and trade deficit? Explain the intuition of your answer.

An increase in a home country's interest rate would increase the value of the home country's currency. This tends to increase imports, decrease exports, and expand the trade deficit. This is due to the fact that the increase in the value of the home

country's currency lowers the domestic price of tradable goods. Imports are less expensive for domestic households, and there is less incentive to export.

3. In Chapter 14, we discussed the links between trade flows and the nominal exchange rate. All other things constant, what would a *decrease* in a home country's interest rate tend to do to its exports, imports, and trade deficit? Explain the intuition of your answer.

A decrease in a home country's interest rate would decrease the value of the home country's currency. This tends to decrease imports, increase exports, and reduce the trade deficit. This is due to the fact that the decrease in the value of the home country's currency increases the domestic price of tradable goods. Imports are more expensive for domestic households, and there is a greater incentive to export.

4. For Appendix readers only. For the euro example of Question 1 above, set up the equivalent of Figure 15.9. Next, show the impacts in this figure of a contractionary monetary policy in the EU and a contractionary monetary policy in the United States. In each case, *explain the intuition of your results.*

A contractionary monetary policy in the EU will increase the interest rate in the EU. This will shift the S_F curve to the right as investors reallocate their portfolios into euro-denominated assets. This will increase the value of the euro or decrease e . A contractionary monetary policy in the US will increase the interest rate in the US. This will shift the S_F curve to the left as investors reallocate their portfolios into dollar-denominated assets. This will reduce the value of the euro or increase e .

CHAPTER 16

Fixed Exchange Rates

Chapter Objectives

Given the large number of crises involving fixed exchange rates and the current concerns over China's undervalued currency, students need a good understanding of this approach to exchange rate management. This is the purpose of this chapter. It will also provide the student with the conceptual tools required to understand the history of monetary arrangements (Chapter 17), balance of payments and exchange rate crises (Chapter 18), monetary unions (Chapter 19), and aspects of structural adjustment (Chapter 24). If there is a bias to the text's treatment of fixed exchange rates (and there admittedly is), it is that they are not sustainable in the long run. If you disagree with this view, you might want to make that clear to you students so they can read with a critical eye.

The chapter explains alternative exchange rate regimes, before taking up fixed exchange rate regimes in particular. It explores the various ways that fixed exchange rate regimes can be maintained, and also explains the "impossible trinity" or "policy trilemma" that often comes up in the exchange rate policy literature. For students with a basic background in monetary theory or macroeconomics, the appendix continues the appendix to Chapter 15 and explores monetary policies under fixed exchange rates.

Analytical elements for this chapter:

Countries, currencies and financial assets.

Chapter Outline

Alternative Exchange Rate Regimes

A Model of Fixed Exchange Rates

BOX: Is China's Currency Undervalued?

Interest Rates and Exchange Rates

BOX: Defending the Brazilian *Real*, 1998-1999

The Role of Credibility

The Impossible Trinity
Currency Boards
Appendix: Monetary Policies

Teaching Notes

After you introduce your students to alternative exchange rate arrangements, you need to ensure they know the correct terminology for exchange rate changes in flexible and fixed exchange rate regimes. This is contained in Table 16.1. With that in hand, they are ready to begin learning about fixed exchange rates. The chapter uses the balance of payments table from Chapter 13 to lead the students up to the following box:

Overvaluation \Rightarrow Excess supply of pesos (demand for dollars) \Rightarrow Central bank draws down foreign reserves

Undervaluation \Rightarrow Excess demand for pesos (supply of dollars) \Rightarrow Central bank builds up foreign reserves

However, these official reserve transactions are, in practice, not the only means used to maintain fixed exchange rates. Interest rates are part of the central bank arsenal. Consequently, the chapter brings the students back to the interest rate parity condition and its assets considerations. Some analysis leads the student to a second box:

If a home country wants to maintain an *equilibrium* fixed exchange rate, it must set its interest rate equal to that prevailing in the foreign country whose currency serves as a peg for the home country currency.

This setting of an *equilibrium* fixed rate can be seen as an attempt to shift the S_F curve to the desired position along the $Z-E$ curve. As the box on the case of the Brazilian *real* shows, this is not always easy to do.

The impossible, often invoked in the policy literature, is not always easy for students to understand and retain. For this reason, a visual is important, such as the triangle contained in Figure 16.3. If you walk the students through the triangle, they will always be able to return to it to check their understanding of it. A learning device that students might relate to: There are three cookies in the cookie jar; only two can be taken out and eaten; one must remain.

The chapter takes a relatively harsh position on currency boards as a viable exchange rate arrangement. You might disagree with this stance. If so, contrasting your views with those expressed in the text would be useful for your students. This is another area that might promote classroom discussion. This could be part of a larger discussion on “dollarization,” particularly in Latin America.

The appendix reinforces the result of the chapter that maintaining a fixed exchange rate regime requires giving up an independent monetary policy. If you include this appendix in your course, be sure to relate it back to the lower right-hand corner of the impossible trinity triangle.

Comments on Review Exercises

1. Until January 2002, the Argentine peso was pegged on a one-to-one basis against the US dollar in an arrangement known as a *currency board*. Suppose that, to begin with, this exchange rate is an equilibrium rate. Next, using a diagram such as Figure 16.2 to show how Argentina can respond to a decrease in the interest rate on the US dollar.

The decrease in the interest rate on the US dollar will shift Argentina's S_F curve to the right, causing an increase in the value of the peso. Argentina must decrease its own interest rate to shift the S_F curve back to its original position.

2. Suppose that a country has a fixed exchange rate and that, over the past few years, it has been quickly accumulating foreign reserves. What does this tell you about the value of the pegged currency? Why?

A fixed exchange rate that results in the country accumulating foreign reserves is undervalued. An undervalued currency results in excess demand for the domestic currency. The country's central bank meets this excess demand by buying foreign currencies, thereby increasing the supply of the domestic currency on foreign exchange markets.

3. Given what you have read in this book up to this point, can you say anything about the desirability of the three policy regime corners in the impossible trinity diagram of Figure 16.3? Please explain your reasoning.

Since opinions differ on this matter even among prominent international economists, there is no one correct answer to this question. Students' answers should be evaluated according to the degree that they are well thought out.

4. For Appendix readers only. For the above example, set up the equivalent of Figure 16.4. Next, show the actions required on the part of the Mexican monetary authority in response to: a decrease in income in Mexico; a decrease in income in the United States; and a contractionary monetary policy in the United States. In each case, explain the intuition of your results.

In the case of a decrease in income in Mexico, Mexico would have to increase the money supply to offset the incipient decline in the Mexican interest rate. In the case of a decrease in income in the United States, Mexico would also have to increase the money supply in order to match the decline in the US interest rate. Finally, in the case a contractionary monetary policy in the United States, the Mexican would need to do the same to match the increase in the US interest rate.

CHAPTER 17

The International Monetary Fund

Chapter Objectives

As in the case of the WTO, the IMF has become a central object of criticism of those with concerns about globalization, drawing the ire of Joseph Stiglitz in his 2002 book, *Globalization and Its Discontents*, for example. This chapter puts the IMF into an historical context, introduces the student to its operations, and makes an assessment of it as a global, monetary institution. It also introduces the student to recent research on the political economy of IMF lending. Its role in recent crises is taken up in the next chapter.

The marginal gains of transmitting the material of this chapter to the students are large. Students might have passionate interests in or opinions about the IMF, but few will know much about it. Most of what you communicate to your students will be a gain to their knowledge base in this area. As always, proceeding step-by-step will maximize these gains for the students.

Analytical elements for this chapter:

Countries, currencies and financial assets.

Chapter Outline

- Some Monetary History
 - BOX: Views of the Bretton Woods Conference
- The Operation of the IMF
 - BOX: IMF Conditionality
- History of IMF Operations
 - BOX: Limited Liquidity in the Early Years
 - BOX: The IMF in Ethiopia
- The Political Economy of IMF Lending
- An Assessment

Conclusion

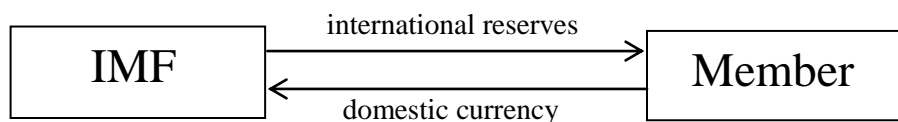
Teaching Notes

Think about the degree to which you want to present historical material on monetary history in your class. Then think about the way in which you want to present it. Timelines are a straightforward way of organizing the material for your students. While for some the gold standards are perhaps of mere historical relevance, the Bretton Woods system is a key part of an adequate understanding of the IMF (and the World Bank discussed in Chapter 23). The transition from the Bretton Woods system to what has become known as the “non-system” is worth emphasizing. Note that the Bretton Woods system was also the model of the European Monetary System (see Chapter 19).

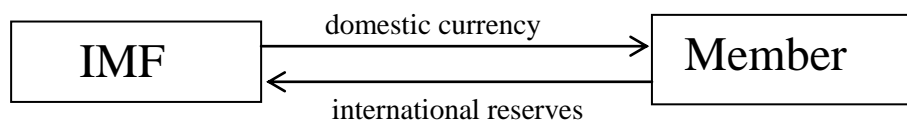
With regard to IMF operations, the key insight is its purchase/repurchase structure as contained in the following figure:

Figure 17.3. IMF Lending

Step 1: Purchase



Step 2: Repurchase



Having described this process and the various IMF tranches, you again need to think about the degree to which you want to present historical material on IMF operations in your class. Then think about the way in which you want to present it. Again, timelines are a straightforward way of organizing the material for your students. However, here case studies (such as the Ethiopian case contained in the text) offer a useful alternative. Having prepared your own case here will impress your students and allow you to focus on a country in which you have a special interest.

The subject of the political economy of IMF lending is an important overlap between the fields of international economics, political economy and international

relations. For some programs, it will be worth expanding upon what is presented in this chapter. The recent book by Copelovitch (2010) referenced in this chapter is a very good place to start in this regard. Much of the literature in this area can be effectively assessed with reference to Figure 17.5.

Comments on Review Exercises

1. How did the gold exchange standard differ from the gold standard? How did the adjustable gold peg (Bretton Woods) system differ from the gold exchange standard?

In the gold exchange standard, countries that were not important financial centers did not hold gold reserves as in the gold standard. Instead, they held gold-convertible currencies. In the adjustable gold peg, the US dollar was to be pegged to gold at \$35 per ounce. The other countries of the world were to peg to the US dollar or directly to gold.

2. Why are post-Bretton Woods monetary arrangements referred to as a “non-system”?

The term “non-system” refers to the range of allowable exchange rate arrangements, namely: 1. currencies fixed to anything other than gold, 2. cooperative arrangements for managed values among countries, and 3. floating.

3. In the IMF credit arrangements, what distinguishes the upper credit tranches from the first credit tranche?

The first credit tranche is more or less automatic. The second through fourth credit tranches, collectively known as upper credit tranches, require that the member adopt policies that will solve the balance of payments problem at hand. These requirements are known as conditionality.

4. What is your reaction to the different visions of the Keynes Plan and the White Plan? If you had been a participant at the Bretton Woods Conference, which would you have supported?

There is no one correct answer here. However, the Keynes Plan continues to be a point of reference in its call for a world reserve currency and the spreading of adjustment requirements between borrowing and lending countries.

5. Would you be in favor of expanding the role of the SDR to make it an international currency along the lines of Keynes’ *bancor*?

Again, there is no one correct answer here.

6. Choose an IMF member in which you have a special interest. Spend a little time perusing the “Country Information” section of the IMF web-site at www.imf.org. This can be found by clicking one of the major tabs along the top of the home page.

You can demonstrate these links in class and have the students do this on their own, perhaps translating the results into a short paper.

CHAPTER 18

Crises and Responses

Chapter Objectives

The purpose of this chapter is to apply the material developed in Chapters 13 to 17 to a subject that the students have both heard about and in which they have a particular interest—crises. Importantly, the chapter distinguishes among different types of crises. It also distinguishes between what Barry Eichengreen terms “old-fashioned” crises (e.g., balance of payments and currency crises) and “high-tech” crises (e.g., the Asian and sub-prime crises). Appropriate policy response to the threat of and to ongoing crises is an issue about which international economists are in disagreement. I have attempted to be as judicious as possible without downplaying the degree of disagreement. You no doubt have your own opinions on these matters, and the hope is that the chapter will provide you a platform to both inform your students and to express these opinions. The role of the IMF in recent crises and a number of “solutions” to crises that are under discussion are presented in some detail.

Analytical elements for this chapter:

Countries, currencies, financial assets.

Chapter Outline

Types of Crises

 BOX: Views of the Banking Sector

Contagion and Systemic Risk

Analyzing Balance of Payments and Currency Crises

The Asian Crisis

 BOX: The Baht Crisis

The IMF Response

 BOX: The Indonesian Crisis

The Sub-Prime Crisis of 2007-2009

Basel Standards
 Capital Controls
 Conclusion
 Appendix: Exchange Rate Target Zones

Teaching Notes

The most important thing you can accomplish for your students with this chapters if to distinguish among the types of crises listed in Table 18.1. This will take them beyond the financial press treatment of crises as a single entity into a more analytical realm. You should feel free to add your own examples to those listed in the table.

Table 18.1 Types of Crises

| Crisis Type | Characteristics | Examples |
|--|--|---|
| Hyperinflation | A rapid increase in the overall price level of a country, typically defined to be 40 percent or higher on an annual basis. | Zimbabwe, 1998- 2009 |
| Balance of payments and currency crises | A large devaluation or rapid depreciation in the value of a domestic currency in response to balance of payments difficulties. | Mexico, 1994-1995 and Brazil, 1999 |
| Asset price deflation | A sustained and large decline in the prices of financial assets. | Japan, 1990 and United States 2007-2009 |
| Banking crises | The occurrence of bank runs and/or the merger, closure or government takeover of banking institutions. | Argentina, 2001 |
| External debt crises | Sovereign default on debt obligations to foreign creditors or substantial restructuring of this debt. | Mexico, 1982 |
| Domestic debt crises | Sovereign default on debt obligations to domestic creditors or substantial restructuring of this debt. | Argentina, 1989 |

Sources: Eichengreen (1999) and Reinhart and Rogoff (2009)

With regard to balance of payments and currency crises, the starting point of the chapter is a look back at the fixed exchange rate model. This is a good opportunity for a quick review to help your students internalize the material of Chapter 16, including the fixed exchange rate implications for the interest rate parity condition. The next key issue is the contrast between Figures 18.4 (old-fashioned) and 18.5 (high-tech) crises. These

figures put in words what is discussed in many places by experts in international finance using very technical language.

No doubt that there is a crisis in which you have a particular interest. If you present a case study of this crisis to your students, it will both impress them and nicely complement the more general material of this chapter.

The discussion on Basel standards is an opportunity to visit the issue of the appropriate role of government in a market economy, including the issue of market failure. It is also a chance to take up the political economy of policy formulation in this area. This is also the case for the subject of capital controls. Please note that the IMF's position on these measures has recently changed.² Here the important distinction is between market friendly and less market friendly types of capital controls.

For programs with a strong emphasis on international economic policy, the appendix on John Williamson's exchange rate target zones might be of interest.

The material of this chapter dates quickly. Since its publication, there might even have been an additional crisis that is worth discussing with your students. Check the book's web site (ije.gmu.edu) for updates that might be available for your students to read.

Comments on Review Exercises

1. What is the key difference between “old-fashioned” and “high tech” crises?

High-tech crises involve, in some fashion, a loss of confidence in the financial sector of the economy. The source of this loss of confidence can and does differ from one country to another.

2. In Chapter 16 we addressed fixed exchange rates. Policies to maintain fixed exchange rates fell into two categories. First, there were policies to address the excess demand or supply of the home country (official reserve transactions). Second, there were policies to change the equilibrium exchange rate (interest rate changes). Please answer the following questions with regard to the use of these policies in balance-of-payments crises.

- a. In a balance-of-payments crisis, what kind of official reserve transactions will be made?

The central bank will have to address the excess supply of the domestic currency but purchasing it with foreign currency, drawing down its foreign reserves.

² One important source not included in the chapters references is: J.M. Chwieroth (2010) *Capital Ides: The IMP and the Rise of Financial Liberalization*, Princeton University Press.

- b. What are the limits of the official reserve transactions approach to resolving balance-of-payments crises?

The limits are set by the amount of foreign reserves of the central bank.

- c. In a balance-of-payments crisis, what kind of interest rate policies will be used?

In order to attempt to shift the S_F curve to the right, the central bank will increase the domestic interest rate.

- d. What are the limits of the interest rate approach to resolving balance-of-payments crises?

Higher domestic interest rates suppress domestic investment and therefore tend to be recessionary.

3. The argument in favor of current account convertibility (free trade) is that it leads to gains from trade. Are there any reasons you can think of why we might not be able to extend this argument to the financial transactions of the capital account? Or to put it differently, are there any ways that financial markets differ from merchandise and service markets?

There is no one correct answer here. However, the recognition that financial markets tend to be volatile will be a key part of any answer.

4. Take the crisis varieties in Table 18.1 and try to list the ways in which one can contribute to another.

There is no one correct answer here. But the answer should reflect the discussion in the text. Periods of hyperinflation can contribute to currency crashes. As significant degrees of inflation occur, asset owners move out of domestic-currency-denominated assets into foreign-currency-denominated assets in order to maintain the value of portfolios. This is a decrease in demand for the domestic currency relative to the foreign currency and puts downward pressure on the value of the domestic currency. Banking crises are often set off by asset price deflation or the bursting of financial bubbles such as land prices, capital inflow surges and financial sector liberalization, all of which can work in tandem with one another. National governments have historically turned to inflation to reduce the real (price-adjusted) value of domestic debt obligations. As with banking crises and external debt crises, preceding inflows of capital are often a contributing factor. Sudden stops interact with banking sectors to cause banking crises. It therefore appears that sudden stops, banking crises and contagion can all be related to one another.

CHAPTER 19

Monetary Unions

Chapter Objectives

Every student wants to learn about “the euro,” and many texts oblige with a chapter on “the euro.” Here we take a slightly broader view of “monetary unions” and include the CFA franc zone and the rand zone as well. A discussion of optimal currency areas places these topics into some theoretical perspective. This chapter, in combination with the section of Chapter 8 on the European Union from the perspective of preferential trade agreements, completes the book’s treatment of the EU. While there are sections on adjustment in the EMU and the current crisis, these will date quickly. As mentioned below, see jie.gmu.edu for updates.

Analytical elements for this chapter:

Countries, currencies, financial assets.

Chapter Outline

The European Monetary Union at a Glance
Planning the European Monetary Union
 BOX: Pierre Werner
Implementing the European Monetary Union
 BOX: Battles over the ECB Head
Optimal Currency Areas and Adjustment in the EMU
The Recent Crisis in the EMU
Monetary Unions in Africa
Conclusion

Teaching Notes

In beginning your discussion of monetary unions in class, it would be useful to refer back to preferential trade agreements (PTAs) as covered in Chapter 8. This will remind students that the topics are linked in the process of regional integration. Refer back to Table 8.2 in doing this.

The initial material on the evolution of the EMU is historical. Space constraints prohibit a full-blown historical treatment, but your students will appreciate any additional historical depth you provide to them with regard to European monetary integration. You can especially draw from Dinan (2010) and Eichengreen (2008), referenced in the chapter. Be sure to draw students' attention to the levels of debt of Italy and Greece upon entry into the EMU (Table 19.1). These have implications for the current crisis. On adjustment within the EMU, it is worth spending time with Equation 19.1:

$$\text{Foreign currency wage for member } i = \frac{1}{e} x \frac{w_i}{P} \quad (19.1)$$

Given the broad scope of the book and its use in development programs, attention is given to the CFA franc zone and the rand zone. In my experience, students do indeed have an interest in these arrangements. The CFA franc zone is also useful in that it contrasts with the EMU in handling the external rate via a fixed exchange rate with (conveniently for classroom discussion) the euro itself.

The material of this chapter will date very fast. It only covers the current EMU crisis through early summer 2011. Please look for updates on the website (ie.gmu.edu). Make sure you link any discussion of the EMU crisis to the discussion of "high-tech" crises in Chapter 18.

Comments on Review Exercises

Review Exercises

1. Imagine that, suddenly, the US dollar was abolished and each state of the United States introduced its own currency (the Arizona, the Montana, the Wyoming, etc.). Would this alter economic life in the United States? How so? What problems would it entail?

There is no one correct answer here, but the student should focus on transactions costs in trade and investment, even if he or she does not use the term "transactions costs."

2. Three European Union countries (the United Kingdom, Sweden, and Denmark) chose not to be part of the EMU. Can you think of any reasons why they would do so?

Again, there is no one correct answer here. However, issues of sovereignty are key, as well as a “wait and see” with regard to the euro and the operation of the ECB. For students in international relations programs, the role of “eurosceptics” will also be relevant.

3. Have you or your classmates had any experiences with the euro or the CFA franc? What are they?

This is a good question for class discussion, as well as for travel tales among students.

4. Do you have any ideas for how the adjustment problems and current crisis in the EMU could be better addressed?

Again, no one correct answer. The key emerging question is whether there should be a “haircut” on Greek bonds and an orderly default. Note that this has been the position of The Economist since early 2011.

5. One region in which there are many discussion of monetary union is Latin America. Would the countries of Latin American qualify as an optimum currency area?

The answer here is “clearly not.” However, the discussion is important and one that can be usefully done in class to illustrate the notion of optimum currency areas. This discussion is not just theoretical, since until recently, Latin American monetary union was a serious topic of discussion.

Part IV

International Development

CHAPTER 20

Development Concepts

Chapter Objectives

This chapter makes the transition to the fourth window on the world economy: international economic development. The main purpose of this chapter is to contrast the income per capita approach to development with the human development approach. This contrast is fundamental in that the latter draws from the Sen/Nussbaum capabilities approach to outcome evaluation. Depending on your preferences, the difference can be treated as just a matter of measurement or a matter of philosophical difference. A box also covers the MDGs or millennium development goals, important within the United Nations system. Appendices take up the GDP/GNI relationship and the Lorenz curve and Gini coefficient.

Analytical elements for this chapter:

Countries, sectors, factors.

Chapter Outline

What Is Development?

Growth

BOX: Surviving in Mexico City

Human Development

BOX: Mahbub ul Haq and the HDI

BOX: Millennium Development Goals

Structural Change

Conclusion

Appendix: Gross Domestic Product and Gross National Income

Appendix: The Lorenz Curve and Gini Coefficient

Teaching Notes

You need to begin this section of the course with a *transition*, however brief, to the fourth window on the world economy: international development. How you do that will reflect your own thinking and sensibilities, but making the transition apparent to your students will be important for their own absorption of the course material.

The main thing to stress to your students is that the growth (per-capita income) and human development approaches to assessing development are two available *alternatives*. While you might be tempted to advocate strongly for one of these perspectives over the other, this might not be the most useful approach. Both perspectives are widely used for different purposes and are widely cited in the financial press. For example, Brazilian poverty programs utilize the HDI, and *The Economist* often mentions the HDI, while most often adopting the income per capita perspective. The HDI can be appreciated (and remembered) by students via the old saying “healthy, wealthy, and wise.” For programs in development, the human development approach is also an opportunity to introduce the notion of *development ethics*.³

The chapter also emphasizes structural change, particularly its economic aspects. An often underappreciated subject of the role of services in structural change is introduced. This is an opportunity to link development to trade in the form of trade in services discussed in Chapter 1.

For most programs, the distinction between GDP and GNI is relevant, and this is covered in the first appendix. Some groups of students will be familiar with the Lorenz curve and Gini coefficient. Others will not be at all familiar. This is covered in a second appendix. This is also a good point to contrast the average measure of income per capita with its dispersion and to remind students that poverty alleviation can come from either (or both) increases in the average or a reduction in the dispersion.

Space constraints prevent the chapter from being exhaustive with regard to approaches to development. For example, the chapter does not go deeply into sustainable development. If you are familiar with such a perspective, be sure to present it. This will communicate to the students the richness of thinking on the important topic of development.

Comments on Review Exercises

1. In your opinion, is the GDP per capita or growth perspective a sufficient measure of economic development? Why or why not?

³ Please note that the Goldin and Reinert book referenced in this chapter is now available in a new edition: I. Goldin and K.A. Reinert (2012) *Globalization for Development: Meeting New Challenges*, Oxford University Press.

There is definitely no one correct answer here. Students' responses should be assessed on the merits of argumentation and consistency.

2. How can the PPP adjustment to income per capita change the ranking of countries' levels of economic development? Is this an important adjustment to make?

In countries where the cost of living is less, a certain amount of income per capita goes farther, particularly in the consumption of non-traded services. Given that it is real income (what income can buy) rather than nominal income (the dollar value) that matters, the PPP adjustment is important. That is why it is used, for example, in computing the HDI.

3. A controversial aspect to the human development index is its use of declining weights for per capita income. Do you agree with this adjustment? Why or why not?

Again, there is no one correct answer here. As stated in the text, some observers think this is a "political" adjustment. Alternatively, one could argue in favor of this adjustment by valuing more highly increases from low levels of income compared to increases from high levels of income.

4. The human development index takes into account health and education as well as per capita income. Why might health and education be important considerations in the process of economic development?

Once again, there is no one correct answer. Ill health and poor education restrict a person's participation in life and society. Ill health and poor education can also adversely affect the quality of life. To the extent that participation and quality of life are important, the HDI captures relevant information.

5. Take some time to explore the UNDP's website at www.undp.org. Try to locate the human development indicators that are a part of the most recent *Human Development Report* (www.hdr.undp.org). Look up the indicators for a country in which you have an interest.

You can demonstrate this in class for your students. In my experience, they will be interested in this exercise.

CHAPTER 21

Growth and Development

Chapter Objectives

This is an important chapter that covers a lot of ground. Particularly for development studies programs, there is ample opportunity to delve further into any number of topics with supplementary readings. The main purpose of the chapter is to integrate some perspectives from new growth theory and the human development paradigm with regard to human capital broadly conceived. It is also an opportunity to revisit the trade issues of Part I of the book in the light of the newly-introduced development paradigm. Finally, this is an opportunity to take a look at the increasingly-important issue of institutions and development.

At one level, the chapter is an expanded treatment of growth theory, made accessible for your students. At another level, it is an exploration of human development that is related to growth. Depending on your predilection, you can approach it from either perspective.

Analytical elements for this chapter:

Countries, factors.

Chapter Outline

Old Growth Theory
New Growth Theory and Human Capital
Trade and Growth
 BOX: Trade and Growth in East Asia
Institutions and Growth
Conclusion
Appendix: Growth Theory Algebra

Teaching Notes

The chapter begins with a treatment of old growth theory, in a simple graphical form. The key thing to differentiate for your students here is the difference between a movement along a curve and a shift of the curve. This is essential if they are to gain an intuitive understanding of growth theory issues. Make sure you spend the time so that they can make this distinction. The policy implication of this discussion is contained in the box:

Increases in per capita incomes can come about through increases in the capital-labor ratio (capital deepening) or through other shift factors such as improvements in technological efficiency.

Understanding the role of savings in this process requires a quick review of the open economy accounts of Chapter 13, and this is an opportunity for a bit of review of these accounts.

With regard to Solow residuals, it is worth a few minutes discussion in class to make a list of what possible could cause them. Referring to them as “a measure of our ignorance” reinforces for the student that there is much we have to learn with regard to the determinants of growth.

Much of the chapter follows Figure 21.6 regarding the connections among education, health, growth, and human development. This is an interdisciplinary realm where you can relate to the broad backgrounds of your class, as well as your own particular interests. With regard to alleged export externalities, the distinction between manufactured (and advanced service) exports and primary products is key. In our experience, students are very much attuned to the problems surrounding primary product exports.

The chapter uses Ghana as a point of reference. If you were to bring another country to class as an additional point of reference, students would appreciate it.

The role of institutions and development is taken up using Table 21.2 as a reference point. The literature here is vast, and the discussion in the chapter is illustrative but not complete. In programs with a focus on development, international relations, and global political economy, this is an area in which you will want to expand.⁴ Feel free to use this table as a jumping-off device and to expand on it in ways that you see fit.

⁴ To name just one source, see F. Fukuyama (2008) “Do Defective Institutions Explain the Development Gap between the United States and Latin America?” in F. Fukuyama (ed.) *Falling Behind: Explaining the Development Gap between Latin America and the United States*, Oxford University Press.

Table 21.2 Institutions and Growth

| Category | Elements | Relevance |
|----------------------|--|---|
| Rule of law | Political representation Elections Independent judiciary Civil liberties Consistency | Prevents violent conflict and provides for legitimacy in political decision-making |
| Property rights | Secure ownership or control of assets Right to returns on assets Asset distribution | Ensures that the use of productive assets will result in appropriate returns that will, in turn, provide incentives for further development and use |
| Contract enforcement | Contract design Escape clauses Recourse | Allows for parties to enter into long-term, productive arrangements with a minimum degree of certainty |
| Regulation | Prudential regulation of finance Macroeconomic management Health and safety regulation | Addresses well-known instance of market failure |
| Social insurance | Transfer payments Employment practices Traditional social arrangements | Ensures that market dislocations are managed so as not to impede human development |

Source: Rodrik (2007) and others.

Comments on Review Exercises

1. Given the discussion of this chapter with regard to trade, education, health and institutions, what policies do you think countries ought to pursue to ensure that international trade supports increases in per capita incomes?

While there is no one, correct answer here, the set of relevant policies (what the World Bank calls “complementary” trade policies) would be focused on human capital and human asset accumulation.

2. Are there any connections you can find between the discussion of this chapter and that on international competition covered in Chapter 11? In particular, are there links between our discussion of education and Michael Porter’s thinking about factor conditions?

Human capital accumulation can be thought of as a movement from “basic” human factors of production to more “advanced” human factors of production.

3. The World Bank suggested that there are important externalities associated with exports. In general, such positive externalities call for subsidies on the part of governments. Given our discussion of the GATT/WTO system in Chapter 7, do you detect any problems with the use of *export subsidies*?

Export subsidies are problematic within the GATT/WTO framework. They are illegal, with a long-standing exception made for agricultural products.

4. This is one of the few chapters in which we mentioned gender issues in our discussion. Are there any other aspects of the world economy in which gender issues are important? How might these issues arise in the realms of international trade, international production, and international finance?

To the extent that occupations are gender specific, the operation of comparative advantage can have impacts on gender issues. Some multinational enterprises favor women workers for their nimble fingers and “docile nature.” Also, it has been observed in the development literature that women’s time (or lack thereof) has been an important endogenous variable in macroeconomic or structural adjustment.

5. Consider a country with which you have some familiarity. Using Table 21.2 as a rough guide, what can you say about the institutional qualities of that country?

There is no one correct answer here, but this is a useful subject for student papers and, potentially, classroom presentations.

CHAPTER 22

International Production and Development

Chapter Objectives

From the point of view of mainstream international economics, there is not much purpose to this chapter. As one reviewer put it, “FDI is always a net benefit.” However, there is much discussion in both the fields of international business and development policy of how to make the most of FDI. Additionally, this is a key concern of international development organizations such as the World Bank. This chapter summarizes this important area for your students, taking a cost/benefit approach to FDI and identifying the key policies that can help to tilt the ratio towards benefits. In this, emphasis is placed on supporting backward linkages to domestic firms.

Opinions on the role of FDI in development differ widely, from viewing MNEs as inherently evil to viewing them as the only saving grace for developing countries. Your students’ opinions with regard for the subject will fall anywhere on this continuum, so there is substantial room for disagreement in the material of this chapter. We hope that the framework offered (and summarized in Table 22.1) will allow you to frame your students’ opinions in an analytical framework to make your classroom discussion productive.

Analytical elements for this chapter:

Countries, sectors, tasks, firms and factors.

Chapter Outline

Attracting International Production

Benefits and Costs

BOX: The Petroleum Industry in the Ecuadorian Amazon

Policy Stances

Promoting Linkages

BOX: Lessons from FDI in Ireland

Transfer Pricing
Governing International Production
Conclusion
Appendix: OECD Guidelines for MNEs

Teaching Notes

The chapter begins with an anecdote regarding FDI in Costa Rica, and the chapter refers intermittently to this case. In class, you can use this case or you can frame your discussion in a different context with which you have interest or experience. Alternatively, you can use two cases, one where the benefits of FDI are readily apparent and one where the costs are more prominent (perhaps a resource extraction example).

This would also be a good time to review some of the basic characteristics of FDI presented in Chapter 1. Students might need reminding of the orders of magnitude of these flows.

You need to spend some time walking your students through Table 21.1 on the benefits and costs of inward FDI. *Feel free to expand or modify this table in any way you see fit.* It is not sacrosanct. By making this table the centerpiece of your classroom discussion, the various ideas and opinions of your students will find an analytical reference point, one that is widely accepted in international business education.

It is perhaps best for you to be honest with your students about the range of disagreement among international economists regarding the role of FDI in development and the balance of costs and benefits reflected in Table 22.1. The studies cited in Table 22.2 are one way of doing this.

The short section of the chapter on “policy stances” takes up the issue of trade-related investment measures (TRIMs), a topic related to the WTO as discussed in Chapter 7, as well as export processing zones (EPZs). You can extend this discussion much farther beyond that contained in this section if you or your students have a special interest in these matters. This could be particularly important in some development studies programs.

The section of the chapter on “promoting linkages” is important, and is often absent from many discussions of FDI available to your students. The key point of this section is that there is an information gap that can be filled by *coordinative* government policy. This would be a chance for you and your class to brainstorm on the various ways, beyond those mentioned in the text, that host governments could fulfill this function. In larger classes, this can be done in smaller groups that report their ideas to the full class.

Transfer pricing and the Multilateral Agreement on Investment are controversial topics that have been involved in recent discussions on the subject of globalization. Here, a reference point worth discussion in class is the non-binding OECD Guidelines for Multinational Enterprises listed in the appendix.

Comments on Review Exercises

1. What institutional elements do you think would make it more likely for an MNE to locate in a particular country?

Hints are given in the first section of the chapter. Relevant factors include democracy (although China and Vietnam are counterexamples), good governance and the rule of law, absence of corruption and intellectual property protection.

2. Table 22.1 lists a set of benefits and costs of hosting foreign MNEs in the areas of employment, competition, education and training, technology, balance of payments, health and the environment, and culture. Are there any additional benefits and costs that you think are important? Are there additional considerations that a host government should address before hosting foreign MNEs?

There is no single correct answer to this question. As mentioned above, this question can be used as a class exercise, including in groups for large classes. This is to bring out the concerns of students in the class.

3. The Agreement on Trade-Related Investment Measures (TRIMs) of the Marrakesh Agreement requires WTO members to phase out local content requirements. Do you think this is a good idea? Why or why not?

Again, there is no single correct answer to this question. Clearly, local content schemes will be a disincentive to inward FDI, but could also promote backward linkages. The question is whether the promotion of backward linkages is best promoted by local content requirements or coordinative approaches as describe in the chapter.

4. Should there be multilateral agreements either constraining the behavior of governments towards MNEs or constraining the behavior of the MNEs themselves?

This is definitely a discussion question rather than a technical question. Use it in class to raise issues with regard to the governance of international production.

CHAPTER 23

The World Bank

Chapter Objectives

Chapters 20 and 21 were developed with Ghana as a reference point. This chapter returns to the case of Ghana (Chapter 22 having taken up Costa Rica) and examines the role of the World Bank in this country. But first, the chapter takes the student on an historical tour of the World Bank not found in most textbooks on international economics. As with many other subjects in this text, there is a good bit of controversy surrounding the subject. As with Chapter 7 on the WTO and Chapter 17 on the IMF, the chapter tries to steer a course through the controversy with a critical, historically-informed approach that allows for the student to draw his or her own informed conclusions.

It needs to be appreciated that the World Bank is a somewhat cacophonous entity, with many voices, orthodox and critical speaking at once. It is also an organization whose positions on development issues change incrementally. A position of some years ago might now be modified in some important respects.

Analytical elements for this chapter:

Countries, currencies, financial assets.

Chapter Outline

- Early History and Administrative Structure
- Infrastructure Project Lending and Poverty Alleviation Phases
 - BOX: Land Redistribution in Brazil
- Policy-Based Lending
 - BOX: The Washington Consensus
- Challenges and Responses
 - BOX: Wolfensohn's Comprehensive Development Framework

Engaging with Ghana
Recent Shifts
Conclusion

Teaching Notes

It is important for students to appreciate both the Bank's historical roots in the Bretton Woods process and the fact that the Bank is a "group" as indicated in Figure 23.1. Taking time to emphasize the function of each of the five members of the World Bank Group will give your students an appreciation of the broad scope of the organization. The evolution of the Bank through its infrastructure project lending, poverty alleviation, and policy-based lending phases is important in appreciating the changing nature of the Bank. It is the most-recent, policy-based lending phase that is applied in the chapter to the Ghanaian case.

The policy-based lending phase is also relevant as an element of the "Washington consensus," discussed in a box in the chapter. It is important for students to appreciate the various meaning of the term "Washington consensus," for they are indeed various. Most crucial here is that, despite its alleged and actual shortcomings, the Washington consensus is not the same thing as neo-liberalism, the *bête noire* of the anti-globalization movement. Taking your students through a critical assessment of each of the ten components of the Washington consensus is a very useful exercise.

Wolfensohn's "comprehensive development framework" sets the stage for many of the current intellectual activities of the Bank, and draws upon many elements of development thinking inside and outside of that institution. For development studies programs, this is an opportunity to tie together some loose ends and apply them to this important development institution. The books by Mallaby (2004) and Phillips (2009) are helpful guides to this era.

The chapter contains a box on land redistribution in Brazil. This is an opportunity for you to give your students an appreciation of the role of asset distribution (and hence income distribution) in development processes. You can refer back to the appendix of Chapter 20 on the Lorenz curve in your mention of income distribution.

Comments on Review Exercises

1. The World Bank and the IMF are the two major institutions of international finance in the world economy. How do their missions and operations differ? Are there any areas in which these missions and operations work against each other?

Ideally, the IMF should be concerned with macroeconomic balance, the balance of payments and exchange rate adjustment. The Bank should be concerned with the microeconomic and structural aspects of development. In practice, the two realms often overlap, leading to certain tensions between the two institutions.

2. How does the poverty alleviation phase of the World Bank differ from its previous infrastructure project lending phase? In what ways does the latter policy-based lending phase represent a break with the poverty alleviation phase?

The infrastructure project lending phase reflected the belief that large-scale infrastructure was a prerequisite for development. The poverty alleviation phase was a recognition that infrastructure was not enough to improve the lives of the poor. Agriculture and rural development, education, health, and urban development all took on increasing importance in this second phase. The policy-based lending phase reflected a belief that the policy environment of the developing countries was the key to improve the lives of the poor, at least in the long term. The key focuses of the poverty alleviation phase (agriculture and rural development, education, health, and urban development) were all downplayed during the policy based lending phase.

3. What is your assessment of Wolfensohn's Comprehensive Development Framework? Does it seem to support conceptions of growth and development discussed in Chapters 20 and 21?

This reflects the personal concerns of the student and, to some extent, his or her own values. Answers should therefore be assessed for consistency and argumentation.

4. If you were assigned the task of designing a development framework for the World Bank, what would it be?

This reflects the personal concerns of the student and, to some extent, his or her own values. Answers should therefore be assessed for consistency and argumentation.

5. If there is a World Bank member in which you have a special interest, spend a little time perusing the "Countries and Regions" section of the Bank's web-site at: www.worldbank.org.

This exercise is one you can illustrate in class for the benefit of the students, using a particular country as an example.

CHAPTER 24

Structural Change and Adjustment

Chapter Objectives

Much of the developing world's recent economic history is one of structural adjustment to new international economic realities. Also, "structural adjustment" is a target of criticism in discussions of "globalization." For this reason, it is important that students have an appreciation of the process of structural adjustment and what it entails. This chapter tries to communicate to your students how this adjustment process takes place, as well as to emphasize the potential role of the order of economic liberalization in making this adjustment successful. It does so, drawing upon the production possibilities frontier analysis of Chapter 3.

Analytical elements for this chapter:

Countries, sectors, factors, and currencies.

Chapter Outline

- Structural Change
- Traded and Non-Traded Goods
- Internal and External Balance
 - BOX: The Structuralist Critique
- Traded Goods and Growth
- The Order of Economic Liberalization
- Conclusion
- Appendix: The Rybczynski Theorem

Teaching Notes

This chapter is not an easy one for students. It is set out in terms of production possibilities frontiers. To assist your students in their learning process, it would be helpful for you to review the PPF concept for them before plunging into the chapter itself. Then, you need to help them re-envision the PPF set out in terms of traded and non-traded goods as in Figure 24.1. The next key step is to understand internal and external balance as summarized in the following box:

Internal balance: all resources are efficiently employed.

External balance: consumption and production of tradable goods are equal.

The PPF analysis provides the following insights, which you might give your students *before* presenting the PPF analysis. This will let them know what you are working up towards. The insights are:

Adjustment via demand reduction alone occurs at the expense of internal balance.

In order to avoid internal imbalance (unemployment), successful adjustment program must combine *both* demand reduction and switching elements.

The structuralist critique of structural adjustment is important, but difficult to pin down from the literature. The chapter attempts to provide some of the elements of this critique in a manner that is understandable in a box. If you want to emphasize this further, you can redraw the PPF diagram for your students with a rectangular PPF.

The chapter contains a short section on the role of trade goods in growth, a topic made relevant by Rodrik (2008). Expand upon this if you find this possibility relevant to your program.

The question of the order of economic liberalization is neglected but, in my view, important. It has been given a recent blessing by Justin Lin, Chief Economist of the World Bank. And it has made something of a re-appearance in the wake of the Asian, Russian, Brazilian, and Argentine crises. Since there are no hard-and-fast rules here, you should feel completely free to provide your own assessment of these matters, even if it is in contradiction to the chapter. Let your students know that even the leading international economists disagree on these matters.

Finally, an appendix to the chapter considers the Rybczynski theorem. If you did not use this appendix when you covered Chapter 5 and the Heckscher-Ohlin model, now might be the time to cover it.

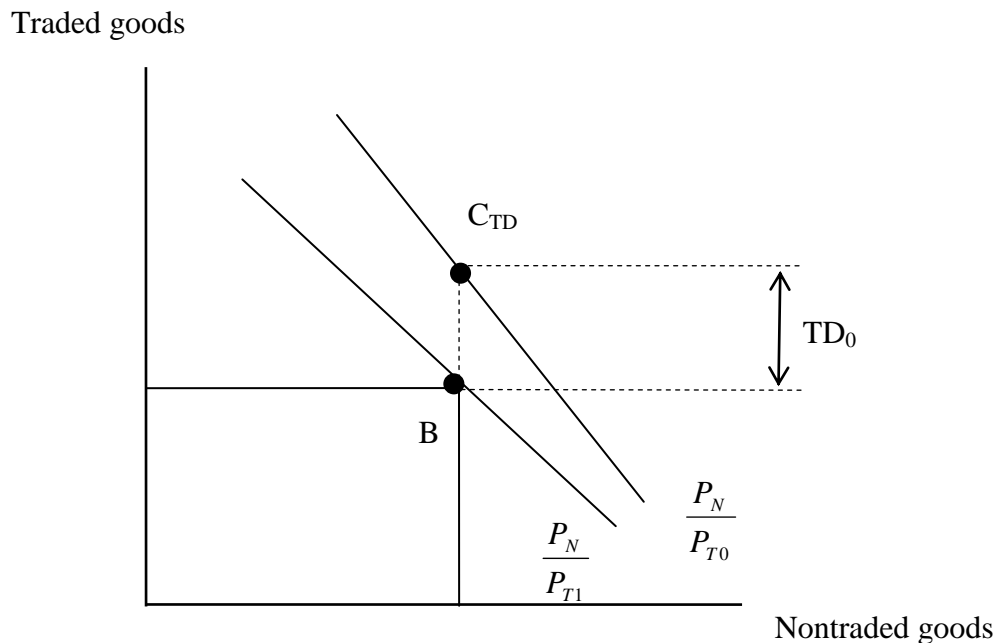
Comments on Review Exercises

1. In our discussion of internal and external balance, we saw that a devaluation of a fixed exchange rate moves production in an economy towards traded goods. A revaluation of a fixed exchange rate, in contrast, would move production in an economy towards non-traded goods. Carefully explain the intuition of these results.

The devaluation of the currency increases the domestic prices of traded goods. This gives an increased incentive for firms to produce these goods, moving production along the PPF in this direction. A revaluation would decrease the domestic prices of traded goods, reducing the incentive to produce these goods and moving production away from these goods on the PPF.

2. Structuralist economists maintain that resources are often not mobile among sectors of an economy. Consequently, PPFs tend to be nearly rectangular, and switching effects small. Can you think of any reasons why resources might not be mobile among sectors? Use a diagram like those presented in this chapter to show the ineffectiveness of switching policies in this case.

Both infrastructure and physical capital must be modified to shift to different productive uses. Labor and human capital must be retrained to shift to a different sector. In some cases, movement along the PPF involves migration within the country, which does not happen automatically. In the diagram below, an increase in the nominal exchange rate will not shift production towards traded goods even as the relative price of non-traded goods falls. The only available adjustment mechanism is via a reduction in demand reduction.



3. In Chapter 18 on Crises and Responses, we discussed capital controls. In this chapter, we have talked about how liberalization of the capital account should come after the liberalization of the current account. Suppose that you were advising a developing country on the liberalization of its capital account. What would you advise? How should the steps towards liberalization be sequenced?

This question has now taken on new urgency given the recent relaxation of the IMF to some types of capital controls. Key concerns include: the length of the maturity to be liberalized, the health of the banking system, the strength of the financial regulatory system, and the role of market-friendly, Chilean-style (encaje) taxes on inflows.

4. In the anti-globalization movement, structural adjustment is often portrayed as *inherently* undesirable. In your opinion, are there elements of structural adjustment programs that do in fact appear necessary? If so, what are they?

There is no one correct answer this question. However, drawing from Chapter 13, the student should emphasize the role of macroeconomic balance as being a “soft” constraint on developing economies. Balance of payments problems are not sustainable.