# **Brief Contents**

PART 1 Introduction to International Trade		PART 5 Introduction to International		
Chapter 1	Trade in the Global Economy 1	Macroeconomics		
DADT 1 Da	itterns of International Trade	Chapter 12	The Global Macroeconomy 411	
		PART 6 Exchange Rates		
Chapter 2	Trade and Technology: The Ricardian Model 27		Introduction to Exchange Rates and	
Chapter 3	Gains and Losses from Trade in the Specific-Factors Model 59	Chapter 13	the Foreign Exchange Market 435	
		Chapter 14	Chapter 14 Exchange Rates I: The Monetary Approach in the Long Run 473	
Chapter 4	Trade and Resources: The Heckscher-Ohlin Model 87	•		
		Chapter 15	Exchange Rates II: The Asset Approach in the Short Run 521	
-	Movement of Labor and Capital between Countries 123			
		PART 7 The Balance of Payments		
PART 3 New Explanations for International Trade		•	National and International Accounts: Income, Wealth, and the Balance of Payments 567	
Chapter 6 Increasing Returns to Scale and				
Chapter 0	Monopolistic Competition 165	Chapter 17	Balance of Payments I: The Gains	
Chapter 7	Offshoring of Goods and Services 197		from Financial Globalization 609	
		Chapter 18	Balance of Payments II: Output,	
PART 4 In	ternational Trade Policies		Exchange Rates, and Macroeconomic Policies in the Short Run 663	
Chapter 8 Import Tariffs and Quotas Under		, chaics in the shere than ees		
Chapter 6	Perfect Competition 233	PART 8 Applications and Policy Issues		
Chapter 9	Import Tariffs and Quotas Under Imperfect Competition 279	Chapter 19	Fixed Versus Floating: International Monetary Experience 715	
Chapter 10	•	Chapter 20	Exchange Rate Crises: How Pegs Work and How They Break 757	
				Chapter 11
Chapter 22	Topics in International			
		,	Macroeconomics 859	
		Index	I-1	

# Contents

Preface xxvi

### PART 1

Introduction to International Trade

# CHAPTER 1 Trade in the Global Economy 1

#### 1 International Trade 3

The Basics of World Trade 3

HEADLINES Sum of iPhone Parts: Trade Distortion 5

APPLICATION Is Trade Today Different from the Past? 5

Map of World Trade 7

Trade Compared with GDP 11

Barriers to Trade 12

"First Golden Age" of Trade 12

"Second Golden Age" of Trade 14

HEADLINES A Sea Change in Shipping 50 Years Ago 15

### 2 Migration and Foreign Direct Investment 16

Map of Migration 16

Map of Foreign Direct Investment 19

#### 3 Conclusions 23

Key Points, Key Terms, and Problems

# CHAPTER 2 Trade and Technology: The Ricardian Model 27

# PART 2

Patterns of International Trade

#### 1 Reasons for Trade 29

Proximity 29

Resources 30

Absolute Advantage 30

SIDE BAR Can Comparative Advantage Be Created? The Case of "Icewine" 31

Comparative Advantage 32

SIDE BAR David Ricardo and Mercantilism 32

#### 2 Ricardian Model 33

The Home Country 33

The Foreign Country 37

# APPLICATION Comparative Advantage in Apparel, Textiles, and Wheat 38

#### 3 Determining the Pattern of International Trade 40

International Trade Equilibrium 41

APPLICATION Labor Productivity and Wages 46

### 4 Solving for International Prices 47

Home Export Supply Curve 47

International Trade Equilibrium 51

APPLICATION The Terms of Trade for Primary Commodities 52

#### 5 Conclusions 53

Key Points, Key Terms, and Problems

# CHAPTER 3 Gains and Losses from Trade in the Specific-Factors Model 59

#### 1 Specific-Factors Model 61

The Home Country 61

The Foreign Country 64

Overall Gains from Trade 64

APPLICATION How Large Are the Gains from Trade? 65

### 2 Earnings of Labor 66

Determination of Wages 66

Change in Relative Price of Manufactures 68

APPLICATION Manufacturing and Services in the United States: Employment and Wages across Sectors 71

APPLICATION Trade Adjustment Assistance Programs: Financing the Adjustment Costs of Trade 73

### 3 Earnings of Capital and Land 74

Determining the Payments to Capital and Land 74

HEADLINES Services Workers Are Now Eligible for Trade Adjustment Assistance 75

Numerical Example 77

What It All Means 80

APPLICATION Prices in Agriculture 80

#### 4 Conclusions 82

HEADLINES Rise in Coffee Prices—Great for Farmers, Tough on Co-ops 83

Key Points, Key Terms, and Problems

# CHAPTER 4 Trade and Resources: The Heckscher-Ohlin Model 87

#### 1 Heckscher-Ohlin Model 88

Assumptions of the Heckscher-Ohlin Model 89

APPLICATION Are Factor Intensities the Same Across Countries? 91

No-Trade Equilibrium 92

Free-Trade Equilibrium 94

### 2 Testing the Heckscher-Ohlin Model 98

Leontief's Paradox 99

Factor Endowments in 2010 100

Differing Productivities across Countries 102

HEADLINES China Drawing High-Tech Research from U.S. 105

Leontief's Paradox Once Again 107

#### 3 Effects of Trade on Factor Prices 110

Effect of Trade on the Wage and Rental of Home 110

Determination of the Real Wage and Real Rental 113

Changes in the Real Wage and Rental: A Numerical Example 115

APPLICATION Opinions toward Free Trade 117

#### 4 Conclusions 119

Key Points, Key Terms, and Problems

# CHAPTER 5 Movement of Labor and Capital Between Countries 123

# 1 Movement of Labor between Countries: Migration 125

Effects of Immigration in the Short Run: Specific-Factors Model 125

APPLICATION Immigration to the New World 128

APPLICATION Immigration to the United States and Europe Today 129

HEADLINES Call for Return of Border Controls in Europe 130

HEADLINES The Economic Windfall of Immigration Reform 131

Other Effects of Immigration in the Short Run 133

Effects of Immigration in the Long Run 134

Rybczynski Theorem 139

Factor Price Insensitivity Theorem 140

APPLICATION The Effects of the Mariel Boat Lift on Industry
Output in Miami 140

APPLICATION Immigration and U.S. Wages, 1990–2006 142

# 2 Movement of Capital between Countries: Foreign Direct Investment 144

Greenfield Investment 145

FDI in the Short Run: Specific-Factors Model 145

FDI in the Long Run 147

APPLICATION The Effect of FDI on Rentals and Wages in Singapore 149

#### 3 Gains from Labor and Capital Flows 151

HEADLINES The Myth of Asia's Miracle 151

Gains from Immigration 152

SIDE BAR Immigrants and Their Remittances 155

APPLICATION Gains from Migration 156

Gains from Foreign Direct Investment 159

#### 4 Conclusions 160

Key Points, Key Terms, and Problems

# CHAPTER 6 Increasing Returns to Scale and Monopolistic Competition 165

### 1 Basics of Imperfect Competition 168

Monopoly Equilibrium 168

Demand with Duopoly 169

#### 2 Trade Under Monopolistic Competition 170

Equilibrium without Trade 172

Equilibrium with Free Trade 174

#### 3 The North American Free Trade Agreement 178

Gains and Adjustment Costs for Canada Under NAFTA 178

HEADLINES The Long and the Short of the Canada-U.S. Free Trade Agreement 179

Gains and Adjustment Costs for Mexico Under NAFTA 179

HEADLINES NAFTA Turns 15, Bravo! 180

HEADLINES Nearly 20 Years After NAFTA, First Mexican Truck Arrives In U.S. Interior 181

Gains and Adjustment Costs for the United States Under NAFTA 184

# 4 Intra-Industry Trade and the Gravity Equation 187

Index of Intra-Industry Trade 188

The Gravity Equation 189

APPLICATION The Gravity Equation for Canada and the United States 190

#### 5 Conclusions 193

Key Points, Key Terms, and Problems

PART 3 New Explanations for International Trade

# **CHAPTER 7** Offshoring of Goods and Services 197

SIDE BAR "Foreign Outsourcing" Versus "Offshoring" 199

### 1 A Model of Offshoring 200

Value Chain of Activities 200 Changing the Costs of Trade 203

APPLICATION Change in Relative Wages Across Countries 205

Change in Relative Wages in the United States 206 Change in Relative Wages in Mexico 211

### 2 The Gains from Offshoring 212

Simplified Offshoring Model 213
Production in the Absence of Offshoring 213
Terms of Trade 216

APPLICATION U.S. Terms of Trade and Service Exports 219

### 3 The Politics and Future of Offshoring 222

HEADLINES How to Destroy American Jobs 224
HEADLINES Caterpillar Joins "Onshoring" Trend 225
The Future of U.S. Comparative Advantage 225

#### 4 Conclusions 226

Key Points, Key Terms, and Problems

# PART 4 International Trade Policies

# CHAPTER 8 Import Tariffs and Quotas Under Perfect Competition 233

# 1 A Brief History of the World Trade Organization 235

#### 2 The Gains from Trade 236

Consumer and Producer Surplus 236

SIDE BAR Key Provisions of the GATT 237
Home Welfare 239

Home Import Demand Curve 241

# 3 Import Tariffs for a Small Country 242

Free Trade for a Small Country 242 Effect of the Tariff 242 Why and How Are Tariffs Applied? 246

SIDE BAR Safeguard Tariffs 247

APPLICATION U.S. Tariffs on Steel and Tires 248

# 4 Import Tariffs for a Large Country 256

Foreign Export Supply 256 Effect of the Tariff 257

#### APPLICATION U.S. Tariffs on Steel Once Again 261

### 5 Import Quotas 263

Import Quota in a Small Country 263

HEADLINES Banana Wars 265

HEADLINES Sugar Could Sweeten U.S. Australia Trans-Pacific Trade Talks 266

APPLICATION China and the Multifibre Arrangement 269

#### 6 Conclusions 272

Key Points, Key Terms, and Problems

# CHAPTER 9 Import Tariffs and Quotas Under Imperfect Competition 279

# 1 Tariffs and Quotas with Home Monopoly 281

No-Trade Equilibrium 282

Free-Trade Equilibrium 283

Effect of a Home Tariff 284

Effect of a Home Quota 286

APPLICATION U.S. Imports of Japanese Automobiles 288

### 2 Tariffs with Foreign Monopoly 291

Foreign Monopoly 291

APPLICATION Import Tariffs on Japanese Trucks 293

HEADLINES The Chickens Have Come Home to Roost 295

#### 3 Dumping 296

Numerical Example of Dumping 298

# 4 Policy Response to Dumping 298

Antidumping Duties 299

APPLICATION United States Imports of Solar Panels from China 299

APPLICATION Antidumping Duties Versus Safeguard Tariffs 302

# 5 Infant Industry Protection 304

Free-Trade Equilibrium 306

Tariff Equilibrium 306

APPLICATION Examples of Infant Industry Protection 308

Government Policies in the Solar Panel Industry 308

U.S. Tariff on Heavyweight Motorcycles 310

HEADLINES Solar Flares 310

Computers in Brazil 314

Protecting the Automobile Industry in China 316

HEADLINES Milestone for China Car Output 316
HEADLINES Shanghai Tie-Up Drives Profits for GM 318

#### 6 Conclusions 320

Key Points, Key Terms, and Problems

# CHAPTER 10 Export Subsidies in Agriculture and High-Technology Industries 327

### 1 WTO Goals on Agricultural Export Subsidies 329

Agricultural Export Subsidies 329
Other Matters from the Hong Kong WTO Meeting 330

# 2 Export Subsidies in a Small Home Country 331 Impact of an Export Subsidy 332

# 3 Export Subsidies in a Large Home Country 334

Effect of the Subsidy 334

APPLICATION Who Gains and Who Loses? 336

HEADLINES G8 Shifts Focus from Food Aid to Farming 339

HEADLINES Hunger and Food Security Back on Political Agenda 340

#### 4 Production Subsidies 340

Effect of a Production Subsidy in a Small Home Country 341
Effect of the Production Subsidy in a Large Home Country 343

# 5 Export Tariffs 343

Impact of an Export Tariff in a Small Country 344
Impact of an Export Tariff in a Large Country 345

# 6 Export Quotas 347

APPLICATION Chinese Export Policies in Mineral Products 349

# 7 High-Technology Export Subsidies 351

"Strategic" Use of High-Tech Export Subsidies 352

Effect of a Subsidy to Airbus 355

Subsidy with Cost Advantage for Boeing 357

APPLICATION Subsidies to Commercial Aircraft 358

#### 8 Conclusions 361

HEADLINES EU Seeks \$12 billion from US over Boeing Aid 362

Key Points, Key Terms, and Problems

# CHAPTER 11 International Agreements: Trade, Labor, and the Environment 367

### 1 International Trade Agreements 370

The Logic of Multilateral Trade Agreements 370

Regional Trade Agreements 373

Trade Creation and Trade Diversion 375

Numerical Example of Trade Creation and Diversion 375

HEADLINES China-ASEAN Treaty Threatens Indian Exporters 376

Trade Diversion in a Graph 377

APPLICATION Trade Creation and Diversion for Canada 380

#### 2 International Agreements on Labor Issues 380

Labor Side Agreement Under NAFTA 381

Other Labor Agreements 382

HEADLINES Wal-Mart Orders Chinese Suppliers to Lift Standards 384

HEADLINES American Tariffs, Bangladeshi Deaths 386

HEADLINES U.S. Suspends Bangladesh's Preferential Trade Status 387

### 3 International Agreements on the Environment 388

Environmental Issues in the GATT and WTO 388

Does Trade Help or Harm the Environment? 391

Examples of the Environmental Impact of Trade 394

The Tragedy of the Commons 396

International Agreements on Pollution 400

APPLICATION The Kyoto Protocol and the Copenhagen Accord 402

#### 4 Conclusions 404

HEADLINES Dismal Outcome at Copenhagen Fiasco 405 Key Points, Key Terms, and Problems

# CHAPTER 12 The Global Macroeconomy 411

# 1 Foreign Exchange: Currencies and Crises 412

How Exchange Rates Behave 413

Why Exchange Rates Matter 414

When Exchange Rates Misbehave 415

Summary and Plan of Study 416

HEADLINES Economic Crisis in Iceland 417

#### 2 Globalization of Finance: Debts and Deficits 418

Deficits and Surpluses: The Balance of Payments 418

Debtors and Creditors: External Wealth 421

PART 5
Introduction to
International

Macroeconomics

Darlings and Deadbeats: Defaults and Other Risks 422 Summary and Plan of Study 423

#### 3 Government and Institutions: Policies and Performance 424

Integration and Capital Controls: The Regulation of International Finance 424

Independence and Monetary Policy: The Choice of Exchange Rate Regimes 426

Institutions and Economic Performance: The Quality of Governance 427 Summary and Plan of Study 429

HEADLINES The Wealth of Nations 429

#### 4 Conclusions 431

Key Points, Key Terms, and Problems

# PART 6 Exchange Rates

# CHAPTER 13 Introduction to Exchange Rates and the Foreign Exchange Market 435

### 1 Exchange Rate Essentials 436

Defining the Exchange Rate 436

Appreciations and Depreciations 438

Multilateral Exchange Rates 440

Example: Using Exchange Rates to Compare Prices in a Common Currency 441

# 2 Exchange Rates in Practice 443

Exchange Rate Regimes: Fixed Versus Floating 443

APPLICATION Recent Exchange Rate Experiences 444

# 3 The Market for Foreign Exchange 449

The Spot Contract 449

Transaction Costs 450

Derivatives 450

APPLICATION Foreign Exchange Derivatives 451

Private Actors 452

Government Actions 452

# 4 Arbitrage and Spot Exchange Rates 453

Arbitrage with Two Currencies 454

Arbitrage with Three Currencies 455

Cross Rates and Vehicle Currencies 456

### 5 Arbitrage and Interest Rates 457

Riskless Arbitrage: Covered Interest Parity 457

APPLICATION Evidence on Covered Interest Parity 459

Risky Arbitrage: Uncovered Interest Parity 460

#### SIDE BAR Assets and Their Attributes 461

APPLICATION Evidence on Uncovered Interest Parity 463

Uncovered Interest Parity: A Useful Approximation 464

Summary 466

#### 6 Conclusions 466

Key Points, Key Terms, and Problems

# CHAPTER 14 Exchange Rates I: The Monetary Approach in the Long Run 473

# 1 Exchange Rates and Prices in the Long Run: Purchasing Power Parity and Goods Market Equilibrium 474

The Law of One Price 475

Purchasing Power Parity 476

The Real Exchange Rate 477

Absolute PPP and the Real Exchange Rate 477

Absolute PPP, Prices, and the Nominal Exchange Rate 478

Relative PPP, Inflation, and Exchange Rate Depreciation 478

Summary 480

APPLICATION Evidence for PPP in the Long Run and Short Run 480

How Slow Is Convergence to PPP? 481

What Explains Deviations from PPP? 482

SIDE BAR Forecasting When the Real Exchange Rate Is Undervalued or Overvalued 483

HEADLINES The Big Mac Index 484

# 2 Money, Prices, and Exchange Rates in the Long Run: Money Market Equilibrium in a Simple Model 486

What Is Money? 486

The Measurement of Money 486

The Supply of Money 487

The Demand for Money: A Simple Model 488

Equilibrium in the Money Market 489

A Simple Monetary Model of Prices 489

A Simple Monetary Model of the Exchange Rate 490

Money Growth, Inflation, and Depreciation 491

# 3 The Monetary Approach: Implications and Evidence 492

Exchange Rate Forecasts Using the Simple Model 492

APPLICATION Evidence for the Monetary Approach 495

APPLICATION Hyperinflations 496

SIDE BAR Currency Reform 497

### 4 Money, Interest Rates, and Prices in the Long Run: A General Model 499

HEADLINES The First Hyperinflation of the Twenty-First Century 500

The Demand for Money: The General Model 500 Long-Run Equilibrium in the Money Market 501 Inflation and Interest Rates in the Long Run 502

The Fisher Effect 503

Real Interest Parity 504

APPLICATION Evidence on the Fisher Effect 505
The Fundamental Equation Under the General Model 506
Exchange Rate Forecasts Using the General Model 507

# 5 Monetary Regimes and Exchange Rate Regimes 509

The Long Run: The Nominal Anchor 510

APPLICATION Nominal Anchors in Theory and Practice 512

#### 6 Conclusions 514

Key Points, Key Terms, and Problems

# CHAPTER 15 Exchange Rates II: The Asset Approach in the Short Run 521

# 1 Exchange Rates and Interest Rates in the Short Run: UIP and FX Market Equilibrium 522

Risky Arbitrage 522

Equilibrium in the FX Market: An Example 524

Adjustment to Forex Market Equilibrium 525

Changes in Domestic and Foreign Returns and FX Market Equilibrium 526 Summary 528

# 2 Interest Rates in the Short Run: Money Market Equilibrium 528

Money Market Equilibrium in the Short Run: How Nominal Interest Rates Are Determined 528

Money Market Equilibrium in the Short Run: Graphical Solution 530

Adjustment to Money Market Equilibrium in the Short Run 530

Another Building Block: Short-Run Money Market Equilibrium 531

Changes in Money Supply and the Nominal Interest Rate 531

APPLICATION Can Central Banks Always Control the Interest Rate?

A Lesson from the Crisis of 2008-2009 533

Changes in Real Income and the Nominal Interest Rate 534

The Monetary Model: The Short Run Versus the Long Run 534

# 3 The Asset Approach: Applications and Evidence 535

The Asset Approach to Exchange Rates: Graphical Solution 535

Short-Run Policy Analysis 537

APPLICATION The Rise and Fall of the Dollar, 1999–2004 540

### 4 A Complete Theory: Unifying the Monetary and Asset Approaches 541

Long-Run Policy Analysis 542

SIDE BAR Confessions of a Foreign Exchange Trader 544
Overshooting 548

SIDE BAR Overshooting in Practice 550

#### 5 Fixed Exchange Rates and the Trilemma 551

What Is a Fixed Exchange Rate Regime? 551

Pegging Sacrifices Monetary Policy Autonomy in the Short Run: Example 551

Pegging Sacrifices Monetary Policy Autonomy in the Long Run: Example 553

The Trilemma 554

SIDE BAR Intermediate Regimes 556

APPLICATION The Trilemma in Europe 557

#### 6 Conclusions 558

APPLICATION News and the Foreign Exchange Market in Wartime 558

Key Points, Key Terms, and Problems

# CHAPTER 16 National and International Accounts: Income, Wealth, and the Balance of Payments 567

# 1 Measuring Macroeconomic Activity: An Overview 568

The Flow of Payments in a Closed Economy: Introducing the National Income and Product Accounts 568

The Flow of Payments in an Open Economy: Incorporating the Balance of Payments Accounts 570

# 2 Income, Product, and Expenditure 573

Three Approaches to Measuring Economic Activity 573

From GNE to GDP: Accounting for Trade in Goods and Services 573

From GDP to GNI: Accounting for Trade in Factor Services 574

APPLICATION Celtic Tiger or Tortoise? 575

From GNI to GNDI: Accounting for Transfers of Income 577

What the National Economic Aggregates Tell Us 578

HEADLINES Are Rich Countries "Stingy" with Foreign Aid? 579

Understanding the Data for the National Economic Aggregates 580 What the Current Account Tells Us 582

# PART 7 The Balance of Payments

#### APPLICATION Global Imbalances 583

#### 3 The Balance of Payments 588

Accounting for Asset Transactions: The Financial Account 588

Accounting for Asset Transactions: The Capital Account 588

Accounting for Home and Foreign Assets 589

How the Balance of Payments Accounts Work: A Macroeconomic View 590

How the Balance of Payments Accounts Work: A Microeconomic View 591

SIDE BAR The Double-Entry Principle in the Balance of Payments 592

Understanding the Data for the Balance of Payments Account 593 What the Balance of Payments Account Tells Us 595

#### 4 External Wealth 596

The Level of External Wealth 597 Changes in External Wealth 597 Understanding the Data on External Wealth 599 What External Wealth Tells Us 601

#### 5 Conclusions 601

SIDE BAR Beware of Greeks Bearing Statistics 601
Key Points, Key Terms, and Problems

# Appendix to Chapter 16 607

# CHAPTER 17 Balance of Payments I: The Gains from Financial Globalization 609

# 1 The Limits on How Much a Country Can Borrow: The Long-Run Budget Constraint 611

How The Long-Run Budget Constraint Is Determined 612 The Budget Constraint in a Two-Period Example 613 A Long-Run Example: The Perpetual Loan 615

Implications of the LRBC for Gross National Expenditure and Gross

Domestic Product 616

Summary 617

APPLICATION The Favorable Situation of the United States 617
APPLICATION The Difficult Situation of the Emerging Markets 620

# 2 Gains from Consumption Smoothing 622

The Basic Model 623

Consumption Smoothing: A Numerical Example and Generalization 623 Summary: Save for a Rainy Day 627

SIDE BAR Wars and the Current Account 627

APPLICATION Consumption Volatility and Financial Openness 628

APPLICATION Precautionary Saving, Reserves, and Sovereign Wealth Funds 629

#### 3 Gains from Efficient Investment 630

The Basic Model 630

HEADLINES Copper-Bottomed Insurance 631

Efficient Investment: A Numerical Example and Generalization 632

Summary: Make Hay While the Sun Shines 635

APPLICATION Delinking Saving from Investment 635

Can Poor Countries Gain from Financial Globalization? 637

APPLICATION A Versus k 641

SIDE BAR What Does the World Bank Do? 645

HEADLINES A Brief History of Foreign Aid 645

#### 4 Gains from Diversification of Risk 646

Diversification: A Numerical Example and Generalization 647

APPLICATION The Home Bias Puzzle 652

Summary: Don't Put All Your Eggs in One Basket 654

#### 5 Conclusions 655

Key Points, Key Terms, and Problems

#### Appendix to Chapter 17 661

# CHAPTER 18 Balance of Payments II: Output, Exchange Rates, and Macroeconomic Policies in the Short Run 663

# 1 Demand in the Open Economy 664

Preliminaries and Assumptions 664

Consumption 665

Investment 666

The Government 666

The Trade Balance 667

HEADLINES Oh! What a Lovely Currency War 669

HEADLINES The Curry Trade 670

APPLICATION The Trade Balance and the Real Exchange Rate 671

SIDE BAR Barriers to Expenditure Switching: Pass-Through and the J Curve 673

Exogenous Changes in Demand 675

# 2 Goods Market Equilibrium: The Keynesian Cross 676

Supply and Demand 676

Determinants of Demand 677
Factors That Shift the Demand Curve 677
Summary 679

### 3 Goods and Forex Market Equilibria: Deriving the IS Curve 680

Equilibrium in Two Markets 680

Forex Market Recap 680

Deriving the IS Curve 682

Factors That Shift the IS Curve 683

Summing Up the IS Curve 685

### 4 Money Market Equilibrium: Deriving the LM Curve 686

Money Market Recap 686

Deriving the LM Curve 686

Factors That Shift the LM Curve 687

Summing Up the LM Curve 688

### 5 The Short-Run IS-LM-FX Model of an Open Economy 689

Macroeconomic Policies in the Short Run 689

Monetary Policy Under Floating Exchange Rates 691

Monetary Policy Under Fixed Exchange Rates 692

Fiscal Policy Under Floating Exchange Rates 693

Fiscal Policy Under Fixed Exchange Rates 694

Summary 696

# 6 Stabilization Policy 697

APPLICATION The Right Time for Austerity? 697

Problems in Policy Design and Implementation 699

APPLICATION Poland Is Not Latvia 700

APPLICATION Macroeconomic Policies in the Liquidity Trap 702

#### 7 Conclusions 706

Key Points, Key Terms, and Problems

Appendix 1 to Chapter 18 711

Appendix 2 to Chapter 18 713

# PART 8 Applications and Policy Issues

CHAPTER 19 Fixed Versus Floating: International Monetary Experience 715

# 1 Exchange Rate Regime Choice: Key Issues 717

APPLICATION Britain and Europe: The Big Issues 717

Key Factors in Exchange Rate Regime Choice: Integration and Similarity 722

Economic Integration and the Gains in Efficiency 722

Economic Similarity and the Costs of Asymmetric Shocks 723 Simple Criteria for a Fixed Exchange Rate 724

APPLICATION Do Fixed Exchange Rates Promote Trade? 725

APPLICATION Do Fixed Exchange Rates Diminish Monetary

# 2 Other Benefits of Fixing 730

Autonomy and Stability? 727

Fiscal Discipline, Seigniorage, and Inflation 730

SIDE BAR The Inflation Tax 731

Liability Dollarization, National Wealth, and Contractionary Depreciations 733

Summary 739

#### 3 Fixed Exchange Rate Systems 740

Cooperative and Noncooperative Adjustments to Interest Rates 740

Cooperative and Noncooperative Adjustments to Exchange Rates 743

APPLICATION The Gold Standard 745

#### 4 International Monetary Experience 747

The Rise and Fall of the Gold Standard 747

Bretton Woods to the Present 750

#### 5 Conclusions 753

Key Points, Key Terms, and Problems

# CHAPTER 20 Exchange Rate Crises: How Pegs Work and How They Break 757

# 1 Facts About Exchange Rate Crises 758

What Is an Exchange Rate Crisis? 758

How Costly Are Exchange Rate Crises? 758

SIDE BAR The Political Costs of Crises 761

Summary 762

# 2 How Pegs Work: The Mechanics of a Fixed Exchange Rate 764

Preliminaries and Assumptions 764

The Central Bank Balance Sheet 765

Fixing, Floating, and the Role of Reserves 766

How Reserves Adjust to Maintain the Peg 767

Graphical Analysis of the Central Bank Balance Sheet 767

Defending the Peg I: Changes in the Level of Money Demand 769

APPLICATION Risk Premiums in Advanced and Emerging

Markets 772

APPLICATION The Argentine Convertibility Plan Before the Tequila Crisis 775

Defending the Peg II: Changes in the Composition of Money Supply 777

APPLICATION The Argentine Convertibility Plan After the Tequila Crisis 782

The Central Bank Balance Sheet and the Financial System 784

SIDE BAR The Great Reserve Accumulation in Emerging Markets 786

Summary 788

### 3 How Pegs Break I: Inconsistent Fiscal Policies 789

The Basic Problem: Fiscal Dominance 789

A Simple Model 789

APPLICATION The Peruvian Crisis of 1986 792

Summary 796

# 4 How Pegs Break II: Contingent Monetary Policies 797

The Basic Problem: Contingent Commitment 797

A Simple Model 798

APPLICATION The Man Who Broke the Bank of England 803

Summary 804

#### 5 Conclusions 804

Can We Prevent Crises? 804

Key Points, Key Terms, and Problems

#### CHAPTER 21 The Euro 811

#### 1 The Economics of the Euro 814

The Theory of Optimum Currency Areas 814

Simple Optimum Currency Area Criteria 815

What's the Difference Between a Fix and a Currency Union? 816

Other Optimum Currency Area Criteria 817

APPLICATION Optimum Currency Areas: Europe Versus the United

States 819

Are the OCA Criteria Self-Fulfilling? 822

Summary 824

HEADLINES Currency Unions and Trade 825

# 2 The History and Politics of the Euro 826

A Brief History of Europe 826 Summary 832

# 3 Eurozone Tensions in Tranquil Times, 1999-2007 833

The European Central Bank 834

The Rules of the Club 838

Sticking to the Rules 842

# 4 The Eurozone in Crisis, 2008-2013 843

#### 5 Conclusions: Assessing the Euro 851

HEADLINES A Bad Marriage? 852

Key Points, Key Terms, and Problems

### CHAPTER 22 Topics in International Macroeconomics 859

# 1 Exchange Rates in the Long Run: Deviations from Purchasing Power Parity 860

Limits to Arbitrage 860

APPLICATION It's Not Just the Burgers That Are Cheap 863

Nontraded Goods and the Balassa-Samuelson Model 865

Overvaluations, Undervaluations, and the Productivity Growth: Forecasting Implications for Real and Nominal Exchange Rates 867

APPLICATION Real Exchange Rates in Emerging Markets 869

Conclusion 871

# 2 Exchange Rates in the Short Run: Deviations from Uncovered Interest Parity 871

APPLICATION The Carry Trade 871

APPLICATION Peso Problems 874

HEADLINES Mrs. Watanabe's Hedge Fund 875

The Efficient Markets Hypothesis 878

Limits to Arbitrage 880

Conclusion 884

#### 3 Debt and Default 884

A Few Peculiar Facts About Sovereign Debt 885

A Model of Default, Part One: The Probability of Default 886

APPLICATION Is There Profit in Lending to Developing Countries? 891

A Model of Default, Part Two: Loan Supply and Demand 893

APPLICATION The Costs of Default 896

Conclusion 899

APPLICATION The Argentina Crisis of 2001–2002 900

# 4 The Global Macroeconomy and the 2007-2013 Crisis 903

Backdrop to the Crisis 903

HEADLINES Is the IMF "Pathetic"? 904

Panic and the Great Recession 910

Conclusion: Lessons for Macroeconomics 921

Key Points, Key Terms, and Problems

#### Index I-1