

Mathematical Postscripts	764
Postscript to Chapter 5: The Factor-Proportions Model	764
Postscript to Chapter 6: The Trading World Economy	768
Postscript to Chapter 8: The Monopolistic Competition Model	776
Postscript to Chapter 20: Risk Aversion and International Portfolio Diversification	778
Index	785
Credits	C-1



Contents

Preface	19
---------	----

1 Introduction 29

What Is International Economics About?	31
The Gains from Trade	32
The Pattern of Trade	33
How Much Trade?	33
Balance of Payments	34
Exchange Rate Determination	35
International Policy Coordination	35
The International Capital Market	36
International Economics: Trade and Money	37

PART 1 International Trade Theory 38

2 World Trade: An Overview 38

Who Trades with Whom?	38
Size Matters: The Gravity Model	39
Using the Gravity Model: Looking for Anomalies	41
Impediments to Trade: Distance, Barriers, and Borders	42
The Changing Pattern of World Trade	44
Has the World Gotten Smaller?	44
What Do We Trade?	46
Service Offshoring	47
Do Old Rules Still Apply?	49
Summary	50

3 Labor Productivity and Comparative Advantage: The Ricardian Model 52

The Concept of Comparative Advantage	53
A One-Factor Economy	54
Relative Prices and Supply	56
Trade in a One-Factor World	57
Determining the Relative Price after Trade	58
BOX: Comparative Advantage in Practice: The Case of Usain Bolt	61
The Gains from Trade	62
A Note on Relative Wages	63
BOX: Economic Isolation and Autarky over Time and Space	64
Misconceptions about Comparative Advantage	65
Productivity and Competitiveness	65
BOX: Do Wages Reflect Productivity?	66
The Pauper Labor Argument	67
Exploitation	67
Comparative Advantage with Many Goods	68
Setting Up the Model	68
Relative Wages and Specialization	68
Determining the Relative Wage in the Multigood Model	70

Adding Transport Costs and Nontraded Goods.....	72
Empirical Evidence on the Ricardian Model	73
Summary	76
4 Specific Factors and Income Distribution	79
The Specific Factors Model.....	80
BOX: What Is a Specific Factor?	81
Assumptions of the Model.....	81
Production Possibilities	82
Prices, Wages, and Labor Allocation	85
Relative Prices and the Distribution of Income.....	89
International Trade in the Specific Factors Model	91
Income Distribution and the Gains from Trade	92
The Political Economy of Trade: A Preliminary View.....	95
Income Distribution and Trade Politics.....	96
CASE STUDY: Trade and Unemployment	96
International Labor Mobility	100
CASE STUDY: Wage Convergence in the European Union	102
CASE STUDY: Immigration and the U.S. Economy: Future Prospects	104
Summary	107
5 Resources and Trade: The Heckscher-Ohlin Model	115
Model of a Two-Factor Economy	116
Prices and Production	116
Choosing the Mix of Inputs	119
Factor Prices and Goods Prices.....	121
Resources and Output	124
Effects of International Trade between Two-Factor Economies.....	125
Relative Prices and the Pattern of Trade.....	126
Trade and the Distribution of Income.....	127
CASE STUDY: North-South Trade and Income Inequality	128
Skill-Biased Technological Change and Income Inequality	130
BOX: The Declining Labor Share of Income and Capital-Skill Complementarity	134
Factor-Price Equalization.....	135
Empirical Evidence on the Heckscher-Ohlin Model	136
Trade in Goods as a Substitute for Trade in Factors: Factor Content of Trade	137
Patterns of Exports between Developed and Developing Countries.....	140
Implications of the Tests	142
Summary	143
6 The Standard Trade Model	151
A Standard Model of a Trading Economy	152
Production Possibilities and Relative Supply	152
Relative Prices and Demand.....	153
The Welfare Effect of Changes in the Terms of Trade.....	156
Determining Relative Prices	157
CASE STUDY: Unequal Gains from Trade across the Income Distribution	157
Economic Growth: A Shift of the <i>RS</i> Curve	160
Growth and the Production Possibility Frontier.....	160
World Relative Supply and the Terms of Trade.....	162
International Effects of Growth	163

CASE STUDY: Has the Growth of Newly Industrialized Economies Hurt Advanced Nations?	164
Tariffs and Export Subsidies: Simultaneous Shifts in <i>RS</i> and <i>RD</i>	166
Relative Demand and Supply Effects of a Tariff	166
Effects of an Export Subsidy.....	167
Implications of Terms of Trade Effects: Who Gains and Who Loses?.....	168
International Borrowing and Lending	169
Intertemporal Production Possibilities and Trade.....	169
The Real Interest Rate.....	170
Intertemporal Comparative Advantage	172
Summary	172
7 External Economies of Scale and the International Location of Production	179
Economies of Scale and International Trade: An Overview	180
Economies of Scale and Market Structure.....	181
The Theory of External Economies.....	182
Specialized Suppliers.....	182
Labor Market Pooling	183
Knowledge Spillovers.....	184
External Economies and Market Equilibrium	185
External Economies and International Trade.....	186
External Economies, Output, and Prices	186
External Economies and the Pattern of Trade.....	187
BOX: Holding the World Together	189
Trade and Welfare with External Economies	190
Dynamic Increasing Returns	191
Interregional Trade and Economic Geography.....	192
BOX: Soccer and the English Premiere League	194
Summary	195
8 Firms in the Global Economy: Export Decisions, Outsourcing, and Multinational Enterprises	198
The Theory of Imperfect Competition	199
Monopoly: A Brief Review	200
Monopolistic Competition.....	202
Monopolistic Competition and Trade	207
The Effects of Increased Market Size.....	207
Gains from an Integrated Market: A Numerical Example.....	208
The Significance of Intra-Industry Trade.....	212
CASE STUDY: Automobile Intra-Industry Trade within ASEAN-4: 1998–2002	214
Firm Responses to Trade: Winners, Losers, and Industry Performance	215
Performance Differences across Producers	216
The Effects of Increased Market Size	218
Trade Costs and Export Decisions.....	220
Dumping.....	222
CASE STUDY: Antidumping as Protectionism	223
Multinationals and Outsourcing	225
CASE STUDY: Patterns of Foreign Direct Investment Flows around the World	225

The Firm's Decision Regarding Foreign Direct Investment 229
 Outsourcing 230
BOX: Whose Trade Is It? 231
CASE STUDY: Shipping Jobs Overseas? Offshoring and Labor Market Outcomes
 in Germany 233
 Consequences of Multinationals and Foreign Outsourcing 236
 Summary 237

PART 2 International Trade Policy 243

9 The Instruments of Trade Policy 243

Basic Tariff Analysis 243
 Supply, Demand, and Trade in a Single Industry 244
 Effects of a Tariff 246
 Measuring the Amount of Protection 247
Costs and Benefits of a Tariff 249
 Consumer and Producer Surplus 249
 Measuring the Costs and Benefits 251
BOX: Tariffs and Retaliation 253
Other Instruments of Trade Policy 255
 Export Subsidies: Theory 255
CASE STUDY: Europe's Common Agricultural Policy 256
 Import Quotas: Theory 257
CASE STUDY: Tariff-Rate Quota Origin and its Application in Practice with Oilseeds 258
 Voluntary Export Restraints 262
CASE STUDY: A Voluntary Export Restraint in Practice 262
 Local Content Requirements 263
BOX: Healthcare Protection with Local Content Requirements 264
 Other Trade Policy Instruments 265
The Effects of Trade Policy: A Summary 265
 Summary 266

10 The Political Economy of Trade Policy 274

The Case for Free Trade 275
 Free Trade and Efficiency 275
 Additional Gains from Free Trade 276
 Rent Seeking 277
 Political Argument for Free Trade 277
National Welfare Arguments against Free Trade 278
 The Terms of Trade Argument for a Tariff 278
 The Domestic Market Failure Argument against Free Trade 279
 How Convincing Is the Market Failure Argument? 281
Income Distribution and Trade Policy 282
 Electoral Competition 283
 Collective Action 284
BOX: Politicians for Sale: Evidence from the 1990s 285
 Modeling the Political Process 286
 Who Gets Protected? 286
International Negotiations and Trade Policy 288
 The Advantages of Negotiation 289
 International Trade Agreements: A Brief History 290
 The Uruguay Round 292

Trade Liberalization 292
 Administrative Reforms: From the GATT to the WTO 293
 Benefits and Costs 294
BOX: Settling a Dispute—And Creating One 295
CASE STUDY: Testing the WTO's Metal 296
The End of Trade Agreements? 297
BOX: Do Agricultural Subsidies Hurt the Third World? 298
 Preferential Trading Agreements 299
BOX: Free Trade Area Versus Customs Union 300
BOX: Brexit 301
CASE STUDY: Trade Diversion in South America 302
 The Trans-Pacific Partnership 303
 Summary 304

11 Trade Policy in Developing Countries 311

Import-Substituting Industrialization 312
 The Infant Industry Argument 312
 Promoting Manufacturing through Protection 314
CASE STUDY: Export-Led Strategy 316
Results of Favoring Manufacturing: Problems of Import-Substituting Industrialization 317
Trade Liberalization since 1985 319
Trade and Growth: Takeoff in Asia 321
BOX: India's Boom 323
 Summary 324

12 Controversies in Trade Policy 326

Sophisticated Arguments for Activist Trade Policy 327
 Technology and Externalities 327
 Imperfect Competition and Strategic Trade Policy 330
BOX: A Warning from Intel's Founder 332
CASE STUDY: When the Chips Were Up 333
Globalization and Low-Wage Labor 335
 The Anti-Globalization Movement 335
 Trade and Wages Revisited 336
 Labor Standards and Trade Negotiations 338
 Environmental and Cultural Issues 338
 The WTO and National Independence 339
CASE STUDY: A Tragedy in Bangladesh 340
Globalization and the Environment 341
 Globalization, Growth, and Pollution 341
 The Problem of "Pollution Havens" 343
 The Carbon Tariff Dispute 344
Trade Shocks and Their Impact on Communities 345
 Summary 346

PART 3 Exchange Rates and Open-Economy Macroeconomics 349

13 National Income Accounting and the Balance of Payments 349

The National Income Accounts 351
 National Product and National Income 352

Capital Depreciation and International Transfers.....	353
Gross Domestic Product	353
National Income Accounting for an Open Economy.....	354
Consumption	354
Investment.....	354
Government Purchases.....	355
The National Income Identity for an Open Economy.....	355
An Imaginary Open Economy.....	356
The Current Account and Foreign Indebtedness.....	356
Saving and the Current Account	358
Private and Government Saving	359
BOX: The Mystery of the Missing Deficit.....	360
The Balance of Payments Accounts.....	362
Examples of Paired Transactions	363
The Fundamental Balance of Payments Identity.....	364
The Current Account, Once Again.....	365
The Capital Account	366
The Financial Account.....	366
Statistical Discrepancy	367
Official Reserve Transactions	368
CASE STUDY: The Assets and Liabilities of the World's Biggest Debtor	369
Summary	373
14 Exchange Rates and the Foreign Exchange Market: An Asset Approach	378
Exchange Rates and International Transactions	379
Domestic and Foreign Prices.....	379
Exchange Rates and Relative Prices.....	381
The Foreign Exchange Market.....	382
The Actors	382
BOX: Exchange Rates, Auto Prices, and Currency Wars.....	383
Characteristics of the Market.....	384
Spot Rates and Forward Rates	386
Foreign Exchange Swaps.....	387
Futures and Options	387
The Demand for Foreign Currency Assets.....	388
Assets and Asset Returns	388
BOX: Offshore Currency Markets: The Case of the Chinese Yuan	389
Risk and Liquidity	391
Interest Rates	392
Exchange Rates and Asset Returns	392
A Simple Rule	394
Return, Risk, and Liquidity in the Foreign Exchange Market.....	395
Equilibrium in the Foreign Exchange Market	396
Interest Parity: The Basic Equilibrium Condition	396
How Changes in the Current Exchange Rate Affect Expected Returns	397
The Equilibrium Exchange Rate	399
Interest Rates, Expectations, and Equilibrium.....	401
The Effect of Changing Interest Rates on the Current Exchange Rate.....	401
The Effect of Changing Expectations on the Current Exchange Rate.....	403
CASE STUDY: What Explains the Carry Trade?	403
Summary	406

15 Money, Interest Rates, and Exchange Rates	414
Money Defined: A Brief Review	415
Money as a Medium of Exchange.....	415
Money as a Unit of Account.....	415
Money as a Store of Value	416
What Is Money?	416
How the Money Supply Is Determined	416
The Demand for Money by Individuals	417
Expected Return.....	417
Risk.....	418
Liquidity	418
Aggregate Money Demand.....	418
The Equilibrium Interest Rate: The Interaction of Money Supply and Demand.....	420
Equilibrium in the Money Market	421
Interest Rates and the Money Supply.....	422
Output and the Interest Rate.....	423
The Money Supply and the Exchange Rate in the Short Run.....	424
Linking Money, the Interest Rate, and the Exchange Rate	424
U.S. Money Supply and the Dollar/Euro Exchange Rate	427
Europe's Money Supply and the Dollar/Euro Exchange Rate	427
Money, the Price Level, and the Exchange Rate in the Long Run	430
Money and Money Prices.....	430
The Long-Run Effects of Money Supply Changes	431
Empirical Evidence on Money Supplies and Price Levels.....	432
Money and the Exchange Rate in the Long Run	433
Inflation and Exchange Rate Dynamics.....	434
Short-Run Price Rigidity versus Long-Run Price Flexibility	434
BOX: Money Supply Growth and Hyperinflation in Zimbabwe.....	436
Permanent Money Supply Changes and the Exchange Rate.....	438
Exchange Rate Overshooting	441
CASE STUDY: Inflation Targeting and Exchange Rate in Emerging Countries	441
Summary	444
16 Price Levels and the Exchange Rate in the Long Run	449
The Law of One Price.....	450
Purchasing Power Parity.....	451
The Relationship between PPP and the Law of One Price	451
Absolute PPP and Relative PPP	452
A Long-Run Exchange Rate Model Based on PPP.....	453
The Fundamental Equation of the Monetary Approach.....	453
Ongoing Inflation, Interest Parity, and PPP	455
The Fisher Effect.....	456
Empirical Evidence on PPP and the Law of One Price	459
Explaining the Problems with PPP.....	461
Trade Barriers and Nontradables	461
Departures from Free Competition	462
Differences in Consumption Patterns and Price Level Measurement.....	463
BOX: Measuring and Comparing Countries' Wealth Worldwide: The International Comparison Program (ICP)	463
PPP in the Short Run and in the Long Run.....	466
CASE STUDY: Why Price Levels Are Lower in Poorer Countries	467
Beyond Purchasing Power Parity: A General Model of Long-Run Exchange Rates.....	469

The Real Exchange Rate..... 469
 Demand, Supply, and the Long-Run Real Exchange Rate..... 471
BOX: Sticky Prices and the Law of One Price: Evidence from Scandinavian Duty-Free Shops 472
 Nominal and Real Exchange Rates in Long-Run Equilibrium..... 474
International Interest Rate Differences and the Real Exchange Rate..... 476
Real Interest Parity..... 477
Summary..... 479

17 Output and the Exchange Rate in the Short Run 487

Determinants of Aggregate Demand in an Open Economy..... 488
 Determinants of Consumption Demand..... 488
 Determinants of the Current Account..... 489
 How Real Exchange Rate Changes Affect the Current Account..... 490
 How Disposable Income Changes Affect the Current Account..... 491
The Equation of Aggregate Demand..... 491
 The Real Exchange Rate and Aggregate Demand..... 491
 Real Income and Aggregate Demand..... 492
How Output Is Determined in the Short Run..... 493
Output Market Equilibrium in the Short Run: The DD Schedule..... 494
 Output, the Exchange Rate, and Output Market Equilibrium..... 494
 Deriving the DD Schedule..... 495
 Factors That Shift the DD Schedule..... 496
Asset Market Equilibrium in the Short Run: The AA Schedule..... 499
 Output, the Exchange Rate, and Asset Market Equilibrium..... 499
 Deriving the AA Schedule..... 501
 Factors That Shift the AA Schedule..... 501
Short-Run Equilibrium for an Open Economy: Putting the DD and AA Schedules Together..... 502
Temporary Changes in Monetary and Fiscal Policy..... 504
 Monetary Policy..... 505
 Fiscal Policy..... 505
 Policies to Maintain Full Employment..... 506
Inflation Bias and Other Problems of Policy Formulation..... 508
Permanent Shifts in Monetary and Fiscal Policy..... 509
 A Permanent Increase in the Money Supply..... 509
 Adjustment to a Permanent Increase in the Money Supply..... 510
 A Permanent Fiscal Expansion..... 512
Macroeconomic Policies and the Current Account..... 513
Gradual Trade Flow Adjustment and Current Account Dynamics..... 515
 The J-Curve..... 515
 Exchange Rate Pass-Through and Inflation..... 516
 The Current Account, Wealth, and Exchange Rate Dynamics..... 517
BOX: Understanding Pass-Through to Import and Export Prices..... 518
The Liquidity Trap..... 519
CASE STUDY: How Big Is the Government Spending Multiplier?..... 522
Summary..... 524

18 Fixed Exchange Rates and Foreign Exchange Intervention 534

Why Study Fixed Exchange Rates?..... 535
Central Bank Intervention and the Money Supply..... 536
 The Central Bank Balance Sheet and the Money Supply..... 536
 Foreign Exchange Intervention and the Money Supply..... 538

Sterilization..... 539
 The Balance of Payments and the Money Supply..... 539
How the Central Bank Fixes the Exchange Rate..... 540
 Foreign Exchange Market Equilibrium under a Fixed Exchange Rate..... 541
 Money Market Equilibrium under a Fixed Exchange Rate..... 541
 A Diagrammatic Analysis..... 542
Stabilization Policies with a Fixed Exchange Rate..... 543
 Monetary Policy..... 544
 Fiscal Policy..... 545
 Changes in the Exchange Rate..... 546
 Adjustment to Fiscal Policy and Exchange Rate Changes..... 547
Balance of Payments Crises and Capital Flight..... 548
Managed Floating and Sterilized Intervention..... 551
 Perfect Asset Substitutability and the Ineffectiveness of Sterilized Intervention..... 551
CASE STUDY: Can Markets Attack a Strong Currency? The Case of Switzerland..... 552
 Foreign Exchange Market Equilibrium under Imperfect Asset Substitutability..... 555
 The Effects of Sterilized Intervention with Imperfect Asset Substitutability..... 555
 Evidence on the Effects of Sterilized Intervention..... 557
Reserve Currencies in the World Monetary System..... 558
 The Mechanics of a Reserve Currency Standard..... 558
 The Asymmetric Position of the Reserve Center..... 559
The Gold Standard..... 560
 The Mechanics of a Gold Standard..... 560
 Symmetric Monetary Adjustment under a Gold Standard..... 560
 Benefits and Drawbacks of the Gold Standard..... 561
 The Bimetallic Standard..... 562
 The Gold Exchange Standard..... 562
CASE STUDY: The Cost to Become an International Currency: The Renminbi Case..... 563
Summary..... 567

PART 4 International Macroeconomic Policy 579

19 International Monetary Systems: An Historical Overview 579

Macroeconomic Policy Goals in an Open Economy..... 580
 Internal Balance: Full Employment and Price Level Stability..... 581
 External Balance: The Optimal Level of the Current Account..... 582
BOX: Can a Country Borrow Forever? The Case of New Zealand..... 584
Classifying Monetary Systems: The Open-Economy Monetary Trilemma..... 588
International Macroeconomic Policy under the Gold Standard, 1870–1914..... 589
 Origins of the Gold Standard..... 590
 External Balance under the Gold Standard..... 590
 The Price-Specie-Flow Mechanism..... 591
 The Gold Standard “Rules of the Game”: Myth and Reality..... 592
 Internal Balance under the Gold Standard..... 592
CASE STUDY: The Political Economy of Exchange Rate Regimes: Conflict over America’s Monetary Standard during the 1890s..... 593
The Interwar Years, 1918–1939..... 595
 The Fleeting Return to Gold..... 595
 International Economic Disintegration..... 596
CASE STUDY: The International Gold Standard and the Great Depression..... 597
The Bretton Woods System and the International Monetary Fund..... 598
 Goals and Structure of the IMF..... 598

Convertibility and the Expansion of Private Financial Flows 599
 Speculative Capital Flows and Crises 600
Analyzing Policy Options for Reaching Internal and External Balance 601
 Maintaining Internal Balance 602
 Maintaining External Balance 603
 Expenditure-Changing and Expenditure-Switching Policies 604
The External Balance Problem of the United States under Bretton Woods..... 605
CASE STUDY: The End of Bretton Woods, Worldwide Inflation, and the Transition to
Floating Rates..... 606
 The Mechanics of Imported Inflation 608
 Assessment 609
The Case for Floating Exchange Rates..... 610
 Monetary Policy Autonomy 610
 Symmetry 611
 Exchange Rates as Automatic Stabilizers 612
 Exchange Rates and External Balance 614
CASE STUDY: The First Years of Floating Rates, 1973–1990 614
 Macroeconomic Interdependence under a Floating Rate 619
CASE STUDY: Transformation and Crisis in the World Economy 620
CASE STUDY: The Dangers of Deflation 626
What Has Been Learned Since 1973? 628
 Monetary Policy Autonomy 628
 Symmetry 630
 The Exchange Rate as an Automatic Stabilizer 630
 External Balance 631
 The Problem of Policy Coordination 631
Are Fixed Exchange Rates Even an Option for Most Countries? 632
Summary 633

20 Financial Globalization: Opportunity and Crisis 642

The International Capital Market and the Gains from Trade 643
 Three Types of Gain from Trade 643
 Risk Aversion 644
 Portfolio Diversification as a Motive for International Asset Trade 645
 The Menu of International Assets: Debt versus Equity 646
International Banking and the International Capital Market 647
 The Structure of the International Capital Market 647
 Offshore Banking and Offshore Currency Trading 648
 The Shadow Banking System 649
Banking and Financial Fragility 650
 The Problem of Bank Failure 650
 Government Safeguards against Financial Instability 652
 Moral Hazard and the Problem of “Too Big to Fail” 655
BOX: Does the IMF Cause Moral Hazard?..... 656
The Challenge of Regulating International Banking 657
 The Financial Trilemma 658
 International Regulatory Cooperation through 2007 659
CASE STUDY: The Global Financial Crisis of 2007–2009 660
BOX: Foreign Exchange Instability and Central Bank Swap Lines 663
 International Regulatory Initiatives after the Global Financial Crisis 665
How Well Have International Financial Markets Allocated
Capital and Risk? 667

The Extent of International Portfolio Diversification 668
 The Extent of Intertemporal Trade 670
 Onshore-Offshore Interest Differentials 671
 The Efficiency of the Foreign Exchange Market 671
Summary 676

21 Optimum Currency Areas and the Euro 681

How the European Single Currency Evolved 683
 What Has Driven European Monetary Cooperation? 683
BOX: Brexit 684
 The European Monetary System, 1979–1998 686
 German Monetary Dominance and the Credibility Theory of the EMS 687
 Market Integration Initiatives 689
 European Economic and Monetary Union 689
The Euro and Economic Policy in the Euro Zone 690
 The Maastricht Convergence Criteria and the Stability and Growth Pact 691
 The European Central Bank and the Eurosystem 692
 The Revised Exchange Rate Mechanism 692
The Theory of Optimum Currency Areas 693
 Economic Integration and the Benefits of a Fixed Exchange Rate Area:
 The *GG* Schedule 693
 Economic Integration and the Costs of a Fixed Exchange Rate Area:
 The *LL* Schedule 695
 The Decision to Join a Currency Area: Putting the *GG* and *LL* Schedules Together 698
 What Is an Optimum Currency Area? 699
 Other Important Considerations 699
CASE STUDY: Is Europe an Optimum Currency Area?..... 701
The Euro Crisis and the Future of EMU..... 704
 Origins of the Crisis 704
 Self-Fulfilling Government Default and the “Doom Loop” 710
 A Broader Crisis and Policy Responses 712
 ECB Outright Monetary Transactions 713
 The Future of EMU 714
Summary 715

22 Developing Countries: Growth, Crisis, and Reform 720

Income, Wealth, and Growth in the World Economy 721
 The Gap between Rich and Poor 721
 Has the World Income Gap Narrowed Over Time? 722
 The Importance of Developing Countries for Global Growth 724
Structural Features of Developing Countries 725
BOX: The Commodity Supercycle..... 727
Developing-Country Borrowing and Debt 730
 The Economics of Financial Inflows to Developing Countries 731
 The Problem of Default 732
 Alternative Forms of Financial Inflow 734
 The Problem of “Original Sin” 735
 The Debt Crisis of the 1980s 737
 Reforms, Capital Inflows, and the Return of Crisis 738
East Asia: Success and Crisis 741
 The East Asian Economic Miracle 742
BOX: Why Have Developing Countries Accumulated Such High Levels
of International Reserves? 742

Asian Weaknesses.....	744
BOX: What Did East Asia Do Right?.....	746
The Asian Financial Crisis.....	747
Lessons of Developing-Country Crises.....	748
Reforming the World's Financial "Architecture".....	749
Capital Mobility and the Trilemma of the Exchange Rate Regime.....	750
"Prophylactic" Measures.....	752
Coping with Crisis.....	753
Understanding Global Capital Flows and the Global Distribution of Income:	
Is Geography Destiny?.....	754
BOX: Capital Paradoxes.....	755
Summary.....	759
Mathematical Postscripts.....	764
Postscript to Chapter 5: The Factor-Proportion Model.....	764
Factor Prices and Costs.....	764
Goods Prices and Factor Prices.....	766
Factor Supplies and Outputs.....	767
Postscript to Chapter 6: The Trading World Economy.....	768
Supply, Demand, and Equilibrium.....	768
Supply, Demand, and the Stability of Equilibrium.....	770
Effects of Changes in Supply and Demand.....	772
Economic Growth.....	772
A Transfer of Income.....	773
A Tariff.....	774
Postscript to Chapter 8: The Monopolistic Competition Model.....	776
Postscript to Chapter 20: Risk Aversion and International Portfolio Diversification.....	778
An Analytical Derivation of the Optimal Portfolio.....	778
A Diagrammatic Derivation of the Optimal Portfolio.....	779
The Effects of Changing Rates of Return.....	781
Index.....	785
Credits.....	C-1
ONLINE APPENDICES (www.pearsonglobaleditions.com/Krugman)	
Appendix A to Chapter 6: International Transfers of Income and the Terms of Trade	
The Transfer Problem	
Effects of a Transfer on the Terms of Trade	
Presumptions about the Terms of Trade Effects of Transfers	
Appendix B to Chapter 6: Representing International Equilibrium with Offer Curves	
Deriving a Country's Offer Curve	
International Equilibrium	
Appendix A to Chapter 9: Tariff Analysis in General Equilibrium	
A Tariff in a Small Country	
A Tariff in a Large Country	
Appendix A to Chapter 17: The IS-LM Model and the DD-AA Model	
Appendix A to Chapter 18: The Monetary Approach to the Balance of Payments	

Preface

Years after the global financial crisis that broke out in 2007–2008, the world economy is still afflicted by tepid economic growth and, for many people, stagnating incomes. The United States has more or less returned to full employment, but it is growing more slowly than it did before the crisis. Nonetheless, it has been relatively fortunate. Europe's common currency project faces continuing strains and the European Union is itself under stress, given Britain's June 2016 vote to withdraw and a surge in anti-immigration sentiment. Japan continues to face deflation pressures and a sky-high level of public debt. Emerging markets, despite impressive income gains in many cases, remain vulnerable to the ebb and flow of global capital and the ups and downs of world commodity prices. Uncertainty weighs on investment globally, driven not least by worries about the future of the liberal international trade regime built up so painstakingly after World War II.

This eleventh edition therefore comes out at a time when we are more aware than ever before of how events in the global economy influence each country's economic fortunes, policies, and political debates. The world that emerged from World War II was one in which trade, financial, and even communication links between countries were limited. Nearly two decades into the 21st century, however, the picture is very different. Globalization has arrived, big time. International trade in goods and services has expanded steadily over the past six decades thanks to declines in shipping and communication costs, globally negotiated reductions in government trade barriers, the widespread outsourcing of production activities, and a greater awareness of foreign cultures and products. New and better communications technologies, notably the Internet, have revolutionized the way people in all countries obtain and exchange information. International trade in financial assets such as currencies, stocks, and bonds has expanded at a much faster pace even than international product trade. This process brings benefits for owners of wealth but also creates risks of contagious financial instability. Those risks were realized during the recent global financial crisis, which spread quickly across national borders and has played out at huge cost to the world economy. Of all the changes on the international scene in recent decades, however, perhaps the biggest one remains the emergence of China—a development that is already redefining the international balance of economic and political power in the coming century.

Imagine how astonished the generation that lived through the depressed 1930s as adults would have been to see the shape of today's world economy! Nonetheless, the economic concerns that drive international debate have not changed that much from those that dominated the 1930s, nor indeed since they were first analyzed by economists more than two centuries ago. What are the merits of free trade among nations compared with protectionism? What causes countries to run trade surpluses or deficits with their trading partners, and how are such imbalances resolved over time? What causes banking and currency crises in open economies, what causes financial contagion between economies, and how should governments handle international financial instability? How can governments avoid unemployment and inflation, what role do exchange rates play in their efforts, and how can countries best cooperate to achieve their economic goals? As always in international economics, the interplay of events and ideas has led to new modes of analysis. In turn, these analytical advances, however abstruse they may seem at first, ultimately do end up playing a major role in governmental policies, in international negotiations, and in people's everyday lives. Globalization has made