International Economics

ECO320 Study Guide

Faculty of Commerce

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A general introduction to the Study Guide


Given the vastness of the subject matter coming under international economics, we are unable to cover all the material in the text book within a one-session course. Therefore, selected core chapters, and in certain cases only selected sections of the core chapters, are covered in this subject.

**We also skip all the appendices in the text book.** This is because the purpose of most of the appendices is to clarify the details of, or provide proof for, some of the aspects included within a chapter in a more advanced form, often using complex graphical and mathematical derivations.

You should read, re-read and thoroughly understand the contents of the relevant sections (including case studies, chapter summaries and glossaries) of the text book in light of this Study Guide. It is also very important that you practise the diagrams and calculations given in the relevant sections of the text book.

This Study Guide is not intended to be a substitute for the text book. The Study Guide provides directions for you to study the material covered in each section of the relevant chapters in Salvatore text.

Some **focus questions** are indicated at the end of each topic in this Study Guide. These questions are from the text book in which two types of questions are given at the end of each chapter: **Questions for Review** and **Problems**. You are urged to attempt answering the focus questions once you have completed reading for each topic. Answers to some of the **Problems** type questions are given at the end of the text book. However, you should understand the details of how these answers are arrived at.

Your prescribed text is comprehensive enough in its treatment of the subject. Therefore, the two recommended text books, Lindert (1991) and Root (1990) [see the Subject Outline], should be consulted only if you feel that you need an alternative description of a particular topic.

The additional **Readings** for each topic, indicated in the Study Guide, are those included in the accompanied volume of *READINGS*. These Readings are provided with a view to giving you a wider perspective with regard to historical, policy and practical aspects of the subject. Some of these readings give you an Australian perspective on certain topics.

The study of international economics requires a familiarity with principles of microeconomics and macroeconomics (your prerequisite subjects). It is, therefore, essential that you revise and renew your knowledge of these principles where necessary, reading an economic principles text book such as: Jackson, J. and McConnell, C.R. *Economics*, 3rd edition, McGraw-Hill, 1988.
Learning objectives

Your specific learning objective is to understand the concepts, theories and policy issues presented in the relevant sections of the Salvatore text sufficiently well, to be able to answer the focus questions indicated at the end of each topic in this Study Guide.

You will find that International Economics is a challenging but interesting and rewarding subject. I hope that this subject will help you to understand the current issues relating to international trade and finance in an in-depth and more systematic manner. Finally, I wish you all the best in achieving the results you desire at the end of your course of studies.

Reading list for ECO320

Topic 1
- Salvatore, Chapter 1
- Reading 1: Root, pp. 1-10 and 30-32
- Reading 2: Helpman, pp. 121-144
- Reading 3: INDECS, pp. 152-160

Topic 2
- Salvatore, Chapter 2
- Reading 4: Article on Porter’s theory from The Australian, 8 Sept. 92

Topic 3
- Salvatore, Chapter 3 and Sections 4.2 and 4.6 in Chapter 4

Topic 4
- Salvatore, Chapter 5
  (except section 5.6)

Topic 5
- Salvatore, Section 5.6 (except 5.6c) in Chapter 5 and Sections 6.1, 6.2, 6.3, 6.4 and 6.5 in Chapter 6
**Topic 6**
- Salvatore, Sections 8.1, 8.2 and 8.3 in Chapter 8 and Sections 9.1, 9.2, 9.3 and 9.4 in Chapter 9
- **Reading 5**: Bhagwati, pp. 43-59
- **Reading 6**: Krueger, pp. 2497-2546
- **Reading 7**: Dani, pp. 2925-2972
- **Reading 8**: Baldwin, pp. 119-135
- **Reading 9**: Curran, Freeman and Sterland, pp. 147-156

**Topic 7**
- Salvatore, Sections 9.5 and 9.6 in Chapter 9
- **Reading 10**: Anderson and Garnaut, pp. 6-12
- **Reading 11**: Clark, pp. 141-151.
- **Reading 12**: Dyster and Meredith, pp. 295-298
- **Reading 13**: INDECS, pp. 285-293
- **Reading 14**: Greig, pp. 94-107
- **Reading 15**: Khor
- **Reading 16**: IMF Staff

**Topic 8**
- Salvatore, Chapters 14 and 15
- **Reading 17**: Rogoff, pp. 21-42

**Topic 9**
- Salvatore, Chapter 13
- **Reading 18**: INDECS, pp. 87-110

**Topic 10**
- Salvatore, Chapter 16

**Topic 11**
- Salvatore, Chapter 16 (except Section 16.4);
- Section 17.1 in Chapter 17
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Topic 12

- Salvatore, Chapter 21
- **Reading 19:** Juttner, pp. 41-44
- **Reading 20:** Feldstein, pp. 1-7
Introduction

International economics deals with economic interdependence among nations. More specifically, it deals with the issues related to the theory of trade, trade policy, foreign exchange, balance of payments and the balance of payments adjustment mechanisms and policies.

The economic relations among nations differ from the economic relations among the various parts of a country. This gives rise to different problems, requiring somewhat different tools of analysis, and justifies international economics as a distinct and separate branch of applied economics. The study of international economics is, therefore, useful in our day to day lives as citizens as well as in carrying out our professional duties.

For example, when an Australian firm wants to export its product (say, wheat or meat) to EC countries, it faces certain restrictions (such as tariffs and non-tariff restrictions) imposed by these countries. It must also overcome differences in languages, customs and laws. In addition, the Australian firm may receive payment in the foreign currencies which will have to be converted into the Australian dollar. No such barriers are involved when this firm sells its product in the local markets. In order to analyse the different problems arising from international relations, we must modify, adopt, extend and integrate the microeconomic and macroeconomic tools appropriate for the analysis of purely domestic problems.

International economics covers the following areas (subject matter of international economics):

1. Pure theory of trade

This examines the basis for and the gains from trade.
2. Commercial policy

This studies the reasons for and the results of obstructions to the free flow of trade.

3. Balance of payments

This examines a nation’s total payments to and total receipts from the rest of the world. These involve the exchange of one currency for others.

4. Adjustments in the balance of payments

This deals with the mechanism of correcting balance of payments disequilibria under different international monetary systems.

Topics 1 and 2 (Pure Theory of International Trade and Commercial Policy) represent the microeconomic aspects of international economics and are covered in the first half of your textbook. Topics 3 and 4 (Balance of Payments and Adjustments in the Balance of Payments) are the macroeconomic aspects and are covered in the second part of the book.

You should study the following specific aspects in this Topic:

- Importance of International Economics (Reference: Salvatore, Section 1.1)
- International Trade and the Nations Standard of Living (Reference: Salvatore, Section 1.2)
- Subject Matter of International Economics (Reference: Salvatore, Section 1.3)
- Purpose of International Economic Theories (Reference, Salvatore, Section 1.4)

Before you proceed to the Topics which follow, read Salvatore Preface (Organisation of the Book).

Focus questions for Topic 1

From Salvatore, Chapter 1

Questions for Review: 2, 3, 4, 5 and 6

Problems: 1(a), 1(c), 4, 5
In Topics 2 to 5 we shall study the pure theory of international trade. In this Topic (Topic 2), we shall try to understand the answers to two basic questions that the pure theory of trade is concerned with. The first question is: What is the basis for trade and what are the gains from trade? The related questions to this first question are: How are the gains from trade generated? How large are the gains? How are the gains divided among trading nations? The second basic question is: What is the pattern of trade? Here we deal with the questions: What commodities are traded? and Which commodities are exported and imported by each nation?

The theory that has been developed by economists in their attempt to answer these questions is called the law of comparative advantage. This theory was first developed by David Ricardo. It was further developed on a firm foundation by Gottfried Haberler. Before discussing the law of comparative advantage, it is important to briefly review the ideas of mercantilism with regard to international trade and Adam Smith’s theory of absolute advantage.

The specific aspects that you should study in this Topic are:

- Mercantilists’ Views on Trade (Reference: Salvatore, Section 2.2)
- Trade Based on Absolute Advantage (Reference: Salvatore, Section 2.3)
- Trade Based on Comparative Advantage (Reference: Salvatore, Section 2.4)
- Comparative Advantage and Opportunity Costs (Reference: Salvatore, Section 2.5)
- The Basis for and the Gains from Trade Under Constant GS&S (Reference: Salvatore, Section 2.6)
Focus questions for Topic 2

From Salvatore, Chapter 2

Questions for Review: 1, 2, 5, 9

Problems: 1, 3, 5, 6, 7 and 8
**Topic 3**

**The standard theory of international trade, demand and supply curves and the terms of trade**

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**Read**  •  Salvatore, Chapter 3 and Sections 4.2, and 4.6 in Chapter 4

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**Introduction (Reference: Salvatore, Section 3.1)**

In the last section of Topic 2, you studied how the supply conditions determined the basis for and gains from trade in the case of constant opportunity costs. In Topic 3 we shall first examine the basis for and gains from trade applying the more realistic supply condition of *increasing opportunity costs* and incorporating demand conditions through community indifference curves. We shall then study the determination of export supply curves and import demand curves and equilibrium relative commodity prices, using partial equilibrium analysis. Finally, we shall introduce and define the concepts of the terms of trade.

You should study the following aspects under this topic:

- The Production Frontier with Increasing Costs (Reference: Salvatore, Section 3.2)
- Community Indifference Curves (Reference: Salvatore, Section 3.3)
- Equilibrium in Isolation (Reference: Salvatore, Section 3.4)
- The Basis for and the Gains from Trade with Increasing Costs (Reference: Salvatore, Section 3.5)
- Trade based on Differences in Tastes (Reference: Salvatore, Section 3.6)
- The Equilibrium Relative Commodity Prices with Trade - Partial Equilibrium Analysis (Reference: Salvatore, Section 4.2)
- The Terms of Trade (Reference: Salvatore, Sections 4.6).
Focus questions for Topic 3

From Salvatore, Chapter 3
Questions for Review: 1, 3, 8
Problems: 1, 9, 10

From Salvatore, Chapter 4
Questions for Review: 10
Problems: 1, 8, 12
Topic 4
Factor endowments and Heckscher-Ohlin theory

Introduction (Reference: Salvatore, Section 5.1)

In Topics 2 and 3 you studied the ‘classical trade model’. According to the classical trade model, differences in relative commodity prices between the two nations reflect their comparative advantage which forms the basis for mutually beneficial trade. Classical economists like Smith, Ricardo and John Stuart Mill contended that comparative advantage was based on the differences in productivity of labour among nations. But they offered no explanation of such differences in labour productivity, except for differences in climate.

The Heckscher-Ohlin (H-O) theory extends the classical trade model by examining what determines comparative advantage, relative commodity prices, gains from trade and the effect of trade on factor prices and income distribution. We shall not cover factor price and income distributional aspects of H-O theory in this subject.

The H-O Theory is based on a number of simplifying assumptions. According to this theorem, a nation will export the commodity whose production requires the intensive use of its relatively abundant and cheap factor and import the commodity whose production requires the intensive use of its relatively scarce and expensive factor.

The H-O Model holds that comparative advantage is determined by the underlying factor endowments of a country relative to endowments in the rest of the world.

In this Topic, you should study the following specific aspects in order to have a better understanding of the factor endowment and H-O Theory:

- Assumptions of the H-O Theory (Reference: Salvatore Section 5.2)
- Factor Intensity, Factor Abundance and the Shape of the Production Frontier (Reference: Salvatore, Section 5.3)
- Factor Endowments and the Heckscher-Ohlin Theory (Reference: Salvatore, Section 5.4).
Focus questions for Topic 4

From Salvatore, Chapter 5

Questions for Review: 1, 3, 4

Problems: 1, 2, 4
Topic 5

Leontief Paradox and complementary trade theories

Read

• Salvatore, Section 5.6 (except 5.6c) in Chapter 5 and Sections 6.1, 6.2, 6.3, 6.4 and 6.5 in Chapter 6.

Introduction (Reference: Salvatore, Section 6.1)

In Topic 4 you have seen that the H-O theory explains that comparative advantage is based on the differences in factor endowments in the two nations on the assumption that technology and tastes are the same in the two nations. (This is the major assumption of the theory). In Topic 5 we shall first study the earliest and well known empirical test of the H-O theory, the Leontief paradox.

In 1953, Wassily Leontief published the result of one of the most famous empirical investigations in economics, an attempt to test the consistency of the Heckscher-Ohlin-Samuelson model with the US trade patterns. Leontief found that US import substitutes were 30 percent more K-intensive than its exports. Since the US is the K-abundant nation, this finding of Leontief was the opposite of what the H-O model suggested and became known as the Leontief paradox. You will find Chapter 5 of your textbook covers the Leontief paradox in detail.

The specific aspects that you should study in Chapter 5 are:

• The Leontief paradox (Reference: Salvatore, Section 5.6a)

• Explanations of the Leontief Paradox (Ref: Salvatore, Section 5.6b)

Since the H-O theory does not explain a major portion of world trade today, several theories complementary to the H-O model have also been developed by economists. These complementary trade theories include trade based on economies of scale, trade based on differentiated products (intra-industry trade), and trade based on technological gaps and product cycles. We will also discuss these theories in this topic.
**Trade based on economies of scale**

According to the H-O model, trade between the two countries cannot take place if they are identical in every respect. However, in reality, even if they are identical mutually beneficial trade can take place, based on the benefits of economies of scale. When each nation specializes in the production of one commodity, the combined output of both commodities will be greater than without specialization due to the presence of economies of scale. The increased output then will be shared in the form of gain. Thus, international trade can be based on economies of scale.

**Intra-industry trade**

At the present time, a major portion of international trade involves the exchange of similar types of products. Such intra-industry trade arises in order to take advantage of economies of scale in production, which result when each firm produces only one or a few varieties of a product rather than many different varieties. The nation then imports other varieties from other countries. This type of trade is not discussed in the H-O model. Examples of intra-industry trade are not difficult to find in the real world. Computers made by IBM are exported to countries around the world at the same time that Americans import computers made by NEC, EPSON and other foreign companies.

**Trade based on technological gaps and product cycles**

Technological gap model is sketched by Posner in 1961. According to this theory, a firm exports a new product until imitators in other countries take away its market. In the meantime, the innovating firm will have introduced a new product or process and be able to export these products, based on the new technological gap established.

A generalized and extension of the technological gap model is the **product cycle model**. Accordingly this model a product goes through five stages:

- In Stage I, the product is produced and consumed only in the innovating country.
- In Stage II, production is expanded to meet the local and export demand.
- In Stage III, the product becomes standardized and the imitating country starts producing the product for domestic consumption.
- In Stage IV, the imitating country starts underselling the innovating country in third markets and
- In the final stage foreigners undersell the innovating firm in its home market.
You will find Chapter 6 of your text book examines these complementary trade theories in detail. The specific sections that you should study in this Chapter are:

- Economies of Scale and International Trade (Reference; Salvatore, Section 6.3)
- Imperfect Competition and International Trade (Section 6.4)
- Trade Based on Dynamic Technological Differences and Synthesis of Trade Theories (Section 6.5)

**Focus questions for Topic 5**

**Chapter 5**

Questions for Review: 4, 6, 10 and 11

**Chapter 6**

Questions for Review: 4, 5, 6, 10, 12

Problems: 10
Introduction (Reference: Salvatore, Sections 8.1 and 9.1)

In your study of pure theory of trade in Topics 2 through to 5, you saw that free trade maximises world output, while benefiting all nations participating in free trade. But almost all the nations in the world impose some restrictions on the free flow of international trade. Since these restrictions deal with commerce among nations, they are known as ‘commercial policies’. Trade restrictions or commercial policies are generally grouped into two broad groups: tariffs and non-tariff trade barriers (quotas, voluntary export restraints, technical and administrative regulations, international cartels, dumping and export subsidies).

**Tariff** is a tax imposed by a government either on exports or imports. The taxation of trade is probably as old as trade itself. There are three types of tariffs:

i. Ad valorem tariff,
ii. specific tariff and
iii. compound tariff.

The meaning and definition of these various types of tariffs are clearly stated in Section 8.1 of your text book. Chapter 8 of your textbook examines the effects of tariffs on the economy. For instance, tariffs have a **revenue effect**. That is, they are a mechanism for raising government revenue. They also have effects on **consumption, production and trade**. All these effects of tariffs are discussed in Section 8.2 of your textbook.

In this topic we will also discuss why the concept of effective protection is better than the nominal protection (tariff) and how it is calculated.

The specific aspects that you should study in Chapter 8 are:

- Introduction (Reference: Salvatore, Section 8.1)
- Partial Equilibrium Analysis of a Tariff (Reference: Salvatore 8.2)
- The Theory of Tariff Structure (Reference: Salvatore, Section 8.3)
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Apart from tariffs, a nation can also control the flow of trade through other forms of restrictions such as quotas, subsidies, cartels etc. Chapter 9 of your textbook examines the effects of import quotas and discusses various types of NTBs such as VER, technical, administrative and other regulations, cartels, dumping and export subsidies. You should thoroughly understand the meaning of these terms and think how they can influence the volume of trade. In this topic we shall also study the arguments for and against the trade restrictions.

You should cover the following aspects in Chapter 9:

- Import Quotas (Reference: Salvatore, Section 9.2)
- Other NTBs and New protectionism (Reference: Salvatore, Section 9.3)
- The Political Economy of Protection (Reference: Salvatore, Section 9.4)
- Strategic Trade & Industrial Policy (Reference: Salvatore, Section 9.5)

**Focus questions for Topic 6**

**From Salvatore, Chapter 8**

Questions for Review: 1, 4, 5, 6 and 7

Problems: 1, 2, 3

**From Salvatore, Chapter 9**

Questions for Review: 1, 2, 3, 4, 5, 8, 9

Problems: 1, 2
Topic 7

History of U.S. and Australian commercial policies, the GATT, the Uruguay Round and the WTO

Introduction

In this topic we shall briefly survey the history of commercial policies in the US and Australia from 1930s. We shall also discuss the international attempts to liberalise trade under the General Agreement on Tariffs and Trade (GATT) and World Trade Organisation (WTO).

GATT - which was created in 1947 to liberalise international trade - made remarkable achievements in reducing tariffs under the eight round of trade negotiations that it initiated. However, it was not very successful in removing non-tariff barriers (NTBs) and handling trade disputes. Hence, the last round of trade negotiations (known as the Uruguay Round) aimed to incorporate these as well as other issues under the GATT.

The Uruguay round of trade negotiation incorporated not only trade in goods but also in services, brought agriculture into the GATT and introduced rules for intellectual property. With the signing of the Uruguay Round Agreement on 15 August 1994 at Marrakash, the GATT was replaced with the WTO. The WTO came into operation from 1 January 1995 and has at its disposal a much stronger enforcement and dispute settlement mechanism than what prevailed under the GATT.

In this topic we shall discuss issues relating to WTO.

You should study the following specific aspects under this Topic:

- History of U.S. Commercial Policy and the GATT (Reference: Salvatore, Section 9.6)

- History of Australian Commercial Policy (Reference: Readings 10, 11 12 and 13)
• Outstanding Trade Problems and the Uruguay Round (Reference: Salvatore, Section 9.7 and Readings 14 and 15)

• Issues in Multilateral Trade Liberalisation and WTO (Reference: Readings 14, 15 and 16)

**Focus questions for Topic 7**

*From Salvatore, Chapter 9*

Questions for Review: 11, 12, 13 and 14
Introduction (Reference: Salvatore, Section 14.1)

The aspects covered in the previous Topics deal with the ‘real’ side of the international economy where the concern was with the international commodity trade and prices were mainly specified in terms of relative commodity prices. In the remaining Topics, we study the monetary aspects of international economies, or international finance. We shall bring money explicitly into the analysis; and commodity prices will be expressed in terms of domestic and foreign currency units.

In Topic 8, we shall study the foreign exchange markets and exchange rates. In Chapter 14 of Salvatore, definitions, participants and functions of foreign exchange markets are examined first. Next, under the heading of foreign exchange rates, definitions of foreign exchange rates, exchange rate determination, arbitrage, spot and forward exchange rates, and foreign exchange futures and options are considered. Foreign exchange risks, hedging and speculation are discussed next, followed by a study of interest arbitrage. Finally, there is an introduction to exchange rate theories in brief. Reading 16, discusses the nature and composition of the foreign exchange markets in Australia, while Reading 17 analyses the world financial markets. You must go through these Readings once you read the following sections from your textbook.

You should study the following specific aspects under this Topic:

- Functions of the Foreign Exchange Markets (Reference: Salvatore, Section 14.2)
- Foreign Exchange Rates (Reference: Salvatore, Section 14.3)
- Spot and Forward Rates, Currency Swaps, Futures and Options (Reference: Salvatore, Section 14.4)
- Foreign Exchange Risks, Hedging and Speculation (Reference: Salvatore, Section 14.5)
• Interest Arbitrage and the Efficiency of Foreign Exchange Markets
  (Reference: Salvatore, Section 14.6)

• Exchange Rate Determination (Reference: Salvatore, Chapter 15, Sections
  15.2A, 15.2B, 15.3C, 15.3D, 15.4A, 15.4C)

Focus questions for Topic 8

From Salvatore, Chapter 17

Questions for Review: 4, 5, 7, 8, 9 and 10

Problems: 3, 7, 9 and 10

From Salvatore, Chapter 15

Questions for Review: 2 and 9
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Topic 9
Balance of payments

Introduction (Reference: Salvatore, Section 13.1)

In Topics 10 to 12 you will study the mechanisms and policies for correcting balance-of-payment disequilibria and the history of the international monetary system. An understanding of foreign exchange markets and rates as well as the balance of payments is necessary to study the aspects covered in Topics 10 to 12. You studied the foreign exchange markets and rates in Topic 8. In Topic 9 you will study the balance of payments.

The balance of payments (BOP) is a summary statement of all the transactions of the residents of a nation with the rest of the world during a particular period of time, usually a year. For this reason it is particularly important for government authorities – treasuries, central banks and stabilization agencies – who are directly responsible for maintaining economic stability.

The BOP of a country may influence the trade and investment decisions of business people. An experienced investor or trader does not overlook the intimate bearing of the BOP upon the foreign exchange markets and the course of government policy. A domestic exporter may hesitate to deal with an importer if it is suspected that the authorities of the importer’s country will shortly tighten foreign exchange due to an adverse BOP condition. Foreign exchange brokers or dealers also pay close attention to the BOP of countries whose currencies they handle in daily transactions.

In BOP all international transfers are grouped into three major accounts: the current account, the capital account and the official reserve account. Since the BOP is a double-entry accounting statement, total debits always equal to total credits. An international transaction that increases a country’s assets or decreases its liabilities is a debit, while an international transaction that decreases a country’s assets or increases its liabilities is a credit entry.

Exports and imports of goods and services are recorded in the current account. Except for official reserve transfers, all financial transfers between a country and the rest of the world are placed in the capital account. Finally the international
reserve transfers of a country’s monetary authorities are recorded in the official reserve account.

Sources of disequilibrium in the BOP may be seasonal, cyclical, structural, speculation and capital flight.

The specific aspects that you should study under Topic 9 are:

- Definitions and purposes of the balance of payments (Reference: Salvatore, Section 13.1).
- Balance-of-Payments Accounting Principles (Reference: Salvatore, Section 13.2)
- Accounting Balances and Disequilibrium in International Transactions (Reference: Salvatore, Section 13.4)
- Brief Postwar Monetary History of the United States (Reference: Salvatore, Section 14.5)
- The International Investment Position of the United States (Reference: Salvatore, Section 13.6)
- The structure and the history of balance of payments and the international investment position of Australia (Readings 18 and 19).

**Focus questions for Topic 9**

**From Salvatore, Chapter 13**

Questions for Review: 10, 11, 12

Problems: 2
Introduction  (Reference:  Salvatore, Section 16.1)

The BOP adjustment mechanisms are grouped into two broad categories. They are:

i. automatic adjustment mechanism and
ii. adjustment policies.

An automatic adjustment mechanism is one that is activated by the BOP disequilibrium itself, without any government intervention and operates until the disequilibrium is eliminated. On the other hand, adjustment policies are specific measures taken by the government.

Automatic adjustment mechanisms are subdivided into three categories;

i. automatic price adjustment mechanism
ii. automatic income adjustment mechanism
iii. automatic monetary adjustment mechanism.

Automatic price adjustment mechanism relies on price changes in the deficit and surplus nations to bring about adjustment. Automatic price adjustment mechanism operates differently under a flexible exchange rate system than under the gold standard (or a fixed exchange rate system). Therefore, in this topic we shall cover this aspect of automatic adjustment mechanism in detail. Including this, the remaining topics in this subject concentrate on open economy macroeconomics.

Here, ‘adjustment’ means correcting the balance-of-payments disequilibria (deficits and surpluses). ‘Price changes’ mean the changing relationship between domestic and foreign prices of imports and exports.

You should study the following specific aspects in Topic 10:

• Adjustment with Flexible Exchange Rates (Reference:  Salvatore, Section 16.2)
- Elasticities in the Real World (Reference: Salvatore, Section 16.5)
- Adjustment Under the Gold Standard (Reference: Salvatore, Section 16.6)
- Effects of Depreciation (Reading 20).

**Focus questions for Topic 10**

*From Salvatore, Chapter 16*

Question for Review: 1, 2, 4, 6, 10, 12
Topic 11
The income adjustment mechanism, monetary adjustments and adjustment policies

Introduction (Reference: Salvatore: Section 17.1 and Section 18.1)

In Topic 11 you will study the automatic income adjustment mechanism, monetary adjustments, synthesis of automatic adjustments (Salvatore, Chapter 17) and adjustment policies (Salvatore, Section 18.1).

In Chapter 17 of Salvatore, the meaning, assumptions and contents of the automatic income adjustment mechanism are discussed very clearly. Then, income determination in a closed economy is reviewed. This is followed by a discussion of income determination in a small open economy. (You should avoid Section 17.4 on Foreign Repercussions). The absorption approach to income adjustment is reviewed next. Monetary adjustments and synthesis of automatic adjustments are then discussed.

Since the automatic adjustment mechanisms have several shortcomings, nations often use adjustment policies to correct balance of payment disequilibria. Although you are not required to know the details of how these policies work, it is still important for you to be aware of these policies. A brief introduction to these policies is presented in Salvatore, Section 18.1. Read this Section so that you should be able to know how these policy measures operate in real life and their impact on BOP adjustment.

You should study the following specific aspects in Topic 11:

- Income Determination in a Closed Economy (Reference: Salvatore, Section 17.2)
- Income Determination in a Small Open Economy (Reference: Salvatore, Section 17.3)
- The Absorption Approach (Reference: Salvatore, Section 17.5)
Focus questions for Topic 11

From Salvatore, Chapter 17

Questions for Review: 1, 7 and 12

From Salvatore, Chapter 18

Questions for Review: 1, 8
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Topic 12

The international monetary system: Past and present

Introduction (Reference: Salvatore, Section 21.1)

In Topic 11, we shall undertake a review of the past and present international monetary systems. This is important to understand how the balance-of-payments adjustment process actually took place under various international monetary systems that existed from 1880s to the present. The definitions, classifications, required features and the criteria for evaluation of international monetary systems are discussed in Salvatore, Section 20.1. In the remainder of Chapter 21 of Salvatore, the gold standard and the interwar experience with regard to the international monetary system are discussed next. This is followed by a review of the Bretton Woods system. Finally, the present international monetary system is discussed.

The specific aspects that you should study under Topic 12 are:

- The Gold Standard and the Interwar Experience (Reference: Salvatore, Section 21.2)
- The Bretton Woods System (Reference: Salvatore, Section 21.3)
- Operation and Evolution of the Bretton Woods System (Reference: Salvatore, Section 21.4)
- US BOP Deficits and Collapse of the Bretton Woods System (Reference: Salvatore, Section 21.5)
- Operation of the Present International Monetary System (Reference: Salvatore, Section 21.6A)
- Current IMF Operation (Reference: Salvatore, Section 21.6B)

Read

- Salvatore, Chapter 21
- Readings 19 and 20
Focus questions for Topic 12

From Salvatore, Chapter 20

Questions for Review: 1, 2, 5, 12