International Trade and Finance: New Frontiers for Research Edited by Benjamin J. Cohen, Cambridge University Press, 1997, pp. ix + 402.

This book is a collection of essays in honour of Peter Kenen. The essays aim at defining the research agenda for the late 1990s and beyond in international trade and finance. The essays are grouped into three parts: international trade theory, international monetary theory and applied policy analysis. The book is introduced by Benjamin J. Cohen, a student of Prof. Kenen, alongwith another introductory piece by Prof. Paul Krugman. Contributors to this volume are well known scholars in their respective fields. Krugman's essay highlights Peter Kenen's more important achievement and serves as an useful starter. Kenen's contribution to trade theory mainly lies in expanding the two - commodity, two-factor (Heckscher - Ohlin) model to three-factor two-goods model. The distinctive features of this model are that it is amenable to analytical treatment the way the standard two - factor model is, and the Leontief paradox could be resolved by its application. Kenen's contribution to international monetary theory mainly relates to Optimum Currency Areas and the role of Reserve Currency. Kenen builds up on the premise that demand for reserves may increase not only along with increase in world trade but rise due to precautionary motives. This premise led reserve money demand analysis beyond simple money multiplier model. Kenen enlisted two additional factors for success of the Optimum Reserve Currency Area. His work showed that even in the absence of labour mobility and openness of the regions the currency area may succeed provided the regions' economies are diversified, and taxation and spending policies are followed in a harmonious way. The portfolio approach to exchange rates had many exponents but the most definitive statement exploring its implications for macro policy, Krugman says, came from Allen and Kenen. Krugman also makes a special mention of Kenen's silent role in negotiating the Brady debt relief plan and many of his other initiatives in the field.

Patrick J. Conway essay takes a second look at the international trade theory. He agrees

with the thesis developed by Kenen in his 1965 article 'Nature, Capital and Trade'. Kenen suggested that international trade theory might best be understood if the factor capital were viewed not as a direct input into production but rather as an activity that improves land and labour services. This in effect means an extension of the standard 2 x 2 Heckscher-Ohlin model to incorporate the third factor. Efforts to update that formulation within a general 3 x 3 theoretical structure, Conway shows, reinforces Kenen's conclusion that neither factor price equalization nor identical technology is a necessary result of international trade. The asymmetric role played by capital in production process is not fully explored in the emergence of trading patterns as yet and could form a part of the agenda for future research. This, the author says, will be particularly rewarding given the improved and more complex role of capital to many sectors. Arvind Pangariya tries to bring in focus the history, the analytics and the implications of the Meade-Model of preferential trading areas. He finds the post-Meade literature in error in two important aspects. The post-Meade literature attributes Meade model with the assumption that union members are price takers in the world market. This was first made by Lipsey though without explicit recognition, and later adopted by virtually all analysts. Pangariya is of the view that Meade model in fact considers explicit the effects of the changes in the international price of the products on which tariff preference is granted. The results he obtained for welfare implications for the Union or an individual Union member under fixed terms of trade are similar to those obtained by Meade under flexible terms of trade. Pangariya proves that the problem of world welfare can be analysed by solving the model in terms of expenditure function rather than by ex-post analysis. Since Mead's assumption of complete specialisation is arbitrary further research towards reformulating the Meade model in terms of Dixit - Stiglitz - Krugman model of monopolistic competition would, he feels, be rewarding.

The relationship between a country's openness in terms of foreign trade and its

government expenditure is a largely neglected area in the literature. David Cameron's paper of 1978 show that the best single predictor of the increase in OECD governments' size between 1960 and 1975 was the economy's openness in 1960 with a correlation coefficient of 0.78. This study was confined to a small sample limited to 18 OECD countries and therefore raised doubts about the generality of this finding. D. Rodrik takes up this issue in his paper using a larger sample of more than 100 countries. He found openness in the early 1960s to be a statistically significant predictor of the expansion of the government sector over the following three decades. The correlation held both for low and high income samples and existed in all the available data sets including Summers - Heston data on government consumption, World Bank data on broader spending, IMF data on tax revenues and UNESCO's data on public spending on education. The components of government spending closely associated with openness were economically meaningful items, such as education, subsidies, social security and welfare and public investment (and not defense, interest payment and 'other' expenditures). Rodrik's work on estimating a system of equations that treats both government spending and openness as endogenous suggested that the causality runs directly from openness to large size of the government and not vice versa. Further, the relationship between openness and different components of government spending and tax revenue was analysed individually. The distance variable approach confirmed the negative association between geographical distance of a country's trade partners and size of that country's government sector, an evidence of the size of government increasing with international trade integration. The plausible reason for a positive correlation between openness and large size of government sector, the author feels, is that a large public sector serves the sheltering role in very open economies, exposed to significant amounts of external risks. The public sector serves to insulate the economy to some extent from the vagaries of the global market forces and demand for such insulation is greatest in countries most exposed to the rest of the world. A larger government sector can reduce instability in economies that would otherwise experience higher level of volatility due to exposure to external risks. Government and the market are complements and not substitutes for each other. A strong positive association was found between openness and import tax revenue (the Laffer curve for import tariff revenue) and tendency of a more open economy to rely more on import taxes and less on quantitative restrictions. In the light of these findings it is for further research to understand the channels through which governments have been forced to respond to increase openness and also about the role of the government in todays global economy.

R. Glick and C.G. Wihlborg's article deals with relationship between risk, exchange rate

regimes and trade flows. Establishing a clear link between risk, exchange rate regimes and trade flows is fraught with difficulties. Greater exchange rate variability does not necessarily imply a greater exposure to risk. The time variations in the subjective evaluation of risk is difficult to capture. To over come these problems, the authors made use of 'exchange rate flexibility' measure by scaling actual exchange rate variability by a measure of exchange rate pressure eminating from macro-economic shocks. This measure essentially captures the share of exchange market pressure that is not offset by intervention but is allowed to be transmitted into actual exchange rate changes. By using this method the authors estimated the effects of cross-country variation in exchange rate regimes on export and import elasticities. For this purpose data on bilateral trade in manufactures between the U.S. and its 30 largest trading partners, constituting over 80 per cent of the U.S. trade in manufactures, over the period 1980 to 1993 was used. The pooled regression as also the scatter plot analysis showed a positive relationship between export elasticities and the degree of exchange rate flexibility. The U.S. export elasticity increased with the degree of bilateral exchange rate flexibility of the importing country. The total macro-economic risk exporters face decreased with exchange rate flexibility. The conventional presumption that firms face more risk under floating exchange rates and that exchange rate flexibility reduces international trade was not proved by the study. Studying the link between exchange rate risk and trade flows using industry-wise decomposed manufactures trade data, both for across countries and across industries, and adding a few variables to control industry specific characteristic, the authors feel, could be instructive.

Kenen's seminal work of 1994, on exchange rate and investment linkages was based on industrial countries' experiences. Cinda S. Goldberg's paper takes the topic further and examines the link between exchange rate movements and investment activity in six Latin American countries of Argentina, Brazil, Chile, Columbia, Mexico and Venezuela. It was found that the investment responses to exchange rate changes depend upon producer export shares, degree of reliance on imported inputs into production and effects of sectoral exchange rate pass-through elasticities of domestic sales, export sales or imported input costs. The paper used aggregate investment data because of non-availability of industry specific or sector-wise time series data on real investments. The empirical results were in agreement with the broad mainstream development economists. Export production diversification proved of milder aggregate implication when faced with individual shocks but was found of dubious appropriateness when faced with sharp exchange rate movements. This is because, unlike commodity price movements, exchange rate movements are common to all traded-goods sectors. The revenue elasticities of exchange rate effects were found smallest for Argentina and Mexico while for Chile and Venezuela, the two countries with the least diversified activity, the elasticities were strongest. The net consequences of exchange rate movement on profitability depended on the level of external trade, the producers' ability to influence world market prices for their products and the share of imported inputs into export production. As regards the pass through effect of exchange rate changes, it was one for one in these Latin American countries except Brazil, since over 75 per cent of these countries' import were manufactures. For Brazil where manufacturing imports were closer to 60 per cent of its total imports, the pass through was less than one.

On the subject of optimum currency areas and exchange rate volatility, Bayoumy and

Eichengreen's paper examines individual country's choice of exchange rate regime in a framework that allows consideration of systemic as well as country - specific factors. By adopting a historical approach spanning from that under the Bretton Woods, during the transition to generalised floating in 1970s, and in the 1980s, and 1990s when that transition was largely completed, it suggests that evolution of the broader system of exchange rate has been critically important for individual country's decision in such a choice. The European experience strongly supports the view that international and regional monetary arrangements influence exchange rate outcome. The stability of bilateral exchange rates was found significantly affected not only by the characteristic of the two countries concerned but also by the structure of the global and regional monetary arrangements. The investigation has revealed a robust correlation between observed exchange rate behaviour and OCA variables like a symmetric shocks and the importance of trade and country size. The Optimum Currency Area variables were found relatively more important in the 1970s and 1980s whereas other factors in the 1960s. This was, the authors point out, because in the 1960s, when the currencies stabilized against one another, there was no optimum currency area dilemma as such and stabilizing against one currency facilitated stabilizing against the rest.

The standard theoretical work on optimal currency areas has suppressed the role of market forces. This effectively amounted to ignoring the existence of cross border currency competition. Benjamin Cohen in his paper An Optimum Currency Area Theory has gone beyond the standard theory. He probed into the welfare implications of a currency region for both the home and host countries. In formation of a formal currency area in regions where there were market determined currency regions already in existence, the currency substitution was found depend upon the relative rate of inflation and political stability. Much of the same effect also could be achieved even in the absence of an overt currency substitution provided external financial linkages were sufficiently strong. The effects of tying up of home capital markets to a strong currency abroad Cohen opines, is cededing of domestic monetary management control to a foreign central bank. The gains will be more to the dominant currency, he pointed out, since market forces create a hierarchy of national moneys. All the benefits of reduced adjustment cost resulting from larger currency regions are, however, not likely to accrue to the dominant currency alone. Formation of the currency areas also increases opportunities for extraction of seigniorage, international as well as domestic. Thus, he points out, the implications of the currency region are much wider than those relating to capital markets or to a few narrowly defined economic policies. A more detailed work is needed for understanding the mutually endogenous roles of governments and markets in determining the overall organisation of currency areas.

Despite the academic concern and discussions about the relationship between trade and

employment, the actual effects of trade regimes on labour market adjustments remains largely unexplored. No cross country studies linking changes in the trade regimes with unemployment or wage effects at the aggregate economy-wide level are available. Whitman takes up this issue in his paper on "Labour market adjustment and trade : Their Interaction in Triad" (i.e. in the US, Japan and Western Europe). His empirical analysis found that despite significant differences in institutions and processes of labour market adjustments, greater reliance is placed on external (between firms) as opposed to internal (within - firm) adjustment process and this tends to move the costs of adjustment away from firms and towards workers making them more visible and politically sensitive. Such a phenomenon, particularly when countries are facing labour market difficulties, the author says, leads to an enhanced vulnerability to protectionist pressure, and also makes more difficult the expansion efforts of such regional groups particularly if that involves inclusion of relatively more low wage developing or Eastern European countries since such efforts would call for harmonization or convergence of labour-market policies. Intensified pressure for harmonization of domestic labour market policies could, however, impede the potential benefits of international trade and investments. The author feels that further studies inquiring other vital aspects of the link between nature of structural changes and relative efficacy of different labour-adjustment process could be undertaken.

The book containing essays on the vital aspects of international trade and finance will be an intellectual stimulant to the serious students of the subject. These essays have accorded a rigorous mathematical treatment to many of the problems with which both academia and practitioners in the field are often confronted with. The book has raised substantial issues for further research work, besides providing a succinct presentation of the current research status in the area of international trade and finance.

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