The Handbook of International Economics: Volume 3

edited by Gene M. Grossman and Kenneth Rogoff

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Adam Smith wrote insightfully about international trade in the *Wealth of Nations*, and our field has had a proud history during the two centuries since. Still, the first two volumes of this *Handbook* were published only in 1984 and 1985. So why a third after only a decade? The editors of this volume point out that research in international economics has progressed rapidly in the last ten years, and their aim is to compile a lucid summary of that new work.

What areas of international economics have flourished in the last decade? First, there has been a revival of growth theory. Second, much of the recent econometric research on nonstationary time series has ready application in foreign exchange markets. Third, Kydland and Prescott's seminal work on real business cycles has been extended to the open economy. And fourth, the literature on exchange rate target zones has applied finance models in which assets are diffusion processes. This volume has chapters surveying the research in each of these areas, but it also covers some of the older areas of international economics as well.

Grossman and Helpman's "Technology and Trade" is a good chapter, and it could not have been written before the second flowering of growth theory in the last decade. Although Krugman's well-written "Increasing Returns, Imperfect Competition, and the Positive Theory of International Trade" recognizes how important it is to develop a theory of multinationals, it gives this topic little substantive discussion. Likewise, Brander's "Strategic Trade Policy" makes no mention of the work on integrated markets, the natural case for international economists. Both chapters show how difficult it is to develop a robust analysis of imperfect competition under general equilibrium. This, however, is a task confronting the profession as a whole, not just our subdiscipline.

Leamer and Levinsohn's and Feenstra's chapters on empirical aspects of international trade are some of the best in the volume. Leamer and Levinsohn call their work "International Trade Theory: The Evidence," and the beguiling title leads the reader into a lively analysis of the observable implications of the Hecksher–Ohlin–Vanek paradigm. The writing is appealing, and Leamer's ironical voice rings clear, especially when he pokes fun at empty aspects of the received theory and shoddy examples of past empirical work. The authors also include a data appendix that is a real jewel; it is a guide to a wide array of sources on international trade data. Likewise, Feenstra's "Estimating the Effects of Trade Policy" is in many ways better than the theoretical chapters on imperfect competition. Feenstra uses a simple model to unify several aspects of the empirical work. It is fitting that these are strong contributions because, to my mind, the best work in international economics in the last decade may have been empirical analyses of the received theory.

Rodrik's "Political Economy of Trade Policy" raises the obvious question: Why is international trade not free? After all, commercial policy is an inefficient way of redistributing resources between special interest groups. So why do impediments to trade emerge so readily? Of course, the answer has to do with the logic of collective action, as Mancur Olson emphasized. It is curious that neither Rodrik nor Staiger in "International Rules and Institutions for Trade Policy" uses cooperative game theory, since that branch of economic theory would seem to have ready application to political economy and multilateral international agreements.

There was not much discussion of preferential trading areas in the first volume of the *Handbook*, perhaps because only few scholars worked in this area in the 1970s and 1980s. Still, the Theory of the Second Best is perhaps one of the most important contributions our field has given to the larger discipline, and customs unions and free trade areas are given a more complete treatment in this volume's "Regional Economic Integration" by Richard Baldwin and Venables.

The second half of the volume covers topics in international finance and open economy macroeconomics. It starts with Froot and Rogoff's "Perspectives on PPP and Long-Run Real Exchange Rates," a very good chapter. Much of the recent econometric research on nonstationary time series has ready application in foreign exchange markets, and Froot and Rogoff use a simple time series model and representative data to present a unified survey of this field. Frankel and Rose's "Empirical Research on Nominal Exchange Rates" seems written with two voices. It has perhaps too much overlap with the survey by Froot and Rogoff.

The literature on exchange rate target zones, an application of the theory of regulated Brownian motion, has also grown rapidly. But that work has not matured since most of its first and second generation of models are soundly refuted by the data. Still, Garber and Svensson's chapter on "The Operation and Collapse of Fixed Exchange Rate Regimes" shows the relationship between the newer literature on target zones and its antecedent in Flood and Garber's earlier work. Garber and Svensson are refreshingly honest about the empirical shortcomings of this branch of applied theory.

Lewis's "Puzzles in International Financial Markets" seems an afterthought. It analyzes the risk premium in the foreign exchange market and home bias in international portfolio decisions. The partial equilibrium analysis of the risk premium is somewhat confusing because it is difficult to keep track of what is real and what is nominal. The chapter comes onto more solid ground when it uses a general equilibrium approach, especially when analyzing why domestic residents hold disproportionate shares of their wealth in local securities.

Obstfeld and Rogoff's "The Intertemporal Approach to the Current Account" rehashes the crux of their recent text. This long chapter is best when the authors bring the theory to the data. There is perhaps too much emphasis on modeling a country as an infinitely-lived agent, and the applied theory is at times confusing. For example, there is a discussion of growth that uses the small-country assumption to solve for an economy's long-run net asset position. But the authors assume that the small country grows permanently more rapidly than the rest of the world! Baxter's "International Trade and Business Cycles" gives a unified presentation of the nascent literature in real business cycles in open economies, and this chapter complements the wider survey by Obstfeld and Rogoff quite well.

Research on sovereign debt had already begun during the early 1980s, and it has matured in the last decade. The salient aspects of any theory of lending between countries are that these relations entail repeated interactions and that contracts must be incentive compatible. This literature, then, took advantage of the rapid progress in the

theory of repeated games and applied it to a topical issue in international economics. Indeed, Eaton and Fernandez's "Sovereign Debt" is one of the stronger contributions in this volume, using an elegant model to present an exegesis of this work.

Persson and Tabellini's "Double-Edged Incentives: Institution and Policy Coordination" could have been more illuminating. This chapter is broken into two parts: fiscal policy and monetary policy. The first half presents a model where budget surpluses raise real interest rates, and the second half uses an *ad hoc* monetary model without sound theoretical foundations. It is remarkable that there is almost no use of cooperative game theory in this chapter, although its main themes concern policy coordination.

This volume's strength is that it encompasses research in trade theory, international finance, and open economy macroeconomics. The editors are right to highlight the convergence of research in the real and monetary aspects of international economics in the last decade. Unfortunately, the hard cover volume is quite expensive. I might welcome, therefore, an abridged soft cover version that includes the contributions by Grossman and Helpman, Leamer and Levinsohn, Froot and Rogoff, Eaton and Fernandez, and Garber and Svensson.