

Summary and policy assessment

This *Review* sets out a quantified assessment of world and UK economic prospects for the 1980s, conditional on the policies adopted by governments and international institutions. The purpose is to measure the scale of major problems and to indicate the consequences of alternative actions in the face of those problems.

The policy assessment below is followed by a summary of specific conclusions about world trade, EEC policies and the particular problems of the UK on which it is based. The analysis underlying these conclusions is set out more fully in Chapters 1-3. It was carried out with the aid of models of the world trading system and the UK economy developed by the Cambridge Economic Policy Group. The world trade model is similar in some respects to OECD's Inter-Link model, which divides the world into major countries and blocs and treats all trade flows as endogenous. But our model breaks new ground in several respects: it is based on consistent annual time-series going back to 1960; it treats trade in food and raw materials, oil and other fuels, and manufactures separately; and it incorporates a well defined representation of the determination of national government policies.

Policy assessment

The existing framework of international economic relations, the rules by which it operates and the theories on which those rules are based, now serve to entrench unemployment and inflation in many countries, including the USA and the UK. The rules are not easy to change, particularly at the international level. Yet unless they are changed or broken, national policies are so tightly constrained by international interdependence that many governments are no longer able to resolve major economic problems in their own countries. The central problem is that the system of world trade no longer induces adequate economic growth.

At the world level there is no political basis for an international plan requiring co-ordinated action on the part of all major trading countries and blocs. But there are tendencies which can be encouraged or discouraged in the light of a better understanding of their effects.

The most important implication of the analysis presented here is that persistent structural trends in trade in manufactures are now a serious obstacle to

growth of world trade and GNP. The changes in trend which would most improve matters are:

- (i) a sharp reduction in the growth of Japanese exports;
- (ii) reductions in the import propensities of the USA and certain other countries, such as the UK;
- (iii) discrimination in favour of exports of manufactures from developing countries on the part of importing countries which have strong trade balances or themselves control imports.

These changes would benefit some or all countries without harm to others. Taken together, these changes would provide what we may term a *growth-inducing system of trade* for the 1980s.

Given that structural trends will not in practice be changed sufficiently to allow each country to reconcile internal growth objectives with external current account balance, the other main implication is that growth of trade and GNP in the next few years will depend on deficits, in particular the US deficit, to compensate for the surpluses of Japan and some EEC countries.

It is worth noting that two widely feared eventualities – higher oil prices and retaliation against US or UK import controls – would *not* be particularly harmful to world trade. The real danger now is that the USA may deflate to eliminate its deficit while Japan's share of world exports continues to grow and EEC countries deflate to avoid having the US deficit passed on to them. This combination of circumstances would rapidly deepen the world recession.

In the EEC, although formal arrangements exist for mutually beneficial policy co-ordination, the rigid framework which developed from the Treaty of Rome, and conflicts of interest between member countries within that framework, have created an impasse which is just as formidable as that which prevents effective policy co-ordination in the world system as a whole. Again we can only suggest tendencies to be encouraged or discouraged. Among the dangers are:

- (i) increases in agricultural prices and the Community Budget, which would make EEC transfers even more burdensome to the UK and Italy than they are already;
- (ii) tying of exchange rates under the European Monetary System, which would worsen industrial recession in weaker member countries.

It is possible to strive for reform of the Budget and

for fiscal reflation by strong members to assist growth of weaker members. But the major problem of unequal industrial performance between EEC members cannot be ignored much longer, since it has now reached the point where it is clearly in the interests of the UK, at least, to ignore the industrial common market and restrict manufactured imports from other EEC countries and from outside the Community.

For the UK itself we can only point out that neither incomes policy nor fiscal and monetary restriction nor devaluation will provide a remedy for problems of slow growth, unemployment and inflation which are becoming more and more severe. Incomes policy may help a little: financial restriction or devaluation will positively make matters worse. General import controls and reflation to expand internal demand are now an urgent necessity.

We do not accept that nothing should be done because corrective action is inconsistent with EEC and wider international rules. Such rules are meant to be beneficial to all countries which abide by them. It is the purpose of policy evaluations such as that presented here to find out whether existing or proposed rules will be beneficial in practice. If rules are harmful they should ideally be changed by agreement. But if the predicament is as severe as that encountered by the UK and agreement is not forthcoming, there is a perfectly good case for breaking rules unilaterally.

The world economy

After twenty-five years of growth and stability the world economy has entered a disturbed period in which inflation, slow growth, unemployment and

regional depression are serious problems even in most of the more prosperous countries. To clarify the international context of these problems, the world economy must be analysed as a system.

The analysis presented in Chapter 1 is based on measurement of trade and current account transactions for the past eighteen years, dividing the world into seven major 'blocs'. These measurements confirm the persistence of long-run trends in the structure of trade in manufactures, some of the most striking of which are shown in Table 1. During the past two decades Japan's share of world exports of manufactures has risen dramatically, while its import propensity has remained very low. The export shares of the USA and the UK have fallen dramatically while their import propensities have increased. The import propensity of other EEC countries has been slightly higher than that of the UK, but these countries have slightly increased their already high share of world exports. By comparison with these large changes in trade in manufactures, the cost of net imports of primary commodities to all these countries, shown in Table 2, has undergone comparatively small long-run changes despite the rise in world oil prices. Net capital flows, shown in Table 3, have been very small indeed.

Our conclusions are based, not on summary figures such as those in Tables 1-3, but on a market-by-market examination of trade in manufactures and on a separate consideration of volumes and prices for trade in fuels and for food and other raw materials, so as to take account of the particular pattern of interdependence between every pair of blocs in manufactured trade and of the sensitivity of each bloc's trade balance to world prices of oil and of other primary commodities. The results show what

Table 1 Trade in manufactures

(percentages)

	Shares of world trade in manufactures			Ratio of volume of manufactured imports to GNP		
	1961	1969	1978	1961	1969	1978
UK	12.7	8.6	7.0	4.6	8.0	14.2
Rest of EEC	33.9	35.0	37.1	6.1	10.1	15.8
USA	17.9	15.5	11.5	1.5	3.4	4.5
Japan	5.0	8.3	11.5	1.8	2.2	2.4

Note: See Appendix A for definitions.

Table 2 Trade in primary commodities

(Ratio of cost of net food, raw material and fuel imports to GNP, %)

	1961	1969	1978
UK	8.4	6.8	4.6
Rest of EEC	2.3	2.5	4.1
USA	0.2	0.3	1.5
Japan	4.2	4.2	6.6

Note: See Appendix A for definitions.

Table 3 Capital flows

	(Ratio of net capital flows to GNP, %)		
	1961	1969	1978
UK	-0.1	-0.1	-0.1
Rest of EEC	-0.7	-0.6	-0.8
USA	-0.7	-0.1	1.1
Japan	1.8	-1.3	-2.4

Note: Net capital flows including reserve changes, measured as the residual of current account flows.

future configurations of GNP and trade would be consistent with the continuation of past structural trends.

Seen in such a perspective, the disturbance from which the world economy now suffers is not primarily due to high oil prices, but rather to a persistent and growing tendency to surplus on the part of Japan and a few European countries, notably Germany. The sudden rise in oil prices in 1973-74 certainly gave an impetus to cost inflation and industrial recession in oil-importing countries. But the problem of oil prices and OPEC's surplus was a short-term one. OPEC revenues from oil exports rapidly created a large and fast-growing new market for imports of manufactures and services supplied by other countries, which has already reduced OPEC's surplus to what is in world terms a trivial level, while over a period of years high-cost energy imports have in themselves been only a very small component of general price inflation in oil-importing countries. The structural problem for world trade is now that, notwithstanding their considerable dependence on oil and raw material imports, Japan and some EEC countries have achieved large current account surpluses. Japan and the EEC as a whole are net importers of oil and other primary commodities to the tune of about \$125 billion a year (compared with little over \$30 billion for the USA). Yet their net exports of manufactures have been so large as to give them a combined current account surplus of about \$30 billion last year, while the USA suffered a \$20 billion deficit.

Looking to the future, our main conclusion is that it is trends in manufactured trade which constitute the obstacle to growth of GNP and employment in most parts of the world, including the USA. The predicament we see is that if, to take one extreme, the USA substantially reduced its external deficit in the next few years, all other blocs except Japan would become balance of payments constrained. The EEC and most other developed countries would then manage growth of only 2-3% a year and the USA would manage very little growth at all.

But if, to take the other extreme, the USA continued to expand its GNP at the 'full employment' rate (which we take to be 4% a year), its current account deficit would rise steadily, reaching a level of around \$100 billion (at 1978 prices) by the mid-1980s. No intermediate point between these extremes looks acceptable. For example, if the US deficit were to be maintained at its 1978 level, the US growth rate would have to average little more than 1% a year.

The essential quality of these results is not very

sensitive to the particular assumptions which have been made. Anyone who is prepared to base policy on radically different conditional expectations has to postulate a very large change compared with past performance. Indeed the relevant trends are so well established, having already survived major changes in effective exchange rates, that the onus is very strongly on the optimist (or quietist) to establish any presumption that there will now be a major break.

In particular, the results are not sensitive to assumptions about oil prices. There is every reason to suppose that OPEC imports will again rise to match OPEC revenues if there are further substantial oil price increases. Moreover, provided that disruptions like those in Iran do not recur, the volume of fuel and raw material supplies should be adequate to support even fast growth of world GNP in the next few years.

The predicament now facing the world economy and the USA becomes clearer if seen in a historical perspective.

In the first years after the Second World War an exactly contrary situation obtained, in which the USA held such a dominating position in world markets that many supposed a dollar shortage to be an abiding predicament which other countries would have to live with *sine die*.

The USA responded to this situation with some wisdom and foresight, not only providing loans and aid, but also allowing other countries to discriminate against US exports. In the subsequent period, which extended roughly from the late 1950s until the late 1960s, although trends in trade went against the USA, its exports of manufactures were in absolute terms so much larger than imports that the balance between them only declined slowly. The emergence of a deficit was then postponed by the sharp recession in the USA in 1974-75.

The favourable trends of Japanese trade were in many ways the mirror image of the adverse trends of US trade. Until recently Japan needed very fast growth of its manufactured exports to support fast growth of GNP without a rising trade deficit. But now the continuation of those trends has given Japan a large surplus and its growth is no longer balance of payments constrained.

The US import propensity is still low, Japan's share of world manufactured exports is still far below that of Germany, and the structural trends are persistent. Thus, unless action is taken to change those trends, then either GNP growth in many

countries including the USA must be restrained well below the rate compatible with full employment, or the current accounts of major countries and blocs must move further and further out of balance. Chapter 1 considers different policy responses to this problem and shows in particular:

- (i) that the required changes in structural trends in the 1980s are larger than can be achieved by exchange rate adjustments;
- (ii) that reduction in the growth of Japanese exports would permit faster expansion of the trade of all other countries;
- (iii) that whether or not growth of world trade accelerates, the USA will need to restrict growth of imports in order to achieve internal growth and full employment, and provided such restrictions are used to maintain internal growth rather than to cut the US trade deficit, they will not reduce the trade of other countries;
- (iv) that countries which are able to maintain internal growth, either because they have strong trading positions or by means of general import controls, could then aid growth of developing countries by discriminating in their favour;
- (v) that to the extent that structural changes needed for balanced growth are not achieved, expansion of world trade will turn mainly on the size of the deficit which the USA is able to sustain and on the fiscal and monetary policies of stronger EEC countries;
- (vi) that fast expansion in Japan has little 'locomotive' power for world trade because of Japan's low import propensity.

Policies of the EEC

Within the EEC, trends in trade between member countries are causing problems of structural imbalance similar to those in the world system as a whole. Although Ireland, the poorest country in terms of GNP per head, is rapidly improving its relative position, another relatively poor member, Italy, has lost the 'catching-up' momentum it had in the 1960s. A third member, the UK, has fallen from near the top to near the bottom of the league and shows a continuing trend of relative decline.

Chapter 2 presents an analysis of transfers between EEC countries through the Community Budget and Common Agricultural Policy. In the UK, discussion of this matter has previously centred on the hypothetical question whether and to what extent this country has gained or lost through membership of the Community. The question examined in Chapter 2 is the simpler and less hypothetical one of whether existing EEC transfers are favourable to internal balance within the Community.

The question is important because the European Community is not a full federal system. It has no mechanisms for equalising taxes, public services and welfare benefits between member countries and therefore lacks the built-in redistributive system which transfers funds from rich to poor regions within federal states such as the USA.

The estimates presented in Chapter 2 show that the redistributive effects of financial transfers which

do take place within the EEC are arbitrary and in certain respects extremely perverse. Two of the three poorest members, the UK and Italy, are net losers (the only other net loser is West Germany), while the richest member in per capita terms, Denmark, benefits from large net receipts.

Proposals now being considered could make the problem of internal imbalance in the EEC even worse. If, for instance, the major food producing areas obtain yet higher prices for their output, this would increase the total cost to the UK and Italy and benefit some richer members. The European Monetary System would further impede growth in those EEC countries which suffer inflation because of their relatively low incomes and weak trading positions.

The main directions of change which would improve economic performance in the EEC are:

- (i) a radical alteration in the system of transfers;
- (ii) policies to aid convergence of industrial performance between member countries and their regions;
- (iii) reflation by governments of member countries with strong currencies.

Prospects for the UK

Slow growth of world trade and the burden of EEC transfers both create problems for the UK. But these are less important than adverse trends in UK trade in manufactures, which have already been a decisive constraint on growth of GDP since the beginning of the 1970s. The UK has in fact suffered for many years past the structural problem now facing the USA. Despite North Sea oil and gas, which are rapidly reducing the burden of high-cost net imports of oil, the balance of payments constraint on UK growth has become more severe as time has gone by. The deterioration in trade in manufactures was particularly marked in 1977-78. With domestic inflation becoming a chronic problem, and after the unpleasant experience in 1976 when depreciation of the sterling exchange rate got out of control, devaluation has been more or less discredited as a remedy for this adverse trading position.

From the analysis in Chapter 3 we conclude that UK prospects will be very poor indeed in the 1980s when North Sea benefits level off. Even in the short term unemployment is likely to rise and inflation to accelerate. On the implausible assumption that nothing is done, unemployment would rise to 2½-3½ millions during the 1980s and inflation would be in the 15-20% range (when not temporarily checked by incomes policies). Faster growth of world trade or relief from EEC transfers would help to delay the process of deterioration for two or three years, but would not reverse it.

Our main conclusions about the effects of alternative policies are:

- (i) that fiscal and monetary restriction would marginally reduce inflation in the short term by holding up the sterling exchange rate, but would after a few years run into the impasse of severe 'stagflation', as the adverse effects of a high exchange rate on trade, GDP, unemployment and public finances made themselves felt;
- (ii) that incomes policy is a weak instrument for

- reducing inflation in the long term;
- (iii) that devaluation, aimed at restoring growth and stabilising unemployment, would accelerate domestic inflation and require a very large fall in the sterling exchange rate;
 - (iv) that with import controls and fiscal expansion of internal demand the UK would achieve faster growth and a gradual return to full employment;
 - (v) that inflation would become less serious in the long term if faster growth were achieved by import controls or by any means other than devaluation;
 - (vi) that on the other hand a permanent reduction of inflation through incomes policy, even if it were possible, would not alter the prospect of slow growth and rising unemployment (except if used as a substitute for overt devaluation).

Some underlying issues

The above conclusions about the world economy, the EEC and the UK can be disputed in three main respects. The case for faster expansion of demand may be denied on the grounds that this would make inflation worse. The case that the balance of payments can be a major constraint on growth may be denied on the grounds that imbalances can be corrected by exchange rate changes. The case for import controls may be denied on the grounds that they would reduce trade, distort consumer choice, featherbed inefficiency and provoke retaliation which would nullify any benefits.

General objections like these are based more on theoretical assumptions than on historical observation. None of them is universally valid and, more important, they are misleading when applied to present-day problems.

Expansion and inflation

Expansion of demand and employment on a world scale is said to be inflationary either because it increases prices of primary commodities or because higher demand for labour directly accelerates money wages (the 'Phillips curve' relationship).

There seems little substance in the argument that demand expansion will cause inflation through its effect on primary commodity prices, so long as the expansion is not sudden. If it were, short-term inflexibility of supply, compounded by speculative demand, might force up commodity prices very sharply (as in 1951 or 1973). There has been no clear long-run tendency for the 'product' terms of trade to move against manufactures in the past. There are no empirical or theoretical grounds for supposing that in the next decade any rise in the long-run supply price of primary commodities due to expansion of demand will not be offset by the improved trend of productivity in industry which would also follow from demand expansion. Faster expansion will improve the 'factor' terms of trade in industry, helping to keep down industrial prices. The benefit to industrial productivity should outweigh any increase in costs of producing primary commodities, particularly since value-added in industry is nowadays many times

greater than in the primary-producing sector.

The direct, Phillips-curve, effect of expansion of employment on wage increases is potentially far more important. The question whether such an effect exists has generated enormous controversy at both the theoretical and the empirical level. In our view theory can create no strong presumption that high demand for labour makes any difference to the growth of money wages in those economies where wage bargaining is highly institutionalised and where industrial prices are determined, not by a market clearing process, but as a predetermined mark up on costs. But the decisive issue is the empirical one, the onus being on anyone who opposes expansion on the grounds that it would be inflationary to produce the relevant evidence. So far as the UK is concerned, the answer to this question is clear: economic studies are as likely as not to find a 'perverse' sign implying that high employment would *reduce* wage inflation*. It is not impossible that new factors are making the Phillips curve impossible to identify, but for the time being those who believe that unemployment reduces wage inflation in the UK must do so without any assistance whatever from observations drawn from the real world.

Our impression is that in some other countries, notably the USA and France (see, for instance, Mitchell (1978) and Boyer (1979)) there has, since the late 1960s, been at best weak evidence of any species of Phillips curve at work. But we are not in a position to rule out the mechanism in these countries, or in others, such as West Germany, where fiscal and monetary policy are clearly conducted on the assumption that expansion would indeed cause inflation.

In any case all countries should have the right to conduct their own fiscal and monetary policies on assumptions that they believe in, and this implies their right to sacrifice some real growth for what they believe to be a pay-off in terms of price stability. But, while any country is entitled to operate on this view, other countries, such as the UK, where there is no longer evidence of a Phillips curve at all, should not have to restrain their own expansion on this account.

Balance of payments adjustment and exchange rates

The abstract theory of international trade is a profound obstacle to comprehension of present-day issues, because it is an essentially static analysis in which the level of employment in each country is taken as given, thus assuming away the very problem which needs to be solved. By begging the prime question, international trade theory comes to misleading conclusions about the effects of different policies. For example, the theory asserts that trading countries which maintain full employment with protective tariffs are doing so at a lower level of trade (and supposedly welfare) than would exist

*For instance Parkin, Sumner and Ward (1976), who explicitly deploy the 'expectations-augmented' Phillips curve theory, only obtain the correct sign on unemployment when they constrain other parameters in their equation to *a priori* values which, incidentally, the evidence comes close to rejecting. For a full discussion see Godley (1977).

without tariffs. It is this framework of thought that underlies GATT 'rounds' of mutual tariff reduction and supports the view that protection always reduces trade. It also creates the prejudice that devaluation is better than protection as a policy instrument for achieving internal and external balance simultaneously.

Yet it is extremely doubtful whether devaluation, except under rare and special conditions, can really be used as a policy instrument for correcting a situation in which full employment has become inconsistent with external balance.

Recourse to the econometric literature reveals again the lack of evidence to support any such assumption. The consensus of empirical research* seems to be that the full positive effects of devaluation take several years to materialise and are so small that continuous 'real' devaluations (i.e. after allowing for the feedback on inflation) of several per cent per annum would be needed to correct the adverse trends we can observe. Thus, although such studies show that the 'Marshall-Lerner' conditions hold, this is not sufficient to demonstrate that 'devaluation works'. Bearing in mind the side-effects of devaluation on inflation and the distribution of income, as well as the difficulty of controlling currency markets, the relevant question is whether the scale of devaluation required to offset existing trends in trade within a reasonable period of time is such as to be feasible. The evidence so far from exchange rate changes which have taken place in the 1970s is that devaluation does not 'work' in practice, and our quantitative assessment in Chapters 1 and 3 is that it cannot in practice do so in the 1980s.

Advocates of devaluation (e.g. Corden, Little and Scott (1975)) suppose exchange rate changes to be the 'price mechanism' solution to the problem of external imbalance. But there is no natural tendency for the 'price' of foreign exchange to move in a way which maintains equilibrium. It generally happens that a tendency to external deficit is suppressed by fiscal and monetary deflation, leaving the market 'price' of a currency entirely out of line with what might lead towards, let alone re-establish, internal full employment (the present strong sterling exchange rate is a good example).

Import controls

Objections to import controls mostly stem from the same theories which support reliance on exchange rate changes to maintain world equilibrium.

We have so far considered the use of import controls in conjunction with expansion of internal demand, as an alternative to deflation, and under the proviso that the level of imports is not lower than it otherwise would have been. We have assumed that, however administered, the controls do not discriminate against weak and vulnerable trading partners relative to others, and that they do not discriminate between domestic industries (unless such discrimination were shown to be beneficial to overall industrial efficiency). It is with general import controls of this type, used under the conditions defined above, that

the following paragraphs are concerned.

The view that import controls necessarily restrict world trade and preserve jobs in one country at the expense of those in others is based on comparison with a hypothetical alternative state in which trade balances have been fully adjusted by exchange rate or price level changes. Once that unrealistic assumption is removed, and it is seen that the alternative to import controls is deflation of internal demand which restricts imports to the same degree, the argument breaks down. For the country suffering a tendency to deficit, import controls may be a much better solution than deflation, while the effects on other countries will in general be no worse than those of deflation.

Nor are general import controls inflationary (except if there is a strong Phillips curve, in which case the conflict between inflation and full employment is anyway inescapable). Although the internal price of imports will be raised if tariffs are used, the revenue can be given back in general tax relief so as to leave overall prices and costs unchanged. Indeed the higher demand made possible by import controls will also provide non-inflationary benefits to productivity, profits and the PSBR, permitting additional tax reductions. Our conclusion is that in the UK, and probably in the USA, general import controls, with all the tax reliefs they would make possible, would reduce inflation, not increase it.

Devaluation on the other hand is inflationary by comparison with import controls and, in the short run, by comparison with deflation. It raises import prices and costs directly with no benefit to public revenues and it cuts real wages, leading to demands for higher money wages.

Objections that import controls distort consumer choice always start from the standard assumption of international trade theory that the level of consumer spending is given and that the total volume of imports is reduced. They therefore miss the crucial point that general import controls in the circumstances considered here add substantially to the level of consumer spending without any reduction in the level of imports.

The objection that import controls 'featherbed' inefficiency ignores the fact that devaluation is just as much a protective device and, more important, assumes that competition is the only general economic factor influencing productivity. Here historical evidence is strongly to the contrary. The most systematic factor causing productivity growth is the expansion of markets and sales. On the other hand there are innumerable cases where foreign competition has stunted or even destroyed industries. It is hard to argue that restriction of foreign competition would have made those industries perform even worse. However, it must be repeated that the case for import controls is strong where they would not reduce, or could even increase, the level of external trade. For the expansion of markets through trade has clearly made an important contribution to modern industrial productivity.

Finally, the retaliation danger is much exaggerated. Given that general import controls used in the manner considered here would not reduce the trade of other

*See Stern, Francis and Schumacher (1976).

countries, those countries have no valid reason for retaliating. But since retaliation might nevertheless take place, the magnitudes of possible effects must be assessed.

Our quantitative estimate is that even if there were retaliation on a world-wide basis against US import controls, this would reduce growth of world trade by about ½% a year and growth of US manufactured exports by about 2% a year. The effect on the USA

would be to require tighter restrictions on imports of manufactures, but these could still be allowed to increase, although only slowly, from their present level. The likely result in practice is that US import controls would be emulated by certain other countries which have similar problems and that discriminatory retaliation would be confined to a handful of countries. The adverse effects of retaliation would then be much smaller than in the example above.

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