

# **Facts and Fictions in International Trade Economics –**

Speech by Pascal Lamy, 12 April 2010

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It is a great pleasure for me to be here today. I can think of no better place than the Paris School of Economics for what I wish to discuss today — facts and fictions about international trade economics.

Economists have long analysed and helped us understand trade, why nations needed it to prosper, and what governments had to do to reap the gains while managing the costs. The many theories you and your predecessors have developed leave no doubt about the importance of trade to growth and economic development.

But if the economics of trade policy are clear, the politics of trade are highly complex. Trade policy, like so many other areas of policy, has ramifications on how resources are distributed, and this inevitably creates competing interest groups within society. Pressures exerted by such groups mean governments must balance these interests in ways that do not necessarily conform to what economic analysis might prescribe.

The public debate that inevitably accompanies contested policy formulation challenges the notion that open trade brings overall societal benefits. At the same time, contested policy provides a fertile field for the growth of urban legends and falsely premised ideas with popular appeal.

In my comments today, I wish to identify and address some of these fallacies. We need to bring sound economic analysis to centre-stage in this debate. Secondly, I want to locate trade policy in a wider policy setting because it is at our own peril that we take trade policy and all its political complexities out of their proper context.

## **Fallacy #1: Comparative advantage does not work anymore**

At the outset, let me recognize Paul Krugman's intellectual contribution to international trade theory — the so-called “new trade theory” — in which he shows that, even in the absence of productivity differences between two countries, trade benefits them both. He focuses on the presence of increasing returns to scale, in which a firm's average cost per unit declines as production increases and underscores that consumers value variety in consumption. While the new trade theory reduces the role played by comparative advantage, it identifies new sources of benefits from trade that were not emphasized or recognized by the classical economists. More trade benefits all countries because specialization in production reduces average cost and consumers gain access to a wider variety of products. In contrast, traditional theories of trade assume the variety of goods remains constant even after trade-opening.

We often hear the claim that the principle of comparative advantage and mutually beneficial exchange may have been true in the past, but it no longer applies in the 21st century — where, among other changes we see the seemingly inexorable rise of countries like China and India.

There are those who now call into question Ricardo's theory that differences in relative productivity between countries lead to their specialization in production and to trade. Doubt has arisen that this specialization based on comparative advantage results in higher total output, with all countries benefiting from the increased production.

There is a much-cited paper by Paul Samuelson in the Summer 2004 issue of the *Journal of Economic Perspectives* which showed theoretically how technical progress in a developing country like China had the potential to reduce the gains from trade to a developed country like the United States. This paper appeared to be a dramatic about-face against the idea that open trade based on comparative advantage is mutually beneficial.

I emphasize the word “appeared” because subsequent analysis by Jagdish Bhagwati, Arvind Panagariya, and T. N. Srinivasan contradicted this view. In that paper, starting from autarky, China and the United States open up to trade and experience the usual gains based on comparative advantage. In the following part of the paper, Samuelson considers how technological improvements in China will affect the United States. In the case where China experiences a productivity gain in its export sector, both countries benefit. China gains from the higher standard of living brought about by the increase in productivity while the United States gains from an improvement in its terms of trade. In the case where China experiences a productivity gain in its import sector, there is a narrowing of the productivity differences between the countries which reduces trade; and as trade declines, so too do the gains from trade.

So what Samuelson has showed is not that trade along lines of comparative advantage no longer produces gains for countries. Instead, what he has shown is that sometimes, a productivity gain abroad can benefit both trading countries; but at other times, a productivity gain in one country only benefits that country, while permanently reducing the gains from trade that are possible between the two countries. The reduction in benefit does not come from too much trade, but from diminishing trade. Furthermore, even in this case, Samuelson himself does not prescribe protectionism as a policy response since, as he put it, “what a democracy tries to do in self defense may often amount to gratuitously shooting itself in the foot”.

In my view, the analysis by Bhagwati, Panagariya and Srinivasan should convince us that the principle of comparative advantage, and more generally, the principle that trade is mutually beneficial, remains valid in the 21st century.

## **Fallacy #2: It is unhealthy for trade to grow faster and faster compared to output**

After the Second World War we have seen a marked expansion of international trade, with trade growing much faster than world production. The ratio of international trade to the value of world GDP has risen from 5.5 per cent in 1950 to over 20 per cent today. There are those who argue that this trade expansion poses a danger to the health of the global economy.

I would argue this is a reflection of the international fragmentation of production and the rise of trade in intermediate products. Reductions in transport costs, the information technology revolution, and more open economic policies have made it easier to “unbundle” production across a range of countries. The parts and components that make up a final product are manufactured in different countries around the globe, many of which are developing countries. These intermediate goods may cross national borders several times before they are assembled as a final product. Some of what passes for international trade is in reality intra-firm trade, exchanges of intermediate inputs and goods for processing between establishments belonging to the same company. By allowing each country that is a member of the supply chain to specialize in the part or component in which it has a comparative advantage, the internationalization of supply chains creates enormous economic benefits.

This growth in the trade of parts and components means that import statistics will overstate the degree of competition that comes from one’s trade partners. In international trade theory, trade in goods is seen as a substitute for the movement of factors of production. Thus, a country’s imports of goods from its trade partner are seen as additional supplies of the partner country’s labour and capital, which competes with the importing country’s own workers and entrepreneurs. But the share of value added by factors of production of the origin country in traded products is considerably lower than in the past.

Take the example of an iPod assembled in China by Apple. According to a recent study, it has an export value of \$150 per unit in Chinese trade statistics but the value added attributable to processing in China is only \$4, with the remaining value added assembled in China coming from the United States, Japan, and other Asian countries. Now I know we tend to use statisticians like lamp posts — both for support and for illumination — but I find these statistics very enlightening. The degree to which a given volume of imports implies competition between the factors of production in the country of origin and the importing country’s factors of production will be overstated. Focusing on gross values of trade or imports coming from a particular country also understates the degree to which the importing country’s own firms benefit from trade because part of their output is incorporated in the imported good.

So bilateral trade statistics may not correctly reflect the origins of traded products. To go back to the example of the \$150 dollar iPod imported from China, it turns out that less than 3% (\$4 out of \$150) of the value of the product reflects China’s contribution, with the bulk of the product’s value being made by workers and enterprises in the United

States, Japan and other countries. And yet current trade statistics would attribute \$150 to Chinese exports.

Relying on conventional trade statistics also gives us a distorted picture of trade imbalances between countries. What counts is not the imbalances as measured by gross values of exports and imports, but how much value added is embedded in these flows. Let us take the bilateral trade between China and the United States as an example. Based on data from the Institute of Developing Economies (IDE-Jetro) and WTO estimates, in 2008 the domestic content comprised 80% of the value of the goods exported by the US. The comparable figure was 77% in the case of Japan, 56% for Korea and 42% for Malaysia and Chinese Taipei, meaning that about half the exported value originated from other countries. Using conventional trade statistics would overestimate the US bilateral deficit vis-à-vis China by around 30% as compared to measuring in value added content. The figures would reach more than 50% when the activity of export processing zones are fully taken into account. Does it make sense for us to start measuring trade in value added rather than on gross value as is the case today!

### **Fallacy #3: Current account imbalances are a trade problem and ought to be addressed by trade policies.**

Imbalances are a natural and widespread economic phenomenon, if we only care to observe it. If we examine the flows of spending and income between Aix en Provence and the city of Paris, or between the 16ème and 5ème arrondissements of Paris for that matter, the flows are not balanced. But we do not think this is a problem and make no big deal of it. Yet we worry about imbalances between countries.

I think one legitimate reason why one may be more concerned about imbalances between countries is that they may be governed by a different set of economic institutions and regulations. Fiscal and monetary policies are likely to be different. Regulations, particularly in the financial sector, could also differ even among neighbours. Exchange rate systems may vary significantly as well. These differences may introduce “distortions” and thus provide a legitimate reason to pay greater attention to imbalances among countries. Another reason for paying attention to imbalances is when the amounts are large, in absolute and relative terms, and there is fear that they could have significant spillover effects on other countries.

Current account imbalances between countries are primarily a macroeconomic phenomenon, a sign of international differences in aggregate savings and investment behaviour and have little to do with trade policy. A current account deficit of a country reflects dissaving by domestic residents — an excess of total expenditures, both private and public, over national income. A current account surplus, on the other hand, represents savings by domestic residents with national income exceeding total expenditures.

Put in another way, a current account surplus is created if domestic savings exceeds domestic investment, which means that the country is a creditor to the rest of the world.

A current account deficit ensues if domestic savings is less than domestic investment, in which case, the country is drawing on savings provided by foreigners.

The growth of global imbalances in the last decade reflects in part the greater integration of financial and capital markets. This has made it easier to accommodate big differences in savings propensities and investment opportunities across countries. Domestic residents can afford to save less because citizens of other countries are saving more, and with few restrictions on capital flows, those foreign savings can be made available at lower cost to domestic residents.

In the absence of policy distortions, imbalances provide a means to better allocate capital internationally. Imbalances are a sign that savings in one country are being deployed or used in another country. If investment prospects are plentiful in a country, but its residents are unable to generate a sufficient amount of saving to exploit them, foreign savings can fill the gap. The domestic economy benefits from being able to undertake the profitable investment project while foreign investors get a higher return than what they can obtain in their own country.

Given that current account deficits and surpluses originate in differences in savings propensities and investment opportunities across countries, trade restrictions will not permanently reduce deficits since they do not alter the underlying conditions driving the imbalances. In fact restrictions could make matters worse. First, they can trigger retaliatory action by those affected by the import restrictions. Second, import restrictions create economic inefficiency, not least in the country applying the restrictions. As Abba Lerner taught us a long time ago, policymakers often fail to recognize that one undesirable, but irrefutable consequence of applying import restrictions is that such restrictions also discourage exports.

Given that differences in savings behaviour between countries lie at the root of current account surpluses or deficits variations in exchange rates will not correct chronic imbalances.

Exporters, moreover, often do not fully pass through the effect of an exchange rate appreciation or depreciation to the selling price in export markets. There is an extensive economic literature that documents this “less than full pass through” to prices of exchange rate changes in a wide variety of industries from automobiles to photographic film to beer. This may explain why empirical studies about the impact of exchange rate changes on imbalances tend to show only limited or ambiguous effects and why adjustment in exchange rates may have little effect on imbalances.

My arguments assume that exchange rates are allowed to adjust freely to their equilibrium levels as determined, for example, by long-term inflation differentials as in the so-called purchasing power parity theory, or by interest rate differentials as in the classic Mundell-Fleming explanation. I know that the lack of exchange rate flexibility in some countries has been raised as a problem in the context of global imbalances. The only thing I can say about this issue is that it is difficult to talk about the optimal

exchange rate system for a country — whether completely flexible or fixed — without addressing the much broader question of what the appropriate international monetary system must be.

#### **Fallacy #4: Trade destroys jobs**

The problem with the argument that trade destroys jobs is that it sees only the threat posed by imports to jobs but does not take into consideration how jobs may be created in the export sector as a consequence of trade opening. It also fails to take into account that trade opening can increase the rate of economic growth, and therefore improve the ability of the economy to create new jobs.

I recognize that traditional trade models assume full employment so that more trade in those models does not result in the creation of new employment. Jobs are merely reallocated from shrinking to expanding sectors. Nevertheless, even if trade opening does not necessarily create new jobs, the re-allocation of labour is valuable. It means workers are moving from sectors where their marginal product is lower to those where it is higher, resulting in productivity gains to the economy and increased output.

More open trade can increase the rate of economic growth by increasing the rate of capital accumulation, speeding up technological progress through innovation or knowledge creation, and improving the quality of institutions. A country that opens up trade may become more attractive to foreign investors with more foreign capital flowing to its shores. Since technology is often embodied in goods, trade can be a very effective means of diffusing technological know-how. Another way in which trade can increase productivity is “learning-by-exporting”, whereby participation in world markets enables producers to lower costs or move up the value-added chain over time. This diffusion of technology through trade is important because of the skewed distribution of research and development expenditures around the world, which is even more skewed than the distribution of world income. For example, the G-7 countries accounted for 84 per cent of global R & D expenditures in 1995 but only 64 per cent of global GDP. Finally, international trade can have a positive impact on the quality of a country's institutions, such as the legal system, which in turn improves economic performance. A faster growing economy will be able to absorb more workers than a slow-growing or stagnant economy, a point that may be particularly important for poor countries with large or rapidly expanding populations.

Trade opening can today contribute to economic growth and through that to creating much needed jobs. The stimulus package of the Doha Round is there to be taken.

#### **Fallacy #5: Trade leads to a race to the bottom in social standards.**

Some have argued that more trade will drive governments in rich countries to lower their social or labour standards. More trade would hurt workers in rich countries. The problem with this argument is that there is very little empirical basis for it. It is difficult to find

examples where countries have lowered social or labour standards in response to trade competition.

One variant of this argument has been used by Emmanuel Todd who claims that open trade between developing countries such as China and industrial countries is the reason for the economic crisis. In his view, the competition coming from low-wage countries has put pressure on wages in industrial countries and caused a deficiency in aggregate demand.

I would argue that differences in wages largely reflect differences in labour productivity. There is a fairly close correlation between wages and productivity across countries with some estimates going so far as to suggest that 90 percent of wage differences between countries can be explained by productivity differences. While wages in many developing countries may be low, labour productivity in these countries is also a fraction of western levels.

A more fundamental problem with Todd's analysis of the causes of the economic crisis is his presumption that trade is a zero sum game, that what one nation gains, another country loses. But we know from economic theory that trade is mutually beneficial and that there are overall gains to countries who are involved in trade. Hence, trade should increase incomes of trading countries and, consequently, increase demand rather than lead to a deficiency in demand.

The rise of China and India meant the integration of tens, if not hundreds, of millions of Chinese and Indian workers into the global economy. What is astonishing is that this integration occurred at the same time unemployment rates in OECD and Euro zone countries were declining. Between 1998 and 2008 for example, the average unemployment rate in the Euro area fell from 9.9% to 7.4% while the corresponding reduction in the OECD countries was from 6.6% to 5.9%. Surely, if the zero sum argument is correct, the rise of China and India would have thrown millions of workers in developed countries out of work.

Finally, some also argue that trade has been responsible for the observed widening of the gap in the wages of skilled and unskilled workers in industrial countries. However, much of this gap can be explained by skill-biased technological change rather than by trade. Skill-biased technological change refers to improvements in technology, such as the information technology revolution, which increased demand for skilled workers relative to unskilled workers. In the United States, this technological change combined with the slowdown in the relative supply of college-equivalent workers led to the expansion of wage differentials between skilled and unskilled workers. While industrial countries have experienced greater trade openness during the same period, trade has not played a big role in rising wage inequality. Empirical studies that have attempted to measure the contribution that trade has made to inequality give estimates of only between 4% and 11% to 15%.

## Fallacy #6: Opening up trade equals deregulation

There is a tendency to confuse trade opening with deregulation of the economy. One way to distinguish between the two is that trade opening refers to a reduction in trade barriers or a reduction of those measures that discriminate against foreign goods and services. A country that opens up to trade does not compromise its ability to regulate, provided of course those regulations do not discriminate in an unjustifiable manner against foreign goods and services, thus contradicting opening commitments.

There are many good reasons why governments intervene in the economy and why such intervention needs to continue even while trade is being opened. The production or consumption of a good may generate pollution (an environmental externality) as a by-product. The market for a good or service may be characterized by information asymmetry, with sellers being more informed about the quality or safety of their product than buyers. Firms may be restricting competition by colluding or abusing their dominant position. There may be moral hazard, i.e. excessive risk taking, in the banking system because of the existence of deposit insurance. In all these cases, regulations may form part of the public policy response to the underlying market failures. Moreover, there are very legitimate distributional reasons for governments to intervene in markets with a view, for example, to improving poor people's access to public services or to ensure equitable access to such services across all regions of a country. WTO rules do not constrain governments' ability to pursue such regulatory objectives.

To see the difference between trade opening and deregulation, I would like to take financial services in the North American market as an example. The North American Free Trade Agreement (NAFTA) opened up cross-border trade in financial services between Canada and the United States, but otherwise allowed each country to retain its system of financial governance. I believe this is one reason why despite freer trade in financial services, the financial systems of Canada and the United States had radically different experiences during the financial crisis. Lax regulations in the U.S. mortgage market contributed to the resulting sub-prime crisis. Meanwhile, on the other side of the border, for Canadian banks, which were more tightly regulated, sub-prime loans in 2006 accounted for less than 5% of new mortgages in Canada, compared to 22% in the United States. They were hardly touched by the crisis. In the midst of the global crisis in late 2008, they remained liquid and had an average tier 1 capital ratio that was significantly above the regulatory minimum.

The issues I have touched upon today are crucial to get the economics of trade right. But they can also contribute to a more informed political debate on trade. We need debate, and informed choices, because trade has an impact on our lives, whether as workers or as consumers.

But I also wish to avoid getting stuck in the old policy rut that simply promotes greater trade openness as a matter of virtue or as the secret of a nation's economic success. Debunking fallacies about trade is not enough. We should always remind ourselves that



trade is but one element of the story, an element from which it is possible to expect too much as well as too little.

The benefits from open trade will only be realized if the overall policy context is right. This is why I believe that what I have referred to as the “Geneva Consensus” is so important. The essence of this consensus is that trade openness can — and I stress CAN — contribute to economic well-being and political harmony in important ways, but only if other conditions are met. What are these conditions?

Firstly, we need sound macroeconomic policy, and not a doctrine that sees trade policy as a quick fix for over-arching economic fundamentals.

Second, trading opportunities created by openness are worth little, and perhaps even unwelcome, if price signals do not reach their destination because this is made impossible by a lack of physical infrastructure and functioning markets. These elements are part of a basic development agenda, one in which the international community certainly has a role. This is why I have placed so much emphasis on the Aid-for-Trade initiative. This programme is firmly grounded in the belief that facilitating trade in the broadest sense is part of a grand international bargain. I should emphasize that arguing for pre-conditions to make trade openness work is not to make the case for eschewing trade openness. On the contrary, it is the case for creating conditions to embrace openness.

Finally, governments have a responsibility to address the distribution of the benefits from trade. If trade opening is perceived as benefiting a small privileged group, quite possibly at the expense of others in society, then it loses its political legitimacy. Spreading the benefits from trade is no easy matter, especially for poor countries. Challenges arise both in terms of adjustment costs associated with changes in relative prices, as well as in a more fundamental sense which has to do with creating social infrastructure and personal opportunity.

These are just a few facts that I wanted to share with you and I would like to thank you very much for your attention.

Let the public debate commence now.