PP5183: 10–13.
Globalization, Trade, International Finance

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2016–2017 Sem 2

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OUTLINE

1. Trade and Comparative Advantage
2. Balance of Payments
3. Conclusion

Policy Setting: World 2010; US 2017

"Once again, a troubled world is taking out its frustrations on China. In recent months, the United States has imposed trade sanctions on Chinese tires, coated paper products, and steel piping and grating. The European Union has done the same with respect to several steel products, sodium gluconate, and aluminum road wheels."

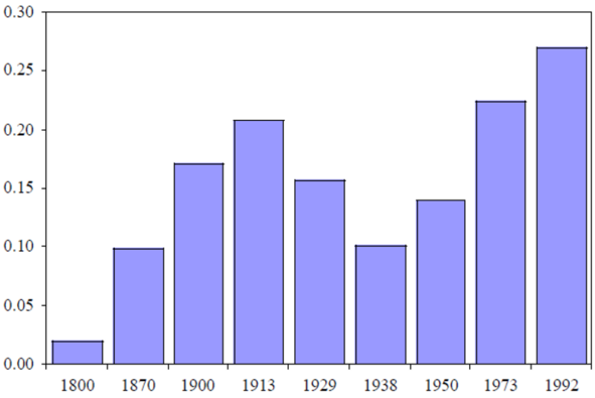
(Wall Street Journal Op-Ed 28 January 2010)

Trade Fallacies

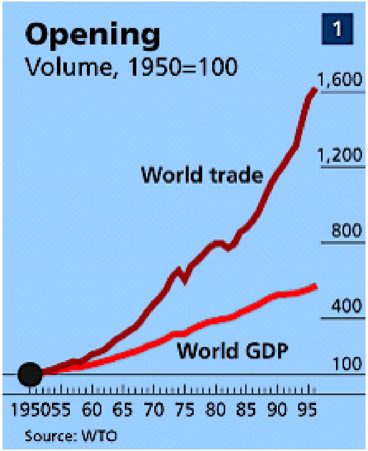
1. Bilateral trade deficit ("We're losing to China") vs overall trade deficit. Plus multi-link value chain.
2. "Running a trade deficit means we're losing money". Current account vs capital account. Trade deficits, savings, and investment
3. "Running a trade deficit means we're losing more jobs from importing stuff, than we gain from exporting." (Japan's last three decades of consistent trade surpluses. US 2007–2009, 5.8% to 2.7% unemployment. US in 2000, among the largest trade deficit years, but unemployment only 4%.)
4. "Trade is good for everyone." It is, and it isn't—displacement, adjustment

Outline

Globalization in History

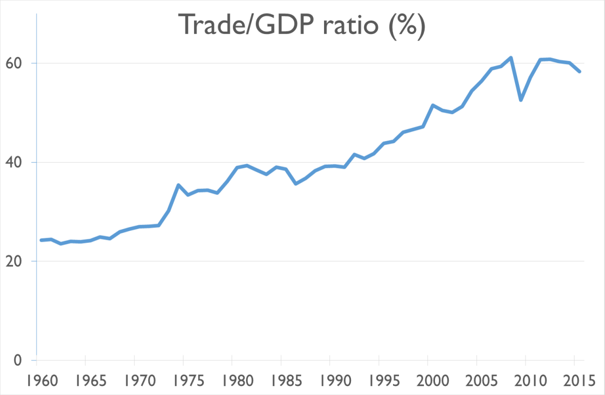


Source: Alan Taylor, 2002



Source: The Economist, 06 Nov 1997

Globalization Challenge



Trade peaked in 2008 as a ratio of GDP, and since then has mostly declined.

Source: Author calculation from World Bank data, Apr 2017

Protectionism History

Mercantilism 1500-1750. Western Europe, including England and France.

1. "Economic nationalism"
2. Total amount of global trade is a given. Zero-sum game
3. National wealth is capital—to raise through trade surplus
4. Discourage imports, except possibly irreplaceable raw materials

Why Trade? To Raise Consumption Possibilities

The Idea of Comparative Advantage

Example: Even when the West is better at everything.

West	**East**
1,000 workers	1,000 workers
• 1 worker $\rightarrow$ 1 Refrigerator; • 5 workers $\rightarrow$ 1 Jet	• 2 workers $\rightarrow$ 1 Refrigerator; • 50 workers $\rightarrow$ 1 Jet

Table: The West is better at everything.

Comparative Advantage Raises Consumption Possibilities

West	**East**
Autarky—Production and Consumption	
500 Refrigerators, 100 Jets	250 Refrigerators, 10 Jets
Trade—Production	
300 Refrigerators, 140 Jets	500 Refrigerators, 0 Jets
Trade—Consumption (Terms of Trade 12R/J)	
540 Refrigerators, 120 Jets	260 Refrigerators, 20 Jets

Table: Both sides benefit. Even when the West is better at everything, it benefits from trade—as does its trading partner.

Caution on Comparative Advantage

1. Nonlinearity; diminishing marginal returns
2. Possibility of over-specialization. Risk. Need for diversification.
3. Dynamics. Developing comparative advantage
4. Differential benefits. Income inequality

Historical development and trade strategies

- 1930–1950: Restricted trade and shipping $\implies$ **import substitution** (Asia, Latin America)
- 1950s on: East Asia (HK, Singapore, ROK, Taiwan) switched to **export-led industrialisation**
- Primary products: Terms of trade. Instability
- Manufactures: Economies of scale. Learning by doing. Innovation. Transition

Import Substitution

Reduce imports dependence (usually industrialised goods), encourage local production:

1. Industrial policy. Pick winners
2. Protective barriers, tariffs
3. Over-value domestic currency, cheapen intermediate inputs
4. Discourage Foreign Direct Investment (FDI)

Why might this work? Infant industry. Kickstart economies of scale. (Latin America)

Export-led Industrialisation

Sell to the world.

1. Subsidise production of goods targeted for export
2. Favour under-valued domestic currency
3. Size matters — even if your domestic markets unimpressive

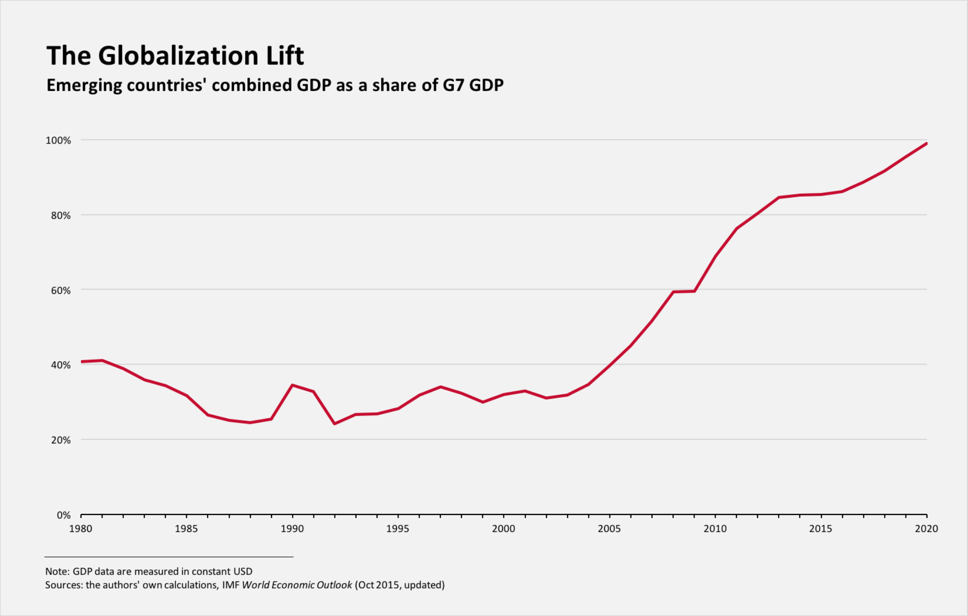
Why might this work? Large markets for economies of scale to raise productivity. (Singapore, China; East Asia generally)

Heckscher-Ohlin Model of Trade

- Factor endowment (not technology) determines comparative advantage:
  - Economies export goods that use intensively the abundant factor of production
  - Relative abundance implies relative cheapness (e.g., US makes aircraft drawing on capital and skilled labour; the East makes refrigerators using unskilled labour)
- . . . and inequality, via **Stolper-Samuelson Theorem**

Stolper-Samuelson Theorem

- Output prices drive factor payments: Increased price benefits that factor input intensive in the good's production
  - US: aircraft (capital, skilled labour)
  - East: refrigerators (unskilled labour)
- Trade implies
  - Increased US inequality
  - Reduced inequality in the East?



Source: Quah and Mahbubani (2016)

The Elephant Curve. Source: Branko Milanovic 2016

Outline

Roach on US-China Trade

“We don’t have a bilateral trade problem with China. We have a multilateral trade problem with over one-hundred different trading partners. Last year, the United States ran bilateral trade deficits with almost one hundred countries. And the reason for that is that we have a savings problem.

“If we were to close down trade with China through some ill-begotten trade legislation or currency adjustment, we don’t save the deficit. It just goes somewhere else. And they usually go to a higher-cost producer, which taxes the American public.”

(Stephen Roach, CFR interview, 22 October 2009)

A trade deficit is the same as taking a loan

Exchange Rate Trilemma. Impossible Trinity

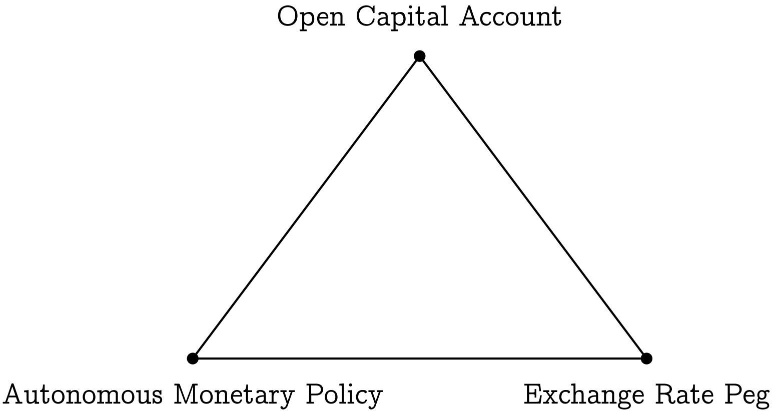


Figure: Location only possible towards triangle boundary. Impossible to have all three (in the middle).

Impossible Trinity (2)

- Open capital account and uncovered interest parity: Stable currencies imply monetary policy.
- Open capital account and monetary policy: Exchange rate peg only for limited time, especially depreciation pressure
- Most of world effectively open capital accounts—FDI
- Most advanced economies: Northwest (except within Eurozone)
- Hong Kong, most of Asia: Northeast

In developing economies with open capital accounts:

1. Exchange rate peg implies procyclical monetary policy
2. Exchange rate peg implies pent-up pressures

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Outline

Concepts to remember and use

1. Globalization. Trade. Comparative Advantage
2. Income Inequality — Domestic and Global
3. Balance of Payments

Balance of Payments

Home Exports	$+$	Capital Inflows	$=$	Demand \$
minus		minus		
Home Imports	$+$	Capital Outflows	$=$	Supply \$
Trade Balance		Capital Flows		Balance of payments

1. The balance of payments is always … balanced
2. The trade balance can be in surplus (+) or deficit (−)…
3. …exactly matched by net capital outflows or inflows.
4. Current account. Capital account
5. China has "capital flowing uphill"

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Open Economy Macro

$$
\begin{aligned}
&Y = C + I + G + (X - M) \\
\implies &Y - C - G \overset{\text{def}}{=} S = I + (X - M) = I + NCO \\
\implies &X - M = NCO = S - I
\end{aligned}
$$

Higher savings implies greater surplus on the balance of trade (and net capital outflows).