Trade-led Growth in Times of Crisis
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Session 1

Do We Need a “New Approach” to Trade?

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Questions

• Two main questions:
  – Is growing trade (exports and imports) (still) a good thing?
  – Are growing trade imbalances a good thing?
Questions

• Related questions:
  – Has trade (or trade imbalance) increased...
    • ...Instability?
    • ...Vulnerability?
  – Would trade restrictions now be beneficial?
  – Are problems made better or worse by...
    • ...Exchange-rate movements?
    • ...Exchange-rate intervention?
Growth of Trade
Growth of Trade

• Countries have become more dependent on
  – Exports for employment
  – Imports for
    • Consumption
    • Investment
    • Inputs
World Exports / GDP 1980-2009

Source: IMF World Economic Outlook 2009
Growth of Trade

• Thus they have become more vulnerable to
  – Drop in demand for exports
  – Rise in price (or reduced availability) of imports (e.g., oil, food)

• Do these changes hurt? Yes!

• Is it worth restricting trade in order to avoid this hurt? No!
Growth of Trade

• Why not?
  – Need to consider two cases:
    •Flexible exchange rate
    •Fixed exchange rate
Growth of Trade

• Flexible exchange rate
  – Drop in exports leads to
    • Currency depreciation
    • Offsetting rise in exports & fall in imports
    • Net effects
      – On aggregate demand: none
      – On terms of trade: negative
Growth of Trade

• Result under flexible rate
  – There is a loss, via the terms of trade.
  – But what is lost is the gains from trade.
  – Implication
    • Don’t deprive countries of the gains from trade in good times in order not to lose them in bad times
    • Would be like avoiding a good restaurant because the excellent chef may leave
Growth of Trade

• Fixed exchange rate (peg or currency area)
  – Drop in exports leads to
    • Intervention / monetary outflow / deflation
    • Effects
      – On aggregate demand: negative
      – On terms of trade: negative
Growth of Trade

• Result under fixed rate
  – Country is more vulnerable to shocks from abroad
  – But shocks at home are dampened
  – Choice is between
    • Little trade and own shocks only, or
    • More trade and subject to shocks from abroad
  – Trade is like a diversified portfolio
    • Note: should be better ex ante but can turn out bad ex post (e.g., this year!)
Growth of Trade Imbalances
Growth of Trade Imbalances

• Some countries have run persistent current account deficits
  – And accumulated resulting debts
  – Most notably, U.S.

• Others have run persistent surpluses
  – And accumulated resulting assets
  – Most notably, China

• Thus we have growth of unbalanced trade
Growth of Trade Imbalances

• Are there gains from unbalanced trade?
  – In theory, yes, if undistorted
  – This is just trade over time
  – Surplus countries are exporting goods now in exchange for goods later (or earlier)
  – Deficit countries are importing goods now, paid for by goods later (or earlier)
Growth of Trade Imbalances

• Illustration of inter-temporal trade
  – Countries differ in abilities to produce for two periods
    • Present
    • Future
  – May also differ in preferences for present and future consumption
  – Existence of financial assets makes trade possible across time
Growth of Trade Imbalances

• Inter-temporal trade as drawn above
  – Country B is growing faster than country A
    • See future output compared to present
    • Thus B is like China and A like U.S.
  – But B runs the trade deficit and A the surplus
  – To get surplus in B, we’d need very different preferences
    • B preferring future consumption even more than its future production
  – Or perhaps it’s more likely that A and/or B are distorted by policy
Growth of Trade Imbalances

- Inter-temporal trade
  - May be based on comparative advantage
    - And thus be beneficial
  - May be more likely distorted by policies
    - And thus more questionable
    - Figure could then look as follows
      - Assumes A subsidizes international borrowing and/or B subsidizes international lending
      - (Both financed by lump-sum taxes that reduce expenditure below income.)
Country A

\[ Q_{\text{future}} \]

\[ Q_{\text{present}} \]

Deficit

Country B

\[ Q_{\text{future}} \]

\[ Q_{\text{present}} \]

Surplus
Growth of Trade Imbalances

• Is this plausible?
  – Can we imagine governments subsidizing international borrowing and lending?
  – On one side, at least, China’s massive purchases of US debt for its reserves seems to qualify.
Growth of Trade Imbalances

• Other problems with inter-temporal trade
  – May have time consistency problem:
    • Will future generation be willing to complete the transaction begun earlier?
    • Specifically, will U.S. pay back what it has borrowed today?
Growth of Trade Imbalances

• My own views, not based on much expertise or evidence:
  – U.S. and China (and others in comparable positions) are being short-sighted
    • U.S. consumers have been living beyond their means, ignoring the need to pay their debts in the future
    • Chinese government has been using surplus to grow production, not consumption, ignoring the likelihood that US won’t pay its debts.
Growth of Trade Imbalances

- All are relying on inter-temporal markets that lack the guarantees of intra-temporal markets
- Witness the financial crises that demonstrate this, even within countries subject to rule of law, lender of last resort, etc.
- How much worse might happen when the irresponsible borrowers and lenders are countries and their governments
Growth of Trade Imbalances

– Efforts among heads of state in the G20 to “rebalance” are overdue, but not likely to succeed
– Need leadership that is currently absent, and probably new international institutions
Growth of Trade Imbalances

• Thus, I see this as a serious problem
• Does it require a “new approach” to trade?
  – Not if that means trade restrictions
  – These, we know, do not reduce surpluses and deficits, which arise instead from imbalance between income and expenditure
• What is needed:
  – New approach to spending
  – Not new approach to trade