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

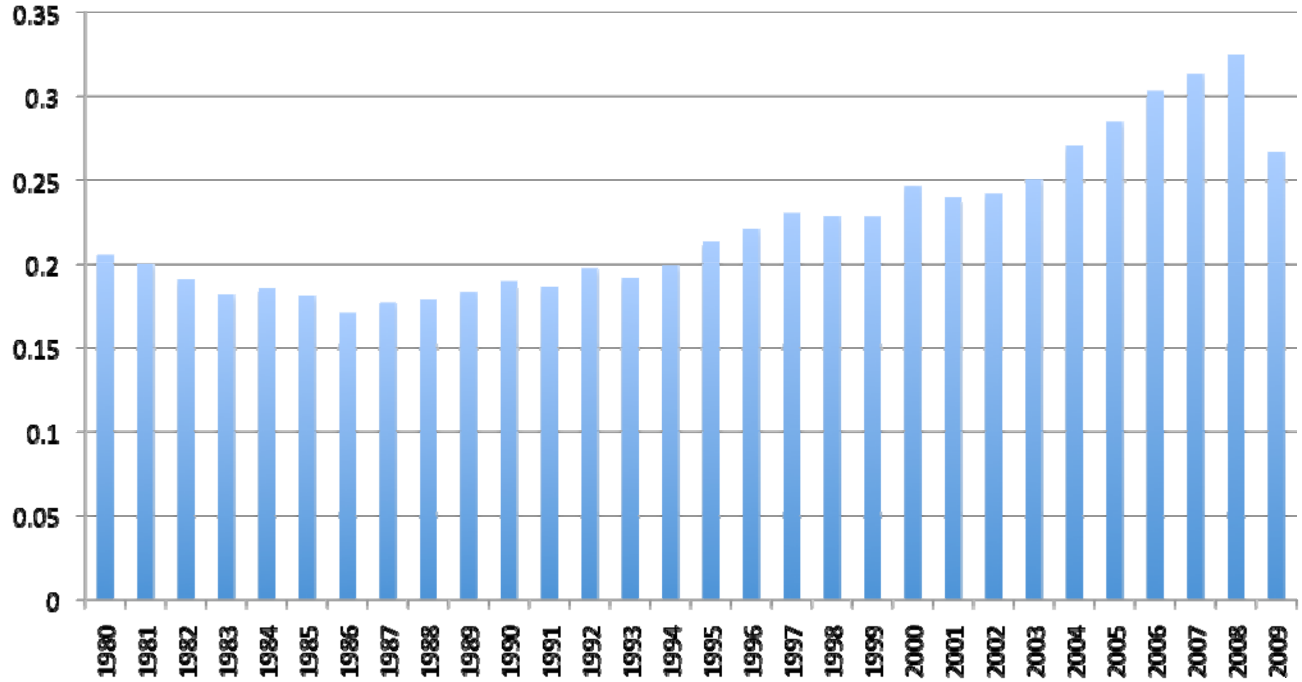
- Related questions:
  - Has trade (or trade imbalance) increased…
    - …Instability?
    - …Vulnerability?
  - Would trade restrictions now be beneficial?
  - Are problems made better or worse by…
    - …Exchange-rate movements?
    - …Exchange-rate intervention?

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

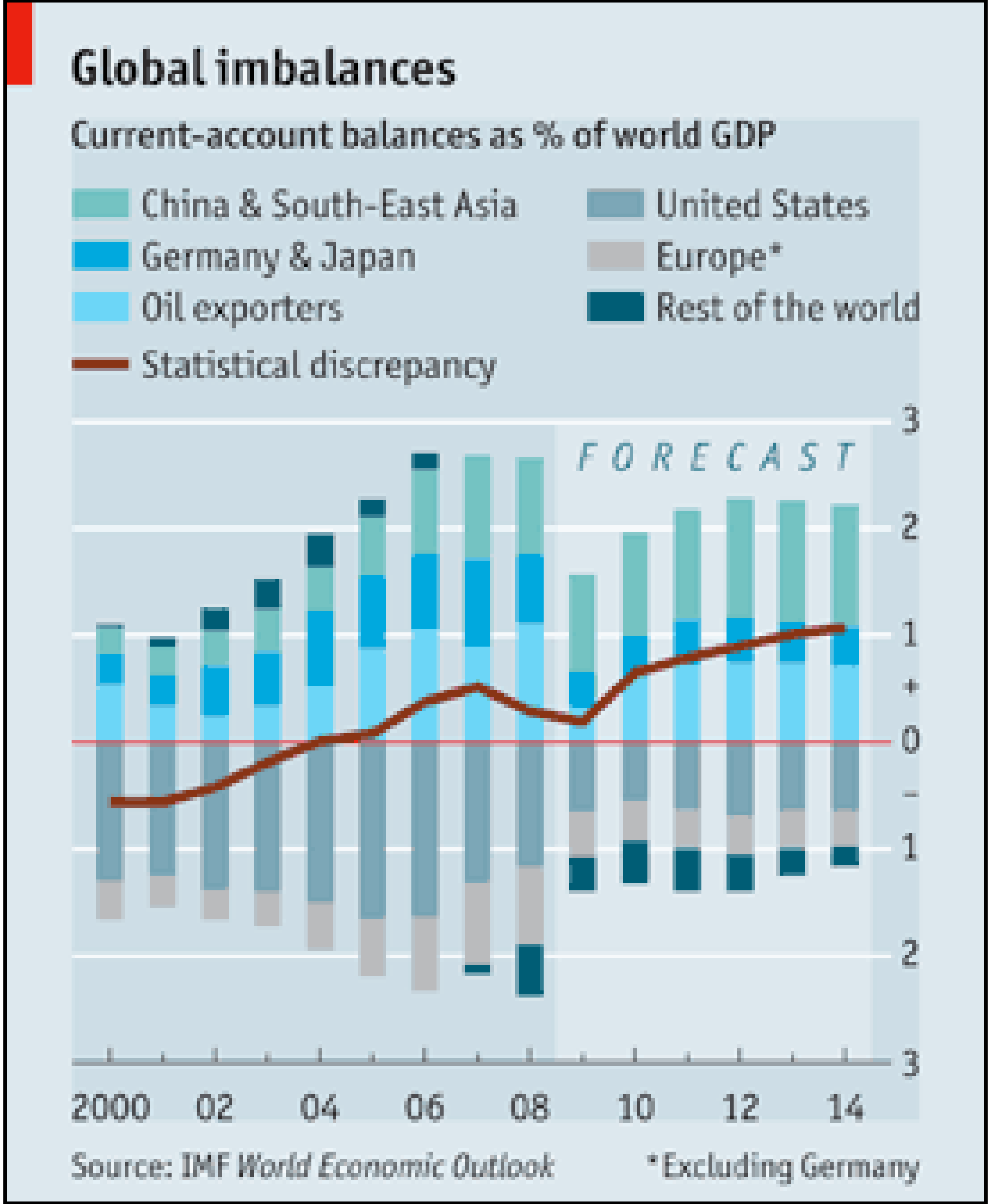
Growth of Trade

- 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 <u>ex ante</u> but can turn out bad <u>ex post</u> (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 <u>unbalanced trade</u>

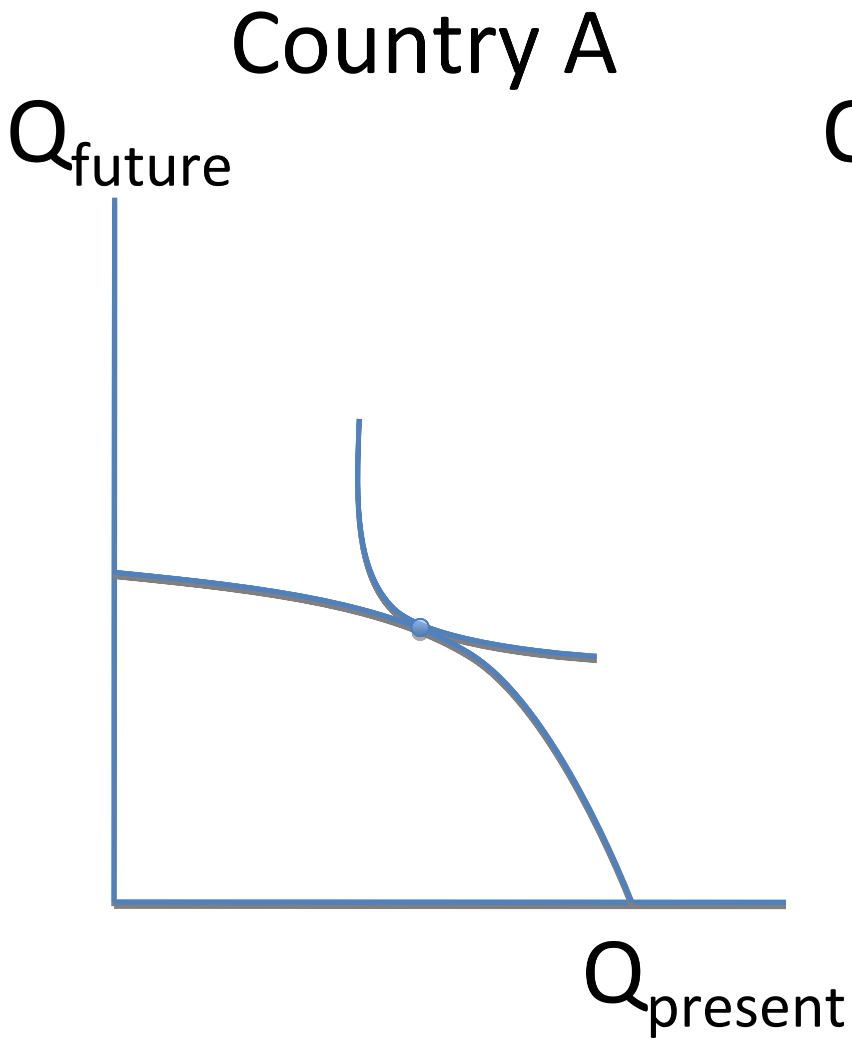

Global imbalances
Current-account balances as % of world GDP
China & South-East Asia
United States
Germany & Japan
Europe*
Oil exporters
Rest of the world
Statistical discrepancy
FORECAST
3
2
1
+
0
–
1
2
3
2000
02
04
06
08
10
12
14
Source: IMF World Economic Outlook
*Excluding Germany

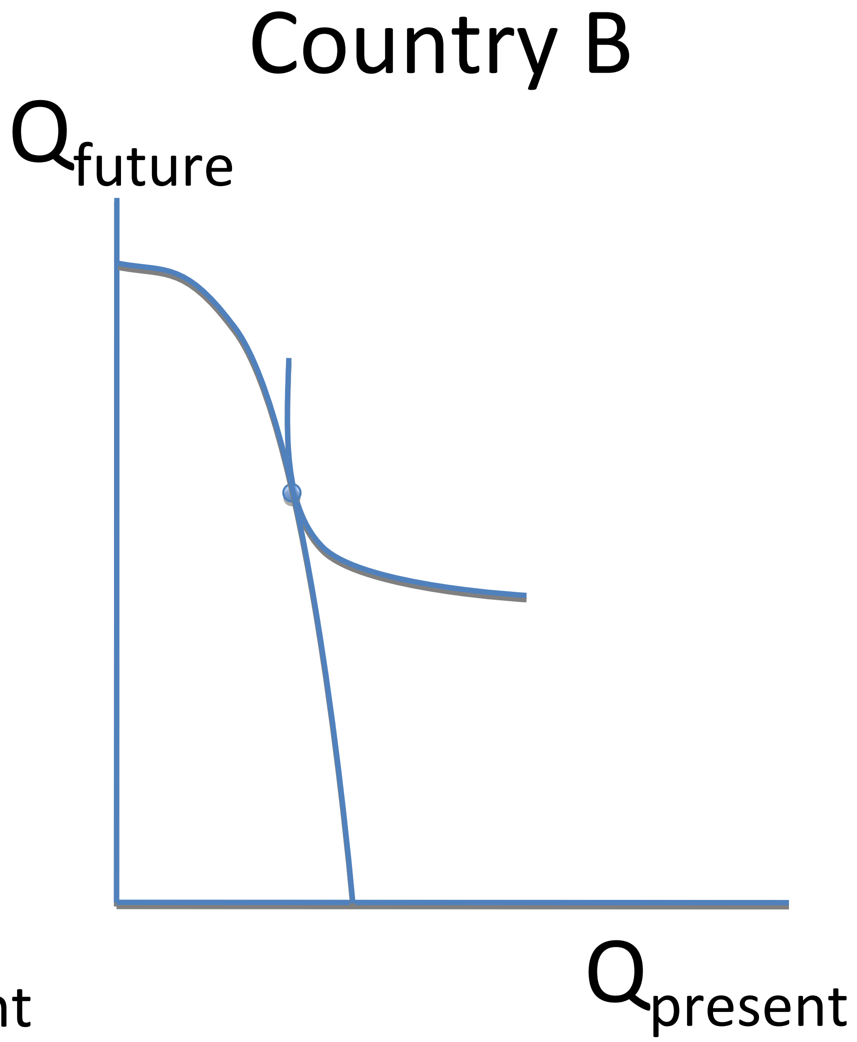
Growth of Trade Imbalances

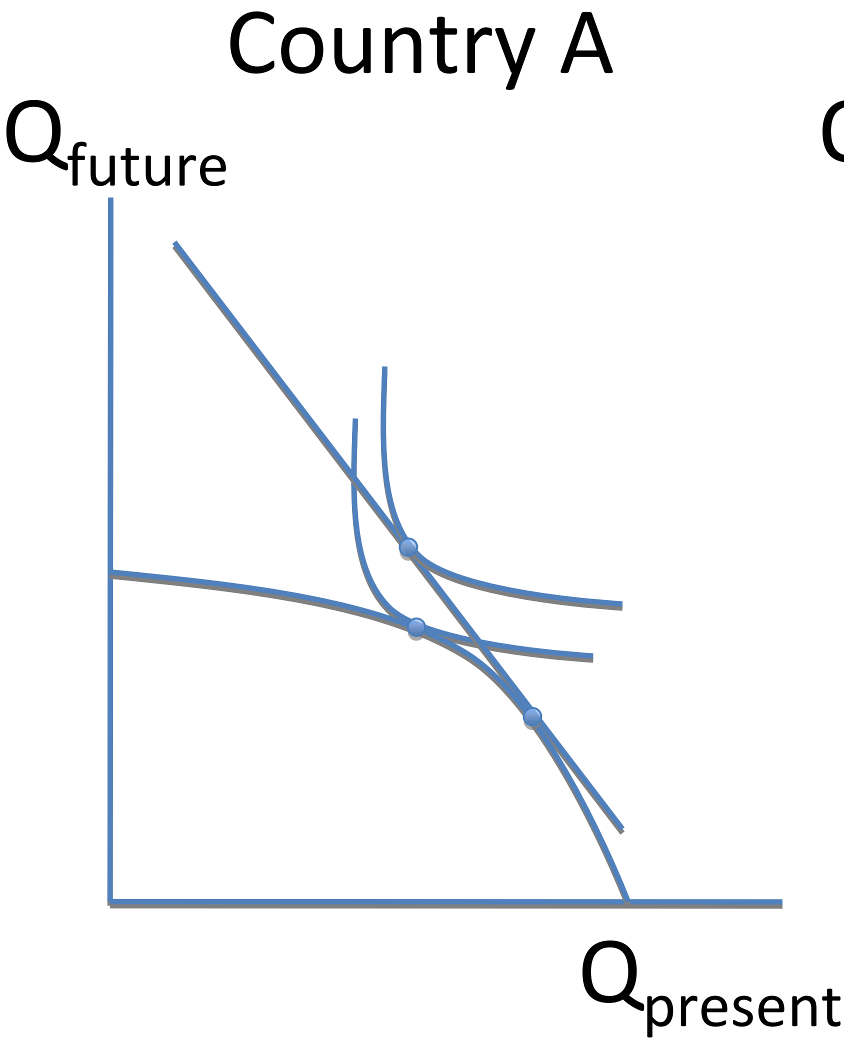
- Are there gains from unbalanced trade?
  - In theory, yes, if undistorted
  - This is just trade over time
  - Surplus countries are exporting goods now in exchange for goods later (or earlier)
  - Deficit countries are importing goods now, paid for by goods later (or earlier)

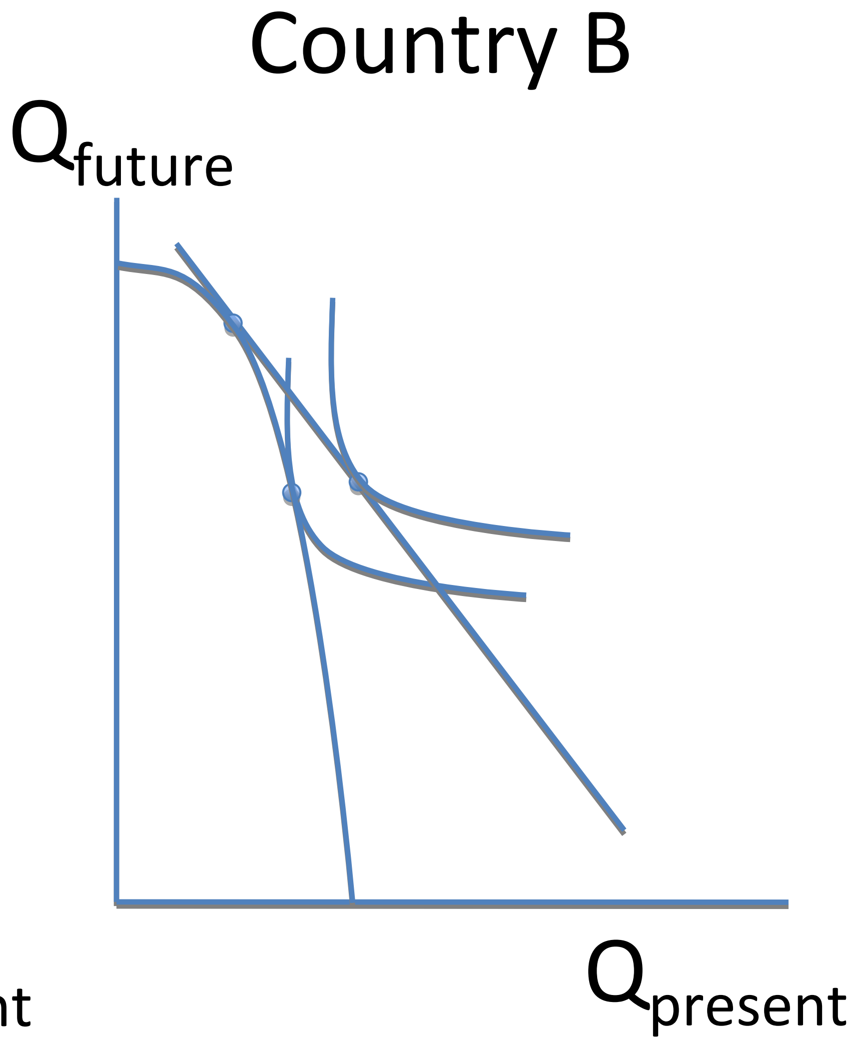
Growth of Trade Imbalances

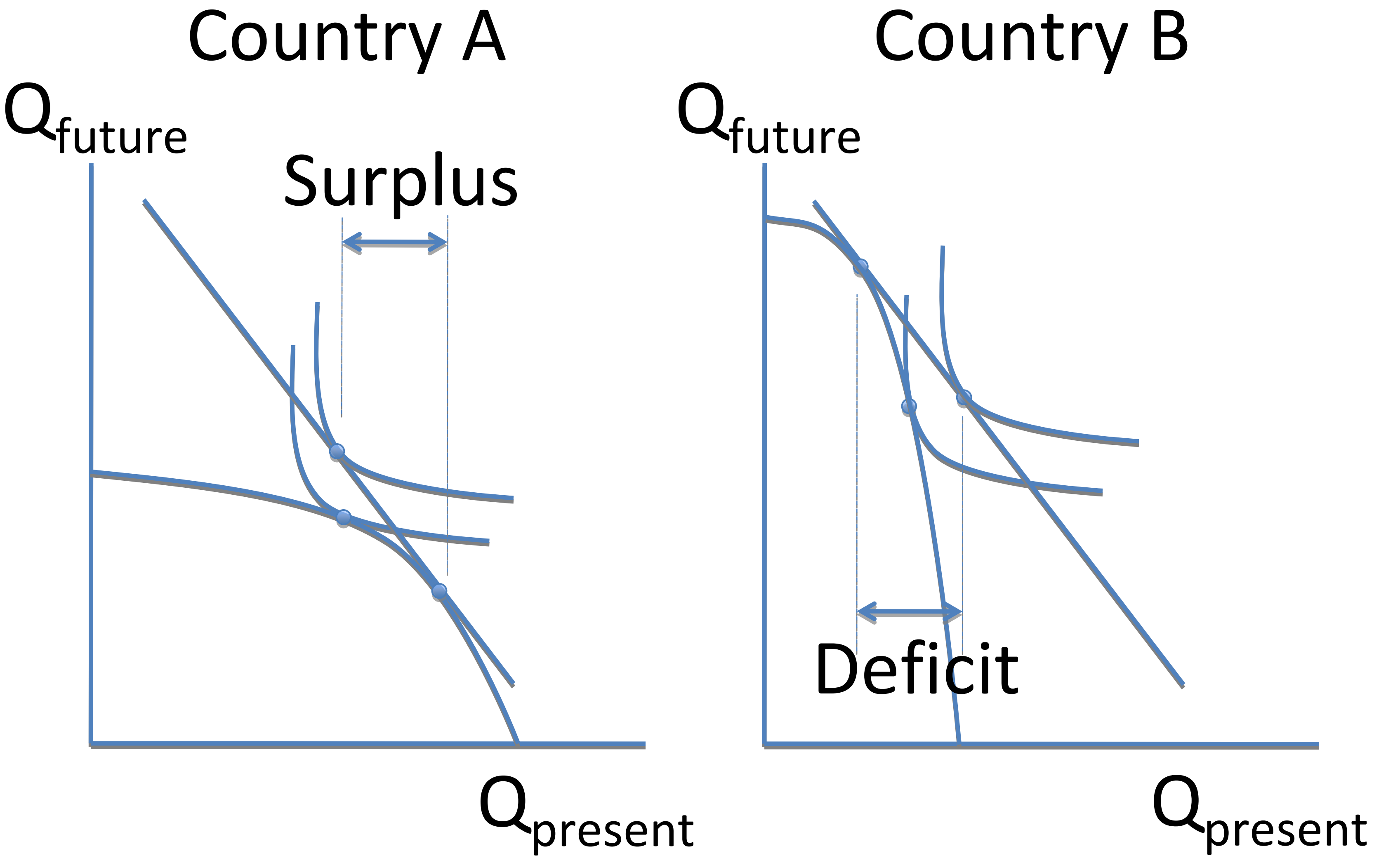
- Illustration of inter-temporal trade
  - Countries differ in abilities to produce for two periods
    - Present
    - Future
  - May also differ in preferences for present and future consumption
  - Existence of financial assets makes trade possible across time


Country A
Q_{future}
$Q_{present}$


Country B
Q_{future}
$Q_{present}$


Country A
Qfuture
Qpresent


Country B
Qfuture
Qpresent

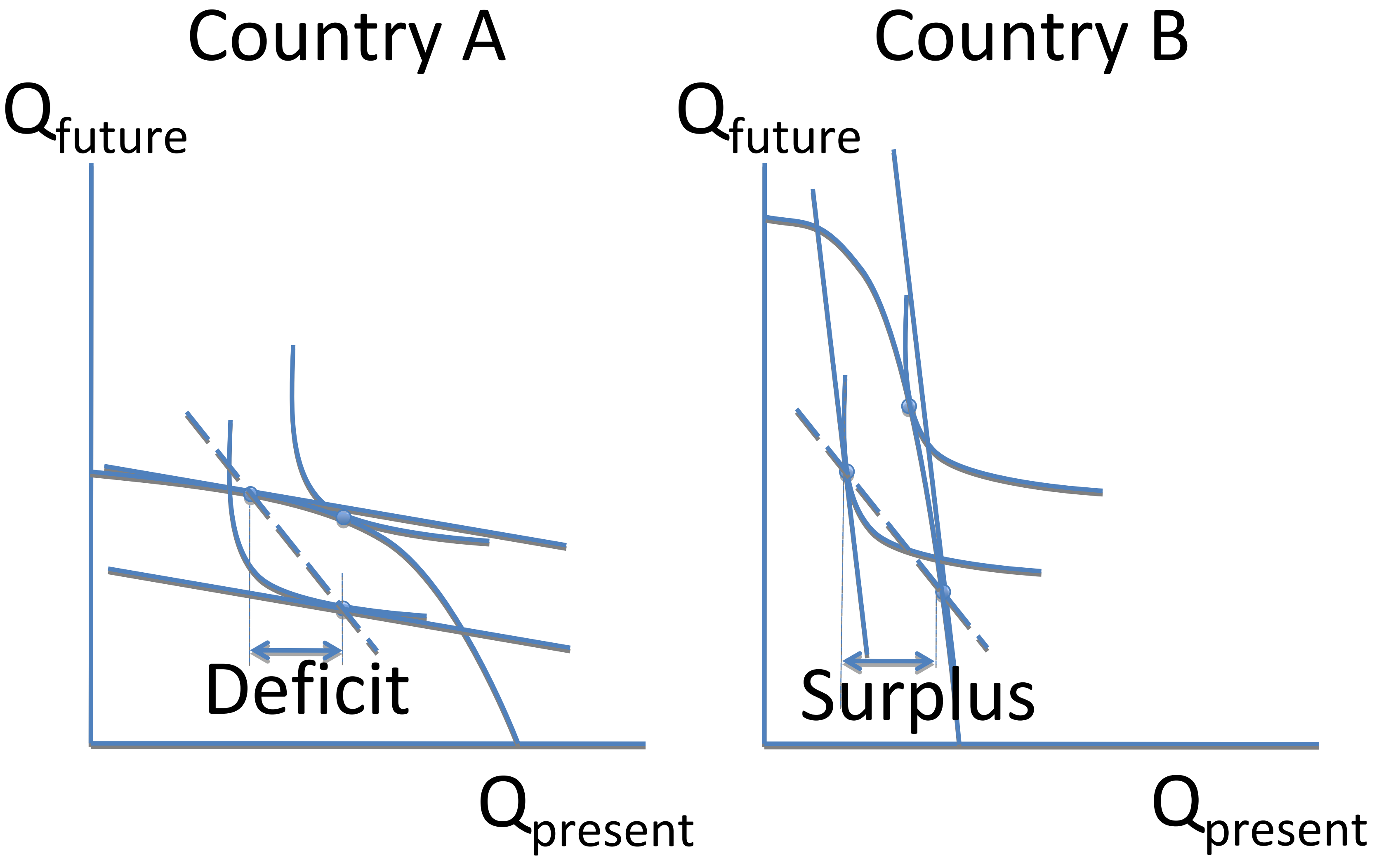

Country A
Q future
Surplus
Q present
Country B
Q future
Deficit
Q present

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 <u>very</u> different preferences
    - B preferring future consumption even more than its future production
  - Or perhaps it's more likely that A and/or B are <u>distorted</u> 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
Country B
Q_{future}
Q_{future}
Deficit
Surplus
$Q_{present}$
$Q_{present}$

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 <u>imbalance</u> between income and expenditure
- What is needed:
  - New approach to spending
  - Not new approach to trade