



Trade winds

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The fourth in our series of briefs on globalisation looks at international trade. Why does it make sense for countries to trade goods and services? How much trade do they do? And why are there obstacles to freer trade?

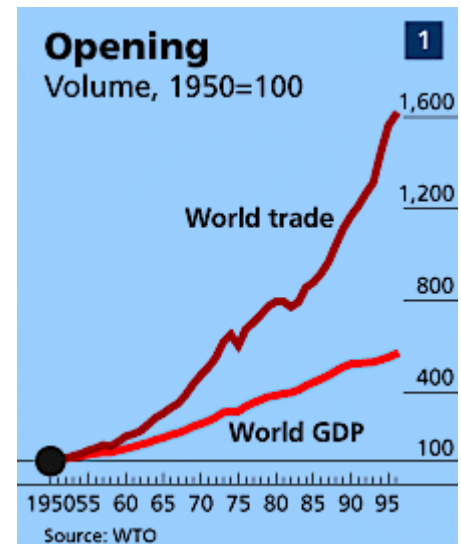
TIME was when trade flows were of interest mainly to economic experts and executives of big corporations. But over the past few years, the movement of goods and services across national boundaries has become the subject of intense public attention all over the world. To the public at large, trade is the most obvious manifestation of a globalising world economy.

Measured by the volume of imports and exports, the world economy has become increasingly integrated in the years since the second world war. A fall in barriers to trade has helped stimulate this growth. The volume of world merchandise trade is now about 16 times what it was in 1950, while the world's total output is only five-and-a-half times as big (see chart 1). The ratio of world exports to GDP has climbed from 7% to 15% (chart 2).

Virtually all economists, and most politicians, would agree that freer trade has been a blessing. However, the economists and politicians would probably give quite different reasons for thinking so.

Politicians, by and large, praise greater trade because it means more exports. This, in turn, purportedly means more jobs—and, if the exports involve sophisticated products such as cars or jet engines, more “good” jobs. The American government, zealous to promote exports, has even produced estimates that try to show how many new jobs are created by each \$1 billion of American sales abroad.

This is misleading. A big export order may well cause an individual company to add workers, but it will have no effect on a country's total



employment, which is determined mainly by how fast the economy can expand without risking inflation and by microeconomic obstacles, such as taxes that deter employers from hiring or workers from seeking jobs. America, where exports are a relatively small fraction of GDP, has fuller employment than Germany, where exports loom larger.

Gains from trade

To economists, the real benefits of trade lie in importing rather than in exporting. Politicians frequently urge consumers to favour domestically made goods, and portray a widening trade deficit as a Bad Thing. But economists know that the only reason for exporting is to earn the wherewithal to import. As James Mill, one of the first trade theorists, explained in 1821:

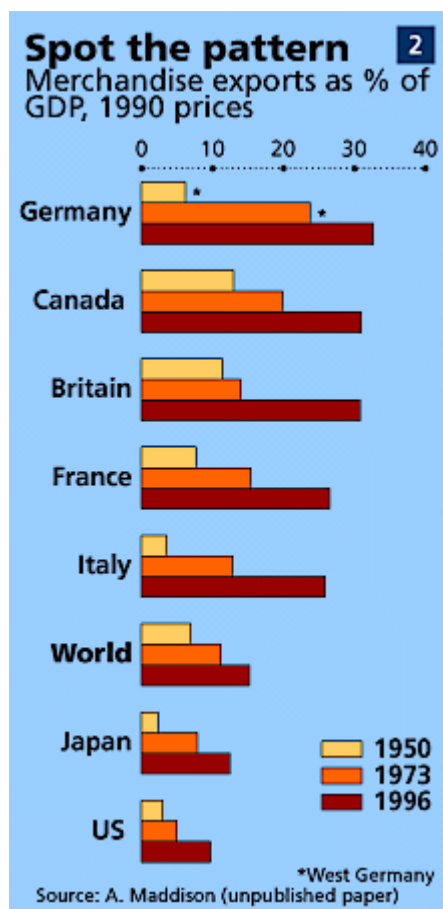
The benefit which is derived from exchanging one commodity for another, arises, in all cases, from the commodity *received*, not the commodity given.

This benefit arises even if one country can make everything more cheaply than all others. The basic theory that explains this, the principle of comparative advantage, has existed since Mill's day. His contemporary, David Ricardo, usually gets the credit for expounding it.

To see how this theory works, think about why two countries— call them East and West—might gain from trading with one another. Suppose, for simplicity, that each has 1,000 workers, and each makes two goods: computers and bicycles.

West's economy is far more productive than East's. To make a bicycle, West needs the labour of two workers; East needs four. To make a computer, West uses ten workers while East uses 100. Suppose that there is no trade, and that in each country half the workers are in each industry. West produces 250 bicycles and 50 computers. East makes 125 bikes and five computers.

Now suppose that the two countries specialise. Although West makes both bikes and computers more efficiently than East, it has a bigger edge in computer-making. It now devotes most of its resources to that industry, employing 700 workers to make computers and only 300 to make bikes. This raises computer output to 70 and cuts bike production to 150 (see table 3). East switches entirely to bicycles, turning out 250. World output of both goods has risen. Both countries can consume more of both if they trade.



Gains from trade

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	Output and consumption under autarky		Output after specialisation		Consumption after trade	
	Bicycles	Computers	Bicycles	Computers	Bicycles	Computers
East	125	5	250	0	130	10
West	250	50	150	70	270	60

At what price? Neither will want to import what it could make more cheaply at home. So West will want at least five bikes per computer; and East will not give up more than 25 bikes per computer. Suppose the terms of trade are fixed at 12 bicycles per computer and that 120 bikes are exchanged for ten computers. Then West ends up with 270 bikes and 60 computers, and East with 130 bicycles and ten computers. Both are better off than they would be if they did not trade.

This is true even though West has an "absolute advantage" in making both computers and bikes. The reason is that each country has a different "comparative advantage". West's edge is greater in computers than in bicycles. East, although a costlier producer in both industries, is a relatively less-expensive maker of bikes. So long as each country specialises in products in which it has a comparative advantage, both will gain from trade.

Fair deal

Some critics of trade say that this theory misses the point. They argue that trade with developing countries, where wages tend to be lower and work hours longer than in Europe and North America, is "unfair", and will wipe out jobs in high-wage countries.

It is generally accepted that trade with poor countries has been one of the factors reducing the wages of unskilled workers, relative to skilled ones, in the United States. That said, the threat to rich-country workers from developing-country competition is often overstated.

For a start, it is important not to confuse absolute and comparative advantage. Even if developing countries were cheaper producers of everything under the sun, they could not have a comparative advantage in everything. There would still be work for people in high-wage countries to do.

Moreover, it is not true that countries with cheap labour always have lower costs. Wage differences generally reflect differences in productivity; companies in low-wage countries often need far more labour to produce a given amount of output, and must deal with less efficient communications and transportation systems. In most cases hourly wages are not decisive in determining where a product is made.

Suppose that the "fair traders" succeed in eradicating international differences in production costs, so that a given product cost precisely the same to make in different countries. In that case, no country would have a comparative advantage, and hence there would be no trade. Rich-country workers, who are also consumers, would lose.

At first blush, real-world trade patterns would seem to challenge the theory of comparative advantage. Most trade occurs between countries which do not have huge cost differences. America's biggest trading partner, for instance, is Canada. Well over half the exports from France, Germany and Italy go to other European Union countries. Moreover, these countries sell similar things to each other: cars made in France are exported to Germany, while German cars go to France, dependent largely upon consumers' differing tastes rather than differences in costs.

The importance of geography and the role of similar but different products appealing to diverse

tastes expand our understanding of why trade occurs. But they do not overturn the fundamental insight of the theory of comparative advantage. The agricultural exports of Australia, say, or Saudi Arabia's reliance on oil, clearly stem from their natural resources. Poorer countries tend to have relatively more unskilled labour, so they tend to export simple manufactures, such as clothing. So long as relative production costs differ between countries, there are gains to be had from trade.

Enter the state

What is confusing, perhaps, is that comparative advantage is often the product of history and chance, not of differences in natural resources or workers' skills. A stark example is America's civil-aircraft industry. There is no God-given reason why the production costs of jumbo jets, relative to other goods and services, should be lower in America than in Japan. But they are: America's early embrace of airmail, its large purchases of military aircraft and the great public demand for air travel in a large country all helped American plane makers get big early on, allowing them to achieve per-plane costs lower than those of foreign competitors.

A logical question follows: if comparative advantage can be created, why should governments not help create it? The idea is that through subsidies, such as those given by several European nations to finance the European-made Airbus passenger jets, governments can promote their own national champions and hobble foreign rivals. Since the late 1970s, a stream of theoretical research has shown that governments can use such "strategic trade policy", in principle, to make their own citizens better off.

The theoretical work, however, has shed little light on how, in practice, governments can select which industries to subsidise—and which to tax in order to finance the subsidy—so that, in the end, the country's welfare is improved. And then there is the matter of politics: once the government has agreed to support "strategic" industries, every industry will assert its strategic importance in order to share in the pie. Under real-world political pressures, the allure of strategic trade policy fades quickly.

Governments' intervention in trade is not limited to fine calculations of strategy. There is plenty of aid to politically sensitive industries, such as agriculture. And governments often rush to obstruct "unfair" competition from abroad.

Anti-dumping duties are a case in point. In theory, these are intended to keep foreign producers from "dumping" goods abroad at less than their cost of production, by subjecting the goods to extra import duties. In practice, they are a politically neat method of protecting a particular industry. Once the favoured weapon of rich-world governments, anti-dumping duties have been taken up eagerly by developing countries (table 4).

Despite such machinations, world trade flows more freely than it used to. This is due mainly to international agreements under which governments agree to forswear trade barriers—most notably, the General Agreement on Tariffs and Trade (GATT). All told, there have been eight rounds of GATT talks since 1947, in which countries have cut their import tariffs. Tariffs on manufactured goods are now down to around 4% in industrial countries.

The most recent GATT round, the Uruguay round, ended in 1993. The Uruguay round did much more than cut tariffs on goods. It heralded a big institutional change, creating the World Trade Organisation (WTO), which now boasts 132 members, as a successor to GATT. It also made three big changes to the rules

of world trade. First, it began the process of opening up the most heavily protected industries, agriculture and textiles.

Second, the Uruguay round vastly extended the scope of international trade rules. The rules were extended to cover services, as well as goods. New issues, such as the use of spurious technical barriers to keep out imports and the protection of foreigners' "intellectual property", such as patents and copyrights, were addressed for the first time.

Of these new agreements, the one in services is especially interesting. A lot of trade no longer involves putting things into a crate and sending them abroad on ships. Many services, can be traded internationally: a British construction firm can build an airport in Japan, and an American insurance company can sell its products in Germany.

Lots to talk about

The WTO estimates that commercial-service trade was worth \$1.2 trillion in 1996, around one-quarter of the value of trade in goods. The services agreement, plus a recent deal on telecommunications trade, should ease the barriers that limit such trade.

The third change wrought by the Uruguay round was the creation of a new system for settling disputes. In the past, countries could (and sometimes did) break GATT rules with impunity. Under the new system, decisions can be blocked only by a consensus of WTO members. Once found guilty of breaking the rules (and after appeal) countries are supposed to mend their ways. This system so far seems to be working better than the old one, and is helping to build up the new institution's credibility.

Despite these recent advances, there are plenty of difficulties ahead. China, the world's second-biggest economy, and its 11th-biggest exporter, is not yet a member of the WTO, and talks on its accession have been difficult. Some countries, such as America and France, would like to see the WTO address itself to the relationships between trade, labour standards and the environment. Others, notably India and Malaysia, are opposed. In 1996 the WTO's members agreed to study the issues, but there is no agreement about whether the WTO should go further.

Anti-trade

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Summary of anti-dumping actions, 1996

	New actions	Measures in force*
South Africa	30	31
Argentina	23	30
EU	23	153
United States	21	311
India	20	15
Australia	17	47
Brazil	17	24
Korea	13	14
Indonesia	8	na
Israel	6	na
Canada	5	96
Peru	5	4
New Zealand	4	27
Chile	3	0
Mexico	3	95
Venezuela	3	3
Malaysia	2	na
Colombia	1	7
Guatemala	1	na
Thailand	1	1
Japan	0	3
Singapore	0	2
Turkey	0	37
Total	206	900

Source: WTO

*31 December 1996