Introduction to World Trade

Economia Internacional I – International Trade theory

August 15th, 2012

Lecture 1

Free Trade

- Free Trade occurs when a government does not attempt to influence, through quotas or duties, what its citizens can buy from another country or what they can produce and sell to another country.
- Different types of trade including
  - trade in goods, services,
  - trade in labor - migration, and
  - trade in capital - foreign direct investment.

Globalization

- Flow of goods and services across borders.
- Movement of people and firms.
- Spread of culture and ideas between countries.
- Tight integration of financial markets.

Trade in the Global Economy

- **Imports** are the purchase of goods or services from another country.
- **Exports** are the sale of goods or services to other countries.
- **Trade** is Exports+Imports

Trade in the Global Economy

- **Merchandise goods:** includes manufacturing, mining, and agricultural products.
- **Service exports:** includes business services like eBay, travel & tourism, insurance, and transportation. Other examples:
  - Communication services.
  - Construction and related engineering services.
  - Distribution services.
  - Educational services.
  - Financial services.
  - Health-related and social services.
  - Recreational, cultural, and sporting services.

Trade in the Global Economy

- **Migration** is the flow of people across borders as they move from one country to another.
- **Foreign Direct Investment** is the flow of capital across borders when a firm owns a company in another country.

Question

Why do you think countries trade?

Answer

- Why do countries trade?
  - They can get products from abroad cheaper or of higher-quality than those obtained domestically.
    - China produces goods more cheaply than most industrialized countries.
    - Germany exports high quality manufactres.

Some Basic Concepts

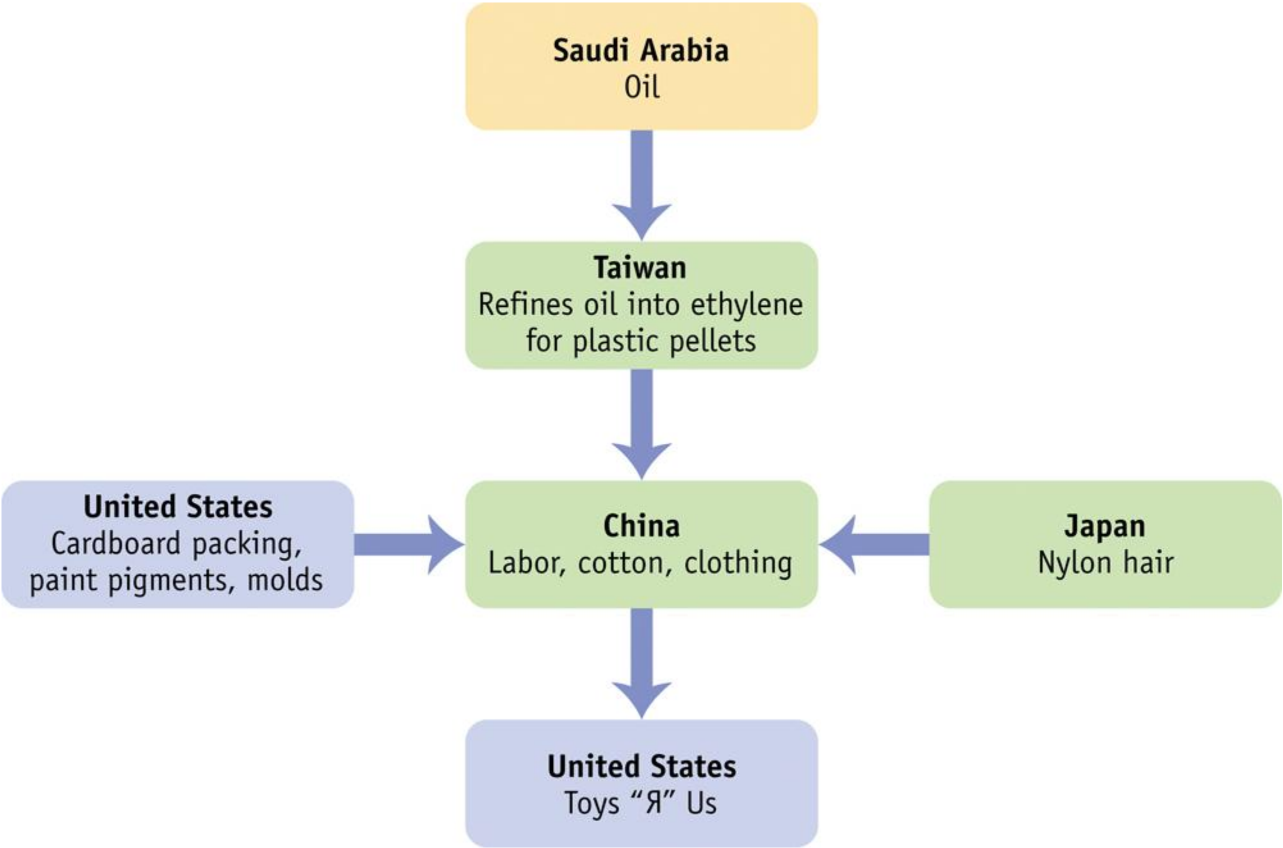
- The **Trade Balance** of a country is the difference between the total value of exports and the total value of imports.
  - Usually includes both goods and services
- A **Trade Surplus** exists when a country exports more than it imports.
- A **Trade Deficit** exists when a country imports more than it exports.

Problems with Trade Data

- What are the problems with bilateral trade data?
  - If some of the inputs are imported into the country, then the value-added is less than the value of exports.
    - Barbie is made with oil from Saudi Arabia, plastic from Taiwan, hair from Japan, and is assembled in China.
    - Doll is valued at $2 when it leaves China but only 35 cents is value-added from Chinese labor.

Barbie in World Trade

Figure 1.1 Barbie Doll



Barbie in World Trade

- What are the problems with bilateral trade data?
  - The whole $2 is counted as an export from China to the U.S. even though only 35 cents of it really comes from China through their labor contribution.
  - This shows the bilateral trade deficit or surplus is not as clear as you might think.
    - This is a short-coming of the official statistics.

Problems with Trade Data…

- So why is this a big deal?
  - In 1995, toys imported from China into the US totaled $5.4 billion.
  - As trade with China continues to grow, China's apparent trade advantage begins to worry many in the U.S.
  - When the trade statistics are misleading, it can cause undue controversy.

Trade Compared to GDP

- Another way to measure trade is by looking at its ratio to GDP.
- In 2005 trade relative to GDP for the U.S. was 13%.

  For Mexico?
- Most other countries have a higher ratio.
- Countries that are important shipping and processing centers are much higher.
  - Hong Kong, Malaysia, and Singapore

Trade Compared to GDP

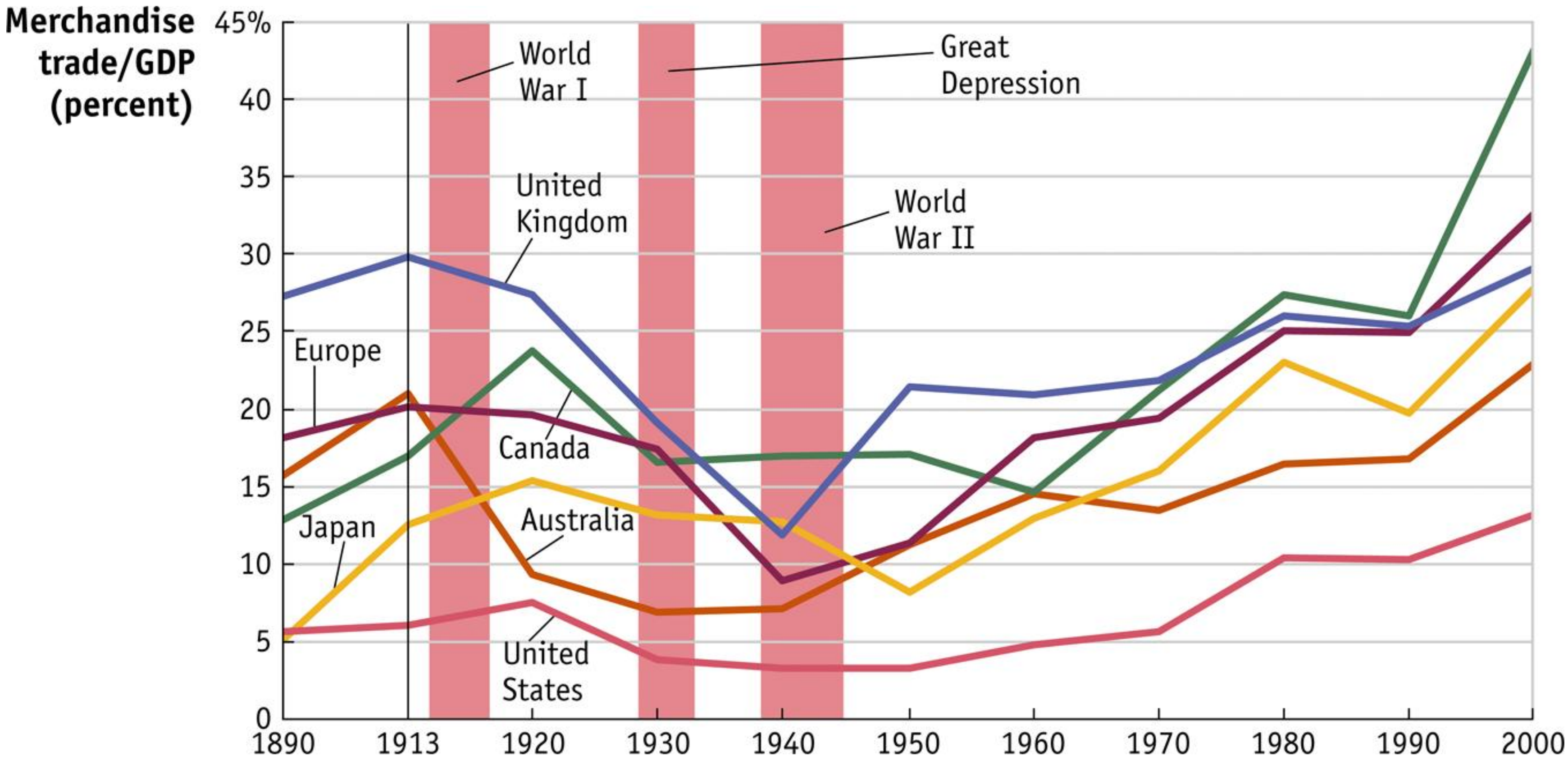
- As we saw with the Barbie example, the value-added can be much less than the total value of exports.
  - This is why trade can be greater than GDP.
- The countries with the lowest ratio are those with large economic values or those that have just started trading.
- Although the U.S. was the world's largest trader in 2005, it had the smallest ratio to GDP.

Trade Compared to GDP

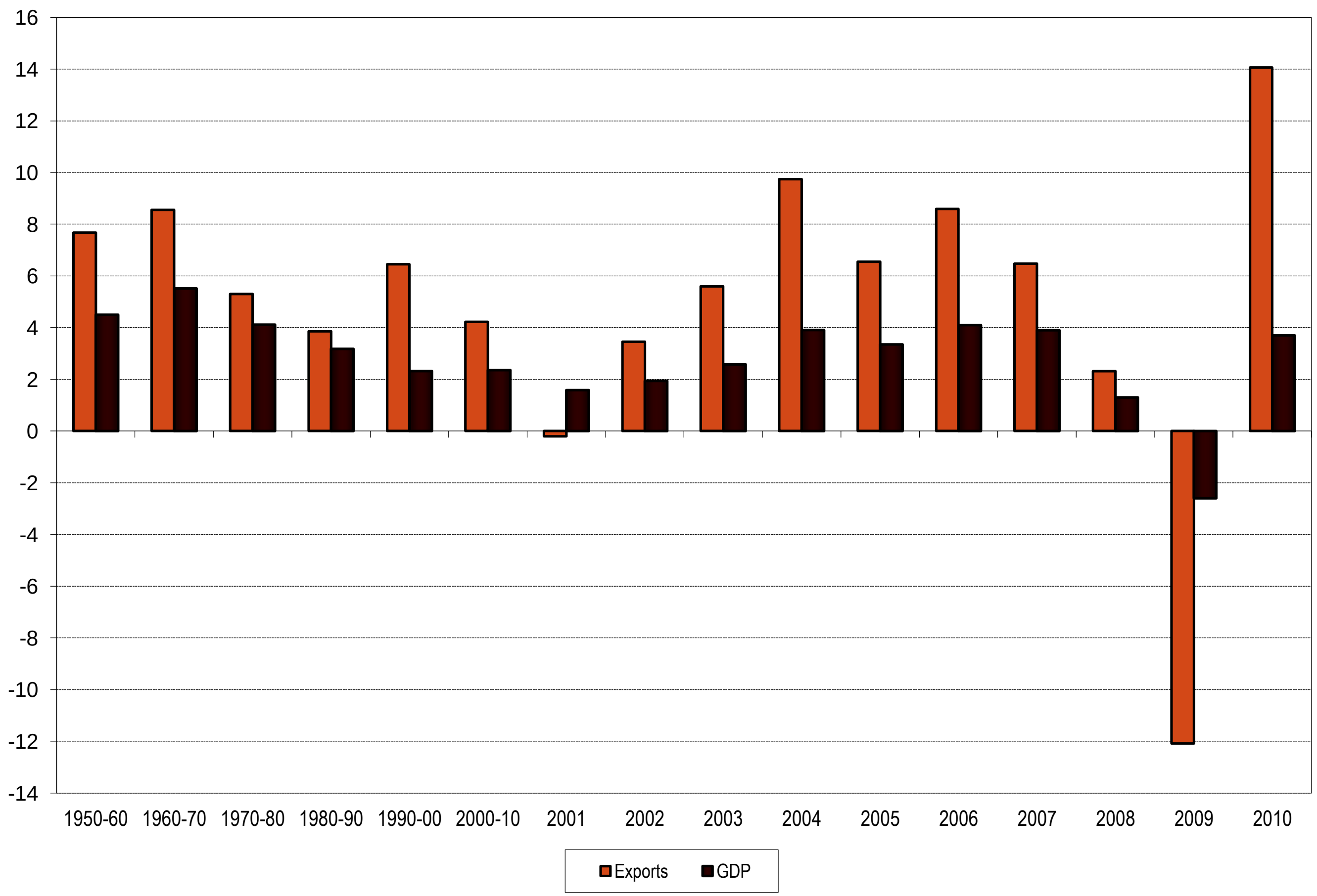
Table 1.2 Trade/GDP Ratio in 2005

Country	Trade/GDP (%)	GDP ($ billions)	Country	Trade/GDP (%)	GDP ($ billions)
Hong Kong (China)	192%	$178	Russian Federation	28	764
Malaysia	111	130	Spain	28	1,124
Thailand	75	177	United Kingdom	28	2,193
Hungary	68	109	Greece	28	214
Switzerland	49	366	Italy	27	1,723
Sweden	42	354	France	27	2,110
South Korea	42	788	South Africa	24	240
Denmark	41	254	Argentina	22	183
Germany	38	2,782	Australia	20	701
Norway	38	284	India	20	785
Canada	36	1,115	Brazil	19	794
Indonesia	35	287	Pakistan	18	111
China	33	2,229	Japan	14	4,506
Venezuela	31	139	United States	13	12,455
Mexico	31	768			
Turkey	31	363			

Trade in Goods Relative to GDP

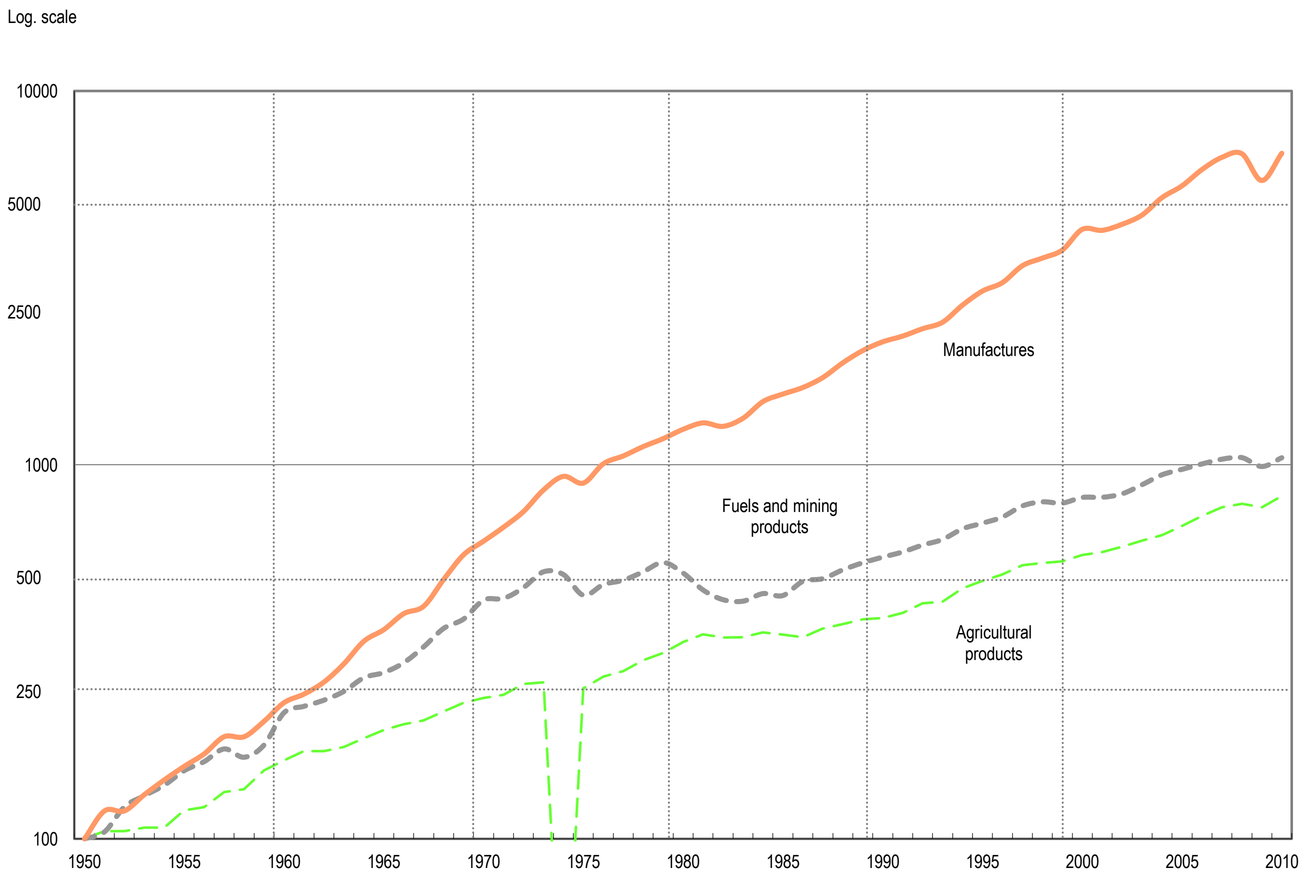


Volume of world merchandise exports and gross domestic product, 1950-2010
(annual percentage change)



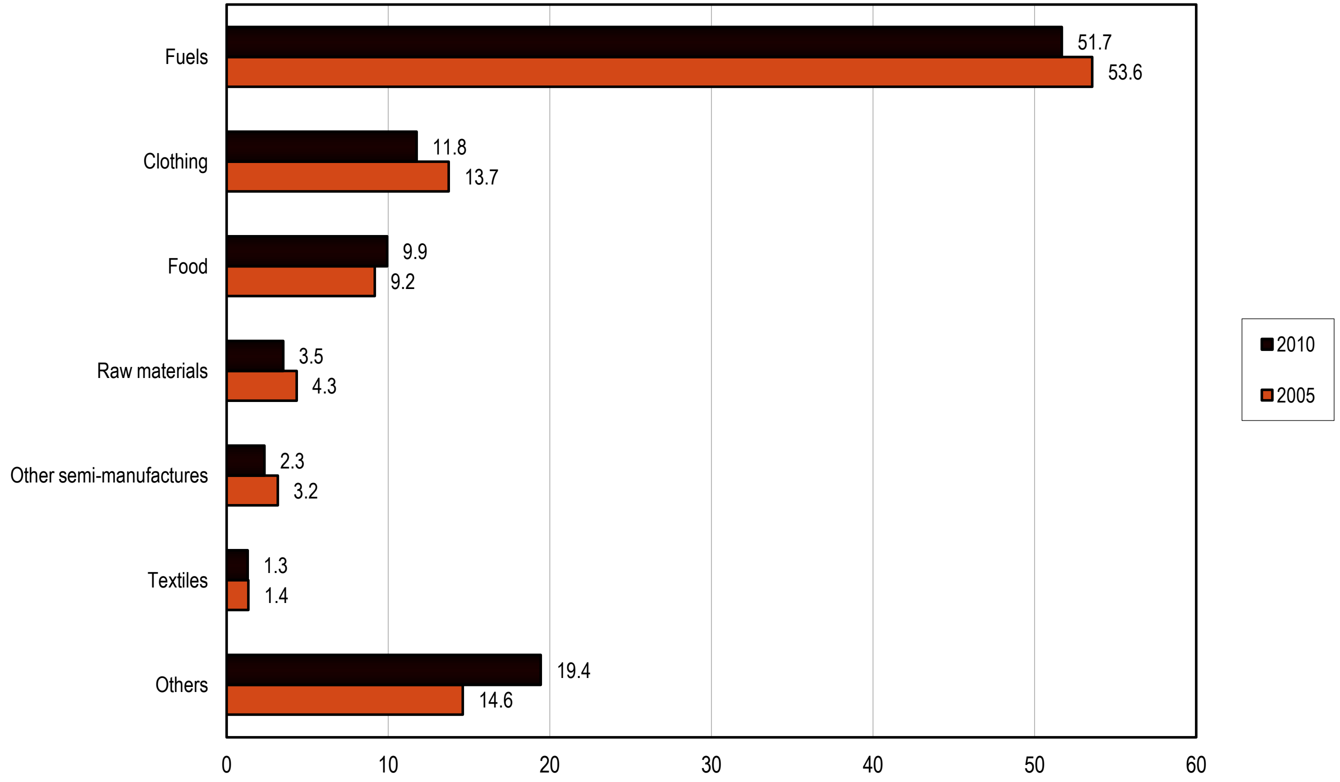
World merchandise trade volume by major product group, 1950-2010

(Volume indices, 1950=100)



Exports of least-developed countries by major product, 2010

(Percentage of total value)



World Trade Organisation

- http://www.wto.org/english/res_e/statis_e/statis_maps_e.htm
- http://www.wto.org/english/res_e/statis_e/its2011_e/its11_highlights1_e.pdf

Measuring Trade in Services

- In the GATS, trade in services is defined as the supply of a service:
  - From the territory of one [World Trade Organization] Member into the territory of any other Member.
  - In the territory of one [World Trade Organization] Member to the service consumer of any other Member.
  - By a service supplier of one [World Trade Organization] Member, through commercial presence in the territory of any other Member.
  - By a service supplier of one [World Trade Organization] Member, through presence of natural persons of a Member in the territory of any other Member.

Measuring Trade in Services

- The GATS modes of supply are thus defined based on the location of the supplier and the consumer when a service is supplied, taking into account their nationality or origin.
  - Cross-border supply (Mode 1), where both the supplier and the consumer remain in their respective territories (which would correspond to the traditional notion of trade and cover, for example, services supplied by telephone or the Internet).
  - Consumption abroad (Mode 2), where the consumer consumes the service outside his or her home territory (as is the case, typically, for international tourist activities and amusement parks abroad).

Measuring Trade in Services

- Commercial presence (Mode 3), where service suppliers establish (or acquire) an affiliate, branch or representative office in another territory through which they provide their services (as is the case, for example, when a foreign bank investing in a host economy creates a subsidiary in order to supply banking services).

Measuring Trade in Services

- Presence of natural persons (Mode 4), where an individual (either the service supplier himself if he or she is a self-employed person or his or her employee) is present abroad in order to supply a service (as is the case, for example, when an independent architect oversees a construction project abroad or a computer specialist is sent abroad by his employer to supply an information technology (IT) service).

Theories of Trade

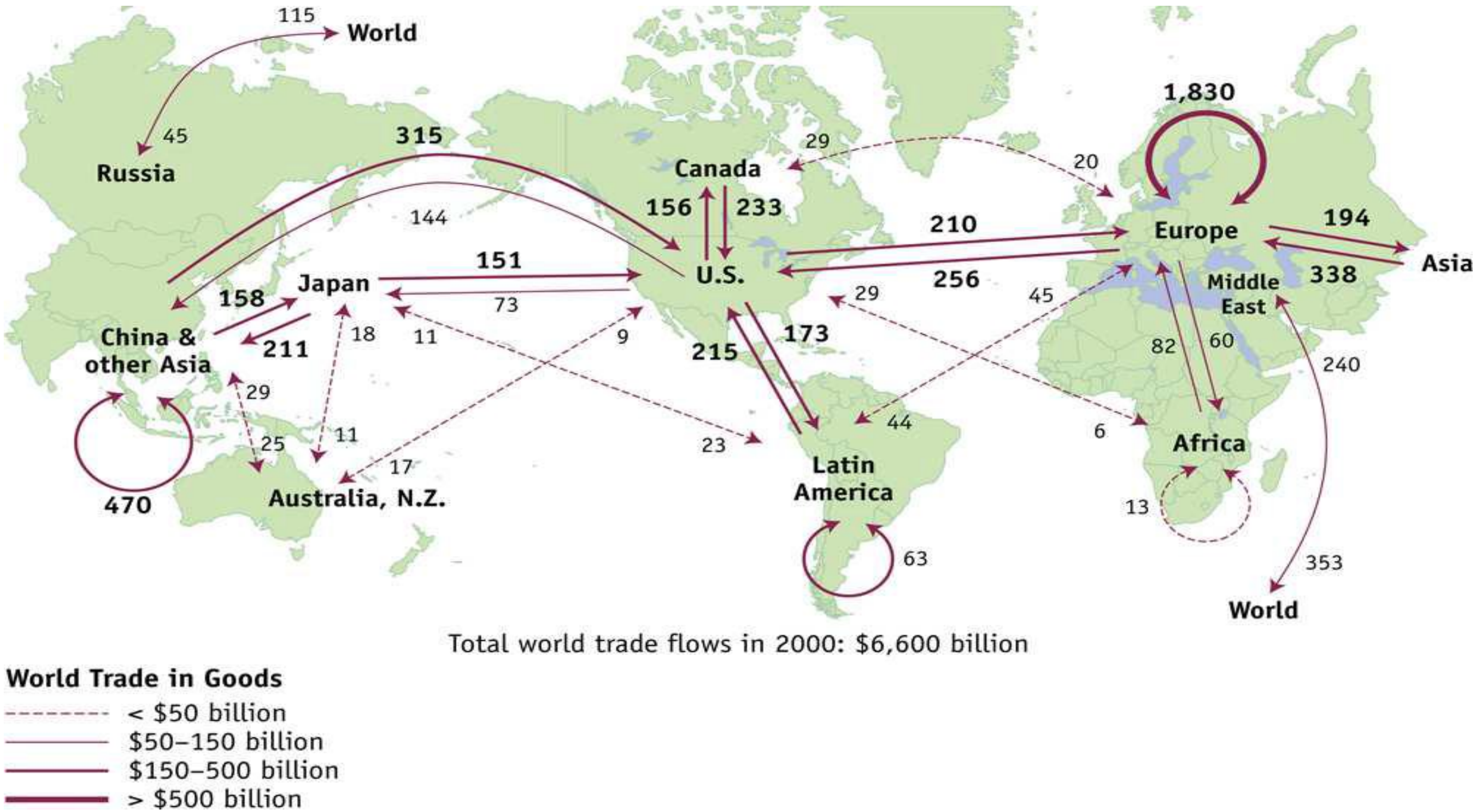
- A number of models/theories are developed to help explain reasons for trade.
  - Mercantilism: emerged in England in mid-16th Century
  - Absolute Advantage: Adam Smith (1770s)
  - Comparative Advantage: David Ricardo (1810s)

    (Ricardian model of trade)
  - Heckscher- Ohlin Theory (mid 1930s)
  - The Product Life Cycle Theory: Raymond Vernon (mid 1960)
  - New Trade Theory – increasing returns to scale and monopolistic competition

Mercantilism

- A country should earn gold and silver and increase its national wealth.
  - Exports would increase its stock of gold.
  - Imports would decrease the stock of gold.
- The idea was that a country should have a trade surplus.
  - Maximize export through subsidies.
  - Minimize imports through tariffs and quotas.

Map of World Trade (2000)



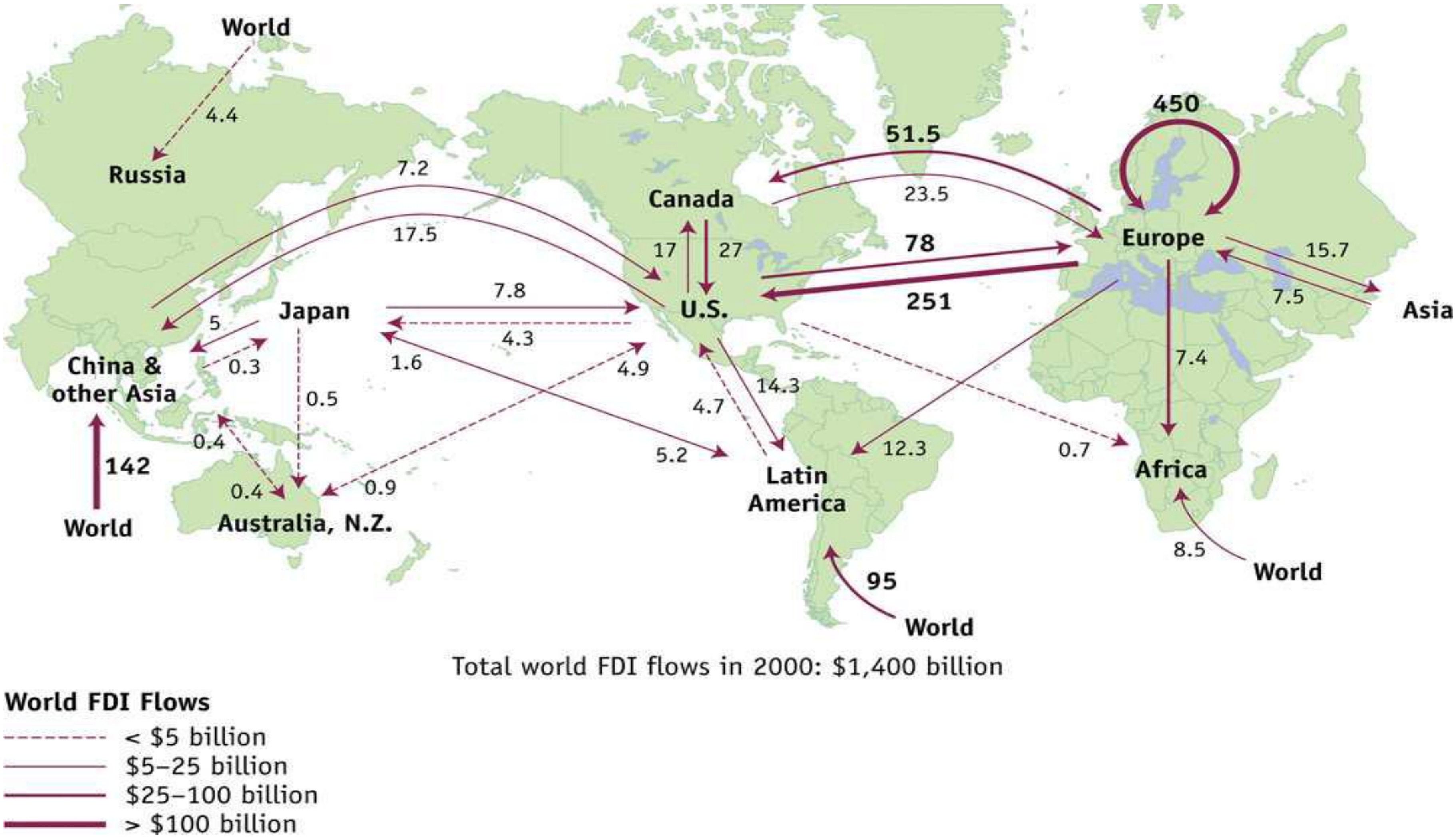
Composition of World Exports (2003)

- Agriculture – 8%
- Mining – 11%
- Services – 20%
- Manufactures – 61%

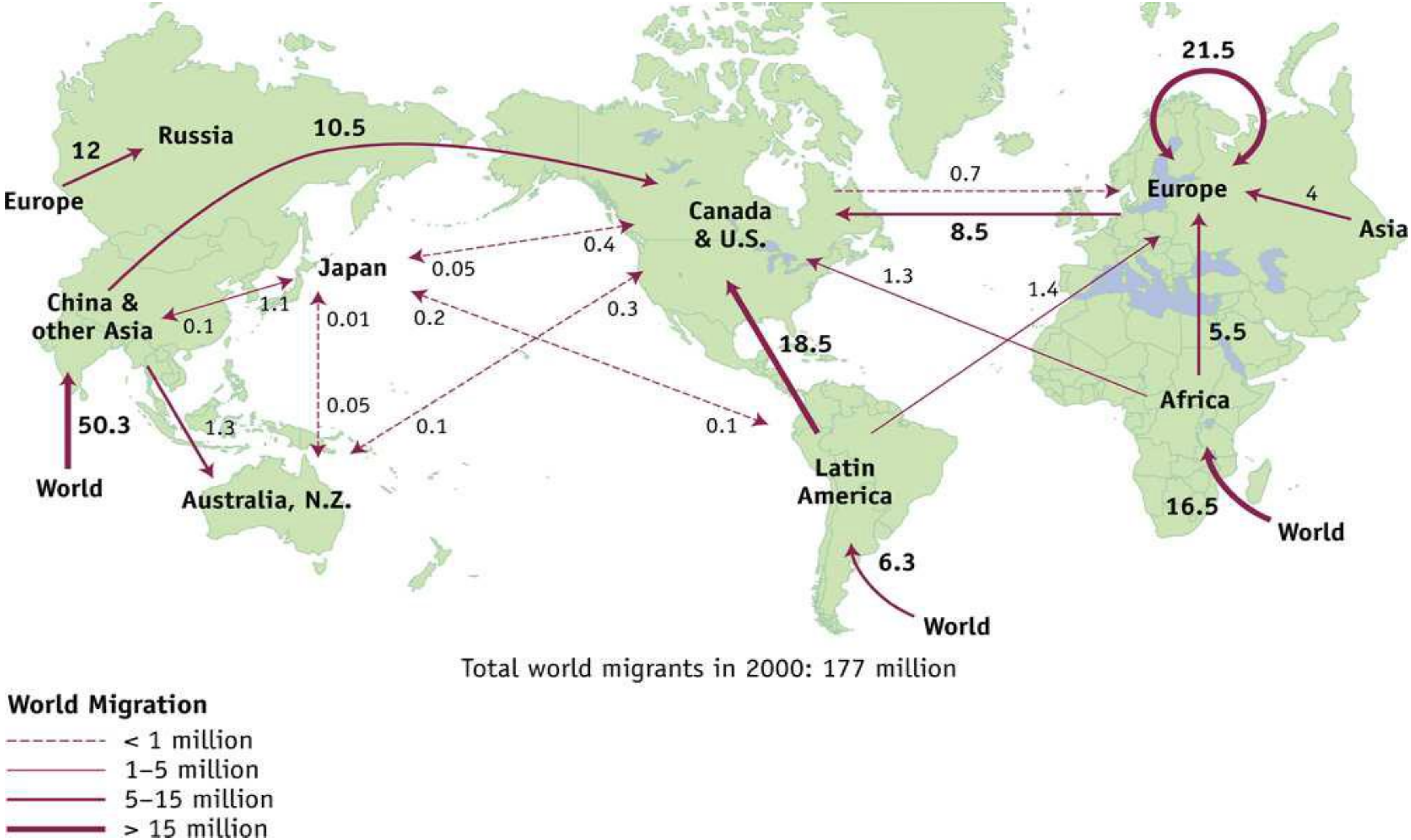
Foreign Direct Investment (FDI)

- FDI occurs when a firm in one country owns a company in another country
  - **Horizontal FDI** occurs when a firm from one industrial country owns a company in another industrial country.
    - to avoid any tariffs or quotas from exporting to a foreign market,
    - to get improved access to that economy because the local firms will have better facilities and information for marketing products,
    - alliance between the production divisions of firms allows technical expertise to be shared.
  - **Vertical FDI** occurs when a firm from an industrial country owns a plant in a developing country.
    - to take advantage of lower wages in the developing country,
    - to avoid tariffs and acquire local partners to sell there.

Map of FDI (2000)



Map of Migration (2000)



Migration and Trade

- Given a choice, migrants would like to move to a higher-wage country.
- Unlike trade, there are much more significant regulations on migration.
  - Policy makers fear that immigrants from low-wage countries will drive down wages for a country's own lower-skilled workers.
- However, international trade can act as a substitute for movements of capital and labor across borders.
  - Trade can raise the living standard of workers in the same way that moving to a higher-wage country can.
  - As trade has increased worldwide, more workers are able to work in export industries. This allows them to benefit from trade without moving to another country.

Summary

- Trade has become very large, and is growing.
- A large portion of international trade is between industrial countries.
- Over time the composition of trade has shifted towards manufactured goods from agricultural goods.
- The majority of world migration occurs into developing countries.
- International trade in goods and services acts as a substitute for migration.
- The majority of world flows of FDI occurs between industrial countries.