The World Market: Why do we trade?

Christopher J. Neely

Federal Reserve Bank of St. Louis

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Why do we trade?
The simple story

- Why do kids trade in the lunchroom?
  - They trade for what they want but don't have.

- How does this change with production?
  - We trade for what we want and can't produce as cheaply domestically. For example, we can't produce oil as cheaply domestically as we can buy it abroad.

Reasons for trade

- Comparative advantage
- Increasing returns to scale
- Trade increases competition

Reasons for trade

- *Comparative advantage* is not *absolute advantage*.
- Absolute advantage is the ability to do something more efficiently - with less labor or resources - than another country.
- Comparative advantage is what you do relatively well - or less badly.
  - Bill Clinton has a comparative advantage in golf when compared to Michael Jordan.

Reasons for trade

- A country always has a comparative advantage in something. It must.
- The United States tends to have a comparative advantage in industries intensive in skilled labor, land, and capital.
  - This doesn't mean that every skilled labor/capital intensive job will end up in the United States.

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Leontief's paradox

- If trade is motivated by comparative advantage, why does the U.S. tend to import the same sorts of stuff that it exports?
  - U.S. imports and exports might differ more than one would think.
  - There might be more than 2 factors of production. U.S. exports could be intensive in knowledge or innovation.
  - The U.S. could have an even greater demand for manufactures than capacity to produce them.
  - There are other motivations for trade besides comparative advantage.

Reasons for trade

- Increasing Returns to Scale
  - Some industries, such as shipbuilding, are only efficient at very large scales. For example, one country may specialize at shipbuilding.
  - Most countries only have a market for a few large civilian airliners. National production would be very inefficient.

Reasons for trade

- Imperfect Competition
  - International trade reduces national monopoly power in industries like automobiles, airlines, electronics, etc
  - U.S. auto manufacturing became much better when exposed to serious foreign competition in the 1970s.

Benefits of trade

- Lower prices through greater competition and economies of scale.
  - Fritz Hollings: But foreign-made towels on the shelf don't cost any less than American-made towels.
- Greater selection of different products
  - Beer, wine, cars, food, clothing, movies, etc.
- Better quality
  - Who remembers American-made cars in the 1970s?

Summary of reasons for and benefits of trade

- There are three reasons for trade.
  - Comparative advantage
  - Increasing returns to scale
  - Imperfect competition

The World Market: The Current Account

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What is a trade deficit?

- A trade deficit means that U.S. exports are less valuable than our imports. T
  - The rest-of-the-world ships us more real goods and services than we ship them.
- Why would countries ship us more valuable goods & services than we ship them?
  - What's in it for them?

What is a trade deficit?

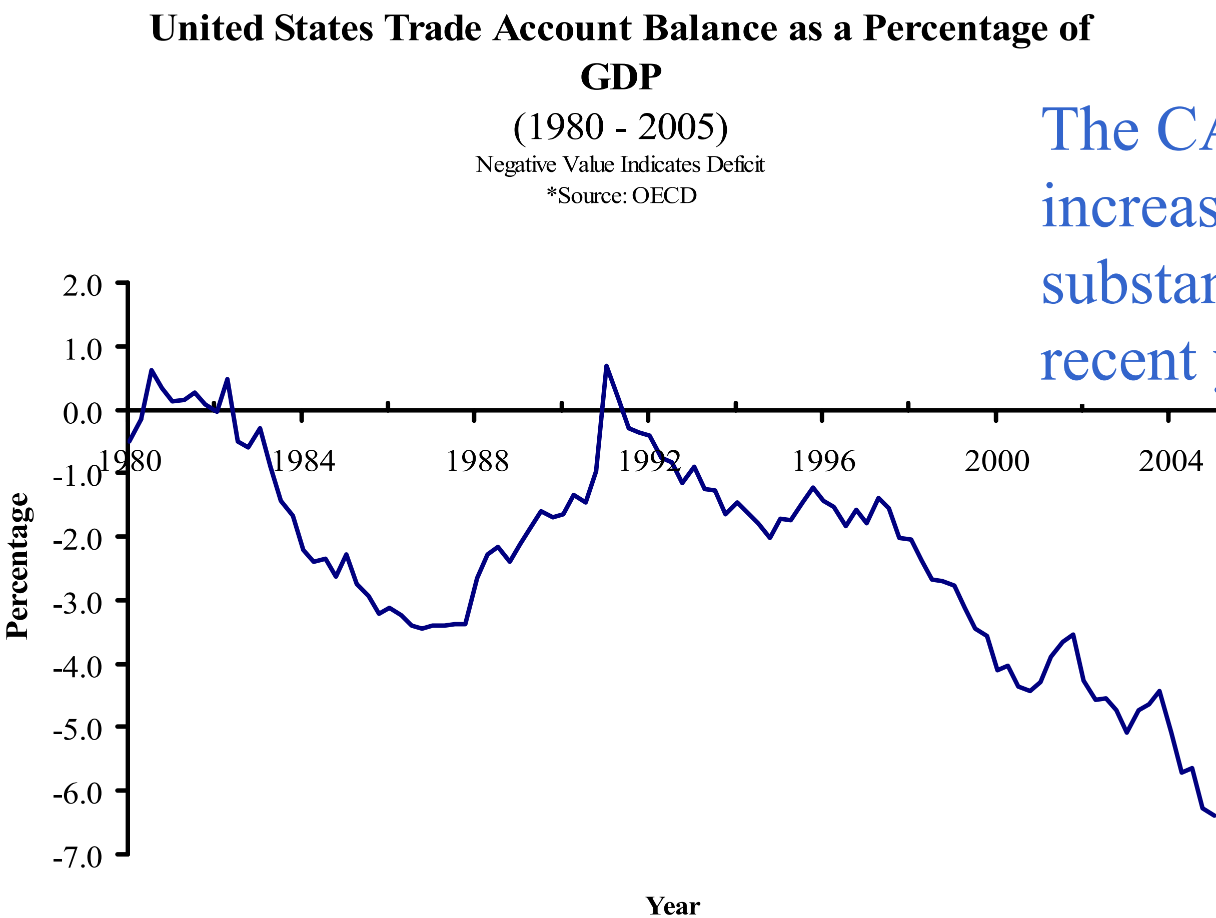
- Foreign countries are willing to do this because we give them *real* or *financial assets* in return. This is called "dissaving" or borrowing money.
- A trade deficit is an exchange of assets for goods and services. It is borrowing from abroad.

What is the current account?

- The *current account* (*CA*) measures trade in goods and services, net receipts on foreign investment, and unilateral transfers.
  - The CA is dominated by the *merchandise trade balance*.
- A *CA deficit* means that a country imports more goods and services than it exports.

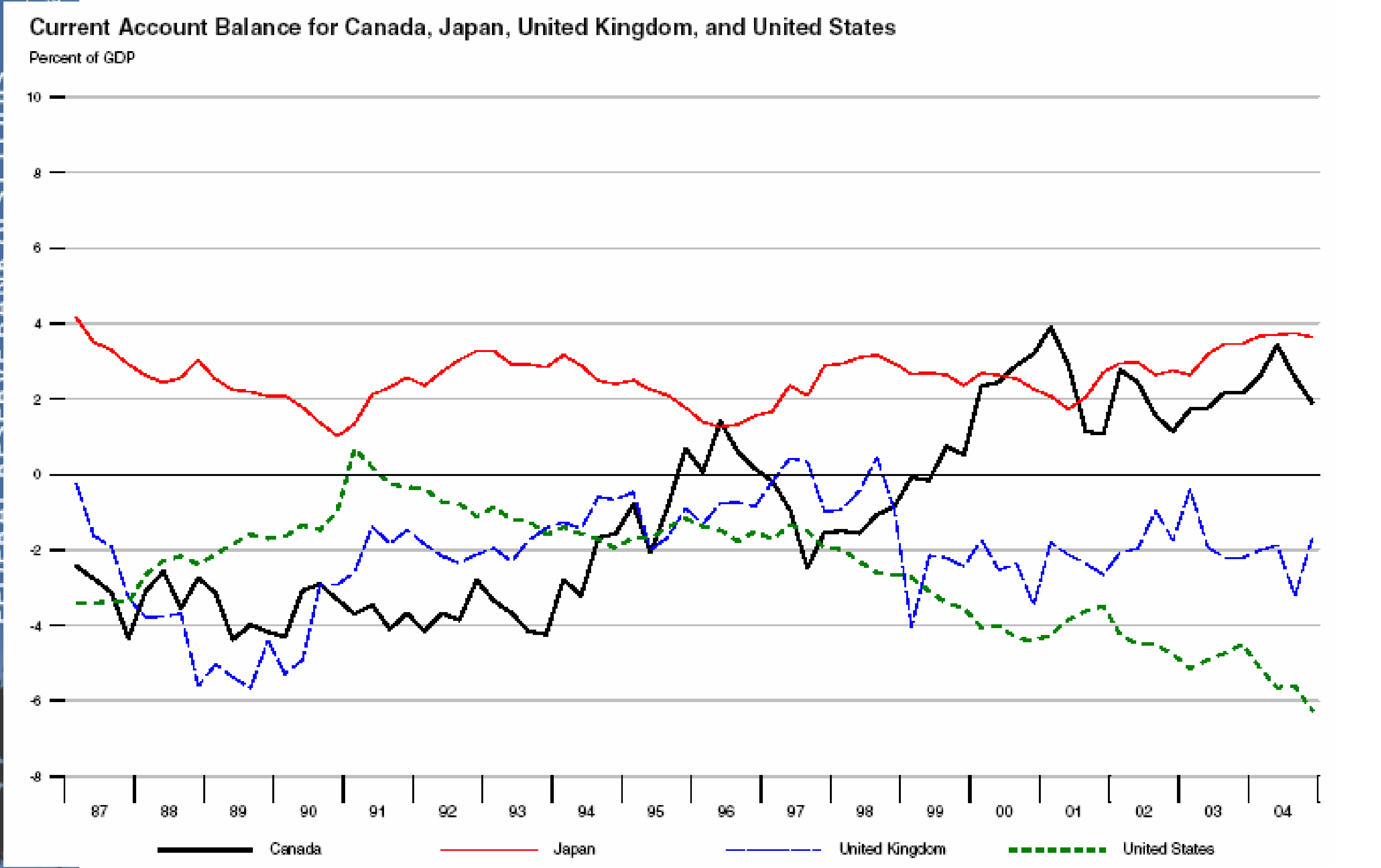
The U.S. Current Account Balance

- The U.S. current account deficit is very large. What does this mean?

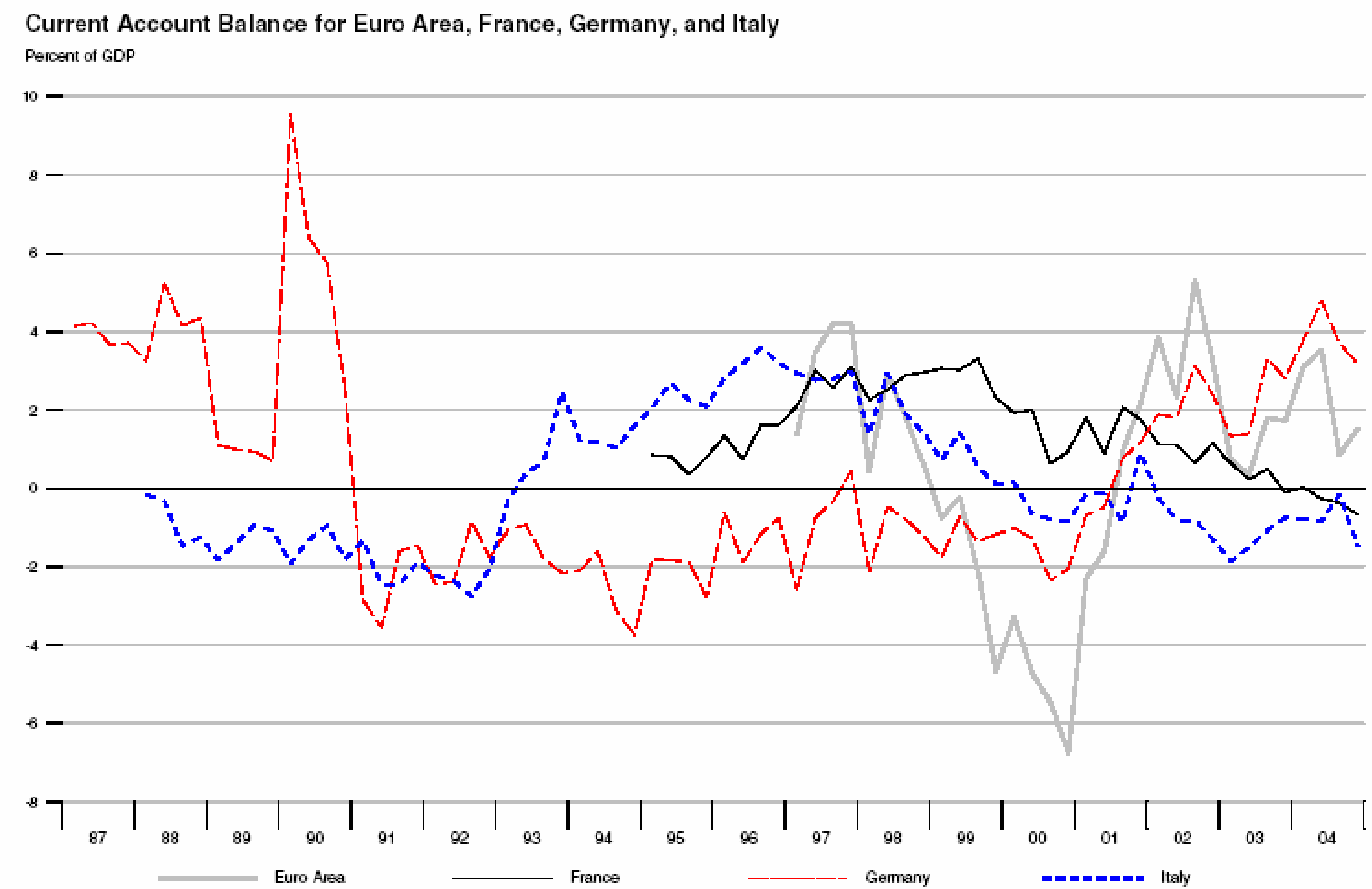


The CA deficit has increased very substantially in recent years.

U.S. vs. G-7 current account deficits



U.S. vs. G-7 current account deficits



What drives CA deficits?

- Competitiveness?
  - Does a CA deficit reflect poor goods/services?
- Trade barriers?
  - Does a CA deficit reflect trade barriers or currency manipulation?
- Oil imports?
- Savings/investment decisions

Savings/Investment and the CA

Recall that a *current account deficit* occurs when we import more goods & services than we export.

Why does the rest of the world give us more goods & services than we give them? (What's in it for them?)

A CA deficit is always accompanied by a *capital account surplus*. A capital account surplus means that we sell more assets abroad than we buy from abroad.

A CA deficit always means that a country sells claims on future income. This is neither intrinsically good nor bad.

Savings/Investment and the CA

Another way to look at CA deficits.

Output = Consumption + Investment + Net exports

Output = Income

Income = Consumption + Investment + Net exports

Income − Consumption = Investment + Net exports

Savings = Income − Consumption

Savings − Investment = Net exports (CA deficit)

Savings/Investment and the CA

Anything that reduces savings and/or increases investment in the U.S. will raise the CA deficit.

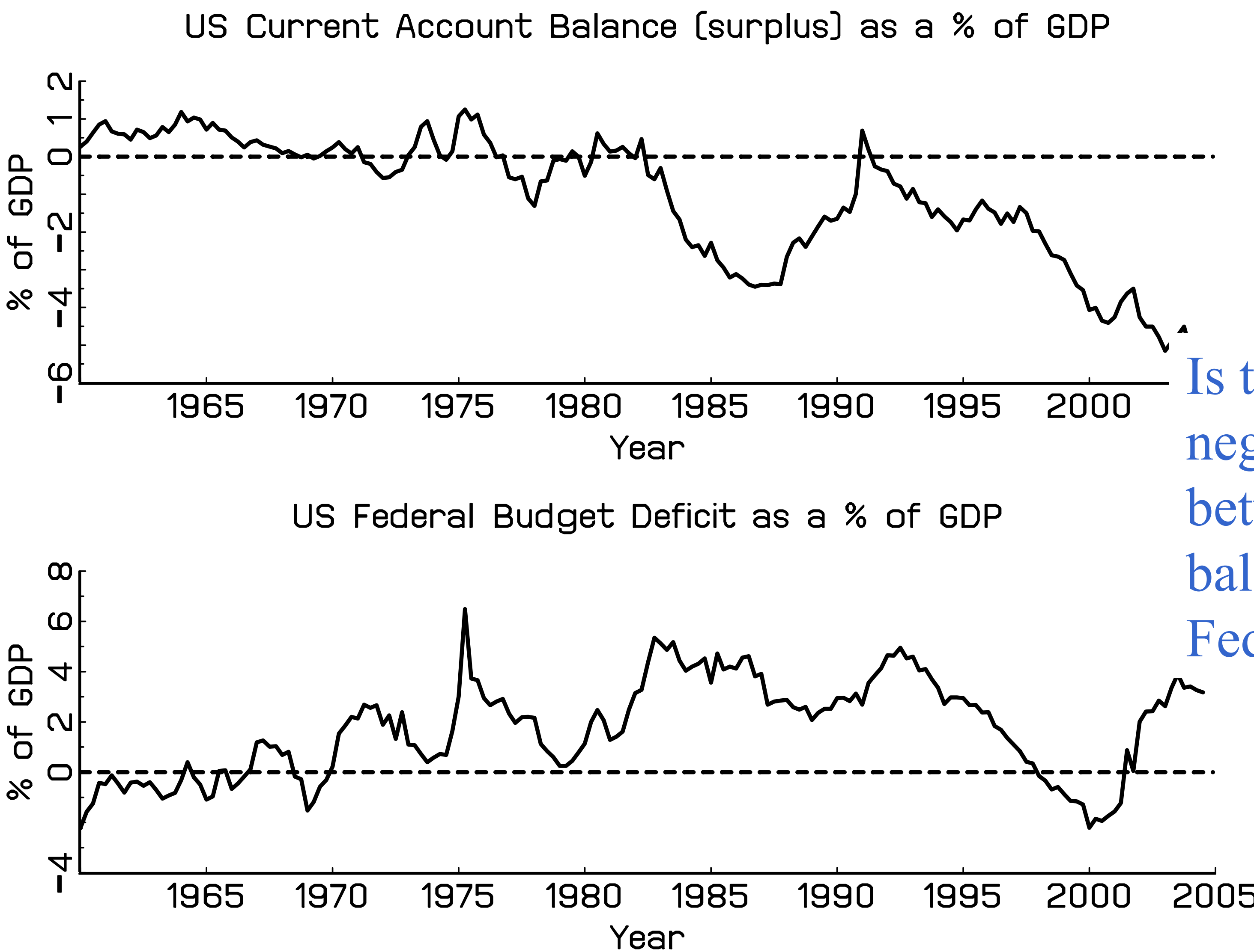
What might change savings/investment?

(ceteris paribus)

- Changes in desired savings rates.
  - Demographics, perception of risk, legal changes.
- Government deficits (negative saving)
- Cyclical demand for investment goods.

Savings/Investment and the CA

Government deficits: The "Twin Deficits"



Is there a negative relation between the CA balance and the Federal deficit?

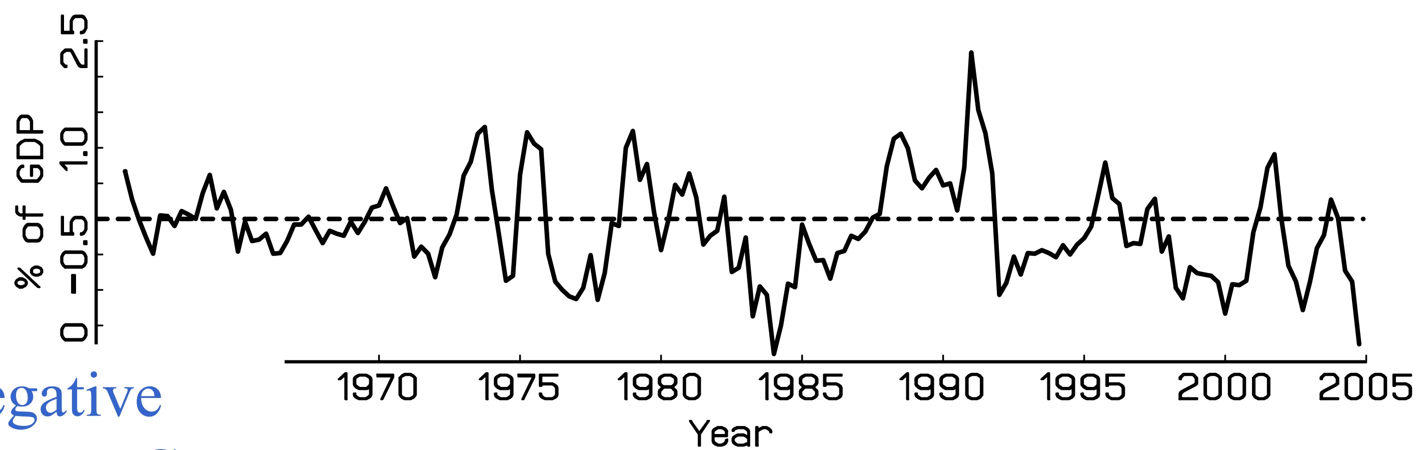
Savings/Investment and the CA

- Government deficits: The “Twin Deficits”
  - The negative relation between the CA balance and the Federal deficit is a “ceteris paribus” relation.
  - We shouldn’t expect it to hold unconditionally.
  - For example, a rising stock market might decrease the budget deficit while increasing the current account deficit through investment demand.

Savings/investment and the CA

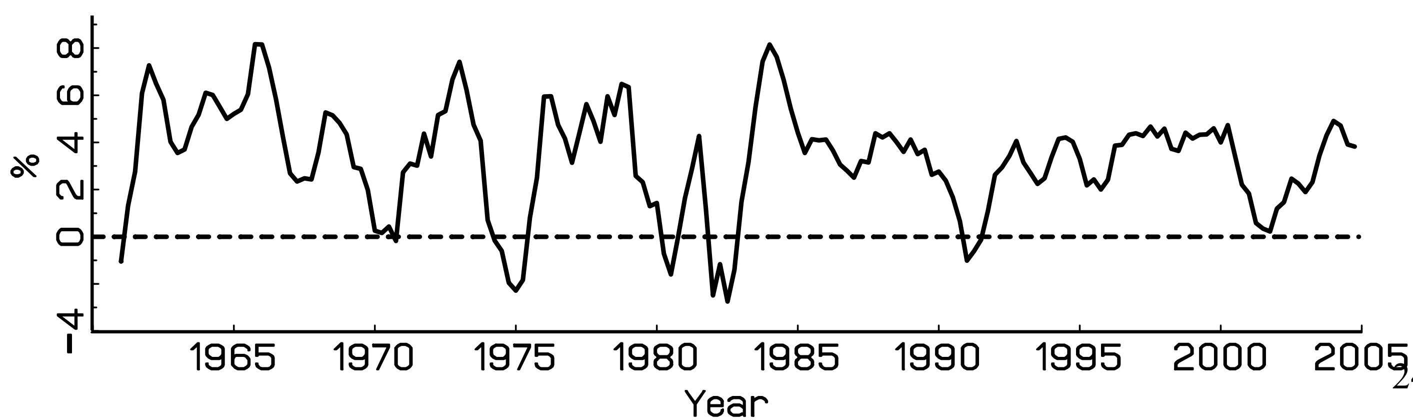
- Cyclical demand for investment goods.

Change in 4-Qter US Current Account Balance as a % of GDP



Is there a negative relation between GDP growth and the CA?

4-Quarter Change in US Real GDP



What doesn’t change S/I decisions?

- Changes in exchange rates.
  - Changes in prices are *endogenous*, they don’t change quantities. Both P and Q react to fundamental shocks through supply and demand.
- Changes in preferences, trade barriers, etc have very small effects on S/I decisions.
  - Changes in trade barriers/preferences will be offset through changes in exchange rates.

Why is the U.S. CA deficit so big?

- Business Cycle effects
  - The U.S. is growing relatively rapidly compared to our trading partners.
- The Federal Deficit:
  - A rise in U.S. government dissavings (the deficit) leads to a fall in the national savings rate.
- Flight to safety
  - The international security situation might have increased demand for relatively safe U.S. assets.

Can a CA deficit persist forever?

- Theoretically, there is no reason why a nation cannot run a CA deficit forever.
- The size of deficits is limited by expectations of claims on future income. (Can you pay it back?)
- In practice, countries have run persistent deficits, as long as they attracted foreign investment.
- The U.S. deficit is likely to decline at some point.

How will the U.S. CA resolve?

- Will the U.S. experience an exchange rate crash like those in Mexico (1994) and Asia (1997)?

  - Probably not. The U.S. has a flexible exchange rate system and a fall in demand for U.S. assets will gradually reduce the value of the dollar.

  - A reduction in the CA deficit must be accompanied by a rise in S/I.

Is a CA deficit disastrous? Are we exporting jobs?

- If you buy a foreign-made car, do you put some Detroit autoworker out of a job?

- When Dell outsources a call center to India, does that put Americans out of work?

- If we could eliminate the CA deficit, how many Americans could be put to work?

Does a CA deficit export jobs?

- When foreigners sell us goods, they must do one of two things with the money: 1) Buy U.S. goods; or 2) Buy U.S. real or financial assets.
- Either course of action creates about as many jobs as are "lost" by the imports.
- Trade can help or harm individuals, but—on net—it neither creates nor destroys jobs.

Does a CA deficit export jobs?

To answer that question, we have to consider what determines unemployment.

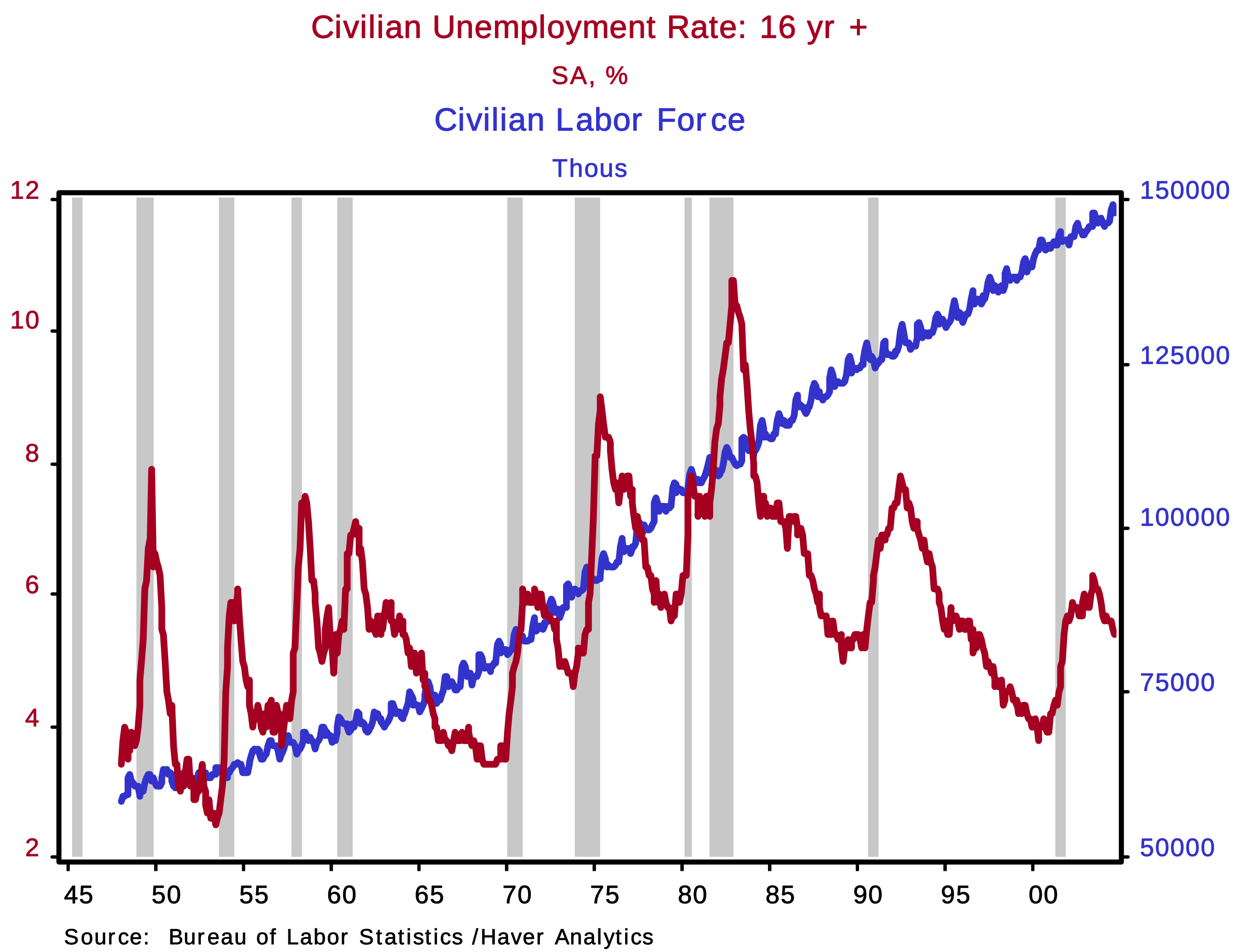
Question: What would happen to unemployment if the U.S. labor supply more than doubles in the next 50 years?

Answer: A huge rise in trade in the last 60 years has not increased the average unemployment rate.

In the absence of labor market frictions, like minimum wages, or related demographic changes labor supply determines employment <u>in the long run</u>.

Unemployment & labor supply

- The U.S. unemployment rate 1948-2004.



Summary on CA deficits

- The U.S. is running a very large CA deficit.
  - That is, the U.S. is selling claims on future income. This might be good or bad.
- The CA deficit results from the fact that U.S. saving is less than U.S. investment.
- A "crash" is unlikely, but the level of the CA deficit will not persist.
- Current account deficits do not destroy net jobs.

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Thanks for your attention.

The End