

International Trade and the New World Order

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Keynote Address given at the
Eurobank EFG Conference titled,
“International Trade Trends and Perspectives: The Challenges Ahead”
April 3, 2008
Athens, Greece

Synopsis of "International Trade and the New World Order"

Address to be given on April 3, 2008

It is a pleasure to be here. Attempting to assess the future is always hard. You can either extrapolate, or essentially try to predict the unpredictable. I propose to do something of both: first, I will talk about the determinants of international trade and the role of trade in the past. I will then examine those factors that may result in changes in the composition and growth of trade in the future.

I start by noting that expansion of world trade as a leading engine of growth has been a hallmark of economic history. That expansion has been both in domestic trade and in international trade. For lack of time I will concentrate on the period since the Second World War, but it should be noted that trade growth in the 19th century far outpaced the rate of growth of real GDP: it is estimated that, in 1800, world trade (exports plus imports) accounted for about 2 percent of world GDP; by 1913 it accounted for about 22 percent; it now accounts for about 58 percent, having risen almost continuously from the low of 9 percent to which it fell in the Great Depression.

The only period during which world trade did not grow rapidly was during the era of the First World War and then during the Great Depression. Most analysts consider that the contraction of trade during the depression was, at a minimum, a major factor in making the Great Depression deeper and more prolonged than it otherwise would have been, as countries tried to "beggar their neighbors" by erecting high walls of protection in the hope that domestic import competing industries could expand.

The major factor influencing the growth of trade until 1914 was falling costs of transport and communications. It is estimated that bulk shipping costs fell an average of about 70 percent between 1870 and 1914, making many more goods tradable and lowering the costs and prices of those already traded to importing countries, thus increasing demand. Canals and railroads also lowered transport costs dramatically, enabling many goods (such as wheat grown in the Midwest of the United States) to reach ocean ports much more economically as well as integrating domestic economies. Communications also improved with the advent of the telegraph and the telephone, making transactions at long distance less costly.

The history of trade and its relationship to economic growth is a fascinating one, but one on which I cannot dwell here. Turning to the period since the Second World War, which I shall refer to as the past half-century, it has been the most successful in economic history in terms of raising living standards and well-being of people around the world. Moreover, that success seems to have accelerated in recent years, as the past 5 years have recorded one of the highest rates of growth of any five-year period in economic history.

Broadly speaking, the past half century's economic performance divides into two periods: a first, during which the industrial countries grew very rapidly, and trade among them and with developing countries expanded even more rapidly. Although the rate of growth of real GDP and real per capita incomes in most developing countries was higher

than it had been in earlier times, industrial countries' economic performance was even better. In large part, this was because developing countries had adopted policies which were intended to insulate their economies from competition from abroad; their share in world trade and world GDP actually fell.

Based on the dramatic success of a few developing countries, mostly in east Asia, the 1980s saw a shift in the policies of one after another of the developing countries. In some trade barriers were dramatically reduced and exchange rates made much more realistic so that there was rapid growth; in others the reform was more gradual, but even in those countries growth accelerated. Hence, after the 1970s, more and more developing countries experienced accelerating growth so that, by the turn of the century, successful growth was a worldwide phenomenon and real per capita incomes in developing countries were rising more rapidly than in the developed countries. China was the most dramatic example of this second wave of accelerated growth, and, given her size, the most visible. But India, whose share of world trade and world GDP had fallen until the 1980s, also changed course, opened the economy to trade substantially, and grew at an average annual rate well above 8 percent in the past five years. Other countries in south and southeast Asia, parts of Latin America, and elsewhere also experienced more rapid growth of trade and real incomes.

This success was broad enough so that life expectancies are not only much higher than they were 20 or 50 years ago, but the gaps in life expectancy, health status, literacy attainment and other measures closed even more rapidly than that in per capita incomes.

In India, for example, life expectancy was estimated to be around 30 years in 1950; it is now about 64 years.

A major hallmark of successful growth has been the growth of trade. International trade has grown at about twice the rate of growth of world GDP. It was, in every sense, an “engine of growth”. Although transport and especially communications costs continued to fall, they were already a much smaller fraction of imported cost than had been true in earlier periods. The major change was the reduction in the trade barriers, first of the industrial countries and then, after 1980, also of the developing countries.

Clearly, there was a two-way relationship between the growth of trade and the growth of real world GDP. Rapid growth of trade accelerated the growth of productivity and real incomes, which made trade liberalization easier. Trade liberalization, in turn, enabled acceleration in trade.

Trade liberalization took place for a variety of reasons and in a variety of ways. In the first postwar period, it took place primarily among the industrial countries and in the context of multilateral trade negotiations under the GATT (the General Agreement on Tariffs and Trade) and now the WTO (the World Trade Organization). In successive rounds of multilateral negotiations (in which the industrial countries were the main participants), average tariffs on manufactured goods fell from 40-50 percent in most industrial countries in 1948 (with many quantitative restrictions and bilateral clearing arrangements also serving as major barriers to trade) to levels of 3-5 per cent today. And

quantitative restrictions among industrial countries are virtually nonexistent. In addition, of course, the successful integration of the economies now in the European Union further reduced trade barriers, as has the entry of the countries of the former Soviet Union and Eastern Europe into the world trading system.

Among developing countries, trade liberalization was often undertaken unilaterally – the early successes among the east Asian countries were built partly on the lowering of their own trade barriers, thus making the international market more attractive to producers and reducing incentives for import-competing production at home.

With trade liberalization and further reductions – albeit not so dramatic – in transport and communications costs, trade growth was rapid, as I already stated. Growth of trade was, at least for the first three decades, most marked in manufacturing; services trade began growing slowly from a small base, but now accounts for about 25 percent of all trade in goods and services, while the share of primary commodities in world trade (and world GDP) has fallen (until very recently when commodity price increased).

By now, tariffs are low for most countries and most manufacturing commodities. Tariffs and other trade barriers for agricultural goods are higher than on manufactures in both developed and developing countries. Barriers to international trade in services have been reduced somewhat, but there remains a long way to go. I shall return to these issues at the end of my talk in discussing prospects for the Doha Round.

For present purposes, I want to dwell a bit further on the drivers and nature of trade growth until the present time, and then turn to examining the extent to which changes in the world economy may lead to a different future course of trade.

As already mentioned, the “virtuous circle” of growth of real incomes and growth of trade enabled trade liberalization to continue, to the point where average tariff rates on manufactured goods are now very low multilaterally, and of course, even lower within preferential trading areas including the European Union, NAFTA, and others. Falling transport costs have been far less important, if only because transport costs had already become a much smaller percentage of the import costs for all goods. However, the ease and falling costs of communications have undoubtedly further facilitated international trade. It is estimated, for example, that in 1930 a 3 minute phone call between New York and London cost the equivalent of US\$230 in 2000 prices, while today it costs a few cents at most. And although transport costs have not fallen as rapidly as in earlier periods, the time it takes for goods to reach their destinations has continued to drop, thus reducing costs in different ways. Traffic carried by air, which now accounts for a sizeable fraction of merchandise trade, has grown much more rapidly than goods shipped by sea.

Rising incomes have, of course, led to a higher fraction of production and consumption (within manufacturing) of high value-added goods; bulk shipping is less important as a fraction of the total than it was. And, until recently, primary commodities were falling in their share of both volume and value of international trade. Whether this will continue is another question to which I shall return.

However, with increasingly sophisticated production, many services, that used to be provided within manufacturing companies, are now provided (at much lower cost) by firms specializing in them, and selling to many manufacturers. Business services include such obvious ones as finance and insurance but also “back office processing” of transactions and records, software utilization, and the like. These have assumed increasing importance as a share of international transactions in recent years, but there remain a significant number of trade barriers whose elimination would enable further growth of trade. Again, this issue is under negotiation in the Doha Round and I shall return to it at the end.

Since developing countries began integrating with the international economy, of course, another major source of growth in international trade has been their increasing participation in trade. To give only one example: in 1960, Korean exports constituted only 3 percent of Korean GDP; today the figure is above 30 percent and Korean exports grew at an average annual rate of 40 percent for the first decades of rapid Korean development. Korea is now one of the world’s largest trading countries. And, of course, the growth of exports from China (and imports into China) has been exceptionally rapid: China’s exports now exceed Japan’s, but Japan itself experienced very rapid growth of exports and imports during the high growth years of the 1960s and 1970s.

One last factor should be mentioned among the drivers of growth in trade: as incomes have risen, an increasing fraction of consumption has been allocated to discretionary and luxury items. These include international tourism, which has been

growing very rapidly, but the very fact that there is more discretionary income means that consumers can exercise their tastes for variety in such goods as Australian, South African, French, and other wines, Asian furniture, specialty goods (including handicrafts) produced in different countries, alongside their greater purchasing power and hence purchases of traditional goods such as apparel, footwear, and the like.

Before turning to the future, I should take a moment to address the immediate situation. Thus far I have been discussing long-term trends. Since the summer of 2007, attention has focused on the financial markets, and their possible impact on the rate of world growth and of international trade. In the past, trade has been significantly impacted by short term recessions; in the recession of 2001, for example, trade volumes actually fell. Should there be a recession or prolonged slowdown in growth, trade would obviously be negatively affected. However, there have been some structural changes in the world economy that can be expected to mitigate the impact relative to earlier downturns. These include the increased importance of the Asian exporting countries, the improved fiscal positions of many developing countries (so that they need not undertake contractionary policies as rapidly as in earlier downturns), the high levels of reserves held by many, and the fact that a higher percentage of GDP is in services, where inventory levels will not be as significant a factor as in earlier downturns.

With this background, we can address the currently perceptible trends and risks that are likely to affect future trends in trade. First, there are those underlying factors that would influence the future growth and composition of world trade even if current trends

in real GDP growth in the international economy continue. Second, there are uncertainties in the future outlook that could affect trade over the longer term. And, finally, there are short-term issues arising out of the current conjuncture.

On current trends, it would be expected that the share of Asia in world trade would continue to increase, that services trade would continue to grow as a share of the total, and that more and more countries would liberalize their trade regimes with accelerated growth of real GDPs and trade. There would be no strong reason in the foreseeable future to anticipate a reduction in the relationship between growth of world GDP and of trade, with trade growth approximately double the rate of growth of world GDP. Of course, that relationship cannot continue forever (as eventually world GDP would consist entirely of traded goods), but over the medium term accelerated growth in some parts of the world would offset – as it has in the past decade – reductions in growth elsewhere.

This growth would result in increased trade in services relative to goods, and in a continuation of the trend toward higher value added per unit of volume of trade for manufactures. The outlook for world economic growth going forward would indeed be rosy, and we could hope that the Millennium Development Goals (MDGs) could be achieved by all countries, if not by 2015, without too long a lag, as they appear to be reached in China and India.

However, there are, of course, a number of risks to this optimistic outlook, both longer-term and shorter term. Let me start with the longer term risks first.

Most importantly, the rosy continuation-of-trend scenario depends heavily on the continued integration of world markets, both for growth of trade and for growth of world GDP. And, as I noted, there is a virtuous circle between the two. Should protectionist forces halt, or worse yet, reverse, the trend toward liberalization, the outlook for world economic growth and trade would be much less promising, especially for those low-income countries that have not yet taken advantage of the opportunities offered by the world trading system for rapid growth.

We all recognize that significant geopolitical events could be a major source of disruption for trade flows and world economic growth. It is not possible, however, to assess each and every possibility, and so I concentrate here on other possibilities, assuming that there is no such event.

In this context, satisfactory completion of the Doha Round and a thwarting of rising protectionism that that would entail is vital for world economic prospects. Strong support of the Doha Round is the interests of all, but vital for low-income countries if they are to have the opportunity for rapid development, and of great importance for small trading nations. Failure to complete the round would strengthen protectionist pressures in many countries. We would not witness a sharp or sudden change in the international environment, but gradual erosion and a slowing of trade.

In this regard, it is important that trading nations take measures to offset some of the internal negative income distributional effects that have been noted in recent years. Although the evidence is strong that most of these effects have been the result of technical change rather than trade, the tendency to blame trade is strong and has been a major source of reviving protectionism. It will also be important that disciplines be imposed on preferential trading arrangements in such a way that the multilateral trading system remains predominant. Time precludes me from saying more, but the issue is important over the longer term.

While increasing protectionism poses a threat to the system over the longer term, there are other, perhaps more immediate issues. Here, the issue of high commodity prices, and especially high energy prices is most important. Should energy prices remain at their current high levels, or even increase further, that would surely affect transport costs, as would measures to mitigate environmental concerns. Significant increases in energy prices would undoubtedly serve to reduce the rate at which trade volumes grow and could, if they were extreme enough, even result in a reduction in volumes. For the industrial countries, the rate of growth of energy utilization per percentage growth of GDP is less than one and falling. That, however, is not true of some of the rapidly growing emerging markets. A critical issue is how their energy use per unit of GDP changes as growth proceeds. And should the international community work out a workable scheme for carbon taxes that could also significantly impact trade flows.

An increase in energy prices and transport costs would most disadvantage countries that are far removed from their major international markets, and those whose trade consists of bulk commodities. Trade in higher value-added per unit of volume items would of course be negatively affected, but significantly less so. And, of course, there is always the possibility of discovery of new and cheaper energy sources, which could mitigate these effects. Nonetheless, as of 2008, the future trajectory of energy prices and costs associated with environmental protection must be counted as a significant factor that could impact the future of international trade and the resulting world order.

The most immediate concern must, of course, be the current situation in world financial markets. For purposes of assessing trade flows, the major question is the degree to which the financial turmoil spills over to the real economy. Here, there are two issues: changes in governments' policies toward the financial sector; and the impact of the current situation on real economic activity. In the longer term, it is essential that the international financial system function smoothly in support of international trading relations. Should regulation, or other policy reactions to the current situation, impair the functioning of the system sufficiently, it could negatively affect the future of the trading system.

However, most policy makers appreciate the essential role of the financial system in supporting trade and growth. While there are measures that can and probably will be undertaken to strengthen the system without impairing its functioning, it is unlikely (but

not impossible) that policies will be adopted that fundamentally weaken the functioning of the system.

Much depends, however, on the course of the real economy. Most important in this regard is the United States, in part because of its size, and in part because the U.S. seems to be the center where financial difficulties started because of the problems in the subprime mortgage sector. For the U.S., there is no question that real economic activity has slowed down – although to date the data do not show a drop in real GDP. Whether there is a slowdown or a drop, however, there will be an effect. To some extent, the decline in construction activity is already being offset by an increase in exports, spurred by the depreciation of the U.S. dollar. U.S. exports are estimated to have risen at percent in 2007, and the rate of growth appears to be accelerating. The further depreciation of the dollar in the first quarter of 2008 is likely to accelerate this trend.

The more rapid growth of American exports will offset part of the decline in construction activity. And, the American economy is highly flexible. For both these reasons, there is a basis to hope and expect that the slowdown will not be of long duration, and that the pace of economic activity may accelerate even before the end of 2008.

Moreover, for reasons I discussed earlier, real GDP in the rest of the world would be less negatively affected by an American slowdown than has historically been the case: the U.S. share of world trade and world GDP is not as large as it was; the rapid growth of

India, China, and other emerging markets will contribute more to world growth and provide an offset for at least part of any American slowdown. And many countries are better positioned in their fiscal policy and holding of reserves to maintain their levels of economic activity, and hence their demand for imports from the rest of the world.

There are uncertainties in the world economy at the present time: should the financial system's current difficulties persist and spill over into the real sector, there is no doubt that a downturn could occur. And slowdowns or downturns always result in intensified protectionist pressures. It is to be hoped that the international community has learned enough about the importance of trade, and the financial system, so that this dire outcome does not occur. If not, there is every reason to believe that the prospects for future economic growth of the world economy are favorable: with a satisfactory completion of the Doha Round, and as more and more countries and regions adopt appropriate policies to support growth, growth of world trade and GDP could even accelerate relative to what it has been in the past. I remain an optimist: we have learned the importance of an open trading system, and it is more likely than not that present difficulties will prove to have been relatively short term in nature. The trend toward greater economic integration that has accompanied the growth of the past half century is likely to continue, with ever more countries and regions participating in a healthy and growing international economy.