The Benefits and Casualties of Trade

Global Interdependence Center

Central Banking Series

Dublin, Ireland

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Thank you, it's a pleasure to be here.

I can definitively say that after the speculation about the Federal Open Market Committee's September meeting, I'm delighted to have a break from being asked about interest rates, which means I'll take the opportunity to not talk about interest rates. And since I'm in Ireland, a country that knows well the benefits of global trade and cooperation, I thought I'd turn to the subject of international trade.

Before I go any further, I should issue the disclaimer that the views expressed today are mine alone and do not necessarily reflect those of anyone else in the Federal Reserve System.

International trade is a sensitive topic, particularly at the moment. You'll know it's a subject of debate in the U.S. election, as it is in countries across the globe, from mature economies to developing ones.

As a Federal Reserve president, I obviously have no say in making the policies that govern trade. And in general, Fed policymakers avoid opining on the state of fiscal or economic policy.

But the American economy has reached a point in which monetary policy has done what it can. As everyone in this room knows, the reach and arsenal of monetary policymakers is limited. We can move rates and that's about it — the times that call for exceptional use of mechanisms, such as quantitative easing or forward guidance, are times of economic upheaval.

At this juncture in the post-crisis recovery, at least in the U.S., it's time for fiscal and other policies to take the reins. We cannot foster growth without long-term approaches, legislation, and investments that are far outside the scope of the Fed's reach.

So, while I offer neither advice nor prescriptions on the subject, in the context of how trade affects the economy — and therefore the decisions I and my colleagues make about monetary policy — I feel comfortable calling for a more comprehensive and analytic review of its different aspects. Discussing the pros and cons, and even the "winners" and "losers," is well within my purview and, I believe, necessary when discussing the future path of monetary policy in the U.S.

And perhaps, for the sake of my colleagues back home, I should reiterate that disclaimer about these being my views and mine alone …

Classical Gains from Trade

It's clear from the media coverage, the political narrative, and the policy stances emerging around the globe that trade is experiencing a good deal of backlash from many corners.

While resistance to international trade is not new, the central role it has taken in public discussion — and the animosity toward it — is something I haven't seen for some time.

It is particularly acute when considering that, from a textbook standpoint, international trade makes perfect economic sense — especially under the principle of "comparative advantage." That is, the idea that countries will import goods from abroad if they're cheaper and export their own goods if they're inexpensive to make at home.

Trading countries can focus on producing and exporting goods that use their relatively more abundant resources, which cost less, to countries that want or need them. For goods that require resources that are relatively scarce, nations can import goods for less than they would cost to produce at home. Scotland, obviously, would find it difficult to supply its own pineapples, while Hawaii would struggle to cultivate a wool industry. International trade allows countries to focus on producing what they're good at, rather than expending valuable time and resources attempting to produce *every* good they need.[1]

While different geographies have different resources — and indeed, different quantities of resources — comparative advantage is a great democratizer in that everyone has one. And in a globalized economy, this increased specialization allows, for the most part, nations of all sizes to benefit from greater efficiencies in production. This ideally means that trade can make each country more productive and ultimately better off.

International trade also allows participants to benefit from differing cycles. The creation of goods fluctuates, meaning nations can borrow and consume more in lean times and pay back debts when the output pendulum swings back to its high point. This ensures the stream of goods stays steady and stable and protects average citizens from disruptions in both availability and the prices they pay.

Production Chains

Another aspect of the ever-more integrated global economy is that an increasing share of trade involves multiple contributions along the supply chain, often across borders. For example, Japan exports raw steel to Mexico, where it's stamped and shipped to the United States, where it's used to make farm equipment, some of which is then exported to buyers in other countries.

The classic term for this is *vertical integration* or *fragmentation*, although it's more commonly referred to as the dreaded *outsourcing*. Outsourcing obviously has negative connotations, frequently seen as the force behind exporting domestic jobs, but this is another aspect. This multiparty approach allows for more efficient organization of production and lets countries focus, again, on those areas in which they have more abundant resources or better specialization. It is an increasingly important facet of both production and international connectivity.[2]

This kind of global production is particularly sensitive to trade protection because every time a good crosses a border, it exposes itself to a potential tariff. This is an area in which I will tread

[1] David Ricardo, *On the Principles of Political Economy and Taxation*. John Murray, Albemarle-Street. 1817. Print.

[2] David Hummels, Jun Ishii, and Kei-Mu Yi, "The Nature and Growth of Vertical Specialization in World Trade," *Journal of International Economics*, 54:1 (June 2001), pp. 75–96.

carefully — I'm not dispensing advice on trade policy for the U.S. or any other nation. But from a purely economic perspective, it's important to remember that the world has evolved to an interconnected economy, and trade on this level is unlikely to disappear — rather, it's likely to be more and more a part of individual industries' and nations' economies. Even modest tariffs, therefore, if they are applied several times to the same production chain, would be enough to disrupt this type of trade.

The Relationship Between Trade and Growth and Trade and Income

Trade can promote knowledge and expertise and, as a result, foster technical progress. A 10 percent increase in trade is associated with a 5 percent increase in income per capita.[3] Likewise, an increase in international trade has a positive impact on growth rates: Doubling a country's trade share can lead to an estimated 25 percent increase in gross domestic product (GDP) over the span of a decade.

History is also rife with examples of trade's benefits. Looking at economic development from 1800 to 1980, we see a steady rise in global inequality because, at the time, only developed economies were open to trade. Conversely, when we look at previously closed economies that have subsequently opened to trade, the trend is reversed.[4] China is just one, but perhaps the most discussed, example of how trade allows countries to rapidly reverse their economic fates. Korea is another example, as are, increasingly, places such as Vietnam and the Philippines.

A powerful illustration of trade's influence is the steady drop in global poverty. Although the world's population grew by 1.6 billion between 1980 and 2000, the number of people living in extreme poverty actually declined by 200 million.[5] While this phenomenon cannot be attributed to trade alone, it certainly played a role.[6]

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[3] James Feyrer, "Trade and Income — Exploiting Time Series in Geography," National Bureau of Economic Research Working Paper 14910 (2009).

[4] David Dollar and Aart Kraay, "Trade, Growth, and Poverty," *Economic Journal*, 114:493 (February 2004), pp. F22–F49.

[5] "Poverty," World Bank, n.d., http://data.worldbank.org/topic/poverty (accessed September 27, 2016).

[6] Matthias Busse and Jens Koeniger, "Trade and Economic Growth: A Re-examination of the Empirical Evidence," *Economics Bulletin*, 35:4 (2015), pp. 2862–2876.

Common Myths

If trade's benefits are so overwhelmingly positive, why has there been such animosity toward it? I believe the answer is twofold. First, there are common myths attached to trade and its effects. Second, there are, in fact, losers in the trade game.

First, the myths of trade. A frequent strain of the current narrative is that low-wage countries unfairly compete against mature economies, thereby having the double effect of exporting jobs away from developed countries such as the U.S. and creating scenarios in which advanced economies exploit their less developed counterparts.

A more accurate depiction is that low wages are associated with lower productivity, meaning less developed economies do not, in fact, have an edge. Additionally, as trade in these goods shifts, it frees up resources in more developed economies, allowing them to concentrate on more specialized goods made by skilled workers, who, in turn, earn higher wages.

As for lower-wage countries, the simple math is that without trade, those wages would be even lower.

Distributional Costs

That said, there are people who feel the downside of global trade more acutely than others.

Trade, on the whole, is a benefit. It makes products cheaper, including necessities such as food, and countries tend to reap the rewards on a macro level.

What makes the subject so heated, and so impassioned on one side, is that the many who benefit don't do so in a life-altering way; we aren't moved by a price change of a few dollars or cents in our everyday purchases. In the case of the U.S., the relatively abundant supply of skilled workers benefit, while the unskilled portion of the labor force can lose out to competition from abroad.

The rewards are reaped in breadth, spread among the 320-plus million people who live in the U.S. On the other hand, those who suffer do so on a catastrophic level — it affects entire industries and the populations that depended on them. Its effects are felt in depth, shouldered by a small fraction of America.

Even when jobs do not disappear, there is evidence to suggest that vertical integration — wherein different parts of supply chains originate in different countries — has impacted the increasing wage gap between skilled and unskilled workers.[7] In the U.S., the production chain sees more of its contributing goods imported than produced domestically, reducing demand for low-wage workers, and pushing paychecks even further down. This is not the only source of the wage disparity in the U.S. over the past 30 years. There is also the displacement of workers because of automation, and other factors, which have muddied the waters regarding the exact cause.

Additionally, industries in international competitive markets are in a race with foreign firms. Even when they succeed, it's often the case that gains are disproportionately realized by the owners of capital instead of those working to produce it. International competition puts particular stress on areas or industries that compete with the imported good — whether the value of land for agricultural products or the return on capital for specialized workers.

China Shock

China, of course, has played the role of economic bogeyman in the trade debate. But is the fear based on facts?

A recent paper on the role of trade and its effect on wage disparity, called *The China Shock,* has been getting a lot of press lately.[8] It assesses the losses in U.S. manufacturing jobs tied to increased exposure to Chinese imports. It will come as no surprise that it is the lower end of the pay and skill spectrum that has been most affected.

The extraordinarily rapid rise of China and its focus on manufacturing and exports have created something of an economic laboratory — a rare and exceptional one. Because China's import penetration varies widely across manufactured goods, the authors could better assess its impact

[7] Robert Feenstra and Gordon Hanson, "Global Production Sharing and Rising Inequality: A Survey of Trade and Wages," National Bureau of Economic Research Working Paper 8372 (2001).

[8] David Autor, David Dorn, and Gordon Hanson, "The China Shock: Learning from Labor Market Adjustment to Large Changes in Trade," Centre for Economic Policy Research Discussion Paper 11054 (2016).

by looking at industries and counties in which China has a stronger or weaker presence. That led to more detailed research and more specific findings than previous work.

The results do highlight a downside.

There were industries that were affected and unemployment followed. In many cases, contrary to general assumption, when people lost their jobs, they didn't move or look for new ones in new areas. Instead, people stayed where they were. The jobs they lost weren't replaced by new ones in new industries and that had significant ripple effects. Instead of replacing one manufacturing job with another, they wound up in even lower paying jobs, if they managed to find one at all. Adding to the effects was that the decline in activity by manufacturers most exposed to imports from China had spillover effects for their suppliers as well. All in all, of the 5.8 million manufacturing jobs lost in the U.S. from 1999 to 2011, about 985,000 can be attributed to trade.

As for wages, the most affected workers were those in the bottom 40 percent of the payscale. For every additional $1,000 of imports per worker, wages were reduced by $213 a year.

So, there is some truth to the worry about outside competition. Then again, it is often difficult to untangle the influence of trade from that of other factors affecting changes in wage distribution. There are causes that have nothing to do with China, such as technological advances or the waning share of specific industries — it's worth remembering that U.S. manufacturing has been steadily declining since the end of World War II, long before China opened its doors to the rest of the world. And while there have been job losses, the authors point out that post-war trade has only had minimal influence on the wage stagnation for lower skilled workers and the overall decline in American manufacturing.

This is where I circle back to my opening remarks about monetary policy having its limits. Addressing issues of unemployment from the decline in American manufacturing requires fiscal policy and legislative action. What we haven't done very well in the U.S. is to figure out a path for people to absorb those changes. Whether it's some form of wage insurance or retraining, we have to find some way to help these communities, many of which have been all but abandoned, to transition to a new economic reality. I realize that's easy to say when you're not the one making the policy, but in my view, that sort of help is in the interest of the country as a whole.

Conclusion

So, I can understand some of the animosity toward trade. I also see the need for policies to help alleviate the pain that those who bear the brunt of the downside encounter. But a connected world is a better place and trade helps far more people than it hurts. We just need to find a way for everyone to benefit from that free exchange.