

INTRODUCTION TO INTERNATIONAL TRADE

International Trade in Services

ITALI

Alireza Naghavi

From:

From Ricardo To Brexit and Beyond

Lecture by my PhD Supervisor

J. Peter Neary

University of Oxford

Trade@200



David Ricardo, 1772-1823

"On the Principles of Political Economy and Taxation" (1817)

Outline

1. The Dawn of Economic Theory
2. Trade and Income Distribution
3. What Ricardo Didn't Know
4. Policy Relevance
5. Conclusion

Outline

- 1. The Dawn of Economic Theory**
2. Trade and Income Distribution
3. What Ricardo Didn't Know
4. Policy Relevance
5. Conclusion

Economics as a Science

- David Ricardo: The Founder of Economic Theory
 - Deliberately simplified assumptions ...
 - ... plus abstract reasoning ...
 - leading to general principles
- The second essential ingredient for economics as a science
 - The first: Adam Smith's broad perspective and concern with empirics
- Especially important to the theory of international trade

Before Ricardo: Trade Theory 0.0

- Trade Theory 0.0: Mercantilism
 - Trade surpluses are good, imports are bad
 - A zombie theory:
 - Trump: "American carnage": "protection will lead to great prosperity"
 - Peter Navarro (Director, White House National Trade Council): "Death by China" (2011)

Before Ricardo: Trade Theory 1.0

- Trade Theory 1.0: Absolute Advantage (Adam Smith)
 - A big advance over mercantilism
 - A central determinant of absolute living standards and trade volumes
 - But, as a theory of trade patterns: clear, simple, and wrong!

Before Ricardo: Trade Theory 1.0

- The curse of common sense!
 - Europe is more efficient at producing cars than China ...
 - ... so Europe should export cars to China. Right?
 - But isn't "efficiency" measured in real terms (e.g., labor productivity)?
 - And Europe is also more efficient at producing textiles than China ...
 - ... so Europe should also export textiles to China?
 - But Chinese wages are much lower, so it produces textiles more cheaply
 - Ahhhh! So it's all about "efficiency" measured in money terms?
 - But at Chinese wages, they could produce cars more cheaply ...

Before Ricardo: Trade Theory 1.0

- And indulges common-sense prejudices:
 - Europe is exploiting poor countries because it is more efficient
 - ... or ...
 - China is competing unfairly: its wages and/or its currency are too low

Trade Theory 2.0: Comparative Advantage

- Ricardo's Big Idea: Comparative Advantage
 - Emphasizes not just differences, but differences in differences:
[Costinot (2009)]
 - Relative to China, Europe is relatively more efficient at producing cars than textiles ...
 - ... so Europe will export cars, China textiles.
 - Double difference gets rid of exchange rates, wages, etc.
 - They matter, but not for composition of trade
- Predicts trade patterns and aggregate gains from trade
 - Both countries gain: Trade *not* a zero-sum game

Comparative Advantage: The Scientific Legacy

- Sets an agenda for theory and empirics
 - Early empirical studies hampered by theory's low dimensionality [MacDougall (1951)]
 - Theory needed to be generalized [Dornbusch, Fischer, and Samuelson (1977), Eaton and Kortum (2002)]
 - Which allows quantification and confirmation of the theory [Costinot, Donaldson, and Komunjer (2012)]

Outline

1. The Dawn of Economic Theory
- 2. Trade and Income Distribution**
3. What Ricardo Didn't Know
4. Policy Relevance
5. Conclusion

Trade and Income Distribution

- Ricardo's analysis of the Corn Laws
 - Eliminating corn tariffs would harm landowners, help laborers
 - Net gains, implying that losers could be compensated ...
 - ... though they never are ...
- Trade and Income Distribution 1.0
 - Highlights a central, "common-sensical", mechanism
 - But: At best, a version of the specific-factors model [Findlay (1974)]
 - Not integrated with the theory of comparative advantage

Outline

1. The Dawn of Economic Theory
2. Trade and Income Distribution
- 3. What Ricardo Didn't Know**
4. Policy Relevance
5. Conclusion

Of Course, We Have Learnt a Lot Since Ricardo

1. Gravity
2. Intra-Industry Trade
3. Trade in Intermediate Goods
4. Firms in Trade
5. Big Data, Quantification, etc.

Gravity or Levity?



Mr. Gravity



Mr. Levity

- Mr. Gravity [Jim Anderson]: $V_{jk} = \left(\frac{\tau_{jk}}{\Pi_j P_k} \right)^{1-\sigma} \frac{I_j I_k}{I_W}$

Gravity or Levity?



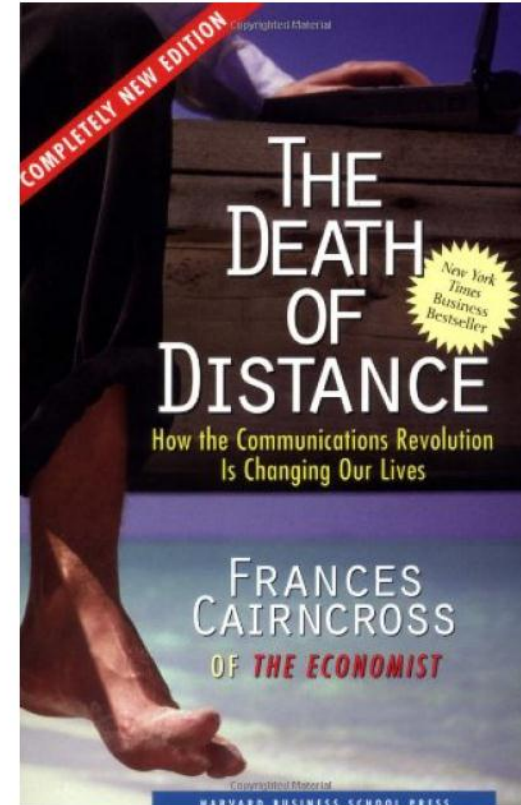
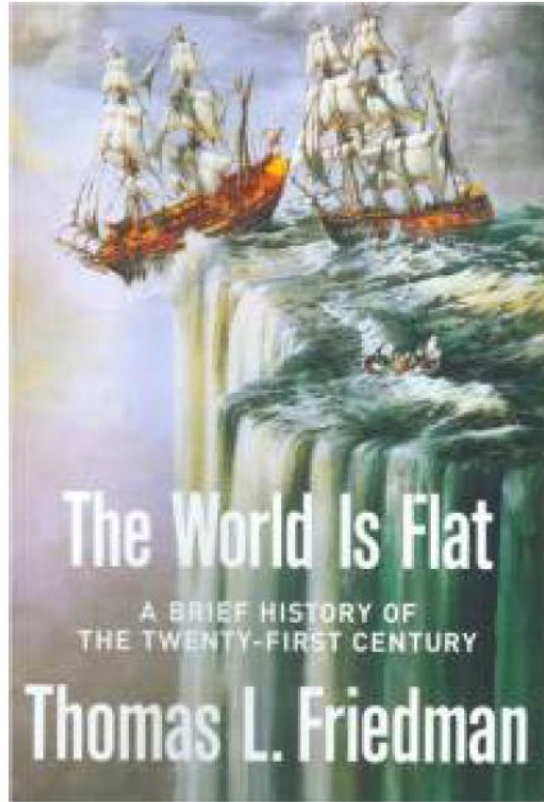
Mr. Gravity



Mr. Levity

- **Mr. Levity [Liam Fox, UK Minister for International Trade]:** "Today, we stand on the verge of an unprecedented ability to liberate global trade for the benefit of our whole planet with technological advances dissolving away the barriers of time and distance. It is potentially the beginning of what I might call 'post geography trading world' where we are much less restricted in having to find partners who are physically close to us."

Levity: Not Stupid, Just Wrong



- Has the World Become Flat?
- No: Borders still matter for trade, FDI, finance, eBay, Google etc.

Other Things We Have Learnt

2. Intra-Industry Trade

- Driven by product differentiation and increasing returns
- Dominates trade between similar economies
- Implies gains from increased variety
- Minimizes costs of adjustment

3. Trade in Intermediate Goods

- "The division of labor limited by the extent of the market"
- Global and mega-regional value chains

Other Things We Have Learnt

4. Firms in Trade

- Heterogeneous: Minnows and superstars
- Intra-firm margins of adjustment: Multi-product, multi-destination
- Globalization typically implies a "Matthew Effect" [Mrázová and Neary (2018)]
- Strategic behavior

5. Big Data, Quantification, etc.

- The scientific study of international trade

Outline

1. The Dawn of Economic Theory
2. Trade and Income Distribution
3. What Ricardo Didn't Know
- 4. Policy Relevance**
5. Conclusion

What are These People Doing?



A Special Relationship



Shared Values

What are These People Doing?



A Special Relationship



Shared Values

Discussing Trade Agreements of course!

Are we Scientists or Citizens?

- Trade agreements are fundamentally *political/non-economic*
 - As economists we have no right to condemn non-economic perspectives
 - As citizens, we have every right, but we should not claim too much
- This is a deeper kind of "political" from trade models:
 - Trade agreements as a way to internalize terms of trade externality [Bagwell and Staiger (1999)]
 - Trade agreements as a commitment device to restrict producer interests [Maggi and Rodríguez-Clare (1998), Maggi, Mrázová, and Neary (2017)]

Are we Scientists or Citizens?

- Back to the Science: What is the best trade agreement for the UK?
 - "Global Britain"?
 - "I don't think it makes sense for us to pretend we should remain in the single market and I think there are real question marks about whether it makes sense to remain in the customs union. [Doing so ...] could undermine the government's ability to sign trade deals with countries outside the block."
 - Mervyn King, Former Governor, Bank of England, 26 Dec. 2016

Who to Trade With?

- Lessons from Ricardo:
 - Countries that are very different have the potential for large gains ...
 - ... but also for greatest disruption
- The ideal trade agreement:
 - Respecting comparative advantage -- but not too much ...
 - Nearby - so the agreement works with gravity, not against it
 - Deep: Including regulation and "behind-the-border" protection
 - Comprehensive: Covering agriculture and services as well as industry
- So, what is the ideal trade agreement for the UK?
 - The Single Market, of course!

Outline

1. The Dawn of Economic Theory
2. Trade and Income Distribution
3. What Ricardo Didn't Know
4. Policy Relevance
- 5. Conclusion**

Conclusion

- Ricardo's Legacy:
 - Economics as a science
 - We stand on the shoulders of this giant:
- Role of Theory
 - A lens through which to view the world ...
 - ... and flush out bad ideas
- Bad ideas?
 - Not Brexit per se
- Rather:
 - Mercantilism
 - Death of Distance
 - Global Britain