Balance of Trade Concerns

By:

OpenStaxCollege

In the 1950s and 1960s, and even into the 1970s, openness to global flows of goods, services, and financial capital was often viewed in a negative light by low- and middle-income countries. These countries feared that foreign trade would mean both economic losses as their economy was "exploited" by high-income trading partners and a loss of domestic political control to powerful business interests and multinational corporations.

These negative feelings about international trade have evolved. After all, the great economic success stories of recent years like Japan, the East Asian Tiger economies, China, and India, all took advantage of opportunities to sell in global markets. The economies of Europe thrive with high levels of trade. In the North American Free Trade Agreement (NAFTA), the United States, Canada, and Mexico pledged themselves to reduce trade barriers. Many countries have clearly learned that reducing barriers to trade is at least potentially beneficial to the economy. Indeed, many smaller economies of the world have learned an even tougher lesson: if they do not participate actively in world trade, they are unlikely to join the success stories among the converging economies. There are no examples in world history of small economies that remained apart from the global economy but still attained a high standard of living.

Although almost every country now claims that its goal is to participate in global trade, the possible negative consequences have remained highly controversial. It is useful to divide up these possible negative consequences into issues involving trade of goods and services and issues involving flows of international capital. These issues are related, but not the same. An economy may have a high level of trade in goods and services relative to GDP, but if exports and imports are balanced, the net flow of foreign investment in and out of the economy will be zero. Conversely, an economy may have only a moderate level of trade relative to GDP, but find that it has a substantial current account trade imbalance. Thus, it is useful to consider the concerns over international trade of goods and services and international flows of financial capital separately.

Concerns over International Trade in Goods and Services

There is a long list of worries about foreign trade in goods and services: fear of job loss, environmental dangers, unfair labor practices, and many other concerns. These arguments are discussed at some length in The International Trade and Capital Flows.

Of all of the arguments for limitations on trade, perhaps the most controversial one among economists is the infant industry argument; that is, subsidizing or protecting new industries for a time until they become established. (Globalization and Protectionism explains this concept in more detail.) Such policies have been used with some success at certain points in time, but in the world as a whole, support for key industries is far more often directed at long-established industries with substantial political power that are suffering losses and laying off workers, rather than potentially vibrant new industries that have yet to be established. If government is going to favor certain industries, it needs to do so in a way that is temporary and that orients them toward a future of market competition, rather than a future of unending government subsidies and trade protection.

Concerns over International Flows of Capital

Recall from The Macroeconomic Perspective that a trade deficit exists when a nation's imports exceed its exports. In order for a trade deficit to take place, foreign countries must provide loans or investments, which they are willing to do because they expect they will be repaid eventually (that the deficit will become a surplus). A trade surplus, you may remember, exists when a nation's exports exceed its imports. So, in order for a trade deficit to switch to a trade surplus, a nation's exports must rise and its imports must fall. Sometimes this happens when the currency decreases in value. For example, if the U.S. had a trade deficit and the dollar depreciated, imports would become more expensive. This would, in turn, benefit the foreign countries who provided the loans or investments.

The expected pattern of trade imbalances in the world economy has been that high-income economies will run trade surpluses, which means they will experience a net outflow of capital to foreign destinations or export more than they import, while low- and middle-income economies will run trade deficits, which means that they will experience a net inflow of foreign capital.

This pattern of international investing can benefit all sides. Investors in the high-income countries benefit because they can receive high returns on their investments, and also because they can diversify their investments so that they are at less risk of a downturn in their own domestic economy. The low-income economies that receive an inflow of capital presumably have potential for rapid catch-up economic growth, and they can use the inflow of international financial capital to help spur their physical capital investment. In addition, inflows of financial capital often come with management abilities, technological expertise, and training.

However, for the last couple of decades, this cheerful scenario has faced two "dark clouds." The first cloud is the very large trade or current account deficits in the U.S. economy. (See The International Trade and Capital Flows.) Instead of offering net financial investment abroad, the U.S. economy is soaking up savings from all over

the world. These substantial U.S. trade deficits may not be sustainable according to Sebastian Edwards writing for the National Bureau of Economic Research. While trade deficits on their own are not bad, the question is whether they will be reduced gradually or hastily. In the gradual scenario, U.S. exports could grow more rapidly than imports over a period of years, aided by a depreciation of the U.S. dollar. An unintended consequence of the slow growth since the Great Recession has been a decline in the size of the U.S. current account deficit from 6% pre-recession to 3% most recently.

The other option is that the U.S. trade deficit could be reduced in a rush. Here is one scenario: if foreign investors became less willing to hold U.S. dollar assets, the dollar exchange rate could weaken. As speculators see this process happening, they might rush to unload their dollar assets, which would drive the dollar down still further.

A lower U.S. dollar would stimulate aggregate demand by making exports cheaper and imports more expensive. It would mean higher prices for imported inputs throughout the economy, shifting the short-term aggregate supply curve to the left. The result could be a burst of inflation and, if the Federal Reserve were to run a tight monetary policy to reduce the inflation, it could also lead to recession. People sometimes talk as if the U.S. economy, with its great size, is invulnerable to this sort of pressure from international markets. While it is tough to rock, it is not impossible for the $14 trillion U.S. economy to face these international pressures.

The second "dark cloud" is how the smaller economies of the world should deal with the possibility of sudden inflows and outflows of foreign financial capital. Perhaps the most vivid recent example of the potentially destructive forces of international capital movements occurred in the economies of the East Asian Tigers in 1997–1998. Thanks to their excellent growth performance over the previous few decades, these economies had attracted considerable interest from foreign investors. In the mid-1990s, however, foreign investment into these countries surged even further. Much of this money was funneled through banks that borrowed in U.S. dollars and loaned in their national currencies. Bank lending surged at rates of 20% per year or more. This inflow of foreign capital meant that investment in these economies exceeded the level of domestic savings, so that current account deficits in these countries jumped into the range of 5–10% of GDP.

The surge in bank lending meant that many banks in these East Asian countries did not do an especially good job of screening out safe and unsafe borrowers. Many of the loans—as high as 10% to 15% of all loans in some of these countries—started to turn bad. Fearing losses, foreign investors started pulling their money out. As the foreign money left, the exchange rates of these countries crashed, often falling by 50% or more in a few months. The banks were stuck with a mismatch: even if the rest of their domestic loans were repaid, they could never pay back the U.S. dollars that they

owed. The banking sector as a whole went bankrupt. The lack of credit and lending in the economy collapsed aggregate demand, bringing on a deep recession.

If the flow and ebb of international capital markets can flip even the economies of the East Asian Tigers, with their stellar growth records, into a recession, then it is no wonder that other middle- and low-income countries around the world are concerned. Moreover, similar episodes of an inflow and then an outflow of foreign financial capital have rocked a number of economies around the world: for example, in the last few years, economies like Ireland, Iceland, and Greece have all experienced severe shocks when foreign lenders decided to stop extending funds. Especially in Greece, this caused the government to enact austerity measures which led to protests throughout the country ([link]).

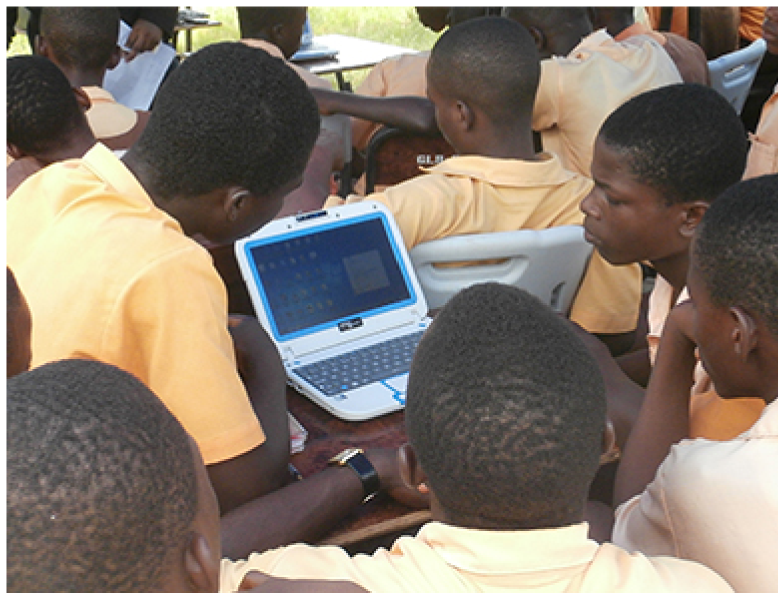
Protests in Greece
The economic conditions in Greece have deteriorated from the Great Recession such that the government had to enact austerity measures, (strict rules) cutting wages and increasing taxes on its population. Massive protests are but one byproduct. (Credit: modification of work by Apostolos/Flickr Creative Commons)

Many nations are taking steps to reduce the risk that their economy will be injured if foreign financial capital takes flight, including having their central banks hold large reserves of foreign exchange and stepping up their regulation of domestic banks to avoid a wave of imprudent lending. The most controversial steps in this area involve whether countries should try to take steps to control or reduce the flows of foreign capital. If a country could discourage some of the inflow of speculative short-term capital, and instead only encourage investment capital that was committed for the medium term and the long term, then it could be at least somewhat less susceptible to swings in the sentiments of global investors.

If economies participate in the global trade of goods and services, they will also need to participate in international flows of financial payments and investments. These linkages can offer great benefits to an economy. However, any nation that is experiencing a substantial and sustained pattern of trade deficits, along with the corresponding net inflow of international financial capital, has some reason for concern. During the Asian Financial Crisis in the late 1990s, countries that grew dramatically in the years leading up to the crisis as international capital flowed in, saw their economies collapse when the capital very quickly flowed out.

Market-Oriented Economic Reforms

The standard of living has increased dramatically for billions of people around the world in the last half century. Such increases have occurred not only in the technological leaders like the United States, Canada, the nations of Europe, and Japan, but also in the East Asian Tigers and in many nations of Latin America and Eastern Europe. The challenge for most of these countries is to maintain these growth rates. The economically-challenged regions of the world have stagnated and become stuck in poverty traps. These countries need to focus on the basics: health and education, or human capital development. As [link] illustrates, modern technology allows for the investment in education and human capital development in ways that would have not been possible just a few short years ago.



Solar-powered Technology
Modern technologies, such as solar-power and Wi-Fi, enable education to be delivered to students even in remote parts of a country without electricity. These students in Ghana are sharing a laptop provided by a van with solar-power. (Credit: EIFL/Flickr Creative Commons)

Other than the issue of economic growth, the other three main goals of macroeconomic policy—that is, low unemployment, low inflation, and a sustainable balance of

trade—all involve situations in which, for some reason, the economy fails to coordinate the forces of supply and demand. In the case of cyclical unemployment, for example, the intersection of aggregate supply and aggregate demand occurs at a level of output below potential GDP. In the case of the natural rate of unemployment, government regulations create a situation where otherwise-willing employers become unwilling to hire otherwise-willing workers. Inflation is a situation in which aggregate demand outstrips aggregate supply, at least for a time, so that too much buying power is chasing too few goods. A trade imbalance is a situation where, because of a net inflow or outflow of foreign capital, domestic savings are not aligned with domestic investment. Each of these situations can create a range of easier or harder policy choices.

Youth Unemployment: Three Cases

Spain and South Africa had the same high youth unemployment in 2011, but the reasons for this unemployment are different. Spain's youth unemployment surged due to the Great Recession of 2008–2009 and heavy indebtedness on the part of its citizens and its government. Spain's current account balance is negative, which means it is borrowing heavily. To cure cyclical unemployment during a recession, the Keynesian model suggests increases in government spending—fiscal expansion or monetary expansion. Neither option is open to Spain. It currently can borrow at only high interest rates, which will be a real problem in terms of debt service. In addition, the rest of the European Union (EU) has dragged its feet when it comes to debt forgiveness. Monetary expansion is not possible because Spain uses the euro and cannot devalue its currency unless it convinces all of the EU to do so. So what can be done? The *Economist*, summarizing some of the ideas of economists and policymakers, suggests that Spain's only realistic (although painful) option is to reduce government-mandated wages, which would allow it to reduce government spending. As a result, the government would be able to lower tax rates on the working population. With a lower wage or lower tax environment, firms will hire more workers. This will lower unemployment and stimulate the economy. Spain can also encourage greater foreign investment and try to promote policies that encourage domestic savings.

South Africa has more of a natural rate of unemployment problem. It is an interesting case because its youth unemployment is mostly due to the fact that its young are not ready to work. This is commonly referred to as an employability problem. According to interviews of South African firms as reported in the *Economist*, the young are academically smart but lack practical skills for the workplace. Despite a big push to increase investment in human capital, the results have not yet borne fruit. Recently the government unveiled a plan to pay unemployed youth while they were "trained-up" or apprenticed in South African firms. The government has room to increase fiscal expenditure, encourage domestic savings, and continue to fund investment in education, vocational training, and apprentice programs. South Africa can also improve the climate

for foreign investment from technology leaders, which would encourage economic growth.

India has a smaller youth employment problem in terms of percentages. However, bear in mind that since this is a populous country, it turns out to be a significant problem in raw numbers. According to Kaushik Basu, writing for the BBC, “there are 45 national laws governing the hiring and firing decisions of firms and close to four times that amount at the state level”. These laws make it difficult for companies to fire workers. To stay nimble and responsive to markets, Indian companies respond to these laws by hiring fewer workers. The Indian government can do much to solve this problem by adjusting its labor laws. Essentially, the government has to remove itself from firms’ hiring and firing decisions, so that growing Indian firms can freely employ more workers. Indian workers, like those in South Africa, do not have workforce skills. Again, the government can increase its spending on education, vocational training, and workforce readiness programs.

Finally, India has a significant current account deficit. This deficit is mainly a result of short- and long-term capital flows. To solve this deficit, India has experimented by lifting the limitation on domestic savers from investing abroad. This is a step in the right direction that may dampen the growth in the current account deficit. A final policy possibility is to improve domestic capital markets so many self-employed Indians can get access to capital to realize their business ideas. If more Indians can get access to capital to start businesses, employment might increase.

Key Concepts and Summary

There are many legitimate concerns over possible negative consequences of free trade. Perhaps the single strongest response to these concerns is that there are good ways to address them without restricting trade and thus losing its benefits. There are two major issues involving trade imbalances. One is what will happen with the large U.S. trade deficits, and whether they will come down gradually or with a rush. The other is whether smaller countries around the world should take some steps to limit flows of international capital, in the hope that they will not be quite so susceptible to economic whiplash from international financial capital flowing in and out of their economies.

Self-Check Questions

What do international flows of capital have to do with trade imbalances?

Given the high level of activity in international financial markets, it is typically believed that financial flows across borders are the real reason for trade imbalances. For example, the United States had an enormous trade deficit in the late 1990s and early 2000s because it was attracting vast inflows of foreign capital. Smaller countries that have

attracted such inflows of international capital worry that if the inflows suddenly turn to outflows, the resulting decline in their currency could collapse their banking system and bring on a deep recession.

Use the demand-and-supply of foreign currency graph to determine what would happen to a small, open economy that experienced capital outflows.

The demand for the country's currency would decrease, lowering the exchange rate.

Review Questions

What are the major issues with regard to trade imbalances for the U.S. economy?

What are the major issues with regard to trade imbalances for low- and middle-income countries?

Critical Thinking Question

Explain why converging economies may present a strong argument for limiting flows of capital but not for limiting trade.

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