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COMMENTARY 20161122

Trade Challenges

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We comment on a presentation to the Detroit Economic Club by Joe Hockey, Australian Ambassador to the United States and former Treasurer. Mr. Hockey puts forward the case for continued free trade to take advantage of a massive and expanding Chinese market, and highlights the large economic threat to lower trade in an economy in which 75 per cent of final goods and services pass through an intermediate country. We comment that free trade has led to tangible benefits and is operating in the manner the textbooks predict, namely via gains to specialization. The U.S. exports high value goods and high quality services, like education. However, we need to recognize that aggregate benefits, while large, are dispersed widely and the negative impact on workers in some sectors is large and concentrated. Reducing frictions in the labor and education sectors, and providing opportunities and incentives for workers, is important to ensure free trade policy receives broad support.

Yesterday, Joe Hockey – Australian Ambassador to the United States and former Treasurer – addressed the Detroit Economic Club on free trade. With free trade at the forefront of political and economic debate, his presentation was timely. He presented three figures that policy makers in Michigan and Washington should note.

The Chinese middle class is large and expanding at an extraordinary rate. According to Mr. Hockey's estimates this consumer segment will grow from 500 million to three billion people over the next 15 years. Mr. Hockey's point is that trade with China represents a tremendous opportunity for the U.S., rather than a threat.

Yet global trade growth has stalled. Mr. Hockey quoted an estimate from the World Trade Organization that global growth in trade this year will be just 1.7 per cent, the slowest rate of growth in free trade since the end of the recession in 2009.

A third figure which should be at front of mind for policy makers is the proportion of goods and services that are intermediate goods. Mr. Hockey noted that 75 per cent of all goods and services now travel through one country to another before they reach the end product. This can be compared to just 20 per cent four decades ago. The reason this can occur, and productivity improvements made, is the ability for the goods and services to pass through countries without in imposition of tariffs at those intermediate stages.

In short, Mr. Hockey puts forward the case for continued free trade to take advantage of a massive and expanding Chinese market, and highlights the large economic threat to lower trade in an economy in which we simply cannot attribute a "Made in …" label to any one particular country.

However, at an individual level we face challenges. The difficulty is that the benefits from trade, while large, are dispersed across the aggregate economy. But workers in some sectors face large, concentrated costs.

The aggregate gains to trade do not mean that every individual ends up better off. The median real household income in the U.S. was $56,500 in 2015 according to the U.S. Census Bureau, which remains below the peak of $57,900 from 1999. In this 16 year period it is the top 25 per cent of households which have experienced rising incomes.

The Federal Reserve Bank of St. Louis analyzed the income and wealth distribution and highlighted the relationship between education and income (Ricketts, LR., and C.J. Waller, 2014, "U.S. Income Inequality May Be High, but It Is Lower Than World Income Inequality," The Regional Economist, July). The bank concluded that:

"Income inequality in America is not as dire as that between developed and developing nations, but it remains a contentious domestic issue that will likely lead to greater class division and unrest. The labor market has changed into a system that places a greater value on education than physical labor and rewards skilled workers with wage premiums."

The key point is that free trade has led to tangible benefits and is operating in the manner the textbooks predict, namely via gains to specialization. The U.S. exports high value goods and high quality services, like education, and the beneficiaries of this export income are those with higher education and skills. The challenge is that frictions in the labor market are real. Workers do not seamlessly transition from one role to another and it is not costless to move from one location to the next.

This does not mean we need to impose protections on industry, via subsidies, tariffs or otherwise. That would bring to light the problem of which industries should be protected. What it does mean is that we need to recognize the impact on some sectors of the economy at an early stage, and ensure that frictions in the labor and education markets are low, so that workers have the opportunity and incentive to improve their skills.