PSCI 214
Lecture 11, Week 6
Trade
Subtopic: Exchange rates

- Post-Bretton Woods anarchy
- Regimes
  - Dozens of varieties
  - Floating (Japan, US)
    - Euro monetary area (limited autonomy)
  - Fixed
    - Currency board (Hong Kong)
    - Central bank pegged (but really fixed): China
  - Pegged (most medium sized countries)
    - Baskets
    - Or single currency
    - Crawling peg or bands
Characteristics of world currency system

• Higher volatility post Bretton Woods
• Large swings
  – 1980-86 high dollar
  – 1990-95 high yen
• Has made economic fundamentals difficult: currency crises more frequent
Bonds and currency exchange

- China vs. Lesotho
  - Lesotho pegged to S.Afr. Rand
  - China pegged to dollar
- Koizumi’s signals 2005
- What could this mean for the dollar?
- What could this mean for interest rates?
Currency and trade

- Overvalued or undervalued currency can lead to trade tensions
- How do governments achieve accord on these conflicts?
Speculation in currency

- Tequila crisis
- Asian financial crisis
Competitiveness

- Krugman: competitiveness between nations isn’t the same as competition between corporations
- Domestic productivity is what matters
- Government policy that promotes (hinders) domestic productivity matters more than trade policy
Supporting Krugman’s view: Lawrence and Weinstein

- Note that Japan and Korea’s strong domestic markets made them competitive as exporters, not the other way around
- Conclusion of their regression analysis
  - Import barriers are bad for ‘economically backward’ states
    - (measured by TFP compared with US)
  - Higher productivity *leads* to greater exports
  - Import competition leads to greater innovation
Trade Deficits are not caused by trade policies

- Not intuitive?
- Trade deficits are largely caused by others investing in our country
- Because our savings rate has seriously declined
- And because we’re a great place to invest in
Trade

- Krugman: “Competitiveness is a meaningless word when applied to national economies. And the obsession with competitiveness is both wrong and dangerous.”
- Countries don’t go out of business; firms do
- International trade is not a zero-sum game
Ricardo’s Competitive Advantage

- Port vs wool, potato chips vs. semiconductor chips: why it shouldn’t matter
- Both sides are better off making only the product in which it has a comparative advantage -- even if it can make both products more efficiently than its trading partner
In the end

• “The fact is, when jobs disappear in America it is usually because technical change has destroyed them, not because they have gone anywhere. In the end, Americans' increasing dependence on an ever-widening array of technology will create a flood of high-paying jobs requiring hands-on technicians, not disembodied voices from the other side of the world.

• Jagdish Bhagwati, NY Times, Feb 15, 2004
Trade in goods as a percent of GDP, 2003 (Bureau of Labor Statistics)
The U.S. Balance Of Trade, 1970-1999
Source: CBO
Trade deficits

- Are an indicator sometimes of a healthy economy
- Trade surpluses may point to weak economies
But, this is still alarming:
Decomposition of the Trade Deficit

U.S. Trade Balance / GDP

- Dollar risk premium shock
- Foreign demand shock
- Productivity shock
- Saving shock
- Fiscal shock
- Actual

Gross Capital Flows to and from the United States (billions of $s)