

The Economic Potential of Trade Integration with the Indo-Pacific Region

Prof. Robert Koopman

School of International Service

American University

Prepared for 15th Annual Queen's Institute on Trade Policy

Towards a Trade Policy for the Indo-Pacific Region

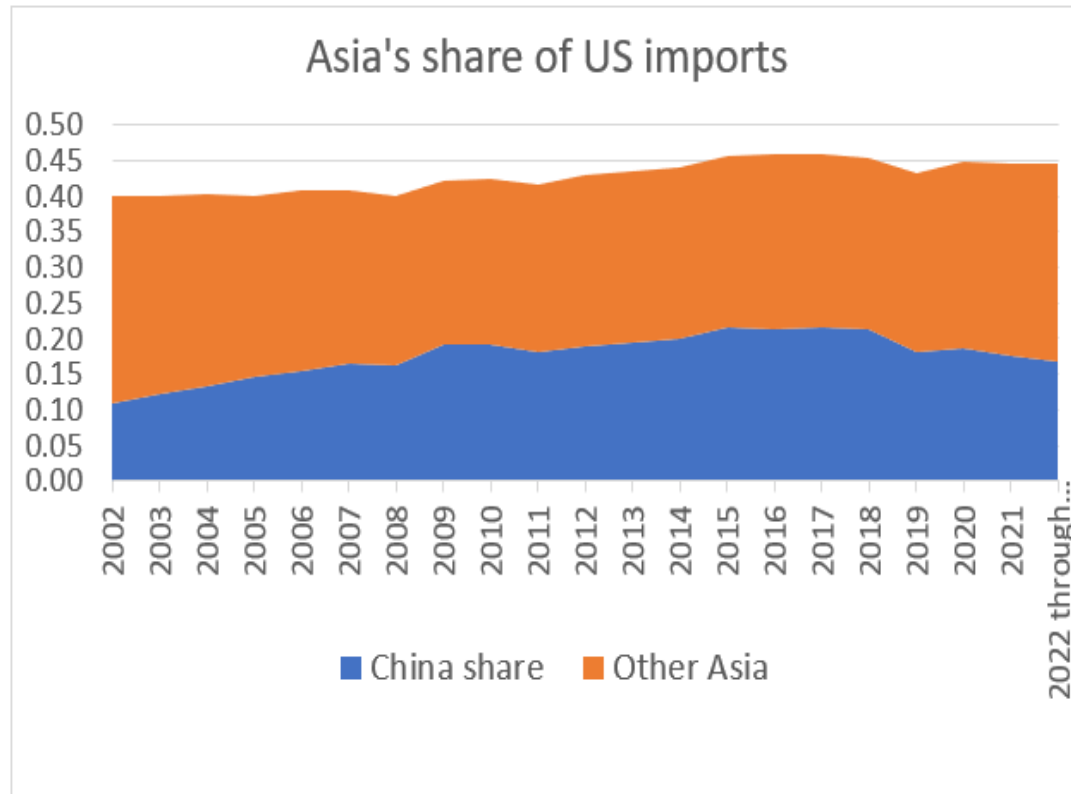
Kingston, Ontario

October 24, 2022

From where do we integrate next using a NAFTA like template to – do we or how do we integrate?

- A new “agreement” template being formed?
- Do “we need one?”
 - Clearly globalization is under duress from rising inequality (economically measurable) and cultural perceptions of changing social status (harder to measure).
 - Economic evidence tends to find other drivers of rising inequality are more important than trade - though trade has doubtlessly contributed.
 - For example Antras et al 2017 find high correlation for the period 1979 and 2007 between measures of US trade openness and growing Gini coefficient, yet also correlation with declining US tax productivity over the same period.
 - A big question is ... can changes in trade policy achieve the objective?
 - COVID and related policies has raised lower end wages in the US while the US trade deficit remains very large.

Some myths in the US...



Source: US Census Bureau

- Similarly to what happened from the 1980's onward Asia's share in US imports remained reasonable constant, while China's share crowded out other Asian countries initially (Japan), and peaking at 22% in 2017, China's share of US goods imports has fallen to 17% No evidence of reshoring: US import value grew 21% from 2017-2021 compared with 4% from 2013-2017 Nor nearshoring: Rest of Asia absorbed the drop, with Asia's share of US imports flat at ~45%

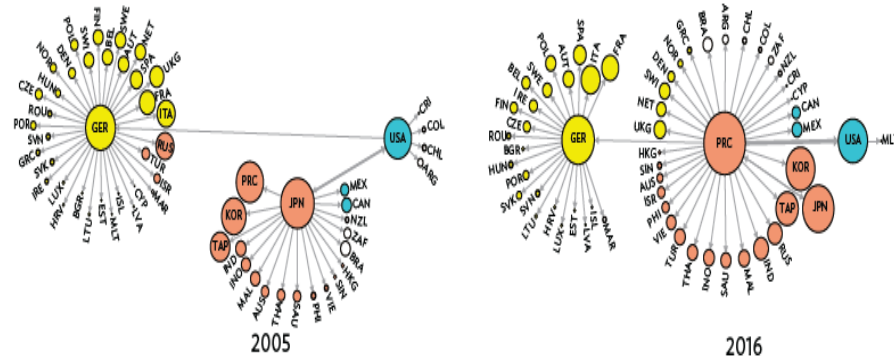
Demise of globalization? No, a reorganization of globalization.

- No evidence of reshoring, more evidence of trade diversion/diversification.
- Global trade share of global GDP slowed but stabilizing (with variation) at around 30%.
- Faster growth in services trade, including harder to measure data flows.
- So composition of trade is definitely shifting...consistent with growing share of services in GDP and decline in manufacturing VA in most advanced economies. More output, but less value. Driver...automation in nearly all economies...ag to mfg to services increasingly looking like ag to services. See Baldwin on Globotics.
- But supply and demand balance in globalization needs more attention...supply more diversified, but demand seems still US (and EU) centric.
 - Repressed consumption in China? Germany's relative wages and weak demand? See Michael Pettis' work.
 - Something to watch going forward...will fast growing, converging economies encourage consumption or repress it?

GVC Development Report 2021 - The evolution of manufacturing production and demand based value chains. US drives demand – so its policies matter – but Europe integrated regionally and globally – yellow circles.

Figure 1.8: Complex Global Value Chain Networks, Supply Perspective, 2005 and 2016

a. Domestic Manufacturing Firms



b. Multinational Manufacturing Firms

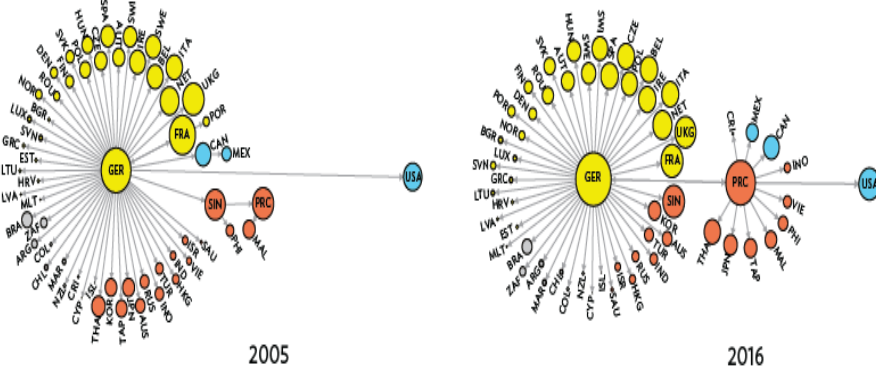
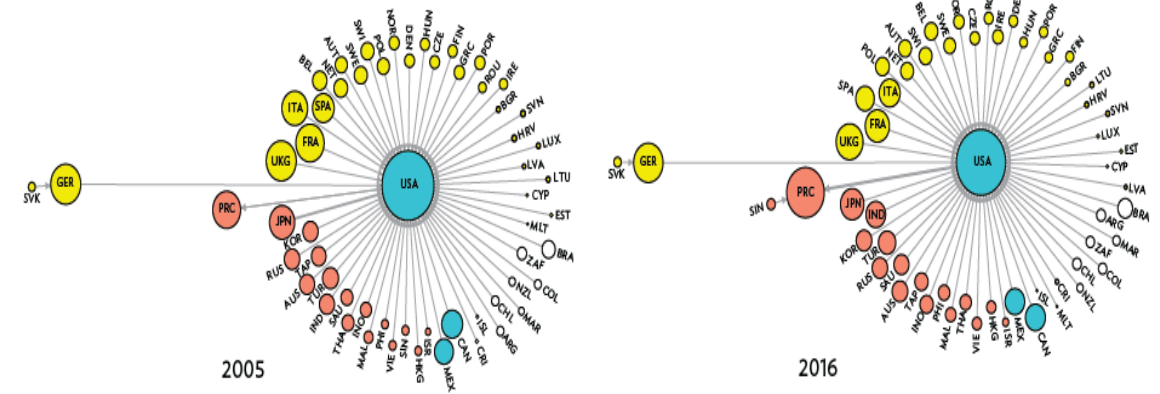
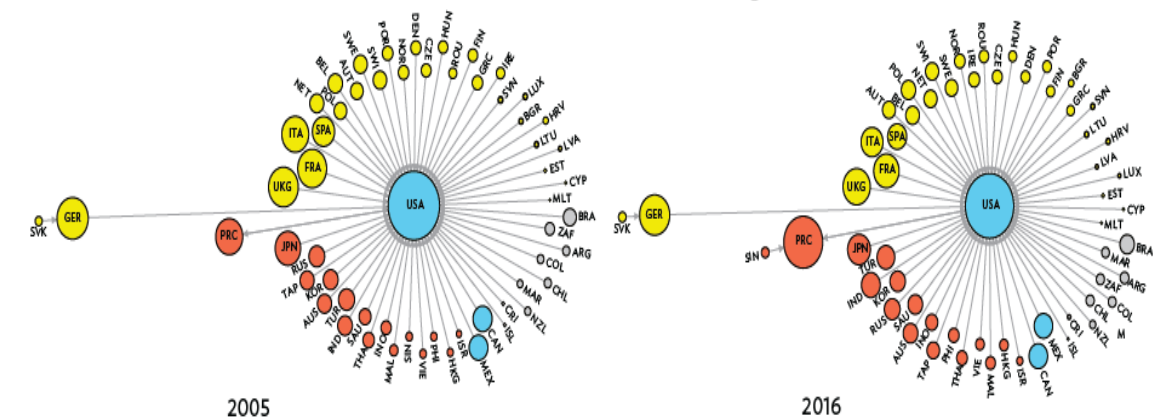


Figure 1.9: Complex Global Value Chain Networks, Demand Perspective, 2005 and 2016

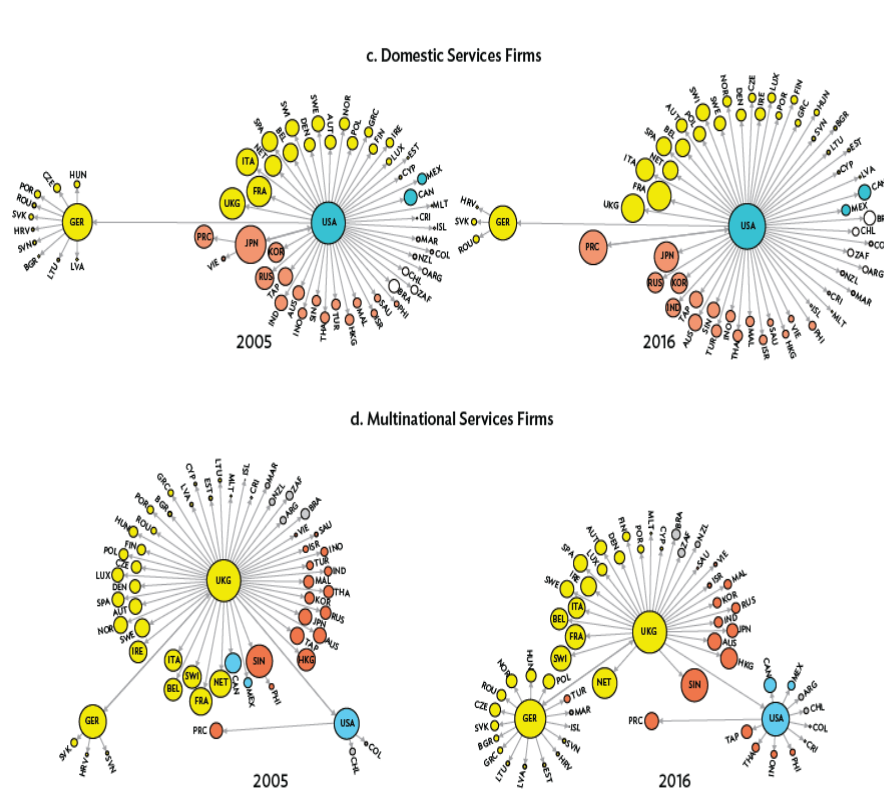
a. Domestic Manufacturing Firms



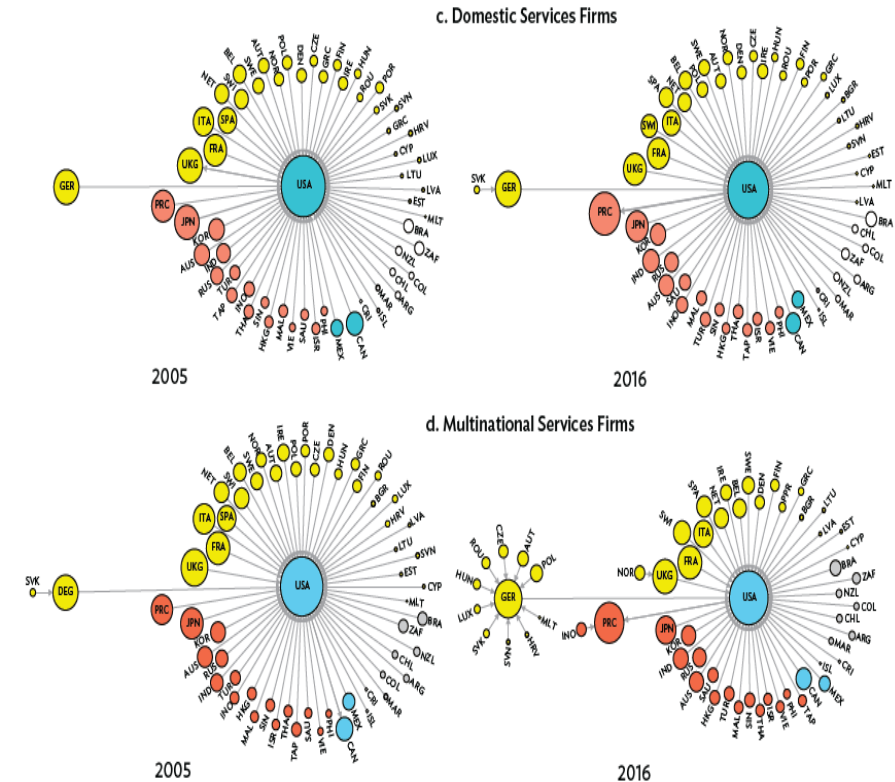
b. Multinational Manufacturing Firms



The evolution of services production and demand based value chains. US drives demand – so its policies matter here also



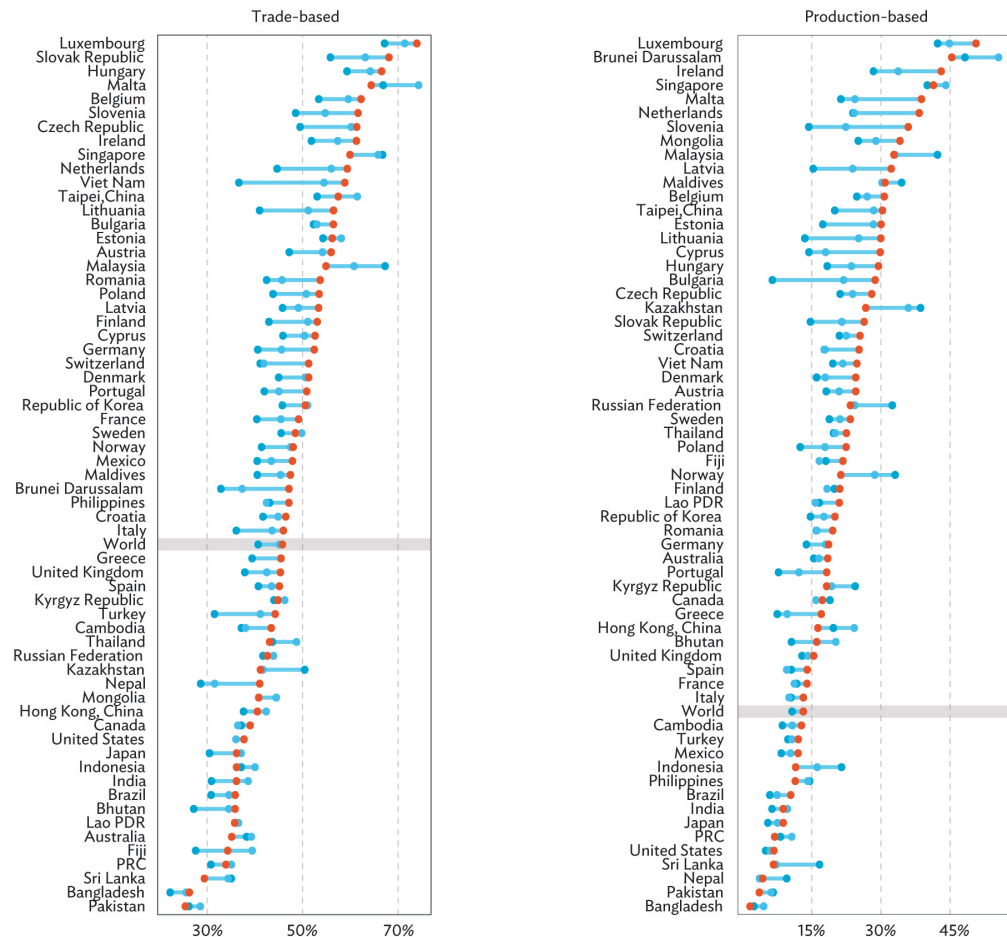
Sources: Y. Gao, B. Meng, G. Suder, and J. Ye. 2021. Who Dominates Global Value Chains? Multinationals vs Domestic Firms. *IDE Discussion Paper*. No. 825. Chiba, Japan: Institute of Developing Economies – Japan External Trade Organization; Organisation for Economic Co-operation and Development. Analytical Activities of Multinational Enterprises Database. <https://www.oecd.org/sti/ind/analytical-amne-database.htm> (accessed 31 July 2021).



Sources: Y. Gao, B. Meng, G. Suder, and J. Ye. 2021. Who Dominates Global Value Chains? Multinationals vs Domestic Firms. *IDE Discussion Paper*. No. 825. Chiba, Japan: Institute of Developing Economies – Japan External Trade Organization; Organisation for Economic Co-operation and Development. Analytical Activities of Multinational Enterprises Database. <https://www.oecd.org/sti/ind/analytical-amne-database.htm> (accessed 31 July 2021).

Recent Trends in Global Value Chains – while not growing as fast as historical rates still growing in aggregate. China's role declining.

Figure 1.2: Measures of Global Value Chain Participation, 2000, 2010, 2019 (%)



➤ Almost all economies had seen participation expanded between 2000 (dark blue dots) and 2019 (red dots).

➤ The participation rate for Germany: 45.6% in 2010 & 52.4% in 2019;

But

➤ The GVC participation rate of the PRC, the center of global manufacturing assembly: 35.1% in 2010 & 33.9% in 2019;

Economic gravity, trade costs and rising policy uncertainty – implications for trade integration in the Indo-Pacific Region

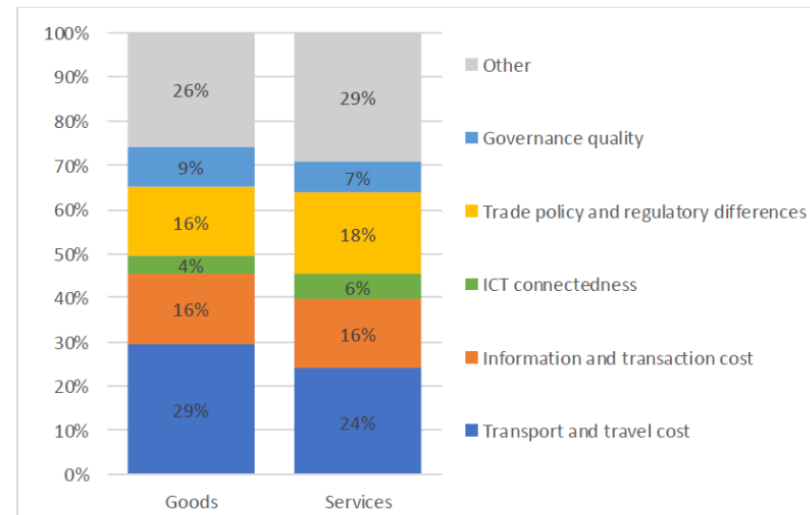
- A very strong empirical finding in the trade data is often described as the gravity model of trade.
- In its simplest form mathematically it shows that trade is greater between large economies, and economies that are closer together.
 - Thus the amount of trade between two countries is positively related to their size and negatively related to their distance.
 - This empirical finding is very strong.
 - Distance can be considered both geographic distance, but also importantly economic distance.
- More complicated versions of the model can account for borders (-) and border policies (tariffs and NTMs), cultural affinity (+), language (+), geographic barriers (mountains/land locked) (-), historical/colonial ties (+), etc.
 - During the long period of globalization after WWII borders and border policy related “economic distance costs” steadily declined due to tariff reductions and improved regulatory cooperation. The GATT/WTO and PTAs played a important but far from exclusive role in this in decline. Trade and investment agreements, more open capital flow environment reduced both direct costs but also policy uncertainty.
 - Other factors include technological improvements in the movement of goods and services. Think containerization.
 - But lets also not forget large scale unilateral economic liberalization in European CPEs, China and India.
- A fully specified gravity model also accounts for two other important factors – domestic trade costs...how easily can goods move from factory gate to consumers in your domestic economy, and “multilateral resistance” – your and your trading partners trading relationships with your other trading partners.
 - This second concept is a bit complex, but in a simple example consider that when the Trump administration put tariffs on imports from China that policy indirectly IMPROVED (or reduced) other countries trading relationships with the US – reducing “economic distance” and others countries trading distance with China.
- Rising policy uncertainty – illustrated by Trump trade policies, Brexit, COVID, Climate Change, Russia’s invasion of Ukraine will essentially increase economic distance. Many of these increases in policy uncertainty are BY DESIGN and intended to increase economic distance.

Let's review some of the recent assessments in the evolution of “economic trade costs”

- **Some findings from recent WTO work**
 - Global trade costs have declined by 15 per cent between 2000 and 2018.
 - Trade costs for services are higher than trade costs for agricultural goods. Trade costs for manufactured goods are the lowest.
 - Overall trade costs are higher for women, SMEs, and unskilled workers.
 - High-income groups face higher trade costs, given their larger share of consumption in services.
 - Trade policy barriers and regulatory differences are estimated to account for at least 14 per cent of trade costs in all sectors. They include tariff and non-tariff barriers, regulatory differences, as well as other policies covered by trade agreements, such as a lack of investment facilitation or of intellectual property protection.
 - **Trade policy barriers** are relatively the most important component of trade costs for trade among *low income* economies.
 - **Transport and travel costs** together with information and transaction costs explain the largest share of trade costs between *high-income economies*.
- **These findings are consistent with other work by UNESCAP and the WBG where the work overlaps**

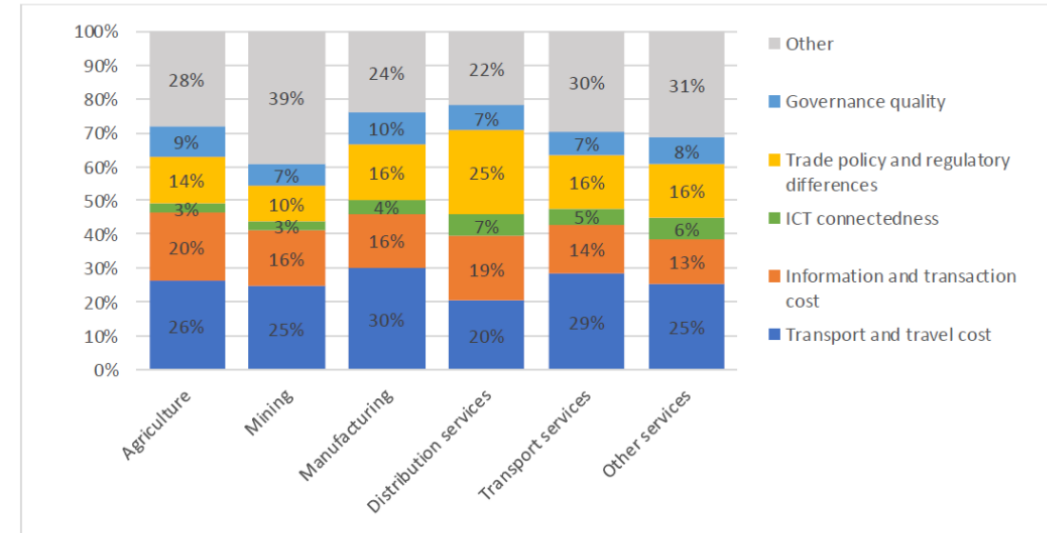
WTO trade cost work finds that trade and regulatory measure account for 16-18% of trade costs in the aggregate but with variation by sector.

Figure 4: Determinants of trade costs, percentage of bilateral variation



Note: Results of the underlying regressions are included in Table 6 and Table 7 of the Appendix. Sector-specific results are aggregated to the two categories using a weighted average where the weights are determined by the variance of trade costs in each sector.

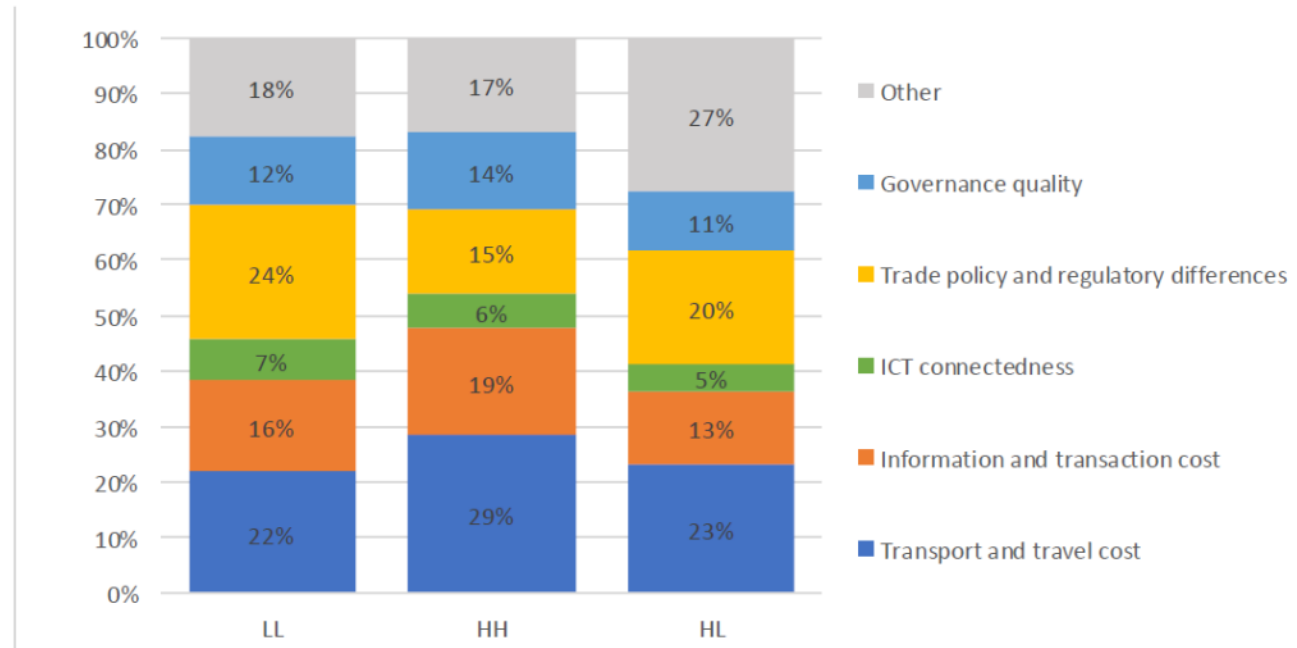
Figure 5: Determinants of trade costs by broad sector, percentage of bilateral variation



Note: Results of the underlying regressions are included in Table 6 and Table 7 of the Appendix. Sector-specific results are aggregated to broader categories using a weighted average where the weights are determined by the variance of trade costs in each sector.

And this varies also by income group.

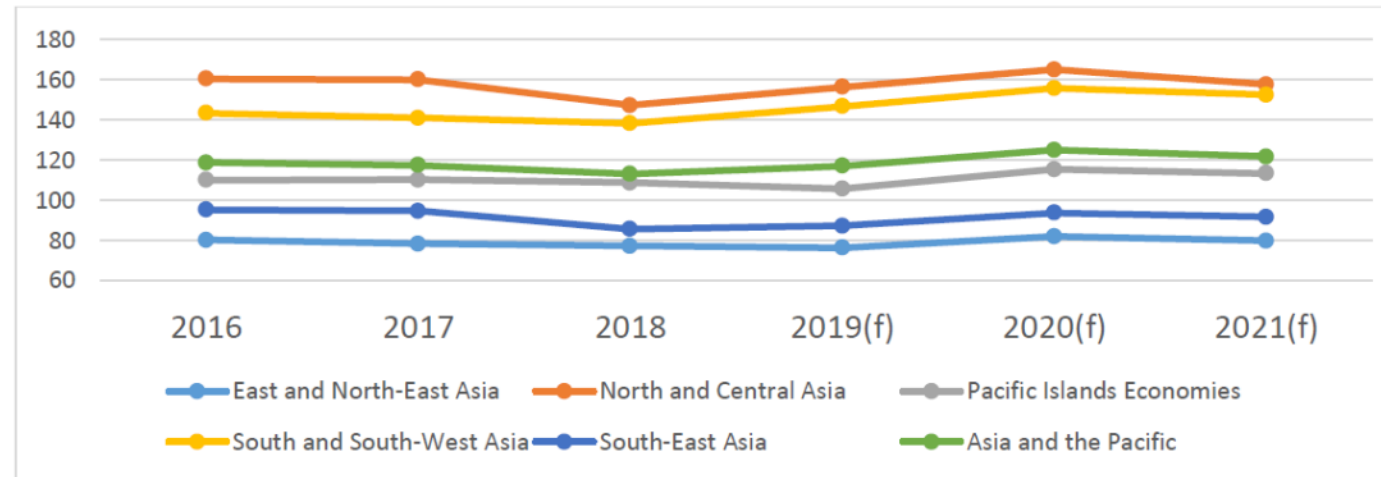
Figure 6: Determinants of trade costs by country income group



Note: LL refers to trade flows between lower-income economies, HH to trade between high-income economies, and HL to flows between high-income and lower-income economies. Results of the underlying regressions are available upon request.

UNESCAP and WBG Find large differences in trade costs between different regions of Asia Pacific with large developed countries.

Figure 1 – Trade costs of Asia-Pacific subregions with large developed economies (2016-2021)



Source: ESCAP (2020)

Notes: Trade cost numbers may be interpreted as tariff-equivalent trade costs, as per Novy (2009) and Arvis et al. (2016). The figure shows trade-weighted average trade costs of selected subregions with the following 3 developed economies: Germany, Japan, United States. Note that Pacific Island Economies include only Australia and New-Zealand because of data limitations on smaller Pacific Islands. Average trade costs for 2018 include forecasted trade costs for countries with missing ESCAP-World Bank trade cost data for that year.

Trade facilitation efforts work through a number of trade cost channels

- Transport and travel – which are still a relatively large share for all economies. Think improved ports...US challenges with COVID import surge.
- Trade policy and regulatory differences – large for developing countries. Think tariffs and NTMs – core market access negotiations.
- Information and Transactions costs – also significant. Think enhanced logistics integration into supply chains rather than just lead firm and suppliers.
- ICT costs are relatively low in the aggregate but likely higher for least developed countries.

Tracking trade drivers and “trade costs” moving forward ... will we see economic fragmentation/decoupling

- Recall size is a key driver in economic gravity. So as China slows and if India accelerates gravity suggests that China’s trade growth will slow and India’s quicken....depending on policy.
 - China’s dual circulation model, current domestic economic challenges, and external responses to changing political/policy environment will likely exacerbate that outcome. Keep in mind that much of China’s fast growth fueled through policy to close technology frontier gap.
 - India is poised for more sustained economic growth (much further to global technology frontier) and is now interested in potential integration into global supply chains...sees an opportunity in China’s growing tensions in global trade.
 - Other Indo Pacific countries also have SOME strong economic growth fundamentals...but will they lower trade costs and enhance integration into the global economy?
- Economic distance component of gravity -National security and near/friend shoring developments.
 - These are likely to be implemented in a way that raise “trade costs”, including through linkage through “multilateral resistance” related provisions...recent US IRA.
 - Semi conductor policies...
 - These elements are likely to show up in estimates of trade costs.
- Fragmentation/Decoupling – recent work by WTO shows significant long term costs from security related decoupling, with an important element being slower technological spillovers slowing dynamic economic growth, particularly for those countries further from global technology frontier, but also for developed countries at the frontier.

Conclusions

- Extraordinarily uncertain times for global trade policy and continued integration.
- Will the nature/template of trade agreements change?
 - If they do will they actually address those economic and social forces that are driving policy makers?
- It will be important to have some indicators of changes in trade costs unrelated to standard market access indicator such as tariffs.
- Tracking trade cost changes at a more granular level is challenging – not good enough nor timely enough data. But at the aggregate level such measures are likely to provide significant clues as to how policies are working through cross border economic relations.