What Do Undergrads Need to Know About Trade?

Paul R. Krugman

The American Economic Review, Volume 83, Issue 2, Papers and Proceedings of the Hundred and Fifth Annual Meeting of the American Economic Association (May, 1993), 23-26.

What Do Undergrads Need To Know About Trade?

By Paul R. Krugman *

Few of the undergraduates who take an introductory course in economics will go on to graduate study in the field, and indeed most will not even take any higher-level economics courses. So what they learn about economics will be what they get in that first course. It is now more important than ever before that their basic training include a solid grounding in the principles of international trade.

I could justify this assertion by pointing out that international trade is now more important to the U.S. economy than it used to be. But there is another reason, which I think is even more important: the increased *perception* among the general public that international trade is a vital subject. We live in a time in which Americans are obsessed with international competition, in which Lester Thurow's *Head to Head* is the nonfiction best-seller and Michael Crichton's *Rising Sun* tops the fiction list. The news media and the business literature are saturated with discussions of America's role in the world economy.

The problem is that most of what a student is likely to read or hear about international economics is nonsense. What I want to argue in this paper is that the most important thing to teach our undergrads about trade is how to detect that nonsense. That is, our primary mission should be to vaccinate the minds of our undergraduates against the misconceptions that are so predominant in what passes for educated discussion about international trade.

I. The Rhetoric of Pop Internationalism

As a starting point, I would like to quote a typical statement about international economics. (Please ignore the numbers for a moment.) Here it is: "We need a new economic paradigm, because today America is part of a truly global economy (1). To maintain its standard of living, America now has to learn to compete in an ever tougher world marketplace (2). That's why high productivity and product quality have become essential (3). We need to move the American economy into the high-value sectors (4) that will generate jobs (5) for the future. And the only way we can be competitive in the new global economy is if we forge a new partnership between government and business (6)."

OK, I confess: it's not a real quotation. I made it up as a sort of compendium of popular misconceptions about international trade. But it certainly sounds like the sort of thing one reads or hears all the time—it is very close in content and style to the still-influential manifesto by Ira Magaziner and Robert Reich (1982), or for that matter to the presentation made by Apple Computer's John Sculley at President-elect Clinton's Economic Conference last December. People who say things like this believe themselves to be smart, sophisticated, and forward-looking. They do not know that they are repeating a set of misleading clichés that I will dub "pop internationalism."

It is fairly easy to understand why pop internationalism has so much popular appeal. In effect, it portrays America as being like a corporation that used to have a lot of monopoly power, and could therefore earn comfortable profits in spite of sloppy business practices, but is now facing an onslaught from new competitors. A lot of companies are in that position these days (though the new competitors are not necessarily foreign), and so the image rings true.

Unfortunately, it's a grossly misleading image, because a national economy bears very little resemblance to a corporation. And the ground-level view of businessmen is

* Department of Economics, Massachusetts Institute of Technology, Cambridge, MA 02139.

deeply uninformative about the inherently general-equilibrium issues of international economics.

So what do undergrads need to know about trade? They need to know that pop internationalism is nonsense—and they need to know *why* it is nonsense.

II. Common Misconceptions

I inserted numbers into my imaginary quotation to mark six currently popular misconceptions that can and should be dispelled in an introductory economics course.

1.—"We need a new paradigm..." Pop internationalism proclaims that everything is different now that the United States is an open economy. Probably the most important single insight that an introductory course can convey about international economics is that it does *not* change the basics: trade is just another economic activity, subject to the same principles as anything else.

James Ingram's (1983) textbook on international trade contains a lovely parable. He imagines that an entrepreneur starts a new business that uses a secret technology to convert U.S. wheat, lumber, and so on into cheap high-quality consumer goods. The entrepreneur is hailed as an industrial hero; although some of his domestic competitors are hurt, everyone accepts that occasional dislocations are the price of a free-market economy. But then an investigative reporter discovers that what he is really doing is shipping the wheat and lumber to Asia and using the proceeds to buy manufactured goods—whereupon he is denounced as a fraud who is destroying American jobs. The point, of course, is that international trade is an economic activity like any other and can indeed usefully be thought of as a kind of production process that transforms exports into imports.

It might, incidentally, also be a good thing if undergrads got a more realistic quantitative sense than the pop internationalists seem to have of the limited extent to which the United States actually has become a part of a global economy. The fact is that imports and exports are still only about one-eighth of output, and at least two-thirds of our value-added consists of nontradable goods and services. Moreover, one should have some historical perspective with which to counter the silly claims that our current situation is completely unprecedented: the United States is not now and may never be as open to trade as the United Kingdom has been since the reign of Queen Victoria.

2.—"Competing in the world marketplace": One of the most popular, enduring misconceptions of practical men is that countries are in competition with each other in the same way that companies in the same business are in competition. Ricardo already knew better in 1817. An introductory economics course should drive home to students the point that international trade is not about competition, it is about mutually beneficial exchange. Even more fundamentally, we should be able to teach students that imports, not exports, are the purpose of trade. That is, what a country gains from trade is the ability to import things it wants. Exports are not an objective in and of themselves: the need to export is a burden that a country must bear because its import suppliers are crass enough to demand payment.

One of the distressing things about the tyranny of pop internationalism is that there has been a kind of Gresham's Law in which bad concepts drive out good. Lester Thurow is a trained economist, who understands comparative advantage. Yet his recent book has been a best-seller largely because it vigorously propounds concepts that unintentionally (one hopes) pander to the clichés of pop internationalism: "Niche competition is win–win. Everyone has a place where he or she can excel; no one is going to be driven out of business. Head-to-head competition is win–lose." (Thurow, 1992 p. 30). We should try to instill in undergrads a visceral negative reaction to statements like this.

3.—"Productivity": Students should learn that high productivity is beneficial, not because it helps a country to compete with other countries, but because it lets a country produce and therefore consume more. This would be true in a closed economy; it is no more and no less true in an open economy; but that is not what pop internationalists believe.

I have found it useful to offer students the following thought experiment. First, imagine a world in which productivity rises by 1 percent annually in all countries. What will be the trend in the U.S. standard of living? Students have no trouble agreeing that it will rise by 1 percent per year. Now, however, suppose that while the United States continues to raise its productivity by only 1 percent per year, the rest of the world manages to achieve 3-percent productivity growth. What is the trend in our living standard?

The correct answer is that the trend is still 1 percent, except possibly for some subtle effects via our terms of trade; and as an empirical matter changes in the U.S. terms of trade have had virtually no impact on the trend in our living standards over the past few decades. But very few students reach that conclusion—which is not surprising, since virtually everything they read or hear outside of class conveys the image of international trade as a competitive sport.

An anecdote: when I published an op-ed piece in the *New York Times* last year, I emphasized the importance of rising productivity. The editorial assistant I dealt with insisted that I should "explain" that we need to be productive "to compete in the global economy." He was reluctant to publish the piece unless I added the phrase—he said it was necessary so that readers could understand why productivity is important. We need to try to turn out a generation of students who not only don't need that kind of explanation, but understand why it's wrong.

4.—"High-value sectors": Pop internationalists believe that international competition is a struggle over who gets the "high-value" sectors. "Our country's real income can rise only if (1) its labor and capital increasingly flow toward businesses that add greater value per employee and (2) we maintain a position in these businesses that is superior to that of our international competitors" (Magaziner and Reich, 1982 p. 4).

I think it should be possible to teach students why this is a silly concept. Take, for example, a simple two-good Ricardian model in which one country is more productive in both industries than the other. (I have in mind the one used in Krugman and Maurice Obstfeld [1991 pp. 20–1]. The more productive country will, of course, have a higher wage rate, and therefore whatever sector that country specializes in will be "high value," that is, will have higher value-added per worker. Does this mean that the country's high living standard is the result of being in the right sector, or that the poorer country would be richer if it tried to emulate the other's pattern of specialization? Of course not.

5.—"Jobs": One thing that both friends and foes of free trade seem to agree on is that the central issue is employment. George Bush declared the objective of his ill-starred trip to Japan to be "jobs, jobs, jobs"; both sides in the debate over the North American Free Trade Agreement try to make their case in terms of job creation. And an astonishing number of free-traders think that the reason protectionism is bad is that it causes depressions.

It should be possible to emphasize to students that the level of employment is a macroeconomic issue, depending in the short run on aggregate demand and depending in the long run on the natural rate of unemployment, with microeconomic policies like tariffs having little net effect. Trade policy should be debated in terms of its impact on efficiency, not in terms of phony numbers about jobs created or lost.

6.—"A new partnership": The bottom line for many pop internationalists is that since U.S. firms are competing with foreigners instead of each other, the U.S. government should turn from its alleged adversarial position to one of supporting our firms against their foreign rivals. A more sophisticated pop internationalist like Robert Reich (1991) realizes that the interests of U.S. *firms* are not the same as those of U.S. *workers* (you may find it hard to believe that anyone needed to point this out, but among pop internationalists this was viewed as a deep and controversial insight), but still accepts the basic premise that the U.S. government should help our industries compete.

What we should be able to teach our students is that the main competition going on is one of U.S. industries against *each other*, over which sector is going to get the scarce resources of capital, skill, and, yes, labor. Government support of an industry may help that industry compete against foreigners, but it also draws resources away from other domestic industries. That is, the increased importance of international trade does not change the fact the government cannot favor one domestic industry except at the expense of others.

Now there are reasons, such as external economies, why a preference for some industries over others may be justified. But this would be true in a closed economy, too. Students need to understand that the growth of world trade provides no additional support for the proposition that our government should become an active friend to domestic industry.

III. What We Should Teach

By now the thrust of my discussion should be clear. For the bulk of our economics students, our objective should be to equip them to respond intelligently to popular discussion of economic issues. A lot of that discussion will be about international trade, so international trade should be an important part of the curriculum.

What is crucial, however, is to understand that the level of public discussion is extremely primitive. Indeed, it has sunk so low that people who repeat silly clichés often imagine themselves to be sophisticated. That means that our courses need to drive home as clearly as possible the basics. Offer curves and Rybczinski effects are lovely things. What most students need to be prepared for, however, is a world in which TV "experts," best-selling authors, and $30,000-a-day consultants do not understand budget constraints, let alone comparative advantage.

The last 15 years have been a golden age of innovation in international economics. I must somewhat depressingly conclude, however, that this innovative stuff is not a priority for today's undergraduates. In the last decade of the 20th century, the essential things to teach students are still the insights of Hume and Ricardo. That is, we need to teach them that trade deficits are self-correcting and that the benefits of trade do not depend on a country having an absolute advantage over its rivals. If we can teach undergrads to wince when they hear someone talk about "competitiveness," we will have done our nation a great service.

REFERENCES

Crichton, Michael, *Rising Sun*, New York: Knopf, 1992.

Ingram, James, *International Economics*, New York: Wiley, 1983.

Krugman, Paul and Obstfeld, Maurice, *International Economics: Theory and Policy*, New York: Harper Collins, 1991.

Magaziner, Ira and Reich, Robert, *Minding America's Business*, New York: Random House, 1982.

Reich, Robert, *The Work of Nations*, New York: Knopf, 1991.

Thurow, Lester, *Head to Head*, New York: William Morrow, 1992.