WHAT CREATES WEALTH?

PART 2: INTERNATIONAL TRADE

By now we know that only *two* phenomena can *create* wealth, without taking anything away from anyone. These are called Productivity and Trade. In Part 1 we discussed **Productivity**. In Part 2, we will discuss **International Trade**.

Ever since 1776, when Adam Smith published his Wealth of Nations book, we have known that when people specialise in something and trade with each other, they raise everyone's productivity. Concentration, focus and specialisation raise productivity and thereby create wealth.

However, throughout history, politics has dominated economics. This means whatever is best for the general population is not necessarily implemented. Politics are conducted by governments. Most governments are often influenced by special interests, which generate *concentrated benefits and diffused costs.*

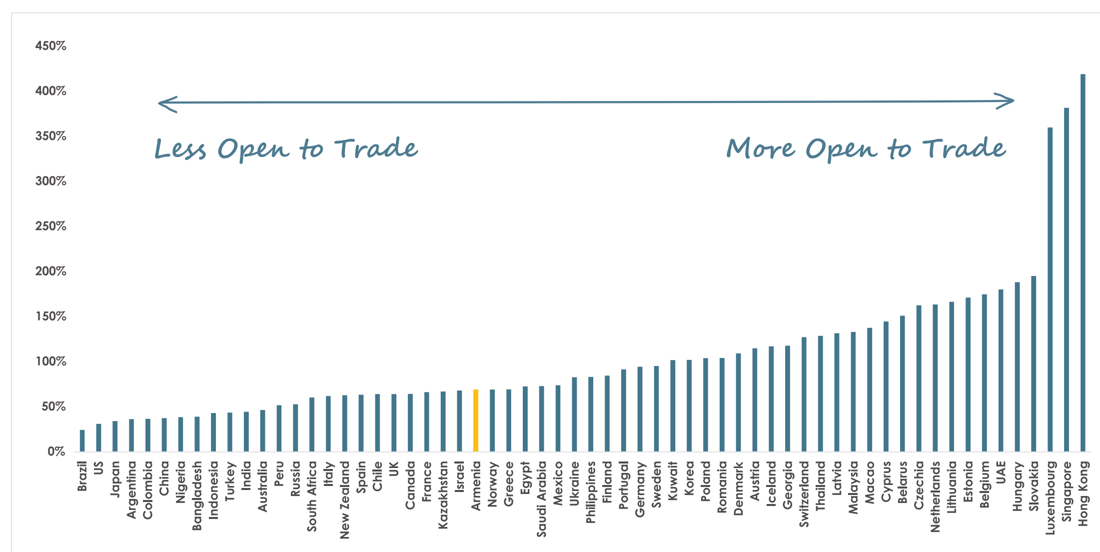
In this note, we would like to share with you **four key points** on international trade. These four points will (a) remain useful and relevant for many years, and (b) will make it much easier to understand and filter the daily barrage of information we receive on this subject.

Point 1 – Country Openness

Total exports plus imports of any country relative to that country's GDP is called the Openness Index. Chart 1 shows which countries are the most open and dependent on trade (Singapore, Hong Kong, Luxembourg, Slovakia, Hungary) and which countries are the least open (Brazil, the US, Japan) and therefore least concerned about international trade.

This explains why the current US administration is not very worried about its trade war with different countries. The US is among the least open economies in the world, mostly because it is nearly entirely self-sufficient. The US economy is large enough to trade internally, among its states.

Chart 1: Trade Openness (Exports + Imports as % of GDP)



Source: World Bank

Moreover, President Donald Trump is not a big fan of international organisations. He has stated many times that he preferred bilateral to multilateral trade deals because in bilateral trade agreements it is easier to bamboozle other countries into a "better" trade deal.

If he gets re-elected on November 3rd, the US will most likely continue to review its international trade arrangements and will concentrate on domestic production and domestic trade.

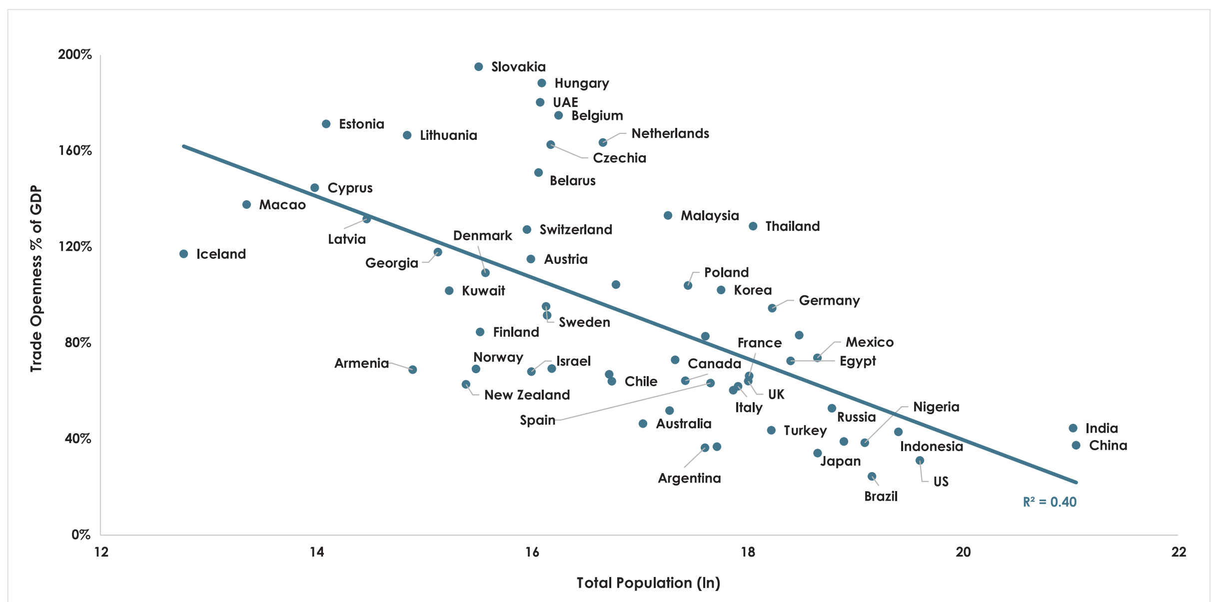
Point 2 – Small Countries benefit the most from International Trade

In economic theory, smaller countries should benefit the most from international trade because they get access to a huge global market. Chart 2 shows that smaller countries are usually more open to trade.

This is one of the main reasons many small European countries want to join the European Union, as it is the only way to get guaranteed and equal access to a huge market. There are geopolitical reasons as well, but we will not discuss them in this note.

Small countries which do not focus on international trade are highly unlikely to have rapid productivity growth, which means they will not be able to generate wealth.

Chart 2: Smaller Countries Tend to be More Open to Trade



Source: World Bank

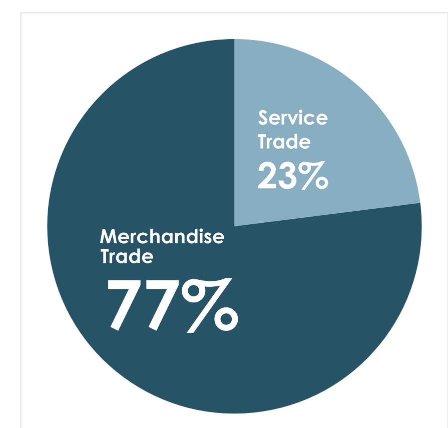
Point 3 – World Trade relative to World GDP

World GDP currently stands at around $85 trillion. World Trade is at around 60% of World GDP. From late 1980s until the end of 2007 (just before the financial crisis), world trade doubled, from 30% to 60% of world GDP.

Throughout the 1990s, many economies around the world – including the US – had a rapid increase in productivity growth, which confirms the hypothesis that international trade leads to higher productivity.

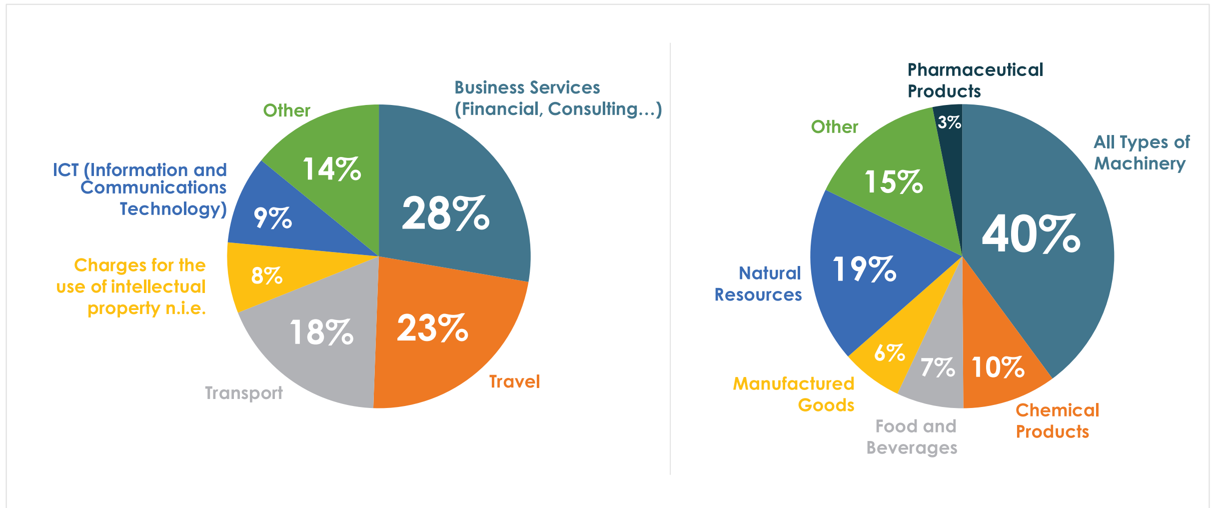
Chart 3 shows that World Trade consists of Goods/ Merchandise (80% of total trade) and Services (around 20%). The four biggest items in world trade are Machinery, Natural Resources, Business Services and Travel. With COVID, many sectors of Travel got decimated. See the breakdown of traded goods & services in Chart 4.

Chart 3: Share of Merchandise/Goods and Services Trade in Total Trade



Source: World Bank

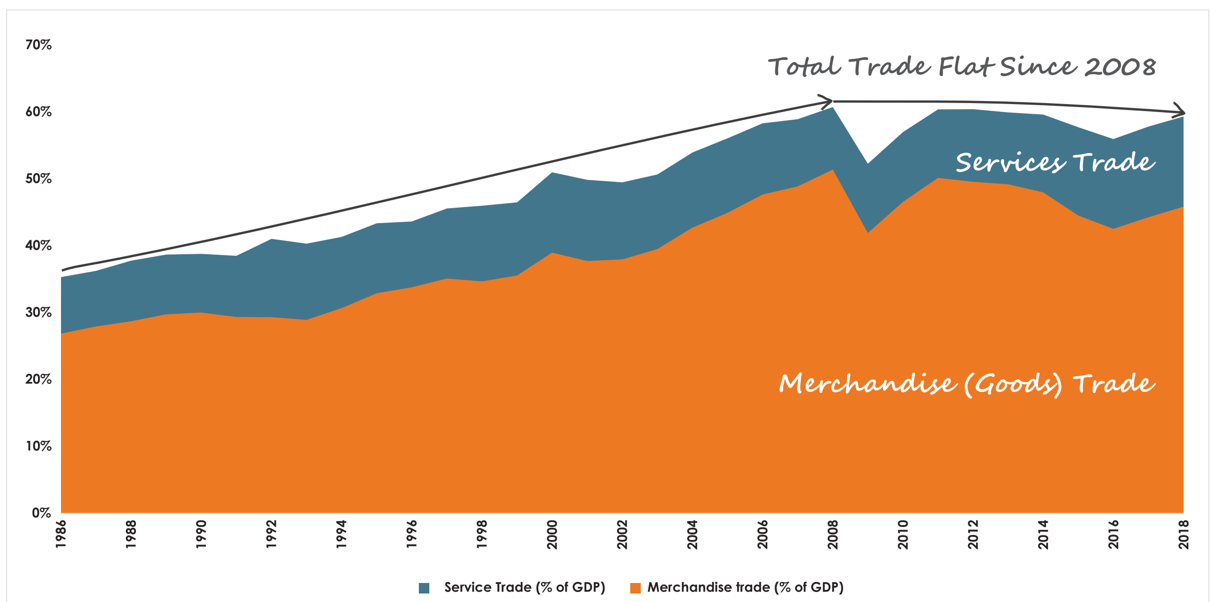
Chart 4: Breakdown of Merchandise/Goods and Services Trade



Source: World Trade Organization, International Trade Centre

As shown in Chart 5, world trade peaked in 2008 and since then hasn't really recovered. After COVID, world trade will most probably decline (as a share of world GDP).

Chart 5: The Dynamics of World Trade as % of GDP



Source: World Bank

Point 4 – Foreign Direct Investments

Financial Capital (or simply money) is an internationally traded commodity, just like goods and services are. In economic statistics, international capital flows and international trade are different sides of the same coin.

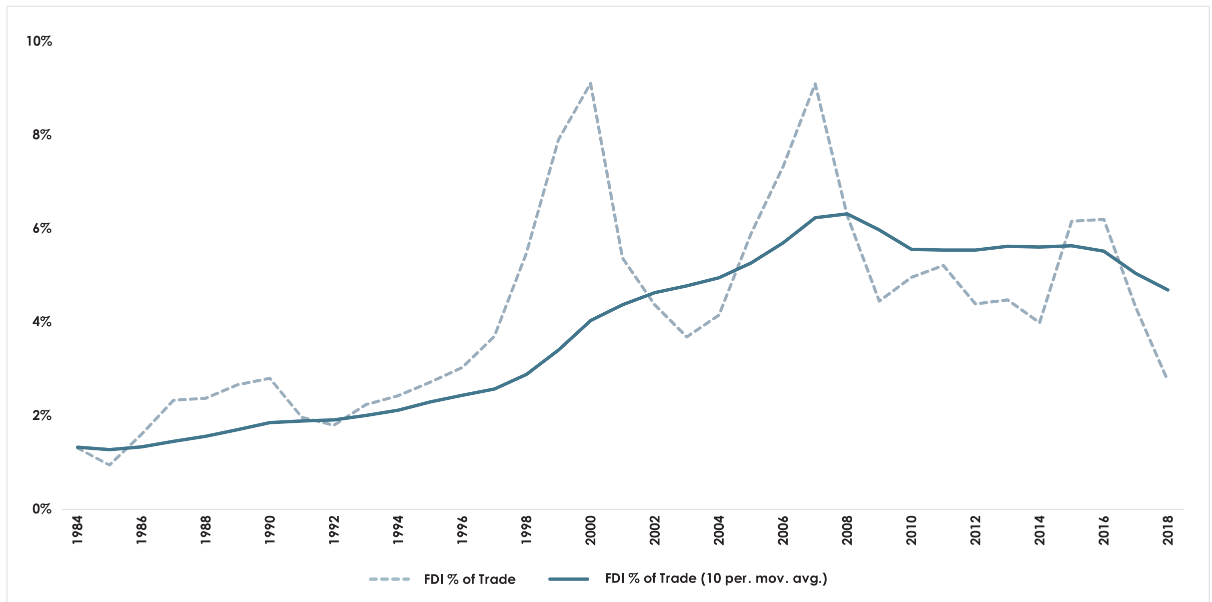
International financial capital flows are usually divided into two parts – *portfolio investments* and *direct investments*. Portfolio investments are usually up to one year, into stocks or bonds, are easily bought and sold, with minimal transaction costs. Direct investments, on the other hand, are for longer than one year and have large transaction costs. For example, Samsung building a production plant in Russia is a Foreign Direct Investments (called FDI).

FDI is among the biggest drivers of innovation and productivity because apart from financial capital, FDIs generate a lot of advanced knowhow and expertise. Even if Samsung decides to close its production plant in Russia, the knowledge it transferred to workers in Russia will forever remain in Russia.

Portfolio investments generate minimal knowledge transfer. This is the biggest difference between portfolio flows and direct investments.

Chart 6 shows that Foreign Direct Investments around the world have collapsed since the 2008 financial crisis. This, of course, doesn't bode well for productivity and innovation growth around the world.

Chart 6: Foreign Direct Investment as % of World Trade



Source: World Bank

Conclusion

In Parts 1 & 2 we have discussed the two sources of wealth creation – productivity and trade. We have argued that "sad productivity growth" doesn't really create any wealth, it simply redistributes it.

Since the 2008 financial crisis, the world economy has witnessed a fall in productivity growth and in international trade. After COVID international trade will most likely continue to fall. Productivity growth is in trouble for various reasons, some of them we understand – big governments, regulatory complexity – and some we don't. This means wealth creation around the world has slowed considerably.

Despite slower wealth creation, most asset prices around the world have increased. The main reason is falling interest rates. When pricing different assets – real estate, stocks, or any business with expected future profits, people often underestimate a simple mathematical fact: a 1% point fall in interest rates (e.g. from 5% to 4%) can compensate for a 10% fall in future profits. To rephrase, interest rates can be ten times as powerful as profits.

Falling interest rates are propping up all asset prices, but higher asset prices do not necessarily imply wealth creation. For example, an increase in house prices does not necessarily create any wealth, it could simply transfer it from those who don't yet have a house to those who already have houses.

The biggest potential for productivity growth (and therefore wealth creation) is in countries with low productivity levels, because all they have to do is catch up. However, corruption in many developing countries is preventing them from catching up. Corruption, once again, is a symptom of big governments. Developing economies which manage to eliminate corruption will have the potential to generate significant amounts of wealth.

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