

World” initiative to develop approaches in measuring and analyzing trade in value-added.¹⁰ The World Bank, WTO, and OECD have all recently held conferences on global value chains and many are developing work plans to address some of the main issues raised.

The WTO in particular has a very focused interest in GVCs relating to the calculation of value-added trade. With the rise of GVCs, trade flows, which are expressed on a gross basis, may become increasingly inflated as a product is counted multiple times when it crosses a border as part and again as a final product. This can have the effect of multiplying the impact on trade flows of changes in demand as was observed during the financial crisis. It also has the impact of making trade appear to be more important than it actually is and on the distribution of bilateral trade flows and bilateral balances – although importantly, not on overall trade balances. It is therefore hoped that by developing a value-added measure of trade, that this will allow countries to have a better understanding of the “true” trade linkages between countries as well as producing a more accurate representation of the role of trade for national economies. Having a value-added measure of trade could also be used to produce a more accurate assessment the impact of exchange rate movements on bilateral trade flows, an issue of current importance given concerns over global imbalances.¹¹

How GVCs Fit Into Economic Theory

Since David Ricardo expressed his views in 1817, international trade theory has been governed by a belief in comparative advantage which loosely states that each participant in trade will specialize in producing that good in which it has comparative advantage. Comparative advantage under Ricardo is simply measured as a cost advantage, without being explicit as to the source of the advantage, although is generally interpreted and modeled as a difference in technology or geography. Heckscher and Ohlin built on this foundation arguing that differences in factor endowments determine differences in relative costs. This produces, for example, the now well-known result that labour intensive countries should specialize in producing labour-intensive products and capital-intensive countries in capital intensive products.

In these classical models it is recognized that firms or even individuals trade, but that differences in technology (as in Ricardo’s example) or endowments (as in the H-O model) are specific to different locations, usually assumed to be countries. Under the so called “new trade theory” developed by Paul Krugman in the 1980s it is no longer only the differences that matter. Even countries that are similar will engage in and benefit from trade if each specializes and as a result becomes more efficient in production. Again, it is firms or individuals that trade, but the potential gains from specialization are characteristics of the industry.

An additional element of the new trade theory is the importance of geography. In order to minimize transportation costs, firms will have a preference to locate close to customers as well as to suppliers. Those firms that can lower costs in this way gain an advantage over competitors. Large population centers thus become a magnet for production, which is self reinforcing as upstream and downstream activities follow and

¹⁰ See http://www.wto.org/english/res_e/statis_e/miwi_e/miwi_e.htm

¹¹ See, for example, the presentation by Kei-Mu Yi, Senior Vice President and Director of Research, Federal Reserve Bank of Minneapolis. <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/TRADE/0,,contentMDK:22894003~menuPK:2644066~pagePK:64020865~piPK:51164185~theSitePK:239071,00.html>