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Defying gravity? Emerging Asia's export boom, Western industrial upgrading, and persistent upstream financial flows

In the globalisation wave since the 1990s, emerging Asia, notably China, has run current account surpluses, while advanced economies like the United States ran deficits. The persistence of "upstream" capital flows from emerging to developed nations contradicts conventional economic wisdom. A new perspective on this phenomenon** links global financial flows with trade integration. It models surging imports, above all manufactures from emerging Asia, facilitating advanced economies to upgrade production sectors and shift towards high value-added economic activities. It turns out that the direction of financial flows depends on the degree of industrial upgrading in advanced economies.

In the same wave, technological advancement and tumbling trade barriers have integrated emerging economies into global trade and fragmented what is made where. In the 1990s, China and other emerging Asian economies expanded their respective shares in the world manufactured exports by three percentage points. In the 2000s, China's share soared by another ten percentage points, boosted by joining the World Trade Organization in 2001. In contrast, the joint share of the G-7 countries fell by over 20 percentage points during these two decades. Chinese import competition reallocated the US jobs from manufacturing to services, while almost all of the manufacturing job losses are in large, multinational firms that are simultaneously expanding in services.

The study's model steps through how finance and trade could play out between two simplified blocs: advanced (North) and emerging (South). North now floods with cheap Southern imports. Its entrepreneurs upgrade further to exploit North's comparative advantage: high-return but "financially constrained" tasks and sectors, like R&D and product design, market analysis and pricing strategy, supply-chain management, marketing and branding, and customer services. High-return, high value-added tasks and sectors demand extensively intangible capital, often technology and knowledge, and financiers who can understand these forms, wear the risks, and still muster large sums.

Hamstrung partly by a less developed financial system and business environment, South cannot emulate North's sectoral upgrading, so plays to its own advantage: cheap labour. It follows North's mirror image: specialisation in less financially constrained sectors, like mass manufacturing sectors mainly using tangible capital but with low value-added. As finance increasingly crosses borders, investors also hunt higher interest rates abroad. If North's savings are not fully soaked up by its high-return sectors, its current account surplus should flow downstream into South, stanching or even reversing upstream flows. Earlier research predicted such a reversal, assuming that South was not large enough and its exports did not fundamentally change North's industrial structure.

Fast forward to the trade surge from South, as emerging Asia. What if North now specialises fully in high-return tasks and sectors? It might, if conditions lined up: among other things, sufficiently large imports from South, a wide enough gap in financial development, and a highly vibrant and dynamic Northern investment environment. If trade flows could allow North's high-return sectors to expand and absorb not only home savings but also investments from South seeking higher interest, the reversal predicted by earlier research would itself be reversed, and upstream financial flows would lock-in.

Under certain conditions, then, stubborn current account imbalances in the recent decades may stem from the structural change and industrial upgrading in advanced economies since the 1990s. If they do, booming exports from emerging Asia may exacerbate them. Though conditional, this intricately reasoned perspective sheds important new light on the sophisticated interactions between trade, industrial structure and upstream financial flows.

The ongoing geopolitical tensions are significantly reshaping the landscape of global trade policy and redirecting trade flows among major economies. The long-term implications to the global production network and the patterns of capital flows require further research.

** The full study results are available in an open access article authored by Haiping Zhang: "Trade-induced sectoral upgrading and upstream financial flows". Canadian Journal of Economics 56(3) (2023) https://doi.org/10.1111/caje.12670

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