Globalization, Trade in Middle Products, and Relative Prices

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Abstract

As pointed out by Ronald W. Jones in a joint paper with Kalyan Sanyal (*American Economic Review*, 1982), most international trade is in raw materials and intermediate goods, and even most so-called endproducts that are traded must still transit through the production sector before reaching final demand. The recognition that nearly all international trade takes place in *middle products* – rather than in finished goods as it is assumed in most models of international trade theory – has some far reaching consequences for the measurement of real value added, real domestic income, and productivity. Besides being more realistic, the middle products approach also presents the major advantages that it is fully consistent with national accounts data and that it brings forward the role of a number of related, yet distinct, key price ratios: the terms of trade, the real exchange rate, and the trading gains. Given that most import and export decisions are made by firms, rather than by households, production theory, instead of consumer theory, is the appropriate setting for analyzing such issues as openness, trade imbalances and income distribution. This paper proposes a unified framework to address these issues and assesses the impact of changes in these price ratios on the external position of the United States.

Keywords: Globalization, middle products, imbalances, terms of trade, real exchange rate, trading gains, income distribution

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