Chapter 12 Lecture - International Trade Theory and Development Strategy

ECON 211 – 70: Economic Development

Chapter 12 Lecture – International Trade Theory and Development Strategy

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Economic Globalization: An Introduction

- Globalization– many interpretations
- Core economic meaning– the increased openness of economies to international trade, financial flows, and foreign direct investment
- Concerns with globalization center around the unevenness of the process, and risks

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Globalization Versus Internationalization: By Herman E. Daly

Globalization, considered by many to be the inevitable wave of the future, is frequently confused with internationalization, but is in fact something totally different. Internationalization refers to the increasing importance of international trade, international relations, treaties, alliances, etc. Inter-national, of course, means between or among nations. The basic unit remains the nation, even as relations among nations become increasingly necessary and important. Globalization refers to global economic integration of many formerly national economies into one global economy, mainly by free trade and free capital mobility, but also by easy or uncontrolled migration. It is the effective erasure of national boundaries for economic purposes. International trade (governed by comparative advantage) becomes interregional trade (governed by absolute advantage). What was many becomes one.

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International Trade: Some Key Issues

- Many developing countries rely heavily on exports of primary products with attendant risks and uncertainty
- Many developing countries also rely heavily on imports (typically of machinery, capital goods, intermediate producer goods, and consumer products)
- Many developing countries have chronic deficits on current and capital accounts which depletes their reserves, causes currency instability, and may slow economic growth
- Recently many developing countries sought to promote exports and accumulate large foreign exchange reserves to cushion against crises – spurring new policy debates

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Five Basic Questions about Trade and Development

- How does international trade affect economic growth?
- How does trade alter the distribution of income?
- How can trade promote development?
- Can LDCs determine how much they trade?
- Is an outward-looking or an inward-looking trade policy best?

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The Terms of Trade and the Prebisch-Singer Hypothesis

- Total export earnings depend upon:
  - Total volume of exports sold; and,
  - Price paid for exports
- Prebisch and Singer argued commodity export prices fall over time, so developing countries lose revenue unless they can continually increase export volumes
- They concluded that developing countries need to avoid dependence on primary exports
- Some evidence relative prices within manufactures are also diverging with falling prices for low-skill products

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The Traditional Theory of International Trade

- Comparative advantage
  - specialization
- Relative factor endowments and international specialization: the Neoclassical model
  - Ricardo and Mill (static model)
  - Heckscher and Ohlin (factor endowment theory)
    - Different products require productive factors in different ratios
    - Countries have different endowments of factors of production

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The Traditional Theory of International Trade (cont'd)

- Main conclusion of the neoclassical model is that all countries gain from trade
- World output increases with trade
- Countries will tend to specialize in products that use their abundant resources intensively
- International wage rates and capital costs will gradually tend toward equalization
- Returns to owners of abundant resources will rise relatively
- Trade will stimulate economic growth

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The Traditional Theory of International Trade (cont'd)

- Trade theory and Development: The Traditional Arguments
  - Trade stimulates economic growth
  - Trade promotes international and domestic equality
  - Trade promotes and rewards sectors of comparative advantage
  - International prices and costs of production determine trading volumes
  - Outward-looking international policy is superior to isolation

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Trade and Development

- Two basic strategies regarding trade have been adopted through history:
  - Import substitution: Replacement of imported goods by goods produced domestically; via protection of domestic markets against imports
  - Outward-looking trade policies (export-oriented strategies): Shift focus from production for domestic markets to production for export to foreign markets; via policies trying to promote and support exports

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Import Substitution

- The basic idea is the following:
  - There may be high initial costs of local production
  - So, in order to make it profitable for local entrepreneurs to invest, protective barriers are raised to reduce the influx of imports
  - This increases the market for potential local producers and increases their profitability
- How are these protective “barriers” erected?
  - The government uses instruments that it has available
  - These usually include tariffs or quotas on imports, sometimes ban on imports of certain goods, subsidies to the inputs of the local producers

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Import Substitution

- But why should the government protect some industries?
  - If local firms have high costs, maybe they shouldn’t produce at all, and it would be better for the economy to import these goods
  - But there are some situations where initial costs are high, but tend to decrease once industry develops
  - In these cases, it may be interesting for society to protect local industries in the first stages, in order to take advantage of the higher productivity that will ensue in the future
  - This idea is related to the discussion of the “big-push” and “forward and backward linkages” from before

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Import Substitution

- This idea that industries should be protected in the first stages of their development is called the "Infant Industry" argument, and it's associated with German economist Friedrich Liszt
- New industry in a country has to compete against firms abroad, that have long experience with the same production technology, with marketing strategies, distribution channels, etc
- So these new national industry needs time to "learn" the best way to operate on all these dimensions

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Import Substitution

- Note that there is a cost of industry protection to society as a whole
- Every consumer has to pay a higher price for the good, and possibly consume less, in order for a single firm to be protected ➔ these welfare costs can be very high
- And discussions in these area are always very political: producers will always try to convince the government and society that their sector has to be protected, in order for the industry to develop, for jobs to be generated and etc
- We usually see lots of industries being protected for long periods of time, when it would be very hard to find any economic reason to justify such long term protection

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Import Substitution

- This is similar to the danger of political "capture" of the government that can be discussed in the context of industrial policies
- Internal producers may be able to influence the government (well-connected or bribes) in order to maintain the protection, even when it's not socially desirable anymore
- In reality, this was probably the main reason behind the failure of the historical experiences of import substitutions: after the initial growth of industries, when the most of the "learning" was over, governments were not politically able to reduce trade barriers (pressures from industrialists, unions, etc)

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Trade Policy Instruments

- Protective Tariffs
  - A protective tariff works like a tax on imported goods: if you're an importer, you have to pay a fraction of the imported good price as a tax to the government
  - The basic effect of a tariff is to raise the domestic price above the world price
  - In a competitive market, with no tariffs, the world price of any good would be close to the price observed in each country; the only difference in prices between countries would be due to transportation costs

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Trade Policy Instruments

- Domestic producers will be able to charge the same price as the imports, and still compete with them, so that's what they'll do
- The tariff will increase domestic producers welfare because it'll allow them to sell more at a higher prices
- It will reduce domestic consumers welfare because they'll consume less at a higher price
- Additionally, it will tend to reduce the efficiency of the economy (at least in short run), because resources will be diverted into production in the import substitution sector, when they'd be more productive if used elsewhere

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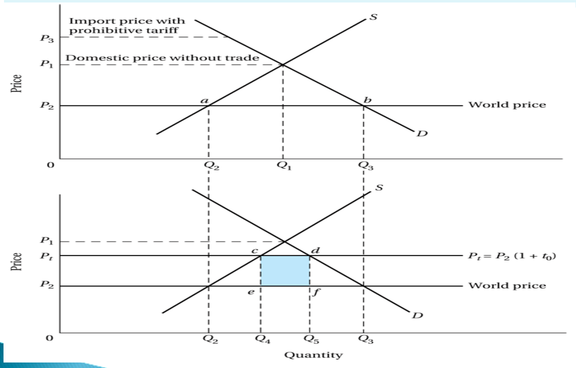
Import Substitution and the Theory of Protection



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Trade Policy Instruments

- Import Quotas
- Quotas are quantitative restrictions: the government fixes the maximum quantity of a good that can be imported
- In principle, we could think that quotas would have the same effects of corresponding tax rates (in our previous example, if government sets quota equal to M2, the final allocation would be the same of the t0 tax)
- But there are some important differences

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Trade Policy Instruments

- Subsidies
  - Governments can offer subsidies to domestic firms in order to increase their profitability and, therefore, "protect" national firms
  - Subsidies can be over production, use of inputs, or exports, for example
  - In this case, the burden (real cost) of the policy does not fall on consumers, but on tax payers (the money that finances)
  - Consumers of the good in question actually benefit from the policy, since they can buy more of the good at a lower price

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Trade Policy Instruments

- Exchange Rate Management
  - Governments sometimes try to control the exchange rate to affect the relative prices of tradables and, therefore, affect amount of imports and exports
  - This kind of intervention has a similar effect for all tradable goods, and cannot distinguish between different sectors
  - Interventions in the exchange rate will tend to have the same effect over all exports (and an opposite effect on the imports)

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Trade Policy Instruments

- But the exchange rate – as we saw before – is just another price in the economy
- So artificial interventions in the exchange rate will also introduce distortions in the economy, which will tend to reduce overall efficiency (either by increasing the exporting sector or imports beyond what would be economically efficient)
- In addition, changes in the exchange rate also affect the relative wealth of different segments of society: the people who consume imported goods, on one side, and the industrialists or agriculturalists (who export goods), in the other

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Outward-Looking Strategies

- Shift the focus from import substitution and domestic markets towards manufacturing for exports to foreign markets
- In this strategy, tariffs and quotas should be reduced to a minimum, and prices should move closer to world prices
- Also, governments should set up institutions to help promote exports: duty exemption systems, export processing zones, infrastructure development (ports, roads, energy supply), export subsidies, etc

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Outward-Looking Strategies

- Typical pattern:
  - In early stages, some firms manufacture simple labor-intensive products (textiles, shoes, clothing, etc), and some firms assemble more sophisticated products using components manufactured elsewhere
  - Over time, workers learn new skills, labor force becomes more qualified, country gain access to improved technology, and production shifts to more technology-intensive goods (electronics, consumer durables, etc)

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Outward-Looking Strategies

- Advantages:
  - Economies of scale and specialization: By concentrating on export markets, scale of operation can be larger (not restricted to domestic market) ➔ take advantage of gains from learning by doing and allows industry to overcome fixed costs
  - Foreign exchange: Exports generate foreign exchange that may be necessary to pay for imports of raw material and capital goods (great limitation in the import substitution strategy)
  - Enhanced capacity to import capital goods + exposure to competition from world markets generates conditions and incentives for domestic firms to keep up with technological advances in the rest of the world ➔ productivity increases

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Outward-Looking Strategies

- Necessary conditions for a successful exports-oriented strategy:

1st: Macroeconomic stability: A stable economic environment, with moderate inflation and stable exchange rate (at market-determined level); economic policy making not strongly affected by political interests, rent-seeking, or corruption

2nd: Infrastructure: Development of adequate infrastructure (roads, railways, ports, energy supply, telecommunications)

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Outward-Looking Strategies

3rd: Educated labor force: Development of adequate education and training institutions, in order to provide workforce the relevant set of skills

4th: Access of exporters to capital goods and raw materials at world prices: This can be achieved via an open economy (no tariffs or quotas); or via Export Processing Zones (EPZ's), which are areas where exporters have access to duty-free imports of capital and raw materials, and adequate infrastructure (duty exemption systems do a similar job, but are not geographically defined)

5th: Flexible factor markets: Well-functioning labor and capital markets, where labor and capital can move freely, and their prices are not controlled

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World Trading Arrangements

- The world trading arrangements that we observe today are the result of the evolution of institutions that were created after the 2nd World War, together with the creation of the IMF and the World Bank
- The most important of these institutions evolved out of a round of trade negotiations involving 23 countries, which took place between 1947-48
- The name of this round of negotiations was later on inherited by the institution created to support and enforce the agreement: the General Agreement on Tariffs and Trade (GATT)

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World Trading Arrangements

- The GATT was progressively expanded, and became the most important multilateral trade institution in the world up to the mid 1990's
- The last and most important GATT agreement took place between 1986 and 1994 and involved 123 countries; it came to be known as the "Uruguay round"
- The Uruguay round also changed the institutional, framework:
- The World Trade Organization was created (1995)
  - Its role is to establish the rules of open trade and "fair" competition
  - It also plays the part of a tribunal, to settle trade disputes among member countries

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World Trading Arrangements

- Trading blocs
  - Free-trade areas: Eliminate tariffs among member countries, although each member sets its own tariffs in relation to the outside world; Ex.: North American Free Trade Agreement (NAFTA), MERCOSUR (in theory)
  - Customs union: Eliminate tariffs among member countries and sets a common set of tariffs to the outside world; Ex.: Preferential Trade Area (eastern and southern African countries); South African Customs Union
  - Common markets: Free trade among members, a common external tariff, and no restriction on the movement of factors of production (labor and capital); Ex.: European Union, Central American Common Market (later on dismantled)

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South-South Trade and Economic Integration

- Economic Integration: Theory and Practice
  - The growth of trade among developing countries.
  - Integration encourages rational division of labor among a group of countries and increases market size
  - Provides opportunities for a coordinated industrial strategy to exploit economies of scale
  - Trade creation
  - Trade diversion

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South-South Trade and Economic Integration

http://news.bbc.co.uk/1/hi/business/4510792.stm

- Regional trading blocs and the globalization of trade
  - NAFTA http://www.fas.usda.gov/itp/policy/nafta/nafta.asp
  - MERCOSUR http://www.cfr.org/trade/mercosur-south-americas-fractious-trade-bloc/p12762
  - SADC http://www.sadc.int
  - ASEAN http://www.asean.org/
  - GCC http://www.gcc-sg.org/
  - Local conditions matter
  - Still not fully answered: Do blocs promote growth or retard the progress of globalization

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