UNIVERSITÁ DEGLI STUDI DI TERAMO

International Economics

Noemi Pace
Facoltá di Scienze Politiche
npace@unite.it

Economic Globalization: An Introduction

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

International Trade: Some Key Issues

- A significant number of developing countries still rely heavily on exports of primary products with attendant economic and political economy risks and uncertainty, and evidence of deteriorating terms of trade
- A majority of developing countries rely heavily on imports of machinery, capital goods, and intermediate producer goods; and in some cases consumer necessities
- Many developing countries have chronic deficits on current and capital accounts which depletes their reserves, causes currency instability, and may slow economic growth
- Since the 1990s, a larger number of developing countries gave sought to promote exports and accumulate large foreign exchange reserves to cushion against crises - spurring new policy debates

International Trade: Some Key Issues (Continued)

- 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 developing countries determine how much they trade?
  - Is an outward-looking or an inward-looking trade policy best? (Or can hybrids of these be effective?)

International Trade: Some Key Issues (Continued)

- Importance of exports to different developing nations
- Exports of developing countries are generally less diversified than those of developed countries
- Merchandise exports as a share of GDP are often higher for developing countries

Structure of Merchandise Exports: Selected Countries, 2017

Country Name	Country Code	GDP,$ billions, 2017	Merchandise exports, $ billions, 2017	Merchandise exports, % of GDP, 2017	Food, % of Total, 2017	Agricultural raw materials, % of Total, 2017	Fuels, % of Total, 2017	Ores and Metals, % of Total, 2017	Manufactures, % of Total, 2017
Algeria	DZA	167.6	35.2	21%	1	0	95	0	4
Benin	BEN	9.2	2.0	21%	31	50	3	1	16
Bolivia	BOL	37.5	7.8	21%	17	0	38	40	5
Brazil	BRA	2053.6	217.8	11%	36	4	9	12	38
Burkina Faso	BFA	12.3	2.9	23%	37	36	1	17	9
Burundi	BDI	3.2	0.2	5%	80	0	0	8	12
Central African Republic	CAF	2.2	0.1	6%	1	12	0	4	65
China	CHN	12143.5	2263.3	19%	3	0	2	1	94
Cote d'Ivoire	CIV	38.1	11.9	31%	60	10	13	1	16
Ecuador	ECU	104.3	19.1	18%	50	6	37	1	6
Egypt, Arab Rep.	EGY	235.4	25.6	11%	19	2	21	4	54
Gambia, The	GMB	1.5	0.1	7%	77	1	0	0	22
Ghana	GHA	59.0	13.8	23%	40	3	43	3	11
India	IND	2652.6	299.3	11%	12	1	12	4	71
Indonesia	IDN	1015.4	168.8	17%	23	5	22	6	44
Iran, Islamic Rep.	IRN	454.0	92.8	20%	6	0	71	3	20
Japan	JPN	4860.0	698.1	14%	1	1	2	2	88
Malawi	MWI	6.3	0.9	14%	90	2	0	0	8
Malaysia	MYS	314.7	217.7	69%	11	2	15	4	68
Mauritius	MUS	13.3	2.3	18%	38	1	2	0	57
Mexico	MEX	1158.1	409.4	35%	8	0	6	3	82
Mozambique	MOZ	12.7	4.7	37%	10	1	52	31	6
Nicaragua	NIC	13.8	5.2	37%	52	1	0	1	46
Nigeria	NGA	375.7	44.5	12%	2	0	96	0	2
Peru	PER	210.7	45.3	21%	23	1	9	55	11
Philippines	PHL	313.6	68.7	22%	9	1	2	6	83
Russian Federation	RUS	1578.6	353.5	22%	6	3	59	6	22
South Africa	ZAF	348.9	88.8	25%	11	2	13	26	47
United Kingdom	GBR	2637.9	441.1	17%	7	1	8	4	77
United States	US	19485.4	1546.3	8%	10	2	11	3	62
Vietnam	VNM	223.8	214.3	96%	12	1	2	1	83

Source: World Bank World Development Indicators, Table 4.4, accessed 6 August 2019.

Demand Elasticities and Export Earning Instability

- Often low price elasticity of demand for agricultural commodities but supply shocks
- Often low price elasticity of supply for basic commodities but demand shocks
- Result can be export earnings instability; risks to income
- Also, low *income* elasticity of demand for primary products

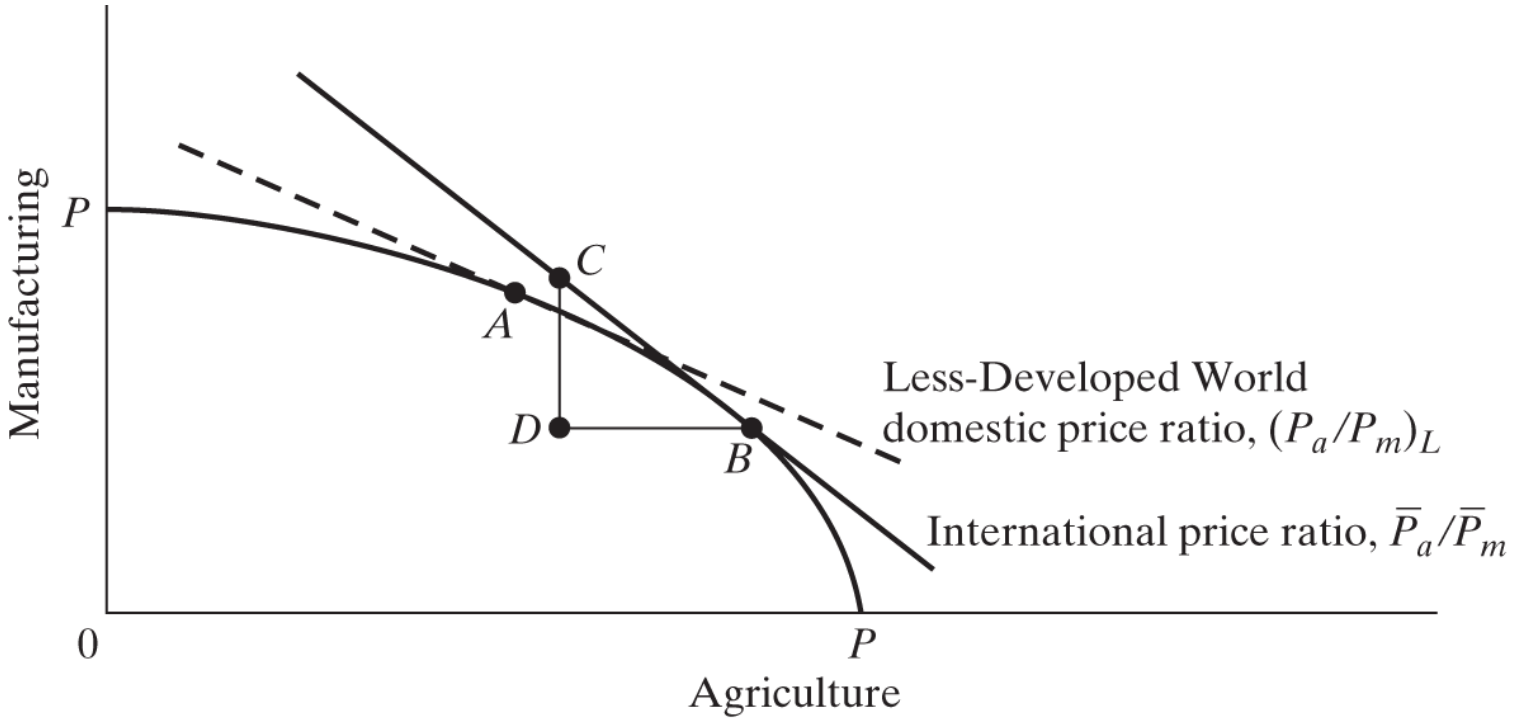
The Terms of Trade and the Prebisch-Singer Hypothesis

- Total export earnings depend upon:
  - Total volume of exports sold
  - 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

The Traditional Theory of International Trade

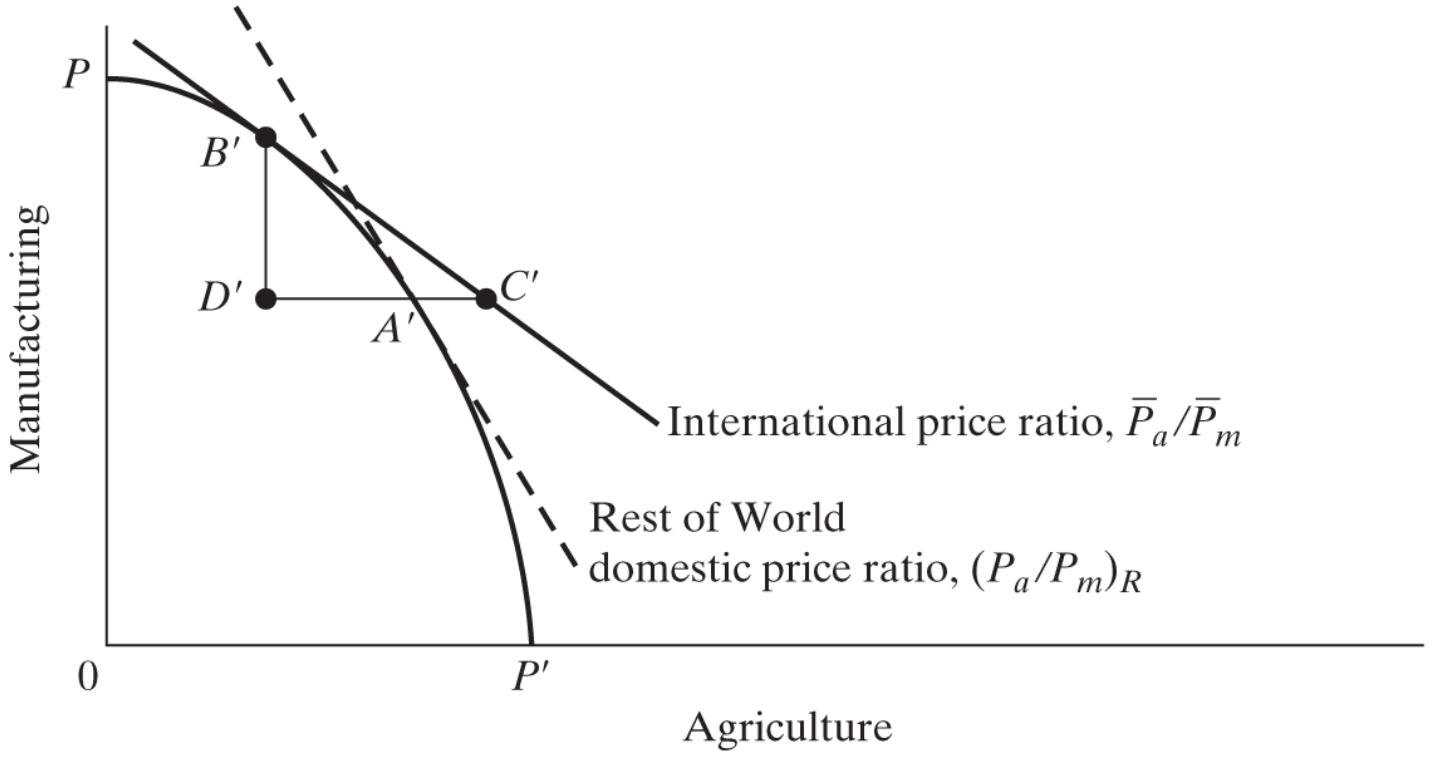
- Comparative advantage
  - Specialization
- Relative factor endowments and international specialization: the Neoclassical model
  - Ricardo and Mill (static model)
  - Heckscher and Ohlin (factor endowment theory)
    - Different products require productive factors in different ratios
    - Countries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

Trade with Variable Factor Proportions and Different Factor Endowments



(a) Less-Developed World (without trade, production and consumption occur at A; with trade, production is at B, consumption is at C; exports = BD; imports = DC)

Trade with Variable Factor Proportions and Different Factor Endowments (Continued)



(b) Rest of World (without trade, production and consumption occur at A'; with trade, production is at B', consumption is at C'; exports = $B'D'$; imports = $D'C'$)

The Traditional Theory of International Trade (Continued)

- 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

The Traditional Theory of International Trade (Continued)

- Trade theory and Development: Other 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

The Critique of Traditional Free-Trade Theory in the Context of Developing-Country Experience

- The conclusions of traditional international trade theory are derived from a number of explicit and implicit assumptions that in many ways are often contrary to the reality of contemporary international economic relations.

- This is not to deny the potential benefits of a world of free trade but rather to recognize that the real world is beset by national protectionism, international non-competitive pricing policies, and other market failures.

The Critique of Traditional Free-Trade Theory in the Context of Developing-Country Experience

- The following assumptions of the basic Neoclassical model have been scrutinized:
  - All productive resources are fixed in quantity and constant in quality across nations and are fully employed.
  - Within nations, factors of production and perfectly mobile between different production activities, and the economy as a whole is characterized by the existence of perfect competition.
  - Governmental non-interference in trade vs. active trade policies

- We can now take a critical look at each of these assumptions in the context of the contemporary position of developing countries in the international economic system.

The Critique of Traditional Free-Trade Theory in the Context of Developing-Country Experience (Continued)

- Fixed Resources, Full Employment, and the International Immobility of Capital and Skilled Labor
  - This initial assumption about the static nature of international exchange – that resources are fixed, fully utilized, and internationally immobile with product production functions everywhere identical – is central to the traditional theory of trade and finance.
  - In reality, the world economy is characterized by rapid change, and factors of production are fixed neither in quantity nor in quality

The Critique of Traditional Free-Trade Theory in the Context of Developing-Country Experience (Continued)

- It follows that relative factor endowments and comparative costs are not given but are in a state of constant change
- Moreover, they are often determined by, rather than themselves determine, the nature and character of international specialization.
- Specifically, if rich nations (the *North*) as a results of historical forces, are relatively well-endowed with the vital resources of capital, entrepreneurial ability, and skilled labor, their continued specialization in products and processes that use these resources insensitively, can create the necessary conditions and economic incentives for their further growth.

The Critique of Traditional Free-Trade Theory in the Context of Developing-Country Experience (Continued)

- By contrast, developing-world countries (the *South*), endowed with abundant supplies of unskilled labor, and for which world demand prospects and terms of trade may be very unfavorable, often find themselves locked into a stagnant situation that perpetuates their comparative advantage in unskilled, unproductive activities.
- This, in turn, inhibits the domestic growth of needed capital, entrepreneurship, and technical skills.

The Critique of Traditional Free-Trade Theory in the Context of Developing-Country Experience (Continued)

- In recent years, some economists have challenged the static neoclassical model with alternative dynamic models of trade and growth, that enphasize the process of factor accumulation and uneven development.
- These *North-South* trade models focus specifically on trade relations between rich and poor countries, whereas the traditional model was assumed to apply to all nations.
- The typical *North-South* model argues that initial higher endowment of capital in the industrialized north generate exernal economies in manufactoring output and higher profit rates.

The Critique of Traditional Free-Trade Theory in the Context of Developing-Country Experience (Continued)

- This in combination with the rise in monopoly power, stimulates higher Northen growth rates through further accumulation.
- As a result, the rapidly growing North develops a cumulative competitive advantage over the slower-growing South.
- Some economies, like four Asian Tigers (Taiwan, South Korea, Singapore and Hong Kong), have succeeded in trasforming their economies from unskilled-labor to skilled-labor to capital-intensive production.

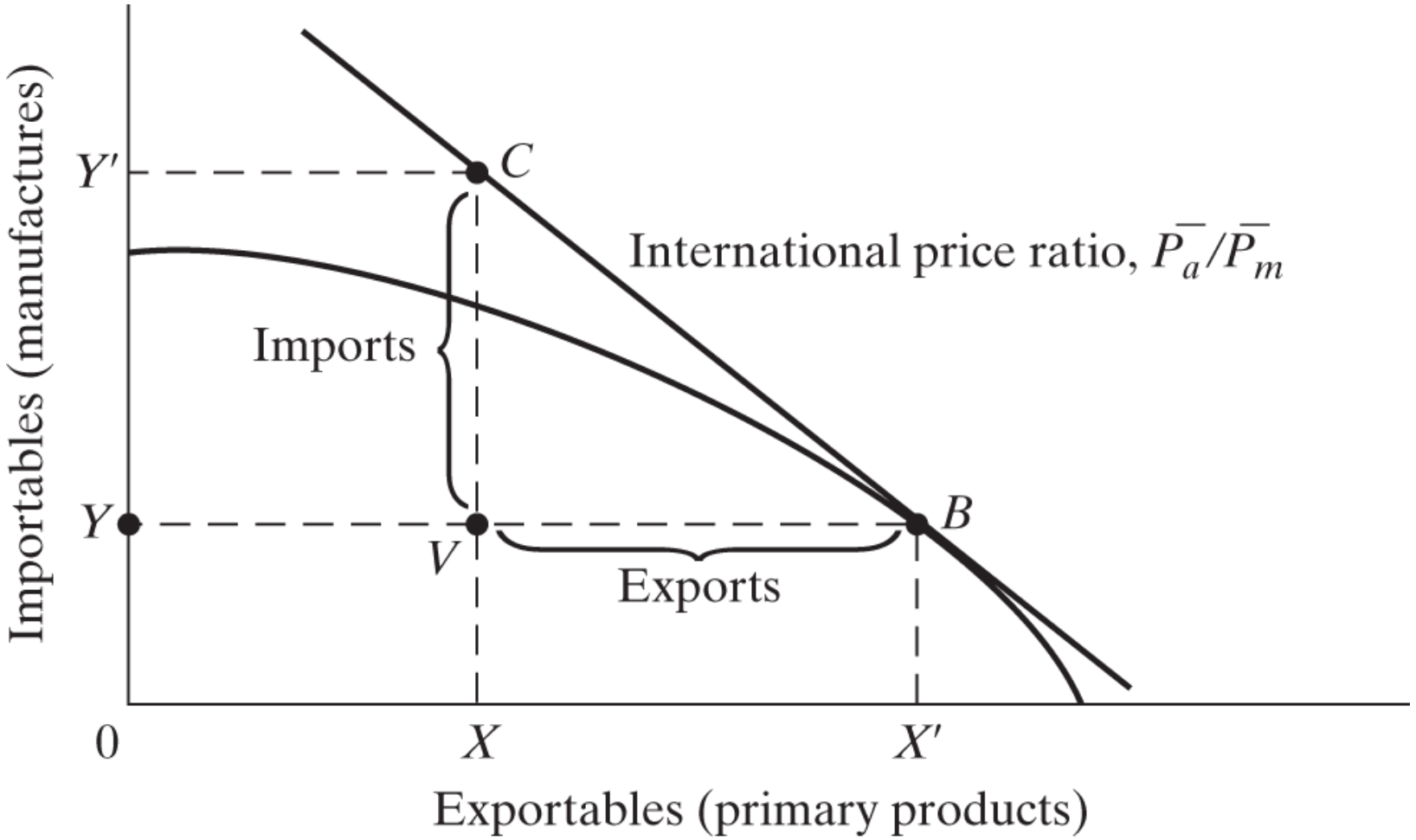
The Critique of Traditional Free-Trade Theory in the Context of Developing-Country Experience (Continued)

- Another example of model is contained in Michael Porter's *Competitive Advantage of Nations.*
- Porter departure from the standard factor endowment theory is to posit a qualitative difference between basic factors and advanced factors of production.
- He argues that standard theories apply only to basic factors of production like undeveloped physical resources and unskilled labor.
- For advanced factors (highly trained workers, government and private research institutes, universities) standard theories do not apply.
- Porter argues that "*the central task facing developing countries is to escape from the straitjacket of factor-driven national advantage…where natural resources, cheap labor and other basic factor advantages provide a fragile and often fleeting ability to export*".
- He concludes that "*creation of advanced factors is perhaps the first priority*"

The Vent-for-Surplus Theory of Trade

- The assumption of full employment in traditional trade models violates the reality of unemployment or underemployment in developing nations.
- Vent-for-surplus theory of international trade: first formulated by Smith and then expanded to consider the position of developing countries by Hla Myint.
- According to the theory, the opening of world markets to remote agrarian societies creates opportunities not to reallocate fully employed resources as in the traditional models but rather to make use of formerly underemployed land and labor resources to produce greater output for export to foreign markets.

The Vent-for-Surplus Theory of Trade



The Critique of Traditional Free-Trade Theory in the Context of Developing-Country Experience (Continued)

- International Factor Mobility, Perfect Competition, and Uncertainty
  - Traditional theories of trade assume that nations are able to adjust their economic structures to the changing dictates of world prices and markets.
  - Movements along production possibility frontiers involving the reallocation of resources from one industry to another may be easy in theory but it could be very difficult to be achieved in practice.
  - It might take many years to transform an underdeveloped economy from an almost exclusively primary product to a more diversified, multisector structure.

The Critique of Traditional Free-Trade Theory in the Context of Developing-Country Experience (Continued)

- International Factor Mobility, Perfect Competition, and Uncertainty
  - By assuming fixed or diminishing returns to scale, the factor endowment theories of trade neglect one of the most important phenomena in international economic relations.
  - Producers in rich nations are able to reach increasing return to scale (diminishing average costs of production) and product differentiation.
  - This favors the creation of monopolistic and oligopolistic market control of large corporations that are able to manipulate world prices and supplies.

The Critique of Traditional Free-Trade Theory in the Context of Developing-Country Experience (Continued)

- International Factor Mobility, Perfect Competition, and Uncertainty
  - Assumption of lack of risk and uncertainty in international trading arrangements.
  - Specialization in the production of one or two primary exports can be dangerous.
  - Theory gives ambiguous answers on the pros and cons of specialization.
  - On the one hand, traditional theory suggests that developing nations can reach higher level of income by specializing in the world economy according to the comparative advantage and that, as globalization proceeds, the opportunities and benefits of doing so increase.
  - On the other hand, as countries develop, they gain a wider range of skills and technologies and can move beyond producing only few primary goods to become competitive in a range of relatively advanced goods.
  - Imbs and Wacziarg found that sectoral concentration follows a U-shaped pattern: “Countries first diversify,…but there exists, relatively late in the development process, a point at which they start specializing again”

The Critique of Traditional Free-Trade Theory in the Context of Developing-Country Experience (Continued)

- The Absence of National Governments in Trading Relations
  - Definite role for State
  - Industrial policy is crafted by governments
  - When developed nation government pursue restrictive economic policies that are designed to deal with domestic issues such as inflation or underemployment (tariffs, quotas, export subsidies) can have profound negative effects on the economies of developing nations.
  - Developing nations' domestic economic policies usually have little impact on the economies of rich nations.
  - Despite the growing role of the World Trade Organization, there is no superagency or world government to protect and promote the interest of weaker parties in such international affairs.

The Critique of Traditional Free-Trade Theory in the Context of Developing-Country Experience (Continued)

- Some Conclusions on Trade Theory and Economic Development Strategy
  - Trade can lead to rapid economic growth under some circumstances
  - Trade seems to reinforce existing income inequalities
  - Trade can benefit developing countries if they can extract trade concessions from developed countries
  - Developing countries generally must trade
  - Regional cooperation may help developing countries

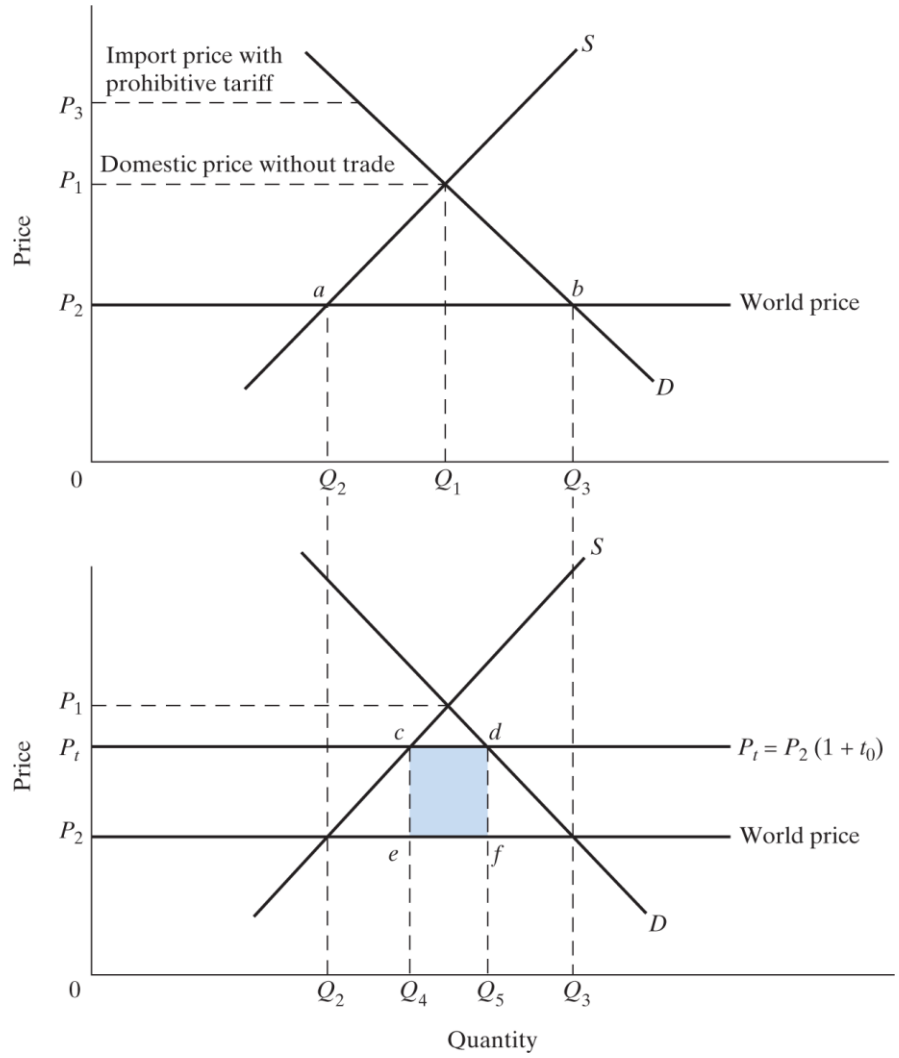
Traditional Trade Strategies and Policy Mechanisms for Development: Export Promotion versus Import Substitution

- A traditional way to approach the complex issues of appropriate trade policies for development is to set these specific policies in the context of a broader strategy of looking outward or looking inward.
- Outward-looking development policies: policies that encourage exports, often through the free movement of capital, workers, enterprises, and students, a welcome to multinational corporations and open communications.
- Inward-looking development policies: policies that stress economic self-reliance on the part of developing countries, including domestic development of technologies, the imposition to barriers to imports, and the discouragement of private foreign investment.

Traditional Trade Strategies and Policy Mechanisms for Development: Export Promotion versus Import Substitution (Continued)

- Export promotion: Governmental efforts to expand the volume of a country's exports through increasing export incentives, decreasing disincentives, and other means in order to generate more foreign exchange and improve the current account of its balance of payments (good examples: South Korea, Taiwan, Singapore, Hong Kong, China). Strong export promotion policies: devaluation of currency. Weak export promotion policies: promotion of exports by comparison with previous import substitution policies.
- Import substitution: A deliberate effort to replace consumer imports by promoting the emergence and expansion of domestic industries (tariffs and quotas).

Import Substitution and the Theory of Protection



Traditional Trade Strategies and Policy Mechanisms for Development: Export Promotion versus Import Substitution (Continued)

- The import substitution (IS) industrialization strategy and results
  - Protected industries get inefficient and costly
  - Import substitution policies often have worsened the local distribution of income by favoring the urban sector and higher-income groups while discriminating against the rural sector and lower-income groups.
  - Does not stimulate self-reliant integrated industrialization

Traditional Trade Strategies and Policy Mechanisms for Development: Export Promotion versus Import Substitution (Continued)

- By how much IS policies (tariffs, quotas) cause the domestic prices of imports to exceed what their prices would be if there were no protection.
- Two basic measures of protection:
  - Nominal rate of protection
  - Effective rate of protection

Traditional Trade Strategies and Policy Mechanisms for Development: Export Promotion versus Import Substitution (Continued)

The nominal tariff rate, t, is

$$t = \frac{p' - p}{p}$$

Where

p' is the tariff-inclusive price

p is the free trade price

Traditional Trade Strategies and Policy Mechanisms for Development: Export Promotion versus Import Substitution (Continued)

Tariff Structures and Effective Protection

The effective tariff rate, ρ, is

$$\rho = \frac{v' - v}{v}$$

Where

v' is the value added per unit of output, inclusive of the tariff

v is the value added per unit of output under free trade

Traditional Trade Strategies for Development and Policy Mechanisms: Export Promotion versus Import Substitution (Continued)

- Standard argument for tariff protection
  - Sources of revenue
  - Response to chronic BOP problems
  - Help foster industrial self-reliance (general import substitution)
  - Greater control over economic destinies
- Must be applied selectively and wisely
- Infant industry protection argument
  - Many examples of perceived failures, but some success in East Asia

South-South Trade and Economic Integration

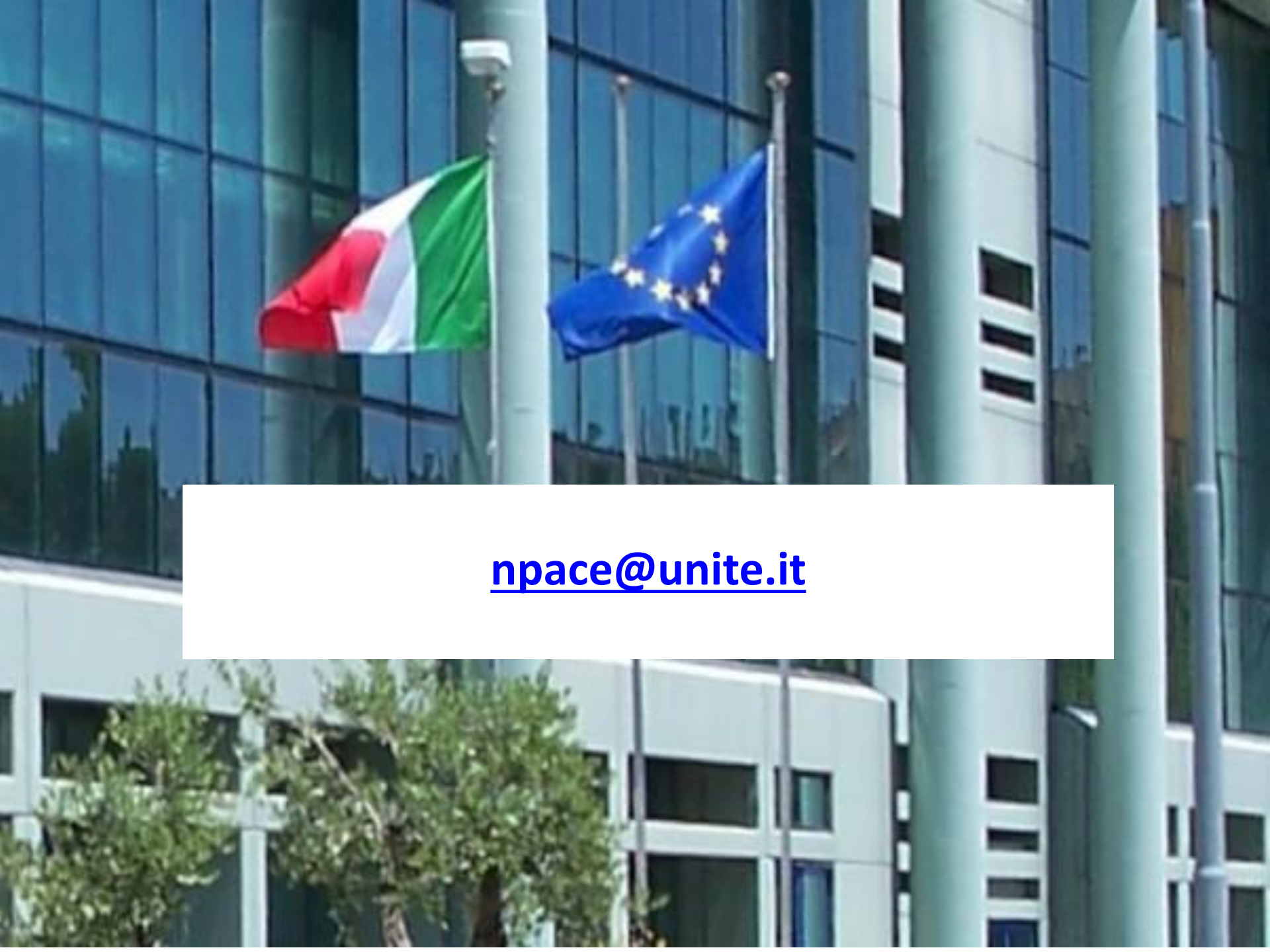
- Economic Integration: Theory and Practice
  - The growth of trade among developing countries.
  - Integration encourages rational division of labor among a group of countries and increases market size
  - Provides opportunities for a coordinated industrial strategy to exploit economies of scale
  -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

South-South Trade and Economic Integration (Continued)

- Regional trading blocs and the globalization of trade
- Examples:
  - Canada-Mexico-U.S. (formerly known as NAFTA)
  - European Union
  - MERCOSUR
  - ASEAN
- Not fully answered: What effects do blocs promote have in promoting or slowing (or modifying) globalization?
- Can blocs, including among developing countries, mitigate potential negative impacts of globalization?

Trade Policies of Developed Countries: The Need for Reform and Resistance to New Protectionist Pressures

- Rich-nation economic and commercial policies matter for developing countries
  - Tariff and *non-tariff* barriers to developing country exports
  - Adjustment assistance for displaced workers
  - General impact of economic policy
- World Trade Organization
- Despite eight liberalization rounds over 50 years, trade barriers remain in place in agriculture; and, through various mechanisms, to a degree in other sectors
- Doha Development Round begun 2001 were to change the nominal focus to needs of developing world; but talks remained stalled over the next two decades, passing self-imposed deadlines



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