Chapter 12

International Trade Theory and Development Strategy
Three “International” Chapters

- 12: International Trade
- 13: Balance of Payments
- 14: Foreign Finance, Direct Investment and Aid (and “Armed Conflict”)
12.1 Economic Globalization: An Introduction

- Globalization - Many Interpretations
- Core Economic Meaning - The Increased Openness Of Economies To International Trade, Financial Flows, And Foreign Direct Investment
- Does Globalization Benefit DCs?
  - All or Some DCs?
  - All or Some People in DCs?
- Does Globalization Benefit Rich Countries?
This Chapter

1. Traditional International Trade Theory (and a few facts)
   a) Prebisch-Singer Hypothesis
   b) Immiserizing Growth

2. Critiques of Traditional Theory in the Developing Country (DC) Context

3. Export Promotion vs. Import Substitution
12.3 The Traditional Theory of International Trade

- Comparative Advantage
  - Specialize Production in Low Opportunity Cost Activities
  - Trade for Diverse Consumption
Relative Factor Endowments And Specialization: Heckscher - Ohlin

- Different Products Use Productive Factors In Different Ratios
  - Manufactures Vs. Agricultural Products
- Countries Have Different Endowments Of Factors Of Production
  - DCs Relatively Well Endowed With Land And Other Resources, And Less Well Endowed With Capital
- Trade => DCs Specialize In Agricultural And Primary Products
Relative Factor Endowments And Specialization: Heckscher - Ohlin

• Different Products Use Productive Factors In Different Ratios
  – “High Tech Vs. Low Tech”
  – Jets vs. Textiles
  – Engineering vs. Assembly

• Countries Have Different Endowments Of Factors Of Production
  – DCs Relatively Well Endowed With Low Skill Labor, And Less Well Endowed With High Skill Labor

• Trade => DCs Specialize In Low Tech
Figure 12.1 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 = \(DC\))
12.2 International Trade: Some Key Issues

- Many developing countries rely heavily on exports of primary products
- Many developing countries rely heavily on imports of machinery, capital goods, intermediate producer goods, and consumer products
Table 12.1 Merchandise Exports in Perspective: Selected Countries, 2008

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Sources: Derived from World Bank, World Development Indicators, 2010, tabs. 4.2 and 4.4.
Demand Elasticities and Export Earning Instability

- Often low market price elasticity of demand for agricultural commodities
  - Supply Shocks $\Rightarrow$ Price Instability
- Result can be export earnings instability; risks to income
Immiserizing Growth

- Definition: Growth that makes a country worse off
- How: By lowering the (world!) price of an export good or service
BRAZIL DESTROYS ITS COFFEE TO KEEP THE PRICE UP

July 18. Brazil advertised in the New York Times that it was destroying 30% of its 1931-32 crop, despite a national 40% yield. It also disclosed that it was destroying 90% of its 1932-33 crop, despite a national 90% yield. Brazil is the world’s largest coffee exporter. The total world demand for coffee is estimated to be 20,000,000 bags, of which Brazil alone supplies over 50%. Brazil is the only country where coffee is grown as a cash crop. Coffee is grown in several other countries, but Brazil leads in production. Brazil has a monopoly on coffee production and is able to control the market. The demand for coffee is high, and Brazil is able to dictate the price. The government of Brazil is very protective of the coffee industry and will not allow any foreign coffee to enter the country. This has led to a very high price for coffee, which is reflected in the high prices paid by coffee growers. The coffee industry is very important to Brazil, and the government is very protective of it. The government has taken many steps to protect the coffee industry, including destroying part of the crop to keep the price up. This has led to a very high price for coffee, which is reflected in the high prices paid by coffee growers.

COPPER BEANS ARE SHOVELLED INTO THE ATLANTIC OCEAN BY HOIST AND ARE THEN THROWN OVER IDEAS IN THE HOLD

The copper beans are then shipped to the United States and sold for a high price. This is a very profitable industry for Brazil, and the government is very protective of it. The government has taken many steps to protect the coffee industry, including destroying part of the crop to keep the price up. This has led to a very high price for coffee, which is reflected in the high prices paid by coffee growers. The coffee industry is very important to Brazil, and the government is very protective of it. The government has taken many steps to protect the coffee industry, including destroying part of the crop to keep the price up. This has led to a very high price for coffee, which is reflected in the high prices paid by coffee growers.
On July 18, Brazil advertised in the New York Times that it was destroying 50% of its 1937–38 crop, storing another 40% and selling the remaining 10%. Purpose: to keep the price up to $1.50 per lb. Of the world’s five billion coffee trees, more than half are in Brazil, producing in the last six years an average of 30,500,000 180-lb. bags. But the total demand is only 25,000,000 bags. Apparent solution would be to destroy coffee trees and reduce production. But in Brazil as in the U. S., farmers flinch with horror from destroying trees. Hence Brazil does the next best thing and destroys coffee beans, has destroyed so far 48,350,000 bags of the cheaper grades. The Government buys the doomed quota with money derived from taxing the quota exported. On this page is shown coffee being dumped into the Atlantic Ocean and on the next, being made into bricks for use as fuel in factories and locomotives. Neither way is as effective as mixing the beans with tar and burning them. Today the great Brazilian coffee city of São Paulo lies under a continual pall of coffee smoke with a heavy, acrid stench.

On July 9, Brazil invited foreign chemical companies to begin experimenting to make something besides coffee out of coffee. Possibilities: fertilizer, caffeine, acids, adhesive, cardboard and rayon.
Necessary Conditions

- Growth biased toward exports
- Nation’s exports are a large portion of world supply
- World demand is price inelastic
  \[ Q↑ \Rightarrow P↓ \text{ a lot!} \]
- Trade is important for the country
Conversely, Raise Price by Reducing Supply?

- US Exports Wheat (20-30% of World Exports)
- Price Elasticity of Demand
  - Short Run: -0.25 (%ΔP = -4*% ΔQ)
  - Long Run: -1.00 (%ΔP = -1*% ΔQ)
- But US Production as Share of World Production (2002-2004 average): 10%
Immiserizing Growth

• Logical Possibility
• Practical Examples are Hard to Find
• (Except in certain bathrooms ...)
Demand Elasticities and Export Earning Instability

• Also, Low Long Run *Income* Elasticity Of Demand For Primary Products cuz:
  – Services (education, health) grow as shares of expenditures as income rises
  – Development of synthetic substitutes
The Terms of Trade and the Prebisch-Singer Hypothesis Box 12.1

• Commodity prices fall over time, so developing countries lose revenue unless they can continually increase volumes

• “the relative price of ... coffee has been declining 0.77% per year for approximately 300 years.”

• => Developing Countries Need To Avoid Dependence On Primary Exports

• Some evidence that relative prices within manufactures are also diverging with falling prices for low-skill products
12.3 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
• Trade will stimulate economic growth
Why Haven’t All Countries Adopted Free Trade and thereby Prospered?

1. Text: For various reasons, the Traditional Theory doesn’t apply, so one would not expect trade to enhance incomes, etc.
12.4 The Critique of Traditional Free-Trade Theory in the Context of Developing-Country Experience (cont’d)

• Fixed, Freely Available Technology and Consumer Sovereignty
  – Challenged by the Product Cycle theory
  – Development of synthetic substitutes for developing country exports
12.4 The Critique of Traditional Free-Trade Theory in the Context of Developing-Country Experience (cont’d)

• International Factor Mobility, Perfect Competition, and Uncertainty: Increasing Returns, Imperfect Competition, and Issues in Specialization
  – Structural realities in developing countries
  – Increasing returns and exercise of monopolistic control over world markets
  – Risk and uncertainty inherent in international trading arrangements
12.4 The Critique of Traditional Free-Trade Theory in the Context of Developing-Country Experience (cont’d)

- The Absence of National Governments in Trading Relations
  - Definite role for State
  - Industrial policy is crafted by governments
  - Commercial policies instruments (tariffs, quotas) are state constructs
12.4 The Critique of Traditional Free-Trade Theory in the Context of Developing-Country Experience (cont’d)

• Balanced Trade and International Price Adjustments
  – Unrealistic (example: impact of oil price hikes of the 1970s)
12.4 The Critique of Traditional Free-Trade Theory in the Context of Developing-Country Experience (cont’d)

- Trade Gains Don’t Accrue To Locals
  - Enclave economies are promoted by trade
  - Difference between GDP and GNI becomes important
  - Doug: So how big are the differences between GDP and GNI?
  - GNI = GDP + Income Earned Abroad by Residents + Aid – Income Earned Domestically but Paid Abroad (e.g. Domestic Profits of Multinationals sent “Home”)
Why Haven’t All Countries Adopted Free Trade and thereby Prospered?

1. Text: For various reasons, the Traditional Theory doesn’t apply, so one would not expect trade to enhance incomes, etc.

2. Doug: After WWII, many developing countries tried Import Substitution
Figure 12.3
Import Substitution and the Theory of Protection
Exchange Rate Policy

- Exchange Rate “Fixed” Above Market Value
  - => Imports Cheaper to DC
  - => DC Exports More Expensive to Others

- => Value of Imports > Value of Exports: Chronic “Balance of Payments Problems” (next chapter)

- => Firms Import (Artificially) Cheap Machinery rather than use (Actually) Cheap Domestic Labor (Excessive K/L)
Import Substitution: Theory

• Standard Argument for Import Tariff
  – Source of revenue
  – Response to chronic BOP problems
  – Help foster industrial self-reliance (general IS)
  – 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
Import Substitution: Results

- Protected Industries Are Inefficient, Costly and Fail to Innovate
- Foreign Firms Locate Behind Tariff Walls
- Subsidization Of Imports Of Capital Goods Tilts Pattern Of Industrialization And Contributes To Balance Of Payments (BOP) Problems
- Overvalued Exchange Rates Hurt Exports
- *Does Not Stimulate Self-reliant Integrated Industrialization*
12.5 Export Promotion

- Expanding Exports Of *Manufactured* Goods
- Greater Successes, Particularly China, Taiwan, Korea, Singapore
- Unevenly Distributed Across The Developing World
Summarizing the Traditional Debate: Trade Pessimists

- Limited growth of world demand for primary exports
- Secular deterioration in terms of trade
- Specializing in comparative advantage inhibits industrialization, skills accumulation, and entrepreneurship
- Rise of “new protectionism”; WTO benefits limited in practice
Summarizing the Traditional Debate: Trade Optimists

- Promotes competition, efficiency, quality
- Accelerates overall growth
- Attracts foreign capital and expertise
- Generates foreign exchange
- Eliminates distortions caused by government interventions including corruption and rent-seeking activities
- Enables DCs to take full advantage of reforms under the WTO
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12.6 Export-Oriented *Industrialization Strategy*

- Market failures in transfer of innovations
- Coordination failures may hinder industrialization
- There may be learning by doing (or “watching”) effects in manufacturing sectors
- Performance is rigorously tested when firms attempt to export
- Export targets more visible; focus on manageable problems
- Thus, export oriented industrial policy may help overcome market failures in the process of technological progress
12.6 The Industrialization Strategy Approach to Export Policy

- Government interventions to encourage exports (Industrial Policy)
- Problem: without proper attention to incentives, industrial policies may be counterproductive
- Problem: level of competence and political authority of governments to carry out policies effectively
- Policy approaches are addressed in case studies of Taiwan (Chapter 12) and South Korea (Chapter 13)
Trade Policies of Developed Countries

• Rich-nation economic and commercial policies matter for developing countries
  – Tariff and *non-tariff* barriers to developing country exports
  – General impact of economic policy

• World Trade Organization

• Trade barriers have declined over last 50 years, but remain in place in agriculture; also subsidies
Additional Reading

• “Two Cheers for Sweatshops” Kristoff and WuDunn from NY Times

• “The Travels of a T-Shirt in a Global Economy” Chapters 6 & 7, Pietra Rivoli