

Part Three
Problems and Policies: International and Macro

Chapter 12

International Trade Theory and Development Strategy

■ Key Concepts

This chapter focuses on alternative theories of international trade and trade policy in order to answer the following questions:

- How does trade affect economic growth and income distribution?
- Does trade promote the achievement of development objectives?
- Should less developed countries pursue outward or inward oriented trade policies, or some combination of the two?

It is emphasized that the answers will not be the same for all countries given the great diversity that exists among developing countries; no unique solution can be recommended as regards the role of international trade in promoting economic development.

Section 12.1 serves as an introduction, with section 12.2 following with the central importance of international trade in economic development is explained in detail with both theoretical arguments and statistical evidence. The weak export performance of many developing countries is explained by low income and price elasticities of demand for their products, and declining terms of trade (the Prebisch-Singer Thesis described in Box 12.1).

In section 12.3, the traditional neoclassical model of international trade is reviewed, including:

- Complete specialization based on the theory of comparative advantage.
- The factor endowment theory that emphasizes production of those goods that intensively use a country's abundant factor. Graphical analysis and detailed conclusions are presented.
- The traditional arguments for the impact of trade upon development are summarized.

Criticisms of traditional free trade theory are presented in section 12.4 by scrutinizing some of the assumptions the theory makes that are typically violated in less developed countries. The text analyzes the implications of such violations.

- North-South Models of Unequal Trade: These models suggest that trade tends to reinforce the unequal distribution of resource endowments between countries, particularly with respect to skilled and unskilled labor. For many developing countries trade is unlikely to stimulate a shift to more capital-intensive forms of production, and the associated benefits.
- The Vent-for-Surplus theory of trade: This provides a good description of the actual experience of many less developed countries.
- The impact of the international movement of capital and skilled labor is mentioned.
- The existence of monopoly and oligopoly power, product differentiation, increasing returns, and the existence of risk and uncertainty are also discussed.

The impact of international trade is examined in terms of the effects on growth, income distribution, poverty, and employment. To summarize, trade can be an important stimulus to rapid economic growth by promoting greater utilization of idle human and capital resources, increasing foreign exchange earnings, and expanding access to technological knowledge. At the same time, for a majority of developing countries, the principal benefits of world trade have accrued disproportionately to foreign residents and wealthy nationals (as well as to the developed countries).

Clearly, some developing countries such as Taiwan, South Korea and other Asian economies have benefited from trade. The issue is not whether to trade but which export products to try to promote. Whether expanding trade is economically beneficial depends on the nature of the export sector and its medium to long term potential (for example, terms of trade), the distribution of benefits, its linkages with the rest of the economy, and the country's ability to respond smoothly to changing international price signals. In general balanced success will require access to developed countries' markets for labor-intensive manufactures, extensive linkages between the export sector and other sectors of the economy, and the ability to influence activities of foreign enterprises to the benefit of the local economy.

In section 12.5 two broad trade and development policy strategies are defined: outward-looking and inward-looking development policies. Outward-looking policies encourage free trade and the free movement of the factors of production, while inward-oriented policies encourage production for the domestic market and restricted trade and movement of factors of production.

The major topics addressed include:

- Encouraging the export of primary products.
- Encouraging industrialization via the import substitution strategy.
- Encouraging industrialization via the export promotion strategy.
- The trade optimist/pessimist debate.
- Encouraging South-South trade and economic integration.

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The pros and cons of emphasizing primary product exports as a growth strategy are discussed. Five important factors tend to work against the success of this strategy: low income and price elasticity of demand for primary products, slow population growth in developed countries, the development of synthetic substitutes, and agricultural protection in developed countries. Supply side factors emphasize rigidities in the structure of production and low productivity (covered in Chapter 9).

The export of manufactured goods as a growth strategy is mentioned, particularly with respect to the spectacular performance of the four Asian Tigers. The text cites rising protectionism by the developed countries as a barrier against the success of this strategy. The text also points to the need for more South-South trade.

The import substitution strategy involves identifying consumer goods with large domestic market and simple technology to produce that are currently being imported, and replacing the imports with domestic production. A second stage would involve expanding domestic production to more sophisticated manufactured items, including those with linkages to the consumer goods sectors established in the first stage. Key points mentioned include:

- A built in demand for the product already exists.
- The infant industry argument.
- The use of tariffs and quotas.
- The effective rate of protection.

- The appropriate exchange rate policy.
- Reasons for the failure of the strategy.

A section on foreign exchange rates reviews the concept of a foreign exchange market and discusses the options available for maintaining an official exchange rate. Overvalued exchange rates, dual exchange rate systems, and currency devaluation are discussed.

The trade optimist and trade pessimist arguments are listed. This is a good summary of the major issues relating to inward versus outward oriented trade strategies. Trade pessimists focus on the limited growth of world demand for primary exports, the deterioration in the terms of trade for many developing countries specializing in the production of primary products for export, and the rise of protectionism within the developed countries. The trade optimists focus on economic efficiency: the promotion of competition, getting prices right, improving resource allocation, and achieving economies of scale.

Section 12.6 on “The Industrialization Strategy Approach to Export Policy,” argues that, during the last two decades, several countries have pursued a strategy that emphasizes following an industrialization path through expanding presence in global markets. This strategy is broadly sympathetic to the arguments of trade optimists but also places heavy emphasis on government efforts to promote industrial export growth rather than leaving industrialization entirely to the market mechanism. This section discusses the experience of several countries, especially the South East Asian economies, with this strategy.

Section 12.7, on South-South trade outlines arguments why developing countries should move in the direction of economic integration. Economic integration among developing countries at relatively equal stages of development with similar market sizes and an interest in coordinating their efforts stand to gain the most. Mercosur, the Andean Bloc, and the Southern African Development Community are mentioned.

The final section of the chapter, 12.8, discusses how developed countries can reform their trade policies to promote the expansion of world trade by lowering tariff barriers, lowering export subsidies such as those used by Japan, expanding domestic adjustment assistance, and considering macroeconomic policies in the context of the developed as well as the developing world’s needs.

A chapter concludes with a case study on Taiwan.

■ Discussion Topics

Discussion topics may be of more interest after the next chapter is covered.

- Does trade reinforce existing inequalities? This fits in nicely with the North-South model. Discuss supply and demand basics and vicious circles.
- Creating a demand for wage goods, and increasing value-added are two important goals for growth. How does trade impact either of these goals?
- Can all countries pursue export led growth and be successful? What are the limitations if any?
- Can import substitution and export promotion of manufactured goods be pursued at the same time? What are the difficulties in terms of selecting appropriate policies?
- Compare and contrast a successful strategy of import substitution (Korea, Taiwan) with a disastrous one (e.g. Argentina).

■ Sample Questions

Short Answer

1. What are the terms of trade? What factors lead them to change over time?

Answer: The ratio of the price of a country's exports to that of its imports both in index form. Changes in the pattern of relative demand as income or tastes change in various parts of the world, and changes in supply, such as those brought about by technological progress. Discussed in detail in the chapter.

2. Briefly explain the major argument of the factor endowment trade theory.

Answer: Countries will tend to specialize in the production of commodities making intensive use of their relatively abundant factors of production; for example, unskilled labor, or natural resources.

3. You are a lobbyist hired by a less developed country to try to prevent a developed country from increasing trade barriers against labor-intensive manufactured imports such as textiles. Make your case, arguing from both developed and developing country perspectives, in terms of who gains and who loses.

Answer: Requires synthesis of the neoclassical theory of international trade as applied to developed countries and benefits of outward looking trade policies from the developing country point of view. Students should note benefits to developed country consumers and developing country incomes.

4. Explain why a country's gains from trade may not accrue to nationals. Indicate the differential effects on GNP and GDP.

Answer: Discussed in the chapter; students should note that some of the value of output is repatriated by multinational corporations.

5. Provide a concise statement about the relationship between a developing country's emphasis on the export of traditional commodities and: (a) export earnings stability; (b) comparative advantage; (c) terms of trade.

Answer: (a) Traditional commodities may tend to experience greater price fluctuations; (b) less developed countries tend to have a comparative advantage in traditional commodities; (c) terms of trade for traditional commodities may tend to fall over time according to the Prebisch-Singer thesis.

6. Evaluate critically the following statement: In light of the experience of the last two decades, free trade is the best trade policy for most developing countries.

Answer: Discussed at length in the chapter.

7. When and under what circumstances is intervention in international trade justified on market correction grounds? What preconditions would have to be met from the government side for there to be a reasonable likelihood of success?

Answer: This will depend on what you cover in lecture.

8. In the North-South model, how are "basic factors" distinguished from "advanced factors," and what are the implications for growth and development possibilities?

Apple iPhones

Answer: Basic factors include relatively unskilled labor, physical resources, location, and general infrastructure. Advanced factors include education and firm specific human capital, knowledge resources including universities, research facilities, and specialized infrastructure. Trade based on a comparative advantage in primary products may result in limited growth possibilities for a country.

9. Briefly, what are the major causes of export earnings instability for developing countries?

Answer: Low price and income elasticities of demand leading to erratic movements in export prices.

10. What are the key ingredients of Taiwan's successful entry into world markets? What lessons can other developing countries draw from Taiwan's experience with global markets?

Answer: The new case study discusses some of the key factors of Taiwan's success in global markets. The case study focuses mostly on economic variables but social variables (such as the work ethic, somewhat relegated under "other factors" in the case study) should be mentioned in lectures.

11. Explain briefly the vent-for-surplus theory of international trade What is the relevance of this theory to the current development experience of low-income economies?

Answer: Discussed in the text.

12. A country simultaneously raises tariffs on manufactured goods and overvalues the exchange rate. Why might these seemingly contradictory policies be pursued together?

Answer: Students should show they understand why a general import substitution strategy could include making some imports cheaper while effectively prohibiting others. You may wish to combine this question with the following question.

13. What are the drawbacks of overvaluing the exchange rate as an import substitution policy?

Answer: Discourages exports and leads to trade deficit or to use of exchange controls.

14. After a policy of import substitution has begun, a developing country finds that employment has not risen significantly and that urban unemployment seems to be rising. Explain how these developments might be connected.

Answer: Modern sector enrichment with wage increases/migration/capital intensive industries.

15. Many developing countries have a static comparative advantage in the production of one or two primary products. In what ways might specialization in these products contribute to growth and development? In what ways might this fail to contribute?

Answer: Calls for a discussion of short and long run effects as in the text.

16. Taiwan and Jamaica are both islands that have pursued export-oriented development strategies, but Jamaica has experienced increases in unemployment and poverty, while Taiwan has experienced decreases. How might you explain this?

Answer: The type of exports, commodity or manufactured, may matter. You may wish to use other countries as illustrations, depending on the examples you use in lecture.

2008 Great Recession
1997 East Asian Crisis

17. Discuss some of the factors that lead infant manufactured goods industries to become more efficient over time, and some of the factors that might lead them to fail to do so.

Answer: Industries with significant learning by doing; firms threatened by a specific deadline for tariff reductions. *cars*

18. (a) Under what circumstances is the effective rate of protection of a tariff greater than the nominal rate? (b) Why is this a concern for developing countries?

Answer: (a) When tariffs on final goods exceed those on intermediate and capital good inputs. *auto market*
(b) The magnitude of protection may be greater than intended, which comes with opportunity costs. *backups*

19. State three country characteristics that encourage and three that discourage economic integration among developing countries.

Answer: Among those encouraging: similar economic systems, locations, development levels, and goals. Discouraging: nationalism, desire for high tech prestige projects regardless of efficiency, similar resources, and similar comparative advantage.

20. Explain the dynamic rationale for economic integration among developing countries.

Answer: Similar to the infant industry argument—see the chapter.

21. State and explain three [or some other number chosen by the instructor] reasons why the scope for further expansion of developing country commodity exports is likely to be limited.

Answer: (a) development of further synthetic substitutes, (b) continued agricultural protection in developed countries, (c) the developing country's desire for agricultural self-sufficiency, (d) low income elasticities for these products. (e) instability of export earnings.

22. Suppose that a good that was formerly an import becomes an export, perhaps after an import substitution and export promotion strategy. How is this change reflected in the production possibility frontier?

Answer: The good that was on the import axis, now is found on the export axis. Leaving the goods on the same axes as before, with the import on the y-axis, the ppf becomes more bowed out toward and further up this axis.

23. Explain the difference between nominal and effective tariffs.

Answer: Spelled out in the text.

24. What is the difference between a devaluation and a depreciation?

Answer: A currency is devaluated when the rate at which the central bank will exchange the local currency for foreign convertible currency, such as dollars, is abruptly increased. A depreciation is the gradual decrease in the purchasing power of a domestic currency in foreign markets relative to domestic markets.

25. Explain how international trade and trade policy helped Taiwan transform itself from an underdeveloped country to a high income country in a relatively short span of time. You might begin by discussing Taiwan's trade strategy. Why do you think international trade is of such vital importance to Taiwan?

Answer: Discussed in the case study.

26. Economists frequently urge governments of developing countries to replace import quotas with import tariffs as a first step in a strategy that aims to reduce import protection. What is the reasoning offered by economists to support this recommendation to developing countries?

Answer: Quotas yield rents that result in domestic groups wasting real resources fighting over these rents and at the same time quotas generate no public revenues.

27. What is an overvalued exchange rate? What factors may cause a country's currency to become overvalued?

Answer: The value of the domestic currency is greater than its value at the equilibrium point in the foreign exchange market. One likely reason why currencies become overvalued is the insistence of the central bank in maintaining fixed exchange rates in the face of substantial domestic inflation.

28. How did active government industrialization strategy and industrial policies, including the collaboration between private and public sectors contribute to the East Asian development success?

Answer: Page 615 in the textbook. The policies included encouraging indigenous skills, technologies, and firms. Upgrading technologies over time from labor intensive to relatively more capital intensive. The government also played a coordinating role with good communication with the private sector.

■ Multiple Choice

1. The ratio of a country's average export price to its average import price is
- (a) its absolute advantage.
 - (b) its comparative advantage.
 - (c) its terms of trade.
 - (d) its exchange rate.

Answer: C

2. According to the Prebisch-Singer thesis
- (a) demand for primary products has steadily fallen.
 - (b) profits of primary producers have steadily fallen.
 - (c) primary producers' terms of trade have steadily fallen.
 - (d) prices of primary products have risen over time.

Answer: C

3. The purpose of commodity buffer stocks is
- (a) to moderate price fluctuations.
 - (b) to raise commodity prices.
 - (c) to encourage commodity substitution.
 - (d) to guarantee national security.

Answer: A

4. Developing countries might be unable to respond smoothly to changing international price signals because of
- (a) a lack of government regulation.
 - (b) an abundance of skilled labor.
 - (c) inelastic supply curves.
 - (d) limited foreign exchange.

Answer: C

5. Autarchy as used in the text refers to
- (a) an economy that does not trade.
 - (b) an economy that trades primary products in exchange for manufactures.
 - (c) developing country dictatorships.
 - (d) the caste system and related social structures.

Answer: A

6. Which of the following is an argument in favor of the liberalization?
- (a) Increased technical efficiency.
 - (b) Accelerated technical progress.
 - (c) Decreased shortages of foreign exchange.
 - (d) All of the above.
 - (e) both (a) and (b) are correct.

Answer: D

7. Which of the following is an argument in favor of trade liberalization?
- (a) Increased investment.
 - (b) Infant industry.
 - (c) Fluctuating export earnings.
 - (d) Increased government revenue.

Answer: A

8. Which of the following is an argument in favor of interventionist trade policies?
- (a) Cheaper capital goods.
 - (b) Declining terms of trade.
 - (c) Decreased losses from rent-seeking activities.
 - (d) All of the above.
 - (e) None of the above.

Answer: B

9. Guiding the market through strategic coordination of business investments to increase export market shares is known as
- (a) development planning.
 - (b) industrial policy.
 - (c) shifting terms of trade.
 - (d) all of the above.
 - (e) none of the above.

Answer: B

10. The opening of export markets for primary products can provide employment for previously underutilized land and labor. The term for this is
- (a) vent for surplus.
 - (b) comparative advantage.
 - (c) Prebisch-Singer thesis.
 - (d) barter trade.

Answer: A

11. Which of the following statements is true?
- (a) larger countries (in terms of size) tend to be more open (in terms of larger share of exports in GDP) than smaller countries and developing countries tend to be less open than developed economies.
 - (b) larger countries (in terms of size) tend to be less open (in terms of lower share of exports in GDP) than smaller countries and developing countries tend to be less open than developed economies.
 - (c) larger countries (in terms of size) tend to be more open (in terms of larger share of exports in GDP) than smaller countries and developing countries tend to be more open than developed economies.
 - (d) larger countries (in terms of size) tend to be less open (in terms of lower share of exports in GDP) than smaller countries and developing countries tend to be more open than developed economies.

Answer: D

12. The dependence on the export of one or two primary products for a majority of the revenue from exports is most severe in countries in
- (a) South Asia.
 - (b) East Asia.
 - (c) Sub Saharan Africa.
 - (d) Latin America.

Answer: C

13. The real price trendline for non fuel primary commodities from 1960-2005 has been
- (a) Unchanged
 - (b) Steadily increasing
 - (c) Steadily decreasing
 - (d) First decreased and then increased.

Answer: C

14. The nominal rate of protection shows the extent to which the domestic price of imported goods exceeds
- (a) what the price would be without tariffs.
 - (b) the cost of intermediate inputs.
 - (c) the social opportunity costs of the good.
 - (d) the no-trade equilibrium price.

Answer: A

15. The effective rate of protection is
- (a) value added with protection divided by value added without protection.
 - (b) value added with protection.
 - (c) value added without protection.
 - (d) (value added with protection minus value added without protection) divided by value added without protection.

Answer: D

16. The average level of effective protection has exceeded 300% for which of the following countries?
- (a) Pakistan and Uruguay.
 - (b) Argentina and Brazil.
 - (c) Philippines and Mexico.
 - (d) India and China.

Answer: A

17. An economic community
- (a) attempts to raise prices by restricting quantity.
 - (b) seeks to stabilize commodity prices.
 - (c) seeks concessional loans.
 - (d) imposes a common external tariff.
 - (e) none of the above.

Answer: D

18. The long-run social benefits of infant industry protection are more likely to be realized if
- (a) investors believe that tariff barriers are permanent.
 - (b) investors believe that tariff barriers are transitory.
 - (c) tariff barriers increase over time.
 - (d) tariff barriers are replaced with quotas over time.

Answer: B

19. Which of the following factors makes the success of economic integration more likely?
- (a) Nationalism.
 - (b) Desire for prestige projects.
 - (c) Diverse economic systems.
 - (d) All of the above.
 - (e) None of the above.

Answer: E

20. Why is it impossible that all industries in a developing country qualify as infant industries?
- (a) You cannot have a comparative advantage in everything.
 - (b) You cannot have an absolute advantage in everything.
 - (c) This would violate international law.
 - (d) This would reduce the terms of trade.

Answer: A

21. Which of the following is not a reason why the prospects for the further expansion of developing country commodity exports are likely to be limited?
- (a) Low income elasticities for these products.
 - (b) Low likelihood of development of further synthetic substitutes.
 - (c) Continued agricultural protection despite trade agreements.
 - (d) Declining terms of trade.

Answer: B

22. Which of the following is a major argument of trade pessimists?
- (a) Increased productivity of developed country agriculture.
 - (b) Increased efficiency in industrial use of raw materials.
 - (c) Protectionism against labor-intensive manufactures.
 - (d) All of the above.

Answer: D

23. Which of the following is a major argument of trade optimists?
- (a) Industrial policy can increase productivity of developing country manufacturing efficiency.
 - (b) New synthetic substitutes are constantly being discovered and improved.
 - (c) Developing country efficiency would improve with trade liberalization.
 - (d) All of the above.

Answer: C

24. Which of the following countries provides the best example of a successful import substitution development strategy?
- (a) Chile.
 - (b) Taiwan.
 - (c) Argentina.
 - (d) Botswana.

Answer: B

25. Which of the following is a nontariff barrier policy tool?

- (a) Sanitary regulations.
- (b) Average duties.
- (c) Phased liberalization.
- (d) Ad valorem tax.

Answer: A

26. Nontariff barriers

- (a) decrease foreign exchange earnings.
- (b) reduce the quantity of goods exported.
- (c) lower the effective price received for exports.
- (d) all of the above.

Answer: D

27. The most important role of the World Trade Organization is

- (a) to promote market oriented economic policies.
- (b) to settle trade disputes.
- (c) to provide development assistance.
- (d) to help countries choose the appropriate level of a tariff or quota.

Answer: B

28. If the equilibrium exchange rate is 15 pesos per dollar and the central bank fixes the exchange rate at 17 pesos per dollar then we can conclude that the peso is

- (a) appreciated.
- (b) depreciated.
- (c) overvalued.
- (d) undervalued.

Answer: D

29. In most less developed countries, the initial target of import substitution is to promote domestic production of

- (a) consumer goods.
- (b) food and other agricultural goods.
- (c) capital goods.
- (d) manufactured intermediate goods.

Answer: A

30. Which of the following is not an argument in favor of export promotion over import substitution?

- (a) international competition compels domestic producers to become more efficient.
- (b) exposure to world markets provides greater opportunities to learn new technologies.
- (c) producing for export permits greater specialization and economies of scale.
- (d) outward-looking development promotes larger firms.

Answer: D