UNIVERSITY OF ESSEX

DEPARTMENTS OF ECONOMICS

EC336

ECONOMIC DEVELOPMENT IN A GLOBAL PERSPECTIVE

SPRING TERM

2011/2012

BEATRIZ VARGAS

1106912

VARGA59906

Number of Words: 2676

Date Submitted: due to 4th May 2012

TERM PAPER

Recent decades have witnessed an acceleration of economic globalisation, in particular international trade. Is trade openness the key strategy to achieve economic development? What lessons could you draw for policymaking? Support your arguments with economic theory and empirical evidence from developing countries.

Nowadays, the integration and interdependence of countries has become a major issue especially regarding policy making. Evidence shows that international trade plays a key role in this process but the challenges governments are facing is if strategies which mainly focus on international trade are the key to achieve economic development. Throughout this essay, different data and trends will be analyzed, comparing policies across countries and examining how the results of these ones may vary. In this sense it has been found that there isn´t a correct set of strategies for a country to implement and the results of these ones will depend upon each particular context.

The process of globalization has been characterized by an enlargement in the integration of national economies, expansion of international markets, a raise in portfolio investments and an augment in international trade. As shown in figure 1, there has been an increase in the sum of exports and imports of goods and services measured as a share of GDP at a world level. On the other hand as shown in figure 2, there has also been an increasing

trend in GDP worldwide. As it can be seen, both international trade and income have been increasing. The question which might arise then is if there is any correlation between these two variables and if so, up to which point could it be argued that international trade has been the main determinant of economic growth.

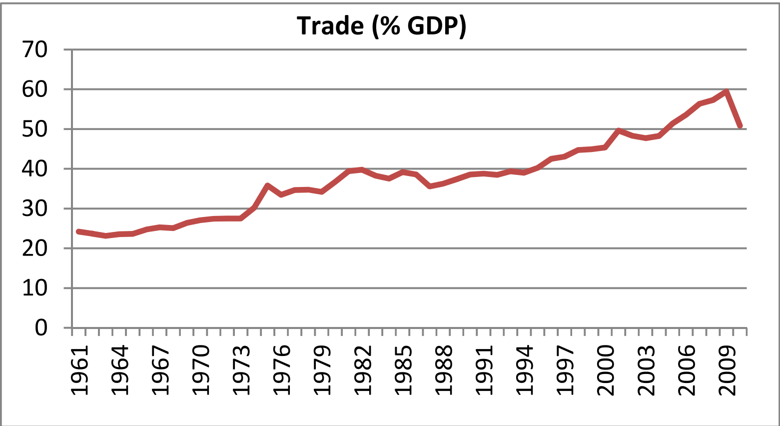

Figure 1- Trade
Source: Data World Bank Series (2012)

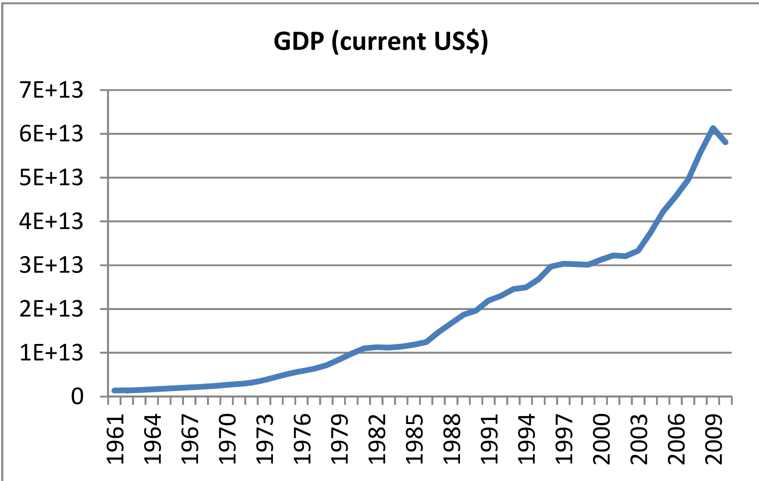

Figure 2
Source: Data World Bank Series (2012)

There are different theories which illustrate the important role that international trade has in promoting economic growth. A key model was developed by David Ricardo and it is known as the comparative advantage theory. It states that a country will specialize in exporting the products that it can produce at the relatively lowest cost. This specialization will lead to an increase of the total amount of goods and services produced worldwide thus enhancing economic growth. Other theories have also been developed as the Hecksher Ohlin model. Here trade is explained not due to technological differences but to differences in factor endowments which in turn makes factor prices differ. This will make that countries tend to specialize in the production of the commodities that make use of their abundant factors of production. Just as in the previous model, specialization and trade enhance economic growth (Todaro, 2011).

Following these basis, there are different reasons why countries are willing to trade. Trade provides access to wider markets and scarce resources. As Adam Smith theories suggest "the larger the market that can be sold to, the greater the gains from trade and the division of labour". This will lead to a more efficient allocation of resources as firms can make a better use of economies of scale. As well, transfer of knowledge and information is made simpler allowing a shorter time between innovation and adoption of new ideas meaning a faster rate of capital accumulation and technical progress can be achieved (Rodrik D, 2001).

All of this seems to show that international trade is the key for economic growth, but is this directly linked to economic development? Over the past few years the concept of development has been evolving. Whereas in the 70's it was seen mainly as economic growth, nowadays it is perceived in a different way. As defined by Todaro (2011): "Development is the process of improving the quality of all human lives and capabilities by raising people's levels of living, self-esteem, and freedom". In this sense, development involves giving opportunities to individuals such that they can achieve a desire estate given a specific context. Thus, when assessing whether international trade is the key strategy to achieve economic development one must consider the broad definition of this concept and take into account other variables rather than only economic growth.

One of these variables is productivity and competition. Trade can affect positively both economic growth and development if there is greater competition amongst firms as this can lead to an increase in productivity. Economists such as Waczierg (1998) have tested the effect of liberalisation on industries when measuring the entry rates of firms in different sectors. Results show that in developing countries that liberalised trade, the entry rates were 20 times higher in comparison to those countries who implemented protectionist regimes. In this way the entry rates are used as a proxy instrument to measure competition and therefore the results prove that there are efficiency gains from liberalisation. Additionally, the rewards in terms of productivity can also be seen as an improvement in human capital. Trade may allow introducing more efficient educational

technologies, which in turn will make the labour force more productive. This means that individuals would be better off and so would the economy as greater productivity implies an increase in output (Winters, 2004).

Other factors such as corruption and institutions can also be positively affected by trade. In a more open economy there are fewer incentives for corruption as there´s a greater international pressure to have more transparent and non-discretionary policies. Additionally there´s pressure to implement and enforce property rights, publish information and promote democracy (Winters, 2004). This exemplifies the fact that trade can have an effect on many variables which are interrelated both with growth and with development.

Countries who want to enjoy the benefits of trade may implement an “Outward oriented” policy. The main objective of this one is export promotion. In this way, there are export incentives and elimination of disincentives such as tariffs. An example of a country which has had spectacular growth rates in the past century and which is known to be one of the greatest economical miracles is China. Starting in the late 1970s, this country gradually began to open its economy to both trade and foreign investment but until very recently doing so within the boundaries of a highly unorthodox set of institutions. As seen in figure 3, “The share of exports in GDP rose from virtually nothing in the 1960s to close to 30 percent in 2003. Inward direct foreign investment has risen from close to zero in the early

1980s to around 5 percent of GDP" (Rodrik, 2006). Thus, it has been argued that trade has had an essential role in this process.

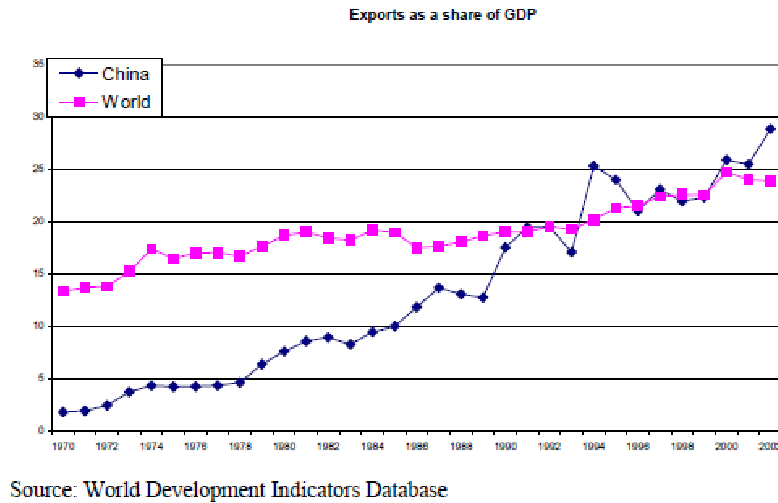

Figure 3– Exports (% GDP)
Taken from: Rodrik (2006)

Nevertheless there are economists who believe that the success of these "miracle" countries wasn´t due to trade but to reforms in prior institutions. As Rodrik (2001) expresses, there were reforms in China that took place even before liberalization started such as the introduction of the household responsibility system in agriculture. In this sense, when assessing the positive outcomes of the economy it is important to try to isolate the different causes. The problem is that as we are dealing with "natural" experiments, doing so is very difficult as events occurred very closely and it is very likely that the different variables are interrelated. Therefore we can conclude that it wasn´t

trade alone that triggered these results but that there were other factors such as institutional reforms that contributed to the process.

On the other hand, although China serves as a great example of trade having a positive impact on growth, this isn´t the general case for developing countries. The problem with these ones is that many of them have an unfavourable condition regarding trade due to the type of exports they have as they have tended to specialize in producing primary goods; "In 2006, the UNCTAD reported that out of 141 developing countries, 95 are more than 50% dependent on commodity exports…In most sub-Saharan African countries, the figure is 80%" (Todaro, 2011). The problem with relying on these types of goods as the major source of income is that the markets and prices are often unsteady. Also the income elasticity of demand is relatively low compared to manufactured goods; "A 1% increase in a developed country's income will raise food import demand by a 0.5% but raise import of manufactures by about 1.9%". Adding to this, developing countries also tend to rely on the importation of intermediate products for their industrial expansion. The combination of all these factors implies that developing countries must face a very difficult challenge when opening their economies to the international market.

Another important thing to take into account is the relative prices of exports and imports. The Commodity terms of trade (which is the ratio of a country's average export price to its average imports price) must not deteriorate with increasing trade or specialization. But as

the Prebisch-Singer hypothesis suggests, the commodity terms of trade for primary-product exports of developing countries tends to reduce over time as it has historically been confirmed that prices of primary commodities have declined relatively to manufacture goods (Todaro, 2011). This again proves to be evidence for developing countries having an unfavourable position regarding trade.

Additionally to this, there has been a big issue regarding agriculture and subsidies. In the last decades many powerful countries and EU states have applied a policy known as “Dumping” which is basically when a government buys domestically at high prices and then sells cheaply abroad. This means that world food prices are pushed down, and as many developing countries rely on food exports as their main source of income, this means that their economies would be compromised as their export revenues would decrease: “According to studies from the World Bank, developing countries are estimated to face annual welfare losses of $20bn a year as a result of Northern agricultural policies” (Oxfam, 2002). In this way, trade distorting policies compromise developing country’s economies and because of it there has been large pressure from these countries and international organizations for subsidies to be removed.

However, defenders of agricultural subsidies have claimed that there are some developing countries which actually benefit from this policy as they are net food importers rather than exporters. Valdes and McCalla (1999) used 1995-97 data on agricultural exports and imports to classify the different countries depending on the volume of their exports and

imports. They concluded that 48 out of 63 Low Income Countries were net importers of food and in the Low Middle Income Countries, 35 out of 52 were net food importers. In this way, the low food prices due to dumping policies benefit these types of countries as they can import more at a lower price. This means that agricultural subsidies can both benefit and harm developing countries so when assessing the consequences of a policy like this, the effect on every particular country and sector must be considered.

Following these set of ideas, there are many opinions which clash regarding what countries must do. In this manner, many economists have argued that trade isn´t always associated with development and that it has actually accentuated inequalities both between and within countries. As Muhammad Yunus wrote in 2008, “Global trade is like a hundred-lane highway criss-crossing the world. If it is a free-for-all highway, with no stop lights, speed limits, size restrictions, or even lane markers: its surface will be taken over by the giant trucks from the world’s most powerful economies”. Therefore some people believe that trade has allowed for the expansion of the international dominance of rich countries. As Seen in figure 4 there has been an increase in absolute inequality with income growth. However it is important to consider that here the variable used is absolute inequality which measures the actual difference in income and not the ratio of incomes to the mean (relative inequality). (Ravallion, 2004).

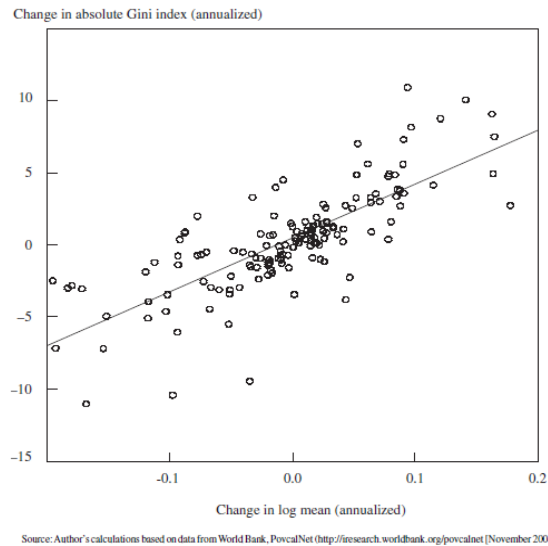

Figure 4- Change in absolute inequality versus the change in log mean per capita income
Source: Ravallion, 2004

Another problem which developing countries might have is related with the Balance of payments (BoP) which is “The summary statement of a nation’s financial transactions with the outside world” (Todaro, 2011). The presumption is that trade liberalisation will raise the growth of exports and imports but the proportion of these increases will have an effect in the BoP. Santos-Paulino and Thirlwall (2004) estimated the effect of trade liberalisation and they reached the conclusion that trade liberalisation policies stimulated import growth in a higher proportion than they did with export growth such that there was a worsening in the balance of trade and payments: “At an average level of the 22 countries in the sample the effect for a one percentage point reduction in duties, exports have grown by just under 0.2%, while imports have grown by between 0.2 and 0.4%.”In this sense, countries faced problems with an exhaustion of international monetary reserves, currency instability, and stagnation of the economy. So if a country wants to

liberalise it must keep the current account of the balance of payments in equilibrium to make certain that the policy will promote growth instead of inhibiting it.

Given the disadvantages of opening the economy for developing countries, many of them had decided to follow an “inward oriented” policy. An example of this one was the Import-substituting industrialization (ISI) policy. It was widely implemented in Latin America in the 1950´s-1960´s. It was based on the idea of substituting import consumption by promoting the expansion and growth of domestic industries. Along these lines, the increasing of tariff rates with the consequent reduction in import consumption allowed for newly and growing industries to emerge, thus promoting economic growth; “Until the first oil shock hit in 1973, no fewer than 42 developing grew at rates exceeding 2.5 percent per capita per annum (Rodrik, 2001). Although this policy had many positive effects at the beginning, it also had some disadvantages. As tariffs were raised and industries were protected from international competition, this made that many of them where inefficient and costly to operate. In the 1980´s, due to a series of external shocks, an increasing external debt, countries had to change their policies.

Economists who are against liberalization argue that the ISI policy promoted economic growth. However there are other people who argue that this wasn´t the case. Panagariya, (2004) presents the case of Brazil during this period. He argues that the increase in economic growth wasn´t due to the ISI model but the reforms which were taking place at

the moment. During 1961-68, the average growth rate was 1.6% followed by 8.3 and 3.5% in the following decades. However at the same time there were reforms as the devaluation of the exchange rate, adoption of the crawling peg to ensure stability, several export incentives were introduced and the average legal tariffs on imports was lowered. Hence, the critical question which must be considered is whether it was the previous ISI model who promoted growth or if it was lowering the protectionist wall during the period of rapid growth.

In conclusion we have seen that the world has been experiencing an increase in international trade. Nonetheless this process has not been uniform across countries as these ones differ in their resource endowments, preferences and technologies, political and social systems, institutions, capabilities of growth and development. Thus there are several examples of countries who have benefited from trade as China, but there are others who haven´t. In this sense trade can contribute to promote economic growth but other factors such as the internal policies of each country must be taken into account. There isn´t a single model or strategy to follow. Each country should create its own policy and adjust its institutions depending on the objectives it wants to reach. If a liberalization process is to be implemented, this one should be gradual, allowing the economy to adjust. Countries should try to keep their balance of payments in equilibrium finding stability between exports and imports as to reach their potential growth performance. In this way the combination of good internal policies and trade will lead to economic development.

References:

- Michael P. Todaro and Stephen C. Smith, 2011, Economic Development (11th Edition), Pearson Education Limited, Addison Wesley.
- Oxfam (2002), 'Rigged Rules and Double Standards: Trade, Globalization and the Fight Against Poverty'. Stable URL: http://www.maketradefair.com/en/index.php?file 26032002105641.htm

- Panagariya A, 2004, Miracles and Debacles: In Defence of Trade Openness. The World Economy, 27(8), pp. 1149-1171

- Ravallion, Martin (2004). Pro-Poor Growth: A Primer. Development Research Group, World Bank

- Rodrik D, 2001, "The Global Governance of Trade as if Development Really Mattered," UNDP, New York.

- Rodrik D , 2006, What's so special about China's exports?, China & World Economy, Sept/Oct 2006, pp 1-19.

- Santos-Paulino, Amelia and A. P. Thirlwall (2004). The Impact of Trade Liberalisation on Exports, Imports and the Balance of Payments of Developing Countries. The Economic Journal, Vol. 114, No. 493. Stable URL: http://www.jstor.org/stable/3590110 .
- Stiglitz, J . 2005, "The Overselling of Globalization." In Globalization: What's New? Michael E. Weinstein (ed). New York: Columbia University Press.

- Trade Liberalisation and Economic Performance: An OverviewAuthor(s): L. Alan Winters. The Economic Journal, Vol. 114, No. 493, Features (Feb., 2004), pp. F4-F21Published by: Blackwell Publishing for the Royal Economic SocietyStable URL: http://www.jstor.org/stable/3590108

- -Valdes, A. and A. F. McCalla (1999), 'Issues, Interests and Options of Developing Countries', World Bank and WTO Conference on Agriculture and the New Trade Agenda in the WTO 2000 Negotiations (Geneva, Switzerland, 1–2 October).

- Winters L. Alan (2004).Trade Liberalisation and Economic Performance: An Overview.The Economic Journal, Vol. 114, No. 493, Features (Feb., 2004), pp. F4-F21

- Wacziarg, R. 1998. "Measuring the Dynamic Gains from Trade." Working Paper 2001. Washington, DC, United States: World Bank.

- World Bank Series. Retreived the 22 april 2012; URL: http://data.worldbank.org/indicator/NY.GDP.MKTP.CD?display=default