UNIVERSITAS PELITA HARAPAN

CITI CENTER FOR INTERNATIONAL TRADE & INVESTMENT

# Globalization, Economic Integration and International Trade

Week 1 of a twelve-week survey course on the law and policy of the global trading system

# Structure of the present lecture

In this module we will cover a number of topics:

- We will discuss several definitions of the term "globalization" and what it essentially means for you
- We will discuss why countries trade and a few key theoretical underpinnings of international trade
- Finally, we will discuss three simple principles of trade policy that everyone would best be advised to internalize

# Part 1 Globalization

Why has it become a dirty word?

# What's all the fuss about globalization?

# Definitional issues

Wikipedia (itself arguably a product of globalization) defines “globalization” as follows:

> *Globalization [...] is the process of international integration arising from the interchange of world views, products, ideas and other aspects of culture*.

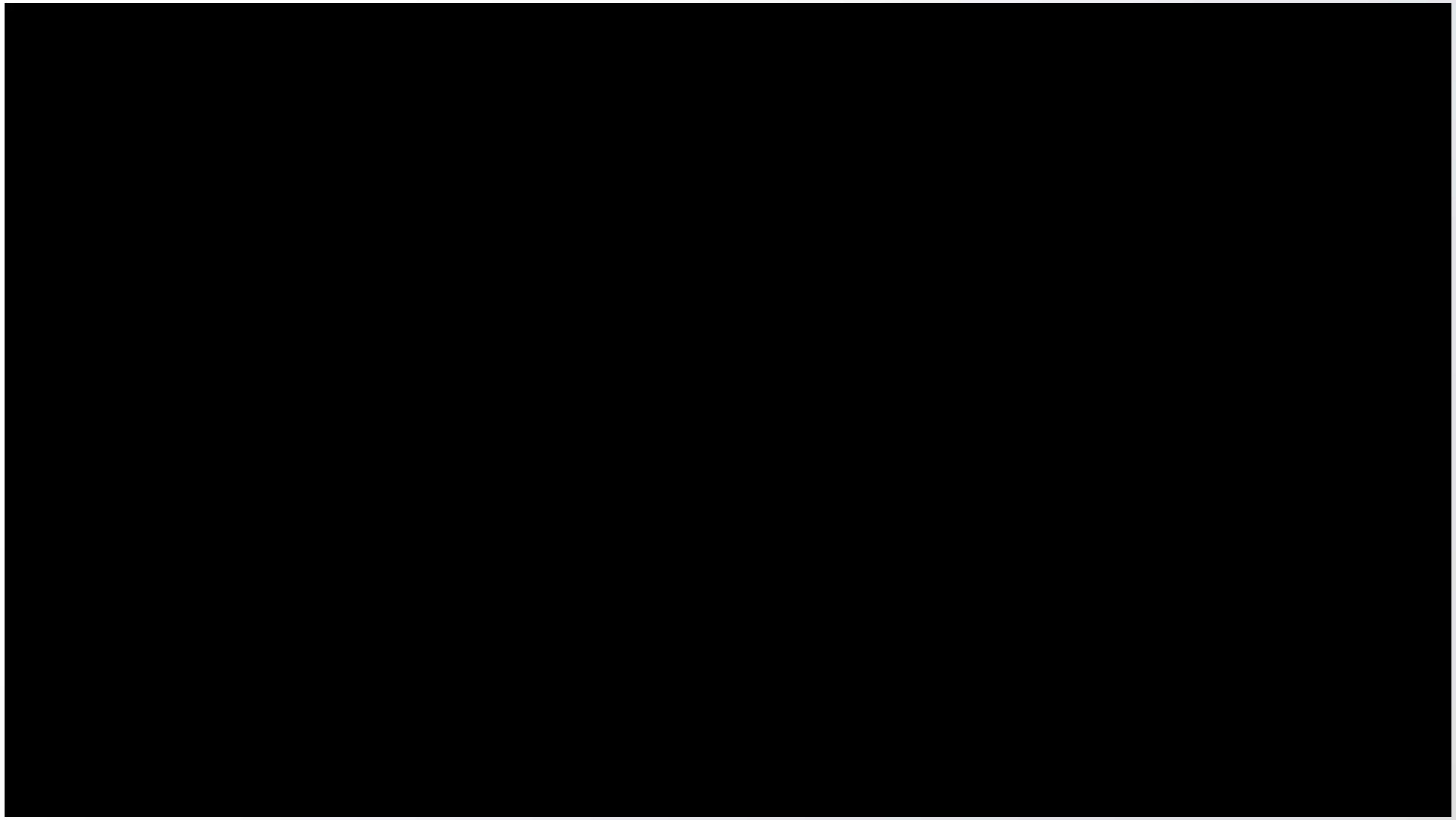
The New Shorter Oxford English Dictionary (which some at the WTO have an almost reverent regard for) defines globalization in the following terms:

> *The action, process, or fact of making global; [...] the process by which businesses or other organizations develop international influence or start operating on an international scale, widely considered to be at the expense of national identity*.

In a figurative sense, globalization is about the world becoming smaller, meaning that it is easier and cheaper for people, goods, services and ideas to travel further and faster than at arguably any time in history - although some posit that the so-called Golden Age of Globalization actually occurred in the second half of the 1800s.

On the next slide we show a short video that should impart some understanding of the factors and forces underpinning modern-day globalization and why it is also a force that has attracted its fair share of criticism

# Video clip by *Wissenswerte* on Globalization (8 minutes)



# Over to you | your thoughts and reflections

- In the 1960s, industrialized countries like the United States used to have thriving steel sectors, now the towns that grew up around the steel mills are mere shadows of themselves and the number of workers able to find employment in this sector has dwindled dramatically.
- Explain how globalization has played a role in the the decline of the US steel industry. Do you think this is ultimately a good or a bad thing? Who are the winners and losers from this phenomenon?
- Some 30 years ago, Bangladesh started down the road towards becoming what it is today, namely one of the world's largest and most competitive producers and exporters of clothing, apparel and textile products. This industry has provided employment, livelihoods and a path out of poverty for thousands of textile workers and their families, and has played an important role in improving the social mobility and status of women in Bangladesh.
- Explain what role globalization has played in this process. Are there any downsides to this phenomenon, either for the Bangladeshi textile workers themselves or for other textile workers in other countries?

# Want to do some more reading on globalization?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Globalization and International Trade

"Globalization" refers to the growing interdependence of countries resulting from the increasing integration of trade, finance, people, and ideas in one global marketplace. International trade and cross-border **investment** flows are the main elements of this integration.

Globalization started after World War II but has accelerated considerably since the mid-1980s, driven by two main factors. One involves technological advances that have lowered the costs of transportation, communication, and computation to the extent that it is often economically feasible for a firm to locate different phases of production in different countries. The other factor has to do with the increasing **liberalization** of trade and capital markets: more and more governments are refusing to protect their economies from foreign competition or influence through **import tariffs** and nontariff barriers such as import quotas, export restraints, and legal prohibitions. A number of international institutions established in the wake of World War II—including the **World Bank, International Monetary Fund (IMF),** and **General Agreement on Tariffs and Trade (GATT),** succeeded in 1995 by the **World Trade Organization (WTO)**—have played an important role in promoting free trade in place of **protectionism.**

Empirical evidence suggests that globalization has significantly boosted **economic growth** in East Asian economies such as Hong Kong (China), the Republic of Korea, and Singapore. But not all **developing countries** are equally engaged in globalization or in a position to benefit from it. In fact, except for most countries in East Asia and some in Latin America, developing countries have been rather slow to integrate with the world economy. The share of Sub-Saharan Africa in world trade has declined continuously since the late 1960s, and the share of major oil exporters fell sharply with the drop in oil prices in the early 1980s. Moreover, for countries that are actively engaged in globalization, the benefits come with new risks and challenges. The balance of globalization's costs and benefits for different groups of countries and the world economy is one of the hottest topics in development debates.

**Costs and Benefits of Free Trade**

For participating countries the main benefits of unrestricted foreign trade

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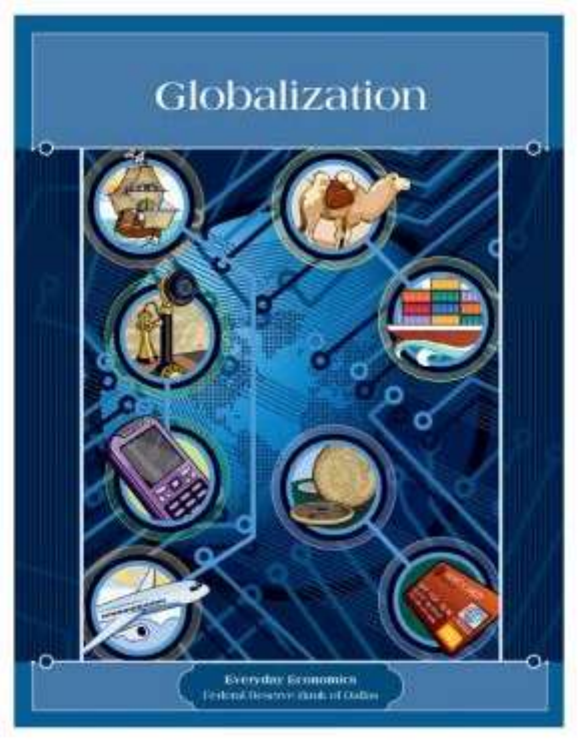
World Bank, *Globalization and International Trade*, 7 pages, click on the thumbnail to download or click here.




Federal Reserve Bank of Dallas, *Globalization*, 16 pages, click on the thumbnail to download or click here.

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# Part 2
# Why Countries Trade

The theoretical underpinnings of international trade

# What's the rationale behind trade?

- Trade primarily happens thanks to one phenomenon, and that is specialization!
- Most people don't wake up in the morning and prepare breakfast from food they have grown or cultivated in their own back gardens, or wear clothes that they have designed and produced themselves. Most of us live in societies characterized by various degrees of specialization, meaning we buy food, clothing and other essentials from others.
- Thanks to specialization, most of the world's population can lead lives that are more productive, interesting and rewarding than they would be if everyone had to do everything, and make everything they needed themselves.
- It's the same with countries. Countries could make almost everything themselves (and some still do), but basically it's better for countries to focus a greater share of their limited resources making things they can make better or more cheaply than many other countries.

# Should Tiger Woods mow his own lawn?

## [Care of Gregory Makiw, Principles of Economics]

Tiger Woods spends a lot of time walking around on grass. Formerly one of the most talented golfers of his time, he used to be able to hit a drive and sink a putt in a way that most casual golfers only dream of doing. Most likely he is talented at other activities too. For example, let’s imagine that Woods can mow his lawn faster than anyone else. But just because he can mow his lawn fast, does that mean that he should?

To answer this question, we can use the concepts of opportunity cost and comparative advantage. Let’s say Woods can mow lawn in 2 hours. In that same 2 hours, he could film a television commercial for Nike and earn $10,000. By contrast, Forrest Gump, the boy next door, can mow Woods’ lawn in 4 hours. In the same 4 hours, he could work at McDonalds and earn $ 20.

In this example, Woods has an absolute advantage in mowing lawns because he can do the work with a lower input of time. Yet because Woods’ opportunity cost of mowing the lawn is $10,000 and Forrest’s opportunity cost is only $20, Forrest has a comparative advantage in mowing laws.

The gains from trade in this example are tremendous. Rather than mowing his own lawn, Woods should make the commercial and hire Forrest to mow the lawn. As long as Woods pays Forrest more than $20 and less than $10,000, both of them are better off.

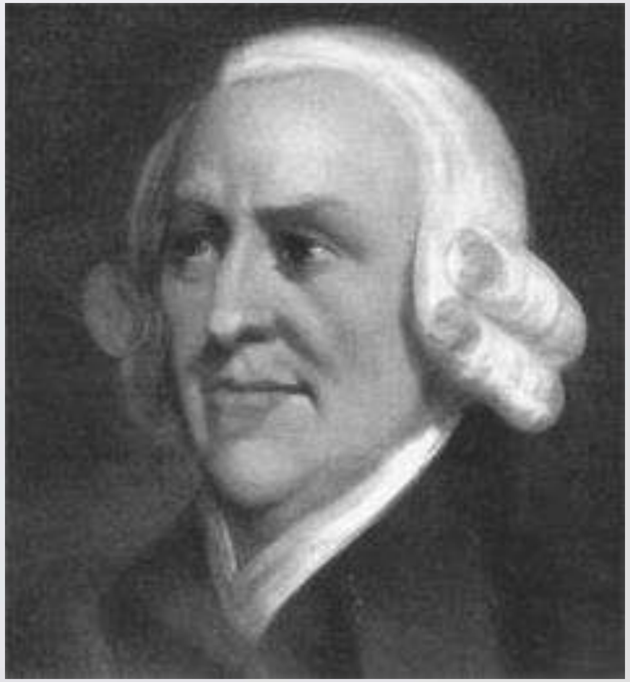
# Adam Smith and the theory of absolute advantage

"It is the maxim of every prudent master of a family, never to attempt to make at home what it will cost him more to make than to buy.

What is prudence in the conduct of every private family, can scarce be folly in that of a great kingdom.

If a foreign country can supply us with a commodity cheaper than we ourselves can make it, better buy it off them with some part of the produce of our own industry, employed in a way which we have some advantage."

Adam Smith *The Wealth of Nations*, 1776



# More thinking on absolute advantage

- A country has an absolute advantage in the production of a good if it can produce the **SAME** amount of the ***good*** with **LESS** *input* relative to other countries.

OR

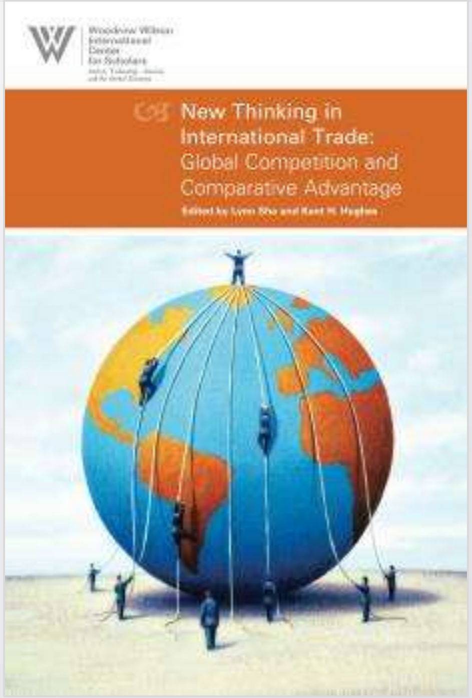
- A country has an absolute advantage in the production of a good if it can produce **MORE** of the ***good*** with the **SAME** amount ***input*** relative to other countries.

# David Ricardo and the theory of comparative advantage

- David Ricardo realised that Absolute Advantage is a limited case of a more general theory called Comparative Advantage.
- It can be seen between two countries that even when one country has an absolute advantage in both commodities, it could still be mutually beneficial for both countries to specialise in 1 product and trade.
- According to the law of comparative cost advantage two countries can gain from trade even if one of the countries is more efficient in producing both products.
- A country specializes in producing and exporting goods in which its comparative advantage is greatest, or comparative disadvantage is the smallest.
- A country should import goods in which its comparative advantage is smallest or comparative disadvantage is greatest.

# Want to do more reading on absolute and comparative advantage?


Reinhard Schumacher, Free Trade and Absolute and
Comparative Advantage, 116 pages, click on the thumbnail to download or click here.




Lynn Sha and Kent H. Hughes, New Thinking in
International Trade:
Global Competition and
Comparative Advantage, 168 pages, click on the thumbnail to download or click here.

# The gains from trade

- The example discussed above involving Tiger Woods and his neighbor Forrest Gump highlights something economists refer to as the “gains from trade”.
- Trade also provides benefits by allowing countries to export goods whose production makes relatively heavy use of resources that are locally abundant while importing goods whose production makes heavy use of resources that are locally scarce.
- International migration and international borrowing and lending are also forms of mutually beneficial trade.
- The international exchange of risky assets, such as stocks and bonds can benefit all countries by allowing each country to diversify its wealth and reduce the variability of its income.

# More gains from trade

- International trade increases both the incentives for not waging war and the costs of going to war.
- International trade intensifies cross border contacts and exchange of ideas, which can contribute to better mutual understanding, as well as spurring innovation.
- It has also been argued that open, international trade may also promote a number of core values such as liberty, human rights, and democracy

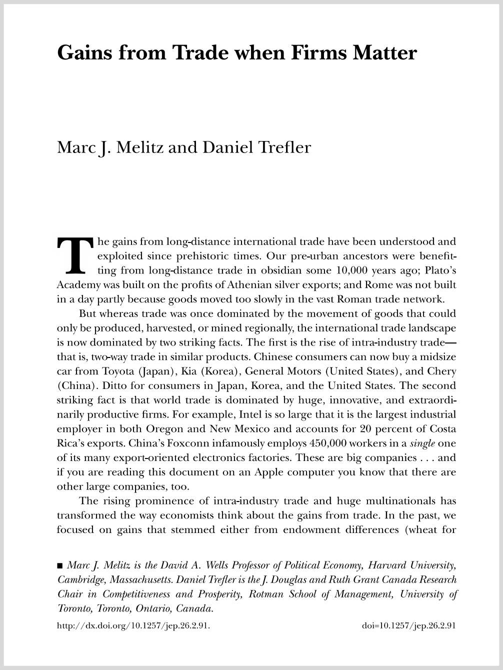
# But its not all good news for everyone | important caveat!

- While nations generally benefit from international trade, however, it is quite possible that international trade may hurt particular groups within nations (think about the steelworkers of the North-eastern United States we discussed earlier).
- This is because international trade has strong effects on the distribution of income.
- International trade can adversely affect the owners of resources that are “specific” to industries that compete with imports and cannot find alternative employment in other industries.

# Over to you | your thoughts and reflections

- What do you think are some of the benefits that a developing country like Indonesia reaps from trading with its partners both regionally and globally?
- Can you name some countries that have been more successful in harnessing trade as an engine for economic development, while pointing to others that have had less success so far?
- Can you think of some groups within your own country that have suffered from some of the adverse distributional effects of trade liberalization? What do you think can and should be done to help them?

# Want to do some more reading on the gains from trade?



**Gains from Trade when Firms Matter**

Marc J. Melitz and Daniel Trefler

The gains from long-distance international trade have been understood and exploited since prehistoric times. Our pre-urban ancestors were benefitting from long-distance trade in obsidian some 10,000 years ago; Plato's Academy was built on the profits of Athenian silver exports; and Rome was not built in a day partly because goods moved too slowly in the vast Roman trade network.

But whereas trade was once dominated by the movement of goods that could only be produced, harvested, or mined regionally, the international trade landscape is now dominated by two striking facts. The first is the rise of intra-industry trade—that is, two-way trade in similar products. Chinese consumers can now buy a midsize car from Toyota (Japan), Kia (Korea), General Motors (United States), and Chery (China). Ditto for consumers in Japan, Korea, and the United States. The second striking fact is that world trade is dominated by huge, innovative, and extraordinarily productive firms. For example, Intel is so large that it is the largest industrial employer in both Oregon and New Mexico and accounts for 20 percent of Costa Rica's exports. China's Foxconn infamously employs 450,000 workers in a *single* one of its many export-oriented electronics factories. These are big companies . . . and if you are reading this document on an Apple computer you know that there are other large companies, too.

The rising prominence of intra-industry trade and huge multinationals has transformed the way economists think about the gains from trade. In the past, we focused on gains that stemmed either from endowment differences (wheat for

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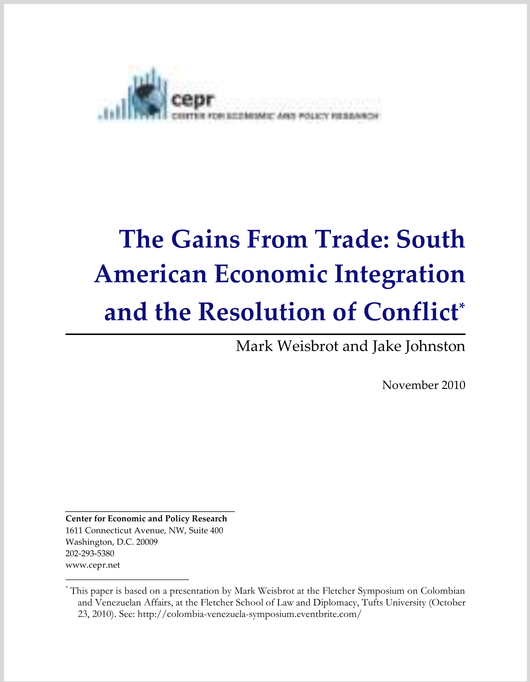
http://dx.doi.org/10.1257/jep.26.2.91. doi=10.1257/jep.26.2.91

Marc J. Melitz and Daniel Trefler, *Gains from Trade when Firms Matter*, 28 pages, click on the thumbnail to download or click here.




**The Gains From Trade: South American Economic Integration and the Resolution of Conflict***

Mark Weisbrot and Jake Johnston

November 2010

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* This paper is based on a presentation by Mark Weisbrot at the Fletcher Symposium on Colombian and Venezuelan Affairs, at the Fletcher School of Law and Diplomacy, Tufts University (October 23, 2010). See: http://colombia-venezuela-symposium.eventbrite.com/

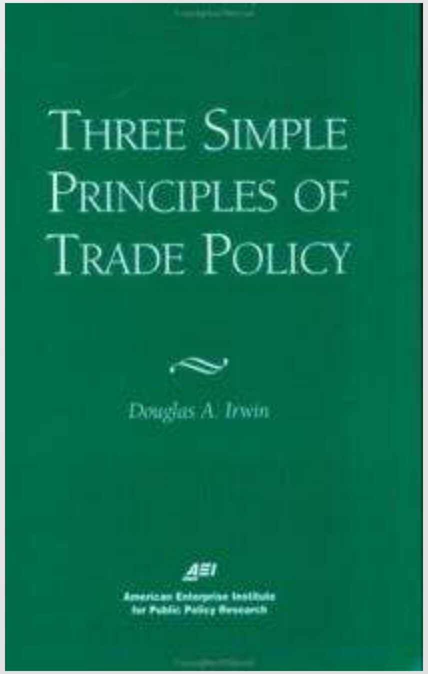
Mark Weisbrot and Jake Johnston, *The Gains From Trade: South American Economic Integration and the Resolution of Conflict*, 12 pages, click on the thumbnail to download or click here.

# Part 3
# Three Simple Principles of Trade Policy

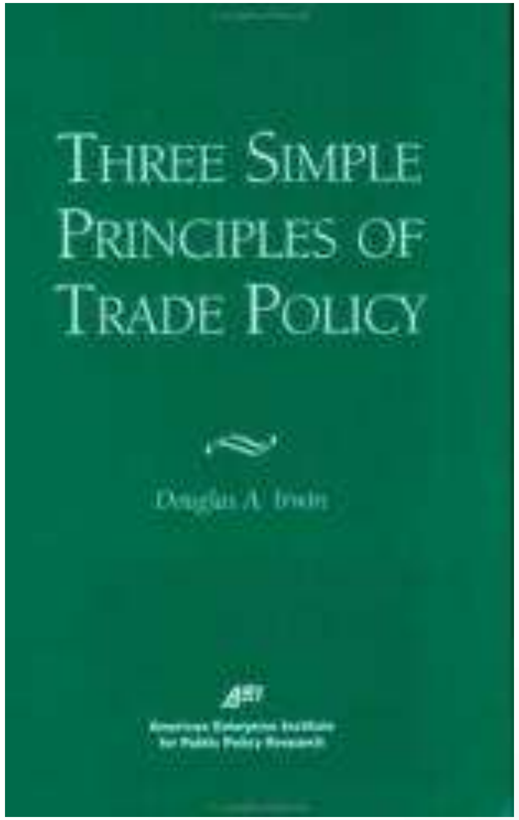
Care of Doug Irwin *Three Simple Principles of Trade Policy*

# First some recommended reading

- This section draws heavily on a little-known but very well written short monograph written by renowned trade economist Doug Irwin.
- If all policymakers and other officials working in the area of trade policy, as well as politicians were required to read this before making any decisions in the world of foreign economic policy, the world trading system would function a lot better than it does now.
- The American Enterprise Institute, who published the work, has graciously uploaded the entire text as a PDF. You can download it by clicking on the thumbnail or by clicking here.



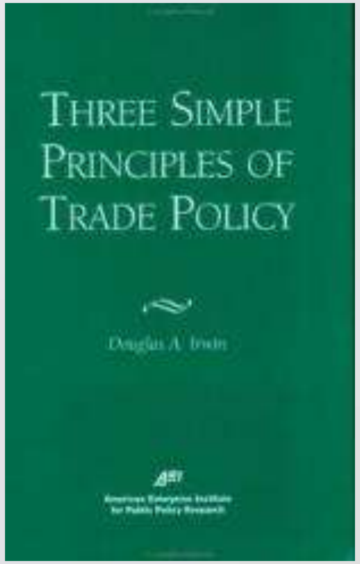
# 1st Principle
# A Tax on Imports is a Tax on Exports




- Any restrain on imports is equivalent to a tax on exports
- Any restraint on imports also acts, in effect, as a restraint on exports.
- When a government undertakes polices to expand the volume of exports, it cannot help but to expand the volume of imports as well.
- This is because exports and imports are flip sides of the same coin
- Exports are necessary to generate the earnings to pay for imports
- Exports and imports are inherently interdependent, and any policy that reduces one will also reduce the other.
- This truth has a long intellectual pedigree but is known today as the Lerner Symmetry Theorem.

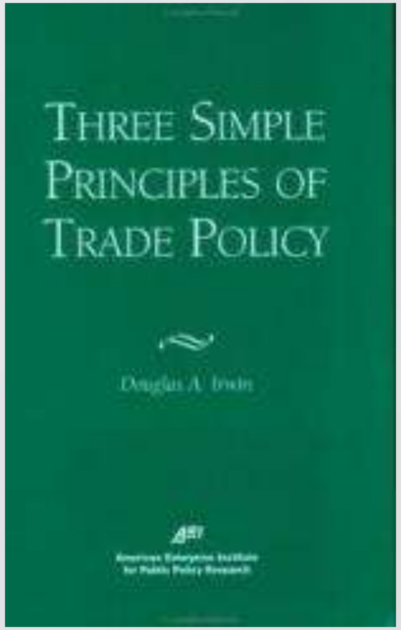
# 1st Principle
# A Tax on Imports is a Tax on Exports

- What mechanisms specifically link a country's exports and imports to one another?
- The mechanisms can be complex and subtle, but focusing on the foreign exchange market can perhaps illustrate what is going on.
- If Indonesia unilaterally reduces its tariffs on goods from Japan, for example, one would expect Indonesian demand for Japanese goods to increase.
- In this case, consumers in Indonesia will (indirectly) have to sell IDR on the foreign exchange market to purchase Japanese Yen.
- This tends to depress the value of the IDR in terms of the Japanese Yen, or conversely, to raise the value of the Japanese Yen in terms of the IDR.
- The depreciation of the IDR tends to raise the price of Japanese goods in Indonesia dampening demands for those goods.



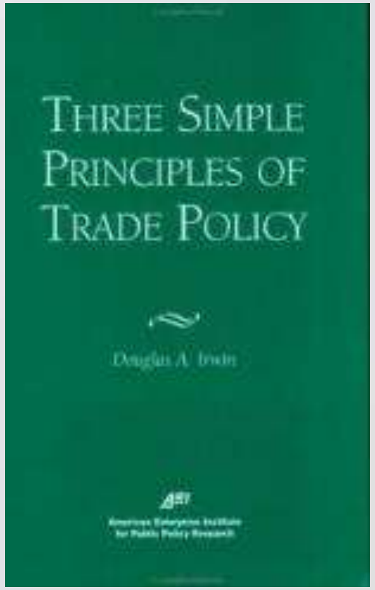
# 1st Principle
# A Tax on Imports is a Tax on Exports

- But here is the flip side: even though Japan did not change its tariff on Indonesian goods, Japan will now purchase more goods from Indonesia because the depreciated IDR will tend to lower the price of Indonesian goods.
- In other words, the foreign exchange market is one mechanism that links exports and imports to ensure that when a country unilaterally reduces its tariffs, its exports increase as well.
- There is sufficient evidence of this symmetry to indicate that exports and imports are unmistakably correlated: they rise and fall in lockstep.
- If a government undertakes policies that systematically reduce the volume of imports, it also systematically reduces the volume of exports.

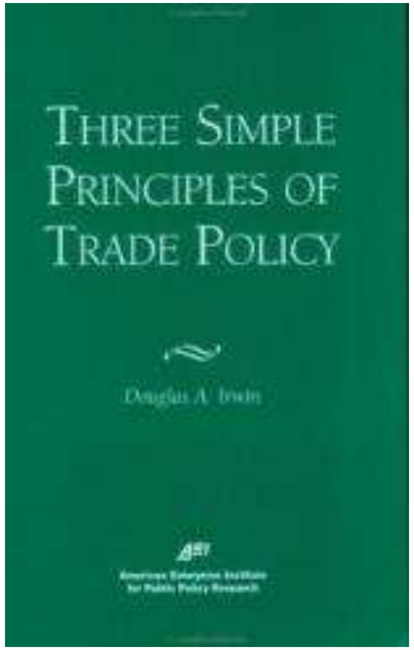


# 2nd Principle
# Businesses are consumers too

- Economists since Adam Smith have always stressed the costs to consumers of various trade restrictions.
- Examples of trade restrictive policies which imposed huge costs on consumers were the Multi Fibre Arrangement (MFA) in the textiles sector, and Vertical Export Restraints (VERs) in the automobile sector.
- The consumer cost of protection argument is, however, getting a bit worn out.
- Jobs are also viewed as very important in the political arena.
- If it comes down to saving a few hundred jobs in some industry or saving consumers a few hundred dollars in income, the policy of import protection will win every time.
- What's more, producer interests are concentrated and thus well represented politically, while consumers' costs are spread over millions of households.



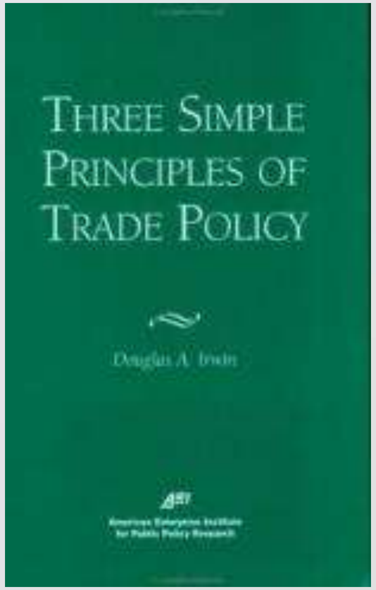
# 2nd Principle
# Businesses are consumers too



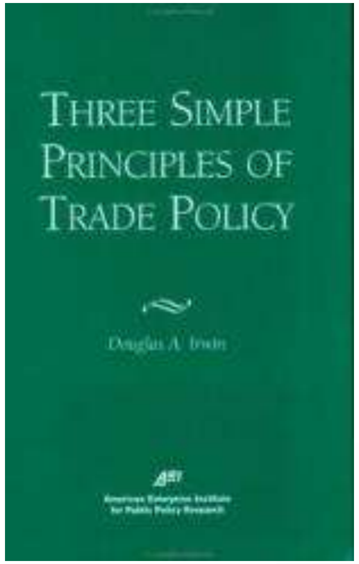

- But the producers versus consumers argument overlooks the fact that businesses are consumers too.
- Business firms are, in fact, bigger consumers of imported products than households.
- One can go down the list of trade policy interventions over the last few decades and see that many of the commodities at issue constitute intermediate goods.
- Any trade intervention that raises the price of an intermediate good will at some point adversely affect most households as final consumers.
- But the immediate adverse affect is on other downstream industries, and, necessarily, employment in those industries.
- Example of US steel policy is an illustrative one. Other examples include sugar, and Dynamic Random-Access Memories (DRAMs).
- By viewing imports not as final consumer goods but as inputs to domestic production, policy makers can more clearly recognize that the issue is not so much one of “saving” jobs but of “trading off” jobs between sectors.

# 3rd Principle
# Trade imbalances reflect capital flows

- Any analysis of trade imbalances must begin with the general balance of payments.
- The balance of payments is simply an accounting of a country's international transactions.
- One important lesson to remember in the context of the balance of payments is that it always balances – that is, sums to zero.
- Two broad categories of transactions enter into the balance of payment:
  - The *current account* , which records all trade in merchandise goods and services; and
  - The *capital account*, which records all trade in assets, either portfolio or direct investments
- Because the balance of payments always balances, a country running a current account deficit must also have a counterbalancing capital account surplus.
- In other words, if a country is buying more goods and services from the rest of the world than it is selling, the country must also be selling more assets to the rest of the world than it is buying.



# $3^{rd}$ Principle
# Trade imbalances reflect capital flows



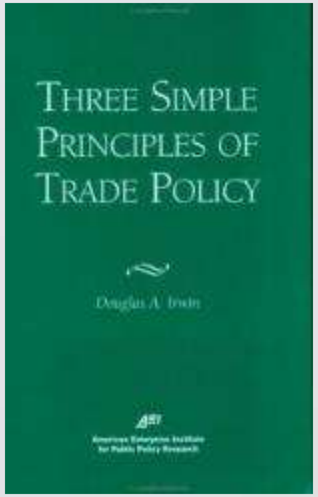

- Countries with current account deficits are effectively borrowing from or selling assets to the other countries.
- Countries with current account surpluses in contrast, are buying assets from the rest of the world, or using their savings to act as net lenders to other countries.
- There is a fundamental equation of international finance that relates this net borrowing and lending activity to the current account:

  Exports minus Imports = Savings minus investment

- In other words, countries running trade surpluses (the value of their exports exceeding the value of their imports) have domestic savings in excess of domestic investment.
- This "excess" savings, which is invested or lent abroad, manifests itself in a capital account deficit, the counterpart of which is a current account surplus.
- Countries with trade deficits can sustain greater domestic investment than domestic savings because of the addition of foreign savings, which come in as a capital account surplus or current account deficit.

# 3rd Principle
# Trade imbalances reflect capital flows

- The powerful implication of this equation is that if a country wishes to reduce its trade deficit, the gap between its domestic investment and its domestic savings must be reduced.
- Unless a country's trade policies also affect its total savings or investment, those policies will be ineffective in altering its balance of trade.
- That is why simple observation shows us that some countries with open markets run trade surpluses and others run trade deficits, while some countries with closed markets run trade surpluses and others run trade deficits.
- Those imbalances have everything to do with international borrowing and lending and virtually nothing to do with commercial policies.



# Over to you | your thoughts and reflections

- Explain in your own words the mechanism that links imports to exports.
- How does what you learned under the 2nd Principle (Businesses are Consumers too) fit with what you already know about global value chains or say, the way a smart phone is manufactured in today's economy?
- Try and find some recent statements by the trade minister or economic policymakers in your country recently. To what extent to they reflect some level of understanding of the these three simple principles of trade policy? (hint: the answer may be "not very much at all")

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