

Chapter 1

Growth and Direction of International Trade

International trade is the exchange of goods and services across national boundaries. It is the most traditional form of international business activity and has played a major role in shaping world history. It is also the first type of foreign business operation undertaken by most companies because importing or exporting requires the least commitment of, and risk to, the company's resources. For example, a company could produce for export by using its excess production capacity. This is an inexpensive way of testing a product's acceptance in the market before investing in local production facilities. A company could also use intermediaries, who will take on import-export functions for a fee, thus eliminating the need to commit additional resources to hire personnel or maintain a department to carry out foreign sales or purchases (Daniels and Radebaugh, 2004).

International trade in services has grown over the past decade at an annual rate of about 18 percent compared to that of approximately 9 percent for merchandise trade. Trade in services constitutes 25 percent of overall world trade in 2004 (WTO, 2004a). In some countries, such as Panama and the Netherlands, services account for about 40 percent or more of total merchandise trade. Typical service exports include transportation, tourism, banking, advertising, construction, retailing, and mass communication.

IMPORTANCE OF INTERNATIONAL TRADE TO THE GLOBAL ECONOMY

International trade allows manufacturers and distributors to seek out products, services, and components produced in foreign countries. Companies

acquire them because of cost advantages or in order to learn about advanced technical methods used abroad; for example, methods that help reduce the cost of production lower prices and in turn, induce more consumption thus producing increased profit. Trade also enables firms to acquire resources that are not available at home. Besides providing consumers with a variety of goods and services, international trade increases incomes and employment. In 1990, the number of U.S. jobs supported by merchandise exports to all foreign markets reached 7.2 million. U.S. merchandise exports to all foreign markets contributed to 25 percent of the growth in U.S. civilian jobs between 1986 and 1990 (Davies, 1992). It is estimated that each billion dollars of merchandise exports supports about 25,000 jobs. A survey of 3,032 small- and medium-sized manufacturing enterprises in Canada over a three-year period (1994-1997) strongly indicates that growth in exports is associated with an increase in jobs (Lefebvre and Lefebvre, 2000). Even though imports are associated with loss of jobs due to plant closings or production cutbacks of domestic industries, the export job-generation effect is about 7.5 percent larger than the import job-loss effect (Belous and Wyckoff, 1987). During the 1979-1999 periods, about 6.4 million U.S. jobs were displaced due to import competition. Such losses are largely concentrated in electrical/nonelectrical machinery, apparel, motor vehicles, and blast furnaces. A quarter of displaced workers reported earning losses of about 30 percent, while 36 percent indicated comparable or higher earnings than from their previous job (Kletzer, 2001). Most occupations show a net job gain from an equal amount of exports and imports except for blue-collar occupations, which are shrinking in most developed countries due to increasing pressure from low-wage imports.

Exports create high-wage employment. In a study of recent wage statistics, the U.S. Trade Representative's Office found that U.S. workers employed in export-related jobs earn 17 percent more than the average worker in the United States. Export-related wages are higher for manufacturing and service sector jobs. While service-related jobs generally pay less than manufacturing jobs, service jobs in the export sector were found to pay more on average than manufacturing jobs in the overall economy (U.S. Department of Commerce, 1994). A recent study on wages and trade finds a strong positive correlation between export intensity and wages. This could be partly explained by the fact that export intensive sectors tend to show higher levels of productivity than other firms. It is also consistent with economic theory, as industries in which a nation enjoys comparative advantage are likely to be those in which workers are more productive and therefore receive higher wages. It also shows that greater import penetration is associated with greater demand elasticity, which reduces workers' bargaining power (Harless, 2006).

DETERMINANTS OF TRADE

Why do some countries export or import more than others? Several studies have been conducted to establish major factors that influence exports. The trade and exchange rate regime (import tariffs, quotas, and exchange rates), presence of an entrepreneurial class, efficiency enhancing government policy, and secure access to transport (and transport costs) and marketing services are considered to be important influential factors of export behavior (Kaynak and Kothavi, 1984; Fugazza, 2004). A study on the nature, composition, and determinants of Singapore's technology exports suggests that the country's open trade and investment regime and development-oriented economic policy have been the key factors in enhancing the country's exports. Singapore's economy has shown continued and remarkable growth in exports for over thirty years with only two brief and mild recessions in the mid-1970s and mid-1980s. Its total trade as a proportion of GDP remains one of the highest in the world, over 300 percent of GDP in 2003 (Fong and Hill, 1991; WTO, 2004b). A recent study on the determinants of export performance underlines the importance of foreign direct investment (FDI) and the general quality of the institutional framework. Foreign direct investment contributes to capital formation and helps promote the development and export of knowledge-based industries (Fugazza, 2004).

Much of the research literature on imports underlines the importance of high per capita incomes, price of imports, and the exchange rate in determining import levels (Lutz, 1994). For developing countries, however, determinants of import demand also include factors such as government restrictions on imports and availability of foreign exchange. A study examining the factors influencing import demand in Pakistan from 1959 to 1986 found that the policy of devaluation or the policy of raising tariffs was not significant in reducing imports except in the case of imports of machinery and equipment (Sarmand, 1989).

VOLUME AND DIRECTION OF TRADE

The growth in the volume of world merchandise trade has always exceeded the growth of output (1870-2004) except for the period 1913-1950, which was marked by global political and economic instability. Since 1950, while world economic output has shown steady growth, world exports increased at an average annual rate of more than ten times the estimated rate for 1913-1950 (Rostow, 1978, 1992). The volume of world trade in 2004 was about three times what it was in 1990 and approached eleven trillion

U.S. dollars (WTO, 2004a). The dollar value of total world trade in 2004 was greater than the gross national product of every nation in the world except the United States. Another measure of the significance of world trade is that one-fourth of everything grown or made in the world is now exported.

The rapid increase in the growth of world trade after World War II can be traced to increased consumption of goods and services as more people joined the middle class in many countries of the world. Trade liberalization, both at the regional and international level, has created a global environment that is conducive to the growth and expansion of world trade. New technologies such as computers, telecommunications, and other media also assisted in the physical integration of world markets.

Small countries tend to be more dependent on international trade than larger ones because they are less able to produce all that they need. Larger countries (in terms of population) import less manufactured goods on a per capita basis because such countries tend to have a diversified economy that enables them to produce most of their own needs. The previous statement can be exemplified by the case of the United States, Japan, India, and China, which have low import propensities compared to countries such as Belgium or the Netherlands.

Merchandise trade currently accounts for about four-fifths of world trade. The top seven exporters accounted for just over one-half of world merchandise exports (United States, Germany, Japan, France, United Kingdom, Italy, and Canada). Merchandise trade includes three major sectors: agriculture, mining, and manufactures. Trade in manufactured goods has been the most dynamic component of world merchandise trade. In 2004, the value of world merchandise exports was estimated at \$8.91 trillion (U.S.) compared to that of \$2.12 trillion (U.S.) for services. Growth in service exports has lagged behind that of merchandise trade for the past few years. However, during 2000-2004, both merchandise and service exports rose at an average of 9 percent (WTO, 2004a).

Industrial market economies account for the largest part of world trade. Trade among these countries is estimated to be greater than 67 percent of global trade. In view of their role in world trade, Western countries also account for major shares of trade with developing countries and an increasing share of trade with transition economies.

IMPORTANT DEVELOPMENTS IN TRADE

- In 1994, the World Trade Organization (WTO) was established replacing the GATT under the Final Act of the Uruguay Round. Member

countries of the GATT as of the enforcement date of the WTO agreement became original members of the WTO. World Trade Organization became the principal agency of the United Nations (UN) with responsibility for international trade.

- The Final Act of the Uruguay Round was signed in 1994 by 124 governments providing for a global reduction in trade barriers, establishment of a multilateral framework of discipline for trade in services, and protection of trade-related intellectual property rights. The agreement also strengthened existing multilateral rules in agriculture, textiles, and clothing and provided for a more effective and reliable dispute-settlement mechanism. After the implementation of the Uruguay Round, WTO members launched a subsequent round in Doha, Qatar, in 2001 to further reduce trade barriers. The focus of this round has been the reduction of trade distorting agricultural subsidies provided by developed countries and the introduction of equitable trade rules for developing nations.
- There has been a steady growth in the role of developing countries in world trade. In 2004, developing countries accounted for over a third of the world's top twenty-five exporters and importers. Since the 1980s, a number of newly industrializing countries (NICs), particularly the four in the Pacific Rim (Hong Kong, Singapore, South Korea, and Taiwan), and China have greatly increased their roles in world trade. Another significant development is the opening up of China and Eastern Europe for trade and investment.
- China joined the WTO in 2001. Within three years its exports doubled and the country is now the world's third largest exporter/importer of goods and services.
- Over the past few decades, the major emphasis of many developing countries had been on the liberalization of world markets for their exports. Their focus has now shifted from demanding tariff cuts by wealthy countries for their exports to requesting technical assistance to increase production and exports. In 2004, thirty-six countries depend on a single commodity and fifty-two on two commodities for over 50 percent of their export revenue. In view of their domestic economic conditions, the emphasis is on increasing supply/productive capacity and exports.
- There has been a marked increase in the establishment of common markets and free trade areas, thus further increasing economic linkages among nations through trade, investment, and the operation of multinational companies. The most notable examples are the North American Free Trade Agreement (NAFTA), the Asian Free Trade Area, the

Preferential Trade Area for Eastern and Southern American Common Market (MERCOSUR), U.S.–Central America–Dominican Republic Free Trade Agreement (CAFTA-DR), and so on. Many scholars believe that such agreements are inferior to the multilateral, nondiscriminatory approach of the WTO. Bilateral/regional trade arrangements discriminate against nonmembers and create a maze of trade barriers that vary for every exporting country: rules of origin, tariff schedules, nontariff barriers such as quotas, etc. There are concerns that such agreements also work in favor of powerful nations that will sneak in reverse preferences such as protection of intellectual property rights or labor standards.

- Export trade is no longer limited to the big multinational firms. Small and medium-sized businesses are increasing their share of exports and already account for almost a quarter of all exports in the United States. Such firms still represent the largest pool of potential exporters and can play a significant role in improving the U.S. balance of trade, while at the same time enhancing their competitiveness and increasing their profits. These firms also have the advantage of developing much more flexible structures than the big multinational enterprises.
- Given the dynamic role of services in today's economy, trade in services has shown continued growth in most countries. Even though services trade takes place mainly among the industrialized nations, some developing countries have established strong service sectors that are competitive on a global scale in areas such as engineering, construction, tourism, or financial services. The liberalization of services trade (under NAFTA, EU, and WTO), in tandem with the advent of communication and information technology, will inevitably induce an upsurge in services trade. Among the developed countries, the United States has had a healthy surplus in service trade for some years. In 2005, for example, U.S. service exports exceeded imports by \$66 billion, offsetting 8 percent of the deficit in merchandise trade. A few developing nations such as Egypt, India, and Pakistan also have a surplus in their service account, largely resulting from tourism and workers' remittances.
- Today's integration of the world economy is driven by advances in communications and information technology as well as government policies to reduce obstacles to the flow of trade and capital flows. This growing integration of nations has intensified competitive pressures partly because countries have access to similar pools of knowledge and technology. Traditional notions of comparative advantage do not squarely fit with present patterns of production and trade. For example,

even though U.S. comparative advantage lies in high-skilled, high value-added activities, many developing countries such as China and India (with high-skilled, low-cost workforce) are competing in the very products for which the United States has had a global competitive advantage. Such competitive pressures have resulted in the reorganization and relocation of the firm's basic activities overseas, either to affiliate firms or independent contractors. With the reduction of trade barriers and transportation costs, many U.S. firms have outsourced labor intensive work to overseas firms and reimport for final assembly and sale. A number of Western service industries have also started to migrate to low cost locations overseas. This process of outsourcing is likely to have major implications for employment and the structure of international trade flows.

- The U.S. current account deficit reached 7 percent of GDP in the last quarter of 2005. Imports are 60 percent higher than exports. At the same time, the East Asian economies (including Japan) held about \$2.4 trillion (U.S.) in official foreign exchange reserves out of a global total of \$4 trillion. China's foreign currency reserves alone reached \$1 trillion (U.S.) by the end of 2006. The Southeast Asian countries' heavy reliance on exports as a way of sustaining domestic economic growth, weak currencies, and high savings has resulted in unsustainable global imbalances. Global imbalances cannot diminish without, *inter alia*, reducing such excess savings through currency adjustments and/or increased imports in the surplus countries.
- About 60 percent (by value) of total world trade in goods is carried by sea and a substantial increase in fuel costs could act as a disincentive to exports by raising transportation cost. In air transportation (more fuel sensitive than shipping), rising oil prices could severely damage trade in time-sensitive products such as fruits and vegetables, or parts in just-in-time production, etc. Faster economic growth in emerging economies is also putting pressure on the limited supply of other raw materials such as copper, coal, etc.
- After the terrorist attacks of 9/11, there was a marked decline in trans-pacific freight container rates for 2001 and 2002. Since 2002, however, demand for container shipping has grown by over 10 percent per year compared to the thirty-year average of 8 percent. Programs were introduced at domestic and foreign ports to screen the containers. Extra security costs are estimated at about \$18 per typical container. The volume of trade has since grown and traders appear to have coped with new guidelines without sacrificing efficiency or market share.

CHAPTER SUMMARY

Major Benefits of International Trade

To acquire a variety of goods and services, to reduce cost of production, to increase incomes and employment, to learn about advanced technical methods used abroad, and to secure raw materials.

Determinants of Trade

Major determinants of exports. Presence of an entrepreneurial class; access to transportation, marketing, and other services; exchange rates; and government trade and exchange rate policies.

Major determinants of imports. Per capita income, price of imports, exchange rates, government trade and exchange rate policies, and availability of foreign exchange.

Volume of Trade

1. World trade approached eleven trillion (U.S.) in 2004 and was triple what it was in 1990.
2. Services trade accounts for about 25 percent of total trade.
3. Since 1970, average annual growth in world merchandise exports is estimated at about 12 percent.
4. The industrial market economies account for 70 percent of global trade.

Major Developments in Trade

1. The establishment of the World Trade Organization (WTO) as a permanent trade organization.
2. The introduction of rules under the WTO to govern trade in services, trade-related intellectual property, and investment measures.
3. The marked increase in the establishment of regional trading arrangements such as NAFTA, MERCOSUR, etc.
4. Growing role of developing countries in world trade.
5. Increasing participation of small and medium-sized businesses in export trade.
6. The dynamic role of services in today's economy and continued growth in trade in services.
7. Globalization, competitive pressures and the reorganization/relocation of value-added activities.

8. The increasing U.S. current account deficit and global imbalances.
9. Fast economic growth in many countries and pressure on limited resources. Business adjustment to security costs after 9/11.

REVIEW QUESTIONS

1. Discuss the importance of international trade to national economies.
2. What are the major determinants of exports? Why do some countries trade more than others?
3. What is the volume of trade?
4. What are some of the major developments in trade over the past two decades?
5. What are the implications of the increasing U.S. trade deficit for global production and exports?
6. What is the reason behind the increase in common markets and free trade areas over the past few decades?
7. What are the limitations of export-led growth?
8. Why are small countries more dependent on international trade than larger ones?

CASE 1.1. THE LIMITATIONS OF EXPORT-LED GROWTH

International trade played an important role in the economic development of North America and Australia in the nineteenth century and that of East Asian economies in the second half of the twentieth century. East Asia's growth contributed to improve living standards and reduced inequality as the new prosperity was widely shared among its population. In Malaysia and Thailand, for example, the level of poverty was reduced from almost 50 percent in the 1960s to less than 20 percent by 2000.

Central to the success of these countries is the promotion of exports. Governments provided credits, restricted competing imports, and developed export marketing institutions. As they increased their exports to wealthy countries, their economies grew at 7 to 8 percent per year.

The export-led model may have worked for a few countries during the time when most developing countries pursued import substitution policies—substituting domestic production of manufactured goods with the exportation of raw materials. There are a number of limitations to export-led growth

when many countries including China begin to use it. Here are some of its potential limitations:

- It is difficult for all countries to increase exports by 8 to 10 percent per year when the world economy grows at 2 or 3 percent per year. It is not possible for every country to have a trade surplus.
- The major importing nation, the United States, cannot continue to run large trade deficits. U.S. current account deficit set a record of \$790 billion in 2005 (nearly 6.5 percent of GDP). Other potential destinations for global exports, Japan and the European Union, also rely on an export promotion policy to sustain economic growth and are not willing to run large deficits.
- China and other East Asian economies have not taken measures to open their markets in order to absorb increasing exports from the rest of the world. Foreign currency reserves of China, Japan, South Korea, Taiwan, Malaysia, Singapore, and Indonesia were estimated at \$2.22 trillion in 2005. In the absence of other sources of economic growth, focusing on the U.S. market is unsustainable in the long run.
- Many multinational corporations are already experiencing flat or shrinking revenue growth due to reduced demand reflecting the natural limitations of export growth (see Table 1.1).

TABLE 1.1. Average Rate of Revenue Growth for Selected Sectors in the 1990s and 2000s (%)

| Sectors | Industries | Average Rate of Growth, 1990s | Average Rate of Growth, 2000s |
|----------------|--|-------------------------------|-------------------------------|
| Consumer goods | Beverages, tobacco, food items, personal care products | 4.98 | 1.95 |
| Technology | Software, hardware, semiconductors | 13.59 | 3.67 |
| Communications | Telephone service, equipment, cellular/wireless, long distance | 12.53 | 1.53 |
| Health care | Biotechnology, pharmaceuticals, medical products | 14.3 | 9.82 |
| Financial | Banks, investment brokerages | 22.64 | 5.37 |

TABLE 1.1 (continued)

| Sectors | Industries | Average Rate of Growth, 1990s | Average Rate of Growth, 2000s |
|-----------------|-------------------------------------|--------------------------------------|--------------------------------------|
| Energy | Oil, drilling | 2.21 | 20.39 |
| Transport | Air freight, rail, airlines | 5.08 | 2.44 |
| Capital goods | Equipment, aerospace, manufacturing | 9.84 | 1.92 |
| Basic materials | Chemicals, paper, aluminum | 7.53 | 4.69 |
| Utilities | Electric, gas, water | 7.48 | 6.39 |

Source: Adapted from SEC Filings, Moody's Industrial manuals, 2004.

Questions

1. Do you agree with the author's view on the limitations to export-led growth?
2. What other alternatives are available to export-led growth?

