International Trade Strategies

RIDLEY COLLEGE

SINCE 1889

Learning Objectives

Specific Expectations	
AO3	Explain and evaluate trade strategies including: - Import substitution - Export Promotion - Economic integration - Trade liberalization
AO3	Explain and evaluate the strategies of: - Diversification - Social enterprise
AO3	Explain and evaluate market-based policies including: - Trade liberalization - Privatization - Deregulation

Import substitution

- **Import substitution** is a growth strategy where a country begins to manufacture simple consumer goods oriented towards the domestic market (such as shoes, textiles, beverages, electrical appliances) in order to promote its domestic industry.
  - It presupposes the imposition of protective measures (tariffs, quotas) that will prevent the entry of imports that compete with domestic producers.
  - Justified by the infant industry argument recommending the use of trade barriers to protect "infant" domestic firms against competition from imports.
  - Import substitution had the following common characteristics and consequences:

1. **Neglect of agriculture**
   - Agriculture is often neglected and due to the failure to make agricultural investments, there is an increased need for food imports.

Import Substitution

2. **High levels of protection of domestic firms**
   - Lack of competition leads to high costs and inefficiency in private and public sector industries, resource misallocation and high prices for consumer goods.
3. **Overvalued exchange rates**
   - Many countries overvalue their exchange rates (set them at a higher level than the free market level) reducing the price of imports and increasing the price of exports.
   - The objective was to allow firms to import capital inputs more cheaply.
   - Cheap capital imports lead to capital-intensive production methods (inappropriate technologies), unemployment and growth in the informal economy in urban area.
   - It makes agriculture exports more expensive, worsening rural poverty

Import Substitution

4. **Too much government intervention**

   - Most import-substituting countries rely heavily on industrial policies, with strong intervention in the form of protective trade barriers, overvalued exchange rates, subsidized credit, tax allowances, production subsidies, wage subsidies, and price controls.
   - This leads to serious resource misallocation and inefficiencies in production.

5. **Deterioration of the balance of payments**

   - The deterioration of the balance of payments is attributed to several factors.
   - Increasing imports of capital equipment as inputs in production.
   - Increased need for food imports.
   - Outward flow of financial capital due to profit repatriation of foreign multinational corporations (profits taken to the home country).

Import Substitution

6. **Encouragement of capital-intensive production methods**
   - Limited effort to provide support for small entrepreneurs more likely to use labour-intensive techniques.
7. **Negative impact on employment and income distribution**
   - Capital-intensive technologies and neglect of small producer increases unemployment and worsening income distribution and increasing poverty.
8. **Limited possibilities for growth over the longer term**
   - Many firms enjoying protection never "grew up" to become efficient, low-cost producers, firms that should have closed down were kept going, while others that should have been set up or expanded were not.

Export Promotion

- **Export promotion** refers to a growth and trade strategy where a country attempts to achieve economic growth by expanding its exports.
  - As a trade strategy, it looks towards foreign markets and is based on stronger links between the domestic and global economies.
  - **Example:** Hong Kong, Singapore, South Korea, Taiwan are known as the *Asian Tigers* and extensively used export-promotion.
  - Some typical policies include:

  1. **Financial assistance to targeted key industries**
     1. **Targeting of export industries** – utilization of increasingly higher skill and technological levels.
     2. **Industrial policies to support export industries** – including investment grants, production subsidies, export subsidies, and special benefits for export oriented multinational corporations.

Export Promotion

iii. **Incentives for R&D in technology** – encourages the development of domestic skills and technologies to local conditions.

2. **Strong government intervention in economy**

   i. **State ownership and control of financial institutions** – provision subsidized credit to industries being promoted, such as lower interest rates and other favourable borrowing terms.

   ii. **Large public investment in key area** – including education and skills, R&D, and expansion and modernization of transport and communication infrastructure.

3. **Requirements imposed on multinational corporation** – intended to maximize the benefits of foreign direct investments, such as the promotion of R&D, transfer of desired and targeted technologies into the domestic economy, training of domestic workers, and the use of local input.

4. **Exchange rate management** – involving undervaluing currencies that encourage exports while making imports more expensive.

Export Promotion- Advantages and Disadvantages

- Factors being the success of export promotion include,

  1. **Expansion into foreign markets** – taking advantage of economies of scale.
  2. **Emphasis on diversification** – beginning with support for simple labour-intensive goods (for example, textiles and clothing), industrial policies later support the diversification based on increasing skill and technological levels.
  3. **Major investments in human capital** – including education, training and skills.
  4. **Appropriate technologies** – government supported R&D for the development of appropriate technologies, as well as transfer from abroad of technologies to local conditions.
  5. **Increased employment** – resulting from the use of labour-intensive technologies.

Export Promotion - Advantages and Disadvantages

6. **No balance of payment problems** – due to significant increases in exports and export earnings.

- Possible disadvantages of export promotion,

1. **Dependence of exports** – exporting countries may become overly dependent on exports so that in the event of a recession in the major trading partners, exports will fall leading to a drop in aggregate demand with consequent recession.

2. **Efforts to maintain low wages** – there may be efforts to maintain low wages to keep labour costs low thus making exports more competitive; hence workers may not benefit from growth that exports make possible.

3. **Strong exports** – over a long period of time lead to a trade surplus corresponding to trade deficits in trading partners, possibly leading to trade protection by the trading partners.

Diversification

- **Diversification** involves a reallocation of resources into new activities that broaden the range of goods or services produced.
  - As a country grows and develops, the relative share of the primary sector in GDP usually shrinks, becoming progressively replaces by manufacturing (industry).
  - The decline in the relative share of the primary sector's contribution to GDP is made possible by **diversification** of production into manufacturing services with exports likely to become more varied.
  - The concepts of "value-added" refers to the value of a good that is added in each step of a production process.
  - Adding value in diversification is important because it means:
    - Engaging in more varied production activities
    - Creating employment opportunities
    - Establishing new firms involved with manufactured goods
    - Expanding into activities requiring higher skill and technology levels

Diversification – Advantages

- Diversification permits countries to achieve the following important objectives:

  1. **Sustained increase in exports** – increased in exports must be maintained over longer periods. This can only be achieved through diversification into markets with a sustained increase in global demand.
  2. **Development of technological capabilities and skills** – diversification provides incentives to acquire new technologies and higher training, education and skill levels, which are very important for growth and development.
  3. **Reduced vulnerability to short-term price volatility** – diversification protects countries against loses from fluctuating export prices.
  4. **Use of domestic primary commodities** – countries that already produce primary products are in a strong position to use these as the basis for their diversification into manufacturing.

Social Enterprise

- **Social enterprise** a type of commercial organization that aims to achieve particular social goals in an effort to improve people's well-being and promote social change.
  - May be either for-profit or not-for-profit organizations
  - If they are for profit their primary objective is to achieve their social goals, not to maximize profit.
    - They try to be commercially viable (cover all their costs) rather than rely on grants or donations, by selling the services or products they provide.
    - If they make profits these are put back into the enterprise rather than received as profit income by owners.
  - Provision of **microfinance**, banking service provided to unemployed or low-income individuals or groups who otherwise would have no other access to financial services, is considered to be a type of social enterprise.

Market-based policies

- The free-market approach to growth and development includes:

  1. **Trade liberalization** – involving moving to free trade by lowering and eliminating tariff and other barriers to trade.
  2. **Privatization of state enterprises** – involving the transfer of ownership from the public sector (the government) to the private sector.
  3. **Deregulation** – adopting marker-based supply-side policies for labour (reducing labour union power and unemployment benefits, reducing or eliminating minimum wages); it also means removing barriers to enter product markets.
  4. **Encouraging floating exchange rates**
  5. **Reduced restrictions to foreign direct investments by MNCs** – encourages increases in FDI.
  6. **Limited government borrowing** – keeping budget deficits under control.

Trade and Market Liberalization - Government Intervention

- Generally, a combination of government intervention combined with free-markets is the most effective strategy for growth and development.
  - Governments must support education, health services and infrastructure development, as well as research and development (R&D) and transfer of technology for both industry and agriculture.
  - Large budget deficits should be avoided, but if contractionary fiscal policy is needed, it should not affect spending on education, health and infrastructure.
  - Governments must pay attention to the effects of policies on income distribution, and must pursue policies that promote income equality and alleviation of poverty.
  - Governments must provide a proper regulatory framework for markets to work effectively; there should be effective regulation for competition.
  - Efforts must be made to promote institutions such as property and land rights, an effective tax system, and effective banking and credit system.

Trade and Market Liberalization - Government Intervention

- Developed countries must assist economic development by increasing foreign aid and providing increased access to their markets for developing country exports.
- Developing countries should receive special treatment by international agreements under the World Trade Organization regarding removal of rich country trade protection measures.
- Government intervention is important to help create the conditions for markets and trade to work to the advantage of developing countries.