



## Globalization and International Trade

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“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 1994 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

stem from the increased access of their producers to larger, international markets. For a national economy that access means an opportunity to benefit from the international division of labor, on the one hand, and the need to face stronger competition in world markets, on the other. Domestic producers produce more efficiently due to their international specialization and the pressure that comes from foreign competition, and consumers enjoy a wider variety of domestic and imported goods at lower prices.

In addition, an actively trading country benefits from the new technologies that “spill over” to it from its trading partners, such as through the knowledge embedded in imported production equipment. These technological spillovers are particularly important for developing countries because they give them a chance to catch up more quickly with the **developed countries** in terms of **productivity**. Former centrally planned economies, which missed out on many of the benefits of global trade because of their politically imposed isolation from market economies, today aspire to tap into these benefits by reintegrating with the global trading system.

But active participation in international trade also entails risks, particularly those associated with the strong competition in international markets. For example, a country runs the risk that some of its

industries—those that are less competitive and adaptable—will be forced out of business. Meanwhile, reliance on foreign suppliers may be considered unacceptable when it comes to industries with a significant role in national security. For example, many governments are determined to ensure the so-called food security of their countries, in case food imports are cut off during a war.

In addition, governments of developing countries often argue that recently established industries require temporary protection until they become more competitive and less vulnerable to foreign competition. Thus governments often prohibit or reduce selected imports by introducing quotas, or make imports more expensive and less competitive by imposing tariffs. Such protectionist policies can be economically dangerous because they allow domestic producers to continue producing less efficiently and eventually lead to economic stagnation. Wherever possible, increasing the economic efficiency and international competitiveness of key industries should be considered as an alternative to protectionist policies.

A country that attempts to produce almost everything it needs domestically deprives itself of the enormous economic benefits of international specialization. But narrow international specialization, which makes a country dependent on exports of one or a few goods, can also be

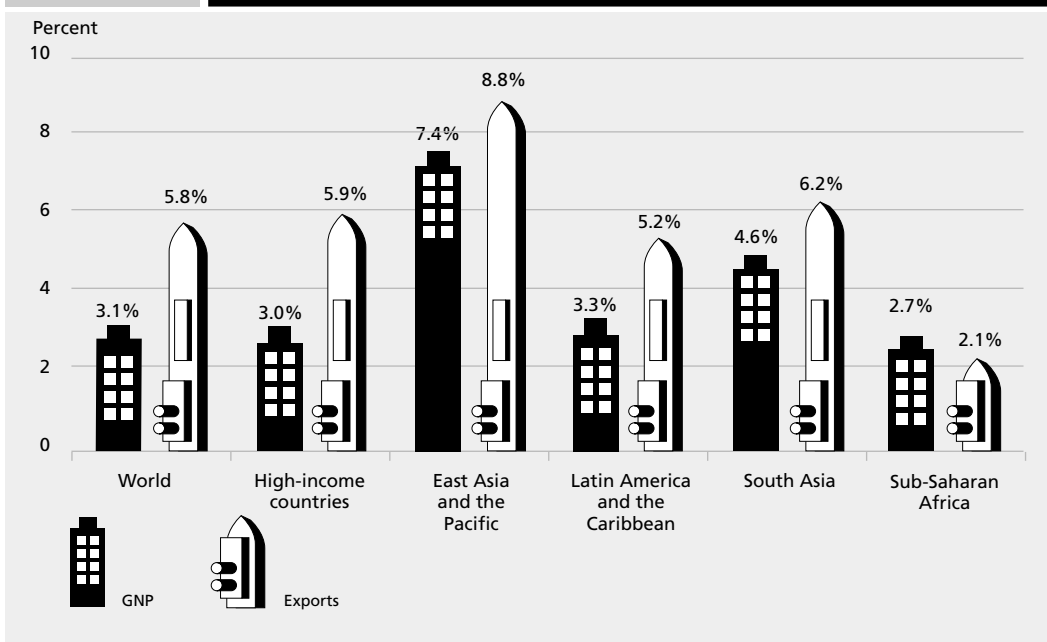
risky because of the possibility of sudden unfavorable changes in demand from world markets. Such changes can significantly worsen a country's **terms of trade**. Thus some diversification of production and exports can be prudent even if it entails a temporary decrease in trade. Every country has to find the right place in the international division of labor based on its **comparative advantages**.

The costs and benefits of international trade also depend on factors such as the size of a country's domestic market, its natural resource endowment, and its location. For instance, countries with large domestic markets generally trade less. At the same time, countries that are well endowed with a few natural resources, such as oil, tend to trade

more. Think of examples of countries whose geographic location is particularly favorable or unfavorable for their participation in global trade.

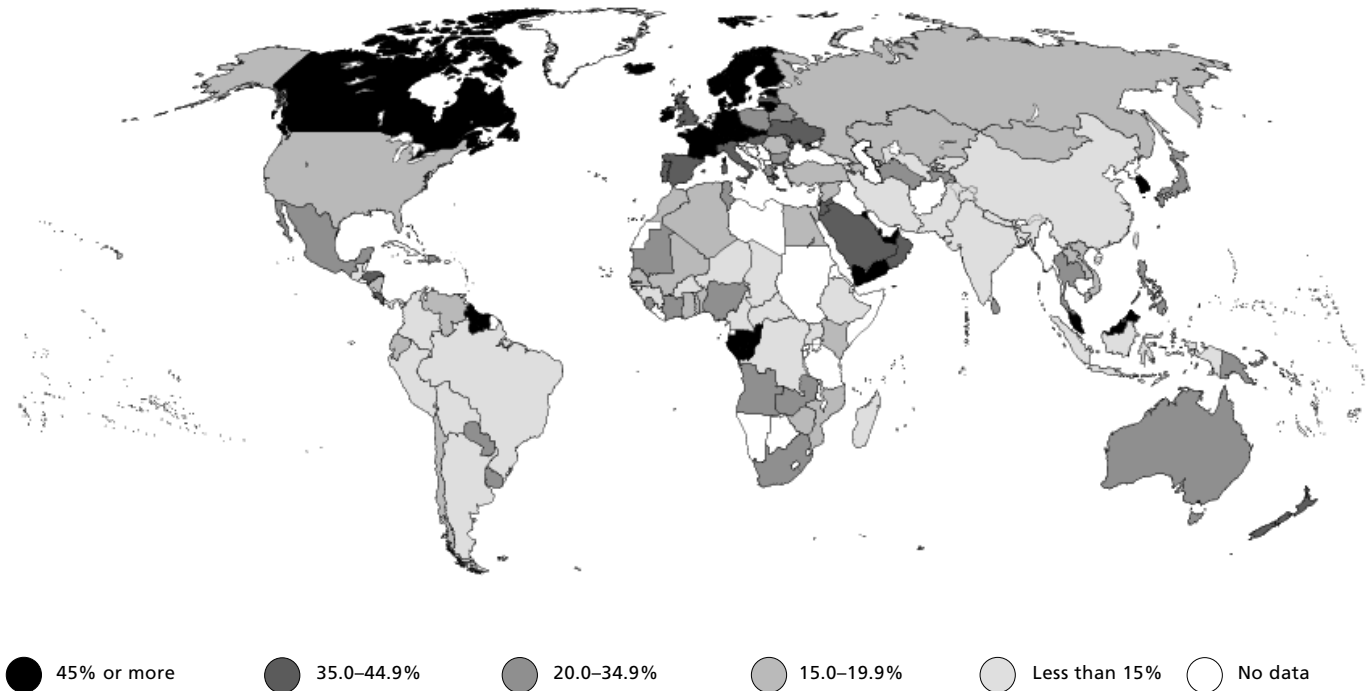
Despite the risks, many countries have been choosing to globalize their economies to a greater extent. One way to measure the extent of this process is by the ratio of a country's trade (exports plus imports) to its GDP or GNP. By this measure, globalization has roughly doubled on average since 1950. Over the past 30 years exports have grown about twice as fast as GNP (Figure 13.1). As a result, by 1996 the ratio of world trade to world GDP (in purchasing power parity terms) had reached almost 30 percent—on average about 40 percent in developed countries and about 15 per-

**Figure 13.1** Average annual growth rates of GNP and exports of goods and services, 1965–96



Map 13.1

Trade as a percentage of real GDP, 1996



Note: The ratio of trade to purchasing power parity-adjusted GDP is considered the best available tool for comparing integration with the world economy across countries. But the use of this tool is complicated by the different shares of the service sector in the economies of different countries. For example, developed countries appear to be less integrated because a larger share of their output consists of services, a large portion of which are by their nature nontradable.

cent in developing countries (Map 13.1 and Data Table 3).

### Geography and Composition of Global Trade

Over the past 10 years patterns of international trade have been changing in favor of trade between developed and developing countries. Developed countries still trade mostly among themselves, but the share of their exports going to developing countries grew from 20 percent in 1985 to 22 percent in 1995. At

the same time, developing countries have increased trade among themselves. Still, developed countries remain their main trading partners, the best markets for their exports, and the main source of their imports.

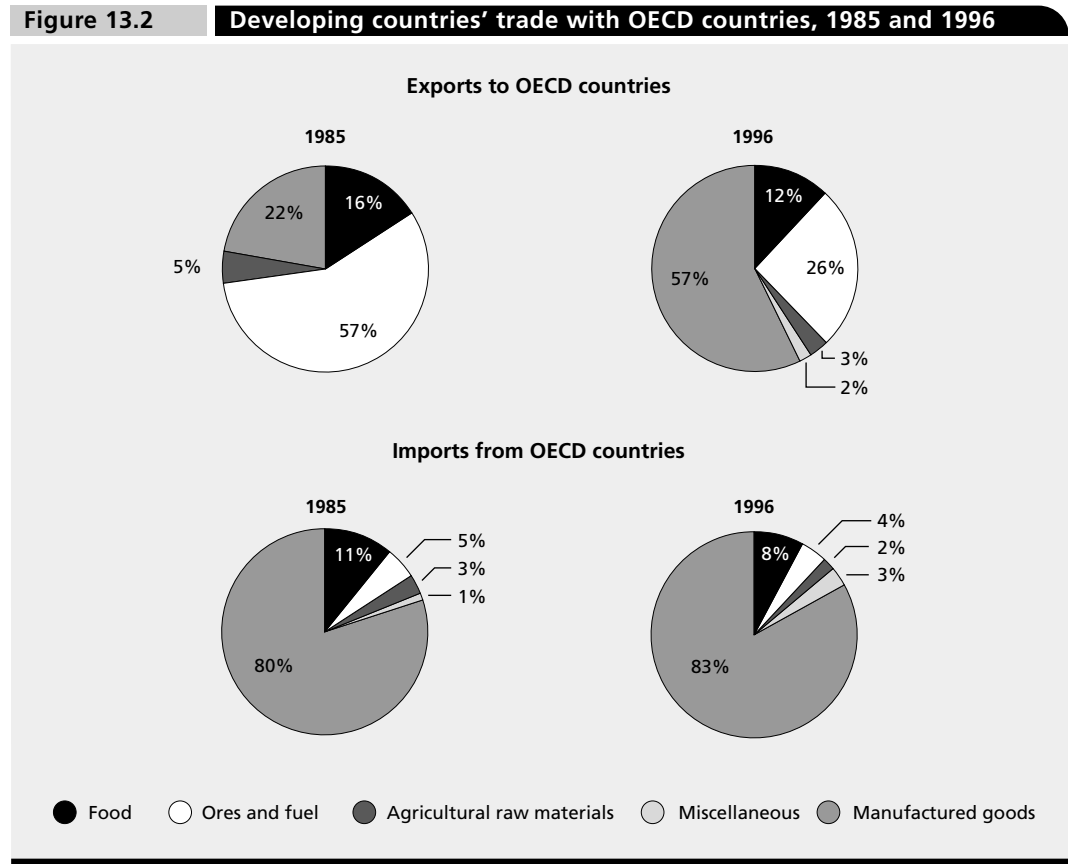
Most developing countries' terms of trade deteriorated in the 1980s and 1990s because prices of **primary goods**—which used to make up the largest share of developing country exports—have fallen relative to prices of **manufactured goods**. For example, between 1980 and 1995 **real prices** of

oil dropped almost fourfold, prices of cocoa almost threefold, and prices of coffee about twofold. There is still debate about whether this relative decline in commodity prices is permanent or transitory, but developing countries that depend on these exports have already suffered heavy economic losses that have slowed their economic growth and development.

In response to these changes in their terms of trade, many developing countries are increasing the share of manufactured goods in their exports, including exports to developed coun-

tries (Figure 13.2). The most dynamic categories of their manufactured exports are labor-intensive, low-knowledge products (clothes, carpets, some manually assembled products) that allow these countries to create more jobs and make better use of their abundant labor resources.

By contrast, developing countries' imports from developed countries are mostly capital- and knowledge-intensive manufactured goods—primarily machinery and transport equipment—in which developed countries retain their comparative advantage.<sup>1</sup>



## Trade Issues in Transition Economies

Countries in transition from planned to market economies have recognized the potential benefits of global integration, and most have significantly liberalized their trade regimes. As a result many Central and Eastern European countries saw the share of trade in GDP increase from 10 percent or less in 1990 to 20 percent or more in 1995. In Russia and other countries of the former Soviet Union the ratio of trade to GDP fell during this period, but this was a result of the collapse of trade within the former Soviet Union—trade with the rest of the world actually expanded. As market-determined patterns of trade replace government-determined patterns, a massive reorientation of trade is under way favoring closer links with established market economies.

Trade among transition countries is also recovering following a sharp, politically motivated decline at the start of the transition. A number of regional economic integration initiatives are unfolding—the Baltic Free Trade Area (comprising Estonia, Latvia, and Lithuania), Central Europe Free Trade Area (the Czech Republic, Hungary, Poland, the Slovak Republic, Slovenia, and countries of the Baltic Free Trade Area), and free trade initiatives within the Commonwealth of Independent States. One of these initiatives started in 1995 with negotiations about establish-

ing a customs union for four members of the Commonwealth of Independent States—Russia, Belarus, Kazakhstan, and the Kyrgyz Republic. Russia and Belarus have since signed a treaty on forming an Interstate Commonwealth.

Regional trade blocs can contribute to transition countries' economic stabilization but they also carry risks of diverting trade from potentially more beneficial trade partnerships with other countries. Ten transition countries in Central and Eastern Europe and the Baltics have applied for membership in the **European Union**, and nearly all transition countries have applied to join the World Trade Organization (WTO). Membership in the WTO would provide these countries with protection from substantial barriers—particularly quotas—which still impede their exporting of so-called sensitive goods to developed countries. Among these goods are agricultural products, iron and steel, textiles, footwear, and others in which transition economies may have comparative advantages. Joining the WTO would not only confer rights on transition economies, it would also require them to meet certain obligations, such as maintaining low or moderate tariffs and abolishing nontariff barriers.

A major challenge for transition economies is finding their place in the worldwide division of labor. In many cases that implies diversifying the structure of exports, particularly to developed

countries. Some former Soviet Union countries are narrowly specialized in the production and export of a small number of commodities, such as cotton in Turkmenistan and Uzbekistan and food products in Moldova. For others, such as Russia and Belarus, the biggest problems are the quality and international competitiveness of their manufactured goods.

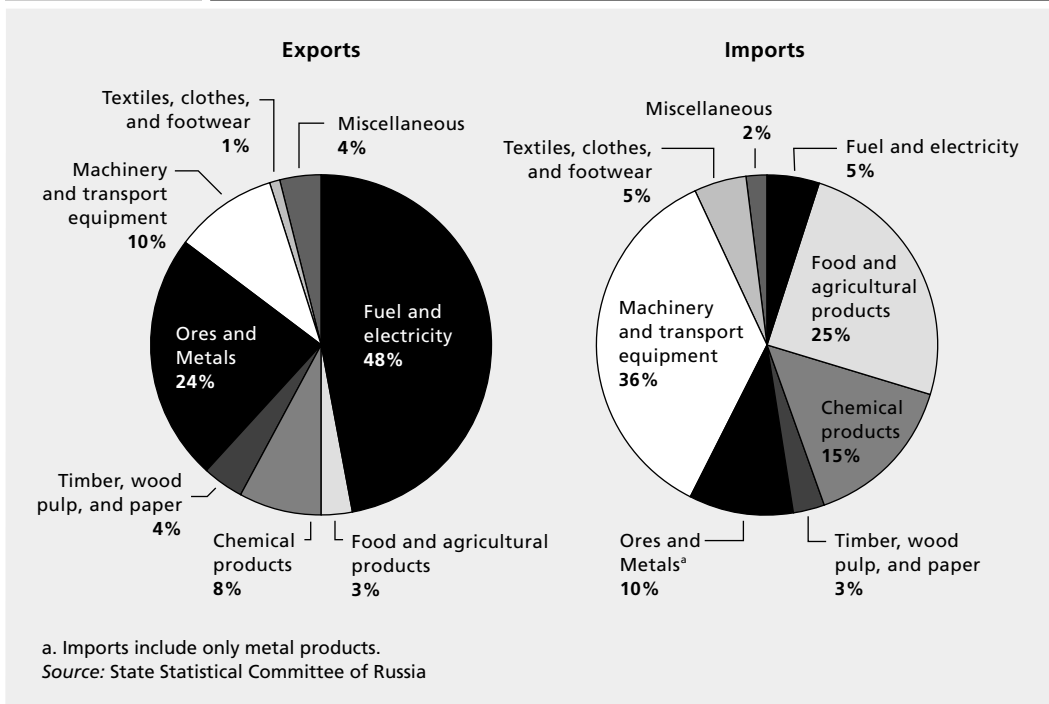
*An inability to meet world standards in the quality of many of its manufactured goods is the main reason Russia's exports are dominated by primary goods, especially oil and gas (Figure 13.3). This dependence on exports of primary goods makes Russia's terms of trade extremely unstable. For example, during the 1970s world energy*

*prices increased sharply and boosted the USSR's export receipts. But during the 1980s and 1990s oil and gas prices plummeted and Russia's terms of trade deteriorated significantly. Thus Russia needs to diversify its exports by increasing the share of manufactured goods. As for imports, Russia could arguably benefit from decreasing the share of food and increasing the share of machinery and equipment, which would help modernize domestic manufacturing and improve the quality of its manufactured goods.*

#### Note

1. A popular debate in many developed countries asks whether the growing competitive

**Figure 13.3** Russia's foreign trade, 1997



pressure of low-cost, labor-intensive imports from developing countries pushes down the wages of unskilled workers in developed countries (thus increasing the wage gap between skilled and unskilled workers, as in the United Kingdom and United States) and pushes up unemployment, especially among low-skill workers (as in Western Europe). But empirical

studies suggest that although trade with developing countries affects the structure of industry and demand for industrial labor in developed countries, the main reasons for the wage and unemployment problems are internal and stem from labor-saving technological progress and postindustrial economic restructuring (see Chapters 7 and 9).