The Global Economy—MALS

Unit 7: Trade with the Poor

Introduction

The impacts from trade between rich nations such as the US and Germany and Japan, and between rich and poor nations such as the US and Mali or Sudan are quite different. While we are made richer by both kinds of trade, trade between rich nations tends to be based on differentiated products within similar industries. Trade between rich and poor nations tends to be based on comparative advantage—that is, it depends on differences in natural resources, labor skills, and so on. In this unit, we look briefly at theories of economic development, and then explore the impact of trade between rich and poor nations on labor and the environment.

Part 1: Development Growth Theory—ISI, Export Lead Growth, and the Washington Consensus

Import Substitution Industrialization

During the "old economic order"—prior to World Wars I and II—the theory of comparative advantage held that industrialized countries should specialize in the production of manufactured goods, while developing countries specialized in the production and export of primary products—agriculture, minerals, forests, etc. Typically, though, the manufacturing/extraction processes associated with these primary products were controlled by the outside interests of First World nations. Or, when the industry was entirely domestically owned, it brought wealth to only a small "elite" social class. Because of the perceived inequity of such policies, and despite the fact that these exports brought in much needed foreign revenue, the economics of comparative advantage was viewed with suspicion by many in the Third World, particularly in Latin America.

Two developments beginning around World War II made economic specialization in primary products untenable for developing countries:

- First, the war itself forced the industrialized countries to shift production **from a civilian consumer market to a wartime military market**. Tanks and guns were produced in place of automobiles and kitchen appliances. This left many developing countries, which had come to depend upon foreign manufactured consumer goods, vulnerable to shortages.

- Second, a long-term trend of **declining real prices for primary products** began after World War II. This development meant that Third World countries specializing in primary products received less and less foreign exchange from trade, and therefore had to produce more and more for export just to keep even.

Both of these developments led many Third World leaders to decide to promote domestic industrialization as a means to reduce their country's economic dependence on, and vulnerability to, the First World economies. **Import substitution industrialization (ISI)** became the policy strategy they pursued to gain this independence.

Home production and protectionism. ISI is a form of industrial policy that focuses on those industries that produce substitutes for imported goods. One of the most important roles of import substitution is to reduce the need for foreign exchange—which, at the time, was becoming more and more expensive—by producing goods at home instead of buying them from abroad. ISI theorists argued that a country should begin by producing inexpensive and relatively simple consumer items, such as toys and clothing, and then gradually target the production of more complex industrial goods, such as electronics. They also advocated the use of protectionist policies, such as government monopolies and subsidies, and import restriction mechanisms like tariffs and quotas, in order to shelter their newly created industries from international competition.

Initial success. At first, these policies had success. Per capita GDP in many Latin American nations—where ISI was most aggressively pursued—rose steadily throughout the 1960s and 1970s, and, in general, people were better off. This did not last, however, and in the 1980s (often referred to as the lost decade) the economies of Latin America unraveled, with many nations experiencing negative real economic growth and triple digit inflation. So what went wrong? Why did ISI fail?

Criticisms of ISI. The two most common criticisms of ISI and citations for its failure are (1) inefficiencies caused by too much government involvement in production decisions, and (2) inefficiencies caused by currency controls that kept exchange rates overvalued.

The problem of overconfidence. The biggest difficultly with ISI is the overconfidence that governments exhibit in their belief that they can direct resources to their best uses. In the early years of ISI, leaders of developing nations assumed that their markets had inherent externalities, or failures, and that industrial policy—which encouraged certain industries while discouraging others—was the necessary fix. While this approach is not altogether wrong, it relies on a certain competency in decision making which was largely absent at the time. For in reality, government officials are not selfless individuals, and corruption and lobbying by the elite easily distorted the stated goal of market efficiency. In the end, powerful groups ended up dictating the policies of ISI for their own means, and not the good of the nation.

Currency overvaluation. The second problem—which too is linked to the power and corruption of the elite—was the persistent and often deliberate currency overvaluation which seemed to go hand in hand with ISI. As a deliberate policy, overvaluation accomplished several goals:

- It made it easier for industries the government targeted for growth to obtain the necessary imported manufacturing equipment.

- It helped the elite maintain political alliances with the urban middle class by increasing their purchasing power abroad, keeping living standards higher than they otherwise would have been.

The impact of these high exchange rates, however, also had great costs, particularly for the rural sectors of the population.

- Strong currency valuation made it difficult for the agricultural sectors of ISI economies to export their comparative advantage.

- And even when they could export, the purchasing power of the foreign exchange they received was too low.

Falling incomes increased rural poverty, resulting in Latin American nations experiencing some of the largest income gaps in the world. Furthermore, the lack of competition thwarted innovation and investment in new technology, causing Latin American industries to fall further and further behind the productive capacity of the rest of the world.

Export Lead Growth

While the economies of Latin America sought ISI isolationist policies of self-sufficiency throughout the post-war era, the high performing Asian economies (HPAE's) of Hong Kong, Indonesia, Japan, Singapore, Malaysia, South Korea, Taiwan, and Thailand began to take a fundamentally different approach. Rather than focusing on industries to relieve their reliance on imports, the HPAE's gradually began shifting the focus of their industrial polices toward the targeted development of manufacturing-based export industries. To achieve this objective, they pursued policies that encouraged (1) schooling and worker training, (2) increases in savings and investment, and (3) fiscal restraint. And the policies worked. The income gap between the rich and the poor fell as workers left their rural communities to fill the needs of the higher paying urban manufacturing plant. Productivity and efficiency improved, and living standards rose. With the onset of a financial crisis in the mid-1990s, however, the "miracle" policies of the HPAE's became suspect by institutions like the IMF and World Bank.

The "Washington Consensus" on Economic Development and Policy Reform

The "Washington Consensus" is a set of economic policies initially aimed at Latin America that has most recently become the prevailing development strategy throughout the world. (The "Washington" part of the name refers not only to the home of the US government, but also to the headquarters of the IMF and World Bank.) Initially, the list of policies had broad consensus among both conservative and liberal economists.

The list of "Consensus" policies includes five macroeconomic and five microeconomic components:

Macroeconomic components:

1. Avoid large budget deficits.

2. Spend public money on health, education, and basic services rather than giving it to special interests or huge projects.

3. Cut taxes, but tax a wider range of activities and make the collection system effective.

4. Make certain interest rates are greater than inflation rates and that no one is given special, preferential rates.

5. Make the exchange rate competitive and credible.

Microeconomic components:

1. Use tariffs if protectionism is necessary, and gradually reduce them.

2. Encourage foreign direct investment.

3. Privatize state enterprises in activities where markets work.

4. Remove barriers to competition which keep firms out of industries.

5. Guarantee the security of property rights.

Over time, however, the "Consensus" has evolved beyond a list of policies and taken on a controversial life of its own. It has been interpreted by supporters of neoliberal free-market policies as a government "to do" list that emphasizes the idea that government should be as small as possible and pursue market-based outcomes wherever possible. On the other hand, the left has increasingly questioned this interpretation, believing the pursuit of "Consensus" policies along side active industrial policy to be perfectly consistent.

Crisis in Asia. The height of the debate over "Consensus" policy came during the financial crisis in S.E. Asia in the 1990s. Neoliberals argued the lack of "Consensus" policy was the cause of the crisis, while the left countered by arguing that it was these very industrial policies—which were now under attack by "Consensus" advocates—that lead to the astounding "Asian Miracle" of economic growth in the first place.

VIDEO: ISI and Export Lead Growth I

VIDEO: ISI and Export Lead Growth II

Part 2: The Environment

Global economic growth requires increased use of energy and natural resources, often causing adverse environmental effects. While developed economies have imposed relatively stringent environmental protection laws, less developed economies generally have only limited regulations concerning the protection of their environment.

Environmental advocacy groups argue that international trade results in eco-destructive production being shifted to countries with the least restrictive regulatory standards, since this is where the lowest production costs for such firms will be realized. Furthermore, they suggest that increased trade liberalization will make it more difficult for eco-conscious countries to enact stricter environmental laws, since such a move would reduce their ability to compete in international markets.

Advocates of free trade, however, note that the demand for environmental protection rises as countries develop. Individuals who are hungry tend to be more concerned about where their next meal is coming from than about air and water quality. Since free international trade is expected to encourage economic development, it is argued that international trade encourages increased environmental protection.

Those who support free trade also observe that increased trade is often accompanied by increased foreign direct investment. Since foreign direct investment generally involves a technology transfer from developed to less developed economies, developing economies usually adopt the relatively "cleaner" production methods in use in developed economies. This argument suggests that free trade encourages the adoption of more environmentally sound production processes in developing economies.

WEBSITE: For information in the relation between the WTO and the environment visit:

Harvard University Center for International Development

AUDIO: Click here to hear an NPR story on the Russia to Ratify Kyoto Climate-Change Treaty.

http://www.npr.org/templates/story/story.php?storyId=4121843

Part 3: A Tragedy of the Commons Exercise

Experiment Rules

1. This is an experiment in holding property in common. You will play over three rounds with several moves each round.

2. You are a member of a community that jointly owns a resource. The resource is pumpkins. Your field starts with ______ pumpkins on it. This is the carrying capacity of this field; it can never hold more than this amount.

3. In this experiment, each of you will be asked to record the number of pumpkins you wish to harvest. No one may harvest more than 20 pumpkins in a round. And you may **NOT** try to influence how much another member harvests.

4. Everyone's harvest will be revealed simultaneously after everyone has chosen.

5. If the total desired harvest exceeds the number of pumpkins in the field, everyone will get a prorated share of the total harvest (ie, your desired harvest multiplied by the number of pumpkins in the field divided by the total desired harvest).

6. After the harvest, the pumpkins left in the field will reproduce, provided that there is enough genetic diversity for reproduction. That is, there must be at least eight pumpkins left.

7. If there are at least eight left, then each pumpkin will have one offspring, so that the total pumpkins in the field will double if the carrying capacity permits. Keep in mind that the carrying capacity is _____ pumpkins.

8. After the harvest reproduces, there will be a new round in which you decide again how many pumpkins you want to harvest.

9. However, if there are less than eight pumpkins left at the end of any round, there is not a sufficient population for reproduction. The population crashes and the experiment ends. The experiment will continue for a specific number of moves unless the population crashes. However, you will not know how many moves the game will last.

Round 1. In Round 1 you will decide on your own how many pumpkins you want to harvest. You may not discuss or try to influence the other players.

Round 2. In Round 2, you may set ground rules and try to influence how much other players harvest.

Round 3. In Round 3, you will be given a portion of your own, and may decide how many pumpkins to harvest.

Part 4: Impact on Labor in Developing Nations

One of the most contentious issues surrounding globalization is the impact it has on labor, particularly when the trade takes place between developed and developing nations. Critics argues that trade with developing nations results in the outsourcing of American jobs to laborers in the Third World who are "forced" to work in sweatshops that abuse their basic human rights.

AUDIO CLIPS: The following audio clips present the arguments against outsourcing.

- Overseas Outsourcing: A Trend with No End?
  02-12-04, NPR, Morning Edition

- Wisconsin Fights Outsourcing of State Jobs
  01-27-04, NPR, Morning Edition

- Benefits of Overseas Outsourcing Questioned
  12-18-03, NPR, Morning Edition

Proponents, on the other hand, argue that such relocation is a natural progression of economic growth that, ultimately, will lead to higher living standards for all.

- Thomas Friedman, 'The Other Side of Outsourcing'
  06-03-04, NPR, Fresh Air

- Foreign Firms Adding Jobs to U.S.
  03-18-04, NPR, Morning Edition

The anti-sweatshop movement (e.g. Scholars Against Sweatshop Labor, Sweatshop Watch) in the United States has received headline coverage by exposing the working conditions in factories where many celebrity icons' clothing lines are produced. For example, they showed that Kathie Lee Gifford's clothing company had employed Honduran sweatshop workers to produce her line of clothing for Wal-Mart. According to their evidence, the typical workweek in these factories was 75 hours, and nearly 10% of those employed were between the ages of 13 and 15.

WEBSITE: Scholars Against Sweatshop Labor

WEBSITE: Sweatshop Watch

Several organizations have been created or have expanded their roles in hopes of addressing the concerns raised by the anti-sweatshop activists (and general public). The Workers Rights Consortium (WRC), the Fair Labor Association (FLA), and the International Labor Organization (ILO) all serve to monitor working conditions in less developed countries.

WEBSITE: Workers Rights Consortium (WRC): http://www.workersrights.org/

WEBSITE: Fair Labor Association (FLA)

WEBSITE: International Labor Organization (ILO)

Many anti-sweatshop advocates encourage boycotts of items produced in sweatshop working conditions, arguing that such boycotts will force foreign companies to improve pay and working conditions. The opponents, however, argue that workers freely choose to work in sweatshops, and that consumer behaviors which reduce demand for the products produced in these factories will simply reduce the demand for labor in these economies, resulting in lower wages.

WEBSITE: For information in the relation between the WTO and labor visit:

Harvard University Center for International Development

VIDEO: Put Your Money Where Your Mouth Is If You Want Change I

VIDEO: Put Your Money Where Your Mouth Is If You Want Change II

Weblinks

During your reading of UNIT 7 the following weblinks were presented. Read them now if you have not already done so.

Harvard University Center for International Development

Russia to Ratify Kyoto Climate-Change Treaty:
http://www.npr.org/templates/story/story.php?storyId=4121843

Overseas Outsourcing: A Trend with No End?

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Workers Rights Consortium
http://www.workersrights.org/

Fair Labor Association

International Labor Organization

The relation between the WTO and labor:
Harvard University Center for International Development