Day Two & Three

Globalisation:

The Driving Force of the 21st Century

G*lobal* ***E****conomic* ***G****rowth*

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Content:

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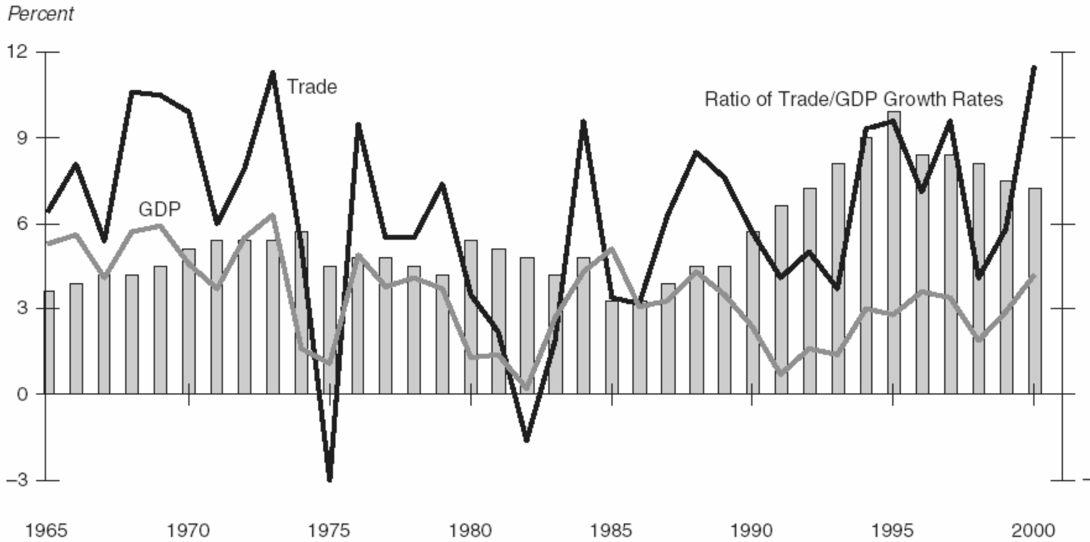
Summary

The Conferderation of British Industry (CBI) has been asked to produce a report covering the economic growth in world trade since 1970. Attention is paid to sectoral, geographic shifts and the effects of regional trade blocks on world trade, including possible reasons.
Trade has been growing considerably since 1970. Organisations such as the WTO are constantly trying to enhance trade by eliminating trade barriers and promoting trade liberalization, with success. Several studies show a link between trade growth and a nation's prosperity/ GDP which makes it desirable for every nation and especially developing economies to make use of its individual comparative advantage and contribute to everyone's benefit. Various factors determining trade growth will be discussed and evaluated.

International Trade flows since 1970

"International trade is the exchange of goods and services between countries. It enables countries to obtain some goods and services more cheaply than they could produce them for themselves (comparative advantage), or be able to consume goods and services which would otherwise be unattainable from domestic supply sources. Through trade countries can capitalise on their economic strengths." (Pass. C, Lowes. B, Davies. L (1988) *Dictionary of Economics*)

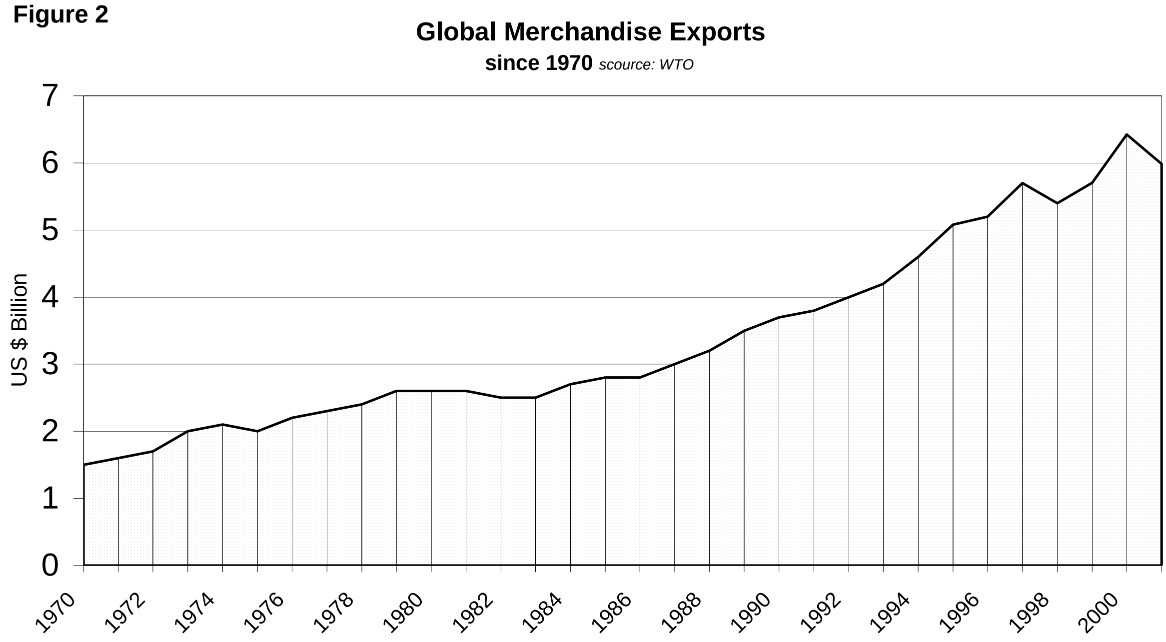
Figure 1 Trade versus GDP growth



Note: Trade is defined as the average of real exports and imports of goods and nonfactor services. Trade-to-GDP growth-rate ratio is based on five-year moving average.
Source: World Bank staff estimates.
adapted from World Bank. 2000. Global Economic Prospects and the Developing Countries 2001. Washington DC: World Bank

Figure 1 shows the annual trade and GDP growth rates (in %) since 1965 against a ratio of trade/GDP. It is obvious that that the growth in trade has hardly slowed down (been negative) except for 1975 and 1982, this being most likely linked to the oil-crises. And it appears that trade growth is linked with Output or vice versa. It is also notable that trade has been growing faster than GDP in the great majority of time, shown by the constant positive trade/GDP ratio. However growth has not been constant or steady. Trade is linked to a wide variety of economic factors, such as Oil prices, politics, the business cycle etc. and shows a corresponding volatility throughout.
Recently trade growth reached a record high of 13% in 2000, but after the 9/11 Terrorist Attacks and the crash of the new economy in 2001, trade grew by only one percent.

Figure 2



A steep increase in world trade and foreign direct investment can be noted in the nineties (see fig. 2). Until 1994 GATT (General Agreement on Tariffs and Trade) had been the international trade framework, which, in the course of the Uruguay Round (1986-94), was then incorporated and succeeded by the WTO (World Trade Organisation). The WTO establishes the rules of the trade policy game for its members (currently 144 member states, but more than 50 developing countries have yet to join the WTO, more than 90% of world trade is covered by the WTO framework). The trading system was extended to include agriculture, textiles, clothing, services (GATS), intellectual property (TRIPs) and trade-related investments (TRIMs).
With the final act signed on April 15th 1994 in Marrakech the WTO entered into force in January 1995, 'almost fifty years after the original proposal to create an international trade organization'
This '*landmark in the history of the trading system*'[18] shows clearly in the world trade balance. Trade liberalization (i.e. removed trade barriers and the ability to trade with any country) enables nations to take advantage of their individual comparative advantage and trade without a distortion of prices by tariffs, taxes or quotas. Trade is also enhanced by multilateral agreements promoted by the WTO. These enable countries to export to, and import from all other member nations. Fig 3 shows clearly the decrease in tariffs since 1980.

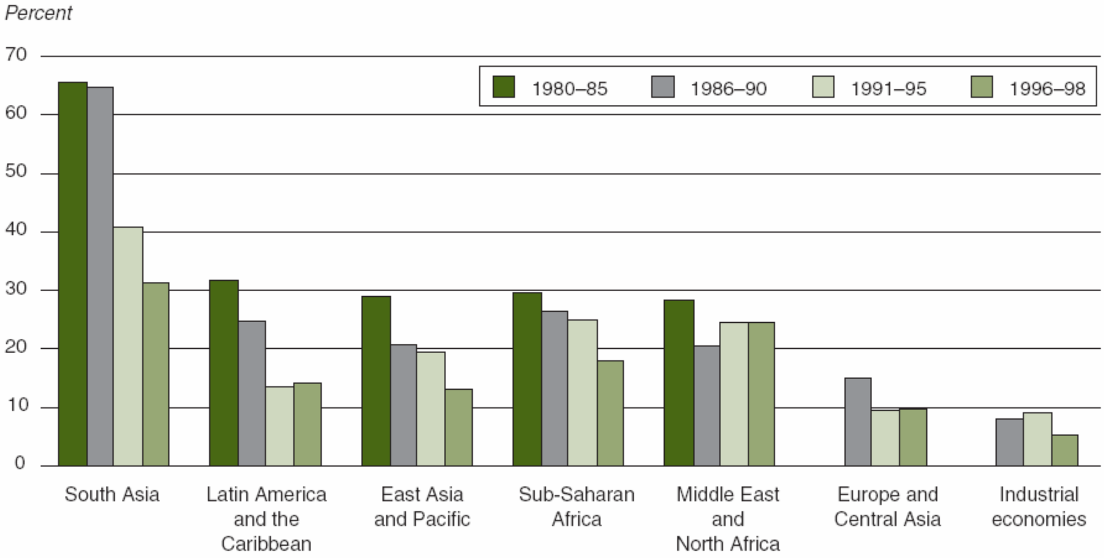
Also established in 1994 was NAFTA, (North American Free Trade Agreement) which enabled the USA to outsource labour intensive works cheaply in Mexico. Along with NAFTA the nineties saw huge increase in Regional Trade Block (RTB) registration to the WTO (see fig 14). In fact there are now more RTBs than countries in the world.

In the 1990s, the exceptional developments saw increasing prosperity for countries and businesses to take advantage of globalisation, new information and communication technologies. International trade has flourished and the European Union, with the USA and other dynamic regions, has enjoyed a period of economic expansion. Importantly, this growth was not confined to the richer nations. Developing countries experienced a strong growth in the 1990s with GDP increasing from 2.7% in the 1980s to 4.3% in the 1990s.

Along with the mentioned decrease in trade value in 1975 and 1982 (conform with the negative growth shown in fig 1) decrease in trade value also occurred in 1998, possibly caused by the crisis in Asia in 1997. Most recently after growing at an record pace in 2000, trade growth has plunged in 2001. The terrorist attacks have worsened what were the first signs of a first recession, preceded by the NASDAQ Crash.

It is worth noting that the statistics account only for 60 percent of world trade for 1973 and for over 90% by now, since not every country was/is a GATT/WTO member.

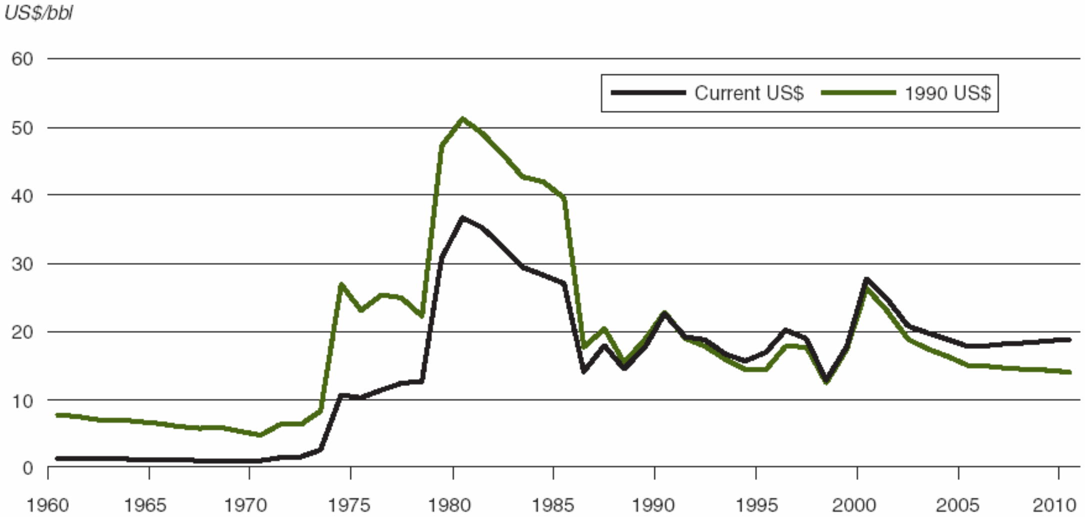
Figure 3 Average unweighted tariff rates by region



Source: World Bank data, and World Trade Organization data.
adapted from World Bank. 2000. Global Economic Prospects and the Developing Countries 2001. Washington DC: World Bank

In the mid 1980's non-tariff barriers distorted trade. This consisted mainly of voluntary export restraints or quotas (as they are more commonly known). During 1986 the world agricultural prices were on a downward trend reaching the lowest point and leading to a fall in US agricultural exports. This could be attributed to a lack of government intervention, which normally keeps food prices from falling. Supply has been rising faster than demand because of increases in technology and more efficient levels of production.

Figure 4 Crude oil prices, 1960–2010



Source: World Bank data and staff estimates.
adapted from World Bank. 2000. Global Economic Prospects and the Developing Countries 2001. Washington DC: World Bank

The graph above shows the oil prices during the 1970s to 2000 (including a forecast). In 1977 the 'as paid'. price was $10 per barrel, this compares with the 'real price' which was $33 per barrel. In 1973 Organization of Petroleum Exporting Countries (OPEC) decided to quadruple the price of oil. This sharp oil price rise is thought to be one of the explanations of the decline in production and trade from the 1960's to the 1990's. This oil price rise heavily affected developing countries as they continued to import large amounts of oil at the expense of higher current account deficits.

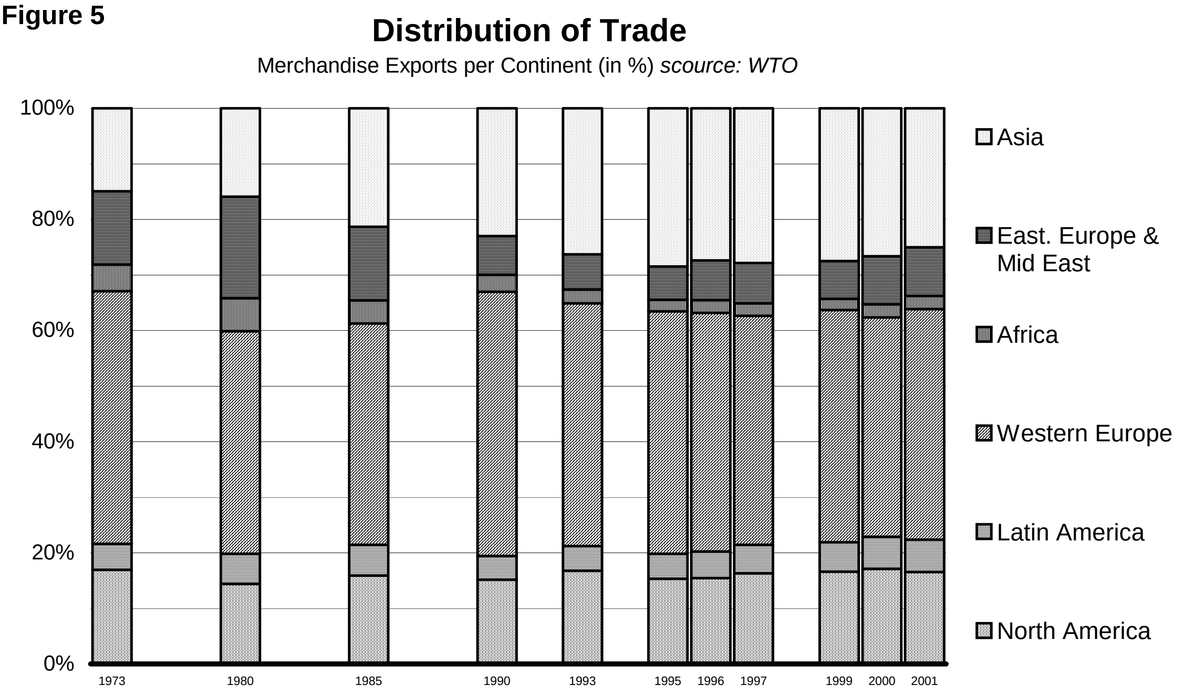
Volatility in Oil Prices have less effects today than the ‘impact of price rises during the oil price shocks of 1973-74 and 1979-80,’[20] simply because the current increases are smaller and output is less dependent on oil than before (also see the declining share of mineral products in the trade of merchandise fig 9). However higher oil prices do pose a problem for developing countries, ‘because they consume more energy per unit of output and have less access to the external financing required to sustain expenditure levels until oil prices decline.’[20]

‘For Instance, an industrialized economy with the same trade-GDP ratio as a developing country may find it easier to absorb fluctuations in trade levels: thus there is a difference in between sensitivity and vulnerability to external factors.’[21]

Geographic Shifts in International Trade

'*The geography of trade […] is […] complicated, simply because trade consists of flows between areas. Theoretically every nation can trade with every other although, in fact, trade flows tend to be channelled into certain dominant routes.*'[2] for example within the TRIAD (EU, NAFTA, JAPAN).

Figure 5



However it is possible to detect the main centres of trade by looking at the greatest sources of exports; Over time more and more trade is created in Asia, with Japan and recently China being the main drivers, however Asian trade has decreased since 1997, possibly caused by the Tiger-Economies-Crisis in the same year. The increase of trade with Asia falls together with a decrease of tariffs in the same time (see fig 3) and a constantly cheap labour force (see fig 8), except Japan.

Africa, Eastern Europe and the Middle East Nation have lost in their importance as a trading nation, possibly because some are now in transition (Russia, etc.) to market economies. Western Europe appears most volatile in its trade volume, whereas the American Continent has remained very stable in its exporting share, slightly increasing after the founding of NAFTA.

Figure 6

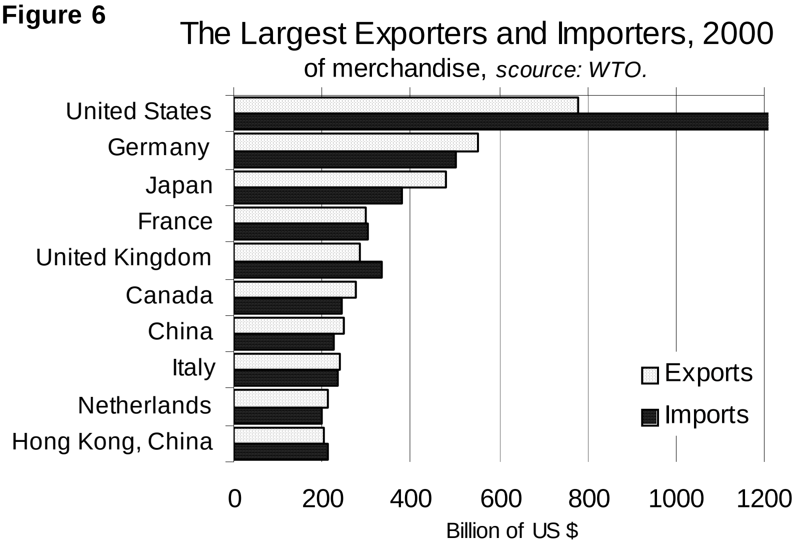
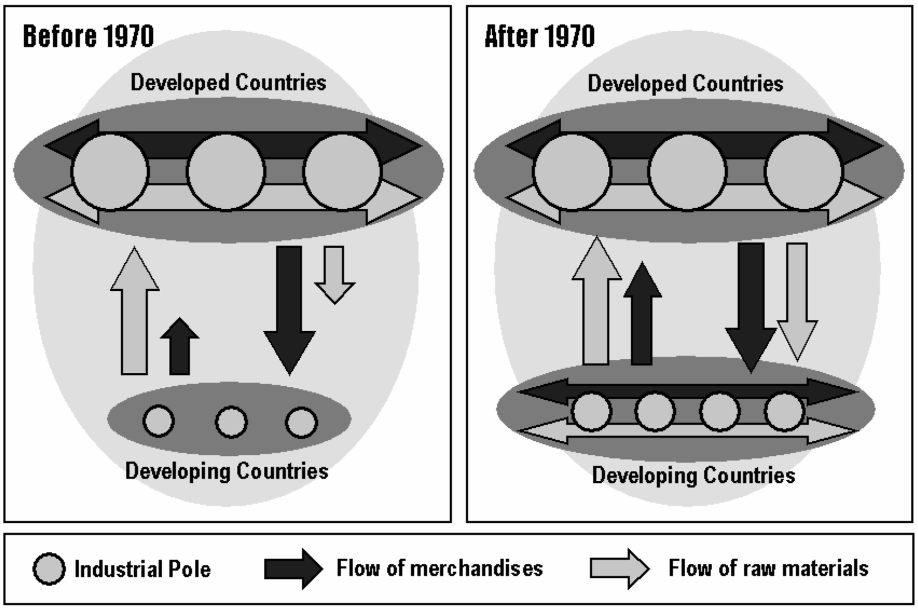


Figure 6 shows that the United States is the leading exporter of manufacturers followed by Germany and Japan. However the USA is more significant as an Importer (leading to their recent trade deficits) whereas Germany and Japan are exporting more. Japan even more so caused by their strict policy that makes it difficult for foreign companies to sell their products in Japan.

The majority of countries more or less achieve equilibrium of import and exports therefore verifying the validity of fig 5 when choosing only exports as a basis of comparison.

More developing countries now take part in world trade, the WTO/ GATT, UNCTAD encourage their participation (70% of WTO members are developing countries).

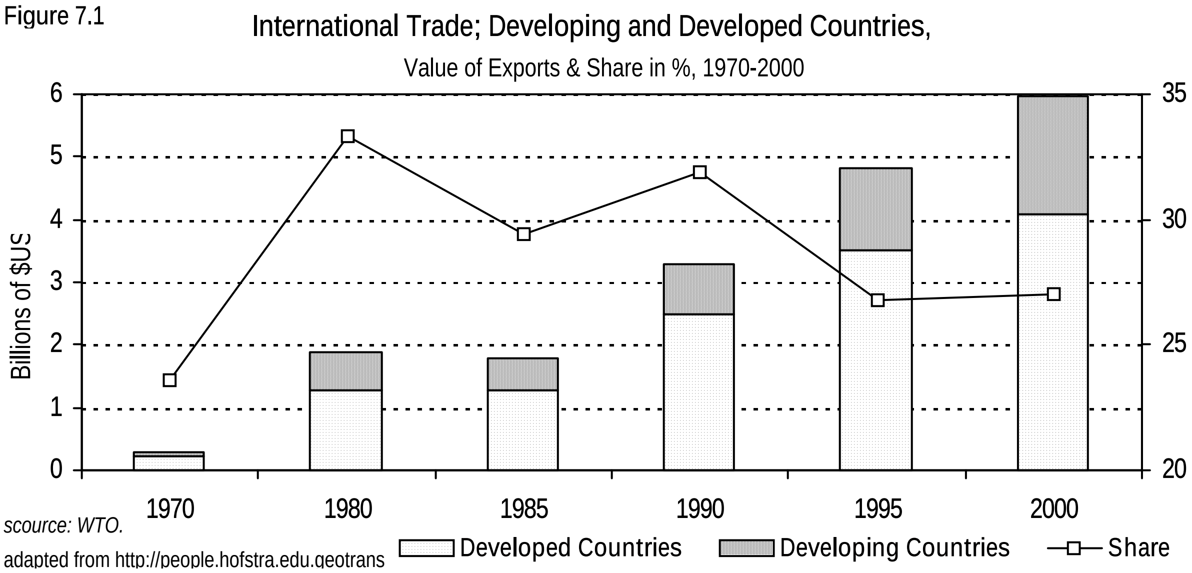
Figure 7 Changes in Global Trade Patterns, Developed -> Developing



adapted from http://people.hofstra.edu.geotrans

Before 1970, world trade flows were dominated by the TRIAD. Finished goods tended to flow from developed countries (north) to developing countries (south), and in turn primary sector goods flowing back north from developing countries. This 'can mainly be explained by differences in levels of development as well as by the domination of the majority of developing countries by colonial powers'. (quoted from http://people.hofstr.edu/geotrans) The situation changed after 1970 when industrial development took place in many developing countries (Southeast Asia, East Asia and Latin America (Mexico)). Consequently industrial processes 'which initially took place in developed countries, were relocated in new locations offering lower production cost, namely because of cheap labour (see fig 8). Consequently, global trade flows are now characterized by significant flows of merchandise from developing to developed countries' (quoted from http://people.hofstr.edu/geotrans)
Figure 7.1 illustrates the participation of developing nations in world trade and also shows that in times of difficulty developing countries are hit harder than industrialised countries.

Figure 7.1



(for a definition of "developing" countries see any WTO Statistics Report's Appendix)

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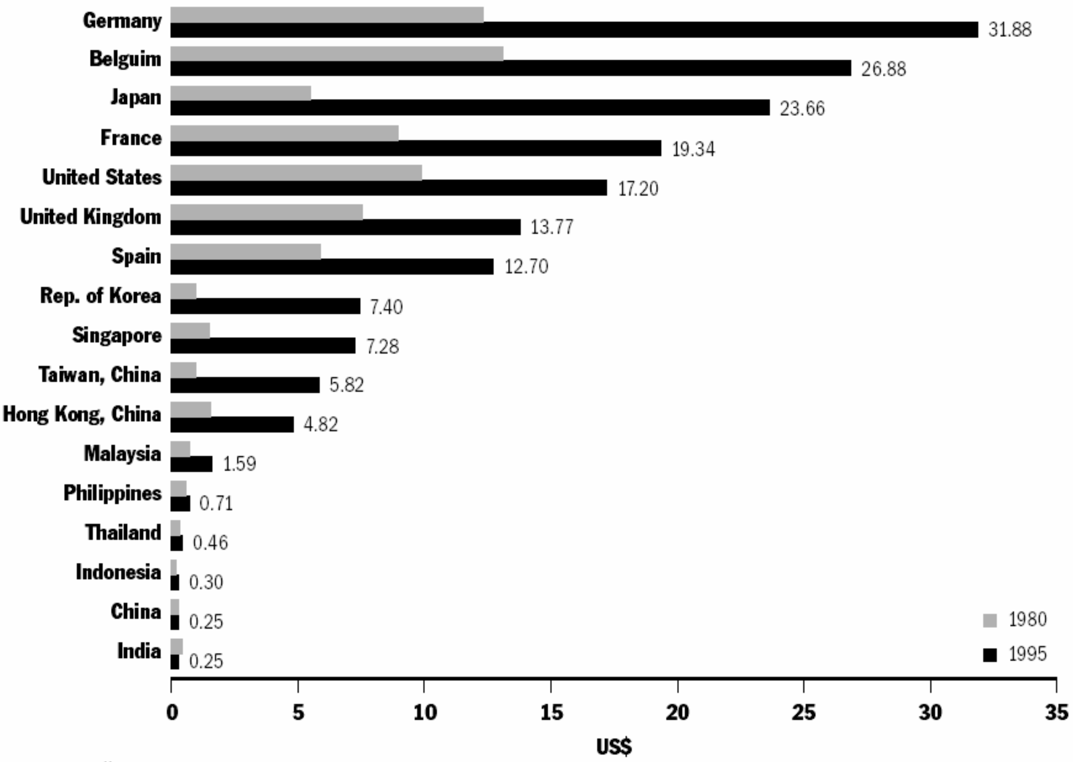
Figure 8 **Hourly labor costs in manufacturing**

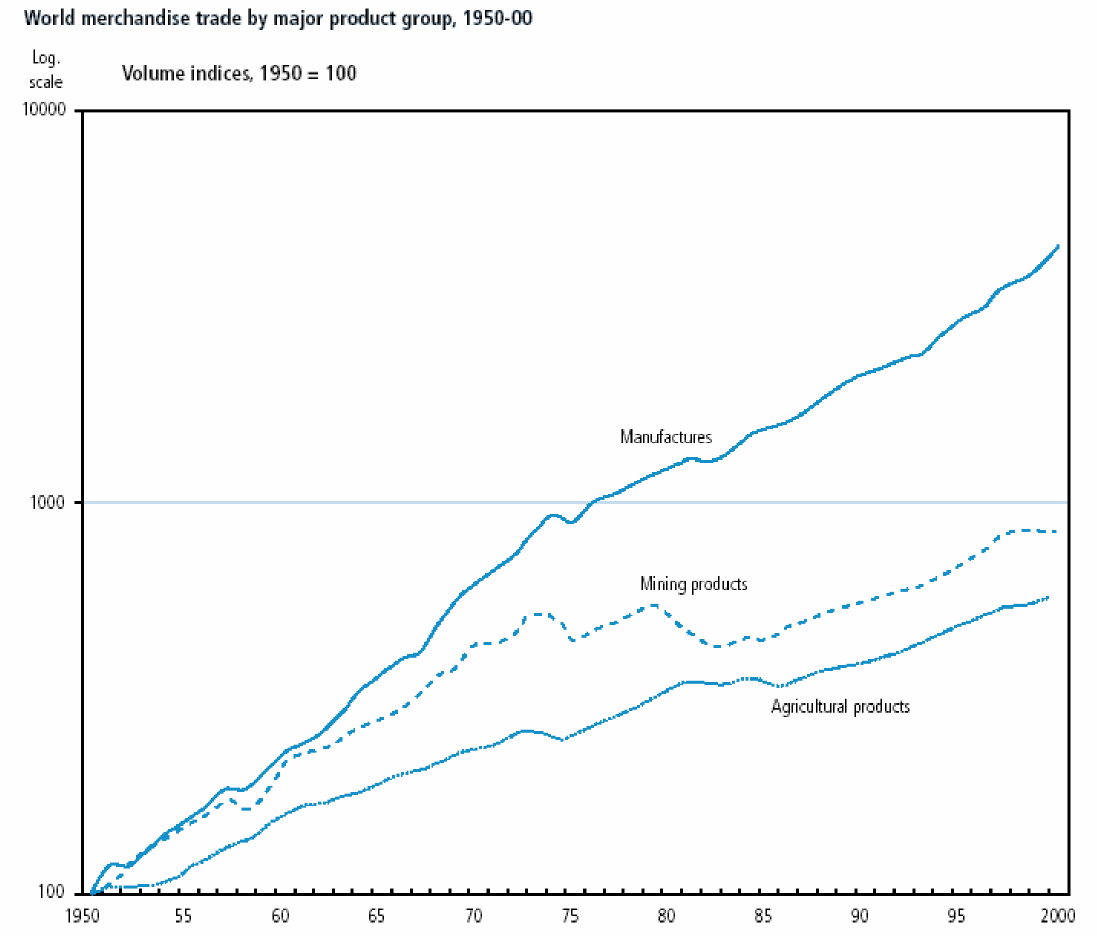


Source: Stalker (2000). adopted from World Bank. 2002. Globalization, Growth and Poverrty. Washington DC: World Bank and Oxford University Press

Sectoral Changes in International Trade

Since 1970 the main shifts in sectoral trade patterns have been away from primary and to secondary and tertiary. More precisely: developed countries are increasing their share of tertiary trade while developing countries now trade mainly with secondary products (fig 10).

Figure 9



adapted from World Trade Organisation. 2001.WTO 2001: International Trade Statistics

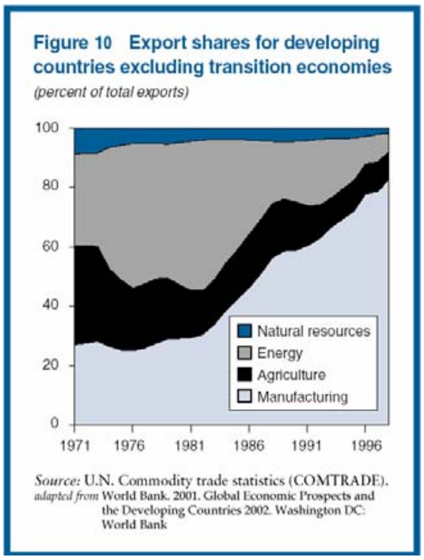


Figure 9 (above) shows the increasing trade within the secondary sector (manufactures: high growth) while primary commodities (mining products (including oil therefore showing more affection by oil price changes) and agricultural products) grew less and account for a lower share than they did in 1970.

Figure 10 shows the trading areas of developing countries which have moved away from primary sector trade and trade mainly with manufactured goods, possibly the majority of which are outsourced by MNEs (USA Car Industry -> Mexico).

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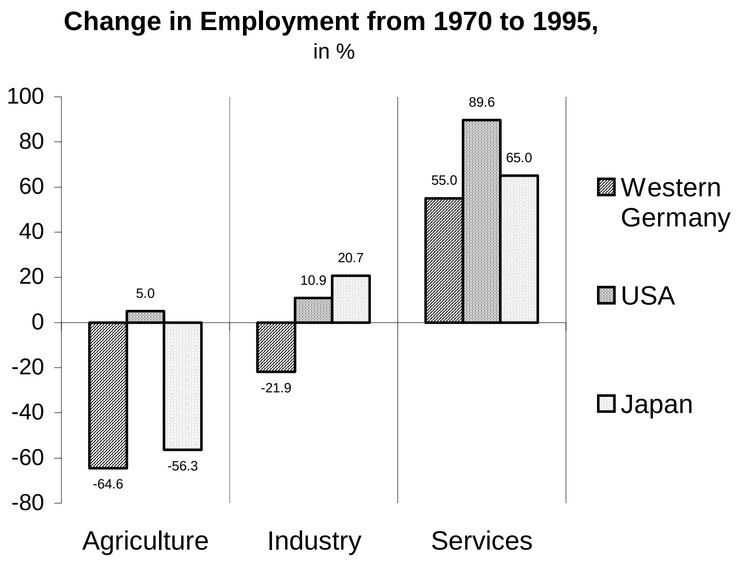
'Services are difficult to distinguish from goods. Most economists refer to characteristics such as intangibility, invisibility, non-storability or transience as being unique to services. One of the features of many services is that, because they cannot be stored, they must be produced and consumed at the same time. This feature means that many services are not capable of being traded across borders. Increasingly, however, as a result of technological progress, it is possible to export services produced in one country to a buyer in another country.'[6] Prime examples are financial (banking) or telecommunication services. Only recently technology made it possible to trade services and therefore 'data on world trade in services only became available from 1980 onwards and are subject to a considerable margin of error.'[4] 'For a variety of reasons, these statistics significantly underestimate the true extent of trade in services. GATT […] gives five reasons for this:'[6] Not all countries are IMF (International Monetary Fund) members and don't supply comparable data, other countries don't provide statistics on certain services. A large number or services transactions go unrecorded (i.e. electronically transmitted), or some trade in services is misclassified (e.g. as trade in goods or as transfers). Additionally 'statistics are sometimes reported on a net (export minus import) rather than gross basis.'[6]
So care has to be applied when relying on statistics on trade in services, since accuracy can't be guaranteed. However it should be sufficient to detect trends and relationships.

Since the traditional definition of trade, goods crossing the frontier, would miss out on a whole range of transactions, trade in services is defined by four modes:

- *cross-border supply* occurs when a service crosses a national border, for example the purchase of software of a foreign manufacturer
- *consumption abroad*, occurs when the consumer travels abroad to the supplied, for example tourism
- *commercial presence* consists of foreign direct investment, i.e. a service company setting up a new branch in another country.
- *movement of individuals* is the temporarily movement of service providing bodies (individuals or company) to another country. (definitions taken from *Global Economic Prospects and the developing countries*. World Bank. 2002)

Hence if it is required to have an historic view of tertiary trade before 1980 one possibility is to look at the employment figures; these will give a, while not exact, look into the changes in industrial patterns in general – and trade will certainly be linked to those. Figure 11 shows a typical shift pattern of developed (TRIAD) nations. Primary goods are imported unless they are available in that particular country, and secondary manufactures are increasingly outsourced be the home industry because labour is considerably cheaper in developing countries and very expensive at home (see fig 8). Therefore administration (tertiary sector) of all activities is left in the developed countries.
Developing countries are now at the stage where their share of secondary exports increases the primary sector (see fig 10) and the tertiary sector is still small but already growing faster than any other (prime example: India's software industry)

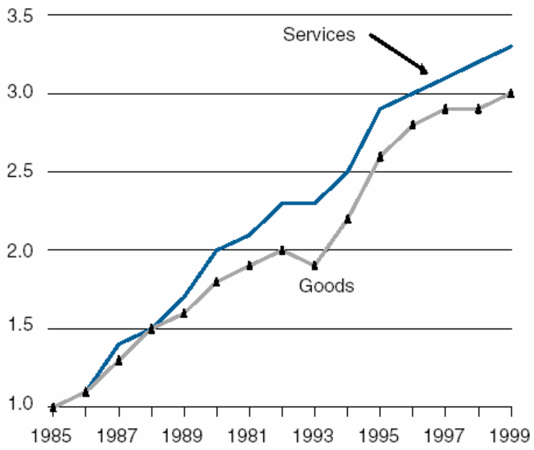
Figure 11



Original data: Federal Statistical Office, OECD, IW - Institut der deutschen Wirtschaft, Cologne - scource: Federal Ministry of Economics - adapted from 'The Prospects of International Trade in Services'. by Dietrich Barth. 1999.

Figure 12 Trade in services has grown faster than trade in goods—

(compound growth, 1985=1)



Note: Population estimate from a sample of 100 countries for period 1985–98. Figure for 1999 is estimate from 69 countries. World trade defined as (X+|M|)/2
Source: IMF BoP Rev. 5, through SIMA; EPPG staff calculations.
adapted from World Trade Organisation. 2001. WTO 2001: International Trade Statistics

'Services are the fastest growing components of the global economy, and trade […] in services have grown faster than goods'[18] constantly since 1985. The performance of services are of vital importance to every country: 'More efficient services - in finance, telecommunications, domestic transportation, and professional business services - improve the performance of the whole economy because they have broad linkage effects. Collectively, they are essential to increasing domestic productivity'[4] These features make services very important for developing countries and desirable to trade or produce.

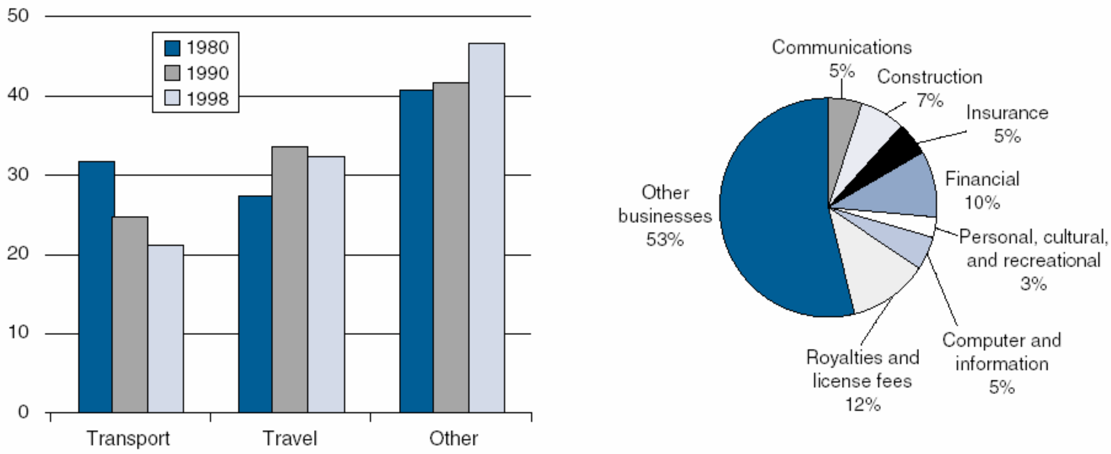
GATT did not administer trade in services, but only since the WTO came into force and introduced the GATS (General Agreement on Trade in Services) standard rules for trade with services were set, which further facilitated trade.

Figure 13 shows what kind of services the tertiary sector contains and the changes in distribution since 1980. "Other" have increased considerably containing the

Figure 13 Transport has declined, while "other" services have increased

"Other" services

Percent of world total services exports



Note: Population estimate from a sample of 89 countries.
Source: IMF BoP Rev. 5, through SIMA; EPPG staff calculations.
adapted from World Trade Organisation. 2001.WTO 2001: International Trade Statistics

Source: Trade Handbook, based on IMF BoP rev. 5.

In 2000 Commercial Services accounted for 18.4% of world Exports (and Imports) and good's world exports (and imports) for 81.6% (*source: WTO data*[24])

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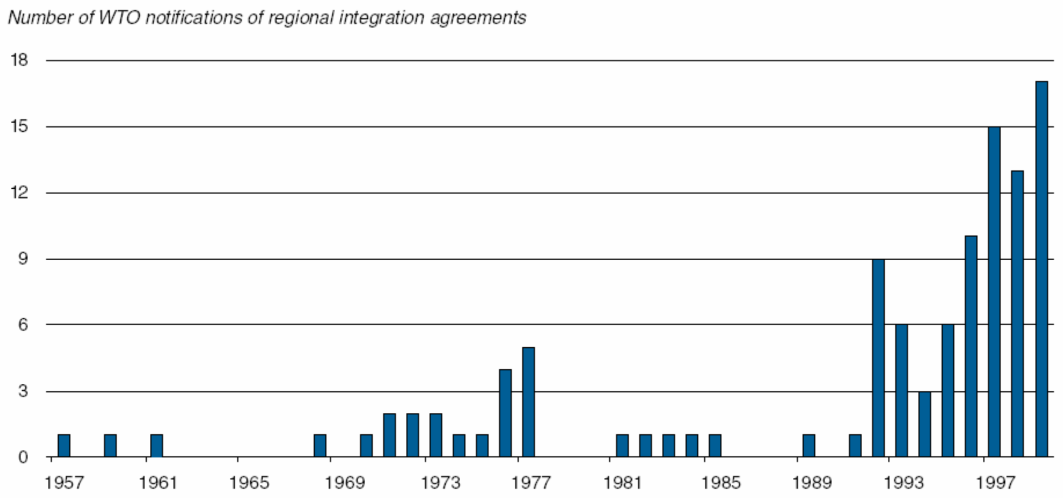
Regional Trade Blocks

'Most industrial and developing countries in the world are members of a regional integration agreement, and many belong to more than one: more than one-third of world trade takes place within such agreements. The structure of regional agreements varies hugely, but all have one thing in common - the objective of reducing barriers to trade between member countries. At their simplest they merely remove tariffs on intrabloc trade in goods, but many go beyond that to cover nontariff barriers and to extend liberalization to trade and investment.'[16] The last ten years have seen an almost exponential increase in the notifications of new regional agreements to the WTO (see figure 14 below).

Figure 14 Regional integration agreements are proliferating



Source: World Trade Organization.
adapted from World Trade Organisation. 2001.WTO 2001: International Trade Statistics

'Regional trading blocs are essentially discriminatory in nature. As such, they go against the general principle of non-discrimination established by the GATT.'[3] It is feared that regional blocs are too protective of their markets and try to defend their markets from outside competition. However GATT Article XXIV was amended to allow the creation of blocks.
There are two effects that the formation of trade blocks can have on trade patterns as described by Peter Dicken, 1998, in *Global Shifts*:

- *Trade Diversion* occurs where, as a result of regional bloc formation, trade with a former trading partner (now outside the bloc) is replaced by trade with a partner inside the bloc.

- *Trade creation* occurs where, as the result of regional trade bloc formation, trade replaces home production or where is increased trade associated with economic growth in the bloc.

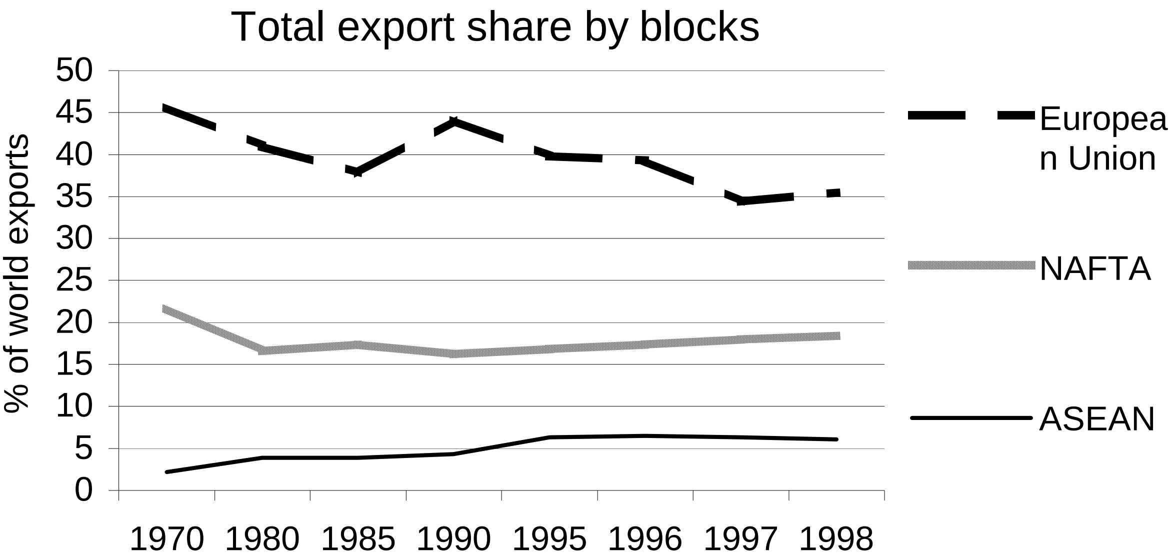
Trade diversion is negative; it increases intrabloc trade at the expense of trade with outside countries while trade creation is desirable as it does not have these negative effects.
Figure 15 gives a short overview of the degrees of possible integration of trade blocks.

Figure 15 *Adapted from:* Dicken, *Global Shift*, 1998, where x = yes	Free-Trade Area	Customs Union	Common Market	Economic Union
Removal of trade restrictions between member states	X	X	X	X
Common external trade policy towards non-members		X	X	X
Free movement of factors of production between member states			X	X
Harmonization of economic policies under supranational control				X

This report will look closely at three different Trade Blocks, EU, NAFTA and ASEAN and their effect on world trade. The EU is the oldest amongst them and originally founded (1957) to ensure peace between Germany and France. The EU is the only regional bloc that can be classified as an economic union

NAFTA (North America Free Trade Area) consist of the United States, Canada and Mexico founded in 1994 and is classified as a free trade area. The free trade agreement between USA and Canada was already signed in 1989.

ASEAN (Association of South East Asian Nations) comprises Indonesia, Malaysia, Philippines, Singapore, Thailand and Vietnam. It was founded in 1967 and turned into a free trade area in 1992.



Shown above are the exports of each trading bloc (*source: world bank data*) as a percentage of world export. NAFTA and EU have lost in significance since 1970 but ASEAN has grown especially from 1990 to 1995 when ASEAN was transformed into a free trading area. ASEAN exports have declined slightly in the late nineties, possibly because of the Asia crisis in 1997. NAFTA and EU have lost share heavily from 1970 to 1980 but NAFTA has steadily grown since, where as the EU lost more share after a short-term boom around 1990. These figures are very similar to the findings made from figure 5.

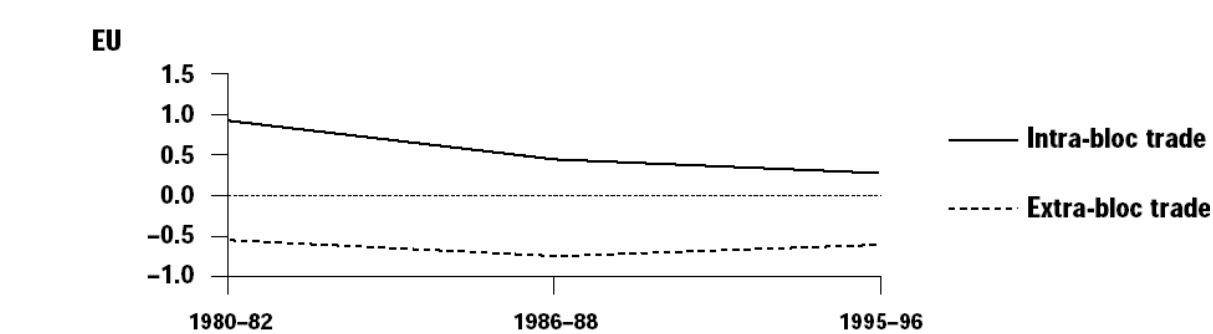
A study[16] by the World Bank investigated major trade blocs over 1980 – 96. The main aim was to find out if trade diversion or trade creation occurred. To make only the changes occurred by the trade bloc creation visible, the raw data of trading analyzed via econometric (gravity) models of trade. The findings on EU, NAFTA and ASEAN are discussed below.

‘A positive value on the vertical axis of these figures indicates that a country is trading more than would be suggested by other factors.’[16] i.e. more than entering a trade bloc.

Graphs below *adapted from: Trade Blocs*. World Bank. 2000.

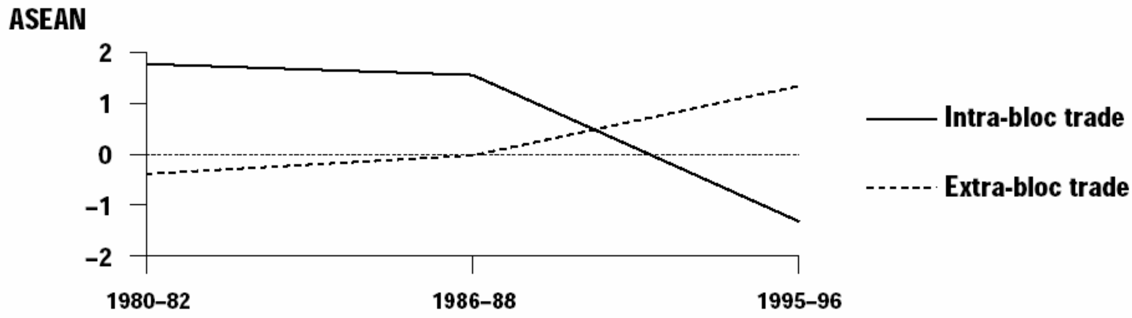
RIA's Trade within and across Borders: Evidence of Diversion

(Gravity model estimates over three periods; 1980–82, 1986–88, 1995–96)



For the EU it clearly shows that intra-bloc trade has increased and extra-bloc trade decreased, a typical sign for trade diversion, a typical source could be the common agricultural policy. Trade creation however should be expected from manufactured goods.

The same pattern here: Intra-bloc and extra-bloc trade diverge as the trade area is formed, clear evidence of trade diversion. The USA is now able to draw oil from Mexico and other natural resources from Canada. Low-skilled labour intensive works can be outsourced to Mexico, so that Mexico benefits from direct investments from the USA. Trade is diversed from Asia, as the original prime supply area for cheap labour.



Source: Soloaga and Winters (1999a,b).

The picture looks different for ASEAN nations, they seem to have increased their share of trade with non ASEAN member countries but haven't increased their trade with member countries; no evidence for diversion could be found. The formation of the bloc might have made these countries more attractive for foreign investors which would have created more external trade; trade creation.

However this study only investigates the advantages and disadvantages of trade, and does not consider other factors that might be positive about the formation about a trade bloc (such the Euro, introduced by the EU). Also it is very difficult to measure any particular harm caused by trade diversion.
Generally trade blocs also bring benefits to its members through scale and competition. Economies of scale might be applied if more can be sold in a larger (or several) market. Competition will increase but also make companies more competitive internationally through lower cost.

Figure 16 shows the world's main trade blocs, including NAFTA, EU and ASEAN.

FIGURE 16

Selected regional integration agreements

Source: World Bank staff.

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Agenda: Presence and Prospects

Most recently 'growth in trade has undergone one of the most severe decelerations in modern times—from over 13 percent in 2000 to 1 percent in 2001. The terrorist attacks in the United States, although it is still too early to evaluate them fully, have unleashed new and unpredictable forces that have substantially'[15] lead to a global downturn. A round of new global trade negotiations at the ministerial meeting of the WTO 'would offer an opportunity to renew progress on multilateral rules that open markets and expand trade. A reduction in world barriers to trade could accelerate growth, provide stimulus to new forms of productivity- enhancing specialization, and lead to a more rapid pace of job creation and poverty reduction around the world.'[18] However Support for new trade initiatives is not unanimous amongst countries, recent times have seen an opposition to "globalization" and expanded trade in general as it is feared to leave to the poorest worst off.

The future of the world economy remains uncertain as the performance in the first half of 2002 has fallen short of expectations and wiped out hopes for a rapid recovery. China's accession to the WTO is expected to make a positive contribution. Recent issues such as further declining stock prices, scandals in accounting (Enron) and corporate governance in United States have not increased trust of investors. Continuing terrorist attacks worldwide and political instability in the Middle East have added to the uncertainty for the world economy.

Appendix:

Bibliography:

Direct quotes from books and reports are marked 'like this'[5] with the source number superscripted and listed underneath.
Graphs or Diagramms that have been taken from publications with little or no alteration are marked as "*adapted from*" Every effort has been made to present the most up-to-date and accurate figures.

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