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Globalization and Trade: An Unfortunate Tangle

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Globalization disrupted the seemingly solid construction emerged in the aftermath of WW II, called the international trade system. For over fifty years, the system grew constantly thanks to the increasing number of countries that joint it as well as to its ubiquitously-accepted rules. For better and for worse the system has worked according to traditional theory principles, whose core credo was that all participating countries would gain more if engaged in trade than if in autarchy. Globalization has muddied the waters. The contemporary order in which multinational companies make the rules has made these predictions look elusive. One serious implication is today's unorthodox approach of trade policy, free trade being sacrificed in favor of managed trade, with the whole string of good and bad consequences that derive from states' intervention.

***Keywords**: globalization, conventional theory, free trade, managed trade*

***JEL Classification:** B11, B12, B13, B17, B27, F11, F12, F13, F15, F60*

1. Introduction: The World Arguably Misdirected by Globalization

It looks as if we lived in "two worlds" instead of "one", namely, "358 billionaires vs. 2.3 billion people", James Gustave Speth (1997), ex-director of the United Nations Development Program once asserted. Whether plausible or exaggerated, Speth's bitter remark has a double gist: for one thing, it points to an incontestable reality, that is the gap between the industrialized North and backward South, which is nevertheless not new but dates to the 19th century Industrial Revolution; for another, it echoes a worldwide commonly held feeling, that the gap has been widened by globalization, meaning that multinational companies and implicitly the rich nations have been reaping much greater benefits from the process as compared to developing nations let alone the poorest countries. It is understandable then why the latter use to consider themselves as losers rather than winners from globalization. After all, the map of today's world is eloquent: it is strikingly obvious that most nations are small, lack natural resources and have a low welfare grade.

Is globalization running counter to developing nations' interests? Opposing hardliners like Naomi Klein would surely instantly answer yes. Intellectually, their resentment is aimed at the underlying doctrine of liberal capitalism, which they consider a recipe for economic disaster such as, they contend, the dire consequences of the neoliberal reform implemented in 1970s Chile in the aftermath of the political upheaval that toppled Salvador Allende. "The only people benefiting were foreign companies and a small clique of financiers known as 'piranhas', who were making a killing on speculation…At the same time, Chileans were thrown out of work because Pinochet's experiment with 'free trade' was flooding the country with cheap

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imports…" (Klein, 2007). Not surprisingly, the same Chilean case is dealt with utterly differently by globalists such as Johan Norberg: "Chile replaced its authoritarian economic policy with liberalization and free trade about 1975. Tremendous growth ensued, with real earnings more than doubling by 1995, at the same time as infant mortality fell from 6 percent to just over 1 percent, and average life expectancy rose from 64 to 73 years. Chileans today have almost a Southern European standard of living, in stark contrast to their neighbours." (Norberg, 2003).

Today's literature abounds in clashing viewpoints of the kind shown earlier, which seem to be bewildering learned and non-learned people alike. The contemporary business environment supervised by multinational companies, characterized by production fragmentation and relocation of activities through offshoring, has rendered the question whether and in what ways does international trade still foster economic development in more backward areas of the world, murkier. Intellectually, obfuscation is probably best illustrated by the inability of the conventional theory of international trade, hereafter called the conventional theory, to accommodate to changes that have reshaped the structure of trade like for example, the faster increase in the trade in intermediary inputs and manufacturing services relative to the trade in finished goods, as well as to changes that have reshaped the global configuration of trade flows such as the increase in intra-firm trade.

2. Conventional Theory: Jumbled by Today's Economic Order

"Countries trade with each other because this enables them to participate in and to profit from the international division of labor. Not unlike businesses and individuals, each area specializes in those lines of economic activity to which it happens to be best suited and then trades some of its own outputs for commodities and services in the production of which other countries have a comparative advantage." (Leontief, 1969) The quoted excerpt outlines Ricardo's well-known comparative costs theory, centered on the concept of comparative advantage, resulting from differences among countries in tastes, technology and factor productivity. "Under a system of perfectly free commerce, Ricardo argued two hundred years ago, each country naturally devotes its capital and labor to such employments that are most beneficial to each." (Ricardo, 1996, a) The key phrase, "naturally devotes" suggests comparative advantage is a law of international trade (Burnete, 2015), provided exchanges are not restricted or hampered by public barriers such as tariffs, quotas, bans, levies, fiscal measures, restrictive arrangements, administrative procedures, standards etc.

During time, scholars revealed several limits of the conventional theory. Admittedly, certain assumptions underlying it such as Adam Smith's labor theory of value, oversimplify reality. The wealth's value, Smith argued, "to those who possess it, and who want to exchange it for some new productions, is precisely equal to the quantity of labor which it can enable them to purchase or command." (Smith, 1979) Another limit lies in the assumption – plausible two centuries ago but far-fetched today – that factors of production are mobile inside countries but immobile between countries. Interestingly, Ricardo explains this constraint through the prism of capital owners' presumed fear of insecurity resulting from foreignness. "Experience has shown that uncertainty, fancied or real, associated to capital when the latter is not under the immediate control of its possessor, as well as the natural discomfort which everyone will feel when leaving their country, severing relations with people thereof and passing – along with all their customs – under an alien rule and alien laws, stops capital emigration. These feelings which I would hardly see dwindle, make most capitalists content with a shrunk profit in their own country, rather than seek a more profitable use of their wealth elsewhere." (Ricardo, 1996) Finally, the comparative costs theory demands that countries' specialization should be complete, an assumption which hardly made sense even in Ricardo's times. For a plethora of reasons, nations will refuse to abandon certain less competitive economic sectors even if the latter need be heavily subsidized. Notoriously, the United States (US) keep sheltering their own production of steel, a commodity in which they obviously have comparative disadvantage, although they might import infinite quantities of cheaper steel from abroad[1]; far-eastern nations like Japan and Republic of Korea keep granting lavish subsidies to their rice growers and protect them by import tariffs despite the handouts raising the price of rice many times above the world average level.[2] Egypt has long been subsidizing wheat production for sustaining a nationwide bread subsidy program.[3] One of the most serious cases is probably that of the European Union, which spends, by means of its agricultural program, huge sums of European taxpayers' money to subsidize the export of farm goods despite their high price relative to global levels.[4]

The classical doctrine was developed by neoclassical economists, who nevertheless made use of additional forced assumptions. New theories emerged, while the existing ones were substantially improved. Nobel laureate Paul Samuelson claims international trade in goods is an ideal substitute for international trade in factors of production (Samuelson, 1948), further implying that free trade will raise the income of the

relatively abundant factor and lower the income of the factor that is relatively scarce. (Stolper-Samuelson, 1941) It follows that in a labor abundant country, free trade will raise the real wage of workers in the economic sector that uses labor intensively and lower the income of landlords and capital owners. However, this last prediction hardly materializes nowadays because the Stolper-Samuelson effect is being dimmed, if not even mollified, by the free movement of factors of production on a global scale. Wages, Krugman (1996) explains, usually reflect productivity, not at the level of the individual company or industry but at the level of a given national economy.[5] Besides, wages in poorer countries are often much lower not necessarily because of lower productivity relative to developed countries but because of the huge supply of labor they are endowed with, which obviously exceeds demand (Roberts, 2004).

In brief, under unfettered movement of capital and other factors across national frontiers, which is globalization's underlying rule, low skilled workers in developing economies are not favored by international trade with developed countries in the way suggested by conventional theory. Rather, it is capital movement, mostly through offshoring, that raises labor productivity and implicitly real wages of both skilled and low skilled workers in receiving countries. In China for instance, labor costs and implicitly wages "have been rising sharply at about 10 per cent a year since the early 1990s and even more quickly in the past decade, due to technological progress, increased capital investment and rising human capital."[6] Arguably, the effects of offshoring on home countries' average labor productivity have been less joyful, as shown by the data in table 1.[7] Figures are eloquent enough as to the degree to which large and dynamic emerging economies like China and India have been availing themselves of offshoring: labor productivity in the two countries increased significantly during the one and a half decade after 2000. Yet the cardinal problem concerning developing economies is that legions of them continue to be bypassed by foreign direct investment (FDI) flows, although some progress has been scored in this respect of late.

Table 1. *Total factor productivity growth by region (%)*

Country/region	1999-2006	2007-2013	2013
United States	0.5	- 0.2	- 0.5
Europe	0.4	- 0.6	- 0.2
China	2.3	1.3	0.2
India	0.1	0.6	0.9

Source: The Economist, Jan. 11, 2017

The literature that emerged after globalization gained prominence generally emphasizes the conventional trade theory's limited power to explain today's world. Porter (1990)'s thesis for example, that comparative advantage resulting from factor endowment might simply vanish overnight under the pressure of technological development has been highly influential; yet it is the same author that admits that "factor proportion theorem still has unquestionable intuitive power and differences among nations in terms of factors' cost had doubtless played an important role in shaping international trade within certain industries" (Porter 1990).

Conventional theory's proponents claim its predictions hold provided there are no impediments whatsoever, either public or private, to trade. In such an ideal context, the theory goes, benefits from trade will spread across all participating nations, which is equal to saying that free trade is better than no trade. Yet globalization has rendered this rule inapplicable: at present, free trade is feared by developed and emerging nations alike. Indeed, one may easily notice that free trade among countries with different development standards yields contradictory results: on the one hand, developing nations use to complain about their terms of trade deterioration, causing them to lose from the North-South trade. Curiously enough, free trade has been vocally denounced by the industrialized North too. The latter's discomfort stems not from trading with less developed countries but rather from the new type of competition, brought about by globalization, to which some of their own industries are now vulnerable.

The conventional theory seems to hardly accommodate to recent empirical evidence like, for example, the relation between offshoring and the skill-biased wage gap: reality shows that low skilled workers' relative wages have fallen not only in (mostly developed) home countries but also in (mostly developing) host countries; in other words, offshoring has made the unskilled invariably worse off, while providing the skilled with a "premium" (Irwin et al., 2008). This unexpected outcome obviously "overturns the Stolper–Samuelson theorem" (Zhu and Trefler; 2005) according to which, in (host) developing countries low skilled workers' wages are supposed to rise because of offshoring. Acemoglu (2003) and Goldberg and Pavcnik (2007) and others ascribed this result to developing countries' outward-oriented policies in terms of trade reforms and friendly FDI regimes, which paved the way for "skill-biased technological changes". The so induced

"complementarity of capital with skilled labor" increased the demand for skilled workers, pushing the latter's relative wage upward.

3. Unorthodox Approach of Trade Policy: Free Trade vs. Managed Trade

Conventional theory's limited possibilities to explain the changed structure and novel patterns of trade is due to, inter alia, international trade having become "inextricably intertwined with industrial organization". (Krugman, 1995) Production processes can be broken down into "separate parts that can be located in countries in which factor prices are well matched to the factor intensity of the particular fragments" (Jones, Marjit, 2001). More concisely, "a good is produced in a number of stages in a number of locations, adding a little bit of value at each stage". (Krugman et al.,1995) The problem is that most developing countries are unfavorably positioned within this novel division of labor: even in knowledge intensive sectors, firms from developing countries use to perform low skill intensive tasks, most commonly assembly of imported inputs, a formula that has come to be the epitome of exports of cheap labor. Economic research (e.g. Harris, 1984) has nevertheless highlighted the potential gains that might result from trade barriers removal by small nations whose open economy incorporates features associated with industrial organization approach to trade.

The debates over the question whether free trade is or not an optimal case became very animated during the 1980s. Paul Krugman (1995)'s rhetorical question: "Is free trade passé?" signaled a fundamental change of outlook, heralding the adoption of a new theory of international trade, hereafter called the new theory. Scholars' interest shifted towards two basic concepts which, according to their view, could better explain contemporary international trade than comparative advantage, namely second best optimal respectively managed trade. Apparently, conventional theory's underlying notions of perfect competition and constant returns to scale are not adequate to explain the workings of contemporary world economy, especially why intra-industry trade (i.e. trade among countries with similar factor endowment) is dominant relative to the North-South trade (i.e. trade among countries with complementary factor endowment). For one thing, intra-industry trade would make no sense if firms obtained constant returns to scale: on the contrary, firms wish to boost sales on foreign markets to reap increasing returns to scale; for another, intra-industry trade is incompatible with perfect competition, as economists (e.g. Chang and Katayama, 1995) emphasized: economies of scale render marginal cost lower than medium cost. If firms faced perfect competition, the argument goes, they would be compelled to fix sales price at the level of marginal cost, thereby incurring losses.

The new theory challenges the traditional view that all nations gain from trade. Although certain models still support this idea, that free trade is no longer viewed as the best policy to follow is a fact. If free trade is no longer an option, it follows that the only possible substitute is managed trade, equivalent to subjecting international trade to government intervention. The necessity of managed trade is derived, firstly, from the existence of market failures and secondly, from the historical propensity of sovereign states to regulate this matter of utmost importance for their welfare. "In reality – remarked Laura Tyson – the world of international trade is not a world of free trade. Governments control or manage trade in various ways. Even the regulations of the GATT, an organization championed by most free traders, are a concoction of negotiations among governments, not private traders…However characterized, such rules will continue to be a determining feature of international trade, as long as the world continues to be divided into sovereign nations."

Regarding the market failures issue, according to the new theory, optimality of free trade policy is dependent on the structure of the economy, more specifically, the existence and size of domestic distortions. If this is the case, a second-best policy would yield better results than free trade. Additional trade barriers such as tariffs, quotas or subsidies could be used to offset such distortions and thereby increase welfare. "Welfare is not necessarily improved by removing a single distortion (such as an import tariff). An equivalent statement is that in the presence of distortions, adding an additional distortion may improve welfare." (Markusen et al., 1995) Does it follow that governments must interfere with nations' trade? It so appears. Yet government intervention is a double-edged sword, suggested by the "uti non abuti" (use not abuse) adage: once unleashed, it will likely extend beyond the need to adjust domestic distortions. Governments may easily succumb to the temptation to shelter domestic industries from foreign competition by protective measures.

Managed trade has different relevance depending on the size and economic power of the nation, and not least on specific national characteristics such as: stronger or weaker independence from the central bank, tighter or weaker cooperation between capital and labor, higher or lower degree of industrial specialization etc., which may carve out different development patterns. Yet beyond idiosyncrasies, most problems governments are faced with are commonly-shared ones. OECD members for example, witness at times, the emergence of long-term unemployment, a consequence of the enhanced global competition, which is manifest

on both hi-tech and traditional markets. “Such globally-induced structural unemployment is believed to further circumscribe the range of policies that are available to governments as they endeavor to combine domestic socio-economic well-being with international economic competitiveness.” (Barry Jones, 1995) Considering, as an example, the case of a powerful economy, say, the US, its commercial policy has been following three main directions: first, a strategic trade policy on certain international oligopoly markets such as civil aircraft, where externalities are important (trade policies can raise the level of domestic welfare by shifting profits from foreign to domestic firms); second, a virtually free trade policy on other oligopoly markets (e.g. automobiles), where externalities are less important than in the first group of industries; third, a policy of administered protection on commodity markets like steel or cotton etc. By contrast, in case of a small emerging economy such as Romania, leaving aside the fact that strategic trade policy would not make sense, other trade policy options are scarce. If hypothetically, the Romanian government would decide to support one of the country’s major industries, say, aluminum production, by subsidizing aluminum exports, it would accomplish little or even nothing (except supplying cheap aluminum to other countries), for several reasons: firstly, because aluminum is not a hi-tech product but a resource-intensive one, the world demand is price inelastic, causing additional export revenues not to rise as high as to offset the subsidizing financial effort; secondly, the production distortion induced by the subsidy might harm the country’s welfare; thirdly, on aluminum markets, externalities are less important and hence, intervention does not rely on a sound motivation. Generalizing, in developing countries, commercial policy decisions are relatively harder because their options range is squeezed by world markets rigors. Governments make efforts – which are sometimes tremendous relative to their possibilities – to make international trade end investments spur their economic development. Yet finding the most appropriate trade strategy to reach this target is not an easy task. Actually, it is a kind of paradox: on the one hand, for reasons emphasized earlier, many nations are less confident in the opportunities offered by the world trade. Furthermore, many of them are pursuing export-biased strategies, hoping to establish a dynamic base that should boost economic growth. Unfortunately, industrial enterprises in most developing countries often lack the required knowledge and abilities that should allow them to compete on the global markets. (UNIDO, 1995) On the other hand, all developing nations are engaged in a fierce competition to attract FDI. In this battle, the opening of frontiers and removal of barriers is an indispensable condition. Potential investors will be likely to circumvent countries that have a lower degree of openness.

The experience of the post 2nd WW period reveals that nations’ own efforts toward economic development will not bear fruit failing international boost. “International trade helps economic development when a country’s exports drive its economic growth.” (Stiglitz, 2002) Yet exports will bolster economic growth only if nations find ways to improve terms of trade, increase export revenues and reduce vulnerability against international markets fluctuations. “Vulnerability is a product of the continuation of overdependence upon a narrow range of exports and a limited number of major foreign markets.” (Barry Jones, 1995) From this point of view, apparently, liberalization of world trade is not conducive to benefits for all: countries manifest different degrees of dependence on foreign markets and benefit differently from international trade. The situation worsened during the last decade of the twentieth century. According to Joseph Stiglitz, the net terms of trade effect after the conclusion of the Uruguay Round has been unfavorable to the poorest countries: the prices the latter receive for what they export as compared to the ones they pay for what they import, declined. (Stiglitz, 2002)

4. Free Trade, Cui Bono?

International trade and globalization are intertwined. The good part lies in the noticeable expansion of commercial exchanges worldwide, mostly due to the boom in offshoring and intra-firm trade. On the other hand, countries’ participation in international trade seems to have gained momentum, especially after the resounding success of South-East Asian tigers. Governments are removing protective barriers, trying to “integrate into the world economy, attracted by the possibilities of world markets.” (Tussie, Woods, 2000) The bad part derives from the fuzzier facet of globalization, which makes it look like a daunting phenomenon, making many people anxious, even scared. On more than one occasion, these feelings translated into anger, often aimed at trade liberalization. Briefly, international trade has been gradually drawn into clashes and skirmishes engendered by globalization. “For reasons that are difficult to fathom the anti-globalization agitationists seem to think that…if you are for free trade, you must also be for free short-term capital flows, for free direct foreign investment, for free immigration, for free love, for free whatever!” (Bhagwati, 2002)

Globalization has broadened the scope of international trade with a cumbersome social agenda, which is equally a two-side coin. On the one hand, social and environmental issues must no longer be separated from international trade talks because international trade is the source for a great lot of social and environmental

woes. The problem may be judged from two different angles: from the moral standpoint and from the business standpoint. Morally, the use of sweatshops, child labour, overwork and other practices involving infringement of human rights are generally looked upon as antisocial behaviour and therefore, severely condemned everywhere in the world.

Commercially, the mentioned practices are being condemned for providing the exporters in developing countries with an unjustified competitive edge against their counterparts in the developed world. Ostensibly, western countries are faced with unfair competition from many developing countries, especially in labour-intensive industries, because the latter fail to comply with minimum social and environmental standards. Yet the way industrialized nations intend to deal with this matter is not exactly the most appropriate. The recent proposal put forward by the United States and the European Union, for a Social Clause to be added to the WTO agenda is obviously aimed at resolving certain social and moral matters through the usage of trade sanctions. The advocates of the Social Clause hope that, by imposing trade sanctions to nations that infringe or overlook social and moral standards, the latter will be forced to toe the line. As Columbia University professor Jagdish Bhagwati put it, this is as though one would try "to kill two birds with one stone". (Bhagwati, 2002)

Despite difficulties, the fight for trade liberalization drags on. Although the current round of trade talks, which started in 2001 in Doha, has broken down, good omens have also emerged. After several setbacks (e.g. the argument in Cancun, Mexico in 2003), the 150 strong member-countries of the WTO reached an agricultural deal in 2004, whereby the United States, the European Union and other industrialized countries bound themselves to cut the huge subsidies they grant to their farmers, currently amounting to about 300 billion dollars a year.[8] Aside from that, the deal contains the firm pledge of participating nations to further lower their trade barriers affecting imports of manufactured goods and services, which accounts for about 60 percent of global trade.[9]

It seems we are being headed toward a freer trade world, thanks to certain trade agreements, which, some years ago, were hardly dreamt of. However, if, as shown earlier, a certain success in multilateral trade talks is undeniable, world trade is still far away from what it should be. Temporary achievements such as the Geneva deal are but the visible part of the iceberg, while the biggest part is still hidden in the water. Yet reality is more complicated than it looks. "Agricultural subsidies are certainly undesirable… but the claim that removing them will help the poorest countries is dangerous nonsense and a pernicious fallacy"– contends Columbia University economist Jagdish Bhagwati. Why? Because "most poor countries are net importers of agricultural goods" – contends Mr. Bhagwati's colleague, Arvind Panagariya[10]. It looks as though we were at a loss: on the one hand, subsidized exports of primary commodities from industrialized countries have driven many developing countries towards the brink of despair. On the other hand, the removal of subsidies, which is intended to drive up world prices, will most certainly benefit exporters in many developing countries but the population in those countries will be likely to be affected. The future might provide clues to this kind of contemporary conundrums.

5. Notes

1. US steelmakers have long blamed foreign rivals, especially from Europe, Japan and of late, China, for dumping cheap steel on the US market, prompting the government to institute tariffs on steel imports. In the 1980s Ronald Reagan signed a series of agreements to limit imports. In 2002 George W. Bush imposed tariffs of up to 30 percent. (The Economist, April 17th, 2017)
2. Japan and Korea levy on average, tariffs on imported rice of 200-300 percent and spend billions of dollars annually on handouts to rice farmers. (The Economist, Nov. 12th, 2015)
3. Egypt local wheat harvest ends with sharply low figure, Reuters, June 27, 2018, https://www.reuters.com/article/us-egypt-wheat/egypt-local-wheat-harvest-ends-with-sharply-lower-figure-idUSKBN1JN1P0

"The vast majority of Egyptians are entitled to buy five loaves per family member per day at E£0.05 (0.3 US cents) per loaf. However, the cost of production is estimated at about ten times that price. Each transaction is recorded through the buyer swiping a smart card, and the bakery is entitled to compensation from the government for the difference between the sales price and the cost of production." (The Economist, Intelligence Unit, July 21st, 2017)

4. For example, farmers are given a refund for each kilogram of butter or skimmed-milk powder they export, so that they can sell at something closer to the market price and avoid making a huge loss on the transaction. (Who's creaming off EU subsidies? The Observer, May 2006) https://www.theguardian.com/business/2006/may/21/europeanunion.food

5. "It is a fact, Krugman argues, that some Bangladeshi apparel factories manage to achieve labor productivity close to half those of comparable installations in the United States, although overall Bangladeshi manufacturing productivity is probably only about 5 percent of the US level. Non-economists find it extremely disturbing and puzzling that wages in those productive factories are only 10 percent of US standards." (Krugman et al., 1996)

6. Labour costs (including benefits) for blue-collar workers in Guangdong rose by 12% a year, in dollar terms, from 2002 to 2009; in Shanghai, 14% a year. Roland Berger, a consultancy, reckons the comparable figure was only 8% in the Philippines and 1% in Mexico. (The Economist, April 5th, 2011, March 10th, 2012)

7. According to Paul Craig Roberts, former assistant secretary of the U.S. Treasury during the Reagan administration, when capital and technology flow from western developed economies like U.S. to emerging economies like China and India, the productivity of labor in China and India rises, whereas in the U.S. it falls. Outsourcing is eliminating entire American occupations in engineering and information technology (IT). (P.C. Roberts, The downward cycle of the US economy, People's World, Dec. 28, 2005, https://www.peoplesworld.org/article/the-downward-cycle-of-the-u-s-economy/)

8. "Failure to Conclude Trade Pact Would Be Blow to Poor Nations" (The Wall Street Journal. Europe, August 2nd, 2004)

9. Disputes around subsidies are not circumscribed to agriculture. They are an as hot subject in other fields such as civil-aircraft production. Here, the American strategic trade policy fiercely clashes with the European Union's. Although the conflict between these two world's biggest aircraft producers is not new (it dates to the eighties), the ongoing transatlantic row over aircraft subsidies could jeopardize the Doha Round of global trade talks that is expected to close in December 2005. ("An ill-time spat", The Economist, March 26th, 2005, p.13)

10. "Punch-up over handouts" (The Economist, March 26th, 2005, p.76)

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