

S6D



Suggested Answers

TYS Nov 2004

- (a) Explain the economic case for free trade and assess whether the data supports the view that free trade would have disastrous effects throughout the developed world. [10]

First issue :

Students should be aware of how to use LCA by now to illustrate the benefits or welfare gains from trade based on specialization according to CA.

- Trade takes place because of different factor endowments in countries and regions across the world. As a result the opportunity cost of producing goods and services differs, and the law of comparative advantage shows that all will benefit through specialisation and trade.
- Define and state the Law of CA.
- Briefly explain how specialization and trade according to CA will mutually benefit the countries involved. (No need tables or diagrams)
- Trade also allows for a wider variety of goods and services to become available and encourages greater efficiency in production through the utilisation of economies of scale and the positive effect of increased competition on company performance.

Second issue:

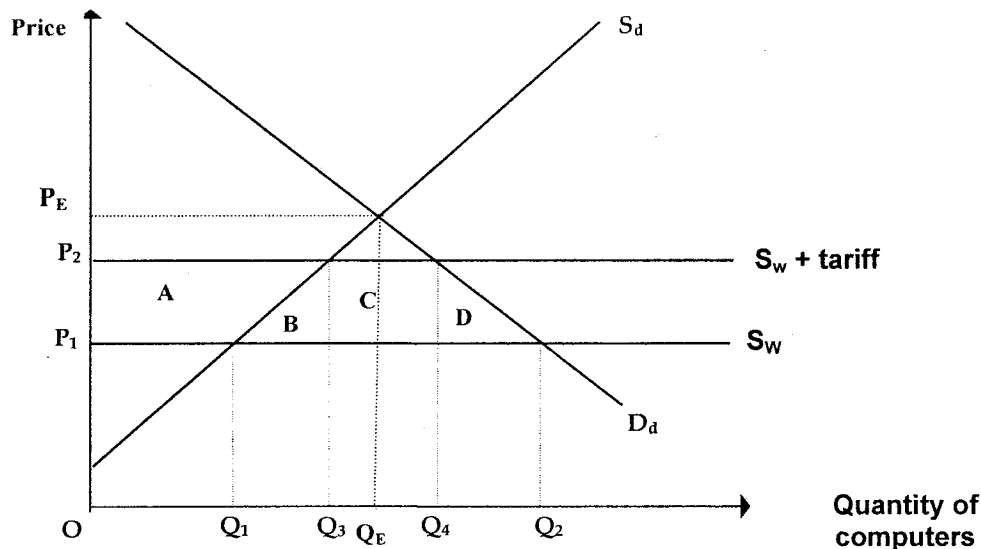
- Yes as data seems to support the view that free trade have "disastrous effects" throughout the developed countries. How?
 - This is exemplified by job losses especially amongst the low-skilled employed in the manufacturing industries in developed countries.
 - It is estimated that even in the long run, the job losses outweigh the expected job gain in this sector by a factor of 3. Note the source of this report and it can be biased - 'Source: adapted from a Trade Union Congress Briefing Paper, June 2002'
- However.....
 - Data showed that despite rapid growth in trade, the UK did not experience rising unemployment. On the contrary total employment went by 1.2 m between 1990-2001.
 - Moreover, job losses experienced by the developed countries are likely to be transitional. Why?
 - In the long run the developing countries will also provide markets for exports of the developed countries thus creating jobs for capital-intensive manufactured goods produced by the developed countries
 - In reality, the distribution of comparative advantage can change as the quantity and quality of factors change. For example, the quality of labour in Southeast Asian economies, together with lower wage rates, means that labour-intensive forms of production now have a lower opportunity cost in Southeast Asia compared to the West.
 - Therefore, the law of comparative advantage suggests that resources would be more efficiently distributed, if Western economies were re-structured, and resources diverted into more capital-intensive production and services. From this perspective, the rise of the Asian tigers was not disastrous, but consistent with the law of comparative advantage and efficient resource distribution across the world. The prediction would be that all would benefit. The Western economies would bear some re-structuring costs but would benefit in the long run.



- (b) Explain who would lose and who would gain both in the short run and in the long run as a result of the US government's policy of protection for the steel industry. [8]

Short-Run:

Figure 1: A Specific Tariff



Gainers:

- In the short run, the steel producers would gain from protectionism by producing steel at higher production from Q_1 to Q_3 and at higher domestic prices of P_2 .
- US steel workers – protected from job losses due to competition by foreigner steel producers.

Losers:

- US Car manufacturers - As major consumers of steel they suffer from a hike in production costs. This may eat or erode their profits
- US industries linked to steel (so-called “knock on effects”) e.g. shippers (drop in volume of business) ; grain producers (higher transportation cost)
- Foreign Steel producers (Russia, China, Brazil and South Korea) relying on US market for their steel exports – fall in foreign exports from Q_1Q_2 to Q_3Q_4 .

Long Run:

No Gainers but losers since free trade was not allowed to operate, and result in the most efficient allocation of the world's resources and maximum welfare.

- US consumers - US consumers of cars. Price of cars go up as car producers try to pass on higher cost of using US steel. There will be loss in consumer surplus, part of which will not be accounted for, hence resulting in deadweight loss. Also, rise in costs may eventually filter down to other sectors of the economy e.g. agricultural products.
- US workers - Workers employed in US car making industry – relocation of plant overseas to save costs might lead to job losses.
- US economy - American jobs and business losses if widespread could impact on the rest of the economy e.g. produced deflationary effects on the economy.
- Global Economy - Tariffs may result in retaliation sparking off trade wars etc and thus restrict the volume of international trade to the detriment of all trading nations. Thus, protectionism ultimately works against the interest of all free trading nations.

Conclusion: Protectionism can only bring about short term gains for some but long term pains for all. So it's again back to the lessons learnt in 'EC 101' on the gains from trade!



- (c) With the help of the data provided, discuss the opportunities and threats of globalization for Singapore and other Asian economies.

[12]

This question focuses on the analysis + discussion of the benefits (opportunities) and threats (costs) of globalization from the perspective of Asia (Singapore + the other Asian economies).

Opportunities of globalization

- **Growth and development for some hitherto backward Asian economies**

From Table 2, globalization may provide opportunities for agriculture economies like Cambodia, Vietnam to climb up the value chain towards move towards manufacturing.

- **Opportunities for intra-regional outsourcing (i.e. within Asia itself)**

Since China, Malaysia, Vietnam and Cambodia assume larger export and import shares as a percentage of GDP, there is potential for Singapore, Japanese and Korean firms to move their low cost industries to China, Vietnam and Cambodia to benefit from their changing comparative advantages.

- **Opportunities for restructuring of the Singapore Economy**

This means that economies like Singapore may have to invest heavily in training workers (retrenched and younger workers) for higher value-added industries e.g. pharmaceutical, chemical industries where there exists comparative advantage. So how fast these economies able to realize their new CA depends on whether they are able to churn out knowledge workers to produce idea-based goods and hence fill the knowledge jobs that are created. In addition, Singapore and Japan may move into service oriented industries like other developed countries.

- **Opportunities in attracting FDI**

China and other low-cost economies ideal as a production location for many MNCs wishing to leverage on their cheap land and relatively skilled labour. China is considered today as "Factory of the world" producing a wide range of manufactured goods for MNCs world wide e.g. Nikes to Lenovos Computers. It is 'giant magnet' sucking in FDI from all over the world. This in turn has helped spur growth.

- **Opportunities for forging FTAs**

Singapore and the other Asian economies like S Korea have forged many FTAs with their trade partners.

Threats of globalisation

- **Job losses due to Outsourcing, Relocation and Restructuring**

Singapore and other Asian economies like Japan and Korea may have to outsource more of the low end productions processes in low cost countries or to emerging economies like China, Malaysia, Vietnam and Cambodia to produce integrated products. This could result in job losses in those outsourced sectors. Based on data in Table 1, we observe that labour cost in Singapore is relatively higher compared to Hong Kong, Korea and Taiwan. Thus globalization may lead to relocation of manufacturing firms from Singapore to other parts of the world where cost of labour is relatively cheaper, especially for labour intensive industries like electronic assembly operations, hard disk industries.

As economies globalization undergo restructuring there would be the inevitable fallout in terms of structural unemployment e.g. Migrant unemployment as farmers moved to cities in seek of jobs. Retrenchment may become acute in cases where there are older workers, lowly educated workers and mid-career professionals.

- **Widening Income Disparity**

Globalisation may accentuate the income divide amongst the talented and the unskilled; the rural and urban dweller etc

- **Trade Friction**

A possible threat could be the emergence of trade friction as Asian countries sharpen their export competitiveness. A case in point is China's current export boom is causing trade friction with the USA.

Conclusion:

Of the Asian economies, data seem to suggest that Singapore stands to gain more than lose from globalization due to the very openness of our economy (Table 2: M and X as a % of GDP highest amongst all Asian economies) despite our relatively higher labour cost.