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Niina Pautola

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of East-West Trade in the New Europe

Bank of Finland  
Institute for Economies in Transition, BOFIT

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Bank of Finland  
Institute for Economies in Transition (BOFIT)

PO Box 160  
FIN-00101 Helsinki  
Phone: +358 9 183 2268  
Fax: +358 9 183 2294  
[bofit@bof.fi](mailto:bofit@bof.fi)  
[www.bof.fi/bofit](http://www.bof.fi/bofit)

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# The New Trade Theory and the Pattern of East-West Trade in the New Europe

## 1 Introduction

In the late 1970s few theorists started to apply concepts drawn from industrial organization theory to the analysis of international trade. At the time "the new trade theory" was considered as a radical departure among traditional-minded trade theorists while requiring a serious shift in perspective and a change of paradigm.

The basic concepts of new trade theory were the importance of increasing returns as a cause of trade and the principle of imperfectly competitive markets. In spite of this successful innovation and its academic success, it has been proved difficult to turn the new trade theory into recommendations for a new trade policy. After all, it has implied a challenging of the "traditionals"; the principle of comparative advantage as well as an appreciation of free trade.

## 2 The Traditional Theory of International Trade

Traditional trade theory explains trade as essentially a way for countries to benefit from their differences. Because countries differ in climate, skills, culture, resources, and so on, each country will have a comparative advantage in producing goods for which its particular character suits. As a consequence one can see trade dominated by exchanges that reflect the certain strengths of economies – for example, exports of manufactures by advanced countries and exports of raw materials by underdeveloped countries.

The basic model of comparative advantage in the theory of international trade has been that associated with the names of Heckscher and Ohlin. The form in which this model has been analyzed over the last decades has been in terms of the two-factor, two-good geometry developed by Lerner and Samuelson. The basic analytical relationships that obtain in the Heckscher–Ohlin model provide the propositions that underlie the H–O theorem relating to the pattern of trade: A country will export that commodity which intensively uses its abundant factor and in which it has a comparative advantage.

The Heckscher–Ohlin model has the following main features. On the production side there are two factors of production. Given supplies of these primary factors there are constant-returns-to-scale production functions in each of two goods. Further, there are identical technological know how (i.e., identical production functions) in each industry internationally, and non-reversibility of ranking for the two commodities.

On the demand side it is assumed balanced trade obtains, requiring that the economy spends no more than its earned income. The restrictions on the shape of the demand functions vary with the definition of factor-abundance. There are no transportation costs, only two traded goods and factors are immobile internationally. Finally, institutional assumptions call for pure competition.

The Heckscher–Ohlin model stated as above has explained some trade patterns quite well. Underlying characteristics of countries shape the pattern of international trade. Countries indeed tend to export goods that intensively use their relatively abundant factors. Countries with highly skilled work forces tend to export goods that require skill-intensive production, countries with abundant land and climate export agricultural products, and so on. However, empirical evidence while testing the H–O theory has been generally conflicting. Since World War II, a large and generally growing part of world trade has changed to consist of exchanges that cannot be attributed so easily to underlying advantages of the countries that export particular goods. Nearly half the world's trade actually consists of trade between industrial countries that are relatively similar in their relative factor endowments. Further, trade seems to consist of temporary advantages resulting from economies of scale or shifting leads in close technological races.

Perhaps the most famous empirical evidence challenging conventional trade theory has been that of Leontief. In 1953 Leontief published his finding that US exports in 1947 embodied a lower ratio of capital relative to labour inputs than did US import substitutes. Because it was widely presumed that the USA was better endowed with capital relative to labour than the rest of the world, these results seemed to contradict the Heckscher–Ohlin theory of comparative advan-

tage. In addition, some recent changes in Europe suggest that countries are becoming more similar in their endowments. If so, the H-O theory, which emphasizes international contrasts in endowments, may slowly become less relevant. Meanwhile, international trade has been slowly moving toward trade among similar countries and toward trade in similar goods rather than trade between very different industrial sectors.

## 3 Key Features of the New Trade Theory

### 3.1 Introduction

The most basic idea of the "new trade theory" has been that of non-comparative advantage trade. The new trade theorists argued that countries do not necessarily specialize by following their true comparative advantage and trade solely in order to take advantage of their differences in factor endowments. Countries also trade because of increasing returns. Further, who produces what has been seen as a result of history, accident and past government policies rather than underlying differences in national resources and aptitudes.

The new trade theory made three crucial innovations. First, the new trade theorists became freed from the perfect competition modelling by introducing industrial organisation into trade theory. Second, the new trade theorists found ways to avoid the "two-ness"<sup>1</sup> in trade theory. Finally, the new trade theorists broke down the artificial distinction between purely technological and pecuniary external economies.

### 3.2 Imperfect Competition

Much economic analysis is based on the working assumption that markets are close being "perfectly competitive"-in other words, there are many producers, each of whom is too small to attempt to influence prices or the future actions of his competitors. However, in the light of new trade theory, the pattern of trade is changing as a great deal of trade now seems to arise because of the advantages of large-scale production, the advantages of cumulative experience, and transitory advantages resulting from innovation. In industries where these kind of factors are important, one is not going to see the kind of atomistic competition between many small firms that is required for "perfect competition". Firms in this situation are described as being in "imperfectly competitive" markets. They face a few identifiable rivals, they also have some direct ability to affect prices, and they make strategic moves to affect their rivals' actions. In other words, what can happen in these markets is different from, and more complicated than, what is captured by the simple concepts of supply and demand.

Yet until the late 1970s, the only formal models of trade with increasing returns assumed purely external economies of scale. External economies of scale occur, when the cost per unit depends on the size of the industry, but not necessarily on the size of any one firm. In particular, the pure technological external economies were the only ones approved with perfect competition. This was natural since internal economies of scale, where the cost per unit depends on the size of an individual firm, implied imperfect competition, and that time there were no widely accepted models of imperfect competition.

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<sup>1</sup> The either-or choice which trade theorists faced when determining the cause of trade; is trade determined by comparative advantage or trade determined by increasing returns.

However, during 1970s theorists in the industrial organization area (Dixit, Stiglitz, 1977) developed models to analyze imperfect competition. These models provided a set of tools and ways to approach issues involving economies of scale at the level of the firm, increasing-returns driven trade that did not require assuming purely external economies.

All in all, the main feature of the new trade theory was that it offered models in which increasing returns were allowed due to their natural existence with imperfect competition. This obviously made a huge difference in terms of plausibility.

### 3.3 Two-ness

As mentioned, traditional trade theory assumed two factors of production, two goods and constant returns to scale. In the traditional trade theory the shape, the convexity of the standard production possibility frontier has been the result of differences in factor intensities among goods. Modelling trade under increasing returns has made the situation more complicated and raised the question, how increasing returns influence this production possibility frontier. Increasing returns imply a large amount of products all produced with identical factor proportions. As a result, increasing returns push production possibility frontier to the opposite direction against its original shape (based on the assumptions of traditional trade theory) and being strong enough the curve, instead of being convex, becomes concave. This, in turn, has raised another question of which one of these two options should be chosen when determining the pattern of trade. Is trade determined by comparative advantage or increasing returns?

This has been indeed a focusing point for new trade theorists. They wanted to get away from this two-ness and release one from making an either-or choice between comparative advantage and increasing returns. In particular, the neo-industrial trade generally assumed a hierarchical structure. In this structure large groups of differentiated products were all produced with identical factor proportions. As a consequence, they could also be aggregated into "industries". While "inter-industry" trade continued to be determined by Heckscher-Ohlin theory, the "intra-industry" trade was driven by increasing returns as a result of specialization within industries.

As a result, the traditional opposition between comparative advantage and increasing returns had been eliminated since the new trade theory allowed economists to believe in both.

### 3.4 External Economies

As mentioned earlier, once talking about scale economies one should keep in mind that not all scale economies apply at the level of the individual firm. When economies of scale apply at the level of the industry rather than the firm, they are external economies. For many reasons it is often the case that concentrating production of an industry in one, or few locations reduces industry's costs, even if the individual firms in the industry remain small. Further, it is probable that

similar factors explain persistent national advantages in industries for which there is no obvious advantage in resources.

External economies like internal economies play an important role in international trade. However, they are quite different in their effects. First, external economies need not necessarily lead to imperfect competition, since it is possible that individual firms may remain small in spite of important advantages to large scale at the industry level. Second, and more important for the assessment of trade is the possibility that trade in the presence of external economies may not be beneficial to all countries.

The traditional trade theory assumed perfect competition. This meant assuming constant or diminishing returns at the level of the firm, which in turn meant that market size effects were ruled out and only technological externalities mattered. However, in the real world, where returns are mostly not constant and firms mostly not perfectly competitive, market size does matter.

The new trade theorists restored a proper view of external economies and showed that external economies could be rigorously modelled without appealing to diffuse, pure spillovers. A monopolistically competitive intermediate goods sector could lead to external-economy-like behavior in the downstream industry. Two outcomes were possible. In case the intermediate goods were traded, the external economies would be international. In case the intermediates were non-traded, the external economies would give rise to national specialization in final goods.

### 3.5 The Role of History and Accident

Conservatives believe mostly in the effectiveness of free markets as ways to organize economic activity. When people are left with free choices, they are far more productive and efficient than if you try to control their activities. However, the new trade theory offered a different way of thinking. It believes that the way markets are organized and the shape of the economy is determined often depends crucially on historical accident. Further, this conclusion emphasizes the role of past government policies, because a government may have tried to make sure that the accidents of history run the way it wants.

Economic geography, the location of industries within as well as between countries, is a subject in which the role of historical accident and government policies has often been obvious. To understand this, let us think about one example, an industrial cluster of Silicon Valley in California. First, Silicon Valley is located where it is, because of the vision of Frederick Terman, vice president of Stanford. He supported a few high-tech entrepreneurs in the 1940s, forming the seed around which the famous high-tech concentration started to be made up. This demonstrates the powerful role of historical accident. Further, there are several factors that could have been affecting both the government and its industrial-cluster-supportive kind of policies: The individual firms that form the Silicon Valley are not very big, but this grouping of firms promotes the exchange of information and thus the advance of technology. Hence, the whole is greater than the sum of its parts reflecting external economies of scale. Furthermore, a cluster of related firms in the same area provides a large market for people with specialized skills meaning that workers have some insurance against unemploy-



ment and that firms have some insurance against labor shortages. Finally, Industrial clusters, like Silicon Valley, support providers of necessary specialized services.

All in all, the new trade theory really changed the way of thinking among international economists. They could no longer ignore the alternatives to comparative advantage, the idea that trade can also be the result of increasing returns and that the trade is to some extent determined by history rather than resources.

## 4 Theory and Policy in International Trade

### 4.1 Introduction

The new trade theorists have been motivated by an effort to explain the pattern of trade, primarily in positive rather than in normative manner. Their effort has focused on a description of how the world economy is, not a prescription about what to do about it. Further, the aim has been to fill a gap in standard trade theory, rather than to find a legitimacy for neo-mercantilist trade policies.

Despite of that, it has been like an afterthought that new trade theorists began to talk about possible policy implications and new ideas about policy.

What is the relationship between theory and policy in international economics in general? Since the time of Adam Smith economists have advocated free trade as an ideal toward which trade policy should strive. Theoretical models suggest that free trade will avoid the efficiency losses associated with protection. In addition, many economists believe that free trade produces additional gains beyond the elimination of production and consumption distortions. Finally, even among economists, who believe free trade is a less than perfect policy, many still believe free trade is usually better than any other policy a government is likely to follow.

The first step toward understanding actual trade policies is to ask what reasons there are for governments not to interfere with trade, in other words, what is the case for free trade. Once this question has been answered, arguments for intervention can be examined as challenges to the assumptions underlying the case for free trade.

At this point it seems natural to think of the GATT, and the relatively free trading system built around the GATT, as the result of the ideology of free trade. Although the GATT itself represents the ideology of free trade, the behaviour of different GATT-parties in trade negotiations reflects something different. If one examines the reality of international trade negotiations, one can notice that in practise the GATT is not built on a foundation laid by economic theory. Instead, it is more a way of thinking. As Krugman (1992)<sup>2</sup> has suggested, it could be called as a "GATT-think" that can be seen as a simple set of principles. It reflects the behaviour of negotiating parties, gives explanations to most of what goes on in the negotiations and captures some basic realities of the political process.

### 4.2 The Principle of GATT-think

When talking about international trade negotiations there are three simple rules concerning the objectives of the negotiating countries: exports are good, imports are bad, and other things equal, an equal increase in imports and exports is good.

On one hand, the GATT-think can be seen mercantilist, because it presumes that each country acting on its own, would like to subsidize exports and restrict

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<sup>2</sup> "New Trade Theory", World Economy vol. 15, 1992.

imports. On the other hand, it also recognizes that it is destructive if everyone does this, and it is a good thing if everyone agrees to expand trade by accepting each other's exports. All in all, GATT-think can be described as Prisoner's Dilemma: Individually, countries have an incentive to be more or less protectionist, yet collectively they benefit from free trade.

GATT-think can be a very good model to explain, what happens in the "real life". It can explain some basic realities of the political process: The first two principles of GATT-think (exports is good, imports is bad) imply the idea that trade policy generally reflects the interests of producers-export producers, import-competing producers – rather than consumers. The third principle points out that, on average, a dollar of exports adds more domestic value added than a dollar of import subtracts. This occurs because not all imports compete directly with domestic goods.

The process of multilateral negotiation sets each country's exporting interests against import-competing interests. Thus, if international trade is seen as international competition, naturally, it makes common sense to do everything you can to help your side win. If imports quotas that give our domestic industries the advantage of a protected home base or export subsidies that help them break into foreign markets help our country compete, why not go ahead and use them? If every country follows such policies, the end result will be destructive. In other words, according to GATT-think, negotiators, countries, seem to treat exports as desirable and imports as undesirable. As trade negotiators bargain for access to each other's markets, they move toward free trade. Thus, free trade looks like a good idea but only if every country practises it.

### 4.3 Strategic Trade vs. Free Trade

The normal position of economists on international trade is that free trade is best regardless of what other countries are doing. However, the rethinking of the basis of trade policy that is now occurring among new trade theorists offers two ways in which an activist trade policy can benefit a country relative to free trade (possibly at the expense of its competitors). The first way can be through the ability of government policies to secure for a country a larger share of rent; payment to an input higher than what that input could earn in an alternative use. If there are important rents in certain sectors, trade policy can raise national income by securing for a country a larger share of the rent-yielding industries.

Now the conventional view is that under perfect competition there will be very little rent. If profits or wages are exceptionally high in an industry, capital or labour will come in and quickly eliminate the extra profits. If, however, the new way of thinking is right, important trading sectors are also sectors in which rent may not be so easily competed away. If the nature of world market for some products is such that it can support two highly profitable producers but the addition of a third would eliminate the profits, it becomes possible at least in principle for trade policy to be used to make a country one of the lucky par.

The second way in which an activist trade policy can benefit a country relative to free trade is through the ability of these policies to get the country more external economies, a benefit from some activity that accrues to other individuals or firms than those engaging in the activity. The most common example is that of

technological innovation. It involves the generation of knowledge, but is particularly also likely to generate valuable spillovers. Thus, there is now good reason to believe that trade policy can be used to protect external-economy-producing activities.

#### 4.4 Theory and Policy – Far From Each Other

Current trade policy is based on the conventional trade theory, implying that free trade is best. However, along examining new trade theory one has noticed that free trade would not always necessarily be best. As a consequence, for the new situation there should also be a change in the policy.

But the actual practice in trade policy is far from ideal. Similarly, the behaviour that underlies trade negotiations is to a large extent unrelated to the trade theory of academics. As a conclusion, since policy plays so little attention to theory, a big change in theory may not mean much in terms of policy recommendations. This may also explain why no dramatic policy recommendations have come out of new trade theorists.

In the end the most important policy implication of the new trade theory can be that it has freed traditional free trade theorists to take seriously the role of external economies. Even though these external economies offer rather reasonable justification for a neo-mercantilist view of international trade, it does not automatically mean that neo-mercantilist policies are actually a good idea. If so, what kind of trade policy does new trade theory then justify? Trade and industrial policy, like any microeconomic policy, is made by legislators and bureaucrats. Both of them aim to serve pressures of special interests groups. Thus any recommendation about trade policy must take into account the political economy of the policy process together with the strict economics of trade itself.

Krugman (1986) has presented a fourfold distinction among intellectually legitimate views on trade policy. It is a useful measure to show how difficult it is to go from theory to policy and at the same time rationalize all positions between pure free trade and interventionist policies.

These four views are as follows: First, there are strong non-activists. These economists believe that the potential gains from any sort of government intervention are small, and that only a strict rule of hands-off can defend against political abuse. Second, there are cautious non-activists. They have doubts about government intervention, but they are still willing to reconsider. In particular, they are willing to take seriously charges of predatory strategic trade policy by competitors. Third, there are cautious activists. They think that although we know enough to do some good with an activist trade/industrial policy, it should be small-scale and restricted to only very clearest cases. Finally, there are strong activists, who would call for an immediate move to a general industrial policy.

All in all, the fundamental point is that the structure of trade policy is changing. New answers are to be searched. Answers will most likely involve to a large extent industrial policy under some name. The new trade theory does not necessarily require a new trade policy, but it can, perhaps, help provide the guidelines for making reasonable industrial policy.

## 4.5 Summary

The traditional trade theory based on the Heckscher–Ohlin model of comparative advantage is suggested not to be the only explanation of international trade. At the moment a large and increasing part of world trade is changing to consist of exchanges that cannot be attributed so easily to underlying advantages of the countries that export particular goods. Instead, trade seems to consist of temporary advantages resulting from economies of scale or shifting leads in close technological races. World's traders are observing changes in comparative advantage, along with associated changes in the terms of trade. International trade is moving toward trade among similar countries and toward trade with similar goods. Finally, the question is how to identify such situations in policy-making when free trade is not always, and not necessarily, the best policy for any one country.

## 5 The New Trade Theory and the East-West Trade Pattern

### 5.1 Overview

The ongoing East-West integration development has produced a great amount of new players to the world's markets. The East-West integration with its economic and political consequences has gathered a great amount of interest among economists and politicians. Due to trade liberalization and growing markets, the general interest has focused on the gains, volume, direction and composition of the East-West trade. Both current and future trade- and production patterns have been analyzed reflecting not only the principles of the comparative advantage, but also those of the new trade theory. Furthermore, trade policy practised in trade negotiations has been a combination of conventional and new ideologies of trade policy and other policy fields. The EU's enlargement negotiations have been guided by the mixture of the principles of free trade and protectionism reflecting the basic ideology of the "GATT-think".

The trade liberalization and trade negotiations between Eastern and Western Europe are developing gradually. Current trade arrangements are driven by urgency, by political considerations, and by economic advantage. Individual agreements have been signed linking the European Union to East European countries. These agreements involve not only trade relations but also a wide range of economic institutions and political ties. This maze of bilateral deals is now the framework for European economic and political development. In the background there is the intention towards a fully integrated Europe, the intention of most of the European countries not yet in the union to join it as soon as possible. Along the integration process many political and economic changes have occurred and will occur both in the Eastern and Western European countries. These economic and political changes together with the radical transformation that is taking place in Eastern Europe have led and most likely continue to lead to significant changes in trade and production patterns. In the short-run, it seems that countries' comparative advantage and differences in the factor endowments are key elements forming the pattern of the East-West trade and production. In the longer-run, however, it looks like that the trade pattern of East European countries will adjust to look more like the trade patterns of West European countries. The trade is moving toward trade among similar countries and toward trade among similar goods rather than trade between very different industrial sectors. Thus, a trade pattern based on the conventional trade theory is giving more and more room to a trade pattern based on the new trade theory.

### 5.2 Comparative Advantage and The Likely Effects of Trade Liberalization

At the moment the European Union is not trading very much with the East because the East is not integrated yet with the West and they have yet to attain Western levels of income. Thus as trade liberalizes and these markets will become

more integrated, the Eastern markets will become much more important to the Western markets. As the system of planning in Eastern countries is removed and the market mechanism starts to work, one would expect two things to happen. First, Eastern countries will be likely to do more trade for the same level of income, and second, their incomes will begin to catch up with West European levels. As a consequence, trade- and production patterns are moving from inter-industry trade determined by comparative advantage towards intra-industry trade driven by increasing returns as a result of specialization within industries.

Most likely, the best indicator we can have of Eastern Europe's comparative advantage pattern is that reflected in its current trade with the West. In general, the average, current trade pattern between East and West European countries can be characterized as follows: There is some Heckscher–Ohlin trade between East European countries and the West. The East exports natural-resource-intensive commodities and to some extent labour-intensive commodities. The West European countries on the whole export to the East commodities that are intensive in capital and human capital. There is, however, a substantial amount of intra-industry trade in these commodities.

There can be doubts that this trade has been greatly distorted by centralized planning in the former socialist countries and by misguided domestic pricing. Thus, this is important to keep in mind when analyzing current pattern of trade and especially Eastern areas of comparative advantage. Even if existing trade flows with the West are reflecting true comparative advantage, the future trade pattern is unlikely to be a simple radial blow-up of today's. All historical episodes of significant trade expansion have involved a great deal of product diversification in exports. With these caveats in mind, let us turn to the comparative advantage patterns reflected in current East-West trade flows and predict the likely effects of trade liberalization.

The energy sector represents an important area of Eastern factor endowments. The region of the former Soviet Union is extremely important for the overall outlook of global energy production since, historically, it was the biggest producer and the second largest consumer of energy in the world<sup>3</sup>. The Eastern-bloc countries still have an important role in the world production and exports of oil, gas and coal. It can be expected that the economic and trade liberalization could lead to changes in their energy sectors. These changes can be characterised in three dimensions: There could be an increase in domestic demand, due to economic growth. The domestic demand may also decrease as the systemic waste is reduced. Finally, a change in domestic supply may occur as these countries adopt criteria for assessing and selecting investments and more closely approach Western environmental standards. The direction of the change in the energy sector due to economic and trade liberalization, however, is not obvious. Some estimates have nevertheless been made. It seems highly likely that the energy sector will be strongly promoted<sup>4</sup>. The net export will increase pushing the world price down. Cheaper energy will stimulate the Western economies bringing terms-of-trade improvements. Further, the adoption of existing Western techniques will help with the inefficiency problem.

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<sup>3</sup> Carl B. Hamilton and L. Alan Winters, *Economic Policy. A European Forum*, Eastern Europe, no. 14, University of Cambridge 1992, p.90.

<sup>4</sup> *Monitoring European Integration, The Impact of Eastern Europe*, CEPR, London 1990, p.14.

Historically, the Eastern European countries were also large agricultural exporters whose comparative advantage was based on the low level of labour and production costs<sup>5</sup>. However, the notorious inefficiency of their agriculture is said to be one of the most significant factors in the failure of the Soviet economic experiment. During last years Eastern European countries have gone through a crisis in the agricultural sector and witnessed a serious deterioration in their trade with the West. The further trade liberalization together with the observations stated above suggest now the likelihood of a substantial increase in Eastern agricultural output. Moreover, in case East European consumption increases by less than production, Eastern Europe will be able to increase significantly its level of net exports of agricultural produce. However, there are some factors that might constrain the expansion of the East agriculture. First, there are fears that poor farming practices have either permanently reduced fertility or "poisoned" the land. Second, there are concerns about the skills of the workforce. Finally, there is a technology constraint; part of the agricultural deficit can be explained by quality deficiencies in the existing stock of equipment and substantially less machine intensive agriculture. The suggestion is that agriculture will shed significant amounts of labour to labour-intensive manufacturing over next decade<sup>6</sup>. A resurgence of agriculture in Eastern Europe raises several issues for the West, for the European Union. Increased net exports will lead, *ceteris paribus*, to lower world prices. Further, if Eastern Europe is to finance imports, they will need to export, and will look to Western Europe as natural outlet, hence increased EU imports from the East may become inevitable. A liberalized East might also offer an outlet for certain EU surplus produce.

Just like the abundance of natural resources, agricultural land area and energy reserves remains, similarly, the relative abundance of labour in Eastern Europe remains. Given the abundance of labour in the East compared with current EU members and with the existence of systematic trade barriers in so called sensitive sectors such as clothing (textiles and shoes), food, agricultural products, and steel, freeing up trade would most likely stimulate production of labour-intensive goods in the East and discourage it in the West. As a result, freed resources in the West would be employed in more productive activities. This increased specialization would allow nations to allocate their resources on what they do relatively best, increasing output per capita throughout the whole region.

The most difficult factor to value is the capital base of Eastern Europe. If the capital stock were to be measured in terms of historical cost, we should probably find that Eastern Europe is abundantly endowed with capital since it has maintained very high investment rates throughout the post war period<sup>7</sup>. At the same time, however, much of the stock is of little or no value today. This because it either has been poorly maintained or does not enjoy best-practice technology. Further, much of the stock has been tied to unprofitable industries, reflecting systemic misallocations of investment. After all, it is generally believed that technology and capital are relatively scarce in the East European economies. Thus,

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<sup>5</sup> Economic Policy, A European Forum, Eastern Europe, No. 14, University of Cambridge, Great Britain 1992, p.90.

<sup>6</sup> Monitoring European Integration; The Impact of Eastern Europe, CEPR, London 1990, p.17.

<sup>7</sup> Monitoring European Integration, The Impact of Eastern Europe, CEPR, 1990 London, p.3.



one would expect that integration with the West systematically lowers the price of goods that are intensive in these factors. Further, The increased East Europe's demand for capital and intermediate goods will benefit primarily the advanced industrial countries, which can supply these capital-intensive products. Standard comparative advantage theory suggests the following result: In the short and medium run trade leads most likely to a fall in the proportion of resources devoted in the East to the production of capital and technology-intensive goods. Moreover, since the infrastructures are extremely underdeveloped in the East compared with those in the EU, structural spending is likely to be more productive in the East.

Although Eastern Europe's comparative advantage seems to be more likely based on labour-intensity and natural-resource-intensity than capital-intensity (human and physical capital), there have been some contradictory studies of comparative advantage as well. The conclusion that the Eastern countries may have a comparative advantage in industries that are relatively intensive in capital stems from the studies of CEPR ( 1990, 1991) and Hamilton and Winters (1992)<sup>8</sup>. While being completely contradictory, they, on the other hand, offer an interesting viewpoint and are there to remind of complexity involved with the issue:

East Europe seems to have a greater proportion of research-skilled workers in the total workforce than West Europe. However, one important note must be made here: There may be a definitional problem when measuring the numbers and quality of scientists and technicians engaged in R&D. On the other hand, the lower rates of school and university enrolments in the East in reality suggest a possible shortage of skilled production and commercial workers. These factor abundances suggest that among manufactures it is hi-tech goods rather than simple labour-intensive goods that represent Eastern Europe's area of comparative advantage.

Such a conclusion can be reinforced by considering the other components of hi-tech production and the alternative uses of skilled labour. Research workers in the East may have had relatively better access to the international market for ideas through journal and travel than its skilled workers have opportunities to train in the use of modern machinery and techniques. Thus as the latter constraint is eased productivity in hi-tech sectors could leap ahead.

The reduction in military manpower may also have implications for industrial skill levels. If there are reserves of highly-skilled scientists in military occupations- a likely hypothesis- a further relative stimulus to the hi-tech sector may appear as military numbers and expenditure decline. Hence the magnitudes involved in this adjustment are quite significant. The release of highly-skilled labour together with declining training at somewhat lower levels again suggests a shift towards hi-tech rather than more standard manufactures.

While this can be a plausible scenario, its likelihood depends critically on a number of factors, including the level of capital inflows into the East. It can be imagined that if a great amount of capital flows are made available, Eastern countries will be able to maintain relatively expensive currencies that overvalue their labor costs in dollar terms. That, in turn, would undercut the incentive to compete in export markets on the basis of cheap labor. Furthermore, at the same

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<sup>8</sup> Neven Damien, Trade Liberalization with Eastern Nations, How Sensitive? ,Centre for Economic Policy Research, Discussion Paper No. 1000, 1994 London, p.36.

time, large capital inflows attracted in part by the skills potential of the region would "validate" and unlock domestic human capital and set the stage for exports of relatively sophisticated skill-intensive manufactures. On the other hand, in case capital is not so freely available, things will look very different. The export expansion would be based on labor-cost advantages rather than on an abundance of human skills.

However, since the data on educational attainment are unreliable, it's difficult to make international comparisons and define exactly how highly skilled East European labour today is. Thus, the results and conclusions drawn from different empirical studies should be treated with caution.

To summarize, at the moment, current trade includes some H-O trade, where the East mainly exports natural-resource-intensive commodities and the West exports commodities that are in capital and human capital. There is, however, a growing tendency towards intra-industry trade in these commodities.

### 5.3 The Composition of Trade

There has been a large misunderstanding in many parts of Western Europe that Eastern European countries are only exporting food, agricultural product, clothing, textiles, iron and steel, products that are sensitive to the West. There is also perhaps a mistaken impression in the West that most of the growth of the exports from Eastern countries has come in these simple products that are sensitive to the West. But in fact those products account for about one third of Eastern total export to the EU and the rest is fairly evenly spread across a range of goods. Of course the sensitive products do constitute a major fraction of Eastern export growth and it is possible that this growth would have been even greater if they had not been constrained by trade barriers. In that sense the existing trade data concerning sensitive sectors does not reflect the growth and development of trade flows that would have occurred under free trade.

In particular, in addition to the sensitive sector production, worth mentioning are the large shares of chemicals, machinery and transport equipment, and other semi-manufactures.

Generally speaking the former Soviet Union has been exporting crude materials (minerals) and fuels and importing manufacturing. For the other Eastern European countries the composition is more mixed and less stark. Based on trade data they appear to export fuels, even though in former intra-CMEA trade they were large net importers of fuels from the former Soviet Union. Furthermore, other exported product categories are food, crude materials, basic manufacturing, and miscellaneous manufacturing. Finally, main import sectors have been chemicals and machinery.

When analyzing recent data on the composition of East-West trade the numbers indicate that the former Soviet Union will continue to trade energy and minerals for manufactured products. The other Eastern European countries, on the other hand, are likely to have comparative advantage in many standardized, low-skill items in the basic and miscellaneous manufactures categories, although these countries, at the moment, are net importers of manufactures taken as a whole.

## 5.4 Future Trade Pattern and Trade Policy

### 5.4.1 Future Trade Pattern

We have now studied how the Eastern European countries are generally endowed. How then will the future look like? First, from the point of view of intra-industry trade, in order to exploit their comparative advantage in skill-intensive sectors, Eastern economies need to rebuild their stock of capital, because a large part of their existing capital stock is obsolete and needs to be replaced, but also because skills and capital are usually complements to one another in production. The required capital may come either from domestic or foreign sources. If domestic savings and foreign direct investments stay stagnant, the inherited production capacities will determine to a large extent the future pattern of trade. The export structure will then most likely be the one that exists at the moment. It will stay based on natural resource-intensive and low quality-low price processed products.

In case, however, domestic savings and FDI increase, it will also carry new technology, new management and new organizational techniques. If so, Eastern nations should most likely be able to exploit their comparative advantage more fully. In addition, Eastern European countries will be able to expand intra-industry trade with the West as they achieve a more similar pattern of factor endowment with respect to industrial countries. Thus, trade will be based more on product differentiation rather than relying on relatively low labour costs as in the recent past.

Expanding productive infrastructures may also facilitate the process of capital stock accumulation often related to economic growth. Finally, strengthening skilled labor force together with improvements in the educational system will make the Eastern labor force more flexible and better to adapt to the constantly changing economic and social environment.

All in all, the general opinion states that the contribution to growth of capital inflows and the key to economic recovery in the East depends mainly on the success in strengthening and mobilizing domestic saving. In addition, macroeconomic fundamentals and the extent of structural transformation will also have their own impact (although smaller than domestic saving) on growth prospects and economic development.

### 5.4.2 Policy Implications

The assessment can be made that much, if not all, of the future development of East-West trade will crucially depend on the political economy; the decisions made by politicians, both in the past and in the future, and their influence on economy. While believing so, there are some aspects that have a substantial role in the future development of East-West trade. First, political aspects of intra-industry trade are highlighted. Secondly, attention will be drawn towards future trade policy.

The degree of intra-industry trade – two-way trade in similar products – is seen as an important determinant of the adjustment cost involved in trade

expansion. From an economic policy point of view, the higher is the index of intra-industry trade, the lower will be the adjustment costs.

This intra-industry trade done by rich countries dominates approximately three quarters of the world trade. Although it is typically connected with rich countries, there is an increasing trend of such trade both in the East and between the East and the West. For example: it is striking that although current East-West trade is still to a large extent inter-industry trade determined by comparative advantage, the amount of two-way trade in similar goods, for example, done by Hungary, Czechia, Slovakia and Poland is greater than for Portugal, Finland, Norway, Greece and Iceland. Hence, in some ways these economies are becoming similar to many Western economies.

From an economic policy point of view, another implication of a high degree of intra-industry trade can be that there is less trade friction when trade expands. Where inter-industry trade tends to dislocate workers and lead to negative reactions among workers, intra-industry trade, at most, leads to shifts within the same industry. Thus, intra-industry trade is politically less sensitive than expansion of inter-industry trade. All in all, since intra-industry trade is positive in the form of smaller adjustment costs and less trade friction when trade expands, it is natural to think that future political decision making could support intra industry trade. If so, intra-industry trade will continue to expand in the future.

Second interesting aspect is that of the direction of future trade policy in general. One common theme in trade policy-making is the desirability of international agreements in binding governments to "good behaviour". The GATT represents a constructive and liberal element of this "good behaviour", because it encourages countries = governments collectively towards free trade. The danger, however, in trade-policy making in general is much more a weak government that becomes a victim of special interest groups, which usually call for protectionism, than an actively working bad government.

Internal reforms and policy decisions affecting the success of these reforms are important determinants of whether market-oriented transformations will succeed in Eastern Europe. The West has an equally important role since the policy response of the West can either help or hinder the likelihood of success. The most supportive environment would include open markets for trade and foreign assistance – including some financial assistance, debt relief for some countries, transfer of technology, and technical assistance in a wide range of areas. However, at the same time there are some major questions that Western policymakers face such as, how does the magnitude of Western capital flows increase trade competition. The more Eastern nations get capital flows the more one can expect trade competition between the East and the West. The other important question that western policymakers are to face is should the gap between East and the West be closed either by capital flows from the West or by labour migration from the East and so on. If Western countries do not provide the capital, it may well end up with a major migration problem on its hands. Further, if the West does not assist in the recovery of the Eastern European countries, they will soon be at the receiving end of a larger trade diversion by the Eastern European countries.

All in all, under these kind of circumstances one can most likely expect rocky road for future trade policies.

## Conclusions

The traditional trade theory based on comparative advantage and perfect markets cannot be seen as the only way to explain international trade. An increasing amount of trade is moving toward trade among similar countries and toward trade among similar goods reflecting the principles of the new trade theory, those of increasing returns and imperfect markets.

Also, the future development of East-West trade will reflect more and more the principles of the new trade theory. In the short-run, Eastern Europe's comparative advantage will be mostly based on natural, resource, and labour-intensive commodities, where as the West's comparative advantage will lie in capital, and R&D-intensive production. In the longer-run, however, at least two outcomes are possible. In case Eastern countries are able to increase domestic savings and also succeed to attract enough foreign capital, they are closer to do more intra-industry trade in similar products. However, if strengthening and mobilizing of domestic savings does not succeed and, if, in addition, there is not enough foreign capital available for Eastern European countries, their trade will most likely look like the one existing now based on natural resource-intensive and low quality-low-price processed products.

The direction of the future East-West trade development will by far depend on economic and political decision making practised by both parties. The best and most supportive solution towards successful transformation in the East and growing (intra-industry) trade between the East and the West would include open markets for trade and aid for the Eastern countries.

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