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Graduating Into a Global Economy

by

R. J. Wonnacott

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RONALD J. WONNACOTT, LLD

On June 8, 2001, the University of Western Ontario awarded Ron Wonnacott an honorary doctorate, recognizing his pathbreaking work on international trade and his many other scholarly contributions over a distinguished career. His speech provided comments on trade agreements and an analysis of the proposed Free Trade Agreement of the Americas (FTAA) that we believe will be of interest to a wide audience. We are therefore very pleased, and honoured, to present "Graduating Into a Global Economy" as the first working paper of the RBC Financial Group Economic Policy Research Institute.

The text of the Citation delivered by John Whalley at the June 8th Convocation is reproduced at the end of the paper.

James B. Davies
Executive Director, EPRI

GRADUATING INTO A GLOBAL ECONOMY

R. J. Wonnacott

It's a particular pleasure being here this afternoon, because not so many years ago, as a UWO graduate I sat with you in one of those chairs. Actually not one of those, strictly speaking – because in those days this Alumni Hall didn't exist and graduation was held in the football stadium. That worked well, unless there was an unexpected forecast of rain, in which case there was a mad scramble to get indoors.

Other changes at Western: the economics department has grown from 3 full-time faculty in 1955 to 34 today; there has been similar growth in other departments. Now Western has a world-recognized reputation in a number of fields. While we could not hope to teach you everything you will need to know in your future careers because no one knows the direction knowledge will be exploding, our hope is that here at Western you have learned how to learn. With human capital – knowledge and experience – now more important for economic growth than physical capital – plant and equipment – it will be important for you, no matter what your activity, to keep asking “What am I learning?”

Global Challenges and Opportunities

As you graduate into a global economy the challenge is that you will have to compete with the best; the opportunity is that you will be better able to do so because recent remarkable improvements in communications have made it easier to compete from a Canadian location. Note that it has always been possible to do this: witness, for example the world reputation of those like Charlie Drake and Angus McLachlin in medicine and Alan Davenport in engineering

– all of whom have done it in lifetime careers based at Western. True, specific career reasons will draw some of you to opportunities outside Canada. Our challenge is to ensure that none of us leave because we have failed to make Canada as good a place as any other to work and compete internationally.

Trade Agreements: Their Effect on Incomes in Poor Countries

Globalization has been marked not only by the exploding exchange of information world-wide, but also by the opening of trade, with agreements like the WTO (the World Trade Organization), the Canada-U.S. FTA, NAFTA and the proposed Free Trade Agreement of the Americas (FTAA). John Whalley has indicated that I've done a lot of work on the design of these agreements. But as I look back on this, I recognize once more how much I owe, on these trade topics and others, to my book co-authors Grant Reuber, John Whalley, other faculty and students in the economics department, and especially my two brothers. I feel very much like the turtle on top of an 8' high fence post. I could not have possibly got there through my own efforts alone.

Let me then share a few thoughts with you on the most current of these trade topics, the FTAA. No Quebec City soundbites: you've already heard more than enough, some of which are overly optimistic, implying that the FTAA will be almost a cureall; it won't, and there will be massive hurdles in negotiating it. At the other extreme, some claims remind me of the soundbites fifteen years ago that Canadian culture and health services would be destroyed by the FTA. So let's try to get down to a deeper economic understanding of what's going on.

The big story in the FTAA will not be its impact on the U.S. or Canada. (For example, while Canadians will benefit from expanding markets and cheaper products from Latin America, our special privileges in the U.S. will be eroded.) Instead the major impact will be on Latin America (my shorthand for Central and South America). Under an FTAA, producers in Latin America would receive a higher price for their exports to the U.S. because they would be duty free. Because of this incentive -- along with the FTAA assurance (though no complete guarantee) of a relatively open U.S. market -- foreign investment in Latin America would increase. Thus the volume, as well as the price, of Latin American exports would rise -- with this increased volume reducing unit costs. Moreover, producers in Latin America would also become more efficient, since the FTAA would reduce their own protection, thus forcing them into greater competition in their own markets.

For all these reasons, Latin American productivity and wages would rise. As an example of the many historical confirmations, a World Bank study of developing economies by David Dollar and Art Kray concludes that those that are open have grown by 3, 3 1/2 and 5% over the last 3 decades, while other developing economies have had negative growth. In Mexico, the wage in the Maquiladoras is four times the national minimum wage -- the Maquiladoras being the area that gained relatively free access to the U.S. market even before NAFTA, and has been marked ever since by multinational investment for export to the U.S. This is not a zero-sum game. Such studies show that international trade and investment raises both profits and labour income.

Trade is like technological change. In either case, we get goods less expensively; i.e., our real income rises. But there are some losers in the short run, as less efficient jobs are cut back. However, in the median or long term, the displaced find jobs – and typically better ones. There is no better example than the U.S. in the late 90's, when there was both rapid technological change, and trade liberalization, in particular in NAFTA. Yet despite these two sources of potential dislocation, U.S. labor was quickly employed in other often higher-wage activities. Thus the rate of U.S. unemployment remained below the rate previously viewed as the lowest attainable. Moreover, despite this full employment, there was essentially no inflation. Two important reasons: technological change and trade liberalization, both of which reduced costs, thus making substantial non-inflationary increases in incomes possible. While adjustment cannot be expected to be always this quick and efficient, this illustrates how an economy adapts to these 2 important income-increasing changes.

One often hears that, under NAFTA, multinational corporations are exploiting Mexican labour by paying it a much lower wage than the Canadian or U.S. wage. But look at it from the Mexicans' point of view. They're not only getting an increased wage, but also a job. But note: the ability of international trade and investment to fully raise productivity and wages in poor nations requires that their lower wages now are not used by opponents to scuttle trade agreements that can raise those wages in the future. But let me emphasize: despite their benefits, trade and investment are not a cureall; for example, though they reduce poverty, they don't eliminate it. Those looking for poverty in Mexico have been able to find it, though they need not have looked so far from home. Moreover, there are examples of foreign trade and investment

abuse. One example is the manipulation of transborder pricing by parent multinationals to avoid taxes in the host country. But despite such caveats, our conclusion stands: trade and investment are important keys to growth. The evidence on this is in direct contradiction to the claim sometimes heard that the FTAA will lead to the impoverishment of poor countries.

Now let's turn to the view of some Canadian and U.S. firms and unions that they believe in fair trade, sometimes interpreted as competing with foreign firms only if they have the same labour costs. But a major benefit from trade is that costs differ between trading partners. We sell them products we produce at lower cost; they sell us other products with a high labour content that they produce at lower costs. If all costs were the same, this incentive for trade would disappear and they would be limited to selling us coffee and other niche products: Ask yourself this: To what degree is the demand for tough labour and environmental standards -- requirements that Latin American countries can scarcely today afford -- simply a disguised attempt by protectionist interests to scuttle a trade agreement -- an agreement that could, by increasing Latin Americans' income, allow them to afford higher labour and environmental standards in the future? Already, there has been substantial environmental cleanup in Mexico under NAFTA, as in Central and Eastern Europe where, as a result of improved access to Western European Markets, Volkswagens are produced rather than the notoriously dirty Trabant, the car so bad that -- according to one wit -- it doubles in value if you fill its tank with gas.

Other Benefits from Reducing Trade Barriers

The FTAA -- the inclusion of other Latin American countries into NAFTA -- would largely resolve two problems Latin American exporters now face due to present U.S. trade

barriers: (1) Their difficulty in competing in the U.S. against *U.S.* firms; and (2) their difficulty in competing in the U.S. against *Canadian* and *Mexican* firms. (Because of NAFTA, Canadian and Mexican firms export to the U.S. duty free. Latin American firms do not, and therefore suffer from discrimination in the U.S. market.) The more countries in a free trade area, the greater the discrimination against any outside country and the greater its incentive to escape this by getting inside. For example, although some Brazilians may wish that the FTAA had never been suggested, if all other Latin American countries participate, Brazil may have little choice but to do the same, rather than remaining an outsider facing discrimination in essentially all other Western Hemisphere markets.

This leads us to another effect of the FTAA: it will clean up the morass of roughly 20 smaller regional trade agreements in the hemisphere, such as Mercosur (4 southern countries, including Brazil and Argentina); the 5-nation Andean Community, the Central American Common Market, and so on. When any country now looks out over the hemisphere, it sees liberalized trade with its partners in its own trade agreement; but when it looks out over other countries in the hemisphere, it sees a byzantine maze of discriminatory trade barriers. While this may be heaven for trade lawyers, it is often hell for trading firms. The FTAA would end this, with each country in the Americas looking out over a hemisphere of free trade.

But beneficial as this may be, it's only a hemispheric, not a world solution; world trade will still be fragmented – although less so – because of remaining regional agreements, in particular the FTAA and European union. This is why our first priority should be liberalized world trade in the World Trade Organization, with no excluded countries and thus an end to

trade discrimination. This is why the demonstrations in Seattle against the WTO were even less justified than the demonstrations in Quebec City against the FTAA. (One of the reasons the FTAA may be a useful first step towards the goal of liberalized world trade is that it puts pressure on the Europeans and other outsiders to negotiate in the WTO, as a means of reducing the discrimination they would otherwise face in our hemisphere.)

The Twin Problems of Income Inequality and Poverty

Finally, how about the concern that trade will increase income inequality within countries and between them? While there is no doubt that there *is* severe inequality between nations, it's difficult to statistically measure whether, in the course of recent trade liberalization, this problem has been getting better or worse. One reason is that inequality may be increasing in absolute terms, but decreasing in relative terms. There is no doubt that statistics are highly useful, but they must be carefully examined, as illustrated by the observation by a 102 year old man. When asked if he feared dying, he said no: statistics prove that there are very few people who die at 102.

One thing we do know about income inequality is that, regardless of how it's measured, the industrial revolution increased this problem as some countries embraced that revolution while others did not. [As an aside, note that the same remains true today: if some countries fail to embrace the current revolution in information technology while others do, the result will be to increase inequality.]

Now let's go back to the earliest stages of the industrial revolution: Suppose the Luddites had been able to block it? The result would have been more equality – the lowest common

denominator equality of the poor – but no one would recommend this. The more important problem is not inequality, but raising the income of the poor. Thus the objective for the poor countries should be to open up international trade and investment that will help them to start to catch up – and to embrace the new information technology (as India in particular is doing) so as to keep from falling further behind.

Indian experience and that of other similarly developing countries is also instructive in addressing the concern about trade increasing inequality within nations. As these economies have become more open, there has been little change in comparative income between groups. The big change is that, with rising national income, more have now escaped from poverty.

To sum up: While one can applaud those concerned with poverty in developing countries, one cannot applaud the anti-trade policies some recommend -- policies that would make the problem worse.

Finally a personal footnote: as you now embark on a continuing lifetime association with your alma mater, I offer one brief reflection on your last 3 years. Whether you love them or hate them, at some point you have all had multiple choice exams. But the most interesting reaction of all was that of the student who brought in dice which he proceeded to roll, each time recording the result. Soon after he was finished he started this noisy procedure again. The professor said “I thought you were finished”. He said “I am, I’m just checking my answers”.

CITATION

Ronald J. Wonnacott, son of Western, teenager of Harvard, and father of free trade; we are here today to honour you with the award of the honorary degree of Doctor of Laws. This is a great day for Western because of your long association with the University. A top undergraduate, you left in 1955 for Harvard, from where you returned in 1958, with your PhD degree completed in 1959. The intervening 42 years have seen you exclusively at Western engaged in your teaching and research, and occasional administrative duties as chair.

And what research! And what impact! Papers in the very leading journals in the field, the *American Economic Review* and the *Journal of Political Economy*; and standing the field appropriately on its head by highlighting the role of the missing foreign tariff in customs union theory. And underlying it all the clear theme of the virtues of free trade to Canada.

And if any academic career highlights the virtues of consistency and determination to see through an idea it is yours. Early on you developed the clear contribution that for smaller economies such as Canada the gains from free trade should be large due to scale economies and specialization gains. Your pivotal 1967 book with your brother, Paul Wonnacott, showed this, and presented initial calculations demonstrating that if free trade narrowed the Canada-US productivity gap, gains as large as 10% of GDP could result. Your later work refined and further projected these ideas, picked up later by the MacDonald commission and policy makers in government. You are known as the father of free trade; we are your offspring and it is from you and your work we have benefited.

Many of you perhaps know that Ron and his equally prolific brothers Tom and Paul are part of a family of Wonnacotts. Well, Ron, we want you to know that there will only ever be one

Ron Wonnacott and there aren't simply words to describe your contributions, nor how important you are to everyone at Western, and how indebted we are to you.

Congratulations, and keep going on free trade.

John Whalley