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The new goods margin in new markets

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ABSTRACT

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We analyze the role of the new goods margin in the Baltic countries' exports and imports growth during the 1995–2008 period. Using the methodology developed in Kehoe and Ruhl (2013), we define the set of least-traded goods as those that account for the lowest 10% of total exports and imports in 1995, and then trace its growth in several markets including the Baltics' main trade partners, the European Union and Russia. We find that, on average, by 2008 least-traded goods accounted for nearly 50% of total Baltic exports to their main trade partners. Moreover, we find that increases in the share of least-traded exports coincided with the timing of the trade liberalization reforms implemented by the Baltic countries. Least-traded imports also grew at robust rates, but their growth was lower than that of exports, accounting for slightly less than a quarter of total imports, that is, about half of the exports value. Moreover, we find that the shares of least-traded imports from the EU 15 and from Russia started diverging around the time the Baltic countries joined the EU, with the EU 15 share increasing and the Russian one declining. We also find that the Baltics' share of least-traded exports outpaced that of other economies in Central and Eastern Europe. Finally, exports of new goods from the Baltic countries suffered noticeably during the Global Financial Crisis. After the crisis ended, the restart in new goods exports growth displayed mixed patterns. *Journal of Comparative Economics* 000 (2017) 1–16. School of Economics, UNSW Business School, University of New South Wales, Sydney, 2052, NSW, Australia; Department of Economics, Quinlan School of Business, Loyola University Chicago, 820 N. Michigan Avenue, Chicago, IL 60611, United States.

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1. Introduction

The enlargements of the European Union (EU) that granted membership to ten former members of the Eastern Bloc in 2004 and 2007 were watershed events in which the transition economies of Eastern and Central Europe became integrated with Western Europe.¹ Since free trade was one of the key components of EU accession, joining the EU provided new opportunities for trade growth among new and old members.

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This increase in trade could occur because countries export and import more of the goods that they had already been trading. But the liberalization of trade could also promote trade in goods that had previously not been traded. In the literature, the former is usually referred to as trade in the intensive margin, while the latter is usually called trade in the extensive margin, or the *new goods margin*.²

What drives the increases of trade in previously non-traded goods? Kehoe and Ruhl (2013) find that growth in the new goods margin of trade is brought about by trade liberalization reforms (such as NAFTA or China's accession to the WTO) and by episodes of deep structural change (such as the one that Korea and Chile underwent during the 1970s and 1980s). Moreover, they also find that increases in the new goods margin are not driven by other factors such as the product cycle or the business cycle. Ruhl (2008) proposes a theory to account for these findings. Following Melitz (2003), Ruhl's model features firms that face entry costs of exporting. Trade liberalization reforms are modeled as permanent changes that raise the profit from exporting and induce firms that were initially non-exporters to begin exporting, thus leading to increases in the new goods margin. This hypothesis is supported by the study of Bernard et al. (2003), who find that US manufacturing firms choose to enter the export market as trade costs fall. Other papers report similar outcomes: Arkolakis (2010), for example, uses market penetration costs to understand the positive correlation between trade liberalization and the number of small exporters in each exporting market.

A number of studies have recently highlighted the importance of the new goods margin during episodes of trade liberalization. This is due to the fact that increases in the extensive margin of both imports and exports have significant implications in terms of welfare and productivity. For example, Broda and Weinstein (2006) quantify the welfare gains resulting from the growth in product variety from US imports for the 1972–2001 period, and estimate the value to American consumers of the expanded import varieties to be 2.6% of GDP. Thus, increases in the imports extensive margin have significant welfare consequences. On the export side, in his very influential article, Melitz (2003) shows that reductions in trade barriers increase the profits that firms can earn abroad, and encourages both existing exporters to increase their exports (the intensive margin) and also new firms to begin exporting (the extensive margin). This in turn leads to output and employment being allocated towards exporters, which are highly productive firms, thus raising the average industry productivity. Therefore, if export growth following the liberalization of trade is mainly due to the extensive margin, then increases in productivity can be attributed, at least in part, to increases in trade in new goods.

In this article, we study the patterns of the extensive margin of trade for the case of the three Baltic States: Estonia, Latvia and Lithuania. After gaining independence from the Soviet Union in 1991, these countries implemented a series of extensive market liberalization policies, including aggressive trade liberalization reforms. As they opened their economies to the world, the Baltics experienced rapid trade growth. We ask whether this period of rapid trade expansion also coincided with increases in newly-traded goods by quantifying the relative importance of the new goods margin between 1995 and 2008.

Our choice of the three Baltic countries is motivated by the following facts. First, the Baltic countries went through exactly the kind of economic transformations that Kehoe and Ruhl (2013) identify as the main drivers of extensive margin increases. Second, unlike other Eastern and Central European economies, the Baltics used to be part of the Soviet Union and therefore lacked of any degree of autonomy. Upon independence, they faced a vast array of challenges, most notably among them the difficult task of establishing trade relationships with the rest of the world, which prior to 1991 were determined solely from Moscow. Third, as mentioned previously, from the onset of the transition, the three countries became leading reformers among the formerly centrally-planned economies and quickly underwent market reform transformations with success. Indeed, the term “Baltic Tigers” was coined to highlight the rapid economic growth experienced by the Baltic countries, in contrast to the economic and political crises that have plagued other regions, such as the countries of the former Yugoslavia. Lastly, as former Soviet republics, the Baltic nations had sizable portions of ethnic Russian-speaking population, most of which remained in the Baltics even after their independence. Thus, in principle, this gives the Baltic countries a unique potential to better tap into the Russian market.

In our empirical analysis, we assess the role of the Baltic new goods margin with a number of trade partners. In particular, we choose the EU (taken as the single bloc made up of the 15 countries prior to its expansion in 2004), as well as some of its individual members such as Germany, Sweden and Finland, since they are among the most important Baltic trade partners. We also study the new goods margin with Russia, given the historical ties between the Baltic states and Russia. Besides our benchmark analysis, we extend our investigation to test whether the increase in the new goods margin with the EU and Russia was unique to the Baltic countries, or instead it was a generalized fact across the transition economies. Finally, we also extend our period of study up to 2014 to determine whether the large collapse in international trade during the Global Financial Crisis (GFC) of 2009 had any impact on the new goods margin in the exports of the region.

Our study employs the methodology recently developed by Kehoe and Ruhl (2013) (henceforth KR), who rank goods from smallest to largest by their trade values in the base year and accumulate the ordered goods to form ten sets or bins, each containing 10% of total trade. The goods in the first set are labeled as “least-traded goods,” since they represent the goods with the lowest trade values.³ We believe KR's approach of defining least-traded goods by using a threshold that

² To be precise, the “extensive margin” and the “new goods margin” measure similar, but not exactly identical margins of trade. The extensive margin includes both new goods that become traded and previously-traded goods that stop being traded, whereas the new goods margin only includes new goods that become traded. We explain these differences in more detail in Section 3.

³ Note that the set of least-traded group contains both goods with zero trade value and with positive, but small, values.

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