# Chapter 2

## Literature and Theory Review and

## Framework of the Study

### 2.1 Literature Review

The important components of the cross border economy are cross border trade and cross border migration, whether formally or informally. This paper is going to emphasize only on formal cross border trade activities.

When Paul R. Krugman (2006) commented on the complicated nature of border trade, he said that border trade is the increased trade in areas near a national border caused by a price difference, either generally or only for particular products in the two countries. That is refers to the flow of goods and services across the international land borders between countries. In this sense, it is a part of normal trade that flows through standard export import frameworks of nations. However, the economic, social and political implications of border trade are far deeper than normal trade that flows through the sea and airports.

#### 2.1.1 Types of Border Trade

Than (2005) mentioned that the types of border trade can be organized as follows.

**Formal Border Trade:** Trade between neighboring countries with permission from respective governments or from the country of study by paying dues (custom duties, commercial tax, etc.) at border posts.

**Informal Border Trade:** Trade where no border post exists and where both sides avoid border posts or when sanctioned by local authorities but not recorded in official statistics.

**Illegal Border Trade:** Trade without the knowledge of local authorities or trade in goods that are banned by the governments on both sides of the border.

**Transit Trade:** Importing goods across one border and exporting them from another; importing goods across one border and exporting them overseas; and importing goods from overseas and exporting them across a border.

Although there has been no study directly focusing on the cross border trade activities on Myawaddy particularly, the scope of a few of studies provide some idea and background of cross border trade between Myanmar and Thailand.

**2.1.2 Major Characteristics of Border Trade**

The major characteristics of border trade were discussed by Jorge Aseff & Morales (1995) in their paper entitled *The Importance of the Border Trade: The Case of Bolivia*.

They said that border economic relationships are the trading of international merchandise and non-factor services, and the trading of factor movements especially labor. There are two kinds of merchandise trade which are goods produced at host country and in the neighbor countries, and goods in transit from third countries. In the second one, trade with the bordering countries is in services attached to the transportation and managing of merchandise in transit.

Border trade normally starts with goods for local consumption and low transportation costs from the closest neighboring country. When the border posts provide government services like customs, so the diversity of the tradable goods are increasing. Thus trade shifts from local traders to the people from the cities. At this point, the nature of trade has changed. After this very initial stage, the more developed forms of international trade appear. The border towns are mainly conducted as "transit" points assisted by customs, warehousing, and distribution services there. In this stage the bundle of goods traded on the border posts does not vary distinctly from the trade bundle of the country as a whole.

The people engaged in border trade in early stages are mostly the local populations of the border posts. Cross border movements become significant. Labor moves freely in border towns, sometimes illegal. Moreover, the opportunities of profit in border towns from purchasing goods and selling them in major cities creates an influx of people from places far away from the border. This transient population could be significant.



The transportation cost is the most important characteristic of border trade because the cost is very low in the concerned regions. Because of the lower transportation cost, trade could be very active, even though the overall regional development depends on various factors, including the density of population. Since the transportation costs have fallen between border towns and the mainland cities, there is a natural enlargement of the zone of influence of the border. Transportation costs act as a tariff-giving protection to a host of activities. In the situation of high transportation costs, the production of some goods is possible even when done in a less efficient way than in other countries. The tariff-like effect of high transportation costs may create a diversified pattern of production, with some industrialization, some of which exhibit increasing returns. As transportation costs decrease, the concentration of the production taking place on one side or the other of the national boundary may be slowed only by national policy measures, which are difficult to carry out at that level. Besides, the government may extend specialization by liberalizing the specific constraints by economic policy that block the natural evolution of border trade. Liberalization will act first on border trade by enlarging it.

Trade creation and trade diversion are fundamental in the assessment of the formation of free trade zones. As transportation costs decrease in a given region some trade will be diverted from other countries. In addition, intra-regional trade increases but so does the specialization in production. The effects of macroeconomic instability influence border trade and the movements of factors. Foreign exchanges are also important at border town markets which used to be very active.



**2.1.3 Review of Cross Border Trade**

*The Importance of the Border Trade: The case of Bolivia* by Aseff, Espejo and Morales (1995) stated that the development of border towns is marred by two problems that cannot be overcome by incentives for investment and production.

First, none of the neighboring countries have a large economic center near the border town. Second is the economic instability. The study also mentioned that border trade could contribute to growth in two major ways. One way is that the advantages of location and some characteristics of border trade could be extended to progressively wider spaces. The advantages of location are related to economies of scale and agglomeration, externalities, and increasing returns. Trade as a flow through border points could generate border economies of scale, especially the hub and spokes model[1]. Hubbing has the potential to significantly reduce the costs of trade among the countries in the surrounding area. In practice, this concept would require good transportation infrastructure, warehouse services, and a very efficient distribution system.

In a potential situation for an economic integrated zone, the current economic agreements have to develop gradually toward the more advanced form of free trade agreements. The study also pointed out that the acts of expanding border trade and joining FTAs should be welfare improving both domestically and globally but as international trade along with benefits also generates risks. Bolivia's situation of significant economic backwardness with regard to three of her neighbors creates the danger that her low degree of industrialization would decrease even more. Production risks being limited to primary products, using location-specific factors (land and mineral resources) with little technology spillovers, and without the benefit of increasing returns to scale. As a result, the

[1] The hub and spoke model is a system which makes transportation much more efficient by greatly simplifying a network of routes. It is extensively used in commercial aviation for both passengers and freight, and the model has also been adopted in the technology sector as well. Delta Airlines pioneered the method in 1955, but it wasn't until the 1970s, when the FedEx Company took advantage of the concept, that the method really took hold, revolutionizing the way airlines were run.

Bolivia economy would remain mired in very low wages and incomes. There could be de-industrialization in the aggregate. But this does not imply that all industries would decline. The core periphery model[2] could be repeated in a regional scale, but Bolivia could be pushed toward the outer ring. The gap in wages and income relative to those of the more advanced neighbors would narrow only when transportation costs fall further, when the advantages of location become less important and the mobility of industry increases.

The study also found that border trade has the potential to increaseproduction and consumption in regions that are far from the main cities. That means that economic activity will emerge in areas that would have very little economic power otherwise. This new economic activity is a source of stable income. The authors reported that even if the concentration of population at the border areas is low, they may have a good prospect as a transit and distribution center for goods bound for the inland country. That population has the potential to become important suppliers of services. Border trade has been in various ways a forerunner of the current attempts at regional integration. The authors concluded that as the costs of transacting over space fall and the policy-generated walls to international trade disappear, many (but not all) characteristics of border trade will naturally spread to the rest of the economy.

*Thailand's Cross Border Economy: A case study of Sa Kaeo and Chiang Rai* by Worawan, Yongyuth and Srawooth (2005) reported that the certain degree

[2] **Core-periphery theory** is based on the notion that as one region or state expands in economic prosperity; it must engulf regions nearby to ensure ongoing economic and political success. The area of high growth becomes known as the core, and the neighboring area is the periphery. Cores and peripheries may be towns, cities, states, or nations.

of direct benefits from border trade is experienced by both trading partners. Thailand has been enjoying a trade surplus with Laos for a number of years because Thailand could largely import high-value manufactured products to Laos and imports primary products from it. The benefits of border trade highly depend on population density on both sides of the border and the types of merchandise traded in the border market. Lao would buy all consumer and non-consumer products necessary for the development while the country could not produce such products itself. They also pointed out that the financial and banking systems are poorly developed in the Lao PDR. The value of the Lao currency is not stable and is unpredictable. The black market exchange rate is different from the official rate by a wide margin. Branches of reliable banks are still few at border towns.

*The Role of Informal Cross-Border Trade in Myanmar* is a study conducted by Aung (2009). It shows that there are many reasons for engaging in informal trade practices. Some of these reasons are;

- to avoid the lengthy licensing process
- to import products without having earnings from export
- to import/export products that are restricted on a temporary or permanent basis
- to evade tax



The author classified the two kinds of trade in the border areas as documented and undocumented trade. His paper presented the role of broker trading companies and also stated the two types of informal players in border areas. The first one is the broker trading companies responsible for documented trade and the latter is smugglers (also called carriers) for undocumented trade. The route used by broker trading companies is called the “upper channel” and the route used by the latter is called the “lower channel”.

Evans (2003) found that under the assumption of a reasonable elasticity of substitution, implied price wedges between imports and domestic goods are far higher than recognized tariff barriers. The author also presented that transactions –cost differences between foreign and domestic products create border effects.

Evans (2006) classified the distinction between two broad explanations of border effects: (1) less international than domestic trade in the goods that are actually traded between countries (2) differences between the sets of goods traded internationally and domestically. The author suggested that a portion of the border effect may be due to differences between the sets of goods available domestically and internationally.

Clark and van Wincoop (2001) highlighted that bilateral trade is not more than a proxy of the complicated trade relationship that exists between regions and countries. The authors also cited that the business cycle movements between two regions depend not only on the total level of trade between them, but also on trade with others and the type of goods that are traded.

Anderson and Wincoop (2004) reported that there is a rich relationship between domestic and international trade costs, market structure, and political economy. Some trade costs provide benefits and it is more likely that the pursuit of benefits partly explains the cost.

Kudo (2007) reported that border areas in Myanmar are no longer the regions that depend on assistance from the center. In contrast, they are frontiers and conduits that absorb the economic energy of emerging countries, such as Thailand and China at present and India and Bangladesh in future, into a core part of the Myanmar economy.

Most studies on cross border trade supported the ideas that the development of the cross border trade would benefit people living in border areas by creating more job opportunities, achieving stable income and contributing to poverty alleviation.

## 2.2 Theory Review

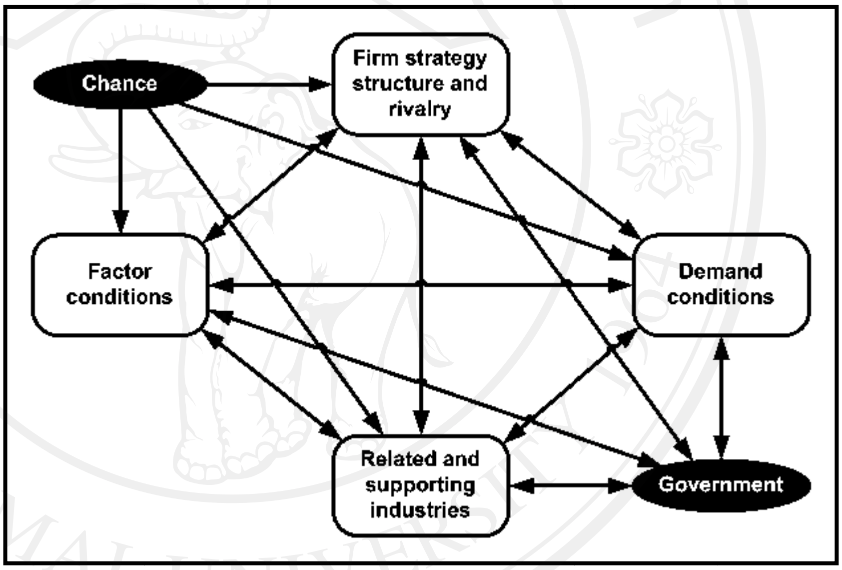
There are classical theories in international trade contributing to the explanation of trade between countries.

### 2.2.1 National Competitive Advantage Theory

In the competitive advantage of nation's theory, Michael E. Porter (1990) explains that a nation's competitiveness depends on the *capacity* of its industry to innovate and improve. The companies gain benefit over the world's finest competitors because of pressure and challenge. They gain advantage by having strong domestic competitors, powerful home-based suppliers and demanding local customers. Competitive advantage is constructed and sustained through a highly localized process. Such diversities in economics, structures, institutions, histories, culture and national values contribute to competitive success. There are prominent dissimilarities in the patterns of competitiveness in every country that a nation cannot or will not be competitive in every industry. Countries achieve success in particular industries because their home atmosphere is the most onward looking, dynamic and challenging.

Porter Diamond determined four extensive characteristics of a nation which attributes individually and as a system and serve as determinants of the model. These are factor conditions, demand conditions, related and supporting industries, and firm strategy, structure and rivalry.

**Figure 2.1 Model of Determinants of National Competitive Advantage**




Source: Adapted from Michael E. Porter (1998), "The Competitive Advantage of Nations", pp 127

**Factor Conditions**: According to the economic theory, the factors of production, land, labor, capital, natural resources and infrastructure, determine the flow of trade. A nation exports goods which are produced by using relatively well endowed factors. Skilled human resources or the scientific base are specialized and involve sustained and vast investment. Basic factors such as an abundance of labor and raw material sourced locally do not comprise in knowledge-intensive industries. Countries succeed in industries where they are particularly good at factor creation. Advanced factors are the most significant.

Although Myanmar has been weakening in terms of capital, infrastructure, skilled human resources or the scientific base, the competitiveness of natural gas export has been most significant among Myanmar's top five export items which could offset the country's long term trade deficits.

**Demand Conditions:** It might seem that globalization would reduce the importance of home demand, but the nature of the home market has an unequal effect on how companies receive, interpret, and respond to their customer needs. Countries achieve competitive advantage in industries where home demand provides more challenging needs, where customers encourage companies to upgrade their respective technologies. A nation's firm achieves competitive advantage if their domestic consumers are the world's most sophisticated and they pressure companies to meet high standards, to upgrade, to innovate, and to develop into a more advance stage. Demand condition offers competitive advantage by pushing companies to respond to challenges.



The communication and feedback between final consumers and producers has been poor in Myanmar. One possible explanation could be the lengthy procedure of importing required inputs which would delay firms to receive, interpret and respond to their customer needs. In relation to this one determinant, competitiveness for demand conditions, Myanmar's market demands for capital goods, intermediate goods and consumer goods have been growing to respond to its own consumer needs.

**Related and Supporting Industries:** The third attribute of the Porter Diamond model is the presence of suppliers or supporting industries that are internationally competitive. Home-based suppliers contribute to advantages in several ways. They provide the most cost effective inputs in an efficient, fast, and preferential way. Home-based related and supporting industries provide the innovation and upgrading needed for an advantage based on close working relationships. Suppliers and end-users situated nearby can achieve advantage of short lines of communication, quick and constant flow of information, and ongoing exchange of ideas and innovations. Home-based competitiveness in related industries offers benefits; information flow and technical exchange speed up the rate of innovation and upgrading. Successful industries within a country tend to be grouped into clusters of related industries.

Although Myanmar has been developing its own industrial development, it is still hindered due to many reasons; some are shortages of electricity, the weakening of the financial sector, restrictions to export/import and lengthy licensing procedures. Myanmar is not host to the presence of many related and supporting industries apart from the energy sector.

**Firm Strategy, Structure and Rivalry:** The fourth broad determinant of national competitive advantage in an industry is the situation in which firms are shaped, organized and managed as well as the nature of domestic rivalry. The goals, strategies, and ways of organizing firms in industries vary widely among nations. National advantage results from a good match between these choices and the sources of competitive advantage in a particular industry. Domestic rivalry creates demand on companies to innovate, develop and upgrade. Local rivals pressure each other to lower costs, improve quality and service, and create new processes and products. Local rivalries become intensely personal which go beyond pure economic or business competition when compared with overseas competitions which tend to be analytically distant. Domestic rivals hold in active dispute that they compete not only for a market share but also for consumers as well as for technical excellence. Local companies push each other to look outward to foreign markets to get greater efficiency and higher profitability particularly when there are economies of scale.

There are domestic rivalries in Myanmar since they are inherent to the nature of economics. Yet the pattern of rivalry has not played a profound role in the process of innovation and ultimate prospects for international success.

Apart from above mentioned four broad determinants of a nation, Porter explained the diamond as a system, the role of government, the role of chance and the company agenda to guide the nations to gain and sustain competitive advantage as well. This study will not give emphasis on the company agenda.

**The Diamond as a System:** The effect of one determinant often depends on the condition of others. Domestic rivalries and geographic concentration change the diamond into a system. Domestic rivalries support the development of four determinants. Geographic concentration promotes and expands the interaction between determinants. The diamond creates the environment that elevates clusters or networks of competitive industries. Networks encourage technologies, new ideas, research and development approaches, and flow of information.

In conclusion, the relationship between four determinants of Porter's national advantage is when one determinant is significantly stronger and it can facilitate the other determinants to some extent.

**The Role of Government:** Porter explains the role of government as an important role in his four broad determinants. He also stated that government's real role in national competitive advantage is in influencing the four determinants to become positive or negative. As an example, he cited that factor conditions are affected through subsidies, policies toward the capital markets, policies toward education, and so forth.

Porter's theory emphasizes that market pressures and resulting innovations can overcome factor costs, so that undervaluation can slow the upgrading of competitive advantage and direct firms to less sustainable, price-sensitive market segments. The outcome is a long-term loss of competitive advantage. Government support that removes the pressures on firms to improve and upgrade is counterproductive. According to Porter, successful policies work in those industries where fundamental determinants of national advantage are present and where government reinforces them.

Myanmar, which exhibits a high level of state dominance, would be hesitant to some extent to shape the four basic determinants of Porter's diamond.

**The Role of Chance**: Chance events are significant because they create discontinuities that allow shifts in competitive position. The nation with the most favorable "diamond" will be most likely to convert chance events into competitive advantage.

Cross border trade between Myanmar and Thailand will be briefly explained by referring to other classical trade theories such as Absolute advantage theory, comparative advantage theory and Heckscher-Ohlin theory.

### 2.2.2 Absolute Advantage Theory

Absolute advantage theory of Adam Smith (1991) is the ability of a country to produce goods using fewer resources than another country. Countries should specialize in the production of goods for which they have an absolute advantage and then trade these goods for goods produced by other countries. According to Smith, when two parties trade with one another, both must gain from the exchange. Smith pointed out that trade is not a zero-sum game as like with mercantilism which is a theory that a country should discourage imports and encourage exports in order to increase its wealth. The idea is that both nations would benefit from trade.

Natural advantage theory of Adam Smith (1991) is when a country has natural advantage in the production of a product because of climate conditions, access to certain natural resources, or accessibility of an abundant labor force.

### 2.2.3 Comparative Advantage Theory

Another economist explained that trade is based on comparative advantage (David Ricardo, 1817 cited in (Pugel, 2007), pp 35) Ricardo states that it makes sense for a country to specialize in the production of those goods that it produces most efficiently and to buy the goods that it produces less efficiently from other countries, even if it could produce them more efficiently itself. In other words, comparative advantage is the ability of a country to produce a good at lower cost than another country. The concept mainly focuses on efficiency. Ricardo's theory pointed out that international trade was not ruled by absolute advantage in price but by comparative advantage. If each country specializes in producing goods with which it has a comparative advantage, then extra goods are produced and the wealth of both countries increases.

Ricardo's theory assumes that the world has only two countries and two commodities. One of the assumptions of this theory states that firms produce under conditions of perfect competition. This theory is especially good at pointing out the links between different markets.

### 2.2.4 Heckscher-Ohlin Theory or Factors Endowment Theory

In the early part of the 20th century, two Swedish economists, Eli Heckscher and Bertil Ohlin (cited in (Pugel, 2007), pp 60) explained the causes of comparative advantage which is referred to as the Factor-proportions theory.[3] The factor-proportion theory explains that a country's comparative advantage is determined by its initial resource endowments. Different nations have different factor endowments and different factor endowments explain differences in factor costs. The more abundance of factor endowments, the lower its cost will be. This theory assumes constant return to scale.

The H-Ohlin theory predicts that countries will export those goods that make intensive use of factors that are locally abundant, while importing goods that make intensive use of factors that are locally scarce. The H-Ohlin theory prediction reflects the current situation in trade but not completely. It does not satisfy the condition of importing goods for re-export. The factor-proportion theory does not explain the two types of international trade. First, international trade in products based on natural resources is not explained by using this theory. Examples of these types of goods are diamonds, copper, coal, coffee, oil and natural gas. Second, there is a substantial amount of international trade that involves countries importing and exporting very similar goods. An example of this type of trade is the U.S. export and import of automobiles.



[3] The factor proportions theory is referred to as the factor-endowment model, the Heckscher-Ohlin theory (HO), or the Heckscher-Ohlin-Samuelson model.

In conclusion to the above discussion of stated classical theories, Myanmar can benefit from border trade with neighboring countries by exchanging some products when it can produce other products at lower costs.

### 2.3 Framework of the Study

This research will approach the macro analysis mainly through national competitive advantage by referring to Porter's Diamond model. The Revealed Comparative Advantage (RCA) of Myanmar and the other classical theories will be employed for macro level analysis too.

The three objectives of this research will be investigated by collecting primary data in Myawaddy Township as a micro level analysis. Trade and cross-border trade related secondary data will be requested from the Ministry of Commerce in Myanmar. The researcher will also gather historical data, macro and micro socio-economic data from secondary sources; books, articles, available local and national government reports on national policies towards international trade, published interviews and newspaper clippings.

**Macro Level**

Porter's Diamond model will be mainly employed to explain the national competitive advantage of Myanmar. The RCA index will contribute to the description of comparative advantage of Myanmar. Porter Diamond comprises four characteristics of a nation which attribute individually and as a system. These are factor conditions, demand conditions, related and supporting industries, and firm strategy, structure and rivalry. The other classical theories will be briefly used to explain the comparative advantage of Myanmar.

**Micro Level**

The research site will be in Myawaddy Township bordering on Mae Sot of Thailand. The three objectives of this thesis will be explored by using interview survey, in-depth interview survey and focus group interview survey methods. Interviewees will be selected by the random sampling method. Key informant interviews will also be done. The people who will be interviewed are classified into seven categories; wholesalers, managers, company/shop owners, traders, broker companies, broker persons and border inhabitants. Twenty persons each from the above categories will be asked to participate. The overall number of interviewees will be 140 people from Myawaddy. The thirty retailers from major markets (including key informants) in Yangon will also be interviewed to reach the third objective of this research.

The following data will be collected based on the above stated interview methods at Myawaddy Township.

a. Gender/Age/Ethnics
b. How many and types of business or factories in Myawaddy
c. Nature of business/ their customers/ suppliers/ kind of products
d. Mode of transportation/ transportation cost
e. When/ how did they start business?
f. Their problems
g. Mode of currency/ exchange rate

h. Whether they have knowledge or/ their opinions on ASEAN free trade areas

i. How traded goods flow into the major cities inside Myanmar

These data will be cross-checked with existing secondary sources from local government records, local newspapers and archive materials. The process of fulfilling the three objectives of this research is described below in detail.

To explore the characteristics of cross border trade in Myawaddy, interview survey and in-depth interview survey will be mainly employed. To investigate how people are buying and selling goods and services at the Myawaddy border area, interview survey and focus group survey will be utilized. The trade pattern of how they are buying and selling goods and services will be asked in detail. To examine the pattern of traded goods through Myawaddy transit and to the final consumers in Myanmar, in-depth interview survey will be done. To learn the pattern of traded goods, the wholesalers in Myawaddy and the retailers in Yangon will be interviewed.