

## CONCEPTUAL FRAMEWORK FOR FACTORS AFFECTING THE FEASIBILITY OF THE ISI

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### Abstract:

This article discusses the importance of the International Statistical Institute (ISI). While one country intends to develop its industry behind high trade barriers, other countries do not let that country's industrial products be sold without restrictions as well. In other words, the protected industry's operations will mainly be constrained by the domestic market. Therefore, policymakers should take into consideration that the larger the domestic market size is, the more likely the country might succeed in economic growth even through ISI policy or at least experience fewer distortions than a relatively small country, and vice versa.

### Keywords:

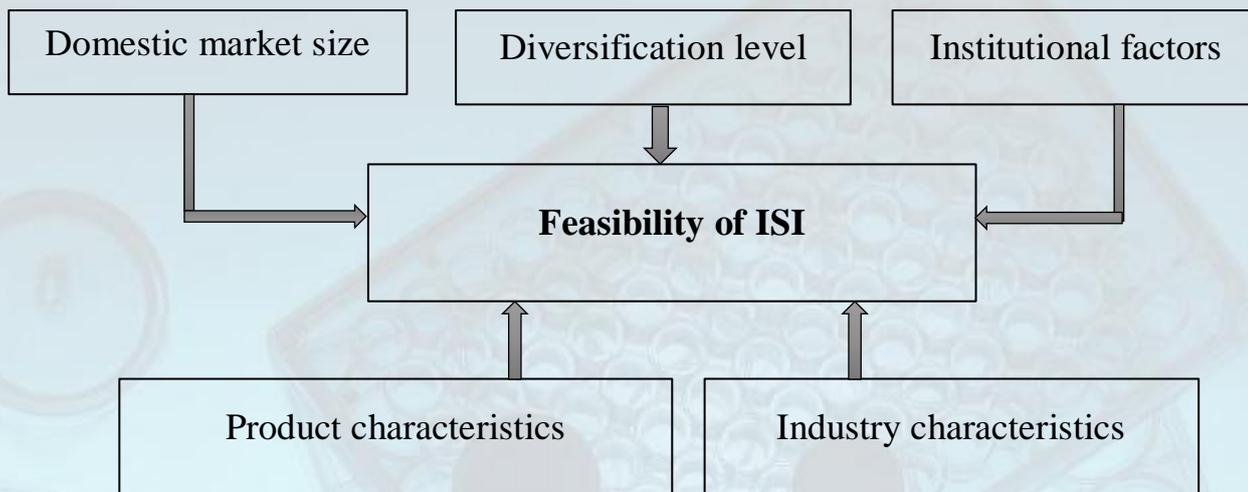
International Statistical Institute (ISI), domestic market, factor, Product characteristics, Industry characteristics, GDP, home price, foreign price

Two reasons exist to build the conceptual framework for factors affecting the feasibility and efficacy of ISI, although the analysis of the strategy's critical aspects shows that trade restrictions have caused serious distortions in most cases due to different reasons. On the one hand, it is intended to reply to a research question on this issue in the introduction of this work. On the other hand, being aware of these factors is crucial because some LDCs have still been addressing protective measures in some of their industrial sectors.

Perhaps, it does not help to make industrial protection successful but at least may tend to decrease improper approaches to trade barriers and negative outcomes.

According to the literature survey, several essential factors that may cause the feasibility of ISI to some extent become obvious.

In this regard, Figure 1 illustrates the conceptual framework for factors that should be taken into account in industrial protection.



**Figure1: Conceptual model of factors affecting the feasibility of ISI.**

As previously stated, several active development policy instruments, that directly tend to the competitiveness of emerging industries, exist but there might not be necessary conditions and possibilities to use them in the case of underdeveloped countries. As the complementary support, ISI could be feasible and efficient or at least less distortive according to factors such as *domestic market size, sector-specific diversification level, institutional factors, characteristics of products that local industries produce, and industry characteristics*.

To better understand to what extent the feasibility of ISI depends on these factors, they are shortly described below.

#### **Domestic market size**

While one country intends to develop its industry behind high trade barriers, other countries do not let that country's industrial products be sold without restrictions as well. In other words, the protected industry's operations will mainly be constrained by the domestic market. Therefore, policymakers should take into consideration that the larger the domestic market size is, the more likely the country might succeed in economic growth even through ISI policy or at least experience fewer distortions than a relatively small country, and vice versa.

Discussing some economic issues such as ISI, trade barriers, or market size, economists have frequently focused on the importance of market size as one of the country's privileges in conducting protectionist policy. Relatively, Baldwin (2013) states that "*ISI could make sense for sufficiently large nations*".

As one of valuable literature on the analysis of trade and market size for achieving economic growth, Alesina, Spolaore, Wacziarg (2005) is addressed to understand the importance of market size better.

Accordingly, the model of trade, market size, and growth is shaped using utility and production functions through several assumptions and the proposition created according to this model is as follow:

*The steady-state level of output per capita in each location  $i$  of a country of size  $S_n$  with trade openness  $\omega$  ( $0 < \omega < 1$ ) is*

$$Y_i^{ss} = A^{1/(1-\alpha)} \left(\frac{\alpha}{\rho}\right)^{\alpha/(1-\alpha)} [\omega + (1 - \omega)S_n]$$

Where  $A$  donates total factor productivity.  $\alpha$  ( $0 < \alpha < 1$ ) is the intensity parameter of aggregate capital, and the sum of all countries' sizes is as one unit:  $1 = \sum_{k=1}^n S_k$  ( $0 < S_k < 1$ ),

The expression precisely shows that both trade openness and market size tend to increase the per capita output because individual derivatives of the equation according to both trade openness and size are positive. However, the doubled derivative of the expression according to openness and size is negative, which means that:

- 1) in a free trade condition, market size becomes less meaningful for achieving economic growth;
- 2) and conversely, trade openness is less meaningful for relatively large countries.

In other words, large countries are able to provide market opportunities for several sectors of the economy to achieve sufficient economies of scale, to create a competitive environment. On the other hand, small countries need a free trade policy to specialise their economic activities in certain sectors and then to achieve their scale economies.

In addition, Alesina, Spolaore, Wacziarg (2005) empirically tests the model investigating the wide range of data belonging to circa 113 countries for the period 1960-2000.

**Table 1: Descriptive statistics variables such as trade openness, market size, and economic growth (1960-2000 averages)**

	Number of observations	Mean	Standard deviation	Minimum	Maximum
Average annual growth	104	1.669	1.374	-1.259	5.515
Openness ratio (current)	114	64.098	41.871	14.373	322.128
Openness ratio (real)	114	37.363	35.376	4.350	244.631
Log of per capita GDP 1960	110	7.730	0.889	5.944	9.614
Log of total GDP	113	23.905	1.943	19.723	29.165
Log of population	114	15.763	1.678	11.019	20.670
Fertility rate	156	4.569	1.797	1.733	7.597
Female human capital	103	1.116	1.067	0.024	4.923
Male human capital	103	1.523	1.225	0.096	5.467
Investment rate (% GDP)	114	15.653	7.880	2.023	41.252
Government consumption (% GDP)	114	19.869	9.439	4.297	48.635

**Source:** Alesina, Spolaore, Wacziarg (2005)

In this investigation, the country's openness is determined by two methods. Firstly, current openness is equal to the ratio of a country's total trade to GDP (in current prices), and the second, real openness equals to the ratio of the country's total trade (in exchange rate) to GDP (in PPP). In this case, a country size is figured out as the log of the population and the log of GDP.

According to this data, the conditional correlation in the following table shows that the results repeatedly confirm the statement claimed theoretically in the model mentioned above.

Hence, the correlation between openness (current) and growth for small countries is high (0.511 if country's population is less than 6.7 million<sup>1</sup> (Log of population  $\leq 8.807$ )). Inversely, this coefficient is small (0.104) for large countries with more than 6.7 million inhabitants.

<sup>1</sup>In the extremely increasing conditions of the world economy, the estimated median size of country might be more than 6.7 million inhabitants according to the recent data.

**Table 2: Conditional correlation of trade openness, market size with economic growth (1960-2000)**

Variable	Conditioning statement	Correlation with growth	Number of observations
Openness (current)	Log of population > median=8.807	0.104	54
Openness (current)	Log of population ≤ median=8.807	0.511	50
Openness (current)	Log of GDP > median=16.700	0.301	52
Openness (current)	Log of GDP ≤ median=16.700	0.462	52
Openness (real)	Log of population > median=15.715	0.131	54
Openness (real)	Log of population ≤ median=15.715	0.579	50
Openness (real)	Log of GDP > median=23.607	0.223	52
Openness (real)	Log of GDP ≤ median=23.607	0.474	52
Log of population	Openness (current) > median=53.897	0.107	50
Log of population	Openness (current) ≤ median=53.897	0.426	54
Log of GDP	Openness (current) > median=53.897	0.324	50
Log of GDP	Openness (current) ≤ median=53.897	0.563	54
Log of population	Openness (real) > median=26.025	-0.089	51
Log of population	Openness (real) ≤ median=26.025	0.587	53
Log of GDP	Openness (real) > median=26.025	0.137	51
Log of GDP	Openness (real) ≤ median=26.025	0.625	53

**Notes.** Medians computed from individual samples, while correlations are common sample correlations.

**Source:** Alesina, Spolaore, Wacziarg (2005)

And the correlation between country size and growth is low if the openness is high (for instance openness (current) > 53.9), and vice versa, the correlation between country size and growth is high if the openness is low (openness (current) ≤ 53.9).

The results confirm the statement for other definitions of openness and size as well.

Moreover, the effect of tariff barriers for small countries is different from that for relatively large countries. In this regard, Krugman, Obstfeld, and Melitz (2011) explains the effect of import tariffs with the assumption of two countries' trade in one specific product. Accordingly, two countries initially trade the good in world price ( $P_w$ ). If one (Home) of them imposes a tariff ( $t$ ) on imports of that good, it theoretically changes the price in that country by raising it ( $P_t$ ) and in the other by lowering ( $P_t - t$ ). Where  $P_t > P_w > P_t - t$ . In this case, tariff ( $t$ ) is divided between prices reflecting one part in the Home price (by raising) and the rest part in the foreign price (by lowering). The share of this distribution depends on the product's market size in the country, which imposed tariffs on imports. If the share of the country's market size is relatively small compared with the world market, the main part of tariff reflects in the protected country's price that is much distortive for its consumers' welfare. Contrary, if the protected country's market size is large enough (significant in the world market), the domestic price increases less than the previous case, so less distortive. Moreover, investigating the trade in vertically differentiated products between LDCs and developed countries, Lambertini and Rossini (1993) states that producer of a poorer country might gain from such trade in general, and however, the consumers' surplus in poorer country increases in particular if the market size of poorer country is larger than of rich one.

Therefore, country's market size is very important to implement tariffs, as an instrument of ISI as well. However, investors try to use the privileges created by trade barriers in any country. Even so, they thoroughly assess the potential market size through investigating indicators such as country's demography and the potential income per capita for a certain period.

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