CHAPTER - 2

THEORETICAL PERSPECTIVE

Traditional trade theory states that if each nation specializes in the production of those commodities in which it has a comparative advantage and exchanges part of these for the commodities of its comparative disadvantage then each nation can end up consuming more of all commodities than without trade. A nation has a comparative advantage in those commodities which are produced with a great deal of the nation’s relatively abundant and cheap factors of production. Gains from trade result because, with specialization in production, world output will be larger and each nation can share in this larger output.

Many economists today attack the static nature of traditional trade theory. They point out that comparative advantage is based on the assumption of given factor endowments, technology, tastes, and perfect competition. Since factor endowments, technology and tastes all change and perfect competition dose not usually hold, therefore traditional trade theory may not lead to the best allocation of resources for maximum growth and development over time. Classical and neo-classical economists attached so much importance to international trade in a country’s development that they regarded it as an engine of growth. The
opposite view holds that historically foreign trade has led to international inequality where by the rich countries have become richer at the expense of poor countries.

Role of trade in development has been a subject, which has been exposed to considerable controversies. Classical economists held that foreign trade could make an impressive contribution to country’s development. Trade was considered to be not simply a device for achieving productive efficiency; it was also considered as an “engine of growth”. When a country specializes according to its comparative advantage, it gains an increase in real income. This gain is tantamount to an outward shift in the country’s production frontier. This increases the domestic resource potential for capital formation. In the classical economic thought, there was clear-cut recognition of growth transmitting aspect of trade. The classicists held that gains from trade were entirely consistent with the gains from growth. An over-riding issue in the relations between trade and development is the ultimate question whether there is a conflict between the gains from trade and growth? The orthodox interpretation as expounded by classical and neoclassical economists was that foreign trade can be a propelling force in development. This was reflected in Adam Smith’s model of foreign trade which postulates the existence of idle land and labor before a country is opened to world
markets. The excess resources are used to produce a surplus of goods for export and trade thereby “vents” surplus productive capacity that would otherwise be unused.

In Smith’s concept of trade and development relationship, trade contributes to development also through extension of market. In his book, “An Inquiry into the Nature and Causes of the Wealth of Nations,” he stated, “By means of it, the narrowness of the home market does not hinder the division of labor in any particular branch of art or manufacture being carried to the highest perfection. By opening a more extensive market for whatever part of the produce of their labor may exceed the home consumption, it encourages them to improve its productive powers and to augment its annual produce to the utmost and thereby to increase the real revenue and wealth of the society.” Thus Adam Smith clearly envisaged a process in which forging trade plays vital role in extending the market and hence leads to increase in productivity through the scope given for greater specialization.

In Ricardian economic thought also trade and development was integrally related. The key initiator of growth in the Ricardian model is the capitalist class, which rather than consuming most of its profits, invests these funds to hire additional labor and thereby expand production. While this action bids up the wage-rate for a given size of
labor force, it also has the effect of increasing the supply of labor as the wage rises above its natural level and death rates are reduced. Increasing the use of labor in the manufacturing sector always increases output in the same proportion. But the application of labor to agricultural production is subjected to diminishing marginal productivity because of the fixed supply of high quality land. Consequently, as capital accumulation takes place mainly in the form of larger wage-fund, prices of agricultural products rise relative to manufactured goods and competition for better quality land causes an increasing proportion of output of a given amount of labor employed on high quality land to be transferred to the land owner in the form of rent. In the manufacturing sector, the relative cost of subsistence-wages squeezes the profit rate earned by capitalists. Consequently capital accumulation and population growth tend to decline until a stationary state is reached. Through trade, an economy can postpone the stationary state. In Ricardian thought, comparative differences among countries in the labor required to produce agricultural and manufactured goods are based on differences in land / labor ratio or in the technological knowledge. This serves as the basis of trade at any point of time. For England, as Ricardo realized, the comparative cost situation favored exports of manufactured goods and imports of agricultural products.
John Sturat Mill was exceptionally clear on the role of trade as propelling force for development. Trade, according to comparative advantage, results in a more efficient employment of factors of production and this may be considered the direct advantage of foreign trade. According to Mill, there are some dynamic benefits of trade. One of the significant dynamic benefits is the tendency of every extension of the market to improve the process of production. A country, which produces for a large market than its own, can introduce a more extended division of labor, can make greater use of machinery and is more likely to make inventions and improvements in the process of production. In his book, “Principles of Political Economy”, Mill stated, “Another important consideration principally applicable to an early stage of industrial advancement is that a people may be in a quiescent, indolent, in cultivated state, with all their tastes either fully satisfied or entirely undeveloped, and they may fail to put forth whole of their productive energies for want of any sufficient object of desire. The opening of foreign trade, by making them acquainted of things which they had not previously thought attainable, sometimes works a sort of industrial revolution in a country where resources were previously undeveloped for want of energy and ambition in the people inducing those who were satisfied with scanty comforts and little work, to work harder for the
gratification of their new tastes and even to save and accumulate capital, for the still more complete satisfaction of these tastes at a future time.”

Classical economists thus perceived trade as a crucial factor for growth in three ways- via (i) as a vent for surplus, (ii) maximization of gains through comparative cost advantage. (iii) Through widening the extent of market and the scope of the division of labor. In classical economic thought, trade was conceived as dynamic force which by widening the extent of the market and the scope of the division of labor, permits a greater use of machinery, stimulates innovations, overcome technical invisibilities, raises the productivity of labor and generally enables the trading country to enjoy increasing returns and economic development. Trade gives a developing country opportunity to remove domestic shortages and to overcome the diseconomies of the small size of its domestic market. Trade offers opportunity for the exchange of goods with less growth potential, thereby achieving the progress that results from a given effort on the savings side.

Classical economists also noted the effects of trade on domestic factor supply, especially on capital accumulation. According to these economists, capacity to save increases and real income rises through more efficient resource allocation associated with international trade and stimulus to investment is strengthened by the realization of
increasing returns in the wider markets that overseas trade provides. Further by allowing economies of large scale production, access to foreign markets makes it profitable to adopt more advanced techniques of production which require more capital; opportunities for the productive investment of capital are greater than they would be if the market were limited to the small size of the home market.

In the neo-classical approach, International Trade propels development through efficiency in the allocation of scarce resources. Central proposition of neo-classical trade theory is that, given certain assumptions, free trade is superior in economic efficiency. For internationally traded goods and services, efficient allocation of resources is determined according to their marginal productivities at international prices. This will be achieved through the unfettered operation of the market mechanism with market prices serving to allocate resources efficiently according to comparative advantage. Basic policy prescription which flows from the neo-classical analysis is the need to get the price right. To achieve these ends, two complementary policy prescriptions are invariably advocated (i) removal of domestic market distortion, (ii) liberalization of international trade and exchange markets by the removal of trade and exchange controls, so as to allow the economy to function as efficiently as possible within a free trade regime. Central proposition of
neo-classical trade theory is that, given certain assumptions, free trade is superior in efficiency-terms both to autarky and various forms of trade restrictions. The neo classical theory emphasizes gains from free trade, which will lead each country to specialize in the production for exports that are in line with its relatively abundant factor of production.

From the early nineteenth century until the late 1950s, international trade theory was dominated almost by the concept of comparative advantage. According to this concept, countries trade to take advantage of the differences in the cost of production, which primarily arise from differences in factor endowments. The formal models, incorporating these concepts, were based on the assumption of constant returns to scale and perfect competition. On the empirical evidence of the actual international trading relations in the Post-War Era, economists perceived that several factors such as increasing returns, imperfect competition, endogenous technical change, consumer’s demand, intra-industry trade, etc determine the flow and pattern of trade. The new theories of international trade analyzed relationship between these factors and international trade. New trade theories focused on the influence of technology on the pattern on international trade. Technological Gap theories emphasize that innovating firms enjoy a temporary monopoly at home and in foreign markets. Innovation determines export mix rather
than capital-labor ratio, which was emphasized in neo-classical theory. Location of innovative activity is not random. Innovation, improvements in new product and marketing require highly skilled labor. So new goods are produced in the most skill abundant country. As the product matures, demands for skilled labor in production and marketing become less pronounced until the product becomes standardized.

R. Vernon (1966) developed the idea of a product cycle in which trade patterns depend upon country’s relative skilled endowment and age of each product. According to Theory of Product Cycle, when the new product is first produced in the skill abundant countries, exports from the innovating country to other developed countries begin. Over the passage of time importing countries begin to produce their goods domestically reducing their demand from original exporter. With increasing product maturity, demand in lower income countries develops and is supplied first by the original innovator and then by imitators. Eventually, the second generation producers become net exporters of mature product and the innovating country becomes net importers. Latter still, the less developed countries may become net exporters if the standardized product is unskilled labor intensive. Many examples of the product-cycle determining the pattern of trade during post-war era can be
documented and these include trade of automobile, semiconductor, synthetics and chemicals.

The other important factor which Cales for the re-examination of the assumptions underlying the neo-classical theory of international trade was the effect of intra-industry trade. In the neo-classical theory, international variations in product-functions determine in which goods, country’s comparative advantage and comparative disadvantage lie and trade patterns follow in which exports come from the former group and imports from the latter group. There is no room for simultaneous import and export of the same good. Grubel and Lloyd (1975) documented the pervasive importance of intra-industry trade in the trade flows of the major trading nations. They identified over 2000 categories of products in which intra-industry trade flows. According to Grubel and Lloyd, economies of scale and product differentiations, were the two crucial factors, which restrict number of varieties, which can be produced domestically. As a result, minority interests are satisfied by imports and popular varieties are supplied by exports. The automobile industry provides an example of an imperfectly competitive industry in which economies of scale and product differentiation are important. Thus, Grubel and Lloyd stimulated new thinking about imperfectly competitive markets and international trade. In other words, intra-industry trade
phenomenon is the result of increased division of labor, which is dependent on the size of the market. As countries have grown economically and become more integrated into the world economy, they faced a larger market, which has permeated further division of labor. Vertical specialization, i.e., the location of different stages of production in different countries, underlines the growth and current preponderous of intermediate goods in international trade. Paul Krugman developed the theory that economies of scale lead to arbitrary specialization by nations on products of industries that operate under monopolistic conditions because they enjoy increasing returns. Countries specialize in trade not only because of underlying differences in factor-endowment, but also because increasing returns are an independent force. Thus, imperfect competition emerged as one of the significant contributing factors to modern international trade.

The neo-classical theory of trade was also challenged by S.B. Linder who opined that the theory of trade based on the Nation’s of relative factor abundance is possible only for an analysis of trade in primary products but not of trade in manufactured goods. He developed analytical framework which gave an alternative explanation of trade in manufactures. Linder’s basic thesis was that demand structures are an important determinant of the pattern of trade. The more similar the
demand structure of the two countries, more intensive, potentially is the trade between these two countries. According to Linder’s theory, volume of trade between a country and each of her trading partners as a proportion of national income will be higher, greater the similarity in the demand pattern measured in terms of per capita income levels of the pair of trading countries. In further theoretical evolution, classical view of trade as an engine of growth was questioned by development economists. At theoretical level, it was contended that the conclusions from the static equilibrium analysis of traditional trade theory are irrelevant for interpreting the problems of development which are inherently dynamic. The continuation and spread of underdevelopment in a number of countries in Asia, Africa and Latin America did not also indicate the classical optimism of trade and development relationship. Critics of the traditional view, that trade will transmit development, denied the relevance of conclusions of traditional trade theory and secondly they contended that historically the forces of international trade impeded the development of poor countries.

According to Nurkse, trade was “an engine of growth” during the 19th century for the “region of recent settlement” (the United States, Canada, Australia, New Zealand, Argentina, and South Africa). That is the very rapidly growing, demand for food and raw materials,
particularly from industrializing but resource-poor England, resulted in rapid and sustained export-led growth in the economies of these new lands. Today, although trade can still make an important contribution to development, it can no longer be regarded as an engine of growth for developing nations because demand for their exports (except for petroleum and other minerals) is not growing as rapidly as in the 19th century. Cairn cross pointed out, however, that presence of supply inflexibilities in developing nations were also responsible for the slower growth rate of their exports in the 20th century. Finally, Kravis argues that rapid growth in the regions of recent settlement during the 19th century was due to primarily very favorable internal condition, with trade offering only an important supportive role. Such an important supportive role is still being provided by trade for today’s developing countries and if these nations are not growing rapidly today, it is due primarily to their much less favorable internal conditions.

The development-economists engaged themselves in working out estimates of the capital-requirements of LDCs which revealed major saving-gaps. The estimates of LDC import requirements were based on assumed target rates of economic growth together with fixed import coefficients. Uniformly they revealed the prospects of “foreign exchange gaps” left by adverse prospects for LDC export and
inadequate aid by developed countries. Of the two gaps, the ‘foreign exchange gap’ appeared to be more serious constraint on economic development as the LDCs with a few exceptions struggled to meet chronic balance of payment difficulties through import and foreign exchange controls. In the theoretical literature, this gave rise to “two gap analysis”.

The Haberler committee Report criticized the tariff and other barriers erected by developed countries, which it described as an important factor contributing to the foreign exchange difficulties of LDC. This led to the appointment of a standing Committee-the famous Committee III, with the task of encouraging policies to help exports. The Report commented adversely on LDC policies of import substitution which had almost been to the disadvantage of the underdeveloped countries themselves.

The other landmark in the evolution of the concept linking ‘Trade and Development’ was the study of ‘Europe and Trade’. Needs of the Less Developed Countries’ by the UN Economic Commission for Europe’ in which it argued that since aid and exports of primary products would meet only two-thirds of the import requirements of the third world in 1980s, this would leave the remaining one-third i.e., at least $ 15 billion to be filled by exports of manufactures and on infant-industry
ground prepared the first scheme for a generalized system of preference for LDC manufactures.

With a view to establish the organizational link between trade and development, the Belgrade Conference in September 1961, President Tito launched the idea of a World Conference on Trade and Development. In December 1961, the U.N. General Assembly endorsed President Kennedy’s designation of the 1960s as the UN Development Decade and passed resolution 1707, which gave approval in principle to the idea of a Conference on Trade and Development. Subsequently another non-aligned Conference in Cairo in June 1962, gave more precise form to the demand for a Conference on Trade and Development. ECOSOC resolved to convene UNCTAD, known as UNCTAD I, established a preparatory Committee, appointed Prebisch, Secretary General of UNCTAD and invited him to prepare a report on the issue.

The Report, which Prebisch submitted to the Conference, was entitled “Towards a New Trade Policy for Development”. This report recommended policies to increase the trade of developing countries so as to make it a vital instrument of growth. It was emphasized that policy of removal of trade barriers by developed countries should be supplemented by positive policies to assist the trade of developing countries. The main policy innovation of the Prebisch report was a new emphasis on the need
for developing countries to export manufactures. It was also pointed out in the report that the inward looking import substitution policy had generally insulated national markets from external competition, weakening and even destroying the incentive necessary for improving the quality of output and lowering costs under the private enterprises system. It had, thus, tended to stifle the initiative of enterprises as regards both the internal market and exports.

During the decade 1960-70s, several studies by development economists such as I.M.D.Little, Bela Balassa, of the industrialization experience of a number of developing countries was undertaken with a view to evaluate the effects of import substitution policies on the growth. The studies indicated that industrialization sheltered by high levels of protection had led to the creation of high cost enterprises. In some cases, it was found that with high industrial prices, maintained by high tariffs, industrialization was carried out at a high cost to agriculture. By 1967, the encouraging experience of some of the developing countries in East Asia and South East Asia, further contributed to shift of development thinking away from inward looking strategies towards an outward looking strategy. Development Economists gradually felt that there was a need to search for new engines of economic growth in the international economy and to push the development of export oriented industrial-activity. Hla
Myint, one of the pioneers of development economics also endorsed the view that the South East Asian countries should move away from import substitution policies towards a radically different approach to industrialization.

Thus on the one hand it became difficult to retain the validity of Prebisch-Singer concept of trade-development relationship; on the other hand the emergence of NICs in mid 60s and 70s clearly showed that there was a strong link between export performance and economic growth. The theoretical evolution in the growth theories also strengthened the link between trade and development. The ‘dual gap’ theory of economic growth which was pioneered by Hollis-Chenery and M. Bruno in 1962, gave a new orientation and focus to the study of relationship between trade and development. Growth requires investment goods which may either be provided domestically or be purchased from abroad. The domestic provision requires savings; the foreign provisions require foreign exchange. For import of investment goods from aboard, a developing economy must earn sufficient foreign exchange to sustain growth process in a situation where there is a limited availability of external finance and the inflow of foreign exchange through external borrowing is beyond the capacity of a developing country.
In developing economies, a salient feature of development is the heavy reliance on imports, particularly the import of capital goods. There is a positive relationship between export performance and economic growth because an increase in export helps to finance the import of capital goods which in turn gives rise to a more rapid rate of capital formation and hence a higher rate of growth of output. According to ‘dual-gap’ theory of economic growth, there is a minimum necessary amount of imports required to support a given increase in national output. At a certain projected level of output, imports may exceed exports and the trade gap, if not financed by external resources, inhibits the optimum rate of economic growth. If developing countries can expand their exports rapidly to generate sufficient earnings to finance imports, then there should not be any foreign exchange constraint on development. In many cases where rapid development has failed to take place, one of the major reasons lies in the inward looking policies based on the pessimistic view of export possibilities. So, a synthesis between the ‘two-gap’ analysis of economic growth and the concept of export led growth can provide the basis for a conceptual link between trade and development. Role of export led growth lies in its importance in financing capital goods, imports that are necessary for rapid economic growth because of its significant effects on domestic investment. At current stage of development thinking, there is no doubt on the positive effects of trade on
development. The question that has been debated most in 1970s and 1980s is whether free trade is conductive to economic growth or not. A number of economists have undertaken various studies and the issue is still have remained open to debate. The NICs spectacular export-led growth since 1970s generated considerable interest among economists for research and study in the relationship between export performance and economic growth of the developing economies. Many empirical studies were conducted to assess the role of exports in economic growth. The recent works on the subject include the studies conducted by Bela-Balassa, G. Feder, Hollis Chenery, A.Maijels, Anne Krueger, G.S. Fields etc. They all are in agreement that positive export performance has beneficial effects on economic growth and free trade accelerates the rate of economic development.