[Academic Script]

International Trade and International Inequality

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1. Introduction

In this session we will discuss the role of foreign trade in economic development of a nation. Classical economists propounded theories that explain the profitability and gains from trade. It has been noted from experience of countries that trade has several direct and indirect benefits for developed as well as for less developed countries.

Objectives

1. Review the classical theory of trade.

2. Understand the direct and indirect gains from trade for developing and developing countries.

3. Check the trends of world trade.

4. Understand if trade helps in establishing a more equal world.

5. Understand the dynamics of export-led growth strategy.

Trade in classical theory

According to classical theorists, trade has an impelling effect on development which can be explained by forwarding various arguments as,

1. The surplus land and labour can be utilized to produce goods for exchange in the foreign market.
2. The unemployed resources can get employed in the production of exportable goods.
3. If a country already produces surplus goods; that is, enough demand does not exist in home country for certain goods, those can be sold abroad in exchange of more necessary goods.
4. A country may also exchange her less necessary goods for more necessary goods by regulating the demand for less

necessary goods in the home country. For example, a country may have some iron ore reserves and may be producing steel for domestic use. This country may regulate her own demand for steel and save some steel for export against her imports of petrol.

5. By using their unused resources or by reorganizing production if countries can create exportable surplus, they can increase their gains by importing essential intermediate goods which they cannot produce at home. In a way, when a country buys cheaper and/or better intermediate goods in international market and replaces them for the more expensive and inferior quality domestic goods, the terms of trade for this country are said to have improved.
6. When countries can utilize their unused resources by engaging them in production for trade, when they can consume more goods than before as well as when the international exchange ratio is more favourable than the domestic exchange ratio then the real gains and real incomes both tend to increase.

Determinants of the Pattern of Trade in Theory of Economics

The pattern of trade in economic theory is determined by (a) comparative cost advantage. (b) demand intensity for imports and relative bargaining capacities of trading countries and (c) factor endowments and factor prices in the trading countries.

According to these theories, the trading countries can enjoy higher real incomes through trade even when there is no increase in their resources or when there is no technological progress.

Dynamic/indirect gains from trade

Along with the direct benefits or gains, trade also has dynamic or indirect benefits. Gerald Meier classifies these as:

(a) Those that pertain to widening of markets, inducing innovations and increasing productivity.

(b) Those which increase savings and capital formation.

(c) Those which promote education, awareness, instil new tastes and preferences or alter preferences which lead to improvement in life conditions; as well as those which pertain to transfer of technology, development of skills and entrepreneurship.

According to the classical theory, trade is beneficial not just to the developed countries which have surplus production to sell but also to the developing countries which have underutilized resources or untapped natural resources. Developing countries also attain more indirect benefits.

2. Trade benefits explained in theory of economic development

The theory of economic growth and development has given convincing relevance to the role of trade in growth and development of nations.

1. The *staple theory of growth* emphasises that developing countries may find vent for their unexploited or surplus *staple resources* through trade. They may exchange their resources for other goods or may buy technology from foreign markets to exploit and use their resources for growth and development.

This is akin to Arthur Lewis's model of growth where he emphasises upon the transfer of labour from less productive use to more productive use. The staple theory also hints at improving the productivity of resources.

The staple theory is also said to be similar to Rostow's leading-sector theory. The staple sector can well be the leading sector whose growth can propel the growth of other sectors of the economy.

2. Meier mentions in his book, W. Max Corden's ***supply-motored*** model of trade-induced growth which brings out five distinguishing effects of trade on development.

- The first effect is the 'impact effect' which is like the static effect explained by an increase in real income which occurs because of trade.
- Second effect is the 'capital accumulation effect' which occurs when the static gain in the form of increased real income is invested. Thus when investment is made by curtailing consumption in the current period, there is a transfer of real income from present to the future.
- Thirdly, there may be a relatively greater fall in prices of investment goods than in the prices of consumption goods because of two reasons. (a) When more capital is imported the supply of capital goods in the home country grows. (b) When the trade induced increased incomes are invested in domestic economy, the supply of capital goods increases. This way when the ratio of investment to consumption rises, the rate of growth increases.
- Fourthly, there will be an 'income distribution effect' towards the export-oriented sector. Investments in export-oriented sector will increase and income of factors which are used intensively in the export sector will rise. When exports tend to raise the real income and growth, the society will invest more in this sector.

- Fifthly, there will be the 'factor weight effect' which means that in a constant return production function, if exports are produced by using more of the abundant and faster growing factor in the country then rate of growth of exports will be much higher as the surplus units of the abundant factor are used to produce the exportable goods.

3. Factor price equalization theorem of the neo-classical trade theory

The neo-classical trade theory stated that free trade promotes perfect mobility of factors across boundaries and thus the prices of factors and products are equalized in the trading countries.

The classical theory stated that even when factors are immobile across countries, trade will equalise factor prices through the investment process. Investments will increase in the production of export goods and domestic industry will make greater use and demand of the abundant factor which will raise its price. And price of the less demanded scarce factor of production will then tend to fall.

Criticisms against the assumptions of trade benefits explained in the classical and the neo-classical theories of trade

1. The comparative cost advantage theory is static and does not consider the dynamics of real trade.

However, the theory is still relevant in understanding the reasons for trade.

2. According to some critics, the factor prices are not equalized in trade but rather the inequalities increase.

Trends of world trade

- Between 1850 and 1913, the world trade increased tenfold in real volume which was twice as fast as the increase in world production. This growth was attributed to specialization in production. Britain and the countries around British Empire took major share. The low income countries experienced a typical lopsided growth pattern. Production of primary products for exports was carried out by using foreign capital; while the rest of the domestic economy remained far more less developed.

Thus, these countries started developing into dual economies arising from investment for trade. However, owing to cyclical fluctuations in production of export goods, the growth of these countries was irregular.

- From 1913 till around mid 1980s, the quantum of world trade increased little less than world production. This was owing to restrictive trade policies as well as owing to use of new technologies by the developed world.
- The terms of trade significantly moved in favour of developed countries between 1913 and mid 1980s. Between 1913 and 1950, Europe's terms of trade improved 55 percent against the poorer countries. (The developed world used technology to produce synthetic raw materials and reduced their dependence on developing countries for raw materials. While the dependence of developing countries on the developed countries for industrial goods and technology increased).
- Between 1980 and 2011, developing economies raised their share in world exports from 34 per cent to 47 per cent and their share in world imports from 29 per cent to 42 per cent. Asia is playing an increasing role in world trade. This is attributed to increasing incomes, expansion of markets, increasing manufacturing capacity of the developing countries

and a slow-down in the economic growth of the developed world.

International supply chains have also improved helping the developing countries to increase their trade.

3. Trade and equality

It may be natural to ask if trade directly creates equality. There cannot be one answer to this question.

- Trade benefits countries that are able to create investments favouring the poor from the real income which trade helps to earn.
- According to Meier, economic development is a process of circular and cumulative causation and trade may help the already well endowed countries more while the efforts of poorer countries may be thwarted if they have poor physical and financial infrastructure, policies which fail to provide equal opportunities, poor education systems and beliefs which pose impediments to development.
- Trade results in greater development in countries where national economic integration is greater.
- The quality of factors is poor in countries with high economic and social inequalities and the effectiveness of their production efforts is also low. Trade fails to equalize remuneration of factors thus disproving the factor price equalization theory of trade.

  Rather, trade aggravates the economic divide. It will award the efforts of those factors which are skilled and thwart the efforts of those which are unskilled. In other words, the sectors with fair amount of technology and skill sets will be able to export their goods and increase their incomes while the backward sectors will remain poorer.

- Countries with large markets and a relatively developed industry will be rewarded with better consumer welfare, and transfer of technology and knowledge by trade.
- Small and less developed industries of poorer countries will be competed away by foreign industries in trade. Hence, such countries may be impoverished further.
- Countries which export only primary sector goods may face inelastic demand in the international market and if their demand for industrial imports is high, they may face a balance of payments deficit. Thus trade does not benefit the growth of these countries; rather trade results in external debt. (Countries of the world do not depend much on other countries for their staple food requirement. And, the demand for agricultural goods is limited as these goods have limited industrial applications. Hence, when prices of these goods fall in international market, their demand expands in a lesser proportion than the fall in price. Thus inelastic demand results in a reduction in total revenue when prices are lowered).
- Factor trade between rich and poor countries during the 1960s and the 1970s led to brain drain from developing countries and to the sale of obsolete technology at high prices to the developing countries by the developed countries. This hindered the growth and development process of the developing countries. External debts of many developing countries rose to threatening levels and these countries were forced by the developed world to globalize to fulfil their debt obligations.

Export-led development

Developing countries that tried to develop their export sector by borrowing capital from abroad aggravated the economic divide under their dual economic structures.

Export-led development is more beneficial to countries which have more equitable distribution of opportunities, and have undertaken large scale skill formation programmes, have well developed credit systems for setting up export-oriented units and which have necessary infrastructure and inputs for the growth of export industry.

4. Summary

We may wrap up this lecture by ascertaining that trade definitely helps the developing countries to develop more. However, the gains will depend upon the nature of commodities traded, the mobility of factors, and the productivity of the underutilized resources in a country and so on.

We must recollect at the end of this session, the theories of international trade especially the theory of comparative cost advantage and the Heckscher-Ohlin theory.