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ROLE OF INTERNATIONAL TRADE IN ECONOMIC DEVELOPMENT

By

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International trade refers to exchange of goods and services between one country and another *i.e.* bilateral trade or between one country and the rest of the world *i.e.* multilateral trade. The basis of international trade, from the supply side, is the Ricardian theory of comparative cost advantage. According to Ricardo the source of comparative advantage is difference in labour cost between two countries. Modern economists have extended Ricardo's theory and identified technological gaps and product cycles as sources of comparative advantage. Ricardo's theory is static in nature. The same is true of the modern theory of comparative advantage, viz., the Heckscher-Ohlin theory. Given different factor endowments, but identical technology and tastes, Heckscher-Ohlin theory proceeded to determine the nation's comparative advantage and the gains from trade. However, factor endowments change over time; technological improvement occurs in the long run; the tastes may also change. Consequently the nation's comparative advantage also changes over time.

In the long run, a nation's population grows and with it the size of its labour force. Similarly, a nation increases its capital stock in the long run. Moreover, natural reasons (such as minerals) can be depleted or new ones

found through discoveries or new applications. All these changes lead to economic growth and changing pattern of comparative advantage over time. Technological progress also leads to faster growth of real per capita income and is thus an important source of growth of nations and also a determinant of comparative advantage.

The growth of resources (such as land, labour, capital) and technological progress cause a nation's production possibilities curve (frontier) to shift outward. There are two main sources of growth : (1) increase in the supply of resources and (2) technological progress. The effect of growth on the volume of trade depends on the rates at which the output of a nation's exportable and importable commodities grow and with it the consumption pattern of the nation as its real per capita income increases through growth and trade.

Favourable Effect of Growth on Trade : If the output of the nation's exportable goods increases proportionately faster than that of its importable commodities at constant relative prices (or terms of trade), then growth tends to lead to greater than proportionate expansion of trade. Economic growth has neutral effect as it leads to the same rate of expansion of trade. On the other hand, if the nation's consumption of its importable commodity increases proportionately more than the nation's consumption of its exportable commodity, at constant prices, then the consumption effect tends to lead to a greater than proportionate expansion of trade. What in fact happens to the volume of trade in the process of growth depends on the net result of these production and consumption effects. This prediction is relevant for a small country which cannot influence world prices of tradable goods.

If economic growth, whatever its source may be, expands the nation's volume of trade at constant prices, then the nation's terms of trade (which is the ratio of the price index of exports to that of imports) tend to

deteriorate.[1] On the other hand, if growth reduces the nation's volume of trade at constant prices, the nation's terms of trade will improve. This is known as the terms-of-trade-effect of growth.

The effect of economic growth on the nation's welfare depends on the net result of terms-of-trade effect and a wealth effect. The wealth effect refers to the change in output per capita as a result of growth. A favourable wealth effect, by itself, tends to increase the nation's welfare. Otherwise, the nation's welfare tends to decline or remain unchanged. If the wealth effect is positive and the nation's terms of trade improve as a result of growth and trade, the nation's welfare will surely improve. If they are both unfavourable, there is a loss of social welfare. If the wealth effect and the terms-of-trade effect move in opposite directions, the nation's welfare may deteriorate, improve or remain unchanged depending on the relative strength of these two opposing forces.

Immeserising Growth : Even if the wealth effect, by itself, tends to increase the nation's welfare, the terms of trade may deteriorate so much that there is a net loss of social welfare. This is termed immeserising growth by Jagadish Bhagwati. The phrase refers to a situation in which a developing country's attempt to increase its growth potential through exports actually results in a retardation of that potential. This is very much an exceptional situation confined only in theory to a country where export specially (some mineral or agricultural crop) accounts for a major share of world trade in the product. The country needs to export more to earn the necessary foreign exchange to finance the capital imports which it requires to underpin domestic growth. If all its export effort is concentrated on its speciality, this could lead to an 'oversupply' of product resulting in a deterioration of the country's terms of trade. As a result the country's foreign exchange earnings will now buy fewer imports and domestic growth potential will be impaired.

The classical (Ricardian) trade predicts that if each nation specialises in the production of the commodity of its comparative advantage, world output will be greater, and, through trade, each nation will share in the gains from specialisation and exchange. According to modern theory of comparative advantage (known as the factor endowments or the Heckscher-Ohlin theory) developing countries should specialise primarily in the production and export of raw materials, fuels, minerals and food to developed nations in exchange for manufactured products.

It is now believed that this pattern of specialisation and trade relegates developing countries to a subordinate position vis-a-vis developed nations and keeps them from deriving the dynamic benefits of industry and maximising their welfare in the long run. The dynamic benefits include a more trained labour force, more innovations, higher and more stable prices for the nation's exports, and higher per capita income. With developing countries specialising in primary commodities and developed nations in manufactured goods, most, if not all, of these dynamic benefits of industry and trade accrue to developed nations, leaving developing countries poor, backward and dependent. Another reason for this is that all developed nations are primarily industrial, while most developing nations are largely agricultural or engaged in extractive activities such as construction and mining. For these reasons the traditional theory of comparative advantage is static and irrelevant to the process of economic development. Critics comment that as a developing nation accumulates capital and improves its technology, its comparative advantage shift away from primary products to simple manufactured goods first and then to more sophisticated items.[2] This has recently occurred in Brazil, Korea, Mexico and other developing countries.

Trade as an Engine of Growth : During the 19th century the export sector of resource-poor developing countries, mainly Great Britain (where most

of the world's modern industrial production was concentrated), was the leading sector that propelled these economies into rapid growth and development. Thus international trade acted as an engine of growth for these nations. The expansion of exports stimulated the rest of the economy. For other countries, including the USA, foreign trade shaped their factor endowments and furnished investment opportunities for foreign as well as domestic capital.

According to Ragnar Nurkse the industrial revolution happened to originate on a small island with a limited range of natural resources, at a time when synthetic materials were yet unknown. In these circumstances, economic expansion was transmitted to less-developed areas by a steep and steady demand for primary commodities which those areas were well suited to produce. Local factors of production overseas, whose growth may in part have been induced by trade, were thus largely absorbed in the expansion of profitable primary production for export. On top of this, the centre's increasing demand for raw materials and foodstuffs created incentives for capital and labour to move from the centre to outlying areas, accelerating the process for growth-transmission from the former to the latter.

Nurkse has argued that the young economies of the 19th century, viz., the USA, Canada and Australia had temperate climates and unusual factor endowments – vast quantities of land and small amounts of labour. They could therefore supply coffee, wheat and the other staples needed at the centre of the world economy. Furthermore, the new countries of the 19th century (often called areas of recent settlement) were peopled by recent immigrants from Europe, who brought with them institutions and traditions conducive to the growth of a modern economy.

However, some economists, notably Kravis, hold a different view on the relation between trade and growth. According to them, rapid growth of such

nations as Canada, Argentina and Australia during the 19th century was primarily due to very favourable internal conditions (such as an abundant supply of natural resources), with international trade playing only an important supportive role.

Modern economists generally believe that today's developing nations can rely much less on trade for their growth and development than what Developing economies could do in the past. This is due to less favourale demand and supply conditions.

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