A Trade Theory for Developing Countries

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The trade policies of developing countries and the thinking which has inspired these policies differ greatly from conventional trade theory and policy. Although the explanation of this phenomenon may simply he that the policies actually pursued are misguided, this paper will instead suggest a reformulation of trade theory.

On the basis of this alternative theory it could be concluded that conventional theory is inapplicable and that present policies, although probably sub-optimal in many respects cannot be evaluated on the basis of conventional theory.

For an Indian reader, critical as he is likely to have been for a long time of conventional trade theory, this approach will probably not appear startling. However, what does not seem to have been sufficiently well done is a replacement of the conventional theory with a coherent alternative demonstrating clearly why and how conventional doctrines are not applicable.

The present paper will be directed towards this task of reconstruction.

[This paper contains ideas put forward in a book soon to be published under the title "Trade and Trade Policy for Development." The approach also formed the analytical background to a report written for UNCTAD under the title "The Significance of GATT for Underdeveloped Countries",]

FIRST of all, it must be observed that the group of underdeveloped countries is so heterogenous that no single theory can be formulated which offers adequate insights into the problems of ail these countries. The particular theory to be advanced here is aimed at the situation of developing countries or regions, i e, areas which have entered into a development phase holding out real promise of propelling them into a process of self-sustained growth. For these countries or regions a distinction must first be made between trade with advanced countries and with other developing countries.

TRADE WITH ADVANCED COUNTRIES

The Import Minimum

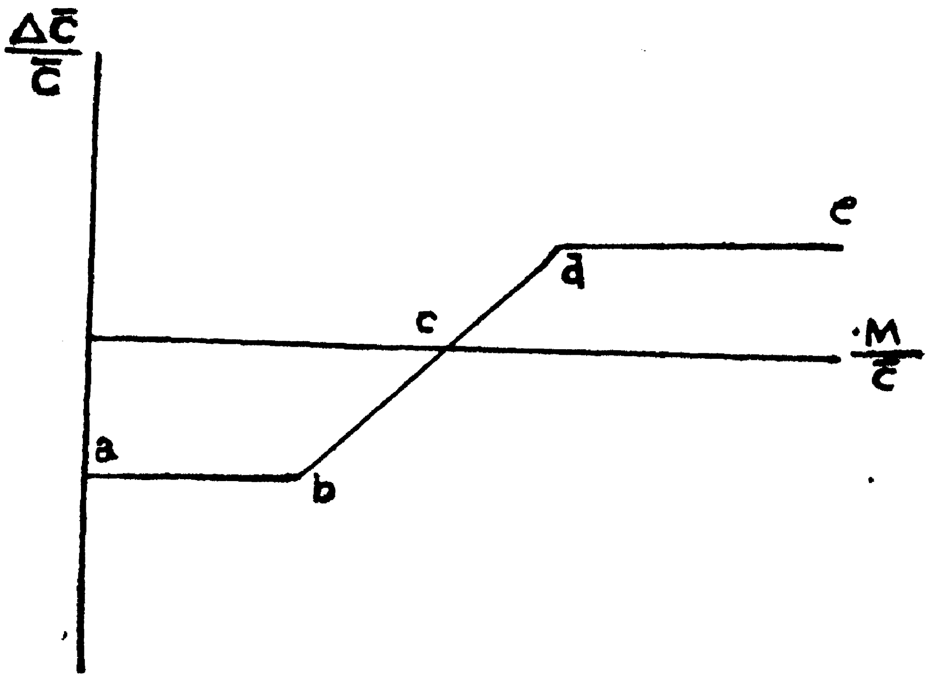
As to the trade with advanced countries our starting-point will be the observation that certain imports into the developing countries fulfil a special function. They are what will be called "input imports" which cannot be produced domestically and which are required by the developing country in order to utilize the existing productive capacity and the growth potential. The input imports consist of *operation imports,* i e raw materials not existing at home and spare parts to imported machinery; of *reinvestment imports,* i e, various capital goods needed to replace the third kind of input imports, or *expansion imports,* i e. imports of various investment goods. To the extent that a sufficient amount of operation imports cannot be secured the existing productive capacity cannot be fully utilized. To the extent that enough reinvestment and expansion imports (which we can lump together into *investment imports)* cannot be obtained, there will be a frustration of the growth potential. This frustration will be manifested in a failure to realize the savings which would be forthcoming if there were opportunities to import investment imports. If there is even a lack of reinvestment imports, the absolute stock of capital goods will decline.

The relationships between input imports and domestic production and capacity can perhaps best be set out in terms of a simple diagram. In Figure 1 the rate of growth of capacity $\frac{\Delta \bar{c}}{\bar{c}}$ is measured on the vertical axis. Input imports as a fraction of total capacity $\frac{M}{\bar{c}}$ are measured along the horizontal axis. In this diagram a function can be drawn to express the role of input imports.

If there are input imports just enough to operate the existing capacity and to maintain its size, i e, if there are input imports just enough to cover the operation and reinvestment purposes, the rate of growth will be zero. To the extent that additional amounts of input imports can be obtained for expansion purposes, there will be a positive rate *of* growth. When the amount of expansion imports is so big that all planned savings in the economy can be realized, the function will level off. From here on the rate of growth can increase only by ordinary capital imports which *serve* the function of adding to domestic factors, rather than complementing them. Whether or not the maximum rate of growth in capacity that can be achieved in a particular country or region reaches the rate which could be referred to as the "minimum socially acceptable rate of growth" is uncertain. Our diagram has, of course, nothing to say un this point.

If, on the other hand, the actual amount of input imports is so small that the full need of reinvestment imports cannot be secured, there will be

Figure 1



a negative rate of growth. This negative rate will reach its maximum level when there are no reinvestment imports at all. Further reductions in input imports would mean a curtailment of operation imports and would affect capacity use rather than capacity size.

On the basis of this reasoning the function a b c d e in Figure I can be drawn. It should be noted that on the horizontal axis input imports have been measured as a fraction of total capacity so that any change in capacity would not immediately mean a shift in the function. It is, of course, obvious, however, that even a function of the type in Figure 1 may change through time. It will be affected by such things as changes in the propensity to save, changes in the relative need for input imports, and changes in the capacity to produce domestically goods which in former periods have qualified as input imports. Changes of this latter kind are of particular interest because they are necessary for the country in order to change the role of trade as depicted in the Figure over to a role which would more resemble what it, on the basis of conventional theory, is thought to be in advanced countries.

However, it is obvious, though not underlined in conventional theory, that the imports of advanced countries, too, consist to some extent of what could very well be referred to as input imports. The gains from trade for countries such as the U K and Japan are regularly said to be "extraordinarily great". This is only because their imports are made up to an unusual extent of goods which, if they could not be imported, would lead to difficulties in maintaining production.

Nevertheless, the neoclassical theory is applicable to the conditions of countries such as the U K and Japan. Thus, the fact itself that the developing countries need certain imports, which we have called input imports, is not of any definite importance for the relevance of neoclassical trade theory. However, if the import minimum were combined with an *export maximum* and the export maximum were, in fact smaller than the import minimum, the consequences would be far-reaching. Then it would be impossible to transform domestic factors into certain strategic inputs not only through domestic production put also through trade.

The Export Maximum) and the Foreign Exchange Gap

According to the conventional theory the existence of an export maximum is an impossibility, A simple application of the comparative cost doctrine tells us that a country can always export goods in the production of which it is relatively efficient in order to import products in the production of which it is relatively inefficient, i e, in this case the input imports. However, in this doctrine although it has almost achieved the status of a truism there is a serious flaw. The comparative cost theory is based on the implicit assumption that in the production of the goods in which it has a comparative advantage a country is sufficiently efficient to be able to pay the factors of production involved in the export activities a minimum reward, i e, a reward above subsistence incomes. In advanced countries this assumption can very well be made; but it should of course be specified. As long as appropriate expenditure policies are being pursued, an advanced country can certainly export goods in the production of which it has a comparative advantage. Thus, in spite of the failure to specify the assumptions of the comparative cost doctrine, it remains applicable to advanced countries; and the import minimum which for countries like the U K and Japan is conspicuous, does not, since it can be covered, call for any reformulation of the theory. However, in the case of developing countries the assumption concerning minimum factor rewards must not only be made explicit; it must also be recognized that it might very well not be fulfilled in their trade with advanced countries.

The reason why the developing countries may encounter an export maximum is that they may be sufficiently efficient only in the production of various primary commodities, the foreign demand for which is too small and too inelastic to allow an expansion of exports beyond the need for imports. As regards manufactures, there are great differences in demand and production structures between the advanced and the developing countries. Those manufactures which are currently produced in the developing countries, and in the production of which the developing countries thus must be sufficiently efficient to pay more than minimum factor rewards, are not demanded in *advanced countries.* As to the manufactures that *are* demanded in advanced countries, they are not currently produced in the developing countries. And due to the difficulties the developing countries have in meeting the high requirements, technically and commercially, production of such goods cannot be taken up at an efficiency sufficient to cover minimum factor rewards.*

If *the export maximum is smaller than the import minimum, a developing country can be said to face an acute foreign exchange gap.* This gap, it should be noted, exists in spite of optimum expenditure policies. This should be emphasized, at the same time as it must be stressed that the foreign exchange difficulties of a developing country may self-evidently be much worse than they have to be, i e, if the country pursues inept expenditure policies.

The foreign exchange gap need not be reflected in an actual balance of payments deficit. It will be reflected in such a deficit only if the developing country can find means of financing the deficit. Otherwise, and this is the interesting feature of the trade situation of developing countries, an *internal disequilibrium will be substituted for the external imbalance.* The only third alternative would be that the developing country finds ways of closing the foreign exchange gap through recourse to trade policy measures of a kind which, on the basis of conventional trade theory, would be considered highly unorthodox.

Trade with Other Developing Areas

However, as has already been indicated, the foreign exchange gap analysis is intended to cover only the trade with advanced countries. What concerns trade with other developing countries, it seems as if it could be appropriate to make use of conventional trade theory. In this trade there are no particular import minima or export maxima. Instead, trade serves the role of permitting a more efficient allocation of resources and of enabling the utilization of economies of scale. However, the application of conventional theory will lead to certain unexpected results when Juxtaposed with the theory of trade with advanced countries. This is so since, in order to make use of the advantages of trade with other developing countries, a developing country must pursue discriminatory policies against the advanced countries. If the unorthodox policies at which has been hinted already as recommendable to direct trade with advanced countries have to be applied against other developing countries also, trade with those countries would probably be reduced to a trickle.

The discriminatory policies mean that developing countries should, in an optimum solution, pursue their trade within a single large customs union. Interestingly enough, it is not only trade creation within such a union which is to be welcomed. This we should expect on the basis of the neo-classical trade theory use of which is presently made. But also trade diversion away from advanced countries would be beneficial since it would permit a greater concentration of the actual imports from advanced countries to the particular input import category.

CONCLUSIONS

At this stage the theoretical implications of the foreign exchange gap analysis might be summarized as follows.

(i) *The gains from trade are of a different nature. A.* developing country trades to exert, a multiplicative effect on its capacity use and growth, rather than to improve the allocation of the existing, fully employed resources in the marginalist sense. For this reason, trade could be characterized as a super-*engine* of growth, rather than as a mere engine of growth as it has often been described. However, to the extent that a developing country does not succeed in meeting its- import requirements and thus faces an acute foreign exchange gap, the extremely attractive gains from trade tend to become exasperating since they cannot be fully realized. Trade is then a *potential* super-engine of growth. Trade with other developing countries takes place, however, to improve allocation.

(ii) The possibility of an export maximum in relation to an import minimum means that the *comparative cost doctrine has limited validity.* A developing country need not be able to export the goods in which it is most competitive, since there might be no demand for these products in advanced countries. And, as regards products for which there *is* a foreign demand, the country need not be able to export enough of those goods in the production of which it has what the conventional theory would refer to as a comparative advantage, since productivity is not high enough to support the factors involved in their production,

(iii) *The existing balance of payments theory cannot be applied* if there is a foreign exchange gap. Contrary to the situation in conventional analysis, internal and external equilibrium cannot be established simultaneously. Whatever the expenditure policies, imports cannot be reduced below a certain limit without causing internal instead of external disequilibrium, and exports cannot be stimulated as in advanced countries. Thus, a foreign exchange gap reflected in an actual balance of payments deficit does not imply over-absorption of goods and services in the ordinary sense. No matter how much absorption is reduced, the deficit could not be removed without substituting internal disequilibrium for external.

Conventional balance of payments adjustment measures are applicable, however, in the sense that suboptimal expenditure policies would worsen the situation.

(iv) *The usual kind of savings-investme fit equation in Keynesian models and in growth models must be modified.* As long as there is an acute foreign exchange gap, it is inappropriate to put I = S = sY, even though this is an *ex-post* identity. Instead, one should work with an equality stating that investments are limited by the availability of investment imports.

(v) In countries with an cute foreign exchange gap *capital imports are of an unconventional nature* since they do not supplement scarce domestic resources. Instead, they have the effect cf increasing input imnorts so that the investment constraint can be lifted. Capital imports beyond the closing of the foreign exchange gap serve the usual function.

(vi) If external and internal equilibrium cannot be achieved simultaneously, *the basic postulate of the pure theory of international trade is not fulfilled.* The usual division of trade theory into balance of payments theory and pure theory cannot be made. Balance of payments considerations must be brought into the analysis of structure and welfare. This means that *the whole edifice of commercial policy conelusions built within pure theory is inapplicable* to trade relationships with advanced countries. Also, the trade policy towards other developing countries will, though based on conventional theory, show distinctive differences from the recommendations usually deduced from that theory.

British Books for the World

THE Book Development Council, an independent organization to promote the export of books, was launched in London on April 9. Its chairman is Patrick Gordon Walker, former British Foreign Secretary. Part of the Council's work would be research into the developing book needs of selected areas of the world. The Council would assist at least one bookshop in every major city in the world to carry a representative selection of current and standard British books. It would also carry out curriculum research in consultation with authorities on the spot.

"*In* the present drive for exports, there can be no item more important than that of books", according to Gordon Walker, "They provide an essential contribution to international understanding which cannot be overestimated."

Nearly every British publisher of note has joined the Council, which has been described as a "British enterprise for international co-operation". It will try to make available overseas the skills of British publishing wherever they can be used — particularly in the developing countries.

Exhibitions, trade fairs and special displays of books will be arranged in co-operation with the British Council and the Publishers Association. Among the short-term objectives of the Book Development Council are coupon schemes, correspondence courses, low-priced book schemes, co-operative mailing facilities, and improved bibliographical services for overseas. Booksellers from overseas will be invited to Britain for training, and British booksellers will go abroad to study the needs of other countries.