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INTERNATIONAL TRADE & ECONOMIC DEVELOPMENT

RAJAT ACHARYYA & SAIBAL KAR

International Trade and Economic Development

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and

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PREFACE

With considerable interest and not necessarily the best expertise, we endured a mutual feeling for the last few years that despite sifting through a lot of resources in the subject, there seems to be a dearth of Masters-level textbooks in International Trade and Economic Development which bring together the entire gamut of issues that should be staple reading for a student opting for this course. Several disparate studies in various areas of trade and development are available in academic journals and as contributions in edited volumes, which we realized could be put together in a systematic and coherent manner to constitute a good stock of course materials for postgraduate course work. At the same time, we observed that issues like trade and labour market, trade and labour migration, standards and copyrights, and outsourcing or offshoring, to name a few, despite their critical importance in view of contemporary experiences in the developing countries, do not receive adequate emphasis in available books. Thus, our ambitious project began. While writing different chapters of the book, we set our goal to offer the most advanced and contemporary readings in trade and development with obvious references to developing countries. In the end, we hope that we have been able to provide our readers a systematic account of the progress of the relevant and important topics on which future research in trade and development shall be built.

We expect that the book should cater best to Masters-level students in Economics interested in international economics broadly defined, and influence critical research questions in related areas. It may also be useful, in parts, for advanced undergraduate students, who have studied basic international economics and mathematical tools commonly used in economics as the prerequisites.

In the course of writing this book, we made debts with many people. First of all, we are deeply indebted to two anonymous reviewers of the book proposal for invaluable suggestions to do with the contents and overall directions. Second, we owe our intellectual debts to friends and colleagues who shaped our scattered ideas during discussions, through critiques in seminars and conferences and via informal interactions in the past. Special mention must be made of Kaushik Basu, Hamid Beladi, Gerrit Faber, Maria D.C. Garcia-Alonso, Kausik Gupta, Basudeb Guha-Khasnobis, Ronald W. Jones, Eliakim Katz, Sugata Marjit, Devashish Mitra, Late Kalyan K. Sanyal, George Slotsve and Thomas Straubhaar for offering valuable suggestions and lending support as mentors, co-authors, and friends. We have undoubtedly learnt a lot more from the colleagues and the students at the various places we visited and been affiliated to, such as the Amsterdam School of Economics; Calcutta University; Centre for Studies in Social Sciences, Calcutta; HWWI, Hamburg; IZA, Bonn;

Jadavpur University; University of Burdwan; University of Kent; University of Rochester; UNU-WIDER; Utrecht University, etc. We remain indebted to Adam Swallow and Aimee Wright for bearing with us during the course of writing this book. Saibal Kar would also like to thank his daughter Ujjayini, now 10 years old, for reading and appreciating the introduction to this book.

The writing of the book borrowed precious time from our families, which they have endured and yet, indulged us at the same time. We express our heartfelt thanks to them.

November 2013
Rajat Acharyya and Saibal Kar

CONTENTS

LIST OF FIGURES xi
LIST OF TABLES xiii
LIST OF ABBREVIATIONS xv

Introduction: The Scope and Coverage of Trade and Development 1

1. International Trade and Development Paradigms 6
1.1 Mercantilist Theory of Trade and Development 6
1.2 Classical Political Economists on Trade and Growth 7
1.3 The Post-World War II Debate: Free Trade vs. Trade Protection 10
1.4 Export Pessimism and Legacy of Inward-Looking Development Strategy 11
1.5 Development Crises and Globalization as a Universal Development Strategy 14
1.5.1 The Beginning of the Crisis 15
1.5.2 Combating the Crisis in Europe 16
1.5.3 What is in Store for Developing Countries? 19
1.6 International Trade, Pollution, and Sustainable Development 20

2. Problems of Trade in Primary Commodities 25
2.1 Prebisch-Singer Hypothesis of Unequal Distribution of Gains 26
2.2 Critique of Secular Deterioration of TOT 27
2.3 Unequal Exchanges 29
Appendix: Proof 35

3. Terms of Trade and Growth 38
3.1 Trade, Factor Mobility, and Immiserizing Growth 41
3.2 Structuralist Theories: Foreign Exchange, Savings, and Growth 48
3.3 North-South Trade, TOT, and Growth 52
3.3.1 Lewis-Nurkse Growth Process and Economic Dependence 52
3.3.2 Long Run TOT and Growth 56
3.4 Country Experiences 62
Appendix: Fundamental Theorems and Proofs 64

4. Foreign Direct Investment and Multinational Firms 72
4.1 Introduction 72
4.2 Targeting Sectors for Foreign Capital Inflow and Welfare Implications 74
4.2.1 FDI in Retail 77
4.3 Foreign Capital and Skill Formation 80
4.3.1 The Model 82
4.3.2 Changes in Policy 85
4.4 Concluding Remarks 87
Appendix 1: Proof of Tariff Reduction and Skill Formation 89
Appendix 2: Proof of Interest Rate Rise and Skill Formation 90
Appendix 3: Proof of Export Price Rise and Skill Formation 91
Appendix 4: Proof of Currency Devaluation and Skill Formation 91

5. International Labour Mobility and Welfare 96
5.1 Introduction 96
5.2 Overview 97
5.2.1 Host Country Problem 100
5.3 Various Effects of Migration: Source and Destination Interactions 108
5.3.1 Immigration and Skill Formation 110
5.4 A Model and the Results 112
5.4.1 Effects of Trade Liberalization 114
5.4.2 A Terms-of-Trade Improvement or an Interest Cut on Foreign Capital 116
5.5 Conclusion 117
Appendix: Algebraic Proofs and Graphical Analyses 119

6. Information, Labour Migration, and Occupation 127
6.1 Introduction 127
6.2 Asymmetric Information and the Decision to Migrate 131
6.3 Asymmetric Information in the Labour Market 134
6.3.1 An Example 140
6.4 Concluding Remarks 141

7 Trade, Foreign Aid, and Welfare 146
7.1 Introduction 146
7.2 The Analytical Dimensions of Foreign Aid 151
7.2.1 Types of Foreign Aid 152
7.2.2 Macroeconomic and Generalized Implications of Foreign Aid 154
7.3 Foreign Aid, Governance, and Policy 163
7.4 Concluding Remarks 165

8. Trade, Poverty, and Readjustments 170

8.1 Introduction 170

8.1.1 How Does Trade Affect the Poor? 171

8.2 Trade, Informal Sector, and Poverty 176

8.2.1 Modelling the Informal Sector 178

8.3 The Political Economy of Trade Policy 182

8.3.1 Trade and Readjustments 185

8.3.2 Wage Subsidy 189

8.3.3 Group-specific Welfare 193

8.4 Concluding Remarks 195

Appendix 1: The Relation between Trade and Informal Wages 197

Appendix 2: Trade Adjustment Assistance and Welfare 199

9. Regional Trading Arrangements as Development Strategy 207

9.1 Types of RTAs 208

9.2 Causes and Consequences of RTAs 209

9.2.1 Static Welfare Gains and Old Regionalism 209

9.2.2 Causes of Contemporary Regionalism 218

9.2.3 Dynamic Gains and Formation of Regional Trade Blocs 219

9.3 Regionalism and Multilateralism 225

10. TRIPS, Product Standards, and the Developing Economies 230

10.1 TRIPS 231

10.1.1 Parallel Imports, Innovation, and Welfare 233

10.1.2 TRIPS, Parallel Imports, and Market Access to New Drugs 240

10.1.3 TRIPS, Innovation, and Growth 241

10.2 Environmental Standards 249

10.2.1 Unfair Trade and Ecological Dumping 250

10.2.2 Trade, Growth, and Pollution 253

10.2.3 Environmental Regulation as a Non-Tariff Barrier 256

10.2.4 Capital Flight and Pollution Haven 258

10.3 Labour Standards, Trade Sanctions, and Child Labour 259

10.3.1 Trade sanctions, boycotts, and perverse effects on the incidence of child labour 261

10.3.2 Product Labelling and Child-Labour Content Tariff 261

11. International Outsourcing, Offshoring, and Industrialization Strategies 271

11.1 Concepts, Measurement, and Magnitude of Outsourcing and Offshoring 272

11.2 Costs and Benefits of Offshoring and International Outsourcing 275

11.3 Export Processing Zones (EPZs) as a Development Strategy 279
11.4 EPZs and Welfare in Developing Countries 283

12. Contagion of Crisis and Concluding Remarks 288

12.1 Introduction 288
12.2 Analytical Categories of Currency Crisis 291
12.2.1 Trade Links of Contagion 295
12.2.2 The East Asian Crisis 296
12.3 Concluding Remarks 303

NAME INDEX 309
SUBJECT INDEX 313

LIST OF FIGURES

1.1	International Trade and Vent for Surplus	9
1.2	Public Debt as a Percentage of GDP in Select European Countries	18
3.1	Savings and Foreign Exchange Constraints on Growth	51
3.2	Per Capita Growth Rate in the North	54
3.3	Balanced Growth and Persistent Poverty of the South	55
3.4	Steady State Southern Employment	60
5.1	Capital Outflow from a Rich to a Poor Country	102
5.2	Labour Inflow from a Poor to a Rich Country	103
5.3	Migration Hump, Plateau, and Trough	105
5.A1	Country-wise Immigration to the USA	121
5.A2	Ratio of Highly Skilled to Relatively Unskilled Immigration in Select Developed Countries	122
5.A3	Net Foreign Capital Inflows in Developed and Developing Countries 1985–2002	122
5.A4	Foreign Capital Inflow in India	123
6.1	Migration Pattern Under Asymmetric Information	132
8.A1	Relationship Between (β, t) for Subsidy-Import Comparison	199
8.A2	Relationship Between (β, t) for Price Effects	200
8.A3	Relationship Between (β, t) for Elasticity Effects	200
8.A4	Relationship Between (β, t) for Wage-Elasticity Effect	201
9.1	Welfare Gains from Formation of FTA	211
9.2	Trade Diversion is Bad (Lipsey Case)	213
9.3	Trade Diversion is Bad with No Production	214
9.4	Trade Diversion is Bad (Bhagwati Case)	215
10.1	Steady State Product Growth Rate of the North	247
10.2	Larger Capital Stock and Supply Bias	252
10.3	Equilibrium School Time	264
10.4	The World Price Schedule	266
10.5	Subsistence-Income and Child Labour	267
11.1	International Outsourcing and Economies of Scale	276

LIST OF TABLES

7.1	Total Bilateral Aid to All Sectors in Developing Countries	147
7.2	Total Bilateral Aid to All Sectors	148
7.3	Total Direct Investments	149
7.4	Percentage of GDP Committed to Foreign Aid in Developed Countries	150
8.A1	Annual Growth Rates of Real Informal Wage for States and Union Territories in India	202
8.A2	Sensitivity of β^* to Parametric Changes	203
9.1	Number of Regional Trade Arrangements Signed by Select Countries Until 2009	227
11.1	Growth of Export Processing Zones	280
11.2	Share of EPZs in Manufacturing Exports	282

LIST OF ABBREVIATIONS

ASEAN	Association of South East Asian Nations
BENELUX	Belgium, The Netherlands, and Luxembourg
BOP	balance of payments
BPO	business process outsourcing
CAC	capital account convertibility
CARICOM	Caribbean Community and Common Market
CGE	general equilibrium model
CM	Common Market
CU	Customs Union
DAC	Development Assistance Committee
ECB	European Central Bank
ECSC	European Coal and Steel Community
EDT	total outstanding debt
EEC	European Economic Community
EFSF	European Financial Stability Facility
EKC	Environment Kuznets Curve
EMU	Economic and Monetary Union
EPZ	export processing zone
ERM	Exchange Rate Mechanism
EU	European Union
FDI	foreign direct investments
FII	foreign institutional investments
FTA	Free Trade Area
GCC	Gulf Cooperation Council
GDP	gross domestic product
HOS	Heckscher-Ohlin-Samuelson
ILO	International Labour Organization
IMF	International Monetary Fund
IPR	Intellectual Property Rights
IR	individual rationality
IT	information technology
ITeS	IT-enabled services
LDCs	less-developed countries
LHS	left hand side
LTRO	Long Term Refinancing Option
MBD	market-based (price) discrimination
MERCOSUR	Mercado COMUN DEL Sur (Spanish) / Southern Common Market
MFN	most-favoured nation
MNC	Multi-National Corporation
MNE	multinational enterprise
NAFTA	North American Free Trade Agreement

NICS	Newly Industrialized Countries
NTPC	National Thermal Power Corporation of India
OBM	own brand manufacturing
ODA	Official Development Assistance
ODM	original design manufacturing
OECD	Organization for Economic Cooperation and Development
OEM	original equipment manufacturing
OPEC	Organization of the Petroleum Exporting Countries
PPF	production possibility frontier
PTA	preferential trading arrangement
R&D	research and development
RHS	right hand side
RTA	regional trading arrangements
RTB	regional trade blocs
SACU	South African Customs Union
SDT	short-term debt
SEZ	special economic zone
SMSA	Standard Metropolitan Statistical Area
TA	teaching assistant
TAA	Trade Adjustment Assistance
TFP	total factor productivity
TIC	trade indifference curve
TOT	terms of trade
TRIPS	trade related intellectual property rights
UNCTAD	United Nations Conference on Trade and Development
UNESCO	United Nations Educational, Scientific and Cultural Organization
UNHCR	UN High Commission for Refugees

Introduction: The Scope and Coverage of Trade and Development

The history of international trade in commodities chronicled over the last two millennia is as rich and complex as the epics of *Iliad* and *Odyssey* and the *Mahabharata*, which spread over 8 to 4 BCE. In fact, the perceived timings of when the underlying storylines of these epics were taking shape and the period when ancient trade was reaching its new heights are not historically anachronous. Powerful archaeological and textual evidence suggests that at the peak of ancient civilizations, breakthrough techniques in agriculture, brewing, metalwork, weaving, and cattle rearing had become the appurtenances of political and economic power. Strange as it might seem in view of the escalating cost we associate with international trade in goods and services even today, autarky was not the natural choice for traders in 10000 BCE. Various luxury items, stone beads, gold, silver, silk, and seeds were regularly traded between the early-urban settlements in lowland Mesopotamia. By 8000 BCE, trade routes throughout Asia, Africa, and Europe were already in place. Cross-country transport of wheat and grains, dried meat, fish and fruits, liquor etc. were treated as the blue-chip goods that comprised the caravan consignments of the time. City states of Mesopotamia, Eastern Mediterranean, lower Nile Valley, Indus Valley, and countries like China controlled the ancient trade in olive oil, spices, incense, opium, wool, textiles, copper, iron, enamelled mosaics, celadon pottery, cedar timber, silver inlay, carved ivory, precious gemstones, honey, wine, raisins, livestock, and horses.

About a century prior to the birth of Jesus of Nazareth, these trade routes across the East and the West were bustling with activities. Major trade took place along the Incense Route, the Spice Route, the Silk Route and through shorter passages epitomizing perhaps the first wave of globalization. The epics distinctively name and recount the locations, the characteristics, and the interactions between the most important agents of that world order. If the reader judiciously discounts the supernatural excesses of the time, these epics and numerous other religious accounts provide evidence of strong bilateral and multilateral trade, at least exchanges, in goods between the pockets of civilizations. Interestingly, and as a justification for this paraphernalia as motivation for our book, these pockets of civilization both in the East and in the Middle

East, Asia Minor, Egypt, Rome, Athens, and the Horn of Africa were substantially more advanced technologically, and were richer settlements compared to places where much of the wealth has accumulated over the last four centuries.

The pattern continued through the Middle Ages, with Catholic Crusades, expansion of dominion by Muslim conquests, and by the Mongols. The sea routes started getting greater prominence at the time, along with firmly settled trade relationships between cities in Europe, the Middle East, China, India, and the Far East. The trade interactions took truly biblical proportions over the next few centuries provoking the European fortune-seekers, usually with the help of state patronization, to venture into lands of flowing milk, honey, and spices on the one hand and to the land of gold, access to which would allow them to buy all of these, on the other. The fall of the Aztecs in the hands of the Spanish conquerors (1521 CE) and a decade later the similar fate of the Incas (1532 CE) actually began an era of 'fortune reversals'. The El Dorado remained as hidden as ever (even the last hope of finding it, Indiana Jones, seems to have retired—but of course, who can be sure of hidden cards in Hollywood!) and did not help in recovering the lost fortune. Trade and outflow of resources by that time had largely become a one-way traffic to Europe. It is also well-known that once the prosperous trade routes of yesteryears, both land and sea, brought in economic and political aggressors with guns, horses, syphilis, and strong business acumen, the pockets of prosperity started growing big holes in them through which resources drained out thick and fast (Diamond, 1997 had provided strong arguments in favour of 'longitudinal' expansion). By the time the Mercantilists shaped the modern forms of international trade (of course, they believed only in trade surpluses), accumulations and growth in the manner the world recognizes these aspects now, the tables had turned and the odds that trade brings prosperity and peace were largely in favour of the colonial rulers on four corners of the earth. While we witnessed brief turnabouts during the two World Wars, pushing the richer nations in Europe to 'man-made' distresses (fortunately, almost nobody talked about environment at the time), the general direction that the study of international trade and economic development would adopt had found a structure. In other words except for a few unanticipated occurrences, such as the 'transfer paradox'—an outcome of the reparations sent to war devastated Europe, Japan, and the US, the developing countries started drawing the full attention of the subject of trade and economic development. Such attention may have intellectually compensated for the reversal of fortune. The reversals of fortunes for the poor countries have recently been studied from the point of view of institutional reversals in the colonies of Europe (Acemoglu, Johnson, and Robinson, 2002). However, long before that, observed patterns of trade between the developed and the developing countries served as the progenitor of the celebrated Singer-Prebisch hypothesis (1950) and subsequently, the 'subject' of international trade and economic development. In a different way, the reversal according to this thesis occurred owing to the falling terms of trade for the colonies specializing in the export of primary products and importing the costlier manufacturing goods from the colonizers. We devote due attention to this hypothesis in Chapter 1, graduating into several interesting sub-domains in the area. These include further discussion on the problems of trade in primary commodities in Chapter 2, of interactions between international trade, domestic markets for factors, and implications for economic growth in Chapter 3, and the considerably debated role of FDI and MNC activities in developing countries in Chapter 4. Some of these issues, as it is well known to the reader, constitute the core debates in this subject area. As pointed out earlier, we intend to cover the available and time-tested wisdom in the field with some of the less-traversed and yet compelling issues. These include the rich, but textbook-wise under-emphasized, relationship between trade and factor mobility.

We realize that any attempt to cover the length and breadth of topics related to factor mobility, literally speaking, is clearly beyond the scope of a couple of chapters, and for that matter a couple of oversized books. So essentially, we focused on a few interesting issues ranging from well-known graphical treatments by Bhagwati (in Chapter 5) to more modern observations on the complex dynamics involving labour, capital, and technology. The role of asymmetric information between source and destination of the mobile factors of production is the subject matter of Chapter 6. Since money as the form of capital is supposed to be monochrome and speaks the same language no matter where it is deployed, the onus of discrimination, of information black-out, and of considerable social tension is borne, often disproportionately, by the mobile labour. Evidently, the impact of labour mobility is non-trivial for both the source and the host countries. The impact, as this literature claims, depends crucially on how the productivity of mobile labour is interpreted across countries. It simultaneously determines the choice of location made by labour and capital, the occupational categories for labour, the pattern of inward remittances, and of investments in physical and human capital in the context of North-South models of international economics. We offered a few interesting observations on these matters outside the traditional domain of international trade.

Subsequently, the book discusses foreign aid (Chapter 7), dealing with conventional as well as contemporary treatments in the economics of trade and development. The flow of foreign aid is a deeply researched topic and quite dispersed across a number of sources—books, journals, and cross-country development reports. While much of the interest in the interaction between foreign aid and development is reflected in the simple and elegant structures available in Basu (1998), the important ramifications on the theory of aid and on the methodological and empirical studies on aid are briefly touched upon to apprise the student of its scope and coverage. Tracing such topics chronologically may be important at a time when there seems to be a general bias against reviewing older literature beyond a decade or so from the present time, to the extent that the incidence of proving and re-proving the Hechscher-Ohlin-Samuelson theorem gets quite pervasive in the field. We continue to discuss important references on which newer ideas are built. In the later part of the book, we begin with a chapter on economic welfare and poverty. It is also a well-researched topic with numerous contributions available in the literature. We made use of the most comprehensive and commanding surveys in this area to motivate and explore the trade-poverty links with the help of simple models (Chapter 8). Further, Chapter 8 argues that since the main resistance to trade liberalization in most countries comes from import competing industries where it directly leads to job losses, the trepidation about economic reforms turns itself into heated political debates. Compensation schemes (generally termed as Trade Adjustment Assistance or TAA) for those who lose jobs due to trade liberalization, are available only in a few advanced countries. None of the developing and transition countries practice TAA schemes. Moreover, the majority of developing countries do not 'functionally' offer unemployment benefit or other social security safeguards. However, any intervention such as unemployment benefit creates further distortions, particularly when unemployment is frictional and not structural. The solution is a second-best in comparison to a market-driven first best outcome. This chapter derives a second-best policy of trade adjustment assistance, with implications for group inequality in a developing society.

The issues about economic integration (Chapter 9), despite seeming aberrations from much more challenging free trade regimes, cannot be set aside in view of development and welfare implications entrenched in it. Chapter 10 discusses the role of TRIPS, the debates about trade standards and of industrial strategies as part of very recent literature in this area. It also accommodates the relations between international trade and the endogenous growth theories of more recent origins. Chapter 11 deals with outsourcing, offshoring, and industrial strategies at the destination as an example of the recent industrial organization-centric developments in international economics.

The choice of topics to be included in this book has not been easy. The subject is extremely rich with contributions from the best in the field. Consequently, we relied partly on our experiences with teaching postgraduate courses in trade and development where the slow build-up to the topics of current interest have been generally accepted and appreciated by the students. The course material we have chosen is also influenced by the contents and references adopted by specialists in the subject. Consequently, each chapter discusses the relevant literature and then provides detailed analytical structures that closely capture the core elements of the topic in hand. The theoretical applications duly supported and motivated by empirical evidence have been drawn mainly from papers published in leading journals and therefore, might be construed as a useful compilation of somewhat dispersed teaching materials. We nevertheless acknowledge that despite our best efforts, we may not have done justice to many interesting questions in trade and inequality; on the impact of international trade on land as an important input; about trade and entrepreneurship; or trade and redistribution etc. These currently remain as vibrant subjects of research. Chapter 12 summarizes findings from each chapter, preceded by a non-technical discussion on international financial contagion. The conclusion further highlights our shortcomings, both owing to constraints in time, space, and our incapability of comprehending the subject more than we could grasp in this attempt. If the students and teachers of international trade and economic development consider this book to be a useful source of information, it will give us the right kind of incentive to work further in the area.

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1 International Trade and Development Paradigms

Interaction between international trade and the process of development is a complex one. The importance of international trade as a development strategy dates back to the writings in seventeenth- and eighteenth-century Europe, known as the 'mercantilist ideas'. It was viewed as a means of acquiring wealth by maintaining a trade surplus. This idea, however, was criticized by Hume (1752) who argued that a trade surplus is only a temporary phenomenon, as the changes in prices and money supply consequent upon a trade surplus would lead to an automatic adjustment towards a balance of payments (BOP) equilibrium. Since then, the role of international trade in promoting development and growth of countries has been debated by economists as well as policy-makers. Such debates essentially evolve around costs and benefits of free trade vis-à-vis those of protectionism. Even in the writings of ancient Greek philosophers, just as among the present-day economists, the dual role of international trade was apparent: recognition of the benefits of international exchange along with the concern that certain domestic industries and economic agents would be harmed by foreign competition.

This chapter reflects upon these debates. We begin with the mercantilist idea of trade promotion as a development strategy, and its critique by Smith (1776). The development debates around free trade versus protectionism are discussed thereafter.

1.1 Mercantilist Theory of Trade and Development

Mercantilism was a school of thought on international trade policy that emerged in the seventeenth and eighteenth centuries. Two distinct ideas associated with the mercantilists shaped much of the public policy of that time. First was that countries should maintain a trade surplus through export promotion and import protection, since this is the only alternative to war to acquire precious metals, known as specie. This idea was severely criticized by Hume in the eighteenth century. A country acquiring specie through a trade surplus will experience a rise in its purchasing power. Consequent increased spending will raise prices of domestic goods, which will induce the domestic consumers to switch to consumption of foreign goods. Imports thus increase. On the other hand, higher prices of domestic goods erode their competitiveness in the foreign markets and exports thus decrease. That is, rising prices leads to a trade deficit and a consequent outflow of species. This is known as Hume's price-specie flow mechanism and constitutes the starting point of the monetarist approach (see later) that postulated balance of payments imbalances as a purely monetary, and more importantly, temporary phenomenon.

The second idea associated with mercantilism was that a nation should promote exports of manufactured goods and imports of raw materials essential for such manufacturing exports. This selective trade promotion and protection was motivated by better employment opportunity in manufacturing production than in mining or extracting raw materials from the earth. There was also the idea of building up industries to strengthen the domestic economy and national defence. In achieving these trade promotion and restriction policies, the mercantilists advocated export subsidies and tariff protection for domestic manufacturing firms.

Smith, in his Wealth of Nations (1776), criticized this idea by asserting that if certain trade is not profitable for private merchants *without subsidies*, then it would be unlikely to be profitable for the nation. He essentially was talking about the costs of export subsidies. Smith also did not subscribe to tariff protection, as he viewed such a policy as eliminating competition and encouraging domestic producers to exercise their market power. To Smith, monopoly was inefficient and thus wasteful. Accordingly he refuted the idea of trade protection and instead advocated that free trade is good by developing his productivity and vent for surplus theories.

1.2 **Classical Political Economists on Trade and Growth**

Smith, Ricardo, and Malthus were among the classical political economists who had some well-articulated arguments on the relationship between international trade and growth of nations. However, their arguments were mostly on the supply-side constraints on output growth. Most of the classical political economists were pessimistic about long run growth prospects of the industrialized countries. They believed that these countries would reach a point of stagnation much earlier than the resource-rich, primary goods-exporting countries. In this perspective, Ricardo viewed international trade as a way of delaying the stationary state. Through his doctrine of comparative advantage he demonstrated two important results. First, all trading nations will experience welfare gains when they trade according to their comparative advantage. Even a country that is inferior in all lines of production relative to other nations will benefit if it exports goods in which its inferiority is least, and thus in which it has comparative advantages. The consequent increase in the rate of profit and efficient reallocation of resources through production specialization will step up the rate of capital accumulation and hence the rate of growth. Malthus, on the other hand, viewed reallocation of resources from agriculture to the manufacturing made possible by international trade as a way of offsetting diminishing returns in agriculture. With growing population, agriculture is over-cultivated, which in turn lowers yield per acre by the law of diminishing returns. International trade allows imports of food and releases the pressure on agriculture. To Malthus, trade also had a favourable effect on output growth through increase in labour supply. As international trade expands the set of consumables, the people will perceive the opportunity cost of leisure rising and thus will work harder and for longer hours than in absence of international trade and such increased consumption opportunities.

Smith perceived the two ways in which international trade promotes growth. First, by widening the extent of the market, international trade makes possible large scale production and consequently creates scope for further division of labour, which in turn improves the level of productivity and thus growth. This was his Productivity Theory, which in contrast to Ricardo's static gains from trade, looked upon international trade as a dynamic force. To Smith, large scale production also enables firms to reap the benefits of economies of scale and would encourage them to innovate. In Ricardo's argument, production specialization meant allocation of resources and was a reversible process. But in Smith's argument, specialization involves adopting and reshaping production structure of the economy to meet export demand, which is an irreversible process.

As Myint (1958) observed, in late nineteenth-century Europe, this productivity theory was pushed into an export-drive argument, which has been seen by many as the precursor to the subsequent export-led growth argument. It was believed that since international trade raises productivity and growth, so the state should *promote* trade instead of adopting a laissez faire policy. This often led to exploitation of the colonies by their European rulers to step up their exports.

The second contribution of international trade perceived by Smith was providing a vent for surplus productive capacity of the economy. To Smith, surplus land in an economy isolated from international trade arises because of the narrowness of the domestic market. He also talked about surplus labour, which was linked to his concept of *unproductive* labour. So essentially, low productivity according to him was the cause of actual output falling short of the potential output in nineteenth-century Europe. Thus, according to Myint, Smithian argument of surplus productive capacity was a supply-side argument rather than the effective demand argument of Keynes and Kalecki in the early twentieth century. In such a context, a surplus productive capacity suitable for export markets was virtually a costless way of acquiring imports and expanding domestic production.

Later, Findlay (1970) put Myint's interpretation of the Smithian vent for surplus argument into a formal analysis, which is illustrated in Figure 1.1. The negatively sloped straight line DC reflects the production possibility frontier (PPF) of a country producing handicrafts and food. The constant slope indicates the constant opportunity cost of expanding food production in terms of handicrafts. Initially, the economy was operating at a point A well within the PPF, which is a reflection of surplus land as well as surplus labour. Low productivity of labour in food sectors implied low food-wages. This meant that labour enjoys leisure, since the opportunity cost of leisure is low. Now suppose the food price relative to handicraft price is higher in the world market as shown by the steeper line p^*. When this economy opens up for international trade, larger quantities of handicrafts exchange for one unit of food. This raises the opportunity cost of leisure and results in an increase in labour supply. Food output thus shifts to point B on the PPF. Note that, due to initial surplus land and labour, expansion of food production did not require handicraft production to contract. But once international trade pushes the economy on to its PPF indicating that all surplus land and labour have now been fully utilized, further expansion of the food production (along the PPF) would now require a contraction of handicraft production to release land and labour to sustain additional food

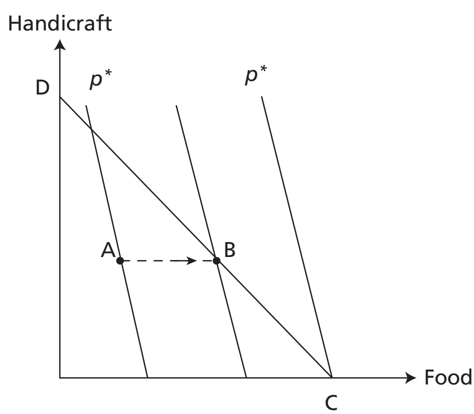

Figure 1.1 International Trade and Vent for Surplus

production. Now the Ricardian phase starts. The economy, having a comparative advantage in food production, moves down along the PPF until it is completely specialized in food production, and is importing all its requirement of handicraft. The entire process, Smithian adjustment followed by Ricardian complete specialization, leads to a gain for the economy as its consumption possibility frontier (indicated by the p^*C line) now expands beyond the PPF.

1.3 The Post-World War II Debate: Free Trade vs. Trade Protection

The current debate on international trade as a development strategy largely focuses on costs and benefits of free trade vis-à-vis trade protection. Whereas there is often a two-way relationship between pattern of trade and a country's stage of development in the existing theory, the country experiences regarding the role of international trade in a country's development and growth process are mixed. There are both success and failure stories, and more recent evidence indicates that rather than international trade per se, it is perhaps the composition and quality-content of a country's export basket that matters most (Hausman, et al., 2007; Agosin, 2007). Moreover, an export-led growth may not always be desirable because the terms of trade may deteriorate so much so that the initial favourable welfare effect of growth may actually be reversed; a phenomenon, demonstrated by Bhagwati (1958), which is known as the *immiserizing growth*.

Even the perceived static benefits of free international trade are grounded on some restrictive assumptions, which may not always be satisfied. Actual gains may, therefore, remain far below the potential. The gains from trade theorem, the oft-quoted benefit of free international trade, which postulates that international trade is a positive-sum game for all trading nations, loses much of its appeal because within each trading nation international trade creates winners and losers. Thus, without a compensation principle, trade does not benefit all economic agents. A compensation principle is hardly applied by trading nations, and thus what emerges is a redistribution of income within trading nations (along with across the trading nations), and this may not always be in the desired direction. For example, if trade redistributes income against unskilled workers, as has been observed in recent times, this has far-reaching implications for the poor, since most of the poor are unskilled workers. Even if we set aside such distribution issues, the gains from trade theorem itself is far from realized when markets do not function properly in the sense that the market prices fail to reflect a country's actual line of comparative advantage. The typical examples of such market failures are externalities in production and consumption. This does not mean that trade should be prohibited or restricted, but the crux of the matter is that without necessary corrective actions, such market failures may actually lead to a fall in welfare when a nation opens up for trade.

The primary argument for trade protection, in the present context, on the other hand, is to protect infant industries of a nation in its early stages of development. Mill made a strong argument in favour of promoting infant industries as early as in 1848, which subsequently has been a critical element in discussions and design of the development strategy of a nation. Unfortunately, the infant industry argument has often been misunderstood, misperceived, and misused. Infant industry protection does not call for once and for all tariff protection. Protecting industries that can withstand foreign competition will only encourage inefficient production specialization and inefficient resource allocation. Moreover, there are some obvious costs of protection, which should be weighed against the long run benefits that infant industry protection may generate. What is even worse, trade protection generates rents for certain economic agents, which might encourage them to undertake wasteful lobbying activities in order to influence the government policy in actually protecting the domestic industries. Krueger (1974) and Bhagwati (1982) were the leading researchers to point out such losses of trade protection. Resources used in lobbying to influence trade policy choice mean that the economy produces and consumes less than its endowments would have allowed. The developing country experiences do support the existence of such lobbying or rent-seeking activities and costs thereof.

On the other hand, Metzler (1949) demonstrated that for a large trading nation, an import tariff may not protect its domestic, import-competing industries. At the initial world relative price of imports, an import tariff raises the domestic relative price of imports. This in turn lowers the demand for the country's imports in the world market and thus lowers the world relative price of imports. If this subsequent terms of trade (TOT) improvement is large enough to outweigh the initial effect of the tariff, the domestic relative price of imports declines. This paradoxical result, known as the *Metzler Paradox* in the trade literature, arises when the exporting country's import demand elasticity is smaller than the importing country's marginal propensity to consume its export goods.[1] In such a paradoxical situation, an import tariff fails to protect the domestic industry.

1.4 **Export Pessimism and Legacy of Inward-Looking Development Strategy**

The infant industry argument, the theory of optimum tariff and above all the writings of Lewis (1954), Rosenstein-Rodan (1943), Prebisch (1950), Singer (1950), and Hirschman (1982) on export pessimism and North-South debate

[1] For derivation of this condition see Caves, Frankel, and Jones (2006).

contributed towards shaping development policies of many countries and the adoption of inward-looking development strategies by a large number of less-developed countries in the immediate post-World War II period. The export pessimism grew out of the observations on defaults on international debt for a large number of countries, suggesting that the external environment was not as conducive as it was during pre-World War I times to promote growth. It was contended that the rich dividends that countries received by promoting trade during the golden years of booming world trade prior to 1914 were unlikely in the post-World War II period, because the world trade had not boomed since 1914. The cornerstone of the export pessimism was, however, the Prebisch-Singer hypothesis that primary goods-exporting poor countries will experience secular deterioration of their TOT vis-à-vis the manufacturing-exporting rich nations. They shared the view that the trade relation between rich and poor nations is a kind of C*entre*-P*eriphery* relation, a term coined first by Lewis (1954), in which the advanced Centre, or the rich nations, generates the momentum of capital accumulation and innovation, and the backward Periphery, or the poor nations, responds more or less passively to the parameters set by the Centre. This trade relation leads to perpetuation of the role of poor nations as producers of primary goods and buyers of manufacturing goods. Moreover, as we will elaborate in Chapter 2, whatever technical progress that international trade ushers in results in falling prices of the primary exports (or further worsening of the TOT) to the benefit of the Centre. That is, the productivity gains in the Periphery are actually exported away to the Centre. These observations led Prebisch (1950) to conclude that '…industrialization is the only means by which the Latin American countries may fully obtain the advantages of technical progress'. A few years later, Nurkse (1959), in his Wicksell lecture, put forward his export lag thesis in which he contended that the exports of primary goods-producing countries tend to lag behind the rate of increase in world trade and that of the manufacturing-exporting countries. The common idea shared by all these economists advocating export pessimism is that the demand for primary goods is income inelastic, so that as the per capita income grows the demand for primary goods rise less than proportionately. These writings on export pessimism and secular deterioration of TOT for the primary goods-exporting countries, despite a great deal of subsequent criticisms of the hypotheses, had a tremendous influence on the policy-makers in the less-developed countries (LDCs) in adopting a protectionist and inward-looking import-substituting development strategy.

At the same time, Bhagwati (1958) published his immiserizing growth thesis by which he argued that if export demand is price inelastic, an export-biased growth that worsens the country's TOT may actually make the country worse off as the TOT in such a case may worsen so much so to outweigh the initial benefits conferred by growth. Though Bhagwati himself strongly advocated free trade policy and export promotion as the most appropriate development strategies, his immiserizing growth thesis had its influence on the adoption of import-substitution development strategies. However, subsequent analysis by Johnson (1967) demonstrated that similar immiserizing possibility may arise even when a small country grows under tariff protection. Thus, a protectionist development strategy may not insulate a country from immiserization.

The inward-looking development strategies got further support from the unequal exchange thesis of Emmanuel (1969). The cornerstone of the unequal exchange thesis, as we will elaborate in Chapter 2, is that low prices of exports from the Periphery, consequent upon low wages or undervaluation of labour there, contribute to the high standard of living in the Centre. The wage differences across the Centre and Periphery, not commensurate with productivity differences, underlie the undervaluation of exports and the unequal exchange that international trade implies for the Periphery. This caused further apprehension for the perceived static and dynamic gains that international trade ushers in.

But, during the late 1960s and 1970s, many LDCs found it difficult to maintain the momentum of growth and development when they experienced deteriorating balance of payments and depleting foreign exchange reserves. Of course, a major reason for this was the adoption of pegged exchange rate regimes that required interventions in the foreign exchange market by selling or buying foreign currencies whenever external shocks puts pressure on the pegged exchange rate.[2] But, tariff protections also distorted export and production compositions of the LDCs by shifting resources from the export sectors to the import-competing sectors. This lowered export earnings significantly and made it difficult for most of the LDCs to pay for the import bill for necessary imports of capital and intermediate goods to sustain their industrialization processes. A new orthodoxy of export promotion development strategy thus emerged, reiterating ideas of the classical political economists on dynamic gains from free trade, on the one hand, and offering new theoretical arguments based on economies of scale and product innovations, on the other hand.

However, as Bhagwati (1988) argues, whether a protectionist import-substitution strategy or an export promotion strategy will be appropriate for a country depends to a large extent on its level of development itself. The argument that an import-substitution development strategy will promote industrialization and growth is perhaps more relevant for more primitive countries that have little industrial base and are dependent heavily on primary and agricultural goods, such as the African countries. But for semi-industrialized countries like India, and many other Asian and Latin American countries at present levels of development, for which manufacturing constitutes a sizeable

[2] See Krugman (1979) for a formal analysis of how a BOP crisis may emerge under a pegged exchange rate regime and Acharyya (2013) for similar arguments in the context of India's BOP crisis in the early 1990s.

proportion of total exports, import-substitution development strategy is more likely to impede development and growth by encouraging inefficiencies.

1.5 Development Crises and Globalization as a Universal Development Strategy

We presently live in a world that is characterized by substantial complexity in both economic and social fronts. In the post-world war decades, overshadowed by a long spell of cold war, most countries were essentially circumspect about the actions of other countries. However, once the IT revolution and the slow but unmistakable capture of globalization swept the nations since the early 1980s, it became quite impossible to insulate individual countries from various changes that followed considerable homogenization of economic and social spheres. This undoubtedly has favourable and adverse implications for countries all around, and in general interactions between most countries would be increasingly difficult to strategize under the circumstances. There are too many independent players with incentives and disincentives nested in a complex maze of activities. Available evidence suggests that countries that have so far fended off adverse impacts of globalization may not have done so by virtue of premeditated domestic planning, but may have benefited from the presence of many other idiosyncratic factors that could well generate other forms of crises at a different point in time. This situation is distinctly different from much more conservative, self-reliant, closed-door, non-integrated countries of yesteryears, which interacted with others mainly via international trade in commodities and through international political relations. However, since 2008 as it would be agreed upon even by the most liberal of economists, there is a relentless supply of crisis globally, and that it has significantly outweighed the positive impacts of globalization. It is undoubtedly important to check five years hence, whether the end of the dark tunnel is at all visible or not, despite the fact that many countries that are collateral damages of the blazing wildfire will not have the instruments to contain it independently. The damages caused by these crises meant huge loss of economic resources and activities everywhere the crisis took significant proportions, led to unemployment as high as 25% in many developed countries, and lowered growth and redistribution remarkably. India, fortunately, has not been seriously affected by the ongoing crisis, although very recently the macroeconomic calculations had to be readjusted to a growth rate of 6%, the lowest in a decade. This is blamed on the so-called *eurozone crisis*.

The newest in the series of crises is the European debt crisis, the eurozone crisis represents Europe's struggle to pay the debts it has built up in recent decades. Five of the region's countries—Greece, Portugal, Ireland, Italy, and Spain—have, to varying degrees, failed to generate enough economic growth to make their ability to pay back bondholders the guarantee that publicly-issued bonds directly carry. The five countries were seen as being the countries in imminent danger of a possible default. But surely the global integration does not allow individual countries to operate in isolation any longer? Thus, the crisis has far-reaching consequences that extend beyond their borders to the world as a whole. In fact, the head of the Bank of England, Sir Mervyn King referred to it as 'the most serious financial crisis at least since the 1930s, if not ever'(October 2011).[3] Under the circumstances, it is probably important to enquire if India would be able to avoid spillover effects of this crisis completely. We will discuss some of the opinions and predictions of the highest authorities in this country in this regard, preceded by a brief description of what constitutes the core of the crisis in Europe.

1.5.1 THE BEGINNING OF THE CRISIS

The global economy has experienced slow growth since the US financial crisis of 2008–2009, which has exposed the unsustainable fiscal policies of countries in Europe and around the globe. Greece, which spent heartily for years and failed to undertake fiscal reforms, was one of the first to feel the burden of weaker growth. When growth slows down, the tax revenue falls, and the budget deficits soar to the extent that it pushes the entire economy to an unstable quarter. In this regard, one must not forget that the macroeconomic condition of a country, which is now part of a complex monetary union, can no longer be treated in isolation. The unavoidable transactions between members of a monetary union would immediately lead to the spread of the impact in the territories of its members, both via capital and labour mobility. Whether by falsification of national accounts or by the compulsion of generous redistributive practices common in Europe, Greece's debts were larger than the size of the nation's entire economy, and the country could no longer hide the problem.

Investors responded by demanding higher yields on Greece's bonds, which raised the cost of the country's debt burden and necessitated a series of bailouts by the European Union and European Central Bank (ECB). The markets also began driving up bond yields in the other heavily indebted countries in the region, anticipating problems similar to what occurred in Greece. As investors contemplate that the debtor could soon become insolvent (with some possibility that they might also bounce back to normalcy), the investments are driven into

[3] See: http://www.telegraph.co.uk/finance/financialcrisis/8812260/World-facing-worst-financial-crisis-in-history-Bank-of-England-Governor-says.html.

high-risk zones and must require high compensation. If the indebted countries turn around then the investors make huge returns, but in case the countries falter, the entire system takes a nosedive along with the investors begetting a global crisis. Characteristically speaking, this is somewhat different from the burst of the real estate bubble. Boldrin and Levine comment that in the real estate crisis, the transfer of monitoring responsibility from the public authorities to individual private banks was the root of the crisis.[4] The imprudent private banking system in the US as a whole failed miserably in checking the credentials of the borrowers and pushed loans where it did not belong in the first place. The real estate market was destined to suffer because people borrowed much more than they could ever pay back. In addition, financial engineering by big lenders such as Fannie Mae or Lehman Brothers spread the risk of holding unstable mortgages to many other subsidiaries and financial institutions globally. On a good state of nature, this financial jugglery to raise quick capital and continue with production and service in seamless manners could generate fortunes. On a bad spell of events it leads to a global crisis where millions lose jobs and homes and wait for the governments to pull them out of misery. Compared to the housing crisis, the European crisis is much grander. This has to do with national governments of five different countries that acted much more irresponsibly, despite the presence of such a supra-national authority as the European Union. The major reason for the lack of monitoring, it is argued, lies in the lack of fiscal coordination between EU member countries. EU is, after all, a monetary and currency union with fiscal decisions still controlled exclusively by individual countries with intermittent cautions from the ECB to retain the fiscal deficit within manageable limits, such as 3–4% of the country's gross domestic product (GDP). The lack of fiscal prudence on the part of five major countries led to a vicious cycle. As country risks of investment went up, institutional and individual investors in publicly-issued bonds demand higher yields and this equates to higher borrowing costs for the country in crisis. To meet debt servicing, the countries will need to borrow again in a short while and the entire mechanism may blow up within a visible time frame. Worse still, the effect of high borrowing cost by countries in distress will spill over as a contagion effect to other countries that are also in need of external and internal borrowing.

1.5.2 COMBATING THE CRISIS IN EUROPE

The European Union has taken action, but it has moved slowly since it requires the consent of all nations in the union. The primary course of action thus far has been a series of bailouts for Europe's troubled economies. In spring 2010, the European Union and International Monetary Fund (IMF) disbursed 110

[4] (www.dklevine.com/general/crisis_and_bailout.pdf).

billion euros (the equivalent of $163 billion) to Greece. Greece required a second bailout in mid-2011, this time worth about $157 billion. On March 9, 2012, Greece and its creditors agreed to a debt restructuring that set the stage for another round of bailout funds. Ireland and Portugal also received bailouts, in November 2010 and May 2011, respectively. The eurozone member states also created the European Financial Stability Facility (EFSF) to provide emergency lending to countries in financial difficulty.

The European Central Bank (ECB) had to be involved in the process simultaneously. It is expected in most such situations that the central bank of a country, in this case the ECB for the whole of Europe, consented in purchasing government bonds via an announcement made in August 2011. In other words, it is still the backdoor policy to sustain fiscal stability of a region and bail out the worst hit countries by pledging guarantee and support on behalf of individual institutional and other investors. This may be a way out in the short run, but does not guarantee that the countries will be normalized soon, given that the debt-to-GDP ratio for these countries is more than 100%. In December 2011, the ECB made €489 billion ($639 billion) in credit available to the region's troubled banks at ultra-low rates, then followed with a second round in February 2012. The name of this programme was the Long Term Refinancing Operation (LTRO). Numerous financial institutions had debt maturing in 2012, causing them to hold on to their reserves rather than extend loans. Slower loan growth, in turn, could weigh on economic growth and make the crisis worse. As a result, the ECB sought to boost the banks' balance sheets to help forestall this potential issue. The problems are manifold with such short-term approaches, typically because these do not provide directions for turnaround and there is no optimal bailout rule as yet established for countries varying in size significantly. Notwithstanding, in 2012, President of the ECB Mario Draghi announced that the ECB would do 'whatever it takes' to keep the eurozone together.[5] In the same way as favourable budgetary announcements turn around the drooping share markets from time to time, the bond market also reacted favourably and investors started settling for lower yields during the second half of the year. While Draghi's statement didn't solve the problem, it made investors more comfortable buying bonds of the region's smaller nations. Lower yields, in turn, have bought time for the high-debt countries to address their broader issues. Unless the country really turns around based on such favourable investment climate, the central bank, which holds a large part of the country debt, will plunge in turn. Banks are required to keep a certain amount of assets on their balance sheets relative to the amount of debt they hold. If a country defaults on its debt, the value of its bonds will plunge. For banks, this could mean a sharp reduction in the amount of assets on their balance sheet—and possible insolvency. Due to the

[5] http://www.telegraph.co.uk/finance/financialcrisis/9428894/Debt-crisis-Mario-Draghi-pledges-to-do-whatever-it-takes-to-save-euro.html.