Underdeveloped areas

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The Pains of Free Trade

& Less Developed Countries

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The Pains of Free Trade and Less Developed Countries

Free trade is the condition where international exchange is not subject to direct government control. Implicitly this involves unrestricted movement of all resources which can facilitate specialization. Tariffs, import quotas, and export subsidies are the most common means used by government to influence or limit international exchange. Truely free trade would mean an absence of barriers on the flow of goods and services.

The free trade theory is considered by some to have proven its validity in 19th century England. Many opinion leaders came to this conclusion when they linked or associated the "freeing of trade" to the rise out of the European depression, which followed Napoleon's defeat. This conclusion combined with free trade's success in Victorian England's emergence to power and wealth, did appear to give the theory of free trade validity.[1/]

Since the 19th century, the world has changed. An example of a current policy situation would be the United States. Current U. S. agriculture policy is founded on a philosophy of minimum government involvement and maximum use of free markets. The principle aims of the current policy are:

1. Maximum reliance on the market to allocate production resources and the flow of argicultural commodities to domestic and international markets.

2. High levels of agricultural exports.

3. Unrestricted production to assure adequate supplies of food and fiber for domestic and foreign users.

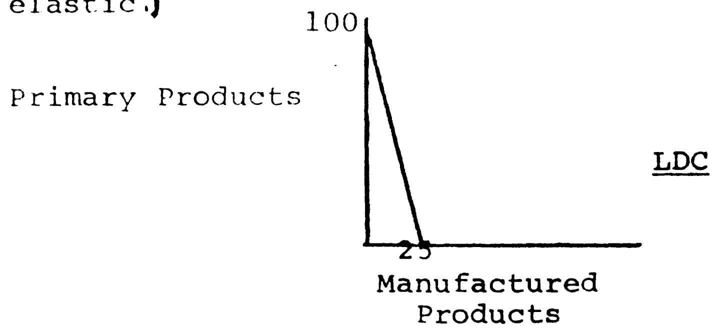
4. No government-held grain reserves.[2/]

These were made operational through the Agriculture and Consumer Protection Act of 1973.

However, actual U. S. policy does not totally rely upon free trade. This can be shown in some of the provisions of the A.C.P. Act and agriculture trade activities. Relevent major points in the A.C.P. Act of 1973 were that a price floor was set under farm prices effected via commodity loans, and when market prices fell below the loan rate, producers would be permitted to allow the government to accept the commodity as payment on the nonrecourse loans. A second major point is that in the event market prices fell below target prices availability of deficiency payments would be established.

Moreover, since the large wheat sales to Russia in 1972 United States agriculture foreign trade policy has involved the use of informal agreements or understandings. The main purpose of these agreements is to stablize the flow of agriculture commodities in the trade channels over a period of time at prices suitable to both parties concerned. Nothing, however, is guaranteed in the agreements. They leave competition for supplies and establishment of purchase price to the free market. Judging from this example it might be said that more of a "pseudo free trade" exists in the U. S. agriculture than "true free trade".

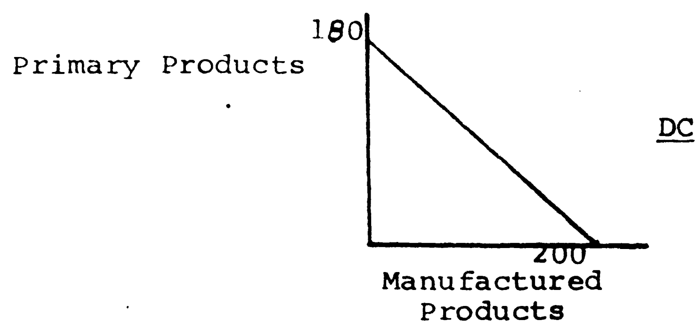
A primary assumption in the theory of free trade calls for specialization. A country would specialize in those goods for which it has the greatest comparative advantage or least comparative disadvantage. This effect can be viewed in a production possibilities curve. (For simplicity costs will be assumed to be constant in the following examples.) This is an illustration of the production possibilities curve of primary goods vs. manufactured goods. This illustration is especially true for those countries producing primary products using labor intensive techniques. (Moreover in world markets primary products have tended to be income inelastic while manufactured products have tended to be income elastic.)



Source: Hypothetical

It shows that these Less Developed Countries can produce 100 units of primary products at a mere cost of 25 units of manufactured product, or one (1) unit of manufactured product buys four (4) units of primary products. The LDC's can produce primary goods for less cost than manufactured goods.

The production possibilities curve of primary vs. manufactured goods for the Developed Countries looks a bit different.



Source: Hypothetical

The Developed Countries produce 180 units of primary goods at a cost of 200 units of manufactured goods. Since there is a difference in the slopes of the two curves, both countries can gain from trade if we assume zero transportation cost. The LDC's would be able to buy manufactured goods for a lower sacrifice of primary goods from the Developed Countries. The converse is also true, the Developed Countires would be able to buy primary goods for a lower sacrifice of manufactured goods. The Less Developed Countries have a least comparative disadvantage in production of primary goods and the Developed Countries have, not only a comparative advantage but an absolute advantage in production of both manufactured goods and primary goods. Thus in free trade the two would tend to specialize in their respective areas of comparative advantage and least comparative disadvantage in order that they might realize benefits from increased total output resulting from specialization. Again the assumption of zero transportation cost is important for this analysis.

The previous analysis does not include full recognition of the income elasticities of world demand for primary or manufactured goods.* A specific case in point is the Prebisch thesis. Raúl Prebisch's thesis argues that terms of trade have an inherent tendency to turn against the producers of raw materials.[3] Anindya Bhattacharya summarizes the trend outlined in the Prebisch thesis as a result of:

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*In the world market primary products have tended to be income inelastic, while manufactured goods have tended to income elastic.

1. low-income elasticity of demand for primary products and relatively higher income elasticities for manufactured products

2. technical progress in manufactures and the development of synthetics, both of which reduce raw material inputs

3. monopolistic industrial markets (makes discrimative pricing possible)[4]

Moreover, supporting Prebisch's thesis is Engel's Law, which generalizes that as a family's income increases the percentage spent for food decreases, that spent for clothing, rent, and light remains the same, while that spent for education, health, and recreation increases. Engel's Law shows how the income-elasticity of demand for primary products, which in addition to raw materials include food and fiber, causes free trade to be less desirable in those Less Developed Countires using labor intensive technisues.

The LDC's are also handicapped as a result of technological developments which make it possible to replace, with capital, those factors of production, mainly labor and some primary raw materials which the LDC's have to offer. Again technology strikes with the growth of synthetics which replace such materials as cotton, rubber, silk, and so on. Other advances in technology have decreased quanitics demanded of raw materials per unit of product manufactured. This enables the same amount of a primary product to make a greater number of finished products.

In the world market place, the LDC's selling primary products perceive themselves as being perfectly competitive. While at the same time they perceive the buyers of these products to be monopsonistic in nature. Moreover, when the LDC's buy manufactured goods from the Developed Countries. they fact a wall of product differentiation which permits more administered pricing.

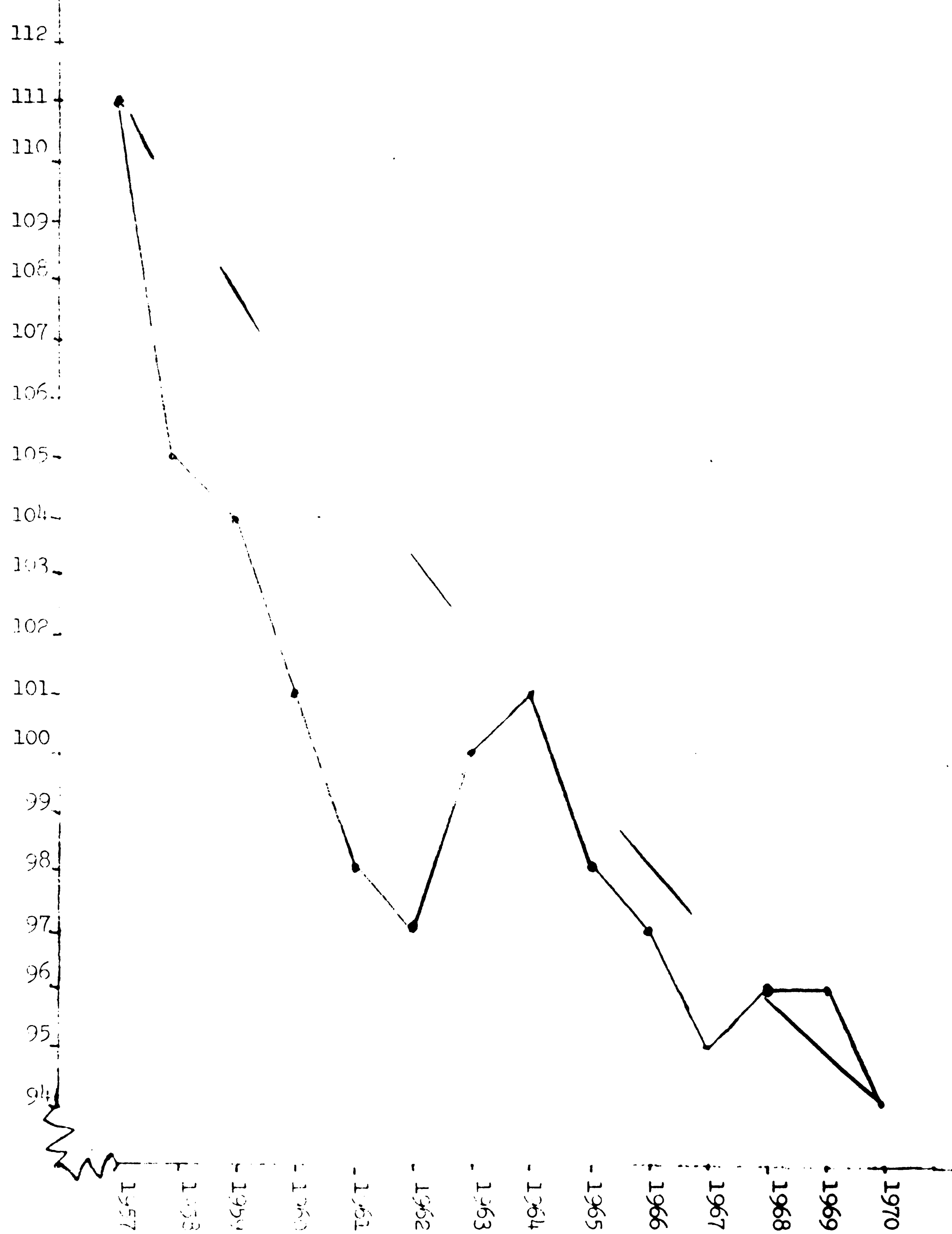
This graph shows the results of the situation.

(See figure next page following.)

The general trend has been the primary products are losing ground in terms of trade. This means that those countries which specialize in primary products are paying relatively more for their imports while the relative value of their exports declines. The Developing Countries may have a hard road ahead as they try to improve their situation. There appears to be no doubt why the leaders of the Less Developed Countries consider "free trade" a clever Western trick to keep them in a subordinate position.

In the 1750's the actual level of economic well being was probably not much, if any, higher in Europe than in China or India. With the approach of the 19th century and "free trade", however, the income gap started to widen. This gap has continued to widen in the 19th and 20th centuries as countries become more specialized.[5] Since the Developed Countries have both a comparative advantage and absolute advantage in production of manufactured goods, the LDC's tend to specialize in the production of primary products where they have a least comparative disadvantage. From the Prebisch thesis it was shown that terms of trade have an inherent tendency to turn against the country specializing in raw materials.

TERMS OF TRADE FOR PRIMARY/MANUFACTURED PRODUCTS



Unit value index of world exports of SITC sections 0-4 divided by unit value index of world exports of SITC sections 5-8.

SOURCE: United Nations Monthly Bulletin of Statistics, Special Table: H, December, 1971.

Noted and References Cited

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