**UNIT 5**

**INTERANTIONAL TRADE AND ECONOMIC DEVELOPMENT**

Pretest

Dear learners, from your general knowledge and intuitive understanding, do you think that free trade is important for economic development? Briefly outline.

**5.1 Trade Theory and Development Experience**

**5.1.1 Basic Questions about Trade and Development**

Our objective in this section is to focus on traditional and more contemporary theories of international trade in the context of five basic themes or questions of particular importance to developing nations.

1. How does international trade affect the rate, structure, and character of LDC’s economic growth?
2. How does trade alter the distribution of income and wealth within a country and among different countries? How are the gains and losses distributed, and who benefits?
3. Under what conditions can trade help LDCs achieve their development objectives?
4. Can LDCs by their own actions determine how much they trade?
5. In the light of past experience and prospective judgment, should LDCs adopt an outward-looking policy (freer trade, expanded flows of capital and human resources, ideas and technology, etc.) or an inward-looking one (protectionism in the interest of self-reliance), or should they pursue some combination of both, for example, in the form of regional economic cooperation? What are the arguments for and against these alternative trade strategies for development?

Clearly, the answers or suggested answers to these five questions will not be uniform throughout the diverse economies of the developing world. The whole economic basis for international trade rests on the fact that countries do differ in their resource endowments, their preferences and technologies, their scale economies, their economic and social institutions, and their capacities for growth and development.

**5.1.2 Importance of Exports to Different Developing Nations**

Developing countries are generally more dependent on trade than developed countries are. This is shown clearly in the case of traditionally export-oriented Japan, whose exports amount to roughly 10% of GDP, whereas LDCs with somewhat larger populations such as Indonesia, Bangladesh, and Nigeria export a far higher share of output.

 While total exports and the share of manufactures in merchandise exports have been rising for many developing countries, it is important to keep this rise in perspective. A few Newly Industrialized Countries still command a dominant position in developing- country exports. For example, in 2000, South Korea alone exported more than all of South Asia and sub-Saharan Africa combined. And South Korea and Taiwan together exported more manufactured goods in 2000 than the entire regions of Latin America, the Caribbean, the Middle East, North Africa, South Asia, and sub-Saharan Africa combined.

 Moreover, since the price elasticity of demand for (and supply of) primary commodities also tends to be quite low (i.e., inelastic), any shifts in demand or supply curves can cause large and volatile price fluctuations. Together these two elasticity phenomena con- tribute to what has come to be known as export earnings instability, which has been shown to lead to lower and less predictable rates of economic growth.

While almost all attention goes to merchandise exports, there has been a slow rise in the share of commercial services in the exports of both developed and developing countries. For the former, these are more likely to represent highly skilled activities such as investment banking and management consulting, while for the latter, construction and other less skill-intensive activities are more common.

* 1. **The Terms of Trade and the Prebisch-Singer Thesis**

The question of changing relative price levels for different commodities brings us to another important quantitative dimension of the trade problems historically faced by developing nations. The total value of export earnings depends not only on the volume of these exports sold abroad but also on the price paid for them. If export prices decline, a greater volume of exports will have to be sold merely to keep total earnings constant. Similarly, on the import side, the total foreign exchange expended depends on both the quantity and the price of imports.

Clearly, if the price of a country's exports is falling relative to the prices of the products it imports, it will have to sell that much more of its export product and enlist more of its scarce productive resources merely to secure the same level of imported goods that it purchased in previous years.

 The relationship or ratio between the price of a typical unit of exports and the price of a typical unit of imports is called the  **commodity terms of trade** , and it is expressed as Px/Pm where Px and Pm represent the export and import price indexes, respectively, calculated on the same base period (e.g., 2001 = 100). The commodity terms of trade are said to deteriorate for a country if Px/Pm falls, that is, if export prices decline relative to import prices, even though both may rise. Historically, the prices of primary comodities have declined relative to manufactured goods. As a result; the terms of trade have on the average tended to worsen over time for the non-oil-exporting developing countries while showing a relative improvement for the developed countries.

The main theory for the declining commodity terms of trade is known as the **Prebisch- Singer thesis,** after two famous development economists who explored its implications inthe1950s. They argued that there was and would continue to be a secular decline in the terms of trade of primary-commodity exporters due to a combination of low income and price elasticities of demand. This decline would result in a long-term transfer of income from poor to rich countries that could be combated only by efforts to protect domestic manufacturing industries through a process that has come to be known as import substitution.

Both because of this theory and because of the unfavorable terms of trade trends, developing countries have been doing their utmost over the past several decades to diversify into manufactures exports. After a slow and costly start, these efforts have resulted in a dramatic shift in the composition of developing-country exports, especially among middle-income LDCs. Led at first by the East Asian "tiger" economies of South Korea, Taiwan, Hong Kong, and Singapore and now followed by many other countries in Asia, including China and India, the share of merchandise exports accounted for by manufactured goods has risen strongly in many developing countries.

 Unfortunately, this structural change has not brought as many benefits to most developing countries as they had hoped, because relative prices within manufactures have also diverged: Over the last quarter century, the prices of the basic manufactured goods exported by poor countries fell relative to the advanced products exported by rich countries. The price of textiles fell especially precipitously, and low-skilled electronic goods are not far behind. Having reviewed some of the international trade issues that developing countries face, we turn next to consider alternative theories of the role that trade plays in economic development.

**5.3 The Trade Policy Debate**

**5.3.1 Traditional Arguments for Free Trade**

Based on the neoclassical free-trade model discussed in the course “International Trade Theory and Policy” you took earlier, the answers to our five basic questions about trade and development are given below.

1. Trade is an important stimulator of economic growth. It enlarges a country's consumption capacities, increases world output, and provides access to scarce resources and worldwide markets for products without which poor countries would be unable to grow.
2. Trade tends to promote greater international and domestic equality by equalizing factor prices, raising real incomes of trading countries, and making efficient use of each nation's and the world's resource endowments (e.g., raising relative wages in labor-abundant countries and lowering them in labor-scarce countries).
3. Trade helps countries achieve development by promoting and rewarding the sectors of the economy where individual countries possess a comparative ad- vantage, whether in terms of labor efficiency or factor endowments. It also lets them take advantage of economies of scale.
4. In a world of free trade, international prices and costs of production determine how much a country should trade in order to maximize its national welfare. Countries should follow the principle of comparative advantage and not try to interfere with the free workings of the market.
5. Finally, to promote growth and development, an outward-looking international policy is required.
6. In all cases, self-reliance based on partial or complete isolation is asserted to be economically inferior to participation in a world of unlimited free trade.

**5.3.2 Criticisms of Traditional Free-Trade Theory in the Context of Developing-Country Experience**

 The conclusions of traditional international trade theory are derived from a number of explicit and implicit assumptions that in many ways are often contrary to the reality of contemporary international economic relations. This theory therefore often leads to conclusions incompatible with both the historical and the contemporary trade experience of many developing nations. This is not to deny the potential benefits of a world of free trade but rather to recognize that the real world is beset by all sorts of national protection and international noncompetitive pricing policies.

Six basic assumptions of the traditional neoclassical trade model must be scrutinized:

1. All productive resources are fixed in quantity and constant in quality across nations and are fully employed.
2. The technology of production is fixed (classical model) or similar and freely available to all nations (factor endowment model). Moreover, the spread of such technology works to the benefit of all. Consumer tastes are also fixed and independent of the influence of producers (international consumer sovereignty prevails).
3. Within nations, factors of production are perfectly mobile between different production activities, and the economy as a whole is characterized by the existence of perfect competition. There are no risks or uncertainties.
4. The national government plays no role in international economic relations; trade is carried out among many atomistic and anonymous producers seeking to minimize costs and maximize profits. International prices are therefore set by the forces of supply and demand.
5. Trade is balanced for each country at any point in time, and all economies are

readily able to adjust to changes in the international prices with a minimum of dislocation.

1. The gains from trade that accrue to any country benefit the nationals of that

country.

We can now take a critical look at each of these assumptions in the context of the contemporary position of developing countries in the international economic system. Some of these criticisms form the rationale for other, non-neoclassical theories of trade and development, including vent-for-surplus, structuralist, and North-South models.

**5.4. Fixed Resources, Full Employment, and the International Immobility of Capital and Skilled labor**

**5.4.1 Trade and Resource Growth: North-South Models of Unequal Trade**

 This initial assumption about the static nature of international exchange – that resources are fixed, fully utilized, and internationally immobile with same product production functions everywhere identical is central to the traditional theory of trade and finance. In reality, the world economy is characterized by rapid change, and factors of production are fixed neither in quantity nor in quality. Critics point out that this is especially true with respect to resources most crucial to growth and development, such as physical capital, entrepreneurial abilities, scientific capacities, the ability to carry out technological research& development, and the upgrading of technical skills in the labor force.

It follows, therefore, that relative factor endowments and comparative costs are not given but are in a state of constant change. Moreover, they are often determined by, rather than themselves determine, the nature and character of international specialization.

In recent years, some economists have therefore challenged the static neoclassical model by introducing alternative dynamic models of trade and growth that emphasize the process of factor accumulation and uneven development along the lines suggested in the preceding paragraphs. These so-called North-South trade models focus specifically on trade relations between rich and poor countries, whereas the traditional model was assumed to apply to all nations. The typical North-South model argues, for example, that initial higher endowments of capital in the industrialized North generate external economies in manufacturing output and higher profit rates. This, in combination with the rise in monopoly power, stimulates higher Northern growth rates through further capital accumulation. As a result, the rapidly growing North develops a cumulative competitive advantage over the slower-growing South. If we then add differential income elasticities of demand discussed earlier and capital mobility to the model (in the form of South-to-North capital flight, as occurred in the 1980s), the basis for the developing-world trade pessimism would be further enhanced.

**5.4.2 Unemployment, Resource Underutilization, and the Vent-for-Surplus Theory of International Trade**

 The assumption of full employment in traditional trade models, like that of the standard perfectly competitive equilibrium model of microeconomic theory, violates the reality of unemployment and underemployment in developing nations. Two conclusions could be drawn from the recognition of widespread unemployment in the developing world. The first is that underutilized human resources create the opportunity to expand productive capacity and GNP at little or no real cost by producing for export markets products that are not demanded locally. This is known as the vent-for-surplus theory of international trade. First formulated by Adam Smith, it has been expounded more recently in the context of developing nations by the Burmese economist Hla Myint.

 According to this theory, the opening of world markets to remote agrarian societies creates opportunities not to reallocate fully employed resources as in the traditional models but rather to make use of formerly underemployed land and labor resources to produce greater output for export to foreign markets. The colonial system of plantation agriculture as well as the commercialization of small-scale subsistence agriculture were made possible, according to this view, by the availability of unemployed and underemployed human resources.

 The vent-for-surplus argument does provide a more realistic analytical scenario of the historical trading experience of many LDCs than either the classical or the neoclassical model. However, in the short run, the beneficiaries of this process were often colonial and expatriate entrepreneurs rather than LDC nationals. And in the long run, the structural orientation of the LDC economy toward primary product exports in many cases created an export "enclave" and inhibited needed structural transformation in the direction of a more diversified economy.

**5.4.3 International Factor Mobility and Multinational Corporations**

The third component of the crucial first assumption of traditional trade theory – the international immobility of productive factors – is, after the assumption of perfect competition, the most unrealistic of all premises of classical and neoclassical trade theory. Capital and skilled labor have always moved between nations. The nineteenth- century growth experience of Western nations can largely be explained in terms of the impact of international capital movements. Perhaps the most significant development in international economic relations during the past three decades has been the spectacular rise in power and influence of the giant multinational corporations.

These international carriers of capital, technology, and skilled labor, with their diverse productive operations throughout the developing world, greatly complicate the simple theory of international trade, especially as regards the distribution of its benefits. To assume away their existence and their impact on the economies and economic structures of developing nations, as in the classical and factor endowment theories of trade, is to blind ourselves to the realities of the contemporary world economy. In fact, one of two ironies of the 1980s was that because of the phenomenon of capital flight, over $250 billion of capital fled the larger developing countries and added to the stock of capital in the already capital-abundant developed nations! Although large amounts of capital flowed to middle-income developing countries in the 1990s, the least developed countries received almost none of these capital flows. The second irony is that as a result of stagnating economies and limited financial opportunities, skilled labor (the resource most in demand in poor countries) has been moving in great numbers from the South to the North. This brain drains severely affected numerous African economies in the 1980s and 1990s.

**5.4.4 The Absence of National Governments in Trading Relations**

In domestic economies, the coexistence of rich and poor regions, of rapidly growing and stagnating industries, and of the persistent disproportionate regional distribution of the benefits of economic growth can all, at least in theory, be counteracted and ameliorated by the intervention of the state. Cumulative processes for inequality within nation-states by which **growth poles** may grow rapidly while other regions stagnate can be modified by government through legislation, taxes, transfer payments, subsidies, social services, regional development programs, and so forth. But since there is no effective international government to play a comparable role across countries, the highly uneven gains from trade can easily become self-sustaining. This result is then reinforced by the uneven power of national governments to promote and protect the interests of their own countries. The spectacular export successes of South Korea and Taiwan, and, more recently, China, were in no small way aided and abetted by government promotion of export industries.

 Governments are often partisan players whose activist interventions in this area of **industrial policy**  (guiding the market through strategic coordination of business investments to increase export market shares) are specifically designed to create a comparative advantage where none existed before but where world demand is likely to rise in the future. The history of industrial growth in Japan in the 1950s and 1960s with its famous Ministry of International Trade and Industry (MIT!) and more recently in Taiwan and South Korea are widely cited examples of industrial policies.

 Governments may also employ various instruments of commercial policy, such as **tariffs,**  import  **quotas,**  and export  **subsidies,**  and can manipulate commodity prices and thus their trade position vis-à-vis the rest of the world. Moreover, when developed-nation governments pursue restrictive economic policies designed to deal with purely domestic issues like inflation or unemployment, these policies can have profound negative effects on the economies of poor nations.

 The reverse, however, is not true. LDC domestic economic policies generally have little

impact on the economies of rich nations. Moreover, governments of developed countries often join to promote their shared interests through coordinated trade and other economic ventures. Though these governments may not intend for such activities to promote their own welfare at the expense of that of poor countries, this is often the result.

 Governments often serve to reinforce the unequal distribution of resources and  **gains from trade** resulting from differences in size and economic power. Rich country governments can influence world economic affairs by their domestic and international policies. They can resist countervailing economic pressures from weaker nations and can act in  **collusion** and often in conjunction with their powerful multinational corporations to manipulate the terms and conditions of international trade to their own national interests. Despite the growing role of the World Trade Organization, there is no super agency or world government to protect and promote the interests of the weaker parties (the LDCs) in such international affairs. A trade and industrialization strategy must therefore consider the powerful governmental forces of the developed world.

**5.4.5 Balanced Trade and International Price Adjustments**

The theory of international trade is also one in which flexible domestic and international product and resource prices always adjust instantaneously to conditions of supply and demand. In particular, the terms of trade (international commodity price ratios) adjust to equate supply and demand for a country's exportable and importable products so that trade is always balanced; that is, the value of exports (quantity times price) is always equal to the value of imports. With  **balanced trade** and no international capital movements, balance of payments problems never arise in the pure theory of trade. But the realities of the world economy, especially in the period following the rapid increase in international oil prices in the 1970s, were such that balance of payments deficits and the consequent depletion of foreign reserves (or the need to borrow foreign funds to cover commodity deficits) were a major cause of concern for all nations, rich and poor.

For the non-oil-producing poor nations, a combination of declining terms of trade and sluggish international demands for their export products has meant chronic merchandise **trade deficits.** The gradual drying up of bilateral and multilateral foreign assistance and the growing concern of LDCs with the social costs of private foreign investment have meant that severe balance of payments problems necessitates further departures from relatively free trade.

**5.5 General Conclusions on Trade and Development**

We can now attempt to provide some preliminary general answers to the five questions posed early in the unit. Again, we must stress that our conclusions are general and set in the context of the diversity of developing countries. Many will not be valid for specific nations at any given point in time. But on the whole, these conclusions do appear to represent the consensus of current economic thinking, especially from developing-country economists, on the relationship between trade and development, as the latter term has been defined throughout this book.

First, with regard to the rate, structure, and character of economic growth, our conclusion is that trade can be an important stimulus to rapid economic growth. This has been amply demonstrated by the successful experiences of countries like China, Malaysia, Thailand, Brazil, Chile, Taiwan, Singapore, and South Korea. Access to the markets of developed nations (an important factor for developing nations bent on export promotion) can provide an important stimulus for the greater utilization of idle human and capital resources. Expanded  **foreign-exchange earnings** through improved export performance also provide wherewithal by which LDCs can augment their scarce physical and fin resources. In short, where opportunities for profitable exchange arise, foreign trade can provide an important stimulus to aggregate economic growth.

But rapid growth of national output has little impact on development. An export-oriented strategy of growth, particularly when a large proportion of export earnings accrue to foreigners, may only bias the structure of the economy in the wrong directions (by not catering to the real needs of local people) but also reinforce the internal and external dualistic and in egalitarian character of that growth. Therefore, the fact that free trade +-promotes expanded export earnings and even increase output levels does mean that it is an unambiguously desirable strategy for economic and social development. It all depends on the nature of the export sector, the distributional benefits, and its linkages with the rest of the economy.

As for the distributional effects of trade, it is fair to claim that the principal benefits of world trade have accrued disproportionately to rich nations and, within poor nations, disproportionately to foreign residents and wealthy nationals. Factors such as the widespread existence of increasing returns, the highly unequal international distribution of economic assets and power, the growing influence of large multinational corporations, and the combined ability of both governments and businesses to manipulate international prices, levels of production, and terns of demand are crucial. Together, they lead us to the general conclusion that many developing countries have in the past benefited disproportionately less from their economic dealings with developed nations.

It should be apparent by now that the answer to the third question-the question of the conditions under which trade can help LDCs achieve their development aspirations-is to be found largely in the ability of developing nations (probably as a group) to extract favorable trade concessions from the developed nations, especially in the form of the latter's elimination of barriers to LDC export of labor-intensive manufactured goods. Here the Uruguay Round of the General Agreement on Tariffs and Trade (GATT) negotiations lowering worldwide tariff barriers and the later creation of the World Trade Organization provided a helpful but incomplete start. Also, the extent to which LDC exports can efficiently utilize scarce capital resources while making maximum use of

abundant but presently underutilized labor supplies will determine the degree to which export earnings benefit the ordinary citizen. Links between export earnings and other sectors of the economy are crucial. For example, small-farm agricultural export earnings will expand the demand for domestically produced simple household goods, whereas export earnings from capital-intensive manufacturing industries are more likely to find their way back to rich nations in payment for luxury imports. Finally, much will depend on how well LDCs can influence and control the activities of private foreign enterprises. These nations' ability to dea1 effectively with multinational corporations in guaranteeing a fair share of the benefits to local citizens is extremely important.

The answer to the fourth question-whether LDCs can determine how much they trade- can only be speculative. For small and poor countries, the option not trading at all, by closing their borders to the rest of the world, is obviously not realistic. Not only do they lack the resources and market size to be self-sufficient, but their very survival, especially in the area of food production, often depends on their ability to secure foreign goods and resources. Some 32 of the least developed countries face annual threats of severe famine for which international assistance is not a choice but a necessity. Whether to trade or to remain in isolation is not the major issue that developing countries face.

**5.6 Balance of Payments and Macroeconomic Stabilization**

**5.6.1 The Balance of Payments Accounts**

The extension of our analysis beyond simple merchandise trade into areas related to the international flow of financial resources permits us to examine the balance of payments (BOP) of developing nations. A balance of payments table is designed to summarize a nation's financial transactions with the outside world. It is divided into three components:

1. **The current account**: records export and import of goods and services, investment income, debt -service payments, and private and public net remittances and transfers. Specifically, it subtracts the value of imports from exports and then adds flows of the net investment income received from abroad (e.g., the difference between interest and dividend payments on foreign stocks, bonds, and bank deposits owned by LDC nationals and brought into the country, as opposed to being left overseas, and those securities, if any, of the LDC owned by foreigners plus repatriated profits of multinational corporations). Taking this total, it subtracts debt-service payments, which represents a major and growing component of developing-world current account deficits, and adds net private and public remittances and transfers, such as money sent home by LDC nationals working abroad (e.g., Ethiopians in the United States, Algerians in France, Pakistanis in Kuwait). The final result yields the current account balance – a positive balance is called a  **surplus**, a negative balance a  **deficit**. The current account therefore allows us to analyze the impact of various commercial policies, primarily on merchandise trade but also indirectly on investment income, debt- service payments, and private transfers.
2. **The capital account**: records the value of private foreign direct investment (mostly by multinational corporations), foreign loans by private international banks, and loans and grants from foreign governments (as in the form of foreign aid) and multilateral agencies such as the IMF and the World Bank. It then sub- tracts "resident capital outflow", otherwise known as capital flight. During the 1980s debt crisis, capital flight by wealthy LDC nationals, who sent vast amounts of money into developed- nation bank accounts, real estate ventures, and stock and bond purchases, is estimated to have had a value of up to half the total debt of some Latin debtor nations.
3. **The cash account, or international reserve account**, is the balancing item (along with the "errors and omissions" item, which reconciles statistical inequalities) that is lowered (shows a net outflow of foreign reserves) whenever total disbursements on the current and capital accounts exceed total receipts. Nations accumulate international cash reserves in any or all of the following three forms:

(1) foreign **hard currency** (primarily U.S. dollars, but increasingly Japanese yen, pounds sterling or the European **euro**) whenever they sell more abroad than they purchase (2) gold, mined domestically or purchased; and (3) deposits with the IMF, which acts as a reserve bank for individual nations' central banks.

**A Hypothetical Illustration: Deficits and Debts**

Table *5-1*5-1 presents a hypothetical balance of payments table for a developing country.

First, under the current account, there is a $10 million negative merchandise trade balance made up of $35 million of commodity export receipts, minus $45 million of mostly manufactured consumer, intermediate, and capital goods import payments. To this total we add $5 million in payments for the services of foreign shipping firms and $1 million of investment income receipts representing net interest transmitted on foreign bond holdings, subtract $15 million of debt-service payments representing this year's interest costs on the accumulated foreign debt of the LDC, and add $2 million of remittance and transfer receipts derived from payments of domestic workers living overseas who send home part of their earnings. Together, all of these items add up to a deficit on current account of $ 27 million.

 Turning now to the capital account, we see that there is a net inflow of $7 million of foreign private investment, consisting of $ 3 million of direct investment from multinational corporations in the form of new local factories and $4 million in private loans (from international commercial banks) and private portfolio (stock and bond) investments by foreign individuals and mutual funds. There is also a net positive $ 3 million inflow of public loans in the form of foreign aid and multilateral agency assistance***.***

***Table 5-1 A Hypothetical Balance of Payments Table for a Developing Nation***

|  |
| --- |
| Item Amounts (millions of dollars) |
|  Item  |
| 1. Current Account (CA)
 |
| Commodity exports +35  |
| Primary +25  |
| Manufactured goods +10  |
| Commodity imports  |
| Primary -10  |
| Manufactured goods -35  |
| Services -5  |
| Investment income +1  |
| Debt-service payments -15  |
| Net remittances and transfers +2  |
| * Balance on current account -27
 |
| 1. Capital account (KA)
 |
| Private direct foreign investment +3  |
| Private loans and portfolio investments +4  |
| Government and multilateral flows (net) +3  |
| Loans +9  |
| Debt amortization -6  |
| Resident capital outflow -8  |
| * Balance on capital account +2
 |
| Balance on CA and KA -25 |
| 1. Cash account
 |
| Net decrease in official monetary reserves +25  |
| * Balance on cash account +25
 |

Note that the gross inflow of $9 million in public loans and grants is partly offset by a $ 6 million capital outflow representing **amortization** (gradual reduction) of the principal on former loans.

From the table, we see that a major reason for the perverse flow of financial capital from poor to rich nations was very high levels of resident capital outflow. It is listed as an outflow of $ 8 million. The net result is a $ 2 million positive balance on capital account, bringing the total balance on current and capital accounts to a deficit of $ 25 million.

**5.6.2 Financing and Reducing Payments Deficits: Some Initial Policy Issues**

To finance this $ 25 million negative balance on combined current and capital accounts, our hypothetical country will have to draw down $ 25 million of its central bank holdings of official monetary reserves. Such reserves consist of gold, a few major foreign currencies, and special drawing rights at the IMF. **International reserves** serve for countries the same purpose that bank accounts serve for individuals. They can be drawn on to pay bills and debts, they are increased with deposits representing net export sales and capital inflows, and they can be used as collateral to borrow additional reserves.

We see, therefore, that the balance on current account plus the balance on capital account must be offset by the balance on cash account. This is shown by the net decrease of $25 million in official monetary reserves. If the country is very poor, it is likely to have a very limited stock of these reserves. This overall balance of payments deficit of $25 million may therefore place severe strains on the economy and greatly inhibit the country’s ability to continue importing needed capital and consumer goods. In the least developed nations of the world, which have to import food to feed a hungry population and possess limited monetary reserves, such payments deficits may spell disaster for millions of people.

Facing existing or projected balance of payments deficits on combined current and capital accounts, developing nations have a variety of policy options.

* First, they can seek to improve the balance on current account by promoting export expansion or limiting imports (or both) through
* export expansion
* policies of import substitution (the protection and stimulus of domestic industries to replace previously imported manufactured goods in the local market)
* selective tariffs and physical quotas or ban on the importation of specific consumer goods may be tried
* altering their official foreign-exchange rates by a currency devaluation that lowers export prices and increases import prices
* They can also follow very restrictive fiscal and monetary policies (called structural adjustment by the World Bank and stabilization policies by the IMF. These policies are designed to reduce domestic demand so as to lower imports and reduce the inflationary pressures that may have contributed to the “overvalued” exchange rate that slowed exports and promoted imports.
* Second, developing countries can try to improve the balance on their capital account by encouraging more private foreign direct or portfolio investment, borrowing from international commercial banks, or seeking more public foreign assistance. But neither private foreign investment nor a major proportion of foreign aid comes in the form of gifts (outright grants). The receipt of loan assistance implies the necessity of future repayments of principal and interest. However, the encouragement of private foreign investment has broader development implications than the mere transfer of financial or physical capital resources.

**5.7 Trends in LDC Balance of Payments**

During the 1980s, the developing world experienced a substantial deterioration in both current and capital account balances.

 The reasons for the decline in current account balances in the 1980s and 1990s included

 (1) a dramatic fall in commodity prices, including oil; (2) global recessions in 1981-1982 and 1991-1993, which caused a general contraction in world trade; (3) increasing protectionism in the developed world against LDC exports; and (4) some severely overvalued exchange rates, particularly among East Asian exporters and certain other key developing economies, such as Argentina.

 The capital account showed its dramatic turn as a combined result of rising LDC debt- service obligations, sharp declines in lending by international banks, and massive capital flight. During the 1980s, these factors turned what had previously been a positive annual resource flow of $25 billion to $35 billion from developed to less developed countries into a negative annual flow of $25 billion to $35 billion from the developing to the developed world. Behind these trends, however, was the debilitating dilemma of developing-country debt.

**5.7.1 Attempts at Alleviation: Macroeconomic Instability, IMF Stabilization Policies**

One course of action that was increasingly used by countries facing serious macroeconomic instability (high inflation and severe government budget and foreign payments deficits) along with growing foreign-debt obligations was to renegotiate loans with private international banks. However, such debtor countries had to deal with the IMF before a consortium of international banks would agree to refinance or defer existing loan schedules. Relying on the IMF to impose its usual "conditionality" medicine of tough  **stabilization policies** before it agreed to lend LDCs funds in excess of their legal IMF quotas, the private banks interpreted successful negotiations with the IMF as a sign that borrowing countries were making serious efforts to reduce payments deficits and earn the foreign exchange needed to repay earlier loans. There are four basic components to the typical IMF stabilization program:

1. Abolition or liberalization of foreign exchange and import controls
2. Devaluation of the official exchange rate
3. A stringent domestic anti-inflation program consisting of (a) control of bank credit to raise interest rates and reserve requirements; (b) control of the government deficit through curbs on spending, along with increases in taxes and in public enterprise prices; (c) control of wage increases, in particular abolishing wage indexing; and (d) dismantling of various forms of price controls and promoting freer markets
4. Greater hospitality to foreign investment and a general opening up of the economy to international commerce

In the early 1980s, numerous debtor countries with greatly depleted foreign reserves, including Mexico, Brazil, Argentina, Venezuela, Bangladesh, and Ghana, had to turn to the IMF to secure additional foreign exchange. To receive their loans and, more important, to negotiate additional credits from private banks, all these nations were required to adopt some or all of the enumerated stabilization policies. Although such policies may be successful in reducing inflation and improving the LDCs' balance of payments situation, they were very unpopular.

**Review Questions and Discussion**

1. The effects of international trade on a country’s development are often related to four basic economic concepts: efficiency, growth, equity, and stability. Briefly explain what is meant by of these concepts as they relate to the theory of international trade.
2. What factors – economic, political, or historical – do you think will determine whether or not a particular developing nation is more or less dependent on international exchange?
3. Traditional free-trade theories are based on six crucial assumptions. What are these assumptions, and how might they be violated in the real world of international trade?
4. Critics of international trade from developing countries sometimes claim that present trading relationships between developed and underdeveloped countries can be a source of “antidevelopment” for the latter and merely serve to perpetuate their weak and dependent status. Explain their argument. Do you agree or disagree? Explain why.