PERSPECTIVES AND RISKS OF AN INTERNATIONAL DIVISION OF LABOUR

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Very few topics in the history of international relations have been so controversial as the patterns of trade between nations. Disputes have been occurring ever since the means of transportation made long distance exchanges possible.

In the beginning, controversy arised related to problems of control and monopoly over supply sources and over transportation routes. It evolved to disputes on trade-related internal welfare gains and losses, on one side, and competition from foreign products on the other; in this case, however, trade questions were related to an option which countries were supposed to make — to produce domestically which they were capable of, or to import. This question still maintains discussions alive, although it has been going on for a long time, as shown by the succeeding rounds of negotiations of the General Agreement on Trade and Tariffs.

More recently, however, this question reaches different grounds, which include not only the question of making or buying abroad, but also the more complicated issues of technological dependency and the right, or the possibility, to learn. This is a dinamic problem which becomes particularly worrysome when trade discussions arise between countries in unequal stages of development.

If before the issues involved domestic welfare gains and losses, and redistribution of income — which can, in principle, be corrected by compensation mechanisms if overall welfare is increased — they now involve structural questions such as relations of dependency across nations, and so, not likely to be subject to the same potential compensation mechanisms.

As such, trade issues and policy discussions among nations on equal level of economic development do not raise the same controversies as those between countries in different stages of growth of technological development.

This is a fundamental difference which must be considered in the analysis of patterns and policies of international trade.

The Classical Doctrine of Trade

The paradigm of the classical doctrine of trade says that the countries of the world can benefit from trade and from international division of labour. It is a long-run theory that penetrates the veil of money and stresses the fact that both absolute cost advantages or comparative cost advantages give rise to trade possibilities which potentially may benefit all partners; specialization increases the standard of living by making more goods and services available for consumption.

Initially, the basic idea of comparative advantage was in the assumption that production functions are different between countries; in its modern formulation, the Hecksher-Ohlin model it stresses that if factor proportions are different between countries that would be enough for trade to be profitable.

No logical objection can be raised against this trade model. It requires, however, that certain premises be true: perfect competition, no wage and price rigidities, no factor intensity reversals, constant returns to scale, no externalities or other forms of market failures. If this is all true, than, it can be safely said that a country will gain by specializing in the production of that commodity which uses more intensively the country's more abundant factor (the Hecksher-Ohlin Theorem); furthermore, trade can replace factor mobility since factor prices will be equalized between countries (the factor-price equalization theorem).

Also it can be shown that direction of trade will depend on pre-trade equilibrium price ratios — these depend on production possibilities and on internal demand conditions; also, production possibilities depend on technology and on factor availability.

All these assumptions are usually assumed to be true, and as a result, the idea of free-trade is presented as an immediate objective which only requires political will and common sense in order to be achieved.

The free-trade doctrine can be challenged in terms of its own basic assumptions. On static terms, which characterizes the main structure of the classical trade doctrine, it can be shown that free-trade and specialization is not always the best policy for a national economy, especially in the case of a large country which, by its own actions, can induce a favourable change in its terms of trade. Although trade may lead to an increase in the world availability of goods and services, there is no way to guarantee that the benefits from trade will accrue to all participants. Depending on the terms of trade, the gains from exchange may be totally absorbed by one country, leaving the other in the same situation, in terms of social welfare, as before trade started. As a matter of fact, trade may even make a country worse-off than the pre-trade situation.

Thus, it is not enough to show that trade is capable of increasing world welfare — it is also necessary to show that the distribution of these gains will benefit all partners, and this, the classical trade theory is not capable of doing, even on its own theoretical foundations.

In general, tariffs and other forms of protectionism decrease the volume of trade and increase domestic production of the protected industry, at the expense of exportables. In the limit, a tariff can be prohibitive, impeding trade. Also, it redistributes income in favour of factors used intensively in the protected industry, at the expense of the welfare of the economy as a whole (the Stolper-Samuelson theorem). These results are all true if the basic postulates of neo-classical economic theory are satisfied, and if the country is a price-taker in international trade.

In the case of a large country, however, tariffs may improve terms of trade and increase its social welfare. For a small country, the optimum tariff is zero — but this is not necessarily so for a large country, which may gain at the expense of others, even if the world's welfare decreases as a result of its protectionist policies.

Since, however, international trade cannot yet be shown to be a cooperative game, if it ever will be, retaliation may occurr, reducing world output of commodities by reversing the international division of labour and forcing the suboptimal allocation of commodities among consumers.

Arguments for protectionism become even more powerful if the postulates of neo-classical theory are questioned. Two of the most important distortions — with regard to perfect competition — are external economies and factor-price differentials. If they can be shown to be present, then it can be shown that tariffs are called for.

Price rigidities and factor imobility can also justify the adoption of protectionist policies in order to avoid domestic unemployment. Thus, in terms of static theory, laissez-faire is the first best policy for a perfectly competitive economy with no monopoly-monopsony power; it is also a first best policy for the world as a whole. However, for a large country the best policy can be attained by means of the optimal tariff.

Thus, there are frictions and distortions, with regard to the ideal conditions, caused by monopolistic and oligopolistic traits in the market functioning, external economies and diseconomies, price and wage rigidities, lack of information, etc. Each one of them may turn out to be a proper justification for deviations from free-trade policies, considering the question from a purely economic viewpoint. [To identify the possible consequences of such economic distortions is an easy thing to do. But quite another matter is to identify these cases in concrete instances, measure its frequency of occurrence and its possible consequences, and finally to prescribe the correct economic policy to cope with these deviations.

The question becomes even more complicated if trade theory is approached from a dynamic standpoint. As Prof. Edgeworth once wrote, referring to foreign trade curves "a movement along a supply-and-demand curve of international trade should be considered as attended with rearrangements of internal trade; as the movement of the hand of a clock corresponds to considerable unseen movements of the machinery". Although referring to internal resource allocation changes caused by international trade, these remarks can be extended to include the theory of the infant-industry — in effect a case of dynamic externality. The essence of this argument rests in the fact that a movement along the transformation curve caused by trade possibilities will cause an outward shift of the curve itself. It can be considered as an international trade application of Arrow's "learning-by-doing", coupled with other dynamic effects such as factor endowment growth and technological progress.

If the link between goods production and technological progress is proven to exist — be it increased factor efficiency or an outward shift of the production function induced by a new input mix — then the present costs of protection must be compared to the discounted flow of future benefits; if there is a net gain, once again, protectionism is the correct policy. Thus, the chief criticism is that comparative advantage is mainly a static theory, which ignores a variety of dynamic elements.

Trade and Growth

Growth theory is concerned with the interactions over time among consumers, producers and investors. The emphasis is shifted from general equilibrium considerations to a sequence of expansion paths of production and consumption. As stated by Prof. Chenery in analysing resource allocation, growth theory either ignores comparative advantage and the possibilities of trade completely, or it considers mainly the dynamic aspects such as the stimulus that an increase in exports provide to the development of related sectors, or the function of imports as a carrier of new product and advanced technology. With this different point of view, growth theorists often suggest investment criteria that are quite contradictory to those derived from considerations of comparative advantage.

The conflict between trade theory and growth theory are due to differences in assumptions or to the inclusion of factors, in one approach, that are excluded from the other. Growth theory goes on to assume, or at least to give explicit attention, to a few basic characteristics of underdeveloped economies: factor prices do not adequately reflect their social valuation, factors of production may change substantially over time both in terms of quantity and quality often as a result of the production process itself, and their production processes frequently show economies of scale and various types of externalities in production and in consumption.

Such findings have destroyed the simplicity of classical trade doctrine and have resulted in a strong argument for "balanced growth", as opposed to international division of labour and specialization. In terms of economic policy and resource allocation it becomes necessary to compare alternative patterns of growth, rather than isolated sectors — easy rules such as those suggested by the Hecksher-Ohlin model no longer apply.

A large literature has developed related to the dynamic effects of trade patterns on economic growth and development. This approach, usually carried out in terms of historical analysis, tries to explain the process of underdevelopment in terms of economic dependence resulting from international trade, from specialization in production and from unequal terms of exchange between countries.

Adam Smith, somehow warned about the dangers of international trade between the "metropolis" and the peripheral countries (this was not his own terminology). He literally warned about the disruptive effects which trade could have on backward societies, pointing out that the unfair savagery of the Europeans turned something which could be beneficial for all (trade) into something destructive for some of those unfortunate countries.

According to economists belonging to the structuralist school, free-trade was something that was in the interest of the British industrial sector. It is not a scientific truth, as they succeeded in proving, but represented a concrete possibility of lucrative trade. After centuries of strong state interventionism in world trade patterns, the British created conditions under which their particular interests could be best served by the removal of protectionist policies around the world; of course, the British manufacturing sector was prepared to enter into all markets, profiting from virtual monopoly powers. Also, according to this point of view, free-trade was never the smooth result of laissez-faire, but required the use of considerable political and military strength in order to be enforced. The nations that could not resist to the free-trade doctrine fell victims to underdevelopment induced by specialization in primary products, as happended in Africa, Asia, Latin America and some parts of Europe. Those that could resist it, as the US and Germany developed into mature industrial economies. President Grant of the US has sarcastically stated that after two centuries the British found convenient to adopt free-trade because protectionism had nothing left to offer. And he went on to say that, as far as he knew, the US would also adopt free-trade two centuries later, after it had taken all the benefits possible out of protectionist policies.

Indeed, the research carried out in most underdeveloped countries of today showed that the trade patterns imposed by the colonial powers had lasting effect on their internal economy, as suggested by Prof. Edgeworth's reference to the movement of the hand of a clock and of the unseen movement of the machinery inside. Specialization in production influenced deeply the internal relations of production — remember the plantation systems or the enclave economies in Latin America — and the unequal exchange which regulated trade served as a guarantee that benefits from trade would be unequally distributed in favour of the exporters of manufactures. The degree of dependence of

underdeveloped countries on international trade could be pushed even further, as I have done myself in analysing the Brazilian case using the "staple hypothesis" framework, and suggesting that development patterns would depend not only on structural relations of production but also on the linkages generated by specific staples, or products.

Summing up, the relations between growth and trade are claimed to be strongly biased in favour of the developed countries, and the benefits from trade and specialization are not a scientific truth.

Free-Trade Today

If neither on theoretical nor on empirical grounds free-trade can be proven to improve social welfare, why is it still one of the most fundamental dogmas of the so called free-world?

In part because of simple inertia; that is, because it is easy to keep talking about something that everybody is supposed to know already. Free-trade is a sort of a code-word that can be used against other nations every time that one's commercial interests are hurt by somebody else's. Another reason for the immortality of free-trade ideals is that you can use it whenever it is convenient without really having to behave accordingly.

Modern nations of the western world are steadily taking a swing away from state interventionism at home; state-owned companies are being sold off to the private sector and the ideals of the private enterprise system are regaining its former respectability. Most places, deregulation and market solutions are recommended instead of state mediation. But this is happening mostly when it comes to the internal market. The presence of the state as a negociator, as a mediator and as a retaliator seems to be growing stronger when it comes to international relations.

At the end of last year there were approximately 400 legislative projects in the US Congress imposing protectionist policies aimed at cutting down the north-american trade dêficit. Countries have been induced to impose voluntary trade cuts in products such as textiles, automobiles and electronics. Europe and Japan have also raised barriers against imports to protect their home industries; in the US and in the European Common Market it is estimated that more than US$ 44 billion will be spent this year on agricultural subsidies. Only recently, the US sold 140 thousand metric tons of sugar to China at a price of 4.75 cents per pound. The product was deposited at the Commodity Credit Corporation and financed at the minimum price of 17 cents per pound; in the international market the September price was 6.30 cents per pound. Such deals are frequently carried out by the developed countries, with devastating consequences for the primary products exporters of the Third World.

But state interventionism has also been growing in a punitive way, with strong pressures being levied against third-world countries that still protect their terciary sectors against foreign competition. This is the case, for instance, in the recent meetings in Uruguay where developed countries forcefully tried to include banking, software, insurance, shipping, auditing and business consulting, construction, and other services — which together represent 25% of the US$ 2 trillion world trade — in the list of products to be regulated by the rules of the General Agreement on Tariffs and Trade. These are sectors which most certainly would not be able to stand direct competition from developed nations, and a removal of barriers would most certainly mean the end of domestic production and their replacement by imports or by the entry of foreign concerns in their home market.

A tipical situation is found in Brazil where the high-technology market for micro and personnal computers are simply closed to foreign firms, to foreign capital, and to foreign technology.

The argument goes beyond the infant-industry argument. Protection during a period in which the national industry learns a certain process is not really valid in high-technology products such as computers. The reason is in the fact that research and development in such industries reach billions of dollars a year making them a market segment where survival does not mean producing a certain item efficiently, but rather, launching new products, technologically more sophisticated as frequently as possible. Ten years ago the computer industry in the US spent US$ 2 billion on research and development (IBM alone spent US$ 1.1 billion). This figure amounts to present total sales of the Brazilian computer market. In such circunstances, how to open up the market to foreign competition without inevitably killing the domestic firms?

The decision to close the market to foreign capital in addition to foreign products is based on the belief that international transfer of a capital-technology combination may induce permanent links of managerial and technological dependency, and that in such dynamic industry, native technology and control over production processes may never be attained.

It is highly unlikely, however, no matter how correct the formal reasoning may be, that domestic production will ever catch-up with the main foreign producers, at least while that industry continues to incorporate high technology. In the meantime, domestic producers of traditional products may even risk loosing competitiveness in foreign markets due to the impossibility of incorporating high-technology components in their products or, may not have available to them, modern capital goods such as those available abroad.

This is a case of strong and extremely dynamic externality which classical comparative advantage theory does not capture. As the world evolves into more sophisticated production processes the problem will be compounded. The basic postulates of free-trade doctrine will tend to loose validity and trends of international trade will tend to be an increasingly negociated phenomenon. Game theory may soon become more useful in the process of understanding and setting patterns of trade than economic theory.

<u>Internal versus External Markets as Sources of Growth in Brazil</u>

International trade has frequently been mentioned as an "engine of growth" for the developing economies. So, the removal, of trade barriers across the world would serve as a mechanism for transferring demand across all nations.

In the specific case of Brazil I have shown that international trade has indeed created the initial momentum for the development of an internal market. But such chain of events only happened effectively during the coffee cycle of primary exports, in the second half of the 19^{th} century, while development linkages were not observed during the previous cycles. Furthermore, for large countries like Brazil, growth of the internal market induced by exports tends to become weaker as the process continues, reaching a point where, eventually, engagement in international trade looses importance, both as a source of growth of production and of employment. Historically, in Brazil, the export drive was replaced, from 1930 to 1960 by import substitution industrialization as a source of growth and, finally, by the growth of the internal demand itself.

Together, the total value of exports and imports amount to only 17% of G.N.P. Presently, over 75% of the industrial growth of Brazilian manufactures are induced by the internal market; the remaining can be almost equally traced to growth of exports and of import substitution. Basically the same pattern can be observed in employment in the industrial sector. The Brazilian economy relies on its own internal market for sustaining its growth.

However, the strategic importance that external trade has on internal growth cannot be ignored. Oil, capital goods, raw material and wheat account for almost 95% of total imports and only a few years ago a balance of payments crisis caused a recession which lasted almost four years to be overcome. The capacity of the economy to adjust can be evaluated by the fact that the trade balance deficit of almost US$ 3 billion in 1980 was turned into a surplus of US$ 6.5 billion in 1983 and of approximately US$ 12.5 billion in 1984, 1985 and probably also in 1986.

At present, the balance of payments is in equilibrium, but the brazilian economy is exporting capital at a rate of almost 5% of it G.N.P. a year: US$ 9.5 billion in debt service and US$ 1.5 billion in profit remittances.

As a result, national savings has fallen dramatically, from almost 27.4% of G.N.P. in the middle of the 70's, to 16% last year. Unless capital flows are reduced, the country will not be able to invest what is needed to sustain its historical rate of growth of 7% a year.

The realization os this shortcoming is behind the current efforts to reduce capital outflows to not more than 2.5% of G.N.P. a year. Brazil needs to remove this obstacle to growth, by rescheduling the principal payments of its external debt — US$ 105 billion — and by reducing interest payments through cuts in fees, commissions and spreads. Only by cutting on such capital outflows

Brazil will be able to promote the openning up of its internal market to foreign exporters.

Trade and debt became intimately related issues, since Brazil can import more only if it reduces the cost of carrying it debt. This trade-off became a issue which only negotiations, which attend to the mutual interests of Brazil and the trading partners can resolve in a satisfactory way. Actually, trade patterns between nations have never been distant from politics, from negotiation, from the so called "economic statecraft". The art of conducting state affairs has always used economic weapons, and according to experts in this field, regulation of foreign trade has been used as techniques of statecraft throughout history. According to David Baldwin, "the American use of trade policy to construct an international order based on nondiscriminatory trade liberalization in the period after World War II was one of the most successful influence attempts using economic policy instruments ever undertaken". Corroborating this view, Albert Hirschman demonstrated that international trade has potential political implications "whether it takes place under a system of free-trade or protection, of state trading or private enterprise, of most-favoured-nation clause or of discriminating treatments". Thus, even free-trade policy can be a technique of economic statecraft; by the same taken, free-trade, can be denied and protectionism can be adopted, legitimately, as means of economic statecraft.

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