Chapter I

A Historical Perspective on Trade Theory and Policy

Introduction

While trade which is internal to a country is important, international trade too can occupy a pivotal position in the life of a nation as well as in the relations between nations. It is commonly believed that it was the exploration by Western Europeans of the ocean routes around the world and which first caused the rapid growth of overseas trade in general from the later half of the sixteenth century. This is certainly true from the viewpoint of the Europeans, since international trade had dropped to very low levels from about the 6th century A.D. onwards in Europe, which developed a largely self-sufficient and decentralized feudal production system which lasted for over eight centuries, before the revival of long-distance trade from the 12th century (see B. H. Slicher van Bath, 1963). The question of the impact of trade in aiding the break-up of the self-sufficient feudal economy and stimulating the beginnings of capitalism has been the subject of a famous debate on the transition from feudalism to capitalism in Europe. ¹

However this belief on vigorous international trade being a recent development among nations, is an Euro-centric one which is ignorant of the phenomenal development of both land and sea-borne trade among Asian nations from about the 6th century onwards, leading to the diffusion of not only goods but also the ancient cultures of China and India, which fused in a unique way to produce the successive trade-dependent empires of Champa, Srivijaya, Majapahit, Pagan and Pegu in south-east Asia. Straddling the Malacca Straits, the Majapahit empire (7th to 13th centuries A.D), in particular grew rich on trade much earlier and to an even greater extent than did Venice or Genoa in Italy during the Renaissance. Similarly India had a vigorous trade not only with Bali, Java and the South-east Asian kingdoms, but also with the West African coast, the Arab world

¹ M. Dobb's Studies in the Development of Capitalism was reviewed by P. M. Sweezy (Past and Present) who raised some questions regarding Dobb's analysis, and this was followed by a reply by Dobb and contributions from C. Hill, R. Hilton, H. K. Takahashi and G. Lefebvre. See R. H. Hilton, ed. The Transition from Feudalism to Capitalism.
and even with distant Rome—the last, as early as the 2nd century B.C. as the discovery of Roman coin hoards and amphorae in South India (at the site of ancient ports of the Pallava kingdom) have shown. For more than a thousand years, every year ships sailed from the eastern coast of present-day Orissa in India after the monsoons ended, in the Autumn month of Kartik, to Bali and Java laden with goods, and this is commemorated in a festival to this day.

It is also significant that in modern times the highest share of trade in GDP, is not found in any country of West Europe or North America but in South-east Asia: average trade (the sum of exports and imports divided by two) is more than GDP, so that the average trade to GDP percentage is more than 100, for Singapore and Hong-Kong (see World Development Report, 1994). This is because these countries are the entrepot for a huge trade in goods, just as the port-centered kingdoms of these regions had been in the past. A much larger volume of traded goods pass through these regions than are actually retained within them for value addition. There is little that today’s advanced countries have to teach Asia on the benefits of trade which is free and fair, for the Asian countries themselves engaged in more extensive trade than perhaps the European countries did before the era of colonialism. Even China was not always inward looking and Chinese admirals like Ho Lung carried out long-distance voyages, sailing along the Western coast of India and to the West African coast. India was the world's largest producer as well as exporter of fine cotton fabrics in its pre-colonial era according to The Cambridge Economic History of India, (1985).

However, it is true that the linking of distant Europe with Asia through sea-borne trade took place only from the late 16th century, with the aggressive overseas expansion of the Western European nations searching for a western sea routes to India and to the Spice Islands of the Indonesian archipelago. Their discovery of the continent of America in this process, had a far-reaching impact on the West European countries as it enabled them to obtain vast territories for the settlement of their surplus populations.

It is believed that international trade helps to redress the uneven distribution of resources and to raise welfare to people by effective division of labor as well as use of

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resources. Besides, it provides a greater freedom of choice to the consumer and also upgrades the living standard. However this belief is crucially dependent upon assuming that nations have the freedom to enter into trade relations of their own free will and volition, and it ignores the fact that in a large number of cases, countries have been forced to trade with other countries which dominated them militarily and which obtained benefits from trade while the dominated countries did not necessarily benefit.

The concept of international trade and internal trade may appear to be the same but they are not ultimately the same. In the internal trade of a country there cannot be a great difference between the goods which are produced in different regions within the same country (unless the country is of Continental size as the former Soviet Union was). In international trade however, the set of goods which are produced in distant lands or in countries at very different stages of development, may be quite different from the goods produced in the local economy. This point is not sufficiently recognized by writers who think only in terms of the effects of the profits made in the process of "buying cheap and selling dear" and not about the great difference in the nature of the types of goods which can be produced, the output vectors across countries engaging in trade, which is what permitted in the first place the great differences of buying and selling price.

Of course, the question of the ability of merchants "to buy cheap and sell dear" has been very important as well and this arose mainly from the difficulties of communications between the direct producers, which made the role of the merchant indispensable even within a given country, and more so in the case of long-distance trade. In overseas trade the difference between the buying price and the final selling price of goods could be so great and trading profits so high, that trade as such was seen as the means of enriching the nation. In this connection, M. Dobb had stated: “domestic trade did not enrich a nation but merely transferred wealth from one individual to another where as foreign trade made a net addition to a country’s wealth.” (Dobb, 1975, p.209).

In classical economic thought, the economists maintained that international trade could make an impressive contribution to a country’s development. Thus, International trade was considered to be not simply a means for achieving productive efficiency; but also for enhancing economic prosperity. Therefore, the classicists held that the gains from trade were entirely consistent with the gains from growth. “The orthodox interpretation as
expounded by classical and neoclassical economists is that foreign trade can be a propeller force in development.” (Isser, 1997, p.1)

This chapter brings into focus the continuous evolution of trade, which passed through several phases in history. Through the analysis of the concepts expounded by the economists, it emphasizes on how trade was related to the course of economic growth and how changes of the trade pattern and trade structure took place between the developed and underdeveloped countries.

1.1 A Brief Historical Overview of International Trade

The long evolution of trade from primitive barter to the recent complex global networks of commodity exchange has been a vital process and part of international economic development in history. The earliest forms of trade under the “barter system” took place occasionally between communities or tribes in the prehistoric age and it mainly involved a few useful or essential goods which were themselves specific to particular locations, but could be transported without problems, such as the trade in salt, or in metals like iron. Perishable goods on the other hand were rarely traded except over short distances. The development of the medium of exchange, namely commodity money, facilitated trade compared to the barter system as the direct coincidence of the interests of the buyer and seller with regard to the quantities to be exchanged, and their direct interaction became unnecessary. A group of people who specialised as traders connecting widely separated groups of people and facilitating exchange between them, was a logical but later development connected with the earliest rise of urban centres.

Prehistorians like V. Gordon Childe (1967) point out that the commodities used as money are found to be very widely dispersed, thus shells or cowries which developed as 'humble money' for small-scale transactions, are found many hundreds of miles away from the sea in pre-historic settlements. The geographical and occupational division of labor also started from that time and worked as the basis for exchange of goods. While the first use of metallic money is supposed to have started in Asia Minor in about the 6th century B.C. according to many encyclopaedias, this ignores the much earlier use of metallic money in older civilizations like in China, where from the Shang dynasty onwards, we find stamped metal pieces of standardised weight being used as the medium
of exchange. In an earlier age, the possibilities of international trade were limited due to the lack of development of transportation and communication. The discovery of aids to sea navigation like a good knowledge of astronomy, and accurate time-keeping (or the science of clocks, horology), can also be traced to China, as Landes points out. With the growth of long-distance sea navigation the trade in low-bulk but high-value goods like precious metals and spices also became highly profitable.

The expansion of European trade largely began in the 12th and 13th centuries. A great period of overseas trade exploration began in the late 1400's, stimulated by the Portuguese and Spanish search for alternative westward routes to the spice growing areas of India and Indonesia, as the earlier eastward overland routes and the Mediterranean Sea were under the control of Arab rulers. The resulting discovery of an entirely new continent then led to the well-known history of the destruction of the local Amerindian civilizations by conquest and the colonization of these areas by Europeans. All this was destined to effect a revolution in commerce for the Western European countries. Between 1500 and 1600, trade routes between Europe and Africa, India, and Southeast Asia were established. The traded goods were silk (well known as the China silk trade), spices, pearls, cotton, cinnamon and incense.3

The Portuguese first developed trade between Europe, and India and East Indies. The Spanish, Dutch, French and English followed. Each of them set up trading companies, like the East India Company, to monopolize trade to each region by government charter, in order to govern and control trade in new areas and keep out 'interlopers'. Their commercial activities were not confined to commerce but extended to conquest through wars and led to the setting up of colonial empires. They penetrated the other continents and colonized the countries of Asia, Africa and Latin America for commercial expansion. Most of the colonized countries were developed as agricultural export economies, since they were situated in the tropical regions. These areas are rich in the earth's bio-diversity in general and in botanic diversity in particular: more than ninetenths of the earth's bio-diversity is estimated to be concentrated in the tropical and subtropical areas combined.

3 World Book, Encyclopaedia, V4, 10,19.
The tropical products were at the centre of colonial trade, and getting a cheap and unlimited supply of these products was the central aim of economic policy for the Europeans. This is because these tropical products could not be produced in Europe but at the same time they were strongly demanded by Europeans either as necessaries or for raising their own living standards. Spices were not a necessity for the people in Java or Kerala where they grew, but spices were essential for preserving meat in Europe through the long and barren winter months. Also the Western Europeans’ basket of consumption goods was completely transformed over time - goods like sugar, tea, coffee, tobacco, wine, cotton clothing, all entered the consumption basket first of the rich and then the general population. The tropical and sub-tropical products provide "the physical basis for rising standard of living" (Patnaik, 1999). Therefore, with the seizure of tropical colonies, Europeans "exploited for themselves the benefits of tropical botanic diversity, by dispersing a range of commercially valuable crops from their countries of origin to colonies with similar climatic conditions, for plantation production for export to metropolitan markets.” (Patnaik, 1999, p.380).

For these purposes of plantation production, the indigenous labour supply was often not enough especially since, in the process of conquest many millions died. For example whereas Central America, at that time called Hispania, had a population of 25 million indigenous people in 1510, it is estimated to have gone down to only 1.25 million by 1610 or so (according to evidence cited in J.H.Parry, The Spanish Sea-borne Empire. This was partly because the Spanish conquerors took away large areas of land on which the local people depended for subsistence and partly owing to disease introduced by the Europeans). So labour was imported by kidnapping people from West Africa and turning them into slaves to work in mines and plantations for feeding metropolitan industry and for direct consumption. The colonists solved their labour shortage problem for production purposes by the slave trade. Hence, the Negro slavery known as the “Black Ivory trade” had played a vital part in Western industrialization until the mid-19th century. "At the end of the 18th century, trade between what are now the industrial countries and what is now the third world was based on geography rather than on structure. The composition of trade was changed in the second half of the 19th century.”(Lewis,1978,p.4).
The economic doctrines of Mercantilism dominated during the colonial period. According to Mercantilist doctrine, all trade was to be controlled and regulated in order to achieve an excess of exports over imports and achieve a favorable balance of trade. Acquisition of colonies was deemed desirable in order to enhance national economic power. They were to be exploited for exclusive benefit of mother country. The doctrine of mercantilism is discussed in more detail in the second chapter.

In line with their main purposes, for strengthening national power and to obtain the national self-sufficiency, they monopolized all colonial trade by framing various law and acts. Some were forced to produce chiefly goods that would benefit the English industries were paid a lower than market price for those goods. However, the colonists got around the restrictions by developing trade routes that linked colonial ports. Most of the Western Europe countries penetrated into the Asia, Africa and Latin America countries and colonized and exploited them for their own benefits. During the period of colonial era, the colonies provided a captive market for the manufactured products of the colonizing countries while in return supplying them with raw materials and tropical foodstuffs. Apparently, the colonies served as a customer of metropolitan manufactures and as a supplier of tropical products.

The historical development of trade and especially periods of rapid growth in trade, were closely connected with the development of the methods and techniques of transportation and communication. Innovation in transport, such as steam ship, and railway, has been one of the major stimulus for world trade. The process of development of international trade will be discussed briefly in a later chapter in terms of two periods; (a) before and after the industrial revolution and, (b) before and after the Second World War.

1.2 Theoretical Approaches to International Trade

Economic theories do not develop in isolation from the dominant trends in economy and society but are thrown up by the attempt to understand those trends at the theoretical level. Theories are also influenced very deeply by the practical attempts to follow policies, which are thought to be in the interests of the nation—thus often we find later, explicit theoretical justification being advanced, for policy measures which have
been undertaken by governments, initially independently of any theoretical understanding, or perhaps on the basis of an implicit theory. It is to be expected therefore that there should be very different theories of trade corresponding to the different phases of development of society.

The theory of international trade has its origins in the era of mercantilism in Western Europe, which marked the overseas expansion of some of the West European countries, especially Spain, Portugal, Netherlands, Britain and France. This expansion took place both through trade by these countries and through migration from them of people to the new lands over which they obtained control. The economic theories of mercantilism (16th to 18th centuries) emphasized the importance of active regulation by the nation state, of not only trade but also of the particular areas of production of goods domestically and in overseas colonies, which were most important for trade. The mercantilist era was characterized by wars between the European countries to capture valuable sea trade routes and by the systematic attempt to establish national monopolies and monopolies of exclusive chartered companies wherever possible.

Mercantilist policy and theory were in most ways the very opposite of the classical theory of trade which developed later in Britain during the Industrial Revolution, and which is to be found in the writings of Adam Smith and David Ricardo, at the end of the 18th and the beginning of the 19th centuries and which also underlies the modern neo-classical theories of trade. This argued for greater laissez faire as opposed to state regulation, and for “free trade” without restrictions as opposed to monopoly trade. But these prescriptions as we will see arose from Britain’s own position as ‘the first industrial nation’ which by that time, having completed the first stage of its industrial revolution, stood to gain from ‘free trade’ as defined by itself, since it had no competitors in machine-made goods. Free trade was not initially accepted by the other European nations or the USA, which advocated and implemented protection of their own infant industries.

The relationship between international trade, industrialization and economic growth has been a major area of theoretical discussion. In this chapter we will try to address some aspects of this relationship according to the economic thought of Adam Smith and Ricardo among classical economists and briefly discuss the views of some
neo-classical, and development economists in post War era. Second, the importance of any particular trade theory lies in its policy implications. Since we seek not only to describe but also to analyze the effect of trade policies, we will discuss the effect of trade policy on an economy and in particular the impact of tariff as an instrument of trade policy on the economy.

Mercantilist policies probably can be said to have come before mercantilist theory, indeed many historians of economic thought find it difficult to identify a coherent body of theory called mercantilism. According to the historical record, the study of trade actually emerged in the mercantilist era as a set of arguments and writings that cannot be classified as a formal school of thought, but rather as a collection of similar attitudes towards the role of international trade. The economics doctrine of Mercantilism was quite prominent from the 16th to the 18th century, and in the last century policies with some aspects of similarity, followed by some developing countries have been called “neo-Mercantilist“ policies.

As a set of policies, the objectives of mercantilism for the Western European countries were clear: to promote the perceived economic interests of the nation through active intervention by the state by military and naval means in order to secure valuable trade routes, to colonize other distant lands especially tropical ones, in order to get a monopoly supply source for trade in their goods (which could not be produced in Europe). It included the measures to promote domestic economic interests in every way, by regulations forbidding the colonies to produce or trade in goods competing with the home country (whether agricultural goods or manufactures). These bans were enforced through naval embargo on the colonies, so naval power was very important to the mother country. Mercantilist theory was essentially colonial theory – as M. Dobb has put it, “The Mercantile system was a system of state-regulated exploitation through trade which played a highly important role in the adolescence of capitalist industry: it was essentially the economic theory of the age of primitive accumulation” (Dobb, 209).

By ‘primitive accumulation’ is meant the gathering together and concentration of the wealth that can be potentially invested, even before capitalist production has started and before capitalist profits are made. It included all the pre-capitalist types of accumulation - all colonial loot and plunder and the large profits made by trading on very
favourable terms owing to monopoly access by the particular country to other colonised countries’ resources. (Primitive accumulation did not stop even after the European and other Northern countries became quite developed, but continued side by side with normal accumulation for we find the drive by advanced countries to obtain colonies or in other ways to get control over valuable resources continued into the 20th century, and exists in the present era as well).

The best way of understanding how mercantilist policies worked is to briefly look at the description given by economists and historians like M. Dobb and C. Hill, of England, which started developing earliest as a nation state after the Civil War of 1640-1660. Once the rule of the king was overthrown and a ‘commonwealth’ established under Cromwell, the Navigation Acts were passed in the 1650s. These Acts were very wide in scope and were the assertion of a coherent, national imperial policy according to Christopher Hill. Thus all-important traded goods from the colonies whatever the final destination had to first pass through English ports and compulsorily had to be carried only in English-owned ships. The conquest and colonization of Ireland started at the same time, and a number of “Cattle Acts” were passed by English Parliament, under which the Irish were forbidden to export their cattle or butter to England to protect English farmers’ interests and woolen goods exports were also banned. By an Act of 1699 the north American colonies also were forbidden to export woollen goods and later were forbidden to produce many manufactured goods including iron and hats – everything had to be imported by them compulsorily from England. They were taxed and had no say in how taxes were to be spent, while owing to the provisions of the Navigation Acts tropical goods in demand, like tea, became very expensive because they were not permitted to come directly to the colonies but had to be shipped after passing through English ports.

The Navigation Acts of the 1650s were amended from time to time but they were not seriously modified until the end of the 18th century and not abolished until the 19th century. They lasted for 170 years. The Navigation Acts were very wide in scope - under them every important item of trade was put on the ‘enumerated’ list and as mentioned this trade had to be carried out only using British ships serviced by British officers and all

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4 C. Hill, 1969, From Reformation to Industrial Revolution
enumerated goods had to go through English ports no matter how irrational this was in terms of extra distance and cost. This gave a monopoly of invisible earnings through shipping and insurance, to England and also gave a big stimulus to the English shipbuilding industry. The only colonial goods were shipped directly to their final markets without compulsorily first coming to English ports, were African slaves and Newfoundland fish, according to Ralph Davis (Davis, 1962). The second good, the fish were too perishable and the first, the slaves, were 'a shameful and immoral source of profit' to which the rulers and educated people in England wished to close their eyes even though many of them participated in the purchase and sale of human beings and their exploitation on plantations in West Indies and the New World (Drescher and Engerman 1998).

According to Adam Smith “the slave trade raised the mercantilist system to its full pinnacle of glory” (Smith, p. 701-3) Perhaps what he meant by this was that it got the slave traders and plantation owners very high profits. This was especially true when for some time England got from Portugal, the Assiento which was the monopoly of supplying slaves from Portuguese-controlled territories in West Africa, to the whole of the Americas.

Some of the main mercantilist writers of the 18th century were North (Discourse on Trade), Thomas Mun (England’s Treasure by Forraign Trade), Josiah Child who was a very influential person on the Board of the East India Company and who wrote New Discourse on Trade. But there were numerous other books and also anonymous pamphlets dealing with trade and the nation’s interests. Some economic historians have stated that the mercantilism as a theory was primarily concerned with the relationship between a country’s wealth, identified by its stock of precious metals, and its balance of trade. Mercantilism was highly nationalistic in approach and looked at foreign countries with suspicious eyes. Imports were viewed with apprehension as it would drain away gold, while export were viewed favorably as it would bring in gold and would make the country rich. The more gold and silver a nation had, the richer and more powerful it was. Thus the mercantilists, it is said, believed that the way for a nation to become rich and powerful was to have a continuous inflow of precious metals into the country and this could be achieved if the country always
exported more than it imported, so that there was a positive trade balance, which was considered desirable. This doctrine was, therefore, primarily an interventionist philosophy advocating government regulations to achieve a surplus on the balance of trade in order to accumulate precious metals.

However both Dobb and Lipson have contested this by saying that the emphasis on inflow of precious metals (bullion) was true only of the very early phase of mercantilism which can be called Bullionism, and for most of the later period, “the general body of mercantilist thought (1558-1750) was not based on a Midas-like conception of wealth”, as Dobb says, quoting Lipson (Dobb, p. 201). In fact over time their emphasis shifted from trade alone, to production. For example their emphasis on increasing exports, later on clearly arose not just for bringing in specie, but was linked to the idea that domestic production would also then increase, providing new employment and incomes. We find that wherever imports were competitive with domestic products they banned them or put high tariffs, but wherever imports were necessary to carry on a higher level of domestic production and increase exports, as with imports of raw materials or foodgrains, in such cases monopoly sources of cheap imports of these goods were deliberately created through state policy and use of armed force.

A very important part of mercantilist ideas was that a country should always try to push down the price of its imports as much as possible and try to raise the price of its exports to others, that is, it should turn the barter terms of trade $P_x/ P_m$, in its own favor. As M. Dobb (p.202-3) points out, under conditions of trade carried on by free economic agents, we would expect that raising export prices and lowering import prices, carries the danger (if the foreign demand for exports and home demand for imports happen to be elastic), of reducing export revenues and raising the import bill, thus reducing the trade balance, perhaps even turning it negative. But the mercantilists did not ever worry about this possibility because they always assumed regulated, colonial trade, and therefore they assumed inelastic demand. They assumed price-inelastic demand for the home country’s own exports to colonies because these were treated as captive markets where exports from England simply displaced colonial production. Lowering import prices by England on the other hand meant access to a
larger volume of imported goods for the same money outlay. It might lead to an autonomous import surge as well but then England simply re-exported the goods to other European countries which did not have colonies at that time but demanded the goods, for example Davis (1979, pp. 30-31, 70-72) points out that lowering of coffee prices led to a huge rise in the volume of coffee imports by England comparing 1770 and 1800, but a large part was re-exported to Germany. In fact given that the both domestic output and exports were growing under mercantilist policies, they did not mind rising import values either as long as the imports were necessary wage-goods and raw materials helping growth of domestic manufactures and their export. Since domestic production was in fact highly import dependent, it was the case that imports had to rise fast under mercantilist policies. Also they did not mind importing more and more of tropical goods with the aim of re-export to other countries.

Thus it is a mistake to underestimate mercantilist philosophy as a primitive one which was simplistic or not coherent in its approach. On the interpretation given by later writers including Dobb, it was quite consistent in advocating the interests of the nation through the systematic use of state power to establish monopoly of access by the concerned country to resources it lacked for development, and systematically protecting its own producers to promote the home country’s industries. Mercantilist philosophy was thus developed as a set of ideas relating to protectionism, and it systematically introduced the methods of both trade barriers and non-trade barriers for competing goods and induced import-substitution. Ralph Davis points out in his article “The Rise of Protectionism in England” (1962) that there was a logic to the nature of protectionist measures.

In the case of Britain, it is quite clear that the interests of consumers were always put as secondary to the interests of developing the manufacturing capacity of the nation. This is clearly shown by the history of the cotton textile industry which was the leading industry of Britain’s Industrial Revolution. We will briefly discuss the question of protection in the case of cotton textiles, at the end of the next section.

In the last quarter of the 18th century, systematic ideas on the economic benefit of free and unhindered international trade were evolved. The classical trade theories all advocated ‘free trade’, emphasizing the role of specialization, comparative
advantage and productive efficiency. The classical idea of Laissez Faire took over from mercantilist philosophy. Many economists argued that a nation's real wealth did not consist in the mere heaping up of gold and silver, but rather in the capacity to produce goods and services. Accordingly Adam Smith criticized the early mercantilist's philosophy of precious metals and specie being the sources of wealth and stated that domestic production is the prime source of wealth, and specialization and division of labor are major causes of increased productivity. Moreover, he proposed a policy of free trade rather than the bans on some imports and high tariffs advocated by the mercantilists.

Adam Smith systematically analysed the reasons why nations trade and how nations gain from trade, by putting forward the idea of absolute advantage in production among various nations. According to his principle of absolute advantage, some countries produce goods cheaper than the other do, but different goods are cheap in different countries, so that the nations will obtain mutual benefits from trade. He assumed that the existence of idle land and labour before a country is opened to world markets. The excess resources are used to produce a surplus of goods for export, and trade thereby provides a "vent" for surplus productive capacity that would otherwise be unused. When two countries voluntarily exchange existing goods, they mutually gain, even though there is no increase in the amount of goods in the economy. People benefit from trade by obtaining a more highly preferred combination of the different goods compared to before trade. He was convinced that imports rather than exports are the purpose of trade; and import of goods and services rather than the accumulation of gold and silver improve people's standard of living. The only reason to export more therefore is to pay for rising imports.

International trade was seen as a mean of allocating national resources more efficiently and as a mean of expanding the market. Hence, trade also contributed to development through extension of market. In a famous passage in "The Wealth of Nations" (1776), Smith said regarding trade:

"By means of it, the narrowness of the home market does not hinder the division of labor in any particular branch of art or manufacture being carried to the highest perfection. By opening a more extension market for whatever part of the produce of their labor may
exceed the home consumption, it encourages them to improve its productive power and to augment its annual produce to the utmost and there by increase the real revenue and the wealth of society". (p.415)

Accordingly, Smith clearly envisaged a process in which international trade overcomes the narrowness of the home market and provides an outlet for the surplus product above the domestic consumption. It makes the home market more competitive. Besides, it plays a vital role in extending the market and hence leads to increase in productivity through specialization in according to the principle of absolute advantages. This principle was a fundamental attack on the mercantilists' idea that trade is a zero sum game. In his example of tailor and shoemaker, if both the tailor and the shoemaker gain from specialization and exchange then, similarly, two countries can also gain by specialization and trade. He identified the division of labor as a key reason for trade. The cost of production reduces through division of labor, and better use of skill and resources in different countries.

According to Adam Smith, trade between two nations, which is based on absolute advantages, only applies when both countries have an absolute advantage in one commodity in the absence of any artificial barriers. Moreover the whole point of trade is not export for its own sake but to be able to import goods and increase consumption possibilities. But he did not attempt to find the cause of international trade and to explain why one country produces some goods at a lower cost than another country does. Also the theory does not try to address what happens if one of the countries produce both goods more efficiently and cheaply than other, or if there will be any benefit from trade in such a case.

Adam Smith did not visualize a dynamic situation where the absolute advantage itself in producing goods by a country might change over time. It has been pointed out by U. Patnaik (1998) that Smith was as nationalistic as the mercantilists were, in advocating that developing areas of that time should remain as agricultural nations, for example he advised the North American colonists to concentrate on primary production and leave the manufacturing to be done by Britain.

"It has been the principle cause of rapid progress of our American colonies towards wealth and greatness that almost their whole capitals have been employed in agriculture. They have no manufactures, those household and coarser manufactures expected which... are the work
of the women and the children in every private family. The greater part both of the exportation and coasting trade of America is carried on by...merchants who reside in Great Britain. Were the Americans, either by combination or by any other sort of violence, to stop the importation of European manufactures, and, by thus giving a monopoly to such of their own countrymen as could manufacture the like goods, divert any considerable part of their capital into this employment, they would retard instead of accelerating the further increase in the value of their annual produce, and would obstruct instead of promoting the progress of their country towards real wealth and greatness."

In the period up to the early 17th century, the economy of England was based mainly on agriculture within a disintegrating feudal system. Although the landlords dominated the economy as well as politics, the rise of a national consciousness was clear in the revolt by the English monarchy against the control of Rome, represented by the rise of Protestantism as the official creed. A lot of land changed hands as the traditional monasteries were attacked and their lands confiscated, helping in the primitive accumulation of capital. At the beginning of the 17th century, British commerce and industries began to develop and in time this led to a great commercial empire under mercantilism. At that time, the Parliament which was dominated by landlords encouraged the export of corn – the term used for wheat. From 1670, corn exports, agrarian profits and rents grew substantially. From about 1740 the situation began to change: the population began to grow at a much faster rate and the demand for food especially wheat increased.

The entire 18th century was a period of "agricultural improvement" and Enclosures of common lands, with the aim of enlarging farms, fencing them and running them as larger scale capitalist farms by tenants leasing the farms from the landlords. More than 2,000 Acts of Enclosure were passed by English Parliament. On the other hands the poorer farmers and 'cotters' could not meet the costs for enlarging and consolidating their holdings and having lost their rights to common property, many became mainly dependent on wages for a living within the villages and the others migrated to the towns and cities in search of work. In spite of all the enclosures and the investments in improving the productivity of agriculture, the supply of basic food and

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feed grains began to fall behind the population growth rate and prices rose. The price rise became very fast after Britain became involved in the Napoleonic Wars from 1793 onwards and there were many years of food riots by starving poor people. (U. Patnaik 1998, quoting Chambers and Mingay 1967). In fact according to U. Patnaik there was not much of an ‘agricultural revolution’ in Britain as their historians claim, because growth in agricultural productivity was too slow to keep pace with the demands of development. The fact of rapid price inflation of food staples as well as the very long agitation lasting for over 50 years, for free imports of cheaper foreign corn, unrestricted by Corn Laws, indicate that there was failure on the domestic agricultural front. She argues that it was only the access to colonial sources (including Ireland) of the staple foods, whose import was were financed by taxes or rent burdens on the colonized people, which allowed Britain to become a large food importer – and also later on a large raw materials importer - without facing any balance of payments problems. Today’s developing countries on the other hand at once face balance of payments problems when their imports go up, because obviously they do not have access to transfers from colonies.

The import of corn had been regulated by the mercantilist measure of protecting the interests of English landlords and farmers. There was a sliding scale – until domestic prices of corn reached a certain level, no imports of corn were allowed. Up to another, higher domestic price level, imports at high tariffs were allowed up to a certain limit, and only when the domestic price level rose very high, were low-tariff imports allowed. The levels were changed from time to time depending on changes in domestic and import prices of corn in order to maintain a constant, high effective rate of protection. Thus the domestic price of corn was deliberately maintained at a high level to give enough surplus to the high-cost English producers and this was done through imposing duties to keep out lower –cost corn from the European Continent.

The more rapid growth of population and the shifting of people to the urban centers with development of factories, rapidly converted Britain to a net importer of corn despite the barriers of the Corn Laws. The Cattle Acts against Ireland were all abolished by the 1760s, and by 1800 according to the estimate by E.L. Jones, Ireland was made to supply as much as 12 to 18 per cent of Britain’s consumption of meat, butter and wheat – or more than half the urban consumption. The Irish tenant farmers
who produced these goods, and paid heavy rents to the English landlords who had settled there, were reduced to deep poverty and could consume only potatoes (which were cheaper than the wheat they produced for export).

Adam Smith and his later followers advocated a policy of Laissez-Faire and Free trade. Trade freed from all restrictions would cause world resources to be utilized most efficiently to exploit the advantage of specialization, and would maximizes world output and benefit all nations. As a result of greater specialization, the size of international market would be widened. From the consumers' point of view, they would get more choice for a variety of consumer goods. This opinion came into prominence from the political interest due to the security for raw materials to feed their industrial expansion and for the market outlet for their manufactured goods of colonizing nations. Adam Smith referred to this policy as 'a system of commercial policy which draws no distinction between domestic and foreign commodities and thus which neither imposes additional burden on the latter nor grant special favor to the former.'

However we find that this was an ideal rather than any actual reality since free trade in practice only meant policies serving the new manufacturing capitalists' interests, aimed at reducing their input costs and wage-good costs, but maintaining barriers to competition by cheaper foreign goods. This was sought to be done, by getting rid of monopoly trade by chartered companies and opening all colonised areas to private trade, and by agitation for abolishing the restrictive Corn Laws. The agitation for the repeal of the Corn Laws had been inspired by the arguments of classical economists. Ricardo came out as a strong supporter of free trade by attacking the Corn Law (1813-15) and he published his famous essay "On the effects of a low Price of Corn on the Profits of Stock" in 1815. This has been later characterized as theorizing the wage-profit frontier, by putting forward an inverse relation between money wages and money profits.

The beginning of the industrialization and growth and structural changes were already apparent by middle 18th century. Under the Corn Laws, it was the burden for the consumers and manufacturers. Consumers paid a high price for their food and the workers in particular for whom food was the major expenditure, suffered. The
manufacturers' cost of production increased due to the higher money wages they had to pay as inflation went on, even for a lower wage in terms of corn. So it reduced profit and discouraged investment. As a result, manufacturers and workers both demanded abolition of the Corn Laws. If parliament removed the tariff on corn, the price of corn would fall. Therefore, landlords' rents would fall but the capitalist's profit would rise. Also workers' wages would rise in term of corn.

Ricardo revealed the benefits of free trade in corn arguing that first, free trade would raise real wages directly for the workers for a given money wage, by making the wage-good, corn, cheaper. Second, it would increase the demand for labour by raising money profits and encouraging investment. Thus, Ricardo's prime concern as regards his support for "free trade" was the abolition of the Corn Laws which had kept the price of the wage-good artificially high. The landlords on the other hand, opposed the abolition of the Corn Laws and since they dominated in Parliament they could successfully block any change. In fact the sharp inflation during the war period was incorporated again by them into a new Corn Law in 1815, under which the domestic price had to be nearly as high as the maximum wartime price before low-tariff imports would be allowed. As it became clear that landlords would not yield, the manufacturers shifted their attention to also reforming the representation in Parliament so that they too could enter Parliament and influence policy. At the same time they agitated from a common platform with the workers for free trade in corn.

Since the end of the 18th century, Britain's economic circumstances were changing. The growing population had made her increasingly dependent on imported wheat and by 1840s she was feeding between 10% and 15% of her population on foreign wheat. Britain was also changing politically for the growth of manufacturing industry was shifting the balance of political power from a rural to an urban voters, where industrialization was creating a new economic interest which demanded "cheap bread" and an end to agricultural protection. In support of these demands Anti-Corn Law League, first set up in 1838 maintained an unrelenting attack on agricultural protection. In the face of mass starvation restrictions on the free import of food could not be tolerated and the Corn Laws were finally eliminated in 1846. (Kenwood, p.75, 76)
In fact, the full realization of free trade depended upon the repeal of Corn Laws. "Laissez-Faire" was not a maxim, which determined the issue in any instance, but it played a notable role in the contemporary lobbying and propaganda. (Coats, p.189) Thus "Free trade" was not meant to apply to all commodities at any time, even by its strongest advocates. It was on a particular commodity for particular purpose at a particular period, especially for importation of corn. There was never any demand by the free traders including Smith and Ricardo, for the abolition of high tariffs on Asian cotton textiles, in fact tariff rates were increased in 1813 even though the English factory system had triumphed by then. The manufacturers did not wish to face any competition from Asian textiles until they had achieved an overwhelming unit cost reduction and so they clung to protection until final abolition only after 1846.

Thus the theory of "Free trade" can be said to be in practice, "one-way free trade". Britain was the only country to advocate the free trade policy under the very particular circumstance because she was the first industrial nation and faced no competition in machine made cloth by 1820, and was also the only source of output of machinery. So free trade is a political as well as an economic doctrine.

Cotton Textiles

The East India Company imported printed and painted pure cotton cloth and fine muslins from Asia – mainly India and Persia – and these became very popular in England in the 17th century. (Raw cotton could not be produced in England or the European countries and there was very little local skills in spinning in weaving the raw cotton imported from the Levant, the output was a coarse cloth). The woollen industry demanded a ban on import of Asian cotton cloth because it feared that some of the market for its output would be lost, and in 1700 English Parliament completely banned the use of imported cottons. Because of smuggling, in 1721 the law was made stricter and large fines were put on any individual found wearing cotton and on merchants found to be selling them, which was quite effective. Woollen industry workers would physically attack anyone found wearing pure cotton and would tear the clothes, and such direct action was also effective. The East India Company continued to import Asian cotton goods but these were entirely re-exported to Europe, North
America and so on. So Britain had a large trade in importing Asian textiles but their own people were not allowed to consume the goods.

Pent-up consumer demand was created by the ban on imports and the final result was the opposite of what the woolen industry wanted for it led to import-substitution in cotton cloth. It has been argued (Patnaik 1985) that the completely protected English market and pent-up demand, combined to give "high potential profitability of import substitution" and led to the repeated attempts to imitate fine Asian cottons and so led to the series of technical innovations. The period of protection which encouraged innovation, was very long – 65 years passed before a successful spinning machine was developed (Hargreaves 1765), and 74 years of protection were over by the time Arkwright successfully petitioned Parliament that the ban on use of pure cottons should be modified because now English pure cottons were being produced. The argument he gave according to the account by Paul Mantoux (1928) was that while imports created jobs and incomes abroad, domestic production of cotton textiles created jobs and incomes in England and more jobs would be created than were lost by the woollen industry – an argument which persuaded Parliament. Instead of a ban on consumption of cotton, high tariffs were imposed on Asian cottons and continued even for decades after the factory system had developed and costs per unit of output of yarn and cloth had been lowered drastically owing to machine spinning and weaving.

To summarize, the various protections of British market against Import of Asian Textiles were:

1. 1700: Parliament banned consumption of all printed and painted cotton textiles from Asia & Pacific.
2. 1721: New law again banning consumption, with £5 fine for individuals found wearing cotton cloths and £20 fine for trader selling cotton fabrics.
3. 1774: General ban on cotton cloth consumption lifted only after Arkwright’s petition to parliament saying that now pure cotton was produced within Britain and provided employment to local workers. Ban on importing and selling Asian textiles continued and implemented strongly.
4. High tariffs imposed 75 to 85% on Calicoes (1813)
5. Tariffs reduced after 1820 but continued at lower levels until 1846 when all tariffs were abolished. Thus, parliament banned or put tariffs on importation of Asian cotton textile for 146 years. When the English cloth had become sufficiently lower in cost to compete with Asian cloth (which bore a high transport cost to European markets), English cloth displaced Asian cloth in those markets from 1800 onwards. Cost had to lower much further by the late 1820s, before English yarn and cloth bearing transport cost, could go to Asia and start displacing the local production, leading to de-industrialization there.

The German economist Friedrich List said that the real motivation of English economic policies was to encourage the “powers of production” and develop their own manufacturing and for this they used protection to discriminate against Asian textiles and also denied their own consumers any free choice. While Adam Smith and David Ricardo might talk in general of ‘free trade’ the actual policies, List said, were designed in such a way that all competing manufactures were discriminated against through protection. This actual practice of England is what the other nations like Germany had to follow if they wanted to become industrialized, and not follow general free trade policies.

Referring to the support of the English economists for the ban on import of Asian textiles, List said:

“Had they sanctioned the free importation into England of Indian cotton and silk goods, the English cotton and silk manufactories must, of necessity, soon come to a stand. India had not only the advantage of cheaper labor and raw material, but also the experience, the skill, and the practice of centuries. The effect of these advantages could not fail to tell under a system of free competition. ...Accordingly, England prohibited the import of the goods dealt in by her own factories, the Indian cotton and silk fabrics. The prohibition was complete and peremptory. Not so much as a thread of them would England permit to be used. She would have none of these beautiful and cheap fabrics, but preferred to consume her own inferior and more costly stuffs. She was, however, quite willing to supply the Continental nations with the far finer fabrics of India at lower prices, and willingly yielded to them all the benefit of that cheapness; she herself would have none of it. Was England a fool in so acting? Most assuredly, according to the theories of Adam Smith and J.B Say, the Theory of Values. For according to them, England should have bought what she required where she could buy them cheapest and best; it was an act of folly to manufacture for itself goods at a greater cost than she could buy them at elsewhere,
and at the same time give away that advantage to the Continental. The case is quite the contrary, according to our theory, which we term the Theory of the Powers of Production, and, which the English Ministry, without having examined the foundation on which it rests yet practically adopted when enforcing their maxim of importing produce and exporting Power.”

1.3 Ricardo’s Theory of Comparative Advantage

Ricardo explained the existence of international trade even in the absence of absolute advantage by the comparative cost advantage theory. In his *Principles of political Economy and Taxation* (1817) in the Chapter “On Trade”, he demonstrated what has become known as the famous *Principle of Comparative Advantage*: namely, a nation, like a person, gains from trade by exporting goods or services in which it has its greatest comparative advantage in cost and importing those in which it has the least comparative advantage (p.133).

According to Ricardo, countries tend to specialize in and export the goods in which they have low relative cost and import products in which they have a high relatives cost. Ricardo, like Smith, believed labor cost dictated value and prices as long as the country held no international trade. Like the absolute cost theory, international trade is attributed to differences in advantages that accrue from varying production costs in different countries. Unlike the absolute cost theory, it shows the possible benefit that the trading nations can gain even if one of them has absolute cost advantages in both the goods and hence the other has absolute disadvantage in both goods.

According to his example, there are two countries Portugal (A) and Britain (B) in which produce two commodities Cloth (X) and Wine (Y). Each country fully employs at the given labor force under constant cost. Initially there is no trade between two countries. The total available labour time at full employment is assumed to be 200 units in country A and 400 units in B. We use output per unit of labor to compare the labor productivity between countries.

Let us assume that Portugal produces 2 units of cloth per unit of labour and 4 units of wine per unit of labour, while Britain produces only 1 unit of cloth per unit of labour and 1.25 units of wine per unit of labour. Considering the unit labour cost

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which is the reciprocal of these numbers, clearly Portugal has lower unit labour cost in both goods (0.5 for cloth and 0.25 for wine) compared to Britain (1.0 for cloth and 0.8 for wine), and is therefore more efficient in the production of both goods compared to Britain. If Portugal devotes all its labour time to either X or to Y, it would produce either 400 units of cloth or 800 units of wine, defining the linear transformation frontier between the two goods. Similarly Britain by devoting all its labour to either X or to Y would produce either 400 units of cloth or 500 units of wine, similarly defining the linear transformation frontier between the two goods. Assuming in the pre-trade situation, each country devotes half of its labour resources to producing one good and the remaining half to the other good, the production of each good in each country is shown in Table 1.1 and the total output of each good taking both countries is shown in the last line – 400 units of cloth and 650 units of wine.

**Table. (1.1) Output in the Pre-Trade Situation and after Specialisation**

<table>
<thead>
<tr>
<th>Country/commodity</th>
<th>Pre Trade Output</th>
<th>Post specialization Output</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>X Cloth</td>
<td>Y Wine</td>
</tr>
<tr>
<td>A: Portugal</td>
<td>(2)×100 = 200</td>
<td>(4)×100 = 400</td>
</tr>
<tr>
<td>B: Britain</td>
<td>(1.0)×200 = 200</td>
<td>(1.25)×200 = 250</td>
</tr>
<tr>
<td>Total production</td>
<td>400</td>
<td>650</td>
</tr>
</tbody>
</table>

Note: Labour cost per unit of output is the reciprocal of output per unit of labour shown above. The unit labour cost in A is 0.5 and 0.25 respectively for cloth and wine while for B it is 1 and 0.8 respectively for cloth and wine.

Even though Britain is inefficient in production of both the two commodities, Ricardo points out that both Britain and Portugal can benefit through specialization in the commodity in which it has relatively lower cost of production. The amount of wine that can be produced by giving up a unit of cloth, is 2 in Portugal and 1.25 in Britain, so Portugal has a better cost advantage in wine and Britain has a lower cost disadvantage in cloth. If Portugal specialises in wine and Britain in cloth, the output taking both countries remains unchanged for cloth at 400 units but for wine it goes up to 800 units. Thus there is an extra 150 units of wine for no lower total output of cloth, which can be obtained by both countries specializing. The initial situation was not Pareto optimal, for the new situation of specialization means that each country can
move through trade, to a higher level of wine consumption for a unchanged level of cloth consumption, compared to the pre-specialization and pre-trade situation. The extra 150 units of wine can be shared between them, for example by Portugal offering 300 units of wine out of its 800 units output to Britain in return for 200 units of cloth from it (Table 1.2). Portugal benefits because its rate of obtaining units of cloth per unit of wine through trade, 0.67 is higher than the rate it could domestically obtain cloth by transformation from wine, which was 0.5. On the other hand Britain too benefits because the rate at which it obtains units of wine per unit of cloth by trading, 1.5, is higher than the rate of 0.8 at which it could domestically obtain units of wine by transforming a unit of cloth. Each country thus moves to a higher level of wine consumption for the same level of cloth consumption, in the post-trade situation compared to the pre-trade one. Portugal consumes an extra 100 units of wine and Britain an additional 50 units of wine for the same level of cloth consumption at 200 units each.

<table>
<thead>
<tr>
<th>Country</th>
<th>Commodity X wine</th>
<th>Commodity Y cloth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portugal</td>
<td>200</td>
<td>500</td>
</tr>
<tr>
<td>Britain</td>
<td>200</td>
<td>300</td>
</tr>
<tr>
<td>Total Output</td>
<td>400</td>
<td>800</td>
</tr>
</tbody>
</table>

**Criticism of Ricardo's Theory of Comparative Advantage**

Ricardo's theory has been very influential and powerful in strengthening the idea that there is mutual benefit to be had from specialization and trade even when a country is a low-cost country in producing all goods compared to other countries. It is the basis for all the modern theories of trade, except for the dissenting tradition (like the theories of declining terms of trade and theories of unequal exchange). A very important normative aspect of the mainstream modern trade theories has been the idea of increased welfare for all trading countries from free trade, which has its origins in Adam Smith's ideas and more so in Ricardian theory of trade based on comparative advantage. In fact this idea has been revived as a theoretical argument in recent times with the processes of neoliberl reforms, globalisation and trade liberalization during the last three decades.
Ricardo’s theory of comparative advantage has been criticized by those who have accepted the basic argument of the theory, but have pointed out that there is no discussion of the terms of exchange between the two countries. While there is a range of exchange ratios within which both countries benefit from specialization and exchange, what determines the exact rate at which they will exchange one commodity for the other is not clear in the model. Paul Samuelson has discussed the question of the terms of exchange by treating Ricardo’s theory in a linear programming framework (Samuelson, 1970).

There is an objection that transport costs are not taken account of in the model but this is not a strong objection because we can assume that variation in transport costs are random across commodities and destinations and no systematic advantages are present for any one country or in any particular good on account of transport costs.

Also it has been pointed out that it is a static theory and that the pattern of comparative advantage can change over time. This however is also not a very strong criticism since Ricardo himself recognized that if one country found a cheaper way, say through technical change, of producing the good in which it had initial relative cost disadvantage, it could lower cost enough to get relative advantage in that good and specialize in it to its own and other countries’ benefit. For example he says that at the moment Portugal might have a relative advantage in producing wine but if England could achieve higher processing efficiency and reduce cost in wine production then it could end up with a relative advantage in wine production and Portugal in cloth production. In short the pattern of relative advantage could be reversed over time (Ricardo, p.137-8).

However there is a different kind of more fundamental objection raised to Ricardo’s theory of comparative advantage by U. Patnaik (2000, 2003) who says that while the theory is very clever in its argument, it is based on a logical fallacy when considered as a general theory of why trade takes place. She points out that the theory of comparative advantage is not in fact a general theory of trade as Ricardo himself considered it to be and as all the text books on trade theory treat it, because the assumption “both countries produce both goods” is not satisfied and cannot be satisfied, in the case of a high proportion of actual international trade both in Ricardo’s time and in modern times. This assumption of the model, that both countries produce both goods, is crucial because without the assumption being satisfied, it is not possible to define the
cost-ratios and transformation frontiers, hence relative cost and relative advantage cannot be defined at all. As pointed out by Patnaik, all trade by advanced countries in tropical primary products involves violation of this assumption since these tropical primary products could never be produced at all in temperate lands in the field. In Ricardo’s own time when he wrote *The Principles of Political Economy and Taxation*, about half of the total volume of England’s trade, was trade in tropical goods like cane sugar, coffee, tea, indigo, teak and mahogany, rice, oilseeds, opium, tobacco, raw cotton, and may other tropical or sub-tropical products which could never be produced in England with its cold climate, or in any of the other cold temperate regions of Europe and North America. (Later on, additional tropical goods like jute and natural rubber became important for packaging, and for tyres in the automobile era). But Ricardo ignores this fact that if a good cannot be produced, no question of any cost of production can arise leave alone relative cost. Unlike any other good, many such primary goods could never be import substituted in Europe and North America, and this remains true today as it was then, so countries wishing to consume those goods have to import them since no question of producing them directly, arises.

She points out that Ricardo’s own example of wine and cloth production by both Portugal and England has a problem of ‘material fallacy’ because grape wine could not be produced in England which was too cold for growing grapes in the open: “The northern limit of grape growing is defined by a mean July isotherm of 19 degrees Celsius or 66 degrees Fahrenheit.” Yet Ricardo talks of the possibility of England specializing in wine production and Portugal in cloth production if the cost of processing could be lowered enough by England, without ever mentioning the fact that grapes could not be grown in England and that is why no one has ever heard of English wine. Later on Samuelson replaces the good ‘wine’ with ‘food’ when discussing Ricardo’s model but does not explain to the reader why he is doing it (Samuelson 1970). Many modern textbooks also take the two goods as cloth and food when discussing Ricardo’s model. But, says Patnaik, simply quietly changing Ricardo’s own example in this way, is not an answer to the basic problem that a very large part of world trade simply does not satisfy his assumption and does not fit into the model.
According to Patnaik (2003), the assumption ‘both countries produce both goods’ is a highly limited and specific assumption, but the conclusion based on this specific premise, namely that both countries necessarily benefit from specialization and trade, is incorrectly put forward as a general conclusion and hence the fallacy is what in applied logic, is called “the converse fallacy of accident”. Many economists and historians incorrectly make statements, to quote her, of the following kind: “India specialized in producing and exporting primary products and England in manufactured products like cotton textiles because India had a comparative advantage in primary goods while Britain had a comparative advantage in manufactured cloth. They forget that this necessarily implies that England could produce the tropical primary goods, which is factually untrue. “ (Patnaik, 2003). In the case of Myanmar, similarly it would be incorrect to say that when it was a colony called Burma it specialized in and exported teakwood and rubber to Britain because it had a ‘comparative advantage’ in these goods and in turn Burma imported cloth from Britain which had a ‘comparative advantage’ in cloth. It is an incorrect statement because the rubber-cloth transformation frontier for Britain did not exist since Britain could not produce rubber at all, and hence neither unit cost of rubber production nor relative cost could be defined or compared with that of Burma, where the rubber-cloth frontier could be defined since it could produce both goods.

Unfortunately the term ‘comparative advantage’ has passed into common usage and is applied incorrectly all the time in this way, by academics and other people, to very many situations where it is completely inapplicable - because the question of cost of production does not arise where a good is not producible. The conclusion of mutual benefit is thought to hold in these cases whereas in fact trade may prove to be positively harmful for the weaker trading partner - how exactly it may be harmful is discussed in more detail in another chapter. Here we can only note that de-industrialization often took place, and export of primary products was often at the cost of falling availability of basic food for the populations of the weaker or colonized trading partner.

Of course, a great deal of trade did take place in tropical products and continues to take place today, but the basic point is that this trade cannot be explained by the theory of comparative advantage. In reality historically speaking the trade was not voluntary, it was mainly colonial trade and it did not necessarily give rise to benefit for the colonized,
although it did benefit the colonizing country which got to consume a number of products it could not produce at all. Even when it was not colonial trade, as in the case of Portugal and England, one country was dominated in terms of naval power by the other, and was obliged to sign treaties giving market access to England without any necessary benefit to itself since its own value-added industry was displaced by cloth imports and in fact it faced rising trade deficits.

1.4 Recent Theories of International Trade

In classical economic thought, trade was conceived as a dynamic force which by widening the extent of the market and the scope of the division of labor, stimulates innovations, permits a greater use of machinery in expanding output, overcome technical indivisibilities, raises the productivity of labour and generally enables the trading country to enjoy increasing returns and economic development. Trade gives a developing country opportunity to remove domestic shortages and to overcome the diseconomies of the small size of its domestic market. To sum up the classical economists perceived trade as a crucial factor for growth in three ways: 1) as a vent for surplus output 2) a means of maximizing gains through the working of comparative cost advantage, and 3) gain through widening the extent of the market and hence the scope for the division of labour.

About a century after Ricardo’s contribution, Eli Heckscher (1919), Bertil Ohlin (1933) and Paul Samuelson (1948) developed the current orthodox explanation of the ultimate cause of international trade. This has come to be known as the neoclassical model of trade and they took account of some of the shortcomings of classicists’ theoretical assumptions.

Regarding the cause of comparative cost advantage, their basis idea resets on two ultimate situations;

1. Difference in factor combinations required for the production of different commodities, and
2. Relative difference in the factors endowments in different countries.

The Heckscher-Ohlin-Samuelson (H-O-S) theory stated that a nation’s comparative advantage is determined by the relative abundance of its factors of production, such as capital and labor. Given the assumptions of two country, two factor,
two products, factor immobility between two countries and perfect competition with zero transportation cost, the theory maintains that a country will export (import) commodities that intensively use the country’s relatively abundant (scarce) resources. According to this concept, countries trade to take advantage of the difference in the cost of production, which primarily arises from differences in factor endowments.

They argued that what determines trade is the difference in factor endowments, by developing a simple model that is known as Heckscher-Ohlin-Samuelson \((2 \times 2 \times 2)\) model. As a result, the relative factor endowment is the crucial and sole consideration that determines the comparative advantage and the pattern of trade too. It can be seen that there are some differences from classical theory. It gave up the idea of a single factor “labour” assumed in the Ricardian model. The crucial difference, moreover, between the H-O-S theory and Ricardo’s theory is its stress on factor endowments as the determinant of comparative advantage rather than on differences in relative labour cost. According to the H-O-S theory, the basic for trade arises, therefore, not because of inherent technological difference in labor productivity for different commodities between countries but because countries are endowed with different factor supplies. Theory focuses on the differences in relative factors endowment and therefore the relative factor prices between nations as the most important cause of trade.

In fact, the factor endowments are continually changing over time across countries through the effects of technical advancement, population growth, migration and investment. Comparative advantage is also determined partly by physical and human capital, and partly by technology in the country relative to other country through natural resources or a good climate. Accordingly comparative advantage changes over times should be considered as a dynamic concept.

However the same basic objection can be made about the ‘factor endowment’ concept as was put forward for Ricardo’s theory. The non-homogeneous character of land as a productive factor in different countries is completely ignored by the H-O-S theory just as Ricardo had ignored it by assuming that both countries could necessarily produce both goods. The question is, what is “land” and what is “relative land abundance”. A thousand square miles of Sahara desert is land, but it does not compare as land with a thousand square miles of the Irrawady delta. In fact even a thousand square
miles of North American prairie does not compare with a similar area of the Irrawady delta whose productive capacity is very much higher than the productive capacity of the prairie. But there is nothing in the H-O-S theory which says that land is not homogeneous and should be taken in standardized units. Even if it did recognize non-homogeneity of productive capacity, the fact remains that standardization cannot be done even at the level of concepts, in a situation where the products are so qualitatively so different that some of them cannot be produced at all in one country or the other: Canada cannot produce rubber or coffee while Myanmar cannot produce maple syrup or fir trees.

Thus regarding the question of "relative factor endowment" we have the same problem of assumptions in the H-O-S model, which are far too simplistic to capture the reality. In fact we would expect that population growth would be adjusting itself to productivity-adjusted land. Population and land would be complementary, because in history over time, human settlement is the most dense wherever the land is the most productive (whether through natural fertility or through the efforts of past generations). With everything else remaining the same, if country A has X units of land of a certain quality capable of bearing a certain range of products, and supports P population, then country B with 2X standardized, comparable units of land would be found to support about 2P population, and the ratio of land to workers would be about the same in both countries. If China is the most populous country in the world with one-fifth of the world’s population despite having less than 6% of its cultivated area, it is because that 6% is far more productive than the 24% of total area lying as North American prairie or Russian tundra.

In history, in pre-industrial society, as long as movement of populations were not artificially restricted, population and hence labour as a factor always adjusted to land productivity, with low density in low-productivity land and high density in high-productivity land. Thus land and labour are so interdependent that they cannot be taken as independent ‘factors’ for the purpose of analysis. Variations in factor proportions could arise only later, such as through a deliberate policy of restriction of immigration of new settles, carried out by earlier settlers.

Regarding the question of factor endowment, Linder (1967) has taken a different view by challenging the neo-classical theory based on relative factor abundance, saying
that is possible only for an analysis of trade in primary products but not of trade in manufactures. It is a fact of modern life that most trade in manufactures takes place between countries whose factors endowments and technologies are similar. Linder stated that demand structures are an important determinant of the pattern of trade. In his concept, the more similar the demand structures of the two countries, the more intensive, potentially is the trade between these two countries. He pointed out the importance of similarity in demand patterns.

He suggested that a country will only successfully export a sophisticated manufactured good if it has a buoyant domestic market to provide the jump-off point to make it competitive, i.e. the country can take advantage of economies of large scale production, and if it exports to an economy displaying similar tastes and income level. In this sense, Japan is more likely export television set to Singapore than to Bangladesh. In addition, unlike in the case of primary goods where production would tend to be closely related to factor endowments, the most important determinant of the pattern of trade in manufactures is the level of income per capita. Countries with high incomes do not only consume more TVs, but higher quality TVs. Hence, according to Linder’s approach, each country would tend to produce TVs appropriate to their income levels and then would export them to countries with similar income levels once the jump-off had been established. (Linder, 1961) So the volume of trade between a country and each of the trading partners as a proportion of national income will be higher, the greater is the similarity in the demand pattern measured in term of per capita income levels of the pair of trading countries. Linder analyzed it from the demand point of view. What about the supply side? We have to consider what happens if the supply of the factor endowments is changed.

Rybczynski described the effect of change in the supply of factor of production on the trade pattern in what has come to be called, The Rybczynski Theorem. This states that:

*At constant commodity and factor prices, an increase one factor endowment will cause the output of the goods intensive in that factor to increase by a greater proportion, and will reduce the output of other goods.* (Mikic', p.547)

This theorem is basic to the functioning of the H-O-S model. It states that the link between the changes in factors of endowments and the change in the output of goods
under the constant return to scale. And the changes in a nation’s factor endowment will affect trade in different ways which can be called antitrade, neutral or protrade. According to the Rybczynski theorem, we can consider the case where country is assumed to be abundant in labour but scarce in capital and both are fully employed. Let us suppose that for both factors (labour & capital) supply increase in same proportion, so that economy’s overall capital-labour ratio remains constant. The effect of these factors changes on trade is neutral because these increase do not alter the comparative advantage of the economy. It also states what happen, if the change in factors endowment is not proportionate. Suppose if only the supply of capital (the relatively scarce factor) grows with no change in the labour supply, it lessen the country’s comparative advantage in the labour-intensive export goods. Therefore the effect is anti-trade. Conversely if there is only increase in labour supply which is abundant in the nation but there is no change in the capital stock, the comparative advantage in labor-intensive goods is stronger than before and hence its effect will be pro-trade. This is known as Rybcznski effect.

In fact each of the factors of production is subjected to many influences that alter its supply within a nation over time. Factors changes are continuing phenomenon within nations, causing shifts in factor proportions and in comparative cost structures. Hence, a nation’s trade is not static but is frequently changing in magnitude, composition, and direction at a rate that varies from time to time and from country to country.

Peter Heller also considered the evidence in his paper “The case of Japan’s trade”. In the study he concluded that shift in Japan’s factor endowments from a relative-labor abundance to a relative capital/human skills abundance over the period 1956-1969 strongly altered its comparative advantage in favor of capital and skill-intensive exports. (Heller, 1976, pp.283-292). Generally, therefore we can say that any growth in factor endowments that causes disproportionate change in country’s production possibilities will create a bias in production. As the result of these changes, the term of trade will be either beneficial or harmful for a country depending on whether occurs in the exporting or the importing industry. Therefore, Maki’c (1998) inserted a corollary to the Rybczynski theorem:
An increase in the amount of one factor will cause a fall in the relative price of the good that is intensive in that factor, so that the term of trade will improve or deteriorate according to whether this good is an importable or exported good. (P.103)

However all these theories are descriptive in nature and circular in their method of argument because, as in the case of the Japan study, the conclusion is reached that relative endowments and comparative advantage shifted to skill and capital intensive goods from labour intensive ones, once it is empirically actually found to be the case that capital intensive goods started to be exported. If Japan had continued to export raw silk the 'conclusion' would have been drawn that it is because relative factor endowments were unchanged. In fact what is being put forward as the cause is actually derived from the observed empirical trends. The modern theories do not seem to have any predictive capacity to tell us in advance what direction a country's 'relative factor endowment' will move and hence in what direction its 'comparative advantage' will change. Similarly Akamatsu's theory of the 'flying geese' pattern of development which we will refer to in more detail later on, is also based on the actual historical trends of import-substitution and export-promotion in Japan but it cannot be generalized because Japan was developing with access to its colonies' resources.

The modern theories too are thus based on extremely simplistic concepts of productive 'factors' which are assumed to have uniform and homogeneous productive capacity across countries. Retrospectively, international trade theory of the early 19th century was dominated almost entirely by the concept of comparative advantage. And trade theories assumed constant return to scale, perfect competition and free trade situation. But countries also trade because of differences in cost of production, natural resource endowment, technologies and taste among countries. On the empirical evidences of the actual international trading relations in the post war era, the economists perceived that several factors- (such as increasing returns, imperfect competition, endogenous technical changes, changing consumers demand, per capita income, intra-industry trade), influence and determine the flow and the pattern of trade.

According to the statistical record of trade patterns, after the post world war period the proportion of world merchandise trade that took place between countries that were similar in resources, technology and tastes, was in fact, far larger than the share of
trade between these and developing countries. More than two-third of world exports in manufactured goods originates in the developed countries, while the developing countries make about a-quarter of world's manufactured goods exports while primary products exports occupied a larger part of their trade. Most of the exported primary products of developing countries are inputs (raw materials) of industries of developed countries and the rate of growth is related to the rate of growth of industrial production in developed countries.

In view of this, Lewis (1980) suggested that the rate of growth of output in the developing world for the past hundred years has depended on the rate of growth of output in the developed world, and that the principal link through which the latter controls the former is through trade. "The growth rate of world trade in primary products over the period 1873 to 1913 was 0.87 times the growth rate of industrial production in developed countries; and just about the same relationship, about 0.87, also ruled in the two decades to 1973." (Lewis, 1980, pg.556) According to this statistical argument, Lewis concludes that trade depends on the prosperity of the industrial countries and trade acts as an engine of growth for developing countries.

However it has also been pointed out by the radical critics of the argument especially the Lewis argument, that it completely ignores certain important historical dimensions of the trade in primary products carried out between the now developed, and the developing countries. One dimension which is ignored is that this trade in primary products was largely induced not by the primary producers but by the interests of today's advanced countries at that time, in getting hold of the raw materials and wage-goods they needed but either could not themselves produce at all in their own countries, or could not produce in sufficient amounts. Most of the trade in primary products did not arise from the free decisions of the concerned economic agents like peasants producing the goods, since the latter were so heavily taxed in cash that they had to produce exportable cash crops to pay their taxes.

Another dimension which is ignored is that the export earnings of most of the primary producing countries, which were colonies, had been quite systematically siphoned off for use by their metropoles through the mechanism of administered charges on the colonies making them in deficit no matter how large their export surplus was to the
world. India for example which had the second largest export earnings in the world at 71 million pounds in 1913-14, owed 11 million pounds to Britain because of trade deficit plus normal items of invisibles deficit, but actually 60 million pounds more than this was credited to Britain because of the administered charges (Patnaik, 2003c). When India’s export earnings went up further during WW I as the wartime demand for jute sandbags and packaging went up, an extra 100 million pounds sterling of exchange earnings were taken by Britain as a compulsory ‘gift’ from India as mentioned by Bagchi (quoted in Patnaik, 2003c). The import of primary products by industrializing countries were not be paid for by them fully through their own exports and a large part was simply transfer from their colonies, which had the effect that trade became an engine of retardation for the exporting primary countries.

Even in the present era, by the later half 20th century, the view of trade as an engine of growth has been lost gradually. The failure of trade to act as the engine of growth for developing countries was caused by a number of potentially important influences. Prebisch (1950), Singer (1950), Nurkse (1959) and Cairncross (1960) identified these influential factors. Evans (1989) has summarized these factors as follow:

1. The change in industrial structure favoring of industries with a low import content of imported raw materials.
2. The rising share of services in total output of advanced countries.
3. The low-income elasticity of consumer demand for many agricultural products.
4. Agricultural protectionism.
5. Economies in the use of raw materials e.g., through the reprocessing of scrap.
6. The introduction of synthetic materials.

The above factors influenced the trade pattern and terms of trade of the developing countries that heavily relied on primary exports. Furthermore the trade between developed and underdeveloped countries have seen secular movement of the terms of trade in favour of the former and against the latter. Most of the complaints of developing countries have resulted from their dependence on the export of primary products. The most serious one concerns the barter commodity terms of trade which has been deteriorating over the long run.
Regarding the secular decline in terms of trade, we see different arguments as explanations. There are many influences contributing to declining term of trade. First is the nature of primary products’ price and income elasticity of demand. When world income grows, the demand for manufactured goods expands faster than the demand for primary products, so that the relative price of the primary products declines. The reason is that at first primary products are marketed competitively, their prices are flexible, and any improvement in productivity is partly passed on to the foreign consumers in the form of reduced prices. On the other hand, monopolistic practices in manufacturing make prices rigid in a downward direction, so that the benefits of productivity increases are reaped in the form of high earnings in the producing countries and are not reflected in lower prices.

Secondly the development of synthetic substitutes lowers the demand for many primary materials and thereby depresses their prices. As for industrial goods, most of the manufactured products exports of developing countries are faced by non-tariff barriers or tariff wall in developed country markets. The manufactured products are simple technology, relatively labour intensive products like textiles and electrical goods which face quantitative restrictions or non-tariff barriers by way of safety standards or quality norms. These barriers restrict the volume of exports of developing countries and thus their volume of imports through restricted exchange earnings (Kreinin, 1971 pp. 321-323).

The evidence of 1970s, 1980s and 1990s is that growth in developed countries has continuously slowed down. As unemployment has risen, protectionist sentiment in developed countries especially against the import of labor-intensive goods such as textiles and apparel from developing countries increased.

These and other theoretical arguments supported the claim of the less developed countries that their commodity terms of trade have deteriorated over the years. Raul Prebisch (1950) and Paul Singer (1960) put forward the view that the commodity terms of trade of developing countries have the tendency to deteriorate over time. They attributed this deterioration to differences in the process of adjustment to technical progress. They thought that, unlike the developed countries in which improvement in
productivity leads to wage increase, in the underdeveloped countries, labors supply pressure keeps wages unchanged and, therefore, it leads to lower prices.

Prebisch (1950) claimed that “the great industrial centers not only kept for themselves the benefit of the use of new techniques in their own economy, but were in a favorable position to obtain a share of that deriving from technical progress of the periphery”. (Ibid. p. 14)

Also Prebisch (1959) developed a two country, two-commodity model in which the advanced centre produces and exports manufactured goods with income elasticity of demand greater than one, and the backward periphery produces and exports primary commodities with an income elasticity of demand less than unity. With a certain rate of growth of income for the centre, he argued that there will be a lower rate of growth of imports (of the primary products) from the periphery. In contrast, he showed that the same rate of income growth for the periphery will lead to a higher rate of imports (of industrial products) from the center. Therefore, even with a trade balance for the both center and periphery, the former’s income will grow at higher than that of the latter. That is, with free trade, the pace of economic growth in the periphery will always lag behind that of the centre.

According to the Prebisch hypothesis, foreign trade is not a central issue of the development problem of the less developing countries. The important issue he focuses on is the level of industrialization of the country. The disparity in the pace of industrialization, causes the imbalance in international trade between countries. Even though the exposure to foreign trade does spur development in a various ways, but the main motivation comes from within. The balance of macroeconomic situation and political environment conducive to growth are necessary. In the present time, international trade theories centre on the reduction trade barriers in world trade transactions. And they emphasize trade liberalization through bilateral and multilateral trade negotiation, and regional trade integration.

In more recent years, several additional factors have come to the fore to influence international trade. The concerns of the environment, assertion of human rights, and the consideration for child labour- have been exerting dominant influences the relevance of the traditional theories of trade. The real world is very different and the distortions in the
pattern of trade are become apparent. The present world trading system is a complex one, and what is peculiar about it is that it is not economics but politics that dominates the system.

Moreover, one cannot simply underestimate the influence of the political factor as a determinant of the scale and pattern of a country’s international trade. People of different nations and their governments perceive differently the advantages and disadvantages of trade owing to their varying actual circumstances. For an advanced country the question of food security of the population is not so important because they export only the surplus, but for poor developing nations it becomes a very important question whether they can divert their limited land to export crops and still maintain their own output and consumption of the basic foods. A too-general prescription that free trade is good for everybody, without taking account of special circumstances of poor nations, may not work well where world incomes are highly skewed towards rich nations which can assert their superior purchasing power through the international market. And so the government of different nations employ different domestic policies affecting their trade on account of the differing circumstances in which their populations are placed.

During the periods of political uncertainty and economics insecurity, the security of the nation and the State is considered first. At times, the protection of employment takes precedence while in some; the questions efficiency and the consumers’ freedom of choice come first. The choice is after all, inherently political and is influenced by subjective ideologies as well as objective political and economic considerations. Countries in turn, are obliged to choose policies towards trade which reflect the importance they attach in their perception of national interest, to different opportunities and benefits, the risks and the costs which trade opens to them. This issue will be discussed in chapter 3. A general discussion of the development problem and its implications for trade policy will be mentioned in the later part.

In the next chapter, we take up some aspects of the development of trade patterns in the pre-industrial period and up to the Second World War.