CHAPTER 2

Review of Literature

2.1 Introduction

In the preceding chapter, a brief outline is given as to how and why trade between different nations takes place. It has been followed by a discussion on the origin and development of European Union and how Indo-EU relations have grown.

This chapter attempts to review some of the existing studies on the subject so as to have an idea of the type of research methodology to be set out and the kind of analysis to be carried out in the present work.

2.2 Some Theoretical Development

As pointed out earlier in Chapter 1, that trade between different nations occurs due to various reasons. Economist like Adam Smith (1776), Ricardo (1817), Heckscher-Ohlin (1933), etc. have pioneering contributions in this area. Here a review of some attempts to test the leading hypothesis of international trade is presented.

Empirical studies by MacDougall (1951), Robert Stern (1962), and Bela Belassa (1963) are the major ones to investigate the explanatory value of the doctrine of comparative cost in determining trade patterns. All of them have compared the data for U.K. and U.S.A. between 1937 and 1950. In order to avoid the necessity of estimating the effect of tariffs, these authors have compared the export performance of the two countries in a third market, assuming that the trade barriers tend to affect the exporters equally, when difference in export patterns would clearly be the outcome of comparative costs and not tariff as such.
For empirical analysis, MacDougall examined the relationship between (i) the ratio of U.S. exports to U.K. exports of a series of products and (ii) the ratio of U.S. to U.K. labour productivity regarding these products. Assuming the first ratio to be $y$ and second to be $x$, the hypothesis may be set as: “a higher $x$ causes a higher $y$”. This is in line with Recardian hypothesis that relative labour productivity is a fundamental factor determining comparative costs advantage.

Using the regression analysis, empirically, it was found true by these investigations. For instance,

Stern found the relationship:

$$y = -0.68 + 1.27x$$

$$r = 0.44$$

MacDougall obtained, in another test:

$$y = -2.19 + 1.89x$$

$$r = 0.61$$

The high degree of positive correlation sustains the hypothesis and suggests that the Ricardian model has explanatory value.

Many economists have also tried to test the validity of Ohlin’s factor-endowment theorem with empirical findings.

MacDaugall (1951) made a pioneering attempt to find whether a country’s export consists of goods involving relatively intensive use of its abundant factor or not. For this purpose, he compared England’s and America’s export shares of relatively capital-intensive goods and low capital intensity relative to labour. That is to say, America, being a capital–abundant country, is found to be importing capital-intensive goods, which is quite contrary to the
factor-endowment principle. As such, empirical finding seems to have refuted Ohlin’s theory.

However, this test of MacDougall has been severely criticised on the ground that his measure of capital intensity - in terms of horse power used at prevailing factor prices is not very satisfactory.

Leontief (1956) measured and compared the factor intensities of American exports and imports by comparing the effects on the release of resources (labour and capital) under a reduction of one million dollars worth of exports if there was an equivalent import substitution. He, however, came to a paradoxical conclusion from his empirical study that though America was assumed to be capital-abundant country, her exports consisted of labour-intensive goods and imports of capital-intensive products.

Leontief’s study has been criticised on the methodological ground that it was basically concerned with export industries and competitive import replacements rather than actual imports. Since, Ohlin’s theorem is concerned with actual exports and imports, it is obvious that Leontief’s conclusion is inapplicable to Ohlin’s theory and so cannot disprove it.

Jones R. (1956) argues that possibly both U.S. export and import competing goods might be produced by more capital-intensive techniques than those obtained in other foreign countries. And since Ohlin’s theorem has no reversibility, one cannot say from trade patterns as to what relative factor endowments are. It is, however, advocated by Hoffmeyer (1958) that the Leontief Paradox is on account of the fact that he did not deal adequately with the national resource component of goods.

On the pattern of Leontief, Bharadwaj (1962) made an empirical study of India’s bilateral trade with U.S. He found that Indian exports consisted of capital-intensive goods to U.S. and her imports from U.S. of labour-intensive goods, which seems to be quite opposite of Ohlin’s doctrine.
Thus, these selected empirical tests appear to refute Ohlin’s theorem. But similar studies, such as those of Talemoto and Ichimura (1959) of Japan’s bilateral trade, do not entirely refute Ohlin’s theory.

In recent years several new ideas have been presented by the economists in explaining the phenomenon of international trade. Most of them are based on empirical findings.

Kravis I.B. (1970) has developed the availability theory against the comparative cost theory as a plausible explanation of international trade in certain cases. His argument is that a country exports certain scarce resources in the world because these are available with it. His argument is not very satisfactory for international trade. It only serves some purpose in explaining the exports of certain commodities like oil, minerals, etc. by some countries. But, a general pattern of world trade cannot be explained in term of this theory. The implication of Stopler-Samuelson idea is that an increase in any product price due to trade produces a proportionally greater increase in the price of factor used intensively to that good and a fall in the price of the factor used less intensively. The income gain is shared in a greater proportion by the abundant factor.

Besides the theoretical developments, mentioned above, attempts by Heckscher, Ohlin and Samuelson (1962), Rybezynski (1955), Williams (1997), Vernon (1966) and Porter (1998) are worth noting. Their contributions have opened new dimensions in international trade and made it easier to understand the mechanism which governs the trade relations amongst different nations.

This section also covers the review of those studies, which have focused their attention on the analysis of trade relations between India and other countries.

We begin our discussion with the study by Sharma P.N. (1982), which has tried to examine the impact of joining the membership of EEC by Britain on Indo-British trade relations. In particular, the study tried to assess the
establishment and enlargement of EEC from the commonwealth countries’ point of view specially that of India. For a critical appraisal, the author has considered the impact of common economic policies of enlarged European community/on their trade relations with non-member countries. Various trade agreements, which the enlarged Community has negotiated with third World countries, have been studied. For an empirical analysis, the study considered the economic impact of enlargement of the EEC on Indo-British trade in the light of EEC’s ‘Common External Tariff’ and ‘Generalised System of Preferences’.

The trends in Indo-U.K. trade in the Post-Second World War period have been examined. The study has found that during Second World War, the significance of commonwealth preferences was considerably reduced and EEC emerged as a powerful economic entity accounting for a major share of world trade. India had not been caught totally unaware by the U.K.’s decision to do away with the commonwealth preferences and adopt the tariff structure of the Community.

Elsbree Willand H. (1953) presents a detailed history as regards the events of the Second World War, which was crucial to the nationalist movement of the countries of Southeast Asia, while the story of these events is not completely clear even yet, and many conclusions still remain tentative.

Lalit Man Singh and Lahiri Delip (1997) presented agenda for the 21st century intended to provide a perspective on India’s foreign policy in the past fifty years as a protection of the challenges that lie ahead for India.

Lall Samnjaya (1980) explained the trends in manufactured export by region and by product and the comparative advantage underlying the observed pattern.

Sethuraman S. (1997) has thrown light on the radical shift from a highly regulated to an outward oriented economy. India has generated immense
interest abroad, but it has a long way to go before emerging as a strong global player.

Kapur J.C. and Harish Kapur opine that the European Union is stating to forge all round relationship with ASEAN but many among European officials perceive the economic dimension as more important than anything else.

The EU has begun to reaccess and streamline its partnership with Asia through a string of separate policy document for the ASEAN countries, for Asia as a whole and for China and Hong Kong, to name only a few. The main objective of these roadmaps encompass wide ranging economic cooperation, enhanced EU presence in Asia and renewed political and human right talks. The Union has finally realised the fact that in order to win a slice of the Asia growth cakes its approach to Asia on the whole must gain speed.

Khan Mohd Israr (2000) took a similar study to examine various dimensions of trade relationship between India and ASEAN countries. The study has also attempted to highlight the emerging issues in the post-liberalisations regime and the assessment of the impact of economic liberalisation on trade and investment between India and ASIAN. It has been shown by this study that trade between India and ASEAN got a boost-up during post liberalisation period. This was because of the improved banking services, liberalised trade policy, etc.

Chaudhary Asiya (2001) conducted a study to analyse India’s trade relations with European Union. It was hardening to note that India was flaring well in the export of textile items. They were successfully competing with the European Textile Industry which poses itself to be the producer of very high quality of goods suitable for the consumers of European market.

A study by Sarma et.al. (1997) has attempted to take note of the changes in the policy regime in India as well as those relating to the EU in its unification process and the newly emerging trading environment in the wake of the Uruguay Round agreements, and to assess the impact of these sets of forces
on Indian exports. The study has also tried to identify the areas for concerted policy initiatives to facilitate rapid Indian export growth in the EU market.

The study reveals that Indian exports are largely confined to only two member states of the EU, viz., the UK and Germany. Further, India’s exports to the EU relate to the sectors in which EU’s global imports grow the least. The study has also found that India’s export to EU has diversified. Moreover, it has been shown that a large number of commodities traded in the EU are price elastic. This calls for price competitiveness. This is possible if a proper feedback mechanism is evolved for in cooperating the overseas customers’ preferences in the latest product design.

A subsequent study was undertaken by Katti (2004) on behalf of IIFT to examine the extent to which India’s exports to the acceding countries to EU would get affected once the common external tariff of the EU comes into effect. The enlargement of the EU raises a number of issues which are important from analysis viewpoint. Thus the whole analysis under discussion was carried out in two phases- the Pre-notification phase and the notification phase (notification for the enlargement of the EU). The study has brought out that the enlargement of the EU offered several benefits for the Third World countries including India. It offered new trading opportunities for developing countries and EU as single market became favourable for these countries. The analysis of notification also reveals that the number of tariff lines, where India is going to lose the revenue due to negative movements where the MFN bound rates is likely to increase, is much smaller as compared to the tariff lines showing positive movements, i.e. where the MFN bound rates are likely to decrease once the accession takes place. This also goes in favour of India.

Rangarajan et.al. (2007) have tried to identify various challenges and opportunities that came out of the enlargement of the EU. Authors also try to evaluate impact of EU enlargement on the Indian SMEs in food processing sector. Indian food exports to the EU have been already subject to a number of
regulations. EU had rejected different types of the Indian food and ingredients on grounds that they did not meet SPS norms.

Analysis by Harshe (2007) pointed out that EU-India ties in multiple areas of development cooperation would bind vast territorial spaces, their respective immediate neighbouring regions as well as intermediary regions into cooperative ventures. Such co-operative ventures could progress well only with the formation of multilateral counter-terrorist coalition.

Recently Dutt (2007) has focused on the development of European Union and the role of Euro-Revolution. It provides a useful discussion of EU as a learning model for other trading blocks.

Besides the studies reviewed above, there are many more on the subject including Rosel (1996), Jovanovic (1997), Sundaram (1997), Mathur (1999), Endow (2003), etc. Most of the studies are diverse in their findings. With regard to India’s trade relations with EU, the studies by and large agree at the point that prospects of trade between India and EU are bright in the new trading system. However, there are many constraints which hinder free trade between these two trading partners and these constraints need to be removed in order to strengthen bilateral trade relations between India and EU.