CHAPTER 8

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In this study we have examined the role and behaviour of terms of trade of a developing economy in the context of a liberalised trade and investment regime. The study has focused on both the theoretical and empirical aspects of the problem. The theoretical part of the study examines some distinctive aspects of the role and behaviour of terms of trade in a developing economy. Taking into account the structural features of the developing economies, we have analysed the impact of improvement in terms of trade upon the wage gap between skilled and unskilled labour. Secondly, we have studied the behaviour of terms of trade of a developing economy in the presence of non-traded goods when the stock of capital, the autonomous demand for nontradeables and the autonomous demand for foreign exports change. Thirdly, using a North-South trade model, we have examined how terms of trade for the South behave when trade is liberalised. We have also seen how the movement of terms of trade for the South is associated with its stock of skilled labour and the inflow of foreign capital from the North. The empirical part of our study analyses the behaviour of the terms of trade for India over a period of thirty years (1970-71 to 2000-01). We have tried to relate the behaviour of terms of trade with the growth of the openness of the traded sector and the share of manufactures in total exports of India. In this section of the study, we have also examined whether terms of trade for India can be considered to be exogenous.
The third and the fourth chapters of this work analyse the impact of liberalised trade and investment regime upon the movement of the relative wage of the skilled vis-à-vis unskilled labour. In chapter 3 we have considered a three-sector HT model characterised by migration of unskilled labour from the rural to the urban area along with the existence of urban unemployment of the unskilled ones. The analysis shows that when terms of trade improves due to rise in the world demand for agricultural products which are produced by the unskilled workers the relative wage of unskilled section rises and the rate of urban unemployment falls. But, when terms of trade improves due to rise in the price of manufactured products, which use skilled labour as a specific factor, relative wage for the unskilled labour falls and the rate of urban unemployment rises. The results of the model remain unaltered when we extend the model by introducing disguised or open rural unemployment. Our results thus support the conventional wisdom of the Stolper-Samuelson result and the experiences of the East Asian countries.

In chapter 4 we have considered a four-sector HT model. In this model we have introduced a foreign enclave where inflow of foreign capital takes place. Foreign capital has been used as a specific factor, but in this framework, skilled labour can move freely between the sectors. We have shown that an increase in the inflow of foreign capital and improvement in terms of trade, irrespective of the source of its improvement, reduces the skilled-unskilled wage gap and the rate of urban unemployment of the unskilled labour. The mobility of the skilled labour is seen largely to be the key to ensure unambiguous results about the impact of terms of trade upon relative wage. Acharyya and Marjit (2000) have considered a full employment model to contradict the conventional wisdom
and they have shown that wage gap between the skilled and unskilled widens. But the introduction of the HT model with rural-urban migration paves the way for establishing our results.

Chapter 5 of this work has theoretically analysed the behaviour of terms of trade when it is endogenously determined. We have considered a model, which includes both traded and nontraded goods. The internal and external equilibrium are simultaneously determined and terms of trade is obtained from the trade balance condition. Any disturbance in the nontraded goods market creates disequilibrium not only in the internal balance but also in the external balance. So terms of trade changes to maintain equilibrium in the trade balance condition. The desired change in terms of trade is obtained through a change in the relative prices of the traded goods in terms of the nontraded good. The equilibrium in the market for nontraded good is achieved through a change in the supply of this good. In this model, we have studied the impact of a rise in the stock of capital upon terms of trade and we have shown that such an increase in capital stock improves the terms of trade. While Komiya (1967) has shown the impact upon terms of trade by looking at the change in the demand for imports only, we have justified this impact both from the supply and demand for exports and imports in the world market. In this chapter, we have also analysed the impact of changes in the demand for nontradeables and foreign demand for exports upon terms of trade. Interestingly, we have seen that when the development process in the developing countries increases, the demand for some nontradeables, such as roads and education, leads to an improvement in their terms of trade.
In Chapter 6 we have examined the role and behaviour of terms of trade in the framework of a North-South trade model. Our study has shown how terms of trade behaves when trade is liberalised in the South and how the movement of terms of trade influences the stock of skilled labour and the inflow of foreign capital into the South. When the skilled labour in the South is an intermediate input produced with the help of capital and unskilled labour, any change in terms of trade can influence the supply of skilled labour through its influence upon the demand for the skilled labour. When terms of trade is endogenously determined, the South could adopt suitable trade policy to manipulate its terms of trade and to mobilise funds for skill formation by attracting more foreign capital. We have seen that if terms of trade deteriorates the net rate of return on the foreign capital increases. It will then help to raise the inflow of foreign capital in the South.

Finally, we have attempted an empirical analysis in Chapter 7. We have studied the behaviour of terms of trade for India over a period of thirty years covering almost the last quarter of the 20th century. The study has been made in the light of the rise in the openness of the traded sector and the growth in the share of manufactured exports. We have estimated the trend values for different aspects of terms of trade in order to get an idea about their nature and behavioural pattern. It is seen that the trend values are low but positive for NBTT and MBTT, while it is relatively high for the ITT. We have also estimated the regression equations for different types of terms of trade on trade orientation ratio (a measure of openness) and percentage share of manufactured exports.
The estimates of the regression on share of manufactures give statistically significant results but the regression of the NBTT on TOR is not a good fit. Our results, in a sense, do not contradict P-S hypothesis since India has been able to increase her share of manufactured exports over the period of our analysis. We have also considered an exogeneity test to examine whether the 'small country assumption' is applicable to India. The study shows that the terms of trade for India is exogenous. Any empirical study about the behaviour of terms of trade for a particular developing country is very limited in literature. Sarkar and Singer (1991) have studied the movement of the manufacture-manufacture terms of trade for the developing countries as a whole and for some individual developing countries. But our study has focused on the behaviour of different aspects of terms of trade, like NBTT, ITT and MBTT, for a developing country, such as India, taking into account the degree of its trade openness and the growth of her share of manufactured exports.

To conclude, we like to mention that the results of our study are significant from the point of view of policy makers of the developing economies. Chapters 3 and 4 show that when trade liberalisation leads to improvement in terms of trade, particularly for the agricultural products in the developing economies, then the wage gap between the skilled and unskilled labour and the rate of urban unemployment will fall. Chapter 5, however, shows that terms of trade may improve in the presence of nontraded goods when stock of capital, demand for nontradeables and foreign demand for exports rise. Chapter 6 shows that developing economies could be able to increase the stock of skilled labour and inflow of foreign capital when terms of trade deteriorates due to liberalisation of imports.
In Chapter 7, we see that terms of trade for India improves over time when degree of trade openness and share of manufactured exports also rise. So, from our study it follows that increased liberalisation of the traded sector added with greater emphasis upon manufactured exports is certainly welcome as far as the improvement in terms of trade is concerned.