

The trade theory



Neoclassical Trade Theory

The classical theory is limited in their analysis by the labor theory of value and the assumption of constant costs. The neoclassical trade theory provides tools of analysis and studies the impact of trade in a more rigorous and less restrictive manner. The application of neoclassical theory and later refinements of these ideas constitute the basis of modern theory of international trade.

The principal changes in trade theory since Ricardo's time have centered on a fuller development of the demand side of analysis and on the production side of the economy that does not rely on the labor theory of value.

Most neoclassical trade theories assume that the world only has two countries (which means that country A's exports must be country B's imports). They also usually assume only two commodities in international trade. One of the most important, and limiting, assumptions in neoclassical trade theory is that firms produce under conditions of perfect competition. Any industry that is controlled by a small number of firms is not perfectly competitive.

Neoclassical trade theory offers two main perspectives on how trade liberalization will affect the interests-and hence the preferences-of various groups. One perspective, informed by the Heckscher-Ohlin and Stolper-Samuelson theorems, asserts that interests and preferences are determined at the factorial level. Whether the model uses two factors (Stolper and Samuelson 1941), three factors (Rogowski 1989), or more factors (Leamer 1985; Midford 1993), the underlying logic remains the same. Trade

liberalization will increase the income of owners of abundant factors and decrease that of scarce factors;. conversely, trade barriers will hurt abundant-factor owners and help scarce-factor owners. Assuming that preferences reflect factorial interests, factorial models provide a parsimonious explanation for different groups' trade-policy preferences based on their countries' relative factor endowments.

The second main approach to explaining trade policy preferences locates interests and preferences at the level of the sector. Proponents of sectoral models (Frieden 1991; Gilligan 1997; Grossman and Helpman 1994; Magee, Brock and Young 1989; Milner 1988, to name just a few) make two main objections to factorial models. First, factorial models assume perfect factor mobility between different sectors. If, however, factors are "specific" to particular sectors, then their interests are effectively tied to the fate of that sector. In that case we would expect trade policy preferences to reflect the competitiveness of different sectors: exporting industries should lobby for free trade and import-competing industries for protection. The second point made in support of sectoral models is based on the logic of collective action. (Olson 1965) Political action, whether in support of free trade or protection, requires that political actors first overcome collective-action problems. This is generally assumed to be easier for small groups whose members derive concentrated benefits from collective action. Since sectors are smaller than factors, and the benefits to them more concentrated, collective action should be easier for sectors than for factors. Trade policies should therefore reflect sectoral rather than factorial preferences.

Known also as the neoliberal theory, neoclassical economics asserts that free movement of goods (free trade), services, and capital unimpeded by government regulation will lead to rapid economic growth. This, in the neoclassical view, will increase global output and international efficiency because the gains from division of labor according to comparative advantage and specialization will improve overall welfare. Even modern trade models (such as the Hecksche-Ohlin) are based on the neoclassical trade theory, which assumes perfect competition and concludes that trade generally improves welfare by improving the allocation of factors of production across sectors of the economy.

Problems with neo-classical trade theory

Some of the assumptions in the models are not realistic, the world does not have perfect competition, identical preferences, constant returns to scale. Empirical findings have contradicted the predictions of the models , lots of trade between similar countries, large amounts of intra-industry trade (exports and imports of the same goods)

The Structuralist School: State-Led Development Was Key

what the structuralists argue

The structuralisms focus on the mechanism by which “ underdeveloped” economies transform their domestic economies from a traditional subsistence agricultural base into a modern economy. They measured development by the number of economic sectors using the most advanced levels of technology. The goal was to have an economy in which the total

output would be divided equally among all of the country's economic sectors.

In addressing the cause of underdevelopment, structuralism economists focused on the evolution of economic relationships between developed countries and the rest of the world. Developing countries were brought into the international economy to serve two purposes: (i) to supply cheap raw material and (ii) to purchase finished manufactured goods from industrialized economies. This gave rise to "enclave" economies in developing countries that expanded the primary product export sector at the expense of the industrial sector.

The structural relationships in the international economies led to a dual economic structure in developing countries, where a modern economy (the export sector) coexisted with a backward and undeveloped one. The modern sector was maintained not through internal innovations and advancement but by purchasing new technology from the developed countries. As long as dualism persisted, autonomous economic development would be impossible; that is, growth would be dependent on the industrial countries.

Structuralists argued that economic growth had to stem from internal demands. The structuralists argued that the structural changes needed to bring about economic development could only be achieved by state intervention. For example, government-imposed tariffs on imports were designed to stimulate the internal market by protecting new industries within the country. A tariff was viewed as a way to even the playing field between a manufacturer in an industrialized country and one in a developing nation.

The former tended to have better access to capital and technology as well as

a more productive workforce. These factors enabled manufacturers in industrialized countries to produce a given product faster and cheaper than “infant industries” in developing countries.

The Structural Transformation of the Economy Could Only be Achieved Through Government Intervention

A tariff is a tax that the government of the importing country places on imported products. The tax is designed to make the imported product more expensive than the domestic product, thereby making the latter more attractive to the consumer of the product because it is cheaper. In theory, the structuralists thought tariffs could be lowered or eliminated when the domestic industry had reached the level of development that enabled it to compete without the government-imposed protection.

Another important component of the structuralism approach was state-owned enterprises. The structuralists believed that, given the underdeveloped capital markets in developing countries, only the state could generate and manage the sizeable investments needed to industrialize. Other policies that were recommended were fiscal (taxes and government spending) and monetary (money supply and interest rates) in nature.

In sum, all of these policies, known collectively as “import-substitution,” were geared at encouraging the country to industrialize. Thus, the structuralists accepted the notion that development was to be achieved through capitalism. But they were not convinced that the market alone could achieve the type of thriving capitalism that industrialized countries were

enjoying. Governments of developing countries had to actively promote industrialization through government regulation of the economy.

The Structuralism Policies Enjoyed Limited Success.

While the Structuralism made significant contributions to our knowledge of the process of development, their prescriptions were not successful in many cases. Countries that adopted the import-substitution model of development began to notice in the 1960s that government-led initiatives to industrialize could not effectively create the most important phase of industrialization relating to heavy machinery and plant installation. Moreover, the heavy involvement of the state in the market created inefficiencies that eventually caused major internal and external economic problems. And the drive to industrialize led, ironically, to increased dualism in developing countries as the gap between the rich and the poor widened.

We Need to Examine the Assumptions

Economic theory is built on assumptions about human behavior-assumptions which are embodied in rational choice theory. Underlying those assumptions are implicit notions about how the mind works. Until recently economists have not self-consciously examined those implicit notions but recent work in economics and particularly game theory has forced economists to explore the sources of the beliefs that underlie economic choices and therefore to build a bridge between cognitive science and economics. In this essay I explore the path of economic reasoning that leads to cognitive science.

The Assumption about the Markets

The neo-classical approach to analyzing the performance of an economy assumes that in the face of pervasive scarcity individuals make choices reflecting a set of desires, wants or preferences. Neoclassical theory is constructed by aggregating those preferences in the context of fixed resources, private goods, and given technology. The result has been a powerful set of tools to analyze resource allocation at a moment of time in developed economies under the assumption that the markets being modeled are governed by impersonal forces of supply and demand. The competitive model of neo-classical theory enshrined in general equilibrium theory makes a major contribution to economic understanding by demonstrating that a decentralized system of market forces would generate an efficient system of resource allocation. In this framework beliefs played no role in decision making.

But valuable as the neoclassical approach has been for the development of an elegant body of theory, it is a very imperfect tool for solving economic problems either at a moment of time or particularly over time. Both information and the enforcement of agreements are imperfect, leading to transaction costs. Further markets are the creature of political forces. In the real world of imperfectly competitive markets, beliefs determine the choices of the actors. Their motivation is derived from their private information and expectations about price movements. Moreover since some goods and services are public-not only the traditional ones of national defense and public security, but in particular property rights and the rule of law-they are traditionally created through the political system, which entails not only knowledge about the preferences for such goods but the incentives to

produce them, given peoples beliefs about others' willingness to pay for them. Preference based models of either markets or elections are relatively simple. Beliefs, on the other hand, are anything but simple because they involve some description of how people learn, how they update theories, and how they model the world they live in. And it is modeling beliefs that is at the heart of all theorizing in the social sciences.

The Assumption about the Preference

Neoclassical theory assumes that preferences are stable and that choices are made within a framework of constraints. The constraints include those imposed by income and technology but not those imposed by the institutions of a society. The reason for their absence is that the chooser is assumed to have perfect information and therefore certainty about alternatives. Agents in such a setting know what is in their self-interest, act in their self-interest, and are able to perform the calculations necessary to discriminate amongst alternative decisions. In such a world institutions are unnecessary.

Institutions exist to structure human interaction in a world of uncertainty, or, as Ronald Heine put it in a article of fundamental importance, " The Origins of Predictable Behavior" (1983), they arise from the effort of individuals in the face of pervasive uncertainty to reduce that uncertainty by limiting the choices available to the players and thereby making behavior predictable. Without institutions there would be no order, no society, no economy, and no polity. Therefore the construction of an institutional framework has been an essential building block of civilization.

Once we recognize this fundamental role of institutions in reducing uncertainty we must restructure the theoretical framework we use in economics and the other social sciences. Institutions not only provide the incentive structure of a society at a moment of time and therefore constrain the choice set, but also they are the carriers of the process of change. Therefore whether we are modeling economic performance at a moment of time or over time, institutions are central to the theoretical construct. But what are institutions and where do they come from?

Debates about the gains from trade: The trade optimists and the trade pessimists

The trade optimist and trade pessimist arguments are presented, and are a good summary of the major issues discussed in the chapter with respect to inward versus outward oriented trade strategies. Trade pessimists focus on the limited growth of world demand for primary exports, the deterioration in the terms of trade for many LDCs specializing in the production of primary products for export, and the rise of protectionism within the developed countries. The trade optimists focus on economic efficiency arguments such as promoting competition, getting prices right, improving resource allocation, and achieving economies of scale. The text concludes that neither argument is superior for every period in history, but rather that it depends on world economic conditions at any particular time.

I have to admit, when it comes to the gains from trade, I am somewhat of an optimist. I wouldn't go as far to say that I am what some have termed a

trade “cheerleader,” but in many instances it seems that there are welfare and efficiency gains to be realized from increased trade.

One thing that has always interested me, is how the trade optimists, and pessimists debate the benefits of trade. It seems that the optimists primarily rely on economic reasoning while the pessimists are concerned with political arguments against trade. The arguments against trade are usually rooted in interest group politics and are hard for politicians to ignore, especially during election time.

The problem is that, for the most part, these two camps seem to be talking past each other. Debates surrounding the benefits and drawbacks of trade are rarely settled and if anything lead to further disagreement. What this all seems to point to, and perhaps illuminates an area for an interesting research agenda, is the fact that although we often like to separate the spheres of economics and politics, they are intimately intertwined. Populist discourse dominates debates surrounding international trade which often precludes meaningful discussion on the topic.

At the end of the day, I think we need to remember that trade is ultimately a political instrument, wielded to secure particular interests. Much more attention needs to be devoted to understanding how trade is used as a political tool. Viewing this topic from the standpoint of politics or economics will rarely lead us to meaningful outcomes. One only needs to look at the current impasse at the Doha round to see this.

Perhaps I have the benefit of studying in an interdisciplinary program but it would be interesting to see the political science people and economists

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working much more closely on these issues. Rhetoric surrounding international trade needs to be deconstructed and evaluated in an empirical manner to reenter these debates in a way that will lead us to constructing much better policy in the future.