



The link between trade and growth: Some questionable assumptions

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Received: 9th January, 2023 *Accepted:* 15th February, 2023, *Published:* 01st March, 2023

ABSTRACT: It is often assumed that trade would definitely boost economic growth in a country. But the fact is that this seemingly natural correlation may not hold in reality. The paper presents various assumptions that trade models assume but they may not hold good in real world.

KEYWORDS: Trade, growth, assumptions of trade models

1. INTRODUCTION

The link between trade and growth has been the centre of an ongoing debate. The paper aims to highlight that the link between trade and development is not as natural as assumed. On the contrary, assuming that trade does not lead to growth at all is all the more spurious. What is advised is that a proper cost-benefit analysis must be done instead of relying on assumptions of trade models which break down in reality. Moreover, models with realistic assumptions could be developed.

2. TRADITIONAL THEORY OF TRADE

There are certain assumptions made in traditional theory of trade which may not hold in reality. To begin with, theory suggests that both countries benefit by specializing in products in which each has comparative advantage as consumption possibilities of both countries increase. But as pointed by Smith and Toye (1979), here a strong assumption is made that “resources are fully mobile within a country and completely immobile between countries” (Smith and Toye, 1979, p. 3) which may not always hold in reality.

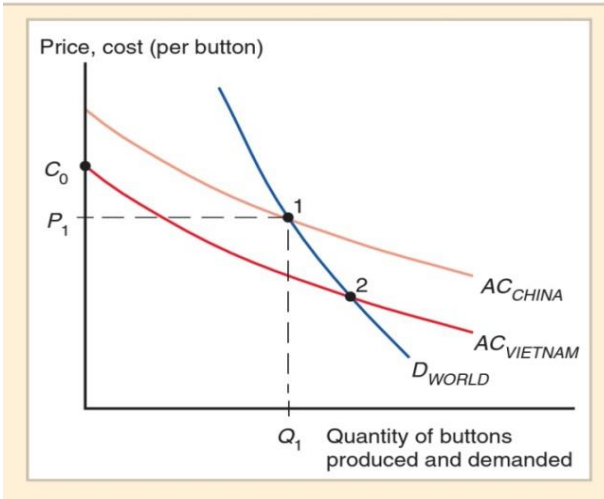
According to Lin and Chang (2009) one of the assumptions of the Heckscher-Ohlin-Samuelson theory is perfect factor mobility, i.e., resources employed by industry shutting down will be reemployed in another industry, but it is known that factors of production are fixed in real world, also workers not always have the skills required to work in other industries.

The other assumption pointed by Chang is, ‘There exists only a single best technology for producing a particular product and also all countries have the same ability capability to use it’ (Lin and Chang, 2009), which also doesn’t hold in reality.

A model suggested by Rodriguez and Rodrik which is a version of that in Matsuyama (1992) concludes that tariff actually impose a distortion in production side in allocation of resources of economy (Rodríguez & Rodrik, 2001). Hence, tariffs have ambiguous effects on growth.

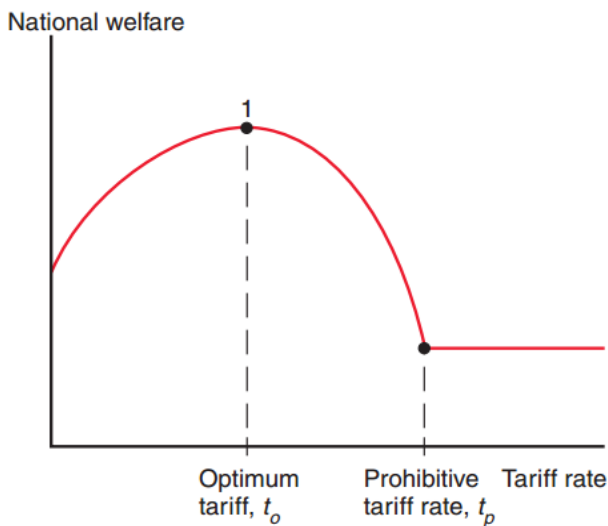
Krugman et al. (2012) present some theoretical models which show how protection can be beneficial for a country. Here a case of external economies is presented in two countries—China and Vietnam. Since there are external economies and no economies of scale at the level of firms, each country consists of small perfectly competitive firms, so $P=AC$. Vietnamese cost curve is below Chinese curve. Suppose the China establishes them in the industry first, then world equilibrium would be at point 1, with Chinese production as Q_1 and prices at P_1 . If the Vietnam allowed no trade then it would produce at point 2 which is lower than P_1 . Hence, no trade is beneficial for the Vietnam.





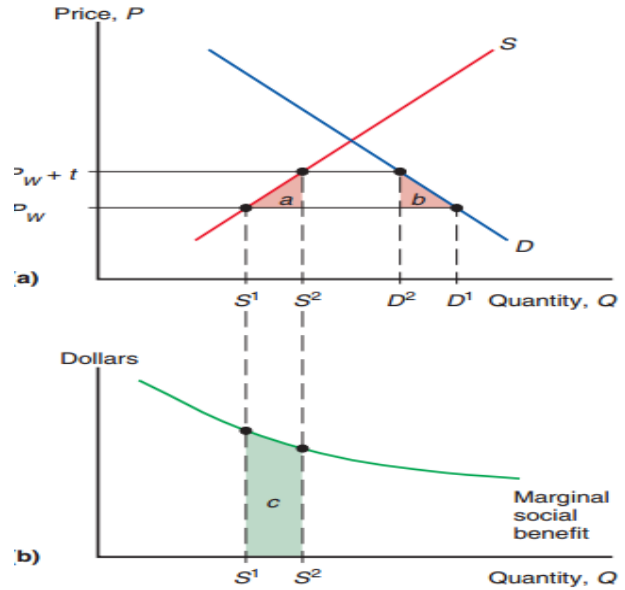
Source: Krugman et al., 2012, p. 146

The traditional argument is that protection reduces national welfare but this may be reversed when we have small tariff, and welfare may turn out to be even greater than with trade. In Figure 2 it is observed that, t_p is the optimal tariff which maximizes national welfare. (Krugman et al. , 2012)



Source: Krugman et al., 2012, p. 225

Third case explores the fact that there may be Marginal social benefit from additional production of some product which may not be taken into account in production decisions. Because of a tariff, domestic price increases from P_w to P_w+t , production increases from s^1 to s^2 , a is production distortion and b is consumption distortion. Considering only the consumer and production surplus, cost of tariff is greater than the benefits but if additional social benefit (c) is considered, then benefits are greater than costs (Krugman et al. ,2012).



Source: Krugman et al., 2012, p.227

Hence, even theoretically it can't be concluded that definitely under all circumstances trade will lead to growth.

3. TRADE LIBERALIZATION

This section analyses the case of trade liberalization for developing countries which face substantial costs in the process of liberalization and the process is often painful, contributing very little to growth or sometimes resulting in losses also. The empirical evidence doesn't support unconditionally international financial institutions' claim that trade would lead to growth. Baker and Weisbrot (2003) claim that costs are associated with trade liberalization in the developing countries.

According to the estimates of the World Bank, the removal of rich countries' barriers to the merchandise exports of developing countries would add only 0.6% to the GDP of Low and Middle Income countries. Models show that developing countries may lose from trade liberalization in agriculture as suggested by Baker and Weisbrot (2003).

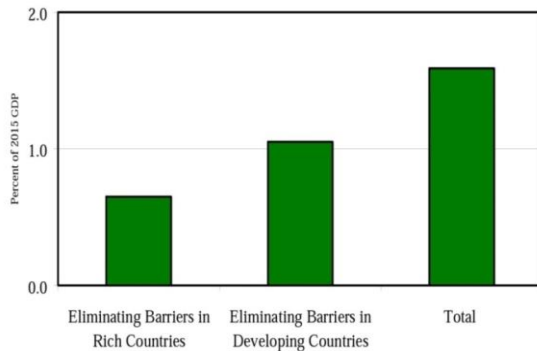
Figure 4 shows BDS estimates of annual losses due to Uruguay Round of Trade Liberalization in Agriculture. They observe that projected losses for the Philippines and Indonesia are equal to 1.1% and 1% of GDP, respectively (Baker and Weisbrot, 2003).



Source: Brown, Deadorff & Stem ,2001 as cited by Baker and Weisbrot, 2003, p.25

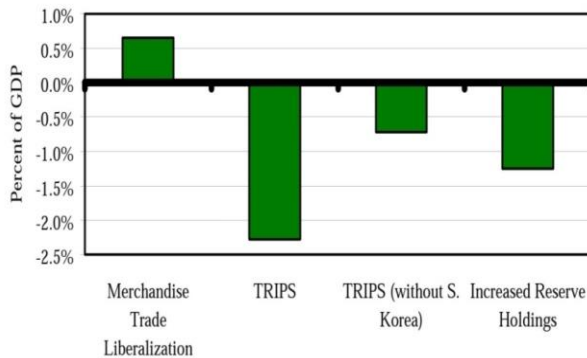
Figure 5 shows the gains to developing countries projected from reduction of trade barriers in industrialized countries, with gains from removing their own barriers. They observe that gains from removing their own barriers are larger. Because tariffs make 10-20% of revenue in developing countries they are reluctant to follow liberalization. If they do so they'll have to rely on inefficient taxes also the adjustment process of reemployment is painful. (Baker and Weisbrot, 2003)

Gains to Developing Countries from Reduction of Trade Barriers



Source: Baker and Weisbrot, 2003, p.27

Change in GDP, Developing Countries, 2015 as a result of various policies



Source: World Bank 2002 and Baker and Weisbrot's calculation, as cited in Baker and Weisbrot, 2003, p. 50

4. DISCUSSION

As Lin and Chang (2009) had already highlighted that the assumption of perfect factor mobility of the Heckscher-Ohlin-Samuelson theory is not true in reality. According to me, every human is gifted with particular set of skills which I call "*inherent unique gift of skills*". An academician has very different set of skills when compared to an engineer. It is very unreasonable to assume that there is no uniqueness in skills of a person. Moreover, assuming that people get employed even when they are a mismatch for a particular kind of work is all the more unreasonable. The trade models assume what I call "*impersonal skills*" exist in workers. Moreover, assuming that people get employed even when they are a mismatch for a particular kind of work is all the more unreasonable. Firms are very particular about the skill set of their workers. Some set of skills is really unique and not everyone could be employed for a particular job. The paper concludes that the assertion that trade leads to growth

cannot be taken as a logical conclusion without caveats especially for developing countries. Many factors like political economy of trade, world economic position of countries, structural constraints of countries become important. The experiences of a few countries can't be generalized. Developing countries face different problems and need special attention. On the contrary, assuming that trade does not lead to growth at all is all the more spurious. What is advised is that a proper cost-benefit analysis must be done instead of relying on assumptions of traditional trade models which break down in reality. Moreover, models with realistic assumptions could be developed.

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