

Benefits from trade and development

Discuss how the promotion of specialisation and international trade might assist the development of developing economies

The promotion of specialisation, and in turn trade will bring about benefits from trade in the form of profits and/or increased consumption within the economy participating in trade. These supernormal profits, which can continue to be made in the long run due to a lower opportunity cost of production in economies with a comparative advantage, can be used for a number of purposes.

Within the economy these profits can be invested in skills training the labour force or invested in capital goods, often imported from more developed nations. The increased consumption in the economy also benefits consumers and combined with the extra output created to fuel the export market will lead to an increase in GDP.

The real increase of GDP will help create self-fuelling growth, part of the 'take-off' stage of Walt Rostow's development theory. Unemployment is also likely to decrease as demand for labour will increase to create the extra output in the economy.

Increased incomes in the economy mean that individuals will have some disposable income and the choice of saving, not needing all their income for their immediate survival. Market systems for savings should then develop and lead to improved economic growth, as the savings ratio is a key aspect of the Harrod-Domar theory, explaining how economic growth comes about.

An economy open to trade is also attractive to multi-national companies considering investment as costs of production in developing economies are generally lower than in developed economies due to lower wage rates. Whilst the poor infrastructure may act as a deterrent to development the initial costs of setting up may be compensated for in the cheaper labour and costs of production in the long run.

Inward investment combined with the gains from trade above will cause multiplier effects, where income is spent and re-injected into the economy meaning the gains from an increase in exports are likely to have a greater effect on final GDP and development than just the size of the initial increase in exports or investment. Due to the high proportion of income consumed and the low savings ratio the multiplier effect could be relatively high in an economy, though this is offset by the spending on imported goods from outside the economy.

However, the benefits of trade can be limited by a number of factors stopping the ideas outlined above from functioning as the theory suggests. Many developing economies currently have large debts on which they must service repayments, slowing down reducing investment of profits where finances are most scarce.

The extra consumption may come with a poor equity distribution. Either a few individuals will gain most from the additional consumption or the increased consumption will fall primarily in urban areas, and as equity can be used as a definition of development the profits from trade may not help to improve development in rural areas.

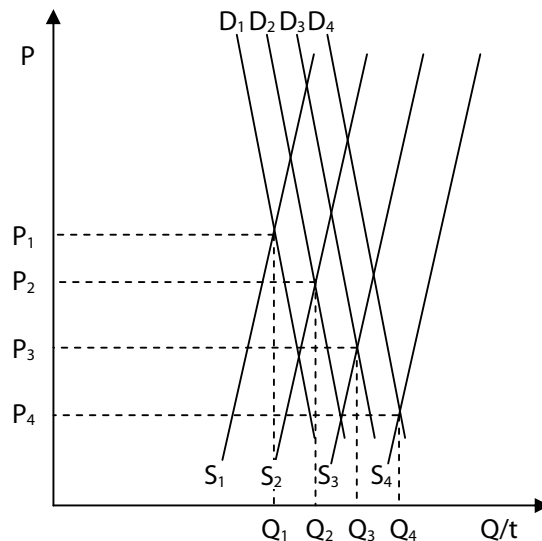
The nature of the extra output in which the economy has an absolute, or more likely a comparative, advantage may not be a labour intensive process (though it is likely to be due to the nature of resources in developing economies) and may involve dangerous working conditions, demerit goods or those with negative externalities. The output may

focus on the production of consumer goods for current consumption when the developing economies require investment for future growth.

As mentioned earlier savings and their efficient allocation are crucial to self-fuelling growth, but in many developing economies the markets to direct this capital do not exist, certainly not in rural areas. This means that due to information failures and infant markets investment is not likely to be allocatively efficient, and will not utilise the maximum potential savings of consumers in the economy.

Whilst there are large benefits to be gained from trade specialisation can make an economy very reliant on particular goods. Generally in developing economies this reliance is on primary sector industries, often a particular raw material. In the short run prices are volatile, and in the long run decrease.

Demand and supply of raw materials are very inelastic due to the time taken for production and future prospects either from stock market speculation or the business cycle are likely to impact demand. Due to the inelasticity of both supply and demand a small movement in one of the curves will cause a proportionally large change in the price with respect to the change in output.



In the long run demand for raw materials increases as incomes increase, but due to the low income elasticity of demand, the responsiveness of demand to a change in income, this increase is small, causing a shift over time from D_1 through D_2 and D_3 to D_4 .

New technology and improvements in efficiency cause a greater shift in supply over time from S_1 through S_2 and S_3 to S_4 . This causes the equilibrium output to increase by a small amount, from Q_1 to Q_2, Q_3 and then to Q_4 . Due to the inelastic supply and demand curves the change in price is much greater from P_1 down to P_4 .

To conclude, overall development is aided by trade and no economy has achieved development without international trade. However economies need to avoid the problems of over-specialisation by specialising in a range of sectors, with less focus on the primary sector industries. This is very ambitious, perhaps unrealistic for developing economies. Investment in infrastructure may help attract foreign direct investment to widen the base of specialisation within an economy.