

Quadrant II – Transcript and Related Materials

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Module Name: Prebisch-Singer Thesis

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Notes

In this module we are discussing a Prebisch-Singer Thesis. On the basis of export statistics concerning the United Kingdom between 1870 and 1940, Raul Prebisch demonstrated that the terms of trade had secular tendency to move against the primary products and in favour of the manufactured and capital goods. This viewpoint has been strongly supported by H.W. Singer. The essence of Prebisch-Singer thesis is that the peripheral or LDC's had to export largest amount of their primary products in order to import manufactured goods from the industrially advanced countries. The deterioration of term of trade has been a major inhibitory factor in the growth of the LDC's.

The industrialist countries have maintained a monopoly control over the production of industrial goods. Therefore it manipulates the prices of manufactured goods in their favour and against the interest of the LDC's. Thus, the term of trade remains unfavourable to developing countries. Singer has proved that, the recent increase in debt problem of the LDC's has imparted the hypothesis of secular deterioration of Terms of Trade for them in two ways: Firstly, a high proportion of proceeds from exports are not available for imports. Secondly, there is an increased pressure upon the LDC's to raise exports in order to repay external debts on account of IMF induced adjustment policies.

These pressures make the debt ridden LDC's to compete with other poor countries to enlarge their export earnings. It results in decline in the prices of export products of these countries.

Assumption:

This thesis is based on certain assumptions:

1. As income rises in the advanced countries, the pattern of demand shifts from primary products to the manufactured products due to Engel's law.
2. The slow rise in demand for primary products in the developed countries.
3. The export market for products of LDC's is competitive in nature .
4. The export market for products of developed countries is monopolistic in nature.
5. Wages and prices are low in LDC's.
6. The appearance of substitutes for products of LDC's leads to fall in demand.
7. The benefit of increased productivity is not passed by the producers of manufactured products in advanced countries to the LDC's through lower prices.
8. The economic growth in the LDC's is indicated by income terms of trade.

Reasons for secular Deterioration of terms of Trade

The secular deterioration in the term of trade of the developing countries has occurred on account of the following reasons :

- I. **Absence of qualitative improvement of products:** According to Raul Prebisch, the principal reason for the lower prices of primary products relatives to those of manufactured goods is that the LDC's continue to produce and export goods like coal, iron ore, tea, coffee, copper, rice sugar etc. The quality of those products has remained roughly the same as fifty year back. In contrast, there has been tremendous improvement

in the quality of manufactured goods almost in every industry. Consequently, the demand for the every industry. Consequently, the demand for the latter has maintained a strong upward trend and their prices relative to the prices of primary products have remained high. This argument has, however, been refuted by the writers like Lipsey, J. Viner and H.G. Johnson on the ground that the empirical evidence has not supported it.

- II. **Distribution of gains from technical progress :** in the opinion of H.W. Singer, the secular deterioration in the terms of trade in the LDC's can be attributed to the fact that the gains from technical progress in the developing countries have been passed on to the consumers in the advanced countries through export of primary products at lower prices. In contrast, the gain from technical progress in the latter has been retained by the producers themselves in the form of higher incomes. Singer could not provide proper explanation for this phenomenon. A.M. McLeod has pointed out that the less developed countries are relatively less organised. They compete among themselves for the limited primary products and give away the gains from increased productivity, in a substantial measure, to the developed countries through lower prices. On the opposite, the advanced countries exercise a greater degree of monopolistic control. The emergence of regional economic groupings among the advanced countries has also contributed in their retention with themselves the gains from increased productivity.
- III. **Immiserizing growth:** The worsening of the international terms of trade in the case of less developed countries may be on account of the process of "immiserizing growth" explained by Jagdish Bhagwati. The excessive emphasis on ultra export biased growth and the lack of complementary resources for the expansion of import competing industries tend to lower not only the consumption equilibrium but also cause the deterioration in the terms of trade.
- IV. **Low income elasticity of demand:** The deterioration in the terms of trade of the LDC's can be explained also in terms of Engel's law. There is predominance of the production of food crops in these countries. As the

production of food crops in predominance of the production of food crops in these countries. As the income elasticity of demand is low, the aggregate expenditure as the proportion of national income incurred on the agricultural products falls relative to the proportion of spending on manufactured goods. This results in large exportable surplus which is disposed of in the foreign markets at relatively lower prices. The increasing demand for manufactured goods results in more imports of such products at relatively higher prices, consequently the terms of trade remain unfavourable for the developing countries.

- V. **Impact of import on the import competing industries:** The worsening of the terms of trade for the LDC's has resulted also from the destructive effect of foreign imports upon the indigenous import competing industries. For instance, the competition from cheap mill made cloth from Britain in the 19th century caused the decline of India handicrafts. As the surplus labour fell back on agriculture, the exports of primary products increased. The excessive dependence on export of primary goods as a source of income depressed the prices of these products relative to the prices of manufactured imported goods.
- VI. **Large Surpluses of farm products:** the advanced countries have large surpluses of farm products such as food grains, cotton, oilseeds and dairy products. These products are transferred on a large scale to the scarcity ridden countries of Asia and Africa. It has a depressing effect on the international prices of agricultural products. As a consequence, the terms of trade remain persistently unfavourable for the developing countries.
- VII. **Shortage of intermediate goods:** S.B. Linder has attributed the adverse terms of trade in LDC's to the shortage of intermediate goods. As a result of lesser availability of intermediate products, the process of diversification and transformation remains hindered in these countries. In view of the increased pressure of demand for such products to push to push ahead the process of expansion, the imports of such products have to be made at relatively higher prices. The higher import prices relative to export prices make the term of trade unfavourable for these countries.

- VIII. **Impact of foreign investment** : According to Singer, the opening of the economies of LDC's to trade and foreign investment has resulted in the cumulative multiplier effect upon the economies of advanced countries in the form of large scale expansion of exports of intermediate and producer goods and heavy remittances of profits from these investments. The foreign direct investment in LDC's have been directed to plantation industries and mining sector and have not contributed in the growth of manufacturing industries. Apart from depressing the overall growth process, they have reinforced the secular deterioration of the terms of trade of the LDC's.
- IX. **Growth of synthetic products** : The technological developments in both advanced and LDC's have resulted in the production synthetic rubber, artificial silk, rayon, plastic production etc. That has hit hard the production of traditional items of exports of the LDC's. As the prices traditional exports have declined relative to import of manufactured goods, the terms of trade have turned against the LDC's.
- X. **Regional economic groupings**: The growth of regional economic grouping among the advanced countries such as the European Union has promoted trade among themselves. As a result the growth of exports of LDC's has slowed down worsening their terms of trade.
- XI. **Protectionist policies**: As some of the developing countries have started developing the industries, the advanced countries have adopted the protectionist policies. They have raised tariff against the manufactured products of the developing countries. Consequently, the terms of trade has turned against the developing countries.

Criticism of Prebisch-Singer Thesis

The Prebisch-Singer Thesis has come too criticized on several grounds:

- a) **Not firm basis for inference**: The inference of secular deterioration of terms of trade for the LDC's rests upon the exports of primary vis-a-vis manufactured products. In the regards, it should be remembered that the LDC's export wide variety of primary products. Sometimes

they export also certain manufactured products. They at the same time do not import only manufactured products but also a number of primary products. It is, therefore, not proper to draw a firm inference about terms of trade just on the basis of primary versus manufactured exports.

- b) Faulty index of TOT:** The prebisch Singer hypothesis rests upon the index, which is the inverse of the British community terms of trade. This index overlooks the qualitative changes in products, appearance of new varieties of products, services like transport etc. The generalisation based on British terms of trade for the period 1870 to 1930, according to kindleberger, is not true for the other developed countries of Europe.
- c) Neglect of supply conditions:** In the determination of terms of trade, the prebisch Singer thesis considers only demand conditions. The supply conditions, which are likely to change significantly over time, have been neglected. The relative prices, in fact, depend not upon the demand conditions but also on the supply conditions.
- d) Inapplicability of Engel's Law:** The secular decline in the demand for primary products in developed countries was attributed to Engel's Law. But this is not true because this law is applicable to food and not to the raw materials, which constitute sizeable proportional of exports from the LDC's.
- e) Benefits from foreign investment:** The deterioration of the terms of trade for the LDC's is sometimes linked not to non transmission of productivity gains to them by advanced countries through lower prices of manufactured goods, yet the benefits from foreign investment have percolated to the LCD's through the product diversification. These benefits can amply offset any adverse effects of foreign investment upon terms of trade and the process of growth.
- f) Difficult to assess variation in demand for primary products:** The secular deterioration in terms of trade of the LDC's during 1870 to 1930 period was supposed to be on account of the declining world demand for primary products. During that period, there were tremendous changes in world population. Production techniques. Living standards and means of transport. Given those extensive

developments, it is extremely difficult to assess precisely the changes in world demand for primary products and the impact of those changes upon the terms of trade

- g) Export instability and price variations:** The Prebisch Singer thesis suggested that export instability in the LDC's was basically due variations in prices of primary products relative those of manufactured products. Mc Bean, on contrary, held that the export instability in the countries could be on account of quantity variation rather than the price variations.
- h) Development of export sector not an expense of domestic sector:** In this thesis, contended that foreign investment in poor countries no doubt, enlarged the export sector but it the expenses of the growth of domestic sector. Contention is, however, not always true being the foreign investments have not always cross out the domestic investment. If foreign investment have helped exclusively the growth of export even that should be treated as acceptable be some growth is better than no growth. It fetched to relate worsening of term of trade non growth of domestic sector.
- i) Faulty policy prescription:** Prebisch prescribed the adoption of protectionist by LDC's to offset the worsening terms of any gain from tariff or non tariff restriction imports from advanced countries can at only short lived because they will retaliatory actions from them causing still injury to the LDC's. in the present WTO of dismantling to trade restrictions suggestion is practically not possible to import they should be rather greater recourse promotion, import substitution, favorable agreement and adoption of appropriate and fiscal action for improving the terms in the developing countries.
- j) Lack of empirical support:** the made by Morgan Ellsworth, Haberler, Kin are perilously close to the debt trap, where fresh borrowing have to be obtained for off setting the debt servicing, obligations no satisfactory multilateral debt relief arrangement has so far been evolved because of inflexible attitude of the advanced countries.
- k) Adverse effect on growth:** The persistent BOP deficits decline in the capacity to import, mounting external debt and increasing restrictions on the inflow of capital in the wake of deteriorating terms

of trade have serious depressing effect upon the growth process in the developing countries.