



TRADE AND POVERTY: ANY HELP FROM THEORY?

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Opinion Paper



Poverty influences foreign trade and vice-versa. This will be my main argument in this paper. However, this statement depends on the theory that is being used. Every approach to poverty found in trade theories is based on relative poverty because the variables that are being compared are from different companies, sectors or countries. Our questions problematize the relationship between trade and poverty: what influence does poverty have in determining who is able to trade and who is not? And what kind of trade relations might contribute to an increase in poverty?

Two different issues arise: one is that the impact of poverty on unit costs may contribute to the participation in trade and the other is that existing trade influences changes in poverty and competitiveness. Some of the competitors, for example, may be expelled from the field. Trade is not a once-and-for-all conquest. Different issues, usually imply diverse theoretical approaches.

In order to focus on the problem of poverty, it will help to specify the meaning of unit costs. An empirically sound approach would be to suppose that the variation of unit labour costs is a good approximation to the variation of total unit costs. In all theoretical approaches, the unit cost of the product is the result of a simple operation: the unit price of labour divided by the productivity of labour.

In real life, this means that lower wages and higher productivity increase competitiveness. The levels of these variables in different countries determine the pattern of trade; and as long as the unit cost of labour is related to the wage rate, we can claim that poverty influences competitiveness, and the existence of trade.

To trade is to compete, hence the need for a theory of competition. To begin with, we must ask ourselves if there is any clear theoretical relation between competition and poverty. As it is widely known, trade theories can be divided into two categories that are not mutually exclusive, but are clearly different.

Beginning with Adam Smith, the theory of absolute or competitive cost advantages characterizes itself by emphasizing the differences between the total unit costs of products *in the same international market*. If two agents compete in a certain market, for instance, in the selling of corn, the one with the lowest unit cost will sell, while the other will have to adapt or disappear. The prevalence of this basic rule does not depend much on whether trade occurs at the domestic or international level. If the market is opened, one will win and the other will lose.

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By contrast, Ricardo's perspective on the theory of comparative cost advantages emphasizes the comparison not of absolute costs for, let us say, two countries but of the two relative unit costs *in the production of different goods within each country*. According to this approach, the relative cost of producing corn and bicycles within each country would be the initial relevant point of comparison. Indeed, in its simplest form, the comparative advantage can be seen as the comparison of two competitive advantages. It is a derivative notion.

Let us move to the second analytical stage on the story of trade. In the absolute advantage approach, the loser in pure trade competition will have to abandon the field and unemployment will grow. If in spite of that the country wants to consume the imported good, it will have to use its reserves or get in debt. Actually, this is what happens to many developing countries. In this approach, trade deficits can be prolonged, and interest rates will increase and be higher in the countries running a deficit, compared to those of the surplus countries, as they usually are because countries with a deficit need to pay more in order to obtain the private financing needed not to lose all reserves. And if debt is not used to create new, productive, and competitive activities, this will also contribute to increase the deficit. In other words, trade deficits may increase poverty.

On the contrary, in the comparative advantage approach, there cannot be persistent trade deficits because a great flexibility of prices is assumed. Therefore, there is no long term indebtedness. The originally deficit-running country will have to pay to the surplus one and its domestic prices will decline with the outflow of money. It will become cheaper to produce there, making some producers competitive even if they were not so at the beginning and have not improved technologically.

On the contrary, the surplus country will receive money and it will become more expensive to produce there, and the country will become less competitive in certain products, even in those cases where they are more technologically advanced. Changes in prices in both countries, or in the exchange rates, will move fast enough to impede persistent deficits. At the same

time, specialization emerges. Due to price or exchange rate changes, those who were relatively competitive will become more competitive, and those that were competitive, but relatively less than others, will lose competitiveness.

Like a Robin Hood, the international market will steal competitiveness from the stronger countries and make some of the weaker more competitive. Technology is irrelevant. Prices and exchange rates will do the whole job of generating international competitiveness in the two countries. "So, while low productivity is a problem, low productivity relative to other countries is not only not a disaster; it is irrelevant."¹ At the end of the two stages, there are no winners and losers; only winners. That is why this approach is so popular and so widely taught. Poverty does not appear on the scene also because in such theory, full employment is assumed in competing countries. There is no unemployment because the employment lost by the uncompetitive producer will be compensated by the successful exporter. The two assumptions, full flexibility in prices and full employment, explain why, in this approach, there is no relation between poverty and international trade.

On the contrary, the competitive advantage approach stresses a more explicit relation between relative poverty and productivity, and therefore competitiveness. For instance, a second round of interactions may include financial aspects as capital movements and interest rates differentials that make the equilibrating of the trade balance unnecessary, and the flexibility of prices less relevant.² In this case, once a country records trade deficits because of, for instance, its lack of productive development, debt increases, unraveling a vicious circle that may aggravate the original competitive asymmetry between the more competitive economy and the less competitive one. The less productive and deficit-running country will experience higher interest rates and it will become more and more difficult to regain competitiveness and poverty may as well increase. This way we establish the double causality at stake.

On the one hand, the poverty of the wage earners may contribute to the competitiveness of the companies and to their possibilities of participating in foreign trade. On

1 Krugman, Paul (1994) *Peddling Prosperity*. New York and London: W.W. Norton, p.274.

2 Shaikh, Anwar (1991) *Competition and Exchange Rates. Theory and Empirical Evidence*. Working Paper 25, Department of Economics, New School for Social Research. New York.

the other, foreign trade makes it easier for some and harder for others to sustain previous wage levels.

What can we say about the relationship between trade and poverty? I hope I have managed to show that it depends heavily on the theory used. In any case, it is difficult to accept, as it may occur within mainstream

theory, that competitiveness and poverty are not related to worldwide differences in productivity, and that price and exchange rate movements will enable, by themselves, inefficient producers to escape uncompetitiveness and poverty. The competitive advantage approach allows us to suggest that poverty influences foreign trade and vice-versa.

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