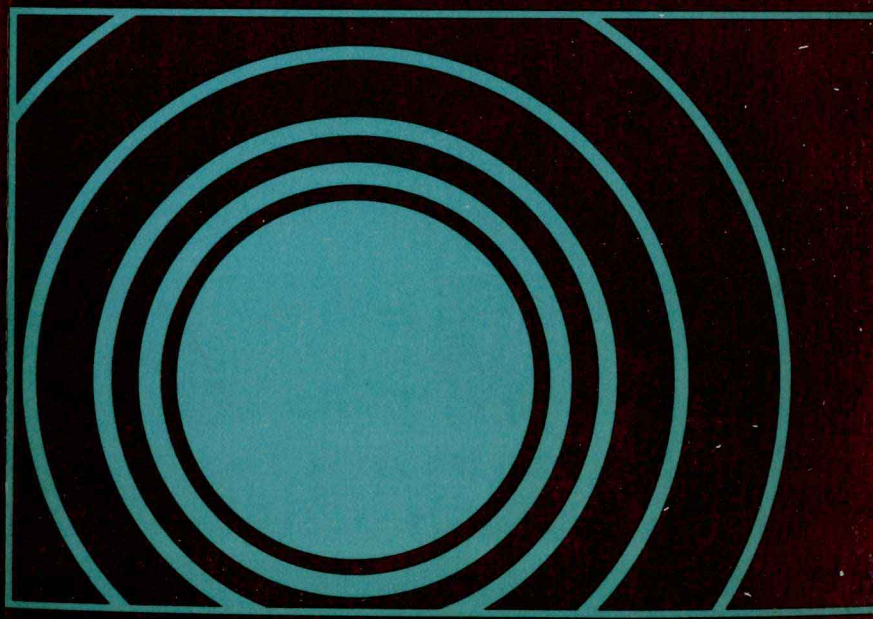
The Growth of the International Economy

1820–1980

An Introductory Text



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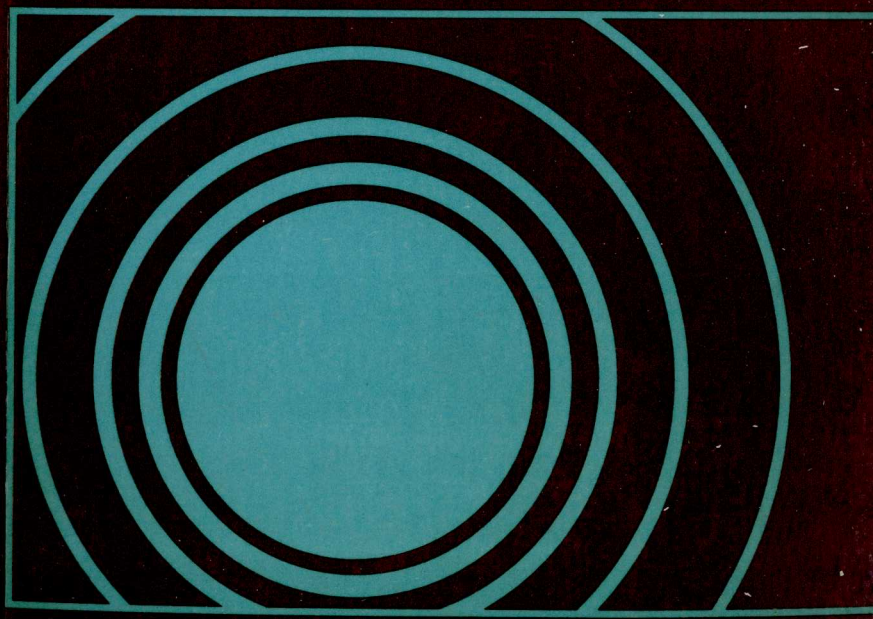

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This is the successor-volume to *The Growth of the International Economy 1820-1960* which was first published in 1971 and which established itself through six large printings as simply the best introduction available to the study of the international economy as a mechanism for diffusing modern economic growth between nations.

The book remains divided into three parts, of which the first two remain substantially the same, apart from minor revisions and updating, particularly of references.

Part One examines the workings of the international system in the years before 1914. It includes an analysis of the conditions favourable to the growth of international economic relations, examines the changing character of the international flows of labour, capital and trade, and surveys contemporary commercial and international monetary policies. The first part concludes with a chapter which considers the international economy as a mechanism for diffusing economic growth, and another chapter which examines the nature of the economic trends and fluctuations associated with this phase.

Part Two gives an account of the collapse of the international economy during the interwar years, and traces the causes of collapse to changes in the structure and functioning of the system brought about by World War I and the depression of the 1930s.

The final part is entirely new and takes the story beyond World War II right through until 1980. It describes the wartime and post-war efforts to reconstruct the international economic system and examines the workings of the new system in the period after 1945 and through the 1970s, bringing out both its strengths and its weaknesses.

A. G. Kenwood and A. L. Lougheed are Senior Lecturers in Economics at the University of Queensland, one specialising in economic history and the other in international trade.

THE GROWTH OF THE INTERNATIONAL ECONOMY, 1820–1980

'The Causes which determine the economic progress of nations belong to the study of international trade . . .'
A. Marshall, *Principles of Economics*, 8th edn., reprinted (London, 1959), p. 255

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AN INTRODUCTORY TEXT

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Introduction

The exchange of goods and services is the means through which independent economic units enter into economic relations with one another and become part of a local or national economic community. As exchange passes beyond a country's boundaries, national economic systems become parts of a broader regional, continental or world economy. Flows of commodity trade are not the only economic links forged between nations, however. People are also highly mobile, and the long evolution of trade from primitive barter to our modern worldwide network of commodity exchange has made necessary an intricate system of international credits, loans and investments. It is these flows of trade, labour and capital that constitute the vital processes of the international economy. Obviously, therefore, any study of the growth of the international economy must be concerned with the measurement and comparison of the rate at which these processes go on over time. It must also be concerned with examining the ways in which the international economic system is organized to carry out these vital processes, and how the structure, organization and functioning of these processes change as the international economy expands. In the final analysis, however, the international economy is studied not as an end in itself, but rather as a means to an end, for in studying its expansion in recent times, we are analysing one of the most potent causes of modern economic growth.

The international economy encourages national economic growth in two ways: by providing opportunities for international specialization; and by acting as a mechanism for diffusing between nations the apparatus and/or benefits of modern industrial technology. Since specialization implies trade and cannot occur without it, and since specialization and division of labour are a major cause of increased productivity and rising *per capita* real incomes, some comment is called for on the nature of the basis of trade between countries before we say something briefly about the international economy as a means of spreading industrialization.

International trade arises simply because countries differ in their demand for goods and services and in their ability to supply them. So far as supply is concerned, the basis for trade is to be found in the uneven distribution of economic resources among the nations of the world, coupled with the fact that commodities and services require different proportions of these economic resources in their production. This uneven distribution of resources is partly a matter of climate and geography, and partly a result of each nation's historical development, which has left it with a certain stock of capital and

a population trained and educated in numerous techniques and skills. Whatever their origin, however, each country's endowment of land, minerals, skills, and machinery equips it to produce certain goods and services more efficiently (cheaply) than others. For differences in the relative supplies of different productive resources within a country will mean differences in their relative prices and therefore differences in the costs of producing various goods and services.[1] Considering these elements alone, each country would tend to specialize upon those products best suited to its factor endowment, which means those using little of its scarce factors but drawing heavily upon the cheap and abundant ones. Thus differences in relative factor prices based on the relative abundance or scarcity of economic resources within countries will mean differences in international costs of production and therefore differences in commodity prices. It is these differences in commodity prices that are a basic cause of trade between nations.

However, the international structure of commodity prices and the pattern of foreign trade based on it are not fixed for all time. Over time, changes occur in the distribution of economic resources between countries which alter the comparative cost structure and modify the pattern of world trade. Any one country's factor endowment can change radically from internal causes, as technological progress occurs, as population changes, as domestic capital is accumulated, and as the economic extent of the land is modified. It can also change from external causes, by virtue of international movements of labour and capital and the spread of technical knowledge. The effect of such changes on a nation's relative factor endowment should be obvious. The principal basis for its specialization and the character of its trade are altered. In analysing the growth of the international economy, therefore, we must consider how changes in factor supplies, technical progress, increasing productivity, and changes in demand can transform the structure of comparative costs. For changes in comparative costs affect the pattern of international trade, while developments in international trade in turn influence the economic growth processes in the world economy that bring about changes in the international distribution of economic resources.

Whatever the structure of comparative costs at any particular point in time, the size of the trade flows between nations will also

[1] What is important is the relative, not absolute, supply of the factors of production. Thus China is a country large in area, but, relative to its population's demand for food, land is scarce and capital is relatively even more scarce. On the other hand, Belgium may have a small population in absolute size, but its labour supply relative to the country's land and capital may be the most abundant factor.

depend upon the existing level of transport costs. Since trade is based mainly on international price differences, it may be severely limited in situations where transport costs largely offset the price advantage of low-cost producers. In other words, the basis for trade, whether international or interregional, lies in comparative cost differences which are not neutralized by transport costs. It follows therefore that any reduction of transport costs due to technical improvements in the carriage of goods enhances the opportunities for trade by allowing international cost and price differences to become more apparent in world markets.

One apparent failure of the factor proportions theorem just outlined is that it does not provide an adequate explanation for the comparative advantage which industrialized nations appear to possess in different industries. This is brought out clearly by the fact that, in this century, trade has tended to expand fastest between the advanced industrial nations, many of which have roughly similar factor endowments. The need to explain the trade advantage of industrial countries has led consequently to emphasis being placed on factors other than simple resource scarcity. One approach to the problem stresses the importance of economies of scale. The technical superiority of certain large indivisible units of capital or the use of specialized labour, both of which depend on the existence of large markets, suggests that a large country, especially one with a big population and high *per capita* incomes, will be more fruitful for the development of large-scale industry than a smaller country with a similar level of income. Hence the scale economy explanation essentially asserts that the country with the largest domestic market tends to specialize in those commodities which exhibit the *greatest* scale economies.

The growth of trade between industrial nations has also been explained in terms of the technological gap between nations created by the discovery of new products and new processes of production. According to this theory, trade consists of the impermanent commerce which originates solely in the temporary technological superiority gained by the nation making the industrial breakthrough. In other words, the innovating country's export trade in the new product will last until such time as other countries adopt the new techniques or produce the new product on a scale sufficient to supply their domestic markets and make them independent of imported supplies. The period it will take for the manufacture of a new product to spread from one country to another will obviously depend upon a variety of factors, including the threat which new products pose to existing goods and the lure of the high profits to be earned in the new line of production. At the same time, technological gap trade may be pro-

longed by the fact that the innovating country enjoys a peculiar advantage in harvesting scale economies. This advantage arises because the markets for new products expand rapidly at first. The innovator can thus more confidently erect large plant and secure an entrenched position in domestic and export markets than can successor firms abroad. In this respect the technological gap theory is an improvement on the scale-economy theory, since according to the former a small country which innovates may yet build a large plant, whereas the latter theory simply asserts that the country with the largest home market builds the biggest plant, regardless of when it begins production. Finally, it should be noted that while the technological gap theory implies that trade between industrial nations is only a temporary thing, the fact that innovation and technical progress are continuous processes means that trade between advanced industrial nations may well persist and even grow over time.

Another explanation of the rapidly expanding trade between industrial nations stresses the importance of domestic demand as a determinant of the products which a country will export. Only after the new product is firmly established in the domestic market, it is argued, will the entrepreneur be ready to respond to profit opportunities in foreign markets. Moreover, since income, more than any other variable, appears to determine the consumption and purchasing habits of broad sectors of the population, countries having similar income levels are likely to trade with each other more intensively than countries having different income levels. This explanation of the basis of trade between nations is, of course, dramatically opposed to the factor-endowment theory which implicitly argues that trade between capital-rich (high-income)and capital-poor (low-income) countries tends to be the more promising for the trading partners than exchange of goods between countries whose average income levels are similar, where labour and capital may be expected to be distributed in similar proportions. But having made this point, it should also be noted that none of the alternative theories just discussed completely dispenses with the factor proportions approach. Indeed, over time, a country's comparative advantage in certain industrial activities may be largely a matter of historical accident, in the sense that past international specialization based on relative factor endowment may lead to a strengthening and developing of natural skills, innovative capacity, and investment activity along lines which are different from those of other countries. Consequently opportunities for technological gap trade may emerge and economies of scale assert themselves in the production of commodities and services which will have a ready market in other countries with similar income levels.