The theory of declining terms of trade

• Main proponent: Raul Prebisch (ECLA).

• Terms of trade: the exchange rate between good you export and goods you import
  – \( \text{Price}_{\text{exports}} / \text{Price}_{\text{imports}} \)

• Prebisch argued that the terms of trade of underdeveloped countries decline over time, leading to more poverty.
The theory of declining terms of trade

• What causes the decline in the terms of trade?
  – Increase in supply greater than the increase in demand.

• Demand side:
  – By Engel’s Law, as income increased in developed countries, the demand for food only increased a little.
  – Due to technological progress and synthetics, small increase in the demand for raw products.
The theory of declining terms of trade

• Supply side:
  – In order to gain more, underdeveloped countries reinvested surpluses on the production of the same primary goods, and supply increased a lot.
The theory of declining terms of trade

• The preceding argument explained why the price of exports decreased. But what if the price of imports also decreased?

• According to Prebisch, monopoly power of firms in developed countries and their unions prevented the prices of industrialized goods from dropping.
Import substitution industrialization

• According to the declining terms of trade thesis, as long as countries specialize in a single product, they will remain in poverty.
  – Then, to develop they must diversify their economies

• **Import substitution industrialization (ISI)**: industrialization by producing the manufactured goods that are imported.
  – Goal: diversify economies.
Import substitution industrialization

• Example: Country A exports cocoa, but imports clothes and cars. Through ISI, Country A would provide incentives for firms to produce clothes and cars domestically. As a result, its economy would be more diversified and would not be subjected as much to the pervasive effects of declining terms of trade.

• But how can Country A provide incentives for the production of clothes and cars.
Import substitution industrialization

• Main policies of ISI processes:
  – Protection from imports through tariffs and exchange rate controls.
  – Attraction of multinationals.
  – State enterprises.
  – Development banks.
Import substitution industrialization

• To better seek diversification, ISI was “across the board”.

• Main consequences:
  – Investments in new industries caused economic growth.
  – Focus on manufactured goods led to a structural change: industry became the main component of GDP.
Import substitution industrialization

- Main problem: import coefficient (M/GDP) after an initial decrease, started increasing again.