

## 6 Heterodox theories of economic development

**After studying this chapter, you should understand:**

- the importance of the distinction between the center and the periphery in structuralist theory;
- the Prebisch-Singer hypothesis on declining terms of trade for primary product exporters and the debate surrounding it;
- the role of import substitution industrialization according to the economists of the Economic Commission for Latin America and their subsequent critique of this policy;
- Ayres' concept of inhibiting institutions and the importance of education and technology to the institutionalist perspective;
- Gunnar Myrdal's seminal ideas about spread effects and backwash effects as examples of cumulative causation;
- the distinction between associated dependent development and the dependency perspective of underdevelopment;
- Baran's view of the equilibrium trap of underdevelopment; and
- the distinction between stagnationist dependency analysis and the classical progressive Marxist view of development as presented by Bill Warren.

### Introduction

This chapter discusses and analyzes the ideas of economists and social scientists who have broken with economic orthodoxy and also have moved beyond the framework of the developmentalist economists considered in the previous chapter. These heterodox economists do not believe that relatively minor changes in economic conditions, such as an increase in foreign aid or a sudden increase in investment, will be sufficient to create the "big push" or the "take-off" into sustained growth, as did the developmentalists. In fact, many of the heterodox economists would argue that such limited changes, within the context of the existing structures and institutions prevailing in less-developed societies, might result in a strengthening of backward socio-economic framework, consolidating adverse path dependence. For the heterodox economists, the changes required to propel the development process forward are more fundamental, more sweeping, and more profound.

Included among the heterodox grouping are a number of thinkers who hold no

more in common than the fact that they vigorously dissented from the general premises and propositions of the developmentalist economists, and of orthodox economists, as well. In this chapter, then, we will trace the ideas of the Latin American structuralists, represented by Raúl Prebisch and Hans Singer; the institutionalists, represented by Clarence Ayres and Gunnar Myrdal; the dependency school, represented by Paul Baran and Fernando Henrique Cardoso; and the classical Marxist approach in its more modern form, represented by Bill Warren.

The heterodox thinkers reached their maximum point of influence within the field of development economics in the late 1960s and early 1970s.<sup>1</sup> Indeed, the impact of some of their views was so profound that their ideas exerted some indirect impact on the leading development institutions, most notably the World Bank. In the 1970s, these institutions embraced the basic needs (BN) approach, as is discussed in Chapter 17. As we shall see, the heterodox thinkers had much more ambitious hopes for change than those embodied in the limited goals of the basic needs approach.<sup>2</sup>

### **The Latin American structuralists**

In 1948, as the result of a Chilean initiative, the United Nations agreed to form the Economic Commission for Latin America, known best by its acronym as ECLA. Unlike the UN's more technically oriented Economic Commission for Asia and the Far East, created in 1947, or the Economic Commission for Africa (1958), the ECLA was destined to become a center of advocacy for a distinct Third World perspective, and a hotbed of controversy. It was in and around the work of the ECLA that a Latin American school of structuralist economics was forged. The structuralists argued that the less-developed countries of the periphery were structurally and institutionally different from the developed nations of the center in ways that made some aspects of both orthodox economic theory and developmentalist theory inapplicable. In particular, the Latin American structuralists were quite suspicious of the Ricardian theory of comparative advantage and the alleged benefits of free trade among nations that supposedly derive from specialization and trade. In introducing the possibility of conflictive or adversarial relations in trade, the Latin American structuralists challenged the "harmony of interests" assumption in market transactions that had been a cornerstone of economic thinking since Adam Smith (see Chapter 4). As Gabriel Palma explains, structuralism is concerned with the *totality* of a social system and the many forms of interaction of the component elements within that system.

The principal characteristic of structuralism is that it takes as its object of investigation a "system", that is, the reciprocal relations among parts of a whole, rather than the study of the different parts in isolation. In a more specific sense this concept is used by those theories that hold that there are a set of social and economic structures that are unobservable but which generate observable social and economic phenomena.

(Palma 1989: 316)

***The structuralism of Raúl Prebisch***

Perhaps the best-known Latin American structuralist economist was Raúl Prebisch (1901–1986). As a young man finishing his MA degree in economics at the University of Buenos Aires, he already had published six articles on economics, and his views and analysis were impeccably mainstream, orthodox, and neoclassical. During Prebisch's formative years, at least to the early 1920s, Argentina seemed to symbolize an outstanding example of the validity of the theory of comparative advantage, with producers having a cost advantage in producing beef and wheat for the world market. From the 1860s through to the second decade of the twentieth century, the Argentine economy grew at a rate that can only be described as spectacular, and the country's standard of living rivalled that of the great European powers. It certainly seemed that specializing in the export of a limited range of primary products to the world market was successfully contributing to the overall development of the country.

In the 1920s, Argentina began to experience difficulties with its primary trade partner, Britain, as the prices for its main exports began to fall. As the country incurred a growing foreign debt burden, trained observers, including Prebisch, viewed Argentina's troubles as transitory. By the 1930s, however, Argentina faced both the adverse effects of the Great Depression and the growing dominance of the world economy by the United States. Unlike the late nineteenth century, when Britain's thirst for Argentina's exports had seemed unquenchable, now Argentina had to confront the troubling reality that the United States had a relatively modest propensity to import, compared to Britain. Even worse, the United States had a surfeit of domestically produced beef and wheat and did not want or need Argentinian exports to the same degree that Britain had.<sup>3</sup>

Like most Argentinians who had experienced the favorable conditions of the late nineteenth and early twentieth century, Prebisch was extremely reluctant to revise his views on the Ricardian doctrine of comparative advantage (see Chapter 4). None the less, he eventually did so, with consequences which were particularly far-reaching. Much of Prebisch's work on questions of development policy pivoted on his willingness to draw a distinction between the timeless constructs of neoclassical economic theory and what he saw as the dynamic effects of real economic forces, particularly those existing between the already developed center nations, such as the European powers and the United States, and the less-developed **periphery nations** of Latin America, Asia, and Africa. Prebisch began to learn and grapple with the fact that behind the laws of demand and supply there often lurked power relations and quite dissimilar forms of production between nations.

In particular, Prebisch noted that during the Great Depression, the export prices of agricultural and other primary products fell much further and faster than did the prices of manufactured, or secondary, products. At that point, in 1934, Prebisch did not as yet have a theory as to *why* this asymmetry in the behavior of the export prices of primary and secondary products might be occurring, but he did begin to develop a critical perspective on neoclassical economic theory. According to Prebisch's calculations, in 1933, Argentina had to sell 73 percent more of its primary agricultural products into the world market in order to import the same amount of imported manufactured products as it had in the mid- to late-1920s, as a result of the asymmetric behavior of world export prices.

By 1937, Prebisch and his colleagues at the Argentine central bank had begun to develop a theory which would explain the relative collapse of the agricultural markets. In manufacturing, they reasoned, the supply of output was relatively price elastic; thus as demand decreased (from  $D_0$  to  $D_1$ ), so did the quantity supplied. The equilibrium price would fall, of course, but in a somewhat more limited manner, depending on the value of the supply elasticity, as shown in Figure 6.1, along supply curve  $S_M$ . In the extreme case, as with supply curve  $S_E$ , which is perfectly elastic, the decrease in demand has no effect on price, but only on the quantity traded in the market.

On the other hand, in the agricultural markets, supply conditions are dramatically different; suppliers, many of whom were small farmers with limited land, tended to plant or grow as much as possible, year-in and year-out. Supply was therefore relatively price inelastic. When demand decreased, the quantity supplied did not fall by much, but prices quickly and dramatically decreased, as shown along supply curve  $S_A$  in Figure 6.1. In the extreme case, which might be somewhat more common in agriculture than in manufacturing, the momentary supply curve would be perfectly inelastic, as for supply curve  $S_I$ , and all the decrease in demand would be transmitted as a lower equilibrium price for the agricultural good.

What might account for these differences in the supply response of primary product prices and for manufacturing good prices? Prebisch's early explanation was somewhat vague. Industrial producers of manufacturing goods could control supply, at least to some degree, whereas in agriculture, producers had failed to organize their production and control their output. In 1933, Prebisch became active in the

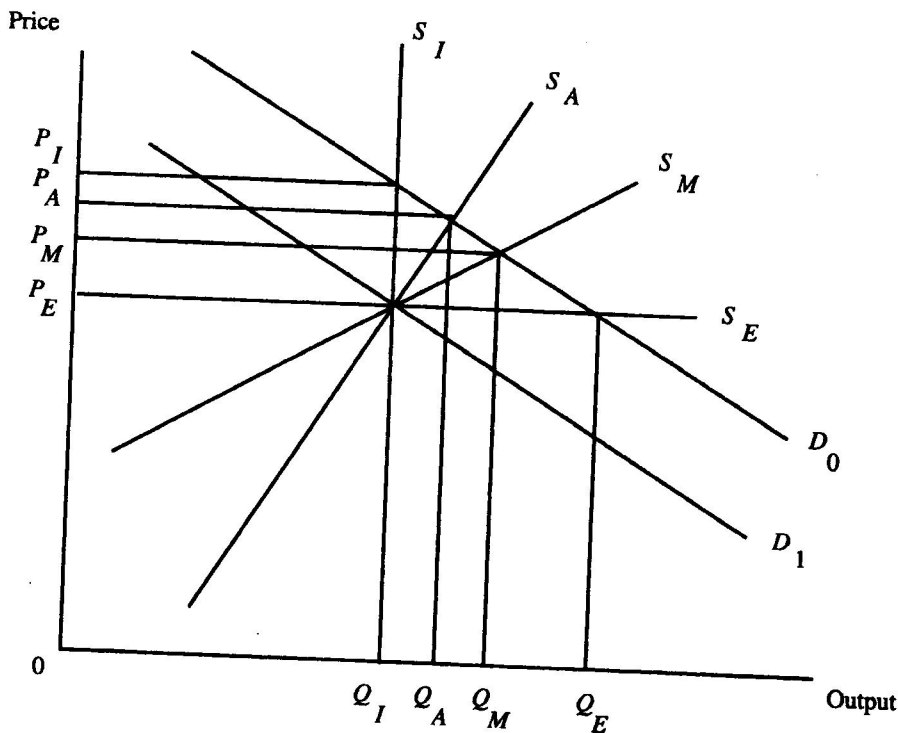


Figure 6.1 Elasticity of supply and equilibrium price adjustment.



attempt to form an agreement among the major wheat-growing nations of Argentina, Australia, Canada, and the United States to try to stabilize the world market price. Unfortunately, all the participants had violated the terms of the agreement by late 1933. This experience undoubtedly helped form Prebisch's perspective on the meager possibilities of coordinated actions undertaken among nations with the goal of controlling global agricultural output. But, at this point in time, Prebisch's explanation for the differences in the supply behavior of primary agricultural products and secondary manufactured goods in the face of changes in demand was mostly incipient.

### *The terms of trade*

In mid-1948 Prebisch joined ECLA, having been asked to be its first director. At ECLA, Prebisch made a major and lasting breakthrough with his study *The Economic Development of Latin America and Its Principal Problems* (Prebisch 1950). This study was largely made possible by a UN report entitled *Relative Prices of Exports and Imports of Underdeveloped Countries*, which provided an empirical basis for a thesis that soon would become associated with Prebisch: given the existing international division of labor, in which the developed center countries produced manufactured goods for export to the periphery and the less-developed peripheral countries produced primary products for export to the center, all the benefits of trade would accrue to the center and none to the periphery. The periphery would have to produce more and more agricultural or raw material products simply to obtain the same quantity of imported manufactured products. Technically, this result was the outcome of a long-term deterioration of the terms of trade for the primary exporting peripheral countries.<sup>4</sup> Based on the years from the late nineteenth century to the late 1930s, the UN study had concluded that "On the average, a given quantity of primary exports would pay, at the end of this period, for only 60 percent of the quantity of manufactured goods which it could buy at the beginning of the period" (UN 1949: 7), and it was this data Prebisch used in reaching his conclusion on the detrimental effect of the existing trade patterns on the periphery.

Prebisch was soon to be the target of a number of attacks by those who argued that the methodology of the UN study was flawed. Unfortunately, the study was flawed, particularly in the sense that the prices used were not really comparable. The study measured British manufactured exports in terms of "freight on board" (F.O.B.) values, while British raw material imports were measured in terms of "cost including freight" (C.I.F.) values. The prices of exports at F.O.B. prices did not include shipping charges, while those of imports did. During the later part of the nineteenth century, rail and steamship charges dropped rapidly due to improvements in technology. Thus, by capturing the price benefits of technological change on only one side of the equation, British imports of raw materials, and excluding such changes on the other side, British exports of manufactured goods, the method utilized by the UN biased the results.

Was the conclusion Prebisch reached therefore incorrect? Controversy has stirred over this matter for over fifty years. Correcting for changes in both shipping costs and the changing quality of traded goods, studies conducted by J. Spraos have continued to support the basic hypothesis of Prebisch, as has research conducted by Prabijit Sarkar (Sarkar 1986; Spraos 1983). Spraos, for example, found that

from 1950 to 1970, the terms of trade for primary products (in relation to manufactured products) decreased by 25 percent (Spraos 1980: 121–126). In a more recent study, D. Sapsford found a 1.2 percent decline per year in the net barter terms of trade (NBTT) from 1900 to 1982 (Sapsford 1985). Perhaps most startling is the recent confirmation of Prebisch's view by A. Maizels, T. Palaskas and T. Crowe, who show a decline of the NBTT of roughly 4 percent per year from 1979 through 1993 (Maizels *et al.* 1998: 74). More generally, Sapsford and J. Chen demonstrate that since Prebisch's ECLA study *none of the 10 major published empirical studies has refuted the Prebisch findings* – although two found no trend, perhaps due to the time period under analysis (Sapsford and Chen 1998: 28–29). When we examine the contribution to this debate made by Hans Singer, below, we shall elaborate on the mechanisms by which such a deterioration in international purchasing power might be explained.

If Prebisch was correct in believing that the terms of trade would move against the developing nations, then a successful development program would, of necessity, force a nation to either:

- adopt a program that emphasized internal changes which would restructure the peripheral economies more toward the domestic market and away from exports, or
- develop a new export strategy which would emphasize manufacturing and processing and other secondary production activities, rather than the export of raw materials, foodstuffs, and other primary products.

Abandoning raw materials exports, or de-emphasizing them, was viewed as a radical and theoretically unfounded step by the more orthodox within the economics profession, who continued to insist that it was in these goods that the less-developed nations had comparative advantage.

#### *Import substitution industrialization as a response to declining terms of trade*

At ECLA, Prebisch became known as the chief advocate of the “development from within” approach, a strategy that is often associated with **import substitution industrialization**, or ISI.<sup>5</sup> With ISI, a country begins to manufacture the simple, consumer non-durable goods that are being imported. As we shall examine in more detail in Chapter 9, this stage of industrialization involves relatively simple production and does not require either large physical or financial capital outlays or the use of sophisticated technology. If, in fact, the terms of trade were tending to shift against the periphery due to the structure of export production, an argument could be made for industrializing the peripheral economy so that it became more like the center nations in terms of its productive and export structure.<sup>6</sup>

Furthermore, even if the declining terms of trade argument proved to have no validity or were weaker than Prebisch had supposed, no one contested the fact that over the course of a normal business cycle, primary product prices tended to rise much faster during an expansion and to fall to a much greater degree during a contraction. Thus, there was a second argument for industrialization: greater overall economic stability could be maintained if the degree of industrialization was

increased. Third, an industrial base might facilitate the transmission of technological advances from industry to agriculture – that is, a growing manufacturing base could create technological externalities in agriculture which would increase productivity and income.

The success of ISI required that governments restrict imports of goods that might compete with the new ISI industries through the imposition of effective tariff barriers. ISI also entailed an activist governmental policy in providing and allocating public expenditures to those areas where the highest rate of return could be anticipated. In Prebisch's words:

The structural changes inherent in industrialization require rationality and foresight in government policy and investment in infrastructure to accelerate growth, to obtain the proper relation of industry with agriculture and other activities, and to reduce the external vulnerability of the economy. These (are) strong reasons for planning. . . . International financial resources (are) to complement and enhance a country's capacity to save, while changes in the structure of trade (are) necessary to use these savings for capital goods imports. Planning should help obtain these resources and accomplish the latter objective. Planning (is) compatible with the market and private initiative. It (is) needed to establish certain basic conditions for the adequate functioning of the market in the context of a dynamic economy. But it [does] not necessarily require state investment, except in infrastructure and development promotion.

(Prebisch 1984: 180)

Prebisch did have some reservations regarding ISI. First, in order to promote industrialization, it would be necessary to import a considerable amount of technology embedded in machinery and equipment, or to obtain it under licensing agreements. Thus a new drain on already scarce foreign exchange earnings would be created. Furthermore, some of this technology would be more capital-intensive than previous production methods, meaning that expansion in the industrial sector would absorb a relatively modest amount of labor unless the level of investment increased substantially. There was thus a danger of structural unemployment, as young workers entered the labor force and migrants from rural areas entered the cities in search of industrial jobs at a rate faster than they could be absorbed. Finally, the domestic market was too narrow to permit the most efficient use of imported machinery and equipment. The economies of scale to be anticipated from large-scale industry would only be achieved if equipment was utilized at its peak rate, and given the relatively low incomes of much of the population, the demand for industrial output would quite likely fall short of what was required to move to the most efficient level of production. In spite of such reservations, Prebisch maintained that the anticipated benefits of leaving the treadmill of the agro-mineral peripheral export economy clearly outweighed the costs of industrialization.

Prebisch's advocacy of ISI did not initiate such policies in Latin America. ISI had been adopted in a number of Latin American nations since the 1920s, and in some as far back as the 1890s. For the most part, these ISI programs were extremely successful in their initial or "easy" stage in spurring growth in the Latin American economies. By the 1960s, however, the easy ISI stage had ended. As Prebisch moved on to head the UN Conference on Trade and Development (UNCTAD) in 1963,

ECLA itself became the source of increasingly strident attacks on ISI, as the optimism for what such a strategy might achieve, which ECLA had projected in the early 1950s, disappeared. ECLA's structuralist critique of ECLA's ISI concluded that these policies had resulted in:

- 1 a failure to diversify exports and a continued reliance on one or a few raw materials or agricultural products for export;
  - 2 a shortage of foreign exchange earnings;
  - 3 an increase in foreign debt;
  - 4 a weak domestic agricultural sector, leading to major food imports; and
  - 5 increasing foreign ownership of the economy by transnational corporations, leading to a drain on scarce foreign exchange as profits were repatriated
- (Kay 1989: 39–46; Sunkel 1990: 137–139)

Thus ECLA, originally the crucible for initiatives which were based upon optimistic projections, became one source of critical analysis known as dependency theory. Dependency theory, to be discussed below, nearly inverted the early optimism of ECLA; development came to be viewed either as an impossible task, or one that demanded a major reorientation of the policies originally pursued by ECLA. We will argue in Chapter 10 that what was necessary was to go beyond ISI, something ECLA had promoted, but which governments in their policies failed to do, in Latin America at any rate. It was not so much ISI which had failed, but the deficiency of policy follow-up.

### *The contribution of Hans Singer to the terms of trade debate*

Hans Singer, a German-born economist, received a PhD from Cambridge University in 1936, precisely during the period when J.M. Keynes' influence was reaching its zenith. In 1947 Singer, an ardent Keynesian, went to the United Nations as one of the first three economists to be employed in the newly created Economics Department. He remained there until 1969, when he became associated with the influential Institute for Development Studies at the University of Sussex in England.

Singer is perhaps best known for a widely cited research paper, the argument of which closely paralleled Prebisch's theory of the tendency of the terms of trade to fall for the periphery. Thus, in development economics, the theory that the terms of trade tend to move against raw materials and agricultural and primary producers is known as the Prebisch–Singer (P–S) hypothesis.

### *The Prebisch–Singer hypothesis*

Prebisch had analyzed the relations between nations at unequal levels of development using the spatial imagery of the center and periphery. In this perspective, the more advanced center countries tend to reap the gains from international trade and investment at the expense of the less-developed periphery. Indeed, trade relations between the center and periphery reinforce higher levels of development in the center countries, while maintaining a relatively lower level of development and poverty in the periphery. In Prebisch's and Singer's analysis, then, free trade can actually be harmful to the peripheral, less-developed nations. This view, of course, is

in diametric opposition to the very basic orthodox economic contention, from the time of David Ricardo at least, that the pursuit of comparative advantage in international trade will benefit all participating nations and that, in time, income levels between different regions of the world should tend toward equality as a consequence of the equalizing tendencies set in motion by the movement of goods and factors of production with free trade.

The reasoning behind the P-S hypothesis, that the relations between the center and the periphery are antagonistic and detrimental, rather than complementary and harmonious, is derived from three bases. In essence, the existing economic, productive, and labor market structures of the center and the periphery are sufficiently different to the degree that engaging in trade can be detrimental to the periphery, for the following reasons.

The application of technology to traded goods, predominantly manufactured goods for the center and primary products from the periphery, has quite different consequences. The advanced center countries are dominated by oligopolistic industries with a substantial degree of control over the prices of their final products; in other words, they are "price-makers." Further, unions and widely accepted social convention dictate that rising worker productivity from technological change be rewarded with higher incomes. In the periphery, on the other hand, most primary products, that is, agricultural goods and many minerals, face substantial domestic and, especially, international competition in trade, so the supply price is difficult to control by individual producers, who are classic, competitive "price-takers." Labor, particularly unskilled labor, is generally in some degree of surplus in the periphery, and this puts downward pressure on wages. Unions and pro-labor social attitudes, particularly in the primary sector, are not as strong in the periphery, so the institutional mechanism present in the center for raising wages with increased productivity as a result of advances in technology is lacking.

Given these structural differences, the application of new, cost-saving technology in the center would contribute to greater worker productivity and hence higher wages. However, there would be little tendency for output prices to reflect falling unit costs due to oligopolistic pricing by firms. Corporations would thus see their profits rise, as they shared with workers the fruits of technological progress in higher incomes. In the periphery, however, where something closer to the competitive "ideal" is common in many primary product lines, the introduction of new technology results in falling output prices, as the industry supply curve shifts out and downward with technological progress. Stagnant, and perhaps even declining, wages for workers is the result, given the labor surplus conditions characteristic of the rural sector and the lack of social mechanisms for demanding higher incomes with greater productivity.

Thus, according to the P-S hypothesis, the center nations gain doubly from new technology and trade with the periphery, while the periphery becomes worse off as a result of a deterioration in their terms of trade that results from the price movements on center exports and periphery exports. In effect, with the constant spread of new production technologies in the world economy, the P-S hypothesis predicts that the prices of what the periphery sells on the world market will decline, while the import prices of what the periphery purchases from the center remain about the same. Just the reverse is true for the center nations, which find their terms of trade, and hence the purchasing power of their exports, rising.

As a result, the center nations are able to buy the periphery's cheaper imported primary products with their own higher-profit manufacturing exports and with higher wages for workers, while the periphery nations find that new technology only forces the prices of their exports down on the world market, thus requiring more to be exported just to be able to purchase the same quantity of manufactured imports from the center. All the benefits of new technology, which is constantly advancing, thus accrue to the already-developed nations, as their incomes rise and the prices of what is imported from the periphery fall.

The center realizes all the benefits from trade over time; the periphery gains nothing. Any benefits from comparative advantage were realized long in the past in the first period of specialization, when a shift of production in the direction of the lowest relative opportunity cost (as discussed in Chapter 4) result in a one-time gain in world efficiency. Since that one-time gain, however, the P-S hypothesis argues that the declining terms of trade for the particular goods in which the periphery has specialized have made primary product specialization by those nations a source of impoverishment, rather than a means to increase income and welfare.

Embedded in this critique of trade is an obvious policy recommendation. To avoid declining terms of trade for its exports, the periphery should become more like the center, particularly through greater industrialization. With time, imports of manufactured goods would become less necessary. Basically, the escape from the Prebisch-Singer dilemma requires the periphery to follow a path of structural change similar to that traced by the center nations before them; as we shall see in Chapter 9, that is what import substitution industrialization as an initial strategy for development was at least partly about.

According to the P-S hypothesis, then, less-developed countries that continue to follow traditional comparative advantage by persisting with primary products exports will not benefit from trade, due to the tendency for their terms of trade to deteriorate. The theory of comparative advantage may provide a one-off boost to world production such that all countries gain, but over time, primary product exporters will not profit from staying with that static comparative advantage. Singer believed that he and Prebisch had been quite successful in alerting the developing countries to their dilemma, and that these countries had, in many instances, responded correctly by either diversifying their exports or developing their own internal markets via ISI policies. "We do not know what the data would have been without such action – the deterioration in terms of trade would presumably have been even sharper than it was" (Singer 1984: 283).

#### ***Additional factors contributing to declining terms of trade***

Besides the tendency for the ever-changing impact of technology to result in declining terms of trade for the primary product, given the existing domestic and international structures of production and trade, Prebisch and Singer identified two additional forces at work in the world economy that tend to move in the same direction and which reinforced the Prebisch-Singer effect.

First, differences in the income elasticities of manufactured versus primary commodities, especially agricultural goods, work over time to the detriment of the periphery.<sup>7</sup> In essence, as world income grows, the demand for manufactured goods, which have an income elasticity  $>1$ , rises faster than the demand for agricultural



products, with an income elasticity that is positive, but  $<1$  (this is the essence of **Engel's Law**), thus contributing to the secular, or long-term, deterioration of the terms of trade for the periphery. The differences in income elasticities for the exports of the center and periphery simply reinforces the need for peripheral industrialization, as suggested by the P-S hypothesis, along with the need for international commodity agreements to stabilize primary product prices, and regional integration to expand existing markets and increase competitive pressures on firms.

The second contributing factor to declining terms of trade for many peripheral countries, and certainly those in Latin America, was the lower level of the import coefficient in the United States than in Great Britain, already mentioned. As the United States replaced Great Britain as the world's major economic power, it became more difficult for some countries to expand traditional exports to be able to earn the foreign exchange required to purchase the desired manufactured imports, again supporting the argument for expanded industrialization in the periphery.

There is by now a substantial body of research over the P-S hypothesis, evidence that generally supports the Prebisch-Singer prediction of the long-term evolution of primary product export prices and the deterioration of the terms of trade facing nations that specialize in the export of these commodities. Oil, of course, has been a partial exception to this tendency in some decades, and a limited number of other primary-based goods (e.g., tropical drinks) show a long-term tendency toward rising prices. And even a few countries in the region, at least since the Second World War, have had rising terms of trade over some periods, but the overall trend would seem to be downward for primary product exports (see Focus 6.1 and Figure 6.2).

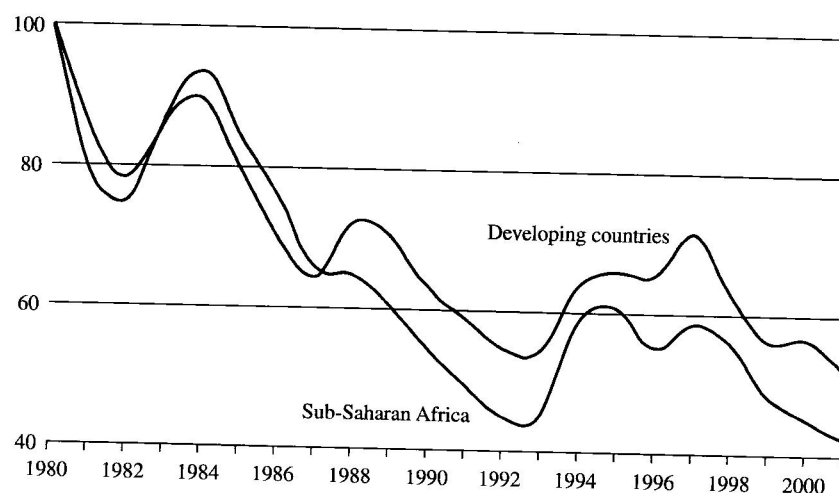


Figure 6.2 Declining real commodity prices: 1980–2001<sup>a</sup> (1980 = 100).

Source: World Bank Economic Policy and Prospects Group, World Bank, *Global Development Finance*, [www.worldbank.org/prospects/gdf2002/](http://www.worldbank.org/prospects/gdf2002/).

Note

a Excluding petroleum products.

**FOCUS 6.1 THE TERMS OF TRADE DEBATE**

Debate over the terms of trade of primary product producers has raged since Prebisch and Singer published their hypothesis of a long-run downward trend. Recently, support for the Prebisch–Singer hypothesis came from an unexpected quarter: the IMF.

Prices of commodities other than energy products are near their lowest levels this century in real terms. And given that prices have been trending downward over most of the past 95 years, nonenergy commodity exporters should be studying how to accommodate the drift in prices and not how to resist it, . . . [M]ost of the commodity price declines have been too persistent to be cyclical and, for purposes of policy design, can be assumed to be permanent.

The following data illustrate the nature of the deterioration of the terms of trade for developing countries.

	<i>average % change/year</i>
Raw materials, 1957–1987	–0.78
Raw materials, 1968–1987	–1.52
33 Commodities, 1979–1993	–3.6 to 4.2

Changes in demand in developed countries, better technology, which saves on the use of primary products in manufacturing production, and substitutes for some primary products (such as rubber) mean smaller markets for primary product producers and more difficult demand conditions.

What can primary product exporting countries do, according to the IMF report, to reduce the impact of declining terms of trade for their exports? Economies which evolve away from depending upon primary product exports and begin to substitute manufactured goods exports, such as has occurred among some of the East Asian economies, have a chance to transform themselves into economies structurally more similar to the center developed economies, just as Prebisch had recommended. Becoming an exporter of manufactured goods is the best protection against declining terms of trade.

At the same time, the IMF study notes the importance of improving the productivity of the agricultural sector which does remain. The transformation toward a diversified range of exports, in which manufactures dominate, cannot ignore the need to transform traditional agriculture into a modern, productive sector as well.

Sources: IMF 1994: 350–352, based on Borensztein *et al.* 1994; Maizels *et al.* 1998: 74; Ocampo 1995: 134

***Structural characteristics and the terms of trade***

In a recent work, Singer has taken pains to clarify a point that neither he nor Prebisch had adequately emphasized in their early work; it may be more important to analyze the *structure* of a nation than it is to simply distinguish between the nature of exports. That is, economic structure may be a more important explanation of the direction of the terms of trade than whether a country is a raw materials or manufactured goods exporter.

It will be noted that some of the . . . explanations for a deteriorating trend in terms of trade of developing countries relate as much or more to the characteristics of different types of *countries* – their different level of technological capacity, different organization of labor markets, presence or absence of surplus

labor, etc. – as to the characteristics of different *commodities*. This indicates a general shift in the terms of trade discussion away from primary commodities *versus* manufactures and more towards exports of developing countries – whether primary commodities or simpler manufactures – versus the export products of industrial countries – largely sophisticated manufactures and capital goods as well as skill-intensive services including technological know-how itself.  
(Singer 1989: 326)

There is a growing body of evidence that supports this insight that declining terms of trade may be associated not so much with the structure of exports, as with the institutional and economic structure of the less-developed countries *per se*. Thus, even as the periphery diversifies exports and adds manufactured exports to its tradables, the deterioration in the terms of trade may still be observed (see Focus 6.2).

Not only did relative price conditions continue to move against the poorest nations in recent years, Singer also emphasized that relative changes in the volume of trade had also cast the poorest nations in a disadvantageous position:

#### **FOCUS 6.2 ARE THERE ADVERSE TERMS OF TRADE FOR SOME MANUFACTURED GOODS?**

Using official IMF and UN data, the results on manufacturing terms of trade are conflicting. For the period 1960–1980, UN data show a 0.77 percent per year increase in the terms of trade of manufactured exports from less-developed countries. Covering a slightly different period, IMF data reveal a –0.88 percent per annum *decrease* in less-developed country manufactured goods terms of trade.

If the latter figure is correct, it may suggest that, at this point in time, less-developed countries tend to produce and export manufactured products in highly competitive international markets, for example, for textiles, shoes, and toys. The same pressures on prices when there is technological change would be likely to be working on these commodities as on primary products and agricultural products, just as the P–S hypothesis suggested. This downward tendency of the terms of trade for manufactured exports would fit Singer's concern that it is not the products, *per se*, being exported by the less-developed economies, as it is the structural characteristics of the countries (surplus labor) and of the markets where the exports are sold (highly competitive) that is important. In a study of the terms of trade for manufactured products between developing nations and the EU, Maziels, Palaskas and Crowe found an annual decline of –0.30 1960–1994, with the decline accelerating after 1980. They note that the volume of manufactured products exported to the EU has risen faster than the fall in prices. East Asian high-technology exports fared better in terms of their terms of trade than did any other region.

If Singer and other observers are correct, then countries need to look to produce commodities, be they agricultural or manufactured, for which the demand is more income elastic and for which competition is perhaps not so fierce. For example, one agricultural export that has been successful for Chile has been wine. Wine is a **non-traditional** primary product export, and it is one for which demand is quite income elastic. Further, competition is not perfect, so countries with outstanding or niche products have a chance to experience increasing terms of trade.

Sources: Maziels *et al.* 1998: 75–83; Ocampo 1995

in overall terms, and in spite of the group of fast-growing LDC [less-developed countries] exporters of manufactures, the volume lag of LDCs is clear. Between 1948 and 1970, world trade volume (excluding the socialist countries) increased by 7.3 per cent a year, but the export volume of LDCs by only 5.3 per cent. In the decade 1970–80, the figures are 5.8 per cent and 3.1 per cent respectively. For the least developed countries, typically primary exporters, the respective growth rates were only 4.4 per cent [for the 1948–70 period] and a dismal –0.4 per cent for 1960–70. At least in this relative sense, volume changes have increased any gap created by the worsening terms of trade and in that sense trade pessimism has not been proven wrong.

(Singer 1984: 295)

Like Prebisch, Singer remained a strident critic of neoclassical policy-making and of the effects which unmediated market forces tend to impose on the poor nations.

### ***The role of foreign aid***

Convinced as he clearly was of the unequal effects of market outcomes for the poor relative to the advanced nations, it is hardly surprising that Singer advocated non-market offsets to compensate for the effects of *laissez faire*. Singer was, indeed, perhaps the most outspoken and relentless advocate of foreign aid among the heterodox economists. He maintained that aid could take many forms, such as buffer stock purchasing programs for primary products to temporarily offset falling raw materials prices, and “soft loans,” that is, lending made at below the market rate of interest to the poorer nations to permit them to build up their infrastructure and/or make other long-term social investments. Such projects, Singer believed, would very rarely, if ever, find private-sector backing. Singer devoted much of a decade to an attempt to create a soft-loan fund at the UN to be known as SUNFED, the Special United Nations Fund for Economic Development. Because the UN expected to control this fund and to distribute much-needed credits on a multilateral basis, and without regard to the foreign policy priorities of either the United States or the United Kingdom, these nations systematically blocked attempts led by Singer to operationalize this fund.

### **The institutionalists**

Institutionalists believe that the institutions of an economy, that is, the forms of production, ownership, work processes, and ideologies which combine to create an economy and society, are the proper subjects for economic analysis. Since, furthermore, such institutions are subject to evolutionary change, the process of studying economics should also properly be evolutionary. This is clearly not the case for those who postulate that economics is the science of choice and that the function of economics is to discover the laws of the economy, just as a physicist might attempt to understand the laws of physics. While institutionalists have not made development economics their primary focus, there have been notable contributions. We shall consider but two, the American economist Clarence Ayres, and the Swedish Nobel Prize winner in economics, Gunnar Myrdal.<sup>8</sup>

***The Ayresian view of development***

Clarence Ayres (1891–1972) was one of the leading proponents of an American school of institutional economics, centered from the 1930s to the 1960s at the University of Texas, Austin. Ayres was dismissive of much of mainstream economics, and his references to development economics occur within a much broader framework. Ayres was interested in a “megatheory” of development, which would have application to both the advanced and the poor nations alike. At the center of Ayres’ theoretical structure on the “how” of economic development are two fundamental forces: technology and ceremonialism.

***Technology***

Ayres placed more emphasis on technology than on any other factor which contributed to economic development. Technology, to Ayres, arose from a combination of tools and human beings, with the latter actually defined as “tool-users.” Past tools lead to future tools, because human beings are so constituted as to be endowed with “the inveterate restlessness of human hands and brains” (Ayres 1991/95):

the technological process can be understood only by recognizing that human skills and the tools by which and on which they are exercised are logically inseparable. Skills *always* employ tools, and tools are such *always* by virtue of being employed in acts of skill by human beings. Once the dual character of the technological process is understood, the explanation of its dynamism is obvious. Technology advances by virtue of inventions and discoveries being made.... But all inventions and discoveries result from the combining of hitherto separate tools, instruments, materials, and the like. These are capable of combination by virtue of their physical existence ... no one ever made a combination without there being something to combine. Furthermore, the more there is to combine in any given situation the more likely inventions and discoveries become.

(Ibid.: 90–91)

For Ayres, technological progress and economic development were virtually synonymous.

***Ceremonialism***

Unfortunately, this “restlessness” which speeds forward the technological process can be curbed or limited by **ceremonialism**, the dichotomous opposite of technological dynamism. Ceremonialism imposes a curb on human creativity; in its essence, it is any **past-binding** behavior that tends to thwart the forward progress that technology imparts. There are five ways in which ceremonialism intrudes on any society, according to Ayres:

- 1 the **nature** of social stratification or class structures;
- 2 **via** social mores or conventions of what is acceptable behavior;
- 3 ideology which justifies the existing social stratification and mores and which

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further attempts to emphasize the negative consequences of changing either the social strata or the mores;

- 4 a social system of indoctrination which emotionally conditions individuals to accept the dominant ideology, mores and class and social stratification; and
- 5 social patterns of ceremonial behavior designed to reinforce the first four factors.

Which of the two elements – past-binding ceremonialism that tends to retard the pace of change, or technological dynamism which expands human potentiality – is dominant at any point in time is the determining factor in establishing a country's pace and level of development. For Ayres, all societies, developed and less-developed, have ceremonial and technological forces at work in them at the same time, often within the same organizations and institutions. Ayres insisted that economic development is the consequence of the successful triumph of technology over ceremonial behavior. Ceremonial structures assign privileges to some classes, while they condition the population to resist social and economic change. Successful development, in the Ayresian view, thus requires a revamping of those institutions, and the behavioral patterns that accompany them, which continue to be detrimental to the creation of an indigenous technological capacity (this need is discussed more fully in Chapter 13).

#### *The central role of education*

In Ayres' view, the means to diminish the negative effects of ceremonialism on technological progress was via expanded education, which he defined as the diffusion of knowledge and skills. Of course, organized educational institutions can be hostile to "educating" and be a determined element in society's efforts to inculcate and perpetuate the prevailing ceremonial structures. Indeed, this is often the case with educational institutions in poorer nations, even through the university level. Still, Ayres felt strongly that expanded educational opportunities for larger numbers, or what we will later call **human capital accumulation**, was the surest means for any society to promote economic and social progress:

[T]he most important factor in the economic life of any people is the educational level ... of the community. A technically sophisticated community can and will equip itself with the instrumentalities of an industrial economy. There is no instance of any such community having failed to do so.

(Ayres 1995: 94)

Economic development in the Ayresian perspective is thus indistinguishable from technological progress, and without continuing technological change economic development falters.

Technological change is the result of scientific discovery, experiment and innovation. The successful introduction of technology into the domestic production process in any country, what can be called domestic innovation, requires a scientific establishment capable first of adopting and adapting foreign-produced technological knowledge to local conditions and, later, of conducting its own research, designing its own experiments and recognizing the potential and sometimes actual dangers of



its own discoveries when applied to the domestic economy. In short, a developing nation must attain an independent technology learning capacity. This is the first step toward greater technological self-sufficiency.

While Ayres' work does not address the particularities of any developing society, and while it is difficult to link his unique form of analysis to that of the other heterodox thinkers, he addressed issues of crucial importance which complement the other perspectives presented in this chapter. And while Ayres had no major influence on mainstream thinking, his views on the importance of technology, the significance of education and other human capital creation, and the need for creating an appropriate institutional structure that is supportive of sustainable economic and human progress is one that is quite compatible with the viewpoint of the endogenous growth theories to be examined in Chapter 8. Thus, by isolating issues stressed by Ayres, one can explain a very significant proportion of the successes of the East Asian economies in recent decades. (We consider such matters directly in Chapters 8, 9, 10, and elsewhere in the remainder of this text.) So although Ayres' own writings perhaps exerted little influence at the time, the thrust of his approach and his insights into the sources of growth and of the barriers to progress are substantially the same as the perspective behind much of the recent scholarship on the growth process.

### *The institutionalism of Gunnar Myrdal*

Gunnar Myrdal's contribution to the social sciences has been remarkable, particularly for its breadth. A Swedish-educated economist, Myrdal (1898–1987) won the Nobel award in economics in 1974, ironically sharing it that year with one of the most fervent supporters of the free market, Frederick von Hayek. G.L.S. Shackle, a noted Cambridge economist, maintained that had Keynes not achieved renown for his revolutionary innovations in macroeconomic theory, the early work of Myrdal indicated that he would have supplied the same theory. Myrdal and his wife, Alva, made fundamental contributions to the development of the welfare state in Sweden, and Myrdal's study of American racism (1944) has remained a classic study of race relations. His massive work, *Asian Drama* (1968), established his reputation as a development specialist, which began in earnest in 1957 with his *Economic Theory and Underdeveloped Regions*.

In his later book, Myrdal drew three main conclusions which he sought to further support and demonstrate in his subsequent research.

- 1 "In the absence of counteracting policies inequalities would tend to increase, both internationally and within a country" (Myrdal 1984: 152).
- 2 International trade theory was biased against the poor regions, particularly in the contention that trade in commodities would tend to equalize factor prices, especially wages.
- 3 Greater income equality, rather than inequality, was the correct basis to achieve enhanced economic growth.

We shall examine briefly the significance of each of these three propositions.

**Cumulative causation and backwash effects**

Each of these three propositions was, in Myrdal's view, directly linked to the others, and all could be understood through an appreciation of what Myrdal termed **cumulative causation**. This concept sought to account for dynamic economic effects which progressively moved a society away from equilibrium. Myrdal assumed that there were notable inequalities between the regions of poor nations – that is, there was “dualism,” as discussed earlier. What happens when a less-developed nation receives a stimulus to growth? If, as is likely, this stimulus is experienced in the more prosperous region of the economy, then that region will surge even further ahead, leaving the more economically deprived regions of the economy lagging behind.

This cumulative causation will occur for many reasons, only a few of which can be summarized here, but all of the reasons lead to a movement in society away from equalization among regions and sectors and toward increasing inequality. First, more ambitious and better-trained workers will migrate from the poorer regions to the growing regions. This will leave behind a bifurcated population of the young and the old in the poorer areas, a population largely composed of dependents and low-productivity workers compared to those who leave. At the same time, in backward rural areas, there is likely to be a higher rate of fertility, leading to a more rapid rate of population growth that puts increasing demand on a smaller number of the least productive workers, pushing down income per person in these poorer rural regions. Thus movements in any one direction tend to be cumulative, exacerbating poverty and sustaining low levels of development where they exist and favoring and expanding upon economic development and progress where they already exist. The cumulative movements which tend to economically weaken a region were termed **backwash effects**.

*Secondary* backwash effect also might be anticipated. If the economic stimulus took the form of the expansion of industry in the economically more advanced region of a country, the output of the new firms might well compete with the peasant and artisan production methods prevalent in the poorest region. Artisan production might then be undercut by the economies of scale realized by manufacturers in the more advanced region of the country, slowly disrupting and then displacing artisan and small manufacturing industry in poor, rural regions. Such effects could be accelerated if the more economically advanced region of the country became more involved in international markets.

The **spread effects**, or positive externalities, of such a new growth stimulus might induce other, linked domestic manufacturing needed to support an expanded export sector, à la Nurkse's “balanced growth” or Hirschman's “linkage” models considered in the previous chapter. One might think that such effects would be a plus for development. Myrdal, however, cautioned that proper analysis demanded an understanding of both the positive impact of spread effects and the negative impact of backwash effects. Benjamin Higgins neatly summarized this aspect of Myrdal's thinking:

The spread effects could outweigh the backwash effects only if income and employment in the leading sectors grew relative to that of the laggard sectors, as they did in the now advanced countries. In underdeveloped countries, however, the historical pattern of growth has been weak. The rural sector did not produce

the raw materials for the expanding industrial sector, nor did the expanding industrial sector rely heavily on the rural sector for foodstuffs. Thus the growth of the industrial sector did not much expand the market for cash crops of the rural sector.

(Higgins 1959: 351)

The pattern of production in most less-developed countries reflected the legacy of colonialism and neocolonialism. The structure of the economy was one wherein a predominance of backwash effects arose because of past institutional arrangements, rather than on the workings of the laws of comparative advantage. The failure of investments in the export sector to generate multiplier effects sufficient to swamp the backwash effects arose from the lingering effects of colonial policies and adverse path dependence. In the advanced nations, investments in the raw material sector created new opportunities for manufacturing and processing, as well as for banking and shipping. But Myrdal argued that in most Asian and African countries, colonial policy was concerned only with advancing the key sectors owned or controlled by the advanced nations. Therefore, the stimulus to banking and insurance, shipping, processing, and manufacturing occurred primarily in the advanced nations, rather than in the colonial or post-colonial regions. The very weakness of the spread effects, coupled with the strong backwash effects, virtually guaranteed that the latter would dominate the former in the poor nations.

#### *The state*

For Myrdal, a crucial difference between the advanced nations and the poor nations was to be found in the strong state in the former and the weak (or soft) state in the latter (Myrdal 1970: ch. 7). With a strong state, the advanced nations could develop a coherent national policy which could address the question of the manner in which the benefits of economic growth might be spread through the economy. This was due to the fact that, to some degree, the state has some power to influence and direct the growth process. On the other hand, in the poor nations the state lacks effective policies to either ensure that there is a movement toward national economic integration or to address the impact of backwash effects.

Myrdal noted that one of the major weaknesses of the state in the less-developed nation is that it is an institution of, and for, the top social strata. He did not believe it likely that redistribution of wealth and income could be achieved via income and wealth taxes. The rich would only evade these, since they effectively controlled the taxing authorities through their political power. The elites thus did not fear state power. On this point, Myrdal noted that in Singapore, economic development proceeded to a certain degree, because it was "one of the few States in the underdeveloped world which actively fought against corruption" (Myrdal 1984: 158).

#### *Myrdal's institutionalism*

Myrdal utilized an institutional approach, but in a manner largely distinct from Ayres. Myrdal believed that one could not understand the sources of economic underdevelopment nor address the problems of underdevelopment as long as analy-

sis was restricted to the intellectual constructs of orthodox economics, such as the theory of comparative advantage.

The institutional approach meant enlarging the study to include what in a summary way I referred to as "attitudes and institutions". They were found to be largely responsible for those countries' underdevelopment and would have to be changed in order to speed up development.

(Myrdal 1984: 153)

Only radical institutional reforms would allow for development. Some examples of such changes needed might be land reform, a campaign against corruption, and displacement of the elite from the commanding heights of state policy. In short, the causes of underdevelopment and the cure for poverty were to be found in the study of and changes in the "attitudes and institutions" of the less-developed nations. Economic theories about saving and investment, "big push," "balanced" or "unbalanced" strategies were hardly enough.

### **Dependency analysis**

Dependency analysis became extremely fashionable, particularly in Latin America, and later in Africa, in the late 1960s. Dependency analysis built on the ideas of the structuralists, specifically Prebisch's distinction between the center and the periphery. The center was viewed as *cause* and the periphery as *effect*. According to dependency writers, the less-developed nations had to be understood as part of a global process. Their fate was merely to provide the inputs to the advanced nations or to receive their cast-off, low-wage manufacturing processes under trading conditions which were likely to worsen. Dependency theory found the causes for the lack of development to be *external* to the socio-economic formations of the less-developed nations. Thus, alleged internal backward or dysfunctional institutions of the less-developed nations were not treated seriously by dependency writers as a subject of analysis, or were seen as extensions of external domination. Internal institutional structures, such as the role of state corruption, large and unproductive land holdings, the extreme concentration of wealth, unresponsive political institutions, and so on, were played down. Instead, the negative influence of transnational corporations, multilateral institutions like the World Bank and the IMF, and the extensive influence of foreign governments in the internal affairs of less-developed nations were highlighted.

Several factors contributed to the rise of dependency analysis. Of utmost importance was the sway of "modernization" theory on social science analysis and policy, which promised quick and sweeping development, as suggested in the developmentalist theories considered in Chapter 5. As was noted there, Rosenstein-Rodan, Nurkse, Hirschman, Rostow, and others had maintained that the attainment of development for the less-developed countries was only a matter of time. Since most nations had already reached the "pre-take-off" stage, using Rostow's stage categorization, spectacular results were to be anticipated in little more than a decade. Yet, in the 1950s and 1960s in most of the less-developed nations, growth was only modest. Population growth had slowed gains in per capita income. Furthermore, confirming Myrdal's work, a process of cumulative causation leading to greater

dualism could be observed. Economic growth had created poles of prosperity in a sea of despair. Shanty-towns and slums ringed the new and fashionable city centers. Water quality was abysmal, state schools were pathetically incapable of offering an adequate education, for most people health care remained either non-existent or minimal, transportation was a daily nightmare, and the average diet remained rudimentary and inadequate. New woes arose, or were first analyzed, in these decades: environmental pollution and degradation accelerated, while work-place hazards mounted, as new chemicals and substances were introduced into the production process.

True, a new techno-bureaucracy of government functionaries, applied scientists and engineers, financial operatives, and managerial cadres now shared some of the income with the agro-export elite in some nations. A skilled middle class had formed, and they had experienced tangible social mobility. But for the working classes and small farmers who made up the bulk of the population, the changes wrought in the 1940s through to the 1960s were both traumatic and cruel.

It is not possible to find one dependency writer who could serve as an exemplar of this school of thought. Indeed, in what may well stand as the classic attempt to summarize and detail the ideas of the Latin American dependency writers, Cristóbal Kay referred to their works as a "Tower of Babel" (Kay 1989). While the gradations and subtleties of positions defy condensation, we have, following Kay, utilized a logical division: Marxist dependency analysis and non-Marxist dependency thought. Even this distinction, unfortunately, is less crisp than it might appear at first glance. The dependency writers were nothing if not eclectic, and borrowing from Marxism and employing Marx's categories and concepts was never treated as "trespassing," even by the non-Marxist theorists.

### *Marxist dependency analysis*

Paul Baran was, at the high-water mark of McCarthyism in the 1950s, the only known Marxist economist to hold a tenured professorship at a major US university, Stanford. Unlike Marx, who believed that capitalism had a dual role of "destruction and regeneration" to play in the colonial regions, Baran emphasized the destructive side of capitalism in less-developed regions, but could find scarce evidence of "regeneration." Rather, twentieth century monopoly capitalism, unlike the earlier form of competitive capitalism which Marx had scrutinized, had, according to Baran, a vested interest in maintaining backwardness and dependence in the periphery.

It might be argued that Baran initiated the analytical process which later led to the flowering of the pessimistic and stagnationist dependency school in Latin America and Africa. Baran's favorite example of the destructive effects of capitalism was that of India. He found that many Indian social scientists had discussed and developed concepts very similar to those employed by the dependency writers, but that they had done so as early as the late nineteenth century, having experienced the full force of British imperialism (see Chapter 3).

Baran's theoretical point of departure was an analysis of what he termed the **economic surplus**. This is defined as the mass of resources, actual and potential, which a society could have at its disposal in order to facilitate economic growth; it is the amount that might be reinvested in productive ways to increase the future level of

social output. This "surplus" is that residual left over out of total income after a society's basic needs have been met for food, clothing, shelter, and human companionship. But this surplus may be grossly misused. It may be utilized to erect sumptuous and multiple residences for the rich, or it might be wasted through a variety of other forms of conspicuous consumption. The military or the church may make tremendous demands on the surplus, or it may be drained away by a foreign power via plunder or simple profit repatriation, as a result of foreign control over a less-developed economy's most important industries. Baran's study of the history of the less-developed regions under colonialism led him to argue that the source of their poverty was to be found in the extraction of this surplus. Had this surplus, or a large portion of it, been used for investment rather than for waste, then the poor regions would have been transformed.

Colonialism, however, blocked the potential for change. Baran summarized in one short paragraph the broad history of colonialism, condensing in the process a tremendous amount of material, striking at the very essence of the colonial legacy:

To oppression by their feudal lords, ruthless but tempered by tradition, was added domination by foreign and domestic capitalists, callous and limited only by what the traffic would bear. The obscurantism and arbitrary violence inherited from their feudal past was combined with the rationality and sharply calculating rapacity of their capitalist present. Their exploitation was multiplied, yet its fruits were not to increase their productive wealth; these went abroad or served to support a parasitic bourgeoisie at home. They lived in abysmal misery, yet they had no prospect of a better tomorrow. They existed under capitalism, yet there was no accumulation of capital. They lost their time-honored means of livelihood, their arts and crafts, yet there was no modern industry to provide new ones in their place. They were thrust into extensive contact with the advanced science of the West, yet remained in a state of the darkest backwardness.

(Baran 1957: 144)

Reviewing the history of colonialism, Baran drew an extremely powerful conclusion.

Thus the peoples who came into the orbit of Western capitalist expansion found themselves in the twilight of feudalism and capitalism, enduring the worst features of both worlds.

(Ibid.: 144)

#### ***National capital, foreign capital, and the state***

Potentially, Baran argued, there were three forces which could both increase the economic surplus and harness it for economic development. These three potential sources for socio-economic change were national capital, foreign capital, and the state.

Regarding the first, Baran acknowledged that in some of the poor nations ISI had changed the structure of the economy. But he also maintained that ISI had failed to go far enough, and that, in fact, the end result of ISI would be the perpetuation of a



fragmented and disarticulated national economy dominated by pervasive monopoly and oligopoly firms.

The new firms, rapidly attaining exclusive control over their markets and fencing them in by protective tariffs and/or government concessions of all kinds, blocked further industrial growth while their monopolistic price and output policies minimized the expansion of their own enterprises. Completing swiftly the entire journey from a progressive to a regressive role in the economic system, they became at an early stage barriers to economic development rather similar in their effect to the semi-feudal landownership prevailing in underdeveloped countries. Not only not promoting further division of labor and growth of productivity, they actually cause a movement in the opposite direction. Monopolistic industry on one hand extends the merchant phase of capitalism by obstructing the transition of capital and men from the sphere of circulation to the sphere of industrial production. On the other hand, providing neither a market for agricultural produce nor outlets for agricultural surplus labor and not supplying agriculture with cheap manufactured consumer goods and implements, it forces agriculture back toward self-sufficiency, perpetuates the idleness of the structurally unemployed, and fosters further mushrooming of petty traders, cottage industries, and the like.

(Baran 1957: 176)<sup>9</sup>

As to the second potential source of change, Baran agreed with Hans Singer, whom he cited in this regard, that foreign investment, while clearly a *potential* source of development, actually failed to have an impact on more than a narrow, isolated portion of the national economy. Not only did he emphasize the enclave effect of foreign investment, Baran took the analysis one step deeper, arguing that foreign capital diminished the possibilities of economic development. This was so, Baran argued, because in order for the foreign mining and agro-export capitalists to gain a foothold in the less-developed areas, it was necessary to form an alliance with the merchant capitalists who dominated politically and economically within these regions. These relatively backward elements, with semi-feudal and semi-capitalist ideologies and behavioral traits at one and the same time, were actually strengthened by foreign investment. And, in turn, the institutions which they sought to perpetuate, Ayresian-type ceremonial or retarding institutions, also were bolstered by the enhanced revenues which flowed into the possession of the national strata of bankers, speculators, semi-feudal landlords, and political operatives.

In Baran's view, foreign investors in mining, oil and gas, and agro-export firms learned quickly to become hostile to genuine economic development as promoted through ISI. He listed four reasons for such opposition.

- 1 higher wages and tolerance of unionization meant lower profit margins;
- 2 foreign capital would become a targeted source for increasing state revenues, meaning that higher taxes and royalty payments would be imposed;
- 3 foreign exchange controls limiting the amount of funds which could be taken out of the country as repatriated profits would be imposed; and
- 4 tariffs on imported wage goods would be utilized to protect domestic manufacturing, thereby raising the likelihood that workers would demand higher wages to maintain their living standard, thus cutting into profits.

As to the third potential source of the surplus, in theory the state could break this deadlock by opting for new programs which would make ISI ever more dynamic and successful. In fact, however, the state in the less-developed regions seemed incapable of performing the crucial role or in making the decisions needed to move forward on any front that would advance development.

For Baran, following the capitalist road in the less-developed regions was to steer a course which would eventually lead not to Rostow's society based on mass consumption, but rather to an economic and social graveyard. Only by turning to socialism could the less-developed countries reasonably expect any relief from their poverty.<sup>10</sup>

### ***Associated dependent development: non-Marxist dependency theory***

One of the most noted non-Marxist dependency writers was Fernando Henrique Cardoso, who has had an active career as a Brazilian sociologist/economist with a worldwide reputation, and also as a powerful Brazilian politician, rising to be President of Brazil from 1994–2002. While most dependency economists argued that the nations of the periphery were capitalist, they suggested it was a particular kind of *peripheral* capitalism. One of the defining characteristics of this mutation was economic stagnation, or "the development of underdevelopment," in the catchy rhetoric of Andre Gunder Frank, another of the eminent dependency writers.

Cardoso, however, did not embrace this stagnationist perspective. Rather, he maintained that the economies and societies of the periphery had evolved and could continue to do so (Cardoso and Faletto 1979). There had been three major stages in the economic history of the less-developed countries. First was the agro-export stage of the colonial period, when economic dualism was prevalent. During this stage, the pre-capitalist sector of artisans, petty producers, and peasant producers had accounted for the bulk of all economic activity. Some sectors of the economy were integrated into the world economy, particularly the production of precious metals, minerals, and tropical products which were exported to the world markets. Production of these export products often took place in a modern semi-capitalist enclave.

Second, after the First World War, a major transformation in some of the less-developed economies, especially those of Latin America, had occurred with the creation of what Cardoso called the "developmentalist alliance." The strategic locus of this transformation was ISI. A new social structure of accumulation had been formed on the basis of common or cooperating interests of industrial workers, industrialists, governmental workers, and some powerful individuals in shipping, banking, and the agro-export sector who had made the change from the agro-export model of accumulation to that of ISI.

Eventually, however, the developmentalist alliance had been replaced by an authoritarian-corporatist regime. In this third stage, the populist orientation of the state, which had been characteristic of much of the ISI stage, had given way to drastic curbs on democracy, unions, the universities, and other areas of society where dissent might be encountered and tolerated. The weak welfare state developed in the ISI stage, in which social security and minimum wage legislation, public health care, and public education had been expanded for at least some part of the population, gave way to drastic cuts in the public service aspect of the state's budget. Above all, in this stage, the transnational corporations (TNC) were

welcomed and accommodated in the less-developed nations. In fact, the TNCs became pivotal in the new process of accumulation and were central to the growth process.

Although this new capitalist model was extremely accommodating to the interests of the TNCs, Cardoso argued, the TNCs were not all-powerful. The nations of the periphery needed the TNCs due to their ability to control and reproduce technology and complex capital goods. But the TNCs also needed the nations of the periphery, as their middle- and upper-income consumers had become an important source for final TNC sales. The peripheral labor force, kept docile and cheap by the authoritarian state, was necessary to keep costs down in an era of global competition.

Under this new regime, in which the authoritarian state and TNCs cooperate, some economic growth and development does occur. GDP rises; even the standard of living for the masses may improve. The continued stagnation that some dependency writers, like Frank, argued was the fate of the less-developed nations was neither theoretically plausible nor, even more importantly, argued Cardoso, was it empirically founded. One should not anticipate economic stagnation, or be surprised at a certain degree of economic progress in less-developed nations. Nor should one view the peripheral nations as powerless to shape their destiny, simply buffeted about by outside forces. Rather, a new form of capitalist accumulation was at work, which Cardoso termed **associated dependent development**.

Cardoso did not view this new stage, or its particular characteristics, as immutable. The poor nations had a certain capacity to bargain with the TNCs and the advanced nations and they had certain, but limited, opportunities to develop their own technological capabilities. The question was how, within this new structure, the poor nations were to respond. Innovation could have certain rewards. On the other hand, Cardoso found that the yearnings for a revolutionary rupture with the world system, as voiced by many dependency writers, was unfounded. By attempting to portray a situation of submissive dependency and stagnation, many intellectuals had hoped to stimulate a political shift toward revolution. Cardoso disagreed with the thrust of this analysis; the economic situation of most less-developed nations no doubt was difficult, the state had ceased to attempt to combat some of the most noxious problems in their nations, but the growth created by the new alliance between domestic capital and the transnationals under dependent development opened up some new possibilities for elements of the working class, the techno-bureaucracy, and the state to progress. At least for some less-developed nations, there was reasonable hope for modest reform and some limited autonomy, within the context of a new, more globalized, system of production. Less-developed nations may "depend" upon outside technology and finance via TNCs, but Cardoso believed that good state policy would permit less-developed nations to take advantage of the reciprocal needs of the TNCs in the less-developed countries, so that the poorer countries could obtain some of the positive effects of TNC investment and some of the benefits of economic growth would be shared within the poorer countries (see Focus 6.3).

Cardoso did not see dependency as necessarily a "zero-sum" game, in which the periphery lost and the center nations gained, as the stagnationist dependency writers believed. Rather, the current world economy provided opportunities for "positive-sum" games in which both the developed and less-developed nations could "exploit" each other. Growth in the periphery was possible, but achieving it depended on having the appropriate internal policies to gain advantage vis-à-vis the TNCs.

### FOCUS 6.3 DEPENDENCE AND THE SEMI-PERIPHERY

By the late 1970s a chorus of voices dissented from the simple center-periphery dichotomy of many dependency writers. The periphery, as destined to stagnation without a break with the world capitalist system, was increasingly seen as an incomplete, and inaccurate, description of the socio-economic conditions and the dynamic of change at work in some parts of the less-developed world, as Cardoso also argued.

It was true that some nations seemed caught in a post-colonial torpor, continuing to specialize in one or a few raw material exports. These non-industrializing nations, it was suggested, could best be described by what did not exist, but needed to be in place, if they were to develop. These nations were thus described as the **dependent economies**, stuck on the periphery of progress. They seemed incapable of autonomously altering their economic structures, stuck with adverse path dependence born of colonial structures carried over into independence.

Some less-developed nations, however, were growing and industrializing rapidly. For these economies, the term **dependent development** was applied by those who accepted this new way of looking at center-periphery relations. These were countries in the periphery, but which seemed to be changing their economic structures. Economic growth, often quite rapid growth, was taking place. These countries (Mexico and Brazil often were singled out), did not fit the stagnationist perspective of the original dependency analysis, but neither did they fit the pattern of independently developing nations.

In another path-breaking attempt to present an alternative to the stagnationist dependency perspective, Peter Evans defined "dependent development" as a situation which included:

both the accumulation of capital and some degree of industrialization on the periphery. Dependent development is a special instance of dependency, characterized by the association or alliance of international and local capital. The state also joins the alliance as an active partner, and the resulting triple alliance is a fundamental factor in the emergence of dependent development.

Although economic growth is achieved, countries engaged in a process of dependent development suffer a variety of ills:

a regressive profile of income distribution, (an emphasis on) luxury consumer goods as opposed to basic necessities ... underutilization and exploitation of manpower resources ... [and the] frequent reliance of foreign firms on capital-intensive technologies [which] increases rather than solves the unemployment problem.

Politically, a nation at the stage of dependent development is categorized as being in the **semi-periphery**, neither in the periphery nor in the center. Could nations undergoing dependent development ever graduate to the status of "core" nations? Dependent development theorists, such as Evans and Cardoso, did not rule out the possibility.

Sources: Evans 1979: 32; Evans and Gereffi 1982: 113

### Classical Marxism

While the dependency and other heterodox perspectives discussed in this chapter were under heavy attack from more orthodox development economists, an attack was also mounted from the political left.

Bill Warren, a former lecturer in Economics at the University of London, provided a cutting and intelligent critique of both non-Marxist and Marxist dependency

analyses. His ideas were extremely controversial, and his untimely death in 1978 foreclosed the possibility of a meaningful dialogue with his many critics.

Warren's position was that capitalism continued to be a progressive force for change wherever it operated. The capitalism sweeping into the less-developed regions of the world at a rapid rate may manifest signs of social pathology, but they were of a transitory nature, similar to the problems of early capitalism in England after the Industrial Revolution. Capitalism, Warren argued, had brought trauma and social dislocation in its wake wherever it had been established. But, he maintained, it had also brought an incomparably higher standard of living to the masses than any previous socio-economic system (you will recognize this, from Chapters 3 and 4, as Marx's view too). Furthermore, as the less-developed regions industrialized at a rapid rate, their industrial work force expanded. This social class would eventually bring socialism to those countries, but only after the initial triumph of capitalism, which was a necessary stage of social and economic development.

Holding aside Warren's prediction of a shift toward socialism somewhere in the undefined future of the less-developed regions, what is one to make of Warren's claims of the progressiveness of capitalism in the periphery? He made use of statistical data to show that in the 1950s and 1960s overall annual per capita growth in the poor regions had been relatively high: 2.4 percent in the 1950s and 2.6 percent in the 1960s. He implied that the pace was improving over time, noting that in the early 1970s, the average rate of growth of per capita income reached 3.8 percent.

Warren maintained that overcrowding, slums, and chronic unemployment arose from population growth, but that this growth itself was a fundamental indicator of an improvement in living standards. For Warren, all institutions within the less-developed nations which were ceremonial or dysfunctional from the standpoint of economic development were by-products of the colonial era and earlier modes of production. That era had ended after the Second World War, according to Warren, and a new era had dawned with political independence. And this, he argued, was sufficient to thwart whatever impediments to social and economic progress which could be attributed to either the policies of transnational corporations, the multilateral institutions, or the governments of the advanced nations. The spread of capitalist methods of production would sweep away outmoded institutions and structures, and the now less-developed nations would be brought into the modern era, just as England was, by the imperative forces of capitalist progress.

In the heady era of the early 1970s, Warren's thesis had a ring of plausibility; there can be no doubt that, like the developmentalists with whom he quarrelled, he shared a fundamental optimism about the possibility, even inevitability, of progress. However, the aggregate data utilized by Warren need to be carefully analyzed in terms of their representative nature. Warren's results were strongly influenced by the performance of the East Asian miracle economies. Without detracting from the great strides made in these nations, which are discussed beginning in Chapter 8, it should be noted that there has been a significant decline in their rate of growth in recent years. Thus, the Asian miracle economies had a tendency to skew the aggregate data after the 1950s and through the early 1970s. Warren, and others who use similar forms of analysis, should have presented disaggregated data, showing the overall growth of less-developed nations both with and without the miracle Asian economies. This would have been a more reasonable basis for attempting to evalu-

ate the thesis that "Capitalism has struck deep roots [in the less developed regions] and developed its own increasingly vigorous dynamic" (Warren 1980: 9).

Events would seem to have overtaken Warren's brash analysis. The durability of the retarding factors which disturbed the heterodox development economists have, if anything, become more significant for most developing nations in the 1990s. Ayres, Baran, Myrdal, Prebisch, and Singer would, we suspect, not have been surprised by the difficult conditions faced by many less-developed nations since 1980, nor by the anaemic responses to these conditions from so many of these economies. It is not that progress is impossible; it is just that, contrary to Warren, it is unlikely that it is *inevitable*. Becoming developed requires the right decisions and the proper policies; it does not just happen to all countries like manna from heaven, just as a consequence of the spread of capitalism.

### Questions for review

- 1 Using the definition in note 4 for the terms of trade, (a) calculate what happens to the terms of trade index for some country between 1995 and 2000, if, in 1995, the price index for its exports was 110 and the price index for its imports was 108; and in 2000, the price index of exports was 105 and the price index of imports was 112. Has there been an increase or a decrease in this country's terms of trade? If the country wishes to buy exactly the same physical quantity of imports in 2000 which it purchased in 1995, how much more, or how much less, will it have to export, in physical terms, in 2000 compared to 1995? Now, (b), examine what has happened to the terms of trade for two countries of your choice over a period of at least five years, using data in either the *World Development Report* or the *Human Development Report*. Does the trend you discover tend to support or refute the P-S hypothesis? Explain.
- 2 What is meant by the "international division of labor"? What function does the periphery play vis-à-vis the center countries in this division of labor? Who benefits from it?
- 3 Why do you think Raúl Prebisch's use of the terms "center" and "periphery," and the idea that relations between them were antagonistic, was such a challenge to orthodox economists?
- 4 Imagine you are an adviser to your government and that your economy faces a problem of declining terms of trade for its exports. Discuss the possible policy changes for the economy and any other strategies you would recommend to avoid declining terms of trade in the future.
- 5 What are the problems faced by primary product exporters? Are there primary products that countries might export which would, perhaps, not be subject to the same difficulties? Can you give some examples of so-called non-traditional primary products which it might be desirable to export? In general, what makes one export a "good" export and another less desirable?
- 6 Distinguish between backwash effects and spread effects. Are these the same as vicious circles and virtuous circles? How do these two ideas of Myrdal's relate to the concept of cumulative causation?
- 7 What similarities are there between the classical Marxist view of Bill Warren and the views of the developmentalist economists reviewed in Chapter 5? What differences are there?



- 8 Contrast the institutionalist approach to development with the dependency approach? Are there strong similarities, as well as differences?

### Notes

- 1 As we shall see in Chapter 8, however, the ideas of the institutionalists concerning the central role of education, technology, institutions, and path dependency have been "rediscovered" by the new development theorists, though without attribution.
- 2 The basic needs approach to development issues was a retreat from the optimism of the 1950s and 1960s, which had anticipated that within a decade or two the poor nations, or many of them, could achieve sustained growth and development. By the 1970s, such optimism had been shaken for many reasons. Among these reasons was the unexpected durability of social institutions which were to have been swept away by the forces unleashed via the developmentalist path. In lieu of the high hopes projected by the developmentalist perspective, the basic needs approach substituted a more modest and immediate agenda: some significant part of development funds were to be expended on projects that had a direct and tangible effect on the well-being of the poor, for example, self-help housing projects, water treatment projects, health clinics, schools, and so on. Much of the BN approach attempted to address an uncontrolled result of economic change in the less-developed world: the phenomenal growth of urban slums and blighted mega-urban areas.
- 3 The propensity to import is defined in Note 9, Chapter 5. For the United States, this ratio was much smaller than was true for Britain, meaning that imports were less important for the United States economy and that exporters to the United States would have less bargaining leverage on prices as a consequence.
- 4 Specialists in the area of international trade have used at least four separate concepts under the heading of "terms of trade." We will utilize the most basic concept, which is the ratio of the price of exports to the price of imports in a given period compared to some earlier (base year) period. The terms of trade is an index number. Thus  $(P_{x,i}/P_{m,i}) \times 100$  where  $P_{x,i}$  is an average price index of exports in year  $i$  and  $P_{m,i}$  is the average price index of imports in year  $i$ . This measure of the terms of trade is sometimes referred to as the **net barter terms of trade**.  
 Another measure of the terms of trade that captures changes in productivity between nations is called the **double factorial terms of trade**. We will not attempt to consider this or any of the other terms of trade measures which might be used. Students wishing to do so should turn to any text in international trade.  
 The *Human Development Report* includes data on the terms of trade for all countries covered.
- 5 The "development from within" approach, correctly understood, encompasses more than ISI, however. It is an evolutionary strategy of development that depends upon domestic sources of finance, domestic entrepreneurship, and domestic innovation to produce for both export and the domestic market. However, sometimes in practice, "development from within" has been too focused only on the domestic market, so that it has become "inward-oriented" development. This, however, was not Prebisch's own view, though it has incorrectly been attributed to him (see Sunkel (1993), for a finely detailed look at development from within).
- 6 Certainly, complete industrialization in all sectors would not be urged on all of the national economies of the periphery. Prebisch's experience with industrialization programs was primarily with relatively large economies, like Argentina, Brazil, Mexico, Peru, and Venezuela. The smaller economies, such as Costa Rica, Sri Lanka, the Caribbean countries, and some African countries, could not hope to have large and diversified industrial sectors. For smaller economies, Prebisch advocated enhanced common market-type arrangements so that sharing of markets could accomplish what was possible internally in large economies. The development problems facing small nations may sometimes be a bit more difficult, but as the successes of Singapore and Hong Kong in recent decades suggest, the situation is far from hopeless. Size, per se, does not seem to be a particularly powerful explanatory variable.

- 7 Income elasticity measures the change in consumption resulting from a change in income. Technically, it may be written as

$$E_Y = \frac{\% \Delta Q}{\% \Delta Y}$$

Where  $E_Y$  is the income elasticity,  $Q$  is the level of consumption of some good or service, and  $Y$  is income.

- 8 There are two newer branches of institutionalism besides the dominant strain discussed in this section. One is European institutionalism, organized around the efforts of the European Evolutionary Economics Association. The other, grounded in the work of another Nobel winner in economics, Douglass North, is called the "new institutional economics." For recent applications of the latter view, and a number of critical evaluations, see Harriss *et al.* (1995).
- 9 In Marx's writings, a major distinction was made between economic activities which took place in the "sphere of circulation" and those which took place in the "sphere of industrial production." In the former, activities such as banking, insurance, stock, and bond markets, were to be found "circulating" funds from various groups within a social strata, for example, savers and investors. In the sphere of production were to be found workers and capitalists, investment activity, production of manufactures and raw materials and, most importantly, technological development. The sphere of circulation was viewed as unproductive, although to some degree necessary for the economy to function, while the sphere of production was viewed as productive. Hence, an expansion of the sphere of circulation indicated that the surplus was being diverted and development opportunities thwarted.
- 10 Recall that when Baran died, in the mid-1960s, the Cuban revolution was viewed quite positively by many, and China seemed to be making forward strides in many areas as well. We will not attempt to speculate on how Baran might have viewed the issue of capitalism versus socialism from the perspective of the twenty-first century. He greatly admired the Cuban revolution and seemingly agreed with his close associate Paul Sweezy that the Soviet Union had become a "state-capitalist" society dominated by a bureaucratic strata of state-managers, and that progress would be only for a narrow elite.

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