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"The Theory of Trade and Development from the Indian Point of View"

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Ladies and Gentlemen, it certainly gives me great pleasure to come and address you. I have been to the Exim Bank before, many years back giving a lecture. And I am really honored to give it again and to meet so many of you and to see Exim Bank thriving. My topic today is the Theory of Trade and Development from the Indian Point of View.

The theory of trade and development as most of you know is probably one of the oldest branches of economics. In fact if you think about classical economists including Adam Smith, trade and development was their pre-occupation. Some classical economists were writing about a developing country at that time --- Britain, which was going through a process of industrial transformation. Since then, there has been a large and long standing literature of trade policy and development.

After the British development occurred, with industrial revolution, in many other countries which followed, there was much interest again in the issue of trade policy and development, in view particularly of the early start in Britain. In United States for example, one of the founding fathers of the US constitution, Alexander Hamilton presented to US Congress in 1791 a report on manufactures; this was largely about US policy to withstand British competition. Then in the middle of the 19th century as Germany started industrializing, Friedrich List, was a major economist who wrote about what to do for German economic policy when the British had gone ahead. In Eastern Europe, several economists in the 19th century and early 20th century wrote about trade policy. In India, particularly in this part of India, M. Ranade wrote a lot about the need of rapid industrialization and the nature of necessary trade policy.

In recent years, most of the emphasis in Economics literature has been on the literature of trade and growth, including the implications of the so-called new growth theory. And the hypotheses resulting from that growth theory have been tested, often with cross-country data. The new growth theory started being discussed around the beginning of the 1990s, but very recently if you look at the literature on trade and development in the last, say 7-8 years, there's a big shift, and my starting point would be with that shift. The shift is now from macro to micro.

This recent emphasis on micro studies or the micro foundations of the links between trade and development looks at different channels through which trade policy affects economic performance. This is mainly at the firm level and at the industry level and most of my talk today will be about that level. However, very little work has been done in India at the micro level. There are some macro level studies, but very little at the micro empirical level. In the last few years, fortunately, some new empirical work is going on, mostly abroad, with Indian data, and I am going to refer to some of that.

Let me give you an overview of what I am going to talk about. I am going to talk quite a bit about within-firm productivity change. Not

at a macro level. Not even at a level of a sector. But within a firm how trade policy affects productivity change. I'll discuss firm-level 'learning by doing' as an outcome of industrial policy; I am also going to talk about the importance of product quality and new imported inputs embodying technical progress; and also about productivity growth within multi-product firms. So these are all within-firm productivity changes. I am also going to talk about industry-level productivity that changes through market share re-allocation and how trade may improve aggregate productivity in an industry. Yet I'll discuss how it may not necessarily reduce poverty. I think this may be an important issue to discuss in India. I also say in that context that there is need for more work, on an integrated analysis of trade policy and labour market studies. I will then mention some evidence that within-firm productivity rise has been more important in India as an effect of trade liberalization than market share re-allocation, and discuss some possible reasons for this.

Finally, I will make some remarks on sharing of the gains from trade, in this case sharing between developed and developing countries and also sometimes between groups within a country. And I will refer to the importance of marketing and middleman margins and the role of quality reputation in international trade. So that is roughly the kind of issues I will talk about.

So let's start with the large theoretical literature on 'learning by doing'. As I already hinted, this has been in Economics literature for a very long time, at least since Alexander Hamilton more than two centuries back. He didn't use the expression learning by doing, but potentially he was talking about it in the United States

with some protection given to American manufactures against British competition at that time.

In the theory of technical change, there is a particular distinction between easily quantifiable and thus transferable technical knowhow and the type that requires 'doing'. With the former, you get a blueprint and you learn how to do some things. You don't need to learn by doing. You learn by reading, or by making a Xerox copy of the blueprint and studying it. That's a different kind of learning. But the more important form of learning is actually practicing it. And this requires on-the-job training and slow adoption of practices that avoid earlier mistakes, thus making us more productive. On this there are many empirical studies in developed countries. For developing countries the macro case that people have talked about in learning by doing is the East Asia success story. For example, South Korea has been a phenomenal case on learning by doing. In fact anecdotally people have talked about how in the mid 1960s Korea wanted to produce steel and had asked for a World Bank loan. The World Bank was of the opinion that Korea did not have any comparative advantage in producing steel, as it lacked the basic resources like iron ore or coal. But Korea still went ahead and produced steel, importing those resources, and, of course, over the years Korea became one of the most efficient producers in the world in some varieties of steel. So that is a clear example of successful learning by doing. However, while there are successful cases, there are also failures, even by Korea; for example, the heavy chemical industry didn't do that well. But there is a political aspect that I want to emphasize in the East Asia success story cases. And that I will illustrate by giving you a story from another East Asian case.

I saw a striking example in Robert Wade's 1990 book, Governing the Market. This is an example from Taiwan in the early 1980s. Those were the days of one of the new consumer electronic products, the VCRs, the videocassette recorders which nobody uses these days anymore. But at that time it was a new product. And the Taiwanese VCR producers could not compete with Sony, which was the leading Japanese producer. So Taiwanese producers went to the government and lobbied for temporary protection for the industry. The Taiwanese government said yes, and announced that the protection would be given but for a very short period and if the industry did not succeed in competing with Sony by the end of the period, then the protection would be dropped. The VCR producers in Taiwan were given 18 months to shape up or drop out. Taiwan did very well in some other industries but in the VCR industry after 18 months they did not succeed in out-competing Sony.

The next thing that happened is not a familiar story in many developing countries. After 18 months passed and the Taiwanese producers of VCRs did not succeed in out-competing Sony, the government said that protection would not be extended. That is the political difference. The difference is that in many countries, industry would lobby hard and get an extension of the protection. It has happened in India, it has happened in the United States and in many other countries when they were trying to get infant-industry protection. What does this mean? This is an unusual political case of what economists call credible commitment. Once you commit to an 18-month period of protection, you stick to it. In India even if the government gives you a commitment you know more or less, that come the crunch time you will be able to get

your extension. So I think this politics of credible commitment is intimately related to the economics of infant-industry protection. In the protection literature this political aspect is quite often under-stressed.

In India, very little empirical work has been done on 'learning by doing' in a firm or industry. But I am going to start with some recent studies. There is a new book by John Sutton from the London School of Economics, Competing in Capabilities: The Globalization Process (2012). John Sutton is a theorist on industrial organisation but he did some micro empirical studies in China and in India. He studied the car industry in China as well as in India, on how within a few years after the arrival of international car makers, the producers of car components, the intermediate producers of car parts, attained world class standards (particularly measured by the rate of defective parts produced) in a very short period.

In certain industries, the learning is faster compared to other industries. Learning is faster in car industry because of two particular reasons: one, many of the business practices and production routines in car industry are now standardized and secondly, within the supply chain back and forth, the sharing of information and incentives is much more easily aligned in the vertical structure of the car industry. These two aspects were not there, for example, in the Indian machine tool industry, which made learning very slow and difficult.

The machine tool industry in India also illustrates an important aspect, of learning to achieve quality that is crucial in global trade. Most international trade theorists will tell you that what is

important is comparative productivity. There is no doubt that productivity is important but sometimes low productivity can be made up by lower wages. And I am coming to a particular example of that. But if the quality of a product is below a certain threshold level, international customers will not buy it at any price. The standard theory of trade does not take this into account. If the quality attained is lower than the minimum threshold, then most international customers will not buy it even if your labor cost is very low. This is a major problem in international trade for poor countries to which trade theories have not paid enough attention. Sutton gives the example of the basic CNC lathes in the Indian machine tool industry. In the 1990s, after trade liberalization, Indian machines were losing market share to machines imported from Taiwan. The main problem was not low productivity. Though Indian productivity was lower than Taiwanese but that was not the main problem. Why? At about the same production technique at that time, that is, in the nineties Taiwanese labor productivity per hour was 6 times that in India. That is a big difference. But the Taiwanese wage was 8 times higher. So unit labor cost was actually somewhat lower in India. So labor cost was not the problem even though Taiwanese productivity was much higher. But labor cost was only about 15 per cent of the total cost of CNC lathes machine tools. About half of the unit cost was accounted for by computer controls. Production engineers measured that the quality of Indian machines was about 3 per cent lower than that of the Taiwanese machines, measured in terms of recorded numbers of machine hours lost due to machine malfunction. Even this small quality difference of 3 per cent led to a large loss of market share for the Indian machine tool industry. Therefore, a small difference in quality made a big difference in market share, but not a large

difference in labor productivity. So it's the quality story that I think needs a lot of emphasis.

If the quality level can be raised then globalization increases the incentive of making profits from trade because if you have a minimum satisfactory quality you now have the whole world market rather than just the domestic market. So for quality producers, globalization certainly helps. In fact Bharat Forge is an example of attainment of top international quality in specialist forgings. Another success story in innovativeness is Mahindra & Mahindra in the commercial vehicles industry. Unfortunately these are stories and you read them in the business press. But you really need a great deal of detailed empirical work in the firm or industry level learning. And that is what is lacking in India. So part of the purpose of my talk is to inspire at least some of you to do detailed micro level empirical work on which there is a lot of work going on in other countries but not so much in India.

Now what are the industrial policy implications of learning? Of course in the old literature it was protection, at least temporary protection. But today it is much more complicated because meanwhile, just to give an example, some of the policies of 'local content requirement', protecting the car component industry are no longer legal by the rules of WTO . Still there is a lot of scope for some kind of soft industrial policy. This is a term that has been used by a survey article in 2009 by Ann Harrison and my Berkeley colleague Andres Rodriguez-Clare in the Handbook of Development Economics. The goal is to develop domestic policies of coordination that improve productivity, which are permitted by WTO, rather than interventions that distort prices. What kind of coordination? Through fiscal incentives for new activities,

encouraging skill formation and technology adoption, supporting collective action for self-help business clusters and improving regulation and infrastructure. Also one should be clear that old-fashioned protectionist policies are now ill-suited to industries which can thrive only in the world of global supply chain networks. This is a big change in international trade. If anybody asks you what has been the biggest change in the pattern of international trade, in the last say 10-15 years, it is that today, there is no national product as such. Everything comes from a global supply chain. In the United States, a car produced in Detroit is called an American car but it is not really an American car. More than 80 percent of the car is produced elsewhere. International trade policy, for a long time, has been about 'us' versus 'them'. We are no longer in that world. So the old slogans of economic nationalism are obsolete because the pattern of international production has changed. And one of the major successful users of that pattern is China; China has used the global supply chain in a big way.

Now let me move to the topic of productivity growth from imported inputs. The new growth theory has pointed attention to the static and dynamic gains from trade with increased access to new and imported inputs that didn't exist before or to new varieties of existing products. I am going to now cite some work that has been recently done for India. Not in India but using Indian data. This is the Prowess dataset for large companies, collected by CMIE, Center for Monitoring the Indian Economy. With this dataset Goldberg, Khandelwal, Pavcnik and Topalova in a paper in the Quarterly Journal of Economics in 2010 have studied the impact of tariff reduction in India in the 1990s. It shows substantial gains from trade through access to new imported

inputs. Two-thirds of the surge in imported inputs occurred in products not imported prior to trade liberalization. After trade liberalization, the new products started being produced because the new imported inputs were now being available. That brought a substantial gain from trade. Another finding is that lower input tariffs accounted on average for 31 per cent of new products by domestic firms, largely through increased firm access to new input varieties unavailable before. Lower input tariffs also improved firm performance in TFP, Total Factor Productivity, and R&D, research and development activity. The same authors have another article, in the Review of Economics and Statistics 2011, that, on the basis of the same data, showed that firm productivity growth on account of re-allocation in favor of higher valued products in multi-product firms in India was not significant. It was found significant in some Latin American studies but not so significant in India.

Another way of understanding industrial productivity and how it increases with trade liberalization is through market re-allocation within the industry. Trade liberalization facilitates exit of low-productivity inefficient firms and encouragement of larger sized efficient firms. Thus market re-allocation within an industry can be a major source of industry level productivity change. And we have evidence for this in the Indian manufacturing sector in a paper in the Journal of International Economics, 2011 by a student of mine, Shanthi Nataraj. in Berkeley. She got hold of two large data sets, one from the ASI data, the Annual Survey of Industries data, for the organised sector firms, and for the much larger number of unorganized manufacturing firms, she used data from the NSS, the National Sample Survey data for unorganized sector enterprises. On the basis of this combined dataset, covering both organized

and unorganized manufacturing, her statistical analysis yielded some interesting results. First, productivity increased by 15 percent for a 50 per cent average reduction in tariffs over 1989 to 1999 in India. But the firm size distribution was compressed, so that much of the brunt of their adjustment of trade liberalization was borne by the informal or unorganized sector firms. Greater competition wiped out many of these low-productivity firms, so as a result the average productivity in the industry as whole rose because of trade liberalization. But what does it tell us about the link between trade and poverty? Another way of putting the question is, yes, low-productivity firms were wiped out but for the people who were working there, what happened to them? Nataraj's paper did not answer this question because she did not have the requisite data.

Many of the people employed in the low productivity manufacturing firms may now have gone and crowded in the non-traded sector because it is the traded sector which faces competition. Crowding the non-traded sector and informal services must be bringing down average productivity in the rest of the economy. So even though the productivity of manufacturers in the traded sector went up there is a cost. These job-displaced people became worse off, but even if you just concentrate on productivity, the average productivity in the economy might have gone down or did not increase as much as otherwise would have. In India we do not have enough data to accurately measure this problem. Another ex-student of mine at Berkeley, Marc Muendler, a German, who along with a Brazilian co-author Menzes-Filho, has worked on Brazil on exactly this question. They tried to track individual workers across jobs. The Brazilian data allow you to track individual workers across jobs after trade liberalization of the

1990s in Brazil. Their results show that the tariff cuts trigger worker displacements which are not absorbed in the traded sector (just as I guessed), increasing transition of workers to services, to unemployment and forcing many out of the labor force altogether. This paper has come out as a 2010 NBER working paper.

So globalization was not necessarily pro-poor. This does not mean globalization cannot be pro-poor. There are cases where globalization had pro-poor effects. In fact one of the major examples I would say is the Bangladesh garment industry. Lots of poor young women got jobs in the garment industry in Bangladesh because of globalization. But in the Indian case of manufacturing in general globalization was not necessarily pro-poor, even though productivity in the traded sector may have improved. Such detailed statistical studies like the Brazilian one cry out to be done in India. But it requires a new set of data combining firm-level data (like those from ASI and NSS) with household labor survey data. Unfortunately our surveys do not yet collect data that can link employer-employee records, or firm characteristics with the job history of workers. Much also depends on the politics of domestic redistribution mechanisms. Because standard trade theory as well as general economic theory tells you that if a policy improves productivity, it should ultimately help everybody. How? For those who gained, you just redistribute some of their gain. Gainers can compensate the losers and still retain much of the gain. This is the old idea of economics of welfare improvement in the potential sense. But unfortunately the politics of the real word is such that very seldom gainers compensate the losers.

Harrison, Martin and Nataraj in a recent paper forthcoming in the World Bank Economic Review, have used the ASI firm level data to

show that in the period from 1985 to 2004, most of the productivity improvements happened due to learning rather than the market share re-allocation through exit of low productivity firms, or entry or expansion of high productivity firms. They find in the ASI data that the productivity improvements have been more due to within-firm learning that I have discussed before, rather than market-share-re-allocation. Why is it so? Why did India not have enough of market share re-allocation? The usual explanation of limited inter-firm re-allocation is India's rigid labour laws relating to job security which do not allow you to have employment adjustment in response to market changes through the hiring or firing of workers, so the labour laws are supposed to cause barriers to entry and exit of firms. The business media emphasize this quite often. But the article by Harrison, Martin and Nataraj that I just referred to shows that economic reforms had a similar effect on re-allocation among firms in different states with different degrees of implementation of labour laws. Everybody knows that the labour laws are applied very loosely in some states, the state government essentially looks the other way when people are laid off; but in some states they are very rigid. But Harrison, Martin and Nataraj, on the basis of their dis-aggregated firm level data, did not find much of a difference in the different states in this inter-firm re-allocation even though the labour law applications were so different.

On labour laws, my own position is this: while I am in favour of relaxing some of the rigidity, there are some considerations usually ignored in the business media. Let me mention some of these. In this context one of the industries I have studied is the garment industry. The reason I am interested in it is because the garment industry is a highly labor-intensive industry and if we

could expand it, it could give lots of jobs to relatively poor unskilled or semi-skilled people. Why is it that India is not among the more successful garment industry cases in the world, even though India has a long tradition in this industry and a large pool of unskilled workers? The most successful case is that of China, and the second most successful is Bangladesh. The garment industry in Bangladesh has done much better than in India. I looked at the combined firm-level dataset, the formal sector data from ASI and the informal sector data from NSS, for the garment industry I looked at ASI and NSS together. So labour law (Chapter VB) mainly tells you that if you employ more than 100 people then you have to take Government's permission to fire anybody, and that permission is often very difficult to get. So I thought if that is really an important constraint, looking at the scatter diagram of firms I would expect a lot of bunching just below 100-employee size. I did not see any such bunching in the scatter diagram. Most of the bunching in India was in a different part of the scatter. It is for below-8 employee firms, which I didn't expect: 92 per cent of the firms had fewer than 8 employees. It immediately struck me this must be your corner neighborhood tailor shops with very small number of employees. That's where the bunching is. So immediately my question is: what prevents an 8-employee garment enterprise to expand and become a 50-employee firm? Labour law should not be a problem. Labour law will kick in much later with larger number of employees. So at least for a whole small set of enterprises, labour law is not the binding constraint at least in garment industry so far as the data tell you anything. A binding constraint is more likely to be reliable supply of electricity. Suppose you have an 8-employee firm in garment industry and you are thinking of becoming a 50-employee, 40-employee or 30-employee unit, immediately you have to think about making some investments in power equipments of various kinds.

Formerly, probably your 8-employee firm only uses electricity for a bulb, or a sewing machine. But when you want to expand into a 50-employee unit you have to think about regular electricity supply which is missing in large parts of India; even when there is electricity, voltage fluctuations can burn up the machines and so on. So electricity is a big constraint. Roads, credit, managerial and organizational training, etc are other constraints. While in spite of all this, we only point to the labour laws, we are often barking up the wrong tree.

What one needs is a package deal allowing more flexibility in hiring and firing, but that has to be combined with a reasonable scheme of unemployment compensation from an earmarked fund to which employers as well as employees should regularly contribute. No Indian politician has yet gathered the courage or imagination to come up with such a package deal.

The 2010 study of the garment industry by Minu Tewari shows that at the ground level of even such a footloose and globalized industry like garments, there are some new initiatives on the part of suppliers in the global chain to follow labour-friendly practices which actually improve productivity so that labour and capital need not always be in conflict. Some labour-friendly policies are complementary with raising of productivity, by reducing labour turnover and helping firms in timely delivery and achieving product quality. While some business groups continue to think of 'flexibility' to mean 'union free', there are now new kinds of independent unions. Take for example the NTUI Labor Federation, particularly the Garment and Textile Workers' Union in Bangalore, which tries to mediate in the change and sustain labour-friendly practices that are compatible with global competitiveness.

Finally, in international trade theory, much of the work concentrates on production costs. That is important no doubt, but it is often relatively less important in deciding the sharing in the distribution of gains from trade. So let me give you two examples. In the United States a very popular doll for children has been the so-called Barbie Doll. It sells in US Stores for $9.99. Turn the doll around, it would say 'Made in China'. How much money do the Chinese make out of the $10 Barbie Doll, which is made in China? An estimate says that of the $10, 65 cents go to the Chinese worker, and roughly 35 cents to the Chinese producers of the materials, altogether $1. So the Chinese producers get $1 out of the $10. The rest of it is other costs, transport, distribution, advertisement and a lot of other costs. But there is also a large middleman margin in this case. The Mattel company, I think, gets a large part of the retail margin. Let me give you another example. You walk into a US GAP store. You buy a shirt, it will cost you $25, and it is also 'Made in China'. There has been some analysis of the decomposition of this price. Out of the $25, around $2 goes to the Chinese manufacturer. You always hear about this phenomenal rise in Chinese exports to GDP ratio. China really had a phenomenal export growth but think in terms of value added. The export GDP ratio is a strange hybrid, because the numerator is in terms of gross value and the denominator is value added. If you really compare value added to value added, Chinese export performance is not that huge.

For quite some time, I have been interested in the fact that if a $10 doll or $25 shirt is made in China, but if China is getting a very small part of it, who is getting the rest of it? How are the gains from trade being shared between countries? Along with my

co-authors Mookherjee and Tsumagari, we have now developed a theoretical model of middleman margins related to globalization (in a paper forthcoming in American Journal of Economics, Microeconomics). The problem is that it is very hard, costly and time-consuming for producers or manufactures and service providers in poor countries to establish a brand name and reputation in quality and timely delivery, which are crucial in marketing. Particularly in international markets, this can be much more important than comparative costs of production that traditional trade theory emphasizes. (Abhijit Banerjee and Esther Duflo have a 2000 paper in the Quarterly Journal of Economics which gives an account of the difficulties of reputation building even in the Indian software industry in its early years). There are economies of scale in reputation building, which work against small sellers or poor countries. Though I gave you examples from manufacturing products, the middleman margin issue is true for agriculture as well. Even for the coffee that you are drinking, the actual coffee producer gets a minute fraction of the price that you have paid.

There is a general policy issue here. Many people are justifiably outraged by the very high marketing margins that the monopolistic multi-national trading companies currently charge, but they should agitate more for international anti-trust action, not anti-trade action. There should be more energetic international attempts to certify quality of poor country products and against international restrictive business practices. One should establish an international anti-trust investigation agency possibly under the WTO auspices. Some may ask what is the point of having an anti-monopoly agency when internationally you cannot

enforce, as there is no international government. I think even investigation by a recognized international agency is important, and it will also help domestic competition commissions like the one we have in India now. Domestic competition commissions can use those data to take out individual cases where monopoly practices are rampant in international retail. I think it is extremely important.

I have talked to many thoughtful anti-globalization people about the main source of their difference of opinion with the pro-globalizers. The primary complaint is partly about this kind of monopoly pricing of international companies and partly about something that I already mentioned about what happens to the process whereby the poor people lose jobs and there is no social protection for them.

Let me end by saying that the major part of my Lecture was to really bring out certain issues on which we now have new evidence but quite often a lot more evidence is needed for informing the policy discussion in India. I would like a lot more micro level empirical studies on these issues to answer some extremely important questions if you are interested in trade and development.

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