World Development Vol. 34, No. 6, pp. 981–995, 2006

0305-750X/$ - see front matter

www.elsevier.com/locate/worlddev

doi:10.1016/j.worlddev.2005.11.011

# Revisiting the Revisited Terms of Trade: Will China Make a Difference?

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**Summary.** — In challenging the conventional wisdom at the time, Singer and Prebisch posited a number of explanations for declining terms of trade of developing economies, including both country- and product-specific factors. Over the past decade, we have begun to witness a simultaneous process of price differentiation within commodities (with the prices of some commodities increasing) and within manufacturing (with the price of many manufactures falling). These price changes may reverse the decline in the terms of trade of commodity producers. The entry of China into the global market has played an important role in this, augmenting the demand for many "hard commodities." Its role as an exporter of manufactures, coupled with concentration in global buying may undermine the prices of many manufactures.


*Key words* — terms of trade, globalization, China, India, reserve army of labor, buyer concentration

## 1. EARLY THINKING ON THE TERMS OF TRADE [1]

A focus on the particular problems confronting developing countries was a by-product of post World War II reconstruction. Until then, low-income economies had not been seen as a special case. This neglect resulted in part because of the challenges posed by the need to cope with the Great Depression of the 1930s, and subsequently due to the years of disruption during the war. But with reconstruction came the demand for raw materials—food and commodities—and hence with the developing world as a source of supply. But at what prices?

The prevailing wisdom at the end of WWII was that developing country barter terms of trade would increase due to the relative rapidity of technological progress in industry, which would push down the relative prices of the manufactures exported by the high-income economies. This was contested by Prebisch and Singer in the early 1950s (Prebisch, 1950; Singer, 1950). [2] They argued that the likelihood was that it was the developing country terms of trade which would decline, and they offered a number of explanations for this predicted outcome. The first reason was that many of their (exported) products were inputs into the production of (imported) manufactures. Hence, a fall in the price of a primary commodity which is an input into a manufacturing product would have different implications for the producer of the commodity and the purchaser of the manufacture. [3] Second, Singer and Prebisch argued that the income elasticity of demand for the products produced by low-income economies was less than that for products embodying higher technology (Engels Law). A third and related explanation concerned the price elasticity of demand for the primary products exported by developing economies. The demand for these lower technologies and more basic products would be much less price sensitive. Hence, an increase in demand for the output of low-income country exports would only come from a large and disproportionate fall in prices. Fourth, many of the commodities exported by low

* I am grateful to three anonymous reviewers, and to Ricardo Gottschalk and John Humphrey for comments on an earlier draft. Final revision accepted: November 3, 2005.

income countries were subject to synthetic substitution, and hence to declining demand. Fifth, the output of low income economies generally embodied products with low barriers to entry. Thus, these products would be subject to a greater squeeze on prices and margins than products which were more difficult to produce and which had greater technological content.

But they also offered a sixth explanation, which has largely been ignored in the literature (but see Bloch & Sapsford, 2000 [4]). It is an explanation which addresses the country—rather than the product-determinants of the terms of trade. Singer-Prebisch argued that price-formation was rooted in labor markets, and used a framework later elaborated in 1954 by W. Arthur Lewis. Their view was that in the industrialised countries, labor markets were tight and trade union power strong. Thus product pricing occurred on a cost-plus basis. By contrast, developing countries were characterised by a "reserve army of labor", keeping wages down and close to the subsistence level. In these labor-surplus economies, product prices were therefore much less likely to rise than those in the industrialised countries. Prebisch and Singer would have liked to compare the trends in the relative prices of products emanating from these two different types of economies, but this was not possible given data-limitations at that time. Therefore, they chose to measure the differential trends in unit prices of manufactures and commodities *as a surrogate for the output of high-income and developing economies*.

This focus on the commodities-manufactures terms of trade has been the subject of extensive debate in the literature. There has been disputation on both methodology, and perhaps more importantly on the significance of the choice of base- and concluding-year in the analysis. [5] There is also the need to separate long-term secular and shorter-term cyclical trends. Nevertheless, it is now widely accepted that for much of the 20th century, [6] the barter terms of trade did indeed run against commodities, and in favor of manufactures. Figure 1, for example, drawn from UNCTAD data, plots the aggregate terms of trade between a weighted basket of manufactures and commodities, [7] and shows a declining trend, except for the latter half of the 1970s.

## 2. THE TERMS OF TRADE REVISITED

In 1971, Singer reworked his ideas about the gains from international trade to raise the possibility that the determinants of price formation may reflect the degree of innovation-intensity (Singer, 1971). This revisited the earlier discussion of the 1950s in three important respects. First, it re-emphasized the initial focus on the role played by barriers to entry in income determination. In this sense, Singer was reflecting the growing importance of neo-Schumpeterian perspectives on the role played by innovation as a determinant of income-growth (Freeman, 1976). But, second, it re-opened the country- (as opposed to product-) determinants of price trends, since Singer observed that systematic innovation was centered in the high-income economies. It was at that time that Singer played a prominent role in what came to be called the Sussex Manifesto, a document which observed that less than 5% of global R&D took place in the developing world (Singer *et al.*, 1970). Third, and perhaps most importantly, it opened the possibility that not all manufactures would necessarily experience rising terms of trade.

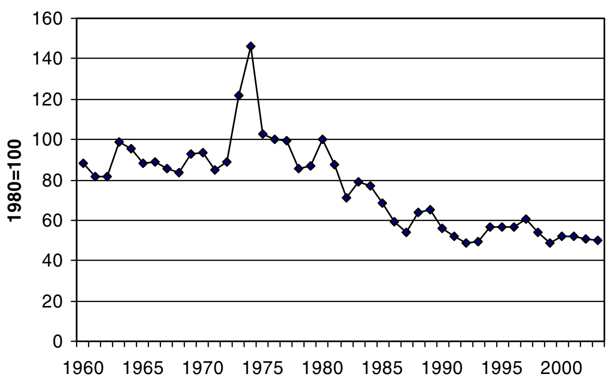


Figure 1. *Manufactures-commodities terms of trade, 1960–2004. Source: Drawn from UNCTAD-database.*