THE PREBISCH THESIS AND POLICIES FOR DEVELOPMENT OF LESS DEVELOPED COUNTRIES

A Report

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CHAPTER I

INTRODUCTION

As past head of the Economic Commission of Latin America and secretary general of the United Nations Council on Trade and Development, Raul Prebisch's ideas and recommendations have been debated and to some extent accepted by the economists in the less developed countries.

In 1949, Dr. Raul Prebisch wrote the Economic Development of Latin America and Its Principal Problems. In this he argued that the world was divided into two parts - the Center and the Periphery. The Center is the industrial centers of the world, and the Periphery is the underdeveloped countries of the world which specialize in agricultural and primary products. Using a 1949 United Nation's study of relative prices of imports and exports of underdeveloped countries, Prebisch noted that the terms of trade of the less developed countries had declined and he argued that they would continue to decline. Prebisch believed that if a country's terms of trade were falling then it would have a hard time developing into an industrial nation. Since 1949, Prebisch has elaborated his thesis and has offered various policy recommendations which should be followed to achieve economic development in less developed countries.

Prebisch's thesis has been highly regarded partly because of his position as a leading Latin American economist and partly because the criticism of the thesis has been scattered throughout economic literature.

This paper will bring together this information with (1) a review of Prebisch's thesis and of the later refinements; (2) a critical

evaluation of the Prebisch thesis giving both favorable and opposing arguments which have been raised by various economists; and (3) a review of the policy recommendations of Raul Prebisch noting the change of his recommendations through the last quarter of a century.

First it will be necessary to define certain terms used in this paper. The terms Third World countries, less developed countries, and underdeveloped countries will be used interchangeably throughout this paper to mean those countries which have in common an economic society characterized by the following: (a) a low per capita income; (b) a relatively low rate of income growth per capita because of high rates of population growth; (c) a relatively small percent of gross domestic product devoted to investment; (d) a high proportion of the work force engaged in agriculture; (e) a low literacy level; (f) a shortage of technical and managerial skills; and (g) a small percentage of per capita investment in public works and services.[1]

The developed countries are those which enjoy (a) a higher level of industrialization, (b) a more adequate economic infrastructure, (c) a higher income per capita, (d) a more literate population with adequate technological and managerial skills, and (e) a sufficient level of domestic savings to be invested in domestic industry, agriculture, and services.[2] The developed countries are in a position to have or to

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[1]John Pincus, Trade, Aid and Development: The Rich and Poor Nations (New York: McGraw-Hill Book Company, 1967), p. 118.

[2]Alfred Maizels, L. F. Campbell-Boross and P. B. W. Rayment, Exports and Economic Growth of Developing Countries (Cambridge University Press, 1968), p. 7.

obtain the necessary finances for growth and upon obtaining finances, they are able to sustain growth because they possess the other prerequisites for growth.

Although the phrase "terms of trade" is often used, it is not adequately descriptive as there are a number of meanings assigned to the term. The most frequently cited is the net barter, or the commodity, terms of trade, which is the relation between the prices of exports and the prices of imports (Px/Pm). The gross barter terms of trade is the relation of the quantity of imports to the quantity of exports (Qm/Qx). The most useful is the income terms of trade or the capacity to import, which states that the price of exports times the quantity of exports is equal to the price of imports times the quantity of imports (PxQx=PmQm). Using a little algebra, we find that Qm (the quantity of imports a country can afford) is equal to the relationship of the price of exports times the quantity of exports to the price of imports (Qm=PxQx/Pm).[3] The less developed countries claim that they cannot change the price of exports or imports or the quantity of exports; therefore, their volume of imports is determined for them.[4]

The single factoral terms of trade, which gives importance to productivity changes, is the relationship of the price of exports to the price of imports times the productivity of exports (Px/Pm·Zx) where Zx is equal to the productivity of exports. The double factoral terms

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[3]Charles P. Kindleberger, International Economics (Homewood, Illinois: Richard D. Irwin, Inc., 1973), pp. 74 and 75.

[4]Kindleberger, p. 75.

of trade take into account not only the productivity of exports but also the productivity of foreign factors in the country's imports; it is the relationship of the price of exports to the price of imports times the productivity of exports to the productivity of imports $(Px/Pm \cdot Zx/Zm)$.[5]

[5] Kindleberger, p. 76.

CHAPTER II

THE PREBISCH THESIS

Raul Prebisch presented his terms of trade thesis in a report to the United Nations Economic Commission on Latin America in 1950. He based his assumptions on the long-term decline of the terms of trade evidenced in the rise of British terms of trade since the 1870's.[1] In 1959 he:

> ...strengthened his arguments by (1) adding the implications of surplus labor in less developed countries, (2) couched his price weakness arguments in the technical concepts of income elasticities of demand and terms of trade, and (3) attempted to demonstrate the means by which productivity gains in raw commodity production would be exported in the form of lower prices rather than be captured domestically.[2]

He also felt that productivity increases in the Center also resulted in gains to the Center because the competitive force of labor in the Center resisted decreases in wages when prices fell. This chapter will review the Prebisch thesis in light of these refinements.

A United Nations Publication in 1949 showed the relative prices of imports and exports of underdeveloped countries. Using this study, Prebisch noted that from the years 1876-1880, when the ratio of primary to manufactured commodities was 147, to 1938, when the ratio was 100, the

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[1]Werner Baer, "The Economics of Prebisch and ECLA," Economic Development and Cultural Change, X (January, 1962), p. 174.

[2]C. Richard Bath and Dilmus D. James, "Dependency Analysis of Latin America: Some Criticisms, Some Suggestions," Latin American Research Review, XI, No. 3 (1976), p. 4.

long-run trend for primary products had fallen (Table I - column A). The United Kingdom, in the years included in the study, was considered to be one of the most developed countries. Column B shows the ratio of the United Kingdom's imports to exports. In 1876-1880, her imports were greater than exports by a ratio of 167; in 1938, it was 100.[3] Prebisch noted that the United Kingdom's demand for primary products (imports) had fallen.

> ...from the 1870's until the Second World War, the price relation has turned consistently against primary production. With the same amount of primary products only 63.5% of the finished manufactures which could be bought in the 1860's were bought in the 1930's; in other words, an average of 58.6% more primary products than in the 1870's are needed to buy the same amount of finished manufactures.[4]

Prebisch reasoned that the terms of trade of the less developed countries had declined and that they would continue to decline.

In 1959, Prebisch explained the decline of terms of trade of the developing countries from the demand side. He found that income elasticity of demand at the Center is low--at the Periphery it is high.

> The low income elasticity of demand for imports of the Center --which means that imports of the Center grow at a slower rate than national income--combined with higher rates of output at the Periphery due to increasing productivity causes a downward pressure on the prices of exports of the Periphery. Meanwhile, the higher income elasticity of import demand in the Periphery tends to either keep the import price steady

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[3]P. T. Ellsworth, "The Terms of Trade Between Primary Producing and Industrial Countries," International Economic Affairs, X (Summer, 1956), p. 49.

[4]Ellsworth, p. 48.