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# Notes on Unequal Exchange between Developing and Industrialised Countries

by Detlef Lorenz, Berlin\*

**Proponents of the theory of unequal exchange claim that the international division of labour is based on the exploitation of the developing countries by the industrialised countries. But the international division of labour allows the developing countries to import goods which they either could not produce themselves, or only at a higher price than they pay for the imports. The lower wage-levels in the developing countries may also help them to obtain employment at the expense of the industrialised countries. Low wages are therefore ultimately not a question of exploitation but of development priorities.**

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Conventional economic theory, from Ricardo down to the present day, has certified international division of labour in accordance with the law of comparative advantage to be *efficient*. Critics, predominantly of the Marxist tradition, on the other hand, object that this international division of labour is *unjust* because it is based on the exchange of unequal labour inputs<sup>1</sup>, implying exploitation especially of underdeveloped by developed countries. Hence, we not only have a confrontation between the positive and the normative aspects of the theory of international trade embodying the classical conflict between allocative efficiency and justice of distribution, but as well one of the principal problems of the division of labour between countries with marked differences in levels of development is evoked.

In the interest of justice of distribution the theorems of unequal exchange are based on a *direct* comparison of *absolute* labour inputs *between* countries. Classical and neo-classical theories of comparative advantage have also been aware since Ricardo that the international division of labour explained by them likewise presupposes the exchange of unequal labour quanta or input units, which could not take place within a country<sup>2</sup>. Re-allocative efficiency, on the other hand, calls for an *indirect* comparison of *relative* labour inputs (prices) *between two industries/products within* the countries concerned.

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The argument on the side of the theory of comparative advantage concentrates on proving the *economising* effects in the use of the means of production through specialisation. The larger the cost disparities between the two products within the two countries in the Ricardo model, the larger is the potential of specialisation or the saving in labour inputs; and the more specialisation differs between the two countries the larger are the gains from trade for the country with the greater disparities. Consequently, according to the criterion of comparative advantage it is also entirely possible for the developing country to achieve the larger economy in labour.

The fact that *domestic* specialisation gains are no longer the only determinants of the distribution of foreign trade gains, once the terms of trade are also taken into account, is another matter. However, the above-quoted statements on specialisation gains imply by the very nature of Ricardo's transformation of absolute in favour of relative costs/prices a very significant restriction in the sense that "the absolute levels of economic efficiency or the stages of economic development" are thus

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<sup>1</sup> Henceforth "labour inputs" is used in the meaning of quantities of directly and indirectly embodied labour inputs.

<sup>2</sup> "Thus, England would give the produce of the labour of 100 men for the produce of the labour of 80. Such an exchange could not take place between the individuals of the same country. The labour of 100 Englishmen cannot be given for that of 80 Englishmen, but the produce of the labour of 100 Englishmen may be given for the produce of the labour of 80 Portuguese, 60 Russians, or 120 East Indians." D. Ricardo: On the Principles of Political Economy and Taxation, London 1817, pp. 159-160.

ignored<sup>3</sup>. The importance of this restriction will be examined below. For the moment it suffices to establish that, according to the criterion of efficiency, even an unequal exchange of labour inputs does not prevent a country thereby put at a disadvantage from nevertheless achieving specialisation advantages.

Using Ricardo's classical example and the diagram below both quite opposite views can be demonstrated as follows:

The proof of domestic saving of labour inputs emerges only if an *indirect "horizontal"* comparison is chosen as in the theory of comparative advantage. In the case of complete specialisation Portugal closes down the production of cloth, requiring 10 units of labour more per output than wine, in favour of the production and export of wine in order thereby to acquire the cloth more cheaply in an indirect manner, i. e. by trade. In England the production of wine, which embodies 20 units of labour more per output than cloth, is replaced in favour of the production of cloth. Apart from the fact that England – the “developing country” in Ricardo's example – achieves the larger specialisation gains, the indirect comparison amounts to a comparison of the pre-trade and the trade situations in both countries. Portugal reduces her input for the production of both goods in autarky from 170 to 160 labour units in the case of production of her specialisation commodity, wine, thereby satisfying the demand of both countries. In England the labour input decreases, as against the autarkic situation, from 220 to 200. The two countries together save 30 labour units (390 minus 360) for the same output of both products in both countries. It should be emphasised once more that Ricardo's example is based on the domestic terms of trade and that it furthermore, as is well known, neglects the international terms of trade by assuming a 1 : 1 ratio.

The unequal exchange theorems, on the other hand, are based on the *direct "diagonal"* comparison of the national labour inputs in foreign trade specialisation. Indirect comparison of the respective national inputs for autarkic and for specialised production is replaced by a *direct international* comparison between the unequal labour inputs of Portugal's (80) and England's (100) exports resulting in a loss of 20 for England. The unequal exchange theorems also disregard the international terms of trade, emphasising a direct comparison of labour inputs instead of labour saved. This comparison of labour inputs naturally no longer shows any equivalence of value, such as the Marxist law

of value stipulates, but instead a non-equivalence interpreted as exploitation of the less productive/underdeveloped country by the more productive/developed country.

### Exploitation Charge Inappropriate

The inappropriateness of the charge of exploitation can indeed be illustrated by two examples from Marxist authors, the one quoted by Mandel erroneously demonstrating an advantage for the industrialised country and the one quoted by Palloix erroneously demonstrating a disadvantage for the developing country.

In Mandel's example 1,200 man-hours (m-h) spent on the exports of a developing country are exchanged against 300 m-h spent on the exports of the industrialised country. To be “just”, according to Mandel, the industrialised country should likewise expend 1,200 m-h; in other words it should have delivered an additional 900 m-h worth of goods to ensure an equivalent exchange of labour inputs<sup>4</sup>. But why should it do so when, because of its superior productivity, it would be able, in the case of autarky, to produce its imports from the developing country itself with an input of less than 1,200 m-h (e. g. with 500 m-h, even if not with 300)? Mandel thus construes a *misleading advantage* to the amount of about 900 m-h for the industrialised country. The difference (the advantage) could at best, given import substitution in the industrialised country, amount to 200 m-h. Another point to be taken into account, moreover, would be the import advantage enjoyed by the developing country whose domestic input requirements for the product imported from the industrialised country would certainly exceed 1,200 m-h – an aspect not taken into account by Mandel at all. This aspect is shown very clearly in Palloix's example which in turn construes an *erroneous disadvantage* for the developing country. In his example

<sup>4</sup> “Equal international values are exchanged for equal international values. Where then, does the “unequal exchange” lie hidden behind this equivalence? It is to be found in the fact that these equal international values represent unequal quantities of labour. In the commodity package exported from the metropolitan country let us say that there are approximately 300 million hours of work; the commodity package exported from the semi-colony, by contrast, contains – let us say – some 1,200 million working hours . . . Now if there had not been any unequal exchange A would have had to pay, not 300 million, but 1,200 million working hours for the commodity package imported from the semi-colony. It would only have been capable of realizing a fraction of this import”, cf. E. M a n d e l : *Late Capitalism*, London 1978, pp. 359-360; translated from the German (Verso Edition). According to Bogomolov, even among socialist countries there is “no reason . . . why price formation should be (proposed) on the basis of production conditions in the economically less developed countries. In the latter case a unit of less qualified labour of these countries would be the international referential unit”, cf. O. T. B o g o m o l o v : *Theorie und Methodologie der internationalen sozialistischen Arbeitsteilung (Theory and Methodology of the International Socialist Division of Labour)*, translated from the Russian, Berlin (East) 1969, p. 113.

<sup>3</sup> H. G. J o h n s o n : *International Trade: Theory*, in: *International Encyclopaedia of the Social Sciences*, Vol. 8, 1968, p. 85.

wheat and watches are produced in the industrialised country at the same low m-h input of 20 units in either instance, as against 80 and 320 m-h, respectively, in the developing country. Given an international terms of trade ratio of 1 : 1 the developing country exchanges 80 m-h against 20 m-h whenever it exchanges its relatively cheaper product, wheat, for watches from the industrialised country. The *direct* m-h comparison evidently demonstrates the unequal exchange<sup>5</sup>. This disadvantage, however, instantly turns into an advantage for the developing country if one reflects that it must expend not 320 m-h for the production of watches but only 80 *indirectly* in the production of wheat

(apart from the fact that the domestic specialisation advantage for the developing country is 320 minus 80 = 240, whereas that for the industrialised country is zero, i.e. 20 minus 20).

Even though the developing country "gives more objectified work *in natura* than it receives" – as Marx already pointed out – "it nevertheless receives the commodity at a lower price than it would itself be capable of producing it"<sup>6</sup>.

<sup>5</sup> S. Amin, Ch. Palloix: *Neuere Beiträge zur Imperialismustheorie (Recent Contributions to the Theory of Imperialism)*, German translation, Vol. 1, Munich 1971, pp. 42-43.

<sup>6</sup> Quoted in Bogomolov, loc. cit.

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**Complementary Trade Flows**

Beyond the methodologically important distinction between the indirect "horizontal" comparison under the law of comparative advantage and the direct "diagonal" comparison under the theorem of unequal exchange another question arises: what is the point, in the exchange of *complementary* goods (industries), of comparing the difference between absolute labour inputs? If, for example, one country produces and exports industrial/technological goods and the other country cannot supply these but instead produces and exports primary goods, then these goods/exports are not in any competitive relationship to one another but in each case add to the availabilities of the partner country<sup>7</sup>. From a direct comparison of the labour inputs into these complementary productions it is not advisable to make an economic judgement whether the one product is more expensive or cheaper than the other. It would, moreover, be pure coincidence if both these products had the same inputs or prices. The only significant aspects here are, for one thing, the ratio of inputs (prices) with regard to one another and over time (terms of trade), and for another – and even more important – what matters is the explanation of differential prices by differential values in use<sup>8</sup>, or by differential degrees of priority in reciprocal demand for these two complementary supplies in both countries. What is inappropriate is a direct "diagonal" comparison of inputs and costs, a comparison which must fail if only because, in view of the *absolutely* different production availabilities of the two products in the two countries, the costs of whichever product is not available might be put at infinite.

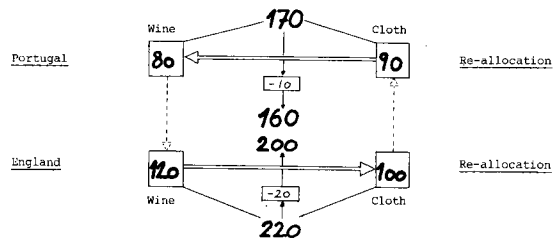
The terms of trade in such a situation can certainly be better for the one country than for the other, as well as being greatly affected by differential monopoly positions in the commodity and labour markets<sup>9</sup>. Such constellations, therefore, may also have something to do with power and influence. But they can also, and even more simply, be explained, for example, by differences in development levels and catching-up

<sup>7</sup> For the distinction between micro-economic models of complementary and substitutive trade flows using various categories of goods cf. D. Lorenz: Parallels Between Different Systems in International Economic Relations, in: Z. M. Fallenbuchl, C. H. McMillan (eds.): The Choice of Partners in East-West Economic Relations, New York 1980, pp. 400-401 as well as D. Lorenz: Explanatory Hypotheses on Trade Flows Between Industrial and Developing Countries, in: H. Giersch (ed.): The International Division of Labour. Problems and Perspectives, Tübingen 1974, pp. 84-92.

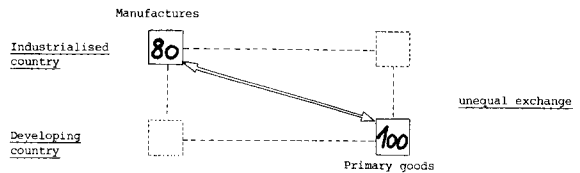
<sup>8</sup> Cf. also S. Amin, Ch. Palloix, op cit., pp. 28-29 and 42.

<sup>9</sup> Cf. also my interpretation of the Prebisch model, in: D. Lorenz: Non-Equivalent Exchange and International Income Distribution, in: The German Economic Review, Vol. 8, 1970, No. 4, pp. 280-283.

A. Specialisation in Comparative Advantages (Ricardo's model)



B. Exchange of Availability Goods\* (Complementary trade flows)



C. Displacement Competition with Ubiquitous Goods\* (Substitutive trade flows)



\* For the categories of goods see table below

processes within the framework of industrialisation (e. g. values of income elasticities above vs. below unity). As a rule there will be unequal labour inputs here, too, but these should not be used as criteria for a normative assessment of such a division of labour and, hence, not as a yardstick of exploitation either. "Unequal" countries, on the other hand do not infrequently also cause "unequal" prices or market advantages (rents)<sup>10</sup>. goods, and differential conditions of scarcities then cause "enqual" prices or market advantages (rents)<sup>10</sup>. Direct cost comparisons for the purpose of establishing reciprocal appropriateness or equivalence are out of place here.

The situation changes, however, as soon as *direct* "vertical" comparisons for *substitutive* production and international trade conditions are added to the indirect "horizontal" comparisons discussed above (cf. the diagram above and footnote 7). Although the customary substitution model of international trade theory<sup>11</sup> is also used by proponents of unequal exchange theory, as a

<sup>10</sup> On the significance of these elements for foreign trade theory cf. D. Lorenz: Dynamische Theorie der internationalen Arbeitsteilung. Ein Beitrag zur Theorie der weltwirtschaftlichen Entwicklung (Dynamic Theory of the International Division of Labour. A Contribution to the Theory of International Economic Development), Berlin 1967.

<sup>11</sup> Cf. D. Lorenz, op cit., 1967, p. 28 ff. and D. Bender: Außenhandel (Foreign Trade), in: Vahlens Kompendium der Wirtschaftstheorie und Wirtschaftspolitik, Vol. 1, Munich 1980, p. 371 ff.

rule they nevertheless have in mind the Prebisch or colonial case of complementary exchange of machinery (technological goods) for colonial goods/raw materials (primary products), an exchange in which the production possibilities of the two groups of countries are likewise complementary. As a result they follow a misleading "diagonal" in the Ricardo model to prove unequal exchange, instead of using the "vertical" that is correct for substitutive exchange.

### Substitutive Trade Flows

It is only in the substitution model with an additional direct vertical relationship that the foreign and the domestic supply confront one another directly in competition and now comparisons of costs or labour inputs become meaningful again. This is true particularly with regard to unequal input and not with regard to the correct structure of the division of labour (choice of export and import goods), this structure being less interesting in any case for the distribution-oriented rather than allocation-oriented theory of unequal exchange.

If one disregards intra-industry trade as a special case, then, even in Ricardo's model, it is of course not the same goods which are imported and exported in inter-industry trade but different products, such as wine for cloth. The essential difference of the substitution model as against the complementary model lies in the fact that the foreign supply is seen *not as a complementary but as a displacement* supply, designed to underbid an equally available domestic supply, so that one is dealing not with value in use but with costs in determining the direction of trade flows.

Going one step further, from *micro*-economic comparison of merely certain individual goods or industries to *macro*-economic magnitudes then, in the case of ubiquitous or ordinary competitive products in the substitution model, the development-determined inequalities of countries play a very important part via unequal productivity and wage *levels*. Of course, the two levels may be compensatory as a rule. A high level of overall economic productivity entails a high wage level, which means that the potential reduction of prices through the development of productivity can be compensated for by high wages. Conversely, a low productivity level in developing countries is usually offset by a low wage level. With regard to an improvement in the competitive position of the developing countries what matters is not only the resultant of the two opposite movements of wage levels but also the fact that, on balance, the result is not merely

neutralisation of productivity levels but over-compensation<sup>12</sup>. In that case, for standardised ubiquitous goods, unequal exchange in terms of differential *real* labour inputs per unit of output is, in a sense, more than offset by the development of wage levels or other level parameters (such as exchange rates).

Finally, the substitution model gains an important further emphasis if one includes the assumptions of Emmanuel, for some time no doubt the most prominent champion of the theory of unequal exchange and one with whom conventional economic theory has found it worthwhile to join issue<sup>13</sup>. He sublimates the maintenance of the international immobility premise for the production factor labour into "institutionally fixed international wage-rate differentials"<sup>14</sup>. On the other hand, the abandonment of the international immobility of the production factor capital postulates, moreover, not only an equalisation of profit rates but also the elimination of productivity differentials. The further assumptions of perfect competition and homogeneous labour lead practically to a model for the special case of standardised products and unskilled labour, which is, however, remunerated at different rates in developing and in industrialised countries. The comparison of *real* input is thus fundamentally transformed into a *nominal* one in such a way that unequal wages are paid for equal work – which of course means that the charge of exploitation continues to be programmed into the pattern. This situation is probably shown most clearly in the direct foreign investment-model<sup>15</sup>, when capital is internationally mobile and when, in the foreign enclave only the immobile factor labour is "hired" more cheaply in order to keep production internationally competitive and profitable.

After all, in both these instances "absolute competition" also works against the charge of exploitation since, as compensation for lower wages for equal work, we find in the developing countries the provision of employment which contrasts with the displacement of jobs in the industrialised countries.

<sup>12</sup> Of course, the development of the wage levels in the industrial countries might relieve the burden of the underdeveloped countries by "outcompeting" themselves when wage levels are not in line with productivity progress.

<sup>13</sup> Cf. the detailed presentation and discussion with Emmanuel and other authors of the unequal exchange theory, in: A. S c h m i d t : Internationale Arbeitsteilung oder ungleicher Tausch, Kontroversen über den Handel zwischen Industrie- und Entwicklungsländern (International Division of Labour or Unequal Exchange. Controversies on Trade between Industrialised and Developing Countries), Frankfurt 1979.

<sup>14</sup> Cf. A. S c h m i d t , op. cit., p. 226.

<sup>15</sup> Cf. e.g. H. D. M e i e r : Der Konkurrenzkampf auf dem Weltmarkt (Competition in the World Market), Frankfurt 1977, p. 158 ff.

**Different Categories of Traded Goods in the New Theory of International Trade**

	Hirsch	Gray	Lorenz
1.	a) Heckscher-Ohlin goods b) Every Man's Goods	Ordinary/homogeneous competitive goods	Ubiquitous goods (Heckscher-Ohlin)
<b>Non-competitive or availability goods</b>			
2.	a) Ricardo goods b) Poor Man's Goods	Type A: natural resources	Primary goods (in the narrow sense): minerals/tropical products (A. Smith)
3.	a) Product cycle goods b) Rich Man's Goods	Type C: technological expertise	Technological or gap products (Schumpeter/Hufbauer)
4.	- -	Type B: limited availability goods	Supplementary bottleneck products: micro- and macro-econ. (Lorenz)
5.	- -	Differentiated goods	Preferential goods (Chamberlin/Linder/Grubel)

**Sources:**

For S. Hirsch cf. (a) his contribution in: H. Giersch (ed.): *International Division of Labour. Problems and Perspectives*, Tübingen 1974, pp. 66-69, and (b) *Rich Man's, Poor Man's, and Every Man's Goods*, Tübingen 1977, pp. 3-16.

For P. Gray cf. *A Generalized Theory of International Trade*, London 1976, pp. 45-48 (arrangement here with slight divergencies).

For D. Lorenz cf. *Dynamische Theorie der internationalen Arbeitsteilung (Dynamic Theory of the International Division of Labour)*, Berlin 1967, pp. 85-88, 72-73, 157-160 (at that time the designations used in this table were not yet in use).

Taken from: D. Lorenz: *Parallels Between Different Systems in International Economic Relations*, in: Z. M. Fallenbuchl, C. H. McMillan (eds.): *The Choice of Partners in East-West Economic Relations*, New York 1980, p. 397.

If micro-economic analysis of the theory of comparative advantage and of that of unequal exchange are transposed to the macro-economic level then the absolute differentials in productivity or wage levels between the countries may also be seen as a reflection of the differential development of productive forces in the sense of Friedrich List. Unequal exchange in that case would simply be the result of unequal development in industrialised and developing countries<sup>16</sup>. The aspects of justice and normative equivalence would undergo devaluation. Moreover, the problem of unequal exchange then boils down to the rather different question of whether it is *opportune* to exchange more domestic labour for less foreign labour. Unequal exchange in this way acquires an *economic function* in the overall context of international economic development; it is lifted out of the isolation of the exploitation argument. The opportunity argument can, moreover, provide a link with the economic calculus of conventional international trade theory, which in turn could thus become significantly more related to reality in its analysis of relations between developing and industrialised countries.

The low wage levels in the developing countries, which are reflected in their low-price exports and which are such a thorn in the side of the proponents of the unequal exchange theory, may ultimately even be interpreted as a development-advantage *sui generis* for the achievement of a higher level of employment through export strategy. This advantage rests upon the development-determined availability of general or structural unemployment or underemployment in the developing countries. This could be interpreted as an additional level parameter or an *absolute factor availability*<sup>17</sup>. Parallel to the development of the infant industry-argument into the infant economy-argument one might speak of an enlargement of the micro-economic specialisation argument into a *macro-economic employment argument*. So long as the models of conventional international trade theory cling to the premise of full employment, the factor availability of structural underemployment is virtually excluded. A

<sup>16</sup> This interpretation is also supported by the fact that unequal exchange between *industrialised countries* is not mentioned even by the authors of the unequal exchange theory.

<sup>17</sup> Cf. D. Lorenz, *op. cit.*, 1967, pp. 97-100.

very topical result of the elimination of this model premise would be that unequal exchange would then contain a *beggar-my-neighbour aspect* since employment is achieved at the expense of the industrialised countries by means of underbidding the wage levels of these countries. This beggar-my-neighbour effect escapes full attention only so long as full employment and the necessary high transformation capacity are either simply postulated for the industrialised countries or so long as full employment in the developed countries is not seriously impaired.

### Mercantilistic Effects

Whereas the general purpose of international trade is seen in the realisation of re-allocation gains (saving of resources), and not in the creation of additional jobs, in the case of North-South trade an additional competitive element emerges as the result of development differentials, i. e. *vertical* competition<sup>18</sup> or macro-economically interpreted low-wage trade<sup>19</sup>. This element – if not in its cause then probably in its effect – bears a mercantilistic character!

Such a mercantilistic effect may remain limited so long as the developing countries themselves ensure through domestic development potential and a high propensity to import additional expansive capacities for the industrialised countries. However, once the industrialised countries have used the developing countries for their part as a mercantilistic market potential – via a balance of trade *surplus* in manufactured goods<sup>20</sup> – this element becomes correspondingly less important or disappears altogether. It was, in a sense, already anticipated. The limitation of pressure, moreover, further diminishes as a result of the “counter-offensive” (export strategy) of the developing countries within the framework of the new international division of labour.

This mercantilistic component should finally be combined with an element of negotiation which might be of considerable significance in the assessment of the inequality of North-South trade. It should be remembered that in the process of achieving balance of payments equilibrium the parameters: exchange rate,

wage level, and price level can be substituted with one another, and that it is only after the attainment of equilibrium that these parameters are fixed and price advantages and disadvantages of international trade are thereby transformed from relative into absolute ones<sup>21</sup>. Analogously the wage level differentials between developing and industrialised countries could be interpreted as resulting from reciprocal demand or from different national priorities (development priorities, elasticities).

If the drain on import capacity is important for reasons of development-determined requirements in the sense of imports of development goods, an attempt must be made to increase foreign exchange revenue as much as possible by underbidding competitors; this can be achieved by low income (wages) or (currency) devaluation of the developing countries' output<sup>22</sup>. The degree of urgency of the developing countries' import requirements on the one hand and the elasticity of supply of the industrialised countries on the other are the criteria, in the sense of the opportunity reflections made above, of how far the wage level (the exchange rate) may be allowed to drop or to be kept low in order to keep imports economically justifiable.

Just as in industrialised countries productivity losses or cyclical unemployment are combatted by means of a lowered rate of exchange, or as competitive devaluation is practised to increase market shares – successfully or otherwise according to the reaction or situation of one's trading partners – so the wage level is likewise an instrument for the shaping of the level of employment in the developing countries. Efforts by trade unions in the industrialised countries to incorporate so-called social clauses in order to diminish the danger of competition merely confirm this fact.

Whether imports are bought at the cost of excessively low wages in the production of exports is therefore ultimately not a question of exploitation but a question of development priorities. Besides, even a strategy of dissociation or of self-reliance may lead to “domestic exploitation”, to cutting into one's own flesh, if the costs of such a strategy become disproportionately high. Generally speaking, the element of exploitation would seem to enter the picture only when (a) rational calculations are set aside and/or when (b) actual *power* constellations produce an economic distortion of reciprocal demand relations through the use of unequal negotiating positions.

<sup>18</sup> A. L e m p e r: *Handel in einer dynamischen Welt. Ansatzpunkte für eine Neuorientierung der Außenhandelstheorie* (Trade in a Dynamic World. Points of Departure for a Reorientation of International Trade Theory), Munich 1974, pp. 156-158.

<sup>19</sup> G. C. H u f b a u e r: *Synthetic Materials and the Theory of International Trade*, London 1966, p. 94 ff.

<sup>20</sup> Cf. D. L o r e n z: *Ursachen und Konsequenzen des Neomerkantilismus* (Causes and Consequences of Neo-Mercantilism), in: A. W o l l (ed.): *Internationale Anpassungsprozesse. Schriften des Vereins für Socialpolitik*, NF, Vol. 114, Berlin 1981, p. 24 ff.

<sup>21</sup> Cf. D. L o r e n z, op. cit., 1967, p. 153 f.

<sup>22</sup> Or arises in any case in many developing countries as a result of the pressure on wages by the “reserve army of the Third World”.