

# Chapter 4

## Globalisation and the Ladder of Comparative Advantage

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**“The division of labour is limited by the size of the market.” (Adam Smith, 1776)**

### 1. Introduction

With Asian and Latin American examples, this paper examines the conditions under which openness to world trade and investment can foster both faster growth and greater income equality between and within countries. The theory of comparative advantage is explained from a dynamic point of view. This highlights the need for outward-oriented development strategies to be accompanied by complementary measures to enhance the geographic and occupational mobility of labour as the growth process alters countries' comparative advantage. Growth and income distribution benefits are maximised when factors of production are helped to move smoothly from activities where comparative advantage is being eroded (for example because rising real wages undermine the ability to export labour-intensive products) to those where new opportunities emerge. The complementary role of foreign investment in this process is also indicated. As countries develop through trade-induced industrialisation and urbanisation, land values escalate in metropolises such as Shanghai, Bombay, Singapore and Bogota (albeit interrupted with some sharp, disruptive downturns) with adverse effects on income distribution and stability. These negative features of globalisation require policies that direct these unearned increments away from landowners and toward the wider community.

### 2. Productivity and Market Size

Adam Smith's famous aphorism, above, is the fundamental insight that drove him to protest against the dominant mercantilist philosophy of his time. He is best understood not as the advocate of unbridled *laissez faire* – which may lead producers to defend protectionism and monopoly – but rather as the champion of competition and openness on behalf of the consumer, not least the worker as consumer. Thus the opening chapters of his opus *magnum* stress how important for the wealth of nations is the “power of exchanging” (Smith 1776

[1976]: 21). He explains that this power is greatest where markets are most open and that the greater the opportunity to exchange, the greater is labour's productivity. To give this central idea maximum impact, he opens his treatise thus:

The greatest improvement in the productive powers of labour, and the greatest part of the skill, dexterity, and judgment with which it is any where directed, or applied, seem to have been the effects of the division of labour.

As stressed elsewhere (Sandilands 2009; Chandra and Sandilands 2005), one of the most fertile extensions of Smith's aphorism on the importance of open markets, nationally and internationally, was by Allyn Young (1928) in his seminal paper on "increasing returns and economic progress". He complained that most of Smith's successors were "disappointingly vague with respect to the origins and the precise nature of the 'improvements' which they counted upon to retard somewhat the operation of the tendency towards diminishing returns in agriculture and to secure a progressively more effective use of labour in manufactures" (529). Thus Young's intention was to convert Smith's insights into a broader theory of increasing returns or self-sustaining growth that depended on the growth of increasingly capital-intensive methods and the division of labour among increasingly specialised firms, as and when the size of the market grew.

Market size could grow because of the elimination of mercantilist and monopolistic barriers to entry. Also, because the organisational and technical changes that larger markets make economical are themselves the cause of price reductions that further extend consumers' purchasing power in a process of cumulative circular causation.

Young explained this theory of self-sustaining growth in terms of reciprocal real exchange in the marketplace, abstracting from the money and finance that intermediate the vast bulk of these transactions. But while money and finance are an essential element in the extension of the market, they can also be a barrier to progress and a cause of national and global business cycles if mismanaged, nationally or internationally (as stressed by Wolf 2009). It was a tragedy that Young, one of the world's most prominent monetary theorists and policy advisers, met an early death in 1929 on the eve of the Great Depression of the 1930s. In view of the prominence at this workshop of scholars who have studied both the world economy and more specifically the place of Colombia as an 'emerging economy' over the past 50 years, my paper will conclude by referring to ways in which one of Young's most prominent Harvard students, Lauchlin Currie (1902-93), developed his ideas on money and growth as a top economic adviser, first in the Roosevelt administration, 1934-45, and then as a development economist in Colombia from 1949 until his death in 1993, and his continuing influence in that country thereafter.

### **3. The Ladder of Comparative Advantage**

Another of Young's students at Harvard (in 1922-23) was Bertil Ohlin who would later win a Nobel prize for his work on trade theory. Ohlin wrote:

I am inclined to believe that [Young] was a man, who knew and thoroughly understood his subject – economics – better than anyone else I have met. I tested him by means of a question about the 'Wicksell effect', i.e. the special aspects of the marginal productivity of capital, which at that time was practically unknown in most countries outside of

Scandinavia. He immediately gave a fine account in a five minutes speech before the students. (Sandilands 1999: 473.)

The Wicksell effect, or effects, as Heinz Kurz (2009) explains, concern ways in which alterations in the distribution of income between labour and capital (and ignoring land as a separate factor) affect (i) relative product prices (especially between consumer and producer goods) – the “price Wicksell effect”; and (ii) the choice of techniques (the labour-capital ratio) – the “real Wicksell effect”. Both effects are generally held to be positive, although interesting caveats were hotly debated during the capital controversies of the 1950s and 1960s that pitted Cambridge England against Cambridge Massachusetts in their evaluation of neoclassical marginal productivity theory of efficient resource allocation and ethically defensible income distribution under putative free-market capitalism. Ohlin was the co-author of the famous Heckscher-Ohlin theory of comparative advantage. He related each nation’s set of relative factor prices to their relative factor supplies which in turn explained their relative product prices, hence their comparative advantage in international trade.

This took trade theory beyond David Ricardo’s theory of comparative advantage which was an extension of Smith’s explanation of the wealth of nations based on the above dictum that the *absolute* productivity of labour depends on the division of labour and the size of the market. Ricardo explained that even the poorest nations, with very low productivity in all lines of production, could still engage advantageously in trade so long as there was some line in which their absolute disadvantage was less than elsewhere, and so long as low overall productivity was reflected in a similarly low going wage rate.

Ricardo’s theory thus greatly increased the extent to which nations could profitably engage in mutually advantageous trade through productivity-enhancing specialisation. But Ricardo is also regarded as the originator of the modern theory of diminishing returns (or diminishing marginal productivity) and the related theory of rent. As one factor of production (such as labour or capital) increases relative to other factors (notably land, the “free gift of Nature” but whose supply is fixed), its marginal productivity and price tend to decline (and vice versa). In modern textbooks, Ricardo’s theory of trade has been caricatured as a one-factor (labour) theory of value and price. But his theory of rent, based on diminishing marginal product of labour as population increases relative to the fixed supply of natural resources, indicates a more sophisticated understanding of the basis of comparative advantage than he is commonly allowed. His celebrated example of Portugal with a comparative advantage in wine while England’s was in cloth, despite England having a lower absolute advantage in both, was based on Portugal having a greater abundance of natural resources (including sunshine) relative to its population, and because wine is relatively more land-intensive than cloth. However, Eli Heckscher and Bertil Ohlin spelled out a factor-proportions (and related factor-abundance) explanation of comparative advantage that was more explicit than Ricardo’s.

Nevertheless, Ricardo’s classical theory of comparative costs provides other insights that are often obscured by modern neo-classical theory. First, his was a labour theory of value (as was Smith’s) that highlighted that capital goods could be regarded as “stored-up” or “indirect” labour, so that relative product prices could be determined as the present value of direct and indirect labour, with the cost of land (in the form of Ricardian rents) being a transfer payment, or surplus, hence not a cost of production from the social point of view.<sup>1</sup> In modern theory, land tends to be lumped in with capital, and so-called 2x2x2 models are constructed with two countries trading two commodities that embody (in different proportions) just two factors of production, “capital” and labour. This somewhat vitiates the comprehensiveness of Ohlin’s neoclassical trade theory insofar as it is in line with, and may have evolved from, Wicksell’s two-factor (direct and indirect labour) approach to the effect

of changing relative factor prices upon the evolution of product prices, hence comparative advantage through time and in different countries.

Second, Ricardo's static or snapshot analysis of the example of the comparative cost differences that drove the pattern of trade of wine for cloth between Portugal and England, and how this represented an advance over Smith's explanation of trade, should not distract us from a more important motive behind Ricardo's analysis, namely, to stress the role of specialisation in offsetting his own so-called "law" of diminishing returns by extending the size of the market. Comparative advantage drives specialisation, and specialisation drives productivity. But as it drives productivity, it also drives the accumulation of different factors at different rates. This in turn helps determine the distribution of income – not only between the rate of interest and the wage rate, as in the analysis of Wicksell effects, but also between these and the rent of land and natural resources whose overall supply is fixed, even if access to them is affected by the application of labour and capital to the opening up of cultivable land or exploitation of mineral reserves.

#### **4. Growth, Globalisation, and the Dynamic Ladder of Comparative Advantage**

Allyn Young's most notable contribution was his analysis of specialisation in the theory of growth and, by extension, in trade theory also. Dissatisfaction with neoclassical growth and trade theories has recently spawned new interest in Young's theory of increasing returns. The result is modern endogenous growth theory (with Paul Romer perhaps the best-known contributor; e.g., Romer 1994) and "new" trade theory (with Paul Krugman's work perhaps the best known; e.g., Krugman 1990).

The new growth theory has been driven by attempts to explain, or endogenise, the unexplained or exogenous productivity growth that characterises long-run growth in the seminal neoclassical growth models of Robert Solow (1956) and Trevor Swan (1956). Empirical tests of these models (in which the rewards to labour and capital were taken as a measure of their marginal product) seemed to reveal that additional inputs of labour and capital have often played a minor role in growth as compared to the increased productivity of these inputs. Yet the early models offered little explanation of this so-called "total factor productivity growth", or "technical progress", or "residual", or "measure of our ignorance" (Moses Abramovitz 1956: 11; 1989:15). If the aggregate production function could be characterised as exhibiting constant returns to scale but diminishing marginal product to each factor taken separately, countries could be expected to converge toward a similar level of per capita income if international trade and capital flows were liberalised.

This would, in theory, have two main effects: First, the opening up of international trade would mean that poor countries could increase their export of relatively labour-intensive goods and services (including the direct export of low-wage labour) in exchange for imports of relatively capital-intensive goods and services (including human capital), thereby tending to drive up wage rates in poor countries while restraining the wages of lower skilled workers in rich countries. However, the expected benign effect of increased trade on wages in low-wage countries would be disguised if rapid population growth increased the supply of labour faster than trade increased the demand, as has often been the case.

Second, the neoclassical models suggested that international capital flows would reinforce the benign effect of trade on poor country wages and restrain the growth of wages in high-wage countries.<sup>2</sup> This was explained by the expectation that rich, capital-abundant countries

would have relatively low marginal rates of return on investment (because of the “law” of diminishing returns), inducing a flow of capital from rich to poor countries where return on capital is greater, so that workers would have more capital and technology to work with, thus boosting their productivity and wages (again assuming the effect is not diluted by population growth).

In view of the relative lack of economic convergence between rich and poor countries, modern endogenous growth and trade theories have sought to explain this by reference to the way in which innovation – new ideas embodied in technical processes and new products – yield special kinds of external benefits that maintain the return on capital in rich countries beyond what neoclassical theory predicts. New ideas are non-rivalrous (in the sense that firms may acquire new knowledge without taking that knowledge away from those who already possess it) and only partially excludable (because it is hard to keep trade secrets, and patents offer only limited protection).

Allyn Young also stressed these features of new ideas, and drew two important implications that differentiate his ideas on increasing returns from some of the recent endogenous growth theorists. First, he agreed that because new ideas are largely non-excludable the return to innovators is much less than their social productivity. Therefore what conventional factors are paid may greatly exaggerate their contributions to growth. But this did not, in his view, justify strong patent protection nor tariffs that promote “industrial policy” to internalise the externalities associated with innovative industries. He regarded pecuniary externalities as inherent in the market process, which means their elimination would, by keeping taxes and/or prices high, also reduce the gains from expansion of reciprocal trade.

Secondly, the productivity gains arising from increased market size were not so much gains from increased size of firm – or economies of scale in the microeconomic sense – but rather gains from specialisation due to a larger overall market size. For, “with the extension of the division of labour among industries the representative firm, like the industry of which it is a part, loses its identity” (Young 1928: 538), and may be larger or smaller than its predecessors. Any internal economies of scale will

tend to dissolve into the internal and external economies of the more highly specialized undertakings which are its successors, and are supplemented by new economies. Insofar as it is an adjustment to a new situation created by the growth of the market for the final products of industry the division of labour among industries is a vehicle of increasing returns. It is more than a change of form incidental to the full securing of the advantages of capitalistic methods of production -- although it is largely that -- for it has some advantages of its own which are independent of changes in productive technique. (ibid)

Thus capital is important for the aggregate degree of roundaboutness, though the individual firm may not need more capital than its less specialised predecessor. But the greater the degree of overall roundaboutness, the greater the productivity in the economy; and it is this that can explain why the underlying trend of endogenous growth may be self-sustaining rather than self-exhausting as in the Solow (1956) model. Dynamically, the ‘law’ of diminishing returns is offset by the economies of specialisation.

This may partly explain why capital may flow ‘uphill’ internationally or, rather, why it flows two ways between rich and poor countries in search of heterogeneous returns that depend on differing factor prices in different industries. 2 x 2 x 2 models of trade and investment cannot explain the rich tapestry of modern trade relations. The great bulk of global trade in recent decades has taken the form of “intra-industry” trade between rich industrialised countries rather than “inter-industry” trade between rich and poor countries. The latter type is the focus of the Heckscher-Ohlin theory and the related Stolper-Samuelson

theorem that predicts factor-price equalisation from trade in products whose factor intensities differ greatly.<sup>3</sup>

Nevertheless, the theory of increasing returns from increasing market size (a theory that has been characterised, non-tautologically, as explaining growth largely by growth itself) predicts that both kinds of international trade promote a more rapid growth of the global economy, inducing more rapid accumulation of capital and innovation that have the potential to boost global wages, especially for workers in low-wage countries. The main offsets again would be the drag of population growth and the related rise in land and natural resource rents as global growth boosts demand for these resources (even as technical progress can mitigate these pressures on cost).

In this process of global growth – inherently self-sustaining (in the absence of exogenous shocks or binding resource constraints) through increasing specialisation – changes in international relative wages, interest rates, and resource rents, plus changes in patterns of demand, will dictate continuous changes in the global pattern and ladder of comparative advantage. These changes are disruptive in that they impose a greater burden on the mobility mechanism, especially labour mobility. To take full advantage of the new opportunities that these changes offer requires a high degree of occupational and geographical mobility of labour and capital to those sectors and locations where actual and potential returns are growing most rapidly. In the Third World this implies a faster rate of rural-urban migration. This has huge cultural, political and sociological implications that may not be comfortable. But the alternatives – lower economic growth, per capita income, standards of health and education, and high birth rates – may be even less comfortable.

## **5. The Ladder of Comparative Advantage: A Singaporean Example**

Those countries that most successfully embrace and promote competition and mobility will tend to enjoy relatively fast growth through progressive cost and (real) price reductions, with associated increases in real purchasing power. This goes hand in hand with (i) relatively fast erosion of these countries' traditional areas of comparative advantage, plus (ii) relatively fast opening up of new opportunities in sectors that become newly competitive internationally as their productivity improves with the progressive accumulation of physical and human capital and technology.

Thus, to give one dramatic example from which much can be generalised, Singapore in the 1960s and early 1970s had a strong comparative advantage in simple, labour-intensive products such as textiles, and these sectors attracted considerable foreign investment. Per capita growth averaged more than 8 percent a year between 1965-75, and as wages rose so labour-intensive manufacturing and services (especially in the busy port) rapidly gave way to more capital- and skill-intensive products and activities (Sandilands and Tan 1986).

Firms complained of “disloyal” job-hopping but the government ignored these complaints. If firms lost their competitive edge their resources were to flow to sectors where demand and rewards were greater. Overall, the country's real costs and prices fell continuously, and monetary inflation was lower than anywhere in the world. With the growth of the market many firms failed, only to be replaced by new firms specialising in activities where new comparative advantages were emerging. The firms that disappeared reappeared in new forms in Malaysia, then China, Vietnam, and Cambodia, with Singapore happily importing labour-intensive products from there instead of wasting her own resources on them. Singapore

meanwhile increasingly exported in exchange pharmaceuticals, specialist optical instruments, refined oil, or high-quality health, education, legal and architectural services.

From 1965 to 1987, Singapore ran a trade deficit every year (Lloyd and Sandilands 1986; Sandilands 1992). Though her exports grew at more than twice the rate as GDP, imports grew even faster. The difference was covered by foreign investment inflows that financed the importation of the raw materials and component parts that were processed by multinational firms prior to being re-exported in finished products. Some of the capital inflows were also used to accumulate official foreign exchange reserves. But Singapore did not allow the domestic currency counterparts to grow much in excess of the growth of the domestic demand for money to finance the growth of real GDP, and inflation seldom exceeded 2 percent a year. After 1987 Singapore became a net exporter of capital as her own entrepreneurs sought to expand overseas. Thus a negative capital account began to be matched by a positive current account balance (increasingly through high quality services and more sophisticated consumer and capital goods).

## **6. Global Imbalances and Distortions to Comparative Advantage**

Singapore's experience differs from China's on foreign reserves and inflation control. Whereas Singapore's reserves reflect the precautionary motive – to cushion the country from unusual exchange rate volatility associated with capital flight (as during the 1997 Asian financial crisis) – China's reserves seem to far exceed any precautionary need, and are more motivated by desire to maintain an undervalued currency in the pursuit of export-led growth. But having accumulated such a large stock of dollar assets, China is now on the horns of a dilemma: if it allows the renminbi to appreciate this would help correct global imbalances by reducing her own net exports, but would also diminish the value of her US dollar assets.

How apportion blame for this egregious bilateral global imbalance? Martin Wolf (2009) blames China while Terry Mckinley (2009), for example, blames the United States for prolonged loose fiscal and monetary policy (helped by its reserve currency status). So long as the US runs fiscal deficits that exceed the surplus of domestic saving over private investment, she must finance them through foreign borrowing. This in turn involves a balance of payments deficit on current account that requires a surplus on capital account; and since much of this is Chinese money it also explains the build-up of China's reserves. Official Chinese purchases of US dollar assets greatly exceed Chinese private sector investment in the US (Wolf 2009: 86, 123).

Whoever is to blame, global imbalances of this magnitude (with international capital flows greatly exceeding the amounts needed to finance profitable investments, or being wrongly directed) move exchange rates away from “fundamental equilibrium” rates which in turn distorts the pattern of international comparative advantage.

In light of the superior performance of outwardly oriented developing countries that fostered industrialisation through an export-promotion (XP) strategy supported by freer importing (notably the “Asian Tigers”) compared with inwardly oriented, protectionist countries (such as Pakistan, India and most countries in Africa and Latin America) that followed an import-substituting industrialisation (ISI) strategy, China likewise chose the liberal XP path as soon as reformers were able to discard the shackles of Maoism in the late 1970s. ISI strategies raised costs for potential exporters, causing real exchange rate appreciation that exacerbated the bias against trade. As Jagdish Bhagwati (1978) explained, countries can go too far in their enthusiasm for export-led growth.

Although the distortion associated with XP strategies is usually less than with ISI (see David Dollar 1992), nonetheless a heavily undervalued exchange rate also creates a bias in favour of too much exporting and too little importing. In the case of China's current account surpluses, much of the counterpart has been an excessive payments deficit for the United States. The result has been excessive US public and household debt (leading to the sub-prime housing crisis with its dire international repercussions), and repression of Chinese wages and domestic consumption. The difference between China's recent growth and that of the earlier Asian Tigers is that the latter allowed the growth of their imports to be almost as impressive as the growth of their exports, with *both* greatly exceeding growth of GDP, with imports not only complementing the export effort but also allowing a faster growth of wages and consumption. Though many millions have been lifted out of absolute poverty in China in the last 20 years (Dollar 2007; Sandilands 2008), many millions still subsist in this state than is likely if a less extreme XP strategy had been pursued.

The articles of agreement at the 1944 Bretton Woods conference that established the International Monetary Fund included the famous but very rarely invoked "scarce-currency clause". This imposed an obligation on surplus as well as deficit countries to share the burden of adjustment in the face of disruptive "fundamental disequilibrium" in international payments. Failing appropriate action by countries in chronic surplus, the IMF has the power to invoke the scarce-currency clause to approve discrimination against the exports of such countries. It is surprising that China has so far escaped this sanction.

Since the collapse in 1971 of the Bretton Woods "adjustable peg" exchange rate system, most of the world has adopted a floating rate regime, though this has often been "dirty" floating through currency manipulations by central banks – not least by the People's Bank of China. However, much of the increased exchange-rate volatility since the 1970s has been associated with private hot money flows, most notoriously prior to the 1997 Asian financial crisis. That was largely due to the speculative carry trade with money borrowed at low interest rates in Japan to invest in short-term bank deposits in Bangkok, for example, where rates were much higher, and where they fuelled an unsustainable real estate boom. But the rates were higher because the risk of depreciation was also higher. When the Thai baht could no longer be supported by central bank intervention, the real estate market began to turn sour, leading to massive flight of hot money from Thailand – and from its neighbours too.

A nation's money supply and spending is closely linked with the exchange rate and/or changes in official reserves. Hot money flows can therefore be very disruptive of domestic stability. So a case can be made for sterilizing the monetary implications of short-term international finance, or for a "Tobin tax". It is clear that money is not neutral, for failure to control monetary inflation has profound implications for the efficient allocation of resources. There are two main ways in which inflation carries this danger: (i) through its impact on the real exchange rate, hence on the volume and direction of international trade; and (ii) through its effect on interest rates which can harm the volume of savings and investment, and cause large distortions in the allocation of loanable funds between long- and short-term debt. This has important effects on housing finance which is an especially grave problem for developing countries that need to accelerate rural-urban migration if they are to capture the full benefits of the Youngian increasing returns that arise from greater integration into the global economy.

Colombia offers an instructive case study of these effects and the policy responses. In view of the prominence given to Colombia by other participants at this conference, the following is a review of an influential critique of recent development strategies in Colombia by a former director of its National Planning Department, Juan Carlos Echeverry. Notable among these strategies was one known as "The Plan of the Four Strategies", 1972-74, drawn up by

Colombia's prominent economic adviser, Lauchlin Currie, and defended by him vigorously, in the face of much opposition, over the next 20 years until his death in 1993. Currie was a student of Allyn Young at Harvard in the 1920s and was greatly influenced by Young's writing on money and growth, as explained below.

## **7. The Case of Colombia: a Review of Juan Carlos Echeverry's "Keys to the Future" (2002)**

Juan Carlos Echeverry directed the National Planning Department during the crisis years of 1998-2002. His book under review surveyed the evolution of the Colombian economy over the previous 30 years, with a focus on the 1990s during which time Colombia embarked upon an ambitious programme of "*apertura*", or openness. He negotiated with the IMF and was sympathetic to the "Washington consensus" that stressed "fiscal health", privatisation, financial liberalisation, central bank independence, and tax, pension, and labour-market reforms. He laments that the vicious "narco-guerrilla war" that Colombia suffered during this "reform" period greatly offset the benefits of sound economic policy, and that this gave liberalisation an undeserved bad name.

The appearance of his book was timely, coinciding with much publicity surrounding the centenary of the birth (in 1902) of Lauchlin Currie. After a distinguished career at Harvard, the Federal Reserve Board, and in the White House as Franklin Roosevelt's economic adviser from 1939-45, Currie headed a World Bank mission to Colombia in 1949 (see Sandilands, 1990, and Laidler and Sandilands, 2002). He then stayed on as an adviser to successive governments for the next 40 years. Most notably, in 1972 he founded a unique index-linked housing finance system (known by its Spanish acronym, "UPAC", for "unit of constant purchasing power") as part of the above-mentioned "Plan of the Four Strategies" (for urban housing, export diversification, agricultural productivity, and improved income distribution).

Echeverry gave considerable space to an analysis of Currie's innovative but controversial housing finance system. He notes that its original aim was to make construction a "leading" sector that could permanently boost the overall economic growth rate (see details in Currie, 1974). In 2002 the system lay in ruins, the victim of countless debilitating modifications. Construction had for the previous four years been leading the economy down instead of up. Many thousands had lost their jobs, both directly and as a result of depression in industries that supply the construction sector. Urban unemployment stood at 18 percent (with urban underemployment officially 33 percent). In other words, only half of the workforce was fully employed (rural underemployment was even worse.)

The two directors of the National Planning Department who implemented Currie's Plan of the Four Strategies between 1971 and 1974 were Roberto Arenas and Luis Eduardo Rosas. At the Currie centenary in October 2002 both recalled the great impulse that "UPAC" had given to construction and overall growth in the 1970s, together with full employment and improved distribution. Comparing the dynamism of the 1970s with the stagnation of 1998-2002, Rosas remarked, in his tribute to Currie: "Como nos hace de falta en estos momentos!" ("How we have need of him now!")

Echeverry concedes that in the 1970s and 1980s construction played a positive role. It created jobs and was a contra-cyclical influence. But he claims that in the 1990s, with "*apertura*" and the great influx of external credits and drug money, construction became a pro-cyclical speculative activity that was bound to collapse, as collapse it did in 1998 – though he stressed that the problem was compounded by the worsening civil war. His main complaint was that construction had diverted resources from traded goods. Also that It relies

on unskilled workers whereas the future depends on skills and an allocation of resources more in tune with market forces. Let us rely on Adam Smith, he insisted, not on protectionist “models of development” and privileged “leading sectors”.

However, Currie’s ideas were also heavily influenced by Smith. As noted above, Currie’s mentor at Harvard was Allyn Young, whose famous paper (1928) on “Increasing Returns and Economic Progress” inspired modern development theory, to which Currie was a prominent contributor (for example, Currie 1997). Echeverry did not refer to this endogenous growth theory, perhaps because of his profound scepticism of “models of development”. But Young and Currie were inspired by the opening chapters of *The Wealth of Nations* where Smith emphasised specialization or the division of labour which in turn depended upon the size of the market, or upon real demand.

Today demand management is generally associated with Keynesian policies to tackle short-run business cycles around a secular trend. These cycles are closely associated with interruptions to the flow of monetary incomes and expenditures (or monetary demand). But Smith and Young focussed on competition, openness, and the mobility of labour to increase the underlying trend of real demand and market size (or what Smith also called “the power of exchanging”), hence specialization, hence productivity.

Young explained that in the modern economy specialization takes the form of new, more specialized firms and industries that compete against the old. They introduce new forms of organization and technology, but only as and when it pays to do so. The larger the market, the greater the incentive to innovate. Currie extended this idea to show that the existing growth rate (of the overall market, or GDP) had a tendency to perpetuate itself. But in Colombia where resources were abundant but grossly misallocated and underutilized, and where labour mobility was very poor, growth fell far short of potential. This self-perpetuating (or endogenous) growth rate was a vicious circle best broken by institutional measures to mobilise the great potential supply by liberating the great potential demand.

This is where Currie’s vision of construction’s potential role differs from Echeverry’s. As a “leading sector” it is valuable not so much as a contra-cyclical, stabilizing force (though it could also serve that purpose). Rather, it could help Colombia (and other countries) to break free of her historically slow, endogenous growth path. It is a leading sector because (a) it is an important direct and indirect component of GDP, so its growth has a significant effect on overall growth; (b) it moves independently of movements in the rest of the economy, and can be moved exogenously through discretionary policies; (c) it plays a vital role in promoting labour mobility; and (d) it is a sector with enormous latent demand.

But in the past this latent demand had been severely repressed. Potential homeowners can usually only buy a home with the help of substantial mortgages. Thus effective demand required a rapidly expanding flow of credit on convenient terms. This was not available because chronic inflation discriminated against it. High inflation requires high interest rates to attract savings. But for people borrowing large sums high interest rates impose a severe cash-flow problem (the “front-end loading problem”). This curtails effective demand. By contrast, “constant value” savings and loans made it both more attractive to save and easier to borrow.

Echeverry is a stout opponent of inflationary finance. But in Colombia chronic inflation has been a reality. Echeverry failed to highlight its main distortionary effects. In practice some sectors suffer far greater harm than others. The disadvantaged sectors – mainly construction and exports – are not “privileged” when measures are introduced that protect them from harmful inflation. Furthermore, conventional policies to squeeze inflation out of the system (through temporarily higher interest rates on government bonds) and to reduce

fiscal deficits (partly due to depressed incomes) can also damage the housing sector by making it less attractive to place savings there.

Currie sought to combine tight monetary and fiscal policies with policies to reactivate the real economy by redirecting incomes and expenditures toward leading sectors that rely not on the printing press but upon genuine savings. The great economist Harry G Johnson (1958) similarly distinguished between “expenditure-reducing” and “expenditure-switching” policies. A blueprint for such a combination, with detailed quantitative estimates of the size of the required “compensatory” effect required of the leading sectors, was drawn up by Currie and Alvaro Montenegro (1984) as advice for President Belisario Betancur in the mid-1980s. The advice was not taken and the country suffered severe instability and capital flight.

The construction sector’s indispensable role in the labour mobility mechanism was also ignored by Echeverry. It promotes not only faster growth but also better distribution. In Colombia there is still a great imbalance in the allocation of labour, notably between low-paying agriculture and high-paying urban activities. And in cities like Bogota there is urgent need for better balance between where people live and where they work, and for improved housing for all.

Echeverry claims there is a conflict between investment in internationally traded goods and investment in housing. Yet in countries such as Singapore, noted for spectacular export growth, investment in housing has also been enormous, and far greater than in Colombia. Despite re-housing almost the entire population in the last 35 years its construction sector still booms. There has been no saturation of demand.<sup>4</sup> As incomes increased so Singaporeans demanded better accommodation and related infrastructure. This has been aided by low inflation and large pension fund contributions that can be released for down payments on homes and the servicing of mortgages at low nominal interest rates. Building is concentrated on well-built conventional high-rise blocks for the middle classes. As these families move into new homes lower-income families move into the ones vacated. This “escalation” process enables poorer families to enjoy far better accommodation than the type of subsidised “vivienda de interes social” (popular housing) that Colombia is desperately trying to provide today out of limited fiscal resources.

Housing and exports are complements, not substitutes. Both are capable of expanding on the basis of a stimulus to and redirection of real savings, rather than via inflationary finance or subsidies. Here are the real “*claves del futuro*”.

By contrast, Echeverry’s overview of the Colombian economy and economic policies focused mainly on the structure and balance of the national budget and the rate of growth of money and credit. This is rather typical too of the focus of the international lending agencies when drawing up conditions for further foreign loans. Its key limitation is that it gives insufficient weight to the dynamic changes in the composition of real incomes and expenditures over time in developing countries like Colombia, and of the need to ensure that a country’s abundant natural and human resources are allocated – and reallocated – accordingly. Herein the supreme importance of the mobility mechanism, and of the related role of a dynamic and well funded construction sector as a necessary adjunct to greater industrialisation and integration into the global economy.

## 8. Conclusion

We have explained how openness to world trade and investment can foster both faster growth and greater income equality between and within countries. However, theory and the case studies reviewed here have shown that dynamic comparative advantage highlights the need

for trade strategies to be accompanied by greater mobility of labour and capital as comparative advantages change. Experience also shows that land values escalate with increased urbanisation, and this negative aspect of globalisation requires that these unearned increments be recaptured for the wider community if growth is not to be vitiated by increasing inequality.

## Endnotes

- 1 Cf. Allyn Young's comment in his LSE lectures, 1927-29, as reproduced in Sandilands (1990a: 99): "From the individual point of view, one can 'invest' in either land or capital. But, socially, investment in land merely transfers ownership, while capital investment produces capital." Thus rent is a cost to the individual but not to society. Young also distinguished the static from the dynamic view. In the static view, with given amounts of land, labour and capital, the return to each may be regarded as a rent (or surplus over 'normal' returns). But for dynamic long-run tendencies – which most interested Ricardo – land rent never enters into social cost but does affect the distribution of income. For, unlike the price of capital, "rent cannot control the process of land accumulation; there is no such process" (*ibid.*, 100). Young (1908) had already shown how this clarifies the ambiguous concept of "productivity" and the value of the "social dividend" within a "continually recurring cycle of income and outgo" as final products emerge from a long sequence of past investments in intermediate products – and dependent on differential changes in the supply of and demand for the various factors. This is helpful in understanding his later paper (Young, 1928) on increasing returns.
- 2 A more optimistic view of the effect on rich country wages would be that international capital flows would increase the global efficiency of capital, hence global growth, and that the resultant increased spending power of poorer countries would spill over on to demand for rich countries' products.
- 3 This theorem abstracts from transport and other transactions costs (as well as tariffs) that interfere with free trade. These prevent complete factor-price equalisation.
- 4 Colombia has not relied heavily on global finance for its private housing programmes, and that was not the intention for the system introduced in the early 1970s. Instead it relied on non-inflationary domestic saving. This may have helped insulate Colombia from the kind of fallout from the US sub-prime debacle that engulfed Britain, for example, after 2007. However, its housing sector has been subject to recession whenever incentives to saving in the system were cut. "Valorisation" taxes have also helped curb inflationary booms, and have returned some of the Ricardian rents to the community whose taxes have financed the urban infrastructure that helps create those rents.  
In China, where "house" (read "land") prices have recently risen spectacularly (partly due to reckless use of inflationary finance rather than real saving), there are calls for an annual property tax to moderate her boom-bust cycles. China obviously requires a dynamic urban housing programme (the urbanised proportion of its population is still far below that needed for greater equality), but it also needs a far less cyclical character.

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