Towards a Compatible World

Dr. Sreehari Chava, FCMA

Absolute Advantage

In economics, the principle of absolute advantage refers to the ability of a party (an individual, or a firm, or a country) to produce more of a good or service than the competitors, using the same amount of resources. The main concept of absolute advantage is generally attributed to Adam Smith for his 1776 publication 'An Inquiry into the Nature and Causes of the Wealth of Nations' in which he countered mercantilist ideas. Smith argued that it was impossible for all nations to become rich simultaneously by following mercantilism because the export of one nation is another nation's import. Instead, he stated, that all nations would gain simultaneously if they practiced free trade and specialized in accordance with their absolute advantage.

Example

- Country A can produce 100 units of product 'X' per hour with 25 employees.
- Country B can produce 50 units of product 'X' per hour with 25 employees.

Country A has the absolute advantage.

Comparative Advantage

The law of comparative advantage refers to the ability of a person or a country to produce a particular good or service at a lower marginal and opportunity cost over another. Even if one country is more efficient in the production of all goods than the other and possesses absolute advantage in all goods, both countries will still gain by trading with each other, as long as they have different relative efficiencies.

Example

- Country A can produce 100 units of product 'X' or 60 units of product 'Y' per hour with 25 employees.

• Country B can produce 50 units of product ‘X’ or 50 units of product ‘Y’ per hour with 25 employees.

Country A has the absolute advantage in both the products ‘X’ and ‘Y’. However the relative costs of producing those two goods are different in the two countries. Country A will benefit if it can exchange 100 units of product ‘X’ with anything above 60 units of product ‘Y’; and country B will benefit if it can exchange 50 units of product ‘Y’ with anything above 50 units of product ‘X’.

Therefore while it is cheaper to produce product ‘Y’ in country A than country B, it is cheaper still for country A to produce excess product ‘X’, and trade that for product ‘Y’ of country B. Conversely country B benefits from this trade because its cost for producing product ‘Y’ has not changed but it can now get product ‘X’ at a lower price. The conclusion drawn is that each country can gain by specializing in the good where it has comparative advantage, and trading that good for the other.

Comparative advantage was first described by David Ricardo who explained it in his 1817 book ‘On the Principles of Political Economy and Taxation’ in an example involving England and Portugal. The comparative advantage concept is formulated on the basis of two countries – two commodities case. It can, as well, be extended to the two countries - many commodities case or many countries - two commodities case. But in case of many countries (more than 3 countries) or many commodities (more than 3 commodities), the notion of comparative advantage looses its facile features and requires totally different formulation.

Some scholars, notably Herman Daly, an American ecological economist and professor at the School of Public Policy of the University of Maryland, have voiced concern over the applicability of Ricardo's theory of comparative advantage in the light of a perceived increase in the mobility of capital: "International trade (governed by comparative advantage) becomes, with the introduction of free capital mobility, interregional trade (governed by Absolute advantage)."

Much has been written since Ricardo, as commerce has evolved and cross-border trade has become more complicated. Today trade policy tends to focus more on "competitive advantage" as opposed to "comparative advantage".

Competitive Advantage

Competitive advantage is defined as the strategic advantage that one business entity has over its rival entities within its competitive industry. Achieving competitive advantage strengthens and positions a business better within the business environment.

Competitive advantage occurs when an organization acquires or develops an attribute or combination of attributes that allows it to outperform its competitors. These attributes can include access to natural resources, such as high grade ores or inexpensive power, or access to highly trained and skilled personnel human resources. Competitive advantage is perceived as the ability to stay ahead of present or potential competition. Superior performance accomplished through competitive advantage will ensure market leadership. Also it provides the understanding that resources held by a firm and the business strategy will have a profound impact on generating competitive advantage.

Project Socrates

In United States of America during the Reagan Administration, a team of experts led by Michael Sekora was brought together to: (a) determine why US industries were losing their ability to compete in the world marketplace and (b) develop a solution to restore US industry's ability to compete. As a result, Project Socrates was initiated.

The Socrates team launched one of the most in-depth research undertakings ever conducted in the US intelligence community, producing ten key findings that became the basis for the "Socrates technology-based competitive strategy" system, and support tools for developing and executing competitive strategies. The Socrates system was successfully deployed and considered instrumental in the economic recovery of the 1980s.

Monopolistic Advantage

The monopolistic advantage theory is an approach in international business which explains why firms can compete in foreign settings against indigenous competitors. It is frequently associated with the seminal contribution of Stephen Hymer.

Stephen Hymer was puzzled by the inability of the prevailing neo-classical theories of international trade and international finance (portfolio capital investment) to explain the foreign activities of firms. Hymer saw the role of firm-specific advantages as a way of marrying the study of direct foreign investment with classic models of imperfect competition in product markets. He argued that a direct foreign investor possesses some kind of proprietary or monopolistic advantage not available to local firms. These advantages must be economies of scale, superior technology, or superior knowledge in marketing, management, or finance. Foreign direct investment took place because of the product and factor market imperfections. The direct investor is a monopolist or, more often, an oligopolist in product markets. Hymer implied that governments should be ready to impose controls on it.

Economic Systems

An Economic System is the set of principles by which problems of economics are addressed, such as the economic problem of scarcity through allocation of finite productive resources. An economic system is composed of people, institutions, rules, and relationships; e.g. the convention of property, the institution of government, or the employee-employer relationship. Examples of contemporary economic systems include capitalist systems, socialist systems, and mixed economies.

In a capitalist economic system, production is carried out to maximize private profit. Production takes place within the process of capital accumulation. The means of production are owned primarily by private enterprises and decisions regarding production and investment are determined by private owners in capital markets. Capitalist systems range from laissez-faire, with minimal government regulation and state enterprise, to regulated and social market systems, with the stated aim of ensuring social justice and a more equitable distribution of wealth or ameliorating market failures.

In a socialist economic system, production is carried out to directly satisfy economic demand by producing goods and services for use; decisions regarding the use of the means of production are adjusted to satisfy economic demand; investment (control over the surplus value) is carried out through a mechanism of inclusive collective decision-making. The means of production are either publicly owned, or are owned by the workers cooperatively. A socialist economic system that is based on the process of capital accumulation, but seeks to control or direct that process through state ownership or cooperative control to ensure stability, equality or expand decision-making power, are market socialist systems.

Mixed economy is an economic system in which both the state and private sector direct the economy, reflecting characteristics of both market economies and planned economies. Most mixed economies can be described as market economies with strong regulatory oversight, in addition to having a variety of government-sponsored aspects.

Today the world largely operates under a global economic system based on the capitalist mode of production.

Purchasing Power Parity

Purchasing power parity (PPP) is an economic theory and a technique used to determine the relative value of currencies, estimating the amount of adjustment needed on the exchange rate between countries in order for the exchange to be equivalent to (or on par with) each currency's purchasing power. It asks how much money would be needed to purchase the same goods and services in two countries, and uses that to calculate an implicit foreign exchange rate. Using that PPP rate, any given amount of money, thus, has the same purchasing power in different countries. Among other uses, PPP rates facilitate international comparisons of income.

Deviations from parity imply differences in purchasing power of a "basket of goods" across countries, which means that for the purposes of many international comparisons, countries' GDPs or other national income statistics need to be "PPP-

adjusted" and converted into common units. The best-known purchasing power adjustment is the Geary–Khamis dollar (the "international dollar"). The real exchange rate is then equal to the nominal exchange rate, adjusted for differences in price levels. If purchasing power parity is held exactly, the real exchange rate would always be equal to one. However, in practice the real exchange rates exhibit both short run and long run deviations from this value, for market exchange rates are affected by political and financial factors.

There can be marked differences between purchasing power adjusted incomes and those converted via market exchange rates. For example, the World Bank's World Development Indicators 2005 estimated that in 2003, one Geary-Khamis dollar was equivalent to about 1.8 Chinese yuan by purchasing power parity—considerably different from the nominal exchange rate. Similarly, when converted via the nominal exchange rates, GDP per capita in India is about US $1,704 while on a PPP basis it is about US $3,608. At the other extreme, Denmark's nominal GDP per capita is around US $62,100, but its PPP figure is US $37,304. Such of these discrepancies have large implications for a true and fair representation of the facts and figures relating to GDP.

Primary Multiplier

Primary Multiplier may be defined as the multiple that denotes the income of any sector with reference to one given unit of income of the primary sector. In other words, it is a ratio of income of the other sectors with that of the primary sector. Primary multiplier is indicative of the composition and sharing pattern of GDP. If the composition of GDP consists of 20% of income from primary sector, 20% from secondary sector and 60% from tertiary sector; the primary multiplier for secondary sector is one (20% / 20%) and that of tertiary sector is three (60% / 20%).

It may be evidenced that in an economy of developing pattern, the income of Primary Sector bears a transition cum multiplier impact on the incomes of Secondary and Tertiary Sectors. Assuming that the balanced level of composition of GDP consists of 20% of income from primary sector, 20% from secondary sector and 60% from tertiary sector; every increase of 20% in the income of Primary Sector can,

ultimately, be transmitted into a value addition of 20% for Secondary Sector and 60% for Tertiary Sector.

Accordingly, given a capital output ratio of 4, every investment of Rs.80/- in Primary Sector can result in an immediate income of Rs.20/- for the Primary Sector; an income of Rs.20/- in the Secondary Sector during the transition period; and an income of Rs.60/- in the Tertiary Sector over a time frame of one business / economic cycle depending upon the rates of consumption, savings & investment, and pace of growth of the economy. In the process, every rupee infused into Primary Sector multiplies itself several times over a Business Cycle.

The income multiplication takes place because of the impact of the Value Addition Chain of the Agro Products and Natural Resources on Consumption, Savings and Investment. The examples that may reveal the pattern could be many: like "Wheat – Atta – Bread – Pizza"; "Cotton – Yarn – Cloth – Garments"; " Pulses & Nuts – Oil Processing – Food Processing"; "Sugar cane – Sugar – Confectionary"; "Coal – Power – Manufacturing"; "Lime Stone – Cement – Construction" ; and so on.

Citing practical aspects of it, infusion of investments into irrigation will enable conversion of dry farming / mono cropping into multiple and commercial cropping whereby inputs are produced for agro industries. Simultaneously, the levels of income, consumption and savings of agri population are also increased, in turn, leading to higher demand for the products of secondary and tertiary sectors. The higher demand, thus initiated through the agri sector, draws additional investments into secondary and tertiary sectors. Mining & quarrying, the other constituents of the primary sector, support the growth by means of natural endowments of raw material and other benevolence.

As a consequence, the growth and development of primary sector enables infusion of additional investments into secondary and tertiary sectors thereby propelling an overall growth of the economy and also by facilitating forward and backward linkages.

An onward reading of the theorem is that any investments infused into Primary Sector are bound to generate direct returns which are explicit for the sector itself and also would propel consumption, savings and investment that would lead to resultant indirect returns which are implicit for the Secondary and Tertiary Sectors. The theorem holds good till the point of optimum utilization of employable resources. The utility of the theorem lies in strategizing the prioritization and balanced distribution of investments amongst the competing sectors.

The theorem can be corroborated with the development story of Indian Economy that has concentrated on primary sector during 1950s & 60s; nurtured industrial sector during 1960s & 70s; followed by phenomenal growth of tertiary sector thereafter.

The Rural-Urban Divide

The rural and urban sectors of an economy are interconnected economically, financially, and socially. Ideally, resources such as capital and labour should move freely between these two sectors. In an undistorted economy, marginal returns to any factor of production, be it rural or urban, should be equal. As a result, labour productivity and consequently per capita income should be the same. However, the relationship between urban and rural sectors in many developing countries is still characterized by an economic dualism, in other words, by the coexistence of a modern urban sector and a traditional rural sector. This duality arose because many developing countries like India pursued a heavy industrialization development strategy based on the transfer of resources and labour surpluses from the traditional rural sector to the modern urban sector.

Cities take up less than two percent of the Earth's land surface, but are home to almost half of the world's population and utilize seventy-five percent of the Earth's resources. In 1998, 47 percent of the world's population lived in cities as opposed to 29 percent in 1950. According to the World Bank, urban areas in developing countries account for an estimated 60 - 80 percent of GDP.

Urban populations report higher levels of income mainly drawn from secondary & tertiary sectors; and have better access to employability, health care, education, water, sanitation and other services. In contrast the rural populations rely on primary sector and report low levels of income; and have limited access to employability, health care, education, water, sanitation and other services.

At the same time, an estimated quarter to a half of the urban population continues to live in slums or squatter settlements. People living under those overcrowded and impoverished conditions tend to increase the likelihood of epidemics like tuberculosis, diarrhea and other contagious diseases.

The complex rural urban divide has lead to a multiplicity of economic and social problems all over the world.

Globalization Advantage

The era of globalization, evidenced for the last couple of decades, has brought the countries and continents nearer and closer. The movement of goods and services has become more convenient, more economical and more rational. International trade, international travel, and international money flows are, now, a way of life. The movement is towards Continental Citizenship and then Global Citizenship. The way-forward could be towards planetisation during the next couple of decades.

However, a number of complexities still remain unresolved. Some of the counties are highly developed; some are developing, and many still undeveloped. Necessities of the developed countries are the luxuries for the undeveloped counties. Different countries adopt different economic systems. There are huge variations in nominal GDP and PPP GDP. The rates of foreign exchange are volatile from time to time. Trade tariffs and barriers continue to prevail, some visible and others invisible. Some nations are powerful and some are toothless.

Globalization is leading to increased urbanization and the resultant rural urban divide. Unidirectional Strategy towards Universal Prosperity appears to be too distant.

Compatible Economic Units

It is a well-established fact that the theories of economic advantages have an universal and also situation specific application within a continent as also within a country, state and region. Geographically, the theories can be adopted in a compatible manner from village to village, region to region, state to state, country to country and continent to continent, the unidirectional target being 'Balanced Development'. In the process, balanced development of villages would facilitate balanced development of the regions & states, and, in turn, balanced development of states would lead to balance development of countries, there from balanced development of continents and then the balanced development of planet earth as a whole.

It is note worthy to realize that primary sector is a basic necessity for the survival of human race whereas secondary and tertiary sectors cater, mostly, to comforts and luxuries. Compatibility warrants minimization / neutralization deviations in income levels between rural & urban folks. Any self sustainable geographical unit, accordingly, implies a viable primary sector that would form the base for secondary and tertiary sectors.

It also relevant to keep in mind that primary sector is rural based, whereas secondary and tertiary sectors are urban and semi-urban based. The number of persons dependent on primary sector is many times more than that of secondary and tertiary sectors. Any compatible balanced development would, therefore, imply a matching spread of secondary and tertiary sectors in rural areas. One of the feasible solutions could be to create adequate employment opportunities within an affordable distance of travel.

In order to facilitate balanced development, the preliminary step may be identification of compatible economic units comprising village clusters woven around small towns that would facilitate infusion of planned investments into primary sector which, in turn, would propel balanced growth of secondary and tertiary sectors as well. At the state level, the target could be achievement of adequate economic potentiality to cater to the necessities and comforts on a

sustainable basis. External dependability should, mostly, be limited to luxurious consumables. A critical aspect of initiating the balanced development is that the initial infusion of investments into the primary sector will have to be undertaken by the exchequer.

Compatible Advantage

Compatible Advantage may be perceived to refer to Resource Specific Advantage that would enable synergic utilization of the resources towards balanced development of Planet Earth as a whole. It envisages that taking cognizance of the multifarious theories of economic advantages, viz. absolute advantage, comparative advantage, competitive advantage, monopolistic advantage, etc., the world as a whole can adopt a single Compatible Economic System that aims for Compatible Wealth Maximisation by means of Balanced Development. It also implies neutralization of rural urban divide at the national level and unity between nominal GDP and PPP GDP at the international level.

Compatible World

A compatible world implies 'Compatible Economic Advantage' to the whole of the Human Race. It is free momentum of 'human, capital, and other productive resources' all over the world. It means achieving balanced development for the planet earth as a whole. It is to be Global Prosperity all over with 'One World, One Citizenship, One Economic System, One Currency'.

It is a dream that can be realized by means of Focused Economic Research and Pragmatic Political Vision. It warrants channelization of Globalization towards Global Citizenship. Such would be the eventuality where global interests take precedence over vested interests. It is where American autocracy, Indian democracy and Chinese authoritarianism may come together. It is a win-win situation for all the countries without fear or favour. And there lies a 'Compatible World'.