

## **Globalization and the Myth of Free Trade**

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## Globalization and the Myth of Free Trade

*I. Introduction*

The world today is beset by widespread poverty and persistent inequality. Some developing countries have managed to advance in the face of these obstacles, but many others have not, and still others have slipped back (UNDP 2002, Ch. 1). How should we proceed in the face of all of these problems? What role should international trade play in all of this? It is obvious that access to international resources can greatly benefit economic development. But it is equally obvious that there it can cause much "collateral damage". How then should a nation proceed to take advantage of the potential benefits while avoiding potential pitfalls?

The answer which currently dominates both theory and policy is that given by Mike Moore, the former Director General of the World Trade Organization (WTO): "the surest way to do more to help the poor is to continue to open markets" (Agosin and Tussie, 1993 p. 9). Thus the powerful countries are pressing the developing world to adopt wholesale trade liberalization, on the grounds that the best way to raise global living standards is to maximize trade (Rodrik 2001, pp. 5,10).

But there has been a growing reaction to this agenda. From outside the so-called Washington Consensus and its variants has come a mounting attack on its various theoretical and empirical claims. It has been argued that the empirical evidence does not support the claim that trade liberalization leads to faster growth. Rather, it is concluded that almost all of successful export-oriented growth has come with selective trade and industrialization policies. So much so that there "are no examples of countries that have achieved strong growth rates of output and exports following wholesale liberalization policies" (Agosin and Tussie, 1993, p. 26; Rodrik 2001, p. 7). This holds not only in recent times, but even in the distant past when the currently rich countries were themselves climbing the ladder of success. For they themselves relied heavily on trade protection and subsidies, ignored patent laws and intellectual property rights, and generally championed free trade only when it was to their economic advantage. Indeed, the rich countries do not follow many of these policies even today (Agosin and Tussie, 1993, p. 25; Rodrik 2001, p. 11).

Such sentiments have begun to show up even in the principal agencies pushing for dominant agenda. Joseph Stiglitz's stinging critique of WTO and IMF policies continues to reverberate throughout the world (Stiglitz 2002). And most recently, even the IMF itself has grudgingly conceded that, contrary to the rosy predictions of its theoretical models, a systematic examination the empirical evidence leads to the "sobering" conclusion that "there is no proof in the data that financial globalization has benefited growth" in developing countries (IMF, Prasad, Rogoff, Wei, and Kose, 2003, pp. 5-6).

So if global trade liberalization has not lived up to its theoretical claims, where does the basic problem lie? In this paper I will argue that the deficiency lies within the theory of free trade itself, in the very principle of comparative cost upon which it is founded. From this point of view, it is not the real world that is "imperfect" because it fails to live up to the theory, but rather

## Globalization and the Myth of Free Trade

the theory that is inadequate to the world it purports to explain. Indeed, I will argue that globalization has been working out as would be expected from the point of view of what I will call the classical theory of "competitive advantage". That is to say, it generally favors the developed over the developing, and the rich over the poor.

Section II.1 of this paper will trace out the fundamental role played by the theory of comparative costs in current policies of trade liberalization, and will discuss the many empirical problems this theory encounters. Section II.2 will examine the two main branches that have developed from standard trade theory in reaction to its empirical weaknesses. And Section III.1 will outline the classical theory of competitive advantage as a third alternative, and develop some of its principal implications.

Section III of the paper then address the relation between trade liberalization and the historical record. Section III.1 will show that the developing countries themselves did not follow the very policies they now espouse, and in many cases do not follow them even today. Section III.2 will argue that even in the modern era there is no convincing link between trade liberalization and economic development. Section IV will then summarize the preceding historical and empirical evidence, and relate it to the classical theory of competitive advantage.

### *II. The theoretical foundations of trade policy*

#### **1. The theory underlying the policy of trade liberalization**

Conventional economic theory concludes that trade and financial liberalization will lead to increased trade, accelerated economic growth, more rapid technological change, and a vastly improved allocation of national resources away from inefficient import-substitutes toward more efficient exportable goods. It admits that such processes might initially give rise to negative effects such as increased unemployment in particular sectors. But any such negative consequences are viewed as strictly temporary, to be addressed by appropriate social policies until the benefits of free trade begin to take hold. From a policy point of view, this means that best path to economic development involves opening up the country to the world market: the elimination of trade protection, the opening up of financial markets, and the privatization of state enterprises.

It is quite striking to note that this powerful panoply of claims is actually based on two crucial premises: the premise that free trade is regulated by the principle of comparative costs; and the premise that free competition leads to full employment in every nation.

For over a one hundred and eighty years, economic theory has insisted that "that international trade benefits a country whether it is 'fair' or not...[This is] one of the touchstones of professionalism in economics...[that] makes the defense of free trade as close to a sacred tenet as any idea in economics" (Krugman 1987, p. 131, cited in Haque 1995, p. 13). And underlying this

## Globalization and the Myth of Free Trade

sacred tenet is the doctrine of comparative cost, which by now is so familiar that it has come to be seen as a truism. Most often, this is presented in the form of the proposition that a 'nation' would always stand to gain from trade if it were to export some portion of the goods it could produce comparatively more cheaply at home, in exchange for those it could get comparatively more cheaply abroad. It is the *comparative* costs of production which are said to be relevant here, not the absolute costs, so that a nation is enjoined to focus on producing and exporting goods which are comparatively cheaper at home. Implicit in this presentation is the claim that the market will then ensure that exports will be exchanged for an *equivalent* amount of imports, *so that trade will be balanced* (Dernburg 1989, p.3).

But a normative proposition such as this has little value unless it can be shown that free trade among market economies actually operated this way. After all, in the world market it is not 'nations' which barter some goods for others<sup>1</sup>, but rather myriad firms in different countries who buy and sell goods for money, all with the aim of earning profits on the export and import of a ever shifting variety of commodities. Therefore when (if) conventional trade theory seeks to appear more realistic, it moves to a second stage in the argument in which a quite different, positive claim, is substituted for the previous normative one. And here, it is argued that in free trade the terms of trade of a nation *will* always move in such a way as to eventually equate the values of exports and imports. Thus even when multitudes of profit-seeking firms are the actual agents of international trade, the end result is said to be the same as if each nation directly barter a particular quantity of exports for an equivalent value of imports (Dornbusch 1988, p.3). Since this applies equally to advanced and developing economies, no nation need fear trade due to some perceived lack of international competitiveness. In the end, free trade will make each nation equally competitive in the world market (Arndt and Richardson 1987, p. 12). Note that for this positive proposition to hold, it is necessary to claim that the terms of trade fall whenever a country runs a trade deficit and *also* that the trade deficit will diminish when terms of trade fall. Obviously, the opposite movements must occur in the case of a balance of trade surplus.

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<sup>1</sup> It is astonishing how easily even otherwise skeptical writers slide from the idea of how trade actually operates to how trade should operate. A standard example of this tendency is Magee's (1980, ch. 2) presentation of a Ricardian example of initial absolute advantage, in which each country produces two commodities but one country (the U.S.) can produce both more cheaply than the other (Canada). Ricardo himself notes that in this case the more efficient country would enjoy an initial balance of trade surplus and the less efficient one a balance of trade deficit. This is because Canadian *consumers* will gain by buying the cheaper US products, and US *firms* will gain by exporting them. Ricardo then claims that the trade imbalances will change the real exchange rate in such a way as to raise the foreign prices of US goods and lower the foreign prices of Canadian goods, until at some point the two nations each have a cost advantage in one good. The motivations of consumers and firms remain the same throughout, but the US absolute cost advantage and the corresponding Canadian absolute cost disadvantage are transformed into comparative cost advantages for both, in such a way as to eventually balance their trade. Magee jumps all of this, and simply asserts that "one of Ricardo's important contributions was to debunk the myth of absolute advantage; that is, the notion that the United States would *should* produce both products *and not engage in international trade*" because "it" can get both products more cheaply at home. From there he moves quickly to the claim that US consumers *should* engage in international trade, which he now presents as a form of barter run based on comparative costs (Magee 1980, p. 19, emphasis added). All of this from an author who says early on that he views the theory of comparative costs as "overrated" (Magee 1980, p. xiv).

## Globalization and the Myth of Free Trade

Finally, in order to complete the standard argument on the benefits of free trade, it is also necessary to assume that full employment is the norm in countries with competitive markets. Without this additional assumption, even automatically self-balancing trade would not necessarily lead to gains from trade for the nation as a whole. After all, who is to say that balanced trade constitutes a 'gain' from trade if that outcome is achieved at the expense of sustained job losses?

The theory of theory of comparative *advantage* lies downstream of the theory of comparative *costs*. Since these two are frequently confused, it is worth dwelling on their difference. We have noted that the principle of comparative costs claims that the terms of trade of every nation will automatically adjust so as to balance international trade. In such a process, each nation will find that its cheapest goods, the ones in which it is presumed to specialize, are those in which it has the lowest relative (i.e. comparative) costs. For example, if trade were opened between nations with equal wages but great disparities in technology, comparative cost theory would say that even if one nation was absolutely more efficient in producing all goods, it would nonetheless end up with lower international costs only in those goods in which it was relatively (comparatively) most advanced. Conversely, the absolutely less efficient nation would nonetheless end up with lower costs in those goods in which it was comparatively least backward. Hence it is comparative efficiency, not absolute, which would ultimately rule free trade in this case. The Hecksher-Ohlin-Samuelson (HOS) model of comparative *advantage* takes this principle of comparative *costs* for granted, as it does the notion that full employment obtains in both nations. It then seeks to locate differences in national comparative costs in differences in national factor endowments, on the usual assumption of "perfect competition, international identity of production functions and factors, nonreversibility of factor intensities, international similarity of preferences, [and] the constant returns-to-scale" (Johnson 1970, pp. 10-11). Two well-known conclusions emerge. First, that within a system of free trade, nations with capital-intensive factor endowments will have lower comparative costs in capital-intensive goods. Hence they will have a "comparative advantage" in the production of such goods, and will tend to specialize in them. And second, that international trade by itself, without any need for direct flows of labor and capital, will tend to equalize real wages and profit rates across countries (the factor price equalization theorem).

To summarize. Three propositions are essential to the whole corpus of standard trade theory: the terms of trade fall when a nation runs a trade deficit; the trade balance improves when the terms of trade fall; and there is no overall job loss generated by any of these adjustments. All of these mechanisms are assumed to operate over some period short enough to be socially relevant<sup>2</sup>.

The trouble is that each of these three foundational claims of standard trade theory has been widely criticized for its theoretical and empirical deficiencies. We will consider each proposition

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<sup>2</sup> The length of the putative period of adjustment is actually quite critical. In this regard, Meese and Rogoff (199..) are forced to conclude by the empirical evidence that period of time required to bring international trade into balance (or PPP? check this) seems to be over 70 years.

## Globalization and the Myth of Free Trade

in turn, in reverse order, because this is the order in which they are best known.

Let us begin with the claim that full employment is a natural consequence of competitive markets. The International Labor Organization (ILO) reports that as much as one-third of the world's workforce of three billion people are unemployed or underemployed (ILO 2001, p. 1). even in the *developed* world, the unemployment rate has ranged from 3% to 25% across countries in the last decade. Matters are much worse, of course, in the *developing* world, where there are 1.3 billion unemployed or underemployed people at the current time (ILO 2001), many of whom with no prospects of reasonable employment in their lifetime. It does not take much reflection to recognize the linkages between persistent unemployment and intractable poverty. Given such patterns, it is hardly surprising that there remain a significant body of analysts who argue that there is no automatic tendency for full employment even in the advanced world. Indeed, this has long been the foundation of Keynesian and Kaleckian thinking.

Consider next the claim that a fall in the terms of trade will improve the balance of trade, at least after some initial negative effect, the so-called J-curve (Isard 1995, p. 95). This proposition that the balance of trade will ultimately improve lies at the root of the famous 'elasticities problem' which has long been the subject of great controversy<sup>3</sup> (citations).

We come finally to the most important claim of all, namely that the terms of trade automatically move to eliminate trade imbalances. As noted earlier, this hypothesis requires that terms of trade continue to fall in the face of a trade deficit, and continue to rise in the face of a trade surplus, until "trade will be balanced so that the value of exports equals the value of imports" (Dernburg 1989, p.3). To put it another way, it says that this particular real exchange rate will adjust to make all freely trading nations *equally competitive, regardless of the differences in their levels of development or of technology*. At an empirical level, this leads to the expectation that "on average, over a decade or so, ebbs and flows of competitive 'advantage' would appear random over time and across economies" (Arndt and Richardson 1987, p. 12).

The trouble is that this proposition has never been empirically true: not in the developing world, not in the developed world, not under fixed exchange rates, not under flexible exchange rates<sup>4</sup>.

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<sup>3</sup> The 'elasticities problem' arises from the fact that a fall in the terms of trade, which implies a cheapening of exports relative to imports, has two contradictory effects. A lower relative export price implies that each unit of exports earns less for the country. But since the exports are thereby cheaper to foreigners, the quantity of exports should rise. This means that the *value* of exports could fall, stay the same, or rise, depending on the relative strengths of two effects. The obverse would apply to imports. Thus the overall response of the trade balance of trade to a fall in the terms of trade would depend on the combination of the two sets of responses, i.e. on the respective price elasticities of exports and imports.

<sup>4</sup> "Many trade theorists argue that traditional theory has been unable to explain empirical evidence over the last century in an adequate manner. This includes the persistence of structural current account imbalances in countries such as Japan and the USA and most developing countries; the export of labor-intensive commodities by capital-abundant countries in violation of the Heckscher-Ohlin predictions, known as the "Leontief Paradox"; the reversal of the Stolper-Samuelson prediction; and the failure of open economies to operate and reach full employment" (UNDP Report on Trade and Development..).

## Globalization and the Myth of Free Trade

On the contrary, persistent imbalances are the *sine qua non* of international trade. This will come as no surprise to those familiar with the history of developing countries. *But it is equally true in the developed world.* For instance, over most of the postwar period the United States has run a trade deficit, and Japan has enjoyed a trade surplus (Arndt and Richardson 1987, p.12). Similar patterns hold for most other OECD countries.

Since the HOS theory rests on the assumption of comparative costs, it is not surprising that it too has had grave difficulties at an empirical level (Johnson 1970, pp. 13-18). In addition to the empirical difficulties it inherits from the theory of comparative costs, it has the further problems that it fails to correctly predict trade patterns about half of the time, that technologies differ markedly across countries, and that real wages remain persistently unequal even across developed countries. As Magee (1980, p. xiv) puts it, the "history of postwar international trade theory has been one of attempting to patch up either the Ricardo [comparative costs] or Hecksher-Ohlin model to fit the facts as we know them". It is acknowledged among experts that this persistent failure of the most fundamental propositions of standard trade theory has undermined confidence in its whole structure (Arndt and Richardson 1987, p.12).

## 2. Reactions to the problems of standard trade theory

In the light of the many deficiencies of the standard theory, the question arises as to where the theory goes wrong, and how should we correct for that. Two general approaches are widespread, and we address them here. In the next section we will take up a third, alternative approach, which I will call the classical theory of "competitive advantage".

Of the two types of reactions to the problems of standard theory, the first one focuses on the fact that the basic predictions of the theory of comparative costs and/or Purchasing Power Parity (PPP) are supposed to hold over the long run. Therefore one tack has been to redefine this "long run" to be on the order of *75 years or longer* (Rogoff 1996, p. 647; Froot and Rogoff 1995, pp. 1657, 1662). Keynes' pithy phrase comes quickly to mind in this regard. But in any case, that still leaves us with the problem of explaining what happens before then. And here the tendency has been to switch the focus to a host of short run (e.g. portfolio balance) models (Harvey 1996; Stein 1995; Isard 1995). But even here, the "evaluation of ... [these] contemporary models ... shows why economists have been so disappointed in their ability to explain the determination of exchange rates and capital flows" (Stein 1995, p.182). The problems of the standard theory have become so acute that "neoclassical economists have expressed increasing frustration over their failure to explain exchange rate movements ... Despite the fact that this is one of the most well-researched fields in the discipline, not a single model or theory has tested well. The results have been so dismal that mainstream economists readily admit their failure" (Harvey 1996, p. 567). Nonetheless, "the notion of comparative advantage continues to dominate thinking among economists" (Milberg 1994, p.224). Worse still, these very same failed models "continue to be offered as the dominant explanation of ... exchange rate determination [even though] most scholars are aware of the deficiencies of these models" (Stein, op. cit., p. 185). And worst of all,

## Globalization and the Myth of Free Trade

these same models continue to have a major influence on economic policy, for they provide the underpinning for the current policies of the IMF and the World Bank (Frenkel and Khan, 1993).

The other major reaction to the empirical troubles of standard theory has been to modify one or more of its assumptions concerning perfect competition, factor mobility and returns to scale. This New Trade Theory approach assumes that the crucial weakness of standard theory lies in the fact that actual competition, indeed the actual world itself, is "imperfect". It therefore situates itself within the problematic of "imperfect competition", and seeks to fill the gap between theory and the empirical evidence by incorporating oligopoly, increasing returns to scale, and various strategic factors into the standard analysis (Milberg 1993, p.1). New Trade Theory shares the standard view that trade openness is generally good, but admits not always so. Therefore the focus shifts to identifying particular conditions under which trade can produce real gains and act as an engine of growth. The task is to explain why, in contradistinction to standard theory, "most trade occurred between countries with similar resource endowments; was intra-industry in character; was carried on primarily in intermediate as opposed to final goods, in the presence of [apparently] monopolistic market conditions; and took place without significant reallocation of resources or income distribution effects" (UNDP 2003, Ch II, p. ..). In order to explain these phenomena, increasing returns to scale and imperfect competition are introduced into the traditional HOS framework<sup>5</sup>. This allows the principal of comparative advantage to be consistent with between specialization in goods rather than specialization in whole industries. Thus countries might end up exporting a particular type of automobile while importing another type of automobile, so that its international trade would be intra-industry. Similarly, economies of scale in the face of larger market could potentially overturn the HOS prediction that free trade would serve to equalize international factor prices (real wages and profit rates). In addition, the composition of trade, as opposed to its mere volume, becomes important since it may lead to significant effects such differential elasticities of demand (the Prebisch-Singer thesis)<sup>6</sup>, or differential transfers of technology. Finally, differences in knowledge (which includes technology) also modify the standard results. Once the notion of "factor endowment" is expanded to include accumulated and/or institutionalized human knowledge, then this changes the predicted patterns of comparative advantage, benefits of trade, and international rates of growth (Romer 1987; Lucas 1993). All of these give rise to a set of possible exceptions to the standard

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<sup>5</sup> For instance, money wages may be sticky, and even if they do adjust partially downward in the face of a trade deficit, this will worsen income inequality, may lead to social turmoil (J. M. Keynes (1936b), quoted in Milberg 2002, p. 242), and will worsen any problems of excess capacity (Taylor 2001).

<sup>6</sup> The Prebisch-Singer thesis posits three things. First, that free trade leads developing countries to specialize in primary goods and developed countries to specialize in manufactured goods. Second, that primary goods have low elasticity of demand, and manufactured goods have high elasticities of demand. Third, product and labor markets are imperfectly competitive in the center, but highly competitive in the periphery. Thus producers in the center are able to maintain high prices and workers are able to reap the benefits of technological change through rising wages; while in the periphery firms face declining prices in the face of competition from other primary producers and workers face stagnant or declining wages in the face of large pools of unemployed labor. Therefore the terms of trade of the developing countries deteriorate over the long run, which undermines their development process (UN 1949 and Singer 1984).

## Globalization and the Myth of Free Trade

results, which in turn provide some (limited) room for state intervention in certain strategic sectors and certain strategic activities such as R&D (UNDP 2003, Ch II, p. ..). But "the models involved in the new trade theory, even with a few factors, are extremely complicated in terms of their outcomes – potentially generating multiple equilibria and complex patterns of adjustment to or around them" (Deraniyagala and Fine 2000, p. 11) and in the end the theory provides "few unambiguous conclusions" (*ibid*, p. 4).

### 3. The classical theory of 'competitive advantage'

We have seen that the problems of standard trade theory have led to two basic types of reactions. The first of these is to argue that standard long run propositions such as balanced trade and/or PPP only hold over periods of 75 years or more. The focus then shifts to "short run" models, of which there is a considerable variety. The second reaction, on the other hand, argues that the real world fails to live up to the standard model. This in turn leads to focus on introducing various real world "imperfections" into the standard theory.

One purpose of this paper is to argue that the fundamental problem of standard theory is that it is wrong on its own terms. That is to say, it is flawed at its very root, in the analysis of competitive free trade between nations: the very principle of comparative costs is wrong even under competitive conditions<sup>7</sup>. The alternative argument, which I will call the classical theory of "competitive advantage"<sup>8</sup>, rejects the standard theory altogether. In brief, the argument here is that relative prices of international goods, and hence a nation's terms of trade, are regulated in the same way as relative national prices. In both cases, high cost producers lose out to low cost ones, and high costs regions (nations) tend to suffer trade deficits which will tend to be covered by corresponding capital inflows (subsidies and borrowing). Unlike in the theory of comparative costs, there are no magic mechanisms that will automatically make all regions (nations) automatically equal. Indeed, persistent trade imbalances covered by foreign capital flows are the "normal" complement of international trade between unequally competitive trade partners. Thus free trade does not make all nations equally competitive, as is argued within standard trade theory. Rather, it exposes the weak to the competition of the strong. And as in most such cases, the latter devour the former (Shaikh 1996, 1980; Milberg 1993, 1994).

The starting point of the classical competitive advantage approach lies in the classical theory of competition. But this is very different from the conventional theory of "perfect" competition. In

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<sup>7</sup> The Classical theory of competition encompasses both Smith and Ricardo. But whereas the former extend this theory to the case of international trade, the latter substitutes a different principle altogether when it comes to trade between nations – the principle of comparative costs. The logic of the two arguments, including their respective treatments of the exchange rate, the balance of trade, and the balance of payments, is developed in detail in Shaikh 1999, 1998, 1996, 1980).

<sup>8</sup> Within the classical theory of "competitive advantage", just as real wages and production coefficients regulate relative prices within a nation, so too do they regulate international relative prices and hence international terms of trade. Hence it is the *differentials* in real wages and technologies across nations that determine their international competitiveness (Shaikh 1980, Cagatay 1993, Milberg 1993, 2002).

## Globalization and the Myth of Free Trade

the classical tradition, competition means *real* competition, in the sense of business competition. Firms utilize strategy and tactics to gain and hold market share, and price-cutting and cost reductions are major feature in this constant struggle (Shaikh 1980).

Secondly, the Classical approach argues that this real competition regulates trade *between* nations operates in much the same manner as it regulates trade *within* a nation. In regard to the latter, it was a central theme of classical theory that competition within a country is driven by the law of *absolute costs*, that is to say, firms with higher unit costs of production enjoy suffer an absolute competitive disadvantage. From this point of view, firms within high-cost regions of any one country, if exposed to competition, would tend to suffer declining shares in the national market. Their higher costs would make it difficult for them to sell outside the region ("exports") and would leave their markets vulnerable to products originating in lower-cost regions ("imports"). In other words, in domestic free exchange, regions with higher costs would tend to have "balance of trade" deficits. Such deficits would of course have to be financed, either by running down some monetary stocks, or by attracting other funds to cover its net import needs. This in turn implies that if such regions entered into trade with other more competitive ones within the same country, they would tend to suffer job loss and real wage declines --- at least until they caught up and/or their labor migrated elsewhere.

The last step in the Classical approach is to extend these results of real competition to the case of free trade between nations. Since a nation's international terms of trade are merely international common-currency relative prices, they will be regulated in the same manner as any relative price: by relative real costs. However, the terms of trade will then not be free to automatically adjust to eliminate trade imbalances unless real costs themselves did so. The latter depend on real wages and productivity, and while international trade affects these, they also have many other social and historical determinants<sup>9</sup>. It follows that under unregulated trade, countries at a competitive disadvantage in the world market would tend to suffer trade deficits<sup>10</sup>. These in turn would have to be covered by foreign debt or subsidies. It is easy from within this framework to

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<sup>9</sup> From the classical competitive advantage point of view, technological differences among nations play a central role. This provides an alternate theoretical foundation for the neo-Schumpeterian emphasis on technological differences between countries. Such models fall within the imperfect competition tradition, and focus on conditions in which absolute (competitive) advantages *dominate* over comparative advantages as determinants of trade flows, depending on the specific interactions between international differences in technology, wage rates, and market structures such as average firm size, concentration ratios, and the role of international oligopolies (Fagerberg 1988; Dosi, Pavitt, Soete 1990; Milberg 1993; Milberg and Houston 2002).

<sup>10</sup> For instance, a country with relatively higher real costs will suffer in international competition. Insofar as this leads to a fall in real wages (possibly abetted by state policies), this may temporarily improve the trade balance – at the expense of workers' standards of living. But this is at best a temporary solution, for if a nation's productivity growth rate is lower than that of its competitors, it will find its *relative* real unit labor costs rising once again after the wage adjustment is completed (Shaikh 1996).

## Globalization and the Myth of Free Trade

explain the familiar cycle of persistent trade deficits, periodic and ineffective exchange rate devaluations, and eventual debt crises (Shaikh 1999, 1996)<sup>11</sup>.

Three crucial corollaries follow. First, trade liberalization will principally benefit the firms of the developed countries of the world, since they are the most technologically advanced. Without adequate time to prepare for this challenge, the developing world will largely fall back to providing foreign access to cheap labor and cheap natural resources. Nothing in such a process promises that development, or poverty reduction, will automatically follow. On the contrary, cheap imports and capital-intensive foreign direct investment are likely to displace more jobs than they create, thereby intensifying poverty. Secondly, it is now easy to make sense of the industrial strategy followed by the *Western countries themselves*, as well as that subsequently followed by Japan, South Korea, and the Asian Tigers, as they moved up the ladder. We shall see that in both sets of cases, trade protection and state support to industry played a central role – the very roles that are forbidden under current WTO, IMF, and World Bank rules. It should be noted that the Classical approach provides much more room for government regulation of trade and industrial policy than does New Trade Theory, since it is no longer just a question of handling particular instances in which free trade fails to perform as it should. On the contrary, within the Classical approach what-you-see is what-you-get: free trade does what it is supposed to do, namely reward the strong. Conversely, if development is really the objective, then trade is merely one of many means to this end, not the end in itself.

To summarize. There are three basic types of responses to the failures of standard theory. The traditional approach, which remains within the standard framework, retains its faith in the virtues of free trade, but concedes that it might take 75 years or more to work. The imperfections approach, which argues that free trade does not always work as it 'should' because of the effects of imperfect competition, economies of scale, and an uneven distribution of skills, knowledge, and institutions across countries. And the classical competitive advantage approach, which argues that free trade does indeed work as it should – which is to benefit advanced firms and advanced countries. All three approaches imply some room for government intervention, from a little for the first, so somewhat more for the second, and to possibly a great deal for the third (as in the historical rise of England and the U.S., and the subsequent rise of Japan and South Korea).

In what follows, we will turn to the actual practices in international trade. The next section will focus on the role of (the absence of) free trade in the historical rise of the Western countries themselves, and to the later rise of Japan, S. Korea, and the Asian Tigers. In the subsequent section we will then turn to the more recent history of the effects of trade liberalization of developing countries. It will be argued in both cases that the actual outcomes in both cases are

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<sup>11</sup> At an empirical level, the Classical approach also allows us to explain the actual movements of real exchange rates. This also permits us to explain why Purchasing Power Parity theory does not work at an empirical level between countries with low or moderate inflation, and yet does appear to work in high inflation cases. And finally, it allows us to derive an empirically robust *policy rule* to judge the sustainability of a particular level of the exchange rate (Shaikh....).

## Globalization and the Myth of Free Trade

perfectly consistent with the classical theory of competitive advantage. This in turn will shed a different light on the actual policies followed by powerful countries in any given epoch.

### *III. Trade liberalization and the historical record*

#### **1. The role of managed trade in the rise of the advanced world**

The rich countries of the world are pushing developing countries to adopt policies of liberalized trade, foreign investment, and strong laws on intellectual property and patents. It is useful to note, then, that they themselves assiduously *avoided* such policies when they were climbing the ladder of success (Chang 2002).

For instance, Britain and the USA relied heavily on trade protection and subsidies in their own process of development. Even as early as the 14<sup>th</sup> and 15<sup>th</sup> centuries, Britain promoted its leading industry, which was the manufacture of woolen goods, by taxing the exports of raw wool to its competitors, and by trying to attract away their workers. In the heyday of its development from the early 1700s to the mid-1800s, it used trade and industrial policies similar to those subsequently used by Japan in late 19<sup>th</sup> and 20<sup>th</sup> centuries, and by Korea in the post World War II period. It was only when Britain was already the leader of the developed world that it began to champion free trade. This point was not lost on its rivals, such as Germany and the United States (Chang 2002, pp. ...). Prominent thinkers in these countries argued instead for protection of newly rising industries. Indeed, even as Britain was preaching free trade after 1860, the United States "was literally the most heavily protected economy in the world", and remained that way until the end of the World War II. In doing so, "the Americans knew exactly what the game was. They knew that Britain reached the top through protection and subsidies and therefore that they needed to do the same if they were going to get anywhere.... Criticizing the British preaching of free trade to his country, Ulysses Grant, the Civil War hero and the US President between 1868-1876, retorted that 'within 200 years, when America has gotten out of protection all that it can offer, it too will adopt free trade'". And this, indeed, is exactly what happened.

Similar stories of protectionism and state intervention can be told for most of the rest of the developed world, including Germany, Sweden, Japan, and South Korea. Even countries like the Netherlands and Switzerland that adopted free trade in the late 18<sup>th</sup> century did so because they were already leading competitors in the world market and therefore could afford to do so. But even here, "the Netherlands deployed an impressive range of interventionist measures up till the 17th century in order to build up its maritime and commercial supremacy... and Switzerland and the Netherlands refused to introduce a patent law despite international pressure until 1907 and 1912 respectively, [so that they were free to appropriate] technologies from abroad" (Chang 2002, p.2).

But this prior history of globalization is not just a matter of protectionism and state support as a means toward development in the West. There are also the small matters of colonization, force,

## Globalization and the Myth of Free Trade

pillage, slavery, mass slaughter of native peoples, and the deliberate destruction of the livelihoods of potential competitors (East India Company..). "Globalization was brought to many at the 'point of a gun' and many were 'globalized' literally kicking and screaming" (Milanovic 2002, pp. 5-6). Gunboat diplomacy of the West was central in its treatment of Japan, Tunisia, Egypt and Zanzibar, and China, among others. Millions suffered in slavery and near slavery on plantations all across the world. According to recent conservative estimates, from 1865-1930 the "Dutch East Indies company... pillaged ... between 7.4 and 10.3 percent of Indonesia's national income per year" (*ibid*, p. 6).

Many other examples of such events can be adduced. What is striking is the cumulative impact led not only to widening inequality among nations (Table 1), but also to the early *de-industrialization* of the Third World in the face of the industrialization of the First World.

Year	Ratio of Rich-to-Poor Country GDP per Capita
1820	3 to 1
1913	11 to 1
1950	35 to 1
1973	44 to 1
1992	72 to 1

Source: UNDP, Human Development Report, 1999, p. 38.

	1800	1830	1860	1880	1900	1913
Total developed countries	8	11	16	24	35	55
Total Third World	6	6	4	3	2	2
<u>Memo</u>						
United Kingdom	16	25	64	87	100	115
United States	9	14	21	38	69	126

Source: (Bairoch 1977, volume 1, p. 404, as reproduced in Milanovic 2002, p. 12 )

We are therefore left with three central conclusions. First, that during their own process of development the rich countries relied heavily on trade protection and subsidies, that they did not generally abide by patent laws or so-called intellectual property rights, and that they generally championed free trade only when it was to their economic advantage. From this point of view,

## Globalization and the Myth of Free Trade

these countries are currently pushing the developing world to adopt the very policies that they themselves avoided. Second, that the policies of the rich countries included not only protectionism and state intervention, but also one of colonization, pillage, slavery, and the deliberate de-industrialization of the Third World. And third, that the historic globalization of capitalism was attended by secularly rising international inequality.

How is one to interpret this history? It is clear that even as academic economic theory was trumpeting the universal benefits of free trade, advanced countries were not following its prescriptions. Should we say that policy makers lacked the confidence to wait three-quarters of a century or more for the theory to work itself out? Or should we say that the world was always beset with imperfections that negated the standard propositions, at least in practice? I would argue that neither of these readings is adequate, or even necessary. On the contrary, if free trade benefits the strong, then it is perfectly understandable that it would be championed in theory by the strong and resisted in practice by the up-and-coming.

But perhaps this is all in the past. Might we argue that the more recent history of trade liberalization in developing countries tells a different story?

### **2. Trade liberalization in recent times**

The drive for wholesale trade liberalization rests on the assertion that the best way to raise global living standards is to maximize free trade (Rodrik 2001, pp. 5,10): "no protection is the best protection and that all economic decisions are best left to the market"(Agosin and Tussie, 1993, p. 25). This means lowering of tariff and non-tariff barriers and reduction or elimination of subsidies; adherence to WTO rules on intellectual property rights, customs procedures, sanitary standards, treatment of foreign investors; and various tax reforms, labor market reforms, and policy reforms designed to provide social support for displaced workers and technological support for displaced businesses (Rodrik 2001, p. 24).

All of is grounded in two sets of claims. First, that the goal of the WTO is to increase consumer welfare through the expansion of trade. And second, that the expansion of trade will reduce poverty and raise general living standards in the developing countries.

On the WTO, it is important to recognize that in reality it "is an institution that enables countries to bargain about market access", not about poverty reduction. Indeed, its actual agenda was "shaped in response to a tug-of-war between exporters and multinational corporations in the advanced industrial countries (which have had the upper hand), on the one hand, and import-competing interests (typically, but not solely labor) on the other. The WTO can best be understood in this context, as the product of intense lobbying by specific exporter groups in the United States or Europe or of specific compromises between such groups and other domestic groups" (Rodrik 2001, p. 34).

## Globalization and the Myth of Free Trade

As for trade liberalization as the route to increased wealth, we have already seen that this prescription was not followed by the rich countries themselves in their own processes of development, and is not followed by them in many respects even today (Agosin and Tussie, 1993, p. 25; Rodrik 2001, p. 11).

From this perspective, it should come as no surprise that even in recent times, the empirical evidence does not support the claim that trade liberalization or incentive neutrality leads to faster growth. It is true that higher manufacturing growth rates have been typically associated with higher export growth rates (mostly in countries where export *and* import shares to GDP grew), but there is no statistical relation between either of these growth rates and degree of trade restrictions. Rather, almost all of successful export-oriented growth has come with selective trade and industrialization policies. In this regard, stable exchange rates and national price levels seem to be considerably more important than import policy in producing successful export-oriented growth (Agosin and Tussie, 1993, pp. 26, 30, 31). Conversely, there "are no examples of countries that have achieved strong growth rates of output and exports following whole-sale liberalization policies" (Agosin and Tussie, 1993, p. 26; Rodrik 2001, p. 7). Indeed, financial liberalization "leaves the real exchange rate at the mercy of fickle short-term capital movements" so that "even small changes in the direction of trade and capital flows can produce large swings in the real exchange rates". It also ties the domestic interest rate to that in international capital markets, which makes it difficult to have a lower rate to for selective industrial development policies (*op. cit.*, p. 23).

Japan, South Korea and Taiwan are the classic cases of successful development through the application of "highly-selective trade policies". On the other hand, Chile (1974-79) and Mexico (1985-1988) and Argentina (1991) did follow wholesale liberalization, which not only wiped out weak sectors but also potentially strong ones, often at great social cost over a long period of time. Chile's economy grew at less than 1% per capita from 1973-1989. Mexico suffered similar setbacks and slowdowns. And Argentina, which was lauded as being a good 'globalizer' as recently as 2002 (World Bank, 2002, p. 35, cited in Milanovic 2002, p. 30, footnote 29), is now of course mired in deep crisis. (Agosin and Tussie, 1993, pp. 26-27).

What *is* true is that economic growth is correlated with reductions in poverty. In countries where the distribution of income is stable, growth benefits the poor. But since the income distribution does not generally stay stable in the developing world, growth does not necessarily produce poverty reduction. And at the other end, poverty reduction is generally good for growth. Thus the high correlation between growth and poverty reduction does not tell us the causation, and certainly does not guarantee that the former will produce the latter (Rodrik 2001, pp. 12).

*IV. History and policy from the perspective of competitive advantage theory*

## Globalization and the Myth of Free Trade

How then do we interpret the empirical evidence that trade liberalization does not automatically produce growth, and that growth does not automatically reduce poverty?

Well, the latest official response of the rich countries has been to say that the problem lies not in the basic theory, but in the lack of adequate institutions in the developing world (Rodrik 2001, pp. 5, 9, 10). From the point of view of this 'augmented' Washington Consensus view, successful integration into the world market requires the developing world to undertake further reforms that "include financial regulation and prudential supervision, governance and anti-corruption, legal and administrative reform, labor-market 'flexibility' and social safety nets". In return, the developed world is supposed to provide greater access to its own markets. As always, these reforms are driven by the aim of strengthening the integration of the developing countries into the world economy, on the premise that free trade will take care of the rest (*op. cit.*, pp. 14-15).

It is a good thing that the Washington Consensus has begun to recognize the importance of institutions. Institutions clearly matter. The question is, are *these* the institutions and policies that matter? It is really true that they will somehow make free trade succeed where it has failed so far?

One way to address that question is to look back on the history of the developed world itself. We have already remarked that this is a history of protectionism and state intervention, not one of free trade and laissez faire. But it is also worth noting that the very institutions now being pushed on the developing world did not exist in the rich countries during their own rise. For example, in 1820, when the UK was more developed than India today, "it did not even have many of the most "basic" institutions that India has today. It did not have universal suffrage (it did not even have universal male suffrage), a central bank, income tax, generalised limited liability, a generalised bankruptcy law, a professional bureaucracy, meaningful securities regulations, and even minimal labour regulations (except for a couple of minimal and hardly-enforced regulations on child labour)". The first real central, which was the Bank of England, came into being in 1844, well after England was an economic power. The United States only followed suit in 1913. And as for patent laws, "Switzerland and the Netherlands refused to introduce a patent law despite international pressure until 1907 and 1912 respectively, thus freely 'stole technologies from abroad". And so we see once again the rich countries are pushing an agenda which they did not themselves follow: by and large, neither the trade liberalization policies nor its associated institutional extensions were central to their own development.

But the matter takes on a different cast when one interprets it in the light of the classical theory of competitive advantage. Institutions are important, but even more important is advanced technology and large scale finance. And here, it is the developed countries of the time that possess the greatest advantage. Simply opening up the markets of a developing country exposes its businesses to powerful international competition, whether or not they are internationally competitive. And if they are not, they will lose out on a large scale. This can be offset to some extent by foreign investment attracted by natural resources and/or low wages. But even here, the unemployment created by the displaced domestic industries need not be absorbed by any new

## Globalization and the Myth of Free Trade

production by foreign firms, for the latter will generally be far less labor-intensive. Some countries, such as some oil producers, may be fortunate enough to have an export revenue large enough to offset these effects. But there is nothing in the market mechanism *per se* that guarantees this, and it is more likely that free trade and unfettered capital flows will leave developing nations in deficit, debt, unemployment, and underdevelopment. Without the intervention of appropriate institutions that *counter* these tendencies of free trade, the problems will tend to be chronic. From this point of view, the historical avoidance of free trade by the rich countries when they themselves were developing, as well as their current insistence on it now that they have climbed the ladder, make perfect sense.

Conversely, if trade liberalization is not a panacea, how should the developing countries try to proceed? If the goal is to reduce poverty and raise the general standard of living in the developing world, then *that* should be the direct focus of economic strategy capabilities (Rodrik 2001, p. 13). But as far as trade policy is concerned, both the history and competitive advantage theory suggest that the most appropriate procedure would be to consider trade liberalization in a selective manner, as individual industries become sufficiently competitive in the world market. To accomplish this would require a great social push, along with clear standards and deadlines on meeting the standards of the world market (Agosin and Tussie, 1993, pp. 25, 28). Of course, none of this would be possible without major change in current WTO rules and international conditions attached to financial assistance. Development must be brought back to the center of the picture, and a whole range of institutions and practices considered as alternatives (Rodrik 2001). In the final analysis, "[t]rade is a means to an end, not an end in itself" (Rodrik 2001, p. 29).

This has long been the focus of the opposition to the Washington consensus, and it is precisely the right track. But, in my opinion, it needs to be freed from its residual dependence on the standard theory of trade and all of its trappings.

## Globalization and the Myth of Free Trade

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