

International Trade Theory and Policy: What is Left of the Free Trade Paradigm?

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ABSTRACT

Free trade doctrines have been questioned from the angle of their logical validity as well as relevance. Their replacement by New Trade Theories has been matched by important policy moves on strategic trade and industrial policy in advanced countries. These are defended by the advanced nations, both at inter-governmental levels and in multilateral institutions, largely in the interest of big capital in industry and finance. However, the theoretically discarded principles of free trade are still in use to push trade liberalization in developing countries. An uneven power relation between the rich and poor nations of the world has generated this asymmetric combination of policies in the world economy. Neglect of the macroeconomic issues relating to the national as well as the world economy has led these theories and the related policies to ignore the concerns for growth as well as development.

INTRODUCTION

This survey is intended to provide the reader with an overall view of the evolution of trade theory and its impact on policy. The first two sections examine the theory of free trade, with the classical theory followed by the further development of free trade theory which includes the neo-classical doctrines of free trade as originally developed by Heckscher and Ohlin. An account of the empirical and methodological critiques in the literature which question the validity of these theories is followed, in the next two sections, by the more recent approaches in the forms known as new trade theories (NTTs). Although these NTT models propose modifications of the standard neo-classical trade theories, they do not depart from the basic thrust of the original models in terms of Pareto-optimality under free trade. Nevertheless, the new trade theory made its own contributions to the literature by deviating from the restrictive assumptions of the traditional trade doctrines, which exclude increasing returns to scale, imperfect competition and product differentiation from consideration. Introduction of these variables brings

these models closer to the world of realities. A variant of the NTT involves the principles of strategic trade. This theory has been behind the trade and industrial policies which are currently being pursued in the advanced countries. New trade doctrines also include issues connected with the flow of foreign direct investment (FDI) and technology, and their impact on trade.

The article then turns to an examination, in the following section, of the literature on growth and development in the context of trade. Many of these contributions contest the notion of free trade as an 'engine of growth' and development. Attempts on the part of the advanced nations to push their national interests — through multilateral negotiations at the World Trade Organization (WTO) and through unilaterally imposed strategic trade — contrast with the hapless situation faced by the developing nations, unable to resist the external pressures to further open up their domestic markets. The final section of the article offers some concluding observations relating to the limitations of the trade doctrines, old and new, in providing an acceptable trade policy which is capable of generating growth as well as development.

CLASSICAL AND NEO-CLASSICAL THEORIES

The Beginnings of Free Trade Theory

Tracing back the evolution of what today is recognized as *the standard theory of free trade* takes us back to the years between 1776 and 1826, which respectively mark the publication of Adam Smith's *Wealth of Nations* and David Ricardo's *Principles of Political Economy and Taxation*. These two volumes heralded the formulation of a theory of free trade, based on the unprecedented success of England in the fields of industry and trade. For Smith (1776), the division of labour in the nascent large-scale industries of England provided the base for lowering labour costs, which ensured effective competition across countries. Possible dilemmas such as the need for monetary adjustments for countries with a continuous trade surplus (with absolute advantage in all traded goods) could be set aside by relying on the principles of automatic price-specie flow mechanism, as proposed by Smith's contemporary, David Hume (1776).

It was left to Ricardo (1826) to sort out the basic premises of the theory of free trade which Smith had initiated. Industrial capitalism in Ricardo's England was at a relatively advanced stage, with rapid growth in large-scale industries and captive markets in overseas colonies. Imports of wage goods (corn) had the special role of cheapening those wage goods and hence labour cost for industry. Free trade, as opposed to the mercantilist policies of protection, was championed by both Smith and Ricardo as a route to achieve production efficiency at a global level. Despite his concerns for the introduction of machinery on a large scale, Ricardo's cost calculations were based on labour hours, treated as a single homogeneous input with

production (in a two commodity world) subject to constant costs. It was the comparative and not absolute advantage which was considered both necessary and sufficient to ensure mutually gainful trade across nations, warranting complete specialization in the specific commodity with comparative advantage in terms of labour hours used per unit of output.

In the first two decades of the nineteenth century, Benthamite utilitarians rose to prominence. In their view, the Ricardian doctrine had failed to take account of the role of demand as an explanation for terms of trade in exchange. It was J. S. Mill who undertook the balancing act by introducing the notion of 'reciprocal demand', while a few years later, Alfred Marshall further advanced the role of demand in terms of the 'offer curve' construct; according to him, this completed the Ricardian trade theory by determining the 'terms of trade'. However, the supply side embedded in these theories had in the meantime changed, from the Ricardian notion of fixed labour time inputs to 'real costs'. These costs, for Marshall, were measured by the subjective disutility or sacrifices of labour at the job. In addition, output was subject to diminishing returns, with changing factor proportions rather than constant factor (labour) coefficients as in Ricardo's theory. Units of 'representative bale' — of goods offered by the respective nations in the two-country model — bore the mark of demand as well as supply. These were thought to settle the terms of trade at a stable equilibrium, as long as goods exchanged were of a 'normal' category, facing elastic demand, and production was not subject to increasing returns. Marshall carefully avoided the possibilities of multiple equilibria, which arose when these conditions were not met, by assuming that all costs are irreversible, even when subject to increasing returns (Bharadwaj, 1989).

Neo-Classical Theories of Trade

The balancing act between forces of supply and demand was carried forward by the Austrian school with their notion of 'opportunity cost', defined in terms of the utility of foregone consumption. This provided the methodological tools for the Heckscher-Ohlin version of the free trade doctrine which used marginal rates, turning the classical theory on its head. At the same time, it laid a basis for the defence of free trade as Pareto-optimum, rather than on grounds of comparative labour costs alone. This ensured optimization of production, consumption and exchange (trade) for the two trading nations at equilibrium, as under Pareto-optimality.

The above version of neo-classical trade theory has continued to have a special appeal. In particular, it has been widely used by economists championing the cause of free trade on grounds of optimization at a global level, of productive efficiency, consumption (and therefore welfare), and the automatic utilization of factors of production at full capacity. Returns to factors of production which consisted of labour and capital were in

proportion to their respective material contribution, valued at market prices. Unlike the Ricardian paradigm where the supply cost (measured in labour hours) was the factor determining trade advantages, in these new theories consumer preferences (with ordinal rankings) for goods was as important as the supply factors in determining price competitiveness of exports from the trading nations.

It is interesting to note how the Heckscher–Ohlin (and later Heckscher–Ohlin–Samuelson, or HOS) version (see Samuelson, 1949) of free trade doctrine played down the otherwise overwhelming role of demand on market prices. This was to bring resource endowments of nations to centre-stage as *the* determining factor for mutually gainful trade. With this device, free trade theory moved away from the skill- or technology-based interpretations of the Ricardian comparative cost doctrine, to an endowment-based explanation for nations having similar access to technology.

It was a Herculean job for the neo-classical economists to arrive at the factor-endowment based theory of free trade. Logically, consumer preferences (or demand) in either of two trading countries could be a determining factor for both commodity and factor prices (including those of labour) in the pre-trade stage, independent of the impact of the disparities in factor endowments. Assumption of identical consumer preferences between the trading partners made factor endowments the only determining factor of the price-competitiveness of the traded goods in these models. The common world price was to settle at a level which was within the boundaries set by the pre-trade prices in the two countries. While factors of production were assumed to be immobile (as in the classical comparative cost theory) equalization of commodity prices was supposed to bring about a similar equalization of factor prices across countries. The potential problem of arriving at uniform prices in absolute terms with different national currencies was avoided by completely ignoring the possibility of different currencies across nations. The implicit justification for such an assumption lay in the branding of this kind of theory as ‘pure’, as distinct from a ‘monetary’ theory of trade.

Apart from factor price equalization, theorems following from the HOS theory of free trade doctrine include a corollary, named after Stolper and Samuelson, which relates protection to real wages (Stolper and Samuelson, 1941). In terms of the above, the scarce factor in each trading nation would lose out under free trade as a result of factor price equalization. Thus labour, considered the scarce factor of production in the US, was thought to benefit from protection and not from free trade. Attempts have been made by a number of scholars to construct models of the old trade theories (both comparative cost and HOS models) for multi-commodity, multi-factor and multi-country cases. However, these models, dealing with ‘higher dimensional issues in trade theory’ (Ethier, 1984), have not made a very significant contribution.

In the decades that followed, the failure of the HOS model to address the world of realities was taken up at different levels. At an empirical level, the

observed tendency for exports to be more labour intensive than imports in the US (where capital is relatively abundant) created an anomaly for the endowment-based explanation of trade patterns under the HOS theory. Leontief (1956) tried to resolve this paradox with his interpretation that one unit of US labour is equivalent to more than one unit of labour in rest of world.

At a logical level, the HOS model needed some qualification in order to validate its central argument relating to factor price equalization. The work of Minhas, in particular, further restricted the model's application to situations of constant elasticity of substitution (CES) between factors of production: the production function, which entailed factor intensity reversals when elasticities of substitution are different for the two goods, thus avoided the disruption of the factor-price commodity-price frontier with the strict ordering of goods in terms of factor intensities (Minhas, 1962). Other assumptions which remained in terms of the HOS model included the usual specifications of a $2 \times 2 \times 2$ model, differing endowment ratios in the two trading countries, different factor intensities for the two goods, constant returns to scale and diminishing returns with varying factor proportions. Eventually it was incomplete specialization with trade in both goods which was to ensure, under the assumptions stated above, an equalization of factor prices as a consequence of free trade in goods. As in the Ricardian model, prices continued to be defined in real terms and not in units of money.

Deviating from the existing supply-side theories, an alternative explanation for the pattern of trade was offered by a Swedish economist, Staffan Linder, in terms of 'overlapping demand' (Linder, 1961). Linder argued that 'representative demand' in the trading nations — that is, a range of goods which are typically in demand at a given per capita income level — determines the feasibility of trade between them. For trade to occur, there needs to be an overlapping zone in the representative demand of the respective countries, in terms of the range of goods which are produced and consumed in common. With this interpretation, demand (rather than supply) returned to centre-stage as an explanation of trade. Linder's theory of overlapping demand superseded the earlier emphasis in the literature on supply-based explanations of trade via comparative cost or factor endowments. Despite being rich with potential for explaining intra-industry trade, product differentiation (or 'sophistication' as Linder calls it), and even the South–South trade of recent years, Linder's work has remained rather neglected in the literature.

NEW TRADE THEORY (NTT)

By the early 1980s, the rigid framework of the neo-classical models of free trade was being questioned from different quarters. The major efforts to restructure the free trade doctrine were made in the NTT literature. The key

contribution of the NTT was to discard the limiting assumptions of the traditional trade theory: the absence of scale economies in production, and the assumptions of homogeneous products and perfectly competitive markets in exchange. These three aspects (scale economies, imperfect markets and product differentiation) which differentiate the NTT from the old trade models, effectively challenge the capacity of the HOS model as a predictor of the trade pattern across nations on the basis of pre-trade commodity and factor prices as determined by relative endowments.¹

The introduction of returns to scale, which was a major departure of the NTT, influenced both the predictability of trade patterns as well as the benefits from trade to the trading countries. The theory of increasing returns, if related to economies of scale which are internal to the firm, is incompatible with competitive equilibrium, a problem recognized earlier in the literature (Sraffa, 1926; Young, 1928). This is because producers enjoying internal economies of scale are usually in a position to influence the market by exercising control over prices as well as the market share. A related point concerns the size of firms and the market structure, both intricately linked to possible economies of scale, which could lead to market imperfections with monopolistic competition, oligopoly or monopoly. These possibilities — especially the oligopolistic sharing of the market — led to the application of strategic trade principles which emerged as an alternative with strong policy overtones. We will deal later with these developments in the area of strategic theory. To appreciate the implications of scale economies, it is also important to note that products, especially under monopolistic competition, are likely to be differentiated, generating further deviations from the traditional competitive models. By incorporating these possibilities of product diversifications, the NTT added an important dimension to trade theory.

The new trade theories affected the basic assumptions underlying the HOS model, and as such its major conclusions, including the corollaries relating to factor price equalization, protection and real wages (the Stolper-Samuelson theorem), and effects of changes in proportions of factor endowments (the Rybczynski theorem) (see Darity and Davis, 2005; Deraniyagala and Fine, 2001). Efforts from within NTT circles to reinstate the HOS theorems by introducing a set of restrictive assumptions did not help much (for example, Helpman, 1981). Use has sometimes been made of 'Dixit-Stiglitz preferences (represented by a utility function in which utility increases with the varieties consumed, not just the quantity of each variety)' to conclude that the welfare effect of the variegated consumption basket outweighs the losses to the nation, if any, from the movement from autarky

1. Some NTT theorists attempted, rather unsuccessfully, to validate the HOS predictors within the framework of the new theory.

to free trade. These losses may affect the small producers who are unable to reap the economies of scale.

In its work on scale economies and the gains from trade, the NTT literature also showed that with economies which are external to the firm but internal to industry, production achieves a global span in terms of location. This permits cost reduction on a global scale while relocating production away from areas/countries where it is not cost-efficient (Ethier, 1982; Krugman, 1981). Implicit in this is an argument for free trade with potential gains to all trading nations by achieving increasing returns on a global scale (Krugman, 1981). A further distinction in scale economies is drawn in the NTT literature between scale economies which are external to the firm but are of 'national' origin, as distinct from those which are 'international' — the latter arising from developments at the level of the global industry. The distinction is relevant for identifying situations in which the trading nations can gain from trade. Thus gains from trade arise for countries with increased output in industries which enjoy national-level scale economies. Gains from trade are also possible for industries with scale economies arising at an international level: in particular, small economies which otherwise cannot access such economies are supposed to gain by opening up (Bhattacharjea, 2004: 111). Thus trade can be beneficial with external economies at an international level, for nations with opportunities of accessing economies and avoiding diseconomies of scale in integrated markets. This applies even for countries with identical resource endowments and therefore with similar pre-trade prices. In this case, a small country has more to gain as markets are opened up and external economies of scale become available at an international level (Ethier, 1979; Helpman, 1984). It can be argued, however, that the validity of this argument would depend on the prevailing state of trade restrictions in the world economy.²

In retrospect, the major contribution of the NTT was its work on product differentiation and intra-industry trade. As with economies of scale and market imperfection, product differentiation also distorts the basic properties of the HOS trade model. Thus, with demand generated in either country for individual varieties produced by the same industry, the process makes space for intra-sectoral (intra-industry) trade across nations. Intra-industry trade is possible in both directions across countries when global markets are segmented and firms adopt price discrimination/dumping. The goal is to

2. There were also earlier attempts to address issues relating to increasing returns. Alfred Marshall sought to avoid the problem of possible multiple equilibria under increasing returns by assuming that costs are historical and hence irreversible over time. At one stroke, Marshall thus avoided the Pigouvian proposal for taxes and bounties for respectively increasing and decreasing cost industries. A similar issue was also raised by Graham and Knight who dealt with increasing returns and its effects on trade; for both of these, see Viner (1937).

maximize revenue by taking advantage of the different demand elasticities for the same good in different countries, which can be described as a strategic trade deal.³

The notion of 'strategic trade' was formulated by Brander and Spencer (1985) in the context of the widely prevalent practice of reciprocal dumping within the industrial policies of advanced nations (see also Krugman and Obstfeld, 1992). This relates to situations in which demand curves are subject to elasticities which are different in the two countries. Using the famous example of Airbus and Boeing in the aeronautics industry, the strategy was one of aggressive pre-emption by creating a market niche through subsidized dumping of exports. A parallel possibility also exists with internal economies of scale at a national level: countries which are historically ahead of others in producing a good clearly have an advantage, with the capacity to produce at lower costs experienced by the starting countries. As with 'infant industries', this situation justifies a strategic trade policy, with subsidies offered to the high-cost country in order to enable its industries to benefit from scale economies. Paradoxically, however, this has often provided the basis for aggressive strategic trade on the part of industrially advanced nations.

The strategic trade component of the NTT gained currency, especially in the US, in public policy debates during the 1980s. It was generally recognized that the 'vagaries of history', rather than resources, determine what a country produces and exports. Thus the role of 'history and accident' were both considered crucial in determining the location of an industry on the world map (Krugman, 1994: 201).⁴ By the early 1980s, influential people, including Robert Reich and Lester Thurow, were recommending governmental intervention to shift resources from 'sun-set' to 'sun-rise' industries, thus generating 'high value added products' (ibid.: 248). Around the same time, the Berkeley Roundtable, an influential thinktank at the University of California, drew attention to what they saw as tendencies towards de-industrialization in the US, and recommended active state intervention, advocating industrial policy along the above lines (ibid.: 249).

The NTT also encompasses new theories of FDI and technology, which are seen as conditioning factors for trade flows and trade patterns. Although the role of these factors was also recognized in the earlier trade theory literature, NTT drew attention to the 'product-life-cycle' (PLC) of technology-driven foreign investment and trade flows (see Hufbauer, 1966;

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3. The efforts of NTT to re-validate the 'predictive power' of trade theory, and the related problems of incorporating increasing returns to scale, have been rather complex, especially when the point of departure of these theories continued to be defined in the neo-classical HOS tradition, and when the theorists concerned tried to rehabilitate the HOS theory (see Helpman, 1981, 1984).
 4. This is what Krugman calls the economics of QWERTY or path-dependence, as in the age-old typewriter keyboard which continues in the latest models of computers.

Posner, 1961; Vernon, 1970). According to the NTT, innovations which led to the adoption of new technology in advanced countries, introduced new products which were made, consumed and exported to the rest of world. With the 'maturing' of product innovation, both technology and capital (FDI) are supposed to move to other advanced countries, to produce similar goods, which in turn are exported back to the lead nation. Less developed countries import these goods from the advanced country/countries during the new/maturing stages of the PLC. Production starts in the less developed countries only when the product is 'standardized', thus completing the life cycle of the product. Thus, technology and capital travel first from the most advanced to other advanced nations, and eventually to the developing countries which now export the product to the advanced nations. With product specifications (new, maturing, standardized) and the initial control over the market by advanced countries, the PLC theory of technology-driven trade incorporates both product differentiation and market imperfections. A similar emphasis was laid on technology-driven trade flows in models which looked at the 'technology gap' among nations. The explanations for this gap included a 'demand-lag' on the part of consumers and a 'reaction-lag' on the part of producers in the home country, along with an 'imitation-lag' on the part of producers in the foreign country (Posner, 1961).

While the basic premise of PLC and other neo-technology models rested on diffusion (or transfer) of technology across nations, the process by which this would happen remained unclear, with no reference to multinational corporation (MNC) practices relating to parent companies and subsidiaries. This opened up new areas of research in the branch of economics known as Industrial Organization theory, with models which, again, seem rather remote from the world of realities. A somewhat more realistic approach to the FDI-trade nexus was provided by Ozawa's 'Flying Geese' paradigm, which sought to explain the relocation of production and the shifting export platforms in Asia since the 1980s (see UN, 1995: 246). Overall, the PLC literature provided a platform for an integrated approach to trade, technology and FDI, incorporating product differentiation and market imperfection. Compared to the earlier approaches to trade, which were primarily location-specific (comparative cost, resource endowments), PLC theory introduced product-specific (new, mature, standardized) characterizations and organization-specific factors.

How far has the NTT departed from the old models of free trade doctrine? Notwithstanding its innovative critique of the traditional trade theories, it has been pointed out that the NTT has remained 'fully consonant with "traditional theory"'. It explores creatively and extensively the exceptions that the "traditional theory" would admit to its standard results' (Darity and Davis, 2005: 142; see also Deraniyagala and Fine, 2001). An exhaustive analysis and critique of NTT claims that 'limitations remain embedded in the new theory because of its excessive fidelity to the old'

(Bhattacharjea, 2004: 117). Indeed, the free-trade doctrines, both of the traditional and the new variety, with their positive approach to world trade, have failed to address the dynamic implications of trade opening in terms of growth and development of the trading nations, especially concerning developing countries.

It is interesting to note that the static theories of optimal resource allocation in neo-classical trade theory do not share the awareness demonstrated by both Smith and Ricardo of the uneven development of nations (Darity and Davis, 2005: 143). Smith analysed increasing returns, innovation and market size, while Ricardo explored technical progress and the Corn Law debate as possible hindrances to industrialization. Smith, in particular, was aware of the 'marked differences' in economic development of nations: 'he refers to "nations of savages" coexisting with "civilized nations"' (ibid.: 146). Both Smith and Ricardo, despite their basic differences on increasing as distinct from diminishing returns to scale, 'provide a framework for directly addressing the phenomenon of *divergent* economic development' (ibid.: 149).

TRADE, GROWTH, DEVELOPMENT, DEPENDENCE

On balance, the neo-classical HOS trade theories and the more realistic models introduced as NTT have both failed to address the issue of growth and development. They view 'change by comparing static equilibrium states, rather than as a process occurring in irreversible historical time' (Bhattacharjea, 2004: 121). The agenda the NTT theorists had set for themselves clearly excluded situations in which changes can happen in resource endowments, technological possibilities or consumer preferences (see Ruttan, 1998; Stewart, 1991). Furthermore, neither set of theories paid much attention to issues of changing income distribution, as is usual with free or even restricted trade.

Early attempts to capture the relation between trade and growth include Johnson's (1956) 'trade-cum-growth' and Bhagwati's (1958) 'immiserizing growth' models. Despite limiting assumptions, Bhagwati was able to pinpoint the relevance of terms of trade movements as a factor related to growth rates for trading countries. It is, however, rather paradoxical that Bhagwati's 'immiserizing growth' through deteriorating terms of trade seemed to prevail in a country growing *faster* than its trade partner, or even growing in isolation.

Terms of trade resurfaced in the literature as a powerful tool to demonstrate the inequities of trade for developing countries. Raul Prebisch (1963) and Hans Singer (1950) both advanced the much celebrated thesis relating to a secular decline in terms of trade experienced by the primary producing and exporting countries. Supplementary material, which supported the hypothesis, was provided in the Haberler report from GATT (1958), spelling out the factors responsible for the lack of demand for exportables from

the semi-industrialized countries in advanced country markets (see also Haberler, 1968). The reasons included the falling or low import content of production in advanced nations as a consequence of technological changes. It was argued that 'industrialization is a significant factor in the long term tendency for exports of the semi-industrialised countries to rise even more slowly than those of non-industrial countries' (Theberg, 1968: 42). The low price and income elasticity of demand for exports from developing countries in the advanced country markets was another contributing factor.

Further support to the trade and underdevelopment thesis was lent by Nurkse (1959), Singer (1950) and by Myrdal (1957). Nurkse stressed the role of agricultural protectionism in advanced economies, along with lagging demand for imported inputs (both primary and intermediate) from the less developed countries, as factors contributing to under-development. Looking at foreign investment flows to developing countries, Singer (1950) documented the damage done, not only from falling export prices and the declining terms of trade for the primary producing countries, but also from the outflow of funds to service and repay foreign investment. Singer held that foreign investments indirectly foster a base for export-oriented primary production, thus ruling out the prospects of an alternative path of development based on industrialization. Myrdal (1957) argued that similar 'back-wash effects' of investments in open economies often over-ruled the 'spread effects' if any. Many of these arguments are of relevance today.

A variant of the alternative approaches to trade and underdevelopment can be found in the neo-Marxist literature. Inequities resulting from trade was one of the main themes in the Marxist literature dealing with trade. Using the labour theory of value, Arrighi (1972) pointed out the asymmetry in exchange across countries, with productivity gains in the developing countries appropriated by the rest of world. The result is equivalent to a drop in the double factorial terms of trade, independent of the assumptions of the labour theory of value. Other studies in this tradition, which reject the mainstream neo-classical theories of optimal trade and growth, offer a picture of inequitous and exploitative world trade. The literature includes the classics on imperialism, and especially, the under-consumption thesis of Rosa Luxemburg (see Luxemburg, 1968). It signifies an inevitable crisis for capitalism which could be remedied only by having access to pre-capitalist markets within the nation state or overseas. Trade thus had a major role in the process, providing access to markets hitherto unexploited.

The emphasis on trade continued in the debates on related themes on capitalism, with Sweezy (1976) highlighting the primacy of 'circulation' (or exchange) as against 'production relations' which was emphasized by Dobb (1962). Borrowing from Sweezy, Wallerstein (1979) dwelt on commerce as a major tool in the 'peripheralization' of new territories and the transfer of resources to 'core areas'. This generated the widely known core-periphery distinction in the literature. 'De-industrialization' via trade, and transfers of surpluses from colonies also remain important elements in the analysis and

documentation of the colonial past of developing countries (see, for example, Bagchi, 1982; Sen, 1992). Trade and investment are used even more effectively in Frank's analysis of the 'development of under-development', which explains much of neo-colonial expropriation of surpluses from the developing areas (Frank, 1967). Such theories have influenced the 'dependencia' school of thought which dwells on the inequities of the world trading and financial order (Amin, 1972; Amin et al., 1981; Braun, 1983).

WHAT THEN REMAINS OF THE FREE TRADE PARADIGM?

The wave of liberalization, which has swept the developing world in the process of globalization, also generated some specific tools for policy-makers to justify moves towards deregulation. Trade barriers employed by import-substituting or Quantitative Regulation (QR) regimes were identified as 'social costs of protection', often measured by 'effective rate of protection', popularly known as ERP (see Corden, 1957, 1966). Such costs could also be identified as the 'domestic resource cost' (DRC), providing a measure of the cost efficiency of domestic industries in comparison to international standards. For developing countries which were on the move from an import-substituting regime to one of export promotion during the 1980s, the tool could be used to identify potential exportables from a country (Bhagwati, 1978; Helleiner, 1992; Krueger, 1978). To compute 'shadow prices' which reflect 'dynamic comparative advantage' (Chenery, 1961), the cif (cost, insurance and freight) prices of importables (in the absence of programming exercises) was used to arrive at the ERP and DRC calculations. These were used extensively by the free-trade lobby in developing countries as tools to question the controlled trade regimes.

Limitations, conceptual as well as operational, can easily be detected in the approaches to trade efficiency which underlie these concepts. These problems limit the validity of the ERP/DRC indices as guidelines for resource allocation in developing countries. Three main issues give an idea of the related problems. First, the restrictive assumption of fixed input coefficients as used in these calculations fails to measure the gains in efficiency through factor substitution. The assumption reduces to triviality all prescriptive claims of such models on issues relating to efficiency gains within the economy. Second, by using international (cif) prices as a surrogate for 'shadow prices', calculations of these indices often lead to serious anomalies with negative ERP/DRC values, which are meaningless for allocational purposes. Third, the possibilities of monopoly power enjoyed by different protected units may generate a ranking of industries by ERP/DRC criteria, which does not necessarily reflect inefficiencies under protection (see Sen, 1982).

This brings to mind the developmental agenda for open economies which had rather limited success under neo-colonialism. However, despite their

subordinate economic and political status in relation to the advanced industrial nations, the developing countries have been able to draw attention to the ongoing inequality of the world economic order — albeit rather unsuccessfully in terms of remedial steps. These include the voice raised by the Group of 77 developing nations in the 1960s, which culminated later in the United Nations Conference on Trade and Development (UNCTAD). At another level, the Non-Aligned Nations tried, over the limited period for which the movement was active, to demand fair deals on trade and investment. More recently, developing countries have been active (although again with limited success) in defending their national interests against the aggressive unilateralism of the powerful industrialized countries at the level of the multilateral trading institutions like the WTO. We will return to this below, in the context of the asymmetry and inequity of the current international trading system.

Let us now draw attention to the fact that not much has remained of the predictions of a conflict-free, harmonious world of free trade. Advances in trade theory and policy have not kept pace with the issues which concern the majority of nations in the developing areas. Trade policies prescribed by mainstream neo-classical economists for the developing region have focused exclusively on the Pareto-optimality conditions in multiple markets which are achievable under free trade. In the literature dealing with sub-optimal conditions, all deviations from competitive equilibrium are treated as ‘distortions’ in terms of the favoured Pareto-optima. It is not surprising that policy conclusions emerging from such formulations have failed to address the problems of the real world.

In the advanced nations, where theories of free trade are nurtured even today, rising unemployment as well as over-supply of domestic goods are often related to labour market distortions (trade union militancy and wage rigidity, in-migration, lack of skills), cheap foreign goods (produced abroad with cheap labour, outsourcing) or even an overvalued foreign currency (such as the Chinese yuan). Little attention, if any, is paid to deficiencies of demand at home, which remains a major source of the malaise in the advanced economies.

In this context, rather anomalous usages of trade theory are appearing in the policies advanced by industrialized nations, which seem to rely on two distinct strands of theory. For developing countries the recommendation is to liberalize and open up as much as possible, in order to avail of the ‘benefits of the free trade doctrine’ (old variant). For their home economies, however, the prevalence of unemployment and low growth are taken seriously, and a remedy is sought through strategic trade of the NTT variant. Such arguments permeate the policy moves of the advanced countries, not only at the level of inter-governmental trade deals, but through multilateral trading institutions such as the WTO where these nations often reign supreme.

There are many instances of anomalous and discriminatory practices in the current WTO regime. One major example is of the unilateralist

approach implicit in the emerging regional trade blocs, including NAFTA and the EU. Article XXIV of the GATT — and its updated version in the WTO — allowed exemptions from most-favoured nation (MFN) status for customs unions and free trade areas. This was based on the condition that the common external tariff of the union members should not be raised further. While attempts have been made to justify the burgeoning of preferential trade arrangements (PTAs) as a form of ‘open regionalism’ to prepare the way for complete trade liberalization (see Council of Economic Advisers, 1995), it is not hard to see the regional trade arrangements like NAFTA and APEC ‘as a process by which a hegemonic power [often manages] to satisfy its multiple trade-oriented demands on other weaker nations more easily than through multilateralism’ (Bhagwati and Krueger, 2001: vii–ix; see also Srinivasan, 1998). At the same time, various pressures — including threats of denying market access to the large industrialized countries — have been countering moves by the weaker nations to manage alternative trade forums like the SAPTA in South Asia or the Mercosur in Latin America.

Notwithstanding the goals initially set up in the Uruguay round of trade talks, to achieve efficiency gains by eliminating trade barriers across nations, the rich industrialized countries have managed to retain various non-tariff barriers. These include subsidies on agriculture, industrial and innovative activities in the home countries. Anti-dumping provisions are being used to weed out potential threats from developing country imports to manufactures of local origin. There are also attempts to push through the new WTO agenda, including the Competition Policy and level playing field for FDI in host countries, whilst guarding against ‘outsourcing’ by FDI subsidiaries abroad. Many of these moves have the intellectual backing of strategic trade and industrial policy arguments.

Ministerial talks following the Uruguay rounds have opened up areas of discord between the members, with developing countries trying to resist pressures to adopt trade practices which have an in-built bias in favour of the developed countries. Expansion of the negotiating agenda, rather than the consolidation of prevailing negotiations, was the central issue in early rounds, with the broadening of the discourse at the Singapore Ministerial Conference in 1996. This sought to cover investment, competition policy, government procurement, trade facilitation, labour and environmental standards. The developed countries were not willing to incorporate these demands, mostly from the developed countries, within the existing WTO framework. The Doha Ministerial Round in 2001 failed to resolve issues of market access for agriculture, especially in the advanced countries.

The last meeting of the Ministerial group at Cancun in 2003 similarly, and spectacularly, failed to arrive at a consensus on major issues relating to the Doha and Singapore concerns. Some felt that the plans for agriculture were too ambitious, others that they were not ambitious enough. The member nations even differed on whether to launch negotiations on the Singapore

issues. They also had comments on the non-agricultural market access text, including the description of the tariff-cutting formula, and on the proposal to introduce sectoral deals (zero tariffs for all products within specified sectors) on a compulsory basis for all members. Several of the Ministers felt that the text on the cotton initiative did not reflect the proposal to phase out subsidies in the long run and to compensate African producers in the interim. A number of African and Caribbean countries, in particular, pointed out that the draft does too little on special and differential treatment for developing countries. The scepticism was even reflected in the official WTO website: 'It is ironical that a few countries, both developed and developing, expressed concern that the negative sentiments would wipe out what they described as possible significant results in areas such as agriculture, which are particularly important for developing countries. Two large members warned that each delegation would be responsible for what happened that night'.⁵

Such signs of discord between member countries in the face of 'aggressive unilateralism' on the part of the more powerful nations have continued to surface in the course of the long drawn-out WTO negotiations. Examples include the near-collapse of the multifibre arrangement (MFA) relating to textiles,⁶ the shrinking coverage of products (with the 'graduation' provision of the EU) in terms of the generalized system of preferences (GSP), dilution of the special and differential treatment for all developing countries down to 'best endeavor clauses', and so forth.

The strong-arm tactics of the advanced nations within and outside the WTO continue alongside the never-fulfilled promise to developing countries of greater market access (in agriculture, textiles and clothing), and movement of natural persons under services. In addition, the international financial institutions including the International Monetary Fund, the World Bank and even the G10-controlled Bank for International Settlements, exercise control over finance, imposing regulations which have a major impact in shaping world trade. It has proved important to the advanced nations not to give up their 'export platforms' in countries with cheap labour, and accordingly to protect FDI as well as other forms of finance in these regions. Problems in developing areas, which remain the major suppliers of raw materials to the rest of world, are sometimes addressed by 'debt cancellations'. These protect not only the cheap source of raw materials, but also the lending institutions. Such debt cancellations (including the debt negotiations of the G8 at Edinburgh in July 2005) carry a price tag in terms of further trade opening by the debt-ridden countries, which will make it easy for the

5. See http://www.wto.org/english/thewto_e/minist_e/min03_e/min03_14sept_e.htm. See also RIS (2003).

6. Even after the phasing out of the MFA on 1 January 2005 under WTO, developed countries have sought to restrict imports from countries like China.

lending nations to make good the cancelled debt, in the form of export earnings. Theory seems to have been turned on its head, with trade-liberalizing forces operating in developing countries, while protectionist subsidies continued unabated in the developed world.

CONCLUDING OBSERVATIONS

From the discussion above, we observe that the evolution of trade theory, from old free trade doctrines to the NTT, has impacted on policy at three levels. The first relates to the advocacy of the free trade doctrine to determine policy for developing areas. Thus traditional trade theory, in the form of comparative cost or the HOS doctrine, continues to be used to justify trade liberalization in developing countries, notwithstanding the serious theoretical and empirical limitations embedded in these theories. Unsurprisingly, the use of such (old variant) free trade policies is defended by the advanced nations, both at inter-governmental levels and in multi-lateral institutions like the IMF and the WTO.

The second impact relates to policies pursued by the advanced nations themselves, which rely heavily on the NTT doctrine of strategic trade. Thus NTT is used to justify the strategic trade objectives of advanced countries with interventionist policies in the sphere of trade negotiations and domestic industrial policy. The uneven power relations between the rich and poor nations of the world permit the continuation of this asymmetrical combination of policies, to which the microeconomic approaches to efficiency gains under free trade have contributed much. Neglect of the macroeconomic issues relating to the national as well as the world economy has led these theories and the related policies to ignore the implications of demand-led recession in the global economy. Instead of launching a global expansionary policy along with trade opening, which is potentially capable of working the links between trade, growth and development (Sen, 1998), policies in advanced nations have reinforced the 'beggar-thy-neighbour' approach, garbed in strategic trade principles.

The third impact is the preoccupation of some academics and policy-makers, even from developing areas, with trade liberalization for developing countries. This precludes an understanding of the role which mutually gainful trade can play in economic growth and development, even though this was one of the professed goals of multilateral trading organizations like the WTO, which promised wider market access to the member countries through trade liberalization. Very little of this promise has been fulfilled, despite adherence to efficiency gains under liberalization as prescribed by the WTO and its rich member nations for the developing world. With tendencies for global recession, especially in advanced countries, the need to protect jobs has led to protection of domestic markets, using new forms of trade barriers which tally with WTO obligations. The recent outcry

amongst advanced countries about 'outsourcing' by FDI subsidiaries, the continuation of agricultural subsidies in their domestic economies, and pressures on so-called 'cheap labour' economies like China to revalue their currency, are just some of these devices. There seems to be little recognition of the mutual gains which could potentially accrue to both advanced and less developed countries, as additional demand is generated through trade-led expansion of these economies.

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