Preface

The purpose of this book is to argue that trade liberalisation, with the ultimate objective of free trade, is not in the interest of poor developing countries at their present stage of economic and social development. History, economic theory and contemporary statistical evidence does not support the view that trade liberalisation, or making economies more open, necessarily raises the growth of living standards, reduces poverty or leads to a more equal, fairer, distribution of income between countries in the world or between people within countries. The orthodox theory of trade liberalisation is therefore being sold by international institutions to developing countries on a false prospectus.

The book is the last of a trilogy of short, readable books which attempt to provide an alternative approach to that of orthodox neoclassical trade and growth theory for an understanding of the growth and development process, with particular reference to poor developing countries. The first book, *The Nature of Economic Growth: An Alternative Framework for Understanding the Performance of Nations* (Thirlwall, 2002) presents a structural, demand-constrained model of growth, in contrast to the one-sector supply-oriented growth model of orthodox neoclassical theory, in which the balance of payments or foreign exchange is identified as the major constraint on growth, and the structure of production is crucial because different goods have different production and demand characteristics. The second book, *Trade, the Balance of Payments and Exchange Rate Policy in Developing Countries* (Thirlwall, 2003) focuses on the neglect of the balance of payments (or monetary) consequences of trade in orthodox trade and growth theory and casts doubt on whether exchange rate devaluation, or depreciation of the currency, is an efficient balance of payments adjustment weapon.

This new book continues to question the orthodoxy proposed by mainstream academic economists, and policymakers in international institutions such as the International Monetary Fund (IMF), World Bank and World Trade Organization (WTO), that trade liberalisation is the panacea, or magic bullet, that will launch poor developing countries on to a higher growth path consistent with balance of payments equilibrium. We argue that what we witness in the world economy today, in an era of unprecedented trade liberalisation, resembles much more closely the predictions of non-orthodox models of growth and development that highlight cumulative processes and polarisation between people and countries, rather than the equalising, equilibrating predictions of orthodox neoclassical trade and growth theory.

The prevailing consensus in the years since the Second World War has been that if countries are to develop and prosper they must liberalise their trade, almost at any cost. Free trade has become a mantra. The orthodoxy has a long and distinguished ancestory that goes back at least to Adam Smith's famous book, *An Inquiry into the Nature and Causes of the Wealth of Nations* (1776) and David Ricardo's *On The Principles of Political Economy and Taxation* (1817), but it was given renewed impetus after the Second World War following the great depression and the beggar-thy-neighbour policies (protectionism) experienced during the 1930s. At the Bretton Woods Conference convened in 1944, which established the IMF and the World Bank, the world's major economies committed themselves to a liberal, free trade, order, endorsed in the 1980s by the so-called Washington Consensus, and reinforced by the establishment of the WTO in 1995.

There is no doubt that there are real resource gains from trade, as Smith and Ricardo originally showed, but there is nothing in the doctrine of free trade, or in the practice of liberalising trade, to guarantee an equal distribution of the gains from trade among participating countries or between individuals within countries. Indeed, in certain circumstances, which are not so unusual, such as terms of trade deterioration and balance of payments problems, countries may suffer absolute real income losses from specialisation according to the law of comparative advantage. Nor is there anything in the doctrine of free trade that guarantees a *permanent* increase in the rate of growth of output and living standards. On the contrary, it is an interesting and pertinent fact that despite extensive trade liberalisation, the economies of many countries, particularly those in Africa and Latin America, have performed very poorly in the last 20 years or so, and world income inequality has worsened – ignoring the fast growth of China. The Gini ratio, as a measure of income distribution across countries of the world (international inequality) and across peoples of the world (global inequality), is as high today (if not higher) as it was in the 1960s. Only a handful of poor developing countries (mainly in Asia) have narrowed the relative income gap between themselves and the rich developed countries. The vast majority of developing countries continue to lag behind, and many African countries are absolutely poorer today than they were 30 years ago. Does this mean that these countries do not trade enough, that their trade needs to be more liberal, or is there something wrong with the doctrine of free trade? It is also interesting and significant that while international organisations and rich developed countries preach free trade to developing countries, the rich countries themselves do not practice what they preach, and never did so historically when they were attempting to industrialise and develop (Chang, 2002). The basic problem with the free trade orthodoxy is that it brushes to one side the different production and demand characteristics of different types of goods, and assumes continuous full employment so that in the reorganisation of resources that specialisation and trade bring about there is no permanent unemployment; everyone finds a job. In practice, however, some goods (for example, land-based activities) are produced under conditions of diminishing returns, while others are produced under conditions of increasing returns. This makes a profound difference to the growth of living standards in countries specialising in these different types of activity. Also, some goods (for example, primary commodities) have a low income elasticity of demand in world trade, while others have a high income elasticity of demand. This makes a significant difference to the rate at which exports and imports grow in different countries specialising in different types of activity. There is a crucial link between the structure of production and trade and the economic performance that can be expected from trade liberalisation, which the orthodoxy ignores. In many circumstances, trade liberalisation may not be optimal for developing countries, at least without the implementation of complementary measures such as export promotion policies, strategic investment in structural change, infant industry protection and supportive exchange rate policies. The speed and sequencing of liberalisation measures are also important to bear in mind.

In the book we attempt to bring together in a readable and coherent way the vast literature that now exists on the theory, practice and impact of trade liberalisation – for the benefit of students, policymakers, and all those interested in what is happening to developing economies as the world economy becomes more liberalised and globalised (to use the fashionable terminology). The book has three essential messages:

1. Trade liberalisation is neither a necessary nor sufficient condition for the more rapid development of poor countries, when development is defined in its broad sense (Goulet, 1971, 1995) of not only providing life sustenance for its people, but also self-esteem and freedom. If trade liberalisation does not reduce poverty, that is not development. If trade liberalisation leaves countries more dependent on others because trade is 'unequal', that is not development. If pressure to liberalise trade reduces countries' freedom to pursue their own economic policies, that is not development.
2. Neo-liberal economics, which puts faith in trade liberalisation as the route to development, has become like a religion or creed, which not only ignores perfectly respectable economic theory which shows that there are several legitimate economic arguments for protection, but also disregards history and the facts of experience of how today's developed countries progressed in the 19th century and the first half of the 20th century, and the miserable contemporary experience of many of today's developing countries that have been forced by multilateral institutions to liberalise prematurely or too quickly.
3. The extensive empirical research on the impact of trade liberalisation on exports, imports,

> the balance of payments and growth does not support the view that liberalisation, at least since the 1980s, has been associated with a superior economic performance of poor countries, or a narrowing of the degree of international income inequality between countries and peoples of the world. The view to the contrary, espoused by neo-liberal economists and international institutions, is largely dependent on the inclusion of China and India in the sample of poor countries taken by investigators. These are two poor populous countries, which have grown very fast in the last 20 years, and where trade as a proportion of GDP has grown very rapidly, and they naturally make a huge difference to the statistical results relating to trade and growth and trade and income inequality. But China and India are just two of over 150 poor, developing countries. If they are excluded from the sample of poor, 'globalising' economies, a different picture of the world is painted – one in which international and global inequality is rising, where the number of people living on less than $2 a day is rising, and 'globalising' countries are performing no better on average than those which are not liberalising their economies so fast. Individual case studies show a variety of experience.

We argue, therefore, that the rhetoric of trade liberalisation, as a necessary condition for development and poverty reduction, is not matched by the reality.

The choice is not between autarchy and free trade, but the sensible management of trade: to achieve a balance between the growth of exports and imports so as to avoid balance of payments deficits; to allow policy space for poor countries to identify and encourage new areas of comparative advantage; to enable the State to intervene to promote 'self-discovery' (Hausmann and Rodrik, 2003); and to allow a judicious mix of tariffs and subsidies for infant industry protection. This is the way rich countries developed historically, and it is the way that poor developing countries today should be allowed to develop. In an environment of *laissez-faire*, *laissez-passer*, structural change is impossible.

In Chapter 1 we briefly rehearse the theory of trade liberalisation, and the benefits that it is supposed to confer on countries, and then outline the various meanings and measures of trade liberalisation that investigators have used in their research. Then we challenge the orthodoxy in a formal way, and consider history.

Chapter 2 focuses on the trade performance of countries that have liberalised, but not just the effect of liberalisation on exports which is the conventional approach. The effect of liberalisation on imports and the balance of payments is also considered, which can act as a constraint on economic performance. We survey the vast amount of research that has been conducted on trade liberalisation and economic growth, both within countries using time-series data, and across countries using cross-section and panel data.

In Chapter 3 we discuss unorthodox models that predict growing inequality with trade and we give evidence of the degree of income inequality in the world economy between rich and poor countries, using measures of international inequality (which take the average per capita income of each country) and global inequality (which takes account of the distribution of income within countries as well).

Chapter 4 examines research on the link between trade liberalisation in developing countries and poverty, wage inequality, and the personal distribution of income using household survey data. Orthodoxy predicts a narrowing of the domestic income distribution within poor countries, but the reality is different.

Chapter 5 draws some policy conclusions on how trade policy should proceed in the interests of the poorer, developing nations of the world, and of poor people within poor countries. There are national issues to consider, and also international issues relating to how international economic relations are organised and conducted relating to trade in goods and services, capital flows and financial arrangements between rich and poor countries, in the interests of a fairer distribution of income in the world economy between countries and people.