Free Trade in the Real World:

Competing perspectives about the role and impact of trade in developing countries.

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Since the end of the Second World War the Western World has lead the way in the quest for free trade between nations. In particular, various arms of The United Nations, chiefly The World Bank, The International Monetary Fund (IMF) and The World Trade Organisation (WTO) have been the main bodies through which the developed world has pushed its agenda of liberalisation. The policies pursued by these supranational organisations are based on western economic concepts and theories and have become broadly known as the 'Washington Consensus', a term first coined by John Williamson in 1989.

The Washington Consensus is rooted firmly in the Neoclassical approach to economic thinking and has been criticised by two main schools of thought; Structuralists and Dependency Theory. These two schools question many of the assumptions made by the Neoclassical framework and use real world observations to discredit Neoclassical policies. While Neoclassical theory suggests that all free trade is eventually mutually beneficial to everyones welfare, Dependency Theory advocates argue that free trade is a destructive force and a threat to the Developing World or the Least Developed Countries (LDC's). Structuralist make their position in the middle ground and acknowledge that while there are gains from free trade to be made for LDC's and Developed Countries (DC's) alike, free trade is potentially harmful to developing economies and needs to be managed appropriately.

This essay will consider each argument and ultimately show how Neoclassic philosophy, which has underpinned WTO and IMF policy for much of the past half century, relies upon too many unsatisfactory assumptions and that many observations made in the real world are contradictory to what the theory implies. Dependency Theory, on the other hand, while highlighting some of the very troubling side effects of free trade, will also be criticised in favour of the Structuralist approach for ignoring too many of potential gains LDC's stand to make from opening their borders to free international trade.

Williamson used the notion of a Washing Consensus to broadly summarise the policies that were derived from Neoclassical principals, the roots of which can be traced back to Adam Smith's classical theory that all trade is mutually beneficial, explained through Absolute Advantage, and David Ricardo's theory of Comparative Advantage. These ideas were more recently built upon by the Swedish economists Eli Hecksher and Bertil Ohlin to construct the general equilibrium Hecksher-Ohlin model (H-O model). The H-O model explains how free trade between nations enhances a populations welfare by allowing a nation to employ its various factors of production (land, labour & capital), more effectively.

The basic premise of Factor Endowment Theorem (one part of the H-O model) is that, through the combination of specialisation in the production process and free trade between nations, the participating nations can raise their consumption beyond their domestic Production Possibility Frontier, thus increasing the overall welfare of said nations populations. This happens because specialisation in goods that a nation has comparative advantage in means that this nation can produce them at a lower opportunity cost than that of its trading partners. A nations factor endowments determine what goods a nation will have comparative advantage in and so the Neoclassical lobby believe that many of the LDC's, which typically have a high abundance of cheap labour relative to their other factor endowments, should specialise in labour intensive goods. The labour intensive goods of the LDC's can then be traded for the capital intensive goods produced by capital abundant, typically Western, nations.

Another supporting argument of the H-O model, for LDC's adopting free trade, is the predicted effects of Factor Price Equalisation. Without the need for any cross border movement of the factors of production, the costs of the abundant factor within a nation should rise as demand for that factor increases. As a result, labour abundant LDC's will see rising real incomes for their workers, eventually leading to domestic and international equality. The H-O model, therefore, becomes a case for LDC's to adopt export orientated industrialisation (EOI) as a means for development.

Not only should free trade benefit LDC's through efficiency gains from specialisation and better use of the factors of production, but a whole host of other effects also come into play as a result of greater liberalisation. Rudiger Dornbusch (1992) lists “improved resource allocation” due to the price mechanism, “access to better technologies, inputs and intermediate goods”, ”economies of scale and scope” and “greater domestic competition” as benefits of a free and open market place. Furthermore, Schumpeter's work on creative destruction is used by Dornbusch (1992) to show how “favorable growth externalities, like the transfer of know-how; and a shakeup of industry” can create an “environment especially conductive to growth”.

All of these ideas about greater liberalisation lead Neoclassicals to the traditional arguments of trade theory that Michael Todaro (2000) lists as:

1. “Trade is a stimulator for economic growth”. Even if this means the rich get richer first (a widening of dual economies), it is believed that the ‘trickle down effect’ will mean spending by the rich will eventually raise the incomes of the poor.
2. “Trade tends to promote greater international and domestic equality”. Dual economies will narrow, bringing about combined and even development.
3. Trade encourages countries to play to their comparative advantage.
4. The price mechanism is the best way to “maximise national welfare”, and so advocating minimal state intervention.
5. “Isolation is asserted to be economically inferior to participation in a world of unlimited trade”.

With these core beliefs driving the Neoclassical school, the Washington Consensus rests on the ten recommended policies for LDC’s; fiscal discipline, re-orientation of public expenditures, tax reform, interest rate liberalisation, competitive exchange rates, trade liberalisation, openness to FDI, privatisation, deregulation and secure property rights.

According to traditional trade theory the Washington Consensus makes sense, but six basic assumptions made by the neoclassical trade model weaken this position. The first assumption made is that of a fixed quantity and quality of resources; that these factors are fully employed and that they are not internationally mobile. In reality, capital and labour do move between borders, they are not always of the same quality, and in many areas they are underemployed. Fixed (classical) and freely available (neoclassical) technologies and fixed tastes, the second faltering assumptions, are not a true reflection of the real world either. Todaro (2000 p.480) uses synthetic substitutes and mass marketing campaigns as just two examples of how these assumptions can be shown to be false.

Perfectly mobile factors of production within a nation assume no risks or uncertainties. The argument of national governments playing no role in international economic relations falls down when trying to explain the agricultural subsidies of the West. Balanced trade seems unrealistic considering the large deficits that can be observed in some of the most open economies in the world and the sixth flawed assumption, gains from trade accruing to nationals, is extremely controversial when considering the questions of Multinational Corporations (MNC's), and the actual ownership of the factors of production.

It is these flawed assumptions and the contradictory real world observations from which the Structuralist and Dependency arguments can best make their case.

One obvious criticism of Neoclassical theory is that it has been developed almost entirely by Western economists who have a bias to look at the problem from a western point of view. Historically, the British Empire and its colonies achieved growth through exporting, but the same conditions do not prevail now, a point Amartya Sen raises with his work on late industrialisers. The LDC's of the modern world face DC's operating with first mover advantages in technology and production skills, and who also benefit from a greater deal of political and economic muscle when negotiating terms of trade.

Another major problem, and highlighted by the Prebisch-Singer Thesis, is that of a "secular decline in the terms of trade of primary-commodity exporters due to a combination of low income price elasticities of demand." (Todaro 2000 p.467). As most LDC's comparative advantage is in labour intensive primary goods, specialisation and exportation of these commodities is argued by Structuralist and Dependency theory alike to be bad for LDC's. Estimates have placed a "deteriorating terms of trade for the LDC's at over $2.5 billion per year during the last decade" moving third world merchandise trade balances from "+$55 billion in 1981 to -$42 billion in 1993" (Todaro 2000 p.466).

A combination of relatively low income elasticities of demand for most primary goods, and export earnings instability due to the steepness of the demand and supply curves for these commodities, mean that import substitution industrialisation (ISI) is preferred as a means for growth, at least to begin with, for both Structuralists and Dependency Theory. Neoclassicals do make the valid point, however, that tariffs and quotas used to keep imports out lead to a "resulting decline in demand for foreign exchange" (Dornbusch 1992 p.71), and that this will subsequently lead to an appreciation of the domestic currency, making exporting even harder.

Structuralists see ISI as a means to get LDC's producing simple manufactured goods; the next step is to switch to EOI when the time is right. This Structuralist belief, that free trade can be good but needs to be managed properly, has lead to the creation of the Augmented Washington Consensus - an additional ten points added to the original ten.

Dependency Theory argues that there will never be a right time for LDC's to trade with the DC's, and that ISI and self reliance should be maintained indefinitely. Unfortunately, permanent ISI denies LDC's access to many of the technological advances that DC's have made. A good example of this happening is in Argentina, where "the 1964 Ford Falcon is still being produced with the U.S. machinery of that time, without model change, as if the clock has stopped." (Dornbusch 1992 p.75).

Dependency Theory finds free trade to cause unequal exchange and uneven development, arguing that without extensive state support the dual economy will only widen. MNC's are of particular concern to Dependency Theory for this reason as they repatriate the profits made by their activities in foreign countries - much like BP drilling for oil in the Niger Delta. Instead of a trickle down effect, Dependency Theory finds a 'trickle up effect', with money flowing from poor countries to the richer DC's. Furthermore, Dependency Theory points to the environmental damage caused through such operations and also considers the fact that a lowering of health and safety standers for LDC workers is triggering a 'race to the bottom', whereby nations must lower regulations and standards to remain competitive.

Dos Santos 1971 states that "Dependency is a historical condition which shapes a certain structure of the world economy such that it favors some countries to the detriment of others and limits the development possibilities of the subordinate economies". Whilst this statement is meant to argue that free trade is bad, this essay hopes to show that it should be treated more as a 'wake-up call' to the Neoclassical proponents of the Washington Consensus. Dependency Theory shows weaknesses in many conventional ideas, but isolation is not the solution either.

Larger markets offer increased scope for firms to take advantage of economies of scale, and the intensified competition from foreign firms encourages domestic firms to cut costs and improve their efficiency. In addition, a diffusion of technical knowledge and managerial knowhow results from the increasing activity and collaboration of and between large MNC's. As a result, free trade must not be denied, but must not be given free reign. Free trade needs to be managed - and so the Structuralists Augmented Washington Consensus is the best path for growth. As Dani Rodrik writes: “trade is a means to an end, not an end in itself”.

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