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Introduction

We live in a world characterized by enormous wealth and widespread poverty. The richest countries have an annual GDP per capita greater than $30,000, while the poorest countries have one less than $1,000. And even that appalling lower level is misleadingly high, because great inequality within countries means that the poor live on far less than the average. More than 1.2 billion people, one in every five people on this Earth, are forced to live on less than $1 a day. Except in China, the past decade of rapid globalization was associated with increased poverty and hunger. More than 13 million children died from diarrhoeal disease over this period. At present, over half a million women die each year in pregnancy and childbirth, one for each minute of the day. More than 800 million suffer from malnutrition (UNDP 2003, pp. 5-8, 40). Yet we have long had the means, on a world scale, to provide decent food, medical care, and shelter for the Earth's whole population.

What is the best way, for the world as a whole, to tackle such problems? The prevalent answer is surprising in its simplicity: through unrestricted global trade. This is essence of the doctrine called neoliberalism.

The theory and practice of neoliberalism

Neoliberalism dominates modern globalization. Its practice is justified by a set of theoretical claims rooted in standard economic theory. Markets are represented as optimal and self-regulating social structures. It is claimed that if markets are allowed to function without restraint, they would optimally serve all economic needs, efficiently utilize all economic resources, and automatically generate full employment for all persons who truly wish to work. By extension, the globalization of markets would be the best way to extend these benefits to the whole world. To quote Mike Moore, former Director General of the WTO, "the surest way to do more to help the [world's] poor is to continue to open markets" (cited in Agosin and Tussie, 1993 p. 9). This is the first axiom of neoliberalism.

From this point of view, the reason that we have poverty, unemployment, and periodic economic crises in the modern world is because markets have been constrained by labor unions, the state, and a host of social practices rooted in culture and history. This reading of history is meant to apply not only to conditions in the poor countries of the world, but also to those in the rich ones. It follows that successful globalization requires the creation of 'market friendly' social structures throughout the world. By curtailing union strength so that employers could hire and fire whom they choose; by privatizing state enterprises so that their workers would fall under the purview of domestic capital; and by opening up domestic markets to foreign capital and foreign goods. This is the second axiom of neoliberalism.

The theory and practice of neoliberalism has generated substantial opposition from activists, policy makers, and academics. Nonetheless, this conception still has enormous authority. It continues to be a major influence in the social sciences, in popular understanding, and most of all, in policy circles. As a practical matter, the powerful nations and institutions supporting this agenda have succeeded in greatly extending the rule of markets. And as an equally practical matter, enormous poverty and deep inequality continue to exist, and crises continue to erupt, all around the globe.

Free Trade Theory as the Economic Rationale for Neoliberalism

The rationale for neoliberalism rests on the orthodox theory of free trade, whose central claim is that competitive free trade will automatically benefit all nations. As Paul Krugman has noted, this is a "sacred tenet" of (standard) economic theory (Krugman 1987, p. 131). To appreciate its significance, consider the following dialogue. Critics point out that the world today is very far from the competitive conditions assumed in standard free trade theory. They remind us that although the rich countries now preach free trade, when they were themselves climbing the ladder of development they relied heavily on trade protectionism and state intervention. They point out that even now, rich countries often do not follow their own preaching (Agosin and Tussie, 1993, p. 25; Rodrik 2001, p. 11; Chang 2002; Stiglitz 2002).

The defenders of neoliberalism have a ready response to this charge. Truly competitive conditions did not hold in the past, they say, so the past is not a useful guide. However, with the help of international institutions, competition can be spread throughout the globe. And when it is, free trade will work as promised. It is therefore essential to eliminate restrictions on markets, particularly in the developing world (Bhagwati 2002, Lecture 1). This is the central conclusion of neoliberalism.

Posed this way, the debate centers on how closely, and at what social cost, actual markets can be made sufficiently competitive. To the critics of neoliberalism, markets will never work in the textbook manner because power rules the modern world: monopoly power, class power, state power, and the power of the center over the periphery (McCartney 2004). Attempting to force-fit a competitive model onto actual society would be unsuccessful, and would lead to widespread "collateral damage". To the defenders, the putative long-term benefits of the market justify the short-term transition costs. All the more so if the cost happens to be borne by others. In its extreme form, which used to be called "shock therapy" by its proponents, it is claimed that the best way to proceed would be through an all out assault on the offending institutions and practices.

What is striking about this debate is that both sides accept a fundamental premise of

neoliberalism. Namely, that given sufficiently competitive conditions, free trade *would* work as promised. In this chapter I argue that this claim is wrong, even on its own grounds. It is not the absence of competition that produces development alongside underdevelopment, wealth alongside poverty, employment alongside unemployment. *It is competition itself.*

Free trade between nations operates in much the same manner as competition within a nation: it favors the (competitively) strong over the weak. From this point of view, collateral damage from globalization is to be expected. This also tells us that the developed countries were quite right to recognize, when they were on the way up, that unrestricted international competition was a threat to their own plans for development. What they so strenuously deny now, they knew to be true then. Namely, that that the great power of the market is best utilized when it is harnessed to a broader social agenda.

The Logic of Standard Free Trade Theory

Textbook introductions to free trade theory begin with a deliberate misrepresentation. We are asked to treat two nations as *individuals* engaged in freely undertaken barter. Such individuals, we are told, would only give over something in return for something else if they each thought they were going to gain in the process. And if their expectations were correct, each would indeed gain. Hence free trade would benefit all those who engage in it. All the rest is detail.

But like any magic trick, this incorporates a central misdirection. In a capitalist world, it is *businesses* that engage in foreign trade. Domestic exporters sell to foreign importers who in turn sell to their residents, while domestic importers buy from foreign exporters and sell to us. At each step in the chain, it is profit that motivates the business decision. The theory of international trade is actually a subset of the theory of competition. In order to make standard free trade theory come out right, it is therefore necessary to show that international competition is always beneficial. This is the real thrust of standard free trade theory, and the real foundation of neoliberalism. If it is addressed at all, it is only in advanced textbooks. Doubts might creep in, otherwise.

Several things are necessary to make the story come out right. First, if trade between any two nations leads to imbalances between exports and imports, it is necessary that these provoke compensating relative price changes. Suppose a nation is running a trade deficit. This means that the value of the goods sold abroad by its exporters is less than the value of the goods sold domestically by its importers. For this imbalance to be automatically corrected, it is necessary that exports become cheaper to foreigners, who would then presumably buy more; and that imports become more expensive to domestic buyers, who would then presumably buy less. Second, these relative price changes must be effective in reducing the trade deficit. This means that they must raise the money value of exports

relative to that of imports. The opposite is perfectly possible. For instance, suppose that export prices fall by (say) 10 percent, and foreigners buy 5 percent more of these goods. Then the total money value of exports will have *fallen* rather than risen, because the decline in price was greater than the rise in quantity. Thus the standard theory also needs to assume that quantities sold are sufficiently responsive to prices. In the language of international trade theory, the first requirement is that a country's terms of trade (export prices relative to import prices, in common currency) automatically fall when it experiences a trade deficit, while the second requirement is that this fall be sufficient to eliminate the trade deficit. Taken together, these first two assumptions would ensure that trade deficits, and trade surpluses also, would be self-negating. Then, regardless of differences in levels of development, in resources, in labor costs, or in anything else, each nation will be able to hold its own in the world market. In other words, free trade would then ensure that each nation ends up being competitive in the world market (Arndt and Richardson 1987, p. 12).

While the preceding assumptions are necessary to make the story work, they are not sufficient. We also need to consider the implications for employment. Countries exposed to trade may lose jobs in some sectors and gain them in others. Some firms may prosper, while others may go out of existence. None of this excludes the possibility of overall job losses in the countries involved. So we need something more. Standard theory solves this problem by assuming that competitive markets automatically provide jobs for all who desire them. When this is carried over to trade theory, it ensures that the international adjustments will not lead to any overall job losses, for those who lose one job will always find another. This is the third pillar of the conventional theory of international trade.

To summarize. Standard trade theory relies on three claims. First, that any deficit in a nation's trade would provoke a fall in its export prices relative to its import prices, i.e. a fall in its terms of trade. Second, that such a fall would increase the money value of exports relative to that of imports, i.e. would improve the trade balance. This requires the relative physical ratio exports to imports to rise more than the fall in relative price of exports to imports, i.e. that the "elasticities" be propitious. And third, that once the dust has settled, that no nation would suffer overall job losses from international trade. These three propositions constitute *the neoclassical theory of comparative cost advantage*. Taken together, they imply that nations will always gain from being involved in international trade.

It is important to distinguish between the theory of comparative *cost* advantage and the theory of comparative *factor* advantage. The two are often confused, although they are conceptually distinct. The theory of comparative cost advantage implies that international trade between nations will settle at balance trade with no departure from full employment in both nations. Thus even if one of the nation had absolutely lower costs when trade opened, and was therefore able to run an initial trade *surplus*, the theory of comparative costs says that free trade would automatically erode this initial superiority. In this process, the industries with the *least* initial absolute advantage would be the first to lose out. But the tide of red ink would not stop rising until a sufficient number of industries had been eliminated

to make the initial trade surplus disappear. Thus the final survivors would be only those industries with the greatest initial relative -- i.e. "comparative" -- cost advantage. Obviously, the reverse would hold for the country whose initial absolute inferiority in trade led it to begin with a trade deficit. Here, the most favored would be the industries with the least initial comparative cost disadvantage.

Comparative factor advantage theory stands on the shoulders of the theory of comparative cost advantage, by seeking to explain which particular industries in a given country will have a comparative cost advantage. The basic answer is that it would be those industries whose production benefited the most from the cheap local input. And the locally cheap input would in turn be explained by the relative abundance of the corresponding "factor of production" (land, labor, capital). Thus if land was relatively abundant in some country, then according to factor advantage theory, land-intensive industries such as agriculture would be the most likely to have a comparative cost advantage in international trade.

Trouble in Paradise

We have seen that standard trade theory assumes that market forces automatically eliminate trade imbalances, while maintaining full employment throughout. Thus international trade provides access to cheaper, and/or more desirable, commodities without harming anyone. All would be best in the best of all possible worlds, if only nations followed the standard theoretical prescriptions.

The first problem with this story is that the empirical evidence does not support it at all. Trade imbalances have not been automatically eliminated, not even in the developed world, not in the past, not in the present, not under fixed exchange rates, not under flexible exchange rates (Harvey 1996). On the contrary, persistent imbalances are absolutely common. For instance, the United States has been running a trade deficit for almost thirty years, and Japan has been enjoying a trade surplus for almost forty. A similar problem arises for the claim that full employment is a natural consequence of competitive markets. In just in the last decade, even developed countries have suffered unemployment rates ranging from 3% to 25%. 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. A significant number of economists argue that capitalism produces no automatic tendency towards full employment, even in the advanced world. This has long been the foundation of Keynesian and Kaleckian analysis.

The second problem is that standard international trade theory requires one to perform a theoretical about-face in the treatment of competition. When economists discuss competition *within a nation*, they are clear that it rewards the strong over the weak. If two sets of firms are competing in the same market, those with lower costs will tend to beat out those with higher costs. The former will expand their reach, while the latter will contract. Economists

celebrate this outcome as a virtue of competition, since it winnows out weaker firms. The same reasoning applies to any two *regions* within a nation. A region with low cost producers will tend to be able to sell many of its products in the high cost region, without buying much from it. Thus the low cost region will enjoy a regional trade surplus, while the high cost region will suffer a regional trade deficit. Orthodox economists do not find this problematic, because they assume that those who lose jobs in the weaker region will find new jobs in the stronger one.

Yet when these same economists discuss competition *between nations*, i.e. international trade, they abandon their previous theory and substitute a different one. Whereas competition within a country is said to punish the weak and reward the strong, competition between countries is said to fortify the weak and enervate the strong. While this may be appealing as a biblical vision, it is somewhat lacking in descriptive value. Where, then, is the catch?

Real competition on an international scale

International trade theory stops being mysterious as soon as one recognizes that real international competition works in the same way as national competition: it favors the competitively strong over the competitively weak (Shaikh 1996, 1980; Milberg 1993, 1994).

Let us return for a moment to the case of competition between two regions of one country. We saw that all schools agree on the outcome in this instance: the region with low cost producers will tend to enjoy a regional trade surplus, while the high cost region will tend to suffer a regional trade deficit.

In the case of competition between two nations, all schools also agree that a similar outcome obtains *at first*, when international trade is opened up. The country with the initially lower costs of production will tend to enjoy a national trade surplus, and the other a trade deficit. Moreover, all sides agree that the country with the trade surplus will be a net recipient of international funds, since it will be selling more abroad than it is buying. The trade deficit country will in turn suffer an outflow of funds.

It is at this point that a critical divergence arises between standard trade theory and the theory of real competition. Standard trade theory says that in the country with a trade surplus, if the authorities maintained the exchange rate at a fixed level, the resulting inflow of funds would raise the country's general price level. This means that export prices would be raised also. Conversely, if the authorities allowed the exchange rate to respond to market pressures, standard theory says that the inflow of funds would raise the exchange rate,

which would make exports more expensive to foreigners. The opposite movement would take place in the trade deficit country. Thus the surplus country would find its export prices rising in foreign markets, and its import prices falling in domestic markets, due to automatic movements in the real exchange rate (the nominal exchange rate adjusted for the price level). In other words, the terms of trade of the surplus country would automatically rise, while that of the deficit country would automatically fall. This is the foundational premise of the theory of comparative costs.

Consider the following example. Japan opens international trade with a trade surplus, an average export price of 1000 yen per unit and an average import price of 2000 yen per unit (20$ per imported unit at an exchange rate of .01 $/yen). The initial terms of trade is therefore 1000/2000 = 1/2. According to standard theory, if the exchange rate were fixed, the Japanese trade surplus would cause inflation in Japan, and the U.S. trade deficit would cause deflation in the U.S. Thus Japanese export prices would rise to say to 1200 yen per unit, while U.S. export prices, which are Japanese import prices, would fall due to say to $16 per unit (1600 yen per unit at the fixed exchange rate). Alternately, if the exchange rate were flexible, it might rise to say .015 $/yen. This would not affect domestic prices of Japanese exports (1000 yen), but would raise the price of imports from the U.S. to 1333 yen ($20/.015). In either case, the Japanese terms of trade would have risen from 1/2, to 1200/1600 = 1000/1333 = 3/4. Japan's initial competitive advantage would have therefore been automatically eroded, as would the initial competitive *dis*advantage of the U.S.

It is a necessary implication of comparative cost theory that once nations engage in international trade, relative prices of commodities are *no longer* regulated by their relative costs of production. At the opening of trade, competition in each nation would have produced relative prices regulated by relative costs. Hence the terms of trade, which are merely international relative prices, would initially also be regulated by the relative costs of exports and imports. But comparative cost theory requires that the terms of trade subsequently move in such a way as to balance trade. It follows that they can no longer be regulated by relative costs. They cannot serve two masters (Shaikh 1980, 1996).

The theory of real competition comes to the very opposite conclusion. Competition forces prices, and hence terms of trade, to be regulated by relative real costs at all times. In a country that enjoys an initial trade surplus, the resulting inflow of funds would enhance the availability of credit, which would lower interest rates. Conversely, in the country with the initial trade deficit, the fund outflow would tighten the credit market, and raise interest rates. With interest rates lower in the surplus country and higher in the deficit country, profit-seeking capital would flow from the former to the latter. Thus the surplus country would become a net lender on the world market, and the deficit country a net borrower. Instead of eliminating the trade imbalances, this would end up offsetting them with capital flows. Trade imbalances would be *persistent*, and deficit countries in particular would become international debtors. This is an exceedingly familiar historical picture.

The theory of real competition therefore implies that international trade will favor those countries able to produce at the lowest real costs. Real costs are in turn dependent on three factors: real wages, the level of technological development, and the availability of natural resources. High real wages raise costs, but high levels of technology and easily available natural resources lower costs.

Rich countries have high levels of technology, often have abundant natural resources, but have high real wages. Poor countries generally have low levels of technology, sometimes have abundant natural resources, and have low real wages. International competition, i.e. free trade, would bring these two different constellations into collision. In each country, internationally competitive sectors would gain, while those at a disadvantage would suffer. Jobs would be created in expanding sectors, and lost in contracting ones.

Given the situation, the poor countries would tend to be forced into those sectors in which their low wages more than compensated for their less developed technologies, and those in which their natural resources, if any, gave them a sufficient cost advantage. Conversely, rich countries would tend to have an advantage in high technology sectors and in certain natural resources.

But this is not a viable international division of labor. First of all, nothing in real competition guarantees that trade will be balanced in any country. Indeed, it is entirely possible that individual countries might have very few sectors that would be competitive on the world market, and hence might have very limited exports. Countries with persistent trade deficits (exports less than imports) would be forced to run down their reserves and to depend on foreign borrowing (foreign capital inflows) to cover such deficits. Currency crises and economic crashes often result in such circumstances. Secondly, nothing guarantees that job gains would cancel out job losses. So it is entirely possible that some countries would be worse of than before, in terms of employment. Thirdly, even the low wage advantage of poor countries would be eroded unless their technologies advanced *more rapidly*, and/or their real wages advanced *less rapidly* than in the rich countries. The crucial variable in this dynamic is the differential in technological progress: if the rich countries are advancing at a faster pace, then the poor countries have to widen the real wage gap to even maintain what cost advantages they have. This would be the very antithesis of development. Yet there is nothing in free trade that would ensure that poor countries would develop at a sufficiently rapid technological pace. Finally, it is possible that cheap labor in poor countries could become a powerful attractant for foreign capital, whose advanced technologies would allow them to take full advantage of the low wages. They might move operations, so that workers in the rich countries might lose some jobs; or they might create new operations. But in either case, they would drive out local labor-intensive production and displace many workers. Foreign capitals would certainly profit in the process, but it does not follow that they would create more jobs than they destroy. This is certainly not their goal, at any rate.

Development as an end in itself

Neoliberalism claims that free trade is the best way to foster economic development. But its doctrine is premised on the faulty notion that international competition levels the mighty and raises up the weak. Real competition operates quite differently: it rewards the strong and punishes the weak. From this perspective, the neoliberal push for unfettered free trade can be viewed as a strategy that is most beneficial to the advanced firms of the rich countries.

This also explains why the Western countries themselves, and subsequently Japan, South Korea, and the Asian Tigers, resisted free trade theories and policies so strenuously when they were themselves moving up the ladder. Equally importantly, it allows us to make sense of the actual policies that they followed in their rise to success: using international access to markets, knowledge, and resources as part of a greater social agenda. The object should not be to level the playing field, but to bring up the levels of the disadvantaged players. In this regard, practicing neoliberalism on the poor of the world is a particularly cruel sport.

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