Lecture Delivered at the World Bank on June 25th 2008
(with Dr. Justin Lin, Senior VP for Economics, in the Chair)

THE CRITIQUES OF FREE TRADE: A REFUTATION

Introduction

It is a pleasure to be lecturing at the World Bank today. As it happens, the Bank has entered my life at several points. One of my most remarkable teachers was Paul Rosenstein-Rodan. He was among the earliest two economists of great distinction --- the other being Sir Alec Cairncross who joined the Economic Development Institute at its founding --- to have worked at the Bank. This was between his career in London and at MIT where he taught me. He developed my interest in development economics: he was the first to write about absorptive capacity in determining aid flows, and was the pioneer of the theory of balanced growth and the "big push".

I can say without exaggeration that, while he was a superb theorist, he also taught me, as did my English teachers in Cambridge, that Economics was a science with whose wise use we could rescue millions languishing in poverty. So, when I was offered the job of a Professorship in the Indian Statistical Institute and the chance to simultaneously work in the Indian Planning Commission on how to bring the bottom 30% of India's population up to a "minimum standard of living", I found this enormously attractive. In fact, I wound up writing then The Economics of Underdeveloped Countries (Weidenfeld & Nicolson, 1966) which was in several

languages and sold over 150,000 copies at the time[1], suggesting not that I was an unusually gifted economist but that developmental economics was at a premium as the newly liberated developing countries and their citizens were preoccupied with the overriding objective of accelerating growth and reducing poverty. I recall this particularly because the first Chapter was titled "Poverty and Income Distribution", and even had the picture of a malnourished child, decades ahead of the modern activists and "poverty economists" who like to believe that these are modern concerns that the earlier economists ignored. I sometimes say: familiarity breeds contempt but contempt does not breed familiarity.

Rosenstein-Rodan also was a role model to me in using elegance and wit in putting across complex economic ideas to the public at large. I will tell you the story of how Lionel Robbins brought him, along with Hayek and other Austrians and Hungarians, to London. He then took Rosie, as he was called by his friends, to the Political Economy Club run then by Bowley. You will recall in particular that Bowley is the latter half of Edgeworth-Bowley in their famous locus in the box diagram in all 101 courses when we teach general equilibrium in the 2x2 model. I recall how, when I was teaching it at MIT where Maurice Obstfeld, at that time a math senior, was a student in my 101 class, I waxed eloquent about how you could read off six different parameters in the model (the four factor allocations and the

[1] I must confess that I did not quite believe the information about the sales of this book as it seemed an astonishingly large number for its time. But then, decades later, I ran into Sir George Weidenfeld talking to a well-known Israeli economist, Avi Braverman, at Davos. I went up to them because I wished to say hullo to my Israeli friend who then introduced me to Sir George. Imagine my surprise when Sir George immediately said:" Oh, you are one of my six-figure authors; do you have a new book I can publish?" It must be said that sales figures are usually impossible to get and some publishers and their publicists today tend to inflate them as part of their "spin". Even claims like "a million copies sold" are bandied about, and believed by the unsuspecting public, when a book has not been on the New York Times bestseller list for even one week and besides has been badly reviewed in most places. PR today is something else again!

two outputs) in equilibrium. One of the engineering students reacted with contempt: "you mean to say that it took <u>two</u> guys to invent <u>that</u>"!

A paper would be read at the Political Economy Club, then Bowley would stoke the fire and lots were drawn to comment on the paper. Rosie had just written about the role of Time in Economics, an early analysis of the distinction between stocks and flows as I recall. So, when he read the paper (published later in <u>Economica</u>), he said he would illustrate the role of time with an example. "If I were offered a choice", he said, "between spending some time with Greta Garbo or Marlene Dietrich, my choice would depend on how much time I was given. If a weekend, I would choose Marlene Dietrich; if a lifetime, I would take Greta Garbo". Lionel Robbins (who did not have the advantage of being a member, like Keynes, of the *avant garde* Bloomsbury set), almost went through the roof at this Austrian behavior in Bowley's English presence. But Bowley came up to Rosie after the paper and said: "Professor Rodan, I have heard of this statistician Dietrich; but tell me who is this economist Garbo?" So, Robbins told Rosie: "You got away with it this time, but if you do this again, you go back to Vienna."

But I owe the Bank also my career in public writing in another way. I arrived as Adviser in 1987 for a year, just as Barber Conable had become the President, to my good friend Anne Krueger, then Vice-President in the position that my distinguished Chairman today, Dr. Justin Lin, occupies. By the strangest coincidence, Anne resigned almost a week after my arrival. So, I had no one left to advise, which pleased me immensely! And I wound up having a sabbatical at Bank expense. And I put that time to good use by writing my little book, <u>Protectionism</u>

(MIT Press) which was so successful and reached so many people that I have never turned back and indeed have written many other such books, including --- pardon me a lapse into self-indulgence --- a short one that was published just last week by Oxford in defense of multilateral trading system and against preferential trade agreements. I fancy that Rosie would have been delighted by the title: Termites in the Trading System: How Preferential Agreements Undermine Free Trade.

So, let me turn to the theme which my hosts have selected for me to lecture on this morning. My principal focus will be the critiques addressed to free trade in the developing countries, though I will survey the entire set of critiques briefly at the outset so that you get a clear idea of the landscape within which all of you have to operate if you accept at the end of my Lecture today the argument that freer trade is desirable for developing countries which, of course, constitute your constituency and clientele.

I must confess also to a sense of distress as the two distinguished players on the other side of freer trade for the developing countries are my friends, a current Columbia colleague (and former World Bank Chief economist) Joe Stiglitz and my former Columbia colleague Dani Rodrik (whom I encouraged, when he was unknown and fresh out of his Ph.D. at Princeton, in many ways such as publishing his early articles in the Journal of International Economics which I edited and in the American Economic Review where I was on the Editorial board).

I might add that Rodrik also runs a blog where he unfortunately writes, in a somewhat careless and cavalier manner customary on blogs, against globalizers and free traders, often with a dismissive attitude to serious refutations of anti-

globalization arguments. So, the young Research Associates at the Council on Foreign Relations on my floor have suggested that, just as Al Franken was put up against Rush Limbaugh, they would like me to start a counter-blog. They even suggested a cute name for it: Blogwati! But so far I have declined.

Instead, I have allowed my gifted RA, Seth Flaxman, to do a mischievous power point response today, with animation, to emphasize the advantage of freer trade and the gains from specialization. First, we have an animated cartoon that takes off from Rodrik's recent article featuring a monkey[2], and a jaguar that illustrates how comparative advantage is not nullified by random events that bring disaster. Then we have me and Rafael Nadal playing tennis, with a message in favour of comparative advantage again. Finally, we go back to the Garden of Eden and demonstrate how free trade by Adam and Eve would have saved them and gained us huge gains from trade. Just hang in there. (The animations can be found on my Columbia University home page under the title "Animations for World Bank Lecture June 25, 2008.")

Perhaps I should add, before I proceed to the critiques, that the World Bank itself has exhibited a tendency to indulge these critiques. Thus, I was startled to see in The Financial Times last year an account of the Report of the Angus Deaton Committee on Bank research, which said that the Committee had found that the Bank's support for freer trade was based on "ideology" rather than research. This was indeed startling. The Committee had been appointed under the auspices of the Chief Economist, Dr. Lin's predecessor, and did not have particular expertise on

[2] See his Blog entry, "Monkeys, trees and the product jungle" on July 28, 2007. You might dismiss this as economics for the Planet of the Apes; but it never pays to be too complacent.

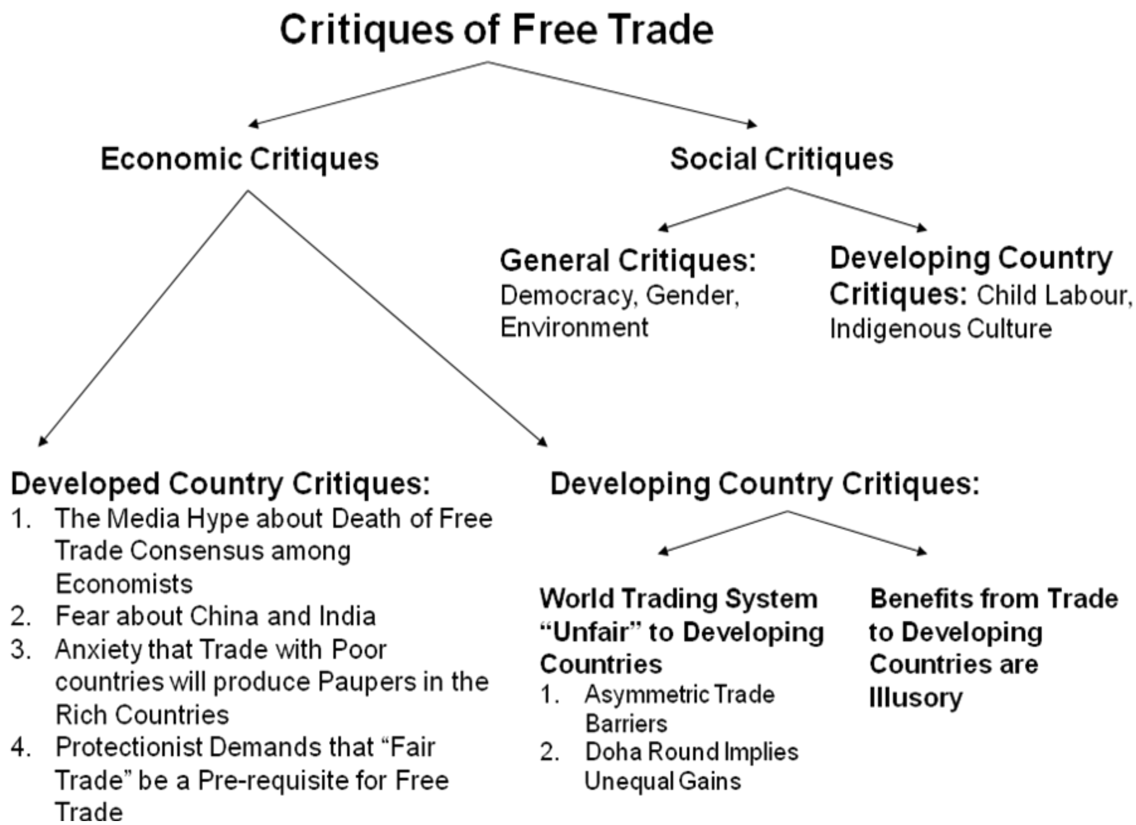
trade, nor had it consulted the premier trade-policy economists of the day to my knowledge. Now, Deaton is a very distinguished economist, known also in developmental circles mainly for his important work on measuring poverty in India. Abhijeet Banerjee is captivated by randomized trials and has argued (in The Boston Review) that "macroeconomic" issues such as trade are less important for policy than the microeconomic results of randomized trials to which he is devoted. Ken Rogoff, another among my most distinguished MIT students, is a world-class macroeconomist and probably did not focus on what was said about trade in the Report. The fourth member of the Committee was Nora Lustig, whose economic expertise is unfamiliar to me but whose knowledge of trade can only be negligible.

I do not mean to suggest that the Bank ought not to welcome and learn from thoughtful, dissident and critical evaluations. But I do suggest that, when these evaluations are singularly inapt, and undermine the Bank's understanding of good policy, they must be challenged at the highest levels strictly on professional grounds. If the Deaton Committee argued --- assuming that The Financial Times correctly quoted the Report --- that trade policy at the Bank was driven by ideological motivations, this should have been immediately challenged and the accusation refuted with logic and evidence. Indeed, the evidence that trade affects growth, and hence poverty, over the long run is fairly strong, and the literature on the subject is so considerable by now, that the Bank's economic leadership could have returned the compliment to the Committee, for being itself ideological. After all, as the great English poet Alexander Pope wrote, everything seems yellow to the jaundiced eye.

Of course, not all parts of the World Bank have gone along with what can only be described as skepticism about the benefits from trade, expressed in all kinds of direct and indirect ways which I will detail and refute below. Thus, the Independent Commission appointed by Mr. Leipziger at the World Bank under the Chairmanship of Michael Spence of Stanford is generally supportive of freer trade. I noticed that two recent Commissions , one by the ILO on Globalization, and the other on International Migration from the Swedish government in tandem with the UN, each had 19 members and produced rather disappointing reports. So, I have always thought that 19 is the unlucky number for International Commissions. Fortunately, Mr. Leipziger's extended group had 21 members; perhaps the extra two members --- most likely, Robert Solow and Michael Spence --- managed to break the "curse of 19" and made the Report more sensible on trade!

Putting the Critiques of Freer Trade for Developing Countries into Context

Before I turn to the critiques of freer trade for the developing countries, my principal task today, let me put them into context by giving you a quick *tour d'horizon* of the entire set of critiques of free trade (and often globalization as well) that are in the public domain today. [You may profitably look now at the Chart which sets out systematically the different critiques in a tree diagram.] Thus, at the head of the tree diagram, note that the current Critiques of Free Trade divide into Social and Economic.



I: <u>Social Critiques</u>

Let us start with the Social critiques. These can broadly be divided into General critiques addressed to issues such as Gender Equality, Democracy and the Environment; and those directed at the impact on developing countries: chiefly, Child Labour, Poverty and Indigenous Culture (i.e. the concern of President Evo Morales of Bolivia rather than of Monsieur Bove of France who worries instead about the impact of trade and globalization on mainstream French culture).

These social critiques surfaced melodramatically at the WTO meeting in Seattle in November 1999, with massive protests and even bomb threats. I recall being intercepted on the street by a large and menacing woman, as I was trying to get to the Convention Hall amid the protests. She said: no way; and her pugnacious

manner made it clear to me that the consequence of my trying to get past her would not be very pleasant for me. So, I turned to a policeman and asked him: I became an American citizen recently and believe that I have the right to go down the street if I want to. To which, the policeman replied: Yes, you do have the right. But if I were you, I would not try to exercise that right today. As I debated Ralph Nader in the Town Hall and interviewed many who were marching in the streets, I found that what agitated the agitators was, not whether freer trade increased the GNP but how freer trade affected the social, or what we might call the citizens', agenda. These social issues were their concern. My 2004 Oxford book, <u>In Defense of Globalization,</u> addressed precisely these issues.

It turned out that many civil society groups, the NGOs if you please, were of the view that, on these social dimensions, freer trade would set their agendas back instead of advancing them. In the language of Tony Blair and Gerhard Schroeder, even of Bill Clinton at times, this presumption meant that Globalization <u>Needed</u> a Human Face, i.e. it lacked one. In my book, I set myself the agenda of examining whether this presumption was correct. And I concluded, having read masses of NGO literature and examined the specific worries that they expressed, that the NGO presumption of adverse impact on social agendas was either mostly erroneous or at times badly exaggerated, that in fact Globalization <u>Had</u> a Human Face.

To take but one example, would trade accentuate unequal pay for women? Looking at pay equality on similar jobs, e.g. at the World Bank pay for Young Professionals, one could formulate a Becker-type hypothesis: that, in fiercely competitive industries, the differential against women would reduce faster because

paying more to men than to women with equal qualification and efficiency would cause a firm to be at a competitive disadvantage, thus leading to greater demand for women and reduced demand for men, bringing market pressure to reduce the differential based on prejudice against women. So, one would expect that the differential would go out faster in traded industries, which are likely to have more fierce competition than non-traded industries: as seems to have been the case (discussed in my Globalization book) in US experience according two brilliant economists Sandra Black and Elizabeth Brainerd.[3]

I must say that the social critiques have generally gone out of fashion, compared to the heady days after 1999. In fact, even the Bank-Fund Annual meetings in Washington D.C. do not attract the milling and militantly anti-globalization crowds any more. Last year, when Paul Wolfowitz was President of the World Bank, there were smaller crowds but even then they seemed to be anti-war rather than anti-globalization. There are several reasons why these crowds have thinned out and the militancy seems behind us. But, if I were flamboyantly self-indulgent like my distinguished Columbia colleague Jeffrey Sachs, I would claim

[3] I might add that Stiglitz's Globalization and Its Discontents book came out a couple of years earlier than mine and had literally nothing on the social issues that were animating the anti-globalization movement. It was instead largely about his own discontent with having been dismissed by James Wolfenson, President of the World Bank, and his sense that it was at the insistence of Larry Summers, acting in concert with Stanley Fischer because he had been openly critical of the IMF and the US Treasury policies over the Asian financial crisis. While his book received critical reviews almost everywhere, it has still been embraced by the populist groups that want a prominent economist, however flawed his analysis, to cite on their side. Besides, there is nothing more attractive to these audiences than to have an "insider" reveal the "real truth" about globalization, development, trade et.al. This also accounts for the strange fact that a book, Confessions of an Economic Hit Man (2004), by a commonplace consultant John Perkins on how he acted as a "hit man" against developing countries for US agencies, enticing them for the US into dependence and subsequent exploitation, and implying that this was the *modus operandi* of US assistance abroad rather than his strictly limited experience, even made it to several bestseller lists for many weeks.

that this is the result of my Globalization book which undermined their fears and cooled their passions!

II: Economic Critiques

Turning now to the Economic critiques, I divide them into those that relate to freer trade for the developed countries and those that are designed to qualify and undermine the case for freer trade for the developing countries. The specific arguments, and the persona that figure as the critics, are generally different between these two groups. But birds of the same feather will often flock together, and the knee-jerk anti-trade journalists (such as Lou Uchitelle of the New York Times whose mission in life seems to be to write fawning profiles of these critics while betraying little comprehension of the economics at issue) often conflate the two, and it is best therefore to be familiar with both sets of critics and critiques.

A. Developed Countries:

The developed-country critiques may be divided in turn into four classes. First, there is huge media hype about the death of the "free trade consensus" among economists. Second, there is a gnawing feeling that the rise of India and China, and trade with them, spells the end of US prosperity. Third, there is substantial anxiety that trade with the poor countries -- and India and China kick in here also --- will produce paupers in the rich countries. Fourth, given this anxiety about the impoverishment of our workers, there is now a demand on the part of the labour unions, and growing parts of the public and the politicians, that free trade is not desirable unless we also have "fair trade" in the shape of imposition of labour and

domestic-environmental standards "comparable to ours" in trade treaties and institutions. Take each contention and worry, in turn.

1. <u>The Media Hype about the Death of Free Trade Consensus among Economists</u>:

The US media has repeatedly announced the death of consensus on Free Trade among economists--- the polls of public opinion are another matter, though even they, as Karlyn Bowman (whose writings on poll results of all kinds are the most perceptive today) has recently pointed out, are often sending confusing signals and by no means have shifted unambiguously in favour of those who decry free trade and globalization.

I have written a fairly comprehensive essay titled "Do not Cry for Free Trade", as part of a debate with Alan Blinder at Harvard last year, which shows how the U.S. media have been playing the game of announcing the death of the Free Trade consensus among economists since the time when Paul Krugman, my remarkable MIT student, developed the theory of scale economies in international trade to include the case where these economies lead to collapse of perfect competition (thus meeting frontally the "Sraffa problem" that conventional theory had to get around by assuming that the economies were internal to the industry but external to the firm so that perfect competition could be preserved). Numerous media reports at the time argued that the case for Free Trade was now dead; but that proved to be a false alarm as Krugman himself retreated into being a proponent of Free Trade.[4]

[4] For details, see "Do Not Cry for Free Trade", <u>op.cit</u>. I have also discussed earlier how nearly every generation since <u>The Wealth of Nations</u> has seen a prominent economist depart from Free Trade because market failure --- usually relevant to the time --- implies that Adam Smith's Invisible Hand may be pointing in the wrong direction. The postwar theory of commercial policy, on the other hand,

This was followed by the alleged death of Free Trade consensus when my teacher, Paul Samuelson, arguably the greatest economist of the 20th century along with Keynes, was cited as having become indulgent towards protectionism. Countless numbers of trade theorists have pointed out that this is not what he said or implied; but the media and the economists with the labour unions and allied think tanks would not let go. Indeed, Senator Hillary Clinton, in a celebrated interview with Edward Luce in The Financial Times, notably cited Paul Samuelson in defense of her reservations about Free Trade, betraying the sad reality that her comprehension of trade issues does not go beyond the invocation of the names of famous economists. [I might add that she also called here for a "pause" on Doha and other trade deals, a position supported by only one academic economist: yes, you guessed it right, it was Dani Rodrik on his Blog (according to media reports).]

What Samuelson was essentially saying was that, if external changes (such as the growth of India and China) were to create a terms-of-trade loss for the US, that would harm the US: her gains from trade would diminish. He seemed to think that the proponents of Free Trade, and of Globalization, were claiming otherwise. But if they were, that could hardly have been because they did not recognize the adverse-outcome possibility; it was surely because they did not believe, on the basis of scholarly argumentation, that this outcome was probable. Regardless, it is clear that a protectionist response to the materialization of the adverse possibility would have

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successfully rescued Free Trade from this crippling problem by simply pointing out that, if the market failure was domestic and fixed through an appropriate policy --- e.g. the environmental market failure was fixed by an environmental policy --- then the policy of Free Trade would be restored. On all this, see my Bernhard Harms Prize acceptance speech in Weltwirtschafliches Archiv, reprinted as Chapter 1 in my essays edited by Douglas Irwin, Political Economy and International Economics, MIT Press, 1991. Also see Chapter 1 of my later Free Trade Today, Harry Johnson Lecture, Princeton University Press, 2002.

been to make matters worse, not better. Thus, if Miami were to be devastated by a hurricane over which its Governor has no control --- I doubt if he believes in weather gods who can be propitiated ---, it would be dumb on his part to respond by closing off Florida's trade with the rest of the US: that would only make the anguish greater.[5] The media frenzy over Samuelson's "heresy" has died now (except for its attempted revival by politicians such as Hillary Clinton or by labour lobbyists): the consensus on Free Trade among economists has not been dented.

Recently, there has been frenzy again over Alan Blinder's 2006 <u>Foreign Affairs</u> article where he seemed to be arguing that the expansion of service transactions in international trade made outsourcing a major threat to US welfare and that, by implication, the case for Free Trade was in doubt. In response to criticisms directed at him, however, he has now retreated into arguing that, because more activities (chiefly services) are now tradable, we need to expand adjustment assistance. Well, Alan, come and board the bus: we trade economists starting with work in the late 1970s[6], and indeed policymakers starting with President Kennedy's 1962 Adjustment Assistance legislation because of the ongoing Kennedy Round at the GATT, have been on the bus for over a quarter of a century.

2. <u>Fears about India and China:</u>

[5] If the terms of trade are variable in response to US volume of trade, then there is a case for an optimal tariff before and after the hurricane. And one can even investigate the conditions under which the post-hurricane tariff may be higher than the pre-hurricane tariff. But this sophisticated qualification to the contention above is hardly one that Samuelson would contemplate for policy: I have never heard him, either as a teacher or as a colleague over 12 years at MIT, propose that the US adopt an optimal tariff policy because of "monopoly power in trade".

[6] E.g. the substantial book on the subject that I edited for the NBER, <u>Import Competition and Response,</u> Chicago University Press, 1982, with important contributions by Michael Mussa, Peter Neary, Robert Feenstra, Paul Krugman and many others.

The fear that the rise of India and China, two huge countries with an abundance of cheaper labour, will lethally undermine US competitiveness has also fueled protectionism. Two different confusions are in play here.

First, it is strange that many in the US feel that US industries cannot compete with those having to pay lower wages in India and China. Ironically, when I was young, many in the poor countries felt that they could not compete with industries in the rich countries because the rich countries had infrastructure, a better-fed workforce, human capital, financial capital and all the attributes of development. As Paul Krugman correctly argued, in an influential article in Foreign Affairs, titled "Competitiveness: a Dangerous Obsession", the notion of "competitiveness" at the national level has to be carefully handled. As long as two economies are not fully identical, there will always be comparative advantage in some activities and disadvantage in others, at any point of time.[7] You cannot lose competitiveness in everything.[8] Also, remember that if wages are raised, they can be offset by exchange rate change, restoring lost "competitiveness" for a country.

Second, econometric studies of multinationals show that labour abundance or wage rate differentials contribute little to their locational decision. Other factors such as availability of raw materials, infrastructure, tax advantage, political stability etc. are more important, if we do not consider only labour-intensive industries.

[7] Under scale economies, trade can still take place even if the economies are identical in terms of know-how and endowments. This is also true if the economies are not identical on the demand side.

[8] There are, of course, indexes of competitiveness such as the one at the World Economic Forum, started by Jeffrey Sachs and now being run by Xavier Sala-i-Martin, also my colleague now at Columbia. But this controversial index seeks to rank-order countries according to their policies conducive to growth. However, it is a misnomer to call it an index of competitiveness in any of the conventional meanings of competitiveness.

Third, the very size of India and China creates the illusion that, instead of gains from trade, we face the prospect of immiseration when we trade with these countries. I recall, from the time I spent three months at the Turkish State Planning Commission (*Devlet Planlama Teskilati*) in 1962, being told that Mustafa Kemal Ataturk had discouraged the publication of maps of Turkey which showed the gigantic Soviet Union across the Black Sea, as its sheer size would frighten the Turks.

Thus, those who argue that outsourcing will take call-answer services entirely to countries like India are extrapolating from a few such shifts and the fact that India has a huge population of young people. But once you examine this prospect carefully, it seems to be fanciful. Only about 12% of the population in the age cohort that could go to College are doing so in India today. Of this, only a small fraction study in English. Of this again, a still further small fraction can speak English. Then, a still small fraction of this can speak English in a way which you and I can understand. [This last point reminds me that, when I left for Cambridge to study Economics in 1954, I could speak good English. But my accent was a mix of Spanish (since I had been to St.Xavier's High School, a school run by Jesuits from Spain) and American (from the movies) accents so that, when I arrived in Cambridge, I found that no one could understand me. After two years, , when I arrived at MIT (the other Cambridge), I had a fine BBC accent; but then, it was a waste since in America, as you know, everyone has a different accent and I would have been perfectly at home with my Jesuit-Hollywood hybrid.] So, when you have

multiplied all these fractions together, you see that the "huge" pool of Indian call-answer service suppliers shrinks to very modest proportions.

Then again, take China. It is commonplace nowadays to say that they are producing more engineers than the US does. But what about their quality? Besides, even most of these low-quality engineers will have to be deployed in building bridges and repairing them, maintaining and expanding roads, and countless other domestic activities, leaving far fewer for employment in tradable activities. Also, remember that China destroyed her bourgeoisie, including engineers, during the Cultural Revolution: these "normal" stocks will also have to be rebuilt. Yet, the "yellow peril" posed by Chinese engineers is the staple of discourse in the US Congress and in some of the media.[9]

Besides, I also have noted recently, if China and India develop high skills, that will not necessarily mean diminished gains from trade. Rather, as happened with the resurrection of postwar Japan and Europe, similar countries wind up trading in similar products. Yet another of my distinguished students, Robert Feenstra (who heads the NBER Program on International Trade), and independently my colleague David Weinstein have in fact calculated the gains from trade in similar products (or "variety"), and they are truly dramatic. The traditional theory of the gains from trade tends to neglect this aspect and therefore has a bias towards producing pessimistic conclusions as our trading partners become "more like us" with capital accumulation and diffusion of know-how to them.

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[9] I have advanced other arguments against regarding China with dread in my testimony to the Senate Finance Committee on March 27th 2007. titled "US Trade Policy: The China Question".

3. Anxiety that Trade with Poor Countries will Produce Paupers in the Rich Countries:

The fear that trade with poor countries will immiserize the workers in the rich countries goes well beyond the fear of India and China. In fact, it is a general worry about trade with all poor countries and keeps recurring in the battles in the Congress over Free Trade Agreements with countries as diverse as Mexico, Chile, Jordan, and the Central American nations. Yet, I must stress that the evidence in support of such fears is negligible; and one can even produce empirical arguments, as I have, that the effect of trade on wages has instead been to moderate, not accentuate, the pressure on wages that would have followed from acute labour-saving technical change.

The issue has been written about, not least by me, for nearly 15 years now. I turned to it systematically in 1994, in a volume that I edited with Marvin Kosters, titled Trade and Wages: Leveling Wages Down? (American Enterprise Institute: Washington DC). I should say that most analysts, in one way or another, have found little impact of trade on wages (except for a few labour economists such as Borjas, Freeman and Katz whose analysis however is flawed, as I argue immediately below, in regard to the question that must be analyzed).

I must stress that, even as the conclusion that "trade has no significant impact on wages" is agreeable, we have to be extremely careful as to what precise question the analyst is in effect asking. Thus, as Alan Deardorff noted in his

important joint paper in the Bhagwati-Kosters volume, one can ask several different questions.

One could be: if the US had been hypothetically under autarky between two periods, would the change in real wages have been less or more than the observed one under trade? I am not particularly intrigued by the answer to this question; but some observers may well have it in mind, in some vague fashion.

Or one could just take the more intuitive policy question which is my preferred way of posing the problem: how would US real wages behave if the world prices of her tradables[10] were to change as a result of external changes such as foreign capital accumulation and technical change and foreign trade liberalization? Thus, if the US is importing labour-intensive goods, and these external, exogenous changes would reduce the world relative prices of importables, the Stolper-Samuelson theorem would imply that the real wage of labour would fall (subject to well-known qualifications). If, however, these relative prices were to rise, then we would have the real wage of US labour rising instead.

To me, this second is the relevant question; and my own 1997 paper, "Play It Again Sam: Yet Another Look at Trade and Wages", suggests theoretically and empirically that the Stolper-Samuelson effect actually worked in the wrong direction from what the fears of the labour unions and their sympathizers presumed: the world relative prices of labour-intensive tradables, for reasons such as rapid foreign capital accumulation and technical change which I analyze using

[10] I am assuming that the foreign offer curve of the US is not changing simultaneously. If it is, then the effects of growth and trade policy change in the US would also have to be factored in unless we assume that the US trades more or less at world prices that it cannot change.

general equilibrium theory from the 1950s[11], appeared to have risen, not fallen, during the years that the real wages were falling. On this line of analysis, "the effect of trade on wages" has been benign, not malign. Since domestic labour-saving technical change has been acute, it would have put pressure on real wages of workers, an outcome which trade then moderated, (maybe even mildly reversed) not accentuated.

On the other hand, some serious analysts have used the so-called "factor-content" approach (whose analytics goes back to an ingenious 1988 Journal of International Economics paper of Alan Deardorff and Robert Staiger but which was used intuitively in 1991 by George Borjas, Larry Katz and Richard Freeman in a paper published later in Borjas and Freeman (ed.) Immigration and the Workforce, NBER and Chicago University Press: 1992) to measure the impact of trade on wages in the US. Under this approach, the factors embodied in trade are added to the factor endowment to infer how trade affects wage inequality compared to autarky, and then to make inferences in turn as to what changes in factor imply for "trade-caused" changes in income inequality between two periods. But these calculations are problematic and do not seem to answer any question of interest.

Note first that these factor-content calculations consider changes in inequality (the so-called wage premium for the skilled vis-à-vis the unskilled or what is sometimes also called "wage inequality"). Our interest however is in the effect on absolute real wages, not on wage inequality. [12] Inequality can increase between

[11] These general-equilbrium analyses come from the 1950s and 1960s, most notably in the writings of Hicks, Johnson, Rybczynski, and Findlay and Grubert.

[12] Within the 2x2 analytical model typically used by the factor-content theorists, increased wage inequality will imply reduced real wages of the unskilled as well unless complete specialization occurs. Complete specialization is not empirically implausible, as I discuss below.

skilled and unskilled workers; but that is consistent with unskilled workers improving their wages while the skilled ones improve even more. In fact, in a celebrated 1999 Quarterly Journal of Economics paper by Robert Feenstra and Gordon Hanson on the wage effects of outsourcing to Mexico, these authors found inequality increasing; but when I requested Feenstra to get me the effects on absolute real wages, it turned out that these too had increased.

Second, as Arvind Panagariya noted in a thorough analysis of this approach, "Evaluating the Factor-content Approach to Measuring the Effect of Trade on Wage Inequality" in the Journal of International Economics in February 1988, the two-period comparison gives an answer to a very different and frankly speaking policy-wise uninteresting question than the one (the second question I distinguished above) that I believe most people are interested in when they ask about the "effect of trade on wages".

Thus, suppose that we are looking at the impact of trade on wage inequality between 1990 and 1995. Allow tastes, technology, endowments and trade policies to change in the US and abroad between the two years. Then, the factor-content analysts decomposes the total change in observed wage inequality into two component effects: (i) the change that would occur if we were to freeze the trade vector to that in 1990; and (ii) the additional change that would occur when the trade vector is changed to the observed one in 1995. It is difficult to see what policy meaning can be attached to this decomposition although Borjas, Katz and Freeman, and some others, have deployed it in the trade-and-wages literature.

Recently, Paul Krugman, whose earlier work over a decade ago had also relied upon the factor-content approach to argue that trade with poor countries was not a significant factor in explaining skilled-to-unskilled wage inequality[13], has returned to the scene and argued in one of his <u>New York Times</u> columns that the expansion of trade with developing countries "may" have changed the situation into a more pessimistic one. But "may" have changed, it must be noted, failed to translate into "has changed" in his recent 2008 Brookings Institution paper whereas recent empirical analysis, by Robert Lawrence (using a different approach, similar to mine) has shown otherwise.[14]

In short, we still lack any plausible evidence that the effect of trade with the poor countries, in the sense that shifts in trade possibilities arising from several changes in the world economy, has been to depress US unskilled wages. The enormous anxiety over such an adverse effect is therefore unjustified; and unsupported statements of its plausibility regardless of robust evidence are also unfortunate as they fuel protectionism against the poor countries whose use of trade as one of the important ways out of poverty is thereby jeopardized.

4. <u>Protectionist Demands that "Fair Trade'" (e.g. Enhanced Labour and Domestic-Environmental Standards) be a Pre-requisite for Free Trade</u>

[13] Panagariya also shows that to go from the factor content calculations to the inequality inferences requires heroic assumptions that flatly contradict what we know from econometric evidence. Thus, we have two negatives: an irrelevant question and an inference about inequality (and hence about real wages under non-specialization) that requires unacceptable assumptions.

[14] See Robert Lawrence's critical Comments on Paul Krugman's Brookings paper, and his own important pamphlet <u>The globalization paradox: more trade-less inequality</u> (published by the Peterson Institute for International Economics, 2008) that essentially looks into the Stolper-Samuelson type argument that I invoke in the text. His conclusion, like mine earlier in 1997, is also sanguine but for different reasons: that complete specialization away from several labour-intensive goods improves real wages of workers simply as consumers (a point that has been empirically explored also by Peter Schott of Yale); and that some of the imports are actually capital-intensive (implying factor-intensity reversals which, in fact, the econometric literature of the 1960s strongly underlined when explaining the reasons for the Leontief Paradox was the rage of the day).

In fact, such protectionism is manifest in the demands by labour unions and some environmental lobbies that free trade requires that the developing countries with which we trade must also have our standards regarding labour and domestic (as distinct from global) pollution. Ever since I and Professor Hudec, a doyen of trade jurists, did a major research project on whether "fair trade" and harmonization were prerequisites for Free Trade, with two massive volumes edited by us with MIT Press in 1996, the matter has been analyzed in countless writings by me and by others[15], showing that, neither on altruistic grounds (i.e. that we want to spread higher standards abroad to the poor countries even if we do not trade with them: e.g. we may not want Green Men on Mars to put little Green children to work simply out of interplanetary empathy even though we have no economic interaction with Mars) nor on self-interest grounds (i.e. that it would be "unfair" if we had to compete with firms in countries with lower standards than ours) , having labour and domestic-environmental provisions in trade treaties makes economic and political sense.

There is in fact a massive literature by now, much of it discussed in my Globalization book and in several essays that have been reproduced in collections of my writings with MIT Press, that shows that these demands, masquerading as altruism, are in fact prompted largely by self-interest-driven fears of competition and its feared, though unjustified (as I argued earlier here), impact on the real wages of US workers.

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[15] **See, for instance, Chapters 22-24 in my 1998 collection, <u>A Stream of Windows</u>, and Chapters 7-9, 13-15 and 20 in the 1992 collection, <u>The Wind of the Hundred Days</u>, to mention just a few of the analyses that the simple-minded pronouncements by Rodrik does not come to terms with. In this context, the evolution of WTO jurisprudence on the matter is also of interest; see the paper by me and Professor Petros Mavroidis on the French Proposal to tax imports from the US because it had not signed the Kyoto Proposal, in the <u>World Trade Review</u>, 2008.**

Again, the only notable trade scholar who has yielded to these demands, without seriously confronting the numerous scholarly analyses, is Dani Rodrik. His argument is that, since trade is a technique of transformation of your exports into imports (so that, as is well-known to every trade student, we teach the theory of free trade as being optimal for a perfectly competitive economy with no monopoly power in trade because free trade brings the "foreign" transformation rate into equality with the transformation rate in domestic production) , there should be no reason to object to extending your restrictions on how these importables are produced at home to how they are produced abroad. But I am afraid that this argument borders on illiteracy.[16]

For instance, the same argument can be extended by others to US exports, resulting in intransitivities and trade chaos. It also is tantamount to giving license to asymmetric browbeating of the poor countries by the rich ones, since only the latter can implement such demands in reality, a point that prominent third-world NGOs (like the highly reputed Center for Science and the Environment in India) have made in rejecting the Rodrik type of assertion, and which was also mentioned in the 1991 GATT discussion of the Tuna-Dolphin case.[17] In fact, the desire to extend to others our own production-process restrictions, which I have often encountered in debates and dialogues with labour union and environmental activists, should be only

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[16] See his discussion of the issue in his pamphlet, Has Globalization Gone Too Far?, Institute for International Economics, 1997. I have also heard him ask for anti-"social"-dumping provisions to enforce the virtually unilateral extension of US or "core" ILO labour standards to foreign countries with lower standards. But there is nothing sacrosanct about US labour standards which are notoriously inadequate in practice (see the Human Rights Watch report on how the US undermines the key right to unionize), nor has the US ratified five a majority of the eight core ILO conventions.

[17] Since Rodrik is sometimes regarded as a champion of developing-country interests, it is strange that his embrace of the rich-country labour-unions' and some NGOs' lobbying position on this issue flies in the face of developing countries' legitimate concerns and objections.

the starting point for analysis, not the end point. Much of our ink has been spilled precisely on addressing and resolving the complex issues raised by such desires.

B. Developing Countries

So, let me turn now to the specific arguments which are aimed at undermining, in one way or another, the support for freer trade in the developing countries. Let me distinguish here among two types of critiques, several of which are based on either half-truths or whole-falsehoods (even if unwitting).

One critique states that the world trading system is "unfair" to the developing countries. Such an assertion undermines the confidence of the developing countries in free trade and therefore may be regarded as an insidious critique that attacks free trade for developing countries from the flank. There are two ways in which this claim of unfairness is advanced: first, that the way the world trading system is set up, it is stacked asymmetrically against them; and second, that the Doha Round of multilateral trade negotiations is also asymmetrically stacked in favour of the developed, rather than the developing, countries.[18]

Yet another critique is more direct, claiming that the benefits from free trade to the developing countries are either exaggerated or do not exist. These critiques are in error and must be confronted since they are invidious and undermine the confidence with which policymakers in the developing countries will move towards freer trade.

[18] While I reject such a claim for the multilateral trading system, I have long argued that Preferential Trade Agreements (i.e. FTAs in the main) between a hegemonic power like the US and weaker developing countries such as Peru or Costa Rica typically involve extraction of trade-unrelated benefits for the hegemon that typically outweigh the advantages to these weaker nations. See my latest book, Termites in the Trading System: How Preferential Trade Agreements Undermine Free Trade, Oxford University Press: New York, 2008.

1.__**The World Trading System is "Unfair" to the Developing Countries**__

Take the two different arguments advanced in support of this charge, in turn.

__**(i):Asymmetric Protection**__**:** __**Trade Barriers are higher in the Developed than in the Developing Countries**__

Let me first refer you to an article by me and Arvind Panagariya in the __**OECD Observer**__ **(May 2002), titled "Wanted: Jubilee 2010". It refutes four main fallacies that are widely prevalent: (1) Rich-country protection is higher than poor-country protection (which I consider below); (2) Trade barriers against poor countries reflect hypocrisy on the part of rich countries (also addressed below); (3) It is wrong to ask the poor countries to lift their trade barriers when there are trade barriers in the rich countries; and (4) Exports from the poor countries fail to grow because of protection in the rich countries.**

The fallacy that I wish to emphasize today is the first one: that the tariffs in the developed countries exceed those in the developing countries. This is simply not true for manufactures (which was the traditional province of the GATT after the agriculture waiver in 1955 and before services started entering trade dramatically). It is still true that, on average, poor countries have more protection than rich ones, as documented by Michael Finger and Ludger Schuknecht (see the Chart reproduced in the Bhagwati-Panagariya __**OECD Observer**__ **article).**

True, the peaks in tariffs in developed countries are concentrated against the exports of poor countries, and applied with potency to basic products like textiles and clothing, footwear and fisheries. But as UNCTAD estimates show, even the peak tariffs in the developed countries apply only to about a third of the developing country exports. Besides, as Finger and Schuknecht show, much of the protection

against developing country exports is concentrated in developing countries themselves. And, when NTBs like anti-dumping actions are considered, the bigger developing countries like India have been rapidly making up for their neglect of this tool of protectionism.

The reason why the protection in the developing countries is greater than in the developed countries, on the average, comes as no surprise to those who have followed the GATT over the several decades of its existence since 1947. They would doubtless know that Part IV and Special & Differential Treatment have long exempted the developing countries from having to make reciprocal concessions. That being the case, the developing countries could not use politically the need to make reciprocal concessions to contain domestic protectionism. [19]

Equally, if they did not make any trade concessions and were automatically granted (via MFN) the benefit of concessions being made by the developed countries, it was inevitable (as also noted by Michael Finger) that the developed countries would effectively avoid free riding by the developing countries by concentrating on liberalizing import duties on products of interest to themselves rather than to the developing countries. As I have remarked often, if you want a free supper, do not expect to eat at a banquet. So, we got the phenomenon that the tariffs on the exports of the developing countries tended to remain high while the tariffs on items of export interest to the developed countries fell over time with successive trade Rounds. The observation that the tariffs on exports of the developing countries tend to be generally higher than on exports of the developed countries is

[19] **On the "uses of reciprocity" to reduce domestic protection, see the Introduction in Bhagwati (ed.), Going Alone, MIT Press: 2004 and the excellent recent writings on the subject by Kyle Bagwell and Robert Staiger.**

therefore not a result of "double standards" or "hypocrisy" but a simple consequence of Part IV and S&D, and the failure to understand the incentives it set up for the observed outcome.

A word may be added on agricultural protection. It is true that the agricultural subsidies are higher in the developed countries: this reflects budget constraints, of course. In fact, even the developing countries directly subsidize agricultural inputs such as electricity and irrigation water but the degree of subsidization is limited by financial constraints.[20] But what accounts for agriculture being protected in the developed countries relative to agriculture in the developing countries in the postwar period? And why was this tolerated and agriculture in fact withdrawn from GATT's jurisdiction by the 1955 waiver at the instance of the United States? Was all this a product of "hypocrisy" and "double standards"?

No. The fact is that the developed countries, wanted more agriculture, and the developing countries wanted less, than free trade would have led to. The former group had powerful farm lobbies that wanted "agriculturalization"; the latter had powerful policymakers who wanted "industrialization". The result was a Faustian bargain that meant that agriculture was protected in the rich countries and "de-protected" in the poor countries.

Today, the political economy has changed in several poor countries: certainly in the Cairns Group of agriculture-exporting nations like Argentina, Brazil, Mexico,

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[20] Usually, these subsidies are classified under non-agricultural categories such as electricity generation and distribution. Often, they are implicit: the public sector that produces and sells electricity will, for instance, be subject to soft budget constraints and the state budget will make up for the overall losses instead of subsidizing electricity distribution per se. Good numbers on agricultural input subsidies are therefore hard to find. Moreover, Anne Krueger's empirical work suggests that, when the relative resource allocation effect of protection in different sectors is taken into account, there has been for long a net disincentive for agriculture in many poor countries, in keeping with the pro-industrialization preferences of the policymakers that I mention in the text.

Thailand and the Philippines. They seek agricultural liberalization and are frustrated by what they observe[21]; but charges of double standards and hypocrisy, while they may serve the purpose of propaganda in the war on agricultural protection in the rich countries, are not based on a proper understanding of how the situation arose and evolved.

I should also add that the public discourse on agricultural subsidies has been distorted by the World Bank leadership failing to distinguish between distorting and non-distorting subsidies and wrongly adding the two to come out with assertions such as that the agricultural subsidies in the West amount to $1 billion a day: a figure which is both incorrect (since it goes beyond subsidies into other forms of support and protection) and in any event absurd in the trade context because it is only the distorting subsidies that matter in trade. In fact, the Fischler-Lamy reforms in EU's CAP program was precisely to shift a significant amount of support from distorting to the non-distorting category.

I will not bore you with the many statements by World Bank President James Wolfenson, and by Stiglitz (who was his Chief economist), where this figure was bandied about and led to the perception that the subsidies were a much bigger issue than they were in the trade context. In addition, these gentlemen, and some NGOs like Oxfam that repeated these assertions, often thought they were very clever when they divided the (trade-wise wrong) figure of subsidies by the number

[21] **In fact, as President Ms. Kirschner of Argentina learnt the hard way, the political economy has shifted the balance of forces in Argentina to such an extent that she could not even tax some of the extraordinary earnings from agricultural exports, in the current food crisis, to help subsidize the consumption of food by the urban poor. For a Peronist, this is a hard lesson indeed in the new"political economy since Argentine agriculture was undermined by the Peronist preference for industrialization in the old days.**

of cows and then compared them to the gross aid flows to the poor countries. This was a double offense to good economics.

First, dividing subsidies by cows (when the subsidies are not given pro rata to the number of cows on the farm) makes as little sense as dividing the World Bank's research output by the number of hamburgers eaten in the World Bank cafeteria. This bovine procedure is in fact asinine. Lest you think I am inventing a caricature, let me just quote one statement by Stiglitz in The Guardian (August 15th 2003): "subsidies in advanced countries exceed the total income of sub-Saharan Africa; the average European subsidy per cow matches the $ 2 per day poverty level on which billions of people barely subsist"[22].

Second, from an analytical viewpoint, we need to take the adjusted aid flows. We also need then to compare them with the net welfare loss from the agricultural subsidies to the recipient countries, not with the subsidies themselves. Besides, if you compare the subsidies per cow with the poverty level defined by the World Bank, what possible meaning can this have either? How about comparing it with per capita defense expenditures in the poor countries or anything that catches your fancy? Such nonsense pollutes public policy discourse instead of illuminating it and advancing solutions to serious problems, I am afraid. And, in my opinion, bad arguments may win you a battle; but the truth often catches up with you in the end and you lose the war.

One more thought on agricultural subsidies. Where they encourage production or exports, they certainly will lower world prices, ceteris paribus. This

[22] I could also quote another, very distinguished Chief economist who subscribed to similar fallacies regarding agricultural subsidies. But diplomacy and friendship prevent me from doing so. Again, his interests have shifted substantially and his past errors on subsidies do not pose any longer a danger to good policymaking in the developing countries.

is precisely why the Cairns Group exporters object to them. But if you are an importer, you are hurt, not helped, by higher world prices. [As the world prices rise, your welfare falls; it keeps falling until the rise in prices is sufficient to reverse specialization and importables become exportables. At that point, further rise in prices will begin to improve welfare and eventually, the continuing welfare improvement will restore the initially-importing country to reach the initial welfare level and then only to exceed it. This requires therefore that the price rise and the response to it are large enough to lead to reversed specialization and to register a sufficiently large shift in production of the initial importables.]

As it happens, nearly 45 out of the 48 Least Developed Countries (LDCs) in 1999 were importers of food items. Much was made at the Cancun meeting of the WTO in 2003 of the cotton subsidy in the US which surely harmed four African nations: but there, these nations were exporters, and the case therefore was far from typical of the African situation. Why then did the Cairns group persist in the view that the US and EU distorting subsidies were harmful to the poor nations of Africa when in fact they lowered world prices and were helpful to much of Africa instead (as is now admitted in the case of higher world prices faced by much of Africa in the recent food crisis).?

I can only imagine that this fiction, hurtful to Africans in reality, was considered by the Cairns Group of exporting nations to be helpful in the campaign to remove these subsidies. If you can say that such removal is helpful to you, a middle-income developing country, that is good; but if you can pretend successfully that it would help also the really poor developing countries, that surely strengthens

your case hugely. But it is truly harmful to the LDCs who are actually hurt but believe that they are going to be helped. This set of myths was also accepted uncritically at the time by the Bank leadership and Oxfam, and I found that it had been accepted uncritically by some of the unsuspecting African nations who naively think that Oxfam and Stiglitz are their true friends, when I addressed the UNCTAD Ambassadors on a visit to Geneva soon after I had been a member of the Eminent Persons Group on The Future of UNCTAD.

(ii) The Doha Round does not Offer Advantage to the Developing Countries

There is also critical commentary that the Doha Round is of negligible value to the developing countries. Alongside this pessimistic view is the assumption, embodied in the assertion, that the Doha Round is the first "development round" and is even formally titled the Doha Development Agenda, implying that the enormous post-war trade liberalization under GATT auspices was of no benefit to the developing countries.[23] But this is nonsense.

All GATT Rounds have been aimed at development: trade liberalization is an instrument, not a target, the target being gains from trade and hence economic welfare or "development". Is it conceivable, for instance, that the four East Asian tigers would have had their "miracle" if they did not have access to a growing world economy where markets were growing. They adopted economic policies (as I argue

[23] Andrew Rose has argued provocatively, on the other hand, in a paper in The American Economic Review (2004) that the trade effects from having the GATT/WTO were negligible overall. But he uses gravity analysis to infer this. Instead, to analyze whether trade flows and welfare would not have been lower without the GATT/WTO, he must build first a plausible counterfactual. Is it likely that, in the absence of the GATT, the conditions of the 1930s (where lack of rules led to beggar-my-neighbour policies and an accentuation of the world slump after 1929) would have led to a disorderly world? And possibly even to lack of sustained liberalization that occurred under GATT's auspices through several Rounds?

later) that enabled them to exploit these markets, thereby doing extremely well whereas those (such as India) that were export pessimists did extremely badly.

Of course, it is perfectly possible for any Round, because it consists of several policy changes, to result in a setback for some country or subset of countries. The more careful among the international economists always teach that the effect of even MFN trade liberalization among a group of countries can harm a country or subset of countries that are simply bystanders as the effect may be to worsen their terms of trade. In the Uruguay Round, some CGE models did indicate that several African countries could be damaged by the Round.

Again, many (among them I also, writing in 1991 and often later) argued that IP protection, embodied in the new TRIPs agreement in the newly-constituted WTO with the conclusion of the Uruguay Round, could not be argued as having the mutual-gain property that voluntary MFN trade liberalization generally has: instead it represented an unrequited transfer of income (in shape of royalty payments) from the users of IP to the producers of IP, i.e. from the poor to the rich countries. How much this transfer is can be hard to calculate; its qualitative direction for developing countries in the aggregate is however clear. At individual country level, however, aside from the difficulty of calculation, there is also the problem that a developing country like India, which was a consumer of IP and opposed TRIPs, has become an exporter of IP (in the sense that it is worried about piracy of IT software and Bollywood movies and is also now developing patents in pharmaceuticals) and so the calculation of India's losses can turn into gains.

What is absolutely true, and has been well understood by economists and policymakers from the developing countries for well over a decade, is that the lobbying interests from the developed countries have sought to turn trade treaties and institutions into arenas to advance their trade-unrelated agendas like ensuring IP protection (which is about royalty collection), raising of labour standards (which, if raised in the poor countries, would reduce the pressure of competition for the rich countries), enhancing domestic environmental standards (for the same reason), proscribing reliance on capital controls even in times of financial crises (as attempted and imposed in a moderated form in FTAs with Chile and Singapore by the US) and undermining the national medical regimes (as attempted by the US in the FTA with Australia).

PTAs with small and weak developing nations are where we can and must strenuously object to what the hegemonic powers are doing, through pressures from all kinds of domestic lobbies on both the right and the left of the political spectrum, to undermine the trading regime and to force their own trade-unrelated agendas, often harmful, down the throats of the developing countries.[24]

But, returning to Doha, the way Doha negotiations have developed, it is hard to maintain that the developing countries have gained little. At the level of CGE models, despite some early calculations that seemed to suggest limited gains, the World Bank studies now suggest larger gains, including for the developing countries: and Will Martin, one of the world's great CGE modelers, is sitting right here and is nodding his head so I feel reassured.

[24] **These dangers have been noted in my Globalization book, op.cit. and have been discussed in the context of FTAs in my latest book, Termites in the Trading System, op.cit.**

But Rodrik, in his blog, has recently condemned these estimates as blown up. But his own estimates typically rely on the Harberger-Johnson triangles of static gains; and, as we all know from the theoretical work of Paul Romer and of Robert Feenstra, that these triangles dramatically understate the gains from freer trade. [25]

Besides, he thinks --- see his recent Financial Times, March 26th 2007, op.ed. which also characteristically says that globalization is threatened more by the "cheerleaders of globalization" from "the elite universities of north America and Europe", whose policy prescriptions are undermining globalization, than by the "marginalized" protesters who are of course his constituency --- that the gains from trade have by now been virtually exhausted. Perhaps what is likely to get exhausted instead is our patience with more of Rodrik's avuncular assaults on those of us who argue for further freeing of trade. Does he not know that agricultural protection and promotion are still ways to go, that services are far from being yet free, that even in manufactures we have some tariff peaks and more important NTBs like anti-dumping which are spreading rather than shrinking?[26]

2. The Benefits to Developing Countries from their own Trade Liberalization are Negligible

[25] **Gary Hufbauer (2008) of the Peterson Institute for International Economics has also responded vigorously to Rodrik's allegation of ballooning up of the gains from trade in recent calculations by him and others. I leave it to you to look that up for yourselves.**

[26] **As I finish the final version of this Lecture, I note that Rodrik has predictably joined in his blog the civil society groups that celebrated the collapse of the Doha talks. However, most of the poor countries of Africa, several developing nations in Asia and many of the South American countries, were keen to have the Round settled rather than be postponed again. Besides, the talks are not dead, they have just "collapsed" and efforts are under way, by Pascal Lamy, and by the USTR and Minister Kamal Nath to find a final resolution of their differences on agricultural liberalization, whereas on several contentious issues before the talks, differences were virtually resolved during this week's talks.**

The central assault on freer trade for the developing countries from Stiglitz and Rodrik, among a handful of economists, must now be examined.

(1) Let me begin by quoting and critiquing Stiglitz from a recent article in <u>Far Eastern Economic Review</u> (March 2006), titled "Social Justice and Global Trade". I quote him on trade liberalization, though the article's main thesis is that the Global Trading system violates justice and fairness: charges that I have already examined and largely dismissed earlier in this Lecture.

Stiglitz says: "There are some circumstances in which trade liberalization brings enormous benefits --- when there are good risk markets, when there is full employment, when an economy is mature. But none of thee conditions are satisfied in developing countries." The first condition would rule out the East Asian miracle, based on outward orientation: did they have "good risk markets"? Or what about the growth of countries that prospered over a century ago on staple exports?

On the second condition, several counter-arguments are possible. As for the specific argument of Stiglitz, if there is a pool of unemployment, Stiglitz could get unemployed in the contracting import-competing steel sector in Gary, Indiana (where he was born) while I, previously unemployed in New York, get employment in the expanding exportable IT industry there. The total amount of unemployment would remain constant, only its composition would change. And total output would increase, and gains from trade would arise as well, even if we do not attach extra weight to my employment than to Stiglitz's unemployment, as we should, in a "just" and "fair" world! At a theoretical level, one can also argue that if unemployment means slack labour as in the Lewis-Marx model of elastic supply of

labour at a given real wage, development theory would surely argue that a Harro-Domar growth path would yield steady gains from trade until the economy runs out of slack labour and becomes a Solow-Jorgenson economy. Remember also that, as Gottfried Haberler argued in a celebrated 1950 paper in the Economic Journal, factor immobility simply reduces the production gains from trade while leaving consumer gains and terms-of-trade gains intact. But if factor price inflexibility is also present alongside factor immobility, unemployment could result; but that still has to be placed against the other sources of gain.[27]

Let me quote Stiglitz further: "… without protection, developing countries cannot compete in the modern sector. They are condemned to remain in the low growth part of the global economy." Why? Argentina, under Peron, decided to industrialize with effective disincentives to agriculture, to go into the "modern sector", with results that are hardly to be admired and imitated. Some believe that 19th century US protected its way to prosperity. But Douglas Irwin, the smartest economic historian of trade today, has challenged that argument fairly successfully. Industrialization can occur successfully under outward-oriented policies; the notion that protection is necessary to industrialize is not correct. In fact, when India turned inwards and the Far Eastern economies (South Korea, Taiwan, Hong Kong and Singapore) turned outwards in trade in early 1960s, India's industrialization fell seriously behind that in these East Asian economies despite her enormous size and a history of industrialization which had happened, it should be mentioned, despite

[27] For a proper theoretical analysis of the question, combining both factor immobility and factor price rigidity, see the two classic articles by Richard Brecher in the 1960s when he was at Harvard and cross-registered to take International Trade with me at MIT. The issues are treated clearly also in the graduate text by me, Panagariya and Srinivasan, Lectures on International Trade, MIT Press.

British rule and absence of protection. But let me now proceed to some of the other, superficially more plausible, critiques.

(2): Thus, we are accused frequently of asserting that trade openness is <u>the</u> major, principal factor in promoting prosperity. But the focus on trade in the analysis of successful developmental strategies resulted from the fact that, as evidence accumulated about the adverse effects of inward-looking quasi-autrakic trade policies, economists and policymakers were turning away from the long-standing policy of import substitution that had swept across much of the developing world.

It is also noteworthy that economists like Stiglitz (who was a theorist for most of his life) had virtually no firsthand experience of the developing countries during these early years and failed to understand that these countries were moving away from near-autarkic attitudes and policies towards a more open attitude to openness on trade. In attacking the turn to trade, to less knee-jerk extension of the public sector into all kinds of activities beyond where "natural monopolies" existed, and to greater reliance on markets, Stiglitz thought that these reflected an ideological extension of policymaking towards letting markets rip. As it happened, it was a shift towards pragmatism away from an ideological opposition to the use of markets and international trade! He got it all wrong, falling for populist leftwing propaganda as these groups saw their stranglehold on policy in countries like India slip away from them towards economic reforms. In a story in the <u>Wall Street Journal</u>, which featured him and me, I said that he was into Jurassic Park economics: trying to bring back to life dinosaurs that we had slain.

To return to the question of regarding trade as the principal factor in development, few of the prominent reformers among us ever saw trade as such. In fact, for India, I (and other reformers like Padma Desai and T.N.Srinivasan) repeatedly drew attention to the fact that many reforms had to be undertaken, not just in trade policy. Assigning partial derivatives to just trade opening would be difficult. It would also be easy to imagine that, as I argue below, trade reforms without other reforms (e.g. in the draconian licensing restrictions on production and investment) would be nearly ineffective (though, in political-economy terms, the fact that trade has become more profitable may lead in turn to lobbying pressures sometimes to remove these licensing impediments).

In a similar vein, we trade economists are perfectly aware, and teach our students (who often become policymakers) that the gains from trade, even when there are no domestic institutional and policy impediments (all of which can reduce the gains from trade to low levels), these gains can be small or even minuscule for technological reasons that reduce the production gains, for example. If we claim sometimes that these gains are large in practice, we go by empirical studies which suggest that this seems to be a central tendency, not because it is "inevitable". But specific empirical cases where the gains from freer trade are negligible would not surprise us.

So, the frequent criticism that "we liberalized and nothing good came of it", a claim often made by Stiglitz and Rodrik for South American nations including Mexico, even if it were a correct observation (some observers have disputed that the liberalization was substantial in several South American nations), does not in itself

invalidate our prescription that developing countries generally stand to benefit from freer trade. Trade is an opportunity to gain from seizing that opportunity appropriately; whether the size of that gain is large or small reflects the specifics of production technologies and the accompanying institutional and complementary policies.

Then again, all trade liberalization is not good. It is perfectly possible that a country liberalizes under a Preferential Trade Agreement such as NAFTA and that a member country experiences trade diversion which harms it, instead of improving GNP. Thus, it is well-known that Mexico's growth rate and her growth rate of exports have diverged: Mexican trade has grown over a decade after NAFTA was formed but GNP has not. This divergence may well be explained by the fact that Mexico has suffered form trade diversion, not just because of NAFTA itself, but also because, after the 1994 peso crisis, Mexico had to continue lowering tariffs for US and Canada as required by NAFTA but raised over 500 MFN tariffs up towards higher bindings.

Similarly, actual growth rates will be affected by several factors that may moderate or nullify the beneficial effects of trade liberalization: only careful in-depth analysis, rather than the cross-country regressions that economists like Dani Rodrik, Robert Barro and Jeffrey Sachs ---- I used to call them the "Harvard regression-mongers" until Sachs left Harvard and came to Columbia to head its Earth Institute --- rely too much on, can help sort the complexities out[28].

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[28] **Once, a long time ago, when we were discussing labour standards, Rodrik had a paper with a bunch of cross-country regressions, saying that economists like me were indulging in "rhetoric" while he was dealing with "facts". Funny. What he called rhetoric was invaluable conceptual analysis which clarified the issues and indeed provided the basis for proper empirical examination. And by facts he meant his mindless regressions (which, at best, may provide hypotheses to probe more meaningfully).**

In-depth, and broad-based analyses are what Ian Little, Maurice Scott and Tibor Scitovsky pioneered in their OECD Development Center studies of the trade and industrialization studies of several semi-industrialized countries (with me and Padma Desai doing the India volume), followed immediately after by the massive NBER project which Anne Krueger and I directed, using a similar approach (and where T.N.Srinivasan and I extended the Bhagwati-Desai OECD study of India in many ways).

I would also stress that one can draw the wrong conclusions if one does not look at long periods: what we need to focus on is "sustainable development" in the original sense that development will endure, not be a flash in the pan. The Soviet Union is a classic example where huge amounts of investment resulted in a big spurt in investment and growth. But, even though this lasted nearly two decades (allowing for the horrendous impact of the Second World War), the investment continued but the growth rate began to decline and steadily fell for a quarter of a century. So, we had "blood, seat and tears" in the shape of extraordinary rates of savings and investment, but no results. The lack of market incentives to produce, to trade, to invest, and the pervasive nature of state ownership and associated problems, was steadily undermining the economy, a phenomenon whose appreciation led Gorbachev finally to say: this cannot go on.[29] So, the Soviet Union produced

[29] See the long Introduction in Padma Desai, Conversations on Russia, Oxford University Press, 2006. This book contains interviews with major political and intellectual figures in Russia and abroad and offers an extraordinarily insightful commentary on why Gorbachev's attempted perestroika ran into problems that actually moved the Russian economy from steady decline into negative growth rates. In this saga, the role of "shock therapy", associated with Jeffrey Sachs, was a key element, of course, and illustrates well that the transition from bad to good policies has to be managed skillfully, and cannot be undertaken in a gung-ho, technocratic fashion. On this, see also my book, In Defense of Globalization, op.cit. , Chapter 18, titled "Managing Transitions: Optimal, Not Maximal, Speed". Naomi Klein's recent book, a bestseller, on Shock Treatment: The Rise of Disaster Capitalism (Metropolitan Books: 2007) is critical of shock therapy in Russia but the book's attention, and popularity, are due to the fact that she deplores the way in which reforms are introduced when an

extraordinary results for a fairly long period. Economists such as Rodrik (who rejoices in the short-period successes of anti-liberal and anti-trade policies in South America prior to the wave of reforms) would have rejoiced that autarky, lack of market incentives, lack of any role for the private sector did not undermine growth, that the Soviet Union's policies had accelerated her growth remarkably compared to her pre-1917 history and compared to capitalist economies. And yet, time caught up with these arguments.

Similarly, I tell the story of Joan Robinson, the great Cambridge economist, a passionate radical who admired Maoist China, and Gus Ranis, a "mainstream" developmental economist from Yale, agreeing that Korea was a huge success. Astonishing, until it became clear that she was thinking of North Korea while he was thinking of South Korea! That was almost thirty years ago. Now, we know who was right.

In fact, Arvind Panagariya has shown that, for all developed and developing countries for which we have data over a long period spanning over three decades, the "economic miracle" countries with per capita growth rates at or over 3% also had similar high growth rates of exports. But the "economic debacle" countries with stagnant or declines in growth rates had similar experiences with their trade[30]. Of course, the causation need not go from trade to growth; but no one can plausibly argue that the causation went from growth to trade in anything but a few cases.

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economy is in disaster. But that is downright silly. Yes, smart people will indeed take advantage to use crises/disasters to introduce reforms which otherwise were hard to introduce just as a doctor who has been telling a patient to avoid fast foods will have better success after the patient has a serious heart attack. The important question rather is: is the doctor telling the patient to do the right thing?

[30] See his article in The World Economy, 2005. See also the discussion of "Trade and Growth" in my book on Globalization, op.cit., pp. 60-67.

(3) But then, Rodrik has accused us of failing to understand that "one (shoe) size does not fit all". This sounds eminently plausible but do not buy it. A little reflection will tell you why. Economics is a science. At any one point of time, we go by what the bulk of the argumentation and evidence up to then suggests is the way to go. So, we must decide whether to move towards freer trade or to move backwards towards more protection. To put it in terms of shoes: we must decide whether to wear shoes or to go barefoot. The matter cannot be left to the thousands of World Bank staff, and their myriad clients, to decide on an ad hoc basis whether free trade is good or protection is good for the country. That way lies <u>ad</u> <u>hocism</u>.

Also, once you have decided to wear shoes, the size will invariably vary to reflect the political and economic realities. Even the much-criticised IMF, with its fairly limited and hence possibly draconian conditionalities, has been subject to several, what my student Ravi Yatawara (who did a dissertation with me and Roberto Perotti on the subject) has called "policy reversals". Yes, when the rubber hits the road, the pace at which you move to freer trade will adjust to reflect the conditions you confront. In fact, on the issue of trade reform, while the World Bank has tended to see a macroeconomic crisis as a good time to advocate tariff reduction, the IMF has frequently said: if your budget is out of whack, do <u>not</u> remove tariffs if that is going to reduce revenues and exacerbate a macroeconomic situation reflecting excess demand.

So, Rodrik is asking us to ignore that Economics seeks useful generalizations. He is also forgetting that when we apply these generalizations to seek optimal trajectories of reform in the direction of these generalizations, few apply them

without attention to necessary roadblocks and problems in specific situations and without admitting that there have to be "policy reversals". He is therefore talking against science on the former issue, and creating a straw man to chide and correct us on the latter issue.

Concluding Animations: Comparative Advantage and Gains from Trade:

Let me conclude on a lighter note with three animated responses to some of the recent critiques. Take the first one where you see a monkey happily jumping around from tree to tree, pursuing his genetic comparative advantage. But, alas, a jaguar turns up in one of the higher branches; and there goes the poor monkey. Such "random" occurrences do not mean that the monkey should deny his comparative advantage and instead crawl unhappily around on the ground (where also he can be bitten by a scorpion or devoured by a tiger). So, the notion that occasional occurrences where the advantages accruing from trade are nullified does not mean that, overall, advantage from trade has to be considered as ephemeral. It is much as if, after 9/11 and the destruction of the twin towers by the flights from Boston to New York, one were to conclude that improved transportation between Boston and New York was undesirable.

Take next an incontrovertible demonstration of comparative advantage. You see me standing in front of economics scribbled on the blackboard; but instead of the chalk in my hands --- the famous New York Review of Books cartoonist David Levine worked from this photograph when my book, Free Trade Today was reviewed and everyone thought that the chalk was a cigarette, making me look a

little like Humphrey Bogart but more like a politically incorrect intellectual ---, my animator has put a tennis racquet in my hands, and the tennis ball bounces back and forth from my racquet. Then, Rafael Nadal appears in the upper left hand corner, and he smashes the ball and there go I up in a tumble and smoke! Evidently, I should have stuck to my comparative advantage in economics.

My final animation comes from the Garden of Eden. It occurred to me when I was writing a Preface for the French translation of Free Trade Today and I wanted to tell my French readers that, if my splendid pro-trade arguments still left them unconvinced, I had an absolutely irrefutable argument in favour of it that they could not possibly reject. [It has the flavour of the well-known story of how, at Catherine's court, Diderot was becoming a nuisance as an atheist. So, she invited Euler, the greatest mathematician of his time, to come and refute him. So, Euler put up the argument: $x2 + y2 = z2$; therefore God exists. Diderot was flummoxed; he packed his bags and left for Paris.] Well, I argued: if only Adam and Eve had been trading, they would have exchanged the apple for an orange and the whole history of the human race would have been benign. So, the animation shows these ancient forbears of ours, in Christian mythology, trading the apple for the orange and living happily ever after. So, as I wrote for my French readers, trade is good for you. And I say that also to my audience today.