

**Stockholm School Special Lecture on my Forthcoming Book:  
Termites in the Trading System: How Preferential Trading Agreements are  
Undermining Free Trade**

**10<sup>th</sup> April 2008**

**Brief Outline:**

**I: Association with the Stockholm School and Different Lectures Given::**

**It is a pleasure to be here one more time. Let me recall first visiting Stockholm School, almost 45 years ago, as an Opponent of Bo Sodersten's Dissertation, at the invitation of the aristocratic Professor Svennilson; it is gratifying to see Sodersten in the audience today. I also met Professor Erik Lundberg at that time and got to know him well afterwards, though my friendship with Professor Bertil Ohlin, who took kindly to me, would be deeper.**

**Also, when Staffan Linder took over the School, I visited a couple of times, including on the occasion to give the Ohlin Lectures which he had started at the School. I have since then given several Lectures at the School, in all cases leading to unexpectedly successful books on different aspects of the postwar theory of commercial policy which happens to have been the subject of my scientific work since the early 1960s:**

**(1). The first Ohlin Lectures that I gave resulted in the book, Protectionism, MIT Press, 1987.**

**(2). Then, I gave three Lectures which turned into the book, Free Trade Today, Princeton, 2002.**

**(3). Later, I gave in the big auditorium below a Lecture on Globalization, at a substantial meeting cosponsored by the School with the Johnsson Foundation, which (among other occasions) prompted me to write the book, In Defense of Globalization, Oxford, 2004.**

(4). This time around, however, is the other way around. I am giving this Special Lecture, based on a *finished* book, Termites in the Trading System: How Preferential Agreements are Undermining Free Trade, due out in late May from Oxford.

## II: Two Distinct Issues in Theory of Commercial Policy:

The scientific research on the theory of international trade in its welfare aspects --- known sometimes as the theory of commercial policy ---, as also the policy-related writings on the subject informed by scientific breakthroughs, have addressed two distinct issues:

First, should we have Free Trade; and

Second, if we agree that it is desirable to have Free Trade, which method do we use to get to it?

Today, I plan to talk about the Second Issue, concentrating on Preferential Trade Agreements (PTAs) as the way of freeing trade. But let me remark on the First Issue before I do that.

A: Is Free Trade Desirable?

## III: Desirability of Free Trade: The Postwar Revolution

The question of the desirability of Free Trade has gone through a Revolution in the Postwar Theory of Commercial Policy. *In the face of market failure* (what I called “distortions”), economists over nearly 200 years since Adam Smith had

thrown up their hands and said that *we could not rank-order free trade and protection*.

In a striking flash of extremely simple insight, I suddenly saw and then argued (from New Delhi jointly with the late V.K.Ramaswami) in 1963 in JPE that if we could “fix” the distortion through an appropriate policy, we would be back to free trade as if it was under no distortions. The first-best commercial policy then was still free trade if the distortion was eliminated by a suitable additional policy. Two centuries of skepticism had been virtually reversed. As Harry Johnson in the older generation, and Paul Krugman in the younger generation, vis-à-vis me, have written, among many other theorists of international trade: this was a breakthrough of the utmost importance in the economic theory of commercial policy, sometimes called the theory of “trade and welfare”, going straight back to the problem of mercantilism or Protectionism that Adam Smith had founded economic science on. Nothing could be more central to Economic Science, historically and in terms of a matter of great policy consequence.

Of course, my argument worked if the distortion was in domestic markets. It did not work if the distortion was in the external market, as with a nation’s monopoly power in trade when the removal of the distortion itself required a tariff: the optimal tariff argument. The same held, of course, for the models of imperfect competition at the level of the firms themselves, which came up as the developments in the theory of industrial organization enabled theorists to go beyond models of perfect competition. In these cases, clearly the optimal policy intervention would incorporate trade tariffs/subsidies.

In that case, one had to take recourse to “political-economy” arguments to recommend free trade. Thus, one school maintained that there was no beef: i.e. that the national monopoly power was negligible in practice or that firms were almost perfectly competitive. Another school of thought argued that, if tariffs were used to exploit monopoly power, that would lead to retaliation, in which case it was likely that all would be worse off. Yet others thought that the Visible Hand of intervention could make matters worse rather than better. Each of these arguments can be both formalized and has also been contested theoretically and for specific contexts. But

**the three critiques do provide pause to those who would resort to tariffs to take advantage of monopoly and imperfect competition in product markets in world trade.**

**A theoretically correct statement of this modern corpus of the theory of commercial policy, as developed in numerous contributions since the early 1960s, and which has provided a sophisticated strengthening of the case for Free Trade after recurring doubts among economists over 200 years, is what you can find in my Stockholm School Lectures, Free Trade Today.<sup>1</sup> It is in fact a profoundly important development of the case for free trade, belying the lazy notion often heard among several economists who are untutored in trade theory that “it is all in Adam Smith” and that “we all know free trade is good”!**

#### **IV: Refuting the Social Critiques of Free Trade:**

**But whereas the economic case for Free Trade as the policy to embrace to advance economic welfare as conventionally defined by economists has thus been dramatically strengthened in this way, there have also been recent, powerful critiques today which claim that, while economic welfare may increase due to Free Trade (relative to Protection), the social implications of Free Trade are deplorable. E.g. it worsens women’s agendas such as equal pay with men, or it accentuates poverty in the poor countries, or it increases child labour in these countries, or that it undermines mainstream culture (Monsieur Bove’s concern) or indigenous culture (President Evo Morales’s concern), or it handicaps democracy, and so on. In the**

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<sup>1</sup> The US media have often declared, most recently last year, that the consensus among economists over the value of Free Trade for the rich countries has collapsed. I have refuted these claims in my Debate with Alan Blinder, a macroeconomist from Princeton, at Harvard University last year. See my website [www.columbia.edu/~jb38](http://www.columbia.edu/~jb38) for my essay, titled “Do Not Cry for Free Trade”, which will be the lead article in a small volume to be edited by Benjamin Friedman for MIT Press, 2008., and my essay on “Economics and Public Policy” in Daedalus, 2008. I am finishing a companion piece on the alleged disappearance of consensus among economists on the value of Free Trade for the poor countries, debunking the hollow arguments of Dani Rodrik and Joe Stiglitz which are popular in those poor countries where the professional competence, and at times the willingness, to examine and refute their fallacies is limited.

public sphere, these critiques are characterized as alleging that Globalization Lacks (or Needs) a Human Face.

That is precisely the issue that I touched on in my Lecture here and more substantially in the later book, In Defense of Globalization (2004). I took up all of these social concerns and argued in depth that the outcome of Globalization (concentrating principally on trade and direct foreign investment, though I did have chapters on International Migration and on Short-term Capital Flows) for these social objectives and agendas was also benign, not malign. In short, Globalization HAS a Human Face. A third of the book then was devoted to developing the policy and institutional framework, both domestic and foreign, that would enhance the color in this Human Face.

#### **V: Trade and Wages: Cap on Wages Wrongly assigned to Trade**

In Defense of Globalization (2004) also addressed the explosive issue, on the interface of social and economic critiques of trade today (particularly in the US) whether international trade has been a significant factor in the pressure on real wages of workers in the last quarter of a century. This is an issue I have explored in several earlier articles on which I draw in this book, and I have argued (including recently, in a January 2008 Financial Times op.ed.) that, if anything, the fall in wages brought about by acute and repeated labour-saving technical change has been moderated by international trade.

Nonetheless, this fear has led to de facto protectionist demands to impose higher labour and (domestic) environmental standards on the poor countries with whom freer trade is proposed. I have argued in many places, including in 2 substantial (research-project) volumes with the eminent trade law expert, the late Professor Robert Hudec, [Fair Trade and Harmonization: Prerequisites for Free Trade?, MIT Press, 1996], that such demands are in fact “export protectionism”, aimed at raising the cost of production abroad by harmonizing these standards up; and that this strategy is furthermore an ineffective way of trying to live in today’s world of intensified competition which owes to many different factors.

Nonetheless, both the unfounded fear of trade's alleged impact on real wages, and the mistaken attempts at imposing common standards on others trading with us as pre-requisites for freer trade, have become a firm article of faith with American unions. They have now captured the Democratic Party and its Presidential nominees who have turned into protectionists during the American Presidential campaign.

I am writing another book, titled Terrified by Trade, which will be published by early 2009 in time for the new President, using theory and evidence, to argue against such mistaken fears and the resulting protectionism in the United States, and by appropriate extension, to Germany and France.

## II: How to Achieve Freer Trade

### VI: Four Ways of Freeing Trade

I distinguish among four different ways of freeing trade (see Chapter 3 of Free Trade Today):

1. Unilateralism (i.e. just freeing trade unilaterally)
2. Aggressive Unilateralism (i.e. getting others to lower their trade barriers without doing so oneself)
3. Multilateralism (i.e. GATT/WTO)
4. Preferential Trade Agreements (PTAs)

### VII: Unilateralism:

The flip side of Unilateralism is Reciprocity. I argued in Free Trade Today that it was a mistake to argue that reciprocity was based on mercantilism as Harry Johnson had famously argued. If I remove my tariffs, I will gain (subject to well-known qualifications). But (heuristically and generally speaking) if I get you to reduce your tariffs as I lower mine, I would gain yet more. It is only if you refuse to play the game, then I would go ahead with freeing my trade unilaterally.

In Free Trade Today, and elsewhere, I also wrote about “extended reciprocity”. Thus, Prime Minister Robert Peel, when he repealed the British Corn Laws in a unilateral freeing of trade, it was against a background of French recalcitrance in reciprocal liberalization. Peel believed that Britain would prosper so much with Free Trade that France would follow suit to reap similar gains from Free Trade: Britain’s unilateral liberalization would induce French liberalization. This would be reciprocity induced by example.

Some of my students, chiefly Pravin Krishna & Debashish Mitra and Rodney Ludema & Dan Coates, have also examined theoretically the different political-economy-theoretic argument that my freeing of trade would strengthen the exporting interests in your country, thereby altering the balance of free-trade and protectionist forces in favour of the former, leading to the freeing of trade by you. Thus, while there is one-period unilateral freeing of trade, it leads to second-period, making it a case of extended reciprocity.

These and other theoretical arguments, and much historical and sectoral experience with unilateral freeing of trade, were developed and explored in depth in a substantial volume, based on a research project that I directed, titled: Going Alone , MIT Press (2002). I should also cite the splendid work of my colleague Kyle Bagwell and Robert Staiger (MIT Press) which also addresses the question of reciprocity.

#### VIII: Aggressive Unilateralism:

Where unilateralism is about removing one’s own trade barriers unilaterally, the United States has practiced what I have christened, and what is now widely called, Aggressive Unilateralism, i.e. asking others to unilaterally remove their trade barriers. Of course, only a major power can do this; and the US did it, by threatening tariff retaliation against those who would not comply with US demands, after enacting Section 301 of its 1988 Omnibus Trade and Competitiveness Act. The many theoretical and policy issues raised by this legislation and its implementation were the subject of the book that I edited with Professor Hugh Patrick, and titled Aggressive Unilateralism (Michigan University Press, 1990).

## **IX: Preferential Trade Agreements (PTAs) versus Multilateralism**

**Whereas conventional trade liberalization under GATT which embodied in Article 1 the central principle of MFN, the most-favoured-nation clause, was on a non-discriminatory basis, Preferential Trade Agreements such as Free Trade Areas and Customs Unions necessarily involved discrimination between members and non-members of the PTA.**

**The chief lessons of the 1930s were that competitive protectionism had deepened the Great Depression and that discrimination, which also had proliferated greatly under bilateral quantitative instruments, was to be avoided. But today, while protectionism is subjected to many obstacles (chiefly in the GATT/WTO system) that hold it in check, discrimination has returned. Over 350 PTAs have been reported to the WTO; and they increase every week. Ironically, this pandemic of discrimination in the world trading system has arisen, not because of overt protectionism as in the 1930s, but because of free traders unwittingly signing on to the bilateral and plurilateral discriminatory trade liberalization.**

**In my Lecture, drawing briefly on my Termites in the Trading System book, I will answer three questions:**

- 1. Why has this pandemic broken out?**
- 2. What are its adverse consequences for the world trading system?**
- 3. What can we do about it?**

**I urge you to read my short book for the full range of issues that these 3 questions raise.<sup>2</sup> I shall however have to confine myself today to some salient points.**

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<sup>2</sup> In the book, I also have an Appendix on the many developments in the theory of PTAs, distinguishing among five different approaches in the “static” theory begun by Jacob Viner in the 1950s, and then going on to discuss the different “dynamic time-path” analysis which relates more directly to whether PTAs are friends or foes in achieving universal free trade.