The Sylvia Ostry Lecture **Revised Final Version**
October 2008 **November 15, 2008**
C.D.Howe Institute,
Toronto, Canada

Jagdish Bhagwati
University Professor, Economics and Law,
Columbia University

Why the Critics of Free Trade are Mistaken

:

It gives me great pleasure to be giving this year's Sylvia Ostry Lecture. Sylvia is one of Canada's "national treasures". She is also an international legend: indeed, if I may borrow from the nun Hroswitha's celebrated description of Cordoba in medieval Spain, she is an "ornament of the world". She has distinguished herself as the Economist at the OECD in its formative years, as an influential Canadian G-7 participant and in many international capacities. In fact, I got to know her particularly well when we served as External Advisers to Michael Moore, Director General of the WTO, and was impressed yet again by her remarkable ability to get to the core of the problem at hand, each time with her wonderful facility with words. And, of course, who among you has not read her many writings with illumination on the most pressing problems of the day? Indeed, I feel honoured by your invitation to honour her.

Since Sylvia has written often on trade policy, and is indeed one of the major players in the field, and the theory of commercial policy happens to have been my main preoccupation for nearly half a century, I have decided to address this evening the recent challenges to free trade from several directions.

The issue has become more acute since, in the aftermath of the continuing financial, and now macroeconomic, crisis, some populist voices have begun to argue that the crisis shows that, in my colleague Joe Stiglitz's words, "market fundamentalism" is dead, along with free trade. I am afraid that this is nonsense, coming from someone who is himself an "anti-market fundamentalist": as Alexander Pope said, everything appears yellow to the jaundiced eye. Are we to believe that we no longer will use cap-and-trade because that means the use of the market to advance environmental objectives? Are we going to be silly enough to throw the trade baby out with the financial bathwater just because we are a bunch of lazy intellectuals when in fact the smart East Asians, after the 1987 financial crisis, realized that their economic miracle was based on trade but that their crisis was caused by premature financial liberalization, and therefore held on wisely to their embrace of outward orientation in trade? Are we to ignore even the fact that, except for a few libertarians, no one believes that the financial markets are symmetric with non-financial markets, and instead require prudential management? Alas, even good economists can make bad arguments: and Stiglitz seems bent on reminding us of this irony endlessly.

But today, I wish to talk about the critiques of free trade which have little to do with the populist reaction in some quarters to the financial crisis. But let me begin by noting that the current US Presidential debate illustrates well how the traditional fulsome support in the United States for free trade after the 2nd World War has frayed, certainly among my fellow Democrats. So much so that the British Foreign Secretary David Miliband was prompted to send in May a warning to

Hillary Clinton and Barack Obama to cool their protectionist rhetoric and to draw back from it.

The postwar history was indeed energetically pro-trade, under US leadership. The half-century long embrace of Free Trade was common to all Presidents, Democrats and Republicans alike. And nearly every President was associated with some trade liberalizing initiative at the GATT. I might add that the US frowned, quite correctly in my long-held view (which I seek to justify in my latest book, <u>Termites in the Trading System: How Preferential Agreements Undermine Free Trade</u>, Oxford 2008), on preferential trade agreements and was wedded strongly to multilateral freeing of trade.

Let me quote just one President, Harry Truman, who in a speech at Baylor University in March 1947, declared resoundingly that:

"Peace, freedom and world trade are inseparable. The grave lessons of the past have proved it….

The policy of reducing barriers to trade is a settled policy of this Government. To those among us --- and there are still a few --- who would seek to undermine this policy for partisan advantage and go back to the period of high tariffs and economic isolation, I can say only this: Times have changed…The slogans of 1939 [associated with the infamous Smoot-Hawley Tariff] are sadly out of date."

Truman was making the case for Free Trade on two dimensions: that it would advance peace <u>and</u> it would advance prosperity. In short, <u>values</u> and <u>economic</u>s went hand in hand. History tells us, and here we have the brilliant book by Frank Trentmann (<u>Free Trade Nation</u>, Oxford, 2008) to document this, that even in 19th century Britain, the case for Free Trade was couched in terms of justice, fairness and peace, and went beyond the anti-mercantilist arguments we are familiar with (though many of the posters that typically attended British political

campaigns focused for the most part on prosperity alone, as illustrated in the Handout where British housewives flock to the Free Trade shop with lower prices while the Protection shop next door has no customers at all).

Values were certainly part of the belief in Free Trade in postwar America as well. Thus, I have also included in the Handout a cartoon from the Christian Science Monitor in 1947 where a woodpecker marked "opponents of trade agreements", is pecking away at a staff that holds a globe-shaped nest where a dove marked peace is perched. I might add that there is also a lovely cartoon by Herblock (the legendary cartoonist with the Washington Post) from the same period which shows a protectionist muscleman trying to topple an acrobat marked Trade, on whose shoulders is another marked Justice and above him a third marked Peace.

This belief in the larger purpose of trade was certainly held widely in postwar America. In fact, right after the competitive raising of trade barriers worldwide that followed the Smoot-Hawley tariff of 1930, Franklin Roosevelt's Secretary of State, Cordell Hull, was convinced that world commerce led to world peace and he was the architect of the trade-liberalizing Reciprocal Trade Agreements Act of 1934 and worked tirelessly for multilateral free trade (and against preferential trade which he believed undermined peace through fomenting divisiveness and rivalries). In fact, he was awarded the Nobel Peace Prize in 1945: it is unthinkable that a free trade proponent would get remotely close to it today!

Today, in fact, free trade is challenged in the rich countries on both counts. Those who are altruistic believe that, on social dimensions, free trade is malign, not benign. Those who are into self-interest fear that free trade will hurt prosperity.

Also, striking terror into the hearts of labour union leaders, is the belief that trade is a dagger at the throats of workers, imperiling their wages and jobs, that Marx's failed forecast of immiseration of the proletariat will be vindicated finally by free trade. In short, that free trade with the poor countries produces paupers in the rich countries.

Of course, both altruism and self-interest are part of human nature. As Rabbi Hillel said: if I am not for others, what am I; and if I am not for myself who will be? Few know that he also added, for the practice of virtue: Now! In contrast, as many of you must know, St. Augustine was more realistic. He prayed: Dear God, grant me chastity but not just yet!

So, reflecting Rabbi Hillel, the critiques of Free Trade divide into two sets (and you may look at the Chart where I do a taxonomy of the different critiques today): social and economic, the former coming from altruism and empathy, the latter from self-interest and fear. Let me take each, in turn, and show that the critiques are generally mistaken. Since the critiques are many and the time I have is limited, I shall touch only on the main themes regarding rich-country critiques, both social and economic, while doing little justice to the complementary critiques addressed to the desirability of Free Trade for the poor countries.

I: Social Critiques

The first relate to the social critiques, which generally divide into those addressed to poor-country concerns and those which cut across rich and poor nations. These are what might be called "people's issues", drawing on Prime Minister Tony Blair's famous description of Princess Diana as the "people's

princess". They are also typically the issues that the idealistic young embrace. On each of these issues, however, the critics assume that trade harms, instead of helping, the social agendas.

Thus, in regard to the former set of issues relating to the poor countries, the critics argue that trade leads to increased use of child labour, to increased poverty, and to the undermining of indigenous culture (a la President Evo Morales's complaints). In regard to the latter set of issues that cut across nations, trade is argued to lead to undermining of democracy, to detracting from gender rights and welfare, and to sabotage of mainstream culture (a la Monsieur Bove who drove a tractor into a McDonalds in Millau to protest the intrusion of American culture into the French). In short, we might say: trade lacks a human face, or its flipside, that it needs a human face.

But, when I examined these issues in my 2004 Oxford book, In Defense of Globalization, having read systematically through the huge literature and litany of concerns by civil society groups on the subject, I concluded that these critiques were hard to justify, that in fact trade had a human face. That, in truth, trade (and, in fact, multinational investment) advanced, instead of inhibiting, progress on the social agendas. I can only sample for you a couple of issues to illustrate how I reached the more optimistic conclusion: for the full treatment, you will have to buy or borrow, and read, the book itself.

(i)Child Labour: The NGO literature strongly argues that trade encourages the use of child labour. Parents who become better off due to increased earnings may choose between two options. The virtuous ones will say: the increased income

means that I can take one child off work and put her into school. The wicked ones will say: I can now make more money from what I produce and export, so I can take one child from the school and put her to work instead. The empirical evidence (starting from a study of Vietnam where trade liberalization resulted in a significant expansion of earnings) shows that parents tend to be virtuous rather than wicked.

This should not come as a surprise to those who have seen first hand how poor parents value education: Rene Dumont, the great French agronomer and intellectual, who studied post-colonial French Africa, wrote of children walking several miles to get to school, in his expose of the luxurious lifestyles of the African elites who took over from the departing French. But economics also reinforces the benign outcome for trade. Several studies show that the private returns to families from sending children to primary schools are high. The economic reason why these families nonetheless are unable to exploit these returns is because of "credit constraints": it is not possible for them to raise the credit to do so. But if incomes improve, due to trade or other reasons, then the constraint imposed by lack of credit is reduced because, in fact, incomes are increased. So, parents will be more likely to act as virtuous parents.

(ii)Gender Pay Equality: A benign conclusion also follows on the question of gender pay inequality. If we accept the Gary Becker argument that prejudice has a price, and that if an equally qualified man is paid more, that is tantamount to inefficiency. We can then hypothesize that, in internationally traded industries where competition is fierce, there will be pressure to employ fewer men and greater women, increasing the demand for women and reducing it for the men, thus

generating pressure through demand to reduce the pay differential between women and men. By contrast, the non-traded industries, where all entrepreneurs may share the same prejudice and hence none suffers a competitive disadvantage against others, would be expected to progress towards reduced pay inequality at a slower pace. As it happens, this hypothesis, favourable to the view that trade has a human face, appears to be supported by the work of Elizabeth Brainerd and Sandra Black who found that, for a twenty year period in the US, the traded industries appear to have registered faster reduction in pay inequality.

I might add that we can define pay inequality instead in "meta" terms: that, even if men and women are paid in an occupation the same wages when equally qualified, women are led by societal ethos into occupations where they get lower wages. Of course, these occupations may be paying lower wages partly because women traditionally go into them. Besides, women may choose not to acquire education to go into more remunerative occupations because they would not get those jobs because of discrimination (as when women Ph.D.s at Harvard in Economics until recently were simply not able to join the Faculty, just as Jews were not hired at Harvard, leading Paul Samuelson, arguably the greatest economist of the 20th century alongside Keynes, to start teaching at MIT instead, making it the greatest Department of Economics for several decades). It is noteworthy that women traditionally went into "softer options" like literature, history and sociology rather than into mathematics, physics, engineering and economics because there was no point acquiring education in the "harder" sciences --- subjects which you can not study in bed but must sit at a desk to study, one might say mischievously --- when

they would not be able to get employment in these fields. Now that job discrimination against employing women in these occupations has reduced, if not ceased, one sees a surge in the women who go into the harder fields.

But, there is little doubt that societal ethos also plays a role, directing women to seek employment in traditionally "women's occupations" like nursing, school teaching and secretarial. If so, a change in that ethos will also work to reduce effective wage inequality due to society-dictated occupational preferences. As it happens, we can argue that Japanese women profited from this change in values brought about, in part, by Japanese foreign investment abroad. Wives came with men executives in Japanese multinationals to Paris, New York, London, Toronto and other Western cities and saw how Western women had more opportunity and were treated better. So, they became agents of change when they went home. Today, many Japanese women are not **just becoming wives, mothers and holding jobs in "women's occupations". Gender equality has been enhanced, thanks to Japanese multinationals going abroad (and other ways in which Japan has come into closer contact with the outside world).**

II: Economic Critiques:

Turning now to the economic critiques, remember that these divide into those that concern alleged adverse effects on the rich countries, and those that concern the effects on the poor countries. I will focus here only on a few salient arguments concerning the rich countries. Let me mention only one critique,

however, concerning the poor countries, to illustrate the poor quality of the argumentation, coming again from the hardy populist, Joe Stiglitz.

Thus, he has recently argued that freer trade offers little benefits to the developing countries since they will benefit only "when there are good risk markets, [and] when there is full employment…" (<u>Far Eastern Economic Review</u>, 2006). This is nonsense, of course. Lots of poor countries have profited from openness in trade; almost none of them had "good risk markets". Again, suppose that there is unemployment. If Stiglitz leaves his job in the contracting import-competing industry and joins the unemployment pool, and I get a job in an expanding export industry and get out of the unemployment pool, the total unemployment remains the same and yet the economy gets the gains from trade. The economy is ahead, even if we do not weight my employment more than Stiglitz's unemployment, as we should in a just world! Let me turn now to the critiques addressed to the rich countries, taking only three illustrative issues from the taxonomic Chart of the different critiques already with you.

(i)<u>End of Academic Consensus on Free Trade:</u> The US media have argued repeatedly that the academic consensus on Free Trade has vanished. This predisposes the lay public and the politicians into thinking that, if even the scholars are now admitting the virtues of protectionism, it should no longer be a matter of embarrassment to say that one is a protectionist. As it happens, these media claims are plain wrong. The obituaries, while frequent, are always premature.

My illustrious student Paul Krugman once did announce almost three decades ago that Free Trade was passé as far as theory was concerned, thanks to the

introduction of imperfect competition in product markets into international trade theory. But this was quite misleading. Every knowledgeable student of the theory of commercial policy knows that the case for Free Trade depends on there being no imperfections (i.e. "market failures") to worry about. If such imperfections exist, the invisible hand could point in the wrong direction because market prices and social costs would diverge. For two hundred years, economists of note have dealt with one market imperfection or another to argue that the case for Free Trade was flawed. Indeed, in regard to imperfect competition in products markets, the fact that it would undermine the case for Free Trade was noted pointedly by Sir John Hicks at the time of the revolution in the theory of imperfect competition in the 1930s by Joan Robinson and Edward Chamberlin, with Hicks writing about how economists had lost faith in Free Trade in consequence. Nonetheless, the media accepted Krugman's stricture against Free Trade at face value.

But then, Krugman came back to arguing for Free Trade but by using the political-economy argument of the Chicago School, that intervention would make matters worse. So, the alleged heresy on Free Trade was dead: the Free Trade consensus was back! [These issues have been considered with analytical precision in my Bernhard Harms Prize Lecture speech which puts Krugman's arguments into historical perspective. It is also the subject matter of Chapter 1 of my little Princeton book, <u>Free Trade Today,</u> 2003, which surveys the postwar theory of commercial policy and the revolutionary turn in it after nearly two centuries of heresies on Free Trade.]

Recently, there was yet another stir because Paul Samuelson, this time my teacher rather than my pupil, and the most distinguished economist alongside Keynes in the 20th century, wrote an article arguing, with algebra that the sensation-seeking media could not understand, that external, exogenous changes in the world economy --- say, in China and India --- could hurt the US. Now, we knew from the work of Harry Johnson, the immensely gifted Canadian economist who aroused my interest in trade when I was a student in Cambridge in 1954-56, that this could be so and he had even used the standard model of trade theory to establish conditions under which this could happen. The point itself is very simple. Imagine you are in Florida and a hurricane happens. Florida suffers a loss. But then if it is a good monsoon that happens in India, that <u>helps</u> India. And if the monsoon and the hurricane pass you by, nothing happens to you directly. In economic terms, the argument is simple: change abroad could diminish your gains from trade. I suspect some economists may have been writing loosely to suggest that anything that happened abroad would always help the US: I cannot vouch for every economist's sanity, of course. And Paul Samuelson was essentially saying: you cannot always celebrate exogenous change elsewhere.

But this has nothing whatsoever to do with the case for Free Trade, though AFL-CIO economists, the traditional protectionists and the media --- in the US, most of them are trained to learn how to write, not what to write, since they are not exposed to 101 economics, international law and international relations, without which they are seriously handicapped unlike the British and the German economic journalists --- , kept asserting that Samuelson had "shown" that Free Trade could

be harmful. But, in fact, it is easy to see that Samuelson was not arguing for protectionism in his pessimistic scenario where external change was hurting the US through diminished gains from trade. Why? Because, if Governor Jeb Bush of Florida were to respond to the hurricane damage by shutting off Florida's trade with the rest of the US, he would only inflict further damage!

Practically every economist pointed this out, not just me: but the media continues to assert it nonetheless. What is astonishing is that Hillary Clinton, whose knowledge inevitably falls below her grandiose pretensions as a policy wonk, even cited Paul Samuelson in an interview with the Financial Times (with Edward Luce) to justify her skepticism regarding Free Trade, betraying her incomprehension of what Samuelson had actually shown.

(ii)India and China: The Giants at our Door: China and India were supposed in the 1950s to be giants that would soon awaken and become major players in the world economy. Instead, they continued snoring while the Far Eastern economies, which no one took seriously at the time, became the great success stories.

Today, since their policy reforms in the late 1980s and early 1990s, the giants are awake; and the rich countries are in a state of disbelief, thinking that this means that the rich countries cannot compete with them as their markets seem to be getting flooded with goods "made in China" and "outsourcing" of services such as call answer and digital x-ray reading has grown. Yet, this is a misguided fear.

First, the notion that every service will be outsourced online to India, as was feared by many after the Massachusetts General Hospital radiologist had x-rays transmitted digitally to an Indian radiologist in India to be read, is surely

exaggerated. Even for radiology, this has not proven true; indeed not one American radiologist has lost her job and the profession enjoys substantial income. Only a few firms, called "nighthawks", operate in India and Australia, mainly because of the time zone difference with the United States so that they can read the x-rays while the US radiologists sleep; and these too have to be Board-certified by the American Medical Association so that effective restrictions on outsourcing radiology are in place.

But even when such restrictions are not applicable, as with call-answer services, it is a mistake to believe that India's large population of nearly 1.2 billion people means that we face a huge reserve army of Indians who will take over these outsourced services. The large Indian population is misleading.

Thus, of the cohort that can go to College in India, only about 12% actually do so. Of this, a small fraction study English or in English. Of this, only a small fraction can speak English. Of this, again, a tiny fraction can speak English in a way that you and I can understand! So, the effective labour force that can take over call-answer services is truly small compared to the demand for such services; and many Western firms have started looking for other places to do their outsourcing as India begins to experience shortages.

Second, if India's size is misleading when it comes to outsourcing, the fear of China, based on her phenomenal performance in the last two decades, is also misleading when it comes to trade. China's remarkable growth has been based more on exports than has India's, of course. But China faces great difficulties in sustaining that growth. Its authoritarian politics, with lack of democracy (leave

aside a liberal democracy), has meant that widespread human rights abuses, which are usually subjected to the countervailing power provided by a free press, by civil society, by opposition parties and by an independent judiciary, increasingly threaten the acceptability of her exports in a world where democracy and human rights have become more important. Besides, we have recently seen that problems like product safety increasingly afflict China's exports; again, lack of the institutions of a liberal democracy makes it virtually impossible to address these problems effectively.

Those who are fearful of China in the United States also worry about China's size and how the growing skills there will mean that they will take over now most of our skills-intensive jobs as well. Typically, the figure about China's production of engineers as having overtaken that in the United States is being bandied about. But then, can we seriously argue that these engineers are of the same quality on average as the US-trained ones? China faces the same problems in upscaling its better-quality educational facilities as most countries do: they do not have a magic bullet that others do not have. Besides, the vast majority of these engineers will be employed in a variety of non-traded tasks such as repairing bridges and roads, and houses, with few left over to be in the traded industries. Besides, do not forget that China, during the Cultural revolution, depleted its stocks of the bourgeoisie, making them wear dunce caps and sending them to the countryside to be Marx's Compleat Men but in effect turning into Mao's Broken Men. So, the depleted stocks have to be rebuilt.

Let me discuss one related source of fear of India and China. This is that their cheap labour, compared to that in our rich countries, means that we cannot compete with them. Of course, as we know well, lower wages can be offset by exchange rate adjustment: if you raise wages by 100%, the exchange rate can be reduced to offset that fully, and you are back to where you were, more or less. It may also be worth recalling that when I was young and working in the Indian Planning Commission in the early 1960s, there was a lot of sentiment the other way: that there was no way that the poor countries, whose only advantage was cheap labour, could compete with the rich countries which had a better-nourished labour force, skills, cheaper capital and better infrastructure! Those who believed this, like India, turned inwards and failed to compete: it was a self-fulfilling export pessimism. But those who did not, like the East Asian countries which went on to register an economic miracle, proved otherwise.

(iii) Trade with Poor Countries Undermines the Real Wages of the Workers in the Rich Countries

But whereas the fear of losing everything to the big giants, India and China, relates to our alleged inability to compete with them, and can be discounted on several grounds including the few I have discussed, the alarm is at least as great that trade with poor countries generally is harmful to our worker's wages. This belief is what drives the AFL-CIO anxieties and their demand that the poor countries must

be asked to accept the same labour (and domestic environmental) standards as they have. This is clearly turning Tom Friedman on his head: where Friedman believes wrongly that the world is flat, the unions demand that it in fact be flattened!

Of course, this is a demand for what can be properly called "export protectionism" and it is dangerous because few understand it as such, especially as it is often masked cynically in the language of altruism: e.g. that we want your labour standards to be raised because we care about <u>your</u> workers, whereas in fact what we are worried about is the interest of <u>our</u> workers. This is why the big democratic countries such as India and Brazil strongly oppose the inclusion of these trade-unrelated demands in trade treaties and at the WTO, with only the weaker counties succumbing to such demands when they sign Free Trade Agreements in one-on-one negotiations with the hegemonic countries, chiefly the United States but, with some differences, also the European Union. [I have documented this troubling aspect of the bilateral FTAs in my latest book, <u>Termites in the Trading System: How Preferential Agreements are Undermining Free Trade</u> (Oxford, 2008).]

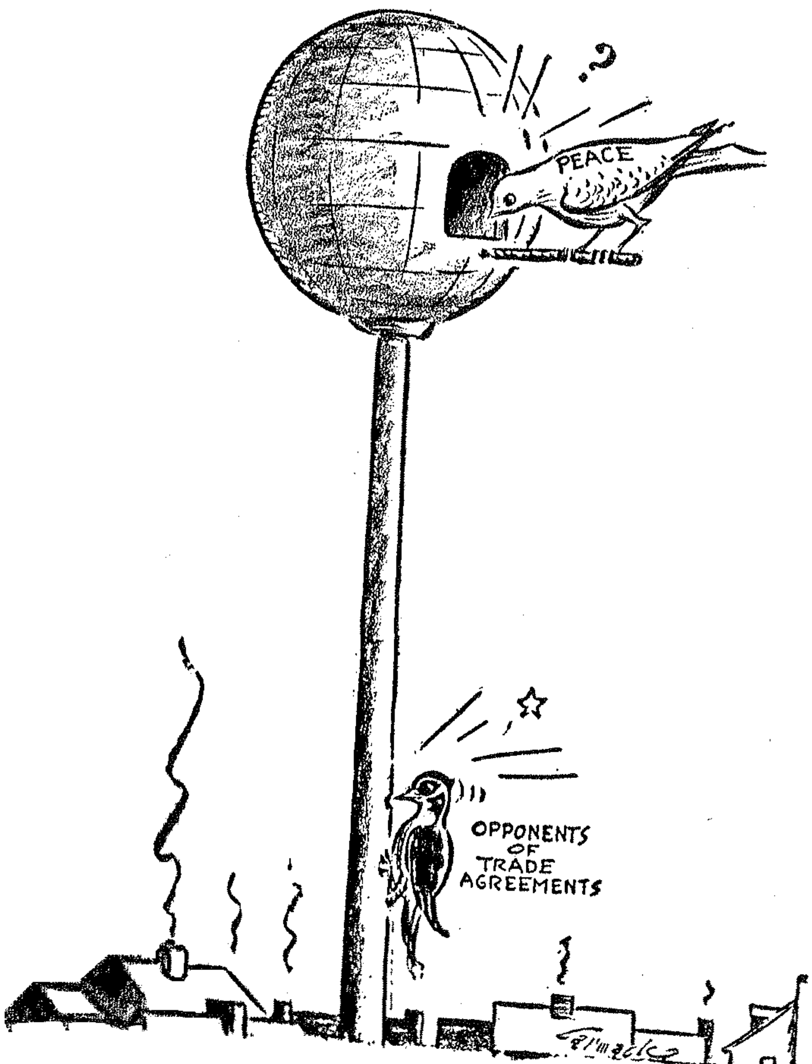
But when one examines the export-protection-driving claim that trade with the poor countries is a principal source of the pressure on our workers' wages, the evidence is pretty thin; indeed, it points the other way in two studies: one by me several years ago and (because Paul Krugman has puzzlingly argued that things "may" have changed since the time when he concurred that trade with poor countries was not a problem for our workers' wages) another with the latest data by Robert Lawrence of Kennedy School at Harvard last year.

So, let me conclude by saying that there is little support for the economic critiques of Free Trade in the rich countries, just as there is little support for the social critiques. Indeed, there is anxiety in the rich countries; and President Obama will have to address this anxiety through institutional change directed at it, rather than through protectionism that is simply not warranted. That will be his greatest challenge.

What that institutional change should be is the subject of a little book with a great theme which I am just finishing, titled <u>Terrified by Trade: Institutional Change to Address Anxiety and Contain protectionism</u>. But then I will have to come back to Toronto next Fall to talk to you about it. For now, let me say again what a pleasure and privilege it has been for me to talk to you in celebration of Sylvia.

London School of Economics and Political Science 2007 Coll Misc 0519-32

"Shoo!"



Christian Science Monitor, February 8, 1947.

Critiques of Free Trade

Economic Critiques

Developed Country Critiques:

1. The Media Hype about Death of Free Trade Consensus among Economists
2. Fear about China and India
3. Anxiety that Trade with Poor countries will produce Paupers in the Rich Countries
4. Protectionist Demands that "Fair Trade" be a Pre-requisite for Free Trade

Developing Country Critiques:

World Trading System "Unfair" to Developing Countries

1. Asymmetric Trade Barriers
2. Doha Round Implies Unequal Gains

Benefits from Trade to Developing Countries are Illusory

Social Critiques

General Critiques: Democracy, Gender, Environment

Developing Country Critiques: Child Labour, Indigenous Culture