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Free Trade Fallacy

Rich countries didn't follow free trade rules when they were developing. They now insist: do as we s

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According to the Washington consensus which governed thinking about global economic development during the 1980s and 1990s, the only way for poor countries to catch up with the US, the EU and Japan was to adopt policies of free trade and free investment. This prescription, however, produced rather discouraging results. Shock therapy failed in post-communist Russia and eastern Europe, while the liberalisation of capital flows was a big factor in the Asian financial crisis. Moreover, the data is now in and it turns out that most third world countries grew faster before they abandoned industrial policy tools like import substitution tariffs than in the period in which they followed the advice of the IMF, the World Bank and free-trade evangelists like Jeffrey Sachs, Jagdish Bhagwati and Paul Krugman.

The failure of free-trade globalism to help the developing world has not been an accident, according to Ha-Joon Chang, an economist at Cambridge University. He argues that the rules of the world economy are designed not to help poor countries develop into modern economies, but to lock in the advantages of the present industrial leaders. The US and other advanced industrial countries are not only selfish but hypocritical. They would deny to newly-industrialising countries the very practices that they used in the past to become economic superpowers.

"When they were in catching-up positions, the now-developed countries protected infant industries, poached skilled workers... and wilfully violated patents and trademarks," Chang observes. "Once they joined the league of the most developed nations, they began to advocate free trade and prevented the outflow of skilled workers and technologies; they also became strong protectors of patents and trademarks... the poachers turned gamekeepers."

Both recent and more remote history undermines the free trade dogma: "All countries, but especially developing countries, grew much faster when they used 'bad' policies during the 1960-1980

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concludes that the developed countries "are in effect 'kicking away the ladder' by which they have climbed to the top." His metaphor comes from the German-American economist Friedrich List, who wrote in 1841: "It is a very common device that when anyone has attained the summit of greatness, he kicks away the ladder by which he has climbed up, in order to deprive others of the means of climbing up after him... Any nation which by means of protective duties and restrictions on navigation has raised her manufacturing power to such a degree of development that no other nation can sustain free competition with her, can do nothing wiser than to throw away these ladders of her greatness."

Coming from a conventional leftist critic of global capitalism, such an argument is likely to be dismissed. But Ha-Joon Chang is the assistant director of development studies at Cambridge and has worked as a consultant for the World Bank, the Asian Development Bank and other international organisations. He is the author of *The Political Economy of Industrial Policy* (1994) and editor of *Joseph Stiglitz and the World Bank: The Rebel Within* (2001). His new book *Kicking Away the Ladder: Development Strategy in Historical Perspective*, published by London's Anthem Press, is the most important book about the world economy to be published in years. It has not been widely reviewed but, if Chang is right, then not only the received wisdom about economic development but also the reputations of many economists are threatened.

Chang challenges orthodox economics as much in his approach as in his conclusions. Instead of engaging in mathematical elaborations of a priori axioms, he looks at history to determine what has worked. Chang notes that "the contemporary discussion on economic development policy-making has been peculiarly ahistorical." It is with good reason that many Anglo-American economics faculties have abolished courses in economic history. The study of the history of industrial capitalism is as fatal to free trade orthodoxy as the Hubble telescope is to the Ptolemaic theory of the universe.

Many things that educated people in the English-speaking world think that they know about economic history are, in fact, false. It is not true that there was a golden age of free trade ended by America's adoption of the much-reviled Smoot-Hawley tariff in 1930; a tariff which is unfairly blamed for the rise of fascism and the second world war-phenomena which originated, respectively, in the cultural trauma of the first world war and the geopolitical ambitions of Germany, Japan and Italy, rather than the depression. The school of thought in economic policy with the greatest global influence between the 1800s and the mid-20th century was not the laissez-faire "English School" of Adam Smith and David Ricardo but the rival school of economic nationalism, which is more accurately labelled as "strategic economics" because its prescriptions have been followed successfully by empires, trading blocs and city-states as well as nation states. In the US in the

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Henry Clay, under the name of "the American System," and implemented under Clay's disciple and admirer Abraham Lincoln and his successors during the period between the 1860s and the 1940s, when the US became the planet's leading manufacturing economy behind a high wall of tariffs.

The lessons of the "American school" of "national economy," transmitted to Germany by Friedrich List, formed the basis of state-sponsored industrialisation in Wilhelmine Germany. Moreover, during a visit to Germany in the 1870s, Toshimichi Okubo, one of the leaders of the Meiji Restoration, became acquainted with the Hamilton-List tradition. Returning to Japan, Okubo founded the ministry of home affairs, which promoted Japanese industry, and in 1874 issued an equivalent of Hamilton's 1791 *Report on Manufactures*, in the form of his influential *Proposal for Industrial Promotion*. By the early 20th century, then, the US, Germany and Japan had successfully used strategic economics to catch up with Britain and (in the case of the first two nations) to surpass it. Even Britain's dominions of Australia and Canada, emulating American and German practice rather than British theory, insisted on the right to use tariffs to keep out goods from Britain and establish their own industrial base.

Not that Britain had any right to complain. From the Tudors until the early 19th century, Britain used various protectionist devices to promote its own industries. The 18th-century prime minister Robert Walpole, remembered chiefly today as a corrupt politician pilloried by Alexander Pope, turns out, according to Chang, to have been an industrial-policy mastermind who inspired Alexander Hamilton. Only when Britain's industrial supremacy was secure did the British begin to promote free trade, in the hope of wiping out competitive industries in the US, continental Europe and elsewhere. Following the Napoleonic wars, which stimulated the growth of American manufacturing by suspending transatlantic trade, Lord Henry Brougham in 1816 told parliament: "It is well worthwhile to incur a loss upon the first exportation, in order by the glut, to stifle in the cradle, those rising manufactures, in the US, which the war had forced into existence, contrary to the natural course of things." The "natural course of things," according to British politicians and British theorists of free trade, required the US to supply Britain with agricultural goods and raw materials and to import, rather than make, all of its machinery and manufactured goods. John Adams wrote in 1819: "I am old enough to remember the war of 1745, and its end; the war of 1755, and its close; the war of 1775, and its termination; the war of 1812, and its pacification...The British manufacturers, immediately after the peace, disgorged upon us all their stores of merchandise and manufactures, not only without profit, but at certain loss for a time, with the express purpose of annihilating all our manufacturers, and ruining all our manufactories." In India and Ireland, the British imperial authorities actually outlawed the native textile industries.

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manufacturing sectors. The revival of Europe and Japan by the 1970s eliminated these monopoly profits, and the support for free trade of industrial-state voters in the American midwest and northeast declined. Today, support for free-trade globalism in the US comes chiefly from the commodity-exporting south and west and from US multinationals which have moved their factories to low-wage countries like Mexico and China. Like 19th-century Britain, 21st-century America tells countries that are trying to catch up: do what we say, not what we did.

As a practical approach to economic policy based on historical experience rather than abstract theory, strategic economics is based on a simple insight. With the exception of raw materials, the location of industries is determined not by fixed advantage (either absolute or comparative) but by public policy or private entrepreneurialism. Cars and computers are made in Japan today because of decisions made by the Japanese government a few generations back; there is no reason in theory why they cannot be made in Kenya and Paraguay too, although comparative advantage once established can become powerfully self-reinforcing. Even agriculture can be undertaken anywhere, with the right technology. The idea that certain activities are "naturally" located in some countries and that the order of things is violated by government industrial policies is an 18th-century superstition.

It is often mistakenly assumed that neoclassical economics favours free trade, whereas strategic economics favours protectionism. In fact, strategic economics prescribes free trade, protectionism, or some mixture of the two, depending on a particular country's circumstances and level of industrialisation. According to the classical strategic economic theory of List and his followers, an agrarian country should export commodities and practice free trade, until it can afford to adopt protectionist, infant-industry policies. Then, once its industries, nurtured by tariffs, subsidies and other policies, have become competitive, the country should move away from protectionism and join other developed nations in liberalising trade at least among themselves. Instead of treating free trade as a panacea, strategic economics treats it along with protection as a policy instrument, to be used or abandoned in the interest of the polity.

Today's Anglo-American free market economics is an unstable compound. It combines perfectly sound analysis with a streak of utopian mysticism rooted in medieval notions about the providential role of trade in uniting the scattered resources of the earth. Economics as a discipline was only separated from moral philosophy and theology in the mid-19th century in Britain and the US. Richard Cobden popularised the slogan "free trade is the international law of God." The religiously-inspired cosmopolitanism underlying economic liberalism is clear from one of the founders of neoclassical economics, Alfred Marshall, who said that economics helps "us to understand the central plan of the Divine government of the world."

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theoretical efficiency of the global economy, considered as a whole," the policy maker in a developing country-the US in the 19th century, Malaysia today-can reply, "I agree; but I am concerned with the relative wealth and power of my country, not with the wellbeing of humanity in the abstract." Likewise, when the neoclassical economist points out that consumers will pay the price of import-substitution policies which force them to buy more expensive local goods rather than cheaper foreign goods, the policy maker can answer, "Yes, you are right. But, just as our citizens are taxed to support our military, so our consumers will be taxed by means of higher prices to support a high-tech manufacturing sector, in the interests of national security, economic independence and economic diversification." (Nothing prevents governments from paying compensation to citizens disadvantaged by state-sponsored industrialisation, although protectionist governments typically have not done so-just as liberalising governments have seldom compensated citizens hurt by free trade.)

Amongst the great economists who saw no contradiction between mainstream economic theory and strategic economic policy were Adam Smith, who argued for a national-security exception to free trade, JS Mill, who conceded the usefulness of infant-industry protection, and John Maynard Keynes, who famously wrote: "Ideas, knowledge, art, hospitality, travel-these are the things which should of their nature be international. But let goods be homespun whenever it is reasonably and conveniently possible."

The whole thrust of international economic management-including conditions for lending laid down by the IMF and World Bank-has been towards tariff and subsidy reduction. Indeed, over the past 50 years the average tariff on manufactured goods has fallen from about 50 per cent to less than 4 per cent. But, writes Chang: "With one or two exceptions (the Netherlands and Switzerland), the now-developed countries (NDCs) did not succeed on the basis of such a policy package. The policies they had used in order to get where they are now... are precisely those that the NDCs say the developing countries should not use because of their negative effects on economic development."

It is true that infant-industry policies of the kind that succeeded in the US, Japan and Germany-and more recently in Korea, Singapore and Taiwan-have failed in many countries, including Argentina and India. The failures are often considered to discredit strategic economic policies, although the failures of democracy in many of the same countries are never thought to discredit representative government. The point is that in selecting a development strategy a country should have a choice.

This does not mean that the world should discard the existing machinery of global economic management. Indeed, a free-for-all might benefit the economically-strong and make life even harder for developing countries. But if Chang is right-and he is supported

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necessary, of general rules.

Will audiences at Davos soon flock to seminars on import substitution, and giggle and snort at references to that discredited cure-all, free trade? Unlikely. The Anglophone media remain thoroughly Cobdenite, and US economics faculties are endowed by people with a stake in the maintenance of laissez-faire orthodoxy. Still, for the first time in a decade in elite circles, the failure of that orthodoxy to make good on its promises has made criticism of its premises acceptable.

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